AORIS

Quarterly Report

September 2022

Aoris International Fund

Aoris Investment Management

Aoris is a specialist international equity manager founded in 2017. We are a focused business and manage a single international equity portfolio. Our investment approach is conservative, fundamental and evidence-based.

The Aoris International Fund

We own a concentrated portfolio of high-quality, wealth-creating businesses run by prudent and capable management. Owning a maximum of 15 companies allows our quality criteria to be unusually demanding and permits us to be discerning on the price we pay. We aim to deliver a return of 8–12% p.a. after fees over a 5–7-year market cycle.

Our Quarterly Reports

We are business owners, not economists. As such, our reports focus on the performance of our investee companies. We report on portfolio performance and changes with candour and transparency. Each quarter, we include a thought piece or feature article on a topic area with direct relevance to our investment approach.

Aoris International Fund

Performance to 30 September 2022

Class A (Unhedged – base fee option) inception 26 March 2018	**September Quarter**	**1 Year**	**Since Inception p.a.***
Portfolio return (AUD) net of all fees	3.6%	–4.7%	11.8%
MSCI AC World Accum Index ex-Australia (AUD)	–0.3%	–11.0%	8.1%
Excess return	4.0%	6.2%	3.7%

Class C (Hedged – base fee option) inception 28th September 2018	**September Quarter**	**1 Year**	**Since Inception p.a.***
Portfolio return (AUD) – net of all fees	–1.6%	–13.0%	7.7%
MSCI AC World Accum Index ex-Australia 100% Hedged (AUD)	–5.6%	–18.3%	3.0%
Excess return	4.0%	5.2%	4.7%

*Past performance should not be taken as an indication of future performance.

Market and portfolio performance

The international equity market, as measured by the MSCI AC World Accumulation Index ex-Australia, declined by 0.3% in the quarter (all returns are in A$ unless stated otherwise). Equity markets fell by 5.6% in local currency terms, with changes in foreign currencies adding 5.3% to the A$ return.

The Aoris International Fund (Class A – Unhedged) rose by 3.6% in the quarter, outperforming its benchmark by 4.0%, while the Aoris International Fund (Class C – Hedged) declined by 1.6%, also outperforming its benchmark by 4.0%. During the quarter, Nike declined by approximately 13%, detracting 0.7% from Fund performance. No other portfolio holding fell by more than 3% in the quarter.

Energy was once again the best-performing sector, rising by 5.3% for the quarter, while the worst-performing sector was Communication Services, which declined by 8.0%.

The impacts of persistently high inflation and progressively tighter monetary policy continue to cascade through the global economy. In the September quarter, these two factors had a particularly noticeable impact on three broad areas: mortgage interest rates, energy costs in the UK and Europe, and the US dollar.

- The interest rate on a 30-year mortgage in the US at the end of September was 6.7%, the highest rate for 15 years. The monthly outgoings to service a mortgage at the prevailing interest rate on a median US home price is 50% higher than a year ago. This is likely to severely slow the purchase and sale of existing homes and, in turn, spending on home furnishings and renovations.
- The impact of higher gas prices has been severe in the UK and Europe. To shield households from the full increase in their energy bills until 2024, the UK government has committed to spend £150 billion on subsidies, which is over 5% of UK's GDP. Gas prices in Europe are about eight times their average of the last 10 years, and 10 times more expensive than prices in the US. This will have a material impact on industrial activity and the competitiveness of European manufacturing, not to mention European government debt, should governments share the burden.
- Since the beginning of this year, the US dollar has strengthened by 17% against a basket of other currencies, as measured by the US Dollar Index. An increase of this magnitude can materially impact the global economy in myriad ways. Two of these are 'imported inflation', or the higher cost for many countries of commodities such as oil, which are priced in US dollars, and the higher debt-servicing cost for countries that have issued foreign debt denominated in US dollars.

For much of the pandemic, the consumer sector of the global economy benefited from government support programs, lower-than-normal spending on discretionary areas such as travel and entertainment, and record-low mortgage interest rates. While employment conditions remain broadly healthy, the impact on the cost of living from higher inflation and elevated mortgage interest rates suggests consumer spending will be much more restrained in the coming year or so.

