MD Sass Concentrated Value

Q4 2019 Commentary

January 13, 2020

The MD Sass Concentrated Value ("CV") strategy was up +12.2%, net of fees, in the fourth quarter of 2019, vs. +7.4% and +7.5% for the Russell 1000 Value and Russell 3000 Value indices, respectively.

For the full year 2019, CV was up +42.0%, net of fees, vs. +26.5% and +26.3% for the Russell 1000 Value and Russell 3000 Value indices, respectively.

The biggest contributors to performance in Q4 were *Qorvo* (**QRVO**), *Bausch Health* (**BHC**), *58.com* (**WUBA**), *SVB Financial* (**SIVB**) and *Target* (**TGT**), which collectively contributed approximately 590 bps to performance.

QRVO, a leading manufacturer of radio frequency ("RF") semiconductors, rallied nearly 57% in Q4 after the company reported better than expected earnings and offered guidance well ahead of consensus. We believe QRVO's business is at a positive inflection point with the arrival of 5G mobile devices which will lead to a significant increase in RF content per phone. Management expects their addressable market to grow nearly $2B next year driven by 300M 5G devices sold with $6-$7 of incremental content per phone. This would equate to double digit revenue growth assuming QRVO maintains its market share. We believe QRVO could gain share in 2020 considering **AVGO**'s decision to exit the RF business.

BHC increased 39% in the quarter after reporting earnings and raising full year guidance. BHC's settlement of a large litigation case was a positive as it provided clarity around potential future liabilities. BHC's weakness in the prior quarter was probably related to the malaise in the generics market and ongoing legal issues pertaining to opioids and price fixing, although only ~5% of BHC sales are generics and they have no opioid exposure. We believe BHC has finally returned to growth driven by their highly durable Bausch + Lomb franchise which accounts for over half the company's revenues.

WUBA also reported a strong quarter with 17% sales growth, ahead of consensus expectations. The stock benefitted from reduced fears that a China slowdown and tariff war would negatively impact WUBA's online classified business. Despite WUBA's exposure to economically sensitive sectors like housing and jobs, we believe the mix shift from offline to online transactions supersedes the economic slowdown those sectors have experienced in China. WUBA's nearly $9/share in net cash and investments provides it with a fortress balance sheet to pursue strategic M&A and/or share repurchases.

SIVB was up 20% in the quarter driven by better than expected earnings and a steepening yield curve. SIVB faces headwinds due to recent Fed rate cuts and the potential for an additional cut in 2020. However, with double digit loan growth and a unique franchise that enables it to achieve a 16% ROE even in this low yield environment, we believe the stock has further upside longer term even in a flat interest rate scenario. In the interim, we see a favorable risk/reward with the stock trading near its trough multiple.

TGT was up over 20% in the 4th quarter as its turnaround is in full swing. TGT experienced an acceleration in same store sales while delivering margin expansion, a rarity in retail, particularly at TGT's scale. TGT is executing very well on its omni-channel initiative and taking market share as they have made the customer experience considerably more convenient with its same day pick-up and same day delivery rollout. TGT is also winning on the merchandising side with apparel growth north of 10% as its private label brands continue to gain share. We believe further multiple expansion can be achieved given the valuation disparity with **WMT** and TGT's ability to grow EPS at a double-digit clip over the next few years while trading at ~16x our '20 EPS estimate.

The largest detractors to performance in the quarter were *Gildan Activewear* (**GIL**), *Carnival Corp* (**CCL**), *Take Two Interactive* (**TTWO**), *CarMax* (**KMX**) and *WR Grace* (**GRA**), which collectively hurt performance by 71 bps.

GIL delivered disappointing results in Q3 and guidance was equally unimpressive. GIL believes a slowdown in corporate spending due to economic uncertainty led to a fall-off in demand and inventory destocking at distributors. However, the company should have enough unique demand drivers (increased private label penetration, growth of athleisure) to fuel continued growth. We spoke with people from three of GIL's top distributors and don't believe GIL's product portfolio has weakened or that there is a structural change in demand trends. After attending an investor event in Honduras, we left impressed with GIL's manufacturing advantage and noticed additional private label wins at Walmart. Despite recent disappointments, we do not believe the long-term thesis is broken and at less than 14x our '20 EPS estimate, we think the stock remains attractive.

