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

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Dear PVP partners and friends

The long-awaited equity market volatility that we discussed last quarter continued through 2Q18. On the one hand we continue to have a strengthening economy, which is a backdrop for solid profit growth for our portfolio companies; generally favorable policies with a deregulatory bent; and a healthy amount of inflation encouraged by the Fed that (so far) remains in check.

On the other hand, as we have mentioned previously, the Fed seems fairly set on its course of reversing Quantitative Easing (QE) by methodically raising rates to return to "normal" levels. Moreover, as the Fed raises rates on the short end but the long end doesn't budge, the yield curve has become worrisomely flat. And finally, toward the end of the quarter the fear of Trade Wars seemed to move beyond mere rhetoric and hover closer to reality. [1]

In our view, **rising rates and the flat yield curve are likely to pose the biggest challenges** to the equity market in this current investment cycle. Assuming the economy continues to grow at least in line with expectations, if the Fed continues to hike rates -- 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. And if the yield curve continues to flatten, or even invert, that certainly does not suggest economic optimism from the bond market. While an inverted curve per se wouldn't really harm the economy, the equity market would likely interpret it negatively, impacting valuations and causing a rise in the ERP. [2]

In terms of the tariff question, we are optimistic that cooler heads will prevail and that impediments to global trade will not spin out of control; however, we do recognize the downside case. In that event there would be little *direct* impact on the PVP portfolio companies, given the commodities being currently discussed. On the other hand, if this were to play out in draconian fashion, most every multinational does business in China, so those expectations would likely have to reset. Moreover, such a scenario would likely cast a big shadow over the entire market, raising the ERP.

"Growth" stocks continued to outperform "value" stocks in the quarter, which is an ongoing headwind for value-oriented investors like PVP. We don't pretend to know when that might reverse, but we would observe that we are now in the tenth year of the current "growth cycle". We may not be in the ninth inning, but we sure aren't in the first inning either. In the meantime our cash flows and book values continue to compound, as we wait for the market to reward us appropriately.

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[1] *QE = the Fed's response to the Financial Crisis of 2008*

[2] *Flat Yield Curve = the diminished differential between yields on long term bonds vs. short term bonds; ERP = market free cash flow yield, less the long bond yield (higher ERP = "cheaper" stocks).*

Energy, a notoriously volatile sector, was the top performer for the quarter on the heels of the performance of the commodity. Consumer discretionary, real estate and technology were the next best performing sectors in the quarter. Financials, industrials and staples were, respectively, the weakest sectors this quarter. Financials represent our largest sector exposure. As staples have continued to be weak, we have been adding to positions in some of these defensive names. We have little representation in industrials currently, as we see a good deal of cyclical risk with generally unattractive valuations.

Overall the portfolio is positioned relatively defensively, with a current beta of 0.83. At the same time, we do also have a large representation in financial stocks, which are likely to generally behave "offensively" in a rising rate environment, but whose generally low valuations also offer some margin of safety.

In aggregate **PVP was down 0.1% in 1Q18, and is now up 36.4% (14.0% annualized) since accepting our first partner capital in February of 2016.** [3] 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.

<u>Actions taken in 2Q18</u>

Buys in the quarter

The recent uptick in volatility has provided us with several exciting new opportunities to deploy capital. For instance, we had previously owned **YumChina (YUMC)** shortly after its IPO in late 2016, but it appreciated very quickly and we took profits. In 2Q 2018, however, the stock fell out of favor and we were able to repurchase it at a discount to where we previously sold, even though the company has grown nicely since then. In spite of having, in our view, much brighter prospects than its US peers, this operator of KFC, Pizza Hut and Taco Bell restaurants in China trades at a significant discount to them.

Macquarie Infrastructure (MIC) is another stock we had owned previously, but sold late last year when our channel checks suggested the potential for weakness in one of its larger businesses, IMTT, which stores bulk oils. It turns out we were fortunate to have exited, as the stock sold off considerably in February on an earnings miss in that business. With the stock now trading at a quite attractive 15% FCF yield and a 9.6% dividend yield, and that hiccup now behind the company, we believe MIC is again quite attractive here.

