The Blue Chips
Investor Letter
Fall 2019

"Some of the best opportunities in the world are the most obvious ones."

Thomas G. Stemberg

Statement from the Chair

Chairman of the Investment Committee: David Ozen

Earlier this quarter I stumbled upon a Wall Street Journal article that I wanted to share. The article had one of those silly titles that initially instills suspicion, "How you can get big gains that Wall Street can't". The premise was simple: individual investors have an advantage over most fund managers because fund managers are obligated to investors and can therefore not withstand short-term price swings. The author gave a few compelling examples to demonstrate his point. To borrow one, if you had invested $1,000 in Jack Henry & Associates in 1989 today you would have $2.6 million; but to get that $2.6 million you would have had to endure a 67% drop along the way.

I was surprised! One of the first lessons we teach in NME is the disconnect between price and value. Surely this was not worthy of news. But as I continued to think about it, I started to recognize how truly unique our thought process is nowadays. A good investment may underperform in the short-run, but in the long-run will outperform. This requires patience and mental fortitude. If it was easy, everyone would do it. I am proud that we, as an institution, continue to maintain our philosophy while the rest of the world continues to rediscover it.

Our Sector Leaders and Analysts again produced another round of great pitches. It almost feels as if the Investment Committee decisions each quarter are getting progressively harder and harder. This quarter we purchased Natural Resource's pitch of Natural Resource Partners LP. NRP has a simple business model; they lease coal mineral rights to coal mine operators. Given the secular decline of thermal coal, it is no surprise that NRP has fallen out of favor with equity investors. This is further exasperated by their connection with distressed operators Murray Energy and Foresight Energy. The future of thermal coal, while uncertain, is dreary; however, it is this very fact that we feel provides us an opportunity. We are of the belief that NRP's current Enterprise Value is justified by the value of its metallurgical coal assets and its stake in Ciner Wyoming, a trona ore and soda ash production business. Thermal coal may not have a bright future, but we are confident in the margin of safety provided by receiving this business line for free.

This quarter we continued to bring in guest speakers for our members. We were fortunate enough to have Win Murray, Director of U.S. Research at Harris Associates, come speak to us. I would like to thank TBC's president, Lance Hao, for organizing this opportunity for our Analysts. Looking towards the future, we hope to continue to bring in investment professionals to present during meeting. To our alumni who may be interested in giving a talk, please feel free to reach out to me or Lance; we would love for you to come back. To continue education outside of NME, members of leadership led a book club. Analysts read The Alchemy of Finance by George Soros or More Money than God by Sebastian Mallaby. Thank you to Ed Chang (Healthcare ICOMM Rep) for spearheading this initiative and to Josh Soong (Consumers SL), Brandon Bleyer (Industrials SL), and Avita Timbadia (Consumers ICOMM Rep) for aiding Ed in leading book club sessions. Programs like this help facilitate meaningful relationships between Analysts and members of leadership and also helps connect members with similar interests.

You can find this quarter's pitches and ICOMM's decisions along with updates on our portfolio in this letter. Please feel free to reach out to me at dozen@uchicago.edu with any questions or comments. Our alumni are what makes TBC more than an RSO, but an actual community.

Thank you to our dedicated Analysts; the effort put into this quarter's pitches shows. I hope you all have a refreshing Winter Break and I will see you all back in Stuart this January!

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Fall Pitches

2U, Inc. (NASDAQ: TWOU)

Communications Sector Leader: Nathan Nangia

Company Overview

2U, Inc. is a graduate online-education platform; 2U provides a platform for educational institutions to develop and distribute a traditional classroom experience online. The business operates in two-segments: short-courses, which range from 6-8 weeks long, and graduate programs, which confer degrees upon completion. Graduate programs comprise 67% of revenues. Revenue is generated through a 60:40 profit share between 2U and its partners.

Investment Thesis

The Communications Sector recommends a BUY in TWOU for the following reasons:

1. <u>Strong University Value Proposition:</u> TWOU is highly attractive to universities for three reasons: (i.) field-work placements, (ii.) reputation, (iii.) low-cost. First, 2U is the only online-education platform to partner with hospitals, schools, and other institutions to provide students with real-world experience in their field of study. Second, universities, especially elite universities, are risk-averse; thus, 2U's strong brand and history make their platform significantly more attractive to high-profile academic institutions. Third, 2U funds the development and deployment of the course, so academic institutions face no upfront cost. These three factors attract universities strongly and compound to consistently, easily attract universities.
2. <u>Network Effects:</u> 2U also effectively attracts students because of university prestige, program breadth, and the quality-of-life benefits inherent to an online degree. The combination of both students and universities flocking to 2U creates a network effect. As 2U gets more universities, it becomes more attractive for students by increasing program breadth, which enhances 2U's reputation, which, in turn, attracts more universities. This network effect creates a moat, drives down marketing costs to students for 2U, and ensures revenue growth for the core business.
3. <u>Attractive Contract Structure:</u> Finally, the 2U-university contracts are strong, which dramatically reduces the threat of new entrants, substitutes, and cements their competitive advantage. On average, 2U contracts are ten-fifteen years long with non-renewal liquidated damages. Furthermore, contracts generally prevent universities from working with competing platforms and have no early termination rights. The strength of these contracts leads to an oligopolistic market with significant barriers to entry. To date, all 2U-university contracts eligible for renewal have been renewed.

Key Risks and Considerations

1. <u>Capital Risk:</u> A crucial point of the university-attractiveness is low-cost for universities. As a result, 2U is exposed to all the initial investment risk; in the event that a program does not perform as anticipated, 2U, not the university, will suffer the losses. To combat this misalignment of incentives, 2U has partnered with KeyPath Education, which will undertake all the initial capital risk.

2. <u>Diversification:</u> 54% of 2U's revenues come from four clients, creating a significant client exposure risk. However, 2U management is aware of these concerns and is increasing client diversity. Furthermore, 2U still benefits from long-sticky contracts which reduce the threat of client exit.

3. <u>Admissions:</u> 2U does not control admissions decisions, yet their revenue is dependent on it due to a 60:40 revenue share. Thus, the business has significant exposure to an idiosyncratic factor—the whims of universities' admission office; furthermore, given that growth is a function of increasing per-student revenue and student volume, value-realization is partially dependent on admissions. Mitigating this risk are two facts: (i.) per-student revenue growth is lower-bounded by inflation and (ii.) a partial alignment of interests. Universities benefit from increasing their students as much as 2U does because the revenue is split.

