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TRIVARIATE RESEARCH

HOW ARE WE GOING TO MAKE MONEY IN 2022?

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HOW ARE WE GOING TO MAKE MONEY IN 2022?

What is a year ahead forecast?

At bulge bracket firms it is a group of people in eight cities around the world, pontificating on a series of three separate four-hour video conferences, trying to impress each other with anecdotes, not analysis. They forecast things with conviction despite demonstrably dismal track-records. A GDP forecast drives a 10-year yield and oil forecast, which in turn drives the equity outlook. It is variability on top of variability on top of variability. Typically, the fixed income team's view always matters more in these conversations than the equity team's view, even at firms where the equity business is way more profitable and the fixed income one has been wrong for seven consecutive years. By mid-January of most years, we've seen many of these "experts" reluctantly revise their recently-issued year-ahead outlooks, as they have already been rendered inaccurate. A common update note will say "things are nearing our bull case."

This was a painful process to be involved in on the sell side. Worse, we found these notes to be useless while we were on the buy side. Therefore, we prefer to focus on what most of our clients want: making money. Our 2022 outlook is focused on long and short stock ideas followed by some analysis on changes in multiples and market dynamics. Though we do not do deep fundamental analysis as a firm, these stock ideas are ones that embody the themes of our research. They are meant to stimulate thought and idea generation for our clients. Please do not hesitate to contact us to discuss our work.

BUY IDEAS

Our themes are as follows:

- 1) **Buy “old technology”:** It is extremely cheap and acts well when the Nasdaq does not
- 2) **Buy select software:** Software with revenue growth, margin expansion, positive free cash flow, and pricing power work well following growth-stock sell-offs
- 3) **Buy mid-cap biotechnology:** Innovation has been overly discounted, and the terminal value argument does not really make sense
- 4) **Buy healthcare services:** They have above average revenue growth, lower volatility of growth, yet lower valuation
- 5) **Buy oil-sensitive energy stocks:** The risk-reward skewed to the upside for oil
- 6) **Buy housing exposure:** housing generally looks strong, so finding idiosyncratic exposure is prudent
- 7) **Buy consumer services:** Restaurants have suppressed margins that should expand as reopening continues and cost pressures slowly abate

SHORT IDEAS

We think that investors can short individual stocks more aggressively. Given the efficacy of the short interest signal over the last several months, we think this is true even of names with higher short interest.

- 1) Short low-quality work-from-home stocks:** High quality reopening has lagged low quality work-from-home since the beginning of COVID. While this has begun to correct in the last few months, we think this trend will continue
- 2) Short profitless software:** Following growth stock sell-offs, outperformers have positive free cash flow and gross margin expansion. Short those with contracting or stagnating margins and negative free cash flow
- 3) Short select industrials:** Industrials with high incremental gross margin expectations will underperform as industrial economic activity plateaus. Avoid capital goods / machinery with incremental gross margin expectations well above normal
- 4) Short expensive staples:** Some staples are over-earning due to COVID behavioral shifts, and now embed continued high growth and elevated valuation, creating potential downside as growth eventually disappoints
- 5) Short regional banks:** Some rate-sensitive banks have seen strong price-to-tangible book expansion on a changed perception of rates that may ultimately prove to be overly optimistic

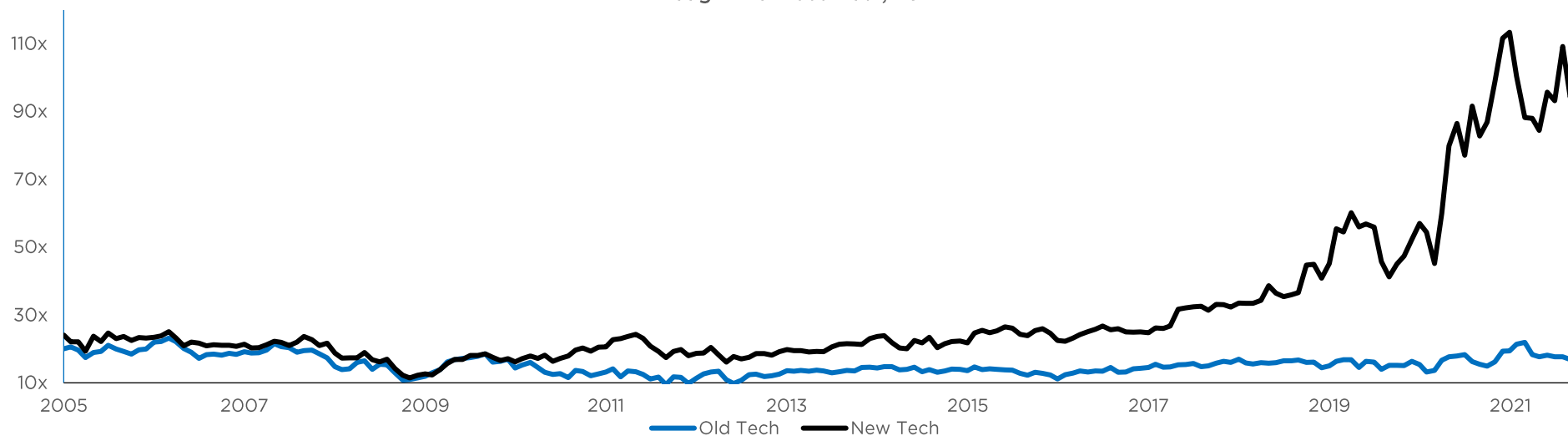
BUY IDEA #1, “OLD TECHNOLOGY”: DELL AND INTC

We think “old technology” is just too cheap on a relative basis. While many think PC-centric companies are “over-earning” due to COVID-induced home-office upgrades, we think these businesses should be more expensive given their importance and stability. Recently the shares have gone up during a broader Nasdaq sell-off, an indication that investors may be thinking of them differently than other tech stocks.

Our first idea, DELL, has some growth from its old EMC business, yet current forecasts are for a revenue decline this fiscal year. Even with that projection, the consensus expects nearly \$7 billion in FCF for a stock with \$77b in EV (\$28b in net debt). Crowding is less likely as the sell side does not love it (13 buys, 7 holds, 1 sell) despite strong prior stock performance. Projecting out three years, \$10 in EPS seems feasible, and with Michael Dell’s high ownership, a \$100 stock price is not impossible. A cheap valuation of 8x forward earnings in a market that is at 21x forward offers downside protection. Dell should trade at a discount to the market, but more than 2.5x cheaper is too severe in our judgment.

