Investing with Insight

Full Year
Investment Report 2023

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Dear fellow investors

In this annual report, we provide some high-level comments on the portfolios and share insights into some themes that we think are relevant to our investment philosophy and strategy.

Our investment approach is centered around ultra-long-term, unconstrained, and concentrated equity funds that focus on investing in publicly traded companies known for consistently generating high free cash flows, demonstrating exceptional capital allocation skills, and boasting a solid history of delivering strong shareholder value.

Our two portfolios (Global and Nordic) consist of Acquisition-driven Compounders – companies that have the acquisition of smaller private firms at the heart of their strategy. These companies excel at identifying, negotiating, and completing acquisitions in private markets at highly attractive valuations.

We firmly believe that long-term investing success hinges upon investing in strong capital allocators, decentralized structures, and people with ownership.

We are committed to investing in what we believe are the best Acquisition-driven Compounders that will generate substantial value for our investors.

Thank you for your trust and support.

The REQ team

REQ Global Compounders

For 2023, the fund's A-class shares in NOK appreciated by 42%. Since the fund's inception in June of 2021, the A-class shares in NOK are up by 32.0%.

No significant portfolio changes occurred within REQ Global Compounders during the second half of the year. Additionally, as part of our continuous reviews for our portfolio companies, we engaged in multiple company meetings and attended conferences, including the Carnegie Serial Acquirer event in Stockholm. Conversations with portfolio companies indicated a sustained business-as-usual approach and improved preparedness for potential adverse changes in market conditions.

The pessimistic sentiment that prevailed after the summer holidays, especially towards Nordic small-caps, saw a notable turnaround as the pessimism faded during the year's second half. As a global portfolio with companies internally diversified across various revenue streams spanning different sectors and end-markets, REQ Global Compounders should be well-prepared to navigate a more demanding economic cycle. Our companies are like skilled musicians playing multiple notes, not overly reliant on a specific theme or factor.

The most significant portfolio change during 2023 was buying more Lumine Group, which spun out of Constellation Software in March in connection with its purchase of WideOrbit. We increased our position post-IPO, in addition to the distributed shares, now ranking among the top 5 holdings in the fund, helped by solid stock performance. Drawing parallels with Constellation Software's 2009 metrics on revenue, margins, and capital allocation prowess, we find the reinvestment runway for Lumine compelling. Lumine is one example of several investments we have where we invest in a company early in its growth journey, with a significant runway for profitable growth, which has already proven highly cash-generating. Other portfolio examples with similar characteristics are Momentum Group and Teqnion.

Through more significant carve-out acquisitions combined with smaller VMS deals, we believe Lumine Group could achieve higher reinvestment rates at attractive returns earlier in its public tenure than Constellation Software. Two factors support this: the preference for larger companies in communication and media verticals with enterprise customers and Lumine's leveraging of experience from Volaris and cumulative insights from Constellation Software. Despite listing in 2023, CEO David Nyland nurtured Lumine within Volaris since 2014. Executing more significant carve-out acquisitions broadens the acquisition pool, potentially redefining the list of potential acquisition targets. While open to new verticals in the future, the present focus centers on abundant targets in communication and media.

Year to date, we have observed continual robust growth across our portfolio, driven by organic growth and acquisitions. Our portfolio companies announced 260 transactions in 2023, compared to 249 in 2022.

REQ Nordic Compounders

During 2023, Nordic Compounders made minimal changes to the portfolio, as the criteria for new companies to enter the fund are stringent. As of December 31st, the portfolio consists of 23 holdings.

The operational performance, in conjunction with a strong market in 2023, is reflected in the strong performance of the fund's A-class shares, which appreciated by 33% during 2023. Since the fund's inception in January 2022, it has increased by 14%.

We believe the fund includes the highest-quality companies in the Nordics, with a proven track record of profitable growth and effective capital allocation. As the name implies, the fund invests in Nordic-listed compounders that pursue acquisitions, reinvest their capital, and generate strong returns over long periods. To exemplify, over the last 15 years, our portfolio of companies has reinvested 85% of their operational cash flow into acquisitions. With strong balance sheets (portfolio weighted Net Debt/EBITDA level of 1.4x as of 2023 Q3), our companies are well positioned to take advantage of the growth possibilities presented.

During 2023, the companies in our portfolio demonstrated strong performance, evidenced by significant growth in earnings, despite lower organic sales growth in recent quarters. The companies in our portfolio also display strong cash flows during the recent quarters due to strong earnings and net working capital releases.

In 2023, our portfolio companies completed 123 transactions, compared to 160 in 2022. The continuously high acquisition pace indicates that companies still see attractive opportunities for acquiring other companies, which signals a stable overall demand. During the year, we have observed several transactions outside the Nordics, demonstrating the fund's diversity in terms of revenue. To exemplify, out of Indutrade's acquisitions conducted in 2023, 55% were outside the Nordics. For Addtech and Lifco, the non-Nordic acquisitions represented 60% and 87%, respectively—roughly half of our portfolio companies' revenue stems from outside the Nordics.

Despite the persistently challenging market conditions and uncertain outlooks that remain a concern, our portfolio companies have adeptly navigated through these difficulties, showcasing their resilience and adaptability. One common thread shared among our best-in-class companies is their unwavering focus on generating reliable and consistent cash flow. This is achieved through decentralization, which enables a framework for cost awareness and a host of best practices.

The superior long-term performance of our holdings is cultivated through large owners with a multi-decade mindset of value creation and owner-operator mindsets. Our companies generally have high insider ownership, aligning their interests with shareholders. For our Nordic Compounders portfolio, the Board of Directors and large families hold 20% of the capital, while management, on average, holds 3%. In general, we have very high insider ownership among CEOs of, on average, 100x their base salary in equity holdings (10x on median), showcasing a high interest in creating long-term shareholder value.

We appreciate your ongoing support and look forward to sharing our progress in the future.

Thriving in Tough Times

As we approach a phase of lower expectations for organic growth, how should we look at Acquisition-driven Compounders in such a landscape?

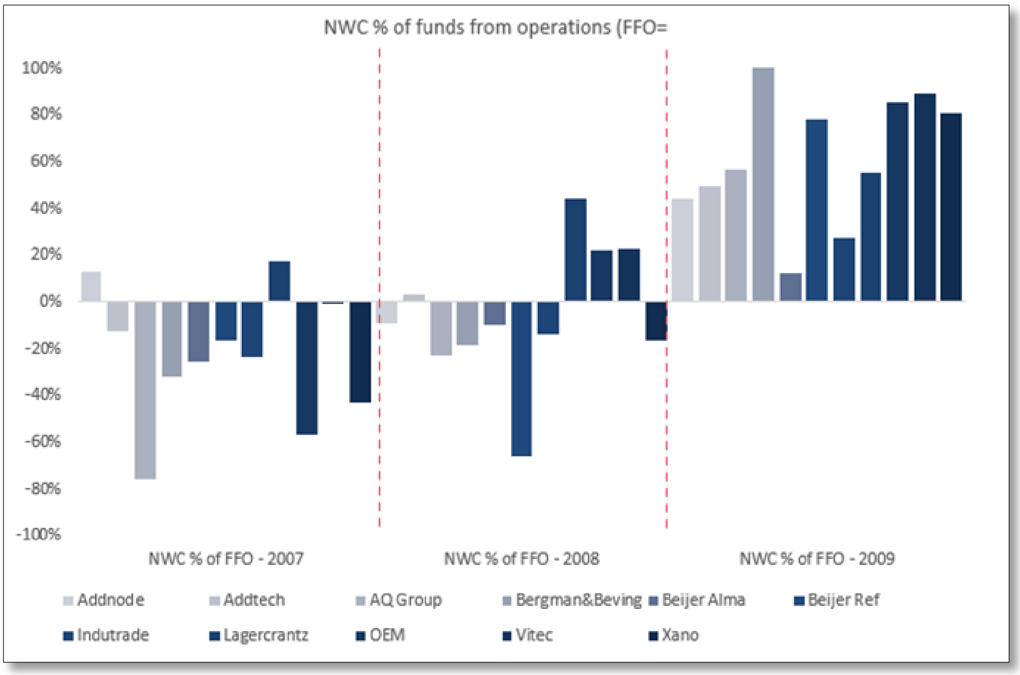
To begin with, the strength of these frequent acquirers often lies in the combined effect of dual growth engines – organic and acquisitions. What do we mean by this? The fundamental model employed by these companies involves acquiring small qualitative specialized private companies, frequently family-owned, with strong market positions in their specific niches.

These companies have traditionally demonstrated healthy organic growth (mid single digit) and solid cash flows. Upon entering larger decentralized structures, these companies retain their core values and business acumen, continuing to prosper and generate cash flow for their new owners. Reinforced by skilled capital allocation strategies, these acquisition-driven compounders deploy the generated cash flow to acquire new companies in a disciplined manner, supporting the second engine of growth: acquisitions.

In a situation with slower/declining organic growth, a common occurrence is the release of cash flow, enabled by a reduction in tied-up net working capital (NWC). This is often also stimulated by smart internal return on capital systems, such as Profit/NWC.

Consequently, the second growth engine enables these companies to some extent offset the decline in organic growth. However, if we see a sharp decline in organic growth, similar to that of 2009, combined with overall market uncertainty, transaction volume would probably decline, hence the inorganic growth may not be sufficient to offset the organic decline.

