January 2021

Dear Friends and Clients,

2020 was an extraordinary year on many levels, certainly for the financial markets. The initial Covid shock triggered a massive selloff, followed by a robust rally that extended to year end, with a particularly strong showing for 4Q20. We are pleased with the performance of our Rewey Asset Management (RAM) small and midcap strategy versus our benchmark of the Russell 2500 Value index for both 4Q20 and the full-year 2020. The Russell 2500 Value index returned 28.5% in 4Q20 and 4.87% in 2020. [1,2]

With Vaccine Approval, Nothing Else Mattered

The predominant focus for investors in 4Q was the approval of the first Covid-19 vaccines. While the economic recovery from Covid is still in its early stages, the advent of a vaccine will likely accelerate its cadence. The economic disruptions caused by Covid are very different than those caused by a typical economic slowdown. The softness was not driven by weakening late cycle demand, but rather a supply shock where desired goods and services were quickly unavailable. If a vaccine delivers widespread herd immunity, supplies of these goods and services should quickly resume, as underlying demand likely remains strong. For investors, the positive news on the vaccine was all that mattered. Fears of higher taxes and regulation under the new administration, a slowing pace of the economic recovery off the Spring lows and congressional tardiness on a second stimulus package were all eclipsed by the vaccine approvals.

Small/Mid Value Outperformed in 4Q20

The Russell 2500 Value index 4Q20 return at 28.5% handidly outpaced the Russell 2500 Growth index at 25.9% and the S&P 500 at 12.1%[3]. Value shares outperformed as investors focused on the restart of the economy, and rotated away from technology driven mega companies that outperformed as ‘lockdown’ stocks. We think that this shift to small/mid value is the beginning of a resurgence of value performance, as we think growth valuations are over extended. According to Bloomberg, the December 31st, 2020 trailing twelve month enterprise value to revenue and enterprise value to ebitda multiples for the Russell 2500 growth index were 3.97x and 46.6x, respectively vs. 1.94x and 22.9x for the Russell 2500 value index.[4] We think this valuation disparity is even larger than these trailing multiples suggest. Covid disruptions had a greater negative impact on earnings for industrials, retail and financial companies, which are more highly represented in value benchmarks. In other words, value earnings were hit harder than growth earnings during the pandemic and now have more room for a recovery.

What No One Is Talking About

In general, investors are focused on the positive impact that Covid vaccines will have on the economy, the second stimulus package passed by Congress at year-end and the the position of the U.S. Federal Reserve to keep short-term rates at zero for the foreseeable future. We agree that each of these are positive factors for economy and for the stock market. However, we also believe that investors are under appreciating the second aspect of the current Fed stance, that it is planning to let inflation run higher than its prior 2% goal for a potentially long period of time. As we wrote last quarter, don't fight the Fed. If the Fed wants higher inflation, it will likely get higher inflation through its policy actions.[5]

While the U.S. CPI inflation proxy, ex-food and energy remains low as of December 10th at 1.6%, we see signs that inflation is accelerating already.[6] The ISM prices paid index for December came in at 77.6 vs. a November reading of 65.4.[7] Propelled by lower rates that have lowered the cost of mortgages, as well as Covid-driven urban flight, U.S. new housing prices are up 8.41% year-over-year in December.[8] Random Lengths Lumber futures soared to a peak of $806 per flat car in December from year-end 2019 levels of roughly $400 and March 2020 lows of $300.[9] Other commodities typically associated with inflation, including gold, copper and iron ore have also all soared in 2020, with gold hitting a new all-time high of $2,062 per ounce in July.[10] If the Fed Funds rate is held at zero while employment and GDP continue to improve, we see a high likelihood for higher inflation into 2021 and beyond.

We detail our view on the potential for higher inflation and interest rates on our market musings blog page https://www.reweyassetmanagement.com/market-musings. The bottom line is that a modest increase in inflation and interest rates should be positive for the value sectors. Financials should see higher earnings due to rising interest rates providing more spread income. Industrials should regain pricing power due to the resumption of demand. Conversely, in general, higher inflation and interest rates are a negative for growth stocks, due to low to negative near-term earnings levels and valuations primarly set as a result of 10-year discounted cash flow models. As the discount rate rises, the discounted value of the 10-year cash flow stream and terminal value are reduced, negatively impacting the price targets.

