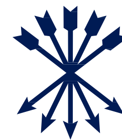
LongRun Equity



Quarterly Letter

Quarterly Letter | Issue 01 | October 2021

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 trusted us with, within 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 27% operating margin, an operating return on invested capital of 60% and a net debt to EBITDA leverage ratio of 0.3x. On a 3.3% free-cash-flow yield, we consider valuation attractive and currently expect annualised forward returns of 10% for LongRun Equity.

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Values: All data as at 30 September 2021.

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 +1.2% in Q3 2021 and is up 18.5% year to date

Strategy performance

The strategy returned 1.2% (in EUR, unhedged) in the third quarter, bringing year-to-date performance to 18.5%.

Annualised returns since inception of the strategy six years ago stand at 14.0% compared to 11.7% for global equities, resulting in an annual outperformance of 2.3 percentage points.

Performance drivers

The main positive contributors to the strategy's performance in the third quarter were Accenture, Adobe, Alphabet, Intuit, Oracle and Relx, all of which returned more than 10%. Each posted solid quarterly results benefiting from their entrenched position as providers of mission critical services and information.

The main detractors were the two Chinese Internet monoliths Alibaba and Tencent, each declining by more than 15% (Alibaba -34% and Tencent -19%). The only other stock with a double-digit negative return was Kone (-12%), which was negatively affected by its high exposure to China where the property sector made negative headlines owing to the struggles of leading property developer Evergrande Real Estate.

Alibaba and Tencent continued to see strong operational momentum and reported a solid set of quarterly results. However, adverse regulatory news depressed their share prices.

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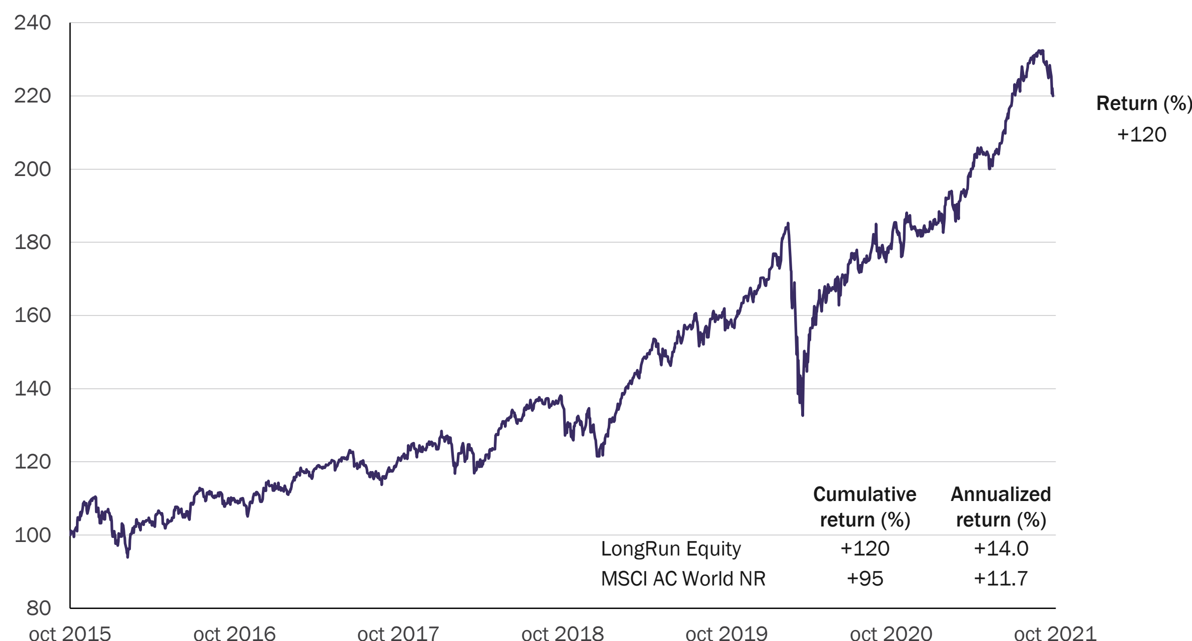
In Alibaba's case, the government is forcing the breakup of payments provider Alipay and imposing stricter regulatory oversight over its lending operations. In Tencent's case the government is again tightening regulation of its video gaming operations.

