CLIO ASSET
MANAGEMENT LLC

July 1, 2024

Dear clients,

In Q2, the Clio Core Portfolio declined (7.1%). Year-to-date, the Portfolio is up 4.1%.

Net Returns (incl. Dividends) through 6/30/2024	Clio Core Portfolio	S&P 500 Index ETF (SPY)	Relative
Q2 2024	(7.1%)	4.4%	(11.5%)
Last Twelve Months	10.6%	24.5%	(13.9%)
Last 5 Years (Annualized)	13.5%	15.0%	(1.5%)
Since Inception (Annualized)	14.4%	13.4%	1.0%
Since Inception (Cumulative)	117.0%	105.8%	11.2%

I. INVESTMENT PERFORMANCE

Since I last wrote to you in November, the Core Portfolio delivered strong performance in Q4 and Q1, rising 25.2% over the six-month period. Some of those gains reversed in Q2, which was one of the Portfolio's worst three quarters on a relative basis to the market since inception.

It's generally more enjoyable to write these letters, and I'm sure for you to read them, when I can report both strong recent and long-term performance. In my last letter in November (the 5-year review), I noted that Clio's returns since inception would have ranked in the top 1% of 5,500+ active US equity mutual funds – a very satisfactory result to me. The recent drop has, however, dented Clio's degree of outperformance.

The 7.1% absolute decline in Q2 was somewhat unique in Clio's history in that it was almost entirely single-stock driven, and not due to some out-of-the-blue external shock or broad market selloff. There was no spike in interest rates or inflation; no major surge in commodity prices; no new geopolitical conflict or pandemic or trade war. It also wasn't a function of holding too much cash during a rising market – the Portfolio has been nearly fully invested all year. No – this past period's performance was almost entirely the result of the quarterly earnings reported by Clio's holdings in April and May. The Portfolio began to recover in June.

In a highly concentrated portfolio like Clio's, a single earnings season can have an outsized impact on short-term results. And over time, the short term becomes the long term. In many quarters, the good and the bad can often offset each other. In Q2, however, the bad overwhelmed the good – with only Hilton and Danaher rising meaningfully on the day of their reports.

The below table shows the single-stock performance of Portfolio holdings in Q1 and Q2, along with their associated reactions on the day of their earnings reports. Q1 performance was almost uniformly strong, while Q2 nearly the opposite.

2024 YTD Single-Stock Performance[1]

Investment	Q1 Return	Feb/Mar Earnings Reaction	Q2 Return	Apr/May Earnings Reaction
O'Reilly Auto (ORLY)	18.8%	(4.3%)	(6.5%)	(3.5%)
CDW (CDW)	12.5%	3.1%	(12.5%)	(11.3%)
Ferguson (FERG)	13.1%	(6.7%)	(11.3%)	(2.9%)
AutoZone (AZO)	21.9%	6.7%	(6.0%)	(3.5%)
Berkshire-Hathaway (BRK.B)	17.9%	(1.9%)	(3.3%)	1.0%
Sherwin-Williams (SHW)	11.4%	0.9%	(14.1%)	(2.2%)
ServiceNow (NOW)	7.9%	0.4%	3.2%	(4.0%)
Hilton Worldwide (HLT)	17.1%	0.7%	2.3%	3.9%
S&P Global (SPGI)	(3.4%)	(5.0%)	4.8%	0.5%
Danaher (DHR)	7.9%	4.7%	0.1%	7.2%
Visa (V)	7.2%	(1.7%)	(6.0%)	0.3%
Builders FirstSource (BLDR)	24.9%	2.6%	(33.6%)	(19.0%)
SPY	10.4%	n/a	4.4%	n/a

During this past quarter, the negative earnings reactions were mostly driven by revenues which came in lower than investors were hoping. In each case, there was an air pocket of demand in a particular end market or customer base which came as a surprise.

