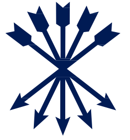

# LongRun Equity

## Quarterly Letter

Quarterly Letter | Issue 07 | April 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 in a way that is similar to how 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 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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Wealth Management

Values: All data as at 31 March 2023.

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 +7.6% in Q1 2023, well ahead of its benchmark

## Strategy performance

The strategy returned +7.6% (in EUR, unhedged) in the first quarter, thus handily beating global equities, which rose by 5.4%. The fund had a mixed first two months but subsequently outperformed by over 4 percentage points in March. This was mainly catalyzed by a flight to quality following the collapse of Silicon Valley Bank and near-death of Credit Suisse.

Annualised returns since inception of the strategy over seven years ago stand at 10.6% compared to 9.3% for global equities, resulting in an annual outperformance of 1.3 percentage points.

## Performance drivers

The main positive contributors to the strategy's performance in the first quarter were our consumer and technology exposed companies while healthcare by and large lagged.

L'Oréal and LVMH both increased by well over 20% as Q4 results came in solidly on the back of strong consumer demand, which was given a further boost from a gradual improvement in China. This also benefitted Alibaba and Tencent which gained well over 10% each.

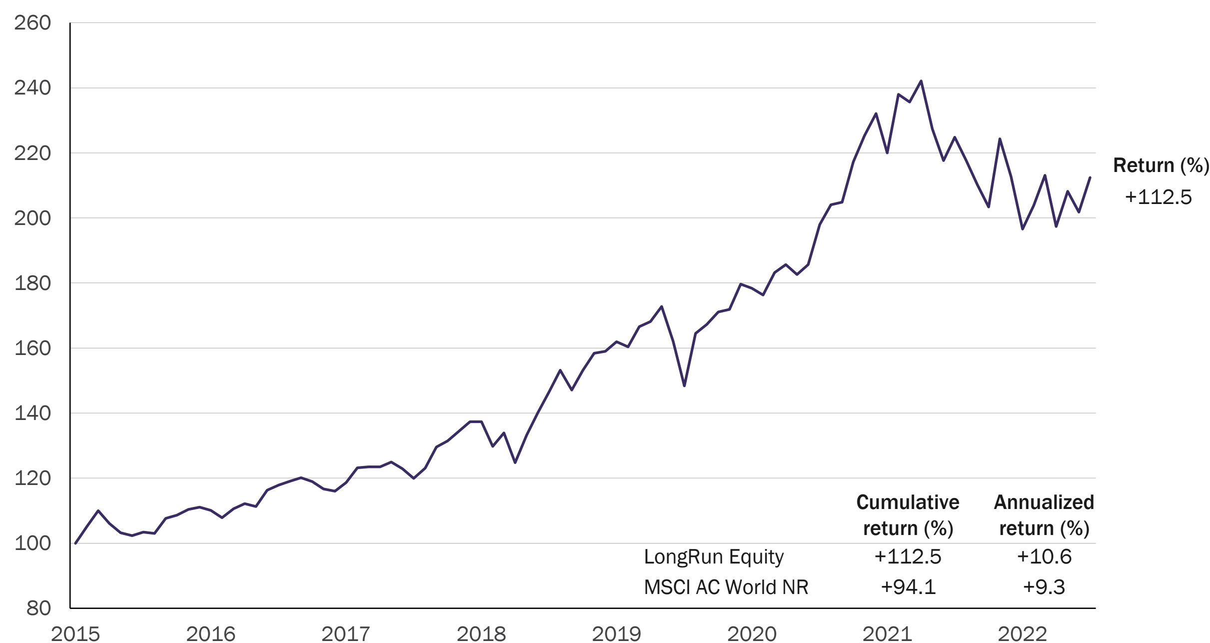
ASML rose by almost 25%, reporting excellent results and an upbeat outlook for the current year, despite a softer economic environment. This is a great example of what we look for in a business — mission-critical status that dampens (or even removes) any macro effects.

Our software names Microsoft, Adobe and Intuit all posted double-digit gains too, driven by continued strong demand for their (again) mission-critical solutions. The same goes for Alphabet where worries regarding disruption from ChatGPT appear increasingly overdone, at least in the short to medium term, while its own efforts in Artificial Intelligence remain vastly underappreciated by the market.

The biggest detractors for the quarter were Roche, Danaher, UnitedHealth and Emerson Electric.

Roche fell by close to 10% due to mixed 2022 results and a rather soft outlook. Visibility for growth over the next few years is now reduced as the tailwind from Covid-19 fades and generic erosion on some of its major drugs may not be offset by sales from recent and upcoming drug launches.

