July 8th, 2019

MD Sass Concentrated Value

Q2 2019 Commentary

The MD Sass Concentrated Value ("CV") strategy was up +5.8%, net of fees, in the second quarter of 2019, which compares favorably to the Russell 1000 Value and Russell 3000 Value indices that returned +3.8% and +3.7%, respectively. CV is up +23.8% YTD thru the end of Q2, vs +16.2% and +16.0% for the Russell 1000 Value and Russell 3000 Value indices, respectively. The biggest contributors to performance in Q2 were ***AECOM*** (**ACM**), ***Fortune Brands*** (**FBHS**), ***Take-Two Interactive*** (**TTWO**), ***Mohawk Industries*** (**MHK**) and ***Crown Holdings*** (**CCK**), which collectively contributed approximately 398 bps to performance.

ACM's strength in the quarter was driven by its decision to spin-off the Management Services segment to shareholders in a tax-free transaction. Valuing ACM using a sum-of-the-parts analysis suggests ACM is cheaper than its peers and the spin-off may unlock value. An activist also disclosed a stake at the end of the quarter and is pushing for an outright sale of the Management Services business. Lower interest rates, benign inflation and an improving housing environment led to outperformance in the Building Products sector that helped drive outperformance for FBHS and MHK. We believe both stocks remain attractively valued and margins should outperform consensus expectations over time as their pricing actions catch up with last year's inflation pressures. TTWO rallied after strong earnings and providing their typical conservative full year guidance. TTWO is a new position that we will discuss later in this memo. CCK's strong position in aluminum cans continues to provide a favorable investment backdrop as consumer packaging shifts from plastics to more sustainable/recyclable aluminum. Pepsi's recent announcement that it will start selling water in cans and reduce its dependence on plastics is indicative of the broader industry trends that favor CCK.

The largest detractors from performance in the quarter were ***NRG Energy*** (**NRG**), ***LKQ Corp*** (**LKQ**), ***Webster Financial*** (**WBS**), ***58.com*** (**WUBA**) and ***Qorvo*** (**QRVO**), which collectively hurt performance by nearly 161 bps. NRG's underperformance was largely due to a report by the Texas energy grid operator, ERCOT, of a larger renewable energy development pipeline than previously reported. However, NRG's business mix and the tight supply in the power market should provide an attractive outlook for NRG, which is trading at a double-digit free cash flow yield. Weaker than expected Q1 results drove the relative underperformance of LKQ. We continue to believe that LKQ will experience better organic growth and margin expansion with the potential for double digit EPS growth over the next couple of years, yet it trades at a depressed valuation of just 10x our 2020 EPS estimate. WBS shares were weak due to lower interest rates. WBS is a highly asset sensitive bank, but we believe the current price implies draconian net interest margin pressures and provides an attractive risk/reward potential. QRVO has been a victim of the ongoing China trade war and, specifically, the U.S. ban of sales to Huawei, a large QRVO customer. QRVO lost more market cap than the total value of the Huawei relationship, which we believe provides an attractive setup for the stock.

We initiated several new positions in the quarter including TTWO, ***Target*** (**TGT**), ***CarMax*** (**KMX**), ***Carnival*** (**CCL)** and ***Charles River Labs*** (**CRL).** The following is a brief synopsis of our investment thesis for each:

