Investing with Insight

Full Year Investment Report 2022

January 2023

REQ CAPITAL

INVESTING WITH INSIGHT

Content

Dear fellow investors

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

During these turbulent times, we are grateful to our investors who continue to invest for the long run. We thank you for your increased confidence and net subscriptions during the year. Our investors include Nordic and international fund-of-funds, pension funds, institutional investors, and high-net-worth individuals.

Our investments share three common characteristics. First, the companies we have invested in are led by management teams with excellent capital allocation skills. They are skillful investors in the private markets. Secondly, we invest in decentralized organizations that unleash entrepreneurial energy. These companies provide autonomy and the right incentives for people to perform. And last but not least, the management teams have significant skin in the game through share ownership. Incentives matter.

We invest with a multi-year perspective independent of any benchmarks. In some calendar years, our funds will perform better than markets in general, like our first year of 2021. In other years, like 2022, our returns are worse than the market in general. Over the long run, we aim to compound capital at highly attractive rates. We have a philosophy and strategy that enable strong long-term returns without taking too much risk.

We spend much time looking at potential risks to our investments. By risk, we primarily mean business risk. We invest in highly decentralized and diversified businesses that are not dependent on a limited number of products, customers, or end markets.

We will ensure that we deliver on our promise to invest in the best compounders that will create significant value for our investors in the decades to come.

Thank you for your trust and support.

The REQ Capital team

REQ Global Compounders

REQ Capital believes value creation drives shareholder performance in the long run. We invest in companies that can reinvest capital at high returns over long periods. These compounders generate strong cash flows and profitable growth through small bolt-on acquisitions in addition to underlying organic growth.

We invest in management teams that are outstanding capital allocators. The cornerstone of our investment philosophy incorporates capital allocation, decentralization, and people. Finding outstanding capital allocators who decentralize their business and act like true owners is essential to achieving exceptional long-term returns as investors.

The fund returned -22,5% in 2022[1]. We invest independently of benchmarks, but for investors that want to benchmark us, the most appropriate alternative investment is the MSCI All Country World Index, which returned -10,4% over the same period.

During the second half of 2022, we continued to see strong growth across the portfolio in terms of organic growth and acquisitions, making 2022 another strong year from a fundamental point of view. In total, 244 transactions were carried out by the portfolio companies in 2022, compared to a record of 264 transactions in 2021. A possibly more challenging period as we enter 2023 might reduce the volume of transactions somewhat since the sellers seldom are in a hurry to sell; after all, these are fundamentally great businesses, not turnarounds, which means the sellers can afford to wait and see.

As previously discussed, we added three new companies to the portfolio in 2022. In the first half, we invested in Kelly Partners in Australia and Pool Corp in the US and shared some thoughts about them in our letter for the first half year. We invested in Momentum Group in Sweden in the 2nd half of the year. We see many right ingredients in Momentum Group regarding capital allocation, decentralization, and ownership. The CEO and CFO got decades of experience from other successful serial acquirers, and since it is a small company, new acquisitions will significantly impact group figures.

A common thread amongst our portfolio companies is a seemingly high industrial exposure often associated with cyclical volatility and corresponding risk. Beneath the surface, however, we find long-lasting business-to-business relationships that transact products and services critical for the end customer, often with little exposure to cyclical spending. Compared to CAPEX budgets, OPEX spending invites less scrutiny when budgets need to be recalibrated, providing high retention rates and recurring revenues. Examples across our portfolio include deeply customized software solutions vital for ongoing operations or crucial flow products like a component that is low cost relative to the overall value of the product. In summary, what we find encouraging across our 26 companies in the portfolio is highly diverse and recurring cashflows streams coupled with conservative balance sheets that should provide resilience and durable growth in the future.

[1] In NOK, as of 30.12.2022, "A" class after 100bps management fee.

A second theme across our portfolio is acquisitive growth, mainly funded internally, not reliant on the kindness of strangers. Self-financed growth places a natural emphasis on cash flow generation and conservative net-debt ratios. In other words, these companies don't suddenly wake up one day, and all of a sudden have to make drastic cost-cutting plans. The modus operandi is an organization thriving on autonomy and rooted in cash flow generation, despite prevailing cycles and sentiments that swirl around the marketplace. Our discussions with management teams in 2022 also echo this reality; we hear a readiness towards what may come next and business-as-usual in terms of cash flow focus and continuous improvement.

REQ Nordic Compounders

We launched the REQ Nordic Compounders fund on January 25th 2022. We believe the REQ Nordic Compounders fund comprises the best high-quality companies in the Nordics, with a clear track record of profitable growth and excellent capital allocation. As the name suggests, the fund invests in Nordic-listed acquisition-driven compounders that reinvest and compound capital and generate strong returns over decades. We have a generational perspective on our investments.

REQ Nordic Compounders follows a bottom-up investment process but is based on the three core principles of the REQ investment philosophy: 1) capital allocation, 2) decentralization, and 3) people. Since inception, we have made few changes to the portfolio as the hurdle for new companies to enter the fund is high. The portfolio comprises 22 holdings as of December 31st, 2022.

