Lateef Investment Management

Third Quarter 2018 Commentary

Multi-Cap Growth Equity

The U.S. equity markets performed strongly in the third quarter. Despite political drama, upcoming mid-term elections, continued international trade skirmishes and a hurricane, the U.S. economy continues to grow. Various leading economic indicators remain strong. Second quarter gross domestic product (GDP) grew 4.2%, August unemployment and consumer price index (a measure of inflation) were 3.9% and 2.7%, respectively. These metrics point to a dynamic and growing economy.

With this constructive backdrop, the S&P 500 returned 7.71% for the third quarter and 10.56% year to date. The Lateef Non-Taxable Multi-Cap Growth Equity Composite returned 8.36% for the quarter and 12.07% year to date (*net of fees*).

While the current economic expansion has reached ten years, we remind our clients that up to now, the U.S. recovery has been tepid. We still see many opportunities, particularly as we focus on individual opportunities within our portfolio that are still in the early stages of their growth cycle.

Portfolio Activity

During the third quarter, we were active in funding four new investments: **Facebook**, **Starbucks**, **The New York Time**s and **Arconic**. We often find opportunities when short-term concerns send stock prices down. In assessing these issues, we consider whether an enterprise's competitive advantage remains intact, whether management's stewardship can enable them to overcome prevailing challenges and whether their products and services continue to delight their customers. If these conditions are satisfied, we may invest. Occasionally, we find that the market is too focused on short-term issues and misses the real changes that point to a new growth cycle for these companies.

First, we repurchased **Facebook (FB)**. As you may recall, we originally purchased shares of Facebook in 2015 and sold our position during the first quarter of 2018. We were concerned that the market did not adequately account for the higher spending Facebook would need to undertake to combat the onslaught of bad actors manipulating Facebook's sites. We also believed that Facebook was at risk of losing their users' trust, which would ultimately erode the company's ability to grow.

During Facebook's second quarter earnings report, the company showed that user engagement and revenues continue to grow at an attractive pace. More importantly, management announced a significant increase in spending to better police and prevent abuses of their sites. Investors were caught off guard, sending Facebook's stock down by ~20% eliminating $120B in market value.

Higher spending will not guarantee that bad actors won't be successful in manipulating Facebook's products, but we nevertheless view management's commitment to spend whatever they need to address the integrity of their products as a positive step. With expectations adequately reset and Facebook's core growth metrics still strong, we took a fresh look at the company and ultimately re-initiated a position. As we look out over the next several years, we think Facebook still has many opportunities to grow. One metric we closely monitor is Facebook's average revenue per user (ARPU) by region.

As of the second quarter, Facebook had close to 1.5 billion daily active users. Of this total, approximately 185 million were in the U.S. and Canada, 280 million in Europe, 550 million in Asia Pacific and 460 million in the rest of the world (ROW).

Facebook's 2nd quarter ARPU are approximately:[1]

	ARPU	Y/Y Growth
U.S. & Canada	$25.4	34%
Europe	$8.6	39%
Asia Pacific	$2.6	23%
Rest of World	$1.9	29%
Average	$5.9	27%

We believe that Facebook will continue to grow ARPU in the U.S. & Canada, but the real opportunity comes from the maturation of advertising markets (specifically online and mobile) in Facebook's other geographies. For instance, if (when) Asia Pacific and Rest of World markets grow to $8 a quarter, then this will generate $32 billion in revenues versus Facebook's current total revenues of approximately $55 billion for 2018. We think it'll take some time for Facebook to work through their regulatory hearings and many investors will take a wait-and-see approach, but over the medium to long-term, we think Facebook's prospects are still attractive.

The second stock we purchased was **Starbucks (SBUX)**. We had previously owned shares in Starbucks and have always kept the stock on our watch list. Despite being founded in 1971, Starbucks is still primarily a North American company with over 70% of their revenues derived from the Americas region. Other global brands like McDonald's and Coca-Cola generate over half of their revenues from outside the Americas.

Over the past year, Starbucks made two strategic decisions that caught our attention. First, Starbucks developed a partnership with Nestle whereby Nestle will pay Starbucks over $7 billion for the right to sell Starbucks branded consumer packaged goods in over 190 countries outside of the U.S. Nestle will purchase coffee beans from Starbucks and pay Starbucks a royalty on these retail sales. We believe this arrangement accelerates the growth of Starbucks' consumer packaged goods internationally and does so in a manner that is not capital intensive, which combined will improve the company's return on invested capital.

