PROSPECTIVE
VALUE PARTNERS
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Dear PVP partners and friends

The third quarter started with a continuation of the positive bounce back from the small correction after the Brexit vote at the end of June. This momentum continued into July and early August, as quarterly earnings for our companies were better than usual in terms of meeting, and frequently exceeding, our expectations. We will discuss some of them in greater detail. As the summer drew to a close, however, as is so often the case, the market got turbulent again, this time primarily driven by uncertainty about ongoing Fed policy and the upcoming elections.

In terms of the Fed, as we have discussed previously, we don't necessarily have a dog in that particular hunt. While a rise in rates would be a meaningful boost to many of our spread-based financials, and would also suggest a stronger economy, it would most likely be a very modest negative to the market overall. It would probably most negatively impact highly leveraged and high dividend paying companies, and in both of these areas we don't have much exposure. What would undeniably help the market, on the other hand, would be a clearer and more consistent message from the Fed. In terms of politics, markets tend to do best with divided government, so an expected Clinton administration with a Republican Congress would probably be good for equities. If the market starts to believe a Trump win, or a Democratic Senate, is an increasing probability, then we should expect volatility to pick up.

In aggregate **PVP was up 4.8% in the quarter, and is now up 19.7% since accepting our first partner assets in early February.** [1] 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.** We believe we remain well positioned in our diverse portfolio of free cash flow generating companies, currently trading at a discount to the market, but with better growth, margin, return and leverage characteristics.

PVP News

We are delighted to announce that Albert Rosano has joined PVP as a Managing Director. I have known Al, and have benefited from his investment acumen, for close to twenty years. Since I recruited him as a Wharton MBA in the 1990s Al has had a distinguished career as an investor at a number of firms, including his own, managing various types of portfolios over

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[1] *Performance figures are net, and assume the maximum 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.*

the years with a value orientation. Al does very deep research, and brings more of an international and "special situation" orientation to PVP. Al and I speak the same (value) language, but we don't necessarily finish one another's sentences. In other words, we agree frequently but not always. This spirited dialogue and occasional debate are already enhancing our portfolio. Please join me in welcoming Al to PVP.

Also, thanks to the tireless efforts of our Chief Technical Officer (my lovely and talented wife, Kristine Flynn), the PVP website is finally up, and is accessible at: www.prospectivevp.com. The site will have abundant information on PVP, and, for those partners and friends who suffer from insomnia, will also house our previous partner correspondence.

A word on the market

Much has been made in the financial media in recent months about the equity market hitting new highs, elevated Price/Earnings ratios, and the like. Admittedly the market has been strong since troughing in early February, and P/E's are a bit historically high. As we have discussed in previous correspondence, however, we need to factor the current historically low interest rates into the valuation equation. Thus the Equity Risk Premium (ERP), which is simply the earnings yield for stocks less the long bond yield. Today by our calculation [2] the market ERP is 2.2%, which, historically speaking, in our opinion, is reasonably valued. The PVP portfolio, as we will discuss later, is currently even more attractively valued.

Needless to say, none of this means we will not continue to experience the occasional "correction", or that unforeseen things that are negative for equities will not happen. On the contrary, we *know* they will happen. We just don't know *when* they will happen or *how severe* they will be. That is why, as the market has generally moved nicely upward in recent months, as we have described in recent letters, we have adjusted the portfolio accordingly. While volatility can of course be painful, we always want to be prepared to take advantage of it to the extent we can.

Nor do we see any of the traditional flashing lights that signal a bear market. Inflation is in check. Monetary policy remains accommodating. The prospect of recession, while much discussed earlier this year, seems remote at this time. The yield curve, while relatively flat, has not inverted. And we are hardly in an environment of investor exuberance.