The most notable change in the portfolio this year was the inclusion of the Swedish company Momentum Group when it was listed in April. Momentum Group has a long heritage from the Bergman & Beving group of companies, with a proven track record of excellent capital allocation, a solid management team with a long-term view, and significant skin in the game through share ownership. Additionally, it is in its early growth phase.

The fund invests in high-quality companies that grow profitably over time through organic growth and acquiring private quality companies at below-market multiples. The fund's focus is companies with decentralized business models with high-quality management and perpetual ownership horizon on their subsidiaries. There are many acquisition-driven compounders in the Nordic countries, especially in Sweden. The companies we invest in tend to operate well in challenging economic environments. Net debt is low across the portfolio, and we continue to see good earnings growth, both organically and through profitable acquisitions.

The fund returned -13,5% since inception[2]. We invest independently of benchmarks, but for investors that want to benchmark us, the most appropriate alternative investment is the MSCI Nordic Index, which returned -0,1% over the same period. We have a long-term view of our investments and do not measure our performance on an annual basis, but we hope to see better performance in 2023, as we believe our companies have the right ingredients to create long-term excess returns.

[2] In NOK, as of 30.12.2022, "A" class after 100bps management fee.

2022 has been a rocky road for the Nordic equity markets, impacted by high macroeconomic uncertainty due to high inflation, rising energy prices, increasing interest rates, and the war in Ukraine. The good organic growth momentum we saw in 2022 should slow down. However, we believe that the companies we invest in are well-positioned to grow earnings through acquisitions, as evidenced by former downturns. Acquisition activity in the fund was strong in 2022, with 160 acquisitions announced by our portfolio companies in 2022 compared to 168 in 2021. We continue to observe several transactions announced outside of the Nordics. The fund is diversified in revenues, with roughly half of the portfolio companies' revenues coming from outside the Nordics.

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

Trust, but verify

Focusing on high-performing serial acquirers requires an analytical reorientation because these companies are essentially vehicles for capital allocation. They are associated with above-average entrepreneurship, generating multiple income streams across industries and geographies. Hence, the failure of a single company in the group should not sink the entire fleet. As long-term investors, we do not bet on home runs or binomial outcomes depending on what OPEC decides next week or month.

The analysis starts at the top by assessing the three critical ingredients for exceptional performance: capital allocation, decentralization, and people. It is a trust-based approach where we rely on the management team, which often takes a religious approach to decentralization, treating the underlying business units as true owners and giving them a high degree of autonomy. Unlike large organizations, cost savings get sacrificed in the belief that the cumulative effect of ownership, autonomy and entrepreneurial spirit will offset them.[1]

It follows that some investors may feel they are giving up some of their hard-earned analytical superpowers, which occasionally raises existential questions: As portfolio managers, what are we actually paid to do?

In fact, our investment decisions are outsourced to the management teams of publicly traded companies that have proven their ability to redeploy large amounts of free cash flow at high rates of return. The opportunities available to these management teams in the private markets are far greater than most public managers can achieve directly. After all, not many public managers can compound capital at high double-digit returns, measured over several decades.

At a deeper level, it is a system based on common sense principles for long-term value creation; trust is a central component, and superior entrepreneurship is the result.

For this reason, some parts of the investment community may not like what we like to call "sidecar investing." As Warren Buffett once said: Investors should remember that their scorecard is not calculated using Olympic-diving methods: Degree-of-difficulty doesn't count. In addition to the analytical framework for finding these high-performing serial acquirers, we should not forget that the overall goal is to stay the course and thus take full advantage of compounding.

Our common goal is to find that rare combination of management teams that simultaneously have excellent capital allocation skills and are outstanding operators. This is a tall order, as most good operators are not necessarily good investors.

Why should we expect the management teams of individual companies, often without skin in the game, to wear both of these hats? Incentives play a significant role, but hired hands often rise to the top not because of per-share value creation but due to a completely different scorecard.

In contrast, the decentralized nature of these companies lends itself to centralizing responsibility for capital allocation while unleashing entrepreneurship at the business unit level, focusing only on what they do best. In practice, the best-performing serial acquirers take a holistic approach to capital efficiency, including organic and non-organic initiatives, and they generally deploy resources more efficiently.

In-depth analysis of unit economics at the segment level is replaced by evaluating capital allocation capabilities. We are not in the game of shuffling stocks and chasing the new and shiny; instead, we take full advantage of compounding through management reinvestment of capital. That said, we spend much time on any data that provides clues about management execution, corporate culture development, and reinvestment potential.

Trust, but verify; stay in the sidecar - but don't fall asleep!

Sources:
1) Interview with Nick Howley (CEO of TransDigm)

Selling Your Life's Work

Imagine you founded and built a business through a lot of hard work and effort over the last 20 years. At some point, you may seek to offload some of the responsibility for various reasons.