**Cumulative track record (EUR unhedged, %)**



Danaher and UnitedHealth both declined by over 5%. We think this was more related to technical factors and some profit taking, particularly for the latter after its stellar run last year. Both companies reported pleasing fourth-quarter earnings with continued solid top-line growth and widening margins. The outlook for the current year follows a similar, steady pattern of resilient organic growth, rising margins and double-digit earnings growth.

Emerson Electric experienced a 10% decrease in value, with no significant updates on its planned acquisition of National Instruments. Despite this, we acknowledge that there are some concerns about the deal, including strategic fit, pricing and integration risks. It seems that the market is also beginning to consider these factors. While we would have appreciated Emerson focusing on strengthening its core industrial automation franchise and repurchasing its own attractively valued stock, new CEO Lal Karsanbhai has decided to make a bold move. By pursuing a company that may offer some strategic fit and cross-sell opportunities, Karsanbhai has made it clear that it is his ambition to leave a lasting impact on Emerson's future.

## Activity

After a quiet Q4 22, we have been more active in Q1 23. We have sold our participation in Roche due to the aforementioned reduction of visibility on sales and, even more so, earnings. Our capital has been reallocated towards a business where we see a very high degree of visibility indeed, namely Linde. We detail the investment case for Linde later in the letter.

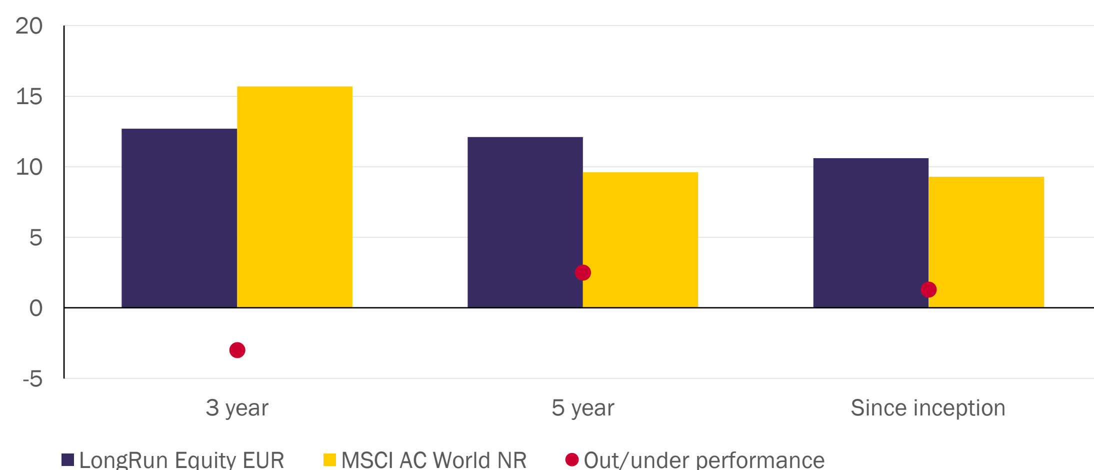
### Annual performance

| | LongRun Equity (%) | MSCI AC World NR (%) |
|---|---|---|
| **2023** | 7.6 | 5.4 |
| **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 | 2099,6 | 7.6 | 7.6 | 112.5 |
| MSCI AC World NR | | 5.4 | 5.4 | 94.1 |
| **Out/under performance** | | **2.2** | **2.2** | **18.3** |

### Annualised performance (%)



# Case study: Linde

## Pricing power part 2: pricing power in practice

In last quarter's letter, we outlined the importance of pricing power and the analytical foundations of it. In this section, we make the link to practice through the example of Linde, a business we have recently purchased and which exemplifies the importance of pricing power well.

### The 101 on Linde

Linde is the world leader in the highly console-dated industrial gas industry with a market share of around 30%. Linde in its current form was created in 2018 through the merger of Praxair from the US and Linde AG from Germany.

The company's revenues are split roughly 30% each from onsite, bulk and packaged (sale of gas) with its engineering business accounting for the remainder. This is a truly global business with around 45% of sales from the Americas, 30% from EMEA and 25% from Asia—Pacific and the rest of the world.

The business model is simple yet powerful. An industrial gas company will build a dedicated manufacturing facility at its customers facility (onsite), entering into a contract to provide it with industrial gas over a 10- to 15-year timeframe. This should be sufficient to recover the sizeable investment cost which typically runs in the triple-digit millions of US dollars.

