UPSLOPE CAPITAL MANAGEMENT: INTRODUCTION

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Upslope Capital Management

George K. Livadas is the founder of Upslope Capital Management, which is based in Englewood, Colorado. His experience includes 15 years on "Wall Street" across sectors and functions, including buy- and sell-side equity research and investment banking. George earned an MBA from the University of Chicago (Booth) and a BA in Russian from Georgetown University.

Upslope's objective is to deliver attractive, equity-like returns with significantly reduced market risk and low correlation vs. traditional equity strategies. To meet this objective, Upslope utilizes a long/short equity strategy focused mostly on midcaps in the U.S. and developed markets. Upslope invests across sectors, with some concentration in those the portfolio manager has deep professional experience. The strategy is currently managed in a separately-managed account format. Upslope also manages a long-only version of the strategy for a subset of AUM.

STOCK IDEA ONE

APTARGROUP, INC. (ATR)

Your first pick is AptarGroup, Inc. Let's start with the basics. What does this business do?

Historically, most of Aptar's revenue has come from businesses that look like that of a traditional packaging company with a niche focus on dispensing solutions – think of the sprayer mechanism on a perfume bottle, an aerosol valve for sunscreen, or a sport cap on a Gatorade bottle. The focus is on the dispensing components and system – not on the bottle or container itself. This is a decent niche within packaging, as there is some element of "technology" and a greater potential to add value. Aptar buckets these traditional business lines into Food + Beverage and Beauty + Home segments. Aside from significant exposure to fragrances, these end-markets are not cyclical.

Aptar also has a Pharma segment. The segment is a gem and the most interesting part of the business. Aptar's Pharma products look a lot like simple medical devices. Products mostly include various drug delivery devices (e.g. inhalers, nasal spray pumps, syringe plungers, etc.). Aptar's solutions are often tied-in to their customer's own regulatory processes – providing Aptar with a strong shield against competition.

Can you give a bit more detail on where the company makes its money and the growth potential?

Aptar is slowly but surely becoming a pure-play Pharma business. Contribution from Pharma to company-wide sales and EBIT nearly doubled from 2010 to 2020: Pharma sales went from 23% to 42% of total and EBIT went from 46% to 83%. The trend to Pharma accelerated in 2020 due to the pandemic and should revert a bit as the traditional segments recover in the year ahead. But, the long-term trend – driven by far superior organic growth and margins in Pharma, as well as a Pharma M&A bias – is extremely clear.

In terms of long-term growth, Pharma has historically delivered 8-10% organic top-line growth, while the traditional segments have averaged closer to 3-4% (with more volatility). Given a strong competitive position and rising global demand for healthcare, I see no reason ATR can't continue to deliver in Pharma. In addition to organic growth, the other major drivers are FX (mostly translation-based, as expenses and top-line are aligned well-enough) and M&A. Combined, these factors (M&A, net of whichever direction FX goes) have added another 2-3% annual growth for Pharma in recent years. Perhaps an obvious point, but as Pharma contributes the vast majority of earnings, it is really just that segment's growth that I care about.

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Ironically, however, I do think the traditional segments are being underestimated in the year or two ahead. While typically not very cyclical, these segments were hit hard by the pandemic: specifically due to travel (e.g. duty-free fragrance sales) and "on-the-go" beverage (e.g. sport-capped beverages typically consumed during travel, in gyms, etc.) exposures.

What first attracted you to the company?

I first learned of the company in 2014, as a sell-side Research Associate covering non-paper-based packaging companies. Even then, Aptar was unusual relative to other packagers: the Pharma segment actually had real organic growth that didn't require a magnifying glass to figure out and it traded at a sizable premium to traditional packagers. It was somewhat of an enigma.

A few things that really attracted me to it and still do: first, the clear shift to becoming a pure-play Pharma business means that every year that goes by Aptar as a whole effectively becomes a better company than the year before. Margins expand, its moat widens, growth accelerates, and the company becomes even less cyclical. While ATR's multiple has clearly expanded over time –

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there is a genuine reason for it (beyond just that "the market" has gotten more expensive). Aptar is a far better business today than 5 or 10 years ago.

