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VALUE PARTNERS
309 COURT AVENUE, SUITE 211, DES MOINES, IA 50309 · prospectiveVP.com

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Dear PVP partners and friends

In recent quarters we have commented on the strange near disappearance of volatility in the equity market, and near the end of January it seemed a continuation of that trend. But changes in the market have a way of appearing just after they have been finally dismissed, and so **February and March were somewhat tumultuous for equities.**

What exactly caused the initial sharp uptick in volatility remains a bit of a mystery. At first most observers pointed to some of the obvious suspects, such as rising rates and inflation fears. But stocks did not react in a way that suggested those causes, so we suspect the impetus was more technical in nature. In a phenomenon known as "reflexivity", after the initial drop at the end of January, there seemed to be a heightened focus on macroeconomic worries that maintained the volatility through the quarter, exacerbated in late March by the sudden downturn in technology stocks. In other words, investor behavior might have impacted investor perceptions, rather than the other way around.

**In our view, the macroeconomic backdrop remains favorable.** The Fed, under the new leadership of Chairman Powell, continued its previous policy of gradually easing out of its post financial crisis Quantitative Easing (QE) program. This quarter, as expected, the Fed raised the Fed Funds rate by 0.25%, and remains on track to continue to gradually raise rates to "normal" levels. The yield curve retained its "gentle slope", albeit not as steep a slope as we would have expected. Recall last quarter we discussed the fear of an inverted curve, which would suggest economic pessimism from the bond market.

As we have said previously, assuming the economy continues to grow at least in line with expectations, if the Fed continues to hike rates -- slowly and methodically and in a well-communicated fashion -- we believe the stock market will be well served**. Longer term, however, higher rates will mean a lower Equity Risk Premium (ERP), which will tend to depress future returns.**

In terms of the economic data, job growth continues apace; economic growth continues to accelerate; and inflation continues to creep up, in line with the Fed's wishes, but remains in check. From a policy perspective, the heated rhetoric around tariffs and a potential "trade war" did scare the market initially, but, as we have already seen several times with the Trump Administration, the bark appears worse than the bite. **Fundamentally we see strength in the economy, and rising profits for our portfolio holdings.** Generally speaking, it was a very strong start to the year as revenue growth accelerated and tax cuts became more visible, with annual "guidance" raised for many of our companies.

**“Growth” stocks continued to outperform “Value” stocks** in the quarter, which is an ongoing headwind for value-oriented investors like PVP. We don’t have a clue as to when investors will return to value stocks (which have outperformed over the long term), but we were encouraged by a slight reversal of this general trend in late March, as technology sold off in the wake of the Facebook (FB) controversy. Still, overall in 1Q18, **notwithstanding all the media attention on the “tech rout”, technology and consumer cyclicals were again the top performers -- and in fact were the only sectors with positive returns.** Consumer staples, energy, REITs, basic materials and telecom were the weakest sectors this quarter. We remain underweighted in technology, where we have taken profits in recent quarters, and where currently valuations are generally unattractive in our view. On the other hand, we are also underweight in REITs and telecom, sectors whose relatively high dividend yields render them somewhat vulnerable to rising interest rates. For quite some time we had been underweight consumer staples as well, but in recent quarters their valuations have become much more compelling, so we have been adding there.

In terms of current themes in the portfolio, two elements are worthy of mention. First, **we continue to be generally defensive**, with underweights in the more cyclical technology and industrial sectors, and overweights in the less cyclical health care and consumer staples sectors. Our portfolio beta is just 0.85, we have taken down leverage in the portfolio, we have sold stocks of companies whose business models are under threat, and valuations remain discounted. On the other hand, **we also have an increasingly large weighting in financials**, which *are* generally cyclical. This is primarily because the margins of financials should particularly benefit from rising rates, which looks like a good bet to us, and valuations are quite palatable; however, much of our financial exposure is in property/casualty insurance, which has its own cycle, and our biggest financial holding remains Berkshire Hathaway (BRKB), which has an AA-rated balance sheet and enough diversification to act both offensively *and* defensively.

In aggregate **PVP was down 1.5% in 1Q18, and is now up 36.5% (15.8% annualized) since accepting our first partner capital in February of 2016.** [1] Regardless of how strong or weak recent performance has been, **we will always encourage our partners to take a longer term view when assessing our track record.** While we obviously cannot control or even predict the overall market direction in the short run, we can say that we continue to hold a diverse portfolio of free cash flow (FCF) generating companies, currently trading at a discount to the market, but with better quality characteristics.

Obviously it disappoints us to be down this quarter, but much more important to us is that none of our portfolio companies were economically impaired. In fact, we believe prospects generally appear brighter than they were at yearend for many if not most of our companies. **We prefer to think of the market as a scale, in the analogy of a famous investor, increasingly weighted by the FCF our holdings generate, compounding over time, rather than the “voting booth” that describes shorter term market movements.** When possible, we strive to take advantage of the vagaries of this short term orientation.