For O'Reilly and AutoZone, unfavorable weather, a delay in customer tax refunds, and some deferral of auto maintenance spend led to a c. 1% revenue shortfall vs. estimates. Ferguson saw slightly higher price deflation on a subset of products, following a couple of years of very strong pricing gains. CDW is still gaining share across IT broadly, but Server and Networking Communication sales were disappointing in the quarter. Sherwin-Williams saw lower than expected paint volumes due to fewer home sales and poor weather in the Southeast region. ServiceNow reported very solid revenues and earnings, but declined to raise its guidance for the

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[1] Q1 and Q2 share price returns are shown for the full period, and may not be reflective of security returns in individual accounts; BuildersFirst Source was first added to accounts in early February

remainder of the year as much as it typically does, leading the stock to fall 4%. The biggest decliner in the quarter was Clio's newest investment, Builders FirstSource, a distributor of building product supplies to the new home construction industry. While single-family construction demand (the bulk of BLDR's revenue) remained solid, the company saw a marked decline in new starts for multi-family units (i.e. apartment buildings) which spooked investors and sent the stock down sharply.

Having analyzed these reports along with those of peers and competitors, I remain confident that the companies in the Portfolio are by and large making progress in line with my original investment theses. I believe these are durable businesses run by excellent management teams, with many years of profitable growth opportunities ahead. As a result, the overall composition of the Portfolio changed very little following the weak April and May reports. The July earnings season will kick off in three weeks, when I will have another opportunity to evaluate how each company is performing relative to both my expectations and those of the market.

Relative Performance vs the S&P 500 (SPY)

While a 7% decline in the Portfolio in a quarter is not particularly unusual or extreme, it feels worse because the S&P 500 (SPY) rose 4.4% during the period. Similarly to 2023, this market-cap weighted index continues to be driven higher by the strong performance of the largest technology companies. Nvidia, a designer of computer chips and software powering the growth of AI, seemed to rise nearly every day, and in late June surpassed Apple and Microsoft as the market's most valuable company. Meanwhile, the equal-weighted index of the same 500 companies (the RSP index) was down 2.6% in the quarter, leaving it up 5.0% for the year. Small caps have fared even worse, with the Russell 2000 index down 3.3% for Q2 and up just 1.6% for the year.

These dynamics have led to a lot of hand-wringing in the investment community and claims that the 'market is broken'. Some complain that the concentration of the tech giants in the S&P, which is now at the highest level on record, has become a self-fulfilling prophecy, whereby passive index funds and ETFs are forced to continually buy the winners at ever-higher prices. Others point to the extreme increase in short-term options trading, which can also have the effect of squeezing these names higher.

To me, these complaints are irrelevant and generally miss the mark. The 'market' is not broken. It is doing what it always does. Yes, beating the index is always hard and has become harder if one has not owned these megacap tech companies in significant size for the past two years. But Clio, and most other investment managers, are perfectly free to own them. If we constantly judge ourselves on relative performance, it's our own fault for omitting these large outsized winners from our portfolios.

It is true that the S&P 500 is no longer a highly diversified index of leading companies across many industries and end-markets – at least by historical standards. The top 3 companies (Nvidia, Microsoft and Apple) now comprise about 20% of the index. That number rises about 30% when Amazon, Alphabet, and Meta are included. Through June 17, more than 60% of the S&P 500's return was driven by these six stocks, a similar dynamic to 2023.

There's absolutely nothing wrong with that, but index fund holders should be aware of what they actually own. These giants are good, dominant companies who have performed extremely well. But they are all reasonably correlated to one another – and so owning the S&P 500 today has increasingly become a concentrated bet on big tech and specifically the promise of Artificial Intelligence.

From a consumer AI perspective, the "sellers"/"suppliers" of the core technology are the semiconductor chip designers (e.g. Nvidia) and manufacturers (e.g. Taiwan Semiconductor). The "buyers"/"customers" are technology companies who are using these specialized chips and servers to power huge mathematical models that can generate text, images, and code based on user prompts. The biggest of these buyers are Microsoft, Facebook, Google, Amazon, Apple, and Tesla – the same companies which have grown to dominate the S&P 500.

On a relative basis, the Clio Portfolio has suffered over the past 2-3 years from its lack of exposure to this sector and theme. The market is now expecting tens of billions of dollars of incremental cash flows to accrue to the tech giants from AI products. I am skeptical that these expectations will be met. If they are, then it is reasonable to assume the Clio Portfolio will underperform on a relative basis vs. the S&P 500.

However, as you know, I manage the Portfolio to deliver absolute, not relative returns. And while it can feel uncomfortable at times to miss out on the latest hot investment theme or underperform the market for extended periods, the strategy remains consistent. I believe that the Portfolio is comprised of durable, growing companies which have created significant value over time and should continue to do so. These are companies which meet Clio's absolute return hurdles, are led by strong management teams, and are profitably gaining share in steadily growing markets.

