Constantia Investment Partners

Quarterly Note

1st Quarter 2023

Dear fellow investor

For the quarter ending March 2023, the AIM Global High Conviction Fund delivered an absolute return (after all fees) of +8.6%. We estimate that AUD weakness added roughly +1.6% to our absolute return over the period.

At the risk of repeating ourselves, it feels that these days we can start every investor letter with the quote (frequently attributed to Vladimir Lenin, of all people) that ‘there are decades where nothing happens, and weeks in which decades happen.’

This quarter, we veered from markets a) sounding the all clear on inflation (January) to b) pricing in the Federal Reserve putting up interest rates above 6% on hot inflation data (February to early March), to c) peak interest rate expectations collapsing to ~4% following a quasi-banking crisis in March (which seems to be contained at present, but as with all banking crises, cannot actually be known to be contained except in hindsight.) And – just to keep everyone honest – inflation remains intractably high at well above the central bank targeted level of 2%.

Instead of commenting on all the above (and arguably adding to the noise), we thought it would be a better use of our time (and frankly, yours) if we simply focus on what you expect us to do: finding and owning great businesses that enable us to compound your wealth. To get the compounding part right, we need to focus on the long-term inputs of value creation and not the quarterly storms that dominate headlines.

As such, this quarterly note will largely be focused on discussing some of the businesses in the Fund, although we will briefly discuss why we don’t believe banks are great investments for long-term compounding.

Performance to 31 March 2023

	GHCF	Benchmark
Financial Year 2023	+16.0%	+13.9%
2023 (Calendar YTD)	+8.6%	+9.1%
2022	-15.6%	-12.2%
2021	+31.1%	+29.3%
2020	+14.2%	+5.6%
2019 (Strategy Inception: 31 Aug. 2019)	+5.3%	+6.3%
Cumulative Since Strategy Inception	+44.6%	+38.9%
Annualized Since Strategy Inception	+10.8%	+9.6%

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.)

A 40-Year Success Reduced to Zero in 72 Hours: A Cautionary Tale on Bank Investing

A lot has been written about the sudden demise of Silicon Valley Bank (SVB). We think that briefly explaining how we view the risks unique to the banking business model may be of value to investors.

Banking is theoretically a simple business. Step one: take deposits, make loans. Step two: pay depositors a lower rate of interest than is charged on the loans. Step three: earn the difference (the net interest margin) between these rates as profit.

Since banks assume that not *all* depositors (who are in effect creditors to the bank) will withdraw *all* their money at the same time, the vast bulk of deposits are advanced as loans to consumers and businesses, and not actually held by the bank at any given point in time. Inherent to this activity is a mismatch: *all* deposits are in theory immediately callable (i.e., if you deposit your money at a bank in anything other than a fixed-term deposit, you can withdraw it all tomorrow). In contrast, loans mature over many years. This ‘borrow short, lend long’ feature of banks is known as ‘maturity transformation’, and introduces two built-in, cannot-be-diversified-away, must-be-managed-risks unique to banks:

1. A bank can become insolvent (liabilities exceed assets) if their assets (the loans they have extended) are impaired due to changes in financial conditions (e.g., interest rates).
2. A bank can collapse if their depositors withdraw all their money in a short period of time (i.e., a bank run).

<u>Insolvency Risk</u>

For banks, loans represent *assets* which generate income, whereas deposits are *liabilities* on which interest must be paid.

Loans tend to become impaired when the economy slows or goes into recession, meaning that the assets held on a bank’s balance sheet may need to be written down. If a bank has only 10% of its assets (predominantly loans) backed by equity, a 10% drop in the value of the assets means the value of the equity (the shares that are publicly traded on the stock exchange) is completely wiped out.

To mitigate this risk, regulators force banks to maintain minimum levels of equity capital to absorb losses on the asset-side of the balance sheet. However, this does not fundamentally alter the fact that for a bank, equity represents a proverbial ’thin sliver of hope between assets and liabilities’.

