MD Sass Concentrated Value

Q2 2020 Commentary

MD SASS

July 20, 2020

The MD Sass Concentrated Value ("CV") strategy was up +23.5%, net of fees, in the second quarter of 2020, vs. +14.3% and +14.5% for the Russell 1000 Value and Russell 3000 Value indices, respectively.

CV is down -14.9% YTD thru the end of Q2, vs. -16.3% and -16.8% for the Russell 1000 Value and Russell 3000 Value indices, respectively.

From inception (January 2019) thru the end of Q2 2020, CV was up +20.6% net of fees, vs. +5.9% and +5.1% for the Russell 1000 Value and Russell 3000 Value indices, respectively.

So much has transpired since January that it's hard to believe this letter reflects upon only a half year of market activity. In Q1, the S&P 500 sank -35% in 19 days, the fastest drop since 1933. However, in Q2 stocks posted their best quarter since 1998. A full market cycle, which typically takes years to complete, was condensed to a matter of months. It'd be an understatement to say that navigating an investment portfolio through this type of environment has been quite challenging. Who would've thought the NASDAQ would be up YTD and the S&P 500 roughly flat despite an unprecedented global pandemic (which is accelerating in the U.S.), a collapse in global growth and record levels of unemployment?

Our Q1 letter focused extensively on the pandemic, its impact on the economy and markets, and how we navigated during the market plunge and subsequent recovery. Now that we've had several months to digest and reflect on the crisis and its aftermath, it is important to crystallize what we learned from this experience and how these learnings will make us better investors. Some of our insights are not necessarily new concepts for us but were nonetheless heavily reinforced by recent events:

- ***Utilizing second and third order thinking early in the onset of a crisis or change event can lead to significant alpha generation.*** It is natural for people to grasp onto first order thinking when a significant event takes place. This level of thinking is "gut" thinking and a natural byproduct of your mind dealing with what's in front of it. When COVID-19 hit the shores of the U.S. and its rapid spread led to a virtual economic shutdown, first order thinking included – will I work extensively from home and for how long? Will air travel and cruises be restricted? Should I take public transportation? Will I be required to work from home? Will it be difficult to get food and basic goods? How many people are likely to die?

  Answering these questions was important but did little to help us discover interesting investment opportunities. Different questions were needed; ones that went a level or two deeper (second and third order thinking). Investors who asked themselves the following questions during the depth of the crisis and panic (a time when many cling to first order thinking) were well rewarded to the extent their conclusions were sound – if people aren't going to fly on planes or take cruises, how will this impact consumers' travel habits? If people aren't going to physical retail stores, what product categories are likely to see a significant increase in e-commerce penetration? If knowledge workers will be forced to work from home, what productivity tools will they need to adopt to perform their tasks? How will peoples' desire for more space/less crowding impact migration and day-to-day travel? This is a terrible time for most businesses, but who will emerge from this in an even stronger competitive position due to balance sheet strength

and/or superior innovation? Many companies will breach debt covenants, but which companies will get covenant relief with only minimal cost?

Howard Marks summed it up well in his book, *The Most Important Thing*. "First-level thinking is simplistic and superficial, and just about everyone can do it (a bad sign for anything involving an attempt at superiority). All the first-level thinker needs is an opinion about the future, as in 'The outlook for the company is favorable, meaning the stock will go up.' Second-level thinking is deep, complex and convoluted."

- ***Don't fight the Fed.*** We already knew this, but the Fed's response to the pandemic highlights the importance of this concept. The Fed's swift and decisive actions early in the crisis, along with its public declaration for further action as needed, played a significant role in the recovery of equity markets in the United States. While many prognosticators lamented the divergence of Wall Street (stock prices) vs. Main Street (unemployment, GDP growth) over the past few months, much of this can be explained by unprecedented Fed policy response. As of this writing, the yield on the 10-year Treasury is only 0.63% which, in real terms, represents a negative rate of return. Contrast this to the NASDAQ which is trading for approximately 32x forward earnings. Sure, the P/E multiple of the NASDAQ is very high by historical measures but relative to a negative real rate of return on a 10-year Treasury which one seems more attractive? Afterall, the NASDAQ earnings had a compounded growth rate of nearly 11% from 2013-2019 whereas interest income on treasuries do not grow. In sum, if rates remain low for an extended period then companies that can compound earnings at very attractive growth rates deserve lofty valuations and those that can grow earnings at even modest growth rates also deserve healthy valuations. If rates fall further, the convexity of high P/E stocks could lead to further outperformance of 'growth' stocks. For example, a 50 bps drop in rates has a much more positive impact on the share price of a 3% yielding stock than a 15% yielding stock, all else being equal.