- *TTWO* is one of the largest videogame publishers with several blockbuster franchises including *Grand Theft Auto*, *NBA 2K*, *Red Dead Redemption*, and *Borderlands*. The publicly traded videogame publishers underperformed the market in 2018 due to the sudden success of *Fortnite* and company-specific issues at Activision and EA that negatively impacted sentiment for the entire group. We believe that TTWO is well positioned for double digit long-term earnings growth due to its investment in new intellectual property, continued growth of *NBA 2K* and margin enhancements as its sales mix continues to shift to digital from physical. We believe consensus estimates are too low as the Street is not giving TTWO enough credit for its emerging new franchises (such as *Outer Worlds*) and its forthcoming delivery of new content for *Grand Theft Auto Online*. Longer term, the proliferation of cloud gaming via services from Google and others should expand their addressable market and reduce royalty fees paid to leading platform distributors like Microsoft and Sony.
- *TGT* is one of the largest retailers in the United States by revenue and operates 1,800 stores with ~$80B in sales. The distribution of physical goods has evolved rapidly over the past decade as e-commerce changed the competitive landscape. Multiple industry players have attempted to navigate the dynamic retail environment via investments in "omni-channel" capabilities, increased focus on private label goods and tweaks to product assortments and SKUs. We believe Target is one of the few winners in this ongoing competitive retail battle as it finally begins to reap the benefits of its investments that should lead to continued earnings acceleration and a re-rating of the stock. We believe the large valuation gap with WMT will diminish as TGT continues to execute on its omni-channel initiatives.
- *KMX* is a leading used car dealership chain in the United States with over 200 stores. Like TGT, KMX has spent the past few years investing in technology to future proof its business model and solidify its competitive moat via omni-channel capabilities. These investments hurt margins over the past few years, but the company is finally seeing the fruits of its investments. Early online initiatives have proven successful with same-store sales comps up double digits in Atlanta, the first launch market for its new omni-channel strategy. We believe KMX's online efforts will expand its addressable market and provide more favorable unit economics that should increase operating margins over time. Ultimately, we believe this will lead to further share gains for KMX, which operates in a highly fragmented industry. Furthermore, we believe the spread of new vs. used car prices is at unsustainably tight levels and a widening of the spread will benefit KMX as the value proposition of used cars increases.
- *CCL* is the largest global cruise line operator with several leading brands including Holland America, Costa, Princess and AIDA. CCL has dramatically underperformed the market and its peer group due to a string of disappointing financial results that caused consensus estimates to get revised lower multiple times over the past year. Several issues facing CCL are transient in nature and the company should experience increased returns on invested capital as it laps headwinds from fuel, weak European sourced demand and extraordinary itinerary adjustments that negatively impacted earnings. We believe CCL is trading at a trough multiple, yet it should experience double digit EPS growth. Recent insider buying is also a positive sign.
- *CRL* is a contract research organization focused on early stage clinical development, safety and quality control for pharmaceutical and emerging biotech companies. An increase in VC funding for early stage biopharma has led to an acceleration in growth as the number of clinical trials has proliferated. We believe CRL is well positioned to not only grow revenues at a double-digit rate but also expand margins as investments in facilities and labor have peaked ahead of new client engagements. This organic growth should be augmented by accretive M&A given the company's healthy balance sheet and strong free cash flow.

During the quarter we sold ***Lennar*** (**LEN**), ***Caesars Entertainment*** (**CZR**), ***Booking Holdings*** (**BKNG**), ***Microsoft*** (**MSFT**), ***Ball Corp*** (**BLL**) and ***Packaging Corp of America*** (**PKG**). The LEN, MSFT and BLL sales were valuation driven after strong moves in the stock prices. We exited BKNG due to deteriorating travel trends in Europe and the potential for negative earnings revisions as fundamentals and foreign exchange take their toll on BKNG's growth prospects. We sold CZR because the thesis did not play out as expected and a new risk emerged that was not previously

anticipated, namely, the potential rollback of parking and resort fees in Las Vegas. We sold PKG because the thesis has been impaired by our recent discovery that Amazon and other e-commerce leaders are "right sizing" their packaging utilization, hampering overall growth for PKG and other containerboard producers.

As of June 30th, our five largest positions were CCK, ***Bausch Health*** (**BHC**), ***Comcast*** (**CMCSA**), ***Gildan Activewear*** (**GIL**) and ***Sabre*** (**SABR**) which represented about 24% of the total portfolio.

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

Sincerely,

Ari Sass

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