MD Sass Concentrated Value

Q1 2023 Commentary

MD SASS

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The MD Sass Concentrated Value ("CV") strategy was up +2.8%, net of fees, in the first quarter of 2023, vs. +1.0% and +0.9% for the Russell 1000 Value ("R1V") and Russell 3000 Value ("R3V") indices, respectively.

From inception (January 2019) through the first quarter of 2023, CV had a net annualized return of +16.8% vs. +10.4% and 10.2% for the R1V and R3V indices, respectively.

The phenomenon of loss aversion is a well-established tenet of human behavior, positing that the pain of losing is twice as potent as the joy of winning. Such pain was all too familiar to us during the first quarter of 2023, as the ~500 basis points excess return we had achieved over our benchmarks through February was sliced in half by mid-March, in the aftermath of the *Silicon Valley Bank* **(SIVB)** fiasco. While we still managed to outperform our benchmarks by the end of Q1, the sensation of pain was more pronounced than that of elation, as we relinquished so much of the gains we had previously enjoyed. The source of our pain traced back to our investments in *First Republic Bank* **(FRC)** and *East West Bancorp* **(EWBC)**, both of which suffered precipitous declines, along with many other regional bank stocks, as the market rapidly repriced the risk of asset/liability mismatches in light of the potential for deposit flight. Investing in banks is different than nearly all other sectors of the market. For non-banks, when a stock price decouples from fundamentals, it creates an attractive investment opportunity for investors with insights and conviction. But because the business of banks is built on trust and confidence, when the stock price drops meaningfully, it can negatively impact the fundamentals themselves, creating a vicious cycle. This is precisely what happened to FRC and EWBC. Rather than viewing their plummeting stock prices as a buying opportunity, we saw them as evidence that our original theses were no longer valid, leading us to exit these investments at substantial losses. In hindsight, we did a respectable job of scrutinizing the banks' income statements and evaluating the credit risks of their loan portfolios, but we fell short in assessing interest rate risk. Specifically, we failed to give enough consideration to the risks associated with the duration mismatch between the banks' assets and liabilities, and we underestimated the potential for deposit betas to rise meaningfully higher than in past cycles during an era of aggressive Fed rate hikes. As bank investing is akin to levered fixed income investing, a thorough analysis must account for both credit and interest rate risks.

Amidst the regional bank crisis, we anticipate compelling investment prospects to surface, albeit accompanied by a set of concerns we shall address shortly. The contraction of bank lending may lead to favorable conditions for private credit originators, facilitating their market share expansion and the deployment of incremental capital at more favorable rates and terms. Our conviction in *Blue Owl* **(OWL)** has grown in light of this malaise. Although fundraising in the near term may become more challenging, particularly from the wealth management channel, we remain optimistic about the long-term prospects. In the meantime, *Charles Schwab* **(SCHW)** must contend with customers redirecting their cash from deposits to money market funds, but we believe the fears are exaggerated. As a high-quality brokerage firm, SCHW offers compelling value relative to its earnings potential over the next two years, which prompted our decision to initiate a position in Q1. Further insights into this investment will be provided later in this memo.

Q1 PORTFOLIO REVIEW

The biggest contributors to performance in Q1 were *Formula One* **(FWONK)**, *APi Group* **(APG)** and *Onsemi* **(ON)** which collectively contributed approximately 403 bps to performance.

We have been bullish on the outlook for growth in sports' media rights given the importance of live programming to the traditional linear TV ecosystem along with the rise of deep-pocketed bidders including *Amazon* **(AMZN)**, *Alphabet* **(GOOG)**, *Apple* **(AAPL)** and others. Within the past year, AMZN signed an exclusive agreement with NFL for Thursday Night Football at an average cost of $1.1B per season and Alphabet's YouTube signed an agreement for NFL Sunday Ticket for approximately $2B per year. *S&P Global* **(SPGI)** estimates that "U.S. TV and streaming sports media rights payments will likely total $25.57 billion in 2023 across broadcast, cable, RSNs and streaming services. This has risen from an estimated $14.64 billion in 2015 and is expected to grow to more than $30 billion in 2025 as new deals are forged." This growth exists even though ratings are declining for most popular sports, including the NBA and NHL. By contrast, Formula One continues to show rapid viewership growth in the United States (+28% according to EPSN) and globally. This season included a record 2.583 million average viewers for the new Miami Grand Prix, setting the mark for the most-viewed live F1 telecast ever in the U.S. Strong ratings, healthy demand for sports media rights and the rumored unsolicited takeover bid by Saudi Arabia all contributed to a 25% rise in FWONK shares in Q1. Despite the move in the stock, we believe consensus estimates for 2023 and 2024 continue to underestimate the earnings potential of the forthcoming Las Vegas Grand Prix.

