Constantia Investment Partners

Quarterly Note

1st Quarter 2024

Dear Partners,

For the quarter ended March 2024, the AIM Global High Conviction Fund delivered an absolute return (after all fees) of +10.2% We estimate that AUD weakness added roughly +3.2% to our absolute return over the quarter.

If one read only the headlines that cover the day-to-day gyrations in markets, investors would be forgiven if they thought that only three factors are currently keeping the world economy afloat: the investment boom in AI, the Federal Reserve's stated goal to cut interest rates in 2024, and the uplift to local economic activity caused by Taylor Swift's global concert tour.

We find that market participants' desire for a top-down narrative that purports to make 'sense of it all' frequently does not mesh well with the bottom-up reality reported by the businesses we own. As we put pen to paper for this note, we await quarterly updates from many of our holdings, but despite all the doom-and-gloom in the headlines, many of our businesses have reported their underlying markets as being in reasonably good shape in recent market interactions.

We believe that we would only add to the unhelpful level of noise by providing real-time commentary on what is driving markets 'in the moment'. We prefer to stand back and see if we can discern more fundamental truths that could have a lasting impact on the investing landscape.

As such, the main section of our quarterly note – entitled *Growth Traps (or, The Art of Going Nowhere in A Good Business)* – explores how investors chasing price momentum in high-growth companies – behaviour that we currently see playing out in the insatiable demand for any stock even vaguely related to the AI thematic – can lose their shirt by revisiting a high-quality, high-growth business we have written about previously: Snowflake.

Performance to 31 March 2024

	GHCF	Benchmark
Financial Year 2024	+16.8%	+19.5%
2024 (Calendar YTD)	+10.2%	+13.9%
2023	+22.7%	+23.0%
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	+80.1%	+78.3%
Annualized Since Strategy Inception	**+13.7%**	**+13.5%**

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. The benchmark is a representative index of global equities listed in developed markets and is denominated in AUD, with dividends (net of withholding taxes) reinvested. Refer to our PDS for more detail.

Portfolio Update

Over the quarter, we have exited two long-held positions, and replaced them with businesses we feel present us with greater management alignment and have a clearer pathway to deploying capital at high rates of return to drive growth, even should economic conditions slow. In the case of the newly purchased businesses, we are still accumulating our positions; regarding the two positions exited, neither were in the top 10 as of 31 December 2023. We will disclose more details to investors after 30 June 2024.

Additional Disclosure

We are nothing if not open to feedback. Following our recent investor presentation and webinar, we received some questions on two specific metrics in our Quality Scorecard (included as Annexure A to this letter): the debt- and net-debt-to-equity ratios.

When we initially selected the ratios to populate our Quality Scorecard, we erred on the side of choosing easily calculated metrics that investors could look up themselves. As a measure of indebtedness, debt-to-equity and net debt-to-equity (with net debt defined as total debt less unencumbered cash) seemed both simple and informative. The problem we have encountered is that many of our businesses are engaged in buybacks, meaning that even if they merely *maintained* their debt in a fixed ratio to their asset base, the debt component would expand mechanically relative to the equity side of the balance sheet as the buybacks reduce the book value of equity.

As such, we think that showing metrics that show 1) indebtedness (both on a net and total basis) relative to the amount of pre-tax cash operating profits and 2) how well said pre-tax cash operating profits covers the nominal amount of interest paid provides a better understanding of how ‘risky’ our businesses are from a debt perspective.

Pre-tax cash operating profits are also known as EBITDA (earnings before interest, taxes, depreciation, and amortization). Because interest is paid out of pre-tax earnings – and because depreciation and amortization are non-cash accounting entries – we see EBITDA as an appropriate measure to assess how indebted a business is. (We concede that EBITDA is a metric that has been much abused by management teams looking to ‘inflate’ earnings over the years, and therefore we would never use it to *value* a business. For students of financial history, famed US cable operator John Malone ‘invented’ EBITDA in the 1970s for exactly this reason: it was a decent measure of how much debt risk a business *could* cover from cash operating earnings. The problem is that it has evolved from being purely ‘pre-tax cash operating profits’ into ‘operating profits before all the stuff management does not consider an expense’).

