Investing with Insight

Half Year Investment Report 2022

July 2022

REQ CAPITAL

INVESTING WITH INSIGHT

Content

Dear fellow investors,

With this half-year investor letter, we would like to give you further insights into the investment philosophy and strategy of our two equity funds. The financial markets have been in turmoil in recent months. We continue to believe that excellent companies are not only able to weather difficult macroeconomic times, but also improve their competitive positions during tough economic times.

Our goal is to create wealth over decades and manage our investors' capital just like our own. We seek like-minded investors who share our values and long-term perspective. We believe sharing a common interest with our investors is critical to long-term success. When the goal is to compound capital for a generation, you need to focus on different variables than most market participants. We do not have a qualified opinion on market returns over the next year, and we do not know what the macroeconomic outlook will look like over the next three to five years.

What we do know is that we invest in companies that will grow and thrive over the long term, regardless of market conditions. Ultimately, the value these companies create will be reflected in their stock prices. As owners of these outstanding companies, we sleep very good at night.

Our companies are led by management teams that have excellent capital allocation skills. They are highly capable investors in the private markets. They tend to organize themselves in a decentralized way to unleash entrepreneurial energy. And last, but not least, the management teams of these companies own a lot of company stock. Incentives matter.

Our investors include Norwegian and international funds-of-funds, pension funds, institutional investors, and high net worth individuals.

We thank you for your continued trust and support. We will ensure that we deliver on our promise to find the best compounders and create significant value for our investors in the decades to come.

The REQ Capital team wishes you a great summer.

REQ Global Compounders

REQ Global Compounders is a concentrated portfolio of companies that reinvest most of their free cash flow at high returns on capital over time. We have found many of these compounders in a unique group of companies that use their strong free cash flow to acquire majority stakes in many small private companies. Our companies maintain an entrepreneurial spirit in the companies they acquire by promoting autonomy and decentralization and ensuring that employees are incentivized to achieve profitable growth. As the fund’s name suggests, it invests globally in companies that reinvest and compound their capital over decades.

The underlying performance of the companies in the portfolio during the first half of the year was strong with better-than-expected growth in earnings and cash flow. The strong underlying development is in sharp contrast to the portfolio performance which was -25.5% (NOK A-class) during the same period, whilst performance since launch in June last year has been -10.7%.

During the first half of 2022 we acquired a new position in an Australian company, Kelly Partners Group. The company acquires accounting businesses in Australia. The CEO, Brett Kelly, owns 51% of the company and other insiders own 9.4%. We like the runway of growth opportunities, both organically and through acquisitions. There is a strong underlying profitability in the business, and we like the management team’s long-term mindset.

Another position we have taken on is Pool Corp, based in the US. Pool Corp is the leading distributor of swimming pools, accessories, equipment, and related outdoor products in the United States. It is a wholesale distributor with a value-add distribution model that generates customer loyalty and good organic growth. Pool Corp's distribution centers operate under a decentralized model with full profit and loss accountability. Acquisitions have been an important part of the strategy, with roughly 60 acquisitions over the last 25 years. The former CEO, Perez De La Mesa, who is now a member of the board, owns 2.3% of the company.

The pace of acquisitions by our companies remains high. In the uncertain macroeconomic environment, we find ourselves in today, our companies provide a “safe haven” for private companies. As a result, we continue to see a high pace of acquisitions at attractive valuations. The earnings development so far this year has been good. Despite last year being a difficult comparative from an earnings growth perspective, both revenue and profit growth are strong and better than expected. The portfolio has an average ROE of 20% and reinvestment rates are high leading to strong profitable growth. Our companies have strong profitable growth opportunities for the next decade which bodes well for good long term returns to shareholders.

REQ Nordic Compounders

We launched the REQ Nordic Compounders fund at the end of January 2022. We believe the fund includes the best high-quality companies in the Nordics, that have a clear track-record of profitable growth and excellent capital allocation. These companies tend to perform well even in challenging economic environments.

While the timing of the fund's launch was favorable, as the Nordic markets were down significantly through the end of January, the financial markets have been highly volatile since then. The fund is down -17.4% as of 30th of June, reflecting market fears of higher inflation and interest rates, as well as a challenging geopolitical environment and supply chain constraints. However, the underlying operational and financial performance of our portfolio companies is strong, decoupled from share prices and market movements. We have a long-term view on our investments and believe that well-managed companies outperform the market over time.

The companies in the REQ Nordic Compounders fund are characterized by high returns on invested capital over time, in addition to strong growth, both organically and through small acquisitions. Our portfolio companies own many private companies, mainly in the industrial segment, technology, and life science sectors. This provides a high degree of diversification and ensures earnings growth when the companies make new acquisitions. The high proportion of insider ownership gives us comfort that interests are aligned.

