MD Sass Concentrated Value

MD SASS

Q4 2020 Commentary

January 13, 2021

The MD Sass Concentrated Value ("CV") strategy was up +22.1%, net of fees, in the fourth quarter of 2020, vs. +16.2% and +17.2% for the Russell 1000 Value and Russell 3000 Value indices, respectively.

For the full year 2020, CV was up +7.8%, net of fees, vs. +2.8% and +2.9% for the Russell 1000 Value and Russell 3000 Value indices, respectively.

From inception (January 2019) through the end of 2020, CV was up +52.2% net of fees, vs. +30.1% and +29.9% for the Russell 1000 Value and Russell 3000 Value indices, respectively.

Since *Pfizer* **(PFE)** reported efficacy data for its innovative vaccine on November 11th, the market darlings quickly shifted from "work from home" beneficiaries to "travel/re-opening" beneficiaries. *Zoom Video Communications* **(ZM)**, the posterchild for the pandemic-induced acceleration in digital transformations, has declined over 30% since the release of very positive efficacy data from both Pfizer and *Moderna* **(MRNA)**. The ebullience for stocks that benefit from a return to normalcy is valid, although we are cautious about the heady consensus expectations for many of these stocks. As an example, the consensus 2021 EBITDA estimate for *Formula One* **(FWONK)**, a clear beneficiary of 'back to normal', is over 20% higher than 2019. *Royal Caribbean* **(RCL)** has an enterprise value only 18% lower than its 2019 peak despite trailing twelve-month sales that are 56% lower than the prior year. The largest domestic food distributor to restaurants, *Sysco Corp.* **(SYY)**, has lost only 10% of its enterprise value since 2019 despite a sales decline of 23% in the most recent quarter. In sum, much of the good news is baked into many of the more obvious recovery plays, at least in the near term.

Despite the recent underperformance of many digitally native companies over the past few months, we believe there has been several structural changes in consumer behavior that will provide lasting, long term benefits to these companies' competitive strengths and future growth rates. While COVID-19 forced consumers to transact digitally, and no one likes to be "forced" to do anything, the adoption of new behaviors (forced or not) that lead to a better overall experience will likely prove sticky over the long term. Likewise, despite a cyclical rebound in re-opening stocks, the lasting benefits of the pandemic on e-commerce, digital payments and cloud-based infrastructures will likely prove sticky over the long term. Nick Sleep perhaps said it best in Nomad Investment Partners' Q2 2011 letter to investors when discussing the merits of its investment in *Amazon* **(AMZN)**. "*Our hunch is that the growth rate in online retailing is regulated, not by physical capacity, although that can be a limiting factor, but more by the rate at which our own incumbent habits and associations are replaced with more rational behaviour.*" COVID-19 accelerated the shift of incumbent habits to more rational behavior that will prove lasting.

Other pockets of the stock market have witnessed an air of irrational exuberance. Ultra-low interest rates, stimulus checks in the hands of eager gamblers whose casinos were closed and FOMO provided a potent cocktail of excessive risk taking in many high growth stocks, "blank check" companies (SPACs) and even bankrupt entities(!). *Snowflake* **(SNOW)**, which now sports a market cap north of $80B, generated less than $500M of sales on a trailing twelve-month basis and lost nearly $200M of free cash flow. *Appian* **(APPN)** generated less than $300M of sales on a trailing twelve-month basis while losing just over $20M in free cash flow yet has a market cap north of $10B. *NIO Inc.* **(NIO)** has a market cap of nearly $100B yet generated sales of less than $1.8B on a trailing twelve-month basis and negative free cash flow. The market is clearly impressed as the stock has risen nearly 1,700% since the beginning of 2020. *Tesla* **(TSLA)**, whose consensus 2021 EPS estimate is down about

20% since July of 2018, has seen its stock jump over 1,000% over that timeframe. Its enterprise value of $836B is more than that of *Ford* **(F)**, *General Motors* **(GM)**, *Volkswagen* **(VOW GR)** and *Toyota* **(TM)**…combined.

