MD Sass Concentrated Value

MD SASS

Q4 2023 Commentary

January 18, 2024

The MD Sass Concentrated Value ("CV") strategy was up +13.4%, net of fees, in the fourth quarter of 2023, vs. +9.5% and +9.8% for the Russell 1000 Value ("R1V") and Russell 3000 Value ("R3V") indices, respectively.

For the full year 2023, CV was up +21.6%, net of fees, vs. +11.4% and +11.6% for the R1V and R3V indices, respectively.

From inception (January 2019) through the end of 2023, CV had a net annualized return of +18.0% vs. +10.9% and +10.8% for the R1V and R3V indices, respectively.

As we reflect on the conclusion of 2023, we are pleased to announce a significant milestone for *Concentrated Value* – the fifth anniversary of our investment strategy. This period has tested our philosophy and process amidst various challenges, including a pandemic, multiple interest rate cycles, inflation, geopolitical tensions, and significant market volatility. We are proud of the results we have achieved despite these hurdles, which we believe affirm the effectiveness of our investment approach.

Since inception, we have been guided by an investment philosophy and operating ethos grounded in several core tenets that form the basis of our approach to investing. While we have long considered these principles to be instrumental to our success, we historically hadn't validated them with actual data. In other words, it wasn't necessarily clear whether the drivers of our performance were our tightly held beliefs or other factors. Did our process drive the excess returns or were we simply lucky? Five years is perhaps an insufficient timeframe to answer this question, but in an effort to answer it in an honest way, we've marked this organizational milestone by examining the data, and listening to its message. So, without further ado, we present to you a few of our key guiding principles along with an analysis of relevant datapoints:

- ***We seek to invest in companies with improving fundamentals for which our estimate of long-term earnings power is well in excess of market expectations, and where the valuation is reasonable to attractive.*** In contrast to many of our value manager peers, whose investment process begins by screening for "cheap" stocks with low multiples or high dividend yields, we take an earnings-centric approach to identifying attractive opportunities. In our view, valuation is an observation, not a thesis. A thesis built primarily on a low valuation is like a house built on quicksand. Should the earnings base of the business begin to erode, the valuation can quickly crumble, yet as long as the market persistently values shares in excess of the negative earnings revision, the stock will appear to become cheaper each day, all while the investment hemorrhages. By contrast, a thesis predicated on positive earnings revisions enables us as investors to mark the progress of company fundamentals against our expectations and scale the position up or down as we gain more or less conviction in our thesis. This "all-weather" approach has proven successful in navigating both bull and bear markets, expansionary and recessionary economic climates, and myriad idiosyncratic company-specific issues. To put numbers to it, we looked at each position taken by *Concentrated Value* since inception and analyzed the outcomes. Across the 99 investments made over the last five years, *Concentrated Value* has achieved a "batting average" of approximately 65%, meaning that nearly two-thirds of our investments

have contributed positive alpha[1] during our holding period. This compares to a batting average of 48% for the average fund tracked on the Alpha Theory[2] platform. Further, on average, our winners generate 1.3x as much positive alpha as our losers cost us. This "slugging ratio" paired with a favorable batting average gives us confidence in the efficacy of our approach to value investing.

- ***Being wrong is a feature, not a bug, of the investment business. A critical element of success is to recognize early when one is wrong to avoid big drawdowns.*** In our observation, many investment managers spend so much of their time trying to be right that they don't put in place the organizational structure needed to optimize the outcomes when they are wrong. As an example, the incentives at most active managers reward analysts for getting more names into the portfolio. While the quality of ideas matters, capital deployed matters more. Thus, in the event disconfirming information on a thesis comes to light, the analyst might be prone to interpreting it through only the most favorable of lenses, or even fail to surface it entirely. At a minimum, this sort of behavior can impair decision-making at crucial junctures, but even worse it can lead to mistrust between the portfolio manager and the analyst, which sows the seeds of bigger issues down the line. At M.D. Sass, we believe a strong culture of intellectual honesty and collaboration within an investment team nurtures our ongoing quest for truth, irrespective of whether it aligns with or contradicts the initial viewpoint or thesis. All members of the team are encouraged to flag relevant data and developments on their positions and make accurate assessments of their impact on our thesis. Importantly, disconfirming information, whether it comes in the form of new developments or the admission of a prior error, is met not with blame or ridicule but rather with an honest desire to ensure our next decision is the right one. While this sounds simple enough in theory, creating an environment that fosters this dynamic is difficult, requiring a mix of institutional norms and values with hiring practices that select for individuals with a specific combination of temperament, emotional intelligence, and zeal for truth-seeking.

