MD Sass Concentrated Value

Q1 2024 Commentary *April 21, 2024*

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The MD Sass Concentrated Value ("CV") strategy was up +7.3%, net of fees, in the first quarter of 2024, vs. +9.0% and +8.6% for the Russell 1000 Value ("R1V") and Russell 3000 Value ("R3V") indices, respectively.

From inception (January 2019) through the first quarter of 2024, CV had a net annualized return of +18.6% vs. +12.2% and 12.1% for the R1V and R3V indices, respectively.

If you've attended an idea dinner—an event where portfolio managers and analysts present their top investment picks—you're familiar with the allure of stock pitches promising significant upside potential. Big gains are captivating, injecting excitement and dreams of success into the discussion. Pitching a stock idea is akin to weaving a narrative, with investors yearning for a triumphant conclusion akin to finding a pot of gold at the end of a rainbow. However, amid these enchanting tales lies a less glamorous truth: the essence of successful investing often lies not in hitting the occasional grand slam, but in consistently notching singles, doubles, and triples while minimizing unforced errors. It's a less captivating storyline, admittedly, but one that we believe holds the key to long-term success.

Consider this hypothetical pitch:

> *Today, I present Ticker XYZ. While the potential upside is uncertain due to a murky path to value creation and uncertain timing, the current price suggests minimal downside risk. The risk/reward ratio appears favorable, with limited downside and the potential for attractive gains if things go well.*

One thing I can assure you is that this presenter won't get invited back to the next gathering of sharp-tongued storytellers, yet there is merit in the approach. Embracing uncertainty and prioritizing attractive risk/reward ratios over lofty return projections is a hallmark of prudent investing. We do not need to have certainty about the upside so much as a high conviction in the downside, which is a function of sentiment, valuation, and fundamentals (and probably technicals in the short-term, although I hate to admit that). Warren Buffett encapsulated this ethos succinctly: "Rule No. 1: Never lose money. Rule No. 2: Never forget rule No. 1."

We initiated four new investments in the quarter, with three of them anchored to the premise that the downside risk is minimal and the potential for attractive returns is reasonable over the next year and beyond. While our visibility on earnings may be clouded by various uncertainties, we believe that clear skies are not a prerequisite for an attractive risk/reward profile, provided conservative assumptions applied to potential downside scenarios suggest an asymmetric payoff opportunity.

These investments may not spark lively conversations at any elite idea dinners at Le Bernardin in Manhattan, but we are confident that they align with the criteria for attractive long-term holdings.

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Q1 PORTFOLIO REVIEW

The biggest contributors to performance in Q1 were CACI International (CACI), Blue Owl Capital (OWL) and APi Group (APG) which collectively contributed approximately 293 bps to performance.

We believe the 17% appreciation in CACI's share price in Q1 was largely due to: 1) management boosting full year revenue and EPS guidance on the fiscal Q2 earnings call; 2) strong bookings with trailing twelve months book-to-bill of 1.2x; 3) Senate passage of a funding package, averting a partial government shutdown; and 4) rising geopolitical tensions led by the Middle East. We continue to believe that CACI's organic revenue growth will be significantly greater than consensus expectations over the next few years due to announced awards, greater investment in defense-related projects and a strong pipeline that includes $11B of submitted bids and $14B of bids expected to be submitted over the next couple of quarters.

OWL's share price increased nearly 28% in the quarter, driven by strong Q4 earnings results and outlook. Notably, originations in the Direct Lending business nearly doubled sequentially, making it the best quarter for originations since 2021. Capital raising was robust, leading to 22% growth in AUM. The 2025 guidance of $1+ in distributable earnings per share, once deemed unattainable, now appears potentially conservative, given the accelerated growth trajectory. This was bolstered by the public listing during the quarter of one of OWL's private BDCs – an event which triggers an increase in management fees – and the likelihood of additional "up-listings" later in 2024 and 2025. Moreover, recent acquisitions are anticipated to enhance earnings in 2025 and beyond. We believe the stock is attractively valued at less than 17x our 2025 distributable earnings per share estimate, which we expect to grow at over 20% CAGR over the next few years.

