

January 3, 2022

December 2021 - Investor Update

Dear Friends & Partners,

Our investment returns are summarized in the table below:

Strategy	Month	YTD	12 Months	24 Months	Inception
LRT Economic Moat	+6.54%	+30.47%	+30.47%	+4.34%	+27.10%

Results as of 12/31/2021. Periods longer than one year are annualized. All results are net of all fees and expenses. Past returns are no guarantee of future results. Please contact us if you would like to receive a full performance tearsheet. Please see the end of this letter for additional disclosures.

In the LRT Economic Moat strategy, as of January 3rd, 2022, our net exposure was 95.63% and our net beta-adjusted exposure was 58.5%. We currently have 44 long positions and our top 10 positions account for 45.84% of our total long exposure. As of January 3rd, 2022, firm assets under management stood at approximately \$136 million.

We achieved great investment results during the past year, welcomed a number of new limited partners to our fund, and successfully shifted our hedging strategy from long-term US Treasuries to a mix of index hedges. Our overall net returns are slightly ahead of broad market indexes, but what is more important than the result itself is how our returns were accomplished. To quote the famous American football coach Nick Saban: “the more one emphasizes winning, the less they are able to concentrate on what actually causes success.”

We believe that while short term investment returns are important (we view anything under three years as “short-term”), the process by which those returns are achieved is even more important. It is easy to outperform in an up year for the overall market by simply taking on more risk. Our results were not achieved by taking on huge risks. In fact, our investment returns in 2021 were achieved with an average market beta of the portfolio of approximately 0.6. When examined in this context, the returns of the past year are a real triumph. Our returns are an

Investment Terms and Service Providers	
Investment Structures:	Delaware LP
	BVI Professional Company
Management Fee:	1%
Performance Fee:	20%
High Water Mark:	Yes
Lockup:	None
Minimum Investment:	\$1,000,000
Redemption:	Monthly, 30-day notice
Auditor:	EisnerAmper LLP
Prime Brokers:	Interactive Brokers
	BTIG, BNP Paribas, GS
Fund Administrator:	NAV Consulting
Legal Counsel:	Winston & Strawn LLP
	O’Neal Webster (BVI)
Compliance:	IQ-EQ (Blue River Partners)

outcome of our highly disciplined investment process, which combines two activities: 1) successfully identifying high quality companies, i.e., those possessing a competitive advantage, the ability to grow and reinvest, and blessed with a high-quality management team; and 2) our unique portfolio construction process using our proprietary and quantitative system. We believe, that having a systematic investment process for identifying high quality business AND a systematic process for putting together a portfolio is key to long term success and it is what gives us the optimism to believe that our results can continue for many years onward. We have written many times about the proprietary tools we have created for portfolio construction and risk management. We believe that what we have is completely unique and constitutes a true element of competitive differentiation for our investment company. We are happy to give you a demo of these tools at any time.

Going forward, we expect to deliver results in-line with our historical returns, of between 20-30% annually, net of fees, with a market beta of between 0.4-0.6. While talking about market beta doesn't mean much in a year like 2021, where market rose ceaselessly, we believe that the year ahead will have much more turbulence, and we expect our hedging strategy to deliver good downside protection should more volatility occur. Finally, we want to highlight that while we have historically delivered very strong returns, we continue to do this in a context of very high transparency (monthly letters, top ten position disclosure, and ongoing performance attribution), and high liquidity (no lockups and monthly liquidity).

It is always useful to reiterate our investment strategy: we look to invest in a diversified portfolio of high-quality companies, purchased at reasonable valuations, and hedged with market indexes to reduce volatility. We have a very clear-cut definition of what constitutes a high-quality company¹: one with a durable competitive advantage (a moat), the ability to grow and reinvest, and a high-quality management team (particularly in the area of capital allocation). Or, said more poetically, we seek to invest in a company with:

A MOAT to protect returns,

A BOAT full of re-investment opportunities,

A GOAT or two running things, and

A QUOTE that's reasonable.²

We see ample investment opportunities in the year ahead but want to give you a sense of what might lead our strategy to perform better or worse than its historical returns. We believe that the most important factor to consider when thinking about broad market returns over the next twelve months are commodity prices, inflation and the outlook for interest rates. If inflation moderates over the next few months and the overall economy slows down, we expect our strategy to do slightly better than it has historically because the types of companies we invest in are very much the “steady Eddy” type, with low overall macro-economic sensitivity. If on the other hand, inflation continues to run hot, and commodity prices increase rapidly, more capital will flow towards these more cyclically sensitive companies, which we generally avoid investing in – although we do currently have a position in Texas Pacific Land Trust (TPL) which would benefit from rising oil and natural gas prices.

¹ You may have imagined that all investment managers seek to invest in high quality companies. Let me disabuse you of that notion: they do not.

² Credit goes to @10kdiver <https://twitter.com/10kdiver>

There are two sides to every story in the market and there are smart people on both sides of the inflation and commodity price debate. While many commodity producing stocks look “cheap”³ we continue to avoid investing in these types of business as we believe their cash flows are generally impossible to predict and they have no competitive advantages. We continue to solely focus on what we believe are high-quality businesses whose cash flows and competitive positions can be forecast with a high degree of certainty. We are reminded of the wise words about the choices one can make in life: **you can do anything, but not everything**. When it comes to investment choices we are strongly in the high-quality / non-cyclical school of investing.

To illustrate why we don’t believe we can invest successfully in commodity-oriented stocks, let us take a look at Arch Coal, Inc. (ARCH), a coal miner with operations in Wyoming, Colorado, and several other states. Arch’s stock returned +108% in 2021 and some investors believe it will return much more in the years ahead. What’s more, the stock has an estimated forward P/E ratio of just 2.5x – 1/10th of the S&P 500 index. But how trustworthy are forward earnings estimates?

First off, ARCH went bankrupt in January 2016 and emerged from bankruptcy in late 2016. During the bankruptcy process, the company shed over \$5 billion of debt and emerged with over \$300 million in cash on their balance sheet. “Great! A coal miner with a clean balance sheet!”, you might have said, and bought the stock in late 2016. What could possibly go wrong? A lot, as it turns out. Unfortunately, while ARCH returned over 100% last year, the stock has actually returned 0% over the past four years.

If you bought the stock in late 2016, as the company emerged from bankruptcy with a fresh balance sheet, congratulations: you’ve held it for over four years, endured a 70% drawdown and made zero return. As of the end of Q3 2021, the company has generated \$1.7 billion in sales over the past twelve months, and this is down from \$1.9 billion in sales over the twelve months ending Q3 2016. But wait, there’s more! Over the past five years the company spent \$943 million on CapEx – and **revenue actually declined**. Net income was negative in two of the past five years – all of this during an economic expansion. Unless something has fundamentally changed in the coal business, the economic profits of a company like Arch Coal are completely unpredictable, as is its stock prices. Hence a “forward P/E” doesn’t really mean much. So, while the company looks like a cheap lottery ticket, we think investors should avoid gambling on its share price.

The ESG Gravy Train of Goodness

ESG stands for Environmental, Social and Governance – and it has been one of the hottest trends in investing over the past five years, with investors increasingly claiming to focus on “doing good” as well as making money. Asset managers have responded in force by creating hundreds of ESG investment products (high fee products of course), ESG consultants⁴ have sprung up overnight to rate the “goodness” of companies, and corporate executives have increasingly adapted the language of ESG. The rare ESG holdouts are quickly learning to adapt.⁵ We sincerely believe that the ESG movement was born out of good intentions, but today it has become something else: a political movement that claims to own the very definition of what is “good” for society. However, as with all complex issues, the question of “goodness” is multi-faceted and escapes easy definition. What is “good” is hard to define and even harder to measure.

³ For example: ARCH, AMR, and CNR

⁴ <https://www.wsj.com/articles/is-tesla-or-exxon-more-sustainable-it-depends-whom-you-ask-1537199931>

⁵ <https://www.bloomberg.com/news/articles/2021-06-07/snowflake-ceo-offers-apologies-support-for-hiring-diversity>

ESG proponents claim to offer a free lunch: companies that do “good” for society are also great investments that will outperform the broader market. For the past several years, this has been true as large tech companies have performed extremely well, and large tech scores very well on various ESG criteria. Hence the reputation of ESG investing has been enhanced and the narrative reinforced: invest in highly rated ESG companies and outperform the market! Of course, in this narrative lies a contradiction: if ESG investing is actually about high returns, you don’t need ESG as a reason to invest – simply seek to invest in high return investments. Who cares if Google, Amazon, and Microsoft are doing “good” for society? If they are good investments, you should invest in them anyway.

ESG investing proponents makes several claims which can’t all be simultaneously true, among which is that companies which adapt ESG principles will: do good for society, increase in value, and offer higher future returns. Professor Aswath Damodaran of NYU has summarized these arguments in a series of excellent presentations⁶ and videos⁷, so we won’t rehash them here. To us, the real problem with ESG is that it tries to outsource to corporations the decisions about societal values – something that should be done in a public forum through a democratic process. Abortion, gun violence, racial justice, investing in renewable energy, or China’s treatment of the Uyghurs – these are all important issues, but are they really things that should be decided by the CEOs of Walmart, Intel and Boeing? Yet, because of ESG consultants, ESG indexes and ESG scoring, companies are now trying to contort themselves to everchanging ESG definitions of “goodness”.⁸

One consequence of ESG politics has been the decline of energy production in Western countries. ESG has gone beyond rhetoric and entered the legal domain. Of note is the Dutch court’s recent decision in a case involving Shell, where the court ruled that: “*Shell was “obliged” to reduce the carbon dioxide emissions of its activities by 45 percent at the end of 2030*”.⁹ How can Shell possibly meet this goal without divesting energy producing assets? ESG has allowed politicians to blame companies for climate change while avoiding the tough questions of how much the transition to a carbon neutral economy will really cost. How many people would support a transition to net-zero emissions if it meant an immediate 10x increase in energy prices? It is pathetic to see Western politicians spouting extremist climate rhetoric and forcing their domestic fossil fuel industries into decline, and then turning around and begging OPEC+ to pump more oil and blaming them for not doing so.¹⁰ To paraphrase OPEC’s response: “if you want more oil, pump it yourself”.¹¹

We believe that for most people ESG is more about virtue signaling than an honest commitment to principles. Earlier this year, a chief investment officer of a major US university endowment shared a story with me at a conference. He mentioned that parents and students would often come to the endowment investment office and complain about the actions of a particular company in the endowment’s holdings. In such cases the chief investment officer would tell the individual in question to draft a letter to the company outlining the actions they wished the company to take and provide the endowment office instructions on how they wanted them to vote the proxy statement. To date, no one has yet done this, suggesting that while people want to vent their anger, they are largely unwilling to invest real efforts in trying to affect change.

⁶ <http://people.stern.nyu.edu/adamodar/pdfiles/country/ESGShortNew.pdf>

⁷ https://www.youtube.com/watch?v=5H6_60Tv0i0&ab_channel=AswathDamodaran

⁸ <https://www.theverge.com/2021/12/24/22852773/intel-apology-china-xinjiang-labor-goods>

⁹ <https://www.nytimes.com/2021/05/26/business/royal-dutch-shell-climate-change.html>

¹⁰ “U.S. calls on OPEC and its allies to pump more oil”, <https://www.reuters.com/world/middle-east/us-call-opec-its-allies-increase-oil-production-cnbc-2021-08-11/>

¹¹ “OPEC+ snubs Biden’s plea to pump more oil” <https://www.aljazeera.com/economy/2021/11/4/opec-sticks-to-plan-to-raise-oil-output-by-400000-bpd>

To us, “sustainability” is a very important component of our investment process, but to us it means the sustainability of the company’s business model and its economic success. Governance is also hugely important, as agency risks in corporate America are pervasive and endemic. But understanding a company’s governance and the sustainability of its business model requires going beyond simplistic labels handed out by ESG consultants.¹² Evaluating sustainability requires a detailed understanding of a company’s business model and doing real work – the kind of investing that we practice at LRT. So, while we have not jumped on the ESG bandwagon, rest assured that we are working hard to ensure that the companies that we are investing in have business models and economic moats that can sustain profitability of many years to come.

¹² <https://www.bloomberg.com/news/articles/2021-10-05/gm-is-the-old-industrial-worth-owning-for-some-esg-investors>

Watsco: The Coolest Company in Our Portfolio



Watsco is a family-controlled company, and the largest distributor of air conditioning, heating, refrigeration equipment, and related parts in the North American HVAC/R industry.^{13,14} Watsco operates primarily in the residential HVAC equipment, and parts business. 69% of the company's revenues come from HVAC equipment sales, while Other HVAC, and Commercial refrigeration products account for 28% and 3% respectively.¹⁵ Watsco is far and above the leader in the highly fragmented North American HVAC/R industry. The overall market in the U.S. contains approximately 2,100 distributors.¹⁶ Today, Watsco has captured approximately 5.2% of the \$97 billion HVAC/R market.¹⁷

<i>Years Ended December 31,</i>	2020	2019	2018
Primary Geographical Regions:			
United States	\$4,535,262	\$4,184,206	\$3,981,056
Canada	301,727	294,040	291,685
Latin America and the Caribbean	217,939	292,116	273,912
	<u>\$5,054,928</u>	<u>\$4,770,362</u>	<u>\$4,546,653</u>
Major Product Lines:			
HVAC equipment	69%	68%	67%
Other HVAC products	28%	28%	29%
Commercial refrigeration products	3%	4%	4%

Watsco distributes a broad selection of systems, parts, and accessories from over 1,200 OEMs and suppliers,¹⁸ with large brands such as Carrier, Trane, and Rheem.¹⁹ The company's primary customer base is contractors, who purchase, and receive HVAC products through dealers and distributors, including the regional companies Watsco acquires. Contractors use the dealer's resources to order, and furnish parts and equipment for HVAC repair, replacement, or installation jobs. The contractors sell to the end users, who in this case are the homeowners, or business owners. Watsco now supplies over 100,000 contractors and dealers in the United States, Canada, Latin America, and the Caribbean, from over 600 locations.²⁰ In fiscal year 2020, revenues topped \$5 billion,²¹ representing a 78x increase in revenues over a 31-year period.

¹³ HVAC/R = Heating, Ventilation, Air Condition, and Refrigeration.

¹⁴ SEC Filing, WSO 2020 10-K.

¹⁵ Ibid.