We have positioned our portfolio to withstand and likely prosper from the return of inflation. We have sought low exposure to highly leveraged balance sheets and added companies that can potentially prosper from pricing power. We see rising rates and the improving economy helping our financial holdings through better yields, spreads and credit outcomes. Further, we should benefit from our companies that can pass on higher prices, such as our lumber holdings Weyerhaeuser and Intefor, and our services driven holdings ABM Industries and Regis Corp.

Portfolio Highlights

We believe that our portfolio is very attractive from a valuation perspective. Four holdings are trading under book value, four additional holdings are trading at less than 1.5x book, and our composite portfolio is trading at an average of 1.91x book value.[11,12] It is also worth highlighting that three of our holdings have no sell-side coverage, and eight others have five or fewer covering analysts.[13] We believe this anonymity provides us with the opportunity to identify companies that pass under the radar for other investors, and help secure positions at attractive valuations.

At quarter-end, our cash level was at approximately 9.3%. Cash levels will fluctuate as part of our investment process, as we continue to be opportunistic to invest in new and existing positions and to harvest from those approaching our Assessed Fair Value (AFV) price targets.[14]

II-VI Corp. (IIVI), which was our top detractor in 3Q20, went from rags to riches in 4Q20 increasing 87.3% and was our top performer. IIVI outperformed low expectations, driven by China and Huawei fears, in its FY1Q (Sept.) earnings report, handily beating on earnings and revenues. Importantly IIVI reviewed its one-year anniversary of the Finisar acquisition, delivering synergy targets over expectations. 3D sensing revenue was up 200% year-over-year, with the company giving an upbeat outlook on the continued penetration into consumer devices and automotive markets. Further, at a trio of sell-side conferences in late November and December, IIVI gave a robust market outlook for its multiple growth opportunities, including 100G and 400G communication equipment for telecom and data centers, Indium Phosphide, laser cutting and welding and of course 3D sensing. IIVI also discussed the burgeoning opportunities it sees in Silicon Carbide applications for low heat emission chips, and the tremendous benefits the access to GE's intellectual property portfolio will bring to its development opportunities. While we prudently trimmed our position back on strength, we still believe IIVI can deliver strong upside over the next few years from its multiple growth vectors.[15]

Lennar Corp. Class B shares (LEN/B) was our top performer in 3Q20, declining 6.5% in 4Q20. In our view there was no fundamental reason for the weakness, which likely represents more of a pause following a very strong rally from March lows. Lennar delivered a stunningly positive FY4Q, announced in late December, with unit orders up 16% and the dollar value of orders up 22%. Lennar noted that it is seeing pricing increases in every market and every price point, from entry level to high end. Lennar noted the 10-year underproduction of homes vs. historical trends has now created a housing shortage that should sustain results for many years. Importantly, Stuart Miller, the Chairman, noted that the millennial generation has pivoted quickly to family formation and demand for single family homes, reversing a trend of city living. In our view, the market is still not giving Lennar credit for the incredible strengthening of its balance sheet. Lennar paid down $2 billion in debt in 2020. It now has zero drawn on its credit facilities and its homebuilding debt to capital ratio is 24.9%, an all-time low. We see earnings and the balance sheet continuing to improve over the next few years, and note that both Moodys and Fitch have upgraded Lennar to investment grade. We remind investors that our LEN/B shares trade at a significant discount to LEN class A shares (with B shares closing the quarter at $61.20 vs. $76.23 for the A shares), even though the B shares have a 10-1 voting advantage versus the A shares. We do not believe this price disparity makes sense, even considering lower liquidity of the B share class. At some point, Stuart Miller, the chairman and former CEO of Lennar who controls 57.83% of the B class, will likely opt to convert his holdings to A shares, which he can do at any time, to capture the pricing disparity.[16]

Photronics Inc. (PLAB)

In this quarter we initiated a position in Photronics Incorporated, the world leader in the design, engineering and manufacturing of photomasks for semiconductors and flat panel display screens. We view Photronics as an overlooked gem that is positioned to gain share, increase earnings and drive strong cash flow for at least the next three years. In our view, the dual 2020 headwinds of Covid and China trade actions have increased investor neglect and created a compelling risk vs. reward opportunity for this company.

