NOT ALL GROWTH IS CREATED EQUAL

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With high inflation being compounded by the fastest rise in interest rates in nearly 40 years[1] *and increased investor risk aversion, capital markets have changed radically over the past year. Growth stocks have been particularly vulnerable as the market deteriorated. As a quality growth investor this has also hurt Comgest's portfolios; however, our long-term investment approach and 38 years of experience have reinforced our belief in our quality growth stocks. Despite the above headwinds, many of Comgest's portfolio companies have been able to raise prices without a loss in demand or profitability, thus shielding shareholders from inflation. In our view, the high profitability, strong free cash flow and sound balance sheets that we seek in quality growth companies are the fundamentals that make the difference in such an environment. In contrast to many companies that have had to scale down their growth ambitions, our portfolio companies continue to grow unperturbed by the sudden rise in cost of capital and volatility of capital markets. The compound growth of our holdings has always been the basis for their long-term performance. This is what could become the differentiating factor in 2023 following the severe valuation contraction that affected 2022 performance.*

— High profitability, strong free cash flow and sound balance sheets are the fundamentals that make a difference for quality growth companies in challenging growth environments

In a Comgest investment letter on whether *"Quality is a shield against inflation"*[2], Analyst and Portfolio Manager Alistair Wittet wrote about the "defensive moat" that sets quality companies apart, which is usually accompanied by pricing power to fight inflation. What is equally important during periods of inflation are the repercussions of rapidly rising interest rates on the cost of capital and financing.

This is a crossroads for equity markets as we believe that the rapidly rising cost of capital could separate the wheat from the chaff for years to come.

Looking at the equity growth side, this may have already happened given the disparity in the way growth stocks reacted to the rise in interest rates. Many early-stage growth companies, such as those prevalent

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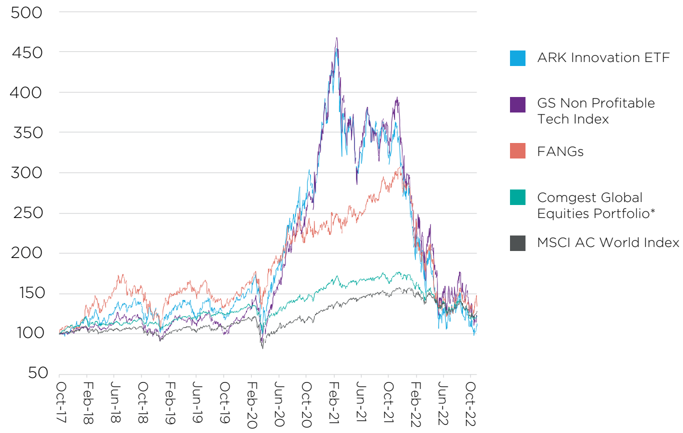
[1] Sahadi, Jeanne. What rising interest rates mean for you, CNN, 2-Nov-2022.
[2] Alistair Wittet, CFA. "Is Quality a Shield Against Inflation?", Jan-2022. Visit your local Comgest website (Our Thinking section) or available upon request.

in innovative and young industries such as tech, internet and biotech – have simply crashed. While these are exciting investments, they're often loss-making – a fact that may not have mattered in the past, but does today.

This is illustrated by a comparison of the past five years of performance of the Goldman Sachs (GS) Non-Profitable Technology Index and the ARK Innovation Exchange Traded Fund (ETF) relative to established FANG[3] technology companies in *figure 1*. The latter are highly profitable, generate free cash flow and boast net cash on their balance sheets[4] – as do the quality growth companies in the representative account of our Comgest Global Equity Strategy ("Global Equities Portfolio") with the exception of HDFC (a mortgage lender) and AIA (a life insurance company)[5].

While the GS Non-Profitable Technology Index consists of non-profitable U.S.-listed companies in innovative industries, we can use the ARK Innovation ETF as a proxy for early-stage growth companies as it invests in companies that are involved in, or benefit from, disruptive innovation.

