

Dear fellow investors, colleagues and friends,

Bend and Break

'If only I don't bend and break, I'll meet you on the other side, I'll meet you in the light'¹.

I hope you are well and that you are having a great start to 2022. Despite it only having been two months since we wrote to you with our [2021 review](#) we thought it was important to update you on three specific topics – investment process and our two new investments in pest control specialist Terminix and consumer and tax software developer Intuit.

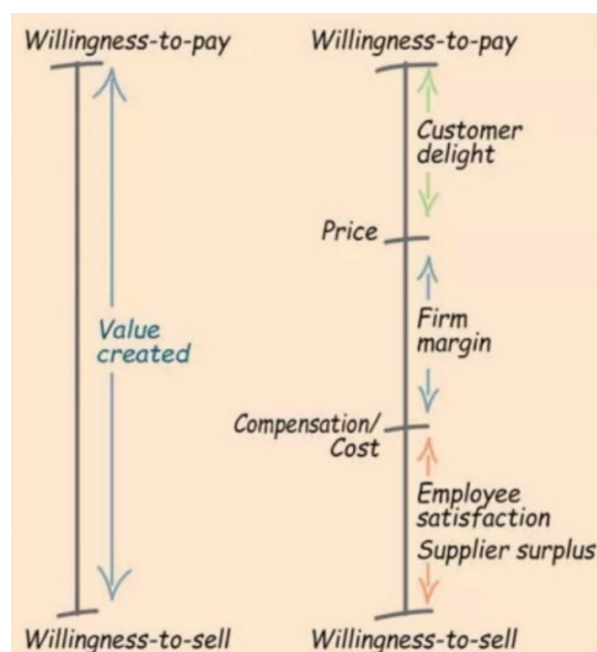
In our experience there are two extremes of investment process with investors potentially either having no process or a quasi-religious overly rigid process. These extremes have popular caricatures – the investing genius who relies on instinct and gut feel at one end of the process pendulum and a team that almost bureaucratically follows their process at the other. We have witnessed first-hand both extremes which are equally dangerous. Without relying on a healthy dose of luck we believe it is hard for most investors with no process to deliver repeatable outcomes and key person risk is accentuated in the event that the freewheeling investing genius is hit by a bus. Elsewhere overly rigid process disciples find it incredibly hard to evolve with process changes being viewed as akin to publishing the Wittenberg Bible. For these investors you might get repeatable outcomes – just not the outcomes that you want to be repeated time and time again. To us, investment process is not religion but a means of executing your philosophy in a repeatable way. It is easy to forget that any process in life, from how you brush your teeth to baking a cake, is designed to drive repeatable outcomes but there is always room for improvement. I enjoy cooking and I recently started using a sous-vide machine² which effectively poaches ingredients – a new approach that has revolutionised how I cook fish and poultry. Despite tried and tested processes there are always better ways of doing things. One of the reasons professional investors find it hard to evolve is due to two of the weapons of influence that we discussed in the [2019 investment letter](#) – commitment and consistency. These two hobgoblins of the mind make it incredibly difficult to make changes to any process – especially when we have made promises to others. Indeed, the more promises we make the deeper the commitment and the greater our desire to act in a way that is consistent with the original commitment. In the investment world the convention for quarterly investment letters, elaborate presentations and podcasts can turbocharge commitment and consistency. We try and question everything – remain flexible but believe in repeatable outcomes. Accordingly, we wanted to make you aware of a recent nuance that we have made to one facet of the existing Global Focus investment process – specifically around the topic of pricing power.

¹ Bend and Break, Keane.

² I was lucky enough to have received one for Christmas!

'Pricing power is a power. If you have that power, it doesn't mean you must display it. The answer is often no. In warfare, you don't always need to shock and awe. A lot of weapons should be kept secret for good reasons. Think of business as a battlefield. You compete for market share. You have certain powers³'.

Real like-for-like pricing power has been a requirement for any Global Focus investment since the inception of the strategy in 2017. We have written extensively on why we are predisposed to companies with pricing power (see our [December 2020 letter](#)) – primarily as real like-for-like price-led growth helps provide high incremental returns on capital and an inbuilt hedge against inflation – a not unhelpful combination in today's environment and one that has served us well. Where we have been widening our philosophical aperture on this topic over the last six months is to think about the interplay between the price a company charges for its goods and the maximum theoretical price that a customer would pay – which is known as the willingness to pay or “WTP”. WTP can be thought of as the walkway price for any customer. What price would your local coffee shop have to charge you for your morning coffee for you to go elsewhere? £6, £8 or even £15? The difference between the price a customer gets charged and the theoretical walk-away price is a sign of the consumer surplus being generated by a company. Economist Felix Oberholzer-Gee elegantly illustrates the difference between willingness to pay and price in his value sticks (see below).