Photronics certainly meets our first investment pillar of a strong financial profile. As of October 31st, 2020, its fiscal year-end, the company had a net cash position of $210 million, or $3.24 per share, representing 29% of the year-end closing per share price of $11.16. This financial strength is driven by PLAB's strong operating cash flow, $143 million in FY2020, which has allowed the company to fund organic growth opportunities and to return cash to shareholders through repurchases. In FY2020, Photronics spent $70.8 million on CAPX, down from $178 in FY2019, as it substantially completed its expansions in China. Looking forward, PLAB does not see the need for brick and motar investments over at least the next 3-years, adding only high-end components to its existing footprint. This strong cash flow and balance sheet strength allowed Photronics to repurchase 3.2 million shares in 2020 for $34 million. Incredibly, PLAB's consistent share repurchase activity has reduced its share count from 79 million in FY3Q15, to 64.8 million to end FY20. Despite these positives, the shares finished 2020 at $11.16, down over 30% from its January 2020 high of $16.01 per share.

Photronics has a clear ability to grow revenues and expand margins driven by compelling secular growth opportunities in semiconductors, share gain opportunities driven by new technologies, captive manufacturer outsourcing and a compelling financial model to expand margins, profits and cash flows. As the global market leader in photomasks for semiconductor manufacturing, Photronics stands to benefit from new semiconductor applications for communications, 5G, internet of things, and aritifical intelligence. These growth areas will require new chip designs, which in-turn require new photomasks for chip manufacturing. In its December 2020 investor day, PLAB estimated a 3-year CAGR of total semiconductor manufacturing of 2.5%-3.5% for 2021-2023, and projected it should double this industry growth rate for 5%-7% growth. We view this forecast as conservative, and management noted that it does believe it can double the industry growth rate, whatever the outcome.

Photronics' share gain forecasts are based on the triad of technology, China and continued outsourcing. Photronics has established technology leadership positions in Integrated Circuit (IC) chips in EUV masking that is transferring more manufacturing complexity to the photomask, and in System on Chip (SOC) manufacturing that is increasing the number of masks per chip needed as 3D chip manufacturing gains adoption. In Flat Panel Display (FPD) chips, PLAB has established the market lead in G10.5+ and AMOLED manufacturing. AMOLED technologies are just penetrating high-end TV's and cell phones now, and are forecast to penetrate mainstream PC screens and automobiles over the next few years.

In China, Photronics has substantially completed its $300 million investment program, and now has capacity to serve both domestic customers and foreign nationals in the region. While the U.S. trade actions caused some revenue pressures in 2020, these pressures should turn to tailwinds in 2021-2023 as domestic manufacturing accelerates in response, and the new administration likely takes a more benign stance towards China.

Last, the captive photomask market, i.e. internal photomask development by semiconductor manufacturers, is still about 10%-15% of the industry. PLAB continues to gain share from these competitors, as its technology lead brings them to partner with it for leading edge designs, speed to market and cost reduction opportunities.

From a valuation standpoint, we find Photronics compelling. PLAB has 64.8 million shares outstanding which equates to a market value of $723 million as of December 31st 2020. Subtracting net cash and adjusting for its joint venture non-controlling interests, we estimate PLAB's enterprise value is $671.3 million, or just 4.3x trailing 12-month EBITDA and an estimated trailing Free Cash Flow yield of 10.7%. In our view, investors have overly punished PLAB for Covid and China trade actions in 2020. While a weaker than expected 2020 did cause PLAB to fall just short of its 2020 revenue goal of $630 million which was given at its 2018 investor day, normalizing for the weak Covid impacted quarter of FY2Q20, management estimates it would have exceeded this goal at $635 million. PLAB also gave strong new 3-year targets for 2023, one of the few companies currently giving guidance of any kind, for revenues to grow to at least $700-$750 million and for earnings to double to triple 2020's result and come in at $1.00-$1.35 per share. We think both the top-line and earnings targets in this view are conservative due to the secular growth opportunities for the industry and PLAB's market leading position. Management even conceded at its analyst day that due to high-end industry strength, PLAB could see price increase opportunities later in 2021, bucking the normal progression of decreasing prices for technologies once introduced and brought to manufacturing scale.

