PROSPECTIVE
VALUE PARTNERS
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Dear PVP partners and friends

In a quarter ravaged by coronavirus, let us first say that **our thoughts and prayers go out to all those affected by the disease.** On a human level this has been a tragedy, and it is our most sincere hope that the progress of the pandemic slows down quickly, so that the death counts drop, we are able to heal those affected, and we can begin to return to our normal lives.

Coronavirus, along with the measures we have taken to slow its spread, is also an economic disaster. Even though the technical definition of recession is two linked quarters of negative real GDP growth – which has not *yet* happened -- it seems a pretty safe bet that we are in a recession. To make matters worse, just as energy was taking a plunge due to decreased demand as coronavirus worsened, Saudi Arabia decided to raise oil production, further dampening commodity prices, in an apparent dig at its energy-producing rival, Russia.

Unemployment, which had been almost nil prior to coronavirus, has already shot up and undoubtedly will continue to rise this month. It is a cruel fact also that the employees most affected have been, and probably will continue to be, millions of service workers whose workplaces have been compulsorily shut down, whose compensation even in "normal" times has not afforded them the opportunity to build a sizable rainy day fund.

And yet, even with all the recent carnage, there is reason to hope. While the pandemic is still far from under control, it is clear that "social distancing" and other measures have been effective in slowing the spread. Although frightening headlines of cumulative new cases and deaths dominate the headlines, under the surface the number of daily new cases – a *leading* rather than *lagging* indicator -- are no longer rising in many of the hotspots. And warmer Spring weather will help. In various parts of the world that were affected earlier than the US, life has begun to return to normal. More than two weeks ago Starbucks said 90% of its stores in China were now open. A little over a week ago Yum China (KFC, Taco Bell, Pizza Hut) said 95% of its stores had reopened.

Furthermore, the Fed has shown its willingness to pull out all the stops. The Fed has taken short term rates to zero, it is providing liquidity in countless other ways to keep markets moving, and it is generally utilizing more tools than most of us knew it even possessed. **Finally, in very short order Congress passed, and the President signed, a $2 trillion stimulus package, unprecedented in size and scope.**

We have heard the comparison of our current situation to the 2008 global financial crisis, but in our view this analogy suffers from the "recency bias", whereby one's frame of reference is skewed toward the most *recent* crisis. **In 2008 we faced an *existential* crisis – the outcome could have been much much worse. Today, on the other hand, we know we will eventually get coronavirus under control,** we just don't know how quickly nor how much economic

damage will have been done by that time, nor how this traumatic experience might alter future consumer behavior. ***In short, we are cautiously optimistic.***

We don't say this in a cavalier spirit at all. We don't know how long this economic impasse will last. The longer it lasts, obviously the greater the economic damage, leading to more bankruptcies and a deeper recession. We also don't know how the equity market will behave in the short term. Frankly we were surprised by the violent bounce back upward at the end of the quarter. We also would expect a drumbeat of bad news for the foreseeable future, and **we have no idea what data point(s) will ultimately act as a catalyst for equity markets to begin to "see through the fog". But we are confident that time will come, hopefully sooner rather than later.**

We have written in previous letters about our portfolio becoming increasingly defensive, as the 11+ year recovery continued and valuations in some quarters began to appear stretched. But **this was a quarter in which *one could not have been defensive enough.*** Although there has been *some* differentiation in the carnage, most everything is down materially. While the market sorts this out, few distinctions are made between the relative quality of different business models. While indeed we *have* been increasingly defensive in terms of the traditional economic cycle, **the policy response to coronavirus weighed most heavily on those companies most dependent on normal social conditions.**

The good news is that we didn't own any airlines or cruise ships, and we have been light in energy. The bad news is that we did have a handful of stocks – thankfully mostly small positions -- whose business models depend on normal social activity, travel, etc. Below we discuss those of our holdings that were most vulnerable. We also have heavy financial exposure, where in the banks in particular the market has begun to assume major impairments to Book Value (BV) due to heavy loan losses. We certainly expect there will be loan losses, but suggesting that they rise to the point of materially impairing BV seems like a worst case scenario.