Additional volumes of gas will then be sold to numerous other customers in the merchant and packaged markets. Volumes will be lower (up to 10x lower in merchant and up to 100x in packaged) but this is made up by much higher price points. Contract durations are also the shorter the lower the volume commitment — typically five years in merchant and up to three years in packaged. Renewal rates are highest in onsite where customers are most captive at close to 100%. But even for the other channels they are fairly high.

The return profiles of the three different seg-ments match the contract duration, renewal rates and revenue visibility — the shorter the visibility, the higher the returns on capital generated. Onsite returns are typically a few per cent above the cost of capital, while packaged generates returns well in excess of 25%.

The integration of the different distribution channels coupled with the benefits of density results in an extremely resilient business model with near insurmountable barriers to entry and high switching costs.

At the local level, and amplified by the fact that industrial gas does not travel well (low value-to-weight ratio), incumbent industrial gas players often enjoy monopolistic local/regional market positions.

### Mission critical x small share of cost

As we have written in previous letters, "pricing power often exists when the service provided is mission critical but accounts only for a small share of customer spend" (Q4 22 letter). Furthermore, "the combination of the two typically results in even higher switching costs as customers treat these services as utility-esque" (Q3 21 letter).

Linde is a perfect example. Industrial gas is a critical feedstock to a variety of producing industries; major customers require an uninterrupted supply of industrial gas because unplanned disruptions in their manufacturing processes result in costly shutdowns and potential damage to equipment. This results in high risk aversion and a preference for trusted suppliers with a long-term track record and a sterling reputation.

Industrial gases share in the total cost stack of its customer is typically low at around 1—3% of total costs, and it is considered a utility-like input like water or electricity with little consideration given to price. Unlike these, returns are not capped on the upside due to regulation on price levels.

### How pricing works in industrial gases

Pricing in the industrial gas sector happens on a local level and is largely a function of contract structures with automatic inflation escalator clauses. Unlike in commodity industries such as energy where prices (Brent crude or WTI) are readily available, pricing in industrial gases is highly intransparent. This greatly benefits industry participants in their ability to increase pricing.

For the onsite business, there are automatic cost-pass through clauses tied to the main input costs (mainly electricity and commodity prices).

For the other two distribution channels, merchant and packaged, industrial gas companies also have a strong track record of passing through higher input costs. In addition to this, they typically also target some real pricing over and above inflation.

### Pricing at Linde

For the onsite business, changes in input costs are automatically passed onto the customer and the company actually reports the cost pass-through for its onsite business. Last year, this amounted to a sizeable 6% which, when adjusted for the fact that this is roughly one-third of its business, implies a price increase north of 15%. The opposite happens during deflationary periods — for example, during the Global Financial Crisis cost pass through was -4% implying prices fell by around 10%.

Disclosure on cost pass-through goes all the way back to Praxair's IPO back in 1993, and cost pass-through over the long term has only been mildly positive. This is not surprising given the inflationary nature of many input costs, such as electricity or natural gas.

Besides cost pass-through, Linde (and formerly Praxair) also reports pricing all the way back to the early 1990s. This is mainly relevant for the merchant and packaged operations. Here, price increases have averaged just over 2% annually. Importantly, pricing has gone up every year, even during the GFC. Most of these price increases are nominal to counter the effect of inflation but we think a portion of it is also real pricing, which is something "really" powerful (more below).

### How they do it

The highly oligopolistic nature of the industry lends itself to strong pricing but is no guarantee itself. The focus on pricing is deeply ingrained in the company's culture and Praxair then and Linde now are considered the industry's "price hawks". Naturally, higher market share and density post the merger further increased the ability to take positive pricing.

The focus on pricing starts at the top with management thinking and acting like owners and incentives focused on profitable growth rather than volume and size (which was the case at Linde AG). A highly decentralized organisation (rather than a monolithic structure with management out of touch with specific market circumstances) with empowered local management in close contact with its customers helps them seize pricing opportunities if and when the need to do so arises.

### Pricing and profits

When thinking about the relationship between pricing and profits, it is important to differentiate between nominal and real (net) pricing. The former has no impact on earnings as price increases in line with inflation merely help to defend profits. That said, it is generally easier to increase prices when inflation is positive and on top of customers' minds, which is the case currently.

Real pricing is a powerful lever to drive earnings growth, but one that only a very select few companies have at their disposal by virtue of their business model or industry structure. Real pricing effectively falls straight through to the bottom line, with USD 1 of real pricing increasing earnings by the same magnitude.

Linde is a perfect example of this. Over the past 20 years, it has increased its operating margins by over 7 percentage points, or around 40 basis points annually, to 25% last year. Besides a relentless focus on costs and productivity improvements, pricing has been a key driver for this, we think.

