TRAN CAPITAL MANAGEMENT

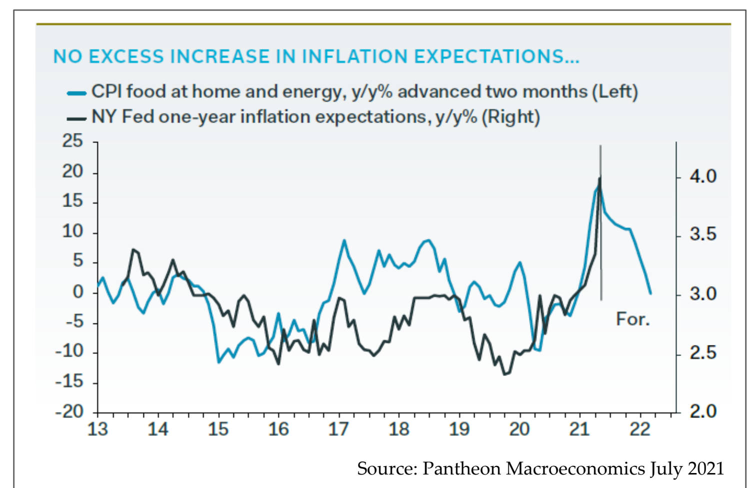
Multi-Cap Growth Equity | Second Quarter 2021

Dear Clients,

We hope you are enjoying your summer. What a remarkable time we live in. A year ago, we were in the depths of a COVID-19 induced global shut down. Today, approximately 55% of the U.S. and nearly 70% of adults have received at least one vaccine, consumers are traveling, and businesses are enjoying a much-needed resurgence. There are certainly mismatches in supply and demand on the labor front. The pace of vaccination caught many industries off guard. Over the past few months, many businesses, including airlines, restaurants, and other service industries had to curtail their services due to a shortage in labor. Who could have predicted this just one year ago?

Although our performance on both an absolute and relative basis has been strong, we are not resting on these results. We avoid guessing what the market will do over the short term and instead take the longer view that our portfolio companies will continue to grow their businesses and thus generate shareholder value over time. We believe that many of our investments' competitive positions strengthened over the past few years, especially as their services became essential during uncertain times. As a result, over the past year, we harvested some of our long-held positions that appreciated towards our estimate of fair value and rotated into what we believe to be more attractive opportunities.

Despite our path towards recovery, there remain concerns in the market over the severity of new COVID-19 variants, inflation, supply chain bottlenecks, the timing of the Federal Reserve tapering, and tightening monetary policy. Further data could change our view, but as of now, we feel that inflation is real but transitory. In fact, we may be experiencing peak inflationary pressures today that, by the fall, could subside to more manageable levels. We anticipate some easing in labor shortage as extended unemployment benefits expire in September and higher wages attract workers. Moreover, technology can be a powerful deflationary force. Advancements in communication tools like Zoom and Microsoft Teams, telemedicine, and flexible working arrangements have increased productivity and lowered expenses. We also expect that while fiscal policy will be less accommodative next year, economic growth will still be above long-term trends. U.S. consumers, who make up 68% of GDP, have accumulated over $2.5 trillion in excess savings since the start of the pandemic, which is positive for continued strength in consumer spending.