Speaking of Tesla, on January 7th, Elon Musk tweeted "use Signal" at which point *Signal Advance* **(SIGL)** surged nearly 1,500% intra-day. SIGL is a healthcare company with a handful of employees at most working in a 1,000 sq. ft office space in Texas. Although Mr. Musk's tweet referenced an unrelated burgeoning competitor to WhatsApp, it fueled a buying frenzy in SIGL, which surged from low millions market cap to $300M+ due to one misinterpreted tweet. The stock is now up over 5,000% as of this writing even though the error should now be well-known. File this under: "things you don't see at market bottoms."

The meteoric rise of some high growth stocks trading at extreme valuations is, in part, fueled by a surge in a new breed of retail traders armed with the Robinhood app and social media. JMP Securities estimates that individual investors opened more than 10 million new brokerage accounts in 2020, a record. Citadel Securities stated that individual traders accounted for nearly 25% of U.S. trading activity on peak trading days in 2020 with retail's overall share doubling to 20% from 10% in 2019. According to a recent *Wall Street* Journal article, "*as of January, posts tied to #stockmarket had garnered over 800 million views on TikTok, more than triple the figure in June. Reddit's infamous WallStreetBets forum has more than doubled in subscribers since the start of 2020. StockTwits, a social network focused on investing and trading, has seen its user numbers more than triple over the past year. Recently, Tesla and NIO have generated some of the most chatter.*" There is an army of social media influencers recommending stocks and ETFs, such as 'Sara Finance', a 19-year old influencer on TikTok with over 600k followers whose favorite investment is *ARK Innovation ETF* **(ARKK)**, an ETF that gained over 100% in 2020 and lured in nearly $10B of flows in 2019 (its biggest position is TSLA). Of course, another favorite investment of the burgeoning retail trader is crypto currencies, such as Bitcoin, which increased over 4x in 2020.

A Special Purpose Acquisition Company (SPAC) is a "blank-check" company formed with the intention of acquiring or merging with another company. According to a Goldman Sachs report dated December 17th, 2020, SPACs comprised more than half of the IPO market in 2020 with more than one new SPAC announced *per day* since July. Goldman estimates there were 193 SPACs with $63B of equity capital searching for a merger target as of December 17th. Over 30% of SPACs that IPO'ed in 2020 didn't even specify a target industry, which means investors were throwing capital at blank check companies that barely acknowledged a stated purpose. Colorful names abound in SPAC land including the recently launched Queen's Gambit Capital (a non-subtle marketing ploy at retail investors) which plans to target businesses that "provide solutions promoting sustainable development, economic growth and prosperity." In other words, they have no area of focus. The record level of capital raised by SPACs in 2020 is indicative of the euphoric appetite for concept stocks and growth at any cost.

These anecdotes and datapoints beg the question - are we in another tech bubble? As described above, it certainly feels that pockets of the markets are. However, we don't think the bubble is nearly as pervasive as the tech bubble of the late 1990s. For one, the valuation of large cap growth stocks today is much more reasonable than the late 1990s. According to Yardeni Research, the forward P/E multiple of the S&P Growth index was about 28x at the end of 2020, significantly lower than the peak of the tech bubble when the index was over 40x, a differential even more pronounced considering the lower interest rate environment of today. Philippe Laffont of Coatue Management recently posited, "maybe today you have 3 categories [of stocks]: old economy, established new economy (many large caps) and contenders/big TAM", suggesting that the area of risk in the market is not in the established new economy stocks but rather the younger, high growth momentum stocks with promises of a large TAM (total addressable market).

If there are, in fact, pockets of euphoria that may lead to a mini-tech bubble, what will cause the bubble to burst? We would posit that there is no event or catalyst for the potential bubble burst, much like there wasn't when the tech bubble burst in 2000. Some say that the Fed killed the last tech bubble by raising interest rates, but the Fed raised rates three times in 1999 and once in 2000 prior to the top. Others suggest that deteriorating fundamentals led to the tech collapse but, according to research from Bernstein, revenue growth from software, computer and comm equipment companies grew 16% in the first quarter of 2000 (when the bubble popped), comparable to the prior few quarters. Revenues didn't decelerate until Q4 2000, demonstrating that fundamentals tend to follow price for bubble stocks.

