

Why we believe in family businesses and entrepreneurs

– For professional investor use only –

08/20

August 2020

**Focus on trends and organic
growth**

p.04

At a glance

- Family businesses and entrepreneurs make up a sizable proportion of our economies.
- Our research shows that these types of companies are closely associated with a specific set of desirable traits that hold the potential for sustainable, long-term returns.
- Namely, that they show superior economic returns, a long term strategy focused on navigating powerful mega-trends and challenges, and shareholder commitment.
- We believe there are four core features inherent to these businesses which are associated with the promise of continued alpha.
- Family businesses and entrepreneurs are more likely to prioritize passing down wealth to the next generation, which can translate into a more stable, long-term vision than that of other companies.
- They are associated with higher economic value creation, driven by a 'skin-in-the-game' mentality.
- In order to achieve the goal of intra-generational wealth transfer, these businesses are required to be more attuned to looming structural shifts that have the potential to cause disruption to their markets.
- These businesses also have a stakeholder alignment to uphold. The pursuit of transgenerational value creation puts stewardship for future stakeholders in focus, which is central to our understanding of what is required in regards to the sustainability revolution.
- Our family leaders strategy aims to capture these opportunities through a disciplined and fundamental-driven investment process to deliver a high-conviction portfolio focused on companies directly or indirectly owned, controlled and/or managed by families.

• Introduction	p.02
• A true long term vision	p.03
• Higher economic value creation, driven by 'skin-in-the-game'	p.03
• Focus on trends and organic growth	p.04
• The right mindset for the sustainability revolution	p.05
• Conclusion	p.05

Our research into companies in Europe has demonstrated that family businesses and entrepreneurs commonly exhibit characteristics we place in high regard.

For professional investor use only. Please see important information at the end of this document.

This document has been prepared by:

Portfolio Manager
Malek Dahmani

Pascal Menges
Head of Equity Investment Process and Research
Client Portfolio Manager

For further information please visit www.loim.com

Introduction

Family businesses and entrepreneurs make up a sizable proportion of our economies. Our research shows that these types of companies are closely associated with a specific set of desirable traits that hold the potential for sustainable, long-term returns.

Family businesses and entrepreneurs are one of the most prominent forms of companies in the world. In most countries, they represent between 70 to 95% of all entities. In Europe, they account for 60% of employment in the private sector, and contribute more than any other forms to job creation. This sheer size has been recognized as crucially important by the European Commission to fight unemployment. In addition to their representative size in major economies, these businesses are more commonly associated with higher equity ratio than others and prioritising organic growth in a stable, long-term fashion.

