Rothschild & Co
Wealth Management

QUARTERLY LETTER | JANUARY 2024

# LongRun Equity

# 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.


Rothschild & Co Bank AG
Zollikerstrasse 1818034
Zurich Switzerland

+41 44 384 71 11

rothschildandco.com



© 2024 Rothschild & Co Wealth Management


Values: All data as at 31 December 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.

*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.*

*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.*

### 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 centred 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 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 27% operating margin, an operating return on invested capital of 75% and a net debt to EBITDA leverage ratio of 0.3x. On a 3.1% free-cash-flow yield, we consider valuation attractive and expect annualised forward returns in the low double digits for LongRun Equity.

# Notes from the manager

## LongRun was up 8.2% in Q4 2023, beating its benchmark

### STRATEGY PERFORMANCE

The strategy was up 8.2% (in EUR, unhedged) in the fourth quarter, thus performing better than its benchmark, which gained 6.4%. The main contributors to this outperformance were most of our technology businesses. They posted mostly resilient earnings, while the broader consumer complex continued to struggle.

Annualised returns since inception of the strategy over eight years ago stand at 11.2% compared with 9.9% 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 fourth quarter were essentially our technology companies, while businesses with exposure to discretionary consumer spending and/or China lagged.

Our software businesses Adobe, Intuit and Microsoft all gained 15% or more. All three enjoyed continued strong sales and earnings growth, driven by their subscription-led business models and high incremental margins.

The two other businesses with high exposure to information technology spending, Accenture and Gartner, performed in similar ways. The same is true for semiconductor monolith ASML. Recent purchase Gartner was our best performer for the quarter, gaining over 30%, closely followed by another recent purchase, Idexx.

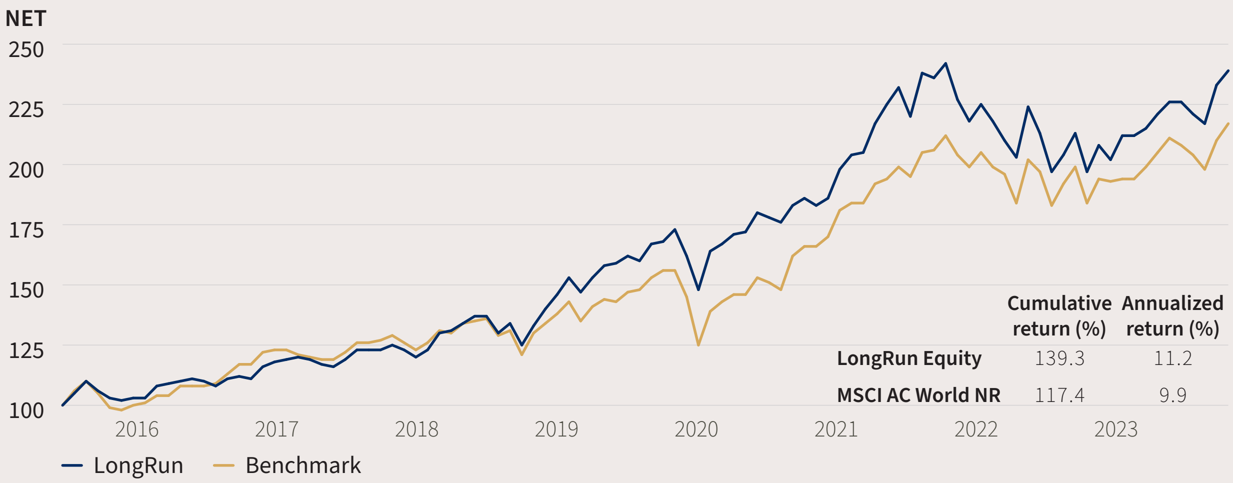
Also performing strongly were businesses that provide mission critical information, such as Moody's and Relx.

With the exception of Costco and l'Oréal, our consumer companies mostly failed to keep pace with the overall portfolio. LVMH fell slightly on the back of a sharp, but certainly not too surprising, slowdown in growth.

Our two Chinese businesses, Alibaba and Tencent, also fell, although the impact on the overall portfolio was contained thanks to their small weightings.

Our healthcare businesses gained modestly, thus finally rebounding after a few difficult quarters with faltering growth rates.

### CUMULATIVE TRACK RECORD (EUR UNHEDGED, %)




| | Cumulative return (%) | Annualized return (%) |
|---|---|---|
| **LongRun Equity** | 139.3 | 11.2 |
| **MSCI AC World NR** | 117.4 | 9.9 |

## ACTIVITY

In the fourth quarter the fund made one new investment, Veralto, and exited two, Emerson Electric and Nestlé.

