Dear Friends and Clients,

We are pleased with the performance of our Rewey Asset Management (RAM) small and midcap strategy versus our benchmark of the Russell 2500 Value index for both 3Q20 and on a year-to-date basis. The Russell 2500 Value index returned 3.54% in 3Q20, and is down -18.39% year-to-date. [1,2]

Market Commentary

In the quarter, the Russell 2500 Value index started out strong, rising roughly 11.8% to its peak on August 11th. In our view, investors reacted positively to data showing a stronger than expected economic recovery with the lifting of Covid shutdowns and with news that the wave of infections in the South and West were lower than initially feared. However, in the 2nd half of the quarter, the Russell 2500 Value index sold off, falling roughly 7.9% from August 11th to quarter end. While there was no specific catalyst to change market sentiment, investors likely wrestled with the overall uncertainty that still loomed, including a slower rate of economic improvement, rising Covid infection rates in certain geographies domestically and globally, the lack of a second Covid stimulus bill from Congress, and the looming election that has the potential to not have a definitive result upon election day.

Our view on the markets has not changed. We see the economy continuing to improve as Covid treatments and vaccines advance, people get back to work, students get back to school and we all adjust to becoming productive in a post-Covid new normal. Employment trends have continued to improve steadily. October 1st reported continuing unemployment claims fell to 11.767 million and initial claims fell to 837 thousand. Both reports represent new lows post the mid-May peak of 25.68 million for continuing claims and the April peak of 6.6 million for initial claims. GDP estimates for 3Q20 in general continue to rise, with the Federal Reserve Bank of Atlanta estimating 32.0% Q/Q GDP growth as of Sept. 25th and the Conference Board's Sept. 9th estimate rising to 32.9%, resulting in a just a modest contraction of 3.8% for 2020 and a 3.1% gain for 2021.[3,4]

Don't Fight the Fed

We think much of 3Q20's sector results can be explained by the U.S. Federal Reserve's September 16th statement that indicated it expects to keep short-term rates at zero for the foreseeable future, and that it is willing to let inflation build to over its 2% threshold.[5] This statement negatively impacted the financial sector, which was one of the worst performing sectors in the quarter. Financials are negatively impacted by lower interest rates and a flat yield curve, as it lowers the interest rates they can charge on loans. At the current level of low rates, the normal offset of lower rates paid on savings is obviated due to most savings and checking rates being close to zero and unable to fall much further.

While the market seemed to focus on the lower rate impact from this Fed announcement, we think it under-reacted to the truly remarkable news that the Fed will now let inflation rise well over the prior boundary of 2%. In our view, if the Fed wants higher inflation, it will get higher inflation through its policy actions. While the U.S. CPI inflation proxy as of August was only 1.3%, we see signs of that inflation is accelerating already.[6] Propelled by lower rates that have lowered the cost of mortgages, as well as Covid-driven urban flight, U.S. new housing sales soared to over 1.1 million in August, the highest level since December 2006.[7] Random Lengths November Lumber futures have soared to over $600 per flat car from year-end 2019 levels of roughly $400 and March 2020 lows of $300.[8] Other commodities typically associated with inflation, including Gold, Copper and Iron Ore have also all soared in 2020, with Gold hitting a new all-time high of $2,062 per ounce in July.[9]

If the Fed Funds rate is held at zero while employment and GDP continue to improve, we see a high likelihood for surging inflation into 2021 and beyond. Recall, we are of the belief that the 2020 recession is a supply-driven shock, vs. a weak demand-driven recession. As we wrote in our August 24th Market Musing blog, we see the approval of a Covid vaccine as likely to serve as a catalyst for a surge in inflation, as the economy accelerates powered by low rates and stimulus actions. https://www.reweyassetmanagement.com/post/will-a-vaccine-deliver-inflation-as-well-as-immunity. If congress does act to pass a second stimulus bill, which is currently under active debate, we see this as adding fuel to the potential inflation fire.

In our view, our portfolio stands to benefit from higher inflation and eventual inflation-driven Fed rate increases. We have positioned our portfolio to help withstand and likely prosper from the return of inflation, through low exposure to highly leveraged balance sheets and through companies that can potentially prosper from pricing power. Over our three to five-year investment horizon, we see rising rates and the improving economy helping our financial holdings through better yields, spreads and credit outcomes. Further, we should benefit from our companies that can pass on higher prices, such as our lumber driven holdings Weyerhaeuser and Intefor, and our services driven holdings ABM Industries and Regis Corp.

