MD Sass Concentrated Value

MD SASS

Q1 2020 Commentary

April 14, 2020

The MD Sass Concentrated Value ("CV") strategy was down -31.4%, net of fees, in the first quarter of 2020, vs. -26.7% and -27.3% for the Russell 1000 Value and Russell 3000 Value indices, respectively.

From inception (January 2019) thru the end of Q1 2020, CV was down -3.1% net of fees, vs. -7.3% and -8.2% for the Russell 1000 Value and Russell 3000 Value indices, respectively.

We estimate CV is up +8.7%, net of fees, in the first few days of Q2 thru April 9th, 2020.

We usually focus our quarterly letters on company-specific commentary and analysis. Considering the unprecedented global pandemic, we will devote much of this letter to address the current crisis, its impact on markets and how we intend to flexibly navigate through the storm.

In February 2020, junk bond yields hit a new post-2014 low, the S&P 500 was at all-time highs, the VIX was trending near historically low levels and the economy was experiencing the longest expansion period in history. Then the COVID-19 virus spread and all the above feels like a very distant memory. What started as a "China issue" very quickly transformed into a global crisis. In the United States alone, the number of cases ballooned from less than 1,000 on March 4th to over 560,000 as of this writing. The battle against the virus called for drastic measures that are taking a significant toll on economic growth. Social distancing, lockdowns and quarantines – actions that seemed like science fiction to Americans one day, became reality the next. According to the National Governors Association, all 50 states have mandated statewide school closures, 49 have stay-at-home orders, 45 have some form of business closure policy, 27 have travel restrictions and 15 have state and local curfews. Five states mandated all the above. The economic consequences of this are unprecedented. The impact on small businesses, which employ approximately 50% of the labor force, has been profound. According to data from OpenTable, global restaurant dining reservations have dropped nearly 100%. Air travel is all but frozen with Delta projecting a 90% drop in revenues in Q2. Hotel RevPAR (revenue per average room) was down over 81% for the week ending April 4th. According to Deutsche Bank, the total number of hours worked by hourly employees is down ~70% since January. Small businesses do not have the balance sheets to weather a sustained period of no revenues. According to JP Morgan, the median small business has a cash buffer of only 27 days with the median restaurant having a buffer of just 16 days. According to Deutsche Bank, full service and limited service restaurants represent 7.5% of all small businesses. Clearly, a sustained period of economic shutdown will lead to record-breaking levels of unemployment. James Bullard, President of the Federal Reserve Bank of St. Louis, predicted the U.S. unemployment rate could hit 30% in the second quarter and GDP could drop a historic 50%. For context, the unemployment rate reached 25% in 1933 during the Great Depression and hit 10% during the depths of the global financial crisis.

The realization that the global economy was coming to a virtual standstill sent perceived riskier assets into free fall. The S&P 500, after peaking at a record high on February 19th, dropped 35% into bear market territory in just 19 trading days, the fastest drop since 1933. The month of March witnessed several single-day stock drop records that surpassed all post-1940 declines other than 1987's Black Monday. The VIX index, also known as the fear index and a measure of implied volatility, hit an all-time high of nearly 83 on March 16th, surpassing the previous peak during the global financial crisis in 2008. This extreme level of implied volatility was not unfounded considering the S&P 500's absolute average daily percentage change in March was 5%,

surpassing a previous all-time high set during the Great Depression, according to Dow Jones Market Data. U.S stocks ultimately experienced their worst quarter of performance since the 2008 financial crisis.

The credit markets also showed signs of extreme stress as the United States was placed into a government-induced economic coma. According to Deutsche Bank, at one point in the month of March credit spreads (outside of CCCs) were pricing in default rates higher than anything we have seen historically, even if we assumed zero recoveries. On March 25th, data from Bloomberg suggested investors yanked a record $38B from investment grade funds over the seven previous days, this beat the previous record of $36B set during the previous week.

