RGA INVESTMENT ADVISORS LLC

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Q1'17 Investment Commentary

Many of the themes from the end of 2016 persisted into the early first quarter of 2017. Around the second week of February, the so-called "Trump Trade" reached its crescendo with many of the politically driven ascents fully faded into the end of the quarter. The market's overall levels largely held up with a shift in strength towards technology and some of the other "high quality" laggards of late last year at the expense of cyclicals.

Underlying economic strength continued into the quarter and helped push the acceleration of expectations for the first Federal Reserve rate hike of 2017. Coming into the year, markets expected less than a 50/50 chance of a March hike, but during a spate of voting member talks in the month of February, these expectations shifted to near certainty. This coincided with the Trump trade's inflection point.

We took advantage of the strength in cyclicals to shed some positions where we felt the pendulum swing in sentiment did not correspond to a shift in fundamentals—we sold both our auto manufacturer and car dealer (while maintaining our entire exposure to the financial sector). Below, we expand on two other notable portfolio changes during the quarter.

In which we realized our mistake quickly, though not soon enough:

In our 2016 year-end commentary we shared our thesis on Under Armour (NYSE: UA). [1] Shortly after publishing our thoughts, the company issued a trifecta of bad news when their earnings missed the mark, they abandoned what had been issued as longer-term guidance only three months prior, and their CFO resigned. Any one of these may have been indicative of a short-term problem, but together they compounded the woes. While our quick about-face may appear surprising, we think it is essential to remain flexible in our views despite our long-term bias and believe it is important to learn the right lessons from our mistakes. One of the foremost mistakes with UA was our under-appreciation for how much this company on the apparel side resembles a "fashion" company more so than a pure sports play. These quotes from their Q4 2016 conference call make this point stark:

- "We need to become more fashionable with the products that we have out there. And one of the things we found is that some of the core basics were some of the challenges that we saw, is

[1] http://www.rgaia.com/2016-year-end/

that we are counting on core basics as we have in years past to do more work for us. But the consumer today frankly has more options, and frankly most of those options are from good brands that we compete with, that are heavily discounting as well." – Kevin Plank[2]

- "So what you'll see is that I don't think it's one shift of abandoning one for the other. Obviously, with things like the investment we're making in UAS (31:30) in sport lifestyle in general, but we need to become more fashion. The consumer wants it all. They want product that looks great, that wears great, that you can wear at night with a pair of jeans, but that also does perform for them. But the performance has just become a bit of a given information. And so I think you'll see us continue to react to that, and hopefully I think you'll see us continue to lead in that."[3]

We cannot help but ask, what is the company's edge if "performance just become a bit of a given." Further, was growth demand-pull or supply-push? That is, did the company grow because consumers kept buying more and more, or because UA kept putting out more and more product. Obviously to some extent there is a symbiotic relationship between the two, but in hindsight it appears certain that the growth emphasis from leadership despite the reset in expectations during the Fall was a sign that the growth had inflected from a balance between the two to a more dominant supply-push. Supply-push is far less certain because it comes with increasing the capital base of the business ahead of the top line and requires growing inventory to the point where if something goes wrong, it will go very wrong. This is evident in the gross margin miss and the inventory build.

While Plank deserves admiration and is a worthy subject to study for how successfully he built UA, there was a warning sign that we did not consider until after-the-fact. Plank had been touting UA's "26 straight quarters of 20% or more YoY top line growth." This is a great accomplishment, but it is also an overt risk. When a streak becomes too important a corporate imperative, the incentive to continue the streak can outweigh the incentive to do the right thing because no one wants to be responsible for it ending.

UA's goal in hindsight seems like it was kept up with pulling growth forward (creating way too much product and discounting heavily. Further, Q3 guidance for 2017 was shaped far too much by attempting to maintain the "above 20%" as an important threshold, instead of being realistic about what already was acknowledge as slowing but robust growth. Accounts receivable was a tell we should have noticed. Whereas inventory only grew 11.9% vs sales growth of 22.1% year-over-year in Q3 of 2017, receivables grew 29.5%. This inventory was sold through the channel to wholesalers who had not paid for the product. This helped boost sales and reach growth targets, when in fact it should have been a big red flag.

