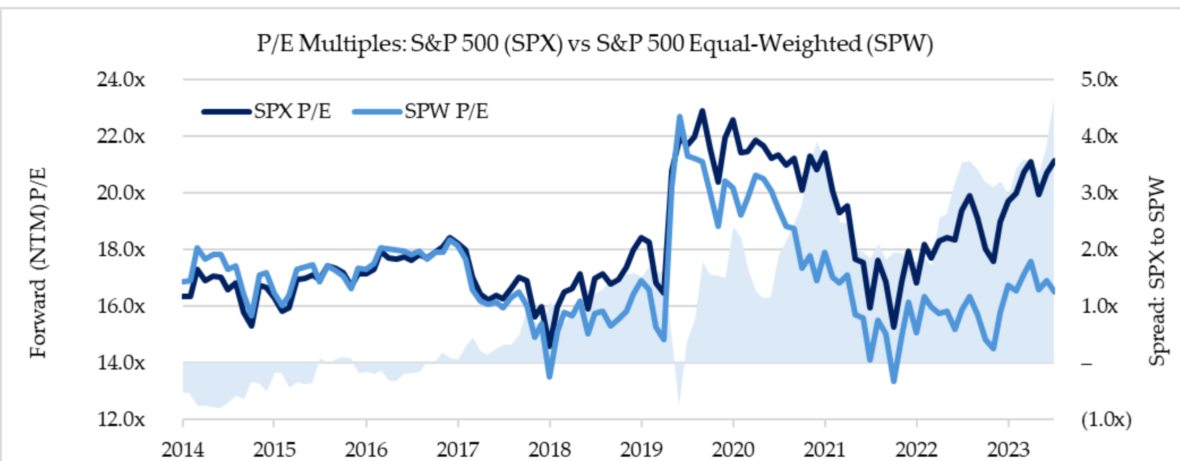
TRAN CAPITAL MANAGEMENT

Partners Strategy | Second Quarter 2024

Dear Clients and Friends,

We hope you are enjoying the start of summer. The stock market advanced 4.3% in the second quarter, bringing the S&P 500's first half return to 15.3%. Our Partners Strategy returned 1.6% net of fees during the second quarter and has returned 10.7% YTD net of fees. While the market's return is impressive, upon a closer look, the constituents in the market's run-up continues to be narrow. More than 100% of the S&P 500's return in the quarter was driven by seven large technology stocks (Apple, Amazon, Alphabet, Meta, Microsoft, NVIDIA, and Tesla). These seven stocks contributed 4.4% of the market's 4.3% total return in the quarter, meaning the remaining 493 companies as a group detracted 0.1% from the market's return. Interestingly, the S&P 500 Equal Weighted Index (SPW) returned 5.0% through the first half of 2024. The weight and concentration of the top constituents continue to increase. With the recent run-up, the five largest companies now account for approximately 28% of the S&P 500. With this, the valuation gap between the S&P 500 and its equal-weighted counterpart continues to diverge. As shown below, the spread in P/E between the S&P 500 and SPW has increased to nearly 5x with the S&P 500 trading at over 21x P/E. We are mindful of the risks posed by this concentration and believe that it would be healthy for the market to broaden out. Our portfolio's active share, or percentage that is different than the S&P 500, continues to be about 80%.



