Dear Friends and Clients,

The third quarter provided yet another coaster ride. Although the Russell 2500 Value index increased by a nominal 0.13% for the quarter, it fell to a quarterly low 6.84% on August 27th, then rallied sharply by 7.48% to finish out the period. This market pattern was similar for the Russel 2000 Value index (small-cap), which fell 0.57%, and the S&P 500, which increased by 1.70% in the quarter.[1] Our RAM composite index increased 2.4% for 3Q19 net of fees, and remains ahead of the Russell 2500 Value and 2000 Value year-to-date up 18.9%, still slightly trailing the S&P 500 for the year, which is up 20.55% year-to-date.[2]

The Value Comeback

The intra-quarter volatility was even more interesting when you compare value to growth indices. Following the market bottom on August 27th, the Russell 2500 Value index returned 7.48% compared to a modest 0.05% for the Russell 2500 Growth index. While this short period of outperformance does not dramatically impact the trailing 5-year performance of the Russel 2500 Growth index (up 62.5%) versus the Russell 2500 Value (40.0%)[3], in our opinion it does reflect our view of the market in general. We see a bi-furcated market fueled by low interest rates that have propelled growth stocks to valuation premiums, while many value names remain out of favor and attractively priced.

We believe there is another message behind the dramatic market move post August 27th, and that is that the current growth paradigm cracked. Of course, we are not anti-growth; in fact, the second tenet of our investment philosophy is that we will not own a company that cannot grow over time. However, today's growth valuation parameters seem to be anti-valuation. The paradigm of lower rates and monetary easing that has encouraged ever higher valuation premiums, will, in our opinion be tested more and more, and fail more and more. We have seen examples of this in the increased scrutiny of risky business models, such as the circus of news surrounding WeWork's structure and corporate governance. WeWork, which contracts for office space in the long term but rents space on a short term, even a month to month basis, has a extreme asset versus liability mis-match. We have also seen high profile IPOs of otherwise attractive business models break price day 1, due to drastic overvaluation parameters. Recent examples of this phenomenon include Peleton (PTON) and Uber (UBER). While not all growth valuations are this extreme, there are many, which support our view of a bifurcated market.

Compounding this disparity is the run away, or run amuck, rise of algorithmic trading. In an example from our portfolio, Callon Petroleum (CPE) traded 1.1 billion shares in 3Q19, compared to its total common shares outstanding of just 228 million[4]. The machines traded 4.82 times CPEs total market cap in the quarter, buying and selling the stock repeatedly. Though technology and algorithms have certainly progressed, they still cannot predict unforeseen events such as the recent missile attack on Saudi oil production facilities. As such, we firmly believe that these models should not be relied on.

Market Commentary

The volatile U.S.-China trade negotiations and the pivot to easing by the U.S. Federal Reserve, which twice cut interest rates by 25-basis points, were the defining themes of 3Q19. While the surprise missile attack on the Saudi Arabian oil fields provided a shock to oil prices on September 16th, this move was reversed by quarter-end, as the Saudis were able to replace supply from inventories while field repairs are made. Brexit was a ho-hum for the quarter as well, but should be monitored during the fourth-quarter as a definitive decision will happen on or before October 31, 2019, the date Britain would leave the EU with no deal.

The 10-Year Treasury moved dramatically, starting 3Q19 with a yield of 2.00%, falling to a low of 1.43% on 9/3/19, then rallying to 1.90% on 9/13/19. It finished the quarter at 1.66%. Some fear was induced in the markets due to the slight 10-year yield inversion vs. the 3-month treasury (at 16 bps at quarter end)[5]. However, we do not believe that this inversion is a sign of a looming recession. You can read more on our view by visiting our blog at the following link: https://www.reweyassetmanagement.com/post/misguided-fears-of-the-inverted-yield-curve.

