

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Constructing Portfolios That Differ From the Index



JOHN P. DEGULIS is the President and Portfolio Manager at Sound Shore Management, Inc. Mr. DeGulis joined the firm in 1996. Earlier, he worked at Morgan Stanley & Co. Mr. DeGulis holds an MBA from Columbia Business School and also graduated from Northwestern University.

SECTOR — GENERAL INVESTING

TWST: Could you tell me a little bit about the firm?

Mr. DeGulis: Yes. Sound Shore was founded in 1978 as a long-only buy-side boutique with a value style and the heritage of the firm from a strategic standpoint has always been value stocks. And so we've maintained that through the 40-year history. And we manage a mix of institutional and retail money. There is a mutual fund, the Sound Shore Fund, which is about a third of our assets, and the rest are in, say, typical separate-account retirement and endowment and foundation assets.

TWST: And many of the stocks that you invest in are large caps?

Mr. DeGulis: Yes, primarily large caps. occasionally invested in midcap names, but it's primarily a large-cap strategy.

TWST: And many of them might be temporarily out of favor too?

Mr. DeGulis: Yes. Being a value investor, you're often looking for stocks that are cheap, cheap on a p/e or earnings basis, or price relative to cash flow. Oftentimes, that means it's a stock that's out of favor or has underperformed or come down on an absolute basis. So that's often a prerequisite.

TWST: And they are in different sectors too?

Mr. DeGulis: They are. We are diversified in the sectors with which we invest. So it's broadly diversified.

TWST: Do you want to highlight a company that you find interesting now?

Mr. DeGulis: Yes. I think what I might do is touch on a stock that was one of our better performers over the last few years. I

can use it as an example of our process and then also can touch on a little bit the market environment that we've had over the last year.

So **First Data Corporation** (NYSE:FDC) was a company that had been public for a very long time before it was taken private by **KKR** (NYSE:KKR) in 2007. They put a lot of leverage on it. They had a number of senior management turnovers, struggled with the business as a payments processor. There's a lot of change going on in the payments industry. Given the leverage that the business had and the turnover with the management team, they had underinvested in the new technological innovation that they needed.

They finally got a hold of a much better manager in Frank Bisignano, who'd come over from JPMorgan. He brought in a whole new team. This is four years ago, and they began to reinvest in the business and had the blessing of the board there to do that. They then took it public. And in the selloff that you had in the fall of 2015 and early 2016, the stock fell in half and was trading for 10 times earnings and a 10% free cash flow yield, which are both low, not only on an absolute basis but also certainly relative to the market. At the time, the S&P was probably at 16 times.

We had done a lot of work on the businesses and had researched various parts of **First Data** over the years. It's a particularly sticky business that is not very volatile, generating tremendous amounts of cash flow. So the leverage that was there we were comfortable with because they were going to delever with the cash flow they were producing, and they had solved many of their problems in terms of the market share loss that they had.

One of the acquisitions they had done brought them a technology called Clover, which is a point-of-sale system. You

may be familiar with **Square** (NYSE:SQ), which is an independent publicly traded company. So it was **First Data's** answer to **Square**. Clover was built into their systems, and **First Data** sold it through their network. It has more installations and is growing faster than **Square**.

So that just is an example of what we're looking for in terms of the due diligence and the work we were doing. We look for change and/or evidence that the new strategy is working. The business was trading at 10 times earnings; we thought it could grow easily in the high-single, low-double digits.

And so fast-forward to this past fall, it had been a very good stock. Because of its leverage and the concerns about market liquidity in the fourth quarter, it fell quite dramatically. We stayed with it and bought more in December. And then, in January, it was announced that they were being bought by **Fiserv** (NASDAQ:FISV), and so one of our worst stocks in the fourth quarter of 2018 has ended up being our best stock so far in 2019.

It's also a very good stock over the life of the investment. But it just shows you the kind of volatility that we've had in the last year. And it's important to know what you own and stick to the holdings that you believe in. And when you do that, you can be rewarded.

So **First Data** has been a good stock. And it also speaks to a few additional themes in the marketplace, which is there are still cheap stocks that are interesting to invest in. You do have to be

taking it out at a nice premium.

TWST: Is that something that you see from time to time with some of the stocks that you hold, that the companies are acquired by other companies or there are mergers?

Mr. DeGulis: Absolutely. As value investors, we're certainly fishing for situations that are statistically cheap, but we think there's a turn fundamentally. Those are often good candidates to be acquired. And we also probably over-index companies that have either management change or what they call activists that get involved because there's also a sense of need and a drive to continue to run the businesses better internally. And so we are often over-indexed for that as well. **First Data** is a little bit backward-looking, but it's a good example of what we do, and it's also an important driver of returns so far year to date.

