Dear Shareholder,

Most of the value in investing comes from buying well and waiting.

Yet all great ideas, such as that, come with chinks in their armour.

The clear potential issues with a "buy and hold" strategy stem from mistakes due to lack of selling, which can take two forms:

1. Failing to sell a stock when the business weakens structurally / permanently
2. Failing to replace a "good" stock with a "great" one

We believe our "shelf" system, whereby we actively consider a wide range of stocks for investment for many years, goes some way to help the behavioural issues which stem from point 2 above. As we've noted in many previous letters, we believe all value is *relative* and go to pains to force ourselves to consider improvements within the portfolio even when the portfolio companies themselves are doing everything right.

An example would be our sale of Novo Nordisk in 2022, a business which we highly admire and would happily invest in in the future but felt our investors capital was better recycled at that valuation into another shelf stock: McKesson.

In this letter we explore some of our behaviour regarding point 1 above.

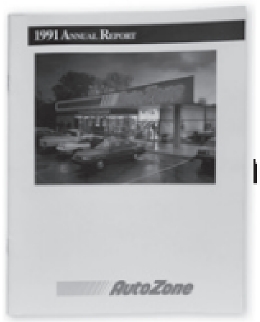
This is where the importance of thinking from first principles can help us focus on the facts as we determine them. Negative narratives and news flow feed on share price falls, resulting in vicious sentiment cycles. Not being guided by market enthusiasm or pessimism, but by our longer-term reflections on the quality of the business and its potential in the future, is where we think our process can add value at times such as these.

It's in this context we discuss three stocks which suffered c.50% share price falls where we felt the position warranted continued ownership. One which worked, one which is tentatively working, and one which is currently on its knees.

First, in brief, **AutoZone**.

This is a business which has suffered many episodes of negative sentiment.

This was on the inside cover of their 1991 annual report:



1991 Annual Report

The Future of the DIY Market

Is the DIY market likely to disappear as technological advances make cars too complex for even the most mechanically proficient DIYers?

As *Scientific American* put it: "The remarkable development in the automobile industry, and the swift advances in automobile construction within recent years, have produced unexpected and unforeseen conditions, and one of the most striking phases in the situation is the lack of men trained to manage and care for the high-powered cars."

U.S. News & World Report, under the subtitle "No more do-it-yourself", proclaimed: "Current models…defy even the most dedicated do-it-yourself mechanics. Professional service has become a necessity."

Sounds like AutoZone ought to be worried…but for one thing: *Scientific American's* article was published in 1908, and since U.S. News & World Report declared the DIY market dead in 1968, the Commerce Department estimates it has grown by more than seven-fold. Our point is that people have been predicting the demise of the DIY market for so long now that we are reminded of the statement that Mark Twain once made: "Reports of my death are greatly exaggerated."

Source: AutoZone 1991 Annual Report

In 2017 the business was suffering from a pair of enormous negative narratives: that EVs would conquer the passenger car fleet and that Amazon would distribute auto parts. The stock peaked in late 2015, fell -40%, and didn't recover its high for three years.