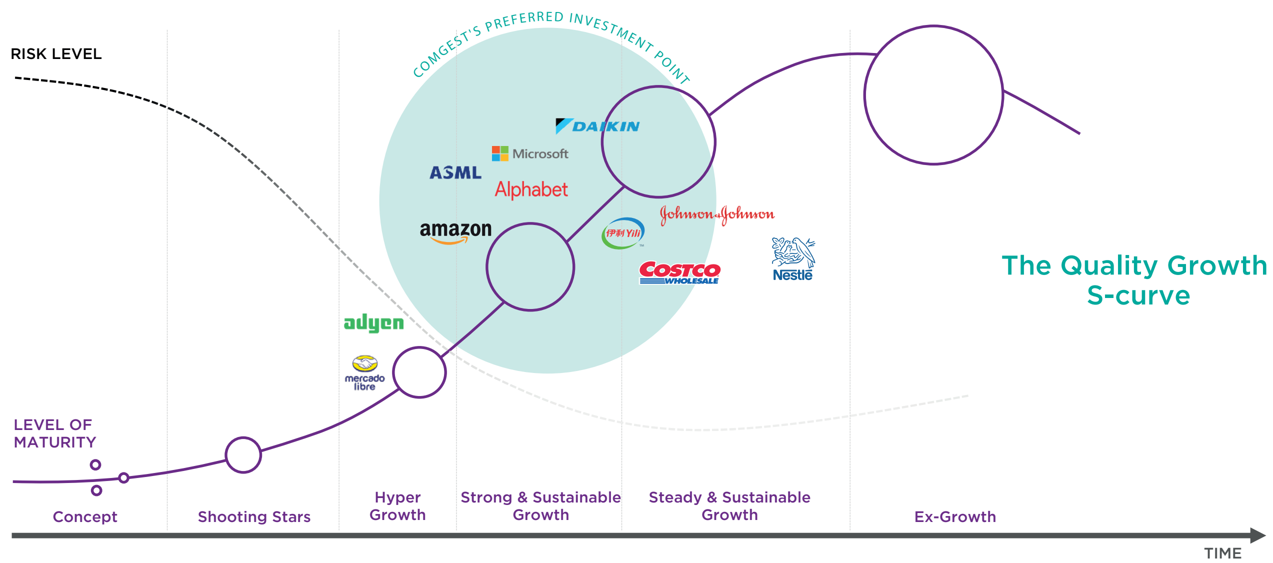
Figure 1. Five-year performance of the Comgest Global Equities Portfolio*, the GS Non-Profitable Technology Index and the ARK Innovation ETF relative to established FANG technology companies (in USD millions)



Past performance does not predict future returns. *Source: FactSet / Comgest, data as of 28-Oct-22. *The data shown is data of the representative account of the Global Equities Composite, managed in accordance with the Composite since the Composite's inception. Please refer to the important information section for more details on the representative account, its selection methodology and where to receive the GIPS report of the composite. Goldman Sachs (GS) non-profitable technology basket consists of non-profitable U.S.-listed companies in innovative industries. Technology is defined quite broadly to include new economy companies across GICS industry groupings. ARK Innovation ETF is an actively managed Exchange Traded Fund (ETF) that seeks long-term growth of capital by investing under normal circumstances primarily (at least 65% of its assets) in domestic and foreign equity securities of companies that are relevant to the ARK Innovation ETF investment theme of disruptive innovation. See page 6 for calendar performance figures.*

In comparison to the GS Non-Profitable Tech Index and the ARK Innovation ETF, we wouldn't say that Comgest holds better companies in our Global Equities Portfolio, merely that ours are *different*. As *figure 2* demonstrates, on the quality growth "s-curve" (i.e., the lifecycle of a company), we typically invest after the hyper growth stage – the point at which we believe we can capture strong, sustainable and self-financed growth. Comgest doesn't invest in early-stage growth companies when they are unprofitable and in need of capital markets to fund growth – a distinction that matters today.

