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Quarterly report Q1 2023

It was a turbulent first quarter in a variety of areas. After recording some all-time highs in February, the portfolio was forced to relinquish these gains in what proved to be an extremely eventful March.

The first two months of the year were dominated by optimism that inflation seemed to have peaked. We've written on this topic before. Whereas until last year no-one believed we'd ever see inflation again, then everyone went into shock when it materialised after all and we saw relief of sorts in the first couple of months of this year when inflation started to fall, we've always attempted to view the concept of inflation from a historic perspective. As the saying goes, history may not repeat itself but it often rhymes.

Inflation averaged 3.2% across the whole of the last century. In the past ten years, during which time inflation was virtually zero, we were constantly aware of being in an exceptional situation. We therefore constructed our portfolio at all times in keeping with the idea that the situation would normalise sooner or later. That meant not buying any long-term bonds, avoiding tech and growth equities and in doing so missing out on the market tailwind in these from time to time. The situation underwent a reversal last year and we were barely affected by the sudden headwind that arose.

In March the OVMK Special Bond Fund was obliged to surrender the gains it had made in the first two months of the year. The main reason for the negative performance in March was the forced merger between UBS and Credit Suisse and the general turmoil among financials. Following the abrupt collapse of Silicon Valley Bank in the US, a bank run started on Credit Suisse. The latter, which is in the midst of a restructuring process, suddenly became easy prey for speculators and was obliged to throw itself into the arms of UBS. The Swiss regulator casually wiped out Credit Suisse's additional Tier 1 (AT1) bonds, an act that is likely to result in long-running lawsuits. Fears of potential contagion caused the equity and bond prices of nearly all banks and insurers to nosedive. We don't think there's any justification for this. The current situation cannot be compared to that of the 2008 financial crisis. Thanks to that crisis, banks and insurers have had over a decade and a half to improve their balance sheet ratios. Increasingly strict capital requirements mean that financials have much more to fall back on than before.

This doesn't mean that individual banks can't get into difficulties or be targeted by speculators but there's a much smaller risk of major problems for the sector as a whole. However, shorters were able to make money from the uncertainty that suddenly surrounded the sector. Banks are an atypical investment, one in which facts sometimes matter less than market perception. Panic briefly flared around Deutsche Bank, for instance, because Credit Default Swaps (CDSs) suddenly rocketed. These are instruments used as insurance against a specific company defaulting.

In retrospect the panic turned out to have been triggered entirely by a single, admittedly sizeable trade in these CDSs and the panic rapidly evaporated again. It nevertheless demonstrates how vulnerable the sector can be. Although, as we said earlier, bank balance sheets are much more robust than they were 15 years ago, things can be set in motion more quickly than ever.

In answer to the question of how it was possible for Silicon Valley Bank to fail so quickly, Steve Schwarzman - CEO of Blackstone, one of the biggest asset managers in the world - said: “Because of people on iPhones”. And that’s the only correct answer nowadays. Aside from this short-lived panic, financials continue to provide interesting investment opportunities as for the first time in years they can again derive substantial earnings from the interest margin. Investors are therefore in two minds and would be well advised to spread their interests when considering investing in this sector, but we believe they’d be wrong to ignore the sector completely because of an isolated incident. The valuations are simply too attractive to do that. The downturn in prices in the Special Bond Fund may hurt in the short term but they also raise the expected return from this point and that makes a recovery probable.