The one part of the market, however, that feels a bit "bubbly" to us is the area with the highest dividend yield: consumer staples, utilities and REITs. As interest rates have fallen and stayed historically low, investors around the world have developed an insatiable appetite for yield. While we do have some minimal representation in these sectors, the handful of staples and REITs that we do own are in the portfolio based

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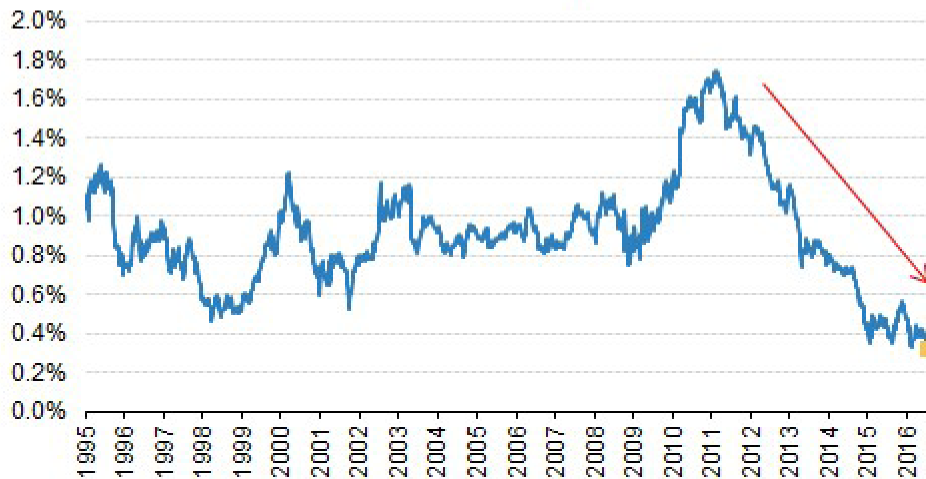
[2] *Russell 3000 2016 FCF yield is 4.5%, less 30-yr Treasury bond of 2.3% = market ERP of 2.2%.*

strictly on their own merits. We believe they are the exceptions in otherwise overvalued sectors.

The chart below helps amplify the point. As you can see, historically the dividend yield in the “staple sectors” is significantly higher than that for the “cyclical sectors”. Today, however, investors are receiving only a slightly higher yield in these staple sectors than in the market overall. In other words, the staple sectors are relatively much more expensive than they have been historically. This is not to say these sectors won’t continue to outperform for the foreseeable future, if interest rates stay low.

Defensive Sector Dividend Yield - Cyclical Sector Dividend Yield



Source: Morgan Stanley

But, as you know, PVP’s modus operandi is to try to avoid these “crowded long” sectors and look instead for value that isn’t currently being reflected. We are striving to “play defense” in more creative ways even in the more cyclical sectors. For example, in financials, **Enstar Group (ESGR)** has specific expertise in acquiring unwanted business at fire sale prices from challenged insurers; in industrials, the trash collector **Waste Connections (WCN)** and the “asset-light” logistics company**, LandStar (LSTR)**; in consumer cyclicals, the funeral home/cemetery company **Service Corp (SCI)** and **TJX (TJX)**, parent of off-price retailer TJ Maxx; and in technology, **Maximus (MMS)**, the largest provider of outsourced social services to state and local government.

<u>Actions taken in 2Q16</u>

Liberty Global (LBTYA) is a stock we acquired in the wake of the brief Brexit panic, when most all UK stocks were being severely penalized. Liberty is primarily a leading cable provider both in the UK and in continental Europe. The notion that tens of millions of households would cut their cable cords on account of Brexit seemed silly to us, so we took

advantage of the temporary flight of capital from the UK and bought the stock down considerably and at nearly a 7% FCF yield. Liberty Global, whose chairman is John Malone, is one of the most capital-disciplined and shareholder-friendly companies we have seen outside the US.

In recent years we have observed the ongoing restructuring of Coca-Cola (KO), and have struggled to figure out how to profit from it. While we believe much improvement has been made at Coca-Cola itself, we don't find KO's current valuation attractive. One of its initiatives, however, is to sell off its bottling operations. **Coca-Cola FEMSA (KOF)**, which we acquired in 3Q16, is one of Coke's biggest and most longstanding bottling partners. Coke has decided to sell its bottling operations worldwide to select partners, including presumably Coke FEMSA. While details have not yet been made public, we believe Coke FEMSA is extremely well positioned to acquire various Coke bottling operations on attractive terms. Investors have not yet incorporated this exciting possibility into their expectations, so KOF trades at just over 9x 2017 EV/EBITDA per current expectations -- nearly a 50% discount to Coca-Cola itself. And if we are correct about these bottling acquisitions, then EBITDA should be *much* higher.