Looking at the years 2007 and 2008. many companies tied up significant capital during these years of strong growth, but witnessed significant releases in net working capital in 2009 during the Great Financial Crisis. This is illustrated in the chart below. We saw a similar pattern during the 2020 COVID outbreak

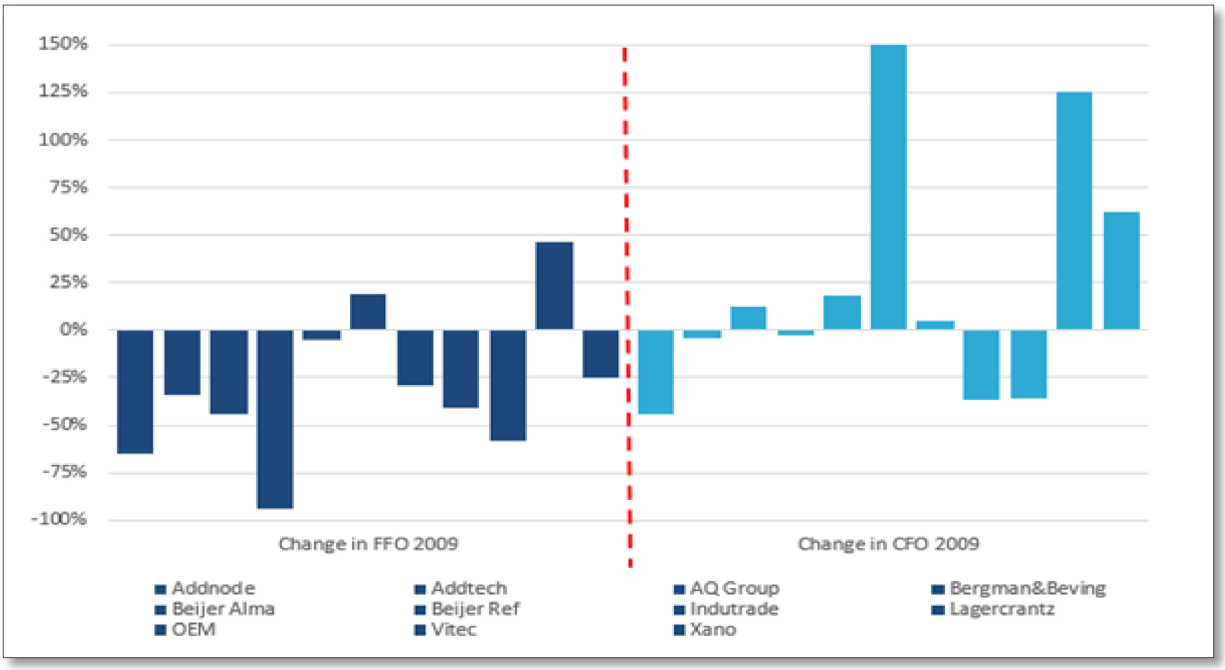


A noteworthy observation from Jörgen Wigh, CEO of Lagercrantz, in a Redeye Q3 interview adds depth to this perspective of the dynamics in play:

Jörgen Wigh: "*I've been doing it for quite some years now, and when we see a slowdown in our topline, which happened during the financial crisis, we see strong cash flows. We release quite a bit of working capital, and this is sort of the fuel for making more acquisitions*."

Transitioning into a phase of lower (or negative) organic growth has the potential to release important cash flow for these companies, allowing them to capitalize on inorganic growth opportunities, thereby sustaining overall growth.

Reflecting on the Great Financial Crisis once again, the operating cash flow before changes in net working capital (FFO) in 2009 decreased by 34% (median), but however increased by 4% (median) after net working capital movements. As seen by the chart, many companies maintained overall good cash flow:



If historical patterns persist in the upcoming year or years, a broader expectation of stronger cash flows may materialize, paving the way for the inorganic growth engine.

In summary

Supported by proprietary M&A pipelines built over many years, sound balance sheets, and healthy cash flows, resilient Acquisition-driven Compounders are well-positioned to seize opportunities when economic conditions decelerate.

Disclaimer: REQ Capital holds positions in several of these companies

The Superinvestors of Bergman & Bevingsville

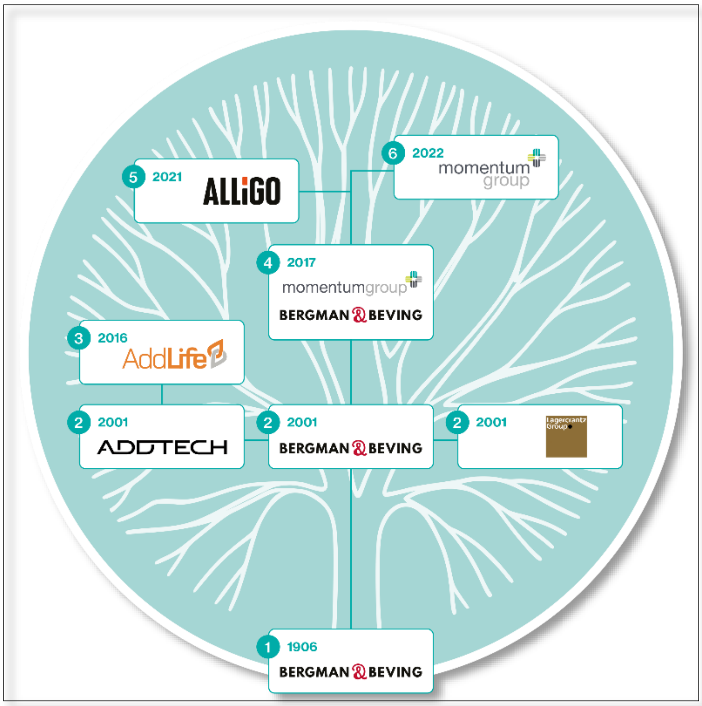
"The Superinvestors of Graham-and-Doddsville" originated as an article written by Warren Buffett in the fall 1984 issue of Hermes, Columbia Business School magazine[1]. In this piece, Buffett highlighted a group of investors whose guiding principles were deeply embedded in the traditions of Graham and Dodd. Despite pursuing diverse paths and selecting different stocks, all these investors adhered to the fundamental principles of value investing. The outcome was a series of investing track records that defied randomness.

At the time of IPO in September 1976, the market cap of Bergman & Beving was SEK 24m with revenue of 140m, EBT of 7.5m and net profit of 3m (PE at IPO of 8x). Today, all the companies within the group have an EBT of almost SEK 4.8bn and a market cap of SEK 118bn, representing an astonishing 14.6% / 19.7% CAGR, respectively. If all shares of Bergman & Beving at IPO were held to today, it would have resulted in 5100x your money over 47 years (with only minor dilutions of Addlife and Alligo when it was Momentum Group).

MSEK	EBT TTM	Market cap	Date
Bergman&Beving	266	4,896	
Addtech	2,191	59,682	
Lagercrantz	1,057	27,732	
Momentum Group	213	6,444	
Alligo	636	6,206	
Addlife	414	13,331	
Total	4,777	118,291	December-2023
Year 75/76	7.5	24	September-1976
CAGR	**14.6%**	**19.7%**	

Source: REQ Calculations

In drawing a comparison, the ecosystem associated with the Bergman & Beving sphere in Sweden, encompassing its various spun-out companies, adheres to a common set of principles crucial for their success as independent entities. Much like the investors in Buffett's narrative, these companies operate with a shared ethos, marked by two notable characteristics: an unwavering dedication to decentralization and a dedication to self-financed growth through simple profit goals, allowing each individual within the system to make a meaningful impact. Numerous successful acquisition-driven compounders find inspiration in the notable influence of the Superinvestors of Bergman & Bevingsville.



Source: Momentum Group AB

Founded in 1906 by Arvid Bergman and Fritz Beving, Bergman & Beving prioritized decentralization and simplicity. Initially operating as a technical trading company in Sweden, the company implemented a decentralized structure, distributing responsibilities among the original shareholders. The acquisition journey began in 1967 with Lagercrantz, leading to nearly 200 acquisitions by the year 2000, primarily in the 1980s and 1990s.

According to Ronald Fagerfjäll, the author of a book chronicling the Börjesson family[2], the Bergman & Beving story starts with Arvid Bergman, a Swedish student from Norrköping who studied electrical engineering in Germany. There, he crossed paths with his German peer, Fritz Beving, in the 1890s. Their collaboration strengthened during pre-World War I European trade, shaped by the industrially expansive German Empire. In October of 1906, after engagements at Brown Boveri, a Swiss group of electrical engineering companies, they moved back to Sweden and founded a trading company. This marked the inception of Bergman & Beving, a trading company focusing on importing technological products for the industrial sector in Sweden. The company thrived despite war challenges and the founders' demise in the 1950s.

In the 1960s, amid family business pessimism where many small and medium-sized businesses were for sale at attractive prices, Bergman & Beving pursued acquisitions. Notably, the first subsidiary and the first foothold in the electronics technology field was Johan Lagercrantz in 1967. The trading firm established by Johan Lagercrantz in 1938 was dedicated to dealing with components and equipment right from its inception. The company was a trading firm with notable brands like General Radio and Du Mont, which were renowned for their oscilloscopes during that era.

Moreover, in the early 1940s, Bergman & Beving also took a significant step into the life science sector by signing an agreement with Radiometer, which laid the foundation for many more companies to come within the Lab and Diagnostics market areas, and ultimately Meditech, which was formed in 1997 as one of four divisions within Bergman & Beving. In 2005, Addtech acquired parts of the MediTech business area from B&B Tools (formerly Bergman & Beving) and formed the life science business area. In June 2015, Medtech was acquired, and in connection with this, the AddLife Group was formed and subsequently listed in 2016.

During the 1980s, the group had distribution rights for over 300 companies and had over 50 subsidiaries. By the year 2000, the group had done nearly 200 acquisitions, primarily in the 1980s and 1990s. Many of these acquisitions involved family-owned trading companies that continued to operate under their existing names. However, intensified competition emerged with the expansion of the European Union, which allowed for parallel imports. The evolution of the market landscape, coupled with the growing commoditization of some distributed products, significantly impacted trading companies like Bergman & Beving. The ensuing challenges prompted a shift towards niche-oriented companies and emphasizing value-add beyond mere distribution.

Significant changes took place in the 1980s and 1990s when Tom Hedelius, the CEO of Svenska Handelsbanken, became chairman in 1982. In 1990, Anders Börjesson from Tisenhult-gruppen became the first external CEO. Börjesson, who had been part of the management team since 1979, had a deep understanding of the organization. This move marked a shift in Bergman & Beving's management strategy since the company had only had four CEOs over the past 84 years, all of whom had been significant shareholders. Börjesson together with Torsten Fardell launched the profit over working capital metric (P/WC), became CEO in 1990 and stayed with the company until 2001. Metrics like P/WC has stood the test of time for over 40 years. It continues to serve as a foundational guiding tool within the entire ecosystem of spun-out companies, influencing all aspects of business operations and acquisitions.

