



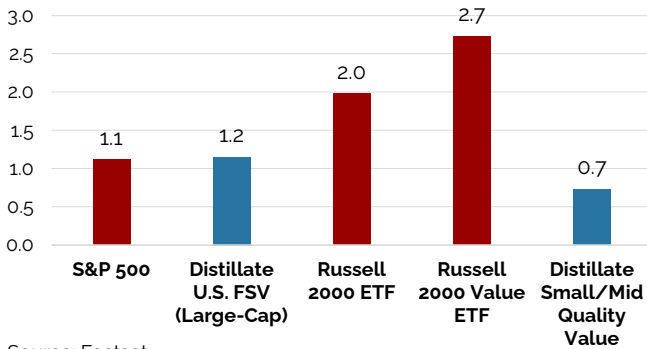
DISTILLATE CAPITAL

Small Stocks, Big Debt Issues

The sharp rise in interest rates and corporate bond yields has significant implications for corporate profits, particularly among smaller stocks. Debt burdens are relatively low among large-cap stocks (proxied by the S&P 500 ETF), but much higher in the smaller cap space, as is evident in the large debt ratios of the Russell 2000 and Russell 2000 Value ETFs in **Figure 1**. Indebtedness for Distillate’s U.S. large-cap strategy in red is comparable to that of the S&P 500 while our small/mid strategy has substantially less debt than its benchmarks.

Adjusted net debt to EBITDA levels are much higher for smaller stocks.

Figure 1: Adjusted Net Debt to EBITDA

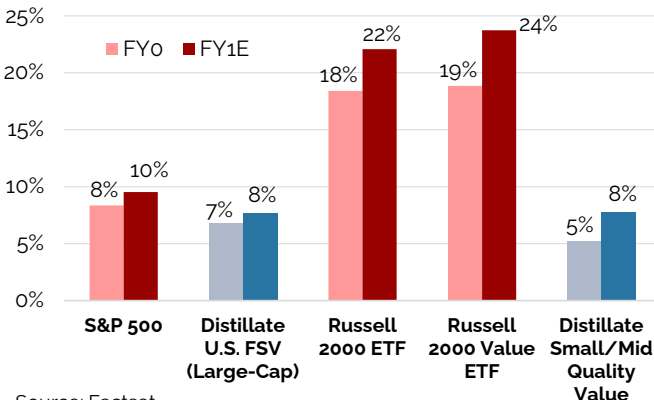


Source: Factset

That smaller stocks have higher debt ratios than large stocks is counterintuitive, as smaller companies tend to have more volatile businesses and thus a prudent debt load should arguably be less. This issue also causes borrowing costs, on average, to be higher for smaller companies. Because of this combination of higher debt and greater borrowing costs, interest expense as a share of EBITDA (earnings before interest, taxation, depreciation, and amortization) is much higher for smaller stocks than larger stocks. This is clear in **Figure 2** which plots this percentage in both the prior fiscal year (FY0) and the current fiscal year (FY1) using analysts’ consensus estimates.

High debt levels and rising borrowing costs have caused interest expense as a share of EBITDA to be very elevated for small stocks.

Figure 2: Interest Expense as a Share of EBITDA



Source: Factset

Several things are notable from this analysis. First, the absolute level of interest expense as a share of EBITDA is very high among small-cap stocks at around 25% for the Russell 2000 and Russell 2000 Value ETFs, but considerably lower for large-cap stocks and Distillate’s U.S. Small/Mid Quality Value (SMID QV) strategy. This is a function of stocks in our SMID QV strategy having both substantially less debt and lower interest costs on that debt.

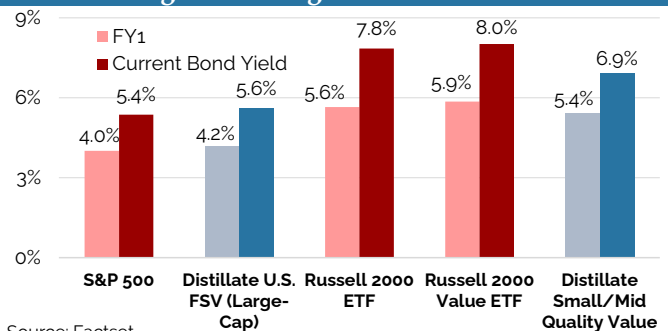
Second, while the increase from FY0 to FY1 is substantial and is related to the rising rates, it does not yet capture the full extent of the changed rate environment. Interest expenses typically roll higher gradually over time as bonds mature and companies issue new debt at higher rates to replace maturing debt. The effect is faster for smaller companies that tend to issue shorter-maturity bonds than for larger companies, but it remains that the analysis does not reflect how much higher interest expense may go as a share of corporate profits.

