October 1, 2019

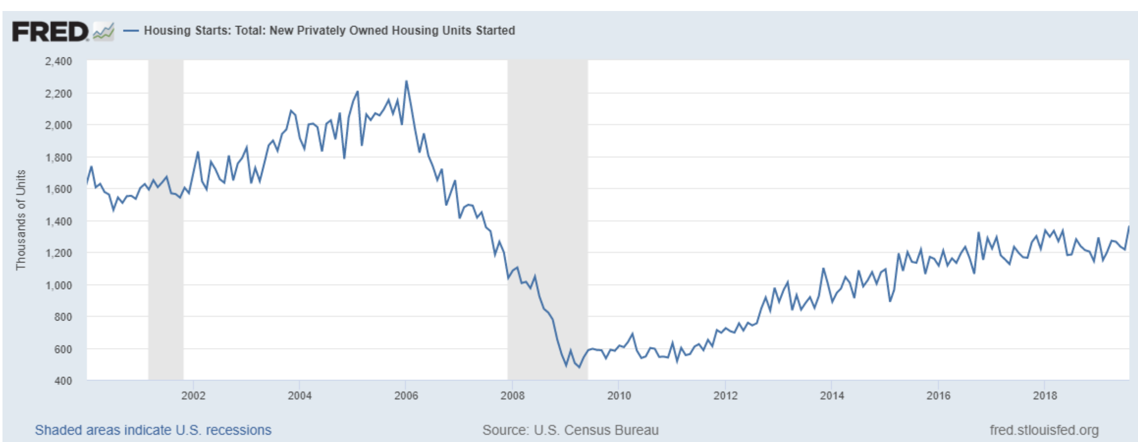
September 2019 - Performance Update

Dear Friends & Partners:

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

September was another positive month for our investment strategy. Most of the stocks in our portfolio rose, offset by a decline in our US Treasury holdings. Notable winners during the month included Ryanair (RYAAY), Colliers (CIGI) and Sherwin-Williams (SHW). Offsetting these were losses from HEICO (HEI-A), Canadian Pacific (CP) and our Treasury position (TLT). Our top equity positions at the end of the month are Ryanair Holdings plc (RYAAY), AutoZone, Inc. (AZO), NVR, Inc. (NVR), Colliers International Group Inc. (CIGI) and UnitedHealth Group Incorporated (UNH). Our five largest equity positions account for approximately 27.08% of our portfolio exposure.

We remain bullish on the US Economy. For a detailed description of why, please review our August 2019 letter[1]. During the month we saw further macroeconomic data that support our optimistic stance with the most important being stronger than expected US Housing starts which exceeded all analyst estimates. Below is a chart of US Housing starts since 2000. Two points are worth making: 1) The August US Housing starts hit a new high for this economic cycle[2]; 2) Housing starts are still incredibly depressed from a historic perspective. We have mentioned in previous letters to you that one of the "themes" that runs through our portfolio is US housing: home improvement retailing, paint, air conditioning, pools, and real estate services. We believe US Housing has lots of room to grow. Expect more good news on this front.



[1] https://www.lrtcapital.com/wp-content/uploads/2019/09/2019-08-August-Performance-Update-Public.pdf
[2] https://fred.stlouisfed.org/series/HOUST

One Force to Rule Them All: Barriers to Entry

In the short-term, it is difficult to separate luck from skill in investing by evaluating returns alone. That is why discerning investors focus on the **investment process** when evaluating investment managers. What matters most is having a repeatable, predictable and consistently executed investment process – like the one we employ at LRT. Investment returns are simply a validation of the efficacy of the process. With that in mind, I believe it is worth repeating the key tenants of the investment process that we follow at LRT and our fundamental premise. At LRT, we are active managers and we are seeking to invest in companies with three characteristics:

- a durable competitive advantage (a moat),
- the ability to grow and reinvest,
- and a management team with a demonstrated track record of good capital allocation.

We believe all three elements are necessary for successful long-term investing and that all three are commonly mispriced by the market. It is crucial that all three elements are present to maximize the chances of a successful investment. If you have a moat, but lack growth, you can end up like shareholders of Kraft-Heinz (down over 65% as of 10/5/2019). Or if you have growth but no moat, you can end up like shareholders of Fitbit (down over 90% as of 10/5/2019). Or if you have a moat and growth but lack management with good capital allocation skills, you can end up like shareholders of Microsoft during Steve Ballmer's tenure as CEO (zero return for over fourteen years)[3]. A company must have a moat, the ability to grow and a management team that understands how to allocate capital, in order to be a successful investment. Today, I want to give you more insight into how we think about the first part of our equity selection process: the evaluation of a company's competitive advantage and its sustainability.

