MD Sass Concentrated Value

MD SASS

Q3 2023 Commentary

October 23, 2023

The MD Sass Concentrated Value ("CV") strategy was down -4.1%, net of fees, in the third quarter of 2023, vs. -3.2% and -3.2% for the Russell 1000 Value ("R1V") and Russell 3000 Value ("R3V") indices, respectively.

Year-to-date through the third quarter, CV was up +7.2%, net of fees, vs. +1.8% and +1.7% for the R1V and R3V indices, respectively.

From inception (January 2019) through the third quarter of 2023, CV had a net annualized return of +15.9% vs. +9.4% and 9.3% for the R1V and R3V indices, respectively.

Almost all investment firms focus on edge, while position sizing generally gets much less attention.
- Michael Mauboussin

My approach to position sizing has room for improvement. While I question where it lands between being an art or a science, I think my past decision-making has often felt a bit too arbitrary. That's not to say that I see a need for a complete overhaul, but I do believe my process could benefit from an approach that was more deliberate.
- Sean Stannard-Stockton, President & CIO of Ensemble Capital (via thescienceofhitting.com)

When asked about their approach to portfolio construction, long-only portfolio managers often mention a confluence of factors that drive their position-sizing decisions such as the timing of catalysts, sentiment, technical indicators and risk/reward considerations. However, the precise manner in which these factors determine position sizes tends to remain somewhat ambiguous. When probed, it becomes apparent that portfolio managers primarily rely on their accumulated experience and instincts when navigating the complex interplay of these variables. As these variables continually shift and evolve amongst a multitude of positions, a portfolio manager's response to these changes is often based on intuition in the absence of a quantifiable and measurable approach.

Truth be told, we, too, had used more art than science when it came to position sizing and portfolio construction. Risk/reward had been our primary determinant of position sizing but that felt inadequate. How do we incorporate our conviction in our estimates or the timeliness of the investment or other important considerations in a measurable way? Recognizing the inherent weakness with our approach we searched for a software platform that would incorporate not just position-level risk-reward but other relevant factors in a quantitative fashion. Ultimately, we found a solution called Alpha Theory. Alpha Theory enables us to combine a position's probability-weighted returns with a scorecard of other factors to derive optimal position weightings. We assign a value to five factors including Conviction, Timeliness, Management Quality, Business Quality and Leverage which derive a Confidence Level that is then weighted against a position's probability-weighted return to determine optimal position sizing. Other considerations also come into play, including liquidity, max drawdown limits and the degree of earnings differential vs. consensus. As these factors change and our scorecards change, we can quantify the impact on optimal position sizing and act accordingly.

The more science we can bring to position sizing the less likely we will be susceptible to behavioral biases. Instinct and intuition can be influenced by a variety of psychological effects and emotions, but a quantitative approach is more immune. As you may recall from prior memos, we are constantly looking for ways to combat behavioral biases and we believe the process enhancement we implemented is consistent with that objective.

Q3 PORTFOLIO REVIEW

The biggest contributors to performance in Q2 were *Blue Owl* **(OWL)**, *Avantor* **(AVTR)** and *Warner Music Group* **(WMG),** which collectively contributed approximately 116 bps to performance.

Heading into Q3, OWL's stock performance significantly lagged that of its alternative investment manager peer group. We believe this was largely a function of OWL's outsized exposure to the wealth management channel which was a big source of asset growth for OWL over the last few years. Fears of a sharp slowdown in asset raising coupled with concerns about macro credit deterioration negatively impacting the performance of its private credit funds hurt the stock's relative performance throughout much of 2023. However, OWL's private credit strategies have not seen any material degradation in credit performance, and we believe asset raising for private credit may be accelerating based on comments from management and SEC filings from several OWL-managed funds and *Blackstone* **(BX)** funds. Likewise, OWL appreciated 12.6% in the quarter. We believe the launch of new strategies, broader distribution for its real estate-related products and an acceleration in private credit demand within the wealth management channel will drive earnings results in excess of consensus expectations over the next few years.

Although AVTR was an out-performer in the quarter, we sold the position as we believe there are better ways to express our bullish long-term view on bioprocessing and life sciences. We will keep you in suspense and reveal the new position later in this memo.