While I do not have confidence that the AI investments of the tech giants will produce compelling returns on capital, in the next section I plan to discuss a sector where I do have this conviction: the decidedly unsexy business of selling aftermarket auto parts.

II. PORTFOLIO UPDATE

As I noted in November, the Core Portfolio at various points in time has been disproportionately exposed to certain sectors and underlying business models. For example, from 2018-2021, the Portfolio contained several payment processing companies – a business model which, when working well, allows millions of transactions with little incremental expense to be run over a largely fixed cost base. The benefits can show up in higher margins and returns on capital. From 2019-2021, the Portfolio had significant exposure to Software-as-a-Service (SaaS) companies. This business model relies on striking a profitable balance between upfront sales, marketing, and R&D costs with the prospect of a long-dated, high-margin, recurring subscription revenue stream.

Today, there are several distribution businesses in the Portfolio. These include CDW, Ferguson, Builders FirstSource, O'Reilly Auto and Autozone. Berkshire Hathaway also owns several distribution subsidiaries. Many distributors are not good businesses – they are commoditized middlemen with little ability to negotiate pricing from either their suppliers or their customers, leading to meagre margins and low returns on capital. Another knock against distribution as a business model is the lack of recurring or subscription revenues, leading to poor earnings visibility over time, especially in cyclical end markets.

However, many best-in-class distributors can generate extraordinary shareholder returns because of certain unique attributes. These can include product complexity, the ability to offer private label products and value-added services, efficient working capital management, a fragmented supplier and/or customer base, a well-trained and properly incentivized salesforce, and strong acquisition capabilities. The leaders also tend to use sector downturns to invest countercyclically and position themselves to take outsized market share on the upswing. I believe Clio's distribution businesses exhibit most, if not all, of these attributes which facilitate customer loyalty, market share gains, improving margins, and above-average returns on investment capital.

Most distributors serve either consumers (i.e. retailers or B2C companies) or other businesses (i.e. wholesalers or B2B distributors). The leading auto parts retailers are quite unique in that they have designed their strategies and built their asset bases to serve both segments of the market. This choice has led to very high returns on capital and extraordinary shareholder value creation in an industry that grows modestly but steadily.

O'Reilly (ORLY) and AutoZone (AZO) are distributors of aftermarket auto parts to individual consumers (the DIY, or Do-it-Yourself segment) and auto repair shops (the DIFM, or Do-it-for-Me professional segment). Clio has owned O'Reilly since February 2020 and AutoZone since September 2023. Both indiviudally and together, they represent a high conviction bet for Clio.

While the companies share several similarities, I would argue that O'Reilly is the gold standard in the industry in terms of operational and strategic excellence, which I expect to continue. AutoZone is more of a story of change and improvement – in part due to its decision to more fully embrace elements of O'Reilly's model in the last decade. I think that each of these companies offers some of the most attractive future returns in Clio's investible universe, and that each deserves a place in the Portfolio.

Aftermarket Autoparts Distribution – US Industry Overview

The addressable market for the products sold by O'Reilly and AutoZone is roughly $150bn in the United States. This figure includes auto parts sold directly to consumers as well as to professional repair shops, but excludes tires and service/labor spending. The market has grown at roughly 3-4% annually for the past 25 years.

Revenues to the industry are reasonably predictable. People drive their cars, parts break down, and they need to be replaced. Deferral of maintenance can only last so long. Total miles driven on US roads have generally increased at about 1% a year, but can fluctuate with the price of gasoline and other factors. The industry should continue to benefit from two additional tailwinds over the coming years – the increase in the number of vehicles on the road which are 6+ years old (the sweet spot after which warranties have expired); and the increased complexity and number of parts within a vehicle. Cars are lasting longer, and Americans are holding onto those cars rather than buying new ones. The demand for replacement auto parts is steady, predictable, and growing.

The industry remains fragmented but is consolidating. There are four larger players – O'Reilly, AutoZone, Advance Auto, and Genuine Parts/NAPA – who garner a little over 30% of the sales, up from 20% twenty years ago. The remaining 70% of the industry is primarily made up of smaller Wholesale Distributors ("WDs"), auto dealerships, regional players, and mass merchants/online sellers (e.g. WalMart and Amazon). I expect O'Reilly and AutoZone to continue to gain additional market share from the long-tail of smaller competitors for many years.

