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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Large-Cap Value Investors Tout 3 Cheap Stocks

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Peter B. Evans is a Partner at Sound Shore Management, Inc. Mr. Evans joined the firm in 2005. Earlier, he worked at American Express. He is a graduate of Dartmouth College and Columbia Business School.

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SECTOR — GENERAL INVESTING

TWST: Could you provide an overview of the firm?

Mr. DeGulis: Sound Shore Management is a value boutique that was founded in 1978. We're a long-only, buy-side boutique with a value style, and a focused strategy that we've been pursuing for over 40 years. Our client base is diversified by both institutional and retail. You've got classic institutional separate accounts. So a lot of retirement money, foundations, endowments, as well as a mutual fund, the Sound Shore Fund, which is about a third of the assets. That split has been reasonably consistent over the years.

TWST: And could explain the Sound Shore Fund?

Mr. DeGulis: We manage the Sound Shore Fund the same way we do our institutional separate accounts. It's a large-cap value strategy that is run in the same manner as we have since the firm's inception in 1978. We screen for what's cheap out there. Then we do our own fundamental research to come up with a reasonably concentrated portfolio of 35 to 40 stocks. It's a very straightforward and disciplined process that we apply across all of our accounts, including the Sound Shore Fund.

TWST: Is there a particular investment philosophy with the fund?

Mr. DeGulis: It's a value investing style. We are contrarians by nature. We're looking for stocks that are cheap, but not just statistically cheap on a sort of static ratio basis, if you will, a low p/e — it's certainly one way to screen and we do that to create our opportunity set. But then we very quickly take that opportunity set and do our own fundamental research to discern which stocks we think are going to be the best risk/reward ratios. So it's a classic value investment style.

TWST: I see that it represents a lot of different sectors.

Mr. DeGulis: Yes, we've always been diversified by sector. And you'll see that those sector weightings change throughout time. We go where we see value. There's no one sector that dominates the portfolio. Nor are there sectors that we completely exclude. It's a diversified portfolio that will cut across all traditional sectors of the equity markets.

TWST: Some of the ones that are more prominent might be financials, health care, information technology and consumer discretionary. Is that just what the holdings happen to be at the given time?

Mr. DeGulis: Yes. We pick stocks one at a time. We screen for what's cheap. And then we do fundamental analysis, talking to the companies and their competitors and suppliers — do classic fundamental securities analysis to make those selections. But it is one name at a time. So when you see the aggregate sector weightings, they are really a function of where we see value in the markets. We look at what is cheap now, both on an absolute basis and also relative to a company's own history, which is an important part of our valuation framework. You will find that in today's marketplace, there's a lot of opportunity in those sectors that you just highlighted. It's natural that even though it's one stock at a time, we get drawn to those sectors that have more opportunity in them.

These are very broad sectors. And there's a lot of bandwidth within each. And it doesn't mean the whole sector is cheap.

But nevertheless, within health care, we're finding a lot of value. Within financials, we're finding a lot of value. And in information technology, which is really now a much broader category than it might have been 10 or 20 years ago, given the proliferation of tech, as it permeates across industrial sectors and automotive sectors.

TWST: Did you want to highlight holdings that investors might find interesting now?

Mr. DeGulis: Sure. I'll start with **Vistra** (NYSE:VST). It is a diversified electricity supplier. They have both generation as well as a retail business that does transmission and distribution.

Highlights

John P. DeGulis, Peter B. Evans and David B. Bilik discuss the Sound Shore Fund and their overall approach to value investing. The fund is a large-cap value strategy that is relatively concentrated in 35 to 40 stocks. They say that currently they are finding value in health care, financials, and IT. They believe that leading up to the pandemic, the boom in growth stocks and long-duration assets was tied to perennially low interest rates and may now be ending; instead they see a marketplace more defined by earnings and earnings growth. Among the companies they recommend are Vistra, a diversified electricity supplier; Flex, which manufactures a wide variety of products ranging from data center routers to glucose monitors to EV charging stations; and Paccar, a global truck manufacturer that is very well run with high returns on capital and no debt at the holding company.

Companies discussed: Vistra Corp. (NYSE:VST); Flex Ltd. (NASDAQ:FLEX); Johnson & Johnson (NYSE:JNJ); Ford Motor Company (NYSE:F); Cisco Systems (NASDAQ:CSCO); PACCAR Inc. (NASDAQ:PCAR); Genuine Parts Company (NYSE:GPC) and O'Reilly Automotive (NASDAQ:ORLY).

