LongRun Equity

Quarterly Letter

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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 26% operating margin, an operating return on invested capital of 56% and a net debt to EBITDA leverage ratio of 0.2x. On a 3.9% 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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Values: All data as at 30 September 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 -3.3% in Q3 2022, slightly lagging its benchmark

Strategy performance

The strategy returned -3.3% (in EUR, unhedged) in the third quarter, thus lagging global equities which fell by 0.6%. The underperformance was mainly due to a few specific stocks, and despite virtually all portfolio companies reporting solid quarterly figures with a continued broadly positive outlook.

Annualised returns since inception of the strategy over six years ago stand at 10.2% compared to 9.0% for global equities, resulting in an annual outperformance of 1.2% points.

Performance drivers

The main positive contributors to the strategy's performance in the third quarter were most of our defensive healthcare and consumer staples companies as well as LVMH and Disney among the companies more exposed to discretionary spending.

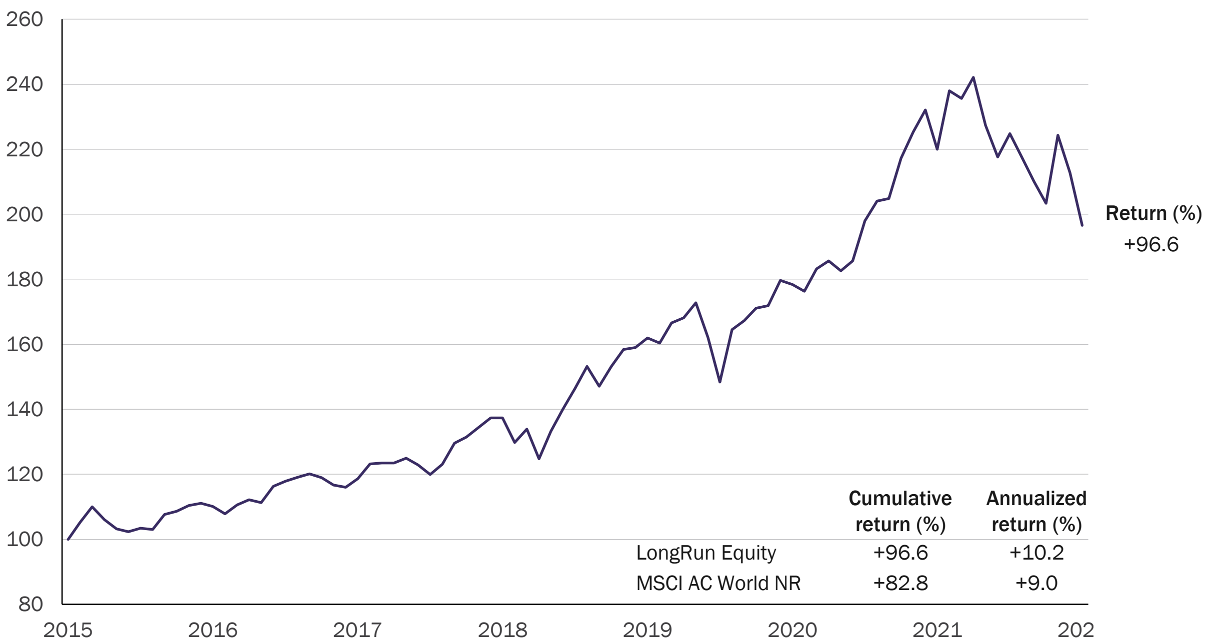
The main detractors were (similar as in Q1) companies with operations in or high exposure to China such as Alibaba, Tencent and Kone as well as Adobe and Sonova which suffered from company specific events.

Relative strength in healthcare was, with the exception of Sonova, broad based and led by Danaher and Roche, which were the two only stocks with a positive absolute performance.

Disney reported solid quarterly results, with strong new subscriber growth in its streaming service Disney+ as the main highlight, thus alleviating worries with regards to increased competition in the streaming space. While this is true, we think consolidation will eventually happen and Disney is well positioned to gain given its superior, must-have content.

LVMH continues to go from strength to strength, with no real slowdown evident yet in Q2 sales with organic growth of 19% and first half profits growing at an outstanding >30% rate. At current valuations, the risk reward profile remains attractive the more discretionary nature of its operations notwithstanding.

Cumulative track record (EUR Unhedged, %)



Alibaba and Tencent dropped 30% and 25%, respectively, solid earnings notwithstanding as the macro situation in China remains difficult and ever dynamic. On a more positive note, quarterly earnings were solid and estimates appear to be bottoming. Kone suffered from similar issues but we think valuation is increasingly supportive with earnings multiples at decade lows and a 5% dividend yield providing support.