The market bottomed on March 23rd with the S&P 500 at an intraday low of 2191 and then rebounded nearly 25%. Despite worsening economic conditions (the past two weeks of jobless claims represent the worst ever recorded, by far), there are several factors that explain the rally. First, the Fed has acted quickly and decisively to combat the economic consequences of the pandemic. The CARES Act will provide more than $2 trillion in fiscal stimulus, representing almost 10% of GDP. Furthermore, the Fed has pumped tremendous amounts of liquidity into the system to ease frozen credit markets and tighten spreads with up to $2.3 trillion of aid announced just last week. "The Fed's role is to provide as much relief and stability as we can during this period of constrained economic activity, and our actions today will help ensure that the eventual recovery is as vigorous as possible," said Fed Chairman Jerome Powell in an official statement. He is unquestionably putting Fed money where his mouth is. Although the ultimate demand destruction and shape of a future recovery are uncertain, recent powerful and unprecedented policy actions have reduced "left tail" risk. An investor articulated the situation quite well on Twitter, "with the Fed pumping in more than $4 trillion of liquidity it is not surprising to see market reactions decouple from Main Street reality." But it's not just the Fed providing massive stimulus measures. The global response has been powerful with countries such as Germany and Japan announcing stimulus packages equating to over 18% of their respective GDPs. According to JP Morgan, countries representing nearly 75% of global GDP have announced stimulus packages that collectively represent over 5% of global GDP.

The other factor contributing to the recent market rebound is the slowing pace of new virus cases in several key economic markets and countries. A peaking of cases is a necessary condition for economic healing and increases the likelihood of a short-lived recession. In Italy, new cases peaked on March 21st and have been on a steady decline ever since. Spain, the second hardest hit country after the United States, also appears to have peaked around March 26th. Spain's Prime Minister has stated that certain economic restrictions could be lifted after Easter, allowing some people performing non-essential jobs to return to their work. New York State case growth was just over 6% in April 9th, the lowest growth rate since the outbreak began. New York has roughly 10% of total worldwide cases. Case growth overall in the United States appears to be slowing. Dr. Anthony Fauci now believes the United States may be close to seeing a peak in fatalities. If this proves to be true, the United States could end up with a significantly lower fatality rate than nearly all of Europe, apart from Germany.

China is clearly on the mend and the world is looking to China's pace of recovery as a proxy for the path of others. On January 23rd, Wuhan, a city of 11M people, went into lockdown and a few weeks later the number of cases peaked. In just over a month after lockdown, Starbucks reopened almost all its stores in China and Apple re-opened all 42 of its stores. "It feels to me that China is getting the coronavirus under control. I mean you look at the numbers, they're coming down day by day by day. And so I'm very optimistic," said Apple's CEO, Tim Cook in an interview with Fox Business. By February 29th, China was in its recovery phase. According to the *South China Morning Post*, Pinduoduo recorded more than 50M retail orders per day since mid-March, a 60% increase from the prior year. The paper also reported transport bookings grew more than 50% while hotel reservations grew 60% during the three-day Ching Ming Festival. A sales rep for an Audi dealership in Wuhan said, "It's like a boom after a two-month dormancy." There is hope and optimism that other countries will follow China's pattern of a recovery ~1 month after lockdown.

Research developments and the promise of medical breakthroughs are also providing some hope. Dr. Jap Bhattacharya, a research associate at the National Bureau of Economic Research, said that the United States will implement antibody testing surveys by the end of April, which would greatly expand our understanding of total infections. He also stated there has been some success in removing antibodies from those that have recovered from the virus. Abbott Labs announced a fast point-of-care virus test kit that can deliver positive results in 5 minutes and negative results in 13 minutes. According to Dr. Scott Gottlieb, former head of the FDA, the Abbott test is a "game changer." As of April 9th, the Milken Institute estimates there are over 160 treatments and 79 vaccines in various stages of development.

As a recent JP Morgan report stated, "the distinction between V-shaped retracements and bear market rallies is only ever obvious in hindsight." Likewise, investors are left pondering what the future path of the market will look like. According to the same JP Morgan report, rallies during bear markets have ended in fresh lows in 6 months only about a third of the time. So historical precedent would suggest that the odds of the market hitting a new low in several months is low. However, this is anything but a "typical" recession. There is no precedent to look to for this public health driven crisis, making projections very difficult. This is unlike the global financial crisis that had precedent and where a study of history acted as a guidepost. The path of the markets looking forward will be highly dependent on several unknowable variables – the growth of new cases in the United States and globally (which itself is dependent on many individually designed health policy initiatives), the duration of economic lockdown and social distancing, unemployment rates, and the impact of the virus on the economy when it returns in the fall. What appears increasingly clear is that the world's reaction to the virus is not binary. It is not a matter of lockdown or no lockdown, but rather a gradual return to "normal", the timing of which is nearly impossible to predict with any degree of confidence. "It isn't like a light switch on and off," said Dr. Fauci in a *Wall Street Journal* podcast, noting a reopening of the United States. could start in May. "It's a gradual pulling back on certain of the restrictions to try and get society a bit back to normal…you gradually come back. You don't jump into it with both feet."