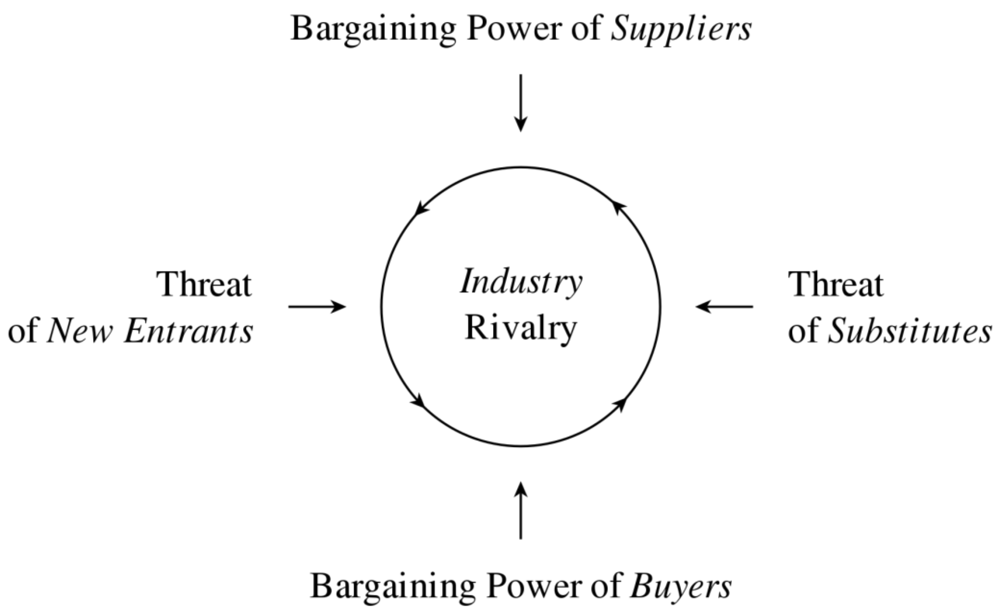
Having a sustainable competitive advantage, i.e. a "moat" means that the long-term profitability and thus the value of a business is not subject to wild swings. If that is the case, stock price volatility represents an opportunity for an investor to acquire shares in a business at an attractive (read: low) price during periods of panic and market turmoil. Without a moat, business values are unstable and market prices may very well be a good approximation of company value. Without a moat, stock price volatility equals risk, because there is no way of knowing how much the value of the underlying business is changing. Without a moat you really have no idea what the future of the business will look like. Many people in the value investing community say that volatility is not risk, but I believe this is true only for companies with durable moats. Only if you are sure of the moat can you say that volatility leads to opportunity.

Therefore, since volatility is an opportunity only when considering companies with a moat, the key to our investment process is evaluating the strength and durability of a company's moat. Useful in this process is an analytical framework called the "Five Forces Model" developed by Michael Porter of Harvard Business School and first published in 1979. A few words on the historical background are in order here.

In the 1970s Harvard Business School did not have an intellectually rigorous curriculum. SWOT analysis – a vague description of a company's strengths, weaknesses, opportunities and threats – constituted the height of intellectualism at the school. Enter Michael Porter, a professor determined to change this paradigm. Drawing upon the theory of structure-conduct-performance, which posited that the industry structure should drive firm conduct which in turn dictated performance, Professor Porter created an analytical framework called the Five Forces Framework. Below is a visual representation of his model. This

[3] All data from Capital IQ

seminal framework is still the basis for teaching strategy courses in business schools around the world today.



The Five Forces Framework is a useful starting point for industry and competitive analysis, but it is too complex for stock market investor to be applied in practice. The Framework analysis posits that all forces are equally important. We disagree and believe that one force stands above all others. There is "one force" that rules them all. That force is the threat of new entrants. Simply put, if the threat of new entrants is high, i.e. there are no "barriers to entry", there is almost no chance that an industry will be able to sustain high profitability. Without barriers to entry, high profitability quickly attracts new competitors who drive down returns for all market participants. Barriers to entry are a necessary condition for any industry to have superior long-term economic characteristics. We believe that the most important force, by far, is the threat of new entrants, and correspondingly, investors should first and foremost focus on assessing the barriers to industry entry. For more information see *Competition Demystified* by Bruce Greenwald[4].

