Constantia Investment Partners

Annual Letter

2024

Dear Partners

For the calendar year ended 31 December 2024, the AIM Global High Conviction Fund (GHCF) delivered a net return of +21.6%. This brings our cumulative net return since strategy inception to 98.7%, translating to an annual net return of +13.7% per year.

Performance to 31 December 2024

	GHCF	Benchmark
Financial Year to Date 2025	+13.0%	+14.6%
2024	+21.6%	+30.8%
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	+98.9%	+104.8%
Annualised Since Strategy Inception	+13.7%	+14.4%

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.

Investors in equities generally have two sources of return: the financial fundamentals of a business, and changes in the price multiple market participants are willing to pay to own those fundamentals.

To oversimplify, earnings growth and the return of capital in the form of dividends or share repurchases are the key drivers of the **fundamental return**. The **price multiple** is generally more reflective of investor sentiment and is influenced by a wide range of factors such as interest rates, geopolitical risk, and the degree of investor bullishness (or lack thereof) in the growth outlook for a specific company or markets in aggregate.

Both are valid sources of return, though we would argue that fundamentals – being grounded in reality – are more dependable over time, considering that the price multiple is subject to the collective sentiment of all market participants.

In 2024, the market benefited to an unusual extent from an upswing in investor sentiment. Multiple expansion contributed around +16.5% of the market return of +30.8%, whereas the growth in cash earnings per share was around +2.5%. (Dividends and currency weakness make up the remainder).

In the Fund, the dynamic was reversed: cash earnings per share grew around +9.2%, whilst multiple expansion contributed around +3.9% to our total return of +21.6%. The remainder can be ascribed to dividends and currency weakness.

Thus, if asked to summarise what drove markets in 2024, we defer to the words of one of Australia's greatest legal minds, Dennis Denuto:

"*It's the vibe, and… ah, no, that's it. It's the vibe.*"

What might be behind this vibe-based market?

The US Federal Funds rate leapt from near-zero in early 2022 to over 5% by early 2024. Dovish commentary was followed by rate cuts in the latter half of 2024, leading to a steady expansion of multiples over the course of the year. In addition, the November election victory of President Donald Trump – with promises of a business-friendly administration, lower taxes and less regulation – almost certainly contributed to the sense of euphoria seen in US stocks (which dominate most global benchmarks) in the final weeks of 2024.

It's definitely ***not*** the Constitution, Mabo, justice or the law.

Source: The Castle (1997), Working Dog Productions.

The positive vibes can be observed beyond equities: there's a raging bull-market in all things crypto. Speculative meme-coins such as *Fartcoin* (regrettably, not a typo) rallied to such an extent following the US election that at one point in January 2025, its return from inception (October 2024) exceeded the *total return* of the Dow Jones or S&P 500 since their respective inception dates in 1896 and 1926.

In our September 2023 Quarterly Note, we wrote to you about the Diamond-Water Paradox:

> *Before the current hiking cycle commenced, the world was awash with cheap liquidity. During this period, asset prices were often determined by what the next buyer was willing to pay, largely irrespective of the asset's intrinsic qualities. Whether it was NFTs [...], the meteoric rise of the SPAC boom, or any one of the deluge of novelty cryptocurrencies promoted as 'the next big thing', the focus was less on an asset's utility and more on the price that could be fetched from the next willing buyer.*

In 2024 – as in 2023 – there were many securities where one only had to find a critical mass of participants who *believed* it would trade higher, to *actually* send the price higher.

What might change sentiment to focusing on fundamentals again? For one, a stickier level of inflation. Considering its dual mandate of full employment and price stability, persistently hot US inflation readings may result in the Federal Reserve backing off from further rate cuts. Additionally, if President Trump is true to his campaign promises of imposing wide-ranging tariffs on imports into the US (as seems to be the case as of writing this in early February 2025), we struggle to see how this is not inflationary, as importers will almost certainly just pass the tariff on to US consumers. In this scenario, the Fed may even be forced to *increase* rates to contain inflation – an outcome which does not seem priced into market expectations at all, in our view.

Our response to this should be unsurprising to you. We do not focus on predicting the path of rates, the whims of politicians, the general macro-economic backdrop, or how these may influence the market multiple in 12-month increments. While we *worry* top-down, we *invest* bottom-up.

Our investment strategy is premised on the belief that the Fund's return over time will mirror the growth in fundamentals of our businesses rather than just reflecting the short-term mood of the market. It follows that we concentrate on finding and owning businesses with much greater predictability and durability to their cash earnings growth for the long term.

If we can get that right, we believe our businesses are well positioned to continue growing their **intrinsic value** at our targeted internal rate of 12% (or better), as has been the case since inception. See page 8 for more detail.

Not All Businesses Are Created Equal

> *What do you think about Commonwealth Bank of Australia's shares? Are they worth investing in?*
> *Have you looked at any emerging market rare earth producers?*
> *Is now a good time to invest in oil and gas?*

As market participants, these are the sorts of questions we are sometimes asked by investors, friends, and family. Our answer is usually along the lines of "We can't really comment. We haven't looked at it."

While that may sound naïve or risk appearing uninformed, it is a true reflection of our investment style. If we are not across the company or industry in question, why should we pretend to have an opinion? To do otherwise and offer an uninformed view risks misleading the questioner, who might then make decisions based on what we've said.

An article from the World Federation of Exchanges in May 2022 suggested the total number of publicly listed companies stood at 58,200. By comparison, we manage a portfolio of 15 – 25 stocks with long holding periods. Our approach requires a deep understanding of the companies and industries we invest in. Simply due to the sheer volume, we cannot look at every stock in the world and may therefore ignore entire industries that don't fit our criteria.

This raises an obvious question: if we don't even bother looking at large sections of the market, how do we define the type of business we *do* want to own?