For the avoidance of doubt, the average debt level of the businesses owned in the fund *has* increased. In the 2019 – 2022 period, our exposure to mega-cap technology businesses (which generally ran with significant excess cash balances) meant that our debt- and net-debt to equity ratios were lower than at present. Currently, we own businesses that do use more debt in their capital structure as a rule. It should be pointed out that two top 10 holdings – Constellation Software and HEICO – both concluded their largest-ever (and in our opinion, transformative) acquisitions in the latter half of 2023. These deals were partially debt-funded, and thus the debt- and net-debt-to-equity ratios are currently somewhat inflated. However, as evidenced by the newly introduced ratios, the current level of indebtedness is not out of line with the historical coverage ratios of the Fund.

In future, we will comment on material changes to any ratios on our Quality Scorecard in Interim and Annual Letters.

Conclusion

As always, we are grateful for your vote of confidence in Constantia and thank you for your ongoing support. Please get in touch if you have any questions.

Kind regards,

Etienne, Les, Dan & Andrew

Growth Traps (or, The Art of Going Nowhere in A Good Business)
by Etienne Vlok

In the halcyon days of June 2021 – when interest rates were zero, and markets went up every day – we wrote an (admittedly *extremely* nerdy) piece entitled *What Test Cricket Can Teach Us About Valuation & Long-Term Investing*.

The main thrust of the piece was to highlight a technique in our investment toolbox called 'base-rate analysis'. To briefly summarise the concept:

When evaluating any situation with an unknown outcome, most people tend to have a similar approach to predicting what will happen: understand the issue at hand, gather relevant information and evidence, apply experience and judgment, and come up with a forecast. Psychologists refer to this approach as taking the 'inside view'. An alternative approach is to place less weight on what makes any particular situation unique, and to simply ask "what happened in previous comparable situations?" This method de-emphasises the subjective judgment of the inside view in favour of relying on statistical analysis – an approach called the 'outside view'.

We used the example of asking how many cricket teams have successfully chased down a winning total greater than 400 runs in the second innings of a five-day test match, and instead of evaluating the teams involved – the strength of the batting line-up, the depth of the bowling attack, the type of wicket, etc. – merely found that in all instances where a team was tasked with chasing down a score of greater than 400 in the final innings, it was only successfully done in 1.2% of cases.

We then applied the same technique to the in-favour, much-loved, high-growth software stock of the moment in June 2021: Snowflake.

A Fantastic Business; A Below-Average Investment

Snowflake is a remarkable business. Simplistically, it allows its customers to more efficiently manage and extract insights from their vast stores of data in a highly cost- and resource-efficient manner across various cloud platforms (such as Amazon Web Services, Microsoft Azure or Google Cloud).

In June 2021, Snowflake hosted an investor day which we (virtually) attended. The centrepiece of the investor day was management presenting long-term targets for the business, extracted from the presentation in the table below. (Accept, for the purposes of this analysis, the non-GAAP guidance on operating and free cash flow margins at face value).

LONG-TERM OPERATING MODEL

	FY20	FY21	FY29 Target
PRODUCT REVENUE	$252M	$554M	~$10,000M
YOY PRODUCT REVENUE GROWTH	164%	120%	~30%
NON-GAAP PRODUCT GROSS MARGIN [1]	63%	69%	~75%
% OF REVENUE			
NON-GAAP OPERATING INCOME (LOSS) [1]	(105%)	(38%)	~10%
NON-GAAP ADJUSTED FCF [1]	(75%)	(12%)	~15%

