LongRun Equity

Quarterly Letter

Quarterly Letter | Issue 06 | January 2023

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 center 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 7%, a 26% operating margin, an operating return on invested capital of 56% and a net debt to EBITDA leverage ratio of 0.3x. On a 3.7% 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 31 December 2022.

Notes from the manager

LongRun returned +0.4% in Q4 2022, slightly lagging its benchmark

Strategy performance

The strategy returned +0.4% (in EUR, unhedged) in the fourth quarter, thus slightly trailing global equities which rose by 0.8%. The fund had a difficult October, lagging its benchmark by over 1%-point but recovered most of the under-performance in November while December was broadly in line.

Annualised returns since inception of the strategy over seven years ago stand at 9.9% compared to 8.8% for global equities, resulting in an annual outperformance of 1.1 percentage points.

Performance drivers

The main positive contributors to the strategy's performance in the fourth quarter were our industrial and most of our consumer exposed names while healthcare and most of technology lagged.

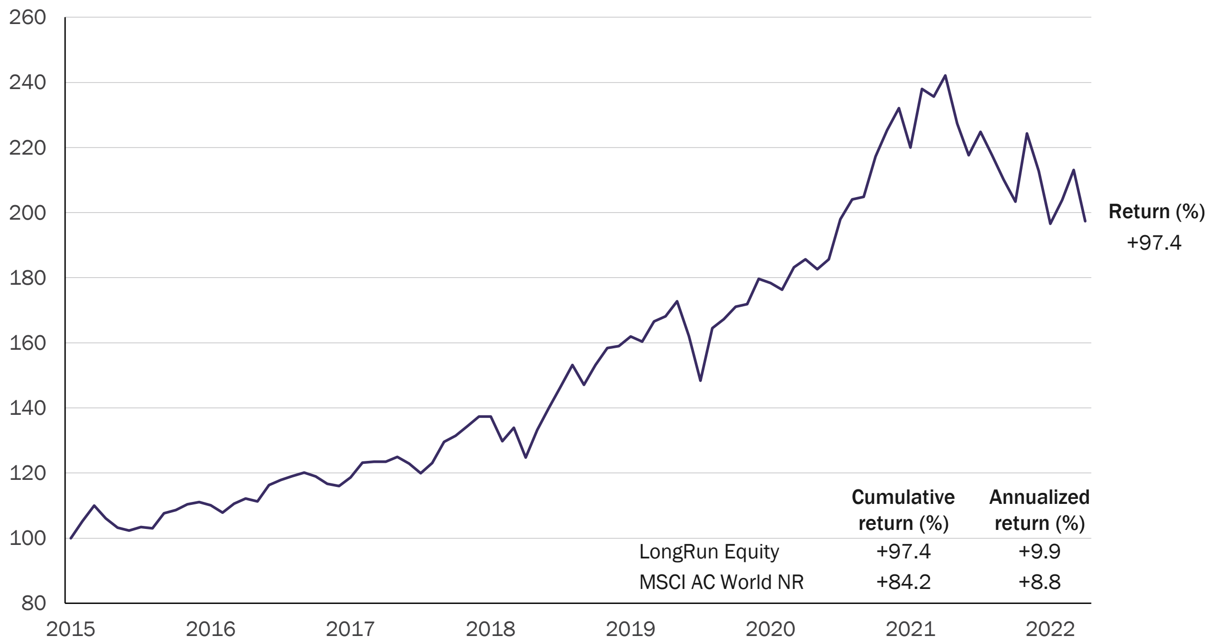
Emerson Electric and Kone both increased by more than 20% driven by the continued simplification of the conglomerate structure of the former and improving sentiment in China for the latter.

Adobe also increased by more than 20%, buoyed by improving sentiment with regards to the planned acquisition of Figma as well as solid earnings. This was also the main performance driver for the other three names with >20% increases in the share price: Procter & Gamble, Mastercard and Tencent. The latter additionally benefited from the loosening of Covid-related restrictions in China, a slightly less taxing regulatory environment as well as approvals for some of its new game titles.

The biggest detractors for the quarter were Roche, Walt Disney and Alphabet, each of which suffered from company specific factors.

Roche fell by 10%, mainly driven by disappointing results for its potential new dementia treatment drug Gantenerumab for which peak sales estimates were as high as CHF10bn. On top of missing out on a new major source of earnings, this is a set-back in the company's aim to diversify its revenues away from the crowded market for cancer drugs, once again highlighting the often binary nature of drug development, a structural risk factor in the overall pharma industry.

