Rothschild & Co
Wealth Management

QUARTERLY LETTER | OCTOBER 2024

LongRun Swiss Small & Mid Cap Fund

Investment philosophy

"Make things as simple as possible, but not simpler" — Albert Einstein

Welcome to the fourth LongRun Swiss Small and Mid Cap fund letter. We kept the previously established structure which includes three sections: A description of our investment philosophy followed by a review of the quarter and finally an investment discussion such as a company case study. The section on our investment philosophy will not change in content but we may from time-to-time sharpen the wording. The review of the quarter covers performance and portfolio changes which we decided to elaborate on more compared to prior letters. The investment discussion focuses on a different topic each time, we will review the largest holdings first before we tackle other topics. Feel free to skip to whichever section interests you most.

Our aim is to invest in a concentrated portfolio of high quality Swiss small and mid-cap businesses and hold these for the long-term. Put differently, we simply want the best. More detail on our investment philosophy below.

LONG-TERM BUSINESS OWNERS

We want to own high-quality businesses which will be around and prospering for decades. Hence, we pay little attention to short-term price moves and rather focus on a business's sustainable competitive position. This means we search for companies with enduring superior business models that can compound their earnings. Consequently, we avoid companies in commoditized industries where price is the main differentiator. We seek solid companies in control of their own destiny, immune to external prices swings. A key metric is often management's allocation of capital as if it were their own, with a dedicated emphasis on achieving sustainable superior returns.

We care about valuation but are not dogmatic about it. If a great business continues to prosper, we are convinced that its share price will eventually follow. Furthermore, an obsessive focus on valuation often fails to identify truly exceptional businesses. We are determined to avoid this mistake.

Warren Buffett's advice "It's far better to buy a wonderful business at a fair price than a fair business at a wonderful price" is gospel to us. We are long-term business owners, which, in essence, implies that we envision acquiring a business and happily owning it for decades, if not longer.

DEEP RESEARCH ON A FEW COMPANIES ONLY

As follows from the previous section, we do not continuously screen our investment universe for "cheap" companies nor do we buy and sell based on short-term price changes. Instead, we leave this to machines which go through publicly available data to identify and exploit perceived arbitrage opportunities.

Our research process is thorough. Once we consider buying a company, we invest a lot of time reading its annual reports, conducting expert calls, talking to management and constructing our own financial models.

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Values: All data as at 30 September 2024.

On a portfolio level, our selection of businesses is complementary, as they serve different end markets across various geographies, generating revenues in multiple currencies.

We also read books on companies and their leaders, industry newsletters and listen to podcasts. In short, we leave no stone unturned to better understand a business.

We prefer to analyse and own fewer companies, ensuring a deeper understanding. To us, this deep understanding of business models is absolutely necessary even if it is no guarantee for superior long-term performance.

WEALTH PRESERVING PORTFOLIO

Avoiding permanent capital loss is essential to long-term investment success. Consequently, we conduct deeper research on fewer companies. Also, it's an ongoing process, never truly finalized. We always strive to learn more and assess whether a business will be around and prospering decades from now, considering environmental, social or governance risks. Only companies of high quality, firmly in control of their own destiny, make the cut.

Our approach stands in stark contrast to benchmark-relative investing, where the allocation to each company is determined by the benchmark. In this method, any particular company then receives a higher or lower or even no allocation depending on a portfolio manger's view. This frequently results in a portfolio with - we would claim - too many positions. To us, the benchmark serves as a yardstick only, and when looking at its constituents, we select simply the best.[1] That is why our portfolio's deviation from the benchmark as measured by the active share commonly exceed 65%.

On a portfolio level, our selection of businesses is complementary, as they serve different end markets across various geographies, generating revenues in multiple currencies. To us, this represents true diversification. We are cautious about merely adding more businesses to achieve diversification by quantity. This results in a robust portfolio.

A robust portfolio is also what then allows us to compound returns over the long-term. Just like we expect our businesses to compound their earnings, we also want to compound our clients' wealth.

