

February 17th, 2023

Nitor Capital Historical Net>Returns¹

2018: (-14.02%)

2019: +30.23%

2020: +47.69%

2021: +32.50%

2022: +0.32%

Annualized 5-year Return: +17.50%

Annualized 10-year Return: +13.70%

Annualized Since Inception (2009): +13.71%

1. Returns are reflective of the performance of 'The Nitor Capital Fund.' Individual managed account performance may vary.

Excerpt from our 2022 annual letter:

(1/24/2022)

“In regards to overall inflation fears, I believe it would be hard to find an equity portfolio that is as well positioned to benefit from such an environment. Since inception, our investments have primarily been focused on inflationary beneficiaries such as real estate, land, energy and other commodities. We have always tried to restrict our investment in these areas to royalty type companies with structurally low fixed cost structures where any price inflation will lead directly to bottom line growth. While these investments have done well in the rather muted inflationary environment over the last 10 years, we believe they will certainly outperform if in fact we are on the verge of a long-term period of inflation.

*While the current speculative and short-term focused investment environment rings eerily similar to the one described by Mr. Buffett over 55 years ago, like Mr. Buffett, I have no idea or interest in opining as to where the current stock market will be in one, five, or even ten years from now. What I believe is clear is that investment markets as a whole seem to be dominated by either steady cash flowing assets trading at historically rich valuations or highly speculative non-cash flowing assets (whether some of these are actually assets is a debate in itself) trading at valuations many would have thought would be entirely improbable only a few years ago. **While the characteristics of these assets may differ, their ability to maintain their recent returns going forward is overly reliant on the very same factor; that the next buyer will continue to pay an even higher premium than the last. Essentially, the returns of these assets have been largely driven by multiple expansion (the price investors are willing to pay relative to the fundamentals, such as earnings, cash flow etc.) and valuations have now reached a point where attractive future returns are heavily dependent on the multiples continuing to expand. Just like Mr. Buffett, I will not invest my own money on such an approach and I will most certainly not do so with your money.**”*

When the above was published, the S&P500 was trading at 4,410 and the 10-year Treasury yield stood at just 1.73%. 2022 will go down as the worst year on record for U.S bonds dating back

250 years (*the only year that came close was 1980 when the index lost 9.2% in nominal terms*) and the 7th worst year on record for the S&P500. While it undoubtedly feels good to be able to preserve investor capital during such a year, we continue to ascribe little, if any, meaning to our performance in any one year. We view 2022 simply as a component of the annualized return figure that we have generated over the last five years and since inception (*performance periods that we actually assign weight and meaning to*).

Over the last five years, our investment portfolio has generated an annualized gross return of +20.65% (+17.50% *net of all fees*), which is more than 2.5x the +7.65% annualized return of the S&P500 over the same period of time. Since inception, we have also managed to generate net returns in excess of the market. On a historical basis, the S&P500 has provided annualized returns of +10.50%.

Ultimately, I believe our gradual improvement in performance (*both on an absolute and relative basis*) is reflective of an investment process that continues to improve and refine with time. Unlike professional athletes, investors have the ability to continually enhance their craft with age especially if capable of recognizing and learning from prior mistakes. Over time, I believe we have only gotten better at understanding where our core competencies lie and at knowing what works and what doesn't. We have become more cynical and far more skeptical and at the same time have learned to appreciate the true rarity of an exceptional company.

As Mr. Buffett once said, there are no called strikes when it comes to investing, an investor has the luxury of sitting back and waiting for the perfect pitch (*a truly exceptional investment opportunity*). Over the years, I believe we have become far more patient at the plate, and as a result, we have seen a meaningful increase in our 'slugging percentage.'

"What did the market do today?" (We don't care!)

At NCM we do not invest in the 'stock market' we invest in businesses whose ownership interests just so happen to be available for purchase on the stock market. We have no interest in 'timing the market,' or what the market did on such and such day and it is highly likely that most of you follow the daily ups and downs of the market far more than we ever will. When we look at publicly traded stocks, we do not see pieces of paper or quotes on the screen or a technical chart to trade. We buy into a Company because we want to own a long-term interest in the business, not because we think the stock is about to go up in price or should go up in price.

As a result, when looking at whether or not to invest in a stock (*a business*) the only matters of relevance to us are the following:

1. Is this a high-quality business?

- a. Does the business have a clear competitive advantage?
- b. Has the business/asset continually increased in value over time?
- c. Is the business/asset enduring and likely to continue to increase in value overtime?
- d. If given the opportunity to buy the entire company, would we be comfortable putting our entire net worth into this one investment?