In the following, we share some perspectives of entrepreneurs who have decided to sell their businesses and their life's work to the serial acquirers within our portfolios. We enjoy talking to these sellers as we gain new cultural insights*. Behind the critical decision to sell are several considerations for the founder.

"CEO-buddies"
We recently spoke to a founder who decided to sell to one of our serial acquirers last year, who started his specialty tool business more than 20 years ago. After selling his company two years ago, he continues to run it. It was a personal match with the buyer. Both parties "*liked small steps*." The founder told us that he appreciates the fact that he now has the opportunity to talk and share ideas with other company CEOs in the group, even though the companies in the group are in different

sectors and niches. He referred to the other company CEOs as "*CEO buddies*" because they share experiences, challenges, and ways to improve. After the transaction, the founder continued to run the company without interference from headquarters. He told us that the only change is "monthly reporting" to headquarters. "Documentation is good," the founder said, as it "*leads to more reflection.*"

Price is not the most important aspect
Another founder we recently spoke to decided to give all the responsibility of the sell decision to the current management team, which owned 20% of the company. The management team needed to determine whom to work with on the ownership side. The company contacted an accounting firm and asked for a valuation of the company and advice on whom to talk to regarding an acquisition. The company was introduced to the buyer through the accounting firm, and there was a cultural fit. According to the founder, the price was far from the most important criterion in the decision-making process.

Caring for employees
A third founder we spoke with recently had built a profitable business over many years and had been approached by one of our portfolio companies many years ago. Private equity firms were also knocking on his door at the same time. He said (loosely translated) that "t*he deal offered by private equity would have been better for me financially, but I had no control over what would happen to my employees. They had built the company with me, and I could not bring myself to let them go into an unknown future*." The founder said he did not want to "*dramatically scale the business over the next five years and sell,*" which was proposed by a couple of buyers.

The above insights from founders who chose to sell part of their life's work to our serial acquirers point in the same direction. When you build a business over decades, you develop an emotional attachment. Price is important, but soft factors and cultural fit are critical. The primary motivation of these founders is not to "cash in" and get out on the golf course.

Capitalism does not always work by the textbook, which we believe benefits many of our portfolio companies in the acquisition process since they have an eternal perspective on acquired companies. The companies we own have a founder's mentality that enables them to negotiate and close attractive acquisitions for us as shareholders. As public investors, we enjoy the value creation in this process.

*We have chosen to keep the company name and the founders who sold anonymous.

Growing trees with expanding root systems

In the plant world, the roots of the African rock tree, Ficus abutilifolia, can split huge open rocks and penetrate up to 60 meters deep in search of water. Plant roots perform several important tasks: They resist the effects of wind, water, and dirt, among other things[1]. In addition, some trees can stand upright for hundreds of years because their roots grow deep and wide into the ground, surviving even when large sections are cut off[2]. Therefore, a robust root system is a prerequisite for a tree to grow for decades because all growth becomes fragile without it.

Photo credits: tampa-tree.com

Most people focus on what's visible and measurable: a growing tree with its corresponding branches and leaves in full glory. Or, in a corporate context: a company experiencing high growth and seemingly firing on all cylinders. But a closer look may reveal a growth profile based on a concentrated product line sold to a single customer in a narrow end-market with favorable macroeconomic tailwinds. Each of these risks may look low-risk, but it's bound to happen if you keep running the clock on a low-probability event. After all, compounding works both ways. Hence, we stay away from companies that are too dependent on any one of those factors because we know that any one of these risks will eventually play out in the fullness of time.

Avoiding blowups
Most investors' fascination with high-performing serial acquirers often stems from a return perspective. This group of companies can systematically deploy large amounts of capital at high returns over a long time. To return to the analogy between a plant and a tree: the tree's growth with all its branches and leaves represents reinvestment opportunities harvested in due course.

To reach the "second half of the chessboard[3]", i.e., where an exponentially growing factor really gets going, one mustn't aim for the highest reward but avoid blowups at all costs. That's why we shun single-exposure risk. Most other outcomes are good if we don't make big losses at the fundamental level. For this reason, we don't try to find rockets but to avoid meltdowns

Therefore, we approach these compounders from two different angles, which are ultimately joined at the hip in the context of compounding:

Fundamental downside protection: internal diversification that ultimately reduces the risk of a blowup. We like deep and expansive root systems. From a return perspective: the ability to deploy capital with high returns through multiple small acquisitions of private companies – a growing tree with corresponding branches and leaves in full glory.