In October, as part of our long-standing investment in Danaher, we received shares in Veralto, which was spun off. Veralto used to operate as Danaher's Environmental and Applied Solutions segment. It was spun off due to Danaher focusing on biotech, life sciences and diagnostics. We analysed the business in depth ahead of the spinoff and, in line with our "up or out" philosophy, decided to build up the position further.

We think Veralto is an outstanding industrial business, providing mission-critical equipment and services across both its segments (Water Quality and Product Quality & Innovation). It benefits from customer captivity and a high share of recurring revenues with a financial profile to match (24% operating margins and 100% free cash conversion).

After a gradual reduction we fully exited Emerson. This remains a strong franchise but we think the new CEO's strategic vision may be too bold, exposing us more to his capital allocation skills rather than the company's fundamentals. We'd prefer this to be the other way around.

A similar reasoning underpins the disposal of Nestlé. The company owns many solid and some outstanding businesses. However, we see a risk that Nestlé is further straying from its "good food, good life" nucleus with questionable capital allocation (Palforzia anyone?), and thus the skills of its CEO becoming "over" important.

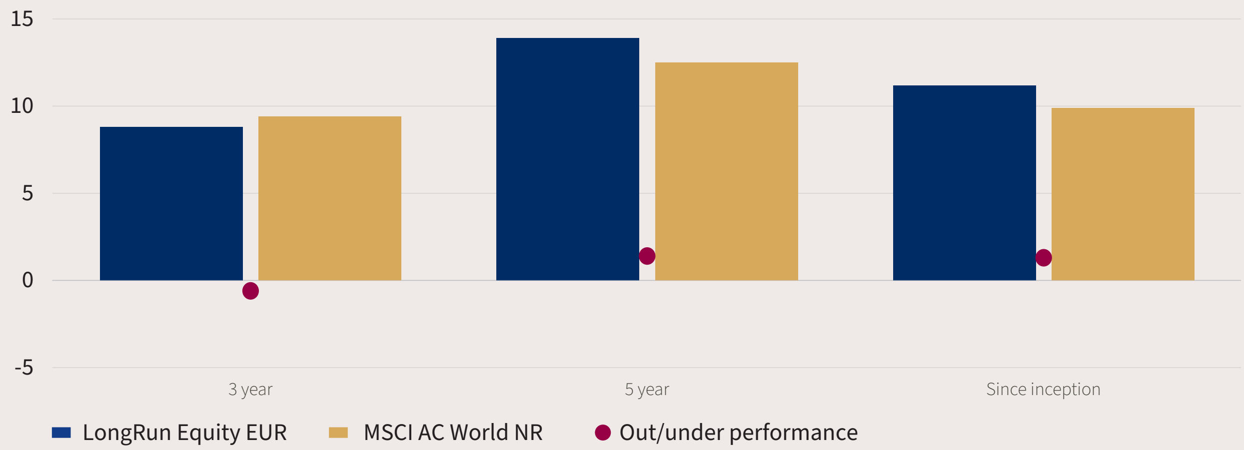
### ANNUAL PERFORMANCE

| | LONGRUN EQUITY (%) | MSCI AC WORLD (%) |
|---|---|---|
| **2023** | 21.2 | 18.1 |
| **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 |

### ANNUAL PERFORMANCE

| | NET ASSET VALUE | QTD (%) | YTD (%) | INCEPTION TO DATE (%) |
|---|---|---|---|---|
| **LongRun Equity EUR Unhedged** | 2,246 | 8.2 | 21.2 | 139.3 |
| **MSCI AC World NR** | | 6.4 | 18.1 | 117.4 |
| **Out/under performance** | | **1.8** | **3.1** | **21.9** |

### ANNUALIZED PERFORMANCE (%)



# LongRun key financial metrics

## 8 – 27 – 75 – 91 – 3 (sic) anyone?

How well do you know your fund? What do these five numbers stand for? The starting line-up of an ice hockey team? No, its actually the five key financial metrics of our fund. They give a very good indication about the quality characteristics of our strategy at a high level.

We constantly look at the financial profile of the LongRun Equity fund on a "look through" basis. The focus is on the following five key financial metrics:

i) organic growth,

ii) operating margin,

iii) return on invested capital,

iv) cash conversion and

v) financial leverage.