We expect CV would be largely immune to any bubble deflation risks within growth/tech/big TAM stocks. We continue to own a concentrated portfolio of stocks that trade for reasonable valuations with attractive growth prospects. We believe our portfolio will achieve double digit EPS growth in 2021 yet trades for less than 17x estimated earnings on a weighted average basis. Furthermore, we believe the Democratic sweep will lead to additional stimulus, infrastructure spending and a de-escalation of China trade tensions that will benefit cyclicals, financials and cash flowing stocks. The potential for higher interest rates will negatively impact long duration cash flows which could lead to money flows out of high growth concept stocks with negative cash flows and into more reasonably priced, cash flowing businesses with accelerating growth post-pandemic. Of note, ISM Manufacturing Prices Paid has recently gone vertical and it generally leads CPI by about 3 months. The prospect for higher rates has likely been a significant factor in the recent outperformance of Value stocks over Growth.

Q4 PORTFOLIO REVIEW

The biggest contributors to performance in Q4 were *Charles Schwab* **(SCHW)**, *SVB Financial Group* **(SIVB)** and *Mohawk Industries* **(MHK)** which collectively contributed approximately 600 bps to performance.

We have been bullish on SCHW ever since the company announced its transformational acquisition of *TD Ameritrade* **(AMTD)** in late 2019. We believe the Street under-estimated the earnings accretion from the deal based on AMTD's organic asset growth since the deal was announced. AMTD's interest deposit accounts (IDAs) totaled approximately $115B at the time the deal was announced but grew to about $150B by the time the deal closed, leading to incremental deal synergies as SCHW leverages its bank charter to generate more spread income on those assets. At an investor event in late October, SCHW's CFO guided for the deal to add 25%-35% to EPS in Q4, implying EPS of $.60 vs. consensus estimates of $.51. This unexpectedly large earnings accretion, coupled with a growing consensus of higher long-term interest rates, drove significant outperformance for the stock in Q4 as it rallied nearly 50%. Despite the recent strength in the share price, SCHW is still attractively priced relative to our forecast for its longer-term earnings power. We believe SCHW can earn over $4.25 per share in 2024 after the company achieves its revenue and cost synergies from the AMTD deal. Using a 19x P/E multiple, we believe the stock could trade for over $81 within the next three years which equates to a double-digit compounded rate of return from today's price of $59. A continued rise in long term rates and the potential for an increase in the fed funds rate could lead to a positive upside surprise to our above-consensus estimates.

Almost all large U.S. banks will report a significant contraction in EPS in 2020 due to lower net interest margins (NIM) and higher provisions for credit losses because of the pandemic. However, SIVB will likely show "only" a 10% decline in EPS in 2020 due to its strong relative growth in assets vs peers. SIVB is a niche bank that dominates its verticals including PE/VC capital call lending and pre-IPO technology sector loans. At its size and scale, SIVB continues to demonstrate incredible

growth. Since 2016, SIVB has grown clients at a 13% CAGR, loans at a 21% CAGR and total client funds at a 27% CAGR. We believe the operating environment remains conducive to further growth over the next few years as VC dry powder is ~25% higher than 2019 and PE dry powder is ~4% higher as of March 31st, 2020. The deployment of this dry powder will propel growth in SIVB's loan book. Given the asset sensitive nature of SIVB's balance sheet, SIVB should experience NIM expansion over the next few years alongside a rise in interest rates. SIVB generated over 20% return on equity in late 2018 when its NIM was 100 bps higher than today. With current ROE at nearly half that level, there is the potential for significant positive earnings revisions should rates trend higher towards 2018 levels. Since June, consensus estimates for 2021 EPS have gone up approximately 50% driven by better than expected execution and a more favorable interest rate outlook which ultimately drove the stock up over 60% in the fourth quarter.

