Skyline Asset Management, L.P.

Executive Summary

Skyline Small Cap Value Composite

June 30, 2018

Overview

The composite generated a 3.8% return for the second quarter, compared to a 7.8% return for the Russell 2000 Index and an 8.3% return for the Russell 2000 Value Index. For the first six months of the year, the composite generated a 2.7% return, versus a 7.7% return for the Russell 2000 Index and 5.4% return for the Russell 2000 Value Index.

Stocks posted solid gains during the second quarter, in response to strong earnings results driven by a strong U.S. economy and corporate tax reform. Stock price gains in the second quarter more than offset first quarter declines, as stock price volatility subsided from its heightened first quarter levels.

Small cap stocks significantly outperformed large cap stocks for both the second quarter and year-to-date periods. Small cap stocks are, for the most part, greater beneficiaries of lower U.S. corporate tax rates and are perceived to be more insulated from the negative effects of a global trade war.

The composite underperformed both of its primary benchmarks for both the second quarter and first six months of the year. Sector allocation and stock selection negatively impacted your relative performance over both time frames. In addition, the smallest, least profitable, and highest P/E stocks outperformed their larger, more profitable, and lower P/E peers, creating a difficult environment for our style of investing.

The near term outlook for earnings is positive given a favorable U.S. economic backdrop and the expected benefits of corporate tax reform. Valuations have improved from their recent highs. However, they remain at levels that provide little downside protection if earnings growth disappoints.

Market Review

Stocks rose during the second quarter, as indicated by returns of 7.8% for the Russell 2000 Index, 8.3% for the Russell 2000 Value Index, and 3.4% for the S&P 500 Index. For the first six months of the year, the Russell 2000 Index generated a 7.7% return, the Russell 2000 Value Index rose 5.4%, and the S&P 500 Index returned 2.7%.

A strong backdrop for corporate earnings helped drive stock price gains during the second quarter. Closely monitored economic models predict U.S. GDP will expand in the second quarter at one of the fastest rates since the start of the current economic recovery.

In addition, many of the benefits of the recently lowered U.S. corporate tax rate have fallen straight to the bottom line. Companies within the Russell 2000 Index generated EPS growth of greater than 20% during the first quarter, and are expected to do so for the second quarter and all of 2018 as well.

Stock price gains in the quarter were more modest than earnings gains. The strength in earnings was partially offset by concerns that a trade war between the U.S. and its major trading partners would develop, potentially derailing the global economy. In addition, interest rates remain near their highest levels in the last five years and the Federal Reserve is poised to raise their target range for the Federal Funds rate several times this year. Rising interest rates raise costs for consumer and corporate borrowers, which could in turn slow economic activity. Rising rates also have the potential to compress stock price to earnings multiples as bonds become a more attractive alternative.

The solid price increases stocks generated in the second quarter more than offset the modest price declines they posted in the first quarter. During the first quarter, interest rates rose at a rapid pace and stocks experienced elevated price volatility. Both of those issues have subsided somewhat as rates have stabilized and volatility has returned to more historic levels.

Small cap stocks significantly outperformed large cap stocks during the second quarter and year to date, as evidenced by the Russell 2000 Index's 7.8% quarterly gain and 7.7% year-to-date gain, compared to the S&P 500 Index's 3.4% and 2.7% returns over the same periods. On average, small cap stocks generate a much higher proportion of their revenues within the U.S. They are therefore perceived to be more insulated from the negative effects of a potential global trade war.

All sectors of the small cap market posted gains in the second quarter. Among the best performing sectors were energy stocks, which rebounded along with oil prices. Real estate stocks also performed well as interest rates stabilized and healthcare stocks benefited from solid fundamentals and increased merger activity.

For the first six months of the year, every major sector of the small cap market generated positive returns, with the relatively small consumer staples sector of the Russell 2000 Value Index being the exception. Healthcare again led the way. Information technology stocks in the core Russell 2000 Index have risen 14.2% year to date, while the Russell 2000 Value Index's information technology stocks are up on 3.5%. This difference highlights one of the reasons small cap value stocks have lagged the broader small cap market so far this year.

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The strong price gains seen in the Russell 2000 Index have been driven in large part by lower quality companies. Over a third of the companies in the index are losing money, and those stocks were up 14% for the first six months of the year compared to about 5% for stocks with below-average P/Es.

Portfolio Review

The composite generated a 3.8% return for the second quarter, compared to a 7.8% return for the Russell 2000 Index and an 8.3% return for the Russell 2000 Value Index. For the first six months of the year, the composite generated a 2.7% return, versus a 7.7% return for the Russell 2000 Index and 5.4% return for the Russell 2000 Value Index.

