Lessons from Acquisition-driven Compounders

Systems for Durable Profitable Growth and Entrepreneurship

REQ CAPITAL

INVESTING WITH INSIGHT

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Lessons from acquisition-driven compounders

Value creation drives long-term shareholder performance. We seek to find companies that can reinvest capital at high returns over time. These compounders generate strong cash flows and shareholder returns.

The cornerstones of our investment philosophy are "capital allocation," "decentralization," and "people." Finding outstanding capital allocators who decentralize their business and act like true owners is critical to achieving strong long-term returns as investors. Below you will find some of our perspectives regarding our strategy's three cornerstones.

We want to invest in management teams that are outstanding capital allocators. When we find CEOs highly competent in human and cultural aspects and capital allocation, we pay close attention to them. Capital allocation significantly impacts a company's value creation and, therefore, the stock return.

REQ Capital manages two ultra-long-term, unconstrained, concentrated equity funds. Both funds invest in listed companies that repeatedly generate high free cashflows, have proven capital allocation skills, and have a track record of creating substantial shareholder value. The 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.

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1 Capital allocation

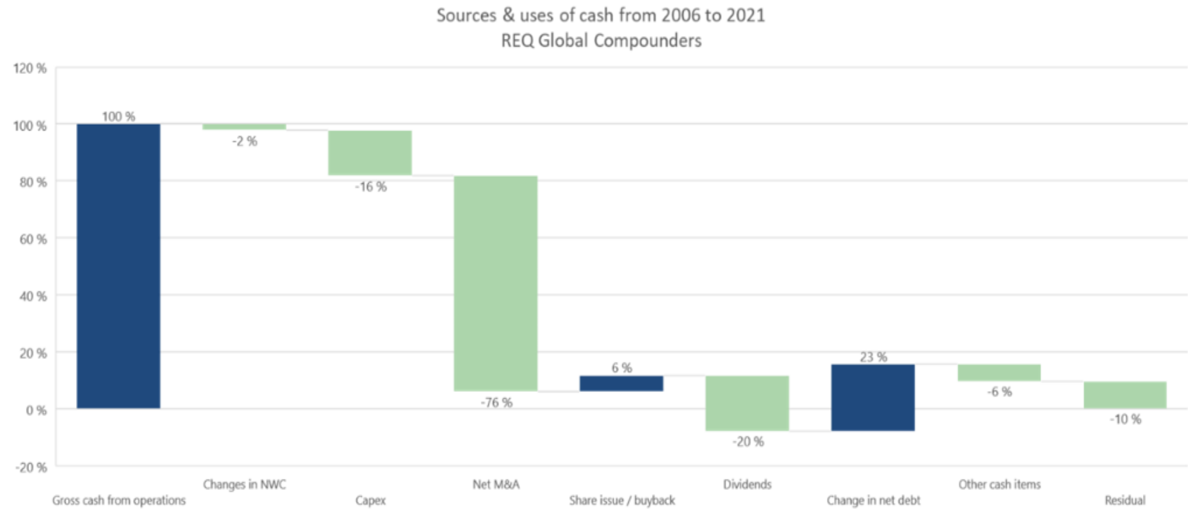
1.1 Finding Outstanding Capital Allocators

Our investment philosophy is based on investing in value creators, companies that can reinvest a significant portion of yearly cashflows 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 substantial 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 significant 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 combined aggregated cash from operations after taxes and interest payments for all our companies.



Working capital
We invest in asset-light companies with limited working capital needs. Only 2% of the cash from operations is deployed as 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 needs, 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. We find this highly attractive as a 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 the acquiring firm's shares. 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.

1.2 Capturing private market opportunities

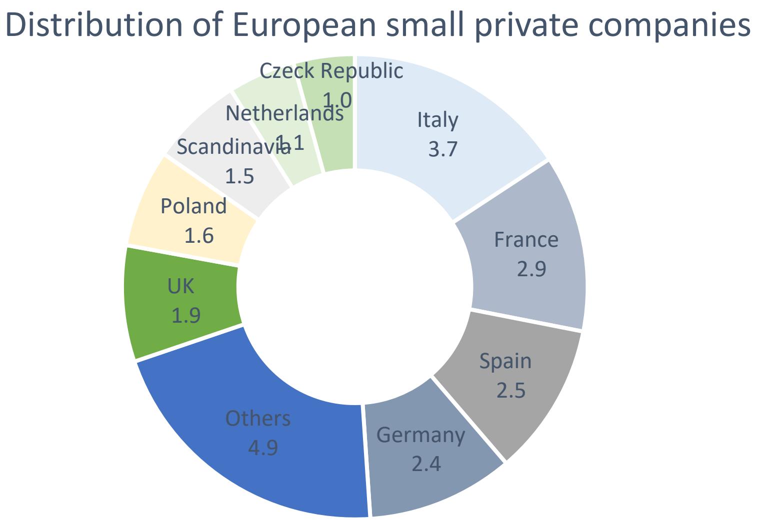
Our investment philosophy is to own companies with a persistently high return on capital against a long growth runway.

Many publicly listed acquisition-driven compounders share these characteristics. We believe that the market underestimates our investments' "duration" aspect because the opportunity set of future acquisition targets is so large. We believe the best acquisition-driven compounders 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 acquisition-driven compounders 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 acquisition-driven compounders. 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 acquisition-driven compounders. 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 acquisition-driven compounders. 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

Acquisition-driven compounders 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:

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- "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 the three-year average for 2019-2021
- "Made in Italy" How culture and history have shaped the 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/

1.3 The three essential investment ingredients

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

High return on capital

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

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

Durability

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

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

Business model certainty

There are many companies that have long track records of profitable reinvestments and high return on capital that we would never invest in. The main reason is that the business models are too uncertain, meaning that the success is basically based on one product, one customer or one end-market. We pass on investing in these companies even though they often have a solid financial track record regarding profitability and cash flow generation. External factors beyond management's control create a risk profile that we don`t like. Regulatory risk is often a key risk factor, and it is nearly impossible to know whether success is based on a "megatrend" or company-specific factors.

We prefer companies that control their destiny and are willing to pay up for that certainty.

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

1.4 A special skillset in capital allocation

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

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

Value creation through small private acquisitions
In private markets, there is a lot of information asymmetry and often less market liquidity. Private markets are structurally inefficient, leading to permanent differences between public and private valuation multiples. After decades of M&A practice, some companies are well-positioned to exploit these valuation differences.

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

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

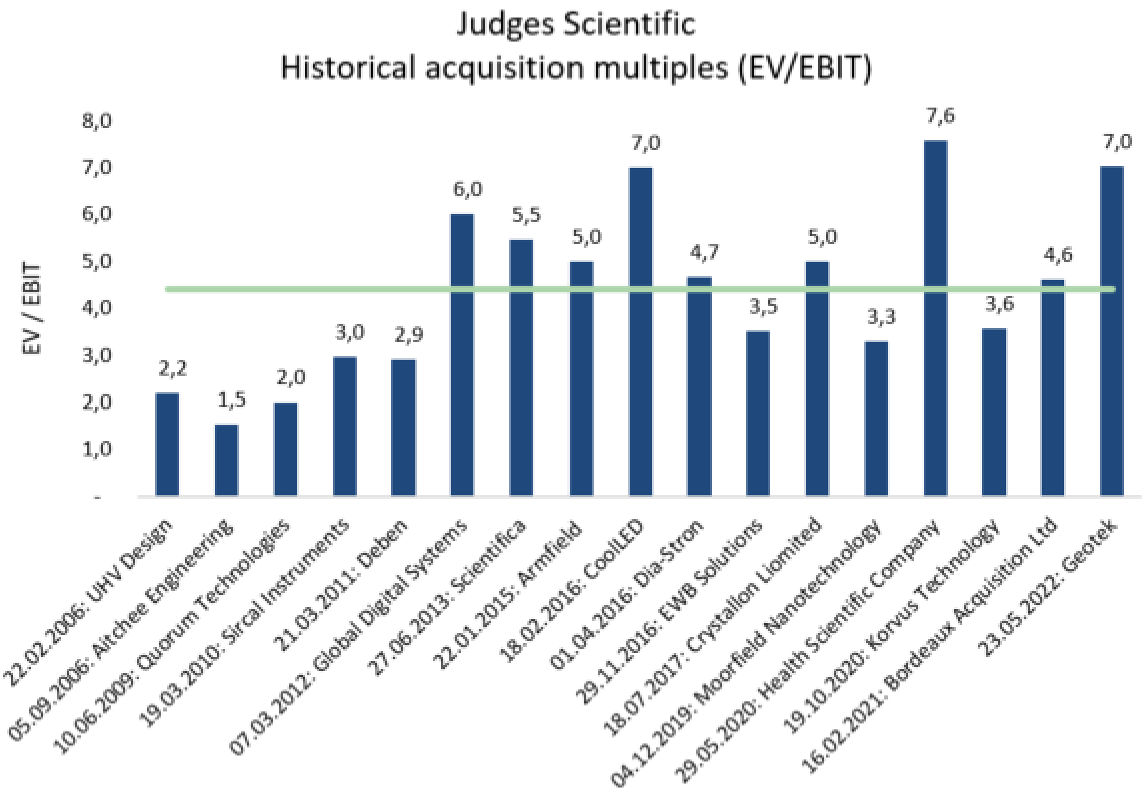
On the other hand, the traditional private equity approach is to buy a broken business at low multiples and turn the company around to achieve multiple expansions at the exit. The “value creation framework” is easy to understand. Strategic corporate buyers also have a different approach from acquisition-driven compounders.

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

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

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

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



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

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

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

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

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

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

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

1.5 Why we favor profitable growth

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

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

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

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

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

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

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

1.6 The value of profitable growth

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

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

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

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

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

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

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

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

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

1.7 The Value of Great Capital Allocation

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

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

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

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

*Return on incremental capital invested

**Growth = ROIC x Reinvestment rate

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

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

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

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

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

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

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

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

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

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

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

1.8 Thriving in Tough Times

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

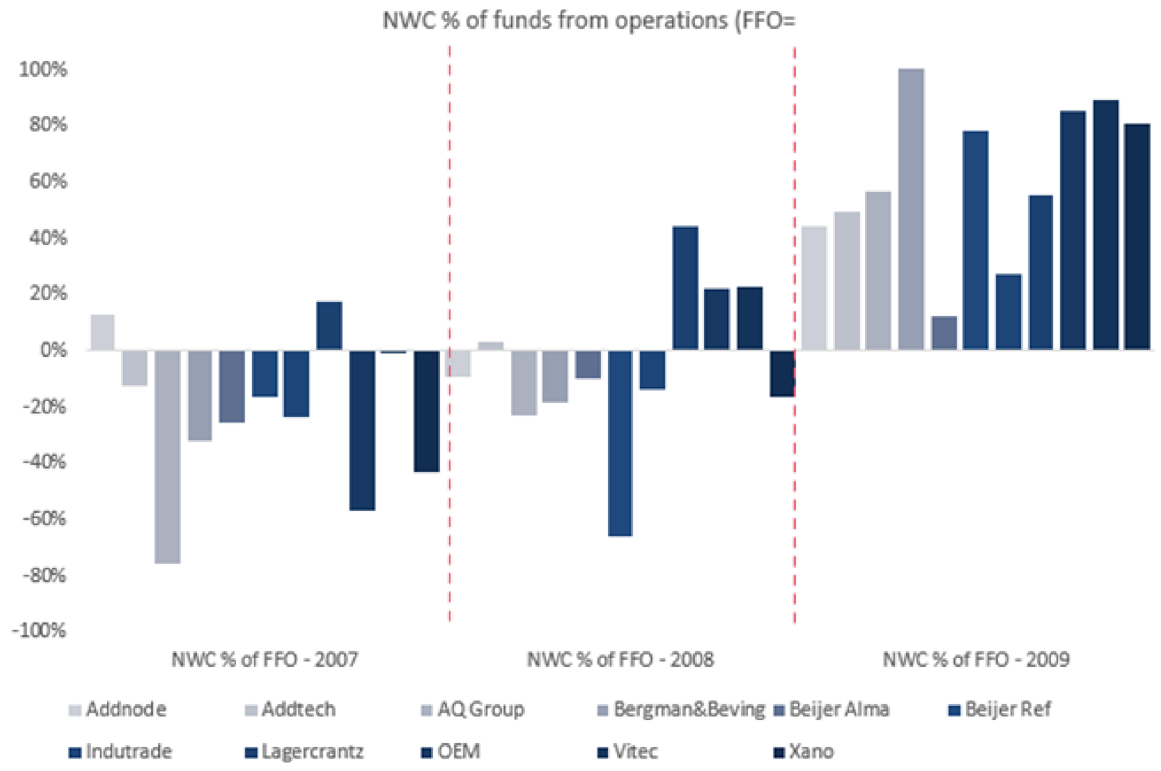
To begin with, the strength of these frequent acquirers often lies in the combined effect of dual growth engines – organic and acquisitions. What do we mean by this? The fundamental model employed by these companies involves acquiring small qualitative specialized private companies, frequently family-owned,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