[1] The SPI Extra defines the strategy's investment universe and is used as the benchmark. Up to a total of 15% can be invested outside of this universe for two reasons: To maintain an existing investment despite benchmark composition changes or to make an investment complementary to the overall portfolio.

Portfolio performance and changes

PERFORMANCE

The fund gained +5.1% over the third quarter and +10.0% for the year 2024 thus far. In comparison, the SPI Extra, serving as the fund's yardstick, gained +4.5% and +9.3% for the same periods, respectively. Annualised returns since the strategy's inception some four years ago stand at +7.7% for the strategy and +4.2% for the benchmark.[2] This results in an annualised outperformance of +3.5%.

Positive contribution over the quarter came from Belimo (+34% share price change over the quarter), Accelleron (+25%) and Straumann (+24%). Detractors included Comet (-8%), Inficon (-11%) and VAT (-15%). We discuss these in turn.

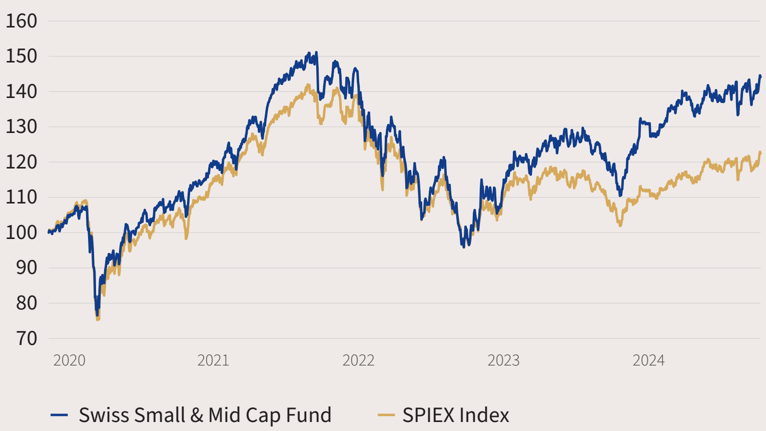
Belimo has seen its share price increase over the quarter in absence of major news. Operationally, the company has maintained its consistent focus on excellent execution. What changed, however, is a step-up in investor communication with a focus on climate control solutions for data centres which was also a main topic at the company's recent capital markets day. Additionally, we expect Belimo to achieve its targets for the year, which are above its long-term guidance of +9% revenue growth and a 19% operating margin.

Accelleron has been going from strength to strength since being spun-off from ABB in the third quarter of 2022. Its dominant position in industrial turbochargers and related services remains largely unchallenged, though this market typically allows for only modest revenue growth of around +5% Yet, several bolt-on acquisitions have increased its growth profile slightly and demonstrated strong capital allocation. For the current year, Accelleron is expecting exceptionally high revenue growth, double its usual rate, along with an operating margin of around 25%.

Dental implant maker Straumann reported a solid third quarter. While Europe may have experienced a slowdown in growth, Asia, Latin America, and North America have held up better. Another area of interest is the impact of recent rate cuts on customer financing, as well as the growth outlook for the EMEA region, following the divestment of the Dr. Smile business. We believe the company is on track to deliver within its 2024 guidance.

[2] Performance based on a certificate from its inception on 2019-11-06 until the fund's inception on 2023-06-11 and the fund's performance thereafter.

FIGURE 1: PERFORMANCE (%)[2]



	FUND	BENCHMARK	DIFFERENCE
2024	10.0	9.3	0.8
2023	21.9	6.5	15.3
2022	-26.6	-24.0	-2.5
2021	22.9	22.2	0.7
2020	14.1	8.1	6.0
2019	4.4	4.9	-0.5
CUMULATIVE RETURN	44.1	22.5	21.6
ANNUALISED RETURN	7.7	4.2	3.5

[3] Based on internal calculations using ca. 8 historical and 2 future years.

