MD Sass Concentrated Value

Q3 2021 Commentary

MD SASS

October 15, 2021

The MD Sass Concentrated Value (“CV”) strategy was up +0.3%, net of fees, in the third quarter of 2021, vs. -0.8% and -0.9% for the Russell 1000 Value (“R1V”) and Russell 3000 Value (“R3V”) indices, respectively.

CV was up +20.5% YTD thru the end of Q3, vs. +16.1% and 16.6% for the R1V and R3V indices, respectively.

From inception (January 2019) through the end of Q3, CV had an annualized return of +24.7% net of fees, vs. +16.2% and +16.3% for the R1V and R3V indices, respectively.

Members of our equity team participate in a program at Brooklyn College called the MD Sass Investment Institute. Students in the program are grouped into teams and assigned specific stocks to research and analyze. These teams present their analyses and financial forecasts to their peers along with a panel of moderators and mentors that includes the members of our team. The primary objective of the program is to provide students with real-world experience in security analysis and selection. On a recent conference call, one of the students asked me the following question (I’m paraphrasing here): “*given you perform bottoms-up research to identify attractive investments, how do you incorporate the macro environment into your thinking?*” This is an astute question and one that I think about often. Although we seek investments where we believe idiosyncratic forces will be the dominant driver of future returns, we cannot ignore the fact that macro variables influence earnings and stock prices. As bottoms-up stock pickers, we still must consider macro variables when forecasting revenues, margins, earnings, and valuations. However, we are not economists and our ability to gain a high degree of conviction in the future path of oil prices, interest rates, the U.S. dollar or GDP growth is nearly non-existent. So, what do we do?

We don’t believe we need to *know* the future to make sound investment decisions. Rather, we need to have a strong conviction that the risk/reward profile of any given investment is in our favor. If we have a portfolio of investments with highly favorable risk/reward scenarios, we believe we can outperform to the extent we are more right than wrong and to the extent we cut exposure to scenarios where we are wrong early before considerable performance impairment occurs. It isn’t necessary to “know” the future, but it is essential to have a strong process to identify investment opportunities where the outcomes have a favorable probability set. As Annie Duke articulated in her fantastic book, *Thinking in Bets*: “What makes a decision great is not that it has a great outcome. A great decision is the result of a good process, and that process must include an attempt to accurately represent our own state of knowledge. That state of knowledge, in turn, is some variation of ‘I’m not sure.’”

We believe we don’t need to have all the answers for a great outcome. Our investment thesis in *Charles Schwab* **(SCHW)** is predicated on several idiosyncratic drivers including the transformational growth opportunity from the acquisition of *TD Ameritrade* **(AMTD)**, yet SCHW is highly asset-sensitive, and its future path of earnings is highly sensitive to Agency MBS yields. We have no discernible edge when it comes to forecasting MBS yields, but the risk/reward is highly favorable in our view given the already depressed level of rates today. With 15-year Agency MBS trading at a low 1.2% yield to maturity, the future path of rates appears asymmetrically in our favor over the next few years, particularly if recent inflationary pressures prove to be structural vs. transient. We are eager to make investments in stocks with company-specific value drivers AND favorable asymmetric payoffs with respect to macro factors. Much like poker, when one is dealt a strong hand, it is often prudent to place a bet even if the outcome is not certain.

Speaking of uncertain outcomes, many value managers contextualize the potential upside of a given stock against the valuation multiples of its “peer group” and the current multiple vs historical multiples for the stock. I’ve grown an aversion to this type

of analysis and have found that it forces an over-simplification of the facts. There is usually a very good reason why Company A's P/E multiple is lower than the multiples of its comp set. Differences in return on capital, tax rates, capex intensity, financial leverage, margins, growth rates and quality of management are all important factors that drive valuation multiples, and these factors can vary widely amongst companies in the same industry. Case in point is *Charter Communications* (**CHTR**) and *Altice USA* (**ATUS**). ATUS bulls have argued that the valuation discrepancy vs. CHTR is incredibly wide and if ATUS traded anywhere near a CHTR multiple the stock has significant upside. But does ATUS deserve the same valuation that CHTR gets? Between 2017-2020, CHTR grew EBITDA by nearly $4B (just over 25%) and spent just over $32.4B on capex over those four years. ATUS, on the other hand, grew EBITDA by $420M or just under 11% over the same period and spent over $4.5B on capex. CHTR grew EBITDA faster than ATUS and generated better returns on incremental capital. All else equal, shouldn't CHTR trade at a premium to ATUS? Unless there is a structural change in relative growth or ROIC, CHTR deserves a premium and the argument for some sort of P/E mean reversion for ATUS is not justified.

