Puffins – Part II

Five years ago, one of our portfolio managers (PMs) made an inaugural trip to Iceland. The PM was fascinated by the *lundi*, Icelandic meaning a puffin species of bird. We wrote about these tough (yet quite cute!) flying creatures in our January 2022 edition of *The Essence*. Their heartiness and extraordinary lives, mostly out at sea, exemplified a part of Aristotle Capital's process of studying how businesses "weather" tough conditions. COVID was still impacting most countries – yet Iceland was largely spared – while its duration and consequences were not fully known.

In this issue ...

Fast forward to 2026 and this same PM set out to replicate what was a unique journey. This time, however, a more circuitous route was taken. First through London to meet with some portfolio companies, then north to Ireland and Scotland. Then on to the Scottish Highlands and through the Faroe Islands as a last stop before Iceland. These 18 islands (population no more than 54,000 on a crowded day) are a self-governing part of Denmark, sitting between Iceland and Norway in the North Atlantic Ocean. This is where our PM met Dánial Hoydal, Founder and CEO of Faer Isles Distillery.

It was a fascinating tour of an independent whiskey distillery, the only one in the Faroe Islands (or anywhere near, for that matter). The location was chosen not only because the founder came from the area, but also because the climate is near ideal. Similar to Scotland (known for its "Scotch" variety of whiskey), the Faroes are blessed with consistently cool temperatures (rarely cold or hot) and high humidity of the "salty" kind as surrounded by sea, with high annual rainfall (it typically rains three out of four days, though the showers are usually brief). All quite optimal for whiskey making. So how does Mr. Hoydal take advantage of this idyllic weather to make whiskey?

➢ At its core, grain (barley in this case) is malted – steeped in water to sprout, then dried over burning peat (centuries old dead plant matter) to add a smoky flavor. This type of peat is unique to the Faroe Islands where even today it is still used to heat some of the homes. The mixture is then milled into a coarse flour called "grist," releasing natural enzymes. The grist is mixed with hot water in a large vessel called a mash tun, where these enzymes convert the grains' starches into a sugary liquid called "wort."

➢ The sugary wort is cooled and transferred to large vats called "washbacks." Yeast is added, which, over a few days, converts the sugars into alcohol and carbon dioxide. Remaining is a low-alcohol, hop-free "beer" known as the wash.

➢ Hot steam is then piped into an exterior "jacket" surrounding a boiler, heating the wash. This separates the alcohol from the water and grain byproducts, which boil at different temperatures (alcohol evaporates first, turning to vapor that is captured and condensed back into a liquid). This process is repeated one to three times to refine and concentrate the liquid, resulting in a clear, high-proof spirit. This ***distillation process*** is ideally done in copper stills, but moonshiners may use less expensive pots.

➢ The final (but most delicate) part of the operation is the pouring of the spirit into oak casks for aging. The Faer Isles Distillery typically uses aged bourbon casks purchased from Kentucky. Over years of storage, the spirit interacts with the wood, absorbing flavors (like vanilla or caramel) and its signature amber color. Finally, the whiskey is blended or diluted with water to reach its prescribed strength and then bottled for sale and consumption (or just admiration if in a fancy bottle).

During each part of the process, Mr. Hoydal had decisions to make. How many times to distill the liquid? What temperatures should be used? From which farms to buy the barley? How many weeks to ferment? How many years to sit in the cask? As a start-up operation, each year would mean delaying revenues, but, perhaps, a higher-quality product would result in and produce a better long-term reputation for the firm's future. A "net present value" calculation ensued, and five years was chosen for the first batch of whiskey.

None of the decisions were pre-ordained. It takes experimental science, judgement, analysis of everything from weather to the weathering of wood barrels and finally a master's "feel" for the taste he is looking to achieve. Thus it must be looked after by the person doing the analysis, as critical elements could be missed if relying upon others' work. Each batch, cask and even bottle of whiskey is unique; sometimes by design and sometimes as chemistry dictates. Rarely can two bottles be identical. Each time, consulting with his staff, Mr. Hoydal analyzed the details, basing current decisions on precedent. After all, whiskey making has been around since the 15th century (first distilled in Ireland or Scotland – we will choose not to enter this debate!). Relying upon facts and science, all then implemented with a dose of skill, intuition and judgement, each decision was based upon the last decision made in the process, never in a vacuum.