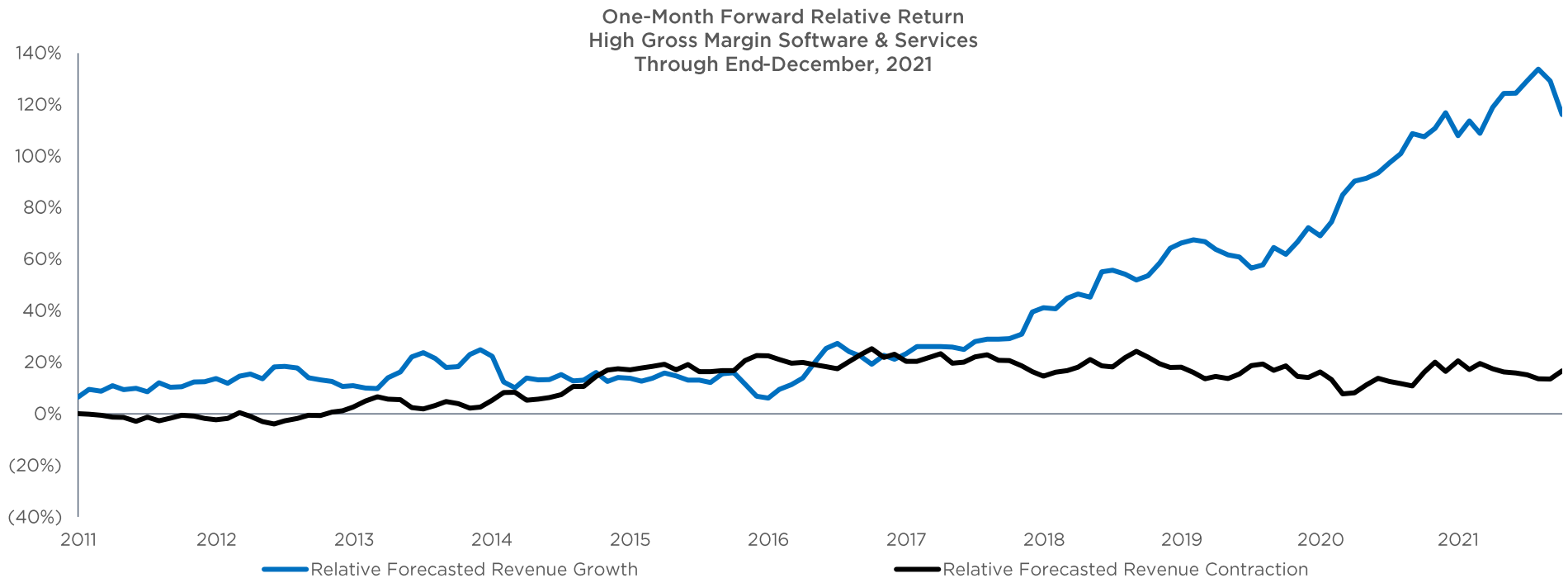
Our second idea is INTC. Even back when we covered the stock fundamentally more than 15 years ago, we thought they were both incompetent and dishonest, massive destroyers of shareholder value and hubristic to boot. But many years of stock underperformance and several new CEOs later, it appears the company is making some adjustments. Gross margins likely trough in the first half of 2022, and investors have historically warmed to gross margin expansion with chip makers three-to-six months in advance. The company likely relatively improves its technology vs. AMD, is hated (19 buys, 21 holds, 8 sells), and the recent counter-tech price momentum is of note.

Median Price to Forward Earnings
Mega, Large, and Mid Cap. Tech
Through End-December, 2021



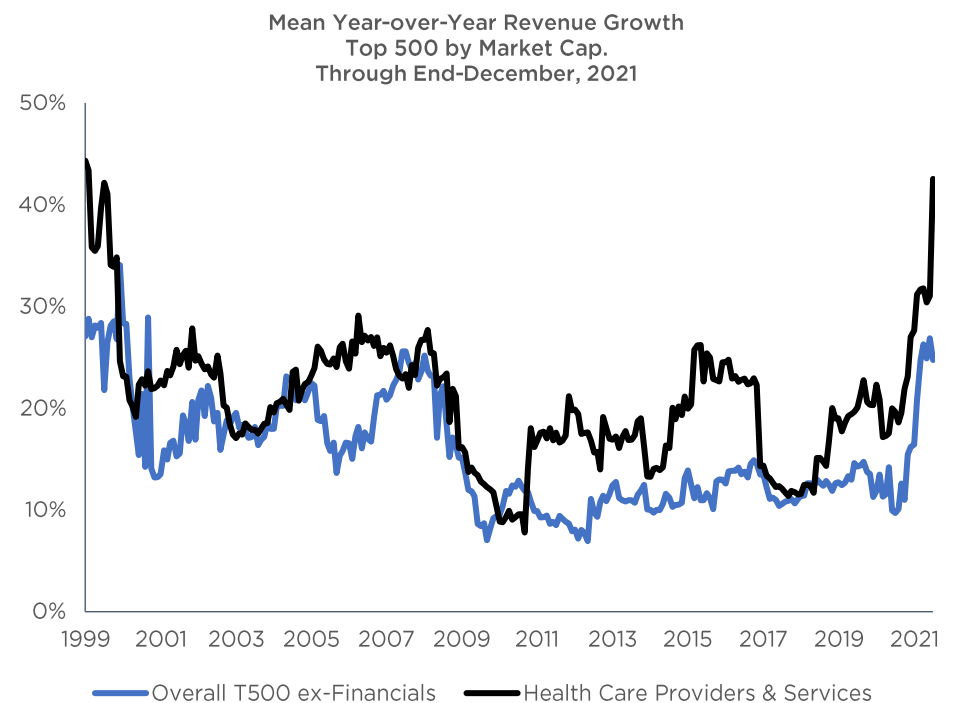
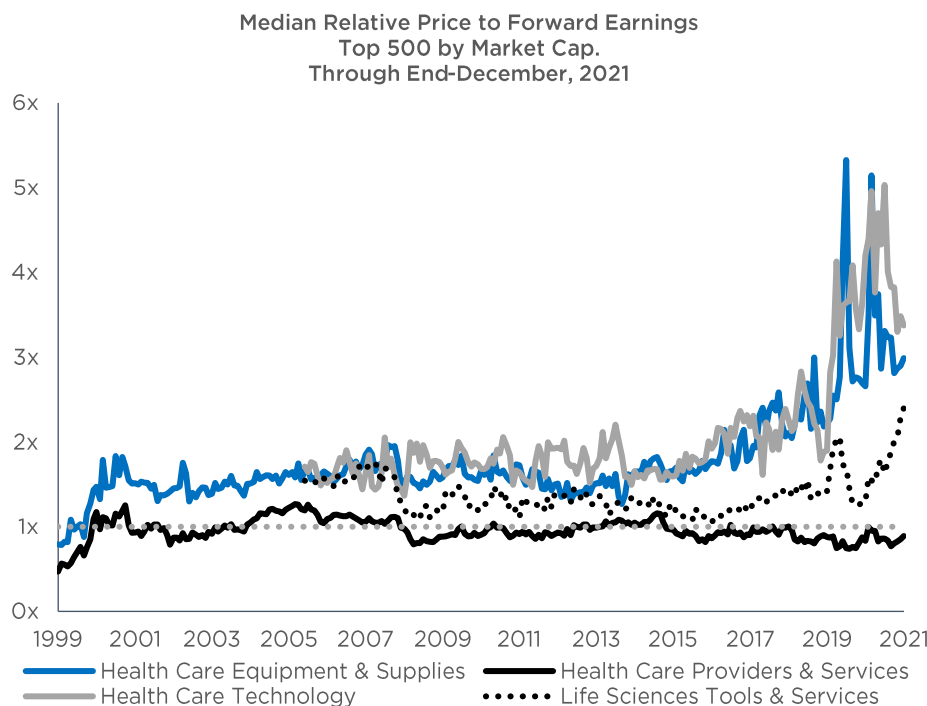
BUY IDEA #2, SELECT SOFTWARE: CRM

We wrote a “software playbook” note last September, and showed that among high gross margin software companies, those that are forecasted to both expand revenues and margins on a relative basis typically subsequently outperform. CRM peaked at \$309 two months ago, is now down over 25% from its peak. This is an uncommon buying opportunity: large cap. software companies with pricing power and robust forecasted sales and margins are rarely down this much. As users of the product, we can tell you that there is a long runway of price increases before we look for alternatives, an anecdotal sign of pricing power. We conducted an analysis of all the stock that are \$100 billion cap. or larger, by focusing on our quantitative models, sell-and-buy side optimism, and share gain and margin expansion. CRM is ranked 4th overall in our \$100 Billion Club framework of our 90 names that size. Sometimes when a stock is down 25% in two months, you get new information that makes you like it even less, despite the correction. In this case, we like CRM more than we did two months ago.



