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## The Greatly Exaggerated Death of Value Investing

Samantha McLemore, CFA and Christina Siegel, CFA

### Opportunity Equity 2Q 2019 Letter

The second quarter could be characterized as lackluster for Opportunity Equity. The Strategy gained 1.15% (net of fees) lagging the S&P 500's 4.30% return. Typically we tend to outperform in up markets so this performance disappointed us. It's attributable mainly to one error: too much exposure to generic companies with potential opioid liabilities. Had we avoided those names completely, the Strategy would have gained more than 6% in the quarter. The good news is that Opportunity is behaving how we'd expect excluding those names. The bad news: we own those names.

Mistakes appear obvious in hindsight, while the correct prospective action remains clouded with uncertainty. From these levels, we believe these companies will outperform but the range of outcomes is wide.

We own three companies with generics and opioid exposure: Teva Pharmaceuticals, Endo International and Mallinckrodt. We made each investment for its own reasons though cheap valuations united them all. We bought Teva because we think extremely highly of the new CEO Kare Schultz and his prospects for improving the operations. When we purchased Endo, it was troubled by a number of factors, including large legal liabilities for vaginal mesh and troubled core generics operations. We thought the market was being too short-term oriented and not looking through to the clear cash generation prospects in 2020, after the company finished its mesh liability payments. Paul Campenelli is another CEO we think very highly of and we agree with his strategy of focusing on sterile injectables where Endo has a competitive advantage. Mallinckrodt was controversial when we purchased it as well. The valuation was compressed mostly due to fears about the sustainability of its main drug, Acthar. We

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believed that drug would be more sustainable than what was implied by the stock. While that has mostly played out, current sustainability fears have grown even more, compressing the valuation further (along with other issues). We considered the prospective opioid liabilities but judged them manageable. We didn't anticipate just how myopically focused the market would become on this point, which was our main error.

The valuations of all three have reached extreme levels. Teva trades at 3x 2020 earnings, Endo under 2x and Mallinckrodt at 1x. Free cash flow yields are similarly elevated: Teva's is ~20%, Endo's is ~50% and Mallinckrodt's is ~95%! Unlike prior periods, since the financial crisis valuation has not provided support when stocks face selling pressure. Whereas before negative developments would be sufficiently discounted at a certain level, now every headline seems to send names down further regardless of what's priced into a stock. This can create heightened downside volatility, but also increases upside if and when things reverse (which they typically do).

While the future is always uncertain, it is particularly so in this case as the legal theories under which liability is being charged are mostly unprecedented. While the worst case cannot be entirely ruled out, the legal experts we've canvassed estimate liabilities mostly far below the extreme numbers being thrown out. On the other hand, the behavioral dynamics of tremendous pessimism and intense selling on the back of extreme liability estimates is not a new one. Among other examples, it reminds us of Bank of America in 2011. The stock hit a low of \$4.92 as fears about their mortgage-backed security liabilities putting them out of business abounded. Warren Buffett invested \$5B in August after the stock had fallen from a high earlier in the year of \$15.31 to \$6.01. While it had a brief rally after that news, the stock then continued on to new lows. As fears abated and improving fundamentals played out, Bank of America turned out to be one of our best performers in 2012 when it more than doubled. It would not surprise us to see a similar outcome with our opioid exposed generics companies.

More broadly, two topics surface most often recently: macroeconomic vulnerability and the risk of recession ([click here](#) for Bill's commentary for our thoughts here) and the relative performance of growth versus value. I spoke at the New York CFA Society's Ben Graham Value Investing conference in June. It was a useful conference with informative talks by highly respected investors such as Lee

Cooperman, Joel Greenblatt, and others. But some sessions felt more support group than professional conference. Value investors are feeling the pain!

We've been able to do well despite the rough overall environment for value managers for two reasons: a focus on cash flow and diversification between secularly mispriced names (i.e., long duration growth assets like Amazon) and cyclically mispriced names (more classic value stocks).

When we talk about value, we focus on the present value of the future free cash flows, which is, of course, the value of any business. If we are close in our estimation of cash flows, we will do well over time. But there is great uncertainty and estimation error when forecasting cash flows. For this reason, investors use many short-hands like price multiples on book, sales and earnings. The Russell Value index defines value using the former two. That is a flawed definition of value and those type of names have underperformed for a number of reasons. One reason is that in a low growth environment, there's more scarcity value to growth so companies that can grow have been bid up. Another reason is that as the economy has evolved to be more global, knowledge-based, and intellectual-property focused, accounting can skew some metrics. Companies expense research and development costs as incurred unlike capital expenditures on physical goods, which become an asset on the balance sheet. Yet both types of spending result in the creation of assets: one in book value, one not. GAAP accounting for book value doesn't reflect those intangible assets which are powering important parts of the market. Our process aims to understand the *economics* of businesses to overcome distortions of this sort.