¹⁶ Ibid.

¹⁷ Calculated using total revenues divided by total market size.

¹⁸ 2020 Watsco Investor Presentation.

¹⁹ SEC Filing, WSO 2020 10-K

²⁰ Ibid.

²¹ Ibid.

Watsco was founded in Hialeah, Florida in 1956. Watsco began its life as a manufacturer of parts, components, and tools. The company quickly expanded and went public in 1962. The company's shares began trading on the American Stock Exchange shortly after, in 1968.²²

Watsco's growth by acquisition strategy dates back to the 1970s when Watsco began buying smaller companies. The business still focused on the manufacturing of tools, and components. In 1977, Watsco acquired a hair care products manufacturer, which further molded the company to fit the description of the popular conglomerate model of the time.²³ The company would go on to divest its hair care operations in 1982 for nearly twice what it paid. Watsco remained unfocused on any particular activities in its businesses, and earnings were unspectacular as a result.

In 1973, Albert H. Nahmad became President, and CEO of Watsco. At first, Nahmad continued the company's initiative of growth by acquisition, particularly in the tool manufacturing division of the company's operations, but things would soon change for Watsco. In 1982, the company began to consolidate its operations by moving two subsidiaries' operations to the company's headquarters in Hialeah, Florida. Additionally, the company's air conditioning business began to grow in the mid 1980's due to the Floridian housing boom in the 1970's. Replacement units, and parts were quickly gaining demand as many HVAC systems were aging past the 10-year mark and breaking.

These events led to the company homing in on a "sun belt" strategy, growing its heating and cooling business by acquisitions. By 1988, the company was mostly focused on manufacturing parts for heating and cooling systems. Revenues had grown from roughly \$3 million in the early 1970's to \$22 million in 1988. The year 1988 was a turning point for Watsco, as the company purchased 80% interest in Florida based Gemaire Distributors Inc. for \$17 million. The company then acquired 80% of another heating and air distributor named Harry Alter Co. These acquisitions boosted Watsco's market share of heating and cooling distribution to 16% of the total Floridian market.²⁴ By 1991, Watsco's revenues hit \$169 million - very strong growth, considering the company brought in only 13% of that figure just three years earlier.²⁵

Watsco's HVAC manufacturing and distribution businesses soon took off in the 1990s. Aging AC units in Florida, as well as natural disasters such as hurricane Andrew causing damage to over 90,000 homes in 1992 boosted sales further for the company. By 1993, about three quarters of the company's revenues came from the distribution operations.²⁶

In 1989, after Watsco had experienced substantial organic growth, the company began its "buy and build" initiative specifically aimed at HVAC/R distributors, which remains its focus today. At the time, revenues totaled just \$64 million. The "buy and build" strategy has resulted in long-term growth by acquisition. The company invests in market leaders to either expand into new markets or capture larger shares in existing markets.²⁷ After Watsco acquires a company fitting its financial, and strategic criteria, Watsco then "builds" the company out by expansion of products, locations, as well as access to capital, and support in improving efficiencies in the business' operations. Watsco also provides, at the corporate level, specialized staff to provide functional support to subsidiaries' growth strategies.²⁸ The results have been fruitful: consistent profitability and consistent top line growth for Watsco. The company has made a total of 64 acquisitions since 1989, averaging about two per year.²⁹

²² Funding Universe, Watsco Company History, <http://www.fundinguniverse.com/company-histories/watsco-inc-history/>

²³ Ibid.

²⁴ Ibid.

²⁵ Ibid.

²⁶ Funding Universe, Watsco Company History, <http://www.fundinguniverse.com/company-histories/watsco-inc-history/>

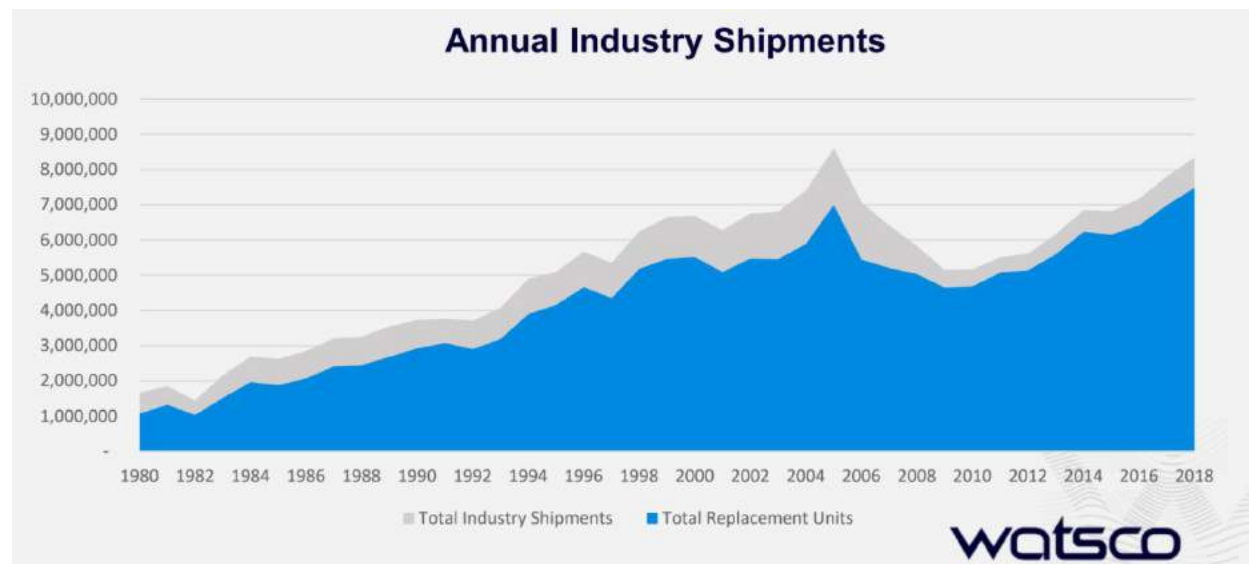
²⁷ SEC Filing, WSO 2020 10-K.

²⁸ Ibid.

²⁹ Watsco 2020 Investor Presentation.

In 1993, Watsco's shares moved to the more prestigious New York Stock Exchange (NYSE), and the company bought out the remaining 20% of its earlier acquisitions of Gemaire, and Comfort Supply from Rheem. This made both of these companies wholly owned subsidiaries, and furthered Watsco's presence in the highly fragmented heating and cooling distribution industry. In 1998, Watsco made the decision to sell off most of its manufacturing businesses, to focus solely on distribution of HVAC/R equipment.³⁰

The great recession of 2008-2009 caused many companies to lose traction in their revenues, and experience financial hardships. Watsco did not experience a drastic decrease in sales, although the company's products are directly related to the housing industry. Since most of Watsco's sales come from repairs, or replacements, the housing bubble burst of 2006-2010 did not adversely affect Watsco's revenues nearly as much as other housing related/housing market dependent companies.



Source: 2020 Watsco Investor Presentation.

The need for a homeowner to repair or replace HVAC related equipment quickly is imperative. Due to the high priority of these product's functionality, the company demonstrated strong resilience through the housing crisis. Although revenues dropped 3.3% between 2007 and 2008, Watsco's revenues grew by 17.7% between 2008 and 2009,³¹ demonstrating a lack of cyclical sensitivity.

In 2009, Watsco formed a joint venture with Carrier Global Corporation, a well-known, and large HVAC manufacturer. The joint venture involved the two companies combining resources where Carrier committed 95 of its company owned locations in 13 sunbelt states, Puerto Rico, and its export division in Miami, Florida.³² Watsco committed 15 locations that distribute Carrier products to the venture, as well as a payment to Carrier of \$172 million for the initially agreed upon 60% interest in the joint venture.³³ Watsco now maintains an 80% controlling interest in this joint venture referred to as Carrier Enterprise I.³⁴ This venture allowed for Watsco to spearhead the distribution operations for Carrier Global Corporation, which created a 42% year over year change in revenues between FY 2009, and FY 2010.³⁵ The joint venture also presented the opportunity Watsco had been looking for to enter the "premium brand equipment" space of

³⁰ Funding Universe, Watsco Company History, <http://www.fundinguniverse.com/company-histories/watsco-inc-history/>

³¹ Sentio

³² SEC Filing, WSO 2020 10-K.

³³ WSO 8-K Agreement, May 7th, 2009.

³⁴ SEC Filing, WSO 2020 10-K.

³⁵ Sentio.

the market.³⁶ Ten years later, in 2019, Carrier Enterprise I expanded by acquiring all of the assets of Peirce-Phelps, Inc (PPI), an HVAC distributor with 19 locations in Pennsylvania, New Jersey, and Delaware.³⁷

Watsco's joint ventures with Carrier Global Corporation did not stop there. In 2011 the company formed another joint venture with Carrier under the same initial 60%/40% interest as Carrier Enterprise I for \$35.7 million, with the option to buy up to 80% interest. The company now maintains the same 80%/20% interest as the previous JV. Sequentially named Carrier Enterprise II, and Carrier Enterprise III, the next two ventures gave Watsco an even greater presence in the HVAC distribution business, and Carrier Enterprise II once again boosted revenues by 15% between FY 2011, and FY 2012.³⁸ Carrier Enterprise III (or "Carrier Enterprise Canada") was formed in 2012 under a 60%/40% interest split with Watsco again possessing controlling interest. Watsco paid a larger \$168.9 million for the third JV of the series. This joint venture helped Watsco expand into Canada where Carrier committed 35 of its company owned facilities for distribution operations.³⁹ Watsco paid \$43 million additionally in 2016 to raise the company's stake to 70%.⁴⁰ These joint ventures with Carrier accounted for 55% of the company's revenues in fiscal year 2020.⁴¹

Most recently, Carrier and Watsco announced two more joint ventures in March of 2021. The two companies agreed to an 80/20 split (favoring Watsco) in ownership regarding the acquisition of TEC, a U.S. based distributor.⁴² Secondly, the companies jointly purchased Chicago-based Temperature Equipment Corp, to expand their presence in the MidWest.⁴³ This JV is also structured as an 80/20 split in ownership favoring Watsco in a \$291 million acquisition.⁴⁴

The company maintains a strong density of warehouses, with well-stocked inventories in order to better serve the company's contractors and dealers. Watsco's scale advantage allows for better coverage across its serviced areas, and more efficient inventory management. Additionally, Watsco's scale advantage also allows for the company to invest significant resources to the growth of digital tools to promote online sales. Smaller, less financed competitors do not have resources to match Watsco's investments in programs such as OnCall Air which we will discuss later.

As part of our due diligence, we recently visited a Gemaire Distributors, LLC location here in Austin, Texas.⁴⁵ Gemaire is a wholly owned, significant subsidiary of Watsco, Inc.⁴⁶ Aaron Gonzalez, the warehouse manager, confirmed that purchases, and interactions with Watsco are handled through regional management. Watsco sells inventory to the warehouses for Gemaire's distribution centers. (pictures shown below). Local management also confirmed recent supply chain shortages, but also expressed a positive outlook for the near-term improvements in the supply chain as well. Moreover, Mr. Gonzalez mentioned the ability to work in a decentralized manner, having free reign to "turn on and off" products that they are selling or are not selling. This decentralized structure of operations is consistent with Watsco's overall model.

³⁶ Albert H. Nahmad, WSO Q1 2009 Earnings Call.

³⁷ SEC Filing, WSO 2020 10-K.

³⁸ Sentio.

³⁹ SEC Filing, WSO 2020 10-K.

⁴⁰ Yahoo News, Watsco Increases Stake in Carrier Enterprise Joint Venture, <https://www.yahoo.com/news/watsco-increases-stake-carrier-enterprise-125112265.html>

⁴¹ SEC Filing, WSO 2020 10-K.

⁴² Collingpost.com, Carrier and Watsco combine to acquire U.S. distributor TEC, <https://www.coolingpost.com/world-news/carrier-and-watsco-combine-to-acquire-us-distributor-tec/>

⁴³ South Florida Business Journal, Watsco, Carrier form joint venture to acquire \$291M company, <https://www.bizjournals.com/southflorida/news/2021/03/16/watsco-carrier-form-joint-venture.html>

⁴⁴ Ibid.

⁴⁵ 231 E Stassney Ln Building 11, Suite 300, Austin, TX 78744.

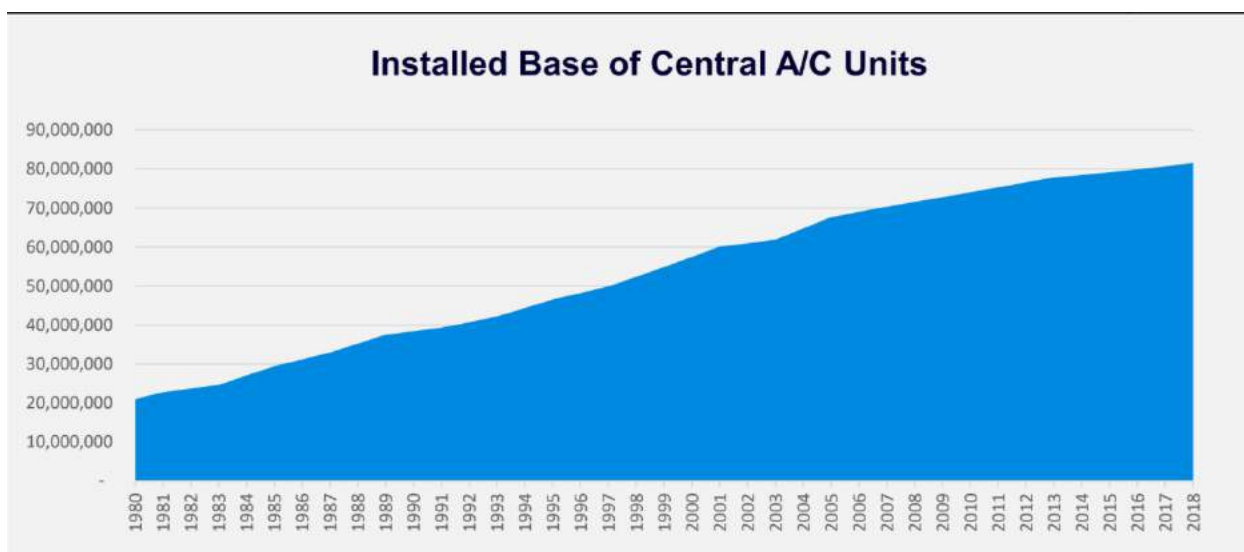
⁴⁶ SEC Filing, WSO 2020 10-K.