Since the fund's inception, there has been little rebalancing of the portfolio. We added the Bergman & Beving spin-off Momentum Group when it listed in late March. We believe Momentum Group is a highly attractive company, that is still in the early stages of growth, with currently only eight underlying portfolio companies. The company has a high-caliber shareholder base, and the CEO comes from a Bergman & Beving background, sharing the corporate values we believe are crucial for long-term value creation.

The underlying earnings momentum has been very good this year, with earnings estimates up an average of 3% for the portfolio so far this year. We believe the multiple contraction we have seen in several companies in our investment universe in recent months creates attractive investment opportunities. The Nordic market is home to several companies that fit the REQ investment philosophy and strategy, and we find several interesting investment opportunities in the Nordic markets, especially in Sweden. We have about 100 companies on our watch list, which we monitor continuously. The fund has 22 positions as of 30th of June 2022.

The value of profitable growth

We invest in companies that grow profitably over time. We are often asked what we think is the fair price for exceptional companies that can reinvest cash flow and grow with high incremental returns on capital.

Value is created when a company grows with a return on capital that exceeds its cost of capital. No value is created in companies whose growth is 0%, or in companies that are unable to generate a return on capital above their cost of capital.

Let us look at what you can pay for different companies that are able to deploy incremental capital (growth) at different rates of return equal to or above their cost of capital. The table below shows what premium you could be willing to pay for a company with different returns on capital and growth prospects, compared to a company with no growth opportunities or a company earning exactly its cost of capital which we have set at 9.5% and is "the market" for all practical purposes.

		Return on Capital				
		9,5 %	**12 %**	**16 %**	**18 %**	**22 %**
Growth	**5 %**	0 %	24 %	46 %	52 %	64 %
	6 %	0 %	36 %	70 %	81 %	98 %
	8 %	0 %	111 %	217 %	252 %	304 %

If a company grows with an incremental return on capital equal to its cost of capital (9.5%), the growth is not creating value, as shown in the first column. In this case, you should not be willing to pay a premium to the market multiple. However, if the incremental return on capital is 16% and the company is growing at 5%, you could justify paying 46% more than for a company with no growth. At the extreme, a company with an incremental return on capital of 22% and growth of 8% is worth three times as much as a company with no growth.

What is striking is how valuable growth is when the return on capital is high. An increase in growth from 5% to 8% increases the value of a company with a high return on capital many times over. The CEO of a company generating 18% return on capital should spend his or her time finding growth opportunities instead of trying to further increase profitability.

An important lesson for us has been to be disciplined about the price we pay, but the paradox is that we need to feel comfortable owning businesses that sometimes trade at multiples where we would not buy them. We have learned that the businesses we own should not be sold based on price alone. There must be more than just a temporarily high multiple to make us sell a stock.

"A stock can trade at 1,000x earnings and be undervalued. A stock can trade at 5x earnings and be overvalued. It took me years to embrace this concept"
(@BrianFeroldi)

Think about this for a while when discussing market prices. Exceptional companies are worth more than you can imagine.

Trust based business models

The cornerstones of our investment philosophy are "capital allocation", "decentralization" and "people". We believe that finding outstanding capital allocators who decentralize their business and act like true owners, is critical to achieving exceptional long-term returns as investors.

Decentralization is an organizational structure where management delegate responsibility down in the organization. This organizational structure is based on the belief that top management does not have all the right answers about how underlying departments and subsidiaries should deal with customers, suppliers, and competitors. With responsibility comes the power of increased motivation, knowledge sharing, and better customer relations because the decision makers are close to customers. Basically, it is a management philosophy of using the carrot rather than the stick. Our companies operate without the anchor of bureaucracy. Our decentralized businesses have lean corporate headquarters by nature.

"*Being a successful investor is all about picking the right guy or gal. Because as an outsider you can't even know enough to really make an informed decision. You are almost entirely dependent on the abilities of the people you invested behind*"

(Barry McCarthy reproduced by Sidecar Capital @sidecarcap)

A complex undertaking

In our experience as investors, there are some unique business models that are based on an extraordinary level of trust. Decentralization is at the core of these businesses. These decentralized businesses, where management is willing and able to provide a significant degree of autonomy to the underlying subsidiaries, create strong returns for shareholders over decades. We invest in many of these decentralized businesses because we firmly believe that these companies have an entrepreneurial energy from which we, as shareholders, benefit greatly from.

To practice simplicity in business is actually a very complex task. Our investment philosophy is based on the belief that a decentralized - non-bureaucratic - and independent management model is the best way to promote entrepreneurship and performance. It is the belief that individuals can influence the company and should be entrusted with responsibility for decision-making. The decentralized businesses we invest in represent independence, accountability, and rapid decision-making. Entrepreneurship should be actively encouraged and protected in order to create extraordinary business performance.