A confluence of events caused MHK to dramatically underperform the market over the past few years including a stronger dollar, inflation in trucking and commodities and material start-up costs related to production of luxury vinyl tile (LVT). The biggest driver of under-performance, though, was MHK's ill-timed entry into the LVT category. LVT has been growing at a strong double-digit rate over the past few years and accounted for nearly 100% of the growth in the overall flooring market. MHK was late to the party and witnessed a significant negative impact to its business as its over-exposure to carpet and ceramic led to market share declines. However, MHK is reaching an inflection point where its internal investment in LVT is about to bear fruit and should ultimately position the company to be the low-cost provider of LVT in the United States and Europe. A properly aligned product portfolio coupled with a large cost restructuring plan and a weaker dollar may provide a very favorable operating environment for the company over the next few years. After several quarters of disappointments, MHK of late has been beating consensus EPS expectations. Since May, consensus EPS forecasts for 2020 have increased from $3.60 to $7.90 which has driven the stock higher and is the primary driver of its +44% return in Q4. We believe expectations are still too low. We expect the company to deliver nearly $11 in EPS in 2021 which is about 10% higher than consensus expectations. At just 13.4x our 2021 EPS estimate, the stock has material upside if they can deliver on the turnaround that we expect. Notably, our 2021 estimate contemplates an operating margin of 10% which is considerably less than the 15% margin achieved in 2017 when business was brisk due to a weak dollar, strong housing market and optimized product portfolio. We believe these conditions will be present in 2021 and could lead to meaningful upside to our estimates. Net debt/EBITDA will be less than 1x and we believe management will allocate capital to drive better returns either via acquisitions or material share buybacks.

The biggest detractors to performance in Q4 were *Molson Coors* **(TAP)** and *Perrigo* **(PRGO)**, which collectively hurt performance by 15 basis points.

We initiated a position in TAP during the quarter and provide a detailed analysis of our investment thesis later in this memo.

In November, PRGO lost its action in the Irish High Court aimed at overturning a €1.64B tax assessment related to the company's sale of intellectual property in the drug, Tysabri. While the ruling eliminated a near-term positive catalyst for the stock, we did not expect PRGO to win the action and have already contemplated the tax liability in our fair value estimate for the company. The decision does not mean that PRGO will ultimately have to pay the fine, but it assures that the matter will go to court. The stock was also pressured by mass quarantines which reduced the incidents of flu during the peak flu season in 2020/21 and will negatively impact sales of PRGO's cough and cold products. With cough/cold products representing less than 10% of total sales, we believe the Street is overly concerned and perhaps under-estimating the tailwinds PRGO is experiencing in other parts of its business, such as infant formulas and nicotine replacement therapies that carry higher margins. 2021 will be a pivotal year for PRGO as we expect gross margins to expand due to favorable product mix, new product innovations and cost containment measures. We believe the key to the stock longer term will be its ability to execute

a plan that will drive mid-single digit EBIT growth and high single digit EPS growth on expanding gross margins. As the leading private label manufacturer of OTC consumer self-care products, consistent execution should lead investors to view PRGO as a consumer staple worthy of a much higher valuation multiple. Although we have confidence in this outcome, PRGO is a "show me" story and investors may keep it in the penalty box until they deliver the results that we expect under the new management team. Encouragingly, the President of Consumer Self-Care Americas (CSCA) bought stock on the open market in early January of 2021 suggesting that perhaps trends aren't as poor as the Street believes.

We initiated three new positions in the quarter – *Duke Realty* **(DRE)**, *East West Bancorp* **(EWBC)** and Molson Coors (TAP). The following is a synopsis of our investment thesis for each:

DUKE REALTY (DRE)

Duke Realty is the largest publicly traded, U.S. focused industrial real estate investment trust (REIT). Its portfolio includes over 159M square feet of space across 526 facilities in 20 major U.S. markets. Approximately 65% of DRE's assets are in "tier 1" markets such as Southern California (12% of net operating income), Chicago (9%), New Jersey (9%), South Florida (9%), Atlanta (7%) and Dallas (7%) with a 2021 year-end goal of increasing that exposure to 70% via acquisitions/dispositions and organic development. DRE's largest tenants are Amazon, UPS, Wayfair, Home Depot and NFI Industries. Transportation and E-Commerce represent the primary tenant industries and comprise about 40% of DRE's total annualized net leases. DRE's debt is investment grade with no significant maturities until 2023.