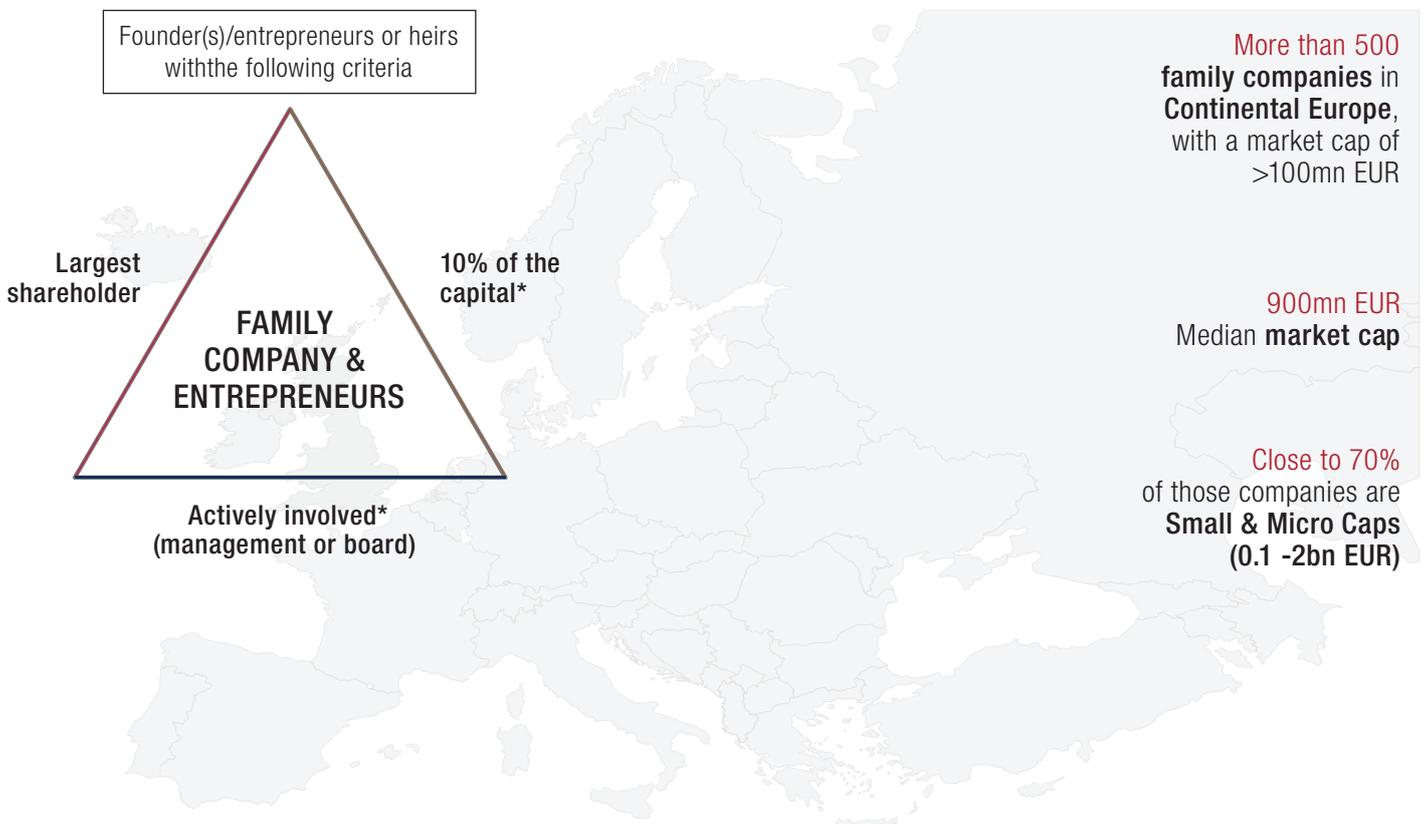
Definitions of what constitutes a family business can vary. In order to bring consistency and effectively capture the opportunities presented in this space, we have established a set

of parameters designed to bring into focus a tangible investment universe (Figure 1). To be considered for inclusion in this universe, the business in question must demonstrate that the founder(s) or heirs must be the largest shareholder, own at least 10% of the capital, and must be actively involved in the operations of the business. By these metrics, our investment universe captures nearly 30% of listed companies in Europe and is typically represented by small cap companies.

Our research into companies in Europe has demonstrated that family businesses and entrepreneurs commonly exhibit characteristics we place in high regard. Namely, that they show superior economic returns, a long term strategy focused on navigating powerful mega-trends and challenges, and shareholder commitment. This has translated into these companies having a better risk-adjusted long term performance over years (Figure 2).

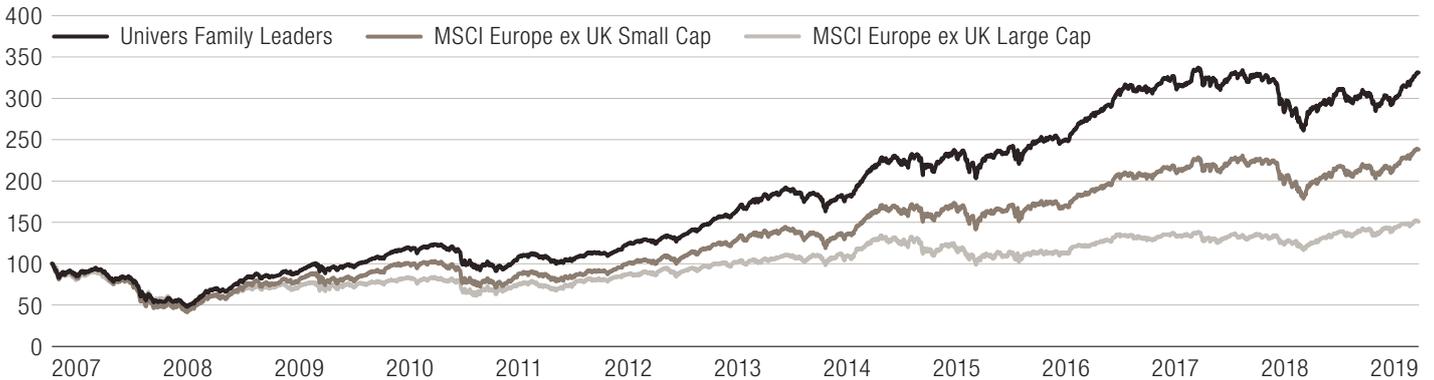
We believe there are four core features inherent to these businesses which are associated with the promise of continued alpha.

