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VALUE PARTNERS
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Dear PVP partners and friends

After a very challenging first quarter of 2022 for most asset classes, **the most recent quarter began with extreme negative sentiment.** According to strategist ISI, in April only 16% of individual investors were bullish (a 30 yr low!), while institutional investors were the most bearish since the "covid quarter" in Spring 2020. While from a contrarian standpoint that negative sentiment likely bodes well for future returns, in the very short term the accelerating negativity exacerbated an already very challenging investment environment. **The result year-to-date has been by some measures the worst start of the year for equities since 1970.**

**What began as a rate-driven rotation from growth stocks into value stocks in 1Q evolved this quarter into a more general market downdraft.** Rates did continue to climb across the yield curve, driven by still-elevated inflation data as well as the anticipated (hawkish) Fed response to that inflation. And in fact, **in June the Fed raised the Fed Funds rate by 0.75% — the most it has done so in one fell swoop since 1994.**

**This aggressive Fed response in turn raised the spectre of recession**. The technical definition of recession is two consecutive quarters of negative *real* GDP growth. Since (revised) 1Q real GDP growth was -1.6%, it is possible that we are currently in a recession – time will tell. This has become the overwhelming consensus view. As an example, in early June JP Morgan (JPM) CEO Jamie Dimon, whom we respect a great deal, articulated a very ominous view at an investor conference, warning that there are not "storm clouds" but rather "a hurricane" on the horizon, adding that nobody knows if it is "a minor one or Superstorm Sandy".

**But if we are in a recession, it is certainly a most unusual one** – one with very little unemployment, one that is not suggested by PMI's and company surveys and other economic data, and also one that is not being anticipated by the bond market -- either in terms of the usual increased spreads over UST that bond investors require to compensate for credit risk, or in terms of an inverted yield curve.

Regarding the latter, it is somewhat strange that as the yield curve has come close to inverting we have frequently pointed out that, even though inversion has preceded every recession for decades, this does not *guarantee* a recession. Yet today we observe a yield curve that is not particularly steep, but it is also not inverted. The bond market seems to currently believe that inflation is coming under control, and that the actions of the suddenly hawkish Fed will not throw us into recession.

So while we would never be flip or dismissive about something as serious as a recession, in our view a recession, whether current or imminent, is not a foregone conclusion. Certainly things have slowed. But even if so, it seems likely mild and also likely (excuse the expression) "transitory". Supply chains will eventually improve, inflation is possibly peaking, and maybe we could even get lucky with a cessation of hostilities in the Russia-Ukraine war.

At this point the market has perceived the economic slowdown/recession and discounted stocks accordingly. If the economy is worse than current consensus, and there is a deep recession, there is likely more downside for stocks. If we escape recession or if it is quick and mild, we believe there is considerable upside in the short/medium term. In our view, though, the Fed is the biggest wild card. If the Fed continues its 180-degree reversal from recent years with an aggressively hawkish posture, not only will equity markets be disappointed, but the deeper recession scenario then also becomes that much more likely.

Shifting from macro to micro, supply chains and materials inflation continue to be a problem for many if not most companies. As our holding NCR (NCR) said on its most recent earnings call: "On a device that only costs $1,200 to have a $400 increase in a chip is pretty painful." These challenges and others wreaked havoc on the results of several companies previously held in extremely high esteem by investors – an especially unhappy combination when the market is already in such an unforgiving mood.

Last quarter it was Meta (ticker "FB" -- the company formerly known as Facebook) that dropped 26% (a quarter of a trillion dollars in market value) in just a day. This quarter it was Netflix's (NFLX) turn. In mid April Netflix – like Meta a proud member of the once seemingly invincible stocks known as the FAANGs – dropped an astonishing 35% in a day after disappointing investors. Then in mid-May Target (TGT), one of the very few investor darlings among retailers, dropped 25% after largely blaming less-than-expected profitability on (you guessed it!) higher freight and supply chain issues.

In terms of stylistic and sector performance, **value continued to handily outperform growth** in the quarter, especially the more "defensive" sectors (consumer staples, health care, utilities, etc.) that comprise value portfolios. Because the equity market now expects recession, the more economically sensitive "value sectors", such as financials, energy and consumer discretionary, were particularly weak. In the "growth sectors", meanwhile, **technology remained particularly challenging.** In terms of size as a factor in returns, interestingly, small value outperformed large value – not what one would generally expect if a recession were imminent, but possibly a function of the strong dollar, which is more likely to hurt the exports of the larger companies than the smaller ones whose operations are more domestic. On the other hand, large growth outperformed small growth – probably an ongoing purge of the "profitless tech" part of the market that has been most frothy in recent years.