Bearing in mind that a) we fundamentally believe that not all businesses are created equal and b) we aim to hold businesses for long periods of time, we seek to own only those **businesses which we deem to be exceptional.**

In our view, the best way to assess the relative quality of a business is by examining a measure of its **return on capital**. Debating which measure to use is outside the scope of this note, but for those interested we direct you to one of our pieces from May 2024, *A Cleanup at the Returns Counter*, where we wrote:

> *When it comes to running a business, you need to spend money to make money. The concept of 'return on capital' simply measures how much money you make (the return) relative to the money spent to make it (the capital).* ***Simply put, the higher the return on capital, the better the business.***

In Part Two of this letter, we explore the concept above in more detail and explain why we think certain businesses or industries are simply better suited for the long-term compounding we seek to achieve, while others simply don't make the cut.

Our Annual Letter

Starting with our 2023 Interim Letter, we share all Fund holdings with our investors. We also provide a summary of each holding's business performance, based on the most recent results available at the time of writing. Because we focus on long-term business ownership, we do not tell the usual 'stock stories' found in our industry. Instead, we want to give an honest and balanced, 'warts-and-all' perspective that helps investors understand what they own and why they own it. You can find the holdings and corresponding summaries in Annexure A.

Structure

This Letter has several parts. Each part stands on its own, so you can read them in any order, though we have arranged the parts in a way that we feel makes the most sense. (If you are reading this letter digitally, you can click on any title below to jump straight to that section).

- In Part One, we discuss the key drivers of performance for the calendar year.
- In Part Two, we discuss what differentiates an exceptional business from the average one, and why large parts of the market do not meet our investment criteria.

- Three **annexures** appear at the end of the letter:
    - Annexure A shows all holdings as on 31 December 2024 and includes details of their business results for the most recently reported period.
    - Annexure B includes our quality scorecard (with past data for comparison), plus our sector allocations and geographic revenue breakdown.
    - Annexure C is a one-page summary of our investment philosophy.

In Closing

Our goal remains to sensibly compound your wealth over the long term. In our observation, there are three ingredients required to do this successfully: an acceptable rate of return, sound risk management (so as not to compromise the progress made in ‘good’ years with huge drawdowns in the inevitable ‘bad’ years), and – most importantly – time.

We look for something very specific when it comes to the **type** of businesses we want to own. (See Part Two for more on this topic.) We then further whittle down the field by looking to only partner with exceptional people in charge of said businesses. In doing so, we seek to add the first two ingredients of compounding (rate of return and risk management) to the batter.

The third ingredient – time – is extended to us by our investors. To reference a Buffett/Munger analogy: even a small snowball rolling slowly down a very long hill can become enormous – the trick is finding a long hill!

Therefore, we want to express our sincere gratitude to our partners for their support and patience. An investment manager can only follow their strategy if they have aligned investors who believe in it. In this regard, we continue to be very fortunate indeed.

If you have any questions, please don’t hesitate to get in touch.

Kind regards,

Etienne, Les, Dan & Andrew

Part One: CY24 in Review
by Etienne Vlok

A year ago, we wrote the following in our 2023 Annual Letter:

> *While it should hardly come as a surprise, we believe in active management: that a considered selection of high-quality businesses will deliver a better outcome than simply owning the entire market over time.*

Because we dislike it when management teams beat around the bush, let us address the elephant in the room straight away: we did not deliver a better outcome in 2024. The Fund rose by +21.6% compared to the market return of +30.8%. As significant investors in the Fund ourselves, we need to answer the obvious question: ‘Why?’

It would be one thing if our stock picks were disappointing due to the businesses we own failing to meet our expectations, or if we were simply overpaying and seeing a huge headwind from multiple compression. Conversely, if our companies were growing their cash earnings in line with our long-term goal of 12% to 15%, and market valuations are not a big drag on performance, we would be inclined to say the process was working as intended to achieve our goal: returns of 12% per year (net of fees) or better with less volatility than the market, over a full cycle. So, which is it?

In the section titled *Growth in Intrinsic Value* (see page 8), you will see that our companies **grew their cash earnings per share by around +9.2%** in 2024. This is below our target of 12% per year, so a brief explanation is warranted.

Nintendo was held at an average weight of 5.6% in 2024. The company is scheduled to release its new Switch 2 video game console around the middle of 2025. As a result, sales have dropped off sharply for the current generation of the Nintendo Switch gaming console in the final half of 2024. This decline **reduced the weighted average growth rate of cash earnings per share** for the Fund by around **-2.1%**. In addition, a few of our firms are in heavy investment phases right now, which depresses the growth in cash earnings. Given the somewhat temporary nature of the current headwinds, we believe that the growth in intrinsic value will again trend towards 12% (or higher) in years to come.

On top of the growth in cash earnings per share, dividends added +1.3% to the total return. The weaker Australian dollar contributed about +5.9%. Combined, these factors mean the earnings multiple that investors were willing to pay for our holdings only added +3.9% to our total return. When multiplied together, these elements equate to our net return of +21.64%. (For those who like the math: $1.0916 \times 1.0125 \times 1.0595 \times 1.0388 - 1 = 0.2164$.)

In contrast, cash earnings per share for the overall market grew by about +2.5%, with dividends adding +1.4%. The weaker Australian dollar contributed +8.1%. This is higher than the boost in the Fund, because our *lower* exposure to the US market on valuation grounds meant we benefited less from the exchange rate shift. (The US makes up around 75% of developed market indices, and the US dollar strengthened by +10.1% relative to the Australian dollar.)

As a result, to reach the market total return of +30.8%, the main driver was an +16.5% uplift from valuation multiples.

Here is a summary of the above numbers in table format, for easier comparison:

CY 2024	Change in Cash Earnings per Share	Dividends	Currency Impact	Change in Valuation Multiple	Net Total Return
AIM GHCF	+9.16%	+1.25%	+5.95%	+3.88%	**+21.64%**
Global Equity Benchmark	+2.47%	+1.43%	+8.06%	+16.46%	**+30.78%**

Source: FactSet, Constantia analysis.

