April 1, 2021

March 2021 - Performance Update

Dear Friends & Partners,

Our investment returns are summarized in the table below:

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

During the month of March, the LRT Economic Moat strategy returned +5.12% net of fees, and the LRT Market Neutral strategy returned +2.4%. Both strategies benefited during the month from a collapse in speculative company stocks and a corresponding shift towards more stable and profitable companies – the types of stocks we tend to focus on.

In the LRT Economic Moat strategy, as of April 1st, 2021, our net exposure was 93.83% and our net beta-adjusted exposure was 56.1%. In the LRT Market Neutral strategy, as of April 1st, 2021, our net exposure was 31.72% and our net beta-adjusted exposure was 18.02%.

Our Portfolio

The top ten investments in our portfolio as of 3/1/2020, in order of position size, are presented below. All valuation metrics and returns are as of 4/1/2020 unless otherwise stated. For a relative valuation context, the S&P500 is currently trading at 44.66x trailing and 22.62x forward earnings, respectively – one of the highest valuations ever recorded.[1] The Russell 2000 trades at a forward PE ratio of over 49x – also an extremely high number. We believe our portfolio will generate far superior returns than the S&P500 going forward.

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

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[2], 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 down 1.75% 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 reasonably valued at 26x forward earnings given the high level of predictability of the company's earnings and low financial leverage. Shares are down 0.5% year-to-date.

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.

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

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 4% year-to-date. We believe the shares are undervalued at 20x trailing and 24x forward earnings and currently represent an excellent opportunity.

Watsco Inc. (WSO)

Watsco is a long time holding of our fund that recently made it into the top ten. The company distributes Heating Ventilation and Air Conditioning equipment (HVAC). The HVAC distribution business is approximately 80% replacement / 20% new construction. This is a great business due to the fragmented supplier base (seven major HVAC manufacturers) and fragmented buyers (thousands of HVAC contractors). This limits the bargaining power of both buyers and suppliers. Furthermore, while homeowners ultimately pay the bill, in most cases it is the contractor that makes the purchasing decision. Parts availability, speed of delivery and ease of installation play a major role in the purchasing decision with price being only a secondary consideration. Most HVAC equipment is bulky and difficult to ship – limiting competition from online players. Simply put, when your HVAC unit breaks on a hot summer weekend you don't spend time shopping around for the lowest price – fixing the AC unit becomes a priority no matter the cost. The company's earnings are also extremely predictable given that the majority of sales are tied to replacement demand which itself is a function of the installed base.

Watsco is the largest player in a very fragmented industry. The company earns mid-teens returns on invested capital and pays out the majority of earnings in the form of dividends. The company also expands through acquisitions over time, buying up smaller independent HVAC distributors. Most recently they have acquired Temperature Equipment, a Chicago based distributor[3]. Watsco also has the most unique long-term compensation policy for senior executives we have ever come across in corporate America – all stock grants vest at retirement or after 10 years, whichever comes later. This makes managers extremely long-

[3] https://seekingalpha.com/news/3673106-watsco-to-acquire-temperature-equipment-terms-not-disclosed

term focused, something we believe is a real benefit for a company that grows primarily through acquisitions.

Watsco last reported earnings on February 11th, beating both top (EPS +24% YoY) and bottom line estimates. The company also raised its dividend in conjunction with reporting earnings[4]. Shares are up 18.85% year-to-date. We believe the shares are attractive at 37x trailing and 33x forward earnings given the extremely predictable earnings the company enjoys, recession proof nature of the product and long growth runway. GAAP earnings are understated due to the amortization of intangible assets related to prior acquisitions.

A.O. Smith Corp. (AOS)

A.O. Smith is the largest US manufacturer of residential and commercial water heaters, boilers and water treatment products. The company generates close to $3 billion in annual sales. The majority of the company's business (73%) is done in North America, with the balance coming from China and India. Approximately 80% of demand is replacing existing heaters and 20% is tied to new construction. The company continues to benefit from a shift towards higher efficiency, but more expensive, tankless heaters.

A.O. Smith generates returns on invested capital in the high teens. The company uses its earnings to consistently grow its dividends and share repurchases. Over the past three years the company's performance has been hurt by its exposure to China as its business there suffered due to the US-China trade war and poor execution. We believe the China business is back on track and the all-important US business is doing better than ever as housing demand heats up in the US. The company last reported earnings on Jan 28th and delivered 11% YoY sales growth with results beating both top and bottom line estimates.[5] A.O. Smith also increased its share repurchase authorization.

We expect earnings to rise sharply over the coming year as the upswing in the US housing cycle translates to much higher earnings for the company. Shares are up 24.41% year-to-date. We believe the shares are attractive at 31.88x trailing and 24.37x forward earnings.

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[6]), 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.

[4] https://seekingalpha.com/pr/18188930-watsco-s-fourth-quarter-eps-jumps-24-setting-new-records-for-sales-operating-profit-net

[5] https://seekingalpha.com/pr/18168832-o-smith-reports-2020-earnings-of-2_12-per-share-supported-record-fourth-quarter-sales-and

[6] Target Q3 2020 conference call

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 up 14.11% year-to-date. We believe the shares are a bargain 23x trailing and 20x forward earnings.

Domino's Pizza, Inc. (DPZ)

Domino's Pizza is the world's largest franchisor of pizza restaurants with over 13,800 locations 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[7]. 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 25x 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 2.37% year-to-date.