Cumulative track record (EUR Unhedged, %)



	Cumulative return (%)	Annualized return (%)
LongRun Equity	+120	+14.0
MSCI AC World NR	+95	+11.7

Increased regulation in China does not come as a surprise to us but the speed at which the government is acting does. We think tech regulation in the West will eventually move in a similar direction. A few drivers support our positive view on the future of these businesses though: i) China's global ambitions in technology and economic standing, which it will struggle to fulfill if it cripples the main champions of its technological ascendance; ii) the walled garden position of either company; and iii) regulation often benefiting the incumbents in the long term. Therefore, we do not think the competitive position and earnings power of either company has been structurally impaired.

Activity

In terms of activity, it was, as you should expect from us, a quiet quarter. We added a position in LVMH, funded by the sale of Colgate. LVMH is the world's leading luxury goods company with the hugely profitable Louis Vuitton brand at its core. It controls a collection of high-quality businesses and boasts a strong operational and capital allocation track record. The recent pullback offered us a compelling buying opportunity and we expect our investment to compound in the low double digits in years to come.

This purchase was financed by the full sale of Colgate-Palmolive. Increased buying power of retailers in mature markets and more competition in emerging markets has resulted in a clear slowdown in volume growth to near zero. Limited scope for innovation due to category maturity and a lack of operational agility vs. emerging market upstarts has resulted in pricing barely covering inflation. Downside risk to margins and the need for increased, but lower-yielding investments leaves earnings growth potential in mid single digits at best. We believe these growing structural challenges are not fully reflected in valuations.

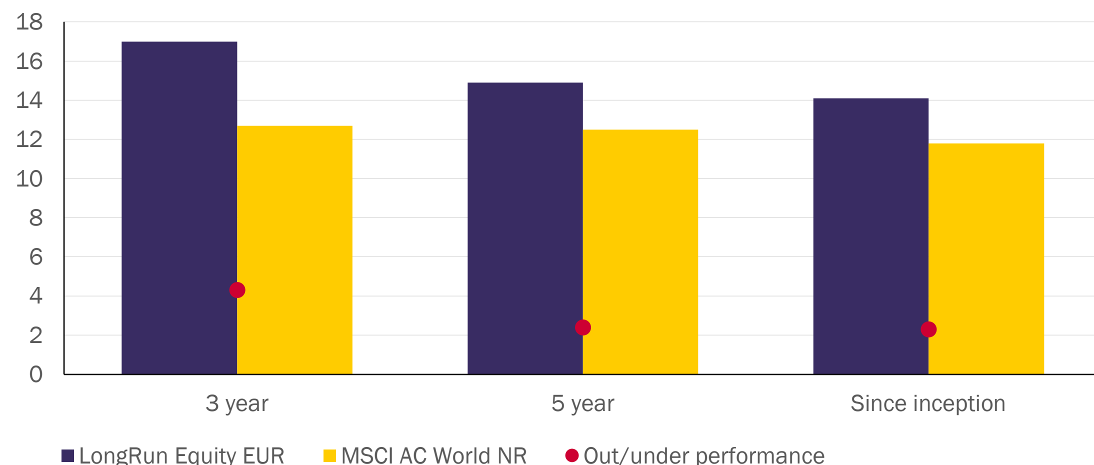
Cumulative performance (as per Sep 2021)

	LongRun Equity (%)	MSCI AC World NR (%)
2021	120.0	94.7
2020	85.7	66.0
2019	68.2	55.6
2018	24.8	20.7
2017	23.4	26.9
2016	12.2	16.5
2015	6.0	4.9