2. Is management doing a good job and are they incentivized to make shareholders money?

- a. Have their decisions helped increase the per share value of the company?
- b. If given the opportunity, would we run the company any differently?
- c. Is management overpaid and is annual overhead appropriate?
- d. Is there any reason to believe that management is incentivized to make decisions that would be detrimental to shareholder value?

3. Are we paying a good price?

- a. Have we developed enough data and research to confirm we are buying into the company at a highly attractive valuation where low probability exists that we will lose money and high probability exists that we will end up making money on the investment?
- b. When we talk about ‘losing money’ we are not referring to the risk of the stock price going down. We are strictly thinking about the underlying fundamental risk, such as ‘business risk’ and ‘balance sheet risk.’ In fact, as discussed in prior letters, we often welcome ‘stock price risk’ as it provides the opportunity to buy more of a business we like at a better price.

At NCM we believe the above is really all that should matter when looking at any investment opportunity whether public or private. Focusing on the above criteria is what enabled the long-term success of great investors such as Warren Buffett, Charlie Munger and Lou Simpson.

“No one wants to get rich slow”

The story has been told that Jeff Bezos once asked Warren Buffett, “Your investing strategy is so simple and you’re the most successful investor in the world, why doesn’t everyone just copy you?” To which Buffett replied, “because no one wants to get rich slow.”

As you may know, the current world we live in has put a major premium on instant gratification. Whether it’s our news or our packages, we have become trained and accustomed to getting things instantly. It should therefore come as no surprise that there are very few investors left in the stock market that appear to be interested and focused on ‘getting rich slow.’ The majority of investment firms that invest in the market are not set up to make money this way. They have built a model that is far more reliant and focused on raising and maintaining investor capital than it is on maximizing long-term risk adjusted returns. Their model has a constant need for ‘sexy’, catalyst driven thematic investments that are designed to appeal and impress their existing investors and new prospective investors (*at the expense of their long-term returns*). Other firms will employ models that avoid actual investing and instead focus on the benefits of ‘diversification.’ Meaningless terms such as “high level allocations” are thrown out to clients. Accounts are constructed by employing multiple strategies, each of which contain underlying portfolios that may consist of over a hundred different securities. Many in finance like to sound smart by making things appear complex. Yet, the most successful long-term investors likely achieved their success as a result of their ability to make things simple.

"The biggest money made in Wall Street in recent years, has not been made by great performance, but it's been made by great promotion."- Warren Buffett

The consensus view is that a portfolio with a hundred securities is built to provide diversification and diversification minimizes risk. Yet, I am often perplexed by the failure to question whether building a 'diversified' portfolio (*of 50 to 200 securities*) is instead an admission of one not knowing how to 'invest' in the first place.

There are not many service industries where such a dynamic exists. Imagine you have a legal issue or a medical issue on your hands. You go to a doctor or a lawyer and rather than giving you one to two remedies for your problem they offer you fifty! They tell you that such a strategy will severely limit your chances of failure.

While we are aware the above scenarios are not directly apples to apples to investing, they nevertheless highlight the point shared below by investor Nick Sleep. Sleep is a rather under the radar investor and former investment manager of the highly successful Nomad Investment Partnership, which generated +18.4% annualized returns to investors over a 13-year period before shutting down and returning all outside capital in 2014.

"The church of diversification, in whose pews the professional fund management industry sits, proposes many holdings. They do this not because managers have so many insights, but so few! Diversity, in this context, is seen as insurance against any one idea being wrong. Like Darwin, we find ourselves disagreeing with the theocracy. We would propose that if knowledge is a source of value added, and few things can be known for sure, then it logically follows that owning more stocks does not lower risk but raises it!....

In our opinion, the massive overdiversification that is commonplace in the industry has more to do with marketing, making the clients feel comfortable, and the smoothing of results than it does with investment excellence."

How are we are structured differently?

