Constantia Investment Partners

Quarterly Note

1st Quarter 2022

Dear fellow investor

As the saying goes, there are decades when nothing happens, and weeks in which decades happen. Sadly, the first quarter of 2022 seems to us to be likely remembered as one of the latter.

Let us state at the start of our quarterly letter that what is currently happening in Ukraine is a tragedy. Bringing hostilities to an end and alleviating the escalating human cost of the conflict should rightly take precedence; against this backdrop, considering market opportunities seems callous. Yet, we are clear-eyed about our job: acting as custodians of our investors' wealth over long periods of time. That requires us to take a level-headed approach in assessing financial risk and opportunity. In doing so, we are not minimising nor ignoring the human cost of the war – we are simply sticking to our knitting.

The first quarter of 2022 was defined by two very different events on either side of the Atlantic.

Firstly, the market has begun to factor in a string of interest rate hikes and withdrawal of monetary stimulus by the Federal Reserve in response to what increasingly appears to be structurally higher levels of inflation.

Supply chain bottlenecks continue to mean that goods such as new cars get snapped up off dealership floors faster than ever; auto dealers are worried more about where they will get the next car to sell than where they will find the next customer to sell to. Economists refer to this as phenomenon as 'demand-pull' inflation.

At the same time, the aforementioned disruption to supply chains (along with increases in commodity prices and other input costs) are leading to 'cost-push' inflation. The dual phenomena of both 'cost-push' and 'demand-pull' inflation playing out at the same time likely explains why inflation is remaining stubbornly high at present.

With that said, the US consumer remains the engine room of the global economy and is still in reasonably good financial health. As we have cautioned in the past, rising interest rates create a headwind to consumption. The current cycle has been aided by record levels of mortgage refinancing (at rock-bottom interest rate levels) that have boosted consumer spending via the wealth effect. While the winds of change are clear, the fact of the matter right now is that if a business has a product to sell and it is in stock, they should not have trouble finding a buyer, regardless of price.

Secondly, geopolitical risk came to the fore as Russia invaded the Ukraine. Without diminishing the aforementioned human tragedy that any form of armed confrontation brings, we are not and will never be military experts. We estimate that the businesses owned in the fund have less than 2% of their combined revenues exposed to Russia and Ukraine.

Quoting from our 2021 Annual Letter, published in January 2022:

> *Your investment team have lived and gained investment experience in numerous countries over multiple cycles, both in emerging markets and in developed markets. We believe this withdrawal of liquidity is a time for caution in knowing not only what your money is invested in, but where your money is being invested.*

While the quote refers more directly to the withdrawal of monetary stimulus (which the market has taken a giant leap in factoring into asset prices during the quarter) we must assess and manage for geopolitical risk as we would for many other seemingly unlikely risks (such as country risk, counterparty risk, liquidity risk, etc.) on an ongoing basis.

While we cannot (and won't) predict how or when geopolitical risk could manifest, thinking about what might happen next and ensuring the Fund is robust to a wide range of possible outcomes is to our thinking the most sensible approach in the pursuit of long-term compounding.

As such, we note with some concern how many other investors are surprised when (for example) the Moscow stock exchange is unilaterally shut to foreign capital, meaning investors cannot be guaranteed of a return of their capital (much less a return on it). Knowing where you are invested is the first step in capital preservation, and is a lesson we believe not all market participants comprehend the value of.

While the cause of risks in seemingly distant corners of the world are unpredictable, certain regions lend themselves to commanding a material valuation discount. Often when something is cheap, it is cheap for a reason, and it may eventually cost you more than you had bargained for.

Performance to 31 March 2022

	GHCF	Benchmark
Financial Year 2022	+1.4%	+2.8%
2022 (Calendar YTD)	-11.1%	-8.2%
2021	+31.1%	+29.3%
2020	+14.2%	+5.6%
2019 (Strategy Inception: 31 Aug. 2019)	+5.3%	+6.3%
Cumulative Since Strategy Inception	+40.2%	+33.2%
Annualized Since Strategy Inception	+14.0%	+11.8%

Total returns shown for the AIM Global High Conviction Fund have been calculated using exit prices after taking into account all the product's ongoing fees and assuming reinvestment of distributions. No allowance has been made for entry fees or taxation. Past performance is not indicative of future performance. Benchmark is MSCI World Net Total Return in AUD (source: Apex Group.)