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

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

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

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



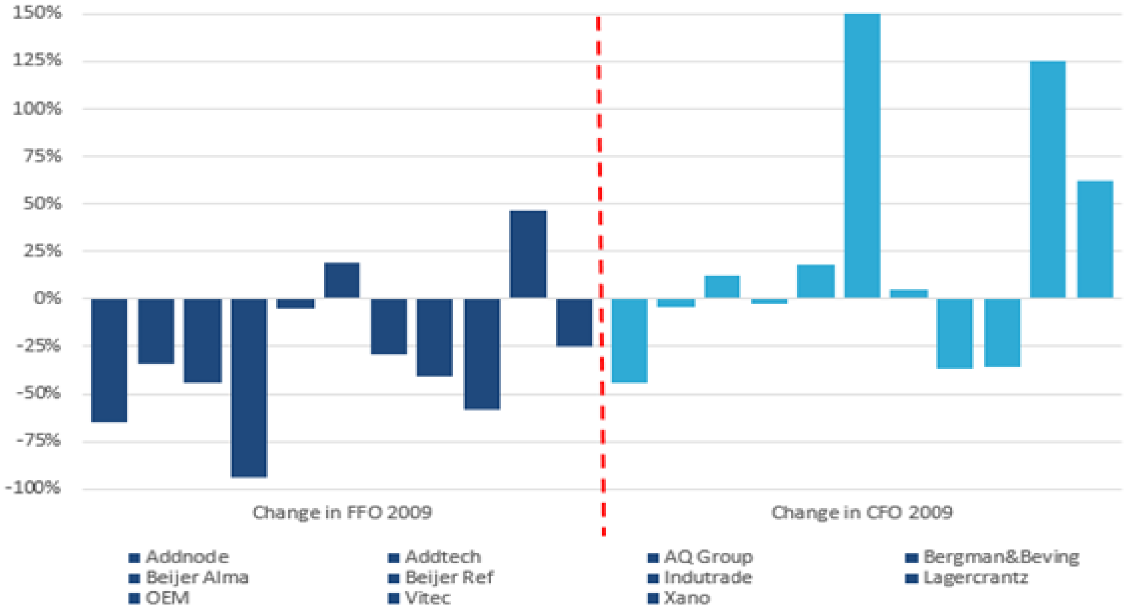
A noteworthy observation from Jörgen Wigh, CEO of Lagercrantz, in a Redeye Q3 interview adds depth to this perspective of the dynamics in play:

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

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

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

As seen by the chart, many companies maintained overall good cash flow:



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

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

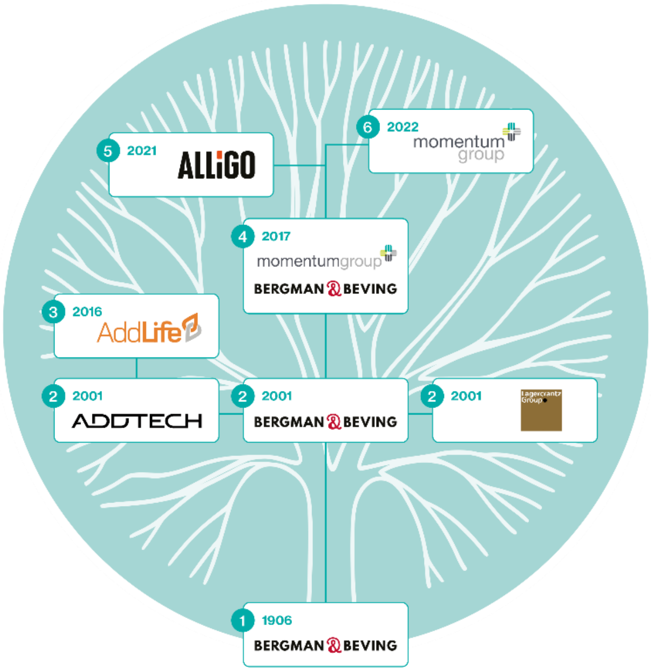
Disclamer: REQ Capital holds positions in several of these companies

1.9 The Superinvestors of Bergman & Bevingsville

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

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

[1] https://www8.gsb.columbia.edu/sites/valueinvesting/files/files/Buffett1984.pdf



Copyright: Momentum Group AB

Founded in 1906 by Arvid Bergman and Fritz Beving, Bergman & Beving prioritized decentralization and simplicity. Originally operating as a technical trading company in Sweden, the company implemented a decentralized structure, distributing responsibilities among the original shareholders. The acquisition journey began in 1967 with Lagercrantz, leading to nearly 200 acquisitions by the year 2000, primarily in the 1980s and 1990s. Many of these acquisitions involved family-owned trading companies that continued to operate under their existing names. Significant changes took place in the 1980s and 1990s when Tom Hedelius, the CEO of Svenska Handelsbanken, became chairman in 1982. In 1990, Anders Börjesson from Tisenhult-gruppen became the first external CEO, marking a strategic shift. Börjesson, who had been part of the management team since 1979, had a deep understanding of the organization. This move represented a departure from the company's tradition of having significant shareholder-CEOs.

Even in its nascent stages, the Bergman & Beving Group had a distinct focus on profitability. The organization pursued ambitious growth targets while adopting a profitability benchmark, which involved maintaining profits divided by working capital (P/WC) at levels exceeding 45%. As we will illustrate, this target has not only generated a self-sustaining business model but has also provided steadfast resilience to navigate the vicissitudes of the business landscape since 1906, guiding the collective of affiliated companies through the many ups and down during this period.

The Money's-not-free-approach to Value Creation

The Profit/WC metric was introduced in 1981 when Anders Børjesson joined the management team of Bergman & Beving. Børjesson's exploration of business strategies and industry trends influenced the concept of an asset-light focus, which serves as the foundation for the return on working capital metric. During his studies, Børjesson discovered the benefits of an asset-light approach commonly used by successful entrepreneurs. This approach became particularly relevant for privately held firms facing a wealth tax on their net assets. Børjesson drew inspiration from entrepreneurs like Ingvar Kamprad (founder of IKEA) and Erling Persson (founder of H&M), who had successfully navigated similar challenges by adopting an asset-light strategy. Motivated by their experiences, Børjesson further explored and implemented the asset-light focus, leading to the development and utilization of the EBITA/WC ratio[2].

Addtech, along with Lagercrantz, was spun out from Bergman & Beving in 2001. They have their own internal book called "The Mind and the Soul" (translated as "Tanken och själen" in Swedish), which outlines the company's fundamental business principles. This book is distributed to all employees and is relatively short, consisting of approximately 80 pages. Its purpose is to explain the company's culture, strategy, and how value creation is implemented at Addtech. The book is written in a way that every employee can understand, providing practical examples to illustrate the fundamental principles. One key focus is the P/WC metric, which demonstrates how every Addtech employee can contribute to returns.
Similarly, Momentum Group has its own book called "Entrepreneurship to Achieve Increased Profitability - Objectives and Tools to Achieve P/WC > 45%" (translated from Swedish to English). This book is an easy read of 45 pages.

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

Originally, the goal of exceeding the 45% target was set during a period when tax rates were higher. It was meant to cover one third tax, one third dividends, and one third growth (15% yearly growth measured over a business cycle, split between organic growth and acquisitions). In other words, each dollar spent in working capital must yield a return of better than 45%.
To analyze whether aiming for a target of 45% or more results in a self-sustaining business model, let's consider a scenario with no debt, a 20% tax rate, a payout ratio of 30%, and a 15% growth target. Half of the growth is acquisitive, requiring a 5x EBIT multiple paid, while the rest is organic. It is important to note that this analysis assumes no maintenance capex, only investments in working capital for growth. This exercise supports the idea that a 45% investment in working capital can indeed create a self-sustaining business.

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

Why use working capital instead of invested capital in the denominator? A trading or value-add distribution company, like those under B&B, primarily relies on working capital rather than fixed assets, which are often outsourced. This is why Profit over working capital serves as a suitable proxy for trading companies and an effective measure of overall capital return.
The P/WC ratio can be divided into 2 main parts, which can be further broken down into 6 distinct metrics: 3 metrics related to the profit (numerator) - sales, price, and cost base, and 3 metrics tied to the denominator (WC) - inventories, receivables, and payables. Profit can be calculated by dividing EBITA (Earnings Before

[2] Acquirers.com: Bergman & Beving to Addtech, a best-in-class serial acquirer and the book: Tisenhult – Grundaren, familjen och foretagen (Ekerlids)

Interest, Taxes, and Amortization) by Sales and then dividing that result by Net Working Capital. This simplification occurs because the "Sales" term cancels out when multiplying the two fractions together.

Profit is determined by the formula: Profit = (EBITA / Sales) x (Sales / Net Working Capital)
This can be further broken down to: Profit = (Sales x Margin) - Cost x Inventory + Receivables - Accounts payable
Let's apply this with another example. Suppose we have Company A generating 9% operating margins, which is typical for a trading business, offering value-added services to customers. Additionally, the business maintains a net working capital of 20, resulting in a P/WC ratio of 45%. To boost the profit ratio, there are six levers to consider. You can either increase sales, raise prices, or reduce costs. Each lever affects working capital differently, and the same applies to the working capital, which is the denominator in the P/WC KPI.

The easiest way to decrease working capital is by reducing inventory, speeding up customer payments, and extending supplier payment terms. These are aspects that every senior management team in large corporations focuses on. Employees in the group companies are encouraged to foster strong relationships with the right customers and suppliers and to have a solid grasp of inventory levels. Essentially, this framework both educates and heightens awareness about excelling in sales. It imparts valuable lessons on prioritizing customers, nurturing relationships following the 80/20 rule, adopting value-based pricing, and comprehending the consequences of providing discounts. These last two choices can result in significantly divergent cash flow outcomes.
Let`s focus on the working capital lever and more specifically receivables. Suppose a new company becomes part of the group, Company B, which historically hasn't been mindful of receivable days. After joining the group, they discover that similar companies in the group typically have receivable days of only 50, not 73. By reducing their receivable days, P/WC increases to 65%, resulting in a favorable impact on cashflow when growing and hence the ability to be self-funded[3].

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

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

The Focus Model

[3] It's worth noting that while both margins and turnover have a similar impact on the profit-to-net working capital ratio, increased margins have a more significant effect on cumulative cash flow compared to equivalent increases in capital turnover.

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

The Focus Model for Different EBITA/WC levels is as follows[4]:

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

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

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

[1] https://www8.gsb.columbia.edu/sites/valueinvesting/files/files/Buffett1984.pdf
[1] Acquirers.com: Bergman & Beving to Addtech, a best-in-class serial acquirer and the book: Tisenhult – Grundaren, familjen och foretagen (Ekerlids)
[1] It's worth noting that while both margins and turnover have a similar impact on the profit-to-net working capital ratio, increased margins have a more significant effect on cumulative cash flow compared to equivalent increases in capital turnover.
[1] From presentation material by Momentum Group AB

2 Decentralization

2.1 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.

[4] From presentation material by Momentum Group AB

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 acquisition-driven compounders 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.