WMG, a pure-play music content company, is a new position and we lay out the investment thesis later in this memo as well. The relative outperformance of the stock was largely due to price increases announced by multiple large digital service providers (DSPs), including *Spotify* **(SPOT)**, YouTube and *Amazon* **(AMZN)** along with a new licensing deal with TikTok that should provide added visibility to strong growth in 2023. Furthermore, Q2 results came in better than expected and management's guidance for accelerating digital music growth alleviated concerns about market share losses heading into the quarter.

The biggest detractors to performance in Q2 were *Formula One* **(FWONK)**, *TKO Group* **(TKO)** and *RTX Corp.* **(RTX)**, which collectively hurt performance by approximately 322 basis points in the quarter. We believe the stand-off between *Disney* **(DIS)** and *Charter* **(CHTR)** created concerns about the future growth rate of sports rights given CHTR's apparent willingness to drop ESPN from its TV lineup which acted as an overhang on both FWONK and TKO. This concern was exacerbated by the deal TKO signed with NBC for the broadcast rights for *Friday Night Smackdown*, which came in below consensus expectations. While we acknowledge that many traditional media companies are reticent to accept significant step-ups in media rights fees, we believe that media rights for certain properties will continue to grow at a healthy pace as newer, deep-pocketed digital platforms demonstrate increased interest in sports rights, including Amazon, *Google* **(GOOG)** and *Apple* **(AAPL)**. In the case of FWONK, we believe that its U.S. media rights are so undervalued that a moderation in overall sports

rights inflation will not have a material impact on its growth path over the next few years. We believe the recent media reports of Apple's appetite to spend $2B per year for global broadcast rights for Formula One (more than double what it currently generates) supports our view. With respect to TKO, we believe the UFC's U.S. media rights will step up meaningfully upon renewal in 2025 given the fact that ESPN generates a very strong return on its original investment, having increased pay-per-view fees significantly since the deal was inked from $59.99 per event to $79.99.

RTX underperformed in the third quarter due to the announcement that a previously disclosed powdered metal issue with its Pratt & Whitney geared turbofan (GTF) engines is worse than originally expected and will lead to a potential cost of $3B. Investors worry that the company has not properly ring-fenced the liability and there may be another shoe to drop. Based on conversations with industry experts and our own assessment of remediation costs to RTX's airline customers, we believe that the company has now set reasonable cost estimates. With the stock having lost about $30B of market cap since the original announcement, we believe the Street is discounting a permanent impairment to the Pratt & Whitney franchise which we believe is unwarranted given the fact that 1) newer GTF's do not have a powdered metal problem so it's a legacy issue, 2) RTX has a very large backlog of GTF engine sales and these can't simply be replaced, and 3) mixed fleets are an inconvenience to airlines and lead to higher maintenance costs. Sadly, the recent geopolitical tensions in Ukraine and the Middle East have led to a more favorable demand outlook for RTX's defense business and any increased confidence in management's GTF liability guidance should be well received by investors.

We initiated new positions in Warner Music Group (WMG) and *Danaher* **(DHR)** in the quarter, which we discuss below. We also initiated a smaller position in *Palo Alto Networks* **(PANW)** that we will write about in a future memo if the investment becomes a 3% position or higher at the end of any given quarter.

WARNER MUSIC GROUP (WMG)

WMG is the third largest music company globally after *Universal Music Group* **(UMG.NA)** and *Sony Group* **(SONY)** with approximately 18% market share of recorded music and 12% market share of music publishing. Like Sony and Universal, WMG operates numerous record labels in a decentralized fashion, each catering to specific genres. WMG's largest labels include Atlantic Records and Warner Records. WMG's music publishing business operates under one brand known as Warner Chappell. After being spun off from Time Warner in 2004 and sold to a group of investors led by Edgar Bronfman Jr., WMG went public in 2005 until it was acquired in 2011 by Len Blavatnik's Access Industries. In June of 2020, WMG went public once again via IPO. Via Class B shares, Access Industries retains a 73% economic interest and 98% voting interest in WMG.