Second, on a micro-level, Aptar – and Pharma in particular – is a classic example of a business that produces really important and essential products (drug delivery devices) that represent a fraction of the cost of their customers' end-products. Combine that with the regulatory tie-in of many of their products and you can see why Aptar customers are unlikely to be price sensitive or interested in leaving for a slightly cheaper competitor.

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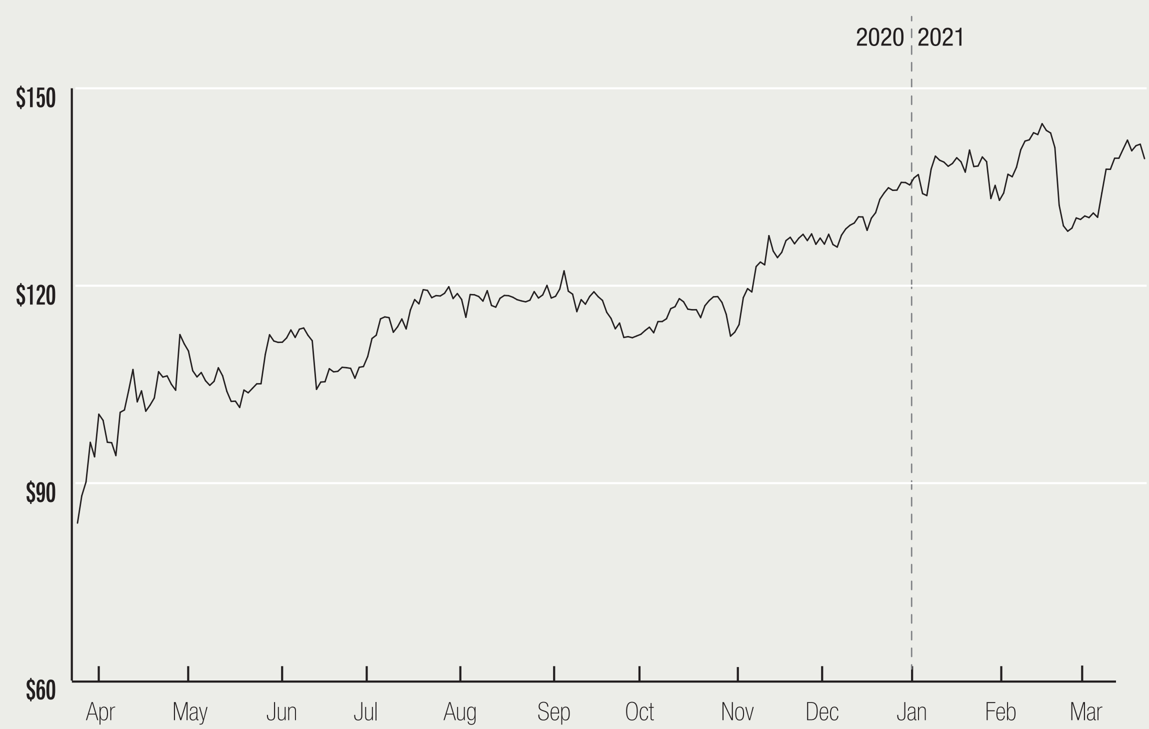
Stock Information | ATR



Pharma., which trades at 25-30x EBITDA and is a fairly clean comp to ATR Pharma) Aptar is still covered by traditional packaging analysts used to following and valuing old-line industrial companies. Does it make any sense at all for a medical device business to be covered by the same group of analysts that cover manufacturers of aluminum cans, glass bottles, and paper? I think not. And while the Pharma transition "story" is increasingly obvious, I still believe this mis-aligned coverage has allowed ATR to continue to be undervalued over the years.

What's management's background, and do they have a record of creating value?

CEO Stephan Tanda joined in 2017 from Royal DSM (which, coincidentally, Upslope became a shareholder of in 2019), where he was a senior executive focused on the company's Nutrition business (DSM sells ingredients for animal feed, human nutrition, dietary supplements, vitamins and personal care). The CFO has been in-role since 2008 and at Aptar for decades. "Hard-charging" is not a phrase I would associate with ATR management; but, in general I believe they've created value. Since Tanda joined, free cash flow is up significantly, Pharma growth has accelerated modestly, and they have completed a handful of successful acquisitions. Their success in managing and turning around the traditional segments is more of a mixed bag. And, I do wish they'd be even more aggressive in accelerating the transition to Pharma and generally telling the Pharma story.