<u>Our response</u>

1. **Hoard and raise cash.** We were fortunate to enter the crisis with a decent amount of cash. As the market collapsed in March we supplemented this cash with a few opportunistic trims and sells (described in more detail below) of stocks that were actually up ytd and or had approached our Target Price (TP).

2. **Closely monitor our most vulnerable holdings.**

    - **Air Lease (AL):** Air Lease is one of the world's leading aircraft lessors to airlines around the world. Although airlines are currently struggling, and some will go bankrupt, leases get paid or else AL takes back the planes. In some cases AL will modify lease terms in the short term, adding a missed interest payment to principal. With low debt and $6 bn of cash plus unutilized lines of credit (about 3x the company's total lease revenues in 2019), AL has tremendous liquidity. In fact, it will likely use this relatively strong position to help ease the burden of certain airline partners with sale/leaseback transactions. With no plans to cut or suspend the dividend (2.9% current yield), AL is now down 53% ytd and trades at about 40% of BV.

- **EPR Holdings (EPR):** EPR is the REIT that owns movie theaters and other "experiential" properties. Although theaters are obviously closed in this period of "social distancing", EPR is in the fortunate position of having recently divested certain educational assets with the expectation of acquiring something different. That acquisition was obviously cancelled, leaving EPR with $1.25 billion of cash (more than 2x the company's entire rental income in 2019) and no debt maturities until 2023 – enough to withstand a very long storm. In fact, in response to its stock drop the Board even authorized a $150 million share buyback program (which out of caution we advised the company not to execute). EPR is now down 66% ytd, and, assuming it continues to pay dividends at the current rate, now trades at a 19% yield.

- **Wyndham Destinations (WYND):** WYND, spun off from its former hotel parent in 2018, is a time-share company. Its model is different from hotels in that, between management fees, membership dues, customer loans, etc., historically 75% of revenues have been recurring (alas the current period will put that history to the test). While continuing to pay its dividend (10% current yield), the company is reducing its largely discretionary expense base, as well as capex and (obviously) share buybacks to preserve cash during this period. WYND currently has cash and other liquidity of just over $1 billion, and its next debt maturity is $250 mm in March 2021. The company believes tremendous pent-up demand is being created with so many Americans stuck in their homes. If we apply 2019 Free Cash Flow (FCF), WYND now trades at an 18% FCF yield. The stock is now down 58% ytd.

- **Macquarie Infrastructure (MIC):** One of MIC's larger business units is Atlantic Aviation, which is an FBO (fixed base operation), located at various airports, that fuels and services private jets. This is MIC's most exposed unit. Fortunately, the cyclicality in that business is balanced somewhat by MIC's biggest business, IMTT, which stores bulk petroleum and other products, and is clearly benefiting from elevated storage demand from the low current energy prices. With the benefit of this balanced business model, about two weeks ago MIC announced that its overall business ytd was performing in line with its expectations; however, subsequent to the end of the quarter MIC withdrew its annual financial guidance (like most companies) and also prudently suspended its dividend to preserve cash. The company has over $1 billion of liquidity, and is in compliance with all of its debt covenants. Recall also that, prior to the coronavirus crisis, MIC was in the process of evaluating various opportunities to create shareholder value – including a sale of the entire company. We will continue to monitor MIC closely. The stock is now off 41% ytd.