When we initiated a position in WMG in July of this year, the stock was down 23% YTD and was 42% off from its October 2021 highs due to disappointing music industry growth rates post-COVID (leading to questions about saturation levels in developed markets), company-specific market share losses and fears regarding disruption from AI. Industry growth rates appear to be stabilizing, WMG's market share is growing again, and AI may be an opportunity not simply a threat. Furthermore, investors are overlooking potential near-term positive developments with respect to DSP price increases, a shift to value-based pricing methodologies and the expiration of below-market deals with emerging platforms like TikTok. With WMG trading near its trough valuation and 19.4x 2024 FCF/share at the time of investment, we believed WMG represented a compelling risk-adjusted investment and, despite the more recent increase in the share price, we still see 23% upside.

Although there are several elements to our investment thesis, the most significant one is pricing. We believe music is underpriced and has lagged the price increases achieved in other forms of entertainment. Goldman Sachs estimates that the industry's revenue per audio stream has declined 20% since 2017 given the growth in streaming volumes has not been matched with increases in subscription fees. Notably, the revenue per streaming hour on Netflix has INCREASED by ~60% between 2017 and 2020 and the revenue per streaming hour is about 4x higher for Netflix compared to Spotify. Music as a percentage of entertainment and nominal spend has declined over the past 20 years and is cheaper than most other major forms of entertainment on a consumption per hour basis. Adjusted for inflation, the U.S. recorded music industry is approximately 40% smaller than its inflation adjusted peak in 1999. Up until very recently, there had not been any price increases by the major U.S. DSPs but that is now changing. Executives from Sony, Universal, WMG and Spotify have all publicly expressed a desire for price increases and given the consolidated nature of the ecosystem, this should come to fruition quickly, subject to some modification to economic arrangements which we believe is currently being addressed. Consistent price increases would accelerate WMG's topline growth in developed markets and lead to positive consensus revisions to record label growth rates. Notably, in the past couple of months, YouTube, Amazon and Spotify have all announced price increases in the U.S. and other markets. Spotify, the #1 DSP globally, had previously never raised prices in the United States in its 12 years of operating in the region. We believe the recent price increase is just the start. On the company's August 8th earnings call, WMG CEO, Robert Kyncl said, "we believe the market will bear further price increases in the future, and we're expecting that they'll arrive on a more regular cadence than in the past."

Labels are also pushing for a change in the economic model. Currently, labels are paid pro rata based on their percentage of total audio streams on the DSPs. However, labels argue that not all streams are created equal and that a 31-second audio sample of rainfall is not as valuable as an Ed Sheeran track as subscribers would churn if a DSP didn't offer the latter. According to research by Universal, 80% of a DSP's customer acquisition and retention is based on the availability of current and catalog content by professional artists.

> *"…the platforms right now are flooded by a tidal wave of content as millions of creators gain access, these are essentially content uploaders, they're not artists in the sense that we traditionally think of artists. Nearly 80% of this multi-million creator uploading pool has a monthly audience of less than 50 listeners, and in fact 90% of these creators have fewer than 400 monthly listeners, that's 400 monthly listeners out of an audience of 400 million.*
>
> *So, just to put a data point behind that, that means that 90% of these uploaders are engaging less than 1 million of the platform. These are hobbyists that are playing to an essentially empty house. Conversely our consumer research shows that 80% of the customer acquisition and 80% of the customer retention is based on the availability of superstar artist content, classic catalog, and the body of work of career artists. Those are the real artists that were aligned with whose careers were focused on promoting. And so, this question of dilution ultimately is a question about the quality of user experience on these platforms."*

We believe a value-based pricing structure would offer significant upside to major record labels' growth rates over time. Interestingly, the *Financial Times* recently reported that Universal signed a value-based agreement with a small DSP called Deezer. Under the new arrangement, streams of songs from artists that generate 1,000+ listens per month will be given double the weight of streams when calculating royalty payments. If a listener actively seeks out a song or musician, the weight of those streams will double again. For example, if a user searches for "The Beatles" on the Deezer app and listens to one of their songs, it will be counted as four streams for royalty calculations. The article alleges that the new arrangement will lift payouts to professional artists by 10%. Should this model expand to the larger DSPs, we would anticipate a significant boost to WMG.

