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Hidden in Plain Sight

ESG-Positive Opportunities Within Small-Cap Industrials

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Introduction

At North Star Investment Management, we monitor emerging themes for new opportunities which are consistent with our emphasis on businesses that historically generate high-quality revenue, earnings, and cash flow. The recent trend toward ESG investing provides a fertile ground for our research. ESG Investing, often referred to as "impact investing," or "sustainable investing," is a strategy based on environmental, social, and governance factors. Within North Star's area of expertise in small-cap equities, we believe the Industrials sector in particular offers attractively valued businesses which may fit the theme of environmentally-friendly or environmentally-improving value propositions.

Small-cap Industrials in the Russell 2000 are currently trading at "bargain" prices with median free cash flow yields of 4.70% compared to the Russell 2000 composite free cash flow yield of 2.44% and the sub-2% 10-Year U.S. Treasury yield. Additionally, numerous companies in this arena are embracing the environmental component of ESG principles, whether through combatting climate change or adopting more energy-efficient systems. As many of these companies have been publicly traded for decades, another positive consideration is that their financial transparency and defensible business models are measurable.

Transparent Financial Statements

One of North Star's six investment pillars is a strong preference for uncomplicated business models. Straightforward financial statements make initial securities research and screening more meaningful. Financial statements with few accrual estimations result in reported net income that tracks closely with cash generation. The outcome is a more impactful research process as discounted free cash flow is the core of our valuation methodology. Our analysis indicates stocks in the small-cap Industrials sector fit this preference. The evidence is demonstrated as the implied free cash flow multiple of the Russell 2000 Industrials Index (RGUSPS) is 21.27 which mirrors the median P/E of 22.55.
As of 09/30/2021

Logical Valuations for Value Investors

As value investors, two valuation metrics can be highly informative. First, current free cash flow yields for companies with near-term profitability outlooks are instructive. By comparing a company's free cash flow yield to the potential yield available from other securities or asset classes, we can determine what financial market participants believe are the prospects for a specific company. For profitable businesses, a high free cash flow yield may suggest low earnings growth expectations while a very low free cash flow yield can imply high earnings growth expectations for a specific company. As such, companies with high free cash flow yields typically drive further research efforts for value investors such as our firm to determine whether the growth prospects are being underestimated.

Another useful metric for value investors is the ratio of enterprise value to sales (EV/S). EV/S is helpful to understanding what financial market participants believe are the prospects for companies with depressed near-tear profits. Because of the cyclical nature of Industrials, there are times when margins are temporarily pressured making the companies appear expensive based on traditional P/E analysis. In the cases where we believe operating margins are likely to be restored over a longer business cycle, "bargain" opportunities can be identified by shares trading at low EV/S ratios despite the P/E seeming elevated.

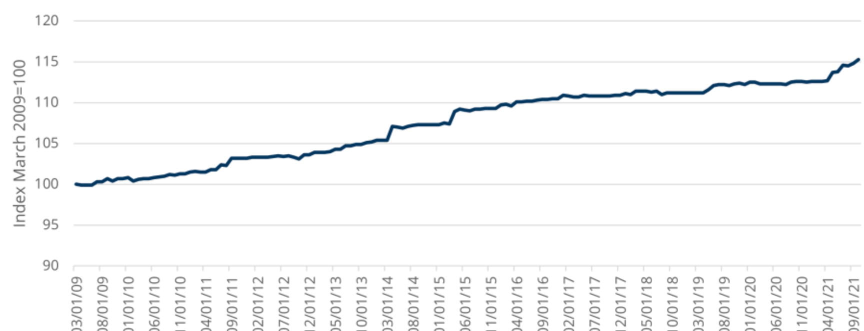
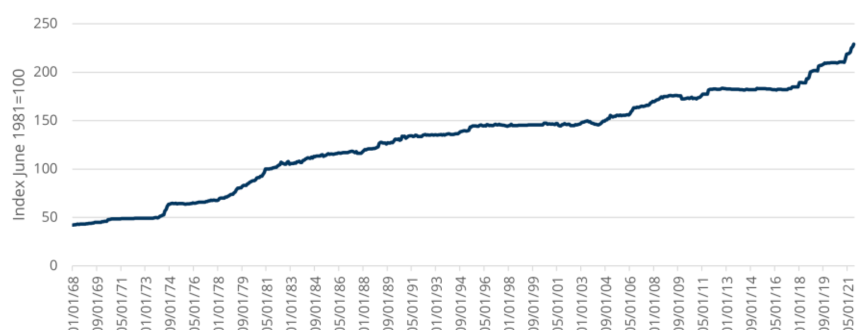
Based on our analysis in the table below, the small-cap Industrials sector offers attractively valued opportunities given both higher free cash flow yield (4.70%) and a lower EV/S ratio (1.71) than comparable sectors and market cap categories.