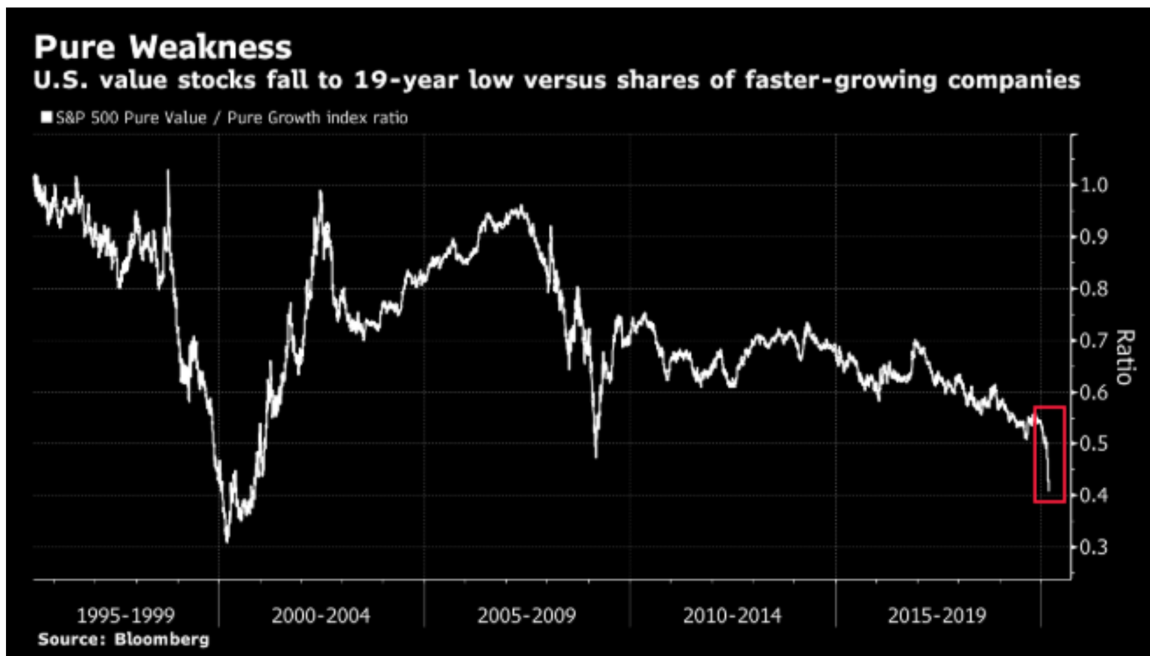
- **MGM Resorts (MGM):** Although gaming and conventions have obviously ground to a halt, MGM is in the fortunate position of having recently done a sale/leaseback transaction of its Mandalay Bay and Circus Circus properties, which netted the company about $5 billion. MGM now has just under $4 billion of cash, with no debt maturing before 2022. MGM is also aggressively reducing its

discretionary operating expenses and obviously scaling back capex plans. A few days ago Bloomberg reported that MGM is sufficiently confident in its financial position that it has declined direct federal assistance – though it "may take advantage of loan guarantees if the shutdown of casinos lasts too long". If we apply 2019 FCF, MGM now trades at a 20% FCF yield. The stock is now down 65% ytd.

3. **Take advantage, to the extent possible, of the extreme levels of volatility.** The volatility beginning in March has been extraordinary. We have seen stocks move 20-30% down one day, and then back up the next day by similar percentages. Although we normally are not so short term-oriented, we cannot ignore some of these opportunities. In times of panic we always do our best to take advantage of these dislocations. In some cases we trimmed certain of our stocks that were up even in the face of a very bad overall market – most likely due to technical factors like short covering. In other cases we were admittedly – from the current vantage point – "too early" in buying. Future stock movements in fact may well show us to have been considerably too early, though we believe over time these moves will prove to be profitable. We will discuss these trades in more detail below.

4. **Prepare a buy list for some of the extraordinary opportunities being created.** Even after adding to a number of our positions that were deeply discounted during the quarter, we still have about 6% cash. (We did not add to the companies that are most vulnerable, that had suffered the most precipitous declines. Rather, we added most to high conviction names that we felt were simply "guilty by association", which we discuss below in more detail.) We also have two stocks that are in the process of being acquired – **Allergan (AGN)** and **TerraForm (TERP)** – that account for an additional 4+% of easy cash. Had the market not roared back so quickly in the last week of the quarter, we might have deployed some of this cash. While the timing is uncertain, you should expect us to continue to add opportunistically to our existing positions at these discounted prices (or possibly more discounted prices). In addition, we have identified a handful of new companies that fit our criteria, at quite attractive valuations. While we like what we already own, we certainly have the capacity to make several completely new investments as well.

