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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Engaging with Management to Identify Long-Term Midcap Investments

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MARIE L. LORDEN is a Portfolio Manager and Co-Founder of Fairpointe Capital, LLC. Ms. Lorden serves as a member of the Mid-Cap Investment Team and the firm's executive team. Her responsibilities include serving as Co-Portfolio Manager for the midcap strategy, including the AMG Managers Fairpointe Mid Cap Fund, Parvest Equity USA Mid Cap Fund, and institutional and private client accounts. Prior to co-founding Fairpointe Capital, Ms. Lorden was, for eight years, a member of the Mid-Cap Investment Team at a predecessor firm. She co-managed the Aston — now AMG — Mid Cap Fund, the Parvest Equity USA Mid Cap Fund, and institutional and private client accounts, as well as providing research and analysis of existing and potential midcap equity holdings. Ms. Lorden held positions specializing in equity product analysis with Zurich Insurance Group, Driehaus Capital Management and The Burridge Group, where she was responsible for midcap equity maintenance research and institutional client service relationships. Previously, she was a project manager at Radio Free Europe in Prague, where she was responsible for analysis of registration options for the international bureau locations. Ms. Lorden received a degree from Elmhurst College and an MBA from the Keller Graduate School of Management.

SECTOR — GENERAL INVESTING

TWST: Did you want to talk a little bit about the firm and its history and philosophy?

Ms. Lorden: Sure. We are 100% employee-owned and 100% female-owned at this time. We had $5.1 billion in assets under management at the end of October. We subadvise two mutual funds, the AMG Managers Fairpointe Mid Cap Fund as well as the Parvest Equity USA Mid Cap Fund, and we also manage a number of institutional relationships. There are 15 people at the firm. Our primary strategy is midcap. We have an 18.5-year track record.

We are very interested in the midcap space and always have been. We think there is a lot of potential there. Midcaps are generally less risky and have a more mature capital structure than small caps, offer better liquidity. Oftentimes, the management is more experienced, as midcaps have come through the small-cap space. Some advantages over large cap: They have more attractive valuation, we get greater access to management, there is often a little bit less coverage on Wall Street and higher growth prospects in midcap.

So we're very committed to the midcap space. When we look at the midcap space, we define it similar to the Russell Midcap benchmark, $2 billion to $29 billion at purchase, and we stay in that range. Our average weighted capital is $6.7 billion, which is right between the S&P 400 at $5.4 billion and the Russell Midcap Index at $14 billion, and that was as of September 30.

In terms of our philosophy, we are really bottom-up, valuation-based stock pickers. We take a long-term view with a three- to five-year outlook. We have a preference for companies that their product or service is integral to their end client, either designed into the supply chain or somehow makes their end client more efficient or profitable. We do have four tenets that we look to fulfill when we are looking at a stock. We look for a compelling business model; financial strength, a strong or improving balance sheet; the valuation must be attractive to get into the portfolio; and last, we're looking for effective management.

Let me take you through a little bit of the process. I mentioned that there are 15 people at the firm. There are seven people on the investment team. Anyone on the team can bring a name. We are looking to build consensus. We are all generalists, and part of the reason we are generalists is we have that long-term view. Our average holding is about 5.5 years, and we own 50 or less names. So we really believe that everyone on the team should know all the names and participate.

Idea generation really can come from anywhere. We look at spinoffs, the competitive landscape, broker research. We subscribe to both bulge bracket and boutique firms for research. Names can come from a user experience, industry knowledge. So again, a name can come from anywhere, and anyone on the team can bring a name.

What we are looking to do is engage with management at the outset to understand the companies and, again, implement the four tenets. We are looking for focused companies that can grow their business, have a niche product or service, something that makes them unique — number one or number two in their market share. Financial strength — I mentioned strong or improving balance sheets, generally debt to cap of 40% or less. We're looking for attractive valuation, and these include ratios of price relative to earnings potential. We're looking at valuation relative to the company's own history, and we're really looking to catch a name when it's out of favor. You might even say we're a bit contrarian.