Figure 2. Different kinds of growth companies



Source: Comgest. The size of the bubbles corresponds to the size of the companies. For illustrative purposes only. The securities discussed above are provided for information only, are subject to change and are not a recommendation to buy or sell the securities. The securities discussed herein may not be held in the portfolio at the time of publication.

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3 In finance, the acronym "FANG" refers to the stocks of four technology companies: Facebook (META), Amazon (AMZN), Netflix (NFLX), and Google (GOOG).
4 Company reports and Factset, as of end September 2022.
5 Comgest's Global Equity Representative Account, a pooled investment vehicle which has been managed in accordance with the Composite discussed since inception of the Composite. Please refer to the important information section for more details on the representative account, its selection methodology and where to receive the GIPS report of the composite.

Cost of capital has not been the centre of interest over the past year. The news has rather been focused on reduced valuations for growth stocks. Investors may be tempted to say, *"it's all in the price"* or that they're *"buying back into those exciting growth stories"*. But this does not answer the question of how the rising cost of capital will impact the future course of business. For long-term growth investors like us, the most relevant question today is: *what level of growth can they now expect with such a steep increase in financing costs?* This is where the difference in quality could lead to more longer lasting and deeper cracks in growth investing than currently considered by investors.

Unlike the past decade, financing a company's growth has become significantly more difficult – to the point that some young and early-stage companies have already had to scale down their growth ambitions and cut costs.

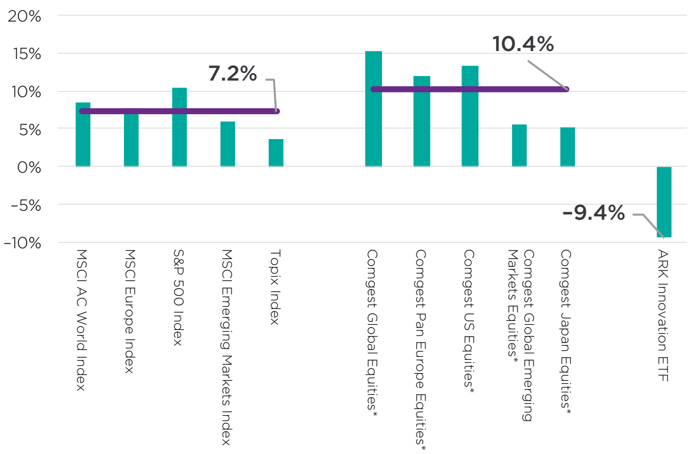
Klarna, a Swedish "buy now, pay later" online payments and credit pioneer, is one such example. Their losses quadrupled in H1 2022 and their private equity valuation fell from US$46 billion in June 2021 to US$6.7 billion in June 2022.[6] As a result, they've announced a plan to cut personnel by 10% to control costs and slow growth to increase profitability.[7] Their CEO summed up the company's new mantra: *"We've had a few years now where growth was heavily prioritised by investors. Now, understandably, they want to see profitability."*[8]

If we take a closer look at the ARK Innovation ETF, the average company in their fund isn't expected to generate a profit before 2025 – at the earliest.[9] This is the nature of early-stage disruptive innovators. They invest heavily, but aren't yet large enough to fund this growth internally. Like Klarna, some may have to scale down their growth ambitions.

In contrast, Comgest's quality growth companies do not have to scale down their growth ambitions. The opposite is true. Their high profitability and free cash flow fuel their growth, making growth and profitability a hand-in-hand value proposition.

As *figure* 3 illustrates, the portfolio companies held in the referenced Comgest portfolios* generated high free cash flow[10] margins in absolute terms, relative to their comparative indices and the ARK Innovation ETF, as of 31 December 2022. *Figure* 3 also highlights that, on average, 10.4% of sales can be reinvested into growth projects over the next 12 months when looking at the representative accounts of our four regional equity strategies as well as our Global Equity strategy. Early-stage growth companies,[11] on the other hand, are expected to burn close to 10% of sales over the next 12 months.[12]

Figure 3. Free cash flow margin (NTM) for Comgest Equity Portfolios,* comparative indices and the ARK Innovation ETF



