Rewey Asset Management
A Member of Advisory Services Network, LLC

Dear Friends and Clients,

The second-quarter of 2019 was a roller coaster ride. After roaring off to a strong start in April, the market experienced a sharp sell-off throughout May, then rallied again in June, allowing most indices to post small gains. The Russell 2500 Value index (small/mid-cap) increased by 1.89%, the Russel 2000 Value index (small-cap) increased 1.37% and the S&P 500 increased by 4.30%.[1] Our client portfolios performed in-line with the Russell 2500 Value index for the quarter, and remain ahead of the index year-to-date.[2]

You may recall from our first quarter letter that we anticipated that the ongoing volatile U.S.-China trade negotiations would dominate the second quarter. This theme held true through the end of May, but in early June expectations of a Fed rate cut took center stage. We believe the market is now fully discounting at least a 25-basis point cut in July, with the potential for as much as 100-basis points total by mid-2020. The yield on the 10-year note fell dramatically from 2.42% to 2.00% in 2Q, and the yield curve remained in slight inversion as the 3-month bill finished the quarter at 2.09%[3]. After 1Q19's blistering economic growth, with a GDP of 3.1%, the most recent reported data shows that things appear to have cooled somewhat[4]. However, the data does not show that the economy is in contraction. Nonfarm payroll gains were a positive 216 thousand in April, 72 thousand in May and 224 thousand in June. Another positive sign is that the U.S. unemployment rate remains very low at 3.1% and average hourly earnings rose 3.1% year over year in June[5].

This economic pattern presents some potentially worrisome cross currents. The new stock market highs seem to be based on the combined expectations of a favorable outcome of the China trade talks, continued positive economic data and a series of rate cuts by the Fed. However, we do not believe the Fed will cut rates more than once unless the economic slowdown intensifies, and/or the trade war worsens, both of which would likely pressure the stock market. While shorter term focused quantitative and growth investors try to guess the correct outcome, our investment cases do not rely on a correct forecast of these macro events. Our value-oriented approach identifies stocks with strong balance sheets, with strong company specific growth drivers and favorable valuations that are still well below what we see as fair-trading value. All but two of our holdings are currently trading significantly below their 52-week highs, which we see as a sign of low expectations. However, these low expectations benefit our portfolios as the investor neglect should provide downside protection in the short-term as we hold for and anticipate significant upside over our 3-5 year investment horizon.

Portfolio Highlights

At the end of March, we held 22 positions in our model portfolio and were 83% 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 trade under book value and 6 additional positions are trading at less than 1.5x book.[6]

Both Ultra Clean Holdings and Cerner Corp provided solid performance and were our top performing positions in the second quarter. Ultra Clean soldiered on in its year-to-date rally despite general weakness in the semiconductor space, as investors embraced the recurring revenue profile of its newly acquired Quantum Global unit. Cerner rallied on strong 1Q19 earnings and news of the Starboard agreement (see below). Our two energy related names, Independence Contract Drilling (ICD) and Carrizo, displayed wearker performance in the quarter, in sympathy with the energy sector, the weakest performing sector in the S&P 500. The disappointing performance was caused by investors fretting about long-term oil demand, despite OPEC extending its production cuts and resilient oil prices, which ended the quarter at $58.47 per barrel[7]. We remain upbeat on ICD, noting that although its drilling fleet is state of the art, its shares are trading at a compelling discount to its net property plant and equipment value of $6.44 per share, its book value of $5.14 per share and our estimate of the replacement value of its 32 marketed rigs of $7.68 per share. In addition, ICD has no debt maturities until October 1, 2023, and continues to invest for growth with rig upgrades[8]. We are also upbeat on Carrizo, and discuss the activist filing in the quarter below.

Activists find us

Similar to 1Q19, there were two instances in which activists initiated positions in our portfolio companies during 2Q19. We see activism and resource conversion, the monetization of hidden or undervalued assets, as a welcome addition to our investment cases. While we would never purchase a company based solely on the hope of activism, spin-off, sale, etc., these items can indeed be a valuable catalyst for increasing value. On April 8th, Cerner announced it had reached an agreement with Starboard Capital regarding board refreshment and operational improvement initiatives, and that Starboard had taken a 3.095 million share position in the company. Specifically, Cerner added four new directors to its board, committed to 20% and 22.5% operating margin targets for 2019 and 2020, increased its repurchase authorization to $1.5 billion and created a finance and strategy committee to oversee operational improvements. While Cerner has recently made excellent progress on organizational and profit improvement efforts, we applaud the addition of Starboard and its initiatives to accelerate Cerner's transformation and bring value to the company. Separately, on May 3rd, Lion Point Capital announced that it had taken a 5.05% position in Carrizo Oil and Gas. In addition to offering its support of Carrizo's Permian basin expansion, its operational efficiency improvements and deleveraging efforts, Lion Point is seeking potential spin-offs or an outright sale of the company. We wrote extensively last quarter about the tremendous value we see in Carrizo, and note that we would only be supportive of any spin or sale actions if they provided our clients a substantial premium over current trading levels.

