Quarterly report Q1 2022

Looking at the result at the close of the quarter you wouldn't think anything out of the ordinary was going on: the portfolio has set a new record by noting a small plus. And all this while the past three months will in many respects go down in history as extremely turbulent and a large number of indices have plummeted in value. Where to start?

Naturally we start with the tragedy unfolding in Eastern Europe. Events in Ukraine relegate everything else - price results, returns and news streams – to second place. When you hear "Eve of Destruction" by Barry McGuire on the radio twice in one week, you know that all is not well in the world. A cynical Thomas Jefferson is quoted as saying:

"Peace is that brief glorious moment in history when everybody stands around reloading."

We're significantly more optimistic than he was, but the war in Ukraine is a clear reminder that things that seem self-evident aren't always so in reality. This brings us to the main trends in our line of business in the first quarter: inflation, interest rates and the energy markets.

You already know our opinion on inflation. Over the past few years we've written at length – almost to the point of tedium – of the enormous risks associated with the extremely expansionary monetary policies and the world's addiction to stimulatory programmes, which can supposedly be expanded and prolonged without any adverse effects. This naive assumption has been dispelled rather abruptly. Interest rates are soaring now that the world is being confronted with the logical price of this policy: inflation. Not that long ago, economists and fund managers attempted to convince people that inflation was a thing of the past and that high interest rates would never return because of the ageing population and high levels of savings. Or because it wouldn't be convenient when so many countries are already burdened by so much debt. Yes, well.

One of the most important traits that investors often lack is a well-developed sense of history. The simple fact that, until a few years ago, interest rates had never been negative in the whole of documented history ought to warn observers of the shelf life of such an anomaly. Investors have notoriously short memories, however, and it's tempting to start believing in the tenability of the anomaly after a few years of extreme conditions. And once you've taken that step, you can carry on putting long-term government bonds, tech equities and growth investments in your basket. It's precisely these investors who were given a reality check in the first quarter.

When central banks print more money for long enough, apparently without identifying any adverse effects, it's only a matter of waiting for the spark that suddenly makes investors and the market realise what's going on. And that spark has now arrived in the shape of tightness on the energy markets. European and US 10-year bond yields rocketed in the first quarter, quite rightly, and in doing so claimed victims left, right and centre. The fun has suddenly gone out of holding businesses in the portfolio that only hope to earn a cashflow in the distant future, or that are so expensive they'll need to generate earnings for many decades for buyers to recoup the purchase price. The no-nonsense Value method isn't particularly bothered by all this.

When you buy a company at a low valuation, you quickly recoup your investment and interest rates don't make that much difference. Moreover, the flow of penitent investors from the growth universe towards value investments helps boost the prices of the much cheaper value equities. And that's precisely what we saw happen in the first quarter. What we're seeing now is only the very beginnings of a shift that has the potential to continue for some time. The difference in valuation between the two styles is so enormous that even now it's still not too late to exchange growth equities for value investments.

Then there are the energy markets.

The already extremely tight energy markets suddenly had to contend with a new factor: Russia. As a result of the US boycott of Russian oil, for instance, the big question is how supply and demand will evolve over the coming months. As we've said before, demand for oil is likely to reach a new record high this year. The question is whether the supply side will be able to meet this. Many years of underinvestment in developing new oilfields, on the basis that we'll all soon be switching to fossil fuel-free energy anyway, mean there are very few options for compensating for the lack of Russian oil. There are still a number of OPEC countries, including Saudi Arabia, that could raise production, but there are also several countries in this pact that would struggle to supply the required quantities. We simply cannot afford not to keep buying Russian oil. Even with a total boycott by the West, Russian oil will of course still find its way onto the market, as countries such as India and China will continue to buy it under the right terms and conditions, but any friction in the system will lead to higher prices.

A couple of quarterly reports back we described our decision to invest in oil and gas in some detail. For a while there was a sense, prompted by ESG campaigns, that we should stop oil and gas production as we ultimately need to head towards a fossil fuel-free world. We couldn't agree more but are perhaps slightly more realistic about what needs to happen in the interim.

