SEPTEMBER 30, 2022

INVESTMENT REPORT
3Q 2022

CT CAPITAL LLC

INTRODUCTION AND SUMMARY

Sustained and real growth in free cash flow, stability in key metrics above benchmark, and above-average credit **will always lead to superior returns**. It is here the firm has possession of the necessary material (cash and credit) to grow capital under which future additional free cash flows are born.

The research tells us over shorter periods, financial instruments carrying greater risk are the "first responders:" to negative financial developments from the fear of bankruptcy and later, of a (perceived) turn towards positive momentum associated with a positive cash-based return on capital. Our firms, as seen this past quarter, may not be first on investors' minds where the future of their investments lies, yet the large daily swings in indexes are proof-positive massive bets in both directions were taking place**.**

We believe in the solace shown in the prior quarter results of large outperformance over each time period, a function of our superior cost of capital, a wide-ranging analysis of risks to future cash flows.

Your account is significantly undervalued, both on a strategic and financial basis. Many positions have reached levels making them ideally suited for a financial buyer, from Aptiv (APTV) to Qualcomm (QCOM), firms with large backlogs and years of positive real growth in free cash flows ahead.

While many of our holdings declined in value, we used the opportunity to continue to reduce our healthcare weighting given increased political risk (cost of capital) and increased our positions in our hydrogen and industrial technology, industrial and services names.

Contrary to their ability to produce higher-than-benchmark returns, our technology investments saw negative 90-day results. **Many holdings reported results above internal estimates yet still saw their share prices fall, meaning it's time to go on to the next quarter**.

***With the industrialized world in a synchronous economic slowdown, rest assured that your portfolio will always be of substantially higher credit than the S&P 500 or the Russell 1000 Value. To wit, the cash interest coverage for our portfolio (adjusting for aberrations, classification error, and adjustments to working capital) is estimated at 18.5 vs. 13.5 for that index*.**

In our modeling, firms with higher stability metrics can have relatively lower cash interest coverage in relation to growth in adjusted cash flows from operations.

On a macroeconomic level, it has been forecasted that the US will be the world's only country to see its population grow by 100M or more by the end of the current century. India is slowly and currently replacing China in investment importance given its 1.4B and growing population, while China is undergoing a population contraction (a fact that we believe not enough investors are focusing on).

By 2027, China will be on its way to population attrition and a possible debt crisis. Firms like Apple will need suppliers to take a large load off Foxconn and others along the supply chain, which will prove a challenging and complex assignment.

For Apple, which was a large contributor to our underperformance[1], now finds itself in a precarious valuation underpinning given forthcoming issues in China. **With 81% of its valuation derived from inflation-adjusted free cash flows five years and out, investors appear to be ignoring the road ahead.**

MANY POSITIVE EVENTS TOOK PLACE

The 2017 tax reform significantly changed the rules regarding the deduction of business interest expense. However, under the Act, the limitation of the expense deduction now reverts to 30% of "adjusted taxable income" from 50%. At the same time, we also see the deduction further removed thru the use of EBIT from EBITDA. **The changes should drift investors to our higher credit holdings**.

It was just an odd quarter, characterized by ultra-large swings, a stock that needed to be sold on litigation risk (MMM), and a firm making a value-destructive deal (Open Text). **Nothing in either MMM's or Open Text's history suggested those possibilities.** Even though the MMM litigation was well-known going into the purchase, the potential size and judge's ruling, given past decisions, were not captured in our cost of equity. Though we expect the case will be settled, a long wait was inconsistent with the philosophy of our practice.

Taking a longer-term perspective, **with worldwide growth at the tip of a long runway below trend, we should find investors gravitating to our holdings, given differential credit, stability, and cash flows**.

If investors had 100% perfect foresight for every component capable of influencing share price until infinity, stocks would always trade at fair value. Once risk regarding any metric is introduced, stocks will reflect an imbalance of opinion—from those having inside information to those relying on tv analysts, hunches, and internet hucksters having large followings.

Therefore, firms with lower cost of equity will generally be associated with superior returns as several economic cycles are introduced. There have been individual cycles that poor credits having unstable cash flows have outperformed.

INFLATIONAL COMPONENTS INFLUENCING VALUATION

Our models undergo numerous inflationary adjustments to *singular* revenues and costs, and, finally, to real free cash flows. **At CT Capital, we direct individual inflation rates to as many cost and revenue items as the data allows so as not to obscure the sources of cash flow, valuation, and areas of potential cash improvement**.