During the second quarter, sector allocation was a negative contributor versus both benchmarks due in part to the composite's modest exposure to real estate and lack of exposure to energy stocks, which were the best performing sectors of meaningful size in the indexes. Sector allocation was also negative for the first six months of the year, with the largest impact coming from our clients' portfolios' relatively low weighting versus the Russell 2000 Index in the strong performing healthcare sector. Stock selection was also negative for both the second quarter and year-to-date periods, with the consumer discretionary sector having the largest negative impact.

The Ensign Group, Inc., a nursing home operator, was the largest contributor to the composite's return for both the second quarter and first six months of the year. Ensign posted solid results as an unusually large number of acquisitions undertaken several years ago transitioned from pressuring profits to becoming meaningful contributors to the company's bottom line. McGrath RentCorp, an equipment rental company, rose as the company significantly exceeded earnings estimates due to strength across all of its business lines. McGrath reached our price target during the quarter and was sold.

Our clients' portfolios also benefitted from the acquisition of VeriFone Systems, Inc. a manufacturer of payment terminals. VeriFone was acquired by a private equity firm at a price that was a 54% premium to its price at the time of the announcement.

Although the composite generated positive absolute returns during the second quarter, it lagged the returns generated by its benchmarks for both the second quarter and year to date. For both periods, high P/E stocks outperformed low P/E stocks, stocks generating low profitability outperformed higher profitability peers and the smallest of the small cap stocks outperformed their larger counterparts. Because we invest in lower P/E, more profitable, and slightly above average-sized small cap stocks, the current environment creates a headwind for our style.

Our clients' portfolios were also negatively impacted by performance at a number of its residential housing-related companies, including Realogy Holdings Corp., Essent Group Ltd., JELD-WEN Holdings, Inc., and BMC Stock Holdings, Inc. Although some of these companies experienced company-specific issues, they were all negatively impacted by concerns that rising interest rates would negatively impact home sales. We believe that long-term demographic trends and a rebound in home ownership levels will allow the housing market to withstand gradually rising interest rates.

Concerns about rising raw material costs also negatively impacted several of our clients' portfolios' holdings, including LCI Industries, a manufacturer of components for recreational vehicles. LCI was among the largest detractors to the composite's performance year to date despite posting organic revenue growth of 20%. A rapid rise in steel and aluminum prices is causing temporary gross margin pressures. Given LCI's strong market position, we believe it will successfully pass those costs on to its customers allowing its gross margins to return to historic levels.

Outlook

The outlook for earnings remains solid. The median current fiscal year expected EPS growth for the companies in our clients' portfolios is over 20%, driven by a healthy U.S. economy, lower corporate taxes, and company-specific factors. The biggest risks to those expectations are increasing trade tensions and higher interest rates. We are optimistic trade tensions won't escalate to a level that would derail U.S. GDP momentum. And absent a dramatic spike, we believe the economy can withstand a gradual rise in interest rates.

Valuations remain reasonable. The P/E on forward 12 month earnings of the companies in our clients' portfolios at the end of the second quarter was 15x. This is a meaningful discount to the Russell 2000 Index's 19x multiple. Over the last year and a half, the forward P/E multiple of our clients' portfolios has contracted by 14% as stock price gains have failed to keep up with an improving earnings outlook.

As previously mentioned, recent Russell 2000 Index performance has been driven by unprofitable companies. Our clients' portfolios are comprised almost entirely of companies that are solidly profitable. We are confident they will continue to generate strong earnings growth. Because of the valuation improvement over the last 18 months, if our clients' portfolios' companies meet our expectations, we believe price appreciation should follow.

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Note: Portfolio holdings are subject to change and are not a recommendation to buy individual securities. The views expressed are those of Skyline Asset Management, L.P. and are subject to change. The composite's performance is gross of fees. Gross returns do not reflect the deduction of investment advisory fees or expenses and therefore the client's return will be reduced by the advisory fees and any other expenses it may incur. For example, a separately managed client portfolio, which earned 15% per annum for ten years, would result in a cumulative return of 304.6% before the investment advisory fee of 0.8% and expenses and 277.3% net of such fees and expenses. Current investment advisory fees are described in Part 2 of Skyline's Form ADV.

Sources: Bloomberg L.P.; CNBC LLC; Jefferies LLC; Northcoast Research Holdings, LLC; RBC Capital Markets; Robert W. Baird & Co. Incorporated; Sidoti & Company, LLC; Stephens Inc.; SunTrust Robinson Humphrey; U.S. News & World Report L.P.; The Wall Street Journal; S&P Capital IQ; Morningstar, Inc.; and Skyline Asset Management, L.P.