Independent Franchise Partners, LLP

Sustainable Investment Policy - December 2020

Introduction

We aim to invest in companies with durable franchises and to be responsible long-term owners of those businesses. These two goals are central to our mission. This document explains our current thinking on assessing franchise sustainability, thinking that continues to evolve with the changing business and investment landscape. These ideas also inform our approach to stewardship and governance, which are covered in more depth in our Stewardship Policy.

Sustainability and responsible ownership are important to us because of our long-term investment horizon. Our typical holding period is between five and ten years. As a result, assessing the durability of a business and the alignment of its management with shareholders always has been integral to our research process. Our definition of sustainability focuses on the vibrancy of a company's intangible asset. It means that we focus on the long-term risks and opportunities that matter. It also means that we have a keen interest in how sustainably companies are managed and how effectively they allocate capital. We believe focussing on these priorities increases the likelihood that our investments can compound our clients' wealth and deliver attractive long-term results.

As a result, we do not take a checklist, exclusionary or compliance-oriented approach to the incorporation of environmental, social, and governance factors (ESG). We consider this inappropriate for long-term owners of a business. Instead, we strongly believe in the critical role of judgement when identifying material investment risks and opportunities.

Sustainable investing in practice

We have developed a comprehensive risk framework to help us assess the sustainability of a company's franchise and the fundamental risks associated with it. Our framework incorporates a wide range of long-term risk factors relating to sustainability, including ESG risks. Companies that manage these risks well should be better at compounding free cash flow and our clients' wealth, and they likely will allocate capital better, enjoy more loyal customers and employees, attract lighter regulation, and attain a stronger social licence to operate.

The framework can be summarised as follows:

Franchise risk: We aim to invest only in companies with demonstrable durability and vigour

Management risk: We seek management teams with proven skill, shareholder alignment, and track record of reinvesting cash flow efficiently

Financial risk: We look for comfortable coverage of fixed costs

Valuation risk: We try to avoid overpaying for our investments by targeting companies with free cash flow yields in excess of the long-term 10-year risk free rate

Portfolio risk: We diversify when we can, but we will not diversify at the expense of franchise quality or absolute value. We are comfortable with a concentrated portfolio because we evaluate the absolute risks of each investment thoroughly

Sustainability and ESG factors can have a material effect on a company's ability to compound returns and can be important factors in evaluating *franchise risk.* Climate change is among the most important of these factors, which has led us to develop a climate risk framework which we provide at the end of this document.

Positive examples of sustainability and ESG factors also can provide opportunities for companies to strengthen their intangible assets and present us with investment opportunities. For example, a business that that relies on innovation to deliver balanced revenue growth through a combination of volume and price is likely to compound free cash flow more sustainably than one that relies purely on price. A software business that takes advantage of high switching costs to price gouge its customers is less attractive than one that grows wallet share through additional functionality. A pharmaceutical business that brings innovative medicines to market that satisfy large unmet clinical needs is preferable to one that relies on aggressive price increases of legacy drugs. And a packaged food business that innovates into healthier categories to meet evolving consumer preferences is more likely to maintain market share and revenue growth.

Proper stewardship and governance support long-term corporate performance and are central to our assessment of *management risk*. We focus on management alignment, compensation, capital allocation and board quality. Our voting process is integrated with our investment work and is an important component of our governance review.

Although we invest in only 30 companies, we conduct more than one hundred one-on-one interviews with company executives each year. The primary purpose of these meetings is investigative, which is why we devote most of the time to a dialogue about the long-term health and risks in the business. We also raise concerns and offer our suggestions about the company's activities and strategy where appropriate.

Furthermore, we escalate our concerns to board members when we believe additional engagement is likely to enhance returns and benefit our clients. We monitor the company's responses to our concerns and follow up as required. Our Stewardship Policy explains our engagement and voting practices in greater detail.

