FLAGSHIP
ASSET MANAGEMENT

# Quarterly Telescope Q3 2025

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## 01

## We are a global specialist investment boutique

Flagship is a specialist global asset manager founded in 2001.

We are 100% independent and fully owned by staff and directors.

Our mission is to be the navigators and global authority of your complete investment future, wherever it may lead.

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## 02

## We manage global portfolios in three distinct strategies

Global Equity | Global Flexible | Global Fund of Funds

We believe in a focused approach to fund management

Our longest running Funds have track records spanning over two decades

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## 03

## We are long term investors who manage diversified portfolios

We use a dynamic investment strategy and active risk management to build robust, diversified equity portfolios.

Our unconstrained approach allows us to navigate diverse market conditions and identify opportunities wherever they arise.

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# The Flagship Global Investment Team

### Philip Short BSc (Maths), CFA

Philip is a fund manager of the global funds at Flagship and brings specialist macroeconomic expertise to the global team. Philip has gained 20 years' experience in the industry at JP Morgan, Fairtree Capital and Old Mutual as an analyst and portfolio manager. He completed his Bachelor of Science in Mathematics at the University of Pretoria and is a CFA charter holder.

### James Hayward BEng (Civil), CFA

JD is a fund manager of the global funds at Flagship, having joined in 2021 as an equity analyst. At the completion of his degree, JD worked in the engineering and fintech start-up industries while pursuing further studies in investments. JD holds an Engineering degree from Stellenbosch University and is a CFA charter holder.

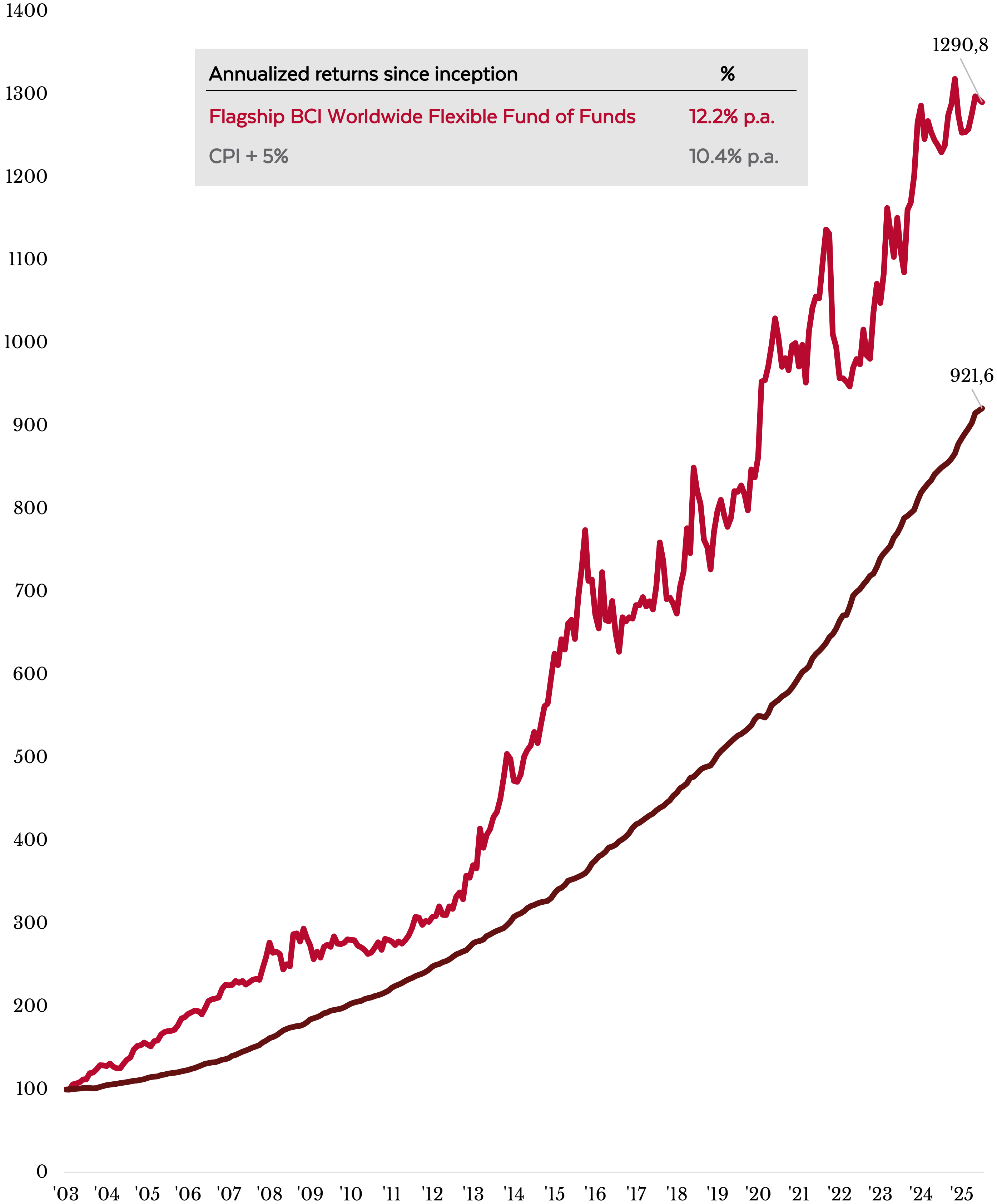
### Paul Floquet CA (SA), CFA

Paul is a fund manager of the global flexible strategies at Flagship, as well as portfolio manager of the Flagship IP Balanced Fund. He qualified as a chartered accountant in 1995 with Deloitte and Touche and gained international investment experience with JP Morgan and Merrill Lynch. He became a portfolio manager and director at Flagship in 2004. Paul is a CFA charter holder.

