

THE ADVISOR

Q3 2018

DARDEN CAPITAL MANAGEMENT



DARDEN SCHOOL
of BUSINESS

A LETTER FROM THE CEO:

November 15, 2018

Greetings,

It is with great pleasure that we at Darden Capital Management bring you the Q3 2018 edition of *The Advisor*. Within the enclosed pages, you will find investor letters from each of our five portfolios detailing the investment approach and portfolio holdings of our portfolio management teams, as well as select investment ideas. Featured in the investment section is the winning pitch from our Fall 2018 First Year Team Competition—a long position in ADT recommended by Vin Paruchuri, Charles Perkins, and Church Waesche.

Darden Capital Management continues to be the premier experiential learning initiative at Darden, and we strive to be the best student-led investment organization in the country. Thanks to the generous support of the Darden School Foundation, our assets under management have reached approximately \$19 million as of September 30th—our asset growth has largely been driven by market appreciation, and was accelerated by a new \$3 million allocation received from the DSF during the 2017-18 school year. Asset growth has enabled DCM to provide our members and portfolio teams with more resources in terms of tools and funding, allowing for enhanced research and educational opportunities. Research highlights from the past year include meeting with Markel management in Richmond, and a site visit at the local Costco here in Charlottesville. This year, we are encouraging all of our portfolio teams to creatively think of ways to conduct primary research in order to develop a variant investment thesis.



Ryan Claxton, DCM CEO

As we work to continue to raise the profile of Darden in the investment management industry, we have increased our focus this year on training and recruiting opportunities. Approximately 30 First Year students participated in our month-long training program in September, designed to teach students how to formulate and deliver a stock pitch. Our executive team believes this program will not only enhance the quality of pitches we receive across the five DCM portfolios, but that building this foundation early in the year will better prepare students for interviews and investment competitions throughout the school year. With 80 new members for the 2018-2019 year and 175 dues-paying members overall, interest in DCM across Darden remains strong.

In January, we welcomed Paul Reeder to the Career Development Center. Paul's focus area is non-banking finance careers, and he has been instrumental in strengthening our alumni outreach and driving more recruiting opportunities in the investment industry for Darden students. Through coordination with Paul, DCM was able to move up our annual Boston Job Trek to October 15-16 this year. A group of First Year students traveled with Paul and Aaron Fernstrom, of the Mayo Center, to Boston to meet with a list of top firms including MFS Investment Management, Polen Capital Management, and Wellington Management Company, among others. We are grateful to all of our alums who hosted students and attended the Monday evening cocktail hour. Future job treks this year are in the planning stages for New York and Washington, D.C.—if you are interested in hosting students in either of these locations please reach out, we would love to hear from you.

Closer to home, we were able to work with the Camp Library and Mayo Center staff to arrange for some small cosmetic and functional improvements to the Capital Markets Room earlier this month. The featured element of our facelift is a new 60-inch display at the head of our conference table, compatible with wireless projection capability. This will allow for easier screen sharing during meetings and pitches, and during non-meeting times will serve as an access point for portfolio monitoring and a source of market-related news.

Finally, we are pleased to report another successful iteration of DCM's premier event—the Darden @ Virginia Investing Challenge. This year marked the 7th installment of DVIC, featuring 12 teams representing the nation's top MBA programs, as well as UVA's McIntire School of Commerce. Our theme for this year's competition was “defensive stocks to hold in a market downturn,” coinciding with the University of Virginia Investing Conference's focus on the 10th anniversary of the global financial crisis. This year's winning pitch was **Zoetis (ZTS)**, presented by the team from the McIntire School—the second consecutive DVIC win for McIntire. We are particularly grateful to have been able to construct a final round panel of judges with strong DCM ties this year. Joining Dick Mayo and Dean Emeritus Bob Bruner on this year's panel were Ichiro Suzuki ('84), Kemp Dolliver ('87), Daniel Mooney ('08), and Taylor Meyer ('13).

I would like to take this opportunity to publicly credit the hard work and dedication of the DCM Leadership Team so far this year. None of this progress would be possible without their selfless devotion and persistent passion for the roles they have taken on this year. This group of eight—CIO Marnie Lanphier, CFO Scott Lusk, Director of Research Macrae Gould, and Senior Portfolio Managers Peter Taylor, Miller Jump, Michael Kellett, Sofia Scott, and Kyle Rose—is the most outstanding collection of people at Darden, and I consider myself very lucky to have the privilege of working with and learning from them each day.

We hope the enclosed pages evoke fond memories of your Darden experience, and maybe even provide a new idea or two. If you would like more information on anything provided here, or simply want to reconnect with your DCM fund, please do not hesitate to reach out. We would be happy to host you back at Darden anytime, and hope to see you in the Capital Markets Room again soon. Thank you for your continued support of Darden Capital Management.

All the best,



Ryan H. Claxton, CFA
CEO, Darden Capital Management
ClaxtonR19@darden.virginia.edu

2018–2019 DARDEN CAPITAL MANAGEMENT**EXECUTIVE TEAM**

Ryan Claxton	Chief Executive Officer
Marnie Lanphier	Chief Investment Officer
Scott Lusk	Chief Financial Officer
Macrae Gould	Director of Research

JEFFERSON FUND

Michael Kellett	Senior Portfolio Manager
Juan Jaramillo	Portfolio Manager
Annie Madeira	Portfolio Manager
Grant Moraven	Portfolio Manager

CAVALIER FUND

Peter Taylor	Senior Portfolio Manager
Maria Melchor	Portfolio Manager
Itay Ron	Portfolio Manager
Freyan Soonawalla	Portfolio Manager

MONTICELLO FUND

Sofia Scott	Senior Portfolio Manager
Sid Rajagopalan	Portfolio Manager
Wenda Sun	Portfolio Manager
Tris Worth	Portfolio Manager

DARDEN FUND

Miller Jump	Senior Portfolio Manager
Rutvik Karve	Portfolio Manager
Jorge Quinteros	Portfolio Manager
Lex Utt	Portfolio Manager

ROTUNDA FUND

Kyle Rose	Senior Portfolio Manager
Emily Caldwell	Portfolio Manager
Jay Kanakiya	Portfolio Manager
Anne McKenna	Portfolio Manager



2018 DCM Transition Dinner: Passing the torch from the Class of 2018 to the Class of 2019

PORTFOLIO UPDATES

CAVALIER FUND

To Our Friends and Partners:

After taking over the fund in the second quarter this year, the Cavalier Team set out to establish procedures that would provide more oversight and ownership for the portfolio. At the individual portfolio manager level, we established coverage groups whereby each team member became responsible for five or six portfolio positions. We now prescribe active monitoring of our positions on a weekly basis by following news flow, meeting with company representatives if they come to Darden, and producing earnings assessments each quarter. This practice allows us to more closely compare our original theses to outcomes, while we rely less on price activity following major announcements and more on our own assessment of company performance.

We have enjoyed strong performance to date this year, aided by some familiar bets and new ones alike. Entering the summer, I asked the team to consider our stewardship this year, and how we might like to define our investing style. We continue to focus on fundamental, bottom-up analysis when choosing our portfolio positions. This year, we are striving to do so with a defensive mindset. We have taken profits by cutting some winners, either as the market has exuberantly fallen in love with growth prospects, our original thesis has come into fruition, or the original thesis no longer seemed like a likely outcome. In total this year, the Cavalier Fund (including the first quarter) has harvested \$328,573 in net gains for a 54% holding period return, excluding dividends. Some exits of note under our tenure are GrubHub (GRUB), CBRE Group (CBRE), Madison Square Garden (MSG), 21st Century Fox (FOXA), and Alliance Data Systems (ADS). We also witnessed the all-cash closing of the General Mills acquisition of Blue Buffalo Pet Products (BUFF) in April and have since redeployed the cash into new ideas. On the whole, our exits have proven timely in nature as volatility and valuation have returned to the forefront of investors' minds as we enter the fall.