Cumulative track record (EUR unhedged, %)



Walt Disney (-8% for the quarter) reported mixed quarterly results with strong subscriber additions at Disney+ and solid sales growth but earnings missing expectations, driven by continued losses in its direct-to-consumer streaming business. Guidance for the upcoming financial year was also underwhelming. Another quarter of weak earnings then culminated in the company bringing back former CEO Bob Iger which we think is a first step in the right direction.

Alphabet declined by 8%. The company reported mixed quarterly results with continued positive but slowing top-line growth as softening consumer and business confidence takes its toll. The cloud business continued to do well, but earnings declined from previous highs driven by a buoyant advertising market in 2021. The outlook for advertising spending remains difficult for 2023, but we think this is more than factored into valuations while scope for, and an increasing willingness to, cutting costs should provide resilience to earnings even in a more difficult economic environment.

This is true not just for Alphabet but also most of the wider tech space, where we think somewhat greater cost discipline would be beneficial. Recent announcements by various industry heavyweights have confirmed this.

Activity

We did not make any changes to the composition of our portfolio. The weightings of the more recently added stocks were gradually increased. We remain happy with the make-up of our portfolio in the current environment, with the vast majority of companies operating in a business-to-business setting where customers give only secondary consideration to price which we think augurs well for their resilience even in a weaker and inflationary economic environment.

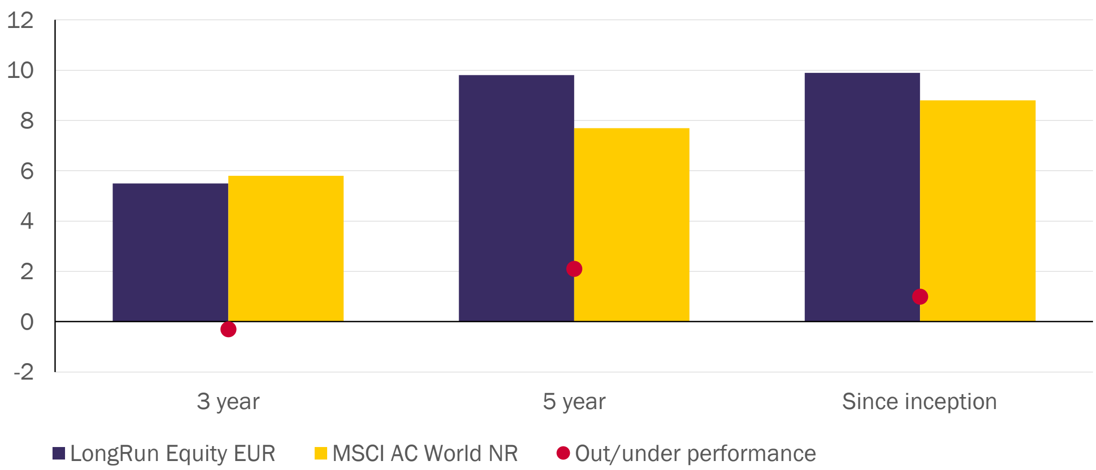
Annual performance

	LongRun Equity (%)	MSCI AC World NR (%)
2022	-18.5	-13.0
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	6.0	4.9

Performance

	Net asset value	QTD (%)	YTD (%)	Inception to date (%)
LongRun Equity EUR Unhedged	1,853	0.4	-18.5	97.4
MSCI AC World NR		0.8	-13.0	84.2
Out/under performance		**-0.4**	**-5.5**	**13.2**

Annualised performance (%)



Case study: pricing power

Part 1: the analytical foundation

In this section, we would like to provide some detail on the aspect of pricing power, the importance of which many investors continue to underestimate, thus allowing us to buy businesses that have pricing power at optically demanding but intrinsically attractive valuations. It is both a key tenet of our investment philosophy and of particular importance in the current environment.

What is pricing power?

Pricing power defines a company's ability to increase its prices, over time, at least in line with the inflation of its input costs, thereby de minimis maintaining its gross margins, without negatively impacting demand or ceding market share.

Why does it matter?

Pricing power is one of the most important quantitative financial metrics, besides the likes of organic growth, operating margins, return on capital and cash conversion. But unlike these, it is typically not readily available from company reports or financial information systems. Furthermore, it is often qualitative information that allows one to assess it in a more quantitative manner.

It also drives all the above financial metrics and most importantly, operating margins and return on capital. The philosophy of the fund is to focus on companies with a high and sustainable return on capital, and pricing power directly drives return on capital (the inverse is not always true). Without pricing power high and sustainable returns on capital are often myopic. Conversely, companies with a high return on capital without pricing power are often the best shorts.

