

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Getting to Know High-Quality Companies and Their Fundamentals



BENJAMIN C. HALLIBURTON, CFA, is a Founder, CEO and Chief Investment Officer of Tradition Capital Management, LLC. He oversees the investment research and strategy. He also heads the Investment Committee and covers the energy and technology sectors. Earlier, he worked at Brundage, Story & Rose where he was Director of Research and responsible for overseeing the firm's equity selection process. He was a principal of the firm and a member of the firm's Investment Policy Committee. He holds a bachelor's degree from Vanderbilt University and an MBA from Duke's Fuqua School of Business, where he was named a Fuqua Scholar.

SECTOR — GENERAL INVESTING

TWST: Could you please identify yourself?

Mr. Halliburton: I'm Ben Halliburton, Founder and Chief Investment Officer of Tradition Capital.

TWST: Could you tell me a little bit about the firm?

Mr. Halliburton: The firm is an equity-focused firm selecting quality companies with above-average growth and buying those at a reasonable price. We are long-term investors, not traders of stocks.

TWST: Can you provide more detail on the firm's investment philosophy?

Mr. Halliburton: We view the process as identifying high-quality companies that are exhibiting above-average financials, high return on equity, high return on capital, cash flow generation, dividend payout — the type of things that are driving the business value forward over time. Now those financial characteristics are driven by qualitative fundamental attributes of the business: What are their products, what markets are they serving, what is their patent position, brand strength, distribution, R&D capabilities? All of those fundamental items of a business end up driving the financial metrics. So our goal is to get to know high-quality companies and the fundamentals.

We then come up with estimates of what we think the key financial characteristics are: What's a normalized return on equity for this particular company, how fast is it going to grow, normalized earnings power, ability to pay out dividends and a payout ratio, growth rate, etc. So the qualitative fundamentals drive our estimates of financial characteristics that we can then put into our valuation model. Our valuation model then helps us estimate what we think each company in our portfolio is worth and also estimate a watch list of companies, where we might be finding

new opportunities. So it's a way to organize our fundamental research in a cost-effective, efficient fashion that allows us to put high-expected-return stocks into our portfolio and identify likely candidates.

TWST: Why does that kind of approach make sense with the current market and economic climate?

Mr. Halliburton: I would claim that that approach makes sense across all climates in that it's a process that I've been using since 1990. I was Director of Research and a Partner in a firm called Brundage, Story & Rose, and I originally developed a valuation model and this approach. So we've been across multiple cycles, and our performance over multiple cycles has been good.

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

Mr. Halliburton: Yes. A company I think that works for a lot of investors right now — extremely out of favor, large-cap name, pays a nice dividend of 4.14% — is **AbbVie** (NYSE:ABBV). They are the producer of HUMIRA. HUMIRA is the primary driver of profits and profit growth over the near term, and represents a huge amount of their business.

People are concerned that biosimilar competition could erode HUMIRA's market share and profitability. **AbbVie**, when you talk to management, indicates that they are very confident in their multiple intellectual property protection strategies, lots of patents that will protect them for years, some of which do not expire for multiple years. The Street is more concerned about this patent expiration of HUMIRA than the actual management team. The management team has been very active in protecting the intellectual property of HUMIRA. So we think that stock is grossly underpriced with a view that the stock can easily trade over \$100 over the next year or two, and it's currently trading in the low \$60s.

The other part that is an interesting potential bonus is they do have a strong product pipeline that the management team has detailed that could put kickers on the revenues and earnings growth in the three- to six-year time frame. But I think the big opportunity is how Wall Street is overly concerned that there will be direct HUMIRA competition, and we don't think that's the case.

TWST: During the fall campaign season there was concern emanating from the presidential candidates about the price of some drugs. Now that President Trump is in office, is that less of a concern, and how does that affect a company like AbbVie?