Decision: NO PURCHASE

Communications Investment Committee Representative: Annie Li

The Communications Sector pitched 2U, Inc. (NASDAQ: TWOU) as a buy in General Meeting on Wednesday, October 30th, 2019. After review, the Investment Committee decided not to purchase TWOU. Our reasons are as follows:

FIRST: We believe that TWOU's contract pricing of over 60% of tuition revenue will likely see compression moving forward, driven by increased competition in the OPM space and weak negotiating power over customers. Early yellow flags include decreasing FCE and Rev/FCEs over the past 2 quarters beyond expected seasonal weakness, renegotiated contracts with USC and Georgetown, and decreased efficiency of S&M spend. Misaligned incentives between the for-profit OPMs and nonprofit Universities call into question the long-term sustainability of TWOU's current business model.

SECOND: Competition in the market presents many uncertainties toward TWOU's growth. Forward integration of players such as Wiley's and Pearson's would likely present structural advantages over TWOU, given the latter entrants are two large educational material publishers and may attract more general educator awareness. TWOU's clinical placement partnership is non-exclusive, meaning other players can develop similar partnerships to enhance the job placement of their online education programs. We expect TWOU's differentiation from its competitors to weaken despite its first-mover advantage and established brand name in the space.

THIRD: Despite our concerns, we do think TWOU has exhibited significant growth and offers an attractive opportunity for potential mispricing due to its pre-inflection FCF, Operating Income, and Net Earnings. Graduate programs and short courses are end markets with significant TAMs for continued compound growth as online versus offline share of education increases. TWOU's cohort-based revenue model makes it likely to have high revenue predictability and high steady-state margins. In addition, the company has a first-mover advantage and an established brand-name in the industry. The company's partnership with top universities and unique offering of fieldwork placements would build stickiness in the business. The newly implemented mini-courses also create up-sale opportunities. There is a valid potential for margin expansion if the business truly benefits from both network effects and operating leverage. In context of these factors, a low 2.28x revenue multiple suggests that TWOU warrants further research and clarity around price.

Natural Resource Partners LP (NYSE: NRP)

Natural Resources Sector Leader: Parth Patel

Company Overview

Natural Resource Partners is a master limited partnership (MLP) that owns and collects royalties from the mining of its portfolio of mineral properties: notably coal reserves in the United States. Its reserves contain both thermal and metallurgical (met) coal. Currently, 65% of its royalty revenue is derived from the mining of met coal, and this number is increasing. NRP also holds a considerable 49% stake in Ciner Wyoming, one of the largest and lowest cost soda ash miner/refiners in the industry, which provides a stable stream of cash flows year to year. NRP is led by its founder/CEO, Corbin Robertson. His family has a 30% interest in the company, primarily through common units.

Investment Thesis

The Natural Resources sector recommends a BUY in NRP for the following reasons:

1. NRP has a fundamentally strong business post-delevering, with renewed focus on its core competency: NRP's coal royalty segment has a 70% net margin due to its low, fixed cost structure. Lessees take on the burden of building the mining infrastructure and in some cases the transportation infrastructure as well, making NRP's mines sticky. As a result, NRP has consistently maintained an occupancy rate higher than 90%, which generates consistent cash flows that enables it to pay a high dividend or pay down debt.

2. Resilience to coal price risk due to minimum payments and long-term structure of royalty contracts: NRP is one step removed from coal price volatility due to its annual minimum payments, which require lessees to pay a minimum fare, credited against future royalties, if they choose not to operate a mine due to the price environment of coal. This acts as a zero-interest loan for NRP if the company resumes production later, or payment if the contract is later dropped. Moreover, NRP's royalties are derived either from percent of sales or the amount mined, depending on which is greater. Finally, NRP's weighted average contract lifetime is currently six years, giving it a stable runway of cash flows going forward.

3. Misunderstood business model and turnaround story resulting in undervaluation: During the peak of the last coal cycle five to six years ago, management made speculative bets on oil and gas assets using leverage. These investments fared very poorly and caused NRP to reach a Debt/EBITDA ratio of beyond 6x. Recently, NRP finalized the divestiture of these underperforming assets, once again streamlining their business to focus on high-margin coal royalty revenue. In the past few years, the company has been dedicated to fixing its balance sheet, putting most of its distributable free cash flows toward debt repayment. Its goal was to achieve a 3x Debt/EBITDA ratio, which they just reached two quarters ago. Altogether, this means margins and dividend payout will increase while NRP will be more prepared to weather tough times do its lower cost of debt and almost fully undrawn line of credit.

Key Risks and Considerations

1. Coal price exposure: As natural gas continues to remain cheap, thermal coal is adversely impacted. However, NRP is shifting its production more towards met coal, which is further insulated against global coal demand volatility due to its key role in steel production. Moreover, even if coal producers choose not to mine in the short-term due to unfavorable coal prices, NRP receives annual minimum payments.

2. Exposure to Bankrupt and Distressed Lessees: Coal mining is a declining industry, prone to commoditization and substitution risk. Many major players have declared or are prone to bankruptcy, which may complicate contract renegotiations or cause drops in occupancy rate for NRP. However, we argue that due to NRP's historically consistent high occupancy rate despite cyclical downturns, resilient contracts due to structure of the lessor-lessee relationship, and annual minimum payments from lessees provide sufficient downside protection when paired with NRP's cheap valuation.

Decision: BUY

Natural Resources Investment Committee Representative: Cale McCormick

The Natural Resources Sector pitched Natural Resource Partners LP (NYSE: NRP) as a buy in General Meeting on Wednesday, October 30th, 2019, proposing a 5% position. The Investment Committee decided to follow the sector's recommendation and purchase NRP, although at an adjusted position size of 4%. We agree with the sector's rationale and believe that NRP presents an attractive opportunity because of the following:

1. We believe that NRP has significant protection against coal price instability: Firstly, NRP receives minimum payments from of all of their clients, even when the clients do not operate the assets, which smooths revenue. Secondly, NRP has been able to advantageously navigate the bankruptcy of its clients. NRP's assets are critical to clients' operations, and clients often augment these assets with their own mining and logistics equipment. When clients enter bankruptcy, they invalidate their contracts with NRP, but in order to continue their mining operations, they must enter into another agreement with NRP. Because of NRP's bargaining position, NRP's contracts are generally more favorable after client bankruptcies. The sector provided evidence that this was the case, most recently with Foresight Energy.

