

# MCINTYRE PARTNERSHIPS

January 27, 2023

Dear Partners,

## **Performance and Positioning Review – FY 2022**

Through YE 2022, McIntyre Partnerships returns were approx. 0.3% gross and -1.2% net. This compares to the Russell 2000 Value's decline including dividends of -15%. In addition, while we typically do not comment on intra-quarter returns, there was significant news in the fund's largest holding, Sotera Health (SHC), and as a result the partnership is up ~29% YTD as of the writing of this letter. This brings the partnership's CAGR since inception to 22% gross and 17% net. The rest of this section will focus on our 2022 year end review, and I will address SHC in a separate section.

In the winners column, CC, our China Tech basket, VAL, OSW, GTXAP, and record labels (UMG/WMG) contributed 100-500bps each, while risk arbitrage situations (SAVE, TWTR, TRQ, ATCO, MANU) contributed over 500bps. In the losers column, TPHS lost 100-500bps, while MSGE lost over 500bps.

Compared to our benchmark, 2022 was a strong year for the partnership. I am particularly glad we had strong outperformance in a down market. I have long argued that the fundamentals of our companies offer strong downside protection; however, this was difficult to show during a five-year bull market with only rapid, short-lived selloffs. In this protracted bear market, our differentiated views and fundamental analyses were given time to play out. For instance, entering 2022, GTXAP and CC were two of the fund's largest positions. As an auto supplier and a chemical producer, these two businesses screen as high beta, and many would expect cyclical businesses to underperform in a bear market. However, the two securities finished 2022 roughly flat on the year, which I attribute to GTXAP's high dividend yield and the significant reset in CC's consensus earnings estimates. By selecting securities with a mixture of growth, attractive valuations, and idiosyncratic catalysts, my goal is to create a portfolio that outperforms with strong alpha, not just levered beta. Further, by limiting our drawdowns, I hope to position the fund to capitalize on the significant opportunities often found during bear markets. I believe our 2022 and early 2023 results speak to that.

Regarding our portfolio, 2022 was a year of significant change. In general, I would describe 2022 as a year in which I rotated capital from our holdings that strongly outperformed into a handful of exceptionally high-quality names that I believe were unfairly dragged down in the broader market selloff – the proverbial “babies with the bathwater.” This has resulted in CC falling out of our top five positions for the first time since 2019, and I have reduced our GTXAP investment from a significantly concentrated one to an average size. Going forward, I believe the fund's three new top five positions – SHC, OSW, and the record labels – are exceptionally strong duopoly/monopoly businesses with significant growth potential. If their shares continue to rally and I can find reinvestment opportunities, I will rotate capital yet again. The shop is open every weekday at 9:30 AM. However, given their defensive characteristics and strong growth outlook, the bar for new ideas is high, and I could see our new holdings remaining in our top five for a significant period.

Additionally, the fund had success in risk arbitrage investments last year, with several individual ideas contributing over 100bps. My risk arbitrage strategy is to identify rumored/announced/hostile deal situations where the price inaccurately reflects the risk/reward skew. As I expect at least some of these

investments to fail – say 15-25% – our risk arbitrage investments tend to be a smaller size than core holdings, thus I believe it makes sense to report their PNL together rather than individually. However, and with unfortunate irony, I believe my largest mistake in 2022 was one of omission, not commission, in that I did not make TWTR a top five position size. I am always cautious and risk focused when making an investment, particularly when it becomes a top five holding, but when a rock-solid merger agreement is met with skepticism such as “Do US courts have the ability to enforce the law?” and “Will the world’s richest man become a political refugee in Texas?”, it is time to put out the buckets, not the thimbles, and, in hindsight, I believe we should have made more than the 200bps we generated on the trade. Fortunately, though, our overall risk arbitrage strategy was strong and, if 2023 is another year of market volatility, there should be further opportunities.

Finally, and unfortunately, the fund had a large loser in MSGE, whose share price fell 36% last year. For MSGE, 2022 was a frustrating year in that, while I do not believe my fundamental analysis is wrong, my timing has been terrible. In our large investments, I always target significant catalysts. Entering 2022, I felt tax loss selling following the poorly received merger with MSGN provided an attractive entry point. However, once through its early 2022 tax loss rally, MSGE lacked a major catalyst until 2023, when the Las Vegas Sphere opens and MSGE spins off the MSG Arena. Other investors had no reason to buy shares so far in advance, particularly when the markets were volatile, and MSGE shares frustratingly drifted lower with all the signs of the dreaded value trap. I reiterate my thesis below. While I can appreciate why some may view MSGE as a value trap, I believe my long-term thesis is correct and MSGE has strong catalysts in 2023. I plan to maintain a significant investment.