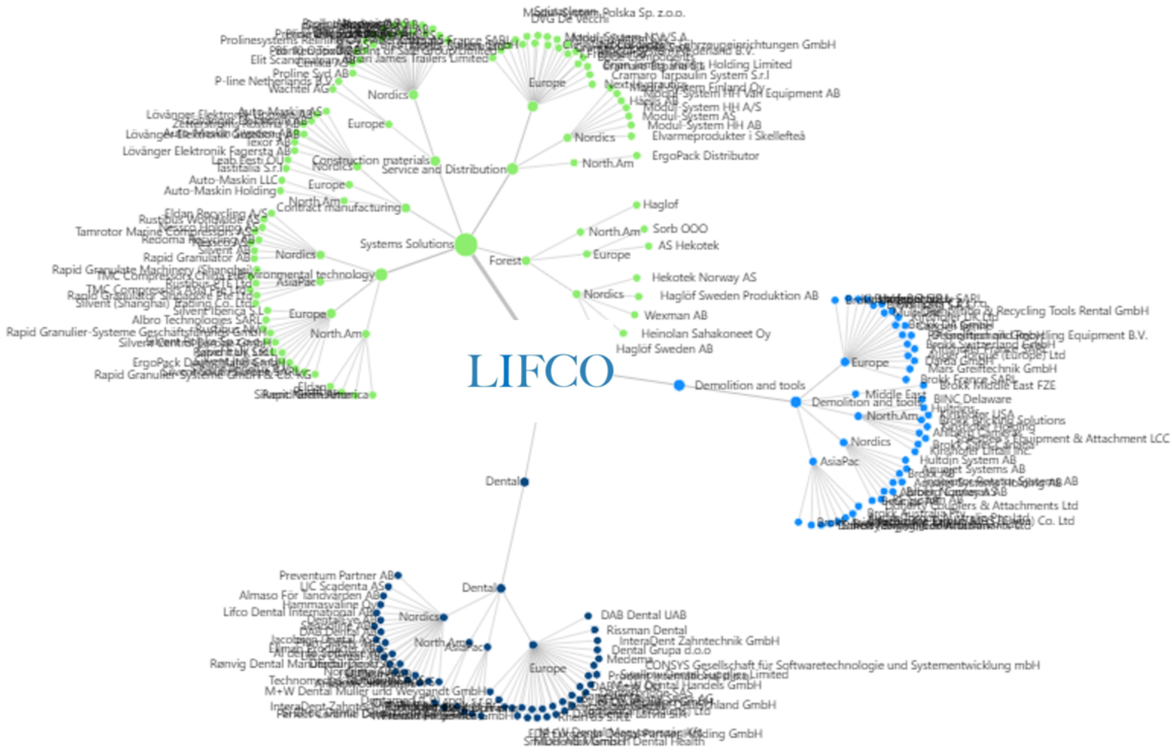
Teledyne

Teledyne's Henry Singleton, an early pioneer of the decentralized model and widely celebrated for his capital allocation skills over nearly three decades, may have shared a similar interest in plants and trees. In a 1978 Forbes interview, he said he saw diversification as insurance against disaster:

"*Teledyne is like a living plant, with our companies the different branches and each putting out new branches and growing so that no one business is too significant*."

Indeed, Teledyne designed a decentralized system of autonomy and ownership that collectively smoothed out peaks and troughs as well as any individual single exposure risk lurking around. It's fascinating to see how many lessons from Singleton and Teledyne shared across high-performing conglomerates. Those investors who invested in Teledyne stock in 1966 earned an annualized return of 17.9% over 25 years, or 53 times the invested capital, versus 6.7 times for the S&P500[4]. We share more about Teledyne in a below chapter.

The following organizational chart illustrates the extensive root system of Lifco, one of many high-performing serial acquirers from Sweden, with more than 200 companies across multiple niches and geographies:



Source: Lifco annual report

We, therefore, prefer growing trees with ever-expanding root systems. These structures should be celebrated for their compounding superpowers, but equally important is their ability to reduce idiosyncratic risk at a fundamental level.

Sources:
1. Myths and Misconceptions About Tree Roots Explained (treehugger.com)
2. The metaphor of root systems was inspired by a blog post (LibertyRPF) related to portfolio construction
3. A concept laid out by Ray Kurzweil
4. Distant Force: A Memoir of the Teledyne Corporation and the Man Who Created It (by George A. Roberts)

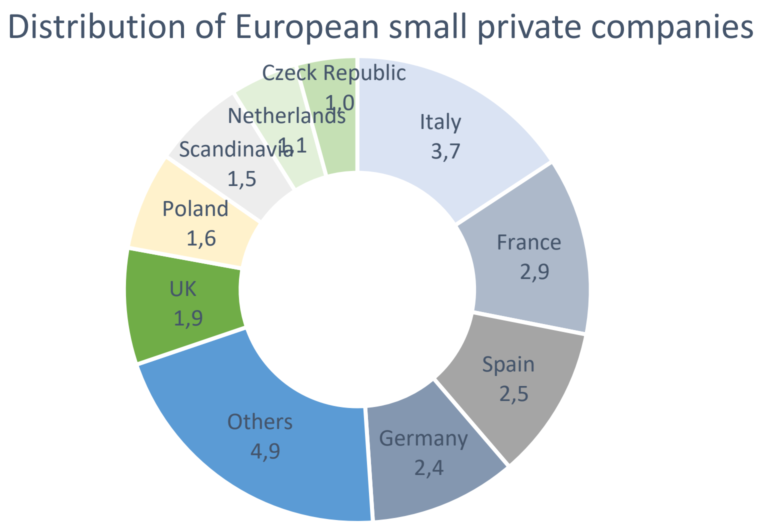
Capturing private market opportunities

Our investment philosophy is to own companies with a persistently high return on capital against a long growth runway.

