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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Three Companies That Are Better, Safer and Cheaper

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SECTOR — GENERAL INVESTING

TWST: If you wouldn't mind, let's start with an overview of Artisan's business and, in particular, what you feel differentiates the company.

Mr. Inman: Artisan as a firm was a brilliant idea, because there's a problem in the money management business: There are a group of people with talent and skill to invest, and it's a different skill set to manage a business and to manage all the rigor around that — the compliance and the regulatory issues and the hiring and firing — and it requires a little bit of scale, too. And so, the model works.

It allows talent to find an environment where they can thrive as an investor and practice their skill set, which is designed to generate alpha for clients, without the headache of running the business that's taken care of by the parent, with all the legal and trading and operational.

So, you get scale, but then you get the economics of owning your own business. It's the best of both worlds, and so it becomes an attractive place for people who have talent and want to bet on themselves to come and operate, because they're given the freedom to execute without the headaches of running a business, and the economics work out in their favor if they're successful.

We never buy AUM because of that. A lot of firms in this industry go out and buy AUM to get the talent. We get the talent organically because they want to be here and they want to be here forever, and they want to build their business inside Artisan.

\TWST: You are part of the Value team, which manages a few strategies and funds, and we're going to focus today on Mid-Cap Value. Walk us through that strategy's investment process and outline the characteristics of the stocks and the underlying businesses you're looking for.

Mr. Inman: We manage three strategies, the Large Cap or All Cap Value, the Mid Cap Value, and then we have a newer Value Income strategy that's a little over two years old. The philosophy is the same at all three, and it's the same philosophy we've operated with for 25-plus years. It will not change. We think it's time tested, and it's the way to operate in and out of cycles. It's a disciplined process.

We have one sentence in our pitch books that's always at the top, and that is: We seek cash-producing businesses in strong financial condition that trade at undemanding valuations. Those are the three pillars.

I'll go in the order that we usually go when we look at a new investment to give you and readers a sense of what we look at. The first thing we look at is the balance sheet. We always look at, is the business financed in a way that it can survive trouble?

The markets and life and the macro environment are not always stable and steady. It has downturns, and so you need the business to have a balance sheet that is built to withstand downturns.

And so, we're always looking at liquidity and financial condition to make sure that if something goes wrong, you can come out the other side, and that during a downturn, the CEO and CFO are not strategically impaired with the direction they can take the business.

So, they're able to continue to invest in their business, launch new products, maybe they can purchase competitors who are distressed, they can buy back stock, they don't have to cut back on R&D — all the things that are important to creating value through a cycle.

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A potential investment can be a great business and even be cheap, but if the balance sheet can't withstand trouble, we won't get involved.

The next one is business quality. We look for businesses that have sustainable and growing returns on capital and free cash flow generation. We look at businesses from a private owner's perspective. If you and I were in business together, is the business a good business? What kind of capital do we have to put up? What kind of returns on that capital do we get? And what kind of free cash flow is generated that we get to keep as owners?

One of our taglines that we talk about is, there are a lot of businesses that trade on Wall Street that aren't good businesses on Main Street. We look for companies that are good businesses on Main Street. They have strong owner economics. That's needed for us to get involved, and it's an important distinction.

We don't need the best, but they need to be adequate. The business needs to earn its cost of capital over time. It can't earn a 6% return on capital. A business like that won't trade cheap enough for us to get involved. So that's the quality component that we lean into.

The two characteristics we just discussed aren't hard to find — good businesses with good balance sheets. The last pillar is the one that usually creates opportunity for us, and that's the asking price. We're looking for depressed expectations, so depressed earnings and/or low multiples. We're looking at price to earnings, free cash flow, EV to EBIT, not EV to EBITDA. We use EBIT around here. We're looking at a sum of the parts discount sometimes.

And importantly, what's usually happened is there's been a setback in the business or a negative shift in the perception about the future of that business. In these instances the valuation of the business has been pushed down to an absolutely low level by investors.

So there's fear around the economics of the business going forward that they won't be as good, or there's actually a cycle happening and something's going wrong in the industry or for that particular business, and the market is fearful and it's pushed it to a valuation that gives us that margin of safety.

We put all three of these elements together, and we need all three to get involved, we can't get involved with only two out of three of our criteria. Due to our rigorous approach there's a very slim set of opportunities that clear all three hurdles. But every time we get involved, that's where the margin of safety is built at the portfolio level.

Our process is designed so that as investors, you always have the balance sheet on your side, the business on your side, and the asking price on your side. That is where you have the probabilities stacked in your favor going forward. The alpha can stack up, because you've put these characteristics in your favor, meaning as time unfolds, uncertainty is untangled.

