TRAN CAPITAL MANAGEMENT

Partners Strategy | First Quarter 2024

Dear Clients and Friends,

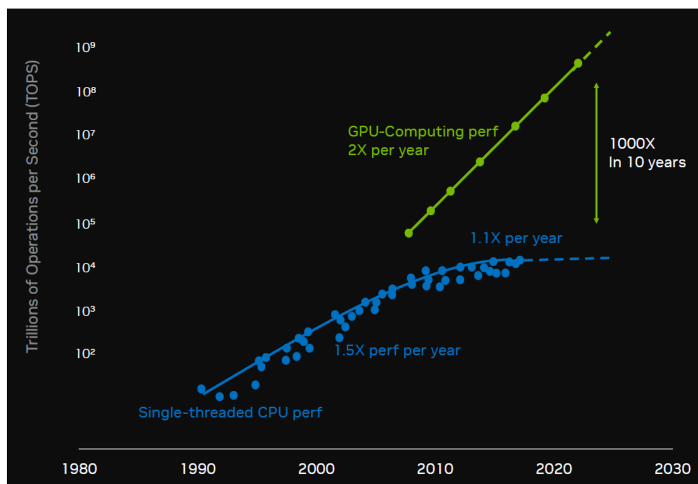
We hope you and your family are well. The stock market's strength from the end of last year continued into the first quarter of 2024 with the S&P 500 returning 10.56%.[1] Our Partners Strategy returned 9.09%, net of fees, in the quarter. Recall that in 2023, the S&P 500 was up 26% with the *Magnificent Seven* (Apple, Microsoft, Alphabet, Amazon, NVIDIA, Meta, and Tesla) contributing 82% of the market's total return. Unlike last year, some of the *Magnificent Seven* underperformed this quarter. For instance, Apple declined -11% while Tesla declined -29%. On the other hand, NVIDIA continued its impressive rally with shares appreciating by another 82% during the first quarter, which alone drove 30% of the S&P 500's first quarter return.

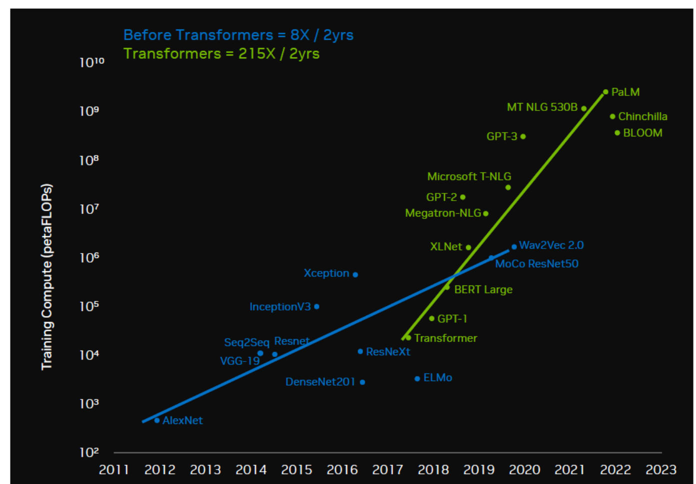
We are seeing signs that the market is broadening out, which we believe is a healthy development. There are many high-quality growth companies that have not yet been recognized, and we are focusing our research efforts to find new opportunities in companies that have yet to re-rate. As these companies continue to execute their growth plans, we believe their intrinsic value will grow to the benefit of long-term shareholders.

Computing's Next Wave

One of the most exciting themes over the past year has been the growth of generative artificial intelligence (GenAI). We may be at the tipping point of computing's next wave. Advances in semiconductors and software tools have enabled the scaling of large language models (LLMs) at incredible rates, with compute used to train LLMs doubling every six months. We have been building our exposure to GenAI over the past year and believe that **40% of our portfolio is positioned to benefit from the growth of GenAI**. We broadly classify our portfolio companies with GenAI exposure into 3 categories: <u>Infrastructure & Hardware</u>, <u>AI & Generative Models</u>, and <u>Applications & Services</u>.

