FLAGSHIP
ASSET MANAGEMENT

Flagship Quarterly Telescope - *30 June 2019*

Welcome to the first publication of our **QUARTERLY TELESCOPE**. *We hope these quarterlies provide you with greater insight into our thoughts on global assets, as well as how our global funds are being managed. In this quarter's brief,* ***Pieter Hundersmarck*** *explains how we use international research trips to source ideas for our funds, as well as outlining the business case for the largest equity holding in Flagship's global funds: Reckitt Benckiser.*

Dear investor

Research is the core of what we do here at Flagship. Should you decide to call in at our offices in Constantia (where you would be most welcome!) you may be mistaken for believing you have wandered into a library, with the 'librarians' debating and engaging with each other on a variety of topics, ranging from the latest actions of the US Federal Reserve, to how defensive a consumer stock's business will be in a recession, or what the appropriate dividend yield is for a UK REIT. Indeed, '*forum*', meaning '*a meeting or medium where ideas and views on particular issues can be exchanged*', could accurately be used to describe the Flagship office space.

In addition to our daily knowledge gathering and model analysis, global research trips are key to our investment process. In early June, Flagship global portfolio managers travelled to a bespoke investor conference in Paris, attended by some of the world's best consumer businesses. Spanning 3 days, the conference showcased over 50 world-class businesses, many of which our investors should be very familiar with.

A few of the brands represented at the conference:

Heineken · L'ORÉAL · Reckitt Benckiser · PHILIP MORRIS · ABInBev · adidas · Coca-Cola · NIVEA · Colgate · Walmart · Carlsberg Group · DANONE · P&G Procter&Gamble · ESTĒE LAUDER · IMPERIAL BRANDS · Nestlé

Our goal when conducting research trips is twofold:

Firstly, as stewards of your capital, we believe gaining a deep first-hand understanding of the businesses we invest in is an important part of our due diligence process. In our view, this can only be achieved through intensive research, as well as multiple engagements with the management teams of the companies we own, *and* their competitors.

As long-term investors, our relationship with the businesses we own often spans many years. The following quote from the excellent book *The Outsiders*[1] reminds us, choosing the right management team is absolutely critical when thinking long-term investing:

"CEOs have five essential choices for deploying capital—investing in existing operations, acquiring other businesses, issuing dividends, paying down debt, or repurchasing stock—and three alternatives for raising it—tapping internal cash flow, issuing debt, or raising equity. Think of these options collectively as a tool kit. Over the long term, returns for shareholders will be determined largely by the decisions a CEO makes in choosing which tools to use (and which to avoid) among these various options. Stated simply, two companies with identical operating results and different approaches to allocating capital will derive two very different long-term outcomes for shareholders."

Fundamentally, business management teams are capital allocators, which is akin to making investments on a company's behalf and, as a result, all CEOs are therefore both capital allocators *and* investors. In fact, this role just might be the most important responsibility any CEO has. We therefore believe it's our job to assess this as accurately as we can.

Secondly, we embark on research trips to find new ideas. In conducting our research process, we are concerned with errors of commission, and not only omission. With over 70,000 globally listed securities (versus the JSE, with just shy of 300), we are not able to intimately know every possible investment opportunity. Rather, it is our goal to seek out and deeply understand the handful of great businesses that we believe are trading at less than what they are truly worth.

Our global investing experiences assist us in our quest for ideas. From time spent investing in global stocks we have built experience in over 30 countries, comprising over 80% of the world's major listed equity markets. We have met with over 900 business management teams and, in so doing, have built up a proprietary universe of great businesses that we constantly evaluate and monitor. Our trips are designed to add to this list, or subtract from it, where appropriate.

During our most recent trip, we met with the management teams of existing portfolio holdings, such as Heineken, Unilever and Mondelez. We also met with potential new ideas in Davide Campari (the maker of Aperol, the main ingredient of the popular "Aperol Spritz" cocktail), Church & Dwight (the producer of Arm & Hammer household products and Trojan condoms), Tiffany (the world's largest jeweller) and General Mills (a leading food products group based in the United States).