**There have been very very few places to hide so far this year.** Whereas we were largely able to "dance between the raindrops" in the first quarter, more recently the rain became torrential, dragging most everything down. While we are not happy with 2022 performance so far, we take some consolation that we have outperformed (or, rather, done less badly) than most every major equity index. And even major bond indices are down in the double digits for the year. Most importantly, we have not locked in losses in the downdraft. We only sold one stock in the quarter (see below), at a healthy profit.

Moreover, as we discussed last quarter (and in more detail below), **we continued to try to pick up quality assets "on sale" during the drawdown.** While we have watched them sometimes continue to sink lower after buying them, we still believe they will ultimately prove to be excellent investments. And we continue to lick our chops, and sharpen our pencils, as some of the values out there become even more compelling.

In aggregate **PVP was down 13.5% in 2Q22 and down 11.9% year-to-date in 2022, with an annualized return since accepting our first partner capital in February of 2016 of 10.6%.**[1] Looking forward, as discussed above, our portfolio's current Equity Risk Premium (ERP) of 6.1% (9.2% portfolio FCF yield, less 3.1% 30 yr UST) is extremely attractive in our view, even in a rising rate environment that is generally a headwind for equities.

## Value creation

It is one thing to own a portfolio of cheap stocks. It is quite another thing to own shares of companies whose management teams think and act like owners rather than employees, principals rather than agents. CEOs of larger companies generally are paid better, so naturally the inclination of many companies is to grow – sometimes just for the sake of growth, sometimes with disastrous results. But we strive to own companies with management teams who think like shareholders. Such recent shareholder-friendly, transformative actions in our portfolio include:

- **XPO Logistics (XPO)** spin out of **GXO Logistics (GXO) –** both of which we currently own. XPO also recently sold its North American intermodal business, and plans to separate its remaining business in two: truck brokerage and less than truckload (LTL)
- **AT&T (T)** combining its entertainment assets with Discovery to create **Warner Brothers Discovery (WBD)**
- **Post's (POST)** spin out of faster-growing breakfast protein company **BellRing Brands (BRBR)**
- **Adtalem's (ATGE)** divestiture of its legacy Devry Education and financial services assets, and its acquisition of complementary business Walden Education
- Spin out of industrial technology firm **Vontier (VNT),** currently owned, from our former holding, Danaher (DHR)
- **Macquarie Infrastructure's (MIC –** formerly held) divestiture of nearly all its operating units, resulting in nearly a complete liquidation, with sales proceeds returned to shareholders, resulting in a sum of the parts greatly in excess of MIC prior to the transactions
- **Perrigo's (PRGO)** sale of its generic drug business and acquisition of complementary unit HRA Pharma

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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 addition, below is a partial list of companies in our portfolio that are *currently* not content with their valuation, and are willing to creatively transform themselves in some fashion in order to create shareholder value:

**Rackspace Technologies (RXT):** Rackspace is the technology service provider that helps small/midsized companies migrate their IT to "the cloud". Even though the company is a significant player in an industry with substantial secular growth, RXT trades at less than 10x expected earnings this year, with a whopping 16% FCF yield. In its most recent quarterly earnings call, the company disclosed that it believed its stock was materially undervalued and that, as a result of inbound interest, it was exploring "strategic options" (sale of unit or possibly entire company). Given that Rackspace had been previously owned as an LBO by Apollo, the disclosure would seem to have credibility, yet RXT has only declined further since then.

**NCR (NCR),** which began its corporate life as National Cash Register in Dayton, OH, in 1884, continues to evolve. While still mostly known as a manufacturer of ATMs, in recent years NCR has transformed itself considerably by leveraging its technology and relationships to become a leading provider of transaction software – a much faster-growing and higher-valued business than the more mature hardware unit (which does continue to provide abundant FCF). This progress, however, has been mostly unrecognized by the market, as NCR currently trades at 10x earnings and at a 10+% FCF yield. In its most recent quarterly earnings call NCR announced that its board had commenced a "strategic review" and would consider various ways for shareholders to benefit from the value that has been created in recent years. Interestingly, like Rackspace, the stock has only continued to drop after the announcement.

Sometimes these steps toward value creation arrive through "activist investors" who become shareholders with a specific agenda for corporate action. In the case of data storage provider **Western Digital (WDC),** the activist firm Elliott management has taken a 6% stake in the company with the "suggestion", among other things, that WDC spin out its flash memory business. Although it is often the case that management fights activists and their "suggestions", in this case Western Digital quickly concluded that it agreed with Elliott, that "exploring potential strategic alternatives" would make sense. WDC currently trades at just 6x earnings and at a 13% FCF yield.

