Quarterly report Q2 2022

The second quarter served to teach some valuable lessons to all those who had come to believe the promises long made by a variety of investment propositions. Whether it was bitcoins, growth equities or long-term bonds, anyone who had fallen for the tenability of the 'free money for all' mantra was in for a severe shock. The reason for this is of course the higher interest rates, triggered by inflation that appeared as suddenly as a genie out of an uncorked bottle. We've so far escaped unscathed and our portfolio has barely been affected this year. The bond portfolio did experience some headwind but the losses here were cancelled out elsewhere, for example in Hong Kong and thanks to our exposure to the energy sector. The absence of losses from the tech sector also helps to explain the portfolio's outperformance over the first six months of the year, which have been disastrous for most investors. The US markets took the hardest hit and noted their worst first half of the year since 1970. The AEX likewise took a severe battering and has so far dropped by about 20 percent.

These are happy days for Value investors. All manner of former market darlings are being toppled from their pedestals and this creates wonderful new opportunities. Although we're not overoptimistic about the economic repercussions of the tightening monetary policy and subsequent recession, it says very little about the attractive individual opportunities presented by the equity market. As always, the market is way ahead of what's happening in the economy and a recession has, quite rightly, already been priced in. It would therefore be a mistake to translate a pessimistic picture of the economy into a pessimistic picture of the market. We believe that a great deal of air is currently escaping from the bloated valuations of companies that have long deserved to see their equity prices fall. Investors who are deep in the red have more than likely simply paid far too much for their stocks and this year we're seeing a logical correlation between the size of the losses on such investments and the valuations at which they're trading. Companies with sky-high valuations are undergoing the corrections they deserve, while companies that are valued too cheaply are hardly experiencing any headwind. This is forcing investors to review why they're investing in the first place. It's tempting to see investment in businesses as little more than flashing prices on a screen that you need to own when they're rising and get shot of as quickly as possible when they drop in price. This is totally at odds with what we try to do. We invest primarily with the ambition of owning a selection of businesses that yield as much cashflow as possible. This cashflow can then be used to buy other investments, and if you do this for long enough this generates a force that is ultimately much stronger than the hope of outsmarting the rest of the world in the short term by buying and selling stocks. This latter strategy is the one used by the overwhelming majority of investors, yet it almost never works because one investor's gains are another's losses.

Coin clipping

Anyone who's surprised that all the years of expansionary monetary policy, QE programmes, support measures and bond-buying programmes ultimately led to inflation should take a good look at the coins in their pocket. You'll see that the edges of the coins are ridged. Not because it looks nicer or sits more easily in your hand but because it's a guarantee. A guarantee dating from a time when coins were still made from precious metals that no-one has shaved or clipped off a small piece of the metal.

The modern equivalent of coin clipping, simply printing more money, ultimately dilutes the spending power of this means of payment. And this is precisely why in the end prices will only go in one direction: upwards. Our society, with leaders who seek re-election every few years, is structured in such a way that it's tempting for those same leaders to avoid economic pain and put it off until some future date. Deferring payment or even leaving a successor to pick up the tab fosters sympathy among the electorate, and this makes it tempting for politicians to implement policies that yield positive effects in the short term. Coin clipping, or its modern equivalent of printing money, initially goes largely unnoticed. In the very short term everyone feels a bit richer, while in the long term this illusion is of course dispelled just as quickly once the public realises what's actually going on.

The financial markets, asset managers and investors had lost sight of this somewhat in recent years, when there was little or no inflation for long stretches, seducing them into thinking that this was a phenomenon from the distant past. On this basis, growth equities became outrageously expensive and investors even decided it was a good idea to buy bonds that had not only already priced in the absence of inflation but in fact even implicitly assumed it would never return. The best example of this lack of a sense of history is found in the pricing of the 0% Dutch State Loan 2052 bond. We discussed this bond in detail in the previous quarterly report. This bond was launched in 2020 at an issue price of 100%. Its price now? 56%. Losing money on an investment that could potentially yield a sizeable profit is one thing, it's quite another to lose money on an investment that literally yields a maximum profit of zero.

For the second half of the year we're very curious about what happens on the energy markets. This sector now forms an important building block in the portfolio and makes for some extremely interesting conversations. We've written in previous quarterly reports about the perfect storm in which we currently find ourselves. The fact that the major oil companies have been under pressure to stop searching for new oilfields for more than ten years has created a shortage on the supply side. However much we would love to reduce our oil consumption, for now demand continues to grow on a global scale. And someone has to produce that oil. Now that the dire situation in Ukraine has provided an external spark, the question is whether we can indeed supply all this oil. The boycott of Russian oil has already caused the Russians to slash production by more than a million barrels a day. JP Morgan recently published an analysis containing apocalyptic warnings. If the West introduces even tighter sanctions, Russia could respond by voluntarily reducing production. If Russia were to cut production from its current rate of about 9 million barrels a day to 4 or 5 million barrels a day, this would create such a supply shortage that oil prices could as much as double or triple. This is just one of many possible scenarios and doesn't match our expectations, but it does demonstrate how minor disruptions can have major repercussions. We therefore expect oil prices to remain high for the time being and believe that the companies we own in this sector are still priced as if all of this is temporary. We expect and genuinely hope that global demand will ultimately decline but are realistic enough to understand that we've not yet reached that stage.