For the Aoris portfolio, we have been cautious of businesses that have benefited from unusually strong revenue growth over the last two years, particularly those where this has been amplified by abnormally high profit margins. For these types of businesses, the pandemic-era tailwinds may well become headwinds. For businesses in the Aoris portfolio that have experienced particularly strong earnings growth over 2020 and 2021, such as luxury goods company LVMH, we have assumed some retracement from last year's profits in our valuation.

In the month of September, several portfolio companies reported strong earnings growth and a resilience to external conditions that speaks to the competitively winning, all-weather characteristics we look for. Two examples are Cintas and Accenture. Cintas, which is America's largest uniform rental and facilities services company, reported underlying growth of 14% for the three months to August, as they won more customers and existing customers took more of their services. Despite higher costs, particularly in energy and wages, Cintas' profit margin increased compared to a year earlier. Accenture's revenue in its August quarter grew by more than 10%, while its new bookings were more than 20% above the prior year's level. As with Cintas, Accenture continues to take market share, providing more services for more customers, and its profit margin also rose compared to a year ago.

Nike was the one portfolio company that reported earnings below our expectations for its recent quarter. The company is being impacted by three factors, none of which we view as permanent. These are suppressed demand in China due to lockdowns, higher freight costs, and an excess of seasonal inventory in the US that will require product to be discounted. We have maintained our holding in Nike as these issues don't impact our view of the company's long-term earnings power. Through the pandemic period we have been impressed by management's willingness to stay the course and invest to support growth and market share, rather than pull back in the face of external headwinds.

Stock profiles

Copart

Copart is the leading auction site for salvaged vehicles in the US. At 50% larger than its only competitor, it dominates an attractive, growing market.

Copart is the largest auction platform in the US for used passenger vehicles that have been deemed a total write-off by their insurer. This may have been due to an accident or damage as a result of a natural disaster, such as the recent Hurricane Ian. On a typical day, Copart has around 250,000 vehicles for sale on its auction website, and it sells over 3 million cars a year. The purchasers of cars on Copart are typically dismantlers, who sell the parts individually, or repairers, who may be able to return the vehicle to roadworthy condition. About half the cars sold through Copart's auctions are returned to the road.

While improved safety features have, thankfully, reduced the frequency of car accidents over the course of many years, they also make cars more expensive to repair. Due to the rising penetration of sensors and electronics throughout the vehicle, the percentage of cars involved in an accident that are written of has increased from 4% in 2000, to 20% in 2020. Copart expects that total loss frequency will continue its long upwards trend, contributing to many years of growth in the number of salvage vehicles to be auctioned.

Copart is the leading player in a duopoly market, and around 50% larger than its only competitor. There are three features of the way Copart has been run that have contributed to its long history of market share gains and competitive success: auction liquidity, land ownership, and technology.

As with any marketplace, sellers want to go where buyers are and vice versa, so auction liquidity is paramount. Over many years, Copart cultivated a substantial and growing number of overseas buyers for the cars it sells from the US. On the seller side, Copart has grown outside of its core US insurance customer base and attracts customers such as rental and government car fleets. As Copart grows faster than its peer, its auction platform becomes incrementally more attractive to both sellers and buyers, driving further growth and so on.

Secondly, Copart's 200 storage yards are a mundane but critical part of its physical infrastructure. They enable it to take possession of vehicles that are to be auctioned, but obtaining municipal approval for new yards can be extremely difficult. Throughout its history, Copart has chosen to own its land and acquire land years in advance of its needs, while its competitor has mainly leased land. Copart therefore owns and controls a highly strategic asset.

Lastly, Copart's leading technology underpins the auction platform itself, and facilitates everything from taking title of the cart, to repaying the lender any outstanding loan. Copart has always invested heavily in technology and created a meaningful competitive advantage in this area. In fact, it ended onsite auctions and moved to an online-only business in 2003, 17 years ahead of its competitor.

Copart has grown revenue at more than 10% p.a. over the last decade at very attractive profit margins. We believe the company has many years of attractive growth ahead of it.

Microsoft

There are few businesses as closely associated with computing, particularly personal computing, as Microsoft. From Bill Gates's founding mission for the company of helping put 'a computer on every desk and in every home', Microsoft has grown to be a true global technology giant, with revenue in its June fiscal year of almost $200 billion.