The second development is Starbucks' commitment to accelerating their café and restaurant development in China. Currently, the middle class population in China is over 300 million and this is expected to double to over 600 million by 2022. China's per capital coffee consumption is only 0.4 cups per year compared to more than 300 cups consumed in the U.S.[2] Importantly, management understands that a simple U.S. export is not going to work. As such, they are being very sensitive in China and developing local drinks and menu items to cater to local tastes. We think the opportunity in China and greater Asia is quite significant. Starbucks' China & Asia Pacific segment currently represent about 17% of total operating profits. We expect this segment to grow meaningfully over the next five years.

Starbucks is attractively priced because of the slowdown in their North America afternoon business. There are many theories as to why this is the case. Some believe that low unemployment means that there are fewer customers visiting Starbucks in the afternoon. Others believe that there is less demand for high calorie Frappuccino drinks. We think Starbucks is experimenting with ways to spur afternoon traffic and are confident that the company will introduce solutions to address this issue. We view that the market's expectations for North American same-store growth have come down sufficiently to a realistic target.

As we wait for this segment to turn around, we are comforted by management's capital allocation decisions. The company pays close to a 3% dividend and has committed to repurchase $25 billion of shares, or roughly 30% of the company's current market cap, over the next three years. Further, Starbucks is still growing new stores in the Americas at 5% per year, as regions in the Southern parts of the U.S. are still underpenetrated by Starbucks. We believe investors are paying close attention to Starbuck's U.S. afternoon traffic but are not focusing on the company's new U.S.

[1] Source: Facebook 2Q 2018 Investor Presentation

[2] Source: Starbucks May 2018 China Investor Day

store growth and international opportunities, which we believe are very much in the early stages of growth.

The next stock we purchased was **The New York Times (NYT)**. Despite the storied history since the company's founding in 1851, technology disrupted the newspaper industry's business model and forced The New York Times to deal with an existential crisis. If The New York Times didn't change, then print subscriptions and advertising revenues would continue to decline, leading to cuts in their writing and editorial staff. This would ultimately hollow out the quality of their product, questioning their vitality as a national "newspaper of record".

In 2013, The New York Times engaged in a soul searching deep-dive study on their own paper and industry. By the end of this project, they had a deeper sense of the opportunities and roadblocks that they needed to overcome in order to survive and produce news "without fear or favor" for the next generation of readers and stakeholders. The New York Times committed to take the necessary steps to become a digital-first newsroom in every sense. They needed to change over 150 years of print centric processes and evolve into a digital and social media centric news organization. This would not be easy.

By 2018, The New York Times had reached an important inflection point. Today, the paper has 3.8 million total subscribers. Importantly, 2.9 million of these are digital-only subscribers. Their digital subscribers generate enough revenue to pay for all of their expenses. Thus, each incremental digital subscriber generates high incremental margins for the company as there is no physical paper to print and deliver. While this milestone took a lot of work, we believe the NYT is not stopping here. Our analysis suggests that their addressable market is quite large and the company's goal of 10 million digital-only subscribers is achievable. As a national and international news organization, The New York Times generates over 100 mm monthly unique online visitors. We suspect that in five years, the number of digital subscribers will be much larger than today.

As an aside, in addition to their core business inflecting positively, The New York Times also has some very important assets. In 2008, they entered into a sale lease back of a portion of their iconic building in Midtown Manhattan; this transaction contained a unique embedded option for The New York Times to repurchase the real estate for $250 million in 2019.

During those uncertain times, this transaction enabled the company to strengthen their balance sheet in case the economic situation deteriorated further. Recently, the company has announced its intent to exercise its right to repurchase this building in 2019. As part of their digital-first strategy, The New York Times will actually occupy much less space in their building and will generate rental income from floors they own but don't use.

We've analyzed several scenarios of how much a Midtown Class A office building with over 950,000 square feet is worth. Our analysis suggests that their building could be worth approximately $2.0 billion. Net of the cash needed to repurchase this building, the company would have over $250 million in net cash on its balance sheet. The New York Times' current market capitalization is about $3.7B or $23 per share. Their building and cash are worth about $13.50 per share. The company should earn about $1.00 per share in 2019. We are encouraged by The New York Time's growth prospects and believe we've purchased the stock at an attractive value.