WMG should see price increases not just via DSPs but also from so-called "emerging platforms" as well. WMG generates over $370M in annualized revenues (~6% of total) from emerging platforms such as TikTok, Meta, Peloton, etc. According to a recent UBS report citing press reports, TikTok generated $13B in ad revenues in 2022 yet paid approximately $500M (less than 5% of revenues) to the record labels. By contrast YouTube, which has been licensing music content for a much longer period, paid more than $6B to the music industry in the 12 months ending June 2022. According to UBS, about $4B of the total was for ad-supported audio; thus, YouTube paid approximately 13% of its $30B in ad revenues to record labels vs. just 5% for TikTok. eMarketer estimates TikTok's revenues will grow to $17B in 2024. While we aren't suggesting that TikTok will pay 13% of revenues to the record labels, we believe there is considerable upside to the record labels' current level of monetization. WMG recently struck a new deal with TikTok that we believe will lead to a significant step up in payments to WMG in 2024.

Consensus estimates for WMG's Digital Recorded Music currently assume just 9% revenue growth in 2024, a figure we believe is far too low given the recent acceleration in streaming growth, a positive inflection in WMG's market share, recently announced DSP price increases, and the upside from the recent TikTok deal. Despite several positive fundamental developments, shares of WMG trade today at just 14.5x EBITDA, down from a peak of 27x, and just above their all-time trough of 12.2x. Universal, which has had more stable market share trends of late, better growth, and more liquidity than WMG, trades for about 18.8x EV/EBITDA. We think that gap will close as WMG's topline reaccelerates. A 16.5x multiple on 2024 EBITDA equates to a $40 target price, or 23% upside. If we are incorrect and growth slows, at 13.5x, the stock would be worth $30 or 9% below current levels.

DANAHER (DHR)

Founded in the 1980s, Danaher initially grew through acquisitions, concentrating on manufacturing businesses in industrial sectors. Over time, they expanded into healthcare with a similar approach: securing strong positions in growing niche markets with recurring revenues. Danaher's unique approach kept acquired companies autonomous. The shift towards healthcare began in 2011 with the acquisition of Beckman Coulter, a clinical diagnostics leader. Later, Pall Corp (2015) added filtration technology for diverse industries including bioprocessing, followed by Cepheid (2016) with molecular diagnostics. In 2020, the game-changer came with the acquisition of GE's Biopharma (now Cytiva), enhancing their presence in bioprocessing capabilities. The recent spin-off of *Veralto* **(VLTO)**, its Environmental and Applied Science business, is the bookend to a series of spin-offs and divestitures done over the last decade to transform the company into a pure-play life science and biotechnology leader.

Danaher (DHR) has been a long-term compounder with annualized returns of 16% over the past 20 years vs less than 10% for the S&P 500. Its strategic shift towards dominant positions in healthcare growth sectors like bioprocessing, molecular diagnostics and genomics, fueled this success. However, the stock has materially underperformed the market over the past couple of years due to disappointing results stemming from short-term headwinds including tough COVID comps and significant customer inventory de-stocking. We foresee these issues waning, supported by conservative guidance. This sets the stage for renewed growth, restoring Danaher's market-beating compounding trend.

Danaher operates within three core business segments: Biotechnology, Life Sciences, and Diagnostics. Danaher's diverse portfolio of businesses shares several appealing characteristics, which underpin the expectation of consistent long-term growth in revenues, profits, and returns. These key traits include:

1. *Revenue Stability*: Approximately 80% of Danaher's revenues are recurring in nature, providing a solid foundation for management to plan effectively. This stability contrasts with more volatile revenue sources.

2. *Specification-Based Revenues*: A significant percentage, potentially up to 50%, of revenues are "spec'd in," meaning they are integral to the manufacturing process of therapeutic products. Switching providers is costly and time-consuming, which is why many large customers express a strong preference for sticking with Cytiva and Pall due to their excellent partnership track record and reluctance to risk switching.

3. *Brand Recognition and Comfort*: An often overlooked but valuable aspect is the brand awareness and comfort associated with Danaher's products. Medical students and young scientists often learn on Cytiva, Pall and Beckman Coulter machines due to their widespread presence. This familiarity simplifies both new and follow-on sales. Moreover, Danaher's technologies are highly scalable and user-friendly, making them accessible and effective on a global scale.

