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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Discovering Pick and Shovel Names in Generative AI Buildout

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SECTOR — GENERAL INVESTING

TWST: Could you provide an overview of the firm?

Ms. Prial: Essex Investment Management is a boutique investment manager. We have three core strategies: micro-cap growth strategy, small cap growth strategy, and a global environmental opportunity strategy.

TWST: And among the companies that you invest in, are some in technology?

Ms. Prial: We do have several holdings in technology across all our strategies. Our technology holdings make up about a quarter of the portfolio.

TWST: Are there any that you might want to highlight or describe to our readers?

Ms. Prial: We like the companies that are benefiting from the buildout that we are seeing today on generative AI. So, think of the companies that are providing picks and shovels for the buildout of generative AI.

That means companies that are supplying data centers, companies that are supplying semiconductor equipment used in the manufacturing, semiconductors for generative AI, communications devices that will be helpful in translating from the real world into the digital world. Think of analog-to-digital conversion.

We also like companies that are helping with the transition to electric vehicles. Again, you can think of things like machine vision, Lidar-type companies. We are very bullish on factory automation as a solution to some of the labor problems in this country. So that is another area of technology that we like a lot.

TWST: So you are not just looking at one or two of the AI names that often pop up. There might be some smaller to mid-sized companies that are also involved in the field.

Ms. Prial: Yes, that is correct. We think that there has been a lot of excitement around the whole area of AI, but there are also a number of companies that are benefiting from the current buildout that have not yet hit investors' radar screen.

In addition, we think there will be, over the next couple of years, some significant opportunities of companies that are using the technologies of generative AI in order to provide solutions to their customers, whether that's for businesses who are looking to gain efficiencies in operations, whether that's for health care, where AI can play a very big role in the diagnosis, treatment, and development of drugs for different diseases and indications, whether that be in financial services, where AI can help change the way that the work is done.

So we are starting to look for opportunities; there are companies that are harnessing the technology and developing other products.

TWST: It sounds like a lot of companies in diverse industries really need to get on the bandwagon with AI, because if they do not, their competitors will.

Ms. Prial: It is a technology that will need to be integrated into a lot of solutions. We think of AI really as a way to improve productivity. We think it will change the way that work is done. We can think of other big innovations that changed the world, like obviously the printing press, but more prosaically, word processing and spreadsheets.

We think AI will ultimately be a tool that allows people to move work to a higher level, automates lower-level work, creates a more fulfilling work environment for many employees. Again, increases productivity, but will also have some dislocations along the way of jobs that go away, as well as new jobs that will be created.

It will be a necessary tool, but it will not be sufficient just to be an AI player. You will need to have a solution that solves a real problem for your customers.

TWST: In a field like pharma or some of the other medical areas that you touched upon; how might AI play a significant role? Will it help develop new medications or something along those lines?

Ms. Prial: We certainly think it could. This is early in its development, but when you think about these large language models and the ability to process information very quickly, to do searches very, very quickly, and to synthesize that information and then bring it down to a conclusion — that can help accelerate the process of discovering drugs.

Similarly, think about the process of diagnosing diseases. There are so many different diseases; some quite common, some exceedingly rare. It is hard for one person to understand all of those things.

An AI system can, again, use all the information that is out there at its disposal and very quickly discern the difference in different presentations, different symptoms, in a way that could help with that diagnosis and lead to faster, better treatment, more targeted treatment.

So there are lots of opportunities for automation to really have a significant impact, both on productivity, as well as, again, on improving working conditions.

TWST: So it could lead to some financial rewards for the companies beyond cost savings on labor; it could help find a new source of oil, for instance.

Ms. Prial: Absolutely. We tend to look for the pick and shovel suppliers in these kinds of industries, the companies that are providing the tools and the building blocks to enable these technologies to work, looking a little bit off the beaten track compared to the larger cap, more visible names that are well recognized in the marketplace already.

TWST: Why don't we switch to some other sectors where you are invested?

Ms. Prial: So, our biggest exposure in our portfolios is on the industrial side. And that is a focus, really, on a couple of broad themes. One extremely broad theme is the reshoring of manufacturing in the United States. This really started to happen well before the pandemic.

We started to see manufacturing come back to the U.S. in about 2016-2017, as the relative cost advantage of moving production overseas was narrowed because of productivity improvements in the U.S. and because of wage increases overseas, but got accelerated after the pandemic when companies realized that supply chains have risk to them and that it was better to have more control over your manufacturing and your supply chain.

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TWST: Will the average consumer see more AI applications? Let us say, they go to a drive-through window at a restaurant. They might see fewer employees, but the order will be placed and will come to them just as efficiently, if not better, than they got it before.

Ms. Prial: Right. And I think, certainly, from a consumer point of view, it will be a continuation and an expansion of the personalization of media, of e-commerce, of social media, etc., that we have already seen.