Source: Better, Simpler Strategy: A Value-Based Guide to Exceptional Performance by Felix Oberholzer-Gee

We have long been hypersensitive to companies that extract too much economic rent through price (see our [September 2020 letter](#)) as, in our opinion, customer abuse erodes any company's long-term competitive position. Taking advantage of a captive customer through price can be expressed when the gap between WTP and the price of the product shrinks and eventually converges – in essence the

³Professor Sanjay Bakshi, MOI Global Podcast, January 2022.

customer is being charged the walk-away price but they can't walk away. In an ideal world the perfect company would be increasing the customer's willingness to pay at a faster rate than its competitors, as expressed in the right-hand value stick above, giving it significant optionality on pricing – with like-for-like pricing being one of those options. Microsoft's recent 15% price increases on its Office 365 Commercial products is perhaps a case in point with the company having chosen not to increase price for the first 10 years of the product's existence. Over this time period with 24 application releases including the hugely popular Teams, which currently has >270m monthly active users⁴, we feel that Microsoft has materially increased the willingness to pay for its core enterprise product and that recent price increases will have resulted in minimal customers switching. The Microsoft Office 365 Commercial example serves as a paradigm for our new focus on willingness to pay with like-for-like pricing power being one option open to companies that deliver a significant consumer surplus. As Sanjay Bakshi mentions above, certain weapons should be kept secret for good reason.

Terminix-Rentokil

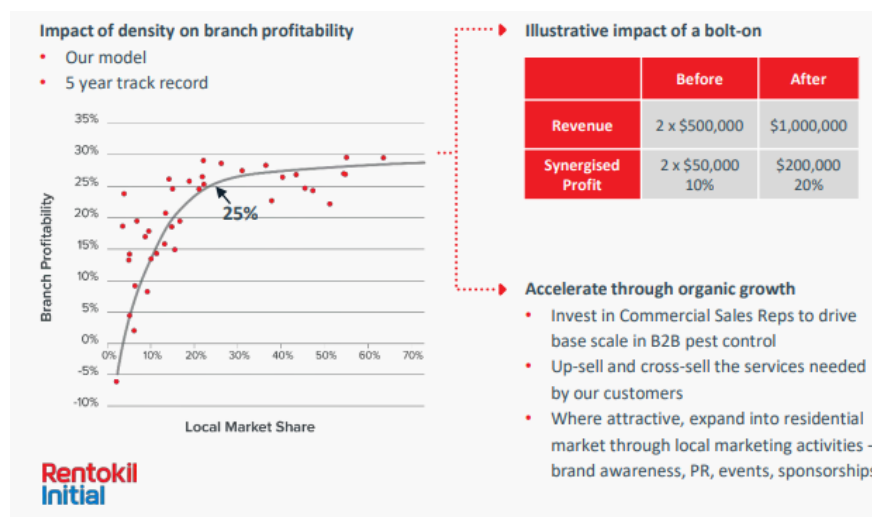
In January we made our first new investment of 2022 when we established a new position in U.S. pest control company Terminix. On 14th December 2021 Rentokil announced its intention to acquire Terminix in a largely equity-financed deal. The acquisition promises to bring together two companies that we have followed for many years and will create the largest pest control company in North America and also globally⁵. At the time of purchase the deal spread on Terminix shares of 14% enabled us to effectively invest in the enlarged Rentokil at our targeted mid-teens IRR with our long-term focus enabling us to look beyond any volatility that the deal process might throw up. To us, the main attractions of the Terminix-Rentokil investment case are the following:

1. **Exposure to the new market leader in pest control** – a biblical industry with largely non-deferrable demand. We expect the pest control industry to grow 4.5-5% long-term with 51% of the market currently in North America. We expect the combined Rentokil group to be the market leader in North America with 26% share and enjoy strong positions in emerging markets.⁶
2. **Barriers to scale** – pest control is a multi-local business with low barriers to entry but significant barriers to scale. After having spoken to numerous independent pest control operators our understanding is that it is relatively easy to start a pest control business, a matter of buying or renting a truck and investing in marketing, but due to the complexities of route planning it is incredibly difficult to scale a multi-location business and cover fixed costs. Local route densities have a material impact on profitability – Rentokil think that once a company has >25% market share in a location then margins disproportionately grow as you can see below. By effectively buying 370 branch locations in Terminix, Rentokil is accelerating a successful bolt-on acquisition strategy that leverages local route densities to give significant barriers to scale. The merger is expected to result in substantially higher densities in certain parts of the combined footprint that we believe will result in a strengthening of Rentokil's economic fortress as the combined business should benefit from substantial barriers to scale.