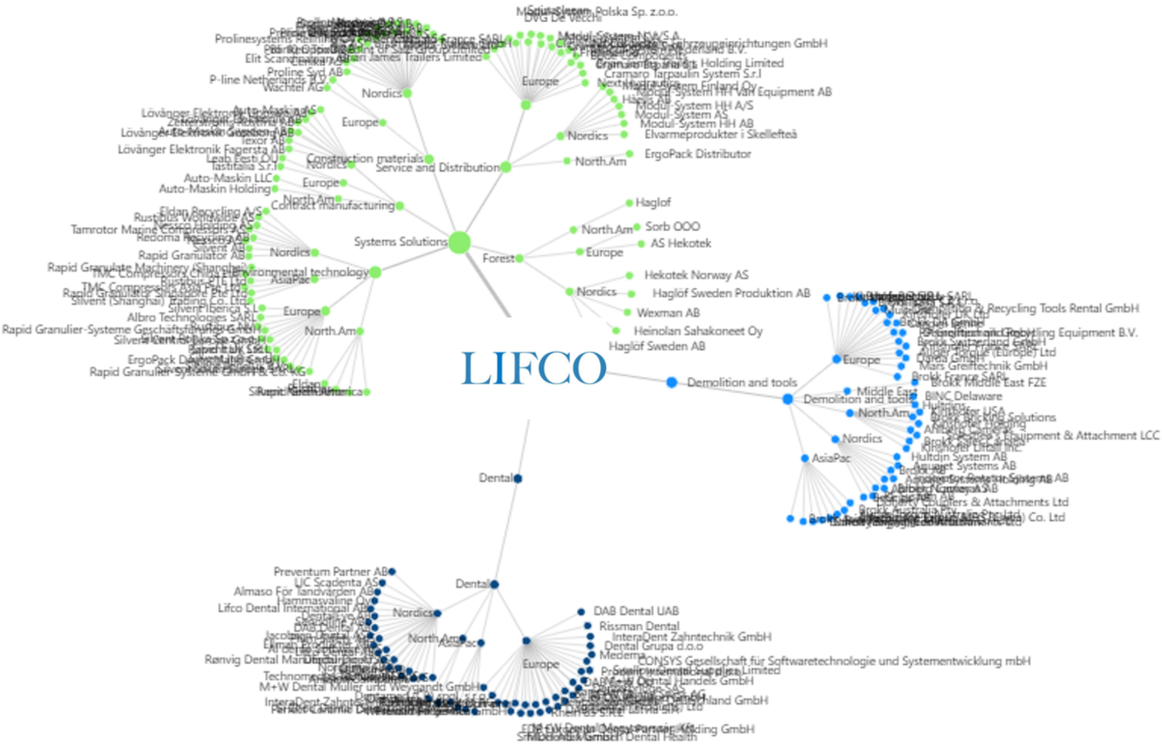
Teledyne

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 acquisition-driven compounders 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.

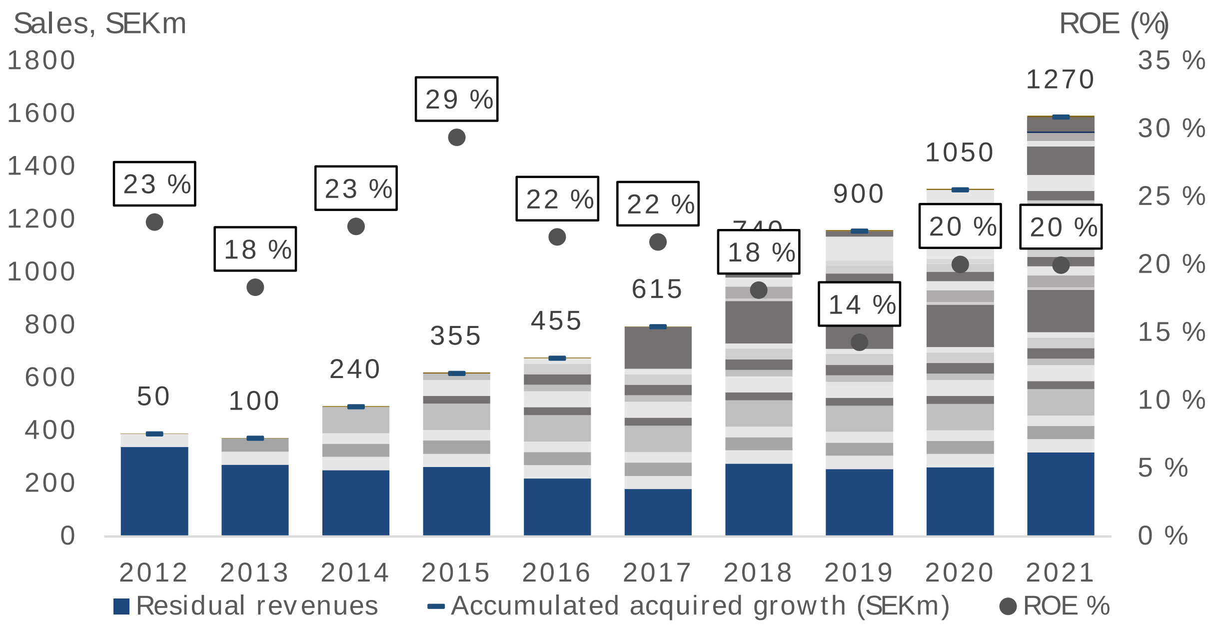
Sources:

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)

2.2 Acquisition-driven compounders: Which to avoid?

We invest in acquisition-driven compounders, a group of companies that follow a specialized business model where they acquire companies through a programmatic M&A strategy. Programmatic M&A is a high-frequent pace of small-to-moderate sized deals, as opposed to the traditional, larger, and more infrequent mergers and acquisitions. The companies we invest in grow organically in a profitable way, but programmatic deals create an extra engine of growth.

The chart below shows the annual revenue and return on equity of Swedish software company Vitec. The grey bars represent the acquired companies' revenues per year, assuming that all acquired companies maintain their revenues at the level at the time of acquisition and that all acquisitions take place on January 1 of each year. Vitec has acquired over 30 software companies in the last ten years, each averaging ~3% of annual revenue. Residual revenues are understated in the chart below due to the assumed timing of revenue recognition of acquired growth, but it is still quite interesting to see that the company has experienced a 17% CAGR in total revenues over the last several years, while ROE has averaged 21% over the same period.



The best serial compounders tend to use internal cash flow to fund acquisitions, which is possible as each deal on average only equals 1-2% of the holding company's annual sales. Combined with pricing discipline the deals are earnings enhancing and increase shareholder value.

The best serial compounders acquire private companies at a discount to their own public prices. Acquisition targets are often privately held and too small to attract the interest of private equity firms. Many owners sell for personal reasons due to estate planning, poor health, or other commitments. They prefer to sell their businesses to serial compounders because they have decentralized business models and an open-ended ownership profile, and because they know the acquiring company will not restructure the business and sell it after a few years.

Below is an example of Swedish printed circuit board manufacturer NCAB Group. The company is listed on Nasdaq Stockholm. NCAB Group's growth strategy is based on both organic growth and acquisitions. The company has acquired eight PCB companies since its IPO in 2018, each at very favorable multiples, as you can see in the table below. The market for printed circuit board manufacturers is highly fragmented and a volume play. This allows the company to leverage its size and relationships to obtain favorable terms when acquiring new companies.

"NCAB often collaborates with more advanced factories that are not available to smaller trading companies, which means we can offer the acquired company's customers a broader product portfolio and thereby increase sales"

(Anders Forsén, CFO NCAB Group, 2020 annual report)

Private

	Elmatica AS (Norway, Oct'21)	sas-electronics (Germany, Jun'21)	Prevent PCB (Italy, Feb'21)	Bare Board Group (US, Apr'20)
EV (SEKm)	315	20.5	185	125
EBITA (SEKm)	45	4	30	17
EV/EBITA	7.0x	5.1x	6.2x	7.2x

Public

	NCAB Group AB FY 2021e
EV (SEKm)	16 586
EBITA (SEKm)	387
EV/EBITA	42.9x

When we analyze acquisition-driven compounders, we are selective about the type of companies we invest in. We have identified several characteristics that we believe create value and some that we believe destroy value:

Capital allocation

Acquisition-driven business models, which we generally consider unattractive, make extensive use of equity or debt to fund acquisitions. Some very early-stage companies use equity as a means of financing, but we generally prefer the use of free cash flow. We want growth with high incremental return on capital. Declining return on capital is a sign that the company is paying too much for acquisitions. The companies we own buy companies with high returns on capital. Turnarounds rarely succeed.

Synergies

Our companies generally do not expect synergies from acquisitions. Acquisition decisions are based on stand-alone valuations and should be accretive to earnings without restructuring or synergies. We avoid investing in companies that justify acquisitions by realizing revenue or cost synergies.

Ownership

We prefer family-owned or management-owned companies to those that are purely institutionally owned. The CEO should hold a significant stake in the company to align interests with those of shareholders. Companies that are purely institutionally owned are often run at the sole discretion of management, who in many cases do not even own shares. We avoid investing in such companies because the interests are not aligned.

Management

Management in the companies we are invested in tend not to guide the market on short term earnings expectations. We do not like the earnings expectations game where companies play with sell side analysts and "beat" consensus expectations with a cent every quarter due to earnings (mis)management. We also avoid investing in companies where the CEOs spends too much time attending financial conferences and investor events, as we believe the CEO should prioritize his or her time on running the company and focusing on his employees, customers, and suppliers. If these stakeholders are happy, shareholders will benefit.

Acquisition targets

Since we prefer "programmatic" serial acquirers the acquisition candidates are small private companies. We do not like companies that undertake few and large deals. Larger deals are more complex to carry out, and the due diligence process and integration takes longer. These deals typically carry higher risk. Larger deals also come with higher valuations. Our companies focus on "active sourcing" of deals. Active is when our companies contact private companies directly themselves. Passive is when companies work mainly through M&A advisors who have a mandate to sell a company. Active sourcing leads to better prices for buyers.

Use of M&A consultants

Companies that specialize in programmatic acquisitions develop an in-house skillset for acquisitions. Very few of these companies utilize external advisors when sourcing and acquiring new companies. Not only does this lower transaction costs, but it also speeds up and improves the strategic sourcing of new deals, deal execution, and integration of the acquired companies. We prefer companies that do the financial due diligence of private companies themselves instead of outsourcing the activity to "The Big 4".

Business models

We prefer investing in serial compounders that have decentralized business models. This enables the portfolio companies to focus on running the businesses, rather than on integration processes post acquisition. Senior management in the companies we invest in delegate responsibility to local managers, who know and understand the business, customers, and employees of the local portfolio companies. The decentralized models make our companies more agile and responsive to change.

Conclusion

We strongly believe our strategy of investing in strong programmatic acquirers will serve us well over the coming decades. These companies have an extra engine of growth and carry out acquisitions in a profitable, low risk, manner. We have identified a set of characteristics that we believe differentiates the best serial compounders, and invest in companies that share these traits.

We look forward to being perpetuity owners of these excellent businesses.

Attractive	Unattractive
Free cash flow to fund acquisitions	Heavy use of equity to fund acquisitions
Strong incremental return on capital	Weak incremental return on capital
No synergies expected	Expects synergies
Avoids guidance to the market	Guiding market
Buys demonstrated track records	Buys turnarounds
Prefers to buy private companies	Tend to buy listed companies
Small, frequent tactical acquisitions	Few, large deals
Inhouse M&A team	Frequent use of "M&A consultants"
Founder operators or family owned	Purely institutionally owned

2.3 Trust based business models

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

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

"Being a successful investor is all about picking the right guy or gal. Because as an outsider you can't even know enough to really make an informed decision. You are almost entirely dependent on the abilities of the people you invested behind"
(Barry McCarthy reproduced by Sidecar Capital @sidecarcap)

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

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

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

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

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

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

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

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

2.4 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]:

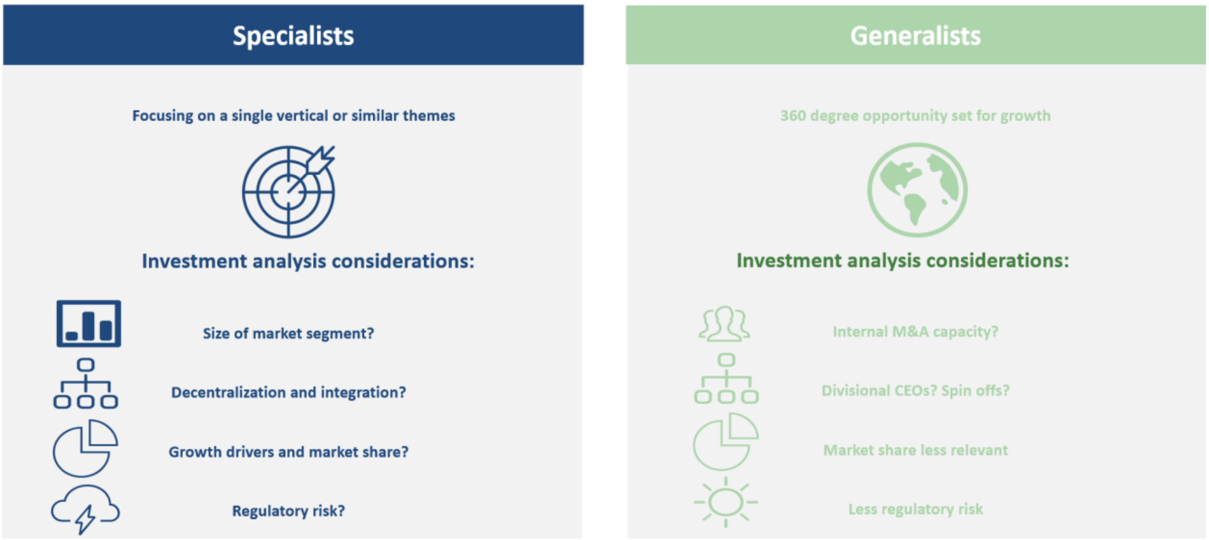
> "All businesses internally is a disaster . . . Almost every operator I know is just trying to go as hard as they can, and you're putting your finger in the leaks and working your tail off all day long . . . If you're putting your head down and you're a founder dominant organization with very little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

1. Sources and further reading:
2. Brent Beshore at Invest Like the Best podcast
3. Scott Management / Demesne Investments / Canuck Analysts / Redeye
4. Redeye panel with Fredrik Karlsson and Magnus Söderlind
5. Carnegie Trading Companies Seminar 2022
6. Serial Acquirers Event March 8, 2023

2.5 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.