  To evaluate how this tenant of our investment philosophy impacts our results, we use two tools, one qualitative and one quantitative. Qualitatively, after we exit any position, we write a post-mortem analysis on the investment in which we look back to our original thesis and compare our expectations with what actually transpired, and we ask ourselves several critical questions – *How did the situation play out compared to our expectations? Why did it differ? Was it due to bad luck or bad process? Are there signposts we could have identified in advance but missed? What lessons can we learn?* These questions force an honest assessment of the facts, and an opportunity for learning. Quantitatively, we look at the dataset described above to understand how positions we exit perform in the year after we sell. In the case of losing positions, in the year after exit, these stocks on average produce 7% of negative alpha. What this tells us is that on average, we exit problem positions reasonably early, before they turn into even bigger losses. When we consider that our average winner has produced 30% of positive alpha and our average loser has produced 23% of negative alpha, avoiding that 7% of additional alpha erosion is the difference between a slugging ratio of 1.3x and 1.0x.

- ***We sell a stock when the risk/reward is no longer favorable or when valuation becomes unreasonable.*** Unlike many of our value investor peers, we don't sell a stock when it hits our fair value target. We maintain the belief that our target prices are grounded in fair and reasonable valuation assumptions. Consequently, we find it imprudent to

[1] Defined as excess return over the Russell 1000 Value Total Return Index during the holding period.
[2] Alpha Theory is a software platform for asset managers used to derive optimal position sizes. Alpha Theory claims to have had 300+ clients since inception and $100B+ in assets managed on the platform.

divest a stock when it hits our target price, as long as our estimates continue to significantly exceed those of the consensus. The primary driver behind our sell decisions stems from no longer being out of consensus – either because consensus increases to meet our view, or we lower our numbers to reflect new information or acknowledge an error in our thesis. As discussed above, we have done a good job of exiting losers in a timely fashion. But equally interesting is that we have done a respectable job in harvesting our winners, too. Post-exiting, our winners produced an average of 2% of alpha in the subsequent twelve months after we sold. This compares to the 7% excess annualized returns our strategy has achieved since inception. Put simply, we believe we are squeezing nearly all of the juice out of our winners, and then redeploying the capital in new opportunities with greater expected returns.

- ***We do not believe that concentration of names equates to more risk, rather concentration of factors/risk exposures does.*** In discussions with potential investors, we have occasionally heard the concern that our strategy carries inherent risk due to our concentration in approximately 20 investments. However, we contend that the number of holdings isn't an accurate gauge of risk. We are all aware of certain funds that owned 100+ stocks that were down 40% or more in 2022. Evidently, having a large number of holdings didn't shield these funds from significant drawdowns as they effectively made one or two factor bets (mostly duration) 100+ different ways. We are mindful of the need to ensure that our risk bets are well dispersed amongst our 20 positions to mitigate the compounding of those risks at the portfolio level. While there are several ways to define risk, one metric we like to look at is downside capture, which gauges a strategy's performance relative to an index during down markets. A downside capture exceeding 100% indicates that, on average, a strategy underperforms its benchmark during negative return months. Since inception, *Concentrated Value* has maintained a downside capture of about 90%, which we believe demonstrates the strategy's ability to preserve capital during months of market decline.