Kurdistan

March was likewise a tumultuous month for our Kurdistan names. The verdict in a long-running arbitration case between Turkey and Iraq caused wild price swings in Genel, Gulf Keystone and DNO. What’s going on here? Kurdistan is a semi-autonomous region in Iraq. The region, with Erbil as its capital, is both independent and part of Iraq. And this causes friction from time to time. Kurdistan’s budget is highly dependent on the production and sale of oil. Even though many Kurdistan oilfields are in the hands of Western companies, they provide a considerable amount of income for the Kurdistan government. This is because the government holds interests in these oilfields, receives royalties over their production and earns money from the sale of oil transported via the Ceyhan pipeline to Turkey, from where the oil is then sold to the rest of the world. It’s precisely this pipeline that is the subject of the dispute. The pipeline has been in use since 1973 and Kurdistan has also used it to export oil since 2014. Iraq isn’t at all happy with this arrangement. It believes that the sale of oil is a national matter and that Kurdistan shouldn’t be permitted to use the pipeline. Or rather not without Baghdad’s blessing. Iraq certainly doesn’t want Kurdistan to be able to decide on oil sales itself and wants Baghdad to make these decisions and not Erbil. This unusual relationship has caused regular conflicts ever since we started investing in the Kurdistan names. As Erbil depends on the budgets it’s allocated by Baghdad for paying civil servants, teachers and hospital staff as well as the international companies that produce the oil, these conflicts frequently lead to payment arrears.

After years of preparation, the long-awaited verdict was recently announced in the arbitration case surrounding the Ceyhan pipeline. As was widely expected, the ruling was in Baghdad’s favour. In tangible terms, this means that Baghdad may decide who puts oil into the pipeline and could therefore refuse to accept oil from Kurdistan. This gives the country de facto say over Kurdistan’s oil production and is exactly what it was aiming to achieve. The ruling isn’t entirely unexpected of course. Kurdistan could see which way the wind was blowing and in recent months there has been close contact between Erbil and Baghdad that has resulted in the two parties reaching an agreement in principle. From now on, Baghdad will assume responsibility for oil sales and share the income with Erbil on the basis of a formula.

However, the Paris court of arbitration's sudden ruling came slightly too soon and the final contracts hadn't yet been signed, which has created a vacuum in the transport of oil. Pending resolution of this situation, Kurdistan decided to temporarily halt the transport of oil and this weighed heavily on the prices of the Kurdistan names. We believe the situation will be resolved quickly. A lengthy period of no oil being supplied is in no-one's interest and there's enormous pressure to reach a definitive agreement soon. Charly Munger (Warren Buffett's business partner) once said, quite rightly: "Show me the incentive and I'll show you the outcome". We therefore assume a speedy end to this deadlock. It's unclear whether the contracts between the oil companies and the Kurdistan government will also need to be amended or whether there will only be adjustments to the way Erbil and Baghdad split the income. Any agreement between Baghdad and Erbil that doesn't involve amendments to the contracts between the oil companies and the Kurdistan government would be positive for the oil companies. It would remove an important factor that has squeezed equity prices for years. The companies are also likely to be paid more regularly and no longer be subject to the erratic payment behaviour of the Kurdistan government, which because of its tight budget cannot always pay them immediately. The wild price swings presented major opportunities. Not all the names dropped by the same amount and within the spectrum we were able to make some changes to take advantage of the relative price movements. A fascinating situation which we're of course monitoring closely and is highly likely to be resolved soon.

PS: On 3 April, Baghdad and Erbil announced that they had indeed reached agreement, with Baghdad taking over control of oil sales from Erbil. In response to this news, the prices of Gulf Keystone, Genel and DNO recovered to their levels before production was halted. OPEC+ also decided to restrict oil production, which generated a tailwind for oil producers based on the sharp upturn in oil prices. The positive price impact of this came just too late to occur in March.

BOE Varitronix

An important name in the OVMK Hong Kong Fund is BOE Varitronix. This company merits some special attention owing to the large weight it now occupies in the fund. And we're happy to oblige as there's a great deal to say about this wonderful company. We've been a shareholder of Varitronix since the fund's inception at the end of 2009. At that time, the company had an annual revenue of HKD1.8 billion.

Last year, it reported revenue of HKD10.8 billion and this year we can probably easily add to that the entire annual revenue from ten years ago. This makes it a rapid growth company in a fast-changing market. BOE Varitronix was added to the portfolio when it was still called Varitronix. Like most of the investments in the fund, the Hong Kong-listed company is Chinese and all its production assets are in China. Varitronix is a large manufacturer of LED/AMOLED screens that are primarily supplied to the automotive industry. The company started manufacturing the very first screens many years ago when these were mainly TFT screens, firstly black and white and later colour screens.

