AORIS INVESTMENT MANAGEMENT

December 2018 Quarterly Report

Aoris Investment Management

Aoris is a *specialist* international equity manager founded in 2017.

We are a *focused* business and manage a single international equity portfolio.

Our investment approach is *conservative*, fundamental and evidence-based.

The Aoris International Fund

Our portfolio is long-only and highly *selective*.

We own a maximum of 15 stocks, each of which has considerable breadth or *internal diversification*.

We aim to generate returns of 8–12% p.a. over a market cycle.

Our Quarterly Reports

We are *business investors*, not economists. As such, our reports focus on the performance of our investee companies.

We report on portfolio performance and changes with candour and transparency.

Each quarter we include a thought piece or *Feature Article* on a topic area with direct relevance to our investment approach.

AORIS INVESTMENT MANAGEMENT

Aoris International Fund

Performance to 31 December 2018 - Class A	December Quarter	Since Inception*
Portfolio Return (AUD) - Net of all fees	**-7.4%**	**3.2%**
MSCI AC World Accum Index (AUD)	-10.4%	0.1%
Excess Return	3.0%	3.1%

*Inception date: 26 March 2018, not annualised.

MARKET AND PORTFOLIO PERFORMANCE

The Fund outperformed our benchmark by 3.0% in the quarter.

The international equity market, as measured by the MSCI AC World Index ex-Australia, declined by 10.4% over the quarter (all returns are in AUD unless stated otherwise). Of this, -12.6% can be attributed to the performance of equity markets in their local currencies and +2.2% to the favourable impact of the weaker Australian dollar over the period. Developed markets declined by 11.1% with little real difference in performance between the major geographies—the UK market declined 9.3% and Japan was down by 11.9%, while Europe, the US and Japan all registered declines of approximately 11%. Emerging markets performed considerably better with a 4.9% fall in aggregate. Brazil was the standout with a gain of 16.6%, as the market enthusiastically embraced the new government under the leadership of President Bolsonaro.

Looking at returns by sector, Energy experienced the largest decline at 18.0% as the price of oil fell by roughly one-third, followed by a 14.8% fall for Information Technology. As one would expect, the perceived safer sectors performed much better in this period of market stress—Utilities was the only group to generate a positive return at 3.6% whilst Telecoms fell 3.6%, Consumer Staples declined 4.0% and Health Care fell 7.0%.

The Aoris International Fund (Class A) declined by 7.4% for the quarter, outperforming our benchmark, the MSCI AC World Index ex-Australia, by 3.0%.

Your Investment Team

Stephen Arnold
Founder & CIO

Swati Reddy
Senior Analyst

Ty Archibald
Equity Analyst

Portfolio Changes

Pricing power and organic growth, along with profitability, are a key part of our assessment of quality. Low cyclicality is key to economic resilience.

We replaced three of our holdings in the quarter with three new investments, which is an unusually high degree of activity. Each of these sells reflects one or more of the following:

- **Pricing power –** we have become warier of businesses for whom achieving price increases of more than, say, 1% per annum has in the last year proved difficult. Over the last five or so years, firms with limited pricing power have not been materially disadvantaged as inflation has been at historically low levels. In fact, the lack of need for material price increases meant it was not always clear who had pricing power and who did not. Nowadays, rising inflation means that pricing power takes on greater significance. Constrained pricing power forces us to question the quality of a business franchise—is it as special as we thought, or just 'pretty good'; is the company as essential to its customers as we believed?

- **Cyclicality –** we have become more cautious of businesses with meaningful exposure to two end markets: automotive capital equipment and semiconductor capital equipment. These markets are both highly cyclical and have risen strongly in the last few years. Oftentimes during an upswing, the cyclical nature of an industry is not easy to discern for what it is. For example, strong growth in capex by auto manufacturers can be explained in terms of Chinese demand and retooling of production lines for electric engines, while semiconductor spending seemed attributable to the 'mobile phone revolution'.