The global pandemic has accelerated the shift to e-commerce, which has long-term positive demand implications for industrial real estate. Whereas e-commerce was gaining approximately 100 bps of share per year pre-pandemic, 2020 e-commerce penetration increased 400 bps. According to Chris Caton, Head of Global Strategy & Analytics at *Prologis* **(PLD)**: "*Prologis estimates [e-commerce] customers require 1.2 million square feet of distribution space for each $1 billion in sales, which means e-commerce requires three times the space as traditional through-put distribution*." This is consistent with a recent CBRE Research study that found for each incremental $1 billion growth in e-commerce sales, an additional 1.25 million sq. ft. of distribution space is needed to support this growth. In July, *Jones Lang Lasalle* **(JLL)** estimated that e-commerce sales could hit $1.5 trillion by 2025, which would increase the demand for industrial real estate by an additional 1B sq. ft (current industrial footprint is about 13.5B sq. ft in the U.S.). Prior to the pandemic, JLL attributed as much as 35% of its industrial leasing to e-commerce, but now, with e-commerce growth of ~20% in 2020 alone, JLL reports as much as 50% of its leasing activity already attributed to e-commerce related operations this year. Interestingly, the researcher that spearheaded the JLL study now believes the 1B of incremental demand is "very, very conservative" and could be as much as 3B. According to *Cushman & Wakefield* **(CWK)**, roughly 25%-30% of warehouse space in the U.S. is used for e-commerce. The average new warehouse in the U.S. increased by 108,665 sq. ft. (143%) in size and 3.7 feet in height when comparing high development activity periods in 2012-2017 to 2002-2007. E-commerce is the main driver of this and DRE has the "biggest" assets of publicly traded REITs as well as the youngest (avg. age of 11 years). The shift to bigger warehouses will favor DRE who has just 4% of its portfolio in sub-100k sq. ft assets.

Reverse logistics will be another important growth driver of industrial real estate over the next few years. According to market research firm Statista, returns for online sales tend to be two to three times more frequent than returns for in-store sales, with 15%-30% of online purchases returned, compared to 8%-9% of merchandise bought in-store. Reverse logistics

uses 15%-20% more space than a traditional outbound supply chain, according to Optoro, a reverse logistics software provider. Many retailers also are outsourcing reverse logistics to third-party logistics providers (3PLs), creating a significant new business for these companies, including *XPO Logistics* **(XPO)**, *Ryder* **(R)** and NFI (one of DRE's largest tenants), which have increased their footprints by about 31% since 2015.

The pandemic highlighted the risk of supply chain disruptions' impact on just-in-time inventory practices. A March 2020 survey by the Institute for Supply Management found that nearly 75% of business respondents experienced supply chain disruptions and more than 80% believe they will in the future. As a result, many businesses are planning a major restructuring of their supply chain processes. The inability to secure goods led to inventory depletions of critical supplies and consumer products. *CBRE Group* **(CBRE)** estimates a 5% inventory bump would necessitate an additional 700M to 1B sq. feet of industrial space. At the NAREIT Conference in June, the CFO of Prologis said they estimate inventory levels could grow 5%-10% as customers shift away from just-in-time inventory.

COVID-19, increased trade tensions with China and the desire to reduce supply chain dependencies on foreign countries could lead to an increase in onshoring and/or nearshoring. Barclay's estimates that onshoring could spur ~$20B in additional annual manufacturing-related recurring capex spend, when applying a typical capex / sales ratio of ~3.5%. *Apple* **(AAPL)**, *Whirlpool* **(WHR)**, *Taiwan Semiconductors* **(TSMC)** and *Stanley Black & Decker* **(SWK)** have all recently announced plans to move production to the U.S. and/or scrap offshoring initiatives. *Rockwell Automation* **(ROK)** recently called out Life Sciences and Semiconductors as the most obvious sectors for onshoring. Onshoring of manufacturing to North America would likely benefit market demand for industrial real estate in the Southeast, Midwest and Texas, which are all important markets for DRE.

New supply outpaced demand in 2019 and that is expected to continue in 2020. Cushman & Wakefield expects vacancy levels to increase 60 bps from 2019 levels to 5.2% by 2021. This is still well below the 10-year average of 6.2% (2011-2021). C&W also noted that built-to-suit (BTS) represents 34% of the construction pipeline which is much more conservative than prior quarters with just under 40% of space under construction being pre-leased. Importantly, among public REITs, DRE not only has the highest pipeline/asset ratio but also the highest % of pre-leased construction space at approximately 65%.