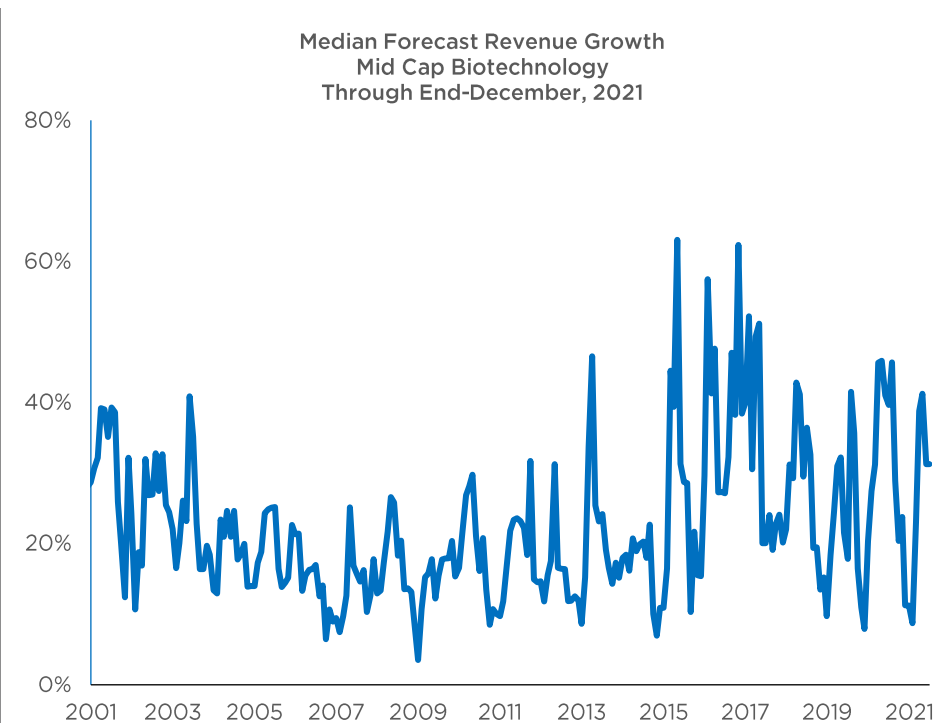
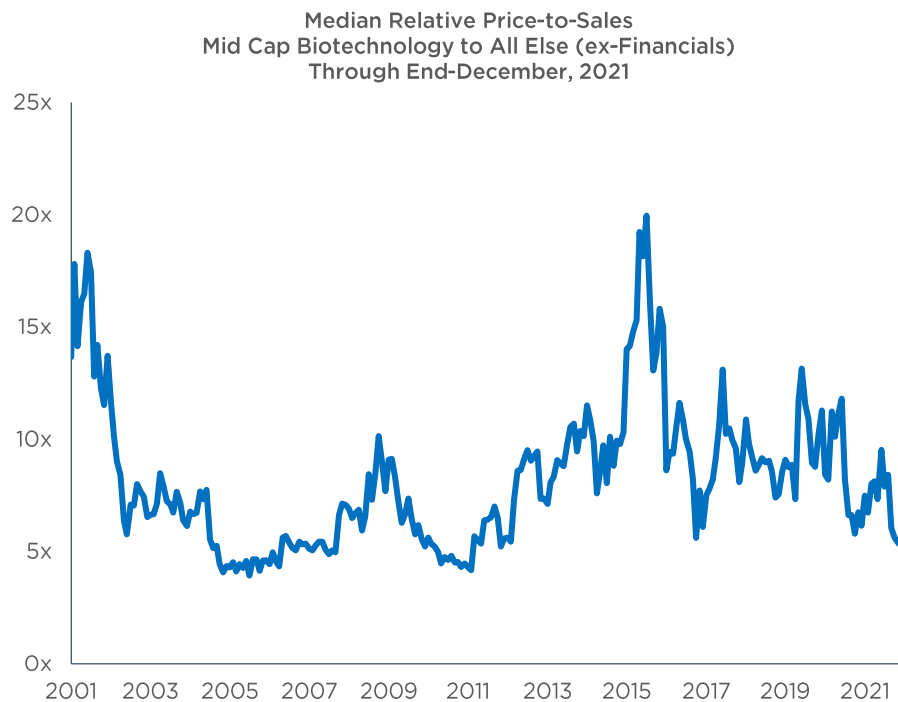
BUY IDEA #3, HEALTHCARE SERVICES: UNH

We generally think investors should buy healthcare services stocks, as they have faster revenue growth (right chart) and lower volatility of revenue growth than average industry in the market. Yet services is the only healthcare industry that experienced relative valuation contraction this cycle (left chart). Investors want pricing power and inflation exposure. UNH provides both. While hardly an undiscovered name at \$470 bn. EV and well loved by the sell-side (24 buys, 4 holds, and 1 sell), UNH nonetheless is a consistent grower (forecasted to growth 10.5% revenue in 2022) and attractively valued at 13.5x 2022 free cash flow, with above average estimate achievability likely. The stock is ranked 3rd of 90 stocks in our \$100 billion club framework, which combines our quantitative models, revenue and margin outlooks, and sell-and-buy side sentiment. We can't imagine what it would take for us to switch our plan away from UNH, but as the old saying goes, if we switch, *you* can tell my wife.