Comparing a company's current valuation to its historical range can oftentimes be an equally misleading and/or fruitless exercise. Afterall, companies change. Industries change. Technology disrupts. Management teams make capital allocation decisions that can forever alter a company (for better or for worse). Back in 2015-2017, *Mohawk Industries* **(MHK)** was a Wall Street darling that traded for 19x earnings. Unlevered returns on invested capital were 12% in 2016 and nearly 11% in 2017 and EPS was growing over 20%. However, over the ensuing years, MHK was caught off-guard by an emerging flooring substrate called luxury vinyl tile (LVT) that rapidly gained share from all other flooring types. MHK was late to the party and lost share while simultaneously investing more and more capital in LVT, thereby depressing margins. MHK currently trades for 11x earnings with ~8% unlevered returns on capital and operating margins several hundred basis points below the prior peak. This begs the question – does MHK's historical valuation have any relevance today? Why should MHK trade at the multiples it had back in 2017? This does not mean MHK is not a good investment. In fact, MHK has been a very good investment for us, and we expect it will continue to be. However, our thesis is not predicated on its valuation achieving some reversion to the mean because it doesn't deserve it.

Over time, I have come to realize that relative valuations are just not that useful. Getting the fundamentals right, on the other hand, is incredibly important.

Q3 PORTFOLIO REVIEW

The biggest contributors to performance in Q3 were *Quanta Services* **(PWR)**, *Sony* **(SONY)** and *Walker & Dunlop* **(WD)** which collectively contributed approximately 215 bps to performance.

Incidentally, Quanta Services, one of our newest positions, provided the greatest contribution to returns in the quarter. We believe PWR's outperformance in the quarter was a result of very strong earnings and guidance, coupled with the announcement of the acquisition of Blattner, the leading engineering and construction company in the United States focused on renewable power infrastructure. We believe Blattner is approximately 18% accretive to PWR's 2022 EPS and will enhance PWR's organic growth rate based on management's guidance for 10%+ topline growth at Blattner over the next few years. Later in this memo we provide a detailed review of our investment thesis in PWR.

SONY was up +13.7% in the quarter which we believe was partly a function of the stock playing "catch up" after significant underperformance in the first half of the year. Additionally, *Vivendi* **(VIV FP)** spun-off shares of *Universal Music Group* **(UMG NA)** which highlighted the value of Sony Music inside the broader conglomerate. UMG's valuation at the time of the spin was approximately 27x EBITDA whereas SONY overall trades for approximately 8-9x EBITDA (Sony Music is approximately 20% of EBIT). We remain very excited about the long-term growth prospects for SONY as: 1) we believe the Image Sensor business has troughed and has a multi-year tailwind, 2) Gaming margins should improve as hardware costs decrease and the mix shift to software continues and 3) Sony Pictures recovers from COVID-related headwinds and recent output deals with *Netflix* **(NFLX)** and *Disney* **(DIS)** drive strong incremental growth at relatively high margins

WD was up +9.3% in the quarter, in part, due to their announced $700M acquisition of Alliant Capital. Alliant is an alternative investment manager focused on the multifamily affordable housing sector through low-income housing tax credit syndications, joint venture development of affordable properties, and community preservation fund management. We believe this deal is a homerun for WD as we expect Alliant Capital will transact on 40-70 deals per year that require property sales brokerage, refinancing or recapitalization. Likewise, Alliant becomes a captive client for WD who can provide all these services. Given the average transaction size is approximately $20M, WD can generate revenue on as much as $2B of transaction volumes per year via Alliant. In addition to Alliant's ability to accelerate growth at WD via transaction volumes, we believe the Biden administration's positive bias to affordable housing will create more demand for low-income housing tax credits which may drive AUM growth for Alliant over time. We believe the Alliant deal is about 15% accretive to cash EPS within the next year and perhaps materially more accretive over time if the revenue synergies come to fruition as we expect.

