REPRINTED FROM SEPTEMBER 6, 2023

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Small Cap Space Offers a Discount Relative to the S&P 500

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SECTOR — GENERAL INVESTING

TWST: Could you tell me about the firm?

Mr. King: Luther King Capital Management is a registered investment advisory firm, based in Fort Worth, Texas, with offices in Fort Worth, Dallas, San Antonio and Austin, principally serving the taxable space that represents about 70% to 75% of our assets under management. And we are an active manager in both the public equity space, as well as fixed income, and an expanding private equity effort as well.

We were founded in 1979 by Luther King, after he had served with another adviser named Lionel D. Edie, who had gone through a sale process. After the sale, he went out to start his own independent investment advisory to serve this region.

We have approximately $25 billion in assets under management. Those are spread, as I mentioned before, across the core equity, small cap, SMID cap, international equity and micro cap, all in the public market, and fixed income, private equity, and various limited partnerships and private funds.

Most of the firm's relationships and assets were actually brought on through referral patterns and not through sales and marketing. So, we've always been a sales- and marketing-light firm whose relationships developed through successful execution with existing clients and additional referrals coming from established clientele.

That leads to, we believe, increased retention and tenure of those relationships, and we continue to look to grow those portfolios and relationships. In some cases, we are working for the third and even a fourth generation of some of the families that we've served through the years.

And we are an independently owned organization, and no shareholder is not active in the business. We believe that is a good indication of our alignment. As well, we're set up as a C-Corp with a lot of retained earnings over the past 40-plus years. The firm itself — along with the employees — is the largest investor in our own strategies, allowing for further alignments of interest.

TWST: Do you have an overall investment philosophy at the firm?

Mr. King: We do. It's really our investment discipline. I believe, at the core of it, our firm, as well as our investment professionals, believe that purchasing a company's stock is investing in the business and not simply a short-term trade. That approach lends itself to a longer holding period. But we always look for attractive entry points and good business models.

And with these longer holding periods, we can generally achieve more tax-efficient returns for our clients. And having such a high clientele in the taxable space, we really train our eyes towards the tax efficiency game.

Since we have a longer horizon and since that is consistent with our investment discipline and philosophy, then you see a bias towards higher quality as it relates to our portfolio holdings. And so, we typically look for quality metrics, such as good or improving return on equity, return on tangible common equity, return on invested capital, return on assets, things such as that.

Also, the ability to reinvest any free cash flow for consistent internal growth at high rates of return. We want to make sure that they are free cash flow generative, and that they can utilize organic financial resources to create additional shareholder value, whether that's through share repurchase or through reinvestment.

And then you want to make sure that their balance sheet is strong, so that they can continue to take advantage of opportunities throughout the cycle, as opposed to becoming vulnerable when the cycle goes against them. Additionally, we try to look for cyclical opportunities in terms of entry points.

But we also like to invest in secular and thematic growth. We identify opportunities that can grow faster than the market and grow faster than more cyclical names, particularly throughout a market cycle if they are exposed to some cyclical factors.

And then, we try to identify idiosyncratic factors within the operations where we might be able to see opportunities for margin expansion beyond what the marketplace may be pricing, or other growth opportunities on the topline, where they might be able to strategically acquire onto a platform and grow inorganically through deployment of cash flow.

with the margins typically expanding as those contracts mature. And so, the growth trajectory was still intact, despite an acute selloff.

With that conviction in the long term, we built out the positions in small cap and have seen a lot of benefits. And we still believe that there's a lot of opportunity ahead at these levels based upon the growth trajectory and their internal growth algorithm.

The company itself is a revenue cycle management and outsource service provider for the health care industry. There's a lot of key reasons why you'll continue to see their addressable market growing. But the number one is the productivity advantages that the outsourcing provides.

"An increasing amount of those in the health care industry are moving towards outsourcing. So there's also a growing addressable market. And all that leads to really a growth algorithm where we expect that you'll be able to get about a 20% CAGR on your EBITDA, perhaps slightly higher."

TWST: Any sectors or individual stocks you might want to highlight for our readers?

