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VALUE PARTNERS
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Dear PVP partners and friends,

The market in the second quarter continued its **upward climb**, **meeting some resistance toward the end of the quarter** on some modestly underwhelming economic data and diminished legislative expectations for pro growth economic policy. As we have written previously, the situation remains fluid. In our view the market has appropriately begun to question the likelihood of these policy changes actually coming to fruition. If they do in fact happen, it will be good for the economy and thus for stocks as well. If not, as we saw toward the end of the quarter, it will not be good for stocks.

Meanwhile, the Fed stayed on its previously communicated course of slowly returning to "neutral" interest rates as the economy strengthens, by tightening an additional 0.25% in June. The bond market, however, is growing more skeptical about the pace of future rate hikes in the wake of less robust economic data, and so the yield curve has flattened.

In terms of policy specifics, the Senate is currently attempting to recraft the Better Care Reconciliation Act of 2017 (aka BCRA, its second attempt at replacing PPACA). The market has begun to conclude that its effects, if passed, will be relatively benign for the health care sector, where we have a meaningful exposure. Also, President Trump has signaled that an Executive Order on drug pricing is forthcoming, which preliminary drafts suggest will also not be overly punitive to the industry. If these assumptions prove correct, it bodes well for our health care holdings.

Health care, buoyed by this abatement of political fears, was the strongest sector in the quarter. Although by historical standards overall volatility remained muted, technology, which was also quite strong in the quarter, became notably volatile late in the quarter. In June investors took profits particularly in the very popular "FANG" stocks (Facebook/Amazon/Netflix/Google, aka Alphabet), along with their brethren Apple and others, that have been quite strong in recent months. While we continue to own some Alphabet and Amazon, we were fortunate to have taken some profits there recently. We continue to like the prospects for these companies, but we believe the stocks had begun to more accurately reflect those still bright prospects. Generally speaking, **when we own stocks that seem overly "popular", we start to get nervous.** Energy, on the other hand, where we are underweighted, was the weakest sector, dragged down by the performance of the commodity. Telecom, where we also have minimal exposure, was the next weakest sector.

In the past we have discussed the issue of the relative performance of "value stocks" vs. "growth stocks". Over very long periods of time there is much evidence to suggest that value stocks outperform. These growth vs. value trends tend to run in multiyear cycles. From 2009 (just after the 2008 financial crisis) through 2015, for instance, growth outperformed value by 4.1% annually. Last year (2016), however, that relationship quickly reversed, with value outperforming growth by 10.2%. Normally we would expect that to mark the beginning of a new cycle, but so far this time it has been different, as 2017 has witnessed a return to growth leadership,

outperforming value by 9.8% through June 30th.[1] This has been a modest recent headwind for value-oriented investors like PVP. It is important to note, however, that this does not necessarily mean our "value" investment *style* will underperform in a market environment which favors growth, but rather that the more economically cyclical *sectors* that are typically less expensive and thus favored by value managers would likely underperform in such an environment.

In aggregate **PVP was up 3.1% in 2Q17, and is now up 8.9% ytd in 2017, 18.3% in the last year, and 29.6% since accepting our first partner assets in early February of 2016.** [2] Regardless of how strong or weak recent performance has been, **we will always caution 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 2Q17

Buys in the quarter

While overall volatility remained generally muted, a few opportunities managed to present themselves, and so we were relatively active in the quarter. **Scotts Miracle-Gro (SMG)** is an iconic brand whose products you might have used in your home garden. While the core business, in which Scotts has a leading share, is obviously mature, what is exciting here is the very rapid growth in its smaller "hydroponics" unit. Hydroponics provides higher yields compared with traditional agricultural techniques, and is more accessible to the "recreational farmer". Although the growing acceptance, and legalization, of cannabis is clearly playing a role as well, the company cannot yet legally market its products on that basis. Scotts had a poor 1Q17 due to weather, giving us the opportunity in the stock. Even without the hydroponics "kicker", we believe we own the leader in its field at a reasonable valuation. With a renewed emphasis from management on FCF generation and the growth of hydroponics -- and cannabis in particular -- we believe we have essentially a "free option" to the extent that market truly takes off.