The last few weeks have made painfully clear how badly the world has shot itself in the foot over this. Years of pressure on major oil companies to stop searching for new oilfields had already created an exceedingly tight market and now that a further 9% of global production, Russia's, has been compromised, the cat has really been set among the pigeons. The upshot is a sharp upturn in oil and gas prices, and this has caused public opinion to undergo an abrupt 180-degree reversal. Almost overnight, all previous objections have been forgotten and a majority of the Dutch population is now in favour of additional gas extraction in Groningen and the impact on the climate no longer even seems to be relevant. We've said before that an extremely tight oil market is in fact a great outcome in this debate. Solar panel installation companies have never been so busy, heat pumps can't be manufactured fast enough and thermostats are tentatively being turned down. Those pension funds that shouted loudest about no longer investing in oil and gas are starting to moderate their tone and reverse their opinions. It's a predictable outcome. Although no-one had foreseen the war in Ukraine per se, it was simply a matter of time before an event occurred that revealed the beginnings of oil production shortages.

All good intentions aside, we're likely to use a record amount of oil this year. If its production is subsequently blocked, prices will simply rise. Our investments in a range of oil companies meant that all these equity price losses passed us by in the first quarter.

The extremely low valuations in this sector mean that this part of the portfolio will experience a strong tailwind over the coming quarters as well. The highly positive conditions under which our Kurdistan producers can extract their oil ensures that emissions per barrel are substantially lower than the global average. In the time we need to be able to switch from fossil fuels to renewable energy, it's precisely this type of efficient producer that we require to meet demand. The higher oil and gas prices rise, the shorter the transition will be and that's ultimately excellent news for the planet.

M&A

The long-anticipated rotation from growth to value investments is most clearly visible in the number of acquisitions in the portfolio. We received an offer on our Hunter Douglas stocks on New Year's Eve, are selling our Yew Grove equities to a Canadian real estate investor and have also witnessed a takeover of John Menzies. At the time of writing, Caretech has received a bid from major shareholder Faroukh Sheikh and shortly afterwards a second interested buyer came knocking, outbidding Faroukh. Last week we saw an investment from the Special Bond Fund, Hibernia REIT, withdrawn from the stock exchange at a substantial premium. The speed at which undervalued companies are currently being snapped up is a sign that other businesses and investors also recognise the enormous opportunities to be found in the value spectrum of the market. Hibernia REIT is perhaps one of the clearest examples of asset mispricing we've seen for many years. Hibernia owns a collection of office buildings in the centre of Dublin and leases these to all kinds of parties, primarily US tech companies. So there's nothing wrong with the quality of the tenants or the location of the buildings. For the right premises tenants are often prepared to conclude multi-year contracts in which rents are adjusted for inflation. A great asset, you'd think. And you'd be right, except when the company is listed on the Irish stock exchange. Investors are rather fickle when it comes to Irish equities. It's a phenomenon we like to keep an eye on, as true bargains are often to be had in Ireland during downturns. Over the past few years, not least around the time of Brexit, investors have displayed little enthusiasm for British and especially Irish stocks. And that of course makes us even more keen on them. In the last couple of years, it was possible to buy Hibernia REIT, listed on the stock exchange since 2013 and trading at more or less its intrinsic value in the first few years after the IPO, at a substantial discount versus its underlying value. Until recently, investors could buy this group of office buildings at a discount of 35% of the market value. And that's crazy. The same period saw regular transactions in which buyers, such as pension funds, were perfectly happy to pay the market value when individual buildings were up for sale. That means the problem didn't lie in the value, it was simply the structure of the market listing that was standing in the way of fair pricing.

