Sweetbay Capital Management, LLC

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Following a prolonged period of market calm, volatility reappeared in early 2018. As we have written in the past, volatility is the friend of the value investor, and embracing the opportunities it creates is core to our strategy. We took advantage of it, along with the continued divergence between value and growth stock valuations, by adding six new positions in the first half of the year, discussed in more detail below.

Our focus is long-term capital appreciation. Stocks are long-term securities, but are often traded on a short-term basis because of their liquidity. This conflict between the temptation from liquidity and the required patience for the asset class is constantly apparent. One example is how investors interpret share repurchases, which rose to a record high in the first quarter for companies in the S&P 500. We view repurchases as a valuable tool for management to create long-term value, but only when shares are attractively priced. While recent repurchases are viewed as supportive of stock prices in the near term, history suggests buybacks are frequently ill-timed, which negatively impacts future returns on the investment. Rather than reflecting attractive valuations in the stock market, buybacks are more often a symptom of buoyant economic activity and the associated benefit to corporate profit margins, which tends to occur when share prices are high. For example, technology companies, one of the most richly valued sectors in the stock market, were responsible for one-third of first quarter share buybacks. According to Standard & Poor's, first quarter repurchases outpaced the prior record set in the third quarter of 2007 as share prices were peaking in the last bull market. When the stock market subsequently bottomed in 2009, companies bought the fewest shares in the last 20 years.

The perceived optimism of those at the corporate tiller – expressed through buybacks, frequently using leveraged shareholder capital – can be in direct contrast to how insiders allocate their personal capital. Robert Jackson, a commissioner of the Securities and Exchange Commission, examined stock trades at 385 companies in 2017 and the first quarter of 2018 and discovered a fivefold increase in the average amount of stock sold by insiders in the eight days following a buyback announcement compared to the days prior to the announcement.[1]

In our view, a bright spot in this market is that the price to earnings ratio for the S&P 500 Value Index is the cheapest relative to the S&P 500 Growth Index in 15 years, as reported by Yardeni Research. Many international markets also offer considerable value, such as mainland China and Hong Kong where broad stock indices are trading at 40-50% discounts relative to US stocks on a price to book and cyclically adjusted price to earnings basis. Central to our philosophy is our belief that value strategies work over time because shares get overly discounted in the near term when

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[1] Robert J, Jackson, Jr. "Stock Buybacks and Corporate Cashouts." Speech at the Center for American Progress. June 11, 2018. https://www.sec.gov/news/speech/speech-jackson-061118

investors are repelled by negative headlines, but prices are anchored to underlying fundamentals in the long run. Despite recent growth outperformance, the cumulative return for the MSCI World Value Index is more than twice that of the MSCI World Growth Index over the last 40 years. We search through stocks that are tossed aside by others, and we winnow them down to the most resilient businesses. Even great businesses encounter episodic challenges. We consider the combination of a strong business and low investor expectations as a basis for investment success.

New Investments

JD.com

JD.com (JD) is the second largest e-commerce retailer in China, the world's largest e-commerce market. China accounts for 15% of global GDP, but over 40% of global e-commerce, according to McKinsey. Nielsen estimates China's online sales grew 27% in 2017. The market is dominated by two companies: Alibaba and JD.com, with about half and one-third of the market, respectively. By comparison, Amazon's share of US e-commerce is about 40%. Because the traditional retail landscape in China is much more fragmented than in the US, JD's competition, outside of Alibaba, is largely unsophisticated.

JD.com was founded by Richard Liu, now 44 years old, who grew up very poor in rural China. In 1998 he opened a tiny shop counter in an electronics market. "I was the first and only stall in that market to put price labels on everything and give official receipts; from day one I never sold any counterfeits and I soon had the best reputation." Within five years, Liu had 12 large electronics stores, and he established an online business to save his company during the severe acute respiratory syndrome (SARS) pandemic in 2003. For the first four years as an online retailer, Liu lived in his office, and set an alarm to wake him every two hours during the night so he could respond to customer inquiries. That's a testament to his drive, but the experience also gave him valuable insight into what was important to his customers, and where his business could improve.