Vista Outdoor (VSTO) is an outdoor recreation company with a diversified portfolio of leading brands in hunting/shooting, camping, hiking, cycling, snow sports, and other activities. In early 2015 VSTO was spun out by Alliant Techsystems at the time of Alliant's merger with Orbital Sciences (now Orbital ATK – ticker "OA"). VSTO currently trades at $22.50, down from over $50 less than a year ago. Two major factors brought the stock down and created the opportunity for us in the stock. First, fears of the potential illegality of shooting sports under a Clinton administration significantly pulled demand forward in that business, taking 2016 revenues well above expectations but also creating a current "hangover" in a segment that had been growing 7% annually for the past quarter century. Second, the impact of a high profile sporting goods retailer bankruptcy (The Sports Authority) rippled throughout the industry, disrupting forecasts with excess inventories and severely discounted merchandise. We believe both of these issues are transitory, and our research indicates that Vista is on its way back to a normal operating environment. At the current price, we believe Vista's capability to generate cash flow suggests a very healthy double digit normalized FCF yield.

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[1] *Figures cited reference the Russell 1000 Value and Russell 1000 Growth indices.*

[2] *Performance figures are net, and assume a 1% annual management fee. Assumes PVP partners, all of whom hold the same portfolio, were fully invested as of the beginning of the time period.*

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Dentsply Sirona (XRAY) is the world's largest manufacturer of dental professional products. The dental business is obviously a rather stable one, and, unlike medicine, is mostly cash pay. Moreover, a significant percent of Dentsply revenues are recurring consumables. Although in the current "risk on" environment XRAY has fallen somewhat out of favor with investors, Dentsply did recently expand its relationship with the leading dental distributor, Henry Schein (HSIC), which should bode well for future growth. We also expect the company to capture more synergies from recently acquired Sirona than the market currently anticipates. Owing to these favorable characteristics, XRAY is never a "cheap stock". Its normal premium valuation, however, is smaller than usual, for a company with much going for it right now, in our view.

As we have previously discussed, **Iron Mountain (IRM),** the world's largest document storage company, was a great stock for us last year, rising well through our Price Target, and we sold it. Subsequently the stock sold off, and in 2Q17 we bought it back. Our experience with this company over many years is that occasionally questions develop about the viability of the business, and those periods of doubt and uncertainty have generally been excellent opportunities to buy the stock. Iron Mountain continues to modestly grow its top line organically, driven in large part by litigation and regulation, which we don't expect to abate anytime soon, as well as by expanding into new geographies. Its market position gives it some pricing power. And it is not just paper, obviously, as IRM is able to accommodate customers digitally or with a hybrid solution – whichever the customer prefers. The company serves 95% of the Fortune 1000 companies, which on average have been customers for fifty years. We believe the document storage business will continue to be with us for quite some time. IRM currently trades at an attractive dividend yield of 6.4%, with a dividend that we expect to grow over time.

For some time we have observed the growing demand for private equity (PE) investments from institutions and high net worth investors, but we have struggled to determine how we might participate. In our view there are a handful of attractively valued publicly traded private equity firms – Kohlberg Kravis Roberts (KKR), Apollo (APO) and Blackstone (BX), for instance -- but all these firms are partnerships that are required to deliver their investors an annual K-1, which is a burden we don't want to impose on our partners. **Hamilton Lane (HLNE),** which went public earlier in 2017, is not a PE investor itself but rather is an investment consultant and "fund of funds" manager, and is quite leveraged to the expected growth in PE. By virtue of its business model, Hamilton Lane has a great deal of visibility and predictability of revenues well out into the future. As a consultative business, the company has almost no capital expenditures required. We believe HLNE has healthy growth ahead of it, and boasts a 3.2% dividend yield and a 6% FCF yield.