The biggest detractors to performance in Q1 were *Alibaba* **(BABA),** *Qorvo* **(QRVO)** and *Air Products* **(APD)**, which collectively hurt performance by about 278 basis points.

Since we initiated a position in BABA earlier this year, China's regulatory crackdown and reform efforts have spread well beyond just BABA and Ant Group. Many sectors have felt the heavy hand of reform including videogame companies, for-profit education providers and food delivery services. We certainly underestimated the duration, magnitude and scope of the Chinese government's reform efforts. This, coupled with risks to China's economic growth (COVID-related shutdowns, intermittent power outages, Evergrande collapse) weighed heavily on BABA which was down 34.7% in the third quarter. We believe Xi's seemingly abrupt focus on "common prosperity" coincides with his ambitions to extend his term as China's leader in 2022. A Central Committee will soon review and adopt new policies before a party congress next fall, where Xi can secure a third term as party leader. Likewise, a big push to lift farmers and working families into the middle class at the expense of the ultra-wealthy is a strategic imperative given, per the *New York Times,* "the Communist Party's long-term authority is at stake."

We do not believe BABA's long-term growth rate or margin profile is impaired by Xi's campaign, but we do believe that the ability for BABA to ever achieve monopoly-type margins is out of the question. However, that was never really a credible argument for the bulls given BABA's margins were compressing for quite some time given its mix shift to lower margin businesses. Since we are of the view that the recent issues are transitory (albeit longer duration than originally anticipated) and the long-term financial model is largely intact, we believe BABA is still a compelling investment opportunity. We believe BABA's "core" business (excluding Ant Group and other investments) is trading for 12x fiscal 2023 EPS ex-cash which is an extraordinary opportunity if the aforementioned issues prove transient. An argument can be made that the cost of compliance with recent mandates could lead to regulatory capture which could even (gasp) benefit the large internet giants in the long-term.

We initiated new positions in Quanta Power (PWR), *API Group* **(APG)** and *Gates Industrial Corp* **(GTES)** in the quarter which we discuss below.

QUANTA SERVICES (PWR)

PWR is a leading provider of specialty contracting services, delivering comprehensive infrastructure solutions for the electric and gas utility, communications, pipeline and energy industries in the United States, Canada, and Australia. Utility customers represent 72% of sales followed by Industrial (13%), Energy Delivery (6%), Communications (4%) and Other (5%). PWR is at the epicenter of several long-term secular themes within energy transmission and communications, including utility grid modernization, grid hardening, renewables, electric vehicles/electrification, 5G communications, infrastructure stimulus initiatives and labor outsourcing. We believe these tailwinds will enable PWR to grow sales and EPS at high single digit and mid-teens growth rates, respectively, over the medium term.

Net Zero Carbon Emissions by 2050: The International Energy Agency (IEA) released a roadmap for realizing net-zero carbon dioxide emissions in the energy sector by 2050. While this is an ideological roadmap rather than an official doctrine, countries and multinationals are aiming to achieve this goal. A dozen states have set carbon-free goals along with some of the country's largest utilities. Dominion, NRG, First Energy, Southern Company and DTE Energy have all committed to 100% clean energy or net-zero carbon emission by 2050. However, achieving a zero-carbon future would require a significant investment in energy transmission. According to a study by Princeton University, to achieve a zero-carbon future by 2050, the existing high voltage transmission capacity will need to expand by approximately 60% by 2030 and triple compared to 2020 capacity through 2050 to connect wind and solar. The study estimates total capital investment in transmission will need to reach $360B through 2030 and $2.4 trillion by 2050 (vs. ~$26B annual spend today). Furthermore, 98,500 GW-km of transmission capacity would need to get built by 2025, which is a 31% increase from 2020's base level of 320,000 GW-km.