Air Lease (AL), led by the legendary industry pioneer Steven Udvar-Hazy, is one of the world's largest aircraft lessors. The company leases to 93 airline customers in 56 countries, and boasts a formidable track record of buying, leasing and sometimes selling planes. When Air Lease recently announced a stock sale, it gave us the opportunity in the stock. AL now trades at about BV and just 9x earnings.

Sherwin Williams (SHW), the paint and coatings maker, is an example of the kind of stock that rarely falls into "value" territory; however, earlier this year the company fell under heavy scrutiny for its rising input costs; its substantial new investment in a relationship with the retailer, Lowes;

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

and its recent acquisition of former competitor, Valspar. We believe that, given time, all these factors will become positives: SHW will pass on higher input costs; it will benefit from increased sales at Lowes; and it will continue to see synergies from the Valspar acquisition.

Crown (CCK), the former Crown Cork and Seal, like our Westrock and Sherwin Williams holdings, is a leader in an industry (aluminum cans) that has become increasingly oligopolistic and disciplined over time. Our opportunity was created when Crown recently acquired Signode, a complementary business, which the market has received with some skepticism due to the higher leverage resulting from the transaction. With a 10% FCF yield, the company has committed to deploying that FCF toward quickly paying down that debt, which should in turn lead to a better valuation.

During the quarter Wyndham Worldwide effectively split into two companies: **Wyndham Destinations (WYND),** the world's largest vacation "time share" company; and Wyndham Hotels and Resorts (WH). We believe Wyndham Destinations (WYND), on a stand-alone basis, with about 75% of revenues recurring annually, is especially compelling. It trades at a discount not only to its smaller peers but also to what we consider its intrinsic value. In time, as the time share piece becomes better understood as an independent publicly traded company, we believe investors will reward WYND with a more appropriate valuation.

Sells in the quarter

Hamilton Lane (HLNE), the Private Equity consultant and fund of funds provider, is a stock we have now bought and sold twice in the company's very brief history as a publicly traded company. This level of turnover is unusual for us, but when we see such opportunities we do our best to capitalize. Most recently we acquired HLNE in March after a secondary offering had taken the stock down, and in May we sold it for a quick 23% gain, after again it had passed through our Price Target (PT).

We had previously taken some profits in **Honeywell (HON),** the diversified industrial conglomerate. With a small remaining position, the stock continued its upward climb through our PT, and was a modest contributor in the quarter, so we sold the remainder.

InfraReit (HIFR) was one of the relatively small number of companies that will be hurt, rather than helped, by the recent tax reform legislation. Notwithstanding HIFR's strong cash flows and high dividend yield owing to its unique position as the first and only REIT to own high quality utility transmission assets, tax reform alters the company's profile in a way that does not benefit shareholders. Still, HIFR was modestly positive in the quarter.

We were way too early on **General Electric (GE).** We were initially encouraged by the plan put in place by the company's new CEO, believing there might be various ways to create value for shareholders. Alas, turning around this battleship will likely be a much more lengthy and difficult process than we had previously believed. GE, which had been a small position, was a modest detractor in the quarter.

While we believe there is likely still much value in **Dish Networks (DISH),** we sold DISH because the company, rather than monetizing its spectrum assets (as the market had assumed), has decided to build out its own network. This strategy may or may not have merit, but the level of new investment this will require does completely alter our investment thesis. DISH was a detractor in the quarter.

Strong performers in 2Q18 [4]

Booz Allen (BAH), the cyber security consultant to the Federal government, had another exceptional quarter, with great ongoing future visibility, as backlog grew 18% and "book-to-bill" was 1.39. Clearly the demand for government cyber security is robust. Though we have taken some profits, BAH remains reasonably valued at 18x earnings and a 5+% FCF yield for a company with its growth characteristics, and was up 13% in 2Q18.

Hamilton Lane (HLNE), as discussed above, continued its impressive albeit short history as a public company, again "beating" estimates for the quarter and increasing future expectations. Again, this stock moved up so quickly that it surpassed our TP, so we sold it.

