GCQ FLAGSHIP FUND | P Class Units

GCQ
GLOBAL CONCENTRATED QUALITY

MONTHLY PERFORMANCE & PORTFOLIO UPDATE

January 2023

"I owe a great deal to economists for their inability to acknowledge the degree to which psychology moves markets."

LEON LEVY

Returns	1 Month	3 Months	6 Months	Since Inception (1 July 2022)
GCQ P Class (AUD)[2]	**10.1%**	**10.0%**	**3.4%**	**12.6%**
MSCI World Index (AUD)	3.6%	(0.5%)	1.1%	8.1%
Outperformance	**6.5%**	**10.5%**	**2.2%**	**4.5%**

The portfolio's net return for the month of January 2023 was **+10.1%**[1]. This compares favourably with the MSCI World index in Australian dollar terms, which was up +3.6% for the month.

Equity markets benefited from a shift in market sentiment that occurred during the month. This change in sentiment was underpinned by increasing confidence that inflation is now falling and that the interest rate tightening cycle is drawing to a close.

The prospects for a soft landing for the global economy now look materially brighter than investors generally believed late last year. The consensus market view is now more aligned with observations we have made in recent months regarding our expectation that inflation in the US had peaked.

We are also pleased to report that, with the quarterly earnings reporting season now drawing to a close, Flagship Fund portfolio companies have generally performed slightly better than expected. The latest round of earnings reports have been supportive of our investment theses for the GCQ portfolio companies, and their share prices have outperformed the broader market.

We continue to be very comfortable with valuations across the portfolio.

On the following pages we have provided an introduction to Haleon plc, a recent addition to the portfolio.

Portfolio Overview as at 31 January 2023

Company	Portfolio Weight
Richemont	7%
LVMH	6%
Hermès	4%
Super-luxury goods	**17%**
Visa	11%
Mastercard	7%
Global consumer payments	**18%**
FICO	7%
Hemnet	7%
Automated Banking Services	1%
Local monopolies	**15%**
S&P Global	7%
Moody's	4%
MSCI	3%
Credit rating agencies & investment index providers	**14%**
amazon.com	9%
Microsoft	6%
Global cloud computing	**14%**
Other high-quality businesses	21%
Shorts	1%
Net exposure	**98%**
Cash	2%
TOTAL	**100%**

1. *Net performance figures are shown after all fees and expenses and assumes reinvestment of distributions.*
2. *Cumulative performance since inception, after all fees and expenses, and assumes reinvestment of distributions.*

Haleon

In our December 2022 Portfolio Update, we noted that we had made a new investment, captured within the "Other high-quality businesses" category of the Flagship Fund portfolio.

That investment is **Haleon**, an investment we made after we met with the company in London late last year.

While the Haleon name will be unfamiliar to many of you, the brand names it owns may well be prominent in your bathroom cupboard. Haleon owns a collection of durable, high-quality brands including **Sensodyne, Panadol, Voltaren, Advil, Otrivin, Theraflu, Paradontax, Polident** and **Centrum**.

Sensodyne dominates the sensitive toothpaste category globally, and is the business that first attracted us to take a closer look at Haleon.

Our investment team has long-admired the Sensodyne business, which we analysed many years ago as part of our industry work when we owned Colgate-Palmolive.

We always viewed Sensodyne as a higher-quality business than Colgate, as it dominates the premium, high-margin sensitive toothpaste category. The sensitive category is growing at a much faster pace than the overall toothpaste industry, and as a result, Sensodyne has compounded revenues at a rate of +10% p.a. over the past decade. We expect significant growth ahead, given nearly one in three adults experience sensitive teeth, while only one in three of those use sensitive toothpaste. The Sensodyne brand is synonymous with premium sensitive toothpaste in the minds of consumers, and is poised to capture most of this growth opportunity.

Haleon is now replicating Sensodyne's success with **Paradontax**, which is clinically proven to treat bleeding gums, and is among the fastest growing toothpaste brands globally. Haleon also owns **Polident**, the world's number one denture care brand.

Through the **Panadol**, **Voltarin**, **Advil** and **Theraflu** brands, Haleon offers relief from pain and cold & flu symptoms. The pain relief category lends itself to strong brands, as consumers typically want their pain solved immediately, using a product from a brand they know and trust. Haleon owns some of the best brands in this category.

Centrum is the number one multivitamin brand globally, and has been using its strong brand, which is associated with clinical research, to take market share.

The opportunity to invest directly in these great brands only emerged in July 2022 when the UK-listed pharmaceutical company GSK completed a spin-off of its shareholding in Haleon. Prior to the spin-off, Haleon was majority owned by GSK while Pfizer had a minority shareholding.

The CPG industry

As discussed in our recent Investor Letter, we pass all potential investments through GCQ's **Industry Quality Checklist** to assess whether they meet our quality standards.