We therefore need to ensure a plentiful supply of oil in the next few decades, while it's both desirable and essential that this oil is produced safely and relatively efficiently. Our Kurdistan oil names meet both these criteria and, if we have our way, they'll end up with the valuations they richly deserve. In the meantime, we're being extremely well rewarded via dividend payments.

Caretech

We're 'losing' yet another model name this year as a result of an acquisition bid. Having already lost Hunter Douglas, Hibernia REIT, YEW Grove and John Menzies, as well as potentially facing a bid on Impellam, it's now the turn of Caretech to exit the market. And we've got to admit that this one hurts. The company has been a fixture in the portfolio for many years and embodies precisely what we're looking for. Caretech is the business founded by Farouk Sheikh and his brother Haroon in the 1990s. It provides services for both children and adults with behavioural issues, a problematic childhood or special needs. Caretech has long applied an acquisition strategy in this highly regulated sector, acquiring local players and adding them to the Caretech group. This has enabled the company to grow and become more profitable by the year. A few years ago Caretech made a major acquisition, Cambian, another listed UK company that operates in the same sector. We were also a shareholder of this company and sold our equities to Caretech. Now it's the turn of Caretech itself. Faroukh, his brother and a number of external financiers, including Tree Hill, are removing the company from the stock exchange at a price of GBP7.50 per share. Given the market climate and opportunities we can identify elsewhere, we're pretty pleased with both the price and the timing of the deal. For years Caretech could be bought at a price that wasn't much higher than the value of its real estate, meaning that the operating activities were either completely disregarded or barely attributed any value. Sheikh is now taking advantage of this by removing the company from the stock exchange and presumably selling a portion of the real estate. We've enjoyed an excellent relationship with Sheikh over the years and have been closely involved in realising this deal. There's been huge uncertainty on the market over the last few weeks about whether the bid would go ahead, as the markets have come under considerable pressure since the bid was announced back in April. The fear was that Faroukh would withdraw or reduce his offer. This had caused the equity price to drop to GBP6.20 as of mid-June, far below the bid of GBP7.50. However, now that the deal is definitely going ahead the price has risen to close to the offer price and we've decided to sell our stock because there are so many opportunities out there at the moment that we're happy to allow someone else to earn a few more cents on it. In doing so we part ways from a great company that has a bright future ahead of it even without a market listing. We expect Sheikh to continue constructing his empire and perhaps expand further in the Middle East. The standard of care in that part of the world is low and we'd love to see Caretech's expertise being used to improve living conditions there too. We wish Caretech every success and can look back on a profitable investment.

Begbies Traynor/FRP

Our favourite stocks in tough times, Begbies Traynor, noted a new record price in June. Investors have little to choose from when seeking investments that manage to profit from an economic headwind. We hold two such names in the portfolio: Begbies Traynor and FRP.

The UK's Begbies Traynor is a name that's been in the portfolio for over ten years. Founded by its CEO, Ric Traynor, it's called in to settle bankruptcies, advise on restructuring and conduct auctions to sell real estate projects. All activities that flourish when there's a strong economic headwind. This makes it a rare counterweight that can absorb price pressure in other parts of the portfolio. We're seeing this happen again this year. Begbies is now trading at its highest prices since we purchased it ten years ago. In this time, the stock has risen from about 25p to 150p and that's quite remarkable.

Back then we bought our shares on the assumption that the low bankruptcy rate, thanks to the large-scale quantitative easing programmes rolled out by central banks in the aftermath of the credit crisis, would eventually rise when all these measures were reversed. As it turned out, year after year the central banks managed to come up with fresh reasons why it wasn't yet possible to normalise this Disneyesque monetary policy. Whether it was the euro crisis, the threat of another recession or the coronavirus, each time governments and central banks continued to pursue policies that are really only appropriate in extreme conditions. The general public's resilience has shrunk so much though that the slightest breath of a headwind is immediately dubbed 'extreme', resulting in companies that in fact ought to go bankrupt being kept afloat. The wave of bankruptcies we expected after the credit crisis therefore completely failed to materialise. However, if we look back at how Begbies Traynor's equity price has evolved since we first bought the stock, we've got no reason to complain. The shares are now worth six times what they were then and the larger part of our purchase price has since been paid out in dividends. The reason for this is that Begbies Traynor operates in a highly profitable niche. An essential technique when selecting investments is to accurately estimate the specific characteristics of the market in which the company operates. In this case, we're talking about the market for settling bankruptcies. It will be plain to all that when a company suddenly gets into difficulties and requires either a rescue plan or settlement (ideally including a restart, acquisition or restructuring that preserves as much value and as many jobs as possible) Begbies Traynor's fee is more a given than a matter for negotiation. This is an ideal basis for generating above-average margins. Moreover, there's a high degree of customer loyalty in this market. Banks, authorities or accountancy firms like to work with the same partner time and again, meaning that customer turnover is relatively low. Another driver of growth and profitability over the past ten years has been the company's successful acquisition policy. Each year Begbies acquires several small businesses, in the process taking advantage of the fact that these can be absorbed at valuations that are lower than the company's own valuation. Paying a portion in cash and a portion in its own shares enables it to create structural value.