[2] https://seekingalpha.com/article/4041127-armour-ua-q4-2016-results-earnings-call-transcript?part=single
[3] https://seekingalpha.com/article/4041127-armour-ua-q4-2016-results-earnings-call-transcript?part=single

- "a larger increase in accounts receivable of $53.7 million in the current period compared to the prior period, due to the timing of shipments driven by current period sales being more heavily weighted to the end of the period."[4]

Perhaps the key takeaway here is as simple as the "capital cycle." We were first introduced to this idea in "Capital Account: A Fund Manager Reports on a Turbulent Decade."[5] The book featured the letters of Marathon Asset Management and its focus on the capital investment cycle at both the micro and macro levels and the impact it would have on valuations. We no longer own any other investments in companies which are simultaneously sacrificing margin & investing in capex at such a voluminous rate. We do have some investments in which out-year margins will be greater due to the investment that flows through; however, these businesses are very capital light and the investment through margin should be long-lived. UA is basically the reverse.

It's very hard not to write off the big investments of the past year given how badly the company missed on both top line and margins, and what the outlook into next year is like for both as well as free cash flow. On the plus side, the company is lowering CAPEX spend, but this seems more out of necessity and leads us to wonder why it didn't happen sooner. This does not strike us as a "capacity to suffer" (Tom Russo's definition) problem right now.6 This more realistically strikes us as a company struggling to find its identity in crossing the chasm from a passionate, profitable niche (performance gear for the active athlete) into mass market appeal. In the process, the UA is wavering between "performance" and "fashion" and "growth" and "operations" with none really emerging a clear-cut winner for the brand's identity. Plank talks a lot about the identity, but if "performance is taken as a given" then we wonder what that identity looks like at the end of the day.

High quality at a depressed price:

During the quarter we commenced a position in Arcadis (AMS: ARCAD). Arcadis is a global design and consultancy firm with specialties in infrastructure, water, environmental remediation and architecture. They work on vital pieces of infrastructure that touch our lives daily: levees, tunneling for subways and water pipes, dams, desalination plants, help municipalities manage flood plains and construct plans, etc. The company's 20,000 plus employees work on 30,000 projects annually around the globe.

[4] https://www.sec.gov/Archives/edgar/data/1336917/000133691716000113/ua-9302016x10q.htm
[5] https://www.amazon.com/Capital-Account-Manager-Turbulent-1993-2002/dp/1587991802

The unique specialty and capabilities in water put this on our radar. If you casually followed some of the post-Sandy reconstruction in New York and the discussion of broader coastal protection, it is likely you have come across this name.[7] As we often do, we noted Arcadis' contribution to the reconstruction efforts and put them on a long-term watch list. Over the past year, between a spate of poorly timed (and executed) emerging market acquisitions, an investigation by Brazilian authorities of corruption in the procurement of construction contracts (notably Arcadis is a design, not construction firm) and evolving needs of the formerly very profitable US environmental remediation business, the stock took a beating. Nonetheless, free cash flow remained high. Heading into the new year, the company "parted ways" (aka fired) its CEO Neil McArthur and hinted at a renewed emphasis on operations over growth. To that end, Arcadis hired Peter Oosterveer, the long-time COO of Fluor Corp (NYSE: FLR) who has the right experience and exposure to help streamline operations and restore profitability accordingly.[8]

Arcadis' main input cost is labor capital. The company is not necessarily unique in this respect; however, they are unique in their ownership structure. The single largest owner of shares is an aggregated pool of employee holdings—representing 17.2% of the outstanding shares. There is very little physical capital deployed in the company. As such, capital expenditures are very low and most investment flows through in the form of labor expenses. The company has a shared common knowledge base that is "housed" in its DNA that gets deployed to each project along the way. This knowledge and expertise is something that other companies would have difficulty to replicate both in its scale, its vintage, and its specialty.