A wonderful example of these absurd differences was once revealed when together with a broker we were invited to a capital markets day that included visits to the buildings owned by some of these listed REITs in Ireland. One of our Dutch travel companions worked at a Dutch pension fund that was extremely interested in these buildings as an investment for the portfolio. When asked whether he had any interest in the Irish REITs he admitted that he would like to be but his boss thought them too risky an investment. The stock prices fluctuated daily and that just caused problems. They preferred to buy buildings because they only needed to revalue them once a year. The fact that the REITs could be bought on the market at a discount of as much as 35% wasn't even a factor in their deliberations.

It was only a question of time before someone put in an offer to take advantage of the opportunities that were ripe for the picking. The offer on Hibernia REIT at a price very close to its intrinsic value means that the last of the listed REITs have now been sold from the portfolio following the sale of our other REIT, Yew Grove, at an excellent price earlier this year. We're pleased to be selling our Hibernia REITs at this price and will immediately reinvest the proceeds in all kinds of other attractively-priced securities.

Gemfields

An obvious candidate for the next delisting is Gemfields. We've written about this special name on several occasions and do so again after the company published its results over 2021. In the previous quarterly report we were hoping for a first dividend and this was indeed announced recently. It marks a milestone in the troubled history of this market fund and rewards shareholders for their patience and faith of the past few years. We still think Gemfields to be an absolute bargain at a price of ZAR3.60. The dividend, of about ZAR0.25, gives investors a cash return of 7% and that's a great starting point. Yet this is only a portion of the underlying earnings, as the company is holding on to the overwhelming majority of the earnings and reinvesting them in further growth. At a price/earnings (P/E) ratio of about 5, this is one of the cheapest equities in our portfolio. And this isn't even taking into account the fact that Gemfields held a cash position of over USD62 million as of the year end, as well as an interest in a platinum mine that could well yield tens of millions of US dollars in the near future. If you adjust for all this, the company's valuation drops to a bit more than three times its annual earnings. Even more remarkable is that Gemfields is also one of the fastest-growing companies in the portfolio. Revenue is soaring as a result of the sharp upturn in prices for both rubies and emeralds. Gemfields recently reported the outcome of the first auction of 2022 of commercial-quality emeralds. A total of more than 4.5 million carats of these stones were sold (about 900 kilos) in the Indian city of Jaipur, netting the company over USD42 million. This translates into USD9.37 per carat, 42% more than at a similar auction last year. And that was a new record at the time. You have to realise though that not all carats are equal. In the premium segment, carat prices can be many hundreds or thousands of US dollars, making it impossible to compare carat prices.

What you can do is compare prices at previous auctions of the same class, and when you do so you can see that carat prices are shooting upwards. This is of course excellent news for all future auctions, both in the commercial and premium segments and for both emeralds and rubies. We expect the revaluation of coloured gemstones versus diamonds to continue. Incidentally, the diamond market is also in good shape. About 30% of global diamond production comes from Russia. The United States, buyer of about 40% of the world's diamonds, has placed Russian diamonds on the boycott list. With the biggest importer now forced to buy diamonds from other countries, prices are rising. Indirectly this is also good news for coloured gemstones. In uncertain times we also see a renewed focus on safe havens, such as gold and gemstones. Add soaring inflation to the mix and we have all the ingredients for higher prices. We therefore anticipate another year of record revenue and earnings and believe our position in Gemfields to be an excellent investment. As we've mentioned before, another interesting fact is that the company could well be a candidate for a takeover.

Assore, a large South African mining conglomerate, bought 30% of the company's stocks at the end of last year. A second strategic party from the Middle East also surfaced at the beginning of this year, meaning that there are a couple of candidates for putting in an offer on the company. We're happy to wait and see what happens and remain extremely enthusiastic about this company, which we believe could fairly easily double in value from today's level.

The Hut Group Plc (THG Plc)

The 2020 pandemic provided an additional boost for internet stores after many years of sharp growth but also substantial investment to acquire market share. The online retail sector is not unique in this, takeaway delivery companies are another good example of large-scale investment and high growth forecasts that might recoup the investment at some distant date. In the meantime, their stocks are trading at high multiples.