2.6 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.

2.7 «When are they running out of companies to buy?»

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

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

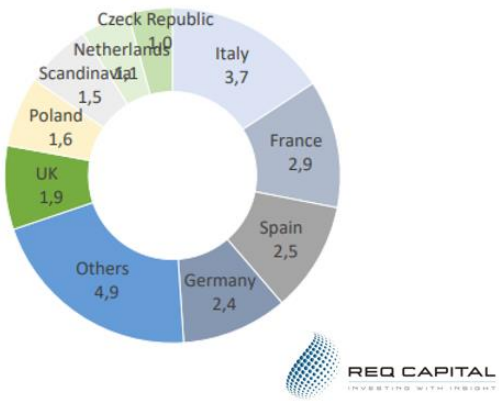
Having that sector-agnostic approach means that these companies have a large pool of companies within many different industries to fish from. Still, questions arise about how many companies there are to buy and how to scale M&A properly to other geographies. We believe that the "duration" aspect of many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

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

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

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

Distribution of European small private companies

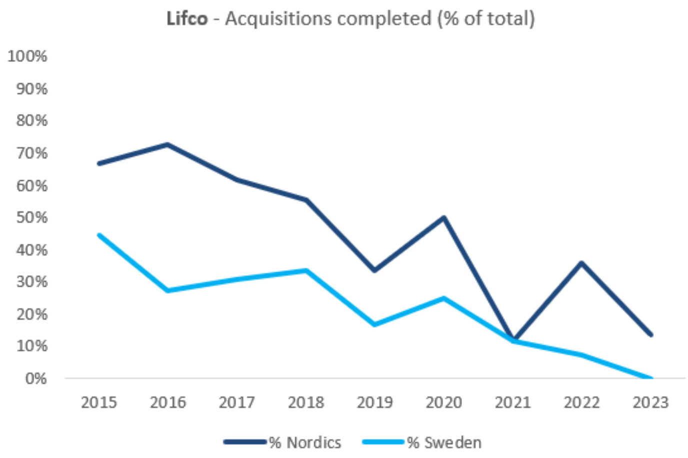


Looking at the larger Swedish generalist acquisition-driven compounders Lifco, Indutrade, Addtech and Lagercrantz, they have together the last 10 years made around 175 acquisitions outside the Nordics, more or less a drop in the ocean compared to the total potential acquisition targets. While Lagercrantz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

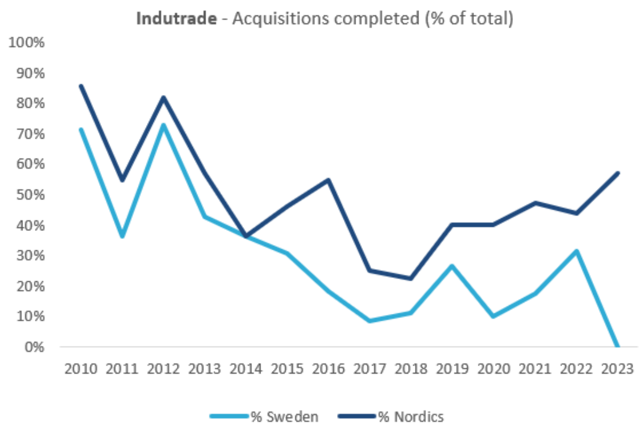
Establishing a stable foundation in their core market (the Nordics) has allowed these companies to gradually expand geographically, while still maintaining their disciplined approach and applying their best practices to M&A.

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

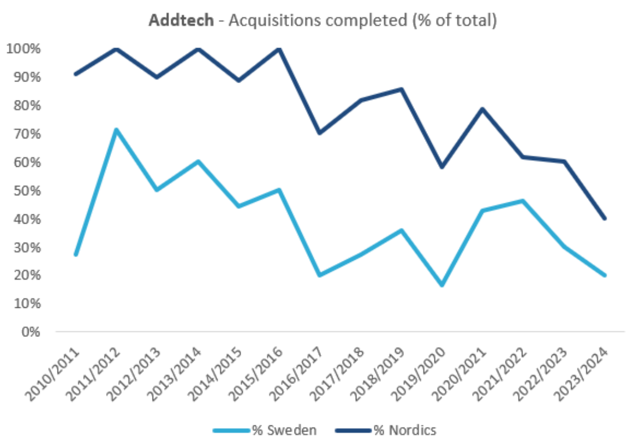
For this reason, it's interesting that these companies have, in recent years, begun acquiring more companies outside the Nordics by building them brick-by-brick and avoiding rushed decisions. Ten years ago, acquisitions in the Nordics accounted for over 70%, compared to the current range of 30-50%.



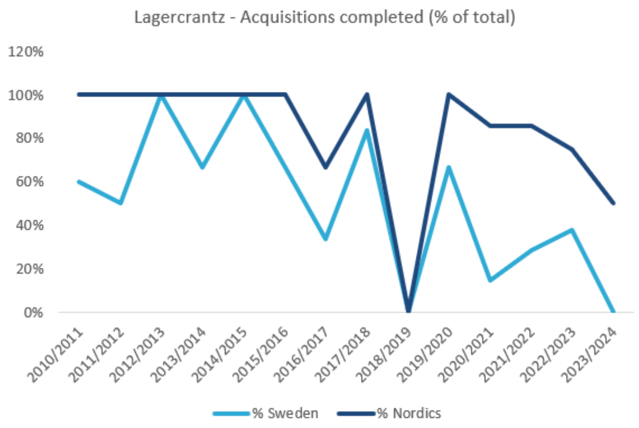
Source: company reports



Source: company reports



Source: company reports



Source: company reports

In summary

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

Sources:

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

2.8 The Swedish legacy of decentralization

Our investment philosophy is built on three key pillars: capital allocation, decentralization, and people. We strive to identify exceptional capital allocators who decentralize their operations and embody true ownership. This approach is fundamental for securing superior long-term investment returns.

Decentralization is an organizational structure where management delegates responsibility down in the organization. This organizational structure is based on the belief that top management does not have all the correct answers about how underlying departments and subsidiaries should deal with products, customers, suppliers, and competitors.

With responsibility comes the power of increased motivation, knowledge sharing, and better customer relations because the decision-makers are close to customers. It is a management philosophy of using the carrot rather than the stick. Our companies operate without the anchor of bureaucracy. Our decentralized businesses have lean corporate headquarters by nature.

We often encounter the question, "Why does Sweden have a significant number of acquisition-driven companies?"

There isn't a single answer but rather several factors that collectively weave a history explaining why Sweden has successfully fostered numerous companies, many of which have thrived on acquisitions spanning decades.

Sweden's rich industrial heritage dates back to the 19th century, with industrial pioneers such as Sandvik, Atlas Copco, Electrolux, Ericsson, Tetra Pak, Asea, and Trelleborg. As a relatively small and geographically isolated country, Sweden quickly adopted trends in innovation and globalization. Many industrial firms initiated their international journeys through acquisitions in the mid-20th century. Companies such as Bergman & Beving (with its first acquisition being Lagercrantz in 1967), Electrolux, and Atlas Copco, backed by financially robust families (like the Wallenberg family), embarked on acquiring companies to grow their operations.

The 1970s witnessed the rise of a decentralized governance model influenced by Jan Wallander, the former CEO of Handelsbanken, and Hans Werthén, CEO of Electrolux. This decentralized corporate governance model was adopted widely, becoming deeply ingrained in Swedish business practices. Inspired by models like Electrolux, Atlas Copco and Bergman & Beving, companies like Indutrade emerged in 1978, founded on similar decentralized principles. The success of these ventures inspired other Swedish companies to adopt similar models, creating a model that proved to be scalable globally.

By the mid-1970s, Atlas Copco, under the leadership of Tom Wachtmeister, began to embrace the decentralized structure:

"The role of Atlas Copco AB as a parent company of the Atlas Copco Group was more closely identified in 1976. As a result of a reorganization which was made in the course of the year, the responsibility for a number of operative functions has been transferred to other companies in the group. /.../ As a consequence of this reorganization /…/, the number of employees in group management functions has been reduced to about 200.

The decentralization has meant that several service functions have been moved closer to the actual users, cost accountability has been linked directly to needs, and the central corporate management has been relieved of several routine matters in order to allow more time for strategic management questions."[1]

Organizational transformation of Electrolux

In his book, "You Don't Sell Any Christmas Trees the Day After Christmas – A Book About Hans Werthén,"[2] Carl Uggla explores the impactful tenure of Hans Werthén as CEO (1967-1974) and Chairman (1974-1991) at Electrolux. Uggla identifies Werthén as an early advocate for decentralization towards the end of the 1960s, a significant shift from the company's previously bureaucratic and middle manager-heavy structure. Werthén fundamentally transformed Electrolux's culture by implementing a decentralized framework, wherein all operational responsibilities were delegated except for acquiring companies, making large capital expenditures (greater than USD 1 million), and purchasing properties.

When Hans joined Electrolux in 1967, one of his first actions was to sell the fancy office in central Stockholm and move to a more outskirt location, while all unnecessary staff at the time was adjusted to a minimum. Budgeting and forecasts were useless in Hans Werthén's playbook, and unnecessary internal meetings closed down. As stated in the book: "*Forecasts are only interesting when you look at them in the rearview mirror*."

Leif Johansson, former CEO of Volvo Group, and at that time 28-year-old Head of Motorbikes at Husqvarna, in the book describes Electrolux's decentralization when he called headquarters to ask about advice about restructuring production units, he was answered, "*We have hired you with a high salary – take your own decisions!*" .

In Hans Werthén's decentralized structure, he implemented simple ways to measure profitability as profit before tax, which every manager was measured against. He also implemented the same accounting system and monthly follow-ups, which then was unusual. As we also see today, among many decentralized organizations, managers are given a lot of freedom as long as the business performance is satisfactory. The book also describes how top management thought it was " *poetry to hear the managing directors talk about return on assets.*" Words like corporate culture and delegation were never mentioned; they were embedded in the Electrolux culture.

A management philosophy in accordance with human nature

Dr. Jan Wallander, the long-standing CEO of Svenska Handelsbanken, stands tall among visionary business leaders, earning his place among the influential figures during his tenure at Svenska Handelsbanken. His transformative journey with Svenska Handelsbanken turned the bank into one of the globe's consistently successful banks at the end of the century and redefined the essence of effective management.

In the early 1970s, when corporate empires were built with strategic planning departments and centralized control systems, Dr. Wallander dared to be different. He orchestrated a series of groundbreaking changes, steering Handelsbanken into uncharted territory by adopting controversial measures at the bank. Facing resistance to decentralization, Dr. Wallander acknowledged the time-consuming process, taking about five years to achieve the goal of becoming a decentralized organization.

"Bringing about decentralization is a very time-consuming process. One has to begin with oneself."

In his book "*Decentralisation – why and how to make it work: The Handelsbanken Way*", Jan Wallander states his management philosophy: "*Decentralization is a management philosophy that can release the full potential of the people in any corporation, because it is in accordance with human nature, not against it. People are the only sustainable competitive advantage*."

Wallander abandoned the tradition of bank management when he took over as a CEO. Annual plans and budgets were tossed aside, breaking free from the fixed performance contracts that stifled innovation. Branch employees were bestowed with independent lending authority, embracing autonomy and responsibility. Despite initial skepticism, Handelsbanken's credit risks diminished as decisions were made closer to customers, and the bank abandoned centralized risk assessments.

Dr. Wallander's mantra was clear – decentralize, empower, and trust the frontline. Headquarters' role shifted from control to being a service provider for the front line, emphasizing a customer-centric approach. The head office saw a 33% reduction in employees, challenging the perception of superiority over branch staff. Local branch offices became primary profit centers, challenging the traditional pyramid structure. The marketing department saw a drastic reduction from 40 to just one person, emphasizing efficiency over bureaucracy.