One way to get around this risk is to hold such high levels of equity capital that the losses need to be truly gargantuan in size before insolvency becomes a risk. In doing so, the bank will earn a very low return on said equity capital, turning it into a mediocre business proposition.

<u>Deposit-flight Risk</u>

Of course, even a solvent bank can be destroyed by a deposit run. In fact, all banks operate on the trust of their depositors, and should that trust be shaken for any reason, equity owners are yet again faced with the potential of seeing their investment zeroed out.

If anything, banks are unique in that their risk is often systemic: the mistakes of Bank B could cause a write-down of assets or a run on deposits at bank A. In almost every other industry we can think of, having incompetent competition is a blessing; in banking, it could be an existential risk.

In the case of SVB, its downfall was caused by the purchase of very long-dated US treasury securities at the very bottom of the interest rate cycle. As rates increased, the value of these bonds dropped and impaired the banks’ assets, causing the equity value to dwindle ever closer to insolvency. (The risk management at SVB left much to be desired).

As depositors got wind of the insolvency risk and withdrew their money, the bank was faced with an insurmountable situation: to address the problem, it would need to raise equity, but since the equity was rapidly approaching zero, the amount of shares it would have to issue to shore up its balance sheet became nearly infinite. Thus, a storied bank with a 40-year track record of supporting Silicon Valley went bust in three days.

Our Approach

While few would have predicted the speed of collapse at SVB, we believe that banks have inherently poor business models, which is why we have avoided them, and will largely continue to do so.

As equity investors, we can be focused on all the right inputs of long-term value creation, understand the (literally) tens of thousands of pages of regulation covering banks, invest into a quality banking franchise, and ultimately still get a zero (or a deep impairment of our investment) when a *different* bank from the one we own is felled by a left field risk that shakes the trust in the banking system. Banks are built on confidence; once that off-balance sheet asset is impaired, history proves that shareholders are largely left with nothing. To us, this is a poor risk/reward trade-off.

As a result, we have not viewed the SVB collapse and resulting share price declines of numerous other banks as an opportunity to acquire deeply discounted banking shares. Instead, it has served to confirm why we largely avoid the sector.

One thing we *do* know is that the surest way to interrupt the journey of long-term compounding is to introduce a zero into the mix. Given banks' inherent risk of such an outcome, the hurdle rate required to own a bank is almost insurmountably high to us. At the very least, we do not believe owning a bank is nearly as risk-free as most investors seem to think, and even banking sector experts (which we do not claim to be) can get it very wrong.

With that said, we do think there is at least one intelligent way to benefit from turmoil in the banking sector: by owning Berkshire Hathaway. Warren Buffett has demonstrated a remarkable track record of investing in banks over decades, including some extraordinarily attractive transactions for Berkshire during the GFC. The key point is that when Buffett negotiates, he has the luxury of negotiating a private market valuation not available to public market participants. Equally as important, he can structure a transaction to participate further up the capital table than we could. In combination, these two considerations can materially reduce the downside risk of bank equity.

On a final note, we think that there is a not-insignificant chance that banking regulations will be further tightened over the medium term as a result of this episode. We believe that it is highly likely that the type of regulation required to address this risk will result in sustainably lower net interest margins for banks globally – an outcome which we doubt is fully discounted by the market today.

Portfolio Update

Moving away from banks, there have been positive developments in several businesses we own.

Update on Lumine

As we anticipated in our February monthly update, our spun-out parcel of Lumine shares did indeed begin trading on the Toronto Stock Exchange in March, though at a price well above our estimate of fair value. Holding on to a small allocation (less than 0.5% of the Fund's net asset value) of a position we don't intend on adding to at current prices was a sub-optimal use of capital, and thus we sold the position for an uplift in NAV. We would revisit Lumine if it traded closer to our assessment of fair value.

