LongRun Equity

Quarterly Letter

Quarterly Letter | Issue 02 | January 2022

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 27% operating margin, an operating return on invested capital of 59% and a net debt to EBITDA leverage ratio of 0.3x. On a 3.2% free-cash-flow yield, we consider valuation attractive and expect annualised forward returns in the high single digits for LongRun Equity.

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Values: All data as at 31 December 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 +10.1% in Q4 2021 and was up 30.4% in 2021

Strategy performance

The strategy returned 10.1% (in EUR, unhedged) in the fourth quarter, bringing performance in 2021 to 30.4%.

Annualised returns since inception of the strategy over six years ago stand at 15.2% compared to 12.7% for global equities, resulting in an annual outperformance of 2.5% points.

Performance drivers

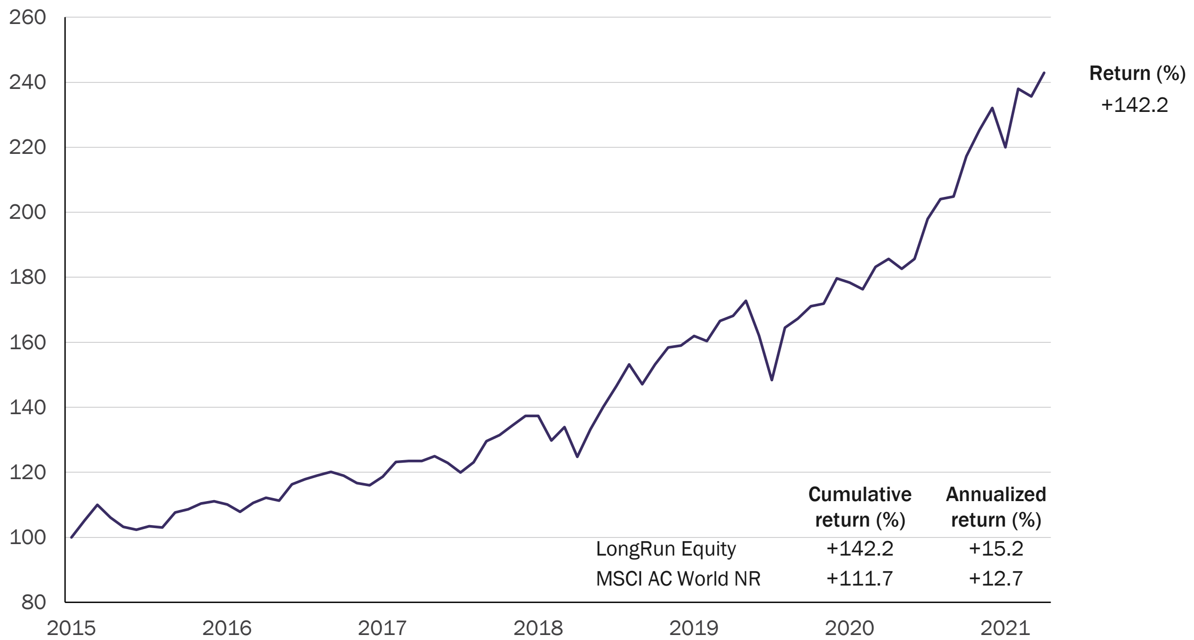
The main positive contributors to the strategy's performance in the fourth quarter were Accenture, Intuit, Microsoft and UnitedHealth, each of which returned more than 20%. This strong performance was amplified by the relatively high weightings in all four of them. The former three benefited from continued healthy demand for their mission-critical software solutions and services. This drove strong sales and margin improvements well ahead of estimates. UnitedHealth also posted solid results and gave a bullish view on its long-term prospects at its investor day which further supported its share price.

The main detractors were Chinese Internet monolith Alibaba and healthcare technology provider Medtronic, each declining by 15%.

The main positive contributors to performance in the fourth quarter were Accenture, Intuit, Microsoft and UnitedHealth, all of which returned more than 20%.

Alibaba continued to be affected by negative news flow which soured sentiment. In addition, and in contrast to Tencent which was broadly flat for the quarter, the company reported soft second quarter results and lowered its outlook on account of a slowdown in consumer spending and increased competition. In our view, the former is transitory and the latter something the company is well positioned to fight back against thanks to its dominant scale and entrenched position in the online commerce landscape.