JD is primarily a direct-to-consumer retailer similar to Amazon, whereas Alibaba sells direct but also maintains a marketplace akin to eBay. This is an important distinction because counterfeit is a major problem in China, and is much easier to perpetuate within consumer-to-consumer (C2C) channels. The US Trade Representative publishes annually a black list of retailers[2] that "engage in, facilitate, turn a blind eye to, or benefit from substantial piracy and counterfeiting". Alibaba's C2C marketplace made the list in 2011, 2016 and 2017; JD.com has never made the list.

Alibaba's model primarily relies on third party logistics. There are no dominant and modern logistics providers like FedEx or UPS in China. Rather, the market is characterized by tens of thousands of small courier services that are largely unreliable. In another sharp contrast between the two competitors, Richard Liu made the decision in 2007 to internally develop logistics infrastructure so JD could control its supply chain. It now has the largest fulfillment infrastructure of any e-commerce company in China, with 515 warehouses – including the world's first unmanned whole-process distribution facility – covering 10.9 million square meters of gross floor

[2] Office of the US Trade Representative Notorious Markets List. https://www.ustr.gov

area. These facilities enable 97% of orders to be delivered within 20 hours, with an average delivery time of six hours.

JD's annual active customer accounts of 302 million and annualized revenue of $64 billion are growing at 28% and 33%, respectively. At our purchase price, the shares traded for less than 1x revenue, compared to 4.4x for Amazon with 43% revenue growth, and 2.2x for the S&P 500 with 7% revenue growth. Walmart in May invested $16 billion in Flipkart, India's leading e-commerce company, at a valuation of over 7x revenue.

JD's discounted valuation can in part be attributed to slowing revenue growth from 44% last summer, due to what management described as "coercive" tactics by Alibaba, which forced about 100 top apparel merchants to choose between platforms. Unlike electronics and appliances where JD is dominant, apparel is an emerging category for its platform, making it vulnerable to Alibaba's ploy. The tactic was very unpopular with merchants, and some are returning to JD's platform. JD is also criticized in the investment community for its thin profit margins, but it generates healthy free cash flow, its growth is financed by working capital, its balance of cash and investments continues to grow, and its debt is minimal. We believe our risk is limited by the fact that its revenue growth rate and price/sales multiple would both have to fall by half for the stock market value to be lower in three years than it is today. That scenario would entail JD trading at the same multiple of sales but with 4x higher sales growth compared to Walmart. We view this as an unusually attractive opportunity to pay a discounted price for a premier internet retailer in the world's largest e-commerce market, relatively early in the life cycle of both.

CK Hutchison

Hong Kong-based CK Hutchison Holdings (CKHUY) was founded as Cheung Kong Industries in 1950 by Li Ka-shing. Li initially manufactured plastic flowers, and parlayed his early success into Hong Kong real estate, buying aggressively in times of political crisis. Over his near 70-year career, Li amassed a global portfolio of assets in various industries, and in 2015 split off the real estate portfolio into a separate entity called CK Asset. The remaining businesses, which make up CK Hutchison Holdings, span telecom, infrastructure, ports, retail, and energy. Its vast portfolio of global infrastructure investments, primarily through its 76% interest in CK Infrastructure Holdings, drive one-third of EBITDA and include conventional and renewable electricity generation and distribution, water supply and sewerage, aggregates, cement and asphalt, and toll roads and bridges. Telecom accounts for nearly 30% of EBITDA and has approximately 45 million active accounts across Europe, with leading mobile franchises in the UK and Italy. CK Hutchison is also one of the world's largest port operators, with interests in 52 ports in 26 countries. Other businesses include the world's largest international health and beauty retailer, and integrated Canadian energy assets. Roughly half and one-third of CK Hutchison's EBITDA is generated in Europe and Asia, respectively.

The stock price has fallen 30% in the last three years while per share earnings have grown 9%, following a slowdown in earnings growth from a mid-teens historical rate. Earnings have been impacted by the broader economic environment, especially slower rates of GDP growth in Europe and China, as well as the decline in oil prices. Another contributing factor is increased competition

posing challenges to its retail and telecom businesses, although both of those segments have maintained growth. The announcement earlier this year of Li Ka-shing's retirement further dampened investor sentiment. The reins have been handed to Li's eldest son, Victor, 53, who holds bachelors and masters degrees in civil engineering from Stanford University, and has been his father's apprentice at the company for 33 years.

