Rothschild & Co
Wealth Management

QUARTERLY LETTER | JULY 2024

LongRun Swiss Small & Mid Cap Fund

Investment philosophy

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

Welcome to the third letter of the LongRun Swiss Small and Mid-Cap fund. We kept the structure of the letter as before, because if you are with us again after the previous editions then we must be doing something right. To some, the name of the fund may ring a bell, at least in parts, as we also manage the LongRun Equity fund. Both strategies share the same investment philosophy. Their chief distinction is the investment universe: Swiss small and mid-cap companies or global mid and large-cap companies. More on the second quarter of 2024 and one of our main investments on the next pages.

As stewards of our clients' wealth, we invest the monies entrusted to us in a selective and concentrated portfolio of high-quality Swiss small and mid-cap businesses. Put differently, we simply want the best.

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 characteristic 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. 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.

Rothschild & Co Bank AG
Zollikerstrasse 181, 8034
Zurich Switzerland

+41 44 384 71 11

rothschildandco.com

Values: All data as at 30 June 2024.

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 CHF, after all fees, in total return, combining income and capital growth.

Please ensure you read the Important Information section at the end of this document.

We do not continuously screen our full investment universe for "cheap" companies and buy and sell based on short-term price changes.

Avoiding permanent capital loss is essential to long-term investment success. Consequently, we conduct deeper research on fewer companies.

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 among other things. 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, a company then receives a higher or lower or even no allocation depending on a portfolio manager'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 exceeds 65%.

On a portfolio level, our selection of businesses is designed to be 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. Our aim is to build a robust portfolio.

A robust portfolio is also what then allows us to compound returns over the long-term. Just as 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 lost -1.8% over the second quarter and gained +4.7% for the year 2024 thus far. In comparison, the SPI Extra, serving as the fund's yardstick, lost -0.1% and gained +4.5% for the same periods, respectively. Annualised returns since the strategy's inception some four years ago stand at +7.0% for the strategy and +3.5% for the benchmark.[2] This results in an annualised outperformance of +3.5%.

Positive contribution over the quarter came from VAT Group (+10% share price change over the quarter), Comet (+15%) and Inficon (+5%). Detractors included SIG Group (-16%), Tecan (-19%) and Straumann (-22%).

ACTIVITY

The second quarter saw some portfolio changes. As a reminder, the strategy was launched on November 6, 2019 as a certificate. On June 11, 2023 we launched the fund, which required some adjustments due to regulatory concentration and maximum position size restrictions. Over the second quarter 2024 we added one investment and sold two. The addition is Galderma, a pharmaceutical company specialising in dermatology, which went public at the end of the first quarter 2024. The removals are the electronic component manufacturer LEM and the real estate holding PSP. Other than that, we only changed some weights.

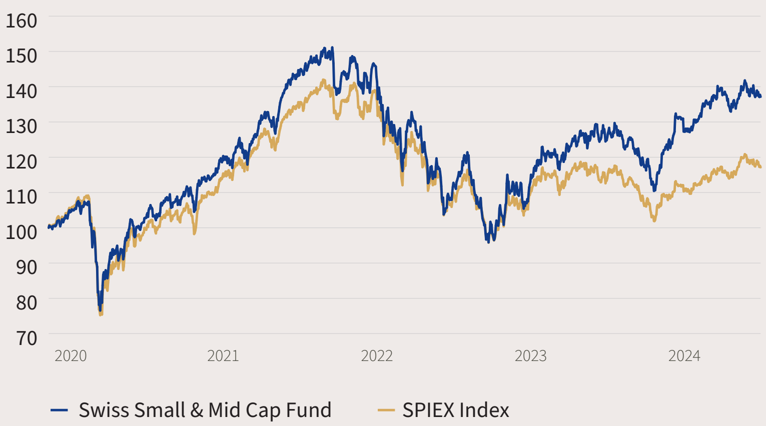
RESULT[3]

Our portfolio comprises high quality businesses as evident from the financial metrics: Cross-cycle sales growth of 8%, a 21% operating margin, an operating return on invested capital of 28%, a net debt to EBITDA leverage ratio of -0.1x and a strong cash conversion of 70%. We consider current valuation fair as current free cash flow yield of the portfolio is 3.1% versus 3.2% for its yardstick.

[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.

[3] Based on internal calculations using around eight historical and two future years.

PERFORMANCE (%)[2]



	FUND	BENCHMARK	DIFFERENCE
2024	4.7	4.5	0.2
2023	21.9	6.5	15.4
2022	-26.6	-24.0	-2.6
2021	22.9	22.2	0.7
2020	14.1	8.1	6.0
2019	4.4	4.9	-0.5
CUMULATIVE RETURN	37.1	17.2	20.0
6ANNUALISED RETURN	7.0	3.5	3.5

Schindler: Taking on gravity

A Swiss champion moving people

[4] Anyone else convinced that the 1993 hit by Reel 2 Real feat. The Mad Stuntman is excellent elevator music?

