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Rewey Asset Management
A Member of Advisory Services Network, LLC

Dear Friends and Clients,

We are pleased to report that our Rewey Asset Management composite outperformed our benchmark the Russell 2500 Value index for 2019, with a net return of 25.80% vs. 23.54%. In the fourth-quarter our composite returned 5.80% vs. the Russell 2500 Value 7.05%, the Russell 2500 growth 10.56% and the S&P 500 9.06%. For the year, the Russell 2500 growth index was up 32.63% and the S&P 500 was up 31.48%.[1,2] In general, our composite outperformed when value took the lead, and lagged in periods when growth outperformed. This pattern is not surprising, as our focus is on minimizing downside risk while seeking upside returns.

Market Commentary

In the fourth-quarter, investors scrambled to buy stocks as fears surrounding trade stagnation and yield curve inversion melted away.[3] The December 13th announcement of a Phase 1 trade deal with China provided the major spark for the markets, bringing clarity that a trade war would not spiral out of control and that tariffs would begin to be removed. Momentum was also fueled by the passage of the new USMCA trade deal by the U.S. House of Representatives, and by the December 12th election results in the U.K. which finally clarified the Brexit road map. Lastly, in almost a perfect scenario for the markets, the Federal Reserve brought a double-barreled shot of liquidity to fuel the trade-driven market run, by resuming the reinvestment of maturing securities and by the NY Fed proactively announcing a major liquidity boost for the repo markets into year-end.[4]

Got Value?

We believe the opportunity in small and mid-cap value equities is compelling as we look forward to 2020, both in an absolute sense and in a relative comparison to growth-based indices, where we see clear signs of excess and concern as we move past the 10th year of a robust market advance. Many new growth companies are valued at what we consider to be fantasy levels, reminding us of the extreme investor exuberance surrounding internet stocks in 1997-2000. In contrast, we see many interesting small-mid value opportunities of financially strong companies that have been overlooked and neglected, particularly in the Financial, Industrial and Energy sectors. While these sectors are out of favor with growth investors, we see compelling value in these sectors, including Lincoln National (LNC), Webster Financial (WBS), Graftech International (EAF) and Callon Petroleum (CPE), which are all current holdings.

Our portfolio is not meant to replicate or even resemble the market, but instead offers what we believe to be invaluable diversity to the broader indices. We commit capital only when we see a compelling valuation opportunity. There are over 4,600 exchange traded companies in the U.S. with market capitalizations between $100 million and $10 billion, significantly greater than the 1,789 companies in the Russell 2500 value index[5,6]. We own 24 holdings in our portfolio, of which 10 are not in the R2500 value index.[7] Our fundamentally based research approach provides the conviction to hold a concentrated and differentiated portfolio from our benchmark, with a focus on both absolute returns and downside risk protection.

Portfolio Highlights

Our valuation metrics continue to look very attractive, with 13 of our companies trading at or below a 12 times price-to-earnings ratio based off 2020 estimates. Nine portfolio holdings are trading under book value and five additional holdings are trading at less than 1.6x book.[8] The price/earnings ratio of our portfolio is approximately 13.2x at year-end versus the Russell 2500 Value Index at 17.6x and the Russell 2500 Growth Index at 27.9x (as of 11/30/19 FTSE Russell Factsheets)[9]. It is also worth highlighting that three of our names have no sell-side coverage, one has just one analyst following and five others have five or fewer covering analysts.[10] This anonymity provides us with the opportunity to identify companies that pass under the radar for other investors, and secure positions at attractive valuations.

Ultra Clean Holdings Inc. and G-III Apparel Group, a new addition, were our top contributors this quarter. Ultra Clean (UCTT) outperformed following an upbeat 3Q19 earnings report, that both highlighted the strength of UCTT's new Quantum Global Technologies service business and also provided a first indication that the semiconductor chip weakness seen throughout 2019 was close to a bottom. We entered G-III Apparel (GIII) following a sharp FY3Q20 (October 2019) earnings report sell-off. GIII, a women's apparel manufacturer, offers a compelling growth profile driven by its Calvin Klein, Tommy Hilfiger and Donna Karan brands. In our opinion GIII has been overly punished along with the retail group in general, despite its agnostic view towards end market point of sale. CPI Aerostructures (CVU) was our worst performing holding in 3Q19. We believe investor concerns regarding the 2020 U.S. defense budget delay negatively impacted the shares. As the budget did pass in late December, we remain confident in the revenue and margin trajectory of CVU.