The industry tends not to compete on price, but rather on customer service and parts availability / delivery times. A car is often mission critical for its owner, who needs the right replacement part as quickly as possible. An auto repair mechanic doesn't make any money if he doesn't have the needed part, and he wants to turn his service bays over as quickly as possible. The difference between a part delivery in 30 minutes vs. 3 hours (let alone 3 days) is huge. Price is generally not a deciding factor in choosing a distributor. Thus, the share gainers are those who have the broadest assortment of products, knowledgeable employees, and a well-developed logistics and warehouse network designed to replenish parts as quickly as possible. O'Reilly and AutoZone are by far the leaders on this front.

The Dual-Market Strategy

O'Reilly was founded in 1957 and originally served professional customers (auto repair shops). In 1978, O'Reilly began to pioneer the "dual-market strategy" of serving both professional (DIFM) and retail (DIY) customers. While simple in theory, this strategy requires additional investment and superior execution vs. a single-segment model. Once up and running, though, the strategy allows for a shared set of physical assets (inventory, stores, trucks, warehouses) to serve a much larger addressable market. Sales and profits through each store can thus rise without a commensurate increase in the physical assets required. This leads to higher returns on invested capital and a stronger, more resilient business model. O'Reilly has benefitted from its pioneering role for more than forty years.

AutoZone was founded in 1979 and its legacy is in serving the retail/DIY segment where it is the market leader and built its reputation on obsessive customer service. Around 2008, the company decided to make a major push into commercial/DIFM, in large part replicating the O'Reilly playbook but from the other direction. Each year since then, AutoZone has added commercial programs to c. 5% of its retail stores, and now has 90% commercial coverage across its store base. The company has also invested in its warehouse and distribution network, as well as in "hub" and "megahub" stores, which are larger store formats that can more effectively serve the DIFM market. These investments began to accelerate about five years ago. As a result, AutoZone has seen improving share gains in the DIFM market, which I expect to continue as this initiative matures.

At the same time, Advance Auto Parts, a sizable competitor, has struggled for years and ceded market share across both categories. The company neglected to build a warehouse and distribution network to adequately replenish its stores on a regular basis, and has gone through multiple management teams and turnaround initiatives over the past decade. New management has finally decided to make these investments and pursue the 'dual market strategy', but it is starting 45 years behind O'Reilly and nearly 20 years behind AutoZone on this front. With roughly half the sales volume of the other two players, I believe Advance will continue to cede share, as will the smaller WDs. O'Reilly and AutoZone are well poised to be the 'last men standing' in large format auto parts distribution without having to make any acquisitions – they will simply continue to consistently take business away from the competition. This part of the story has echoes of the history of Home Depot and Lowe's in the home improvement category.

Advance's new CEO Shane O'Kelly talked about this dynamic on the company's most recent earnings call in late May when he was asked about a pilot program to convert some Advance stores to 'market hubs'. Here is how he responded:

> "I think you see this elsewhere in the industry *[e.g. at O'Reilly and AutoZone]*. The premise is that if you have parts closer to customers and you're more responsive, you get more orders. And so what we did is we looked at how we fit in that regard in terms of what can we get you in 30 minutes, what can we get you in 2 hours, 4 hours, same day, next day. And we found there's a significant shortfall in the number of parts that we can get you at those requisite time frames. So we said, well, how do we accelerate that? How do we be more competitive? And so what a market hub does is it pushes parts closer to the

> customer to where we can get it to other hubs or stores, where it would otherwise have to come from the Distribution Center (DC).
>
> And so by using the hub, we can get it to a store more quickly than if it was coming from the DC. And so that's what we've seen. And what we see both physically within that store, that actual hub, where we have those parts, we get sales. And then the surrounding stores, if you could think about that as about 100 stores, they're now getting better service because they were previously relying on only the DC. So that's the premise. I think just another comment here. <u>Sometimes in a business, being a fast follower can be an effective strategy</u>. [Emphasis: Clio's] And so beyond our own pilot results, I think the effectiveness with this market hub concept elsewhere in the business *[e.g. at O'Reilly and AutoZone]* also points to the idea that it's a good one.