FIG. 1 HOW WE DEFINE A FAMILY & ENTREPRENEUR COMPANY



Source: Bloomberg, LOIM, 31 December 2019. *or bound through a shareholder pact.

FIG. 2 PERFORMANCE OF EUROPEAN ‘FAMILY LEADERS’ INVESTMENT UNIVERSE



	UNIVERS FAMILY LEADERS	MSCI EUROPE EX UK SMALL CAP	MSCI EUROPE EX UK LARGE CAP
Annualized return	10.50%	7.50%	3.50%
Volatility	13.89%	18.98%	20.52%
Sharpe Ratio	0.67	0.33	0.11
Max DD	-52%	-59%	-55%

(based on monthly data)

Benchmark: MSCI Europe ex-UK Small Caps. Source: LOIM.

A true long term vision

Family businesses and entrepreneurs are more likely to prioritize passing down wealth to the next generation, which can translate into a more stable, long-term vision than that of other companies.

This objective is more complex than the straightforward financial goals, as it generally encompasses what is termed **socioemotional wealth**. This refers to the non-financial aspects of the firm; those that encompass identity, influence, and the promise of a lasting corporate story. This additional set of factors influence the long-term thinking of their activities and reinforce the notion that the goal is to preserve what has been created for future generations. Stability is key to achieving this outcome which tends to affect positively long-term strategic planning, from an investment perspective. There are a number of prominent companies which have effectively utilised this approach over the course of their history, including luxury brand Hermes¹ and fashion group Inditex.

Forward thinking is crucial to the success of any business but family businesses and entrepreneurs are also built on the lessons of hindsight. A retrospective analysis can provide examples of successes to be reproduced but it also encompasses the lessons learned through mistakes. There are competitive advantages afforded to companies with the capacity to learn from their past

and we believe family businesses and entrepreneurs have potentially longer memories than others, due to the closer interpersonal relationships and emphasis on transgenerational value creation and preservation.

However, a company's ability to enact a long-term strategy is largely dependent on the degree to which management and employees can demonstrate loyalty and support the company's direction of travel. Family members present a grounded and loyal foundation for the company. As the company showcases better stability, and realises its long term vision, it can positively influence non-family members to stay longer and positively associate themselves with the company.

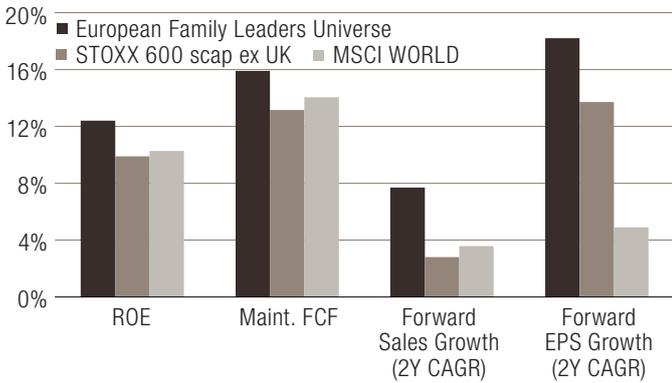
Higher economic value creation, driven by ‘skin-in-the-game’

The greater the level of personal investment a person has in a business, the greater the desire to achieve lasting economic value creation. This ‘skin-in-the game’ mind-set is often intertwined with the need to maintain control and influence.