It's an interesting company that came together through a series of acquisitions over the years, but now is one of the largest providers of electricity in the United States. They have exposure to many markets. Their biggest market is Texas. But they also have exposure in the mid-Atlantic, they have some exposure in Illinois and business in California. So it's diversified geographically within the United States, but still entirely a U.S. business. And it trades for very, very cheap multiples on both earnings and cash flow today and prospective cash flow and earnings as you look out. So in today's marketplace, given everything that's happened in the electricity markets, their earnings power has increased since we bought it.

And it now trades for a p/e that is, we think, under 10 times what the earnings power is of the business. And also very importantly, free cash flow, which is critical in a capital-intensive business such as electricity generation, is similarly at very low multiples of earnings. So when you look out to 2023, and 2024, earnings estimates for **Vistra**, they're north of $2.60 a share; the stock is trading at $23.70 today.

We actually think those earnings numbers are a bit low when we look out at the various scenario analysis of what they might earn in 2023, and 2024, given how electricity prices have increased over the last 12 to 24 months. So we're looking at a company that's trading for less than 10 times earnings, less than 10 times free cash flow, that we think is an increasingly important part of the energy infrastructure in the United States.

The other important part about **Vistra** is they're diversified by their fuel source. So about a third of their businesses encompass retail and electricity transmission and distribution. Meanwhile, the electricity generating business, which is about 70% of the company, is diversified by fuel source. They've got nuclear, they've got coal, they've got natural gas, and now they also have wind, solar and some batteries as well. And so they are increasingly investing in renewables.

You're going to see that mix shift, continue to accelerate towards renewables and away from carbon over the next 10 to 20 years. And they have targets set out for both 2030 and 2050 as they execute their transition. They've already closed about half of their coal plants. They'll continue to close their coal plants over the next five to seven years — that's already planned. They're putting incremental growth capital principally into solar and battery technology and they've already built up a wind business as well.

So you have this transition, much like you're going to see in many parts of the United States, but also globally as we move away from carbon as our electricity generation continues to transition into more renewables. But there has to be a pace to it. Obviously, we've seen with storms and weather and geopolitical events, there's a balance to all this. It's important to maintain stable electricity in all environments. And so the trick is that we need to transition to renewable low-carbon or no-carbon sources at the same time, providing good stable electricity as we transition. It's a big part of the story.

There is a transition to renewables. And in the meantime, they are continuing to grow their cash and their free cash flow and they're generating a tremendous amount of free cash flow that's going to be returned to shareholders. In fact, we think they're going to be buying in upwards of 50% of the stock over a four-year period. They are about a year and a half into that. So you're getting a very significant share shrinkage and return of capital to shareholders in the meantime. If it trades at what we think is a very fair and reasonable 10 times free cash flow per share, which next year could be north of $3.50, you get a stock into the mid-$30s as a target.

1-Year Daily Chart of Vistra Corp

Chart provided by www.BigCharts.com

TWST: Let's discuss another stock.

Mr. Evans: We also own a company called **Flex** (NASDAQ:FLEX), which manufactures a wide variety of products on behalf of companies like **J&J** (NYSE:JNJ), **Ford** (NYSE:F) and **Cisco** (NASDAQ:CSCO), all over the world. Their products range from data center routers to glucose monitors to EV charging stations. In addition to very efficient manufacturing, **Flex** helps its customers navigate supply chain challenges that we've seen of late by nearshoring and then using its scale to source components when there are shortages. **Flex** also has a subsidiary called Nextracker, which sells tracking systems for solar panels to increase their efficiency.

Earlier this year, the private equity firm TPG invested a valuation equivalent of over $6 a share. Their CEO, Revathi Advaithi, who we know from her time at Eaton, refocused the company on less cyclical end markets, like health care and cloud data centers. And despite having a majority of its earnings in these attractive end markets, core **Flex** is trading at less than five times earnings. So just using a modest 10 multiple on this core business, there's more than 65% upside to our price target. The company is operating very, very efficiently under new leadership.

"Their CEO, Revathi Advaithi, who we know from her time at Eaton, refocused the company on less cyclical end markets, like health care and cloud data centers. And despite having a majority of its earnings in these attractive end markets, core Flex is trading at less than five times earnings."

TWST: Do we want to go to the next company?