While I think Advance's strategy here is probably the right one at this point in time, for the CEO to call themselves "fast followers" of O'Reilly and AutoZone is misleading. Advance is at least a decade or two behind.

Simplistically, here is how I estimate future annualized returns for O'Reilly:

- 2025 Maintenance Free Cash Flow Yield: 5.3%
- Steady-State Free Cash Flow Growth (excl. new stores): 4.8%
    - Volume growth of 2.5%; pricing/inflation of 1.5%; impact of improving margins and leverage of 0.8%
- Value creation from $800M incremental investment at 30% ROIIC: 3.6%
- TOTAL RETURN: 13.7%

This base case total annualized return of 13.7% excludes any benefit from value-enhancing share repurchases, which could add another 2.5 percentage points per year. Furthermore, I believe O'Reilly's valuation (multiple of free cash flow) should continue to increase gradually over time as investors more fully appreciate the company's ability to deploy incremental capital at high rates of return for many years into the future.

Thus, as a base case, I'm underwriting a roughly mid-teens annualized return going forward for O'Reilly. My estimates for AutoZone are slightly above O'Reilly, given the higher starting free cash flow yield and impact of share repurchases. However, the AutoZone story comes with modestly higher execution risk given their less mature commercial initiatives. Thus, I am comfortable with the relative sizing of each position in the Portfolio.

<u>The EV Bear Case</u>

For several years, a primary bear case against O'Reilly and AutoZone has been the rise of Electric Vehicles (EVs). Because EV's have fewer parts than traditional Internal Combustion Engine (ICE) vehicles, some people believe that total demand for replacement parts will start to decline in 20-30 years if EVs become a significant share of cars on the road. I have always been skeptical of this argument, and remain so today. I do not believe that EVs will gain mass consumer adoption in the US. They will remain a niche segment of the auto market, with loyal buyers who fit very specific use cases.

For the average American car buyer, EVs have a higher total cost of ownership (in large part due to the need to replace the very large and expensive batteries), and a lower resale value. They also have significant range and hauling challenges. For society at large, I believe they are less environmentally friendly given the need to mine massive amounts of minerals and metals, which also poses geopolitical concerns. Lastly, should they be adopted at mass scale, they will impose unsustainable burdens on the nation's electric grid. While sales of EVs have accelerated in the past few years as a result of heavy government subsidies and industry mandates, popular opinion is turning against their mass adoption for the reasons cited above. I don't believe the mandates will survive in most states.

Over the next twenty to thirty years, I see the nation's car parc evolving slowly to a more balanced mix of ICE and hybrid vehicles, with EVs remaining a minority. O'Reilly and AutoZone will continue to do well in this environment as they remain share gainers in a modestly growing end market.

Conclusion

O'Reilly has been a strong performer in the Clio Portfolio since 2020. My conviction in the attractiveness of the industry and the strength of the business model has only grown with time. As a result, I have felt comfortable letting ORLY grow into the Portfolio's largest position in addition to adding AZO. When I scan the broader market as well as Clio's Focus List of opportunities, I have trouble finding other companies where I feel as confident in the durability of demand and the persistence of high returns on incremental capital. I trust the management teams, many of whom have served at their respective companies for decades, to continue to quietly execute their strategy, enhance customer loyalty, and ably adapt to changing market conditions. At current valuations, I believe each company represents a bargain relative to the value they will be able to create over time by simply sticking to what they do best and disproving the bear cases against them, which they have done many times over decades. While these businesses do not have the explosiveness of an Nvidia or the worldwide dominance of an Apple, I see many years ahead of steady, attractive returns which will compound over time.

In August, I will travel to the suburbs of Chicago for investor meetings with O'Reilly management at their Napierville, IL distribution center. I'm looking forward to learning more about their latest operational initiatives and having the opportunity to tour the warehouse along with two local stores. I also expect management to spend some time discussing their initial forays into the Canadian and Mexican markets, which are a small piece of the business today but have the potential to become meaningful over time.

III. CLIENT BASE AND ORGANIZATIONAL UPDATE

At June 30, Assets Under Management totaled $130 million from 52 clients. Clio has onboarded one new client since the start of the year.

There are no significant operational or organizational updates to report.

Sincerely,

James Aldigé

Clio Asset Management LLC

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