While the depth and duration of the crisis and the subsequent pace of the recovery are unknowable, we can infer what the market is implying. Consensus earnings estimates for 2020 continue to decline with some of the more recent estimates coming in around $125 EPS for the S&P 500 from Goldman Sachs and Credit Suisse, down from $165/share in 2019. With the S&P 500 at 2,790 as of this writing, the market is trading for just over 22x estimated 2020 earnings. This is a lofty valuation multiple by historical standards despite the low interest rate environment. Per Goldman Sachs: "the average P/E ratio on trough corporate earnings at market bottoms during periods of low and stable inflation has been around 17x. If we apply that to our newly lowered 2020 EPS estimate range of $120-$125, that implies an S&P 500 level of 2040-2125." Furthermore, "if the equity risk premium…were to reach the average of the highest point during the financial crisis and the highest point at the time of the 2011 U.S. debt downgrade selloff, it would imply an S&P 500 level of 1950, assuming yields fell to 0.5%." So, either the market is overvalued or investors believe that 2020 is simply a "write-off" year and are looking to 2021 when they expect earnings to strongly recover. We believe the market is effectively "telling" us that the latter is now the consensus view – that investors are looking towards 2021 EPS as the base year to calculate the proper multiple for the market. While we agree with this approach, we also believe the ability to forecast 2021 and 2022 EPS with any degree of conviction is extremely difficult at this stage. If a vaccine is required to bring us back to "normal", and a vaccine is at least 18 months away, then the recovery could take longer than many believe. A U-shaped recovery (which we consider more likely than a "V") could lead to higher earnings in 2021, but it is difficult to have confidence in how 2021 will compare with 2019. A useful exercise is to look at 2019 actual earnings, estimate the time it will take to get back to 2019 earnings power and assess the implied IRR. Our portfolio is trading at just over 11x 2019 EPS for our portfolio companies. Assuming, on average, that it will take two years for our companies to get back to 2019 levels, and assuming a reasonable multiple of 16x on our portfolio, it would imply upside potential of 45% over two years – a very

attractive two-year rate of return. This is not a forecast but rather a back-of-the-envelope calculation to determine the potential return for our portfolio companies if, and when, they recover to their 2019 earnings level.

As long term, fundamental investors, we don't believe you need to find the bottom to generate strong returns. As Ensemble Capital noted in a March 20th conference call, "if you had bought the S&P 500 on October 6th, 2008, the day the market was first down by 30% or approximately the amount the market is already down over the last month, you would have had a sickening ride lower, but the recovery was so violent that you would have had positive returns after just one year. Within two years, you would have been up 15% for a solid but not great 7% annual return. Within four years you would have been up 51% for an excellent 11% return per year." Most news headlines, financial networks and sell-side reports are focused intensely on tail risks, but fewer talk about the "tail rewards" that can come from seemingly overnight game changing developments. It's hard to imagine great news now but when a breakthrough, game changing event comes (e.g., a vaccine) it will then all seem obvious. Although the tail rewards feel so out of reach today, we are confident that investors will one day reflect on this time with the benefit of hindsight and talk about how obvious it was to buy dislocated stocks ahead of the positive developments that almost certainly would take place.

We believe mass vaccinations are a precondition for a return to normal. Until then, demand for travel, concerts, conferences, theme parks, eating out, sporting events, etc. likely will be curtailed. There is reason to believe in the light at the end of the tunnel because the best minds around the world are all-in on the problem. Developments will occur unexpectedly, and literally overnight, that will permanently change the natural course of the virus. Apple and Google recently announced a collaboration on a new joint tech platform that effectively brings contact tracing to potentially 3 billion mobile phone users (the total number of Android and iOS mobile devices). This is a significant and unexpected event. We expect more to come. Per Goldman Sachs: "the amount of talent and resources devoted to addressing both the virus and the disease is immense, and it is hard to imagine that these efforts, as discussed by our panel of experts, will not yield any successful results in the near future."

