MD Sass Concentrated Value

Q4 2021 Commentary *January 21, 2022*

The MD Sass Concentrated Value ("CV") strategy was up +8.7%, net of fees, in the fourth quarter of 2021, vs. +7.8% and +7.5% for the Russell 1000 Value and Russell 3000 Value indices, respectively.

For the full year 2021, CV was up +31.0%, net of fees, vs. +25.2% and +25.4% for the Russell 1000 Value and Russell 3000 Value indices, respectively.

From inception (January 2019) through the end of 2021, CV was up +99.5% net of fees, vs. +62.8% and +62.9% for the Russell 1000 Value and Russell 3000 Value indices, respectively.

Concentrated Value achieved an important milestone as we hit our three-year anniversary at the end of 2021. Although three years sounds like a relatively short amount of time, from our standpoint it felt like an eternity having navigated through a raging bull market and a swift and powerful bear market, along with several bouts of extreme volatility all within a few short years. We believe our ability to weather the storms of the past few years was not possible without a strong investment philosophy, culture, process, and team to guide us. In late December, our team reflected on the past three years to discuss what we did right, what we did wrong, what we can do better and what changes should be made to our process and workflow that can make us even stronger. We also reflected on the merits of our philosophy and process and whether they stood the test of time or need some retooling. Below are some of the takeaways and key discussion points from that meeting. By no means do these represent an exhaustive list of our key principles and tenets but rather a microcosm of some of the issues and topics that are on our minds.

- *The best money managers are able to adapt, remain flexible and do not stubbornly cling to one type of investment style or "situation."* We have observed that several high-profile money managers have gone through a long and difficult period of underperformance largely due to their inability to change and adapt. As an example, prototypical "value managers" who historically found success by identifying cheap stocks that mean revert to some historical/normalized valuation have fared poorly. There are many reasons why this style underperformed but perhaps most notably because of the massive and unprecedented level of technological disruption that has permeated all sectors of the economy leaving the disrupted companies with well-deserved "cheap" multiples. Other managers have been able to adapt their styles over time recognizing that an investment process is like a living breathing organism that must adapt to a changing environment. We have openly and actively discussed the idea that we must remain flexible, we must be open-minded and we must adapt. I believe we score well in this regard and have learned many lessons over the years, which we have shared in previous quarterly investment letters.
- *A review of our most disappointing investments reveals a common thread.* While we always seek investments where our earnings projections are significantly above the consensus, at times we have been enticed by valuation. More than once we have been hurt by stocks where we were more enamored with the valuation multiple than the fundamental underpinning of the businesses. An attraction to valuation for valuation's sake reminds me of the story of Odysseus and the Sirens. The Sirens appeared to be beautiful women with captivating voices when, in fact, they were monsters looking to kill weak-minded sailors that were drawn to their superficial beauty. Avoid the temptation of the Sirens (cheap stocks). To be clear, we LOVE investing in quality companies that appear to be quite cheap where we are out of consensus on the earnings, but valuation in and of itself is not a thesis.