We think that the ultimate use cases for AI will have a much bigger impact, though, on businesses, rather than what the consumer is going to know is AI-driven versus not AI-driven.

TWST: When we talked about business applications, you mentioned automation and related areas. Have you been involved with some of those, too?

Ms. Prial: Yes. The whole area of automation, in general, whether it is the use of robotics in medical care, in surgery, whether it is the use of robotics in factory automation to drive more efficiency, more consistency of manufacturing, whether it is automation in cars.

We all understand what is happening with things like adaptive cruise control, cars that can park themselves. That is going to continue to develop, perhaps ultimately to fully self-driving.

But in the intermediate term, there will be lots of adaptive opportunities that use robotics and robotic technologies. Robotics in some of the dirtier industries that are very unfavorable for humans to work in, whether it be mining and oil exploration, etc.

Reshoring is happening across several industries. And we think this is a long trend that will last for many years to come. On top of that, we are seeing significant moves in this country in terms of rebuilding our infrastructure and moving the U.S. towards the energy transition.

So some of the specific industries that are being positively impacted by this, of course, the semiconductor manufacturing area; we all have heard about the CHIPS Act of 2022. We are starting to see plans be announced for rebuilding semiconductor manufacturing in this country, both for defense reasons as well as for the supply chain reasons I talked about.

We are also seeing it in health care with moving manufacturing back to this country, both on the pharmaceutical side, as well as on devices and other products.

We are seeing the infrastructure rebuild or build, really in this case, of the power grid, where we need to improve the reliability of the power grid in the United States, as well as enhance the amount of power that we produce, given the very large demands on power coming from the data centers that are being built for AI, coming from the data centers that have been built for cloud computing, the needs for the electrification, whether it be EVs or other forms of electrification that are happening on the manufacturing side, that all drive the need for more power. So that's not just generation of power, that's also distribution and transmission.

In addition, we still see a lot of focus on fossil fuels. But what we are seeing there is a move to both drill smarter, drill more costeffectively, but also drill and produce fossil fuels in a way that is less damaging to the environment overall.

Roads, bridges, airports, ports in general, lots of moves there, lots of government spending supporting that.

And then, the final area I will touch on in industrials is defense spending. We do, unfortunately, live in an increasingly dangerous world. We are in an arena where we are moving away from globalization, hopefully not all the way to deglobalization, but it is certainly becoming a multipolar world. And that does necessitate a higher degree of defense spending.

And so, our portfolios are positioned so that we can benefit from the growth that that brings about in the U.S. economy.

TWST: When we talk about onshoring, are there certain regions of the country that might see more of these industries come back to the United States, or is it spread out?

Ms. Prial: Interestingly, it is spread out. I mean, we are seeing it in the Southwest, certainly, with a number of manufacturing plants being announced in Arizona, in particular, and Texas.

We saw an announcement today with **Micron** about a big facility that they are going to build in upstate New York. **Intel** has announced a big facility in Ohio. There is certainly work in Idaho, in the Pacific Northwest, where these companies already have some footprint in manufacturing. We are seeing manufacturing coming back to the Upper Midwest. So it is really quite broad. We think most of the country will be able to benefit.

Ms. Prial: We do think that will stay that way for a while. That is an area where the consumer is reasonably price-sensitive, and the cost advantage of manufacturing those goods overseas is still very real.

Now, there is some near-shoring happening with many of those products, where they may not be being made in China as much, and maybe they are being manufactured in Mexico or Central America, but we don't expect to see all of that manufacturing.

We think the manufacturing that will come back to the United States is a much more technical product, a higher-level manufacturing product than, say, the apparel industry.

TWST: And when we started, you mentioned your interest in micro-caps, small cap, and mid cap. Maybe you can talk about why investors should keep their eyes on those areas as opposed to just the large cap type stocks?

Ms. Prial: So, this has been a market for the last 13 or 14 years that has really been dominated by the large cap stocks. We have seen very strong outperformance in the large cap sector, and that has been driven by the earnings growth that those companies have seen and certainly by many of the companies that have been talked about in the Mag 7, Magnificent Seven, etc.

But what we think is, after 14 years of a large cap cycle, we think that there are some real reasons to be constructive on small caps, and particularly in micro caps.

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We are particularly focused, though, regionally, on the middle of the country. So those parts of the country that were deemed to be less exciting during the previous 15 years or so of the development of the technology and the social media industry.

We think that this focus on manufacturing and reshoring will really benefit those parts of the country that have those strong manufacturing bases. So you can think of the Upper Midwest, the Midwest, and the Southern Midwest as places that will be beneficiaries.

TWST: I guess, in the past, some of that area has been called the Rust Belt.

Ms. Prial: Yes. But the old Rust Belt is certainly an apt geographic description of it, but it is very different technology from what was driving it before. I mean, these are technologically advanced manufacturing facilities. So they do require some retraining, and there are some educational opportunities of public companies out there that are helping to retrain workforces for today's technology needs.