Q1 PORTFOLIO REVIEW

As we entered 2020, our top positions, by and large, were companies that we felt were somewhat recession resistant given their underlying business models. *Quest Diagnostics* **(DGX)**, for example, grew revenues +3% and EPS +20% in 2008 during the global financial crisis when the stock declined just 1% vs the 37% decline in the S&P 500. *Formula One* **(FWONK)** has long-term contracts with broadcasters, race promoters and sponsors that provides a steady, growing revenue stream even in bad economic times as the risk of ticket sales is borne by race promoters *NRG Energy* **(NRG)** transformed its business model into a vertically integrated unregulated utility with large exposure to the fast-growing Texas economy. Many of our top positions were not only defensive but also offensive in the sense that we had much higher earnings estimates than consensus. Although we did not anticipate a recession, we believed our portfolio was well positioned to deal with a "typical" recession. However, the COVID-19 recession is a sudden and unpredictable Black Swan event and is anything but typical. DGX might be defensive in most severe recessions but how can lab test volumes grow in an environment where physician offices are closed? Formula One might have long term contracts but they can't generate revenues if most races are outright canceled. The true defensive names in this public health driven recession are "stay at home" stocks, many of which would not be so defensive in more typical recessions (Peloton, Citrix, Amazon, Electronic Arts, Zoom, etc.).

Our underperformance in Q1 is largely explained by our relative overweight position in consumer discretionary stocks. Three out of our five largest performance detractors were consumer discretionary stocks – *Norwegian Cruise Lines* **(NCLH)**, *LKQ Corp* **(LKQ)** and *Mohawk Industries* **(MHK)**. The other two are highly sensitive to consumer travel or transportation – FWONK and *WR Grace* **(GRA)**. Collectively, these five stocks alone caused an 11.3% decline in the portfolio in Q1. While the performance of these names is disappointing and frustrating, we do not believe our long-term theses on these stocks is impaired, except for NCLH which we sold (and discuss later in this memo). Formula One may see most of its Grand Prixes canceled in 2020, but we don't believe it impairs the long-term growth story. Although lockdowns have led to a temporary steep decline in car miles driven and air travel, we believe the turnaround story at LKQ and the free cash flow growth story at WR Grace are still achievable. Therefore, we have stuck by these positions and, in fact, bought more.

We believe this recession will leave a plethora of dead companies in its wake and the strong ones left standing will likely come out even stronger. *CarMax* **(KMX)** and *Target* **(TGT)** are two such examples. Currently, about 50% of KMX's stores are either closed or running by appointment only with the other half of their footprint experiencing sales declines of 50%. With approximately $700M of cash on its balance sheet and a robust e-commerce platform superior to nearly all its competitors, KMX is well positioned to take market share over a multi-year period as many of its competitors fail. The secular decline in traditional department stores and other retailers likely accelerates in this environment which favors TGT who was gaining market share in Beauty, Apparel and other categories before the crisis. Target's investment in same day delivery and curbside pick-ups is the result of years of investment and this crisis will likely differentiate Target from ailing competitors even more.

We established price triggers for all our stocks in response to market panic and volatility. These price triggers represent what each stock in our portfolio would trade at if they reflected trough P/E multiples on trough EPS. Several positions including FWONK, GRA and MHK briefly came within 5% of our price triggers and we bought more. Although it is psychologically difficult to buy stocks while in virtual free fall, we believe those painful moments prove to also be the most opportune.

We exited our positions in *Sabre* **(SABR)**, *Gildan* **(GIL)**, *Altria* **(MO)**, *Take Two Interactive* **(TTWO)**, *Webster Bank* **(WBS)** and NCLH in the quarter. Since we first bought SABR, several events transpired which are, at best, neutral to SABR and, at worst, materially negative. In September of 2019, a U.S. appeals court breathed new life into an eight-year-old US Airways federal antitrust complaint against Sabre. If Sabre is found to have violated the Sherman Antitrust Act, it could have repercussions with respect to contractual arrangements with airlines. Another surprise blow was the Department of Justice's lawsuit to block Sabre's acquisition of Farelogix. We believe Farelogix's technology is an important strategic asset for Sabre and if they can't close the deal they could be weakened from a competitive standpoint and would need to invest significantly to enhance their own capabilities. The CEO was a significant seller of stock in the latter part of 2019, which was further cause for concern, and the spread of COVID-19 in China in January increased the risk of the company lowering guidance for 2020. In hindsight, the risk factor that we gave the lowest weighting to at the time of sale (COVID-19) turned out to be the most important driver of the stock in 2020 thus far.