Another company that is also interesting is **Capital One** (NYSE:COF). **Capital One** is pretty well-known because of its brand name. It's not just a credit card company; it's also a bank — retail and commercial bank. It's been run since its founding by Richard Fairbank, who was an entrepreneur. The heritage of **Capital One**, albeit mostly in credit cards, is also as a very forward-thinking organization that uses data to be a very good underwriter of credit — personal credit, particularly credit cards.

And they've been through many cycles. They've managed through them very well and continue to do that. And

Highlights

John P. DeGulis discusses Sound Shore Management, Inc. The firm uses a value investment style. Mr. DeGulis primarily invests in large caps but occasionally will buy midcap names. According to Mr. DeGulis, the strategy is broadly diversified across sectors. He says it's important for investors to know what they own and stick to the holdings they believe in. Mr. DeGulis also notes that it's important to be different from the index in order to win.

Companies discussed: First Data Corp. (NYSE:FDC); KKR & Co. (NYSE:KKR); Square (NYSE:SQ); Fiserv (NASDAQ:FISV); Capital One Financial Corp. (NYSE:COF); Microsoft Corporation (NASDAQ:MSFT); NXP Semiconductors NV (NASDAQ:NXPI); Qualcomm (NASDAQ:QCOM) and Alexion Pharmaceuticals (NASDAQ:ALXN).

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careful about industry change and technological change, not just in the classic technology sector, but it really is now pervasive across most sectors and most industries. It's not a new phenomenon. There's always been change. But it's pretty pervasive today.

And so you have to be cognizant of that, particularly as a value investor that you're not buying a business that is facing strategic headwinds that are insurmountable. So we did a lot of work on **First Data** and concluded they were well-positioned to continue to grow, and certainly, **Fiserv** has agreed with us and are

now, in this era today of everybody talking about Big Data and artificial intelligence, they've taken that heritage and rolled it forward. We think **Capital One** is still on the cutting edge of the ability to use the data that they have, which is tremendous, and be very quick to analyze it accurately. We think it is a superior business model amongst a lot of the regional banks and credit card companies. And so this is a business that we've owned for a few years.

We bought it for 9 times earnings when it was making

\$7 a share. It's now making \$11 a share. So it's been a pretty good stock, but then it pulled back almost 40% from the middle of 2018 until the end of 2018 as people worried about the potential for recession and also disruption within credit cards and banks. Back on that same theme of disruption. And so the multiple compressed all the way down to 7 times earnings.

1-Year Daily Chart of First Data Corp.



Chart provided by www.BigCharts.com

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Meanwhile, internally, they have done more in terms of getting themselves ready for what banking in the future will look like than just about any other bank. They’re going to be completely in the cloud with all of their computing and applications by the end of next year. They’re about three-quarters of the way through that already. That’s going to allow them to be more nimble, more analytical — those are going to be critical in the era of digital banking to be responsive and to retain customers.

And so they’re going to, we think, continue to grow. They’re gaining market share. They still have a bank, and so you’re going to have exposure to the economy and, in particular for them, credit cards — credit here in the United States, but they continue to take share. They’re one of the big players within credit cards. They have the scale, and so trading at a multiple that even on the rebound now is still only 8.5 times earnings with a balance sheet that’s very strong, very well-capitalized.

They passed the Federal Reserve stress test very easily, which would say they could go through something like the great financial crisis again and not need capital. It’s still quite a good investment run by an entrepreneurial team that has created a bank that can compete in the future, and yet, it’s trading at a very low multiple.

TWST: When compared to maybe some of the other banks out there or the other credit card companies, they are

more innovative and more up-to-date on some of the newer trends that are going to be dominant in coming years?

Mr. DeGulis: Much more. And I think you’re starting to see it in not only the performance of your average regional bank but also in the discussions we’re having with some of those management teams. There were a couple of conference calls recently where some of their competitors said brand and technology spend and scale are starting to be more meaningful competitively than they’ve ever been. And so I think that’s why you’re going to see some consolidation within that part of the marketplace, and they will embrace the changes that you need to do from a technological standpoint, but it takes a long time and a lot of money to do it.

And **Capital One** is way ahead. And so for instance, they use not only **Microsoft** (NASDAQ:MSFT) but also Amazon Web Services — AWS — on the cloud side. They have over 1,000 — what they call black belts — employees of **Capital One** that are certified for the AWS system. There’s not a lot of banks out there, particularly regional banks, that have more than one or two of those people.

So the scale of this is actually remarkable, and it takes time for that to show up in terms of the results. But what it says

1-Year Daily Chart of Capital One Financial Corp.