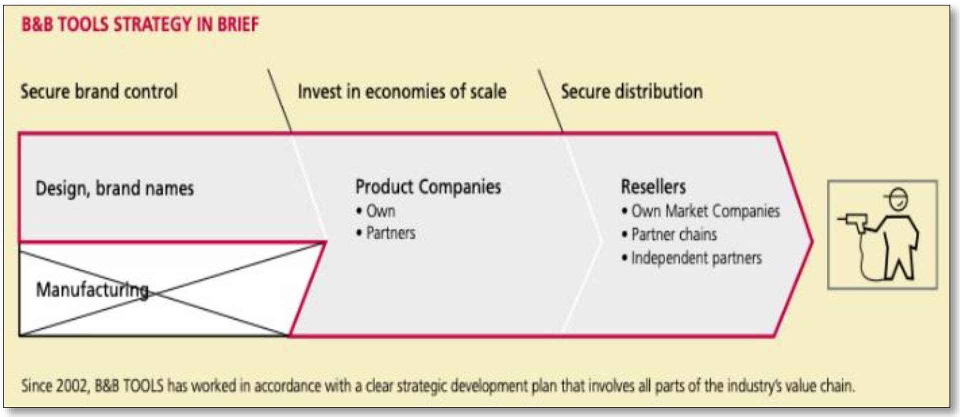
According to an interview with Pär Stenberg, the CEO preceding Anders Börjesson, internal academies and tools like P/WC, played a significant role in “transforming engineers and individuals from non-sales backgrounds into proficient sales professionals”, ultimately shaping a company to become the “Bergman Ideal”[3].

In 2001, Anders Börjesson and Tom Hedelius divided Bergman & Beving into three separate companies. The aim was to highlight the company's underlying values and enable each entity to focus on growth as individual units.

The Industry business area was formed into a new entity called Addtech, while the Electronics business area formed the Lagercrantz Group. The remaining companies evolved into the legacy Bergman & Beving. Since 2001 to today, both Lagercrantz and Addtech has generated more than 20% TSR CAGR. Subsequently, Bergman & Beving adopts the name B&B Tools, refocusing its operations to specialize in the sale of industrial consumables, including tools, machinery, protective and safety equipment, as well as various industrial components such as ball bearings, seals, transmissions, and automation.

The Centralization Experiment
After spinning off Lagercrantz and Addtech in 2001, B&B Tools deviated from its established DNA of decentralization. In pursuit of efficiency gains and economies of scale, the company aimed to transition

into one company, despite a century-long track record of successfully implementing decentralization. This marked the beginning of a decade-long experiment with centralization, hoping to extract synergies by integrating product companies with wholesale and the many reseller entities they bought and integrated.



Source: B&B Tools 2002 Annual report

While the anticipated efficiency gains appeared promising on paper, they failed to materialize in practice. In 2017, B&B Tools underwent a significant restructuring, resulting in the spin-off of Momentum Group. Consequently, B&B Tools reverted to its original name, Bergman & Beving.

This restructuring involved separating the value chain, with B&B Tools retaining wholesale operations and product companies, while Momentum Group took charge of the technical trade businesses (serving machines) as well as industrial supplies, tools, and workwear (serving humans).

In 2021, Alligo emerged as the "old" Momentum Group, offering products and services in tools, supplies, workwear, personal protective equipment, workplace equipment, and product media. Subsequently, in 2022, a new spin-off occurred, establishing the "new" Momentum Group, representing the former Components & Services business areas (primarily through Momentum Industrial AB). An alternative perspective on these changes is that the initial spin-off from B&B Tools involved the restructuring of the value chain, while the subsequent spin-off in 2022 focused on dimensions within the product portfolio.

Profit Over Working Capital

Even in its nascent stages, the Bergman & Beving Group had a distinct focus on profitability. The organization pursued ambitious growth targets while adopting a profitability benchmark, which involved maintaining profits divided by working capital (P/WC) at levels exceeding 45%. Put simply, every dollar allocated to net working capital must produce a return surpassing 45%, akin to the mindset behind Buffett's $1 Test, if you will. As we will illustrate, this target has not only generated a self-sustaining business model but has also provided steadfast resilience to navigate the vicissitudes of the business landscape since it was introduced.

The Profit/WC metric was introduced in 1981 when Anders Börjesson joined the management team of Bergman & Beving. Börjesson's exploration of business strategies and industry trends influenced the concept of an asset-light focus, which serves as the foundation for the return on working capital metric. During his studies, Börjesson discovered the benefits of an asset-light approach commonly used by successful entrepreneurs. This approach became particularly relevant for privately held firms facing a wealth tax on their net assets. Börjesson drew inspiration from entrepreneurs like Ingvar Kamprad (founder of IKEA) and Erling Persson (founder of H&M), who had successfully navigated similar challenges by adopting an asset-light strategy. Motivated by their experiences, Börjesson together with Torsten Fardell, further explored and implemented the asset-light focus, leading to the development and utilization of the P/WC ratio[4].

Addtech, along with Lagercrantz, was spun out from Bergman & Beving in 2001. They have their own internal book called "The Mind and the Soul" (translated as "Tanken och själen" in Swedish), which outlines the company's fundamental business principles. This book is distributed to all employees and is relatively short, consisting of approximately 80 pages. Its purpose is to explain the company's culture, strategy, and how value creation is implemented at Addtech. The book is written in a way that every employee can understand, providing practical examples to illustrate the fundamental principles. One key focus is the P/WC metric, which demonstrates how every Addtech employee can contribute to returns.

Similarly, Momentum Group has its own book called "Entrepreneurship to Achieve Increased Profitability - Objectives and Tools to Achieve P/WC > 45%" (translated from Swedish to English). This book is an easy read of 45 pages.

According to the Superinvestors of Bergman & Bevingsville, a business is considered self-financing when the return on working capital (EBITA/WC) is higher than 45%. By achieving an EBITA/WC > 45%, the business can generate the necessary cash to cover taxes and make required investments in its existing business through capital expenditures, growth, and dividends. The goal of being self-financed means that growth, whether organic or through acquisitions, will not dilute current shareholders through equity raises or rely heavily on debt financing. This highlights the importance of capital efficiency in generating cash.

Originally, the goal of exceeding the 45% target was set during a period when tax rates were higher. It was meant to cover one third tax, one third dividends, and one third growth (15% yearly growth measured over a business cycle, split between organic growth and acquisitions).

To analyze whether aiming for a target of 45% or more results in a self-sustaining business model, let's consider a scenario with no debt, a 20% tax rate, a payout ratio of 30%, and a 15% growth target. Half of the growth is acquisitive, requiring a 5x EBIT multiple paid, while the rest is organic. It is important to note that this analysis assumes no maintenance capex, only investments in working capital for growth. This exercise supports the idea that a 45% investment in working capital can indeed create a self-sustaining business.

Sales	100
Operating income	9
Net Working Capital	20
Profit/Net Working Capital	45 %
Tax	2
Dividends	3
Investment in acquisitions	3
Investment in organic growth	2
Free cash flow	- 0,4

Why use working capital instead of invested capital in the denominator? A trading or value-add distribution company, like those under B&B, primarily relies on working capital rather than fixed assets, which are often outsourced. This is why Profit over working capital serves as a suitable proxy for trading companies and an effective measure of overall capital return.

The P/WC ratio can be divided into 2 main parts, which can be further broken down into 6 distinct metrics: 3 metrics related to the profit (numerator) - sales, price, and cost base, and 3 metrics tied to the denominator (WC) - inventories, receivables, and payables. Profit can be calculated by dividing EBITA (Earnings Before Interest, Taxes, and Amortization) by Sales and then dividing that result by Net Working Capital. This simplification occurs because the "Sales" term cancels out when multiplying the two fractions together.

Profit is determined by the formula: Profit = (EBITA / Sales) x (Sales / Net Working Capital)
This can be further broken down to: Profit = (Sales x Margin) - Cost x Inventory + Receivables - Accounts payable

Let's apply this with another example. Suppose we have Company A generating 9% operating margins, which is typical for a trading business, offering value-added services to customers. Additionally, the business maintains a net working capital of 20, resulting in a P/WC ratio of 45%. To boost the profit ratio, there are six levers to consider. You can either increase sales, raise prices, or reduce costs. Each lever affects working capital differently, and the same applies to the working capital, which is the denominator in the P/WC KPI.

The easiest way to decrease working capital is by reducing inventory, speeding up customer payments, and extending supplier payment terms. These are aspects that every senior management team in large corporations focuses on. Employees in the group companies are encouraged to foster strong relationships with the right customers and suppliers and to have a solid grasp of inventory levels. Essentially, this framework both educates and heightens awareness about excelling in sales. It imparts valuable lessons on prioritizing customers, nurturing relationships following the 80/20 rule, adopting value-based pricing, and comprehending the consequences of providing discounts. These last two choices can result in significantly divergent cash flow outcomes.

Let`s focus on the working capital lever and more specifically receivables. Suppose a new company becomes part of the group, Company B, which historically hasn't been mindful of receivable days. After joining the group, they discover that similar companies in the group typically have receivable days of only 50, not 73. By reducing their receivable days, P/WC increases to 65%, resulting in a favorable impact on cashflow when growing and hence the ability to be self-funded.

	Company A	Company B
Sales	100	100
Operating income	9	9
Margin	9 %	9 %
Inventory	10	10
Receivables	20	14
Accounts payable	10	10
Net Working capital	20	14
Receivable days	**73**	**50**
Profit/Net Working Capital	45 %	65 %

Small adjustments like these, continuously improved upon, create a positive feedback loop that enhances cash conversion, strengthens resilience, and increases the company's self-sufficiency for growth, ultimately leading to long-term value creation for shareholders. The best-in-class companies excel in sharing best practices across multiple levers simultaneously. They successfully boost cash flow and achieve substantial organic growth without resorting to coercive measures that could stifle the entrepreneurial spirit within their operating companies. This balance is a delicate equilibrium that can only be created through experience.

The Focus Model

Aiming for a P/WC ratio of 45% or higher is one aspect, and the companies emerging from Bergman & Beving, including Bergman & Beving itself, adhere to an internal benchmark known as the "Focus Model." This model essentially serves as a prioritization tool applied to all operating companies within the group, and their performance is evaluated accordingly.