Microsoft's story since its beginnings in 1975 has not just been about becoming larger; it has also been about becoming more relevant. Microsoft has become more ever more relevant to more customers, and this is true across enterprises, governments, small businesses, individuals and students, and across all major geographies. We can see this in the Office and Windows products, used by most of us every day; Teams, the communication tool that proved so valuable through the pandemic; and in Microsoft's Azure cloud-computing business.

Microsoft's Windows operating system and Office productivity applications power well over 80% of the world's desktop and laptop computers, which may give the impression of a mature business. To the contrary, revenue from these two business lines has grown at a rate of around 10% p.a. over the last five years, as they have become more relevant to more users. Microsoft has successfully grown its user base in historically underpenetrated markets, such as small businesses and front-line workers, by providing cheaper subscription options that are more appropriate to their needs. For many traditional users, Windows and Office have become more relevant through the addition of advanced security features, Teams, and online storage, which has seen a rising proportion of users take the most advanced subscription options.

Microsoft has a long history of becoming more relevant to more users through successful innovation, such as business communication platform Teams, and cloud computing service Azure.

Teams warrants special mention as it has rapidly become an important application in its own right. Teams currently has over 270m active monthly users, almost double the number one year ago and 10 times the number of users prior to the pandemic. Microsoft's ambitions for Teams go well beyond video calling and intra-office messaging, to a much broader collaboration and communications platform. A recent survey of Chief Information Officers (CIOs) showed 50% of CIOs plan to standardise on Microsoft Team, and over three years that number is expected to reach two-thirds.

Microsoft's Azure has risen to be a strong number two to Amazon Web Services in cloud computing. Microsoft has three extremely valuable assets in this market in the form of its deep relationships with large corporate and government organisations around the world, its trusted brand, and the scale of its physical data centre infrastructure.

We see a bright future ahead for Microsoft as it continues on its path of being more relevant to more users.

Portfolio changes

None

Founder-led companies: Why you should take notice

Written by Ty Archibald, Analyst

Introduction

A popular framework endorsed through time is investing in companies where the business is still run by the original founder, who still has a significant impact on business operations, and the cultural imprint they put in place remains intact.

Investors often refer to companies as being superior investment opportunities because they are 'founder led' or run with a 'founder's mentality'. Does this inevitably lead to better outcomes?

In this feature article we put founder-led businesses to the test. We aim to identify if they really are superior investment opportunities and highlight the common characteristics of those that are successful, as well as the implications for investors when the founder departs.

The glitz and glamour of founder-led fame

In today's world it is difficult to scroll through any news outlet or social media site without seeing a headline mentioning a company founder-turned-billionaire. Globally, names such as Bill Gates (Microsoft), Jeff Bezos (Amazon), and Elon Musk (Tesla) spring to mind. In Australia, the likes of Mike Cannon-Brookes (Atlassian) and Melanie Perkins (Canva) draw attention. Many up-and-coming entrepreneurs may look to them for inspiration, business advice, or general life lessons. Whatever the attraction, the general population watches their moves closely and actively seeks out their opinions on a wide range of matters, from business and politics to life on Mars.

In some cases, they have evolved to be much more than a company founder or successful businessperson, reaching a level of fame worthy of a Hollywood A-lister. With so much hype surrounding these business moguls, people could easily be forgiven for believing that starting your own business is an automatic doorway to fame and riches. For investors, if you weren't along for the ride, you may be kicking yourself. Or perhaps you're out there searching for the next Microsoft, Amazon or Tesla.

A select group of founders have reached a level of fame worthy of a Hollywood A-lister.

But is it really that simple? Are these success stories representative of the reality of investing in companies that are managed by their original founders, or is it an unfair sample size of the 1% that make the front-page news? Do founder-led companies really outperform, and what common characteristics do they share? We set out to explore these questions further.

Do founder-led businesses outperform?

To test whether founder-led businesses outperform, we examined the MSCI World Index, containing around 1500 of the world's largest companies. We defined founder led as companies where the founder is CEO and/or Chairman, still heavily involved in operations, or where direct family members have a leadership position and/or own a substantial proportion of shares. Of all companies in our study, 18% met this definition.