While the U.S. China trade talks may have cooled the economy somewhat, we still believe the overall economy remains healthy. Unemployment fell to 3.5% as of September and average annual wage growth remained healthy at 2.9%[6]. The Fed rate cuts should also further bolster the economy going forward. It is important to always remember that our investment cases are not reliant on a positive guess of these macro outcomes, but rather are built to withstand volatility from these events or other unexpected developments. Our value-oriented approach identifies stocks with strong balance sheets, strong company specific growth drivers and favorable valuations that are still priced well below what we see as fair-trading value.

Portfolio Highlights

At the end of March, we held 25 positions in our model portfolio and were just over 91% invested. 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 2019 estimates. Moreover, 9 portfolio holdings are trading under book value and 6 additional positions are trading at less than 1.6x book.[7] It's also worth highlighting that three of our names have no sell-side coverage, one has just one analyst following and 6 others have less than five[8]. In our opinion, this lack of following allows our proprietary research to identify these names that might otherwise pass under the radar for most other investors, and find them at attractive valuations.

LKQ Corp. and Lennar Class B shares were our top contributors this quarter. On September 12th, activist investor ValueAct Capital announced a 5.2% position in LKQ corp., and sought to discuss operational and governance improvement measures with the company's management. On September 13th, LKQ provided a detailed and credible road map to improve European profitability, which is a key tenet of our investment thesis. Lennar rallied on strong reported housing starts at a 1.34 million annual rate for August, a new post financial crisis high. Starts also benefitted from the decline in the average 30-year mortgage rate to 3.72% at quarter end.[9] We continue to see upside in Lennar from cycle improvement and deleveraging activities, and note that the class B shares that we hold traded at a $11.48 per share discount to Lennar A shares at quarter end, despite having a 10-1 voting right advantage[10]. Conduent Inc. was our largest detractor in the quarter, as investors reacted unfavorably to the second quarter earnings disappointment. However, the new CEO launched a strategic review focused on lowering costs and driving new business that should help the company going forward. We see Conduent shares attractively valued at just over 10x current year EPS, and believe the activist pressure from Carl Ichan, who increased his ownership to 18.05% of the company post earnings, will spur operational improvements throughout the company.[11,12]

Activists find us…again

Similar to 1Q19 and 2Q19, there were two instances in which activists initiated positions in our portfolio companies during 3Q19. We view activism and resource conversion, the monetization of undervalued assets, as a welcome addition to our investment cases. While we will not purchase a company based solely on the hope of activism, spin-off, sale, etc., these items can be a valuable catalyst for increasing value. As discussed above, ValueAct capital announced on September 12th that it had taken a 5.2% position in LKQ corporation and is seeking talks with management. While we welcome the attention brought by a well-known activist like ValueAct, we do not believe the company is in need of any radical shake up or changes. Separately, on September 9th, Paulson and Company announced that it had taken a 9.46% position in Callon Petroleum. Earlier in the quarter, we sold our position in Carrizo Oil and Gas, to lock in a short-term capital loss for clients, and replaced the entire position with Callon Petroleum, which has agreed to buy Carrizo in a 100% stock-based transaction. Thus, we retained our full economic exposure to the post deal company. Paulson is arguing that Callon should break-off the deal with Carrizo, and to seek premium bids for itself from larger buyers. In contrast, we remain supportive of the merger and its operational benefits, and believe that the combined entity post close, will still be an attractive merger target.[13]

CPI Aerostructures

During 3Q19, we initiated a position in CPI Aerostructures (CVU), a $92 million market cap integrator and final assembler of complex aero assemblies and subsystems. While CVU is relatively unknown and only has one sell side analyst following the company, it has an excellent reputation for quality work and an attractive outlook for revenue growth.

CVU carries a strong financial position, with a current debt to ebitda ratio of 2.2x based on our 2019 estimate. This ratio reflects the cash acquisition of Welding Metallurgy Inc. (WMI) in December 2018. The company has a relatively clean balance sheet, with no pension and no material environmental or litigation issues. CVU has fully integrated WMI into its Long Island, NY facility, and does not see a near-term need for large capital expenditures. As such, CVU's near-term focus is on deleveraging, and with its strong Free Cash Flow (current FCF yield is over 10%), we believe CVU will be able to bring its debt to ebitda ratio to less than 1.5x by year-end 2020.

