Danaher Corporation (DHR)

Danaher Corporation (DHR) is a diversified science and technology company that designs, manufactures, and distributes professional, medical, industrial, and commercial products and services around the world. The company is a global leader in each of the following four businesses with operations in over 60 countries.

- **Life Sciences** – provides instruments and consumables (products that regularly used up or depleted, thereby needing regular replacement and/or replenishment) used by scientists to study diseases and develop drugs & therapies and by researchers and engineers to test and manufacture a wide range of biopharmaceuticals, cell and gene therapies.

- **Diagnostics** – provides clinical instruments and consumables to hospitals, clinics, and physicians' offices to aid in the detection, diagnosis, and treatment of diseases.

- **Water Quality** – provides water quality testing & analytics and water treatment for municipal, environmental, and industrial applications.

- **Product Identification** – provides high-speed coding used for consumer-packaged goods (CPG) and pharmaceutical packaging and product traceability.

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Weitz has a long history with Danaher, spanning more than a decade. One of the key pillars of the Danaher story is portfolio transformation through mergers and acquisitions (M&A). Over time, we have seen Danaher shift away from manufacturing and industrial end-markets, and move toward businesses in healthcare, life sciences, and environmental and applied sciences. Important strategic moves include the divestment of Danaher's Industrial businesses, which were spun-out as Fortive in 2016, and its Dental segment, which was spun-out as Envista in 2019. Additional moves include strategic acquisitions within Diagnostics with the purchases of Beckman Coulter in 2011 and Cepheid in 2016, and in Life Sciences with the acquisitions of Pall in 2015 and Cytiva (GE Life Sciences) in 2020.

These portfolio shifts have enhanced Danaher's organic growth rate, cash flow profile, and economic resiliency by mixing into less cyclical end-markets (healthcare, biopharma, water quality) and by emphasizing a greater mix of recurring revenue with consumables, which are contractual and specified into their customers' workflows, now representing over 75% of Danaher's revenue. We believe the Danaher of today offers a higher-quality mix of businesses with more avenues for reinvestment and growth compared with the Danaher of years past.

A critical eye is warranted for acquisitive companies. Looking at the broader market, acquisitions have – on average – destroyed shareholder value over time. Few companies have passed our vetting process, and fewer still are companies where we consider M&A a strategic asset. The bar is high, and Danaher is one of a select few that fall into this category. Danaher has a long history of surpassing our high hurdles for return on invested capital (ROIC) and, more importantly, has business processes in place for creating shareholder value from acquired assets.

At the center of all of this is the Danaher Business System (DBS) – Danaher's system for continuous improvement, commercial excellence, talent development, and strategic planning. Danaher has a highly decentralized organizational structure with 25 operating companies, where business leaders have the autonomy and accountability to drive results through the Danaher Business System. Mapping out business processes and value streams uncovers the data needed by business managers to identify customer demands and pain points; target commercial opportunities and R&D; improve operations to drive lower costs, improve quality, and become more agile; and identify the best uses of capital for organic investment and M&A. DBS is the foundation of Danaher's culture and a core driver of shareholder returns.

The typical DBS playbook for acquisitions is to first enhance operations through continuous improvement and move closer to the customer through voice of customer (VOC) work. Cost savings are then recycled into targeted, high return on investment (ROI) innovation and R&D. This drives value for customers who then increase partnership with Danaher, which further ingrains Danaher's solutions into customers' workflows. This increases stickiness, switching costs, and pricing power. The value created is then recycled into additional M&A and the cycle repeats.

Nearly without exception, we have seen organic growth accelerate and margins expand meaningfully for acquired assets. This has driven average return on invested capital for M&A well above their cost of capital. We believe that DBS is a sustainable moat for Danaher given institutional hurdles to implementation, lengthy time horizon before results manifest, and decades of process iteration it took for Danaher to get DBS where it is today. Moreover, Danaher has the focus within their executive management team, depth of talent throughout the organization, and buy-in from the board to sustain DBS long-term.

In addition to best-in-class management, culture, and capital allocation, we believe Danaher is exposed to industries with attractive secular growth prospects and that Danaher plays within the most attractive pieces of the value chain within these industries.

