# Investing with Insight

# Half Year
# Investment Report 2023

**July 2023**

REQ
INVESTING WITH INSIGHT

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# 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.

REQ manages two distinct funds: REQ Global Compounders and REQ Nordic Compounders.

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. The portfolios consist of acquisition-driven compounders – companies that have the acquisition of smaller private firms at the heart of their strategy. These organizations excel at identifying, negotiating, and completing acquisitions in private markets at highly attractive valuations.

At REQ, our primary objective is to deliver best-in-class long-term performance for our investors, which is achieved through a combination of rigorous fundamental analysis and in-depth qualitative research. We firmly believe that long-term investing success hinges upon investing in the right people, ownership structures, and organizational cultures. Our unique partner-owned corporate structure enables us to develop funds that are optimally designed and structured to yield the best possible long-term returns for our clients.

We are committed to fulfilling our promise of investing in the top compounders that will generate substantial value for our investors.

Thank you for your trust and support.

The REQ team

## REQ Global Compounders

REQ maintains a conviction that long-term shareholder value stems from consistent value creation. We invest in businesses that demonstrate the capacity to reinvest capital at high rates of return over extended durations. We refer to these companies as "compounders," as they are known for generating substantial cash flows and profitable growth. This growth often stems from a combination of organic development and smaller strategic acquisitions, also known as bolt-on acquisitions.

In the first half of the year, the portfolio companies exhibited robust performance, as indicated by significant earnings and cash flow growth. This impressive trajectory did not escape market attention and as a result, the fund's A-class shares in NOK appreciated by 34.6% during this period. Since the fund's inception in June of 2021, the A-class shares in NOK is up 25.0%.

Despite these developments, alterations to our portfolios have been minor to date. The most significant adjustment in the Global portfolio was the addition of Lumine Group, a spin-off from Constellation Software. In conversations with Lumine`s CEO, David Nyland, we have noticed strong parallels with Mark Leonard, the founder of Constellation Software. We particularly noticed a strong commitment to organic growth, and they presented an impressively extensive pipeline of potential acquisitions. Typically, we love to invest in companies like these, which are in the early stages of developing large, diversified portfolios. However, we mandate that such companies are self-financed through cash flow and led by management with a proven track record of success.

Year to date, we have observed continual robust growth across our portfolio, driven by organic growth and acquisitions. In total, our portfolio companies announced 126 transactions in the first half of the year. Notably, three of these transactions, which were more significant than our typical small, private transactions, warrant further discussion.

First, Heico, a US-based aerospace and electronics firm, completed its most substantial investment to date by acquiring Wencor at a 12.9x EBITDA multiple, notably lower than Heico's own multiple. Wencor is expected to contribute a significant 24% to Heico's EBITDA.

Second, Momentum Group, another portfolio holding, purchased 93.7% of Askalon AB from the Warnqvist family, who has held ownership for 50 years and will retain the remaining shares. Askalon's acquisition, larger than our usual deals, represents 18% of Momentum Group's sales. However, the transaction has promising prospects, given Askalon's growth from sales of 30 million in 1997 to 320 million today.

Lastly, in June, Addnode announced the acquisition of Team D3, an esteemed partner of Autodesk. This move aims to enhance Addnode's market presence in the manufacturing and power sectors in the Midwest US region. Despite the sizable purchase price, we project the acquisition to contribute significantly to Addnode's top line and EBITA.

Large-scale acquisitions such as these are exceptional in our portfolio. Our assessments of these deals rely heavily on the means of funding and the track record of the involved management. We appreciate when companies can finance such deals internally and when the management has consistently secured attractive smaller deals over the long term, as has been the case with the transactions mentioned above.

## REQ Nordic Compounders

REQ Nordic Compounders follows a bottom-up investment process based on three core principles of the REQ investment philosophy: 1) capital allocation, 2) decentralization, and 3) people. We have made minimal changes to the portfolio so far this year, as the criteria for new companies to enter the fund are quite stringent. As of June 30th, the portfolio consists of 22 holdings.