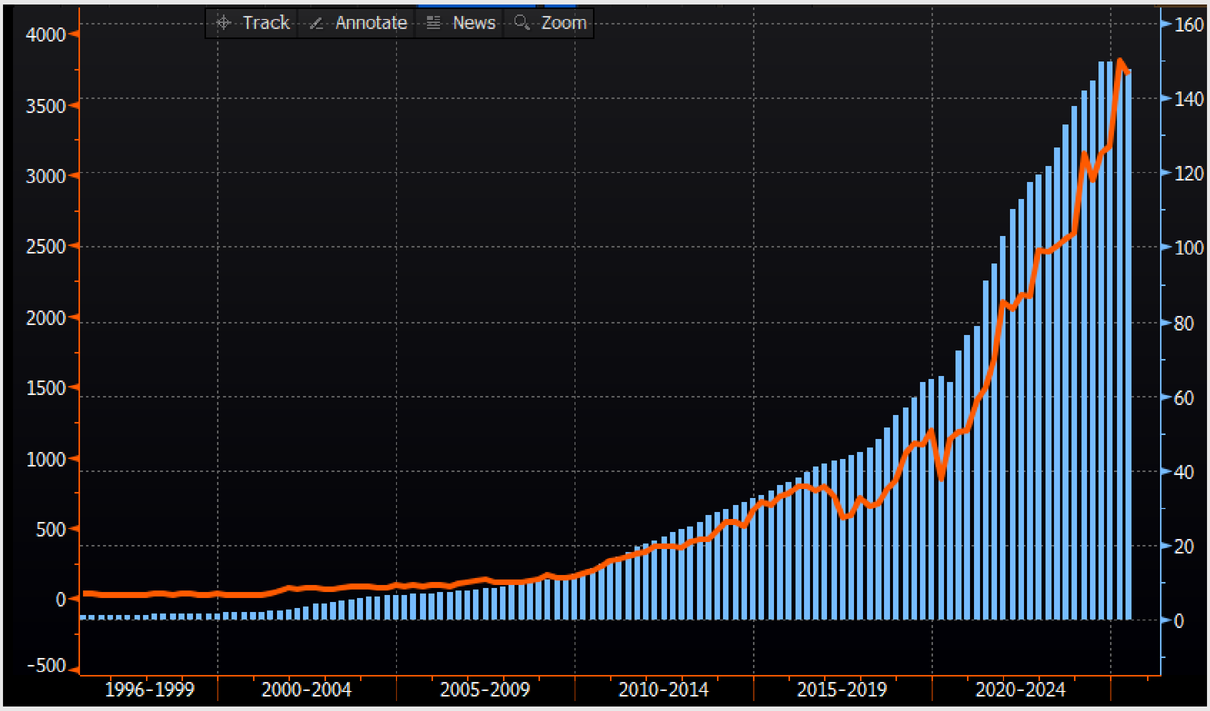
Below is an extract from our 2017 annual report describing how we approached the situation:

"Since I first invested in 2009 in AutoZone the sector has been an incredibly attractive investment. The company has delivered a 100% growth in net income, using cash flow to buy back 50% of its shares outstanding resulting in a 400% increase in EPS. Last year the stock price fell dramatically as we saw the businesses enter ***two bear traps****: namely disruption from Amazon and from increasing penetration of electric and autonomous cars. Given how worried the market has become, inverting the bearish analysis in both cases reveals a strong risk reward in favour of the long-term shareholder. It's true that growth rates in mature industries fade, however, the market consistently overestimates the speed of that decline, in particular in industries with strong fundamental dynamics. Buying AutoZone today an investor pays 15x earnings, a multiple implying little future growth in earnings. For context over the past ten years, including the recession, earnings have consistently grown at 15% per year, and we believe they will continue to grow at least c.5-10% per year in the near future.*

The short-term threat from autonomous driving is misguided*. There are 253m cars in the US, with an average age of 11.4 years, and an average new cars sales rate of 16.8m. If we assume conservatively that autonomous cars arrive on main street in 2020 (we think it will be closer to 2030), and 1/3 of all cars are autonomous, then 5 years from now, the stock of cars in the US will be c.270m of which 11m will be autonomous. Critically in that period the sector will have still been able to grow earnings and cash flow per share, through consolidation, increased cost leverage, buybacks and a higher average vehicle age.*

Regarding the threat from Amazon, 65% of industry sales are to small garages, often fulfilled on a 30-minute delivery time, from a locally managed assortment of inventory. Mechanics care little about cost, and far more about job turnover in their bays, and are thus happy to pay for this availability and quick delivery. Amazon can only compete on a next day basis in the US, so we see little current threat to this side of the business. The remaining 35% of sales is DIY, 86% of which is non-discretionary repair or maintenance spend. Of Amazon's 20 top selling "automotive" products, only one is non-discretionary, due to the fact that items are bulky, fragile, and often require a level of service at the point of sale. As a result, only 10% of the 35% DIY segment is currently online (of which around half is Amazon) so even if Amazon were to double their sales in automotive, and all of those sales were to take share from the listed APRs (unlikely given most share is being taken from non-discretionary purchases at garages, mass merchants etc) then this would imply just a 1.7% sales drag to the industry. Despite the clear bear cases, and perhaps some continued short-term volatility, we believe the best is yet to come for this industry from a cash flow focussed shareholder's perspective."

