LongRun Equity

Quarterly Letter

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Rothschild & Co
Wealth Management

Investment philosophy

"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price." — Warren Buffett

We act as long-term business owners investing the wealth you have entrusted us with in a concentrated portfolio of high-quality companies.

Long-term business owners

We want to own the highest-quality franchises for the long term. Little do we care about potential moves in short-term stock prices. What's crucial for us is a company's competitive position, a superior and sustainable business model and the ability to compound earnings. We want management teams that allocate capital as if it were their own. We care about valuation, but take the long-term view, avoiding excessively valued businesses but not shying away from high valuations. When you have a great business that continues to prosper, the share price tends to follow. Conversely, a narrow focus on valuation can lead one astray from truly great businesses. We are determined to avoid this mistake.

Wealth preservation

The avoidance of permanent capital loss has been in our DNA for centuries. We avoid businesses exposed to external factors outside of their own control, which can crush attractive returns. We think long and hard about whether a business will still have a license to operate in the long term and if there are environmental or social risks. Only robust companies in control of their own destiny make the cut. To find these, we conduct deep research to understand business models so we can take advantage of noise and temporary swings in stock prices. We would expect our portfolio companies to do the same.

Compounding

Einstein once dubbed compounding as the "eighth wonder of the world". We couldn't agree more. We look for companies with superior economics and the resulting ability to compound their earnings over the long term. Strong market positions, pricing power, high margins and asset-light business models are the key characteristics that result in high returns on capital and the ability to compound earnings. A sustainable competitive advantage resulting from high barriers to entry is crucial to maintain these high returns in the face of competition, therefore avoiding a permanent destruction of value.

Deep research

We spend most of our time reading annual reports, conducting and analysing expert calls and speaking with management teams and industry experts. We engage regularly with management, talk to industry insiders and conduct grass-roots research. Books on companies and their leaders, industry newsletters and trade publications as well as podcasts are hugely valuable and are often neglected sources of information.

Capital allocation

Managing our clients' money is a privilege and a role we take very seriously. It is important to us that our clients know us and understand how we operate. In a similar vein, we want to understand how the management of our businesses thinks, acts and is incentivised. Capital allocation is the most important job of management, and the great returns of a high-quality business can be diluted via poor mergers and acquisitions or empire building. We look for management teams with incentives centered on long-term value creation and that have "skin in the game". These are critical if they are to think and act like owners, rather than managers.

Quality over quantity

We prefer to analyse and own fewer companies but understand them properly. We see little value in constant screening for 'cheap' companies and it distracts us from our focus on quality. With financial information abundant, no real edge can be gained based on quantitative information in our view. On the other hand, a deep understanding of business models takes time, but this is the only way we believe it is possible to generate superior long-term performance.

Focus

Focus is front and centre of everything we do. We like focused businesses that are easy to manage and understand. We do not need our companies to diversify; we will take care of this ourselves. Our investment universe and portfolio is equally focused, with limited turnover. This allows us to compound our knowledge of our companies, similar to the way we want them to compound their earnings and cash flows.

Bottom line

The combination of the above results in a high-quality portfolio of businesses. LongRun's main financial metrics remain strong, with cross-cycle sales growth of 8%, a 26% operating margin, an operating return on invested capital of 57% and a net debt to EBITDA leverage ratio of 0.2x. On a 3.9% free-cash-flow yield, we consider valuation attractive and expect annualised forward returns in the low double digits for LongRun Equity.

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Values: All data as at 30 June 2022.

Sources of charts and tables: Rothschild & Co and Bloomberg, unless otherwise stated. Past performance is not indicative of future performance and investments and the income from them can fall as well as rise. Strategy performance is shown in EUR, after all fees, in total return, combining income and capital growth. Returns may increase or decrease as a result of currency fluctuations. Please note the strategy's new management started on 01.08.2021

Please ensure you read the Important Information section at the end of this document.

Notes from the manager

LongRun returned -9.5% in Q2 2022, slightly ahead of the overall market

Strategy performance

The strategy returned -9.5% (in EUR, unhedged) in the second quarter, thus slightly outperforming global equities which fell by 10.2%. After having underperformed in Q1 on the back of a vicious rotation into 'value' stocks, the strategy was able to make up some ground. This was mainly due to our quality focus and more modest valuation levels of some of our companies after the derating in Q1.

Annualised returns since inception of the strategy over six years ago stand at 11.1% compared to 9.5% for global equities, resulting in an annual outperformance of 1.6% points.