Westrock (WRK), which we also acquired in 3Q16, is a leading player in the paper packaging industry. The industry continues to consolidate over time, making it less cyclical. The Westrock management team has a stellar track record over time both as operators and acquirors. E-commerce is something of a demand tailwind in the form of all those Amazon boxes on our front porches. At the same time, supply appears in check, making for a probable healthy pricing dynamic. For this we are receiving about a 9% 2017E FCF yield, with about 1/3 of that FCF targeted to the dividend.

Finally, we also took a position in **Booz Allen Hamilton (BAH),** which primarily provides IT consulting services to the federal government (largely Dept. of Defense and various intelligence agencies). With a defense budget currently artificially depressed by sequestration, while the threat of cyber attacks and such only grow, clearly more dollars will need to be allocated by a federal government trying to stay a step ahead. This strong demand is reflected in Booz's very robust backlog, which was up 30% in the most recent quarter. Booz also has great potential margin opportunities with a greater percentage of fixed price contracts, and also by increasingly applying its IT expertise and learnings to commercial clients. Booz is trading at an attractive 6+% 2017E FCF yield.

To fund these purchases we trimmed a number of our better performing names, particularly in the industrials and financials. We also sold **Intel (INTC)** outright. Intel has struggled relative to some of its large tech brethren in adapting to the shift to the cloud, and recently announced a major restructuring. In our experience these kinds of situations can be long, drawn out, and frequently painful, so we exited the position. Intel remains a relatively cheap stock, but we felt there were better opportunities elsewhere.

Strong performers in 3Q16 [3]

As 3Q was something of a "risk on" quarter, our aforementioned minimal exposure in the high dividend sectors -- mostly utilities and consumer staples, which had hurt us earlier in the year -- actually began to help us. While we are always on the hunt, as discussed above these sectors just seem generally unattractive to us right now, from a valuation point of view.

In terms of specific stocks, we are especially pleased to let you know that several of our holdings that we have profiled recently bounced back nicely in the quarter. **West Corp (WSTC)** posted what we would consider an "ok" quarter, but expectations remain quite low, so the stock returned 13% in 3Q16. West is a stock we expect to be a "grinder", as its quarterly progression should increasingly quiet the skeptics about the resiliency of the business, and if so the stock should continue to grind higher.

Biogen (BIIB), up 29% in the quarter, benefited in a variety of ways in 3Q16: a respectable quarterly financial performance; pipeline advancements in infantile spinal muscular atrophy and ALS; more positive data followed by an FDA fast-track designation in its Alzheimer's development; and, perhaps most importantly, speculation about the company selling itself. On the latter point, in conjunction with its quarterly earnings release Biogen announced that its CEO is departing. This is highly unusual for a CEO so highly regarded. Shortly thereafter there were numerous reports that the company had entered discussions with potential buyers. It is entirely plausible that BIIB will be sold at a considerably higher price, but we have very little information at this point, so we trimmed the position somewhat. Thus we have already locked in profits, and will only further benefit if it comes to fruition, while also reducing our risk in the event a deal fails to materialize.

eBAY (EBAY), which continues to make progress in improving its users' experience, also exceeded top and bottom line expectations in 3Q16, buoyed by 40% growth in its StubHub unit, and was up 41% in the quarter. EBAY remains attractively valued at a 7+% 2017 FCF yield.

Harman (HAR) was another top performer in 3Q16, up 18%. In our previous correspondence we highlighted the basic bear thesis: slowing auto sales will hurt Harman. Yet auto sales continue apace, and Harman's share and backlog just continue to grow. In spite of the strong performance in the quarter, HAR still trades at just 12x expected 2017 earnings and at an 8+% FCF yield.

As strong economic data and Fed commentary have increased expectations for an eventual Fed rate hike, many of our financials also benefited in the quarter. Our banks, especially **Citizens Financial (CFG)**, continue to make progress toward respectable returns even in this very low interest rate environment. CFG was up 24% in 3Q16.