Looking Ahead

How and when the conflict in Eastern Europe is resolved we cannot predict. What we can be reasonably certain of is that there will be structural changes as a result; we can then attempt to reason through what this could mean going forward.

In our opinion, nations around the world may in future relook at their historic curtailment of investment spending on military capability, as well as energy and resource security and independence. It follows that the world is likely entering a period of sustainably higher defence spending, as well as higher investment in energy, commodity, and manufacturing independence for numerous industries.

Decades of globalisation resulted in a certain level of trust developing amongst nations, leading to highly efficient supply, and resulting in cheaper goods for consumers.

Such optimisation now looks set to take a back seat in favour of creating aligned supply chains that provide economic resilience and security in the face of an increasingly polarised geopolitical landscape.

Practically speaking, this likely means onshoring and investment in infrastructure and local manufacturing. How and where capital is redeployed may mean jobs and wages that were previously outsourced to cheaper parts of the world return 'home' to developed nations.

Certain investing principles will remain unchanged. Companies with pricing power, strong balance sheets and exceptional capital allocators at the helm will prevail and flourish independent of the stage of the investment cycle. We believe the Fund owns businesses managed by the sort of aligned owners that can take advantage of the opportunities ahead brought on by these structural changes.

The Ukraine conflict has changed where and how dollars will flow on a global basis. Our approach to how and where we invest your capital and manage risk remains consistent. We remain flexible and where appropriate will direct your capital to capture these shifts and navigate what may very well be the start of a new and very different capital cycle to that of the past decade.

Conclusion

In the remainder of this letter, we will discuss a top holding in the Fund – Constellation Software – and also explore why ‘capital light’ businesses are fundamentally advantaged through periods of higher inflation.

At the back of this letter, there is the usual addendum containing our quality scorecard, internal sector allocation, geographic revenue exposure, and the top ten holdings.

Thank you for continuing to entrust us with your capital, particularly in these uncertain times. Please feel free to contact us directly if you have any questions regarding your existing or a top-up investment.

Kind regards,

Etienne, Les, Dan & Andrew

Ad Astra Per Aspera – Constellation Software

by Etienne Vlok

Founded in 1995 and coming to market in 2006, Constellation Software is an acquiror, owner, operator, and builder of software businesses that service very specific and niche vertical markets. For over 25 years, management have demonstrated a remarkable ability to allocate capital into value-creating acquisitions, bolstering its collection of vertical market software (VMS) businesses to service thousands of public and private sector clients while acting as exemplary stewards of shareholder capital. Returns have been stellar, to say the least: Constellation has compounded at roughly 34% per annum since IPO.

(Vertical Market) Software: Eating The World (Bite by Tiny Bite)

Venture capitalist Marc Andreessen famously wrote in 2011 that “software is eating the world”; his words have proven to be extremely prophetic, as this is precisely what has occurred over the past decade. Today, software investing is generally seen as being about finding businesses that can sell into a broad total addressable market (or TAM, to use the industry jargon), have low customer acquisition costs (CAC), predominantly generate recurring revenue through a subscription-based model, and seek to maximise customer lifetime value (LTV) by optimising for high rates of net revenue retention (NRR) through a combination of cross-sell and up-sell strategies: in short, the software-as-a-service (SaaS) model.

While all these attributes are highly desirable in a lucrative software business, Constellation plays at a very different end of the market. Instead of looking for businesses with a massive TAM, Constellation seeks to own businesses that operate in extremely niche verticals where the TAM is – by definition – very limited. (Some examples include providing software to the forensic investigation teams of police departments, club membership management software to a variety of sporting and lifestyle clubs, software to agricultural, construction & material distributors, software for pension planning in the personal financial advice market. All told, Constellation owns more than 700 of these types of niche VMS businesses all over the world, largely acquired in private markets.)

The attraction of owning software businesses in narrow vertical niches with modest growth rates is not as immediately obvious as owning a software business with wide, horizontal appeal across a variety of end markets. (Microsoft’s Office suite of applications is a good example of horizontal software: applicable to everything from a florist to a coffee shop to an investment manager.) However, since most vertical markets are incredibly narrowly defined, the implication is that there are often no new competitors attracted to it, meaning the incumbents are free to earn reasonably attractive economic returns over time as long as they adequately look after their clients’ needs. (To push the example provided to an extreme length, we think there is little chance of Microsoft developing software that specifically addresses the workflows of an auto repair shop.)