# The Power of Long-term Compounding

The **Flagship BCI Worldwide Flexible Fund of Funds** (net of all fees) vs. SA CPI +5%

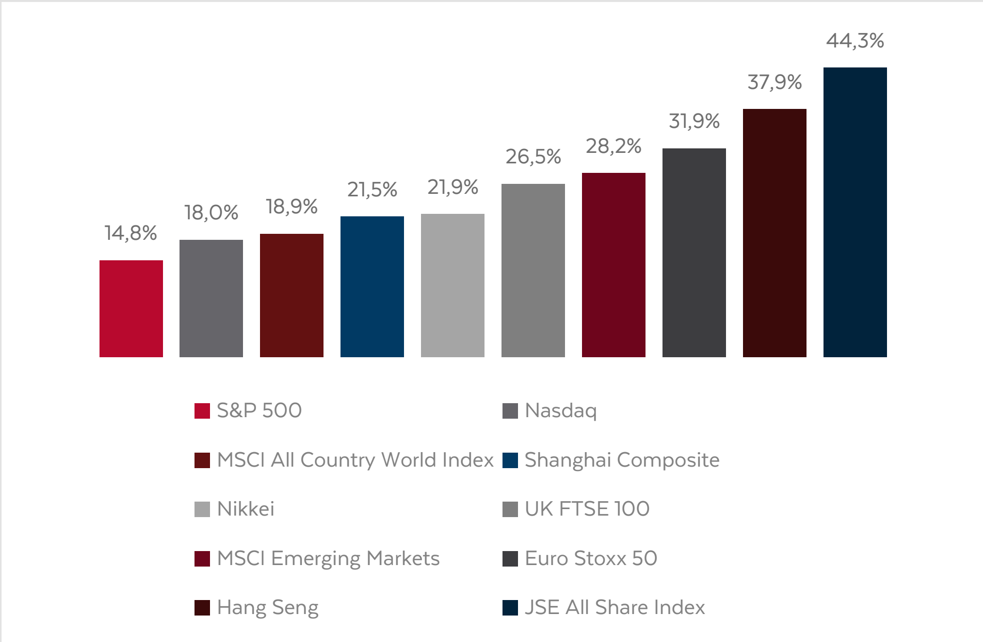
from 3 April 2003 to 30 September 2025 (22 years, 6 months)




| Annualized returns since inception | % |
|---|---|
| Flagship BCI Worldwide Flexible Fund of Funds | 12.2% p.a. |
| CPI + 5% | 10.4% p.a. |

# Global Market Commentary

**Chart 1:** YTD Global Index returns in USD (December 31, 2024 to September 30, 2025)




After a strong set of results for global equity indices during the second quarter, they showed very little signs of slowing down during the third, with several indices, including the local JSE, delivering blockbuster returns.

In the US, the benchmark S&P 500 closed 8.1% higher, while the tech heavy Nasdaq rose 11.4%. Year-to-date (YTD), they are now up 14.8% and 18,0% respectively. Barring a sizeable pullback during Q4, US equity indices are on track for another year of strong returns.

Strong results were not limited to the US, as London's FTSE 100 and the Euro Stoxx 50 closed 7.5% and 4.3% higher, respectively, measured in local currencies. YTD, both markets have also been very strong, gaining 17.7% and 13%, respectively. Due to the weakening US Dollar, however, these returns swell to 26.5% and 31.9% respectively, when measured in USD.

Looking East, we find even more green. Hong Kong's Hang Seng index closed the quarter 12.5% higher, while Japan's Nikkei ended the quarter up an impressive 11.7%. The Nikkei, however, weakened against the dollar, slightly eroding these returns. YTD, and measured in USD, both these indices have also been extremely strong. The Nikkei has gained 21.9%, while the Hang Seng is a massive 37.9% higher than at the start of the year.

Trouncing all these returns for the year has been the local JSE...the YTD gain now stands at 31.8% in ZAR and USD gain at 44.3%

Trouncing all these returns for the year has been the local JSE. After gaining 12.9% during the quarter, the YTD gain now stands at 31.8% in ZAR but, due to ZAR strength vs the USD over this period, the USD gain stands at an impressive 44.3%. This has been driven, to a very large extent, by the JSE Resources index, which is up 124.4% YTD, measured in USD.

Special mention must also be made of gold, which rose another 16.8% during the quarter, and is now up 47% YTD, its strongest run since 1979 when the world was facing a global energy and inflationary crisis. In the "Asset Allocation" section of this Telescope, we take an in-depth look at the drivers behind the bullion's 'golden' run. The short version – political instability, uncertainty, and lofty equity valuations – have investors on their toes, looking for safe alternatives to US Treasuries. Gold has proven a massive beneficiary of this combination of factors.

Influencing both the strong performance of gold and stocks (US stocks at least), has been the resumption of the US rate-cutting cycle by the Federal Reserve. They face no easy task, as economic data continues to point in two different directions. On the positive side we have US GDP growth which, at 3.8% quarter-over-quarter, continues to be strong. One of the key drivers here has been the strength of the US consumer, with retail sales numbers continuing to surprise on the upside. Several prominent CEO's have also mentioned the strength they are seeing in the US consumer. It is also true, though, that most of this consumer spending is driven by the wealthiest group of consumers. The top 10% of earners in the US are responsible for around 50% of consumer spending. These individuals have significant portions of their wealth tied to the US stock market, and its continued rise means these consumers are not under pressure and remain willing to spend. A steep, sudden downturn in the market could change this sentiment rather quickly, though…

The top 10% of earners in the US are responsible for around 50% of consumer spending. These individuals have significant portions of their wealth tied to the US stock market…

On the other hand, there are also some negative economic indicators, with jobs numbers being key among these. The rolling number of jobs being added to the US economy now sits at levels normally seen during recessions and there are now 7.4 million unemployed people in the US, vs 7.2 million job openings, marking it the first time since 2021 that job demand has exceeded supply. This would have been the key factor behind the Fed's decision to lower rates. The market is, in fact, pricing in another cut this year as almost a certainty, while also ascribing a high probability to a 3rd cut before year end. Countering this view, research from Apollo Global Management indicates that the strong GDP numbers and weak jobs numbers are inconsistent and cannot both be true. They believe that jobs numbers are artificially low, being affected by AI implementation and lower immigration due to government clampdowns, rather than an overall economic slump, and that the Fed's focus should therefore remain on battling inflation, rather than caving to the job market. If this proves to be the case, and the market does not get the further cuts it is expecting, we could see equities pull back meaningfully from current elevated levels.