All detractors in the portfolio were semiconductor-related companies. After a strong first half of the year, their share prices came under pressure during the third quarter. The semiconductor industry remains cyclical. Historically, new software, such as operating systems, came with increased demands on hardware capabilities. Hence, the semiconductor cycle correlated with PC software releases. However, this dynamic has shifted as semiconductors have expanded beyond PCs into smartphones, electronic devices, automobiles, and data centres. While short-term demand remains uncertain, the industry sticks to its mid- and long-term growth forecasts. In other words, a recovery is expected, but the exact timing and shape remain uncertain. We are not too worried and remain convinced that share prices will eventually follow the companies' earnings. At the beginning of October, VAT released third-quarter sales, missing guidance due to issues implementing a new enterprise resource planning software. The root causes have been identified and addressed. The issues did not impact manufacturing which is at planned levels but outbound orders and shipping documentation which led to delayed shipments and therefore delayed revenue recognition. The company is confident it will book all delayed revenue before the year's end.

ACTIVITY

The third quarter saw no changes to portfolio constituents and only small changes to individual weights. This is in-line with our long-term investment philosophy.

RESULT

Our portfolio comprises high quality businesses as evident from the financial metrics: Cross-cycle sales growth of 8%, an operating margin of 20% , an operating return on invested capital of 28%, a net debt to EBITDA leverage ratio of -0.1x, and a strong cash conversion of 71%.[3] We consider the current valuation attractive, with the portfolio offering a free cash flow yield of 3.2%, in line with our benchmark.

Our portfolio comprises high quality businesses as evident from the financial metrics.

Elevators: Taking on gravity

Moving people all around the world

We have so much to share about elevators that one letter couldn't cover it all. In this one, we will provide a brief summary of the elevator business model discussed in our last letter before addressing three key questions. First, how did local manufacturers grow into multinational service-focused businesses? Second, how does a business's footprint evolve in a specific region? Third, can the past serve as a (rough) playbook for the future?

HAND IN GLOVE: ELEVATOR INDUSTRY'S BUSINESS MODEL

To recap, the industry's business model covers an elevator's entire lifecycle and starts with the new installation, followed by servicing and eventually modernisation. Each activity begets the next.

New installations depend on construction activity and typically make up less than 5% of a new building's total cost. At Schindler, this activity is ca. 40% of sales with mid-to-high single-digit margins. These individual projects are not highly lucrative but grow the installed base of the service business. A new installation comes with an initial service period of around three years, which converts into a longer-term service contract. Conversion rates across Europe and the US are around 90%, but only around 50% in China.

The service business is where the money is. Long-term service and maintenance contracts with a duration of up to ten years account for less than 1% of a building's annual running cost.[4] At Schindler, service is ca. 45% of sales, with margins above 20%. This activity makes up the lion's share of profits. Contract renewals are almost guaranteed unless the incumbent fails to provide adequate services or prices these too greedily.

Finally, modernisation of out-of-date elevators is common after 15 years or more. At Schindler, this makes up about 15% of sales, with margins slightly higher than new installations. With proper servicing and modernisation, elevators can remain in use for 50 years and longer.

These three activities — new installations, service, and modernisation — are closely linked as every new installation strengthens the installed base, which drives recurring service revenue and eventually modernisation work.

FROM LOCAL TO GLOBAL: THE RISE OF THE MULTINATIONALS

Today, the global elevator industry is dominated by four multinational companies – Otis, Schindler, Kone and TK Elevator – who control around 60% of the market. This has not always been the case. In the first half of the twentieth century, companies were focused on manufacturing and installing elevators. Over time, better-funded competitors consolidated the market, first at the national level and later internationally. By the mid-twentieth century, the focus began to shift from new installations to service and multinationals started to acquire local multi-brand service companies. This allowed them to increase the number and density of their installed base and improve service efficiency. Further, being the original equipment manufacturers, the multinationals knew more about their products and hence provided the best service. Over time, the barriers to entry kept rising because you cannot run an elevator service business without elevators to service.

