March 3, 2021

February 2021 - Performance Update

Dear Friends & Partners,

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

The LRT Economic Moat strategy was negatively affected during the month by a sharp decline in US Treasury Bonds (TLT) – a position we have long held as a hedge against market volatility. Over the past six months, bonds have been a huge drag on our results, so during the month, we decided to close this hedge completely. Going forward, we plan to use direct index hedges to reduce portfolio volatility. We expect net long exposure to vary between 60%-100%. While we still believe that bonds are a hedge against market volatility, they are a very imperfect hedge – sometimes months or quarters can go by before one sees the benefits of this hedge. Using market indexes will provide a more correlated and thus better risk reduction mechanism for the portfolio. We look forward to answering any questions you might have about this.

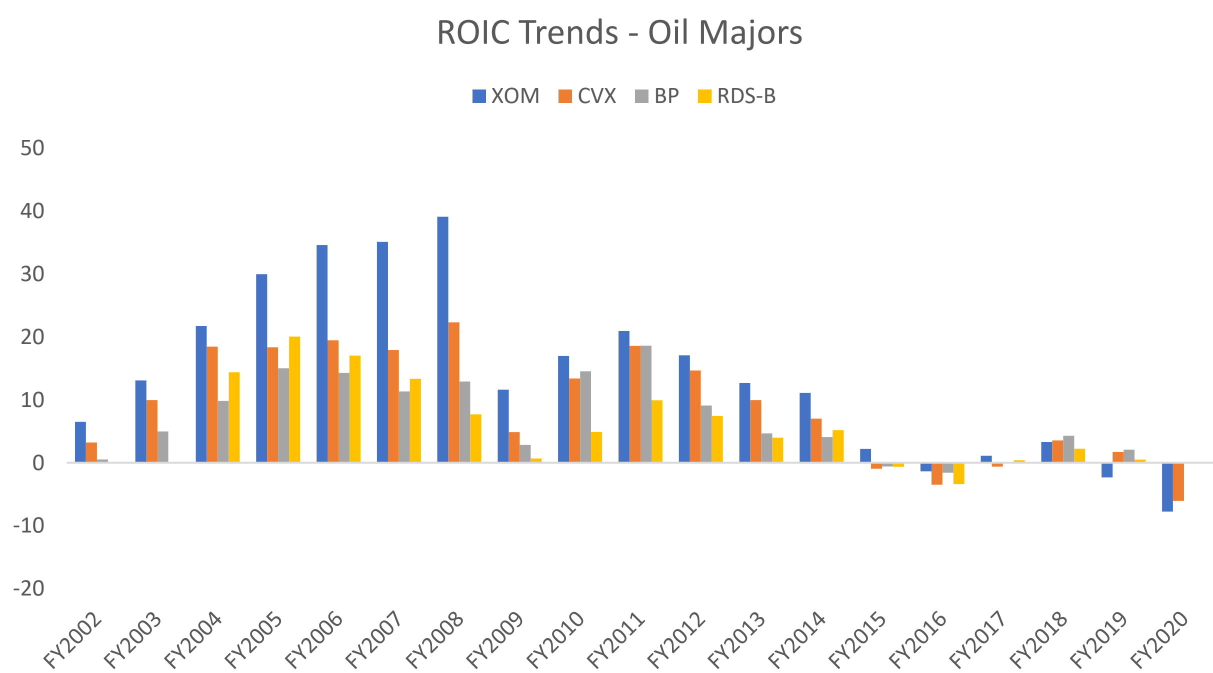
There is currently a lot of uncertainty in the markets, especially with respect to inflation and future fiscal policy. On one hand, the Covid-19 pandemic has resulted in a loss of jobs and income for many. On the other hand, unprecedented growth in the monetary-based coupled with enormous US Federal Government stimulus is resulting in growing fears of inflation. A steepening yield curve and expectations of more fiscal stimulus have had an impact on financial markets. Over the past half a year, the two areas of the market that have done best are commodities and financials – two sectors we generally do not invest in. This has been a relative drag on our performance as we focus on investing in stable companies with predictable earnings, and eschew the more volatile commodity-related securities. We are patient investors and we believe that, in the months and weeks ahead, a more rational environment will prevail and the companies we tend to invest in will once again be in favor.