A transparent steering system ensured that every branch's performance was visible, fostering healthy competition. From an incentive point of view, Wallander introduced "*The Octagon*," a long-term profit-sharing system that prioritized better profitability and return on capital over the company's competitors, while aligning incentives with sustainable success.

In conclusion, Dr. Jan Wallander's legacy at Handelsbanken is a testament to the enduring power of decentralized, human-centric management. By challenging the status quo, he revolutionized a bank and provided a blueprint for success that transcends time. In a world of constant change, Wallander's principles remain a guiding light for leaders seeking a path to sustainable and resilient organizations.

A country built upon transparency and trust

Moreover, Sweden is home to many small and medium-sized businesses, often family-owned, making it fertile hunting grounds for acquirers and small private companies. Sweden is also known for its open societity and data accessibility, contributing to high transparency. Annual reports for all companies are open to the public in Sweden, fostering trust and reliability in the companies' financials and decreasing unpleasant surprises post-acquisition.

As acquisition-driven compounders have demonstrated the practical value of their models and maintained an entrepreneurial spirit within the acquired entities, trust between sellers and buyers has flourished over the years. Today, Sweden boasts one of the highest levels of interpersonal trust globally. The country also ranks favorably on international indices measuring parameters such as ease of doing business, global innovation, perceptions of corruption, and human development.

Another crucial factor is that successful acquisition-driven strategies, with small private transactions at the heart of their strategy, have established a simple, efficient, and standardized way of conducting business, employing simplified, short, and concise deal-making and deal documentation over time.

As evidenced by the histories of Electrolux, Atlas Copco, and Svenska Handelsbanken, the decentralized approach to management has a long legacy in Sweden. Building a decentralized culture and harnessing the strong benefits of autonomy and local decision-making takes time. We believe the decentralized approach adopted by the companies we invest in represents a strong competitive advantage in a rapidly changing world.

Sources:

1 - Directors' Report To the Shareholders, Atlas Copco Annual Report 1976

2 - A translation from the Swedish original title “Man säljer inga julgranar på annandagen – en bok om Hans Werthén.”

3 - Translated from Swedish ”Här har vi anställt dig för dyra pengar. Fatta dina egna beslut!”.

2.9 The Duality of Autonomy and Control

"You have to believe it," insists Nick Howley. "You have to pass up at times apparent cost savings on the belief that the loss of entrepreneurial spirit and ownership will more than overcome what you might save by having a common accounts receivable department or a common sales force. You just have to believe that." As the founder and former CEO of TransDigm—a global aerospace company comprising 50 independent units providing critical parts for commercial and military aircraft—Howley deeply values decentralization and treating employees as owners. He believes true business strength doesn't come from rigid structures or unified sales teams but rather from empowering autonomy, fostering entrepreneurship, and cultivating true ownership.

On the other side of the debate is Brad Jacobs, a serial entrepreneur who prefers operational integration through deep standardization across all business units. Having overseen more than 500 acquisitions—including with companies like XPO, United Rentals, and his latest venture, QXO—Jacobs takes a different approach. He emphasizes integration and standardization. "I've never managed companies with hundreds of independent units," Jacobs says. He stresses that operational integration relies on speed and consistency. Rapidly incorporating an acquired business into a unified technology system is essential: a single enterprise platform, unified HR and CRM systems, central business intelligence, and internal communication tools. Operations are streamlined using one KPI dashboard, a standardized training program, and a common email system. New employees receive a comprehensive manual, including the company's code of ethics, to ensure consistency.

Cultivating a strong culture

Jacobs also highlights the importance of cultural integration, calling it the most crucial element for successful post-acquisition management. Rather than imposing an authoritarian style, Jacobs emphasizes respect and genuine communication, recognizing the value of new team members and fostering unity. For Jacobs, both operational and cultural integration are key to achieving economies of scale. His focus is on industries where synergy grows with scale—where companies can spread SG&A costs, enhance technology, and leverage a broad network. While Jacobs acknowledges the benefits of decentralization for customer proximity, his companies excel by maximizing efficiency and synergy through standardization.

The essence of many successful acquisition-driven compounders is rooted in deep decentralization, which serves multiple purposes: fostering entrepreneurship, enhancing customer proximity, and maintaining a small-company feel even as the organization scales. Decentralization allows newly acquired, often niche, businesses to retain what made them successful. Smaller niche markets, ideal for acquisition-driven compounders, compete on intimacy. Autonomy allows business units to make swift, market-driven decisions and fosters a sense of ownership. This trait is rare in large corporations, where culture often struggles to scale. In decentralized setups, companies grow big by staying small.

Finding the balance

The level of decentralization is not a one-size-fits-all solution; it varies by company. For some, it means full autonomy across all business units, while for others, autonomy may be limited to specific divisions, with each division running its own playbook tailored to its unique industry landscape. In some cases, a light synergy approach works best—centralizing core functions like finance, HR, or IT while maintaining operational independence to preserve entrepreneurial energy.

Companies that share foundational elements across end products may pursue a higher degree of backend integration, such as common sourcing, while still allowing significant entrepreneurial freedom at the customer interface. This approach enables full flexibility in decisions related to product selection, pricing, and marketing. For example, IMCD—a global leader in the formulation, sales, and distribution of specialty chemicals—follows an integration strategy that involves incorporating new chemical companies into their digital platform on the backend. However, it safeguards autonomy at the customer-facing level. This strategy allows IMCD to achieve operational efficiencies while maintaining independent decision-making. This approach fosters a culture where freedom to act is encouraged, yet allows IMCD to benefit from a centralized digital platform across all acquired companies.

Similarly, Brown & Brown illustrates this blend of backend integration and customer-facing autonomy. As a successful acquisition-driven compounder encompassing a network of insurance brokers, Brown & Brown grants each of its acquired brokers full local autonomy, including P&L ownership, allowing them to retain their original branding. This structure enables each branch to focus on customer relationships and local growth, while centralized support functions—such as compliance, IT, accounting, and marketing—enhance operational efficiency. This model, like IMCD's, strikes a careful balance between synergy and local empowerment.

Specialists with heterogeneous attributes operating in global markets often thrive by using a focused playbook while protecting autonomy where it matters most—whether at the customer touchpoint or in the creative process. For example, LVMH, Bernard Arnault's luxury conglomerate, has mastered a dual strategy of vertical integration for efficiency while preserving brand integrity and culture. Functions like logistics, talent mobility, and advertising are centralized as "light synergies," but each brand retains its creative autonomy. This balance allows LVMH to achieve scale efficiencies while maintaining the uniqueness of each brand—a crucial factor in the luxury market.

Pull integration

Across our Nordic portfolio companies, we see a common theme best described as a "pull integration" strategy, a term coined by one of our portfolio companies, Bufab, a trading company that offers a full-service solution for sourcing and logistics of C-parts. This approach emphasizes that acquired companies should retain their entrepreneurial spirit and operational independence. The pull integration strategy allows each newly acquired company to determine the pace and scope of their integration into the larger organization. This flexible approach enables companies to draw on resources, practices, and benefits as needed, rather than being forced into a rigid framework.

This emphasis on autonomy and selective integration is a recurring theme across our portfolio. The focus is on growth synergies rather than cost synergies, ensuring acquisitions can seize opportunities when joining a larger group while avoiding disruptions commonly associated with forced restructuring or cost-cutting. By prioritizing autonomy and leveraging local expertise, while providing access to Bufab’s resources and best practices, the pull integration strategy fosters sustainable growth and preserves the unique strengths of each acquired company.

Acquired companies retain full autonomy in choosing the integration approach that fits their needs. Some may adopt shared ERP systems within the group, but this decision is driven by local accountability rather than a centralized mandate. In cases with significant specialization across divisions, companies may opt for more operational integration—achieving lightweight cost synergies, such as in sourcing—while retaining autonomy and ownership mentality.

Similarly, other Nordic leaders, including Bergman & Beving and its spun-out companies like Addtech and Lagercrantz, as well as Indutrade and others, have varying degrees of shared services and "toolboxes," equivalent to a "pull integration" strategy. Employees can voluntarily utilize the common knowledge within the organizations, freeing up time for CEOs to focus on strategy and growth.

Plow Horses and Meritocracy

A common pattern that runs through the best acquisition-driven compounders is that decentralized autonomy exists alongside centralized control. Managers are free to run their units, often with full P&L responsibility, but this freedom comes with relentless accountability. This culture of accountability attracts a distinct kind of individual—one who thrives under pressure, finds motivation in numbers, and embraces financial discipline. The balance between entrepreneurial freedom and financial control can feel like walking a tightrope—maintaining entrepreneurial spirit while meeting financial demands.

A portfolio example is Ametek, a specialized manufacturer of advanced products across multiple end-markets with a nearly century-long history, including numerous accretive private acquisitions. Ametek values substance over style, referring to this philosophy as being 'plow horses rather than show horses'—a deep-rooted preference for meaningful work and steady commitment over superficial display. The company has had only four CEOs over 58 years, contributing to cultural stability while successfully navigating numerous pivots and course corrections along the way. At Ametek, hitting financial goals is non-negotiable. Underperformance is addressed directly, creating a culture where results are essential and performance drives recognition. This results-driven environment attracts people inspired by accountability and committed to delivering consistent outcomes.

Highly decentralized companies attract business heads who want to prove themselves with full P&L responsibility. High-performing cultures with deep-rooted meritocracy are not for everyone; they naturally self-select for top performers. This culture can often be lost in centralized structures.

The integration spectrum in acquisition-driven companies spans a wide range—from highly decentralized models that prioritize entrepreneurial freedom, even at the expense of easy synergies, to tightly integrated approaches, like Brad Jacobs', which focus on maximizing scale efficiencies with minimal decentralization. The "pull integration" strategy, which is prominent in many of our portfolio companies, represents an effective middle ground. This approach balances synergies with autonomy, allowing each business unit to decide the extent and nature of its integration based on its unique needs, thereby preserving the entrepreneurial spirit.

At REQ, we have great respect for acquisition-driven compounders that prioritize genuine autonomy and an entrepreneurial spirit. These companies invite synergies rather than enforce them, and when they do introduce synergies, it's done thoughtfully to preserve autonomy where it's most needed. We believe that balancing autonomy with control is essential for "growing big by staying small," creating some of the world's best ecosystems for entrepreneurs.

*Nick Howley's quotes are from the 50X Podcast

**Brad Jacobs' quotes are sourced from an interview with The Knowledge Project Podcast and his book, 'How to Make a Few Billion Dollars'

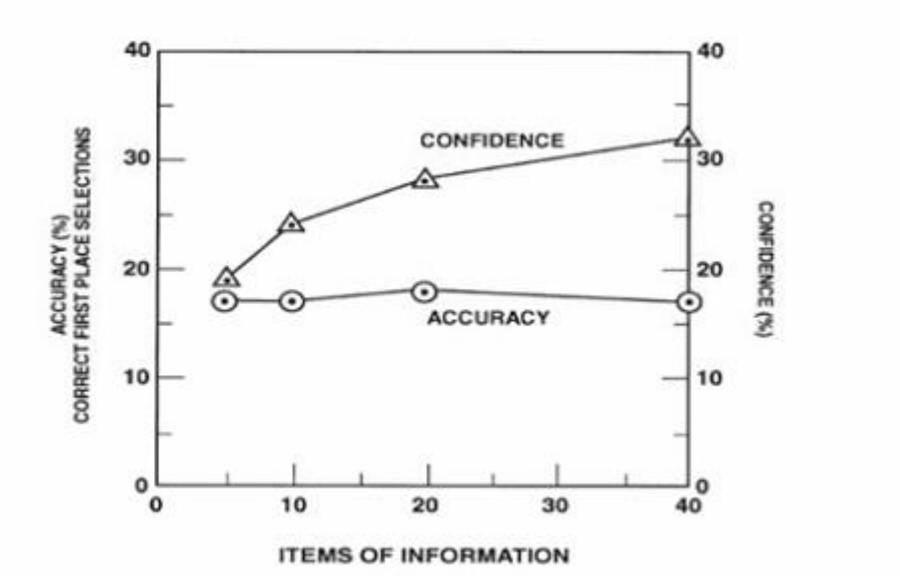
***REQ funds have positions in Addtech, Bergman&Beving, Indutrade, Lagercrantz, IMCD, Brown & Brown and Ametek

3 People

3.1 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 Capital, 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)

3.2 A Top athlete in the field of business

It is very interesting 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 with exposure 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 not only 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 that were financed by both equity and strong free cash flow. In the 1970s, Teledyne used a significantly undervalued stock to buy back and retire 85% of its shares outstanding at prices far below what Singleton believed was the intrinsic value of the company. These were not regular share repurchases. On several occasions, Teledyne made tender offers to buy five percent of its stock, which instantly increased 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 strong 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 managed in a highly decentralized manner.