A balanced approach to ESG controversy

We are as much focussed on value as we are on quality. As value-oriented investors, we often initiate investments when a company is in the midst of controversy. Sometimes that controversy is related specifically to a sustainability or ESG issue.

We use our comprehensive risk framework to make a reasoned judgment of risks and assess whether the company's valuation provides sufficient compensation to bear those risks. We will consider investing in the midst of controversy if we have confidence that the company's franchise is intact, and that management is committed to addressing their challenges. Opportunities also may emerge for management and the company to benefit from our involvement.

A simplistic exclusions-based approach to sustainability or ESG would eliminate such opportunities, and thereby the potential to earn superior investment returns for our clients as companies work through their challenges.

Where companies are not addressing the risks around sustainability, and the valuation is not paying us to bear those risks, we will sell our position.

Our approach continues to evolve

Over the past two decades, we have steadily refined our investment process and approach to responsible ownership, including the analysis and assessment of ESG risks.

For example, we have found that the companies we have researched and selected for our investment universe create comparatively fewer environmental externalities than the average business. They are also more able to attract and retain top talent. Neither one of these was a specific goal of the franchise approach; rather, they are natural consequences of investing in high-quality companies built around dominant intangible assets with naturally capital-light business models.

During this time, the business landscape has evolved, and experience has taught us that a company's relationships with its customers, employees, suppliers, regulators, shareholders, and other key stakeholders are increasingly interdependent. Poorly managed risk in one arena can create important reputational risks in the others. For this reason, we are increasingly encouraging our portfolio companies to more consistently pursue best practices across the full suite of their risks, including environmental, social, and governance risks.

Appendix: Climate risk framework

As long-term investors, we think that climate change represents a material risk to the durability of companies and their supply chains. These risks are broad, complex and uncertain, ranging from changes in taxation or regulatory regimes, physical events such as drought and flooding, and loss of sales as consumers change their behaviour.

To support our current risk management framework, we have developed a set of five principles to help us assess how effectively companies are managing material climate-related risks. As a company's climate risks and opportunities vary depending on geographical exposure and sector, we do not believe a 'one-size-fits-all' approach is effective. Instead, a principles-based approach ensures consistency and rigour in our analysis, while also allowing for flexibility and innovation in a fast-changing area.

This framework also guides our engagement work and voting action on climate-related resolutions. Where we believe a company is not making sufficient efforts to manage its material climate-related risks, we may engage to encourage stronger practices. We believe that it is engagement, not divestment, that drives companies to take appropriate and effective action.

We assess companies on the following five principles:

1. Governance: Companies should demonstrate appropriate expertise and accountability for climate issues at board and executive team level. Climate issues should be integrated into the company's strategy and organisational structures in an appropriate and effective manner.

2. Disclosure: Companies should disclose material information related to climate change following the recommendations of the Task Force on Climate-related Financial Disclosures. Companies should participate in the Carbon Disclosure Project (CDP) as an effective means to provide this information to the investment community.

3. Targets: Companies should set emissions reduction goals in-line with a 1.5°C[1] warming scenario. These goals should cover a short, medium and long-term time frame and encompass a meaningful proportion of scope 3 emissions.

4. Products and services: A company's strategy should take into account to an appropriate degree how climate change might impact its products and services as a result of new regulation or consumer behavior change.

5. Physical risk management: Companies should assess the resilience of their operations and supply chains to climate change physical risk and take appropriate, effective mitigating action.

[1] In 2015, as part of the Paris Agreement at COP 21, over 180 countries agreed to keep global warming by the end of this century to below 2°C above pre-industrial levels, and to pursue efforts to limit the temperature increase even further to 1.5°C. The Intergovernmental Panel on Climate Change's 2018 report makes clear the significant differences in biodiversity, food security, natural resources and the frequency and severity of extreme weather events between a 1.5°C and 2°C world. Therefore, we believe that companies should align their targets with a 1.5°C warming scenario.