The above is an example of just one of Watsco's hundreds of warehouse facilities.

Competition in the HVAC/R distribution space can be characterized as a series of local oligopolies, because the things that Watsco sells tend to be heavy and bulky items which helps localize competition. For instance, a warehouse distributor in Austin, Texas such as the one pictured above would not be in competition with a warehouse in Washington state.

Watsco's growth opportunities are abundant in the United States. With over 115 million installed AC units, there are approximately 91 million central air conditioning and heating systems installed in the U.S. that have been in service for more than 10 years. Many of these units may soon reach the end of their useful life.⁴⁷



Source: 2020 Watsco Investor Presentation.

Additionally, the Federal Government regulates the minimum efficiency standards for HVAC systems, measured by SEER ratings.⁴⁸ The higher the SEER rating, the more efficient the heating and cooling unit. In 2023, the Federally regulated minimum SEER rating is set to increase for new units.⁴⁹

“The current minimum SEER allowed for HVAC equipment is 13 SEER in the North and 14 SEER for the Southeast and Southwest regions. Beginning in 2023, the minimum efficiency level for residential HVAC systems under 45,000 BTUs will be 14 SEER in the North and 15 SEER in the Southeast and Southwest. For systems over 45,000 BTUs, the minimum efficiency level will be 14 SEER in the North and 14.5 SEER in the Southeast and Southwest. Heat pump efficiency levels will be set at 15 SEER for all three regions.”⁵⁰

$$SEER = \text{Cooling Output During Summer} / \text{Energy Used During Summer}$$

The relationship of SEER to price is direct. The higher the SEER rating, the better the efficiency, the higher the price. Many arguments contend that the higher SEER units are worth the extra money and will pay for

⁴⁷ Energy Information Administration Data (2018).

⁴⁸ SEER = Seasonal Energy Efficiency Ratio.

⁴⁹ SEC Filing, WSO 2020 10-K.

⁵⁰ Ibid.

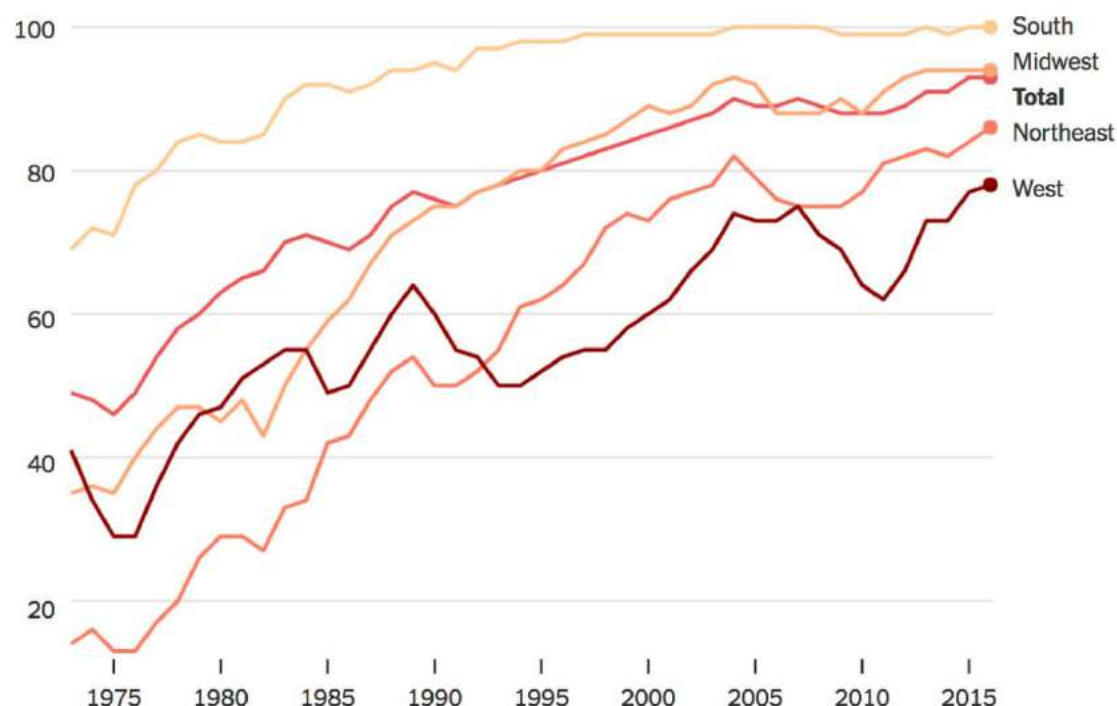
themselves in the long run by providing higher efficiency and lower electrical consumption. Regardless of the arguments if a higher SEER is “better”, the fact of the matter is that regulation is changing, requiring a higher SEER rating on new units. This could be a meaningful impact on revenues for Watsco, although management has stated it is too early to understand what those impacts could look like.⁵¹ There are over 110 million installed HVAC systems in the U.S., many of which are operating under old efficiency standards.⁵²

The global annual market on an installed basis for residential central air conditioning, heating, and refrigeration, related parts, and supplies is estimated at \$97 billion.⁵³ The North American Market represents approximately 50% or \$50 billion of this figure.⁵⁴

The number of new houses across the country with installed central air conditioning has increased over time. As shown in the chart below, the number of homes with central air conditioning has grown significantly since the 1970s, with 100% of new homes in the south including central AC. Watsco’s presence in the south and Midwest presents growth opportunities.

All New Houses in the South Today Are Built With Central Air

Share of new single-family homes that have central air-conditioning.



Source: U.S. Census Survey of Construction

⁵¹ SEC Filing, WSO 2020 10-K.

⁵² Al Nahmed (CEO), Q4 2020 Earnings Call.

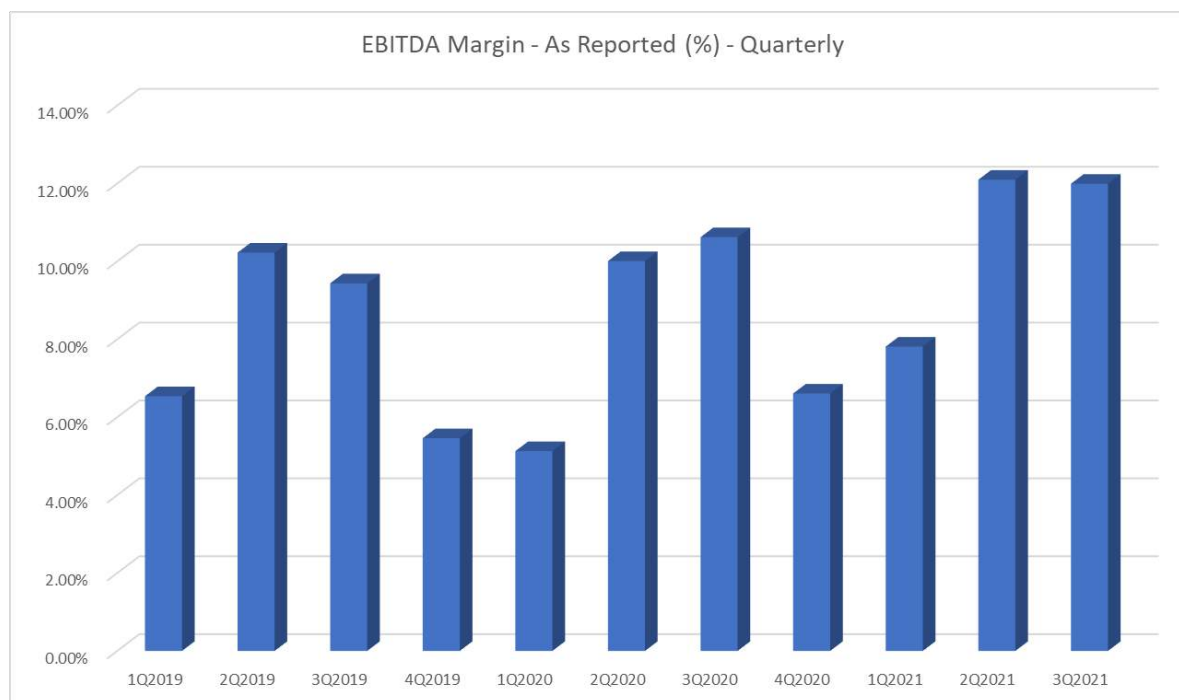
⁵³ SEC Filing, WSO 2020 10-K.

⁵⁴ Al Nahmad (CEO), Q2 FY2021 Earnings Call.

The COVID-19 pandemic, and consequences of government stimulus fueled spending has created obstacles for Watsco. However, the company has been hurt less than smaller competitors. The skyrocketed housing demand in the United States caused many HVAC/R OEMs⁵⁵ to ramp up production to attempt to keep pace with demand. Distributors everywhere are fighting to receive the necessary items to satisfy the increased demand but are falling short. As a result, supply chain issues have interrupted the business operations of many parts and equipment suppliers around the globe.

In many cases, Watsco is the largest customer of the OEM providers, since Watsco is the largest HVAC/R distributor in North America. This scale advantage has benefited Watsco throughout the COVID-19 pandemic in several ways. First, management recently noted that Watsco has gained market share during the ongoing supply chain shortages, due to its superior product availability and inventory management systems versus competitors.⁵⁶ Secondly, Watsco's long standing, and strong relationships with its OEM providers has benefited the company with prioritization throughout the ongoing shortages.⁵⁷

Moreover, inflation in the United States has reached a 31-year high, with the Consumer Price Index (CPI), registering 6.8% in the month of November.⁵⁸ In an unforeseen twist, inflation related price increases have also played a role in benefitting the company's margins,⁵⁹ *"Inflation is something that we pass through and pass on. It adds to a gross profit equation and makes more money for us. There's no question to that."*⁶⁰ These extraordinary events linked to the COVID-19 pandemic, and the consequences on the supply chain have helped boost Watsco's profitability in the short term. Management noted that although the supply chain shortage has caused the company to miss out "a little" on sales,⁶¹ the overall effect on the business has been a net positive one as the company continues to break revenue and margin records. These effects are evident in the company's quarterly EBITDA margins shown below.



⁵⁵ OEM = Original Equipment Manufacturer

⁵⁶ Paul W. Johnston (EVP), Q2 2021 Earnings Call.

⁵⁷ Paul W. Johnston (EVP), Q3, FY2021 Earnings Call.

⁵⁸ CNBC, Inflation surged 6.8% in November, even more than expected, to fastest rate since 1982, <https://www.cnbc.com/2021/12/10/consumer-price-index-november-2021.html>

⁵⁹ Barry S. Logan (EVP), Q3 2021 Earnings Call.

⁶⁰ Ibid..

⁶¹ Paul W. Johnston (EVP), Q3 2021 Earnings Call.

The work from home, or better named “work from anywhere” movement has caused a migration from northern states such as New York, Illinois, and New Jersey⁶² to southern states for warmer weather, and more affordable housing. Several states with the highest “inbound” relocating residents such as Florida, Texas, and South Carolina⁶³ also boast some of the most concentrated, strongest presence of Watsco distributors, and customers (contractors). This migration means more local housing demand which sparks new home starts, and renovations of older homes to the new owner’s liking. As part of home renovations, HVAC systems are candidates for repair, or replacement to newer, and more efficient systems. The increased demand for repair, installation, and replacement of HVAC systems translates to a long-term growth opportunity for Watsco.⁶⁴

Additionally, an HVAC system in need of repair, or replacement is a high priority for a homeowner. Watsco benefits from this sense of urgency, and lack of price sensitivity from customers who are unfamiliar with an average price of the items needing repair/replacement, and customers who want the job done as quickly as possible. In many places it is illegal for a non-certified HVAC technician to attempt to repair or replace an HVAC system. This is due to the impact on the environment that a release of refrigerant chemicals would cause, and the danger presented to the would-be repairer including possible respiratory illness. A technician must be licensed, certified by the EPA, and follow state, and local regulations regarding HVAC repair.⁶⁵

Another benefit of Watsco’s scale is the company’s ability to invest significant resources in digital tools which make life easier for their customers (the contractors). Watsco has long invested in e-commerce tools and has recently grown its e-commerce business sharply. The company’s user-friendly interfaces help contractors buy more items conveniently and sell to homeowners more efficiently. For these reasons, additional growth opportunities stem from its growing digital presence. Active user growth was up 27% in 2020. Overall technology adoption has seen an increase fueled by the changes in commerce brought about by the COVID-19 pandemic. *“Weekly users of our mobile apps increased 27% in 2020, with over 120,000 downloads. The number of e-commerce transactions grew 20% this year to 1.2 million online orders. Our annualized e-commerce sales run rate is 33% versus 31% at the end of last year (2019). In certain markets, it’s over 50%”*⁶⁶

Two of Watsco’s customer-facing (contractor facing) technological initiatives which aim to improve sales are OnCall Air, and CreditForComfort.⁶⁷ OnCall Air is Watsco’s digital ordering system which has been modified for more ease of use during the COVID-19 pandemic. OnCall Air features a virtual showroom with over 728,000 SKUs, and a rich depository of product information.⁶⁸ The application which is now built out to parallel warehousing operations has made touch-less order fulfilment possible for Watsco’s contractors. Dockside, or curbside pickup has been streamlined to further the benefits of the efficient system.

OnCall Air is a software application that allows contractors to talk with homeowners through proposals using a webcam on a computer, iPad, or smartphone. This capability has led to a more efficient selling process for Watsco’s contractors. As an example, OnCall Air was used to provide digital proposals to over 109,000 households in 2019, generating \$350 million in gross merchandise value for Watsco and its customers (contractors).⁶⁹ As of June 2020, Watsco has invested \$30 million in OnCall Air,⁷⁰ made possible

⁶² North American, 2020 Migration Report. https://avlnavblob.blob.core.windows.net/northamerican-com/docs/default-source/default-document-library/key-takeaways---2020-migration-report.pdf?sfvrsn=3b1554ef_0

⁶³ Ibid.

⁶⁴ Ryan James Merkel (Analyst), Q1 2021 Earnings Call.

⁶⁵ AZAirconditioning.com, Warning! Doing Your Own AC Repairs May Be Illegal <https://azairconditioning.com/warning-doing-your-own-ac-repairs-may-be-illegal/>

⁶⁶ Al Nahmed (CEO), Q4 2020 Earnings Call.