To get a better sense for how much further interest costs could rise, we can use current bond yields to estimate interest expenses going forward. To do this, we mapped weighted average bond yield-to-maturities for all companies with data, and then compared it to estimates for FY1 interest expense as a share of total debt to back into an average cost of debt. This comparison between current interest expense as a share of total debt and current bond yields is shown in **Figure 3**.

This analysis highlights how much higher current bond yields are than current interest expenses and indicates how much higher interest expenses could ultimately climb. The figure also confirms that smaller stocks face substantially higher borrowing costs than large-cap companies, though this is less true with our SMID QV strategy where the higher quality nature of the companies and lower debt levels mean their bond yields are considerably lower.

FY1 interest expenses as a share of net debt are much lower than current bond yields and would be expected to roll higher over time as corporate bonds mature and companies have to replace cheap debt with more expensive debt.

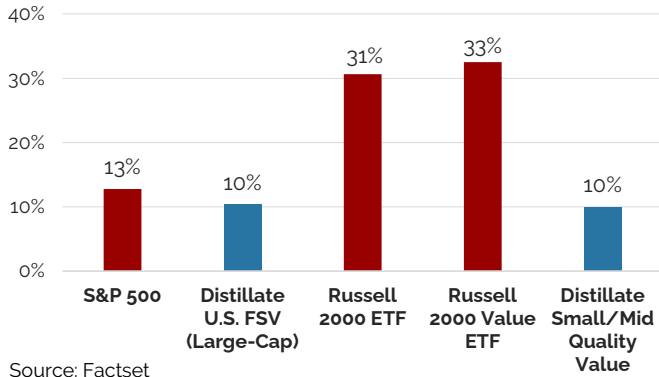
Figure 3: Interest Expense to Net Debt in FY1 vs. Current Weighted Average Bond Yield



Source: Factset

If companies faced current interest expenses that reflected prevailing bond yields, interest expense as a share of EBITDA would amount to around a third of EBITDA for small cap benchmarks vs. under 10% for our SMID QV strategy.

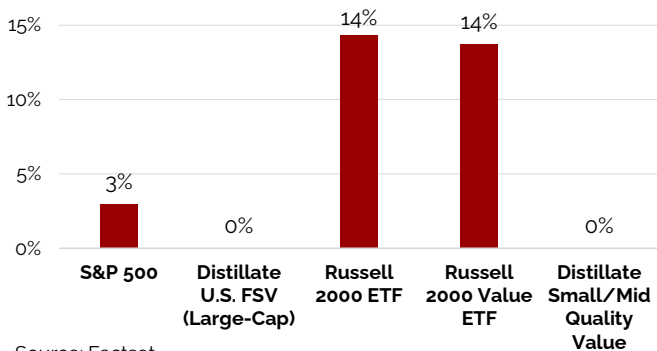
Figure 4: Hypothetical Interest Expense as a Share of EBITDA at Current Bond Yields



To estimate where interest expenses could ultimately go as a share of EBITDA, we can use the data from [Figure 3](#) to estimate what the interest share of EBITDA would be at current bond yields rather than FY1 interest costs. The results are depicted in [Figure 4](#) and show that while interest expenses are likely to move higher for large cap stocks, the cost will still amount to less than 10% of EBITDA versus around 7% last year. The comparable figure for the more highly indebted small cap Russell 2000 ETF, however, is nearly 33%, which is 9 percentage points above the already elevated FY1 estimate. For the Russell 2000 Value ETF, the potential interest share of EBITDA is even higher at almost 36% and nearly 10 percentage points above the FY1 level. For our SMID QV strategy, by contrast, the interest share of EBITDA is a substantially more manageable 9% and is less than 2 percentage points above the FY1 estimate. The 25-percentage point gap between the potential interest expense share of EBITDA for our portfolio and the small cap benchmarks is meaningful and implies a substantially lower risk related to rising rates among our holdings.

A compounding problem for higher interest rates for smaller companies is that a significant portion of small companies are not expected to generate positive free cash flows in the next twelve months.