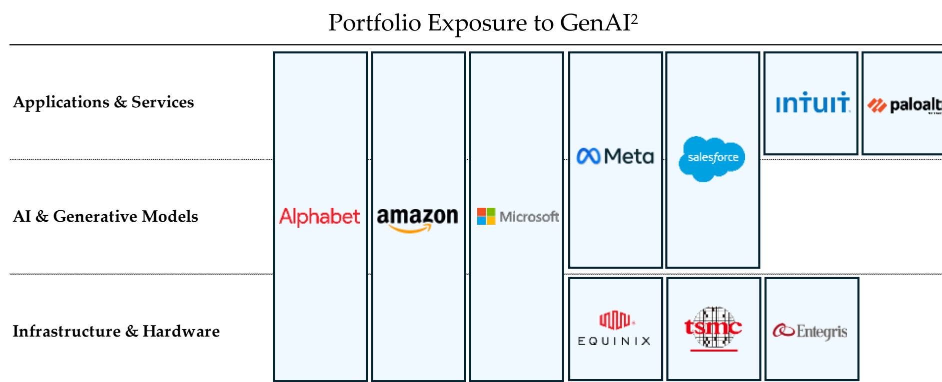
GPUs computing performance is doubling every year enabling the scaling of LLMs that are trained on trillions of parameters…





[1] Please refer to Important Disclosures page.

Source: NVIDIA Company Overview Slides, February 2024



The first level are **Infrastructure & Hardware** companies that provide the computational power needed to train LLMs and other generative models, such as diffusion models used to create images, video, and music. Here, we include:

- Hyperscale cloud providers that offer the high-performance computing and computational power required to train these models, such as **Microsoft** through Azure, **Alphabet** through Google Cloud, and **Amazon** through AWS.
- Semiconductor companies such as **Entegris** and **Taiwan Semiconductor Manufacturing** (or TSMC) that either manufacture or provide key solutions needed to produce chips used for AI, such as graphical processing units (GPUs).
- Other infrastructure players such as **Equinix**, which provides datacenters for edge inferencing and cloud on-ramps that allow enterprises to leverage the power of private clouds while keeping data secure and private.

Next, are companies that foster the development of **AI and Generative Models**. This, unsurprisingly, also includes the hyperscale cloud providers, all of which are developing LLMs and have stakes in some of the most prominent GenAI companies. This includes Microsoft's close ties with OpenAI, Alphabet's development of Gemini, and Amazon's Bedrock that houses foundational models and its investment in Anthropic. We also include **Meta Network's** open-source LLaMa collection of foundational language models that can be applied to many use cases, and **Salesforce's** Data Cloud and Einstein GPT that put a layer of security between LLMs and customer data.

Finally, we have companies that are leveraging GenAI to deepen their moat and provide new **Applications and Services** for their customers. These, again, include the hyperscale providers leveraging AI to enhance their core products such as Microsoft with its Copilots for Office and Alphabet with generative search. This category also includes **Intuit**, which is leveraging its 500,000 financial data points per small business and 60,000 data points per tax filer to create new AI-assisted features for QuickBooks and TurboTax, and **Palo Alto Networks**, which is applying AI to solve the challenges of threat detection and response and will be needed to secure future AI models, apps, and traffic.

Portfolio Positioning

While we are optimistic for the growth prospects of these companies, we also recognize that GenAI has the power to disintermediate as well. That led us to the question: *What business models are at risk of disruption?* After much (and ongoing) research we concluded that **Alphabet** (Google) may be at risk. Google Search makes up about 56% of company revenue and our analysis suggests that Search accounts for almost all of the company's operating profit. As large language models continue to progress, consumer behaviors could change in a

[2] Please refer to Important Disclosures Page

way that results in a decline in search or the use of Google Search, either way threatening Alphabet's overwhelming dominance in search. As of January 2024, Google's share of worldwide search traffic stood at 91.5%.[3]

Does Alphabet face an innovator's dilemma? Do they pivot to a new product that will cannibalize core search? Does Alphabet have the engineering talent, data, and resources to catch up? Maybe. These questions were uncertain enough that it skewed our view of Alphabet's risk-reward. In fact, we were eagerly watching Alphabet's rollout of Gemini, its latest large language model, but we were disappointed when it was plagued with errors and missteps. We know that Alphabet is taking this risk seriously, but we don't know if they can navigate this transition. Therefore, during the quarter, we decided to trim our position.