We sold CCL at a slight loss in Q4 because our thesis turned out to be wrong. When we initiated the position, we believed that the worst of its problems were behind them. However, we were surprised by CCL's guidance for higher fuel costs in 2020 and believed that perhaps the company was "stuck" with an aging fleet that would not be able to compete effectively with **NCLH**'s and **RCL**'s newer hardware. Furthermore, we questioned CCL's flexibility with respect to repositioning its fleet to counteract economic weakness in Europe given the localized brands in the UK and Mediterranean fleets. As of this writing, it appears our CCL sale was poorly timed given the stock has rallied significantly since we sold. CCL raised guidance after our exit driven by lower expected fuel prices (after surprising the Street with higher fuel guidance just a few months earlier).

TTWO weakness was likely due to very elevated expectations going in to the quarter. Since we bought the stock in April of 2019, the P/E multiple expanded from 18x to over 25x as fears of *Fortnite* world domination subsided and TTWO's core franchises experienced accelerating growth. Due to the elevated expectations heading into earnings, the stock was down 2.3% in the quarter despite raising full year guidance. Fortunately, we trimmed nearly half the position at higher levels and exited the year with TTWO as our smallest position. We do have concerns that the company may have a videogame content "gap" in 2020. Additionally, the consumer's propensity to buy new gaming titles will diminish as we get closer to the launch of new consoles from Sony and Microsoft in late 2020. Likewise, we exited the year with some concern about TTWO's risk/reward profile in 2020 and will provide updated thoughts in our Q1 letter.

Although KMX reported strong revenue growth of over 9% in fiscal Q3, including same store unit sales growth of over 7%, the company missed consensus EPS estimates and the stock ended down -0.4% for the quarter. The biggest impacts to margins in the quarter were much higher stock based compensation and higher advertising expenses which collectively impacted EPS by $.16 per share vs last year; significant relative to the $1.04 in earnings for the quarter. We believe these expense headwinds are transient in nature. The company invested in advertising to support its omni-channel roll out nationally and does not reflect a permanent step function higher. Advertising per car sold was $269 and we expect that to moderate to the long-term historical range of $220-$225. We believe KMX's investment in omni-channel is the right strategy to sustain KMX's competitive advantage in the highly fragmented used car market. Home delivery, online appraisals, online financing and express pick-up will prove to be important points of differentiation vs KMX's brick and mortar peers. Although *Carvana* (**CVNA**) has strong online capabilities, its lack of a national physical presence is a disadvantage given consumers' propensity to test drive and "kick the tires". KMX margins have contracted as it has invested capital on infrastructure to support its omni-channel strategy which is currently only available in 40% of its markets. We are hopeful that fiscal 2021 will be the year that KMX achieves strong topline growth with some modest operating leverage which would lead to a re-rating of the stock.

We initiated two new positions in the quarter – *WR Grace* (**GRA**) and *Altria* (**MO**). The following is a synopsis of our investment thesis for each:

WR GRACE (GRA)

GRA manufactures and distributes catalysts (80% of profits) to oil refiners as well as plastics and chemicals manufacturers. Catalysts enable customers to improve product yields and quality while enabling the reduction of emissions to comply with regulatory requirements. Catalysts, and the technology behind them, are critical materials for GRA customers but represent a small percentage of the overall cost base which enables GRA to enjoy some pricing power. Some of GRA's largest competitors are chemical manufacturers themselves (**DOW**, **LYB**), who compete with their catalyst customers. GRA's independence has enabled it to take share over time as customers prefer not to purchase catalysts from their competitors. GRA also manufactures silica (20% of profits) which is used in a wide range of industrial and consumer applications including pharmaceuticals, paint and coatings.