> *Example*
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> *For former portfolio holding and apparel manufacturers like Ralph Lauren, cotton and transportation costs have often moved in diverse directions.*
>
> *All firms have many inflationary layers included in financial (tax, derivatives, currency, etc.), operational (cost of goods, transportation, labor, healthcare, benefits, productivity), and investment (business combinations, cash reinvestment, etc.) sections.*

General inflation has come down, but not so for many firms. Meanwhile, COVID in China, change to tax codes, weather, port strikes, supply chain bottlenecks, and other factors such as labor expense continue to weigh heavily on many firms.

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[1] Apple's weighting in the S&P of 7.2%, not vastly different than the bottom 200 stocks combined.

The inflationary period will impact company reporting—including impairments, leases, and deferred tax accounts. If an impairment charge is recognized for tax-deductible goodwill resulting from the higher discount rate, there could also be an impairment to the deferred tax asset account.

The Fed cannot bring down a permanent structural rise in inflation. While they can force an interest rate decline via recession, inflation will only pop up when the central bank re-loosens policies. Reductions in structural inflation can only be brought about by reversing that or those condition(s) responsible, such as an end to the Russia/Ukraine conflict, new energy sources, additional suppliers of battery and semi-components, manufacturing, and assembly.

We use BLS data[2] for the supplier and revenue components, with a normalization weighting to reflect importance.

The influence of inflation on cost of equity can be particularly pronounced, as fair value often declines by 20% or more for firms with weak credit given a 1% rise to the cost of equity, the latter in part a function of the inflation rate. We believe our firms can overcome the inflation drag, including the tax effect, via operations and pricing.

We have written both energy and labor are contained in all CPI segments, in essence, a subcomponent of costs to hit the P&L with a lag, a factor to be with us for some time.[3] So while wags wrote the energy component dropped last month, they failed to recognize its spillover to other areas.

The inflation rate holds paramount importance to us in setting fair value. As you know from our reports, it is the real rate of unit growth, free cash flow, return on capital, etc., that holds the valuation key, for if the rate of inflation exceeds the change in nominal free cash flows, share multiples drop. Unit growth must be adjusted for the inflation rate of the component under review. To do otherwise would result in analyst error in fair value estimates.

Inflation may be overcome by a greater rise in tax-adjusted real free cash flows and/or a reduction in cost of capital. Firms with annual reliance on the capital markets can overcome an inflationary impact by their ability to pass on costs, boosting productivity, credit enhancements, balance sheet management, and increase in stability metrics.

Over time, our inflation-adjusted metrics correlate much higher than reported (GAAP) income or simple but commonly used definitions of free cash flow.

Example:

Tyson Foods, Inc. was squeezed by across-the-board food cost pricing pressures. As with all our holdings, Tyson benefits from its more than adequate bank and commercial paper facilities to service coming five-year maturities. Their cost of sales also revealed losses in derivative hedges. Yet, COGS would have been higher had they not benefitted from insurance proceeds. Our adjustments normalized for the food price cost increase.

Example:

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[2] The location, https://download.bls.gov/pub/time.series/pc/, provides index levels for all PPI Industry indexes in text format. If you calculate the percent change between two indexes levels, the result will be the inflation rate for the interval associated with those index levels. Please note, the data in these files designated M13, represent the annual average for the given year.

[3] Though the jump in energy prices is still working its way back into margins, there is a glimmer of hope given the upswing in the rig count. See https://bakerhughesrigcount.gcs-web.com/na-rig-count

The release of July CPI of "just" 8.5% when 10-year treasury was yielding 2.72% hid the actual rate increase many sectors were seeing.

Our worksheets adjust values to reflect normalized cycles and organizational efforts to regain margin footholds through price and cost adjustments, productivity measures, and employment of optimum cash management.

IMPAIRMENTS – A CT CAPITAL ADVANTAGE

Impairment occurs when fair value is below amortized cost. Some business decisions, including the sale of assets, could well result in an impairment charge.

Our cash-based return on capital model is excellent at catching future impairment charges under GAAP, especially as **one of the tests in the Standard is a drop of total firm market value below book. We concern ourselves with impairments likely to reduce cash flows, as most impairments are recorded as non-cash GAAP events. The impact on future cash flows is to be determined.**

Impairments may also lead to covenant violations due to cash flows or collateral impacts.

You recall the worldwide credit crisis was exacerbated by FAS 157 and its fair value provision, which forced firms to mark inactive securities to market. This was later replaced with other conditions, including the income approach used by our firms with no need to sell portfolio holdings to supplant cash and whose portfolio consists of non-active fixed income instruments. Assets for sale are shown in OCI (other comprehensive income), and currently show, for our portfolio, no deviation from normal.