	Cavalier	S&P 500
Year to Date	19.8%	10.6%
3/31/18 - 9/30/18	14.3%	11.4%

One of the new positions in the portfolio is a household name, Disney (DIS). Outgoing portfolio manager, Sam Kramer, pitched it to us in the spring and we found the thesis compelling. Disney is a media and theme park behemoth that has hovered around \$100 per share since 2015 while earnings have continued to grow. The core strength to the “Magical Kingdom” that is Disney is the IP; all of the company’s revenue segments are various methods to distribute the IP (in person, through cable, through the big screen, through retail, etc.). Sam identified Disney’s recently announced streaming strategy as a means to mitigate subscriber losses at ESPN and offer a competing service to the likes of Netflix. When adding in the potential streaming growth, Disney seemed undervalued, especially as it traded at a below market multiple. While the thesis was compelling, we were unsure how to approach the acquisition of 21st Century Fox assets.

To hedge ourselves, we bought half the position in Disney outright, and the other half in 21st Century Fox (FOXA). Because there was a competitive bidding afoot between Disney and Comcast (CMCSA), we did not want to be stuck buying a company that was “overbidding”. By buying the target, which would eventually convert to Disney shares, we enjoyed a nice return on the FOXA trade over the summer, and proceeded to funnel that return into a full Disney position. Maria, on our team, conducted a review of the original pitch this fall and confirmed our thesis was intact, allowing us to increase the Disney position to about 4% of the portfolio. Recently, we were pleased to see Fox sell its stake in Sky for \$15.1 billion to Comcast which further reduces the price Disney will pay for Fox, with much less debt incurred.

Another new position we bought in the spring is lesser known. The company is Centennial Resource Development (CDEV), a high growth Permian Basin oil and gas producer that was born out of a Riverstone SPAC (blank check company). The company is led by Mark Papa, the founder and former chairman of EOG resources. Centennial operates 81,000 net acres in the Delaware Basin of West Texas and is the leading producer by growth in the region. The company maintains an extremely conservative balance sheet with very little debt. We conducted a reserves and production based study to determine that short-term hydrocarbon distribution bottlenecks had reduced the company’s valuation to current proven reserves, without the future upside of ongoing production growth. With a best in class management team focused on producing positive

GAAP return on invested capital and maintaining a conservative balance sheet, we are confident that Centennial can grow into a leading Permian producer with extremely attractive well economics.

On the short side of the book, we have four core positions that comprise approximately 8% of the portfolio. We are actively looking to add new names to the short book as position sizing is a key feature of this portfolio group. Much of our shorting psychology is fundamental in nature, similar to our long views. We are comfortable shorting businesses in secular decline, especially when they are over-leveraged and have maturity payments on the horizon. We will not short on valuation alone—that is a good way to lose your shirt in a bull market. If we view a company as overvalued, we will additionally seek a catalyst or two that will bring the market’s attention specifically to the valuation. Because we are defensively minded and conservative in practice, we hold a healthy cash position alongside our short book. Because of this, we never feel over-extended in any direction and have the ability to stomach volatility if a position moves against us in the short term.

An example of such is our core short position in Tesla (TSLA). We have maintained this short since former Senior Portfolio Manager, Dan Nickerson, pitched it in October of 2017, and even added to it since. Our patience is beginning to pay off.

We acknowledge the short is crowded; we acknowledge the short is controversial, which is why we have gone to great lengths to prove its validity. We had a fund-wide conference call with a portfolio manager and Darden alum based in California who offered some interesting takes on the short thesis. We agreed with many of his observations, but the headlines and fanfare of late have not been central to our original thesis. We are concerned that Tesla cannot seem to efficiently manufacture cars to earn a profit. The automobile industry is notoriously capital intensive, with low to negative returns on capital employed. Leading industry operating margins are high single digits, reflecting the fierce competition from global automakers, who have worked tirelessly for decades to improve their manufacturing function. Tesla’s valuation reflects none of these concerns. The company will likely need to raise capital later this year or next and has convertible debt maturities this fall and next spring. Needless to say, breathing room is hard to come by on this balance sheet.

We have revisited the original pitch and our valuation on multiple occasions. We have largely ignored the headlines on Musk and especially his tweets—again, we are patient capital. Despite the seemingly endless hocus pocus we have witnessed over the summer and through the fall, we are short the business because of its core operation and the requirements on its debt financing. We are firmly in the black on our position now; time will tell how much our patience might pay off.

“They may scorn cash now; but let some months go by, and perspective promise of it to them, and then this same quiescent cash all at once mutinying in them, this same cash would soon cashier Ahab.”

-Herman Melville, *Moby Dick*

We continue our attempt of uncovering undervalued businesses that might be misunderstood by the market. We have a relentless focus on our variant perception of a business, and why we might think about it differently than the street. We are contrarian in nature and defensively minded looking forward. We don’t mind holding a little extra cash; it can be one of the best hedges out there through the rough times.

We always welcome any feedback from our participants and sponsors. Thank you to the eager first years who have set aside time from recruiting to join our weekly sessions. Thank you to the faculty and alumni who take an interest in our operation.

Sincerely,

Peter Taylor
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DARDEN FUND

To Our Investors:

Since taking over the portfolio in April, we have made a series of changes that we believe will benefit the Darden Fund in the long term. The two things that we recognized upon taking ownership of the portfolio were that we were heavily biased towards consumer discretionary names, and that our market cap mandates were misaligned with our benchmark. As of quarter end, the consumer weighting clearly helped contribute to our outperformance of the Russell 2000 as we continue to ride out what many believe to be the late innings of an extended bull market. As the next quarter begins we will look to transition out of some of the longer dated holdings that have grown out of the small-cap designation like Markel, Interactive Brokers, and Live Nation which actually weighed down our performance throughout the year as small-cap stocks in the Russell 2000 outpaced large cap alternatives.

Key Transactions since April 2018

Regarding the changes to the portfolio, we tried to balance thematically when we sold out of a name. Examples of this were the purchase of National Vision (EYE) after selling out of Natus (BABY) for healthcare exposure and purchase of a boutique investment bank “parlay” (MC, EVR, HLI, and PJT in quarter-position sizes) when we sold out of Och-Ziff (OZM) to maintain exposure to financials. Additional pitches were used to replace sales of companies where we believed our investment thesis had been broken like Adtalem Education (ATGE) after they sold the DeVry business, or Trupanion (TRUP) after the legality of their sales model was challenged in court.

Recently, we proposed a change to the mandates that would increase the upper market cap limit from \$3 billion to \$5 billion. This is in order to make us more comparable to our benchmark, the Russell 2000, which re-capitalizes with a \$5 billion upper limit once a year. If the proposed changes are accepted, the first position that we will add will be Apergy (APY), an oil & gas equipment company. This year we have the benefit of some unique work backgrounds on the team like Lex Utt who spent the summer working in oil & gas investment banking, which we hope to leverage as we look to diversify the portfolio away from the aforementioned consumer tilt.

Overall, we are extremely proud of the performance that the fund has posted to this point, but we are cognizant of the challenges in sustaining this over time. We have divided coverage of the securities into sleeves for each PM, so risk management at the security level is a manageable, around-the-clock, job. As always, we continue to devote time to both risk assessment and idea generation at our weekly meetings as we strive to produce superior risk-adjusted returns. We believe that we have begun to make changes that will lead to a robust future for the portfolio and look forward to what the rest of the year will hold.

Sincerely,

Miller Jump
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Purchases	Date	Return Since
EYE	4/25/2018	39%
Investment Banks (Basket)	4/26/2018	-1%
GTN	9/24/2018	1%
RDFN	10/1/2018	0%

Sales	Date	Return Since
OZM	4/11/2018	-38%
BABY	4/25/2018	5%
GASS	9/11/2018	-4%
ATGE	9/24/2018	0%
TRUP	10/2/2018	0%

JEFFERSON FUND

Dear Investors,

Please allow me to introduce myself. My name is Michael Kellett, and I am the Senior Portfolio Manager (SPM) of Darden Capital Management's Jefferson Fund. I have looked forward to taking on the SPM mantle since I was first accepted to Darden, and I am very excited for this opportunity. Rounding out the Jefferson Fund team and joining me on this journey are Portfolio Managers Juan Jaramillo, Annie Madeira, and Grant Moraven. Juan, Annie, and Grant have been instrumental in managing the portfolio thus far, and I cannot think of a better group to be joining me. Since we officially took control of the portfolio on April 1, 2018, all three have impressed and inspired me with value-added contributions and great questions. They are all just as excited as I am for this unique opportunity, and we take our positions as stewards of your capital very seriously. I believe that we are up to this great task.