⁶⁷ Watsco 2020 Investor Presentation.

⁶⁸ Ibid.

⁶⁹ Al Nahmed (CEO), Q4 2020 Earnings Call.

⁷⁰ Watsco, Inc. Presents at UBS Global Industrials and Transportation Conference 2020.

by Watsco's large scale. The company now employs 200 additional people and invests money annually to maintain Oncall Air. Although this results in a dilution in operating margins, the company benefits greatly from sales through the platform, resulting in a greater top line.⁷¹

CreditForComfort is a financing service rolled out by Watsco. The company utilizes third party financing, as well as some "on-the-balance-sheet financing"⁷² for its end market customers. As many homeowners may be aware, HVAC repairs or replacements can be very expensive. This initiative helped boost sales by allowing more customers of all financial positions access to Watsco's products through contractors' use of their technology, and services.

Watsco's recent growth has been extraordinary and due to several factors, which we think are unlikely to repeat anytime soon. However, the company has a long, and rich growth history. Watsco has grown largely by acquisition since 1989. The company provides access to capital, aggressive growth plans, and other resources to the acquired distributors as part of the acquisition. These resources help the newly acquired businesses grow in their local markets, while Watsco delegates the decision making to the leaders of the acquired businesses (often called regional managers), therefore working in a decentralized manner.⁷³ Often, Watsco keeps the acquired business' name and logo for local brand recognition - as is the case with Gemaire, the local Watsco subsidiary whose employees we spoke to during our due diligence.

Over the past decade, Watsco's revenues have increased from \$2.98 billion in 2011, to \$5.05 billion in 2020, representing a 69.4% increase to the top line.



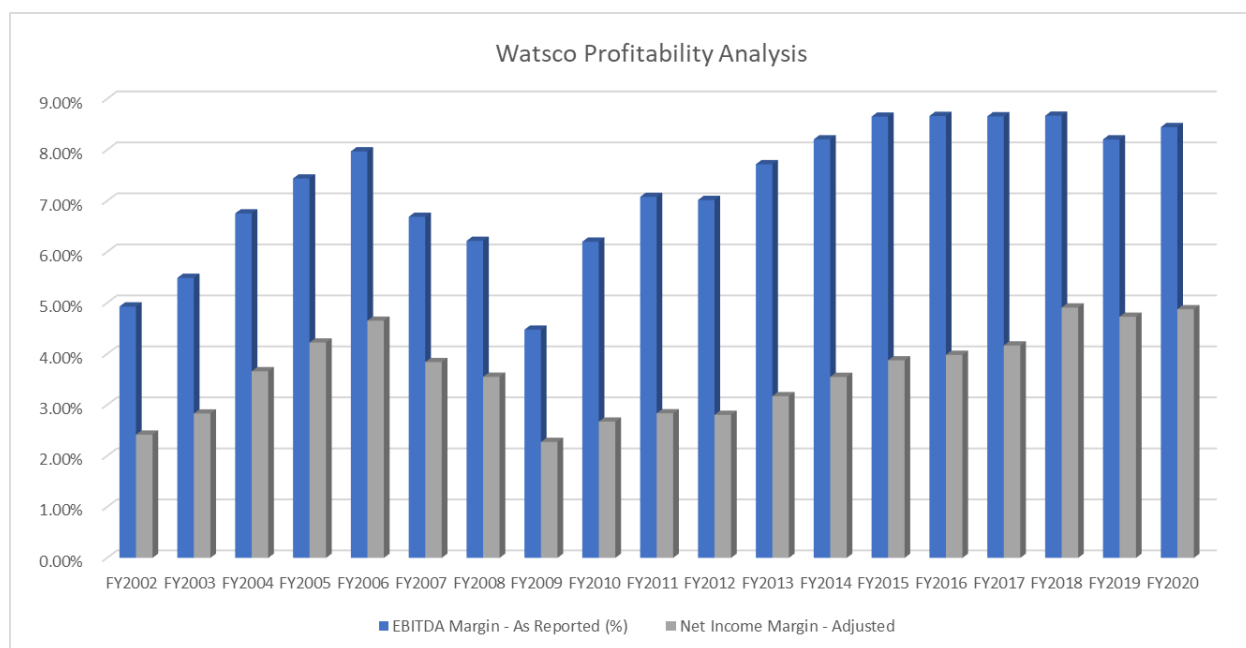
Recent quarterly margins have been exemplary relative to the past. However, Watsco has been a consistently profitable business prior to the COVID-19 pandemic as well. Margins have been steady and

⁷¹ Watsco, Inc. Presents at UBS Global Industrials and Transportation Conference 2020.

⁷² SEC Filing, WSO 2020 10-K.

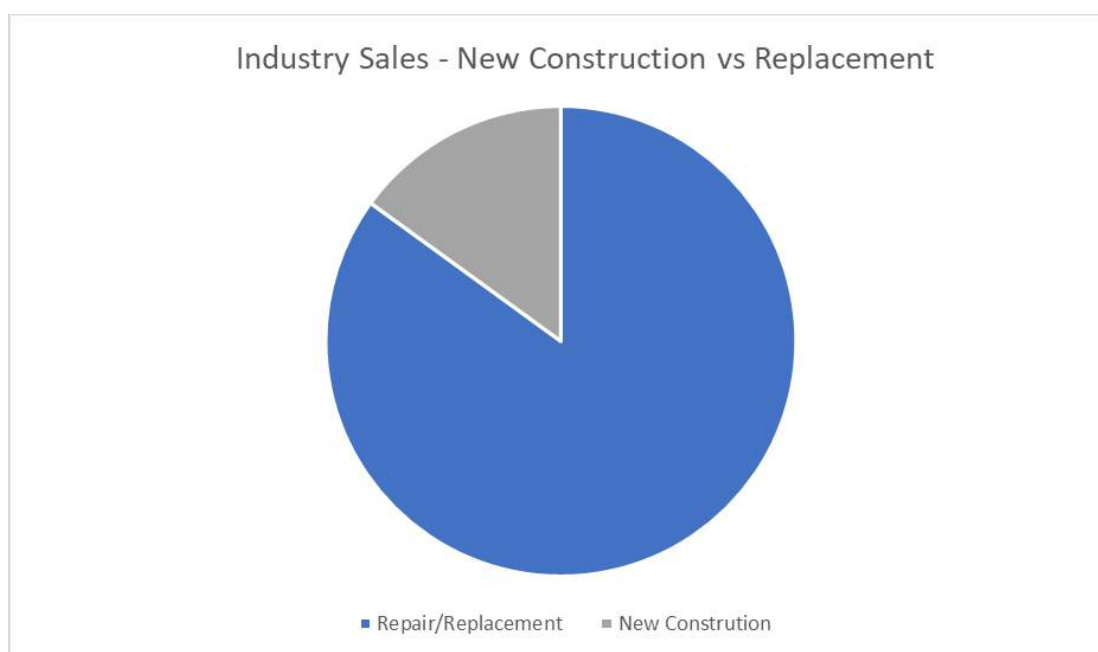
⁷³ Watsco Inc, Q1 2020 Earnings Call.

have grown consistently since 2009. Most recently, Net Income margins have continued to grow despite a tapering in EBITDA margins, largely due to a lower tax rate. The chart below shows the evolution of the company's margins over time.



We also think it is worth pointing out that the company has remained highly profitable during the U.S. housing crash of 2006-2010. Despite what many critics of the company say, the company's sales are largely a function of the number of installed HVAC units already in the field and not new home sales. In fact, only 15% of industry's sales are tied to new home construction, with the remaining sales being driven by replacement demand.⁷⁴

⁷⁴ SEC Filing, WSO 2020 10-K.



Top line growth, and margins have been fantastic for Watsco. But what's the reason? How has the company sustained excellent performance through time? The company's growth has been primarily through acquisition and in such a case, management incentive matters more than ever, because if compensation is tied to short term objectives such as revenue growth, aggressive acquisitions strategies that destroy shareholder value can still lead to bonuses for executives. It is in this context that we want to discuss Watsco's long-term compensation plan for its executives which we believe is unique in corporate America.

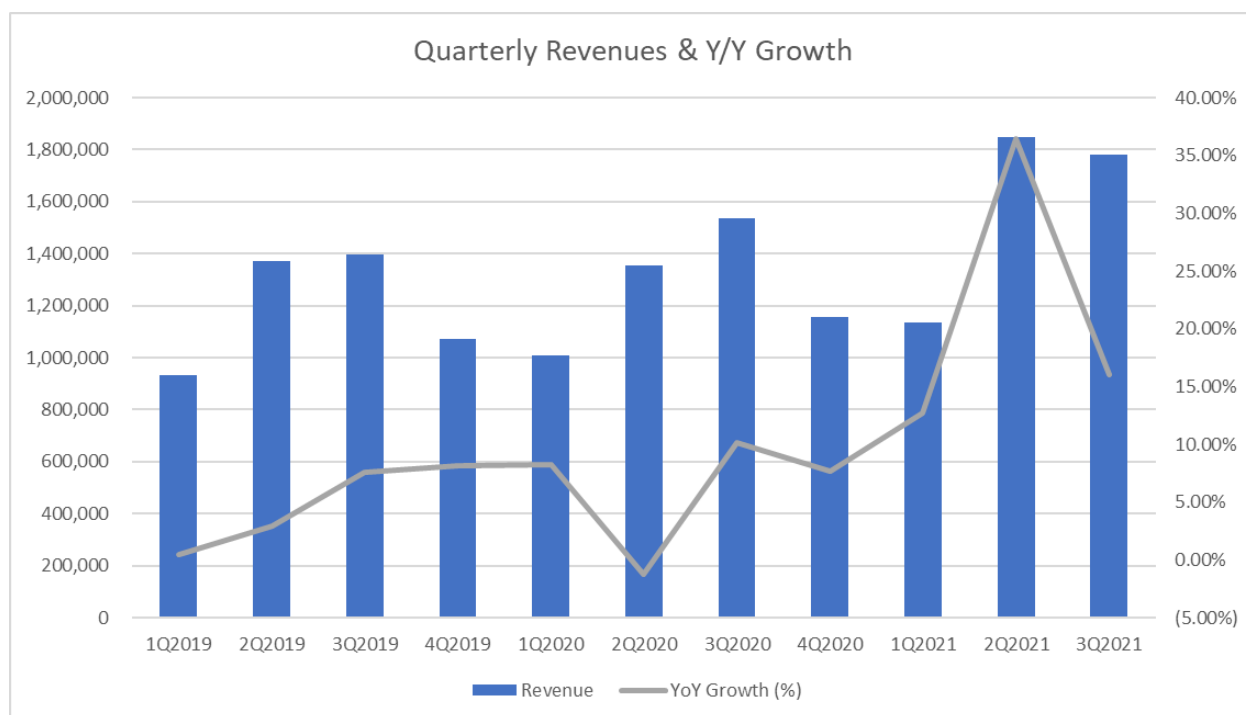
We believe that a large part of the company's success has to do with how senior management at the company is compensated. The management team has a highly unique compensation plan, geared toward incentivizing long-term growth in shareholder value. Since 1997, the company has rewarded executives with restricted stock. The idea behind the restricted stock is to ensure that the executive's interests stay in-line with those of the shareholder. What is atypical about the compensation scheme at Watsco is that normally, in most companies, restricted stock awards vest over a 4–5-year period. Not so at Watsco. The company's executives are required to spend their entire career with Watsco in order to fully vest. Typically, executives are fully vested at retirement age (typically 62 years of age) or when the executive's employment with the company is terminated without cause, for retirement, or for good reason, whichever comes later.⁷⁵ This compensation plan is unique to Watsco, and the company believes that compensating executives in this manner helps build a sustainable future, where executives make the correct long-term decisions for the company, and the shareholder.⁷⁶ As a result, the company has generated a compounded annual growth rate for total shareholder return of 19% over the last 30 years.⁷⁷

Most recently, the company has recently set record highs in revenues, as well as several other financial metrics.

⁷⁵ SEC Filing, WSO 2020 10-K.

⁷⁶ Ibid.

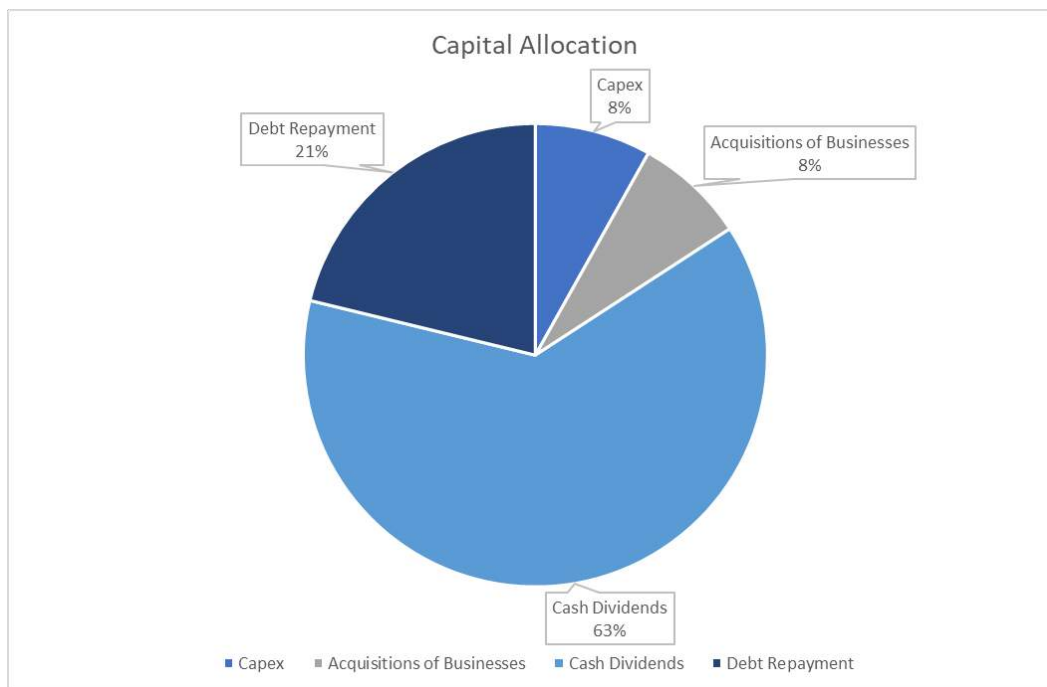
⁷⁷ Ibid.



