LongRun Equity

Quarterly Letter

Quarterly Letter | Issue 03 | April 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 58% 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 high single digits for LongRun Equity.

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Values: All data as at 31 March 2022.

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 -7.2% in Q1 2022, headwind from its quality bias

Strategy performance

The strategy returned -7.2% (in EUR, unhedged) in the first quarter, thus lagging global equities which fell by 3.3%. The underperformance was mainly due to a sharp outperformance of Value stocks such as these in the energy sector, whilst growth and quality companies suffered in tandem, catalyzed by fears of rising inflation and interest rates, which affect longer duration assets disproportionately.

Annualised returns since inception of the strategy over six years ago stand at 13.3% compared to 11.7% for global equities, resulting in an annual outperformance of 1.6% points.

Performance drivers

The main positive contributors to the strategy's performance in the first quarter were most of our healthcare companies, Emerson Electric and Mastercard. In healthcare, all companies apart from Danaher were flat to positive, driven by the sector's defensive characteristics and lower headline valuation levels. Emerson Electric benefitted from its higher exposure to the energy sector where share prices were elevated on the back of a sharp rebound in oil prices. Mastercard benefitted from solid quarterly figures and a continued recovery in cross border travel.

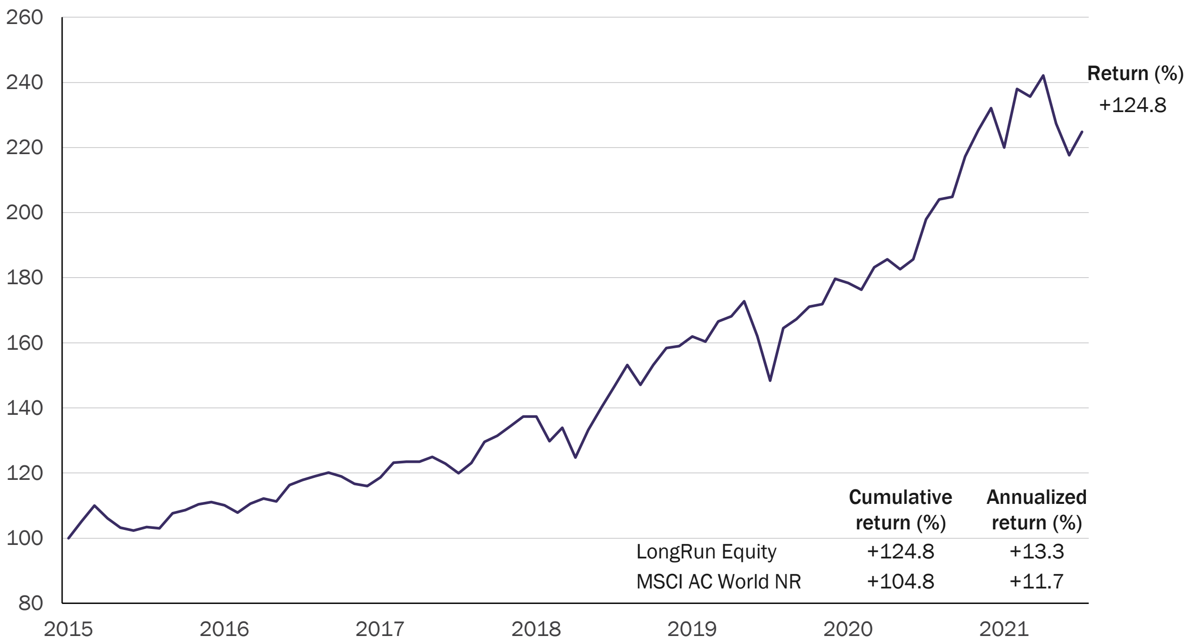
The main detractors for the quarter were companies in the technology space that carry a higher P/E valuation and businesses with larger operations in China.

The main detractors for the quarter were primarily Technology and China.

Most of our healthcare companies weathered the aforementioned style rotation well with a positive contribution to overall performance, led by Sonova, UnitedHealth, Thermo Fisher and Medtronic. Sonova announced a savvy acquisition of Alpaca Audiology in the US, which was well received by the market. UnitedHealth delivered typically strong results, again displaying the strength of the franchise.

Emerson Electric rose in the high single digits, buoyed by its high exposure to oil and gas in its automation segment which benefits from higher oil prices. Mastercard posted strong quarterly results with earnings growth well above 30%; the market is slowly coming to grasps with the company's improved earnings power now that cross border volumes are slowly recovering.