*Source: Factset consensus estimate as of 31-Dec-2022. Free cash flow margin is defined as free cash flow divided by sales. *The Comgest Equity portfolios referenced in figure 4 refer to the following: Comgest's Global Equities Representative Account, Global Emerging Markets Large Cap Equities Representative Account, US Equities Representative Account, Pan Europe Large Cap Equities Representative Account and Japan Equities, which are pooled investment vehicles that have been managed in accordance with their respective Composites discussed since inception of each Composite. Please refer to the important information section for more details on the representative accounts, their selection methodology and where to receive a GIPS report of the Composites. The Topix, MSCI Emerging Markets, S&P 500, MSCI Europe and MSCI AC World indices are used for comparative purposes only. The ARK Innovation ETF is an actively managed Exchange Traded Fund (ETF) that seeks long-term growth of capital by investing under normal circumstances primarily (at least 65% of its assets) in domestic and foreign equity securities of companies that are relevant to the ARK Innovation ETF investment theme of disruptive innovation.*

Delving deeper into the representative account of our Pan Europe Equity strategy[13], our portfolio companies reported sales that grew organically by 13%–14% in H1 2022, while acquisitions added 6%–7% to that growth.[14] They also raised prices by 4%–5% during the same period. Organic growth accelerated

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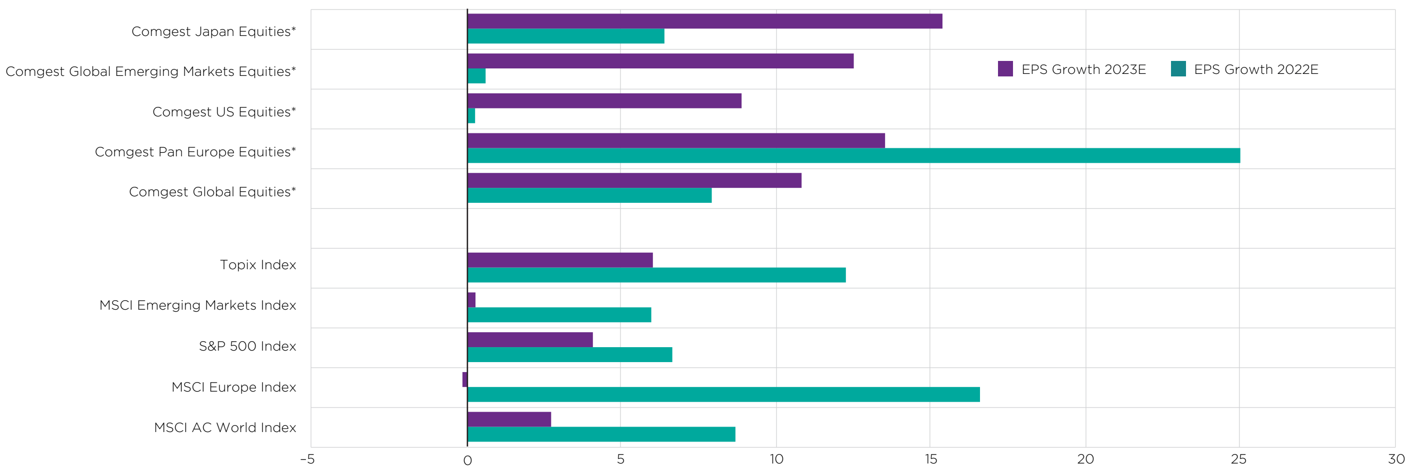
6 Venkataramakrishnan, Siddharth. "Klarna losses quadruple as costs rise". The Financial Times, 31-Aug-2022.
7 Venkataramakrishnan, Siddharth and Richard Milne. "Klarna aims to return to monthly profitability in 2023 as losses double". The Financial Times, 30-Nov-2022.
8 Venkataramakrishnan, Siddharth. "Klarna losses quadruple as costs rise". The Financial Times, 31-Aug-2022.
9 Source: Factset consensus estimates as per January 7, 2023.
10 FCF refers to the money a company has left after deducting all its cash payments towards capital expenditure (for example, property and equipment), inventory, debt and other operating expenses.
11 Proxied by the ARK Innovation ETF.
12 Factset/broker consensus estimates as of 31-Dec-2022.
13 Comgest's Pan Europe Large Cap Equity Representative Account, is a pooled investment vehicle which has been managed in accordance with the Composite discussed since inception of the Composite. Please refer to the important information section for more details on the representative account, its selection methodology and where to receive the GIPS report of the composite.
14 Source: Comgest, company reports.