We have set our Adjusted Fair Value (AFV) price target for Photronics at $17.10. This is our 1-year target, set off 10/21(e) EBITDA and FCF yield, and include only a modest level of repurchases. We view this price target as very conservative, as it incorporates our view of the semiconductor industry as cyclical, despite what looks to be a compelling long-term outlook. If underlying semiconductor demand holds up, we see no reason why PLAB will not be able to exceed its long-term goals and in-turn substantially exceed our 1-year AFV target.[17]

Looking Forward

The markets posted an incredible performance in 2020, with most every domestic equity index delivering positive returns for the year, recovering strongly from the steep March sell-off. We have maintained our view that the Covid recession is a supply constrained slowdown vs. a demand driven recession, and that recovery would come quickly once a vaccine became available. While we have seen this scenario begin to play out as we envisioned, we think small and mid caps should continue to show positive performance.

In our view small and mid-cap value stocks have lagged the broader averages in this recovery, due to the greater impact of the Covid shutdowns on their operating models than growth related companies. As the economy fully re-opens, we see small and mid value posting the highest earnings gains off 2020 lows, which should bring investor attention and confidence back to the group. While company earnings and stock market returns rarely move in a straight line, we think the conditions are solidly in place for small and mid value to move higher over our 3 to 5-year investment horizon.

Thank you for your continued trust and support. Stay safe and healthy. Please do not hesitate to contact us for client service, to discuss our commentary or to simply opine on the market and stocks.

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1 ASN prohibits advertising of strategy returns to non-clients. Please contact us to discuss in more detail.
2 Russell 2500 Value Index performance levels are sourced from Bloomberg. The Russell 2500 Value index is a unmanaged group of securities considered to be representative of the small and mid-cap stock market in general. Indexes are unmanaged and do not incur management fees, costs, or expenses. It is not possible to invest directly in an index.
3 Russell 2500 Value and Growth Index performance, and S&P 500 Index performance levels are sourced from Bloomberg. The Russell 2500 Core and S&P 500 indicies are a unmanaged group of securities considered to be representative of the small and

mid-cap stock market, and large cap market respectively, in general. Indexes are unmanaged and do not incur management fees, costs, or expenses. It is not possible to invest directly in an index.

4 Russell 2500 Value and Core Index valuation statistics for 12/31/2020 sourced from Bloomberg Financial Analysis Function.

5 U.S. Federal Reserve 12/16/20 statement.
https://www.federalreserve.gov/newsevents/pressreleases/monetary20201216a.htm

6 U.S. CPI ex-Food and Energy data sourced from the Bureau of Labor Statistics as reported by Bloomberg.

7 ISM Manufacturing Report on Business Prices Index for December from the Institute for Supply Management as reported by Bloomberg.

8 U.S. single family housing pricing sourced from S&P Core Logic Cash-Schiller Index as reported by Bloomberg.

9 Random Lengths Lumber Futures as quoted on the Chicago Mercantile Exchange, reported by Bloomberg.

10 Gold, Copper and Iron Ore prices quoted from Bloomberg.

11,14 All portfolio discussion is based off our model portfolio. Company financial estimates sourced from Rewey Asset Management proprietary analysis, and Bloomberg BEST company estimates. Historical pricing and company financial data sourced from company 10Q and 10K filings, and Bloomberg. Individual portfolios may hold slight deviations in position sizes and names held.

12 Book value portfolio estimates exclude Graftech International, due to anegative equity position.

13 Covering active sell-side analyst data sourced from Bloomberg.

15 II-VI RAM return information sourced from Black Diamond/ASN performance reports. Other II-VI commentary sourced from company 10Q, 10K filings and company presentations and Rewey Asset Management proprietary analysis.

16 Lennar RAM return information derived from Black Diamond/ASN performance reports. Lennar and Lennar Class B share pricing from Bloomberg. Lennar B share class details derived from Lennar annual proxy and Bloomberg. Stuart Miller Lennar B holding info. Derived from U.S. SEC Form 4 and Bloomberg. Other Lennar corporate and financial information, including dividend announcement information from LEN 10-Q, 10-K filings, company press releases, company presentation materials and Rewey Asset Management proprietary analysis.

17 All financial ratios, statistics, and projections discussed in the Photronics Inc.. (PLAB) commentary are sourced from PLAB's 10-K and 10Q filings, company press releases, company public conference calls and webcasts, company slide presentations, Photronics company webpage, and Rewey Asset Management proprietary financial analysis. Historical share price information sourced from Bloomberg.

Advisory services offered through Rewey Asset Management, a Member of Advisory Services Network, LLC.

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