We invested the proceeds from Alphabet into **Taiwan Semiconductor Manufacturing (or TSMC)**. TSMC is the leading global manufacturer of the most advanced semiconductor chips. As discussed earlier, we view TSMC to be a picks and shovels provider to the semiconductor industry as it counts every leading technology company as a customer. One of TSMC's competitive advantages is that it does not compete with customers unlike competitors such as Intel and Samsung, which manufacture semiconductors for customers as well as for themselves, leading to potential conflicts of interests. Further, while NVDA's valuation has re-rated to record levels, TSMC's valuation is a more reasonable 22x 2024 EPS estimates and 18x 2025 EPS estimates. We acknowledge that TSMC has geopolitical risk with the ever-looming threat of China invading Taiwan. However, our belief is that it would not be in China's best interest and that this tail-risk, while real, is outweighed by TSMC's deep moat and opportunity to provide chips for accelerated computing. **NVIDA CEO Jensen Huang believes that over $1 trillion of capital will be spent over the next four years to upgrade data centers for high performance computing. Meanwhile, AMD CEO Lisa Su predicts that the data center accelerator market will grow 10x from ~$45 billion in 2023 to over $400 billion in 2027.**

While there has been a lot of focus on technology and AI, we would like to highlight some activity in other parts of our portfolio as well. One of our long-held companies is **Catalent (CTLT)**, a leading provider of drug substance and drug product delivery solutions required for the manufacturing of therapies and vaccines. After following the company for two years, we took advantage of the COVID-19 driven stock market decline in March 2020 to initiate our position. A few months after we established our position, Catalent announced partnerships with Moderna and Johnson & Johnson to manufacture their COVID vaccines. The clinical success and volume growth made Catalent our best stock in 2020 when it returned over 180% from when it troughed in March 2020. During 2021 and 2022, the company aggressively expanded vaccine production and ventured into new areas such cell & gene therapy and consumer nutraceutical products through acquisitions.

We had trimmed our position in Catalent into strength towards the back half of 2021 but started rebuilding a position with weakness in 2022. In hindsight we realized that Catalent expanded too quickly. Manufacturing quality and financial controls suffered. Further, by 2022, vaccine exhaustion and fading case rates led to volumes declined. These events contributed to Catalent's underperformance in 2023 when shares were flat while the S&P 500 returned 26%. As we evaluated these events, we trimmed, sold, and eventually rebuilt our position by July of 2023. We believed that the company was making progress on rightsizing its facilities and would eventually benefit from new novel therapies in gene therapy and weight loss. We believed that Catalent's core business was strong and unique. On February 5, 2024, Nova Nordisk, a global pharmaceutical company with the leading GLP-1 drugs (*Ozempic* for type-2 diabetes and *Wegovy* for weight loss) announced that it intended to acquire Catalent for $63.50 per share to secure manufacturing capacity for sterile injectables that are used to deliver GLP-1s. Nova Nordisk believes that demand for this class of drugs will be particularly strong as access expands and tangential therapies develop. We subsequently sold Catalent for about a 30% year-to-date profit.

