January 2021

Following an active period of capital deployment in the first half of 2020, we made no new investments in the second half of the year. This month we initiated positions in defense contractor Lockheed Martin (LMT) and cell tower owner American Tower (AMT), both of which are recession-resistant businesses and leaders in their respective industries. Both companies have seen their share prices dip 20-25% in recent months, and we think that presents opportunity. Please see our investment summary of each company in the following pages.

We've also recently added to our investment in Alibaba (BABA), which we began acquiring in 2018. Its shares fell nearly 30% since October 2020 on increased regulatory scrutiny by the Chinese government, partly in reaction to critical comments made by Alibaba founder Jack Ma about state-owned Chinese banks. It was even speculated that Jack Ma had gone missing as part of a dystopian punishment for his recalcitrance (he has since turned up). The government halted the company's IPO of its Ant Financial unit, which directly competes with traditional banks. Officials are also said to be reviewing Alibaba's monopolistic practice of requiring merchants to exclusively sell through its platform. Pressure on the share price was exacerbated due to consideration by US officials of adding Alibaba to a list of Chinese companies banned from ownership by US investors. The list is part of a broader set of political and economic disputes between the two countries that has escalated in recent years.

Over $1 trillion of gross merchandise value is transacted on Alibaba's marketplaces (compared to BABA revenue of $90 billion), essentially providing indirect employment for millions of people, in addition to providing a better standard of living for its 800 million customers. It's too important for the government to quash. As for the potential ban on US ownership, the most major companies affected – China Mobile and China Telecom – have declined about 25% since being added to the list. Ultimately, the US decided not to ban US investors from owning shares in Alibaba because of the potentially destabilizing effects on markets and the economy.

Taken together, none of these risks can fully be dismissed, but they are acceptable to us compared to the potential long-term reward from owning a rapidly growing, entrenched business in a country with favorable demographic tailwinds. The shares traded down to 19x estimates for next year's earnings, half as expensive as big US tech companies, which are growing slower and have a smaller addressable market compared to BABA. We view the dip in the share price as a buying opportunity.

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New Investments

Lockheed Martin (LMT)

Lockheed Martin is the world's largest aerospace and defense company. Lockheed's high market share and large installed base lead to follow-on maintenance work and fund a robust R&D budget that make it harder for competitors to chip away at its lead. Fixed wing and rotary aircraft account for 65% of its sales, while its space and missile segments make up the balance. Its notable businesses include the best-selling Black Hawk military helicopter, Terminal High Altitude Area Defense (THAAD) missile defense program, C-130J Super Hercules military transport aircraft, hypersonics weapons programs, and the Orion spacecraft. Lockheed Martin has been an integral part of most space missions from Apollo to the Space Shuttle to the numerous Mars missions, and now with Orion, which is a capsule designed for deep space exploration. Orion was recently selected by NASA to carry astronauts back to the moon as preparation for eventually traveling to Mars. These various business segments provide diverse revenue streams, but Lockheed's largest business is the F-35 fighter jet program, which accounts for 27% of sales.

Lockheed Martin has a history of leadership in the fighter jet market, thanks in large part to Skunk Works, its secretive development organization created in 1943. Here's a brief list of engineering feats developed within the Skunk Works division:

- P-80: America's first jet fighter, used in the Korean War
- U-2: the world's first dedicated spy plane, used in the cold war to surveil from an altitude of 70,000 feet
- SR-71 Blackbird: the world's fastest manned aircraft, which flew at a speed of Mach 3 at 78,000 feet
- F-117 Nighthawk: the world's first aircraft that flew undetected by enemy radar, featured in Operation Desert Storm in Iraq during the Gulf War

Lockheed has the industry's only two fifth generation stealth fighter jets in the market: F-22 and F-35. The US government selected Lockheed and Northrop Grumman to compete for the former, and Lockheed and Boeing to compete for the latter. Lockheed won both contracts. The F-35's capabilities are unparalleled by any other fighter jet; the program is so dominant that the United States uses it as leverage in foreign policy. In the past, the US has suspended Turkey and Israel from the F-35 program for dealings with Russia and China, respectively. Lockheed is just five years into the program, which will provide a steady revenue stream for the next two decades. The US Department of Defense (DoD) plans to purchase roughly 2,500, while numerous foreign governments have placed orders or are in the US government vetting process to become approved buyers. The US government accounts for about 70% of Lockheed's company-wide sales, which implies global F-35 orders could ultimately total about 3,500. Approximately 600 jets have been delivered to date.