Somewhat like a chess game where your next move is based upon not only your opponent's, but your last one as well. What can this distillery teach us about investing?

One's Own Work

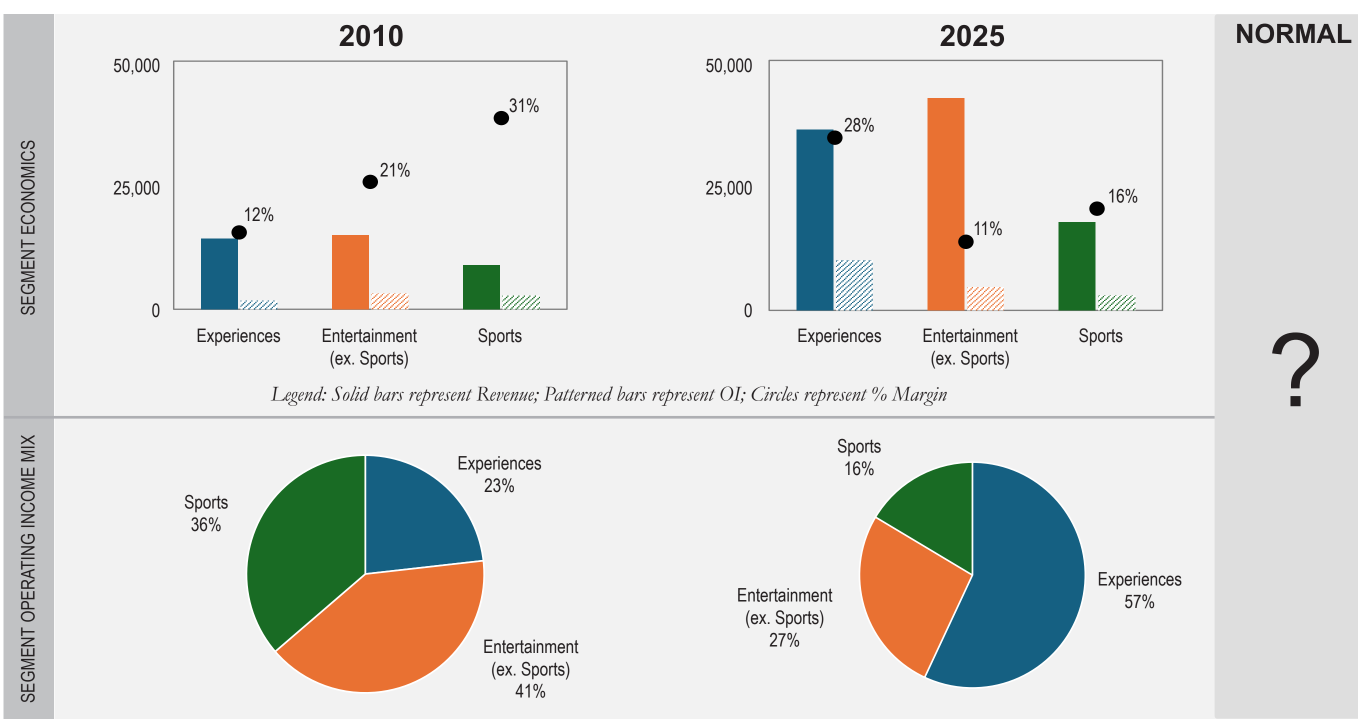
As does Mr. Hoydal at Faer Isles Distillery, analysts at Aristotle Capital perform their own independent research into the businesses we choose to learn about. From factory tours (yes, we love sitting on buses), to management meetings, to competitive analyses, to textbooks to learn the sciences, to hundreds of hours of reading everything we find relevant. Even with "AI" available, analysts build up their own spreadsheet models so as to do their own work. But why? So as to personally monitor the process, and make judgements, along the way.

