STERLING CAPITAL

# COMMENTARY
# SMID Opportunities SMA | 2nd Quarter 2020

The Sterling Capital SMID Opportunities portfolio seeks long-term capital appreciation by investing in a blend of under-appreciated value stocks and emerging growth stocks. The portfolio primarily invests in companies whose market capitalization falls within the range of constituents of the Russell 2500™ Index, at the time of purchase.

We pursue attractive opportunities within small and medium-sized companies, without limiting ourselves by sector or investing style. From a universe of 3,000+ publicly-traded companies, including ADRs, we build a concentrated portfolio that normally holds between 25 and 35 securities – blending relatively young growth stocks, characterized by above average revenue and earnings growth, with more established value stocks that are out of favor for reasons we believe to be only temporary. This balanced approach enables us to act upon our investment team's very best ideas and build a portfolio marked by diversification and high returns on capital and growth, with below average valuation and risk characteristics.

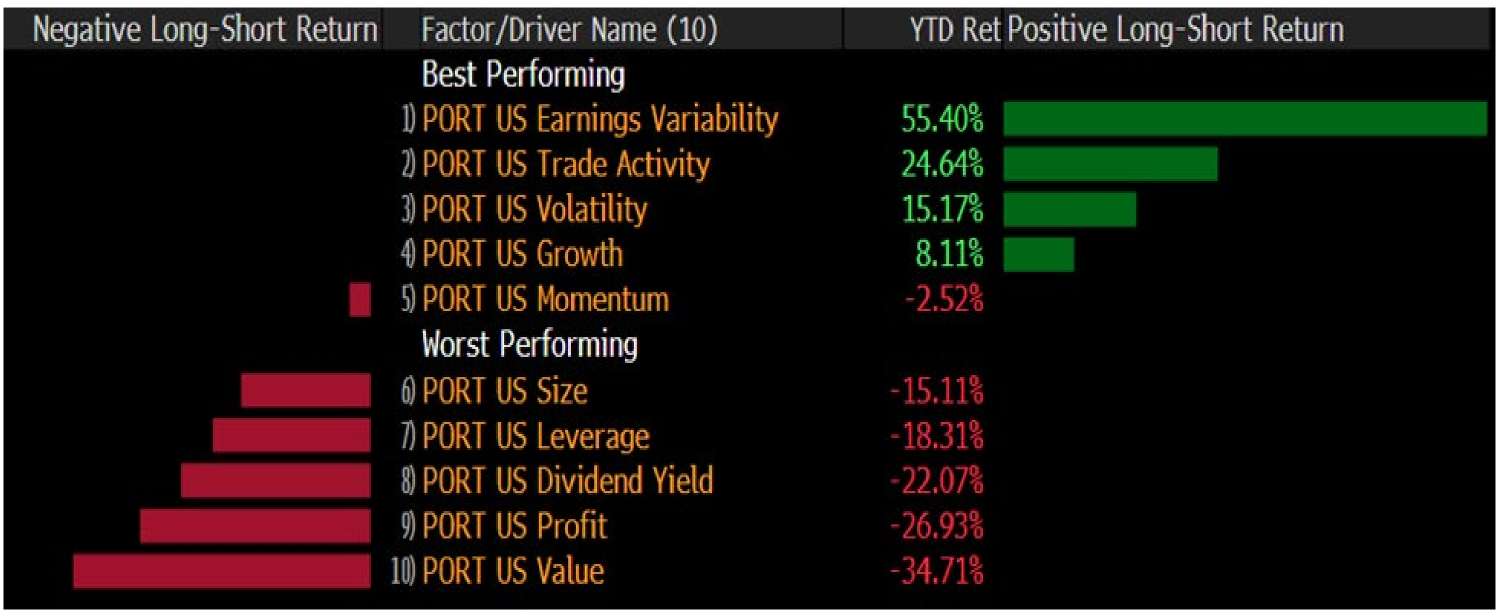
## Performance Summary and Review

The SMID Opportunities portfolio gained 17.9% (gross of fees) and 17.5% (net of fees), the best performance in any quarter since inception. However, the portfolio trailed the Russell 2500™'s 26.6% result. The smaller Russell 2000® gained 25.4%, its best quarter in nearly 30 years and third best ever. As a result, the portfolio now trails year-to-date, returning -14.8% (gross of fees) and -15.3% (net of fees) versus the Russell 2500™'s -11.1%. Meanwhile, the median Russell 2500™ constituent is still down 19.7% in 2020.