In order to achieve this, owners looking to pass on the business to the next generation are likely to be more reluctant to raise capital to finance their growth. Accruing debt has the same effect, while it does not dilute direct control, as it presents a greater risk of ownership being at risk. In order for these businesses to

¹ Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.

FIG. 3 FAMILY LEADERS UNIVERSE VERSUS EUROPEAN STOCKS



Source: LOIM. As at 31 May 2020. Benchmark: Stoxx 600 scap ex-UK Small Caps and MSCI Europe ex UK. For illustrative purpose only.

outperform the market, there has to be a much greater focus on cashflow generation and return on equity. Lower debt to equity ratios are also a characteristic in addition to higher economic value creation.

Consequently, family businesses and entrepreneurs will be less inclined to enter capex-intensive sectors. Our research shows that

they are more likely to be concentrated in “light” industrials (suppliers of components, or small machinery), consumer discretionary, healthcare (services or equipment providers) and technology. There is little exposure to retail banks, heavy industrials, energy, and insurers for example, given the capex intensity associated with these sectors.

Focus on trends and organic growth

In order to achieve the goal of intra-generational wealth transfer, family businesses and entrepreneurs need to be more attuned to looming structural shifts that have the potential to cause disruption to their markets. Our research shows that a large proportion of these businesses in Europe are exposed to attractive long-term trends, which puts them in a good position to achieve long-term stability and superior economic returns. As we have detailed earlier in this paper, the focus of these businesses on asset-light activities tends to favor flexibility and the agility required to seize opportunities associated with such trends.

Digitalisation is one example of these important trends, along with sustainable supply chains (i.e. smart logistics, robotics) and sustainable urban systems (e.g energy efficient building materials) (Figure 4).

FIG. 4 FAMILY & ENTREPRENEUR COMPANIES ARE EXPOSED TO ATTRACTIVE TRENDS, THEREFORE STRONGLY GROWING



Source: LOIM. For illustrative purposes only. Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.

A good example of a family company which has anticipated and adapted in the face of long-term trends is manufacturing company Hella.² Founded in 1899 to supply kerosene lamps for horse-drawn carriages. Its founder, Sally Windmuller recognised that wide-scale changes to transportation would make its company redundant and changed in order to utilise its speciality in a way which remained relevant: he developed the first headlamps for the upcoming automobile. Today, it is a world leader in supplying lighting equipment for cars, still bringing key innovations to the market to improve safety and energy efficiency (e.g. light-based driving assistance systems).

The right mindset for the sustainability revolution

Family businesses and entrepreneurs also have a stakeholder alignment to uphold. The pursuit of transgenerational value creation puts stewardship for future stakeholders in focus, which is central to our understanding of what is required in regards to the sustainability revolution.

This 'sustainability revolution' refers to the fact that our current economic, social and governance models have to change in the face of a series of mega trends and challenges, including a growing and ageing global population, scarcity of natural resources, digitization and rising inequality. This sustainability revolution presents a source of investment opportunities, as a result of regulators and consumers pressing for change. It is also a source of increased scrutiny from investors and consumers alike, impacting a range of considerations such as corporate practices and products' purposes.

We strongly believe these businesses will be instrumental in helping address sustainability challenges, on a global and a local level. Indeed, as discussed, their strategic flexibility and focus on trends bode well for their ability to seize business opportunities.

In addition, reputational risk is a key concern and, in order to mitigate this issue, they have to take an invested interest in their impact on the community and stakeholders.

Owners and operators often take a specific view on reputational risk as their identity overlaps with that of the business. Indeed, when the company's name is the same as the family name, any unfavorable corporate reputation spills over to affect the reputation of the family. At the end of the day, one may change the name of a company, but it would be most unusual to change the name of a family.

Reputation and goodwill in the community are key incentives to pursue a sustainable business model. Consequently, it is often important to determine the level of identification the family/founder holds with regard to the business. Our methodology incorporates this thinking in order to identify the companies which are best aligned with the sustainability revolution.