The Technology and Retail sectors had the highest representation of founder-led businesses, accounting for close to a third of the total. Pharmaceuticals and Health Care were also well represented, as were Real Estate companies. Most founder-led companies are listed in the US (60%), followed by Europe (16%) and Japan (10%).

We compared each business within the MSCI World Index against a broad index of industry peers and analysed share price returns dating back to the business's IPO date, or the beginning date of the respective industry benchmark through to the end of December 2021. Our study revealed founder-led businesses significantly outperformed, delivering an average annual share price return greater than 2x that of their industry benchmarks.

When we compared our sample of all founder-led businesses against all non-founder-led companies within the MSCI World Index, irrespective of industry, founder-led businesses delivered meaningfully higher total returns (adjusted for dividends) over the five years to the end of December 2021. The results suggest that, whether compared against industry peers or a broad universe of non-founder-led companies, founder-led businesses outperform.

Source: FactSet, Aoris analysis

The odds of creating an enduring business are stacked against founders. The U.S. Bureau of Labor Statistics[1] reveals that approximately 20% of new businesses fail within the first two years, 45% during the first five years, and 65% during the first 10. Only 25% of new businesses make it to 15 years or more. If creating a successful business is such a difficult task, what leads founder-led companies to prosper?

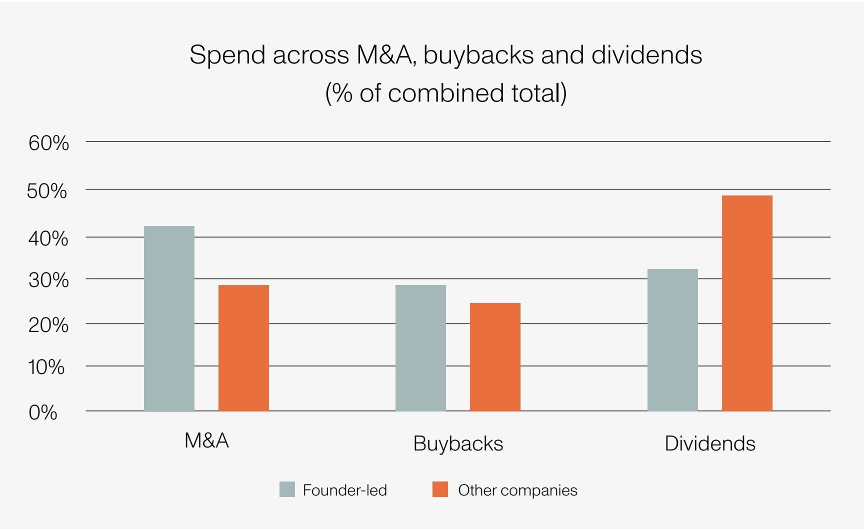
[1] U.S. Bureau of Labor Statistics. Table 7. Survival of Private Sector Establishments by Opening Year, *https://www.bls.gov/bdm/us_age_naics_00_table7.txt,* accessed 21 September 2022

R&D spend in founder-led companies is up to 22% higher than non-founder-led firms.

Our study identified a common driver of outperformance: a willingness to invest.

Willingness to invest

Founder-led companies tend to invest more than peers. We found that in general, all companies across our study spend a similar proportion of capital on share repurchases; however, founder-led businesses spend more on acquisitions and pay out lower dividends. This suggests a greater willingness to reinvest in the business. Although dividends are welcomed by investors, it could signal a lack of future growth opportunities.