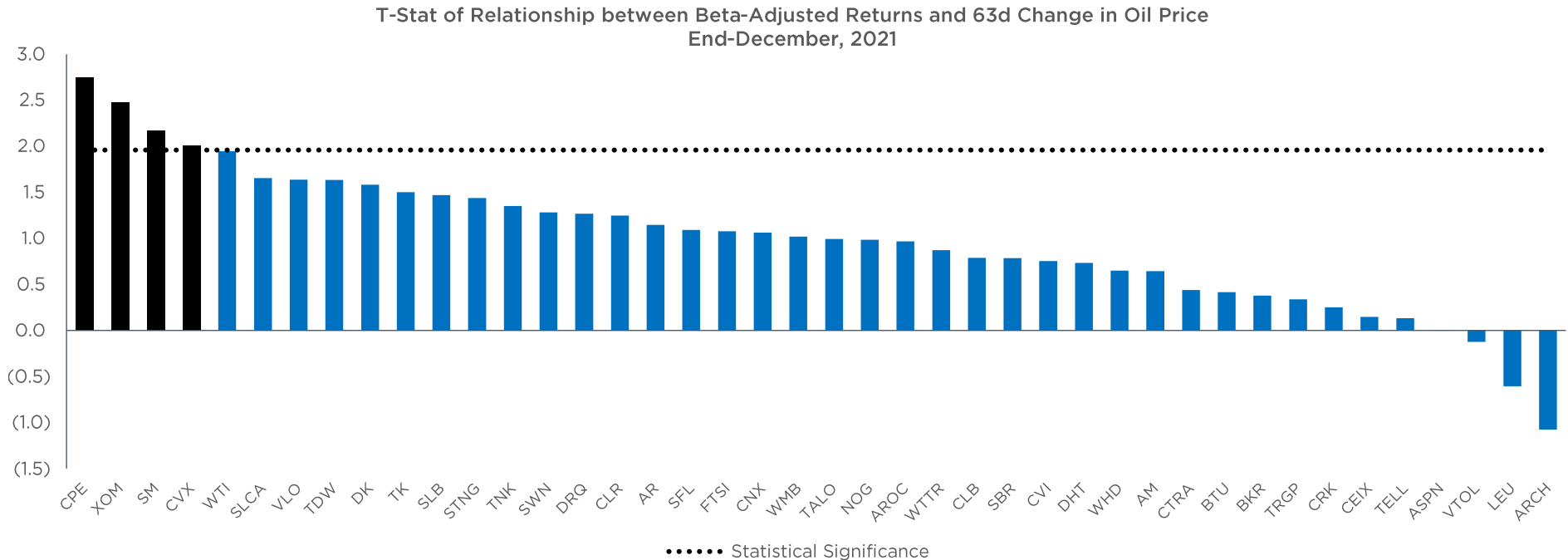
BUY IDEA #4: BUY MID-CAP BIOTECHNOLOGY

Mid-cap biotechnology was down 45% in 2021 while the SP500 was up 27%. This left the group trading at a 10-year low on relative price-to-sales, even though the forecasted sales growth is not commensurately lower than it was a year ago and the long-term innovation pipeline is robust. While 2020 was a year of massive multiple expansion and strong outperformance for speculative stocks, the correction is excessive given the potential of biotech innovation. While it is mathematically true that companies with a significant amount of terminal value get hurt by rising rates, more thought needs to be given to this topic. Many biotech companies have products in early phases of development with cash flow generation likely in years 7-20, not the next few years, and most have negative FCF now anyway. The only question is how much do rising rates hurt the cost of capital needed for the critical investment stage. The answer will vary with investor perception about the potential stability of the business, but our guess is that the cost of capital damage would be 0-5%. This is not a reason for the value of these names to be cut in half.



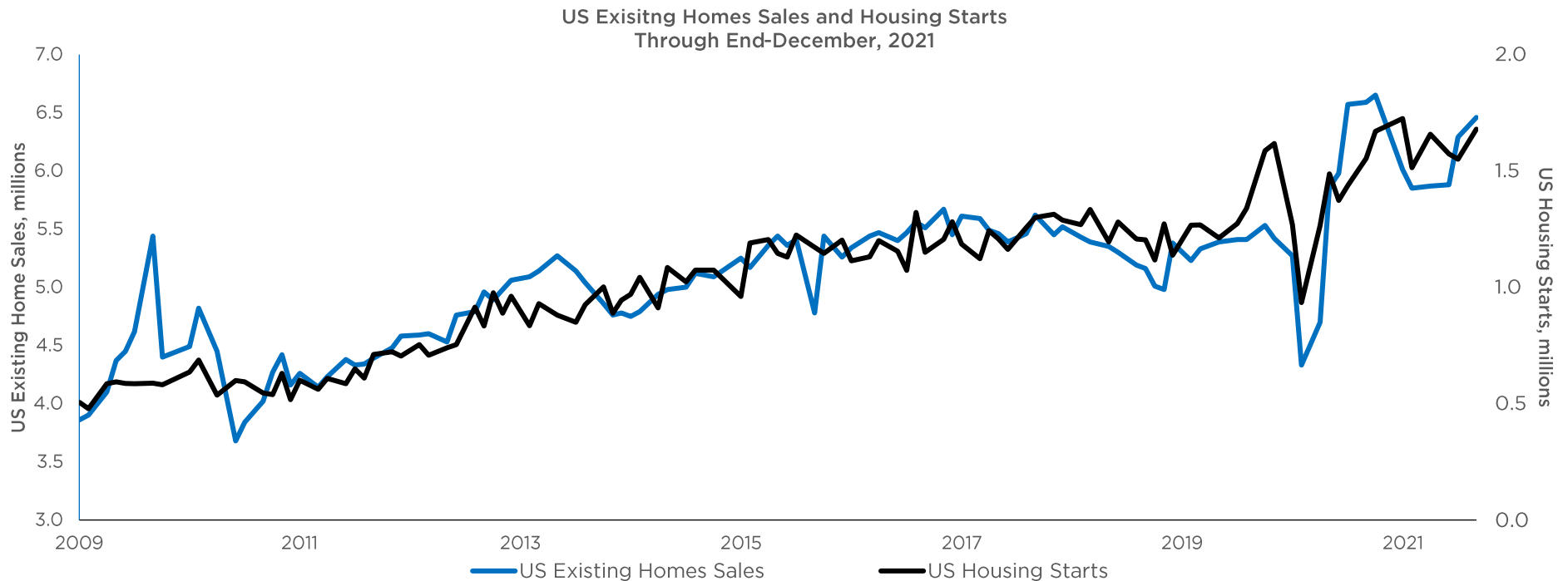
BUY IDEA #5, OIL-SENSITIVE ENERGY: CPE, SM, CVX, XOM

Generally, oil-sensitive stocks are discounting far lower future oil prices than present. We think a higher price is likely. This is a good risk-reward backdrop. Positive revisions, positive momentum, and reasonably attractive valuation vs. history also help. But what continues to attract us to this space is the flippant way some investors dismiss it with the “zero terminal value” argument. We acknowledge that a “pharma patent cliff”-like ceiling on multiples is likely to exist as oil demand from cars peaks around 2030. However, calling energy “un-investable” now seems a bit premature as only 8% of the current auto universe is EV. Moreover, governments may constrain supply, and demand remains robust despite the pandemic, with public transportation substituted for driving in certain situations. Energy was the best performing sector last year (it was our top choice), and we remain very bullish. The stocks we picked all trade with high statistical significance to oil price changes and stand to outperform if oil rises. CPE and SM are smaller E&Ps that likely have more upside. XOM and CVX are the mega cap ways to play oil exposure.



