MD Sass Concentrated Value

MD SASS

Q1 2022 Commentary

April 19, 2022

The MD Sass Concentrated Value ("CV") strategy was up +0.7%, net of fees, in the first quarter of 2022, vs. -0.7% and -0.9% for the Russell 1000 Value ("R1V") and Russell 3000 Value ("R3V") indices, respectively.

From inception (January 2019) through the first quarter of 2022, CV had a net annualized return of +24.0% vs. +15.9% for the R1V and R3V indices.

The degree of ambiguity about the shape of things to come is palpable. Investors are grappling with a myriad of issues including inflation, war in Ukraine, rising geopolitical tensions, COVID lockdowns in China and Fed tightening. "There is so much uncertainty" is a common refrain amongst asset managers and market prognosticators nowadays. While this is undoubtedly true, when was the last time you heard yourself, or any market observer say, "never have I been more certain about what is to come"? There is always a high degree of uncertainty and the only thing that changes is how easy or difficult it is to point to something tangible that explains it. We recognize that we do not know how the issues of the day will drive economic growth or markets over the near term. The only thing we do know is that our guess is likely wrong. After all, during the depths of COVID despair in March of 2020, did anyone accurately predict what was to come? Did anyone imagine the market highs that came shortly thereafter? As we discussed in prior memos, our focus during COVID was not on the immediate impacts but rather the long-term investment opportunities that may arise over the medium to long-term. Likewise, rather than pontificate on how many basis points the Fed will hike rates, what month inflation growth rates will peak, or how long supply chains will be strained, we are focusing our research efforts on what the long-term investment implications might be from these challenges.

One increasingly likely outcome from the current geopolitical turmoil is a structural shift to de-globalization, or regionalization. For decades, the world shifted towards a globalized economy to reduce costs as manufacturing was outsourced to countries with low-cost labor. According to the economist Robert Johnson, international trade had the effect of reducing U.S. consumer prices by an annual rate of 0.1%-0.4% between 1997 and 2018. Furthermore, according to data from the Asia Development Bank, the share of foreign content in global manufacturing production increased from 17.3% in 1995 to 26.5% by 2011. While some argue that globalization peaked several years ago with the departure of Britain from the EU and the implementation of Trump-era tariffs, it is also quite likely that COVID-19 and the Russia/Ukraine war will accelerate its reversal. While COVID exposed the vulnerabilities of our global supply chain, the war in Ukraine is the straw that broke the camel's back. Western countries simply can no longer rely on non-allies to source critical commodities such as oil, natural gas, corn, wheat, aluminum, titanium, etc. With U.S./China relations becoming increasingly tense, how much longer will our country depend on Chinese manufacturing? China's sphere of influence is also an important consideration with respect to globalization. According to TrendForce, Taiwan's contract manufacturers accounted for more than 60% of total global foundry revenue last year and represent a critical source of components for the largest U.S. tech companies including *Apple* **(AAPL)**, *Qualcomm* **(QCOM)** and *Nvidia* **(NVDA)**.

If we are now in the era of de-globalization, there are many important investment implications to consider including:

- *Onshoring/Reshoring of Manufacturing* – this was already a theme emerging from COVID, but the current geopolitical climate makes this even more likely. This would have ramifications for capital equipment companies, railroads, trucking, semiconductor equipment companies, and many other sectors of the economy.

- *Higher Inventory to Sales Ratio* – the concept of more "safety stock" was another post-COVID theme which is even more critical now that the World's supply of corn, wheat and other commodities have been highly disrupted. The ramifications of higher inventories would have profound impacts on certain sub-sectors of the economy such as industrial REITs
- *Increase in Capital Expenditures in the West* – mining, agriculture and manufacturing investments should all see an uptick in North America, Europe and Australia. In the United States, we already had capex tailwinds from the recently passed infrastructure bill.
- *Shift in Energy Sourcing* – Europe will need to figure out how to dramatically reduce its dependency on Russia for oil and natural gas which will have significant repercussions on how Europe sources fossil fuels as well as its longer term aspirations for energy independence via renewables. Over the long-term, this will have implications on energy supply chains (particularly LNG) and demand for renewable energy sources such as solar and wind.
- *Military Spending* – NATO countries committing to defense spending of 2% of GDP will lead to over $100B in incremental annual defense spending and this doesn't consider any increase in spending from NATO countries already above the 2% threshold such as the United States, the largest defense spender globally
- *Structurally Higher Prices* – any shift in manufacturing away from low-cost producers inevitably means higher prices. The implications of this are vast and certainly companies without pricing power will struggle during periods of increasing costs.

