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

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Dear PVP partners and friends

As discussed in January**, we believed the downdraft of equities in December was overdone**, and we were buying. So with quarterly earnings generally meeting or exceeding dampened expectations, more accommodation from the Fed (an abatement of rate hikes likely for the foreseeable future), the end of the government shutdown and rising expectations of a favorable resolution of the China trade dispute, **equities were very strong for most of the quarter.**

Toward the end of March international economic data weakened, which revived questions about the ongoing growth of the US economy. In addition, **the yield curve flattened further, and to some extent slightly "inverted".** What this means is that, perhaps counterintuitively, the 10-year Treasury bill today (2.41%) actually yields slightly less than the 1-month Treasury bill (2.44%). This is significant because inverted yield curves have preceded recessions in recent decades. On the other hand, an inverted yield curve certainly does not *guarantee* an imminent recession, since sometimes it inverts followed by continued economic growth for quite some time – calling to mind the old joke about economists predicting five of the last two recessions.

In any event, volatility picked up again at the end of March. While lower rates are good for stocks, the flat/inverted curve reflects doubts about the sustainability of economic growth, as well as some expectations of the Fed actually reversing course and *lowering* rates sometime in the not-too-distant future. **As these macro factors duke it out, we will continue to do what we always do, which is to proceed…with caution.**

In the quarter we added one new holding and also took advantage of the strong market to sell five stocks. **We would characterize our portfolio as relatively defensive** – somewhat more so than at the beginning of the year. Our beta remains low (0.82); we are carrying a healthy amount of cash (about 7%); and we generally are over-represented in the less cyclical sectors (with the exception of the generally pro cyclical financials, where we continue to have a good deal of exposure).

In the quarter "growth" reverted to its decade-long leadership over "value" – albeit by a relatively narrow margin -- after a brief reprieve of "value leadership" in 4Q18. This continues to be a modest headwind for value-oriented investors like PVP. **The strength in the quarter was relatively broad-based, with every sector up.** The strongest sectors were, respectively, technology, energy and real estate – an interesting combination of economically cyclical and defensive. The weakest sector was health care. Our financial stocks were by far the best performers until very close to the end of March, when both lower rates and the suddenly inverted yield curve put a damper on that sector.

In aggregate **PVP was up 12.8% in 1Q19, and up 41% (11.5% annualized) since accepting our first partner capital in February of 2016.** [1] Looking forward, as we shall discuss below, our portfolio's current equity risk premium (ERP) of about 4% continues to be attractive, historically speaking. In other words, we believe we continue to be well compensated for bearing equity risk. Of course, this is by no means a prediction about near term performance, and as always we 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.

Actions taken in 1Q19

New buys in the quarter

Urban Outfitters (URBN) was, we believe, an opportunistic purchase of a stock we have owned previously. An apparel retailer with an excellent track record and highly regarded management team, with cash on its balance sheet representing over 20% of its market cap, URBN currently trades at less than 5x EV/EBITDA. Notwithstanding the company's track record of growing revenues and profits in a challenging retail environment, URBN is a low-expectations stock in a sector with very low expectations, and we believe the company's digital efforts in particular render it well positioned to possibly surprise to the upside.

Exits in the quarter

We acquired shares of the coffee retailer, **Starbucks (SBUX),** in late Summer 2017, when the company's growth model had been called into question. Under new leadership the company has innovated in various ways and returned to growth mode, even while placing a renewed emphasis on FCF. In 1Q19 the stock ran through our Price Target (PT) and we sold it, up 26% from its original purchase price.

Cisco (CSCO), the networking hardware supplier, was another stock we originally acquired when expectations were quite low. These three years have not been the smoothest of rides, but our patience paid off as the company emerged from a period of flat-to-declining sales to its current expectations of solid mid-single digit growth, with a renewed portfolio of products and very healthy FCF throughout our ownership, resulting in a 132% total return. Now trading at 12x EV/EBITDA, we believe Cisco is close to fully valued.

Hamilton Lane (HLNE) is a stock we have owned more than once in its short history as a publicly traded company. While our investment horizon is generally not so short term, our small size does give us the ability to be nimble when opportunities arise, and HLNE is a good example. As we discussed last quarter, our opportunity arose from the emergence of a very misleading research report in November, causing a swift and severe drop in the stock. With the stock exceeding our PT after a quick 25% move, we sold it in February. We still believe HLNE has a great future in front of it, and we continue to monitor it closely for another timely buying opportunity.

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[1] *Returns are net, and assume a 1% annual management fee. PVP defines "long term" as an entire market cycle.*

Our experience in **Stericycle (SRCL),** the medical waste company, and **Dentsply (XRAY),** the dental equipment supplier, were similar in that we were unfortunately too early in both of these turnarounds. In both cases the slow progress has resulted in management turnover at the top, and re-based expectations. Fortunately, however, with both companies exceeding expectations in their recent quarterly calls, the market has regained some degree of confidence in both companies, which, in the context of a generally strong overall equity market, gave us the opportunity to exit both positions. With both stocks trading through their revised PTs, we sold SRCL and XRAY up 39% and 33% ytd, respectively.

Strong performers in 1Q19 [2]

Voya Financial (VOYA), the retirement/investment/insurance company, has done an admirable job of "self help" since its forced divestiture from former parent, ING, in the wake of the financial crisis. It has de-risked in some areas, it has shed unprofitable business, and it has grown its core business. This has resulted in a nice improvement in the company's returns. Voya, our third largest holding, is perhaps our most interest-sensitive, "high octane" position. In a quarter that favored risk, Voya shareholders were rewarded, with the stock up 24%. Still trading at only 9x earnings and at 90% of Book Value (BV), we continue to like the stock.

