July 14, 2020

Dear PVP partners and friends

As economies around the world reopened and began to crawl back toward something approaching normalcy, and confidence grew that coronavirus treatment(s) and or vaccine(s) would be forthcoming in a reasonable time frame, **the equity market, buoyed by quite massive fiscal and monetary stimulus, continued its rebound in the quarter.**

Many observers have commented recently on what seems to be a disconnect – an economy that, while clearly beginning to heal, is very much still in pain; yet a stock market that has raced back since late March and is now down not really so much since the pandemic began. We believe one major factor at work is that a massive share shift has taken, and is taking, place: from small businesses, generally without the resources and access to capital to withstand the current situation, to large businesses, which have been able to get by (and in some cases thrive) in these very challenging times.

Consider the case of our Walmart (WMT), with annual sales over half a trillion dollars annually, whose US same-store revenues grew 10%, and whose e-Commerce revenues grew an astounding 75%, in 1Q20. We believe this share shift is currently relatively underappreciated, but will likely have profound implications for US society, its economy and its stock market.

With more fiscal stimulus likely forthcoming in short order, a Fed that is in "whatever it takes" mode, and multiple companies (with FDA encouragement) racing toward a vaccine, **there are plenty of reasons to be optimistic.** On the other hand, the virus has also continued to spread (though fortunately mortality rates have slowed down significantly), and the permanent damage to certain sectors of the economy, as well as potential changes in consumer behavior, remain very difficult to forecast. In addition, this is an election year, and since the pandemic began the likelihood not only of a President Biden in 2021, but (more importantly) a Democratic majority in the Senate has increased, with potentially negative implications for equities.

Last quarter we wrote that we were surprised by the violent bounce back upward of equities at the end of the quarter. Well, we remain surprised that trajectory mostly continued this quarter. **We have continued to be relatively cautious** – as we will discuss below, taking profits when our stocks hit their Target Prices (TP) and deploying those proceeds into companies that we believe are well positioned for the current environment as well as whatever the future holds. Last quarter we also discussed in detail our companies most exposed to the pandemic and response. We remain confident in our holdings to ride out this storm – some better than others, of course – but the timing of real economic recovery is impossible to predict with any certainty.

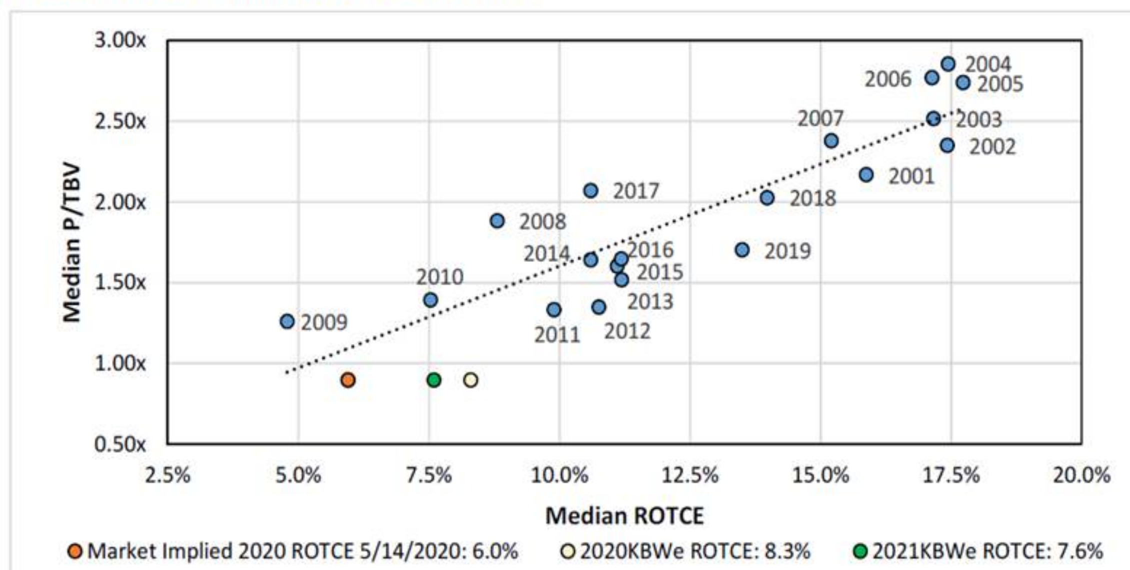
In terms of investor style preferences, **growth continued to outperform value** in the quarter, as technology, with its annuity-like business models that don't require so much human interaction, continued not only to act as a relative "safe haven" but also to gain share over sectors that cannot function normally with "social distancing". In our view, this is the other major factor driving the