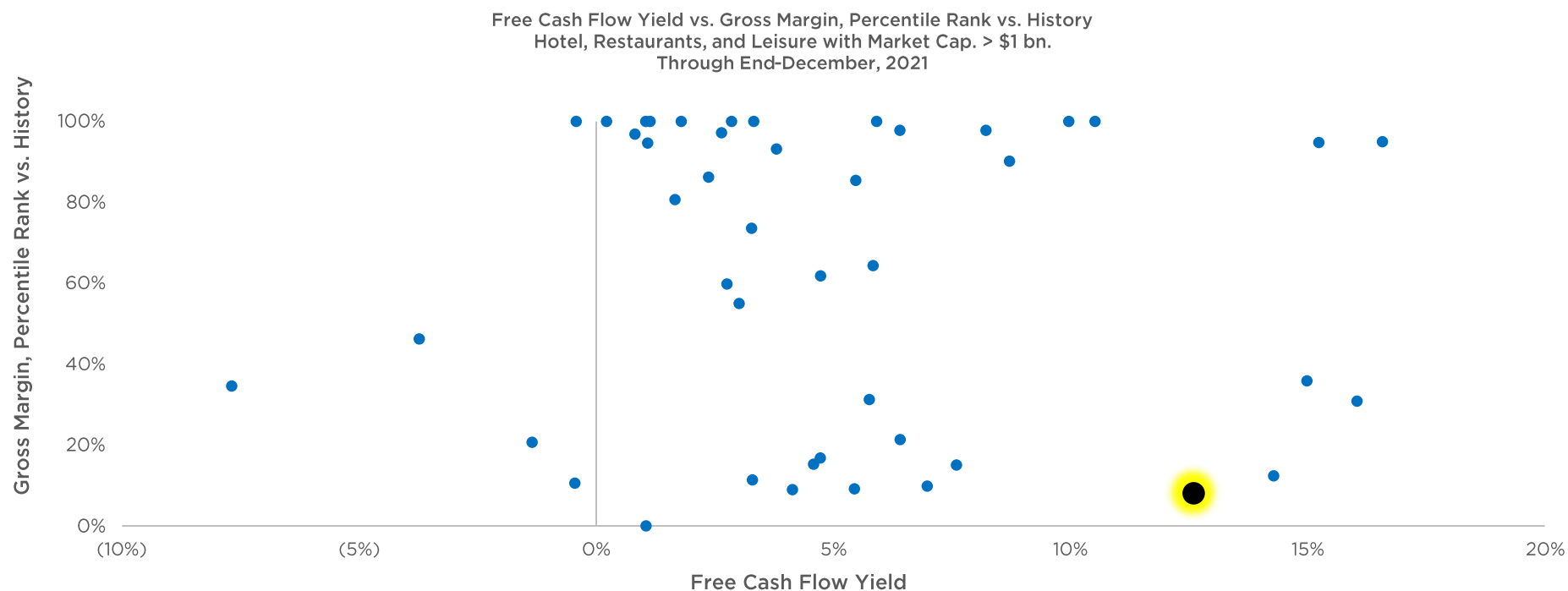
BUY IDEA #6, HOUSING: Z

We are constantly asked about housing given the following: low rates in absolute terms, a strong consumer balance sheet, increasingly abundant loan access, and shortages caused by COVID-induced shifts in consumer behavior, driving strong home sales and housing starts. While homebuilders historically underperform when rates rise and may be over-earning on a normalized basis, we recently heard an extremely compelling pitch on Zillow. Z was \$200 a year ago, and is \$57 today, yet many would argue that the five-year forward outlook looks more compelling now than then. Management sold their 2000 home-flipping properties in November, an admission of error that should have made investors happy. Yet it seems to have fueled a sell-off. Admitting that you are wrong and selling a loser is better than throwing good money after bad, and that alone is a reason to like the stock more now than two months ago. Despite this, the stock is down another 20% since then. Our own observation is that Z-estimates are increasingly accurate, and that by some accounts more than 70% of all house sales start with a visit to Zillow's site – yet monetization is less than 2%. A stock that is down a lot, has exposure to a huge TAM and high market share potential is a compelling way to play housing. The consensus forecasts \$3 in FCF for 2022, on a stock with a 15.7 EV. Only 4 analysts cover it, and none have a buy rating, so upgrades are likely. We like what we Z.



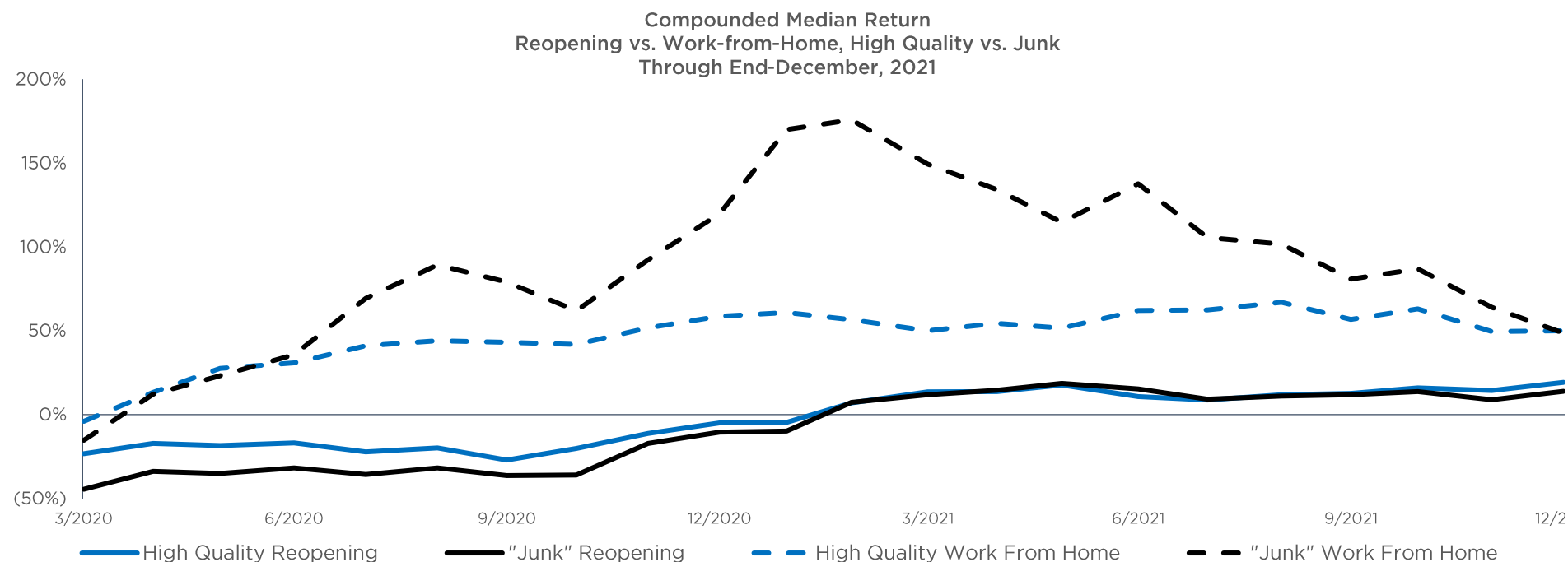
BUY IDEA #7, CONSUMER SERVICES: EAT

As the economy continues to reopen, our view is that owning companies where current profitability is depressed and could materially expand over the next two years is better than loading up on stocks that already have achieved record profitability and have high expectations. When we look at the service-oriented parts of the economy, the lowest margins today in absolute terms are cruises and select restaurants. Among the lowest current profitability with weak expectations is EAT, which is 90% Chili's and 10% Maggiano's. Our expectations are that as pricing pressures moderate, restaurants will ultimately see margin trends begin to mean-revert. EAT generated positive FCF through COVID, and current estimates are for \$4.58 in fiscal 2023 EPS (June quarter), meaning the shares trade at just over 8x forward earnings. EV to forecasted FCF is around 16.6x. This seems like pretty good risk-reward to get this baby back.



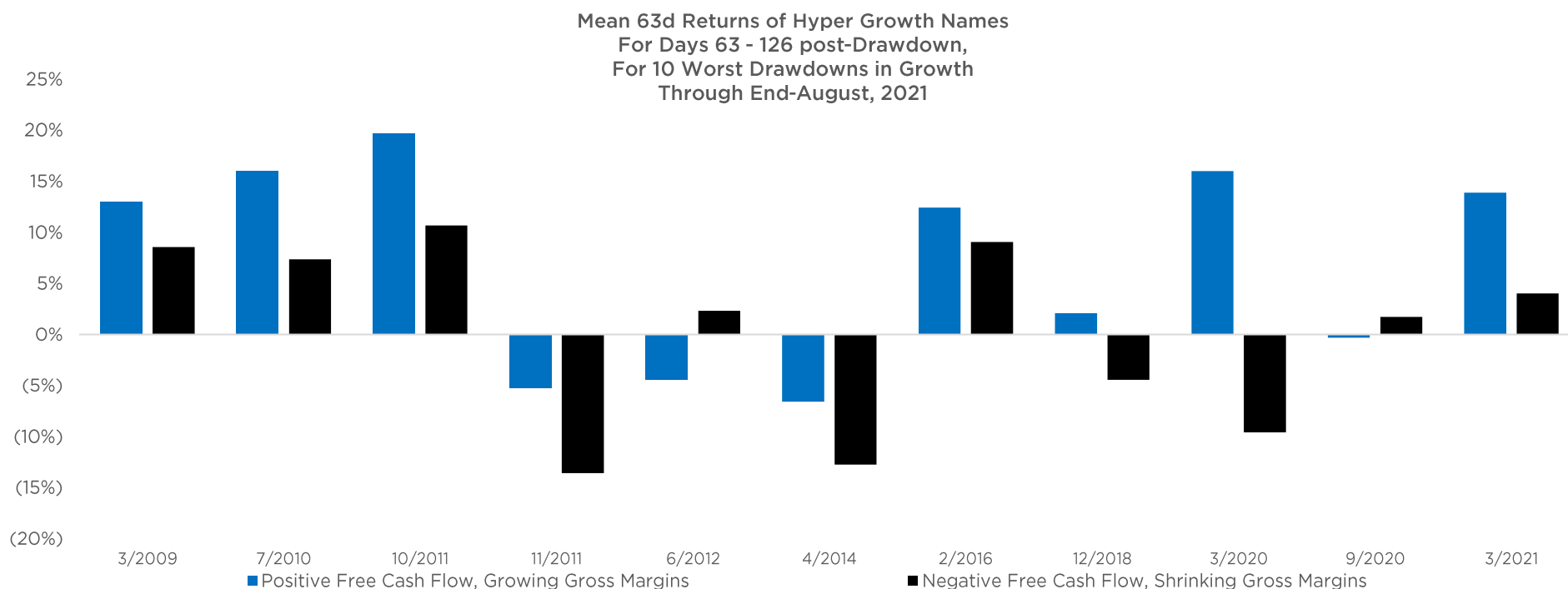
SHORT IDEA #1, LOW-QUALITY WORK-FROM-HOME: PTON