Several of our portfolio companies demonstrate that major change can happen even in the normally staid financial services industry. Life insurance is the legacy of **Principal Financial Group (PFG),** yet over time Principal is shedding life, annuities and other capital-intensive businesses and focusing on "asset lite" retirement solutions and asset management. This frees up capital (which is returned to shareholders in the form of dividends and share buybacks) and also enhances returns. PFG currently trades at 10x earnings and at a modest premium to BV. Life insurance is also the legacy of **Voya Financial (VOYA),** though the history is more complicated – Voya was the US unit of Dutch financial services company ING, which was forced to sell it in the wake of the financial crisis. Voya is undertaking many of the same actions as Principal, and trades at a similarly cheap 9x earnings and at a small premium to BV.

It took **American International Group (AIG)** quite a few years after the trauma of the financial crisis of 2008 to regain its footing. But today AIG has finally restored its house to order, and has been reporting consistently profitable underwriting results, yet this progress does not seem reflected in the current stock price. AIG has already sold 9.9% of its massive Life & Retirement division to Blackstone, and the company's next big step will be to sell that unit to the public in an

IPO possibly later this year. AIG currently trades at just 70% of BV. In the case of **Citigroup (C),** with a very long and complicated history of global expansion, it took a new CEO (Jane Fraser) to arrive on the scene and demonstrate a willingness to take on some sacred cows. In her first year in the seat Fraser has determined that Citi is due for a shakeup, and plans are in place to divest some of the company's far-flung (and often less profitable) operations, with the proceeds likely fueling share buybacks and dividend increases. Citigroup is the cheapest of the big US banks, now trading at just 7x earnings and at about 50% of BV.

Finally, even the venerable **Johnson & Johnson (JNJ)** has shown a willingness to take major steps to create shareholder value. In November 2021 the company announced its plans to spin out its consumer business – home to some of the best-known brands in the world -- which will result in an exclusive focus on higher-growth pharmaceuticals/biotech and medical devices.

**<u>Actions taken in 2Q22</u>**

***Buys in the quarter***

**GXO Logistics (GXO)** is one of the world's leading logistics providers. As you may remember, we owned GXO after its spin off by former parent XPO Logistics (XPO) but just last November we sold GXO at about $102, and it sits today at $44. We are excited to own this stock again, with very compelling secular growth prospects as the whole world struggles with supply chain issues, and at a valuation of just 8x EV/EBITDA.

**PayPal (PYPL),** the technology platform for various kinds of digital payments, is a company we have admired since it was a subsidiary of eBay (EBAY), which we also used to own. But as it grew quickly as an independent company, it attracted a cult following and became increasingly much too expensive for us. In the last year, though, the stock is down more than 75%. In our view, this has presented a wonderful opportunity to own a leader in a secular growth industry at a very healthy FCF yield of over 6%.

**RH (RH)** is the company better known as Restoration Hardware, the retailer of high end furniture. Like PayPal, RH is a former highflyer in a market that has not been kind of late to stocks with that profile. Also like PayPal, it possesses so many of the characteristics we seek in companies – leading market position, very high ROIC, etc. – but had heretofore been too expensive for us. With the stock down about 70% in the past year, and with a current FCF yield exceeding 10%, we believe we are being quite well compensated to bear the risk of a recession.

**Warner Brother Discovery (WBD)** is the new entity created by the merger of Discovery and the entertainment assets of AT&T (T). The company owns Warner Bros. Pictures and HBO, as well as such well-known brands as CNN, TCM, TNT, TLC, and the Discovery Channel. WBD was spun out to us as AT&T shareholders. A small position for us, but one that might be pretty interesting, we are currently evaluating our options with this one.

***Exit in the quarter***

In April we sold **Lyondell Basell (LYB),** the chemical company, which had reached our price target, for a 36% profit in a year and a half. The timing was fortunate, as by the end of 2Q22 LYB was back down into the 80s as investors anticipate a global slowdown.

## Strong performers in 2Q22 [2]

Not surprisingly, given the recession expectations, our strongest stocks in the quarter were generally economically insensitive. **Adtalem Global Education (ATGE),** the health care education company, was up 21% in the quarter. The company has had some messy quarters lately, as it has been pruning its portfolio and redeploying the proceeds from those divestitures, integrating its acquisition of Walden Education and coping with the impact of covid on its schools. In May, however, Adtalem exceeded analysts' expectations and also raised its guidance for the year.

**Post (POST),** maker of cereal and other consumer packaged goods, benefited in the quarter not only from investor perception of its economic insensitivity, but also from extremely healthy results with organic revenues up 12%. Investors were particularly heartened by the company's ability to pass through its price increases. Post also has a history of value-creating transactions for shareholders, such as its recent spin-off of BellRing Brands (BRBR) – which we still own. POST was up 19% in the quarter.

