A Private Equity Approach to the Public Market
Achieving Low Correlation and High Alpha from Smaller Companies with Complex Balance Sheets

Executive Summary
Public equity has historically operated at a capital structure of roughly 30% debt and 70% equity, with high amounts of research coverage and lower opportunity for an information advantage. Inversely, private equity has operated at 70% debt and 30% equity, with little-to-no research coverage and high information advantage opportunity. A private equity approach to the public market focuses on companies in between.

Underlying drivers of public and private equity returns are more similar than most realize, such as the premium derived from size, leverage, liquidity, and volatility factors. As a result, smaller and underfollowed public companies with higher and more complex utilization of debt have exhibited greater returns in line with private equity. However, these factors are underutilized in the public space as they run counter to the quality bias of conventional wisdom. In this paper, we examine the underlying factors of this anomaly and why a high-yield credit skillset, specializing in leveraged capital structures, is ideally situated to exploit this efficiency.

Topics Addressed
• Complex equity characteristics, outperformance, value catalysts, and risk statistics
• Factors contributing to low research coverage and public market underutilization
• Unique potential for an information advantage with proprietary research
• Targeting market inefficiencies using a combination of factors to produce alpha

As of December 31, 2017. Source: Bloomberg, Morningstar Direct. Leverage quintile measured by debt to capitalization ratio ex financial sector due to greater usage and unique utilization of debt from other sectors.
A Private Equity Approach to the Public Market

Utilization of complex, underfollowed, and information advantage factors provide opportunities for alpha generation from market inefficiencies.

**Targeting Market Inefficiencies**

- **Complex Balance Sheets**
  
  Contrary to conventional wisdom, smaller companies with higher and more complex utilization of leverage have significantly outperformed their less-leveraged counterparts.

- **Underfollowed Companies**
  
  Companies are primarily underfollowed by market research analysts because of leverage and size factors due to the required skillset, lack of investment banking opportunities, and lower trading volumes.

- **Information Advantage**
  
  A variety of proprietary techniques are utilized to collect information ignored by most investors to produce a comprehensive mosaic and better determine underlying value.

**Unique Catalysts with Low Correlation Return Profile**

5 Year Return Correlation Matrix by Russell 2000 Factor Index

| Russell 2000 Factor | 0.54 | 0.55 | 0.55 | 0.56 | 0.57 | 0.58 | 0.59 | 0.60 | 0.61 | 0.62 | 0.63 | 0.64 | 0.65 | 0.66 | 0.67 | 0.68 | 0.69 | 0.70 | 0.71 | 0.72 | 0.73 | 0.74 | 0.75 | 0.76 | 0.77 | 0.78 | 0.79 | 0.80 | 0.81 | 0.82 | 0.83 | 0.84 | 0.85 | 0.86 | 0.87 | 0.88 | 0.89 | 0.90 | 0.91 | 0.92 | 0.93 | 0.94 | 0.95 | 0.96 | 0.97 | 0.98 | 0.99 | 1.00 |
|--------------------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|
| Russell 2000 Leverage | 1.00 |
| Russell 2000 Multi Factor | 0.49 | 1.00 |
| Russell 2000 Defensive | 0.51 | 0.99 | 1.00 |
| Russell 2000 Dividend | 0.55 | 0.96 | 0.98 | 1.00 |
| Russell 2000 Div Growth | 0.48 | 0.91 | 0.92 | 0.90 | 1.00 |
| Russell 2000 Momentum | 0.56 | 0.95 | 0.96 | 0.97 | 0.84 | 1.00 |
| Russell 2000 Quality | 0.52 | 0.98 | 0.99 | 0.98 | 0.88 | 0.98 | 1.00 |
| Russell 2000 Value | 0.51 | 0.98 | 0.97 | 0.97 | 0.88 | 0.96 | 0.98 | 1.00 |
| Russell 2000 Volatility | 0.52 | 0.98 | 1.00 | 0.98 | 0.91 | 0.97 | 0.99 | 0.98 | 1.00 |
| Russell 2000 Yield | 0.50 | 0.96 | 0.96 | 0.97 | 0.92 | 0.93 | 0.95 | 0.97 | 0.97 | 1.00 |
| Russell 2000 Growth | 0.55 | 0.90 | 0.91 | 0.94 | 0.76 | 0.98 | 0.95 | 0.91 | 0.93 | 0.87 | 1.00 |
| Russell 2000 Dynamic | 0.54 | 0.89 | 0.89 | 0.93 | 0.74 | 0.97 | 0.94 | 0.93 | 0.91 | 0.88 | 0.98 | 1.00 |
| Russell 2000 Index | 0.54 | 0.96 | 0.97 | 0.98 | 0.84 | 0.99 | 0.99 | 0.98 | 0.97 | 0.94 | 0.98 | 0.98 | 1.00 |

5 Year return correlation by factor as of December 31, 2017. FOR ILLUSTRATIVE PURPOSES ONLY. The index information and data contained herein was obtained from FTSE Russell.

As of December 31, 2017. Source: Bloomberg, Morningstar Direct, FTSE Russell. Russell 2000 Leverage measured as top quintile debt to capitalization ratio ex financial sector due to greater usage and unique utilization of debt from other sectors.
Complex Balance Sheets

Contrary to conventional wisdom, smaller companies with higher and more complex utilization of leverage have significantly outperformed their less-leveraged counterparts.


Further Insight

- **High-Yield Credit Analysts** specialize in leveraged cap structure; ideal skillset to exploit inefficiency with identification of debt catalysts impacting equity value.