Growth continued to outperform value in the quarter, as technology, with its annuity-like business models that don't require so much human interaction, became a relative "safe haven" -- notwithstanding valuations, which in the short term do not rank as a great concern in a crisis. The underperformance of the big "value sectors" (financials, industrials, energy and REITs), on the other hand, overwhelmed the better relative performance of the more defensive but smaller "value sectors" (staples and utilities). As seen below, the gap between value and growth is now at levels not seen since the tech bubble of the late 1990s.



In aggregate **PVP was down 25.7% in 1Q20, and our annualized return since accepting our first partner capital in February of 2016 has dropped to 4.1%.** This was obviously a very disappointing quarter, and we take little consolation in continuing to outperform benchmarks. [1] Looking forward, as we shall discuss below, our portfolio's current Equity Risk Premium (ERP) of 9% is extraordinarily attractive, historically speaking. Now more than ever we encourage our partners to take a long term view. We believe we will be compensated for this massive spread, we just don't know quite when.

Actions taken in 1Q20

Buys in the quarter

As discussed above, given the volatility, we were much more active than usual this quarter. Before the pandemic, though, in one of our all-time untimely purchases, we bought **East West Bank (EWBC)**. EWBC is a high performing, Pasadena, CA-based bank, with a stellar track record, that caters especially to the Asian-American community. Our thinking at the time was that the stock continued to reflect tariff concerns, and this was an opportunistic acquisition of a high quality, niche bank. EWBC's 2019 ROE was a best-in-class 15%. While 2020 appears cloudy for EWBC and most others, the stock is down 45% from our purchase price and now trades at about 75% of BV.

Ciena (CIEN) is the networking equipment maker that should benefit greatly from the 5G rollout. Although like EWBC it was purchased before the corona crisis, it has handily

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[1] *Returns are net, and assume a 1% annual management fee. PVP defines "long term" as an entire market cycle. In 1Q20 PVP gross return was (25.5)% vs. (27.3)% for the Russell 3000 Value. For the three years ending 3/31/20, PVP annualized gross return was (1.1)% vs. (2.7)% for the Russell 3000 Value.*

outperformed the market since then, down just 5% from our purchase price. Based on FY19 FCF, CIEN now trades at about a 6% FCF yield, and has no debt.

We have owned **Maximus (MMS)** previously, and we re-acquired the stock in early March, when coronavirus appeared more like a correction than a pandemic. Recall Maximus is a provider of outsourced government services, including local, state, federal and international. Maximus is defensive and relatively countercyclical in that, as the size of government grows along with peoples' needs, governments count on Maximus to help implement its social and health policies. MMS is now down 11% from our purchase price and, based on FY19, trades at an 8% FCF yield.

Nutrien (NTR) was another relatively defensive purchase made in the early days of coronavirus. Nutrien, the global leader in fertilizer that is the result of the 2018 merger of Agrium and Potash, has a unique business model -- while the commodity side can be quite cyclical (agriculture cycle not economic cycle), the company also has a very steady retail unit that tends to cushion the swings. So while we wait out the currently depressed ag cycle, retail generates the FCF. Based on 2019 FCF, even with depressed commodity prices, NTR trades at almost a 10% FCF yield, and pays about ½ that out to shareholders in the form of a dividend. NTR is now down 11% from our cost basis.

We also added to a number of existing positions during the quarter – some of which are currently up from there and some are not (yet). There were a lot of them, so we will try to be brief here. First, we added modestly to several banks in mid-March as markets plunged, including **BankAmerica (BAC), Citizens Financial (CFG)** and **Pinnacle Financial (PNFP).** We were too early in all of these, as the stocks continued to drop. We also added to our two energy infrastructure holdings, **Williams (WMB)** and **Cheniere (LNG).** Here we were too early as well, as energy continued to plummet – notwithstanding that about a week ago Williams actually re-affirmed its earnings guidance for 2020.