Many publicly listed serial acquirers share these characteristics. We believe that the market underestimates the "duration" aspect of our investments because the opportunity set of future acquisition targets is so large. We believe the right serial acquirers are attractive investments as they reinvest a high proportion of their free cash flow in a disciplined manner (high ROCE acquisitions) over time and repeatedly acquire new companies.

The publicly traded serial acquirers we invest in benefit from several advantageous features of the private SME market (Small and Medium-sized Enterprises). When looking for new acquisitions, these companies are not constrained by the size of an end market, particular sector, or geography. For most of our companies, the global SME market is their target.

The backbone of the economy
Small private businesses are the backbone of the economy. In Europe, 99.8% of all companies[1] are small and medium-sized enterprises with fewer than 250 employees. This group of companies comprises a total of 23.5 million companies. 94% of these companies are "independent," meaning large corporations do not control them. Families and founders own these companies. In Europe, about 15,000 companies get sold each year[2]. Some are acquired by large corporations or strategic buyers, some by private equity firms, and some by serial acquirers. The country distribution of SMEs in Europe is as follows (in millions of companies):



Italy
Italy is one of the largest manufacturing countries in Europe. Many family businesses were established in the 1950s and 1960s[4] when Italy experienced a significant economic boom. Many of Italy's regulations favor small businesses. Transitioning from one generation of entrepreneurs to the next brings challenges and opportunities. Family goals may differ from business rationale and threaten a company's competitiveness, which can lead to a transaction. Given the cultural importance of close personal business relationships, acquirers must have a local presence in Italy. Given the size of the private business landscape in Italy, it is unsurprising that one of our portfolio companies, Lifco of Sweden, made five of its 20 acquisitions in Italy in 2021. In May of this year, the most recent was Trevi Benne S.p.A. - a manufacturer of excavator tools and attachments for demolition, scrap handling, earthmoving, and forestry. Founded in 1992, Trevi Benne employs 105 people and has chosen Lifco as its permanent home.

Germany
There are 2.4 million small and medium-sized enterprises in Germany. There is a strong family influence for larger listed companies and SMEs. A study by the "Institut für Mittelstandsforschung"[5] shows that around 95% of all companies in Germany are family-owned. The shareholder structure is often more broadly distributed among family members than in other countries, such as the United Kingdom. This characteristic represents both a challenge and an opportunity for potential serial acquirers. Since January 1st of this year, our portfolio companies have acquired eight German companies. On March 31st, Addtech acquired 90% of Fey Elektronik GmbH, a German battery manufacturer. Fey has 160 employees, and the CEO remains a minority shareholder with 10% of the shares.

UK
The UK is one of the most active M&A markets in Europe. Private equity buyers continue to drive the deal activity, but the UK is also becoming an increasingly attractive market for serial acquirers. Despite economic and political challenges, the UK mergers and acquisitions market remains exceptionally active. The smaller company segment, defined as transactions of up to £10 million, grew by 21%[6] last year. We are seeing increasing private acquisitions by our businesses in the UK. In June alone, four transactions were completed by our companies in the UK. The Canadian company Constellation Software was particularly active, acquiring two software companies, including Alemba, with 109 employees. On July 25th Swedish Lagercrantz acquired Door and Joinery, a UK supplier of customized fire doors with sales of GBP 4.5 million.

Summary
Serial acquirers take advantage of the highly attractive features of the SME market. With local representatives in each market, our companies find, negotiate and close attractive acquisitions.

In summary, investing in companies with long-term growth opportunities and high returns on capital is necessary to achieve high long-term stock returns. An extensive pool of acquisition opportunities is a perfect starting point for our acquisition-oriented compounders.

We observe that our companies remain disciplined in finding and closing attractive acquisitions at attractive multiples, which keeps returns on capital high. As long-term shareholders, we enjoy substantial value creation in this process.

Sources:

- https://ec.europa.eu/growth/smes_en
- "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)
- Thomson Reuters, based on three-year average for 2019-2021
- "Made in Italy" How culture and history has shaped modern Italian business environment, political landscape and professional organizations. (Susan Global and Kayla Gibson)
- "The Environment for Business in Germany" (CVJ Simpson Associates)
- https://www.cbw.co.uk/2022/01/ma-activity-in-the-uk-sets-new-records-in-2021/

A top athlete in the field of business

It is fascinating to study lesser-known but highly successful companies whose success is based on proven principles rather than a single product, customer, or market. Investing is about recognizing patterns. If we can decode certain principles and lessons behind past successes, we can apply those same insights in our search for investments.

