LRT CAPITAL MANAGEMENT

THE VISION TO SEE
UNREALIZED VALUE

June 3, 2020

May 2020 - Performance Update

Dear Friends & Partners:

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

May was another positive month for both of our investment strategies. The LRT Market Neutral strategy performed strongly during the month. The LRT Economic Moat strategy underperformed, but is now fully invested – we expect strong returns in the months ahead. Returns year-to-date are below our expectations, but we remain optimistic and confident in our repeatable investment process and our ability to generate outsized returns going forward. Despite our short-term underperformance, we have added new assets under management and new investment partners over the past 90 days. We expect the strength we saw in May to continue in the months ahead.

To See the Future, Look to Europe

The alleged "overvaluation" of the stock market remains a hot topic of discussion in financial circles. When assessing the fairness of the valuation of the overall stock market the most important variable to consider is the overall level of interest rates. Are rates going to be lower for longer? Lower forever?

In isolation low interest rates translates into higher implied valuations for stocks, all other things being equal. Of course, all other things are never equal. An environment of perpetually low interest rates implies a perpetually low growth rate for the economy, which should translate into lower growth in revenues and earnings for companies. Hence, while lower interest rates raise the "fair" valuations of the stock market, they also imply lower earnings growth which depresses valuations. The net impact on the stock market's valuation is hard to decipher.

The question of what a "fair" value for individual companies is easier to answer, as forecasts for earnings growth of individual companies are more readily available. Once expectations about future cash flows are formed, one must decide on the appropriate discount rate. There are several ways of coming up with a equity discount rate, each with their own shortcomings – the details of which are beyond the scope of this letter. Whichever method one uses to estimate the appropriate discount rate, two things are true: 1) less risky businesses require a lower discount rate; and 2) lower "risk free" rates imply lower equity discount rates.

From where we sit at LRT, it appears to us that the appropriate discount rate for many businesses is decreasing. One of the reasons is the decline in interest rates, with ultra-low interest rate policies around the world now well into their second decade. The second, and perhaps a more insidious reason, is the decline in the business risk for many large and well-established businesses. Despite the rhetoric about creative destruction and accelerating innovation, many large sectors of the economy appear stagnant, increasingly cartelized, with declining rates of competitive entry.[1] Today, an entire bread of companies exists that appear to have escaped effective competition – to borrow a phrase from Warren Buffett, they are the "inevitables." The term means companies that are almost certain to grow and retain their superior economic position in the decades ahead – Google, Facebook, Amazon, Microsoft, Apple *(just the obvious examples).* We would argue that businesses such as Sherwin-Williams, Visa, and Moody's also belong in that category.

In a world of low interest rates and low economic growth, companies that can grow will command an ever-increasing premium valuation vis-à-vis the overall market. If "inevitable" companies are believed to be low risk, and the overall level of interest rates is low, the "fair" valuations for these types of companies will become truly astronomical. The reality is that in a low growth environment, any business that can sustainably grow earnings will be valued very highly. How highly? The answer can be found in Europe, where interest rates are even lower than in the US. What's more, there are many successful European companies that are headquartered in Europe but do business globally…and as such, are able to grow much more quickly than the anemic growth rates of their listing countries might imply. At the same time, there are local investors in Europe who due to institutional constraints are forced to invest their savings "domestically," i.e. in their local capital markets. This creates a natural experiment – how much should an investor pay for a relatively safe, relatively high growth company in an environment of ultra-low interest rates?

Looking at high quality European companies provides the answers. Europe is home to some wonderful businesses, and here is just a short, select list:

Coloplast A/S (COLO-B:DC) – based in Denmark, Coloplast is the world leader in the development of intimate healthcare products and services. The company's products target people with diseases of private and personal nature such as products for people whose intestinal outlet has been rerouted through the abdominal wall, continence care products for those suffering from damage to the urinary system, kidney damage, etc. Over the last decade the company has growth EPS at a 11.5% CAGR. Current valuation: 9.5x Revenue, EV/EBITDA 27.4x, P/E 40.6x, 2.17% FCF Yield[2]. 10 Year Government Bond Yield in Denmark: -0.25%.

Temenos AG (TEMN:SW) – is a Switzerland-based company engagement in the development of core banking software. Its services include implementation, performance optimization, upgrades, and support for its software solutions. It has software for retail, corporate, Islamic and microfinance companies, as well as private wealth management solutions. Over the last decade the company has growth EPS at a 11.3% CAGR. Current valuation: 12.9x Revenue, EV/EBITDA 31.9x, P/E 45.6x, 2.33% FCF Yield[3]. 10 Year Government Bond Yield in Switzerland: -0.49%.

Chr Hansen Holding A/S (CHR:SW) – is a Danish bioscience company that develops natural ingredient solutions for food, nutritional, pharmaceutical, and agricultural industries. Their core business is the development of cultures, enzymes, and probiotics for the food industry and the dairy industry in particular.

[1] https://www.amazon.com/gp/product/1119548195/ref=ppx_yo_dt_b_search_asin_title?ie=UTF8&psc=1
[2] Source: Sentieo.
[3] Source: Sentieo.

The company also develops dietary supplements and animal feed products. Over the last decade the company has growth EPS at a 28.8% CAGR. Current valuation: 9.0x Revenue, EV/EBITDA 25.8x, P/E 39.0x, 1.63% FCF Yield[4]. 10 Year Government Bond Yield in Switzerland: -0.25%.

Symrise AG (SY1:GR) – is a German-based supplier of fragrances, flavorings, cosmetic ingredients. and nutritional solutions. The company develops and manufactures flavors and ingredients that are used in foods, beverages, and health products, as well as fragrances and oral care products. Over the last decade the company has growth EPS at a 5.88% CAGR. Current valuation: 4.2x Revenue, EV/EBITDA 20.8x, P/E 43.3x, 2.9% FCF Yield[5]. 10 Year Government Bond Yield in Germany: -0.45%.