We also added significantly to **Nextera (NEP), Wyndham Destinations (WYND)** and **Enstar Group (ESGR)** about two weeks ago, and those stocks are all currently up from there. Enstar in particular warrants a brief digression. The company is an insurer with a stellar track record in buying and "running off" the legacy exposures of troubled insurers and reinsurers. Its major competitor for these deals is often Berkshire Hathaway (BRK), so it is in good company, as the underwriting and claims management require real expertise. This challenging time ought to play right into Enstar's strength, and in fact in March Enstar did a major transaction with reinsurer Aspen, and is reportedly considering other deals with insurers that need to raise capital. Yet ESGR still trades now at only 70% of BV, currently down 23% ytd. Our sizable add makes ESGR one of our biggest positions in the portfolio.

Exits in the quarter

We sold **Urban Outfitters (URBN)** in mid-January. While we like the differentiated model and FCF, and admire the management team, we believe retail apparel is just too challenging these days, and decided our capital was better deployed elsewhere. We sold the position down 3% ytd, which turned out to have been a good sale with the stock now down 50% ytd.

Corteva (CTVA) was a small "stub" piece of our legacy DuPont holding, the only progeny we had held after selling the DuPont and Dow pieces. We sold this one in early February, as Nutrien appeared much more attractive for ag exposure. CTVA is now down 26% from our sale price.

eBay (EBAY) was a stock that did well for us in recent years; however, under pressure from activists the company has recently sold its StubHub subsidiary and is contemplating divesting its classified ad business as well. With these catalysts having played out, what investors are left with is the very mature core auction business, which has been mostly impervious to various attempts over the years to accelerate the growth. Even as a cheap stock, we believed our capital would be better used elsewhere. EBAY is now down 23% from our sale price.

Crown Castle (CCI), the cell tower company that is structured as a REIT, is another stock that did quite well for us over time. In mid-March, even as the overall market tanked, CCI held so well that it hit our TP. Looking to raise cash both for defensive purposes and to fund more attractive opportunities, we sold the position slightly up ytd. CCI is now down modestly from our sale price.

We were fortunate also to have trimmed a few positions – specifically **Yum China (YUMC), Adtalem (ATGE)** and **Apple (AAPL)** – in January, at prices well above where they ended the quarter. As mentioned previously, in mid/late March we also took advantage of the extreme volatility and trimmed a few of our stocks that had done well -- specifically, **BJ's Wholesale (BJ), WalMart (WMT)** and **Amazon (AMZN) --** in order to raise cash and fund a bit of a war chest. All of these stocks were trimmed while up ytd, at or near their TPs, in a market that was generally very weak. We continue to like all these stocks.

Strong performers in 1Q20 [2]

In addition to the fact that most stocks were down, another unusual feature of this quarter was that in almost every case the company's quarterly report was irrelevant to the stock's performance. It was almost entirely about the market's perception of each company's vulnerability to coronavirus and its aftermath.

BJ's Wholesale (BJ), the "poor man's Costco" warehouse club, was by far our best performer for the quarter. The stores have stayed open through the crisis, and no doubt are benefiting from a surge of demand for food and other essentials. Though the stock ended the quarter up 12%, we were fortunate to trim about ½ the position up about 28% ytd.

Amazon (AMZN), normally considered a technology company, allows customers to consume even while practicing "social distancing", so the stock acted more like a consumer staple this quarter, up 6%. About a week ago we trimmed a bit of it to raise cash, and it closed the quarter very close to that price. AMZN remains a sizable holding.

Biogen (BIIB), up 7% in the quarter, benefited from its very strong balance sheet, abundant FCF and market-leading position in drugs for MS and other neurological diseases. These prescriptions need to keep getting filled whether or not we are practicing "social distancing".

As discussed above, we were fortunate to sell the e-commerce company, **eBay (EBAY),** in January, up 5% ytd, before coronavirus dragged stocks down.