The Bull-Pen

As we have often stated, one of the keys to long-term investment success is to be a patient buyer and commit capital only with a compelling opportunity. Over the course of the year we analyze many more companies than we add to our portfolio. Some companies that come very close to meeting our investment criteria, but are not purchased, are instead added to our Bull-Pen list, where they are closely tracked for a potential purchase opportunity. Both of our new purchases II-VI and G-III were on our Bull-Pen list, and converted to opportunistic purchases in the fourth quarter. We discuss our Bull-Pen list methodology in greater detail in the market musings section of our website: https://www.reweyassetmanagement.com/post/carpe-diem-patiently.

II-VI Inc.

II-VI is a vertically integrated manufacturer of compound semi-conductor chips and opto-electronic equipment that create, direct and perfect lasers in communication, industrial, life science and defense markets. II-VI met all three of our investment criteria, a strong financial position, the ability to grow and an attractive entry window following a negative market reaction to its FY1Q20 (Sept. 2019) earnings report.

II-VI offered a strong financial position post its September 24th acquisition of Finisar Corporation. Despite an initial post-close net debt to EBITDA ratio of approximately 3.8x, we think IIVI's strong free cash flow and its 3-year cost synergy plan of $150 million will provide ample opportunity for IIVI to develop its new technologies, fund its capex and de-lever the balance sheet over time. Moreover, upon closing of the acquisition, Bank of America backed new term debt and revolving credit facilities that mature in 2024, precluding near term maturity concerns. II-VI is also free of major contingent liabilities such as large defined contribution plans, having only a small plan for its Swiss operation, and no material environmental or litigation risks.

The growth outlook for II-VI is compelling. Its core product offerings are innovating and taking share to drive revenue growth. Its communication offerings (46% of revenues), adjust light wavelengths over fiber networks, and provide high speed communication in data centers. Its industrial lasers (26% of revenues) are used for surface preparation and precision cutting. Its defense offerings (11% of revenues), are in the rapidly growing command, control and surveillance offerings for target identification guidance systems. Its life science offerings (9% of revenues), are used for compound detection and analysis.

In addition, II-VI has truly exciting growth opportunities in rapidly emerging technologies. II-VI's Silicon Carbide (SiC) business is a hidden gem within the business at about 6% of revenues, but rapidly growing. SiC provides more efficient DC/AC power conversion with less heat generation that traditional silicon, a performance profile that is driving sales growth in electric cars, wind and solar applications. SiC is also gaining share in with 5G antennas for wireless base stations, where multiple devices per antenna will be required for higher bandwidth and faster speeds. Its 3-D sensing business, bolstered by Finisar's Indium Phosphide technologies, creates forward looking lasers used in automotive, for safety and autonomous driving, and consumer electronic devices such as facial recognition. Its EUV lithography business is enabling smaller and more powerful integrated circuits that are rapidly growing due to the proliferation of internet of things (IOT) computing devices.

The valuation opportunity post the FY1Q20 report was compelling, as short term focused and algorithmic trading drove the shares dramatically lower from roughly $35 pre-announcement (and its 52-week high of $43.49), and allowed us to purchase our position at under $28 per share. Of the two issues that impacted the quarter, both are likely to be short lived as industrial revenue softness is already showing signs of reacceleration and the production start-up hiccup at its new Sherman TX fabrication facility is likely to be fully resolved in early calendar 1Q20. We have set our initial Assessed Fair Value (AFV) 12-month price target at $42, up 50% from our entry price, conservatively based off 10x 1-year forward EV/EBITDA. As its newer growth technologies accelerate revenue growth and FNSR merger synergies are realized, we envision price strength well beyond this level over three to five years.[11]

Monarch Cement Company

Monarch Cement (MCEM) is a $233 million market cap cement company. Its primary plant based in Humboldt Kansas, produced over one million tons of Portland cement in 2018, with estimated capacity of over 1.2 million tons. MCEM represents a compelling investment opportunity with import resistant central U.S. markets, fully modernized emissions technologies, a fortress balance sheet and strong free cash flow.

