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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Hard Asset Companies Better Positioned to Weather Inflation

ERIC J. MARSHALL, CFA, currently serves as President, Co-Chief Investment Officer, and Director of Research for Hodges Capital Management. He joined the firm in 1997 and also serves on the board of directors of the firm's parent company, Hodges Capital Holdings. Mr. Marshall holds a B.A. in Finance from West Texas A&M University. He is an active member of the CFA Institute and the Dallas Society of Financial Analysts. Mr. Marshall is a frequent guest on CNBC's "Squawk on the Street," "Street Signs," and "Closing Bell," as well as on Bloomberg television and Fox Business News. Mr. Marshall is co-manager of the Hodges Small Cap Fund (HDPSX), the Hodges Fund (HDPMX) and the Hodges Intrinsic Value Fund (HDSVX). Investments in these funds are identified through a process of rigorous fundamental analysis across multiple industries. Mr. Marshall and his team of research analysts use a bottom-up approach to reveal opportunities in stocks that may be overlooked or misunderstood by more conventional approaches.

SECTOR — GENERAL INVESTING

TWST: Please start with a brief overview of your firm and your current role there?

Mr. Marshall: I head up the research department and also serve as a portfolio manager for the Hodges Funds. We have four mutual funds, and have emphasis especially on small caps. The Hodges Small Cap Fund is one of our largest funds as far as assets under management, and is really kind of the core competency of our research effort.

TWST: Where is your current focus? What are the indicators you're watching?

Mr. Marshall: One thing that we would emphasize is that we're very much bottom up; we focus entirely on what's going on with the fundamental earnings picture of the companies that we follow. And we do pay attention to macro factors, such as what's going on with interest rates in the Fed because they affect how risk is priced out in the market. But we don't spend a lot of time trying to forecast the macro environment. What we're really trying to forecast is what does the fundamental backdrop look like for each of the individual companies in our portfolio over the next 12 to 18 months, and then make the best risk/reward decisions in the portfolio based on that.

TWST: If we were to see inflation worries deepen into reality, how would that impact your portfolio holdings?

Mr. Marshall: Obviously, inflation is very important to the equity market because it affects pricing power, it affects asset prices, and it affects how future earnings are discounted back to present value. So obviously, if inflation were to be accompanied by higher interest rates in the future, that would create an environment where you're not going to see very much multiple expansion from here.

In many cases, if you look at what's happened over the past year, we've had a V-shaped recovery in the market and a good deal of the gains — probably two-thirds of it has been driven by an earnings recovery, and then a third of it has been driven by higher multiples. And when we look at multiples right now, relative to where interest rates are, we think that given the current backdrop for inflation rearing its head, there's not much room for multiples to expand.

Also, higher corporate tax rates and higher capital gains taxes potentially could also be headwinds for multiple expansion. So really, what this means as investors, is we want to be focused on businesses that have pricing power and have the ability to leverage their cost structure in an inflationary environment.

TWST: What are some of the sectors that would be most inflation proof? And what might be most vulnerable to a downturn?

Mr. Marshall: It would be companies like energy, materials, and industrials; companies where inflation creates barriers to entry. So if you think about a steel mill and the cost to replicate that steel, capacity is going up because of inflation. So that creates a barrier to entry to new steel mills being built and creates pricing power for the legacy existing assets. Companies that have a lot of hard fixed assets will actually see better equity appreciation in an inflationary environment than companies that, for instance, may be in software or cloud computing, where you don't have the same type of hard assets benefiting from inflation. They're not as sensitive to property, plant, equipment, land and those type of things.

TWST. Would any of these hard asset companies also benefit from infrastructure spend?

Mr. Marshall: I think that's definitely the case. One area that we particularly like in the material space is companies that make things

like cement. One of the stocks that we own in three of our four funds is a company called **Eagle Materials** (NYSE:EXP), and they are one of the largest producers of cement in North America. They also are a leading provider of gypsum wallboard. But the interesting thing about cement is we haven't really added any meaningful cement capacity in the United States over the last 20 years. And the way that we've been able to keep up with demand without adding capacity has been by using substitute products like fly ash, which is derived from a byproduct of burning coal in coal fire power plants.

For the last 20 years, they've been using a lot of that ash, mixing it in with cement. It has similar properties to stretch out the cement, making the cement more environmentally friendly. Today, there's less and less fly ash available because we're not burning as much coal. And we haven't added any cement capacity.

Cement capacity is very difficult to build because of the greenhouse gases that are produced from burning, where giant kilns heat up limestone to make cement. It's been made the same way going back to the pyramids. And the cost and the barriers to entry to build one of those are at least five years to get the permitting and to construct a plant. Right now, there's no cement being added anywhere in the United States. So we like **Eagle Materials** for that reason.

We think they're going to have very good pricing power, with or without inflation, because cement demand and cement supply is going to be in a tight situation for some time, and they have domestic supply in the center part of the United States. They will benefit from infrastructure spending and those type of things. It's one that we think has a very compelling moat around it. And we like that sector right now.