⁴ Source: Microsoft Q2 2022 conference call.

⁵ Source: Acquisition of Terminix by Rentokil conference call, December 2021.

⁶ Source: Company reports.



Source: Company reports.

3. **The Rentokil operating model** – we have long admired Rentokil’s operational excellence model, nicknamed “the Machine” by CEO Andy Ransom, that focuses on energising employees to deliver superior customer service and a significant consumer surplus. This focus produces multiple benefits in a route-based business – less employee turnover, lower customer churn and greater willingness to pay – all of which drives faster and more profitable organic growth as Andy Ransom describes:

‘How are we going to improve Terminix performance? You’ve heard me talk – you’ve all heard me talk at length on the operating model on the machine. The machine is essentially, and it works in every country in the world, the machine is essentially getting the employee part of the organisation right, get engagement, enablement, get training right, get happy, inspired, engaged colleagues delivering great service, then you get happy customers. Happy customers buy more products, they stay longer, and they take inflationary price increases, and they’re open to buying innovation and new products, and they pay their bills on time, in full. That’s the first two cogs in the operational model. We’ve been very successful with that model around the world. I see no reason why we’re not going to be successful in this transaction’⁷

The relationship between customer lifetime value (LTV) and customer acquisition costs (CAC) is a popular yardstick for internet and software investors but it is just as important for pest control. The machine works by keeping customers for longer and leveraging the cost of acquiring them over the fixed costs of a route-based business. Rentokil’s core non-financial KPIs, which are embedded in management remuneration, are colleague retention and customer satisfaction. Interestingly this approach is almost identical to the “Terminix Way” self-help program instituted by Terminix CEO Brett Ponton.

⁷ Source: Andy Ransom, Acquisition of Terminix by Rentokil conference call, December 2021.

4. **Return improvement** – we see significant scope for return improvement and free cash flow growth at the combined Rentokil post-merger driven by a combination of:

A. **Ongoing self-help at Terminix** – under the Terminix Way program and as legacy termite claims roll off. We expect 200bps margin improvement from Terminix standalone over the next four years due to these two factors.

B. **Synergies** – after extensive work looking at the combined footprint and branch economics we think that the \$150m cost synergies revealed by management at the time of the deal announcement are being materially understated. Only \$75m of the \$150m cost synergies of the combined group of 735⁸ branches are being earmarked from branch closures – this is despite 27% of Rentokil and Terminix U.S. branches being within a 10 mile radius of each other. Longer term we expect the group to end up with approximately 400 U.S. branches with a higher average revenue per branch than the \$5m Terminix currently generates. Our belief is that 27% of current Terminix branch costs are indirect which is \$1.35m per branch. Conservatively closing 200 branches with \$1m cost savings per branch should result in \$200m savings from branch closures giving \$275m total cost savings including central costs versus the \$150m that has been disclosed by management. These savings could be materially higher if the combined U.S. network ends up being closer to 400 branches over time.

3. **Free cash flow-based returns for shareholders** – we see a 5-year IRR of 16% for future Rentokil investors by investing in Terminix to get access to the combined entity at a discount. We feel that the company will most likely continue on its serial acquirer path after the merger and could add >2% growth per year from bolt-on acquisitions in the pest control space. We believe that this effort plus the cocktail of Terminix self-help benefits and merger cost synergies will result in Rentokil being able to generate >£1bn free cash flow in 2026. Terminix is currently 9% of Global Focus NAV with the position size limited by the mechanics of the deal process which we expect to close in the second half of 2022.

Intuit⁹

In addition to North America's largest catcher in-waiting of rodents and termites we invested in another biblical business in March. There is a saying that nothing is certain aside of death and taxes¹⁰ - Intuit is the largest provider of consumer tax software in the United States. The company has been on our subs-bench, our ready-to-buy list, for a number of years. After coming tantalisingly close in March 2020¹¹, the value stars aligned in March 2022. We would summarise the attractions of the Intuit investment case as the following:

⁸This estimate is based on 357 company owned Terminix branches and 378 Rentokil branches in North America.