Figure 5: Share of Benchmark/Strategy That Is Expected To Generate Negative Free Cash Flows



Compounding this issue of rising interest costs for small stocks is a problem of profitability. [Figure 5](#) shows the percentage of each benchmark or strategy by weight that is not expected to generate positive free cash flows in the next twelve months. While this figure is a reasonably small 3% for the S&P 500 and zero for each of Distillate’s strategies, it is a concerningly high 14% for both the Russell 2000 and Russell 2000 Value ETF benchmarks. So at exactly the time many small cap companies will see rising debt costs squeeze their profitability, a large number of them are not profitable to begin with.

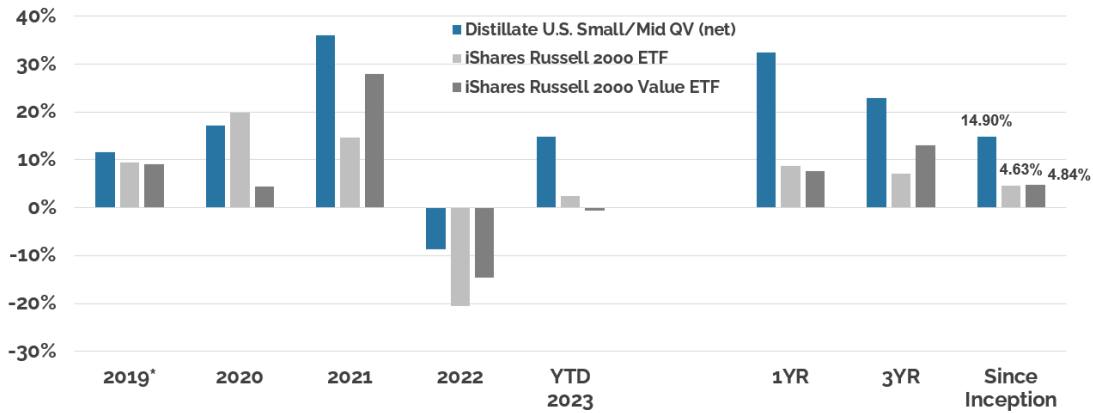
In summary, our SMID QV strategy looks highly differentiated from its benchmarks regarding the potential consequences of higher interest rates and the resulting impact on profitability. Some of the benefits of this contrasting risk profile are likely reflected in the significant outperformance over the prior year when interest rates began moving higher (See [Figure 6](#)). But as the analysis of bond yields showed, interest expenses are likely to continue to move substantially higher for small stocks as they converge over time to where bond yields have already gone. As this occurs and given the lack of profitability for many small stocks, a number of companies may face significant pressures. As this transpires in the coming years, the contrasting the low leverage and lack of unprofitable stocks in our SMID QV strategy may continue to provide a significant relative advantage and critically reduced risk profile compared to the broader small cap markets.

Annualized performance net of fees for Distillate's Small/Mid Quality Value strategy is around 9 percentage points above the Russell 2000 and Russell 2000 Value ETF benchmarks.

Figure 6: Distillate's Small/Mid QV Performance

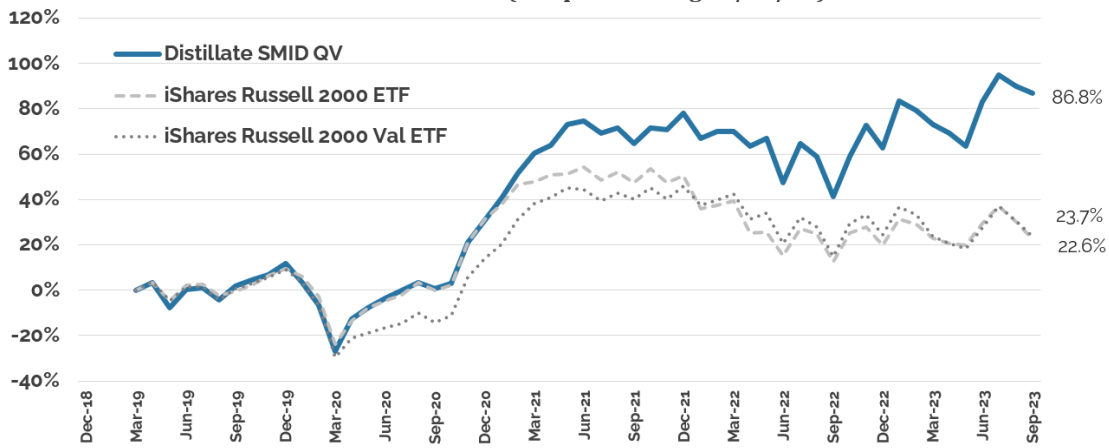
Distillate U.S. Small/Mid QV Composite Performance