Games Workshop

In our recent annual investor webinar, we showcased Games Workshop as a good example of the type of high return on capital, debt-free, free cash flow generating and well-managed business we like to own. In particular, management's rational approach to capital allocation was central to our investment thesis.

In a late-March trading update, the business declared yet another special dividend, in line with its' stated policy of 'returning all truly surplus cash to shareholders'. At the time of our initial purchase in Games Workshop (February 2022), the business had just completed a multi-year investment phase, meaning there is suddenly a greater quantum of surplus cash to distribute. Though the just-declared special dividend will only be received in May, we have now earned a dividend yield of ~6.3% on the stock (based on our average purchase price around the GBP75-level) in a 13-month period, and the total dividend declared for the current financial year-to-date is roughly 77% higher than the dividend declared in the previous financial year.

In addition to good news on the dividend front, Games Workshop announced that the 10th edition of their sci-fi tabletop wargame *Warhammer 40,000* (known by fans as 40K) will launch in July 2023. Their three wargaming franchises are updated on a three-year cycle, and the years in which 40K is updated is normally the largest in terms of sales. In short, the future for Games Workshop looks reasonably bright as our investment thesis plays out.

Special Opportunities: Activision Blizzard and Union Pacific Corp.

In our recent webinar, we explained how we categorise each business in the Fund into one of three value creation models: Quality Capital Allocators, High Quality Franchises, or Special Opportunities. Each category represents how we think value will be created by the specific businesses assigned to each. As a reminder:

- **High Quality Capital Allocators** are businesses which have both a fantastic underlying franchise and excellent capital allocators at the helm. The latter means that we expect value to accrue to the Fund not only from growth in the underlying business, but from management deploying the excess cash generated by the operations into value-creating investments (whether internally or through M&A). **HEICO** or **LVMH** are good examples of the type of business we assign to this category. Importantly, these businesses are not wholly dependent on the business cycle for growth.
- **High Quality Franchises** meet the same criteria for the quality of the underlying business, but we do not have as strong a view on whether management can effectively allocate capital towards value enhancing opportunities. This is not to say that management *cannot* do it – merely that the track record of current management could be too short to form a definitive opinion either way. Many people are surprised when we say that **Microsoft** fits into this category, as the expectation is that Microsoft would meet our highest quality filter. While we have nothing but respect for Satya Nadella and the turnaround he has engineered at Microsoft, we cannot definitively say whether the capital allocation decisions made during his tenure as CEO has benefitted from a period of low rates and increasing valuations in all things tech, or from his ability to allocate capital to value-creating opportunities.
- **Special Opportunities** are generally situations where we see an asymmetric risk/return profile: the simplest example would be turn-arounds. Most investments in this category are somewhat contrarian. A case in point would be **PayPal**, which we sold in September 2021 on concerns about management's capital allocation ability. We repurchased the business in 2022 after a 70% decline from its 2021 peak based on the belief that the core business is very healthy, but that management had lost focus. Our thesis is therefore built on a valuation underpin and management either refocusing on the core business or being replaced. The previous CFO departed in 2022, and CEO Dan Schulman announced his intention to retire by the end of 2023. We look forward to seeing how his replacement will run the business and think that a refocused PayPal is worth significantly more than its current market value suggests.

Key to all our special opportunity investments is a tight risk management process. Specifically, we debate upfront our sale triggers (i.e., if event X happens, we sell, regardless of the price) and how much we are willing to invest as a percentage of the Fund at cost. The latter step keeps us from continuing to buy more of a stock beyond a certain weighting if the price decline continues unabated.

Another special opportunity currently in the Fund is video game developer **Activision Blizzard**. The business is presently subject to a takeover bid from Microsoft, which we also own. Activision had gone through a period of turmoil prior to the bid from Microsoft, with chief executive Bobby Kotick overseeing a poor internal culture. As part of the acquisition, Microsoft indicated in advance the steps they would take to improve the culture, and Activision management are already moving forward with their own initiatives, despite the deal having not yet closed.

