

TACTICAL GROWTH SOLUTION UPDATES

February 12, 2025

Thank you for your continued trust and confidence. We would like to inform you that we recently made changes to the Liberty One's Tactical Growth Solution portfolio. We sold Pepsi Co. (PEP), Hormel Foods (HRL), and Kimberly Clark (KMB), and replaced them with AT&T Inc. (T), UnitedHealth Group Inc. (UNH), and The Kroger Company (KR).

Sell - Pepsi Co. (PEP)

PepsiCo faces a combination of structural, financial, and consumer-driven challenges that make it a less attractive investment going forward. The company is experiencing margin erosion, shifting consumer preferences, increased competition, and rising costs, which threaten long-term profitability. Consumer preferences are shifting from premium-branded snacks and beverages toward cheaper store brands and private-label products, which offer similar quality at lower price points. This trade-down trend has been exacerbated by persistent inflation, leading consumers to seek better value for their money. Additionally, consumers are also shifting towards healthier, smaller-pack offerings, reflecting changing dietary habits and increasing health consciousness. The rise of GLP-1 weight-loss drugs like Ozempic and Wegovy could further reduce demand for PepsiCo's traditional high-calorie snacks and beverages. PepsiCo itself has acknowledged that the competitive landscape is tightening, with store brands gaining market share across snack and beverage categories. This trend raises concerns about the company's ability to maintain pricing power and brand loyalty in a challenging retail environment.

PepsiCo's 2025 guidance is weaker than expected, forecasting low single-digit organic sales growth downgrade from the prior expectation of 4 percent growth. This signals that management lacks confidence in its ability to accelerate revenue expansion in the near term. The company faces headwinds from macroeconomic uncertainty, shifting consumer preferences, and rising competitive pressures, all of which may constrain its ability to drive meaningful top-line and bottom-line growth.

Sell - Hormel Foods (HRL)

Hormel is currently struggling with stagnant revenue growth, shrinking margins, commodity price volatility, and increasing competition from private-label brands and retailer-owned alternatives, which present substantial risks. While Hormel has maintained a strong dividend history, its modest payout growth and uncertainties surrounding its cost-cutting initiatives limit its appeal as a long-term investment.

Although core brands like SPAM, Jennie-O, and Applegate performed well, these gains were outweighed by declines in value-added meats, snacking, and convenient meals. Increased competition from private-label brands, such as Kroger's Simple Truth, Costco's Kirkland, and Walmart's Great Value, continues to put downward pressure on Hormel's pricing power, threatening its long-term profitability. Rising costs and margin compression in premium meats and poultry products are also contributing to underperformance in their foodservice segment while declining demand for turkey exports has continued to put downward pressure on its international business.

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To address these challenges, Hormel has implemented its Transform & Modernize (T&M) initiative, aimed at improving operational efficiency and reducing costs. While the initiative generated \$75 million in operating income in fiscal 2024, it was not enough to significantly impact overall earnings. Management anticipates an additional \$100-\$150 million in benefits in fiscal 2025, but given the broader headwinds facing the company, these cost savings may not be sufficient to offset weak sales and margin pressures. There is also execution risk associated with the initiative.

Overall, Hormel's lack of meaningful revenue growth, increasing competition from private-label brands, reliance on volatile commodity markets, and uncertain execution of its cost-saving initiatives make its stock unattractive at this time as we believe there are better opportunities elsewhere to drive alpha.

Sell - Kimberly Clark (KMB)

KMB faces several near and long-term structural challenges that prompted our decision to make a change. These include mounting margin pressures, declining sales volume, a reliance on cost-cutting measures to maintain earnings, and increasing competition from private-label brands, all of which pose significant challenges to the company's future profitability.