Teledyne is one such example. An investor who invested in Teledyne in 1966 achieved an annual return of 17.9%, or 53 times invested capital, over 25 years, compared to 6.7 times for the S&P500. Henry Singleton was co-founder and CEO over that same period. Teledyne was an industrial conglomerate exposed to areas such as specialty metals, aerospace electronics, and insurance. According to Warren Buffett, Henry Singleton at Teledyne had "*the best operating and capital deployment record in American business*."

What were the key ingredients behind this success, and how can we apply these lessons as investors?

Capital allocation

Henry Singleton was a strong business operator but also a unique allocator of capital, actively using Teledyne stock as a source of funds. In the 1960s and 1970s, he made 130 acquisitions financed by equity and strong free cash flow.

In the 1970s, Teledyne used a significantly undervalued stock to buy back and retire 85% of its outstanding shares at prices far below what Singleton believed was the company's intrinsic value. These were not regular share repurchases. On several occasions, Teledyne made tender offers to buy five percent of its stock, which instantly increased the per-share value for the remaining shareholders.

In addition to acquisitions, Singleton had a firm grip on the organic engine of the business. In the 1970s, organic net income grew 19% annually, compared to 12% for the S&P500. Return on equity was over 25% during this period. The secret behind the solid organic growth was a business model based on decentralization.

Decentralization
Diversification was an insurance against catastrophe, according to Singleton. At its peak, Teledyne consisted of more than 130 individual profit centers that were highly decentralized. According to Teledyne:

"*We had no intention of managing these businesses from the corporate level. We did, however, establish our own unique financial and operations reporting system which enabled us to monitor their performance closely, on a monthly basis, and see any trouble spots before they became serious.*“*

There was no intention of micro-managing these companies remotely because the managers of these companies knew much more than the head office about their products, markets, and competition. The corporate-wide financial reporting system ensured that all companies spoke the same language. The fiscal month always ended on a Friday, and reports from all 130 reporting units were collected at headquarters by the following Tuesday morning. That was in the 1960s, and even today, that would be an accomplishment.

Because the company was always aware of each company's performance, "*we were able to establish an incentive system for honoring those companies that performed exceptionally well*.*" The company called it "The Triple Crown Awards" and honored companies that set all-time records in three categories: Sales, Net Income, and Cash Flow. The group-wide overview and awards were sent monthly to executives at all companies. The top-performing managers were rewarded accordingly. The policy of keeping operating units small, each responsible for its success, was followed throughout the company.

According to Singleton, "*We depend on them. We have to trust them. Our success or failure depends on what they do*.*" People are the most critical factor in a company. "*Why bother them if they are doing their job*" was Singleton's mantra.

People
Henry Singleton was the company's largest shareholder, with a 7.8% stake. Promoting the right people was at the top of the agenda. The result was a high-performance culture. According to Singleton: “*we work our heads off to increase our own capability at collecting and promoting the right people. We increase our bets on the men who seem to be performers.**"
Similarly, the company tried to avoid having people compete within Teledyne but looked outward to its real competitors. "*Our objective is to increase our rate of earnings faster than they do. It is a lot of fun. As a result, we visualize it as a competitive game.**" In 1989, Henry Singleton retired after 29 years of brilliant leadership and outstanding value creation.

Summing up
Our investment philosophy is based on three fundamental principles that stand the test of time: Capital allocation, decentralization, and people.

We want to invest in management teams that are excellent investors who understand the power of decentralization and entrepreneurship and own part of the business themselves. Teledyne is a perfect example of the extraordinary long-term results that come from combining these principles. We believe we have found and invested in a special group of companies with the ingredients to become the "Teledynes of tomorrow."

* Distant Foce: A Memoir of the Teledyne Corporation and the Man Who Created It (2007)

Learnings from HEICO: Entrepreneurism, Cashflow, and Escaping Bureaucracy

There is a saying that a change of direction in large organizations is often comparable to the change of direction of a supertanker; they are both large and slow. Because of its mass, a loaded supertanker would require about 5 to 8 kilometers and about 20 minutes to come to a complete halt when traveling at average speed[1]. Even small course changes require considerable time between the decision and the visible result; this is true for large organizations and supertankers.

Today's challenging business prospects might eventually expose the large, slow, and wasteful, which presents a paradox and a question:

What large organizational models still allow for a startup's nimbleness and entrepreneurial mentality?

In our recent conversation with Larry Mendelson and his son Eric Mendelson of HEICO, they shared the critical ingredients for HEICO's success—a company still flexing speed and alertness—despite its size with 6,400 team members and 88 acquisitions since they took over in 1990. We believe these lessons apply more broadly to other successful serial compounders we can learn from—both as business operators and investors.

Entrepreneurial spirit
"*First and foremost, we are entrepreneurs*." – Larry Mendelson.