Mr. King: There's a few. The first one I'll mention is **RCM** (NASDAQ:RCM). And this is one that we hold in our small cap, so the LKCM Small Cap Equity Fund, which is one fund in our mutual fund family. **RCM** is one that we've had our eye on for a couple of years. It went through a down cycle, if you will, with a bad quarter last year in the third quarter. It was a setback, and revenue came in slightly below expectations and EBITDA expectation was slightly reduced.

But we know the story pretty well. We understood that a lot of that deferred revenue was due to some extended payment cycle from the health insurance companies post-pandemic, and some integration issues related to two new customers. They also took a $20 million charge related to a customer failure to pay, which was related to a bankruptcy.

1-Year Daily Chart of R1 RCM Holdco Inc.

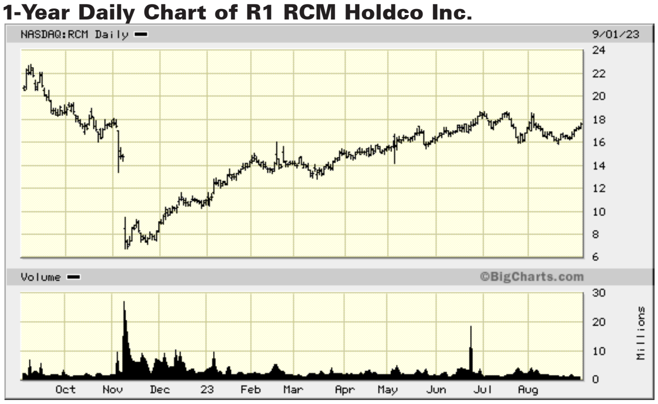

Chart provided by www.BigCharts.com

Those were all transitory. We were comfortable with everything that was going on.

The integration issues just delayed the recognition of revenue off of those new customers. And oftentimes, that can lead to some margin pressure, because they invest in the front end through integration

Their customers end up having faster revenue collection than peers who are doing it in-house. You also are having higher levels of revenue collected. So it's faster and the absolute amount has been proven to be higher.

And what **RCM** is experiencing, or its customers are experiencing, is a 10% to 15% expense reduction with a headcount dropping about 15%.

Additionally, as they go out and they secure these clients, it is a great secular growth story as they're continuing to grow their total addressable market, which is already estimated to be $115 billion — and **RCM** sales for perspective are $2.3 billion. So there is a lot of runway for growth.

You also have a margin expansion opportunity, as I mentioned prior. Margins will benefit from maturing contracts as they're growing faster on the front end. The margin should start to expand as those contracts become a smaller and smaller percentage of the total. And the margin builds out, moving forward to the tune of over 40% EBITDA incremental margins on mature contracts, well above their group margin of, I believe, 27% in the most recent quarter.

And then you have also about 95% to 98% customer retention. And so, you have high customer retention, great product, productivity enhancer, and value proposition to the customer.

An increasing amount of those in the health care industry are moving towards outsourcing. So there's also a growing addressable market. And all that leads to really a growth algorithm where we expect that you'll be able to get about a 20% CAGR on your EBITDA, perhaps slightly higher. And that's really hitting 16% to 18% topline growth and about 75 basis points in EBITDA expansion. This is what we're kind of looking for over the next few years.

A price-to-earnings multiple on the 2024 numbers is about 34 times, and you're paying about 1.5 times price to earnings growth on the run rate growth that we see over the next three to five years, which is our typical underwriting period. EV/EBITDA is 12 times. Those are pretty attractive prices for growth at these levels. So we always want to try to get in around that 1.5x PEG, if not lower.

That would be one that we've built out in November, and we've been able to see perform really well.

TWST: You mentioned small cap. Is now a good time for investors to look at small cap?

Mr. King: Yes. I could say unequivocally that I believe that small cap is certainly attractive from a relative value standpoint. It is a more cyclical benchmark. If there is a hard landing, as some still are forecasting, then it could see some pressure, but the price-to-earnings differentials between large cap and small cap certainly create opportunities in the small cap universe relative to the large cap, even with appropriate risk factors considered.

There are really good business models with great recurring revenue, good return profiles, solid balance sheets that still have not seen the full benefits of those capital flows that have gone into the mega caps like **Apple**, **Microsoft**, **Nvidia**, **Netflix**, **Google**, **Amazon**, etc.

That has been a relatively narrow component that has driven the price on the S&P 500 index higher. You haven't had the same phenomenon at the small cap indexes.