Though the impairment-related Standard calls for an annual review, a change to interim reporting may be called for, especially for firms with inflated inventory and goodwill, the latter **which may not be amortized or deducted for tax purposes. Impairments are normally set at the individual unit level.**

Taxable M&A goodwill may result in tax-deductibility and needs to be studied, including the impact on future taxation.

Our cash flow-based models already incorporate fair asset values into our value estimate. Assets reported below their ability to produce cash are thus late to the game. The same is true for assets such as PP&E, which may be near the end of their useful life for accounting purposes yet are fully capable of producing goods for years to come.

The Inflation Reduction Act may prove to be the most important new legislation impacting cash flows and valuation, requiring a comprehensive understanding of firm accounting (both global and domestic) and actual cash tax. Tax credits and incentives have sway over taxes due otherwise.

The alternative tax provision for a minimum 15% based on a firm's book income must be evaluated in conjunction with the many offsets;[4] as far as the 1% tax on buybacks is concerned, it is of minor influence, and could be overcome if the firm is to issue stock or to repurchase other securities. CT Capital has the abilities necessary to dissect the data in an appropriate form, which is then plugged into our valuation models.

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[4] In this provision the Act generally establishes the 15% tax liability for firms having a $1B average annual adjusted financial statement income. It is an alternative minimum tax to the extent that its "tentative minimum tax" exceeds its regular US federal income tax liability plus its liability for the base erosion anti-abuse tax (BEAT). Impacted firms do receive a credit against future liability.

Free cash flow estimates require getting the fingernails dirty and normalizing results, transactions, accruals, and estimates within the line entries, **and, later, tax credits**. **Most analysts use simplistically lazy models**.

DEAL STOCKS HOLDINGS

When a firm enters into a questionable acquisition, as did Open Text this past quarter, resulting in a hit to its valuation multiple and our investment performance, we re-evaluate, based on the new lower valuation, together with executives' plan for credit re-establishment and the updated financial structure and projected free cash flows. The result is a test of the appropriateness of the holding.

Our firms remain considerably more active on deals than benchmark, given their ability to generate surplus cash.

CVS' purchase of home-health provider Signify became very slightly accretive on our ROI model given the cash-based deal structure as opposed to one which would have been more costly had equity issuance been used. The deal enhances CVS' long-term stability metrics.

Unfortunately, some critical issues required to have more precise estimates were not addressed by CVS, including how **certain stock options with time-based vesting will be handled**, taxes, and others.

CVS management can be expected to continue its aggressive expansion into that of a total healthcare company, already owning Aetna, MinuteClinic, Caremark, and other specialty lines. CVS shares did rebound late in the quarter, only to fall back again as the general equity market plopped.

HYDROGEN VERY LIKELY TO PROVIDE A GOOD BOOST TO FUTURE RETURNS

Hydrogen as an energy source is a sector sure to capture significant future returns for our portfolios in the years ahead.

Recently, the head of BMW said hydrogen is "the only raw material that can be sustainably produced and stored." The company has successfully tested hydrogen fuel cells in extreme cold, intending to place hydrogen into passenger cars

And the EPA is looking to put in more rigid emissions rules for heavy trucks, with hydrogen the obvious replacement.

Hydrogen is now a fuel being widely adopted by various industries as a clean and plentiful energy source while eliminating sovereign risks. **Not a week goes by that we fail to see another large order by a firm for hydrogen-based trains, buses, airplanes, building operations such as forklifts and power, data centers, etc**.

This quarter, large leasing and sales company, Enterprise Leasing, entered a letter of intent to purchase Cummins' (a CT Capital holding) 15-liter hydrogen internal combustion engines when available. Additionally, Werner Enterprises signed a letter of intent to purchase 500 Cummins' 15-liter hydrogen internal combustion engines upon availability.

Air Products (a CT Capital holding) and Associated British Ports announced their intention to partner in bringing the first large-scale, green hydrogen production facility to the UK. They also announced a second large hydrogen liquefaction plant in the Netherlands, confirming the EU's rabid interest in hydrogen.

Linde (a CT Capital holding) announced a doubling of its green hydrogen in the US using hydroelectric power.

Amazon (a CT Capital holding) announced it will buy 10,950 tons of green hydrogen annually for its transportation and building operations starting in 2025.

Among other related announcements, Air Liquide (a CT Capital holding) and Siemens Energy announced the creation of a joint venture dedicated to producing industrial-scale renewable hydrogen electrolyzers in Europe.

In this past quarter we added to all these names with their decline in price and are increased confidence in their future.

Kenneth S. Hackel, CFA

Eli C. Hackel, CFA