Performance

	Net asset value	QTD (%)	YTD (%)	Inception to date (%)
LongRun Equity EUR Unhedged	2,064.66	1.2	18.5	120.0
MSCI AC World NR		1.2	17.3	94.7
Out/under performance		**0.0**	**1.2**	**25.3**

Annualised performance (%)



Case study: relationship businesses

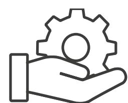
There's no business like a relationship business

Owning businesses that enjoy strong and long-lasting relationships with their clients and customers is the linchpin of our investment philosophy. Typically, our businesses' products and services are mission critical but only account for a small share of customer spend, which allows for pricing power and translates into superior economics.

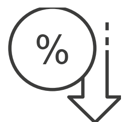
Perhaps the most defining feature of many of the businesses we like, and own, are loyal and lasting relationships with their customers. These are often based on business-to-business relationships with rational decision makers who focus on a variety of decision factors, and not just price. Long-term relationships result in high switching costs which in turn drive greater visibility on revenues and cash flows.

At the opposite end of the spectrum are transactional businesses, often business-to-consumer companies with limited loyalty, where customers focus predominantly on price and which need to earn their revenues each and every day anew. We try to stay clear of these commoditised industries with limited customer loyalty such as energy, airlines or metals and mining, which mainly compete on price.

A business model anchored on long-term relationships is not a panacea, however. We arrive at the holy grail of business models only when it is built on a combination of:



1. mission-critical products or services; and



2. a low share of the customer spending or cost.

The combination of the two typically results in even higher switching costs as customers treat these services as utility-esque.

Long-time holding Relx outlines this well in its (excellent) annual report:

> *"Our products often account for less than 1% of our customers' total cost base but can have a significant and positive impact on the economics of the remaining 99%."*

A paragon is Moody's Ratings business. The cost for the customer is small: the annual cost of a credit rating is well below 20 basis points (of the amount of debt rated) and dwarfed by the additional default spread applied by the market for unrated debt. Furthermore, simply having a debt rating is often crucial to raising debt and ensuring the survival of a business.

Perhaps the most defining feature of many of the businesses we like, and own, are loyal and lasting relationships with their customers.

Rational decision makers are crucial, and ideally they do not pay out of their own pocket. Better still, if the decision maker is not the one paying for the product in the first place. As an example, the building tenants are the ones paying for elevator maintenance, not the owner.

Recurring revenues are the result of these strong, lasting relationships. Ideally, these are based on written contracts. Examples of portfolio companies with high recurring revenues in excess of 50% are Moody's, Danaher, Kone and Intuit.

Forward-thinking companies regularly add new services to their offering, thus providing additional functionalities (and a justification for higher prices), resulting in bundles with superior customer value. For instance, Microsoft has continuously increased the utility of its bundles, thereby forging ever closer relationships with their customers. Microsoft Office already enjoys a monopolistic position in productivity software. But the company continues to reinvest in the business and add additional features, such as MS Teams, at no cost initially. Only later does it increase prices in line with improved functionality.

Even for companies with more transactional, consumer-facing business models, we spend a lot of time working out whether there is customer loyalty or a high share of repeat purchases. This can result in quasi-recurring revenues. Being the default option for customers, this results in greater sales visibility, even in the absence of a contractual relationship. This is exemplified by companies like Alibaba, L'Oréal, Sonova and Walt Disney.

Pricing power often follows when the service provided is mission critical but accounts only for a small share of spend, or where there is customer loyalty. Few companies give long-term quantitative guidance on pricing - the vast majority have zero pricing power - and the ones that do are often veritable gold nuggets. Case in point again is Moody's, which aims for annual nominal price increases of 3–4%. The real figure is unlikely to be much lower. Arrogance? We don't think so, but we are as always on the look-out for signs of hubris!