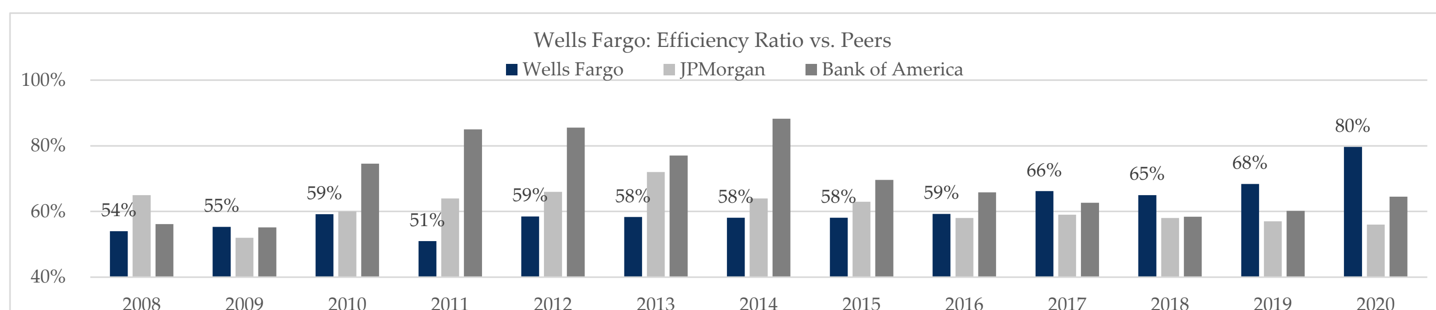
Source: Pantheon Macroeconomics July 2021

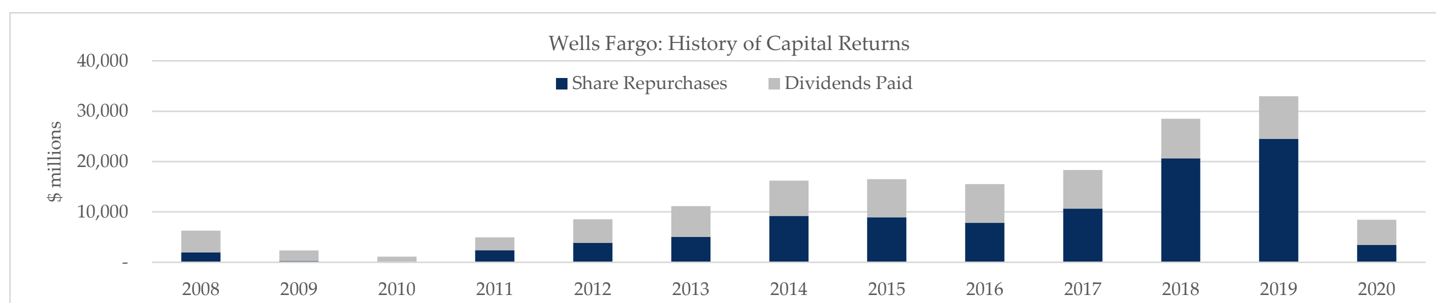
With strong economic activity and profit growth, our **Multi-Cap strategy returned 9.34%, net of fees, vs. the S&P 500's return of 8.55% during the second quarter. This brings our Multi-Cap strategy's first half return to 14.97%, net of fees, vs. the S&P 500's return of 15.25%.** Over the past three years, our Multi-Cap strategy has returned 20.88% per year, net of fees, compared to the S&P 500's annual return of 18.67%.

We are encouraged by the opportunities we see for our portfolio companies. For instance, we initiated a position in **Wells Fargo (WFC)** in November 2020 at around $22.50 per share. Despite the stock price doubling since our initial purchase, our thesis is only just starting to develop. We believe that the new management team's focus on addressing the company's past aggressive sales practices will lead to a relaxation of the $1.95 trillion asset cap that was imposed by the Fed and ultimately resume the company's growth trajectory. Further, the right sizing of the company by reducing costs and the redeployment of excess capital could mean elevated returns of capital to shareholders over the next few years.