Highlights

Mary L. Pierson and Marie L. Lorden discuss Fairpointe Capital, LLC. Ms. Pierson and Ms. Lorden see a lot of potential in the midcap space. Generally, they find that midcaps are less risky than small caps and offer quite a few advantages over large caps, such as more attractive valuations, greater access to management, less Wall Street coverage and higher growth prospects. When it comes to their investment philosophy, Ms. Pierson and Ms. Lorden are bottom-up, valuation-based stock pickers with a long-term view. They look for four tenets when evaluating a stock: a compelling business model, financial strength, attractive valuation and effective management.
Companies discussed: Akamai Technologies (NASDAQ:AKAM); Apple (NASDAQ:AAPL); Alphabet (NASDAQ:GOOG); Netflix (NASDAQ:NFLX); Lions Gate Entertainment Corporation (NYSE:LGF.A) and LKQ Corporation (NASDAQ:LKQ).

Ms. Pierson: Well, it came about because Thyra Zerhusen was the founder of this strategy, and she was the sole Portfolio Manager for a mutual fund that was owned by, I think, at the time, it might have been Alleghany, and it became ABN AMRO, and then ABN AMRO was bought by Aston, and then Aston was bought by AMG — Affiliated Managers Group. And she was the Portfolio Manager from the very outset in 1999. And as the assets grew and her success in the portfolio grew, she was able to add her own staff.

It's just that when she hired, she hired Marie and then she hired me — Marie in 2003 and me in 2004 — and we were people that she knew and had worked with in the past that she trusted. So I would say that the common thread is not female, it's just people that Thyra has known professionally, that she trusted, that she wanted to work with. And so that is what started our three-person team. We were hired as Research Analysts, and then, Marie and I were named as Portfolio Managers in 2008 on the strategy. And the assets had grown from $20 million in 1999 when Thyra first took over the portfolio to $200 million in 2003. And that's when she felt she needed some support and had the ability in terms of the revenues from the strategy to add to her support.

I would say the reason that we haven't really needed to expand our group is that it's a very concentrated client base, and this strategy, as Marie pointed out, has only less than 50 names in the portfolio, and there is a very long holding period. So what we've done over time is we've added resources for the three of us from a research standpoint. And in 2015, we added another Portfolio Manager who is not an owner of the firm yet, and that is a guy.

So we don't have any particular requirement that someone be female. I think that's just the way it is. In a way, I think it's perhaps not even that significant. I know that studies have been done about the effectiveness of all-female teams and all-male teams versus mixed teams, but that's kind of anecdotal I think and not relevant to us. I think people remember us because we're primarily a female-run team, and that's unusual in the industry.

"Yes, I would like to say that in terms of our underlying philosophy, we consider ourselves to be midcap core managers, which means that we have a combination of stocks that are considered value and stocks that are considered growth, and some that are right in the middle. We have a valuation bent."

And the last, I mentioned experienced management. We do engage with management. We have ongoing dialogue with management — following earnings, at conferences, in our office and at investor presentations. We want to know how they think and what their priorities are. As long-term investors, we hold them to account, including actively voting proxies.

TWST: You mentioned you're an all-female-owned company. How did that come about, and how do you think that might make the company different in terms of culture and other things?

TWST: Did you want to highlight a company that you find interesting now?

Ms. Pierson: Yes, I would like to say that in terms of our underlying philosophy, we consider ourselves to be midcap core managers, which means that we have a combination of stocks that are considered value and stocks that are considered growth, and some that are right in the middle. We have a valuation bent. So from time to time, we could have more value stocks than growth stocks in the portfolio, but that could be a function of our concern about the level of the market and about whether or not the individual stocks present a good value going forward as opposed to just being a value stock or a growth stock.

One stock that I would say is a growth stock in the portfolio is **Akamai** (NASDAQ:AKAM). It's a technology company. We do tend to have an overweight in technology in the portfolio, mainly because technology stocks tend to have low debt. **Akamai** has little debt. And they also tend to have niche products that make their clients more efficient. That's one of the tenants that Marie had mentioned at the beginning of the discussion.