We believe that our thesis on APG is playing out nicely as the company is executing its strategy of turning around the recently acquired Chubb Fire and Security business and mix-shifting the business to higher quality service and inspection work. Q4 adjusted segment gross margins improved 230 basis points, adjusted EBITDA margins improved 110 basis points and full year free cash flow conversion increased. We believe APG is a good business becoming a very good business and the market is also recognizing this as the multiple on the stock has gone from just over 10x EV/EBITDA to nearly 14x in the span of a year. Despite the multiple expansion, we believe the stock remains attractively valued on our 2025 FCF/share estimate.

The biggest detractors to performance in Q1 were Crown Holdings (CCK), SBA Communications (SBAC) and onsemi (ON), which collectively hurt performance by approximately 157 basis points in the quarter.

One of the challenges of investing is focusing on what we believe to be the key factors influencing a stock, only to be blindsided by disappointing news related to a previously overlooked aspect of the company. This scenario unfolded post CCK's Q4 earnings release. While volumes and EBIT for the core aluminum beverage can business largely met expectations, smaller segments like aerosol and can equipment exhibited significant weakness, with a deteriorating outlook. These segments, constituting a subset of the "Other" category, are typically under-discussed, given their minor contribution, representing just 7.6% of total CCK EBIT in 2023. However, management guidance implies a nearly 50% decline in Other EBIT for 2024, underscoring its substantial impact despite its size. While the unexpected weakness in the Other segment is disappointing, we maintain optimism regarding the broader beverage can industry, viewing its current state as early in a recovery phase. Furthermore, we interpret the guidance for Other EBIT as indicative of a trough, suggesting potential for improvement ahead. Notably, CCK's current valuation reflects pessimistic expectations, trading near multi-year lows. We contend that the substantial discount relative to its peer, Ball Corp. (BALL), is unjustified. As CCK's beverage can EBIT rebounds and earnings

stabilize, we expect a narrowing of this valuation gap, provided there are no further negative surprises from non-core businesses.

SBAC, a leading cell tower REIT, declined just over 14% in the first quarter despite only a 3% reduction in consensus FFO/share estimates for fiscal 2024. We believe the weakness was due to higher interest rates as opposed to any material deterioration in the fundamental outlook. Wireless carrier lease activity remains cyclically depressed as the industry's 5G build-out has hit an air pocket. We believe the longer-term outlook is promising as only 50% of cell tower sites have been upgraded to 5G (as recently confirmed by CCI on their earnings call) and data traffic growth remains robust. With the stock trading at a trough valuation on trough new lease revenue growth, we believe the risk-reward is attractive. Nevertheless, it's important to acknowledge that further increases in interest rates can exert downward pressure on the stock.

ON's investment thesis is predicated on the growth of its silicon carbide ("SiC") business which surged from nothing in 2020 to approximately $800M (nearly 10% of sales) by 2023. However, SiC is largely sold into the electric vehicle ("EV") market and the recent slowdown in EV demand has dampened the outlook for SiC growth and sent ON's share price down 12% in the first quarter. We believe there are several factors that are negatively impacting EV demand, including higher interest rates, the loss of subsidies and incentives in certain markets such as Germany, and the lack of charging station infrastructure in the United States and Europe. Tesla recently reported a decline in shipments and other automotive OEMs have noted disappointing EV demand which has cast doubt regarding the growth trajectory of SiC for ON. Given strong EV production rates based on new platform launches, we are less concerned about ON's SiC revenues for 2024, but we are incrementally more concerned about 2025 as inventory builds will moderate while SiC supply will ramp up from ON and its peers. We are hoping to hear about significant curtailments in SiC supply growth from ON's peers this earnings season and will re-evaluate our ON position post-earnings season when we have more datapoints to chew on.