Speaking of lofty valuations, these continue to be very worrisome indeed. In a recent Bank of America global fund manager survey, 91% of fund managers said that US stocks are overvalued – the highest proportion in history. The Shiller-CAPE PE ratio (which tries to adjust for longer business cycles) is currently at its second highest level in history, only trailing the peak of the Dotcom-bubble. The fears of a new AI-driven bubble are therefore very much front and centre, and comparisons with the Dotcom era can be found everywhere. It's hard to grasp how big the current AI capex boom has been but, for context, construction spending on datacenters only, not even semiconductor factories etc., has reached an annualized rate of $41 billion, exceeding the total construction costs of private offices in the US. This is datacenters *alone*. According to the Wall Street Journal, the AI boom has in fact been one of the costliest buildings sprees in world history.

Over the past three years, tech firms have committed more towards AI datacenters, semiconductors and energy production than it cost to build the entire US interstate highway system over the course of four decades (adjusted for inflation).

No wonder, then, that investors are getting worried about when, and even if, these tremendous amounts of capital being spent will lead to increased profitability, justifying the sky-high multiples we see in the market...

## Strategy Performance

The performance of the Flagship strategies over Q3 ‘25 and 1 year to 30 September 2025, net of fees, is shown below:

| **Global Equity Strategy** | **Q3 '25** | **%Δ 1YR** |
|---|---|---|
| Flagship Global Equity Fund (USD)* | 3,9% | 21,9% |
| Flagship BCI Global Icon Feeder Fund (ZAR) | 1,3% | 22,5% |
| **Flexible Strategy** | **Q3 '25** | **%Δ 1YR** |
| Flagship Worldwide Flexible Fund (USD)* | 3.7% | 19,6% |
| Flagship BCI Worldwide Flexible Fund (ZAR) | 1,7%% | 20,0% |
| **Fund of Funds Strategy** | **Q3 '25** | **%Δ 1YR** |
| Flagship BCI Worldwide Flexible Fund of Funds (ZAR) | 1,1% | 4,9% |

* 1 year performance is based on the actual returns data of a live portfolio managed under current portfolio processes and philosophies, net of real trading costs and management fees, albeit official inception date of these funds is 23 April 2025.

The ZAR experienced another strong quarter against the USD, with the latter losing 2.5% of its value over the quarter. As was the case during the second quarter, this detracts from the performance of our ZAR denominated funds which invest primarily offshore. We believe our investors are specifically looking for offshore exposure, and in the long term, ZAR depreciation will be a tailwind to performance.

The **Flagship Global Equity Fund** (USD) returned a slightly disappointing 3.9% during the quarter, trailing its MSCI ACWI benchmark by just over 3%. Over the last 6 months, though, the fund has returned 21.8%, outperforming the MSCI ACWI which returned 20.3% over the same period.

The biggest contributors to performance during the quarter were CommScope holdings, Rolls Royce (detailed stock profile later in this Telescope), Celestica and gold bullion.

The biggest contributors to performance during the quarter were CommScope Holdings, Rolls Royce (detailed stock profile later in this Telescope), Celestica & gold bullion, while the main detractors were Blu Label Unlimited and Brinker International.

What is notable, and in line with our investment philosophy and process of letting our winners run for longer, is that Rolls Royce was also one of the top contributors during Q1 and Q2. Blu Label, a top contributor over the long term, as well as Q1 and Q2, experienced a significant pullback ahead of the planned listing of Cell C. We believe the market has yet to fully digest and incorporate the effect of this, and Blu remains the fund’s largest holding, having increased nearly 400% since addition to the portfolios.

The **Flagship Worldwide Flexible Fund** (USD) returned 3.7% during the quarter, reflecting a slightly lower equity weight than the pure equity fund, and the **Flagship BCI Worldwide Flexible Fund** (ZAR) returned 1.7% for the quarter (the lower performance due to ZAR strength over the period).

Over the last 12 months, the fund has returned 20%, handily outperforming its CPI + 3% benchmark which returned 6.5% over the period. As is the case with the global equity fund, the top performers during the quarter were CommScope Holdings, Rolls Royce, Celestica and gold bullion, while the main detractors were Blu Label Unlimited, Netflix and Brinker International.

The performance of the **Flagship BCI Worldwide Flexible Funds of Funds** strategy, which returned 1.1% in ZAR (3.8% in USD), has continued to lag our internally managed funds during the most recent quarter, and this has been disappointing. As a result, we have made the decision to replace some of the underperforming managers, notably in the emerging market and global equity segments. Underperformance during certain periods is almost inevitable for all managers, however the period under assessment has been a particularly strong one, and we grew concerned with the inability of one of our managers to adapt to the current market environment.

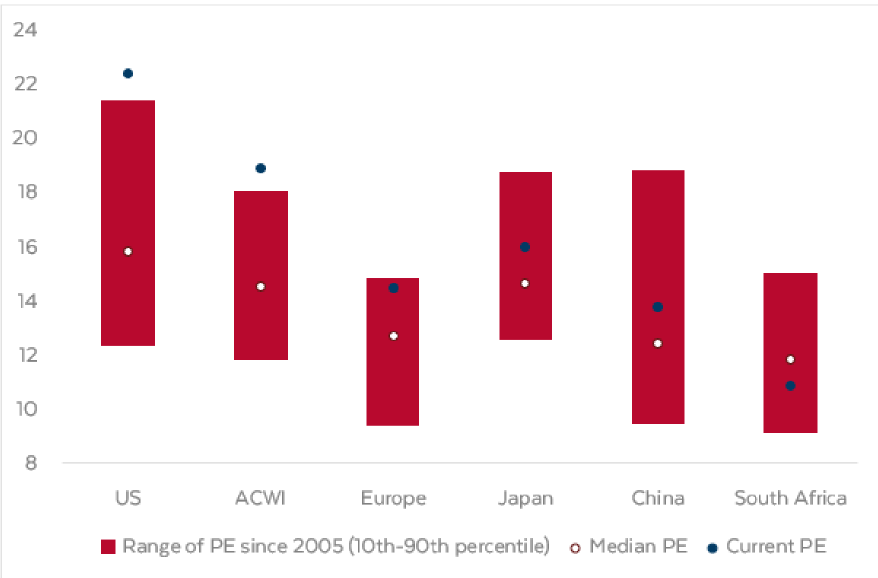
The top performing holdings were the Artisan Global Value Fund, and our gold bullion holdings. Leading the detractors for the second quarter running was the GQG Partners Global Equity Fund, while the GQG Partners Emerging Market Fund also experienced a weak quarter.