Generally, low-quality work-from-home companies have lagged since last Fall. We think investors should short these stocks and buy high-quality reopening stocks. PTON is no exception. After “blowing up” in Q4, the consensus thinks they will expand margins, but still burn more cash in the coming year. While this could benefit in a “risk-on” Nasdaq trade, or if rate expectations moderate (we think they will), ultimately the growth rate of the business will materially slow. This is more likely to us than that PTON materially surprising to the upside. Additionally, it is not a good quantitative signal when a stock has bad momentum and lots of upside to the median analyst estimate.



SHORT IDEA #2, PROFITLESS SOFTWARE: BILL

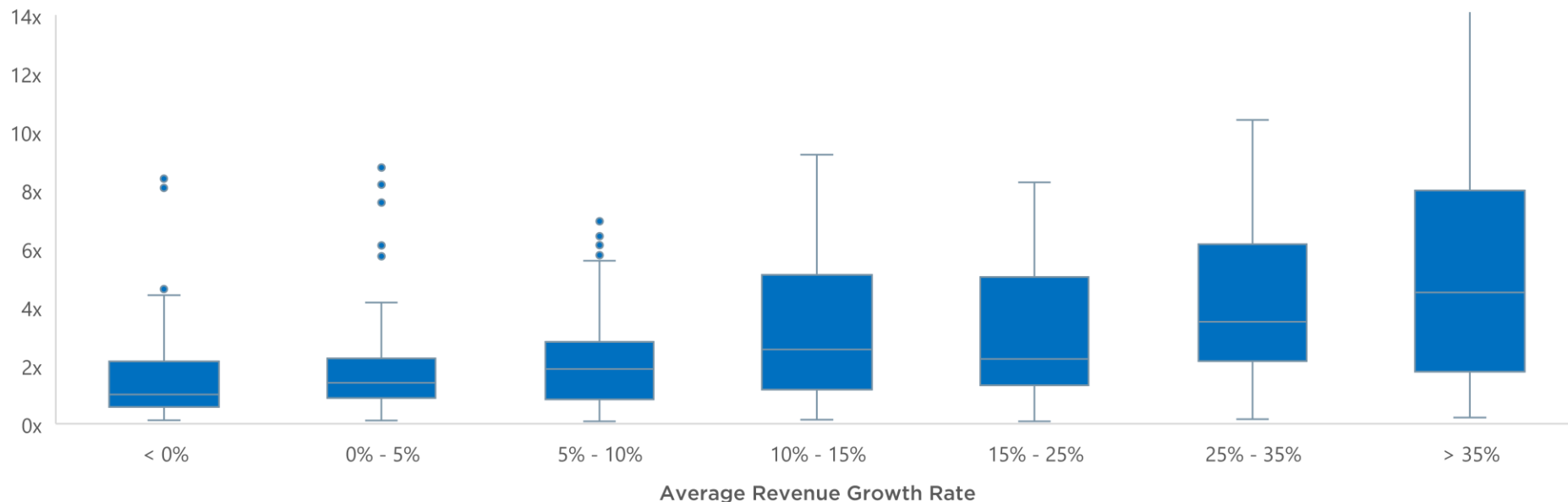
Though profitless software stocks had their day in 2020, most had a huge correction in the fourth quarter of 2021. Our prior works shows that following growth stock sell-offs, names with declining gross margins and negative free cash flow underperform. We have less confidence in these speculative trades than we do in biotechnology. For short ideas, we would look for software companies with forecasted revenue deceleration, and negative free cash flow such as BILL. The consensus expects FY2023 estimates to be below FY2022. The stock was down over 20% from its secondary offering in November, but still trades over 27x EV to forecasted sales (fiscal year is June 2023). The sell side has 15 buys, 2 holds, and 0 sells, so this is the kind of stock that could disappoint, see multiple contraction, and then see several analyst downgrades.



SHORT IDEA #3, SELECT INDUSTRIALS: IR

We remain cautious on industrials, as many have margins that have already recovered and have even higher incremental gross margin expectations embedded in their consensus forecasts. Our judgment is that this makes for below average estimate achievability. Ingersoll-Rand stands out in our work as a risk for a “double whammy” correction, meaning below-consensus revenue and a lower multiple as revenue growth slows. With industrial activity high but leveling off, economically sensitive businesses that make pumps, compressors, bottle blowers, vacuum systems, and other flow control equipment could slow. Nonetheless, the consensus forecast for IR is for 11% topline growth in 2022, up from growth that was closer to 5% in 2021. If estimates disappoint, risk to the EV-to-sales multiple is likely, as at 5x it is well above other companies with similar topline expectations. In addition, we are cautious on industrials that have fully-recovered gross margins and consensus expectations of high incremental margins relative to what their business models have historically delivered. IR is the only industrial stock that is both on our Double Whammy short list (high multiple for its revenue level), and our relatively high incremental margin expectations short list. Together, this means more downside than investors think if revenues disappoint.

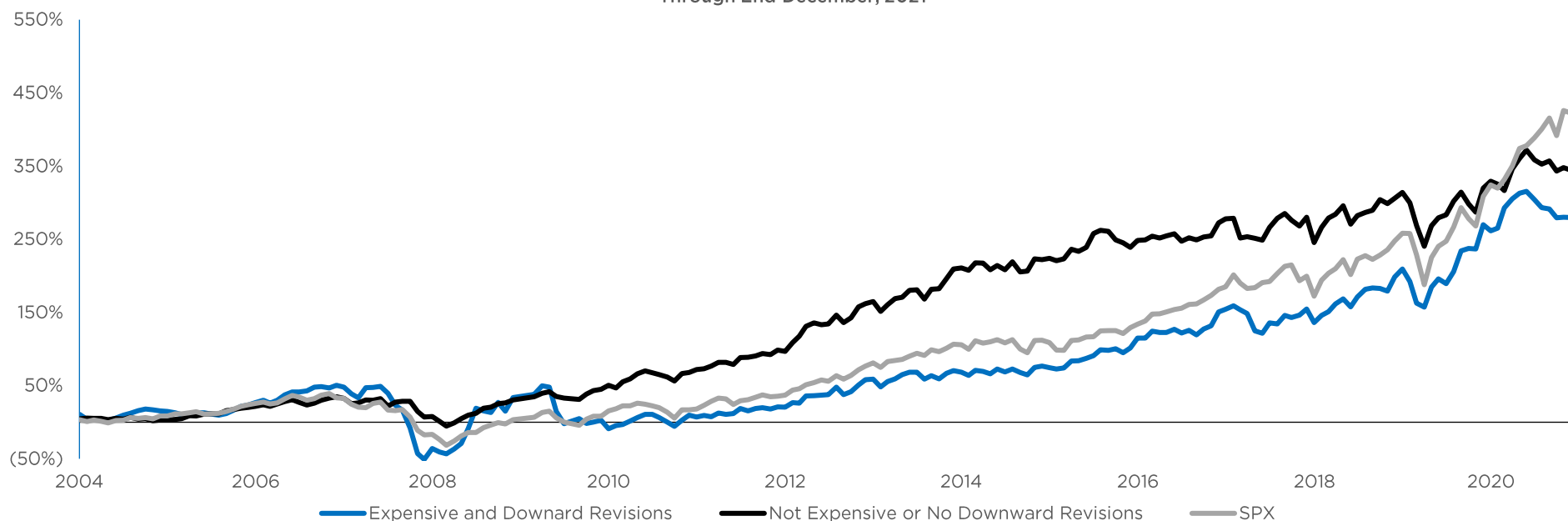
Distribution of Relative to T500 Price-to-Forward Sales Multiple
By Growth Rate Bucket
End-December, 2021