This exercise is aimed at both outlining the outstanding quality of the overall fund and its businesses and how these quality attributes are evolving over time.

In the short term, stock prices fluctuate for various reasons but in the long term, they are strongly linked to performance of the underlying business, i.e. its ability to grow its economic profits. This, in turn, is closely tied to the above five metrics.

### THE IDEA

The rationale behind analysing the main financial metrics of our fund on a "look through" basis is to gain a deeper understanding of its quality on a consolidated basis. Some of our companies are highly focused, essentially one-brand businesses (such as ASML, Costco and Gartner) and others consist of dozens of businesses (Danaher, LVMH and Relx). While the degree of focus varies, all of them are, by and large, focused on a small number of end markets. But naturally, all of them differ in terms of their growth, returns and financial leverage.

The following analysis shows the aggregate performance of these five key financial metrics on a position weighted, consolidated level. This allows us to outline the quality of our fund in greater detail, showing that the "quality" moniker of Long-Run is not just fiction, but also fact. This also helps the identify weak spots and problem areas.

### ORGANIC GROWTH

Organic growth is our main metric when looking at a company's growth. It is the result of changes in volumes, pricing and mix. It is a much more robust metric than reported growth, which can be boosted by, often costly, acquisitions as well as, often volatile, exchange rates, and vice versa. All else being equal, we favour businesses in structurally growing, consolidated end markets and more stable geographies.

Organic growth for the fund stood at a strong 9% last year, marginally greater than the 8% achieved in 2022. This figure is also in line with the compound annual growth rate of 9% delivered since 2019. All these are strong figures in the context of global GDP growth in the low to mid single digits, with our businesses' pricing power the main reason for the growth surplus.

The increase in growth last year was mainly due to higher weightings in our existing positions as well as the replacement of lower-growth businesses (such as Emerson Electric, Nestlé or Roche) with higher-growth ones (Gartner and Idexx).

### OPERATING MARGIN

The operating profit margin is a company's key profitability metric we look at as it is not influenced its vertical integration (like the gross margin) or financial leverage and tax burden (like the net margin). High margins are both a key driver for return on capital and help strengthen a company's earnings resilience since increases in costs have a lesser impact on earnings. Recession or not, we are prepared.

The operating margin of the fund increased by 110 basis points to a strong 26.9% last year, and is now almost 4 percentage points higher than back in 2019.

The main driver for higher margins were increased weights in our existing positions. The impact of newly added positions was more or less offset by the sale of existing ones. The change in margins in our remaining positions was slightly negative.

### RETURN ON INVESTED CAPITAL

The operating return on invested capital is our preferred return metric. We define it as the net operating profit after taxes divided by a company's operating assets (essentially property, plant and equipment, internally generated intangible assets, i.e. software, operating leases and net working capital). We exclude externally generated assets such as intangibles or goodwill stemming from acquisitions, since these tell us little to nothing about the underlying returns of a business. At the same time, they are typically dilutive.

That is not to say acquisitions don't matter (they do), but we prefer to separate the underlying features of a business/industry (operating ROIC) from the capital allocation of management (reported ROIC). Also, in attractive industries, it is pretty much impossible to generate the same returns from acquisitions as through organic means. As long as an acquisition generates a return that at least covers its cost of capital, it is still creating value, even if it dilutes returns on capital.

Operating ROIC increased by over 4 percentage points last year to an outstanding 75% and is some 12 percentage points higher than in 2019, thus mirroring the increases in operating margins. The increase in the returns of the fund was thus not driven by higher asset intensity – in fact, invested capital turns have also continued to improve. For reference, reported return on capital stood at a still solid 30%.

Higher weights in existing positions had a neutral impact on ROIC, while the ROIC of our existing positions themselves deteriorated by around 3 percentage points. The main positive drivers were new additions (such as Gartner or Veralto), which boast higher returns than exited ones such as Nestlé or Roche.

### CASH CONVERSION

We measure free cash flow conversion by dividing free cash flow by net operating profit after taxes. Growth in profits is of little benefit if it absorbs a lot of cash. Free cash flow conversion is highly correlated with return on capital but more volatile due to swings in working capital.

Free cash conversion slightly fell by 1 percentage point to a still strong 91% in 2023. This means that for every dollar in net operating profit our fund generated 91 cents in free cash flow.

Higher weights in existing positions had a neutral impact on cash conversion, while the cash conversion of our existing positions themselves deteriorated by around 5 percentage points. This was partially offset by a 4 percentage point net positive impact from changes in the holdings in the fund.