Sonova reduced full-year guidance in August with an implied downgrade to estimates in the high single digits. The stock was unsurprisingly also derated on the back of this, falling by 28% for the quarter. Our long-term thesis is unchanged and Sonova well positioned to re-cover once the secular trend reasserts itself.

The case of Adobe is slightly more nuanced. The stock dropped another 25% after a near 40% derating over the last twelve months on the back of the USD20bn acquisition of collaboration software provider Figma. Adobe's value was marked down by over a fifth, or more than it actually pays for Figma. While we have some sympathy for some of the concerns (timing, financing and valuation), we have come to understand the deal better as of late and think Figma is a high quality asset that provides Adobe with optionality from a product bundling and customer access perspective.

Activity

We did not make any changes to the composition of our portfolio. The weightings of the recently added stocks were gradually increased. We remain happy with the make-up of our portfolio in the current environment, with the clear majority of companies operating in a business-to-business setting with customers giving only secondary consideration to price which we think augurs well for their resilience even in a weaker and inflationary economic environment.

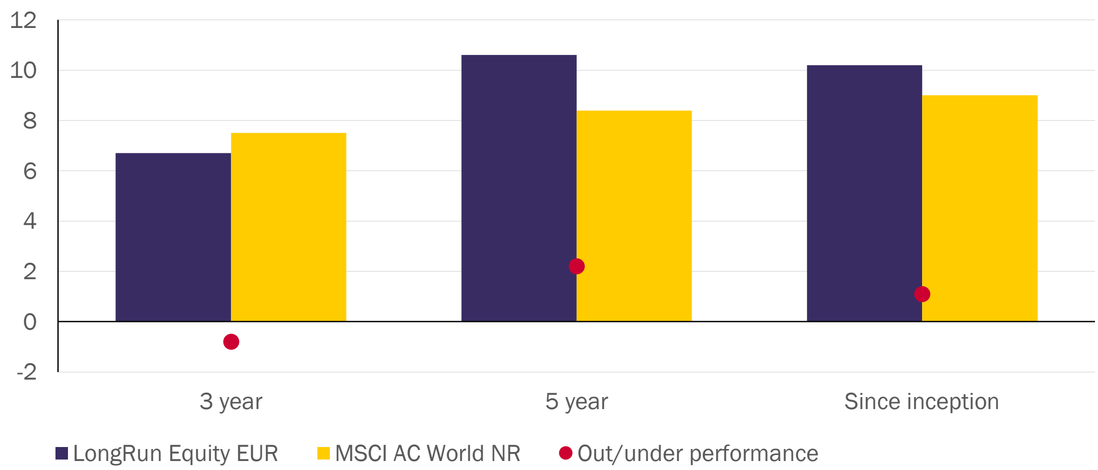
Annual performance

	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	1,845	-3.3	-18.8	96.6
MSCI AC World NR		-0.6	-13.7	82.8
Out/under performance		**-2.8**	**-5.2**	**13.8**

Annualised performance (%)



Case study: purchase of LVMH

King of luxury

In this section, we would like to provide an introduction into LVMH, the world's leading luxury goods company. We initiated a position in it last September, which we have since progressively scaled up to a 4% weight in the fund. LVMH is a company which we have followed for an extended period of time, and we think it is a natural fit for the philosophy of our fund.

The leading luxury goods company

LVMH came into existence in the 1980s when Bernard Arnault, acting CEO and chairman, acquired the bankrupt Boussac Saint-Frères empire, a textile and retail conglomerate that owned luxury brand Christian Dior and Le Bon Marché. The pivotal moment for the business came in 1984 when he took a 24% stake in LVMH over which he gradually took full control over the next decades.

The story of the LVMH conglomerate is the lifetime story of its CEO Bernard Arnault who said "in the 1990s, I had the idea of a luxury group and at the time I was very much criticized for it. I remember people telling me it doesn't make sense to put together so many brands. And it was a success… And for the last 10 years now, every competitor is trying to imitate, which is very rewarding for us. I think they are not successful, but they try." All of the Group's main brands were acquired over the last 30-odd years.

Nowadays, LVMH is the luxury goods juggernaut with sales of over EUR64bn and an operating profit of more than EUR17bn last year. The group operates across five segments, the most important of which is Fashion & Leather Goods which accounts for around half of sales and three quarters of earnings. Fashion & Leather Goods itself is dominated by the Louis Vuitton (LV) brand which accounts for around three quarters of segment profit. The other key brand in Fashion & Leather Goods is Christian Dior.