Over the last three years, revenues and earnings have grown by one-third, but shares have stalled and now trade for 13x estimates of this year's earnings. This multiple reflects investor concerns

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about the Biden administration's impact on the DoD's budget. Under President Obama, the DoD budget was cut, and Lockheed's revenue grew only 2% annually, although per-share earnings grew considerably faster due to margin expansion and share repurchases. Assuming a decline in sales growth to 2%, coupled with the company's consistent return of capital through dividends and share buybacks, our annualized return in the shares should be at least 6% without any improvement in margins. That's an attractive baseline return for a company that grew through the last two recessions. An equally likely scenario is an eventual return to the 11% earnings growth the company realized over the last ten years, which included a range of DoD budgets under both Republican and Democrat administrations. What makes this investment especially compelling is that because of the long duration of the various programs, and the resulting sales backlog, free cash flow is consistent. The company generated $6.4 billion of free cash flow in 2020, after a combined $3 billion of research and development investments and capital expenditures. The board returned $3.9 billion of that cash flow to shareholders through dividends and share repurchases. The balance sheet is conservatively managed with 0.9x net debt / EBITDA. That all sets up an attractive scenario whereby any further decline in the share price from the current $94 billion market cap will provide an opportunity to increase our expected return.

Coincidentally, Lockheed's new CEO James Taiclet was CEO for 16 years of American Tower, our other new investment. During his tenure, American Tower's market cap grew from about $2 billion to over $100 billion. As a graduate of the United States Air Force Academy and a former pilot and officer in the Air Force, his fit with Lockheed is clear.

American Tower (AMT)

American Tower is one of the world's largest owners and operators of communications towers. Wireless providers such as AT&T and Verizon lease tower space to hang communications equipment that services their customers in the surrounding areas. American Tower has about 40,000 towers in the US, 70,000 in India, 20,000 in Africa, 46,000 in Latin America, and 30,000 in Europe. Each tower can host up to four tenants; rent from the first tenant essentially pays for the tower, while margins on each additional tenant are 95% because the tower operating costs are fixed. Tower leases are long-term, and typically include annual 3-4% price increases. Less than 1% of leases to the four big US wireless carriers are terminated annually. The business is recession-resistant, and revenues and cash flow have been growing 12-13% annually for the past five years.

American Tower is especially appealing to us because of the strength of its market position; each tower effectively has a monopoly on its local area. AMT is highly likely to continue to be a toll booth on the growth in data consumption globally. As network technology has evolved from 2G to 5G, capabilities have expanded from voice and text to mobile video to Internet of Things. That has led to an ever-growing wave of global mobile data traffic that Ericsson, a telecommunications company, expects will quadruple over the next five years. That growth will increase utilization of existing towers and continue the need for more towers. Each new network standard requires new equipment to be mounted on the towers, which drives higher rents especially as the new

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standard matures. Two-thirds of AMT's towers are in emerging markets where network standards are several years behind those in the US. The company should benefit from rent growth as the equipment in these markets evolves.

There is an additional growth opportunity that American Tower is pursuing. As the industry deploys 5G network technology, numerous advanced applications will be enabled such as autonomous vehicle connectivity, drone delivery networks, and augmented reality and virtual reality gaming. Latency is a problem for these applications. American Tower is selectively building micro-data centers on some of its tower sites that essentially extend centralized data centers to the end user in order to reduce latency. As 5G proliferates in the coming years, AMT will be able to further leverage its existing footprint to supply market demand for these edge data centers.

AMT's share price declined 20% since last summer as interest rates increased with the threat of inflation. American Tower trades for an implied cap rate of 4.5%. Debt represents about 20% of its enterprise value. The debt is termed out and AMT generates ample cash flow to meaningfully reduce debt as it comes due if rising rates make refinancing prohibitively expensive. Regardless, further increases in rates would pressure the stock. At AMT's current share price, the spread between its implied cap rate and the 10-year Treasury yield is in line with its average over the last ten years, so our return should not be negatively impacted by multiple contraction. Its consistent growth in cash flow and its dividend yield combine for an expected annual baseline shareholder return of about 15%. If interest rates rise, the share price would likely decline and we would have the opportunity to buy the cash flow stream for a cheaper price. In that scenario, we would eagerly build a more meaningful stake in a business that is essential to enabling the secular growth in global data consumption.

Please reach out to me directly with any questions about your account.

Cordially,
Ted Crawford

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