I hope to use these letters to communicate with you my thoughts on investing, recent portfolio changes, and recent performance. This first letter covers our first six months at the helm to catch up to the state of the portfolio today. I will write two more letters after this one, using the traditional quarterly timeframe; these letters should be shorter than this first introductory letter that sets the table for all future Jefferson Fund letters (from me and my successors). For this first letter, I will discuss my general thoughts on "value" investing, portfolio construction, and interpreting performance, before going into more depth on my team's actions during our first six months at the helm. I hope that you find the following pages (and all future letters) useful and informative. Feel free to share your thoughts with me and ask any questions that come to mind.

SECTION 1: MY THOUGHTS ON PORTFOLIO MANAGEMENT

Thoughts on "Value" Investing

The Jefferson Fund is officially DCM's "value" fund. But what does this really mean? A lot has been written about value investing since Benjamin Graham penned *Security Analysis* in 1934, and just as many dollars have likely been invested through self-declared "value" strategies by a diverse set of investors. Value investing began as the search for stocks that traded at significantly lower prices than their assets could be demonstrated to be worth in a liquidation, mostly through utilizing logical quantitative methods. But Graham knew that the approach would need to evolve from this simplistic beginning, as these opportunities would dwindle as more investors entered the market. It certainly has evolved over the years, with great investors like Warren Buffett, Seth Klarman, and Howard Marks all putting their own spin on the central concept of buying stocks that trade at significant discounts to intrinsic values.

The great pastime of value investing continues to evolve today. As technology advances and basic information on quantitative measures becomes instantly available and commoditized, fast-moving quantitative investors have picked the low-hanging fruit in terms of classic indicators of value (e.g. low price-to-book ratios). But despite doomsday fears from many quoted in the press, value investing is far from dead. It is instead shifting from a quantitative search for stocks trading at large discounts to their current value, to a more qualitative and holistic search for companies that – while they may not at first glance appear to be great bargains today – are incredible bargains compared to what they will be worth in 5-10 years. It is becoming more and more difficult to generate outperformance through the static legacy view of value, as stocks that offer substantial discounts to present-day intrinsic values are now typically either extremely risky or in clear decline (and will see their intrinsic values fall substantially over the coming years).

Human investors can best add value over their algorithmic counterparts when they can look past the short-term noise and simple valuation ratios to reason out what a company will truly look like in 5-10 years. In this context, "value" is something much more holistic than trying to buy a stock for, say, half of what it is worth. Modern value investors play the long game, looking to buy a stake in a company at a slight discount to what it is worth today, but with unique insights that give them conviction that the company will grow to a much larger value over time.

We run the Jefferson Fund as modern value investors, searching for high-quality companies that will add value by compounding returns over the long-term and buying them when they offer us modest discounts. My predecessor, Ryan

Hennessee, instituted a framework that my team and I continue to use to ensure that we stay true to these ideals. In short, this framework states that the Jefferson Fund seeks to invest in businesses: (1) with sustainable competitive advantages (i.e. “moats”), (2) managed by people with equal parts talent and integrity, that (3) trade at fair or cheap prices. The presence of a moat is essential; we only consider valuation once we identify a company that fits our qualitative framework. Our valuation work looks beyond present-day discounted cash flow (DCF) analysis and traditional multiples, taking a more holistic view to truly consider “value” over a multiyear timeframe. We do not see much use in viewing companies as static “stocks” and evaluating them solely based on the present. We recognize that companies change a lot over time; something that looks expensive now may actually be a bargain when viewed with a multiyear lens. “Buy low, sell high” refers to stock price, not shorthand multiples like price-to-earnings.

Thoughts on Portfolio Construction

I firmly believe in the “quality over quantity” school of investing, and we will manage only a concentrated, best-ideas portfolio. Truly understanding the qualitative aspects of what makes a great business with a competitive moat is the crux of investing, and this takes time, so it is not realistic to ask for ten to twenty new ideas per person each year. But it is realistic to ask for two to four. And this is all we need to keep our concentrated 15-25 stock portfolio fresh. The legacy team has left behind a great portfolio with high-quality names, and we believe it would be value-destructive to sell out of many of these within the next year (even as some have struggled during our six-month tenure). Having a long-term perspective is key to generating great returns over the long-term, and it can be tough to keep that long-term perspective in a portfolio that turns over its management team each year. It is essential that knowledge and conviction are not lost in the transition from one team to the next. I believe that our transition was seamless, and we recognize how important our transition will be six months from now.

Thoughts on Performance

Investing is a long-term game. If we managed the portfolio simply to outperform this year, we would destroy long-term value for you. The key to outperformance is long-term compounding returns, but year-to-year results have a huge luck component. Our true performance (based on how we position the portfolio to benefit over the long-term) during our single year at the helm will not be determined for several years. Though we must report short-term results, I prefer to evaluate our performance internally on processes (and our companies’ operational performance), not outcomes. Every great investor has had years of phenomenal performance and years of terrible performance. It takes time for skill to show through in the form of long-term outperformance. We ask that you not focus too much on our short-term results, good or bad.

Though we are required to report results relative to a market index, we do not manage the portfolio to any benchmark. At any given time, the portfolio will look very different from the index in terms of sector composition and of course the number of holdings. We are looking to achieve great absolute returns over the long-term. Though we think that this strategy will beat the benchmark over significant periods of time, year-to-year results can be quite choppy.

SECTION 2: RECENT PERFORMANCE

The Jefferson Fund returned 7.57% in the six months ended 9/30/2018. For reference, the Russell 1000 Value Index (R1000V) returned 6.93%, and the broad-market Russell 1000 Index (R1000) returned 11.24% (as the market rewarded higher-growth stocks). Our top five performers were **O’Reilly Automotive** (+56% from our April purchase), **salesforce.com** (+37%), **Microsoft** (+26%), **LVMH Moet Hennessy Louis Vuitton** (+16%), and **Verizon** (+14%). We continue to believe that these businesses meet our qualitative hurdles, have strong competitive moats in place, and are trading at fair or cheap prices when compared with how much the businesses will likely be worth five years from now.

Our bottom five performers were **Realogy** (-24%), **BlackRock** (-12%), **Polaris** (-11%), **McKesson** (-6%), and **Booking Holdings** (-5%). We have since sold McKesson from the portfolio (more on this below) and are currently reevaluating the competitive moats and valuations of Realogy and Polaris, so stay tuned for more commentary on these names in the next letter. We remain confident in BlackRock and Booking Holdings, and we believe that the short-term weakness over this six-month period will be transitory. Of note, both stocks performed very well over the year before our tenure on the portfolio began, with BlackRock up 43% and Booking Holdings up 17%. As a reminder, noise plays a huge role in short-term results, and it is our job to see through short-term noise to find long-term value.

SECTION 3: PORTFOLIO CHANGES

Below, I outline portfolio changes from the past six months. In each letter, I will highlight one new investment to outline in detail, while summarizing the rest. This letter's highlighted investment is O'Reilly Automotive, an April purchase that has been our top performer.

Buy: O'Reilly Automotive (ORLY), April 2018 – Investment in Focus

O'Reilly is a leading specialty retailer of automotive aftermarket parts in the U.S., selling to both individual Do-It-Yourself (DIY) and auto shop Do-It-For-Me (DIFM) customers. O'Reilly is the best operator in its industry, with the top distribution system. It has over 5,000 stores (averaging 23,000 SKUs) across 47 states, serviced by 27 Distribution Centers (DCs) (averaging 148,000 SKUs) and 312 hub stores (averaging 45,000 SKUs). O'Reilly pioneered and gradually perfected the DC and hub store concept, and this best-in-class distribution system provides a competitive moat against its current competitors and Amazon (which is nowhere near O'Reilly's turnaround time in auto parts).

O'Reilly is a great business that generates a lot of cash, has real competitive advantages, and adds a lot of value to customers in solving the critical problem of how to get a disabled car back on the road as soon as possible. It is poised to grow and consolidate a large and fragmented industry for many years to come, with positive near-term macro factors (including increasing miles driven by Americans and a secularly aging vehicle fleet). O'Reilly's management team has proven to be great at capital allocation and acquiring small competitors to grow the brand's footprint through the U.S. They have also added a lot of value for shareholders through continual share buybacks. The stock trades at a discount today, and when this discount is coupled with ORLY's reliable intermediate-term growth profile, tremendous cash flow generation, and substantial share buybacks, it creates a compelling investment opportunity.