Let's use a real example of a business being studied and the thought process used. Think of it as us giving a glimpse into the making of the "sausage" that is Aristotle Capital's investment methodology.

For this, we will use: The Walt Disney Company. While we currently do not have an investment, we choose *Disney* as we have a long history studying it, spending time at its Burbank headquarters and elsewhere; some of its businesses compete with companies in which Aristotle Capital has historically, or is currently, invested; we consider *Disney* as "*relevant*" to the business world; and perhaps, most important, our compliance officer indicated we may do so (as "*illustrative of Aristotle Capital's process*").

[The numbers presented herein are directional indications, used as an illustration, and do not purport to be spot-on accurate. Our complete work does strive for such.]

The Walt Disney Company



Sources: Disney Financial Reports; Aristotle Capital analysis

While an oversimplification, much of what we study may be summarized in this *normalized* chart of the company's top-level financial performance, historically, today and prospectively. The company has historically reported its results broken into two major segments: Experiences and Entertainment. We further split the all-important Sports segment out of Entertainment to shed further light.

➢ ➢ The "Experiences" division includes *Disneyland* in California, *Walt Disney World* in Florida, and the global theme parks in Hong Kong, Japan, China and France. It also includes hotels surrounding many of these parks and a relatively new *Disney*-branded cruise ship business. While large in area and people employed, Experiences comprised ~37% of revenues but only 23% of profits in 2010.

➢ ➢ The "Entertainment" division was the origin of the company in 1923. It comprises the *Disney* movie studio (including *Walt Disney Pictures), Walt Disney Animation Studios, Pixar, Marvel, Lucasfilm, 20th Century Studios* (acquired from Fox Corp. in 2019) and some specialty studios. It also includes the ABC Television Network and, most recently developed, streaming assets including *Disney+* and *Hulu*. This division represented ~39% of revenues in 2010, but a more robust 41% of profits.

➢ ➢ The "Sports" division is technically part of "Entertainment," but we separate it as critical to our thinking about the company. *ESPN Sports* is the lion's share of the business. While representing only ~23% of revenues, note that its high margins provided 36% of the profits in 2010. Fast forward to 2025 and the future.

➢ ➢ ➢ In 2025, the share of revenues between the three divisions changed only a little from that of 15 years earlier. But profit margins moved dramatically, in all three divisions. Experiences increased while Entertainment and Sports declined. Why is this and what may it portend for the future?

The answer, we believe, requires a more in-depth study of capital intensity. For Experiences (the theme parks), the expansion in revenues was largely due to continuously increased pricing power (visited one of the parks with your family lately?), but also the company's wise model of growing outside of the U.S. via licensing. The company doesn't fully own, nor contribute much capital, to the *Disney* theme parks outside of its home country (France being the lone exception). It mostly collects royalties without having to own the properties. Notably, it maintains quality via strict licensing agreements while also contributing additional intellectual property when *Disney's* characters gain popularity. This has proven to be a good business move and, perhaps, one of the reasons that prior Experiences chief Josh D'Amaro was recently made CEO of the entirety of *The Walt Disney Company*.

Alternatively, the Entertainment business has seen a dramatic shift in distribution from cable, broadcast and theatre to streaming. This requires significant capital and operating investments. The company is thought to be "running very hard" just to stay in place, fending off newly competitive threats from Netflix, Amazon Prime, HBO Max and others. Thus far, the rapidly growing streaming business is <u>barely</u> profitable, while the shrinking distribution via cable businesses is <u>highly</u> profitable.

Similarly, the Sports division, while still retaining many valuable assets, has seen its capital intensity shift the most with currently no end in sight. The "value chain" of sports programming continues to move to the benefit of the franchise owners (NFL, NBA, MLB, etc.), with its "must have" content needed by all of *Disney's* competitors bidding up the price of these rights, without the ability to fully monetize such content in a commensurate manner.