Specifically, Wells Fargo's efficiency ratio (a measure of non-interest expense to revenue) was 68% in 2019 and 80% in 2020 compared to bank peers such as JPMorgan and Bank of America that have efficiency ratios in the mid-50 to mid-60s. We see no structural reason why Wells Fargo cannot approach peer averages over the next 3-4 years. Additionally, after the Fed's most recent June bank stress test, Wells Fargo announced an $18 billion share buyback program for the next 12 months, or roughly 10% of its entire market cap. We believe that this is only the beginning. Finally, we believe Wells Fargo can return to growth as the country reopens. Loan growth has been muted over the past few years because of the company's focus on fixing the risk management and governance issues that led to the Fed's asset cap. We believe the company is now on the verge of refocusing on serving customers and returning to growth. Our analysis has Wells Fargo earning $5 to $7 per share in 4-5 years. At roughly $45 per share today, we think there is high upside in Wells Fargo.

Another investment that we would like to highlight is **Palo Alto Networks (PANW)**. Cybersecurity remains top of mind for leaders in every industry. The SolarWinds breach of 2020 was one of the largest breaches in history with over 200 organizations around the world, including several U.S. state agencies such as the Treasury and Commerce Departments, impacted. Palo Alto has positioned itself to benefit from the shift from hardware firewalls to software as companies move from on-premise data centers to cloud and hybrid environments. As businesses move to hybrid architectures, they need robust policies and protection for their own data centers as well as their cloud environments. Palo Alto is a leading provider of on-premise network security and has one of the broadest sets of cloud-based security offerings in the market. We originally initiated our position in Palo Alto in December 2019 and our analysis suggests that the company's competitive position is stronger now than at the time of our original investment. Moreover, we believe the company's valuation remains attractive. At today's levels, Palo Alto is selling at a 4% free cash flow yield. With the company's next-generation security offerings





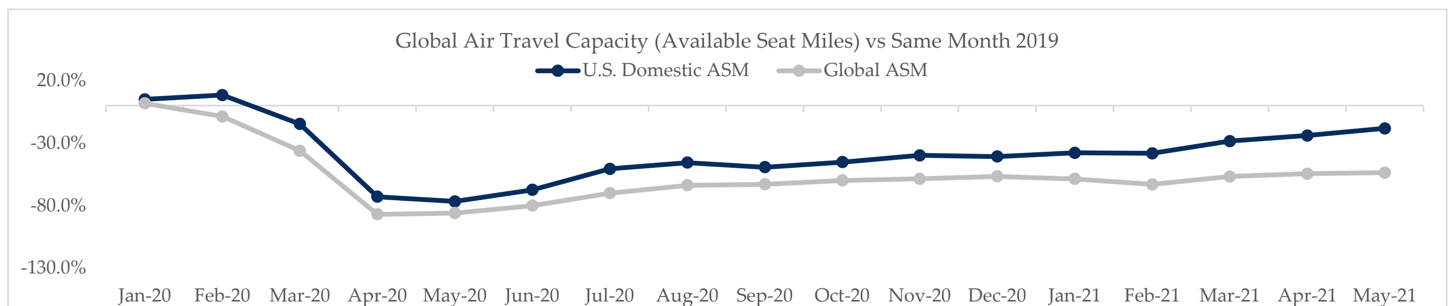
Source: Company Filings

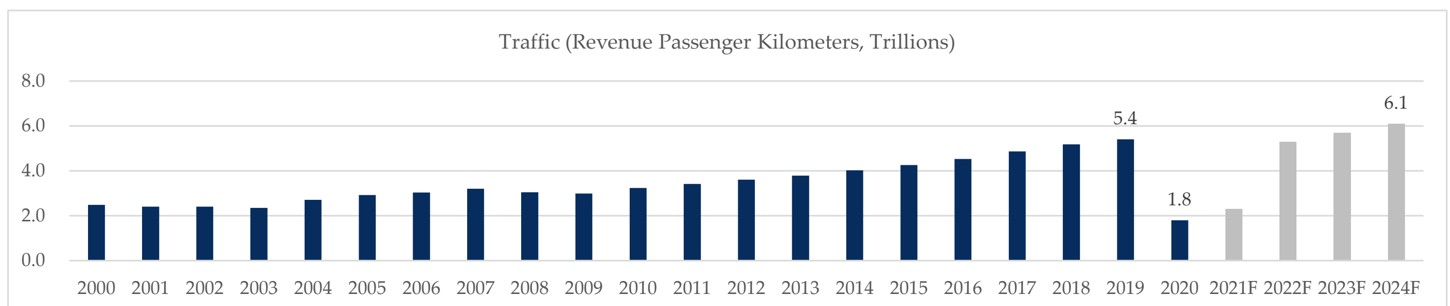
growing annual recurring revenues at over 77% per annum, our analysis indicates that Palo Alto's overall earnings and free cash flow growth will reach the mid-teens to 20% range over the next 3-5 years.