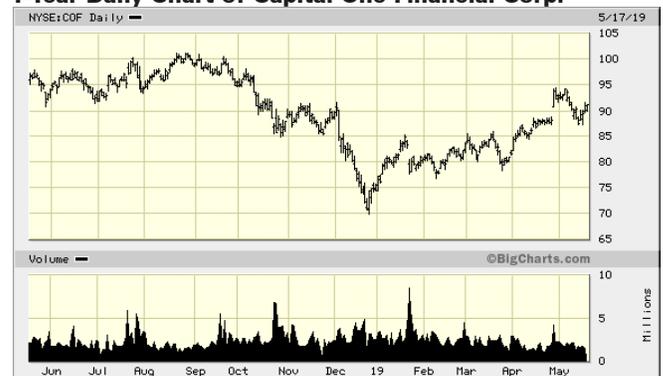


Chart provided by www.BigCharts.com

is, the likelihood of being able to have a sustainable business model that can continue to grow 10 years from now as much as you are today is much higher to **Capital One**, we believe, than your average regional bank.

TWST: Did you want to mention another company?

Mr. DeGulis: Yes, another company that we’ve picked up in the selloff that we saw over the last year was **NXP Semiconductors** (NASDAQ:NXPI). This is a business that

we've known over the years. In fact, we owned one of its pieces years ago. It was a series of acquisitions that are all in the analog semiconductor market. But it was a business that was for sale; it was going to be purchased by **Qualcomm** (NASDAQ:QCOM). And then, in the middle of last year, the antitrust authorities, particularly in China, blocked the deal.

So the stock fell dramatically once that deal broke in the summer of 2018. And then, the stock went down again even further on the more cyclical selloff that we saw broadly speaking in the market in the fourth quarter. So we were able to pick up **NXP** at 9 times earnings and a 10% free cash flow yield for a company that we think on a secular basis can grow units in the mid-single digits, revenue in the mid-to-high single digits and earnings in the double digits.

They've got a good balance sheet. They were taking a lot of the cash flow that they had received not only from the deal breaking up but also had been retained for the deal if it would have happened and deployed that to return it to shareholders. They shrunk the share count by over 20%.

And meanwhile, they benefit from a lot of trends that are in the industry as a technology leader. Within semiconductors, they are the leading automotive semiconductor company, number one market share. The content of semiconductors within automotive, which is about half of their revenue, is going to go up by around 5% per car over the next 10 years. So even if global auto production were flat, they could grow their revenue at 5%. Now, it's unlikely to be flat over a very long period of time. It's obviously cyclical, but there's an upward tilt to global auto production. But then even within that, **NXP** has secular growth over and above that of 5%.

They also have all sorts of other internet of things, exposure within industrials. So to the extent that you are investing in automation and manufacturing, in HVAC systems, in even some mobile applications within phones and iPads. They also have semiconductors for that as well. So even though this is broadly speaking a semiconductor company, which often people refer to those as being commodity-like and/or very cyclical, they certainly are levered to global GDP growth.

But at the end of the day, there's a secular growth driver here that we think is very strong and persistent, a management team that has run the business very well. It's profitable. The returns on capital are high, well-above their cost of capital. And because of the double whammy of the **Qualcomm** deal breaking down and then the cyclical selloff you saw in the second half of 2018, we were able to pick up this company at 9 times earnings. And it's up quite a bit for us here in the first quarter, but we still think there's a long way to go. So those are the kind of businesses that are still available in today's marketplace.

TWST: Even though the Qualcomm deal broke down, is it possible that they might be looking for other mergers and acquisition activity in the coming years?

Mr. DeGulis: It's unlikely that they initiate something right now themselves, but **NXP** continues to be a well-liked asset and one that strategically would fit with some other companies. And so it wouldn't be surprising if they were to be acquired by someone else, but that's not the reason we own it.

TWST: Did you want to mention one final company?

Mr. DeGulis: Sure. Another name that we own that we think is interesting is **Alexion Pharmaceuticals** (NASDAQ:ALXN), which is a mature biotech company that is growing. They've got a number of products. Their most important one has multiple indications, three now and growing, that are often referred to as orphan disease drugs. These are drugs that are used for very small populations, often diseases that are genetic-based or genetically driven.

1-Year Daily Chart of Alexion Pharmaceuticals



Chart provided by www.BigCharts.com

They have a drug called Soliris that has been the innovator in what is primarily blood disorders, often for kids. It's growing. They're now transitioning to the next generation of Soliris, which is called Ultomiris. That transition is happening in the U.S. right now. We think they'll have over 70% of the patients converted to the new version by next year. And along with that, there's a growing business and a pipeline that we don't think you're paying for.

We were able to buy **Alexion** in the second half of last year at 12 times earnings. For a business that is growing revenue at 10%, we think earnings at at least 15% with a pipeline that is undervalued. There's a lot of concerns about the durability of Soliris longer term. There are potential competitors, but we think their mechanism of action is unique. The transition to Ultomiris alone gives them a lot of protection and extends the patent life and is a better product.

