Rothschild & Co
Wealth Management

QUARTERLY LETTER | OCTOBER 2023

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.

Rothschild & Co Bank AG
Zollikerstrasse 1818034
Zurich Switzerland

+41 44 384 71 11

rothschildandco.com

Values: All data as at 30 September 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.

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 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 26% operating margin, an operating return on invested capital of 55% and a net debt to EBITDA leverage ratio of 0.3x. On a 3.4% 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 flat in Q3 2023, slightly ahead of its benchmark

STRATEGY PERFORMANCE

The strategy was flat at 0.0% (in EUR, unhedged) in the third quarter, thus slightly better than its benchmark which fell by 0.5%. The main reason for our outperformance were most of our technology businesses which were boosted by the excitement around, and potential of, artificial intelligence (AI) as well as strong quarterly earnings whilst the broader consumer complex continued to struggle.

Annualised returns since inception of the strategy over seven years ago stand at 10.4% compared to 9.3% for global equities, resulting in an annual outperformance of 1.1 percentage points.

PERFORMANCE DRIVERS

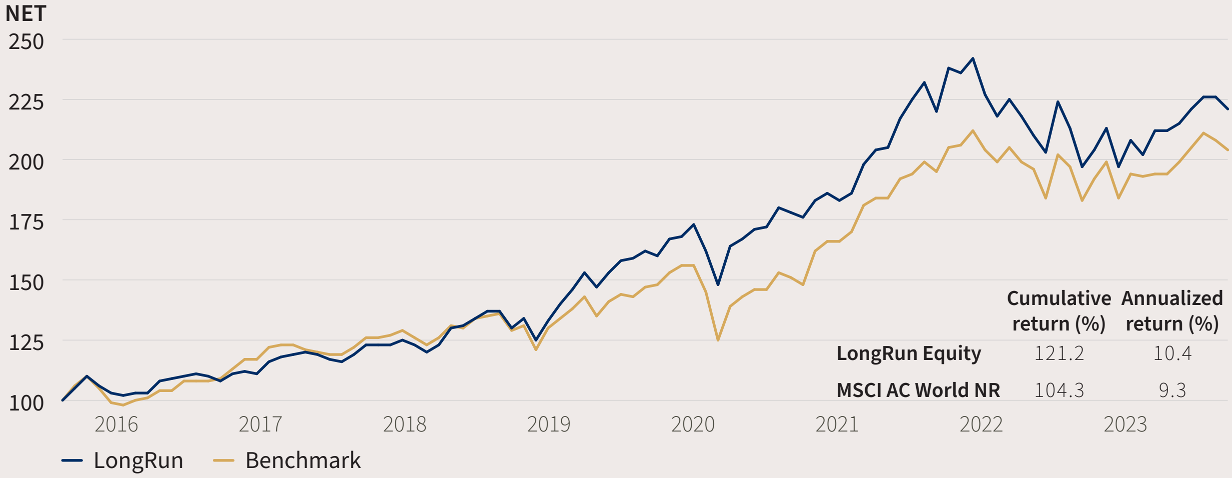
The main positive contributors to the strategy's performance in the third quarter were essentially our technology businesses while companies with exposure to discretionary consumer spending and China struggled. Performance was, however, rather diverse both between and within sectors with company specific factors more important than in previous quarters.

Adobe, Alphabet and Intuit all gained in the mid to high single digits. There was little in the way of company specific news apart from quarterly earnings which were solid and a continued march upwards in their earnings expectations.

Notably, we met with all three companies, as well as many other technology and communication companies in the quarter. While AI was and remains front and center in the space, we do think these three are among the very best positioned to use AI to their advantage, not least because they have been investing into it for years, if not decades, already. First glimpses of this latent earnings power have become visible as of late, with new product launches already including AI functionalities, often at higher price points.

The biggest detractors for the quarter were ASML, Kone and LVMH. There were no major company specific negative news and earnings estimates for each of them have barely budged, but all three were buffeted by industry specific, mostly shorter term concerns regarding their end markets, namely the semiconductor cycle (ASML), the Chinese real estate market (Kone) and the Chinese and US consumer (LVMH).

