TimesSquare Capital Management, LLC

International Small Cap Strategy

Representative Commentary — 3Q22

Performance

			Annualized			
	3Q22	1YR	3YR	5YR	7YR	10YR
International Small Cap Composite (Gross)	-8.38%	-37.00%	-5.62%	-4.68%	2.00%	5.77%
International Small Cap Composite (Net)	-8.61%	-37.65%	-6.56%	-5.62%	1.00%	4.73%
MSCI EAFE® Small Cap (Net) Index	-9.83%	-32.06%	-2.16%	-1.79%	3.24%	5.27%

Please see the important performance and other related disclosures at the end of this Commentary, which are an integral part of this quarterly Commentary Newsletter.

Global markets—using the MSCI World Index as a proxy—began the third quarter in fine fashion (up 8% in July) but stumbled (down -4% in August) and then fell further (-9% in September). For the full quarter, the greatest discomfort was in emerging markets with a -12% return, followed by relative improvements in developed non-U.S. markets, and a -9% showing, to the U.S. with -4%. Measures of global economic activities fell to the demarcation line between expansion and contraction—with manufacturing showing greater weakness than services though both noting slower rates of new orders. That ebbing tide contributed to falling prices among commodities, especially oil and natural gas.

Central banks commanded investor focus during the quarter as they continued constricting their respective monetary supplies. Setting the pace, the U.S. Federal Reserve increased rates twice in the third quarter—each time by 75 basis points—to a new range of 3.00% to 3.25%. There also were a pair of hikes from the European Central Bank, which made its first increase since 2011 in July and followed that with another in September, swinging European interest rates from negative territory to the current 0.75%. Other money centers shadowing those moves included Switzerland, which lifted its interest rates above 0% for the first time since 2014. The one notable holdout remained Japan, which was steadfast with maintaining its negative interest rate policy, though the Bank of Japan bought yen for the first time in over 20 years to buoy its falling currency. Currency woes also knocked the U.K. late in the quarter—bringing its pound to all-time lows vs. the U.S. dollar—as new Prime Minister Truss unveiled an economic stimulus plan that included significant tax cuts (in response to the market reaction, that portion of the plan was withdrawn). Despite all those actions, global inflation rates remained at elevated levels.

Throughout this quarter, there was little differentiation between larger versus smaller capitalization stocks while among the small cap stocks, growth slightly outperformed value. Within the benchmark, the Energy and Materials sectors were relatively more resilient while Communication Services and Real Estate sectors lagged the broader benchmark.

Portfolio Performance Attribution

Amidst this environment, the International Small Cap Portfolio outperformed the MSCI EAFE Small Cap benchmark during the third quarter of 2022. Holdings in Europe and the Emerging Markets had a positive impact on performance while relative weakness was seen in Japan and the Middle East. Asia/Pacific Ex Japan had a neutral impact on performance. There was weakness in the Energy, Consumer Discretionary, and Materials sectors; that was offset by strength in Health Care, Industrials, and Real Estate.

Regional Performance: Europe

Relative outperformance in Europe was attributed to strong stock selection. By country, our holdings in France and the United Kingdom helped while Ireland and Finland detracted. Though we continued to pare our overall exposure to Europe considering the geopolitical risks, we also opportunistically added to areas where we see strong structural demand, such as energy and defense.

The largest contributor in the region was Switzerland based **Siegfried Holding.** They are a contract development and manufacturing organization. Its two key businesses are: 1) Drug Substances, the ingredients used in drug therapies and 2) Drug Products, manufacturing drugs for pharmaceutical customers. Investors initially treated Siegfried only as a COVID vaccine beneficiary though it clearly is not. Its non-COVID Drug Substances segment (around 60% of group revenue) saw strong revenue growth coming from several contracts for new drugs moving from development into commercial production. These results demonstrated the sustainability of the business and shares climbed 17%.

Sweden was more negative with a -24% decline for **Saab,** an aerospace and defense company. Military spending in the world has been in a long-term decline and given the current geopolitical situation, there will be structural increases in spending, leading to more organic sales growth for Saab. The market misunderstood and punished the stock when its CEO expressed frustration on slow sales of its Gripen fighter jets. Though its fighter jet business has high revenues, the margins are low. We do not expect its jet business to materially impact our investment thesis and added to the name on weakness. Another name that lagged was Finland-based food and beverage packaging specialist, **Huhtamaki.** Though the company delivered strong quarterly results and exercised pricing power, shares fell -18% on worries of falling European packaging demand due to the recession. Unlike generalist packaging peers which are more cyclical, Huhtamaki has minimal industrial or ecommerce exposure but benefits from post COVID re-opening activities in the food and beverage industry.