2. The recent shift in management strategy enables NRP to return value to shareholders: Although NRP was originally as it is now, previous management also invested in many different non-core businesses in sectors such as construction and natural gas. These investments came at the expense of incurring significant debt. After most of the old management was removed, NRP divested from nearly all its non-core assets and has been paying down debt. In the second fiscal quarter, they reached their target goal of 3.0x net debt to EBITDA, enabling them greater access to capital markets and the ability to increase their distribution rate. We believe management will continue a no or low growth strategy while paying down debt and increasing LP distributions, which should allow us to realize our investment.

3. We believe this investment has a sufficient margin of safety: As shown in the sector's valuation, the company's royalties per year would have to take a significant hit before the company would reach fair value. In addition to that, NRP has nearly 2 billion tons of proven and probable reserves; these assets mitigate the maximum loss on this investment.

Key Risks and Considerations

1. We are concerned about the stability of NRP's cash flows: Part of NRP's revenue stability in the face of a continued metallurgical coal price decrease is because their royalty rates are contracted out. As the met coal price decline continues, a significant number of NRP's current contracts are up for renegotiation, and likely the decline in coal prices will allow NRP's clients to fight for lower royalty rates. In addition, the soda ash facility with which NRP has received stable distributions from in the past is undergoing a capacity expansion, which will likely increase shareholder value, but further decrease the stability of NRP's cash flows in the near term. NRP's cash flow stability problems will make it less likely that NRP's management will return value to shareholders through distributions in a timely manner.

2. NRP is exposed to unhedged macroeconomic risks: Nearly all of NRP's business comes from its clients' ability to profitably sell metallurgical and, to a lesser degree, thermal coal. Recent macroeconomic events, such as the trade war, have hastened the decline of metallurgical coal prices. Although we don't believe that the demand of metallurgical coal is systemically weakened, we must acknowledge the possibility that met coal prices continue to stay low due to continuing short- and medium-term headwinds.

At Home Group (NYSE: HOME)

Consumers Sector Leader: Josh Soong

Company Overview

At Home Group is a home decor retail chain born out of the Garden Ridge bankruptcy. HOME operates warehouse-style stores averaging 110,000 square feet that enable it to stock 50,000 SKUs of product. This broad product diversification is a key driver of traffic and has helped HOME post 5% annual SSS growth in the past five years. Moreover, the Company has taken advantage of attractive financing terms and its competitors' precarious competitive positions to aggressively expand into new markets.

Investment Thesis

The Consumers Sector recommends a BUY in HOME for the following reasons:

1. Improved Marketing: As with any consumer-facing business, marketing and brand power are important drivers of foot traffic and, in turn, sales. Within the industry, there are two overarching marketing strategies. The high-low model employed by Macy's, Nike, and Nordstrom involves selling products at one sticker price and then using promotions or holiday sales to generate attention and drive sales spikes. In contrast, Walmart and Trader Joe's focus on an "everyday low price" (EDLP) model, which, as the name suggests, centers around lower sticker prices with fewer sales. Previously, HOME deployed a hybrid of these two models — consistently low prices with spontaneous flash sales as it attempted to offload stagnating inventory — that left the Company with a confusing and directionless marketing strategy. With EDLP Plus, At Home wants to capitalize on its brand power potential to shift to an EDLP-centric model while using promotions less to discount product and more to highlight a product's already low price. In doing so, the Company will be able to increase its brand awareness and attract new customers while highlighting its best-in-industry brand perception. Furthermore, this will also enable better inventory management — an area that was lacking during second quarter earnings — as promotions become more category-driven.

2. Strong Growth Engine and Profitable Reinvestment Opportunities: For a 215-store chain, the opening of 35 new locations in a single year is a testament to an untapped TAM. This extends on five consecutive years of 21% YOY store count growth and is a function of the Company's incredible new store ROI. By using sale-leaseback transactions to sell a store's underlying real estate, the Company lowers its initial capital expenditure requirement to $2-3 million for new store builds and $3-4 million for leased stores. Considering these stores generate over $5 million in first-year sales at a 27% adjusted EBITDA margin, this results in a two-year average payback period — an unheard-of metric within the retail industry. This expansion runway can be attributed to two major factors. First, management has proactively scouted and mapped over 20,000 prospective store spaces to find the most profitable locations. This enables them to move quickly when attractive vacancies open up (as is the case when a major retailer declares bankruptcy). Secondly, the Company has developed strong relationships with multiple REITs that provide cheap financing for its new stores. In an era of unprecedentedly low yields where it is difficult to find retail tenants, HOME presents the ideal lessee because of its stability and its willingness to sign longer-term rent contracts. Consequently, HOME has been able to lock in cap rates between 6.46% and 6.95% for new stores.

3. Market Misperception: During second quarter earnings, the Company's tempered growth expectations sent shares down more than 70%. To be clear, the Company continues to forecast double-digit growth; it simply lowered growth forecasts in the face of sustained pressure from the trade war and an expected slowdown in the retail industry. This was a result of the Company's perception as a growth company. However, while growth is indeed a large part of a growth company's valuation — and we do not intend to argue whether this is not or should not be the case — HOME is a fundamentally sound company that trades at a deep discount to its intrinsic value. In fact, even in a zero-growth model where both store count and same store sales flatline, the Company trades at a 20.6% discount to its intrinsic value. Clearly, by taking a value investing perspective on HOME, one can see that the Company has entered oversold territory (indeed, our model suggests any future growth is effectively free for shareholders).

Key Risks and Considerations

1. E-Commerce: E-commerce has long been trumpeted as the death of brick-and-mortar. However, while e-commerce does present a disruption to the industry as a whole, we believe that it presents a much smaller threat to home decor. For one, since every individual has a personal preference when it comes to decorating their homes, many want to see and feel a product before they buy it. This benefits HOME because its warehouse stores carry so much product that they create a unique shopping experience for customers. Moreover, home decor items are generally bulkier and more abnormally shaped, and result in significant shipping costs for e-commerce websites. Consider Wayfair: while it posted 40%+ top line growth last year, its losses continue to balloon, it continues to have trouble with inventory management, and it continues to be overleveraged.

