CAPITAL ALLOCATION VOL. 1

BOREO SERIES | 24 JUNE 2024

BOREO

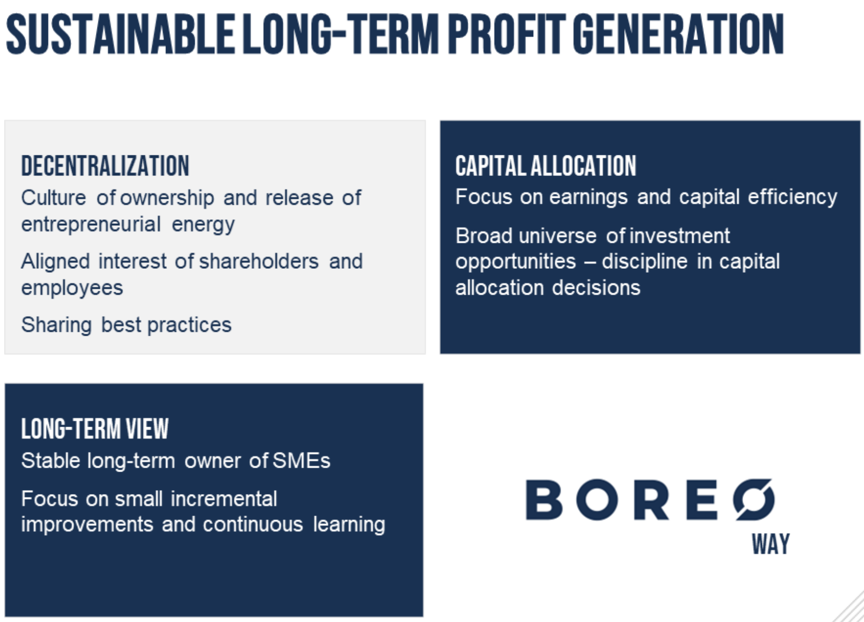
Dear Friends,

We hope you have had a good first half of the year, and soon start to be ready with what you need to get done ahead of the summer break.

For us at Boreo, the beginning of 2024 has been colored by the challenges in the operating environment and weak operating performance. As a result, our focus has been on working with measures to secure short-term profitability and strengthening the company's financial standing. In practical terms, the HQ and Business Area resources have been allocated towards supporting our companies instead of acquisitions. This is not exactly the way we would like to see ourselves allocating resources, but while these challenging times are less fun than the times of growth, they are part of the journey of any company striving to create something of a lasting nature.

These times have made us look at Boreo's strengths and weaknesses even more closely, and in addition to several operational measures, we updated our strategy during the beginning of the year. As our short- to mid-term strategy and tactics might change depending on the situation at hand, the Boreo Book including fundamental principles and beliefs will not.

Hence, we are pleased to continue discussing topics which are of importance for the long-term development of the firm and publish the second writing of the Boreo Series. The theme of the second writing is *Capital Allocation* – one of the three building blocks of our management philosophy and a fundamental concept in the Boreo Way.



We discuss the basics of capital allocation and why it is of great importance for long-term value creation. In addition, we discuss the key principles we apply in making capital allocation decisions. Given the importance of the theme, we plan to publish next in the Series a vol. 2 writing on the same topic that focuses on the ways we create capital allocation opportunities.

We hope you enjoy reading this letter and happily welcome comments you may have.

Yours sincerely,

Boreo Management Team

IMPORTANCE OF CAPITAL ALLOCATION & RETURNS FOR VALUE CREATION

What is Capital Allocation and why does it matter?

Capital allocation refers to the process of allocating a company's financial resources between a variety of alternatives with the goal to maximize returns and financial performance. In practice, for a company like Boreo this process involves determining for example which companies to own, which companies receive the most funding for investments and which new companies to acquire. In our decentralized operating structure, the material capital allocation decisions are the responsibility of the HQ, whereas the generation of opportunities is a joint task of all personnel in our companies.

Acknowledging that Boreo has a variety of options for allocating its capital ('*Uses'* in the picture below), we focus on this letter – similarly with the internal discussions with Boreo's leadership team including company MDs – to the philosophy we apply in case of acquisitions and organic investments.

Furthermore, we cut corners by leaving away the discussion related to the *Sources* side of the below picture and only note that our belief and objective is that cash flow generated by our companies should be the key source of capital for deployment purposes. Prerequisites for this are a cash flow rich portfolio of companies and a conservative level of indebtedness. The latter, in particular, being an aspect where we have work to do.