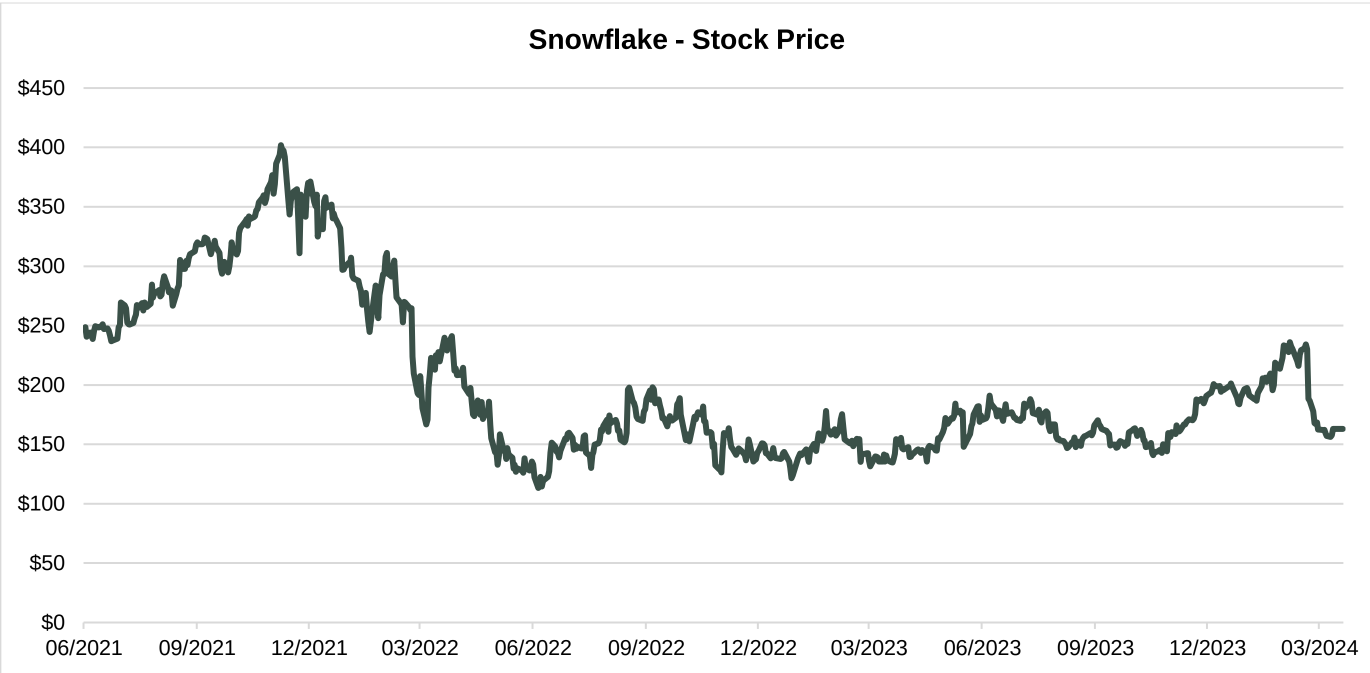
Source: Snowflake Investor Day, 10 June 2021. Edited for brevity by removing some guidance items.

As we noted in our piece back in June 2021, the revenue growth target of $10bn of product revenues by 2029 from a base of $554mn in 2021 implied an astronomical growth rate of 43.6% per year, sustained for eight years. Our base rate analysis suggested that the statistical probability of that happening was vanishingly small – around 2.3% over a five-year period, and around 0.1% over a ten-year period.

Fast-forward to the present day – how has the business and stock performed from the investor day in June 2021?

Given how much value Snowflake's software creates for its customers, the business has grown like a proverbial weed. Product revenues have increased by roughly 482% over the three years from January 2021 to January 2024, which equates to a compound annual growth rate of 68.9% - *above* the rate required to hit the 2029 target of $10bn in product revenues! In anyone's book, this should be seen as an astounding result. Margins have also continued to improve: product gross margins were at 77.8% in 2024, whilst free cash flow margin far exceeded the 15% guidance provided in 2021, coming in at 28.9% in 2024.

With numbers like these, it would not be unreasonable to assume that investors must have made money hand over fist over the past three years. Alas, the only number at Snowflake that did not sustainably increase from June 2021 to March 2024 is the stock price. After a 61% rally from the day of the investor presentation to peaking in mid-November 2021, the stock chart has made for depressing reading ever since.