- ***Our objective is to outperform via superior stock selection, not sector allocation.*** Our strategy is industry agnostic. While each member of the team has certain areas of competency where they are more apt to engage and find compelling ideas, they are all free to dig for opportunities where they see fit. Given the ebbs and flows of the economy and market tend to lead to certain sectors and industries being more or less opportunity-rich at any given time, this approach helps us to make sure we are surfacing the best ideas that satisfy our investment criteria. This may lead to our exposure to certain sectors being over- or under-indexed relative to our benchmark at any given time. Case in point, our strategy consistently maintains a lower exposure to sectors where future returns will be influenced primarily by commodity prices or the broader economic cycle. For example, we have never held a stock in the Energy sector. This proved costly in 2022 when Energy led the market. Despite instances like this, when we look across the life of the strategy, our analysis indicates that 93% of our gross excess return compared to our benchmark has resulted from stock-picking ("selection effect"), with industry selection ("allocation effect") only accounting for 7% of our excess returns. This data is consistent with our intention to create a portfolio of idiosyncratic situations in which we hold out-of-consensus views.

Each year the team meets to reflect on the prior year's results with a focus on process. We have candid discussions about what we did well, what we got wrong and why, and how we can incorporate our learnings via enhancements to our process. We believe "process" is a dynamic concept that should evolve with our learnings over time. Below are some of the takeaways and key discussion points from our last meeting held in early 2024.

- ***"Trough on trough" – a new arrow in our quiver.*** As previously mentioned, our focus lies in identifying stocks with the potential for positive earnings revisions over time. While historically this has been a fundamental principle, we are increasingly discovering compelling investment prospects in stocks that are currently trading at low multiples

on depressed earnings. Stocks that fall into this camp can provide very attractive risk/reward opportunities, particularly if it is a secular grower operating in a cyclically depressed end market. Oftentimes, stocks that are trading at trough-on-trough have experienced some sort of seismic change in the business or operating environment that leads to significant negative earnings revisions, management guidance cuts, sell-side downgrades, and significant turnover in the shareholder base. Often, in these moments, visibility into future fundamentals is low. In these cases, positive sentiment revisions (rather than positive earnings revisions) can lead to outsized share price appreciation well in advance of fundamentals. While these opportunities can be difficult to find, we have had a few recent successes that fit this pattern, including Advanced Drainage Systems (WMS) and Zebra Technologies (ZBRA). We are particularly enthusiastic about our more recent investments in Lamb Weston (LW) and SBA Communications (SBAC), as we perceive them as high-quality secular growth companies currently trading at trough-on-trough levels.

- ***We were unlucky with some investments, but we positioned ourselves to be unlucky.*** There's a common saying about positioning oneself for luck, and the same holds true for being unlucky. While some investors in regional banks blame Silicon Valley Bank (SIVB) for the woes of the entire sector in the first quarter of 2023, the reality is that those investors (including us) positioned themselves to be unlucky. History has repeatedly shown the powerful negative feedback loop and ripple effects that can stem from the collapse of even the weakest bank in the system. Investing in a bank necessitates ensuring it has the right balance sheet and management team to withstand these sorts of potential systemic shocks. In the case of First Republic (FRC), though we believed the business had a best-in-class relationship banking business with the potential for industry-leading growth, it was clear well before the implosion of SIVB that FRC carried significant balance sheet risks, including asset/liability duration mismatches, rendering it vulnerable to the aftermath of a peer failure. Though bank failures of this scale are rare, we positioned ourselves to be unlucky and experienced the consequences we deserved.

  On the topic of luck, it is easy for one to pat oneself on the back when an investment works out well and chalk it up to skill. It certainly makes us feel better to think that our intellect, hard work, rigorous modeling, and proprietary analysis led to a great stock call, but sometimes it’s due to plain old luck. There is nothing wrong with luck – after all it is a factor in every probabilistic outcome – but it is important to recognize when it’s been handed to you so that you can realize the gain and thank the financial gods above for their gift of kindness. Our “successful” investment in MasTec (MTZ) falls into the luck category, and fortunately, we recognized it, leading us to sell our position near its highs and avoid a significant drawdown. Identifying luck requires two key prerequisites: 1) avoiding the temptation to let price dictate the narrative (e.g., “the stock is up, so I must be right”), and 2) maintaining intellectual honesty.