Despite reporting organic sales growth of 3.2% in 2024, a significant portion of this increase came from higher pricing rather than demand expansion. This suggests that consumers are either shifting to cheaper alternatives or reducing their purchases altogether. Price-driven revenue growth is ultimately unsustainable, as customers tend to push back against continued price hikes, opting instead for competitive brands. The North American segment, a key revenue driver, saw flat market share across core categories. While Baby & Child Care posted modest growth of 3.3%, Family Care and Professional segments exhibited weakness, reflecting soft consumer demand and growing competition from private labels. Meanwhile, the International Personal Care segment's 9.2% growth was largely driven by hyperinflationary pricing rather than organic expansion. The reliance on price increases rather than volume growth raises concerns about the strength of KMB's products.

KMB is also facing intensifying competition from private-label brands, particularly in key categories such as tissues, diapers, and feminine care. As inflation-weary consumers seek lower-cost alternatives, store brands are gaining market share, further pressuring Kimberly-Clark's pricing power. More importantly, there is no indication that lost customers are returning to KMB despite some stabilization in inflation and price increases. Increased marketing initiatives have also not resulted in a change of fortunes for volume.

Given the ongoing volume declines, rising input costs, and increasing competition from private-label brands, we believe KMB faces several challenges that would require new investments or a change in strategy to combat. This would also limit its continued dividend increases and would put a strain on its balance sheet. With a weaker guidance outlook and continued exposure to foreign exchange risks, we believe that the stock presents further downside risks.

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Buy - AT&T (T)

After years of ill-considered acquisitions, poorly timed share repurchases, and an increasing debt load on its balance sheet, we believe that new management at AT&T is finally moving in the right direction. John Stankey, who became CEO in mid-2020 spun off DirecTV (2021) and WarnerMedia (2024) since taking the helm. The divestitures were structured to reduce debt and refocus the company on its core telecommunication services, which we believe remains the crown jewel of AT&T and the right strategy. Heavy capital deployment in non-core areas have left their core telecommunications assets underinvested for years which led to market share losses. Additionally, wireless service providers were in heavy capital deployment mode over the last 3 years, primarily in purchasing large C-band spectrum to upgrade their networks. The industry was also facing intense price competition which negatively impacted returns on capital for network providers.

However, we believe a lot of those challenges have been resolved or at least improved substantially. AT&T remains a dominant player in the US wireless market, which together with Verizon and T-Mobile control nearly 90% of retail postpaid and prepaid customers. Business results have also stabilized and returned to growth recently, with the company posting yearly revenue growth for the first time since 2023, supported by stabilizing phone upgrade rates, higher phone prices, and stronger net postpaid wireless phone customer additions. The company remains a strong cash flow generator, with management expecting 2025 free cash flow of more than \$16 billion (almost twice the size of its annual dividend payment), even when excluding \$2.3 billion of inflows expected from the sale of DirecTV in 2025. Additionally, capital spending could come down a bit over the next several years as midband spectrum deployment, fiber network construction, and wireless network modernization initiatives have mostly been built. We see this as a very positive development, especially if the capital base growth can be limited, which increases the likelihood of improving returns on capital.

Nonetheless, AT&T would still need to continue to invest in network capacity additions and new advancements in technology to maintain a competitive telecommunications network. Finally, future growth opportunities from areas like connected devices (Internet of Things) and edge computing could gain adoption, further expanding the market potential of telecommunications providers. With three sizable players in the industry and C-band spectrum upgrades mostly complete, we have witnessed some stabilization in the market. We do not believe that each carrier would price their services aggressively to gain market share as wireless margins have also stabilized. Stable wireless margins, opportunities to improve fixed-line profitability, and potential increases of returns on capital are some of the key reasons why an investment appears attractive today.