Our familiarity with Microsoft and understanding of the gaming market lead us to conclude that not only is Microsoft making a shrewd acquisition, but that their intended use of Activision's franchises (to populate a Netflix-like monthly subscription model for video games through Xbox Game Pass) could shake up the existing video game console business model for so-called AAA-quality games, where Microsoft meaningfully lags Sony in terms of consoles sold.

Putting aside the management issues, Activision's core business has some of the most well-known gaming franchises in the world (including *Call of Duty*, *WarCraft*, *StarCraft*, *Overwatch* and *Diablo*) and an attractive stable of mobile games – another area where Microsoft is weak. On a stand-alone basis, we believed that a conservative valuation for the business was around $70. At the upper end, Microsoft's offer to acquire Activation would close at $95/share. In buying the business in the mid-$70 range, we thought that we had limited downside if the deal failed (Kotick is most certainly on his way out at Activision if the deal does not go through), whilst we would experience a near +27% return if the deal was approved.

While the Federal Trade Commission (FTC) in the US has sued to block the transaction, it has passed significant regulatory hurdles in Japan, the EU and the UK in the last few months. We tend to believe that the FTC's rationale for trying to block the deal will be seen as a novel interpretation of the law, and the transaction will ultimately be allowed to close. Recent developments tend to favour our view, but we remain focused on the price and potential risk/return to deal closure. Trading around $86 at quarter end, the prospective return is now less than when we purchased the stock. Should other opportunities present themselves – or the deal be approved and the stock trades towards $95 – we would likely exit the position.

Another special opportunity in the fund is US railroad **Union Pacific Corporation**. We alluded to this business in our February update, and have built a position over the course of March. This is another case of a top-tier asset being held back by poor management. We explore the rationale for this purchase in more detail later in this Quarterly Note. We recommend reading this part of the letter, as we think it speaks to the heart of how we can maintain our focus on quality whilst also being contrarian in the pursuit of identifying opportunities to compound your investment.

Conclusion

The first quarter of 2023 turned out to be rather benign for equity investors, despite the raft of issues that came to the surface. We don't pretend to know exactly how the balance of the year will play out, but we think that we own a well-diversified portfolio of businesses that can withstand a period of economic dislocation, should one eventuate. Moreover, there are opportunities being offered to us in a volatile marketplace, and we continue to see more value in the Fund today than any time since the advent of the pandemic three years ago.

We are continuing in our process of reaching out individually to all clients to offer a meeting or call, as is most convenient. It will take some time to go through the entire register, but we will do so eventually. In the meantime, please reach out to us if you have any questions or would like to meet.

Kind regards,

Etienne, Les, Dan & Andrew

'They ain't building any more railroads'

Hunter Harrison

Union Pacific Corporation (UNP) is the second largest railroad in the United States and one of only five Class 1 freight railroads, operating across 23 states in the Western 2/3rds of the country. Founded in 1862 after then-President Abraham Lincoln signed the Pacific Railway Act, Union Pacific has been a mainstay of American history, having endured through wars, the Great Depression, geopolitical crises and multiple economic cycles.

A Best-in-Class Rail Network with an Enduring Moat

At first blush, one might not think a railway network has any differentiating factors and that it provides a largely commoditised service. In the US, this misses a key nuance: rail operators frequently own both the track and the land rights underlying the track. Any new entrant to railroading would require land ownership or rail usage rights across swathes of privately-owned land across America in order to establish a competing network at scale – an extremely high barrier to entry.