Mr. Halliburton: I think the concern is still there even under a Trump administration. Not a direct quote, but basically he said that the drug companies are basically murdering us, and we should be able to negotiate as a federal government to get better pricing. So I do think the rhetoric coming out of Washington, D.C. for some sort of price competition negotiation with the federal government across Medicare is definitely in the cards and now has also started to move potentially through Congress.

Our understanding of the situation is Trump cannot via executive order make a change in drug pricing because the Medicare Part D back under the Bush administration specifically said that negotiations were not really allowed, and then part of the Affordable Care Act basically came in and reinforced that view. The drug lobby is pretty strong, so I don't think this is going to be an easy fight for anybody. I do think that probably something eventually happens, and you have a little bit more rational competitive landscape with regards to the government buying drugs. I think that is in the cards. But do I think there's going to be wholesale rollbacks? No. Where products have differentiated value and are showing great use for patients, I think they will continue to be priced more on what's the value to the patient versus what's the cost.

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Now that said, I don't think you're going to see the strong price increase that you've seen over the past 10 years continue in the drug industry. You're going to see more of a unit growth story when things do come off patent, and if they don't have other patents to back them up, there's going to be a lot of competition, and prices for those will drop rapidly. So it's going to be a very hit-or-miss field for drug pricing and also for the drug companies themselves. So I do think the election rhetoric and the drug pricing scheme could change. I don't think it's going to be a draconian that's priced into a company like **AbbVie** for instance. **AbbVie** is basically selling at 12 times earnings.

Highlights

Benjamin Halliburton says his firm is an equity-focused one that selects quality companies with above-average growth, and buys those companies at a reasonable price. It is a long-term investment philosophy identifying companies with above-average financial characteristics. Mr. Halliburton says those characteristics are driven by qualitative fundamental attributes of the business.

Companies discussed: AbbVie (NYSE:ABBV); QUALCOMM (NASDAQ:QCOM); NXP Semiconductors (NASDAQ:NXPI); Hain Celestial Group (NASDAQ:HAIN) and DREAM GLOBAL REAL TRUST UNIT (OTCMKTS:DUNDF).

TWST: AbbVie has a reputation also as a company that defends its patents even with competition from companies or potential competition from companies like Biogen?

Mr. Halliburton: So the news flow on the patent defense front has been positive from cases ruled so far over the past year. The stock has really not reacted, I think, partially because of the rhetoric coming out of

Washington. But I do think the patent protection is going to hold; management is extremely confident it's going to hold, and I think once you get past those two concerns, you're going to get a revaluation on the stock. Here you have a company that's growing in excess of 10%, and it's selling at basically 12 times earnings, and you're getting a 4% dividend. It's grossly mispriced.

TWST: Can you mention another company?

Mr. Halliburton: Another company that's under a lot of pressure right now that we've found attractive for new capital is a company called **Qualcomm** (NASDAQ:QCOM). I have followed this company for about 20 years. We started buying it again over the past year aggressively. We think that their intellectual property is very strong, especially when it comes to CDMA and iterations upon that. The company position is so strong in the market that they're getting pushed back for noncompetitive pricing both here in the U.S., Korea, China. So there's no question that they have strong technology that companies need and are licensing, and is an essential part of wireless infrastructure.

The question that arises: Are they being too aggressive with their ultra-strong intellectual property position? They will probably have to be a little looser and less aggressive on how they price things and how they leverage their IP and also chip sales. But here again, this is a stock that has basically gone nowhere and has a very powerful technology base, has the opportunity to continue to grow its business, is looking into making an acquisition with its foreign cash on **NXPI** (NASDAQ:NXPI)

that will give them a very strong position in autos, so it's very accretive, since we're taking cash and buying a company's earnings stream. So we find that as a very solid risk/reward.

What's interesting is **Qualcomm** actually pays a reasonable dividend at this point, pays a 3.3% dividend. So an above-market dividend for a company with a very high return on equity and that we still think is in one of the higher growth areas. Clearly **Qualcomm**, and technology in general, is no longer a high-growth industry, but it's an above-average growth industry. Global nominal GDP in our view is going to be 3% to 5% over the next five years to 10 years, and we think **Qualcomm** will generate higher revenue growth than that on a longer-term basis.