We also found two investment opportunities this quarter in companies that own growing portfolios of energy infrastructure assets: **InfraREIT (HIFR)** is the first of its kind in the capital markets: a real estate investment trust (REIT) exclusively focused on power transmission assets - power lines, towers, and related electricity distribution assets. InfraREIT's assets are heavily concentrated in energy producing states in the central United States, which we expect to enjoy strong growth for many years in the energy production industry, as well as in emerging alternative energy projects (primarily wind-related). We purchased HIFR at a 5% dividend yield, a premium to peers, and we expect its valuation to improve over time as its growth outlook becomes better understood in the marketplace.

Also this quarter, we purchased **Pattern Energy Group (PEGI),** an owner and operator of alternative energy assets (primarily wind). Sponsored by The Carlyle Group, Pattern Energy is a holding company for completed and operating alternative energy assets, under long-term contract with investment grade counter-parties. Pattern offers a generous 7% dividend yield, and has

guided toward double digit dividend growth over the long term, deriving from new projects sponsored and developed by Carlyle. In our view the Pattern investment provides a unique combination of yield and growth.

We believe the common denominators among these new investments are that these companies are leaders in their respective businesses; the businesses are relatively recurring and resilient; they participate in relatively defensive industries; they are generally idiosyncratic and thus diversifying to the portfolio; and the investments were made at prices that we consider reasonable to quite attractive.

Sells in the quarter

Crown Castle (CCI), the cell tower operator that is structured as a REIT, is a company we continue to like. The stock price, however, had just gotten ahead of itself in our view, up more than 15% year to date (ytd) and jumping through our Price Target (PT), and so we sold the stock.

YUM! China (YUMC) is a stock that we had expected to play out over a number of years. We still believe that in terms of the company, but the stock is another story entirely. After a less-than-inspiring quarter in 4Q16 in its debut as a public company, YUMC results in 1Q17 were a modestly positive surprise, and the stock took off upward, and is now up 51% ytd. YUMC's valuation quickly went from a significant discount to peers to an average multiple, so we sold the stock. It is quite unusual for us to hold a stock for such a short period of time, but we strive to remain disciplined in our Price Targets. Like IRM, discussed above, it wouldn't surprise us if we get another opportunity one day to buy it back.

Part of our Price Target discipline is also that the PT changes if the thesis changes. There are often unforeseen factors that can quickly invalidate a thesis, and when that happens we are not afraid to take action. In the case of **Whirlpool (WHR),** while there is still much to like about the company, and the stock, at the time of purchase we had not adequately anticipated just how rapid the demise of some of WHR's retail partners (e.g., Sears) would be. This will make it very difficult for the company to achieve its objectives, so with this diminished confidence we sold the stock. Fortunately, with the stock now up 5% ytd, it had no material impact on performance this quarter.

FEMSA SA (KOF), the Coca Cola bottler in Latin America, is an example of a thesis that became invalidated because a major corporate event that we had anticipated simply did not happen. Specifically, we had many reasons to believe FEMSA was going to acquire Coke's California bottling facilities at a very attractive price, but, for reasons that are not entirely clear to us, it now does not appear likely to happen. What remains is a solid company at a reasonable valuation, but not a compelling enough situation to fit into the PVP portfolio, so we sold the stock. Notwithstanding the deal not coming together, fortunately the stronger peso actually led the stock to modestly outperform for us in the quarter.

Strong performers in 2Q17 [3]

As discussed above, **YUM! China (YUMC)** was a standout performer in the quarter. While we continue to like the prospects for the company, we took advantage of the strong appreciation and sold the stock.

We have been patient with our **Oracle (ORCL)** investment, as we believed it was just a matter of time before the company's newer cloud initiatives grew to sufficient size to move the overall needle and compensate for the slowdown in the legacy enterprise resource planning (ERP) business. In its most recent quarter Oracle began to fulfill those expectations, with cloud-based revenues and eps growing 58% and 10% year-over-year (yoy), respectively. The stock was up 13% in the quarter, and still trades at an attractive valuation, in our view.