2. Tariffs: Tariffs are a credible concern for a company with an international supply chain. HOME, however, has actively prepared for and mitigated tariffs as they roll out. Certain tariffs were surgically passed on to consumers in the form of competition-based priced increases. Other tariffs were absorbed by suppliers, a result of HOME's strong bargaining power with its manufacturers (it is typically the largest account for its product partners). Yet other tariffs were circumvented entirely as HOME continues to diversify its supply chain.

3. Correlation with the Housing Industry: As a home decor retailer, it is logical that revenues are correlated with new housing starts and sales, which experience extreme cyclicality and are highly exposed to economic slowdowns. Since HOME was not a public company during the 2008-09 recession, we instead looked at home decor industry competitors. Our analysis shows that while there is a correlation with housing starts, it is not as strong as one might expect. During the Great Recession, housing starts fell 60%. In contrast, sales fell 30% at Haverty Furniture and 20% at Pier One. Thus, this correlation does present a risk, but to a lesser extent than its often believed.

Decision: NO PURCHASE

Consumers Investment Committee Representative: Avita Timbadia

The Consumers Sector pitched At Home Group (NYSE: HOME) as a buy in General Meeting on Wednesday, November 6th, 2019. After review, the Investment Committee decided not to purchase HOME. Our reasons are as follows:

FIRST: We are concerned about the highly competitive space that HOME operates in and we struggle to identify a clear competitive advantage, or the potential for it to develop one in the future. A substantive portion of the pitch focused on the fact that HOME has a compelling first mover advantage with its aggressive growth strategy due to its robust unit economics and unique customer experience through the EDLP model. However, we do not believe this argument is compelling given that the home decor and furnishing market is extremely fragmented. The top three retailers in the home furnishings and decor space take up less than 25% of the market share each. The ROIC of businesses such as Walmart and Target are substantively higher, and we do not believe the shopper experience is particularly different, although it is more specialized. The threat of e-commerce was also dismissed due to the average price point of an item being less than $15, and the sticky "treasure hunt" shopping experience. However, we do not agree with this assessment and do not think that HOME can catch up with existing e-commerce players such as Amazon and Wayfair, diminishing its ability to maintain the first mover advantage.

SECOND: There is too much uncertainty around their sale leaseback strategy (SLBs) for growth, its sustainability in the long run, and the managements' motives behind them. Currently, the SLB Strategy allows for HOME to have an average 2-year payback period on a new store, allowing a 21% YoY CAGR in store count and a target 15-20% over the next couple of years to reach a target of 600 stores. The pitch argues that HOME has close relationships with numerous REITS, allowing them to maintain an average cap rate between 6.46%-6.95%, which seems fairly in line with the market. However, we are unsure if management will be able to continue attaining these low cap rates, which would affect their future profitability and growth prospects. The use of the SLB strategy may presently boost growth but it creates less flexibility in operations and cost structure. Furthermore, an SLB strategy is often used if there are issues in accessing credit. With a net debt/EBITDA of 4.22x, it is difficult to be confident that is not a reason that management is using such a strategy. Essentially, using the information the pitch has provided, it is difficult to decipher the time period over which this SLB strategy for aggressive growth will be used, and what the exact motivations of management are.

THIRD: We are concerned about whether discretionary spending can remain strong given the potential of a looming economic slowdown, which could adversely affect the business. In the most recent quarter, foot traffic in stores were down by 4% and comp sales declined by 0.4%. The sector argues it is related to one-time weather events. However, we observe similar trends in HOME's close competitors – Target, Lowe's, Home Depot. Furthermore, we do not believe the model inputs a sufficient collapse in SSSG in the recession case, as it models a quick rebound in SSSG within a year, making it difficult for us to fully understand the impact of changes in trends in discretionary spending in the case of a recession. Lastly, we find that the market shares a similar sentiment as At Home stocks plunged 36% on Dec 4, 2019, after HOME's 3Q Earnings as management revised the outlook for fiscal 2020. Management cited concerns over the trade wars and a cyclical downturn.

Unisys Corporation (NYSE: UIS)

Industrials Sector Leader: Brandon Bleyer

Company Overview

Unisys Corporation is an information technology provider, manager, and consultancy firm that serves clients across enterprise and government markets offering network security and operations cloud-based software and technology infrastructure solutions. In fiscal year 2018, UIS derived 27% and 24% of their $2.825bn sales from U.S. federal and other public clients respectively with the remainder coming from commercial accounts. At the time of the pitch, the firm traded at a 4.2x EV/EBITDA and has a 10.1% EBIT Margin.

Investment Thesis

The Industrials Sector recommends a BUY of UIS for the following reasons:

1. <u>Products Feature High Switching/Replacement Costs:</u> UIS provides mission-critical technological security services to its clients, who are particularly sensitive to security breaches, such as the DoD and financial institutions. Replacing highly embedded, system-wide security infrastructure is time-consuming and costly, especially when it produces vulnerability within a given system. Unisys' offerings integrate with essential infrastructure/cloud-storage systems, such as Microsoft's *Azure* and Amazon's *AWS* platforms. With these features aside, *replacement providers are required to retool and learn existing system architecture from scratch*, a cost that is eliminated if they return to the same provider, which benefits Unisys.
2. <u>Improving Cash Flow Generation from Highly Favorable Contract Structure/Recurred Revenue Model:</u> Unisys typically signs contracts from 3-5 years, which provides reliable and predictable cash flow to fund its operations. Through Q4 2018, its services backlog was up 13% y-o-y, which was enhanced by renewals. With a $4.8bn funded backlog, the firm has substantial cash flow stability. Unisys is strategically shifting its new contract marketing efforts towards capital-light projects that involve lower up-front costs through the introduction of standardized solution suites, *InteliServe* and *CloudForte*. Project implementation channels have been streamlined producing a bottom-line expansion of nearly 8% since 2016. These projects feature recurring-revenue from maintenance and regular infrastructure up-keep fees.
3. <u>Market is Heavily Mispricing Short-term Liquidity Risk Related to a Pension Shortfall:</u> With $1.8bn in unfunded pension liability, the market is highly concerned with the sensitivity of liabilities to changes in interest rates and the general macroeconomic environment. Unisys is required to contribute operating profits to fund any difference in plan asset returns versus annual liabilities as mandated by the Pension Benefit Guaranty Corporation. We postulated that the market is overly-fixated on the liquidity risks related to the plan and pricing in excessive risk compared to more realistic assumptions of the performance of the pension plan assets against current operational cash flow generation. We discovered such support when analyzing the market reaction to a recent exchange offer between Unisys and holders of $250mm in 2021 senior secured convertible notes, which featured a 50% cash swap and 20% equity dilution for a substantial reduction in the principal owed. The market's overreaction to the news sent the stock down roughly 40% in the following weeks despite announcing strong operational performance and positive sales growth and margin expansion. Unisys' fundamental low risk of default provides an adequate margin of safety for investing in the overall quality business model below 5x EV/EBITDA.