The 2015 to 2018 period now looks like a simple period to have owned the business but, at the time, at least half of the investor questions we received were focused on this underperforming sector and why we owned it through such *evident* radical disruption.



Source: Bloomberg

Next, we turn to our holding in **Dollar Tree**.

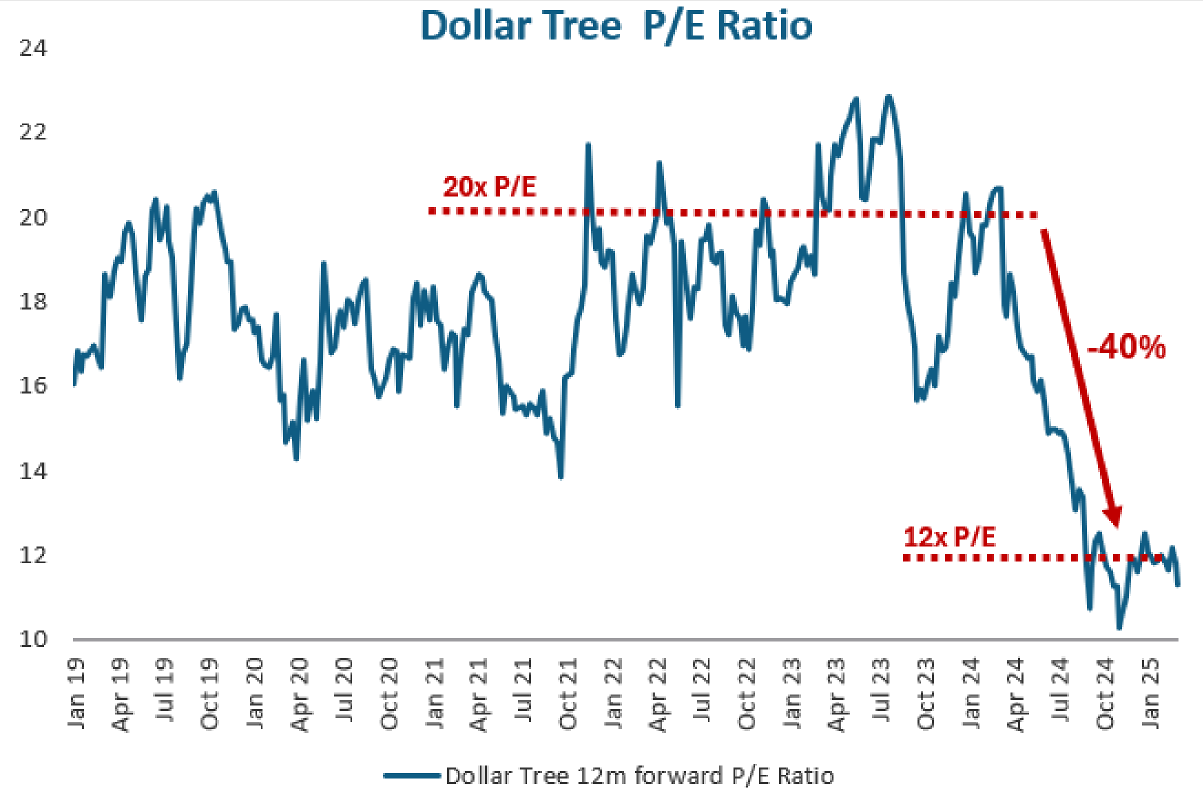
We added meaningfully to the position during the quarter.

Regular readers will know that we equally weight our portfolio and seldom trim or add to our holdings, so the context and reasons behind this decision warrant an explanation.

Dollar Tree is a US based discount retailer with 9,000 stores nationwide. Dollar Tree's product mix splits 50/50 between consumables (pantry staples, drinks, sweets, cleaning products, personal care items) and discretionary items (craft supplies, party items, kitchen crockery, glassware, light DIY). Until 2019, everything in store could be purchased for $1, Dollar Tree then expanded the price architecture to include items in the $3-7 range (currently available in 5,000 of the 9,000 stores). The consumer retail proposition is everyday items at very low prices and Dollar Tree's appeal spans low-income households to those with six figure incomes.

In share price terms, Dollar Tree had a difficult 2024, experiencing a -47% drawdown[1] which we reviewed in our annual report. The drawdown comprised of a -40% reduction in valuation multiple and the remainder was attributed to a slight reduction in earnings expectations.