Cumulative track record (EUR Unhedged, %)



In the technology sector, Accenture, Adobe and Intuit all declined by over 15%, largely off the back of worries with regards to the disproportionate effect of higher interest rates on the multiples of these companies. As we've written in the past, we feel the pricing power element should also be part of the perspective, especially if inflation is persistent and margins suffer, or growth slows as a result of Central Banks' efforts.

In China, the overall market declined off the back of the persistence of Covid-19, weaker domestic growth and increasing geopolitical risks on the back of the Russia-Ukraine war. The fund is exposed to China via two direct holdings, Alibaba and Tencent, as well as our Western companies that do business there. Alibaba actually slightly outperformed the local index for the quarter while Tencent's decline was broadly in line. More impacted were Kone, L'Oréal and LVMH which generate 20-40% of their revenues in China or via Chinese consumers and were penalized accordingly with their share prices declining in the double digits.

Activity

In terms of activity, it was a quiet quarter. We made one switch in the healthcare sector where we purchased Thermo Fisher Scientific, financed by the full sale of Medtronic. The rationale behind this transaction is outlined in the following article to our quarterly letter.

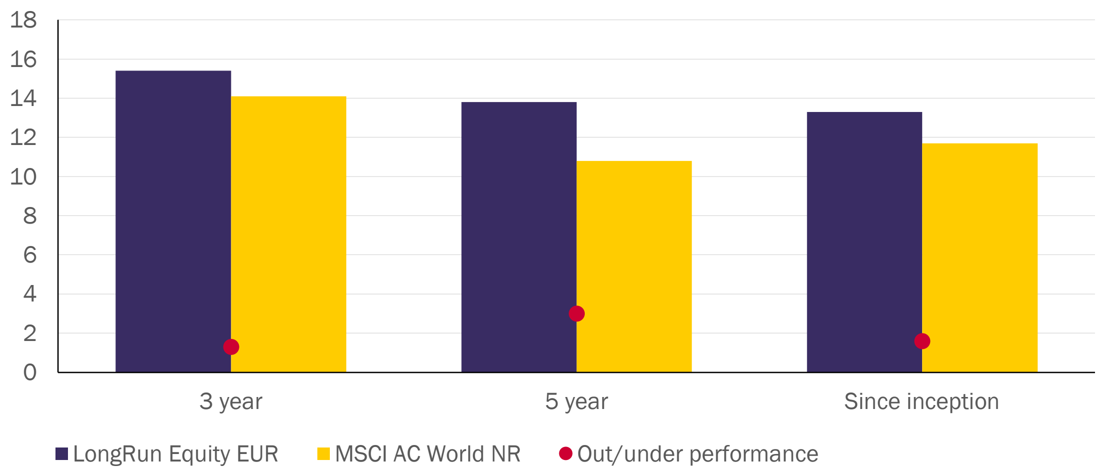
Annual performance

	LongRun Equity (%)	MSCI AC World NR (%)
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	2,110	-7.2	-7.2	124.8
MSCI AC World NR		-3.3	-3.3	104.8
Out/under performance		**-3.9**	**-3.9**	**20.0**

Annualised performance (%)



Case study: purchase of Thermo Fisher

Going from good to great in medtech

The fund initiated a position in Thermo Fisher Scientific this March, financed by the full sale of Medtronic. Thermo Fisher is a business we have been following, and admiring, for a long time, having met the company a few times already. We spent a considerable amount of time deepening our knowledge on both the overall medtech sector, and these two companies specifically, in the last few months. We think this switch within the sector, coupled with the continued ownership of Danaher and Sonova, has further improved the quality of the portfolio and our exposure to this attractive industry.

What does Thermo Fisher do?

Thermo Fisher Scientific is one of the world's largest medtech companies with sales of around USD40bn. The company was formed in 2006 through the merger of Thermo Electron and Fisher Scientific, both of which had been in existence for well over half a decade.

Thermo sells a vast range of products and services such as laboratory equipment, chemicals, supplies and services to customers from the pharmaceutical, biotech, healthcare, research and diagnostics industries. Just over half of revenues are generated in North America, followed by another quarter from Europe with Asia-Pacific accounting for most of the remainder.

The company operates within four segments:

1. Life Science Solutions (40% of sales): reagents, instruments and consumables used in biological and medical research, the discovery and production of new drugs and vaccines as well as diagnosis of diseases.
2. Analytical Instruments (15% of sales): instruments, consumables, software and services that are used for a range of applications in the laboratory, on the production line and in the field.
3. Specialty Diagnostics (10% of sales): diagnostic test kits, reagents, culture media, instruments and associated products for customers in healthcare, clinical, pharmaceutical, and industrial industries as well as for food safety laboratories.
4. Laboratory Products and Services (35% of sales): products and services used by laboratories as well as provision of outsourced services for the pharma and biotech industries.