As the world recovers from the pandemic, businesses are reopening. Perhaps one of the most noteworthy areas is the airline industry. In the second quarter of 2020, global air travel capacity declined over 80%. Airlines reduced schedules, furloughed employees, and applied for emergency assistance from the government. Today, passenger traffic is quickly returning to pre-pandemic levels. We have two investments that should benefit as air travel continues to recover. In addition to **Southwest Airlines (LUV)**, which we have discussed in past letters, we initiated a position in **AerCap Holdings (AER)**, a leading aircraft financing company.

Based in Ireland, AerCap has been a leader in the aircraft leasing industry for decades. AerCap purchases new aircrafts in bulk from Boeing and Airbus before leasing those planes to airline operators around the world that have less attractive access to financing. Given its strong operating history, AerCap's cost of capital is lower than that of its customers, enabling the company to earn a spread on its leases. Therefore, AerCap can help airline customers reduce balance sheet intensity through leasing and generate an attractive economic profit for shareholders. The pandemic made this value proposition even stronger as airlines sought to reduce their cash burn. Looking ahead, we believe more airlines will choose financing over purchasing. Additionally, during the first quarter, AerCap announced its intention to purchase GE's aircraft leasing business, GECAS. We view this as a once in a generation opportunity that will make AerCap the largest player globally in aircraft leasing. Our analysis indicates that AerCap is purchasing GE's assets at a discount to book value and that the company has identified significant cost savings from combining the two companies. We believe AerCap's revenues and earnings will accelerate over the near term and will emerge with even more benefits of scale. This growth opportunity seems underappreciated as the stock is currently selling at under 7.5x next year's earnings.

As we think about the outlook for our portfolio over the next three to five years, we would note that all of our portfolio companies provide essential services that lead to repeatable business, enjoy the benefits of secular tailwinds, and are led by management teams with strong track records of superior capital allocation. We also built a portfolio with attractive absolute and relative characteristics to the market. Our portfolio has a smaller weighted average market cap than the S&P 500, generates a higher return on equity (a measure of quality and capital efficiency), and grows earnings faster than the market. We look forward to many more years of compounding value for our clients. Thank you for your support and we look forward to our next conversation.





Source: IATA & TCM Estimates

Sincerely,

Quoc K. Tran	Eric A. Winterhalter
Chairman & CIO	*President*

Important Disclosures

Past performance is not indicative of future results. The actual return and value of an account will fluctuate and at any point in time could be worth more or less than the amount initially invested.

Performance is provided as supplemental information and is based on the Non-Taxable Multi-Cap Growth Equity Composite. 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 TCM composites and performance results is available upon request.

The 1-year, 3-year, 5-year and 10-year net of fees returns of the Non-Taxable Multi-Cap Growth Equity Composite as of June 30, 2021 are 52.49, 20.88, 17.33 and 13.02 respectively. The 1-year, 3-year, 5-year and 10-year returns of the S&P 500® Index as of June 30, 2021 are 40.79, 18.67, 17.65 and 14.84 respectively. 3-year, 5-year and 10-year performance figures are annualized.

The S&P 500® is an unmanaged stock market index and is 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 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® Index may be greater or less than the volatility of the portfolios in the composite. One cannot invest directly in an Index.

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