## Asset Allocation

Most equity markets are very expensive when viewed versus their own history. The US S&P 500 and the All Country World Index (ACWI) are very expensive, while the European STOXX Europe 600 index...is somewhat expensive. China, Japan and South Africa look more attractive on a forward. PE basis.

Most equity markets are expensive when viewed versus their own history. The US S&P 500 and the All Country World Index (ACWI) are very expensive, while the European STOXX Europe 600 index, which includes the UK, is somewhat expensive. This is viewed when looking at their respective forward PEs trading at the top end of their 20-year history, and significantly ahead of their median measured over the same period. China, Japan and South Africa look more attractive on a forward PE basis. South Africa is the outlier with its current forward PE below its 20-year median. This is despite the strong local rally, which was almost exclusively driven by gold and other precious metals.

**Global valuations: 1 year forward PE**




Note: range of forward PEs is of the $10^{th}$ to $90^{th}$ percentile so as to exclude extreme outliers.

Source: Flagship Asset Management, Bloomberg

Shortly after Russia's invasion of Ukraine ... the West, and notably the US, froze Russia's foreign reserves, which included Russian's holding of US debt. Russia held US Treasuries, and the US froze those, too. In our view, at that point, the US had weaponized its debt.

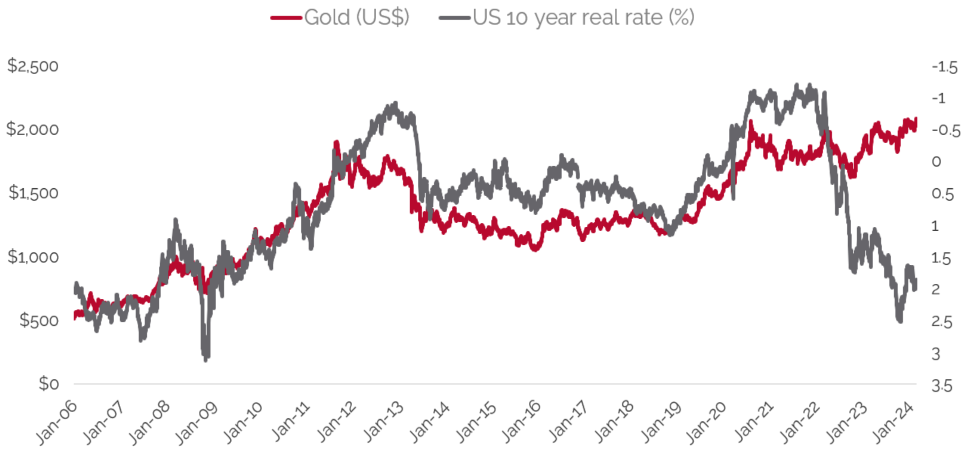
## Gold

Topical now is gold, trading at all-time highs at around $4,000 per ounce. We have been vocal about gold being a core part of our portfolios for the last two years, reflected in our holding of close to 8% in the worldwide flexible funds and 6% in the global equity fund.

Our reasoning is as follows, with the following charts taken from a Flagship investor presentation in May 2024:

Shortly after Russia's invasion of Ukraine in February 2022, the West, and notably the US, froze Russia's foreign reserves, which included Russian's holding of US debt. Russia held US Treasuries, and the US froze those, too. In our view, at that point, the US had weaponized its debt. This was first reflected in the dislocation of gold bullion's price and US real rates. When real interest rates i.e. adjusted for inflation, are negative, investors tend to move into gold. This is because gold does not provide a dividend or interest return, so the opportunity cost of holding gold is less punitive. Note in the chart, below, how the relationship broke down at the same time as the Russian invasion of Ukraine.

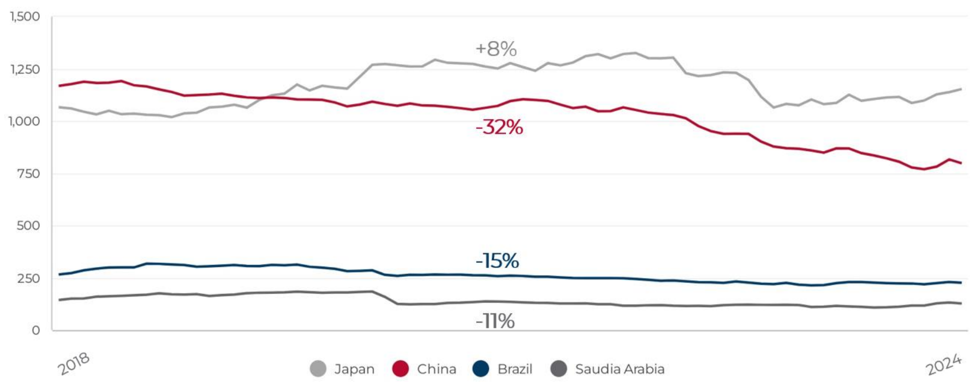
**Chart: gold's relationship dislocating from US real rates**