The Focus Model for Different EBITA/WC levels is as follows[5]:

- Above 45%: Increase profits through revenue increases (organic and acquisitions)
- Below 25%: Increase margins!
- 25-45%: Increase margins and working capital turnover for “proof of concept.”

The P/WC ratio serves various purposes, such as assessing operating units, evaluating product performance, analyzing markets and customers, and even as a tool for assessing acquisitions, whether they are substantial or smaller bolt-on additions. Moreover, it is aggregated and measured at the group level. Ultimately, all employees receive incentives based on this profit ratio.

The overarching goal is for all employees to easily grasp and see the measurable impact on financial performance, which is quite different from aggregated accounting metrics that aren't as relatable. This theme is prevalent among the best-in-class companies, emphasizing straightforward profit objectives that genuinely make a difference, often tied to smart incentives. The recurring lesson from these top performers is to avoid unnecessary complexity. It's about establishing an internal language that resonates, especially with small business owners who may have engineering backgrounds and might not be well-versed in financial or sales terminology.

Sources and further reading:

1. https://www8.gsb.columbia.edu/sites/valueinvesting/files/files/Buffett1984.pdf
2. Tisenhult – Grundaren, familjen och foretagen (Ronald Fagerfjäll)
3. Acquirers.com: Bergman & Beving to Addtech, a best-in-class serial acquirer and the book: Tisenhult – Grundaren, familjen och foretagen (Ronald Fagerfjäll)
4. From presentation material by Momentum Group AB

“When are they running out of companies to buy?”

“When are they running out of companies to buy?" It is a quite common question that we often receive regarding the length of the growth runway for acquisition-driven compounders and the number of companies they can find and acquire.

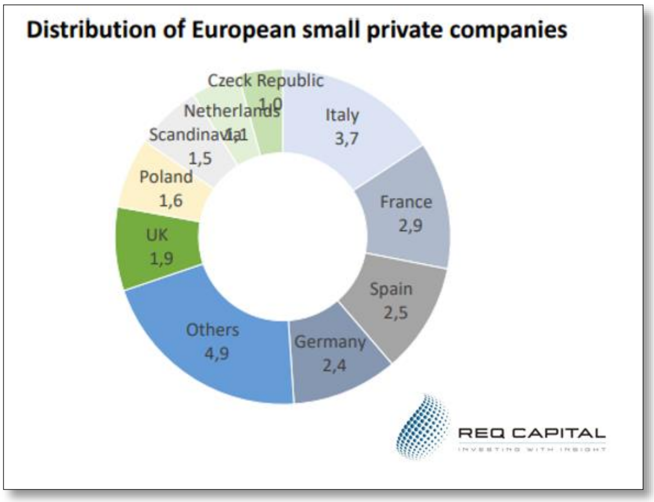
Generally speaking, when studying acquirers with a sector-agnostic/generalist approach, their strength lies in the decentralized model where the acquired companies continue to operate according to their own way of doing business, complemented with best practices and smart incentive structures.

Having that sector-agnostic approach means that these companies have a large pool of companies within many different industries to fish from. Still, questions arise about how many companies there are to buy and how to scale M&A properly to other geographies. We believe that the "duration" aspect of many of these companies is underestimated by the market, because the pool of future acquisitions is large. So, what does the "pool of companies” look like?

Our findings show that just in the Nordics there are close to 60,000 independent companies with the following characteristics:

Sales < SEK 500m (USD 50m)
EBIT > SEK 5m (USD 0,5m)
EBIT-margin of > 8%.

This is the “sweet spot” for acquisition-driven compounders with acquisition of SME companies at the heart of their strategy. Looking into the EU, according to Statista there are around 1.3 million companies within EU with 10-249 employees and in total 22 million companies with <10 employees, of which a decent percentage over time will grow and qualify for the sweet spot and hence increase the fishing pond.

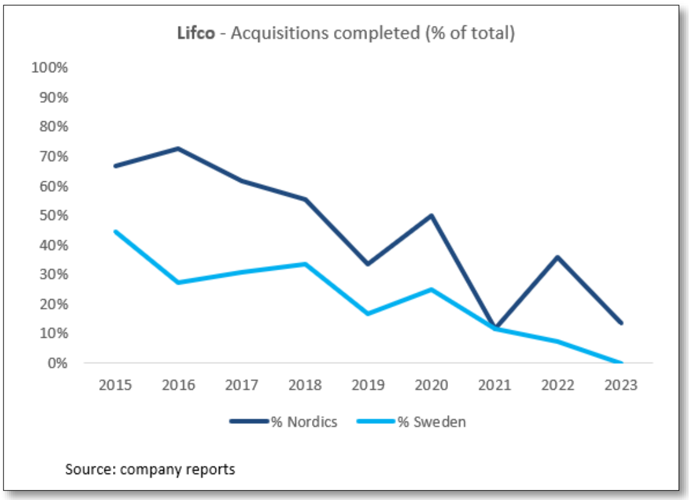


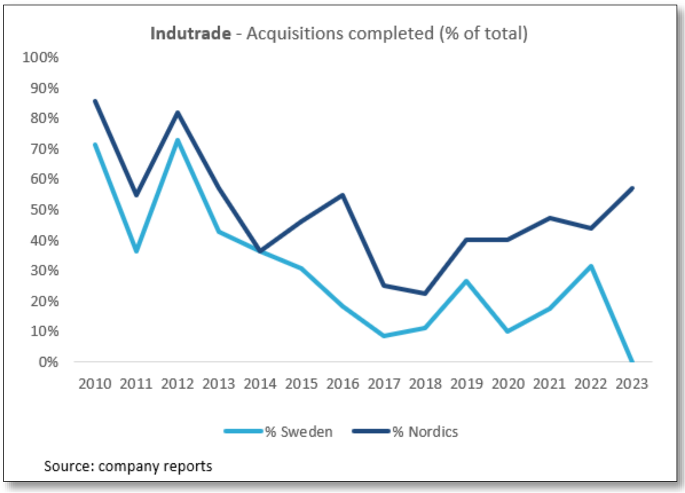
Looking at the larger Swedish generalist acquisition-driven compounders Lifco, Indutrade, Addtech and Lagercrantz, they have together the last 10 years made around 175 acquisitions outside the Nordics, more or less a drop in the ocean compared to the total potential acquisition targets. While Lagercrantz is the smallest among these companies and is going through similar phases as the larger ones, it has more recently placed more emphasis on scaling M&A outside the Nordics.

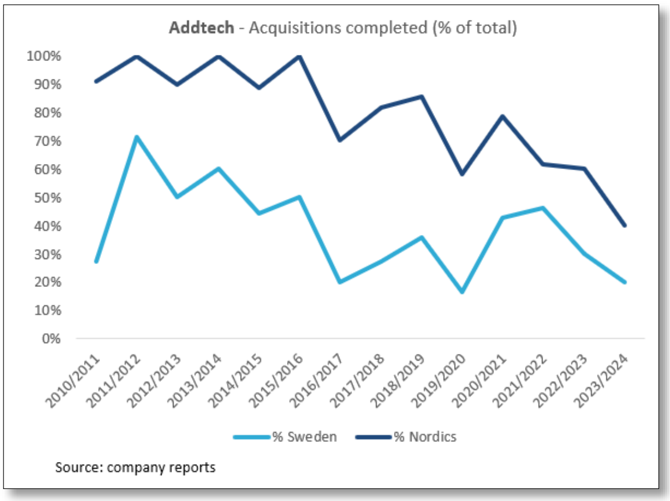
Establishing a stable foundation in their core market (the Nordics) has allowed these companies to gradually expand geographically, while still maintaining their disciplined approach and applying their best practices to M&A.

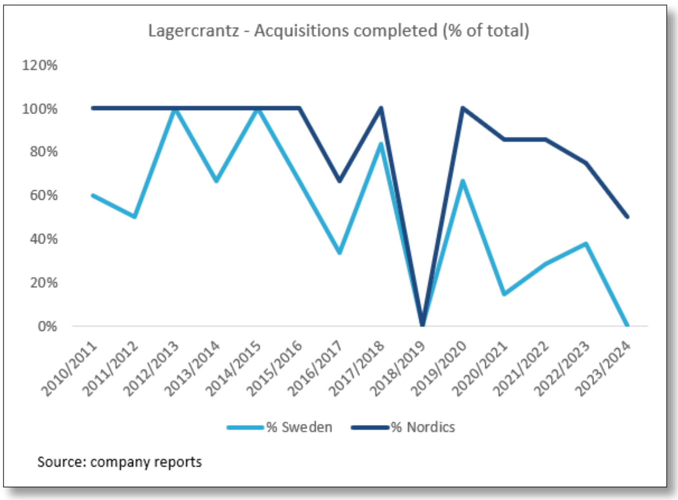
Moreover, companies that are already successful in M&A within their home markets can reduce risks and increase optionality compared to companies in the early phases of geographic expansion. However, it's crucial to note that this trial-and-error approach needs to be monitored more closely by shareholders.

For this reason, it's interesting that these companies have, in recent years, begun acquiring more companies outside the Nordics by building them brick-by-brick and avoiding rushed decisions. Ten years ago, acquisitions in the Nordics accounted for over 70%, compared to the current range of 30-50%.









In summary

Acquisition-driven compounders take advantage of the highly attractive features of the SME market. An extensive pool of acquisition opportunities serves as a strong starting point for acquisition-driven compounders. Long runways of growth opportunities, coupled with highly disciplined acquisition approach, will lead to strong long-term value creation.

Sources:

-Company reports and “Statistics on small and medium-sized enterprises” by George Papadopoulos, Samuli Rikama, Pekka Alajääskö, Ziade Salah-Eddine (Eurostat, Structural business statistics), Aarno Airaksinen, Henri Luomaranta (Statistics Finland)

The Value of Great Capital Allocation

Investing in a company requires trust in its management's ability to create value. Therefore, it is crucial to identify and invest in management teams that excel in capital allocation, effectively utilizing the company's resources to maximize returns on investment.