It's not as cheap on a p/e basis. It's about 34 times on 2024 EPS estimates. But that brings that PEG down to about a 1.4 to 1.6. And that range is really depending on what estimate you're using when you're constructing your price to earnings growth. I'm starting to look more out at 2024 to set that ratio.

Great name, improving returns, expanding market, and great management and leadership — all bring this one to a head as a good investment idea that we still feel has a long runway ahead of it.

Another one that I'll mention is **Primo Water** (NYSE:PRMW). This is one that's probably a little more on the slower growth, but good value with some good opportunities that exist from a margin standpoint. They came into our universe after an acquisition a few years ago, when **Cott Water** acquired **Primo** in 2020 and then took on their name. There's been some noise in the thesis. The leverage ratio has moved up some and the integration challenge has started.

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TWST: Did you want to talk about some other sectors that you're looking at or other stocks?

Mr. King: Yes. Another one that I'd mention, which has been another kind of outsourcing platform, is **Goosehead** (NASDAQ:GSHD). **Goosehead** is an insurance brokerage platform that partners with brokerages in order to provide better customer service and customer experience, as well as operational efficiencies.

They'll go in and either start or acquire corporate stores, which are owned, or they'll do a franchise model, in which case they take care of a lot of the back office and servicing of the policies. The franchise model has actually been growing as a portion of the mix.

This is one, again, where you see a lot of the benefit from automation of their process and protocol from an operational standpoint, leading to more and more brokerage houses adopting the platform to free up time to focus on sales of policies.

And so, what you typically see is cost savings in the back end with efficiency gains, and better customer service, according to responses from the surveys. And you actually see an improvement in the growth rate of the policies originated as agents are freed up to spend more of their time and resources for new policies.

Goosehead is still early on in profitability. But we feel like it's really starting to approach a steeper profitability inflection. It's still recognizing strong revenue growth of about 25% to 35% on a total basis, and strong incremental margins are providing attractive operating leverage off the platform.

They have modest financial leverage, but it's still less than three times net debt to EBITDA, which we feel is plenty comfortable for a business model with such high recurrence of revenue from their existing clientele. That reduced churn in revenue provides much better peace of mind that they can service this debt in any environment.

It is a drinking water solution to consumers and commercial users through purified delivery and dispensing offerings. There is always an increased focus on potable water — quality of water and increased concerns around the safety of municipal water as deferred maintenance continues to rise. So we believe that that also plays to some of the cultural preferences within the population base.

1-Year Daily Chart of Goosehead Insurance Inc.

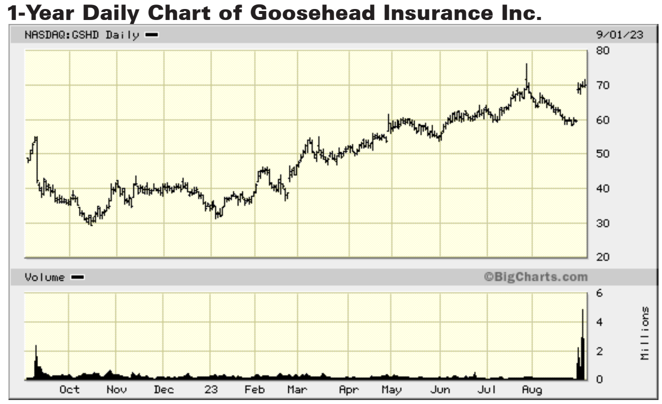

Chart provided by www.BigCharts.com

It is a route-based business. You should see some margin expansion as infill density continues to increase. They also have the benefit of scale in order to add resources to expand their software automation and logistics' capabilities.

The gross margin improvement has been a little slower to flow into the EBITDA margins than we had anticipated. But recent signs of progress, particularly in the latest quarter, showed the EBITDA expansion of 160 basis points. These delays had really depressed expectations and sentiments. We feel that continued improvement on the margin story — and starting to see that flow through at an EBITDA level — will reverse the direction of sentiment and improve price moving forward.

Also, there were some COVID disruptions that popped up in this marketplace. They experienced commercial slowing down, while residential sped up, creating mix shift dynamics.

The company has, by and large, seen those markets come back to kind of a normal mix and normal trajectory going forward. And the company continued to make acquisitions during that disruption, completing five acquisitions in 2022.