We sold GIL because our original thesis proved to be wrong. We originally thought that Gildan's low cost production and broad portfolio would enable it to gain significant private label apparel market share and accelerate revenue growth to high single digits while expanding margins. Although Gildan is winning significant private label business, it is ceding market share in other channels to two private competitors – Bella+Canvas and NextLevel. Furthermore, we believe Gildan was artificially inflating its growth by pushing price which forced distributors to stock up ahead of price increases. When cotton prices fell and Gildan was unable to push price increases, the company experienced material declines in orders. We sold our position as our aspirations of growth were too optimistic.

We sold Take Two Interactive after a strong run in the stock and as the stock approached our price target. We like the company's videogame portfolio and believe they have strong long-term growth prospects, particularly as the next gaming console cycle launches this winter, but believe the valuation reflects this optimism.

There were two stocks that we believed could experience structural impairments because of the global pandemic, and, therefore, we sold them in the quarter. NCLH clearly has significant near-term pressures given the demand destruction for cruises, but the mid to long term outlook is also murky. We think demand for cruising could take many years to return to 2019 levels as cruising skews towards an older demographic that has been most impacted by the virus relative to other age cohorts. Although NCLH's balance sheet can withstand a few months of pain, we are concerned about their ability to survive a protracted environment of subdued demand. The other stock we sold that is at risk of structural impairment is Altria, the largest manufacturer of cigarettes in the United States. COVID-19 is a respiratory illness and data suggests smokers are at much higher risk of hospitalization and death vs non-smokers. Furthermore, with stimulus packages boosting deficits, higher taxes seem inevitable and a dramatic increase in the federal excise tax on smoking is an obvious target. States will likely boost cigarette taxes as well. Further demand destruction seems likely and this was not in our base case when we underwrote the investment last year.

We initiated five new positions in the quarter – *Facebook* (**FB**), *Google* (**GOOGL**), *Charles Schwab* **(SCHW)**, *Perrigo* **(PRGO)** and *Delta* **(DAL)**. The following is a synopsis of our investment thesis for each:

FACEBOOK (FB) AND GOOGLE (GOOGL)

We have followed and admired several large cap growth stocks from afar with the hope of having the opportunity to own them should a sell-off occur. We were quite fortunate to buy both Facebook and Google at very attractive prices during the depths of the recent market rout in March. We reviewed comments from several large media buyers and are confident that both Facebook and Google are some of the highest ROI platforms for advertisers in the world. So long as these leading digital advertising platforms provide a compelling ROI they will continue to exert pricing power. In the short-term, both FB and GOOGL will experience a sharp deceleration in growth as advertising dollars get pulled, but we believe the pandemic will make them stronger in the long-term. For one, cord cutting will likely accelerate in the coming months as consumers seek to cut costs and as the attractiveness of broadcast TV content diminishes due to lack of live sports content. This should lead to an accelerating shift of advertising budgets from TV to digital. Additionally, usage of social media, e-commerce and search have increased because of quarantines and lockdowns. "Facebook's traffic has heavily benefitted from the coronavirus outbreak, with the company reporting that messaging has increased by 50% and video calls on Facebook Messenger and WhatsApp have doubled in countries hit hard by the pandemic. According to an internal Facebook report analyzed by the *Times*, the company has also seen an 'unprecedented increase in the consumption of news articles on Facebook' as a result of the coronavirus, which has accounted for more than 50% of its news consumption in the U.S.," according to a March 25th article in *Vanity Fair*. Google's cloud and productivity software are also seeing a boost. CNBC reported that Google's G Suite bundle had over 6M paying businesses in March, up from 5M in February 2019. Events like COVID-19 prove that these businesses are more akin to utilities than discretionary platforms.