The Biotechnology and Life Sciences segments are levered to the growth in biologics which we believe will grow at a low-teens growth rate over the next five years. *Repligen* **(RGEN)**, a competitor to DHR, estimates that the mAbs (monoclonal antibodies) market will grow greater than 10% annually and Cell & Gene Therapy (C>) will grow greater than 25% annually, implying a blended total bioprocessing market growth of approximately 11%. This growth rate is supported by the robust pipeline of products in clinical trials which dwarfs the total number of existing FDA approved biologics. We believe this forecast is consistent with other industry stakeholder estimates including those of *Catalent* **(CTLT)**, a large contract manufacturer of biologics who estimates a long-term growth rate of 10%-15%. Cowen estimates that the manufacturing volume requirements to meet future demand necessitates a mid-teens growth rate that will drive sales of both equipment and consumables for Danaher. There are many drivers of this expected growth, including the proliferation of biosimilars, emerging Alzheimer's and GLP-1 therapies, and demand for oncology therapies. As many of the original large molecule drugs have gone off-patent the generic versions – called biosimilars – have taken significant share. The lower prices for these products have increased global adoption and benefited industry volumes. The industry is headed into another wave of blockbuster biologics losing exclusivity. More volumes should lead to more demand for DHR's Biotechnology and Life Sciences products.

Scientific breakthroughs with new modalities (C> and mRNA for example) are a long-term growth driver, but breakthroughs in the massive Alzheimer's and obesity categories will also be a tailwind. Alzheimer's especially will benefit DHR as the therapies from *Eli Lilly* **(LLY)**and *Biogen* **(BIIB)** are mABS where the company has a leading position. The therapies require significantly more materials per patient than other large molecule therapies, also supporting a large increase in bioprocessing demand. It is still early days for these therapies, but even assuming the lower end of estimated peak sales (~$5B), these therapies could add ~+1-2% to annual revenue growth for the associated DHR businesses in Biotechnology and Life Sciences. If peak sales come in multiple times higher like many experts predict, DHR volumes could be significantly higher.

Diagnostics should grow at a similar rate to the Biotechnology and Life Sciences segments. Several factors contribute to this growth projection. Firstly, we anticipate continued expansion into high-growth markets, which today constitute approximately 25% of segment revenues, as healthcare standards continue to improve. Secondly, the demand for automated and user-friendly instruments, a forte of Beckman Coulter and Cepheid, is poised to thrive due to skilled labor shortages and rising labor costs. Most significantly, the increased adoption of molecular testing will be a long-term growth catalyst, with the pandemic accelerating its uptake. The installed base of Cepheid's GeneXpert more than doubled from 2019 to 2022 and

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revenues increased more than 4x. We believe the larger installed base will drive significant growth in consumables over the next few years for the molecular diagnostics business which is nearly half of the revenue for the Diagnostics segment.

In sum, DHR should organically grow revenues at least high single-digits which is more than consensus estimates but consistent with their long-term growth algorithm. The consensus revenue CAGR for DHR from 2023 to 2027 is approximately 7.2%, which we believe creates a low bar for positive earnings revisions after over a year of negative earnings revisions dating back to March 2022.

DHR excels at acquiring and enhancing businesses, with their secret weapon being the Danaher Business System (DBS). DBS is a holistic management philosophy and operational framework applied throughout DHR's enterprises. It centers on continuous improvement, efficiency, and innovation, streamlining processes and optimizing performance at all levels. By integrating DBS principles into M&A activities, Danaher generates value through cost synergies and nurtures a culture of ongoing improvement and innovation within its diverse business portfolio. This results in sustained growth and improved performance, benefiting shareholders. While many serial acquirers have destroyed value by demonstrating declining returns on invested capital (RoIC), DHR has nearly doubled its ROIC from 2015 through 2022 despite several sizable acquisitions. Danaher has significantly more capacity for M&A relative to its peer group given its unlevered balance sheet, positioning the company for greater optionality of delivering shareholder value via smart capital allocation. A recent Goldman Sachs report noted that DHR has the capacity to do an additional $30B of M&A in a scenario where the company takes net debt to 4x EBITDA, dwarfing the capacity of its mature Tools peer group.