We divested our position in TKO Group (TKO) during the quarter. During the holding period the stock declined by -9.3% compared to the +9.9% return of the Russell 1000 Value index. Our decision to sell stemmed from our realization that we had overestimated TKO's long-term potential, particularly in terms of media rights growth. This was evidenced by the modest increase in fees associated with the renewal of *Friday Night Smackdown* with NBC Universal and the Netflix deal for premium live events and *Monday Night Raw*. Additionally, we harbored concerns regarding a potential UFC class action lawsuit, which could result in unspecified damages, making it challenging to assess the financial impact. Such uncertainty might also exert downward pressure on UFC's leading margins within the industry. In light of these factors and considering our apprehensions regarding the valuation of media rights broadly, we opted to reduce our exposure to sports rights. We concluded that our combined exposure to TKO and FWONK posed an elevated risk from a portfolio management perspective. Our confidence in FWONK as a more promising long-term investment remains steadfast, notwithstanding our broader industry concerns. We perceive F1's U.S. media rights as significantly undervalued. To provide context, while F1 generates approximately $80 million in media rights fees from ESPN in the United States, NASCAR commands over $1 billion. While there are inherent structural reasons for NASCAR's higher fees, such as a greater number of races and more events during prime viewing hours, we believe the current disparity is excessive.

During the first quarter, we initiated new positions in Crown Holdings (CCK) and Dollar General (DG). Given our previous ownership of CCK over several years, we've opted not to provide an investment summary for it in this memo. Additionally, we established smaller positions in Target (TGT) and Air Products & Chemicals (APD). If either of these investments reach a 3% position or higher at the end of any quarter, we'll delve into them in future memos.

DOLLAR GENERAL (DG)

Dollar General operates a vast network of approximately 20,000 discount retail stores across the United States, serving a diverse clientele with their essential everyday and household requirements, alongside a diverse selection of general merchandise items. Founded in 1939 as J.L. Turner & Son, the company rebranded as Dollar General in 1968 upon its initial public offering. Following a period of private ownership by Kohlberg Kravis Roberts (KKR) starting in 2007, Dollar General returned to public ownership in 2009. The company strategically caters to customers earning less than $40,000 per year, with an average transaction size of around $15 per visit. Consumables, which include packaged food, perishables, paper goods, cleaning products, snacks, health and beauty items, pet supplies, and tobacco products to name a few, represent the largest revenue category at 80% of sales. Seasonal items, home products, and apparel account for the remainder. Dollar General's merchandise mix includes national brands from leading manufacturers as well as private-label brands, which are offered at lower prices than their national counterparts but carry higher margins for the company. By curating a streamlined merchandise assortment and maintaining a cost-efficient operating model, Dollar General can offer lower prices compared to most food and drug retailers.

Dollar General operates stores in rural, suburban, and urban locations; however, approximately two-thirds of revenues and 80% of profits originate from stores in Metropolitan Statistical Areas (MSAs) outside the largest 100, which are generally markets too small to harbor national competitors. DG's small-box format enables the company to locate stores in convenient locations, often along routes to work or school in smaller communities, making them more convenient to visit than larger drug, discount and grocery stores. As a result, visitation rates are high, averaging 2 to 3 visits per week, whereas the same consumer might only visit the local Walmart once or twice per month.

DG's share price has meaningfully underperformed the market since the end of 2022. We believe the drivers of underperformance are straightforward: the implementation of new initiatives by a recently appointed CEO fell short of expectations. Following the retirement of the prior CEO in 2022, who has since returned to lead the company's turnaround efforts, a series of growth and efficiency strategies were introduced. However, conversations with industry insiders suggest that these initiatives coincided with a challenging period, exacerbated by the strains of the COVID-19 pandemic on labor and supply chains, resulting in operational inefficiencies at the store level. Among the initiatives, self-checkout aimed to reduce costs by automating processes, but it proved counterproductive as store managers found themselves dedicating more time to managing the machines. Moreover, the absence of staff at the front of the stores led to increased theft, or shrinkage, further complicating matters. Recognizing the drawbacks, the new CEO is swiftly rolling back this initiative. Another significant initiative, Fresh, holds promise for enhancing Dollar General's competitive edge by lowering overall distribution costs. However, the timing was less than ideal, with labor shortages and stretched supply chains hindering its execution. The introduction of pOpshelf, a new store concept focusing on home categories, has garnered limited success. Management is now scaling back expansion plans for this concept. Additionally, changes in district manager responsibilities, including increased store oversight and technological enhancements, failed to yield desired outcomes, resulting in elevated turnover rates. In response, the new CEO is reverting to previous staffing levels, adding 140 new district managers to alleviate the burden and improve operational efficiency.

