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VALUE PARTNERS
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Dear PVP partners and friends

It was a good quarter for our portfolio. As the economy has continued to accelerate, with resulting solid profit growth for our portfolio companies, stock prices have followed.

Monetary policy remained consistent, with the Fed – as it has previously communicated – continuing to tighten, again raising Fed Funds by 0.25% this quarter. In terms of tariffs and possible "trade wars", it has been a bit of a roller coaster, though the market seems to be currently projecting a relatively optimistic view.

Significantly, the "flattening" **yield curve**, which we have described in the past few letters as a potential flashing yellow light, **has recently taken on a healthier slope** – a reflection both of the inflation the Fed has successfully helped to manufacture, as well as general optimism about the direction of the economy.

While higher interest rates generally help our substantial financial exposure, and the steeper yield curve suggests overall economic optimism, there is another side to the coin: With rising rates, over time companies with more leverage will have greater interest expenses, and stocks paying a higher dividend become less attractive investment alternatives.

Most importantly, though, rising rates have the effect of lowering the Equity Risk Premium (ERP), which is one measure of how well we are compensated for bearing the risk of equities. As we discuss below, we continue to believe we are appropriately compensated, but if rates continues to rise the ERP will likely continue to get squeezed, reducing our compensation for bearing equity risk. In time a diminishing ERP tends to predict diminishing equity returns. This is simply another way of saying that, while we remain optimistic, it is probably not realistic to expect a continuation of the very strong equity returns we have enjoyed since 2009.[1]

At the risk of repeating ourselves: **"Growth" stocks continued to outperform "Value" stocks** in the quarter, which is an ongoing headwind for value-oriented investors like PVP. Every sector showed positive performance during the quarter. Health care, where we have substantial exposure, burst out of its recent slumber as the top performer, followed (of course) by technology, where we have limited exposure. Though for the first time in recent memory some cracks have appeared in the technology façade. The weakest sectors in 3Q18 were real estate and energy, where we have small exposure; and basic materials, where we have healthy exposure.

Overall the portfolio continues to be positioned relatively defensively, with a current beta of just 0.81. We are generally over-represented in the defensive sectors, such as health care and consumer staples; and under-represented in the pro cyclical sectors, such as technology and industrials. At the same time, we do also have a large representation in financial stocks, which are

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[1] *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).*

likely to generally behave “offensively” in a rising rate environment, but whose generally low valuations also offer some margin of safety in our view. Of course the portfolio is not “engineered” to result in these sector weightings, since investments are selected on a “bottom up” basis.

In aggregate **PVP was up 6.7% in 3Q18, and is now up 4.9% YTD in 2018 and 45.4% (15.3% annualized) since accepting our first partner capital in February of 2016.** [2] 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.

Actions taken in 3Q18

In the quarter we were not as active as usual in establishing new positions, or in exiting existing positions, but we did add to a number of our existing holdings on weakness and trim several of our stocks on strength. We also had **two highly favorable special situations.** With respect to **Adtalem (ATGE),** the for-profit education company formerly known as Devry, the stock had been quite strong leading into the company’s quarterly call in mid-August, and had approached our Target Price (TP), so we sold the stock. Just a few days later the company announced results that disappointed Wall Street, sending the stock down almost 20%. We believe the concerns are transitory, and, like Macquarie Infrastructure (MIC) last quarter, we bought the stock back again. We can’t claim any special insights motivated us to sell ATGE before the call, but we do believe this is a good example of disciplined price targets benefiting our investors.

Also, at the end of the quarter, our **Cheniere Energy Partners LP (CQH)** was “bought in” by its “parent”, **Cheniere Energy, Inc. (LNG),** in order to simplify the LNG corporate structure. LNG, which develops, constructs and operates liquefied natural gas projects, represented the underlying economics of CQH anyway, which are quite promising, so PVP investors will hold on to the LNG shares for the foreseeable future.