Given the "reflation" trade that has been so successful over the past few months, one might ask why we don't own more commodity-based businesses. While we do own one very special such company (more below), we don't generally believe that commodity producers have any competitive advantage. Occasionally, oil companies or miners perform really well – usually for a relatively short period of time. This should not be mistaken for a durable long-term investment case. Take, for example, the five largest integrated oil companies: Exxon Mobil Corporation (XOM), Chevron Corporation (CVX), BP plc (BP), Occidental Petroleum Corporation (OXY), and Royal Dutch Shell plc (RDS-B). Should you think I am picking on these companies specifically, I have also included the SPDR S&P Oil & Gas Exploration &

Production ETF (XOP) for comparison. Their year-to-date and 10-year compounded annual returns (including reinvested dividends) are summarized in the table below[1]:

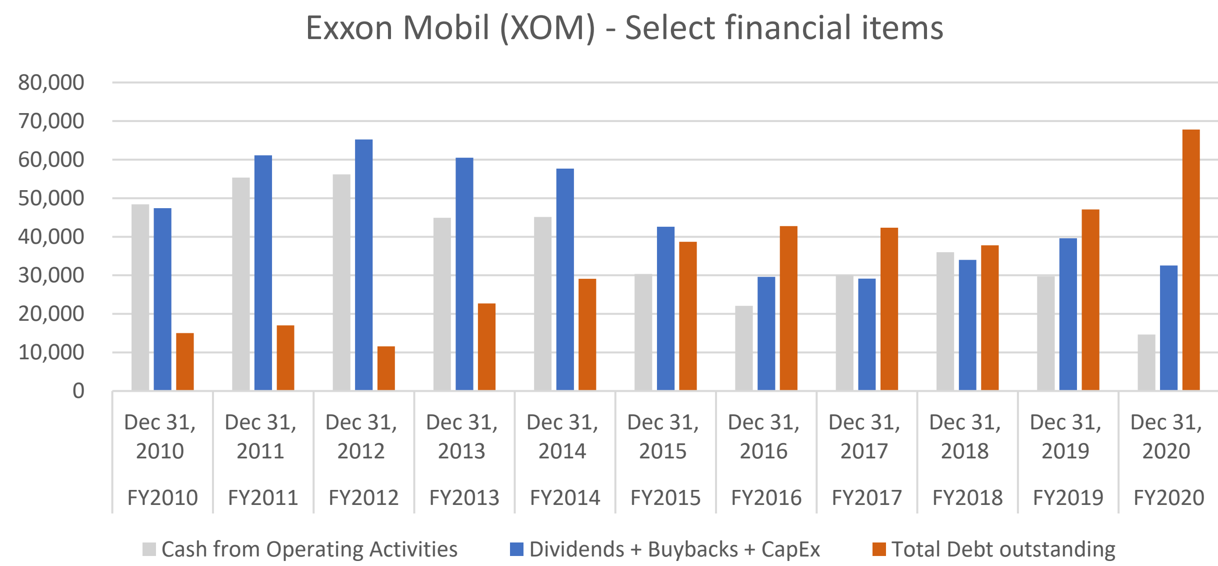
Name	Year-to-date	10-Year
Exxon Mobil Corporation (XOM)	39.45	-0.33
Chevron Corporation (CVX)	24.4	4
BP p.l.c. (BP)	26.35	-0.49
Occidental Petroleum Corporation (OXY)	65.57	-8.3
Royal Dutch Shell plc (RDS-B)	18.6	-1.14
SPDR S&P Oil & Gas Explor & Prodtn ETF (XOP)	43.25	-9.02

As you can see, the returns over the past two months are outstanding, but the longer-term picture is one of pain and misery for shareholders. We believe that long-term stock performance is a function of long-term business performance. One way to measure business performance is through the return-on-invested-capital (ROIC) which measures profitability. Erratic and declining profitability has characterized all the major oil companies over the past decade. The graph below illustrates this phenomenon. The decline in profitability of major oil companies is not a recent issue that can be tied to the collapse in oil prices due to the Covid-19 pandemic. It has been a multi-year process.