The REQ Nordic Compounders fund was launched on January 25th, 2022. We believe that 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 focuses on investing in Nordic-listed compounders that pursue acquisitions, reinvest their capital, and generate strong returns over long periods. We adopt a generational perspective when it comes to our investments.

During the first half of this year, the companies in our portfolio demonstrated robust performance, as evidenced by significant growth in earnings and cash flow. This positive performance is also reflected in the strong performance of the fund's A-class shares, which appreciated by 37.6% during this period. Since the fund's inception in January 2022, it has grown by 19.1%.

During the month of June, our portfolio companies announced 16 transactions, bringing the total number of announced transactions to 70 so far this year. We have observed several transactions announced outside of the Nordics, demonstrating the fund's diversity in terms of revenues. Roughly half of our portfolio companies' revenues come from outside of the Nordics.

Despite the persistently challenging market conditions and uncertain outlooks that continue to be 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. At the heart of their success lies their ability to cultivate enduring business-to-business relationships, which often revolve around the provision of mission-critical consumable products and service agreements. These products and services exhibit resilient characteristics, remaining in demand even when budgets undergo recalibration. Crucially, some of these agreements possess contractual elements that generate recurring cash flows, fostering a self-funded approach to both organic growth and acquisitions.

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

## 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 higher 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 ones 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 represent an ongoing battle with temptations and difficult tradeoffs.

The book "Billion Dollar Lessons" has a chapter on deflated rollups, companies rolling up a single vertical of companies geographically or across borders. The author shares plenty of case studies documenting when these rollups failed, lessons from which we can all learn. 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. Hence, the best acquisition-driven compounders often take a religious approach to decentralization, treating the underlying business units as actual owners and giving them a high degree of autonomy, sacrificing efficiency gains.
Brent Beshore, CEO of Permanent Equity, once shared a fascinating glimpse into the ups and downs of integrating small businesses[1]:

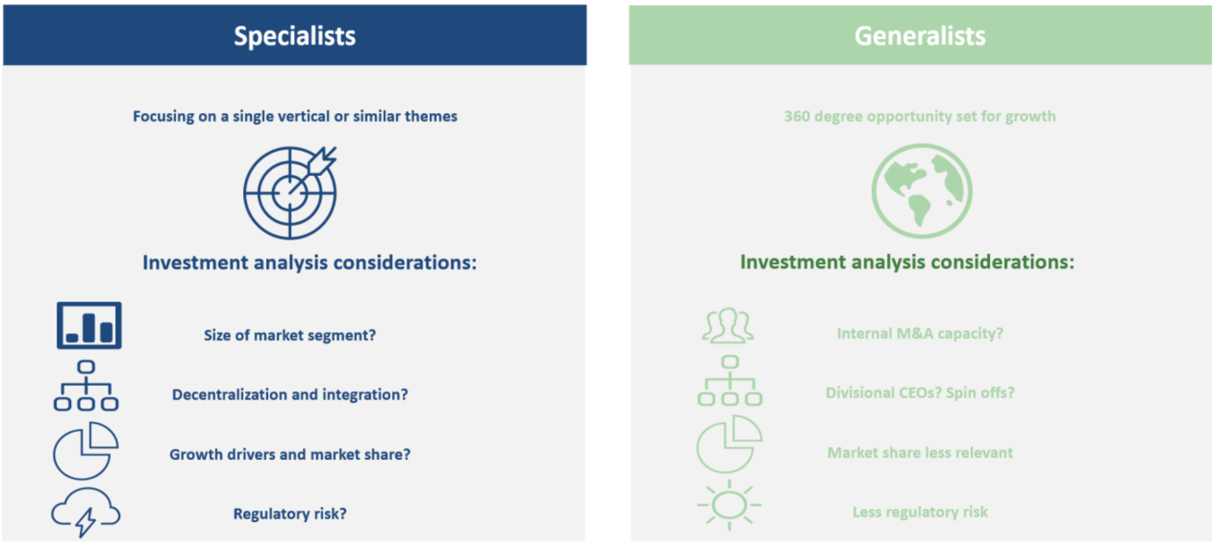
"All businesses internally is a disaster . . . Almost every operator I know is just trying to go as hard as they can, and you're putting your finger in the leaks and working your tail off all day long . . . If you're putting your head down and you're a founder dominant organization with very little scale, 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 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.