Source: FactSet. Snowflake stock price from 9 June 2021 to 31 March 2024.

The Curse of Elevated Expectations: Running to Go Backwards

So, what went wrong? By all accounts, management knocked it out of the park on a fundamental level.

Stock prices are interesting things, and can tell us a lot about what expectations the market believes to be true about the future of a business. In June 2021, Snowflake was trading at a beyond-eye-watering price/sales multiple of around 102x. To emphasise: not the price-to-earnings ratio (P/E), nor price-to-cash flow – price-to-SALES was in excess of 100 times.

On its recent fourth quarter earnings call, Snowflake's management provided product revenue guidance for the year ending January 2025 that implied a growth rate (21.9%) meaningfully short of market expectations. This announcement – combined with the highly experienced and well-respected CEO announcing his retirement to a board-only role – caused the stock to lose about 29.7% (in USD) between its reporting date on 28 February 2024 and the end of March 2024.

The high initial expectations and the recent downgrade has seen the stock massively underperform the market from June 2021 onwards, despite more than delivering the goods in a fundamental sense. (We would be remiss if we did not point out that management *upgraded* the 2029 gross, operating and free cash flow margin targets at subsequent investor days held in 2022 and 2023, as reflected in the rightmost column in the table below.)

Snowflake Inc. Selected financial metrics	Actual Results 2020	2021	2022	2023	2024	Guidance 2025	Target (updated 2023) 2029
Product Revenue ($)	252.2	553.8	1,140.5	1,938.8	2,666.8	3,250.0	10,000.0
year-over-year growth (%)		*119.6%*	*105.9%*	*70.0%*	*37.6%*	*21.9%*	
Product Gross Profit ($)	158.4	380.4	844.6	1,457.4	2,076.0		
Product Gross Margin (%)	62.8%	68.7%	74.1%	75.2%	77.8%	76.0%	78.0%
Non-GAAP Operating Profit ($)	- 278.2	- 224.9	- 31.2	95.3	229.7		
Non-GAAP Operating Margin (%)	-105.1%	-38.0%	-2.6%	4.6%	8.2%	6.0%	25.0%
Free Cash Flow ($)	- 199.2	- 71.6	149.8	520.4	810.2		
Free Cash Flow Margin (%)	-75.2%	-12.1%	12.3%	25.2%	28.9%	29.0%	30.0%

Source: Summary of data provided by Snowflake in 1) 2020 – 2024 Annual Reports (Form 10-K),2) June 2023 investor day and 3) February 2024 earnings call.

In short, the expectations embedded in Snowflake's ~$73bn valuation were *so* extreme in June 2021 that even near-perfect fundamental execution over the following years wasn't good enough.

For those interested in an updated 'base rate' assessment of the stock (and perhaps we are kidding ourselves that anyone is!), consider that for Snowflake to achieve $10bn in revenues by 2029, it would need to grow by 30.2% per year for the next five years from its' 2024 starting point of $2.67bn. The historical data for the class of businesses with revenues between $2bn and $3bn compounding for more than 30% per year for 5 years suggests a 6% probability of this happening.

So, is it 'cheap enough' yet? We don't comment on where we think stocks are attractively priced (far better to buy them first, then tell everyone about it), but even after the recent correction, Snowflake still trades on a price/sales ratio of around 19x – hardly a steal, in our opinion. Moreover, valuation is just one factor to consider: as always, management alignment & capital allocation track record carry a heavy weight in our assessment of any opportunity.

In Closing

Most people have heard of value traps, but we believe the opposite – a **growth trap** – not only exists but is far more prevalent in markets than is widely appreciated.

We define a growth trap as a stock that is set up against expectations that are so elevated that even top-notch fundamental performance cannot outrun the implied growth rates. When the stock then disappoints (and this is where a base rate analysis is extremely helpful in understanding how likely such a disappointment is), hyper-growth (or growth-at-any-price) investors sell out. The quality-growth (or growth at a reasonable price – GARP) investors tend to see value a fair bit lower than where the stock was previously trading, creating an air-pocket as the shareholder base rotates and high-growth investors or short-term momentum traders sell out.