Performance drivers

The main positive contributors to the strategy's performance in the second quarter were most of our healthcare names, led by UnitedHealth, consumer staples and our Chinese holdings. Both healthcare and staples benefitted from their ability to deliver growth even in a tougher macroeconomic environment and earnings resilience as investors flocked to defensive names on the back of worries about an economic slowdown or potential recession. Alibaba and Tencent did well on the back of easing worries regarding regulation and decent earnings.

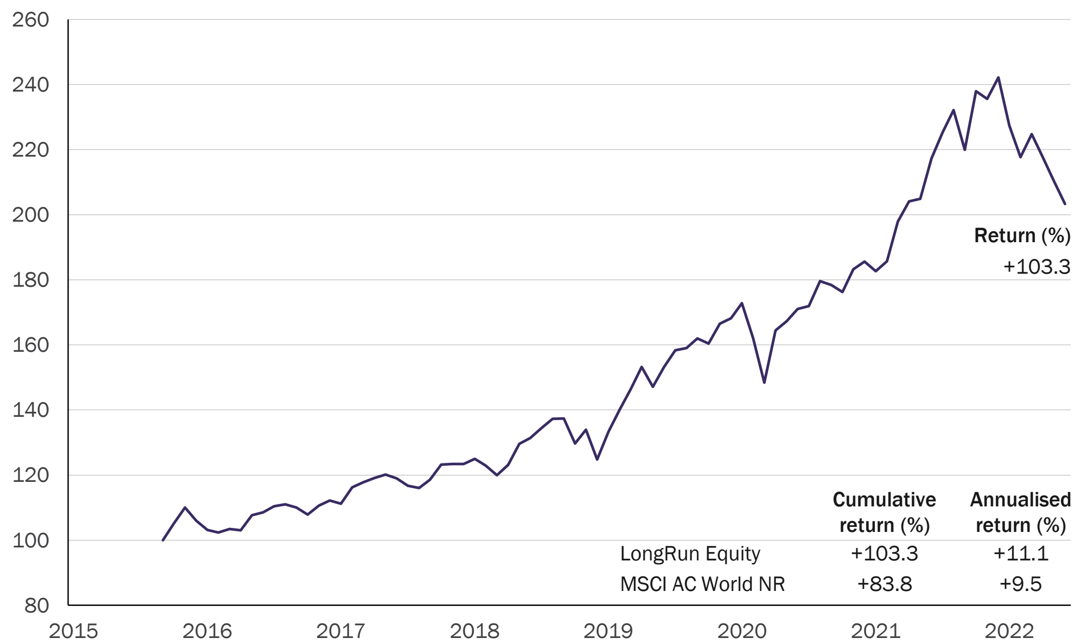
The main detractors for the quarter were companies in the technology space and/or with exposure to more discretionary end markets, all of them shedding more than 15% in value.

The main detractors for the quarter were primarily Technology and Discretionary.

UnitedHealth was our only holding which was up for the quarter, buoyed by its defensive profile, attractive valuation and solid quarterly earnings with another upgrade to full-year guidance.

Our Chinese holdings were flat (Alibaba) and -5% (Tencent) respectively, with both stocks benefitting from more attractive valuation levels and a lesser focus on the risk of further regulation. Quarterly earnings were mixed but overall solid. Importantly, they were better than expected in light of the resurgence of Covid-19 in China and a generally more difficult consumption backdrop.

Cumulative track record (EUR Unhedged, %)



	Cumulative return (%)	Annualised return (%)
LongRun Equity	+103.3	+11.1
MSCI AC World NR	+83.8	+9.5

Our consumer staples holdings all fared comparatively well, declining in the mid to high single digits, thus outperforming the overall market.

The wider technology complex was under continued pressure, largely on the back of optically higher valuation levels, strong quarterly earnings notwithstanding. Companies with higher exposure to business spending such as Microsoft or Accenture did slightly better than the ones with higher consumer exposure such as Alphabet or Adobe, which declined by 15% or more.

Lastly, companies with a high exposure to equity markets (T Rowe Price) or discretionary consumer spending such as Sonova or Disney fared worst, declining by more than 20% each. The latter was furthermore negatively impacted by worries about increasing competition in the streaming industry, catalysed by weak subscriber growth at its main competitor Netflix. Disney's subscriber growth remained solid, demonstrating the importance of superior content.