apparent "disconnect" between the real economy and the stock market: Technology has grown to be such a significant percentage of major indices (and especially the "growth" indices) that great technology stock performance can mask real weakness in most other sectors.

At the other end of the spectrum are the financials, which have bounced considerably off the bottom but do continue to be laggards. With companies increasingly learning how to navigate a virtual office environment, the market has begun to seriously question the value of commercial real estate, with profound implications for the REITs. Fortunately we have no direct exposure here. In insurance, where we have healthy representation, the market is grappling with, among other things, the extent of Business Interruption (BI) exposure; however, in insurance bad news is often good news, and so the industry has responded with an acceleration in premium pricing – a very healthy reaction to what had been a nascent firming market.

In the banks, where we also have substantial exposure, clearly the market continues to assume major impairments to Book Value (BV) due to heavy loan losses. We certainly still expect there will be loan losses, but suggesting that they rise to the point of materially impairing BV seems like a worst case scenario -- yet that is what the market seems to expect per the charts below. The first chart shows bank Price/Tangible Book Value (P/TBV) ratios over time. On this basis the banks are about as cheap as they have been since the 2008 financial crisis – even though returns have improved – with a valuation suggesting they are worth just slightly more alive than liquidated. In the second chart, as shown by the white and blue dots well below the regression line, banks also remain very cheap relative to expected returns.

Exhibit 7: Time Series ROTCE and P/TBV



Data as of 5/14/2020.
Source: Bloomberg and KBW Research.

In aggregate **PVP was up 15.2% in 2Q20, and our annualized return since accepting our first partner capital in February of 2016 is now 7.3%.**[1] Looking forward, as we shall discuss below, our portfolio's current Equity Risk Premium (ERP) of 8%, while down from last quarter, continues to be extremely attractive, historically speaking. As always, we encourage our partners to take a long term view. We believe we will be compensated for this very healthy premium, we just don't know quite when.

Actions taken in 2Q20

Buys in the quarter

We were somewhat less active than usual in the quarter, watching and evaluating the simultaneous evolution of the pandemic and market reaction. Out of caution, our purchases were not necessarily the companies hardest hit by mandated "social distancing", but rather were a few very high quality companies for which we might not ordinary be inclined to "pay up", companies that are either unaffected by or actually benefiting from the current situation, and that we believe have very favorable prospects long after it passes.

Arch Capital (ACGL) is a property/casualty insurer and reinsurer with a tremendous long term track record of profitable underwriting and value creation. We have written previously about a long-awaited upward turn in p/c pricing – which has been slowly occurring – but the pandemic has caused p/c pricing to inflect upward to, most recently, increases of high single digits % in primary insurance and 25% in reinsurance. Arch's CEO has likened the current situation to the "hard market" just after the 9/11 tragedy – which was indeed a very good time for insurance stocks. In spite of the better pricing environment, ACGL is down 33% ytd and now trades at a

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

very slight premium to BV. In late June Arch, taking advantage of its clean Balance Sheet, raised $1 billion of cheap debt as dry powder in order to take advantage of the significantly better industry pricing.

