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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Choppy, High-Inflation Environment Benefits Value Investors

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COLIN KELLY, CFA, is Director of Research, Portfolio Manager and Principal at Signia Capital Management. Mr. Kelly has 18 years of experience in the investment management industry. Prior to joining Signia in 2009, Mr. Kelly was Vice President of Equity Research for a Pacific Northwest asset manager. In 2020, Mr. Kelly and Rich Beaven acquired an equal and majority interest in Signia. Mr. Kelly also serves as an adjunct finance professor at Gonzaga University. He holds a BBA with emphasis in finance and marketing from Gonzaga University. In addition, he is a CFA charterholder and serves on the Board for the CFA Society of Spokane.

SECTOR — GENERAL INVESTING

TWST: Please introduce Signia, and tell us about your roles there.

Mr. Beaven: Sure. Signia was founded in 2001. So we've been around as a small-cap value firm for over 20 years. And I joined in 2002, so essentially, I was one of the founding individuals with Signia back two decades ago.

My career started in 1995, value investing, and with another asset manager here in Spokane. Myself and some other partners decided to launch Signia, and we had some high net worth capital at that point. And we managed to do that in 2002, and to grow the firm and then proceed through the next number of years.

Ultimately, we came to the point, in September of 2020, where Colin and I had the opportunity to take controlling interest in the firm. Prior to that, I had a minimal amount of ownership in Signia, in low double-digits; Colin didn't have any. And we reached a point where our other partners in the firm were interested in doing other things. It was a wonderful opportunity for Colin and me, at the height of the pandemic, to put our own capital to work and buy the firm and run it as majority owners.

And so, we've been doing that as partners, majority owners, since the end of 2020. So we've been delighted with the eventual shift back to value investing that's occurred since then, and we're happy to put together two very strong performance years post acquisition as well.

Mr. Kelly: Rich and I have worked together for the last 13 years here at Signia. And our relationship actually goes even further back than that, to the early 2000s. In fact, I actually interned with him. So we have a lot of experience together. And the opportunity to purchase the firm and put our own capital into the firm when small-cap and value were significantly out of favor speaks to the type of investors that we are. We're contrarian and value by nature. And so looking at September 30 of 2020 and how value had performed up until that point, it was certainly a contrarian idea.

And so I think Rich and I saw tremendous opportunity and decided to put our own capital behind it and really reestablished the firm in 2020. So today, Rich and I are majority owners, and we know that brought significant performance and advantages for us.

It allows us to simplify the process and allows us to make decisions in a very quick and thoughtful manner. There's no committee, there's no hierarchy, we work hand in hand together. We run the portfolio together, do all of our research calls together. And that allows for pretty significant efficiency as far as idea generation and monitoring of the portfolio.

There are thousands of companies within the small and micro-cap space where we play. And our setup allows us to really turn over as many rocks as possible. And really eliminate the biases that occur in a larger organization where you have junior analysts reporting up to senior analysts and ultimately portfolio managers. We think there's a lot of information that's lost. And from our perspective, we're able to make clear, concise decisions, since we're working together and working in tandem.

anomaly and very much unheard of. So for us, keeping an eye on those dynamics is very, very important.

Now we have a positive GDP print today, but the expectation is that the U.S. economy will continue to slow. So for us looking into last year, we saw that rates were likely going higher. We wanted to avoid those names that are highly levered or had refinancing risk, which our portfolio typically avoids anyway. We have a quality bias. So typically, we have companies that have a net cash position, and actually higher rates are good for them.

The other aspect of the market that is welcome is just the shift from extremely low rates, negative interest rates, into a more normalized interest rate environment. Now there is competition for capital. And as a result, companies that we're not self financing or losing money, or negative cash flow, or relying on multiple rounds of equity financing, those names have been hit pretty hard.

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So that's the firm today. As Rich said, we're really pleased with the performance. If you look on a two-year basis from external data that I've seen, we're top decile, certainly top quartile over that timeframe, and a significant change in our performance profile since the ownership change.