Within the same supply chain, another detractor was United Kingdom-based food ingredients company **Tate & Lyle** with its -17% pullback. Their addressable market is focused on Soluble Fiber, Starches and Specialty Sweeteners where we view demand as stable. The market raised concerns on the company's relative exposure to Europe (around one third of food and beverage solutions sales) and rising corn and gas input prices. Given the necessity of Tate & Lyle's ingredients for food companies, we have confidence that the company will be able to raise prices and sustain profitability.

Moving over to Germany, **Befesa** specializes in the collection and recycling of steel dust and aluminum residues. Base metals prices have remained flat while energy prices have gone up, which led to margin pressure. Negative sentiment on their China exposure and the operation disruptions caused by ongoing COVID lockdowns there also dampened sentiment. In addition, its share price was pressured along with the broader German market underperformance. As a result, the holdings dropped -37% this quarter.

Returns were relatively better in France as exemplified by **Nexans**, one of the largest players globally in the cable manufacturing industry. They reported solid organic growth and shares jumped 16%. The company aims to become a pure player in the electrification end-market by 2024. Another beneficiary of Europe's structural energy transition and new to the portfolio is **Technip Energies.** We believe Technip is well positioned as the world transitions to cleaner energy sources. It is one of only a handful of companies able to build liquefied natural gas plants. Shares declined only -2% since it was added to the portfolio.

Regional Performance: Japan

Japan was our weakest area during the quarter due to both selection and our underweight to the region. We faced some idiosyncratic challenges this quarter. For leading conveyor belt sushi restaurant **Food and Life**, disappointing execution on advertising and operational matters in combination with downward earnings guidance revisions raised concerns on the quality of management. In addition, market worries on weaker consumer demand continued to be a dark cloud over its share price. As such, we exited the name with a -14% loss for the period it was held throughout the quarter.

Nabtesco, a global leader in speed reduction guides for robots, was adversely impacted by lockdowns in China, which limited its ability to complete shipments. Management cut its full-year guidance at the end of July which contributed to the -13% share price decline for the quarter. We continue to like the name as a medium-term beneficiary of growth in automation and cobots (robotic devices designed to assist workers with their tasks).

Turning to the positives, helping performance was **Zenkoku Hosho** which provides credit guarantee services for mortgages. Zenkoku Hosho recently attracted a new activist investor calling for a minimum of a 70% dividend payout plus share buybacks as measures to improve its ROE and stock price. Management is getting friendlier on shareholder returns via dividend payout increases. Meanwhile, they are making some very attractive acquisitions and we expect several in the coming months; we added to the name. Shares returned 6% for the quarter.

New to the portfolio is **Internet Initiative Japan** (IIJ), one of Japan's oldest Internet Service Providers that has leveraged its early extensive Internet connectivity footprint across Japan's government and blue chip enterprise customers. It upsells and cross-sells additional network connectivity solutions and has transformed itself into a dominant data infrastructure player, network services provider and system integrator. We expect that IIJ will continue to benefit from the digital transformation of Japanese companies. When the company missed on its most recent results, we used this as an opportune entry point for the name. Shares returned -16% for the period that it was held.

Regional Performance: Asia Pacific Ex-Japan, Middle East, and Americas

The portfolio's Asia Pacific Ex-Japan holdings performed in line with the regional benchmark. Selection was strong, but partially offset by our underweight to the region. Leading insurance broker **Steadfast** raised guidance for 2023 to a level that was ahead of consensus. However, the market was not supportive when they raised capital to purchase Insurance Brands Australia (IBA) where its current multiple was above the upper end of its historical range; this dampened Steadfast's share price by -13%. IBA is one of the few remaining large acquisitions and serves well in Steadfast's strategy to consolidate the insurance broker industry.

In discussing mergers, the long awaited Canadian acquisition by intellectual property services provider **IPH** finally arrived and at an attractive price. Canada's legal system is based on similar principles as Australia (legacy of the Commonwealth) and material operational synergies can be extracted. On top of this comes the cross-border opportunities in the rest of IPH's markets with notably growing presence in Singapore, Indonesia, and Malaysia. IPH has a strong track record in integrating acquisitions and extracting operational synergies. Investors were pleased with the acquisition and its shares were rewarded with an 11% share boost.