Balance sheet remains relatively stable, 3.5 times net debt-to-EBITDA, slightly higher than I might prefer, but still plenty of resources from a cash flow standpoint and recurring revenue standpoint. Valuation trades at 7.8 times EBITDA with a free cash flow yield over 6%, which is above many of its peers who trade at around 4%. So you kind of have a slight discount, as contemplated from either an EV-to-EBITDA or a free cash flow yield standpoint.

And on an earnings growth algorithm, you're coming up with about 8% to 10% EPS CAGR. And over the next three to five years. About 5% to 6% of that is organic revenue with a little bit of the EBITDA margin expansion contributing to the remainder. This implies a PEG ratio of about 1.7, so a little bit higher on the PEG ratio than some of the growthier names that I mentioned with **Goosehead** and **RCM**. But still attractive relative to its peers and still attractive on a free cash flow generation basis.

This also does not contemplate further acquisitions, in which they are very active and could contribute another few points on the growth rate and bring that PEG down even further.

At this point, we're looking for the return profile to improve. This is one where you have a lot of intangibles that are built into the businesses from the acquisitions that were made. But if you look at it on a return on tangible common equity, tangible assets, or tangible capital, these returns are attractive.

It's a little disingenuous to ignore goodwill from prior acquisitions, but it highlights what they're able to accomplish with the fixed assets that they have in place. So I expect that those returns will continue to trend higher as they continue to expand margin.

TWST: And what's on the minds of the investors that you deal with, largely, I guess, in Texas, given what's going on in the economy and in the stock market?

Mr. King: I think that there's an increasing positivity right now amongst some in the investment community. I think that a lot of this is a result of good, coincident economic data that provides better peace of mind that we will be able to accomplish either a soft landing or no landing in the effort to restrict money, as well as bring down inflation.

I don't know that my outlook is as sanguine. There are others within our clientele who share some of that sentiment. In the more hawkish case, the decline in leading indicators, the collapse in PMI in other markets, and the monetary restrictiveness that has been coming through the policy continue to tighten up economic activity.

As we've noted in the past, rate policy typically acts with a 12- to 18-month lags, and we're only through the first couple of rate increases, which means that we likely will continue to see a bite out of economic activity from increased rates and monetary policy over the next four quarters.

Offsetting some of this is the fiscal stimulus that you saw coming out of the pandemic, as well as some of the infrastructure programs that were announced by the current administration.

That doesn't provide a clear outlook, because it seems to be very binary on how it might proceed forward. Our outlook is for the possibility of a small recession in 2024, but we feel like we're getting close to the peak rate and containment of inflation moving forward, which should be constructive to market dynamic and equity prices moving forward over the longer timeframe.

TWST: And what would be the advantages of going to a firm like yours as opposed to one of the mega, global firms?

Mr. King: Well, for the separate account side of the business, I think it's pretty straightforward. Our portfolio managers are the ones who directly interface with the clientele. There are few exceptions to this. But, by and large, we try to keep that point of communication consistent across our clientele.

We also don't provide or don't stack fees. And so, the single fee that you pay to Luther King Capital Management is for the investment advisory, as well as the actual management of the portfolio.

Oftentimes, you see with some of these other institutions that there will be fees — for asset management, asset allocation, wealth management, financial planning, or something along those lines. There is a headline fee. And then you end up having buried in the account the investment management fee of the actual portfolio manager who is executing.

Ours is a simple fee. It's one, and it's for all the services that we provide on both the investment counseling and investment management side. So I'd say that those are a couple right there.

Obviously, having a big emphasis on the communication with the client lends itself also to our clientele being close to our existing physical offices, those predominantly in Texas, although we do have quite a few clients outside of the state as well.

TWST: And anything else we haven't discussed?

Mr. King: I think we touched on the key things. I would just in summary say we continue to execute; we continue to look for good opportunities. As I mentioned, the small cap space and even international, are two where you end up seeing a wide discount relative to the S&P 500 pricing. Obviously, that is still contemplating the risk of a cycle, an economic cycle, that's weighing on the more cyclical names in those benchmarks. But we anticipate that ultimately those will lead to a good value proposition over time.

TWST: Thank you. (ES)

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