[1] *Returns are net, and assume a 1% annual management fee.*

## Actions taken in 1Q18

***Buys in the quarter***

**Pinnacle Financial Partners (PNFP**) is a relatively small ($5 bn market cap) Nashville, TN-based bank, with an increasing presence in the southeastern US. Pinnacle has achieved excellent growth over time, both organically and via acquisition, and also boasts among the highest returns on tangible equity (ROTE) in the industry, yet trades at a very attractive valuation.

**Walmart (WMT),** the ubiquitous retailer, has made excellent progress in its e-commerce business, but until recently we felt the strong stock largely reflected that progress. In its yearend call with investors, however, WMT's e-commerce sales did not meet the elevated expectations, and the stock sold off, giving us the opportunity. We believe its web business will continue to grow nicely, and view WMT as a defensive stock at an attractive valuation with nice momentum.

**Hamilton Lane (HLNE)** is the Private Equity (PE) consultant that was a great stock for us last year, which we sold. In light of that performance, the company announced a secondary share offering, which knocked the stock down significantly, giving us another opportunity in the name. Hamilton Lane has a leading presence in an exciting part of the market, with excellent visibility on future earnings.

**Crown Castle (CCI)** is the wireless "tower" company, structured as a REIT, which was also a very profitable holding for us last year. We sold it because its valuation had become less compelling, but the decline in the overall REIT sector created another opportunity in 1Q18. CCI has excellent earnings visibility and growth prospects, with an attractive dividend yield of just under 4%.

**BNP Paribas (BNPQF):** BNP is primarily a French commercial bank, which should benefit from rising rates in much the same way as its US brethren. The differences are primarily that European interest rates are even lower than those in the US, suggesting greater potential margin expansion, and BNP trades at a very attractive valuation of less than 80% of its Book Value (BV).

***Sells in the quarter***

**Amerisource Bergen (ABC),** the drug distributor, was a profitable investment for us, but the stock has been challenged for over a year by both elevated generic drug price deflation (ABC makes most of its profits distributing generic drugs) and also the threat of Amazon (AMZN) entering its business. Since we already have adequate generic exposure through Mylan (MYL), as generic deflation improved and the Amazon threat seemed to fizzle early in the quarter, we sold the stock. ABC was a modest outperformer in the quarter.

**Interpublic Group (IPG),** the advertising agency holding company, is another company whose business model is potentially under threat by technology. We bought the stock late in 3Q17, after a very disappointing quarter, and at a time when there was great uncertainty around IPG's future. In 4Q IPG's results surprised investors to the upside. After a nice move in the stock, given the ongoing uncertainty, we were inclined to take profits. IPG was one of our top performers in the quarter.

**Lamar (LAMR),** the outdoor billboard advertiser that is structured as a REIT, is yet another company in the advertising arena that faces an uncertain future due to the impact of technology. While the valuation remains attractive, we believe our capital is better deployed elsewhere. Lamar was a small position, and was a modest underperformer in the quarter.

**Strong performers in 1Q18** [2]

As we mentioned above, technology was the strongest performing sector, and two of our tech holdings were among our best overall performers. **Palo Alto Networks (PANW),** the cyber security software provider, has begun to benefit from some of the sales force changes the company made when we initially bought the stock, with 28% revenue growth and 32% FCF growth in 4Q17, and increased guidance for 2018. The stock was up 25% in 1Q18.

**Cisco (CSCO),** the networking hardware manufacturer, also continued its momentum from last quarter. Just two quarters ago the company's revenues were in decline, but its most recent quarter demonstrated that its business transformation efforts are paying off, with 2.7% revenue growth and expectations of that growth accelerating to 3-5% in the current quarter. Cisco also generates a lot of FCF, and announced plans to deploy it into an increased dividend and a very large share buyback plan.

**Adtalem Education (ATGE),** the for-profit education company formerly known as Devry, was again one of our strongest performers during the quarter. The company continued to refine its portfolio of schools by agreeing to divest one of its underperformers. Meanwhile, steady growth continues in its core medical, veterinary and nursing schools, where demand continues to exceed supply, which the market has begun to reward.

As noted above, **Interpublic Group (IPG)** entered 2018 with very low expectations, given questions around the advertising holding company business model and also weak results from one of its major competitors. When the company announced its yearend results in mid quarter, with very healthy 3.3% organic revenue growth, the market reacted quite positively. We expect skepticism to remain, however, and so we sold the stock.

**Sony (SNE),** the Japanese consumer/media conglomerate, continued to make excellent progress in restructuring its portfolio of businesses and simplifying its reporting to investors. In February the company also announced the retirement of its CEO and the elevation of its CFO, who has been instrumental in all the recent progress. Even with the strong recent performance of the stock, Sony remains attractively valued, in our view.