Timing some of these potential emerging themes can be quite difficult. The companies that may experience long-term benefits from some of these secular shifts could see their business quickly erode in the near term due to a cyclical deceleration in demand. Also, some of the structural changes may be glacial, in which case, the structural tailwinds might be hardly perceived at all over the next few years. We believe we have time to be thoughtful and diligent about the longer term "winners" from deglobalization but it is most certainly an area of focus in terms of idea generation and research.

Q4 PORTFOLIO REVIEW

The biggest contributors to performance in Q1 were *Crown Holdings* **(CCK)**, *Quanta Services* **(PWR)** and *Vertex Pharmaceuticals* **(VRTX)** which collectively contributed approximately 257 bps to performance.

CCK, one of the largest global producers of beverage cans, was a laggard in 2021 as investors were concerned a temporary demand benefit from COVID would make for difficult comps in 2022. However, CCK squashed that bear case after providing guidance of 9% volume growth in 2022. This outlook is impressive considering the company grew volumes 9% in 2021 as well. We believe the structural demand shift from plastic and glass to aluminum will lead to higher EPS and free cash flow than consensus estimates and that return on capital will continue to improve as the company reprices contracts at more favorable terms and as the business mix continues to shift to higher margin specialty cans.

PWR reported better than expected Q4 2021 results and guided to 2022 earnings ahead of consensus expectations despite the lingering effects of supply chain disruptions and labor inflation. Many of PWR's large utility customers have provided multi-year capex plans that suggest a very robust outlook for PWR as the leading outsourced engineering and construction company for the utility sector. For example, *NextEra* **(NEE)** guided for 8%-9% CAGR in capital growth from 2022-2025. *Duke Energy* **(DUK)** intends to deploy $63B of capital from 2022-2026 up from the $59B of capital the company deployed from 2021-2025.

Dominion Energy **(D)** expects to spend $37B in capital from 2022-2026, up from $32B from 2021-2025. We continue to believe PWR will grow EPS at a mid-teens growth rate over the next several years driven by favorable utility capex plans, increased use of outsourced labor and accretion from the recent acquisition of Blattner.

When we initiated a position in VRTX in Q4 of 2021, we thought that investors were overly concerned with the potential threat of a new Cystic Fibrosis drug from *Abbvie* **(ABBV)**. We believe the perceived threat is all but a distant dream at this point as ABBV didn't deliver on its promise of releasing data on its pipeline drug in Q1. In fact, commentary from ABBV management has been all but reassuring on the drug's promise. Meanwhile, VRTX is not only demonstrating its clear and distinct advantage in Cystic Fibrosis treatment, it is also showing continued momentum in new therapeutic areas including Type 1 Diabetes, APOL-Mediated Kidney Disease and pain treatment. Despite the recent run in the stock, we believe the current valuation implies very little value to VRTX's promising R&D pipeline which has the potential to deliver several blockbuster drugs over time.

The biggest detractors to performance in Q1 were *Qorvo* **(QRVO),** *APi Group* **(APG)** and *Bausch & Lomb* **(BHC)**, which collectively hurt performance by approximately 322 basis points in the quarter.

QRVO is one of the leading manufacturers of radio frequency (RF) semiconductor chips to the mobile phone industry. We believe that the proliferation of 5G devices and new spectrum bands to support 5G will lead to double digit growth in RF over the next few years even with no growth in actual smartphone shipments as the mix shift to 5G drives greater content per phone. However, the near-term outlook has been dampened by a variety of factors that we believe are transient, including supply chain disruptions, COVID-related lockdowns in China and the timing of key customer product launches. The semiconductor sector broadly is out of favor as investors fear waning demand will lead to an oversupply of components and a sharp correction in earnings. While we agree that the near-term outlook is tepid, we believe the longer-term fundamentals are strong, and with the stock trading near trough P/E valuations, we believe the short term concerns are overly discounted in the stock.

