LRT CAPITAL MANAGEMENT

THE VISION TO SEE ECONOMIC MOATS

August 2, 2018

July 2018 - Performance Update

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

July's performance resulted from a number of portfolio companies reporting outstanding earnings but disappointing future earnings guidance. Notably, portfolio under-performance was NOT the result of any deviation from the consistent application and disciplined execution of the LRT process. LRT remains committed to a high-conviction, concentrated portfolio of rigorously evaluated companies.

Specifically, a deeper look at three (3) of the largest contributors to July under-performance illuminates the common theme of earnings and macroeconomic issues:

- **Facebook (NASDAQ: FB)** –
    - Facebook reported revenue and earnings growth of over 40% and 30% respectively but issued confusing guidance about slowing revenue growth and the prospect of declining operating margins.
    - The company has issued similar warnings in the past and always beat their guidance which indicates it is conservative in its projections. Based on the recently reported quarter, Facebook trades at 21x trailing twelve-month earnings (excluding cash), operates in an advertising duopoly (with Google), and has enormous growth potential ahead of it, as advertising continues to shift online, while the company develops new products and monetizes existing ones (Facebook stories, WhatsApp, Facebook Messenger, Facebook Watch). The S&P 500 currently trades at over 21x trailing twelve-month earnings, suggesting that investors are not giving Facebook the premium it deserves.
    - FB reach is unparalleled with 2.5 billion global users of the platform. With that said, among the most challenging issues for FB as THE platform for free expression is management and monitoring of user-driven content, some of which may be viewed as "offensive". Additionally, FB is being investigated by the Federal Trade Commission over the misuse of data by a British media consultancy linked to the 2016 Presidential election. As such, FB has been under increased headline scrutiny as it undertakes a process to purge "fake accounts" and user-oriented content that does not meet standards. Concerns that such activity may lead to an overall decline in usage, which in turn impacts growth and revenue are overblown in our opinion.
    - We believe Facebook is undervalued as the company has one of the widest moats in the world, ample growth opportunities, and a management team that has consistently been willing to sacrifice short term profits to deepen and widen their moat.

- **NVR Homes (NYSE: NVR)** –
    - NVR reported revenues and earnings that rose by 16% and 37% from a year before, respectively. Yet, the company issued conservative guidance compounded by fears of a slowdown in housing.
    - NVR is a homebuilder, a traditionally unattractive industry, but one in which the company has thrived due to its disciplined and unique business model that focuses solely on home

construction and eschews land development (which is volatile and capital intensive). This makes NVR, an "asset-light" homebuilder and has allowed the company to earn returns on invested capital of over 30% (as of last twelve months).

  - NVR has consistently repurchased its own shares over the past two decades – an action that has proven an excellent use of shareholder capital as the company continues to generate solid returns. The company's shares are down over 25% since peaking in January of this year and the company announced a new share buyback on August 1st. The shares trade at only 16x trailing and 12x forward earnings – extraordinary value for a company that generates ROIC of over 30%, has the potential to grow and has a history of excellent capital allocation.

- Finally, our **US Treasury (NYSE: TLT)** position was a drag on performance as long-term interest rates rose during the month in response to President Trump's threats to the Fed's independence. We continue to expect a slowdown in the economy in the second half of 2018 as the sugar rush of Trump's tax cuts wears off and the full effects of interest rate increases along with the ambiguity of trade policy and tariffs hits the economy. As the economy slows, the expectation is for inflation to moderate and boost long-term Treasuries.

Portfolio Updates

On July 19th, **Comcast (NASDAQ: CMCSA)** ceased pursuit of Fox ceding victory to Disney. This came as no surprise to us at LRT. A quick look back at LRT's June letter: we indicated Comcast was likely to drop its bid for Fox. Upon the announcement, Comcast stock promptly rose 2.5% (suggesting this was viewed as a positive "surprise"). LRT expects further positive performance ahead as uncertainty about "cord-cutting" abates and other market participants come to appreciate how "cheap" this great company really is.

Our Strategy

In last month's letter I discussed the LRT investment strategy and our stated goal: to earn a 20% annualized rate of return over an entire market cycle. This goal is achievable because of the differentiated and disciplined strategy we follow at LRT. As a further step, this month's letter illuminates what LRT really means by "differentiated strategy" and why it's important.

To achieve sustained investment performance, better than most market participants, one must by definition do something different from the substantial majority of investors. The LRT investment strategy is dramatically different with regard to what most equity investors pursue. How many investment process presentations have you seen that have neatly defined steps and funnel charts? Quantitative screening, using traditional approaches, industry standard tools and broad diversification ("di-worsification") are part of the conventional investment process – which by definition CANNOT result in truly better outcomes because the investment process is not meaningfully differentiated. Simply, if you do what everyone else does you will get what everyone else gets!

