PACIFIC RIDGE
CAPITAL PARTNERS, LLC

Commentary November, 2019

Has Company Debt Really Increased by Trillions?

Earlier this year, a new accounting pronouncement took effect that created quite a bit of ink for the financial press. In February, CNBC ran a story with the following statement:

"The results will be trillions of dollars in liabilities added on to their books."

Like so many headlines we read, the meaning of this one is only partially true.

The issue referenced by the CNBC story pertains to lease accounting and how it should be recorded on the financial statements of companies. Since 2006, the US Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) have been on a path to standardize accounting methodologies, with most of the changes being made to GAAP standards. The latest change has been the treatment of operating leases on company financial statements. An operating lease is a rent payment for the use of an asset that is not owned by the company. Formerly, companies in the US recorded the obligation of these leases as a footnote in their financial statements. Now, US companies must show these obligations as a new line item on their balance sheet. This means that companies will now have a liability called "Lease Obligations" and an offsetting asset called "Right of Use."

An example of this recent change can be found with Children's Place (PLCE), a large operator of children's apparel stores. PLCE has long been noted for its pristine balance sheet—specifically, its large cash balance and no debt. The company's 2018 annual report* continues this trend. On page 50, the company lists no debt and $70 million of cash. However, on page 71, there is a footnote that discloses nearly $500 million of rent payments due over the next five years.

Beginning in 2019, PLCE must now show that $500 million as a new liability on their balance sheet. Are these lease obligations really new? Of course not. They've always been there. If you agree to rent something for a defined period of time and at a certain rate, it's fairly easy to figure out what the ongoing liability should be. You will still find a footnote with lease payments that the company is required to make over the next five years.

All that is happening is the relocation of a company obligation from one area of its reporting to another. So why does this matter? On the surface, this is about optics and ease of comparability. The issue comes from data aggregators and financial reporters. Some aggregators are now including these lease obligations in their calculations of total debt, which is used to calculate total enterprise value. Many analysts and financial reporters rely on data providers to deliver "ready to read" financial information to them. With this recent accounting change, on any given day, the financial press can be found declaring its astonishment about "ballooning" debt when certain companies report their results, leading to headlines like the one from CNBC. However, the numbers have always been there. They're just showing up on the balance sheet instead of being pushed to a footnote.

To some investors, though, this accounting change appears to have added huge amounts of debt—and hence a dramatic increase in liabilities, leading to potentially broken credit covenants and equity holders left holding the empty bag. In truth, credit covenants, for the most part, are excruciatingly specific in their composition. We are not aware of any company whose credit covenants have suddenly been thrown into question because operating leases are now reported on the balance sheet.

Here is the reality. The new accounting standard adds no new economic information to the evaluation of a company's financials. It just moves information from the "Notes" section of an annual report to a higher place of prominence on GAAP statements. As analysts, we always read the notes to financial statements and compare them to economic developments at a company. Similar to unfunded pension obligations, these items have always been reported by companies and used by our investment team to calculate the claim of liabilities that stand ahead of the equity holders. In our view the investing public, and the financial press, should stop thinking that companies are any more leveraged today than they were yesterday because of this change in reporting.

As investors, we always applaud improved disclosure. We believe that highlighting risk is certainly a prudent principle to maintain in accounting and financial analysis. At the same time, as seasoned analysts, we step over dramatic headlines and remain focused on our ongoing mission: to search for companies that demonstrate an ability to earn a fair return on capital.

We welcome any questions or comments you may have and thank you for your continued support.

Sincerely,

Pacific Ridge Capital Partners

Investment Team

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*Children's Place 2018 Annual Report can be found here:

http://investor.childrensplace.com/financial-information/annuals-proxies

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Commentary - November, 2019, continued

Portfolio Characteristics

As of 9/30/2019

Small Cap Value

	PRCP Small Cap Value	Russell 2000® Value
Number of Holdings	88	1,399
Weighted Average Market Cap ($M)	755	1,996
Average Market Cap ($M)	722	1,012
Median Market Cap ($M)	614	648
Price/Earnings (FY1)	13.2	13.6
Price/Earnings (FY2)	11.4	12.9
Price/Book	1.6	1.6
Dividend Yield	1.1%	2.3%
Beta (vs Russell 3000)	1.2	1.2
L.T. Growth Forecast Median	15.0%	10.0%
Annual $ Turnover (LTM)	24.5%	

Micro Cap Value

	PRCP Micro Cap Value	Russell Microcap® Value
Number of Holdings	69	1,042
Weighted Average Market Cap ($M)	329	462
Average Market Cap ($M)	303	285
Median Market Cap ($M)	239	225
Price/Earnings (FY1)	14.8	13.0
Price/Earnings (FY2)	12.2	11.6
Price/Book	1.4	1.3
Dividend Yield	1.5%	1.7%
Beta (vs Russell 3000)	1.1	1.1
L.T. Growth Forecast Median	15.0%	15.0%
Annual $ Turnover (LTM)	20.6%	

