MD Sass Concentrated Value

MD SASS

Q3 2022 Commentary *October 18, 2022*

The MD Sass Concentrated Value ("CV") strategy was down -2.26%, net of fees, in the third quarter of 2022, vs. -5.62% and -5.56% for the Russell 1000 Value ("R1V") and Russell 3000 Value ("R3V") indices, respectively.

Year-to-date through the third quarter, CV was down -13.40%, net of fees, vs. -17.75% and -17.97% for the Russell 1000 Value ("R1V") and Russell 3000 Value ("R3V") indices, respectively.

From inception (January 2019) through the third quarter of 2022, CV had an annualized net return of +15.70% vs. +8.10% and +8.03% for the R1V and R3V indices, respectively.

It's interesting how one's initial foray into the world of investing can lead to either valuable or bad lessons learned, depending on which market environment one encounters first. For example, there is a large cohort of analysts and investors who have (until recently) only known a market environment in which valuations do not really matter. The post-Global Financial Crisis bull market from 2009-2020 rewarded speculation – unprofitable tech, crypto currencies, SPACs, and NFTs all witnessed fantastic gains. Even amongst "real" companies, for a time, investors were incented to pay nearly any price for businesses so long as they were perceived to have a wide moat and consistent earnings growth. It's easy to understand how investors who cut their teeth in such an environment would learn to prioritize growth, momentum, and the greater fool over valuation. But the reality is that valuations DO matter, along with fundamentals and sentiment. Arguably, these are the three pillars of investing and focusing on one while ignoring the others is a recipe for disaster. The hope for future growth, in and of itself, is not a thesis, nor is it even an adequate fundamental basis for owning a stock unless that growth comes with profits or, at the very least, the promise of profits over a reasonable time horizon, to say nothing of complicated and annoying considerations like cost of capital and return on invested capital. Much like the tech bubble burst of the early 2000s, plenty of stocks with decades of robust growth ahead of them have and will continue to see their shares pressured. Then as now, higher interest rates served as a wakeup call to the idea that perhaps most fast-growing unprofitable companies are really just long duration assets and not compounding disrupters.

And so here we are – the NASDAQ Composite is now 34% off its 52-week high and about 1,500 of its constituents are down more than 50% since the index peaked in November 2021. While most of the speculative, unprofitable growth stocks deserve to be down meaningfully, we believe there are instances where the baby has been thrown out with the bath water. Amidst the growth stock carnage lies terrific companies with real free cash flow, dominant market positions and growing addressable markets that were too expensive during their heyday but are now left for dead amongst a peer set unworthy of their company. Sure, the near term might be challenging for these companies as they lap difficult growth comparisons from COVID, face increasing FX headwinds, battle inflation and supply chain bottlenecks and contend with a deteriorating macro backdrop. However, the valuations for some of these former darlings suggest an outlook considerably worse than the reality. Recall, valuations and sentiment also <u>do</u> matter in investing, and we believe there are some interesting opportunities amidst the growth stock carnage where one can find companies with favorable fundamentals, attractive valuations and washed-out sentiment; companies that due to valuation and sentiment considerations were historically off-limits for boring, value-oriented

investors like us. We were fortunate to find three such stocks in the quarter, including *Charles River Laboratories* **(CRL)**, *PayPal* **(PYPL)** and *Match Group* **(MTCH)**. We discuss our investment theses for CRL and MTCH later in this memo.

Q3 PORTFOLIO REVIEW

The biggest contributors to performance in Q3 were *On Semiconductor* **(ON)**, PayPal (PYPL) and *Interactive Brokers* **(IBKR),** which collectively contributed approximately 290 bps to performance.

