MD Sass Concentrated Value

Q1 2021 Commentary *April 22, 2021*

MD SASS

The MD Sass Concentrated Value ("CV") strategy was up +13.7%, net of fees, in the first quarter of 2021, vs. +11.2% and +11.9% for the Russell 1000 Value ("R1V") and Russell 3000 Value ("R3V") indices, respectively.

From inception (January 2019) through the first quarter of 2021, CV had an annualized return of 27.7% net of fees, vs. +17.9% and +18.1% for the R1V and R3V indices, respectively.

We've had the pleasure of speaking to our clients and many prospective clients over the past few months to reflect on 2020 results and discuss the opportunities we see in our portfolio in 2021 and beyond. While most were pleased with our relative results since our 2019 inception, we received many questions about why they should be excited about CV's future potential. While it is well known that this is an industry of "what have you done for me lately?" it is equally relevant to characterize it as "what will you do for me soon"? We recognize that significant outperformance is difficult to maintain on a consistent basis, year in and year out; however, we find several reasons to remain quite bullish about the prospects of our portfolio vis-à-vis the market. On a portfolio basis, we expect EPS growth of over 20% on average over the next two years, which is comparable to the consensus expectations for the Russell 1000 and 3000 Value. However, our portfolio trades at a significant discount on a P/E basis. Our portfolio trades for approximately 16.6x our 2021 EPS estimates and 13.8x our 2022 EPS estimates, which compares favorably to the R1V and R3V which trade for nearly 20x consensus estimates for 2021 and 17x 2022 estimates. The valuation disparity is even more attractive considering our portfolio companies in the aggregate are less levered than our benchmarks based on an analysis of factor exposures.

Valuation is not a thesis but rather an observation. The fundamentals of our portfolio companies (relative to consensus expectations) will be the primary driver of future relative performance, not valuation. Surprisingly, we find that this is lost on many value managers. Anecdotally, the number of stock pitches we hear that start with "the stock is really cheap at X times earnings" is astoundingly high. Most stocks are "cheap" for a reason. Furthermore, a low P/E stock is not "cheap" if the stock continues to decline due to poor fundamentals. Saying "low P/E" is more appropriate than "cheap"…but I digress. More important than the relative valuation of our portfolio companies versus the benchmarks is the expectation that our EPS estimates for our portfolio companies are, on average, 12% higher than consensus for 2021 EPS and 25% higher than consensus on 2022 EPS. If our forecasts are directionally correct we should enjoy positive relative performance. Positive earnings revisions drive attractive relative returns and to the extent consensus expectations are too low, as we believe to be the case, our portfolio is well-positioned.

In addition to questions regarding the sustainability of our performance, many have asked us why we achieved the results we did and what "edge" we have over our investment management peers. In a bygone era, information was a significant source of alpha. Before the days of Reg FD and the internet, investors could chat with management and others to get valuable information with relative ease or use various tools to receive information before it was widely disseminated. But today, information and data are largely a commodity. The internet has leveled the playing field in terms of universal access, and management teams, under much stricter SEC guidelines and enforcement, are not apt to disclose privileged information to charming analysts. In our view, a competitive "edge" comes from adherence to a process, fostering a positive team culture based on intellectual honesty, attacking behavioral biases, and synthesizing the commoditized data with an independent and long-term perspective. Let's dive deeper on each of these points:

Process – We believe an institutionalized process that is clear, repeatable and embraced by the investment team is critical. However, the market frequently goes through periods of extremes driven by panic or euphoria. During these periods, many investors tend to throw their process out the window. This concept is not too dissimilar to Mike Tyson's famous observation, "everyone has a plan until they get punched in the mouth." In the investment world, time horizons of so called "long-term investors" compress when emotions run high. In periods of crisis or panic, investors' quickly abandon their long-term theses in favor of short-term price fluctuations. Similarly, in periods of euphoria, investors turn their attention to short-term price momentum. In sum, investors tend to disregard the core tenants of their process during many critical periods of the market, yet these are the periods where alpha generation is most exploitable and when long time horizons are most beneficial.

Culture – It is interesting to note that some investors spend a material amount of time researching portfolio companies' culture as part of their research process yet fail to succinctly communicate their own corporate culture to clients and prospects. We believe that a strong team culture within investment teams can be the difference between success and failure and is, likewise, a source of edge. We believe that intellectual honesty is the hallmark of a good investment team culture. Intellectual honesty means that all participants feel comfortable analyzing and communicating all material facts, circumstances and perspectives regardless of whether they support or invalidate previously held viewpoints. If a team member dismisses new information that runs counter to prior beliefs AND fails to communicate it to the team, it can lead to disaster. A portfolio manager may not trust his or her analysts if there is a belief that information is withheld. Thesis creep can become a significant problem when an invalidated thesis is ignored, and hope becomes the overriding impetus to maintain a position. Conviction and confidence can quickly erode when information dissemination among a team is filtered. Likewise, a culture that promotes, fosters and encourages candid assessments and communications is an important element to long-term outperformance as it mitigates the risk of blow-ups and improves opportunity cost of investor capital.