TWST: What's your overall view of this past year? Have you ever before seen a market like this?

Mr. Beaven: Having done this since 1995, the short answer is yes. There have been so many different cycles that have occurred. But broadly, to see both equities and bonds do as poorly as they did in 2022 was quite interesting. So there's been a real change in the markets, certainly with an inflationary bias. In addition, a very quick increase in interest rates.

I've seen markets that have been very tumultuous, but to see the combination of rates rising as quickly as they have, and also seeing a spike of inflation that happened simultaneously — that's somewhat of a first for me. So, quite interesting. But we're pretty pleased to report that in spite of that challenging background, our portfolio did quite well.

Mr. Kelly: We were down 6.2% and Russell Micro Value was down 16.7%. So, from our standpoint, the inflationary situation that we found ourselves in wasn't necessarily all that surprising, given the amount of stimulus that was put through the system so quickly.

For example, we talked to a number of retailers and one anecdote that we heard was that there were no clearance items in 2021, and that's absolutely unheard of. So you can see that kind of supply/demand mismatch, and the resulting inflationary impact that was coming out of the pandemic.

We had a pretty good consumer waiting, as the consumer was given a fair amount of stimulus and there were reopening tailwinds behind them. Yet we saw that the consumer was going to be pinched and that companies, especially in the retail sector, were going to be challenged to duplicate the incredible performance that occurred. So it was very strange to see that if you look back, you saw retail sales actually grow through the pandemic recession, which is also an

I think that one of the reasons our portfolio performed admirably in a choppy market was that our companies are high-quality companies that self finance, and they're not speculative.

1-Year Daily Chart of Patterson-UTI Energy, Inc.

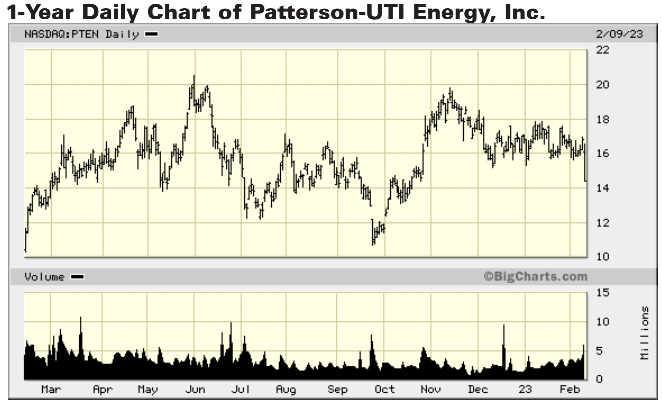

Chart provided by www.BigCharts.com

TWST: Which subsectors did best over the past year? And how are you positioning for 2023? Do you expect those names that previously outperformed to continue in 2023?

Mr. Kelly: It was pretty broad-based for the most part, from a sector standpoint. But certainly energy and durables lead for us. We had a decent energy weight early in the year — actually coming out of the pandemic, we were pretty significant energy weighted. And there was underinvestment for the past decade within that space. And with U.S. reopening and increasing oil and gas demand, a lot of these names were still beaten down.

A name that we owned back in early 2020 was **Patterson-UTI** (NASDAQ:PTEN). And at that point, that was really a mid-cap fallen angel that had traded into the micro-cap space. And they're one of the largest U.S. land drillers here in the U.S.

And after talking to the company, we were buying **Patterson** in the $5, $6 range, so we were paying $0.25 on the dollar for replacement cost of their rigs. So, as you fast forward today, **Patterson** has tripled in value. We exited that position, and we've been able to rotate into some other energy names with more focus on offshore, which may be a subsector within energy that has typically been later cycle than the onshore names, such as **Patterson**.

