October 11th, 2019

MD Sass Concentrated Value

Q3 2019 Commentary

The MD Sass Concentrated Value ("CV") strategy was up +1.7%, net of fees, in the third quarter of 2019, vs. increases of +1.4% and +1.2%, respectively, for the Russell 1000 Value and Russell 3000 Value. CV was up +26.0% YTD thru the end of Q3, vs +17.8% and +17.5% for the Russell 1000 Value and Russell 3000 Value indices, respectively. The biggest contributors to performance in Q2 were ***Target*** (**TGT**), ***LKQ Corp*** (**LKQ**), ***NRG Energy*** (**NRG**), ***Qorvo*** (**QRVO**) and ***Crown Holdings*** (**CCK**), which collectively contributed approximately 311 bps to performance.

TGT rallied nearly 25% after the company beat Q2 earnings estimates and raised full year guidance. TGT posted healthy same store sales growth and generated meaningful operating leverage – a formula that is core to our thesis as outlined in our Q1 2019 quarterly letter. LKQ was up over 18% in the quarter after the company outlined a comprehensive action plan to substantially increase margins in its European business and after ValueAct, a reputable activist investment firm, reported a 5.2% stake in the company. We believe LKQ has significant upside potential from material restructuring actions and management changes with the probabilities of both considerably higher due to the aforementioned developments. NRG's strong performance in the quarter was driven mostly by higher power prices in Texas amidst tight supply during the peak summer months as well as a relief rally after underperforming in Q2. We believe the Street continues to misperceive NRG as an independent power producer despite its ongoing transformation into a vertically integrated retail energy company. QRVO reported strong earnings results and the guidance was well-received considering the ban on shipments to Huawei. We believe the arrival of 5G phones in 2020 and beyond will drive significant content growth for QRVO given that mobile phone radio frequency (RF) requirements will rise considerably. Investor sentiment towards CCK continues to improve as aluminum cans gain market share from plastics and glass. New, fast growing product categories like spiked seltzer over-index to aluminum cans and major beverage producers have publicly announced initiatives to drive legacy product categories, like bottled water, to aluminum cans. CCK remains stubbornly cheap relative to ***Ball Corp.*** (**BLL**) and we expect that valuation gap to narrow as the former continues to renegotiate customer agreements at more favorable terms which will drive an increase in returns on invested capital.

The largest detractors from performance in the quarter were ***58.com*** (**WUBA**), ***Mohawk Industries*** (**MHK**), ***Bausch Health*** (**BHC**), ***Gildan Activewear*** (**GIL**) and ***SVB Financial*** (**SIVB**), which collectively hurt performance by 252 bps. WUBA has been a victim of the ongoing U.S./China trade war. As the largest online classifieds platform for jobs and used homes, investors remain cautious about the prospects for growth in a protracted conflict. While we acknowledge the risks, we believe the stock is undervalued relative to its prospects for continued double-digit growth at 12x earnings. MHK provided a disappointing outlook for Q3 EPS, which sent the stock nearly 16% lower for the quarter. We continue to believe that MHK's cyclical slowdown is at, or near, its trough as the company ramps capacity for luxury vinyl tile (LVT) and as the inventory build of Chinese ceramics in the United States ahead of the tariffs has peaked. BHC underperformed roughly in-line with the broader pharmaceutical sector in Q3. The upcoming U.S. elections is causing angst amongst healthcare investors who fear the election of Elizabeth Warren or Bernie Saunders would put downward pressure on drug pricing. GIL reiterated full year guidance but provided a disappointing outlook for Q3 which implies a V-shaped growth outlook for Q4. Although Q3 results won't be as positive as we'd hoped, we

do not think there is any change to our structural bull thesis that its private label apparel will take market share from branded producers. SIVB under-performed as short-term interest rates declined and the yield curve inverted. As an asset sensitive bank, SIVB's growth outlook has diminished with the movements in rates. However, the risk/reward at this price is attractive to us as it approaches a trough multiple on near trough net interest margins.