Our variant perspective is centered around the overly dire market perception of two forces that could lessen or eliminate O'Reilly's substantial competitive moat around its best-in-class distribution system. The market perceives Amazon as a huge short-term threat to O'Reilly and its competitors, but the reality is that Amazon is poorly positioned to capitalize on the dimensions that win in this industry – service and speed. People who need their cars repaired cannot afford to wait two (or more) business days for parts to arrive in the mail; their cars are their livelihoods, and they need to get back on the road immediately. Amazon has nowhere near O'Reilly's inventory and delivery capabilities at present (and will not for many years). At present, Amazon's \$2-10 billion in "auto" sales are focused primarily on auto accessories, like iPhone cords, and their top selling auto part is not even in the top fifty of their overall auto sales. O'Reilly has also successfully dealt with RockAuto as an online discount retailer for many years, with no impact on its business in this fragmented industry.

The much bigger threat to O'Reilly's business is the potential proliferation of electric vehicles. These vehicles have very few parts and need to be serviced at dealerships, so O'Reilly would seem to have no business in a fully electric world. However, this dystopian (for O'Reilly) future is very far away, and there are technological limitations that would inhibit mass adoption of electric vehicles at this time. For some color, electric vehicle sales would have to be 2-3 million every year starting now for that to have any noticeable impact on O'Reilly revenues in fifteen years, due to the lag from dealership warranties and few repairs in the early lives of cars. With electric vehicle sales of under 200,000 in 2017, this risk is negligible in the near-term, and O'Reilly is poised to generate a ton of free cash flow for years to come.

Of course, we will continue to monitor any developments related to the risks around Amazon and electric vehicles. But we are confident that the market is overestimating them at present, and this gave us a great opportunity to invest in a great company that is poised to grow its intrinsic value for several years while it traded at a discount. Though the stock price has increased 56% since April, we continue to see long-term upside and are holding onto the stock.

Buy: United Rentals (URI), September 2018

United Rentals is the leader in North American equipment rentals for construction projects completed by a diverse group of both construction and non-construction organizations. Like O'Reilly, United Rentals is consolidating a fragmented industry with a clear value proposition (renting equipment is typically a smarter solution than buying equipment) and should improve margins as it grows scale. We believe that United Rentals has a substantial competitive moat in being able to acquire competitors and instantly make them more profitable by integrating them with the underlying strength of the United Rentals business and fleet. United Rentals trades at a discount to the broad market due to its highly cyclical position in the construction market, but recently it has traded significantly below its own long-term average multiples, despite the business's clearly superior positioning today, in terms of top-line growth, bottom-line growth, and being a more diversified

and less cyclical business. Although there is uncertainty in short-term outcomes due to swings in the construction market, we believe that United Rentals will add substantial value over the long-term, both through growth in the business's intrinsic value and a narrowing of the valuation discount to its long-term average.

Buy: Facebook (FB), September 2018

Facebook is the leader in social media across the world, with ubiquitous products like Facebook, Instagram, Messenger, and WhatsApp, as well as Oculus virtual reality headsets. Facebook and Google are the unquestioned market share leaders in terms of digital advertising spend, with 90% of incremental growth in the ad market going to these two players. Despite slowing growth in the United States, Facebook continues to see rapid growth in users and ad revenues in other markets. We believe that Facebook is poised to growth substantially as its network effects take hold in new markets and as it further monetizes its stable of products. Facebook also has zero debt and is thus well-positioned to acquire any potential competitors. We believe Facebook has a substantial competitive moat in monetizing ad spend in the social media space—we hope to own this capital-light compounder for many years. Facebook has been a controversial stock over the past year, as fake news and account hacks have been in the headlines, and this has taken a toll on the stock, which is trading down significantly over the past few months due to concerns about incremental spend to combat fake news hurting margins. These are very real concerns, but we do not believe the competitive moat is in danger, and we believe that CEO Mark Zuckerberg will be able to steward the company through this difficult period with the same skill and long-term vision that he has shown in the past (creating Facebook, making it an advertising giant and money-making machine, and acquiring Instagram for just \$1 billion). This may not be our typical “sleep at night”-type value stock, but if we were to wake up in five years and not hear any of the day-to-day noise, we believe that we would see Facebook with a substantially higher share price.

Sell: Eastman Chemical (EMN), April 2018

Eastman Chemical is a specialty chemical company. We decided to sell because we could not wrap our heads around this complicated business, and we struggled to identify a competitive moat. Instead of spending hundreds of hours attempting to figure it out, we realized that we were fighting a losing battle and that our time would best be spent elsewhere.

Sell: Smiths Group ADR (SMGZY), September 2018

Smiths is a diversified industrial application company that produces a diverse range of equipment, from mechanical seals, to in vitro fertilization devices, to explosive-detecting sensors. Like Eastman, we realized that we did not fully understand the business, and we could not find a competitive moat. A new CEO appeared to be leading a turnaround, so we held onto the stock through the summer, but it was an easy sell when we needed to fund new buys.

Sell: McKesson (MCK), September 2018

McKesson is a leader in pharmaceutical distribution, and it has a dominant share in that industry. Despite low margins, the company generates a ton of cash and has added value over the years through returning capital to shareholders. McKesson's scale currently gives it a bit of a competitive moat, but that moat is under attack from a combination of companies that we were very hesitant to bet against. The venture from Amazon, J.P. Morgan, and Berkshire Hathaway that aims to cut U.S. healthcare costs by undercutting the middlemen (like McKesson) seems to be very far away from having a meaningful impact, but the combination of this long-term threat and mediocre recent results pushed us to sell. The stock appears cheap based on its historical valuation multiples, but we do not have a lot of faith that the company will continue to command a premium over the average market multiple. We would rather sell a company with serious long-term business pressures a year too early than a year too late.

CLOSING REMARKS

Once again, my team and I are thrilled to take on management of the Jefferson Fund, and we hope that we prove ourselves worthy of this great task. I look forward to keeping you up-to-date with the Jefferson Fund over the next six months.

Thank you very much,

Michael Kellett
KellettM19@arden.virginia.edu

MONTICELLO FUND

To Our Friends and Partners,

On behalf of Darden Capital Management's Monticello Fund, it is a privilege to manage a portfolio that supports the Darden School, an institution that provides its students with a transformative and premier educational experience. As the 2018 - 2019 investment team, we are extremely grateful to have the trust and support from a client that shares our view of long-term investing. We also want to thank our predecessors: Tyler Kirchoff, Gayatri Kulkarni, Arun Shankar, and Whitney Abraham. They ensured a smooth transition for us as stewards of the Monticello Fund capital as well as provided guidance across the portfolio before their departure.

GUIDELINES OVERVIEW

For our new readers, I want to highlight the parameters we operate under before going any further with my reflections on our first few months managing the portfolio. The Monticello Fund seeks to invest in a blend of companies across the globe with a minimum market capitalization of \$2 billion. These companies utilize a bottom-up, fundamental approach supplemented by awareness and analysis of macroeconomic and local market factors. The Fund will hold approximately 25 positions. The Monticello Fund is benchmarked against the MSCI All-Country World index which measures midrange and large-capitalization companies across 23 developed markets and 23 emerging markets countries, representing nearly 3,000 constituents. The index covers 85% of the investable global equity markets. The Fund is subject to additional parameters: The Fund must not hold more than 65% of its market value in domestic companies. The Fund will be invested in a minimum of six different sectors and a minimum of five different countries at any one time as defined by the MSCI ACWI index. No more than 35% of the current market value of the fund may be invested in any one sector.

Currently, the Fund is meeting all its investment guidelines, apart from a slight overweight to domestic stocks (less than 100bps over this guideline). We currently hold 24 individual security positions including Berkshire Hathaway, Microsoft, Walt Disney, and Apple which have grown to be drivers of portfolio attribution. Within portfolio allocation we are currently focused on deploying the ~18% dry powder that is invested in the iShares MSCI ACWI ETF.

PERFORMANCE OVERVIEW

Since taking over the portfolio, on March 31, 2018, the MSCI ACWI Index delivered 5.1% return and the Monticello Fund delivered 6.1%. This 100bps alpha for 10 weeks (no trades were conducted during our 10-week summer internships) in which we were making active decisions is a win for us as we were technically achieving the Fund target. As long-term investors, it is a slippery slope assessing our work in this short time frame, so to put this in perspective, over the last 3 years as of September 30, 2018 the MSCI ACWI Index delivered 14.0% return and the Monticello Fund delivered 11.6%. It is disappointing that we haven't delivered on our long-term objective, but I will share briefly on what challenges we face as an international portfolio and how the 2018-2019 team plans on navigating the portfolio allocation process.