- **Organic growth –** we are placing an increased degree of emphasis on a company's long-term organic growth, meaning the rate of revenue growth excluding the impact of acquisitions and currency changes. We are less interested in businesses that have supplemented 'GDP minus' organic growth with margin expansion or bolt-on acquisitions. We are placing greater emphasis on firms that have demonstrated, over a long period, organic growth at least in line with nominal GDP growth. Furthermore, we prefer businesses that invest to support their superior growth through innovation investment in brand or sales force expansion, as opposed to those that simply benefit from the tailwind of favourable end markets.

SALES

Legrand

Our sale of Legrand from the portfolio reflected concerns regarding the company's ability to pass on rising input costs, as well as historic organic growth that has been GDP-minus but supplemented with many bolt-on acquisitions. Shortly after we sold our position, the company reported disappointing results which evidenced our concerns. Price increases remain at about 1.5% while input cost inflation has accelerated to 3.5%. Furthermore, half of the company's sales in the US are imported from China, making Legrand vulnerable to further tariff increases. Growth, particularly in Europe, was below expectations.

Illinois Tool Works (ITW)

ITW is an industrial company with strong positions in many different niche markets, and generates very attractive profit margins. Our divestment of ITW reflected our concerns about pricing power and long-term below-GDP growth, as well as its exposure to the automotive construction market, which accounts for about 20% of revenue. Similar to Legrand, ITW has not been able to pass on to its customers accelerating input cost and labour inflation. While management has prioritised an improvement in the rate of organic growth over the last three years and in fact changed executive incentive compensation accordingly, there is little to show for these efforts.

Atlas Copco

We sold Atlas Copco based on concerns regarding cyclical end markets and GDP-minus organic growth. Equipment sales into the automotive construction market account for approximately 10% of earnings, while the semiconductor equipment market makes a similar contribution. In the last year, Atlas Copco has spun-off as an independent business its activities related to the mining and infrastructure equipment markets, and has made further acquisitions in the semiconductor equipment market. As a result, its dependence on the automotive and semiconductor end markets has risen.

PURCHASES

L'Oréal

We repurchased L'Oréal for the portfolio, having sold it in June. In our June Quarterly, we stated that "L'Oréal now sits on our A-list and is a candidate for future re-entry to the portfolio based on valuation". We raised our assessment of its intrinsic value based on our increased emphasis on pricing power and long-term organic growth. L'Oréal's underlying growth last year was an impressive 5% and this year has accelerated to around 7% and it continues its long-running record of gaining share in most of its markets and geographies. Pricing power is strong, supported by a high level of investment in product innovation and brand communication.

Cintas

Cintas is America's largest uniform rental company. It was founded in 1929 and earned revenue of USD6.5 billion last year. Cintas provides clean uniforms, as well as restroom supplies, entrance mats, and first aid and safety products to more than one million businesses. Cintas' customers come from service industries such as hospitality, healthcare, food service and entertainment, as well as manufacturing and construction. Cintas' organic growth was approximately 5% in each of the last eight years and pricing power has been reasonable.

Halma

Halma describes itself as a global group of technical life-saving companies. It produces products and solutions with a focus on safety, health and environmental markets worldwide, and has very strong positions in niche markets that are in many cases supported by regulation.

Halma's products include instruments that detect flammable and hazardous gases, fire suppression systems, elevator safety products, devices that assess eye health and assist with eye surgery, and products for environmental data recording and water quality testing. Halma's organic growth over the last decade has been approximately 5% with very good pricing power. This has been supplemented by the acquisitions of many small businesses with similar characteristics. Halma had revenue in 2017 of approximately GBP1.0 billion.

Feature - Growth in Value

INTRODUCTION

We want to own businesses that become more valuable through time and to make these investments at a discount to today's value.

In our September quarterly, "**Growth versus Value**", we wrote about growth investing, which is conceptually simple and highly appealing, but often disappointing in practice. Who doesn't get excited about the earnings prospects for A2 Milk, Amazon or Netflix? Even better, how about finding the next Amazon? The starting presumption for those who follow a growth investing approach is that earnings per share (EPS) growth matters above all else. In identifying companies that will deliver superior EPS growth in the future, investors often look to historic growth in EPS or sales. However, on average, there is simply no relationship between these historic variables and future EPS growth.