Weyerhaeuser

We are all undoubetdly familiar with the old adage 'money doesn't grow on trees,' but, in reality our purchase of Weyerhaeuser this quarter contradicts this! Weyerhaeuser is the largest timber Real Estate Investment Trust (REIT) and the largest private owner of timberland in North America, owning a staggering 12.2 million acres. The company also has both a significant wood products operating company and a real estate unit. Weyerhaeuser easily meets all three tenets of our investment philosophy and we were able to add the position to our portfolios this quarter as it traded near a 52-week low.

Weyerhaeuser has impressive financial strength. The company has 43% debt to total capital, or 24% debt to enterprise value, but more importantly, net debt is only 27% of the timber only value in our sum-of-the-parts valuation (SOTP)[9]. The trees on its timber acreage grow in value every year, and are monetizable hard assets that easily support this debt level. Another benefit is that 96% of its debt is fixed, with no maturities before 2021. In early 2019, the company redeemed its near-term maturity $500 million of 7.375% notes, and issued 10-year notes at 4%, demonstrating its strong access to the capital markets and its investment grade rating from both Moody's and S&P. Weyerhaeuser's operations produce substantial earnings and cash flow, allowing a significant return of capital to shareholders annually through dividends and share repurchases, $1.4 billion in 2018 and a total of $7.5 billion since 2014. Weyerhaeuser repurchased $60 million in stock in 1Q19 and has $440 million remaining under its current authorization. The company currently pays a $1.36 annual dividend, offering a 5.2% yield, and has raised its dividend 127% since 2011. Additionally, the company has made tremendous strides with its pension plan, pre-funding $300 million in 2018 and transferring assets and liabilities of $1.5 billion through the purchase of an annuity contract in 1Q19, bringing the plan nearly to fully funded.

Weyerhaeuser has a clear growth path in all three of its divisions. One of the company's greatest opportunities lies in housing. Timber harvests can increase if housing starts accelerate back to long term trend levels of 1.4-1.5 million, vs. current levels of approximately 1.2 million. While housing can help timber's overall performance, Weyerhaeuser is not dependent on new housing starts as residential construction accounts for only 29% of timber use, compared to 40% in repair and renovation, and 25% in industrial uses. With an average age around 40 years, the existing U.S. housing stock should continue to produce more and more repair and renovation activity. Weyerhaeuser's real estate unit aims to increase its timberland value through monetizing higher and better use acres for residential, vacation and commercial development. The unit seeks at least a 30% increase in per-acre value for transactions, but recently has been monetizing acres at an impressive 65% premium, and it increased its 2019 targets on its first quarter earnings report. Weyerhaueser also has made significant improvements to increase the profitability of its building products division through $329 million of achieved cost reductions since

2014. These improvements have paid off, as profitability has risen from a net loss in 2011 to a $1 billion in EBITDA level in 2017 and 2018. Weyerhaeuser is targeting continued cost reductions for all divisions in 2019 of $80-$90 million, with half of this in the building products division. This should allow the division to thrive independent of volume driven housing start increases.

Weyerhaeuser offered a compelling valuation at our purchase levels of around $22.70 per share, down from its 52-week high of $37.44. This value was significantly below our assessed fair value (AFV) price target of $34 per share. At purchase, the Weyerhaeuser's dividend yield was almost 6%. We determined our price target through two methods. First, we took the approximate market value of its timber assets by region, as estimated by NCREIF (National Council of Real Estate Investment Fiduciaries), valued the Real Estate unit on a 10-year DCF with no residual value, and took a market value of the building products company vs. peers to deliver a net SOTP of around $34. Second, a 4% dividend yield is $34, and over the last five years WY has primarily traded in a 3%-4% dividend yield range.

We also find Weyerhaeuser to be attractive from a restructuring standpoint. The wood products operating company does not fit well within a REIT structure. In 2014, the company spun off its homebuilding operation, and with the significant improvement in profitability of the wood products division over the last five years, this division could also be separated into a stand-alone company. This action would help close the discount to our SOTP valuation. A divestiture of the wood products division would also make the timber REIT more attractive to Environment, Social and Governance (ESG) focused investors as a pure play. Weyerhaeuser already has high ESG scores due to both its carbon capture nature and its Board of Directors structure, and it has been listed on the Dow Jones Sustainability index since 2005. While this split up vision is not included in our current valuation, it is part of our longer-term vision for the company.