Our relentless search for high quality businesses unearthed several opportunities this year. These companies have attractive business models, predictable cash flows and should improve the portfolio's risk/reward profile. Additions were not made as a short-term bet on a steep V-shaped recovery, but were instead an allocation of capital to companies we believe will deliver higher risk adjusted returns over time.

During swift market rebounds, it's common for lower quality companies to outperform. During the second quarter, the lowest quintile of ROE in the index gained 46%, the most expensive stocks rose 30%, unprofitable companies advanced 39% and the highest beta group soared 62%. Biotech stocks soared as investors gambled on various potential treatments and vaccines in the early stages of development – the Russell 2000 Biotech index returned 46% (+73% from the lows). Most of these companies are unprofitable, eliminating them from consideration for the portfolio – none of the top 10 performers generate positive EBITDA.

As shown in the small cap universe chart below, three of our four pillars generated negative alpha year-to-date (Leverage, Profit, Value), with Growth being the only positive contributor.




*Source: Bloomberg*

## 2Q20 Contributors and Detractors

| Top Contributors | GICS Sector | Contrib. to Return |
|---|---|---|
| Hologic | Health Care | 2.36 |
| Teleflex | Health Care | 1.67 |
| Global Payments | Info Technology | 1.18 |
| Genpact | Info Technology | 1.10 |
| Broadridge Financial Solutions | Info Technology | 1.03 |

| Top Detractors | GICS Sector | Contrib. to Return |
|---|---|---|
| Ryman Hospitality Properties | Real Estate | -0.38 |
| Universal Health Services | Health Care | -0.20 |
| Hexcel | Industrials | -0.18 |
| Aramark | Consumer Dis. | -0.13 |
| SLM | Financials | -0.11 |

*Source: FactSet*

Top contributors:

- **Hologic**, a leader in women's health, beat estimates and raised guidance owing to its COVID-19 test, Aptima. One million tests are being delivered per week and capacity is expected to increase later in the summer by 50% or more. At an average price in the low $20s per test and a cost of $1-2, Aptima could generate more than $1 billion in revenues, a third of last year's total, and as much as $2 in EPS, more than 80% of last year's profits. More importantly, Panther (the diagnostic machines that process the tests) placements are ramping from 20 per month to 40 per month, providing a longer-term revenue stream of $250,000 per year in consumables, on average. This should improve the growth profile and increase the diagnostic mix of revenues to 40%-45%, possibly warranting a higher valuation.

- **Teleflex**, a medical device provider, expects a significant rebound in UroLift sales, the only minimally invasive procedure to treat benign prostate hyperplasia, as elective procedures resume. UroLift sales grew 48% to $290 million in 2019 and to-date, only 200,000 patients have been treated in the domestic target market of 12 million. In other words, penetration of the $30 billion world-wide addressable market is nascent. A national direct-to-consumer campaign later this summer, introduction of the easier to use and higher margin UroLift 2 later this year and entry into Japan in 2021 should provide catalysts to accelerate growth.

- **Global Payments'** software-centric payments model provided resiliency in a difficult environment. In April, the quick service restaurant (QSR) industry saw transactions tumble -30-50%, while Global Payments' Xenial business posted record bookings. Global Payments added more than 2,000 QSR customers requiring cloud-based SaaS solutions for curbside pickup, online ordering, mobile and drive-through capabilities. In healthcare, the company's AdvancedMD business saw a surge in demand for digital offerings, including enabling telemedicine capabilities for 1,500 practices that delivered more than 80,000 virtual visits in the last two weeks of March. AdvancedMD's bookings rose 35% in the first quarter and 65% in April.

- **Genpact**, a leader in business process outsourcing, is benefiting from digital transformations as businesses accelerate migrations to the cloud as well as the use of real-time analytics. Transformation service deployments represent 30% of revenues, grew at 30%, and encouragingly were included in three-quarters of new business wins. Commenting on the first quarter, management said, "We had a really good start to the year, in every vertical." We believe the company is a double-digit top and bottom line grower.