- ***The global pandemic will have a cyclical and structural impact.*** COVID-19 led to an acceleration of trends that were already underway such as e-commerce, cloud computing, streaming, and video games. While some of this increased demand will prove temporary, more permanent changes in consumer behavior will drive structural changes. The longer the pandemic persists, the more engrained some of our "new" behaviors will get in our daily lives. For example, working from home will likely play a larger role in our society moving forward, which will have significant ripple effects in terms of where people want to live, their method of transportation and real estate values in densely populated cities. Some structural impacts are becoming increasingly apparent, others not so much. We continue to focus our time on structural changes that have not yet made their way into consensus thinking.

- ***Price triggers are a helpful tool to facilitate bargain buying when it is emotionally difficult to do.*** As we described in our Q1 letter, we established price triggers for all our stocks in March. These price triggers represented the price at which any given stock in our portfolio would be trading at a trough multiple on trough earnings. We decided that if any of our stocks hit its price trigger we would automatically buy more absent any material incremental news. Ultimately, certain price triggers were hit, and we bought more of a few names that ultimately proved beneficial in hindsight. For example, we bought more *WR Grace* **(GRA)** on March 26th and then again on April 1st when the stock was in the low $30s, whereas the stock is currently at ~$50/share. It was emotionally painful to buy more stock when everything was in free fall but that is precisely the time to act.

- ***Time horizons compress when there's panic but that's exactly when one should be extending them.*** During crises, many investors tend to focus on the short term. This is due, in part, to the fact that narratives oftentimes follow price

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so when stock prices drop precipitously, narratives shift from long term fundamentals to short term price movements, which are oftentimes arbitrary. In a rapidly declining market, if a portfolio manager stares at his Bloomberg screen long enough, the long-term perspective quickly dissipates and the desire to answer questions about daily or hourly price moves takes priority. This is when long term fundamental investors can exploit time arbitrage and scoop up great, high quality companies at attractive prices. We believe our purchases of Google and Facebook in March were good examples of keeping our eye on the long term but, in hindsight, there was clearly a lot more we could've done to capitalize on time horizon compression. This is probably one of our biggest errors of omission thus far in 2020.

- ***Nobody knows.*** In January, when the virus was still considered by most as a China problem, few people accurately predicted the enormous impact of COVID-19 on global public health, economy or markets. In March, during the depths of the crisis, very few forecasted the neck-breaking rebound that markets experienced over the ensuing months. Probably no one accurately predicted both. Even some of the smartest investors got it wrong (so far) – Stan Druckenmiller and David Tepper both rang the alarm bells on the equity market in mid-May only to see the S&P 500 rally another 15% since. We would argue that the distribution of potential outcomes over the next 12 months is extremely wide and the numerous variables that will determine the outcomes (status/availability of vaccines, Presidential election, health and public policy responses, etc.) are equally opaque. Quite simply, nobody knows what the next 12 months will bring. How do we invest in an environment that is so unknowable? We use conservative underwriting assumptions for our projections, we seek businesses with high quality management that can navigate turbulent waters, and we invest in stocks where we have high conviction that our earnings projections are above consensus. We also maintain a larger cash balance than usual (currently 10% of our equity portfolios) to exploit the expected volatility that accompanies uncertainty.

Q2 PORTFOLIO REVIEW

The biggest contributors to performance in Q2 were GRA, *Quest Diagnostics* (**DGX**), *CarMax* (**KMX**), *SVB Financial* (**SIVB**) and *NXP Semiconductors* (**NXPI**), which collectively contributed approximately 855 bps to performance.

GRA, a leading specialty chemicals manufacturer, rallied over 44% in Q2 after reporting first quarter earnings that came in at the high end of their guidance range even though economic conditions deteriorated meaningfully since they offered first quarter guidance. With ~40% of oil demand coming from cars and trucks, we believe GRA will benefit from cyclical factors (relaxation of economic lockdowns and quarantines) as well as potential emerging secular trends (shift in leisure travel from planes to cars, migration from urban to suburban/rural dwellings, shift from public transportation to private). GRA is trading for less than 12x our projected 2021 EPS and we believe there is attractive upside in the shares if the stock reverts to its historical multiple of 17x, which we think is achievable as demand improves, margins expand and free cash flow growth accelerates.