At Aoris, we love growth too, but we have a different take on what sort of growth matters and how to find it. We do not believe in the primacy of EPS growth, even though every single business we own has generated faster EPS growth over the last decade than a global average. Our investment approach is about *growth in business value*. We want to be owners of businesses that become more valuable through time, and we want to acquire our ownership interests at prices that represent some discount to what we appraise the business to be worth today.

ROIC, THE COST OF CAPITAL AND THE PROCESS OF CORPORATE WEALTH CREATION

At the heart of growth in value for a business is the return it earns on its invested capital (ROIC). Let's start by looking at what return on invested capital means and how we measure it.

Return on invested capital

The 'invested capital' or 'capital base' of a business is made up of the assets required to run the business and, in equal amount, the debt and equity used to fund them. A business' assets include its inventory and accounts receivable, which together are often known as 'working capital', and its investment in fixed assets, such as plant and equipment. To this must be added capital that has been deployed in making acquisitions. We show this in the stylised balance sheet below, with the assets on one side and the funding sources on the other. The capital invested in this business is $1,000.

Assets	
Inventory	100
Accounts receivable	200
Plant & equipment	300
Acquisition goodwill	400
Total	**$1,000**

Liabilities	
Debt	400
Shareholders' equity	600
Total	**$1,000**

ROIC is calculated by dividing after-tax earnings by the capital base. Because debt is part of the capital base, we need to add the cost of debt, which is the net interest expense, back to the after-tax earnings. That way we can evaluate earnings before the cost of capital relative to the amount of capital invested. Let's imagine this business earned an after-tax profit of $48. If the tax rate is 25% and its interest rate on debt is 5%, then the after-tax cost of interest is 0.75 x 5% x $400 = $15. To calculate ROIC, we will add $15 to the $48 of after-tax profit, giving us $63, then dividing the total by $1,000 to give 6.3%.

Now that we have calculated the return on invested capital, the next thing to consider as we delve into the process of corporate wealth creation is the appropriate benchmark . What is the cost of capital that we should measure a company's ROIC against?

The cost of capital

When we deposit cash in a bank, we expect something in return in the form of interest, even if we consider the risk of losing our capital to be zero. When we invest in equities we expect considerably more, to compensate for the longer investment time horizon, the uncertain return and the risk to our capital. Over many years, 8% has been viewed as a fair return to equity holders. Indeed, long-term equity returns in developed markets have been around this number. The 8% return has, in round numbers, come in the form of 3% from dividends and 5% from growth in capital value.

If a typical company's capital structure is, as in our example earlier, made up of 40% debt and 60% equity, and debt costs around 4% after tax and equity costs 8%, then we can say 6.5% is approximately the after-tax cost of capital for an average business.

HOW THE ROIC A BUSINESS EARNS IMPACTS ITS VALUE

We think about a business in two parts:

1. **The existing capital base –** this is the capital or assets in place supporting the business today ($1,000 in our example earlier).
2. **Reinvested capital –** this is the *change in* the capital base year-to-year, which we will come to in the next section.

Let's focus on the first part, the existing assets of the business. By way of analogy, let's imagine a commercial building that cost $1,000 for the land and construction is generating rent under long-term leases of $150. This is earning an ROIC of 15%. If 7.5% is considered an acceptable market rental yield, then a fair price for the building will be $2,000, twice the value of its invested capital.

Similarly, a business will be worth more or less than its capital base depending on whether its ROIC is greater than or less than an acceptable cost of capital. **L'Oréal** earns an ROIC of approximately 13%, which is well in excess of its cost of capital thanks to the strength of its brand, global distribution and retailer relationships. It is worth a substantial premium to the value of its capital base. At Aoris, we will own only companies with superior ROIC.