The earnings multiple has declined from 14x in 2015 to 7.7x 2019 consensus earnings estimates at our purchase price. That's a multiple typically assigned to companies whose survival is in question. It also trades for 70% of book value, and the dividend yields 3.4% with plenty of room for growth as the company is currently distributing just 31% of earnings. We view the conservative payout, strong balance sheet with net debt of 1.6x EBITDA, high market share across multiple industries, and geographic diversity as additional protection for our investment, even in light of concerns regarding tariffs and potential global trade disputes. We expect eventual multiple expansion will enhance the current yield and deliver us an attractive return.

Walgreens Boots Alliance

Walgreens Boots Alliance (WBA) is the world's largest pharmacy retailer, and one of the world's leading pharmaceutical wholesalers and distributors through its wholly-owned European subsidiary Alliance Healthcare, and through its 26% ownership of North America's second largest distributor, AmerisourceBergen. Walgreens' competitive position is secured by its purchasing consortium that accounts for one-third of all US generic pharmaceutical volume, and its vast retail network of more than 14,000 stores. The company is ideally situated to benefit from aging demographics. The US Census Bureau expects nearly 50% growth over the next 15 years of the 65+ population, for which per capita prescription consumption is more than twice that of the rest of the adult population. The Centers for Medicare and Medicaid Services projects that total US drug spending will rise to $600 billion by 2026, more than twice the growth rate of US GDP.

Over the last ten years, Walgreens has averaged 15% returns on equity, maintained consistent operating margins, and grown earnings 10% annually. There's been no share count dilution and the balance sheet is strong, with net debt to EBITDA currently at less than 2x. Its biggest operating earnings decline in 25 years was just 7% during the 2008/2009 recession. Not surprisingly for a business with such stability, its shares have traded at an average earnings multiple of 20x – a premium to the broad market – over the last 15 years, but we purchased shares for less than 10x consensus earnings estimates for 2019. The board appears to share our view that the current price is attractive, bucking the typical lack of price sensitivity described above. It announced in June a $10 billion share buyback program, equal to more than 15% of the outstanding shares of the company. The discounted valuation reflects investor concerns about the opioid epidemic, the potential impact on Walgreens' revenues and margins from the current backlash against branded drug inflation, and the risk of Amazon entering the market for pharmaceutical distribution and retail.

Regarding opioids, the causes of the epidemic include broader insurance coverage for pharmaceuticals than other treatment options, manufacturers downplaying the risk of addiction, over-prescribing by doctors, and a failure by distributors and pharmacies to flag the excess. We are concerned about this crisis, but believe the ultimate liability will be shared across the industry

and should be loosely tethered to the size of the opioid market, which is a subset of the pain medication category that totals about 4% of the dollar volume of annual prescriptions.

The effects of drug pricing pressure on Walgreens' earnings should be constrained just as the effect of drug pricing inflation appears to have been minimal. Walgreens' inventory turnover of 10x and its use of LIFO (Last-In-First-Out) accounting for the majority of its inventory limited the impact on its margins from higher drug prices. In comparison, drug manufacturers Celgene, Gilead and Biogen all use FIFO (First-In-First-Out) inventory accounting, turn inventory at much slower rates of 1-4x, and experienced 25-50% improvements in operating margins during the period of unusually sharp increases in drug prices, suggesting far more vulnerability to a reversal in pricing.

The heightened focus on drug prices is a symptom of broader concerns about bloated costs in our healthcare system. Walgreens is leveraging its retail footprint to provide medical services that keep patients away from the more expensive hospital setting. Currently, Walgreens has about 400 healthcare clinics across the US, staffed by advanced degree nurses known as family nurse practitioners. These licensed professionals provide a range of services including physical exams, diagnosis and treatment of illnesses, prescription writing, and treatment of chronic conditions such as diabetes and high cholesterol. A study[3] published in the Annals of Internal Medicine found that costs for similar care at retail clinics are 30-40% cheaper than doctor's offices, and 80% cheaper than emergency rooms. A separate study[4] published in the American Journal of Managed Care found that quality of care at retail clinics is the same or better than that provided for similar medical conditions by hospital emergency care departments and urgent care facilities. Walgreens is testing additional services including lab testing, vision, and senior-focused primary care centers.