- **Broadridge**, a first quarter addition, delivered upside to last quarter's estimates driven by higher trade-related revenues as volumes surged and core services grew 9%. Management expects recurring revenues, which represent 85% of total revenues, to grow in the year ahead, even if the economy is mired in a protracted recession. We expect COVID-19 could accelerate adoption of Broadridge's digital services, such as virtual annual meetings and digital delivery of statements and proxies, possibly contributing to a 20% increase in year-over-year bookings.

Top detractors:

- **Ryman** re-opened entertainment venues in May and four of its five hotels in June. Management noted, "Initial spending and demand has been encouraging and indicates pent-up demand." Ryman is helping Nashville artists who had to cancel tours book events at the Ryman Auditorium later this year. While the shutdown will severely impact Ryman's 2020 financial results, we believe the company's conservatively managed balance sheet ($828 million of available liquidity, enough to cover 22 months of operations) coupled with the decision to retain 80% of its salesforce throughout the pandemic will lead to an even stronger market position when the virus is contained and economy recovers. Room nights reserved for 2021, at 1.6 million, are up 1.2% versus the same point last year. We don't know if these events will be allowed to take place, but we do know associations are eager to hold events that help them raise funds.

- **Universal Health Services**, a hospital and behavioral health operator, was impacted by lower utilization, in part due to mandated deferrals of higher margin elective procedures. Late in the quarter we saw early signs of a recovery in procedures, many of which can only be temporarily deferred, but accelerating COVID-19 cases in the South may cause another reset. On the behavioral side, an argument could be made that COVID-19 may lead to greater demand for behavioral services. The stock is down by nearly a third year-to-date, reflecting investors' focus on near-term headwinds, while 2021 earnings estimates are in-line with 2019 earnings (and could be revised higher if pent up demand returns quicker than expected). We believe the long-term earnings power hasn't materially changed, aside from a potential slight payer mix if unemployment remains elevated. As a result, UHS trades at its lowest relative valuation since 1999.

- **Hexcel** is a key supplier to the commercial aerospace industry that has been severely impacted by COVID-19. The lengthy multi-year order backlog for aircrafts, driven by increasing air travel and demand for more fuel efficient aircraft, is likely to be revised materially lower. Boeing cut output for the 737 Max for the third time, even as potential FAA certification approaches, and Airbus recently announced a 40% production cut. Meanwhile, airlines are struggling in the current environment, not adding to their fleets. We suspect it will years before air traffic returns to pre-COVID-19 levels.

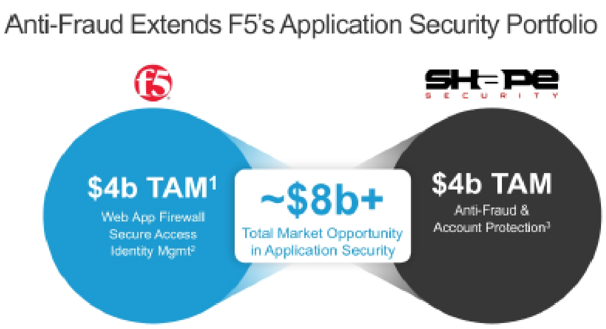
- **Aramark**, an outsourced food and beverage and uniform provider, didn't meaningfully contribute to the portfolio in the quarter as we swapped into competitor UniFirst in early April. We see a better risk/reward opportunity with UniFirst's debt-free balance sheet, limited exposure to large sporting events, concerts, etc., and ability to play offense in a depressed market environment. Our rationale is detailed in the *Portfolio Changes* section.

- **SLM Corp** fell on concerns that accelerating COVID-19 cases could spell trouble for college enrollment in the fall, dampening private education loan originations. Presumptive Democratic Presidential nominee Joe Biden has advocated for subsidizing tuition for students from families with very low incomes and various forms of loan forgiveness. We believe any related weakness in SLM's stock is unwarranted, considering SLM's target borrowers are not low income households and free, means-tested in-state tuition has been implemented in New York for several years and SLM hasn't been impacted.