- *Do not let price dictate the narrative.* Our sell discipline is quite simple. Sell a stock when either 1) material news, data or other information arise that conflict with prior views and invalidate our thesis, 2) our estimates are no longer out of consensus or 3) the valuation gets to a level that suggests a poor risk/reward on a go-forward basis. We do not hold onto stocks simply because they are "working" if rules 1-3 are triggered as we never want the price of a stock to dictate what our narrative should be. We are more than happy to sell a stock while it's soaring higher to all-time highs if we are starting to question our thesis or no longer have a differentiated view. A rising stock price is not a sufficient reason to own a stock in our view. We believe this philosophy has worked quite well for us over the past few years. We sold our cable stocks while the Street was enamored with them due to our concerns about competition, we sold *Target* **(TGT)** near its all-time highs over concerns about supply chain issues and labor inflation, we sold *Perrigo* **(PRGO)** when our thesis did not seem to be playing out as expected even though the stock price didn't suggest a problem and we sold *Performance Food Group* **(PFGC)** after a step function increase in consensus estimates and our own numbers were no longer out of consensus. Undoubtedly, we also got a few things wrong along the way, but our disciplined approach to trimming and selling positions has been a net benefit to our performance over time.
- *Do not sell just because a stock hits our definition of "fair value."* We have become less and less focused on our fair value targets. After all, who are we to say a stock is worth 13x or 14x or 18x earnings? In our view, it is much more important to be right on the earnings estimates and if the stock is reasonably valued, it will likely continue to outperform as long as positive earnings revisions are expected to continue. A quality, reasonably priced stock should not be sold simply because it hit our theoretical assessment of fair value. Unfortunately, we sold some terrific stocks too early because I was too focused on our target prices rather than the quality of the businesses and our own out-of-consensus view of forward earnings; *Charles River Laboratories* **(CRL)** and *Silicon Valley Bank* **(SIVB)** are two great examples (with apologies to our rock star analyst who recommended these stocks in the first place, Craig Barney).
- *Wait for the right pitch and be patient.* This sounds obvious but investors oftentimes find it difficult to do nothing. After spending many hours researching a stock, an investor wants to transact in order to justify the effort put forth to date. It is very hard for an investor to put so much time and effort into a stock only to walk away; that requires a tremendous amount of discipline and restraint. This is especially true during a roaring bull market when stocks are going up seemingly daily and the temptation to pull the trigger becomes even greater due to FOMO. I believe the team showed terrific patience over the past year. There were several stocks we discussed in-depth and decided to wait for lower prices before transacting. This patience paid off well as we were able to buy *Chemed* **(CHE)**, *Jazz Pharmaceuticals* **(JAZZ)** and *Gates Industrial* **(GTES)** at lower prices by waiting for the right time to act.
- *Respect the market.* It is a difficult balancing act to have both conviction and an open mind. We strive for both and not let one dominate the other. Respecting the market forces one to have an open mind. If a stock drops for a week or two and underperforms significantly, it's not because people are foolhardy and it's not just noise getting in the way. There is a reason for the underperformance. We may not agree with the reason, and it very well may be a tremendous buying opportunity but it's important to investigate and understand why a stock is under-performing and then make a judgment rather than be dismissive of the event. Note that I am not suggesting we let price dictate our narrative, but rather we need to recognize that the price action represents <u>a</u> narrative, and it is our job to assess whether there is merit to that narrative or not.

These are only some of the discussion points at our year-end meeting. We spent time reviewing a variety of other topics, including research productivity and the devotion of more team meetings to analyzing secular themes (rather than just individual stocks). However, we do not wait for annual meetings to analyze how we can be better investors. Throughout the year we utilize other feedback loops such as post-mortem analyses to refine our process and learn from our achievements and mistakes.

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Q4 PORTFOLIO REVIEW

The biggest contributors to performance in Q4 were *Walker and Dunlop* **(WD)**, *APi Group* **(APG)** and *Air Products* **(APD)** which collectively contributed approximately 393 bps to performance.

WD's Q3 2021 revenue and EBITDA significantly exceeded consensus expectations as the company continued to execute on its growth strategy in multi-family debt originations, debt servicing, property sales brokerage and asset management. We believe WD's significant investment in headcount and technology has depressed margins. However, over the next few years, we expect the company to grow revenues by double digits while expanding operating margins and improving returns on invested capital. Although WD is the largest multi-family loan originator in the United States, it has virtually no market share in the sub-$10M multi-family loan market known as small balance loans ("SBLs"), which represent over 20% of the market. We believe WD can disrupt the SBL market by leveraging its differentiated technology and data to drive growth at very high incremental margins. We believe WD will partner with financial institutions in an arrangement that will enable WD to retain the servicing rights to SBLs that they originate. SBL servicing fees are typically higher than servicing fees on large institutional loans. Previously, WD guided to $5B of annual SBL originations by 2025, but we think this might be too conservative as this represents just 4% market share, yet they have over 13% market share of Fannie Mae and Freddie Mac non-SBL multi-family loans. We believe WD could generate over $10 in adjusted EPS in 2023, which makes the current stock price attractive relative to our expectation for double digit EPS growth over the next few years.