Clinical services are a natural advantage over the potential threat from Amazon. In retail and distribution where Amazon may become a formidable competitor, Walgreens could face margin pressure. However, we think the shopping habits of Walgreens' core pharmacy customers will be slow to change. The incumbents should prove difficult to unseat because of long-term contracts with major distributors, medical claim processing and payer management solutions, regulatory compliance, and specialized distribution capabilities including cold-chain logistics for certain medications. A key point in our decision to invest in Walgreens is that these risks are well known to the market, and have caused the share price to decline nearly 40% from its 2015 high. We believe low expectations for Walgreens' shares increase the margin of safety of our investment.

GlaxoSmithKline

GlaxoSmithKline (GSK) is a UK-based global healthcare company that operates in three businesses: pharmaceuticals (57% of revenues), consumer healthcare (26% of revenues), and vaccines (17% of revenues). There were a number of issues weighing on Glaxo's stock at the time of our purchase in early 2018: concerns about UK companies and the impact of Brexit, the impending generic competition for Glaxo's largest respiratory drug, Advair, and concerns about

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[3] Ateev Mehrotra, MD, et al "The Costs and Quality of Care for Three Common Illnesses at Retail Clinics as Compared to Other Medical Settings," *Annals of Internal Med*, September 2009.
[4] William Shrank, MD, et al, "Quality of Care at Retail Clinics for Three Common Conditions," *American Journal of Managed Care*, October 2014.

its ability to maintain the dividend given a potential bid for Pfizer's over-the-counter (OTC) business, which would have stretched the balance sheet. We viewed these concerns as overblown, and purchased shares around 12.5x adjusted earnings and a 5.9% dividend yield. This represents one of the most attractively valued companies in the large-cap global pharmaceutical industry.

Advair, used to treat asthma and chronic obstructive pulmonary disease (COPD), is the world's top-selling respiratory drug. It went off patent in 2016 and is facing price declines from increasing competition. Advair sales have been declining over the last few years, and represented roughly 8% of total company sales in the first quarter, down from 20% of sales at its peak in 2013. Glaxo has promising new drugs in its pipeline, and recent new drug approvals offer significant growth potential that should offset the loss of sales from Advair. Total pharmaceutical sales in the first quarter increased 2% on a constant currency basis, despite a 20% decline in Advair sales. New drugs include Shingrix for shingles, Trelegy Ellipta for COPD, Juluca for HIV, and a pipeline drug for the blood cancer multiple myeloma. Glaxo hopes to retain market leadership in COPD through Trelegy, which puts three COPD drugs in one inhaler.

In 2017, Glaxo promoted Emma Walmsley to CEO from her prior role as head of the consumer healthcare division. She is narrowing the company's focus by reducing the number of product launches and targeting four core treatment areas, while also reducing administrative and other costs by 1 billion pounds per year by 2020. Even accounting for potential generic competition to Advair, she has guided to low- to mid-single-digit revenue growth, and mid- to high-single-digit growth in adjusted EPS through 2020, a goal we believe is achievable. Management has also guided to a target of 1.25-1.5x free cash flow dividend coverage before returning to dividend growth. We commend their fiscal discipline, and believe the current dividend is safe. Instead of potentially overpaying for Pfizer's consumer healthcare business, Glaxo bought in Novartis' stake in their shared consumer healthcare joint venture, allowing it to capture the full value of the business, and removing uncertainty regarding its capital plans. Given the diversified portfolio, potential growth from new drugs, and attractive valuation and dividend yield, we believe Glaxo is a compelling long-term investment.