[1] Bloomberg



Source: Bloomberg, LIM

There is a saying in markets that "price drives narrative" and consequently the reflexivity and momentum within financial markets means prices can trend (both positively and negatively) until something fundamentally changes. Bad news likes company, and over the remainder of 2024 investors became increasingly concerned by the muted same store comparable sales, the overhang of the strategic review, whether Walmart and Temu were taking share from discount stores, why the softer consumer backdrop wasn't driving higher footfall from bargain seeking consumers, competitor profit warnings (notably Five Below which also skews towards discretionary items) and finally by Rick Dreiling's surprise departure (ostensibly for health reasons) in November 2024. The combination of all these factors was enough to see Dollar Tree's multiple compress to 10x earnings.

In our annual report we identified that our principal concern with Dollar Tree was the acquisition of Family Dollar in 2015 – which approximately doubled the size of the business. Family Dollar has a store format skewed more towards low-income consumers and consumables, rather than discretional general merchandise (approx. 80/20).

Last year, Dollar Tree announced the 'strategic review' of Family Dollar, which we supported. At that point we ran several scenarios on what we felt could be done with the business and the potential impact on the financial and competitive positioning. At the same time, we remained content with Dollar Tree's standalone performance: even with consumers under significant pressure, 2024 same store sales averaged c. 2%, never turning negative.

As we remarked in the annual report, our principal concern was with the outcome of the Family Dollar strategic review. We felt that Dollar Tree was inexpensive (certainly based on the strength of Dollar Tree's same store sales) and that the reason for the lack of uptick in footfall was the lack of unemployment. We noted:

"A small silver lining is our practice of never averaging down into positions without concrete evidence of operational improvement in the numbers, which means that today Dollar Tree represents a 2% holding."

To add to our position, we were looking for a positive resolution to the Family Dollar strategic review and confidence that trading was improving. At the end of March 2025, Dollar Tree announced the sale of Family Dollar for $1bn, at the upper end of our scenario analysis from last year. In the preceding quarters we had also witnessed the improving same store sales trends between consumables and discretionary items which had improved for three consecutive quarters. As such we incorporated 'the facts' and were able to double our position in Dollar Tree on the day of the sale announcement at an average price of $70.

The sale achieved two things:

1. All of Dollar Tree's profit and cash generation would be available for reinvestment in Dollar Tree's growth at high returns on capital
2. The $1bn proceeds from Family Dollar would materially delever the balance sheet which had historically been solely carried by the Dollar Tree banner.

The combination of these factors meant that at $70, Dollar Tree traded on c. 12x earnings, with a high single-digit prospective free cash flow yield and an under levered balance sheet positioned to repurchase over $1bn of stock (>7% of shares outstanding) *per annum*.

We do not factor multiple expansion into our investment decisions. With Dollar Tree primed to return capital to shareholders we see mid-teens intrinsic value growth without a re-rating and, without the distraction of Family Dollar, a greater probability of execution success.

That said, a couple of years post-completion, we see potential for >$9 of earnings which on its historic multiple of 22x means the shares could approximately treble to $200.

We believe waiting for tangible evidence of improvement before adding to underperforming positions is the optimal, value maximising approach for investors. It is not guaranteed that you will always get the opportunity to, as positive clearing events often result in a material repricing of the equity; however, this instance illustrates that this is not always so, great opportunities do present themselves to patient and prepared investors.

Finally, **Diageo**.

Diageo has also fallen around 50% and currently sits at the lowest level in ten years.

During the inflationary period which followed the lockdowns in 2020, alcoholic beverage prices rose. Volumes initially spiked although they fell below trend in 2023 and 2024. The cumulative effect of this can be seen in the below data[2], which shows "litres of pure alcohol" (LPA) growth, a metric which normalises for sales across beer, wine and spirits.