In the short term, the impact of pricing power is often marginal but over the long term its impacts tend to be profound, because they compound.

Where to find it

The annoying issue (for the average investor), but beautiful thing for us is that many companies don't regularly disclose the contribution of pricing to sales and earnings. Rather, one needs to sift through countless earnings calls, expert transcripts and management interviews to get useful data. Management teams typically eschew disclosing information on pricing, for competitive, or other reasons (though we would hope they have the necessary information at least readily available).

How to find it

Companies with strong pricing often operate in consolidated, highly oligopolistic industries. Fixed costs tend to be low and supply flexible, thus shielding them from the crippling curse of oversupply. Product differentiation also tends to be supportive for pricing power as it makes direct comparisons to competing products or services more difficult.

On the other hand, commodity industries are often burdened by deflationary pricing, forcing them to play the volume game in search of scale benefits, thus further exacerbating the issue of excess supply. Constant cost cutting becomes a must, even to just stand still. Earnings are unlikely to compound.

Pricing power often exists when the service provided is mission critical but accounts only for a small share of customer spend, or where there is customer loyalty. The former is the case for most of our more business-to-business focused companies and the latter for the ones with business-to-consumer operations.

We routinely ask companies what would happen if they increased prices by 10% overnight. If they think this is impossible, they are unlikely to boast pricing power, and vice versa.

This does not mean we would want them to do this in reality. Rather, we prefer a more measured approach with regards to pricing, with continued small increases at least in line with underlying inflation in order to not alienate their customer base.

A long runway for pricing is particularly important. This is often the case for the businesses discussed above, which provide mission critical services but only account for a small share of customer cost. If a company's products account for less than one per cent of total customer cost, it will face much less scrutiny from its customer allowing it to steadily raise its prices over time.

Our pricing power framework

In order to better understand pricing power and to incorporate it into our investment process, we have developed a proprietary pricing power framework here at Rothschild & Co over the past few years.

The first step was the definition of the following five levels of pricing power: i) deflationary (declining nominal and real pricing), ii) none (declining real pricing), iii) low (positive nominal but zero real pricing), iv) medium (positive nominal and real pricing) and high (strongly positive nominal and real pricing).

In a second step, each company in our investment universe is awarded with one of the above five levels of pricing power. This is based on an in-depth analysis of its business model, barriers to entry, competitive dynamics and historical pricing track record.

The final step is to then embed the pricing power into the financial modelling in terms of sales growth, costs and operating margins.

It is important to note that the distribution of pricing power among companies does not follow a bell curve, but has a fat left tail with most companies having no pricing power at all. The gold nuggets are on the right side of the curve, which is also where we focus the bulk of our efforts on.

Inflation, currencies and pricing

Pricing power becomes particularly important when inflation is rampant. Inflation can quickly erode earnings if prices are not increased in tandem, or at least with a time lag.

The same is true when a company operates in highly inflationary countries where earnings can disappear almost overnight, unless it is able to increase prices accordingly.

Important to note is that even when a business posts solid pricing, this does not necessarily mean it has pricing power, unless it is able to increase prices in line with inflation.

For this reason, we look carefully at an enterprise's geographic footprint, since many a company appears to have solid pricing when in fact this merely masquerades the fact that is active in highly inflationary emerging markets. We favor companies which generate the bulk of sales in mature markets with hard currencies, and a reliance on emerging markets will need to be compensated via higher discount rates.

Pricing and profits

The impact pricing power has on profits is a powerful one. This is because every dollar of real pricing directly falls to the bottom line, unless the company decides to reinvest it.

For this reason, businesses with strong pricing power tend to generate wide margins. This in turn further increases their resilience and fortifies their earnings, since any (temporary) uptick in costs takes a smaller bite out of their profit pool.

Pricing power here and now

After years, if not decades of having been relegated to the sidelines, inflation, and the importance of pricing power have come to the fore again in the last couple of years.

This was sparked by sharp and oftentimes unprecedented increases in many input costs such as energy, raw materials, transportation and labor in the aftermath of Covid-19. For example, Asia-to-Europe container freight rates at some stage more than quintupled relative to 2019 levels while prices for certain microchips rose more than tenfold.

Many of these input costs, and arguably the ones with the biggest spikes, are the quintessential commodities where surging prices were first and foremost due to a temporary supply shortage. And indeed, as capacity bottlenecks have eased, many of them have started to correct.