The short-term headwinds described earlier have driven a series of negative earnings revisions over the last year. We believe we are at the end of that revision cycle and that management has set conservative guidance such that the bias going forward is to positive revisions, which will drive positive sentiment and improved relative stock performance. Regarding its customers' inventory de-stocking issue, DHR pivoted from its usual practices in Q2 by adjusting customer inventories. Despite having penalty clauses for order cancellations in customer contracts, management chose to waive these penalties and only accepted orders for near-term needs. This decision negatively impacted 2H23 revenue guidance but paves the way for stronger fundamentals exiting this year.

Danaher's long-term growth algorithm calls for high single-digit revenue growth and 35%-40% incremental margins, leading to double-digit EPS growth. With the transitory headwinds described above now largely behind the company, we think Danaher is poised to see revenue growth and incremental margins in excess of its long-term model, resulting in high-teens earnings growth over the next few years. Assuming the multiple remains stable, we believe shares could be worth $429 (27x our 2028 EPS estimate of $15.87), equating to an expected 17% IRR. Conversely, our downside price target of $234, which assumes slowing end-market growth, reflects a 13% potential decline. In summary, we believe that the current share price offers an attractive risk/reward profile for long-term investors in Danaher.

As of October 20th, our five largest positions were Formula One (FWONK), *APi Group* **(APG)**, *Chemed* **(CHE)**, *Charles River Laboratories* **(CRL)** and *Clean Harbors* **(CLH)**, representing 32% of the total portfolio. Approximately 6.8% of the portfolio is currently held in cash and cash equivalents.

MARKET COMMENTARY

Over the course of about two years, the consensus went from "inflation is transient" to "higher for longer." Deglobalization, geopolitical tensions and tight labor supply have raised concerns about structural inflation and, likewise, structurally higher rates. Logic would dictate that higher interest rates are bad for the NASDAQ, yet it appears that the tech heavy (duration heavy) index has decoupled from rates this year with the NASDAQ 100 up 37% this year as of this writing despite a 100+ bps increase in the 10-year treasury. One explanation for this is that the NASDAQ has an "easy comp" given the blood bath it took last year but clearly the hype around AI is another factor. The consensus view that the largest tech companies are the biggest AI beneficiaries explains why, according to Jefferies, the largest seven S&P 500 names have seen their P/E multiples expand from 29x to 45x while the rest of the S&P 500 hovers around 19x. In fact, the S&P 500 is up nearly 14% as of this writing whereas the equal weighted S&P is virtually unchanged.

If you thought moderating economic growth and rising geopolitical tensions would lead to outperformance of "defensive" sectors such as Staples and Utilities, well, you were wrong. Year-to-date through the end of Q3, the *Utilities Select SPDR* **(XLU)** was down 14.4% while the *Consumer Staples Select SPDR ETF* **(XLP)** was down nearly 6%. A confluence of factors explains their underperformance including the sharp rise in long-term rates, fears of a slowdown in consumer spending and, in the case of Staples, the rise of GLP-1 drugs that lead to weight loss as well as appetite suppression. Talking heads and pundits have been very quick to declare GLP-1 winners and losers with the latter being largely food and beverage companies. We believe the dramatic underperformance in certain Consumer related stocks is creating some potentially attractive long-term investment opportunities which is top of mind for our team.

FIRM UPDATE

Our objective has always been to reinvest a portion of our asset growth into the expansion of our research resources. Thus, we are pleased to announce a new addition to the investment team. Joon Lee joins us from Point72 where he was a TMT-focused analyst. Prior to Point72, Joon was an analyst at Causeway Capital and started his career as a sell-side analyst at Bank of America Merrill Lynch and Goldman Sachs. Joon brings 10+ years of investment experience with extensive knowledge of technology and media, complementing the core competencies of the rest of the team. We now have three analysts that clock in over six feet tall, which probably makes us one of the tallest investment teams on Sixth Avenue.

Additionally, we are pleased to welcome Edward Riley to the MD Sass family as Senior Managing Director, Sales and Relationship Management. Prior to joining the firm, Ed spent over ten years at Iridian Asset Management as SVP of Business Development, Client Relations and Consultant Relations. Prior to Iridian, Ed held sales and marketing positions at EIM Management, Bank of Ireland Asset Management and Lazard Freres. He isn't quite as tall as most of the investment squad, but we don't hold that against him.

Thanks for your continued support and interest. 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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