Mergers and acquisitions have been common in the industry, facilitated by the capital-light business model and outstanding earnings visibility. Capital-light means not a lot of financial investment is tied-up. For instance, elevators are assembled mostly on the installation site with externally provided parts which limits in-house manufacturing and the corresponding capital requirements. Indeed, less than 25% of the value of elevator equipment production is done in-house. Most revenue and profit stem from lucrative service contracts barely requiring any investment at all. Quite the contrary, customers' upfront payments for service contracts essentially fund operations.[5]

[4] Service contract duration is longer in the U.S. and Europe (2–10 years) than China (1–3 years).

[5] Service contracts are long-term and typically paid up-front. Elevator companies receive cash before providing any services. Therefore, companies have negative working capital and most have a net cash balance on their balance sheets. This gives the multinational competitors ample financial flexibility.

[6] Source: Own calculation using industry, company, broker and UN census data. Calculated as number of elevators per 1,000 urban inhabitants.

The cash earned can then be ploughed back into the business to cover the limited internal needs, finance acquisitions, or capital returns to shareholders. Hence, the elevator industry is a prime example of industry concentration and profitability uniting in rational markets. Eventually, near local monopolies developed, such as Schindler's approximate 50% market share in Switzerland.

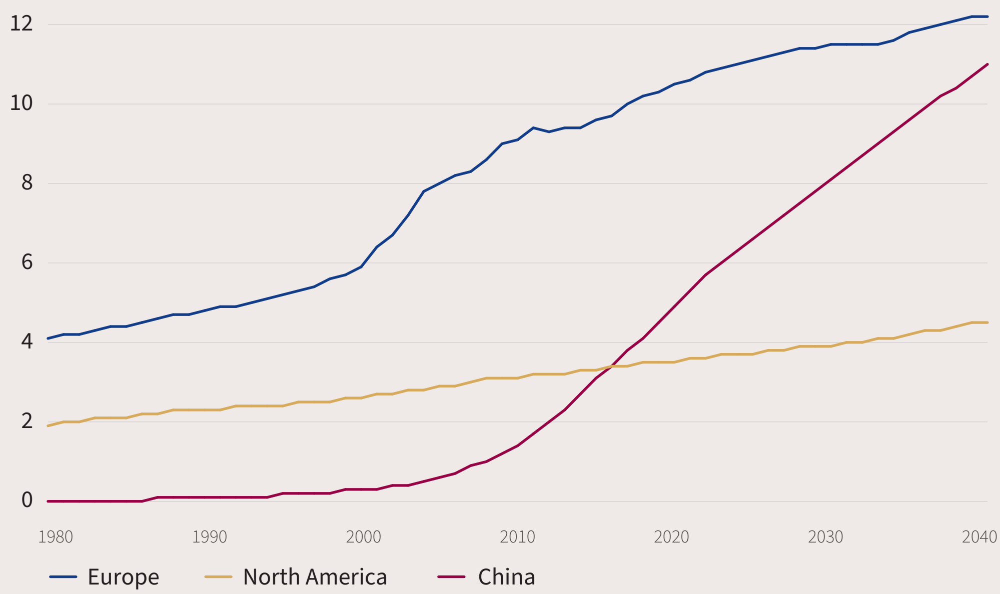
PAST BUSINESS ACTIVITY CHANGE: A PLAYBOOK FOR CHINA

With consolidation largely complete, elevator companies have turned to emerging countries for growth. In 2023, the global market for new elevators and escalators was below one million units, with Greater China accounting for more than 60% of installations. This dwarfs the more than 10% in Europe and less than 5% in North America. Globally there are around 25 million elevators and escalators in operation of which around 40% are in China, less than 10% in the U.S. and 30% in Europe. These numbers may seem odd initially but let us look at them relative to urban population as depicted by the elevator intensity in figure 2 below.