CVU's bright outlook for accelerating revenue growth over the next three years should also serve as a meaningful catalyst to valuation. CVU's current multi-year backlog is $447 million, which is staggering compared to its trailing twelve-month revenue total of $94.2 million. CVU has estimated its forecast 3-year CAGR revenue growth for each segment as follows, Aerostructures (55% of 2018 revenues) to grow 12%-18%, AeroSystems (24% of 2018 revenues) to grow 16%-20% and Kitting/SCM (21% of revenues) to grow 16%-18%. Moreover, the company thinks these estimates could be conservative as they are based predominantly on funded backlog, allowing even more upside from new awards.

CVU should also deliver margin improvement over the next three years, as it harvests operating synergies from WMI now that the integration is complete, and due to sales leverage, as the company indicated its new business wins were at or above comparable pricing levels to current business. Longer-term revenue trends look healthy as well; defense budget priorities should promote growth in areas of strength for CVU such as electronic warfare pods, hypersonic missiles and large unmanned drones.

We believe there is a compelling upside of 50%+ from current levels of roughly $8 per share. Earnings should accelerate with or above revenue growth, to over $1 per share by 2021. Even on our estimate of $0.90 per share for 2020, a 14x price/earnings multiple would yield a $12.60 price target. Alternatively, a 10x EBITDA multiple on our 2020 estimate would yield over $11.50 per share, with potential upside if substantially all its FCF is deployed to deleveraging. Based on our 2020 estimates, the current FCF yield is a very attractive at 11.7%, and we believe a more appropriate, but still conservative FCF yield should be 7.5%, which also equates roughly $12.12 per share. Our Adjusted Fair Value (AFV) price target of $12 per share over the next 12-18 months blends these approaches. A near-term catalyst for the shares could be 3Q19 earnings, where we believe CVU will share additional details on its 3-year segment revenue growth details. These plans were only first announced September 5th at the Gabelli Aerospace conference, and thus we do not think they have been widely digested across the broader market yet.[14]

Hillenbrand

I'm sure many of you recall our 4Q18 discussion of Milacron Holdings (MCRN), where we stated our positive view on the company and our $22 AFV target, versus its year-end closing price of $11.89. On

7/12/19, Hillenbrand (HI) announced the acquisition of MCRN for $11.80 in cash and .1612 per share, or an implied value for MCRN of $18.06 off HI's 7/11/19 closing price of $38.87. While we were pleased that HI recognized the value we too saw in MCRN, we felt as though this deal was more of a take-away for our clients rather than a take-over. Even though we received a cash value roughly equal to the year-end closing price, the .1612 per share conversion ratio did not leave us much room to benefit from the upside the deal could create. Needless to say, we were baffled by the negative investor reaction to the deal, as HI sold off from $38.87 pre-deal, to a low of $26.01 on 8/28/19. However, opportunity knocked and we answered by initiating a position in HI at roughly $27.50 per share, as it is our belief that the acquisition of MCRN by HI strengthens the investment outlook for both companies.

From a balance sheet perspective, the initial debt to ebitda ratio of 3.6x EV/EBITDA immediately post close is not ideal, but the company is pledging to prioritize debt repayment and reduce this ratio to 2.75x within 12-months of close. This goal seems credible and HI has several areas and goals to pursue. We believe the company can achieve its targeted $325 million in Free Cash Flow (FCF) by year-end 2021 compared to our estimated pro-forma FCF of $300 million in 2019, which should help meet and exceed their deleveraging goal. HI has a solid base of FCF from its Batesville unit that sells caskets. This business, while highly recurring, is in slow decline and is being managed as a cash cow, with annual estimated FCF to be just shy of $100 million. Additionally, HI could monetize MCRN's Fluids segment as both companies deem this segment "non-strategic". This segment produces lubricants for advanced cutting processes and would likely trade in excess of $300 million, or at least 10x 2018 EBITDA. Further, HI believes it will be able to fully utilize MCRN's U.S. net operating loss carryforwards of $107 million. Importantly, HI has already completed the necessary external financing for this deal, raising $375 million in 7-year notes at 4.5% on 9/16/19. As neither company has any material pension, environmental or litigation cash drains, the combined entity should be able to execute its deleveraging plan.