Yet problems arose when car manufacturers started asking for increasingly high grade screens and the investment required to build a new factory was too big for Varitronix to bear. The company had two options: either keep going as long as possible with the manufacture of simple TFT screens, which are also found in products such as battery-powered drills, Barbie dolls, toys and vacuum cleaners. Or take the plunge, find a partner with the required resources and work together to meet the changing demand from the industry. Varitronix decided on the latter option and, in retrospect, found itself the perfect partner in BOE Electronics. BOE is a gigantic electronics manufacturer. It produces a wide range of components for all kinds of brands and can also manufacture screens on a large scale. A deal was struck in which BOE took ownership of half of Varitronix's shares, after which Varitronix changed its name to BOE Varitronix. In exchange, in addition to a large pot of money, Varitronix was able to buy screens at favourable rates to sell on to the automotive industry. In doing so, BOE used the knowledge and expertise of Varitronix to get a foot in the door of this rapidly-evolving market, in which vehicle electrification is leading to car dashboards needing increasingly state-of-the-art screens. The company has many years of growth ahead of it now that more and more car manufacturers are modernising their dashboards and using the most advanced screens to tempt consumers into choosing their brands. This means that the company could grow even bigger and despite the meteoric rise in its equity price cannot be labelled expensive. At HKD13.50 per share it's worth no more than about 13 times its expected earnings over 2023, and that's excluding its sizeable cash position. Its stocks have fallen again slightly from the peak of HKD20 dollar and in our view have an excellent chance of surpassing previous highs later this year.

It's all about cashflow

Sooner or later, anyone who studies the world of investing in any depth will conclude that investment is nothing more than a collection of future expected cashflows. An investor pays a one-off amount to become the owner of these cashflows and, in theory, company valuations ought to grow in line with the total present value of these cashflows. Value investors are notoriously keen on situations in which this isn't the case.

On paper, growth investors are basically also looking for this type of anomaly but are willing to forego cashflows in the short term in the hope of much bigger cashflows in the long term, based on the assumption that the company will have grown substantially by then. And this is precisely what we take issue with: any prediction relating to the distant future involves a huge amount of uncertainty. In this sense, value investors are in fact a more modest form of growth investor. Value investors openly admit that it's impossible to predict the future and therefore better to make as few predictions about it as possible and yet still receive enough cashflow to recoup the purchase price. And preferably more.

In this respect, it's worth taking another look at where our cashflow comes from. A clear pattern emerges when we focus purely on a small handful of big names in the portfolio. In both 2022 and 2023, our most important names gave back a record amount of money to investors.

Our biggest investments - Petrotal (13%), Genel (14%), GKP (14%), Impellam (12%), Gemfields (19%) and DNO (10%) – all paid out double-digit dividends. Many of these also have share buyback programmes and are retaining a portion of their profits to fund acquisitions or other expenditure. In short, the companies only need to continue making their current cashflows for a few years to convert their total valuations into cash. Furthermore, a significant portion of the valuations of most of these names already comprises the cash that is currently included on the balance sheet.

That's reassuring for investors because it sharply reduces the downside risk. The end of the era of free money in 2022 prompted investors to shift their focus back to the cash returns that an investment generates. Many growth investments lost a large portion of their value on that basis, while value investments acquired some new fans thanks to their low valuations. We think the coming years will revolve around cashflows and are happy with the profile our investments have in that regard.

Diversified Energy Company Plc

Imagine you need to arrange a new energy contract and have the option of fixing the price of a cubic metre of gas for the next three years at an average discount of 50%. Would you do that? Of course you would, it would mean certainty about the price you pay for gas plus a discount for the next couple of years!

