There Honestly is Some Wheat Amongst all the Chaff

The equity market in 2022 has faced significant headwinds, including inflation, war in Ukraine and continued supply chain issues, just to name a few. Not surprisingly, these various factors have resulted in major sell offs across all major indices including the NASDAQ down 20.4% and the S&P 500 down 12.3% through 8/22/2022. The small cap and micro-cap markets have been hit hard as well with the Russell 2000 Index down 14.0% and the Russell Microcap Index down 14.8%. One interesting feature of a bear market is that small and micro-cap stocks, in particular, are often caught up in a kind of "throw the baby out with the bath water" effect. Because many small and micro-cap stocks are far more illiquid than large cap stocks, even small quantities of selling can have a material and exaggerated downward effect on the price of the stock. Not surprisingly the "risk-off "environment that has plagued the market for the last ten months resulted in significant sell-offs of individual companies; and most importantly for the purpose of this paper, those selloffs have occurred regardless of the actual execution and financial performance on an individual company basis during the broad bear market.

We thought it would be interesting to take a look at a few microcap companies that we follow (and own) that have seen their stock prices fall in 2022 despite strong operating results. One of the attributes that makes these companies interesting is that they have managed to perform at levels at or above projections that were put in place at the end of 2021, before the sell-off began. Despite hitting their numbers, however, their stock prices have dropped by substantial amounts.

- Alta Equipment Group, Inc. (ALTG): ALTG is a material handling and construction equipment company that has locations throughout the Midwest, Northeast, and Florida, in addition to its recent acquisition that expanded its footprint into Canada. As of 12/31/21, ALTG had a market cap of $474 million, an enterprise value of $892 million, and a stock price of $14.64. ALTG's stock had fallen to $12.36 by the end of the first quarter as the market in general saw significant selling. ALTG, however, reported strong results for Q1 2022 and maintained its EBITDA guidance for 2022. Unfortunately, those stellar results clearly did little to stem the tide. With the market clearly believing the US economy was headed into a recession, did investors want to own a dealership of construction and material handling equipment? The answer in the second quarter was a resounding no, and the stock declined by 27.4% in the quarter, closing at $8.97. ALTG recently released its second quarter results and beat their numbers again and actually raised guidance for the remainder of 2022. ALTG also initiated a common stock dividend and stock buy-back program. The stock has experienced a nice bump following the release of their Q2 results, closing at $12.40 and an enterprise value of $845 million on 8/22. However, it still remains down 14.9% on the year, despite executing on (and in fact outperforming) the 2022 guidance they had provided back at the end of 2021. We would argue that the stock is attractive at 5.6x times EV/2022 estimated EBITDA, especially when compared to the 7.8x it was trading at back at year end.

- Potbelly Corporation (PBPB): Potbelly is a chain of sandwich shops with over 440 stores. PBPB began the year with a market cap of $150 million, an enterprise value of $166 million and a stock price of $5.58. PBPB reported strong results in Q1 2022 as its average unit volume (AUV) continued to improve, particularly in its central business district stores that were particularly hard hit by COVID-related issues. While the stock responded favorably to these results in Q1 2022, the results were no protection against indiscriminate selling as PBPB saw their shares fall significantly during Q2, finishing the quarter at a price of $5.65, down from $6.70 as of the end of Q1 2022. This decline continued into Q3 2022, with the stock descending to a 52-week low of $4.96 and enterprise value of $150 million in July 2022. Fast forward to PBPB's announcement of their results for the second quarter and we saw something similar to ALTG. For the quarter, PBPB beat estimates and produced stellar results that outperformed the guidance they had provided at the end of 2021. Following their earnings release, the stock price has seen a nice uptick, closing on 8/22 at $5.97. While PBPB trades approximately 7% above where it did as of the end of 2021, in our view, its results certainly warrant more than a 7% increase from the beginning of the year.

- Lantronix, Inc. (LTRX): Lantronix is a provider of intelligent hardware and turnkey solutions for the Internet of Things (IoT) and remote environment management. LTRX had a market cap of $270 million, an enterprise value of $261 million and a price of $7.83 as of 12/31/21. In early May, LTRX reported its calendar Q1 (3^{rd} quarter fiscal year results) which were outstanding. As with ALTG and PBPB, LTRX beat its guidance, and while LTRX's management expressed some concerns over the continuing supply chain issues, they actually raised their guidance for the next quarter. LTRX's reward for these outstanding results was to see their stock price dragged down with the rest of the market over the succeeding months. Ultimately their stock hit a 52-week low in June 2022 at $4.65, and ended the quarter at $5.38 on 6/30/22. While LTRX doesn't report its results until 8/25 (this piece was written as of 8/22), LTRX did pre-release results for the quarter on 7/28 announcing record revenues for the quarter that were above guidance and analyst estimates. LTRX's stock moved higher following the announcement, but the bottom line is that with a price of $7.255, LTRX still remains below where it was at the beginning of the year despite putting together two outstanding quarters to start the year.

Bear markets like the one we have been in through the first two-plus quarters of 2022 have a tendency to take all companies down with them with very little discernment between companies that are struggling and those that are performing. We believe that for those that do the work, it is possible to separate the "wheat from the chaff" and find the companies that have continued to execute during the tough headwinds that currently exist and which we believe represent extraordinary value with a longer-term outlook. At 180, we prefer to do the work on individual companies instead of making sweeping generalizations about the entire asset class as not all companies are created, nor do their management teams run their businesses equally. We believe therein lies the potential for us to generate outsized returns for our shareholders and our third-party capital investors.

Note: The information discussed above is solely the opinion of 180 Degree Capital Corp. Any discussion of past performance is not an indication of future results. Investing in financial markets involves a substantial degree of risk. Investors must be able to withstand a total loss of their investment. The information herein is believed to be reliable and has been obtained from sources believed to be reliable, but no representation or warranty is made, expressed or implied, with respect to the fairness, correctness, accuracy, reasonableness or completeness of the information and opinions. All enterprise value metrics are excluding operating leases.