In the late 80s, Larry and his sons had already entertained the idea of taking over an industrial company. Therefore, in 1990, the Mendelson family realized their ambitions by eventually taking control of HEICO Corp, a Florida-based company founded in 1957. HEICO is a technology-driven aerospace, industrial, defense and electronics company. The company is best known as the world's largest independent provider of FAA-approved engine and component parts through its Flight Support group.

A decentralized vehicle for cash generation
"*We are not an aerospace company, but a vehicle that generates strong cash flow, and we do it through aerospace parts and technology*." – Larry Mendelson.

As an accountant at Arthur Andersen, Larry learned the importance of cash flow early. His boss at the time had a mantra that said, "*GAAP is crap*" and "*the key is cash flow*." He also learned that he needed high margins to get the cash flow. According to Larry, "*most industrials run on an 8% margin;*

in other words, they need to invest 92 to get eight. But, compared to HEICO, with a 25% margin; we only need to invest 75 to get 25. It's that simple!".

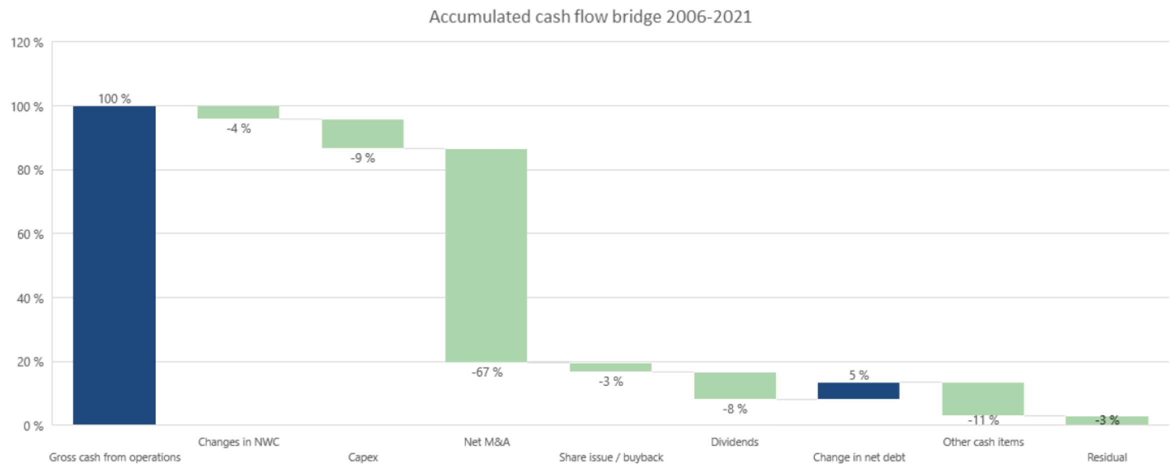
Ultimately it boils down to two central rules that govern everything in HEICO and like-minded organizations:

1. Cashflow is key
2. Don't forget rule number 1

Once they had established a culture rooted in cash flow generation, the next step was a rational capital allocation framework. The core part of the capital allocation strategy has been to buy small niche manufacturing companies, 88 in total, since 1990, between 2006 and 2021, close to 70% of gross cash from operations channeled through their deal machine, adding significant growth at high returns on capital.

Cash flow bridge: Heico

Sources and uses of cash 2006 to 2021



Source: REQ Capital

Besides cash flow and capital allocation, Larry also singled out "*the lack of politics*" as one of the central ingredients for HEICO's success since 1990. As a family-led company—an orientation that runs deep at the top and across the many acquired companies—they avoid the many headaches that predominate most large organizations: conflicts, friction, and slowness.

Moreover, in stark contrast to most large organizations, the family and employees own about 23% of HEICO. As a result, a shift in attitude happens; owner-operators deeply realize that they are managing their own money. According to Larry, "it's our own money; it's not other people's money!". As a result, there is a collective understanding of the alternative cost to every decision; the use of capital comes with a price tag and an easy-to-grasp incentive structure that runs deep throughout the organization.

Furthermore, when personal wealth is at risk, one fully realizes that earnings that don't ultimately translate into free cash flow are not worth much. The importance of cash flow also goes back to acquisitions and deal structure: keeping the acquisition engine going long-term requires self-funded growth. Any organization pulling the M&A lever financed entirely with borrowed money is a disaster waiting to happen, and the graveyard is rich with examples. Hence everything must be rooted in cash flow, and companies like HEICO realize that free cash flow is the ultimate truth teller.

Another critical lesson is organizational structure. A decentralized system is vital for the acquisition engine to keep its cadence of multiple small private transactions. Without decentralization and autonomy within each business unit, the M&A engine breaks down. It's simply too hard to keep an acquisition cadence of 5-10 new companies if not 100, a year if management resources are tied up in integration efforts and micromanaging. Hence, the organizational design for these acquisitive companies is a feature, not a bug.