Despite posting better than expected Q4 results and providing an outlook in-line with consensus expectations, APG sold off sharply in Q1 and ended the quarter down 18.4%. We believe APG has been on the wrong side of the factor-driven market swings in the quarter – mid-cap industrials with leverage and sizable hedge fund ownership were simply not well bid in Q1. While there has been some concern about the timing of APG's acquisition of Chubb given its heavy exposure to Europe and Hong Kong, we believe the company will continue to grow sales organically at 5%+, EBITDA 7%+ and EPS 10%+ as APG continues to take market share of the commercial fire inspection market in the United States and abroad. We believe APG's valuation is very attractive at 10x our 2024 EPS estimate.

BHC has put up a few disappointing quarters of late that has led to negative earnings revisions. This, coupled with delays in spinning off Bausch & Lomb due to "market conditions" has significantly weighed on the stock. We continue to believe that the spin-offs have the potential to unlock value but believe meaningful upside will come from a return to organic growth rather than financial engineering. We believe BHC fundamentals will improve as the company laps COVID-related issues and headwinds from loss of exclusivity on certain drugs subside. However, given the company's leveraged balance sheet and dependency on healthy capital markets to drive some of the value creation, BHC is the smallest position in the portfolio.

We initiated new positions in *Corteva* **(CTVA)** and *Interactive Brokers* **(IBKR)** in the quarter, which we discuss below.

CORTEVA (CTVA)

Corteva is a pure-play agricultural seed and crop chemicals company, born out of the merger and subsequent spin-off of Dow Chemical and DuPont's agricultural sciences businesses. Earlier in this memo we discussed the potential for structurally higher prices resulting from de-globalization and the potential for a shift in where commodities, including agricultural commodities, are sourced. All things being equal, higher agricultural prices are good for farmers who tend to spend more on ag seeds and crop chemicals when their incomes are strong. On CTVA's Q4 2020 earnings call, former CEO Jim Collins said, "clearly…improving commodity price markets helps the psychology of everybody involved and as what they think, farmers always think about their decisions as investments in their future to drive productivity and yield and so higher commodity prices means they will continue to push for yield."

Ukraine is the fourth largest exporter of corn, the third largest exporter of wheat and the largest global producer of sunflower seeds. Russia is estimated to be the largest global exporter of wheat. The Russia/Ukraine war will likely lead to a multi-year impact to wheat, corn and sunflower seed exports that will force the West to pick up some of the slack. Brazil has the capacity to add acreage whereas the U.S. may take longer to grow acreage. With Western acreage set to grow and farmers' income likely to remain heathy due to supply/demand imbalances, we believe a favorable backdrop exists for CTVA over the next few years. Importantly, the majority of CTVA's revenues come from North America and Brazil with less than 5% coming from Russia and Ukraine combined. Likewise, any shift in production from Russia/Ukraine may have an outsized benefit to Corteva given its geographic mix.

There are other factors driving sustainably higher corn and soybean prices. In 2020, one third of China's hog production was wiped out by swine flu. To put this in perspective, the lost production is similar in size to the rest of the world's hog production. In response, China moved a significant amount of production out of rural areas and into more centralized farms that have better controls and feed their animals a diet richer in grains. This drove a ~5% increase in global corn demand that China can't meet internally as their cost to produce is ~2x imports.

Demand for renewable fuels is driving increased demand for soybeans. According to AgResource Company, soybean acres would need to grow by 30M over the next few years to meet the projected demand for renewable diesel. This is significant relative to the estimated ~86M soybean acres planted in 2021.

We believe there are several idiosyncratic drivers of value creation for CTVA above and beyond the favorable agricultural commodity backdrop. First, we believe there is a material opportunity for CTVA to drive margins substantially higher over time as the company's mix of patented products increases. Monsanto, which is now owned by *Bayer AG* **(BAYRY)**, has seed margins that are ~1000 bps higher than CTVA's seed business which is largely explained by the $700M of royalties that Corteva pays Bayer each year for its patented soybean traits. However, Corteva's new Enlist product is proprietary and is uniquely positioned to gain market share as it doesn't release chemicals into the air and spread to other crops like Monsanto's licensed product. As Enlist gains share and is ultimately licensed out itself, CTVA's significant royalty expense will decline and ultimately go to zero which will drive earnings growth and margin enhancement.