Givaudan SA (GIVN:SW) – is a Swiss company in the flavor and fragrance industry. Givaudan manufactures and sells fragrance ingredients that are used in cosmetics, personal care, hair and skin products, household products, and oral care. The company is also involved in flavorings for soft drinks, fruit juices, instant beverages, ice cream, yoghurt, desserts, soups, sauces, and confectionary. Over the last decade the company has growth EPS at a 14.25% CAGR. Current valuation: 5.2x Revenue, EV/EBITDA 25.4x, P/E 33.5x, 2.84% FCF Yield[6]. 10 Year Government Bond Yield in Switzerland: -0.49%.

Spirax-Sarco Plc (SPX:LN) – is a UK-based industrial engineering company. Spirax-Sarco designs and manufactures solutions for industrial steam systems. The company's products include steam traps, boilers, as well as pumps and associated fluid management technologies. Over the last decade the company has growth EPS at a 10.25% CAGR. Current valuation: 5.88x Revenue, EV/EBITDA 22.5x, P/E 34.9x, 2.42% FCF Yield[7]. 10 Year Government Bond Yield in the UK: +0.18%.

LVMH (MC:FP) – is a French luxury goods group active in six different sectors: Wines & Spirits, Fashion and Leather Goods, Perfumes & Cosmetics, Watches and Jewelry, and Retailing. The company owns such brands as Moet & Chandon, Krug, Veuve Clicquot, Hennessey and Chteau d'Yquem, Luis Vuitton, Christian Dior, Givenchy, Christian Drio, TAG Heuer, Zenith, Bulgari, Sephora, and others. Over the last decade the company has growth EPS at a 7.14% CAGR. Current valuation: 4.3x Revenue, EV/EBITDA 16.4x, P/E 29.2x, 3.95% FCF Yield[8]. 10 Year Government Bond Yield in France: -0.07%.

All the above are strong companies with dominant positions in their respective industries. The table below summarizes their valuations.

Company	Ticker	10 Year EPS CAGR	P/S	EV/EBITDA	P/E	FCF Yield	10-Year Yield	Spread
Coloplast A/S	COLO-B:DC	11.50%	9.50	45.60	40.60	2.17%	-0.25%	2.42%
Temenos AG	TEMN:SW	11.30%	12.90	31.90	45.60	2.33%	-0.49%	2.82%
Chr Hansen Holding A/S	CHR:SW	28.80%	9.00	25.80	39.00	1.63%	-0.25%	1.88%
Symrise AG	SY1:GR	5.88%	4.20	20.80	43.30	2.90%	-0.45%	3.35%
Givaudan SA	GIVN:SW	14.25%	5.20	25.40	33.50	2.84%	-0.49%	3.33%
Spirax-Sarco Plc	SPX:LN	10.25%	5.88	22.50	34.90	2.42%	0.18%	2.24%
LVMH	MC:FP	7.14%	4.30	16.40	29.20	3.95%	-0.07%	4.02%
Average		**12.73%**	**7.28**	**26.91**	**38.01**	**2.61%**	**-0.26%**	**2.87%**

4 Source: Sentieo.
5 Source: Sentieo.
6 Source: Sentieo.
7 Source: Sentieo.
8 Source: Sentieo.

Should you be excited to pay these valuations for these companies? Of course not. The valuations are very high. But this is the reality that we live in. The companies in the table above trade at an average FCF Yield of 2.6%. Add to that, 4-5% growth every year (less than 50% of the previous 10-year average), and your total return should be between 6-7% per year. Exciting? No, but this is much, much better than the -0.26% per year you are guarantee on the "risk free" government bonds. This is the state of affairs in Europe today. **We believe the US equity market is heading in the same direction.**

The lesson for investors in the US is that many high quality businesses here still look very cheap compared to those in Europe. If the United States is following in Europe's path *(with a 15-year lag)*, then there is still substantial upside from owning high quality companies in the US. We believe there is nothing stopping valuations in the United States from rising further, especially for the highest quality companies: those possessing competitive advantages and capable of generating growth in an overall low-growth environment.

While some companies are being valued at increasingly high multiples, many others are being left behind, their valuations are staying stagnant…or even declining. Companies that cannot grow and reinvest capital are being valued at historically low levels today. Why? Simply put, returning cash to shareholders is not valuable if the real yield earned on cash is negative. This explains why US banks are trading at extremely low valuations. This "corporate inequality" is likely to persist and even get worse – with the "best" companies being rewarded with high valuations and incredibly cheap capital. If Europe is any guide, then it is likely that this gap between the corporate "haves" and "have nots" will continue to widen. In a no-growth world, any growth is highly prized.

We believe that investors should focus their attention on company fundamentals, specifically on companies they believe can grow and reinvest capital. Companies with high ROIC and growth opportunities are likely to continue to be rewarded with high and potentially increasing valuations – perhaps much higher than seen today. At the same time, we believe that investors betting on "value" stocks outperforming[9] will continue to have their hopes frustrated[10]. You can rest assured that our investment strategies are positioned accordingly.

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As always, we thank you for your ongoing trust and the opportunity to help grow your hard-earned savings. We look forward to answering any questions you might have.

Lukasz Tomicki
Portfolio Manager
LRT Capital

[9] https://www.aqr.com/Insights/Perspectives/Its-Time-for-a-Venial-Value-Timing-Sin
[10] https://www.aqr.com/Insights/Perspectives/Never-Has-a-Venial-Sin-Been-Punished-This-Quickly-and-Violently

Appendix I: Investment Philosophy

In the past twenty-four 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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