We believe the strength in ON's share price in Q3 was partly a reflection of oversold conditions in the prior quarter when the stock dropped nearly 20%. In the first half of 2022, it seemed like all semiconductor stocks were in freefall together regardless of end market exposure or product type. However, not all semiconductor companies are created equal, and we felt that those offering value-added products to the Auto and Industrial sectors were much better positioned than commodity-oriented manufacturers catering to Mobile and Consumer Electronics end markets. It was encouraging to see ON start to meaningfully outperform its peer group based on its strong financial results with ON +24% in Q3 vs. the SOX index down nearly 10%. Another driver of outperformance in the third quarter was an article released by the *Seoul Economic Daily* which stated that *Tesla* **(TSLA)** selected ON to provide silicon carbide ("SiC") power modules in a billion-dollar long-term supply contract. This article was effectively validated by ON's CEO on the company's third quarter earnings call where he raised its three-year revenue guidance for SiC to $4B from $2.6B previously. We continue to be very bullish about ON's potential for significant share gains in SiC power modules and the beneficial mix shift in semiconductor content/car as the industry shifts from internal combustion engines to electric vehicles.

PYPL was a new position in the quarter and, due to fortuitous timing, was a significant contributor to returns. In late July, it was reported that activist investor Elliott Management took a $2B stake in the company which led to a 12% rise in the stock. Purportedly, Elliott saw value creation through an increase in share buybacks, cost-cutting initiatives and an acceleration in growth after several quarters of tough year-over-year comparisons. PYPL was not quite a 3% position at quarter end so we will refrain from providing a detailed investment writeup until it becomes a more meaningful investment. We remain bullish on PYPL's long-term prospects and believe there is considerable upside to consensus estimates over the next few years as growth accelerates and margins outperform expectations.

There was no clear catalyst or event that explains the outperformance of IBKR in the quarter. Q2 earnings results missed consensus estimates and the monthly data released by the company did not point to any material acceleration in the underlying business. However, valuation does matter (remember?) and perhaps a shift in sentiment from awful to negative largely explains the strong relative performance. After all, by early September the stock was down ~20% YTD despite a 30% increase in consensus estimates. We also believe that the increase in rates globally in Q3 benefitted IBKR stock as higher rates drive higher income on customer cash balances. While we acknowledge that IBKR simply got "too cheap," that in and of itself is not a long-term thesis. In fact, we believe our original thesis placed too great of an emphasis on account growth (which remains very strong) but not enough focus on margin balances, trading activity and equity per account, which have disappointed our prior expectations. We believe that, in many respects, IBKR is really a bull market stock and that it will be difficult for the company to outperform expectations should inflation eat into consumer savings or if market volatility dampens retail investors' appetite to engage with the stock market. Given our lack of conviction in our earnings estimates, we sold our position in early October.

The biggest detractors to performance in Q3 were Alphabet **(GOOGL)**, *Raytheon* **(RTX)** and *APi Group* **(APG)**, which collectively hurt performance by approximately 308 basis points.

GOOGL is facing similar issues as other tech related COVID winners, including difficult growth comps, FX headwinds, inflation, and macro-related pockets of weakness. Despite these challenges, total revenues grew 12.6% in Q2 and the two-year revenue growth CAGR accelerated to 34.9% despite increasing foreign exchange headwinds that hurt growth in the quarter by nearly 400 basis points. However, data from at least one third-party, alt-data provider suggests a material slowdown in Q3 advertising trends for Google, which we believe negatively impacted the stock in the quarter. Also, fears of a recession coupled with lousy tech sentiment broadly and weak demand signals from social media companies undergoing hiring freezes weighed on the stock price in Q3. We understand near term concerns but believe that GOOGL's growth will prove more resilient than the Street thinks as the company will reign in costs more than expected to preserve margins and Google Cloud will leverage its large, fixed cost structure to improve EBIT. We believe the stock is a very attractive value at less than 16x our 2023 earnings estimate, ex-cash. It's important to note that our 2023 earnings estimate includes an expected loss of nearly $10B on Google Cloud, Waymo and other early-stage ventures. Therefore, the implied P/E of core Google Search and YouTube is even less than the headline P/E ratio suggests.