HUB Group

HUB Group is a leading supply chain management company, offering intermodal rail shipping (containers shipped over rail), logistics solutions and transportation brokerage. As an innovative pioneer in the space, HUB's intermodal activities date back to 1971. The unit has capitalized on its first mover advantage through its alignment with both the Union Pacific and the Norfolk Southern Railroad. Its logistics unit includes its Unyson and newly acquired Case Stack operations, and it provides transportation optimization from mode selection to load consolidation to warehouse solutions. While its truck brokerage unit does not own trucks, it matches loads with third party capacity to optimize delivery timing while minimizing costs. Its dedicated truck load unit allocates specific assets to specific customers under long-term contracts and therefore reduces cycle pricing and volume risk when compared to spot-based truckload operators.

HUB easily meets our first pillar of a strong financial position. The company's net debt of $203 million is 16.8% of total capital and roughly .78x 2019 estimated EBITDA[10]. HUB's estimated 2019 free cash flow yield is currently almost 7%, despite continued investment for growth with expenditures of $120 million, $20 million over depreciation and amortization. HUB's free cash flow conversion to net income is roughly 85%. In addition, on May 28th HUB's board approved a $100 million share repurchase program. We view this as a reinforcement of our positive view of HUB's financial strength.

HUB's intermodal unit offers a compelling vision for growth, as improved rail service and better on-time delivery from its partners allow its clients to confidently move shipping loads from highway trucking to intermodal service. Both the Union Pacific and Norfolk Southern have greatly increased their capital expenditures to raise bridges to allow for double stack container trains and to improve network fluidity to increase on-time arrival. There are also several secular drivers that should allow intermodal to gain market share from highway trucking. Intermodal is cheaper than highway shipping due to on its significant fuel efficiency (4x) compared to highway trucks. Intermodal shipping alleviates the concerns of driver shortages, undertrained drivers and driver restrictions due to hours of service laws. Intermodal shipping is also a more environmentally-friendly option, not only because it provides superior fuel efficiency and pollution reduction, but it also removes up to 300 trucks from highways for each intermodal train.

HUB's logistics unit should benefit from its CaseStack acquisition, which closed in December 2018. CaseStack provides value through warehousing and transportation relationships with retail customers, providing a more seamless solution for HUB's offerings. The recent trade tariffs could prove to be beneficial to the logistics unit if manufacturers relocate their production activities back to the U.S. HUB's brokerage unit extends its service offerings in a non-capital intensive way, by matching loads with freight providers as needed, but with relatively low spot market sensitivity as 85% of its revenue is under contract. HUB also continues to grow revenues in its dedicated trucking unit while also improving margins through increased pricing. This division could also be monetized at some point as it is the smallest segment and is operationally different from the other three divisions.

HUB is attractively valued compared to our AFV price target of $55, 31% higher than its quarter end price of $41.98. Our AFV is an average of 8-times our 2020 EBITDA estimate, 16x our EPS estimate, and also offers a slight discount to its 52-week high of $56.60 set in August 2018. Our valuation metrics are toward the low end of historical ranges and leave room for upside to our target over time as HUB executes on its long-term growth vision.

Looking Forward

We expect the wild ride to continue as markets will likely remain volatile into the second half of 2019. We believe investors are anchored on an aggressive Fed easing campaign. If job growth resumes a healthy 150,000+ monthly pace and GDP continues at 2%-3%, we believe the Fed will likely cut only once. The current geopolitical landscape, from China trade talks to Iranian military moves to Brexit, could also buffet sentiment.

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 own securities that are misunderstood and undervalued. Our long-term investment philosophy allows us to look past uncertainties and negative sentiment with an understanding that the current market prices are not an efficient mark of value. Our investment approach allows us to discern what a company's equity is worth, and not sway based on short-sighted Wall Street research or the daily hysteria of the financial press. We seek to uncover companies with fundamental strengths that are currently undervalued, and whose value will likely emerge over our investment horizon.

Thank you again for your continued trust and support. 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.
3 U.S. Treasury yield data sourced from Bloomberg.
4 GDP information sourced from the Bureau of Economic Analysis.
5 Nonfarm Payroll, U.S. Unemployment and Average Hourly Earnings data sourced from the Bureau of Labor Statistics.
6 Estimated valuation statistics for Rewey Asset Management portfolios are sourced from proprietary financial analysis and/or Bloomberg estimates.
7 WTI crude current and historical pricing sourced from Bloomberg.
8 ICD valuation statistics sourced from company 1Q19 10-Q filing and Rewey Asset Management proprietary financial analysis.
9 All financial ratios, statistics, and projections discussed in the Weyerhaeuser commentary are sourced from Weyerhaeuser's 1Q19 10Q, 2018 10-K, 1Q19 company conference call, WY's June 2019 investor deck, its June 4th NAREIT presentation and Rewey Asset Management proprietary financial analysis.
10 All financial ratios, statistics, and projections discussed in the HUB Group commentary are sourced from HUB Group's 1Q19 10Q, 2018 10-K, 1Q19 company conference call, Bloomberg News Service and Rewey Asset Management proprietary financial analysis.

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