In the case of **Ciena (CIEN),** also discussed above, it was a matter more of "less bad" than "strong", as this networking equipment stock was only off 5% in the quarter from our purchase price. Technology was the best performing sector in the quarter, and CIEN also carries the strong

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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.*

5G secular tailwind. The company may well also benefit from a continuing backlash against Chinese competitor Huawei.

Weak performers in 1Q20

Financials were one of the worst performing sectors during the quarter. **Citizens Financial Group (CFG),** the Providence, RI-based super regional bank, was down 53%. Ultimate losses from the pandemic and its aftermath are impossible to predict at this point, but with CFG now trading at less than 50% of BV, it seems the market is assuming a worst case scenario. In light of the current uncertainty, in order to preserve capital Citizens has prudently suspended its share buyback program. At this point in time, at least, Citizens is continuing to pay its dividend, the yield of which is now over 8% on an annualized basis.

Energy was the worst performing sector this quarter. **Cheniere (LNG)** is the energy infrastructure business that liquefies natural gas and distributes it to ships bound for ports around the world. The precipitous drop in oil prices does make LNG less competitive in the short term at least; nonetheless, Cheniere has locked in 97% of 2020 revenues, and 85+% of revenues for the next 15+ years. The only risk to these revenues would be the bankruptcy of Cheniere's customers, but they are almost entirely investment-grade oil majors and national oil companies. LNG was down 45% this quarter.

Voya Financial (VOYA), the retirement planner and investment manager that has been a terrific investment for us over time, becoming one of our biggest positions, was down 33% in the quarter and now trades at just 85% of BV. Voya is sufficiently confident in its excess capital position that it appears to be continuing its share buyback program.

Air Lease (AL) is discussed in some detail above. With the stock down 53% ytd and trading at 50% of BV, the market seems to be assuming that the majority of AL's customers discontinue their lease payments, and that AL takes back the jets and is only able to re-sell them at a massive discount. We don't believe this is a likely scenario.

Like AL, **MGM Resorts International (MGM)** is also discussed in some detail above. Though the near term looks quite bleak for gaming and conventions, MGM is in the very fortunate position of having recently sold off some of its real estate, leaving it with excess liquidity that, prior to the pandemic, the company planned to use to buy back stock (a decision that was subsequently prudently reversed). MGM was off 64% for the quarter.

Setup

Particularly in times of stress, such as we face today, the equity market functions more as the proverbial voting booth than the scale that is preferred by fundamentally-oriented investors like PVP. We don't know how others will vote, so we don't pretend to know what will happen to the market in the short term. But if we make the assumption that we *will* get through this period, we believe it is still helpful to look at some comparative metrics. Since 2020 results will be an aberration and are impossible to estimate now anyway, we are using 2019 data as a starting point.

The numbers below have changed, but the story remains very much the same: PVP's portfolio is historically cheap, with superior returns. Moreover, our companies' superior margins will take a hit but will help them weather this storm. Using 2019 FCF, the Equity Risk Premium (ERP) of our portfolio is unlike anything I've ever seen at 9% (10.4% FCF yield less 1.4% 30-year UST).

This is a wider spread than we saw during the 2008 financial crisis. At this level we believe we are being extraordinarily well compensated to bear the risk of equities.

	PVP [3]	Russell 3000	Russell 1000 Value
Free Cash Flow yield (2019)	10.4%	4.3%	5.2%
Price/Earnings (2019)	12.4x	19.0x	14.4x
Debt/Total Capital	45%	43%	40%
Debt/EBITDA	2.8x	3.0x	3.4x
2019 EBITDA margin	32.5%	19.3%	19.1%
2019 Return on Equity	17.9%	17.6%	14.1%
2019 Return on Invested Capital	12.9%	7.7%	6.3%

At times like this we are more appreciative than ever of the confidence you have shown in PVP, and we promise to continue to work tirelessly to make you pleased with that decision. Now more than ever, 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

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