"*It is easy to teach quantitative analysis and business valuation methods. Unfortunately, it is not so easy to teach qualitative methods. These can be taught, but learning from experience is often the best way*"

(Charlie Munger)

Does cooperation pay off?

We believe the simple answer is "yes!" In the book, "The evolution of cooperation" by Robert Axelrod, the author explores the long-term rational approach to solving situations where two parties' benefit from cooperation in the long run, but where the short-term rational approach is to maximize their own gain. We know this from business school as "The Prisoner's Dilemma."

The main conclusion of the book is that a so-called "tit-for-tat" strategy is highly beneficial in all types of relationships. This is an optimistic view of cooperation. Itis about starting with a friendly invitation and hoping that the other party will respond in kind. What does this have to do with business and ultimately with investments?

In a business context, "tit-for-tat" means that the head office offers a lot of autonomy and trust from the start, helping subsidiaries to develop. The subsidiaries, in turn, sense this freedom from above and respond by cooperating and ultimately making business decisions that benefit headquarters, themselves, and ultimately shareholders. When this long-term, two-way cooperation develops in these decentralized business models, all parties benefit – not least the shareholders.

To say that the concept of decentralization works well is an understatement when you look at the results of our portfolio companies. The headquarter does not micromanage the acquired companies. However, the acquired companies are offered support and assistance in their development and growth. Trusting cooperation with the headquarter is the hallmark of the decentralized business.

The powerful concept of decentralization is of great benefit to us as investors. It is an investment concept that stands the test of time. We have invested in many decentralized models that will continue to create high shareholder value in the years to come.

Why we favor profitable growth

Growth stocks have been out of fashion lately, triggered by fears of rising inflation and higher interest rates. This follows years of massive outperformance in these stocks. Most of this outperformance has come from companies operating in industries that are predicted to grow significantly over the next decades, such as sectors like technology and renewable energy. As interest rates have risen, the discount rate for these future cash flows has increased, resulting in lower company valuations. But do higher interest rates and poor market sentiment mean you should steer clear of growth investing?

The companies in which we are invested have shown impressive growth rates over the past decade. We invest in companies that we expect will continue to grow profitably in the future. Growth is achieved step by step through small acquisitions and is not dependent on positive macro cycles or large megatrends in the distant future.

Growth alone does not always create value. Growth requires investments, and for growth to be profitable those investments must generate a return on capital that exceeds the cost of capital. If a company grows with returns below its cost of capital, growth is value destructive. We value profitable growth and invest in companies that can deploy a lot of capital at high returns over long periods of time. Therefore, two criteria must be met: profitable reinvestment opportunities (high incremental ROCE) and long runways of growth. We capture both criteria through our investment philosophy.

Programmatic M&A is high-paced acquisition activity of small private companies, that often generate no more than 1% of the parent company’s total revenue (USD 1-10m). Acquisitions are made at significant discounts to market multiples due to the size of the target companies. Acquisition targets are often too small to attract interest from private equity and private owners are sellers. The sellers of these companies often prefer to sell their companies to serial acquirers. As perpetual owners, they offer a decentralized organizational structure without restructuring or major change in any way.

Serial acquirers are characterized by their systematic approach to M&A, and strict return requirements. They rarely acquire companies presented to them by M&A brokers, but rather source deals themselves. Dialogues with potential acquisition targets often lasts for years. They rarely pay more than 5-8x EV/EBITA, which equates to 13-20% return.

Despite rising asset prices and multiples in the public markets in recent years, we have not witnessed the same multiple expansion in private markets. We are often asked how it is possible for these serial acquirers to buy private companies at these valuations. The answer is that most acquisition targets are too small to attract interest from other buyers, and that sellers care about non-financial factors, such as keeping employees employed, and continuing the business without restructuring it or liquidating assets. Purchase considerations often include earn-out mechanisms, with a portion of the consideration often consisting of stock in the parent company, and management of the acquired company continuing to run the business.

Successful serial acquirers achieve high returns by purchasing well-managed companies that generate a high return on invested capital. However, the prudent pricing discipline of these public companies also leads to a public-private arbitrage, as most of these serial acquirers buy private companies at significantly lower valuation multiples than their own valuations.

The three essential investment ingredients

Our investment philosophy is to identify companies that have superior capital allocation capabilities, decentralized business models, and where management develop a high-performance corporate culture. This often leads us to invest in business models that have three key ingredients that we believe drive long-term shareholder returns.

High return on capital
Shareholder value is created when capital is deployed at high returns over time. Our companies tend to defy the financial laws of gravity, because their returns on capital do not revert to the mean.

Stocks are often priced on the assumption that the return on capital will decline. Competition is likely to drive profitability down over time. Our strategy implies investing in companies where the return on capital does not decline. These companies grow stronger over time.

Durability
Growth is often overestimated. Durability is often underestimated. We seek to invest in companies that have attributes that increase durability. We believe that the longevity of companies is closely related to their ability to both protect the core strengths of the business and be innovative and changeable. We believe that decentralized business models with autonomy increase durability.