[5] An elevator car, or car, is the "room" in the elevator shaft which moves vertically.

As you can expect from this section of the letter, we focus on a single investment. We do this because we select businesses using a fundamental approach and want to share our insights. This time we take a closer look at the ups and downs not of Mr. Market's mood, but of elevators and the company Schindler.

The global elevator market is highly consolidated. Its four largest companies – Otis, Schindler, Kone and TK Elevator – control around 60% of the market today. Yet the success of passenger elevators once seemed uncertain when in 1860 the first elevator in NYC was dismantled after only three years in service because people refused to use it. While this elevator was made by Otis, all four companies have origins that stretch back more than a century.

Schindler has been in business for 150 years and installed its first passenger elevator around 1890. Early elevators were slow-moving curiosities in luxury hotels but soon found their way into high-rise buildings moving people to office floors and penthouse apartments. At that time, bell boys were responsible for managing the flow of people. Fast forward almost a century, and things could not be more different. For instance, the tallest building equipped with Schindler elevators is the 599 metres high Shenzhen Ping An International Insurance Centre in China, where you will find no bell boys. In fact, there are not even buttons inside the elevator cars.[5] Instead, algorithms direct people towards cars that move them at 25 kilometres per hour to their desired destinations.

"I like to move it" – a hit with industry slogan potential[4]

These are some impressive numbers. However, you may wonder: how does the industry make money?

The industry's business model covers the entire lifecycle of an elevator, starting with new installation followed by servicing and eventually modernisation. These distinct activities are described in turn.

The demand for new installations depends on construction activity. Although elevators cost only a fraction of a new building's total costs (far less than 5%), they have a lifespan of 25 years or longer. Projects are often bid for keeping a lid on margins, which average mid-single digits. At Schindler, the one-off revenue from new installations amounts to an estimated 40% of sales. Yet every sale increases the installed base, benefiting the service business. Over time, Schindler has built the world's second-largest installed base which they service, with around 2 million units.

The service business is where the money is at. Once a building is completed and occupied, reliable elevator service is crucial. Failure may, in the worst case, result in injury or even death, making regular service indispensable. Most service contracts initially go to the manufacturer and make up only a small fraction of a building's total maintenance cost (less than 1%). Building owners commonly select reputable service counterparties, even if there are cheaper alternatives because tenants ultimately pay for it. Hence, margins on service contracts are above 20%. It gets even better because contracts are paid in advance, gifting elevator companies negative working capital. Schindler's service revenue should be around 45% of sales and makes up the lion's share of profits.

This share may increase further due to higher value services. Today, about one-third of Schindler's elevators are connected, meaning that integrated sensors detect unwanted vibrations and communicate these to service staff for predictive maintenance. This allows service technicians to address potential issues before they happen and increase uptime. Schindler believes the perceived value to building owners and tenants allows for 15–20% higher service prices compared with unconnected elevators. Such an increase seems feasible, considering the average service cost per person moved in 2023 was only CHF0.01.[6] Just think about being able to avoid taking the stairs up the Ping An International Insurance Centre or, hopefully, never being stuck in an elevator far above ground.

Lastly, elevators are modernised once they are too old, or requirements change. At 15% of total revenue and margins only slightly higher than new installations, the activity may wrongfully be overlooked. A badly executed modernisation project may allow a competitor to snatch up the project and/or the ensuing service contract.

In summary, the three activities go hand in hand. The one-off new installation sale strengthens the installed base, which supports decades of recurring service revenue. Modernisation then prolongs the service revenue. The result is great earnings visibility.

As you can imagine, the industry is oligopolistic, and the elevator companies act rationally. You may rightly ask: where do they differ?

Frankly, the product offering is comparable, and any technological innovation usually gets copied quickly. Even corporate slogans are interchangeable: "Made to move you" (Otis), "People flow" (Kone), "We elevate" (Schindler) and "Move beyond" (TK Elevator). Still, some differences remain.

Geographic sales exposure is one difference. Schindler is more focused on Europe, Kone on China and Otis as well as TK Elevator on the Americas. To increase their installed base, companies often target countries with high levels of construction activity. The last such "land grab" happened in China and currently it remains unclear how this will pan out.

Management and corporate culture are further key differences with an undeniable effect on profitability and growth. Historically, new installation margins at Schindler were behind industry leader Otis, at low single-digit versus high single-digit, respectively. To drive higher sales and close the margin gap, Schindler's management drew up a plan to modularise the product offering. While the plan seemed promising in theory, execution fell short.