Source: Bloomberg

Portfolio Positioning

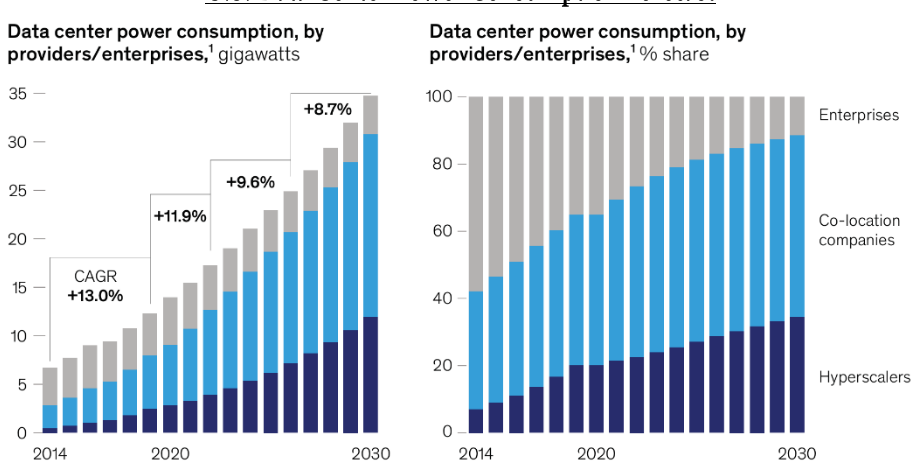
We believe that the excitement for technology and artificial intelligence warrants meaningful exposure in our portfolio. As you may remember, we added **Taiwan Semiconductor (TSM)**, the leading global semiconductor manufacturing company during the first quarter. During the second quarter, we took advantage of **NVIDIA's (NVDA)** stock price pullback in April and added it back to our portfolio at approximately $85 a share. NVIDIA ended the quarter at $123 per share, up about 45% so far. We have owned NVIDIA in the past and sold it during the first quarter of 2022 in anticipation of rising interest rates and an oversupply of personal computers. We should have reestablished our position earlier as NVIDIA declined but are happy to have found an attractive price during the second quarter. NVIDIA's Jensen Huang believes that over a trillion dollars will be spent to upgrade data centers for AI and accelerated computing over the next few years. With NVIDIA's leading semiconductor and software embedded chips, we think that NVIDIA will maintain their lead for many years to come.

Investments in AI and the training of large language models (LLMs) at data centers are not just driving investments in semiconductors and software but are driving a meaningful increase in electricity demand that we believe will strain our existing power grids for many years to come. According to the IEA, global electricity demand rose by 2.2% in 2023 but is accelerating to a 3.4% annual rate through 2026.[1] Underlying this is a forecasted doubling of electricity consumed by data centers, AI, and cryptocurrencies from 460 TWh in 2022 to 1,000 TWh by 2026. To put this in context, 1,000 TWh is more than the electricity consumed by Germany and France combined. Looking closer to home, McKinsey forecasts electricity consumption by IT equipment in U.S. data centers to grow by 13% per year through 2030.[2] Goldman Sachs forecasts an even greater increase in data center power demand, estimating a 15% CAGR to 2030 with data centers growing from 3% of total US power demand in 2023 to 8% in 2030.[3]

This has very significant implications for the energy and utilities sectors. While demand is forecasted to accelerate, supply will be constrained. The U.S. currently sources 40% of its electricity from natural gas, 20% from coal, 18% from nuclear, and 22% from renewables.[4] Building new power generation capacity takes years (or decades), is expensive, and is often blocked by communities holding the sentiment of *not in my backyard*. For instance, building a new nuclear plant could not only take 20 years to plan, permit, and build, but would also cost over $20 billion. While it is challenging enough to build new power generation plants, the supply-demand imbalance may tip further in favor of the supply side due to the end of life of many current energy plants. Our research suggests that incumbent energy producers enjoy a strong competitive advantage and should benefit from rising demand over the next decade.

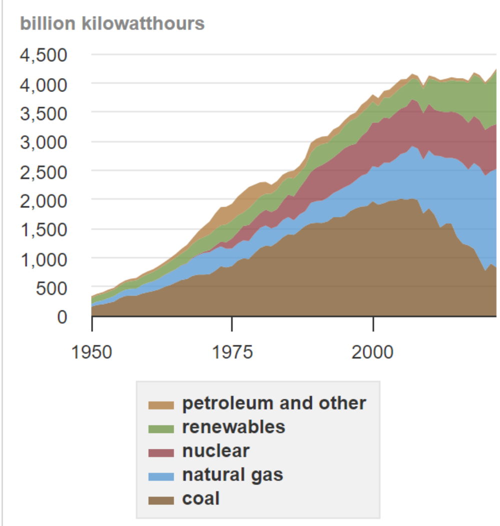
We believe that one of the most interesting opportunities in power generation is **Talen Energy Corporation (TLN)**, an independent power producer based in Houston, Texas. Talen emerged out of bankruptcy in 2023 with a clean balance sheet, a new and experienced management team, and safe and unencumbered power generation assets. The company produces and sells electricity and capacity into wholesale power markets, primarily the PJM Interconnection (Pennsylvania-New Jersey-Maryland electricity grid). The PJM grid estimates that approximately 20% of its current supply will be retired by 2030 due to regulatory and economic reasons. We do not believe new capacity will be built at the same rate as these retirements. Talen owns and operates 10.7 GW of power generation capacity via a 2 GW nuclear power plant (Susquehanna), over 6 GWs of gas plants, and coal plants. Given Talen's recent emergence, we believe that there are many ways to win with this investment.