We invest in many companies that are family-owned, or in which management has a significant ownership stake. Incentives matter. These management teams create corporate cultures that balance the original and often frugal corporate culture with entrepreneurship and growth. They focus on continuity and create a good balance between tradition and change.

Business model certainty

There are many companies that have long track records of profitable reinvestments and high return on capital that we would never invest in. The main reason is that the business models are too uncertain, meaning that the success is basically based on one product, one customer or one end-market. We pass on investing in these companies even though they often have a strong financial track record in terms of profitability and cash flow generation. External factors beyond management's control simply makes risk too high for us. Regulatory risk is often a key risk factor, and it is nearly impossible to know whether success is based on a "megatrend", or company-specific factors.

We prefer companies that are in control of their own destiny, and we are willing to pay for that certainty.

High return on capital, durability and the security of the business model are the three essential ingredients for successful long-term investments. Our investment philosophy and strategy increase our chances of finding and investing in these exceptional businesses.

A special skillset in capital allocation

An important cornerstone of our investment philosophy is exceptional capital allocation. There are many ways a company can allocate its capital. Most of the companies we are invested in use strong free cash flow to buy profitable small private companies.

Many of the companies we invest in are excellent at sourcing, negotiating, and closing private deals. Over the years, they have developed a strong expertise in this type of capital allocation. They are disciplined buyers of well-managed small private companies at prices well below market multiples. They repeat the process in a structured manner and consistently close attractive private transactions. Capital allocation is at the core of their strategy.

Value creation through small private acquisitions

In private markets, there is a lot of information asymmetry, and often less market liquidity. Private markets are structurally inefficient, which we believe leads to permanent differences between public and private valuation multiples. Some companies, after decades of M&A practice, are well positioned to exploit these valuation differences.

We invest in many publicly traded companies that acquire private companies at highly accretive multiples for us as shareholders. The multiples are generally in the range of 5-8 times EBITA, well below where the listed companies themselves trade. Over the years we have not seen any increase in the multiples paid by our listed companies for the acquisition of private companies. There are several reasons why our companies can close acquisitions at these attractive multiples. Small private companies are often heavily dependent on a small group of customers and key personnel. Consequently, the prices paid for these companies reflect this risk.

There are several non-financial arguments that our companies have to offer prospective sellers of businesses. Sellers can retain some ownership, stay independent, keep employees and the location of the headquarters, and continue to build the original brand and organization.

On the other hand, the traditional private equity approach is to buy a broken business at low multiples and turn the business around to achieve multiple expansion at exit. The "value creation framework" is easy to understand. Strategic corporate buyers also have a different approach from serial acquirers.

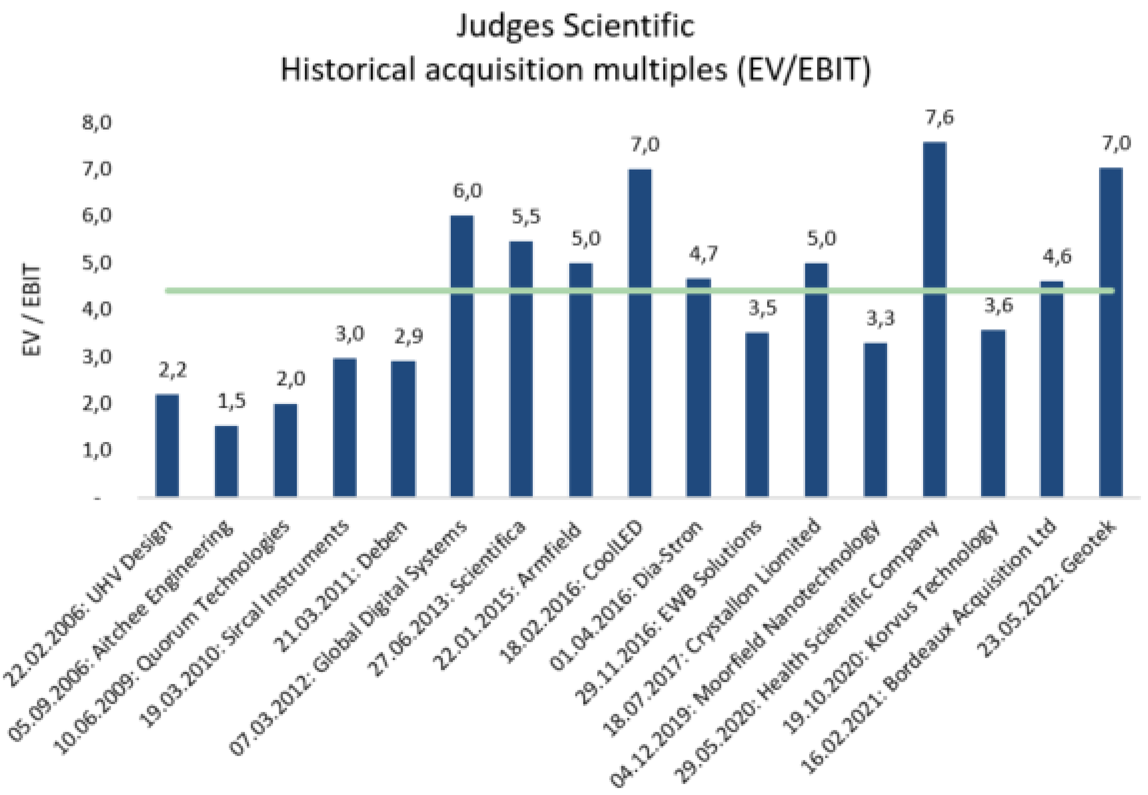
FEATURES	Serial acquirers	Strategic acquirer	Private equity
Investment horizon	Permanent home	?	5-7 years
Continuity of culture	No change	?	?
Due diligence	Internal DD	Long process	Long process
Governance	Board member	Subsidiary	Operational involvement
Post transaction	Autonomy&reporting	Integration	Change
Financing	Free cash flow	?	Use of debt