CUMULATIVE TRACK RECORD (EUR UNHEDGED, %)



	Cumulative return (%)	Annualized return (%)
LongRun Equity	121.2	10.4
MSCI AC World NR	104.3	9.3

ACTIVITY

We made two new investments in the fund in the last quarter: technology research leviathan Gartner and the global leader in pet diagnostics, Idexx. Furthermore, we fully exited our position in Walt Disney. We outline the rationale for the investment in Gartner in more detail and depth later in the letter.

Idexx is the biggest player in the US companion health diagnostics market, dominating both in the point of care and in reference labs with a >50% market share. The business benefits from a long runway for growth, boasts strong margins and return on capital thanks to customer loyalty and network benefits and should be able to compound earnings well above 10%. We seized the recent pullback to initiate a position after having finished our due diligence earlier in the year.

With regards to Disney, uncertainty remains high, further amplified by major changes on the management and organizational level. This led us to make a full reassessment as to whether our capital can be better allocated. The Disney franchise is one of the most powerful in the world, however it has become increasingly clear that the path to monetizing it and also achieving satisfactory profit levels in it's direct-to-consumer business will be a lengthy and rocky one. Furthermore, cash cow ESPN is increasingly under threat in the rapidly changing US media landscape and faces additional challenges due to continued cord cutting. Coupled with a valuation which remains rather demanding, we fully exited the position to deploy our capital elsewhere.

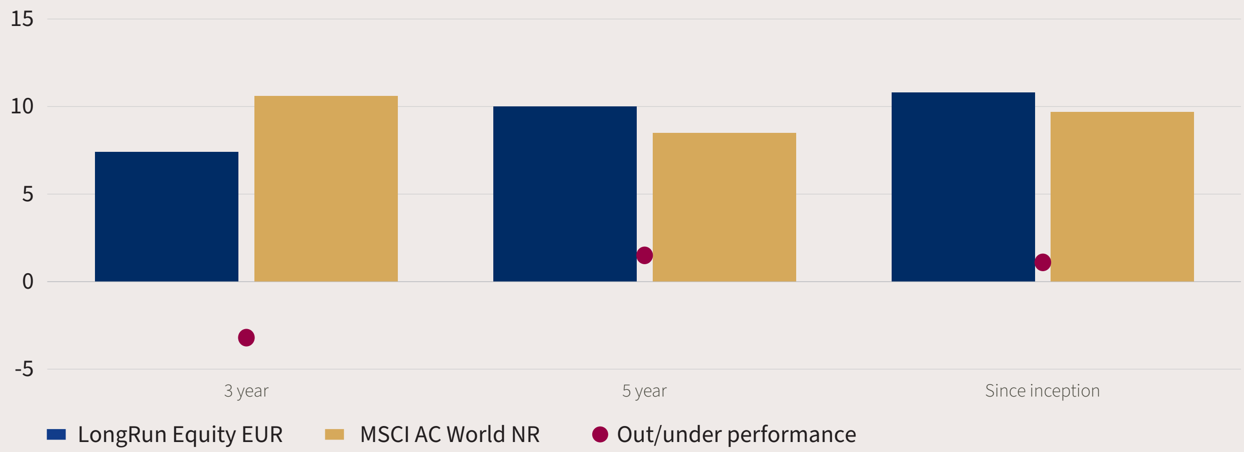
ANNUAL PERFORMANCE

	LONGRUN EQUITY (%)	MSCI AC WORLD (%)
2023	12.0	10.9
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	2185.54	0.0	12.0	121.2
MSCI AC World NR		-0.5	10.9	104.3
Out/under performance		**0.5**	**1.1**	**16.9**

ANNUALIZED PERFORMANCE (%)



Case study: Gartner

Hand in glove

In this letter, we wanted to take the opportunity to outline our rationale for a new investment in the fund, Gartner. This is a business which fits our investment approach "hand in glove" and which, despite its powerful position, is little known to many investors. We have followed Gartner for a long time and also recently met with management at their headquarters in Stamford, Connecticut. Over the last few months we have analyzed Gartner with deep and due diligence, the culmination of which was the purchase of its equity.

THE BUSINESS

At the core of Gartner is its Global Technology Sales (GTS) business unit, which provides technology research, mainly to Chief Information Officers and other senior leaders in IT. It sells research content (mainly in the form of research papers), data and benchmarks, produced by its 2,000-strong army of research experts. This business remains the linchpin of Gartner with a near unassailable market position.