A few examples of companies with enormous barriers to entry can help to illustrate this important point:

- **Union Pacific Corporation (UNP)** – competing effectively would require recreating a complex rail network, which requires enormous amounts of capital and more importantly securing the right-of-way with thousands of land owners across multiple states – a complex, expensive and time-consuming task.
- **Moody's Corporation (MCO)** – regulations and reputation protect Moody's from competition. Once a company's ratings become a de-facto agreed upon standard it becomes very hard to break this norm. Many have tried to break into the bond rating industry but have failed to establish a successful business.
- **Fiserv, Inc. (FISV)** – core bank processing operated by Fiserv constitutes the most vital part of any bank's operation. Changing core bank software providers is risky, time-consuming and a potentially career ending move – should something go wrong. Since core processing constitutes a vital and necessary function of every bank but does not enable a bank to develop its own

[4] https://www.amazon.com/Competition-Demystified-Radically-Simplified-Approach-dp-1591840570/dp/1591840570/ref=mt_hardcover?_encoding=UTF8&me=&qid=1569509639

competitive advantage, banks are extremely risk averse when picking a provider. As a result, customers very rarely switch providers and strive for extreme safety by picking well established companies. The have been no new entrants into the core bank processing business in over forty years.

- **Visa Inc. (V) –** the value of Visa rests on the trust conveyed by its brand and the enormous network of merchants and customers carrying its card. Without a large number of merchants that accept a card, customers won't sign up. Without customers, merchants won't accept the card – thus creating a huge problem for any newcomer. Simultaneously developing a two-sided network is an extremely difficult task that explains why no new entrant has emergent in decades.
- **Waste Management, Inc. (WM) –** people don't like living next to landfills, so governments don't give out many permits for landfills. As a result, in markets where Waste Management owns a landfill it is almost impossible for a new competitor to come in. Government regulatory fiat keeps would be competitors at bay.

In the investment world, managers should first consider the end state of an industry given the threat of new entrants. Since no industry can sustain high profitability without barriers to entry, it follows that company managers looking to build superior long-term businesses must focus on erecting and sustaining barriers to entry. Companies can build such barriers by several means: developing intangible assets (lobbying for a tougher regulatory environment, building brands, patents), increasing capital intensity and/or fixed costs necessary to operate in an industry, increasing customer lock in (long-term contracts, increase customer training, selling a bundle of a goods ands services), etc. Strengthening a company's moat and its long-term position is the cornerstone of all business strategy and should be the focus of all corporate management teams. As investors, we judge a company's management by the daily actions they take to deepen and widen their moats.

Tolstoy, wrote in the opening lines of his novel, Anna Karenina: "happy families are all alike; every unhappy family is unhappy in its own way." A twisted version of this can be applied to business: "each successful business is unique in its own way; every unsuccessful one is alike – mired in endless brutal competition." Therefore, a business with a deep moat that has erected huge barriers to entry will be unique, with few, if any, competitors. Paradoxically, a business operating in a competitive industry does not have the means to do many of the things society would increasingly like businesses to do, such as: investing for the long term or taking care of workers and the environment. A business engage in a hugely competitive industry does not have the ability to plan or invest for the long-term, because every day is a life and death struggle. It does not have the ability to take care of the environment, workers, and least of all its shareholders. In a perfectly competitive environment, the bankruptcy of such a business will be of no consequence at all to society, as its place will immediately be taken up by another undifferentiated competitor. As investors we must avoid such businesses like a plague.

Competition brings advantages to society at large but that is not what we are after as investors. Our goal is the sustainable compounding of wealth. Competition, while cherished by consumers, is antithetical to this goal. It is therefore important to not be carried away by the allure of a fast-growing business or industry without understanding its likely longer-term competitive dynamics. In the words of the chess grandmaster, Jose Capablanca "you must begin by studying the endgame." For example, mattresses which carry very high gross margins have been a category targeted by many newly established companies seeking to disrupt the industry. "Beds in a box" sold online and shipped directly to consumers have been all the rage in the past few years. But would you invest in any of the companies involved?

Casper, Purple, and Nectar are just some of the names of the companies in this new and exciting industry (Personally I own a mattress made by Zinus and highly recommend it – $399 for a King on Amazon[5]). In fact, CNBC reports that there are now over 175 online mattress companies[6] - too many to list or even tell apart. Of these, only Purple is publicly traded, under the ticker PRPL. Clearly, the barriers to entry in this industry are virtually non-existent, as evident by the number of competitors. We would advise investors to steer clear from investing in this industry, as the companies involved are locked in a brutal fight to the death with profits nowhere in sight. The mattress industry is clearly being disrupted, but it is consumers, not investors who are likely to benefit from this change.