Elevator intensity increased over time but varies between regions. Today, in the U.S., there are about four elevators per 1,000 urban inhabitants, compared to seven in China and 11 in Europe. This discrepancy can be explained by differences in dominant housing types. In Europe, overall space is limited, urban areas are dense and most of its population lives in multi-storey buildings. In China, space is not an issue, but urban centres are dominated by multi-storey buildings and around half the population lives in flats. This contrasts with the U.S. where space is abundant and urban areas are commonly more spread out making low-rise residential buildings including single-family homes dominant. China's lower elevator density compared to Europe also reflects its economic development stage.

Due to differing new installation activity, the average elevator age varies between geographies. The installed base in China is still young, with less than 5% of elevators over 20 years old, compared to over 50% in the U.S. and slightly less in Europe. In mature markets such as the U.S. and Europe most money is made with service and modernisation. Unsurprisingly, overall margins are highest in the U.S. with the most mature and concentrated installed base in urban centres. This makes servicing more efficient, especially considering that as little as 5% of elevators cause 50% of service calls. If, as we believe, China plays out similarly to the Western hemisphere, revenue will eventually be dominated by service and

FIGURE 2: ELEVATOR INTENSITY (NUMBER OF ELEVATORS PER 1,000 PEOPLE)[6]



The elevator industry's unique business model is immensely attractive, with consolidation creating strong barriers to entry.

modernisation as well. As figure 3 shows, the business mix in China (right) will look more like the U.S. (left) in the future.

Today, Schindler's China revenue is split around 75% new installations and 25% service with the latter growing mid-teens over the past years. Whilst new installation margins in China are higher than other regions, they are eclipsed by service margins. With about 15% of Schindler's overall revenue coming from China, the company is well positioned to benefit from future service and modernisation growth.

Two concerns about China must be addressed. First, the construction boom resulted in some overcapacity and pockets of poor building quality. Consequentially, elevator equipment may outlive its shell. However, this is unlikely to be an issue everywhere. Secondly, China's market dynamics differ from the West. Distributors arrange a good chunk of new installations and manufacturers have no direct contact to end customers. This makes it harder to secure service contracts resulting in lower conversion rates. Overall, there are still plenty of smaller multi-brand service companies. We do not know when this will change and to what degree but are confident that the Chinese elevator market dynamics in ten years from now will resemble those of the U.S. and Europe more than today. Ultimately, margins and visibility across the region should improve.

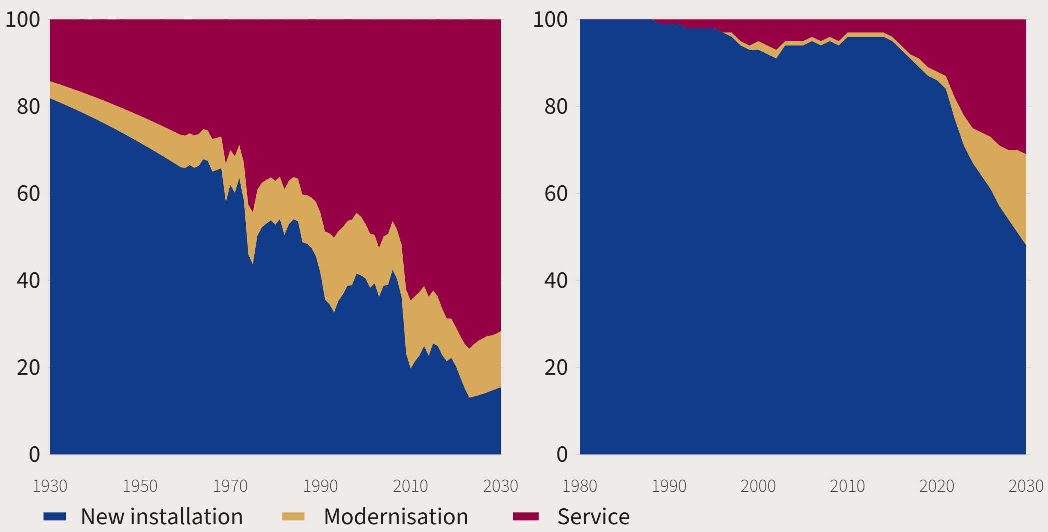
IN SUMMARY

The elevator industry's unique business model is immensely attractive, with consolidation creating strong barriers to entry. Elevators are essential to modern life, and most of us would much prefer taking one up Ping An International Finance Centre in China which has a greater altitude difference than hiking up Uetliberg from the shores of Lake Zurich.[8] To us, China presents an opportunity for growth in the coming decades. Unless, of course, humans acquire the powers of Clark Kent making elevators obsolete.