Google and Facebook collectively have over $150B of net cash on their balance sheets as of the end of 2019. While some of their competitors will fold and others will suppress spending on innovation to preserve capital, we expect Facebook and Google to go on the offensive. They will continue to innovate, hire talented engineers and invest for long-term opportunities,

which remain plentiful. They will also use their capital and technological expertise to assist in the war against the virus, which may forever alter the negative perception that governments and regulatory bodies have on "big tech." Google is not only working on a COVID-19 tracking system with Apple but Verily, a Google subsidiary, launched a pilot project designed to guide people toward local coronavirus testing. The online tool was first announced by President Trump in a press conference on March 14th. Facebook is working with researchers at Carnegie Mellon to survey users about coronavirus symptoms and announced a $100M grant program for small businesses impacted by the virus. Part of the bear case on Facebook, Google and the other tech behemoths is that these companies are too big, wield too much power and influence and control too much data – they need to be regulated or even broken apart. This has acted as an overhang on these stocks.

Both Google and Facebook have long-term opportunities in large addressable markets that they have yet to monetize in a meaningful way. Google has several at bats in autonomous driving (Waymo), life sciences (Verily, Calico), public cloud (Google Cloud), artificial intelligence (DeepMind) and drones (Project Wing). Facebook has significant untapped opportunities with payments and e-commerce for Instagram, WhatsApp and Messenger and virtual reality via Oculus. We believe current market prices do not reflect the call option value of these nascent opportunities.

It is difficult to forecast earnings for Google and Facebook in 2020 given the highly uncertain ad environment but we feel confident that they should exceed their 2019 earnings levels in 2021. Google trades for approximately 20x 2019 EPS ex-cash. We believe this is very attractive for a company that should consistently grow revenues at a high teens rate over the next few years. Free cash flow per share growth will likely accelerate in 2021 and beyond as capex growth moderates. Facebook trades for approximately 19x 2019 EPS ex-cash and should experience ~20% revenue growth over the medium term. Facebook invested heavily the past year to bolster its compliance, and we believe the worst of Facebook's margin declines are behind them.

In sum, the recent market turmoil gave us an excellent opportunity to buy very high quality, growth businesses with secular tailwinds, deep moats, powerful data network effects and fortress balance sheets at very reasonable prices.

CHARLES SCHWAB (SCHW)

Schwab engineered a series of brilliant moves in October and November of 2019 that positioned it to become the scaled, dominant player in retail brokerage and independent RIA advisory services. In October, SCHW disrupted the industry by slashing trading commissions on U.S. equities and options to zero. Although this hurt SCHW given it generated ~4% of sales from these commissions, it crippled its rivals even more due to their much heavier exposure to commissions. *Ameritrade* **(AMTD)** saw its stock drop by 26% with 30%+ of its EPS from these commissions. On November 25th, SCHW announced the acquisition of the beleaguered AMTD with built-in synergies from a renegotiated agreement with TD Bank on cash sweep services.

SCHW had a 30%-40% market share with independent RIAs and will have 40%-50% share post-acquisition. SCHW provides custody, trading, advisory, reporting and asset management solutions for this customer segment. The independent RIA market has witnessed healthy growth over a long period driven by the mix shift from financial advisors at wirehouses to independent RIAs. According to LPL Financial, total advisor assets in the independent channel have grown at an 8% CAGR since 2016 and has gained 700 bps of market share. Wirehouses had a 2% CAGR and other employee channels had a 3% CAGR over the same time. With over half of the $20 trillion market for advisor-mediated services residing at wirehouses and other employee channels today, there is still significant room for further share gains looking forward. We believe SCHW's

competitive position within the RIA community will be enhanced by AMTD as it brings better trading systems to the platform (thinkorswim) and an industry leading rebalancing platform (iRebal).

Ultimately, cash EPS accretion from the AMTD should be 20%+ while removing a major player from the market and positioning SCHW as the powerhouse in a group crippled by the zero-commission policy established by SCHW. SCHW has a path to $4 in cash earnings power by 2024 (depending on interest rates) which could take the stock to the mid-$70s in four years, worth $50 discounted back to today.