Spirits LPA in the US				
Vol Growth	**%**			
2007	2.2			
2008	1.7			
2009	1.4			
2010	2.0			
2011	2.9			
2012	3.0			
2013	1.9			
2014	2.3			
2015	2.3			
2016	2.4			
2017	1.1			
2018	1.9	**Avg. 07-19**		
2019	3.1	2.2		
2020	6.2			
2021	5.4			
2022	0.8			
2023	-2.8	**Avg. 20-24**	**Below Trend 1y / 5y**	
2024	-2.1	1.5	-0.7	-3.3

Source: Bernstein, LIM

Volume growth which averaged 2.2% per year pre-pandemic has averaged 1.5% per year since, with a cumulative "lag to trend" of 3.3% of growth over five years. It's worth noting revenues rose 22% over the same period when including price increases across the products.

This weaker trend in volume has been attributed by the market to two primary drivers:

1. The young / Gen Z's drinking habits
2. Those on weight loss drugs are drinking less alcohol

The former is quite easy to refute as a cause for this fall in volumes. While they may, or may not, drink less than previous generations, across all the major spirits companies which we can find data or estimates for (including

[2] Bernstein data and LIM calculations

Diageo, Remy, Pernot, Campari and others), Gen Z (those born after 1996) only account for around 2-3% of sales.

This could be a longer-term issue should they decide to drink less as they mature, but this cannot account for the drop in volumes today. At Diageo specifically we note 75% of sales are generated by consumers born before 1981. Consumers take longer to mature than the scotch they drink.

Moreover, there is strong evidence that younger consumers are drawn to spirits earlier through cocktails, and there is also recent evidence that their drinking habits are, in fact, coming back in line with previous generations already.

So, what could it be?

A far more benign potential answer strikes us as the most probable. The average working capital cycle for spirits in the retail and wholesale channels is around 100 days. A 3.3% cumulative fall in volumes (from trend as shown above), could be a sign of lower inventory as opposed to lower-end demand. If this were the case, this would imply a 12% reduction in volume held in inventory through the supply chain. Given the rapid increase in prices over the past five years, might those in the supply chain simply have targeted their working capital efficiency?

This is supported by data shown by Remy in their latest investor update which discusses the shape of the inventory cycle[3].

Time will tell but the potential for Diageo from here, in our opinion, warrants holding the shares with the potential to add to a highly undervalued business if the operating performance improves.

Spirits are a long-lived category, where the value of their assets actually rise in value the longer they are held in barrel inventory.

Diageo has around 6% market share[4] in the US, their most important market. It seems highly plausible to us that this figure will rise over time, with this current low ebb creating opportunities for bargain acquisitions of challenger brands as venture capital financing dries up.

The new CFO has addressed some of the elevated costs which crept in during the boom years of 2021 and 2022, which should be straightforward to fix.

We leave you with another old newspaper cutting from 1984[5] proclaiming the change in drinking habits and the demise of alcoholic beverage companies.

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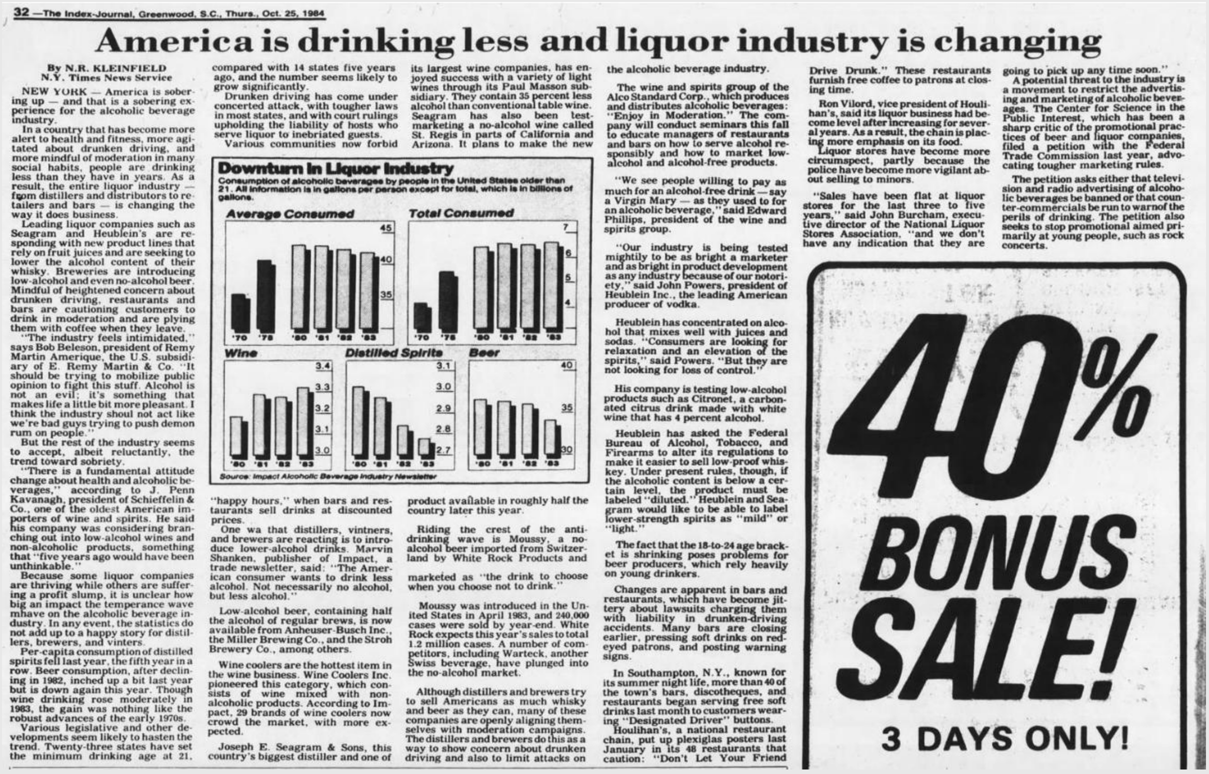
[3] Remy Cointreau FY24-25 Presentation, slide 7
[4] Diageo and Nielsen data
[5] The Index Journal