The significance of CEOs with strong capabilities in human and cultural aspects, combined with adept capital allocation skills, cannot be overstated. While many CEOs may ascend the corporate ladder based on their excellence in production, sales, or political acumen, the role of capital allocation becomes a critical responsibility when leading a company. It's essential to recognize that two companies, even if they have similar earnings but different approaches to capital allocation, can yield vastly different long-term results for shareholders.

Consider this scenario: imagine we have two companies, Company A and Company B, both generating hundred dollars of earnings. These earnings are converted fully into cash flow. Let's assume that the management team at Company A can reinvest their capital at a rate of 10%, which coincidentally matches their cost of capital. Moreover, they can reinvest 100% of their earnings every year over a 20-year period. In this case, a reasonable Price-to-Earnings (P/E) ratio to consider would be 10.

	Company A	Company B
Earnings	100	100
Invested capital	1 000	714
Return on capital (ROIIC)*	10 %	14 %
Reinvestment rate	100 %	100 %
Reinvestment period	20	20
Cost of capital (WACC)	10 %	10 %
Value of company**	1 000	1 971
Fair P/E ratio	10	20

*Return on incremental capital invested

**Growth = ROIC x Reinvestment rate

Future value = Earnings x ((1+Growth)^Years-1) | Company A: 100 x ((1+0.1)^20-1) = 611.6

Terminal value = Future value / WACC | Company A: 611.6 / 0.1 = 6116

Value of company = (FV+Terminal) / (1+WACC)^Years | Company A: (611.6+6116) / (1+0.1)^20 = 1 000

Fair P/E ratio = Value of business / Earnings | Company A: 1000 / 100 = 10

However, now put yourself in the shoes of an investor tasked with evaluating the management team at Company B. This team not only excels in day-to-day operations but also possesses good investment skills. They manage to reinvest 100% of their capital at returns of 14% over a span of 20 years. Given these circumstances, you could justify paying a price-to-earnings (P/E) ratio of 20 and still achieve a return comparable to the market over the entire holding period. Thanks to their shrewd capital allocation abilities, Company B's value surges by 100% compared to company A, all attributable to the astute investment acumen of its management team.

Now, let's shift our focus and analyze two other companies, still generating 100 dollars of earnings, that achieve identical incremental returns on their capital investments. However, they diverge significantly in terms of their reinvestment opportunities.

Company A can generate an impressive incremental return of 20% on invested capital. However, it operates within a niche market, selling a single product with restricted distribution potential. Another scenario is that it could be a company that already commands a substantial market share in a market characterized by slow growth. Consequently, it can only reinvest 35% of its capital at this attractive 20% rate. The remaining 65% is distributed to its shareholders, who must diligently seek comparable returns in the broader public markets. Because there is a “leak” of 65%, a fair P/E ratio to pay for Company A is 15.*

In contrast, Company B operates across diverse end-markets globally and consistently acquires small private companies of which there are many. The company has a long runway of growth opportunities. This strategy enables them to reinvest a substantial 75% of their cash flow each year at the same incremental return of 20% as Company A. Company B not only maintains an extensive list of potential acquisition targets but also benefits from the illiquidity of private markets, the relatively small size of transactions, and limited competition for these targets. This favorable landscape allows them to secure acquisitions at highly advantageous multiples. If Company B can sustain this compounding rate for 20 years, you might find it justifiable to pay a multiple of 30 times earnings and still achieve a market return throughout the entire holding period.

Despite both companies achieving a similar incremental return on capital of 20%, Company B experiences minimal leakage compared to Company A. Consequently, the reinvestment trajectory for Company B, in comparison to Company A, is worth double as much. To put it differently, public shareholders of Company B can effectively leverage the exceptional capital allocation expertise in the private market. As long as they remain invested, they can enjoy compounded returns** that are typically elusive for most fund managers when investing in publicly traded equities over extended multi-decade periods.

*Computed through a 20-year discounted cash flow (DCF) analysis, where the terminal value is determined using the Gordon growth model without assuming constant growth. Subsequently, the Price-to-Earnings (P/E) ratio is derived by dividing the DCF value by the earnings of $100.

**Assuming the market values the company based on a theoretical DCF framework.

Qualification for the Opera

A friend of ours was recently in an entrance exam for the Oslo Opera orchestra. As she entered the stage to play her cello, a blanket covered the stage. The judges decided not to observe her playing. They only wanted to hear her cello performance. There was no other influence. She was purely evaluated by her performance. Nothing else. She was assessed on current performance. No promises attached.

As we explain below, there are many commonalities between the entrance exam of the Opera orchestra and long-term stock investing. Investors ultimately weigh the underlying company's performance, not fancy slide decks, bullish outlook statements, and earnings guidance. You enter and stay in our portfolios by being able to reinvest a lot of free cash flow today at a high return on incremental capital for an extended period. Cash generation is the ultimate truth teller.

No earnings guidance, please

Most companies we invest in do not guide the market regarding earnings growth, have no outlook statements or promises, and keep communication short and to the point. They simply present performance with the key KPIs that matter for long-term investors and let investors judge by themselves. They do not need to paint a rosier picture than reality because they know investors will ultimately judge the numbers they deliver.

Constellation Software, one of our holdings, does not even have a quarterly conference call. They release quarterly figures as required with some brief factual comments but let the numbers do the talking. Since its IPO in 2006, Constellation Software has returned 190 times your initial investment. Lifco, another company we own, has a quarterly presentation of results, but the average conference call lasts about 10 minutes. The company focuses on what matters without rosy guidance and corporate entertainment. Since the IPO in 2014, Lifco has returned nine times your initial investment. These companies are consistent in how they present results and present them the same way year after year. As an investor, you can easily judge them.

These companies are obsessed with performance and attract shareholders that judge them on performance, not promises. The shareholder base becomes a competitive advantage. If a company issues quarterly guidance, it should not complain about short-termism by shareholders. Companies get the shareholders they deserve.

When we consider investing in a new company, we find it positive that there is no company guidance. We are not surprised by academic research, which shows that volatility in stocks where management guides the market is <u>higher</u> than in stocks where the company avoids guidance. The McKinsey&Company research «The misguided practice of earnings guidance*» concludes:
«*Our analysis of the perceived benefits of issuing frequent earnings guidance found no evidence that it affects valuation multiples, improves shareholder returns, or reduces share price volatility. Our recent survey found, however, that providing quarterly guidance has real costs, chief among them the time senior management must spend preparing the reports and an excessive focus on short-term results*»

A chain of trust

Investing is a chain of trust. The company's underlying performance and consistent communication build trust over the years. Our job is to find management teams we can trust and invest in for years. We prefer no rosy outlooks, just consistent performance.

*https://www.mckinsey.com/capabilities/strategy-and-corporate-finance/our-insights/the-misguided-practice-of-earnings-guidance

Finding Entrepreneurial Energy

Acquisition-driven compounders can be analytically confusing at first glance. From a 30,000-foot view, what you see might look like a mess. The logical conclusion may be to embark on integration efforts as these businesses seem ripe for serious cost and sales synergies. A closer look at the highest-performing companies in the universe reveals a collection of decentralized and autonomous business units, each protecting its entrepreneurial independence. Many of these businesses have distinct cultures, but they all thrive on ownership and autonomy enabled by decentralization. Therefore, finding the right balance between decentralization and integration represents an ongoing battle with temptations and difficult tradeoffs.

The book "Billion Dollar Lessons[1]" has a chapter on deflated rollups, companies rolling up a single vertical of companies. The author provides numerous case studies that resonate with our own experiences, documenting instances when these rollups faced failure. One lesson that characterized many failed rollup attempts stood out: "Buying a string of rock bands to form an orchestra." The architects of these rollups assumed they could benefit from both decentralization and integration. In his study, the author concluded that the rollups could choose either decentralization or integration but not both. Herein lies one of our takeaways from spending time in the field: forced synergies rarely unfold as modeled in Excel. The sacred multiplier in these organizations – a vibrant entrepreneurial culture – must be nurtured, regardless of the sacrifice.

Furthermore, the author also outlined three additional failures commonly associated with rollups that strongly resonated with our own observations:

•Rollups required an unsustainably fast rate of acquisitions.
•Rollups went for scale that wouldn't produce economies. Sometimes, rollups wound up with diseconomies of scale.
•Companies didn't allow for the tough times—and it seems every rollup runs into tough times at some point.

Brent Beshore, CEO of Permanent Equity, once shared a fascinating glimpse into the ups and downs of integrating small businesses[2]:

All businesses internally is a disaster . . . Almost every operator I know is just trying to go as hard as they can, and you're putting your finger in the leaks and working your tail off all day long . . . If you're putting your head down and you're a founder dominant organization with very little scale, with very little structure, how in the heck do you slam together two, three, four, five of these things and somehow standardize... I mean, it is like the most mindbogglingly difficult thing. You can produce a lot of EBITDA for a short period of time and then the wheels come off.

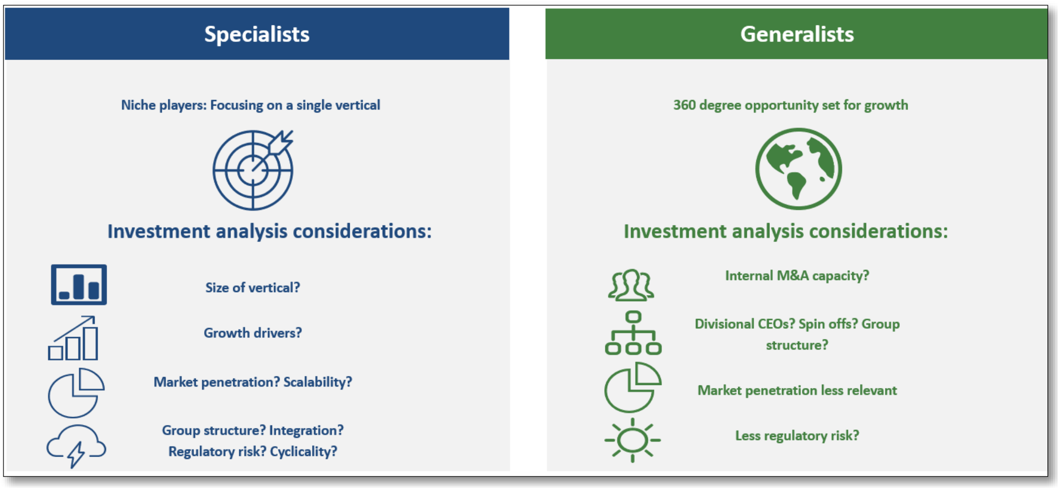
It speaks to the metaphor of buying a string of rock bands to form an orchestra. It might look good in Microsoft Excel; however, it's hard to model real-life interactions with human beings carrying different personalities in a complex system we call organizations.