Mr. Beaven: In the early part of 2020 through the pandemic, we actually saw oil go negative. And so many of these companies that we've watched for years and years were trading significantly below their book or replacement value. So as contrarians, we tend to gravitate to where the real value is. And at that point there were so many opportunities, because ultimately, we were convinced that the U.S. and the world needs energy. And that ultimately demand is going to come back post pandemic. So we needed to find the best of breed and the best companies out there to fortify the portfolio.

One of the names in our portfolio that will benefit from increased copper demand and ultimately, hopefully, a rising copper price would be **Taseko Mines** (NYSEAMERICAN:TGB) mines. **Taseko** is a producer of copper in Southern British Columbia. They produce about 130 million pounds there. And they have a new project in Arizona that over the next couple of years should add an additional 70 million pounds of production that's produced via in-situ mining. So it's a very environmentally friendly way of producing copper via injecting a liquid into the ground. And that is very much less energy intensive, very low cost, and with less impact to the environment. So they are able to produce refined copper at a very, very low price.

Taseko is one of the names that will benefit as we enter an environment of increased copper demand, and possibly a very, very tight copper supply/demand dynamic. Not only are they currently producing copper, but over the next couple of years they will almost double copper production via a very environmentally friendly method in Arizona.

"So broadly, it looks as though copper demand over the next number of years should continue to pick up as the load factor of copper for EVs goes from an internal combustion engine of 50 pounds to an EV of 150 pounds. So a pretty big step up per vehicle and as it relates to copper demand."

So back in 2020, we were more focused on U.S. onshore. And that's more of the short-cycle companies that immediately were able to put capital to work and grow earnings in a more short-cycle environment. And as we enter in the middle of the latter parts of the energy cycle, a lot of the names that hadn't participated in the early stages of the energy recovery were those names that focus on offshore. And there's just been very little activity offshore, offshore drilling.

And so at that point, in mid last year and into late last year, we found the opportunity to buy names like **Diamond Offshore** (NYSE:DO), which is one of the dominant providers of deepwater drilling rigs in the Gulf of Mexico and around the world. And **Helix** (NYSE:HLX), which is a provider of plugging and abandonment services and other offshore services. And also **Dril-Quip** (NYSE:DRQ). So our energy focus is still there, but it's transitioned from more U.S. onshore to offshore, and deepwater, where that part of the cycle is really just, from our perspective, beginning and getting traction.

TWST: What's your view of the emphasis on ESG? Do you look at investor sentiment as it relates to clean energy investing?

Mr. Beaven: It's something we're keenly aware of — the transition going into a low-carbon environment. And as we look at the growth in EVs and how that relates ultimately to materials demand for copper, graphite, nickel and more, those are areas of the market that can't be ignored. So as we progress over the next number of years, we'll see a slow transition away from hydrocarbons ultimately to nuclear, wind, solar, and other less carbon emitting forms of electrical generation.

And then also a transition to electric vehicles. So the implications surrounding those create some interesting investment opportunities. And one of the ways that we've found is to leverage that is the copper market. So broadly, it looks as though copper demand over the next number of years should continue to pick up as the load factor of copper for EVs goes from an internal combustion engine of 50 pounds to an EV of 150 pounds. So a pretty big step up per vehicle and as it relates to copper demand.

TWST: Any other energy names that you've recently added to the portfolio, where you see good buying opportunity now, and good growth ahead?

Mr. Kelly: On the energy side, it'd be **Diamond** and **Helix**. Additionally, new names that we've added are actually on the discretionary side. One new name is **Universal Technical Institute** (NYSE:UTI). And **UTI** is a post-secondary education provider focused on machine welding and automotive. And they've made a transformative acquisition into the health care space with Concorde College.

1-Year Daily Chart of Helix Energy Solutions Group Inc.