Source: Flagship Asset Management, Bloomberg

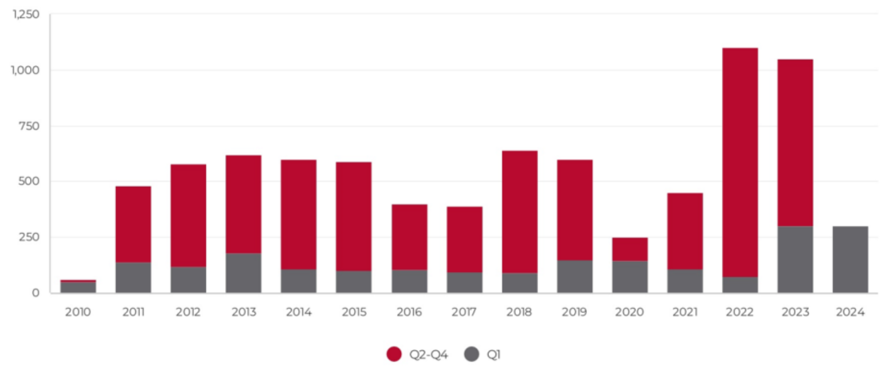
What was once perceived as a risk-free asset, US Treasuries were no longer completely risk-free. Other nations, including China, noted this and began, or accelerated, the selling of their holdings of US Treasuries.

**Chart: Sovereign holdings of US Treasuries (US$bn)**



Simultaneously, it was noted that central banks across the globe started increasing their holdings in gold bullion. This was no coincidence. The world now viewed gold as the primary risk-free asset and switched from US Treasuries into gold. Once again (note in the graphic below) the acceleration of gold purchases post Q1 of 2022…the Russian invasion of Ukraine was in February 2022.

**Chart: Central bank gold net purchases (tonnes)**




Source: Flagship Asset Management, Metal Focus, World Gold Council

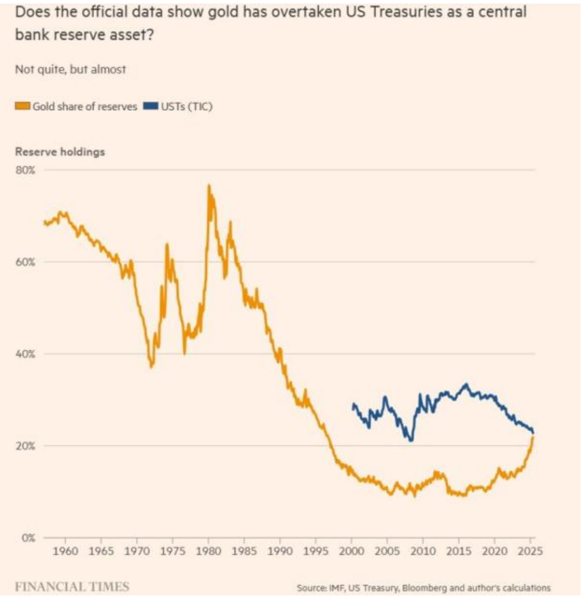
This has been/is the major driver of gold, in our view, with the traditional reasons for holding gold taking a back seat. Some might say gold is too expensive, but how does one value gold? We see gold's value as being relative: when we see another asset that rivals gold's status as the primary global risk-free asset, we will re-evaluate our view on gold.

The world now view[s] gold as the primary risk-free asset and [has] switched from US Treasuries into gold.

China and India's gold reserves, as a percentage of total reserves (in USD), is standing at 6.7% and 13.1% respectively. To put that into context, by the same measure, the US and Germany each stand at 77%. We see this as a long runway for China and India to increase their gold holdings to achieve a higher percentage of total reserves.

See also, below, a graph (Financial Times) which shows that gold's share of reserve holdings is about to overtake that of US Treasuries.

**Chart: Gold vs US Treasuries reserve holdings**




In summary, we view equity markets, in general, expensive. Our view on gold has not changed, and we have an 8% allocation of gold bullion in our global flexible funds, and 6% in our global equity fund.

# AI’s Hidden Beneficiaries


**By**: Philip Short, global portfolio manager: Flagship Asset Management

> “As manager of Flagship's global funds, I've been closely tracking what I believe represents a once-in-a-generation investment opportunity…”
>
> Philip Short,
>
> Flagship global fund manager

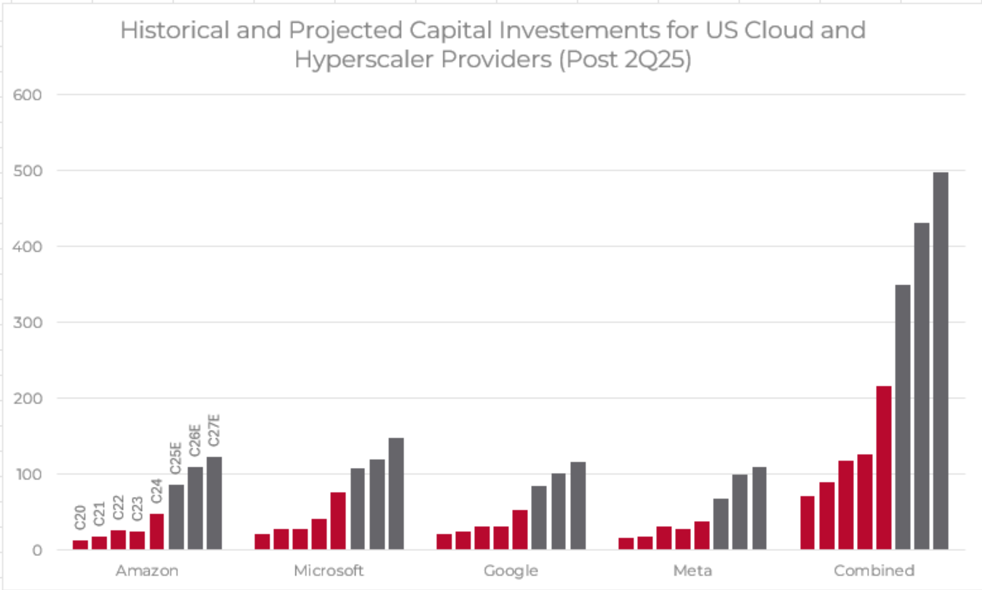
**The AI Infrastructure Gold Rush: Beyond Nvidia Lie the Real Investment Opportunities**

*The hyperscalers' unprecedented capital expenditure boom is creating compelling opportunities in the power and infrastructure companies that make AI possible*

The numbers are staggering. Microsoft, Amazon, Meta, Google, and Oracle have collectively announced capital expenditure plans that dwarf anything we've seen in modern corporate history.