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 head office about their products, markets, competition, and so forth. The corporate-wide financial reporting system ensured that all companies spoke the same language. The fiscal month always ended on a Friday, and by the following Tuesday morning, reports from all 130 reporting units were collected at headquarters. 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 own 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 important 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 on 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 retires after 29 years of brilliant leadership and outstanding value creation.

Summing up
Our investment philosophy is based on three fundamental principles that we believe 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 good 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 that have the right ingredients to become the "Teledynes of tomorrow."

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

3.3 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.

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 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 track their long-term progress.
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. McKinsey & Company shared the same findings in a report* titled «The misguided practice of earnings guidance»:

«*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 long-term. Our job is to find management teams we can trust and invest in for years. We prefer no rosy outlooks, just consistent performance.

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

3.4 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 acquisition-driven compounders 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 acquisition-driven compounders 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 acquisition-driven compounders 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.

3.5 The best shareholder letters

We spend a lot of time reading shareholder letters and have drawn inspiration from the best of them when writing our investor reports.

The best shareholder letters should give you, the investor, a good insight into the company's culture. Unfortunately, most shareholder letters do not provide insight into the company or management's thinking. But the best shareholder letters share many similar characteristics. We will try to summarize the most interesting ones below which is a summary of both our own experiences as investors and some takeaways from the book “Dear Shareholder” by Lawrence A. Cunningham.

Trust

The best shareholder letters instill confidence. They are not written by the investor relations department, but by the CEO. The best shareholder letters establish management accountability. The best CEOs talk openly about underperforming investments and failed product launches. They seem almost proud to describe failures. They are personal. They do not try to cover up challenges. They are honest and convey a message based on trust.

"*One of the analysts who covers Constellation recently changed his perennial "sell" recommendation to a "buy". We lost one of our few critics. Analysts who worry about the quality of earnings and reversion to the mean and the impossibility of trees growing to the sky are valuable*"
(CEO Mark Leonard, Constellation Software, Shareholder Letter 2017)

Culture
The best shareholder letters provide a deep insight into a company's culture. Over time, employees self-select into or out of a culture. So, it is with investors. Companies often get the shareholders they deserve. A company that takes a long-term view and does not focus on quarterly numbers will attract investors who value those aspects. If the company spends a lot of time talking about short-term results and quarterly numbers, it will attract speculators. Long-term communication attracts long-term investors, which is a great competitive advantage for any company.

Conservatism and frugality
The best shareholder letters convey a story of conservatism, but also of rationality and boldness. The best shareholder letters convey a culture of frugality. The message sends a strong signal to the company about how best to spend its hard-earned money. CEOs themselves lead by example and do not spend money on expensive hotels or airline tickets in front of the curtain. Employees are adapting to the frugal mentality.

Ownership and compensation
The best shareholder letters are written by CEOs who act like owners. They treat the company as if it were their own. These companies often have a dual stock structure where the original founders or CEO control the voting stock of the company. These companies are big fans of internal stock ownership among all employees and often supplement employee 401(k) plans with company stock. In cases where the company grants stock to employees, the vesting period lasts for many years.

Long termism
The best shareholder letters provide a long-term vision. The CEOs who write these letters do not provide earnings forecasts and use the shareholder letter as their primary medium to communicate information about the company. Many of these CEOs aim for low share turnover, which is a sign that many long-term shareholders are on board. They use the shareholder letter to explain the company's strategy and often take the time to explain the company's history and how it got to where it is today. The best letters address the importance of long-term shareholders.

"Our approach to ownership is perpetual"
(CEO Per Waldemarson, Lifco, 2020 Annual Report)

Principles
The best shareholder letters contain ideas that relate to the business and management principles on which the company is built. These principles serve both to build the company's culture and to manage investor expectations. Management principles are often about how people in the company treat each other, and they focus on processes rather than goals. These CEOs know what they are influencing. By making the culture process-oriented, they increase the chances of achieving their goals.

Succession planning
The best shareholder letters clearly set out the company's succession plan. Therefore, there are no surprises for employees or shareholders when the CEO decides to leave the company. Often, internal candidates are promoted to CEO, which reduces the risk of changes in corporate culture and strategy.

Capital allocation
The best shareholder letters emphasize the important aspect of capital allocation. The letters explain how the company will allocate its capital and what its priorities will be in terms of dividends, share buybacks, investments, acquisitions, and leverage. Some of the CEOs have very clear ideas about dividends and share buybacks. Most CEOs who write good shareholder letters are aware of the need to reinvest in the company at high returns on capital to create shareholder value.

Performance measurement
The best shareholder letters describe how shareholders should evaluate the company's performance. The best letters include different types of performance metrics, but the common denominator is some type of economic value creation (EVA). The performance metrics that the CEO presents do not alter from year to year. The CEO does not cherry- pick the metrics based on what looks good in the current year. The best letters often explain and argue why the metric is used.

Accounting
The best shareholder letters frequently discuss accounting and the limitations of accounting in measuring true economic profit. They explain to investors the subjective nature of accounting and its drawbacks. These letters take time to explain to investors what they should look for in financial statements. They try to guide investors.

For example, Larry Page and Sergey Brin wrote in their first investor letter on Google's IPO, *"We won't 'smooth' quarterly or annual results: If earnings figures are lumpy when they reach headquarters, they will be lumpy when they reach you."*

Conclusion
The best shareholder letters stand out from the rest. These letters are based on trust and go to great lengths to attract the right shareholders. They have a long-term focus and often cover the same topics such as ownership, principles, capital allocation, and how best to value the company.

When you invest in companies that can clearly articulate the fundamentals of their corporate culture, you increase your chances of excellent long-term returns. At REQ Capital, we call it "Investing with Insight".

3.6 The value of succession planning

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

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

The "Forever-CEO"

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

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

The internal candidate

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

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

External recruitments

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

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

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

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

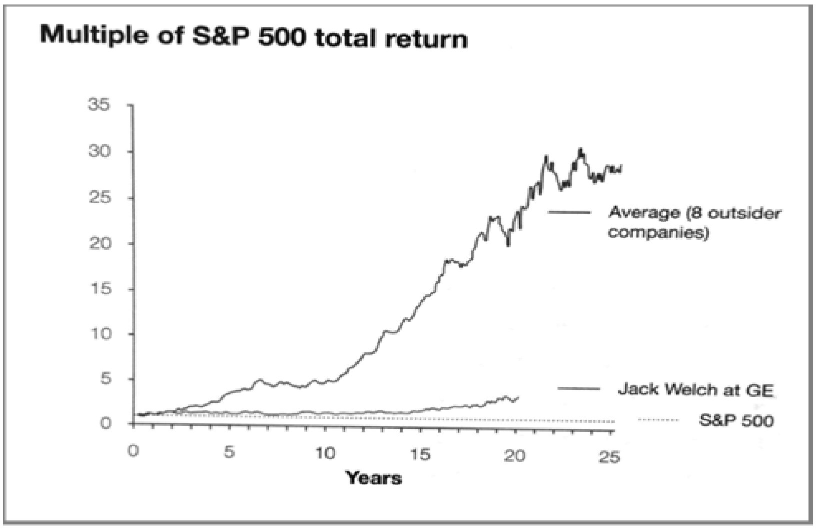
3.7 Extraordinary CEOs

As an investor you entrust senior management in an organization with your capital. Finding exceptional management teams is perhaps the most important aspect of an investor's job, but it's not an easy task; it's more of an art than a science. Warren Buffett put it this way:

"It is almost impossible to overpay for the truly extraordinary CEO…but the species is rare"
(Warren Buffett quote, from "The Outsiders", 2012)

William N. Thorndike has written a brilliant book about exceptional CEOs. When we combine the insights from the book with our own experiences as investors, we find some commonalities among CEOs who achieve extraordinary results.

The eight truly exceptional CEOs featured in The Outsiders share many common characteristics. What is extraordinary about these CEOs is that they have led their respective companies for decades, not years, while delivering total shareholder returns that truly stand out from the crowd. The chart below compares the average stock performance of the companies led by these individuals relative to the S&P 500 and that of "rock star" CEO Jack Welch at GE over a 25-year period.



Source: "The Outsiders" (William Thorndike)

Over time, many of the stocks of companies run by the "outsiders" became so-called "100-baggers" - stocks that multiplied the original investment by 100 times. Aside from Warren Buffett, one of the eight CEOs featured in this book, these individuals are less well known to the public. We should study these very successful CEOs like we study very successful athletes. As investors, we like to learn about their similarities and use these traits in our search for new outstanding investments.

A great example of an extraordinary CEO is Henry Singelton, who founded Teledyne in the early 1960s, and generated a 20.4% annual return on Teledyne stock during his 30-year tenure as CEO. He may be one of the best CEOs in American corporate history, but he is less known than Warren Buffett. $1 invested in Teledyne when

Singelton took the helm had grown to $180 by the end of 30 years. The same dollar invested in the S&P 500 index would have grown to $15. Investing that same dollar in Teledyne's "peer" companies, mostly conglomerates, would have returned $27. All in all, an extraordinary performance.

What is the measure of a CEO's success? It's not the size of the company, the number of employees, or the number of headlines in the business press. The role of the CEO is to manage people and capital in a way that gets the most out of these two vital resources.

For us as shareholders, the most important criterion for judging a CEO is the total return of the stock over very long periods of time, and comparing those returns to those of the overall market, and the returns of a relevant peer group. If the leadership team has been in place for many years and has delivered total shareholder returns that far exceed the market index and peer group, you know the leadership team has done something right and maximized value per share. So, looking for commonalities between exceptional CEOs is not only interesting, but could also increase the chances of finding new exceptional investments where the right kind of top management is in play.

It's easy to be intrigued by an outgoing and well-articulated CEO who constantly shows up at stock conferences and trade shows and speaks with great conviction about strategy and market opportunities. Busy CEOs who are constantly on their private jets talking to journalists and analysts seem to be the norm for many. Wall Street loves these CEOs.

The extraordinary "outsiders" in Thorndike's book could not be more different. They are not fixated on Wall Street. They see Wall Street as a distraction. For them, customers and employees are their top priority. If customers and employees are happy, shareholders will be happy. These outstanding CEOs plan for the long term, and let their performance speak for itself. Of course, they know that as a publicly traded company, they are exposed to a lot of short-term noise, but they choose not to pay attention to it. They build dominant companies with enduring cultures.

Thorndike draws on Jack Welch as an example of a charismatic and outgoing CEO who has long been considered the perfect blueprint for a CEO. Welch was CEO of GE from 1981 to 2001, and during his tenure, the stock achieved a CAGR of 20.9%. That's a very impressive return, even during one of the longest bull markets in history. But the truly exceptional CEOs in Thorndike's book have achieved even higher returns over longer periods of time.

Exceptional CEOs differ from other CEOs in three different ways.

1) They are masters at capital allocation
2) They run very decentralized organizations
3) They are independent-minded and humble

Truly extraordinary CEOs do most things differently than their peers, which helps explain their performance.

"*It is impossible to produce superior performance unless you do something different*"
(Sir John Templeton, Investment Maxims)

Capital allocation

The truly exceptional CEOs choose capital allocation as their most important job. These CEOs are investors rather than managers.

Every CEO has a toolbox when it comes to capital allocation. There are three sources of capital and five ways a CEO can allocate capital, as shown below. Exceptional CEOs are masters at using the right source of capital at the right time and investing capital where it will produce the best returns for shareholders.

Sources of cash	Uses of cash
Free cash flow	Acquisitions
Debt	Capex
Equity	Dividends
	Share buybacks
	Debt reduction

Most senior managers in a company are promoted to CEO because of their strong performance over many years in functions such as operations or marketing. Many managers are promoted to the role of CEO because they are successful in corporate politics. On your first day as CEO, you have sole responsibility for allocating the company's capital. This is a skill that very few people have experience with before becoming CEO.

Most of the CEOs in Thorndike's book made large stock buybacks during their time as CEO. Sometimes the best investment opportunity is your own stock. We are not talking about ordinary stock buyback programs that most companies do. Outsider CEOs undertook large buyback offers when the stock price was undervalued and used stock as payment in acquisitions when the stock was highly valued. Many bought back as much as 90% of outstanding shares during their tenure as CEO. Most companies today announce stock buyback programs for a set amount and run them over several years. This is not the outsiders' approach.

These CEOs very rarely paid dividends, even at times when dividends were "popular" with investors. Instead, they focused on maximizing cash flow per share rather than earnings per share.

Many of these very successful CEOs acquired many private companies during their tenure. The acquisitions were often made through direct contact with the sellers. By avoiding auctions, they were able to secure assets at attractive prices. They showed patience and occasionally acted boldly.