### **Portfolio Review – Exposures and Concentration**

At quarter end, delta adjusting for our interest rate hedge, our exposures are 109% long, 5% short, and 104% net. Our five largest positions are GTXAP, SHC, MSGE, record labels (UMG NA, WMG), and OSW, and account for roughly 83% of assets.

### **Portfolio Review – New Positions**

#### *Sotera Health Company (SHC)*

When I initially sat down to write this letter, I planned to write a section on SHC that would have been substantially different than the one I am writing now. Only a few weeks ago, my thesis was primarily centered on SHC’s litigation, and I believed that SHC’s fundamentals, while excellent, were only a minor driver of the stock. However, in mid-January, SHC settled substantially all its worrisome litigation, sending shares up ~110% in a few days. Now, I believe there is little to talk about on the liability side, though I think the market has not fully processed the extent to which the overhang has been removed. Despite this quick reversal in share price and story, I continue to believe SHC is an excellent investment. While remaining bullish when a stock is up over 100% seems beyond the partnership’s value investing roots, I am not alone in my thinking. The below excerpt from a recent Wolfe note matches my thoughts:

**Infrequently a stock ~doubles and still could be undervalued by at least ~half.**

Following scrub of model, including add-in of expected borrow to cover proposed settlement, and fresh review of broader comp universe, we see a lot of room for this multiple to continue recovering as proposed IL settlement progresses to final and fundamental merits return as focus (i.e., substantial moat, real pricing

power, favorable industry structure and trend, long-duration contracts). Stock seems better set up now than ever to be a 'reverse LBO' equity story which, based on our prior experience, is an attractive descriptor. We frame new \$25 year-end 2023 target price as 15 times 2024 adjusted EBITDA. Versus our provisional range, we rolled time horizon forward and used high end of quoted multiples. Even still, room for the uber-bulls to squint and see potential for more.

To explain our SHC investment, I am going to walk through how I came across SHC, the business' fundamentals, and my thinking on the liability. I will then explain why I think it remains a strong investment going forward. The fund also has a large presentation available upon request.

I originally came across SHC in the fall of 2021 when it was [written up](#) on a popular investment idea website. I was immediately drawn to the idea for two reasons: it seemed to be an excellent business and it had a legal liability, which I consider be an area of expertise. Regarding the business, SHC provides outsourced sterilization services for medical device manufacturers, where it shares a duopoly with Steris (STE). Med device volumes overall grow in the 4-6% range, with minimal cyclical, and as a service provider to med device manufacturers, SHC does not take product design or reimbursement risk (i.e. the risk Medicare decides to lower the price they will pay), the two biggest issues that have previously stopped me from investing in the med device space. Further, SHC's services are mission-critical, as you cannot sell an unsterilized heart stent, and changing sterilizers often requires FDA approval, yet sterilization makes up under 1% of med device manufacturers' total costs. This low share of COGS combined with high switching costs creates substantial customer lock in, and SHC boasts a 100% renewal rate with top accounts while consistently pushing 3-5% annual price increases. The result is a business with 10% organic sales growth, de minimis cyclical, and 50% operating margins. Unsurprisingly, businesses with such favorable characteristics tend to trade at high valuations, and in fall 2021, SHC was trading at 25x forward P/E and 17x forward EV/EBITDA, though shares were at a discount to peer STE, which traded 30x forward P/E and 21x forward EV/EBITDA. While I have no firm rules for what multiple I will pay for a stock, SHC's valuation was modestly higher than where I am typically comfortable initiating a position, though I do acknowledge some truly great businesses compound for years without ever getting much cheaper.

However, what truly gave me both pause and interest was the potential volatility surrounding SHC's legal liabilities. SHC uses two primary methods of sterilization, ethylene oxide (EtO) and gamma radiation, and SHC had been sued at three EtO facilities following an unfavorable EPA report. The legal issues included personal injury lawsuits alleging SHC's EtO caused cancers at two separate facilities in Illinois and Georgia, and the Illinois personal injury cases were scheduled to begin first in mid-2022. Illinois is one of the [most plaintiff friendly jurisdictions](#) in the USA, and Cook County, where the cases were filed, has made the Institute for Legal Reform's list of the "Cities or Counties with the Least Fair and Reasonable Litigation Environment."