What makes Thermo Fisher great?

Since 2009, when current CEO Marc Casper took the helm and following the successful completion of the merger between Thermo Electron and Fisher Scientific, the company has deployed over USD55bn via acquisitions, with the aim to build a complete portfolio of products and services and round out its geographic footprint. The strategic aim of this was to uniquely position Thermo as the go-to provider of life science instruments and consumables, all under one roof.

Besides the long-term nature of its relationship with its customers, the beauty in Thermo's business model is that it provides mission-critical products which account for a small share of customer-spend, thereby affording it with pricing power.

Sales can be broadly split into three product areas: **instruments, consumables and services.** Thermo employs a classical razor-and-razorblade business model where razors (instruments and equipment) are sold at a low(er) margin while the fitting razorblades (consumables and services) are then sold later on over an extended period of time at a much higher margin. The latter two make up for a combined 80% of sales and are largely recurring, mainly exposed to "lights on" activities of research laboratories rather than capital budgets thus providing a high degree of visibility on Thermo's sales and earnings.

Instruments account for around 20% of sales. Instruments have a relatively high ticket price of up to USD150,000, a useful life of up to 20 years and are part of a customer's capital investment. As a result, these revenues are more discretionary in nature but the resulting installed base of instruments drives long-duration future sales of consumables and services.

Consumables account for close to 60% of sales. These are products which are used to run the instruments Thermo supplies; these are critical elements of the process flow of its customers. A change in the production process of a drug is difficult as it requires a regulatory review, hence customers are often highly risk averse and inert. This results in switching costs and limited price elasticity with customers favoring first and foremost product quality, reliability of supply, interoperability and ease of ordering. A typical instrument generates 2-5x the purchase price in consumable revenues over its lifetime.

Services account for the remaining just over 20% of sales. The offering is mainly composed of outsourced services for the pharma and biotech industries for drug development, clinical trials and drug manufacturing. The cornerstone of the offering is the company's rapidly growing CDMO (contract development and manufacturing organization) business.

The company boasts an industry leading product portfolio both in terms of breadth and depth, exemplified by the Fisher catalogue, established in 1904, which consists of over 1.5m products and continues to dominate the marketplace. Thermo's competitive advantage is further strengthened by its large salesforce and distribution network which give it unmatched reach and scale.

Thermo's highly decentralized operations are anchored by lean central functions and a small headquarters. The foundation is the Practical Process Improvement (PPI) business system, focused on driving operational efficiencies and increasing profitability across Thermo's businesses through a continuous focus on quality, productivity and customer allegiance. This creates a shared understanding and focus on customer satisfaction and value delivery amongst its 90,000 strong employee base and is the linchpin on which the successful organization hinges. Such a scalable structure is crucial to both manage its wide portfolio of more than 25 different businesses and facilitate further inorganic growth.

Capital allocation extraordinary

In addition to the previously mentioned, large value-accretive acquisitions, Thermo has deployed another USD10bn via capital investments in order to drive continued strong organic growth which has averaged over 6% since 2007. Organic investments have generally been well timed, and the company was quick to seize opportunities to capture pockets of growth, such as in the last couple of years with capital investment more than doubling vs. 2019. We think the company is now very well positioned to be the supplier of choice for the research, development and production of biologics and large molecules, but without any outsized exposure in terms of single products, patent cliffs or diseases. Notably, all this was achieved without asking shareholders for additional money – in fact the share count has fallen by over 10% since the merger back in 2006.

We also consider the company's executive remuneration and alignment of interests with shareholders as exemplary, with a i) large share of variable, performance-based pay, ii) a strong focus on profitable growth in management incentives and iii) top management owning close to USD1bn of company stock.

Let the compounding continue

The strategic vision, bold capital allocation and strong delivery outlined previously have allowed Thermo Fisher to continue to gain market share which now controls close to 25% of its addressable market (with #1 or #2 positions in most of its categories) which is forecast to grow in the mid-single digits going forward. Since the merger, earnings per share have compounded at roughly 20%, around a third of which was due to acquisitions, we estimate.

Going forward, we expect Thermo Fisher to grow sales in the high single digits, driven by further market share gains and continued solid pricing. Coupled with margin improvements and disciplined capital allocation, we expect earnings per share to compound above 10% with continued strong free cash conversion of close to 90%.

Sale of Medtronic

The purchase of Thermo Fisher was financed by the sale of Medtronic. Medtronic is a much less focused company and, unlike Thermo Fisher, mostly exposed to less differentiated product areas. In categories such as knees, hips or pacers, hospital purchasing departments make buying decisions mainly on a price driven basis with less/no input from clinicians. In contrast, Thermo is mainly active in preference driven categories in which clinicians influence matters for buying decisions.