1-Year Daily Chart of Akamai Technologies

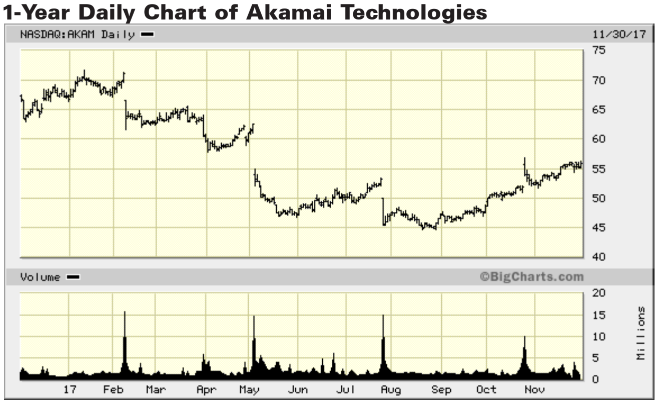

Chart provided by www.BigCharts.com

What **Akamai** does is they provide a content delivery network for traffic over the internet. And that was their basic product when they started the company. Their algorithms, which are proprietary, feed traffic across the internet from the source of the data to the destination. And they find the most efficient route across the internet from end to end. This product and their unique positioning in this market has made them a very popular provider of service to very, very large, high-traffic companies like **Apple** (NASDAQ:AAPL) and **Google** (NASDAQ:GOOG) and **Netflix** (NASDAQ:NFLX), and lots of the huge content providers in the internet space.

What they have done over time is they've added other products to their suite that are much more value-added and command a much higher margin than their basic content delivery platform. And those products include things like security and website performance enhancement. Over the years, this has become more than half of the revenue for **Akamai**, and as higher-margin products and higher growth products, this is where we see the value in holding on to **Akamai** in our portfolio. From time to time, there has been some volatility in the volume of revenue from the media business, which is their CDN business, the content delivery part of the business, and that has caused volatility in the stock, but it's giving way to this more important higher-value part of the business that we see as the growth engine for the company, and that is the high-teens growing performance and security part of their business.

So we have had **Akamai** in the portfolio since 2007. And what we do with all of our holdings is that if they're up, we are trimming them, and if we see them at the low end of their valuation range, we're adding to the position. And that's been the case with **Akamai**. We've made a significant amount of money from the stock over the 10 years that we've owned it.

TWST: What do you think might be something that investors would want to know about the company that might be on their horizon in the next year or two?

Ms. Pierson: Well, I would say maybe the answer is that they make quite a bit of investment in their business from time to time, and that actually coincides with the stock going down because there can be investors that are looking for a short-term payoff. And if you're investing in your business where the payoff is three to five years out, and that's a typical thing to do in a high-tech leading-edge type of business that **Akamai** is in, these periods of investment can temporarily lower their margins and push out revenue and earnings growth out over a longer period of time, which we consider to be a positive thing. But I would say right now that **Akamai** is in one of these investment phases. The stock is at the low end of a valuation range that we think is going to pay off in, who knows when, perhaps in a quarter, perhaps within the next few quarters.

TWST: Did you want to mention another company?

Ms. Lorden: Another stock that we think has quite a bit of potential and has done well recently is **Lions Gate** (NYSE:LGF.A). They produce and distribute motion pictures and television programming. They're really a global content provider. We like content; we think there's a lot of value to it.

What's interesting about **Lions Gate** is they use a relatively risk-averse approach to how they produce their content. And they sell a good portion of the rights to their production in advance of producing the films. So they take the risk down. They even give some of the talent in the film tagalong rights on the film, no matter how well it does, in order to take their costs down at the front end.

1-Year Daily Chart of Lions Gate Entertainment Corporation

Chart provided by www.BigCharts.com

They have a library of over 16,000 film and television titles. We think there's great value in that. Last December, they bought **Starz** entertainment, and that really has helped take out some of the volatility of when films work or not. So **Starz** has subscription cable network channels, and they're also global. They have premium TV pay networks. They recently are starting to focus on underserved markets — African-Americans, Latinos, women. There should be a lot of value there. The **Starz** subscribers went over 2 million, and it's a premium channel. So there are high rates on that.