A comparison between LRT's investment process and the "conventional" process illuminates the critical differences. A typical investment process involves a well-defined series of steps. For example, let's look at a typical "value fund". First, a Bloomberg screen for low-PE, low-PB, low EV/EBITDA stocks is completed, which yields a list of 200 stocks meeting the criteria. The next part of the funnel process requires further work on the list: Analyzing balance sheets, looking for hidden assets, reading proxy statements and some sell-side research. This enables identification of companies with near term "catalysts". Subsequently, market sentiment is obtained by calling "around the street" to friends at other funds to see what they think and swap "best" ideas. Finally, the "value fund" portfolio is comprised of 120 positions; that neatly tracks the market (i.e. "low tracking error"). This approach checks many institutional boxes for a good process: it is well-defined, repeatable and scalable. Unfortunately, there is zero alpha in this approach.

Twenty years ago, when information was less available and computer screening less accessible, this approach tended to yield superior results. Today it is largely worthless, as indexing and cheap "smart beta" has replaced most systematic, easy to implement strategies. In today's investing climate, all quantitative information is priced very well by the market. In the example above, screening for low-PE, low-PB, low EV/EBITDA stocks will result in a portfolio of companies with structurally challenged business models. Many investors continue to cite low EV/EBITDA as a powerful predictor of returns – but these are all based on studies of the past! These simple quantitative factors have all been arbitraged and competed away over the past decade. Today, there is no easy funnel process or <u>quantitative</u> screening approach that will result in sustainable outperformance.

The LRT process is different. We have no interest in what "Wall Street" thinks of our ideas and don't read their research to identify opportunities. We focus on hard to arbitrage **<u>qualitative</u>** factors. We don't use computer screens. We start with primary source research instead of relying on Bloomberg or CompuStat to identify companies that have "moats" (durable competitive advantages). We dissect the value chain and globally search for overlooked companies that meet our stringent criteria. We invest substantial time and effort to understand businesses at a granular level, their barriers to entry, and the nature of competition in the industry. We speak to key industry insiders and model the growth opportunities ahead of the business. We spend time to understand the management, their ability to execute their strategy and philosophy with respect to capital allocation. We don't seek to build a portfolio of 100+ stocks. Instead, we assemble a high conviction portfolio comprised of 20-25 positions of our best ideas with the objective of outperforming the markets over the long term and low portfolio turnover, which is reflected by LRT's infrequent trading.

Just as we seek to invest in companies with strong competitive advantages, at LRT our competitive advantage is our disciplined and differentiated investment process. When speaking to prospective investors we never focus on our performance, but rather on our philosophy and process. Our long-term performance is simply a validation of the efficacy our process. In the short-term performance, will ebb-and-flow, but our philosophy and process remain consistent. Our firm belief is that success is a result of consistency. Consistent hard work leads to success and most importantly, that consistency and success serves to form the most critical attribute in our relationship with you: **TRUST**.

<u>LRT Strategy</u>	**<u>Typical Process ("Fidelity, Blackrock, etc.")</u>**
• Concentrated (20-25 positions)	• Broadly diversified (100+ positions)
• Low turnover	• High turnover
• Alpha: growth in per share value (ROIC crucial)	• Alpha: multiple re-ratings (ROIC irrelevant)
• No computer screening, idiosyncratic idea generation	• Computer screening, funnels, mechanistic process
• Focus on qualitative insights	• Focus on quantitative (PE, PB, EV/EBITDA, etc.)
• Primary source research	• Standard tools (Bloomberg, FactSet, CompuStat)
• Lots of field work, independent/internal research	• Trading ideas with friends; Social proof; Sell-side research
• Frequent travel	• Don't want to leave Manhattan
• Goal: Outperform indexes	• Closet-indexing, "tracking error" focused

Continuing last month's theme, I've selected two portfolio holdings with a common thread: US housing. Americans love their homes and spend lavishly on them. As a home owner myself, I can attest: homes are expensive. Their maintenance and upgrading are a consistent outlet for disposable income. Two portfolio companies positioned to continually benefit from the boom in US housing are Pool Corp and Home Depot.

Pool Corp (NASDAQ: POOL)

Pools are figurative money pits. Building, maintaining and upgrading pools is expensive, yet the number of pools in the US continues to grow year-by-year. Founded in 1993, Pool Corporation is the largest national distributor of pool supplies. The company aggregates parts and equipment from 2,200 suppliers and sells primary to pool contractors. While the company has a global presence, most of its distribution centers are in just four states: Texas, Florida, California and Arizona. Anyone who has visited these states in the summer understands why.

Pool Corp is a great business. Supply distributors benefit from local oligopolistic competition: the larger distributors have better parts availability and higher asset turnover. Most buyers are contractors who simply pass on the costs to their ultimate customers. This leads to high barriers to entry, low customer price sensitivity, low cyclicality and high returns on invested capital.