An example of a truly great business: Reckitt Benckiser

Flagship's global funds hold a number of global, high quality (or '**iconic')** businesses, many of which attended the Paris conference. All of these businesses share certain fundamental character traits, such as:

- A deep 'moat' around the business, normally exhibited by *brand*, *distribution* or *culture*
- Cash generative, allowing the business to re-invest without the need for leverage
- Pricing power, or the ability to price ahead of inflation without excessive volume loss
- High returns on invested capital

Over long periods, these 'iconic' businesses (and many other lesser known ones that share similar traits) have outperformed market indices. Indeed, many have achieved outperformance – even when deemed 'expensive' on forward PE multiples and other short-term metrics. The secret to their outperformance has been their ability to *compound* earnings and dividends at a rate faster than the market. Sometimes even these businesses can stumble – creating 'buy' opportunities for those watching closely. Reckitt Benckiser is one such business.

If you can keep your head when all about you are losing theirs . . . Rudyard Kipling, "If"

[1] *The Outsiders: Eight Unconventional CEOs and their Radically Rational Blueprint for Success* – William N Thorndike

Reckitt Benckiser or "RB" (est. 1938) is the manufacturer of several of the world's most enduring consumer health and household products. Consumer health brands such as *Dettol*, *Clearasil*, *Mucinex*, *Nurofen*, *Durex* and *Mead Johnson* as well as many others are all manufactured and sold by RB.

We view RB as one of the world's highest quality businesses. It enjoys a moat of strong heritage brands backed by requisite research and innovation; an effective corporate culture that allows innovation to thrive; and subsequent strong financial metrics such as EBIT margins of 27% and free cash flow conversion of over 100% of net profit annually.

Great brands, when continually invested in, allow pricing power. Pricing power is something the Flagship global team value highly, as it, firstly, allows the business to offset the effects of rising costs such as wage and manufacturing inflation and, secondly, allows the business to increase revenue without the commensurate increase in unit volume (which comes at a cost to produce).

We particularly like the consumer health business of RB, with its portfolio of repeatable, well-known medicines which are mainstays in popular health culture globally. The consumer health business generates two thirds of RB's £12.6bn of annual revenue and, due to its higher margins, generates over 75% of Group profits.

Furthermore, the footprint of the health business is well balanced, with nearly half of revenue generated in emerging markets, and categories split evenly between infant nutrition, OTC and wellness products. These categories enjoy growth rates of 3-5% globally (higher than most competing categories) and generate higher margins.

A balanced geographic and category split - Reckitt Benckiser

More recently, RB has struggled against competition across its product portfolio, as well as an unprecedented series of 'own goals' surrounding its operations in South Korea; the integration of Mead Johnson; and issues surrounding its internal IT systems. On top of this, there has been a handover of the CEO position from Rakesh Kapoor to Laxman Narasimhan (previously Global Chief Commercial Officer at PepsiCo responsible for group Strategy and R&D) and this may have caused nervousness among investors.

We anticipate that these issues are transitory, and that the management and culture of the business will prevail against these current headwinds…as it has been able to do in its 70-year history. The reason for this, we maintain, is due to the company's ethos of encouraging employees to 'think like owners', and to take responsibility for 'their' business. This is reflected in RB employee compensation, where the fixed portion is only 20%, with the balance of employee financial rewards accruing across many years, with claw-back measures to prevent short-term thinking. This alignment – of shareholder and employee interests – is rare, and has proven to be extremely profitable to RB investors.

We view the recent share price weakness as an opportunity to buy one of the world's best businesses at a discounted price, reflected partially in its P/E of 17.7x for next 12 months earnings (well below its own long-term average *and* the P/E multiples of its largest competitors).

Summary

The Flagship global investment team focusses on allocating investors' capital to the highest return assets in our mandated universe. We also follow the time-tested philosophy of investing for the long-term, steadfastly avoiding the siren call of the dangers of short-term thinking.

Please contact the team at Flagship if you have queries regarding your investment in Flagship, or if you would like to speak to one of the portfolio managers. Our door is open. We thank you for your continued support.

Regards

Winston, Kyle and Pieter



Flagship's three global funds provide investors with exposure to a collection of global assets that trade at a meaningful discount to their fair value. We adhere to a valuation-based investment philosophy, and our funds are constructed without reference to a benchmark. The equity holdings in our global funds consist of high-quality businesses that compound returns over long periods of time; generate high levels of free cash flow; and demonstrate considerable potential for growth.

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