The weaker strategic positioning and execution is also mirrored in Medtronic's financials. Organic growth has only averaged roughly half Thermo's rate and margins and returns on capital have been under pressure as a result of increasing pricing pressure. We also consider the capital allocation track record as decidedly poorer, with the share count ballooning as a result of the "bigger-but-not-better" acquisition of Covidien in 2015 which did little to improve the company's strategic positioning, we think.

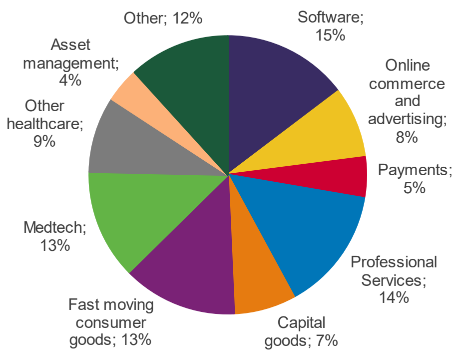
Conclusion

With the purchase of Thermo Fisher we believe we have further strengthened the quality of our portfolio. Compared to Medtronic, we think the company is a clear improvement in terms of i) business quality and focus, ii) end market exposure, iii) pricing power, iv) margin improvement potential and return on invested capital and v) capital allocation and management quality. We think these factors more than offset Thermo's slightly more expensive valuation in terms of free cash flow yield. Going forward, we expect Thermo Fisher to compound in the mid teens.

Business owner's portfolio

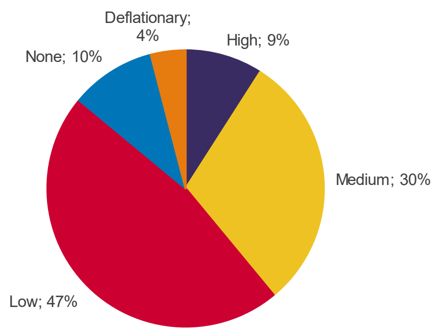
A deeper look into the strategy and its companies

Sales by business



By weight in portfolio, excluding cash

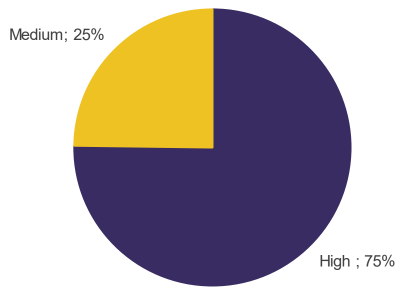
Degree of pricing power*



By weight in portfolio, excluding cash

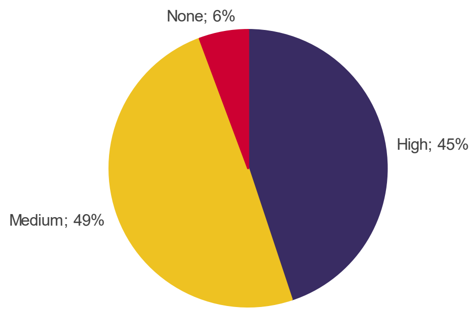
** In the investable universe, around 5% of companies have medium or high pricing power.*

Strength of competitive advantage



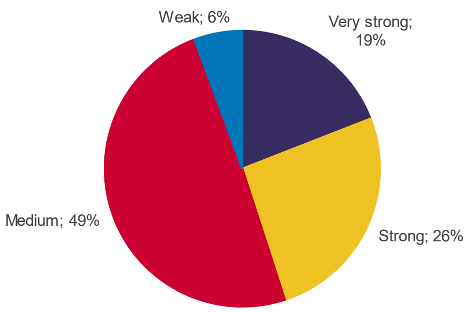
By weight in portfolio, excluding cash

Strength of switching costs



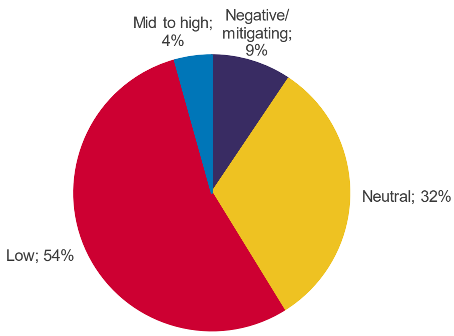
By weight in portfolio, excluding cash

ESG rating breakdown



By weight in portfolio, excluding cash

Carbon exposure risk breakdown



By weight in portfolio, excluding cash

Notes

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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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