APG has chronically traded at a discount to its business service peers, and we believe this is largely due to its relatively poor FCF conversion and overabundance of non-GAAP adjustments to EBITDA. APG's Q4 2022 earnings report in February went a long way to show that FCF conversion is improving and that the non-GAAP adjustments will dissipate in the next few years after Chubb cost synergies are fully realized. Additionally, the company provided solid 2023 guidance with Chubb's organic growth improving. The outlook and results largely explained the 19.5% rise in the stock in Q1. We believe APG will earn approximately $2/share of FCF in 2024, making the stock attractively valued at current levels.

ON was up 32% in the quarter, significantly outperforming the market but only modestly outperforming the *Philadelphia Stock Exchange Semiconductor Index* **(SOX)**. We believe investors are warming up to ON's strong position in silicon carbide ("SiC"), which is a critical semiconductor substrate for electric vehicles that increases efficiency and range while allowing for faster heat dissipation vs. traditional silicon. The Yole Group, an industry research firm, estimates that SiC power component demand will approach $8B by 2028, up from just $1B in 2021. We believe ON will be one of the industry leaders given its vertical integration and deep expertise in automotive power semiconductors. The stock trades for just over 14x our 2023 EPS estimate, and 12X our 2024 estimate, which we think is quite attractive relative to our expectation for double-digit EPS growth over the next few years.

The biggest detractors to performance in Q1 were First Republic Bank (FRC), East West Bancorp (EWBC) and *Avantor* **(AVTR)**, which collectively hurt performance by approximately 450 basis points in the quarter. We provided commentary on FRC and EWBC in the introduction of this memo so won't rehash that here as we are not masochists. We discuss AVTR in greater detail in the following section.

We initiated new positions in Avantor (AVTR), *Copart* **(CPRT)** and Charles Schwab (SCHW) in the quarter, which we discuss below. We also initiated smaller positions in *Advanced Drainage Systems* **(WMS)** and *PayPal* **(PYPL)** which we will write about in future memos if either investment becomes a 3% position or higher at the end of any given quarter.

AVANTOR (AVTR)

Avantor is a global provider of mission-critical products and services to customers in the life sciences (70% of sales), advanced technologies, and applied materials industries. Avantor's revenue is primarily generated through the sale of products such as chemicals, laboratory equipment, and consumables. About 55% of sales pertain to proprietary products, an important driver of higher margins, with the balance from third-party manufacturers that Avantor distributes to over 200,000 customers in more than 30 countries.

Post-IPO in 2019, Avantor had three consecutive years of mid-high single-digit organic revenue growth and margin expansion. However, in 2022, the company hit several speed bumps including tough COVID comparisons, foreign exchange headwinds, customer inventory destocking, supply chain bottlenecks, and inflation. These issues were compounded by the acquisition of two high quality companies that over-earned during COVID, resulting in significant negative earnings revisions in 2022 and 2023 that sent the stock into a tailspin during the past year. With expectations reset, we believe 2023 guidance is attainable. Longer term, we expect Avantor's significant exposure (~25% of sales) to the fast-growing bioprocessing market will enable it to exceed consensus revenue growth expectations. Bioprocessing refers to the use of biological agents such as cells, enzymes, and microorganisms, to produce a wide range of biologics, including vaccines, antibodies, and recombinant proteins, among others. We think Avantor will grow its bioprocessing business more than 20% per year over the next few years implying that bioprocessing alone will generate over 4% annual sales growth for the company. This compares to consensus expectations of just 5% for the entire company, implying virtually no growth for the non-bioprocessing business. We think this sets a low bar for positive earnings revisions.

We believe AVTR is attractively valued at less than 12x our 2024 EPS estimate given our expectation for double-digit revenue and mid-teens EPS growth over the next several years.