The medium-term outlook for RTX has gotten brighter as the Russia/Ukraine conflict along with escalating geopolitical tensions with China will lead to growth in defense spending throughout the developed world. However, the near-term financial outlook for RTX has gotten slightly less rosy due to supply chain bottlenecks, inflationary pressures, and labor shortages. The supply chain challenges have been particularly acute with everything from semiconductors, structural castings and rocket motors all causing production delays. RTX still has 13,000 job openings that it needs to fill. We believe these issues will resolve themselves over the coming quarters and that the longer-term growth trajectory led by defense spending and commercial aerospace recovery will lead to double-digit EPS growth CAGR over the next few years.

We are a bit perplexed by the magnitude of the weakness of APG's share price this year. With a significant portion of revenues tied to mandated regulatory fire and safety inspection services, we believe the business will prove to be quite resilient in an economic downturn. In 2020, during the worst of COVID, APG's adjusted EBITDA declined just 3%. The bear case is an easy one to understand – APG levered up to acquire Chubb Fire & Safety, a European business, in 2021 at the peak of global economic growth, the company has a high mix of floating rate debt and free cash flow conversion is poor. However, we believe the acquired business, called Chubb, is a turnaround story and despite the economic environment it is showing accelerating organic growth. We expect the company's cost synergy guidance for Chubb will increase later this year at the APG Investor Day. Floating rate debt is a negative, but we believe the company swapped a sizable portion of it to mitigate interest rate risk. Free cash flow ("FCF") conversion IS poor, and we expect improvement in this metric will be the single biggest catalyst for the stock. We expect working capital headwinds to abate by year end and that the company will generate ~$2/share in FCF in 2023, implying an attractive 14% FCF yield.

We initiated new positions in Charles River Laboratories (CRL) and Match Group (MTCH) in the quarter which we discuss below. We also initiated smaller positions in *World Wrestling Entertainment* ***(WWE)*** and PayPal (PYPL) which we will write about in future memos if either investment becomes a 3% position or higher at the end of any given quarter.

CHARLES RIVER LABORATORIES (CRL)

CRL provides essential products and services to help pharmaceutical and biotech companies, government agencies and academic institutions accelerate their research and drug development initiatives. CRL breaks out their business into 3 segments. The largest segment is Discovery & Safety ("DSA") which accounts for approximately 60% of profits and provides outsourced services for innovative drug discovery research and regulatory-required safety testing of potential new therapies. The second largest segment is Manufacturing (~25% of profits) which offers testing of facilities and large molecule batches in the Biologics and Microbials businesses. Recent M&A (Cognate & Vigene) has added a third leg to the Manufacturing stool that is focused on contract manufacturing for cell and gene therapy. Finally, CRL's legacy research models are the anchor of the RMS segment (~15% of profits). This segment engages in the production and sale of rodent research model strains and purpose-bred rats and mice used for drug discovery. 60% of total revenues come from the US with the remainder mostly from Europe and Canada. CRL worked on over 80% of FDA approved drugs over the past 3 years and originated 85 novel molecules for its clients since 1999.

We owned CRL from 2019-2021 and wrote about our investment thesis in our Q2 2019 investor letter. We first initiated our position at around $125/share with an expectation that the company would earn $6.60 in 2019. We most recently bought CRL at about $195/share with an expectation for EPS of over $12 in 2023. In other words, we are getting a second bite at the CRL apple at a 15% valuation discount vs our original investment, yet we do not expect organic revenue growth over the next couple of years to be materially different than the ~8.5% CAGR the company did back in 2019 and 2020. In fact, CRL trades at an EV/EBITDA multiple comparable to the 2015-2017 timeframe when CRL's organic growth was just 5%-8%. We believe the primary driver of the stock's multiple contraction is a decline in biotech industry funding. A recent Jefferies report stated that biotech funding dropped a whopping 60% yr/yr in the second quarter of 2022. Biotechs represent over 40% of CRL's client base and the fear is that a steep decline in biotech funding will negatively impact CRL's business which relies on biotech outsourcing services. With shares down roughly 50% YTD, we believe these concerns are more than priced in and CRL has several idiosyncratic growth drivers that will enable it to sustain strong organic revenue growth despite a decline in biotech funding. For example, CRL operates in an oligopoly providing non-human primates ("NHPs"), commonly known as lab monkeys, for medical research studies. With China no longer exporting macaques for scientific research, there is now a shortage of lab monkeys which is leading to increased demand for CRL's research models and safety services. In January of this year, The National Institute of Health stated, "expansion of current domestic NHP resources and facilities is urgently needed for the U.S. to be able to respond to emerging infectious disease threats and to continue to identify treatment approaches and develop new medical products to improve health across medical fields."