In UNP's case, we believe it owns the best rail franchise in the US, located across the Gulf Coast and Southwestern states (see map below). UNP alone provides rail access to all 6 major crossing points from Mexico into the US, and its rail network is optimised for longer length-of-haul (in contrast to lower-density rivals, who typically operate intercity-type networks that represent a 'spiderweb' of tracks). As a result, UNP's rail network lends itself to longer train lengths, translating into greater operating efficiencies than shorter-haul peers. In addition, the ever-present threat of shifting freight from rail to road is reduced due to this longer length-of-haul, meaning UNP has a wider moat than other rail networks. Its geographic footprint – close to Mexico – also positions UNP to benefit from the structural trend of reshoring supply chains in an increasingly uncertain geopolitical environment.

Source: Union Pacific Corp.

Given this asset base, we believe UNP has a deep and enduring economic moat, and that there is a very high likelihood of its rail network outlasting many other business models, brands, mines, banking franchises, etc. over the coming decades. The US transcontinental railroads constructed more than a century ago are effectively irreplicable today. As the larger-than-life US railroader Hunter Harrison once remarked, they simply 'ain't building any more railroads'.

It's Not Just About the Tracks: Operating Efficiency is Key

Anyone acquainted with the North American railroading industry will no doubt be familiar with Harrison, who is widely regarded as having pioneered the concept of Precision Scheduled Railroading (PSR). For readers not familiar with PSR, it is an operational strategy used by railroad companies to streamline their operations and improve efficiency. At its core, PSR changes the way railroads operate so that the trains 'run on time' as the first priority. Before the implementation of PSR, a train would set off for its destination only once fully loaded. PSR revolutionised the industry by implementing schedules that operators strictly adhere to, whether the train is fully loaded or not – not too dissimilar from how an airline schedule operates.

Correctly executed, PSR makes the trains run like clockwork, allowing for more carriages, longer trains, faster turnaround times and less congestion. This development ultimately improved metrics such as dwell times and average train speeds. resulting in much improved efficiency for the industry as a whole. Harrison was lauded for pioneering PSR in 1993, and its implementation has largely been credited with transforming railroads from mundane, low-return utilities to the more efficient, higher-return operators of today, with much improved returns to shareholders.

UNP adopted PSR in late 2018. Despite embracing PSR for nearly four years, UNP has underperformed peers on customer-satisfaction, safety and operating efficiency metrics for much of the last decade. Based on our analysis, this suboptimal track record can be assigned to poor management execution rather than any intrinsic obstacle in the business. In short, UNP is a business that has not reached the full potential permitted by its ownership of best-in-class rail network assets, as reflected by the fact that it has traded at a discount to other Class 1 rail peers for the last several years.

On the 26th of February 2023, an activist investor made representations to the Board of UNP, outlining the same issues we have identified regarding poor operational execution. In response, the Board announced on 27 February the retirement of the current CEO and formalised a recruitment process to appoint a successor to the role, with a view to the new CEO taking the reins later in 2023. (The fact that the Board immediately agreed to replace the CEO is, in our opinion, telling of their own reading of the challenges faced by UNP).

2019 saw the appointment of industry veteran and PSR expert Jim Vena as Chief Operating Officer of UNP. Vena had previously spent ~40 years operating Canadian National Railway, a decade of which as a disciple of Harrison's. During his brief 2-year tenure at UNP, Vena delivered an improvement of approximately 7% to the Operating Ratio (OR – essentially, the inverse of the railroad's operating profit margin), which bottomed at 56%.

Subsequent to Vena's departure from UNP in 2021, the OR has deteriorated again, and as of its most recent set of financials, it was back to 60%. Some of this OR deterioration was driven by external factors (notably, inflation has hurt costs industry-wide), but even accounting for this, UNP has underperformed peers on metrics such as volume growth, incremental cost per revenue ton mile and safety incidents over the period. What UNP needs is an operator that is focused on addressing all these issues.

In our opinion, Vena would be the ideal candidate to take over the CEO role. Public reports state that he would be willing to do so, and he enjoys the backing of the aforementioned activist shareholder in UNP.

Under the right management team that can not only improve the implementation of PSR but work to accelerate volume and sales growth, we think the OR number could get back to a mid-50s level, and possibly even a percentage point or two below that over time.