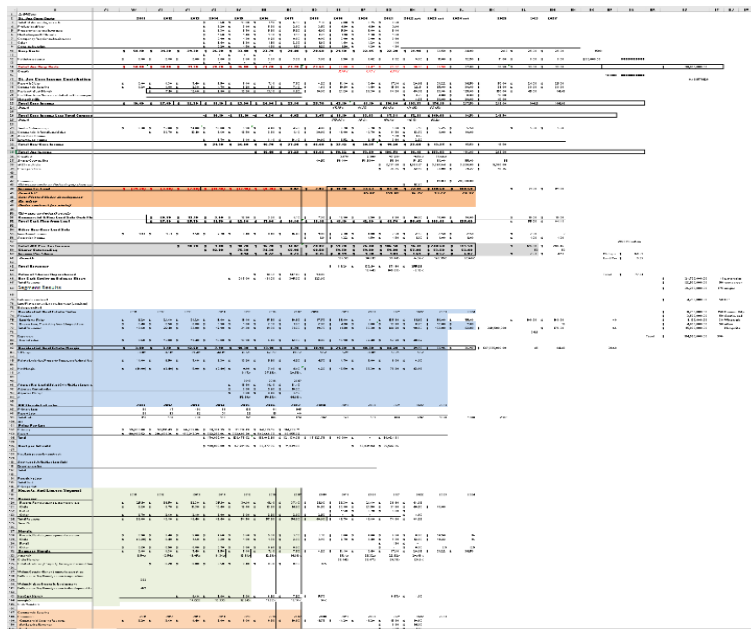
Have you met our new head of investor relations yet? Have you visited our new midtown class-A office? Did you make it to this year's annual golf outing? As you should know, none of the aforementioned exist. Nitor Capital Management was set up with a singular goal in mind; to maximize **long-term** returns for our investors. We were not set up with an aim of raising a certain amount of capital from investors. We do not engage in activities conducive to raising capital, which might come at the expense of our underlying investment results. Thus, little if any time or money is spent on marketing, raising assets or investor relations. Our approach has always been to remain laser focused on the investment side. This very approach has allowed us to take concentrated positions in investments with longer-term horizons without having to worry about the implications short-term underperformance might have on our existing capital base. Simply put, we can tolerate an investment horizon that most firms are not built to withstand.

There is a ‘70-20-10’ theory of investment (*given notoriety by Smead Capital*), which postulates that 70% of a stock’s return over a 12-month period is determined by the overall performance of the market, 20% is the result of the performance of the underlying industry and just 10% is the result of the underlying valuation/success of the company. However, over a 10-year period the model works in reverse order. Over ten years, 70% of the return will be driven by the underlying success/valuation of the Company and just 10% will be driven by the performance of the overall market.

Hence, why little if any weight or attribution is given to our short-term results, as they are most often driven by factors outside of our control, and we make this clear to investors well before their capital arrives in our account. As we often say, we can’t control the market but we can control the companies we chose to invest in.

Identity Crises

Over the years we have encountered many investment managers who describe themselves as ‘long-term’ value investors. Yet, it has been truly surprising to see how far many have deviated from actual long-term investing. When we research an investment, we will spend almost all of our time going through the Company’s recent and historical annual reports. Depending on the investment, we might read through ten to twenty years’ worth of annual reports and then take the relevant financial information and manually input it into an excel sheet like the one below (*in order to increase our understanding of the Company’s business and financials*):



I am sharing this with you because I believe this is the type of work required to truly gain an understanding of a company that one plans to make a sizeable long-term investment in. Certainly, on the private side if an investor was contemplating putting a substantial amount of their net worth into a single investment, they would likely undertake a similar process (*if such information was made available to them*). Yet, we continue to be surprised by the apparent areas of focus of today’s ‘long-term’ investment managers.

When discussing investments with these managers we are made to feel as if our investment criteria and process has suddenly become antiquated and no longer relevant in today's world. The core tenants of long-term successful investing implemented by investment legends such as Buffett, Munger, Lou Simpson have been replaced by the following new matters of importance:

- Is there a catalyst and when will it take place?
- Why did such and such institution recently sell shares?
- So and so owns this stock, it must be a good investment.
- Why did the stock perform so poorly the past few years (*the market is always right so something must be wrong*)?
- What happened to earnings this past quarter? (*Has anyone ever sold a private business because of one soft quarter?*)
- What are earnings going to be next quarter?
- Is the stock going to be picked up by a new index?
- What do the sell side analysts say?
- There are no sell side analysts covering the stock, why not?
- How big of a position do you own?
- How am I going to make money on this in the next 12 months? My cost of capital is high and I need to be in position to raise additional capital

At the end of the day, if one can buy into a great well-run business at a highly attractive price nothing else should matter. All of the above questions are irrelevant when it comes to the true **long-term** performance of the investment. I believe such questions are in reality reflective of speculators masquerading as 'long-term' investors.