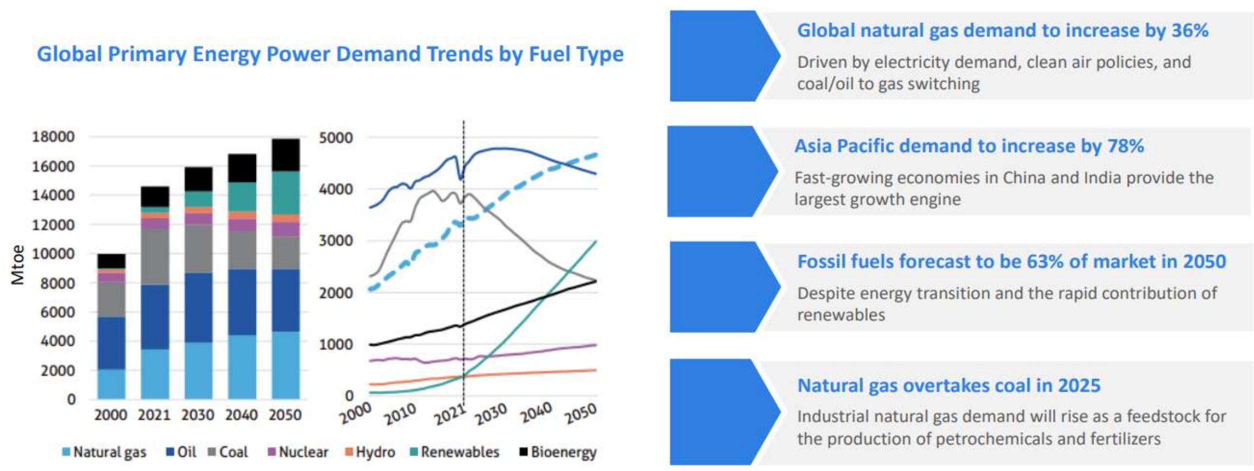
It may sound strange but you find similar situations on the stock exchange. Companies that can provide an enormous amount of certainty but are in the meantime caught up in the downward movement of prices in a sector. More on this later.

We first got in touch with the management of Diversified Energy Company (DEC) in 2021. Diversified is an expert in operating gasfields in the final stages of their lifespan. It has already built up an impressive track record by taking over mature gasfields and subsequently optimising, operating and closing them sustainably. As such, Diversified is a trusted partner of large companies such as ConocoPhilips. Large companies that wish to sell these assets but to someone they can trust. After all, negative news will reflect directly on the company that owned the location for many years. Oddly enough, DEC is listed in the UK but all its activities take place in the United States, in the states of Texas, Oklahoma, Kentucky, Ohio, Virginia and Pennsylvania.

Gas, a crucial component of the global energy mix

Although some people see things differently, these companies contribute greatly to today's energy mix as well as to the energy transition as we head towards 2050. Despite all the innovations relating to green energy generation, fossil fuels will still account for two thirds of the global demand for energy in 2050 (see graph below). The overall demand for energy will also grow as a result of population growth.

Within the fossil domain, gas (dotted line) is a crucial solution for replacing coal and diesel. Alongside restricting carbon emissions, methane gas is released during gas extraction. Diversified has received a golden rating in this respect from the UN programme for reporting methane emissions but also mitigating/capturing them. Only fourteen companies in the world possess this rating, while over 100 companies have signed up to the UN programme. These include Shell, Eni, BP, EQT (US market leader in gas), Total, Petronas and ConocoPhilips.



Source: Presentation by Diversified Energy Company PLC March 2023

Scale

Acquisitions and optimisation are the way to boost the company's scale. Since the IPO in 2017, this has been an extremely successful exercise involving USD2.5 billion in acquisitions, a return of 256% and USD530 million paid out in dividends versus a current market value of USD12 billion.