Increasing capital intensity drives down returns on capital. It also reduces operating margins as depreciation becomes an ever-larger expense. The opposite (such as with Experiences) is also true.

What will the future hold?

➢ ➢ ➢ ➢ We have worked to better understand what is ***normal*** for the future profitability of *Disney's* divisions. While the company's brand reputation and considerable clout will likely result in continued increases in sales (market share) across all three divisions, the profitability of Sports could lag further. Oppositely, Entertainment ex-Sports could begin to absorb recent streaming investments, with profitability moving (potentially meaningfully) higher.

Net-net: In 2010, *Disney's* overall segment operating earnings (before overhead, amortization, taxes and extraordinary non-recurring expenses) were ~$7½ billion. That grew to ~$17½ billion in 2025 (we believe nearly fully recovered from a COVID-induced slump). Of course, this included earnings from some large acquisitions (the Fox studios being the largest), so, while the company's equity share count remained about flat during that period, its net indebtedness grew from $10 billion to $40 billion – reducing the company's economic value per share by ~$16.70.

If we ***normalize*** for all that discussed above, we calculate *Disney's* normal segment operating income = ~$21 billion. Getting to the bottom line, including other detailed factors (not repeated herein for expediency), we view *The Walt Disney Company's* prospects as overall reasonably encouraging, and likely not fully reflected by the economic value accorded the company today.

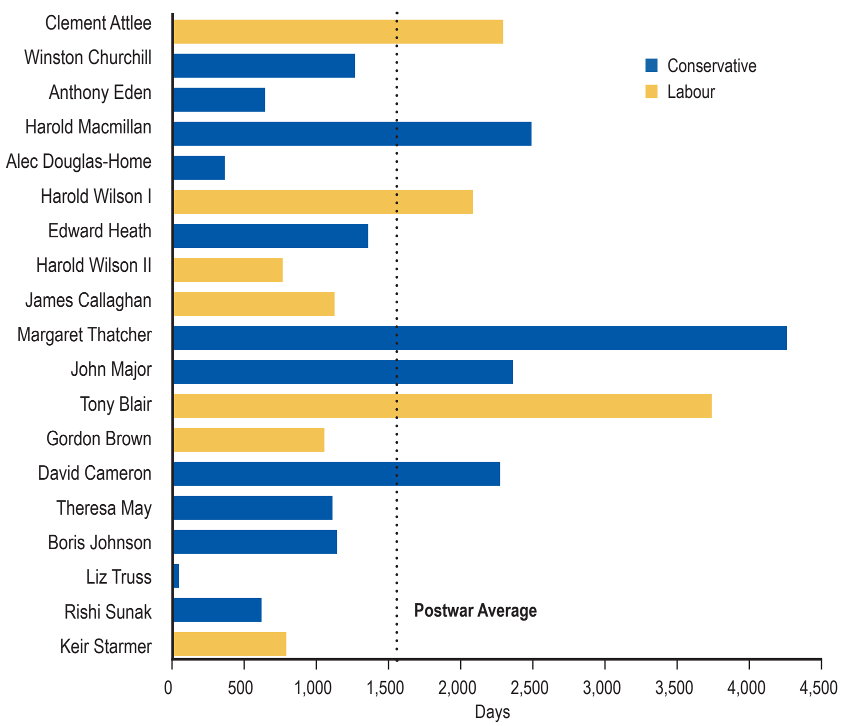
One point we'd like to make clear is that all these *numbers* we work through are a means to better understand the *business*. It is **not** the other way around. Numbers may be manipulated (such as quarterly earnings per share to "beat the Street") or even bought (such as with mergers or divestitures). Cash flows (per share) are much harder to fake.

We have also not, in this issue of *The Essence,* dived into the entirety of Aristotle Capital's investment process: Quality – Valuation – Catalyst. Our goal is to highlight that Aristotle Capital analysts do their own work … just as if they were distilling whiskey (and hopefully not simultaneously!).

