The second quarter began with fears surrounding the soundness of our banking system and ended with considerable optimism about the path of inflation. Banking system fears quietly subsided as First-Citizens Bank bought the remains of Silicon Valley Bank and JP Morgan rescued First Republic Bank from imminent demise. The fear had been a cascading snowball of risk spreading from the financial sector to the real economy and the absence of further risk manifesting over a period of months proved the soundness of the banking system in the face of today's challenges. Without financial sector risk to sweat, market pundits shifted their focus from to the accelerating disinflation story. As we move farther from the initial inflationary shock, we are firming in our belief (which had been challenged along the way) that inflation was truly a consequence of policy action to protect individual health and supply chain tensions stemming from the lockdowns. In tandem with this belief, we are increasingly convinced the aggressive fiscal response has helped close the "output gap" which was attributed to "secular stagnation" following the Great Financial Crisis. We will discuss these evolving thoughts below.

In recent commentaries we have pointed out the marked weakness in small cap securities versus large caps. This trend accelerated in recent quarters and is notable within our portfolio itself. Our five largest positions, which happen to be larger companies, have performed ahead of the market so far in 2023, while the rest of our portfolio has largely suffered. These same forces have both the Equal Weighted S&P 500 and Russell 2000 Indexes down mid-single digits, while the S&P 500 itself is up low double digits. Large companies are typically more resilient than smaller ones through volatile economic environments, though as our current supply side environment stabilizes and these forces abate, the pain in small caps has not receded.
In good times, many would look past these cyclical forces to longer-term ones; however, today, even when fundamentals do come into play, far too much capital is focused on changes in the second derivative of fundamentals rather than true value in and of itself. In some cases, prices have become a fiction of sorts, where they are driven by the liquidity needs of shareholders rather than fundamental or strategic value. We recently saw an amazing example of this in the biotech space where a company trading below $1 per share and a ~$50m market cap raised $80m in equity at a price of $5 per share and received $25m in upfront payments.[1] A year ago, we kept hearing anecdotes about how “there is a wide spread between bid and ask of would be sellers and buyers in strategic deals, because the sellers have not grasped the new valuation realities.” Meanwhile, here is a very clear example of sellers and buyers alike saying that Mr. Market’s assessment of the situation is entirely irrelevant. aPrice was negotiated independent of the day-to-day market quotations and value was determined to be far wide of the prevailing quote. Obviously, this is a unique example and nowhere near all securities fall in this bucket of irrationally valued, though extreme examples are often proper illustrations of broader dynamics. We have never seen such a diverse array of companies trading for valuations below our estimation of both fundamental and strategic worth.

**MONITORING INFLATION**

Supply chains have reached normalized, pre-pandemic levels affording companies, which is critical for “just-in-time manufacturing” as well as needs-based pressures on household necessities. This is measurable and observable as seen below:[2]

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Supply chains were a critical variable preventing better visibility for companies into their customers’ intents and the appropriate level of inventory to hold onto. This will be a critical component of our company deep-dive below. Although the Federal Reserve is deploying aggressive monetary policy actions to fight inflation, easing supply chains to date have been the single most important catalyst in driving inflation lower so far. Wages remain a lingering source of tension. With inflation falling and wage growth lingering, workers are now receiving raises ahead of the rate of inflation; however, rather than wage pressures snowballing into other vectors of inflation, it is slowly receding to healthier levels:

And the most acute areas of shortages, which exacerbated wage pressure, are resolving to more normalized levels indicating further relief ahead:


Although the pace of progress may slow during the remainder of the year, we expect further progress towards normalization to continue, especially as rental prices start declining year-over-year. Importantly, the cost of shelter component of CPI is based on a household survey that observes price with a considerable lag. In reality, price pressures on shelter have entirely receded and will soon flow through to yet lower inflation metrics.[5]

While inflation continues to subside, the growth impulse of the economy remains incredibly strong. In October 2022 100% of economic forecasters on Wall Street were predicting a recession within a year, yet here we are a year later and not only has the economy avoided recession, but growth is accelerating. [6] The economy is far more like a tanker where change in direction happens slowly and takes time, though we think the most important takeaway is that underlying growth forces remain strong. Chairman Powell and the Fed are holding things back to quash inflation, but with inflation approaching target levels faster than most had expected, once the Fed concludes its aggressive policy phase and signals an intent to once again foster growth, these impulses should propel a strong economic expansion the likes of which we have not experienced in recent times.

