



July 12, 2022

To Our Clients and Friends:

For the second quarter of 2022, Giverny Capital Asset Management's model portfolio, which is a Poppe family account, declined by 18.48%, net of fees,¹ vs. a decline of 16.10% for the Standard & Poor's 500 Index.² For the year-to-date, the GCAM model generated a return of -25.17% vs. -19.96% for the Index, also net of fees. Our firm has been in business for nine quarters and has generated annualized performance of 17.02%, net of fees, vs. 20.35% for the Index since our inception.

There is so much happening in the country and world right now, much of it alarming, and I'm modest about my ability to add much to your understanding of the times we are in. However, I can say one thing with confidence that I suspect you are not hearing elsewhere: for stock market investors, long-term earnings health is the only consideration that matters. What I am focused on, always, is the quality of earnings today and the prospect of higher earnings tomorrow.

On that score, I feel better about our portfolio than I do when I look at stock prices.

Reduced to a math equation, a stock price represents the estimated net present value of all the future income streams generated by a business. If the business is going to generate a lot of income in the future, the stock price should be high. If the business faces obsolescence, or is managed by dingbats, or participates in a sharply competitive industry, the price shouldn't be very high, relative to current earnings. And if nobody really knows what the future will look like, then stock prices might ricochet around like pinballs in an arcade game.

Importantly, over short periods of time the market often provides unreliable feedback – the pinballs just fly around. Not infrequently, the market takes a shine to businesses that have poor long-term earnings prospects or detests businesses with great prospects. This doesn't last, but it doesn't quickly disappear either.

Knowing this, the most useful thing I can do is focus on earnings and earnings power rather than the scoreboard. Is our portfolio company thriving today and at the same time being managed to enhance earnings power tomorrow? Does it enjoy competitive advantages in a growing industry? Can it deploy

¹ The family account does not pay a management fee. The returns presented herein assume the deduction of an annual management fee of 1% to show what a client account's performance would have been if it had been invested the same as the family account during the period. Past performance is not necessarily indicative of future results.

² The S&P 500 Index returns include the reinvestment of dividends and other earnings. The Index is an unmanaged, capitalization-weighted index of common stocks of 500 major US corporations. The Index does not incur expenses and is not available for investment.

capital at high rates of return within its own business? What about geopolitics? Current events matter to the extent they may impair long-term earnings power. But history shows geopolitical events rarely have long-term impacts on earnings power or stock prices.

What current events do, however, is frighten people. They can massively influence short-term stock prices. Right now, the price of oil is high and almost everything else is down dramatically. Do I believe that over the coming decade, demand for oil will be so strong (and supply so short) that energy investments will perform better than all others? Meanwhile, demand for everything else will be weak, such that earnings growth outside of energy will be paltry? I don't have deep thoughts about this other than: no.

In fact, my experience is that commodity-related businesses, in general, have shallow moats around their castles. We aim to own companies with deeper moats.

I sat through a thoughtful presentation by a stock-market strategist a few weeks ago. He is profoundly pessimistic about the future. Afterward, I mentioned this presentation to a friend who knows the strategist well. The friend said, "Yeah, he's been giving that presentation for 20 years." For the record, the market is up a fair amount over the past 20 years.

There is a lot to be worried about right now. Sadly, that is often the case. I try to listen to people who can help me understand our portfolio. At a conference in Chicago in June, an executive from our holding MasterCard said that, thanks to a strong job market and pandemic-relief payments, most US households have stronger balance sheets and spending capacity than three years ago; they are spending on experiences, restaurants, travel and shows. Said the executive: "Consumer spending is holding up, notwithstanding the war and social issues that are all around us." In May, MasterCard saw 10% spending growth in every merchant category except airlines, and virtually every merchant category today is higher than pre-pandemic. And airline travel figures to rebound to pre-pandemic levels over the summer.

An executive from Live Nation, which operates the Ticketmaster event ticketing service and owns more than 300 concert venues, said the demand for concerts across all genres and price points is so extraordinary that it can't price tickets high enough to put a dent in the secondary market. That is, ticket scalping is more profitable than ever. Sure, retorted an investor, but this is all about wealthy people paying premiums to see their favorite performers after being cooped up at home for two years. No, responded the executive, demand for shows at clubs and festivals at \$25 and \$35 ticket prices is off the charts. Young people have income, in other words. (Note: Live Nation is not a GCAM holding).

When I visited with Arista Networks, a large GCAM holding that supplies routers, switches and other hardware to Cloud computing networks and giant data centers, the company insisted that demand is strong. Arista itself has procurement orders in place equivalent to more than 3x the amount of inventory it consumed last year. In fact, it's scrambling to source enough component parts to fill orders.