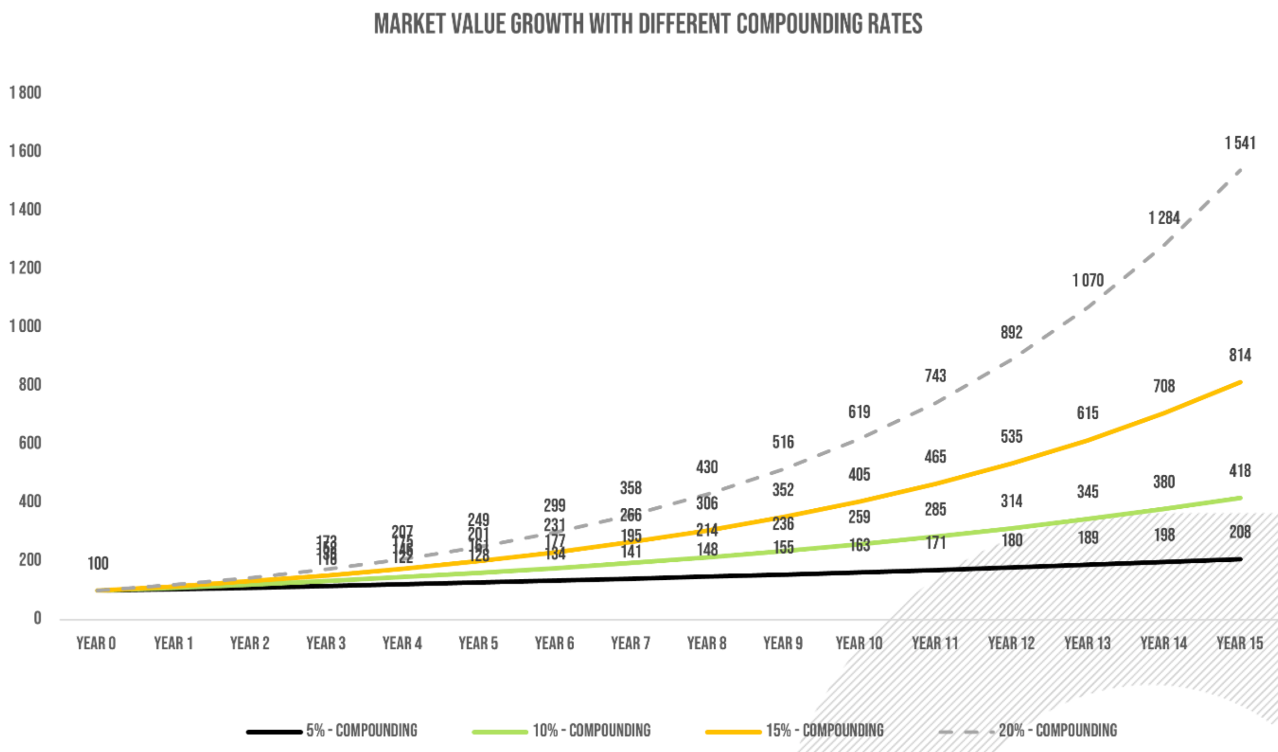
'If you buy something with a 10% free cash flow yield and hold it for 3 years, management is going to be responsible for allocating a third of the value of the company over that time. You have to really care about that.'

- Adam Weiss

'After ten years in the job, a CEO whose company retains earnings equal to 10% of net worth, will have been responsible for the deployment of more than 60% of all capital at work in the business '

- Warren Buffett

The above quotes from well-known investors describe the critical role of capital allocation for companies' long-term success and we believe these statements are self-explanatory in highlighting why every company should pay a great attention to its ability to allocate capital. The decisions have a significant impact on long-term results and companies with identical operations but with different abilities to allocate capital successfully have a very different value generation potential in the long-term. This is well illustrated by the below graph showcasing the significance of the quality of capital allocation for a company's value creation over time.



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KEY PRINCIPLES WE APPLY IN OUR CAPITAL ALLOCATION PROCESS

In the Boreo Book, we not only outline the theoretical framework of capital allocation but also detail the key principles we use for making capital allocation decisions. These principles, which are briefly discussed below, are implemented throughout our organization. We achieve this by engaging with our companies in strategic planning and sharing best practices across the group.