Although DGX was negatively impacted by consumers opting to forego doctor visits (which negatively impacts DGX's diagnostics business), DGX is a beneficiary of increasing demand for COVID-19 testing – both molecular and antibody tests. In early June, DGX had capacity to perform 100,000 molecular tests/day and 200,000 antibody tests/day. DGX's molecular

testing capacity increased 50% by the end of June. Furthermore, DGX's base business was improving at a faster rate than expected. Putting all this together, heading into this quarter, we believed that DGX would materially beat consensus estimates for Q2 and on July 13th DGX released preliminary Q2 results with expected EPS of $1.39-$1.42 vs. consensus expectations of only $.13. In the medium term, we expect COVID test volumes to remain significant even after a vaccine is widely disseminated as any symptoms will necessitate a test. Longer term, we expect recent Medicare pricing pressures and COVID-related demand destruction will materially weaken DGX's competitors, which will lead to organic market share opportunities and potential accretive M&A.

KMX rallied more than 66% in Q2 as used car sales rebounded materially intra-quarter. Used car sales benefitted from a consumer "trade down" effect from new to used cars and from consumer subsidies offered by the CARES Act. We were concerned about the potential for capital markets to dry up and negatively impact KMX's ability to offer financing to customers but our checks with sophisticated asset-backed securities investors suggested otherwise. Specifically, we learned that CarMax generally has a higher quality borrower base that is less exposed to hourly wage earners and expect prime/near prime auto transactions (KMX's sweet spot) to be less impacted than subprime. We believe the pandemic puts KMX in a position of strength relative to its competitors as KMX is one of the few used car retailers to have invested substantially in omni-channel capabilities including free home deliveries and express pickup from stores. KMX has the potential to gain market share as its omni channel value proposition has only increased. This concept is not dissimilar to our *Target* **(TGT)** thesis although TGT is a year or two ahead of KMX in terms of implementation.

The CEO of SIVB used the word 'clients' 30 times in his Q1 letter to shareholders. We believe SIVB's relentless focus on customer service and client relationships have paid off handsomely for the company. Even during a global pandemic SIVB put up impressive numbers. In Q1, loans grew 25% (an acceleration from Q4), noninterest-bearing deposits grew 9% and revenues grew 4% despite a collapse in interest rates. Higher provision expenses are a concern across the banking sector, but we believe it is very manageable for SIVB. Loans represent 50% of its assets and greater than 50% of SIVB's loan portfolio is venture capital and private equity capital call loans that have virtually no credit risk. We believe SIVB has a unique franchise and can get back to its 20%+ return on equity when interest rates rise. In the interim, we own a growth bank with dominant niche businesses trading at 1.6x price/book, near its trough. SIVB is trading for less than 14x our expected 2021 EPS, which we believe is conservative based on virtually no recovery in net interest margins.

NXPI is the largest supplier of semiconductors to the automotive industry and rallied sharply in Q2 as global auto production came back online. China auto sales recently returned to growth as some consumers appear to be opting out of public transportation and purchasing their own cars. We believe NXPI's long term revenue growth will exceed auto production growth by ~600 bps due to the growth of semiconductor content per car. This outlook is consistent with NXPI's track record – between 2012 and 2018 NXPI grew its auto segment revenues about 9% per year on average, significantly higher than auto production growth of ~2.4%. This content growth is driven by the adoption of new technologies, including battery power management (electric vehicles), radar and active driver-assist systems (ADAS). We think consensus estimates for 2020 are way too low as the resurgence of auto production and the ramp of 5G infrastructure are potentially underappreciated catalysts for NXPI in the second half of 2020.

We had only two detractors to performance in the quarter – *Axalta Coatings* (**AXTA**) and *Delta Air Lines* (**DAL**), which collectively hurt performance by 29 bps. We discuss the investment thesis for AXTA, which is a new position in the portfolio, later in this memo. With respect to DAL, we continue to believe that DAL has the liquidity to weather the storm with over $15B of liquidity at the end of Q2. Furthermore, assuming 2022 demand is 13% below 2019 levels and revenue per available seat mile is 9% below 2019 levels, we think DAL could earn $6 in 2022 putting the stock at less than 5x '22 EPS. However, we

recognize that it is difficult to have a high level of conviction in our 2022 EPS estimate and given the high fixed cost structure of the business, even slight changes in demand variables can lead to significant EPS revisions. Additionally, we have concerns about whether load factors will remain structurally depressed for an extended period to regain consumer confidence and trust in air travel. For example, DAL may intentionally keep middle seats vacant for the foreseeable future. Our 2022 EPS estimate has a relatively conservative load factor assumption of 77.9% (vs. 86.3% in 2019) but that may prove aggressive if DAL continues to intentionally depress loads. Given the uncertainty and risks described above, DAL is the smallest position in the portfolio at 1.5%.