Serial acquirers buy private companies with good growth prospects and good returns on capital and source and close these acquisitions at attractive multiples. The goal is to let these good companies continue to operate independently, help them achieve their growth ambitions and generate better cash flow. Generally, the companies we invest in work with carrots, not sticks, in terms of incentive structures. Basically, they create a lot of value through collaboration, permanent capital and offering a permanent home.

"As the new owner of a company, Momentum Group does not focus on revolution, but rather on evolution"

(Momentum Group, webpage)

Below is an example of one of our portfolio companies, Judges Scientific, which is listed in the UK. The company acquires niche private scientific instrumentation companies. Below is an overview of the acquisitions and the corresponding multiples paid since launch of the company.



Given the attractive multiples, one might assume these businesses are broken businesses with limited growth opportunities and weak returns on capital. They are not. These companies are growing with high returns on capital. The transactions are often sourced and negotiated off-market, which explains the multiples paid. When a company like Judges Scientific can deploy capital by acquiring well-managed, high-growth companies with average returns on capital of 22%, shareholders like us benefit. The original management continues to run the companies as they did before the transaction. These acquisitions are small. Often an EBIT of less than £1m explains why many acquisition opportunities never make it to the private equity radar. With less competition and information, opportunities arise for our companies.

The quality of earnings acquired from these private companies is often at or above the level of the public company. When the company announces its earnings, the acquired earnings trade at the same multiple as the parent company. In the case of Judges: 19x instead of 3-6x. For the public company, the key is to find high-quality private companies that meet or exceed the financial metrics that they themselves can realize as buyers. They need to raise the bar and buy at deep discounts. That requires discipline.

As an example, in late May, Judges Scientific announced a larger-than-usual acquisition. Geotek is a global leader in the design and manufacturing of instruments used to measure and log features of geological cores. Geotek generates EBIT-margins of about 40% and ROIC of over 30%. This is Judges' largest acquisition to date. If Geotek is able to achieve maximum earn-out considerations, Judges' earnings estimates will increase by 25-30%. Geotek's management has a strong incentive to grow EBIT in order to receive the deferred consideration for the acquisition. The CEO of Geotek, Anthony Bosley, will remain in his role. The acquisition multiple is 7xEBIT, which is slightly higher than what Judges typically pays, but this is a much larger acquisition (GBP 6.4m acquired EBIT) than Judges' former acquisitions. We believe the acquisition represents excellent value for shareholders, and look forward to following Geotek as part of Judges Scientific.

In Europe alone, there are more than 23 million privately owned small and medium-sized businesses, with approximately 15,000 for sale each year. Some are bought by private equity firms, others by large strategic buyers. A small number are acquired by our publicly traded serial acquirers, who take a structured approach to buying, holding and supporting their portfolio companies. They rarely sell and rarely acquire companies presented to them by M&A brokers. They often source deals on their own.

Many private entrepreneurs who sell their businesses are concerned with keeping employees employed, continuing the business without restructuring or liquidating assets, and ensuring that the headquarter remains where it has always been. They accomplish this by selling to one of our companies.

We have witnessed firsthand that capitalism does not always work the way it is written in finance textbooks. Even when there are multiple buyers of assets, the highest price does not always win. Inefficiencies lead to opportunities for our companies.

The advantage for public investors like us is that we get access to several well-managed private companies at significant discounts to publicly traded companies. These prices are not normally available to public investors. We have invested in many public vehicles that acquire these private companies and create great value over the years. As long-term investors in publicly traded companies, we enjoy the opportunities that arise in the private markets.