There was an article recently in *The Wall Street Journal* talking about the resurgence of Detroit. And that is a perfect example of what we are seeing in a number of these traditional Rust Belt cities where these manufacturing-based cities are coming back. Their real estate is improving, their education is improving, and the job prospects are improving.

TWST: It looks like, for the time being, there are some industries that will not be reshoring, like textiles and clothing still being made overseas.

So, first is valuation. These companies are much less expensive than their larger cap brethren. Micro caps in aggregate, sell for less than 15 times estimated 2024 earnings. That compares to a multiple on the S&P 500 that is something much more like 24 times today.

And so that is a big valuation difference. Another factor is that earnings growth in small cap, over the long term, has been faster than that of large cap companies. Now, that has not been true in the most recent past, but we think that with this move, with this economy being driven by those industrial sectors which tend to be overrepresented in the small cap universe, that that is positioned to drive an acceleration of growth in small cap.

It is not that the large cap companies will not have good growth, but they are coming off a very high growth rate, which is likely to slow. And these small cap stocks are coming off a lower growth rate, which is likely to get better.

In addition, small caps, and micro caps in particular, are incredibly under-owned. Small cap stocks in total make up less than 4% of the overall U.S. equity market. The average over the long term for small cap stocks is about 7% at its high point in the early 1980s, which was a magnificent small cap cycle after the concentrated market of the mid-1970s was 11% of the overall U.S. equity market.

So we are not predicting that it will get back to 11%. But with a 7% average and a less than 4% weighting today, this is one of the most neglected, least well-owned segments of the market.

And so, we think that as the earnings growth comes through, as the economy continues to be strong — and we do expect that the economy will continue to be strong — and as growth in those large cap stocks starts to slow and investors look for where the growth is accelerating, that will lead investor interest back into these small cap sectors.

And because they have lower liquidity, when that attention returns, this sector can act like a coiled spring, where it is just waiting to be released, and then it will spring up just like a spring does.

TWST: Would some of these micro-cap stocks come out of ideas from a university lab that is commercialized, or maybe from somebody who's been working in the field that has a good idea for how to meet a need in the economy?

Ms. Prial: Actually, not the way we invest in micro-cap stocks. We are investing in companies that have revenue. We are not investing in development-stage companies. Most of the micro-cap stocks that we find are companies that have a revenue base.

Now that can range in size from a small revenue base of $25 million to $30 million a year, to a much larger, a couple of hundred million a year, or even over a billion a year.

But where the company has fallen out of favor, either because it's in an industry that's out of favor, perhaps because it was a company that was growing very rapidly and they missed a product cycle, or the management that they had wasn't the right management to take them to the next level of growth and they disappointed and the stock came down. Or it is a company that is just in a business that has not attracted a lot of attention.

And so, it is that neglect factor that makes the market cap of these companies, in general, smaller, or small relative to the actual sales base that they have.

Now, they may not be making money today, but these are companies that have made money in the past or are on the path to growing into their expense base, but they are making money on a gross margin basis because they are well-run companies.

And one of the misunderstandings, we think, about the smaller micro-cap space is that they are overly sensitive to interest rates. Now, it is true that many of these industrial companies do have a debt base in them. They run with leverage, as do many industrial companies. And because so many of the small cap companies are industrials, that impacts the overall average in small cap looking at debt.

But what we have found is they do not have an undue reliance on floating rate debt, nor do they have an undue reliance on very short-term debt that would make it difficult to refinance in this environment. And at least the companies in our portfolio, those that have needed to refinance, have all been able to do it at reasonable prices.

TWST: Any advice for investors who might be interested in the micro-cap or small cap sector?

Ms. Prial: You need to be a long-term investor. The way that money is made — particularly in the micro-cap and in the small cap as well — is the process of discovery.

As other investors start to discover these companies that are so incredibly neglected, have very little coverage, small amounts of institutional ownership, as they get discovered, the prices go up and the multiple starts to expand to look more like the multiple that you would get for a company with the same operating ratios, the same growth rates, operating in the same industry, but on the larger cap segment.

And that process of discovery can either be very quick or it can take a long time. And so that long-term time horizon, investing over at least a cycle and letting the money compound, is how those long-term superior returns in small cap were developed. And we think that is still true today.

One of the best ways, we think, to think about investing in small- and micro-cap investing is to think of it as public-private equity, because many of the same factors are driving the investment.

You want to invest in companies where their business is fundamentally improving, where the management team is proactively acting to both accelerate the growth rate, as well as to improve margins and improve their balance sheet.

And as they do that and increase their growth rate and increase their margins, that is how the stocks get discovered, and you get the positive benefits of both earnings growth, as well as multiple expansion.

TWST: Thank you. (ES)

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