MD SASS

April 11th, 2019

MD Sass Concentrated Value

Q1 2019 Commentary

The MD Sass Concentrated Value ("CV") strategy was up +17.1%, net of fees, in the first quarter of 2019. This compares favorably with the +11.9% return for both the Russell 1000 Value and Russell 3000 Value indices for the quarter. The biggest contributors to performance were ***Crown Holdings*** (**CCK**), ***Bausch Health*** (**BHC**), ***Caesars Entertainment*** (**CZR**), ***Fortune Brands*** (**FBHS**) and ***Gildan Activewear*** (**GIL**), which collectively added about 566 bps to performance.

The rebounds in CCK, BHC and CZR largely reflected a recovery from excessive selling pressure during the market malaise in Q4. Many stocks with leverage on their balance sheets, like these, were severely punished in Q4 regardless of their cost of debt, ability to pay, duration of liabilities, etc. All three met or beat consensus earnings expectations and significantly outperformed as fears subsided in the quarter. Although FBHS missed Q4 '18 estimates, investor sentiment was much worse than the earnings results implied. The stock also rallied as investors took comfort that the fundamentals will likely inflect positively through the course of 2019. FBHS suffered from a weaker housing market, China tariffs and significant commodity inflation which we think is largely in the rearview mirror. Although GIL issued guidance for Q1 '19 that missed expectations, we believe that the issues impacting Q1 are transient and management's commentary regarding private label apparel, gross margins and 'fashion basics' apparel was quite positive. Consequently the stock rallied despite the disappointing Q1 guidance.

Only two positions detracted from performance in the quarter – ***Mohawk Industries*** (**MHK**) and ***Sabre*** (**SABR**) which collectively hurt performance by 40 bps. MHK is a new position established within the quarter, discussed later in this letter. SABR declined as the company's outlook for the year missed consensus EPS estimates. However, we believe free cash flow ("FCF") is more relevant and the company raised its FCF forecast. Also, there was confusion as a result of changes to accounting standards and a shift in technology spending from capex to opex that optically depressed EPS. We believe investors will likely appreciate SABR's FCF growth potential as we progress through the year.

We initiated several new positions in the quarter including MHK, ***Booking Holdings*** (**BKNG**), ***Vulcan Materials*** (**VMC**), ***Ball Corp*** (**BLL)** and ***Air Products & Chemicals*** (**APD).** The following is a brief synopsis of our investment thesis for each:

- *MHK* is one of the largest flooring companies in the world with a cost/scale advantage vs. peers. The CEO, Jeff Lorderbaum, is a highly regarded operator with significant skin in the game to the tune of $1.3B of stock. The industry underwent rapid change the past couple of years as luxury vinyl tile ("LVT") gained share at the expense of other flooring types. Although MHK is ramping its own LVT capacity in the United States., the process has led to elevated startup costs and slowing sales. Also, rising commodity prices outpaced price increases, further depressing profit margins and earnings growth. We believe that the worst is behind them and margins should improve sequentially every quarter of this year and in 2020 as their LVT capacity comes online. At 11.5x our 2019 estimate, MHK is trading at a trough multiple on arguably trough earnings. We are comforted by $100M+ worth of insider buying within the past year.