The market is always uncertain. You never know what's going to happen in the future. But you've always got a better asking price, a balance sheet, and a business. That's selected down to a portfolio, in Mid Cap, of about 50 names. When you stack that up against the index, the index doesn't do that, the index isn't constructed that way, and that's where we believe our advantage comes from.

TWST: Is there anything else you'd add in terms of portfolio construction, for example, determining the size of each position?

Mr. Inman: Going in, a new position, if it clears all the hurdles but isn't a standout, might be 175 basis points to start. If it's a little bit better opportunity, we could push it up to 250 basis points to start. So, most names at the beginning live in that range.

The ones that get towards the 3%, 3.5%, even 4% range, those are ones that reflect that there's been success in that investment, and those are usually names that we're pulling capital out of when we're sourcing new ideas.

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TWST: Let's talk about a few of your favorite investments in the portfolio. They could be in the top 10 holdings or a recent addition, it's your choice.

Mr. Inman: Going back to what we talked about, one of the things that's usually happening when we get involved is the business is under pressure. That's our opportunistic style. There's been some kind of setback, something has disrupted expectations from investors, they've become fearful about future conditions, and that's created a discount. And we've done the homework to figure out where that disconnect is, and determine if it is an alpha opportunity.

So, one is **Baxter** (NYSE:BAX). We've followed **Baxter** for the better part of 10 years. It was always expensive, traded over 25 times earnings for over a decade. Results were always strong, it had good organic growth, strong margins, a great management team. They created value by spinning off a business called **Baxalta**, and then the RemainCo tripled operating margins, so the market just loved it.

It's focused on consumables, so it's the picks and shovels in the operating room and in the medical environment. They sell IV solutions, infusion pumps, nutrition supplements that go through your IV, anesthetics, generic injectables, surgical equipment, hospital beds.

In 2021 the management team — that was well thought of — bought Hillrom, a bed manufacturer, primarily for hospitals. They paid about $12 billion for it. They overpaid, and they put too much leverage on the balance sheet.

At the same time, that was when COVID was raging, and so a lot of the consumables were being used, but there was a lot of inflation in that environment.

Well, **Baxter's** products are sold to the hospitals and the medical community through group purchasing organizations, GPOs, and those are contracted rates that only allow for a little bit of inflation each year, maybe 2% to 3%. Because **Baxter** is a big manufacturer, they have a big advantage in terms of their scale and manufacturing. So, all of a sudden there was a surge in cost, but they can't raise prices to fully offset cost inflation, and so margins are compressed.

And then they bought Hillrom for too much money, which put leverage on the balance sheet, and margins fell, leverage went up, sales began to slow because they lapped that COVID environment, and all of a sudden everyone doesn't like management and is worried about what's going to happen to the earnings power of the business in the next two years. The shares went from $80 when investors loved **Baxter** down to the low $30s today.

From our perspective, when we look at **Baxter**, we look through that better, safer, cheaper lens. On the better side, they're a consumable business, so it's a lower risk operation than drugs or some of the other regulated areas of the medical business. It's a low-ticket item that's essential, and they have massive scale in that space, so they have a better business model that usually has about 40% gross margins and mid-teen operating margins.

It's also a very stable business in general, just because that is not a cyclical industry in terms of the consumables.

From a debt perspective, it's a little higher than we like right now, it's about 3.5 turns of leverage, debt to EBITDA, but it's going to be below 2.5 because they're spinning off or selling their diabetes business. But even with the elevated leverage, they're covering interest seven times, they're investment-grade rated, so it's in good shape.

And then on cheaper, at $33 it's trading about 11 times current earnings, but we think when earnings recover and get some of that margin back in the next 18 to 24 months, earnings power will be over 4. So you're talking about a stock that's trading at 8.5 times our view of normal earnings for a business that used to trade for 25 times earnings.

Fundamentally the downturn looks temporary to us. Importantly, all those earnings are turned into free cash flow, because it's not a very capital-intensive business. They'll pay down debt. They'll buy back stock. It has a nice dividend yield of over 3%.

So, that's an example of where we're finding opportunity.

TWST: Is there another you could highlight?

Mr. Inman: Another one is **LKQ** (NASDAQ:LKQ). You'll see a theme here; this is another one we looked at for a long time. **LKQ** stands for Like-Kind-Quality. They're focused on replacement parts in the auto collision business.

When you have an accident, or where I'm from, a wreck, and you need to replace the hood or the bumpers and things like that, they contract with the insurance companies and have the broadest distribution network with the most SKUs.

When a car goes to the body shop and they need to order the parts to prepare the car, **LKQ** is the first call. This business is called North America Wholesale and that's about 55% of their profit. **LKQ** has 70%-plus market share in collision, so they're the dominant player in what's a slow growing business, but it has a big moat around it.