Electrification and Renewables: Although load growth has declined for decades, electrification of cars is estimated to have a material influence on load growth. In a national electrification assessment, the Electric Power Research Institute (EPIR) examined scenarios for increased electric use in current non-electric applications, including cars. It estimates 32% electricity growth between 2015 and 2050 (0.8%/year) and a higher 1.2%/year growth in a more aggressive electrification scenario. Brattle Group estimates a potential for near-term (thru 2030) demand growth of 5% to 15% per year and a potential need for $30B to $90B in incremental transmission investment over the same period. That investment is principally to connect renewable resources to serve total energy demand and to ensure system reliability with increasing peak demands. Importantly for PWR, electrification will entail linking renewable supplies with changing demand locations (e.g., highways) and patterns.

According to a Boston Consulting Group study, assuming 15% EV penetration by 2030, or 1.1M EVs in service, a representative utility will need to make cumulative transmission and distribution investments of $2.8 billion through 2030 for an estimated grid capacity upgrade cost of $2,600 per EV. That's a meaningful sum given that a U.S. utility of this size tends to spend about $1 billion annually on transmission and distribution capital expenditures. Most of these costs are from investments in distribution assets; transmission assets account for only $110 per EV in costs, or less than 5% of the total investment costs.

Long transmission lines are the necessary connection to deliver renewable energy from the remote places where it is generated to load centers where it ultimately is used. As more and more utilities take a "green pledge" to decarbonize their fuel mixes,

more transmission lines will be needed to satisfy those goals. The Brattle Group estimates that $30-$90B of incremental transmission investments will be necessary in the U.S. by 2030 to meet the changing needs of the system due to electrification, with an additional $200B-$600B needed from 2030 to 2050. This equates to a 20%-50% increase over annual average spending on transmission during the past 10 years through 2030.

Grid Modernization: Most of the nation's transmission and distribution lines were constructed in the 1950s and 1960s with a 50-year life expectancy. The DOE estimates 70% of transmission lines are 25 years or older. Furthermore, the frequency and duration of power outages have risen 4% per year and 3% per year, respectively. According to PJM, a regional transmission organization: "Transmission facilities continue to age. Some assets date to the 1960s or even earlier. Two-thirds of all system assets in PJM are more than 40 years old; over one-third are more than 50 years old. Some local, lower-voltage transmission facilities, especially below 230kV, are approaching 90 years old. Asset owners are identifying serious structural deterioration leading to system enhancements to avoid facility failure and customer service interruptions. Asset modernization goes beyond simple replacement."

According to a report by EBP for the American Society of Civil Engineers, the United States is facing an "investment gap" of $208B by 2029 and $338B by 2039 in what is needed to ensure a reliable energy system.

Grid Hardening/Weatherization: In some respects, global warming is good for PWR's business as it brings added emergency storm work that comes at higher margins. In the wake of the California wildfires and Winter Storm Uri in Texas, an acceleration in weatherization investment will drive incremental demand for PWR services at a higher margin. PG&E has guided for sustainably higher capex, as much as 20% higher than 2019 capex levels, as part of its Wildfire Mitigation Plan, and we believe the utility sector broadly will allocate additional funds for weatherization in the face of worsening global warming trends.

Outsourcing: According to a former EVP of Quanta: "I think the largest driver of [outsourcing] is just the sheer volume of utility work that's out there. They're unable to self-perform it. I think over a long trend or a long timeframe, utilities, through attrition of their own workforce, this growing workload out there, have been forced to accept an outsourced model…the trend certainly continues to be a larger percentage of their work being outsourced and I just don't see that change...there's no way."

The trend towards outsourcing is driven by a tight labor market for linemen and is exacerbated by a high percentage of the workforce nearing age of retirement (45% plan to retire by 2024 requiring 100,000 jobs to be filled). About 50% of transmission and distribution workloads have been outsourced and the expectation is for the continued penetration of outsourced services over the next five years.