Key to how the value of a business changes is the profit it earns on the capital it reinvests.

The reinvestment equation

Let's now turn to what a company does with the profit it has generated. Globally, listed companies on average pay out one-third of earnings to shareholders in the form of dividends. Putting the complexity of taxation to one side, there is no value gained or lost in this process—it is simply a distribution. That leaves two-thirds to be reinvested back in the business. The return that a firm earns on the capital that it reinvests will play a significant role in determining the rate at which its value changes over time.

The amount reinvested can be thought of in two categories—let's call them non-discretionary and discretionary. Together they represent what we will call 'reinvested capital'.

- **Non-discretionary –** in most cases, in order to grow, firms need to expand their capital base. Their working capital and fixed assets will need to increase to support higher sales. Let's categorise the investment required to keep pace with the growth of an average business as 'non-discretionary'. At what rate does an average business grow? About 1% of the growth in total corporate profits comes from newly-created businesses. So, if corporate profits grow in line with economic growth, which we'll estimate at 4%, then 3% is the growth in earnings of an average business.

In the illustration above, in order for the business to grow at a 3% rate in the following year, its capital base must increase from $1,000 to $1,030. We know that 60% of the capital structure is equity, so equity must fund 60% of the $30 increase, equal to $18. This consumes 38% of the $48 the company has earned in after-tax profit. So, this non-discretionary consumes roughly one-third of earnings for an average business.

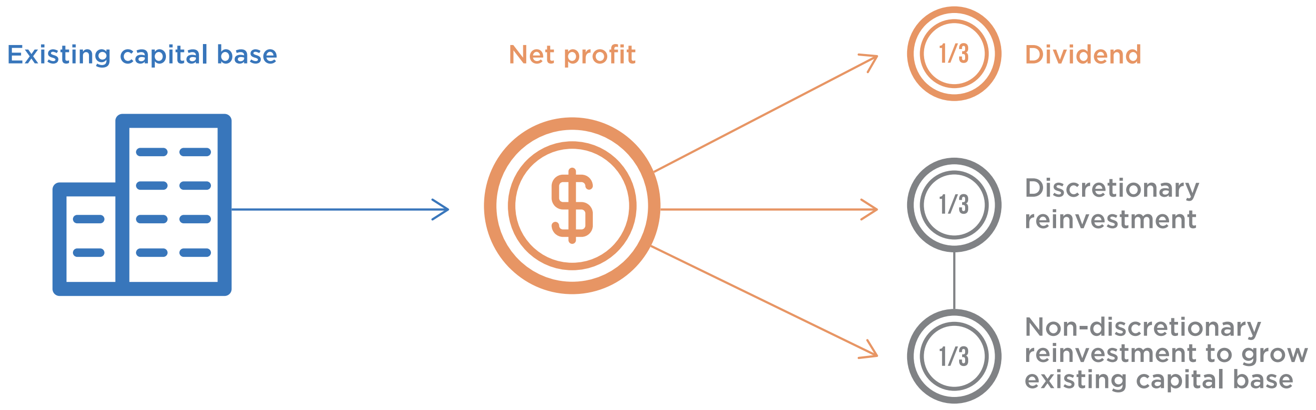
- **Discretionary –** once the non-discretionary reinvestment back in the business has been accounted for, discretionary reinvestment represents the final one-third of earnings. This may take the form of share repurchases or acquisitions. It may also be additional investment in the existing asset base to support a higher rate of what is known as 'organic', or underlying, growth.

The higher a firm's ROIC the more capital available for discretionary investment. If invested well this drives above-average EPS growth.

Note that the higher a firm's ROIC, the greater the proportion of net profit that is available for discretionary investments. These discretionary investments will, in turn, help drive above-average earnings growth, the characteristic that is so desirable to investors. Conversely, a low ROIC will generally result in nothing available for discretionary investment. We will explore how superior ROIC drives above-average EPS growth in our March Feature article.