The consequence of this declining profitability has been a difficulty in funding future exploration. All oil companies need to constantly reinvest large amounts just to maintain current levels of production. In recent years, due to the low level of profitability, oil majors had to choose between investing in production and returning cash to shareholders. They chose both. How is that possible, you ask? By increasing borrowing. The graph below shows select cash flow items and total debt outstanding for Exxon Mobil Corporation (XOM) over the past decade:

[1] Source: Sentieo.



As you can see from the graph above, in most years over the past decade, cash flow from operations (grey bar) was insufficient to cover dividends, buybacks, and capital expenditures (blue bar). The resulting deficit was simply borrowed and added to the outstanding stock of debt (orange bar). A similar pattern can be seen in all the oil major's financial statements. The bottom line is that most oil companies today have much lower levels of profitability, much higher levels of debt, and face a very different competitive environment than they did a decade ago. Aside from a large and sustained rise in oil prices, it is hard to see how investing in oil companies at current prices can lead to success – which is why we are staying far away from the oil & gas sector.

Our Portfolio

The top ten investments in our portfolio as of 2/1/2020, in order of position size, are presented below. All valuation metrics and returns are as of 3/2/2020 unless otherwise stated. For a relative valuation context, the S&P500 is currently trading at 43.7x trailing and 22.5x forward earnings, respectively – one of the highest valuations ever recorded.[2] The Russell 2000 trades at a forward PE ratio of over 58x – also an extremely high number. We believe our portfolio will generate far superior returns than the S&P500 going forward.

The Clorox Company (CLX)

For several months now, our largest position has been Clorox – the cleaning products company. Besides wipes, the company also manufactures bleach, charcoal, cat litter, plastic bags, and container products. Clorox benefited during the Covid-19 pandemic from an increased demand for cleaning products. Companies and consumers trust the Clorox brand – a source of the company's huge competitive advantage.

[2] https://www.wsj.com/market-data/stocks/peyields

United Airlines, for example, chose to partner with Clorox in its push to reassure consumers about the safety of air travel.

The company is a typical "defensive" holding – subject to very small fluctuations in end market demand. Its branded consumer products remain in strong demand. Historically (pre-Covid), the company's sales grew in line with GDP, while earnings-per-share grew slightly faster due to operational and financial leverage. We expect sales will decline slightly in the next few quarters as the Covid-19 pandemic comes to an end, but we believe this decline is more than accounted for by the company's low valuation.

On February 4th, Clorox reported results for Q4 2020, with both earnings and sales beating estimates. Sales grew by +27% (vs. 20% estimate) from the prior year's Q4, and EPS increased +39% ($2.03 vs. $1.75 expected). The company continues to see robust demand and raised its sales and EPS guidance for the rest of the year. Shares are down 11% year-to-date. We believe the shares are undervalued at 19x trailing and 22x forward earnings and currently represent an excellent opportunity.

Target Corp. (TGT)

Target, the Minneapolis-based retailer, continues to fire on all cylinders as the company has reported two quarters in a row of +20% revenue growth (5% traffic growth + 15% average basket size[3]), coupled with the strongest EBITDA margins in over four years. The company has successfully navigated the Covid-19 pandemic with online sales growing by 155% and 118% during Q3 2020 and Q4, respectively. On March 2nd, the company reported another stellar quarter, with same-store sales growing by over 20%, and both earnings (+57% YoY) and revenues (+21% YoY) beating estimates. The shares are down a little more than 1% year-to-date. We believe the shares are a bargain 23x trailing and 20x forward earnings.