The key hurdles to future development are cumbersome entitlement processes, rising labor and land costs, and less availability in sought after locations. According to Green Street Advisors, development costs in the Inland Empire have risen 60% over the past decade with the cost of land driving 70% of that increase. In previous cycles, rent growth was tempered by fast development cycles and substitutional locations within markets but e-commerce has altered this dynamic as access to larger labor pools, lower transportation costs and the need for rapid delivery times makes locations less substitutable and has elongated development cycles due to the increasing size of industrial assets. This trend is even more pronounced in coastal markets which represents 77% of DRE's land bank available for future development.

In 2018 and 2019, DRE grew AFFO/share at just under 8% per year. Consensus estimates imply growth of just over 6% in 2021/2022. With a greater percentage of rents rolling in these years coupled with a development pipeline representing 8% of the asset base, we believe AFFO/share growth will accelerate. Additionally, DRE believes it is under-levered and wants to increase debt to 5.25x EBITDA while maintaining an investment grade profile that should accelerate FFO growth, given the latest debt raise came at just 1.8% for 10-year paper. DRE trades for 22x our 2021 FFO estimate, a premium to its historical valuation. However, we believe trends will accelerate, and with the 10-year rate much lower than historical levels, a premium multiple is warranted. Holding the current multiple constant, we believe the stock could conceivably compound at a low double-digit rate (10% FFO/share growth + 2.6% dividend yield) over the next few years.

EAST WEST BANCORP (EWBC)

EWBC commenced operations in 1973 as a federally chartered savings institution serving the immigrant Chinese-American community and has grown into a full-service commercial bank focused on the U.S. and Greater China markets. The bank is one of the few in the U.S. with a full banking license in China and decades of cross-border banking experience. EWBC has over 125 locations in the U.S. and Greater China, with a heavy concentration in California. The bank also has branches in Georgia, Massachusetts, Nevada, New York, Texas and Washington as well as full service branches in Hong Kong, Shanghai, Shantou and Shenzhen, and representative offices in Beijing, Chongqing, Guangzhou, and Xiamen. East West collects a mix of retail and commercial deposits to fund an asset base made up of shorter duration securities (20% of assets) and a diverse portfolio of loans (80%). The loan book is roughly a third each in Residential real estate, Commercial real estate (CRE), and Commercial & Industrial (C&I) loans. 75% of its loans are variable rate, with 90% of those 3 months or less in duration split equally between prime and LIBOR based. EWBC's capital ratios are among the most conservative in the banking industry ranging from 50% to 100% above the required regulatory levels. This conservatism speaks to the culture of the bank that is led by their highly respected CEO, Dominic Ng, who has been at the helm of EWBC for 30 years. All employees receive stock as part of their compensation, and there are many long-time employees who have generated meaningful wealth via their interest in EWBC shares.

EWBC has grown its balance sheet at a ~10% CAGR over the last 7 years led by its focus and brand awareness within the Chinese American community. EPS growth has averaged closer to 15% over this time until 2019/2020 when lower rates and COVID-19 negatively impacted growth. We believe that net interest income (NII) has troughed driven by 3 factors: 1) the downward re-pricing of EWBC's variable rate loans is largely complete, 2) the cost of funds should continue to decline as higher rate CDs mature and are re-issued at much lower rates (this dynamic should add a few bps to NIM and a few percentage points to NII growth over the coming quarters), and 3) the mix shift of assets from securities that currently yield ~1.2% into loans that yield ~3.7%. The interest rate sensitivity disclosures in SEC filings state that for a sharp 100 bps increase in short rates, EPS would increase by ~15%. In a gradual 100 bps increase scenario the sensitivity is approximately half that level. In a down 100 bps scenario, the sensitivity is minimal due to hedges.