## Portfolio Changes

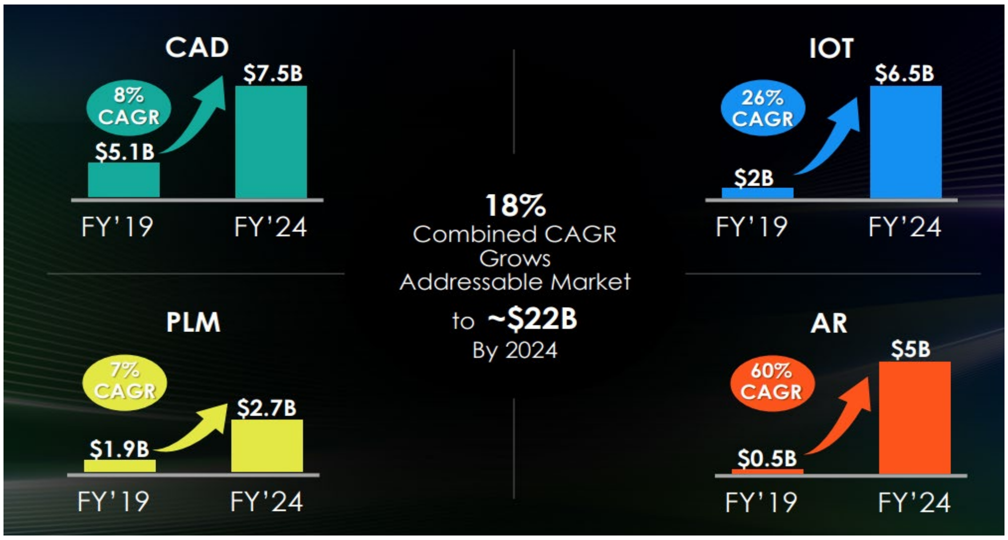
We seek to regularly improve the quality of the portfolio and this quarter provided more opportunities than usual, similar to the prior quarter. We added four holdings and sold three, increasing exposure to secular growth areas involving work-from-home, cybersecurity, industrial digitization, outsourcing and nearshoring/on-shoring.

We added **F5 Networks**, the leading provider of application delivery controllers (ADCs), but importantly, growth drivers have shifted from hardware in the data center to a software play on multi-cloud application growth. F5 has added open source application delivery technologies and with the acquisition of Shape, now has a more robust platform to deliver and secure applications in the cloud that can be accessed by users anywhere, anytime. As the world adapted to COVID-19, working remotely became a necessity that in many cases resulted in increased productivity. We believe a shift toward remote capabilities was inevitable, but the virus likely accelerated the timeline to adoption. IDC estimates there were 700 million application instances in 2018, which will grow at a 40% CAGR to 3.7 billion by 2023. F5 not only provides technology to develop new applications, but also provides application layer security, application infrastructure security and trusted access. High profile customers include Adobe, Cloudflare and Capital One. The recently announced partnership with Amazon's cloud service, AWS, provides additional validation of the quality of F5's offerings, while also opening doors to new relationships. Trading at an 8% free cash flow yield, F5 is being valued like a hardware company. We believe the transition to more software and subscription services will result in steadier, faster revenue growth that should drive a rerating of the stock.




*Source: F5 Networks*

**PTC** is a leading provider of computer-aided design (CAD), product lifecycle managment (PLM) and "Internet of Things" (IoT)/augmented reality (AR) solutions. Management has successfully transitioned from a perpetual license model to a highly recurring (85%) subscription business. Steady growth in its core CAD and PLM businesses is expected to be supplemented with rapid growth in IoT, AR and its new cloud-based CAD offering, Onshape. While COVID-19 has caused a (temporary) slowdown in parts of the business and delayed new deals, it has accelerated awareness of the need for digital capabilities in the industrial sector. This is exactly what attracted us to the company. PTC's IoT offerings enhance the productivity of factories and products by making them smart connected devices, prodviding real-time data that can be accessed remotely. AR solutions improve the productivity of people. A worker on a plant floor may run into an issue and using PTC's Vuforia AR solution, an expert can join remotely and see exactly what the floor technician sees in real-time to help resolve the issue. In late April, managment said daily Vuforia collaboration traffic "soared to levels 10x highern than pre-crisis." Industry-wide CAD software seats are still 99% on-premise and gaining access during COVID-19 was challenging. That sparked a sharp increase in demand for Onshape, the only multi-tenant cloud-based CAD application in the market. We believe COVID-19 has pulled forward the adoption of SaaS solutions and according to the CEO, "PTC is years ahead of the competition across its waterfront."