As detailed in the guidelines overview above, the sheer number of countries and total stocks within the investment universe is an expansive list, requiring us to make many decisions before we land on a single stock to pitch that has merit to be added to the portfolio. The first reason the international universe is challenging to outperform is in staying smart on the activity and market dynamics within each region and country of the ~50 in our universe. We address this by relying on our economic academia backgrounds to choose large macroeconomic themes that we are confident in tackling and underwriting within a position. The second challenge with the international universe is discovering a market deviant view that will frame our thesis, for example through superior understanding of business models or changing company dynamics. To combat this challenge, as a portfolio management team, we are trying to leverage the Darden and University of Virginia network to set up calls with alumni living and working abroad within the industry or company we are focusing on. The last challenge we face with international investing, is the fund's ability to capture market beta in the same ways that the benchmark finds exposure to the market activity across ~50 countries with our limited portfolio of ~25 positions. We have been addressing this challenge by focusing on companies that have diversified geographic revenue streams across countries and continents.

The next level to this solution would be exploring reporting abilities on geographic revenue distribution versus country of domicile for our holdings. Regardless, we will focus on Warren Buffet's focus investing approach where we concentrate our 25 positions on stocks that have the highest probability of beating the market over the long-term since we don't have the means to invest in every geography and sector within our universe.

TRADES TO DATE: KNOWING WHEN TO LEAVE A PARTY (EXIT A POSITION)

Our role as active managers when valuing and reviewing stocks in our portfolio concludes with a binary decision to – trade (buy/sell) or not trade (hold). Both are considered active management, but with active management it feels wrong to do more of the latter, hold, given we are being paid to *actively* manage a portfolio.

Deciding on timing of when to exit a position can be likened to planning your exit from a party that you are attending. Whenever you leave, there is always the fear of missing out (FOMO) - if you had stayed, would it have been more fun? Did more people arrive and finally start dancing? Did they start passing out dessert finally once you left? The reverse of that is you being incredibly happy with your choice, because perhaps, flashback to wilder times, the cops had showed up and you in fact saved yourself by leaving *early*. With investing, just like staying at a party or leaving at the time that best suits your needs, you can easily find out the answer to those questions the next day by speaking with friends or following market performance.

Before heading to our summer internships, we heeded the advice of our outgoing portfolio management team and reviewed several positions that were of low conviction to them and positions we identified as long-term legacy positions that were dragging the portfolio performance down.

Kinder Morgan (KMI)

A simple way to decide if it is time to sell out of a position, is to use the original investment thesis as a standard to hold yourself to, and when the thesis is broken, and you cannot discover a new thesis that justifies continuing to hold the position as it is destroying value of the portfolio, it is likely time to sell. Kinder Morgan, Inc. is an energy infrastructure company in North America that specializes in owning and controlling oil and gas pipelines and terminals. The Monticello team entered the position in 2012 at \$32 and over 6 years the share price fluctuated in a downward trend slowly reaching \$14 at time that we exited the position in May 2018. The predecessors who entered the position believed that the industry had significant growth potential and that KMI was poised to benefit from outpaced growth at 10-14% per year. We realized that actual revenue growth ranged from -11% to 5% each year after entering the position in 2012. Cyclicity and headwinds in oil prices were not the only drivers of poor performance, the company was over-levered and had large risks of defaulting throughout 2017. One final sensitivity we ran after realizing the investment thesis was broken was a regression on KMI's correlation to oil price. However, we found that KMI's valuation was not positively correlated to oil prices, so we didn't feel confident that our view on increasing oil prices would benefit the valuation of KMI, and we chose to exit before leaving for our summer internships.

Tegna (TGNA)

Our philosophy is to own great companies that can be held for the long-term and will outpace market expectations in shareholder value creation. Warren Buffet says it is better to buy a great business at a fair price than a fair business at a great price. Before the SY class left, we heard a re-pitch of Tegna, Inc. (TGNA) which is an American publicly traded broadcast, digital media and marketing services company. After the pitch, we believed that it was trading at fair value, however within its industry, it wasn't a great company with a moat for the long-term. Additionally, we foresaw an upcoming headwind for this company as the industry was consolidating and we saw that pricing power was a key risk. We believed this company was no longer a long-term moat resistant company, and we decided to exit while the company was trading at fair value.

PHILLIP MORRIS: VENTURING INTO A NEW PARTY IN THE MONTICELLO FUND (NEW POSITION)

As mentioned above, one of our goals as a new portfolio management team was to find companies with strong diversified

geographic revenues. Another concern we had discussed as a team was thinking about downside protection during a recession or contractionary period, so we wanted something that would have staying period during business cycles. An investment idea proposed by portfolio manager Wenda Sun was Phillip Morris (PM) as it met the above-mentioned parameters. Phillip Morris (PM), manufactures and distributes cigarettes, tobacco, and nicotine related products. It operates through the following geographical segments: European Union, Eastern Europe, Middles East & Africa, Asia and Latin America & Canada.

PM maintains a diversified geographic revenue and strong brand positioning in traditional cigarette segment with 33.4% of premium market share in 2017. PM's legacy combustible cigarettes segment is the wide moat for the company as they continue to have room to take market share especially as they enter new markets. The deviant view we hold is related to the opportunity PM has regarding emerging as a leader in a new product, iQOS which will be available in 38 global markets when fully distributed. The iQOS product is widely expected to be the next generation of high-tech, healthy alternatives for smokers. This new product makes up \$5 of PM's ~\$83 price per share but is expected to become 30% of PM's revenue in the future. The margin expansion and economies of scale for this product we anticipate will be another strong headwind benefitting PM's ability to create long-term shareholder value.

We entered the position in May 2018 which we believe was both a strategic and opportunistic purchase. It was opportunistic due to a sell-off in April when the stock was down 33% from its peak price; this was due to the market overreacting to a miss in earnings on the iQOS product launch in Japan. In the long-term, by choosing a global market leader such as PM that has the financial agility and flexibility to launch new products and expand into new countries and regions, we feel this company will maintain its competitive moat and provide long-term value creation for the Monticello Fund for years to come.

THE TEAM

At the end of March 2018, Wenda, Sid, Tris, and I took over the portfolio management of the Monticello Fund. We were very excited to be selected by Bob Conroy and Pedro Matos to participate actively in Darden Capital Management. We look forward to making our mark on the Monticello Fund and leaving a better portfolio and process for the next team. Please let us know if you have any questions or comments.

Sincerely,

Sofia B. Scott
ScottS19@arden.virginia.edu

ROTUNDA FUND

Dear Investors,

I write today to update you on the performance of your holdings with the ESG-oriented Rotunda Fund, which comprises 18.8% of Darden Capital Management's \$18.9 million portfolio. I am pleased to report that since the beginning of our fiscal year on April 1, 2018, the fund has returned 12.1% and has averaged 3-year rolling returns of 17.5%, relative to the benchmark S&P 500 index returns of 11.4% and 17.3%, respectively. Cash balance stands at 4.9% of available capital, and the gross/net exposure stands at 100% (cash excluded) with no leverage or short positions currently undertaken.

The top performers in the fund over the past six months have been Cyberark Software Ltd. (NASDAQ: CYBR), Chipotle Mexican Grill, Inc. (NYSE: CMG), and CVS Health Corp (NYSE: CVS), which have returned 45.87%, 39.45%, and 26.76%, respectively. Top detractors from performance have been Unilever N.V. (NYSE: UN), Starbucks Corporation (NASDAQ: SBUX), and DowDuPont Inc. (NYSE: DWDP), which have returned (4.22%), (3.06%), and (0.60%), respectively. With an increased focus on downside protection, we are pleased that top underperformers averaged only 15% below the index relative to 26% for the top performers. Our largest position is currently Visa Inc. (NYSE: V) at 7.16% of the portfolio.