Conclusion

Our research into companies in Europe revealed that family businesses and entrepreneurs commonly exhibit the characteristics we look for before investing: excess economic return, growth and a sustainability mind-set. These businesses have shown to be key outperformers in recent years, while at the same time quite often demonstrating a desirable commitment to sustainability. Our family leaders strategy aims to capture these opportunities through a disciplined and fundamental-driven investment process to deliver a high-conviction portfolio focused on companies directly or indirectly owned, controlled and/or managed by families.

² Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.

Important information

For professional investor use only

This document has been issued by Lombard Odier Funds (Europe) S.A. a Luxembourg based public limited company (SA), having its registered office at 291, route d'Arlon, 1150 Luxembourg, authorised and regulated by the CSSF as a Management Company within the meaning of EU Directive 2009/65/EC, as amended; and within the meaning of the EU Directive 2011/61/EU on Alternative Investment Fund Managers (AIFMD). The purpose of the Management Company is the creation, promotion, administration, management and the marketing of Luxembourg and foreign UCITS, alternative investment funds ("AIFs") and other regulated funds, collective investment vehicles or other investment vehicles, as well as the offering of portfolio management and investment advisory services.

Lombard Odier Investment Managers ("LOIM") is a trade name.

This document is provided for informational purposes only and does not constitute an offer or a recommendation to purchase or sell any security or service. It is not intended for distribution, publication, or use in any jurisdiction where such distribution, publication, or use would be unlawful. This document does not contain personalized recommendations or advice and is not intended to substitute any professional advice on investment in financial products. Before entering into any transaction, an investor should consider carefully the suitability of a transaction to his/her particular circumstances and, where necessary, obtain independent professional advice in respect of risks, as well as any legal, regulatory, credit, tax, and accounting consequences. This document is the property of LOIM and is addressed to its recipients exclusively for their personal use. It may not be reproduced (in whole or in part), transmitted, modified, or used for any other purpose without the prior written permission of LOIM. The contents of this document are intended for persons who are sophisticated investment professionals and who are either authorised or regulated to operate in the financial markets or persons who have been vetted by LOIM as having the expertise, experience and knowledge of the investment matters set out in this document and in respect of whom LOIM has received an assurance that they are capable of making their own investment decisions and understanding the risks involved in making investments of the type included in this document or other persons that LOIM has expressly confirmed as being appropriate

recipients of this document. If you are not a person falling within the above categories you are kindly asked to either return this document to LOIM or to destroy it and are expressly warned that you must not rely upon its contents or have regard to any of the matters set out in this document in relation to investment matters and must not transmit this document to any other person. This document contains the opinions of LOIM, as at the date of issue. The information and analysis contained herein are based on sources believed to be reliable. However, LOIM does not guarantee the timeliness, accuracy, or completeness of the information contained in this document, nor does it accept any liability for any loss or damage resulting from its use. All information and opinions as well as the prices indicated may change without notice. Neither this document nor any copy thereof may be sent, taken into, or distributed in the United States of America, any of its territories or possessions or areas subject to its jurisdiction, or to or for the benefit of a United States Person. For this purpose, the term "United States Person" shall mean any citizen, national or resident of the United States of America, partnership organized or existing in any state, territory or possession of the United States of America, a corporation organized under the laws of the United States or of any state, territory or possession thereof, or any estate or trust that is subject to United States Federal income tax regardless of the source of its income.

Source of the figures: Unless otherwise stated, figures are prepared by LOIM.

Although certain information has been obtained from public sources believed to be reliable, without independent verification, we cannot guarantee its accuracy or the completeness of all information available from public sources.

Views and opinions expressed are for informational purposes only and do not constitute a recommendation by LOIM to buy, sell or hold any security. Views and opinions are current as of the date of this presentation and may be subject to change. They should not be construed as investment advice.

No part of this material may be (i) copied, photocopied or duplicated in any form, by any means, or (ii) distributed to any person that is not an employee, officer, director, or authorised agent of the recipient, without Lombard Odier Funds (Europe) S.A prior consent.

©2020 Lombard Odier IM. All rights reserved.



LOMBARD ODIER
INVESTMENT MANAGERS

www.loim.com