Source: PTC

We purchaed the fourth largest insurance broker, **Arthur J Gallagher**. We like the broker business because it participates in the current "hard" pricing market for insurance, but doesn't take underwriting risk. Scale is a key competitive advantage in a highly fragmented market, providing fertile ground to supplement organic growth with tuck-in acquisitions. During its mid-June investor day, the company provided an outlook that was better than the Street was expecting. Pricing is more than offsetting exposure declines, resulting in 2% organic growth in its brokerage business this quarter. Revenues have grown every year since 1996, a testament to the resiliency of the business. M&A has been paused by COVID-19, but the company maintains ample dry powder and expects a "catch-up" in deals in late 2020 and into 2021. AJG has maintained 30 term sheets with $200 million of annualized revenue, but noted its developing pipeline of more $1 billion in the weeks leading up to its investor day.

**UniFirst** is a leading provider of workplace uniforms and protective clothing. The company also provides higher-margin ancillary facility services, such as floor mats, personal hygience products and dispensers, as well as safety products. Uniform rentals reduce customers' total cost of ownership and improve their business image. Revenues are typically stable – except when businesses are ordered to shutdown – with three to five year contracts. Fiscal 3Q results were released on July 1, with total revenues down 1.8% and First Aid revenues up 26.0%, due to higher safety and personal protecctive equipment sales. While near-term headwinds for small businesses are evident, UniFirst's balance sheet has $421 million of cash and no debt, reducing liquidity risk and enabling the company to do the right thing for customers to forge more valuable, long-term relationships.

We sold **Aramark** as the stock rebounded from COVID-19 related weakness. We added to our position in mid-March, following conversations with management and two sizeable purchases by the CEO and CFO. However, as the stock began to recover and it became clearer that the duration of the impacts of the virus would be lengthier, we decided to redeploy capital elsewhere. Aramark has significant exposure to large group events, such as sports stadiums and live concerts, which will likely take much longer to recover. In addition, Aramark's balance sheet leverage at more than 5x, elevated due to a couple recent acquisitions, created additional concerns.

We sold **Hexcel**, a leading supplier of carbon fiber composites to the aerospace industry. The company's near- and medium-term outlook has been materially altered by COVID-19. Airline passenger volumes troughed down 95% in April and while they've recovered some, they're still down more than 80% in June. Until we have a vaccine and/or a significantly improved treatment regime for the virus, air travel is likely to remain subdued. Even then, we'll be dealing with the economic impacts and structural changes in the travel industry, such as increasing use of technology in place of face-to-face meetings. The impact on airlines has been a swift shift from growth to self preservation. Commercial aircraft downturns typically last four to five years with deliveries falling -40%-50%. This cycle could be more severe.

We sold **Crane**, which also has commercial aerospace exposure and was its most profitable segment. Similar to Hexcel, we see an impaired multi-year outlook for Crane. Its other businesses, Fluid Handling and Payments, have also suffered severe declines. We recycled capital into more predictable businesses with better growth outlooks.

## Conclusion

The rebound in equities has been nearly as extraordinary as the first quarter collapse. However, we remain focused on medium- to long-term opportunities, knowing we have a greater probability of successfully forecasting outcomes over such timeframes compared to shorter intervals. The trailing four-week average jobless claims at 21 million is 10x the average last year. We suspect many workers will soon discover that their "temporary" furlough has become "permanent," while at the same time enhanced unemployment benefits via the CARES Act are set to expire at the end of July. Without a policy extension, 19.29 million workers filing jobless claims will see their benefits fall from $985 per week to $385 per week, on average.

It would be a fool's errand for us to place a high degree of confidence in our ability to predict what incremental stimulus or central bank intervention lies ahead. However, the Fed has signaled it will do whatever it takes to remove worst-case outcomes from occurring. The Federal Reserve's balance sheet has already surged from $4 trillion to $7 trillion, the estimated federal budget deficit has risen from $800 billion in January to $3.8 trillion, the central bank has only recently begun buying individual corporate bonds, the target interest rate is pinned at zero and commentary from the June FOMC meeting suggests rates will remain there until at least the end of 2022.

Elevated uncertainty, a sharp recovery in equity prices and the U.S. entering July posting its highest daily rate of new infections is a lot to digest. We're optimistic markets will follow historic patterns of delivering further gains following strong quarterly returns, albeit at a much slower pace than last quarter's 149% annualized rate. That said, we'd be delighted by such an outcome, even if we trail slightly. On the other hand, if earnings and profitability regain importance, we believe the portfolio is well positioned.