In the most recent quarter (Q3 2021), operating income increased \$50 million, or 32%, to a record \$207 million. Operating margins expanded 100 basis points to a record 11.6%. And cash flow for the quarter was a record \$238 million.⁷⁸

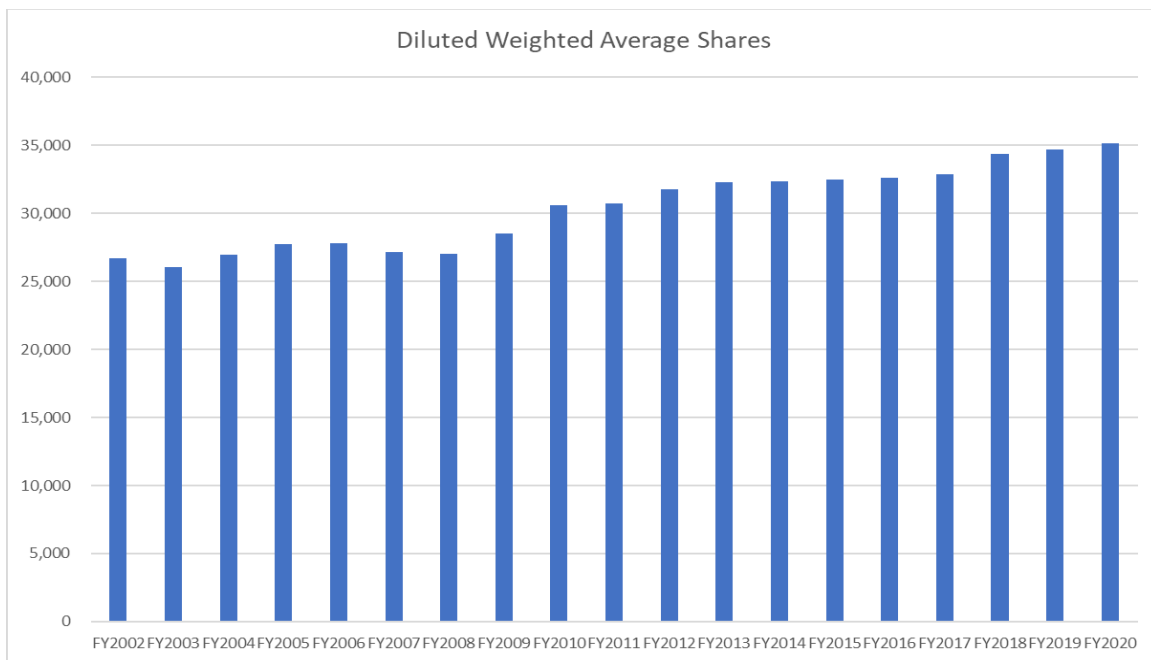
Over the past decade, the company has generated \$2.38 billion in cash from operations. \$198.9 million (8%) was spent on capital expenditures, \$189.2 million (8%) went to business acquisitions, \$520.4 million (21%) to debt repayments, and finally \$1.55 billion (63%) to cash dividends.

⁷⁸ Al Nahmad (CEO), Q3 2021 Earnings Call.



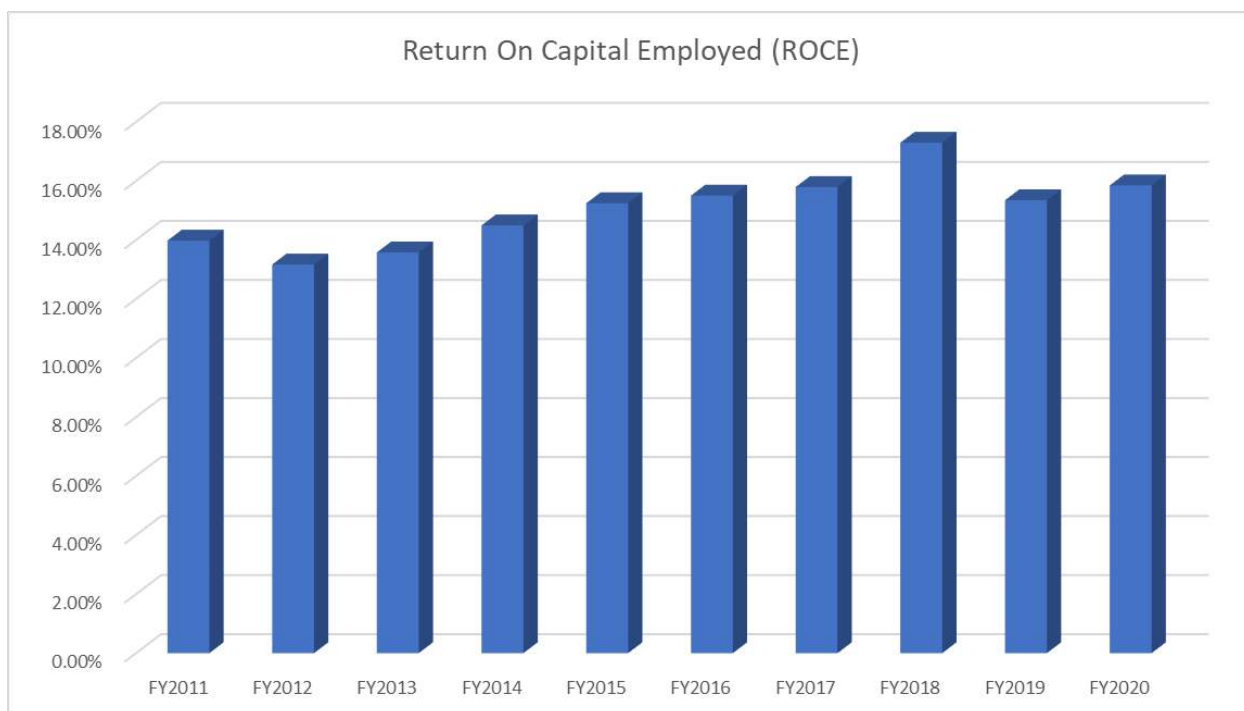
Watsco has been a net issuer of shares, and has eschewed the use of debt, keeping overall leverage very low. We believe this is the result of a “safety first” mentality due to the executive management team's very large personal investment in the company. Historically, Watsco has issued a reasonable amount of equity in order to partially finance its acquisitions. As an example, the 2019 acquisition of N&S resulted in the issuance of 22,435 shares of common stock as part of the financing agreement.⁷⁹

⁷⁹ SEC Filing, WSO 2020 10-K.



While we would ideally prefer a slightly more leveraged capital structure, we believe that overall, the capital allocation decisions by management have been exemplary. The company continues to grow by acquisition and payouts out excess capital in the form of dividends, while reinvesting retained capital at a more than satisfactory rate of between 13% and 17%.

Returns on Capital Employed (ROCE) measures the pre-tax returns on capital. This helps us determine how efficiently Watsco employs available capital. Like Watsco's margins, ROCE has remained high, and continues to be a consistent factor of the bottom line. In general, a company can improve its returns on capital employed by doing one, or a combination of the following: increasing margins, or an increase in asset turnover. Watsco has done both in the past year.

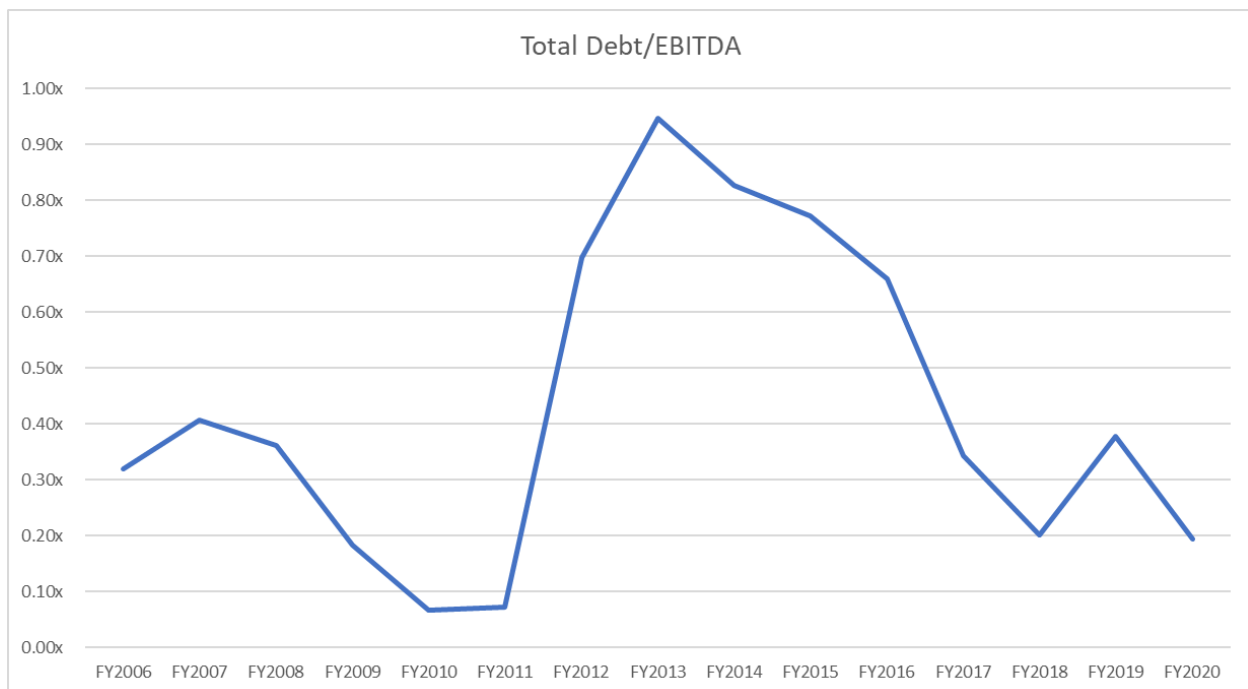


As aforementioned, the company's balance sheet shows a small amount of debt as represented by the below Total Debt/EBITDA ratio. This metric shows that although the company accumulated debt between 2011, and 2013, it was quick to repay the liabilities, and reduce the Total Debt/EBITDA ratio to the current measure of 0.19x EBITDA.

In 2012, Watsco entered into a credit agreement borrowing approximately \$154 million to replace, and refinance debt from two prior revolving lines of credit, including debts taken on from the purchase agreement of Carrier Enterprises Canada (or Carrier Enterprise III).⁸⁰ This transaction played into the sharp increases in Total Debt/EBITDA as illustrated between 2011-2013. The terms of financing also provided a \$50 million swingline subfacility, a \$50 million letter of credit sub facility, and a \$75 million multi-currency borrowing limit.⁸¹

⁸⁰ WSO 8-K Agreement, Credit. May 3rd, 2012.

⁸¹ Ibid.



To sum it up, we believe Watsco is a great business because of the predictable nature of the demand for its products, its scale over competitors, and the nature of the competition in the industry (a series of local oligopolies). Management has intelligently allocated capital while the company's top line has continued to grow. Recent events such as supply chain shortages and inflation have caused prices to rise, which customers have given little push back on due to the necessity of Watsco's products. This shows the company's resilience to economic and market conditions. The necessity of HVAC repair and/or replacement plays a key role in this fact and will continue to be a priority for those homeowners in need of a new or replacement system.

Watsco's customers (contractors) continue to execute their sales of needed items and systems to their customers, builders, and others. The new technologies implemented by Watsco appear to continually gain adoption, making for a more streamlined, and organized sales process. We believe that this will continue to translate to more revenues for the business. Useful tools such as financing for HVAC systems further this prediction.

The upcoming regulatory changes for required SEER ratings by the Federal Government is also a welcomed tailwind. Watsco's contractors have sold higher SEER rated units with ease in the past, and the requirements by the governing bodies overseeing the efficiency ratings may add to Watsco's topline, although management has stated it is too early to predict to what extent.

The company's acquisitions are viewed more as a partnership by management, or perhaps even as a family.⁸² Watsco's acquired companies gain better access to capital, resources, and product expansion in order to grow their businesses in their respective markets. A short search on Glassdoor.com reveals that employees of Watsco's subsidiaries are overall happy about their work conditions, and the culture of the company.⁸³ Most reviews are positive, and further shine light on the benefits of working with Watsco. As aforementioned, Watsco operates on a decentralized basis, leaving the leaders of the local businesses to make decisions they see fit for their market. For this reason, Watsco is careful when searching for additions to their business.

⁸² SEC Filing, WSO 2020 10-K.

⁸³ Glassdoor.com, <https://www.glassdoor.com/Reviews/Watsco-Reviews-E1060.htm>

Management's interests are in-line with the shareholders by way of executive compensation plans geared toward shareholder value, and the management staff's actions. Capital allocation has been intelligent, while the company's shares have continued to compound in value. Management's interest in the company is apparent in the executive's stock ownership - amongst the largest insider ownership of any company in corporate America. The below image shows management's ownership in Watsco, as well as top institutional shareholders.⁸⁴ As mentioned, management must spend their entire careers with Watsco to be fully vested in their shares.

Name and Address of Beneficial Owner (1)	Common stock Beneficially Owned (2)		Class B common stock Beneficially Owned (2)		Combined Percentage of Voting Power
	Shares	Percent	Shares	Percent	
Shareholders owning more than 5% of either class of common stock:					
BlackRock, Inc. (3)	3,452,488	10.5%	—	—	3.8%
The Vanguard Group (4)	3,291,057	10.0%	—	—	3.6%
Baillie Gifford & Co. (5)	1,740,312	5.3%	—	—	1.9%
Directors, Director Nominees and Named Executive Officers:					
Albert H. Nahmad (6)	1,471	*	4,427,594	76.9%	48.9%
Aaron J. Nahmad (7)	2,969	*	235,257	4.1%	2.6%
Barry S. Logan (8)	120,673	*	108,037	1.9%	1.3%
Ana M. Menendez (9)	70,412	*	44,904	*	*
Cesar L. Alvarez (10)	14,667	*	—	—	*
J. Michael Custer (10)	6,667	*	—	—	*
Denise Dickins (11)	32,646	*	—	—	*
Brian E. Keeley (12)	17,539	*	—	—	*
Bob L. Moss (13)	38,367	*	—	—	*
Steven (Slava) Rubin (14)	6,751	*	—	—	*
George P. Sape (15)	17,137	*	—	—	*
All directors, director nominees and named executive officers as a group (11 persons)(16)					
	329,299	1.0%	4,815,792	83.7%	53.6%

We believe that Watsco will continue on its path of being a great business, while providing compound returns for our shareholders for many years to come. For these reasons, and more, we are long term shareholders of Watsco. We look forward to seeing what this great company will do next.

