July 7, 2015

To clients and friends of The London Company:

What you do speaks so loudly that I cannot hear what you say.
– Ralph Waldo Emerson

Talk is cheap. Promises made but never fulfilled are present in many aspects of life, but particularly ubiquitous in politics and business. While it is common to find hypocrisy in these fields, it can be inherently difficult to anticipate beforehand (although on second thought maybe less so politics, where some 'mistruths' seem clear from the start). In regards to business and more specifically, investing in businesses, a leap of faith is often required. The inability to really get in the head of a business leader results in uncertainty. At worst, that leap of faith is broken by poor decisions of a management team which can derail the most airtight investment thesis. In order to avoid negative surprises, The London Company tries to partner with management teams that we respect and trust. We try to gauge their character, integrity, energy and true motivations. We watch closely how they structure their incentives and allocate their personal capital. By observing their actions and not just listening to their oft-biased messaging, we hope to find like-minded partners. It is easier said than done, but in the past we have found particular success with businesses that are family-owned. Across all our strategies we have a number of first, second, third (or more) generation enterprises where the founding family has retained a significant ownership (and wealth) in the business. The reasons should be intuitive as to why we like these enterprises, but are further supported by recent studies that have demonstrated family-led public equities tend to outperform non-controlled peers with less volatility. This quarter, we would like to share some of these advantages but first will provide the prerequisite market recap.

The U.S. equity markets were a subdued mix this quarter. The S&P 500 was more or less flat, up 0.3% when including dividends and the Russell 2000 Small Cap Index was just slightly better at 0.4%. The Russell 2500 Small-Mid Cap Index and Russell Midcap just fell short of even, returning -0.3% and -1.5% respectively. While most indices finished around their starting points, the journey wasn't necessarily boring. Akin to a running back scampering 30 yards east and west to eventually trip over the line of scrimmage, equity returns oscillated without really moving forward or backward. Up and down days increased throughout the quarter as investors speculated on the upcoming rate hike from the Federal Reserve and whatever geopolitical issues of the day seemed important. Year-to-date, all the aforementioned indices remain above zero with small caps (up 4.8%) still outpacing large caps (up 1.2%).

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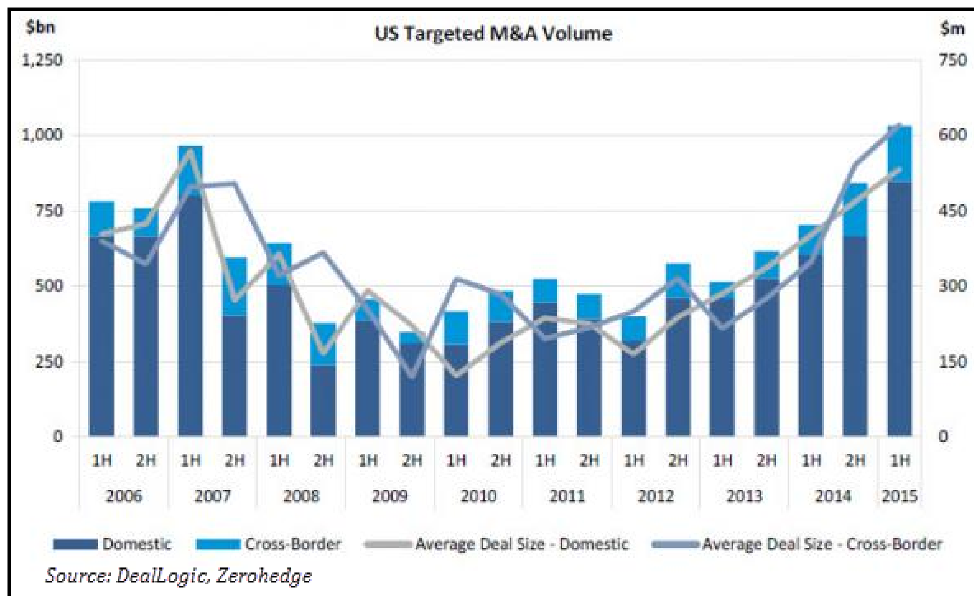
For the most part, 2015 domestic equity returns are paralleling the current pace of the general economy. As we muddle along, there are signs we are slowly gaining traction in a number of areas. Expected GDP growth in the second half of the year is low but positive; inflation remains muted and unemployment continues to tick lower and lower. The 'known worries' are benign when compared to other parts of the world, so U.S. markets are keeping their place as a relative safe haven for global investors. The year-to-date strengthening of the U.S. dollar supports this notion and has assisted some sectors in deviating from others. Across the capitalization spectrum, domestic-centric (export-lite) health care and consumer discretionary stocks outpaced the overall benchmarks. A healthy M&A environment is also aiding those sectors, as well as keeping technology and financial stocks ahead of the curve. Global-centric (export-heavy) industrial stocks and commodity-oriented energy and materials stocks have trailed the averages this past quarter and full year. Utilities are also on the negative side of the ledger for the second consecutive quarter as a backup in long-term interest rates caused these high-yielding, rate sensitive companies to underperform.