Investors' fears regarding inflation and labor shortages weighted on APG's shares heading into Q3 earnings. However, APG reported Q3 EBITDA margins that were higher than Q2 and essentially flat year over year, quickly assuaging cost pressure concerns. Importantly, APG recently completed the proposed acquisition of Chubb Fire & Safety, which we think will be over 20% accretive to EPS over the next few years. Chubb provides APG with a valuable growth platform in Europe and Asia that enables the company to become the largest provider of commercial fire and safety services globally. We believe sales can grow at mid to high single digits and EPS can grow at a double-digit rate over the next few years as the company mix shifts to Inspections & Service and restructures Chubb (which was neglected under the leadership of United Technologies). Using reasonably conservative assumptions, we think APG can earn over $2.20 in FCF/share by 2025, which makes the current share price quite attractive.

We have owned APD in the past and bought it again in February of 2021 when the stock was under pressure, reflecting investor fears regarding delays in two large projects known as Jazan and Lu'An. As one of the largest global producers of industrial gases, we believe APD is well-positioned to capitalized on the long-term trends within clean energy, including green hydrogen, blue hydrogen and carbon capture. Although the stock was up nearly 21% in the quarter, we were disappointed by volume trends and margins, particularly in North America and Asia. After speaking with the company, we believe our estimates were too aggressive and took down our numbers. Since our estimates were no longer materially different than the Street, we sold the stock in the quarter.

The biggest detractors to performance in Q4 were *NRG* **(NRG)**, *Alibaba* **(BABA)** and *Qorvo* **(QRVO)**, which collectively hurt performance by approximately 127 basis points.

Over the past four years, NRG grew EBITDA/share at +23% CAGR with even faster growth in FCF/share. This was during a volatile time including COVID and unprecedented storms in Texas that led to extreme volatility in power pricing. NRG's growth was driven primarily by a repositioning of assets, margin enhancement initiatives, and portfolio transformation. During this period, NRG executed very well, and management credibility strengthened considerably under the new CEO. However, the multiple didn't expand during this period and the longer-term questions still lingered as investors (including us) contemplated what NRG will do for an encore after successfully completing its turnaround. Management gave guidance at a recent Investor Day about longer-term organic growth but provided few details on how they intended to accomplish these financial goals. Furthermore, without a historical basis for organic customer growth and services/customer (or any KPIs for that matter), it's difficult to assess the reasonableness of NRG's guidance. During the third quarter earnings announcement, NRG lowered its outlook for 2022 citing one-time external factors which came as a surprise and led to weakness in the stock. We believe there is a material risk that expenses could be meaningfully higher than the company guided for over the next few years to achieve their growth objectives. Given our view that margins could prove worse than the Street expects, we exited the position during the quarter. We think it's prudent to see progress on their guidance for sustainable growth rather than take a leap of faith on the long-term EBITDA assumptions that management provided.

Earlier in this memo we highlighted the fact that the allure of an attractive valuation had, at times, superseded fundamentals and we ultimately paid the price for our error. BABA is a good illustration of this. We started researching BABA in late 2020 after the stock sold off on fears of increased government regulation and the withdrawal of the pending IPO of its Ant Financial subsidiary. By January of 2021, the stock seemed quite cheap and we believed the stock was trading for less than 17x EPS ex-cash and investments, which was a bargain relative to its historical multiple of 25x-30x. At the time, we thought the government crackdown wouldn't materially alter the growth trajectory of the company and 35%+ growth would continue driven by continued penetration of e-commerce, new retail offerings (Freshippo, Sun Art), cloud services and digital payments. In hindsight, we were too quick to assume that BABA would sustain its growth rate and did not spend enough time reviewing the competitive environment in China, including the impact of smaller, fast-growing rivals such as *Pinduoduo* **(PDD)**, *Meituan* **(2690 HK)**, *JD.com* **(JD)** and others. Fiscal 2022 earnings estimates at the start of 2021 were over $12.50/share but got slashed as the company experienced slower growth and announced a significant boost in spending to combat competitive pressures. By the end of 2021, fiscal 2023 estimates dropped to around $8.25/share. Despite a dimming outlook, which was compounded by a weakening macro environment and tougher regulatory environment in China, we held our position as the valuation was too tempting. This was a mistake given our own estimates were too high and our original thesis proved to be wrong. The risk of the stock de-listing from the U.S. stock exchange was the straw that broke the camel's back, and we sold the position. Perhaps our sale represented the bottom in the stock, but we prefer to sell when our thesis has proven wrong rather than look to hope as the new thesis.