Pool Corp's revenue is driven by three (3) key factors:

1. Number of existing pools (a bit over 6 million): chemicals and minor repairs.
2. Number of pools over 15 years old (over 3 million): refurbishments and upgrades.
3. New pool construction.

The company was profitable in 2008 and 2009 because more than half of the company's revenues are consumables and materials for light repairs, while only 15% of revenue is directly tied to new pool construction. While new pool construction is closely tied to the housing market, the majority of the company's revenues are high predictable and recurring in nature.

The popularity of pools can anecdotally be seen by the number of cable shows directed to solely to pools. Shows such as "Pool Kings" espouse the joys of having a home pool as well as how creative and expensive pools can be. As the US population continues to migrate to the warmer climates where pools can be enjoyed year-round, the installed base of pools will continue to grow. There are currently approximately 6 million pools in the United States, a number that is growing by approximately 90k per year. New pool construction is still far below the previous peak of 2006 (200k units) suggesting there is plenty of room to grow. In addition, the number of pools 15 years and older is also set to grow rapidly in the coming years as the substantial number of pools that were constructed in the mid-2000s age. These pools will drive demand for refurbishment and upgrades.

Over the next decade Pool Corp is poised to continue growing revenue at high single digits (7-9% per annum). Combined with operating leverage and share buybacks, this should translate into mid-teens EPS growth. The company generates substantial cash and management has a good record of allocating capital. Pool Corp's strategy for capital allocation is split between acquisitions, reinvesting in capex and returning cash to shareholders (dividends and buybacks). They have consistently executed this strategy for over two decades and show no sights of slowing down.

In summary, Pool Corp is an easy to understand business with highly predictable revenues. The business is protected by formidable barriers to entry, is highly profitable and should grow earnings per share at a healthy clip (15%) per year for the foreseeable future. The company is also a huge beneficiary of US tax reform as it was a high tax payer and will see a big reduction in its tax bill. If the US population keeps growing and people keep moving to warmer locales, the installed base of pools will keep expanding. As the number of pools grows, Pool Corp will continue to deliver value for shareholders and we are delighted to be amongst them.

Home Depot (NYSE: HD)

In investing there are no points for originality – sometimes the simplest and most obvious investments are the best. We believe that the Home Depot meets this definition. Together with Lowes, the Home Depot operates a duopoly of home improvement stores. As any home owner will tell you, it is hard to do any home project without a trip to Lowes or the Home Depot. Both companies continue to take market share from smaller chains and independent stores. While Lowes is a formidable competitor it lags the Home Depot in several areas, such as sales per square foot, which is why we favor the folks with the orange logo.

The Home Depot is often seen as bet on US housing. While the company's sales are certainly correlated to new housing construction, the company was solidly profitable in 2008 and 2009 – showing that it can earn respectable returns even in a dire environment. The Home Depot is also largely immune from the threat of Amazon: most purchases are bulky, infrequent or require professional help to install. As a homeowner who has done several projects around the house, I can attest to the value that speaking to an expert brings. Being able to go to a store, compare products from a wide selection, and ask expert advice are immense advantages that online shopping cannot replicate. Add to that a no-hassle return policy and you can understand why the Home Depot has grown sales and earnings steadily over the past decade.

The Home Depot has had excellent management since 2007 – since the firing of Bob Nardelli, a serial destroyer of companies with previous "hits" including Chrysler and General Electric. The company's exit from the China in 2012, a market the company had no experience or competitive advantage in, can be seen as a turning point for the business, as the Home Depot refocused on the US market and has executed brilliantly ever since.

There is no doubt that a sustained downturn in the US housing market would hurt the company's sales, but this is an acceptable risk, given the alternative: no downturn and steadily rising sales from existing stores. As the population density and housing stock in the US grows, the Home Depot will continue to grow sales from its existing locations – whether from DIYers or pro customers. Rising sales per store will continue to improve the already excellent profitability of the Home Depot. The company is also a huge beneficiary of US tax reform as it was a high tax payer and will see a big reduction in its tax bill. Due to tax reform, we forecast returns on invested capital to exceed 40% by next year. As the company operates in an oligopoly with Lowes, we believe these gains are going to captured by shareholders and not competed away.

The Home Depot has grown sales by mid-single digit over the past decade – a period that included the worst housing crash in modern history. The company is likely to continue this growth, which should translate into mid-teens EPS growth due to operating leverage and share buybacks. It is popular to worry about the next quarter's comparable sales or where we are in the housing cycle. Instead, we believe investors should focus on the durable strengths of the company – regardless of where we are in the cycle. The Home Depot has shown the ability to prosper even in the toughest economic conditions – as shareholders we expect this strong performance to continue.

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