Constellation acquires, owns, and operates a huge number of VMS businesses. We will return to the ‘acquisition’ part of the model in more detail below but, allow us to spell out a few more points on what makes the VMS market uniquely attractive.

As a starting point, the average VMS business is of reasonably high quality. Every software business has the advantage of at least one natural moat (switching costs), affording it recurring revenue streams and pricing power. Additionally, it is naturally ‘capital-light’, needing little by way of tangible assets (other than some desks and computers) to generate value; the true value lies in the IP of the software and the people who developed it.

In addition, the VMS market is huge. (Constellation says it tracks more than 40,000 VMS businesses around the world.) While each individual vertical niche may be limited in size by market structure and geography, the *number of niches* is truly as broad and diversified as the global economy – and because most software businesses share some basic building blocks and operating models, it means there is a level of best practice than can be developed (over time) and then applied when evaluating, buying and operating VMS businesses, regardless of the diversity of their ultimate end market.

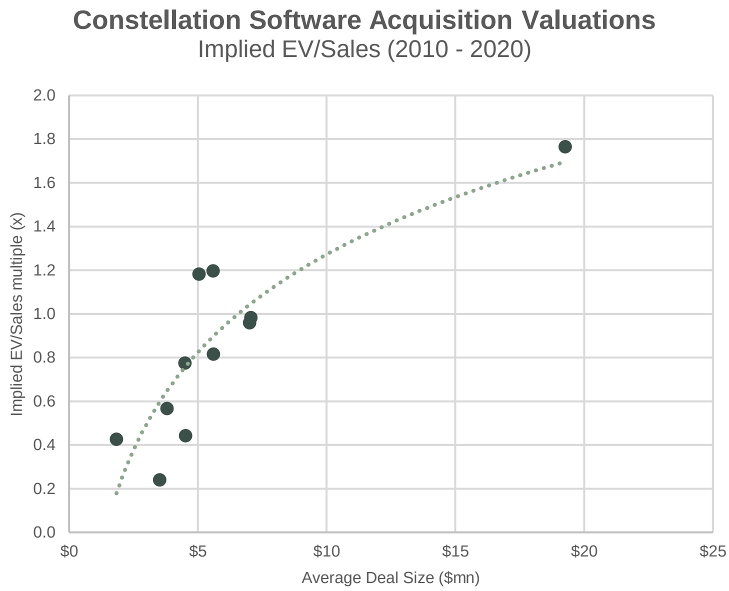
Owner, Operator, Acquirer

While Mark Leonard (CEO and founder) describes Constellation’s objective in the 2017 Shareholder Letter as being “a great perpetual owner of VMS businesses […] because they are asset-light, have robust moats, and attract the sort of managers and employees with whom we enjoy working”, the reality is that we are not buying an ownership stake in a set of low-growth, static VMS businesses owned through a listed entity. (If we were, the expectations embedded in current market values are far too high!) In reality – and in our opinion, far more importantly – we are buying a repeatable process to allocate capital to create value. Constellation should rightly be assessed as a 'serial acquirer.'

As the name would imply, serial acquirers are in the business of buying other businesses on a frequent basis. However, financial history is fraught with examples of this approach coming to a very bad end for shareholders. A simple base rate analysis suggests failure is a likely outcome for most serial acquirers. Constellation, however, has maintained 25%-plus returns on invested capital (ROIC) for all of it's listed existence, implying they are clearly doing something right on a sustainable basis.

We differentiate between the type of serial acquirer we would be interested in buying, and those we'd be well advised to avoid. The type of serial acquirer we are interested in owning has deep moats, allowing them to earn very attractive returns on capital and high levels of free cash flow. However, lacking internal reinvestment opportunities to absorb the excess capital being generated, the management team elects to acquire additional businesses at valuations that mean the capital invested through acquisition earns a return on capital that still handily exceeds the opportunity cost of capital of the firm.