Monarch has 3.86 million shares outstanding, with its 2.65 common shares publicly traded and 1.2 million class B shares, which hold 10-1 voting rights and are held solely by descendants of the four original owner families. Any class B shares that are sold outside each individual family, convert one for one to common shares. As of Sept. 30th, MCEM has only $1.4 million of total debt, and an undrawn $15 million revolving credit facility backed by Bank of Oklahoma. Cash is $15.6 million. Additionally, MCEM maintains an investment portfolio of $46.1 million of marketable securities consisting of Vulcan Materials, Martin Marietta Materials, Eagle Materials, Summit Materials, Pulte Group and CVR energy, all publicly listed companies. Further, MCEM owns an additional 32.4% interest in privately held GFI Brick Company valued at $9.25 mil. Thus, net enterprise value giving credit for net cash and investments is $163 million, vs. its market value of $233 million. Book value of $51.41 has compounded at an 11.1% CAGR for the trailing 5-years, and in our analysis appears to maintain or accelerate this pace over the next few years, due to earnings growth, minimal capex needs and a current free cash flow yield over 11%.

Monarch should see stable revenue growth over the next few years, due to the strong economy, pricing gains and the ability to accelerate production to meet incremental demand from nearby wind farms and highway renovation. MCEM serves markets ranging from Southern Nebraska to Northern Oklahoma and Arkansas which are insulated from foreign import competition, due to the high cost of transport needed to move cement over long land distances vs. water access. Greenfield construction across the industry is likely to be minimal due to environmental considerations, giving established players protection from new supply competition. Monarch has used its excess cash flow to expand distribution vertically with the purchase of 14 ready-mix cement companies. Its wholly owned ready-mix operations comprise roughly 48% of revenues, but operate at a break-even operating income level, providing a significant opportunity for margin expansion from this segment.

The valuation opportunity in MCEM is compelling, as it is trading at 4.2x enterprise value to ebitda (ev/ebitda) on our 2019 estimates, which were negatively impacted due to an extremely wet spring and summer vs. prior year average weather. Its three closest peer companies (MLM, EXP and SUM), all of which are represented in MCEM's investment portfolio, trade at an average of 10x EV/EBITDA on 2019 estimates, which would price MCEM at $118.91 per share, if it traded at the same level. While a discount from this peer group is warranted due to private control from the B shares and limited trading volumes, in our view the significant net cash and investment position offsets liquidity issues for long-term focused investors.

Two recent transactions for peer assets also support a significantly higher valuation for MCEM. Ashgrove Cement, a comparable peer from a holder and geographic perspective, was purchased by CRH PLC for 10.3x trailing EBITDA in 2018. More recently, on November 26, 2019, Eagle Materials announced the acquisition of Kentucky Cement, a 1.7 million ton facility peer facility, for $665 million, or $391k per ton. We estimate MCEM's capacity at over 1.2 million tons as it has produced over 100K tons for over four consecutive months recently, which would imply a valuation of $469.2 million or $121 per share for the cement plant alone, before $14.30 per share for the investment portfolio, $3.60 net cash per share and any value attributed to the ready mix operations.

While we have offered our advice to management to repurchase shares at this current valuation, for now the CEO prefers to buy only at or very near its book value. We believe that the outlook for compounding of book value justifies purchases at this level, and is clearly a superior option than purchasing the equity of its more expensively valued public peers.