As I have written before, I frequently look at securities with legal liabilities as I have previous experience investing in them and many investors simply lump all legal liabilities in the "too hard" bucket, regardless of what the specific liability is. After analyzing SHC's legal situation, I came away largely agreeing with the bull case that the EtO litigation would ultimately prove manageable. However, as I wrote in my post on [Sunday Idea's Brunch](#) I shared a few months ago, personal injury litigation when it gets to a jury is the highest risk moment in litigation analysis:

In my opinion, personal injury litigation is by far the hardest legal liability to estimate, and the highest risk situations are when litigation reaches jury trials in the USA. In US personal injury litigation, juries can award both compensatory damages for emotional suffering and punitive damages, which are arbitrary concepts that can result in staggering sums. You can debate the facts of a case all you want, but the reality is that once it goes a jury, if they come back with a big number, it's a problem. Most of the legal liabilities that have materially impacted companies were personal injury litigation, such as asbestos and Round Up.

While I agreed the liability would be manageable, I found many buy-side and sell-side investors were a bit flippant in their dismissal of the litigation, particularly given IL's plaintiff-friendly courts. It is one thing to look at the facts and conclude the science is on SHC's side, but it's an entirely different animal to understand statutory limits on punitive damages, litigation strategy, where the liability sits in a bankruptcy, etc. For instance, facing mass tort litigation, companies often [intentionally bankrupt](#) a subsidiary, and I wondered how many growth healthcare investors truly had the expertise to understand that losing nine-figure verdicts and then filing for bankruptcy can be an equity positive event.

Given my concerns on valuation and the litigation path, the fund initiated only a small SHC position in H1 2022 and I followed the litigation, looking to build a bigger position if there was a settlement and/or if the stock became materially cheaper. As fate would have it, SHC lost its first case in dramatic fashion, with a jury awarding the first plaintiff ~\$350MM in compensatory and punitive damages, and SHC shares fell 60% in the following two days. While I will not go into detail here on my trading decisions and liability analysis, the fund built a substantial position during Q4. Again, partners are welcome to look at our presentation laying out my strategy and thesis.

Entering 2023, while aware a settlement could happen at any point, I had a strategy to track the cases as they developed, including counsel and "eyes and ears" in the court room, and I was contemplating working out of Chicago part time to be in court on certain days. However, SHC and the plaintiffs settled virtually all IL litigation in mid-January, sending shares sharply higher. While the move is dramatic, I believe the market is still underestimating the degree to which the legal overhang has been removed.

The IL personal injury cases were by far SHC's largest legal liability due to their size (~850 cases vs. ~300 cases in GA) and the nature of IL courts. The settlement resolves over 90% of cases in IL, and more importantly, the IL settlement was for roughly \$400k/case, which was inline with my estimates. While future IL litigation is likely as some residents develop cancer at later dates, I believe there will be under 20 valid cases filed per year, which at \$400k/case is immaterial in the context of SHC's earnings, which I forecast to reach \$700MM in 2025 EBITDA. Regarding GA, the state has a stricter standard of causation than IL, which the GA plaintiffs have not yet met, and punitive damages are capped at \$250k/case in GA. Beyond these two cases, SHC faces no further personal injury litigation, thus I believe SHC's legal risk going forward is no different than most American companies.

While SHC's catalyst path has certainly changed, I believe SHC remains a compelling investment. SHC shares are now trading 17x and 14x my 2023 and 2024 EPS forecasts and 12x and 11x EBITDA. While only a modest discount to the market, I believe SHC is a compelling growth story, and peer STE currently trades 23x 2023 EPS and 15x 2023 EBITDA. Further, SHC is 60% owned by GTCR and Warburg Pincus, two well-respected PE firms who are highly incentivized to maximize value. As the legal resolution is better understood, I believe SHC shares are likely to reweight at least towards STE's multiple while rolling forward onto 2024 estimates. If not, I believe GTCR and Warburg Pincus will eventually pursue a

sale of the company as private valuations for SHC have previously been substantially higher than SHC's current multiple.