COPART (CPRT)

Copart is the country's largest provider of automotive vehicle salvage auctions and related services. The company primarily partners with auto insurers to sell-off vehicles that have been deemed a "total loss" by the insurer following a collision, flood, or other source of damage. The company utilizes its network of 237 domestic and 63 international salvage yards to store, catalog, photograph, and otherwise prepare the vehicles for sale via online auction. Insurance vehicles account for 75%-80% of total volumes, with the balance comprised of various noninsurance suppliers including independent car dealers (~10%-12%), rental companies, wholesalers, charities, and municipalities. Buyers consist of vehicle dismantlers, rebuilders, used vehicle dealers, exporters, and individuals. The breadth of Copart's buyer network is a competitive advantage and spans 150 countries, with approximately 36% of all vehicles, and 50% by value, sold to buyers outside the U.S. Copart enjoys exceptionally high barrier to entry due to its dual-sided network effects, irreplaceable footprint of salvage yards near major metropolitan markets and local economies of scale which has resulted in 24%+ returns on capital. The U.S. market has historically been a duopoly, with Copart and *IAA Inc.* **(IAA)**, a business spun out of *KAR Auction Services* **(KAR)** in 2018, controlling 90%+ share of the market. As recently at 2017, both companies were roughly the same size, however over the last five years, Copart has distanced itself, displacing IAA at GEICO the #3 auto insurer, gaining additional share at other insurers, and reinvesting more capital

back into the business. Today, Copart controls ~60%-65% of the market and is poised for further share growth domestically and abroad.

Copart is a long-term earnings compounder poised for revenue and margin reacceleration as Total Loss Ratio ("TLR"), the key driver of industry volumes, returns to growth following two years of pandemic-induced declines. Shares of Copart sold off in 2022 on investor expectations that a normalization lower of used vehicle prices would result in slowing revenue growth and margin contraction. Our research indicates that significant price increases taken over the last two years should support Revenue per Unit ("RPU") even as ASP's decline. And as we get into FY24, ASP headwinds will abate and RPU and TLR will begin to march in the same direction, leading revenue growth to reaccelerate and margins to expand. CPRT is not an optically cheap stock. However, we find it reasonable for a recession-resistant business with significant barriers to entry and a net cash balance sheet, which should grow earnings in the mid- to high-teens, with upside optionality from additional share gains and international expansion. Our FY '24 EPS estimate is about 9% higher than consensus.

CHARLES SCHWAB (SCHW)

Schwab is one of the largest U.S. online brokerage platforms in the United States with over $7T of client assets at the end of 2022. Just under half of the assets are from RIAs where Schwab enjoys an estimated 40% to 50% market share. Their RIA share was bolstered by the late 2019 acquisition of TD Ameritrade. Although Schwab has over $3T of assets from individual investors, Schwab's share of this client segment is only 12%. Schwab generates revenue primarily from three sources: 1) interest earned by investing the cash balances in customers' brokerage accounts in predominantly MBS securities (~50%); 2) asset management fees, including fees earned on Schwab ETFs, advisory service fees, and distribution fees for third-part products (~20%); and trading activities (~18%).

Shares of SCHW dropped nearly 33% in the month of March in the aftermath of the collapse of Silicon Valley Bank and *Signature Bank* **(SBNY)**. Amid the regional bank panic, stories emerged that suggested Schwab was experiencing a run on the bank and would have significant liquidity concerns. Yes, Schwab is seeing a decline in deposits, but it is entirely due to "cash sorting", or customers' movement of cash from deposits to money market funds, rather than an exodus of client assets. In fact, in Q1 2023, Schwab experienced over 7% organic growth in total client inflows. While we recognize that cash sorting is a significant headwind to Schwab's earnings over the near term, we believe that customers' deposits will bottom out at a level greater than zero as clients will have some level of cash in their accounts to fund expenses, comply with Schwab's advisor services cash minimums or as a by-product of trade activities. We were encouraged by management's comments on the Q1 earnings call stating that cash sorting has materially improved in April. One month alone does not make a trend, particularly when that month has distortions from tax season filings, but we believe that perhaps the worst of the cash sorting is behind it. We think Schwab can earn $3.40 EPS in 2023 assuming cash sorting leads to cash deposits of less than 5% of client assets, equating to a valuation of 16x depressed EPS. Over the next couple of years, we believe Schwab has substantial earnings power from the moderation of cash sorting, the realization of $500M+ of additional cost synergies from TD Ameritrade, and 5%-7% organic growth of client assets.

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During the quarter we sold our positions in First Republic (FRC), East West Bancorp (EWBC), *Rockwell Automation* **(ROK)** and *Match Group* **(MTCH)**. Earlier this year, ROK was within striking distance of our price target, and we felt that the company would likely experience a decline in backlog and order growth deceleration throughout 2023 as lead times compress, demand wanes (based on deteriorating ISM Manufacturing data) and double ordering diminishes. With the stock trading at a relatively lofty valuation, we decided the risk/reward was no longer favorable and exited our position. We believe our thesis in MTCH was wrong and we sold the position in Q1. We had hoped that the company's new senior leadership would focus on innovation to drive engagement and growth at Tinder, but management's product roadmap has proven to be vague and uninspiring. In fact, management appears focused on pushing price as the main driver of growth, which we think will prove costly over the long term. We believe Tinder has a brand problem and does not resonate well with younger demographics, and this issue will persist without material product enhancements and associated brand marketing. Furthermore, we think guidance is aggressive and unachievable for 2023. Although the stock is cheap relative to history, we do not believe that this represents an investable thesis in and of itself.

