October 30, 2020

Long Term + Value = Winning Potential

Samantha McLemore, CFA and Christina Siegel, CFA

Opportunity Equity 3Q 2020 Letter

Opportunity Equity gained 13.01% (net of fees) in the third quarter versus 8.93% for the S&P 500, as we continued to recover from COVID. It's always nice to have a great quarter, but our focus remains on delivering excellent long-term returns. Given the current opportunity set in the market and the underlying potential in our holdings, I'm optimistic about our ability to do that.

Why do I believe we can earn high returns in an extremely competitive market near all-time highs? A timely starting point helps. Given our value orientation, most of our holdings have lagged. In fact, 57% of our holdings were down year-to-date at the end of September. A few top holdings have driven this year's performance. I believe the long tail of laggards presents "deferred outperformance" potential. Most of these names suffered consequences of the COVID crisis, and offer significant upside as the recovery continues (I will come back to this).

More broadly, I think we invest differently from others. We employ a patient, long-term approach that focuses on company fundamentals in 5 or 10 years (and sometimes longer!). This may seem commonplace but I can assure you it's not. When I ask sell-side analysts for their best ideas, they always give me names with 20-30% upside and a near-term catalyst while ignoring names on their coverage list with 50-100% upside but near-term uncertainty. They do this because investors demand exactly these qualities: immediate gains with limited risk.

What is not to like about that? I want low risk, instant returns too, along with a fight-free marriage, babies without sleepless nights, cake without calories, and so on. Alas, there's no free lunch. Doing

Privacy - Terms

what everyone else does will get you the results everyone else gets: market performance less fees. That's a recipe for adding zero value to anyone.

We think the easiest way to outcompete is to play a game most others aren't willing to play. Less competition lowers the bar! People seek immediate results because of high performance pressures. People go to extreme measures to avoid losses, a phenomenon behavioral finance specialists label myopic loss aversion. So our process often begins by looking in areas of the market others avoid.

We spend a great deal of time looking at names that have traded down significantly from their highs, or where there's controversy. We get especially excited about companies we think are uniquely positioned secular winners when their stocks get hit. Many of our recent top contributors fit in this bucket: Amazon, RH and Farfetch. All are great franchises with totally unique offerings in growing markets with high-quality management teams. We entered each after the stock got crushed, and we held as they continued to compound capital over time.

At a macro level, funds have flowed out of public equities into privates, out of active into passive, out of value into growth. This means less competition and helps the prospects for our future returns! One of my favorite lines from my co-manager Bill Miller: "it's never been easier to construct a portfolio you have confidence will do well over the long term (~5 years) but it's never been more difficult to construct one you have confidence will do well over the short term (~6 months)." At a recent Santa Fe Institute event (a great source of differentiated and additive views), one discussion focused on quantitative evidence that the shift to passive is creating inefficiencies in the market.

The other key differentiator for us is our focus on valuation. We are true value investors at our core. We view growth as an input in the value equation, as Warren Buffett is fond of saying. So we've always had a mix of companies that are cyclically mispriced ("classic value") and secularly mispriced (ability to compound capital over time). But the only thing that excites us about an investment is to be able to make a compelling argument for why it's undervalued (and why the market will eventually come to realize this).

Privacy - Terms

We focus on long-term free cash flow potential across a variety of scenarios. If we do good research to properly identify companies that can improve their fundamental business values over time and find attractive entry points, we should be successful at driving excess returns.

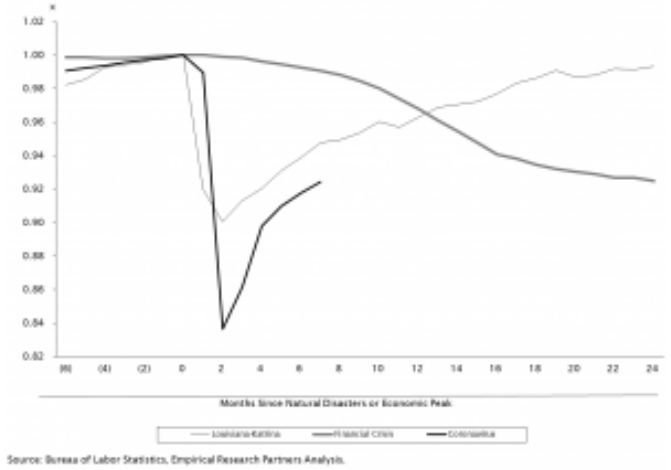
Overall, our valuation bent has been a headwind due to the brutal environment for value strategies. I maintain high conviction it will eventually pay off. Valuation spreads (the valuation difference between the most expensive and the cheapest companies) sit at extremely wide levels. Historically, value outperforms from this type of starting point. Wide spreads often coincide with recessions or crises, as we've seen this year. The companies falling into the cheapest bucket typically consist of those hit hardest in any given crisis, and the ensuing recovery drives this low-expectations group to perform best. We see no difference this time.