In 2006, B&B Tools – a company with a 100-year heritage successfully executing the decentralization playbook – pursued the "One Company" approach, representing a decade-long centralization plan. The aim was to centralize everything, hoping to extract synergies from integrating product companies with wholesale and the many reseller companies in the group. The efficiency gains looked great on paper, but they never materialized. The company – now back to its original name, Bergman & Beving, after spinning off assets – has been on a cleanup mission ever since.

For classification purposes, plenty of excellent and detailed frameworks exist[3]. To keep it simple, we find it helpful to split acquisition-driven compounders into two broad buckets: specialists and generalists.

The Specialists

One frequently comes across centralized specialists exposed to narrow verticals in the specialist category. The failed rollups mentioned earlier are usually found within this group. These setups prioritize comprehensive operational integration, often pursuing cost synergies and economies of scale. Furthermore, there is a tendency to adopt a hasty approach to growth characterized by an unsustainably rapid pace of acquisitions, aggressive guidance, and high leverage. Our observations indicate that this rushed approach, often involving financial engineering, is a response to the inherent size constraints of the narrow verticals they target.



In the specialist category, we prefer global specialists with decentralized decision-making and a focus on customer intimacy, particularly those operating in large and fragmented markets. Synergies are welcomed but not forced. Moreover, we favor vehicles that embrace an industrial mindset and pursue a self-financed route to value creation. In our experience, these traits help mitigate some of the drawbacks commonly associated with centralized specialists exposed to narrow verticals.

The Generalists

The generalist bucket allows for more flexibility. They often hone in on multiple verticals, either with recurring characteristics or unrelated themes. Multiple verticals expand the growth runway while allowing for domain expertise like a specialist. Among those we like best, synergies are often welcome but not forced. Viewed from the outside, they seem to focus on specific niches; in practice, however, they are often not limited by any particular sector. They learn as they move from one domain to a new one. To flesh this out a little bit more: a generalist acquirer like Lifco has three segments; one of them is called “System Solutions," with its subset of themes, where they put anything that does not belong in the other two boxes (Dental and Demolition & Tools). Similarly, with Lagercrantz and their “Niche" and “International" segment which serves the same purpose.

In effect, the segment's name doesn't carry much significance internally as they are – first and foremost – investors hunting for great businesses at compelling forward returns.

Yearly gatherings and academies sharing best practices on pricing, working capital, and numerous other things help generate organic uplift – an essential contributor to overall growth. Simple profit goals related to cashflow conversion and predictability teach everyone that sales growth has to be calibrated with the cost of deploying capital.

Furthermore, among the best, we often see a well-developed pricing culture and a keen awareness of what contributes to cash flow growth and what does not (e.g., discounts). Hence, one typically finds value-based pricing replacing the legacy of cost-plus pricing after onboarding new companies. Moreover, testing and failing are also allowed, helped by the confidence boost you get when part of a larger unit. The aim is to maintain entrepreneurial drive while prioritizing cash flow and a self-funded cadence to growth; striking the correct balance is paramount and a key differentiator.

We don't push synergies; if you ask me, the decentralized responsibility is more important than anything else. If we start taking too many decisions top down, then we will ruin the whole culture. So that will never happen as long as I'm here. But, of course, we urge for cooperation within the units since they are working on similar fields, like the battery group with 14 battery companies. They have similar suppliers, similar production needs, with similar R&D. Of course, they cooperate quite a lot. And, also between the companies….We gather once a year where all the MDs are meeting and…they sit down with gin and tonic or water, whatever, and you can really hear how they are discussing business opportunities and that is because they are driving their own business and are responsible for their own P&L. – Niklas Stenberg, CEO of Addtech[4]

The level of decentralization among specialists and generalists varies. Some companies practice a decentralized model on the platform level while extracting synergies within the platform, adapting to the business dynamics of each particular platform. Moreover, cooperation within and between the various business units also occurs. However, the most successful practitioners let the decision originate from the individual level and not through a top-down approach.

A Negative Flywheel of Incentives

A common thread among deflated rollups is a financial engineering mindset underlying a rushed approach to value creation, chasing "deals" not through the lens of great investments and often with aggressive guidance incorporating future acquired sales and synergies. The result is often added fragility throughout the ecosystem of stakeholders. Hence, we often observe a negative flywheel of incentives rooted in the structural size constraints of rolling up a narrow vertical.

The framework and labels presented here should come with a caveat, however. Companies are organisms in a dynamic environment. Some companies start with a single product niche and gradually expand into other verticals and, eventually, become more of a generalist as they go along. Case in point; in the 1990s, Diploma experienced that their traditional core businesses matured into cyclical, lower-margin companies. As a result, they launched a new acquisition program to diversify into new, more attractive sectors.

There was no master plan from the start; it was all layers of iterations as they learned along the way. A similar story with Lagercrantz when Jörgen Wigh joined as CEO in 2006; he approached the situation with a fresh perspective and promptly addressed the competitive challenges and margin erosion within the distribution of electrical components and telecom. Armed with this insight, Lagercrantz expanded into more expansive product niches, diversifying across higher-margin companies with longer product life cycles, owning the IP outright.

Zooming out, despite our efforts in categorizing these types of companies, one realizes that the labels thrown at the best-performing ones are somewhat limited in portraying what happens behind the curtains. The focus tends to be fully anchored on the acquisition engine, while the second engine of growth – the organic growth unleashed by entrepreneurial energy – goes unnoticed by most observers. In effect, we don't fully acknowledge the reasons behind these companies' long-term fundamental track records. The business-building mentality – in addition to a successful acquisition engine – is something we find particularly interesting.

Jörgen Wigh, the CEO of Lagercrantz, once emphasized a perspective on synergies that we are particularly fond of, synergies in the form of injecting energy and structure:

What we bring to the table is really two things: it's a structure and its energy. You need to realize that it's usually in sort of a succession sort of phase that we come in as new owners. And we find that sometimes we find companies that have been sort of complacent a bit and they need new energy. There might be some discussions between the older generation and the younger generation and when we come in you loosen things up, you get new energy, you get some professionalism in, so we add energy, we add structure. We have a lot of things going on with the companies but it's not about finding new synergies between the companies, that should come from the companies themselves[5].

Organizational psychology has a term called "crowding out," which may explain why a singular focus on external rewards for completing an activity might lower the intrinsic desire to perform that task. The crowding out phenomenon underscores the importance of decentralization and a better understanding of incentive structures that work with carrots, not sticks. In the book "The Evolution of Cooperation," Robert Axelrod also shares many of the same lessons regarding human motivation that echo this sentiment: "You provide freedom from the top and get rewarded from underlying companies that feel the freedom."

Summary

In the specialist category, we exercise caution when dealing with centralized rollups exposed to narrow verticals. Instead, our focus centers on global specialists with decentralized decision-making processes, operating in large and fragmented markets. In the generalist category, we favor decentralized generalists with domain expertise across specific themes or those adopting a more sector-agnostic approach. Furthermore, we favor vehicles with an industrial mindset and a self-funded path to value creation.

Moreover, capital allocation is typically centralized, while operations are fully decentralized, albeit with lead generation – and sometimes small bolt-on acquisitions – initiated from the business units. Synergies are welcomed but not forced.

In effect, this is the laissez-faire approach to efficiency gains where the entrepreneurial spirit is the forcing function; cost efficiencies are sacrificed in the belief that the cumulative impact of ownership, autonomy, and entrepreneurial spirit will offset them.

We believe the best generalists and specialists operate with the same ethos as great long-term investors. They provide click-and-buy public investors with intrinsically diversified operations across private markets and long runways for growth.

Sources and further reading:

1. Billion Dollar Lessons: What You Can Learn from the Most Inexcusable Business Failures of the Last 25 Ye ars
2. Brent Beshore at Invest Like the Best podcast
3. Scott Management / Demesne Investments / Canuck Analysts / Redeye
4. Carnegie Trading Companies Seminar 2022
5. Redeye serial Acquirers Event March 8, 2023

Hidden Champions

Hermann Simon's insightful book, "Hidden Champions of the Twenty-First Century," first published in 2007, highlights lesser-known niche companies that excel in specialized sectors. These businesses operate in the "hinterland" of the value chain, frequently engaging in business-to-business (B2B) transactions by supplying machinery, components, or processes integrated into the final product or service. As a result, they often go unnoticed by consumers.

These hidden champions, commonly family-owned, achieve market dominance by emphasizing focus, global reach, dedication to premium products, and robust customer relationships. To be classified as a hidden champion, a business must meet specific criteria, including market position, revenue generation, and limited public exposure. Examples from the book – some of which have since emerged from obscurity – include Rud, a leading player in industrial chains; Amorim from Portugal, a world leader in cork products and cork flooring; and Jungbunzlauer, a global leader that supplies citric acid for every Coca-Cola produced and sold.

A Decentralized Collection of Niche Businesses

Investing in private niche companies within a decentralized structure presents several advantages. Firstly, their essential offerings grant them resilience against economic fluctuations, allowing them to maintain pricing power and high gross margins. Focusing on a narrow niche can often create an oligopolistic structure that protects incumbents, preserves pricing power, and deters newcomers. These markets are typically too small to attract significant interest from potential competitors.
Secondly, niche companies often exhibit adaptability and responsiveness to market changes, fostering a dynamic entrepreneurial culture through decentralization.

The most successful acquisition-driven compounders collect these specialized companies, building a diverse portfolio that spans products, customers, suppliers, and regions. This combination of different earnings streams provides stability and resilience.

Many of the companies targeted by our portfolio companies share several key traits with hidden champions, which include the following:

• Engaging primarily in business-to-business (B2B) transactions for their products and services.