⁸⁴ WSO DEF 14A 04/30/21.

Our Portfolio

The top ten investments in our portfolio as of 1/3/2022, in order of position size, are presented on the following pages. All valuation metrics and returns are as of 1/3/2022 unless otherwise stated. For a relative valuation context, the S&P500 is currently trading at 29.33x trailing and 22.82x forward earnings, respectively – valuations that are at the upper end of the historical spectrum.⁸⁵ The Russell 2000 trades at a forward PE ratio of over 31.14x – also an extremely high value. We believe our portfolio will generate far superior returns than the S&P500 going forward.

The table below gives additional insight into our portfolio exposure. We continue to be dramatically underexposed in technology, communication, financials, utilities, and basic materials, while being overexposed in industrials, and consumer cyclicals. These sector weightings are an outcome of where we currently see opportunities, and not a top-down decision based on macro predictions. We will happily own many technology companies if their valuations become more attractive.

The weight of Technology in the S&P500 has risen over the past year and is at historical highs. If Technology stocks ever perform poorly – watch out below!

Portfolio Statistics as of 1/3/2022 ⁸⁶			
Sector Allocations (Long Exposure, %)			
S&P 500 Sector	Portfolio	S&P 500	Delta
Industrials	28.25	8.13	20.12
Consumer Cyclical	22.17	12.89	9.28
Healthcare	13.15	12.81	0.34
Financial Services	7.92	12.95	(5.03)
Consumer Defensive	8.86	6.04	2.82
Technology	5.49	26.95	(21.46)
Communication Services	5.34	10.36	(5.02)
Real Estate	4.58	2.62	1.96
Energy	4.24	2.70	1.54
Utilities	-	2.35	(2.35)
Basic Materials	-	2.20	(2.20)
Market Cap Allocations (%)			
Large			28.53
Mid			57.78
Small			13.69
Country Allocations (%)			
United States			88.11
Canada			6.54
Denmark			4.47
Singapore			0.88

⁸⁵ <https://www.wsj.com/market-data/stocks/peyields>

⁸⁶ Source: Morningstar, Sentio.

#1 - Domino's Pizza, Inc. (DPZ)

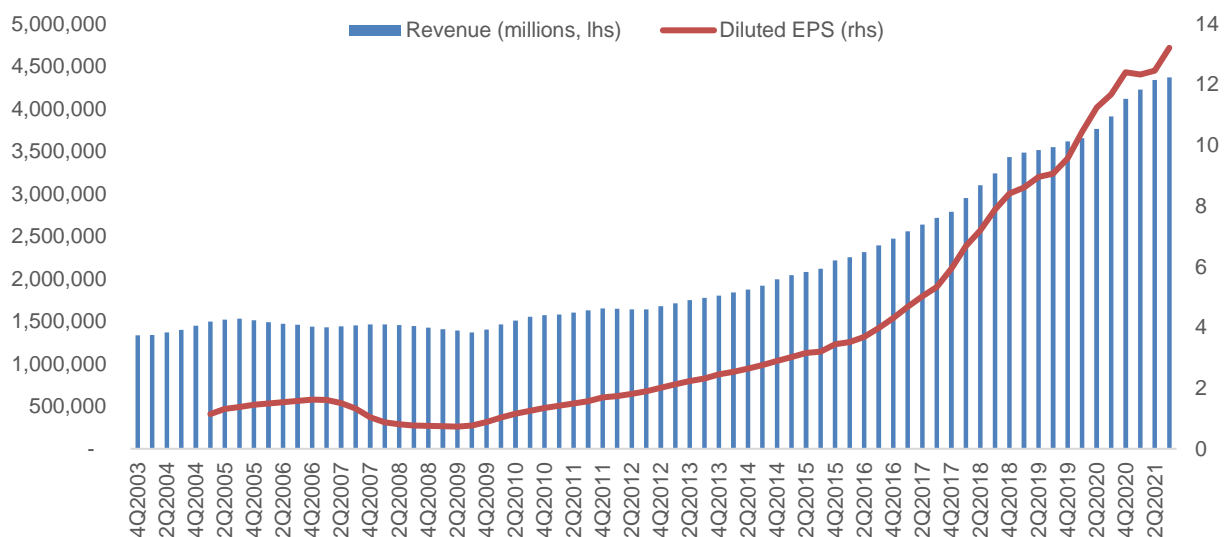
Domino's Pizza is the world's largest franchisor of pizza restaurants with over 13,800 locations in 85 countries. As for any restaurant operator, the key metric to consider for Domino's Pizza is same-store-sales (SSS) growth. Growing same-store-sales are ultimately how a restaurant business increases earnings from its existing assets. The company continues to impress in this criterion with SSS having grown in the U.S. for 40 consecutive quarters, and an astounding 109 straight quarters internationally.



Two-thirds of the company's stores are currently abroad, and the international segment remains the company's largest growth opportunity, as the penetration of convenient fast food remains lower abroad than in the United States. Pizza is a product with exceptionally high gross margins, one that "translates" well across different cultures, and one that literally "travels well", not losing much of its appeal when delivered in a cardboard box. The rise of 3rd party delivery platforms such as Uber Eats, DoorDash and Grubhub is challenging the pizza category as it has expanded the number of choices consumers have for convenient takeout. However, the economics of food delivery remain challenging for most restaurants and platforms alike⁸⁷, while pizza delivery continues to be highly profitable. Regardless of how the "delivery wars" currently playing out end, Domino's financial results show little impact of this increased competition, and the company continues to deliver exceptional financial performance.

Domino's Pizza stock is not optically cheap based on 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.

Select Financial Metrics - Trailing Twelve Months



Shares delivered a total return of +48.39% in 2021.

⁸⁷ DoorDash lost \$312 million in Q4, 2020. Source: DoorDash, 8-K Earnings, Update, 25-Feb-21

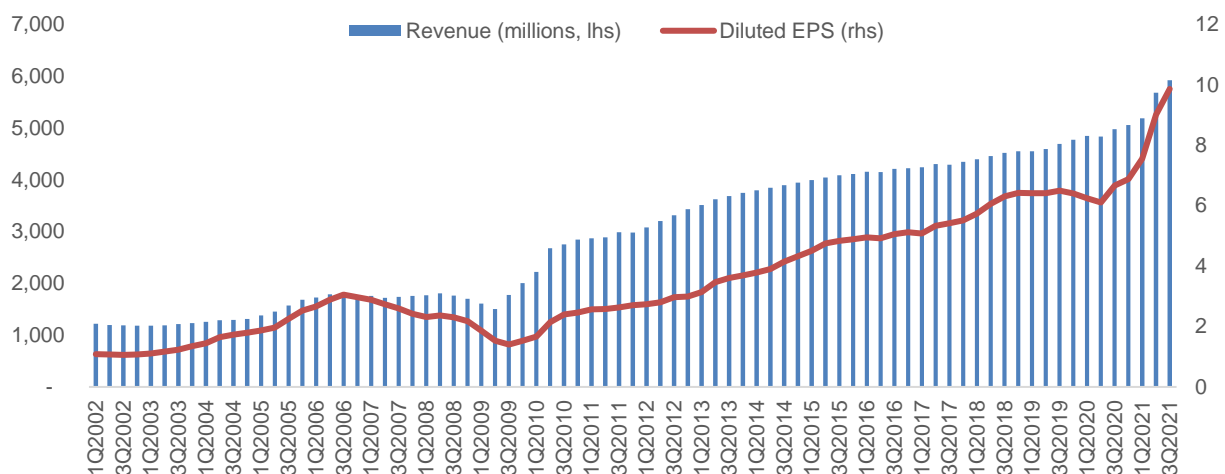
#2 - Watsco Inc. (WSO)

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 most 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 distributor⁸⁸. 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-term focused, something we believe is a real benefit for a company that grows primarily through acquisitions. We believe the shares are attractive at current valuations 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.

Select Financial Metrics - Trailing Twelve Months



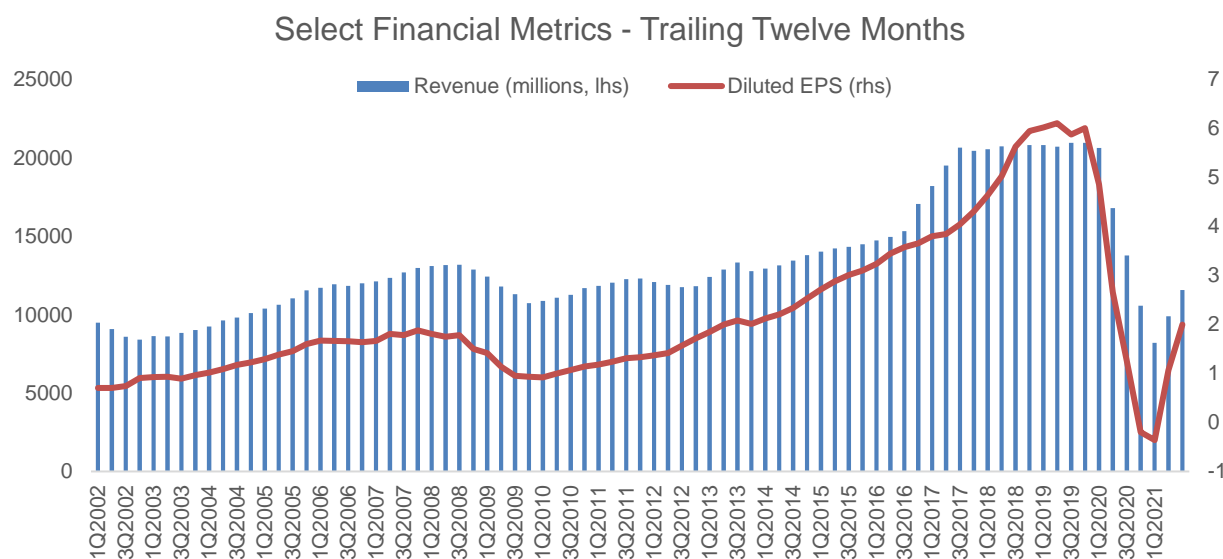
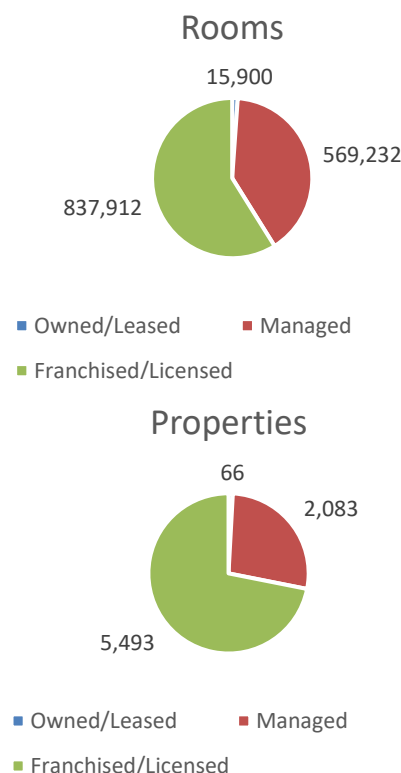
Shares delivered a total return of +42.09% in 2021.

⁸⁸ <https://seekingalpha.com/news/3673106-watsco-to-acquire-temperature-equipment-terms-not-disclosed>

#3 - Marriott International, Inc. (MAR)

Marriott is the world's largest hotel company followed closely by Hilton (HLT) and Intercontinental Hotels Group plc (IHG). The company owns a portfolio of brands from the low end (Courtyard, SpringHill Suites, Aloft), through the mid-tier (Marriott, Sheraton, Westin, Renaissance Hotels), to the luxury high end (JW Marriott, Ritz-Carlton, St. Regis). In total the company had 7,642 properties with over 1.4 million rooms as of the end of Q1 2021.⁸⁹

The majority (85%) of Marriott's revenue comes from hotels in the United States, with the rest almost evenly split between Asia Pacific and Europe. Like its smaller peer, Hilton, the company today is almost exclusively a manager and franchisor of hotels, not a hotel owner. The company owns 66 hotels, manages 2,083 and franchises 5,493. Like all franchise-based businesses Marriott requires very little capital to grow as it utilizes the investment capital of its hotel-owners/partners to expand. Marriott 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 (the company acquired Starwood Properties in late 2016) – 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.



Shares delivered a total return of +25.26% in 2021.

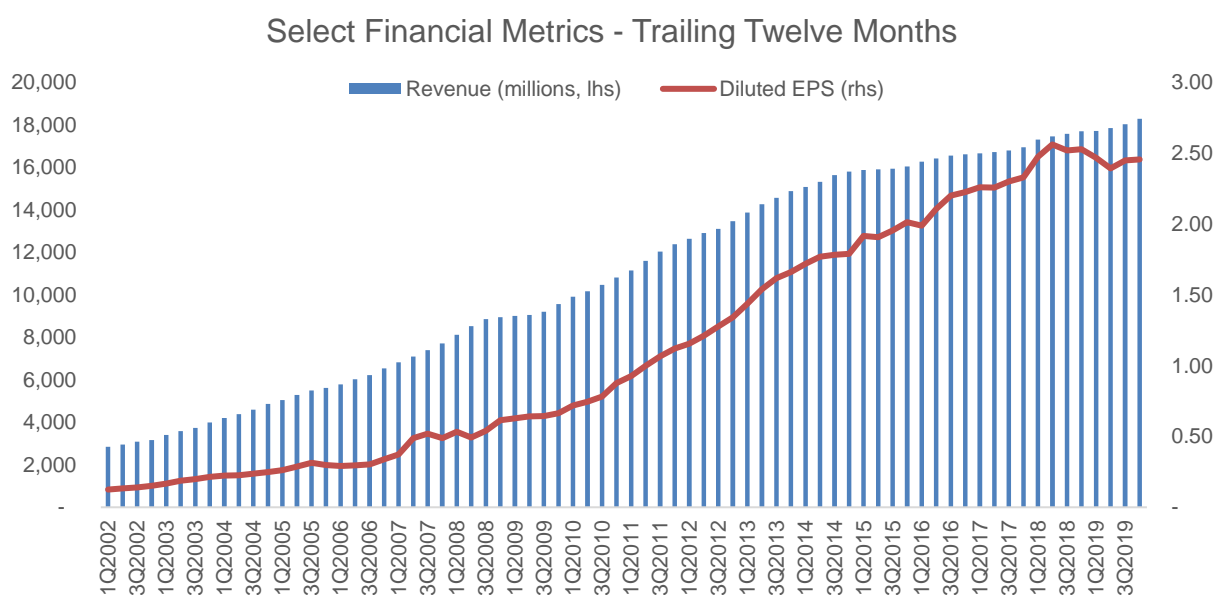
⁸⁹ Source: Marriott, 10-K/A, 02-Apr-21

#4 - 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 alive⁹⁰, 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.