#1: Invested euros do not care whether they are allocated back to existing operations or to acquisitions.

Even though Boreo is labeled as a *serial acquirer,* it is vital to understand that we do not prioritize allocating capital to acquisitions over investing in our existing operations.

Acquisitions do have an important role in our business model, as the expected return on investment in acquisitions is often higher than in the case of organic investments**.** This is mainly because our companies are small and operate in industrial niches where allocation of incremental amounts of capital back to these businesses often proves to be challenging. Hence, acquiring new companies is in our case an important source of long-term returns.

Simply put, the key rule of capital allocation decisions at Boreo is ‘the capital goes to an investment where it provides the best long-term return’.

#2: The same return thresholds for acquisitions and organic investments

In year 2022, we defined internal hurdle rates, financial metrics and a set of non-financial metrics we use both in evaluating acquisitions and organic investments. This has proved to be beneficial as we have since then improved both the quality of our acquisition activity (more efficient deal sourcing, better completed acquisitions) as well as increased the level of understanding of requirements set for any business development initiatives in the organization.

As noted above, invested euros do not care where they are invested, and accordingly the thresholds we have set for acquisitions and organic investments are the same.

Even though return thresholds for different types of investments are the same, *they require different levels of safety margins*. This because of the perceived risk and the confidence in the estimates made for the opportunity. For example, and as a main rule, buying companies whose business we do not know as well as our existing companies, carries more risk. In addition, we might confidently estimate 20% returns on an organic investment while for an acquisition in a new sector, we might be more uncertain in our estimates and aim for +25% returns instead.

#3: All acquisition and material organic growth investments go through the same level of scrutiny

The hurdle rate framework put in place is one of the key tools ensuring our discipline in capital allocation decisions. This contributes to efficient capital allocation and ensures that capital is deployed to the investment opportunities creating most value. For example, if one of our companies plans for significant investments (e.g. acquiring new suppliers, relocation to new premises or cost efficiency related investments), the investment decisions are prepared using the same methodology.

Setting up the framework has been relatively easy, but building sufficient knowledge and ensuring its use is more challenging and time-consuming. Through training and continuous discussions, we have made significant progress in rooting this thinking in the organization. And it has been pleasing to see that many fundamental concepts are now more widely understood. In the past few years, several of our business initiatives have adopted principles such as '*growth is desirable only when the return achieved on an investment exceeds the cost of capital'* or '*stopping a low-margin business, releasing capital and re-investing higher-return opportunities*'.

#4: Making 'Stop' and 'Accelerate' decisions

One of our main priorities for the coming years is to position the group to achieve higher operating margins and capital efficiency. To further support our core playbook of 'acquiring companies with an ability to generate earnings growth with high returns on capital & investing in the growth of our companies which exceed our return targets' (i.e. +50% ROTWC), we focus on making 'Stop' and 'Accelerate' decisions in our existing operations, an important principle we apply at both the group and company levels.

Allocating more focus and resources toward our best opportunities is crucial in achieving consistent and satisfactory returns on capital over time. When we identify these opportunities, we aim to make an 'Accelerate' decision, reflected in our allocation of resources and capital.

Equally, we believe that making considered 'Stop' decisions, which might lead to reductions of revenue and absolute profits in the short-term, is important where the operation does not meet our capital allocation criteria. The focused allocation of our resources allows for improved margins and returns and will ultimately lead to a stronger company with increased profits, overweighing the short-term decrease in absolute levels.

The exit made in 2023 from the SANY excavator business in Finland and Sweden is an example of such action made at the group level. At the company level, we have completed several similar initiatives in recent years. For example, we have made decisions both in Yleiselektroniikka (2020) and YE International AS (2024) to exit B2C operations, close physical stores and re-focus the business solely towards the B2B industrial business. The decisions have since yielded significant positive results and allowed the organizations to allocate their resources toward more high-impact opportunities.

CONCLUDING REMARKS

As discussed in this letter, we believe that every company should pay great attention on capital allocation, as mastering in allocating resources is crucial for achieving long-term results. While we are proud of the progress we have made in creating and applying our framework, we continue to be curious to learn more and improve our capital allocation skills.

And finally, we find the capital allocation framework to be useful not only for making decisions involving euros or other currencies, but also a useful concept for management. More of this in the future letters which will touch upon our thinking with regards to leadership.