To tie this all together: while the Fund’s 2024 return trailed the benchmark, most underlying metrics – such as the growth in cash earnings per share – were in line with our long-term expectations. *The main difference is that our stocks did not enjoy the same boost from valuation expansion that drove the largest part of the market’s gains.*

As we have said before, we value accountability in our partnership. When we make mistakes, we will own them... and, to be fair, we *did* make a few this year. We did not trim LVMH in March 2024 nor Teqnion in February 2024, even though we saw signs that their end-markets were weakening more than the market price implied. In the case of Judges Scientific, greater patience in building our position would have been rewarded, as a key contract was delayed into 2025. (You can find more stock-specific details of our biggest detractors for the year on page 7.)

In the end, our other picks more than offset these mistakes, but we definitely deserve some blame for lagging the market.

General Observations

Before we discuss stock-specific contributors and detractors, we want to briefly highlight a few broader points.

1. *Our businesses **are** growing their cash profits.* Because we are bottom-up stock pickers who invest with the mindset of business ownership, we expect most of our returns to come from the underlying growth in cash profits over time. As discussed above, our businesses grew their cash earnings per share by +9.2% in 2024.

2. *Currency helped quite a lot in 2024.* Up to the end of September, the Australian dollar had been a small drag (-1.6%) on our year-to-date returns. However, in the fourth quarter, two events drove the US dollar higher:

    a. The outcome of the US elections in November – which delivered a second Trump administration – was generally seen as favourable for US growth.
    b. The Federal Reserve's December 2024 meeting suggested US rates might not fall as far or as fast as expected.

    Together, these factors caused the Australian dollar to weaken in the fourth quarter, adding around +7.5% to our return for that period, and amounting to a total currency tailwind of around +5.9% for the full year.

3. *It was another year of concentrated benchmark performance.* We have noted many times that a narrow group of stocks – mostly large- and mega-cap US domiciled tech companies – have pulled the market higher since the start of 2023. This continued in 2024. Consider the following datapoints about the broader market:

    a. We calculate that the Magnificent 7 (M7) group of stocks contributed nearly 37% of the total market return of +30.8% (in AUD) for 2024. (As mentioned on the previous page, AUD weakness increased this return by +8.1%)
    b. The Equal-Weighted version of the market – which negates the size advantage of the mega-cap stocks – increased by +18.7% in AUD (and only +12.3% in local currencies).
    c. If we exclude the US, developed markets appreciated by +15.4% in AUD – 50% less than the market including the US. (In local currencies, this basket grew by +12.4%).
    d. The developed market Small & Mid Cap index was up by +20.7% in AUD (+12.7% in local currency).

4. *Cash was a drag on relative performance.* The Fund held an average of ~5.2% in cash this year. That cash position earned less than the market return, so it effectively 'treaded water' and slightly reduced our relative performance.

A Brief Note on Cash Levels

Our mandate allows us to keep between 0% and 10% in cash at any point in time. When we see many compelling opportunities, you can expect the fund to be near the lower end of the 0% to 10% range.

Conversely, when we see fewer attractive opportunities, the fund will be closer to the upper end of that range. During 2024 the fund held an average cash weighting of 5.2%, reflecting a neutral view on valuations throughout the year.

Contributors & Detractors in CY24

Contributors

The top three contributors to our performance for CY24 are shown in the table below.

Business	Top Contributors Total Return (AUD)	Contribution
TerraVest Industries Inc.	+156.0%	+5.8%
Constellation Software Inc.	+36.8%	+3.1%
Games Workshop PLC	+52.9%	+2.7%

Three of our top five contributors for the year – TerraVest, Constellation Software, and HEICO – serve very diverse markets: respectively, steel vessel manufacturing for a variety of end users, vertical market software, and aerospace parts. All three share a competitive edge in how they allocate shareholder capital for acquisitions, and this advantage underpinned their strong performance in 2024.

- *TerraVest* delivered very strong growth for the year ended December 2024, growing revenues by +25.9% and free cash flow by +71.6% through a combination of strategic acquisitions and organic growth. The largest acquisition – Highland Tank – delivered a significant boost to margins. We believe that management's focus on cost efficiencies and demonstrable track record of good capital allocation have positioned TerraVest to effectively expand its operations in a highly fragmented market.
- *Constellation Software* delivered strong results. Recurring software revenues grew by ~6%, resulting in ~2% total organic growth. (The gap reflects Constellation's strategy to consciously reduce the less profitable parts of acquired businesses.) On the acquisition side, Constellation and its subsidiaries continued to deploy capital, leading to consolidated sales growth of about +21%, with cash profits rising around +19%.
- *Games Workshop* enjoyed strong performance in the 12 months ending November 2024. Continued growth in 2024 was always going to be tough, as the company had already refreshed its most popular tabletop franchise (*Warhammer: 40,000*) in July 2023. In September 2024, the release of *Space Marine 2* – a *Warhammer: 40,000*-inspired video game – proved a major success, generating high-margin licensing revenue and attracting both new and returning fans to the hobby. In December 2024, Games Workshop also signed a creative and commercial agreement with Amazon Prime Video to develop TV shows and films based on *Warhammer: 40,000*, with the option to do the same for the fantasy franchise later. It will take several years for these projects to be released, but we expect them to greatly increase awareness of the hobby.

Detractors

The top three detractors to our performance for CY24 are shown in the table below.