Ownership structures as a competitive advantage

We believe it is important to consider the ownership structure of a company before making an investment decision. We believe that companies with a high degree of insider ownership in most cases are better managed than purely institutionally owned companies. Insiders have a longer-term view on a company's performance, and implement that long-term view through board representation, management composition, and strategic direction. We believe that the ownership structures of our companies provide a major competitive advantage by enabling companies to act in the best interests of long-term shareholders.

We define insider ownership as shares owned by executives, board members, and large private owners (often families), as these are all stakeholders that can have a significant impact on a company's performance. In our portfolios you will typically find ownership structures where the family behind the company controls the votes, but not necessarily the capital. Examples of such companies are Xano Industri in Sweden and Heico in the US.

When management owns a significant stake in a company, they treat the company as their own. You treat your own car differently than a rental car. Management with ownership tends to avoid poor decisions that increase short-term profitability goals at the expense of longer-term value creation. This requires that ownership stakes are not given away for free in the form of warrants or options, but through investment requirements or long-term-incentive plans, with appropriate vesting periods.

It is a paradox that from a governance point of view, high institutional ownership is perceived by many to be better than one or a few large private owners. The argument is often that institutional investors are professional and have experience in implementing appropriate governance measures. However, in many cases institutional investors have a short-term view on their investments, often blindly trusting that management will maximize shareholder value. This gives management a great deal of freedom without, in many cases, properly aligned incentives. In addition, institutional investors rarely take seats on the board, as this limits their ability to trade shares.
A private owner, on the other hand, often has a generational perspective on his or her ownership stake, and wants to take a seat on the board. This ensures a long-term perspective in the board room, which we prefer.

Some will argue that in a well-governed company, insider ownership does not matter as control mechanisms will ensure that the company is well-managed. We believe that stock ownership incentives work better than formal control mechanisms. If incentive structures are not properly aligned, management and directors rarely implement a long-term perspective. We are in favor of both management and directors owning a significant amount of stock, as this increases accountability and forces them to have a longer-term perspective. The total value of the stock ownership should significantly exceed annual compensation.

There are instances when insider ownership can be a significant negative factor for companies. This is especially the case in conjunction with poor governance, where insiders act irrationally to maximize their own personal value at the expense of other stakeholders.

One such example may be when a company is heavily indebted and enters a downturn. Instead of raising equity to repair the balance sheet, a majority owner who holds most of his or her personal wealth in the company, may choose to postpone a capital increase to avoid dilution. This is suboptimal for the company because management may spend more time worrying about the capital structure, instead of focusing on operations during a difficult downturn.

Therefore, it is important to carefully consider whether a company has the right governance mechanisms in place when investing in companies with high insider ownership. Much of the risk of insider ownership can be mitigated by examining a company's governance mechanisms, in addition to its business model, organizational structure and management profile.

We believe that high insider ownership creates long-term value, because insiders often have a long-term view on the company and want to maximize long-term shareholder value. This means that management does not focus on empire building or make suboptimal short-term strategic or financial decisions. We have high insider ownership in our portfolio holdings and believe this is an important investment criterion to ensure long-term value creation.

The value of succession planning

An important part of our investment philosophy is “people” – meaning the analysis of a company’s management team and corporate culture. The CEO role is crucial in every company. The CEO is the “Cultural Executive Officer”. We want to invest in companies led by “outsider CEOs” who dare to deviate from traditional ways of allocating capital, organizing and creating cultures. We like to invest in companies that have systematic CEO succession planning. When analyzing our portfolio companies, we see three common roadmaps in succession planning.

We invest in companies where the CEO treats the company as his or her own. We prefer companies where the CEO has a long tenure with the company, either as a founder, or with years of experience with the company before being appointed CEO. We believe that CEOs who share the company’s beliefs and strategic DNA create more value for shareholders, rather than CEOs who view the position as the next career move or high-paying job.

The “Forever-CEO”

Some CEOs are the DNA of the company. These CEOs are often founders or co-founders of the company, and have been with the company since the beginning. Think of Steve Jobs at Apple or Warren Buffett at Berkshire Hathaway. The board of these companies gives the CEO full autonomy, and the CEO runs the company the way he or she wants. These CEOs treat the company as their own, and often hold large ownership stakes. When investing in such companies, the CEO is an important part of the investment analysis. These CEOs often have a very distinctive leadership style. We own several companies with “forever-CEOs”. Examples from our funds include Mark Leonard at Constellation Software and Gerteric Lindquist at Nibe.

The downside to investing in these types of companies, is that much of the company’s perceived value creation is tied to the CEO. If the CEO suddenly quits, or otherwise leaves the company, it will be difficult to replace him or her immediately in many cases. It is important to assess succession risk in these companies, and whether the corporate culture might change under a new CEO.