Amphenol (APH), a stock we have owned in the past, is a very high quality maker of cables, connectors and other products essential for the growth of the interconnectedness that has been in place for quite some time, but now has accelerated as a result of "social distancing". APH is never a "cheap stock", but with it now down 12% ytd and bearing a 4+% Free Cash Flow (FCF) yield, we find it an attractive way to participate in the ongoing communications revolution within the context of a value discipline.

Berry Global (BERY) is a manufacturer of (mostly plastic) packaging for a very wide range of essential consumer products, such as food, medicines, cleaning and hygiene/safety. The pandemic has only enhanced the company's value proposition to customers, and so Berry is actually growing revenues faster as a result of the current situation. The company is also a prolific generator of FCF, and this year the company expects FCF of at least $800 mm (on a market cap of less than $6 billion). The stock is currently down 5% ytd.

Carrier Global (CARR) is the HVAC company, once part of United Technologies (UTX), that was spun out to shareholders as part of UTX's merger with Raytheon (RTN) to form Raytheon Technologies (RTX). It is a very small position, and we are currently evaluating our options.

Exits in the quarter

BJ's Wholesale (BJ), the warehouse club retailer, has thus far vastly exceeded expectations during the pandemic, breezing through our TP, and in May we sold our remaining position in the low-mid 30s, which we had acquired in 2H19 in the low-mid 20s. BJ is a relatively small and occasionally quite volatile stock, so we will continue to look for re-entry opportunities.

YumChina (YUMC), which operates KFC and Pizza Hut restaurants in China, has also performed exceptionally well during the pandemic. As China re-opened ahead of most of the rest of the world during the quarter, YUMC hit our PT and we sold the stock up modestly ytd. As with BJ, we continue to like the long term growth prospects here, so we will continue to monitor YUMC.

In 1Q the renewable energy provider **Terraform (TERP)** agreed to be acquired by Brookfield Renewable Partners (BEP). While there was for some period of time considerable skepticism that the deal would be consummated with the pandemic raging, in April we sold the stock as the price closely approached the proposed transaction price.

Over time the software provider **Oracle (ORCL)** was a very good investment for us, and near the beginning of the pandemic the stock had approached its TP. As it proved quite resilient through this challenging period, we sold the remaining piece up modestly ytd in April.

Otis Worldwide (OTIS), like Carrier (discussed above), was spun out to shareholders as part of the transaction that created RTX. Although Otis is a very high quality business, it was spun out at a valuation that was not particularly compelling. As the stock moved up rapidly even from there, we sold the stock.

Strong performers in 2Q20 [2]

Amazon (AMZN), one of our top performers in 1Q, continued its hot streak in 2Q. with the stock up 42%. The company continues to thrive in the current environment strongly favoring e-commerce, to the detriment of much of traditional retail. We would be hard pressed to call Amazon a cheap or "out of favor" stock, and so we have taken profits, but its remarkable ability to disrupt and innovate keeps us involved in the stock.

In mid-May cyber security software provider **Palo Alto Networks (PANW)** announced both quarterly results and forward "guidance" that exceeded investor expectations – at a time when most estimates were coming down. Our recent add to the position was fortuitous, as the stock was up 40% in 2Q20. PANW is unusually attractive in that its products benefit from a strong secular growth tailwind, resulting in a quite robust top line, even as the company also generates plentiful FCF, giving it a good deal of optionality in terms of capital deployment.

Cheniere Energy (LNG), the natural gas liquefaction company, was severely depressed in 1Q, with both the energy freefall and coronavirus severely impacting investor perceptions around the stock. We were fortunate to have added considerably to the position in the period, since the company exceeded expectations for the quarter and the stock was up 44%. In addition, in mid-June the company was able to take advantage of the current interest rate environment and refinanced a sizable portion of its debt at much more attractive rates.