### The link to valuation

In our proprietary pricing power framework (more details see last quarter's letter), Linde garners a pricing power rating of medium. This makes it a clear stand out in the wider chemicals sector which is dominated by bulk chemicals players, most of which have low, no or even negative pricing power.

This is then incorporated into our discounted cash flow valuation models. There we methodically separate the different growth drivers. For Linde, the main assumptions are around 2—3% volume growth in the base business, 2% pricing and around 2% from new projects. Clearly separating the different growth drivers is particularly important in the industrial gas industry because the main growth components have wildly different levels of profit drop-through and capital intensity.

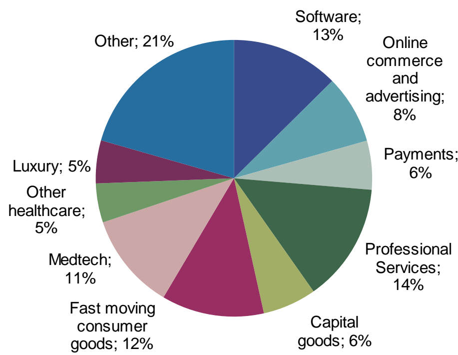
The combination of i) solid growth driven by pricing in particular and ii) an extremely defensive and robust business model resulting in a low cost of capital results in a highly rated business – over the past 20 years the earnings multiple has averaged around 23x.

This may appear high at first sight but context and taking the long-term view matter here too. This is because compound interest is the long-term investor's best friend. Our analysis reveals that one could have paid well in excess of 50x earnings for the company's shares 20 years ago and still have achieved a return in line with the company's cost of equity of around 8%.

# Business owner's portfolio

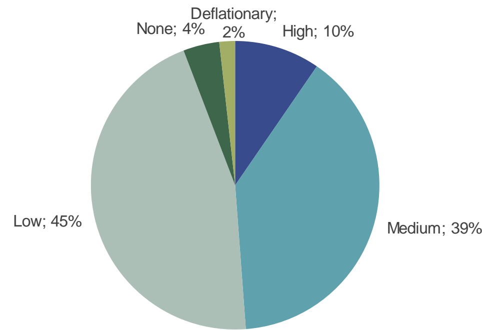
A deeper look into the strategy and its companies

### Sales by business




*By weight in portfolio, excluding cash*

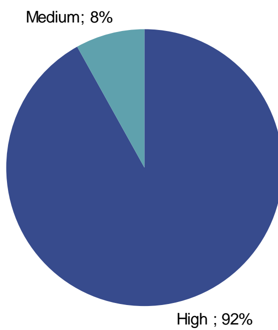
### Degree of pricing power*




*By weight in portfolio, excluding cash*

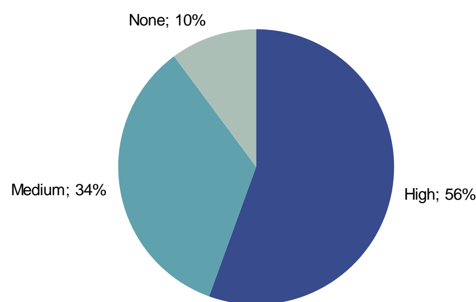
** In the investable universe, around 5% of companies have medium or high pricing power.*

### Strength of competitive advantage



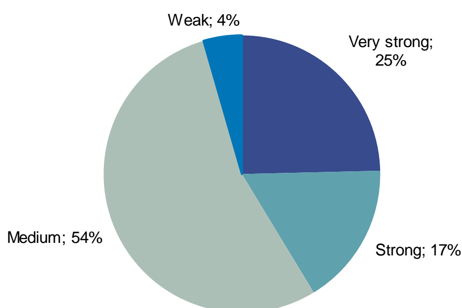

*By weight in portfolio, excluding cash*

### Strength of switching costs



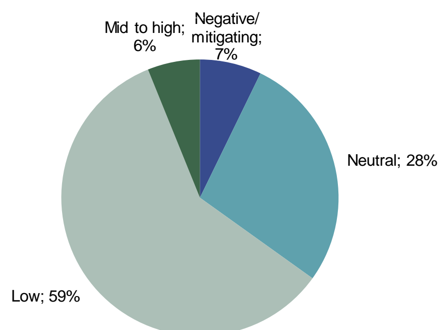

*By weight in portfolio, excluding cash*

### ESG rating breakdown




*By weight in portfolio, excluding cash*

### Carbon exposure risk breakdown




*By weight in portfolio, excluding cash*

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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.

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