The other piece of their business is they have what's essentially NAPA Auto Parts in Europe; it's a mechanical parts business. That's about 36% of the profit. And then they have a small specialty business, which is specialty parts for RVs and trucks and things like that.

This business was, for a long time, very loved by investors. It was growing well. It traded over 20 to 25 times earnings. But the company was focused on M&A, they really weren't focused on per-share value and returns on capital, and then their M&A went sideways. This was in the 2014 to 2016 period.

During that period, an activist came in, and they changed the incentives for the company. They changed them to focus on organic growth, to focus on free cash flow conversion and per-share value. We applauded the changes, but the business still wasn't interesting to us as valuation remained elevated.

But fast forward, and the business slumped during COVID. Miles driven collapsed. Then miles driven picked up, and the same thing we saw with **Baxter** — inflation starts running through the supply chain, and supply chain gets disrupted as well. That's not good for their business in terms of how their margins are going to shake out, and so there's margin pressure up and down.

Now we're on the backside of this, and the margins are being compressed and sales are slowing down. The business has gone from $60 to $40, and today trades about 10 times earnings, so the multiples have been cut in half. The business is performing fine, it's just investors are concerned about the next 12 to 24 months, because there's some pressure building in their costs and their revenue is coming down. So, this is one we've been buying.

"From our perspective, when we look at Baxter, we look through that better, safer, cheaper lens. On the better side, they're a consumable business, so it's a lower risk operation than drugs or some of the other regulated areas of the medical business."

Through the better, safer, cheaper lens, it's pretty simple. They're the dominant player in North America in this collision parts business, with over 70% market share. They generate mid-teens returns on tangible capital. They also are the dominant player in mechanical parts in Europe — the NAPA business in Europe — with over 20% market share there.

From the safer side, leverage is only two turns of debt to EBITDA. Interest is covered over seven times. Another business similar to **Baxter** that's not very cyclical, that's being treated as a cyclical because of the way that the supply chain has moved and the way their earnings have gone up and down. Capex is 2% of sales, so a lot of free cash flow.

The debt is investment grade. And cheaper: It's trading for 10 times earnings, and earnings are a little bit depressed. Free cash flow coupons are probably about 9% right now.

This isn't a business that's going to grow fast, it's not going to grow 8% or 9%, but it can grow 2% to 4%, which at this valuation — you should pay more for a business with this kind of market share and dominance that can grow a little bit. So, that's one we've bought this year.

TWST: Do you want to walk us through one final example?

Mr. Inman: Sure. **Cable One** (NYSE:CABO) is a broadband provider. They provide broadband in rural markets, so they're less well known than **Charter** and **Comcast** that service the big urban and suburban markets. **Cable One's** average market is about 25,000 people.

What's important is they're advantaged in serving those rural markets, because in only about 40% of their footprint is there a competitor that can offer 100 megabits of speed. In 60% of their markets, they don't have a competitor offering 100 megabits. So they have the incumbent speed advantage, and this is a really important advantage, because customers care about speed, price and reliability.

The business is under pressure. **Cable One** was a fast-growing operation; they were growing subscribers 4% or 5%, then during COVID that picked up, and they grew subscribers almost 10% for a couple of years. But fast forward, and you're on the backside of that growth. They've pulled forward a lot of demand from customers. People who wanted to get speed have done that.

Now there's the rollout of fixed wireless, which is taking some subscribers. You have overbuilding of fiber in some of their markets, so some of their competitors have had to push fiber to stay competitive, and that's slowing down their ability to grow customers. And household movement across the U.S. is at the lowest level in the last 20 to 30 years, which also hurts their ability to grow.

So, their growth in subscribers was robust, and then it fell down to about 1%, and the market has taken the shares from $2,000 down to $365. As you can see, there's a lot of pressure there. But what remains is they have the incumbent advantage, they have a less competitive footprint, and they are the low-cost provider.

Thinking about it from that better, safer, cheaper perspective, they are only about 35% penetrated in their footprint, so they still have a lot of room to grow. A traditional cable company will be about 55% penetrated. So, not only do they have a less competitive footprint, they still haven't reached as far into their markets as they can, and so there's more room to grow there.

Importantly, they have the low-cost position in terms of delivering broadband. Fixed wireless is a cheap service, but as data grows you need more spectrum, and that's a very expensive purchase and buildout, and so the economics of that aren't as good as the economics of cable, which can add a lot of capacity with very little capital expenditure.

And fiber over-builders, to compete with cable they must spend to extend the lines, and they must advertise the service to those homes, so that's a very expensive proposition.

Cable is already built and already has the speed, so it doesn't have the same cost intensity to meet these competitive needs.