Over time, Gartner has judiciously expanded from its stronghold in technology research into other areas, both to i) further fortify its position in technology research and ii) drive profitable growth in natural adjacencies. This was achieved both through organic means as well as one larger acquisition.

Gartner started to organically build its Global Business Sales (GBS) business over ten years ago as they saw that technology decision making was becoming more distributed across the C-suite, initially focusing on the marketing and supply chain verticals. The big leap forward then came in 2017 when it acquired CEB which strengthened their offering across all enterprise functions.

GTS ("within IT") and GBS ("beyond IT") are the two components of the company's Research segment which accounts for well over 80% of Group sales. The two other segments are Conferences and Consulting, each accounting for just under 10% of sales. Both are small, but key complements to the core Research business.

In the Conference segment, Gartner organizes flagship events with sessions led by its analysts. Attendees are both existing and prospective clients, and the strategic function of Conferences is to increase i) the retention of existing clients and ii) conversion of prospects. Despite its strategic function, the segment is able to stand on its own with solid profitability.

In Consulting, Gartner does not operate like a pure "paid-by-the-hour" consultant but operates much more strategically. It focuses on technology driven strategic initiatives (such as IT cost optimization, digital transformation and IT sourcing optimization) as an extension of its IT research business. Like Conferences, Consulting is a valuable entity on its own, but also provides a strategic benefit to the group as it helps increase customer captivity.

MISSION CRITICAL

Gartner aptly states that it "delivers actionable, objective insight that drives smarter decisions and stronger performance on an organization's mission-critical priorities".

Gartner essentially provides strategic advice on issues that can make or break a business and are far reaching. It has done this successfully for decades and thus built up a very strong reputation among its customers. Managers are often even more loyal to Gartner than their employer, as evidenced by its strong client retention. As the benchmark in technology research, customers often default to Gartner and its advice as going with a lesser provider could even put their position at risk, in case of the choice of the wrong solution or a botched implementation – better safe than sorry.

SMALL SHARE OF COSTS

Gartner sells its Research product on a subscription basis to its close to 20,000 clients. There are three product tiers with price points of up to USD100,000, and a typical client will have around five “seats” for a total bill of around USD250,000.

While this is hardly pocket change, it is nevertheless a small share of the cost base of its clients. These typically generate revenues in the hundreds of millions of dollars. Since the users are also the key decision makers, they will often have a direct say, rather than having to go through a tedious budgeting process where pricing and contract terms are scrutinized closely. Lastly, Gartner has a clear focus on value-selling and the value of a subscription grows as the installed base of research increases.

PRICING POWER

The combination of the mission-critical nature of its services and the small share of customer costs it accounts for gives Gartner ample pricing power, we think. Scrimping on areas that can have a lasting impact on an enterprise’s future is hardly wise, we think, very much in line with the adage of “penny wise, pound foolish”.

This is all fine and well on paper, but actually taking advantage of one’s pricing power also depends on the right set of structures and incentives. Gartner excels here, too, with an almost religious focus on price and no discretion for its sales force to discount its products to juice up sales. Customers have also become accustomed to regular price increases. And, naturally, being the clear market leader is helpful too.

Overall, we consider Gartner has strong pricing power and estimate it has been able to increase prices to the tune of 2-3% annually over the last 15-odd years.

MIGHTY MOAT

Finally, the combination of the mission-critical nature of Gartner’s services coupled with a small share of its customers’ costs results in switching costs. While its services are not deeply integrated into their customer’s workflows, switching costs are further amplified by the long-term nature of its contracts. The high-touch nature of interactions clients have both with Gartner’s research and sales personnel further strengthens customer captivity, as do the complementary conference and consulting services Gartner provides. Customer intimacy is high.

NUMBERS TO MATCH

The high quality of Gartner’s business model is mirrored by quantitative and financial metrics few can match.

Switching costs are borne out quantitatively in terms of high revenue retention rates of 87% for the Research segment and a subscription revenue share of 83% on a group level.

Financially, Gartner is soundly profitable with operating margins of around 20% with further upside as it can scale its research costs which are partially fixed with a growing sales force. Customers typically pay upfront for their annual research subscriptions. This buoys cash flows whilst capital investment needs are de minimis.

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The result is outstanding cash conversion with free cash flows converting into net profits well above 100%. Return on invested capital is equally strong, consistently eclipsing 100%.