Business	Top Detractors Total Return (AUD)	Contribution
Teqnion AB	-33.4%	-1.3%
Judges Scientific PLC	-14.2%	-0.6%
LVMH SE	-8.9%	-0.4%

- *Teqnion*'s construction-focused businesses were a substantial drag on the company's earnings and cashflow owing to a weakening in demand for housing development that dried up much of these business's contract-based revenue. Whilst Teqnion's organic revenue growth ended the year down -3.0%, the impact on operating income was much more pronounced (with total EBITA down -13.1%). Whilst we still believe a lot of this is cyclically driven and can recover, it's clear we have underestimated the severity and duration of this downturn. During the year, Teqnion announced some poorly communicated management and board-level

changes as well as a deal transferring stock between the CEO and his deputy. The combination of these very poor organic results and governance slip-ups in a relatively illiquid stock has driven the sell-off.
- *Judges Scientific* experienced slowing order volumes for its scientific instrumentation equipment in the first half of 2024, most notably from China (-65%) and North America (-7%). This first half result coincided with the announcement that Judges would not benefit from a coring expedition and the associated revenues in their Geotek businesses in 2024, instead being delayed to early 2025. While the second half of the year saw an improvement in order volumes, November's trading update by management highlighted that orders would fall short of market expectations, causing the stock to sell-off into year end.
- *LVMH*'s sales grew by only 1% on an organic basis in 2024 following several years of rapid growth. The main drivers behind this slowdown related to a weaker Chinese economy as well as more cautious consumer spending in the US. We do not see any major problems with the business itself, and we have confidence in the Arnault family to navigate the current environment for our long-term benefit.

Positions Purchased & Sold: July 2024 to December 2024

The discussion of new purchases and positions sold is reserved for Constantia investors.

Growth in Intrinsic Value

We invest with a business-owner mindset. We focus on how much each company's **intrinsic value** grows over time.

Intrinsic value is an **estimate** of a company's true worth, based on the underlying fundamentals of a business. In simpler terms, it is the amount of cash the company will return to its owners, from now until it closes down. The cash a company can return to its owners is called '**free cash flow**'. It is the money left after the company spends what it needs to a) stay competitive and b) grow. This free cash flow can then be given back to owners as dividends or through share buybacks.

Management can change our ownership stake by issuing or buying back shares. As a result, we measure growth in intrinsic value by tracking the percentage change in free cash flow per share. Simplistically, this can be calculated by adding the percentage change in free cash flow to the percentage change in the share count over each period.

We focus on owning businesses that can **grow their free cash flow per share by 12% or more each year**. We believe that growth of this level should increase their intrinsic value by roughly the same amount over time.

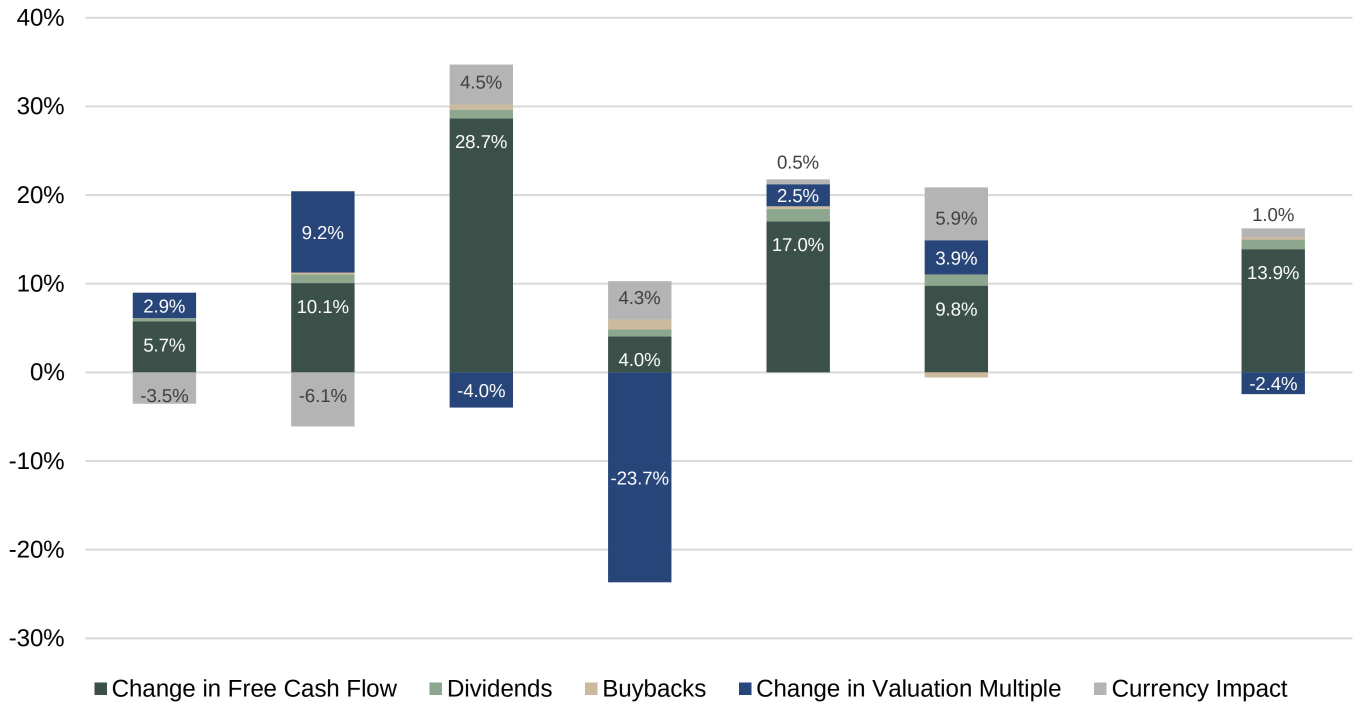
Net Total Return Breakdown: 2024

The chart below breaks down our after-fees total return since strategy inception (August 2019) into the underlying drivers of return for our investors:

- Year-over-year changes in free cash flow (cash earnings).
- Cash returned to investors through dividends and/or share buybacks.
- Changes in the valuation multiple at the time of purchase versus the time of measurement (or sale).
- Currency effects, because we invest worldwide but report in Australian dollars (AUD).