The London Company's strategies didn't do much to distinguish from the benchmarks this quarter. Our Concentrated and Mid Cap portfolios finished ahead and right in line with their respective indices, while our Small Cap, SMID, Large Cap and Income Equity portfolios finished slightly behind. Mid-year results are better as all strategies, with the exception of our Large Cap product, posted positive returns and are sitting ahead or just on top of their respective benchmarks. The current drivers of returns remain steady: high operating margins, copious cash flow generation, M&A activity, stock buybacks and dividend increases. Concerns about equity valuations have increased, but are not substantially elevated from the recent past. Generally speaking, most investors are still cautious and hesitant to embrace the current seven-year bull market. It is worth noting that we are over 1,300 days without a 10% pullback in the S&P 500, the 3rd longest such streak. Not that we can forecast when a correction eventually will happen but just that it will at some point.

The current market environment remains accommodative. Interest rates are low (and will likely remain so even if the Fed starts tightening) and overall inflation is benign. This is an excellent environment for financial engineering and careful consolidation. Both financial buyers and strategic investors are taking advantage of this backdrop, as displayed by the record M&A activity in 2015. According to DealLogic, targeted M&A deals in the U.S. for the second quarter were the highest on record at $635bn (see chart below). Over $1 trillion in targeted domestic deals is also an all-time high through the first six months of the year. Volume and size of deals in most sectors are at a historic pace and particularly robust in health care and technology, which is helping provide a floor on valuations. This later cycle phenomenon has been a long time coming and could continue for quite a while. While some multiples being paid in pockets of biopharma and small cap tech appear rich, the average M&A premium is not egregious at 29%. Lastly, most deals are being funded by cash and debt allowing immediate value-creation, and not in stock, which has been more typical in bubble-like conditions.



Source: DealLogic, Zerohedge

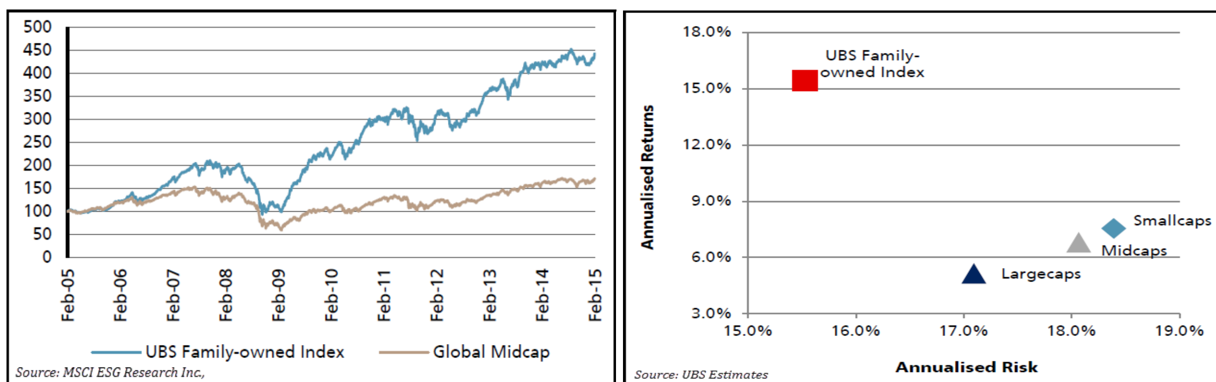
In our third quarter 2014 letter, we warned of poor capital allocation decisions and the damaging effects destructive M&A can have on enterprise value. To rephrase Warren Buffett again, when management teams have excess cash and begin looking around and asking consultants or investment bankers if an acquisition or two makes sense, it can be the equivalent of asking your interior decorator if you need a $50,000 rug. It is in these markets where the winners and losers will eventually be spotted. Poor capital allocation is a risk we cannot forecast well or control, so we attempt to avoid empire builders and seek management teams that are more conservative in their decisions. Where we have had success in the past is by investing in family-run businesses. When owners of the business have direct proprietorship of the company coffers, more rational actions should be expected. These decision makers tend to think much longer term and exercise patience to build, and more importantly, protect wealth for the next generation.