GRA shares underperformed the broader market and ended 2019 approximately 16% off its 52-week high. We believe the underperformance was largely due to a series of unfortunate, one-off events that hurt 2019 earnings. There was an explosion at a customer's refinery that ultimately led to its bankruptcy, negatively impacting GRA's business. A manufacturing issue within the silica business led to revenue and margin degradation during the year. And finally, the Saudi pipeline attack impacted the production out of Saudi Aramco, a large GRA customer. Collectively, these items represented a $.30 hit to EPS or ~6%. We expect an acceleration in EPS in 2020 as the company anniversaries these events. Additionally, according to IHS, global polyethylene capacity is expected to increase by over 7% in 2020 which is a significant increase relative to the three-year average of 4.5%. Polypropylene capacity should grow by over 8% which is double the three-year average. This new capacity should benefit demand for catalysts and creates incremental opportunities for GRA to license its process technology. According to Goldman Sachs, global Crude Distillation Unit ("CDU") outages increased by 16% in 2019 which negatively impacted refinery demand for catalysts. Data from Bloomberg and Goldman Sachs suggest that CDU outages were at their highest levels since 2013. To the extent these outages decline in 2020, GRA should benefit.

The International Maritime Organization ruled that, effective January 1st, 2020, marine sector emissions in international waters must be drastically reduced. The marine sector will be required to reduce sulfur emissions by over 80% by switching to lower sulfur fuel fuels such as diesel and jet fuel. This mandate, known as IMO 2020, will have significant repercussions on the global refinery ecosystem given the marine sector is responsible for half of global fuel oil demand. GRA stands to benefit from IMO 2020 through its joint venture with Chevron called Advanced Refining Technologies, or ART. ART's Hydroprocessing catalysts are used by customers to upgrade heavy oils into lighter, more useful products. This enables less expensive feedstock usage in the refining process while enabling customers to meet more stringent environmental regulations such as IMO 2020. We believe the ART JV income can grow over 20% per year over the next few years because of strong market growth and incremental market share gains as ART brings on significantly more capacity to meet customer demand.

We believe FCF/share will grow meaningfully faster than EPS over the next couple of years. Capital expenditures will decline from $200M to 2019 to approximately $150M by 2021. Additionally, the ART JV will resume dividend payments to its owners given capacity expansions will have been completed. These two factors could add $100M to FCF by 2021 off a base of ~$215M in 2019. We think GRA could generate over $5.60/share in FCF in 2021 which represents an 8% FCF yield using today's stock price. We consider this a very attractive valuation for a company that should deliver high single digit to low double-digit EPS growth (and even faster FCF/share growth) over the next few years.

ALTRIA (MO)

In 2008, Philip Morris split into two companies – Altria and *Philip Morris International* (**PM**). Altria effectively became the U.S. operations of Philip Morris. MO has approximately 50% market share of the cigarette market in the U.S. with brands such as Marlboro, Parliament and Virginia Slims. MO also has ~54% share of the smokeless tobacco market (15% of operating income) with its Copenhagen and Skoal brands. Other assets include a 10% stake in *Anheuser-Busch InBev* (**BUD**) worth nearly $9/share, a 35% stake in Juul which was acquired in late 2018 for $12.8B and a 45% stake in *Cronos Group* (**CRON**), a cannabis company. MO also has the exclusive U.S. marketing rights to IQOS, a "heat to burn" tobacco product growing very strongly outside the U.S. with over 11M users. Despite a steady decline in cigarette volumes over the past few years, MO has delivered mid-single digit operating income growth and double-digit EPS growth while expanding margins 500 bps between 2014 and 2018. This is because MO has tremendous pricing power and the growth in pricing, which comes with 100% incremental margins, overwhelms volume declines. Tobacco users are price insensitive and brand loyal. Furthermore, because fixed rate taxes represent about 40% of the retail price of cigarettes, a 5% price increase taken by Altria translates to ~2% increase in price to the consumer. Since tobacco companies can't market their product, there are inherent barriers to entry which enables Altria's brands to maintain relatively stable market share.