A scarcity of NHPs has also led to stronger pricing. According to a recent *Bloomberg Businessweek* article, prices have more than doubled from pre-pandemic levels to $11,000 per animal. The article cited commentary from a research executive who noted prices of more than $35,000 per primate on occasion.

In sum, we believe CRL is better insulated from a decline in biotech funding than its contract research organization (CRO) peers given its unique oligopolistic position in providing research models to the medical research community. We believe CRL's recent investments in cell and gene therapy (approximately 15% of sales) coupled with continued industry outsourcing trends for Discovery Services and Safety Assessment should drive low double-digit organic growth over the next few years,

© 2022 MD SASS Private & Confidential

which is faster than the company's historical organic growth rate. At less than 14x our 2024 EPS estimate, we think CRL is attractively priced relative to our growth expectations.

MATCH GROUP (MTCH)

We turned our attention to the tech carnage in Q3 for idea generation to assess whether great businesses with dominant market positions, strong future growth prospects and the potential for positive earnings revisions were available at reasonable prices. While the share price of tech companies with nosebleed valuations and indefensible business models may never fully recover, we believe reasonably priced companies offering a strong value proposition to their customers and operating in growing end markets may come out of this period even stronger, particularly as access to capital markets dries up for upstart competitors seeking a slice of market share at virtually any cost. We believe MTCH fits the bill.

MTCH is a leading online dating platform with a global portfolio of brands including *Tinder*, *Match*, *Hinge*, *Meetic* and *OKCupid*. *Business of Apps* estimates that the online dating market was approximately $4.6B in 2021, implying *Tinder* had 35% market share and MTCH properties collectively held a dominant ~65% of the market. According to a Stanford University study, 39% of heterosexual couples met online in 2017, up from just 2% in 1995. We believe there is ample room for continued growth in online dating with just 43% of North American adult singles having tried a dating product in 2021, according to MTCH. Internationally, the prospects for industry growth are also strong with the company estimating user penetration of 43% in Europe, 39% in LATAM, 26% in Middle East/North Africa, 18% in APAC (ex-China) and 10% in Africa. Furthermore, with just ~15% of MTCH's user base paying for dating services, we believe there is a large opportunity to convert more of the user base into paid users thru the introduction of shorter-term subscription services and virtual goods and tokens.

Although *Tinder* is MTCH's largest brand, representing 60% of total sales, *Hinge* is its fastest growing platform and should grow 50% this year and north of 30% next year. *Hinge* is largely an English-speaking dating platform today but has embarked on an aggressive international expansion campaign that we think will drive continued double-digit growth for years to come. Recent third-party app download data suggests strong results for *Hinge*'s recent launches across several European countries.

In addition to COVID and macro-related headwinds, MTCH has experienced some self-inflicted wounds that we think are largely behind them, including mis-execution at *Tinder* and senior management turnover. We are encouraged by the arrival of Bernard Kim as the company's new CEO. We believe Mr. Kim's prior experience as President of Zynga (a leading mobile gaming company recently sold to *Take-Two Interactive*) is relevant to MTCH as the gamification of dating via virtual goods and tokens is a promising long-term opportunity for dating platforms. Furthermore, Zynga is a portfolio of mobile gaming brands and needed to be managed accordingly which is a similar structure to MTCH with its portfolio of online dating brands.