We've also always viewed growth as an input to the calculation of value, as Warren Buffett has said. If a company with returns on capital above the cost of capital can grow its business that creates additional shareholder value. Over longer periods of time, the best performers in the market are the ones who can sustain growth over long periods of time. But there are periods when the market favors growth assets, like the late 90's or now, and periods when it favors more classic value, like the period between the tech bubble and the financial crisis. We've done well in both kinds of environments because of our diversification between classic value stocks and companies able to sustain growth. Empirically, free cash flow yield is the single best factor for predicting performance, which is why it's crucial to how we

think about companies. Most high growth companies appear more expensive, including on free cash flow. Our process attempts to identify companies that can sustain growth for long periods, like Amazon. The problem is that many more companies are priced to grow for long periods of time than can actually accomplish that. We continue to try to identify investment opportunities of that sort.

The good news is that even with the market at all-time highs, we continue to find interesting investment opportunities. The bigger challenge has been deciding how to fund those ideas. In the quarter, we purchased 4 new names: Tivity Health, CVS Health, Alibaba and Eventbrite. We exited 6 names: Allergan, Baidu, Celgene, CenturyLink, Endurance International and Newell Brands.

I will cover our sales first because they can mostly be grouped into two buckets: disappointers and acquired companies. The sell-side of this business is often more challenging than the buy-side. We typically sell for one of three reasons: a stock reaches our assessment of fair value, we are wrong or we find a more compelling investment opportunity. As we've found new ideas, we've largely funded them with names where fundamentals have disappointed us.

We are always trying to improve our process and results. A couple of years after the financial crisis, we hired an external consultant to help us analyze our entire history to figure out how to improve. One conclusion was to avoid big losers by selling names where fundamentals continue to come in lower than our expectations (previously we'd typically buy because valuations fell even more than fundamentals warranted). For this reason, we used Allergan, Baidu, Endurance and Newell to fund new ideas. CenturyLink was a different sort of disappointment: management cut the dividend after reiterating numerous times they'd do the opposite which led to a credibility problem. Celgene was acquired by Bristol Myers.

I will cover our new positions in order of size. Tivity Health is an interesting and not well-known company. It built a business partnering with health plans and gyms to incentivize people, particularly older ones, to go to the gym, thereby improving health through both physical fitness and socialization. Late last year, the company purchased Nutrisystem, the diet food company. Prior to the deal, the combined companies had an enterprise value of \$2.9B. Today, it's down roughly 35% to \$1.9B (the

equity is down substantially more). It's hard to imagine how the combination destroys \$1B in value. The market hates that the company took on \$1.2B in debt. But in our view, the company will be able to pay down the debt and that value should accrue to the equity. Tivity trades at \$16.30 and will generate at least \$3.35 per share in cash this year resulting in a free cash flow yield of 21%. There are some compelling reasons to believe the company can actually deliver on creating additional revenue opportunities from the combination (which typically isn't the case). A small pilot program in the first quarter did just that. As debt is repaid and fundamentals play out, we think there's a good shot this one is worth double where it's trading now.

After acquiring Aetna, CVS fell from a high last year of \$82 to a low of \$52 in the quarter. It currently trades around \$57, or 8x this year's earnings with a nice 3.5% dividend yield. The valuation is less than other pharmacies like Walgreen's Boots, which trades at 9x and other health plans like United (18x), Anthem (16x) and Cigna (11x). The strategy around "Health Hubs" that expands on CVS's Minute Clinic to offer other health services, such as dieticians, to improve health for customers could help drive down health care costs and provide upside to the stock.

We owned Alibaba in the past and it was a mistake to sell it. We swapped our Baidu into it after Baidu disappointed in the quarter. Both names had been under pressure due to China exposure and fears. Baidu has interesting long-term assets but near-term fundamentals disappointed as it transitions its business. Alibaba, on the other hand, reported a stellar quarter beating expectations. Macro fears allowed us to buy this long-term winner that is still growing topline at over 30% per year at an attractive valuation.

Eventbrite is our final new name. It provides a technology and ticketing platform for events. We've known the company for years as our former colleague, Randy Befumo, has run strategy and finance for them. We first bought the company when it came public in 2018 at \$23 before running up to \$40 where we sold because we thought it was fairly valued. Eventbrite then announced a series of disappointing quarters due to some churn resulting from its acquisition of Ticketfly causing the stock to drop to a low of \$15. We believe the company has sizeable opportunity to continue to grow its business for many years and this is an attractive buying opportunity.

As you can see, even this quarter our new purchases were a mix of classic value stocks and long duration growth assets. The common bond is a market price that trades below our assessment of intrinsic value, defined as the present value of the future free cash flows. We think like owners when making an investment. We have conviction this approach will continue to deliver value over time.

