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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Finding Opportunities to Buy Great Businesses as Volatility Increases

MCGAVOCK DUNBAR joined Vulcan Value Partners in 2010. Prior to joining Vulcan Value Partners, McGavock worked as an Associate in the investment banking department at Susquehanna International Group. McGavock earned his MBA from the University of Virginia Darden School of Business. He also has a Master of Education and Bachelor of Arts from the University of Virginia, with a double major in History and Religious Studies.

SECTOR — GENERAL INVESTING

TWST: Please share an overview of Vulcan with a view to any significant changes you've made since we spoke last year.

Mr. Dunbar: We continue to be a privately held, majority employee-owned business. We still operate five strategies with the same basic investment philosophy. The strategies are Large Cap, Small Cap and all cap, which are more diversified strategies with 20 to 40 positions. Lastly, we have two concentrated strategies: Focus and Focus Plus, which hold between seven and 14 positions.

In every strategy, we have the same investment philosophy of investing in really high-quality businesses when they're trading at a discount to fair value. I would also add that any company in All Cap, Focus or Focus Plus would also be included in our Large Cap or Small Cap strategies. In other words, the companies in All Cap, Focus and Focus Plus are a subset of the two large, diversified strategies.

TWST: Can you share the big picture of how the surrounding investment scenario has evolved and supports or presents challenges to your key goals and strategies?

Mr. Dunbar: We're always trying to identify high-quality businesses with stable values, and then, we are just waiting for the market to give us an opportunity to buy them at a discount to that value. I think our philosophy benefits because values tend to compound for high-quality businesses, and the price to value gap will eventually close. We take a five- to seven-year view.

So how does this look in various investment environments? Well, number one, in environments where discounts to fair value are very plentiful, say in the years after the financial crisis, we tend to hold larger positions in companies with the greater margins of safety. This generally means that in such circumstances we will have a more concentrated portfolio.

In the opposite environment — for example, in 2007, when companies were trading closer to fair value and, therefore, would've had a smaller margin of safety — we will hold smaller weights in those businesses, meaning we will be more diversified. So in the current environment, and I would add that this is probably most environments, we are between the extremes. That means we have some companies that are deeply discounted and some that are not so discounted.

Our portfolio management process leads us to trim positions as they get closer to fair value, and we have effectively recycled that capital into more discounted companies. The recent market volatility has given us a tremendous opportunity to take advantage of the widening and closing of the price to value gap. Generally speaking, over the past couple of quarters, we have been trimming or selling positions that are getting closer to fair value, and we have been buying positions with a greater margin of safety. The portfolio has become more concentrated as a result.

TWST: Do you see any important differences in the surrounding market environment compared to previous market cycles?

Mr. Dunbar: First of all, we are at year 10 of a long bull market, where volatility has been at historic lows. That is generally not a very good recipe for success for an active manager. However, with volatility increasing, I think that is going to provide us a greater opportunity to deploy capital in some of the great businesses that we are looking to buy. And I think the current volatility — and long lack of volatility — is a function of interest rate policy. So that is one piece of context that's maybe different than other cycles, the sort of extremeness of the interest rate policy. That's changing, and the volatility is coming back.

TWST: Currently, are there any other macroeconomic or geopolitical trends and themes that you are monitoring?

Mr. Dunbar: Of course, we are watching potential trade wars and how tariff policy shapes up. At this moment, it's hard to differentiate between rhetoric and what is more serious. Obviously, trade wars would negatively affect the global GDP growth rate, so we are curious to see what ends up happening. Whatever does occur, we will try our best to quantify and incorporate that information into our valuations. That is really how we react to macro events; we try our best to incorporate the information as best we can on a bottom-up basis into our valuations.

We rely on resilient businesses that can weather the storm no matter what comes. So when you think about it, a large macro event would likely affect all companies within a sector similarly. The stronger ones are able to use negative events to improve their competitive standing within the industry. In that sense, our process of limiting investments to only those sorts of businesses helps insulate us from macro fluctuations.

TWST: Give us a closer look at your process for stock selection, and walk us through the steps you take.

Mr. Dunbar: We are very process-driven. Our process for investing in high-quality businesses when they are discounted begins with the first question: Does this business have a stable value? We spend the vast majority of our time looking for businesses that do.

Typically, they are characterized by ample free cash flow production, high returns on capital, management that knows how to allocate capital well and, most importantly, some intangible quality or moat that allows us to know that this business will continue to be strong into the future. In that sense, we are mostly business analysts as opposed to stock analysts.

We scour the globe looking for these businesses, and when we find them, we put them on what we call the MVP list. This is our list of high-quality businesses that qualify from a qualitative standpoint. We follow these businesses very closely and keep an estimate of intrinsic value for them. Then, when the market gives us an opportunity to buy them at a discount, we compare them to everything else we have in the portfolio in a survival-of-the-fittest kind of way. We are always trying to drive down the weighted average price to value in the portfolio. In other words, we are trying to maximize the margin of safety in the portfolio.