when compared to the long-term average of 8%.[15] Profitability, in terms of EBIT margins[16] remained high, at approximately 24% over the period, as did free cash flow.[17] We're tempted to say that *"not all growth is created equal"*.

Across our regional and global strategies, we believe these quality growth fundamentals fuel strong earnings growth, as shown in *figure 4*. We estimate robust earnings per share (EPS) growth in 2022 (with the exception of Comgest's US Equities portfolio*) and an EPS growth acceleration in 2023.

Figure 4. EPS Growth 2022 and 2023 (estimated) for Comgest Equity Portfolios* and comparative indices



Past performance does not predict future returns. *Source: Factset consensus estimate as of 31-Dec-2022. Any forecast, projection or target where provided is indicative only and is not guaranteed in any way. *The Comgest Equity portfolios (and their respective currency) referenced in figure 4 refer to the following: Comgest's Global Equities Representative Account (in USD), Global Emerging Markets Large Cap Equities Representative Account (in USD), US Equities Representative Account (in USD), Pan Europe Large Cap Equities Representative Account (in EUR) and Japan Equities (in JPY), which are pooled investment vehicles that have been managed in accordance with their respective Composites discussed since inception of each Composite. Please refer to the important information section for more details on the representative accounts, their selection methodology and where to receive a GIPS report of the Composites. The Topix (in JPY), MSCI Emerging Markets (in USD), S&P 500 (in USD), MSCI Europe (in EUR) and MSCI AC World (in USD) indices are used for comparative purposes only.*

The disparate performance within the equity growth segment could be linked to the higher cost of capital and its potential repercussions on growth. But what are the implications of the cost of capital's sudden rise?

Cost of capital refers to a hurdle rate that would need to be surpassed to justify an investment. A company's calculation of this should include a risk premium commensurate with the degree of risk of an investment. This is what is happening in the market today – investors are asking for higher risk premiums for riskier investments in early-stage companies.

Cost of capital is also the "steering wheel" for the optimal capital structure of a company. Debt is theoretically great because it comes with an interest tax shield, until it becomes too bloated on the balance sheet – thus endangering the company. The cost of equity will rise since the use of high leverage increases the financial risk to shareholders. In theory, every company would find their optimal capital structure which optimises the cost of capital. So goes the theory.

In practice, however, debt has been very cheap for a long time. Debt was so cheap that it was used extensively, even excessively, over the past decade. The extremely low interest rates made it tempting for companies to use a lot of debt to leverage returns on equity.

Low yielding net cash on a balance sheet was viewed as a burden. Shareholders tended to pressure boards to increase their equity returns with share buy-backs or extra dividends to use the "excess" cash on the balance sheet.

Over the past decade, the optimal capital structure of a company seemed to be a maximum amount of debt with a minimum amount of equity and net cash. This cheap debt jeopardised the capital structure of many companies and led to a significant increase in "zombie" companies, i.e. companies with an interest