McKesson

McKesson (MCK) distributes one-third of all medicines in North America, and is one of three companies that control 90% of the market for US pharmaceutical distribution. Its addressable market is expanding; the number of people in the United States turning 65 is growing more than four times faster than the overall population. However, McKesson's shares have declined 37% since mid-2015, having fallen victim to the same issues that we covered in our Walgreens discussion: opioids, Amazon, and drug prices. One additional issue unique to McKesson is its recent loss of contracts with several customers, including Rite Aid and Omnicare, that were acquired by companies that distribute through competitors. Customer losses to consolidation is simply bad luck, and should not persist. After compounding per share earnings at 19% annually from 2010 to 2015, growth has slowed to 4% annually over the last three years. That McKesson has continued to grow earnings at all through a barrage of recent challenges underscores its resilience.

These challenges pushed the valuation down to 10x next twelve months earnings estimates, which we consider attractive for an entrenched, recession-resistant, cash-generative business with secular tailwinds. The shares would have to appreciate by 50% to trade at its 20-year average relative multiple compared to the S&P 500. High inventory turnover and minimal capital requirements combine to produce ample free cash flow that yields 13% on the current market cap and 11% on enterprise value. Over the last three years, cash flow has been allocated to repurchase 15% of outstanding shares at an average share price of $150. An outlier to the typical experience of company buybacks discussed above, McKesson has been sensitive to price, having allocated $5.5 billion to share repurchases at $150 per share, but only $340 million during boom times when the average share price was over $200. Management continuity has likely been a positive factor; Chairman, President, and CEO John Hammergren has been in his role since 2002.

Discovery Communications

Discovery Communications (DISCA) is the owner of Discovery Channel, the #1 non-sports network for men, and TLC, the fastest growing primetime female cable network. Discovery was spun off from Liberty Media Corporation in 2005. John Malone, Chairman of Liberty Media and a director of Discovery, owns over 20 million Discovery shares, including 94% of the super-voting class, worth nearly $550 million. Rather than acquiring linear distribution rights, Discovery's strategy has been to own nearly all its content, affording it the necessary control to transition as the industry evolves more towards direct-to-consumer platforms. Discovery's US subscribers are declining by 3% annually, but the company is expanding into other distribution platforms, such as through Amazon in the UK, Germany and Austria, and through skinny bundles in the US, including those by Sony, DirectTV, and Sky. Despite structural changes occurring in the industry, the company's revenues and operating earnings have both grown low- to mid-single digits for the last three years. Half of revenues are generated in international markets where cord cutting is not a major concern because cable is less penetrated and much cheaper.

Earlier this year, Discovery acquired Scripps Networks Interactive, owner of networks including HGTV, Food Network, Travel Channel, and Cooking Channel, that consistently rank at or near the top for viewership by women. Combined, Discovery now owns five of the top 20 most viewed basic cable networks. Aside from Time Warner and Disney, no other company owns more than two of the top 20. Discovery has forged a loyal following without the burden of expensive content. According to CEO David Zaslav, the company's content costs are about $400,000 per hour, compared with $5 million for a scripted show. Management expects $600 million, or nearly $1 per share pre-tax, of cost synergies from the Scripps deal within two years. Additionally, a key revenue opportunity for the merged companies is to push Scripps' content, currently available in just one market outside the US, to more international markets by leveraging Discovery's distribution across 220 countries.

The Scripps acquisition lifted net debt / EBITDA to about 5x, at the high end of our comfort zone. Zaslav believes the transaction will lead to a more than doubling of free cash flow over the next few years that would decrease Discovery's leverage ratio to 3-3.5x, in-line with its historical range. Throughout his career, Malone has funded growth with debt, optimizing the capital structure for highly recurring cash flows of subscription-based media assets. The cash portion of the Scripps

deal was funded with debt at an attractive weighted average rate and maturity of 3.9% and 13 years, respectively.

Our shares were purchased for less than $24, or 7x 2019 consensus earnings estimates, less than half of their ten-year average forward earnings multiple of 16x. Private market transactions also suggest Discovery's shares are overly discounted. When AT&T initiated in October 2016 its recently closed acquisition of Time Warner, the offer translated to a forward earnings multiple of about 17x. Disney is bidding for most of the assets of Twenty-First Century Fox, which currently trades for 21x 2019 earnings. We believe our investment is protected by Discovery's scarcity value as one of the last remaining independent owners of content in a consolidating industry.

As always, please reach out to us with any questions or comments.

Sweetbay Capital Management

Important Disclosures:

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