	YTD					As of Sep 30, 2023			
	2019*	2020	2021	2022	2023	1YR	3YR	5YR	Since Inception
Distillate U.S. Small/Mid QV (net)	11.65%	17.15%	36.03%	-8.64%	14.92%	32.42%	22.92%		14.90%
iShares Russell 2000 ETF	9.49%	19.91%	14.64%	-20.49%	2.45%	8.81%	7.05%		4.63%
iShares Russell 2000 Value ETF	9.18%	4.50%	27.96%	-14.67%	-0.68%	7.62%	13.07%		4.84%



Source: U.S. Bank, Morningstar Data; Inception 3/31/2019; the period "2019" reflects returns from inception through 12/31/2019; See performance disclosures.

Cumulative Return (Inception through 9/30/23)



Source: U.S. Bank, Morningstar Data; Inception 3/31/2019; See performance disclosures.

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The U.S. Dollar is the currency used to express performance. Returns are presented net of management fees and include the reinvestment of all income. For non-fee-paying accounts, net of fee performance was calculated using a modeled management fee equal to the highest investment management fee that may be charged for the applicable composite (see fee schedule below). For accounts calculated with a per share, net-of fee NAV, gross performance was calculated by adding back the unitary fee associated with that fund. Policies for valuing investments, calculating performance, and preparing GIPS Reports are available upon request.

The investment management fee schedule for the strategies discussed are as follows: 0.39% for U.S. Fundamental Stability & Value; and 0.55% for U.S. Small/Mid Quality & Value.

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The **U.S. Fundamental Stability & Value** composite seeks to distill a starting universe of large cap U.S. equities into only the stocks where quality and value overlap using Distillate's proprietary definitions. Its goal is to achieve superior compounded long-term returns by limiting downside in periods of market stress, while still providing strong performance in up markets. This composite was created in May 2017.

The **U.S. Small/Mid Cap Quality & Value** composite seeks to distill a starting universe of small- and mid-cap U.S. equities into only the stocks where quality and value overlap using Distillate's proprietary definitions. Its goal is to achieve superior compounded long-term returns by limiting downside in periods of market stress, while still providing strong performance in up markets. This composite was created in March 2019.

Figure Methodology notes:

1. Leverage is measured in the form of total debt relative to normalized lease-adjusted consensus estimates for earnings before interest, taxation, depreciation, and amortization (EBITDA).
2. Interest expense as a share of EBITDA is calculated for the entire benchmark or strategy and excludes companies without data. Approximately 70% of the S&P 500, Russell 2000 ETF and Russell 2000 Value ETF by weight had available data and over 90% of our SMID/QV and large-cap U.S. FSV strategies did. Bank stocks were excluded to avoid the issue of higher interest expenses that were offset by higher interest income.
3. Bond yields were obtained by FactSet by taking weighted average yield to maturities for all public companies with debt between 1 and 20 years and mapping this back to the constituencies of each benchmark or strategy. Companies with negative net debt (or positive net cash positions) were excluded. Estimated FY1 net interest expense was calculated as a share of net debt for each company with available interest and EBITDA estimates with banks again being excluded along with companies with negative net debt (or positive net cash positions)
4. Estimated FY1 interest expense as a share of net debt for each company with available data is assumed to adjust to the current prevailing bond yield for companies with available data to estimate the potential change in interest expense. This hypothetical interest expense is then expressed as a share of estimated FY1 EBITDA to create an interest share of EBITDA comparable to what was shown in Figure2, but at the potential interest level of prevailing bond yields.
5. Based on next-twelve-month consensus estimates for free cash flow from FactSet. Companies without estimates are excluded and the benchmarks or strategies reweighted.

Free Cash Flow refers to a company's operating cash flow, less its capital expenditures.

The **iShares Russell 2000 ETF** and **iShares Russell 2000 Value ETF** are investable benchmarks used as a proxies for the underlying indexes of the **Russell 2000 Index** (an index of U.S. listed small cap stocks) and the **Russell 2000 Value Index** (an index of U.S. listed small cap stocks that possess attractive valuation as measured FTSE Russell).

Indices are not available for direct investment. Investment in a security or strategy designed to replicate the performance of an index will incur expenses, such as management fees and transaction costs, which would reduce returns.