U.S. Data Center Power Consumption Forecast



Note: McKinsey subsequently increased their forecast from 35 GW to 50 GW in 2024.
Source: McKinsey, January 2023

U.S. Electricity Generation by Source



Source: IEA, June 2023

[1] International Energy Agency (IEA), *Electricity 2024*, January 2024
[2] McKinsey & Company, *Investing in the Rising Data Center Economy*, January 2023. Forecast for 2026 updated in 2024 (via Reuters, April 2024)
[3] Goldman Sachs Investment Research, *Generational Growth*, April 2024
[4] EIA, *Electricity Generation, Capacity, and Sales in the United States*, June 2023

Over the past year, Talen's management team saw the rising energy demand from data centers and orchestrated the industry's first power purchase agreement with Amazon Web Servies (AWS). In March 2024, AWS agreed to purchase Talen's datacenter campus at Susquehanna for $650 million while also entering into a long-term power purchase agreement with Talen for up to 960 MW at above market rates. We believe this could serve as a model for future deals between energy producers and energy hungry data centers. We estimate that Talen will generate $700 million in EBITDA this year, growing to north of $1 billion by 2027, with more upside potential. Even after the AWS power purchase agreement, Talen still has over 50% of their nuclear capacity exposed to rising energy prices, so actual earnings could trend higher.

Talen's market capitalization is about $7 billion dollars. We believe that the replacement cost for Talen's nuclear power plant is over $20 billion. The company's management seems to agree that the current valuation understates their intrinsic value. Over the past month, Talen used the proceeds from the sale of non-core assets to repurchase over $900 million of stock or about 13% of their shares outstanding. We applaud this capital allocation decision. Finally, on July 10th, 2024, Talen's application to uplist their shares to the Nasdaq stock exchange was approved, and the company now trades on the Nasdaq. We believe listing on a major primary exchange appropriately reflects the improved quality of Talen's business and should also help attract larger institutional investors to consider Talen Energy as an investment. We are pleased to have initiated our position at the end of May.

Looking Forward

While the market has been strong, we observe that there are many high-quality companies whose business models are durable and improving but whose stock price has lagged the overall market. We believe that several companies in our portfolio fit this description and that our patience will be rewarded.

For instance, software companies have lagged the overall market. We believe software has lagged due to the overwhelming attention on semiconductors. Further, near-term revenue growth has faced headwinds from enterprise customers taking longer to make large software decisions while also seeking to simplify their purchases through vendor consolidation. While these reasons are understandable, we believe they are shortsighted as our research shows that historically for every dollar invested in semiconductors, two or three dollars is invested in software a few years down the road. Therefore, companies like **Palo Alto Networks (PANW)**, **Salesforce (CRM)**, and **Intuit (INTU)** can catch up later in the cycle.

Another sector that has underperformed the market is healthcare. While **Danaher (DHR)** has been a good compounder over the long-term, the stock is only up 8% YTD as the life science industry has grappled with overbuilding of capacity since the pandemic and biotech funding has been muted by high interest rates. However, with a disciplined management team, healthy profit margins, low leverage, and potential corporate actions, we are not worried about Danaher's long-term prospects. Similarly, **IQVIA (IQV)** stock is down -8% YTD but should continue to grow EPS 8-12% in each of the next three years. We think pharma and biotech R&D will rebound after the recent post-COVID slowdown, and DHR and IQV will see a re-acceleration in their growth rates.