The COVID crisis and recovery most closely resembles a natural disaster. The following chart from Empirical Research compares employment during and after Hurricane Katrina in Louisiana to the COVID environment and versus the financial crisis. You can easily see the COVID similarity to a natural disaster: a sudden and extreme decline, followed by a more v-shaped recovery. Importantly, following natural disasters, we typically return to baseline within a couple of years (unlike a severe, internal economic problem like the financial crisis where the recovery struggles).

Comparison of the COVID Recovery Relative to a Natural Disaster and the Financial Crisis

Louisiana and the U.S. Total Private Employment Post-Katrina, During the Financial Crisis and the Coronavirus Pandemic (2005-September 2020)

Privacy - Terms



Source: Empirical Research Partners. Used with permission.

For this analogy to hold, we need to continue to recover from the pandemic. We believe we will. The human and financial resources marshaled to solve COVID dwarf nearly anything else we've ever experienced. We've already made significant progress on testing (greater availability and speed), treatments (antibodies, antivirals, steroids), and vaccines (good evidence one will be successful with limited availability soon). Over the next year, we will likely see more progress, which can fuel an ongoing recovery, and eventually normalization.

When we assess our companies in this environment, we focus on 1) what the underlying business fundamentals look like in 5 years when we are confident we will have normalized and 2) if a business is under pressure, an analysis of their balance sheet, liquidity profile and cash burn to determine their ability to sustain the business until things improve. We err on the side of conservatism with the latter.

On the other side of the spectrum, we've been in a growth regime where high valuations provide no impediment to stock outperformance. No one knows how long this will last, but I have confidence prices eventually converge with fundamentals. Stratospheric prices will either be justified by improving fundamentals or they will mean revert. Even the very best companies can struggle under the weight of lofty expectations.

Privacy - Terms

One could argue Amazon is one of the best companies that ever existed given its garnered one of the largest market caps ever in the shortest time since its birth. If you invested in Amazon at the end of 1999 during the height of the tech bubble, you'd have done fabulously BUT it took almost 8 years just to make money and to outperform the index. Few likely held through that pain. Fundamentals were ultimately strong enough to offset very elevated beginning expectations. The same wasn't true for many other names priced for perfection at that time. Our valuation discipline offers us some protection from expectations gone wild. But no one knows when this discipline will pay dividends.

We love to buy great companies that can grow value over time when we get the opportunity. We think our portfolio is unique because it blends classic value names that should benefit from a continued COVID recovery along with attractively value secular winners that should compound capital over time. We think this diversification should allow the portfolio to perform well in a variety of scenarios. The common thread across all our holdings: uniquely positioned companies able to generate more value over time in our view, along with muted current market expectations.

In the quarter, we added a net of 6 new companies, Uber Technologies, Rocket Companies, Acuity Brands, The RealReal, PureTech, and CVS, and exited 2, Endo International and United Airlines. We also participated in 2 IPOs, Lemonade and Snowflake, that we subsequently exited due to rich trading levels.

We bought UBER this quarter (mix of stock and long term call options). We've followed Uber for years but became convinced this quarter that Uber's improving fundamentals weren't reflected in the stock. We think CEO Dara Khosrowshahi, who drove significant excess returns when he was at Expedia, has made significant progress improving the culture, competitive positioning, and fundamentals at Uber. Uber owns significant stakes in prior competitors like Didi (Uber of China) and Grab (SE Asia Uber), whose value totals $10-20B. The stock trades in the mid-$30s, below the $45 IPO price in early 2019 and below most of its private valuations for the past 5 years.

We believe Uber's position as a duopoly in most of its geographies and businesses is underappreciated. Prior to COVID, Uber made excellent progress improving profitability in its Ride's business. It exited weaker markets and priced more rationally, no longer pursuing growth at any cost. It's only accelerated

Privacy - Terms

its cost rationalization in the downturn. As we normalize, we believe both growth and margins will surprise on the upside. The Delivery business boomed in this COVID environment, scaling even more quickly than the Rides business did. Growth will slow as we recover from COVID but there continues to be significant growth potential. Profit improvement should accelerate. We arrive at a conservative base case valuation in the low $60's and built our position through both the long term call options and the stock.

Rocket Companies came public in the quarter at $18 per share, before rallying to $34 then trading back down to $20. We entered on the pullback. Rocket is an amazing company with a fabulously successful history and culture. It dominates online mortgage originations. We believe its technology platform and culture provide a unique competitive advantage that will allow it to grow market share, earnings and cash flow over time. The mortgage market is volatile and refi's are likely to peak this year, which will cause volatility in earnings and potentially the stock. But we believe that taking the long view will pay off. We think that we are getting a great deal paying 14x next year's earnings for a dominant leader with serious long-term compounding potential.