Implicit in this statement is that the 'good' kind of serial acquirer is run by a highly trustworthy and experienced management team that understands hurdle rates, value creation, and that the price paid dramatically impacts the after-tax internal rate of return (IRR) one can earn on capital invested. Constellation ticks all of these boxes, and avoids overpaying by generally hunting in private (rather than listed) markets. For some context, Constellation on average pays a 1x (or less) multiple of sales for the businesses it has acquired, and deal size has historically averaged in the USD5mn – USD20mn range. (This compares to price to sales multiples above 10 – and in many cases of late, well above 20! – in the listed equity space for software businesses). Constellation has made some larger acquisitions (with prices running into the hundreds of millions of US dollars), but these are scarce and don't comprise the bread-and-butter of Constellation's acquisition pipeline.



Source: Constantia analysis, Constellation Software financial reports.

For those interested, the type of serial acquirer we avoid are those in fundamentally low-return industries, run by management teams more interested in 'rolling-up' the industry and frequently paying in equity (rather than in cash, which we have observed tends to focus the mind on the price paid). 'Bootstrapping' as a method of optical value creation (buying earnings on a low multiple, then having it trade on a higher, listed multiple) is another red flag.

The point of all of the above is to say that not all serial acquirers are of equal quality, and to assess them properly requires an understanding of a) what management is looking to achieve through acquisition, b) how they are incentivised to do so, and c) the historical capital allocation framework and track record of said management team. Scott Management, LLC produced what we consider an exemplary framework through which to classify serial acquirers; we present it below with minor modifications for clarity.

Serial Acquirer Classification				
Type	Roll-up	Platform	Accumulator	Holding Company
Degree of Operational Integration	High	Medium	Medium to Low	Low
Attributes	Commodity-like product Scale-driven synergy targets	Product differentiation; clustering of subsidiaries Shared operational excellence programmes	Product differentiation; little to no integration Shared operational excellence programmes	Portfolio of unrelated businesses Influence only via board representation
Examples	Waste Management Inc., Rentokil	Danaher, Thermo Fisher	Constellation Software	Berkshire Hathaway

Credit: Scott Management, LLC.

Launching into an in-depth discussion of each type of serial acquirer is beyond the scope of this note (though you may notice of few of our other holdings cited as an example); for now, let us focus on Constellation as an 'accumulator.'

A feature of the accumulator model operated by Constellation is that acquired businesses are largely left alone to run within one of their six designated operating groups (OGs), beyond the sharing of some 'best practice' ideas when it comes to solving particular operating challenges. There is no attempt to integrate them and extract 'synergies' by centralising back-office functions, for example. To our thinking, this enforces a base level of valuation discipline, as there is not a lot of scope for fuzzy 'back-end loaded synergies' to cause forecasted numbers to look more attractive than what may be achievable in reality.

This is supplemented by data – lots of lots of data. Given the hundreds of deals Constellations has done – in different regions, in different end-markets, and with different types of business model – it has an internal trove of data generated by post-acquisition reviews, normally conducted about a year following the closing of a deal. Analysis of this data has led Constellation to be able to develop evidence-based views (rather than gut-feel based assessments) of whether the assumptions being made when considering a new acquisition is aggressive or not. As Leonard wrote in 2016:

> *As we teach more people at CSI how to deploy capital, we lean on the accumulated data from our historical acquisitions to help maintain investment discipline. We have base rates for a variety of key operating metrics. Whether it is a neophyte investment champion arguing that a particular acquisition is "special", or a senior executive being tempted by a large acquisition, we have enough data to make the discussion rational, not emotional. We all know whether the key assumptions are being pushed to the 55th or 95th percentiles of our historical distributions.*

We think this data-driven approach, supplemented by properly aligned incentives, is the key reason for Constellation not falling prey to the usual curse of most serial acquirers: falling returns on capital as the deployable capital base of the business grows larger. In fact, Constellation has made a point of institutionalising its capital allocation process and devolves decision making down to the six OGs (Volaris, Harris, Topicus, Vela, Jonas, and Perseus) for deals below a certain dollar value as much as possible.

The combination of a deep-seated belief in evidence-based decision making, decentralisation of an institutionalised capital allocation process, and the relative uniformity unique to the VMS market allows for Constellation to close dozens, if not hundreds, of acquisitions each year, allowing for the capital allocation process to 'scale up' with very attractive returns even as the capital base of the business has grown.