I saw several companies exposed to homebuilding and outdoor living. Their businesses are slowing after a pandemic-fueled boom, but most said demand for homes remains above supply. Higher interest rates are causing people to pull back, but that is a different phenomenon from lack of wage income causing people to lose interest in new homes.

At the same conference, I heard from many more executives who see reasonable levels of demand. Many worried more about supply-chain disruption than about orders.

It's fair to wonder if the economy has weakened just in the few weeks since I spoke to those businesses. Recession may be here already, but the level of all-out panic that has led to enormous declines for most stocks outside of energy production seems to have priced that risk in. By some measures, consumer sentiment is at historically low levels, similar to the bottom of the Great Financial Crisis. Yet we have nearly full employment, healthy consumer balance sheets and reasonable demand across most economic sectors.

For sure, rapidly rising interest rates coupled with spiking gasoline prices are causing the economy to slow in real time. Demand is softening and we likely will see downward earnings revisions as second-quarter results come out in the weeks ahead. But I feel confident in the competitive position and long-term earnings power of our portfolio.

On June 30, GCAM owned 26 stocks. Over the five-year period ended March 31, 2022, 23 of those 26 companies had grown their earnings per share at a rate equal to or higher than the S&P 500 Index, per FactSet Research.

S&P earnings over that five-year period compounded at 13%, which is excellent. In the GCAM portfolio, 10 of our 26 holdings compounded their earnings by more than 25% over the past five years. Only one company, II-VI Inc. (8%), compounded its earnings by less than 10% annually. We bought II-VI last year in the belief that its long-term earnings trajectory is likely to inflect upwards in the years ahead. A second holding, M&T Bank, compounded earnings at 10% over the past five years, while Progressive Corp. grew its earnings by 12% annually, barely below the Index.

Over the past five years, current GCAM holdings Alphabet, Arista Networks, Credit Acceptance Corp., Ciena Corp., Eurofins Scientific, Five Below, Floor & Décor, Installed Building Products, Meta Platforms and SS&C all grew earnings per share by at least 25% annually, while MasterCard and Intercontinental Exchange grew above 20%.

The past is not prologue; because our companies have been good performers in the past does not mean they will continue to be. But history is on our side. As I have noted in prior letters, if we use Wall Street analysts' consensus estimates of future earnings, the analysts expect our portfolio's earnings growth rate to exceed the S&P 500 over the next three years. As do I.

I made a handful of trades during the quarter, trying to take advantage of lower stock prices to strengthen the overall quality of the portfolio. I exited two stocks, B&M European Value Retail and Liberty Broadband, and lightly trimmed Progressive Corp. I used the proceeds to initiate three new positions: Ashtead Group, Analog Devices and Floor & Décor.

I think what I did here is exit two good businesses to buy three better ones. B&M is a value retailer in the UK and France, with a proposition not unlike Dollar General in the US. The business is managed well by the Arora family, but we were put off by the surprise announcement that 52-year-old CEO Simon Arora intends to step down. This, after he sold a big portion of his holdings.

Liberty Broadband is a holding company whose primary asset is shares in the cable and broadband Internet service provider Charter. I like the Charter business – broadband internet service is essentially an unregulated utility – and it hurt to sell Liberty at what feels like a depressed price. But Charter grows modestly and uses debt to boost its returns to shareholders. Specifically, it borrows heavily to finance a large stock buyback. If the economy were to deteriorate for a long time – which is not necessarily what I

expect to happen – that debt could become a burden. I believe the businesses I bought will have better organic growth and be less reliant on financial engineering than Charter/Liberty Broadband.

We trimmed Progressive modestly as it reached a 7% portfolio weight. Progressive was our second-largest holding at quarter-end and will continue to be a core position.

As for our purchases, I've followed all three companies for some time and believe we bought exceptional franchises at attractive prices.

Although Ashtead is an equipment rental provider headquartered in the UK, it generates about 90% of revenue and earnings from its chain of US stores called Sunbelt. It rents construction equipment, but also specialty gear like portable air conditioning systems, stages, scaffolding, pumps and lighting to a diverse group of customers. Fifteen years ago, Ashtead was tied to the health of construction markets. Today, it derives less than half of its revenue from construction. On top of that, Ashtead and chief rival United Rentals have consolidated the market over time. They are now the most important customers for many equipment manufacturers and procure gear for less than smaller competitors. Ashtead also tends to achieve high utilization rates, meaning it pays less for fleet and then has that gear out on rental more days per month. This leads to superior returns on investment.