A Century of Technological Disruption

A perennial bear case for the railroad industry is the risk of technological disruption. History is littered with businesses that at one point in time were thought of as invincible yet were upended through technological change. Examples abound: the buggy whip was made obsolete by the invention of the automobile in the late 19th century; the typewriter and the electric printing telegraph (forerunner of the fax machine) were displaced by digital equivalents in the 1980s and 1990s.

In contrast, UNP has thrived through more than a century of technological change. If anything, we believe that railroads are likely a beneficiary of technological changes that lend themselves well to long haul railroading, such as battery/electric powered rolling stock or magnetic levitation. In our opinion, these technologies will serve to make rail even more cost-competitive relative to trucking. The technology used on top of the track may change, but the tracks will remain.

Pricing Power

While the US railroad industry is utility-like in nature, its oligopolistic structure confers it a degree of pricing power. With a structural cost advantage on hauling freight relative to the trucking industry, we believe this pricing power should persist.

Despite UNP’s relatively underwhelming operational track record, it has historically delivered a mid-teens return on invested capital (ROIC). We think this level of ROIC should at the very least be sustainable, and more likely improve under new management.

To be clear, we think incremental improvements on a handful of operational metrics will be sufficient in improving shareholder returns rather than UNP needing to be number 1 in the industry. The group is highly free cash flow generative, and typically converts more than 80% of their EBITDA into cash from operations. We like businesses that exhibit these characteristics.

While UNP is not a typical capital-light model, its pricing power and impressive moat support its ROIC. Over the past decade, the share count has reduced by 35% through share buybacks funded by cash generation and a prudent usage of gearing. On a per share basis, the group has compounded earnings at a double-digit clip over the past decade. We believe with a new management team, UNP’s best years are likely ahead of it, despite being more than 160 years old.

Conclusion

Our investment process places a high degree of scrutiny on the management teams that steward the capital that we allocate to a business. We emphasise the importance of an aligned management team, and through qualitative analysis, we try to understand *what* management are incentivised to do with shareholder’s capital, and *how* they have acted in executing their duty. Based on our analysis of UNP, we believe the replacement of the CEO will be a material catalyst for the group to sustainably reduce its OR and improve its safety track record, which has the potential to close the valuation discount to peers. Said differently, we have always thought UNP was a great asset, but it needed a mechanism to enable its improved prospects for shareholder returns.

After the announcement of the replacement of the UNP CEO, the stock rallied a few percentage points, but it has drifted back down to its pre-announcement price over the balance of March. We have used this opportunity to build a position in relatively short order at an attractive starting free cash flow yield above 5%. On a probability-adjusted basis, we believe the investment can generate a mid-teens 5-year cash internal rate of return (IRR), above our targeted range of compounding returns at 8% - 12% per annum. In an upside scenario, we can see a pathway to an IRR closer to 20%, should new management surprise to the upside.

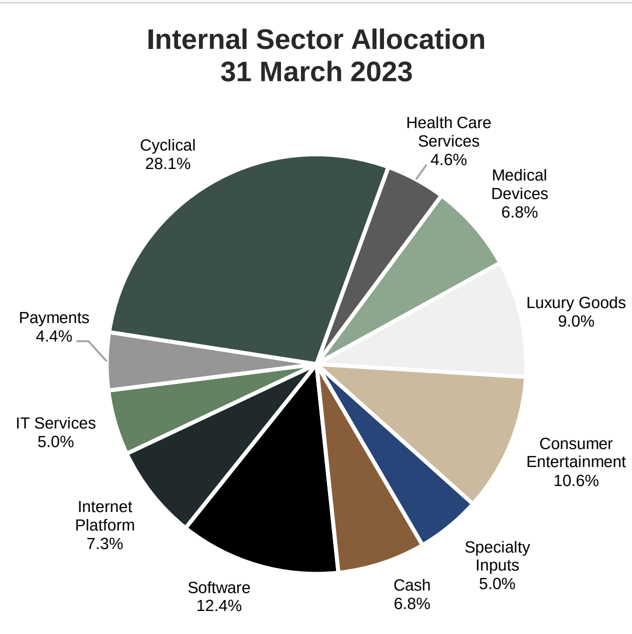
While the possibility of an economic downturn in the US (and by extension, globally) would result in a cyclical softening in rail volumes, we believe UNP presents us with an opportunity to own a best-in-class operator, at a material discount to our assessment of fair value, with a definite positive catalyst to improved shareholder returns.