PERRIGO (PRGO)

Perrigo is a global manufacturer of healthcare products with a leading market share position in private label/store branded over-the-counter cough, cold and flu medications, infant nutrition, smoking cessation aids and more. The company also operates a generic drug business that represents nearly 30% of operating income. Under the leadership of the company’s new CEO, Murray Kessler, Perrigo is transitioning from a healthcare focused entity to a business more akin to a well-run consumer products company. This is at the core of what PRGO had done for decades, with mid-teens ROIC, constant new product innovation, and consistently strong FCF conversion that investors ultimately rewarded with an above market valuation multiple. Under the previous management team, Perrigo lost focus on its core business and started down a path to increase exposure to the generic pharma market, because, at the time, the expected returns in that business were greater. Poorly-timed M&A, significant generic drug pricing pressures, multiple C-suite leadership change and ballooning tax liabilities caused the stock to fall from $200 to $50 in a handful of years. However, the core business of international regional brands and domestic store branded health and wellness products have multiple secular tailwinds that have the potential to enhance returns on capital as Perrigo shifts its focus back to product innovation in these core categories. The execution of this strategy should lead to positive earnings revisions, and Perrigo should regain the credibility it lost over the past few years of capital destruction.

We believe the consumer health business is worth 18x earnings and the generic drugs business is worth 8x for a blended multiple of just under 16x. Net of future tax liabilities, we believe PRGO is worth $60 today (vs current price of $50) and will compound capital at 10% per year. There is a reasonable chance that future tax liabilities are settled at a discount which could meaningfully alter our view of fair value higher depending on the outcome.

In the short term, we expect Perrigo to be a beneficiary of the global pandemic given its exposure to OTC health and wellness products. For perspective, Perrigo's Consumer Self-Care Americas business supplies more than half of the acetaminophen (Tylenol® equivalent) volume in the United States in addition to many other essential products. On April 7th, Perrigo announced Q1 ’20 organic revenue growth of 11% while maintaining full year guidance. Given Q1 trends, we believe there is upside to full year guidance and consensus estimates.

DELTA (DAL)

We initiated an underweight position in Delta in March with the view that Delta will survive this crisis, which will have a more material impact on its business than 9/11 and the global financial crisis combined. If this proves to be the case, we believe the bull vs bear debate on airlines will be settled with Delta proving that “this time is different” for an industry that has consolidated substantially and demonstrated improved returns on capital over the past decade. Certainly, Delta is a very

different company than it was during the financial crisis: Delta owns a greater percentage of its fleet now, which gives it greater expense flexibility, passenger revenue per available seat mile ("PRASM") is structurally higher due to ancillary fees such as baggage fees, loyalty program revenues are materially higher thanks to the growth in credit card accounts and better terms with American Express, unfunded pension obligations are nearly 50% lower, debt/EBITDA is materially lower, etc.

Given the demand destruction in air travel, 2020 EPS does not matter and our ability to forecast it is low. The key questions are: 1) will travel recover; 2) when will it recover; and 3) can DAL withstand the pain in the interim? We don't know the answer to #2 but feel confident that the answers to #1 and #3 are yes. Regarding #3, we believe DAL has adequate liquidity to get through two quarters of severe demand destruction. The CARES Act is a materially positive event for airlines and we believe it elongates Delta's liquidity under severe stress for significantly longer. We anticipate that the CARES Act will provide DAL with over $4B of very low-cost capital and will dilute shareholders by less than 1%. Our base case assumption for 2020 is a 38% decline in revenues, and a loss of $900M of operating income (vs $6.7B of operating income in 2019). In this scenario, we believe DAL can end the year with $2.8B of cash. If we assume passenger volumes in 2021 are 14% below the 2019 peak with 10% lower prices, we think DAL could earn $5 EPS in 2021 (vs. $7.31 in 2019). With the stock trading just above $24/share as of April 10th, we believe there is considerable upside in the stock. Because the ability to project DAL earnings is low and risks increase as the duration of the crisis extends, DAL will remain an underweight position in the portfolio.

As of April 12th, our five largest positions are NRG Energy (NRG), *Crown Holdings* **(CCK)**, Charles Schwab (SCHW), Perrigo (PRGO) and *Sony Corporation* **(SNE).**

We hope everyone is safe and healthy. Thanks, as always, for your continued support and confidence.

"Finally, be aware that the market does not turn when it sees light at the end of the tunnel. It turns when all looks black, but just a subtle shade less black than the day before." – Jeremy Grantham, March 4th, 2009

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.