SHORT IDEA #4, EXPENSIVE STAPLES: HELE

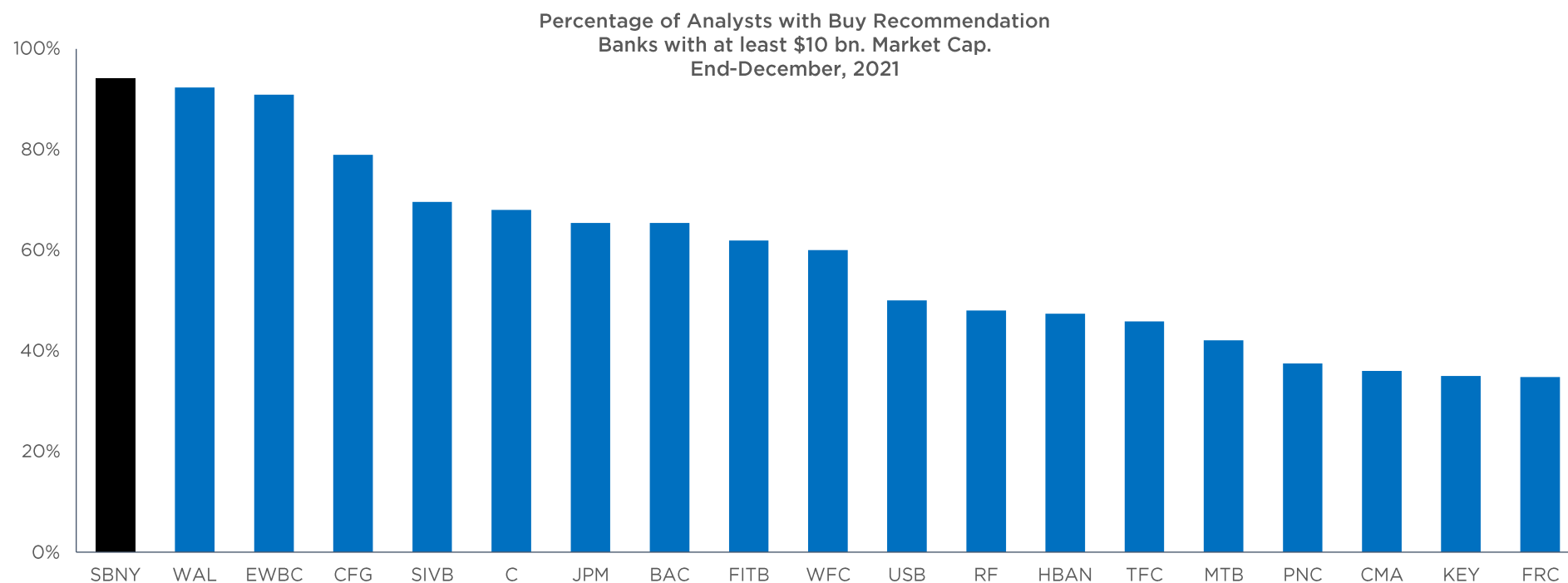
HELE was classic consumer staple that over-earned due to COVID. Women's hair care products, cleaning products, thermometers and air purifiers, kitchen brands like OXO and Good Grips all benefited during COVID as people did their hair at home, cooked at home, and wanted cleaner air. What was a conglomerate of non-synergistic brands became a huge beneficiary of suddenly-altered consumer behaviors. This, combined with an increase in sales from an insulated water bottle business, caused 23% sales growth from end February 2020 to end February 2021, vs. topline growth that averaged closer to 5% the previous several years. Expectations are for revenue growth of 10% for FY 2023 (ending Feb 23), and valuation on that seems extreme at EV to free cash flow of 33.5x. We think the risk-reward is skewed toward downward revisions and multiple contraction. HELE is a collection of businesses that should start to slow as the world continues to reopen and is expensive on potentially overly optimistic expectations. As you can see below, expensive staples that miss tend to lag.