Portfolio Highlights

We believe that our portfolio is very attractive from a valuation perspective. Six holdings are trading under book value, four additional holdings are trading at less than 1.5x book, and our composite portfolio is trading at an average of 1.83x book value.[10,11] It is also worth highlighting that three of our holdings have no sell-side coverage, and eight others have five or fewer covering analysts.[12] We believe this anonymity provides us with the opportunity to identify companies that pass under the radar for other investors, and help secure positions at attractive valuations.

At quarter-end, our cash level was at approximately 9.8%. Cash levels will fluctuate as part of our investment process, as we continue to be opportunistic to invest in new and existing positions and to harvest from those approaching our Assessed Fair Value (AFV) price targets.[13]

Lennar Corp. Class B shares (LEN/B) were the top contributor to results in the quarter. Shares rallied on the growing momentum in single family home sales in the U.S., driven by low interest rates, a recovering economy, and a new wave of urban flight to the suburbs from city centers. Housing, unlike other cyclical sectors like autos, has yet to fully recover from the 2007-2009 financial crisis, as the rate of U.S. Annual Housing Starts has not surpassed the 1.4 million estimated average trend mark since 2006. U.S. home sales climbed to a 1.01 million level in August 2020, the highest monthly rate since 2006. We believe Lennar is poised to benefit from stronger housing levels, due to its balanced production initiatives, its digital sales and marketing initiatives and its balance sheet strengthening over the last few years. On October 1st, LEN raised its dividend 50% to a $1.00 annual rate, signaling its views on financial and market strength looking forward. We remind investors that our LEN/B shares trade at a significant discount to LEN class A shares (with B shares closing the quarter at $65.66 vs. $81.68 for the A shares), even though the B shares have a 10-1 voting advantage versus the A shares. We do not believe this price disparity makes sense, even considering lower liquidity of the B share class. At some point, Stuart Miller, the chairman and former CEO of Lennar who controls 57.83% of the B class, will likely opt to convert his holdings to A shares, which he can do at any time, to capture the pricing disparity.[14,15]

II-VI Corp. (IIVI) was the greatest detractor to returns in the quarter. II-VI sold off on concerns of revenue exposure to the Chinese company Huawei as the U.S. Commerce Department placed new restrictions on sales to the company, and due to fears of weaker U.S. carrier spending. While the Huawei restrictions will likely trim revenues a few percentage points beginning in 4Q20, we think IIVI can reallocate its capacity to other customers to mitigate this impact over time. Further, in a mid-September sell-side investor conference, IIVI said that it had seen no signs of weaker carrier spending, indicating that in their view the concerns raised by Ciena Corp. are likely overstated or company specific. We see numerous opportunities for IIVI to deliver strong growth over the next few years in the exciting emerging sectors of 100G and 400G data center communication equipment, 3D sensing for cell phones, cars and internet of things (IOT) applications, 5G rollout globally and Silicon Carbide wafer adoption.[16]

Regis Corporation (RGS)

We took advantage of the dramatic sell off in shares of Regis Corp. (RGS) over 2020 to establish a position in the in global leader of beauty salons/hair cut salons. Based in Edina, Minnesota, Regis has 6,923 locations worldwide that it owns or franchises. The Company offers haircare services such as haircuts, styling, coloring, as well as haircare products. Regis corporate and franchised locations operate under concepts such as Supercuts, SmartStyle, MasterCuts, Regis Salons, Sassoon Salon, Cost Cutters and First Choice Haircutters. Additionally, Regis also maintains ownership interests in the Empire Education Group, which trains stylists. Regis has a very strong, but potentially misunderstood balance sheet, a strong outlook for growth post the completion of its refranchising program over the next 12-months and a compelling upside opportunity to our AFV price target of $12, vs. its 3Q20 closing price of $6.14 and its 52-week high of $23.27.

Regis has an extremely strong balance sheet, ample liquidity and solid cash flow. As of 6/30/2020, Regis had $113.6 million in cash compared to $177.5 million in debt, for minimal net debt of $64 million. All of its debt is on its $295 million in capacity revolving credit facility, which was just extended to March 2023. We believe there is significant neglect and misunderstanding about the strength of RGS balance sheet due to the addition of lease assets to its balance sheet under FASB's rule ASU 2016-02 and the adopted standard ASC 842 on 7/1/19 (start of FY20). Essentially, this change added $933 million in lease liabilities to its balance sheet, which is now picked up as debt by quantitative services such as Bloomberg. Thus, investors using screens may erroneously conclude that RGS is very levered. This lease expense will run through RGS income statement over time with normal operations, and thus it would be erroneous double counting, in our opinion, to deduct the full impact of this lease expense from RGS enterprise value, without some adjustment back of future lease expenses. RGS shareholder equity at 6/30/20 was $127.5 million or $3.49 per share, for a modest Price to Book ratio of 1.76x.