From a strategic view, the merger adds scale and market reach to their combined injection molding and extrusion businesses, including leading positions in the U.S. and India. Both businesses bring in roughly 35% of revenues from spare parts sales, and roughly 30% from aftermarket service. HI also gains the Mold Flow hot runner unit, which relies on new product introductions versus volume-based production. Growth in this segment is driven by shorter product life cycles, increased innovation, and new product categories such as, medical, packaging and electric vehicles. Cross selling opportunities should accelerate growth, but these opportunities are not considered in the merger synergy estimate.

As the companies unify, total operating synergies from the deal of $50 million over three-years should support earnings and cash flow growth, with half of this targeted for the first year post close. This goal is likely made easier due the fact the companies' corporate headquarters are only 50-miles apart in Indiana. Further synergies are likely as HI applies its successful Hillenbrand Operating System of lean manufacturing, based on the Danaher Business System, to the newly combined operations.

At our purchase price of $27.50, and using our pro-forma 2020 estimates, the combined entity is trading at a modest 7.18x EV/EBITDA and 8.1x EPS. From a free cash flow perspective, the entity is even more compelling, trading at a 14.5% free cash flow yield. In our opinion, the leverage ratio of 3.6x EV/EBITDA post close is giving investors pause, but this also presents an opportunity, as deleveraging should accrete value to equity holders. Our near-term AFV is a modest $37.50, up 36% from purchase and approximately 8.5x 2020 estimated EBITDA, and below HI's value the day the merger was announced. If the deleveraging is as successful and aggressive as we believe it will be, we can see considerable upside beyond this level.[15]

Looking Forward

The geopolitical landscape, from China trade talks to Iranian military moves to Brexit, will likely buffet investor sentiment and weigh on business confidence. However, the underlying strength of the U.S. economy, measured by job growth, wage growth, GDP strength and consumer confidence, should remain healthy and allow for a solid finish to 2019.

While uncertainty can cause short-term market swings and investor anxiety, it can also provide an excellent opportunity for the patient investor to identify and purchase securities that are misunderstood and undervalued. Our long-term investment philosophy allows us to look past these uncertainties and negative sentiment that can often trap other investors. Instead, we carry an understanding that the current market prices are not an efficient mark of actual value. Our investment approach allows us to discern what a company's equity is truly worth, and not sway based on short-sighted Wall Street research or the daily hysteria of the financial press. We seek to uncover undervalued companies with fundamental strengths, whose value will likely emerge over our investment horizon.

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.

-Chip

1, 3 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 portofolio. Performance is unaudited. Past performance is no guarantee of future results.

4 Market capitalization and trading data source from Bloomberg.

5 U.S. Treasury yield data sourced from Bloomberg.

6 U.S. Unemployment and Average Hourly Earnings data sourced from the Bureau of Labor Statistics.

7 Estimated valuation statistics for Rewey Asset Management portfolios are sourced from proprietary financial analysis and/or Bloomberg estimates.
8 Sell side analyst coverage statistics sourced from Bloomberg.
9 Housing start data sourced from U.S. Census Bureau. 30-year mortgate rate referenced is sourced from Bankrate.com U.S. home mortgage 30-year fixed national average.
10 Market prices of stocks discussed sourced from Bloomberg.
11 Conduent financial estimates sourced from Rewey Asset Management proprietary financial analysis.
12, 13 Ownership positions of securities and holders mentioned sourced from 13-F and 13-D filings and Bloomberg.
14 All financial ratios, statistics, and projections discussed in the CPI Aerostructures (CVU) commentary are sourced from CVU'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.
15 All financial ratios, statistics, and projections discussed in the Hillebrand (HI) commentary are sourced from HI's 10-K,10Q and S-4 filings, company press releases, company public conference calls and webcasts, company slide presentations and Rewey Asset Management proprietary financial analysis.