- *BKNG* is the largest online travel agency ("OTA") in the world whose brands include Booking.com, Kayak.com, OpenTable and Priceline.com. The stock was under pressure due to its ~75% exposure to Europe, which is experiencing a slowdown in travel due to Brexit, the Italy recession, protests in France, etc. We believe this creates a great opportunity to own the leading franchise in a growth sector at what we believe to be a very reasonable price. Excluding the $108/share in net cash on the balance sheet, BKNG is trading for 16x our 2019 EPS estimate, an attractive valuation relative to the consistent double digit growth we expect over the next few years. With online bookings representing just ~38% of the total lodging market, we believe there is plenty of opportunity for BKNG to gain additional market share. There's additional upside potential from increased growth in alternative accommodations and online bookings of tours/experiences.
- *VMC* is the largest manufacturer of aggregates in the United States that is sold into the baseload, asphalt and redi-mix markets. We believe the aggregates business is very attractive with high barriers to entry. New capacity is difficult to bring online and can take many years and the cost to transport aggregates is very high. For these reasons, the industry has consistently enjoyed healthy and sustained pricing power. More recently, poor weather and delayed project funding by customers led to a slowdown in volume growth and disappointing results. We believe this has created an attractive entry point in the stock as we expect improving volume growth and a better mix of sales to drive healthy pricing. With the stock trading at the low end of its 10 year valuation range we believe an inflection in volumes/price will lead to a positive re-rating of the stock.
- *BLL* is one of the largest manufacturers of aluminum cans serving the beverage markets globally. The aluminum can industry is benefitting from industry consolidation (Ball acquisition of Rexam) and a mix shift in substrates from plastic to aluminum. These dynamics, along with a very rational competitive environment, are leading to volume growth and the opportunity for BLL to reset customer contracts at more favorable prices. As prices increase and volumes accelerate with new product launches favoring aluminum over plastic, we are likely to see margin expansion. Our 2020 EPS estimate is about 20% higher than consensus and the defensive characteristics of the business should cushion the company from the economic cycle.
- *APD* is a leading provider of industrial gases with a strong position in diverse end markets including chemicals, electronics, manufacturing, medial, food/beverage and energy. Over the past 5 years, APD has shed non-core businesses, exited bad contracts and focused resources on high RoIC projects under the leadership of CEO, Seifi Ghasem, who bought $3.2M of stock on the open market in Nov. '18. APD could spend $15B on development opportunities over the next 4 years that could generate an incremental $5 in EPS assuming a 10% IRR. Further, APD's acquisition of intellectual property from Shell and GE should give them an advantage in gasification projects that could drive meaningful growth over the next few years. We expect a mid-teens CAGR in EPS over the next few years with defensive characteristics even in a downturn as the majority of revenues are under 'take or pay' contracts.

During the quarter we sold *VICI Properties* (**VICI**), *IQVIA Holdings* (**IQV**), *MetLife* (**MET**), *Tempur Sealy* (**TPX**) and *Royal Caribbean* (**RCL**). The VICI and IQV sales were valuation driven after strong moves in the stock prices and the RCL sale was driven by our desire to concentrate our cruise exposure on the "best horse," which we believe to be *Norwegian Cruise Line* (**NCLH**). As of March 29th, our five largest positions were *Comcast* (**CMCSA**), GIL, *LKQ Corp* (**LKQ**), *NRG Energy* (**NRG**) and CCK which represented about 24% of the total portfolio.

As we previously communicated in a memo dated 2/11/19, we initiated several changes to portfolio construction and the management thereof. The following are highlights of these changes:

- Ari Sass has assumed the role of Portfolio Manager with Martin Sass continuing to serve as CEO & CIO of the MD Sass organization and advisor and mentor to the equity team.
- The strategy's name has changed from Relative Value Equities to Concentrated Value to better reflect the intent to focus on a more concentrated portfolio of ~25 positions.
- The portfolio targets a *median* market cap comparable to the median market cap of the Russell 1000 Value.
- Pursuant to conversations with outside compliance advisors, these enhancements require a new GIPS-compliant composite for Concentrated Value, effective January 1, 2019. CV will be benchmarked against the Russell 1000 Value and the Russell 3000 Value indices.

Effective January 28, 2019, Harish Karhade joined our team as a Senior Equity Analyst. Harish has roughly a decade of investment experience and previously held Equity Analyst positions at LTO Capital, Orbis Capital and Inle Capital. Harish graduated with a bachelor's degree from MIT and an MBA from Harvard Business School. After screening many potential candidates, we found Harish to be the most highly qualified in every respect.

Thanks, as always, for your continued support and confidence.

Sincerely,

Ari Sass

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