During the third-quarter call in 2023, CEO Todd Vasos, who previously held the position from 2015 to 2022, introduced a revitalized strategy known as "Back to the Basics," comprising four key investments and adjustments. Firstly, the company plans to boost its labor investment by allocating an initial $150 million towards store labor, primarily aimed at enhancing

employee presence at the front of stores and bolstering inventory management efforts. Secondly, they intend to alleviate the workload of district managers by reducing the number of stores under their supervision and adding 140 new managers to the roster. As part of the initiative, Dollar General is retracting its self-checkout program, transitioning self-checkout stations to assisted self-checkout in approximately 9,000 stores. Moreover, they plan to restrict the number of items available for self-checkout to five in around 5,000 stores and eliminate self-checkout entirely from 300 high-shrink locations. Lastly, the company aims to streamline its product offerings by trimming the number of stock-keeping units (SKUs) by approximately 10%, equating to a reduction of around 1,000 SKUs from the current range of 11,000 to 12,000 SKUs per store. Each of these strategies is geared towards enhancing in-stock positions and reducing shrinkage by simplifying employees' tasks and optimizing labor allocation.

In the years preceding the pandemic, Dollar General maintained remarkably stable margins, with gross margins hovering around 30.6% in calendar years 2017 through 2019. SG&A as a percentage of sales remained at 22.2% during this period, resulting in operating margins in the mid-8% range. While management is optimistic about maintaining these levels over time, consensus views do not anticipate improvement from the current ~6% level. However, the market and sell-side fail to fully appreciate Dollar General's Fresh distribution initiative, which is poised to drive structurally higher gross and EBIT margins compared to pre-COVID levels. This initiative involves the company's decision in 2019 to self-distribute food and beverage merchandise stocked in coolers. By reclaiming approximately 12% of product margin from manufacturers responsible for distribution to stores and stocking coolers, Dollar General should achieve a significant margin boost. Although this initiative will incur higher SG&A costs due to factors such as dedicated distribution centers and increased labor for shelf stocking, the overall impact on margins should be positive, with a projected accretion of approximately 6% for the categories served. We estimate that Fresh initiatives will touch approximately 20% of revenues, leading to a structural tailwind of over 100 basis points to gross margins in the long run. Secondly, shrink was a more than 100 basis point headwind in 2023. With the implementation of the measures outlined in the "Back to Basics" strategy, this headwind should flip to a tailwind starting in the second half of 2024. Gross margins were 30.3% in 2023. We think they will stay in that range in 2024 and then inflect positively in 2025 as shrink decreases materially and the Fresh initiative increasingly shows through to margins. At the same time, SG&A should moderate as incentive compensation returns to normal with improved performance.

In addition to productivity improvements, we believe "Back to the Basics" should drive better sales performance in the problematic stores. While the company is still in the early stages of implementing this strategy, the recent quarterly report for Q4 2023 revealed that comparable sales exceeded both plan and consensus. Despite this, management guidance and consensus estimates currently model 100 bps of deceleration in same-store sales in 2024, something we view as overly conservative considering the various initiatives underway. Revenue will also benefit from two other tailwinds in 2024. Firstly, Family Dollar's decision to close approximately 1,000 stores over the next few years represents a significant opportunity. With Dollar General likely to be the primary competitor in many of these locations, capturing just 20% of the sales from Family Dollar store closures could translate to a considerable boost in revenues. Secondly, the primary headwinds affecting lower-end consumers are likely to ease during 2024. Food inflation, which has disproportionately impacted this demographic, is slowing, and the USDA forecasts slight deflation in 2024. Moreover, the headwind from the mid-2023 reduction in SNAP benefits will go away once the reduction is lapped in mid-2024.