**Samantha McLemore, CFA**

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*Strategy Highlights by Christina Siegel, CFA*

During the second quarter of 2019, Opportunity Equity returned 1.15% (net of fees).<sup>1</sup> In comparison, the Strategy's unmanaged benchmark, the S&P 500 Index, returned 4.30%.

Using a three-factor performance attribution model, selection effect and interaction effect contributed to the Strategy's underperformance but partially offset by allocation effects. **Ziopharm Oncology Inc. (ZIOP), Avon Products Inc. (AVP), Intrexon Corp. (XON), Qualcomm (QCOM), and Facebook Inc. (FB)** were the largest contributors to performance, while **Mallinckrodt (MNK), Endo International (ENDP), Teva Pharmaceuticals (TEVA), Baidu (BIDU), and Tivity Health (TVTY)** were the largest detractors.

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

We added four positions and exited six positions during the quarter, ending the quarter with 38 holdings where the top 10 represented 43.4% of total assets compared to 21.3% for the index, highlighting Opportunity's meaningful active share of 99.8%.

## Top Contributors

- **Ziopharm Oncology Inc. (ZIOP)** increased 51.4% over the quarter. The company announced an exclusive licensing agreement with the National Cancer Institute for intellectual property for the development and commercialization of cell therapies for cancer. Under the agreement, Ziopharm will have the rights to two groups of technologies for use with its “Sleeping Beauty” platform, including T-cell receptors, as well as manufacturing methods and processes to generate large numbers of modified T-cells. This was followed up by the FDA approving the commencement of a Phase I trial evaluating SB-TCR-T cell therapy in solid tumor. The trial will be conducted by the National Cancer Institute (NCI) as part of a cooperative research and development agreement with ZIOP. The company also presented new interim analyses of clinical data from two ongoing sub-studies in its controlled IL-12 platform for the treatment of recurrent or progressive glioblastoma in adults. The company filed a mixed securities shelf with a maximum offering price of \$100m.
- **Avon Products Inc. (AVP)** gained 32.0% during the quarter after Natura announced the acquisition of Avon for \$3.1B dollars in an all stock deal, implying a price of \$4.20/share. Avon shareholders will receive 0.3 Natura shares for each Avon share. The deal is expected to close in early 2020.
- **Intrexon Corp. (XON)** rose 45.6% over the period as CEO, RJ Kirk purchased a total of 5.8k shares for a total consideration of \$27.1M. The company announced early in the quarter that it was aligning operations into two business units, Intrexon Health and Intrexon Bioengineering. While the company disappointed on 1Q earnings with lower revenues, the company opened its gene therapy manufacturing facility which is designed to eventually meet supply requirements for early-stage clinical trials. The company and majority-owned subsidiary Triple-Gene also completed enrollment in the first cohort of the Phase 1 trial of the INXN-4001 triple-gene therapy candidate for heart failure. Later in the quarter, Intrexon and Surterra Wellness announced an exclusive global licensing agreement to advance

Surterra's cannabinoid production, leveraging Intrexon's proprietary yeast fermentation platform.

## Top Detractors

- The top three detractors were all pharmaceutical companies as the market grew concerned with multiple legal battles brought to the fore. **Mallinckrodt plc (MNK)** declined -57.8%, **Endo International plc (ENDP)** fell -48.7% and **Teva Pharmaceuticals (TEVA)** lost -41.1%. All three names were impacted by a lawsuit filed against 20 generic drug companies claiming drug price-fixing. The suit was brought by the attorneys general of 44 States and is more expansive than the suit filed in 2016. The suit alleges that Teva significantly raised prices on ~112 generic drugs and collude with competitors on at least 86 of them while Endo's Par allegedly colluded with Teva regarding five generics. All three companies were also negatively impacted by increasing opioid lawsuits and expectations for large opioid liabilities. Teva announced an \$85M settlement with the state of Oklahoma in connection with an opioid lawsuit but this is just one of many opioid lawsuits against them. Mallinckrodt fell on negative headlines surrounding an on-going case relating to the mispricing and misconduct of Acthar. Mallinckrodt also fell after filing a lawsuit against the US Department of Health and Human Services (HHS) and Centers for Medicare and Medicaid Services (CMS) in relation to a CMS decision to lower the base rate average manufacturer price used to calculate Medicaid drug rebates for Acthar. Management noted the decision could lower Acthar's run-rate revenues by roughly 10% (\$100M per year) and create up to a \$600M retroactive rebate liability.

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[Click to read](#) Bill Miller's 2Q Market Letter.

[Click to read](#) our 2Q 2019 Market Highlights for a recap on what drove market performance.

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**Past performance is no guarantee of future results.** 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.

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