The Group's other segments are Wines & Spirits (Hennessy and Moët), Watches & Jewellery (Bvlgari and Tiffany's), Perfumes & Cosmetics (Parfums Dior, Guerlain, Givenchy) and Selective Retailing (Sephora and DFS). LVMH controls around 75 brands in total, most of which boast strong brand equity and heritage and are leaders in their respective segments.

What is luxury?

The world is (increasingly) littered with 'luxury' goods, but true luxury brands are few and far between, and we think globally there are only around a dozen that actually rightly deserve the moniker, such as LV, Hermès, Chanel, Cartier, Van Cleef & Arpels, Rolex, Patek Philippe, Audemars Piguet and Ferrari.

All of them have a few common attributes which make them 'true' luxury brands (Kapferer 2009): i) a very qualitative hedonistic experience and a product that is made to last; ii) a price that far exceeds the mere (functional) value; iii) are tied to a heritage, unique know how and with a culture attached to the brand; iv) are available in purposefully restricted and controlled distribution; v) are offered with personalized accompanying services and vi) are representing a social market. France is home to most true luxury brands.

Following on from the above, it is also important to note how luxury products are different from fashion as well as premium products.

Fashion products are very much driven by cycles, quality is often a lesser consideration, the "show-off" aspect is very important and product innovation is paramount. These brands often have Italian origins, such as Prada, Armani and Gucci; and are typically owned by "luxury" companies.

Premium (and super premium) products are ones where there is an objective yardstick to measure different alternatives; the more you pay the more you get. Performance and value for money is what matters, the purchase is mostly rational. These products are typically sold by fast moving consumer goods companies, are heavily reliant on traditional marketing techniques and often in the hands of American companies (where hardly any real luxury brands exist).

Louis Vuitton

Louis Vuitton started his namesake business in Paris back in 1854, focused on trunk making (malletier). His main idea was to produce flat trunks, lighter and more convenient to travel than rounded ones. The artisanal heritage to custom design boxes and, later, trunks according to clients' wishes became a success.

To this day, leather goods remain the key part of LV's offering, with leather bags accounting for around one-quarter of sales and bags in aggregate for three quarters. Remaining loyal to the group's origins and heritage is crucial to maintain the brand equity

Despite its ubiquity, LV has been able to maintain strong desirability by controlling distribution carefully and consistently increasing its prices, thereby maintaining the dream component. LV produces extraordinary objects such as its special trunks for ordinary people to support its brand equity while the bulk of profits is generated by selling extraordinary products (such as its Keepall and city handbags) for ordinary people.

The brand's positioning is also fairly wide, bridging both the formal and leisure poles while at the same time rejuvenating its timeless, classic styles through limited editions and the injection of new creative talent such as Marc Jacobs or the late Virgil Abloh.

The financial performance and size of LV is outstanding, and with it comes the risk of overexposure which is the biggest risk to the investment case, and as such watched and monitored carefully by us.

Over the past twenty years, we estimate organic sales growth has compounded at around 10% with sales growing ten-fold to around EUR20bn as a result. Even more striking is profitability with operating profit margins exceeding 50%, driven by economies of scale, strong pricing power and a fully vertically integrated business model with products only sold in its own stores, allowing the group to control pricing and customer access.

Owner operator

The history of LVMH is one of serial acquisitions, the importance of the Louis Vuitton banner notwithstanding. Since the global financial crisis alone, the group has deployed over EUR30bn via acquisitions, the main ones having been Bvlgari, Loro Piana, Rimowa, the remaining part of Christian Dior, Belmond and Tiffany's.

While the jury is still out on the more recent ones, the turnaround of Bvlgari was extremely impressive and Christian Dior's performance has taken another massive step forward over the last few years.

Important to note is that despite all these acquisitions, LVMH has continued to pay out growing dividends (which have risen more than four-fold since 2008) and invested a similar amount via capex investments, with each of the three accounting for roughly one third of total spend.

The successful deployment of such large swathes of capital is closely tied to Mr. Arnault's continued strong involvement in all things LVMH. He remains the majority shareholder with an ownership stake of 47%, or close to EUR150bn in total. Besides this massive amount of skin in the game, he has also a lot of soul in the game, making him an ideal steward of capital for us.

Fantastic five

LVMH's brand portfolio is dominated by five brands which account for over two-thirds of sales and an even greater portion of profits. Apart from the aforementioned Louis Vuitton and Christian Dior (both Parfums and Couture), they are the French cognac maker Hennessy, Italian jewellery maker Bvlgari and Sephora, the world's leading perfume and beauty retailer. Sephora is another example of savvy acquisitions, with strong high single digit growth over the past couple of decades.