Cumulative track record (EUR Unhedged, %)



	Cumulative return (%)	Annualized return (%)
LongRun Equity	+142.2	+15.2
MSCI AC World NR	+111.7	+12.7

Medtronic was hit by a warning letter from the regulator, following an inspection related to product recalls in its diabetes segment. The company is in the process of addressing the regulator's concerns which highlighted shortcomings in the company's device quality procedures. We are always wary of product recalls which are a key risk when investing in the medicinal technology industry, and these cannot be excluded for any company. But we believe a culture of operational excellence, ideally in combination with a focused portfolio, is the best way to minimize said risks.

Activity

In terms of activity, it was, as you should expect from us, a quiet quarter. We debated quite a few positions and new ideas but did not make any changes to the portfolio. In terms of weightings, we slightly increased our exposure to our highest convictions with the top five now accounting for 29% of the total portfolio compared to 27% at the end of the third quarter.

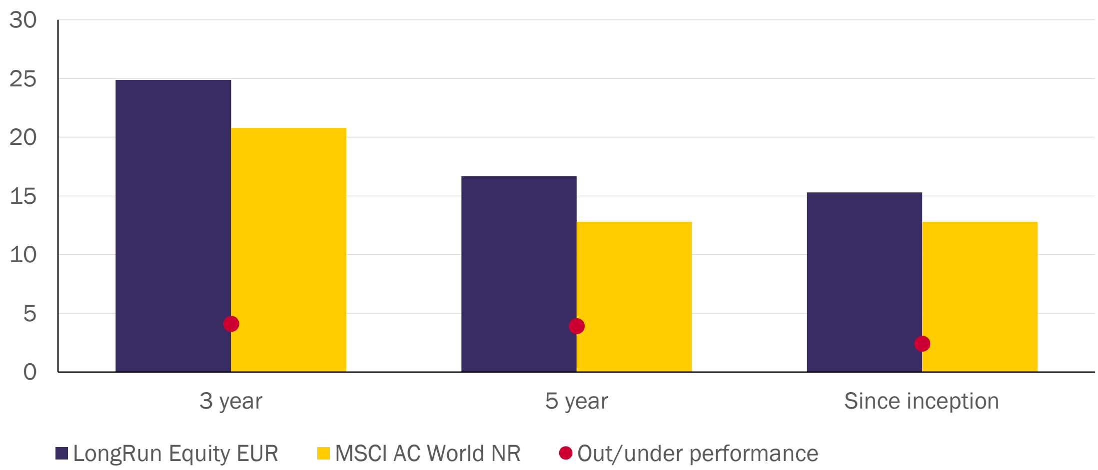
Cumulative performance (as per Dec 2021)

	LongRun Equity (%)	MSCI AC World NR (%)
2021	142.2	111.7
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	2,273	10.1	30.4	142.2
MSCI AC World NR		8.7	27.5	111.7
Out/under performance		**1.4**	**2.9**	**30.5**

Annualised performance (%)



Case study: sale of Colgate

Tube empty?

As outlined in last quarter's letter, we sold out of our position in Colgate. This was not a decision we took lightly, nor a knee jerk reaction. Rather, it was the culmination of our work in the last few months, since we took over the strategy at the beginning of August. Our work has made us appreciate the quality of the portfolio as long-term owners, and we will continue to be very selective when making changes; and we certainly will not change things for change's sake.

Colgate is a business we have been following, and admiring, for a long time. We met the company for the first time more than seven years ago and have been following it ever since. This, combined with our robust investment research process helped us accelerate our decision making since we already had our investment case and financial model in place. A key part of our investment case is an investment checklist and roadmap, and we were thus able to challenge whether the company still met the (high) criteria necessary to remain a part of the LongRun portfolio.

For each company that we divest, we write a detailed post mortem in order to identify potential mistakes and make our process more robust. Below are the main parts of this exercise for Colgate Palmolive.

Off roadmap?

For Colgate, the main parts of the investment roadmap were the following:

- Organic revenue growth in the mid single digits with low single digit volume growth and pricing in line or ahead of inflation
- Reported revenue growth (taking into account currency effects) of a similar magnitude
- Maintain and grow market share over time
- Steady improvements in operating margins
- Maintain or grow brand equity through advertising and other investments
- Maintain sensible capital allocation

Slowdown structural?