Google alone has increased its 2025 capex estimate from $75 billion to $85 billion, while Meta's CFO warns of "similarly significant capex dollar growth in 2026." This represents a seismic shift in how these technology giants are deploying capital, with AI-driven infrastructure investment now adding more to GDP growth than consumer spending.

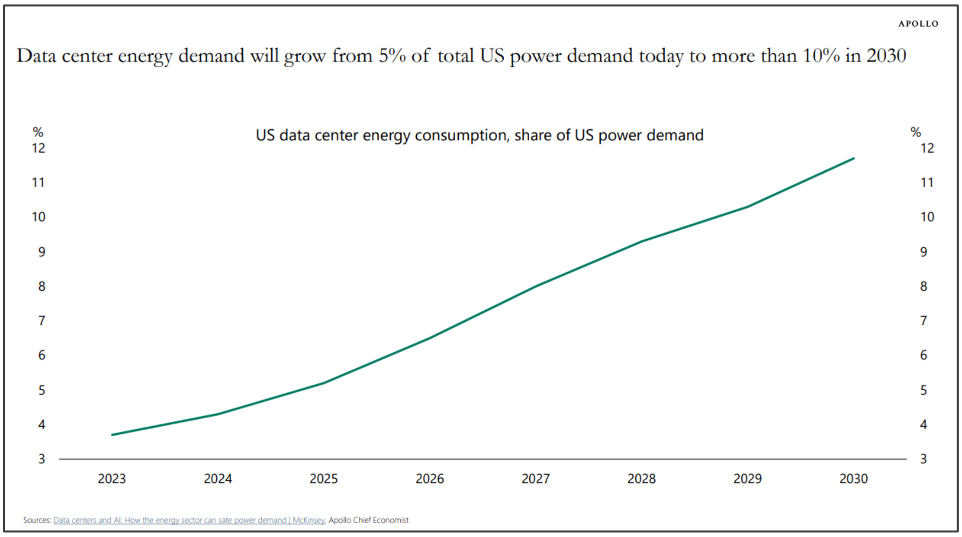
As manager of Flagship's global funds, I've been closely tracking what I believe represents a once-in-a-generation investment opportunity. The current AI-driven capital expenditure boom projects spending will reach $497 billion by 2027, compared with just $71 billion in 2020 – a remarkable 600% increase that is reshaping entire industries.




## The Power Bottleneck Creates Unexpected Winners

While most investors instinctively reach for Nvidia when thinking about AI infrastructure, the real bottleneck – and therefore the most compelling investment opportunity – lies elsewhere entirely. The constraint isn't chips – it's power. Data centres require massive electrical loads to run these AI systems, and data centre energy demand is expected to double over the next five years, growing from 5% of total power demand to more than 10% by 2030.

They're not negotiating on price. Customers are simply grateful to secure an order slot. This isn't a temporary supply-demand imbalance; it's a structural shift that will persist for years.




This power constraint has created what I call the "infrastructure imperative" – a fundamental shift in which the companies providing power, cooling, and connectivity infrastructure have become the gatekeepers of AI development. No matter how much money these hyperscalers *must* spend, they simply cannot deploy AI without the underlying infrastructure.

There is evidence of this everywhere. Schneider Electric, which supplies critical power equipment to data centres, is completely booked until 2030. They're not negotiating on price. Customers are simply grateful to secure an order slot. This isn't a temporary supply-demand imbalance, it's a structural shift that will persist for years.

At Flagship, we've positioned our portfolios to capture this infrastructure boom. When Amphenol announced its $10 billion bid for CommScope's connectivity and cable solutions unit ...its share price surged 86% in a single day.

### Strategic Positioning in Infrastructure Winners

At Flagship, we've positioned our portfolios to capture this infrastructure boom through carefully selected holdings in power utilities, connectivity providers and specialised equipment manufacturers. Our core positions include Dominion Energy, Constellation Energy, Celestica, Credo, and CommScope – companies that form the critical backbone enabling AI infrastructure deployment.

This strategy has already delivered significant returns. When Amphenol announced its $10 billion bid for CommScope's connectivity and cable solutions unit, CommScope's share price surged 86% in a single day. This transaction highlights the significant value that markets are now assigning to critical AI infrastructure components.

Dominion Energy operates in Virginia's "Data Centre Alley," connecting approximately 15 data centres representing about 1 gigawatt of capacity annually, with tens of gigawatts more in their development pipeline. Constellation Energy provides the bespoke energy solutions and long-term power purchase agreements that hyperscalers desperately need to underwrite their renewable energy commitments while ensuring a reliable supply.

### The Scale of Transformation

The hyperscalers themselves are transparent about the scale of their infrastructure ambitions. Meta is constructing data centre clusters with footprints large enough to cover most of Manhattan, each drawing up to 2 gigawatts of power, which is equivalent to a large nuclear plant. Microsoft's CFO states simply: "We will continue to invest against the expansive opportunity ahead, across both capex and operating expenses."

This isn't hyperbole. When Apple's traditionally capital-light CFO says, "You are going to continue to see our capex grow... substantially," we're witnessing a fundamental business model shift. These companies are transforming from asset-light software businesses into capital-intensive infrastructure operators.