The final stock we purchased was **Arconic (ARNC)**, a leading manufacturer of engineered parts for aerospace, transportation, construction, oil and gas, and industrial gas turbine markets. Demand for highly engineered aerospace products is one of the strongest end markets we've been able to identify over the next several years.

Arconic was separated from Alcoa in 2016 so that each company could better focus on their core businesses. We believe that Arconic operates in a consolidated industry with only a handful of competitors and high barriers to entry for its core aerospace business. It would require a lot of capital, time and engineering expertise to build a new high precision fabrication plant, sign multi-year contracts and deliver on those promises.

Despite the potential opportunities from their spin from Alcoa, Arconic was plagued by poor execution and even worse bolt-on acquisitions. Not surprisingly, over the past year, Arconic's Board of Directors has installed new management who have significant aerospace and manufacturing expertise. We believe the company is making progress on improving employee morale and executing for customers. One of the most interesting aspects about Arconic is that the company is currently running at near-full capacity while still having additional multi-year runway and sales continue to grow at an attractive rate. They have the ability to control their outcome with better processes. We view the swirling buyout interest as a confirmation to the fundamental value and growth potential of the business.

In order to fund these new investments, we sold our positions in **Synchrony Financial**, **Allergan**, and a few small positions that we received from corporate spin-offs from existing holdings.[3] Synchrony lost their largest customer, Walmart, and we are concerned that upcoming renewals will be less economical given heightened competition. Allergan has been a difficult stock for us. Our thesis generally played out, but the stock hasn't fully recovered from our initial purchase price. At this point, we think there are more headwinds than opportunities and fewer levers for growth, so we decided to move on.

Looking Forward

We are happy to announce that we've moved from our Greenbrae, CA office to a new space in San Rafael, CA just a few minutes away. Over the past several months, we had the opportunity to build out an office better suited for our employees, business, and client service needs. Please visit us if you are in the bay area! We'll take you to Starbucks in the afternoon and get you started on a New York Times digital subscription.

Our new address is:
Lateef Investment Management
1000 4th Street, Suite 800
San Rafael, CA 94901.

All other contact information remains the same.

As we look toward the end of 2018 and into 2019, we are comforted that our portfolio of companies operate healthy businesses in growing industries. We believe that in most cases, our companies are leaders in their field. Whether it's Facebook and Starbucks, who are just beginning to meaningfully grow outside the United States, or our positions in payments and 5G-related companies (please see 1Q 2018 letter), we have assembled a highly curated portfolio of unique companies whose fundamentals are improving and with whom we should enjoy many years of compounding.

If you have any questions, please contact us at (415) 461-3800. For additional insight into your portfolio, our Q3 2018 Update is available at www.lateef.com.

Sincerely,

Quoc K. Tran
Chief Investment Officer

Eric A. Winterhalter
Chief Operating Officer

~ Celebrating Over 40 Years of Exceptional Results in Investment Management ~

[3] Perspecta (spin from DXC Technology) and Delphi Technologies (spin from Delphi Automotive / Aptiv).

Disclosures

Performance is provided as supplemental information. Performance results reflect all income, gains and losses and the reinvestment of interest and other income. All rates of return are reported "NET" of fees. Additional information regarding the policies for calculating and reporting returns is available upon request. A complete listing and description of all Lateef composites and performance results is available upon request.

The 1-year, 5-year and 10-year net of fees returns of the Non-Taxable Multi-Cap Growth Equity Composite as of September 28, 2018 are 16.53, 9.46 and 10.26 respectively. The 1-year, 5-year and 10-year returns of the S&P 500® Index as of September 28, 2018 are 17.91, 13.95and 11.97 respectively. The 1-year, 5-year and 10-year returns of the Russell 1000® as of September 28, 2018 are 17.76, 13.67 and 12.09 respectively. 5-year and 10-year performance figures are annualized.

The S&P 500® and Russell 1000® are unmanaged stock market indices and are not available for direct investment. The S&P 500® Index represents the stocks of 500 leading U.S. publicly-traded companies from a broad range of industries. The Russell 1000® Index is an unmanaged index that measures the performance of the largest 1,000 companies in the Russell 3000® Index. This unmanaged index represents the universe of large capitalization stocks from which most active money managers typically select. The performance of an unmanaged index reflects no deductions for fees, expenses or taxes which would affect performance of actively managed assets. The volatility of the S&P 500® and Russell 1000® Indices may be greater or less than the volatility of the portfolios in the composite.

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The most recent ADV Part 2 can be found at www.lateef.com or by calling (415) 461-3800.