Core loan growth decelerated from double-digit growth in 2018 to just 5% growth the last two quarters driven by the deteriorating US/China trade environment effecting the C&I book. Relations between the two economic super powers are highly likely to improve in a Biden presidency, which should unlock EWBC's competitive advantage and reinvigorate growth in this important business segment. The bank has collected significant deposits that are parked in lower yielding securities and ready to be deployed into higher yielding C&I loans when demands pick up. The CEO commented on the Q3 call that the bank "*started to see some nice growth in C&I in September*" driven by a mix of new customers and increased utilization of credit lines.

Expense management at EWBC is best in class among mid and large cap banks as measured by efficiency ratio. EWBC has operated at the 40% level over the last few years and, importantly, didn't need to boost expenses to achieve double-digit loan growth in the 2017/2018 period. We believe the revenue growth acceleration described above should drive operating leverage and higher profit growth over the next few years.

We believe consensus estimates for 2021 are too low due to our belief that EWBC will achieve better loan growth and lower credit provisions than consensus expectations. Two sell-side analysts expect flattish loan growth in 2021, but we believe the

recovery post-mass vaccinations and a loosening of China trade issues will lead to accelerated loan growth to approximately 8%, vs. ~5% growth in 2020. With respect to provisions, we believe mass vaccinations in 2021 will lead to a recovery in the loan categories that make up the majority of the "on deferral" bucket - namely energy, hotels and retail. Likewise, the 2021 provision should be significantly less than the 2020 level.

EWBC currently trades for 15x/12x the 2021/2022 EPS estimates and 1.6x book value. The median over the last 7 years (capturing all types of interest rate environments) is ~14x P/E and ~2x P/B. Historically, when short-term interest rates were expected to rise, the multiples were at the high end of the ranges, and vice versa. With short-term rates near zero (there is some expectation built into the valuation with recent positive vaccine data), the risk/reward around the multiple is attractive. Importantly, short term rates don't need to go higher for positive earnings revisions and multiple expansion. If EWBC earns $5.15 in 2022 as we expect, then the stock could hit $72 over the next twelve months implying a 14x forward multiple. Likewise, we see the potential for 20% total return in EWBC over the next twelve months, inclusive of dividends.

MOLSON COORS BEVERAGE (TAP)

Molson Coors is the second largest brewer in North America with multiple global brands including Blue Moon, Coors Banquet, Coors Light, Miller Genuine Draft, Miller Lite, and Staropramen; regional champion brands such as Carling and Molson Canadian; and craft & specialty beers such as Vizzy, Creemore Springs, Cobra, Sharp's Doom Bar, Henry's Hard and Leinenkugel. TAP simplified their business segments into two units - North America, which comprises 80% of revenue and 90% of EBIT, and Europe which accounts for 20% of revenues and 10% of EBIT. The Molson and Coors families have been brewing beer for over 200 years each and have family representation on the board. Collectively, these families own approximately ~10% of the economic interest in TAP. In 2016, TAP acquired the remaining 58% of MillerCorp from ABInBev that it didn't own, thus consolidating operations across all power brands of Coors, Miller and Molson. In 2019, on-premise (bars/restaurants) was 14% of sales in North America and off-premise (grocery stores, liquor stores) accounted for 86%.

TAP spent most of the last four years paying down debt, distributing dividends, searching for cost synergies and defending its volume market share while growth investments (M&A) were value destroying. TAP dramatically overpaid for MillerCorp at a time when beer consolidation and valuations were high across the globe, caused primarily by *Anheuser-Busch InBev*'s **(BUD)** leveraged roll-up strategy (which investors loved at the time). In hindsight, the previous CEO, Mark Hunter, misjudged the synergy potential vs. long-term volume trends. Effectively, TAP levered up to pay a premium valuation for a portfolio of lower priced beer brands at a time when the greatest trend was the premiumization of beer. Said another way, every year more consumers pay a higher price for a beer that they view as new and innovative, full-bodied, better flavored, and/or higher in alcohol content (similar to drinking trends already established in Europe). This opportunity has not been lost on competitors who have gained share over this time, primarily *Constellation Brands* **(STZ)** and *Boston Beer Company* **(SAM)**. As a result, TAP's earnings have been flat over the past 5 years, while the stock is down approximately 60%, as the P/E ratio compressed from 22x (premium to consumer staples at the time) to below 10x; a justifiable peer discount should TAP's financial trends persist.