Returns on capital are very high at Arcadis (30% ROIC ex-goodwill and acquired intangibles). With goodwill and intangibles the numbers are inferior now—hovering around 8%, due to the sluggish performance of some of the more recent, larger transactions and the downturn in the Emerging Markets business.ROIC ex-goodwill is the best way to judge this company, because when you include goodwill, you are making a judgment on management in addition to the actual business. Looking exclusive of goodwill gives a clearer picture on the cash generation capacity of the business as it stands today. This is particularly relevant here as the company transitions from an acquisitive to an operations-focused CEO. Oosterveer comes in with a clean slate and will be unencumbered by the returns generated on goodwill (ie by the strategic decisions of previous management). Cash generation is very lush, and supports both the interest expense in its presently over-levered state, as well as a dividend payout of 30-40% of net income. CAPEX has been, and will continue to be low. Since there is little physical capital deployed in the business, fixed costs in the long run are very low; however, they are high in the short run due to certain institutional imperatives and the uncertainty with respect to how quickly cyclical forces will resolve

[7] http://www.pbs.org/newshour/rundown/engineers-draw-barriers-to-protect-new-york-from-another-sandy/

[8] http://www.enr.com/articles/41625-fluors-retired-coo-will-become-ceo-of-arcadis

themselves. When the company has clarity (as it does in Brazil) that the problems run deeper than merely cyclical ones, they can right-size the cost base and restore margins fairly quickly. This helps make cyclical margin problems shorter-term in nature, even if revenues don't come back quickly enough. While the company is a cyclical, the infrastructure needs they service are secular. To that end, it is the funding cycles, not necessarily end demand which are cyclical. Working capital does eat up some capital, though that is proportionate to the revenue base at any given time. There are nearer-term problems right now as some oil and gas companies and countries exposed to oil and gas pricing have stalled on payments. These problems will be watched closely, though we believe they should be resolved in the not-too-distant future.

As a company that deploys labor, it's important to mention that most of the projects are staffed locally—projects are staffed with people who are located in the same country as the project itself. The Hyder division brought in global outsourcing centers in India and the Philippines that are used for some elements of design and architecture, though this is mainly for UK-based projects. Only 3% of US-based projects are staffed with outsourced talent. This was particularly helpful in thinking about what may happen to the company were the US to adopt a border adjustment tax.

Further adding to our intrigue in Arcadis is the contribution the company can have to the portfolio's correlations--in particular, flooding events are bad for the economy and especially so for insurance/reinsurance, to which we have exposure by way of Markel (NYSE: MKL) and Exor N.V (MILEXO.MI). If a flood event hurt the reinsurance sector, it is likely that Arcadis would move strongly in the opposite direction (for context, Arcadis rose 5.6% the day Sandy made landfall and enjoyed an especially strong year). At the time of our purchase, we picked up shares for just north of a 10% cash flow yield based on our 2017 estimate. Should multiples remain constant, then we would expect to earn this double-digit cash flow yield over time. This estimate assumes no margin improvement. If margins improve in 2018 (and the company has taken action to effect that outcome), alongside any basic recovery in cyclically weak areas of infrastructure demand, there is the potential for powerfully strong performance. One thing is clear with Arcadis: there will continue to be immense need for the crucial services they provide in making our world more livable, especially in the face of climate change.

What do we own?

The Leaders:

The Priceline Group (NASDAQ: PCLN) +21.41%

Exor N.V. (MI: EXO) +20.00%

Arcadis N.V. (AMS: ARCAD) +15.86%

The Laggards:

Under Armour, Inc. (NYSE: UA) -24.95%

GrubHub Inc. (NASDAQ: GRUB) -12.57%

Envestnet, Inc. (NYSE: ENV) -8.37%

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-1945. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

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