⁹ Source for data in this section is company reports.

¹⁰ This saying is attributed to Benjamin Franklin. We have previously looked at funeral parlour operators and passed due to capital intensity, regulation and anemic growth prospects.

¹¹ With perfect hindsight we were penny pinching in 2020 and could be accused, quite rightly!, of being pennywise and pound foolish.

- 1. A dominant business benefitting from channel shifts** – the vast majority of Intuit’s 2021 profits were derived from two almost equally sized segments – Small Business and Self-Employed and Consumer. At the core of Small Business and Self-Employed is the company’s QuickBooks accounting product which, including its predecessor Quicken, has been helping fledgling entrepreneurs run their businesses since 1983. Intuit was an early believer in software-as-service (SAAS) with their cloud-based subscription offering QuickBooks Online (QBO) launching in the 2000s. Today 8m businesses rely on QuickBooks with 5.3m choosing QuickBooks Online. Despite the high failure rate for small businesses, we believe the core QuickBooks product is sticky and at \$80 a month for their most popular product, QuickBooks Plus, it is a de minimis amount relative to the cost of running a business. Despite having a dominant market position, we still see meaningful opportunities for user growth at QuickBooks as there are 30m small businesses in the USA and only 3.7m QuickBooks Online users. The real competition is businesses relying on paper and Excel spreadsheets. In addition, Intuit continues to expand its product offering into the mid-market with QuickBooks Advanced, which comes at a material premium to the standard product, and downmarket with QuickBooks Self-Employed for micro and gig economy businesses. Intuit’s other main segment, Consumer, is centred on TurboTax which is the dominant consumer tax software application in North America. TurboTax is also benefitting from a channel shift and the product helps Americans file 38m tax returns each year out of a 165m total with 87m or 53% by volume, and closer to 80% by value, being completed by assisted tax providers¹² which cost materially more. As consumers become more comfortable with online interactions we expect TurboTax to keep taking share from traditional assisted tax filing services. Intuit’s ability to benefit from these ongoing channel shifts is in part due to their almost maniacal focus on building what has been described as ‘customer-hypothesis products’. The company has lofty ambitions of doubling the U.S. savings rates for consumers and increasing the survival rate of small businesses by 2025. We believe that Intuit’s focus on delivering value for their customers has enabled a substantial willingness to pay that is evidenced by consistent average revenue per customer growth, which has been boosted by periodic like-for-like price increases and the introduction of a number of innovative new services.
- 2. Fortress expansion** – much time and energy is spent by investors on pinpointing potential sources of a company’s economic moat whereas what we think is more important is their trajectory. To us some of the best investments can be made when a company’s economic fortress is expanding and getting stronger. Through customer-focused product development and selective acquisitions Intuit has managed to grow its customer base from 29m in 2010 to 102m in 2021. The company has developed a myriad of services in its core business units – there are too many to list in this letter but payments, payroll and capital management in the Small Business and Self-Employed segment are notable examples. 1.6m small businesses used Intuit Payroll in 2021 and Intuit Payments processed \$91bn of volume in the same year. New products like QuickBooks Live and TurboTax Live are also helping expand the company’s total addressable market (or TAM) by encroaching on the assisted accounting and tax filing industries. These initiatives are exciting but Intuit’s acquisitions of consumer finance platform Credit Karma in 2019 and Mailchimp in 2021 were perhaps the starkest indications that the company is looking to dramatically expand its economic fortress through a growing pool of data that is manipulated by artificial intelligence for the benefit of their customers. Sharing detailed tax filing data between TurboTax and Credit

¹² *These include tax stores like H&R Block, accountants and tax professionals.*

Karma to provide tailored financial products and offering employees on QuickBooks Payroll Credit Karma Money accounts are early examples. Intuit are targeting 200m customers in 2025 and see a \$260bn global TAM vs \$9.6bn 2021 sales following their recent acquisitions. We feel that the below slide from their 2021 investor day highlights the opportunity that the company has to cross-pollinate their different businesses through data sharing and artificial intelligence which we expect will be sources of fortress expansion and future free cash flow growth.

Unique consumer and small business assets at scale



Source: Company reports.