Organization

All outsider CEOs ran extremely decentralized organizations. They were not afraid to delegate responsibility downwards in the organization. Top management's primary focus was capital allocation. They were masters of delegation. By taking a decentralized approach, they were able to unleash entrepreneurial energy in the organization. It's also a good way to keep costs down. They avoided "office politics" by paying for performance.

They often combined this decentralized approach with good incentive systems that focused on maximizing cash flow per share. One criticism of this type of company is that lower-level managers who perform well are handsomely rewarded.

They all set up small headquarters and clearly understood that headquarters did not have the answers to solve customers' problems. These CEOs hired the best people and left those people alone. They had a deep understanding of human behavior and motivation.

These exceptional CEOs had no time for investor relations. They owned part of the companies and acted as owners, not agents. Henry Singelton owned 13% of Teledyne.

Personalities

The outsider CEOs were devoted to their families and often left work to attend school events. They did not attend conferences. They set their own agendas. These were not the CEOs who wrote books of management advice after they retired. They were not the rock stars of the business world, but people who preferred to operate in the background. They were not out for fame. All these CEOs were new to the industries and companies they led. Humility and independence were the salient characteristics of these CEOs. They shunned bankers, consultants, and advisors.

All eight outsider CEOs were new to the CEO role. That may be one of the reasons they were successful. They looked at the companies and industries they were in with new eyes. They were very rational and used new perspectives that led to great performance.

Most CEOs are unable to resist the "teenage pressure" to be like everyone else. The "Outsider" CEOs did not care about conventional wisdom. They relied on rationality and avoided peer pressure in the corporate world.

The bottom line
We can learn a lot from exceptional CEOs who perform well over many decades. As investors, we can use these blueprints for success in our search for future exceptional investments. If we can find investments with high integrity and top managers who focus primarily on capital allocation, are decentralized, and share many of the personality traits mentioned above, we may have found something very special. These potential investments can give us returns that far exceed those of the overall market.

3.8 Ownership structures as a competitive advantage

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

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

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

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

A private owner, on the other hand, often has a generational perspective on his or her ownership stake, and wants to take a seat on the board. This ensures a long-term perspective in the board room, which we prefer.

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

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

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

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

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

3.9 Mark Leonard (Constellation Software) – an extraordinary CEO

The longer we have been invested, the more we have realized the importance of leaving our capital to the masters of capital allocation. Management teams that are excellent investors will always find a way to create value for us as shareholders.

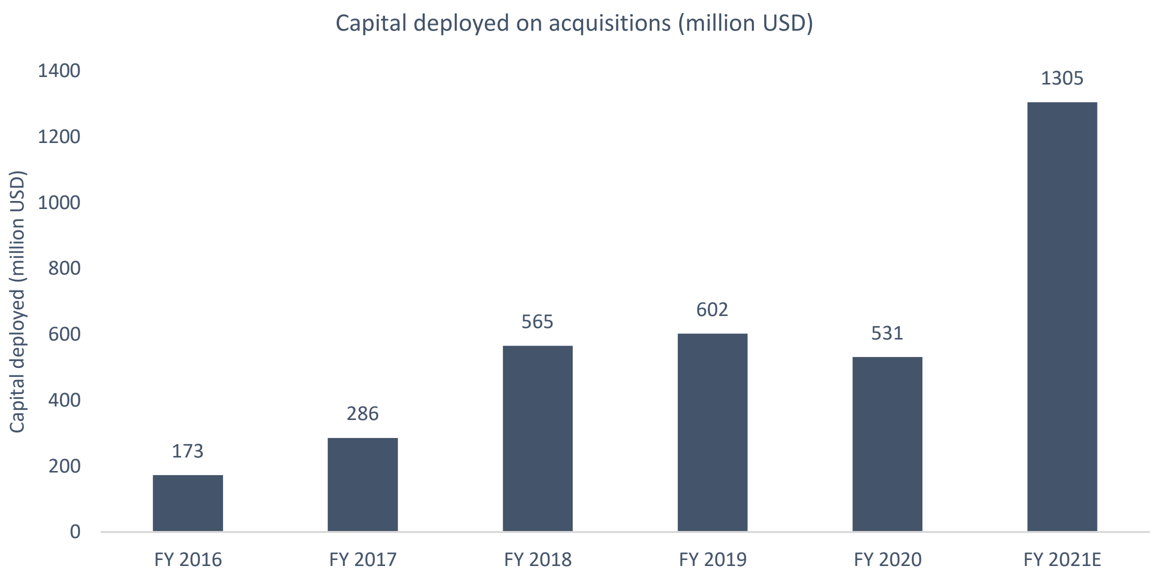
One of the very best CEOs we have come across worldwide is the CEO of Constellation Software, Mark Leonard. His capital allocation skills and approach to decentralization is unique. He is the blueprint for an extraordinary CEO and deserves to be studied along the lines of Warren Buffett.

Mark Leonard built Constellation Software (CSI) with a simple strategy based on his background as a software venture capitalist. The company uses strong, recurring free cash flow to acquire multiples of small, niche software companies.

Capital allocation

Mark Leonard understands the creation of shareholder value. The KPI used at Constellation Software to measure company performance is "ROIC + organic growth." As communicated in Leonard's annual letters, ROIC is the cash return from the acquisitions that CSI makes. ROIC + organic growth" combined is the increase in value of CSI. The company's communication clearly shows that capital allocation is key. As an investor, you also see the result of this strategy in the financials.

The key aspect of the investment thesis in Constellation Software is the company's ability to allocate capital to new acquisitions. Over the past few years, Mr. Leonard and his team have significantly increased the number of employees doing acquisitions. This has resulted in capital invested in M&A more than doubling. The company currently spends 88% of its operating free cash flow on acquisitions. Unlike many other acquisition-driven models where capital allocation is the responsibility of top management, CSI has a decentralized capital allocation policy. Most acquisitions are made by portfolio managers. The model is therefore highly scalable.



The company continues to pay a $1 quarterly dividend which we would gladly forgo. We would rather see the company reinvest that capital at its current 56% return on equity.

Decentralization

Decentralization is the hallmark of Constellation Software. For a decentralized structure to work, it takes a lot of trust and a long-term investment horizon. As Mark Leonard described in CSI's annual shareholder letter in 2015:

"We continue to believe that autonomy and responsibility attract and motivate the best managers and employees"

Authority is delegated to individuals. As stated on Constellation Software's homepage:

"CSI will not take over the day-to-day management of its businesses. We continue to rely on the managers and employees of our subsidiaries to run their businesses well. Managers who are excited at the prospect of creating an exceptional company and who are willing to embrace new ideas tend to flourish at CSI".

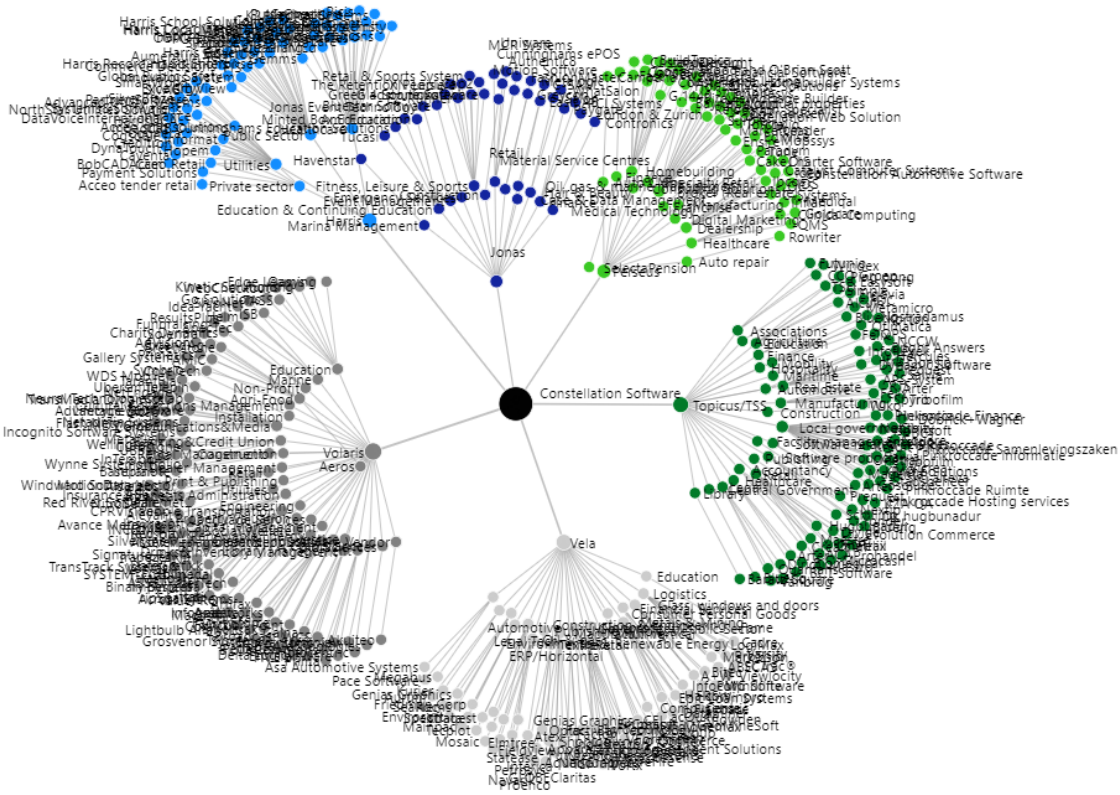
A mindblowing statistic regarding decentralization is well described by Roi Lipovetzky in his writeup “Constellation Software: A capital allocator’s culture”

> *“If someone is looking for evidence for decentralized culture, he should probably look for the number of employees in the headquarters compared to the total company. In Constellation software, a company with approximately 25,000 employees, only ten people sit in the headquarters at Toronto (a ratio of 1:2,500)”*

As part of the decentralized structure, Leonard and his team creates the right incentives. Manager compensation is closely aligned with that of shareholders. Mark Leonard is the 5th largest shareholder of the company. The bonus plan for employees requires those who exceed a certain level of compensation must invest in shares with at least four-years vesting period. According to Leonard, the average holding period for employees is much longer.

The visualization we have created below shows the structure of Constellation Software. CSI is basically a collection of 434 niche software companies spread across six divisions and dozens of different verticals. A “vertical” might be software for “Library Management” or “People Transportation”. The software companies that CSI owns are mission critical software systems for customers and very sticky products.

As can be seen from the figure CSI is highly diversified across divisions and verticals. Software products offered by the individual companies varies from software that test and debug chips and circuit boards (Asset InterTech) to software technology solutions for public libraries (EnvisionWare). A rare Norwegian example is also found in the CSI portfolio. The software company DataGrafikk is one of 15 companies under the "People Transportation" vertical in Volaris. DataGrafikk is a company that delivers software for bus and public transport companies across Norway.



The six divisions could each easily be independent, publicly traded companies. One of them became a publicly traded company earlier this year when Topicus.com was spun off and taken public. CSI is still the main shareholder in this division, with a 50.1% stake.

Of the other businesses, Volaris is known for transportation, financial services, and communications and media. Harris is primarily in utilities and healthcare. Jonas is known mostly for hospitality, clubs and resorts and Vela is more into manufacturing. Perseus Group operates in a variety of industries, including housing, real estate, pharmaceutical manufacturing, and pulp and paper.

There is a clear incentive structure in CSI, based on the ability to deploy capital. According to a former director, "owner operators" are the largest source of acquisitions, accounting for 70% of transactions. 10% of acquisitions are "carve-outs" from large companies and only 3% are from private equity funds or venture capital firms. Constellation accounts for only 3% of total software acquisitions worldwide.

Management characteristics

Leonard's comments are always modest and as a person he avoids publicity. In his 2017 annual letter he shares his very simple management philosophy:

"Our senior managers consistently generate rates of return in excess of 25% on the capital that they deploy. As investors you will know that this is wildly difficult to achieve. How do we keep these multi-talented managers? Hopefully we provide an environment that is fulfilling, colleagues that are both challenging and entertaining and work that is meaningful. We also pay them well"

It is important to emphasize that Mark Leonard has not been alone in building Constellation Software. The years of tenure in the company of the CEO, CFO, COO and CIO is 26, 18, 26 and 26 years respectively. Together they have built a culture from the top that embrace frugality, honesty and prudent risk-taking.