- **Outperformance** of broader market can be observed using the top leverage quintile of the Russell 2000 Index as a proxy.

- **Greater Risk and Return** as leverage acts as a catalyst for success or failure; success rates maximized at 5 to 7 year holding periods.

- **Greater Upside** potential of smaller companies drives outperformance; leverage less effective factor for large cap companies.
Underfollowed Companies

Smaller companies are primarily underfollowed by market research analysts because of leverage and size factors due to the required skillset, lack of investment banking opportunities, and lower trading volumes.

Further Insight

- **Smaller Market Cap** equities receive less focus as brokerage firms cut back on research with less commission potential
- **Higher Leverage** utilization requires analysis of debt catalysts which equity analysts typically avoid
- **Higher Volatility** and leverage factors run counter to conventional wisdom of strong balance sheet bias, leading to less attention
- **Smart Beta** passive instruments focus on factors with high and intuitive marketability, resulting in size and quality bias
Information Advantage

A variety of proprietary techniques are utilized to collect information ignored by most investors, producing a comprehensive mosaic to identify intrinsic value.

Further Insight

- **Reduced Industry Research** on smaller market cap companies enhances value of proprietary research, which can provide otherwise unavailable data points.

- **Increased Passive** driven pricing instead of underlying fundamentals enhances inefficient pricing potential.

- **70% of Stocks in High Yield Companies** have small (sub $5bn) market capitalizations, enhancing synergy of cross-over analysis.

- **Credit Profile and Complete Capital Structure Analysis®** generally not performed by equity analysts due to lack of credit focus and required skillset.

*Credit Suisse High Yield Index (companies with capitalizations below $5bn) as of December 31, 2017*
Targeting Market Inefficiencies

A combination of complex, underfollowed, and information advantage factors provide opportunities for alpha generation. Earnings potential, fundamentals, and credit ratings improve as deleveraging companies move toward their optimal capital structure and receive higher market valuations.

Further Insight

- **Compilation** of three main factors to provide greater depth of research analysis, comprehensive mosaic, and catalyst targeting in low market clarity periods

- **High Yield Skillset** utilized to identify debt catalysts – paydowns, refinancing, covenant amendment/breach, liquidity – before impact to equity value

- **Disciplined** and long-term methods of proprietary data accumulation provide structure for opportunity identification

- **High Active Share** and tracking error versus broad market, targeting unique catalysts to provide alpha with low market correlation
Conclusion – Private Equity Performance with Low Correlation to Traditional Factors and Broad Market

A private equity approach to the public market enhances the efficient frontier with a differentiated and high-alpha return profile targeting unique market factors.

Further Insight

- **Private Equity-Like Performance** over the long term due to size, leverage, and volatility risk premium with greater M&A experience

- **Public Market Benefits** versus private equity with no capital lock-up or 2/20 fee structure while offering daily pricing transparency and liquidity

- **Leveraged Capital Structure Specialists** with high yield skillset ideally situated for early identification of value creating or destroying catalysts

- **Goes Against the Herd** by targeting leverage and size factors counter to conventional wisdom of quality bias

Penn Capital Small Cap Equity Strategy
A Private Equity Approach to the Public Market for Over 20 Years

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As disclosed in Penn Capital’s Form ADV, Part 2A, the stated fee schedule for all separate Small Cap Equity accounts is 1.00% of assets under management.

Composite Characteristics: The Small Cap Equity Composite is defined to include separate accounts with assets over $1,000,000. These accounts solely invest in equities of U.S. companies at initial purchase with market capitalizations less than $2.5 billion or the maximum market capitalization of the Russell 2000 Index, whichever is greater. The Small Cap Equity strategy seeks superior investment returns that are attainable on a consistent basis by applying a disciplined value-driven investment approach, which capitalizes on fundamental and technical opportunities in the market. The Small Cap Equity Composite was created on December 31, 1992. Effective January 1, 2010, accounts which have a significant cash flow (20% or more on the transaction date) will be removed from their respective composite immediately. The account will be reevaluated monthly and if eligible, will enter their appropriate composite the next calendar quarter’s opening. Effective November 1, 2012, accounts are eligible to re-enter the composite at the end of the following month. The Small Cap Equity Composite is comprised of all separate accounts that have been managed by Penn Capital for one full calendar quarter.

Calculation Methodology: The Small Cap Equity composite is shown as total returns, which assumes reinvestment of dividends and capital gains, with no reductions for taxes, presented before the deduction of actual investment advisory fees, calculated in U.S. dollars, and computed on a dollar-weighted-rate-of-return-basis. Performance results have been presented both prior to the deduction of investment advisory fees (“gross of fees”) and after the deduction of actual investment advisory fees and all applicable performance fees (“net of fees”). For example, an account with a compounded annual total return of 10% would have increased by 159% over ten years. Assuming an annual advisory fee of 1.0%, this increase would be 137%. Internal dispersion is calculated using the asset-weighted standard deviation of all portfolio that were included in the composite for the entire year. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. All returns are calculated net of transaction costs and gross of custodial fees and taxes on dividends and interest.

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As of March 31, 2018.* Total combined assets include model advisement, discretionary, and non-discretionary

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Sharpe ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk. Standard deviation is a measure of the dispersion of a set of data from its mean. Alpha gauges the performance of an investment against a market index or benchmark which is considered to represent the market’s movement as a whole. The excess return of an investment relative to the return of a benchmark index is the investment’s alpha. Downside capture can indicate how correlated a strategy is to a market, when the market declines. A drawdown is the peak-to-trough decline during a specific recorded period of an investment, fund or commodity.

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