CTVA's crop chemical business also has lower margins than peers like *FMC* **(FMC)**, *BASF* **(BASFY)** and Monsanto. This is largely a function of its portfolio mix. In 2019, 69% of Corteva's crop chemical sales were off patent products that have low margins. The company expects its mix of patented products to rise from 19% of sales in 2019 to 34% by 2023. Since patented products have up to 2,500 bps higher gross margins, we believe the mix shift alone can account for 400 bps of margin

improvement. We think sales of new crop protection products can grow from $750M in 2019 to north of $2.6B by 2023 led by innovation in insecticides and herbicides.

We believe CTVA has the opportunity to gain considerable corn seed share in the United States over the next few years driven by the launch of its Brevant brand. About one third of all corn seed is sold through the retail channel in the United States but CTVA has very little share of this channel. Corteva's new CEO, Charles Magro, has considerable retail knowledge as the former president and CEO of Nutrien, a company with over 2,000 retail locations in seven countries.

We believe CTVA can earn $3.25 EPS in 2023 which is nearly 10% above consensus estimates. We believe the Street's margin expectations are too low and a combination of better product mix, reduced royalty payments and targeted cost-cutting will drive over 30% EPS growth in 2023. We expect double digit EPS growth over the next few years, improving RoIC and optionality from the company's $3.3B net cash position. At 19x our 2023 EPS estimate, we think the stock is attractively valued.

INTERACTIVE BROKERS (IBKR)

IBKR is one of the largest global online brokerages with operations in 33 countries across three main geographic segments – North America (34% of accounts and 46% of total client equity), APAC (39% of accounts and 39% of client equity) and Europe (27% of accounts and 15% of client equity). IBKR caters to high net worth, sophisticated investors by offering highly competitive pricing on margin lending, securities lending and execution costs. The company's founder and Chairman owns about 76% of the company and has established a culture that places technology and automation at the forefront. This has enabled IBKR to achieve industry leading margins and a 14% return on equity. IBKR has nearly $6/share in cash (nearly 10% of its market cap) and no debt.

Strong Value Proposition: IBKR is one of the only global online brokers that enable seamless trading of stocks and derivatives across multiple geographies under one account. Despite the localized regulatory requirements in each region, IBKR's fully automated platform enables them to navigate through the complexities of various jurisdictions and exchanges at a fairly low cost. In addition to ease of cross-border trading, IBKR's highly competitive margin loan rates, securities lending, superior execution costs and APIs are key points of differentiation. According to a July 2020 release from IHS Markit, IBKR customers enjoyed a $.47 improvement in execution per 100 shares traded vs. the industry average. IBKR's starting margin loan rate for IBKR Pro customers (90% of total customers) is just 1.59% which is meaningfully lower than E-Trade, Fidelity and *Charles Schwab* **(SCHW)**.

Long Runway for Account Growth: At the end of 2021, IBKR had less than 1.7M accounts globally which is a fraction of the overall market. To put it in perspective, SCHW had 33M accounts just in the United States. SCHW estimates it has 12% retail share in the United States, which they estimate to be a $70T market. While IBKR caters to a more sophisticated sub-sector of the overall market, the market opportunity is clearly substantial relative to IBKR's current size. TradeStation estimates that growth of self-directed investor count grew at a 16% CAGR from 2018-2021 with total U.S. active traders estimated to be 6M; IBKR has approximately 500k accounts in the United States. At Schwab's recent Investor Day, they highlighted 22% client asset growth and showed the superior growth versus four other firms but failed to compare to IBKR which grew total assets by 29%. According to eToro, the worldwide wealth invested in equities is $78T. IBKR has about $374B of client equity. Furthermore, eToro estimates just 20% market share penetration for all digital platforms.

flatexDEGIRO, a leading European online broker, estimates that online brokerage penetration is still small in Europe. Developed brokerage markets like England and Sweden have just 35% penetration of online brokerage whereas there are 7 European countries (including France, Italy, Switzerland and Spain) with a population of 285M with just 8% online brokerage penetration. IBKR appears to be gaining share in Europe as well. According to flatexDEGIRO, the average European brokerage firm grew accounts by 17% in 2020 whereas IBKR grew about 60% in 2020. According to Nordnet, online brokerage assets represent about 12% of total addressable savings capital which is up from 6% in 2014. Mirae Asset Global Investments estimates that non-bank institutions held only 10% of retail investor capital and this is expected to grow to 25% by 2024.