We think the 13% drop in QRVO after the release of its fiscal Q2 earnings report was a drastic overreaction, and we added to our position in the quarter making QRVO a top 5 holding. We believe the narrative that QRVO is losing market share, as evidenced by its slower growth relative to *Qualcomm* **(QCOM)** and *Skyworks* **(SWKS)**, is false. We think the recent disappointing growth is more a function of supply constraints and timing of customer deliveries rather than a market share shift. In fact, we expect QRVO to gain significant share with several major mobile handset OEMs including Samsung and HONOR over the next couple of quarters. We estimate QRVO's Mobile business will grow 23% this fiscal year despite the more recent slowdown and generate record margins. The stock witnessed significant multiple compression during 2021 – consensus estimates for fiscal 2022 went from $9.70 at the start of the year to nearly $12 by year end, yet the stock was down 6% on the year. In fact, the forward P/E multiple over the past year has gone from over 19x to just over 11x. We think the current multiple implies expectations for a peaking of earnings, which we think is wrong given RF semiconductor content will

continue to grow meaningfully as 5G smartphone penetration increases. QCOM recently projected the RF market will grow at a double-digit CAGR over the next few years which we agree with. Longer term, we think QRVO's recent acquisitions set it up well to capitalize on the growth of ultra-wideband technology (UWB) and Power Management that could add up to $1B in incremental revenue over the next few years. UWB is a highly accurate location tracking technology able to identify the distance and even the location of hardware or devices relative to itself to within a few inches. There are a multitude of use cases for UWB in mobile phones and automobiles and penetration rates are still low for this nascent technology. Given consensus estimates for fiscal 2025 suggest just $1.1B of total revenue growth vs. the trailing twelve-month period, we believe the Street is significantly underestimating QRVO's growth potential and that QRVO can achieve this growth potentially with just the new technologies mentioned above while the core business organically grows double digits. We believe QRVO can earn over $20/share in EPS in fiscal 2024, which is significantly above the consensus estimate of $15/share.

We initiated three new positions in the quarter that currently have 3% or higher weightings in the portfolio – *Vertex Pharmaceuticals* **(VRTX)**, *onsemi* **(ON)** and *Brunswick Corporation* **(BC)**. The following is a synopsis of our investment thesis for each.

VERTEX PHARMACEUTICALS (VRTX)

"Both poker and investing are games of incomplete information. You have a certain set of facts and you are looking for situations where you have an edge, whether the edge is psychological or statistical."

– David Einhorn

VRTX is a large cap biotech company with a fortress balance sheet ($24/share in net cash) and the dominant position in Cystic Fibrosis ("CF") therapeutics. CF is a life-shortening genetic disease caused by a defective or missing CFTR protein resulting from mutations in the CFTR gene. The absence of working CFTR proteins results in poor flow of salt and water into and out of cells in several organs, including the lungs. As a result, mucus builds up and clogs the airways in the lungs, causing chronic lung infections and progressive irreversible lung damage. VRTX's CFTR potentiators increase the probability that the CFTR protein channels open on the cell surface, increasing the flow of salt and water into and out of the cell. VRTX's CFTR correctors help CFTR proteins reach the cell surface. VRTX's main CF drug, known as TRIKAFTA in the U.S., is used by more than half of the 83,000 CF patients in the U.S., Europe, Australia, and Canada. Real-world data from more than 16,000 U.S. patients treated with TRIKAFTA show an 87% reduction in risk of lung transplant and a 74% reduction in the risk of death. We expect VRTX to generate over $7.5B in revenue from its CF franchise in 2021 with 58% margins and over 30% returns on invested capital. We believe VRTX's CF franchise has several years ahead of high single-digit to low double-digit revenue growth as it expands to new geographies and younger age groups.