The Rotunda Fund received a capital infusion of \$1.16 million in late March at the time of leadership change, so the investment action undertaken prior to our summer hiatus was limited to a pro-rata upsize of the existing portfolio. During Q1 of the academic year, a 5% position of United Natural Foods, Inc. (NASDAQ: UNFI) was added to the portfolio. We also conducted comprehensive surveillance reviews of existing holdings Diageo plc (NYSE: DEO), Laboratory Corporation of America Holdings (NYSE: LH), and Capital One Financial Corporation (NYSE: COF). While future quarterly letters will focus more on the market outlook and specific securities of interest, I believe our first letter is best served to update you on how we think about our roles as stewards of your capital and our investing philosophy.

Investment Philosophy and Outlook

The Rotunda Fund (and each of the five student-led funds under the DCM umbrella) is in a unique organizational position. From my perspective, the three primary objectives of the fund and its team are as follows:

- Generate risk-adjusted alpha to investors by outperforming the benchmark S&P 500 Index over an extended time horizon
- Provide an engaging and educational experience to each of the four portfolio managers and the First Year Darden students that increases their abilities as an investor or in a relevant business context
- Invest capital in a manner that is in accordance with an overarching socially responsible theme

On the face of it, the first objective may seem impossible. By necessity, the Rotunda fund incorporates an organizational structure that guarantees full turnover of investing staff on an annual basis, and a lack of comparable time to undergo exhaustive diligence on companies that many professional analysts have followed for years. How can a student-led fund of investors with varying levels of investing experience possibly do something that experienced (and well-compensated) firms fail to do all the time: generate outperformance?

To answer this, we need to both look to the strengths that we do have relative to the market as a whole and mitigate the structural inefficiencies above that are unavoidable. The first strength is the stability of our capital base and investor confidence that allows us to make investment decisions with an extended time horizon that is rare in the investing world. The second is the wealth of knowledge and talent by which we are constantly surrounded at Darden. We do not pretend to be subject matter experts in every industry, but we do have the ability to walk to our neighboring faculty building and speak to former CEOs, investors, bankers, and strategists from all walks of life, or speak to any one of likely several classmates who have worked for the company we are evaluating.

Our two primary organizational weaknesses, annual staff turnover and limited staffing capacity, have been a focus of both DCM and this year's Rotunda Fund leadership team. The only way to maintain continuity from year to year is to have well established investment philosophies and thorough documentation on each investment and its thesis that can be passed down generationally. Our work to begin the year has focused on re-underwriting and documenting any investment for which we have insufficient documentation or for which we believe the original investment thesis may no longer apply. Additionally, we have worked to extend the ideal time to realization of investment thesis to three to four years to limit the annual turnover of the portfolio.

The second objective is simply the recognition that DCM was not endowed with this capital purely because the board believed that we could generate higher returns than some of the top money managers in the world. The capital is there to facilitate the learning process for aspiring investment professionals so that we may better understand the real-world implications of our investment decisions. To better accommodate this goal, we have worked to institutionalize many of our processes and pitch formats so that those lacking prior experience will not feel so lost when learning how to analyze a company for the first time. We are also looking to actively involve first-years in the pitch development process by soliciting help and feedback on the preparation of the weekly investment committees.

Finally, the Rotunda fund is unique in its ESG-oriented mandate. In this regard, the most obvious decision to be made pertains to our view of absolutism vs. relativism. Should any company operating in industries like firearms, alcohol, tobacco, etc. be excluded from our investing universe or should we promote good behavior in these industries by investing in the companies that exhibit admirable traits relative to their competitors? Ultimately, we feel as though subjective arguments can be made for the morality of almost any industry and complete industry exclusion tends to be used more to highlight the social responsible nature of a fund rather than actually impact change in the world. Therefore, we have adopted a more relative approach to our socially responsible views and continue to hold a company like Diageo in our portfolio. There is hope that one day we will be able to quantify our views for each industry into negative screens for underperformers, but at the current time there is no data feed reliable enough to where we feel comfortable doing so. (MSCI's ESG feed is a great example of a feed that provides outstanding metrics on intra-industry relativism but the data feed is currently cost prohibitive.)

In academia, there is an ongoing debate about the inherent outperformance or underperformance of companies whose management teams engage in socially responsible behavior. This lends itself to the question of the appropriate benchmark against which to compare our performance. If there really is a different level of performance for socially responsible companies, positively or negatively, then the Rotunda Fund's alpha comparison to the S&P 500 could incidentally be capturing the beta of our strategy rather than the alpha generated from our security selection. Because we do not engage in industry exclusion and almost all socially responsible ETFs/Indices do, we decided it would be inappropriate to compare our returns to an index like the KLD 400. However, we acknowledge the shortcomings of the current benchmark comparison and expect that this philosophy could change in the coming years as the research continues to evolve.

We thank you for your continued trust in us and encourage you to reach out directly with any questions.

Sincerely,

Kyle Rose
RoseK19@arden.virginia.edu

FEATURED INVESTMENT IDEAS**ADT, INC. (ADT)****TARGET PRICE: \$15.61****Vin Paruchuri, Charles Perkins, Church Waesche**

Company Data	
Price	\$8.74
52 Week High-Low	\$6.93-\$13.02
Market Cap	\$6.6B
Enterprise Value	\$15.8B
EV/EBITDA	7.1x

Business Description

ADT is the leading provider of monitored security, interactive home and business automation, and related monitoring services in the United States and Canada. The company delivers an integrated customer experience by maintaining the industry's largest sales, installation, and service field force, as well as a 24/7 professional monitoring network. ADT currently serves approximately 7.2 million residential and business customers.

Executive Summary

In our base case projection, ADT is valued at \$15.61, representing a 66% premium to the current share price. We do not think the stock price is consistent with the fundamentals, and we believe that the market is failing to account for improvements in customer retention, further expansion into the commercial segment, and new market opportunities that will ultimately drive revenue and free cash flow growth. Please refer to the scenario analysis for details.

Scenario	Price	Upside to Current Price	Description
Bull	\$17.21	97%	Moderate revenue growth and margin improvement
Base	\$15.61	79%	Low revenue growth and margin improvement
Bear	\$11.44	31%	Very low revenue growth with no margin improvement

*Assumes a 7.53% WACC and a 1% perpetuity growth rate

Investment Thesis*1. Improving Customer Retention*

We believe the market is currently underestimating ADT's ability to improve customer retention through more sophisticated underwriting standards and focus on customer satisfaction. The ability to retain customers is a key driver of earnings power and FCF generation, as 100 bps of attrition improvement implies ~\$100mn of additional FCF. The new management team has shifted its strategy to target a higher quality and more permanent customer base. To combat attrition, management has become hyper-focused on customer satisfaction and is now using credit underwriting tools to better determine customers' ability to pay (~20% of attrition historically). We believe that lower attrition will reduce customer acquisition costs and significantly improve margins over time.

2. Commercial Segment Upside

We think that ADT will begin to prioritize its higher margin commercial business in the near-term. ADT currently generates ~85% of revenues from its residential business and the remaining ~15% from its commercial segment. Apollo took ADT private in 2016 and merged it with Protection 1 (P1), a leader in the commercial security market, while keeping most of the P1 management team in place to run the combined company. We think that ADT's new management team will be able to leverage their previous success and expertise to build out the company's commercial business and expand its customer base. The commercial business is attractive because it typically has 30%-50% lower attrition than the residential segment, lower subscriber acquisition costs, and longer contracts (5-6 years versus 3 years for residential). We think that the customer mix shift should improve margins and revenue visibility going forward.

3. New Market Opportunities

ADT's ability to penetrate the DIY home security and cybersecurity markets will also be potential catalysts for the stock.

The company has been able to capitalize on the DIY trend by not only offering its own DIY product but also providing the monitoring services for competitors such as Amazon, Google, and Samsung. We believe that the monitoring segment has significant value and there are only a few players in the market that have the scale and expertise to be successful. Further adoption of DIY products among renters and millennials will provide an opportunity for ADT to acquire new customers at extremely low costs. ADT is also building out its cybersecurity capabilities which we expect to be a significant growth opportunity in both the residential and commercial segments. With the trusted ADT brand, we think cybersecurity is an easy vertical to pursue and can be a practical add-on service for current customers.

Risks

1. Increased Competition

There has been a large emergence of new competition and technology in the industry over the last few years, specifically related to DIY offerings. If ADT is unable to keep up with the technology offerings of competitors and/or unable to capitalize on the new customers entering the market, the company may start to lose market share and/or grow at slower pace than we expect.

2. Inability to Lower Attrition

ADT's future growth is partially dependent on lowering the number of customers who cancel their service. Inability to reduce attrition in the future would result in lower FCF.