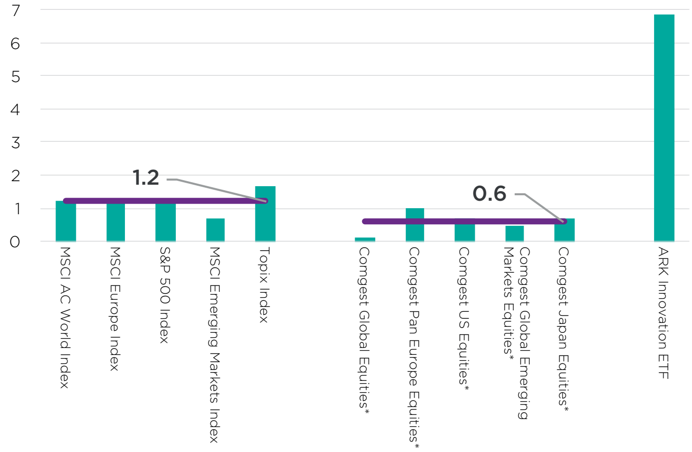
[15] Source: Comgest, company reports.
[16] Definition for EBIT margin: https://ycharts.com/glossary/terms/ebit_margin.
[17] Source: Comgest, company reports.

rate coverage ratio of less than one.[18] According to *Bloomberg,* nearly 1 out of 10 companies in the MSCI AC World and MSCI Europe indices are "Zombie" companies.[19] The widespread use of cheap leverage by the private equity industry to fund transactions, improve equity returns or fund dividend payments has been a factor driving increased financial leverage outside the listed equity market.

Another frequently used ratio for indebtedness is the net debt to EBITDA (earnings before interest depreciation and amortization) ratio. EBITDA, as a proxy for operating cash flow, signals a company's capacity to pay back net debt with the cash their business generates.

As seen in *figure* 5, the net debt to EBITDA ratios across Comgest's referenced quality growth strategies are on average half the level of their comparative indices and 90% lower than the portfolio holdings of the ARK Innovation ETF.

Figure 5: Net debt to EBITDA[21] ratio (LTM) for Comgest Equity Portfolios,* comparative indices and the ARK Innovation ETF



*Source: Factset consensus estimate as of 31-Dec-2022. Free cash flow margin is defined as free cash flow divided by sales. *The Comgest Equity portfolios referenced in figure 4 refer to the following: Comgest's Global Equities Representative Account, Global Emerging Markets Large Cap Equities Representative Account, US Equities Representative Account, Pan Europe Large Cap Equities Representative Account and Japan Equities, which are pooled investment vehicles that have been managed in accordance with their respective Composites discussed since inception of each Composite. Please refer to the important information section for more details on the representative accounts, their selection methodology and where to receive a GIPS report of the Composites. The Topix, MSCI Emerging Markets, S&P 500, MSCI Europe and MSCI AC World indices are used for comparative purposes only. The ARK Innovation ETF is an actively managed Exchange Traded Fund (ETF) that seeks long-term growth of capital by investing under normal circumstances primarily (at least 65% of its assets) in domestic and foreign equity securities of companies that are relevant to the ARK Innovation ETF investment theme of disruptive innovation.*

This means that Comgest's quality growth companies can pursue growth investments with peace of mind, as their financial leverage is low in absolute terms and relative to cash flows. For younger companies with high financial leverage[20] and cash burn, the opposite could be true. Their net debt to EBITDA ratio of 6.9x (LTM) or 5.2x (NTM) signals an acute need for external financing to fund growth or significant cost cutting pressure to improve EBITDA, which will eventually reduce growth. Swedish Klarna is only one of many examples.

The repercussions of a rising cost of capital on younger versus more established growth companies can best be described as a "Darwinian" selection – it's survival of the fittest when times are tough. Resilient companies tend to have significant size, market capitalisation and funding strength. As a result, we tend to observe during a crisis that these companies become stronger while those with weak financials weaken.

Using the examples of Comgest's Global strategy and the ARK Innovation ETF, the median date of founding for the holdings in our portfolio is 1946 and their median market cap is US$180 billion. Meanwhile, the median market cap of ARK's companies is US$4.2 billion with a median founding date of 2009.[22]

At Comgest, the backbone of our portfolios are established growth companies with a history of high profitability, free cash generation and compound growth. We believe they offer stability in today's markets – able to pursue growth unperturbed by volatile capital markets and spiking cost of capital. Within our regional portfolios, our investment team are trained from the bottom-up to seek out those that we believe could be marathon runners, such as for example: Coloplast, Dassault Systèmes, Lindt & Sprungli and L'Oréal in Europe; Costco, Eli Lilly, Microsoft and Visa in the U.S.; Inner Mongolia Yili, Localiza, TSMC and WEG in Emerging Markets; as well as Fanuc, Hamamatsu Photonics, Keyence and Sysmex in Japan.