We base our estimate of intrinsic value on observable, real-world inputs. However, as with *any* calculation of intrinsic value, it remains an **imperfect estimate at best**. We do believe it is directionally correct and rooted in sound economics. In the unscientific realm of capital markets, we prefer being 'roughly right' over being 'precisely wrong.'

2019*	2020	2021	2022	2023	2024	Inception* p.a.
+5.3%	+14.2%	+31.1%	-15.6%	+22.7%	+21.6%	+13.7%



Figures at the top show net total return of GHCF for each period. Past performance is not indicative of future performance.
**2019 and strategy inception are measured from 31 August 2019.*

- The dark blue bar – representing the **valuation multiple** the market is willing to pay for a dollar of free cash flow – has been the most volatile component of our returns over time. This makes intuitive sense, as markets are prone to volatility over short periods. During calendar year 2024, we estimate that the change in valuation multiple increased our absolute return by **+3.9%**.
- The dark green bar – representing the change in intrinsic value as measured by the **growth in free cash flow** from period to period – has been less volatile. In 2024, our businesses grew their free cash flow by **+9.8%.**
- Dividends (light green) and buybacks (light brown) have been modest but consistent positive contributors over time. In 2024, **dividends** contributed **+1.3%** to our total return. **Buybacks** were a minor (**-0.6%**) headwind over the year, as two of our holdings issued equity during the period to fund acquisitions (TerraVest) and to conclude a strategic long-term partnership (Watsco).
- The impact of **currency** (grey) has been volatile from year to year but tends to even out over time. In 2024, currency was a **+5.9%** tailwind to our returns, with the vast bulk of that gain occurring in the final quarter of the year after the US presidential election in November.

Putting all this together, we estimate that our businesses grew in **intrinsic value per share** by **+9.2%** (+9.8% growth in free cash flow minus -0.6% change in share count) in 2024.

Since Inception

We believe that the rightmost column – breaking down our +13.7% per year net total return since strategy inception – is likely the most interesting feature of the chart, since it looks through short-term volatility.

- We estimate that our businesses have grown their **free cash flow by +13.9%** per year.
- **Multiple** compression has been a **-2.4%** per year headwind.
- **Dividends** (**+1.1%** per year) and share **buybacks** (**+0.3%** per year) have been steady positive contributors.
- The **currency** impact – despite being volatile in any given year – has only added **+1.0%** per year.

The estimated growth in **intrinsic value per share** since strategy inception has been **+14.2% per year** (+13.9% growth in free cash flow per year plus 0.3% from a reduction in share count per year).

Over the long term, we believe the return we deliver to you will roughly reflect the growth in intrinsic value of our underlying businesses. Indeed, it would be fair to say this belief is foundational to our entire investment philosophy. As such, we plan to update this chart and present it to you in every Interim and Annual Letter we write in future, enabling you to track the change in fundamental value of the businesses we own.

Part Two: Not All Businesses Are Created Equal

by Andrew Strasser

The returns a business generates (and the consistency of those returns) are shaped by many factors. Although it may be impossible to identify *every* profit driver, systematically thinking through these factors can help identify businesses with structurally attractive features (as well as potential risks).

For a start, the **type of product or service** a business provides influences both the price they can charge, and the degree of recurrence of a sale. A homebuilder that takes a year to build its customer a house requires a significant quantity of materials and labour, leading to a larger transaction size – yet there is little opportunity for a repeat sale barring any future renovations. Compare this to a pest control business whose service is demonstrably cheaper because it can be provided in less than a day with relatively inexpensive consumables and lower labour costs. This service, whilst smaller in ticket size, can be provided to the same customer again and again, providing a recurring source of revenue.

The **competitiveness** of the industry or specific geography within which a business operates will also dictate the level of profitability participants can earn. Is it a highly fragmented market with many small players, or is there an oligopoly where several large firms dominate? Do product or brand differentiation allow higher prices, or do low barriers to entry lead to price competition, meaning that cost efficiencies are the only way to earn outsized returns?

The US grocery retailers are a great case study of all these factors: a few national players compete with a long tail of fragmented local players. In most cases they offer very similar goods (and frequently the same products) and thus compete on proximity and price. This sounds like a recipe for losing money, but attractive returns are not entirely elusive. Businesses which have cost advantages (e.g. Costco or Walmart) can underprice competitors and still earn a profit. If done in a capital-efficient manner, they can earn excellent returns on capital.

This leads to an important point: **profits are not the only driver of returns** because businesses don't solely exist through the income statement. The cash investment in the assets required to generate sales and profits – also known as the **capital intensity** – can differ greatly between two otherwise similar businesses. For example, a beverage manufacturer that outsources their production and canning (like Monster Beverage Corp.) does not require large capital investments in property, plant and equipment. Instead, they can focus on advertising to expand brand awareness. By comparison, a beverage manufacturer that produces and bottles its own drinks (such as brewer Heineken N.V.) requires far more investment in assets to grow. (Admittedly, there exists a trade-off between the capital intensity of operations and the degree of control over product quality and the related intellectual property).

These are just a few of the factors to think about when trying to understand how a business generates returns. In our experience, the investment crowd and related media too often lose sight of all this by abstracting corporate success away to changes in stock prices, with a focus on revenue and earnings per share guidance, as well as quarterly beats/misses of expectations.

Instead, we think investors would be better off focusing on the returns being generated. One dollar of sales for Business X is not equal to one dollar of sales for Business Y, if Business X either 1) earns a higher profit margin per dollar of sales, or 2) uses fewer assets to generate a dollar of sales. Business X can reinvest a far lower percentage of its profits to deliver the same rate of growth than its peer, making Business X a demonstrably better business.

To conclude: some business models are simply 'better' by virtue of the type of product or service they sell, how frequently those sales recur, how effectively they fend off competition, and the percentage of profits required to reinvest for future growth. Many of these dynamics are captured in the returns on capital they generate, and the consistency of those returns through time.

Returns on Capital & Growth

Before continuing, we first need to lay some groundwork.