Although 100% of sales today are derived from its CF franchise, we believe VRTX has a robust pipeline of products for a variety of indications including Sickle Cell Disease, Type 1 Diabetes, APOL1-Mediated Kidney Disease and more. Collectively, these represent a multibillion-dollar opportunity. Furthermore, VRTX is working on a next generation CF drug which has the potential to be a more effective drug that will also provide better economics to VRTX. Currently, VRTX pays royalties on TRIKAFTA in the low double-digits whereas the next generation drug would pay a low single-digit royalty. Since

consensus estimates do not reflect any gross margin improvement for VRTX over the next few years, we believe there is considerable upside to estimates should the drug get approved and commercialized.

At this point, you may be wondering why I started this stock writeup with a quote about poker and investing. For starters, we are dealing with incomplete information. During the first quarter of 2022, *AbbVie* **(ABBV)** is expected to release data on its own CF drug that is currently in Phase 2 trials. There is very little known about this drug outside of some preclinical data provided by the company, but the risk of a competitive drug infringing on TRIKAFTA's leadership position was enough to create pressure on the stock over the last couple of months (along with a failed clinical trial for a different drug and broader biotech sector weakness). When we first started buying VRTX stock in mid-December, it was trading for less than 12.5x our 2023 estimate, which was attractive to us relative to our out-of-consensus expectations for 20% EPS growth. This implied to us that the Street was very concerned about the terminal value of VRTX's CF franchise perhaps due to the perceived threat by ABBV. We spoke to several CF experts and believe that we have a winning hand in this poker game. While several experts we spoke to have questioned the lack of data on ABBV compounds and have pointed to the failed effort from ABBV dating back many years during its partnership with Galapagos, ABBV's own management team's comments are most revealing. Earlier this month at the JP Morgan Healthcare Conference, Michael Severino, President of ABBV said, "we would expect to be in a position to topline the data and to give…people an idea of our decision to advance the program or not, this quarter. So we're making good progress against this quarter, but I don't have an update for you today." In poker terms, Mr. Severino is revealing a pretty bad poker face and suggests he has a weak hand. Just a few weeks ago, investors were worried about ABBV announcing superior efficacy data for its drug and here we have the company saying they will be in a position shortly to determine if they will even advance the program at all! If we liked our hand in December, we like it that much more now.

Even if ABBV publishes comparable data, it will not be good enough. As mentioned earlier, VRTX is working on its own nex-gen CF treatment known as VX-121/VX-561/tezacaftor. Given their stellar track record in pushing the bar on CF drug innovation, we wouldn't bet against them. Interestingly, at the same healthcare conference, VRTX's CEO said, "So, when I think about drug development in CF, you have to go head-to-head against TRIKAFTA, that have to have better outcomes for patients and that's just table stakes. What you really need is the full package of acute improvements and long-term benefit, and frankly the only company that has that full package of registrational benefit and long-term benefit is Vertex and the closest competitor, the most advanced competitor to TRIKAFTA is indeed the VX-121/VX-561/tezacaftor program."

We believe VRTX's current market value gives almost no value to the pipeline. Our $19 estimate for 2023 EPS assumes 99% of revenues are derived from CF treatments. Likewise, we believe the stock represents a free call option on some blockbuster potential pipeline opportunities. CTX-001 is in Phase 3 and is a gene therapy targeting Sickle Cell Disease and Beta Thalassemia. VRTX believes the eligible patient population is 32,000 patients. At an estimated price of over $400k per treatment, CTX-001 alone could generate several billion dollars in revenue for VRTX if approved. VX-880 targets Type 1 Diabetes and is targeting 60,000 patients at a price tag of at least $400k. VX-548 targets acute pain which is a $4B market. We do not know which of these will get approved (if any) and clearly we have incomplete information given these treatments are in clinical trials, but we like our hand given the current stock price assigns little to no value to the pipeline today.