Looking first at their largest business, Life Sciences, Danaher is well positioned within bioprocessing and increasingly within gene and cell therapies. Danaher's largest exposure is to biopharma which, as a category, is taking market share from small molecule (traditional pharma). We expect this shift to continue. There is strong growth in the number of biopharmaceuticals across clinical stages (pre-clinical, Phase I, Phase II, and Phase III) and high R&D budgets across Danaher's customer base. Danaher benefits from diversification as they are a broad "pick and shovels" provider across the biopharma industry. An additional growth driver is the still nascent biosimilars ("generics"), which is likely to see strong growth from drugs coming off patent in years ahead. Danaher has high upfront customer intimacy within customers' R&D processes, and the company also benefits as its solutions are critical for customers to scale up to commercial production. At this stage Danaher enjoys a long stream of high-margin consumables as they have regulatory lock-ins (FDA), where the costs and approval time to switch to a competitor are prohibitively high. Within bioprocessing, Danaher plays in some of the most attractive pieces of the value chain: purification, filtration, and chromatography. Danaher is also a market leader in high margin single-use technologies (SUT), which continues to take market share within bioprocessing applications.

Through their Integrated DNA Technologies (IDT) business, organic investments, and their recent acquisition of Aldevron, Danaher has established a foothold into the rapidly growing gene and cell therapy industry. To the extent that the market scales, we expect Danaher to benefit given the complexity of the gene and cell therapy manufacturing process, growth in automation and continuous bioprocessing, and higher customization of solutions as therapies have tighter tolerances and smaller sub-populations. We also believe this is an industry with ample opportunity for M&A, creating an additional growth avenue for Danaher.

Diagnostics is Danaher's second-largest business line. The diagnostics industry is attractive because diagnostic testing represents a small percentage of healthcare system costs but has a meaningful impact on treatment and patient outcomes. There is also a high recurring revenue mix in diagnostics with reagents and test cartridge consumables and services representing 83% of diagnostic revenue for Danaher. We see industry-wide secular growth benefits from aging populations, growth in preventative medicine, increased companion diagnostics and testing alongside drug treatments, growth in genetic testing, and scientific and technology advancements expanding the diagnostics testing menu.

Within diagnostic testing, Danaher is exposed to the most attractive modalities with point-of-care (POC) and molecular diagnostics through their Cepheid business. Danaher should also benefit as they have invested behind diagnostics integration and workflow automation, which is becoming increasingly important. Despite some near-term headwinds on the equipment side of their business, we see a long runway for molecular diagnostics penetration. In addition, Danaher's consumables business will benefit over time from the more than 75% increase in their install base since the onset of the COVID pandemic.

Danaher's final two businesses are Water Quality and Product Identification (PID), which are reported within Danaher's Environmental & Applied Solutions (EAS) segment. Within Water Quality, Danaher provides water quality analytics, testing, and measurement through Hach, chemical metering and pretreatment through ChemTreat, and UV disinfection through Trojan. We believe these are some of the most attractive niches within the water industry given low capital intensity, low cyclicality, high touch/service model, and barriers to displacement. Within Product Identification, Danaher provides high speed labeling & coding for consumer-packaged goods (CPGs) with VideoJet and color formulation & packaging design with X-Rite and ESKO.

Similar to Life Sciences and Diagnostics, both Water Quality and PID have large consumable revenue streams, represent a small percent of their customers' cost base, and have regulatory and/or process lock-ins. Growth tailwinds within Water Quality include regulatory requirements and a growing number of contaminants. Within PID, tailwinds include growth in traceability and product tracking. While both Water Quality and PID are good businesses in their own right and Danaher has strong positioning within both, we expect EAS to be less meaningful to Danaher's results over time, and we wouldn't be surprised if that part of the business were eventually spun-out to focus on more profitable businesses, like their Life Sciences and Diagnostics platforms.

We expect Danaher to benefit from strong secular growth trends within the industries they participate and for internal execution through DBS to drive market share gains over time. Additionally, withing Life Sciences and Diagnostics, we see long runways for M&A. We believe a combination of secular growth, high competitive moats, strong management, differentiated culture, and value-creating capital allocation makes Danaher a high-quality long-term compounder. With the market decline in 2022, we were able to initiate positions in Partners III Opportunity Fund and Partners Value Fund and add to our positions in Value Fund and Balanced Fund at what we believe are attractive prices.

As of 06/30/2022, the following portfolio company constituted a portion of the net assets of Balanced Fund, Hickory Fund, Partners III Opportunity Fund, Partners Value Fund, and Value Fund as follows: Danaher Corporation: 2.1%, 0.0%, 2.0%, 2.6%, and 4.7%; Envista Holdings Corporation: 0.0%, 0.0%, 0.0%, 0.0%, and 0.0%; Fortive Corp.: 1.0%, 0.0%, 0.0%, 0.0%, and 0.0%.

Holdings are subject to change and may not be representative of the Fund's current or future investments.

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Investors should consider carefully the investment objectives, risks, and charges and expenses of a fund before investing. This and other important information is contained in the prospectus and summary prospectus, which may be obtained at weitzinvestments.com or from a financial advisor. Please read the prospectus carefully before investing.

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