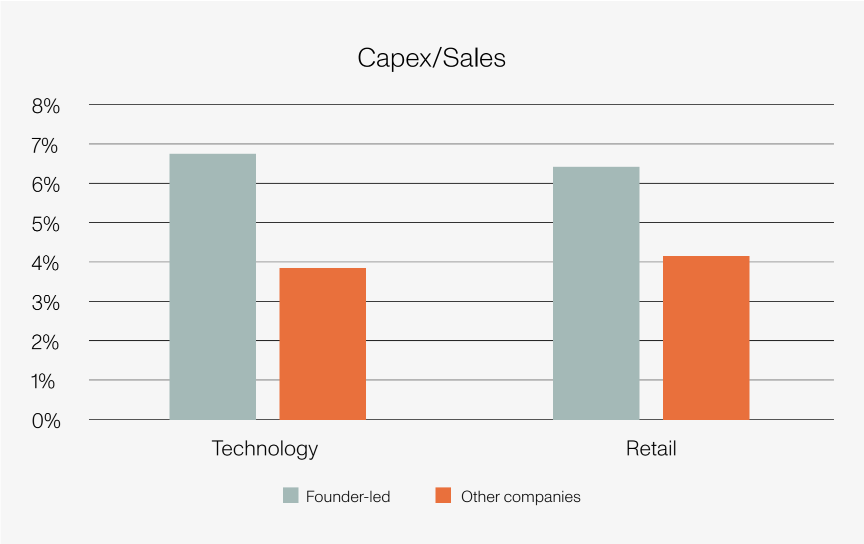
Source: FactSet, Aoris analysis

In many investment circles this appetite to invest for the long term is known as the 'founder's mentality'. Although used as a buzzword at times, there is some truth to it. A 2016 study by professors at Purdue University[2] found that a business managed by a founder delivers 31% more patents, and creates patents that are more valuable than professionally managed companies. They are also more willing to take risks, adapt and reinvent themselves. In many cases the large founder shareholding provides a stable capital base and less pressure to hit short-term targets to satisfy outside investors.

[2] Lee, Joon Mahn: Kim, Jongsoo: and Bae, Joonhyung. 'Founder CEOs and Innovation: Evidence from S&P 500 Firms' (17 February 2016). Available at SSRN: *https://ssrn.com/abstract=2733456 or http://dx.doi.org/10.2139/ssrn.2733456*

The ability to take actions for the long term provides a foundation for higher investment.

As further support for the stronger preference for internal reinvestment, founders in the Technology and Retail sectors (the highest represented sectors) spend roughly 72% and 59% more than peers on capex as a percentage of sales, respectively. Research from The Ohio State University[3] in 2003 also indicates that R&D spend in founder-CEO companies is up to 22% higher than non-founder firms.



Source: FactSet, Aoris analysis

A business doesn't need to operate in fast-moving markets to invest and adapt. LVMH (Moët Hennessy Louis Vuitton) is the largest global luxury goods company, owning 75 iconic brands such as those in its name, as well as Christian Dior, Sephora, Bulgari and Tiffany. The Louis Vuitton brand was born 200 years ago when he founded his business to make suitcases, featuring the classic monogrammed logo design, for the French royal family. Although the brands themselves are old, the business is far from sleepy. Led by Co-founder, CEO and Chairman Bernard Arnault, LVMH invests over €20 billion each year into creating new products, developing engaging advertising campaigns, and refurbishing stores to keep them fresh and vibrant.

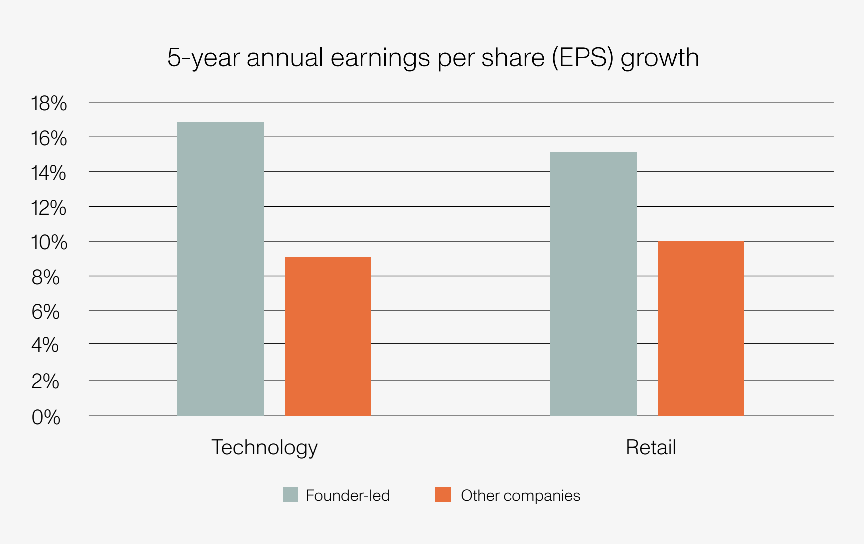
[3] Fahlenbrach, Rüdiger. 'Founder-CEOs Investment Decisions, and Stock Market Performance' (8 August 2007). Dice Center Working Paper No. 2004–20, *Journal of Financial and Quantitative Analysis (JFQA)*, Forthcoming, Fisher College of Business Working Paper No. 2004-01-001, Available at SSRN: https://ssrn.com/abstract=606527 or http://dx.doi.org/10.2139/ssrn.606527

This spend represents about a quarter of sales in a given year.