Management Incentives: Truly Aligned with Owners

Of course, none of the above matters if the people making the decisions cannot be trusted to create value for owners.

As we have written to you before, we see our job being "to prudently allocate your hard-earned capital to trustworthy people at an attractive price, and then to let them get on with creating value." In the case of a serial acquirer like Constellation, every part of this is even more relevant, as the value creation is directly linked to the ability of management to act for shareholders when allocating capital. To say we place a huge premium on good management conduct towards minority owners is an understatement. Management conduct will usually speak for itself over time, but properly constructed and aligned incentives can provide minority owners with a vastly higher degree of comfort.

Below are a few points extracted from Constellation's recent proxy materials:

> *We believe that shareholder value is created by managing two financial components over the long term: profitability and growth. As such, our corporate bonus plan, which compensates employees at all levels of our organization, is based upon return on invested capital ("ROIC") and net revenue growth.*
>
> *A 'risk free' rate of return established by the board (currently 5%) is netted from the ROIC. If the ROIC does not exceed the risk-free rate of return, then the manager of the business receives no bonus.*
>
> *Executive officers are required to invest 75% of their after-tax incentive bonus into Common Shares. The shares are held in escrow for a minimum average period of four years. Once in every five-year period, executive officers may choose to receive their bonus entirely in cash.*

A focus on economic value creation and being co-owners of the business is the right way to ensure Constellation's managers solve for the agent-principal problem inherent between equity owners and management, and aligns well with the decentralized, data-driven capital allocation approach explained above.

In addition, we find it extremely noteworthy that over its history as a listed business, Constellation has not issued a single share of additional equity beyond what existed on the IPO date. The 21,191,530 shares outstanding since 2006 is the same number outstanding today, indicative in our opinion of Leonard and his executive team putting their money where their mouth is when it comes to treating shareholders like true partners. (In a different context, and with our tongue firmly in cheek, we might point to the Constellation share count as being the original "there will only ever by 21 million" rather than bitcoin!)

Thinking like a business owner means treating shareholder's funds and equity with the utmost care and caution. Given our long-term investment horizon, the importance of the capital allocation decisions made by the companies that we invest in within the Fund is paramount.

Compounding Into the Future

In February 2021, Mark Leonard starts off his President's Letter to Shareholders with the following words:

> *One of our directors has been calling me irresponsible for years. His thesis goes like this: CSI can invest capital more effectively than the vast majority of CSI's shareholders, hence we should stop paying dividends and invest all of the cash that we produce, even if it means lowering our hurdle rates.*
>
> *I used to argue that we needed to maintain our hurdle rates because dropping them for a few marginal capital deployments would cause the returns on our entire portfolio to drop. The evidence supported my contention, so we kept the rates high for small and mid-sized vertical market software ("VMS") acquisitions and made very few exceptions for large VMS acquisitions. The by-product of that discipline has been a perennial inability to invest all of the cash that we generate.*
>
> *What have we done with that excess free cash flow available to shareholders ("FCFA2S")? Historically, we have paid three special dividends, and for the last decade we have also paid a regular quarterly dividend. I*

have stopped arguing. I have converted, and with the fervour of the newly converted, I am busy demonstrating my new-found faith.

[…]

At head office our original objective was to be "good perpetual owners of VMS businesses". Our success forced us to delegate that task to the Operating Groups. Head Office now needs to become a "good steward of our investors' capital". To that end, we are working on two initiatives: 1) increasing the number of very large VMS businesses (i.e., those requiring multi-hundred-million-dollar equity cheques) that we pursue, and 2) developing a circle of investing competence outside of the VMS sphere.

Mark Leonard has written extensively about maintaining valuation discipline and keeping hurdle rates high, preferring to invest (by way of example) 20% of free cash flow at returns between 25% and 30% and distributing the balance. In February 2021, he changed his mind, accepting that investing a larger portion of free cash flow at lower hurdle rates may make sense <u>as long as the returns generated remain solidly above the cost of capital.</u>

In the past year, dealmaking levels have ramped up, and in November, Constellation even announced a $200mn internal venture capital fund with very favourable terms and incentives for founders and Constellation. Deal sizes have increased but the return on invested capital has remained firmly in the mid-to-high 20% range in 2021.