It's true that acquisition machines aren't generally viewed as a typical Value investment. Yet if a company is able to continue making acquisitions at a lower multiple, then along with the cashflows from the asset this contributes directly to the earnings per share. These actions are repeated time and again and when combined with price hedging (fixing of future output prices) create a highly predictable business. This makes Diversified an extremely defensive way of obtaining access to the volatile energy market. In addition, Diversified can present sound results in terms of growth in profitability, ongoing improvements in ESG standards and growth in revenue and dividends. Moreover, its management is experienced in building relatively small businesses into major market vehicles.

So why didn't we add DEC to the portfolio earlier? After all, the trading volume on the London stock exchange is more than high enough to accrue a position.

It comes down to the overall coherence within the portfolio and the fact that you sometimes need to wait for the right time or right opportunity. It's very easy to sell a sound investment out of the portfolio, but if we undo value in the process then we fail to achieve our objective.

Wall crossing

Between 2021 and 2023 we continued to talk to the company as well as to analysts and the banks providing advisory services. In February 2023 this resulted in OVMK being involved in the next major acquisition that Diversified planned to announce. We'd like to show you how this type of transaction comes about.

Prior to this kind of news being made public, there's a week of activities that take place in secret. For the company this first involves concluding the transaction but the next step is to obtain financing. This is done by issuing shares and bonds. To enable this, investors (in this case including OVMK) are 'wall crossed' by the bank advising on the acquisition. Wall crossing means that we declare that we will receive price-sensitive information but won't do anything with it until it has been made public. We then 'go restricted', as it's known.

The ball starts rolling from that moment. Investment bankers and sales personnel explain the intended transaction and terms and conditions to us. The aim is to sound us out about participating in the issue of new shares to fund the transaction. After this, a meeting is held with the management of Diversified. This enables us to clarify the terms and conditions of the deal so we can make a final investment decision.

The deal was a repeat of previous manoeuvres by the company. The acquisition of a production location that has yielded cashflows for many years and in 2023 (at fixed prices) will directly generate USD107 million in cashflows. Viewed from this perspective, an acquisition price of USD250 million isn't that expensive (multiple of 2.3) and that's without listing all the synergies the deal brings with it.

Aside from this decision, several things need to be organised on the back office front because as soon as the information is made public, the expedited filling of the order book for the new shares commences. In the UK, the traders at the banks advising on the acquisition are sent an E-mail telling them not to leave their desks at the close of trading as a deal is to be announced, although they don't yet know what the deal is.

The moment has come to apply for the new shares. The advantage of participating in this deal is that the placement often takes place at a small discount in return for the services rendered. On this occasion there was a 5% discount on the market price. The order book was closed after two hours as there was enormous interest in this deal (which accounts for 16% of the total market value). OVMK received the full allotment of shares for which it had applied.

This once again demonstrates that it's sometimes worth waiting. After all, if we'd bought the stocks on the market, we'd have paid 5% more for them.

Furthermore, it's always good to get onboard by helping to finance a deal. In doing so you create closer ties with the management as you've genuinely helped the company to grow.

2023 and beyond

We hope this gives you an idea of what such deals involve before these equities end up on your investment statement. Looking ahead, there's still plenty more to come to be enthusiastic about. Diversified plans a market listing in the US and its application is already at an advanced stage.

Global gas prices are currently facing a headwind. And that brings us back to where we started. Diversified has fixed its gas output prices at 85%, 80% and 70% respectively for 2023, 2024 and 2025. It's done so at a price that's between USD1.00 and USD1.70 higher than today's gas market price! This means it's possible to predict nearly 80% of the company's revenue and earnings for the coming years, and which investor wouldn't want that?

The downturn in the company's equity price that we've seen this year (-17%) is therefore excessive. This only makes DEC more attractively priced, with a free cashflow versus its market value of 40% and a dividend yield of 15% for 2023. In buying this stock investors get an inexpensive, well-managed company with a further value of GBP2.70 per share (after fees) in gas reserves (the market price at the start of April 2023 was GBP0.95). Gas reserves which, as we said earlier, play a crucial role in the global energy mix.

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