### Supply Chain Constraints Create Moats

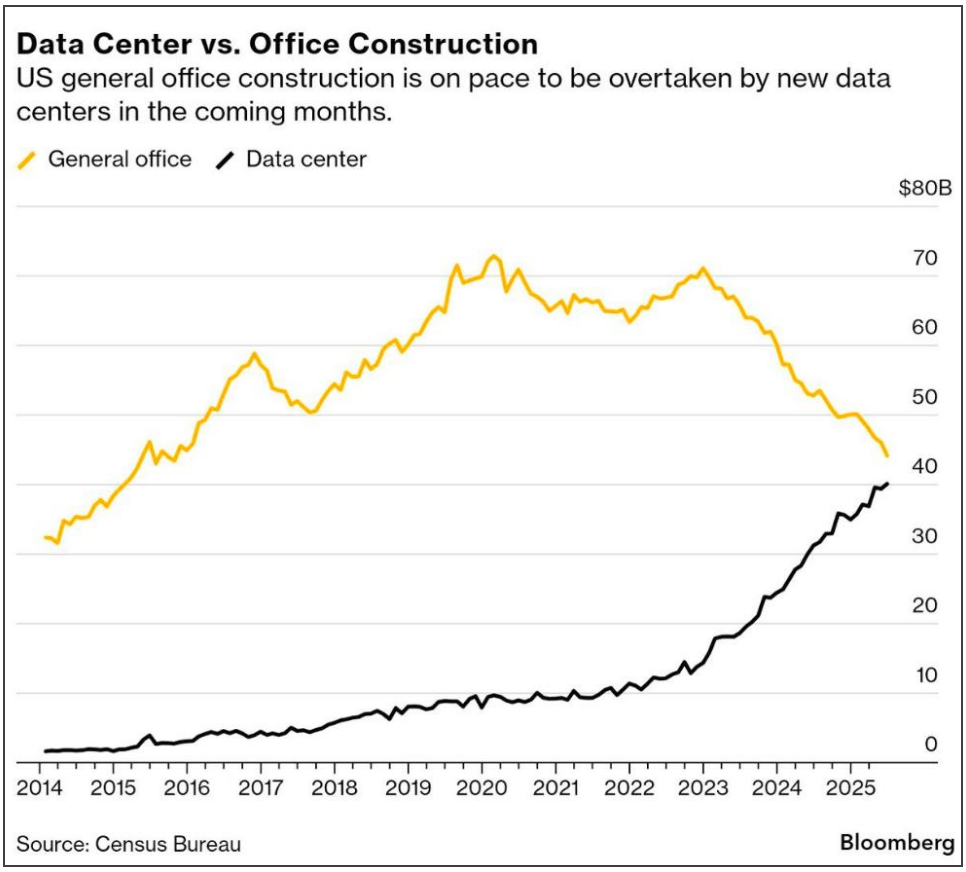
What makes this opportunity particularly compelling is the supply-side constraints that create natural moats around incumbent players. The specialised equipment required for AI data centres, from high-capacity transformers to liquid cooling systems to high-speed interconnects, cannot be rapidly scaled. Manufacturing capacity for critical components like Credo's low-power SerDes chips and Active Electrical Cables is finite and takes years to expand.

CommScope's infrastructure solutions, Celestica's hyperscale hardware integration capabilities, and the specialised power distribution equipment these facilities require all benefit from these supply constraints. In an environment where demand vastly exceeds supply, these companies have immense pricing power.

### Looking Beyond the Hype

While market volatility around AI has created concerns about returns on hyperscaler investments – particularly following developments like China's DeepSeek model –

the infrastructure build-out continues unabated. The fact that data centre construction is set to overtake general office construction highlights the extent of the shift.




For investors willing to look beyond the obvious AI plays, power grids, data centres, and connectivity infrastructure represent some of the most compelling opportunities in today's market.

The hyperscalers aren't pulling back on chip purchases or capex forecasts. Instead, they're shifting investment from AI training toward inference, which requires more distributed infrastructure and therefore more power capacity.

The infrastructure requirements are largely technology-agnostic. Whether the next breakthrough comes from OpenAI, Google, or a Chinese startup, it will still require massive computing power, robust electrical infrastructure, and sophisticated cooling systems. The companies providing these fundamental services will benefit regardless of which AI models ultimately prove most successful.

**The Investment Thesis**

We're in the early stages of what I believe will be a multi-year infrastructure super-cycle. The combination of unprecedented demand growth, supply-side constraints, and the mission-critical nature of these infrastructure services creates an exceptionally attractive risk-return profile.

For investors willing to look beyond the obvious AI plays, the companies building the power grids, data centres, and connectivity infrastructure, that make artificial intelligence possible, represent some of the most compelling opportunities in today's market.

# Stock Profile: Rolls Royce Holdings

**By**: JD Hayward, global portfolio manager: Flagship Asset Management

- ⇒ Rolls Royce Holdings has been a mainstay in all Flagship portfolios under the current management team.
- ⇒ During this time, it has been one of the main contributors to performance, returning around 480% since its inclusion, July 2023.
- ⇒ Prospects for the stock's main operating segments continue to be strong, while additional upside exists thanks to its expertise in the development of small modular reactors (SMRs)

When seeing the name Rolls Royce (RR), most readers will immediately envision the luxury car brand with the famous Spirit of Ecstasy statuette perched on the hood. While they indeed have the same roots, today these companies have no relation at all. RR, the car brand, is owned by German automaker BWM, while Rolls Royce Holdings is an industrial power business, providing means of propulsion to aircraft, trains & marine craft.

Rolls Royce Holdings has been a mainstay in all the Flagship portfolios … returning around 480% since its inclusion in July 2023.

### History

RR has its roots in Britain in the 1890's when Charles Rolls and Henry Royce started their motor vehicle design company. Royce was obsessed with quality and thus had a focus on engineering excellence and precision – the hallmarks and heritage that RR is most well-known for, while Rolls had a more business-savvy mindset. Rolls passed away shortly after formation of the company, leaving Royce's vision as the singular one for the company, perhaps reflected in RR historically underperforming from a pure business perspective as they maintained their obsession with meticulous engineering and precision.

World War 1 was a pivotal moment for the company, as they started producing aircraft engines, mainly to aid the war effort. This was to be the birth of the aerospace and defense segment, which today represents RR's bread and butter. World War 2 led to the next iteration as RR became one of the first companies to build modern jet engines. With the US as its main ally, these designs were shared with US industrial powerhouse General Electric who, until this day, remain their fiercest competitor.

In the late 60's and early 70's, RR experienced weak performance from one of their engines, essentially sending the company into bankruptcy. Due to its importance to the UK defense sector, the company was nationalized and, as part of this, the car business was spun out and sold, retaining only the strategically important part of the business, leading to the company in its current form.