THE GARTNER CULTURE

Gartner also boasts a strong culture with high employee engagement and regularly features at the top of “great place to work” lists. Of particular note is its sales academy which regularly churns out top performers. This has a lot to do with its performance driven, decentralized structure where sales people are incentivized to focus on both contract value retention and growth, notably without any caps on performance based pay.

The management is also of outstanding quality, with industry veteran Eugene Hall having been at the helm of Gartner for close to 20 years and a massive, USD400m investment in the business.

It should come as no surprise then that capital allocation has been equally exemplary. Of note is the USD3.5bn acquisition of CEB in 2017, both strategically and financially. This allowed Gartner to accelerate the buildout of its GBS business while at the same time deploying significant amounts of capital at double digit rates of return.

Of note is that this was partially financed by equity which management is, luckily, loathe to resort to. Otherwise, financial gearing would have become too elevated, even in the face of Gartner’s large recurring revenue base.

This focus on value creation is mirrored on the capital return side. Rather than sticking to regular share buybacks, which often end up being pro-cyclical, management increases buybacks when its stock price is lower and steps on the brakes when it is higher.

GREAT BUSINESS, ATTRACTIVE VALUATION

In light of the above, the final question for us was whether the outstanding quality of Gartner’s business model was already reflected in its valuation.

In terms of sales, it targets at least 10% growth and we do think it can maintain these double digit growth rates over an extended period of time on account of its pricing power and the untapped market opportunity. While the company’s estimate of a market share of just 6% strikes us as perhaps too modest, we have little doubt that given its strong value proposition further sizeable potential does exist.

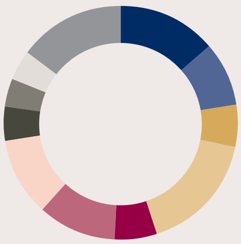
Double digit sales growth coupled with further margin improvements and continued reductions in its share count should drive continued mid to high teens earnings per share growth. This is an ambitious, albeit achievable goal in our view.

A rating of 31x one-year forward earnings will strike many a casual observer as “expensive”. However, on a cash flow basis the multiple is closer to 20x. To us, this appears very attractive – we expect forward returns comfortably in the double digits. Go Gartner go!

Business owner's portfolio

A deeper look into the strategy and its companies

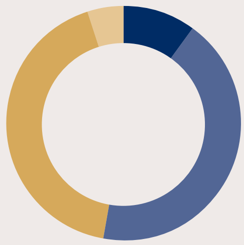
SALES BY BUSINESS (%)



Software	14
Online commerce and advertising	9
Payments	6
Professional services	17
Capital goods	6
Fast moving consumer goods	11
Medtech	11
Other healthcare	5
Luxury	4
Semi-conductors	4
Other	15

By weight in portfolio, excluding cash

DEGREE OF PRICING POWER* (%)

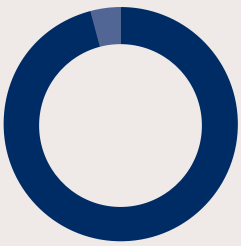


High	10
Medium	43
Low	42
None	5

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

By weight in portfolio, excluding cash

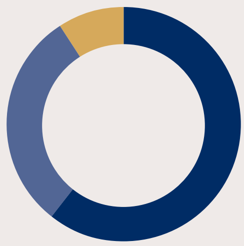
STRENGTH OF COMPETITIVE ADVANTAGE (%)



High	96
Medium	4

By weight in portfolio, excluding cash

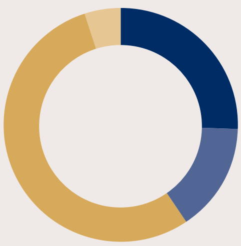
STRENGTH OF SWITCHING COSTS (%)



High	60
Medium	30
None	9

By weight in portfolio, excluding cash

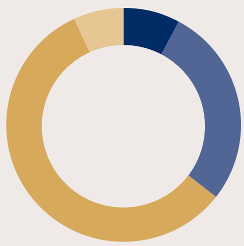
ESG RATING BREAKDOWN (%)



Very strong	26
Strong	15
Medium	55
Weak	5

By weight in portfolio, excluding cash

CARBON EXPOSURE RISK BREAKDOWN (%)



Negative/mitigating	8
Neutral	28
Low	58
Mid to high	7

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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