Crown (CCK), another of our larger holdings, is in the rather prosaic business of making tin cans. We initiated the position last Summer, and later in the year we believed the stock was overly washed out, so we added to the position. The stock had been punished by an adjacent acquisition (Signode) that was not so well received initially by investors. We believe the market is beginning to get more comfortable with Signode now, and also to recognize the environmental (recycling) benefits of aluminum vs. plastic. Though up 31% in the quarter, Crown also remains a cheap stock at just 10x earnings and a 10% FCF yield.

In recent years **eBay (EBAY),** the ubiquitous electronic marketplace, has made nice strides to make itself more customer-friendly and thus better position itself vs. Amazon and other ecommerce providers. But the progress has not been swift enough for some, and so in January certain "activist" investors emerged with their own ideas about creating more shareholder value, including the potential sale or spin-out of fast-growing eBay subsidiary StubHub. This helped push the stock up 33% in the quarter from a very depressed valuation at yearend. The stock now trades at a more reasonable, though in our view still attractive, valuation of 14x earnings, and is increasingly using its abundant FCF to buy back stock.

Post Holdings (POST), which makes cereal and various other foods, continued to exceed expectations in the quarter. POST has also shown creativity in its efforts to create shareholder value. Late last year the company spun out an interest in its private brands business with private equity firm TH Lee as a partner, and this year POST is pursuing an IPO of its fast growing Active Nutrition business. We have long believed the company's progress in building and refining its portfolio had been underappreciated. POST is a relatively large holding, and the stock was up 23% in the quarter.

Yum China (YUMC), the operator of KFC, Pizza Hut and Taco Bell in China, continues to make nice progress in growing its same store sales and in opening new restaurants. Pizza Hut has been the laggard here, but management appears to be improving those operations. The company

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

expects to open 600-650 new restaurants in 2019 (on a base of 8,500), yet still generates enough FCF to buy back stock. We believe the company has a long runway in front of it.

Weak performers in 1Q19

Our biggest detractor in the quarter, by far, was **Biogen (BIIB),** the neurology-oriented biotechnology company, which announced in late March the very disappointing news that its late stage clinical trial of a drug to treat Alzheimer's Disease had failed. BIIB, which was down 21% in the quarter, is now extraordinarily inexpensive at about 8x earnings and 5.5x EV/EBIDA, and responded to the stock drop with a sizable share buyback program.

Sony (SNE), the Japanese technology conglomerate, is in the midst of what so far has been a very successful multi-year transformation. The most recent quarter, however, was weak, much of it due to weakness in the division which makes sensors for the iPhone. We continue to believe Sony is on a positive path, and with the stock now trading at less than 10x earnings, we added to the position during the quarter.

Pfizer (PFE), the pharmaceutical developer, posted a generally solid quarter and 2019 "guidance", but the stock was held back by a sector that was generally weak in the quarter. While the stock still trades at a relatively attractive valuation of less than 15x earnings and a 3.4% dividend yield, we have taken some profits recently as the stock has approached our PT, so it is now an average sized position for us.

Berkshire Hathaway (BRK.B), which remains our second largest holding, posted its typically consistent operating performance for 4Q18, yet the stock has sold off 2% ytd. One factor is that Berkshire owns highly publicized positions in two publicly traded companies – Apple (AAPL) and Kraft Heinz (KHC) – that have had challenges recently. The extent of the decline in BRK.B on the Apple and Kraft news, though, was quite exaggerated relative to the actual impact on the company from those two holdings. We remain optimistic about our Berkshire holding, a company run by perhaps the greatest capital allocators in history, with diverse industrial and financial exposures, both offensive and defensive characteristics, and $130 billion of cash on the balance sheet, trading at a modest premium to Book Value (BV) – a figure that, as Warren Buffett frequently points out, is quite understated due to accounting rules.

Urban Outfitters (URBN), as discussed above, is a new position in a very highly regarded retailer, at a very attractive valuation. As the price weakness that provided the initial opportunity continued through the quarter, we added a bit to the position.

Setup

As always, 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.** 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. Relative to the Russell 1000 Value index, PVP's valuation is cheaper on a FCF basis, yet PVP's margins and returns are substantially better.

To put PVP's FCF yield of 6.9% into perspective, we must also consider the still quite low 30-year US Treasury Bond at 2.8%. This suggests an Equity Risk Premium (ERP) of 4.0% (6.8-2.8).

At this level, as discussed above, we believe we are being well compensated to bear the risk of equities.

Why does Return on Invested Capital (ROIC) matter? We think of ROIC as perhaps the most relevant indicator of the quality of a business, from an owner's perspective: How efficient is the company at converting capital into cash flow? If a company's ROIC exceeds its weighted average cost of capital (WACC), then it is creating value for shareholders. If not, then capital ought to be redeployed. We look for management teams who think similarly, as opposed to "empire builders" sometimes motivated by other considerations. While it is very difficult to arrive at a portfolio WACC with any precision, given the current rate environment we believe ours is somewhere in the 7-8% ballpark. So our companies are creating economic value (as evidenced by our ROIC), and we strive to acquire them at less than their intrinsic value (as evidenced by our FCF yield and ERP).

	PVP [3]	Russell 3000 [4]	Russell 1000 Value
Free Cash Flow yield (2019E)	6.8%	4.9%	5.3%
Price/Earnings (2019E)	14.2.x	17.2x	14.1x
Debt/Total Capital	43%	43%	41%
Debt/EBITDA	2.8x	2.9x	3.2x
2018 EBITDA margin	31.0%	18.9%	18.2%
2019E Return on Equity	18.5%	17.7%	14.2%
2019E Return on Invested Capital	11.5%	8.4%	6.8%

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

[4] *Russell 2019E for ROE and ROIC not available; data is for 2018.*

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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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