Aptar has always carried a modest amount of net debt – today it's around 1.5x, near the higher end of recent years. It may seem under-levered – especially vs. traditional packaging peers that are commonly levered 4x and up – but, it's conservatively managed for a reason.

Does management own a high percentage of the business? What is management's incentive structure?

Management owns a moderate amount of stock ($10+ million each for the CEO and CFO), but it is not a big percentage. On the other hand, their incentive structure is solid. Annual performance-based comp is based on EBITDA and organic sales; long-term incentive is based on ROIC and total shareholder return.

Moving on to valuation, what's the current valuation? Why do you believe this is attractive?

Aptar trades for just over 15x EBITDA, a premium to its historical multiple, but for good reason, as previously noted. West Pharmaceutical (WST) is the obvious comp for ATR Pharma and it trades for 29x EBITDA. I don't expect the two to trade in-line today, given the noise from Aptar's traditional packaging segments. But, I think WST is a reasonable long-term guidepost for where ATR can go. In terms of absolute valuation today, I think ATR is still attractive considering the reliable and profitable growth of the business, clean balance sheet, and potential "reopening" upside from the traditional segments that are likely being underestimated today.

Does the business have any debt?

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What's your long-term price target for the stock?

I think the stock is worth $180 today on a simple sum-of-the-parts basis (using a modest discount to WST for Pharma, SEE-SON-AMCR as comps for the rest, and slightly above consensus estimates for 2021). This works out to about 18x my EBITDA estimate, which I think is a reasonable multiple for the stock in the coming years.

Are there any key risks that could derail this thesis?

Of course: doubling down on non-Pharma via larger acquisitions would be very concerning to me. A lasting loss of momentum in Pharma either in terms of organic growth or material decline in margins would also cause me to re-evaluate the position. Note that Pharma does have some "seasonal" swings, as the business has large exposure to flu season (which can vary significantly in intensity). Beyond these large, obvious risks, the only other item I'd note is FX. About 2/3 of ATR sales come from outside the U.S. (mostly Europe); so, a strong dollar can be a serious headwind to growth.

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And the downside risk if the company struggles to grow?

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UPSLOPE CAPITAL MANAGEMENT

CBOE is the most prominent options trading market in the country. Aside from the options business, can you break down where the group's revenues come from?

There are a few ways to slice it – by product and by asset class. By asset class, CBOE's net revenue split in 2020 was: 52% options, 26% North American equities, 9% European equities, 8% futures (VIX), and 5% FX.

By product, you can break up CBOE's revenues into three roughly equal categories: proprietary transaction-based (e.g. SPX options + VIX, which are traded only on CBOE – very good business), non-proprietary transaction-based (mostly equities and plain vanilla options, e.g. AAPL calls – decent businesses, but commoditized and competitive), and recurring revenue (data/access fees – very good business).

So, you can see that about 2/3 of CBOE's revenues are in what I'd characterize as highly attractive products (monopoly-like or recurring and very predictable). Transaction-based revenues also comprise about 2/3 of CBOE revenue; and, this is one of the features that attracted me to the stock in the first place. While a consensus has emerged over the last 5-10 years that this is less desirable (less predictable and hard to forecast), I consider it a good thing, given the role exchanges have typically played in Upslope's portfolio (I want them to have leverage to volatility and the more volume-driven models generally provide just that).

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Over the past five years, the stock has underperformed the S&P 500. Why do you think this is, are there any legacy issues that could affect future performance?

CBOE has a complicated history that I think explains where it's at today. This history can be divided into a few periods.

Prior to 2017, CBOE was a somewhat typical derivative-focused exchange with the clean operating leverage to volatility I noted above.

During 2017, however, the "short volatility bubble" emerged and really accelerated with the rising popularity of those fatally-flawed leveraged short VIX ETNs (XIV and SVXY). Undoubtedly, CBOE benefitted from this bubble during 2017 when shares nearly doubled. VIX futures open interest surged almost 75% from the beginning of 2017 to their peak on Feb 5, 2018 when the short vol bubble burst and the levered VIX ETNs imploded.

This event really hurt CBOE's business, as the ETNs and traders broadly exited the VIX complex (CBOE's flagship product and a major reason many own the stock). Ultimately, however, the VIX product regained some momentum later in 2018 and during much of 2019. It appeared the product's issue wasn't so much with CBOE and the VIX itself, but with poorly structured third-party-managed ETNs. Without them, perhaps CBOE's VIX business could stabilize and ultimately thrive again.