32 —The Index-Journal, Greenwood, S.C., Thurs., Oct. 25, 1984

America is drinking less and liquor industry is changing

By N.R. KLEINFIELD
N.Y. Times News Service

NEW YORK — America is sobering up — and that is a sobering experience for the alcoholic beverage industry.

In a country that has become more alert to health and fitness, more agitated about drunken driving, and more mindful of moderation in many social habits, people are drinking less than they have in years. As a result, the entire liquor industry — from distillers and distributors to retailers and bars — is changing the way it does business.

Leading liquor companies such as Seagram and Heublein's are responding with new product lines that rely on fruit juices and are seeking to lower the alcohol content of their whisky. Breweries are introducing low-alcohol and even no-alcohol beer. Mindful of heightened concern about drunken driving, restaurants and bars are cautioning customers to drink in moderation and are plying them with coffee when they leave.

"The industry feels intimidated," says Bob Beleson, president of Remy Martin Amerique, the U.S. subsidiary of E. Remy Martin & Co. "It should be trying to mobilize public opinion to fight this stuff. Alcohol is not an evil; it's something that makes life a little bit more pleasant. I think the industry shoul not act like we're bad guys trying to push demon rum on people."

But the rest of the industry seems to accept, albeit reluctantly, the trend toward sobriety.

"There is a fundamental attitude change about health and alcoholic beverages," according to J. Penn Kavanagh, president of Schieffelin & Co., one of the oldest American importers of wine and spirits. He said his company was considering branching out into low-alcohol wines and non-alcoholic products, something that "five years ago would have been unthinkable."

Because some liquor companies are thriving while others are suffering a profit slump, it is unclear how big an impact the temperance wave mhave on the alcoholic beverage industry. In any event, the statistics do not add up to a happy story for distillers, brewers, and vinters.

Per-capita consumption of distilled spirits fell last year, the fifth year in a row. Beer consumption, after declining in 1982, inched up a bit last year but is down again this year. Though wine drinking rose moderately in 1983, the gain was nothing like the robust advances of the early 1970s.

Various legislative and other developments seem likely to hasten the trend. Twenty-three states have set the minimum drinking age at 21, compared with 14 states five years ago, and the number seems likely to grow significantly.

Drunken driving has come under concerted attack, with tougher laws in most states, and with court rulings upholding the liability of hosts who serve liquor to inebriated guests.

Various communities now forbid "happy hours," when bars and restaurants sell drinks at discounted prices.

One wa that distillers, vintners, and brewers are reacting is to introduce lower-alcohol drinks. Marvin Shanken, publisher of Impact, a trade newsletter, said: "The American consumer wants to drink less alcohol. Not necessarily no alcohol, but less alcohol."