**Specialists and Generalists**

Rollups tend to receive much attention, perhaps due to some spectacular failures over the years. For classification purposes, plenty of excellent and detailed frameworks exist[2]. To keep it simple, we find it helpful to split acquisition-driven compounders into two broad buckets: **specialists and generalists**.




The first type of specialists comprises rollups; as mentioned earlier, these vehicles typically operate with high operational integration, often chasing cost synergies and efficiency gains at the expense of entrepreneurship and autonomy in the underlying companies.
The second type of specialists are those honing in on multiple verticals with recurring characteristics. Multiple verticals expand the growth runway while allowing for domain expertise like a rollup. Among those in the second group we like best, synergies are often welcome but not forced, an important distinction recently highlighted[3] by Fredrik Karlsson, former CEO of Lifco (now CEO of Röko):

"It's really difficult for some people to understand what decentralization is because they've never experienced that, so they ask about synergies all the time. And it's very difficult to tell them we don't care about synergies. If they come, they come, but it's not why we invest in the company. We buy good businesses."

**The Generalists**

The generalist bucket allows for even more flexibility. Viewed from the outside, they seem to focus on specific niches; in practice, however, they are 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 which does not belong in the other two boxes (dental and demolition & tools). Similarly, with Lagercrantz Group 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 returns.
Yearly gatherings and academies sharing best practice on pricing, working capital, and numerous other things help generate organic uplift – an important 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.

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, as per Niklas Stenberg, CEO of Addtech[4]:

"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."

**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 single 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 becoming 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. Similar story with Lagercrantz Group when Jörgen Wigh joined as CEO in 2006; he came in with fresh eyes and saw that value-add distribution of electrical components and telecom had declining margins. Based on this insight, Lagercrantz Group 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:

"Underperforming companies are mostly worse than they look, and good companies are mostly better than they look. We don't have the management time to buy underperforming companies and are not superheroes to change them. We are not a PE turn around company. We are in the technical trade. We love people. We love customers. We like to build." - Ulf Lilius, CEO of Momentum Group

**Structure, Cooperation, and Entrepreneurial Energy**

Back to Jörgen Wigh, the CEO of Lagercrantz Group, who recently emphasized a perspective on synergies that we are particularly fond of; synergies in the form of injecting energy and structure[5]:
"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."

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**

We are cautious with pure rollup structures, companies rolling up a single vertical with high operational integration and chasing synergies. Instead, we focus on generalists and specialists with domain expertise across specific verticals with common themes. We prefer vehicles with an industrial mindset and a self-funded route to value creation. The flexibility that both buckets represent creates more of an opportunistic approach, with a small team at headquarters aiding divisions with business development and fostering a culture rooted in entrepreneurship.

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. Brent Beshore at Invest Like the Best podcast
2. Scott Management / Demesne Investments / Canuck Analysts / Redeye
3. Redeye panel with Fredrik Karlsson and Magnus Söderlind
4. Carnegie Trading Companies Seminar 2022
5. 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.