Similar to our healthcare positions, housing related stocks have also underperformed the overall market. Specifically, **Sherwin-Williams (SHW, -3.9% YTD)** and **Ferguson (FERG, +1.0% YTD)** have lagged the market. With mortgage rates doubling since the beginning of 2022, housing related stocks have been hurt. We think this short-term headwind will pass. Much of Sherwin's paint and Ferguson's plumbing and HVAC businesses service existing homes as well as new construction. The average home in the U.S. is over 40 years old and maintenance is critical. Moreover, as the Federal Reserve is near the end of their rate tightening cycle, we believe this headwind will become neutral or even a tailwind when the Federal Reserve potentially cut rates in the third or fourth quarter. We believe these are high quality companies, are leaders in their space, generate impressive free cash flow, and can redeploy their cash flow into shareholder friendly ways. We are not worried about their current stock prices and believe our patience will be rewarded.

We will continue to evaluate our current holdings, research new ideas that have lagged the market, and make minor adjustments if opportunities present themselves. Over the medium-to-long-term, we are excited about our portfolio companies' competitive positions and their ability to compound growth. Thank you for your support and if you have any questions, please feel free to contact us at (415) 461-3800.

Sincerely,

		
Quoc K. Tran *Chairman & CIO*	Michael N. Im *Co-PM & Director of Research*	Eric A. Winterhalter *President*

Important Disclosure

Performance is provided as supplemental information and is based on the Partners Strategy Composite. Performance results reflect all income, gains and losses and the reinvestment of interest and other income. All rates of return are reported "NET" of fees. Additional information regarding the policies for calculating and reporting returns is available upon request. A complete listing and description of all TCM composites and performance results is available upon request.

The 1-year, 3-year and 5-year net of fees returns of the Partners Strategy Composite as of June 30, 2024, are 21.31, 1.68 and 11.65 respectively. The 1-year, 3-year and 5-year returns of the S&P 500® Index as of June 30, 2024, are 24.56, 10.02 and 15.04 respectively. 3-year, 5-year and 10-year performance figures are annualized.

The S&P 500® is an unmanaged stock market index and is not available for direct investment. The S&P 500® Index represents the stocks of 500 leading U.S. publicly-traded companies from a broad range of industries. The performance of an unmanaged index reflects no deductions for fees, expenses or taxes which would affect performance of actively managed assets. The volatility of the S&P 500® Index may be greater or less than the volatility of the portfolios in the composite.

Benchmarks and financial indices are shown for illustrative purposes only and are provided for the purpose of making general market data available as a point of reference only. Such benchmarks and financial indices are unmanaged, assume reinvestment of income, do not reflect the impact of any trading commissions and costs, management and incentive fees, and have limitations when used for comparison or other purposes because they, among other reasons, may have a different trading strategy, volatility, credit or other material characteristics (such as limitations on the number and types of securities or instruments). No representation is made that any benchmark or index is an appropriate measure of comparison.

Select assets shown; additional Partners Strategy investment information is available including the complete portfolio upon request.

All opinions and data included in this commentary are as of June 30, 2024, unless otherwise noted, and are subject to change without notice. The opinions and views expressed herein are of Tran Capital Management, L.P. ("TCM") and are not intended to be seen as fact, a forecast of future events, or a guarantee of future results. The information in this publication has been developed internally and/or obtained from sources believed to be reliable, but the accuracy or completeness of this information cannot be guaranteed. This publication is provided for informational purposes only and not does constitute a solicitation, investment advice or recommendation for any particular investment product or strategy. Economic forecasts and estimated data reflect subjective judgments and assumptions, and unexpected events may occur. Therefore, there can be no assurance that developments will transpire as may be forecasted in this publication. This information should not be used as the sole basis to make any investment decision. No investment strategy can assure a profit or protect against loss. Past performance is not a guarantee or indication of future performance.

The companies profiled should not be considered a recommendation to purchase or sell a particular security, represent only a small percentage of the entire strategy and the securities purchased for advisory clients, and may not remain in the strategy at the time you receive this letter. You should not assume that investments in the securities identified were or will be profitable or that decisions we make in the future will be profitable.

The most recent ADV Part 2 can be found at www.trancapital.com or by calling (415) 461-3800.