- Free cash flow-based returns for shareholders** – given Intuit’s underpenetrated markets and the data optionality afforded to them via recent acquisitions, we expect the company to be able to grow free cash flow at a 17% annual rate until 2027 which underpins our 5-year 14% base case IRR when we invested. Given high incremental returns on capital, this trajectory would see Intuit’s ROIC expand from 8% in 2022 following the Mailchimp acquisition to 25% in 2027. Our expectations include what we believe are conservative assumptions for Credit Karma and Mailchimp and exclude the possibility of further acquisitions that could widen the data-centric fortress further. We feel that a 5-year base case 14% IRR is very attractive for a customer focused dominant business model with an expanding economic fortress and we feel fortunate that equity market volatility gave us the opportunity to invest in Intuit in 2022.

And Finally...

Whilst buying two new companies in three months might feel like a frenetic level of activity for a 10-15 company strategy with a 10-year investment horizon, the reality is that these new investments have been the result of years of hard work. Our analyst team has diligently covered Intuit, Rentokil and Terminix’s predecessor ServiceMaster even before we launched Global Focus in September 2017. We have met with the management of these companies, their customers and their competitors multiple times in the intervening years. Investing is a team sport and I am eternally grateful for all the hard work that our research team put in and the tough questions they continually ask.

Past performance is not indicative of future results. The portfolio information above is based on a Brown Advisory Global Focus representative account and is provided as supplemental information. Please see the end of the letter for important disclosures and a GIPS compliant presentation. The information provided in this material is not intended to be and should not be considered to be a recommendation or suggestion to engage in or refrain from a particular course of action or to make or hold a particular investment or pursue a particular investment strategy, including whether or not to buy, sell, or hold any of the securities mentioned. It should not be assumed that investments in such securities have been or will be profitable. To the extent specific securities are mentioned, they have been selected by the author on an objective basis to illustrate views expressed in the commentary and do not represent all of the securities purchased, sold or recommended for advisory clients. Please see the end of the letter for important disclosures.

As the sad events in Ukraine continue to reverberate around the world it's worth mentioning that the direct exposure for Global Focus investors is minimal with <2% of our combined companies' revenues being derived from Russia and Ukraine¹³. We try to avoid looking into macroeconomic crystal balls with every facet of our investment process being designed to reduce our investors' exposure to macroeconomic volatility and competitive forces. With this in mind we do feel that our underwriting approach, which is based on a 10% cost of capital, and the willingness to pay that exists at the company level should provide a meaningful margin of safety in a rising interest rate and inflationary environment. At the time of writing, Global Focus trades on a historic 3.4% weighted average FCF/EV yield (or 29.0x EV/FCF) in 2021 rising to an 8.9% weighted average FCF/EV yield (or 11.3x EV/FCF) in 2026, based on our estimates, which we think represents attractive value given the quality of the companies we invest in¹⁴. Many thanks for reading this update so soon after the 2021 review – I look forward to catching up with you in 2022 and please feel free to drop us a line (globalfocus@brownadvisory.com) if you would like to discuss Global Focus, Terminix-Rentokil, Intuit or anything else.

Best,

Bertie Thomson



Bertie Thomson, CFA
Portfolio Manager



Mick Dillon, CFA
Portfolio Manager

¹³ Source: FactSet.

¹⁴ Especially as the market implied five-year IRR is 21%.

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ROIC is a measure of determining a company's financial performance. It is calculated as NOPAT/IC ; where NOPAT (net operating profit after tax) is $(\text{EBIT} + \text{Operating Leases Due 1-Yr}) \times (1 - \text{Cash Tax Rate})$ and IC (invested capital) is $\text{Total Debt} + \text{Total Equity} + \text{Total Unfunded Pension} + (\text{Operating Leases Due 1-Yr} \times 8) - \text{Excess Cash}$. ROIC calculations presented use LFY (last fiscal year) and exclude financial services.

The internal rate of return (IRR) is a measure of an investment's rate of return. The internal rate of return is a discount rate that makes the net present value (NPV) of all cash flows from a particular project equal to zero. It is also called the discounted cash flow rate of return.

FCF yield is a measure of financial performance calculated as operating cash flow minus capital expenditures. FCF yield calculations presented use LFY and exclude financial services.

Free cash flow represents the cash a company generates after cash outflows to support operations and maintain its capital assets. Unlike earnings or net income, free cash flow is a measure of profitability that excludes the non-cash expenses of the income statement and includes spending on equipment and assets as well as changes in working capital.