Nextera Partners (NEP), the alternative energy (solar and wind) provider, like most other high-yielding stocks, did well in the quarter as diminished market expectations about rate hikes made dividends relatively more attractive. NEP still trades at an attractive yield of 3.5%, with a dividend that we expect to grow nicely over time, and the stock was up 18% in the quarter.

Palo Alto Networks (PANW), which provides network security solutions mostly to corporations, had another standout quarter, with both billings and product revenue growth of more than 30%. PANW is now up more than 45% in 2018, yet still trades at just under a 5% FCF yield.

Post Holdings (POST), the manufacturer of cereal and other food products, continued to make excellent progress in optimizing its portfolio, and was finally rewarded somewhat in 2Q18 when it was reported that the company was in discussions to sell its private label food business. The $1 billion plus of proceeds of such a transaction could either pay down debt or else be used to acquire something more complementary to Post's core offerings. POST still trades at a 10+% FCF yield, and the stock was up 14% in 2Q18.

Weak performers in 2Q18

Mylan (MYL) can be a very "noisy" and volatile stock. In the most recent quarter questions developed around Mylan's manufacturing capabilities for what will eventually be its generic version of the blockbuster drug, Advair. This is part of life in the generic drug business, and we are confident that the company will resolve the issues in short order. At less than 7x earnings, MYL is a very cheap stock, and was off 12% in the quarter.

Westrock (WRK), the packaging company, had another excellent quarter as it continues to benefit from major secular trends like e-commerce and food delivery; however, fears developed around input costs and then trade, which caused WRK to sell off 10% in 2Q18. Currently trading at a 10% FCF yield, in our view WRK is very attractively valued.

Even though **Goldman Sachs (GS)** generated its highest ROE (15+%) quarter in quite a long time, fears around interest rates and the yield curve prevailed, and GS sold off 12% in 2Q18. We believe GS is quite attractively valued at 1.2x BV and less than 10x earnings, even as its large

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[4] *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.*

bond business (FICC) finally turns around and regulatory burdens abate, freeing up capital to be potentially returned to shareholders.

Voya Financial (VOYA), as part of its ongoing transformation, completed the successful sale of its low return, legacy annuity business in the quarter. Like GS, however, concerns about the pace of Fed rate hikes weighed on the stock, and VOYA sold off 7% in the quarter. VOYA now trades around BV and at 10x earnings.

MGM Resorts (MGM), one of our relatively few high beta, economically sensitive holdings, had a somewhat disappointing quarter, as business was challenged at two of the company's Las Vegas properties (Mandalay Bay and Monte Carlo), and investors also began to worry about the impact of a US-China trade dispute on MGM's business in Macau. We are confident the company will get through these challenges, which took 17% out of the stock in 2Q18.

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 less leverage and better growth. Relative to the Russell 3000 Value index, PVP's valuation is cheaper, yet PVP's margins and returns are substantially better.

	PVP [5]	Russell 3000	Russell 3000 Value
Free Cash Flow yield (2018)	6.6%	4.8%	5.3%
Price/Earnings (2018)	14.8x	17.5x	14.3x
Debt/Total Capital	40%	43%	40%
Debt/EBITDA	2.7x	3.1x	3.4x
2018 revenue growth	9.0%	7.8%	4.9%
2018 eps growth	16.1%	13.7%	21.6%
2018 EBITDA margin	32.1%	18.9%	18.2%
2018 Return on Equity	18.7%	17.3%	13.5%
2018 Return on Invested Capital	12.6%	7.4%	6.0%

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

To put PVP's FCF yield of 6.6% 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 3.3% (6.6-3.0). At this level we believe we are being appropriately compensated to bear the risk of equities.

Finally, as some small compensation to those who have made it this far into the letter, you might be interested to know that your humble scribe was featured recently on Bloomberg TV, which can be accessed at: https://www.bloomberg.com/news/videos/2018-07-02/prospective-value-partners-cio-sees-opportunities-in-financials-video I believe both of the stocks mentioned were down the next day. Oh well, back to the day job…

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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