After some disappointing recent results, **Palo Alto Networks (PANW**) has begun to reward our patience with an excellent quarter, with revenues, eps and FCF growing 25%, 46% and 29% yoy, respectively. In addition, ongoing security threats such as "WannaCry" continue to remind investors of the need for IT security, where Palo Alto is the leader. PANW was up 21% in 2Q17.

Although there were fears in the market that the strong ongoing growth of **Alphabet (GOOG**) might slow in the quarter, given the reaction of certain advertising customers to the placement of their ads by YouTube, the company continued its robust growth, with (constant currency) revenues growing 24%, eps up 28% and FCF up 35%, respectively, yoy. GOOG was up 10% in 2Q17.

Although **MGM (MGM)** as a stock can be quite volatile, the company continues to make excellent progress across multiple dimensions. Whereas last quarter MGM was one of our weaker performers, in 2Q17 MGM was up 15% on solid operating results, improved sentiment toward the hotel/gambling industries, and an increasing differentiation as a consumer-facing company that cannot conceivably be disrupted by online competitors like Amazon (AMZN).

Weak performers in 2Q17

Although **Post (POST)** reported respectable results during the quarter that were in line with its prior "preannouncement", investors were not pleased with the company's announcement of its intention to acquire leading UK cereal maker Weetabix. Moreover, Amazon's (AMZN) announcement of its acquisition of Whole Foods (WFM) during the quarter spooked the entire food sector. In spite of its superior recent track record, Post now trades at a significant discount to peers. In response, the company announced a major share buyback, and we followed suit, adding modestly to our position.

Cisco (CSCO) is obviously in different businesses than Oracle, but their stories are similar in that both have large legacy businesses that are either slow growth or in decline, with smaller but faster-growing lines of business to take their place. For the quarter the company posted flat yoy revenues and modest eps growth, but expects conditions to soften in the coming months. Even with flat revenues, CSCO grew its FCF 14% yoy, and in our view the stock trades at a very attractive valuation. The challenge is that Cisco is not quite as far along in its transformation process as Oracle, so further patience will be required.

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[3] *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.*

Liberty Global (LBTYA), the European cable provider, slightly tweaked down its growth expectations during the quarter, which in our view led to an exaggerated move in the stock to the downside. We remain confident, however, in LBTYA as an investment: Europe remains a strongly under-served market for high speed internet access; customers are hungry for the product; Liberty is growing rapidly to meet that demand; management remains focused on creating long-term shareholder value; and all FCF not spent on growing the business is deployed in buying back shares.

After concluding its strategic review, **West Corporation (WSTC)** decided to sell itself to the private equity firm Apollo Management (APO). Although West was a profitable investment for us, we were disappointed in the outcome, as we believe West should have commanded a higher price in a sale. The deal is expected to close soon, and we will be selling our remaining holdings.

In late June **Booz Allen Hamilton (BAH),** the IT security contractor to the federal government, disclosed that the Department of Justice is investigating its cost accounting practices. The company believes its practices are appropriate, and of course is cooperating with the government. We are closely monitoring the situation, but in our experience these kinds of investigations are not at all unusual for companies doing business with the government. We view the situation as unfortunate but remain confident in our investment.

Setup

We continue to like the positioning of the portfolio. PVP owns a **diverse portfolio 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 grown revenues and eps faster than the Russell 3000, with similar leverage. PVP also has higher margins and greater returns than the Russell 3000.

	PVP [4]	Russell 3000
Free Cash Flow yield (2016)	5.9%	4.3%
Price/Earnings (2016)	19.4x	21.2x
Debt/Total Capital	44%	44%
Debt/EBITDA	2.8x	2.8x
2016 revenue growth	6.0%	5.6%
2016 eps growth	10.2%	0.4%
2016 EBITDA margin	30.5%	18.6%

[4] *Data for both PVP portfolio and Russell 3000 are generally via FactSet. In a few instances, we have made minor adjustments.*

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2016 Return on Equity	17.5%	14.4%
2016 Return on Invested Capital	8.5%	6.7%

To put PVP's 2016 FCF yield of 5.9% 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 3.1% (5.9-2.8). 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 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 strive 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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