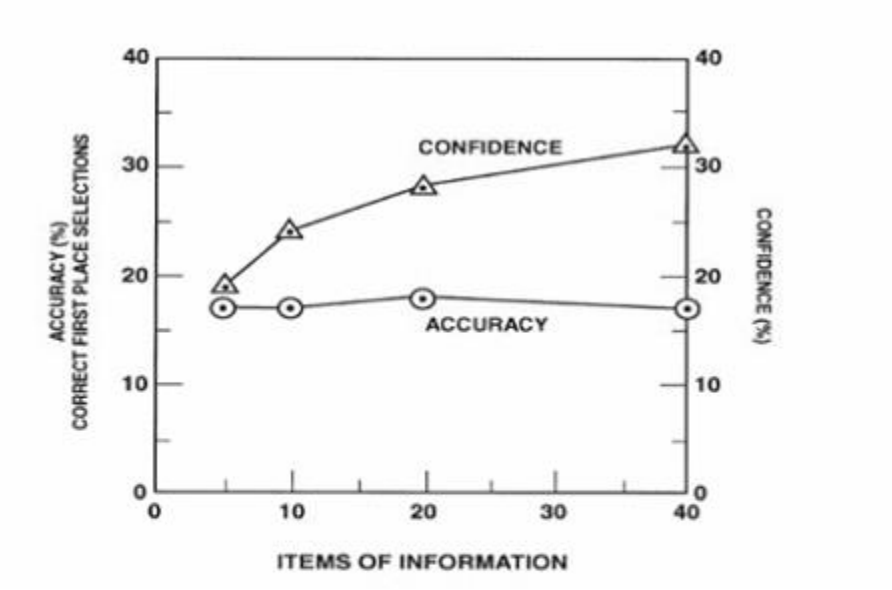
**In Conclusion**

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 (31st of May 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.

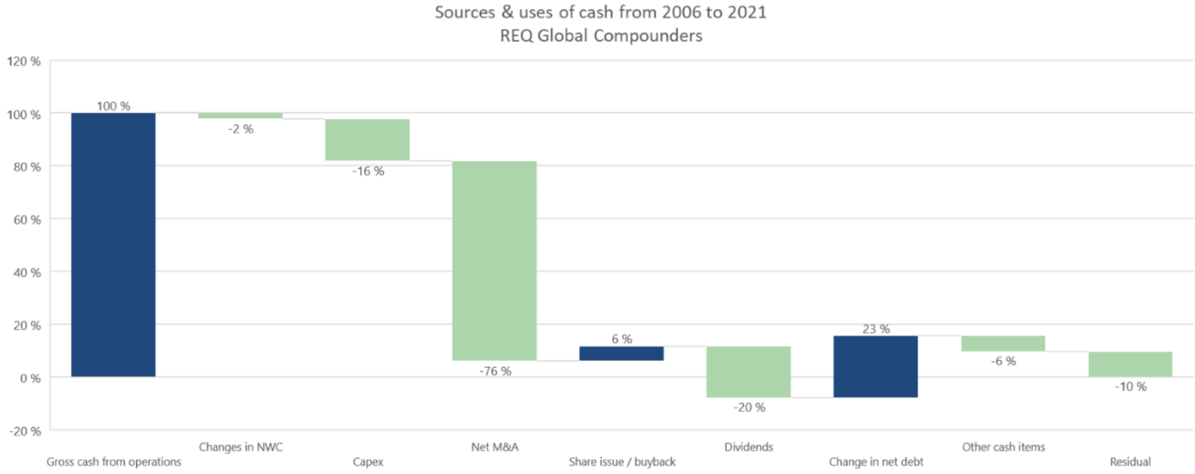
## Finding Outstanding Capital Allocators

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.

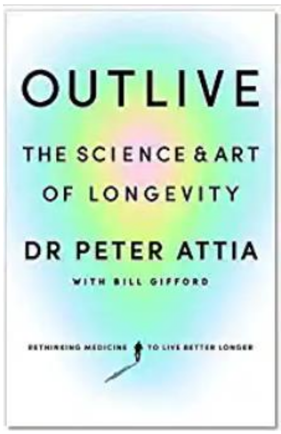
## Suggested Reading Material

The following books and speeches 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!".