**GROWTH AND THE RIGHT LEVEL OF RATES**

From Paul Volcker’s battle against inflation through the Great Financial Crisis, interest rates consistently trended lower. Our most important benchmark, the 10-year Treasury rate spent much of the 1990-2007 period between 7% on the high-end and about 4% on the low end (with some brief visits above and below this range). In the epoch before the GFC, we lived in what many still refer to as a “normal rate regime;” however, following the GFC, peaks in the 10-year were sub in the low 3s, with the 10-year yield bottoming at barely north of 0.5% during the aggressive COVID policy response. The low-rates we have experienced since the GFC have generally been considered a consequence of what economists call “secular stagnation.” Headlines are often emblematic and we think a Time headline from March of 2016 phrases the problem appropriately: “This Theory Explains Why the U.S.

Economy Might Never Get Better”. The theory covered in the article is secular stagnation, and as the article explains:

As a diagnosis, secular stagnation is simple: It’s the idea that the economic problems the U.S. continues to face aren’t a product of the “business cycle,” the ebb and flow of boom times and recession (hence the “secular” part), but may well be permanent drags on the modern economy. “It’s a kind of long term and sustained slow-down in economic growth.” [7]

Numerous explanations were conjured up to explain why we were suffering from secular stagnation, but fast forward to now and that conversation seems quaint. Today, we are experiencing a level of GDP growth that would have been our fastest growth in the decade following the GFC and at a level more consistent with the upper reaches of normal before anyone conceived the phrase “secular stagnation.”[8]

Over the past one and a half years this growth is in nominal, not real terms and therefore inflation eats away a portion of the economic value. This is the problem wrought by inflation. Today, we are approaching a resolution to that problem as inflation continues to abate, while growth remains strong. Stated differently, we are now experiencing better real GDP growth and the first green shoots that “secular stagnation” may have been appropriate in describing the 2010s, but not the 2020s. While perusing stock market headlines, few would believe economic green shoots existed, yet we see promising signs that disinflation continues unabated and growth marches on.

The disconnect stems from this section’s prelude on interest rates. Rather than thinking about high rates as a consequence of structurally higher growth potential, the prevailing narrative holds that 1) rates themselves will bring about the next recession (i.e. stop growth in its tracks); and 2) rates will also impact stock market valuations given the opportunity cost investors must face when deciding between stocks and bonds.

Number 2) above is in many respects the simplest and most important to address. Although it is appealing to point out the direct connection between one’s discount rate (i.e. interest rates) and equity valuations, the reality is far more nuanced. The discounted cash flow terminal value framework holds that your future cash flows are discounted by your discount rate (r) less your expected growth rate (g):

\[ TV = \frac{FCF \times (1+g)}{(r-g)} \]

[8] https://fred.stlouisfed.org/series/NGDPSAXDCUSQ
If interest rates rise commensurate with growth, the implications for value are de minimis and a slight positive due to growth’s presence in the numerator in addition to the denominator. This complex reality is why we see some of the lowest valuations in the last 25 years occurring during the period when rates reached some of their lowest levels:[9]

Why might this be? When the 10-year was trading at just north of 0.5% during the COVID crash, markets never valued future cash flows at a level commensurate with a 10-year sub 1%. In fact, market valuations never truly detached from valuation regimes consistent with a 10-year rate at upwards of 3%. To state this another way: markets have always assumed some degree of mean reversion in interest rates and therefore valuations consistently stayed within previously “normal” parameters. Yes, during COVID markets were above the one standard deviation range from normal; however, so too were earnings with many companies precluded from conducting normal business due to the COVID policy response.

So if interest rates are not the cause of today’s market weakness, must it therefore be that markets are pricing in an imminent recession? Here we would first point to Paul Samuelson’s famous quote that “the stock market has predicted nine out of the last five recessions.” Stock markets do not know more than the average prognosticator. With a long enough time horizon, recessions are always around the corner. What is more important from our perspective is how valuations are already heavily discounting the likelihood of a recession, especially in global and small cap securities. As we have been harping on for several of our last few commentaries, the large cap stocks of the S&P 500 have masked the carnage beneath the surface in global markets.