MARKET COMMENTARY

The yield curve inversion is the worst in decades, the ISM Manufacturing index is at levels not seen since the GFC (ex-COVID), Leading Economic Indicators are in negative territory and continue to fall, after-tax growth in wages and salaries is decelerating (per Bank of America), the 2023 EPS consensus forecast is 12% off its peak and likely to drop further given regional bank issues…and yet, as of this writing, the S&P 500 is just ~10% off its 52-week high and the VIX just hit a new 52-week low. How is this possible?

One reason for the market resilience is the fact that consumer spending is hanging in there, at least for now. Yes, March retail sales showed a slowdown but both *JP Morgan* **(JPM)** and *Bank of America* **(BAC)** were sanguine about the state of the consumer on its earnings calls and consumer-facing companies have been sending mixed messages suggesting the consumer is perhaps more choppy than outright declining (for now, at least). Certainly, the accumulated excess savings from COVID stimulus programs continues to act as a buoy. JP Morgan estimates that $1T of such savings still exists, but this number continues to drop and is now more than $800B off from its peak. These excess savings should run out by late 2023 and this will be a crucial time to assess the true health of the consumer. In the shorter term, tax refunds are down from 2022 which may be a headwind to consumer spending over the coming months. Risks are to the downside absent growth in real wages, which are currently negative.

Another beacon of hope for the market is the expectation for further easing of inflation and for the Fed to reduce rates starting later this year. As of this writing, the futures curve suggests just over 3% fed funds by early 2025. We have written before about structural inflationary elements that may make it difficult for the Fed to bring inflation down to its 2% target anytime soon. According to a recent *New York Times* article, "visas for visitors, temporary workers and permanent immigrants rose to 7.3 million in 2022, up from 3.1 million the previous year but still down from the more than 10 million issued annually in the three years before Mr. Trump took office." Immigrants are an important source of labor supply to the services sector which saw wage growth of 6.4% in March, up from 6% in February. Data Trek Research has noted that the three-month moving average of median wage growth remains near its four-decade highs, and with no signs of rolling over. We need a greater supply of

immigrants to ease labor costs and reduce inflation. Without it, the market is vulnerable to structurally higher inflation and the un-anchoring of the 2% Fed inflation target.

One consequence of the recent regional bank crisis is the potential ripple effects to the U.S. commercial real estate sector. According to Jefferies, small regional banks account for 70% of domestically chartered commercial banks' commercial real estate loans outstanding. Given the outflow of deposits at these institutions, credit may tighten at the very same time fundamentals worsen and/or remain persistently bad (as in the case of office assets). Credit tightness will likely extend beyond just the commercial real estate sector. According to JP Morgan, "of the $5tr stock of commercial loans extended by domestic US banks in the H.8 release (including commercial real estate loans), 41% were extended by the biggest 4 US banks by total assets, 43% by the next 300 listed US banks by assets (mid-size banks) and 16% by the remaining small and unlisted US banks." Clearly, mid-sized banks play a critical role in commercial loan originations. Regional bank deposit outflows and its implications on credit origination and the economy has yet to be felt.

As we reflect on the quarter that has passed, we continue to hold an optimistic view of our portfolio, both in comparison to the market and our benchmarks. Our stocks are valued at just over 15x our 2024 EPS estimate, a figure on par with the Russell 1000 Value. However, we anticipate mid-teens EPS growth for our companies over the next two years, a stark contrast to the flat consensus EPS growth projections for the Russell 1000 Value. We believe that consensus estimates for most of the stocks in our portfolio are too low, which we see as a significant safety net and a highly attractive risk/reward opportunity.

As of April 18th, our five largest positions were *AmerisourceBergen* **(ABC)**, Formula One (FWONK), APi Group (APG), *CACI International* **(CACI)** and *Crown Holdings* **(CCK)**, representing just over 32% of the total portfolio. Approximately 10.8% of the portfolio is currently held in cash.

As we navigate through these challenging times, adhering to our investment process, avoiding behavioral biases, and fostering a culture of intellectual honesty will be critical to our success. We appreciate your trust in us, and we remain committed to serving both our current and future valued clients. Please don't hesitate to reach out to us if you have any questions or concerns.

Sincerely,

Ari Sass
President & Portfolio Manager, M.D. Sass

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