Another company facing turbulence is Boeing. While not a holding, Boeing's recent issues have benefited **AerCap (AER), a company we've owned since December 2020**. Our country and the world needs Boeing to return to manufacturing excellence. However, during this period of reduced new aircraft production, **used airplanes are worth more**. This is due to airlines keeping their fleets longer and buying used planes to meet growing air travel demand. We have owned AerCap since December 2020 and believe that AerCap is entering

[3] StatCounter Global Stats, February 2024

one of the strongest periods in the company's history. As the leading airplane leasing company, AerCap can raise lease rates on new contracts and sell older aircrafts at larger premiums. AerCap has also demonstrated a consistent history of strong capital allocation. When the company has excess capital, it aggressively repurchases shares. After being up 27% in 2023 and another 17% YTD, our analysis suggests that AerCap is still selling below book value and a significant discount to our appraisal of intrinsic value. AerCap trades at about 8.7x 2024 estimate EPS.

AerCap has bought back over 18% of its shares since 2022 and, on the February earnings call, announced an additional $500 million share buyback authorization. Further, AerCap has another $2+ billion in outstanding insurance claims related to seized assets in Russia (roughly equal to 11% of its market capitalization); any recovery will likely result in further buybacks. **We believe the company may repurchase at least 10% of shares in 2024, not including any insurance recoveries.** At current valuations, we strongly support this strategy.

While the first quarter was off to a good start, we do have some companies that have been disappointing. Notably, we sold **Clarivate (CLVT)** at about a -20% YTD loss. Clarivate is a leading research information technology company. We have owned Clarivate on and off over the past five years. After our first successful holding period from 2019 to 2020, we decided to reestablish our position in 2021. We thought that Clarivate's core business of indexing scientific papers and selling that data through subscriptions would prove to be a resilient business model with high recurring revenue. Unfortunately, we were wrong. Clarivate made too many acquisitions, changed its sales structure, and kept missing goals. With a change in leadership in 2022, we wanted to give management some time to see if they could improve the business. After a year of new management and continued delays in revitalizing growth, we didn't see the results we were expecting and decided to sell Clarivate in the first quarter. One of the lessons here is that we should have recognized this loss earlier.

Looking Forward

As we look to the rest of the year and beyond, we are encouraged by the tailwinds that many of our companies enjoy. We believe that these themes will help power continued double-digit earnings growth for our companies and entire portfolio. While we have discussed the growing tailwind from GenAI and digital transformation for core positions like Microsoft, Amazon, Palo Alto Networks, and Intuit, along with our selective new additions to the portfolio this quarter, we continue to see attractive growth prospects in other areas of our portfolio as well. Despite letting Catalent go this quarter, we continue to hold our long-time positions in **Danaher (DHR)** and **IQVIA (IQV)** both of which hold leading positions in their end markets and would benefit from the recovery biopharma production and the development of new novel therapies. With inflation slowly stabilizing, we also see a pathway for a gradual easing of interest rates, which would benefit companies such as **Schwab (SCHW)** along with residential housing related companies such as **Ferguson (FERG)**, **Sherwin-Williams (SHW)**, and **Martin Marietta (MLM)**. All our companies are linked by the common thread of strong capital allocation.

The *Magnificent Seven* carried market returns in 2023 and GenAI/semiconductors so far this year. While we believe 40% of our portfolio would benefit from the potential decades-long tailwind from AI becoming the next wave of computing, our high active share and differentiated, high-quality portfolio will also benefit as the market slowly broadens out. Thank you for your time and interest. If you have any questions, please feel free to contact us at (415) 461-3800.

Sincerely,

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Chairman & CIO

Michael N. Im
Co-PM & Director of Research

Eric A. Winterhalter
President

Important Disclosure

Performance is provided as supplemental information and is based on the Partners Strategy 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 and 5-year net of fees returns of the Partners Strategy Composite as of March 31, 2024, are, 30.93, 4.73 and 13.18 respectively. The 1-year, 3-year and 5-year returns of the S&P 500® Index as of March 31, 2024, are 29.88, 11.49, 9.93 and 15.05 respectively. 3-year, 5-year and 10-year performance figures are annualized.

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Select assets shown; additional Partners Strategy investment information is available including the complete portfolio upon request.

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