We initiated several new positions in the quarter including ***Quest Diagnostics*** (**DGX**), ***NXP Semiconductors*** (**NXPI**) and ***Sony*** (**SNE).** The following is a brief synopsis of our investment thesis for each:

- DGX is one of the leading lab diagnostics companies in the United States, along with ***Lab Corp.*** (**LH**), with approximately 9% share of the $82B market. The Protecting Access to Medicare Act of 2014 (PAMA) has disrupted the lab diagnostics market with Medicare pricing set to decline by ~30% over a three-year period. PAMA will ultimately be a $200M EBTIDA headwind for DGX by 2020 as Medicare represents about 10% of DGX's revenues. However, we believe the impact to DGX's competition will be much worse and estimate that the remainder of the industry could see as much as 80% of its profits wiped out given DGX's and LH's peers are much smaller and much more dependent on Medicare revenues. Therefore, while the PAMA impact to DGX in the short-term is negative, we believe the long-term impact favors scale incumbents like DGX, which will likely take additional market share as its competitors go out of business. Our checks suggest that small to mid-size lab companies are already operating at breakeven to a slight loss, which we expect to worsen as PAMA cuts continue in 2020. The third largest U.S. lab company, Bio-Reference, has negative operating margins despite its scale. Ultimately, we believe DGX will be a share gainer, which will enable it to gain better leverage with commercial insurers. At less than 15x our 2020 EPS estimate, the stock is attractive relative to our expectations for double digit EPS growth.
- NXPI is the largest semiconductor company focused on the automobile sector (48% of revenues) with a strong presence in Industrial/IoT (19%), Communications Infrastructure (19%) and Mobile (12%). The stock has lagged the market and its peers over the past five years due to the collapse of a takeover bid from QCOM and the subsequent recession in the semiconductor industry. We believe the current valuation (<12x our '20 EPS estimate) provides an attractive entry point to own a company leveraged to the long-term secular growth in semiconductor content for automobiles. From 2012-2018, auto production grew at 2.4% yet automobile semiconductors grew at 8% and NXPI's auto business at 9%. The emergence of active safety, radar, digital dashboards and vehicle networking has led to a significant increase in semiconductor content per car sold, which we expect to persist as electric vehicles and various levels of autonomous driving continue to gain share of the vehicle fleet. Additionally, NXPI has idiosyncratic growth drivers from battery power management, ultra-wideband technology (which was just adopted in the new iPhone 11), and advanced driver-assistance systems (ADAS). Our estimate for 2020 EPS is about 8% higher than consensus.
- SNE is a Japanese conglomerate with significant global operations in Music, Gaming, Semiconductors, Film, Electronics and Financial Services. SNE also has a $7B securities portfolio in stocks such as Spotify, M3 and Olympus. We believe SNE is trading for less than 13x fiscal 2019 EPS after backing out SNE's stakes in listed securities, despite attractive secular tailwinds in Music, Gaming and Semiconductors that collectively account for over 70% of EBIT. Sony Music is the third largest record label and largest music publisher globally. After a decade of decline, the music industry is growing once again thanks to the rise of music streaming, which provides attractive economics to the labels while mitigating the damaging effects of piracy that plagued the industry during the early days of the internet. We expect Sony Music to continue to grow mid-high single digits as streaming proliferates and music publishing rates continue to rise. The Gaming segment should enjoy healthy growth over the next few years as the new console cycle takes hold in 2020 with the arrival of PlayStation 5. We expect that the rise of cross-platform gaming, in-game microtransactions and digital delivery of full games will provide a positive tailwind to margins as well. Approximately 80% of SNE's Semiconductors business consists of image sensors where SNE has over 50% market share within mobile phones. The number of cameras per phone has steadily increased, which has led to growth in content per phone for SNE. Image sensors are the critical component to improving picture quality

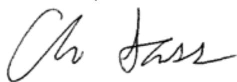
and the $13B market has been growing double digits as the # of image sensors per smartphone has increased from 2 in 2015 to ~2.7 in 2019. We expect this trend to continue along with new opportunities for image sensors in the automotive segment where SNE has a much lower share despite world class technology. In sum, we expect the company to compound earnings per share at a double-digit rate over the next few years, yet we believe the stock trades at a meaningful discount to the market.

During the quarter we sold ***Vulcan Materials*** (**VMC**), ***Air Products & Chemicals*** (**APD**) and ***GCI Liberty*** (**GLIBA**). The VMC and APD sales were valuation driven after strong increases in the stock prices. We exited GLIBA after a strong move in the stock this year but, more importantly, due to emerging risks that were not present at the time we initiated the position 2017 – the maturation of the broadband market and the launch of DIS+ that represents a fragmentation of content delivery more broadly. We reduced our exposure to cable considering the aforementioned risks and have concentrated our cable exposure to ***Comcast*** (**CMCSA**) – an operator with a better video strategy, less leverage and stronger track record of execution vis-à-vis CHTR.

As of September 30th, our five largest positions were NRG, CCK, DGX, BHC and ***Norwegian Cruise Line*** (**NCLH**), representing nearly 24% of the total portfolio.

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

Sincerely,



Ari Sass

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