[7] Source: Own calculation using industry, company and broker data. Percentage revenue share per business activity (i.e. new installation, modernisation, service) as part of total industry revenue across the geography.

[8] Lake Zurich is around 400 metres above sea level and the city's home mountain "Uetliberg" stands 870 metres tall. The hike of 470 metres in altitude difference would get you up around 80% of Shenzhen Ping An International Finance Centre.

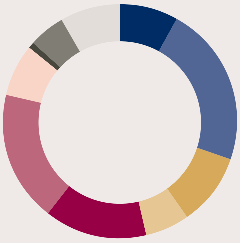
FIGURE3: EVOLUTION OF BUSINESS MIX FOR THE U.S. (LEFT) AND CHINA (RIGHT)[7]



Business owner's portfolio

A deeper look into the strategy and its companies

SALES BY BUSINESS (%)

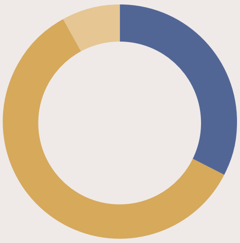


Materials	8
Machinery	22
Other cap goods	10
Transportation	6
Semiconductors	14
Health care	18
Food	7
Real Estate	1
AM	5
Other	8

Based on internal analysis.

By weight in portfolio, excluding cash.

DEGREE OF PRICING POWER* (%)



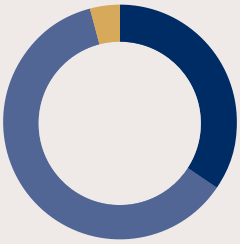
High	0
Medium	33
Low	60
None	8

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

Based on internal analysis.

By weight in portfolio, excluding cash.

STRENGTH OF COMPETITIVE ADVANTAGE (%)

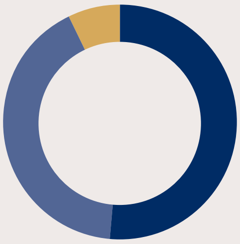


High	35
Medium	62
Low	4

Based on internal analysis.

By weight in portfolio, excluding cash.

STRENGTH OF SWITCHING COSTS (%)

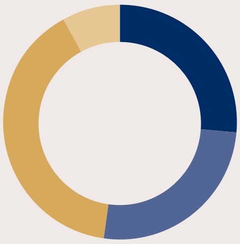


High	51
Medium	41
None	7

Based on internal analysis.

By weight in portfolio, excluding cash.

ESG RATING BREAKDOWN (%)



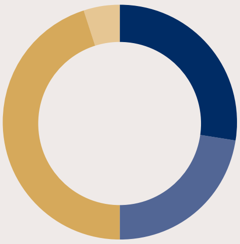
AAA	27
AA	26
A	40
BBB	8

The ESG rating summarizes the ESG performance of a company across environmental, social and governance topics compared to its industry peers.

Data retrieved from MSCI ESG Research LLC.

By weight in portfolio, excluding cash.

IMPLIED TEMPERATURE RISE BREAKDOWN (%)



1.5°C aligned	28
2.0°C aligned	23
Misaligned	45
Strongly misaligned	5

Implied Temperature Rise (ITR) shows the alignment of companies with global temperature goals. This represents the global warming amount if everyone replicated the measured company's practices. Categories range from less than or equal to 1.5°C Aligned to more than 3.2°C Strongly Misaligned.

Data retrieved from MSCI ESG Research LLC.

By weight in portfolio, excluding cash.

Notes

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