TWST: Is there some risk that the Qualcomm/NXP Semiconductor deal could fall through?

Mr. Halliburton: I think there's a fair amount of risk in that, and that's what the market is telling me with the arbitrage spread between the takeover price for NXPI and the current price. Any time you're taking over a foreign company and you've got to get it through regulators, you get a lot more difficult acquisition than it would be if it was strictly U.S.-based. I don't think there's any real antitrust concerns. It's more whether the European regulators will allow a U.S. company to buy one of Europe's few remaining successful semiconductor companies.

1-Year Daily Chart of AbbVie Inc.

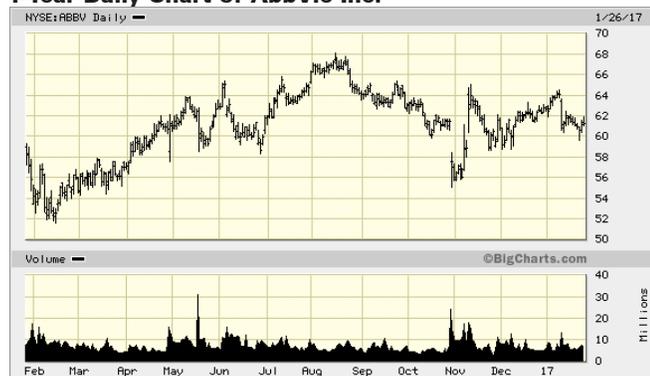


Chart provided by www.BigCharts.com

TWST: What about auto semiconductors is going to be lucrative? People are seeing more and more computers and computer-related technology in cars; is that what it all relates to?

Mr. Halliburton: Yes. So you've got all the various computer safety systems, auto sensors, auto braking, and also those sensors are going to be deployed for driverless cars so that you don't need a driver. So there's going to be more and more technology packed into the car, more chips to make that happen, and having more exposure to that fast-growing market I think makes sense, especially if you can do it on an accretive basis.

TWST: Did you want to mention another company?

Mr. Halliburton: A little more speculative. The company is called **Hain Celestial** (NASDAQ:HAIN), and it's definitely under a cloud. The cloud has started to clear. **Hain** is in the organic natural food business. It's been built through a series of acquisitions, so you definitely have some of that roll-up risk.

The stock is currently trading around \$40, and less than a year ago it was trading closer to \$70. So, what happened to cause the price reaction? They did have to delay filing some of their financials; that process is being remedied. There were rebates made that were improperly booked, rebates to retailers, and some inventory issues. They have addressed those.

They have brought in new senior management in the financial controls area, and they are in a business where you're seeing very strong unit growth across the globe. So 6% to 7%-type unit growth. You get a

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1-Year Daily Chart of Hain Celestial Group, Inc.



Chart provided by www.BigCharts.com

TWST: If they can get it, it would definitely be to their benefit in terms of their long-term growth?

Mr. Halliburton: We work it out as \$0.50 to \$1 accretive almost immediately, maybe \$1.50 after you take some synergy and cost savings, and then you're into the better position for the auto semiconductor market, which is one of the fastest-growing areas.

little pricing, get some margin improvement. We clearly think this can be a double-digit EPS grower over time in a world where most of the world has grown at 6% to 7%. So we think they should receive a premium valuation, and right now it's basically a market multiple.

TWST: They're benefiting from just the general trend that a lot of people in the United States and elsewhere are looking for natural and organic foods?

Mr. Halliburton: Correct, and so that's why they're getting the unit growth. The risk here is this is a company that was built on a lot of small acquisitions; not all of them have been successful. Their current accounting issue basically occurred because one of their acquired companies didn't have the tightest financial rebate inventory controls, and it came back that they had to do some restatements for that division.