Behavioral Biases – Self-reflecting on one's own weaknesses and biases can be painful and time-consuming but, nonetheless, is essential to successful investing. All investors suffer from one or more behavioral biases that can impair outcomes. Confirmation bias, endowment effect, overconfidence, anchoring, loss aversion are just a few examples of cognitive and emotional biases that investors should attempt to manage. While it is extremely difficult to overcome them all, we believe that an analysis of outcomes after a position is sold can help identify investors' biases. Our team writes a post-mortem analysis of every stock in the portfolio after it is sold, and we candidly discuss our findings as a group to identify what we did right, what we did wrong, what role luck played and what potential biases impaired the outcome. Reflecting on past experiences can help recognize and attack inherent biases, which is a source of edge to the extent most of our peers are not addressing these behavioral shackles.

Data Synthesis – Although data is a commodity, it is digested and interpreted very differently by market participants. For example, a recent poll on Twitter regarding *Netflix's* **(NFLX)** recent $5B stock buyback program demonstrates vastly different perspectives. Some believe it is smart capital allocation (17%) while others believe it is an ominous sign (25%). Perhaps at the end of the day the buyback program will be an immaterial event (32%) but this example shows how the interpretation of facts can lead to widely different perspectives. In a world where the average investor is inundated with opinions from talking heads, sell-side reports, social media, blogs, etc., it is easy for an investor to forego independent analysis and lean on the strong opinions offered up by many other "professionals." Adopting the narrative of others becomes even more enticing to the extent the narrative correlates with the recent movement in the stock price. As we oftentimes say, "narrative follows price." Truly independent

long-term thinking can be a source of alpha but is difficult given the constant barrage of strongly held opinions, narratives and daily price fluctuations. An adherence to a defined process enables independent synthesis of data and facilitates the ability to derive out-of-consensus perspectives.

Q4 PORTFOLIO REVIEW

The biggest contributors to performance in Q1 were *Bausch Health* **(BHC)**, *East West Bancorp* **(EWBC)** and *Mohawk Industries* **(MHK)** which collectively contributed approximately 503 bps to performance.

We have longed believed that BHC will achieve an acceleration in organic growth through product innovation, a lessening drag from off-patent drugs and deleveraging. Relative to our expected growth rate, we believed BHC was significantly undervalued on a DCF and sum-of-the-parts basis. In February, the stock responded favorably to news that Carl Icahn took a 9.6% stake in the company, urging an accelerated timeline to spin-off the eye care business to unlock value. While we applaud efforts to maximize shareholder value, we believe the biggest driver of performance for the stock over the long-term is improving EBITDA. Afterall, BHC's ability to spin-off business units in a value-creating way requires the issuance of material amounts of equity, and strong fundamental performance will drive the share price higher ultimately leading to fewer requisite shares to be issued. We believe that BHC is well-positioned to grow faster than consensus expectations as global economies open up from the pandemic.

When we initiated our investment in EWBC we believed that the bank had a differentiated value proposition and was coming off a cyclical trough driven by poor Chinese-American trade relations, depressed interest rates and elevated pandemic-related loan loss provisions. The easing of these pressures drove the stock higher, most notably the significant rise in long term interest rates. EWBC's Q4 results did not disappoint as the company handily beat expectations and offered forward-looking commentary that suggested an easing of loss provisions and accelerated loan growth. Despite the strong stock performance YTD, we believe the stock is trading for just 12x our above-consensus 2022 EPS and represents a compelling investment opportunity.

Over the past year, a healthy housing environment, stimulus checks and work-from-home dynamics drove strong growth in "do-it yourself" home improvement demand. These phenomena boosted growth for companies exposed to DIY such as *Home Depot* **(HD)** and *Lowes* **(LOW)**. However, "do-it-for-me" projects were negatively impacted as homeowners were reticent to let professionals into their homes. The re-opening of the economy coupled with a very strong housing market is boosting demand for building products tied to the DIFM market such as MHK. Additionally, MHK has undergone a significant turnaround and restructuring and has optimized its portfolio to exploit the opportunities in faster growing segments of the market such as luxury vinyl tile (LVT). Although the stock has materially outperformed the market YTD, we believe consensus estimates are still too low for 2021 and 2022 and we see further upside with the stock at just 14x our 2022 EPS estimate.