While we have a long-term investment horizon, we are keenly aware that paying up for quality comes with its own set of risks. When price action drives stock prices to a level where we feel expectations cannot possibly be met, you are unlikely to find us on the share register. As we say when summarising our investment philosophy, solid returns are generated by owning exceptional businesses, run by exceptional people, purchased at the right price. The last one really does matter.

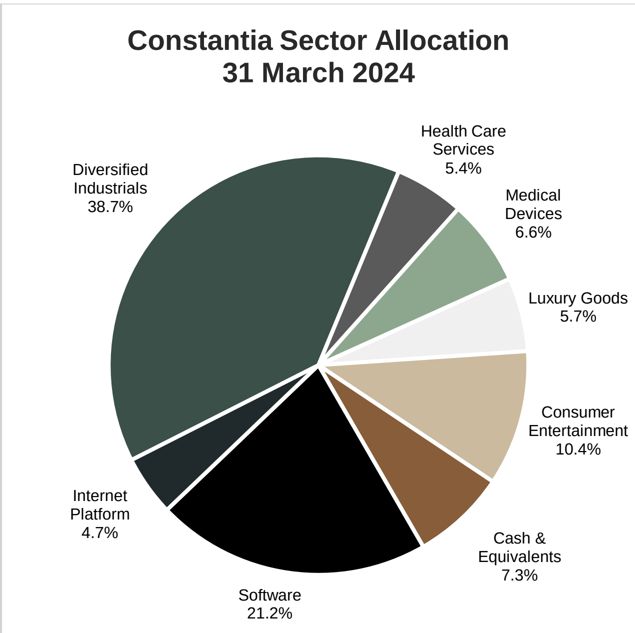
We frequently conduct this kind of inverted analysis on our businesses to better understand the market-implied expectations in the prices we are being offered, and then think quite carefully about whether the expectations can possibly be exceeded over the long-term. Thus far, it seems to have worked.