The internal candidate

Some companies always recruit internally for the CEO position. The board of these companies has a detailed succession plan for the CEO position that includes several internal candidates. This recruitment strategy enables the board to recruit a CEO that understands the existing corporate culture, norms, and strategy of a company. It de-risks the process of changing CEO, and gives shareholders more of what has been.

Typically, these companies will not change their strategic direction or undergo significant changes in execution after the new CEO is in place. In these companies the CEO is simply an excellent enforcer of the company’s strategic DNA, which is set by the board and maintained over time. When a CEO in such a company decides to leave, the board has several excellent internal candidates to succeed him or her, and shareholders know what to expect. Most companies in our fund follow the internal candidate strategy. Examples from our funds are Niklas Stenberg at Addtech and Per Waldermarsson at Lifco.

External recruitments

Some companies recruit externally when they hire a new CEO. An external candidate brings something new to the table, as he or she has limited knowledge of the company's existing organizational culture and internal company DNA. An external candidate also has limited ownership to the execution of the company's existing strategy. External CEOs will in most cases carve out a new strategic business direction when joining a new company, which reflects their own leadership skills and strengths. External recruitment thus ensures that the company's strategy and business development over time is reviewed with new perspectives, and constantly challenged.

The downside of such a strategy is that the company runs the risk of changing its strategic direction too often. In our portfolios, we generally to not observe external recruitments for the CEO position.

If you take the time to study a company's CEO history, you will often see a distinct pattern in how the board does its succession planning. Very few companies tend to alternate between external recruitment, internal recruitment or having multiple dominant "forever CEOs".

The companies in our funds have often been successful for decades, by pursuing the "forever-CEO" and internal candidate recruitment strategies. These are CEOs who properly understand the corporate cultures and mindsets of the companies, and who create long-term value for shareholders.

Suggested reading material

The following books will not only make you a better investor, they are also inspiring and great for discussing with friends. The books have the potential to make you pause and think about investing, business and life in general. Some of the books listed below are purely investment related, others are more appropriate for a dinner conversation.

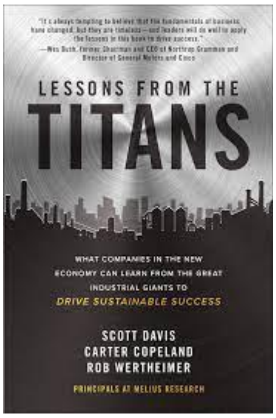
"*I cannot understand how some people can live without communicating with the wisest people who ever lived on earth*"
(Leo Tolstoy)

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

Have a great summer holiday!

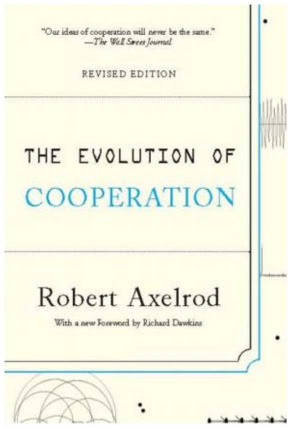
From the REQ Capital Team

Lessons from the Titans by Scott Davis, Carter Copeland and Rob Wertheimer



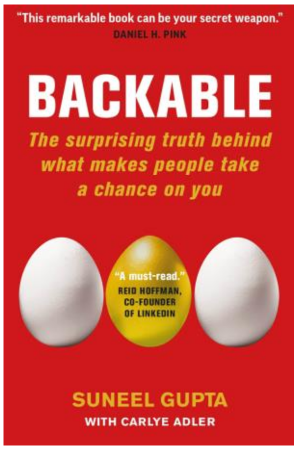
As the authors say: "*One of the great lessons of this project is that successful businesses usually prefer to be out of the limelight*". The companies in the book encourage continuous improvement, are deeply focused on cost control and customer relations. Capital allocation is also seen as core to the business strategies. Another insight from the book is that "*companies usually fail because of the incompetence and arrogance of a complacent management team, not because they struggled to predict the future*"

The evolution of cooperation by Robert Axelrod



Fundamentally the book is about the beauty of cooperation. The book dives into the "Prisoner's Dilemma" where the game allows players to achieve mutual gains from cooperation, but where the game also allows the opportunity that one player can exploit the other. The winning strategy presented in the book is the "Tit for tat" strategy which starts with cooperation and thereafter doing what the other player does in in the previous move. The book is full of insights on cooperation and highlights that "*the world's leaders should all be locked up with this book and not released until they have read it*"

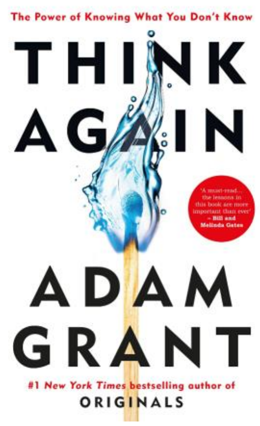
Backable by Suneel Gupta



How do you convey a message which makes people interested?
Suneel Gupta concludes that "*what moves people isn't charisma, but conviction. Backable people earnestly believe in what they are saying, and they simply let that belief shine through whatever style feels most natural*". In order to convince others, you must convince yourself first. "*Investors are attracted to founders with a personal attachment to their business*". The bottom line of the book is that facts alone will not change people's mind – emotions and feelings show that you have embraced the idea yourself.