Given that Constellation is not a buyer looking to 'flip' their acquired businesses, they will likely only ever attract a subset of potential VMS founders looking to sell. But for all the reasons explained above – the data driven approach to dealmaking, the properly aligned incentives, the ability to scale up the M&A function even as the capital base grows, and the willingness to be flexible about investing greater amounts of capital as long as the economic returns are positive – positions Constellation as a highly attractive compounder when we look into the future.

The senior executives of Constellation have earned our trust with years of consistently acting with extremely high levels of integrity for equity owners and have time and again demonstrated a superb grasp of value-based capital allocation. As we have said on numerous occasions, this is exactly the type of management team and business one would wish to own during a period of market distress, as the balance sheet will be judiciously employed to create value for shareholders.

When we purchased our interest in Constellation in March of 2021, we believed we were being amply rewarded with a margin of safety to partner with the Messrs. Leonard & co. at Constellation. We look forward to where the business goes from here.

Capital Lightness & Inflation

by Etienne Vlok

As central banks and consumers currently battle with high levels of inflation around the world, there is an ever-present temptation to want to own businesses that are backstopped by tangible assets on the belief that these will protect against the devaluation of currency.

However, this misses the fact that businesses heavily reliant on tangible capital face asset depletion, meaning a greater part of profits must be reserved to replenish the asset base at increasingly higher nominal dollar values. In this way, accounting earnings can overstate the fundamental profitability of a business reliant on tangible capital, as the depreciation of existing assets is an accounting construct based on a truly magical currency, the "yesterday dollar". (Sadly, new capital expenditure must be made in the all-too-real "today" dollar.)

In the 1983 letter to Berkshire Hathaway shareholders – a document we have referred to on many previous occasions, simply because it is in our opinion the single best summary of the impact of inflation on business reinvestment requirements – Warren Buffett compares the economics of an asset-light business (See's Candies, purchased by Berkshire in 1972) to that of a hypothetical asset-intensive business during periods of high inflation. (For those interested, we would also recommend reading Buffett's 1977 article for Fortune, *How Inflation Swindles the Equity Investor*.)

From the 1983 Berkshire letter:

> *When we purchased See's in 1972, it will be recalled, it was earning about $2 million on $8 million of net tangible assets. Let us assume that our hypothetical mundane [capital intensive] business then had $2 million of earnings also, but needed $18 million in net tangible assets for normal operations.*
>
> *Earning only 11% on required tangible assets, that mundane business would possess little or no economic Goodwill. A business like that, therefore, might well have sold for the value of its net tangible assets, or for $18 million. In contrast, we paid $25 million for See's, even though it had no more in earnings and less than half as much in "honest-to-God" assets.*

What Buffett is saying here is that – despite both the capital light- and the capital-intensive business earns the same dollar amount of profit ($2mn), the required capital investment to generate these profits differ ($8mn vs. $18mn), meaning See's earns a very attractive 25% on invested capital ($2mn/$8mn) compared to 11.1% ($2mn/$18mn) for the 'mundane' business. Given it's 'capital-lightness', See's generates more 'free' cash, and is therefore valued more highly ($25mn equates to 12.5x earnings or 3.1x book value) than the mundane business, which at $18mn is valued for essentially 1x book value of invested capital (or 9x earnings.)

Mathematically speaking, the above scenario can be illustrated as follows:

Pre-Inflation	Capital Light	Capital Intensive
Profits ($mn)	2	2
Tangible Assets (Invested Capital) ($mn)	8	18
Return on Tangible Capital	25.0%	11.1%
Pre-Inflation Price ($mn)	25	18
Price/Earnings (x)	12.5	9.0
Price/Book Value of Capital (x)	3.1	1.0

So far, so good. Now, enter inflation – in Buffett's example below, he uses a 'doubling' of the nominal price level, so essentially inflation of 100%.

> *Could less really have been more, as our purchase price implied? The answer is "yes" – even if both businesses were expected to have flat unit volume – **as long as you anticipated, as we did in 1972, a world of continuous inflation.***

> *To understand why, **imagine the effect that a doubling of the price level** would subsequently have on the two businesses. Both would need to **double their nominal earnings to $4 million to keep themselves even with inflation**. This would seem to be no great trick: just sell the same number of units at double earlier prices and, assuming profit margins remain unchanged, profits also must double.*

While a doubling of nominal dollar value of sales looks fantastic – profits have risen from $2mn to $4mn! – keep in mind that the owners of the business have advanced not one jot in terms of their real purchasing power: their $4mn in profit now buys what $2mn did a year ago.