We see a strong path to growth for Regis, as it is transforming to an asset light, franchise store ownership base, from which it should be able to grow locations with minimal capital intensity. In the short-term, RGS should see a rapid recovery in sales and earnings as the Covid lock-down orders are lifted. As of 6/30/20, RGS had re-opened approximately 80% of its stores, with California representing roughly another 9% of locations to be opened in calendar 3Q20. The balance are stores that RGS had marked to close permanently as part of its restructuring program. RGS operates in a normally consistent market of hair cutting and styling. The Covid disruption is unlike past recessionary periods where haircut demand was not heavily impacted. Covid lockdown mandates prevented RGS salons from operating. We strongly believe that as salons reopen demand will return quickly to this recurring-need business. Further, as is our belief that the U.S. Fed will succeed over time in driving inflation higher, RGS has an enviable business model of consistent demand and pricing power for its services. RGS should be able to pass on higher incurred costs of inflation, as haircuts are priced as the service is delivered.

At 6/30/20 (its FY20 year-end) Regis had 6,923 system-wide locations, 5,209 of which were franchised. RGS indicated that by June 2021, it would franchise another 800-1000 locations, and close the balance as underperformers at the end of their lease term, resulting in a fully franchised, capital light operating profile. RGS will collect a franchise fee of 5.5% of total revenues from its franchises, and collect another 5% of revenues used for group advertising and marketing on behalf of all RGS locations. Regis does not disclose a market share estimate for its stores, but does acknowledge its total share of the sector is under 10%. We see room for ample franchisee location growth, as all of RGS newer franchise agreements have incentives that mandate franchisees to open new locations. Regis also has the opportunity itself to acquire smaller rival chains over time. Further, Regis sees opportunities for growth post the impact of the Covid crisis. RGS believes many independent shops and smaller chains may have gone out of business, allowing a share gain opportunity. We also see an incremental growth driver from RGS newly launched digital initiatives. In its FY20 (6/30) Regis launched its Open Salon Pro mobile device enabled check-in, 3-day prior reservation system, and loyalty programs which should help it stay connected to its customers and represent a platform to build on for future communication and marketing initiatives to increase repeat visits. Additionally, Regis sees strong upside potential to increase its private label (Designline) and third-party product sales (Paul Mitchell, Biolage, Redken) through its salons, as less than 10% of visits now are accompanied by a purchase of product.

Regis is positioned to leverage its revenue growth with margin gains from expense reductions. In addition to reducing its expenses at the corporate level to match its fully franchised footprint, RGS should benefit from its Covid driven lock down expense actions. At the peak of the lockdown, RGS furloughed 85% of employees, reduced salaries on the remaining 15% of employees and significantly cut discretionary expenses. As such, RGS has effectively zero-based its expense structure at an opportune time as it restructures to its fully franchised model. As RGS recovers out of the crisis, it will likely add back only the costs that make sense under its new model and thus more quickly achieve a balanced expense framework.

We have set our AFV price target for RGS at $12.00, almost 100% up from its June 30th closing level. This target is just under 9x our estimate of FY22 (June) EBITDA, which assumes a completion of the franchise efforts in FY21. We note our margin estimates for FY22 are roughly 500 basis points under the 'as-if' look of franchise profitability RGS has provided to investors, due to our conservatism around the pace of Covid recovery and expense reduction progress. As such, there is the potential for significant upside to our estimates as AFV price target. We think the investment community has become overly pessimistic on shares of RGS due to the lower profitability of RGS in FY20 and FY21 due to Covid lockdowns, while ignoring the significant positives of refranchising, digital investment, growth opportunities, pricing power and balance sheet strength for this recurring revenue business model, that stand as long-term drivers over and above the expected short-term benefits of post-Covid salon reopenings.[17]