We initiated a position in MO in October 2019, during the height of the vape scare and an onslaught of negative headlines. On October 10th, the *New York Times* reported that a vaping illness outbreak caused injuries to nearly 1,300 people and 29 deaths. Stories like this were common and were generally accompanied by photos of people vaping tobacco or holding a Juul vape stick. The outbreak led to a furious backlash against the vaping industry. New York issued a statewide ban on most flavored nicotine vaping products, Massachusetts declared a public health emergency and Michigan issued an emergency ban (which was soon overruled by a Michigan Court of Claims judge). While the vaping illnesses were unfortunate and alarming, the public was generally misled by mass media as to the actual cause of the outbreak. According to laboratory data from the Center for Disease Control, vitamin E acetate was identified as the likely cause of "e-cigarette, or vaping, product use-associated lung injury" or EVALI. This is a very important fact because Juul does not contain vitamin E acetate. Furthermore, 80% of victims stated they inhaled THC related vape products before getting ill. What are the chances that the other 20% lied rather than admit to government officials that they consumed illicit substances?

Ultimately, the regulatory capture that MO enjoyed for decades will soon come to the vaping industry. An increase in regulatory and compliance costs will favor scaled incumbents, like MO, that have the appropriate levels of human and financial capital to face the compliance issues head on. The FDA mandated that all vape products submit a pre-market tobacco products application (PMTA) prior to commercial launch while existing products on the market need to apply by March 2020. The FDA estimates the PMTA process will cost manufacturers between $117,000 and $466,000 per application. Philip Morris' application for IQOS included more than 2 million pages of research and took two years to complete. *Swedish Match*'s (**SWMAY**) PMTA submission totaled over 100,000 pages. According to Euromonitor, 66% of all vape sales in the U.S. in 2017 were closed systems and 34% open – the latter category is dominated by small mom and pop companies. We expect the PMTA process to wipe out many of the smaller players and share will consolidate to Juul and perhaps one or two others.

But what if we are wrong? What if the FDA or Congress or another governmental agency decides to crack down hard on vaping? We believe any effort to limit vaping ultimately leads to greater demand for traditional cigarettes which represents the bulk of MO's earnings. If the FDA provides a legal pathway for vape products to flourish, we think Juul wins. In the unlikely scenario where tobacco vape products are curtailed, traditional tobacco cigarettes win. We view both scenarios as a win for Altria.

When we initially purchased shares in October, MO was trading at an 8% dividend yield and just over 9x EPS. This is a significant discount to the 16x avg P/E the company traded for during the previous 7 years. We believe MO has the potential for significant multiple expansion as emotions turn to common sense with respect to the cause of the vape illnesses and as the market consolidates.

During the quarter we sold Carnival Corp (CCL) and *Fortune Brands* (**FBHS**). We discuss the rationale for the CCL sale earlier in this letter. The FBHS sale was driven by a less favorable risk/reward after a strong run in the stock and only 5% upside to our fair value price. We believe the stock currently embeds lofty expectations on the heels of an improved housing market, easing China trade tensions and a more benign commodity environment.

As of December 31st, our five largest positions were *Comcast* (**CMCSA**), *NRG Energy* (**NRG**), *Crown Holdings* (**CCK**), *Quest Diagnostics* (**DGX**) and *Sony Corp* (**SNE**), representing nearly 24% of the total portfolio.

MARKET COMMENTARY

What a difference a year makes. In December of 2018, markets were roiling due to concerns that a Fed policy error, coupled with rising trade tensions with China and an inverted yield curve would send us into a recession. As of this writing, no recession has transpired, the China trade war is easing, the Fed is screaming at the top of its lungs that it will provide a put on the market and the S&P 500 is at all-time highs. As a value investor, it is easy to have a sense of discomfort regarding the prospects for the market. Afterall, in 2019, the S&P 500's forward P/E multiple expanded from 15x to 18.5x despite flat earnings growth. As of this writing, U.S. junk bond yields hit a new post-2014 low of 5.08%, just 25 bps away from the all-time low of 4.83%. The VIX, a measure of investor sentiment, spent much of the year at historically low levels implying an abundance of complacency. The economy is experiencing the longest expansion period in history at 126 months and counting. S&P 500's net debt to total assets (ex-financials) is now above the prior cycle peak. The list goes on.