However LVMH was not able to acquire the ultimate prize, Hermès. Hermès operates a similar, but even more luxury strategy as LV, but is nowhere near as heavily penetrated. LVMH took a position in 2010 (at roughly a tenth of the current price) but had to dispose of it seven years later after heavy pushback from both Hermès majority family shareholders and the regulator. This would have been a masterstroke.

Value in valuation

LVMH is the world's biggest, in our view highest quality, luxury goods conglomerate with the majority of earnings generated by true luxury brands. This affords it with a near impenetrable competitive advantage thanks to its brand equity and heritage as well as strong pricing power and a long runway for profitable growth.

Organic sales have compounded in the high single digits over the past with selective acquisitions further boosting growth. Earnings growth has been even higher. Going forward, we expect earnings to compound in the high single digits.

We think the width of the company's moat has grown further, as evidenced by a steady rise in operating margins and a return on invested capital which now comfortably exceeds 20%.

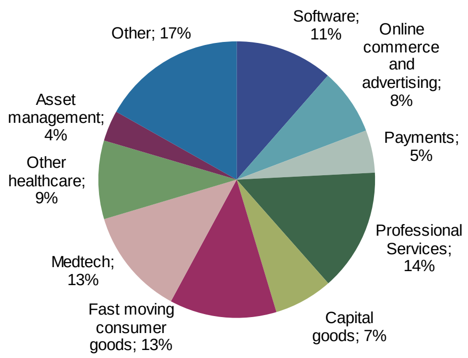
While this feels somewhat 'low' when comparing it to some of our other holdings and considering the quality of the business, the sustainability of these returns is second to only a few consumer goods companies, we think. This is because the deep vertical integration brings with it higher costs and asset intensity but in turn increases barriers to entry; a trade off we very much welcome.

We do not feel this is fully reflected in valuations with a one-year forward earnings multiple of around 20x and a 4% free cash flow yield.

Business owner's portfolio

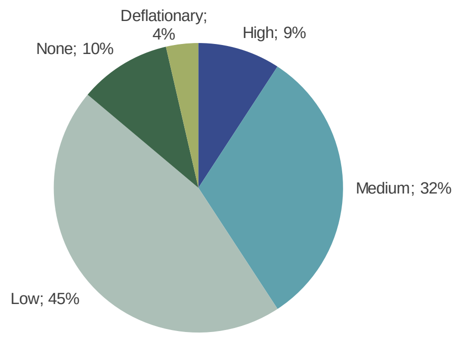
A deeper look into the strategy and its companies

Sales by business



By weight in portfolio, excluding cash

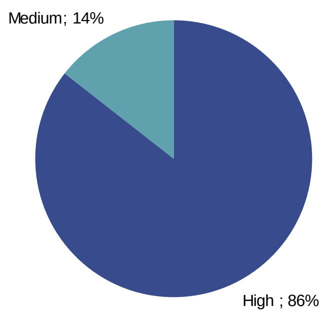
Degree of pricing power*



By weight in portfolio, excluding cash

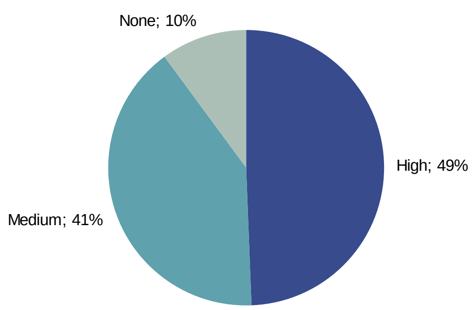
** In the investable universe, around 5% of companies have medium or high pricing power.*

Strength of competitive advantage



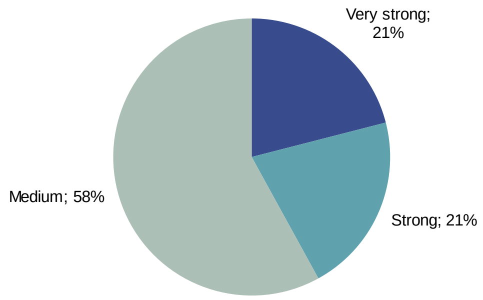
By weight in portfolio, excluding cash

Strength of switching costs



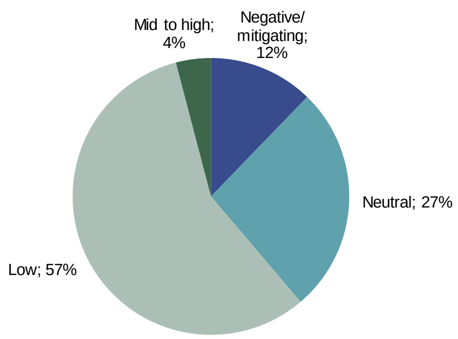
By weight in portfolio, excluding cash

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.

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