At a December conference, the Chairman of IBKR said, "we are comfortable projecting a 30% rate of growth forward indefinitely…we have a definite plan and we are going to work our way through and we will keep growing minimum 30% on the year for many years to come." We believe IBKR account growth can grow considerably slower than this and still significantly exceed consensus EPS estimates.

NIM Expansion Will Drive Over $300M of EBIT Growth: IBKR is highly asset sensitive to the first two Fed rate hikes since it pays Fed Funds minus 50 bps (or more) on client cash. The first 25 bps are worth about $165M of NII (9% of '21 EBIT), the next 25 bps should add $120M annually and approximately $45M for each additional 25 bps hike thereafter. Likewise, if the Fed raises rates four times in 2022, for example, the run-rate EBIT contribution would drive 20% growth excluding the impact of any account growth.

New Initiatives: IBKR recently launched crypto trading capabilities making it the only global online broker that integrates crypto trading with cash equities and derivatives. IBKR charges just 0.12% to 0.18% per trade with a value minimum of $1.75 which is two thirds lower than many of the large competitors. Uptake has been disappointing thus far (only 30,000 accounts) but this is more of a messaging issue versus product issue and there is tremendous long-term opportunity with this value-added feature. Additionally, they have yet to get licenses for Europe or Canada but those should come. According to data.ai, crypto related trading apps such as *Coinbase* **(COIN)** and crypto.com are some of the most popular finance apps. like *Wells Fargo* **(WFC)**, and so any traction here could provide a nice tailwind to IBKR's growth.

Sentiment is Poor Creating a More Favorable Risk/Reward: IBKR is trading at a 5-year trough in P/E despite the significant rate tailwind (16.4x forward consensus estimates vs 5-yr average of 24.3x). This implies expectations for a very significant slowdown in trading activity, securities lending, margin loans and/or account growth. While geopolitical risks have recently led to a decline in securities lending and margin balances, we believe the LT fundamental backdrop remains very favorable to IBKR.

For the first time in five years, IBKR trades cheaper than SCHW on a two-year forward EPS basis. We look at two years to account for the better growth at SCHW in the very near term from rate hikes. However, consensus is for most of the rate hikes to occur in 2022/2023 so it is perplexing to us that IBKR would trade at a discount on a two year forward basis given IBKR's much stronger organic account growth. While valuation in and of itself is surely not a thesis, the attractive valuation in the context of low consensus estimates and strong fundamental backdrop, we believe, equates to a very timely investment opportunity.

During the quarter we sold our positions in *Axalta Coatings* **(AXTA)**, *Gates Industrial* **(GTES)**, *Mohawk Industries* **(MHK)** and Charles Schwab (SCHW). In early January, we concluded that many of the inflationary pressures that were negatively impacting some of our portfolio companies were not transitory. Conversations with management teams as well as their

competitors, suppliers and customers suggested to us that inflation will likely persist for some time and could, in fact, worsen. Yet, in early 2022, many companies gave guidance suggesting that things would get better in the second half and that their pricing actions will overtake inflationary headwinds. These "second half stories", as we like to call them, will likely not materialize. We believe the Russia/Ukraine war further solidifies this view. Based on these observations, we decided it was prudent to sell any cyclical, second half stories where our conviction in forward earnings was waning. This ultimately led to the sale of AXTA, MHK and GTES in early 2022. We sold SCHW because our earnings estimates were no longer out of consensus and valuation appeared quite full which ultimately led us to conclude there was a poor risk/reward in the stock.

As of April 18th, our five largest positions were Vertex Pharmaceuticals (VRTX), Crown Holdings (CCK), APi Group (APG), *Walker & Dunlop* **(WD)** and *On Semiconductor* **(ON),** representing just under 31% of the total portfolio. Approximately 15.6% 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, M.D. Sass

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