Then, in 2020 the pandemic-driven market melt-down led to an unprecedented spike in the VIX. While vol is generally good for exchange trading volumes, the unprecedented spike in VIX – and the volatility of the VIX itself! – made the VIX product practically untradable. Why buy the VIX when it's already at peak-panic levels? And an even scarier thought: why short the VIX if it can move at never-before-seen speed? Markets needed to stabilize.

So, for the second time in two years CBOE investors were left with two not-so-good impressions: (1) VIX may be a severely flawed product, and (2) CBOE is actually pro-cyclical and volatility is bad for business. In my view, both conclusions are wrong. First, without significantly-levered short VIX ETNs, the product itself seems quite useful and sustainable today (e.g. with the VIX ~20 today, it can be a perfectly effective hedge for a wide range of market participants). This should continue to be the case in 99% of market environments. Second, barring genuinely unprecedented events (e.g. a pandemic-driven market collapse), volatility is still in fact good for business at CBOE (as seen by volumes in virtually all of CBOE's remaining products).

The last 12 months have been tough for all investors. How has the CBOE performed throughout the pandemic?

Overall, CBOE performed relatively well during 2020 – but in an unexpected way. Proprietary products (especially VIX) did quite poorly, while the more competitive, commoditized products (plain vanilla options and equities) did very well. The net result was that revenue, EBITDA, and EPS were all up 10% or more in 2020. This may not be how bulls (or former bulls) envisioned the year would go; but, it is a tangible benefit of CBOE's diversification.

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Do you expect this performance to continue, or are you anticipating revenues to moderate after a turbulent year?

I suspect we'll gradually see a reversal of the above trends – proprietary product volumes should return and the non-proprietary side of the business should eventually ease. For 2021, I expect revenues to grow at least mid- to high-single-digits. CBOE's equities and plain vanilla options business have continued their strength YTD. And, VIX open interest levels, which provide a decent proxy for where volumes are eventually headed, are up almost 40% YTD. I expect the VIX complex comeback will continue as we get further away from Covid and into a more normalized volatility regime. The return of SPX volumes remains a bit of an open question; but, there are some encouraging signs YTD.

The company has recently completed several acquisitions to complement the existing business. Do you think this was the right decision?

The most important one was EuroCCP and the jury is still out on their broader plans for the asset. CBOE acquired EuroCCP last July with cash-on-hand and the goal is to use it as part of a platform for launching European equity derivatives (the European derivatives market is far less developed than the U.S.). To me, it seems like a cheap "option" – odds of success appear low, but it doesn't cost much and a win would be a genuine homerun. The biggest issue is the distraction created for the stock. For example, when CBOE reported Q4 earnings, their expense guidance disappointed the Street in large part because of upfront expenses tied to the European derivatives effort (with no corresponding revenues in 2021). Frankly, I think the perception of this deal would be quite different had CBOE gone into it from a position of strength (in terms of share price).