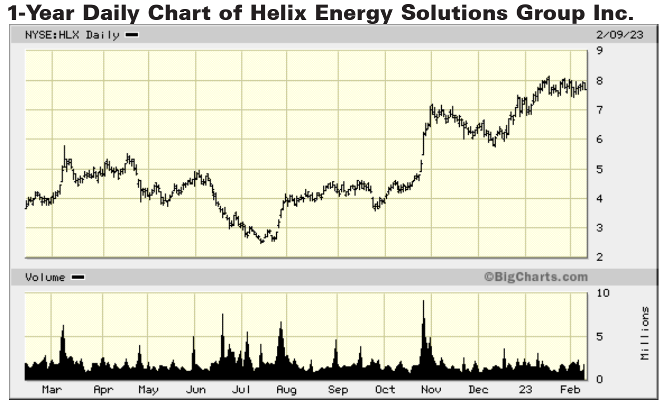

Chart provided by www.BigCharts.com

We see **UTI** growing EBITDA from roughly $60 million today, north of $100 million within the next couple of years through this acquisition and through some internal organic growth initiatives that they have as well. So today, if you look at **UTI**, it's about $250 million, $300 million market cap, and we see EBITDA ramping into the $100 million range within the next 18 to 24 months. So you're paying roughly 2 to 3 times EBITDA.

And the other interesting thing about **UTI** is that it's somewhat of a counter-cyclical play, with all this recession talk out there. And what's going on with the Fed raising rates and trying to slow employment gains and wage gains. So for **UTI**, a softer environment is actually good as people look to go back to work and enhance their skills to get higher paying jobs.

And if you look at **UTI** today, post the Concorde acquisition, they're in some of the best pockets of high-demand job placement in automotive. And on the industrial side, they actually have a clean energy focus as well. And then on the health care side, nurses and physicians assistants and areas like that are in incredibly high demand. So **UTI** is nicely positioned in what could be a softening environment within consumer discretionary.

TWST: Any other subsectors that are heaviest and lightest weightings in your portfolio?

Mr. Beaven: In the energy space, we tend to focus on service companies. We'd rather be in on companies selling the picks and shovels as opposed to the actual goldmine. So currently we don't have any actual production companies there. We're focused on more offshore names like **Helix**, **Diamond Offshore**, and also **Dril-Quip**.

Mr. Kelly: And in our newsletter, we mentioned the name **Powell** (NASDAQ:POWL), which is technically within the producer durables area. **Powell** is focused on electrical control and monitoring, high voltage and medium voltage, down to low voltage. And some of those industries will be touched by **Powell** equipment — offshore energy, but even outside of that, in the transportation space.

The company reported a fantastic quarter with a record backlog, and a very, very positive outlook. So with all this discussion around the recession, here's a company that actually has a growing backlog and a pretty robust outlook.

We were buying the name in the low-$20s. One of the aspects that we really respected about **Powell** was their balance sheet. It was a $20 stock when we were buying it, with $10 in net cash per share, and actually paying 4%, 5% dividend yield at that point.

companies that have the ability to pass through price in excess of underlying inflation. And so we're focusing on companies below a billion in market cap that have very strong capital structures, so they don't have to necessarily go out to the debt markets to raise capital. They already can, essentially, self fund. And we find that a huge advantage.

1-Year Daily Chart of Universal Technical Institute, Inc.

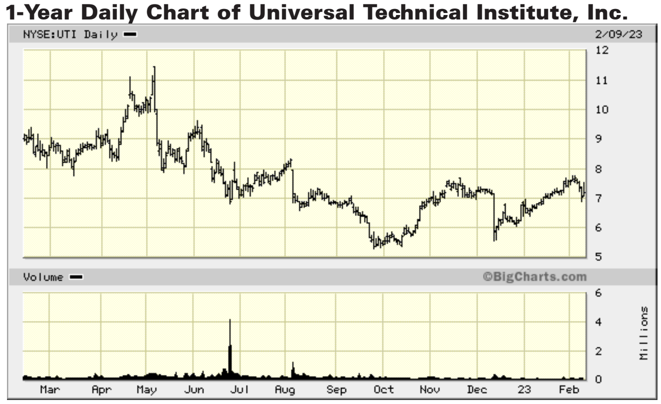

Chart provided by www.BigCharts.com

We find that having companies that have very strong capital structures means that they don't have to go out and raise high-cost debt. They have the capability to use cash on their balance sheet to fund growth. And we find that as a huge advantage as it relates to many of the companies in our portfolio. So we like to think that provides a good deal of insulation and protection from overall market dynamics right now.