Acuity Brands is a leader in the lighting space. It has historically generated attractive returns on capital. We grew interested when the new CEO Neil Ashe, who we knew from his prior days at CNet and Wal-Mart.com, arrived. The company generates significant free cash flow with sustainable levels of roughly $400M per year (10% yield). While end markets are currently under pressure, Ashe's vision is to drive a digital transformation in the business. There's improvement potential from end market recovery along with internal business improvement. We think the stock is worth significantly more than where it's trading.

TheRealReal is an online second-hand luxury goods marketplace. It's unique "reverse logistics" (sourcing goods from many diverse individuals) and authentication process offers a competitive advantage, especially as it continues to scale and achieve network effects of a two-sided marketplace. It hit $30 per share in 2019 after its IPO but traded down and now sits in the mid-teens. Unlike many e-commerce players, the COVID environment pressured the company because of challenges sourcing and authenticating goods. The company built a virtual authentication capability, which should help going

Privacy - Terms

forward. We believe the company will benefit from a continued normalization in the market and see significant upside in the stock.

PureTech is a very interesting biotech company. Unlike most early-stage biotechs that offer binary type returns (big upside if drugs succeed and big losses if they don't), PureTech offers a more favorable risk-reward. PureTech's unique approach to drug development – bringing together the best minds in any disease category to find the most favorable approach – has paid off. PureTech's historical success rates on drug trials significantly outpace industry averages. Also, this approach has led to a portfolio of assets. Historically, these developments have been pursued by independent companies. PureTech's stock doesn't reflect the embedded value of these developments so they've shifted to pursuing internal development going forward. PureTech has built expertise in the brain, immune, and gut area, which offers potential across a variety of indications. When we value PureTech's current indications and give them no credit above baseline drug trial success rates, we get values roughly twice the current price so we are optimistic about the potential.

CVS is a name we owned earlier but exited in the COVID hit to deploy funds to names offering more significant near term recovery potential. CVS lagged in the ensuing recovery but we still think it's an undervalued mix of businesses. If you value you the pieces, a healthcare insurance company, a pharmacy benefits manager, and a retail pharmacy, you get values roughly 50% greater than the current stock price. We think its vertical integration strategy around lowering the cost of healthcare through "Health Hubs" offers you free option value at current prices. We used long-term call options which we thought offered favorable risk-return.

We exited United Airlines and Endo to fund new ideas and because of certain risks to those businesses. We exited the IPO names we entered, Snowflake and Lemonade, primarily for valuation reasons.

We appreciate the support of our shareholders and will continue to work hard to earn favorable risk-adjusted returns for you.

Samantha McLemore, CFA

Privacy - Terms

Strategy Highlights by Christina Siegel, CFA

During the third quarter of 2020, Miller Opportunity Equity returned 13.01% (net of fees) versus the unmanaged benchmark, the S&P 500 Index, return of 8.93%.

Using a three-factor performance attribution model allocation and interaction effects contributed to the portfolio's outperformance while selection effects detracted slightly. Farfetch, Lemonade Inc., Alibaba Group Holdings, OneMain Holdings Inc., and Taylor Morrison Home Corp. were the largest contributors to performance, while Teva Pharmaceuticals, Precigen Inc., Flexion Therapeutics, Ziopharm Oncology Inc., Bausch Health Companies were the largest detractors.

Relative to the index, the Strategy was overweight the Consumer Discretionary, Financials, Health Care, and Industrials on average during the quarter. With zero allocation to Real Estate and Utilities, the portfolio was dramatically underweight these groups and more moderately underweight the Communication Services, Information Technology, Energy, Materials and Consumer Staples sector. In terms of sector allocation, the underweight position in the Information Technology sector, which outperformed the index, detracted the most from the portfolio's relative performance. On the other hand, the overweight in Consumer Discretionary, which outperformed the index, contributed the most to relative performance.

We added ten positions and eliminated six positions during the quarter, ending the quarter with 44 holdings where the top 10 represented 43.7% of total assets compared to 27.9% for the index, highlighting Opportunity's meaningful active share of 88.7%.

Top Contributors

- **Farfetch Ltd (FTCH)**continued to gain during the quarter returning 45.6% as the company reported another quarter that beat expectations while providing strong guidance. The company reported Digital Platform Gross Merchandise Values (GMV) grew +34% above prior guidance of 25-30% and consensus for +26%. The company added ~500k new customers,

Privacy - Terms

growing its active customer base by 42%. The company had lower promotional spend leading to order contribution margins increasing to 35% with earnings before income, taxes, depreciation and amortization (EBITDA) loss beating at -$25M versus -$30m expected. The company reiterated EBITDA profitability in 2021. The company guided for 3Q digital platform GMV growth of 40-45% (+30% consensus) with order contribution margins of 32-35% (consensus 31%) leading to EBITDA of -$25M to -$20M (consensus of -$34M).