Let's look at how this works for 3M. In 2017, 3M earned net profit after tax of $5.3bn, of which half was paid to shareholders in the form of dividends. To grow 3M's capital base by 3% required non-discretionary reinvestment of $520m, of which approximately half was funded from equity in the form of retained earnings, and the other half from increased debt. This left $2.4bn of profit to be used for discretionary investment, about half of which was spent on acquisitions and half on share repurchases.

It is worth noting here that certain types of businesses, such as service and software companies, do not require capital to grow at a normal rate, so their non-discretionary investment needs are zero. **Accenture**, for example, spends little on capital equipment and its working capital is negative. As such, all of its earnings are available for dividends and discretionary growth investment in the form of share repurchases and 'bolt-on' acquisitions, both of which have been a source of shareholder wealth creation over many years.



How it works for an average company

An average business will earn a return on its existing capital base equal to its cost of capital but not more. Reinvested capital will also earn a return equal to its cost of capital. Such a business is worth the value of its invested capital—no more; no less. Its shareholders will earn their 8% fair return in the form of capital appreciation of 5% per annum and dividend income equal to 2–3% per annum.

A business like this, average in all respects, is far more likely to be found in textbooks than in the real world. Most businesses are either superior or inferior, with returns that are either improving or deteriorating.

Value decay—how it works for inferior or deteriorating companies

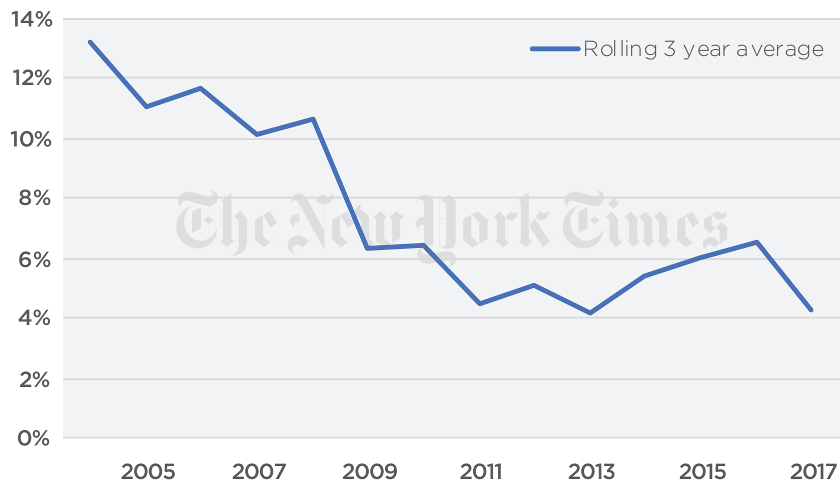
For a business where the profitability of its existing capital base is contracting, intrinsic value is in decline. Such a situation may arise where a company is losing ground to competition, perhaps due to disruption, lack of investment in people or product, management neglect or changes in regulation. These businesses are what we call 'shrinking moats'. A few examples are:

- **Traditional media companies** – the days of the family gathering to spend the evening watching free-to-air television are long gone, never to return. In the last five years, time spent watching traditional TV by 18–24-year-old Americans has approximately halved. How about reading the daily newspaper with your breakfast or morning coffee? Far fewer people buy print newspapers than five or 10 years ago, and

Businesses experiencing shrinking competitive moats are contracting in value and, for investors, are to be avoided.

those who do spend less minutes reading it than they used to, making each reader less valuable to advertisers. For newspaper publishers such as the New York Times, creating a great online paper may help retain eyeballs but not ad dollars, as online ads are smaller and less impactful than in the print version.

