LRT CAPITAL MANAGEMENT

THE VISION TO SEE
ECONOMIC MOATS

January 12, 2018

December 2017 - Performance Update

If you are an accredited investor, please contact us for performance information.

In my October letter, I wrote that we "abstain from excessive self-flagellation after a losing month". Considering our December results that statement needs to be revisited. Some self-flagellation along with rigorous reflection is indeed in order.

I have great conviction in our investment process and our ability to drive meaningful portfolio outperformance in the year ahead. As always, I welcome your questions.

"Yesterday's Homeruns Don't Win Today's Games" – Babe Ruth

In our final letter of 2017, we want to reinforce a warning. Economic moats – the ability to generate above average profitability – are never static. Every day they are expanding or shrinking. We currently see one area of the market where moats could soon be breached. We believe investors are currently overvaluing stocks in the consumer staples sector, based on past high profitability and the false safety that often comes with popular brands. A "Flight to quality" response by investors has destroyed more wealth than it's created. As such, investors are incorrectly treating many of these companies as "bond proxies". Most consumer staples companies today have little to no growth opportunities, and are facing an array of new competitors as the barriers to entry in the sector have declined dramatically in recent years.

Most consumer staples companies, such as Coca Cola, PepsiCo, General Mills, or Colgate-Palmolive, currently trade at above market valuations due to their perceived "moats" or safety. We believe these valuations are going to collapse over the next 3-5 years. Colgate-Palmolive, for example, trades at 29x trailing earnings, a premium to the S&P's 23x. It is similarly expensive on the basis of "traditional metrics" such as price-to-sales and cash flow based metrics. Colgate does enjoy high profits on its current portfolio of products, but it has nowhere to reinvest and faces increasing pressure from more generic competition. Over the past five years, Colgate's: revenues declined 11%, operating profits 7%, and free cash flow 4%. The only things that are up, are: dividends +19%, long term debt +32% and the PE ratio +41%.

Most consumer staples have seen a similar pattern over the past five years: flat to down revenues, flat to down earnings, rising dividends, rising debt and rising valuations. The reasons are broadly the same: barriers to entry have come down dramatically and new companies are challenging incumbents. Legacy brands confer less value than they did in the past, high quality contract manufacturing is more accessible than ever, and selling direct to consumer has never been easier. The rise of brands such as Chobani, Dollar Shave Club and Horizon Organic are just three examples.

If a business can reinvest and grow, a moat can add incredible value to a company. But moats do not dramatically enhance the value of companies without grow opportunities. Incumbent companies with moats are facing the impossible puzzle of growing revenues, maintaining profitability and raising dividends. Paying a premium for growth makes sense. Paying a premium for a company in decline does not. We believe most consumer staples companies with declining revenues should trade at 8-10x trailing earnings, a decline of 50-75% from where many of them trade today.

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