Ahold is hoping to list Bol.com on the stock exchange later this year and in doing so unlock a portion of the value, in part bowing to pressure from activist shareholders. Ahold has always been exceedingly cautious in its statements about Bol.com's revenue and earnings. This makes it tricky for investors to value the company, but it certainly hasn't enjoyed high earnings over the years. Ahold claims it will be easy to turn a profit but that it also needs to build on the brand itself.

The online retail sector faced a range of negative effects in 2021: stock shortages, higher transport costs, staff shortages and lower growth pushed equity prices down sharply. Partly because of this the planned market listing of Dutch company Coolblue didn't go ahead. Countless online retailers are listed on the UK stock market and these also yielded extremely negative returns in 2021.

The bankers supervising the Coolblue listing liked to compare it to a similar company in the same industry: **The Hut Group Plc** (THG Plc). This Manchester-based business was founded in 2004 to trade in CDs, DVDs and games. The company has since transformed itself into a global cosmetics and health food company selling its own as well as other well-known brands. In terms of revenue THG is similar to Coolblue (GBP 2-3 billion), even though they operate in very different markets. THG enjoys much higher profit margins than Coolblue's electronics products.

Founder and CEO of THG Matt Moulding is an eccentric. He likes to style himself as the 'British Jeff Bezos' (CEO of Amazon). If you google him, you'll undoubtedly find a picture of him clad only in swimming trunks and showing off his gym-toned body. He mentions the fact that he works out daily all too frequently. Just what you'd imagine a self-made entrepreneur to be: shrewd, straight talking and not short of opinions.

One afternoon in 2020, Moulding decided that the next step for his company was a stock market listing. You might think that's not something you decide on the spur of the moment, but according to Moulding he did just that and presented the idea to his team. And that's exactly what happened: The Hut Group was listed on the stock exchange in the autumn of 2020, with a slick campaign pushing the company's stocks to unprecedented levels.

It was the biggest market flotation of a company in the UK since 2013. On the day of the Initial Public Offering (IPO), its market value rose by 25% and later climbed to an unprecedented GBP 7 billion.

Yet it would take investors more than 60 years to recoup this value based on the company's pre-tax profit at that time. Not exactly a value investment.

In a low interest rate climate, sound growth forecasts offer investors substantial compensation. And growth is what THG works hard to achieve. In the years 2015-2020, revenue grew from GBP500 million to GBP1.6 billion. Investors were also in raptures over the Ingenuity branch of THG. This business unit (in which Japan's Softbank is also involved) supplies algorithms and marketing services aimed specifically at creating customer loyalty. Ingenuity is dismissed by critics as a glorified marketing department. At THG though they like to boast that they've created a separate department that in addition to its own marketing can also provide marketing and the logistics chain for other companies and in doing so generate revenue and earnings. The number of companies making use of these services is growing fast.

This part of the company only generates a small portion of THG's revenue. Alongside Ingenuity (9% of group revenue), there are now the highly profitable Beauty (approx. 50% of group revenue) and Food divisions (36%). Yet these sound and stable earnings still don't justify a market value of GBP7 billion. Since the spring of 2021, investors have also started to wonder about the company and the sector as a whole.

CEO Moulding accusing the outside world of wanting to bring THG down during a meeting of investors and analysts hasn't helped either. Short-sellers rubbed their hands in glee and partly as a result of this the share price plummeted from GBP6 last year to its current price of 95 pence. The stocks have now become speculative but are still largely in the 'permanent' hands of large parties. Those investors that have been there from the start are now looking at a price loss of over 80%, and we're not talking small fry either: Blackrock, Goldman Sachs, Norges Bank, Vanguard, Pictet and Sofina Belgium are all top-10 shareholders in THG.

You're probably wondering whether this can still turn out well. After the price fell a further 50% in January 2022, we seized the opportunity and added THG Plc stocks to the portfolio. We did so because quite apart from all the developments, accusations and price losses there remains a sound basis for unlocking value. The company's market value has since fallen to GBP1.3 billion. Revenues will grow to about GBP2.5-3.0 billion in 2022. Its customers are extremely loyal (partly thanks to the subscription model) and margins are high for the segment in which THG operates. Moreover, the company holds about GBP0.5 billion in cash on its balance sheet, which means that its net debt position is zero.