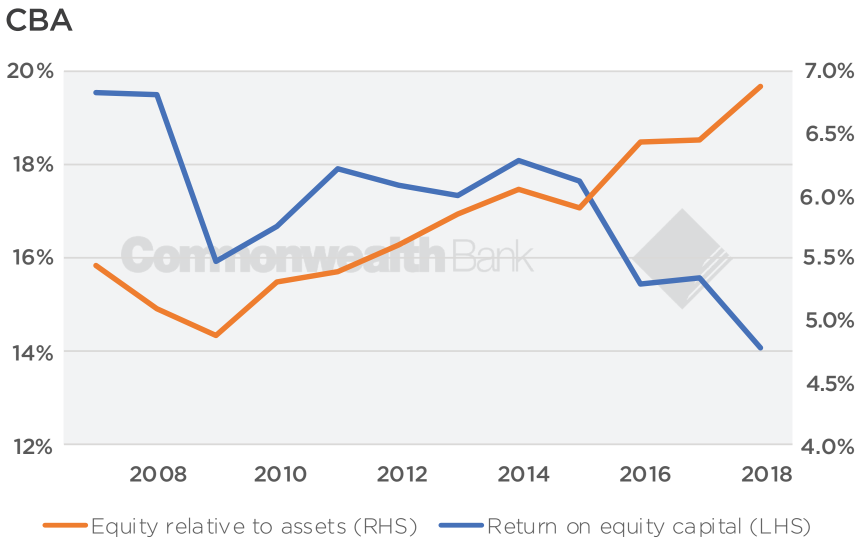
New York Times Company - ROIC



Source: Factset

- **Banks** – perhaps there is no better example of contraction in the value of their existing capital base than major banks. Banks are capital-intensive businesses—regulators require a certain amount of shareholders' equity to be held against each dollar of loans and investments. This capital requirement, has significantly increased over the past decade. The profit banks earn on each dollar of assets has, at best, held steady, so profit as a percent of equity capital has declined. This is shown clearly in the chart below for Australia's Commonwealth Bank (CBA), with increasing equity capital-intensity shown in orange and deteriorating return on equity capital shown in blue.

The deteriorating returns on capital for banks has come principally through rising capital intensity.



Source: Factset

A company whose **reinvested capital** earns less than the cost of capital is also becoming progressively less valuable. Every dollar invested back into the business becomes worth something less than a dollar for shareholders by virtue of the subpar return it earns. The faster such a business grows, the more rapid the process of value destruction. For the 'shrinking moats' described above, in many cases reinvestment in the existing asset base in an attempt to generate even modest growth will most likely produce poor returns. This has certainly been the case for European banks over the last decade, or investments made by newspaper companies in more efficient printing presses.

Often, such 'shrinking moat' companies accelerate the process of value destruction by trying to acquire their way back to prosperity. In the last few years, a number of traditional telcos have made acquisitions in digital media, only for the acquired company to fall short of its promise. Verizon, the large fixed-line and mobile telco, acquired both Yahoo and AOL in a bid to offset competitive pressure in its core business. In December it wrote-off half of the $9bn spent on these two businesses.

Two local examples where incremental capital has been deployed in a way that destroyed value are:

- **Woolworths –** Woolies' decision to take capital from its highly profitable core supermarket business and invest in Masters, a start-up DIY hardware venture, resulted in a total loss of roughly $4 billion. This is an example of what is sometimes known as 'filling in white spaces'.
- **Wesfarmers –** not to be outdone, Wesfarmers' decision to acquire the UK hardware retailing business Homebase resulted in a loss of approximately $2 billion.

We have an aversion to management teams who expand into remote or unrelated areas, filling in 'white spaces' or 'expanding our addressable market'. This is what legendary investor Peter Lynch famously called '*diworsification*'.

*At Aoris we look to own businesses earning a superior ROIC **and** able to reinvest capital at high rates of return.*