Median Compounded Returns
Consumer Staples
Through End-December, 2021



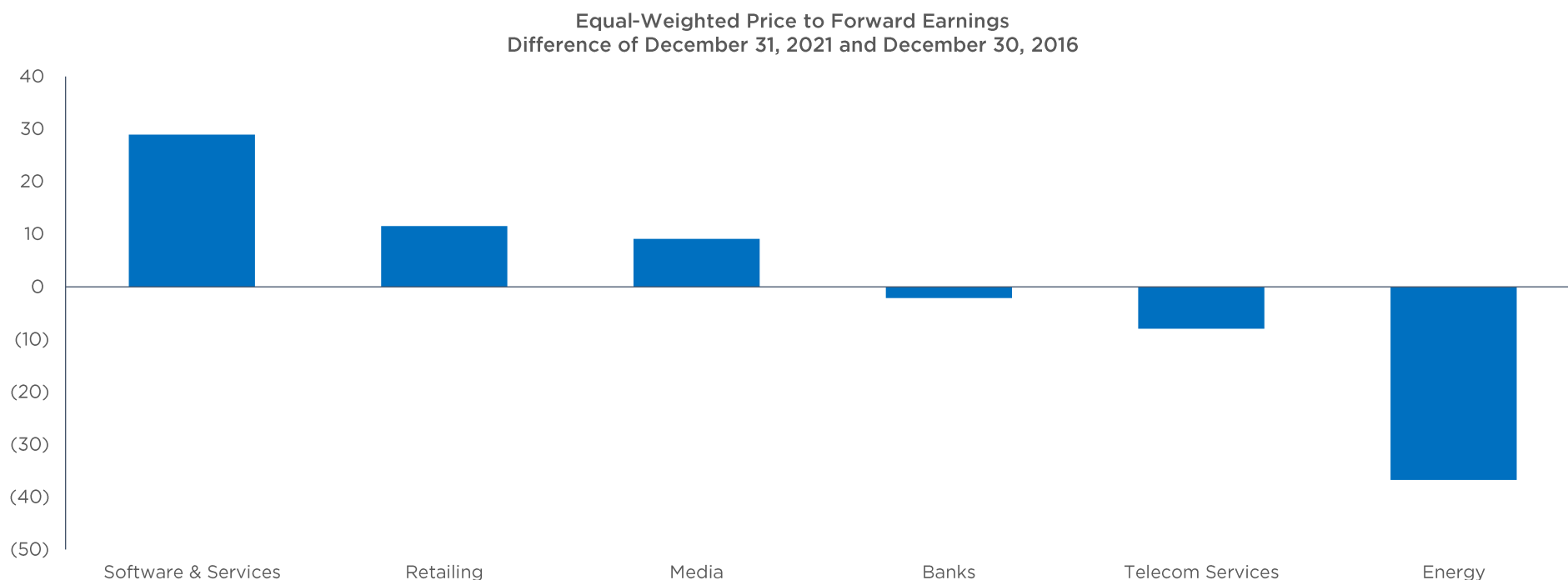
SHORT IDEA #5, REGIONAL BANKS: SBNY

Regional banks are extremely rate-sensitive, and we think expectations for a rising and steepening curve are unlikely to reach the consensus view. Some banks have had huge price-to-tangible book expansion without a lot of tangible book growth, implying that the market thinks future growth will be strong. We think this industry has massive excess capacity, with demand for loans pinched in several areas. Clearly, post-helicopter money savings are being depleted, and demand for credit is starting to grow in the bottom half of the consumer wealth stack. Many regional banks are not equipped to grow without a disproportionate addition of eventual write-offs. SBNY is the most loved bank stock with more than \$10 billion market cap., with 18 buys, 1 hold, and zero sells, is up over 30% in the last six months, and has its highest tangible book in five years. We might as well short one where disappointment will likely be met by multiple contraction.



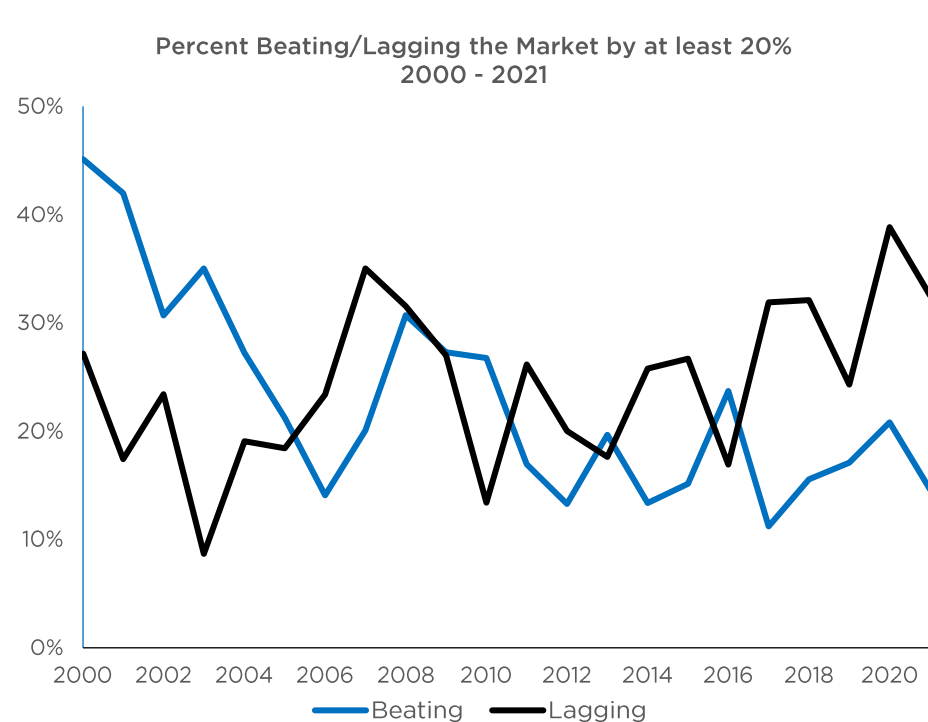
WHERE HAVE MULTIPLES MOVED TOO MUCH?

Over the last five years the market multiple has expanded by five turns (18 to 23x) on a cap-weighted basis, and three turns on an equally-weighted basis (18 to 21x). This is a meaningful increase but is perhaps less than the consensus wisdom for the “average” stock. However, within the market, there have been some major shifts in multiples. Among the industries where earnings are not currently suppressed, software, retailing, and media have seen substantial multiple expansion, whereas energy, telecom services, and banks have seen the most multiple contraction. With the impact of inflation, a constant investor question is where we could see relative multiple shifts in the next couple of years. We have disparate views regarding the industries that have seen relative multiple contraction. We doubt that banks will be a relative multiple expander in the long-term, as poor growth, excess capacity in nearly every business line, poor demand for loans, and potentially higher taxes and regulation are constant threats. However, we think banks will do well in the short-term so long as perceptions that rates will rise are prevalent. We remain bullish on energy. We view telecom services as an area where multiple expansion is possible.



WHAT'S ACTING DIFFERENTLY? SHORT INTEREST

Last year, many hedge fund managers struggled to identify single stock shorts. Some were scarred by damage caused from shorting “meme” stocks in January and February, or the strong performance of heavily shorted stocks in the initial phases of the 2020 COVID recovery. In hindsight, that moment of maximal pain would have been the best time to add to single stock shorts. Last year, more stocks underperformed by at least 20% on a beta-adjusted basis than stocks outperformed by at least 20%. This is the exact opposite of how most investors think of sizing positions (left chart). Moreover, beginning in March of 2021, heavily shorted stocks started strongly underperforming again (right chart). While we are still nervous to short stocks with above 20% short interest, for fear that the “Wall Street Bets” mob will resurface, shorting stocks with more than 10% short interest feels prudent today. For investors who want heavily shorted stock ideas, do not hesitate to contact us.



RISKIER STOCKS THAN YOU THINK?

We considered 11 different ways to assess riskiness of individual names and show stocks that screen as extreme on three or more of those. Among large cap names, risky stocks include WMT, PSA, PTON, ANGI, SWCH, COST, DLR, TWLO, U, GIS, PKI, K, CLX, and W. The eleven screens are:

- | | | |
|---|--|-------------------------------|
| 1) Expensive growth stocks with new CEOs | 5) Large deals with negative initial market reaction | 9) “Junk” work-from-home |
| 2) Negative forecasted free cash flow | 6) Low and declining company-specific risk | 10) Highly convex correlation |
| 3) High insider selling in the last 90 days | 7) Extreme inflation correlations | 11) Negative asymmetric beta |
| 4) Forward gross margin contraction | 8) Bad crowding | |

For more information regarding any of these 11 screens, please do not hesitate to reach out.

**Stocks Appearing on 3 or more Risk Screens
Greater than \$20 bn. Market Cap. If Three screens
End-December, 2021**

Ticker	Company	Industry Group	Number of Screens	Market Cap. (US\$ Bil.)
WMT	Walmart Inc.	Food & Staples Retailing	4	401.35
COST	Costco Wholesale Corporation	Food & Staples Retailing	3	251.74
PSA	Public Storage	Real Estate	4	65.68
DLR	Digital Realty Trust, Inc.	Real Estate	3	50.19
TWLO	Twilio Inc.	Software & Services	3	46.96
U	Unity Software Inc.	Software & Services	3	41.79
GIS	General Mills, Inc.	Food, Beverage & Tobacco	3	40.64
PKI	PerkinElmer, Inc.	Pharmaceuticals, Biotechnology & Life Sciences	3	25.37
K	Kellogg Company	Food, Beverage & Tobacco	3	21.98
CLX	The Clorox Company	Household & Personal Products	3	21.42
W	Wayfair Inc.	Retailing	3	19.86
PTON	Peloton Interactive, Inc.	Consumer Durables & Apparel	4	11.81
ANGI	Angi Inc.	Media & Entertainment	4	4.63
SWCH	Switch, Inc.	Software & Services	4	4.11

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