The biggest detractors to performance in Q1 were *Perrigo* **(PRGO),** *Alibaba Group* **(BABA)** and *Crown Holdings* **(CCK)**, which collectively hurt performance by 57 basis points.

When we initiated a position in PRGO it was a turnaround story. We believed that the new CEO would bring a renewed sense of urgency around product innovation that would drive gross margins and lead to a re-rating of the stock to valuations more akin to consumer staples. Although COVID-19 created a lot of noise in the numbers due to dramatic mix shifts and inventory stocking effects, we were disappointed by the company's inability to drive operating leverage during periods of heightened demand. We expected the fourth quarter results would demonstrate strong margin expansion in the consumer healthcare business, which never materialized. Furthermore, the company has not provided a lot of clarity around the product pipeline and drivers of innovation, which makes us skeptical that the turnaround is progressing as hoped. Finally, we expected one of several call options would materialize but none did – the Irish tax case had a negative initial outcome, the launch of generic Albuterol ran into issues and the potential one-time $400M milestone payment from Biogen never happened. We ultimately sold the position during the quarter given our lack of confidence that the original core thesis would play out as we had expected.

We are very excited by our investment in BABA and believe the recent $2.8B fine imposed by the Chinese government is a favorable outcome to the anti-trust investigation as it represents less than 0.5% of the company's market cap. Although the regulatory crackdown on Ant Financial has yet to reach a conclusion, we believe the downside relative to BABA's current valuation is largely immaterial at this point. Closure of the Ant Financial review will eliminate a key overhang to the stock, and we believe there is material upside to the stock with the core BABA commerce business trading for an implied valuation of 14x based on our sum-of-the-parts analysis. We provide more detail on our investment thesis later in this memo.

We believe CCK's under-performance in the quarter had more to do with sharp sector rotations away from "work from home" beneficiaries to "recovery" stocks than anything company-specific. Given CCK's strong financial performance in 2020 during the depths of COVID, investors are concerned that tough comps will lead to unattractive growth prospects as global economies re-open. We believe that regardless of pandemic induced demand benefits, CCK remains in an oversold position and that long-term demand prospects for aluminum cans over plastic and glass will drive attractive long-term growth for CCK. We believe the Street under-estimates the operating leverage inherent in the business model as CCK restrikes long-term contracts at more favorable terms and the business continues to mix shift towards higher margin specialty cans.

We initiated new positions in *Raytheon Technologies* **(RTX)**, *Liberty Broadband* **(LBRDK)** and *Alibaba Group* **(BABA)** in the quarter which we discuss below. We also built a small position in *Air Products and Chemicals* **(APD)** and *Facebook* **(FB)** but sold the latter in early Q2 as the stock reached our fair value target and our earnings differential vs. consensus was immaterial.

RAYTHEON TECHNOLOGIES (RTX)

Raytheon Technologies is the combination of United Technologies' commercial aerospace businesses (Pratt & Whitney and Collins Aerospace) and the legacy Raytheon defense businesses focused on missile defense, space, and cyber.

COVID's disruption of the commercial aerospace industry created the opportunity to purchase RTX shares at a historically low multiple. Approximately 50% of RTX's profits are derived from the sale of aftermarket parts and services; a business with attractive fundamentals such as long-term contracts with price escalators, GDP+ growth and high incremental margins. The current down cycle has been longer than average leading to extremely low spare parts inventories industrywide. The

inevitable recovery in air travel (we are already seeing "green shoots") should be met with a faster than expected recovery in aftermarket revenues.

RTX's defense business has typically grown 100-200 bps faster than the U.S. defense budget due to a high % of revenues from faster growing international customers (~30%) and greater emphasis on the faster growing categories within the U.S. DoD budget, namely missile defense, space, and cyber.

We believe RTX's earnings have troughed and the recovery in commercial aerospace will drive consensus estimates higher. This should help the stock recapture the current valuation gap vs historical and peer multiples. Our 2021 estimates are ~7% above consensus primarily due to a more favorable view of the aftermarket recovery in commercial aerospace. Remaining cost synergies from the UTX/RTN merger and COL acquisition should add nearly 10% to EPS over the next few years. 20x our 2022 EPS estimate of $5.30 (mid-cycle) equates to fair value nearly 30% above the current price.