One of our strongest investment beliefs is that growth doesn't happen out of thin air. It is a function of the amount of capital invested and the rate of return that investment earns: the Return on *Incremental* Invested Capital ('ROIIC'). Said differently, ROIIC measures how much *additional* profit is generated by the *next* dollar invested.

$$\text{Growth} = \text{Capital Invested} \times \text{ROIIC}$$

Sustaining long-term growth requires 1) generating high returns on invested capital and 2) having a long runway of attractive opportunities to re-invest earnings. For our purposes here we will use Net Operating Profit After Tax ('NOPAT') as earnings, and we define the reinvestment rate as the proportion of NOPAT that goes back into growing the business.

$$\text{Sustainable Growth} = \text{Reinvestment Rate} \times \text{ROIIC}$$

Simplistically, management can grow organically through capital expenditure (i.e. investments in property, plant and equipment ('PP&E')) and increasing working capital. Other forms of capital allocation fall outside the scope of this note.

We label the returns generated on each incremental dollar spent on growing the business the 'Organic ROIIC'. To get an approximation of a business's Organic ROIIC, we must look at what the business currently earns from the tangible asset base they've already invested in, which consists of the cumulative investments in PP&E and net working capital (inventories and receivables, less any payables or unearned revenue ('NWC')). This provides us with a proxy for the incremental returns of earnings reinvested in the existing business.

$$\text{Organic ROIIC} = \text{NOPAT} / (\text{Net PP\&E} + \text{Accumulated Depreciation} + \text{NWC})$$

We are cognizant that ratio makes two key assumptions, namely 1) that future profits from reinvesting in the business will be similar to the past; and 2) that past costs approximate future reinvestment costs. Future returns are unlikely to always equal past returns, and this is where a lot of our research efforts are focused: assessing whether the factors influencing a company's ROIIC are stable and whether the future returns on reinvestment are likely to be attractive.

Example 1: Organic Growth

With some basic theory complete, let us step through some examples with two fictional businesses from different industries: Business A and Business B. Business A generates a 30% Organic ROIIC, whilst Business B generates a 10% Organic ROIIC. Essentially, the former earns 30c for every dollar it invests, the latter only earns 10c. Let us assume both businesses currently earn $100 in NOPAT, and that they can grow their earnings (in this case NOPAT) at 5% p.a. through reinvesting in their operations.

The question we are seeking to answer is 'how much of Business A's earnings do they need to reinvest in order to grow profits by 5% next year?' At a 30% ROIIC, this works out to 16.7% (5% divided by 30%) of earnings that need to be reinvested, leaving a tidy 83.3% available to make acquisitions, pay down debt, or give back to shareholders.

Business A	
Organic ROIIC	30.0%
Organic Growth Target	5.0%
Required Reinvestment Rate	16.7%

Year	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**CAGR (%)**
NOPAT	$100.0	$105.0	$110.3	$115.8	$121.6	$127.6	$134.0	$140.7	5.0%
- Reinvested	-$16.7	-$17.5	-$18.4	-$19.3	-$20.3	-$21.3	-$22.3	-$23.5	
= Free Cash Flow to Allocate	$83.3	$87.5	$91.9	$96.5	$101.3	$106.4	$111.7	$117.3	

In contrast, Business B only earns a 10% ROIC. To match Business A and grow by 5%, Business B must reinvest 50% (5% divided by 10%) of profits: a significantly greater proportion.

Business B	
Organic ROIIC	10.0%
Organic Growth Target	5.0%
Required Reinvestment Rate	50.0%

Year	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**CAGR (%)**
NOPAT	$100.0	$105.0	$110.3	$115.8	$121.6	$127.6	$134.0	$140.7	5.0%
- Reinvested	-$50.0	-$52.5	-$55.1	-$57.9	-$60.8	-$63.8	-$67.0	-$70.4	
= Free Cash Flow to Allocate	$50.0	$52.5	$55.1	$57.9	$60.8	$63.8	$67.0	$70.4	

We can observe the amount of NOPAT to be reinvested and that which is left over, i.e. the free cash flow. Because Business A earns a 30% ROIIC, it simply doesn't need to reinvest as much of its earnings to grow the business. It can both grow and still have plenty of free cash flow to allocate to other value creating opportunities, leading to greater total returns for shareholders.

If we were to assume a growth rate of 10%, Business A would still have free cash flow left over to allocate, as it would consume only 33.3% (10% divided by 30%) of its NOPAT. In contrast, Business B would be reinvesting *all* their earnings (10% divided by 10%) to grow at 10%. If the growth rate were any higher, Business B would need to raise external capital to fund it. Meanwhile, Business A could theoretically continue to internally fund growth up to its total Organic ROIIC of 30%. The key takeaway here is **the higher the Organic ROIIC, the less capital required to grow and the higher the possible rate of growth**. Businesses with lower ROIICs consume more capital to grow, leaving less available for other value creating opportunities.

Looking for **fast growing businesses in isolation is not what we focus on**. What matters to us is how much capital is consumed to grow.

Example 2: Negative Organic ROIICs

The examples above represent fairly 'normal' businesses. Business A could be a high-return consumer discretionary business (for example, Nike), whilst Business B could be a lower-return generating industrials business (for example, Ingersoll Rand). We would argue the former is markedly more attractive for long-term compounding than the latter. We are very comfortable investing in businesses like Business A at the right price.

However, there are some truly exceptional business models that can generate a *negative* Organic ROIIC. This may seem counterintuitive – surely a negative ROIIC is a bad thing?

In this scenario, the ROIIC is not negative because the business is losing money on the capital that they invest. Instead, it is 'negative' because the business essentially *creates* capital (rather than consumes it) as it grows. Referring back to the formula for **Organic ROIIC**, the **NOPAT** from growth remains positive, but net working capital in the denominator is negative (while net property, plant, and equipment is minimal).