Low-alcohol beer, containing half the alcohol of regular brews, is now available from Anheuser-Busch Inc., the Miller Brewing Co., and the Stroh Brewery Co., among others.

Wine coolers are the hottest item in the wine business. Wine Coolers Inc. pioneered this category, which consists of wine mixed with non-alcoholic products. According to Impact, 29 brands of wine coolers now crowd the market, with more expected.

Joseph E. Seagram & Sons, this country's biggest distiller and one of its largest wine companies, has enjoyed success with a variety of light wines through its Paul Masson subsidiary. They contain 35 percent less alcohol than conventional table wine. Seagram has also been test-marketing a no-alcohol wine called St. Regis in parts of California and Arizona. It plans to make the new product available in roughly half the country later this year.

Riding the crest of the anti-drinking wave is Moussy, a no-alcohol beer imported from Switzerland by White Rock Products and marketed as "the drink to choose when you choose not to drink."

Moussy was introduced in the United States in April 1983, and 240,000 cases were sold by year-end. White Rock expects this year's sales to total 1.2 million cases. A number of competitors, including Warteck, another Swiss beverage, have plunged into the no-alcohol market.

Although distillers and brewers try to sell Americans as much whisky and beer as they can, many of these companies are openly aligning themselves with moderation campaigns. The distillers and brewers do this as a way to show concern about drunken driving and also to limit attacks on the alcoholic beverage industry.

The wine and spirits group of the Alco Standard Corp., which produces and distributes alcoholic beverages: "Enjoy in Moderation." The company will conduct seminars this fall to educate managers of restaurants and bars on how to serve alcohol responsibly and how to market low-alcohol and alcohol-free products.

"We see people willing to pay as much for an alcohol-free drink — say a Virgin Mary — as they used to for an alcoholic beverage," said Edward Phillips, president of the wine and spirits group.

"Our industry is being tested mightily to be as bright a marketer and as bright in product development as any industry because of our notoriety," said John Powers, president of Heublein Inc., the leading American producer of vodka.

Heublein has concentrated on alcohol that mixes well with juices and sodas. "Consumers are looking for relaxation and an elevation of the spirits," said Powers. "But they are not looking for loss of control."

His company is testing low-alcohol products such as Citronet, a carbonated citrus drink made with white wine that has 4 percent alcohol.

Heublein has asked the Federal Bureau of Alcohol, Tobacco, and Firearms to alter its regulations to make it easier to sell low-proof whiskey. Under present rules, though, if the alcoholic content is below a certain level, the product must be labeled "diluted." Heublein and Seagram would like to be able to label lower-strength spirits as "mild" or "light."

The fact that the 18-to-24 age bracket is shrinking poses problems for beer producers, which rely heavily on young drinkers.

Changes are apparent in bars and restaurants, which have become jittery about lawsuits charging them with liability in drunken-driving accidents. Many bars are closing earlier, pressing soft drinks on red-eyed patrons, and posting warning signs.

In Southampton, N.Y., known for its summer night life, more than 40 of the town's bars, discotheques, and restaurants began serving free soft drinks last month to customers wearing "Designated Driver" buttons.

Houlihan's, a national restaurant chain, put up plexiglas posters last January in its 48 restaurants that caution: "Don't Let Your Friend Drive Drunk." These restaurants furnish free coffee to patrons at closing time.

Ron Vilord, vice president of Houlihan's, said its liquor business had become level after increasing for several years. As a result, the chain is placing more emphasis on its food.

Liquor stores have become more circumspect, partly because the police have become more vigilant about selling to minors.

"Sales have been flat at liquor stores for the last three to five years," said John Burcham, executive director of the National Liquor Stores Association, "and we don't have any indication that they are going to pick up any time soon."

A potential threat to the industry is a movement to restrict the advertising and marketing of alcoholic beverages. The Center for Science in the Public Interest, which has been a sharp critic of the promotional practices of beer and liquor companies, filed a petition with the Federal Trade Commission last year, advocating tougher marketing rules.

The petition asks either that television and radio advertising of alcoholic beverages be banned or that counter-commercials be run to warnof the perils of drinking. The petition also seeks to stop promotional aimed primarily at young people, such as rock concerts.

Source: The Index Journal