- **Lemonade, Inc. (LMND)** returned 106.5% during period as we both entered and exited the name. We purchased the name on the IPO which we viewed as fairly priced for the large opportunity it is going after. While we are still attracted to the strategy and large total addressable market, we felt that the large move following the IPO was pricing in very high expectations for a young company, so we decided to lock-in our return.

- **Alibaba Group (BABA)** climbed 35.5% over the period despite the continued escalation in US/China relations. The company reported better-than-expected 1Q fiscal year 2021 (FY21) results. Total revenues came in at Rmb 153.8B versus consensus of Rmb 148.1B with EBITDA coming in at Rmb 51.0B versus Rmb 45.2B expected leading to earnings per share (EPS) of Rmb 14.82 versus Rmb 13.79. Annual active customers hit 742m (10% Year-over-Year (YoY)) with mobile monthly active users reaching 874m (16% YoY). Alibaba's fintech arm, Ant Group, filed paperwork in Hong Kong for an Initial Public Offering with expectations of valuation reaching $280B. Founder Jack Ma disclosed he cut his stake in the company from 6.4% to 4.8% over the past year. The company finished out the quarter with its annual investor day that focused on progress the company has made outside its core commerce offering, specifically its cloud offering.

Top Detractors

- **Teva Pharmaceuticals (TEVA)** declined 26.9% during the quarter as the market continues to be concerned on opioid liabilities as well as price fixing lawsuits. The company report 2Q results with total revenue of $3.87B below consensus of $4.024B, but reiterated 2020

Privacy - Terms

company guidance of $16.6-17B (consensus of $17.041B). The company reported 2Q Adjusted EBITDA of $1.108B versus $1.099B expected and reiterated 2020 Adjusted EBITDA of $4.5-4.9B ($4.637B consensus) and adjusted EPS of $2.30-2.55 ($2.53 consensus) and Free Cash Flow of $1.8-2.2B. The company was hit after the US Department of Justice alleged in a lawsuit that TEVA provided illegal copays from 2006-2015 on a drug to treat MS. The allegation is $300mm of false claims which TEVA would be liable for 3x that in potential damages if they were to lose in court.

- **Precigen (PGEN)** fell 29.9%% over the period. The company reported 2Q20 results in-line consensus. The company ended the quarter with $133M in cash, which is expected to fund operations in late 2021. Precigen announced an important advancement in its Ultra CAR-T platform with its UltraPorator technology. UltraPorator consists of proprietary hardware, software, and consumables for a self-contained system for non-viral genetic modification of a patient's T-cells. This technology has been cleared by the FDA for use in current UltraCAR trials and is being technology transferred to clinical sites. The company also announced that they have begun dosing a Phase I/II trial of their potential immunotherapy treatment to treat solid tumors deriving from Human Papillomavirus (HPV). The therapy is designed to activate the patients' immune system to combat cancerous tumors.

- **Flexion Therapeutics (FLXN)** saw a 20.8% decline during the period. The company announced 2Q results that were in-line with their preannounced numbers. 2Q20 net sales of $15.4M was above consensus of $10M. The company plans to recommence manufacturing of Zilretta in 4Q20. The company now expects total operating expenses for 2020 will be between $172-182M up slightly from $167-177M. The company announced the dosing of its first patient in a second dose cohort of a Phase I trial for FX201, their proprietary anti-IL_1Ra-based gene therapy candidate for the treatment of osteoarthritis.

Related Posts

Privacy - Terms

Bill Miller's *3Q 2020 Market Letter*

Christina Siegel's *3Q 2020 Market Highlights*

3Q 2020 Market Infographic

For important additional information on Opportunity Equity strategy performance, please click on the *Opportunity Equity GIPS Composite Disclosure*. This additional information applies to such performance for all time periods.

Contact Miller Value Partners to obtain information on how Top Contributors and Top Detractors were determined and/or to obtain a list showing every holding's contribution to Strategy performance.

The views expressed in this report reflect those of the Miller Value Partners strategy's portfolio manager(s) as of the date published. Any views are subject to change at any time based on market or other conditions, and Miller Value Partners disclaims any responsibility to update such views. The information presented should not be considered a recommendation to purchase or sell any security and should not be relied upon as investment advice. It should not be assumed that any purchase or sale decisions will be profitable or will equal the performance of any security mentioned. Past performance is no guarantee of future results.

©2020 Miller Value Partners, LLC

Privacy - Terms