[18] Lee, Lisa. "Zombie Firms Face Slow Death in US as Era of Easy Credit Ends", Bloomberg, 31-May-2022; interest coverage ratio is the number of times a company can finance its interest from its operating activities.
[19] Source: Comgest and Factset, as of 21-Dec-2022.
[20] Proxied by the ARK Innovation ETF.
[21] EBITDA refers to earnings before interest, taxes, depreciation, and amortization.
[22] Source: Factset as of 7-Jan-2023.

Figure 6. Comgest's "Marathoners"

Comgest Global Equities*	Inner Mongolia Yili Keyence Microsoft Visa
Comgest Pan Europe Equities*	Coloplast Dassault Systèmes Lindt & Sprüngli L'Oréal
Comgest US Equities*	Costco Eli Lilly Microsoft Visa
Comgest Global Emerging Markets Equities*	Inner Mongolia Yili Localiza Rent a Car TSMC Weg
Comgest Japan Equities*	Fanuc Hamamatsu Photonics Keyence Sysmex

*Source: Comgest. *The Comgest Equity portfolios referenced in figure 4 refer to the following: Comgest's Global Equities Representative Account, Global Emerging Markets Large Cap Equities Representative Account, US Equities Representative Account, Pan Europe Large Cap Equities Representative Account and Japan Equities, which are pooled investment vehicles that have been managed in accordance with their respective Composites discussed since inception of each Composite. Please refer to the important information section for more details on the representative accounts, their selection methodology and where to receive a GIPS report of the Composites. The above-referenced companies are provided for information purposes only, are subject to change and are not intended as an offer or solicitation with respect to the purchase or sale of any security. The contents of this document should not be treated as advice in relation to any potential investment.*

CONCLUSION

We believe that investing in quality growth companies is a sound investment choice after the valuation contraction experienced in 2022. With strong free cash flow and sound balance sheets, quality growth companies can continue to grow unperturbed by any volatility in capital markets, steep rise in cost of capital or capricious economic cycle. Companies dependent on capital markets for funding may fall victim to the recurrent cost of capital and a deteriorating funding environment for years to come. For Comgest, this reinforces our belief that compound growth is the basis for long-term performance.

Comgest Global Equity Strategy
Calendar Year Net Performance (%)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Rep. Acct.*	**11.8**	**19.7**	**17.5**	**11.8**	**3.1**	**19.4**	**3.9**	**23.3**	**11.6**	**16.0**
Index	14.3	17.5	18.6	8.8	11.1	8.9	–4.8	28.9	6.7	27.5
+/- Index	–2.5	2.2	–1.1	3.0	–8.0	10.5	8.7	–5.6	4.9	-11.6

Past performance does not predict future returns. *Source: FactSet / Comgest. Net performance data in EUR as of 31/12/21. The performance is the results of the representative account managed in accordance with its Composite (Global All Cap Equities Composite) since the Composite's inception. The inception date of the representative account is 27/06/91. Performance figures are calculated net of investment management fees, administrative fees and all other fees with the exception of sales charges. If taken into account, sales charges would have a negative impact on performance.*

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Wolfgang Fickus is a graduate of the University of Cologne (Germany) with a degree in business administration (Diplom-Kaufmann) and studied at the London Business School. He also holds a CEMS Master's in international management and is a CFA ® charterholder. Wolfgang began his career in 1995 at Paribas Asset Management Paris as a European- equity fund manager. In 2000, he moved to WestLB where he worked as an analyst for European technology stocks before becoming the Head of Mid- and Small Cap Research in 2005. Wolfgang joined Comgest in September 2012 and is a Product Specialist.

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