A prime example of this is the software-as-a-service (SaaS) business model, such as Microsoft's Office365. In a SaaS model, software is delivered to the customer via the internet (at minimal marginal cost) who pays for it in advance through a monthly or annually recurring subscription. Microsoft collects the cash up-front and records it as **unearned revenue,** and then spends the following year providing access to their software at low cost. Effectively, the cash is received **before** revenue is recognised or operating expenses are incurred, meaning net working capital is negative.

We acknowledge that this model often requires substantial up-front investment to create the software, as well as sales & marketing to drive adoption, and ongoing maintenance to ensure the product stays up to date. There is a lot of risk (but potentially a lot of reward for those brave enough) in this early stage. Once established, however, this collecting of payments up-front for SaaS can be incredibly lucrative.

To illustrate this practically, let us assume Business C is an established software business that generates a *negative* Organic ROIIC of -30%. Like in the prior example, let us assume the company can grow organically at 5% p.a. In this case, rather than *consuming* 16.7% of earnings to grow, this business *creates* an additional 16.7% in cash flow as it grows.

Business C	
Organic ROIIC	-30.0%
Organic Growth Target	5.0%
Required Reinvestment Rate	-16.7%

Year	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**CAGR (%)**
NOPAT	$100.0	$105.0	$110.3	$115.8	$121.6	$127.6	$134.0	$140.7	5.0%
- Reinvested	$16.7	$17.5	$18.4	$19.3	$20.3	$21.3	$22.3	$23.5	
= Free Cash Flow to Allocate	$116.7	$122.5	$128.6	$135.1	$141.8	$148.9	$156.3	$164.2	

What is most noticeable in this example is that the ‘reinvested’ line item (in green) has become **positive**: $100.0 of earnings becomes $116.7 in cash flow earned. This software business *creates* cash as it grows, allowing management to allocate even more towards value creating opportunities. Think of it as receiving a portion of next year’s earnings in cash this year: if next year’s earnings are greater, you receive more now. (Conversely, if the business were not growing it would not create additional cash on top of its earnings).

The obvious question here is why doesn’t Business C just grow at an infinite rate if it doesn’t cost them anything to grow? Firstly, there *is* a cost. The original $100 of NOPAT incorporates their *current* spend on sales & marketing. Any further efforts to drive growth may require more of an investment in sales & marketing, reducing the starting NOPAT. Secondly, spending more on sales & marketing may not actually drive greater uptake if the demand doesn’t exist. The software landscape is littered with businesses spending way too much on sales & marketing (and thus making a loss) and not driving enough growth in return to justify it. In our opinion, the best balance is somewhere in between: spending enough on sales & marketing to drive healthy growth, but still maintaining positive earnings and cash flow.

Much like Business A, we are very comfortable investing in opportunities like Business C. We spend a lot of our research effort to identify businesses like these two, which have attractive business models and return profiles which allow them to reinvest and grow at 12% or better for extended periods. We believe investment performance will follow fundamental growth over the long term.

Conclusion

We firmly believe the key to generating attractive long-term investment returns lies in finding exceptional businesses that can generate high returns on capital and have a large opportunity set to reinvest that towards attractive opportunities. We ideally look for businesses with a high recurrence of sales, attractive margins and minimal reinvestment requirements for growth. Perfect businesses are rare (if such a thing even exists!) but there are certainly businesses much better than the average.

Investing in high return generating businesses is something we don’t compromise on – and this is why we screen out large swathes of equities in the public markets: they simply do not fit this description. Furthermore, that is why we don’t comment on every industry or company – if it doesn’t offer high returns on capital with consistent reinvestment potential, it simply doesn’t fit our strategy. Our goal is to generate returns by investing in businesses that can continually grow their earnings. In this regard, not all businesses are created equal.

ANNEXURE A: PORTFOLIO BUSINESSES

This section of our letter is reserved for Constantia investors.

ANNEXURE B: FUND METRICS

Quality Scorecard

Portfolio Characteristic	Dec. 2019	Dec. 2020	Dec. 2021	Dec. 2022	Dec. 2023	Dec. 2024
Profitability						
Gross Margin	55.7%	49.8%	52.3%	48.1%	43.3%	42.3%
Operating Margin	23.5%	20.1%	24.3%	22.8%	21.2%	20.4%
Free Cash Flow Margin	18.9%	17.0%	17.6%	16.8%	15.7%	17.6%
Returns on Capital						
Return on Assets (ROA)	13.0%	11.9%	13.7%	13.9%	13.0%	12.1%
Return on Equity (ROE)	28.3%	24.9%	30.4%	29.8%	26.0%	23.7%
Return on Invested Capital (ROIC)	24.0%	16.5%	20.7%	19.5%	21.2%	26.9%
Debt Ratios						
Debt/Equity	87.2%	68.6%	78.3%	57.9%	77.3%	64.6%
Net Debt/Equity	19.3%	22.1%	27.3%	8.6%	47.2%	33.4%
Debt/EBITDA	1.5x	1.6x	1.2x	1.4x	1.7x	1.4x
Net Debt/EBITDA	0.4x	-0.2x	0.1x	0.1x	0.9x	0.5x
EBITDA/Interest Expense	46.0x	60.5x	56.3x	59.7x	50.3x	31.4x
Valuation						
Free Cash Flow Yield	2.8%	3.2%	2.8%	3.8%	3.7%	3.6%
12m Forward Free Cash Flow Yield	3.3%	3.6%	3.2%	4.4%	3.8%	3.9%
24m Forward Free Cash Flow Yield	3.8%	4.0%	3.6%	5.0%	4.3%	4.4%
Holdings						
Number of positions	19	21	21	24	21	19
Active Share	86.5%	87.8%	89.0%	89.7%	89.0%	91.2%

A few high-level comments:

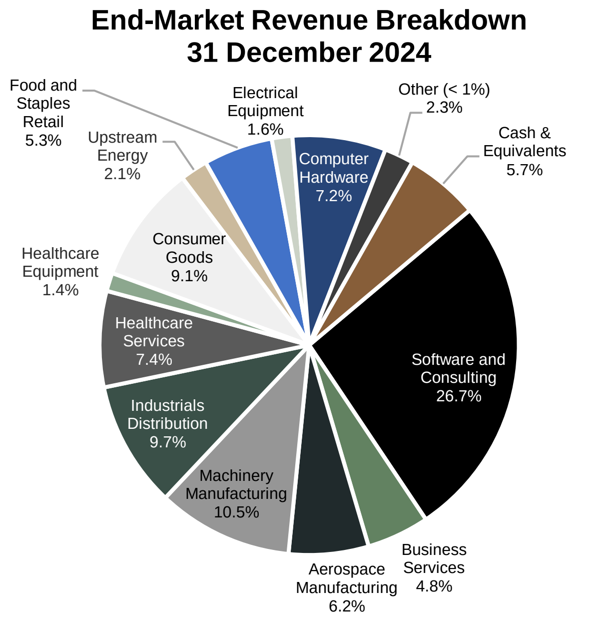
- Gross margins and operating margins have both slightly decreased from 2023. This is due to a lower mix of technology businesses in the Fund, and not due to a marked decrease in the levels of profitability for the underlying businesses.
- At 17.6%, the Fund's free cash flow margin has risen since 2023, but likely understates its 'normalised' cash-generating ability. Several holdings (such as Microsoft and Amazon) have substantially ramped up their capital investments this year.
- From a quality perspective, the Fund continues to invest in businesses earning far higher returns on invested capital than the broader market (26.9% for the Fund – its highest level since strategy inception – versus 11.3% market-wide).
- Debt ratios have improved compared to last year. After several of our holdings raised debt for acquisitions in 2023, they have reduced their gearing levels in 2024 through a combination of growth and principal repayments. Although interest cover declined, this was due to higher borrowing rates relative to the near-zero levels of 2020 and 2021, which increased interest costs.
- Valuation levels are largely unchanged from 2023.
- The Fund continues to be concentrated (19 holdings) and currently has the highest active share since strategy inception.

Fund Breakdown

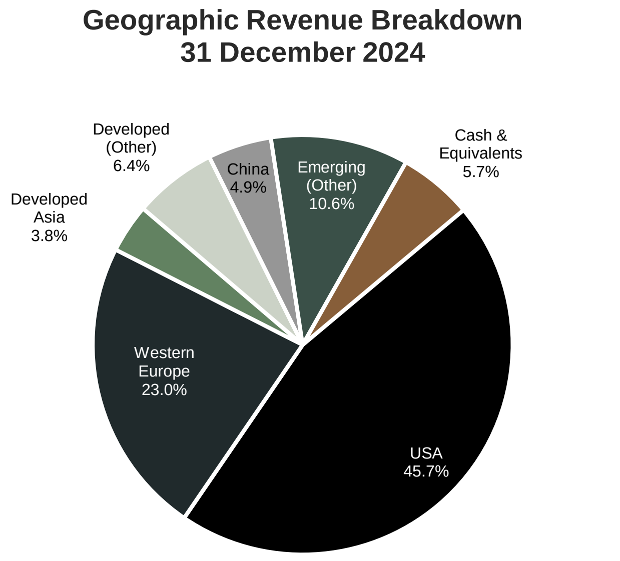
On this page, we present two different ways to understand the portfolio's exposures:

1. **End-market and geographic revenue breakdowns** show the industries and countries where our businesses *earn* their revenues.
2. **Sector and country breakdowns** indicate the sectors and the countries where each stock is listed, based on index classifications.

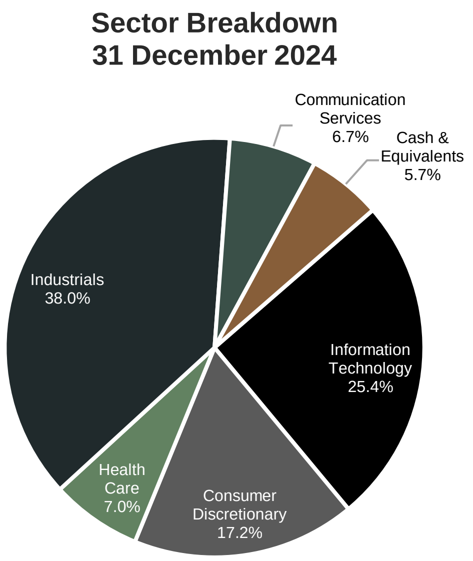
We rely on the end-market and geographic revenue breakdowns for internal portfolio construction because we believe they more accurately capture our businesses' fundamental 'real-world' exposures.



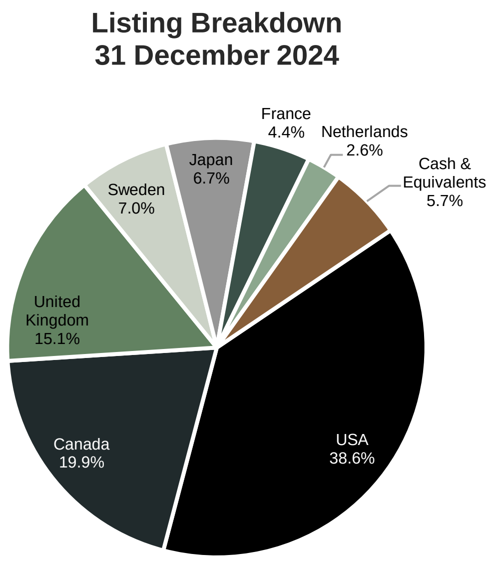
The look-through end-markets in which our businesses earn revenues.



The look-through regions where our businesses earn revenues.



The sectors in which our businesses are classified in the benchmark.



The countries in which our businesses are listed.

Source: FactSet, Constantia analysis.

ANNEXURE C: 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 matters 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 net return target of 12% or better 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.