Our transactions year-to-date improved the portfolio's positioning. New additions are expected to grow earnings 6% on average in 2020, while our exited positions' earnings are forecast to decline -83%. Comparing 2021 estimates to 2019, the average new holdings' profits are estimated to grow 22% versus a -53% decline for our sales. The average new holding generates an ROE of 14%, nearly 3x our exits, and operates with close to half the leverage. Overall, our companies are consistently growing faster, trading at a discount, are more profitable and run their businesses with more conservative balance sheets.

**Pillar Metrics: Growth, Valuation, Profitability & Balance Sheet Strength**

| | Growth/Stablity | | | | Valuation | | | Profitability | | Balance Sheet | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 20y EPS Growth | 21y EPS Growth | '16-'21 EPS CAGR | '19-'21 EPS Gr | 21y P/E | 21y EV/ EBITDA | 21y EV FCF Yld | ROE | EBITDA Mgn | Interest Coverage | Leverage |
| SMID Median* | -10% | 20% | 12% | 11% | 19.8 | 13.1 | 4.6% | 14.1 | 22.4 | 6.5 | 2.4 |
| R2500 Median | -22% | 8% | 1% | -14% | 21.6 | 12.5 | 3.5% | 5.4 | 11.3 | 2.1 | 2.7 |
| vs Benchmark | 12% | 13% | 11% | 24% | -8% | 5% | 30% | 159% | 99% | 210% | -12% |

**Representative account. Source: Bloomberg*

As always, we thank you for your interest in the Sterling portfolios.

Josh Haggerty, CFA®
Portfolio Manager

***Performance Disclosure:*** *Performance is preliminary and is annualized for periods longer than one year. Net of fees performance returns are presented net of the investment management fees and trading expenses. "Pure" Gross of fees performance returns do not reflect the deduction of any fees including trading costs; a client's return will be reduced by the management fees and other expenses it may incur. Investment management fees are described in Sterling's Form ADV 2A. Performance reflects the reinvestment of interest income and dividends and realized capital gains. The performance presented represents past performance and is no guarantee of future results. Performance is compared to an index, however, the volatility of an index varies greatly and investments cannot be made directly in an index. Market conditions vary from year to year and can result in a decline in market value due to material market or economic conditions. The Performance is considered Supplemental Information to the Composite Disclosure Presentation which is attached.*

***Russell 2500™:*** *The Russell 2500™ is a market cap-weighted index that includes the smallest 2,500 companies covered in the Russell 3000 universe of United States-based listed equities.*

***Russell 2000®:*** *The Russell 2000® index is an index measuring the performance of approximately 2,000 smallest-cap American companies in the Russell 3000 Index, which is made up of 3,000 of the largest U.S. stocks. It is a market-cap weighted index.*

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# Sterling Capital Management - SMID Opportunities SMA Composite

June 30, 2011 – December 31, 2019

*Description:* *Consists of all discretionary separately managed wrap SMID Opportunities portfolios. Sterling's SMID Opportunities equity portfolios invest primarily in companies similar to the market capitalization of the Russell 2500 index.*

| Year | Total Return "Pure" Gross of Fees | Total Return Net of Fees | No. of Portfolios | Composite Assets End of Period ($MM) | Percent of Firm Assets | Total Firm Assets ($MM) | Composite Dispersion (%) | Russell 2500 Index | Composite 3-yr St Dev (%) | Benchmark 3-yr St Dev (%) |
|---|---|---|---|---|---|---|---|---|---|---|
| 2019 | 36.12 | 34.46 | 27 | 8 | 0.0 | 58,191 | 1.01 | 27.77 | 12.28 | 14.58 |
| 2018 | -9.34 | -10.41 | 28 | 6 | 0.0 | 56,889 | 0.35 | -10.00 | 11.46 | 14.10 |
| 2017 | 13.93 | 12.62 | 30 | 8 | 0.0 | 55,908 | 0.41 | 16.81 | 9.14 | 12.13 |
| 2016 | 16.08 | 14.64 | 67 | 14 | 0.0 | 51,603 | 1.20 | 17.59 | 10.67 | 13.67 |
| 2015 | -0.39 | -1.64 | 31 | 8 | 0.0 | 51,155 | 0.73 | -2.90 | 10.53 | 12.42 |
| 2014 | 13.30 | 11.94 | 32 | 6 | 0.0 | 47,540 | 0.40 | 7.07 | 10.58 | 11.67 |
| 2013 | 25.34 | 23.89 | 20 | 4 | 0.0 | 45,638 | 0.25 | 36.80 | | |
| 2012 | 17.47 | 16.08 | 13 | 2 | 0.0 | 4,422 | 0.16 | 17.88 | | |
| 2011 (Inception 6/30/11) | -10.17 | -10.72 | 3 | 0 | 0.0 | 3,932 | | -9.78 | | |
| Annualized Since Inception | 11.04 | 9.71 | | | | | | 10.78 | | |