• Providing mission-critical and often customized offerings at relatively low cost. This approach can generate a lock-in effect, leading to high customer retention and pricing power. To attain the latter, the best-performing organizations frequently employ value-based pricing strategies that underscore their offerings' unique value proposition to customers.

• Focusing on flow products, or consumables, linked to customers' operating expenses rather than capital expenditures. This connection enhances predictability and diminishes reliance on cyclical spending fluctuations.

• Benefiting from a favorable working capital mix and typically limited in-house production results in low capital requirements. This aspect is often further optimized following an acquisition.

The culmination of these factors often results in recurring revenue streams with high gross margins and attractive cash conversion. The allure of these core characteristics is far from random. Maintaining a consistent acquisition pace necessitates both predictability and high cash flow conversion. Additionally, steady revenue streams and strong cash conversion rates are vital for a self-financing acquisition strategy, allowing the organization to maintain financial stability without relying on external funding sources. Consequently, once the onboarding process concludes, cash flow and other return-on-capital metrics become the shared language among these companies.

Consider Heico Corp, a Florida-based enterprise founded in 1957. As a leading technology-driven aerospace, industrial, defense, and electronics firm, Heico is recognized as one of the world's largest independent providers of FAA-approved engine and component parts. These mission-critical parts are vital for their customers, primarily airlines, as they ensure their fleets' operational efficiency, safety, and reliability.

In one of our conversations, Larry Mendelson and his son Eric shared the essential factors contributing to Heico's success since they took over in 1990. Despite its size, which now boasts 6,400 team members and 88 acquisitions of niche businesses, Heico has maintained its agility and responsiveness. With his background as an accountant at Arthur Andersen, Larry Mendelson emphasized the importance of cash flow in Heico's success. He began by saying, "We are not merely an aerospace company, but rather a vehicle that generates strong cash flow through aerospace parts and technology." His former boss's mantra, "GAAP is crap" and "the key is cash flow," shaped his perspective. Consequently, Heico's focus on cash flow and decentralization has produced remarkable results. Since 1990, when the Mendelsons took over the business, Heico stock has delivered 21% annual returns, amounting to a staggering total return of 67,900%.

Decentralization and Customer Focus

Another essential lesson focuses on organizational structure, with decentralization being vital for two reasons. First, agile, entrepreneurial companies collaborate closely with customers to create tailored solutions. Therefore, decentralization is essential for these businesses to continue thriving after being acquired as part of a larger structure. This structure encourages entrepreneurial flexibility, enabling companies to excel in their specialty and remain close to their customers.

Second, a decentralized system is critical for maintaining the acquisition engine's pace of multiple small private transactions. Without decentralization and autonomy within each business unit, the M&A engine falters. It's nearly impossible to sustain an acquisition cadence of 5-10 new companies, if not 100, per year if integration efforts and micromanaging consume management resources. In the long run, this isn't feasible. Thus, the organizational design for these acquisitive companies is a feature, not a bug. We tend to grow skeptical if we observe overly optimistic growth targets with acquisitions factored in, but without a decentralized mindset, in place.

The Ideal Combination

While some niche businesses may not be as glamorous as some SaaS enterprises boasting high growth prospects, their true potential emerges when integrated into a decentralized structure. Limited growth prospects in niche markets can lead to these businesses being less sought after in auctions. However, acquisition-driven compounders remain undeterred, as they offer a reinvestment engine to redirect cash flow into other exceptional niche companies. Therefore, limited reinvestment opportunities and size thresholds that disqualify specific buyers don't hinder them. These factors can be advantageous, as they often deter other investors, reducing competition and, ultimately, prices paid for these businesses.

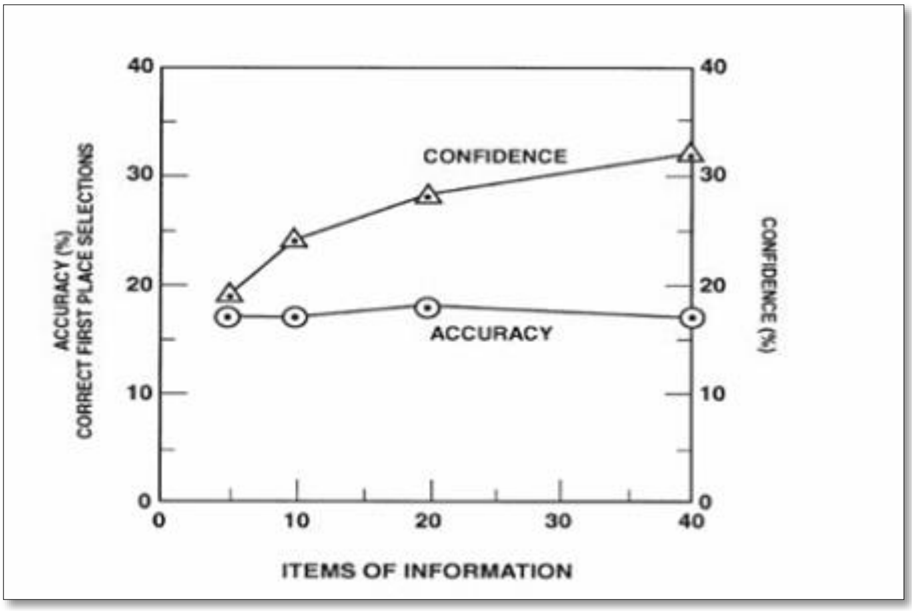
In Conclusion

The achievements of hidden champions, as discussed in Hermann Simon's book, emphasize the importance of focusing on niche markets, decentralization, and fostering close customer relationships. Investing in specific niche enterprises may entail risk; however, the portfolio strategy employed by acquisition-driven compounders offers diversification and an efficient reinvestment mechanism. With predictable cash flow streams, these vehicles can succeed without rapid growth, resulting in resilience, adaptability, and market dominance.

Confidence and Humility

Long-term equity investing requires a delicate balance between confidence and humility. On the one hand, you need confidence to make investment decisions. On the other hand, you must have a healthy dose of humility, as you will often be wrong in your judgment. Surprisingly, research on horse betting can teach us a thing or two about striking this balance.

In 1974, world-renowned psychologist Paul Slovic conducted an experiment in the horse-betting field. Slovic gathered professional horse betters and gave them varying amounts of information about the horses. The betters had to estimate their level of confidence about the correct first place ahead of the race. Slovic found that the betters' confidence in their own estimation ability increased as the volume of information about the horses increased. However, their accuracy in correctly guessing the winner was flat with increasing information. An increasing amount of information did not lead to better decision-making, only higher confidence. This can be shown in the figure below***:



Back to Investing
This study offers important insights for investors looking to make long-term equity investments. Although some investors may believe that having an exhaustive understanding of every single aspect of a company is commendable, it can actually be counterproductive. Focusing excessively on details like the intricacies of the production process or the technical specifications of every product offered by a company's numerous subsidiaries may not be as beneficial in the long term.
Like horse betting, decision fatigue often sets in because the more information you gather, the more conflicting signals you receive about the potential investment. Moreover, too much information leads to overconfidence, as investors begin to look only for information that confirms their investment hypothesis.

When it comes to building a rocket, every single detail requires attention. However, long-term equity investing is not as complex as rocket science.

As the American writer Mark Twain famously said, "It ain't what you don't know that gets you into trouble. It's what you know that just ain't so."

Our Experience

As investors, it is vital to understand that more information does not always translate to better decision-making. Instead, you need the right type of information. Focusing on the essential information pillars like capital allocation, decentralization, and people does, in our experience, the heavy lifting in sound decision-making.

At REQ, we have a robust investment philosophy and a strategy focused on the three pillars above. We consciously miss some details to avoid decision fatigue and overconfidence. We believe our approach and experience can help strike the balance between the confidence and humility needed for long-term equity investing.

In conclusion, while we may not be horse betting experts, we can still learn a thing or two from the world of racing. Remember, it's not about having all the information but the right information when it comes to long-term equity investing. We can make informed investment decisions that align with our investment philosophy and strategy by admitting what we do not know and focusing on the right information.

Sources:
«The Perils of More Data» by David Widmar and Sarah Hubbart (May 31 2022)
**https://ma.tt/2017/11/adam-robinson-on-understanding/
*** Page 53 in «Psychology of Intelligence Analysis»
**** https://medium.com/@bobclarodock/how-can-confidence-kill-investment-returns-cd9fd5b13ae (Bob Dockendorff)

A different Kind of Quality

The investment world is a fiercely competitive arena where distinctiveness becomes the linchpin to achieving enduring success. Value creation necessitates differentiation. A quote we recently encountered harmonizes perfectly with our core convictions:

"*Buying high-quality companies will not lead to outperformance vs. your competitors or the benchmark unless you define 'high quality' differently vs. your competitors*" (Arjun Tuteja).
In the investment context, we interpret "quality" as companies exhibiting a consistent ability to reinvest significant portions of their free cash flow at high returns on capital over extended periods. We aim to curtail fundamental risk by spreading our investments across diverse products, clients, and end markets.

While our interpretation of quality echoes that of many quality investors, our investment pathway in quality companies deviates significantly from the typical "quality investing" approach. We prioritize established, acquisition-driven compounders, permitting us to incorporate companies with extraordinary quality into our portfolios.

Exposure to private quality companies
Our quality-centric approach differentiates us from the typical "quality portfolio" prevalent in the market. As we aren't burdened with managing multi-billion-dollar portfolios, we have the flexibility to indirectly invest in high-quality private companies owned by listed acquisition-driven compounders. This provides us with unique access to smaller private entrepreneurs who are profit-oriented, an opportunity which typically eludes conventional fund managers.
Our approach involves the identification of exceptional capital allocators, often labeled as "Outsiders", who possess a unique mindset towards capital allocation. They astutely employ their free cash flow to acquire smaller, profitable businesses within private markets at appealing valuations. These entities foster a long-term, autonomous, and decentralized culture.

Rather than zeroing in on traditional "quality jargon" such as "moats" and "market positions," our focus gravitates towards capital allocation and an entrepreneurial corporate mindset. The quality companies we find are typically located in the less congested small and mid-cap market segments.