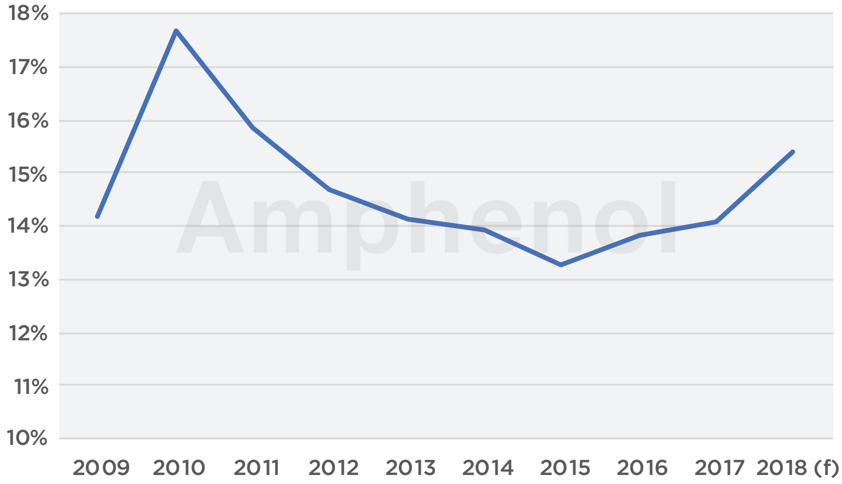
Wealth creation—how it works for a superior company

Businesses earning a return on capital above their cost of capital and able to reinvest their surplus cash at rates above their cost of capital are a rare breed, the superior wealth generators. The value of their existing capital base is growing, and they are amplifying this wealth creation through reinvestment. These are the only business that we will own.

- **The existing capital base –** we look to invest in businesses with strong competitive positions where this is reflected in high returns on invested capital. We look for a high ROIC combined with *persistence or durability*—in other words, staying power.
- **Reinvested capital –** we want businesses where the capital generated by the existing asset base can be reinvested at attractive rates. This will depend a great deal on management and the choices they make.

Often the best place to deploy incremental capital for a strong business is in its existing franchise, not outside it. We like businesses with a strong competitive 'moat', where capital reinvestment strengthens and deepens this moat. The wealth-destructive acquisitions of Woolworths and Wesfarmers can be contrasted with **Amphenol**, which is one of the world's leading producer of electrical connector devices and one of our portfolio holdings. Amphenol generates a high amount of discretionary investment dollars relative to net income, and uses this primarily to make 'bolt-on' acquisitions of other connector companies. In early 2017, Amphenol paid $60m to acquire Phitek, based in New Zealand and a leader in connects for aircraft in-flight entertainment systems. By staying firmly within its area of expertise, and paying modest prices for these businesses relative to their earnings, Amphenol's ROIC from reinvestment has earned returns well above its cost of capital. Amphenol's total ROIC is shown below.

Amphenol - ROIC



Source: Company data and Aoris analysis

Generally, it is easier for a business to earn attractive returns on incremental investments when it is expanding its capital base at a modest rate, say 5–10% per annum, than when it is growing its balance sheet rapidly. Aggressive expansion in the capital base is often associated with large, expensive acquisitions. Wealth destruction through poor returns on incremental investment is ultimately reflected in share prices. In fact, there is a powerful statistical correlation between balance sheet growth and negative share price performance.

Sometimes, companies can improve the attractiveness of their reinvestment options by *exiting* their least attractive businesses and allocating reinvestment dollars only to their best opportunities. This is what we call 'shrinking to the core'. **Cintas**, a portfolio company that is America's largest uniform rental provider, sold its document destruction business in 2015, which accounted for 6–7% of group revenue. This allowed Cintas to focus its investment dollars on its core activity, uniform rental, a far superior business to paper shredding.