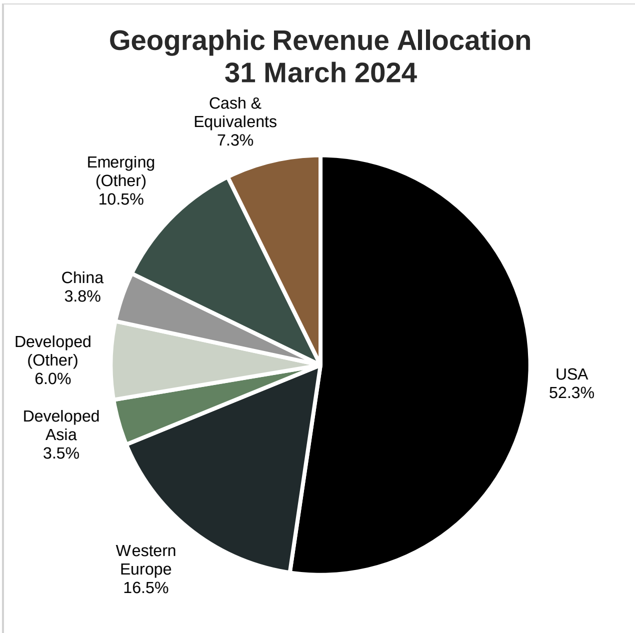
ANNEXURE A: FUND METRICS

Quality Scorecard

Portfolio Characteristic	Dec. 2019	Dec. 2020	Dec. 2021	Dec. 2022	Dec. 2023	Mar. 2024
Profitability						
Gross Margin	55.7%	49.8%	52.3%	48.1%	43.3%	41.2%
Operating Margin	23.5%	20.1%	24.3%	22.8%	21.2%	20.0%
Free Cash Flow Margin	18.9%	17.0%	17.6%	16.8%	15.7%	16.3%
Returns on Capital						
Return on Assets (ROA)	13.0%	11.9%	13.7%	13.9%	13.0%	11.6%
Return on Equity (ROE)	28.3%	24.9%	30.4%	29.8%	26.0%	24.1%
Return on Invested Capital (ROIC)	24.0%	16.5%	20.7%	19.5%	21.2%	22.5%
Debt Ratios						
Debt/Equity	87.2%	68.6%	78.3%	57.9%	77.3%	80.7%
Net Debt/Equity	19.3%	22.1%	27.3%	8.6%	47.2%	51.7%
Debt/EBITDA	1.5x	1.6x	1.2x	1.4x	1.7x	1.7x
Net Debt/EBITDA	0.4x	-0.2x	0.1x	0.1x	0.9x	1.0x
EBITDA/Interest Expense	46.0x	60.5x	56.3x	59.7x	50.3x	39.6x
Valuation						
Free Cash Flow Yield	2.8%	3.2%	2.8%	3.8%	3.7%	3.5%
12m Forward Free Cash Flow Yield	3.3%	3.6%	3.2%	4.4%	3.8%	3.7%
24m Forward Free Cash Flow Yield	3.8%	4.0%	3.6%	5.0%	4.3%	4.2%
Holdings						
Number of positions	19	21	21	24	21	21
Active Share	86.5%	87.8%	89.0%	89.7%	89.0%	89.9%

Internal Sector & Geographic Revenue Allocation





Source: FactSet, Constantia analysis.

Top Ten Holdings (alphabetical)

Business	Sector
amazon	Internet Platform
AMETEK	Diversified Industrials
CONSTELLATION SOFTWARE INC.	Software
GAMES WORKSHOP	Consumer Entertainment
HEICO	Diversified Industrials
LVMH	Luxury Goods
Nintendo	Consumer Entertainment
ROPER	Software
TERRAVEST INDUSTRIES	Diversified Industrials
UNITEDHEALTH GROUP	Healthcare Services

ANNEXURE B: OUR INVESTMENT PHILOSOPHY

We are ‘business-first’ rather than ‘security-first’ investors, and see ourselves as part owners of the businesses we invest in. Because we subscribe to a business ownership mindset, the quality of the businesses we own matter a great deal to us. Our investment philosophy can succinctly be summarised as follows:

‘Exceptional businesses, run by exceptional people, purchased at the right price.’

We define the three key terms as follows:

Exceptional Businesses:

- offer a product or service that is hard to disrupt.
- have strong competitive advantages.
- are highly and sustainably profitable.
- convert the majority of their accounting earnings into cash.
- generate more cash than they need to meet the day-to-day needs of operations.
- have a long runway of opportunities to reinvest the excess cash generated.
- have low debt levels to mitigate the risk of failure.

Exceptional People:

- think and behave like owners.
- are appropriately aligned with minority shareholders through share ownership and fair incentives.
- display a degree of trusteeship or moral responsibility to their shareholders.
- have a demonstrable history of value-creating capital allocation.

Right Price

We look to buy businesses that meet these criteria at prices where we believe we can meet – or exceed – our long-term return target of between 8% - 12% through a cycle.

We do not seek to generate returns by constantly having to trade in and out of businesses. Instead, we believe our long-term return will reflect the fundamentals of the businesses we own. As a result, we tend to own businesses for long periods of time – generally, between three and five years, or longer if warranted by fundamentals.

We manage a concentrated portfolio and own between 15 and 25 businesses at any given point.

We are bottom-up, fundamental investors. While we are cognisant of macro-economic risks, we do not construct the Fund to take advantage of such events.

We are an equity fund and intend to be between 90% and 100% invested in this asset class. We operate under the belief that if you entrust us with your capital, you want it managed in line with the process and philosophy we follow; you do not expect us to make an asset allocation decision.

We believe in time in the market, rather than timing the market.

We do not engage in shorting, nor do we use leverage to enhance our returns.

Our investable universe is global, and we are agnostic when it comes to market capitalisation size.