EQUITIES STRATEGY

At a time when **everything** seems to go by faster than ever before, we have noted that even political leaders' terms in office go by faster – meaning are shorter – than they've ever been.

U.K. Prime Ministers Are Turning Over More Quickly



Sources: U.K. Government; Bloomberg

In June of this year Keir Starmer, Prime Minister of the United Kingdom (U.K.), set a timeline for his departure. Thus, 10 Downing Street (his official residence in London) will have another new occupant, the fifth in as many years. It was only two years ago that Starmer swept to power in a landslide. His apparent successor (uncontested, at least as of this writing) will be Andrew ("Andy") Murray Burnham, a career politician but Member of Parliament only since June.

Similar stories are being played out through much of the world's democracies. Elect from "column A" this year, then "*throw them all out!*" and pick anyone from "column B" next time. Repeat – rinse – repeat. The leader of another of the U.K.'s political parties was quoted as saying "*… the British people are sick of being let down by an endless merry-go-round of prime ministers while nothing really changes.*"

From Peru (twice) to Colombia to Hungary to Japan to Venezuela and Iran (assisted by external forces) and now the U.K., as exemplified by the above chart, the pace of leadership turnover seems to be quickening. While we will remain as "neutral as Switzerland" as to politics in general, this constant churning of democracies cannot be good if stability in government is deemed a positive trait. We will have more to say on this topic in future editions of *The Essence.*

INVESTMENT ACTIVITY

We would now like to highlight recent additions to Aristotle Capital equity portfolios.

- **Edwards Lifesciences** (EW) is a medtech company focused almost singularly on heart valve repair and replacement. It "bet the company" (and won!) by developing what is now the world's leading TAVR – Transcatheter Aortic Valve Replacement – while maintaining a significant share of the more invasive technology SAVR – Surgical Aortic Valve Replacement. Myriad *catalysts* include: (i) Applying TAVR devices in a younger, asymptomatic population; (ii) continuing share gains in TAVR vs. SAVR at a higher reimbursement rate; (iii) newly developed and approved TMTT – Transcatheter Mitral and Tricuspid Therapies – whose market is a multiple of what TAVR is; (iv) favorable use of FREE cash flow estimated at an annual ~$1.8B = ~$3/share = ~4% of current market cap (*plus* EW currently has ~$7/share in net cash). Valuation: Normalized EPS = ~$6.00 (but the company is unlikely to generate this level of earnings near term given the investment opportunities available). Risks to monitor include: (i) PRICING reimbursement as margins for the company's TAVR products are quite favorable; (ii) competitive products (though EW has clinical data with more than a decade of trial results); (iii) TAVR is essentially one product whereas TMTT requires many; (iv) potential for other competitive entries, either from developed or developing markets. While there is some overlap with our existing holding in **Medtronic**, the latter is far more diversified and so we recently made the decision to invest in EW and hold both.

- **Techtronic Industries** (TTI), headquartered in Hong Kong, with a large U.S. and global manufacturing base, is a marketer of power tools, outdoor power equipment, hand tools and floorcare/cleaning products. The company serves professional tradespeople and DIYers through a portfolio of brands such as Milwaukee, Ryobi, AEG, Hoover, Oreck, Vax and Dirt Devil. At first, we studied TTI as a "risk" for our investment in **Lowe's Companies** as its largest and most successful Milwaukee brand is exclusive to Home Depot in the large home improvement retail sector. Our appreciation of the company's success (partly due to its easy-to-use interchangeable batteries) and long runway, including some of its other brands, led us to recently invest in TTI for our International and Global portfolios.

