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At Billinger Förvaltning, we invested heavily in February, March and April of 2020. However, given that we haven't made a single purchase in the last eight months it would be slightly disingenuous presenting a 'buy' idea at Best Ideas 2021. I will therefore describe three clusters of companies in our portfolio that are worth consideration from any quality-focused investor for their shortlist. This is also consistent with our thinking around commitment 'bias' as discussed in a previous conversation with MOI Global i.e. holding a security is in our view qualitatively different from buying it. It is the very essence of long-term investing to spend most of our time preparing for short bursts of activity. This presentation ends up in the 'preparation' camp.

For context, it is also important to touch on our investment philosophy and set-up before looking at the 3 clusters. We are long-term investors in a small number of high quality businesses. For us, priority number one is to manage downside risk which at the company-specific level involves looking at how robust revenues are, how flexible the cost structure is, what the balance sheet looks like etc. Beyond this, we are looking for upside through high returns on incremental capital; the points covered below are all part of this equation.

Introducing Three Clusters

The three clusters made up around 37% of our NAV at the end of Q3 and are as follows:

- *Elevators and escalators.* We are invested in this group through KONE and Schindler.
- *TIC (Testing, Inspection & Certification).* We are invested in this group through Intertek and SGS.
- *Aircraft engines.* We are invested in this group through MTU Aero Engines.

Although representing three very different industries, these clusters have several commonalities. I will touch on a few of these below, as well as some differences.

What makes these clusters attractive to us?

There a number of reasons we find these businesses attractive for a long-term investor. We have chosen to highlight 3 aspects for the purposes of this presentation, however there are many more e.g. their organic growth outlook, their balance sheets etc.

1) Resilient revenues

There are several aspects of resilient revenues. One is providing a critical product or service that is difficult to substitute and on this count, all of our clusters qualify; there is no real substitute for an elevator unit and they need to be serviced regularly, products and services need third party validation by TIC companies before they are launched and it is difficult to think of a more critical service than the proper maintenance of a jet engine. These businesses are also relatively resilient to the economic cycle with the exception of MTU. While there is some technology risk for TIC and aircraft engines, we feel that change happens slowly enough in these industries for the risk to be manageable.

Another aspect of resilience is having a diverse customer base. This is true for both KONE/Schindler as well as for Intertek/SGS which serve a very large number of customers across different industries and geographies. Once again, MTU is the exception where the customer base is very concentrated but we feel there are reasons this is a manageable risk.

Thirdly, these businesses have a large proportion of recurring revenues. In the case of KONE/Schindler, this emanates from regular servicing of installed units, largely mandated by law. In the case of TIC, customer retention is very high partly due to a combination of a critical service provided at a small fraction of customers' overall production costs. For MTU, once an engine is on the wing of an aircraft it will generate aftermarket revenues for decades.

2) Cost structure

In order to manage risk in our portfolio, we like to see companies with limited operating leverage. While of course this reduces the rate of earnings growth in a strong recovery (at least in the initial stages), it also means we are less likely to run into difficulties when the inevitable downturns arrive.

In the case of KONE/Schindler, these are largely assembly operations with limited fixed costs. This is not a business of huge production plants belching out smoke. If you would like evidence, look at the resilience of operating margins for these businesses through the financial crisis as well as this year.

For the TIC companies, there are some fixed costs in the form of laboratories etc. However, most of the cost base is flexible or semi-fixed in the form of staff; while these can not be reduced immediately, TIC companies have proven themselves very able of managing the cost base over time. Just as for KONE/Schindler, their margin performance provides evidence of this.

When it comes to MTU, it is a similar story; walking through their facilities just outside Munich mostly feels like a library tour (with some notable exceptions!). You will find highly skilled engineers quietly assembling and servicing engine parts. Once again, just look at the numbers for evidence; margins are much more resilient than one might expect from a cyclical business like this.

3) Market structure

To paraphrase Buffett and Munger, we are not looking to clear high hurdles but rather trying to identify ones that we can step over. One aspect of an industry that we find helpful in reducing the level of complexity is a relatively stable and concentrated market structure. This makes it easier mapping the competitive environment and contributes to improved pricing power etc.

In elevators and escalators, the market is dominated by 4 large players. In aircraft engines, there are only a few companies able to manufacture and service these large and complex units. The TIC industry is more fragmented, but the large listed players have a very strong market position and are active consolidators in the market. The barriers to entry in these markets are also significant e.g. due to network density in elevators and escalators, technological complexity and the importance of a long track record in aircraft engines etc.

All in all, these clusters provide us with supportive market dynamics and in combination with the provision of a critical product/service at a low share of wallet, this makes for high returns on capital.

Conclusion

While different in nature, we feel there are parallels between thinking about clusters and Charlie Munger's "mental models". Although we make investment decisions on a bottom-up basis, we find that owning a few of these clusters makes it easier to manage our portfolio e.g. when it comes to use resourcing, read-across between companies etc. There are also similarities between the clusters which means we can try to replicate a successful approach we have used in one industry in another industry. All in all, we hope there is something of value in this approach and in our examples for other investors with a similar mindset.

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