ONSEMI (ON)

ON is a global manufacturer of semiconductors that was spun out of Motorola in 1999. ON manufactures and distributes semiconductors serving a variety of end markets, including Automotive (34% of sales), Industrial (26% of sales), Computing, Communications and Consumer. ON has a very strong competitive position in Image Sensors and Power Solutions, which we believe will be the drivers of growth going forward.

In late 2020 ON brought in a new CEO, Hassane El-Khoury, which we think marked the beginning of significant change for the company. Hassane is the former CEO of Cypress Semiconductor, a company he ran for nearly four years before selling it to *Infineon* **(IFX GR)** in April of 2020. When he took over as CEO of ON, he took an "outsider" approach by setting a transformational agenda that was highly disruptive to the status quo. He is closing and consolidating ON's fabs, exiting certain non-value add product categories that represent up to 15% of sales and increasing the company's focus on high value product categories including Power and Sensing. At the Investor Day held in August, ON laid out a financial target of increasing gross margins from under 39% in 2021 to 45% by 2025. They also guided to 7%-9% CAGR in revenues thru 2025, which includes exiting product categories that represent 10%-15% of sales. Although these appeared to be lofty targets at the time, the company has executed very well during 2021 and made significant progress towards its stated 2025 goals. Third quarter gross margins were 41.4%, up nearly 800 bps yr/yr as the company raised prices, exited lower margin product lines and grew its core, higher margin Power and Sensing products. While it is reasonable to assume that the current semiconductor supply shortage has been a tailwind to the margin uplift, it is also true that ON's transformational efforts are having a tangible impact on financial results.

Electrification. We believe ON's biggest opportunity is in electric vehicles (EVs). The mix shift to EVs will drive a significant uplift to semiconductor content/car given the greater need for power semiconductors and sensors in EVs vs ICEs. Hundreds of new EVs will enter the market by 2025 as the car park mix shifts accordingly. *Volvo* **(VLVLY)** is targeting 50% of its production to be battery electric vehicles (BEVs) by 2025 and 100% by 2030. *General Motors* **(GM)** will launch 30 new models by 2025. *Ford* **(F)** has committed $30B in investments in EVs thru 2025 and *Volkswagen* **(VWAGY)** has guided to over $33B of cumulative EV investments by 2022 (vs. original guidance back in 2017 of $22B by 2030). Since 2015, IHS has revised its long-term BEV forecasts up every single year. Consensus is now hovering around 10%-15% penetration by 2025 and 25%-30% penetration by 2030. An inflection point in demand will, in part, be driven by BEV total cost of ownership parity, which should occur in 2022. As BEV's become more economical than ICEs, demand should inflect as one of the main consumer pushbacks on EVs has been price.

The electrification of the car brings significant growth in semiconductor content. According to *STMicroelectroncis* **(STM)**, the total addressable market for Auto electrification semiconductors will grow at a 29% CAGR from 2019-2023 with total average semiconductor content per car growing from $400 in a typical ICE to over $1,000 per BEV. Infineon estimates average semiconductor content/car of $490 for ICE, $600 for "mild" hybrid EVs, $890 for full hybrid EVs and $950 for BEVs. Most of this content growth is driven by Powertrain and ADAS which is ON's sweet spot. *TE Connectivity* **(TEL)**, the largest manufacturer of connectors for the Auto industry, estimates that electrification and ADAS drives a 2x increase in content. Perhaps the best source for content growth is ON itself. At their Investor Day in August, ON disclosed one of its customers pays $131/car in content for an ICE/Level 1 car whereas that same customer pays $160/content for a 48 Volt/Level 2 car and $715 for an EV/Level 2+ car. We have listened to multiple industry experts and former ON employees who cited content opportunities in EV of over $500 with one former employee citing $300-$400 just for Power semiconductors alone (excluding sensors).

On the last earnings call, the CEO said the company has signed long-term supply agreements for committed revenue of $2.5B over three years in Power Solutions with two-thirds for EVs alone. Since ON's EV revenues today are likely no more than

$200M/year, the outlook for Auto revenue growth is very strong even in an environment of depressed auto sales (SAAR). ON grew Auto revenues by 37% in Q3 despite global auto production declines of nearly 18%. Q4 guidance implies very robust growth (probably ~30%) despite continued double digit declines in global auto production. It has become clear that SAAR is not the driver of growth but rather EV growth. Notably, even though global vehicle production has declined every year since 2017, EVs have grown over 30% per year since 2017 (and represented ~13% of sales in 2020). Even in 2020, despite COVID, EV sales grew 36% which was the highest rate of growth in years. We expect ON's 2021 Auto revenues will be 37% higher than 2017 levels despite global auto production down 20% over that timeframe.