STANDARDS OF LIVING / INTEREST RATES COMMENT

We wish to take a few words here to pay tribute (or better, a more respectful **homage**) to one of the most consequential persons of finance in recent history. Alan Greenspan passed away on June 22 at the age of 100. He had a distinguished career, highlighted by his time as Chairman of the U.S. Federal Reserve Board (the Fed) from 1987 to 2006. Known for many policies and memorable quotations, he was perhaps best known in his early days as Fed Chair to have boarded a plane back home on "Black Monday," October 19, 1987, when the stock market was crashing. There was no single fundamental trigger for the decline. Instead, program trading, portfolio "insurance" strategies and a general panic amplified what were moderate concerns about slowing economic growth coupled with consistently stubborn inflation. Greenspan stepped off the plane after the markets had closed, immediately asking for a report. "*The Dow closed off five '0' eight,*" he was told. "*Oh, thank goodness it came back …*" "*NO! Mr. Chairman. Not five* ***point*** *'0' eight, five* ***hundred*** *and eight points!*" Greenspan nearly fell over as, at that time, the decline represented -22.6%.

Mr. Greenspan spent the rest of his term, first (successfully) stabilizing the markets and economy, then trying to ensure such a one-day decline should never recur. It became known as "**the Greenspan put**" as each time the markets or economy looked vulnerable, he quickly enacted policies to forestall damage. This became one of his legacies, but also, to this day, a potential weakness in not allowing "irrational exuberance" – another of his famous sayings describing the lead up to the 2000-2002 dot-com bubble burst – to self-correct. He used ***words*** as well as actions, being the first Fed Chairman to issue a statement following a policy meeting describing the Fed decision and his rationale. But he also became known for "Fedspeak," a way of speaking so as to obfuscate his meaning so as to intentionally confuse market participants, preventing them from "baking in" policy moves before the Fed could actually implement them.

We praise Alan Greenspan, hoping to emulate his process. James Clouse, an economist who worked with him, said "*… he really knew the data at an extraordinary level and could accurately discuss all those details with the board staff, and at the same time he had this incredibly broad perspective.*" We shared our analysis of *Disney* earlier, trying to put into practice just that same way of thinking. One of our Portfolio Managers feels humbled to have met him once, in a meeting in Orange County, California.

CONCLUSION

Our PM finally got to see the puffins for the second time, but not in the same quantity as on the prior journey. He also saw many other species of birds that frequent Iceland and the Faroe Islands. The Eurasian oystercatchers, with their black and white plumage and sharp orange beaks, are featured on the banner of the first page of this edition of *The Essence*.

In this edition, we told the story of Mr. Dánial Hoydal, Founder and CEO of Faer Isles Distillery. We use his process of making whiskey as having a parallel to Aristotle Capital's process of understanding businesses. Using numbers, analyzed by our team of analysts, to understand companies (not the other way around). *Disney* is a company worthy of study, as relevant in so many ways to entertainment, sports, travel experiences and global business. Our analysts, as does Mr. Hoydal, do their own work, so as to truly understand the WHYs in addition to the WHATs of the causes for revenues and profits. Only then can we gain conviction in the direction of where a company may be headed. Only then can a whiskey maker become a true whiskey master.

The U.S. Fourth of July Semiquincentennial celebrations are over, Wimbledon has a new women's champion, Linda Noskova, defeating her fellow Czech, while the men have a repeating champion in Jannik Sinner of Italy. Team USA was outdone by Belgium in the FIFA World Cup Round of 16 with the ultimate men's winner (as of this writing) down to Spain, ~~England~~ or Argentina.

We wish you many interesting adventures for the remainder of the Summer 2026 … and beyond!

The characters described and stories told herein are often, but not always, based on true incidents. Poetic license is taken to dramatize a point about an investment topic. Not all securities mentioned herein are necessarily owned in all Aristotle Capital portfolios. Differences due to restrictions, tax considerations, cash flows and other factors may have impacted the decisions to buy and/or sell certain securities at specific times. Inclusion does not imply that investments in these securities have been profitable and it should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities listed. A list of at least five contributors to and five detractors from performance is available upon request.

May need to think about this for a moment
… A priest, a pastor and a rabbit walked into a blood donation clinic. The nurse asked the rabbit, "what is your blood type?" "I am probably a type O," said the rabbit …

~ Anonymous