While ninety percent of all U.S. businesses are family-owned or controlled, the odds of success are stacked against them during the early non-public years. According to a Harvard Business Review (HBR) study, roughly a third of the family-owned businesses that go public will transition to a second generation. Only 12% make it to a third and just 3% to a fourth. This is typically a result of consolidation, estate planning, or differing objectives and desires amongst the remaining family members. Global companies such as Wal-Mart, Samsung, and Ford are success stories that have bucked the trend and survived for more than one generation. Every successful family business is a story of resiliency and perseverance. It is this history that leads them to consider investments for the long haul, knowing their decisions will affect the next generation and the legacy of the company. This long-term focus resonates with our philosophy of protecting the downside risk first and foremost.

Furthermore, family-run businesses have a tendency to stick to their core competencies and thus take targeted risks in markets they know well. The study also highlighted other advantages, including more tenured leaders and less executive turnover, a more transparent corporate governance structure, and a culture that resonates to all employees

helping retain talent better than non-controlled peers. Yet, the best aspect of family-led public companies is that their actions can result in higher profits and better performance for shareholders. A recent analysis by UBS states that companies that are family controlled have outperformed global benchmarks for the past 1, 3, 5 and 10 year periods. The study evaluated over 250 globally based companies where the founder or founding family has significant influence (meaning more than a 20% voting interest and is active in the decision making) and found a universe with significantly better risk adjusted metrics (see charts below). Specifically, these companies were less volatile, earned higher returns on capital, and had a mean operating margin of 15.7% or 30% higher than the large cap average and double the mid cap average.

UBS study: Family-owned businesses have outperformed with less volatility



In summary, family-owned businesses have historically proven to be better capital allocators, leading them to outperform with less downside risk. The businesses are managed for the long term so the threat of taking excessive risks is much less when the owners personal sweat equity is at stake. We like partnering with leaders that have skin in the game and know they are treating our capital like, well, an owner. This is not suggesting there aren't companies that are not family owned that fit our criteria for investment; just that this is a sweet spot we have identified to increase our downside protection.

Looking ahead, there will be continuous obstacles to overcome to keep the current bull market rolling. Geopolitical turmoil is alive and well abroad and could obstruct the domestic economy. As we watch a modern Greek tragedy unfold, uncertainty abounds. That country voted a resounding 'no' on its referendum, potentially setting the stage for an exit of the Eurozone. If they depart and leave *la familia*, suggesting family by marriage doesn't have the same resolve as blood, then we could expect further volatility and potential financial and political contagion. Across the globe, China is another large macro risk. Pundits are assessing its ability to keep manufacturing growth and avoid a hard landing. China's markets are also experiencing extreme volatility, as witnessed by its composite index dropping nearly 30% in less than two weeks to close the quarter. The Peoples Bank of China (its central bank) had to intervene with emergency capital injections to ease panic selling. Domestically, we will see what The Fed has in store and if the expected tightening begins to impact investors' appetite for equity assets. As the world turns, we will stick to our process and worry about the things we can control. Dispersion amongst the asset classes and sectors is a welcome change from the past few years and should benefit good stock selection going forward. Moreover, we promise to abide by

Emerson's observation and increase our odds of success by partnering with companies and management teams that walk the walk, and not just talk the talk.

Lastly, The London Company family became stronger this quarter as we welcomed Chuck Arrington, CFA to the team. Chuck is our newest Portfolio Manager and is a known asset, having worked with a good portion of our group in years past. He is a Virginia native and an ardent supporter of our philosophy and process. We feel our downside risk is well-protected here and have strong conviction in Chuck's ability to make us better going forward. Also, please note the slight change to our address at the top of the letter. We moved offices this quarter due to our expanding family demanding a little more elbow room. Fortunately, the move was close and as painless as possible. If you visit, we are in the same complex but just across the parking lot in an adjacent building.

Thank you again for your trust and support, and please feel free to contact us with any questions or concerns.

Best regards,

The London Company

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