Our underweight to the Middle East detracted from performance though stock selection helped. Defense company **RADA Electronic's** shares outperformed and rebounded 4% this quarter. In the prior quarter, earnings were negatively impacted by the unpredictable nature of defense budget outlays by the U.S. government. However, with the continuation of the Ukraine war, the current defense budget outlook in the U.S. and internationally bodes well for the broader defense sector.

Over in the Americas, **Cargojet** is a cargo forwarder specializing in "middle mile" air cargo in Canada. Industry bellwether FedEx issued a profit warning and revised outlook citing volume decline in every segment around the world. As we believe Cargojet will not be completely immune to broad based industry challenges, we sold its shares which declined -25% for the period it was held and reallocated capital to other names.

Regional Performance: Emerging Markets

Within the Emerging Markets, Latin America was an area of strength while China lagged. Our largest detractor in the region was **Chinasoft International.** One of the leading information technology services providers in China and a partner of tech giant Huawei, Chinasoft is at the forefront of the creation of China's homegrown HarmonyOS. In August, Huawei warned its employees of tough conditions ahead and emphasized its main target is survival. While Chinasoft affirmed that they would not be impacted by Huawei's cost cutting measures, this news nonetheless drove its shares down -40%.

In Latin America, **TOTVS** is Brazil's largest software-as-a-service software provider. They delivered a solid quarter with revenues up 30% year-on-year. Strong momentum is likely to continue into second half as demand remains high along with cross selling. Merger and acquisition opportunities reemerge with prices coming down and companies more open for conversations with TOTVS. Lastly, its Techfin business, previously an area of concern, showed a solid bounce back. Shares climbed 22% this quarter. Lastly, another winner was online medical education services provider **Afya**. Its resilient business is delivering even in times of rising cost inflation. The company reported higher-than-expected revenue and management reaffirmed 2022 guidance. Later in the quarter, one of its major shareholders increased its stake sizably, which helped push the stock price up 36%.

Conclusion

Surveying the remainder of 2022, there seem to be many uncertain balances ready to tip either way. With nearly all central banks well on the quantitative tightening path, there are concerns whether they might raise rates too high too fast, as well as worries that they may pivot and begin easing too soon. Many economies across the global teeter on the edge between expansion and contraction with the determining factor appearing to be new order demand, which has not yet fully recovered. Across our investment universe, companies are concerned about a future recession, and many have taken precautionary steps for a more challenging future business environment. Our bottom-up analysis and discussions with company management teams aim to find holdings that can be resilient whichever way the scales tilt. As always, we are available for any questions you might have as we endeavor to protect the assets you have entrusted with us.

General Disclosure:

The holdings discussed represent a particular point in time. It should not be assumed that the securities continue to be held, and/or continue to be held in the same percentage, and/or were held continuously throughout the period. In addition, the holdings of a particular client account may differ from the information provided. Securities discussed do not represent the entire portfolio and, in aggregate, may represent only a small percentage of a portfolio's holdings. Information is subject to change without notice. It should not be assumed that any of the securities discussed were or will prove to be profitable. Past performance does not guarantee future results.

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Performance is measured against the MSCI EAFE® Small Cap (Net) Index. MSCI EAFE® Small Cap (Net) Index is a trade or service mark of MSCI Inc. The MSCI EAFE® Small Cap (Net) Index is an unmanaged, market-weighted index of small companies in developed markets, excluding the U.S. and Canada. Its returns include net reinvested dividends but, unlike the Composite returns shown, do not reflect the payment of sales commissions or other expenses incurred in the purchase or sale of the securities included in the Index. All indexes, including the MSCI EAFE Small Cap (Net) Index, are based on gross-of-fee returns, including net reinvested dividends.

This composite generally invests in non-US stocks with market capitalizations at time of purchase generally within the range of capitalizations of stocks in the MSCI EAFE Small Cap Net Index. Portfolios will hold approximately 70-75 securities. The process is fundamental research driven. Primary selection criteria include quality management, distinct competitive advantage, and strong, sustainable growth. Historical turnover has averaged 37% per year. Composite inclusion threshold $500,000. Fee basis is 100 points. The composite creation and inception date is April 1, 2012.

This composite had a significant cash flow policy from April 1, 2015 to December 31, 2016. A significant cash flow is defined as an external flow that exceeds 10% of the composite's market value on the day of the cash flow. Effective 01/01/2017, the significant cash flow policy has been removed.

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