- ***If investing in a commodity-sensitive business due to a differentiated view of something idiosyncratic, the thesis better play out quickly or else it’s more of a commodity bet than anything else.*** In an earlier section of this letter, I underscored our commitment to avoiding investments in stocks where commodities play a pivotal role in future returns. However, I later delved into our investment in FRC, a bank intrinsically linked to interest rates and the credit cycle. How do we reconcile our philosophy of avoiding commodity-driven stocks with our ownership in banks? Our rationale was grounded in a perceived compelling perspective on FRC, specifically tied to loan origination growth, which we inaccurately believed would be the primary driver of the stock's returns. Despite the loan origination growth exceeding consensus expectations, its significance dwindled in the aftermath of the SIVB

debacle. An idiosyncratic thesis on a commodity-sensitive business necessitates a near-term catalyst, otherwise, we believe we are simply exposing the strategy to commodity risk without a company-specific value driver.

Q4 PORTFOLIO REVIEW

The biggest contributors to performance in Q4 were APi Group (APG), Walker & Dunlop (WD) and Charles River Laboratories (CRL), which collectively contributed approximately 527 bps to performance.

We believe APG's third quarter results, which featured an improvement in free cash flow conversion, expanding margins, and a strong growth outlook for the higher-margin inspection and services businesses, lend support to our bullish thesis. Management not only increased full-year EBITDA guidance, a trend uncommon among its industrial peers of late, but they also raised cost synergy guidance related to the Chubb acquisition. We believe APG is executing well on its plan, and the integration risks associated with Chubb are diminishing each quarter. Despite the stock showing an impressive +84% return in 2023, we continue to see material upside to consensus estimates and the shares trade for just 13.5x our 2024 FCF/share estimate, making it a highly attractive investment.

Year-to-date through the third quarter, WD experienced a 55% drop in transaction volumes, a 20% decline in revenues, a 26% decrease in adjusted EPS, and a roughly 800 basis points decline in return on equity. Surprisingly, against this backdrop the stock delivered a total return of nearly 46%. As investors seeking potential beneficiaries of rate cuts became attracted to WD's heavy exposure to multifamily capital markets activity, the stock rebounded sharply in Q4, and we reduced our position size accordingly. However, we maintain optimism regarding WD's long-term potential to capture market share in multifamily debt originations. We anticipate growth in its high-quality servicing portfolio, particularly as Fannie Mae and Freddie Mac increase their debt origination activities in 2024 and beyond.

We posit that the "risk-on" sentiment in the fourth quarter also contributed to the upward movement of CRL's share price. Over the last year, the downturn in venture capital funding for biotechs has weighed on CRL. With a more benign interest rate environment outlook, biotech and related stocks rallied in Q4. The bear case for CRL revolves primarily around the concern that price increases for non-human primates ("NHPs") during the COVID years resulted in CRL over-earning in its Safety Assessment business. However, we anticipate that pricing will remain elevated given CRL's dominant global infrastructure, a competitive advantage its peers lack. We believe any modest price declines in NHPs will not significantly affect operating margins. Considering the stock is trading near its trough valuation, we believe it presents a favorable risk/reward outlook.

The biggest detractors to performance in Q4 were Onsemi (ON), Flex (FLEX) and TKO Group Holdings (TKO), which collectively hurt performance by approximately 96 bps.