TWST: For the companies that have been successful in these fields — natural and organic foods — has there been some characteristics about them that you could identify?

Mr. Halliburton: **Hain** has been successful over the years. It's not like it's not been a good stock. From the bottom in 2009, the stock got down to \$7. It's now \$40, got up to \$70 a year and a half ago. So it has shown success. What we're viewing it as is they're in the right industry, they've got the right products, they have great demand for the products, more and more people want to buy those type products every

time you turn around, and they're in a great position to take advantage of that. The current stock price we view as an anomaly given that it's primarily driven by this hiccup with regards to some sloppy accounting practice control systems. We don't think it's something that's damaging demand. We don't think there's been any indication that consumers have cooled on eating better, healthier. So we think they're at the right spot at the right time.

This is the kind of thing that we like to buy, and pretty much all the companies that I've talked about — high-quality companies, great brands or patents, strong returns on equity — and we're trying to buy them at a reasonable price or an attractive price so we can get some margin for error in case we've made a mistake in our analysis. All of these have a big margin of error, because they're grossly underpriced versus our estimates of value. We generally run a portfolio of 45 to 55 stocks. The vast majority of our stocks right now are closer to a "hold" than a "buy." Really the only opportunities out there are ones that market perceptions are wrong in our viewpoint, and so there are a fewer number of "buy" ideas today than at most times.

TWST: Did you want to mention another company?

Mr. Halliburton: A little off the beaten path, or well off the beaten path, there is a deeply undervalued Canadian REIT called **Dream Global** (OTCMKTS:DUNDF). **Dream Global** is Canadian-based, but almost all of its assets are in Germany. They bought a big slug of the German post office buildings and rented them back to the German post office, and those buildings sometimes have very nice spots that they can upgrade once the German post office downsizes and rationalizes its footprint. So they have come in and started that process of rationalization, so they get a big uptick in rent per square foot as the post office declined the space, and you've seen very nice improvements in revs and cash flows over time. They've also looked at and bought some other additional German A-space office buildings to go with their portfolio.

In our view, the stock is about 20% to 30% undervalued versus where it should be versus comparables. We're getting paid above an 8% to 9% yield while we wait, and this is an environment when yields of REITs and stocks in general have come down dramatically. This is a not very well-followed company. It falls through the cracks. We don't know how long we'll have to wait until people get excited about it, but we're getting paid 8% to 9% while we wait. We know that they're continuing to upgrade their rental properties and prices, and so the value is growing underneath it, and at some point the market will notice or somebody will

acquire them, and we'll get taken out at a higher price. So it's a nice safe place, nice diversification to our portfolio and very unknown.

TWST: The outlook in commercial real estate in Germany is pretty solid?

Mr. Halliburton: It's actually pretty solid. It is actually getting a little boost from Brexit as some of the financial companies are looking to leave London.

TWST: So they might locate in a city like Frankfurt or another financial capital?

Mr. Halliburton: Paris and Frankfurt are definitely seeing upticks in demand on office space.

TWST: As 2017 continues, do you have any advice for institutional clients that you might work with?

Mr. Halliburton: The issue for all of us, including institutional clients, is we've had a massive recovery in stocks and expect the returns, in our viewpoint, to be lower over the next five years to 10 years than they've been historically, and also than they've been over the past six, seven years — off that 2009 bottom. So that puts institutional clients in a bit of a dilemma in that interest rates are also extremely low, so when they're trying to build a portfolio and come up with the required return for their accounting assumptions, they are hard-pressed to actually make that work.

So our long-term view of stocks' five-year, 10-year basis generates around 8%, so it's quite a dilemma for the institutional investor and the pension investor. But stocks do offer much higher prospective return and to some extent a different risk than posed in interest rates, so even though they've been strong, I think investors need to basically grit their teeth and hang with it, because I do think they're going to provide a better return over five years to 10 years than bonds.

TWST: Thank you. (ES)

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