3. Levered Balance Sheet

ADT has relatively high levels of debt with a debt to EBITDA ratio of 4.75x. ADT must continue to generate significant cash flow to service interest payments and payoff principal when the debt matures.

4. Limited Disclosure

ADT provides more limited disclosures than when they were previously public (i.e., not providing subscriber count, gross adds, and ARPU metrics). This makes it difficult to accurately model the company.

APERGY (APY)

TARGET PRICE: \$53.00

Lex Utt, Darden Fund

Company Data	
Price	\$42.51
Market Cap	\$3.29B
Enterprise Value	\$3.96B
EV/EBITDA	12.0X
P/E	31.65X

Business Description

Apergy (APY) was successfully spun off from Dover Corp. and began trading as a standalone company in May 2018. Today APY is a loosely integrated collection of highly respected brands that were acquired over the past decades. APY operates in two specific business segments (1) Production and Automation Technologies, which consists of APY's Artificial Lift business and (2) Drilling Technologies, which consists of APY's synthetic diamond business. APY is predominantly NAM onshore focused, as it earned ~84% of its 2017 from NAM (76% from US).

APY has been able to position itself as a technologically advanced provider of pressure pumping services and drilling technologies. Exploration and Production companies would use APY's pressure pumping services to aid in the extraction of resources from the ground and would use the drilling technology to help dig the initial well.

Executive Summary

U.S. Onshore Environment and Positioning

According to Spears and Associates, there is projected to be ~\$68B in capital spend in Onshore drilling globally with ~74% of that being spent in North America. Within the capital spend on North America, roughly \$30B will be spent on the pressure pumping service line and in the Permian Basin. Also, there is a current undersupply of horsepower for pressure pumping services that coincides with anticipated active rig growth CAGR of 14.1% by 2020.

Drilling Technologies

APY has been able to secure 50% of market share in this segment of industry (~\$1.6B) and serves the six largest drill bit manufacturers in OFS. This segment has also experience 100% y-o-y growth in revenue in 2017 when the rest of the market only saw 60% growth in revenue. This capital light business is technologically differentiated as 95% of its products are custom designed and 50% of revenues come from products launched in the last 3 years. APY has accumulated 673 patents in this area since 2008 and has reduced the time to introduce a new product from a full year in 2015 to just 33 days in 2018. Wells completed is expected to grow by a CAGR of 15.4% by 2020, suggesting that there will be a need for more drill bit inserts to complete these projects.

Merger Possibilities

APY would allow global OFS companies such as HAL to increase their presence in the NAM/Global Lift market. Also, the APY full suite of Artificial Lift solutions allows companies in international markets the ability to fully participate in Integrated Production Management (IPM) contracts in more mature markets. To preserve the tax-free nature of APY's spinoff from DOV, there is a two-year waiting period before an acquisition is possible.

Investment Thesis

1. Apergy has positioned itself well within the Oilfield Services Market to take advantage of the capital spend and increase in active wells in NAM by offering a full suite of technologically advanced pressure pumping services and unmatched customer service
2. Apergy is a market share leader in the capital light, but high margin business of Drilling Technologies and should maintain this position because of their ability to customize solutions for specific customer needs

Valuation

Scenario Analysis	Price	Upside to Current Price	Description
Bull	\$53.19	28.11%	Oil prices stay above \$60 bbl, APY able to take share as NAM lift market expands, leading to high revenue growth
Base	\$44.33	6.77%	Initial drop in oil price due to geopolitical risk, steady long-term growth following resolution
Bear	\$33.43	-19.49%	Sharp decline in oil price, other OFS companies enter lift space with more advanced products to take share

Risks

1. *Growing competitiveness of the Electric Submersible Pump (ESP) as both large and small competitors increase investment.*

Mitigant: APY's full portfolio of solutions will require competitors to invest substantial capital to match their offerings. Also, as companies transition from ESP to Rod Lift, APY's has been converting 2/3 of transitions where it is the incumbent ESP provider.

2. *Larger Oilfield Service companies begin to focus their investment on the Pressure Pumping service line.*

Mitigant: While these companies can afford the capital investment, where they lack is the technology to compete with APY and might elect to just purchase the company instead of developing in house. Additionally, APY would still be differentiated due to its Drilling Technology business.

FACEBOOK (FB)

TARGET PRICE: \$217

Juan Jaramillo, Jefferson Fund

Company Data	
Price	\$163
Market Cap	\$470.415B
Enterprise Value	\$512.724B
EV/EBITDA	19.0
P/E	25.2

Business Description

Facebook, Inc. is focused on building products that enable people to connect and share through mobile devices, personal computers and other surfaces. The Company's products include Facebook, Instagram, Messenger, WhatsApp and Oculus. Facebook enables people to connect, share, discover and communicate with each other on mobile devices and personal computers. Instagram enables people to take photos or videos, customize them with filter effects, and share them with friends and followers in a photo feed or send

them directly to friends. Messenger allows communicating with people and businesses alike across a range of platforms and devices. WhatsApp Messenger is a messaging application that is used by people around the world and is available on a range of mobile platforms. Its Oculus virtual reality technology and content platform offers products that allow people to enter an interactive environment to play games, consume content and connect with others.

Executive Summary

On May 2012, Facebook officially entered the public markets through its Initial Public Offering, which was received with mixed reviews from the market. The stock dropped by around 50% in the first 3 months of trading due to concerns around monetization strategies. Led by Mark Zuckerberg, the company went on an incredible run of organic innovation through the addition of the News Feed, its push into mobile, development of the Messenger platform, and later becoming a key player in premium video content. Facebook has also shown skillful inorganic growth execution through the purchase and evolution of Instagram, the WhatsApp acquisition, and most recently its push into Augmented & Virtual reality through Oculus. As of 2018, Facebook has become an undisputed leader in the social advertising space, with over 2.1 billion Monthly Active Users ("MAUs"). Facebook has achieved a scale and market share dominance very few companies have ever been able to achieve, regardless of industry. More importantly, Facebook has positioned itself as a forward-looking company that capitalizes on macro-trends almost in real-time through its execution, positioning of products, and increasingly creative ways to monetize its enormous user base. For these reasons, Facebook is positioned to sustain its growth and dominance as one of the most successful enterprises in the world, and I believe this creates a very compelling investment opportunity.

Investment Thesis

1. Strategically positioned for future growth: Facebook platform is growing rapidly around the world and in markets where the core platform is showing signs of slowing down (USA, Canada), Instagram has been a source of explosive growth (Instagram has been the highest growing social platform in the world over the past 3 years). User engagement is at record highs and industry tailwinds highly favor digital advertising (and specifically, targeted social advertising).

2. Untapped sources of revenue within its business: Facebook is positioning itself to monetize features like Stories, the Messenger platform, WhatsApp, and Oculus (a longer-term AR/VR play). It is worth noting FB has \$0 Debt on its books and is positioned to make significant M&A plays as opportunities arise.

3. Attractive valuation (timing): The market has punished Facebook stock over the last few months over regulatory concerns. The baked-in discount provides an opportunity to invest in Facebook with the view that the Company will fully/mostly address the concerns without significant impact to its business.

Valuation:

Scenario Analysis	Price	Upside to Current Price	Description
Bull	\$237	46%	User base growth coupled with margin improvements. The primary assumption is that investments in combating regulation and fake news will quickly pay off and margins will improve over time by 6%.
Base	\$217	33%	Assumes that continued investments into the platform will initially decrease by around 3% and over time, by 2023, will stabilize at 2018 levels.
Bear	\$197	21%	Assumes that the pressures from increased regulation will permanently impact margins. Margins are modeled to decrease steadily over time before reaching a steady state that is 6% lower than 2018 margins.

Risks:

1. User growth slows down / reverses: The Company has displayed a track record of innovation and understanding of user needs, which has kept users engaged and its base growing. Additionally, the sheer size of FB and lack of true global competitors addresses this concern for the foreseeable future.

2. Regulation will impact its core business: Although GDPR in Europe and other governments are closely monitoring data sharing and tracking, Facebook is spending significant resources to ensure it is fully compliant. Political ad spend could become more regulated but this represents an immaterial portion of its business.

3. Control of Mark Zuckerberg over Facebook: While this is a valid concern, Mark has guided the Company from a dorm room photo sharing website to one of the largest companies in the world. Despite some mishaps with the media, I believe his commercial acumen and ability to lead Facebook in the right direction is far superior to the next best alternative.

