PMV Month In Review

April 2018

Macro

Volatility continues as peak margin concerns come into focus.

The markets were approximately flat in April as the major indexes were all up less than 0.5% for the month. U.S. corporate profits are very strong, but investors are increasingly concerned that growth rates may be peaking this year. In fact, according to the Wall Street Journal, “more than half of the combined net-income growth reported by 200 large public companies in the first quarter stemmed from a decline in the companies’ effective tax rates.” Our investment team continues to see evidence of mounting cost pressures throughout the economy in the form of higher transportation, labor, and material costs. As a result, companies will need to raise prices to maintain margins going forward. We believe many of our PMV holdings have a significant competitive advantage, and as a result, the pricing power needed to navigate such an environment.

Earnings

Portfolio widens YTD lead vs. index as earnings season starts out generally positive.

The Mid Cap PMV portfolio extended its lead vs. the Russell Midcap Value Index last month as continued market volatility benefitted relative performance. In addition, we have seen a generally positive start to the portfolio’s earnings season this quarter. F5 Networks and Encompass Health rallied on strong EPS releases, while Universal Health and Arconic declined on disappointing financial results. Overall positive surprises outnumbered negative ones approximately 3-to-1.

Portfolio Activity

Increased volatility provides opportunity for several new purchases: CSL, ESRX, SRCL

In terms of portfolio activity, we did tender our shares of CSRA last month as General Dynamics completed their buyout of the firm. That deal created more portfolio cash which we have been able to redeploy given increased volatility. New purchases Carlisle Companies, Express Scripts and Stericycle are all stocks that have been on our watch lists for some time and recently sold off to create attractive entry points.

Carlisle (CSL) is the leading commercial roofing company in the U.S. We like the roofing business long-term given industry barriers to entry and strong visibility with 70% of the business driven by retro-fit. Management has a strong record of capital allocation and consistent free cash flow generation. Recent stock price weakness is related to ongoing concerns about margins in roofing on higher raw material and transportation costs (already reflected in Street estimates). Given CSL’s leading market position and recently announced price increases, we believe margins will bottom sometime in the next several quarters.

Express Scripts (ESRX), the largest independent Pharmacy Benefits Managers (PBM) with 30% market share, is a company we have followed for some time and ‘missed-out’ on last year as the stock rallied and then received a buyout offer from Cigna in early March. However, the stock has declined 20% since the offer was made as pessimism around the deal increased. Investors are guessing regulators will frown upon this merger given other large health care deals which are being scrutinized. However, this deal along with other combinations (CVS Caremark / Aetna & United Optum / Catamaran) highlight the value of PBM integration within the health care ecosystem.

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Finally, we purchased **Stericycle (SRCL)** last month. While the stock has fallen significantly from its $150 glory-day levels, at our sub-$60 entry point we believe risk/reward is positively skewed. Our analysis suggests that medical waste management is still a healthy business that possesses synergies with other compliance-related services. As the dominant market share leader, SRCL should be able to right the ship in what is a fairly stable industry environment. SRCL enjoys high barriers-to-entry (large incinerators and regulatory approvals) with superior route density and over 200 processing locations. Their services are required by regulations yet represent only a small percent of annual spending for customers. The firm generates 10% of revenues in free cash flow even with recent elevated spending, and we believe margin downside (after significantly lowered guidance) is limited as the company has identified $200-300 million in incremental cost savings over the next few years.

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