ON already enjoys the leading market share of image sensors in auto at about 50%. Likewise, the growth in Sensors will come from increased content/car rather than share gains. A typical vehicle now has about 5-7 sensors and that is projected to go to 15-20 over the next decade driven by autonomous vehicles (AVs) and ADAS. According to *NXP* **(NXPI)**, a level 1 car (driver assistance) has 1-3 radars and 1-2 cameras whereas a full Level 4/5 AV has 6-10 radars, 6-8 cameras and 1-3 LIDAR systems.

We believe ON will grow its Auto revenues at a 23% CAGR from 2020-2024 at which point the Auto segment will represent 46% of total sales.

Industrial. Factory automation, renewables and "internet of things" (IoT) should drive high single digit growth in ON's Industrial business over the next few years. STMicro estimates the Industrial semiconductor market will achieve a CAGR of 7.6% from 2020-2023. Renewables require semiconductor content whereas fossil fuels and nuclear do not. Infineon estimates anywhere from $2,000-$5,000 of semiconductor content for wind, solar and battery storage. NXP projects its Industrial business will grow 9%-14% over the next three years driven by edge computing, smart home devices and industrial automation.

ON is well positioned to gain significant semiconductor content within the high growth areas of Industrial. Factory Automation represents $3,000-$10,0000 of content opportunity per factory, Renewables can cost $600/inverter and EV Chargers contain $2,000-$4,000 of semiconductor content per unit. Additionally, Factory Automation could witness an acceleration in demand due to labor shortages and wage inflation. According to a recent Bank of America report, "wage inflation has historically served as a catalyst for companies to invest in productivity-enhancing initiatives." With U.S. manufacturing wages rising at the fastest pace since 1982, increased investments in factory automation may follow. BofA noted that mentions of "automation" in corporate earnings conference calls among S&P 500 Industrials are 22% above prior peak levels back in 2019.

Gross margin Upside. Under the previous management team, ON utilized many small, sub-scale fabs on older technology and pumped as much product through them as possible to keep utilization up. These products oftentimes were lower margin, commodity products. The new CEO is shuttering several small fabs and pushing the capacity over to a large, state-of-the-art fab in East Fishkill, NY running at the cutting edge 300mm technology (12-inch wafers). Each of the smaller fabs have $125M+ of overhead and produce products with margins approaching the low teens. ON is intentionally walking away from as much as $1B of low margin product as it shutters these fabs and/or will work with foundry partners – either way, this strategy will be accretive to gross margins. Most of the incremental growth at ON will come from Auto and Industrial power and sensing products that have much higher margins. These margins will improve as the manufacturing shifts to East Fishkill. Industry leading analog semi peers with a focus on Auto and Industrial have significantly higher margins than ON, and we expect ON's gross margins will dramatically improve as they execute their plan. Although ON is shrinking its footprint, its capacity per factory will go up 2x, such that overall capacity will go up by 30% despite the shrinkage of its manufacturing footprint.

ON appears to be ahead of its plan to reach 45% gross margins by 2025 as gross margins are already at 41% (up from 32.7% in 2020).

We believe ON can earn $5 in EPS by 2024, materially higher than consensus estimates of just under $4. If our 2024 estimates materialize, ON will generate 75% of its revenues from the Automotive and Industrial sectors, ROIC of nearly 30%, operating margins of over 26% and net debt/EBTIDA of just 0.4x. Leading analog semiconductor companies with heavy exposure to Auto and Industrial end markets trade for north of 20x forward EPS and we believe ON can achieve a similar status if they execute on their plan. This would equate to a stock price of $100 vs. the current price of $63.