Looking Forward

We are optimistic that the economy and the market can continue to advance in FY4Q and into 2021. While many pundits have developed a negative call on the market due to 'slowing second derivative gains,' we think this view is misguided, as gains measured in percent will of course mathematically slow post the 'V' shaped recovery we have had, but that absolute gains should continue. While small and mid-cap value stocks have lagged the broader averages in this recovery, it is our view that the performance of this group will move to a leadership position as the economy fully opens. As inflation grows to even moderate levels, as is targeted by the U.S. Fed, the smaller cap value space should stand to benefit greatly. The financial sector benefits from higher rates, spreads and credit quality. Cyclicals benefit from strong demand and pricing power. Services should gain from full utilization and the ability to raise prices to offset inflation. This is in strong contrast to the risk we see in larger cap growth names that in our opinion have been propelled too far by momentum and quantitative models that likely have erroneously assumed lower interest rates for all periods of their long-term discounted cash flow (DCF) models. As the Wall Street Journal points out, there seems to be complacency in the markets as "professional investors expect inflation to average just 1.6% over the next decade."[18] We discuss this topic in detail in our Market Musing blog "Time For A Value Add" https://www.reweyassetmanagement.com/post/it-s-time-for-a-value-add.

While we cannot definitively say when a rotation might take-hold in earnest, we think the signs are clearly in place for this move to happen on the early side our 3 to 5-year investment horizon. It is our view that investors should begin to rotate their holdings to the smaller cap sector now, before they are forced to chase the investor herd once the trend becomes established. Acquiring stocks in line with our philosophy of a foundation of financial strength, the ability to grow and a discounted valuation, allow us to invest with confidence and conviction, and ahead of the herd.

Thank you for your continued trust and support. Stay safe and healthy. Please do not hesitate to contact us for client service, to discuss our commentary or to simply opine on the market and stocks.

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1 ASN prohibits advertising of strategy returns to non-clients. Please contact us to discuss in more detail.

2 Russell 2500 Value, Core and Growth Index performance levels are sourced from Bloomberg. The Russell 2500 Value index is a unmanaged group of securities considered to be representative of the small and mid-cap stock market in general. Indexes are unmanaged and do not incur management fees, costs, or expenses. It is not possible to invest directly in an index.

3 US Initial Jobless Claims and Continuing Claims data sourced from U.S. Department of Labor.

4 US GDP actual statistics sourced from Bureau of Economic Analysis. US GDP forecasts from Federal Reserve Bank of Atlanta GDPNow as of 9/25/20 https://www.frbatlanta.org/. Conference Board estimates from public website https://conference-board.org/research/us-forecast.

5 U.S. Federal Reserve 9/16/20 statement https://www.federalreserve.gov/newsevents/pressreleases/monetary20200916a.htm

6 U.S. CPI data sourced from the Bureau of Labor Statistics

7,14 U.S. Single Family Housing Sales data from U.S. Census Bureau.
8 Random Lengths Lumber Futures as quoted on the Chicago Mercantile Exchange, reported by Bloomberg.
9 Gold, Copper and Iron Ore prices quoted from Bloomberg.
10,13 All portfolio discussion is based off our model portfolio. Company financial estimates sourced from Rewey Asset Management proprietary analysis, and Bloomberg BEST company estimates. Historical pricing and company financial data sourced from company 10Q and 10K filings, and Bloomberg. Individual portfolios may hold slight deviations in position sizes and names held.
11 Book value portfolio estimates exclude Insperity Inc. and Graftech International, due to negative equity positions.
12 Covering active sell-side analyst data sourced from Bloomberg.
15 Lennar RAM return information derived from Black Diamond/ASN performance reports. Lennar and Lennar Class B share pricing from Bloomberg. Lennar B share class details derived from Lennar annual proxy and Bloomberg. Stuart Miller Lennar B holding info. Derived from U.S. SEC Form 4 and Bloomberg. Other Lennar corporate and financial information, including dividend announcement information from LEN 10-Q, 10-K filings, company press releases, company presentation materials and Rewey Asset Management proprietary analysis.
16 II-VI RAM return information sourced from Black Diamond/ASN performance reports. Other II-VI commentary sourced from company 10Q, 10K filings and company presentations and Rewey Asset Management proprietary analysis.
17 All financial ratios, statistics, and projections discussed in the Regis Corp. (RGS) commentary are sourced from WBS's 10-K and 10Q filings, company press releases, company public conference calls and webcasts, company slide presentations, Regis company webpage, and Rewey Asset Management proprietary financial analysis. Historical share price information sourced from Bloomberg.
18 Wall Street Journal article 10/2/20 "How to Avoid Paying the Cruelest Tax: Inflation"