New buys in the quarter

AT&T (T) has been an underperformer for the past several years. In spite of an attractive dividend yield (5.9%), the company has struggled with wireless competition and, in the past couple of years, the distractions of the Time Warner merger. That merger closed finally in June, and remains subject to appeal. We believe expectations are quite low for AT&T here, with a FCF yield now approaching 10%. With wireless competition abating of late, and some likelihood that AT&T actually surprises to the upside with its new asset, we believe the risk/reward here is attractive.

Huntington Ingalls (HII) is the dominant shipbuilder for the US Navy. With a backlog of $21 billion and growing (on annual current sales of just over $8 billion), the company has tremendous visibility on future revenues. Moreover, there is a general consensus that the US will need to continue to spend more to upgrade its existing fleet as rivals (China) grow in power. On its most recent conference call, HII management characterized the current environment as the most

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

exciting it has seen in shipbuilding in the past 30 years. With all this excitement Huntington is far from the cheapest stock in the market, but it still trades at a discount on a P/E and FCF basis, for a company with superior returns, abundant FCF, and solid visibility on future growth.

With the stock now down 39% YTD, **Mohawk (MHK),** the maker of flooring and carpet, has had a difficult run lately. Not unlike Sherwin Williams (SHW), which we discussed last quarter, Mohawk is a high quality company in an attractive oligopolistic industry that has recently lowered its earnings expectations due primarily to rising "input", as well as transportation, costs. Investors also fear a turndown in the housing market. We believe the cost/pricing mismatch is transitory, and that the housing cycle fears are already more than adequately discounted in the stock, which now trades at just 12x eps and 8x EV/EBITDA – an unjustified discount to the market, in our view, for a high quality company with real pricing power.

Sells in the quarter

TJX (TJX), parent of off-price retailers TJ Maxx and Marshalls, was a very profitable investment for us, with the stock now up 46% in 2018 alone. Our PT discipline compelled us to sell the stock, as we are no longer comfortable with the valuation. We still believe the company has a very compelling business model, however, and we would relish the opportunity to buy it again at a more reasonable valuation.

Strong performers in 3Q18 [3]

Johnson & Johnson (JNJ), the health care giant, remains our largest position, and in the most recent quarter it was up 15%. We believed it was oversold going into the quarter, so we added to the position. In July the company posted its typically solid quarterly performance, and then in September JNJ presented its optimistic view of the future of its pharmaceutical business. JNJ continues to trade at a discount to the market.

After several years of dormancy, in the past year **Pfizer (PFE)** has attracted the attention of investors, and in 3Q18 alone PFE was up 23%. Like JNJ, we believe investors are beginning to better understand, and thus model and value, the significant potential for the drugs in the late stage pipeline. Like JNJ, Pfizer remains discounted relative to the overall market.

Early in the quarter **Berkshire Hathaway (BRK),** our second biggest position, effectively signaled to the market that it stood ready to buy back stock in the event that both Warren Buffett (Chairman and CEO) and Charlie Munger (Vice Chairman) "believe that the repurchase price is below Berkshire's intrinsic value, conservatively determined". This new policy replaced the former policy of not buying back stock at more than a 20% premium to BV. Berkshire currently trades at about 1.4x Book Value (BV).

In early August **Biogen (BIIB),** the biotechnology company focused on neurological diseases, released additional details from one of its two late stage clinical studies for a drug to combat Alzheimer's disease. The data was better than expected, which raises the odds that the FDA will approve an Alzheimer's drug in the next few years. Even without Alzheimer's revenues, we believe BIIB remains attractively valued at just 13x current earnings.

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[3] *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.*

Apple (AAPL), which derives about 60% of revenues from iPhones, was up 22% in 3Q18 on a strong June quarter and bullish guidance for the current quarter. Apple is also demonstrating increasing shareholder friendliness. At the end of June Apple had $129 billion of cash on the balance sheet, and bought back an astonishing $20 billion of stock in the quarter. On a FCF yield basis, AAPL trades at a discount to the market.