In terms of organic growth, for Colgate there has been a clear, and steady, deceleration over the last 15 years. For the first five years of this time frame, organic growth was 7.0%, slowing to 5.0% for the middle five and further to 3.5% for the last five. Importantly, this was chiefly driven by lower volumes which weakened from 4.0% to 3.0% and then to 1.5%. The slowdown in pricing was less pronounced, going from 3.0% to 2.0% and then to 1.5%.

We consider volume growth to be one of the most important performance indicators for consumer staple businesses; and the clear and sustained slowdown raised the question whether there are structural issues behind this. Broadly speaking, volume growth should be driven by population growth, penetration (ie. people brushing teeth more often) and market share gains. Leaving the latter aside for later, our findings support the conclusion that volume growth has structurally slowed down to the low single digits, with population growth decelerating and opportunities to increase penetration largely exhausted.

In terms of pricing, this can be disaggregated into two main components: price and mix. Pricing is also a key performance indicator, and not just for the fast-moving consumer goods industry. Our general position is that most of the large consumer goods companies with strong brand equity command low pricing power, ie. they are able to increase prices broadly in line with, but not ahead of, inflation. We consider the slowdown in pricing outlined above as partially due to slowing inflation globally over the last fifteen years. But our work also suggests that some of the weaker pricing is structural on account of the following factors:

- More powerful and aggressive retailers in mature markets: in the US and Europe in particular, pricing has been slightly negative over the past dozen years
- In emerging markets, pricing has been stronger, particularly in Latin America, a traditional stronghold of Colgate with pricing of around 6% broadly in line with consumer price inflation whereas in Asia pricing of around 2% lagged behind consumer price inflation

- In terms of mix, we think Colgate's broad positioning across all price points (with a particularly strong footprint in the value segment), and a historical strength, also puts it in a possibly less advantaged position going forward given that we think premiumization will be a key growth driver in the sector.
- Diminishing ability to innovate: while Colgate continues to pour close to USD300m into research and development investments, we believe the returns on these are diminishing, and see little in the way of true innovation. Higher prices are often contingent on innovation, particularly in mature markets, and the lack thereof further impinges the company's pricing power, we think.

Hard currency cash flows are king

The slowdown in pricing is particularly worrying since pricing has been stronger in markets with higher inflation which over time leads to currency devaluation. Our work shows that pricing is strongly correlated with inflation which in turn, over time, leads to negative currency translation in emerging markets. And here, Colgate was heavily hit in the last ten years on account of its strong presence in emerging markets such as Brazil and India, with negative currency impacts averaging over 4% annually.

Taking the two above together, growth at constant scope went from an average 7% in 2006-10 (which notably includes the global financial crisis) to zero since then.

We think this example illustrates well why a reliance on emerging markets for growth can be dangerous. Cash flows come, and dividends are paid, in hard dollars (or Swiss francs), and not in "constant currencies"; and this needs to be reflected in a company's valuation. In our models we incorporate differences in a company's geographic footprint through different inflation premia in our cost of capital.

Market share topping out?

The above issues are mirrored in Colgate's market share development. Its toothpaste market share fell to around 40% in 2020, down some 5%-points over the past five years. This is in stark contrast to the historical trend of Colgate constantly gaining market share.

Issues are different market by market. In the US, a resurgent P&G, owner of the market leading Crest franchise, has been the main headache. In India, Colgate was slow to react to the upcoming trend in naturals. And globally, we think the company lacks brand equity in some of the more advantaged subcategories such as sensitive teeth where Sensodyne is well positioned.

Squeezed out?

Similar to many of the other higher quality consumer goods companies, Colgate has a solid track record of slow and steady margin improvements. But like many a peer, margins have plateaued lately as top-line growth has slowed down and brand and marketing investment needs to be stepped up.

With operating margins of around 24% and a return on invested capital of around 50%, Colgate remains one of the most profitable staples companies. However, we see margin improvements at risk in light of i) a more difficult outlook for both volume and pricing growth, ii) increased competition in both mature and emerging markets and iii) the need to further step up or at least maintain brand and marketing investments.

Capital allocation record still unblemished

Colgate's track record in terms of capital allocation remains strong and it has continued to return the majority of free cash flow back to shareholders. Larger historical acquisitions such as i) Gaba/Elmex, which has a strong presence in the higher growth specialist/pharmacy channel, ii) skincare brand Sanex, which has strong credentials in the therapeutic space or iii) Tom's of Maine, a leader in natural toothpaste, were clearly value creating. Likewise, investing aggressively into Hill's Pet Nutrition (which we see as a high quality asset in particular because of it being recommended by veterinarians) was a genius move with Hill's operating profit rising more than six fold since the acquisition in the mid 90ies.