Blattner Acquisition & Valuation: As discussed previously, we believe the Blattner acquisition is highly accretive and provides PWR with a platform in renewable energy infrastructure that is highly complementary to PWR's core transmission and distribution business. Proforma for the acquisition, we believe PWR can organically grow revenues at a high single digit rate and EPS at a mid-teens rate over the next five years. We believe consensus estimates for 2022 EPS are too low and the stock trades for about 17.5x our 2022 EPS estimate, which we think is highly attractive for a company with improving returns on capital and a strong LT growth profile.

API GROUP (APG)

APi is one of the largest specialty contractors in the United States. Proforma for the recent Chubb Fire & Safety acquisition, 70% of revenues are Safety Services (nearly all fire safety), 26% Specialty Services and 4% Industrial Services. Over 50% of revenue is service related which includes inspection and associated post-inspection service work. Typically, for every $1 of inspection work, APG gets $3-$4 of incremental work related to retrofits, equipment upgrades, maintenance, etc. Fire safety is a highly regulated function with statutory requirements for quarterly or annual inspections and service making it a recurring annuity for the service provider. With the average project size of just $10,000, APi lacks customer concentration risk with no customer representing more than 5% of sales.

APi's playbook is to roll-up small mom & pop providers in local markets and operate in a de-centralized fashion that enables these providers to keep their own brand and management. APi typically provides procurement benefits, shared services, bonding capacity and the introduction to national accounts to enable acquirees to accelerate growth and enhance margins. The company recently entered Europe thru two large acquisitions, SKF and Chubb Fire and Safety. Proforma for the latest Chubb deal, APi's revenues are 59% North America, 30% Europe & Canada and 10% APAC & other.

APi was listed on the NYSE in April 2020 after being acquired by J2 Acquisition Limited, a SPAC formed in 2019 by former Jarden executives including co-founder Martin Franklin who owns approximately 12% of the common stock. They invested $100M of their own capital into the SPAC - $60M of common stock at the offer price and $40M into preferred shares that carry a promote (payable in common stock) based on the stock performance.

Chubb Fire & Safety ("Chubb") Acquisition Potentially Transformational: While all large acquisitions come with risk, particularly when the acquiree is on a different continent than the mothership, we believe the Chubb acquisition can generate significant value creation for shareholders if management can execute on its plan. Chubb was mismanaged and under-invested as a small subsidiary of *Carrier Global* **(CARR)**, and United Technologies before that. Calls with former employees suggest that Chubb focused on product sales over service despite really being a service company. Chubb employees were pushed to sell Carrier product rather than focus on providing exceptional inspection, maintenance and monitoring service to drive growth. Additionally, branch level accountability and management were weak and the fact that Chubb was on the chopping block for years led to poor morale and elevated turnover. Chubb had 8 CEOs in the last 9 years – stability of leadership was lacking.

Chubb's EBITDA margins are 10% which is about 400 bps lower than APG's Safety business. Given Chubb has a better service mix, it should have HIGHER margins than APG. Perhaps operating in multiple countries reduces scale effects and reduces margin potential but nonetheless margins are too low given the quality of the business mix. APG expects $20M of synergies to drive 100 bps of margin improvement but the longer-term potential is significantly higher.

Given Chubb's strong brand, high quality business mix (60% service) and scaled infrastructure, we believe it has material upside in the right hands. Out of the gate, the transaction is over 20% accretive to EPS and perhaps materially higher than that if APG can improve margins and generate positive organic growth.

Importantly, Chubb is a platform acquisition. It is a beach head asset in Europe where APG can accelerate growth thru accretive tuck-in acquisitions. Like the U.S., the fire safety market in Europe is highly fragmented with lots of small, local mom & pop operators that lack scale, bonding capacity and large-scale procurement benefits.

Another benefit of the Chubb deal is the $600M preferred equity investment by Blackstone which can convert into common stock at $24 or higher. Blackstone has agreed to facilitate APG to compete for business within its vast $400B+ real estate portfolio. Although the Blackstone relationship doesn't guarantee new business for APG, Blackstone is incentivized to assist APG as it will participate in APG equity upside longer term via the convertible preferreds.