Investors in ON primarily hold the stock due to its advantageous position in the rapidly expanding silicon carbide (SiC) business. SiC is gaining ground over silicon in power semiconductors for electric vehicles, and ON is gaining market share with expectations for two times the market growth rate in 2024. Despite ON impressing the market for several quarters with its growth in long-term supply agreements ("LTSAs") driven by SiC, the Q3 earnings call saw a significant downward revision of SiC revenue expectations for 2023. This revision was accompanied by implicit discouragement of 2024 consensus estimates

for SiC, citing weaker-than-expected near-term customer demand. The disappointment largely stemmed from Tesla (TSLA), which experienced unexpected demand weakness and excess inventory, leading to a delay in semiconductor orders with ON. Despite this, we believe ON's LTSA with TSLA will compensate for the near-term order cut, keeping the structural long-term ON story intact. Despite understanding that a short-term guidance cut for the highest value segment of ON's business may impact share performance negatively, we maintain the view that the stock's overall long-term potential remains robust. We acknowledge the possibility of further near-term challenges for ON's auto semiconductor business, as it is the last end market to undergo a semiconductor inventory correction. Consequently, ON is currently held as an underweight position. We continue to see potential earnings power of more than $7 per share, so to the extent shares trade below our trigger price, we would look to rebuild the position.

FLEX revised its full-year revenue guidance downward during the fiscal Q2 report. Excluding NEXTracker (NXT) revenues, the "core" revenue guidance experienced a significant reduction of 9%. While management attributed half of the guide down to a decrease in cost passthroughs, this marks the second consecutive quarter where we adjusted revenue growth expectations downward. Our belief in the improving EMS sector, as scale players shift towards higher-margin and faster-growing end markets like EVs, healthcare, and industrial, remains unchanged. However, we have opted to exit the FLEX position, as we think there is a better way to express our positive outlook. We have transitioned into a different stock within the EMS space, which we will discuss later.

Concerns surrounding the growth in sports rights have been a persistent issue for TKO, contributing significantly to its underperformance in Q4. Investors appear hesitant to commit funds ahead of TKO's U.S. media rights renewal for its *Monday Night Raw* brand, compounded by apprehensions related to a class action lawsuit against the UFC regarding fighter compensation. The lack of imminent catalysts largely accounts for the recent lackluster performance of the stock. Nonetheless, we maintain our belief that the *Monday Night Raw* deal will be renewed in line with consensus expectations, potentially acting as a "clearing event" for the stock. Looking forward, we anticipate improved merger cost synergies, upside potential in WWE sponsorship revenues, growth in international site fees, and substantial UFC media rights fees expansion to be key drivers of long-term outperformance for the stock over time.

We initiated new positions in Lamb Weston (LW), Jabil (JBL), and SBA Communication (SBAC) in the quarter, which we discuss below.

LAMB WESTON (LW)

Founded in Weston, OR in 1950, LW is the largest French fry producer in North America (40% share) and the #2 player globally (23% share), producing 8 billion lbs. of fries annually across its 26 production facilities. The company came together in its current form in FY 2023 when legacy LW acquired the 50% interest in its European JV, Lamb-Weston/Meijer ("LM EMEA"), that it didn't already own, enabling it to fully consolidate the business and increase its global capacity by 25%. That year it also purchased the remaining 50% interest in its much smaller Argentina JV. Following the acquisitions, LW now reports its business in two segments, North America and International, with the former accounting for 68% of revenue and 72% of pre-corporate EBITDA. LW primarily sells through three channels: "Chain", large national and international QSR restaurants (~49% of revenue); Foodservice, industry parlance for restaurants, eateries, and non-commercial venues such as school and hospitals, that are typically serviced by wholesale food distributors such as Sysco and U.S. Foods (34% of rev);

and Retail, which primarily includes grocery stores (17%). Based on segment disclosure prior to the acquisitions, Foodservice has historically been the company's most profitable line of business, with 37% product contribution margins, followed by Chain at more than 21%, and Retail at approximately 20%, though it's worth noting that recent changes in product mix and overall market tightness have resulted in Retail margins improving to the mid-30s in recent quarters.