However, change has been dramatic and impressive over the past 13 months and we believe the product portfolio is at an inflection point. The new CEO, Gavin Hattersley, laid out his revitalization plan in late 2019 that freed the company from

past digressions. The pillars of the strategy are focused on adding new leadership talent, reducing segment structure to two reporting units, and streamlining the operations. These moves were designed to accelerate market share gains in the premium light segment and free up precious capital to invest more on new product launches in the above-premium segment. COVID created noise and complexities as on-premise consumption collapsed and beverage can supply chain disruptions halted production efforts. However, this forced TAP to make bold and swift decisions that have led to a healthier brand portfolio, better distribution and more focused marketing effort. The large earnings beats vs. consensus estimates over the past few quarters weren't a result of luck, but rather an acceleration of a strategic framework that has changed the trajectory of TAP's brand portfolio. We expect the company to continue to meaningfully outperform consensus estimates, the ROE to accelerate and the valuation multiple to expand from all-time depressed levels today.

TAP has recently outperformed expectations because the brand portfolio trajectory is misunderstood by the market, not only on the volume side, but also on the price/mix side. The hard seltzer revolution is accelerating flavored malt beverage (FMB) consumption and driving a positive mix shift within TAP's portfolio. Vizzy and CoorsLight Seltzer recently launched and they've already gained 450 bps of market share, which is growing each month. This is in a category that is expected to be roughly $4B in 2020 (+200% y/y) and industry experts expect another 50%-100% growth in 2021. TAP is currently selling every case they can make and are increased capacity 400% in 2020 for hard seltzers. The portfolio will be aided by the launch of ready-to-drink hard cocktails in the second half of 2021 including Topo Chico, in partnership with *Coca-Cola* **(KO),** and Proof Point. TAP expects to garner double-digit market share in 2021, yet even absent share gains the high growth trajectory of the category alone will drive favorable mix. BlueMoon Lightsky is TAP’s other power brand extension that is outpacing expectations while TAP dramatically increases production to accommodate the growth.

TAP’s premium light beer segment (Miller and Coors) has seen market share gains for 24 straight quarters (primarily from Bud Light). However, overall category growth has been flattish over the past decade and volume growth has been sluggish. The recent marketing campaigns have resonated with consumers and BUD's focus has been on putting dollars behind Michelob Ultra, Busch Light, and other Bud Light brand extensions. Economy brand trends ebb and flow with the economic cycle, but over time we expect these product volumes to be down for TAP as they strategically allocate resources to higher price point beers. We believe the premiumization of TAP’s volume growth will lead to 200-400 bps of revenue growth before price increases. Competitors in the above-premium segment get paid $200-$215/hectoliter (HL) vs. TAP at $125. Even BUD, which has a similar product mix, gets about $145/HL. This explains why TAP had +4.6% price/mix improvement y/y in the United States even though on-premise collapsed -45% in the third quarter of 2020. As revenue accelerates, it should lead to better gross margins and operating margin leverage. This leverage on incremental volume growth drives our earnings estimates approximately 25% higher than consensus for 2021.

On-premise is the highest margin business for TAP and was down -45% y/y in Q3 (up from -90% in Q2). We expect that there will be a tailwind to on-premise as we enter 2021 driven by vaccinations and accompanied by shifts in consumer consumption patterns. Aluminum can shortages created SKU prioritization and lead to production patterns below end consumption for many of TAP’s products. This has started to normalize and should help production levels as they add more “skinny” can capacity.

TAP trades for 8.5x our 2021 EPS estimate and ~7x EV/EBITDA, a steep discount to peers at 20-40x P/E and 12-24x EV/EBTIDA. If TAP can sustainably execute on the growth plan described above, TAP shares could climb significantly. We believe a discount to peers based on historical numbers is warranted but as they continue to execute on its strategy and improve returns on capital, the gap to peers will close.

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As of January 11th, our five largest positions were *LKQ Corp.* **(LKQ)**, *NRG Energy* **(NRG)**, *Axalta Coating Systems* **(AXTA)**, *Crown Holdings* **(CCK)** and *Bausch Health* **(BHC)**, representing nearly 25% of the total portfolio. Approximately 14% of the portfolio is currently held in cash.

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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