Tuck-in M&A: APG has a history of doing smaller, tuck-in deals at anywhere from 5-7x EBITDA. Although APG operates in a de-centralized fashion and lets its acquired companies operate autonomously and with their own branding, APG enhances growth and margins by enabling their acquirees to benefit from APG's scale in procurement, bonding capacity, national sales rep infrastructure and shared service resources. One industry contact suggested that APG brings 100-200 bps of added growth to its acquired companies by providing national account business and additional growth thru bonding capacity. If APG does $100M of tuck-ins per year at 7.5x EBITDA, it should equate to over 400 bps of accretive EPS growth.

Attractive Organic Growth: APG organic growth should be GDP+ if history is a guide. From 2007-2019, APG's organic growth was at least 4.5% implied by reverse engineering its acquired revenue per year. From 2010-2018 the organic growth was 8%. With inspection growth growing double digits, this should portend strong organic revenue growth moving forward as $1 of inspection revenue generally translates into $3-$4 of service work.

Margin Leverage: The company provided guidance to achieve 12% EBITDA margins by 2023 and 13% by 2025 vs the 10.5% achieved in 2020. Margin enhancement will be driven by 1) mix shift to services from installations, 2) productivity programs, 3) procurement and shared services initiatives, and 4) select pricing opportunities. In fact, APG identified about $85M of savings/pricing opportunities and they only need to achieve half of this to hit the margin target.

Valuation: Factoring in LSD organic growth, $100M of tuck-ins, and margins of 12%, we believe APG can earn $735M in EBITDA, $1.82 in adj. EPS and $2.27 in FCF/share. With comps trading for 14-15x EBITDA, APG could be worth $30/share if it hits these financial goalposts.

GATES INDUSTRIAL CORP (GTES)

Gates is a leading manufacturer of Power Transmission and Fluid Power products. The Power Transmission industry is highly fragmented and has a $36B addressable market of which Gates has approximately a 5% share with its portfolio of timing belts, engine metal components, mechanical water pumps and other belt products. 62% of this business segment is replacement parts and 38% is first-fit. Fluid Power is a $29B market and, like Power Transmission, is highly fragmented with Gates having about a 5% share with a portfolio of hydraulic hoses and couplings, hydraulic tubing, oil & gas drilling hoses, etc. This business is predominantly a replacement business at 66% of sales. Gates services a wide array of end markets including Auto Replacement (35% of sales), Industrial Off-Highway (19%), Diversified Industrial (19%), Auto OEM (10%) and more. Gates was acquired by Blackstone in 2014 and went public in 2018 with Blackstone still holding about 66% of the shares outstanding.

Quality Business at an Attractive Valuation: We estimate that Gates will generate over 26% returns on invested capital (excluding amortization of intangibles), convert over 100% of adjusted EPS to free cash flow and achieve attractive EBIT margins of over 13.5%. These strong financial metrics lend credence to our view that Gates is a high-quality company, yet its valuation suggests otherwise as it trades for less than 10x our 2022 EPS estimate and just over 8x EV/EBITDA.

We believe there are several reasons why Gates trades at such a low valuation, all of which we believe are transitory: 1) Blackstone is an overhang as it still owns a significant amount of stock and is a chronic seller as it exits its investment, 2) after going public, Gates took down guidance multiple times due to an industrial recession in 2019 where inventory de-stocking took the company by surprise – management is in the penalty box, and 3) Gates operates in cyclical end markets and the company has already experienced a V-shaped recovery post-COVID leaving the future growth trajectory uncertain.

Regarding the last point on cyclicality – we would note that many of the end markets that Gates serves are far from their peak levels. For example, the auto aftermarket is still recovering as total passenger miles driven globally have not recovered to pre-COVID levels. Continued recovery in miles driven coupled with an aging car park should provide a multi-year tailwind to Gates' auto aftermarket business. Global light vehicle production has been hampered by semiconductor shortages which will lead to global production volumes in 2021 significantly below 2018 and 2019 levels despite a strong demand environment. Furthermore, recent strength in commodity prices should provide a tailwind to Gates' exposure to mining, oil & gas and agricultural end markets. In sum, we do not believe Gates' end markets have peaked and we are comfortable taking beta exposure to its broad Industrial exposure.