In addition, due to the difference in the dollar amount of capital required to bring about this doubling in nominal profits, the owners of these two businesses experience very different economic outcomes.

> *Crucially, to bring that about, **both businesses probably would have to double their nominal investment in net tangible assets**, since that is the kind of economic requirement that inflation usually imposes on businesses, both good and bad. **A doubling of dollar sales means correspondingly more dollars must be employed immediately** in receivables and inventories. **Dollars employed in fixed assets will respond more slowly to inflation, but probably just as surely.***
>
> *And all of this inflation-required investment will **produce no improvement in rate of return**. The motivation for this investment is the survival of the business, not the prosperity of the owner.*
>
> *Remember, however, that See's had net tangible assets of only $8 million. So it would only have had to **commit an additional $8 million to finance the capital needs imposed by inflation**. The **mundane business**, meanwhile, had a burden over twice as large – a need for **$18 million of additional capital**.*
>
> *After the dust had settled, the mundane business, now earning $4 million annually, might still be worth the value of its tangible assets, or $36 million. […] See's, however, also earning $4 million, might be worth $50 million if valued (as it logically would be) on the same basis as it was at the time of our purchase.*

Herein lies the crucial difference: See's owners saw the **value of their business appreciate by $25mn in nominal dollars on an additional $8mn of invested capital** – a ratio of 3.1x. In contrast, the capital-intensive business would still be worth the value of its net tangible assets, i.e., $36mn; it's owners would have put up an additional $18mn in capital for the business to be worth $18mn more.

Again, here is the math:

Post-Inflation	Capital Light	Capital Intensive
Inflation (%)	100.0%	100.0%
Additional Invested Capital Required ($mn)	**8**	**18**
Profits ($mn)	4	4
Tangible Assets (Invested Capital) ($mn)	16	36
Return on Tangible Capital	25.0%	11.1%
Post-Inflation Price ($mn) - nominal	50	36
Price/Earnings (x)	12.5	9.0
Post-Inflation Nominal Price Gain ($mn)	25	18
Additional Nominal Dollar Capital Injection ($mn)	8	18
Price Gain/Additional Capital Injected (x)	**3.1**	**1.0**

The concept outlined above should be extremely helpful in explaining how we think when we allocate your capital, which is why we took the time to run you through the math. <u>At first</u>, higher levels of inflation may well favour businesses that have some scarcity component assigned to their product, such as commodities producers. However, <u>the longer inflation persists</u>, the increase in nominal cost to repair and replenish depleted tangible assets will begin to erode any such advantage:

> *Any unleveraged business that requires some net tangible assets to operate (and almost all do) is hurt by inflation.* ***Businesses needing little in the way of tangible assets simply are hurt the least.*** *And that fact, of course, has been hard for many people to grasp.*
>
> *For years the traditional wisdom – long on tradition, short on wisdom – held that inflation protection was best provided by businesses laden with natural resources, plants and machinery, or other tangible assets ("In Goods We Trust"). It doesn't work that way.* ***Asset-heavy businesses generally earn low rates of return – rates that often barely provide enough capital to fund the inflationary needs of the existing business, with nothing left over for real growth, for distribution to owners, or for acquisition of new businesses.***
>
> *In contrast,* ***a disproportionate number of the great business fortunes built up during the inflationary years arose from ownership of operations that combined intangibles of lasting value with relatively minor requirements for tangible assets****. In such cases earnings have bounded upward in nominal dollars, and these dollars have been largely available for the acquisition of additional businesses.*