[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.*

Weak performers in 3Q16

Mylan (MYL) is a company that has unfortunately been in the news recently, and the stock was down 12% in the quarter. While the vast majority of Mylan revenues comes from generic drugs, Mylan also makes the EpiPen. Recently the company has come under intense public scrutiny for taking large price increases over the years in that product. Mylan has been able to do this because its major competitor was forced to withdraw its product from the market for safety reasons. This made the EpiPen basically a monopoly for Mylan. While Mylan is not exactly the first drug maker to aggressively raise prices, the company admittedly has been a tad piggish in this regard, so now it finds itself on the hot seat. Given the political climate, which has been exacerbated by certain others raising prices at astronomical rates, it has been the wrong time to be taking price *too* aggressively. Mylan's response to the outcry was to expand its various programs to lower out-of-pocket EpiPen costs for customers, and also to launch its own cheaper generic version of the EpiPen. While we wait out the political firestorm, Mylan now trades at less than 7x expected eps and with an expected 11+% FCF yield for 2017. About 18 months ago Teva offered to buy Mylan for $82, which Mylan rejected as insufficient, and the stock is now just over $38. Needless to say, we believe Mylan is currently *very cheap,* but we recognize we will likely have to be patient.

Oracle (ORCL), off 4% in the quarter, has been slower than the market expected in adapting to the shift to cloud computing. Although these cloud-oriented businesses are growing quickly, at this point they are too small relative to the company's gigantic legacy software business to move the needle as quickly as the market is demanding. Still, we are encouraged by the very strong pipeline and bookings numbers, and we are hopeful that soon the market will begin to appreciate the company's progress.

Smucker (SJM) has been a strong stock ytd, but had a somewhat soft quarter on the top line, and the stock sold off 11% in 3Q16. Fortunately we had taken some profits last quarter. Coffee is almost half of Smucker profits today. The good news is that underlying coffee demand remains strong. While overall Smucker profits and cash flows also remain strong, unfortunately the price of coffee beans declined, a savings the company passes on to customers, thus lowering revenues but preserving profitability. Also impacting the top line is the fact that Smucker continues to struggle in its "legacy" pet food brands, like Meow Mix and Kibbles 'n Bits, as pet owners are increasingly paying up for higher quality products. Nonetheless, we continue to like Smucker, and if the company is able to rejuvenate those old brands, whose advertising jingles remain etched in our childhood memory, there is certainly more upside remaining.

Johnson & Johnson (JNJ) posted its usual solid quarterly result, with 5% revenue growth and an increase in both sales and earnings guidance for the full year. In a "risk on" quarter, however, JNJ's defensive attributes were not as attractive as usual to the market, and the stock lagged.

POST (POST), like Smucker, was also somewhat caught up in the downdraft that impacted many consumer staple stocks in the quarter. Although the company exceeded expectations and raised guidance for the full year, the stock was off 7%. We continue to like the way the company is aggressively fine-tuning its portfolio through acquisitions and finding numerous cost-cutting opportunities.

Finally, as you know, PVP strives to be fearful when others are greedy, and greedy when others are fearful. In a relatively "risk on" quarter like 3Q16, therefore, our cash has been elevated, which cost us a bit. At the end of the quarter PVP carried about 7% cash.

Setup

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 portfolio companies are growing revenues and eps faster than the Russell 3000, with less leverage. PVP also has higher margins and greater returns than the Russell 3000.

	PVP [4]	Russell 3000
FCF yield (2016)	**6.3%**	4.5%
Price/Earnings (2016)	16.9x	18.7x
Debt/Total Capital	42%	44%
Debt/EBITDA	2.4x	3.0x
2016 revenue growth	5.0%	0.5%
2016 eps growth	5.5%	0.2%
2016 EBITDA margin	28.9%	18.5%
2016 Return on Equity	15.7%	14.2%
2016 Return on Invested Capital	10.4%	6.5%

To put PVP's FCF yield of 6.3% into perspective, we must also consider the very low 30-year US Treasury Bond at 2.3%. This suggests an Equity Risk Premium (ERP) of 4.0% (6.3-2.3). In other words, **we continue to be very well compensated to bear the risk of equities.** This current ERP is well north of the historical average ERP for the past century, and also still above the average since the 2008 financial crisis.

Finally, as we have previously discussed, for the first time since the 2008 financial crisis **"value" is outperforming "growth"** investing in 2016. As a reminder, from 2009-2015 the growth indices outperformed their value counterparts by 3-4% per year. In 2015, in fact, the Russell 1000 Growth index returns exceeded the Russell 1000 Value by a whopping

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

9.5%. For the first nine months of 2016, however, the dynamic has reversed, with large cap value (Russell 1000 Value) outperforming large cap growth (Russell 1000 Growth) by 2.9% and small cap value (Russell 2000 Value) outperforming small cap growth (Russell 2000 Growth) by 6.6%.

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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