Activity

In terms of activity, we became slightly more active to seize some of the opportunities the market presented us with. In the technology sector, we initiated a position in ASML, the leading supplier of lithography machines used in the production of semiconductor chips, financed by the full sale of Oracle. In consumer staples, we started building a position in Costco (outlined later in the letter), financed by reductions in the weightings of Nestlé and Procter & Gamble.

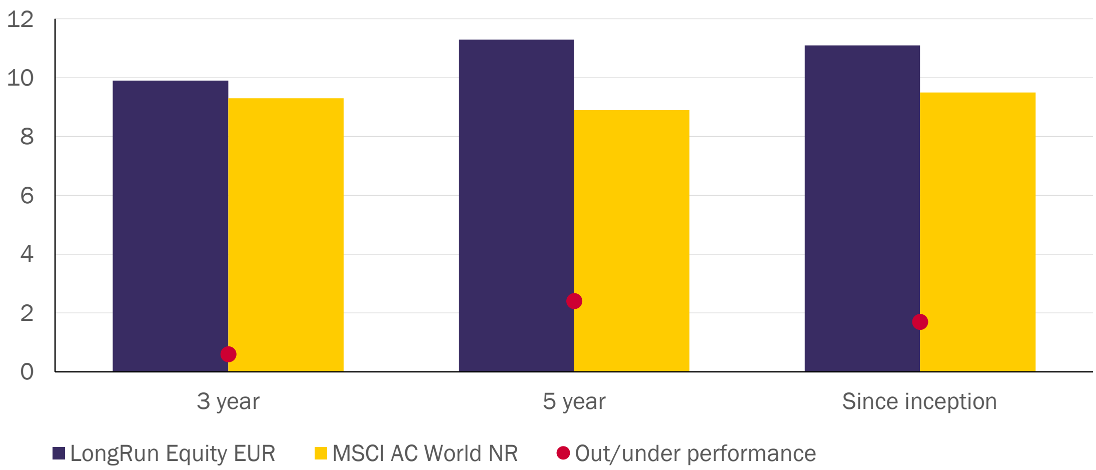
Annual performance

	LongRun Equity (%)	MSCI AC World NR (%)
2021	30.4	27.5
2020	10.4	6.7
2019	34.8	28.9
2018	1.1	-4.8
2017	10.0	8.9
2016	5.8	11.1
2015	14.9	8.8

Performance

	Net asset value	QTD (%)	YTD (%)	Inception to date (%)
LongRun Equity EUR Unhedged	1,908	-9.5	-16.0	103.3
MSCI AC World NR		-10.2	-13.2	83.8
Out/under performance		**-0.7**	**-2.9**	**19.5**

Annualised performance (%)



Case study: Costco

(Not so) Lost in the Supermarket

Costco is a business we have followed closely for years. Our first meeting with them in Seattle dates back over five years; and we have continued to further our understanding of this unique business ever since. Costco is a business that fits the criteria we look for in our holdings very well.

Simple, simpler, Costco

Costco Wholesale Corporation (Costco) traces its history back to 1976 when the first Price Club store was opened in San Diego, thus marking the birth of the warehouse club industry. Price Club was the world's first membership warehouse club, a place where efficient buying and operating practices gave members access to unmatched savings. In 1983, former Price Club manager James Sinegal co-founded Costco in Seattle, generating sales in excess of USD3bn in less than six years. In 1993, Costco and Price Club merged, resulting in a new industry leader with 206 locations and sales of USD16bn. Today there are over 800 warehouses and sales exceed USD200bn.

Costco's business model is simple, focused on offering members i) low prices on ii) a limited selection of nationally branded and private-label products in iii) a wide range of merchandise categories in bulk sizes that will produce high sales volumes and rapid inventory turnover.

Prices are typically at least 20% below supermarkets. The selection is narrow (typically around three items per category, so for ketchup it's Heinz, President's Choice and its Kirkland private label brand), with Costco stocking only a limited number of items for a specific product category. This results in an SKU (stock keeping unit) count of less than 4,000, which is a fraction of a typical supermarket's. The range of merchandise, on the other hand, is wide, with the company offering sundries, hard- and softlines, and dry and fresh foods, as well as ancillaries.

Costco's warehouses are no-frills, self-service facilities which results in reduced handling of merchandise. Coupled with volume purchasing and efficient distribution, this results in high operating efficiencies. With high sales volumes and rapid inventory turnover, Costco operates at much lower gross margins compared to most other retailers.

Importantly, purchasing savings are fully passed on to members with the company capping its gross margins in the low teens. This in turn allows it to maintain its pricing authority and members know they pretty much always get the best deal.