LIBERTY BROADBAND (LBRDK)

LBRDK is a tracking stock whose primary asset is 59M shares of *Charter Communications* **(CHTR)** or 25% of total equity outstanding. LBRDK recently merged with *GCI Liberty* **(GLIBA)** which owns an Alaskan cable business called GCI that is worth approximately $2.5B EV based on 9x multiple or $13/share. Legendary cable pioneer, John Malone, owns about $1.3B of stock and is Chairman of the Board. Marking CHTR stock to market, the net asset value (NAV) of LBRDK was $182/share or 18% above prevailing prices at the time we initiated the position. We believe the management team is very high quality with one of the best operators (Tom Rutledge) and capital allocators (John Malone) behind the wheel.

Our core thesis is that CHTR should earn $60/share in FCF by 2023 which makes CHTR attractive at 10x 2023 FCF. Owning CHTR at a discount via LBRDK makes the implied P/FCF more like 8.6x. There is significant upside over the next three years as the NAV discount collapses from a CHTR/LBRDK merger with upside potential of nearly 80% over the next three years.

The value proposition of cable broadband has arguably never been stronger – we believe the rise of video conferencing and telehealth coupled with a step function increase in digital engagement, videogames, streaming, etc., makes broadband a utility like never before. We believe 2021 growth will take a step down due to fewer subscriber additions, a lack of political ad revenue and some incremental programming costs related to sports – all of which is well known. As we look to 2022, CHTR will benefit from a 'normal' comp and from the deployment of the Rural Digital Opportunity Fund program where they have been awarded a federal program to build out to over 1M new homes. Management is bullish on the ROE of this initiative, which we estimate will be over 10% and will lead to an acceleration in homes passed.

Importantly, Charter's 'turnaround' was successful and execution risk is largely off the table. Charter has industry leading growth and that should continue given its low penetration rates. Declining capex intensity, expanding EBITDA margins due to mix and levered buybacks should lead to very strong FCF/share growth with $60 of potential FCF/share by 2023.

The threat of fixed wireless taking share from cable broadband hasn't materialized thus far. Although this is still a risk factor, its materiality seems greatly reduced. 5G could perhaps change this dynamic and it is something to watch but the reliability and speed of broadband will be unparalleled and difficult to displace.

Last year. GLIBA merged with LBRDK making LBRDK an 'active trader' business. The consolidation of CHTR and LBRDK is inevitable and LBRDK is at a 18% discount to NAV. LBRDK owns 25% of CHTR's shares outstanding and has a 26% equity cap. If CHTR continues to buy back its stock, LBRDK will participate pro-rata. In theory, LBRDK can sell CHTR stock at market value, pay a 5.5% tax on proceeds and use the net proceeds to buy LBRDK stock trading at a 18% discount which is highly accretive.

ALIBABA (BABA)

Alibaba Group is one of the largest technology companies in China. The company operates across multiple different business units, including e-commerce, logistics, distribution, cloud infrastructure, media platforms, advertising and video games.

Over the past 5 years, BABA generated 45% of all incremental retail sales in China and now has an 18% gross merchandise value (GMV) penetration of the growing $6 trillion Chinese retail market. BABA's consumer platforms (i.e., T-Mall and Taobao) boast nearly 900mm active monthly users and millions of Western merchants look to them to tap into the booming purchasing power of the Chinese consumer. Significant investments in logistics, cloud infrastructure and consumer technology has led to an annual revenue growth CAGR of +40% over the past three years. We believe that the continued investments in the consumer platform will widen its moat vs peers and allow it to sustain further e-commerce penetration and grow significantly within adjacent verticals like cloud computing and digital advertising.

BABA's stock has significantly de-rated over the past few months as negative regulatory headlines created uncertainty around the valuation of BABA's equity stake in Ant Financial and structural impacts on core operations. We believe the Chinese government's regulatory enforcement will be less onerous than feared and, accordingly, the Ant Financial impairment (only ~$15/share hit on a -50% valuation haircut) is more than discounted in the current stock price. Excluding cash and Ant stake, we believe BABA is trading for 19.5x forward earnings, a discount to the market despite superior growth.

We believe BABA will continue to sustain +20% annual EPS growth and the regulatory overhang will dissipate over time, which will re-rate the stock to its previous LT P/E range of 25-30x.

As we reflect on the very challenging and tumultuous past twelve months, we believe it's our steadfast adherence to process, strong culture of support and intellectual honesty and independent, long-term thinking that drove our results. We will continue to maintain that same rigor and energy as we look to allocate capital to new and existing positions in the future.

As of April 21st, our five largest positions were *AXTA Coating Systems* **(AXTA)**, Crown Holdings (CCK), Raytheon Technologies (RTX), *NRG Energy* **(NRG)** and *Sony Group* **(SONY),** representing just over 26% of the total portfolio. Approximately 11% 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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