The North American French fry market features several attractive characteristics that have enabled LW to earn returns on capital in excess of 20% for most of the last decade. First, the industry is highly consolidated, with the top four producers – LW, McCain Foods, J.R. Simplot, and Cavendish Farms – collectively accounting for more than 90% of volume. The producers have historically behaved as rational oligopolists, rapidly mimicking price increases taken by one another; telegraphing capacity expansions years in advance and limiting them to the rate of market demand growth; and publicly announcing the results of price negotiations with farmers such that no player becomes a price spoiler either with respect to end customers or raw material suppliers. Beyond functioning as a pseudo cartel, the industry has other structural advantages as well. While potatoes can be grown in a variety of geographies, the Pacific northwest produces the highest quality potatoes (in terms of size, color, and defects) at the highest yields per acre of any land in the world. LW and its peers have sizeable manufacturing plants adjacent to these growing regions, giving them preferential access to a captive resource as well as monopsony bargaining power vis-à-vis the growers. Further, French fries are an important product for restaurants, carrying high margins (81%, among the highest margins of any food items) despite their low selling price and high attach rates (23%).

The European market is more fragmented than that of North America, with at least ten competitors of size. For that reason, pricing power is less pronounced and therefore EBITDA margins are lower. For example, prior to its acquisition, LW EMEA typically earned approximately 10% EBITDA margins, roughly half that of LW's North America business. It is also more export-driven, with sales to countries outside of Europe accounting for as much as 55% of some producers' volumes.

For the last three years, LW has been plagued with several material problems, beginning with COVID. When restaurants shut down during the early days of the pandemic, volumes collapsed by 17% company-wide and 45% in its most profitable line of business (Foodservice). In 2022, demand rebounded to pre-pandemic levels, but logistics bottlenecks prevented the company from fully serving that demand and inflationary pressures hampered profitability. A bad potato crop – the worst in decades – also hurt production yields and forced LW to procure potatoes on the high-priced spot market to meet contracted customer commitments. These issues at various times pressured revenue, margins, or both. In early 2022, LW began recapturing margin by taking significant price increases, first in its Foodservice segment, and later in its Global division. Today, prices are approximately 50% above pre-pandemic levels and EBITDA margins are back to 2019 levels, excluding the impact of recent M&A. Despite the rebound in profitability, shares have been challenged over the last five months as volume growth turned negative following the steep price increases and investor concerns mount regarding the impact of GLP-1 drugs on global food consumption. Additionally, in October, management provided long-term guidance that envisages muted revenue and EBITDA growth with heightened capital investment over the next few years. We think these targets will prove conservative as tight industry capacity should enable LW to continue to raise prices in excess of costs even as it benefits from above normal growth in its own production capacity and a snap-back in utilization rates following the exiting of several large customers. Further, we think the market is ignoring the significant strategic and financial optionality related to LW's recent acquisition of its European JV. With 14% upside to consensus earnings and the potential for shares to re-rate to their longer-term average multiple, we see upside of 40% to shares at their current price.

JABIL (JBL)

In our Q2 2023 letter, we highlighted the investment thesis for FLEX and explained why the electronic manufacturing services ("EMS") company was improving by exiting low-margin, fast turn businesses and prioritizing longer duration programs where FLEX can add more value and earn higher margins.

We believe that the investment thesis for FLEX also holds true for JBL and JBL has other attributes which make it a better means of expressing our thesis on EMS broadly. We believe JBL has a higher quality management team, a better customer mix (for example, JBL's auto business has significantly higher exposure to electric vehicles than FLEX) and a higher long-term revenue growth outlook after shedding its mobility business to BYD Electronic (285 HK).

Please see our Q2 2023 investor for a more detailed discussion of FLEX and the EMS industry as it supports our investment case in JBL.