LVMH purchased the iconic Parisian department store, La Samaritaine, in 2001. It was subsequently closed in 2005 for redevelopment. It took 16 years and over €750m before the refurbished store reopened in 2021 – now that's long-term thinking!

Investment drives sales and earnings growth

A founder's willingness to invest appears to pay off. Our study indicates founder-led businesses grow both revenue and earnings faster than peers. While they are focused on growth, they tend to do so profitably. Again, we use the Technology and Retail sectors as an example.



Source: FactSet, Aoris analysis

L'Oréal is an example of a current portfolio holding that exhibits superior sales and earnings growth. It was established in 1909 by French pharmacist Eugène Schueller with the guiding principles of research and innovation in the field of beauty. Françoise Bettencourt Meyers is Vice Chairman of the Board and the granddaughter of the founder. She has kept the founding principles intact, investing heavily to drive innovation. Consequently, L'Oréal has consistently outgrown its end market, and in recent periods this outperformance has accelerated to a double-digit percentage while delivering strong earnings per share (EPS) growth.

L'Oréal could easily cut back on innovation spend and immediately increase profitability and margins. However, this may lead to slower EPS growth in the future as sales slow, ultimately to the long-term detriment of the business.

Life after the founder

The only inevitable outcome when investing in founder-led businesses is that one day the founder will depart. Analysis from the late 1990s and 2000s[4] showed that fewer than 25% of founders led their companies to IPO. Further, four out of five founders are forced to step down from the CEO position – they don't leave willingly. The same research also highlighted that most founders surrendered control long before their companies went public. The only certainty is that if the business is a going concern, it will have to operate without the founder at some stage. A common situation is the involvement of heirs or other family members who continue the legacy the business was built on. Even then, as generations come and go the business can move further away from the founder's vision and cultural imprint.

Four out of five founders are forced to step down from the CEO position – they don't leave willingly.

We are especially attuned to companies operating in fast-moving markets, where earnings calls and investor days are dominated by the star CEO. We have a preference to hear regularly from business heads, to understand their mindset and gain comfort that there is a deep bench of capable managers to take over when the time comes. We are also wary of external hires to replace a departing founder, which could signal a lack of internal replacements and neglect of a thorough succession planning process. This naturally leads us to competitively stable, slower moving end markets. By operating in a market with less disruption risk, it decreases the likelihood of a detrimental outcome in the event of a 'star' founder departing. We are mindful that the risk can never be reduced to zero.

[4] Wasserman, Noam. 'The Founder's Dilemma', *Harvard Business Review* (February 2008), *https://hbr.org/2008/02/the-founders-dilemma, accessed 21 September 2022*

Consequences of a succession event

The departure of a founder managing a successful business is one of the key risks investors face when dealing with such companies, and the repercussions can be detrimental. For anyone who has watched *House of Gucci*, you understand why it can be such an unsettling experience.

In less extreme circumstances, we take Disney as an example: After Walt Disney's death in 1967, the company largely abandoned the animation industry. This was further magnified by the passing of Roy O. Disney – Walt's older brother and co-founder – four years later.

Subsequently, Donn Tatum became the first non-Disney family member to serve as CEO and Chairman. Disney only hired 21 people from the period 1970 to 1977, and employee headcount in animation declined 75%. By 1981, amusement parks accounted for 69% of total revenue, doubling as a percentage of sales since Walt's passing. It became the centre of gravity for a business that previously focused on developing creative animated films.

Michael Eisner was elected Chairman and CEO in September 1984. When he took over the helm, earnings had declined almost 60% from the Walt Disney era. In this example we can see just how consequential a succession event can be for investors.