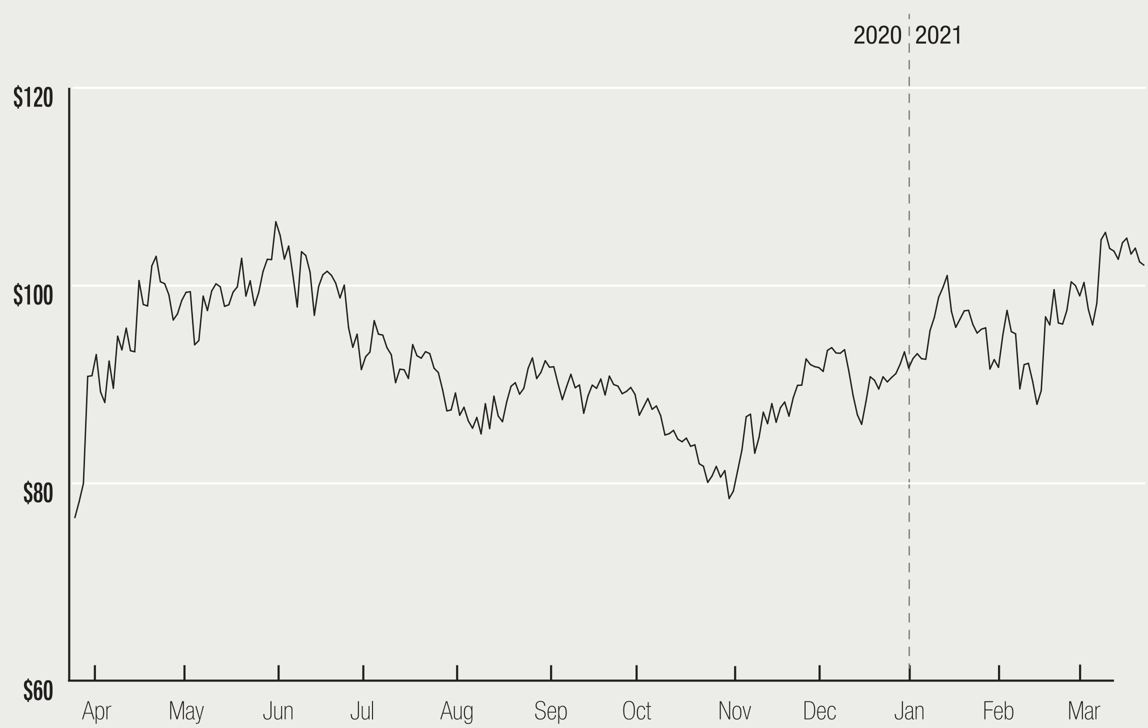
Do you see management pursuing future deals to expand the group's offering?

Nothing material – I think investors would revolt and CBOE would very quickly find itself with an activist (if they don't have one knocking already).

What's the stock's current valuation, and why does this look attractive?

Shares currently trade for an almost 6% FCF yield and about 14x EBITDA (both 2021e). These are reasonable metrics relative to CBOE's own history and to the market overall, given the quality of the business. Additionally, I think consensus estimates are conservative

Stock Information | CBOE



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today: revenues are likely already running ahead YTD and consensus seems to assume little recovery in proprietary products. On the expense side, 2021 expenses are heavy due to one-time investments, but these should fade next year. CBOE also has a history of conservatism and delivering with expense discipline.

An important item to note: part of my thesis since inception has been that CBOE is a logical M&A target. Current valuation is cheap enough that even with a significant premium, a deal could happen in-line with precedent transactions. In Upslope's Q4 2020 letter, I noted that odds of a deal appear elevated in 2021 due to the stock's low valuation (especially relative to peers), disappointing execution in recent years (i.e. room for improvement under new ownership), and a cyclical trough of the VIX complex. Interestingly, after the close on a random February Friday the company filed an 8-K amending severance payments for upper management in the event of a change of control. Management's "line" when asked about the amendment has been that it was a routine update bringing them in-line with peers. From my analysis, it appears they were already in-line with peers and that the amendment clearly bumped them to the generous end of the spectrum. Mike Puangmalai, a talented corporate governance expert, published an excellent analysis on the amendment and general situation. His piece focused, in part, on management's potential motivation to do a deal in light of a year-end compensation cliff. While far from a sure thing, my own opinion is that the 8-K is a concrete sign that management may be preparing to consider a transaction or, possibly, deal with the presence of an activist.

I think CBOE is worth $140 (about 18x EBITDA) either in a nearer-term take-out scenario or longer-term on a standalone basis (that assumes a continued recovery in VIX and some stability in the rest of the business).

What's your estimate of intrinsic value and estimated price target?

I think CBOE is worth $140 (about 18x EBITDA) either in a nearer-term take-out scenario or longer-term on a standalone basis (that assumes a continued recovery in VIX and some stability in the rest of the business).

Resolution of the European derivatives effort over the next 6-12 months should also help fundamentals either way: if it fails, the expenses will quickly drop out of estimates. If it succeeds – well, nobody is seriously considering the possibility.

CBOE GLOBAL (CBOE)

What reasons, if any, would cause you to re-evaluate your position on the stock?

The biggest issue I'm focused on is the VIX complex. If VIX open interest were to stall despite continued normalization in the level of the VIX, I would be concerned about the product. Additionally, any signs that management is being provided an 'out' (regarding compensation) to continue the status quo with nothing to force a sense of urgency would be concerning.