Highlights

Eric J. Marshall discusses several sectors and companies he believes will do well in the current investing climate. Mr. Marshall notes that we've had a V-shaped recovery over the past year, with about two-thirds of the gains driven by an earnings recovery and one third driven by higher multiples. He believes that there's not much room for multiples to expand, given current interest rates and the current backdrop for inflation. He adds that higher corporate tax rates and higher capital gains taxes could also potentially be headwinds for multiple expansion. Mr. Marshall says that companies with a lot of hard fixed assets will see better equity appreciation in an inflationary environment than companies, for example, in software or cloud computing. He also sees upside potential in consumer discretionary companies. He expects to see increased M&A activity across multiple industries in the second half of the year, especially if interest rates remain low.

Companies discussed: Eagle Materials (NYSE:EXP); US Concrete (NASDAQ:USCR); Martin Marietta Materials (NYSE:MLM); Vulcan Materials Company (NYSE:VMC); Brinker International (NYSE:EAT); NCR Corporation (NYSE:NCR); Nordstrom (NYSE:JWN); Summit Materials (NYSE:SUM) and Cleveland-Cliffs Inc. (NYSE:CLF).

Eagle Materials. **U.S. Concrete** would buy cement and then they would mix up the cement, and then put it in cement trucks. Then they have about 30 to 45 minutes to deliver that cement once they mix it to where it's going to be poured on a job site.

If you think about **U.S. Concrete**, they're in the business of mixing cement into concrete, and they're selling concrete, they're not selling cement. But they're buying their cement from manufacturers like **Martin Marietta** (NYSE: MLM) and **Eagle Materials**. **Vulcan Materials** (NYSE:VMC) is a leading supplier of aggregates, so they have a lot of stone and gravel and those types of things. They would also sell their materials to **U.S. Concrete**.

Essentially, what they did in the merger, is they bought downstream assets when they bought **U.S. Concrete**. **Vulcan** is going to have control in distribution in some really important metropolitan markets, like San Francisco, Dallas-Fort Worth, New York, and New Jersey. Those markets have a lot of population density, and the logistics of having these concrete terminals in those heavy metropolitan areas is real, and there is a barrier to entry to that. I think that was the rationale behind **Vulcan** buying **U.S. Concrete**.

TWST: Do you recommend Vulcan? What's your view there?

Mr. Marshall: We don't currently own **Vulcan**, but it's one that we've been looking at.

We know that space very well. But we think **Eagle Materials** looks a little more interesting because they own cement capacity. **Vulcan** is more of an aggregates play, probably more heavily tied to public works. **Eagle** has a little bit more exposure to the residential housing market and so forth. We think throughout a cycle, **Eagle** looks more interesting to us because it trades at a lower p/e multiple.

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TWST: What's the competitive scenario like? How does it compare to a company like USCR? What's the competitive moat there?

Mr. Marshall: Different business models. **USCR** (NASDAQ:USCR) has tripled over the past year, but they got hurt worse during the pandemic because ready-mix concrete is more economically sensitive than the cement business. **USCR** sells concrete, which is basically made from cement. So **U.S. Concrete** would be a customer of

TWST: Any other post-pandemic-related trends that you think are meaningful? Any sectors that look stronger or weaker in the current market environment?

Mr. Marshall: Yes, we think that there is a lot of upside in many of the consumer discretionary-related stocks. We like **Brinker**

International (NYSE:EAT); they're the parent company of **Chili's**. We think one thing you're going to see is as people return to restaurants, there will become a more challenging environment in that space dealing with food costs and labor shortages. We think some of the larger chain restaurants like **Brinker** should be able to manage those challenges a little bit better.

1-Year Daily Chart of Eagle Materials, Inc.

Chart provided by www.BigCharts.com

TWST: Can you share some key points about your sell discipline? And exemplify where you've recently sold or reduced your position?

Mr. Marshall: Our sell discipline is one where we're constantly evaluating: What is the upside potential relative to the downside risk? And when we no longer see as much upside as downside, we'll start to scale out of a name. We also realize that the best company in the world may not be the best investment if everybody thinks it's the best company in the world. Once a stock becomes priced to perfection, it makes sense to take some profits in it. So that's something that we're constantly aware of.

TWST: Are there any turnarounds, or under-the-radar stocks that you would recommend, or might be watching?

Mr. Marshall: One that's definitely kind of a turnaround but you don't hear a whole lot of people talking about is **Nordstrom** (NYSE:JWN). And that's one that's very unloved, and kind of hated. But we see that there are some valuable assets there. In a post-pandemic world, we still think over the next 12 months consumers are going to get back out and update their wardrobe. **Nordstrom** is kind of a higher-end luxury retailer, where you have aspirational customers realizing value.

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There's a lot of mom-and-pop, casual dining restaurants that unfortunately were unable to survive the pandemic. So we think in the early stages of recovery, some of the larger chains, such as **Brinker**, that had the size and the staying power to manage through that will do well.