Key Risks and Considerations

1. <u>The Interest Rate Environment Amplifies Pension Liabilities:</u> If U.S. and global interest rates decrease, then pension liabilities increase in-kind, which may result in higher than expected required cash payouts to meet the PBGC's requirements. However, the sensitivity to interest rates is partially offset by credit pension plan assets, which appreciate with declining rates.
2. <u>Failure to Maintain Technological Relevance:</u> The IT services space requires significant and somewhat risky R&D expenditures designed to keep service offerings at or above the level of competitors. Failure to invest in the correct new horizon technology and processes may result in a steady decline of the business model in the short-term.

Decision: NO PURCHASE

Industrials Investment Committee Representative: Richard Archer

The Industrials Sector pitched Unisys Corporation (NYSE: UIS) as a buy in General Meeting on Wednesday, November 13th, 2019. After review, the Investment Committee decided not to purchase UIS. Our reasons are as follows:

FIRST: We did not feel as though the sector presented the level of understanding regarding competitive dynamics that we would require as value investors; given that UIS is undergoing a major shift in its product offerings, it is absolutely necessary to understand, in depth, the fundamentals of both industries. Such a task is extremely challenging, especially with an industry as opaque and technical as cybersecurity, and we are not confident in our understanding of the competitive landscape. Much of the analysis argued that the company was simply transitioning from an inferior industry to a more profitable one without sufficient exploration of different competitive concerns. As value investors, we want to either be able to take a strong position as to why a given risk is mispriced, or to take a stand on why a company is not yet recognized as a company that will fundamentally outperform. The former point is addressed in the next paragraph, but as to the latter, we do not have anything close to the level of insight that would be necessary to identify true competitive moats in this industry.

SECOND: Although we concede that UIS has a nominally low EV/EBITDA multiple of ~4x, we are not persuaded by the sectors dual argument that 1) this is an attractive multiple because market participants are excessively concerned about the pension risk and 2) unless rates are cut to ~-1%, the pensions aren't actually a material risk. The thesis that UIS is systematically underpriced due to overblown pension concerns is very much in the spirit of value investing, but we did not find evidence of this claim sufficiently persuasive. The analysis of pension risk is extremely complex, and pricing that risk does not necessarily play to TBC's strengths. A seemingly attractive multiple without a concrete argument about where we diverge from the market makes this investment committee uncomfortable moving forward with the purchase.

Arista Networks (NYSE: ANET)
Technology Sector Leader: Chris Sun

Company Overview

Arista Networks creates cloud networking solutions, namely network switches that employ its proprietary switch operating system, the Extensible Operating System. The company centrally serves data centers with cloud computing demands. In FY18, revenue was $2.1B, with $646M from hyper scale cloud titans.

Investment Thesis

The Technology Sector recommends a BUY of ANET for the following reasons:

1. Extensible Operating System: The true differentiating factor in the industry is the software capabilities. Arista's EOS, in contrast to other network operating systems, is the only single-image software capable of operating across generations and types of switches. Competitors currently develop new software solutions with each upgrade cycle and for different switches, in contrast to Arista's unified model. The single-image capability translates to scale and programmability features, enabling clients to grow their data centers to immense scale while accommodating their custom networking needs. The EOS translates to immense switching costs – competitors have to consolidate multiple different software solutions along with their clients' custom solutions.
2. Growth: Globally, data center traffic is growing exponentially as consumer data consumption expands. Data centers incorporate layers of switches that perform different functions, weakening the attraction of competing software solutions. Within the next 400GB switch upgrade, Arista's first mover advantage and consistent software enable clients to make the upgrade quickly. Although this upgrade cycle is still in its nascent stages, hyper-scale data centers at large companies like Facebook or Microsoft overwhelmingly prefer EOS. Lastly, Arista's entrance into the enterprise campus space provides a compelling growth opportunity. As enterprise campus networks face increasingly complex bottlenecks caused by increases in devices and data volume, existing software solutions prove insufficient. Arista's single-image EOS is well positioned to accommodate the industry's needs.
3. Market Mispricing: Following Microsoft and Facebook's declines in switch orders in Q2 and Q3 2019 respectively, projections for long-term demand for Arista has decreased significantly. However, MSFT and FB both indicate that their order declines are temporary – their long-term need to build larger and faster data centers remains. The revenue declines have sparked concern about white box competition and Cisco/Juniper. Given that white box solutions pertain to hyper-scale clients and that EOS provides a solution steps ahead of competitors, market expectations of Arista's performance are not compelling.

Key Risks and Considerations

1. Eroding Technological Advantage: Investors fear that Cisco and Juniper, close competitors, pose large threats for Arista's software advantage. However, given the nature of the single-image software, creating any new software to compete with EOS would result in high switching costs for clients.
2. Customer Concentration: Cloud titans constitute 20-30% of revenue each year, resulting in poor market reactions to declines in these customers' orders. Arista develops its custom solutions in tandem with clients' needs, making switching highly unlikely.

Decision: NO PURCHASE

Technology Investment Committee Representative: Henry Gao

The Technology Sector pitched Arista Networks (NYSE: ANET) as a buy in General Meeting on Wednesday, November 20th, 2019. After review, the Investment Committee decided not to purchase ANET. Our reasons are as follows:

FIRST: We have a strong conviction in the strengths of ANET's differentiating business model. ANET's Extensible Operating System (EOS) technologically differentiates the company in a highly competitive market that enjoys high switching costs and scalability. Compared to other incumbent players, ANET provides the only single-image operating system capable of functioning across generations and switch types. This type of unified interface offers attractive programmability and scalability, that are mission critical to hyper scale data centers, enterprise campuses, and other sophisticated end-users. The industry features high switching costs due to various customized protocols created by end-users. In fact, the high programmability of EOS enables end-users to implement more customization and arguably raise the long-term switching costs compared to other current solutions. In addition, similar to other players, ANET enjoys significant network effects due to the functional structure of network switches which demand connectivity and networks.