As of 09/30/2021	Median P/E	Median EV/Sales	FCF Yield
Russell 2000 Industrials Index (RGUSPS)	22.55	1.71	4.70%
Russell 2000 Index (RTY)	17.41	3.28	2.44%
S&P 500 (SPX)	23.57	4.28	4.04%

Lagging Indicators in Corporate Reports, But Numerous Forward Indicators Elsewhere

One of the challenges with investing in Industrial stocks, given their cyclical nature, is selecting indicators to predict when the trend in operating margins will change. There are very few forward indicators available through analysis of company financial statements. Certain sectors, such as Technology, include balance sheet indicators like "Deferred Revenues" that can assist with gauging near-term growth prospects. However, there are other sources of useful forward-indicating information for companies in the Industrials sector. In fact, there are hundreds of such indicators available through the Federal Reserve Bank of St. Louis "F.R.E.D." database.

For instance, a company that provides cleaning and building maintenance services can be tracked alongside the monthly Producer Price Index for Janitorial Services. Similarly, the monthly Producer Price Index for "Commercial and Institutional-Type Electric Lighting Fixtures" would be useful for following an energy-efficient lighting systems provider for industrial buildings (e.g., warehouses). In combination with the highly transparent financial statements of Industrial companies, discussions with company management teams are always useful, but are also much more meaningful when coupled with independent industry research sources.

Indicator	Trend
Producer Price Index by Commodity: Cleaning and Building Maintenance Services (Partial): Janitorial Services Source: Federal Reserve Bank of St. Louis	
Producer Price Index by Industry: Nonresidential Electric Lighting Fixture Manufacturing: Commercial and Institutional-Type Electric Lighting Fixtures, Including Parts and Accessories Source: Federal Reserve Bank of St. Louis	

See appendix for even more examples of specific F.R.E.D. database economic statistical series.

A Rich Pool of ESG Opportunities as the Industrials and Energy Sectors Converge

Clean energy refers to the sources of energy that are entirely renewable and produce either minimal or no carbon dioxide when used. Clean energy sources include solar, wind, water, geothermal, bioenergy, and nuclear. There is tremendous economic opportunity for the countries that invent, manufacture and export clean energy technologies. The clean energy industry is expected to accelerate its growth after 2021 as the current Presidential administration rejoined the Paris Climate Accord and plans to invest $2 trillion in clean energy, with a goal to fully decarbonize the energy sector by 2035.[i] Whereas most of the attention has been focused on the Energy sector, there is potential for companies in both the Industrials and Energy sectors to benefit from the increased participation in the electricity value chain.

Market participants have raced to engage in ESG momentum investing especially when it comes to the Electric Vehicle industry. Matt Eastwick of Javelin Capital, a leading clean energy boutique investment bank, emphasizes that most clean energy investment thus far has been through private capital and in particular SPACs (Special Purpose Acquisition Companies). North Star believes whereas there is overcapitalization in certain clean energy opportunities, such as the electric vehicle and battery technology areas, there are favorable circumstances within the undercapitalized fields of small-cap Industrials, such as industrial lighting, alternative fuel bus manufacturing, or marine dredging.

For example, there are a few small-cap companies in the industrial lighting space, which are profitably installing energy-efficient lighting systems with compelling return-on-investment dynamics. In addition, somewhat old-school industrial vehicle companies are transitioning to electric vehicle or alternative fuel systems that not only reduce carbon emissions, but also improve air quality, especially in densely populated regions. A third example of Industrials sector companies embracing the “E” in “ESG” is in climate change-related remediation, such as in protecting coastline real estate and ports through dredging, land remediation, and landform protection initiatives.

According to the U.S. Energy Information Administration, “In 2020, the industrial sector accounted for 36% of total U.S. end-use energy consumption and 33% of total U.S. energy consumption.”[ii] Given this high level of energy consumption, many companies in the Industrials sector are well-positioned to move to the forefront of clean energy adoption. Industrial companies that are adopting energy-efficient technologies or developing their own climate-friendly solutions can directly impact climate change, as opposed to merely becoming “climate-friendly” through carbon credits. In fact, many small-cap Industrials sector companies we follow are adopting or developing clean energy elements demonstrating an increased overlap between the Industrials sector and the Energy sector.

Conclusion

Through our analysis, North Star has determined that many companies within the small-cap Industrials sector not only offer value opportunities with unambiguous free cash flow generation but are also attractive candidates for an ESG portfolio with potential to be major pieces in the climate change puzzle.

Contact Information

Please contact us at info@nsinvest.com if you would like to discuss the North Star funds, strategies, and investment research.

North Star Funds do not utilize Environmental, Social and Governance (ESG) practices in their fund activities nor do they consider this their area of expertise.

ESG Investing: Environmental, Social and Governance (ESG) investing may take into consideration factors beyond traditional financial information to select securities, which could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. Further, ESG strategies may rely on certain values-based criteria to eliminate exposures found in similar strategies or broad market benchmarks, which could also result in relative investment performance deviating. There is no assurance that employing ESG strategies will result in more favorable investment performance.

Investors should carefully consider the investment objectives, risks, charges, and expenses of the North Star Funds. This and other important information about each of the Funds are contained in the prospectus, which can be obtained at www.nsinvestfunds.com or by calling (855) 580-0900. The prospectus should be read carefully before investing. The North Star Funds are distributed by Northern Lights Distributors, LLC member FINRA/SIPC. Northern Lights Distributors, LLC and North Star Investment Management are not affiliated. 1767-NLD-12082021

Important Risk Information

Mutual funds have investment risks including loss of principal. There is no guarantee either fund will meet its objective. No-load mutual funds are sold without sales charge; however, they have ongoing expenses, such as management fees.