Putting these various factors together, we see upside to both revenue and gross margins in 2024 and 2025, leading to operating income estimates approximately 7% above consensus. Factoring in a 3% contribution from a higher level of share repurchases leads us to a 2025 EPS estimate that is 10% above consensus. Assuming shares see a modest re-rating on the reacceleration in the business, we see upside of 40%, compared to downside of just 15%, resulting in a 2.6x upside/downside.

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MARKET COMMENTARY

Over the past couple of years, investors have been maniacally focused on inflation data with the view being that lower inflation will lead to lower interest rates and likewise buoy stock prices and risk assets more broadly. Simply eyeballing a chart of the 10-year Treasury yield vs. the S&P 500 from 2022 to the latter part of 2023 suggests a very high negative correlation between long-term rates and the stock market. But that relationship decoupled in late 2023. Of note, as of this writing, the 10-year Treasury yield is about the same as it was back on October 2nd, 2023, yet the S&P 500 is up nearly 17% over that period. This is despite significantly higher geopolitical risks stemming from the conflict in the Middle East. We believe one explanation for stronger markets despite higher rates is a change in expectations for the economy from a soft landing to no landing. Afterall, employment remains robust, consumer spending remains strong, ISM Manufacturing has accelerated, and inflation has moderated.

We believe another important driver of the market has been exuberance over AI. The fact that many of the largest tech companies are the biggest beneficiaries of AI has led to an even more pronounced impact on market-cap-weighted indices like the S&P 500. The Goldman Sachs TMT MegaCap Tech Index (an equal-weighted basket of the largest U.S. tech companies) was up 23.4% in Q1 vs. +7.4% for the equal-weighted S&P 500 with the equal-weighted S&P 500 lagging the cap-weighted S&P 500 by three standard deviations based on a 250-day rolling relative returns basis since 2004. The AI boom has also trickled down into other sectors as investors sought second derivative beneficiaries. The implications of AI advancement on power consumption, for example, led to very strong stock returns for electrical equipment companies and certain utilities (despite higher rates).

Perhaps the market's resilience also contemplates longer term-positive implications of AI on the economy. In theory, AI should lead to significant increases in productivity that should drive down costs and dampen long-term inflation expectations. Deglobalization was a deflationary force for decades and maybe the market is now saying that the baton has been handed to AI. There are some real-world case studies to support this notion. In February, Klarna announced that its AI assistant (powered by OpenAI) is performing the equivalent work of 700 full-time customer service agents, can resolve errands in less than 2 minutes compared to 11 minutes previously, and drove a $40M profit improvement in 2024. Invisible AI, an AI solutions company for the manufacturing sector, noted that an automotive OEM utilized its AI edge devices to drive a 63% increase in throughput per shift. A recent PwC report estimates that AI can drive baseline 2030 GDP higher by 14% with 55% of the impact due to productivity increases. In sum, while enthusiasm for AI clearly has boosted the share prices of some of the largest publicly traded companies, it is also plausible that the market is pricing in broader positive long-term productivity and deflationary effects of AI.

We are sensitive to the fact that valuation multiples have moved higher while geopolitical tensions have increased, and higher commodity prices and resilient economic data may weigh on aspirations for Fed rate cuts. We continue to focus our efforts on investment ideas where we have a highly differentiated view of earnings relative to consensus or where we believe the risk/reward is asymmetric in our favor even if the outlook is difficult to ascertain with high conviction.

OTHER ITEMS

As our assets under management have expanded, we remain committed to reinvesting in the business to uphold best-in-class practices. In the first quarter, we took a significant step forward by purchasing a new pre- and post-trade compliance system to enhance our risk management infrastructure. This software module, which will be fully operational in Q2, will equip us with proactive controls, ensuring strict adherence to client and firm restrictions, portfolio strategies, and regulatory requirements. We will continue to evaluate how we can leverage technology to enhance our process, risk management and performance outcomes.

As of April 18th, our five largest positions were Formula One (FWONK), APi Group (APG), CACI International (CACI), Clean Harbors (CLH) and SBA Communications (SBAC), representing just over 32% of the total portfolio. Approximately 4.4% of the portfolio is currently held in cash.

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

Sincerely,

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

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