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 22x forward earnings. For a company with an extremely predictable business, high returns on capital, and an easily forecastable future, we believe this to be highly attractive.



Shares delivered a total return of +63.52% in 2021.

⁹⁰ According to the WHO there are 422 million diabetics worldwide. This is estimated to increase to over 570 million by 2030.

#5 - Hexcel Corp. (HXL)

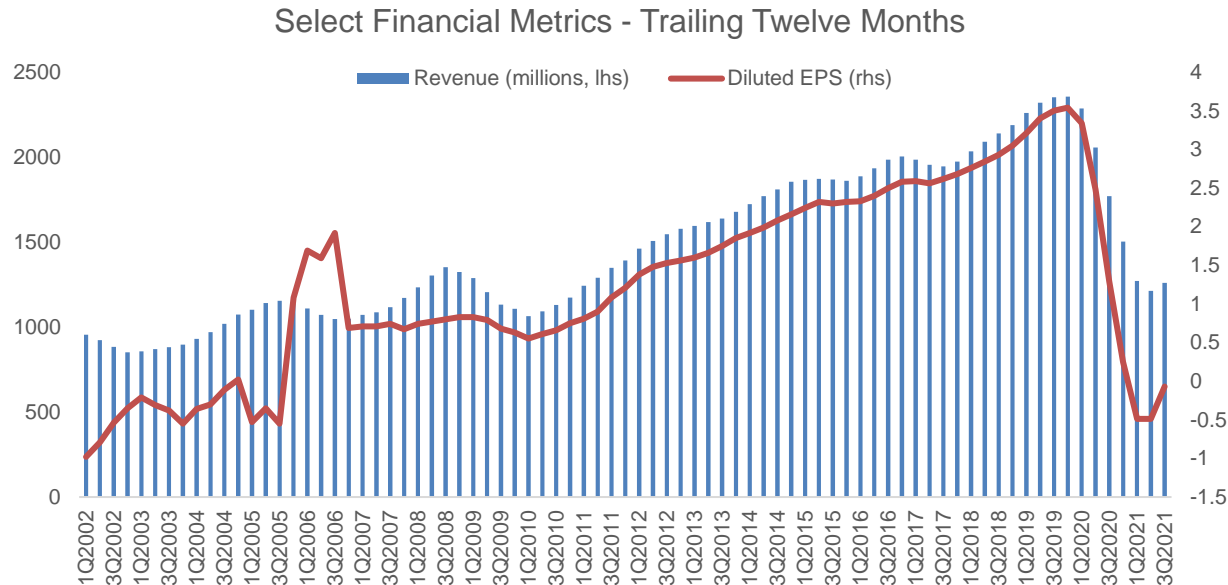
Hexcel manufactures carbon fiber composite materials with the primary end markets being aerospace and defense. The company's stock price was hit heavily last year due to the decline in the aerospace market, but the stock is making an impressive comeback



this year as the outlook for travel and aerospace demand improves. The near-term demand for lightweight, high-performance carbon fiber composites is still 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.

Segment	Share of revenue
Commercial Aerospace	47.60%
Space & Defense	36.00%
Industrial	16.40%

Just as is the case with Marriott, we do not view recent results as meaningful or indicative of a long-term trend, but rather a once in a century aberration due to the Covid-19 pandemic. Once Covid-19 recedes, we expect the demand for more fuel-efficient planes to return rather quickly, powering the demand for the company's light weight carbon composites.



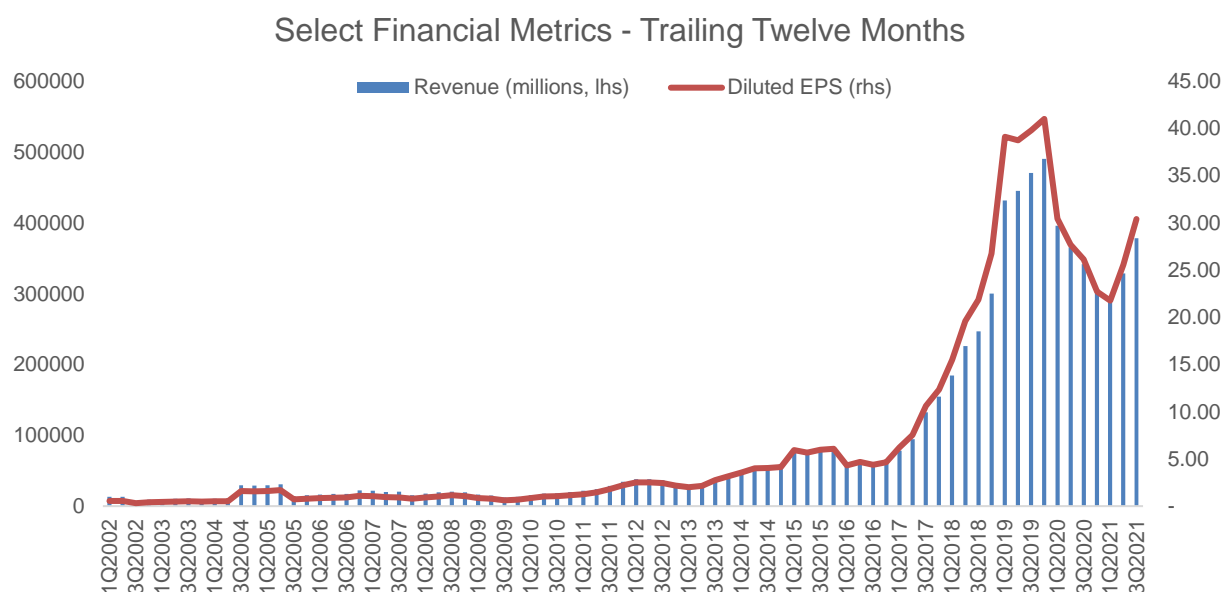
Shares delivered a total return of +6.83% in 2021.

#6 - 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 which 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 low risk of financial distress during periods of low oil prices. The company has no debt, and \$281 million in cash.⁹¹



The company uses most of its cash flows to pay dividends and repurchase shares.



Shares delivered a total return of +73.25% in 2021.

⁹¹ Source: TPL, Investor Presentation March 2021, 02-Mar-21

#7 - Repligen Corporation (RGEN)

Based in Waltham, MA, Repligen makes equipment for the biologic drug manufacturing industry. The company's main products are focus on filtration (48% of revenue), chromatography⁹² (20% of revenue), process

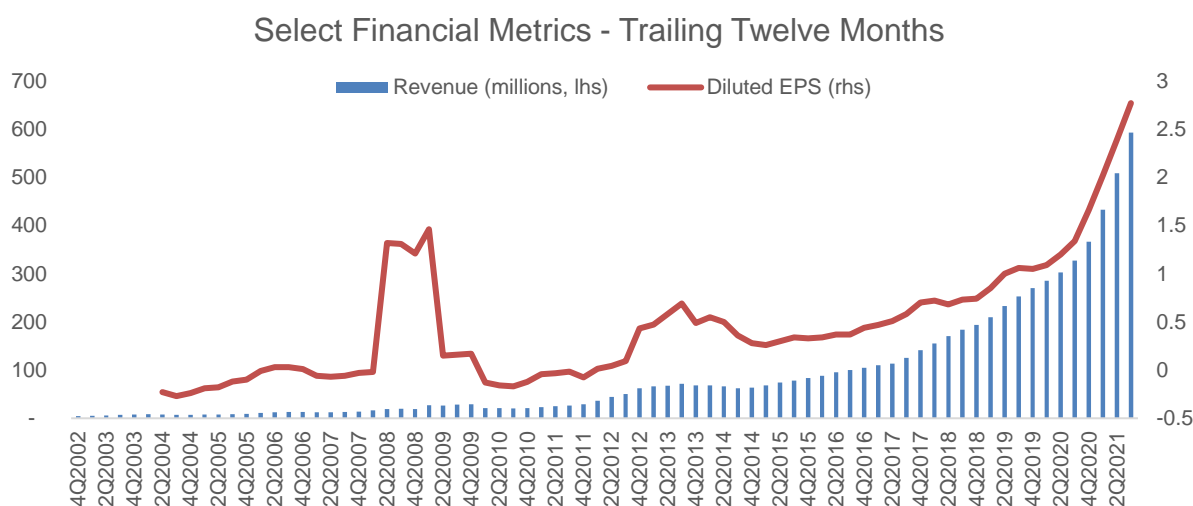


analytics products (9% of revenue), as well as select proteins used in the manufacturing of biological drugs (22%). We believe that biological drugs represent the most exciting frontier of medicine today, with monoclonal antibodies and gene therapy amongst the most promising approaches to tackling rare diseases.

The manufacturing of biological drugs is very different from that of traditional, “small molecule” drugs. Whereas the construction of a traditional line for a traditional small molecule drug might cost as little as \$5 million dollars, the development and scaling of a biological manufacturing line can cost well over \$100 million. Every biological manufacturing process is different, but their common feature is that the active ingredient in the drug is created by living cells and usually consists of a complex protein that is administered to the patient by injection. In the most general of terms the manufacturing of a biological drugs has the following stages:

- Creation and selection of cell culture to produce desired protein.
- Growth and amplification of selected cells – usually in a bioreactor.
- Filtration, purification, and isolation of active ingredient.
- Testing, quality assurance and packaging.

Under CEO Tony Hunt, Repligen has successfully reoriented itself away from selling commoditized inputs to the biological manufacturing process, towards selling specialized proprietary equipment – largely accomplished through M&A. Revenue grew at a CAGR of 22% before Tony joined the company and at 41% since then. Importantly, this growth has not come at the expense of margins or ROIC, which have remained very strong throughout the period.



Shares delivered a total return of +38.2% in 2021.

⁹² <https://www.nist.gov/video/what-chromatography-all-about>

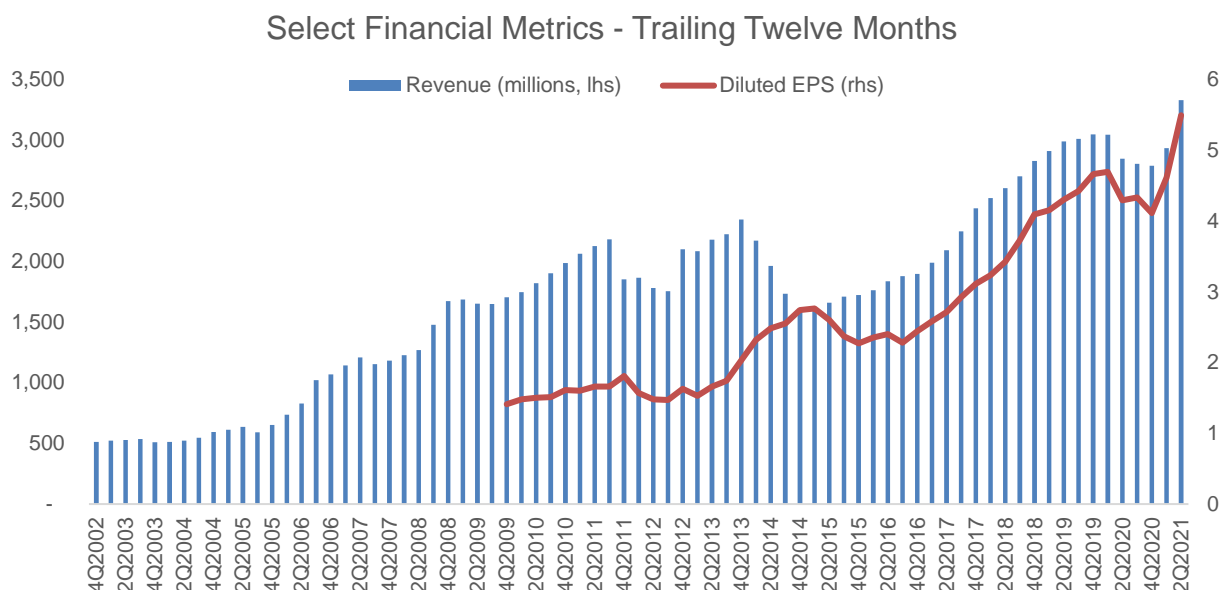
#8 - Colliers International Group Inc. (CIGI)

Colliers International Group is a commercial real estate brokerage and investment management company founded by Jay S. Hennick in 1976 in Toronto, Canada. From humble beginnings the company has grown, primarily through acquisitions, to become one of the five largest commercial real estate brokerages in the world (the others being CBRE, Jones Lang LaSalle, Cushman & Wakefield, and Savills). The company today offers a full range of services and reports in the following segments:



Outsourcing & Advisory (45% of revenue; this includes Engineering & Design services, Valuation services and Property Management), Capital Markets (25% of revenue), Commercial Real Estate Leasing (24% of revenue), and Investment Management (6% of revenue). The company believes that about half of its revenue is recurring in nature. The Investment Management segment deserves special attention, as it is the result of an acquisition of the real estate investment management company Harrison Street in 2018. While the segment contributes the smallest part of revenues, it has a very high margin, contributing over 17% of the company's EBITDA.

Colliers has historically grown by acquisition and we expect it to continue to do so. The real estate services market is highly fragmented outside of North America presenting ample opportunities for Colliers to continue its growth strategy. The company has been a good steward of shareholder capital and spun out FirstService Residential (FSV) in 2014 to maximize the value of that business. This spinout accounts for the drop in revenue in 2014 seen in the chart below.



Shares delivered a total return of +67.02% in 2021.