## **Portfolio Review – Existing Positions**

### *Madison Square Garden (MSGE)*

I have written and spoken on MSGE extensively, and I will not rehash the same basic valuation arguments. For a refresher, please visit my public presentations [here](#) and [here](#). Instead, I want to explain why I believe MSGE's misfortunes will reverse this year, specifically highlighting two large 2023 catalysts: the spin of the MSG Arena occurring in Q1 and the opening of the Las Vegas Sphere in H2.

For the past two years, MSGE has been a black box to investors. Intuitively, most investors familiar with the company understand that MSGE owns iconic assets, yet the company is burning cash because they are funding a large development project. However, I believe the complexity of teasing out profitability from the various segments' accounting, along with a perhaps warranted fear that the Sphere is a money pit, has kept many investors on the sidelines who otherwise would be attracted to MSGE's durable cash flows. By year's end, I believe this complexity will dissipate, attracting a new cohort of investors.

First, MSGE plans to spin the MSG Arena, along with the Rockettes and a few smaller venues, into a separate company in Q1. Previously, MSGE had intended to spin the MSG Networks business as well. However, after discussions with shareholders, MSGE decided spinning their iconic assets without a troubled one would maximize value, and I agree with their decision. Regarding the SpinCo, I believe many investors fail to understand the underlying profitability of these businesses and would be interested in owning these stable assets if they fully understood the returns. For instance, more than occasionally, other investors have told me that they do not believe the MSG Arena is profitable, to which I reply, "they sell \$40 vodka sodas, where do you think the profits are going?" Thankfully, soon this debate will be put to rest. The form-10, containing pro-forma financials, should be filed in February and management believes the spin will be completed by the end of Q1. I believe the SpinCo will earn \$2-\$3 in FCF/sh. and that many investors will be attracted to these stable assets on a standalone basis. A 15x multiple yields \$30-\$45 in value, with the caveat that MSGE shareholders will only receive 2/3rds of their SpinCo shares at first, with the other third likely distributed later. While I cannot be sure exactly how the SpinCo will trade, personally, I sleep comfortably owning the MSG Arena on an unlevered basis at a >10% FCF yield.

For the RemainCo, the clear catalyst is the opening of the Sphere in Fall 2023. Unlike the SpinCo's stable assets, the Sphere is an aggressive growth project with a wider array of potential outcomes. To the downside, the Sphere could be a bust, with underwhelming crowds and a lack of star powered residencies, and MSGE management could end up reinvesting in the project for a few years in the hope of turning it around. To the upside, the Sphere could be a transformational Vegas asset with sold out crowds and an exciting pipeline of future development projects. There are, of course, a variety of mixed results between these two extremes. As a rule, in "moon shot" growth investments, I only invest when I am comfortable underwriting to a worst-case scenario, while being optimistic that its upside potential comes to fruition. For RemainCo, in my worst-case scenario, I value the Sphere at \$500MM, or ~20% of construction costs, supported by my belief that the Sphere can generate at least \$50MM in high margin marketing dollars and only a slight premium to the recently completed Las Vegas T-Mobile Arena, which cost [\\$375MM](#). I also assume a \$200MM stub equity value for MSG Networks, despite its \$1B equity

purchase price 18 months ago, which combined with RemainCo's other assets and debt yields roughly \$1B in equity value, or \$30/sh. To the upside, if Sphere can achieve management's targeted "double digit" return, I believe a 20x multiple on \$250MM in EBITDA is reasonable, or roughly \$150/sh. Regardless of the outcome, by year end, the market will receive substantial updates and indications on the health of the Sphere and I believe the current pricing, at a discount to my punitive worst case scenario, is excessive.

### **Some Thoughts After Six Years and Business Updates**

It has been quite a ride over the last six years, but after a lot of focus and hard work, I am happy the partnership's returns are showing the fruits of our process. When I launched, I said the partnership's goals were 1) 1000bps of gross outperformance annually versus our benchmark and 2) outperformance two out of three years. My goal is consistent execution, rather than swinging wildly at every pitch, with the acknowledgement that our long-term strategy will inevitably encounter rough patches and must be measured over multi-year periods. After a rocky 2019, I am glad the partnership's results have matched my aims.

In addition, I am happy to welcome a handful of new partners. As a result of our growth, while early in the process, I am looking to add additional help on the operations and investor relations side of our business. If anyone has any recommendations, I would love to hear them.

As always, please feel free to contact me with any questions.

Sincerely,

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