Pricing power is, besides return on capital, perhaps the most important feature of a great business with compounding characteristics; and the two go often hand in hand. Pricing often makes no major difference to earnings in the short term, but over the long term its effects are immense. For example, prices in the industrial gases industry have risen by over 50% over the last 30 years. In contrast, in the airline industry they have roughly halved. It should be easy to guess which industry boasts operating margins above 20% and which one constantly struggles to even break even, let alone create economic value. This is because positive pricing both i) drives faster sales growth and ii) real pricing accrues fully to earnings; and vice versa. Pricing power is the secret sauce that drives outsized margins north of 35% for companies like Adobe, MasterCard or Moody's which are the bedrock of our portfolio.

We spend a lot of time working out whether there is customer loyalty or a high share of repeat purchases.

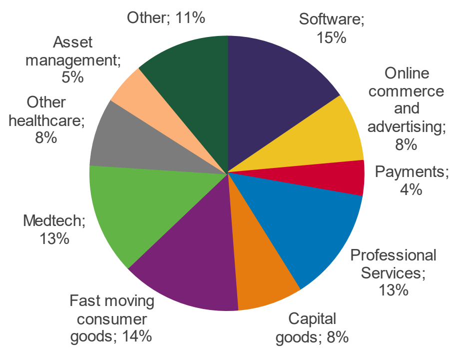
Conclusion

In the LongRun strategy, around half of the portfolio is made up of companies that operate business models built on long-term relationships. Most of the rest enjoy what we consider a loyal customer base.

Business owner's portfolio

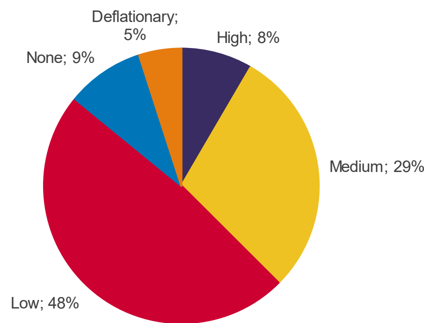
A deeper look into the strategy and its companies

Sales by business



By weight in portfolio, excluding cash

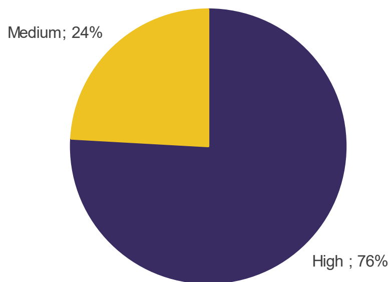
Degree of pricing power*



By weight in portfolio, excluding cash

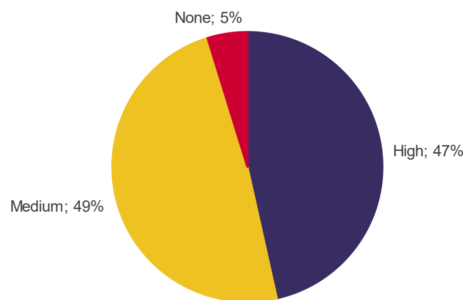
** In the investable universe, around 5% of companies have medium or high pricing power.*

Strength of competitive advantage



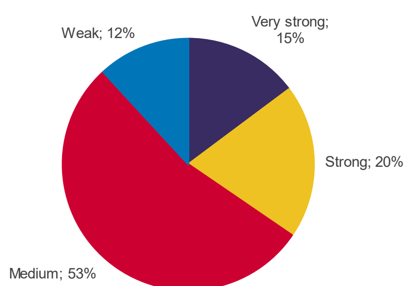
By weight in portfolio, excluding cash

Strength of switching costs



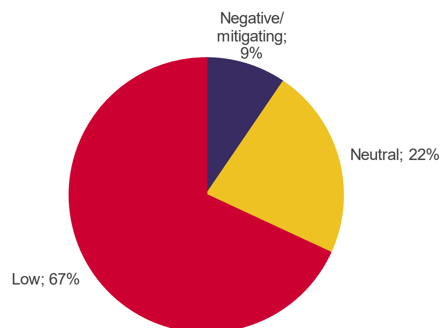
By weight in portfolio, excluding cash

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

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