Price increases were easier to push through when inflation was front and center; a rising (inflation) tide lifted all the (pricing) boats last year, albeit in some cases with time lags which is why most companies are still enjoying positive pricing.

It will therefore be interesting to see the interplay between higher but moderating inflation, price increases and profits in the next few quarters where the (quality) wheat will be separated from the (commoditized) chaff.

We think the companies with solid pricing should be able to retain most, if not all, of their higher prices which should be a boon for their profits as inflation collapses. Maintaining these higher prices will not be, and never is, easy, but product innovation and a focus on value-added selling are but two levers at their disposal.

The link to valuation

A company's pricing power is also consistently incorporated into our discounted cash flow valuation models. We methodically separate the different growth drivers (such as volume, pricing, mix, scope, currencies and inflation) in order to get a better handle on a company's growth track record and prospects. This is particularly important given industry growth reverts towards GDP over the long term.

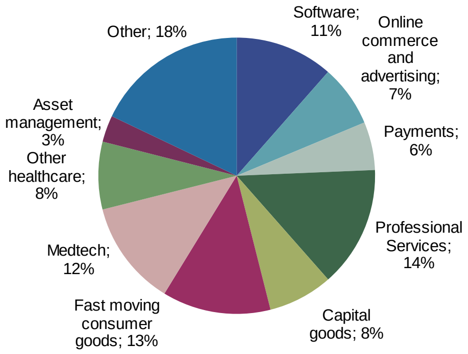
The same goes for the terminal value which is routinely overestimated by putting in a random number for growth, without any real link to an industry's competitive dynamics. The same is true for return on capital, which but for the highest-quality companies will be trending towards the cost of capital, thus further amplifying forecast errors.

Having laid out the analytical foundation of pricing power in this letter, we will make the link to our actual business portfolio in the next one.

Business owner's portfolio

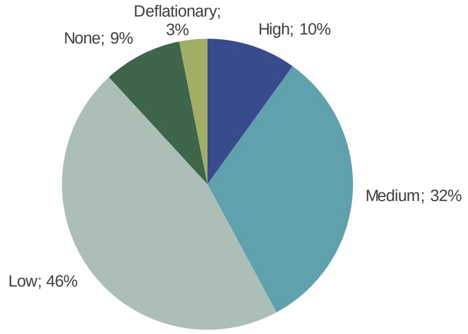
A deeper look into the strategy and its companies

Sales by business



By weight in portfolio, excluding cash

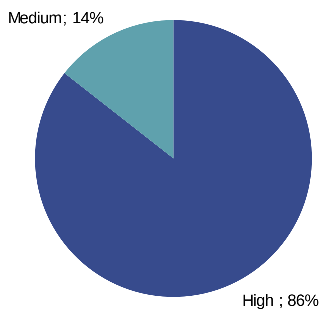
Degree of pricing power*



By weight in portfolio, excluding cash

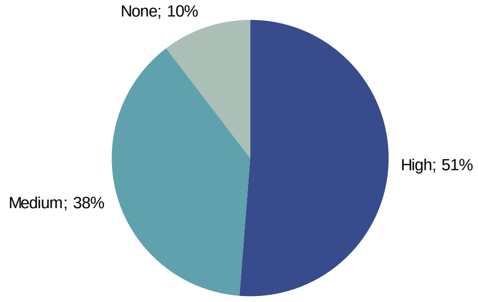
** In the investable universe, around 5% of companies have medium or high pricing power.*

Strength of competitive advantage



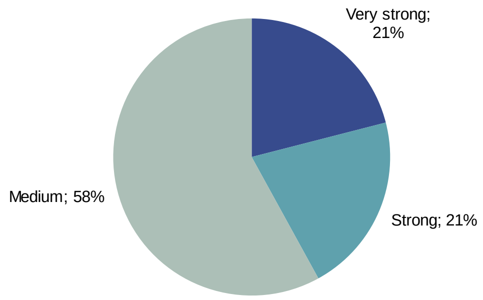
By weight in portfolio, excluding cash

Strength of switching costs



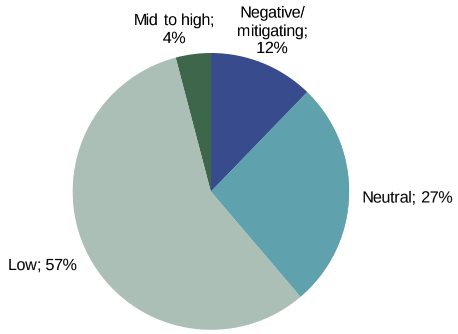
By weight in portfolio, excluding cash

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