SBA COMMUNICATIONS (SBAC)

Established in 1989, SBAC is one of the largest cell tower operators in the U.S. and Latin American markets with 39,546 total towers in its portfolio. Due to the heavy investment required for building towers and the complexity associated with obtaining zoning permits, the tower industry has a wide defensive moat with new entrants struggling to gain market share, especially with higher cost of capital due to the sharp increase in rates. SBAC has compounded revenue at a ~7% CAGR over the past 5 years driven by (1) continued mobile data traffic growth necessitating ongoing investment from wireless operators, (2) the 5G buildout, (3) increases in colocation as part of ongoing network densification by wireless operators, (4) stable pricing escalators of ~3% in the United States and CPI in international markets, (5) new site builds to accommodate population growth and fill in dead spots, and (6) ongoing increases in mobile penetration in international markets driving investment by international wireless operators.

SBAC's domestic site leasing business (~68% of sales) consists of 17,469 towers (as of 3Q23) throughout the United States. SBAC leases these towers primarily to the Big 3 wireless operators (AT&T, Verizon, T-Mobile) who collectively account for ~89% of revenue. Dish has also been a growth contributor as they build out their 5G network to meet the FCC's buildout requirements as part of obtaining spectrum. SBAC is the third biggest tower operator in the United States behind American Tower (AMT) and Crown Castle (CCI). SBAC has historically taken a different approach vs. American Tower and Crown Castle as they relied more on SLA contracts which were designed to be more a la carte vs. the holistic MLA contracts that American Towers and Crown Castle typically sign with wireless operators. However, SBAC is moving more towards the latter, as evidenced by the recent holistic MLA contract that they signed with AT&T. While SLA contracts provide more upside during elevated wireless operator activity, they also lead to more downside during depressed wireless operator activity given they're more closely tied to operator activity levels in a given period. Typical tower leases in the United States range from 5-10 years with multiple renewal periods at the option of the tenant and include fixed, specific annual rent escalators. We see a sustainable long-term growth profile of mid-single digits in core cash domestic site leasing business driven by (1) ~3% pricing escalators, (2) ~2-3% new lease growth driven by increasing colocation, amendments, and new site builds, (3) ~1% from other services (fiber, small cell, IoT, etc.), offset by 1-2% churn. The domestic site leasing business is

characterized by high operating profit margins at ~86% as the incremental operating costs associated with adding tenants to a property are minimal and towers have modest maintenance capex requirements.

SBAC's international site leasing business (~25% of sales) consists of 22,077 towers (as of 3Q23) across 15 markets including South America, Central America, Canada, South Africa, the Philippines, and Tanzania. Brazil is the biggest international market for SBAC and represents ~30% of total towers. Unlike the United States, where annual escalators are fixed, most escalators in international markets are linked to the local CPI index which subjects top-line growth to more volatility. International tower contracts also typically pass through a portion of the operating expense (ground rent, power, and fuel costs) to the tenant. Main competitors in international markets include American Tower, private tower operators, and wireless operators that own and operate their own tower networks. We see a sustainable long-term growth profile of high-single digits in core cash international site leasing business driven by (1) mid-single digit new lease growth fueled by ongoing increases in mobile penetration and mobile data traffic growth (growing faster than the United States given they're in earlier part of the adoption curve), (2) CPI-linked escalators, and (3) increases in colocations offset by ~4% in churn rate. While the international site leasing business has lower operating margins than SBAC's domestic business given greater requisite investments and a lower tenancy ratio as the industry isn't as mature, the international site leasing business still has highly attractive operating profit margins at ~70%.

SBAC's site development business (~7% of sales) consists of services that SBAC provides for carriers including (1) network pre-design, (2) site audits, (3) identification of potential locations for towers and antennas on existing infrastructure, (4) support in leasing of the location, (5) assistance in obtaining zoning approvals and permits, (6) tower and related site construction, (7) antenna installation, and (8) radio equipment installation, commissioning, and maintenance. Following Crown Castle's exiting of its installation services business, SBAC is now the only end-to-end service provider of the public tower companies, which we believe provides them with a competitive advantage when it comes to negotiating with carriers.