MTCH pays meaningful app store fees to both *Apple* **(APPL)** and *Google* **(GOOG)**. In-app purchase fees were over $550M in 2021 and represented nearly 19% of total sales. With both Apple and Google facing increased regulatory scrutiny over their app store policies and fees, we believe there is the potential for a material reduction in MTCH's cost of revenues should legal and/or regulatory tides shift in MTCH's favor. We agree with Goldman Sachs's estimate that a 15% reduction in Apple app store subscription fees (currently running at 30% of all MTCH revenues generated at the Apple App Store) would deliver

~20% upside to MTCH's EBITDA in a few years. We do not underwrite our investment case with this outcome but believe there is a reasonable probability that a favorable ruling or action will occur and drive meaningful value accretion to MTCH.

We estimate that MTCH will generate approximately $1B of free cash flow in 2023 which implies a 7.5% FCF yield based on the current share price. We believe this is an attractive valuation for a company that should grow revenues at a high-single digit/low double-digit rate over the next few years with even faster EPS growth.

During the quarter, we sold our investments in *Quanta Services* **(PWR)** and *Vertex Pharmaceuticals* **(VRTX)**.

MARKET COMMENTARY

Kindly tell us the future path of inflation and we will happily tell you where we think the market is headed. Stock prices are highly sensitive to inflation and interest rate expectations and the uncertain outlook for both variables leaves the market in a highly volatile and uncomfortable state. Treasury Inflation Protected Securities (TIPS) prices currently imply a 5-year expected annual inflation rate of 2.4% that is notably lower than the current 8%+ inflation rate. Furthermore, Fed Funds Futures are pricing in peak rates sometime around the spring of 2023. For the stock market to move sustainably higher from here we will need to see these indicators hold firm or even improve. The good news is that commodity prices have started to roll over which may be a leading indicator that inflation is peaking.

Importantly, S&P 500 earnings are getting cut which is needed to support a market bottom. According to Credit Suisse, Q3 S&P 500 earnings have been cut 7% since June. However, consensus estimates still seem too high with expected EPS growth of nearly 6% in 2022 and 8% in 2023. We think further cuts are necessary. With the S&P 500 trading at 15.5x forward estimates, the market does not appear to be such a compelling value if one believes that forward estimates need to be cut further UNLESS inflation meaningfully declines from current levels.

In sum, TIPS, Fed Funds Futures and equity markets seem to imply that inflation will come down considerably with peak Fed Funds occurring in about six months' time. An elongation of the "peak inflation" timeline will likely lead to a protracted downturn as market multiples do not suggest fragile investor confidence. Forward P/E multiples troughed at around 14x during the last two market panics of December 2018 and March 2020. During the post-GFC and Greek debt crisis era the market multiple was closer to 12x.

Our portfolio is currently trading for about 14.4x our 2023 EPS estimate which we view as attractive relative to our expectations for double digit EPS growth. Furthermore, we like the durability and resiliency of our companies' business models heading into an economic slowdown. Approximately 41% of our invested capital is in companies that either have significant long-term contracted revenues, large backlogs that will drive revenue growth well into 2023, and/or significant government/defense related revenue streams that are uncorrelated with macro-economic trends.

As of October 17th, our five largest positions were *CACI International* **(CACI)**, APi Group (APG), *Walker & Dunlop* **(WD)**, *First Republic Bank* **(FRC)** and *Blue Owl Capital* **(OWL)**, representing about 32% of the total portfolio. Approximately 5.2% 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

* * *

Past performance is not indicative of future results. M.D. Sass does not guarantee any minimum level of investment performance or the success of any of its investment strategies, and investors may incur losses. M.D. Sass does not provide tax or legal advice, or determine an investor's investment objectives, risk tolerance or suitability. Certain statements contained in this report represent forward-looking statements that involve risks and uncertainties. These risks and uncertainties could cause actual results or outcomes to differ materially from those expressed in such forward-looking statements. In addition, while the information contained herein from third parties was from sources we believe to be reasonably reliable as of the date hereof, M.D. Sass accepts no responsibility or liability for any errors or omissions or misstatements however caused related thereto. Opinions expressed herein are those of the author, are subject to change, are not guaranteed and should not be considered investment advice.

Returns referenced herein represent composite level performance, net of fees. Actual client results may differ from composite level returns.