We exited our position in *Aecom* **(ACM)** in the quarter. ACM returned -10% during the 2.5 years that we owned it vs. -11% for the Russell 1000 Value. However, ACM contributed positive 20 bps to our portfolio based on the timing of the bulk of our purchases at much lower prices. We sold the stock in May due to concerns that ACM's end markets could deteriorate in 2021 and the stock wasn't discounting any of this risk. COVID-19 will negatively impact state and local budgets in 2020, which could translate into meaningfully lower transportation budgets in 2021. The government can bridge the gap with a major infrastructure bill, but nothing has been finalized. Consensus estimates +2% revenue growth in 2021, and if state/local transportation budgets are lower, estimates will come down (especially with pressure on the private side of their business - ~20%). The stock had performed relatively well leading up to COVID-19 due to rumors that they would be acquired by WSP Global, a larger Canadian engineering firm. While a potential deal makes sense and would be accretive to WSP, it didn't warrant holding the stock into a period of uncertainty that the market wasn't discounting.

We initiated two new positions in the quarter – AXTA and *AmerisourceBergen* **(ABC)**. The following is a synopsis of our investment thesis for each:

AXALTA COATING SYSTEMS (AXTA)

AXTA is a manufacturer of high-performance coating systems and is the former performance coatings system of Du Pont that was acquired by Carlyle Group in 2012. The company generates 90% of its revenue in markets where it holds the #1 or #2 global market position, including a #1 position in its core auto refinish end-market with approximately 25% global share. The company has 2 reporting segments: Performance coatings (~65% of sales and 75% profits in 2019) and Transportation Coatings (~35% of sales and 25% profits). Auto refinish represents ~39% of sales but more than half of total EBITDA as it's the highest margin business with EBITDA margins estimated to be in the high 20s.We believe auto refurbish is a great business as it enjoys pricing power, high switching costs and a fragmented customer base.

The AXTA story over the past three years has been that of a stable, strong coatings business that was hit with a series of unfortunate events. In 2017/18, significant raw material inflation hit gross margins as the company couldn't raise prices fast enough to compensate. Gross margins declined from over 38% in 2016 to just under 34% in 2018. During this time, global currencies deteriorated against the USD, primarily from recessions in emerging markets such as Brazil. In 2019, Western countries experienced industrial recessions as the China trade war slowed auto OEM production. The company also went through multiple CEOs in a short period of time. Charlies Shaver retired in late 2018 and his successor was there for 6 weeks before a scandal led to his termination. Former CFO, Bob Bryant, is now the current CEO. Since Bryant's appointment, the business was effectively frozen in time under a lengthy strategic review process pushed by certain shareholders. In March, AXTA terminated the review process as COVID-19 eroded demand and forced them to pull their

2020 guidance. The aforementioned events caused AXTA stock to dramatically underperform its peers. Over the past 4 years, AXTA has declined nearly 14% vs. increases of 2.4% in *PPG Industries* **(PPG)**, 32% in *Akzo Nobel* **(AKZA NA)**, 99% in *Sherwin Williams* **(SHW)** and 157% in *Nippon Paint* **(4612 JP)**.

We believe that the issues discussed above are largely behind the company and consensus estimates for revenues and margins are too low as the COVID-19 demand impact on automobile miles driven continues to lessen in all regions across the globe. AXTA's variable cost structure, consistent pricing power and significant drop in raw materials, give us confidence that the decremental margins are too draconian. This was evident in 1Q20, when the early impacts of COVID-19 led to a -8% revenue headwind yet gross margins expanded vs. last year. Notably, PPG released quarterly results on July 16th and reported flat operating margins vs. the prior year despite a 15% decline in net sales. In the short term, we expect consensus estimates to rise due to better gross margins and higher sales from a recovery in miles driven. In China, congestion data in some big cities shows commuter traffic is already at or above 2019 levels. Longer term, with the company free from the shackles of a strategic review process, the CEO can implement his cohesive growth strategy, which includes tuck-in M&A and continued focus on innovation and geographic expansion in higher growth emerging markets. We believe ROIC will expand from tight cost control and execution of growth initiatives. AXTA trades for 14x our EPS estimate for 2021 and ~10.5x EV/EBITDA. This compares to peers at 17-25x P/E for 2021, and 12-19x EV/EBTIDA. We believe an improved ROIC profile coupled with expanded gross margins and consistent mid-single digit revenue growth should lead to multiple expansion over time.