Buy - UnitedHealth Group Inc. (UNH)

UNH boasts one of the strongest economic profit margins and returns on capital in the managed care industry, driven by their diversified and integrated business model covering medical insurance (UnitedHealthcare), pharmacy benefit manager (Optum RX), healthcare provider (Optum Health), and health analytics (Optum Insight). Within medical insurance, UNH benefits from strong network effects, scale, and negotiating leverage over smaller insurers, enabling UNH to lower premiums or improve benefits for their members, which in turn becomes a more compelling offering that attracts more members, that enables UNH to reduce costs or improve benefits further, and creates a virtuous cycle. Their PBM business which processes pharmaceutical claims and negotiate drug prices with manufacturers and pharmacies on behalf of healthcare providers benefits from cost advantages and high switching costs within the industry. Speaking of healthcare providers, UNH is also the

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largest outpatient service healthcare provider in the US, consisting of urgent care facilities, ambulatory surgical centers, and primary care centers. We believe that the incentives with their healthcare service segment aligns with their insurance division to better manage care of its member and are encouraged to lower cost of care for patients. Finally, their health analytics division possesses a wealth of data in the form of analytical tools to improve care quality and efficiency in the healthcare system. Although the percentage of revenue is relatively small with Optum Insight, its operating margins are the highest in the firm (like those of software solutions), which adds another layer of profitability and moats around its business.

Their vertically integrated operations form a significant foundation for the US healthcare system and provide opportunities to alleviate healthcare cost by aligning incentives to help patients control their healthcare costs better than pure-play operators. Although there are regulatory and healthcare policy risks associated with a business like UNH, we believe that their diversified business model mitigates many of those impacts. As a leading healthcare organization in the United States, UNH should also benefit from the ongoing demographic trends and aging population in the country. UNH has an exceptional investment and strategy track record supported by a more conservative balance sheet that should provide some financial flexibility during weaker times. We believe that its recent stock price weakness provides an attractive entry point into an investment in UNH.

Buy - The Kroger Company (KR)

KR is the largest traditional grocery supermarket chain in the US based on the number of stores and second largest grocery retailer based on sales volume. With groceries making up approximately 75% of annual revenue with the remainder from other segments like fuel and pharmacies, Kroger benefits from the stability in its end market, particularly with grocery spending and food-at-home trends. Additionally, of the approximately \$112 billion sales generated from groceries, about \$33 billion of that is generated by Kroger's private label products. With private label products generating between 6-8% higher margins for Kroger, the company has continued to expand their private label SKUs and sales volume. What started as a trade-off by the retailer to help ease inflationary pressures has amounted to a valuable customer loyalty tool that goes beyond lower prices. Customer behaviors have shifted, and private label brands are taking market share from national brands due to the perceived value, quality, and uniqueness that they offer. According to The Food Industry Association, surveys show that most shoppers bought more private brand goods over the past year, and more significantly, plan to purchase more even if grocery prices from national brands continue to fall. Private brands is one of the faster growing categories in staples and continue to provide grocers like Kroger with strong sales results and ongoing opportunities to lock in customer loyalty.

Additionally, KR has stayed on top of digital ordering trends by strategically developing its omnichannel infrastructure. The company generated \$12 billion in digital sales comprised of delivery and in-store pickup at over 2,200 locations. Although small relative to their overall sales, the strategy shows that management can adapt to evolving industry trends. Growth of digital grocery shopping is also showing signs of stabilization, with surveys showing that most customers still prefer to shop in traditional brick-and-mortar stores for perishable groceries.

Financially, the national grocer has a healthy balance sheet with net debt/EDBITA at a manageable 1.2x, interest coverage ratio at 10x, and free cash flow generation of over \$2 billion. The company's dividend is also covered by earnings and cash,

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with a typical payout ratio between 20%-30%. Although Kroger trails its larger rivals Walmart and Costco in terms of both operational and capital efficiencies, its valuation multiples are also less demanding than its peers. As a result, we believe that an investment in KR enables exposure to the nondiscretionary nature of grocery spending, increasing penetration of private label brands, consistent cash flow generation, and at a reasonable valuation.

If you have any questions, please don't hesitate to reach out to us. Thank you for your continued trust and confidence.

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