SECOND: We believe ANET has potentially captured an opportunity to disrupt the network solutions industry by leading the next upgrade cycle and capitalizing on the first-mover advantages. The network solutions industry has experienced multiple bandwidth upgrades in the past and is currently undergoing a transition to 100G and 400G switches. Historically, the bandwidth upgrade cycles have not permitted new entrants to materially alter the competitive landscape and we find no evidence that the current transition would yield drastically different results. However, we believe that ANET has started a new OS upgrade cycle with its EOS offering. The unified network system, with substantially better programmability and scalability, crucially align with the use cases of the wider 100G and 400G bandwidth. The degree of complementarity between the network's bandwidth and the NOS's customizability increases as end-users continue to demand not only higher speed, but more importantly, higher sophistication and customizability. The incumbent players, though still able to participate in the bandwidth upgrades, will fail to catch up in the OS upgrades. They become less suitable solution providers in the long-run, due to their legacy design of the modular integration of NOS and switches – a significantly less nimble structure.

THIRD: We are not fully convinced that ANET's current valuation justifies us to undertake its current risk profile, despite the attractive business quality and first-mover advantages potential. The sector has provided a compelling market mispricing argument for ANET on its relationship with Microsoft and Facebook. The market discount is largely unwarranted, but this alone fails to provide sufficient margin of safety. The majority of upside hinges on whether or not the EOS offering will truly allow ANET to not only differentiate, but to surpass its competitors in serving a future end-market that demands both wider bandwidth and nimbler operating systems, with a strong complementarity. Since the projected upside is not skewed enough relative to the risk profile, the investment decision demands an even wider margin of safety by carefully gauging the downside and its likelihood. However, we recognize that this upgrade cycle is still in its nascent stages and cannot meaningfully quantify the risks that we would be undertaking. The margin of errors in the analysis is therefore too large for us to be comfortable with our current margin of safety. Thus, we hope to monitor for a more attractive entry point for a more skewed upside, a catalyst to contain the downside potential, and/or additional clarity on the OS upgrade cycle and its impact to the networking solution landscape.

IQVIA (NYSE: IQV)
Healthcare Sector Leader: Ricardo Mestre

Company Overview

IQVIA operates three main segments: Research & Development Solutions; Technology and Analytics Solutions; and Contract Sales and Medical Solutions (CSMS), which account for 52.4%, 39.7%, and 7.7% of revenue, respectively. The R&D solutions segment operates as a traditional contract research organization (CRO), offering project management and clinical monitoring for phase 2 – 4 of the drug development process. The Technology and Analytics segment consists of many cloud-based implementations services (SaaS Solutions) that can be used for clinical trial design and planning by traditional pharma companies as well as other CROs. These SaaS solutions can offer critical insights through current or real-time market insights / data, life science specific analytic libraries, and databases of medical professionals. In addition to analytic capabilities, this segment also offers products for orchestrated customer engagement (OCE) which are already being adopted by some of the largest life sciences companies, including Roche and Novo Nordisk. Finally, the CSMS segment provides human-capital intensive services to hospitals and pharma companies including, healthcare provider engagement, patient engagement, and medical affairs services. These segments combine to allow IQVIA to provide end-to-end services in the drug development and commercialization process which range from R&D to pre-launch market positioning to market research to in-market sales forces and marketing.

Investment Thesis

The Healthcare Sector recommends a BUY in IQV for the following reasons:

1. Software as a service segment driving long-term margin expansion: Deployment of the SaaS services, including the OCE segment, are in the early period of their installation resulting in high costs over the 12 – 18 month installation period that are not reflective of the long-term profitability of each of the contracts. The OCE segment provides a powerful tool through which pharma companies can connect their sales, marketing, and medical divisions to effectively manage relationships with their customers. Currently, the OCE space is dominated by Veeva, however, IQVIA is quickly gaining traction and increasing their market penetration. IQVIA has already signed 70 companies onto their OCE platform, including 2 of the largest 15 companies which had previously been customers of Veeva. As these signups continue and installations are completed over the next few years, IQVIA's revenue and profitability will increase dramatically. IQVIA currently has an operating margin of 0% in the technology and analytics segment relative to Veeva which has an almost 30% margin, resulting in a significant opportunity for margin expansion.

2. Dominant position in real world evidence: Real world evidence (RWE) is growing in acceptance as an effective way to test drugs, with the 21st Century Cures Act in 2016 allowing RWE to replace randomized testing if approved by the FDA. RWE is seen as a potential solution to increasing the speed of the drug approval process with the FDA planning to release a framework for the use of RWE in medical trials by 2021. Other trends increasing the need for RWE are a transition to value-based care, where there is a decreased importance placed on the theoretical capabilities, and an increased importance placed on the empirical evidence that drugs can provide cost effective solutions. IQVIA is currently very well position within the RWE segment with them being ranked as the overall thought leader in RWE and leading expert in developing RWE that is applicable to business by a wide margin. Over the past 12 months IQVIA has quadrupled the number of their projects that are using RWE, demonstrating that IQVIA is the leader in the RWE space.

3. Network effects: Underpinning the success of many of IQVIA's products is the advantage that the company has in being able to collect data through their various business segments and then use that data to increase the effectiveness of the products and services that they sell. IQVIA has a centralized data base with 32 petabytes of data which originate internally through the R&D Solutions and CSMS segments and externally through purchases from third party data providers. As the dataset grows, IQVIA will be able to continually offer better solutions that their competition within their technology and analytics business as well as the R&D solutions segment, providing a lasting economic moat for these product lines.

Key Risks and Considerations

1. Increasing consolidation: There has been a significant amount of M&A activity within the industry. IQVIA has been the data leader since their merger, however, if other companies were to consolidate more rapidly in the short-term, they may be able to build a dataset larger IQVIA's and offer higher quality products and services.
2. Proprietary data vs purchased data: IQVIA is unclear about the amount of their data which is developed internally compared to externally. If much or all of IQVIA's data were available through third parties this would represent a significant reduction in IQVIA's economic moat in offering higher quality products and services.