This last Academy Awards in the spring, **Lions Gate** had over 26 nominations, more than any other studio. They license also internationally. They are an above $6 billion market cap firm. They just sold a part of their business, Epix, and they took down debt, which we're very pleased with. We're looking for them to take down additional debt. The stock is trading toward the lower end of the five-year ranges. And it's done quite well recently, and we think there's a lot more for the company in the future.

TWST: What might be some growth areas for a company like Lions Gate?

Ms. Lorden: Well, you're seeing a lot of the skinny bundles and moving around in cable. They're focused on some of the premium offerings. They are getting into some of the miniseries that do quite well. I believe the underserved markets will be a growth area for them. There's very little competition in Spanish language. I think the over-the-top network and the video on demand will continue to be growth areas for them as well. They can supply content to virtually any distribution network. They also license from other studios and are able to put that in their offerings.

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TWST: Did you want to mention a third company?

Ms. Lorden: Sure, **LKQ** (NASDAQ:LKQ). I think we'll talk about that. **LKQ** stands for like-kind quality. And they buy over 200,000 salvage vehicles a year. They repair and replace; they offer alternative and specialty parts for automobiles. So when a car gets in an accident and you need to repair something, you take it into the shop. Well, some of the parts can be from the OEMs — original equipment manufacturers — but oftentimes, what insurance will pay for is like-kind quality parts that are not OEM level.

And what's interesting about **LKQ** is they have a CRM or IT system that is second to none, where they can inventory parts they need, what prices they should pay. They go to auction and buy these parts. They know exactly what and how many parts they need to be inventorying. And then, they have the ability to service the collision repairs shops very quickly. So it's an off warranty, so a couple of years after your car goes off warranty is when parts start to need to be replaced. We were able to get into the stock because there was a warmer-than-normal winter or less snow, and fortunately, there were less collisions, and that drove the stock down a bit.

TWST: Do you see it as having a pretty solid future given the interest from the insurance industry?

Ms. Lorden: We do. They have one of the best geographic footprints around the country. They're expanding in Europe. They just bought a company in the U.K. They just got clearance on that. They had to divest with only nine properties, the company named Andrew Page, that disrupt the competition. So they're able to expand. Again, their IT systems allow them the ability to consolidate, buy, understand what the inventory is and really get the best margins.

TWST: Changing gears a bit, when you talk with clients about 2018 and beyond, what are some of the concerns that they voice to you, and what are some of their hopes for their investment portfolios?

Ms. Pierson: Well, I would say that one of the most common themes — and you hear it whenever you turn on the TV or listen to the market commentators — is the current high level of valuation of the overall market. And there are differing opinions about whether or not that is concentrated in a few names like the commonly called FANG names, the high-tech internet companies. But I think that one very important theme for us has been to, in that context of a fairly high expectation low interest rates, which means very cheap funding for expansion, that there's always the potential for a correction or for some event or some disappointment with the policy initiatives that could trigger a correction in the market. And we've been conscious of that potential.

We made sure that in 2013, after a very big outperformance by our portfolio on a big up year, that our portfolio was refreshed and that we were making sure that our portfolio was attractively valued relative to the market so that we would be protected in the event of a major correction. So I would say valuation is something we're very, very conscious of.

We're also analyzing our companies for their earning potential to make sure that they still have some secular trends that are in their favor, so that even if there were a cyclical downturn economically or in the market that these companies would outperform. And so I would say that that probably is the biggest theme.

TWST: Are these issues that you do hear questions about from clients? Do they raise these things with you when you meet during meetings and chats?

Ms. Pierson: Yes. We're essentially bottom-up, so we talk mostly about our stocks and the ones that we expect to do well, which tend to be our larger holdings in the next period, but yes, there's obviously concern about the overall level of the market and how our portfolio would perform in the event of a correction.

TWST: Thank you. (ES)

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