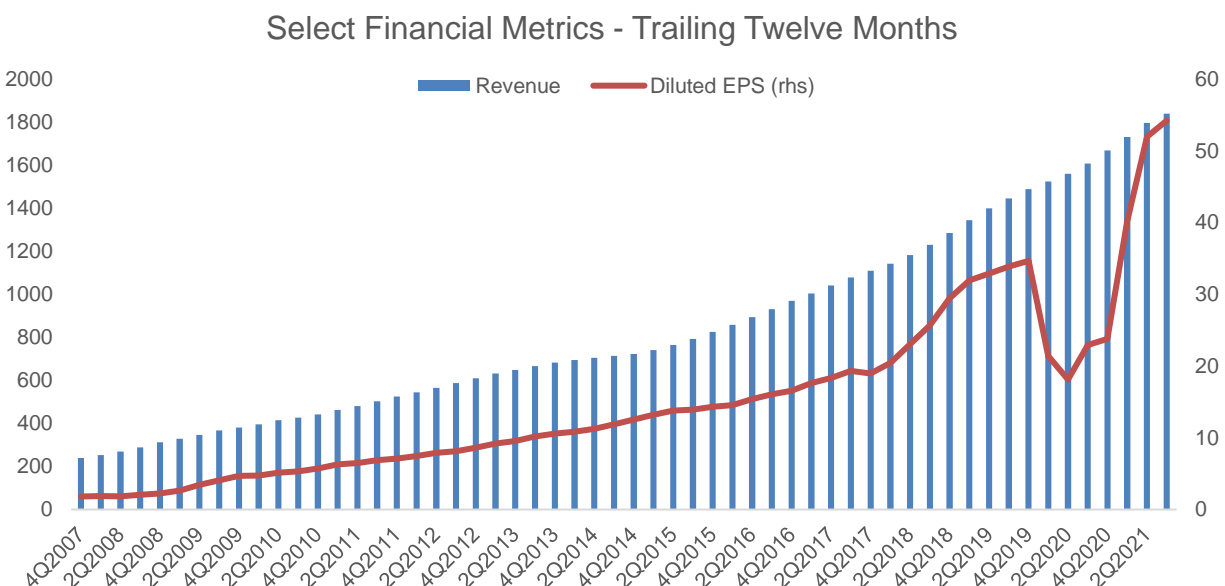
#9 - Credit Acceptance Corp. (CACC)

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 (where many others have failed) and enjoys enviable economics. It turns out that borrowing at 5% and lending at 25% is a profitable business – if you can collect.



The company's high returns on capital and disciplined capital allocation have produced outstanding results for shareholders – over 20% annual returns for over 20 years (we are in rarefied air here). We admire the company for playing the long game and not chasing growth for growth's sake, but rather letting volumes decline in response to increased competition and/or slowing demand. For example, when the company reported a sharp decline in new loan volume in June 2021, the shares promptly fell 10% - a short term price for the discipline the company has shown in not chasing unprofitable growth.

The company remains controversial, operates in a highly regulated environment and is subject to periodic investigations and government fines. Some politicians have advocated banning subprime financing outright.⁹³ 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 delivered a total return of +98.67% in 2021.

⁹³ <https://www.motherjones.com/politics/2016/04/car-subprime-bubble-auto-loans-credit-acceptance-don-foss/>

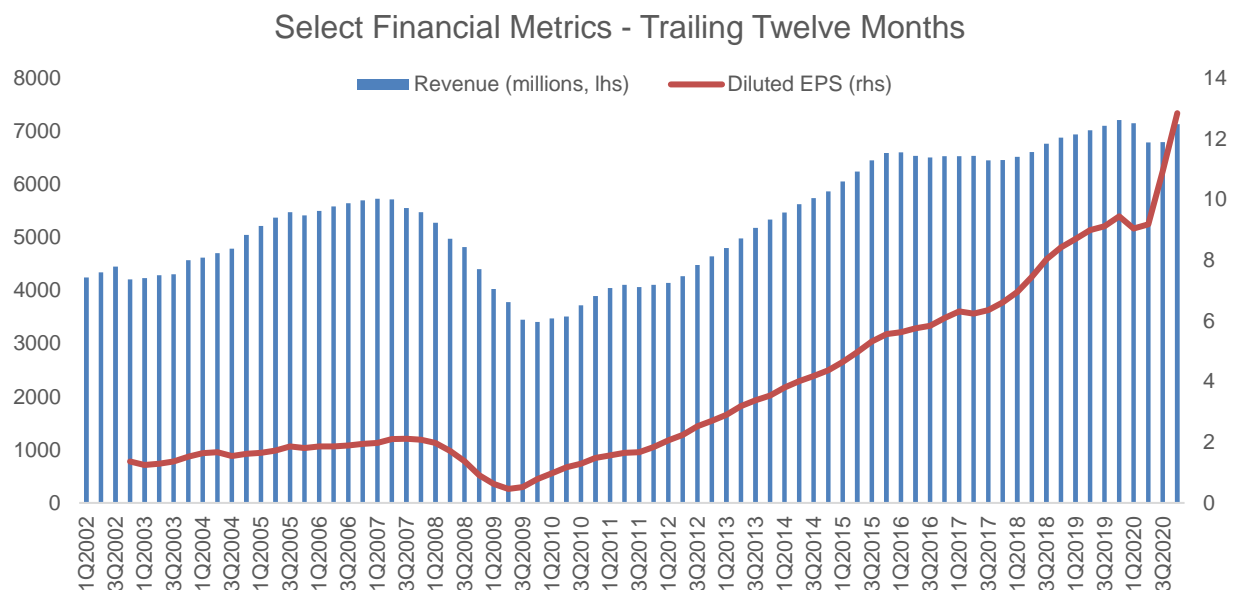
#10 - Asbury Automotive Group, Inc. (ABG)

ASBURY AUTOMOTIVE GROUP

Asbury Automotive Group is one of the largest automotive retailers in the United States. It operates 90 dealerships consisting of 112 franchises and 25 collision repair centers. The company's stores offer new and used vehicles, parts and service, as well as finance and insurance (F&I) products. Franchise agreements controlled by automotive manufactures and state laws create an environment of tightly controlled market entry and restricted competition.

The dealership industry is highly fragmented with 93.5% of dealers having only between 1-5 locations according to data from 2020⁹⁴. In fact, dealers with over 50 locations account for only 0.1% of the industry – a testament to the huge opportunity for consolidation that lies ahead. Industry dynamics, including the rising complexity of automobiles and the need for omnichannel distribution are favoring better capitalized and larger dealer groups. We believe Asbury Automotive Group has several distinct advantages, particularly its highly profitable parts and service business, its overexposure to the luxury vehicle business, which carries the best margins, and its Clicklane omnichannel strategy. Asbury's management has also been acting in the best interests of its shareholders by allocating capital towards acquiring dealerships to aggressively expand its business, and occasionally repurchasing stock when attractive acquisitions targets could not be found.

ABG is not a fast-growing SaaS business, but when paying a valuation of ¼ of the overall stock market, one does not need to make heroic assumptions about the future to enjoy strong returns as shareholders. We believe that over the next several years, Asbury will continue to acquire dealerships, occasionally buyback stock and invest to improve its digital shopping experience. We wrote about Asbury in detail in our August 2021 Investor Letter.⁹⁵



Shares delivered a total return of +18.52% in 2021.

⁹⁴ <https://www.nada.org/WorkArea/DownloadAsset.aspx?id=21474861098>

⁹⁵ <https://www.lrtcapital.com/wp-content/uploads/2021/09/2021-08-August-Investor-Update.pdf>

During the month we reduced our position in AO Smith Corp. (AOS) but we continue to hold shares in the company.

As always, I look forward to hearing from you and answering any questions you might have. Thank you for your continued interest and support.

A handwritten signature in dark ink, appearing to read 'Lukasz Tomicki', with a stylized, cursive script.

Lukasz Tomicki
Portfolio Manager
LRT Capital

Appendix I: Attributions and Holdings as of 12/1/2021

LRT Economic Moat		Portfolio Statistics			
Top Holdings (%)		Sector Allocations (Long Exposure)			
Domino's Pizza, Inc. (DPZ)	6.91	Sector	Portfolio	S&P 500	Delta
Watsco Inc. (WSO)	5.35	Industrials	29.70	8.37	21.33
Marriott International, Inc. (MAR)	5.25	Consumer Cyclical	22.18	12.54	9.64
Novo Nordisk A/S (NVO)	4.92	Healthcare	12.95	13.11	(0.16)
Hexcel Corp. (HXL)	4.52	Financial Services	7.81	13.77	(5.96)
Repligen Corporation (RGEN)	4.23	Consumer Defensive	7.57	6.06	1.51
Texas Pacific Land Trust (TPL)	4.21	Communication Services	5.35	10.83	(5.48)
Colliers International Group Inc. (CIGI)	3.86	Technology	5.12	25.28	(20.16)
AO Smith Corp. (AOS)	3.83	Real Estate	5.12	2.63	2.49
Asbury Automotive Group, Inc. (ABG)	3.52	Energy	4.20	2.85	1.35
Top Holdings Total	46.60	Utilities	-	2.38	(2.38)
		Basic Materials	-	2.18	(2.18)
Hedges (%)		Market Cap Allocations (%)			
Vanguard Mid-Cap ETF (VO)	-11.58	Large			27.09
Vanguard Small-Cap ETF (VB)	-10.54	Mid			60.53
iShares Core S&P Mid-Cap (IJH)	-10.22	Small			12.39
SPDR S&P MidCap 400 ETF (MDY)	-10.21				
iShares Russell 2000 (IWM)	-9.90				
iShares Core S&P Small-Cap (IJR)	-9.54				
Return Attribution (%)		Country Allocations (%)			
Long Equity	3.32	United States			86.80
Hedges	-0.16	Canada			7.22
Unlevered Gross Return	3.16	Denmark			4.92
Leveraged Gross Return	7.90	Singapore			1.06
Net Return	6.54				

Source: Morningstar, Sentieo.

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 36 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.

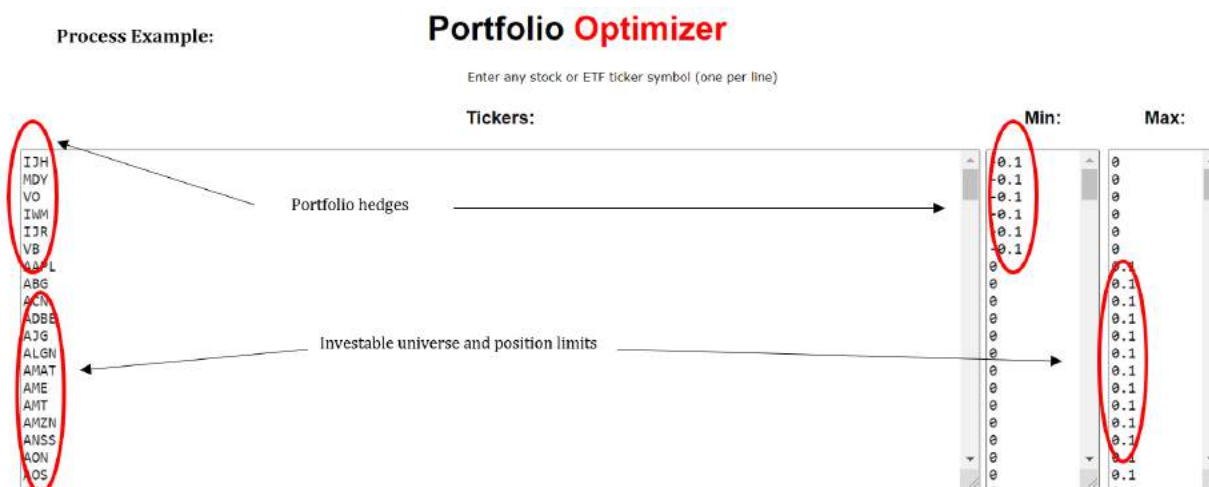
In the long run, stocks are the best investment asset class, but our experience has taught us that our investment process will not generate linear returns. In some years, our portfolio will outperform, and in others, it will generate a below average return. This is a certainty that we must accept. We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

Appendix III: Portfolio Construction Software Overview

LRT separates the discretionary and qualitative **process** of selecting the equity holdings from the portfolio construction **process** which is **systematic** and **quantitative**.



Our quantitative process considers each position's contribution to portfolio volatility, contribution of idiosyncratic vs. systematic risk and portfolio factor (size, value, quality, momentum, vol, etc.) exposures.

The system outputs target portfolio weighs for each position. We trade mechanically to rebalance the portfolio each month to the targeted exposures. This eliminates emotions, human biases and overconfidence risk.

Example system output:

Date	ABG	ALGN	AMT	ANZN	AON	AOS	AVGO	AXON	AZO	AZPN	BA	BAH	BF-B	BKI	BKNG	BL	BRO	CACC	CCI	CDLX	CONS	CONX	CHE	CHTR	CEGI	CHS	CHS	CNE	COST	COUP	CP	CSGP	CSWI	CSX	DG
2019-1-01	2.51%																																		
2019-2-01	2.84%																																		
2019-3-01	3.23%																																		
2019-4-01	3.11%																																		
2019-5-01	3.2%																																		
2019-6-01	3.39%																																		
2019-7-01	3.09%																																		
2019-8-01	3.09%																																		
2019-9-01	3.55%																																		
2019-10-01	4.31%	0.21%																																	
2019-11-01	3.49%	0.35%																																	
2019-12-01	3.27%	0.61%																																	
2020-1-01	3.42%	0.74%																																	
2020-2-01	3.07%	0.74%																																	
2020-3-01	3.59%	0.89%																																	
2020-4-01	3.28%	0.97%																																	
2020-5-01	2.19%	0.33%																																	
2020-6-01	2.43%	0.27%																																	
2020-7-01	2.07%	0.36%																																	
2020-8-01	2.26%	0.31%																																	
2020-9-01	2.63%																																		
2020-10-01	2.39%																																		
2020-11-01	2.64%	1.67%																																	
2020-12-01	3.58%	1.39%																																	
2021-1-01	5.1%	0.95%																																	
2021-2-01	5.22%	0.94%																																	
2021-3-01	7.7%	0.68%																																	
2021-4-01	7%	0.75%																																	
2021-5-01	7.1%	0.93%	0.12%																																
2021-6-01	8.4%	0.92%																																	
2021-7-01	5.41%	1.73%	0.4%																																
2021-7-14	5.27%	1.72%	0.15%																																

Position weights over time

Rebalancing dates, and current date target allocation (7/14/2021 in this example).

Disclaimer and Contact Information

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