Chains-to-Belts Opportunity: We believe Gates is in the early innings of benefitting from a chain-to-belt conversion opportunity. Belts have several advantages vs. chains - they eliminate the need for lubricants (which are becoming increasingly expensive with inflation), require less maintenance, have a longer depreciable life and are generally more efficient. Gates' management believes there is an $8B addressable market opportunity with customers' converting from chains to belts. In 2019, management targeted an incremental $200M of revenues by 2023 from such conversions and we believe they will exceed that goal. The chain-to-belt opportunity is most pronounced in traditional factories and warehouses but also within personal mobility (eBikes, scooters, motorcycles, fitness equipment).

Electric Vehicle Content: The transition from traditional internal combustion engines (ICE) to electric vehicles (EVs) significantly increases GTES content opportunity within the automobile. In fact, the dollar content/car should be anywhere from 20%-40% higher in EV vs. ICE. A mechanical water pump on an ICE car sells for about $10-$15 per unit whereas an electric water pump is over $100 per unit. Thermal management hose assemblies can cost $100-$200 on an EV vs $15-$30 of content on a traditional ICE car. The transition of on-highway vehicles to electric will also provide a content boost. At a recent Goldman Sachs Conference, CEO Ivo Jurek said: "And so from where I sit, the content on the on-highway applications is about $600 for us, $600 to $60 per platform, which is about 3 or 4x of what it is on the diesel-type application on the highway."

Consensus Estimates Too Low: We believe the consensus estimates for 2022 and 2023 EPS are 14% and 20% too low, respectively. We believe that Gates will grow revenues mid-single digits, generate over 30% incremental margins and generate $2 EPS in 2023 which makes the stock a compelling value at $16.

During the quarter, we sold our investments in *Target* **(TGT)**, *Brunswick* **(BC)** and *Liberty Broadband* **(LBRDK)**.

MARKET COMMENTARY

Investors are squarely focused on rising inflation, labor shortages and supply chain issues. These issues are very well known but the consensus view is that these issues are transitory. The Fed certainly thinks so. If investors believed that these issues were structural, the market would not be near its all-time highs, consensus estimates for the S&P 500 would probably not be calling for such robust EPS growth and interest rates would likely be significantly higher. However, detailed explanations for why inflation will ease and why supply chain problems will fizzle are lacking. In fact, data points suggest many of these problems are getting worse, not better:

"Transit times have been increasing due to container shortages, port congestion, rail congestion and labor shortages, impacting the entire industry. And during [fiscal] Q1, these lead times worsened further to now sit at 80 days, roughly 2x normal."- CFO of *Nike* **(NKE)**

"I think the reality is there's a tight supply chain market or supply chain, there's strong demand and we see raw materials elevated for a period of time. And then, I think that's the reality of it." – CFO of *Sherwin-Williams* **(SHW)**

"*I think we're right in the middle of it still this year…I don't think it's over quickly."* – CFO of *Intel* **(INTC)**

We are underwriting our 2022 earnings estimates with increased caution regarding inflation and supply chain issues and have made some portfolio adjustments accordingly, particularly where we believe there is increased risk on margins. In fact, our decisions to sell TGT and BC were a function of our increased caution around supply problems negatively impacting retail sales. After all, demand doesn't matter much if there isn't supply to meet it. We question whether there is considerable downside risk to consensus estimates for holiday retail sales.

We are also very mindful of factor exposures and have attempted to construct the portfolio such that higher rate beneficiaries (SCHW, EWBC, GL, WD) would act as a natural hedge against some of our investments where there is inflation/supply chain/labor risk (AXTA, MHK, SONY, PWR).

As of October 14th, our five largest positions were *Crown Holdings* **(CCK)**, Walker & Dunlop (WD), *Axalta Coating Systems* **(AXTA)**, *East West Bancorp* **(EWBC)** and *Raytheon Technologies* **(RTX),** representing just under 30% of the total portfolio. Approximately 4% of the portfolio is currently held in cash.

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There is no better gift than the gift of life and several members of our team recently received some wonderful gifts. Congratulations to Jeff Edelman on becoming a father and to Donna Langan and Frank Pfeffer on becoming grandparents! May they bring you a lifetime of happiness and joy.

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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