BRUNSWICK CORPORATION (BC)

We previously owned BC and wrote extensively about our investment thesis in our Q3 2020 letter. We bought the stock again after it dropped over 20% due to fears about the impact of inflation, labor constraints and relatively weak retail data for the boat sector. We believe that BC's business model is much more resilient than most investors think. About 50% of EBIT is aftermarket or repower related, meaning BC's business is more correlated to boating engagement than boat sales. In 2006, boat sales represented 41% of earnings but in 2020 it was only 11%. BC's high exposure to boating engagement rather than sales should translate to less volatility and more predictability in financial performance than the past with superior full cycle margins. We are bullish on boating engagement given the structural changes that are taking place with respect to hybrid work environments and increased demand for non-urban dwellings.

Furthermore, Mercury engines (~50% of EBIT) gained 310 bps of market share over the past two years, and we believe this is a long-term sustainable trend with ample opportunities for additional share gains in freshwater engines, international markets and higher horsepower products.

We believe even if retail sales decline mid-single digits, BC can continue to grow based on tailwinds in engine market share, boating engagement and aftermarket growth. We think BC can earn $11.25 EPS in 2023 (consensus is just over $10) and generate 30% ROE with very little net debt, which makes the stock look very attractive at the current price.

MARKET COMMENTARY

If I told you that consumer confidence is at a ten-year low, CPI growth is at a 40 year high, real wages are declining and the Fed has pivoted to a hawkish stance and is about to begin a cycle of raising interest rates, would you also believe me if I said that the market is within 5% of its all-time highs? The U.S. stock market's resilience in the face of a significant spike in inflation reflects the consensus view that supply chain bottlenecks and labor shortages are transitory. According to Credit Suisse, the consensus amongst economists is that CPI will drop to 2.8% by year end with the Fed estimating 2.6%. This would be quite a pivot given the current environment where PPI is +12.2%, WTI Crude is +55%, CPI is +7.0% and wage inflation is +4.7%. The Omicron variant is adding fuel to the fire as it is negatively impacting labor participation and productivity. Although Omicron is potentially peaking in the United States, it has yet to wreak havoc in Asia where so many goods are manufactured (China

is home to about a third of global manufacturing). "Delivery times for products shipped from Chinese factories to the West Coast are as long as ever – stretching to a record high of 113 days in early January, according to Flexport, a logistics firm. That was up from 50 days at the beginning of 2019." (*Wall Street Journal*)

At least 20M people in China are in lockdown, mostly in the city of Xi'an as China continues its zero-tolerance policy. There is no assurance that this does not get much worse in the coming months, which would have ripple effects across supply chains and, ultimately, inflation.

The composition of consumer spending will probably need to shift back to "experiences" from "things" to alleviate the current supply chain and inflationary pressures. According to a recent WSJ article, "although overall spending is more or less on its pre-pandemic trend…the composition of spending has changed: Americans purchased 18% more physical goods in September 2021 than in February 2020." Simply put, we do not have the labor supply, infrastructure or capacity to handle the elevated demand for goods and it will take quite a while for capital investments to bring the needed relief to these pressure points. Earlier this month, the CEO of *Taiwan Semiconductor* **(TSM)** said, "we expect our capacity to remain tight throughout 2022." The shortage of semiconductors is causing all sorts of havoc across the auto, industrial and consumer electronics markets with no signs of easing in 2022. David Solomon, CEO of *Goldman Sachs* **(GS)**, had this to say on January 18th: "based on my experience, it makes sense that coming out of the recent period of easy monetary policy, inflation may be above trend for some time and in the near term, inflationary pressures may continue to intensify before they start to decrease."

We are positioning the portfolio for a period of sustained inflation and adjusting our earnings estimates accordingly. We have reduced exposure to cyclical stocks that are sensitive to commodity inflation and re-allocated capital to portfolio companies that we expect will be largely immune to such risks.

As of January 18th, our five largest positions were *Crown Holdings* **(CCK)**, *East West Bancorp* **(EWBC)**, Qorvo (QRVO), APi Group (APG) and *AmerisourceBergen* **(ABC),** representing nearly 31% of the total portfolio. Approximately 13% 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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