They also have been able to reinvest in more automation and technology into their business, which helps really maximize their labor efficiency. And that's very important in a time when the labor market has gotten tight and is probably disproportionally hurting a lot of service industries, such as the restaurant industry.

We're looking for companies that can actually prevail under difficult conditions like that and then actually emerge, maybe in a little bit better competitive situation than they had before the pandemic.

We also like **NCR** (NYSE:NCR), a company that makes point-of-sale equipment like cash registers, and they also make ATMs. But we also see a real recovery in things like self-checkout at retail, and we think that's something that's here to stay. As companies have learned to change their payment methods, people are paying using their phones. A lot of that is automated through **NCR's** hospitality business. And this is one that we think is actually poised to do really well on the backside of the pandemic as things continue to reopen.

So it's kind of a derivative of the reopening. We think, really, it's a fintech company hidden inside of an old company that used to make cash registers and ATM machines and things like that. Now they've evolved from an appliance manufacturer to more of a software-as-a-service company. Because of the software component of their business and reoccurring revenue associated with that, we think they're going to get a much higher multiple over the next year or two.

1-Year Daily Chart of Nordstrom, Inc.

Chart provided by www.BigCharts.com

And that's one that looks very inexpensive to us. It's been flying underneath the radar and it is in a turnaround situation, but one that we think has a pretty good risk/reward. We believe that they have the balance sheet to make it through.

TWST: Do you see M&A activity ebbing or rising in the post-pandemic era?

Mr. Marshall: We think M&A activities are likely to continue to pick up because although multiples have come up in the public markets, they're still well below those in the private market. Valuations of private companies are still, in many cases, higher than those in the public markets. So we think that creates opportunities for strategic acquisitions.

Also, a lot of companies over the last year, because of the pandemic, maybe held off on research and development or capital expenditures to reinvest back into their business. Now they're sitting with a lot of cash on the balance sheet, and they need to make up for that lack of internal reinvestment in their business. So they're going to go for external opportunities through M&A. And maybe midsize companies will buy up smaller or larger companies or buy midsized companies. That will be one way that companies will kind of prime the pump of growth as the economy continues to recover.

We think that in the second half of this year, especially if interest rates stay as low as they are, we would expect M&A to continue to rear its head across multiple industries. For example, **U.S. Concrete** has another competitor out there called **Summit Materials** (NYSE:SUM). We wouldn't be surprised if somebody didn't make a run at them at some point. We don't currently own them in our portfolio, but I think that type of M&A is probably something that will continue.

TWST: As far as recent earnings reports, have you noted any upside surprises or disappointments that make a difference?

Mr. Marshall: Well, there's certainly been far more upside surprises over the last several quarters — almost to an extreme. At one point, we looked at our coverage universe and about 85% of the companies that our team of analysts follow saw earnings come in better than expected in the most recent first quarter. And I think in a lot of cases, management teams have given very conservative guidance because they lack visibility and because of the timing of the economy reopening. Also, they lack clarity to what's going to happen with federal policies that are currently underway from tax reform to other regulatory items. There's just a lot of uncertainty out there. And that set conservative expectations. So I think that's why you saw so many companies beat analysts' expectations over the last couple quarters.

In many cases, the stocks didn't even go up when the companies beat expectations because it was such a widespread phenomenon that occurred. Where if you didn't beat expectations that was almost like missing expectations, and if you just met expectations, something must be wrong. And that's something that will probably continue for the next couple quarters.

I've talked to a lot of management teams. Our investment team this past year made over 3,200 contacts across over 1,000 different publicly traded companies. We're constantly talking to management and we do get the sense that the guidance that's made public on these quarterly conference calls is very conservative. In many cases, it's much easier to paint a picture for a company to exceed expectations than to miss expectations. And that's kind of become the new phenomenon on Wall Street.

TWST: To conclude, what would you advise an investor to buy now? What's your highest-conviction name?

Mr. Marshall: One that we haven't talked about is **Cleveland-Cliffs** (NYSE:CLF). This is a company that that used to be just in the business of producing iron ore, but they've really gone through a transformation over the last few years. They bought **AK Steel**, as well as another major steel producer and have emerged as a vertically integrated steel company. What's interesting is that they take iron ore, and they turn it into a product that can be used in electric arc furnaces. They sell that product to other steel manufacturers as well.

But we see them in a situation to see significant earnings improvement over the next few years. They're seeing very good pricing power in their business. There are high barriers to entry, and it's one that's been kind of unloved by Wall Street. So it's probably our highest-conviction name. We think the stock can probably trade between $35 and $40 over the next 12 to 18 months, and it's trading in the low $20s today.

TWST: And will they also benefit from increased infrastructure spend?

Mr. Marshall: Yes, as will a lot of steel companies. And they are also a big beneficiary of what's going on in auto manufacturing. As you know, vehicles are in tight supply. So as auto production continues to ramp up, they're one of the leading suppliers of steel to the auto industry.

TWST: Thank you. (VSB)

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