PHILIP MORRIS (PM)**TARGET PRICE: \$96.10****Wenda Sun, Monticello Fund**

Company Data	
Price	\$81.54
Market Cap	\$126.8B
Enterprise Value	\$154.7B
EV/EBITDA	11.92
P/E	19.8
Dividend Yield	5.59%

Business Description

Philip Morris International, Inc. is a holding company, which engages in manufacturing and sale of cigarettes, tobacco and nicotine-containing products. It operates through the following geographical segments: European Union, Eastern Europe, Middle East & Africa, Asia and Latin America & Canada. The company is a spin-off from Altria in 2008, and focuses only in the markets outside of the United States. The company is headquartered in New York, NY.

Executive Summary

PM's aspiration is to achieve 30% of total volume (currently 4%) through its flagship RRP (Risk Reduced Product) iQOS by 2025. iQOS is the heated tobacco device which mimics the real smoking experiences and according to PM, significantly decrease the harm to health. The company separately sells the tobacco used in iQOS which is marketed under the "HEETS" brand. HEETS is sold for approximately the price of a pack of cigarettes in the local market. Despite initial success, PM's share price is down ~30% in the last year because it has not been able to meet sales target in its biggest RRP market: Japan. However, several factors discussed below have positioned PM for long term recovery and growth.

Investment Thesis

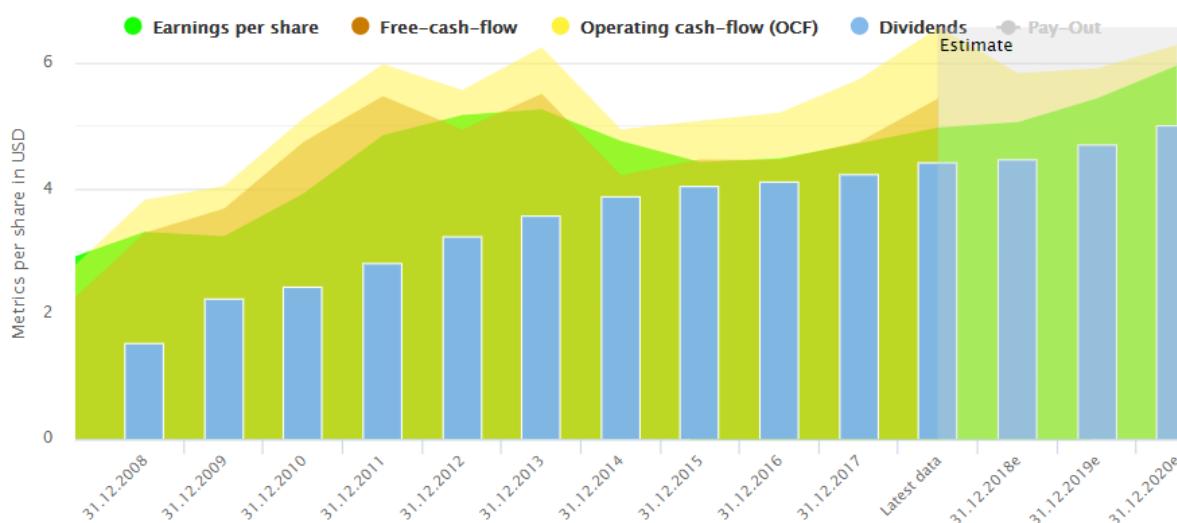
1. PM's legacy combustible cigarettes segment establishes a wide moat for the company. PM combustible market share (ex. iQOS) 31.1% in Aug 2018 vs 31.4% in Jan 2017, PM market share (incl. iQOS) 33.2% in Aug 2018 vs 31.7% in Jan 2017. Combustible pricing +7.5% in H1 2018 offsetting -3.3% volume, net revenue +0.6% H1 2018 ex. FX impact. The current pattern of declining volume compensated by the increase of the selling prices is expected to continue.
2. Economy of scale supports combustible segments, and is positioned to benefit the growth of iQOS. This ensures the cost cutting and sustainable operating margin once iQOS reaches a more mature stage. Adjusted OI +9.8% in Q2 2018 vs +7.7% in 2018. Adjusted diluted EPS +20.2% Q2 2018 vs +10% 2017 primarily due to lower effective tax rate and interest expense.
3. Recent sell off signals over-pessimism of long-term growth prospect of PM. PM stock price is down 33% in the last year primarily due to its inability to meet aggressive iQOS sales target in Japan (currently 74% of HTU volume). However, iQOS is still in the early stage of its product life cycle with effort in reaching more conservative smokers in Japan, different regions still in the early stage of conversion and the launch of next gen iQOS device / platform. For example, HTU volume +100% H1 2018 in all regions except EA and Australia. Importantly, HTU only accounts for 5.5% of volume but 14.7% of net revenue, which signals even stronger cash flow in the future.
4. Stable dividend provides strong income stream at the late stage of the bull market. PM has strong FCF and balance sheet with current 2018 EPS guidance, including unfavorable FX impact and Argentina Peso devaluation, is \$4.97~\$5.02. 2018 dividend is \$4.49, well covered by FCF/share of \$4.74.

PMI Shipment Volume (Million Units)

	For the Six Months Ended June 30,			For the Three Months Ended June 30,		
	2018	2017	Change	2018	2017	Change
Heated Tobacco Units						
European Union	2,123	576	+100%	1,195	392	+100%
Eastern Europe	1,515	171	+100%	951	117	+100%
Middle East & Africa	1,680	163	+100%	971	112	+100%
South & Southeast Asia	—	—	—%	—	—	—%
East Asia & Australia	15,180	9,871	53.8 %	7,838	5,726	36.9 %
Latin America & Canada	55	4	+100%	32	3	+100%
Total Heated Tobacco Units	20,553	10,785	90.6 %	10,987	6,350	73.0 %

Valuation

PM has increased its dividend at a 9.3% CAGR since it was spun-off from Altria in 2008. As a company that has a stable dividend policy, a dividend discounted model is used. Free cash flow fully covers the dividend payments and the company's balance sheet is only 1.94x net levered (Net Debt / EBITDA), providing ample financial cushion and borrowing ability. Cost of equity is 8.1% based on Bloomberg's data. Dividend growth rate is forecasted under three different scenarios along with EPS growth rate, with the goal to bring down the dividend payout ratio to normalized levels. The base case yields equity value of \$96.1, with a 17.9% upside based on Sept 28 price.



An alternative way to look at valuation is to look at the comps. As we can see from the comps table, PM ranks consistently high in different metrics. EV/EBITDA of 11.92x shows that PM is fairly valued on an absolute level among its comps with lower metrics quality, which should mean that PM is in fact undervalued. What's also worth noting is that tobacco industry as a whole has been taken a hit this year: MSCI World Tobacco -22.85% YTD, P/E 14.13 vs MSCI World 3.43% YTD, P/E 19.45. If the investment thesis stands, tobacco industry as a whole should see a recovery as multiple companies are working on next generation products.

Risks

- 1. Foreign exchange:** FX has had a large impact on the company's results and this is largely out of the company's control. However, over the long term, FX risk should balance out but is likely to create volatility in the short term.
- 2. Execution on growth strategy:** We have to fully anticipate that the next phase growth for PM will be a fluctuating one, with iQOS only in the early stage of development and lots of markets still uncultivated. However, investors should

cautiously and periodically investigate whether there is evidence that PM's growth trajectory is on track. At the same time, the strong legacy combustible cigarettes portfolio enables management to act and react with flexibility.

3. Regulation and ESG factors: Both FDA and regulatory entities outside of US are not willing to approve that "reduced risk" to be officially stamped on PM's next generation product. However, PM has sufficient scientific evidence and regulation need time to catch up with the new habit of consuming cigarettes. PM is working on achieving FDA's approval as well as ready to "timing" positive regulatory intervention.

4. Leverage: Currently rated A by S&P, the leverage ratio is outside of its criteria of 1.5x-2.0x. There is not much room for PM to raise additional debt to fund its dividend if PM wants to maintain current rating. PM will have to rely on its own cash flow and expect the dividend payout ratio to gradually come down. Model suggests that this is an achievable target, provided that PM can achieve ~8% EPS growth from 2019-2021. The model also does not consider share buyback, which could be an alternative way for PM to return cash to investors.