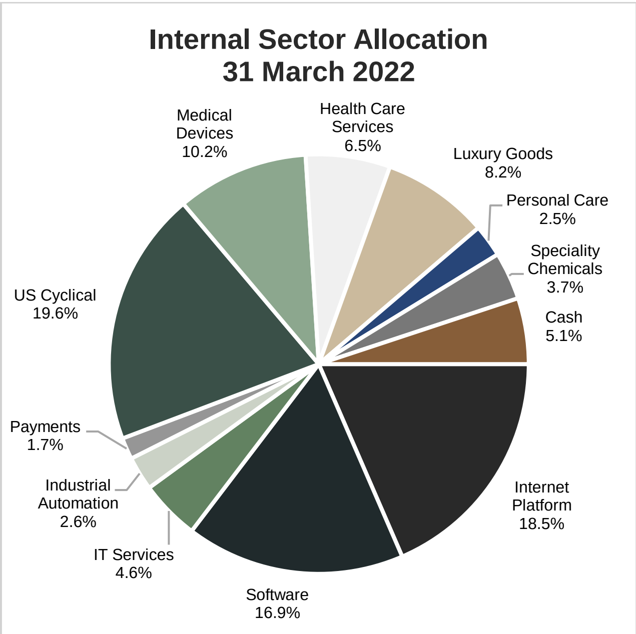
This does not mean we are going to create a portfolio that is a one-way bet on capital-light technology businesses; remaining diversified is important. However, hopefully it explains why we have been so focused in ensuring we own capital-light businesses with pricing power. If inflation *really* takes off – and remains high for a lot longer than people anticipate – our businesses will see their increase in nominal dollar profits be available to allocate into growth avenues.

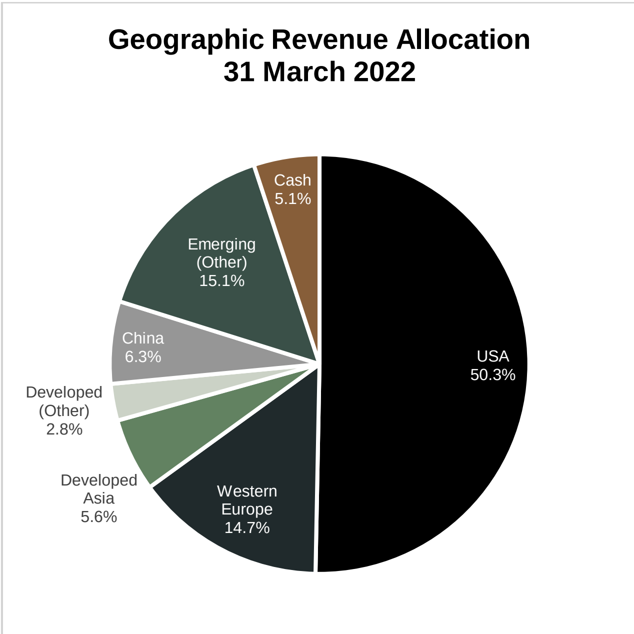
ADDENDUM

Quality Scorecard

Portfolio Characteristic	Dec. 2019	Dec. 2020	Dec. 2021	March 2021
Profitability				
Gross Margin	55.7%	49.8%	52.3%	51.6%
Operating Margin	23.5%	20.1%	24.3%	22.6%
Free Cash Flow Margin	18.9%	17.0%	17.6%	16.4%
Returns on Capital				
Return on Assets (ROA)	13.0%	11.9%	13.7%	13.5%
Return on Equity (ROE)	28.3%	24.9%	30.4%	30.4%
Return on Invested Capital (ROIC)	24.0%	16.5%	20.7%	18.4%
Leverage				
Debt/Equity	87.2%	68.6%	78.3%	75.7%
Net Debt/Equity	19.3%	22.1%	27.3%	24.9%
Valuation				
Free Cash Flow Yield	2.8%	3.2%	2.8%	3.1%
12m Forward Free Cash Flow Yield	3.3%	3.6%	3.2%	3.7%
24m Forward Free Cash Flow Yield	3.8%	4.0%	3.6%	4.1%
Holdings				
Number of positions	19	21	21	21
Active Share	86.5%	87.8%	89.0%	88.4%

Internal Sector & Geographic Revenue Allocation





Source: FactSet, Constantia analysis.

Top Ten Holdings (alphabetical)

Business	Sector
accenture	IT Services
Alphabet	Internet Platform
Berkshire Hathaway Inc.	US Cyclical
Constellation Software Inc.	Software
Fastenal	US Cyclical
HEICO	US Cyclical
Microsoft	Software
Nintendo	Consumer Entertainment
Thermo Fisher Scientific	Medical Devices
UnitedHealth Group	Health Care Services