Surviving a succession event

In the Aoris portfolio we have a great example of an understated business that has withstood the test of a succession event. David Barber co-founded Halma in 1972 with a series of acquisitions of mechanical and electronic engineering companies. From the outset, Halma had strict financial goals: to develop a business that was self-financing, and would be able to sustain earnings growth of 15% plus inflation. The business foundations were laid on these two overarching goals.

Halma built a business with 50 underlying operating companies, all run with an owner mindset. Importantly, all business managers are incentivised the same way: growth in economic value added.

There is also a KPI that constitutes a minimum that must be spent on R&D, to ensure the focus remains on investing for the long term. These incentives align all managers with the interests of shareholders, so everyone shares in the wealth accumulation. The decentralised, highly autonomous nature of operations creates an environment where business managers are also acting as business owners.

David Barber stepped back from the CEO role in 1997 and retired as Chairman in 2003. The founder had departed, but the business is still managed with the 'founder's mentality'. Although businesses such as Halma are no longer founder-led, they carry many of the same attributes that made them successful. Notably, when Barber stepped away, not much changed. Two decades later, Halma maintains the same focus on sustainable, profitable growth. The same distinct M&A principles are intact, as well as the decentralised operating structure and aligned incentive plans. Because success wasn't dependent upon a single star individual, the business purpose and philosophy are well entrenched throughout the organisation.

More recently, another Aoris portfolio holding is experiencing a succession event. Cintas was established in 1929 by Richard and Amelia Farmer. Today, Cintas is America's largest uniform rental company, serving businesses across industries spanning hospitality, health care, education, manufacturing and construction. The business has been managed by direct family members of the founder for most of its history. Most recently, Scott Farmer (the founder's great grandson) served as CEO from 2003 to mid-2021, when he transitioned to Executive Chairman. We view it favourably that the new CEO, Todd Schneider, is a Cintas veteran and understands the cultural elements that differentiate it. Since coming into the CEO role, he has continued to manage the business with the same focus and principles that attracted us to Cintas.

Common recipe for success

Not all founder-led businesses are great, and not all great businesses are founder-led.

It is tempting to get excited when a business is being run by its original founder. If you believe the hype around founder-led companies, that must instinctively make it a good investment proposition. But not all founder-led businesses are great, and not all great businesses are founder-led. For example, BlackBerry had initial success under founder Mike Lazaridis. In the early 2010s, it was the undisputed leader in the smartphone market and a true disrupter in the field, holding roughly half the US market in 2009. By 2014 (still under founder leadership) its market share collapsed to an abysmal 1% after failing to invest behind areas outside of the email messaging system that the phone was built on.

A third of our portfolio holdings meet the founder-led definition. However, what we view as more important is how the business is managed, rather than by who. Across the portfolio we own 15 businesses that we believe are run with a 'founder's mentality', even though a founder may not be at the helm.

For example, Costco is a professionally managed business that is razor-focused on providing the best value to members. Management could increase prices and remain cheaper than peers, in turn increasing profit margins. Instead, it chooses to reinvest back into the business to drive prices lower, delivering sales growth and market share gains. In fact, in recent years Costco invested $400m to vertically integrate and create its own poultry plant, after realising it would be more cost effective and create better value for members. This is an example of a great business that is no longer founder-led, yet it's managed with the same admirable characteristics that allow such businesses to succeed.

The willingness to invest for the long term is a common characteristic across all our portfolio holdings. By focusing on solving customers' problems and investing heavily into advancing existing solutions or creating new opportunities, businesses grow faster than peers (while doing so profitably) and take market share.

Conclusion

Our study indicates that founder-led businesses tend to outperform. Driving outperformance is a greater willingness to invest for long-term opportunities, leading to higher sales and earnings growth.

An implication of investing in founder-led companies is dealing with the departure of the founder. How a business navigates management succession could have long-term ramifications.

Successful founder-led businesses are often driven by purpose and built on a set of distinct cultural principles. These characteristics can live on long after the founder leaves. The enduring 'founder's mentality' can guide businesses to long-term success, regardless of who is at the wheel. At Aoris, we look for these common characteristics across all our portfolio holdings.

Portfolio companies

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