Ashtead says rental revenue growth should be at least 12% this year as commercial construction, infrastructure, maintenance and repair and special events customers are all growing. The stock trades for roughly 12x earnings, which strikes us as far too low for a company generating 25% returns on equity and long-term earnings growth above 15%. We paid roughly £38 (~\$48) for our shares.

Analog Devices is one of two globally dominant providers of analog semiconductor chips (Texas Instruments is the other). These low-cost chips are the lifeblood of nearly all the electronics we use, from conventional and electric cars to PCs to appliances to industrial equipment. ADI sells 75,000 different chips, most of them costing less than \$1. It employs more than 10,000 engineers and spends \$1.7 billion a year on research & development but does not rely on a single line of products for its revenue. The business is extremely sticky, as analog chips tend to be designed into products and never replaced. About half of ADI's revenue comes from products more than 10 years old. It would be very tough for a new entrant to succeed here, as there is no one dominant customer segment, the products are very low cost yet require R&D and engineering know-how, and there is no incentive to replace an inexpensive chip that works.

ADI recently guided to earnings per share doubling over the next five years, to \$15, roughly a mid-teens growth rate. The growth of electric cars, 5G wireless networks, industrial automation equipment and power storage all will require more analog chips. ADI continues to tell investors that it has more orders than it can supply. We paid \$162 for shares.

My partner Francois Rochon wrote in his 2020 annual letter that not buying Floor & Décor during the wipeout in stocks in March 2020 was his biggest mistake that year. I felt the same. It took two years, but we addressed that regret. Floor & Décor sells hard-surface flooring – wood, ceramic tile and laminate – to homeowners, commercial buildings and professional contractors. It has quickly become the largest hard flooring retailer in the country. I believe it has lower procurement costs than others, letting it sell flooring at an everyday low price in large, highly productive stores. It has a deep inventory position, so a

landlord or contractor who needs to install new floors on short notice can find what he's looking for today.

Floor & Décor benefited from a boom in sales during the pandemic, as people were focused on upgrading their living spaces. Its momentum probably will slow for some time as people spend more on experiences and travel and less on their homes. But its stores generate excellent returns on capital, it competes against a fragmented landscape of weak mom-and-pop retailers, and it has a clear path to tripling the store base over time. GCAM paid \$70 per share for Floor & Décor, about half the 52-week high but about double what we could have paid in spring 2020.

My goal, as always, is to own great companies with proven business models and managers who not only think like owners but are owners, with most of their net worth invested in their businesses. That nifty e-commerce/fintech/streaming startup that consumed a ton of cheap investor capital but never made money despite pulling forward years' worth of sales growth during the pandemic? We don't own it.

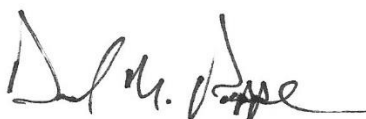
That's because my experience tells me that conservative business owners tend to hate being dependent on capital markets for funding. To avoid that position of vulnerability, they demand that their businesses make money – or at least can self-fund growth. This way, they control their own destiny. If you depend on the kindness of strangers for capital, there will come a day when the strangers aren't very kind.

There is a discipline in managing growth to profitability that augurs well for the future. And there is a sloppiness in losing money in pursuit of rapid growth that, we are learning almost daily, often ends poorly for the shareholder. We are bringing to a shattering close a long period of extreme profligacy with capital. No doubt, a lot of people got wealthy raising money on favorable terms to build something nifty but without earnings power. A lot of promoters amassed fortunes pumping (and probably dumping) cryptocurrency, SPACs, meme stocks, unprofitable financial technology startups, etc. As these assets continue their march downward (because their future earnings power is low to non-existent), all assets could face selling pressure. If that happens, we will try to take advantage of other people's myopia and profit from it.

Ultimately, however, companies that earn a lot of money will do better than those that don't. We've had a rough stretch at GCAM, but our companies control their own destiny. They generate strong earnings and they are self-sufficient from a capital standpoint.

Enjoy the summer and remember that while the market can behave strangely for extended periods of time, ultimately, it values growing streams of free cash flow pretty accurately.

With every good wish,

A handwritten signature in black ink, appearing to read "D. M. Poppe". The signature is fluid and cursive, with a long horizontal stroke at the end.

David M. Poppe

**Giverny Capital Asset
Management***Top 10 holdings**June 30, 2022*

Alphabet A&C	8.9%
Progressive Corp.	6.9%
CarMax	6.8%
Constellation Software	6.1%
Charles Schwab	5.5%
Arista Networks	5.4%
Heico Class A	4.8%
Credit Acceptance	4.6%
Markel	4.6%
<u>SS&C</u>	<u>4.5%</u>
Total	58.1%