We once more find ourselves at a critical juncture. Yet again it looks as if we can expect a significant increase in the bankruptcy rate. Although this has previously always been nipped in the bud by support measures, on this occasion these are being scaled back. With rapidly rising interest rates, a downturn in consumer spending and a potential recession just around the corner, there is good reason to assume that this sector is indeed heading into a busier period.

If this proves to be the case, then Begbies will experience a proper tailwind for the first time since we bought its stock and investors could well decide that it's the ultimate investment in a tough economic climate. The exact same situation applies to FRP, a more recent addition to our portfolio from this sector. This company is a competitor of Begbies but focuses on settling larger-scale and more complex cases. FRP is no stranger to making acquisitions either and the outlook for further growth is extremely good. We bought this stock in 2020, when the company was first listed on the market. Its current price of 154p is almost double the offering price of 80p. At valuations that continue to be far from high, we remain enthusiastic about both these names. These investments fit perfectly within a broadly-diversified portfolio and do their job when the world faces a headwind. And as we said earlier, there aren't many of them about.

Wentworth Resources PLC

Another name with a low valuation is UK-based Wentworth Resources. Wentworth is the main supplier of gas in Tanzania. It was last year that we became acquainted with this great company headed by CEO Katherine Roe, who took up the position in 2019.

Its business case is fairly simple. Produce gas, in the process generating cashflows, pay a dividend, repeat. A highly predictable, low-cost strategy with a focus on economic cooperation with the local population. The contracts for supplying gas comprise an annual price correction based on the US consumer price index. The supplied gas is therefore inflation-linked and this is an exceedingly positive point. It results in an affordable price per cubic metre of gas for customers but also a price at which Wentworth is able to implement its strategy. A win-win situation for the authorities, consumers and shareholders alike.

Approximately 64 million people live in Tanzania (almost as many as in the UK) and the population is set to grow explosively to over 120 million in the next two decades. Average economic growth stands at 6% and demand for gas is still experiencing annual double-digit growth (source: World Bank and Wentworth Resources). Ties between the UK and Tanzania date back to the early 20th century when Tanzania became a British colony after Germany lost the First World War. Tanzania became a democratic republic in 1961 and nowadays has a female president. There's a reason why first Germany and later the UK colonised part of the country: it has large reserves of gold, diamonds, coal, iron, nickel and also gas.

The Tanzanian government has committed to the goal of connecting all inhabitants up to the power grid as of 2030. Power stations in countries such as Tanzania often still run on diesel and that's neither sustainable nor efficient. Gas will save the government billions of US dollars and help substantially reduce CO_2 emissions. Along with hydroelectric power stations, gas suppliers represent the most important energy solution for Tanzania.

Following a lengthy start-up period in the early part of this century involving concessions, investment, research and development, Wentworth supplied its first gas in 2015. This type of specific and technical knowledge is often not directly available in these countries but a combination of local expertise and specialists from abroad was used to set up the main Mnazi Bay project and this has now been fully operational for several years.

Mnazi Bay is run by a consortium of three companies in order to spread the risk, as is often the case with this type of gasfield. It provides 50% of Tanzania's current energy needs. In the long run though, that's not enough to meet the growth in demand.

Wentworth recently announced it was taking a 25% interest in a neighbouring gasfield in Tanzania called Ruvuma. It was discovered in 2012 and is now almost ready to be taken into production. This transaction has the potential to double Wentworth's production as of 2025. The recent acquisition cost USD3 million in pre-financing and will cost a maximum of USD16 million in further payments. Wentworth will easily be able to fund the deal out of its free cashflow and substantial cash position of USD26 million at the present market value of USD50 million.

Another thing that can be financed from (current) cash(flows) is the dividend. CEO Roe has always shown herself to be extremely prudent when it comes to dividends. Her prerequisite is that dividends must be affordable, stable and growing. Last year the company paid out USD4 million in dividends, which translates into a dividend yield of 8% at its present equity price. However, this also included a one-off windfall. Based on Wentworth's current dividend policy the normal dividend yield stands at about 6-7%. Last year's free cashflow also enabled the company to set up a share buyback programme for 5% of the outstanding shares.

All in all, the meetings left us with an exceedingly positive feeling about this company and since its inclusion in the portfolio over a year ago it certainly hasn't disappointed in terms of performance. Wentworth's underlying performance has only improved even further and the outlook is positive. The one marginally 'disappointing' aspect is the equity price. The share price has remained more or less unchanged over the past year.

Perhaps its small size is the reason why the company's performance isn't being expressed in a higher market value. This a common 'problem' for small, listed companies with what look to outsiders to be risky assets. It also leads to us holding what is a relatively small weight in Wentworth for our portfolios. Nevertheless, Wentworth enjoys strong fundamentals and has a proven gas supply that will be able to contribute to the Tanzanian economy's energy problem over the next 10-15 years.