While it is sad to see, we believe the deviation away from true long-term value investing will ultimately prove beneficial to those capable of remaining true to their identity. While the market remains near all-time highs and valuations are broadly stretched, we continue to find and hold on to attractive investment opportunities that remain available to us as a result of investor fixation with instant gratification and short-term price performance, and their growing indifference to long-term fundamental matters of importance.

Take for example an investment we initiated in 2021, which was added to during 2022. Over the last two years we have been buying into the Company at a total enterprise valuation (*value of equity + net debt*) of approx. \$450 million. We found the valuation to be rather head scratching given the following:

- The Company has owned the very same asset/business for the last 30+ years and hard fundamental data exists, which shows the value of the asset/business has increased materially over this period of time.
 - The Company's publicly available financial statements show the following:
 - 2003- the Company generated \$15 million of reported revenues and no reported cash flow.
 - Today- the Company is generating over \$50 million of reported revenues and \$15 million of reported annual cash flow.

- The Company reports transactional data, which implies its primary asset has continually increased in value over the last 5, 10, 15 and 20 years.
 - The reported data implies the value of the asset has increased by over 3x in the last 20 years.
- Upon further analysis an investor would see that the Company has developed joint venture interests that are generating an additional \$100 million of recurring revenues and \$10 million of annual cash flow (net to the Company) that do not show up on the Company's consolidated financial statements due to GAAP accounting rules.
 - The JVs did not exist 20 years ago and the revenue and cash flows have continually increased over the last ten years.
- The Company has a net cash position sitting on its balance sheet.

In the last twenty years the Company's primary asset increased by over 3x in value, the Company added over \$130 million of recurring revenues and \$25 million of recurring net cash flow. Yet, at \$450 million we were able to buy into the Company at a lower valuation than it was selling for 20 and even 30 years ago.

Over a decade into a bull market and with the market near all-time highs we found a growing company that we believed owned an irreplaceable asset that was selling for less than it was worth 30 years ago!

Were we missing something or has the market become so impatient and distracted by noise that such an opportunity could really exist?

Through extensive research we became confident that the Company in fact had a major competitive advantage and a moat, both of which have been increasing over time. We also determined that while those in charge of running the Company were by no means exceptional, they certainly played a role in the growth of the Company over the last few years (*and total Company overhead and compensation was reasonable*).

At the same time, it was also becoming clear that within the last three years the business/asset had hit an inflection point and the Company was clearly in a different position than it was five, ten and twenty years ago.

We felt we found an investment that was conservatively worth anywhere from \$1.5 billion to \$2.5 billion dollars, that was in fact selling for cents on the dollar, and for less than it was worth over thirty years ago. When we spoke with private operators familiar with the asset/business they all but confirmed our view, often responding "at least!" when we shared our view that the Company could conservatively be worth over \$1 billion.

Given the Company had zero net debt and was generating recurring positive cash flows we believed at a \$450 million valuation, the chance for long-term loss of capital was minimal, yet the opportunity to generate a significant return on our investment was ever-present.

When we research investments like the one above, we often back-test our work by sharing it with other investors in hopes they might uncover something we missed and disprove our underlying

thesis. Almost always, this process results in substantial critique and questioning of the investment, which is exactly what we are looking for. Yet, the key is to be able to determine whether the push back we are getting is based on credible fundamental information, which we may have overlooked, or whether it is entirely based on irrelevant noise.

When we were doing our initial work on the St. Joe Company, we felt almost all of the pushback we received was irrelevant noise that was loose on facts and heavy on sentiment. The crux of the pushback we received was based on St. Joe's poor stock performance over the last ten years and events and issues that had occurred ten years ago. We were highly confident these issues no longer pertained to the Company as it was completely repositioned by a new ownership group. We were not investing in the Company in 2007 we were investing in the Company in 2017 and almost all of the counter arguments received were related to issues that were no longer present. At the end of the day, as Mr. Buffett famously said, the investment will ultimately work out "if your hypotheses are correct, your facts are correct and your reasoning is correct." Eventually our thesis proved out and so did the investment.