Enterprise Value to Free Cash Flow (FCF/EV) compares the total valuation of the company with its ability to generate cash flow. It is the inverse of the Free Cash Flow Yield.

Total return is the amount of value an investor earns from a security over a specific period, typically one year, when all distributions are reinvested.

Global Focus Composite

Year	Composite Total Gross Returns (%)	Composite Total Net Returns (%)	Benchmark Returns (%)	Composite 3-Yr Annualized Standard Deviation (%)	Benchmark 3-Yr Annualized Standard Deviation (%)	Portfolios in Composite at End of Year	Composite Dispersion (%)	Composite Assets (\$USD Millions)*	GIPS Firm Assets (\$USD Millions)*
2020	27.0	26.6	16.1	19.6	18.3	Five or fewer	N/A	32	59,683
2019	42.7	42.1	27.3	N/A	N/A	Five or fewer	N/A	12	42,426
2018	3.4	2.9	-9.1	N/A	N/A	Five or fewer	N/A	4	30,529
YTD 2017**	3.7	3.5	8.1	N/A	N/A	Five or fewer	N/A	2	33,155

**Return is for period September 1, 2017 through December 31, 2017

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1. *For the purpose of complying with the GIPS standards, the firm is defined as Brown Advisory Institutional, the Institutional and Balanced Institutional asset management divisions of Brown Advisory. As of July 1, 2016, the firm was redefined to exclude the Brown Advisory Private Client division, due to an evolution of the three distinct business lines.
2. The Global Focus Composite (the Composite) includes all discretionary portfolios invested in the Global Focus Strategy. The Global Focus Strategy seeks to invest in a small number of quality franchises the manager believes have the ability to materially improve their cash flows over the long-term. In choosing securities, the strategy seeks to invest in companies with one or more of the following characteristics: an entrenched competitive position, durable economic moats, and/or is priced at a discount to intrinsic value due to investor misconceptions. The minimum account market value required for inclusion in the Composite is \$500,000.
3. The Composite creation date is June 1, 2020. The Composite inception date is September 1, 2017.
4. The benchmark is the FTSE All-World Developed Index. This index is a market-capitalization weighted index representing the performance of large and mid cap companies in developed markets. The index is derived from the FTSE Global Equity Index Series (GEIS), which covers 98% of the world's investable market capitalization. "FTSE®", "Russell®", "MTS®", "FTSE TMX®" and "FTSE Russell" and other service marks and trademarks related to the FTSE or Russell indexes are trademarks of the London Stock Exchange Group companies. An investor cannot invest directly into an index. Benchmark returns are not covered by the report of the independent verifiers.
5. The composite dispersion presented is an equal-weighted standard deviation of portfolio gross returns calculated for the accounts in the Composite for the entire calendar year period. The composite dispersion is not applicable (N/A) for periods where there were five or fewer accounts in the Composite for the entire period.
6. Gross-of-fees performance returns are presented before management fees but after all trading commissions, and gross of foreign withholding taxes (if applicable). Net-of-fee performance returns reflect the deduction of actual management fees and all trading commissions. Other expenses can reduce returns to investors. The standard management fee schedule for separate accounts is as follows: 1.00% on all assets with a minimum account size of \$50 million. Actual fees paid by accounts in the Composite may differ from the current fee schedule.
7. The three-year annualized ex-post standard deviation measures the variability of the Composite (using gross returns) and the benchmark for the 36-month period ended on December 31. The 3 year annualized standard deviation is not presented as of December 31, 2017, December 31, 2018 and December 31, 2019 because 36 month returns for the Composite were not available (N/A).
8. Valuations and performance returns are computed and stated in U.S. Dollars. All returns reflect the reinvestment of income and other earnings.
9. A complete list of composite descriptions and broad distribution and limited distribution pooled funds is available upon request.

10. Policies for valuing investments, calculating performance, and preparing GIPS Reports are available upon request.
11. Past performance does not indicate future results.
12. This piece is provided for informational purposes only and should not be construed as a research report, a recommendation or suggestion to engage in or refrain from a particular course of action or to make or hold a particular investment or pursue a particular investment strategy, including whether or not to buy, sell or hold any of the securities mentioned, including any mutual fund managed by Brown Advisory.
13. The following exhibit reflects the management fees, performance fees, and total expense ratios of the Brown Advisory Global Focus Onshore Fund, L.P. and Brown Advisory Global Focus Offshore Fund, LTD, which are included in the Composite, as of the most recent fiscal year end (December 31, 2020):