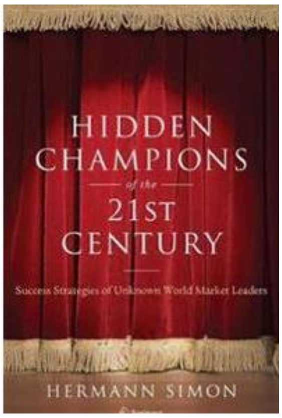
The REQ Team

## Outlive by Peter Attia



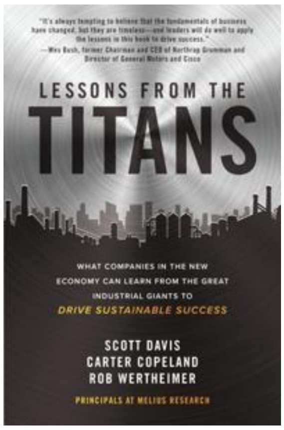

As long-term investors we focus on durability and longevity, not only in the investments we underwrite, but also as human beings. "Outlive" by Peter Attia is a powerful book about prolonging a healthy life. It promotes proactive prevention of chronic diseases, naming four key areas: metabolic syndrome, cardiovascular disease, cancer, and neurodegenerative diseases. It emphasizes regular exercise and emotional well-being as key components of a longer, healthier life.

## Hidden Champions by Hermann Simon




Hermann Simon's "Hidden Champions of the Twenty-First Century" explores niche, often family-owned, B2B companies that dominate their sectors. These "hidden champions" focus on specialization, global reach, high-quality products, and strong customer relationships. Their narrow, essential niches offer economic resilience and deter competitors, while their adaptability encourages a dynamic entrepreneurial culture.

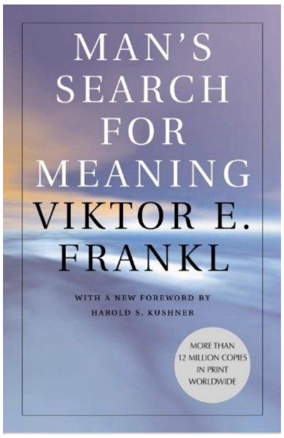
## Lessons from the Titans by Scott Davis, Carter Copeland, and Rob Wertheimer




This is a fascinating book about what companies can learn from the old-fashioned principles of successful industrial titans: there are no secrets, but continuous improvement, benchmarking and decisions based on facts and data, disciplined investment and solid business systems. “Companies usually fail because of the arrogance of a complacent management team, not because they struggled to predict the future.” A book about fostering a humble culture that encourages continuous improvement, focus on cost, and disciplined capital allocation.

## Man`s Search for Meaning

Viktor Frankl, a psychiatrist, shares his harrowing experiences in Nazi death camps and imparts valuable lessons for spiritual resilience in his memoir, "Man's Search for Meaning." Enduring the horrors of Auschwitz and three other camps from 1942 to 1945, Frankl tragically lost his parents, brother, and pregnant wife. Drawing from his own ordeal and the subsequent treatment of his patients, he contends that while suffering may be inevitable, we possess the power to choose our response, discover significance within it, and forge ahead with renewed determination.



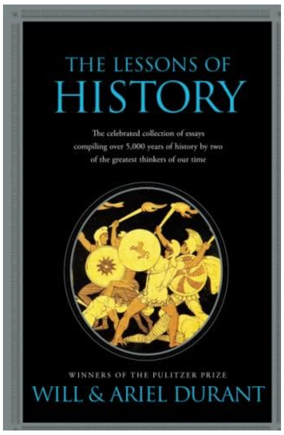

## "Failures of Kindness" by George Saunders

In his commencement speech*, George Saunders reflects on his life and regrets, ultimately concluding that his biggest regret is "failures of kindness." He encourages the audience to prioritize kindness and love, recognizing that it can be difficult but is ultimately worth it. He suggests various ways to cultivate kindness, including education, art, prayer, and meditation, and urges the audience to seek out these remedies for selfishness throughout their lives.

*https://jamesclear.com/great-speeches/failures-of-kindness-by-george-saunders

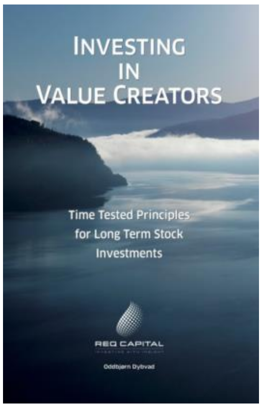
## The Lessons of History

Durant distills centuries of human history into some short, engaging chapters. Though brief in length, "The Lessons of History" serves as a timeless reminder that understanding the past is essential for understanding the present. Durant examines recurring themes such as war, religion, and economics and explains the nature of human behavior.



## 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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