Mr. Bilik: Sure. **Paccar** (NASDAQ:PCAR) is a global truck manufacturer that is very well run with high returns on capital and no debt at the holding company. There are three parts to the business. You've got the trucking business, which they're well known for, and generates about half of their earnings. There's also an aftermarket parts business, which they've been investing in aggressively, which makes up 40%. The last 10% is from their finance arm. The stock is trading around 11 times earnings.

They're gaining share with a new set of trucks that have come out in Europe, North America and Brazil. The truck cabs are more comfortable for drivers and generate significantly improved fuel efficiency. If you look at the first half of this year in the heavy-duty truck market, **Paccar's** market share in Europe has been about 17.5%, versus just below 16% in 2021. These new vehicles come at higher price points and better margins. We don't think that the Street is fully appreciating this market share growth in their earnings models — we're about 10% above the Street, looking for approximately $8.50 of earnings next year.

We also believe the multiple should rerate higher. Recall the aftermarket business is about 40% of earnings, up from around 23% 10 years ago. Over this period they've doubled the revenue and quadrupled pre-tax income. If you think of players like **Genuine Parts** (NYSE:GPC) and **O'Reilly** (NASDAQ:ORLY), in the retail auto aftermarket business, those companies trade in the 18 to 20 p/e range because they're less cyclical businesses with solid returns and steady growth. We're seeing that from **Paccar** as well, and this should translate to a higher p/e versus the historical average. Applying a 14 p/e on the overall company gets us to a $120 target, up around 35% from current levels.

TWST: Could we talk about what's going on with the economy in terms of inflation, the risk for recession, and what advice you might have for investors now as the economy works itself out over the next six months to a year?

Mr. DeGulis: We've been very consistent with the way we've described our strategy and the way we would make sure we articulate that to folks. It's important to know what you own. To own businesses that are winning in their marketplace. That have balance sheets that give you sufficient liquidity and strength to weather through uncertain times, like we are living in today.

And if in fact interest rates really have bottomed, which it appears at the moment they have, and now they're on their way back up, that also changes the dynamic in the marketplace because it impacts, ultimately, the multiple or the p/e ratio or price-to-cash flow ratio that you might pay for equities, given they are by their very nature long-duration assets. And so you've seen multiples come down across the board and the market.

And in contrast to — and this is an important point to make — the years leading up into COVID-19, with interest rates continuing to be remarkably low and persistently low, a lot of the long-duration assets got marked up to very high levels. And so now you're having the reverse of that as interest rates go up and multiples in the market have come down.

sheets that allow them the flexibility to ride through all the uncertainty that we have today. So, as we like to say, we like to know what we own, because you're going to have volatility that we've seen obviously over the last six months. It may continue for quite a while. It tests your conviction and your confidence and your ability to maintain your positions and stay in the marketplace.

But we've been doing this a long time. We've seen many cycles through the years. Every cycle has its own differences in nuances. Ultimately, they test you in the same way. For us, we eat our own cooking. We've got only one strategy. We ask our clients to act the same way in which we do, which is, you need a multi-year timeframe, which requires patience. You need to know what you own, and concentrate on your best ideas that you think can ride through any economic environment. That's the way we build the portfolio.

"The biggest mistake that investors make, and this is across the board, whether it's individuals or on the institutional side, is that you get forced to sell when you don't want to or at bad prices. And that's what kills more return and opportunity than anything else."

That previous three- to five-year period, a very large portion of the gains in the market were really on multiple expansion — it was some on earnings growth. Going forward, if in fact interest rates remain here or go up higher, which is the forecast by most economists, you're going to make money in the equity market by getting earnings growth and ultimately do better than the market if you own stocks. Their earnings are then better than what is today discounted in that stock price. Better than people expect.

1-Year Daily Chart of Flex Ltd.

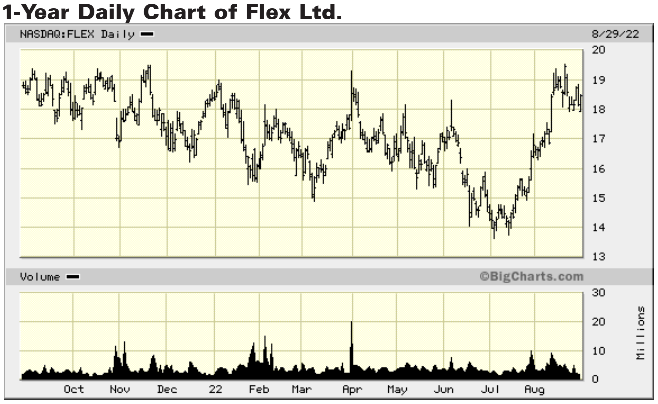

Chart provided by www.BigCharts.com

And so that's what we spend most of our time doing. We're looking for change. We're looking for businesses that one, two, three years from now, which is our normal investment period for an individual name, the earnings and cash flow will be better than the market expects.