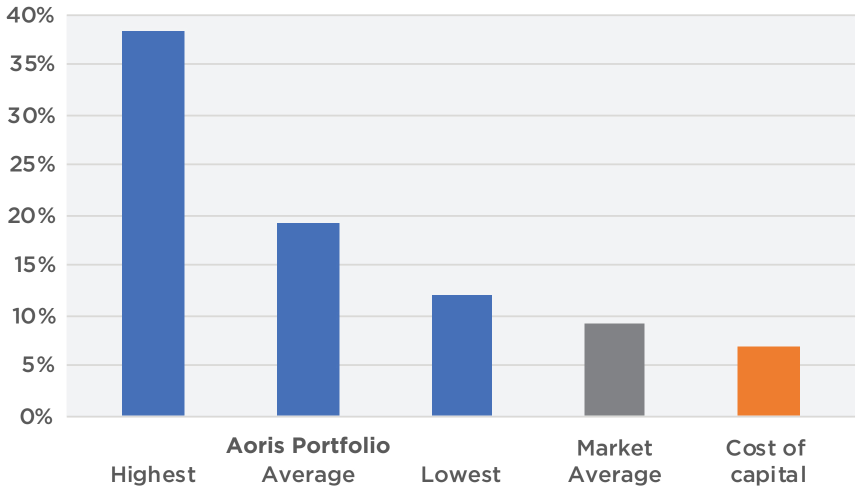
CONCLUSION

As investors, we seek to own wealth-creating businesses, those that become more valuable over time. How is this different from earnings per share growth? If you have money in the bank on a term deposit it may grow at 1.5–2% after tax. But if inflation is 3%, then 3% is the minimum after-tax return you need to preserve your purchasing power. So, on an after-inflation basis, you have gone backwards. Likewise, a business can grow its EPS yet erode shareholder value. How so? If it expands its capital base by making investments that earn a 4% return yet its investors require a return of 6–8%, then in doing so it is becoming less valuable. Beware of management trumpeting a large acquisition as 'EPS-accretive'—EPS growth is not the same as value growth.

We believe in wealth creation through superior ROIC. As shown in the chart below, not only does the Aoris portfolio on average earn an ROIC above a cost of capital, every stock that we own does.

__Every__ single business we own earns a ROIC superior to both the market average and the cost of capital.

Aoris portfolio - ROIC last 12 months

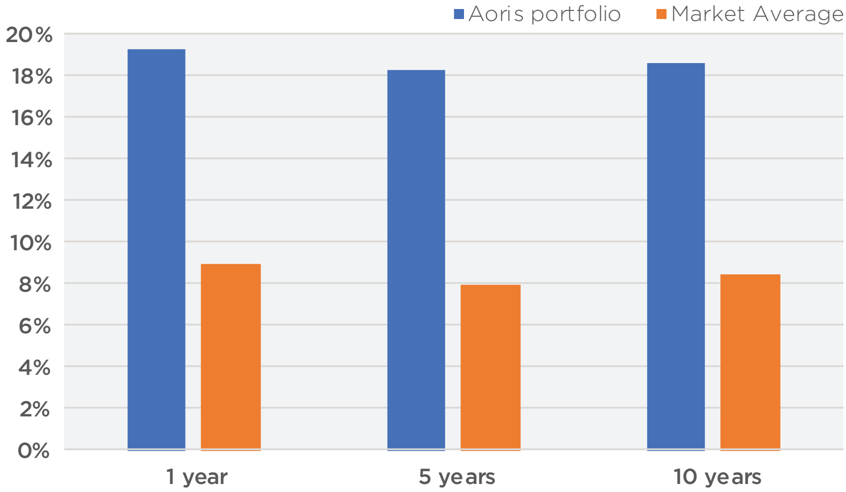


Source: Company data, Factsheet and Aoris analysis.
Market average is all listed non-financial companies with market capitalisation above USD5bn.

We are highly averse to the risk of 'shrinking moats', or highly profitable businesses becoming less so. The persistence through time of the high ROIC of our portfolio is shown below.

The businesses we own have earned high ROIC with impressive durability.

Aoris portfolio average ROIC vs market average



Source: Company data, Factset and Aoris analysis. Aoris portfolio as at 31/12/2018.
Market average is all listed non-financial companies with market capitalisation above USD5bn.

In our March quarterly feature, we will discuss the link between return on capital and earnings growth. In our June quarterly feature, we will round-out our four-part series on growth by discussing how ROIC and EPS growth relate to our 8–12% over-the-cycle investment return expectation.

AORIS INVESTMENT MANAGEMENT

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A COMMON SENSE APPROACH EXECUTED WITH UNCOMMON DISCIPLINE