That said, we wonder whether going forward the risks in terms of capital allocation outweigh the rewards. On the one hand, we wonder whether Colgate remains the best owner for Hill's given Colgate's focus on personal care (and not food) but consider a spin-off, which would be in hot demand, as unlikely. On the other hand, and whilst unlikely, it is difficult to fully rule out Colgate going for a bigger deal in search of growth, or to fend off potential predators.

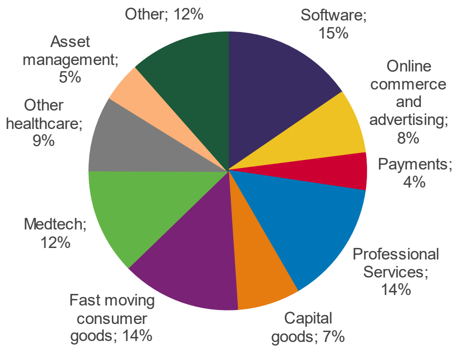
Conclusion

In summary, we decided to sell Colgate which is more exposed to the above issues than other consumer staples companies in the portfolio, notably Procter & Gamble. We think the latter is more advanced in terms of its portfolio streamlining, has improved its strategic focus and operational agility and is less reliant on emerging market growth. On top, its return on capital and cash generation are best in class, and all that at a broadly similar valuation as Colgate.

Business owner's portfolio

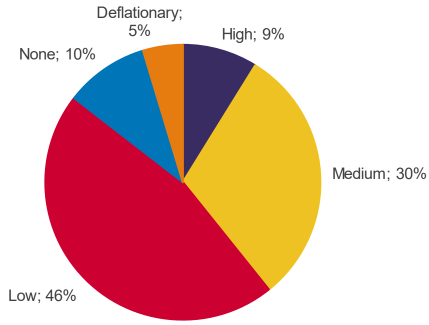
A deeper look into the strategy and its companies

Sales by business



By weight in portfolio, excluding cash

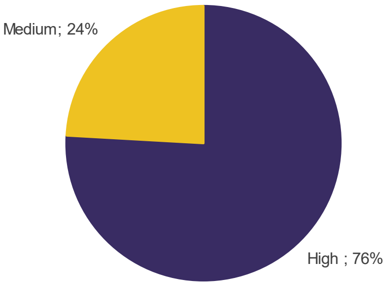
Degree of pricing power*



By weight in portfolio, excluding cash

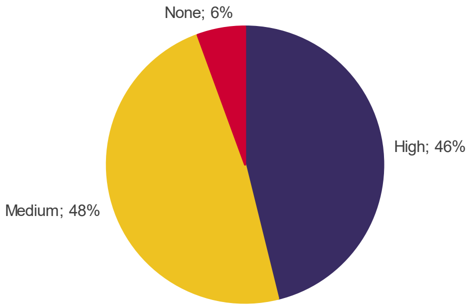
** In the investable universe, around 5% of companies have medium or high pricing power.*

Strength of competitive advantage



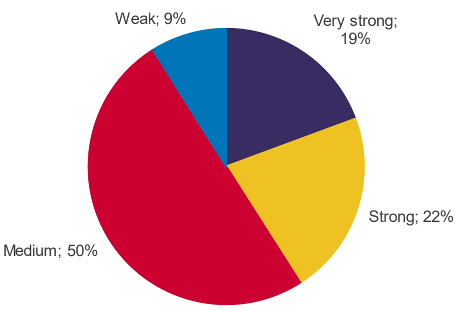
By weight in portfolio, excluding cash

Strength of switching costs



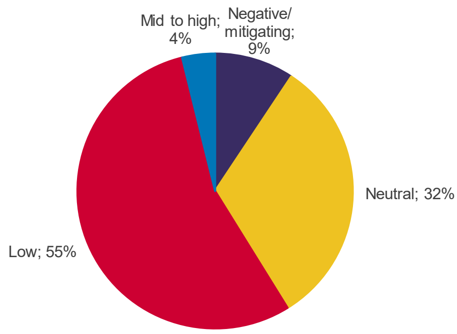
By weight in portfolio, excluding cash

ESG rating breakdown



By weight in portfolio, excluding cash

Carbon exposure risk breakdown



By weight in portfolio, excluding cash

Notes

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