**Sterling Capital Management LLC claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Sterling Capital Management LLC has been independently verified for the periods 01/01/01 to 12/31/18. The verification report(s) is/are available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.**

*Notes:*

1. Sterling Capital Management LLC (SCM) is a registered investment advisor with the SEC. Registration does not imply a certain level of skill or training. Sterling manages a variety of equity, fixed income and balanced assets. Prior to January 2001, Sterling was a wholly owned subsidiary of United Asset Management (UAM). In January 2001, Sterling Capital Management LLC purchased all the assets and business of Sterling Capital Management Company from UAM to become an employee owned firm. In April 2005, BB&T Corporation purchased a majority equity ownership stake in Sterling Capital Management LLC. In October 2010, the management group of Sterling Capital entered into an agreement with BB&T Corporation that reduced and restructured management's interest in Sterling Capital Management. Additionally, BB&T Asset Management merged into Sterling Capital Management. In January 2013, CHOICE Asset Management firm merged into Sterling Capital Management. "Percent of Firm Assets" and "Total Firm Assets" prior to 2013 are for CHOICE Asset Management. In August 2015, eight new employees joined Sterling Capital management via Stratton Management Company following the close of BB&T's purchase of Susquehanna Bancshares. In December 2019, BB&T Corporation and SunTrust Banks, Inc. Holding Company merged as equals to form Truist Financial Corporation. Sterling Capital Management LLC is a wholly owned subsidiary of Truist Financial Corporation.
2. Joshua L. Haggerty, CFA, has managed the portfolio since inception. No alterations of composites, as presented herein, have occurred due to changes in personnel or other reasons at any time.
3. Inception date of composite: June 30, 2011. Creation date: June 30, 2011. The appropriate index is the Russell 2500 Index which measures the performance of the smallest 2,500 companies in the Russell 3000. It represents the universe of stocks from which small- and mid-cap managers typically select. The index is reconstituted annually. Total return includes price appreciation/depreciation and income as a percent of the original investment. A complete list of all of SCM's composites and their descriptions is available upon request. Policies for valuing portfolios, calculating performance and preparing compliant presentations are available upon request.
4. Performance reflects reinvested interest income and dividends and realized and unrealized capital gains and losses. All portfolios are valued monthly as of calendar month-end and utilize trade-date and accrued income accounting. Valuations and performance are reported in US dollars. Portfolio returns are calculated monthly using the Modified Dietz method. Portfolios are revalued for cash flows greater than 10%. Composite returns are calculated by weighting the individual portfolio returns using beginning of period market value plus weighted cash flows. Periodic time weighted returns are geometrically linked. Returns are not calculated net of non-reclaimable withholding taxes due to immaterial dollar amounts.
5. "Pure" gross of fees returns do not reflect the deduction of any fees including trading costs. The net of fee return reflects the actual SMA fee of the individual account. The SMA fee includes all charges for trading costs, portfolio management, custody and other administrative fees. Sterling's actual management fees are 32 basis points annually.
6. The annual composite dispersion presented is measured by an asset-weighted standard deviation calculation method of all portfolios in the composite for the entire year. It is not meaningful when there are less than six portfolios in the composite for the entire year. The three year annualized standard deviation measures the variability of the composite and benchmark returns over the preceding 36 month period. It is not required to be presented for annual periods prior to 2011 or when a full three years of composite performance is not yet available.
7. The performance presented represents past performance and is no guarantee of future results. Stock market conditions vary from year to year and can result in a decline in market value due to material market or economic conditions.