And it is proving to be very difficult to replicate the studies and the efficacy that they had originally. We're comfortable with that. And then, there are a number of new drug development efforts that are in the pipeline that are underappreciated. This is another business that is often off the radar screen within the pharmaceutical industry.

It also could be a takeover candidate. The large pharma are continuing to restructure the way they do R&D. Part of it's internal and then part of it continues to be external, and the external is often an acquisition of a company like **Alexion**. So not the reason that we own it, but it certainly could be a takeover candidate at some point. It's been a good stock for us. It still only trades at 15 times earnings today. And we still think there's very interesting risk/reward even here.

TWST: And looking at companies that do focus on orphan diseases, is it a smart idea sometimes because those diseases need to be treated just like any others do and there's an identifiable market for them?

Mr. DeGulis: Yes. The risk is, of course, can you get sufficient return on the investment, because there's obviously a higher failure rate in drug development. And you don't have a large population to sell to. But often the clinical benefit, if you will, is life-changing. And this is certainly one of those cases.

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The dollars spent are actually very well-spent from a health care society standpoint because you're dramatically changing the lives and the lifestyle of these patients. It is a unique part of the market. **Alexion** has been very good at developing drugs here. You also tend to have less regulatory scrutiny and political pressure on the pricing because there's still a push by the FDA and also a lot of the payers to have drug companies continue to develop drugs for the orphan sort of drug universe because it's been underserved for very long periods of time.

TWST: And changing direction a bit, when you talk with your investors and clients about what their concerns are for the rest of this year into next year, what are some of the issues that come up?

Mr. DeGulis: Well, there's always the next thing everyone's worried about from a cyclical perspective. Recently, as you know, the Fed has been raising rates up until December, where they've decided to stop. Because of those actions largely and also some weakness abroad, our yield curve on the Treasury market has flattened out to around zero depending on what duration you're looking at. If we just look at the 10-year yield versus the two-year yield, it has compressed a lot. And when it does that, historically, it's telling you that, at a minimum, the economy is slowing. And if it continues, it could mean that recession is imminent.

There's a lot of debate about that. And we certainly understand it. We're being very careful with the companies with which we invest to make sure a name like **NXP** has secular growth and a good balance sheet. We're not a firm that is picking stocks based on macro predictions. We certainly understand which way the wind's blowing, and we look at it and talk to our companies about it. But to a large extent, particularly in the fourth quarter of 2018, a lot of these companies were discounting a tremendous amount of economic weakness. So that continues to be a debate.

And then, I've already mentioned it a few times, but being value investors, post the crisis, you've had a long period here where

the growth stocks have outperformed value. And there's a number of reasons for that. One, the amount of innovation you've had on the growth side and, two, the persistence of low interest rates has driven the multiples on long-duration assets like growth stocks, and yield plays to very high levels. So it's been a difficult environment, generally speaking, for value investors, but we think at this point, as long as you're keeping your head on straight and disciplined with what you do and understand the businesses that you own, there's a lot of opportunity for us.

We actually quite like where we sit from a statistical standpoint. The opportunity for us we think going forward the next five years, the next 10 years is actually quite robust. It will be up to us to execute that. But we've been through this before. We've been through environments like this before. And what's most important from our standpoint is to remain disciplined in our strategy with our eyes wide open and understand what's happening within the industries and sectors with which we're investing but to stick to our discipline and our strategy.

TWST: Is there anything we didn't mention you care to bring up, either about the firm or some trends out there?

Mr. DeGulis: I would say the other thing that is notable when thinking about constructing active portfolios — we've designed the firm and the strategy like this from the beginning — you need to be sufficiently different from the index in order to win. And so there's a debate out there clearly of firms that own hundreds of stocks, and their tracking error is very low, and why bother relative to an index, a low-cost index, and we get that. There's still a big trend to do that. But we only own 35, 36, 37 stocks. The active share, if you will, which today's nomenclature in terms of the percentage of your portfolio that is outside of the index is very high for us in the mid-80%, and it can get up as high as 90%.

When you invest with Sound Shore, you're not buying the index, and you never were. Our performance will be different from the index, which is a good thing. That's why you hire us. And we're not changing anything. That's exactly the way the portfolio was structured 40 years ago, and it's the way we run it today. So we're reasonably concentrated. We don't think overly so. But the point is, we can find names that are off the beaten path that you don't own if you own an index and don't own if you own one of the momentum growth strategies.

It's a different part of the market. And it's also a part of the market that, as I said before, is particularly attractive today. There's a big discussion about that in the institutional marketplace in terms of how would you structure an active portfolio to give it

the best chance to win, and we think it's the way we've done it. And we've always done it. The good news is, we've been practicing this for over 40 years. So we have experience. It's not something new for us. So again, it will be important for us to remain so and stick to our disciplines, but the structure of our portfolio remains the same and I think gives us a very good chance to succeed.

TWST: Thank you. (ES)

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