*It was pleasing for us to see that the continued improvement in the quality of the LongRun portfolio is also supported by steady progression in most of the key financial metrics.* ”

## FINANCIAL LEVERAGE

Our preferred way to measure financial leverage is to take a company's net debt and divide it by its EBITDA. The higher its earnings and revenue visibility, the more debt it can take on. Since most of our businesses are relationship, rather than transaction, businesses, they generally have plenty of scope to take on debt.

In a similar vein, their operational gearing is typically low. Nevertheless, we prefer financial gearing to be low and are wary of companies dialing up leverage to juice up their (accounting) earnings.

Net debt to EBITDA for the fund stood at 0.3x at the end of 2023, a slight improvement on 2022. The downward march in financial leverage, which stood at 1.0x back in 2019, continued. We have been able to fortify our portfolio further.

The improvement in financial leverage was largely achieved by a 0.3x reduction from existing positions, partially offset by new positions with slightly higher financial leverage. The other drivers had no material impact.

## WHAT'S NEXT?

For each of the fund holdings, we have a detailed financial model not just looking back at 15+ years of financial history but also modelling the future. This is essential to get an absolute view on a company's intrinsic value. Furthermore, it helps to build conviction into a businesses' operational and financial trajectory.

For the fund, we expect continued solid organic growth in the 7–9% range in the next three years, with a slight dip this year followed by a slight reacceleration rebound the year after. We expect operating margins to continue slightly expanding at a pace of around 50 basis points per year. Operating ROIC is expected to remain broadly stable in the high 70s.

We forecast continued strong free cash flow conversion in the 85–90% range, slightly pulled down relative to the recent history. This is due to some of the additions we have made to the fund (Costco, Idexx, Linde and LVMH) in the last couple of years where free cash conversion is slightly lower on account of a slightly higher capital intensity. This is more than compensated for by the higher barriers to entry potential competitors would have to surmount in the industries these companies dominate.

We expect net debt to EBITDA to continue improving further. This does not include the impact of potential acquisitions, however, which are almost certainly to occur (but impossible to predict) albeit unlikely to alter the picture substantially.

## THE CONCLUSION

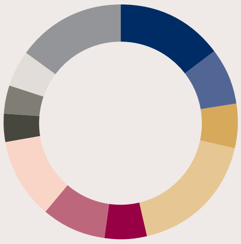
It was pleasing for us to see that the continued improvement in the quality of the LongRun portfolio is also supported by steady progression in most of the key financial metrics.

Needless to say, we aim to further improve the quality of our portfolio of businesses, and you can expect us to continue reporting back to you in regular intervals. Just remember (at least until 2025): 8 – 27 – 75 – 91 – 3, and let the compounding continue.

# Business owner’s portfolio

## A deeper look into the strategy and its companies

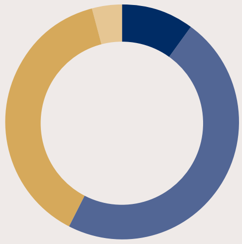
### SALES BY BUSINESS (%)



| | |
|---|---|
| Software | 15 |
| Online commerce and advertising | 8 |
| Payments | 6 |
| Professional services | 18 |
| Capital goods | 6 |
| Fast moving consumer goods | 9 |
| Medtech | 11 |
| Other healthcare | 4 |
| Luxury | 4 |
| Semi-conductors | 5 |
| Other | 15 |

By weight in portfolio, excluding cash

### DEGREE OF PRICING POWER* (%)

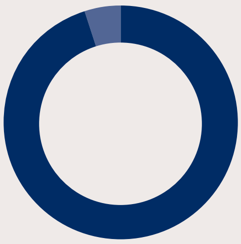


| | |
|---|---|
| High | 10 |
| Medium | 47 |
| Low | 38 |
| None | 4 |

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

By weight in portfolio, excluding cash

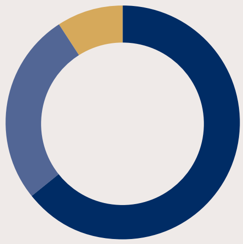
### STRENGTH OF COMPETITIVE ADVANTAGE (%)



| | |
|---|---|
| High | 95 |
| Medium | 5 |

By weight in portfolio, excluding cash

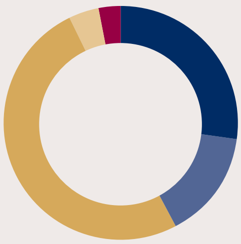
### STRENGTH OF SWITCHING COSTS (%)



| | |
|---|---|
| High | 65 |
| Medium | 27 |
| None | 9 |

By weight in portfolio, excluding cash

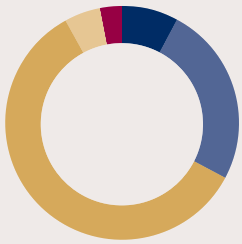
### ESG RATING BREAKDOWN (%)



| | |
|---|---|
| Very strong | 27 |
| Strong | 15 |
| Medium | 50 |
| Weak | 4 |
| N/a | 3 |