And in addition to that, most of our companies are so well capitalized that they don't have to go down the path of debt refinancing in a high rate environment. They have very little debt, or in many cases, they have a net cash position. So we find that it's a big advantage to many of the companies in our portfolio.

> **"So from our standpoint, we see Powell well positioned. They have market share here in the U.S. that is very enviable and makes them potentially a takeout candidate for a larger European competitor. Then, even absent that, Powell has a lot of unique end markets and significant market share, a fantastic balance sheet and a dividend to support that."**

So from our standpoint, we see **Powell** well positioned. They have market share here in the U.S. that is very enviable and makes them potentially a takeout candidate for a larger European competitor. Then, even absent that, **Powell** has a lot of unique end markets and significant market share, a fantastic balance sheet and a dividend to support that.

So with that combination of low valuation, high-quality balance sheet and catalysts on the horizon, **Powell** has quickly become a top 10 name. And as you can see, it still remains in the top 10 today.

TWST: How did some of your top names, like Powell and other top performers, meet with surrounding challenges — headwinds like rising interest rates, supply chain issues, and recession worries? And what have been any tailwinds?

Mr. Beaven: It boils down to pricing power. For example, in the case of **Powell**, although they're certainly hit with rising labor costs as most of our companies in our portfolio are, we tend to gravitate to

Mr. Kelly: And one of the names that I would highlight in that regard is our largest holding: **Tejon Ranch** (NYSE:TRC). **Tejon** owns 270,000 acres just north of L.A. that they are developing presently. They have an operating company that has water assets, they have pistachio farms, grapes, oil and gas. So it's a land-holding company just north of L.A., and they have 270,000 acres.

And if you look at land values, it can vary based upon what the land has been used for. For example, if it is a strawberry farm, it can be incredibly lucrative. Using a modest assumption of $10,000 per acre for **Tejon** times 270,000 acres gives you a valuation of $2.7 billion. And today **Tejon** is a roughly $500 million to $600 million market cap.

Today, we're buying California real estate for about $2,500 per acre. And we always like to tell our clients that you couldn't go out and buy this on your own. **Tejon** would turn you away and any other landowner in California would turn you away if you offer $2,500 per acre. But today you can go out and you can buy this position and be an owner in **Tejon Ranch** for $2,500 per acre. And so we think that's an incredible opportunity.

We think it speaks to inefficiency within the small/microcap space. There's one analyst I know of that follows the name.

And we see tremendous embedded value within **Tejon**. And as Rich mentioned, the company has a net cash position. So although this is a land holding company — and last year was incredibly tough for homebuilders or anybody that held land assets — **Tejon** performed admirably. The stock was essentially flat last year in a market that was one of the worst on record with incredible volatility.

So for us owning **Tejon**, with a fantastic balance sheet, hard assets that underlie the value, and a significant discount to that makes it a key reason for it to be our top holding in the portfolio.

TWST: What about your weightings in the health care space? It looks like you own Xoma. Give us a closer look at that name.

Mr. Beaven: It's tough to find a lot of value in health care. There are so many biotechs out there that we really consider to be somewhat uninvestable, because they're not generating earnings or cash flow. They may have cash on the balance sheet, but they have a bunch of compounds that are years and years away from being developed. And so as a value asset manager, we're really focused on companies that are generating earnings and cash flow. So it's pretty hard to find those that meet that criteria.