So the decision to add to the portfolio really starts with the decision to add a company to the MVP list. We use every tool at our disposal to help identify MVP companies, and of course, we do screens. High free cash flow production is absolutely a part of any screen we do on a business. I will also tell you that screens at this point in our history do not actually yield the most incremental names for the MVP list. So far, simply reading about or talking to our current MVP companies seems to yield the most new names.

We are of course using any technology at our disposal to uncover potential new MVP companies. For several years, we have been pursuing a Big Data or artificial intelligence project, under the leadership of Jim Falbe, another analyst and principal on the team. This is aimed at producing potential MVP companies for the research team to evaluate. It is 100% proprietary. And that project is going pretty well so far.

Highlights

McGavock Dunbar discusses five strategies that use a basic investment philosophy. Mr. Dunbar invests in high-quality businesses with stable values and aims to buy them at a discount to fair value. He characterizes high-quality companies as those with ample free cash flow production, high returns on capital, the ability to continue to be strong into the future and management that allocates capital well. Mr. Dunbar says that limiting investments to these high-quality, resilient businesses helps to insulate the strategies from macro fluctuations. Mr. Dunbar believes the recent volatility of the market has given Vulcan the opportunity to take advantage of the widening and closing price to value gap.

Companies discussed: Visa (NYSE:V); Mastercard (NYSE:MA); Alphabet (NASDAQ:GOOG); Facebook (NASDAQ:FB); Qorvo (NASDAQ:QRVO); Skyworks Solutions (NASDAQ:SWKS); National Oilwell Varco (NYSE:NOV); PayPal Holdings (NASDAQ:PYPL); InterContinental Hotels Group PLC (ADR) (NYSE:IHG); SS&C Technologies Holdings (NASDAQ:SSNC); CBRE Group (NYSE:CBRE); O'Reilly Automotive (NASDAQ:ORLY); Sabre Corp. (NASDAQ:SABR); KKR & Co. (NYSE:KKR); Cardinal Health (NYSE:CAH); McKesson Corporation (NYSE:MCK) and AmerisourceBergen Corp. (NYSE:ABC).

TWST: Where are you currently finding the best value, in what sectors or which geographies?

Mr. Dunbar: I think we've probably increased our weighting in information technology if we're looking on a sector basis. However, we don't really think about it on a sector basis. We think about it more in a bottom-up kind of way. Whatever is cheap on the MVP list will find its way into the portfolio. But when you look at the trend over time, information technology is one area that has been increasing. For us, that is companies like **Visa** (NYSE:V) and **Mastercard** (NYSE:MA), which are categorized in this area. **Google** (NASDAQ:GOOG), **Facebook** (NASDAQ:FB), **Qorvo** (NASDAQ:QRVO) and **Skyworks** (NASDAQ:SWKS) are also some of the companies to which we have been allocating within that sector.

TWST: So looking back over the past year since we last spoke, which are the best performers that you'd like to highlight?

Mr. Dunbar: Our best performers in the Large Cap strategy over the past year have been **Visa, Mastercard** and **National Oilwell Varco** (NYSE:NOV). All were up more than 30% in the past year, and in **Mastercard's** case, it was up over 60%. We still own all three. This highlights the benefit of only investing in high-quality businesses: Their intrinsic values tend to compound.

TWST: What's behind the outperformance in a company like Mastercard? Are there any competitive threats on the horizon? Has it been challenged by any negative impacts stemming from applications like PayPal or Bitcoin?

Mr. Dunbar: Visa and **Mastercard** essentially have a duopoly. They are the rails on which many, if not all, electronic transactions run. Even **PayPal** (NASDAQ:PYPL) is one of the largest customers of **Visa** and **Mastercard**. The truth is, **Visa** and **Mastercard's** largest competitor is cash, and cash still has a meaningful market share. So it's still over half. Even in the United States, it is still significant. There is this tremendous tailwind, a movement from cash to electronic payments worldwide that these companies are benefiting from, and they have established themselves as the rails upon which these electronic transactions flow.

Their competitive position is tremendous and one that is very difficult for anyone else to enter. We think the perceived threats, Bitcoin and other cryptocurrencies, which we are watching, are actually pretty remote. What you would need for this to be a real threat is for consumers to change behavior. And consumer adoption is one of the most difficult things in the world to change.

1-Year Daily Chart of Visa

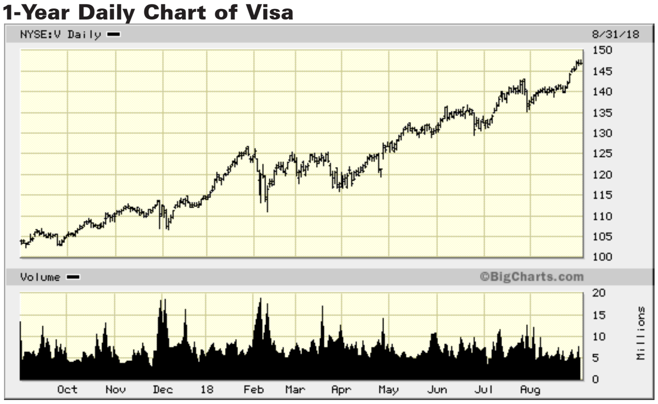

Chart provided by www.BigCharts.com

for the market to give us an opportunity to buy them at a discount.