Decision: NO PURCHASE

Healthcare Investment Committee Representative: Edward Chang

The Healthcare Sector pitched IQVIA (NYSE: IQV) as a buy in General Meeting on Wednesday, November 20th, 2019. After review, the Investment Committee decided not to purchase IQV. Our reasons are as follows:

FIRST: We are concerned about the lack of clarity surrounding the relationship between IQV and its third-party data providers. IQV does not actually own the data it uses for the Technology & Analytics Solutions segment (approximately 39.7% of FY18 revenue), but rather licenses data from third-party providers. Our inability to determine who holds bargaining power in this relationship proves worrying and is potentially disruptive to our 'network effect' thesis point. Specifically, we were unable to find out how the incentive structures for contracts are designed, how historical negotiations / renegotiations have played out, and whether contracts are exclusive agreements. In a worst-case scenario, the data provider market is extremely consolidated, and data providers can negotiate contracts that are destructive to IQV shareholder value.

SECOND: Little numerical evidence exists to suggest that IQV (or any contract research organization, for that matter) possesses a true network effect. IQV does not provide any information on who their clients are, how many clients they have, or the terms of their client's contracts (pricing and duration). While pre-acquisition IQV was most economically profitable CRO in the industry (highest NOPAT margins among its peers), this outcome may be a case of correlation and pure chance rather than true causation.

THIRD: Our view of IQV –a high quality business with significant runway for growth— seems to be priced into the market right now both qualitatively (research reports) and quantitatively (forward multiples). Our lack of a contrarian view (or informational advantage relative to the broader IQV investor base) on IQV is further complicated by a dearth of IQV-specific value catalysts.

Charles Schwab (NYSE: SCHW)

Financials Sector Leader: Jacob Tucker

Company Overview

Charles Schwab, founded in 1971, provides brokerage and related technology-based financial services to retail clients and Registered Investment Advisors (RIAs). They have a diversified set of revenue streams. A significant portion of their revenues is derived from net interest margins generated from client assets held on their balance sheet. Additionally, they derive revenue from RIA banking and advisory activities, as well as brokerage fees. Trading revenues from commissions, formerly a large portion of their revenues, is now a much smaller part of their business, as the firm announced zero commissions trading in October 2019. Today, Charles Schwab boasts over $3.8 trillion in client assets, making it one of the largest firms in the industry.

Investment Thesis

The Financials Sector recommends a BUY in SCHW for the following reasons:

1. Highly Accretive Merger with Robust Synergies: Charles Schwab recently announced what appears to be a highly tactful merger with TD Ameritrade. With $1.2 trillion in assets, the merger should provide Schwab with increased efficiency through various operational cost synergies as well as significant cross-selling opportunities for Schwab's branded wealth services and investment products. Additionally, Schwab paid what seems to be a fairly reasonable price; TD Ameritrade's stock price had recently been suffering heavy blows due to the Schwab zero commissions announcement.
2. Moaty Virtuous Cycle: The Schwab business model carries inherent switching costs due to the direct costs associated with the transfer of accounts as well as indirect costs in the form of "red-tape". The sticky client asset base leads to increased returns from client assets invested for Schwab's gain, which in turn allows Schwab to heavily reinvest in its business model. The sum of these effects begets Schwab further loyal and valuable clientele.
3. Evasion of the Previously Impending Quality War: As recently as 2016, Schwab had publicly announced plans to engage in a "quality war" against competitors (in addition to the price war, which clearly occurred). Schwab sought to differentiate itself through execution quality by choosing market makers according to the best possible trade execution for the customer as opposed to the best rebate. Schwab's acquisition of TD Ameritrade represents a reversal of this philosophy and a brightened future for Schwab's prospects. Schwab now is very well positioned to grow its order routing revenues, which could be highly profitable for the company. TD Ameritrade is known in the industry for having the largest order routing revenues, by a thick margin. Schwab is now very well positioned to take advantage of TD Ameritrade's order routing expertise and apply into a much larger stream of client trades.

Key Risks and Considerations

1. Cyclical Concerns: We acknowledge that there is inherent cyclicality risk to our investment. We found that earnings are likely indicative of the firm nearing the peak of its respective cycle. Thus, this makes us question whether we genuinely would have a sufficient margin of safety. However, we feel that the business' shift away from trading revenues mitigates some of this risk.
2. Potentially Overaggressive Multiple: After a thorough analysis of Schwab's core competencies, it seems that Schwab is highly dependent on NIMs for its steady stream of revenues. After the sector ran a comparables analysis against other NIM-based businesses, we found that the multiple traded at a massive premium. While some of this is likely reasonable due to an attractive stream of advisory revenues, a vastly different cost structure, and different demands for operational efficiency, the multiple we are paying for the business may be somewhat inflated.
3. Murkiness Surrounding Synergies: It is not clear the degree to which Schwab will be able to capture its proposed synergies. While there are clear avenues for Schwab to derive cost-reducing benefits as well as cross-sell its products, there is still a high risk of implementation errors, which would vastly detract from the success of an investment.

Decision: NO PURCHASE

Financials Investment Committee Representative: Kevin Ren

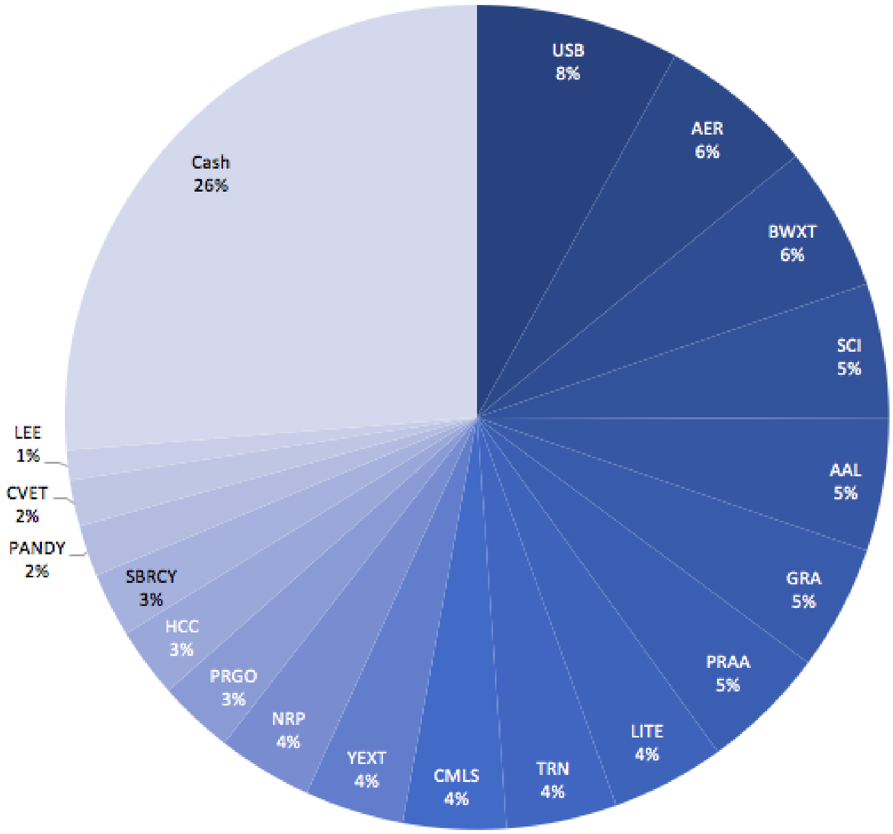
The Financials Sector pitched Charles Schwab (NYSE: SCHW) as a buy in General Meeting on Wednesday, December 4th, 2019. After review, the Investment Committee decided not to purchase SCHW. Our reasons are as follows:

FIRST: ICOMM has concerns regarding the cyclicality of Schwab's business. Schwab's optically cheap multiples appear to be a reflection of their current positioning near peak earnings. In particular, diminished interest rates would greatly impact Schwab's ability to generate net interest revenue on customers' cash balances as seen during the last prolonged series of interest rate cuts (2007-2009). A market downturn diminishing the nominal value of assets managed under Schwab's funds, both due to redemptions and paper losses, provides an additional downward force on Asset Management and Administration fees. The likelihood for these two factors to occur concurrently and in the near future creates significant uncertainty with respect to NPV today. Additionally, the loss of trading revenues due to the new 0 commissions paradigm removes a meaningful buffer against cyclicality which may be to some degree offset by order flow revenues. Adjusting for cyclicality, SCHW's initially attractive price appears more reasonable.

SECOND: SCHW's new business model calls into question what multiple the business should trade at. SCHW will at its core be a NIMs business moving forward. As such, ICOMM is of the belief that in the long-run SCHW will trade like a bank. At the current price, SCHW trades at a premium to most comparable banks on a P/E and P/B perspective. SCHW even trades at a premium to USB, a current portfolio holding and what we consider to be a very high-quality bank. We acknowledge that SCHW has a more attractive growth runway than most banks. For years SCHW has stolen deposits from banks with less attractive brokerage services. Regardless, SCHW trades at a sizeable premium to even the highest quality of banks and we fear multiple contraction in the future. We would be more comfortable paying a premium over other banks for SCHW if we were of the view that SCHW's business model was superior to most banks. ICOMM agrees that clients are relatively sticky once on the platform, but the variability in deposit base (which is dependent both on clients depositing more cash and on client asset allocation) forces SCHW to use deposits less efficiently than a traditional bank. We are still uncertain about the quality and attractiveness of SCHW's deposit base given their limited efficiency.

THIRD: We are not confident that we have a differentiated view on Schwab's ability to realize synergies. SCHW's ability to realize $3.5-$4.0B of run-rate synergies resulting from reduction of employees/locations and optimization between offerings/back-end is crucial for the SCHW-TD Ameritrade merger to create significant value for shareholders. However, industry insiders note the difficulty of integrating two highly disparate order-entry and back-office computer systems even for smaller platforms, much less two behemoths. Even accepting the magnitude of synergies at face value, the timing for the realization of the synergies is questionable. ICOMM is also skeptical of the ability for integration of the two platforms to meaningfully alter user behavior in a way that generates increased revenues for the company. Finally, we are concerned with the likelihood of RIA attrition, particularly in TD's sub-$100M RIAs during the integration period where switching costs may be temporarily diminished.

Portfolio Weightings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BWXT
6%
SCI
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4%
TRN
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NRP
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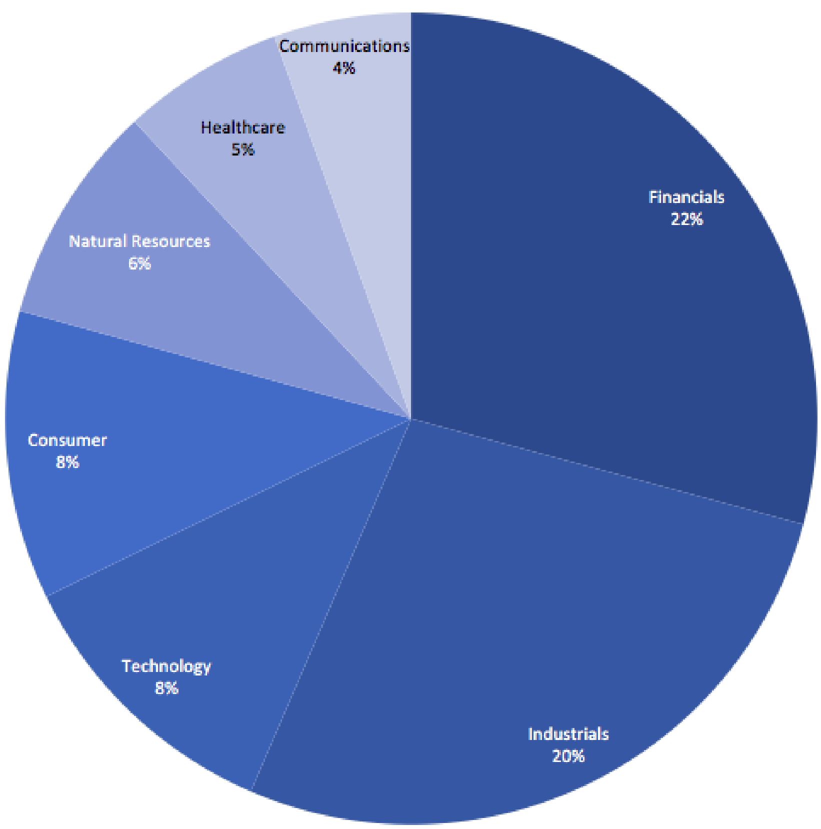
3%
PANDY
2%
CVET
2%
LEE
1%
Cash
26%


Financials
22%
Industrials
20%
Technology
8%
Consumer
8%
Natural Resources
6%
Healthcare
5%
Communications
4%