Weak performers in 3Q18

The flat yield curve for much of the quarter resulted in general weakness for the regional banks, and **BankUnited (BKU),** off 13% in 3Q18, was no exception. BKU has also been de-risking its balance sheet – a move we applaud – but that is also resulting in lower loan growth, which has disappointed some investors. This geographically well positioned franchise (NY and south FL) is currently trading at just 1.2x BV.

Anheuser-Busch InBev (BUD), the global leader in beer, continues to show decent revenue growth worldwide (4.7% in 3Q18), which translates into quite healthy EBITDA growth (7.0%) and eps growth (15.8%). Yet investors are particularly fixated on the challenges for beer in North America, which was down 4.9% in the quarter but represents only about 1/5 of total sales. BUD boasts an attractive 4.5% current dividend yield, and trades at a discount to the market P/E.

eBay (EBAY) has done an admirable job of re-inventing itself in recent years, making itself more relevant to customers. In the most recent quarter, however, the company's revenue growth – while healthy at 9% -- disappointed some investors. The company continues to improve the customer experience, generate lots of FCF, and buy back stock, and currently trades at a discount to the overall market.

Dentsply (XRAY), a leader in the normally quite stable dental supplies business, has been a challenging investment for us. In the most recent quarter the company again lowered its guidance for revenues and profits. We believe Dentsply now has the right management and strategy to return to consistent performance.

In spite of steady fundamental performance, **British-American Tobacco (BTI),** along with its peer companies, were weak as uncertainty continues to surround the regulatory prospects for the so-called "next generation" (reduced risk) tobacco products. BTI now trades at just 11x eps and at an 8+% FCF yield.

Other significant news in portfolio companies in 3Q18

Aspen Insurance (AHL) agreed to be acquired by Apollo Global Management (APO), the private equity firm. We plan to sell the stock soon, as the deal spread narrows.

Post (POST) has spent the past several years acquiring food assets from others, and building a somewhat eclectic portfolio of holdings. In doing so it has also put a good deal of debt on the balance sheet, and shareholders had not been rewarded of late. In 3Q18, however, Post completed the divestiture of its Private Brands business to private equity investor TH Lee. This transaction demonstrates management's ability to create value for shareholders rather than simply "build an empire", and will also help the company reduce its debt load.

In August the retail giant **Walmart (WMT)** demonstrated its best comparable store performance in recent memory, with US comps up 4.5%, driven by e-commerce sales that grew 40% year over year. Although e-commerce remains a relatively small part of the company, the already impressive growth is actually expected to accelerate as Walmart increasingly appears a threat to Amazon's e-commerce hegemony.

Management at **Mylan (MYL),** the developer and manufacturer of generic drugs, continues to be frustrated with the stock price, and announced that it would "explore strategic options". Of course we can't predict the outcome, but, as a reminder, three years ago Mylan generic rival Teva (TEVA) offered to buy Mylan for $82/share, which Mylan rejected. Today Mylan is a bigger and more profitable company, with a current stock price of $35.

Yum China (YUMC), which manages KFC and Pizza Hut restaurants in China, was reported to have rejected a $46/share offer from a private equity consortium. It is difficult to predict what will come next, but we recently added to the position and continue to like the stock at its current $33 level.

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

	PVP [4]	Russell 3000	Russell 3000 Value
Free Cash Flow yield (2018)	6.1%	4.3%	4.7%
Price/Earnings (2018)	15.4.x	18.5x	15.0x
Debt/Total Capital	42%	43%	42%
Debt/EBITDA	2.6x	2.9x	3.3x
2018 revenue growth	8.7%	7.8%	2.9%
2018 eps growth	15.2%	13.8%	20.6%
2018 EBITDA margin	30.8%	18.9%	18.2%
2018 Return on Equity	18.5%	17.4%	14.1%
2018 Return on Invested Capital	12.6%	7.8%	6.6%

[4] *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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To put PVP's FCF yield of 6.1% into perspective, we must also consider the still quite low 30-year US Treasury Bond at 3.4%. This suggests an Equity Risk Premium (ERP) of 2.7% (6.1-3.4). At this level we believe we are still being reasonably compensated to bear the risk of equities – albeit, as discussed above, less compensated than in recent quarters.

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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