Like mattresses, sunglasses carry enormous gross margins and most today are sold through retail outlets, as consumers like to try on a pair of glasses before deciding on a purchase. Furthermore, consumers have become accustomed to paying very high prices for glasses and many can't imagine an alternative. One giant company, Essilor Luxottica dominates all stages of this business: from making lenses, through sunglass design, manufacturing and retailing. But, sunglass are another product category that is undergoing a rapid transformation, as more and more consumers shop for sunglasses online. Will consumers continue to pay $150+ for a pair of Oakley sunglasses[7] when a pair of nearly identical glasses from Duduma are available on Amazon for less than $25?[8] With Amazon offering free delivery and free returns, does one really have to try on the product in a store before buying it? Yours truly, recently purchase a stylish and high-quality pair of polarized sunglasses from Amazon. The price? $10.56 including Prime next-day delivery[9]. How much longer will Ray Ban, Oakley and Maui Jim be able to sustain their extraordinary profitability given this new dynamic? To be clear, we are predicting an end to all branded sunglasses. Nevertheless, high-quality, no-brand and easy to find sunglasses will take market share over time and cut into the profits of industry giants. The very high valuation of Essilor is predicated on very high profits for many years into the future. Given the changing industry dynamics, we are far from convinced that these future profits will materialize. The sunglass industry in ten years' time could look a lot different than it does today.

Online and direct-to-consumer distribution is bringing down barriers to entry in many industries and threatening the profitability of existing companies. Investors need to diligently monitor the competitive environment of the businesses they invest in, and act decisively if barriers to entry are diminishing. If you see lots of capital and new business entering an industry, as an investor, run for the hills. If we believe that the competitive position of a business is declining, i.e. its moat is eroding, we will exit our investment immediately.

Only companies with strong moats and big barriers to entry deserve deeper due diligence as potential investments. While having a moat is not a sufficient condition for investment success, it is, for us, a necessary condition. If we cannot identify a moat and explain it in simple terms to a group of discerning investors, we do not waste any further time in analyzing the company.

In 1999, Warren Buffett wrote that: "the key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage. The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors." We agree.

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[5] https://www.amazon.com/gp/product/B072QBYL1J/ref=ppx_yo_dt_b_search_asin_title?ie=UTF8&psc=1
[6] https://www.cnbc.com/2019/08/18/there-are-now-175-online-mattress-companiesand-you-cant-tell-them-apart.html
[7] https://www.oakley.com/en-us/product/W0OO9438?variant=888392408365
[8] https://www.amazon.com/Duduma-Polarized-Sunglasses-Running-Unbreakable/dp/B012AYL64C/ref=sr_1_4?crid=D6AYUI9DTCCA&keywords=duduma%2Bsunglasses%2Bfor%2Bmen&qid=1567709805&s=gateway&sprefix=duduma%2Caps%2C204&sr=8-4&th=1
[9] https://www.amazon.com/gp/product/B074869RWJ/ref=ppx_yo_dt_b_asin_image_o03_s00?ie=UTF8&psc=1

I hope this letter gives you some insights into how to think about moats and what we focus on first when evaluating a potential investment candidate. Barriers to entry are the most important of Porters' Five Forces and should be considered before all else when considering a prospective investment. No business can sustain high profitability without significant barriers to entry.

In my future letters to you, I will discuss the next components of our investment strategy: evaluating growth and management's capital allocation skills.

As always, I look forward to answering your questions.

Lukasz Tomicki
Portfolio Manager
LRT Capital

Appendix I: Investment Philosophy

In the past eighteen months we saw a large increase in the number of LRT Capital partners (the term we use to describe our clients). With so many newcomers, it is important that we write about our investment philosophy again.

Here are the key points:

- Exceptional stock returns come from exceptional business returns on a **per-share** basis.
- We seek to invest in high-quality companies, i.e. those possessing sustainable competitive advantages (moats), the ability to grow and reinvest capital over time, and management that excels at capital allocation.
- We only purchase companies whose shares trade at a discount to our assessment of their intrinsic value.
- It is futile to predict short-term market movements. We seek to hold our investments for as long as possible.
- The financial markets are dominated by short-term traders who see stocks as casino chips. This occasionally allows us to purchase shares in great companies at large discounts to their true worth.
- If we are right about the trajectory of the businesses we invest in, over time we will be right on the trajectory of their stock prices.

We view stock market volatility as a source of opportunity. Volatility allows us to profit by acquiring shares in superb businesses at attractive prices. The more that markets (the "other" participants) are irrational, the more likely we are to reach our ambitious performance objectives.

Over the long run, stocks are the best investment asset class, but our experience has taught us that our investment process will not generate linear returns. In some years, our portfolio will outperform and in others it will generate a below average return. This is a certainty that we must accept. We are long-term investors and we do not try to dance in and out of the market.

In summary, our investment strategy can be summed up in three steps:

- Only seek out high-quality companies.
- Do not overpay.
- Do nothing – patience and discipline are the keystones to success.

Disclaimer and Contact Information

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