We have been recycling capital into more highly discounted names. One name is **Kohlberg Kravis Roberts** (NYSE:KKR), one of the largest private equity firms. Two things we really like in this business: Capital is locked up for the duration of the fund's life, and then, there is a tailwind of institutions, such as sovereign wealth funds and insurance companies, increasing their allocation to alternative capital and private equity in particular. **KKR** is benefiting from this increase in allocation, and the company thinks that the market will double by 2025. In addition, they recently converted their publicly traded vehicle from a partnership to a C-Corp, which will expand the potential shareholder ownership base considerably. That's a new position.

Regarding our sell discipline, we really sell for three reasons. One, if a company reaches fair value. Two, when we can recycle capital toward more discounted names in the way that I described before. And three, if we've made a mistake about the quality of a business, we will sell it, or if the business no longer has a stable value, we'll sell it.

TWST: When we spoke last year, you liked the U.S. drug distribution industry as home to several discounted names. How has that area performed over the past year? Any disappointments? Are there still any names there that you currently like?

Mr. Dunbar: Yes. Let me start with a disappointment. Since last summer, **Cardinal** (NYSE:CAH) has had some struggles in their medical supply business that were pretty much self-inflicted wounds. They came via acquisitions, and I think the company underestimated the difficulty in the operations of some of these businesses that they acquired. The issues with those acquisitions became apparent in the first half of this year, and

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It is unlikely that consumers would find it easier to take out their Bitcoin wallet as opposed to their very easy-to-use credit card to swipe. Companies like **PayPal** and Apple Pay actually add to the system and make that transaction even easier. I can now go use my phone to pay for a cup of coffee instead of taking my credit card. I think that is actually adding to this ecosystem, and it is hard to see the end of this tailwind. When we see electronic payments gaining market share, where **Visa** and **Mastercard** will no longer benefit from the shift from cash, then maybe the growth will begin to slow. But I think the competitive position will remain, and these are going to be phenomenal businesses for a long time.

TWST: Could you share any other recent changes to your portfolio, any new buys or sells?

Mr. Dunbar: For the most part, we have been trimming positions that are close to fair value. There is nothing wrong with the businesses; we are just recycling capital in the way that I described before. So companies like **InterContinental Hotels** (NYSE:IHG), **SS&C Technologies** (NASDAQ:SSNC), **CBRE** (NYSE:CBRE), **O'Reilly** (NASDAQ:ORLY) and **Sabre** (NASDAQ:SABR) are all companies that we've exited among Large Caps. But we will continue to follow these businesses. They go back on our MVP list, and we watch them and wait

we sold the stock due to the business issues. It's important to note that the core business, pharmaceutical distribution, within **Cardinal** continues to perform well. We were still happy with that segment and still own other investments in pharmaceutical distribution.

The other two companies that we hold in that segment are **McKesson** (NYSE:MCK) and **AmerisourceBergen** (NYSE:ABC), and they continue to perform well fundamentally. The stocks have been down a bit from June 30 last year to June 30 this year. But our portfolio management process with **ABC** is pretty instructive. I mentioned earlier that we trim and add positions as the price to value gap widens or closes.

In **ABC's** case, when we spoke to *The Wall Street Transcript* in the fourth quarter of last year, the stock was falling, and ultimately, it troughed around $73 a share in November. Throughout this time, we thought the value was stable and, therefore, consistent with our process. We were adding to the position in that time. At the end of the quarter, it was close to a 6% weight. During the first quarter, the stock increased steadily and peaked around $105 a share. I think it was on some buyout speculation. Again, we thought the value was very stable, and so we were trimming into that increase. We ended the quarter with about a 3.5% weight.

So despite the fact that **ABC's** stock was down around 8% from June 30, 2017, to June 30 this year, it actually contributed positively to our performance. We also think that **McKesson** and **ABC** are in a very good position fundamentally, and they're trading at a nice discount to fair value, so they are still very attractive.

TWST: To conclude, could you touch on a few key points that would summarize your best advice to investors who are looking for opportunity in the current market? And tell us about anything else you would like investors to know about Vulcan.

Mr. Dunbar: Sure. I would say be patient, invest in high-quality businesses, and over the long run, this strategy should do well. And I would remind readers that at Vulcan our interests are aligned with our clients. All employees at Vulcan are required to invest their publicly traded equity within Vulcan products. We think it is the right thing to do. Whatever our clients experience, we experience all the more.

Also, currently, all strategies are closed to new investors, but we do have a waitlist process. We go to the waitlist once a year to potentially allow new investors to join us depending on capacity.

TWST: Thank you. (VSB)

MCGAVOCK DUNBAR, CFA
Principal, Equity Analyst
Vulcan Value Partners
Three Protective Center
2801 Highway 280 S.
Suite 300
Birmingham, AL 35223
(205) 803-1582
(205) 803-1584 — FAX
www.vulcanvaluepartners.com
email: info@vulcanvaluepartners.com

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Information provided is supplemental information for the Large Cap Composite, Focus Composite, Focus Plus Composite, and Small Cap Composite for period ending June 31, 2018 as of July 11, 2018.

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