Domino's Pizza, Inc. (DPZ)

[3] Target Q3 2020 conference call

Domino's Pizza is the world's largest franchisor of pizza restaurants with over 13,800 location in 85 countries. Pizza sales have benefited during the Covid-19 pandemic, with Q3 2020, same-store sales growing by +17.5% in the US (expected +13.9%) and +6.2% internationally (+1.9% estimated), YoY[4]. Earnings were negatively impacted by lower margins due to higher costs – a trend we expect to reverse shortly. The stock is not optically cheap at 23x forward earnings, however, the company has routinely reported earnings growth of over 20% in almost all quarters since 2009. Given the company's high growth rate, international growth opportunities, and capital light business model, which allows for returns on invested capital of over 40%, we are happy to continue to hold the shares. Shares are down 11% year-to-date.

Church & Dwight Co. Inc. (CHD)

Church & Dwight is another classic "defensive" company – it sells cleaning products (Arm & Hammer, OxiClean), toothache medication (Orajel), and condoms (Trojans). For those that fail to purchase Trojans, the company also offers pregnancy test kits (First Response). Joking aside, the company's revenue has historically grown by GDP+ rates organically. Combined with thoughtful acquisitions, 10-year revenue growth has averaged +6.6%, which has translated to EPS growth of over +11% per year. The company has accomplished all this with ½ of the overall volatility of the stock market. The company reported Q4 2020 earnings on January 29th, beating both top (revenue +14% YoY) and bottom line measures (EPS $0.59 vs $0.51 expected). We view the shares as a bargain at 24x forward earnings given the high level of predictability of the company's earnings and low financial leverage. Shares are down 9% year-to-date.

Stepan Company (SCL)

Stepan is a less well-known company with a market cap of $2.7b[5], focused on the manufacturing of specialty chemicals, primarily for the cleaning industry. Their chemicals are used as inputs into a variety of products such as shampoos and body washes. What is most interesting about the company is their specialty segment which holds the highest margin products, and which is growing as a share of the company's total sales. The impact of this growth can be seen in the company's steadily improving margins. Stepan reported Q4 2020 earnings on February 18th, beating both top (Q4 EPS of $1.42 v $1.08 expected) and bottom line expectations (+11.2% YoY). The company's shares a very attractive at 22x trailing and 17x forward earnings. Shares are up 2% year-to-date.

[4] Domino's Q3 2020 earnings release
[5] As of 2/22/2020. Source: Sentieo.

Credit Acceptance Corp. (CACC)

Credit Acceptance Corp is a very controversial company as it is a subprime auto lender known for aggressive collection and repossession tactics. The subprime auto business is very difficult requiring both underwriting skills and the ability to navigate the ever-changing legal and political environments of lending to low-income consumers. The company has been accused in the past of illegal collection practices and predatory lending schemes. With all of that, why do we hold the shares? Over the past two decades, CACC has carved out a strong presence in an otherwise very difficult market and enjoys enviable economics. The company's high returns on capital and disciplined capital allocation have produced outstanding results for shareholders. Currently, the stock price trades a low valuation relative to its own history as it faces political uncertainty due to the new Biden administration, and its growth prospects appear less promising than in the past. With all that said, none of the risks surrounding the business are new – the company survived and thrived during the Obama administration and has faced legal challenges in the past. Credit Acceptance reported Q4 2020 earnings on February 1st, with both revenue and earnings ($10.75 vs $7.44 expected) beating estimates. The shares are currently trading at 14x forward earnings – a low valuation reflective of the risks. What's more, a substantial amount of the company's shares are sold short, setting up the potential for strong upside if events turn out better than expected. While we recognize the risks, we are happy to hold the shares for now given the company's attractive valuation and favorable risk-reward. Shares are up 9% year-to-date.