The supply chain is highly efficient, with a centralised hub-and-spoke delivery system between stores to lower delivery costs; and inventory is typically sold before Costco is required to pay for it.

Paying to shop

Costco warehouses are for members only. The annual membership fee in the US is USD60 and there are currently over 64 million paying members. The average member has a household income of over USD100,000, thus its member base is skewed towards higher income levels. The member base is both growing steadily and highly loyal, with a renewal rate in excess of 90% globally (which in turn has also been steadily inching higher).

We believe the appeal to be a Costco member lies not just in its superior value but also in that it makes the life of its members simpler. They know that they get i) the lowest price for the ii) highest quality items and that Costco spends a lot of time figuring out what the iii) best products in a certain category are so members don't have to shop around and bother with it themselves.

Members typically visit a Costco store every three weeks to 'stock up', typically spending around USD150 per trip. This implies an annual spend of around USD3,000, meaning the membership pays for itself assuming savings of as little as 2%.

Ancillary services such as gasoline, pharmacies, travel and food courts (where the legendary hot dog and drink combo is sold for USD1.50, unchanged since 1985) are provided at no or a very low margin to drive footfall and increase member loyalty. In addition, besides reliably available staples, Costco also sells special items such as jewellery or high-end watches, which exercises a 'treasure hunt'-like pull on members.

Another pull for members is Costco's own private label brand, Kirkland Signature. It offers high-quality everyday staples that are typically priced at a significant discount to its branded competitors and where the company believes there is space for a competitive offering. Testament to its success, Kirkland Signature sales have grown nearly four-fold over the past decade.

Creating value for all stakeholders

Our belief in the long runway for profitable growth is furthered by the company's long-term vision and focus on all stakeholders, not just its members and shareholders.

Employees earn significantly more than at other retailers and have access to medical and other benefits as well as interesting career opportunities in a growing business. This is perhaps the main factor behind the company's strong corporate culture. Suppliers more than make up for what they give up in price with higher volumes, lower distribution cost and a long-term business relationship. Finally, landlords benefit from a prospering anchor tenant which drives strong footfall.

All the above stand in contrast to many other retailers, where the focus is on the now, and not the far future, and where earnings visibility five or 10 years out is very limited, if not nonexistent altogether.

Costco-esque compounding

Costco's financial track record is unblemished. The strong focus on organic growth and conservative culture is absolutely crucial in order to understand this. Over the last 15-odd years, comparable sales and the member count have grown at 6% and 8%, respectively, with continued growth both throughout the global financial crisis and the Covid-19 pandemic (where its stores were seen as safe shopping environments due to their generous layout). Notably, growth has not suffered despite the gargantuan increase in size since.

The store count has grown at a more modest, but equally impressive, 4% annually. Great locations don't come around too often, and Costco's measured and conservative approach in terms of physical expansion is very much to our liking as bad locations and aggressive expansion have been the undoing for great a many retailers (only three out of the US' top 10 retailers 30 years ago remain on that list, and most of the rest went either bankrupt or were acquired).

Growth in earnings, cash flows and dividends is equally pristine, at 11%, 12% and 13%, respectively. In addition, the company has paid out a bumper special dividend every five or so years to keep the cash pile from swelling too much.

Standout in staples (and retail)

Costco's business model and financial performance stand in stark contrast to most traditional consumer staples businesses. The foundation thereof is its highly differentiated business model, which even its main club store 'competitors' Sam's Club and BJ's Wholesale struggle to emulate. This is due to the former getting 'buried' in a much bigger diverse structure (Wal-Mart) or lack of patient ownership and operational acumen (BJ's).

Costco has sticky relationships with its loyal members, whereas for most staples (and retailers) brand loyalty is rather limited and the relationship is much more transactional and pricing or discount driven.

Financially, consumer packaged goods companies are very much reliant on emerging markets (or new stores) to drive growth, which is often absorbed by currency devaluation from local inflation. Costco's sales and earnings, on the other hand, are mostly in hard currencies such as the USD (emerging markets account for only a few per cent of sales, most of which are from Mexico) — which in our view are much more valuable.

While staples companies have historically enjoyed higher returns on capital, Costco measures up well. Moreover, the competitive moat for all but the strongest staples companies is under assault, on account of i) increasing private label competition, ii) local and regional competitors and iii) nimble indie brands particularly in the organic and natural space. Hence we have greater conviction in the sustainability of Costco's vis-à-vis those of consumer staples companies.