The S&P 600 SmallCap index has valuations at around their GFC levels and the divide with the S&P 500 keeps widening:[10]
Much of the world, excluding the US and the impact of the so-called “Magnificent 7” (the seven largest stocks in the S&P 500 which account for the entirety of this year's return so far) are trading near recessionary P/E levels.

Globally the story is similar to that of small caps. In fact, the MSCI World Index excluding the U.S. is trading at a two standard deviation P/E discount to the U.S., the most extreme in recent history.

There is a further point to make on the valuation spreads. Within the S&P the P/E ratio of the top 10 stocks vs the remaining 490 is at extreme levels only witnessed during the dot com bubble. This is not to say that all 10 of the top stocks are expensive, but rather there is a stark divide at the center of the S&P 500 valuation conversation. The top 10 stocks are more expensive than average and more expensive than typical for the largest components of the index, while the remaining stocks are within striking distance of average and in aggregate cheaper than the S&P itself has been over the last quarter of a century. These forces are nicely summarized in this chart:[12]
We think inevitably this sets the stages for an outstanding stock-picking environment, irrespective of high rates and questions about when we will have our next recession. The path to this point has not been easy, though from here, there are some increasingly obvious examples of “baby out with the bathwater” treatment, whereby indiscriminate selling based on what “category” something belongs to drives valuations to unsustainably low levels. Consequently, we have used these top-down landmarks of cheap valuations, both in geographic and sector terms in order to seek out our favorite bottoms-up opportunities.

PURITY IN THE CROWN JEWEL OF BIOPROCESSING:
One of the companies we have studied for many years, patiently waiting for the opportunity, finally gave us what we were looking for: Danaher Corporation. During the second quarter we bought a sizable amount of Danaher. We have analyzed the company, its spun off entities and studied its history over the years, though we had never purchased shares. This was partly due to questions about company end-markets and valuation, and partly due to impatience on our part. Sometimes certain opportunities simply fall into place.

During several of our recent letters we have articulated and explained our interest in the life science space, especially the tools and instruments companies and Danaher happens to be perhaps the premier asset in the space. Before explaining why, it is worth highlighting why Danaher has been a company of interest for so long. Danaher was founded by brothers Steven and Mitchell Rales in 1984. The brothers focused on acquiring manufacturing companies and applying their version of Japanese kaizen in a process they named the Danaher Business System (DBS). DBS is described by Danaher as follows:

…the DBS engine drives the company through a never-ending cycle of change and improvement: exceptional PEOPLE develop outstanding PLANS and execute them using world-class tools to construct sustainable PROCESSES, resulting in superior PERFORMANCE. Superior performance and high expectations attract exceptional people, who continue the cycle. Guiding all efforts is a simple philosophy rooted in four customer-facing priorities: Quality, Delivery, Cost, and Innovation.[13].

We mentioned that Danaher today is a premier life science company and this resulted from an acquisition closed shortly before COVID began. Larry Culp had retired as Danaher’s CEO in 2015, before joining GE in 2018. Within a year of taking the reigns at GE, Culp sold Danaher GE’s Biopharma business for net proceeds of $20 billion.[14] This move was interesting to us for two reasons: It was transformational for Danaher in making life sciences the company’s largest and fastest growing end-market.

1. It was transformational for Danaher in making life sciences the company’s largest and fastest growing end-market. It was Culp specifically who led Danaher down the road into life science with a series of acquisitions over his decade and half tenure, including assets like Leica Microsystems and Beckman Coulter. This almost seems like a parting gift.

With life science tools and instruments now the company’s largest end market, the stage was set to focus on the company. For most of its history, Danaher had functioned as a traditional conglomerate—acquiring assets without truly integrating them—while operating in an unconventional manner. DBS is at the heart of what makes Danaher unconventional, but the company has also been willing to divest and spin assets to reinvent itself around a core focus. Danaher’s push into a pure-play life science company was cemented with the announcement in late 2022 that it would spin off its Environment and Applied Solutions segment into a standalone company since named Veralto. The confluence of Danaher’s pure-play life science phase of its life and our intrigue in the sector situated us perfectly to capitalize on the opportunity. Our excitement was piqued as Danaher’s stock suffered through most of the first half of this year on falling revenue expectations in life sciences. There were three primary culprits behind the slowdown:

1. Lower demand for the COVID-19 vaccine and COVID-related diagnostics
2. Falling funding at early-staged biotechs, leading to lower levels of spend on new instrumentation and consumables
3. Slowing demand from CDMOs (the companies who manufacture most biologics) due to the burn down of excess inventories built up during the COVID supply chain crisis

We will focus the majority of our conversation below on this third bullet, as in our estimation it has been most impactful and it pertains most directly to the piece of Danaher we find most alluring—the Biotechnology segment comprised of Cytiva, which as of today is the combined GE Biopharma (2020) and Pall (2015) acquisitions. Bioprocessing is the manufacturing process through which a cell or cells are scaled up in number in order to filter out and then, harvest specific pieces or output of the cells themselves. This is the process through which biologics, vaccines and now increasingly cell and gene therapies are made through. It is an oligopolistic market, with a small number of critical players and extremely high barriers to entry—two to four companies compete in any one of the key sub-segments. Danaher owns anywhere from 35-40% market share in the industry.[15] Although many fawn over the criticality of a company like ASML in empowering the semiconductor industry, the bioprocessors are similar for the biotechnology industry. The processes are complex, entailing both upstream and downstream components, with Cytiva the most comprehensive, vertically integrated and unique offering in

[15] SVB Securities Initiation of Danaher Corporation, May 1, 2023
the industry. Cytiva is especially dominant downstream, where bioprocessors make the most money and margin and the offering is truly differentiated. Moreover, once a pharma or biotech commences their clinical process with Cytiva’s components, those pieces become “spec’d in” guaranteeing a long-term revenue stream. These are predominantly consumable revenues by nature with over 75% of revenues derived from recurring sources.

Danaher closed the GE Biopharma (Cytiva) acquisition on the eve of the COVID pandemic. Typically, Danaher would operate a large, acquired business as a standalone business unit; however, Pall and Cytiva have a high degree of customer and product overlap. The plan had been to integrate these two units; however, with COVID and the intense demand for bioprocessing product as well as the complex operating and supply chain environment, Danaher prioritized meeting customer needs over the planned integration. With COVID now behind us, supply chains largely in order and more balanced customer needs, Danaher is finally pursuing a true integration. This will unlock both short and long-term benefits. First, a unified salesforce and a better cross-sell motion will drive better sales; second, and more importantly, a unified R&D effort across upstream and downstream assets will allow for a more harmonized product roadmap that could truly solve some of the biomanufacturing industry’s foremost pain points. While it will take time for Danaher to realize these R&D advantages, we believe the longer-term benefits could be profound as Danaher now owns the most complete portfolio and can build out simpler, more harmonized workflows. In today’s myopic environment, few are focusing on this critical long-term evolution.

As revenue expectations have come down for Danaher and other bioprocessing companies, some of questioned whether these newly lowered expectations are the consequence of temporary forces that inevitably will recede or signs of a more permanent step-down from the double-digit growth rates witnessed over the last decade into a new-normal in the single digits. As we have pursued our work, the answer is clear in our minds that these forces are temporary rather than permanent, meanwhile the valuation of Danaher has moved to a point where it is reflecting a degree of permanence on an artificially low level of earnings.

The following summarizes the findings of our conversations with industry practitioners from the CDMO and biotech space. The typical CDMO contracts with its customer to what level of consumable inventory should be held over time. This was typically in the 6 month range, due to consistent volumes of biologic manufacturing and a two-year or less shelf-life on the critical pieces. This 6 month range was bumped to upwards of one year of inventory and in many cases nearly 18 months of inventory. Further, many put in for weekly orders on critical pieces when monthly orders formerly sufficed, as the more frequent cadence bumped the purchaser up the priority list at the vendor. These actions made sense during COVID when inconsistent supply chains imperiled the ability of some pharmaceutical and biotech companies to bring life-saving drugs to market.

The problem is that CDMOs and their customers made such agreements with hand-shake arrangements rather than formalized re-writes of their contracts and had no system in place to track inventory and to which customer’s account to attribute the purchase of standardized inventory pieces. Therefore, contractually, CDMOs were committed to purchasing certain volumes of consumables with the bioprocessing companies like Danaher; however, the CDMOs customers were theoretically responsible for reimbursing such purchases though not necessarily bound.