But occasionally we do. And we think **Xoma** (NASDAQ:XOMA) is an example of one of those companies: It's a royalty company. And they have rights to 70 different compounds in the portfolio. And essentially, what they do is they go to a biotech that may have a compound but they don't have the cash to proceed and develop it into a marketable product. **Xoma** will provide capital and attach a royalty to that. So they receive a royalty on that compound, and then that biotech will ultimately try to market it to big pharma.

So essentially, what happens is **Xoma** has the rights to a number of these different drugs and as they go from Phase I, Phase II, Phase III, they can receive milestone payments along that process. And then in addition, once the drug is ultimately approved — and at present, they have one drug that has been approved and they have two compounds, two drugs in Phase III, and they have over 20 in Phase II. And so ultimately, when those drugs are approved, they receive a royalty. So it can be anywhere from 1% to 5%, almost 10% royalty on that particular drug.

So we found **Xoma** as a very, very smart way to really benefit from what's happening in the pharmaceutical and biotech space. So that's one name in particular that I would point to.

Mr. Kelly: Yes, **Xoma** exhibits similar characteristics to what we've described. Trading right around book value, and you could argue that book value would be understated since **Xoma** has the right to future cash flow success out of these compounds. And had $78 million in net cash, $6 in net cash. So Xoma is self financing, and that gives them dry powder to deploy.

So similar to **UTI**, **Xoma** actually is kind of counter-cyclical to what's going on in the biotech space. As capital has dried up — especially risk capital has dried up — biotechs are finding it harder and harder to finance. And that's a good thing for **Xoma**, because **Xoma** can put better terms around these royalty agreements that are more favorable to them, and ultimately to shareholders.

TWST: What worries you as you look into 2023? Where would you advise caution now?

Mr. Beaven: We're watching the consumer closely. And as it relates to the retail landscape and certainly housing — and we've owned housing stocks in the past, but we don't at present because we'd like to see them a fair amount cheaper. We're watching consumer spending closely, and we're looking at a number of different retail opportunities; the retail space is quite cheap. But with unemployment possibly increasing, the consumer could be under a little bit of pressure. So we're weighing that. And also financial services.

Mr. Kelly: The inverted yield curve has gotten a lot of press, and justifiably so. We think that needs to be on people's radar screens. And it has a very good history of predicting recessions. The interesting thing about this is that it's been widely reported for an extended period of time that you almost have to think that it's priced into the market. And what we're going to experience here in the next year, as measured by the yield curve, would say that it could be pretty choppy.

The counter argument to that is that typically with a negative yield curve we would be in a recessionary environment — you would think that commodities would be selling off rather dramatically. But looking at Dr. Copper, copper is telling a different story. And that may be a mix of dynamics between supply and demand, and also China reopening.

And so, I think we've kind of characterized it as "crosscurrents." And that's really what we've been working through since the pandemic and the reopening — that there are just a number of crosscurrents.

And you can look at autos, which is another space that is trying to find an even setting. Auto inventories are coming back up. And that's ultimately good for the consumer, because there should be more incentives. So as far as used car prices are concerned, that should make it more affordable. But then when you look at rates and affordability for housing and autos, two of the largest purchases for consumers, those costs have gone up rather dramatically.

So it's a market full of crosscurrents. And what people are trying to judge is, will the U.S. economy have that soft landing? But you have to look globally, at how China's reopening is affecting that and what's going on in Europe as well.

Mr. Beaven: We actually like a messy environment. We like a bias towards higher inflation and higher interest rates. And typically, historically, that really benefits value investing. Value investing is much tougher in an environment where you're seeing a continual decline in interest rates and a continual decline in inflation and a push to increase globalization.

But we have the opposite of that right now. We have, one could argue, stubbornly high inflation that may persist. Maybe rates continue to hang out where they are, or possibly go a little bit higher. All of those things are benefits to value investing. So we like that, we find that's where we can really thrive — in that kind of a choppy, messy environment.

TWST: Thank you. (VSB)

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