The Consumer Packaged Goods (CPG) industry is one that performs well on our checklist, and is therefore a fertile hunting ground for high-quality businesses. The reasons we are enthusiastic about investing in the CPG industry include:

- **Strong brands with high customer loyalty:** The CPG industry contains many strong brands that have been around for decades and even centuries. These brands have an entrenched position in the minds of consumers, who are willing to pay up for the quality and consistency that these brands promise.
- **Scale advantages:** Scale provides the largest CPG companies important competitive advantages in marketing and distribution.
- **Consolidated industry:** As a result of the above factors, the CPG industry is highly consolidated by category. For example, within the toothpaste category, the five largest brands hold over 60% market share (with Sensodyne holding a dominant market position globally in the "sensitive" sub-category).
- **Secular growth & pricing power:** The CPG industry benefits from secular growth due to population growth and rising incomes globally. The best CPG brands also possess pricing power and the ability to leverage existing brands to add premium product lines.
- **High margins and returns on invested capital:** The CPG industry generates high margins and typically has modest capital requirements.
- **Durability and predictability:** CPG products are often repeat purchases, supporting revenue predictability. The CPG industry benefits from a slow rate of technological change and therefore has low disruption risk. Operational risks also tend to be low, with the businesses providing stable and consistent growth with steady margins.

We have kept a close eye on the industry over the past few years. However, until recently these very stable businesses have been in relative favour during the volatile market and economic environment over the past year, and have traded at premium valuations. This meant we could not justify displacing any of our existing high-quality investments within the portfolio.

Haleon is best-in-class within the CPG industry

Within the CPG industry, Haleon's portfolio of brands is particularly attractive. Where most peers typically grow revenue at low single-digit rates, Haleon has recently increased sales at a pace of 12%, demonstrating the company's ability to respond to inflation. Haleon has a medium-term objective to grow revenue at +4% to +6% p.a. going forward. Meanwhile, Haleon generates EBIT margins of c.23%, also meaningfully ahead of peers.

Despite this, Haleon trades at 14x EV/EBIT, which is a material discount to peer valuations in the mid to high teens. This valuation divergence is being driven by two understandable and – importantly – <u>temporary</u> factors:

1. A market "overhang" as investors expect Pfizer and GSK (Haleon's two largest shareholders) to sell down their stakes over time;
2. Concerns that Haleon's debt levels are high relative to the levels that CPG investors typically expect; and

We discuss these factors below.

Haleon's spin-off and market overhang

We are attracted to spin-offs and demergers as they can create material shareholder value for a few reasons:

- **Focus:** Spin-offs allow increased corporate focus. This is particularly relevant to Haleon, which under previous ownership had the management structure of a highly regulated pharmaceutical company. Separation of Haleon's consumer health businesses from GSK's pharmaceutical operations allows the removal of bureaucracy. In our discussions with management, we have been encouraged by steps that Haleon has already taken to remove unnecessary layers of middle management.
- **Incentives:** A more focussed organisation allows more direct incentivisation of management. Haleon has already adopted performance-related incentives which serve to align executives with Haleon shareholders.
- **Simplicity:** Focused business are easier for investors to value, and typically command a valuation premium over businesses with multiple segments and complicated disclosures.

Despite the above advantages, oftentimes a spun-off business can end up in the hands of the wrong shareholder base, which can create short-term selling pressure (and for long-term shareholders, an opportunity!).

GSK's pharmaceutical business is considerably larger than Haleon, and it is consequently no surprise that much of the GSK shareholder register was invested primarily for the pharmaceutical business rather than the Haleon consumer brands.

As a result, we believe many GSK shareholders that were allocated Haleon shares have been selling them down in recent months. In addition, Pfizer continues to own 26% of Haleon, while GSK owns 13%. Both Pfizer and GSK have described their stakes in Haleon as "short-term financial investments", and it is widely expected that they will be sellers of Haleon stock over time. This has created an overhang that we expect will be resolved once these stakes are sold down.

Haleon's debt levels

One key checklist item that Haleon does not yet satisfy regards its debt levels.

At GCQ, we have a strong preference for unlevered businesses, which are better able to endure periods of economic turmoil.

Haleon possesses higher debt levels than we would like, at 3x FY23 net debt to EBITDA. This is by far the highest gearing level of any company in the Flagship Fund portfolio, with Haleon's debt levels a consequence of a pre-spin dividend paid to GSK and Pfizer.

Failure to meet a single checklist item does not automatically preclude a company from being included in the portfolio, although it does provide a focus for internal discussion. In Haleon's case, we take some comfort from the fact that:

- Haleon's business is extremely stable and durable, with a cash flow profile that can support some financial leverage. Even under a severe economic downturn, Haleon is likely to remain substantially cash generative.
- Haleon management has told us that it is focussed on paying down debt rapidly over the next few years.
- Haleon's management is highly incentivised to pay down debt, with 50% of long-term incentive compensation based on free cash flow generation, and 50% based on a reduction in Haleon's net debt to EBITDA ratio.
- Haleon's debt is long duration (average duration of 8.2 years), meaning that refinancing risk is not a concern.
- 80% of Haleon's debt has fixed (rather than variable) interest rates, with an average cost of debt of only 3%.

Despite these mitigating factors, Haleon's failure to meet this checklist item means we have limited its current weight within the portfolio at 2 - 3%. This is something we will re-assess as Haleon pays down its debt.

We look forward to continued steady growth from Haleon, and expect share price appreciation as short-term issues currently impacting the share price are resolved. We believe the business is significantly undervalued and expect to generate a high-teens compound return over the next five years, which we view as highly attractive in light of the quality of Haleon's consumer healthcare franchises.

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