From a balance sheet perspective, **Cable One** is highly cash generative. It does have more leverage than we typically like to see, but it's still well financed. Net debt-to-EBITDA is about four times, and they have a billion dollars in investments on the balance sheet, which we don't even give them credit for, which would decrease leverage if you counted them. Interest is covered over four times, and the business is not cyclical. It generates a lot of free cash flow, allowing the company to de-lever quickly.

And then cheaper. It's an incredibly cheap business at this asking price. It's trading at about 6.5 times our view of earnings in 2024. There's some accounting nuances there, so Wall Street doesn't quite capture the true economics of the business in the way they look at the valuation.

Free cash flow coupon to equity is about 15%. Again, extremely attractive for a well-positioned business that can grow. It isn't very cyclical.

And from a replacement value perspective, the whole enterprise is trading for about $1,900 per passing; that's an

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industry benchmark for looking at the valuation per home passed. They pass about 2.8 million homes and have about a $5.3 billion enterprise value. That's below what it costs to try to build a fiber network today.

So, we own an asset that has cash flow, that is already built, that's trading at a discount to what it costs to try to build a network and gain customers. It's cheap across a variety of metrics.

It's in a tough period right now with a lot of competition, but we think in the next couple of years that competition normalizes, the business continues to generate cash and grow, and the market will have to revalue it to a more appropriate level.

TWST: Recognizing that you're ultimately stock pickers, I'm curious if there are certain industries or sectors where you are seeing more attractive opportunities right now?

Mr. Inman: We would say mid cap's valuation gap, and value versus growth, is re-extended to an absolutely attractive level. We're finding a lot of pretty good businesses in the mid-cap space trading for 10 times earnings. So, we're finding those opportunities.

Where they are living right now, like with **LKQ**, **Baxter**, and **Cable One**, is they're on the backside of some kind of trouble. There's a lot of impatience in this arena. People want to own things coincident with success. They don't want to be around the bad news. They don't want to wait for conditions to get better.

There have been some out-of-favor industrials. There are some areas in health care that have been under pressure. Even staples have started to see some pressure recently. There are a few spinoffs where the conditions are not ideal and growth is slowing, and the market is pushing those down.

There is an unusual what I would call depth to the opportunity set. It's not really in specific sectors — it's around businesses that have had some kind of setback, some kind of revision of guidance, some kind of slowdown in the top line. Market participants seem particularly impatient with those situations.

That's where we've been spending the most time, in areas where the businesses have not performed to expectations that were set, and people are selling them and moving on to areas that are having a little bit better performance right now. It's kind of a momentum-driven market in that sense.

TWST: Given all the attention and focus put on mega caps, the Mag Seven, etc., is this in fact a good time to really be looking at value, the mid-cap space, and perhaps both?

Mr. Inman: We think so. We put out a white paper talking about just that, because we wanted to highlight the valuation gaps between mid cap and large cap, and particularly between mid cap value and mid cap growth. The valuation spreads are an anomaly right now, and there are plenty of quality businesses on sale in that 10 times, 11 times earnings range.

We also do large cap, and it's harder to find those opportunities right now. The mid-cap companies aren't as strong as some of the large-cap companies, but they're discounted, from our perspective, in terms of the return potential going forward, and we don't know why that exists.

If we had to guess, money tends to go to areas that have been the most successful. That's what creates opportunities for value investors. So I think, perversely, as a value investor, even though maybe your performance for the period could look a little tough versus the S&P, you need those herding behaviors to happen, you need people to think like that, because it creates the opportunity going forward.

We're trying to make sure we seize on that, and our process is designed to do that, to find valuation anomalies and then invest patiently for them to recover in the future.

TWST: Do you want to wrap up with any other topics or final thoughts?

Mr. Inman: There was a long period where the cost of capital was suppressed, in the U.S. in particular, and interest rates were low. There was no penalty for aggressive investment strategies, and the more aggressive you were, the better the returns tended to be, because the hurdle was low, the environment was stable, interest rates were low, and there was capital taking risk and coming in and pushing that risk spectrum up. We were in a risk-seeking environment.

We think that's changed. With interest rates higher, there's a real cost of capital and a real hurdle in the market, and that plays well to value investors, and particularly ones like us who are disciplined and operate with discipline in and out of cycles.

That discipline hurt us during that more free money cycle. We think it's going to help during this more restrained cycle. Even though you're still seeing pockets of animal spirits with AI and some of the momentum investing going on that is reminiscent of what happened in 2021 — and we saw how that ended in 2022 — we don't think this time is different.

At some point, you can't just pay anything for a business or an idea and get a return. The economics of what you're buying have to be justified by the asking price you're paying.

We think that's the environment we're in, even though some speculative juices are higher than normal right now. We think that's why it's a good time for value investors. If you want to protect your wealth and earn a real rate of return, I think you need to be sensitive to valuations, and particularly now. That tends to be a good environment for value investing.

TWST: Thank you. (MN)

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