Williams (WMB), the gas pipeline company, like Cheniere and most of the energy sector, was under severe pressure in 1Q, but bounced back 37% this quarter. Again, like Cheniere, we were fortunate to have added significantly to the position in that period. Even after the re-rating of the stock in the quarter, it still boasts a dividend yield of almost 9%.

BJ's Wholesale (BJ), like Amazon, was one of our best stocks in both 1Q and 2Q. As we discuss above, the company vastly exceeded expectations as customers continue to discover BJ's wholesale club value proposition in these challenging times. The stock was up 46% in the quarter, surpassing our Price Target, and we sold the final piece. A volatile stock, we have been quite impressed with the company's execution since its IPO two years ago, and we will continue to monitor it for an attractive re-entry point.

Weak performers in 2Q20

Biotechnology company **Biogen (BIIB),** one of our strongest stocks in 1Q, was our weakest performer in the quarter (off 15%), mainly on two news items: First, its final filing for the potential approval of Aducanumab for Alzheimer's Disease with the FDA was delayed, which temporarily spooked investors regarding that drug's likelihood of approval. (The filing was completed in early July.) Second, the legal battle over the intellectual property (IP) of one of Biogen's major MS drugs (Tecfidera) continued, most recently with a West Virginia court ruling that one of its patents is invalid. This is not unusual in the squabbles between biotechs and generic companies, and so Biogen will appeal the ruling, and we shall continue to monitor the situation.

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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. Please note that, due to a current technology glitch, for 2Q20 these top and bottom performers are estimates.*

Enstar Group (ESGR), off 4% in the quarter, is a company that tends to outperform when other insurers get into trouble. It is thus a defensive holding in the context of insurance, so as 2Q was a "risk-on" quarter, Enstar underperformed. In addition, the company's investments were marked down considerably in 1Q as "unrealized losses", which resulted in a hit to Book Value (BV). We expect those unrealized losses to largely revert in 2Q. ESGR currently trades at about 90% of a 1Q BV that is likely quite understated.

Berkshire Hathaway (BRKB), our second largest position and also a relatively defensive holding in a quarter that preferred offense, was off 2% in the quarter. Like Enstar, Berkshire's operating earnings were fine in 1Q, but its earnings and BV were down considerably due to unrealized losses in its investment portfolio. Berkshire currently trades at a modest premium to its understated 1Q BV.

It was not a great quarter for health care, and electronic medical records provider **Allscripts (MDRX)** was down 4%. While its mostly annuity-like business model held up well, resulting in a profitable first quarter, its new business bookings were down considerably, which is certainly understandable in a pandemic, but it does not bode so well for future growth, and with 2020 guidance withdrawn (like many other companies) investors have decided to currently view this glass as half empty.

The leading global fertilizer company, **Nutrien (NTR),** recently purchased, suggested some degree of caution regarding a recovery in the ag cycle in its 1Q call. In a quarter in which economic cyclicality (not ag cyclicality) was generally well rewarded, Nutrien was a laggard, down 4%. The current ag challenges notwithstanding, we still expect Nutrien to generate Free Cash Flow this year in excess of 10% of its market cap, and the company's dividend yield is just under 6%.

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 still impossible to estimate now anyway, we are continuing to use 2019 data as a starting point. The numbers below have changed a bit, 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 extraordinarily high at 8% (9.3% FCF yield less 1.3% 30-year UST). At this level we believe we continue to be very well compensated to bear the risk of equities.

	PVP [3]	Russell 3000	Russell 1000 Value
Free Cash Flow yield (2019)	9.3%	4.3%	5.1%
Price/Earnings (2019)	14.2x	18.9x	14.4x
Debt/Total Capital	46%	45%	43%
Debt/EBITDA	2.7x	3.3x	3.7x
2019 EBITDA margin	30.8%	19.3%	19.1%
2019 Return on Equity	17.7%	17.6%	14.1%
2019 Return on Invested Capital	13.1%	6.8%	5.4%

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.*

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