Palisade
CAPITAL MANAGEMENT

PALISADE CAPITAL MANAGEMENT, LLC
ONE BRIDGE PLAZA, SUITE 695
FORT LEE, NEW JERSEY 07024
T (201) 585-7733 • F (201) 585-7552
www.palisadecapital.com

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From The Desk of Will Potter, Managing Director, Senior Portfolio Manager

Is Tax Reform Old News?

- ***For some companies, that might be the case***
- ***But for <u>THE COMPOUNDERS</u>, we believe the best is yet to come***

Summary: Tax Reform is a Long-Term Win/Win for "The Compounders"

Some companies will create more shareholder value as a result of tax reform than others. Some, in fact, will compound the benefits from tax reform, while others will squander it. We believe fundamental research that accurately distinguishes between these two outcomes will be key to outperformance over the next few years.

Our investment philosophy generally focuses on companies that generate strong free cash flow, deliver superior return on invested capital, and repeatedly deploy excess capital in both strategic acquisitions and internal growth initiatives. We call these companies "***The Compounders***," and based on our experience, we believe these companies tend to outperform over the long term.

In the next year or two, many of these companies will generate significantly higher free cash flow than previously expected as a result of tax reform. If these companies keep doing what they do well, we believe these companies will outperform to an even greater extent than they would have in a normal cycle.

"Compounders" Extend the Benefits of Tax Reform

In the wake of tax reform, we are increasingly focused on the impact on shareholder value for each stock, rather than the political/macro debates over tax reform, which have been very well covered. Some companies have responded to tax reform by paying special bonuses and raising salaries. That may be appropriate. However, if it took tax reform to prompt companies to increase compensation, we would be concerned that these companies were not paying their associates appropriately in the first place.

Other companies have announced intentions to buy back stock and/or pay higher dividends. While we applaud this in some cases, such a strategy also might indicate that these companies lack active pipelines of strategic opportunities for capital deployment. Returning cash to shareholders can also trigger tax bills, and requires investors to make the reinvestment decision -- often only at average rates of return.

Many companies will take advantage of the new accelerated depreciation rules by increasing capital expenditures. While we believe this would be a good outcome for the economy, we need to be cognizant of the timing, because companies will lose depreciation deductions in future years according to the current law. This is another reason why we believe that "The Compounders" offer some of the best opportunities for sustained benefits and outperformance in the wake of the tax cut. Skillful, repeatable deployment of free cash flow toward strategic acquisitions, in our opinion, is a practice that transcends the front-loaded aspects of the recent tax reform.

After the passage of tax reform, we have paid close attention to management comments in their earnings conference calls related to plans for their companies' incremental cash flow. Here are examples of comments that enhanced our conviction about the compounding of cash flow and shareholder value:

"…Tax reform is just a marvelous thing for us. It benefits us in many, many ways… The way I look at this is really you have the lower tax rate, higher cash flow and then access to global cash is a perfect trifecta for [us]. And we couldn't ask for more and I guarantee we'll use it well…Our ability to compound cash has dramatically changed…. The tax reform is just going to continue to compound more cash flow and an ability of us to deploy capital."

"I want to take a moment to comment on tax reform and [our] capital deployment strategy. Not surprisingly, tax reform is a positive for [us]. We will see a lower effective tax rate. We have better and more efficient access to our foreign cash which will provide us with additional flexibility…. However, the benefits of tax reform do not change [our] fundamental approach to investment and capital allocation. We will continue to invest appropriately back into our businesses to support the growth initiatives."

Conversely, here is an example of management commentary on tax reform in a recent conference call that reduced our conviction because of the lost opportunity to compound the incremental cash flow: "The recent tax reform will create benefits and opportunities for our business… As a first step, we enhanced our benefits for U.S.-based employees and increased our company contributions to the U.S. 401(k) program…Our board has increased the quarterly dividend to $[x], an almost [y]% increase, commensurate with the higher earnings potential of the company post-tax reform."

Conclusion – Harnessing the Wind at Our Backs

For Palisade Capital's Focused All Cap Equity strategy, 2018 is business as usual; we are investing in high-return, high cash-generating companies that we believe will build shareholder value over the long term. Starting this year, there is an incremental wind at the backs of these companies. Most of our portfolio companies will now generate significantly higher free cash flow, with an incremental boost from tax reform. We are confident that their prescription for deploying that cash will continue to compound shareholder value for years to come.

Appendix:

This is an example of one of our proprietary, pro-forma models showing what we believe to be the compounding effects of capital deployment (M&A). In future years, Palisade's earnings and cash flow projections exceed consensus estimates (which do not include the impact of future M&A).

	2017A	2018E	2018E	2019E	2019E	2020E	2020E
	Dec '17	Consensus	Including Future M&A	Consensus	Including Future M&A	Consensus	Including Future M&A
Core Sales (consensus, including announced acquisitions)	6,725	6,956	6,956	7,605	7,703	7,882	8,398
Core growth rate		3.4%	3.4%	4.5%	3.0%	3.6%	3.0%
Added sales from M&A in prior year		323	323		200		220
Future Acquired Sales (derived as a fraction of FCF)			200		250		270
Total Sales	6,656	7,279	7,479	7,605	8,153	7,882	8,888
Revenue Growth		9.4%	12.4%	4.5%	9.0%	3.6%	9.0%
Pretax Income	1,283	1,446	1,533	1,577	1,671	1,721	1,866
Tax Expense	308	289	307	315	334	344	373
Effective tax rate	24.0%	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%
Net Income	975	1,197	1,267	1,308	1,383	1,423	1,539
EPS Non Gaap "cash"	**$ 2.89**	**$ 3.44**	**$ 3.61**	**$ 3.73**	**$ 3.95**	**$ 4.00**	**$ 4.35**
EPS Growth		19.0%	24.8%	8.6%	9.4%	7.1%	10.2%
Free Cash Flow (FCF)	1,040	1,320	1,395	1440	1525	1440	1650
FCF/NI	107%	110%	110%	110%	110%	101%	107%

Source: Palisade Capital Management