The divisions alone are worth much more than today's market value represents and that's without the company growing, which it continues to do.

We expect the Beauty division to be given a separate stock market listing later this year. This division can be compared to major players, such as Estée Lauder, L'Oréal and P&G Beauty. If we examine the company's valuation, then this part of THG alone is worth 1.5 times the market value based on conservative estimates. Sector peers are trading at multiples of 3-4 (source: Davy research). All this still has to come to fruition of course, the stock is currently exceedingly sentiment driven and also the target of day traders and short parties attempting to cash in on the situation.

We're monitoring the company very closely and eagerly await publication of its annual results in April as well as further developments this year.

OVMK Special Bond Fund – bond yields and Zhenro Properties

The OVMK Special Bond Fund had a poor February. A drop of about 8% is certainly not normal for a bond fund. However, if you think this is related to the higher bond yields (including on government bonds), we'd like to disabuse you of the notion. The Special Bond Fund doesn't invest in government bonds. The global bond market is currently facing its biggest annual loss since 1994. The Global Agg (a bond benchmark) is more than 12% lower than it was 15 months ago (source: FD). For bond markets this is the equivalent of an earthquake.

As you're probably aware, we think *government* bonds as an asset class are an unattractive investment. This is because the interest compensation is often fixed and very low. However, investors are being confronted with inflation and in turn an erosion of purchasing power. The OVMK Special Bond Fund focuses mainly on *corporate* bonds with potential.

Last quarter we wrote about the opportunities we'd identified at Chinese property developer **Zhenro Properties**. It's here that the reason for the recent drop in the Bond Fund lies.

Following meetings with the company, we were enthusiastic about the fact that Zhenro would easily be able to redeem the bonds we'd bought in 2022. The company announced that it had renewed its credit lines with banks, it was buying back bonds on the market and planned to redeem a perpetual bond early. All these facts boosted our confidence further.

Although the sector is going through a difficult patch (comparable to 'our' 2007-2009 credit crisis), it looked as if all would turn out well at Zhenro, even though January saw sales dip for the first time. Unfortunately, in January and February Zhenro reported that the banks had withdrawn the company's credit lines after all owing to the sector-wide uncertainties. Zhenro will now need to fund its own working capital and (re)financing. This doesn't mean it will have used up its bank balance by the end of this year but does mean the company needs to set aside some provisions.

This was of course bad news for the value of the Zhenro bonds and they fell to levels at which the market is pricing in a restructuring. Time will tell whether this is necessary, but even so this could still be positive. Zhenro is experiencing short-term liquidity problems (as is the entire sector) but it also owns the right assets (land bank, accepted projects and existing properties).

The real estate sector is too big to be thrown to the wolves. Easing strict policy measures implemented in 2020 is a partial solution. The sector-wide acquisition of assets will also make the sector healthier. Access to credit needs to be restored, however. No sector can operate normally without credit from banks. This process is ongoing but won't happen overnight.

Zhenro had no option but to ask its lenders to extend the maturity of the bonds. In doing so it was following in the footsteps of other companies. The management set to work and immediately rolled over all the USD bonds due to expire in 2022 into a single bond that expires in 2023. This gives Zhenro breathing space to work on solving its liquidity problems this year.

Despite the fact that Zhenro made a profit over 2021 (!) and enjoys a healthy solvency ratio, it cannot be ruled out that these developments lead to the bond being extended by another year in 2023. One positive aspect in our view is that Zhenro continues to pay interest and is consequently not in default.

We've therefore agreed to extending the maturity of the bond but as mentioned this did result in the Special Bond Fund falling sharply in February.

Incidentally, the other bonds from this sector that we purchased in 2021 are also displaying positive trends. The Agile, Dexin, China South and Guangzhou bonds are holding up well in this tumultuous market.

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