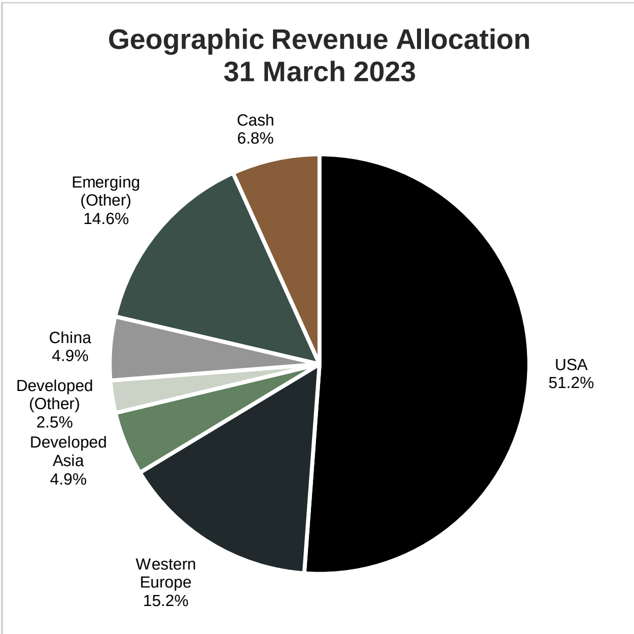
ADDENDUM

Quality Scorecard

Portfolio Characteristic	Dec. 2019	Dec. 2020	Dec. 2021	Dec. 2022	March 2023
Profitability					
Gross Margin	55.7%	49.8%	52.3%	48.1%	45.2%
Operating Margin	23.5%	20.1%	24.3%	22.8%	21.7%
Free Cash Flow Margin	18.9%	17.0%	17.6%	16.8%	16.1%
Returns on Capital					
Return on Assets (ROA)	13.0%	11.9%	13.7%	13.9%	13.3%
Return on Equity (ROE)	28.3%	24.9%	30.4%	29.8%	26.9%
Return on Invested Capital (ROIC)	24.0%	16.5%	20.7%	19.5%	20.0%
Leverage					
Debt/Equity	87.2%	68.6%	78.3%	57.9%	61.0%
Net Debt/Equity	19.3%	22.1%	27.3%	8.6%	26.6%
Valuation					
Free Cash Flow (FCF) Yield	2.8%	3.2%	2.8%	3.8%	3.6%
12m Forward FCF Yield	3.3%	3.6%	3.2%	4.4%	4.1%
24m Forward FCF Yield	3.8%	4.0%	3.6%	5.0%	4.6%
Holdings					
Number of positions	19	21	21	24	22
Active Share	86.5%	87.8%	89.0%	89.7%	89.1%

Internal Sector & Geographic Revenue Allocation





Source: FactSet, Constantia analysis.

Top Ten Holdings (alphabetical)

Business	Sector
accenture	IT Services
Berkshire Hathaway Inc.	Cyclical
Constellation Software Inc.	Software
Games Workshop	Consumer Entertainment
HEICO	Cyclical
LVMH Moët Hennessy • Louis Vuitton	Luxury Goods
Microsoft	Software
PayPal	Payments
Thermo Fisher Scientific	Medical Services
UnitedHealth Group	Healthcare Services