We think you need to be very diligent about the businesses that you own. That they've got sustainable franchises with strong balance

Mr. Evans: A slowdown is likely at this point. But if we dig down to a stock-specific level — if I go back to **Flex**, their free cash flow generation is actually counter cyclical. When there is a slowdown, they wind up selling down their inventory. And they've been very good at buying back shares. **Flex** has shrunk its share count by about 15% over the last five years. They have the ability to actually take advantage of a slowdown and a commensurate reduction in their share price to maintain earnings, and then increase that earnings power over time. We try to find companies that we think can control their own destiny as they go through slow times, as well.

TWST: Any advice you might give to people who are saving for retirement, near retirement or in retirement years, as to what they might want to do now, given some of these conditions we're finding in the economy?

Mr. DeGulis: We're not in the business of giving individuals retirement advice. But I certainly appreciate the question. You have to put that in the context of each person's own timeframe and risk tolerances.

But having qualified my answer with that, I'd go back to what we said before, which is you need to remain diversified, which allows you to ride through the uncertain times. The biggest mistake that investors make, and this is across the board, whether it's individuals or on the institutional side, is that you get forced to sell when you don't want to or at bad prices. And that's what kills more return and opportunity than anything else.

If you remain diversified, you know what you own, you rebalance periodically based on relative performance, it allows you to stay in the markets, and have exposure, yet absorb the volatility that's inherent. Ultimately, you reap the awards over a long period of time. It requires both discipline and patience.

TWST: And a part of that diversification might be having equities, as well as maybe some other types of holdings in your retirement funds?

Mr. DeGulis: Yes. There are certainly traditional metrics that people use to measure diversification. But equities are usually, certainly a large part of it. And then there's different ways to get exposure to the equity markets as well, which also further gives you diversification.

But yes, we certainly would be a proponent of having equities as a part of your long-term retirement plan. Again, it's hard to put all this into context or for each individual's needs.

TWST: And one thing about your firm is it is a boutique firm. And you're going to get, I would think, much more personalized interactions with the professionals than you would at one of these mega firms. Maybe you could talk about that and the benefits of working with a firm of this size and approach.

Mr. DeGulis: Yes. It's a very good point. And one that we emphasize with both our clients and then intermediaries that they may use to help them make decisions and also prospective clients. Sound Shore is very focused. We've got one product and the members of the investment team that are making the decisions are available to talk to clients and prospective clients.

We think of ourselves as an extension of our clients' investment offices. We are always available for them, not only on a more mechanistic quarterly basis, if folks want to talk after every quarter. Some do, some don't. Others will only talk to us when there's a particular issue or item or volatility in the marketplace that they'd like to discuss. We're always available. And you get the senior members of the team that are on the battlefield making the decisions and are accountable, not only to ourselves, but our clients. You have access to them as well. So that's an important part of this culture. We're very focused, and we are there for our clients when they need us.

TWST: Anything else you want to bring up?

Mr. DeGulis: I just would leave you with this thought from me: The setup for us, the opportunity set, is a good one for a value style, such as Sound Shore. And the reasons include that coming into the COVID pandemic, there was a boom in the growth stocks and long-duration assets because of perennially low interest rates. That era may be ending. We're going to move back to, in all likelihood, a marketplace more defined by earnings and earnings growth, which is where we spend most of our time. All the uncertainty that you are now seeing in the market, both economically and politically, gives a lot of volatility and change in market prices that are often more significant than really the value of the businesses.

And that's what our job is: to find those opportunities. And so, we've been doing this for a very long time, very targeted in the stocks that we own. But given the amount of disruption that you've seen over the last 10 years leading into COVID, and now, today's marketplace as the Federal Reserve is raising rates, has actually given us an opportunity set that is quite fertile. As we look forward, we certainly don't make predictions as to where the equity markets are going to go. But we do feel like our strategy has every opportunity to do well.

Mr. Evans: Also, just to the question about our alignment with investors, the firm is 100% employee owned. Our retirement money is in the Sound Shore Fund. So we're very much aligned. We have one strategy. We're very much focused on making sure that we're getting the returns for our investors. So that's another important point to underline in terms of what differentiates Sound Shore.

TWST: Thank you. (ES)

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