Hilton Worldwide Holdings Inc. (HLT)

Hilton is the second largest hotel company in the world after Marriott International (MAR). The company owns a portfolio of brands from the low end (Hampton Inn, Hilton Garden Inn), through the mid-tier (DoubleTree, Hilton, Curio, Embassy Suites, Homewood Suites), to the luxury high end (Waldorf Astoria, Conrad, LXR). Hilton's portfolio is almost perfectly balanced between the three categories, while the majority (73%) of the company's EBITDA geographic exposure is in the United States with Asia Pacific and Europe each contributing another 10%. Hilton today is almost exclusively a manager and franchisor of hotels, not a hotel owner. The company owns 61 hotels, manages 715 and franchises 5,702 – in total 6,478 properties with over 1 million combined rooms.[8] Like all franchise based businesses Hilton requires very little capital to grow as it utilizes the investment capital of its hotel-owners/partners to expand. Hilton currently faces a difficult operating environment due to the covid-19 pandemic and uncertainty about the future of business travel. However, the company is an excellent operator with a somewhat leveraged capital structure – if pent-up demand for travel materializes post-Covid, as we expect it will, the company will quickly go from losing money to raking in profits.

Hilton last reported earnings on February 17th, with both top and bottom line disappointing investment analysts' expectations[9]. However, these poor results are not indicative of the company's long-term outlook. In normal times, Hilton generates prodigious free cash flow which we expect will resume once travel demand returns. Over the longer term we expect Hilton to grow its topline at least twice as fast as GDP due to rising revenues per room and the growing number of rooms. Most importantly, the industry continues to consolidate with chain branded hotels taking market share from independent operations. With the superior

[7] Domino's Q3 2020 earnings release

[8] Hilton 2020 10-K report.

[9] https://seekingalpha.com/pr/18195155-hilton-reports-fourth-quarter-and-full-year-results

marketing and loyalty programs offered by hotel chains (Hilton Honors has 112 million members) driving demand, independent hotel owners see the benefits of signing up with one of the dominant hotel chains (Hilton, IHG and Marriott). Furthermore, the company's main growth opportunities remain abroad, as hotel chain penetration remains much lower outside the United States. Shares are up 9.34% year-to-date. We believe the shares are undervalued at 31.72x forward earnings.

We are also long shares of Marriott International, Inc. (MAR). Our investment thesis with respect to Marriott is essentially the same as with Hilton: excellent business economics, a consolidating industry and a good track record of capital allocation. Shares of Marriot are up 12.39% year-to-date.

Stepan Company (SCL)

Stepan is a less well-known company with a market cap of $2.7b[10], 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 are very attractive at 23.31x trailing and 18.06x forward earnings. Shares are up 8.81% year-to-date.

TFI International Inc. (TFII)

TFII International (formerly known as Transforce) is a recent addition to our portfolio – it is a Canadian logistics company with exceptional management operating in a consolidating industry. TFII came to our attention when they announced their purchase of the US operations of UPS Freight on January 25th, 2021. The company has a long history of growth through acquisition. Long time CEO Alain Bedard is fond of telling investors that he would rather own Scotiabank and get a 3% dividend than make deals that result in 3% returns[11]. This Canadian company also recently dual-listed in the United States.

UPS Freight, recently acquired by TFII, is a less-than-truckload (LTL) operation. LTL operations can build scale-based cost advantages as they require the consolidation of shipments in local hubs. This lends LTL operators to develop competitive moats based on local network density creating barriers to entry, as opposed to pure long-term trucking which is open to competition from anyone able to lease a truck. Pure play LTL companies such as SAIA, Inc. (SAIA) and Old Dominion Freight Line (ODFL) have historically generated very attractive returns for shareholders. Prior to the announced acquisition TFI already generated excellent returns for shareholders through very efficient operations and good capital allocation. Through the

[10] As of 2/22/2020. Source: Sentieo.

[11] TFII Q2 2019 conference call.

acquisition of UPS Freight US, the company immediately becomes one of the largest players in the US LTL market. The relatively low price paid for the asset (5.3x EBITDA pre-synergies, and the fact that UPS is taking a $500 million accounting charge on the deal) suggests TFII got a good deal. ODFL and SAIA both trade at over 15x EV/EBITDA.

We expect earnings to rise sharply at TFII over the next twelve months as the economy accelerates post-Covid. Shares are up 49.08% year-to-date. We believe the shares are undervalued at 31.21x forward earnings. We are currently also long shares of Saia, Inc. (SAIA), the LTL operator headquartered in Georgia, based on the same investment thesis. Shares of Saia, Inc., are up 29.43% year-to-date.

<u>Other notable portfolio changes made during March:</u>

- **Credit Acceptance Corp. (CACC)** – reduced position, falling out of top ten, shares are up +4.86% year-to-date.
- **Texas Pacific Land Trust (TPL)** – reduced position, falling out of top ten, shares are up +120.06% year-to-date.
- **Hexcel Corp. (HXL)** – reduced position, falling out of top ten, shares are up +16.23% year-to-date.
- **Papa John's International Inc. (PZZA)** – sold completely, shares are up +4.51% year-to-date.

As always, I look forward to hearing from you and answering any questions you might have.

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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LRT Capital Management, LLC
108 Wild Basin Road, Suite 250
Austin, TX 78746
Office: +1 512 320 9085
www.lrtcapital.com