These problems were confounded by challenges at the FDA for the industry. Although COVID saw a surge in funding for the biotech industry, it created significant bottlenecks in development and approvals at the FDA. These forces have weighed on bioprocessing demand with a lag, as it resulted in a much slower pace moving indications through the clinic. The FDA is committed to resolving these problems and has expressed its intent on
“if not exponential, at least some logarithmic progression towards more and more gene therapies being approved.”[16] Part of the improvement is facilitated by moving FDA staff off COVID-specific problems and approvals. Another key pillar is facilitating enhanced manufacturing processes and protocols, which would accrue benefits to the bioprocessing industry. Progress is already palpable with Sarepta’s Duchenne Muscular Dystrophy garnering FDA approval despite a panel initially recommending otherwise.[17]

As 2022 drew to a close, there was a sudden realization across the industry that a) supply chains had finally normalized; and b) given the normalization of supply chains there was far too much consumable inventory in the system. Before the bioprocessing companies truly caught wind of this, the CDMOs and pharma/biotech customers had to sort out who would pay the bill for in-place commitments and future were revised and renegotiated. Understanding these dynamics made clear to us that it was difficult for the bioprocessors to get visibility into the trends as they stand today; however, triangulating with other industry reference points, it equally became clear that strong growth for the industry was truly a “when not if question.” We find such setups incredibly attractive given the obsession of most market participants with identifying the precise timing of an inflection. Importantly, several key forces align to suggest this inflection will take shape sooner rather than later. These include:

- A normalization of inventories and return to steady-state consumable purchases.
- Accelerating FDA approvals, breaking the COVID-induced slowdown, which has weighed on the last several years of activity. Approvals are running well ahead of 2022’s painfully slow pace, especially strong in biologics which have a more pronounced revenue impact for the bioprocessors.[18]
- Biologic prescription volumes troughed in the Summer of 2022 and now are accelerating comfortable into double-digit year-over-year growth. Importantly, prescription volumes translate nicely into accelerating volume needs, supporting consumables demand.
- Moving beyond COVID vaccine-related demand from challenging year-over-year comparables
- Rapid uptake of GLP-1 inhibitors which both drives increased investment needed to support demand and increased investment from competitive offerings (same targets, new formulations as well as additional targets) and Eli Lilly and Novo Nordisk investing their proceeds in novel areas. Plus, from a sentiment perspective the success of GLP-1 inhibitors hammers home how much meaningful change for humanity and investors alike comes from the biotech sector.

Breakthroughs during COVID in modalities like mRNA, with a clinical pipeline in the space that never would have happened otherwise, which will reach more mature and volume-demanding stages of the clinical development curve in the 2025-26 timeframe. In fact, several industry experts we spoke to think this cyclical downturn today might sow the stages for overly tight supplies as growth surges for consumables demand accompanying clinical maturation. The above explains our attraction to the bioprocessing space. Below let us point out the specific reasons why we centered our interest on Danaher in particular:

- History: Danaher has a long history of prudent capital allocation and this is an outstanding moment in time for acquisitions in the life sciences.
- Philosophy: centered around a unique and proven operating philosophy (DBS).
- Timeliness: Danaher will spin off the non-life science assets at the end of the third quarter and become a pure-play in the sector for the first time in its history. More importantly, Danaher is strategically integrating Pall and Cytiva for a unified go-to-market motion.

Valuation: Post Veralto spin, Danaher is trading for approximately 21x our view of normalized earnings, which is at a slight premium to a market multiple for a company that will grow at a far swifter pace, for a longer duration. Further, this 21x is understated given the high component of amortization in Danaher's reported earnings that stems from their acquisition-heavy strategy. Amortization alone adds up to about $1.90 hit to EPS, which would reduce the P/E ratio by upwards of 3 turns. In Danaher's case, we think EBITDA is a great proxy for true earnings power and free cash flow generation. If we stack up the last three full years of EBITDA (2020-2022) post-spin and after expensing corporate overhead, the company trades for an EV to average EBITDA of 18.38x. Essentially, when viewed through this prism, between normalized earnings power and looking past non-cash amortization, the business trades at a slightly below S&P earnings multiple for a much better quality and growth profile with an inevitable cyclical upturn looming ahead.

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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