Value in value

On over 35x one-year forward earnings, Costco's valuation appears demanding at first sight. But context and the long-term view matter. First, our analysis reveals that over 10 years ago one could have paid more than 70x earnings and would still have generated annual returns in line with the cost of equity. Finding great businesses is difficult (and hindsight bias is always a risk) but the ability of great businesses to compound earnings is almost always underestimated.

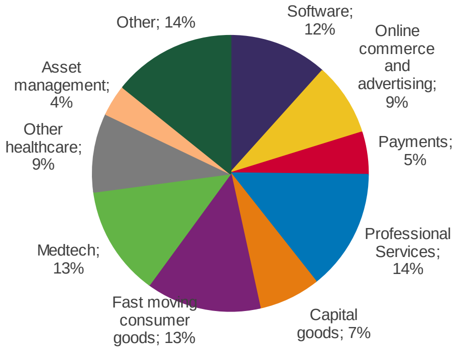
Furthermore, when looking at history, the rating is somewhat above past levels but we think this is more than justified by the further improvements in returns on capital and cash generation Costco has achieved.

Finally, when looking at Costco's earnings, it is important to understand that around two-thirds of the bottom-line comes from (recurring) membership income which improves visibility greatly. This has historically grown in line with member growth and inflation, and we think Costco's ability to cope with the latter is strong.

Business owner's portfolio

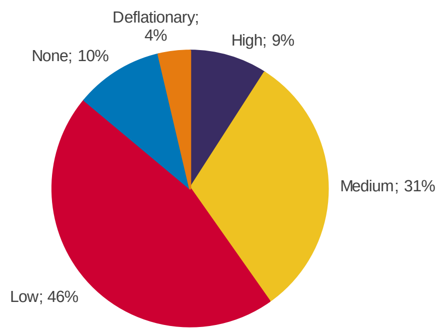
A deeper look into the strategy and its companies

Sales by business



By weight in portfolio, excluding cash

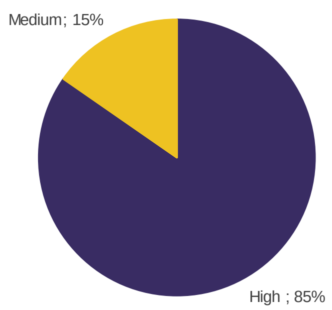
Degree of pricing power*



By weight in portfolio, excluding cash

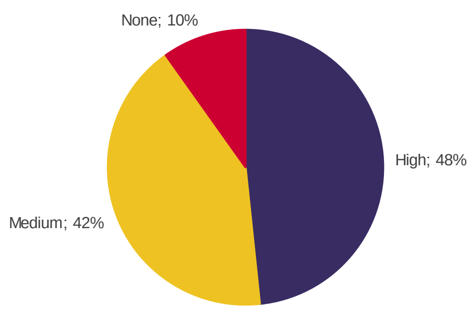
** In the investable universe, around 5% of companies have medium or high pricing power.*

Strength of competitive advantage



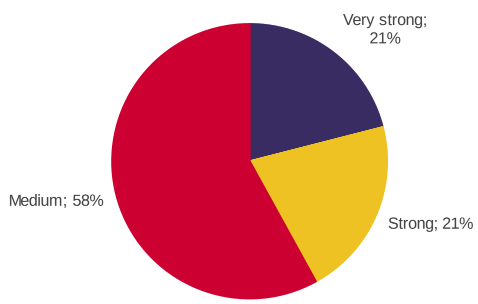
By weight in portfolio, excluding cash

Strength of switching costs



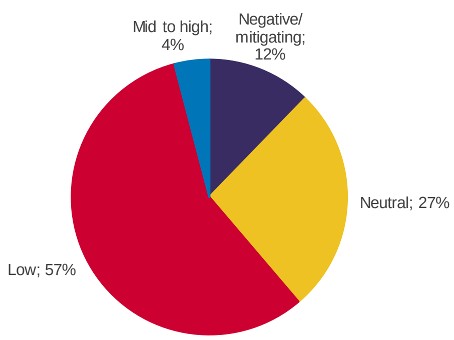
By weight in portfolio, excluding cash

ESG rating breakdown



By weight in portfolio, excluding cash

Carbon exposure risk breakdown



By weight in portfolio, excluding cash

Notes

At Rothschild & Co Wealth Management we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.

To follow a wide set of timely and insightful publications, podcasts and videos please visit our Wealth Insights www.rothschildandco.com/insights.

Important information