We took the same approach once again in 2021, and after thorough research we sent out a detailed presentation to other investment managers in hopes of some serious hole punching. The crux of our thesis was essentially that while the stock had performed terribly over the last 10 to 20 years, the value of the Company had actually grown substantially over this period of time. More importantly, within the last 3-years, long-term tailwinds had clearly formed (that were not previously present), which would lead to substantial growth going forward. Our thesis was accompanied by considerable and detailed data and facts. We also presented a valid reason for why the market has so far missed out on this opportunity; Almost all of the value created over the last 5,10 and 20 years was presently being masked by GAAP accounting treatment (*\$100 million of revenues not showing up due to non-consolidation and earnings were negatively impacted by non-cash depreciation of appreciating assets*) and the Company had so far failed to articulate this publicly to investors. We estimated there was anywhere from \$350 million to \$500 million of masked value that would inevitably surface overtime.

Yet, once again almost all of the pushback we received had nothing to do with the actual fundamentals of the Company.

Below are examples of the feedback we received (and our reaction):

- *"What is the catalyst here?"*
 - Why do we need a catalyst? The Company is being valued as if it is slowly going out of business and heading toward bankruptcy. What happens when the market realizes that this isn't the case and sees the Company is in fact experiencing substantial growth?
- *"A lot of Funds invested in this the last 10 to 20 years and they all lost money and eventually sold out."*
 - I am not suggesting that you should have bought the stock ten years ago, I am suggesting it now. This was a different Company ten years ago and I am fairly sure I wouldn't have been able to justify the investment then.

- And what does this have to do with my thesis?
 - Did those Funds invest ten years ago using the same thesis? (*likely not as the majority of the value I highlighted didn't exist then*)
- *“How can you call this cheap? It sells at 9x sales and 40x earnings”*
 - Didn't I just send you a presentation showing you that the Company has developed JV partnerships generating \$100 million of recurring revenues that don't show up on the reported financials?
 - The Company has substantial asset value not currently generating sales or income.
- *“Why does no one else own this?”*
 - Why does it matter? And isn't that precisely why the opportunity exists in the first place (because no one else has discovered this yet)?
- *“One of their business segments could take 20 years to reach its full potential”*
 - The thesis was not dependent on the success of this segment.
 - At the current valuation, the segment you are referring to could be worth nothing and you would still be getting a great investment.
- *“Management and the board are crooks; they are the only ones benefiting and are using the Company as their piggy bank”*
 - Sure, based solely on the historical stock price performance this would appear to be the case. But the reality is that the current board receives almost all of its compensation in stock (not cash), which they have not been selling. Current top management is certainly well paid but total overhead is considerably lower than peers of similar size. The Company's largest shareholder sits on the board, does he have an incentive to let the board and management 'steal' from shareholders?
- *“This has been one of the biggest 'value traps,' why will we make money on this now?”*
 - Yes, the stock chart indicates this has been a value trap. But 'value traps' are cheap companies with fundamental value that goes down over time. Didn't I just show you that the fundamental value of this Company has clearly increased over the last 10 years?
 - We will make money on this now because the stock price is 50% lower than it was 10 years ago and I just sent you a whole presentation illustrating why the Company has hit a clear inflection point over the last few years.
 - How will we lose money on this now?
- *“If everything you're saying is correct about the emerging tailwinds why has the stock not reacted yet?”*
 - If you're a real fundamental value investor, why do I have to explain to you that markets can be highly inefficient in the short term? (*I didn't actually say this*).

- “Good luck with this pile of crap”
 - I just sent you a presentation of a Company with a pristine balance sheet, high margin recurring revenues and almost no known competitors. Please elaborate?

We received almost no pushback questioning the quality of the business. The pushback we received regarding management was light on facts and heavy on emotion and sentiment. The pushback on the price we were paying for the business was focused on either the historical stock price performance (*not valuation*) or supported by ratios, which lacked relevancy, as they ignored actual in place fundamentals.

As we wrote earlier, a key to long-term successful investing is the ability to keep things simple and separate the facts from meaningless noise. Ultimately, when investing in anything (*whether public or private*) the only questions that should matter are; Is this a good/great business? Am I paying a good price? Are the people in charge incentivized to grow the business and make me money? Everything else is merely added noise.

While others around us continue to gravitate toward the pursuit of instant gratification and over-diversified complexity, we continue to stick to our boring, concentrated, slow moving, ‘antiquated’ process of fundamental simplicity and we sincerely thank you for continuing to allow us to do so with your capital.

Regards,

David

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