**Perrigo (PRGO),** maker of various consumer self-care and OTC health products, has been profoundly transforming itself in recent quarters, divesting its generic drug business and acquiring a UK consumer product business, HRA Pharma. Perrigo's covid experience was very challenging, with social distancing resulting in far fewer colds and coughs, etc., and thus lower Perrigo revenues. This quarter, for the first time in quite a while, Perrigo met expectations with very healthy 10% organic growth, driven by the return of cough/cold and also a boost from infant formula. PRGO was up 6% in the quarter.

Cyber security provider **Booz Allen Hamilton (BAH)** is benefiting both from an ever-increasing need for cyber security and also the enhanced focus on defense spending in the wake of the Russian invasion of Ukraine. With a $29 billion current backlog (vs. annual revenues of $8 billion) and an extremely healthy current book/bill ratio of 1.7x, we believe BAH's future remains bright. The stock was up 3% in the quarter.

**Lyondell Basell (LYB),** discussed above, was up 6% in April before we sold the stock.

## Weak performers in 2Q22

One of our top performers in recent quarters, **Berkshire Hathaway (BRKB),** with its diverse array of holdings, was down 23% in 2Q22. Berkshire's operating companies generally performed well, but the company's very large investment portfolio suffered *unrealized* losses in the equity and bond market downdrafts. Berkshire, like us, will not be selling into weakness, so those losses

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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.*

are not likely to become *real*. Down 23% in the quarter, Berkshire now trades at a modest premium to BV – and BV is certainly understated.

Our tech exposure has grown but is still not large, so we have been able to avoid much of the carnage in the sector; however, in one of our most ill-timed purchases ever, just last quarter we established a position in **Digital Turbine (APPS),** the mobile phone advertising aggregator. In its most recent quarter the company grew organic revenues 19% and EBITDA by 124%, but also modestly lowered expectations for the following quarter and also made a minor adjustment in its financial reporting – enough to provide added ammunition to those who are bearish on the company and the stock. Shares currently trade at just 8x EV/EBITDA and with a 10% FCF yield. APPS was down a whopping 60% in the quarter.

Fertilizer company **Nutrien (NTR),** one of our best performers last quarter, was down 23% in 2Q22. Fundamentals remain very strong at Nutrien – unsustainably strong, in fact. In 2020 NTR earned just 85c a share. This year it is expected to earn $14.16. Nutrien has benefited in the past couple of years not only from a turn in the ag cycle, but also materials inflation and finally the Russia-Ukraine war. In time inflation will decline, new capacity will be built (including by Nutrien) and the fertilizer market will return to something more normal. On current financials, though, the stock is absurdly cheap at a P/E of just 3x and a FCF yield of about 30%.

**Enstar Group (ESGR),** the company that acquires and manages "unwanted" blocks of business from other insurers, ought to behave defensively. Like Berkshire, however, Enstar has a large investment portfolio that suffered *unrealized* losses as bond portfolios showed their worst performance in decades. As the company is holding these securities to maturity, these market movements will not result in *economic* losses for Enstar. With the stock down 18% in the quarter, it now trades at just 75% of BV -- a discount that is difficult to reconcile with the company's track record of BV growth.

Aircraft lessor **Air Lease (AL),** down 25% in the quarter, has been a corporate casualty of the Russian invasion of Ukraine, as the company determined it was unlikely to get the planes back and so was forced to write off its Russian fleet. Air Lease is confident it will be compensated by insurers, but that process will likely be drawn out and complicated, so for now they are effectively guilty until proven innocent. Outside of Russia, the company's fundamentals are solid and continue to improve from the challenges of the covid experience. AL now trades at less than 60% of BV, and it is buying back stock.

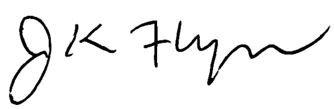
## Setup

As discussed above, quantitatively the story remains very much the same: PVP's portfolio is cheaper than both value stocks and the market overall, with superior returns on capital. While rates have risen, our FCF has risen more, resulting in a portfolio Equity Risk Premium (ERP) that is well above the market at 6.1% (9.2% FCF yield less 3.1% 30-year UST). At this level we believe we are being very well compensated to bear the risk of equities.

| | PVP [3] | Russell 3000 | Russell 1000 Value |
|---|---|---|---|
| Free Cash Flow yield (2022E) | 9.2% | 5.0% | 5.9% |
| Price/Earnings (2022E) | 13.2x | 17.2x | 13.5x |
| Debt/EBITDA (2021) | 3.2x | 2.6x | 2.8x |
| EBITDA margin (2022E) | 27.4% | 20.3% | 19.9% |
| Return on Equity (2022E) | 17.9% | 19.3% | 16.0% |
| Return on Invested Capital [4] | 11.0% | 10.1% | 8.9% |

As always, we are so appreciative of the confidence you have shown in PVP, and we promise to continue to work tirelessly to make you pleased with that decision. As you know, 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.*

[4] *PVP data is 2022; index data is 2021 (2022 unavailable).*