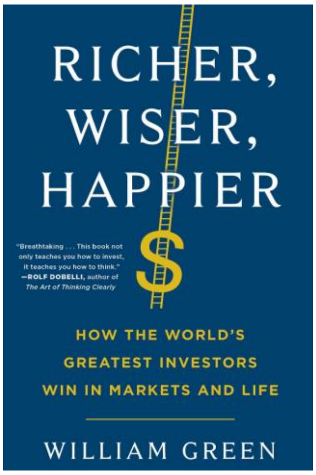
Think again by Adam Grant

Adam Grant is an organizational psychologist at Wharton. He challenges us to question our strong held beliefs. Rethinking is a mindset. Scientists are used to question the limits of their understanding and seek facts. Scientists run experiments and test hypotheses to learn and unlearn. You should dare to disagree with your own arguments and refuse to let your "*ideas become ideologies*". "*Most of us take pride in our knowledge and expertise, and in staying true to our beliefs and opinions. That makes sense in a stable world, where we get rewarded for having conviction in our ideas. The problem is that we live in a rapidly changing world, where we need to spend as much time rethinking as we do thinking*"



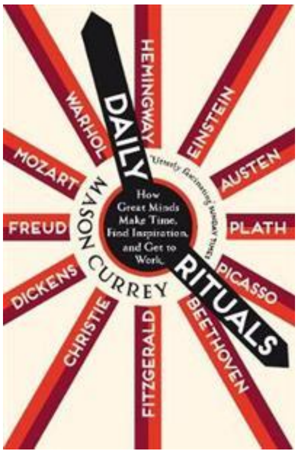
Richer, wiser, happier by William Greene

The book studies the "*principles, processes, insights, habits and personality traits*" that characterize some of the best global investors. The best investors are "*an idiosyncratic breed of practical philosophers*". They try to make rational decisions about the future, even though the future is unknowable. Sir John Templeton is one of the investors in the book and is quoted saying: "*It is impossible to produce superior performance unless you do something different from the majority*". The best investors "*follow their own peculiar path not just in the way they invest but in the way they think and live*". They are "*nontribal freethinkers*"

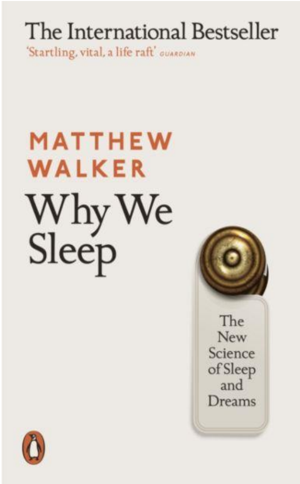


Daily Rituals by Mason Currey

The book is an easy to read and entertaining book about the habits of 160 widely known characters ranging from Ludwig van Beethoven to Pablo Picasso and Leo Tolstoy. They all have their own peculiar way of going through everyday life and the book describes how they structure their days. Some work early in the morning and others do their creative work during nighttime. The common thread among these famous authors, scientists, politicians etc. is consistency. They do the same ritual every day – for years. "*All of them made the time to get their work done. But there is infinite variation in how they structured their lives to do so*" or as W.H.Auden wrote: "*Routine, in an intelligent man, is a sign of ambition*".



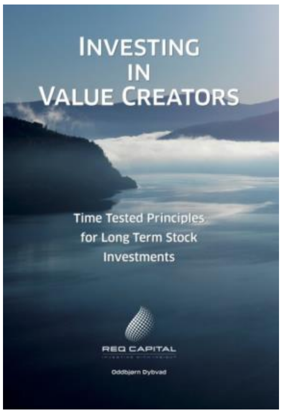
Why We Sleep by Matthew Walker



After reading Why We Sleep you start to go to bed earlier and put your alarm on 15 minutes later in the morning. Matthew Walker is an English scientists and professor of neuroscience and psychology. He has been studying the effect of sleep on our brains and shows that lack of sleep over an extended period has dramatic impact on your physical health and well-being.

A good night sleep makes us healthier, happier and reduce the chances of diseases. On the contrary "inadequate sleep – even moderate reductions for just one week – disrupts blood sugar levels so profoundly that you would be classified as pre-diabetic".

Investing in Value Creators by Oddbjørn Dybvad



Our own 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. The book introduces some concepts on what to look for in the search for outstanding management teams and corporate cultures. By Investing in Value Creators, you increase your chances of earning high stock returns over the long term.