However, evaluating market strength in the context of longer time periods paints a different picture. The market's return over the decade from 2010-2019 was 11.2% annualized which would place it 4th on the list of the top decades over the past 7. Hardly an outlier. Furthermore, while this is the longest economic expansion in history, the depth of the economic expansion is modest relative to previous expansion periods. Between June 2009 and the present, annualized real GDP grew at only 2.3%, which is the lowest annualized growth rate of any expansion period since WWII. Perhaps the economy isn't overheated after all? As for corporate leverage, although it is elevated in absolute terms, it is likely more sustainable than prior decades. Tax rates are lower, cost of debt is low and profit margins are higher. During the 1990s, when corporate leverage was at comparable levels relative to total assets, cost of debt was 8% vs. 3% currently and profit margins were 7% vs. 12% today.

While the market appears expensive on most measures in absolute terms (P/E, dividend yield, price to book, price to cash flow), it appears attractive relative to bond yields. The earnings yield minus the Baa yield is .85 standard deviations higher than the historical average, implying equity valuations are attractive relative to bonds.

JP Morgan estimates that the China trade war negatively impacted S&P 500 U.S. corporate margins by 50-75 bps and EPS growth by 700-800 bps. The damage hit hardest in the industrial and manufacturing sectors which can be seen in the ISM Manufacturing Index which dipped sharply in 2019 and ended the year at 47.2, suggesting a contraction in manufacturing. To the extent the tariff conflict gets resolved, which appears likely at this point, earnings growth could inflect higher as business sentiment would likely improve leading to increased investment in inventories and capital projects. On a cautionary note, we believe the consensus view is that there will be a recovery in industrials and manufacturing. Despite very weak fundamentals, railroad and semiconductor stocks are at their highs, suggesting optimism. Nonetheless, an inflection in corporate earnings growth would likely be supportive of equity markets.

In sum, while valuations are elevated in absolute terms, we think it is still reasonable relative to interest rates and the bull market of 2019 is not cause for concern when looking at it relative to longer term market performance. Importantly, our strategy doesn't "own" the market. We invest in about 25 high conviction ideas where we have an out of consensus view of future earnings. Regardless of what part of the market cycle we are in, there are always alpha-generating investment opportunities for those with a long-term view. We see several powerful opportunities in today's market- there's a renaissance in the beverage can industry (CCK), the lab diagnostics market is undergoing significant disruption where only the largest will survive and take share (DGX), semiconductor content in the car is set to inflect higher as active safety features proliferate (**NXPI**), good businesses with low quality management are taking transformational actions to drive shareholder value due to activist pressure (**ACM**, **LKQ**), the "winners" in retail have been declared and they're just getting started (TGT, KMX). We are excited to be long-term shareholders in these businesses and look forward to what 2020 and beyond will bring.

Happy New Year and wishing you and yours much health, happiness and success in 2020. Thanks, as always, for your continued support and confidence.

Sincerely,

Ari Sass

President & Portfolio Manager, MD Sass

* * *

Past performance is not indicative of future results. M.D. Sass does not guarantee any minimum level of investment performance or the success of any of its investment strategies, and investors may incur losses. M.D. Sass does not provide tax or legal advice, or determine an investor's investment objectives, risk tolerance or suitability. Certain statements contained in this report represent forward-looking statements that involve risks and uncertainties. These risks and uncertainties could cause actual results or outcomes to differ materially from those expressed in such forward-looking statements. In addition, while the information contained herein from third parties was from sources we believe to be reasonably reliable as of the date hereof, M.D. Sass accepts no responsibility or liability for any errors or omissions or misstatements however caused related thereto. Opinions expressed herein are those of the author, are subject to change, are not guaranteed and should not be considered investment advice.

Returns referenced herein represent composite level performance, net of fees. Actual client results may differ from composite level returns.