We have set our initial 3-year AFV for MCEM at $90 up about 50% from its year-end close of $60.40, approximately 7x EBITDA, and a 30% discount to its publicly traded peers as we do not expect any strategic action in the near term. Management is content, for now, to maintain a peer leading dividend, now at $2.00 per share, a 3.3% yield. Thus, we are paid to wait while compounding book value at double digit rates.[12]

Looking Forward

As we look ahead to the new decade, we see a strong start to 2020, based on continued economic growth, a de-escalation of trade tension and an accommodative Federal Reserve. While we are confident that things will be different in the future, we are just as confident that the merits of fundamental, value-based equity analysis and portfolio management will not change. One of our favorite idioms is "it matters when it matters" and we strongly believe this holds true for valuation, risk control and downside protection. In our 30-years of equity management experience, we have seen many periods of excess exuberance, where numerous market pundits announced a new paradigm of valuation, or even declared that valuation did not matter. Conversely, we have seen extreme periods of fear and angst, where pundits claimed the system was broken and fundamentally skewed to a dystopian downside.

Regardless, from our experience, what has worked over time is a disciplined and non-emotional approach to active research and downside protection. This is the cornerstone of our investment philosophy, and it begins with having the financial strength, our first pillar, to weather periods of angst. Our second pillar embraces companies that can grow over time. Our third pillar is valuation, which does matter when it matters. Value and growth are not antonyms. New paradigms of valuation that do not account for economic returns on capital invested and free cash flow generation have never passed the test of time. We strongly believe this will remain true in the future.

Thank you again for your continued trust and support. As always, 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 Index performance levels are sourced from Bloomberg.
2 All portfolios are based off our model portfolio. Individual portfolios may hold slight deviations in position sizes and names held due to reasons including tax loss selling and our philosophy of investing newer portfolios over time that could lead to performance variations versus the model portfolio. Performance is unaudited. Past performance is no guarantee of future results.
3 Our August 31st market musing on "Misguided Fears of an Inverted Yield Curve" proved prescient on both the yield curve and the China trade situation. https://www.reweyassetmanagement.com/post/misguided-fears-of-the-inverted-yield-curve
4 Details on the Repo liquidity injection are available from the Federal Reserve Bank of New York release dated 10/11/19.
5 Market capitalization and trading data sourced from Bloomberg. 4,649 names traded on U.S. exchanges, screened by Bloomberg as of 1/2/2019.
6 R2500 Value Index information according to FTSE Russell R2500V 11/30/2019 factsheet. The Russell 2500™ Value Index measures the performance of the small to mid-cap value segment of the US equity universe. It includes those Russell 2500™ companies that are considered more value oriented relative to the overall market as defined by Russell's leading style methodology. The Russell 2500™ Growth Index measures the performance of the small to mid-cap growth segment of the US equity universe. It includes those Russell 2500™ companies with higher growth earning potential as defined by FTSE Russell's leading style methodology.

7 RAM portfolios hold CERN, WY, LNC and LEN/B (LEN and LEN/B combined market cap) with aggregate market capitalization levels over $10 billion as of 12/31/2019.
8 Estimated valuation statistics for Rewey Asset Management portfolios are sourced from proprietary financial analysis and/or Bloomberg estimates.
9 Rewey Asset Management PE sourced from Bloomberg and RAM proprietary estimate when Bloomberg estimate not available due to no analyst coverage. Russell 2500 Value and Growth PE information sourced from FTSE Russell Index Fact Sheets dated 11/30/19, the most recent available. The R2500V and 2500G PE's exclude non-earning (negative earnings) companies. RAM PE excludes Interfor Corp. and Independence Contract Drilling, who have estimated negative earnings for 2019, and excludes WY, which as a REIT is most comparable on FFO and dividend yield.
10 Sell side analyst coverage statistics sourced from Bloomberg.
11 All financial ratios, statistics, and projections discussed in the II-VI corporation (IIVI) commentary are sourced from IIVI's 10-K and 10Q filings, company press releases, company public conference calls and webcasts, company slide presentations and Rewey Asset Management proprietary financial analysis.
12 All financial ratios, statistics, and projections discussed in the Monarch Cement (MCEM) commentary are sourced from HI's 10-K,10Q, company press releases, Eagle Material and Ash Grove acquisition announcement press releases, company public conference calls and webcasts, company slide presentations and Rewey Asset Management proprietary financial analysis.