AMERISOURCEBERGEN (ABC)

AmerisourceBergen is a drug distributor operating primarily in the United States. Pharmaceutical Distribution represents 80% of profits and consists of two primary sub-segments – Traditional and Specialty. Traditional includes branded and generic drugs that are simple to administer (i.e. pill form). Although most of Traditional revenues come from branded drugs, generics are the bulk of profits. Traditional accounts for about half of Pharma Distribution profits with growth trending flattish more recently. The Specialty sub-segment focuses on sensitive and complex bio-pharmaceuticals where ABC helps administer the drug and generates ancillary revenues from data analytics as well as access/adherence services to nurses and pharmacists. Oncology is the biggest indication within Specialty followed by Rare Diseases and Plasma based services. Specialty has grown at a low double-digit growth rate over the past few years and, we believe, generates profits comparable to Traditional. The remaining 20% of ABC's EBIT comes from logistics services (World Courier), data solutions (Lash) and animal health distribution (MWI).

Generic drug pricing is a key driver of profits within ABC's Pharmaceutical Distribution. A patent cliff of branded drugs that started in 2014 led to a period of outsized returns in generic drugs which benefitted ABC. This ultimately led to an influx of new generic drug manufacturers, mostly India-based, who materially drove down generic drug prices. In 2017, generic drug prices dropped precipitously, and ABC's EBIT declined accordingly. Generic pricing stabilized in mid-'19 catalyzed by a significant behavior shift amongst the larger manufacturers. *Teva Pharmaceuticals* **(TEVA)**, the largest generics manufacturer, kick-started this process by closing 23 manufacturing sites and exiting unprofitable products representing ~7% of their portfolio. *Mylan* **(MYL)** and Sandoz also exited certain products and are now de-emphasizing U.S. generics through portfolio repositioning and M&A. The #2, #3, & #4 players are Indian manufacturers who have

maintained/gained share over the last few years, but recent commentary indicates a focus on margins and returns vs. revenue growth. More recently, supply out of India has been constrained due to manufacturing/regulatory issues.

A benign deflationary environment coupled with 10%+ Specialty growth should enable ABC to achieve mid to high single digit EBIT growth over the next few years. Longer term, biosimilars (generic biologic therapies) offer great potential for ABC as they will provide more value in the distribution process which could provide a boost to margins. Additionally, the potential onshoring of active pharmaceutical ingredients (API) could lead to generic pricing inflation that would benefit ABC. A piece of pending legislation called the Strengthening America's Supply Chain and National Security Act seeks to reduce U.S. dependence on Chinese raw ingredients and APIs.

Many of the negative headlines around drug pricing and AMZN entering the business have passed, and the industry opioid settlement will likely conclude in 2020 (and very manageable for ABC). We believe the focus will shift to AmerisourceBergen's important role in the drug supply-chain in a pandemic and post-pandemic environment. An acceleration in earnings growth into the +10%-15% range could lead to a re-rating of the stock back to its historical mid-teens P/E multiple.

As of July 17th, our five largest positions are *Sony Corporation* **(SNE)**, *Crown Holdings* **(CCK)**, *NRG Energy* **(NRG)**, ABC and *Liberty Media-Formula One* **(FWONK).**

Many of the companies that we admire "lean in" during times of crisis and become more aggressive, not less, to capitalize on opportunities. We intend to do the same at MD Sass as we seek to launch new strategies and grow our existing ones, including Concentrated Value. We believe our value proposition to clients has only improved over the past 18 months as we outperformed our benchmark in the bull market of 2018 and the bear market of 2019 (so far). With top decile performance vs. peers since January 2019 and top quartile Sharpe Ratio and Information Ratio, we are on the offense in terms of messaging our value proposition.

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

Sincerely,

Ari Sass

President & Portfolio Manager, MD Sass

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