By weight in portfolio, excluding cash

### CARBON EXPOSURE RISK BREAKDOWN (%)



| | |
|---|---|
| Negative/mitigating | 8 |
| Neutral | 25 |
| Low | 59 |
| Mid to high | 5 |
| N/a | 3 |

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

This document is confidential and produced by Rothschild & Co Bank AG ("Rothschild & Co") for information and marketing purposes only and for the sole use of the recipient ("you" or "Recipient"). Save as specifically agreed in writing with Rothschild & Co, this document must not be copied, reproduced, distributed or passed, in whole or part, to any other person. This document does not constitute a personal recommendation or an offer or invitation to buy or sell securities or any other banking or investment product or to enter into transactions of any kind. Nothing in this document constitutes legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to an individual's circumstances. The information in this document therefore neither takes into account the specific or future investment goals nor the tax or financial situation or individual needs of the Recipient. Interested persons should consult a qualified expert before making investment decisions.

The value of investments, and the income from them, may fall as well as rise, and you may not recover the amount of your original investment. Past performance should not be taken as a guide to future performance. Investing for return involves the acceptance of risk: performance aspirations are not and cannot be guaranteed. Forward-looking statements, e.g. statements including terms like "believe", "assume", "expect" or similar expressions are subject to known and unknown risks, uncertainties and other factors which may result in a substantial divergence between the actual results, financial situation, development or performance of the issuer or the instrument and those explicitly or implicitly presumed in these statements, if any. Against the background of these uncertainties you should not rely on forward-looking statements. Rothschild & Co assumes no responsibility to update forward-looking statements or to adapt them to future events or developments. Where an investment involves exposure to a foreign currency, changes in rates of exchange may cause the value of the investment, and the income from it, to go up or down. Income may be produced at the expense of capital returns. The preservation of the invested capital cannot be guaranteed. Should an existing client of Rothschild & Co change his/her outlook concerning his/her investment objectives and/or his/her risk and return tolerance(s), he/she shall contact his/her Rothschild & Co client adviser. Additional information can also be obtained from the brochure "Risks Involved in Trading Financial Instruments" issued by the Swiss Bankers Association (www.swissbanking.ch/en/downloads).

Although the information and data herein are obtained from sources believed to be reliable, no representation or warranty, expressed or implied, is or will be made and, save in the case of fraud, no responsibility or liability is or will be accepted by Rothschild & Co concerning this document, e.g. in relation to the fairness, accuracy or completeness of it or the information forming the basis of it or for any reliance placed on it by any person whatsoever. In particular, no representation or warranty is given as to the achievement or reasonableness of any future projections, targets, estimates or forecasts contained in this document. Rothschild & Co excludes all liability for losses or damages of any kind (both direct and indirect as well as consequential damages), which arise from the use of this document. The contents of this document may be changed at any time due to changed circumstances, whereby Rothschild & Co is under no obligation to update once published information.

This document is distributed by Rothschild & Co in Switzerland and abroad. Law or other regulation may restrict the distribution of this document in certain jurisdictions. The contents of this document are not directed or meant for persons subject to a jurisdiction that prohibits the distribution of this document or the investment strategies referred to therein. Accordingly, the Recipient of this document must inform him/herself about any possible restrictions and comply with all applicable legal and regulatory requirements. For the avoidance of doubt, neither this document nor any copy thereof may be sent to or taken into the United States or distributed in the United States or to a US person (including but not limited to US citizens and US residents). The term "United States" encompasses the United States of America, all of its constituent states, its territories and possessions, and all areas under its sovereign jurisdiction.

Rothschild & Co Bank AG. Registered office: Zollikerstrasse 181, 8008 Zurich, Switzerland. Authorised and regulated by the Swiss Financial Market Supervisory Authority FINMA which has its office at Laupenstrasse 27 in 3003 Bern, Switzerland (www.finma.ch).