**Weak performers in 1Q18**

**Allscripts (MDRX**), the health care information technology company, can be quite a volatile stock. In its yearend 2017 call the company met or exceeded expectations by most measures, but its bookings number (which is notoriously "lumpy") was somewhat weaker than expected. We believe Allscripts remains on track, and, with the stock down 15% in 1Q18, MDRX now trades at a steep discount to the market.

**Williams Companies (WMB**), the gas pipeline company, was weak in the quarter along with much of the energy sector, down 17%. Further, as a stock with a relatively high dividend yield, it suffered as fears of rising interest rates mounted. Finally, toward the end of the quarter there was a surprise ruling by one of its regulators, FERC (Federal Energy Regulatory Commission), which could have an adverse impact on the company's tax position.

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[2] *Top and Bottom Five performers in the quarter defined as the most value added or subtracted, in basis points, relative to the Russell 3000. Top and bottom stocks are presented, respectively, in descending and ascending order of value added/subtracted.*

There have been several challenges recently in the normally very steady dental equipment business, where **Dentsply Sirona (XRAY)** is one of the leaders. In addition to uncharacteristically soft recent dental demand, the company has had recent changes in its own leadership and in its distribution strategy, contributing to a 23% drop in the stock in 1Q18. Notwithstanding these challenges, we believe the company will emerge stronger and the business will return to predictable growth.

**DISH Network (DISH)** has been weak, as investors have begun to heavily discount the likelihood of a monetization of the company's extensive spectrum holdings. We initiated the position with the understanding that it might well take time for that value to be realized, and now, with the stock down 21% in 1Q18, we believe the current market value is well below intrinsic value.

**Biogen (BIIB**), the biotechnology company focused on neurological diseases, had two notable news items from its pipeline in the quarter. First, the company plans to expand one of its trials (aducanumab) for Alzheimer's Disease, which the market interpreted as a sign that the drug might not be as efficacious as hoped. Second, the company announced that it was discontinuing a clinical trial of its existing MS drug, Tysabri, in stroke. We acknowledge the pipeline risk, but with the stock off 14% in the quarter we believe we are being more than fairly compensated for that risk in the current valuation.

## Setup

As discussed above, we continue to refine the positioning of the portfolio. PVP owns a diverse set of **high quality companies, operated by shareholder-friendly management teams with a proven track record in deploying capital.** While we are normally reluctant to rely much on benchmark data in the short term, some context can occasionally be helpful. Similar to previous quarters, as shown in the table below, the PVP portfolio remains cheaper than the Russell 3000, yet PVP's holdings have higher margins and greater returns than the Russell 3000, with similar leverage and growth rates. Relative to the Russell 3000 Value index, PVP's valuation is cheaper, yet PVP's margins and returns are substantially better.

| | PVP [3] | Russell 3000 | Russell 3000 Value |
|---|---|---|---|
| Free Cash Flow yield (2017) | 5.7% | 4.0% | 4.3% |
| Price/Earnings (2017) | 16.8x | 21.2x | 17.6x |
| Debt/Total Capital | 42% | 43% | 40% |
| Debt/EBITDA | 2.7x | 3.1x | 3.4x |
| 2017 revenue growth | 10.5% | 5.3% | 7.8% |
| 2017 eps growth | 9.0% | 11.3% | 13.4% |

[3] *Data for both PVP portfolio and Russell indices are generally via FactSet. In a few instances, we have made minor adjustments.*

| | PVP [4] | Russell 3000 | Russell 3000 Value |
|---|---|---|---|
| 2017 EBITDA margin | 32.2% | 18.9% | 18.2% |
| 2017 Return on Equity | 16.1% | 14.9% | 11.8% |
| 2017 Return on Invested Capital | 11.7% | 7.2% | 5.9% |

To put PVP's FCF yield of 5.7% into perspective, we must also consider the still quite low 30-year US Treasury Bond at 3.0%. This suggests an Equity Risk Premium (ERP) of 2.7% (5.7-3.0). While admittedly this number has fallen somewhat as the market has risen rapidly in recent quarters, we still believe we are being appropriately compensated to bear the risk of equities. Since we still expect volatility to eventually increase, we will strive to position ourselves to take advantage where possible.

As always, we are so appreciative of the confidence you have shown in PVP, and we promise to work tirelessly to make you pleased with that decision. We also want to be as transparent as possible. Please let us know if you have any questions, or if we can help in any way.

Sincerely,

J. Kelly Flynn
Chief Investment Officer

Albert Rosano
Managing Director

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[4] *Data for both PVP portfolio and Russell indices are generally via FactSet. In a few instances, we have made minor adjustments.*