About North Star Investment Management

North Star is an employee-owned boutique asset management firm. The North Star Funds, managed by North Star Investment Management Corporation, are part of the North Star Family of Financial Services. North Star is a Chicago-based investment management firm serving individual investors since 2003.

The North Star Funds actively invest in undervalued and often overlooked small and micro capitalization companies where our macroeconomic and primary research and analysis indicate a catalyst for growth. We believe in the businesses we own—we have "high conviction" in the securities we select, and typically only hold 40 to 50 names in each portfolio.

Portfolio Selection – High Conviction, Low Turnover, Risk Management

- Each fund has a concentrated portfolio of 40 to 50 high conviction names with low turnover averaging 11%
- For risk management, each position is limited to approximately 3.0% of a portfolio
- We overweight the best stocks, but no more than 5% in any one position
- For both SMAs and funds we will nibble and bunt our way into positions by buying a little at a time
- We talk to company management in addition to doing our own primary research
- We have a bullpen of potential stocks to add to our portfolios
- Sell discipline results from a dramatic change in firm strategy, or failure to perform according to business goals.

Appendix

Russell 2000 Index: The Russell 2000® Index measures the performance of the small-cap segment of the US equity universe. The Russell 2000® Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

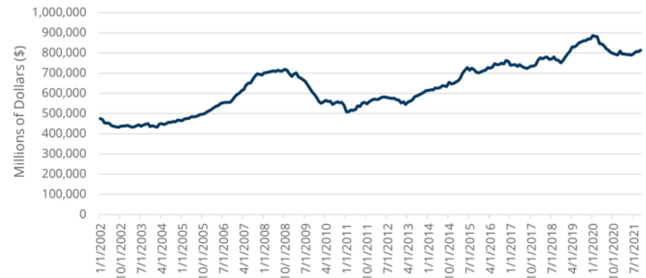
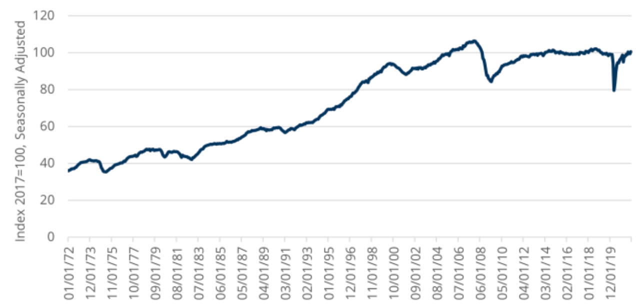
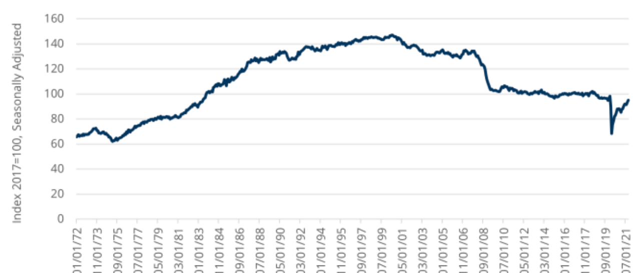
S&P 500 Index: The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

Discounted Cash Flow (DCF): DCF is a valuation method used to estimate the value of an investment based on its expected future cash flows.

Enterprise Value-to-Sales (EV/S) Ratio: Enterprise value-to-sales is a financial valuation measure that compares the enterprise value of a company to its annual sales. The EV/Sales multiple gives investors a quantifiable metric of how to value a company based on its sales, while taking account of both the company's equity and debt.

Price-to-Earnings (P/E) Ratio: The price-to-earnings ratio is the ratio for valuing a company that measures its current share price relative to its earnings per share (EPS).

Free Cash Flow Yield: Free cash flow yield is a financial solvency ratio that compares the free cash flow per share a company is expected to earn against its market value per share. The ratio is calculated by taking the free cash flow per share divided by the current share price.

Indicator	Trend
Total Construction Spend – Nonresidential Source: Federal Reserve Bank of St. Louis	
Industrial Production: Manufacturing Source: Federal Reserve Bank of St. Louis	
Industrial Production: Manufacturing: Non-Durable Goods: Printing and Related Support Activities Source: Federal Reserve Bank of St. Louis	
Motor Vehicle Retail Sales: Heavy Weight Trucks – Nominal Source: Federal Reserve Bank of St. Louis	
Producer Price Index by Industry: Tire Manufacturing, Except Retreading: Truck and Bus (Including Off-the-Highway) Pneumatic Tires Source: Federal Reserve Bank of St. Louis	

[i] Source: The Long-Term Strategy of the United States, Pathways to Net-Zero Greenhouse Gas Emissions by 2050 published by the United States Department of State and the United States Executive Office of the President, Washington DC. November 2021.

[ii] Source: The Use of Energy Explained published by Independent Statistics & Analysis, U.S. Energy Information Administration. August 2021.