### The Business

Today, RR is essentially a producer of industrial power sources. Big engines, basically. Operations can be split into 4 segments:

Civil Aerospace    Defense    Power Systems    New Markets


**Civil Aerospace** is today the crown jewel of RR's operations, comprising around 50% of revenue. They are the world's 2nd largest producer of civil aviation engines, trailing only CFM International, a joint venture between the US's GE Aerospace and French based SAFRAN. From the top, this business seems simple enough. Develop and manufacture the massive engines required to propel the world's largest airplanes. And we really do mean the largest. RR operates only in the widebody segment of the market, i.e., planes with twin aisles. This would basically be the Airbus A350, where RR is the exclusive engine provider, and the Boeing 787 Dreamliner, where the market is a duopoly. It's not quite this simple, though, and the pricing and negotiating behind these contracts are a bit more detailed, as the servicing and maintenance of these engines is where the real margin sits.

Generating revenue from these engines comes in 2 parts: the engine is sold to the producer of the actual plane – mainly Airbus or Boeing. The real money is made in their servicing agreements with airline operators – such as Lufthansa, Quantas and United.

This is generally an industry with good economics, if execution is strong, but also one with strong competition (from other large legacy players, as barriers for new entrants are extremely high). This means missteps can be very costly if it leads to a loss of business, which is generally very low volume, but very high value. RR only produces about 300 jumbo jet engines a year. Get the designs on these engines correct, and the contracts that follow are hugely profitable.

Generating revenue from these engines comes in 2 parts. Firstly, the engine is sold to the producer of the plane – mainly Airbus or Boeing. This would be about 1/3rd of the engine revenue, but at a very low margin.

The real money is made in their servicing agreements with airline operators – Lufthansa, Quantas, United, etc. Long-term service agreements are entered into with the carriers, whereby RR is paid based on the number of flying hours, and they are responsible for the maintenance and servicing of the engine. So, better designs leads to more efficient engines requiring less downtime and less maintenance, which can lead to highly profitable servicing agreements.

These engines generally have very long lifespans, around 30 years, so a good design goes a long way towards profitable contracts in the future. On the flip side, design errors can quickly turn into nightmares of costs spiraling out of control if engines don't deliver according to expectations, as RR experienced in the 60's and 70's.

**Defense** comprises around a quarter of the business, and the segment focusses on power and propulsions systems for military aircraft, naval application, as well as nuclear submarine engines.

**Power Systems** is also around a quarter of the business. This segment encapsulates all off-highway engines (i.e., not normal road going vehicles). A lot of this business was retained after the spin-off, and end applications are industrial power generation and storage, train engines, marine engines, gas turbines, and the like.

And, lastly, there is the **New Markets** segment. While this segment is currently negligible in terms of financial contribution, the potential is large, and RR is already a leader in a key technology known as small modular nuclear reactors (SMRs), basically a micro-nuclear reactor. This expertise comes as a result of their extensive history in producing nuclear reactors for use aboard military submarines. These SMR's are being viewed as a viable alternative for the increasing energy demand we see today and, unlike renewables, they can supply base-load energy. SMRs are built in a factory and are small enough to be transportable. This is a much cheaper and easier-to-produce alternative to traditional nuclear reactors. The opportunity here is clear. The UK have stated a target to get to 24 Gigawatts of nuclear power by 2050, compared to the 6 Gigawatts they have today – so a very notable step-change. RR is optimistic about the opportunity and views the segment as being profitable and free cash flow positive by 2030. So, while negligible today, the optionality provided by this segment is particularly attractive and certainly adds to the investment case.

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**The Investment Case**

The initial investment in RR was based on several drivers:

**Covid Recovery**

Because large parts of revenue is generated by flying hours, Covid represented a complete standstill in the industry. Revenue basically disappeared, as did earnings. When demand recovery was evident, there was an opportunity to buy at trough earnings, coupled with a low earnings multiple at the time.

**Geopolitical Instability**

Defense spending has, for several years now, been a major theme in the European Union, driven by a fractious relationship with Donald Trump and structural underspending by NATO members on defense.

**Increasing Market Share**

RR has about 40% of the current installed engine base, but they have a 50% share of new orders, so they are slowly increasing their share of the total installed base.

**Strong Financial Performance**

3-year revenue growth of around 20% per annum, combined with a net cash balance sheet and gross margin profile that has increased by 5% over the last 5 years. This filters to the bottom line.

**The Outlook**

Given its strong run, RR is currently trading at a lofty multiple of 36x forward earnings. However, over the past couple of years, earnings have consistently been revised upward as RR continues to recover post-COVID and execute on their growth strategies. This has allowed RR to "grow" into this multiple. *Our strategy of allowing our winners to run has enabled us to partake in much of this strong run.*

We believe this trend is set to continue as the company continues to execute their core strengths. The recent traction in the SMR space, and the ever-increasing power demand created by big tech, further provide a massive opportunity, and RR is sitting pretty to capitalize on this.

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# In conclusion

Flagship's global investment process is centered on a comprehensive, active risk management system that has been designed to let our winners run, while cutting our losses sooner. Our funds own a highly diversified selection of businesses across industry groups that we believe are favorably positioned compared to their peers from a multifactorial perspective.

We believe this combination of a proprietary risk management system, used in conjunction with our approach of considering several factors before a stock or manager can be included in our portfolios, will lead to superior risk-adjusted returns across our range of funds.

While we recognize and appreciate that investing is a long-term endeavour, we also realize that most investors do not want to endure prolonged periods of relative underperformance. We believe our approach strikes a middle ground whereby we can deliver alpha (or excess performance relative to one's benchmark) over the long-term, while shielding investors from protracted periods of negative alpha, compared to the benchmark.

We write these Telescopes so that our investors know what it is we are doing, and why we are doing it. For many of you, we are the caretakers of your global investments, and we would like to use this opportunity to thank you for the trust you place in us and emphasize how deeply committed we are to the responsibility that we hold.

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