Summing-up

The focus on cash flow and capital allocation has not gone unnoticed: Net sales of Heico have grown from $26.2 million in fiscal 1990 to $1,865.7 million in fiscal 2021, representing a compound annual growth rate of approximately 15%. During the same period, the company has improved its net income from $2.0 million to $304.2 million, representing a compound annual growth rate of approximately 18%. If you invested $100 000 in Heico in 1990 and reinvested the dividends, the year-end 2022 result of your investment would have been $76 million.

Today's uncertain business climate favors nimbleness, flexible cost bases, and the ownership mentality that only true entrepreneurs demonstrate. Yet, over three decades, the Mendelson family has shown that focusing on cash flow and decentralization has helped escape the bureaucracy that creeps most large organizations.

Sources:

1. Biggest Tanker Ships in the World (marineinsight.com)
2. Conversation with Larry and Eric Mendelson on 2nd of November 2022

Suggested reading material

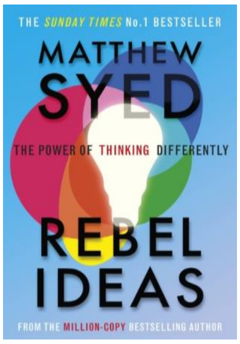
The following books will make you a better investor and are also very inspiring and great for discussing with friends. They also can make you pause and think about life in general. Some books listed below are purely investment-related, while others are more appropriate for dinner conversation.

We believe the best filter while 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 Capital Team

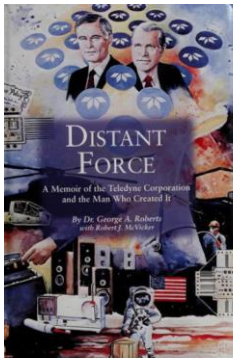
Rebel Ideas by Matthew Syed

The book covers the advantages of outsider views and a wide array of perspectives when making complex decisions. The book is filled with fascinating examples ranging from the CIA's hiring practices to decision-making at Mount Everest's peak. It is important to work with people who think differently. "*A group of wise individuals would almost certainly have become an unwise board*" and "*diverse teams are capable of becoming more than the sum of parts*" sums the whole book.



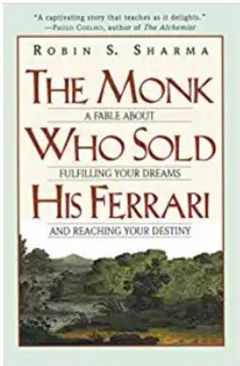
Distant Force by Dr. George A. Roberts

Distant Force is the memoir of one of the US's greatest serial acquirers: Teledyne and its founder Henry Singleton. Through the 1960s, Mr. Singleton built Teledyne into a thriving corporation through small acquisitions. At its peak Teledyne consisted of more than 130 individual profit centers across many fields. Singleton continued through the 1970s with significant share buybacks. More than 90% of outstanding shares were bought back during a short period of a few years. It is a history of an exceptional investor and operator. An investor who invested money into Teledyne achieved an annual return of 17.9 percent over 25 years from 1966, or a 53x return vs 6.7x for the S&P500.



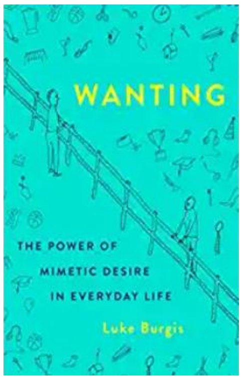
The Monk Who Sold His Ferrari by Robin Sharma

The book is about Julian, who works night and day as a hotshot lawyer. One day he gets a heart attack in the middle of a trial. He survives and leaves his hectic life to become a monk in India. The book is about Julian's spiritual and philosophical lessons from his time with the monks in the Himalayas.



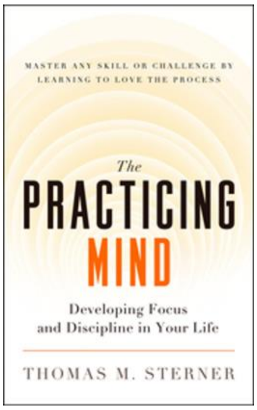
Wanting by Luke Burgis

Luke Burgis draws on the work of Ren Girard, a French polymath who discovered that most of what drives human desire is mimetic or imitative instead of intrinsic. "Humans learn – through imitation – to want the same things other people want, just as they learn to speak the same language and play by the same cultural rules." The book makes one reflect on what drives desire and wanting at a personal level in all walks of life.



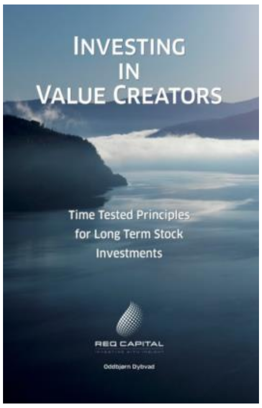
The practicing mind by Thomas M. Sterner

The book covers the power of process and patience in any endeavor. Focusing on practicing a task instead of focusing on the goal makes it easier to maintain motivation and carry on. Mr. Sterner argues that focusing on process instead of the goal you tend to live in the moment, with all its advantages, instead of the distant future.



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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