Customers were given too many options resulting in bloated inventory and unnecessary manufacturing complexities. At some point Schindler's stockkeeping system failed to track the vast number of parts. Modular orders entered the backlog just-in-time with post-Covid supply chain issues and raw material price inflation. As a result, margins on new installations started to deteriorate. Exacerbating the issue, salespeople often gave rebates on list prices, thereby offsetting justifiable price increases to meet their own targets.

In late 2021 Schindler's board became alarmed, and Silvio Napoli was reinstated as CEO.[7] In 2022 the group's operating margin slipped below 10% for the first time since 2007. This was caused by a negative new installation margin but a resilient service margin. Napoli's first move was to stop all growth initiatives and focus on profitability. Most importantly, a redesigned modularisation programme reduced required parts by 40% though still offering the full product range.[8] This reduced warehouse and manufacturing complexity, while improving margins. Moreover, the required spare part inventory for 25 years of service was also vastly reduced. Together, these measures stabilised and should improve new installation margins, and potentially the service margin over time.

Furthermore, Napoli has streamlined management and established clear targets. The executive team was reduced from 16 to 10 people, and sales guidelines are now tightly controlled to drive price increases. Schindler focuses on attaining high single-digit margins on new installations.

We agree with the CEO, who, in a recent interview stated that Schindler experienced an emergency landing in early 2022.[9] Much has changed since and we believe the company will benefit from its self-help programme. We forecast Schindler's sales growth in line with peers (around 3.5% p.a.) and expect profitability to improve from its current low-teens to mid-teens in the long term. Schindler's valuation looks attractive, trading at a one-year forward earnings multiple of 20x, while we deem 25x fair. These multiples are also below competitors. We mention the multiple here for illustrative purposes only, and note that by itself it is insufficient to draw firm conclusions.

To conclude, elevators are a great business commanding a small share of cost stacks and benefiting from recurring service revenues over decades. We see little to no disruption risk unless humans acquire the powers of Clark Kent, making elevators obsolete. To us this seems unlikely.

[6] We arrive at this approximation by taking 45% service revenue of the total CHF11.5bn sales in 2023 and dividing it by an estimated 2bn people transported per day annualised.

[7] Schindler veteran Napoli joined in 1994, was CEO from 2013 to 2016, became chairman in 2017 and was appointed CEO in 2022 for the second time in his career.

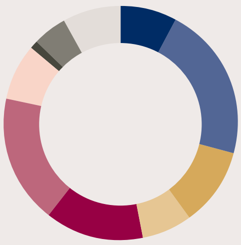
[8] The numbers are staggering. The original programme offered 2,600 car sizes and 21 types of steel, while the relaunched programme had 20 car dimensions and six types of steel.

[9] Neue Zürcher Zeitung 2024-06-17, pp. 22–23.

Business owner’s portfolio

A deeper look into the strategy and its companies

SALES BY BUSINESS (%)

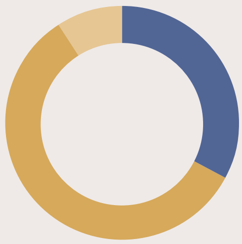


Materials	8
Machinery	22
Other cap goods	11
Transportation	7
Semiconductors	14
Health care	18
Food	8
Real Estate	1
AM	5
Other	8

Based on internal analysis.

By weight in portfolio, excluding cash.

DEGREE OF PRICING POWER* (%)



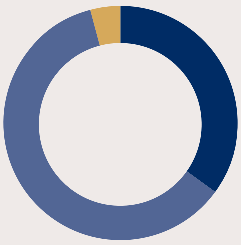
High	0
Medium	33
Low	58
None	9

*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 (%)

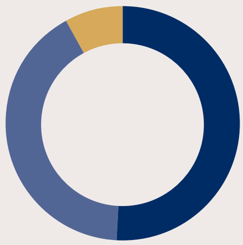


High	35
Medium	61
Low	4

Based on internal analysis.

By weight in portfolio, excluding cash.

STRENGTH OF SWITCHING COSTS (%)

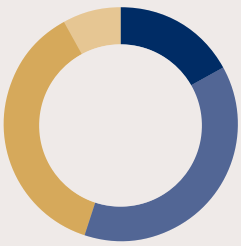


High	51
Medium	41
None	8

Based on internal analysis.

By weight in portfolio, excluding cash.

ESG RATING BREAKDOWN (%)



AAA	17
AA	38
A	37
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	21
Misaligned	41
Strongly misaligned	10

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

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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Important information