SBAC has materially underperformed the market over the past three years with annualized returns of -3% vs. +10% for the S&P 500 due to concerns over (1) higher interest rates which are negative for tower company stocks given high leverage and their REIT status, (2) a more muted wireless operator spending environment in 2024 post robust 5G buildout-related activity in the past three years, and (3) concerns over Dish's financial stability. We believe that the market is currently underestimating the sustainability of structural domestic site leasing growth as most forecasts project a slowdown in domestic leasing growth towards low-single digits long-term vs the mid-to-high single digits growth the industry has seen in the past. We see SBAC sustaining mid-single-digit domestic site leasing growth as (1) mobile traffic continues to grow unabated which will necessitate ongoing spending from wireless operators to expand capacity, (2) 5G buildout is only 50% complete and there are still large swaths of spectrum that wireless operators need to deploy under the FCC requirement, (3) escalator rates have been stable at 3%+, (4) upside from deployment of fixed wireless access (FWA), (5) increase in enterprise adoption of private networks, and (6) ongoing technology migration with 6G expected in late 2020s.

We expect SBAC will sustainably compound revenue and AFFO at a mid-single digit rate long-term. Assuming the stock holds its current P/AFFO multiple of ~25x, we see 30%+ upside to shares and view the current share price as an attractive entry point.

As of January 15th, our five largest positions were CACI International (CACI), Liberty Formula One (FWONK), TKO Group Holdings (TKO), Westinghouse Air Brake Technologies (WAB), and APi Group (APG), representing about 32.7% of the total portfolio. Approximately 6.5% of the portfolio is currently held in cash and cash equivalents.

MARKET COMMENTARY

By the end of 2023, the S&P 500 was trading within spitting distance of its all-time highs. We interpret the market's resilience coupled with low implied volatility (as measured by the VIX) to mean that the Street expects a sustained moderation in inflation, rate cuts by the Federal Reserve in the coming years, the likelihood of a soft economic landing or better, and well-contained geopolitical tensions. While feasible, this Goldilocks scenario seems like a difficult needle to thread and with the market already pricing this as a baseline expectation, we believe the risk/reward for U.S. equity markets is not particularly attractive.

In the excellent book, *Capital Returns*, the author posits that "the starting point for company analysis is not the outlook for end demand but rather the supply side." Elevated interest rates, inflation and untimely capacity investments from short-term, COVID-induced demand led to a capital exodus from certain industries that also saw a sharp decline in demand. We posit that these same industries might present intriguing investment opportunities going forward, given that demand has reached a low point while supply-side investments have remained restrained, creating a favorable environment for outperformance. Examples of such industries include bioprocessing, commercial real estate capital markets, certain semiconductor end markets, and railroad locomotives. We currently have exposure to these industries and are actively exploring additional investment opportunities where capital expenditures have diminished, consequently moderating or reducing industry capacity, while demand has troughed.

FIRM UPDATE

At the close of 2023, we celebrated two significant milestones – the fifth anniversary of our strategic journey and the surpassing of the $1 billion threshold in assets under management for the equity team. These achievements are crucial foundations for the ongoing expansion of *Concentrated Value,* instilling enthusiasm for our growth prospects in 2024 and beyond. Nevertheless, our triumphs have not diminished our humility or appetite for success since the inception of *Concentrated Value* five years ago. Recognizing that complacency may arise after periods of robust performance, we remain dedicated to upholding the same level of rigor, intensity, and intellectual curiosity in the coming five years as we have in the past five.

Thanks for your continued support and interest. Please don't hesitate to reach out to us if you have any questions or concerns.

Sincerely,

Ari Sass
President & Portfolio Manager, M.D. 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.

The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values. The Index is unmanaged and may not be invested in directly.

The Russell 3000 Value Index measures the performance of the 3,000 largest publicly held companies incorporated in America, as defined by total market capitalization. The Index is unmanaged and may not be invested in directly.