Texas Pacific Land Trust (TPL)

Long time readers will know that we rarely invest in commodity businesses. However, there are periods in the market where commodity-based businesses outperform the broad indexes by a wide margin. Therefore, in order to have balance in the portfolio, we have long searched for a competitively advantaged company in the commodity space. We believe that Texas Pacific Land Trust (TPL) meets that criteria. Formed out of assets of formerly bankrupt railroads, TPL controls the largest acreage of land in the Permian basin – the center of the US shale oil industry. The company has two main sources of income: 1) royalties from oil & gas extracted on its properties – essentially a free call option on future oil prices and production; and 2) a water business where it develops water resources and sells services to the fracking industry. We see TPL as an effective way to diversify the portfolio into a commodity exposed business that has a history of smart capital allocation and a low risk of financial distress (the company has no debt) during periods of low oil prices. Shares are up 51% year-to-date.

Novo Nordisk A/S (NVO)

Novo Nordisk is the global leader in insulin, which is, sadly, a growing business as more and more people around the world suffer from diabetes.

Millions of people need daily injections of insulin to stay alive[6], a number that, unfortunately, is likely to continue to grow by millions more in the coming decade. It may seem at first glance that insulin should be a commoditized business, after all, it was discovered and synthesized over a hundred years ago, but nothing could be further from the truth. There are many types of insulin and Novo Nordisk has spent billions on R&D over the years to develop new products. On February 11th, the company reported favorable results from a phase-3 trial of Semaglutide, a drug that is currently used for Type 2 diabetes treatment. The study evaluated the use of Semaglutide for weight loss treatment in non-diabetic patients and found a significant impact on weight loss for patients receiving Semaglutide vs. the placebo control group. If Semaglutide is approved for weight loss treatment, we expect it will be meaningfully accretive to the company's bottom line.

Furthermore, Novo Nordisk reported Q4 2020 earnings on February 3rd, with flat revenues YoY and EPS growth of +8%. The company's proprietary product line supports returns on invested capital of over 40%, and while sales growth is relatively slow (+6% annualized CAGR over the past decade), the company's shares trade at a reasonable valuation of only 21x forward earnings. For a company with an extremely predictable business, high returns on capital, and a forecastable future, we believe this to be highly attractive. Shares are up 4% year-to-date.

Hexcel Corp. (HXL)

Hexcel manufactures carbon fiber composite materials with the primary end markets being aerospace and defense. The company's stock price was hit heavily last year due to the decline in the aerospace market, but the stock is making a comeback this year as the outlook for aerospace improves. The near-term demand for lightweight, high-performance carbon fiber composites is uncertain, but the longer-term trend is clearly very strong. As airplane manufacturers look to improve the fuel efficiency and performance of their planes, the primary way of doing this is to reduce weight. The 787, 777X, and A350 are just the most recent examples of planes from Boeing and Airbus that utilize an increasing amount of carbon fiber materials in their construction. Shares are up 14% year-to-date.

Honorable mentions

Several of our smaller portfolio holdings had notable news during the month:

- Workiva (WK) – reported excellent earnings beating on both the top and bottom line. The stock rose more than 15% on the news. Shares are up 11% year-to-date.
- Align Technology Inc. (ALGN) – reported excellent earnings. Shares are up 5% year-to-date.
- MarketAxess Holdings Inc. (MKTX) – reported excellent earnings. Shares are up 2% year-to-date.

Outlook

[6] According to the WHO there are 422 million diabetics worldwide. This is estimated to increase to over 570 million by 2030.

For several months now, profitable, stable, and cash-generative companies like the ones we typically invest in have been out of favor. In turn, the markets have favored speculative businesses based on vague hopes of "reflation" and ultra-easy monetary policy. We are extremely optimistic about the opportunities we see in the marketplace as many of the companies we usually invest in are down 10%, 20%, and even 30% from their highs just a few months ago. Most of the companies on our "shopping list" were profitable through the Covid-19 pandemic. This is a testament to their resilience.

We look forward to hearing from you and further discussing where we see opportunities.

Lukasz Tomicki
Portfolio Manager
LRT Capital

Appendix I: Attributions and Holdings

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

Net returns are net of a hypothetical 1% annual management fee (charged quarterly) and 20% annual performance fee. Individual account results may vary due to the timing of investments and fee structure. Please consult your statements for exact results. Please see the end of this letter for additional disclosures.

Appendix II: Investment Philosophy

Over the past 24 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.

In 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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