Composite Performance Tables

Small Cap Value

	Q3'19	YTD	1 Year	3 Years	5 Years	Since Inception
PRCP Small Cap Value - Gross*	2.4	15.9	(9.9)	6.0	5.9	10.5
PRCP Small Cap Value - Net*	2.2	15.1	(10.9)	4.9	4.8	9.4
Russell 2000® Value	(0.6)	12.8	(8.2)	6.5	7.2	10.0

Micro Cap Value

	Q3'19	YTD	1 Year	3 Years	5 Years	10 Years	Since Inception
PRCP Micro Cap Value - Gross*	(1.5)	16.0	(10.5)	11.0	11.9	15.7	10.3
PRCP Micro Cap Value - Net*	(1.9)	14.8	(11.8)	9.4	10.2	14.0	8.7
Russell Microcap® Value	(2.0)	9.8	(11.6)	7.7	7.6	10.4	4.7

** Preliminary results*

The firm maintains composites on both its strategies. The Small Cap Value Composite incepted on August 1, 2010. The Micro Cap Value incepted on April 1, 2007. All returns greater than one year are annualized. The performance results of the Micro Cap Value strategy include accounts managed at another advisor. The Firm maintains a complete list and description of composites and a presentation that complies with the requirements of GIPS® standards, which is available upon request by contacting Peter Trumbo, Chief Compliance Officer at (503) 886-8972 or Peter.Trumbo@PacificRidgeCapital.com. The portfolio statistics are shown as supplemental information only and complement the full disclosure presentation (fully compliant GIPS presentation).

About Pacific Ridge Capital Partners, LLC

Pacific Ridge Capital Partners is an employee-owned firm. We generate our own investment ideas using fundamental analysis and bottom-up stock picking. The investment team applies a consistent, patient and disciplined process that results in low turnover and stability. Our proven philosophy has performed well over many investment cycles and it is the consistent application of this strategy that makes Pacific Ridge unique.

The principals of Pacific Ridge Capital Partners are invested along with our clients in each of our strategies.

PRCP Small Cap Value – Our Small Cap Value strategy generally purchases stocks in the bottom three-quarters of the Russell 2000® Index. This smaller capitalization segment has a large number of underfollowed companies, providing us the greatest opportunity to exploit market inefficiencies. The typical range of holdings is between 75 and 110.

PRCP Micro Cap Value – Our Micro Cap Value strategy generally purchases stocks in the Russell Microcap® Index. This segment is widely underfollowed, providing us the greatest opportunity to exploit market inefficiencies. The typical range of holdings is between 50 and 80.

We believe these market cap segments offer great potential returns and additional diversification for our clients.

For further information about Pacific Ridge Capital Partners and our investment strategies, please contact Tammy Wood via email at Tammy.Wood@PacificRidgeCapital.com or by phone at (503) 878-8502.

Disclosures

Pacific Ridge Capital Partners, LLC ("Pacific Ridge", "PRCP", or "the Firm") is an employee-owned investment advisor registered with the Securities and Exchange Commission under the Investment Advisor Act of 1940. The Firm was established in June 2010, and has one office located in Lake Oswego, Oregon. Pacific Ridge claims compliance with the Global Investment Performance Standards (GIPS®).

Sources: Pacific Ridge; FactSet Research Systems ("FactSet"); and Russell Investment Group ("Russell") who is the source and owner of the Russell Index data.

The current annual investment advisory fees for the portfolios managed in the Firm's Small and Micro Cap Value strategies are 1.00% and 1.50% of assets, respectively. Returns for the composites are presented gross and net of management fees and other expenses and includes realized and unrealized gains and losses, cash and cash equivalents and related interest income, and accrued based dividends. The Firm calculates time weighted rates of return by geometrically linking portfolio simple rates of return at least monthly, with adjustments made for significant external cash flows. The composite returns are calculated by asset weighting the individual portfolio returns using beginning of the period values. All returns are calculated after the deduction of the actual trading expenses incurred during the period.

The information provided should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in our strategy at the time you receive this report or that securities sold have not been repurchased. It should not be assumed that any of the holdings discussed herein were or will be profitable or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein. Past performance is no guarantee of future results.

Although the statements of fact and data in this report have been obtained from, and are based upon, sources that the Firm believes to be reliable, we do not guarantee their accuracy, and any such information may be incomplete or condensed. All opinions included in this report constitute the Firm's judgment as of the date of this report and are subject to change without notice. This report is for informational purposes only and is not intended as an offer or solicitation with respect to the purchase or sale of any security.

The Russell 2000® Value Index measures the performance of the Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values. For comparison purposes, the index is fully invested, which includes the reinvestment of income. The return for the index does not include any transaction costs, management fees or other costs.

The Russell Microcap® Value Index measures the performance of the microcap segment of the U.S. equity market. For comparison purposes, the index is fully invested, which includes the reinvestment of income. The return for the index does not include any transaction costs, management fees or other costs.

Returns and asset values are stated in US dollars.