Embracing the Challenge
What makes deviating from the norm in the investment realm such a daunting task? The answer is straightforward:

Embracing a unique approach introduces the potential for failure and misunderstanding. Adopting fresh perspectives demands time. However, within this challenge lies the opportunity for those who dare to be different.

Forsaking the Conventional
We are at ease with our departure from conventional quality investing methods. While our definition of quality investing aligns with many, we employ a unique and distinctive strategy. We maintain

confidence that our investors, who have entrusted us with their capital, will reap substantial rewards in the long run. We appreciate your support as we journey towards a divergent type of quality investing.

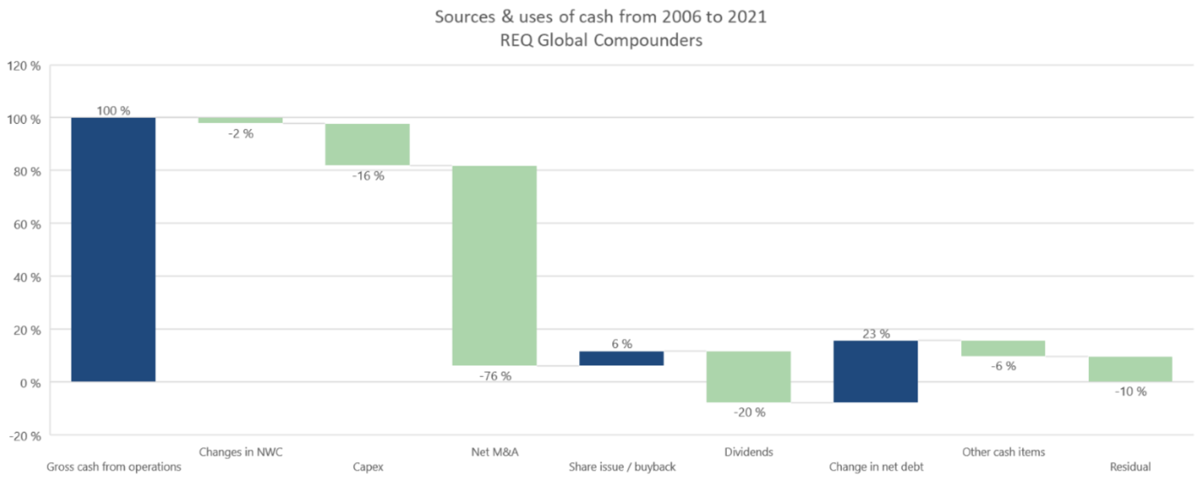
Finding Outstanding Capital Allocators

Our investment philosophy is based on investing in value creators, companies that can reinvest a lot of cash at high returns for a long time. Our strategy is to find companies with a unique and profitable capital allocation skillset.

We invest in listed companies that repeatedly generate high free cashflows, have a proven skillset in capital allocation, and have a track record of creating strong shareholder value. Our two portfolios are represented by acquisition-driven compounders, businesses that have the acquisition of small private companies at the heart of their strategy. These companies are excellent at sourcing and closing acquisitions in the private markets at highly attractive multiples.

Companies that can reinvest a lot of cash flow (typically 70-80% of cash flow) at a high return on capital (typically 15-20%) for an extended period (preferably decades) will generate a lot of value for us as shareholders.

Not surprisingly, given our strategy, we see a common way of deploying cash flow among our companies. Below, we study the sources and uses of cash flow for the portfolio over the last 15 years, weighted by the position sizes in the fund. The blue bars show the sources of cash, and the green bars show how that cash has been deployed historically. The starting point is the aggregated cash from operations after taxes and interest payments for all our companies combined.



Working capital

We invest in asset-light companies that do not need heavy working capital investments or regular capex to grow organically. Only 2% of the cash generated from operations is tied up in net working capital. Some portfolio companies enjoy a net negative working capital position, meaning customers fund the underlying business operations. We often see this phenomenon in software companies where customer payments are usually made in the year's first quarter.

Capex
We recently met the CFO of Swedish-based Indutrade, who told us that they "*do not manufacture products that are bigger than a horse*," meaning large and highly complex products which require high capital expenditures. Many of the businesses we own are assembly businesses or value-add distributors. These companies do not need heavy asset investments to grow. Despite limited capex, the companies can still generate good organic growth.

Bolt-on acquisitions (net M&A)
The companies we invest in spend most of their cash flow to acquire small, private, and profitable companies at attractive multiples. We typically observe transaction multiples in the range of 5-8x EBITA, in other words, a mid-teen return on capital, in addition to minor incremental improvements in EBITA and cash generation after transactions. Therefore, these small private transactions often generate a very attractive return on capital for us as public shareholders. We look at this as a highly attractive way to deploy capital when the proper decentralized organizational structure is in place.

Share issues
As the illustration shows, our companies fund these small private transactions through cash generation, not by issuing shares. Some private sellers choose a part of their settlement in shares of the acquiring firm. The increase in the number of shares outstanding for our companies has been only 6% over 15 years.

Dividends
Despite attractive reinvestment opportunities at high returns on capital, the companies we invest in tend to pay dividends. Given the attractive return on capital, we would instead want companies to reinvest the cash flow than pay dividends, but we also understand the "*disciplinary factor*" behind a dividend policy. Many companies in the fund are controlled by a family that often wants dividend payments.

Change in net debt
Over 15 years, the change in net debt for the companies in the fund has increased 23% to a level of 1.0x net debt to EBITDA today. The conservative capital structure is often due to family ownership in the businesses. These businesses have experienced what it means to go through tough times and hence keep leverage low.

Summary
We try to find management teams with a strong capital allocation mindset. Their toolkit is to deploy large amounts of free cash flow at a high return on capital for many years. They decentralize their operations to unleash entrepreneurial energy and own a significant part of the underlying companies.

We invest behind what we think are the best decision-makers regarding capital allocation. Finding outstanding capital allocators is of utmost importance when investing for the long run.

Suggested Reading Material

The following books and resources will make you a better investor and are also very inspiring and great for discussing with friends. They can also make you pause and think about life in general. Some books listed below are purely investment-related, while others are more appropriate for dinner conversations.

We believe the best filter when reading a book or article is to pause and ask yourself, "Will I still care about this a year from now?" For the following books, the answer is clearly "YES!".

The REQ Team

A Deep Dive into Shareholder Value Creation by Acquisition-Driven Compounders by REQ Capital

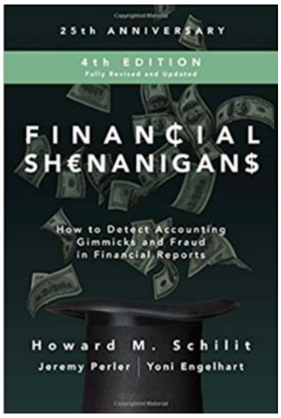
In this recently published Deep Dive, we share essential insights into Acquistion-driven Compounders:

REQ Deep Dive Acquisition-driven Compounders

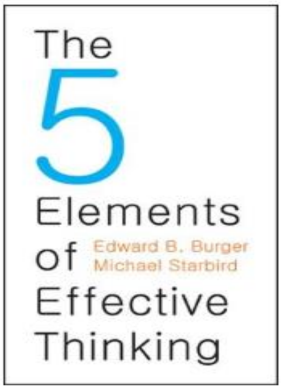
Deep Dive Acquisition driven Compounders December 2023

Financial Shenanigans by Howard M. Schilit

In his book, Howard Schilit provides valuable insights into the tactics companies employ to manipulate financial reports. The book thoroughly explores the diverse methods through which a company can influence the Profit and Loss (P&L) account, such as expediting the recognition of revenues and altering the treatment of various costs. Moreover, Schilit sheds light on the strategic maneuvers that companies employ to manipulate cash flow statements.

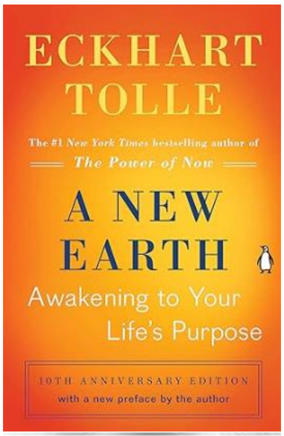


The 5 Elements of Effective Thinking by Edward B.Burger and Michael Starbird



In their book, Burger and Starbird, explain that doing the same thing and expecting a different outcome is the definition of insanity. The book shares concepts of effective thinking and learning. A big focus must be placed on understanding "the basics" of any situation. The authors say that "admitting your own uncertainties is an enormous step toward solid undertanding". Failure is essential for success since mistakes are pointers toward better understanding. As the authors say: "A person willing to fail is a person willing to step outside the box and do transformative thinking."

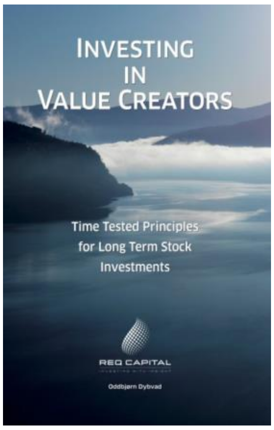
Eckhart Tolle – A New Earth



In 2023, we revisited Eckhart Tolle's "A New Earth," exploring the idea of reducing identification with labels and concepts for spiritual awakening. Tolle presents the concept of the "egoic mind" in his work, arguing that it binds our sense of self to external factors. This idea is just one of the many beautiful insights he shares in his exploration of human consciousness. We believe many of these concepts extends to investing, where we often engage in "first-level thinking" by attaching mental labels to persons, objects and situations. Take, for instance, the term "serial acquirers." It is laden with preconceived notions, but delving beneath the label prompts us to question its true meaning and transcend automatic mental categorization. In aligning these concepts, we found that both personal identity and investment perspectives can benefit from looking beyond superficial labels, encouraging a deeper understanding for more informed decision-making. Furthermore, Tolle challenges the conventional notion of wealth not solely as material possessions but as the spaciousness between our repetitive thoughts. This perspective offers a profound redefinition of true wealth.

Investing in Value Creators by Oddbjørn Dybvad

This book presents our investment philosophy and strategy. Investing in Value Creators presents some basic principles and fundamental reasons why some stocks significantly outperform other stocks over the long term. Investing in value creators increases your chances of earning high stock returns over the long term.



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