The frugality is best described by Mark Leonard in his 2007 shareholder letter:

I recently flew to the UK for business using an economy ticket. For those of you who have seen me (I'm 6'5", and tip the non-metric scale at 280 lbs.) you know that this is a bit of a hardship. I can personally afford to fly business class, and I could probably justify having Constellation buy me a business class ticket, but I nearly always fly economy. I do this because there are several hundred Constellation employees flying every week, and we expect them to fly economy when they are spending Constellation's money. The implication that I hope you are drawing, is that the standard we use when we spend our shareholders' money is even more stringent than that which we use when we are spending our own.

(Mark Leonard, annual shareholder letter 2007)

You very seldom experience CEOs who are willing to "talk down" the share price. In the annual letter from 2010 Leonard shares his insight regarding the importance of the share price moving in tandem with the growth in intrinsic value:

"I used to maintain that if we concentrated on fundamentals, then our stock price would take care of itself. The events of the last year have forced me to re-think that contention. I am coming around to the belief that if our stock price strays too far (either high or low) from intrinsic value, then the business may suffer: Too low, and we may end up with the barbarians at the gate; too high, and we may lose previously loyal shareholders and shareholder-employees to more attractive opportunities"

(Mark Leonard, annual shareholder letter 2010)

In the annual report of 2011 Mark Leonard actually argued that the share price increased too much ahead of intrinsic value by stating:

"Unfortunately, our stock price has increased at over twice that rate (of intrinsic value) during the last year, a differential that would seem difficult to be sustain in future years"
(Mark Leonard, annual letter 2011)

The stock

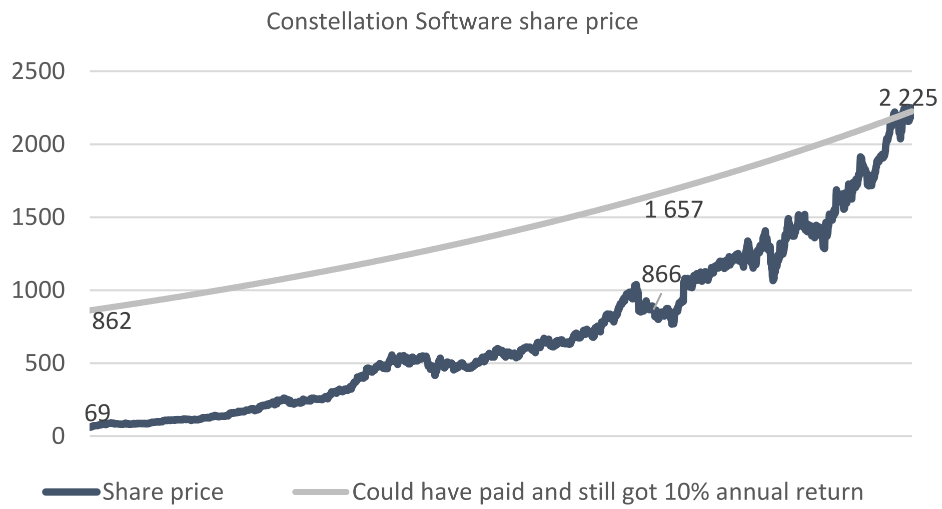
Constellation Software trades at 30x last 12 months free cash flow per share. We still believe the runway of growth opportunities globally for CSI is large. Currently CSI owns almost 500 companies. The total addressable market is about 40,000 targets. Therefore, CSI has about 1% global market share with lots of room to grow. We think CSI can continue to grow strongly for many years into the future. In Mark Leonard's own words:

"A very special case of value investing, is the example of a company that is growing quickly, that the market expects to stop growing within the next 5-7 years, but that actually keeps growing quickly for much longer. If you can spot one of those, it may appear expensive on a P/E basis, but may actually be an attractive long-term investment on a "value investing" basis. Spotting this kind of investment requires the ability to foretell the distant future…which is extremely difficult to do with consistency"

In addition to the specific niche of vertical market software, Mark Leonard appears to be open to other acquisition-related growth opportunities in other sectors. We find it very interesting to see Constellation Software enter new sectors as this will create even more growth opportunities for the future.

The chart below shows Constellation Software's share price over the last ten years, excluding smaller dividends and the extraordinary dividend in 2019. The share price has grown 41% per year over this period, driven by very strong profitable earnings growth of over 30% per year. The grey line shows what share price you could have paid at any point in time and still received a 10% annual return.

This shows that CSI was grossly undervalued at all times and, as we will show below, is still grossly undervalued. If you had paid 862 CAD per share 10 years ago when the stock was trading at 69 CAD, you would have received a 10% annual return to date. If you had paid 1,657 CAD per share 3 years ago when the stock was trading at 866 CAD, you would still be earning a 10% annual return.



The question today is what earnings growth to expect for the next ten years. If it turns out that CSI can continue to grow earnings at the same impressive rate (30% CAGR) for the next ten years, the stock is strongly undervalued today. In that historical case you can justify paying 13 776 CAD per share for the stock today and still get a 10% annual return over the next ten years. In 2020 the company grew earnings 31%. Even with a much slower rate of earnings growth of 15% you can justify paying 3 624 CAD, well above the current market price.

We strongly believe the right ingredients of reinvestment opportunities, scalability, and optionality (new verticals or even completely new business areas outside of software) are in place to continue a very strong path of profitable earnings growth over the next ten years. That is the reason why CSI is a core holding in the portfolio.

3.10 The most important lessons learned

We are always surprised at the variety of special interests in which people are enthusiastic. Some are very interested in ancient Egyptian pharaohs, while others are passionate about researching tanks used in World War II. Kyoto University in Japan offers a doctoral programme in "manga," comic books that originated in Japan.

In finance, there is one topic that we find particularly interesting and that we believe explains in large part why stocks are valued the way they are. This highly interesting topic is "hyperbolic discounting." It sounds like an academic theory - but it's not.

Cash flows in the dividend discounting model are discounted using what is known as "exponential discounting". This discounting method is the standard method for discounting cash flows. We all know it by heart from our business school exams. All investors use it because most have probably only heard of this discounting model. But what does this way of discounting cash flows actually mean, and is it the right way to discount cash flows?

The traditional way of discounting, exponential discounting, is "time insensitive," meaning that the discount factor always decreases at the same rate over time. This is the rational way to look at economics. Consequently, cash flows that are far in the future are not worth much under exponential discounting.

Hyperbolic discounting

Behavioral studies of humans show that we do not behave the way traditional economic theory claims. We are not rational. Our human way of discounting is "time dependent." In other words, we use different discount rates depending on how long it takes to receive a payoff. Consider the following two examples.

1) You can choose between receiving $100 today or $110 in one year. In experiments, people have a strong tendency to choose $100 today to get the instant gratification.

2) You can choose between receiving $100 in ten years or $110 in 11 years. In this situation people tend to be willing to wait an extra year to get $110. Since the instant gratification is not there anyway, we act more rationally and think we can just wait one more year until year 11 instead of receiving the payout in year 10. It is so far into the future anyway.

The challenge in example 2, in which you decided to wait 11 years, is that when you approach year 10, you would rather get the instant gratification of $100 than wait another year. In other words, people avoid waiting the closer they get to the end of the waiting period.

In the short term, people are irrational, but in the longer term, they choose the rational option.

The basis for the hyperbolic discounting model is human behavior. The pattern that emerges from the way people choose as time goes on follows what is called a "hyperbola". People do not appear to use a constant discount rate as exponential discounting purports to do. In economics, hyperbolic discounting is a timeinconsistent model of discounting. People make decisions that are more similar to hyperbolic discounting than exponential discounting.

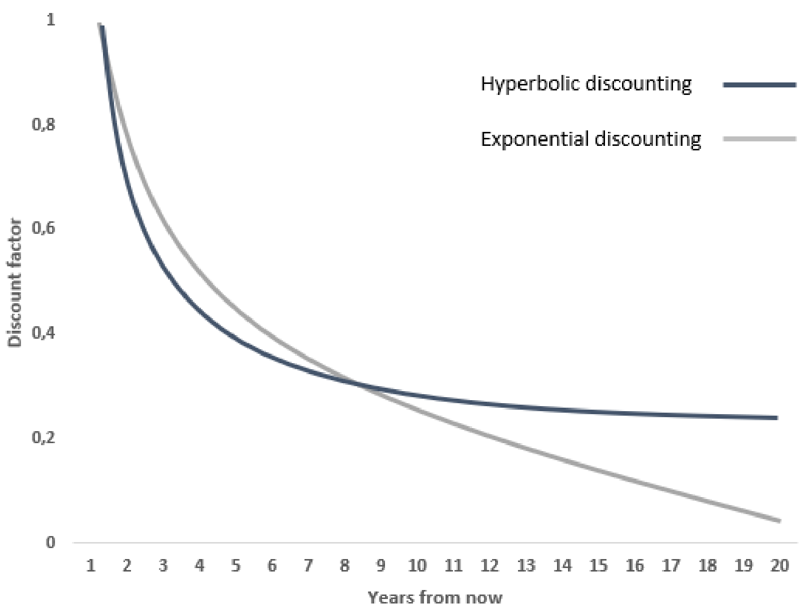
In hyperbolic discounting, valuations fall very quickly for periods close to the present because we want instant gratification, but they then fall slowly for longer periods that are deferred. The hyperbolic model discounts more than the exponential model at the beginning and less than the exponential model for very long term events.

Hyperbolic discounting states that discount rates are greater in the short term than in the long term. What does all this have to do with finance and the valuation of companies?

Hyperbolic discounting in finance

In the hyperbolic formula, the present value of short-term cash flows is lower than in the exponential model, but the present value of longer-term cash flows is higher than in the exponential model. Consequently, the terminal value in hyperbolic discounting for companies with durable competitive advantages, will be higher than in the model we know from business school.

There are various kinds of mathematical expressions for the hyperbolic formula. I will not go into them, but will try to simplify the hyperbolic function using an example of a 20-year cash flow where the discount factor is decreasing over time. The falling discount factor reflects the way experiments point to how we as humans make tradeoffs, represented by the hyperbola. The resulting figure shows the discount rates using the exponential function and a hyperbolic assumption:



You will notice that by discounting the cash flows with a hyperbolic function, the present value of the firm is higher than with exponential discounting for companies with long term competitive advantages. In the example illustrated above the present value of the cash flow using the hyperbolic function is almost 40% higher than using the exponential function!

We are not advocating that you should flip all your DCF models and start using hyperbolic discounting. The reason why we find the topic very interesting is that hyperbolic discounting might be one reason why very strong companies with highly predictable cash flows long into the future deserve to be priced much higher than other companies in the stock market. We think that market participants, in aggregate, price these stocks by discounting their cash flows with a discounting mechanism that is closer to the hyperbolic discounting method than the exponential discounting method.

By using traditional exponential discounting to value very long-term cash flows you might actually undervalue these strong long-term compounders that we invest in significantly.

3.11 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 normal 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—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 to get the cash flow; he needed high margins. 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!".

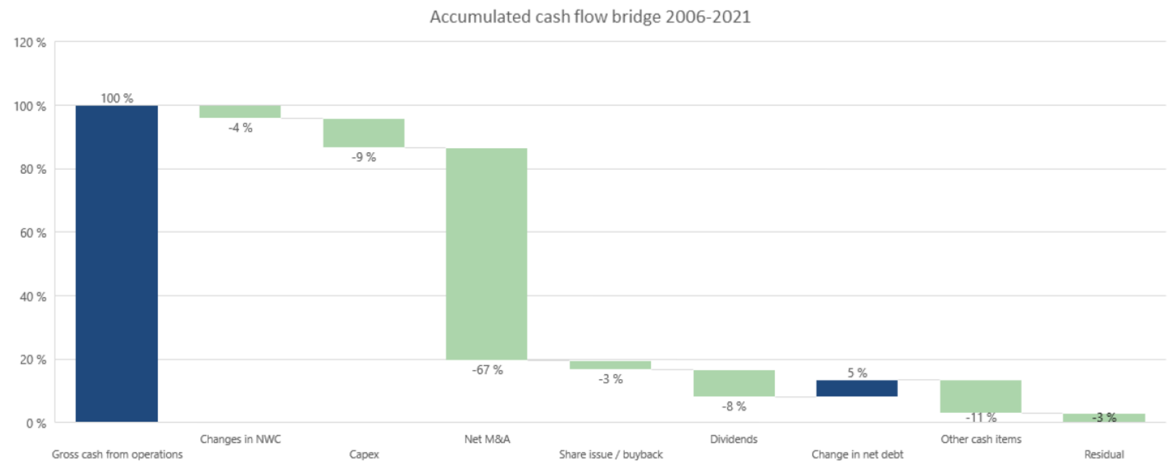
Ultimately it boils down to two central rules that govern everything in HEICO and like-minded organizations:

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, compared 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 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. It's simply not possible in the long run. 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, 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%.

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

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