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Quarterly report Q2 2023

The portfolio took as few risks as possible in the first six months of 2023 but nevertheless earned a very small loss. After noting an all-time high earlier in the year, we experienced a price headwind in April and May. This is a direct consequence of enjoying only a very slight correlation with the market. Last year this worked in our favour: whereas the portfolio closed 2022 at about the same level, the market suffered substantial losses. Some indices dropped by a few dozen percent, mostly due to significant losses for growth companies. In the first few months of this year it's precisely those sectors that performed well last year that have so far lagged behind. Energy, and oil in particular, has fallen after last year's rally. In contrast to last year, when companies operating in the oil and gas sector were extremely popular, energy companies are suddenly being sold again. It's chiefly fears of a recession that are making investors cautious. Although China has now completely reopened after its lengthy lockdowns and Chinese demand for oil has returned to pre-pandemic levels, the market is visibly worried that global demand will drop once the economy enters into a downturn. We view the lower oil price as an opportunity. Firstly, even though it may sound counter-intuitive, global demand for oil continues to grow. This will continue to be the case in the coming years as well and the world will need record quantities of oil. Furthermore, OPEC has expressed its dissatisfaction at low oil prices by simply slashing production when prices are not to its liking. This leads us to believe that oil prices could well rise again, and even if this doesn't happen the oil companies are so cheap that their equity prices contain a significant amount of upside.

The tech sector, which was punished severely last year, is displaying a partial recovery this year and helping to push up indices. Incidentally, not all tech companies are profiting to an equal extent. Investors have fortunately decided that loss-making growth companies such as Takeaway or Fastned were trading at fantasy valuations and their equities continue to perform poorly. However, other tech names that are profitable, and in our opinion still far too expensive, are recovering from the hit the sector took last year. The latest reason for paying high prices is the hype surrounding Artificial Intelligence (AI). As with previous hypes surrounding fintechs, so-called disruptors, cryptocurrencies and start-ups, it's worth being sceptical about the pots of gold promised by some. While we're intrigued by the development of AI, it's hardly a completely new phenomenon. Automatic pilots in aircraft, cars with lane detection, spelling checks in Word, all of these are existing forms of AI that we find totally normal. The fact that ChatGPT has suddenly released a consumer application that works fairly well may be spectacular but it doesn't justify companies such as Tesla, Microsoft or Apple suddenly doubling in value. The rally among these mega caps obscures the view of other stocks in the indices, many of which are performing much less well this year.

There was also plenty of positive news though. After a 10-year battle against the Dutch government, the Supreme Court awarded substantial compensation in the case involving expropriated subordinated SNS bonds. As we have always recorded a price of zero for these securities, this means that payment of this compensation, expected on 21 August, will translate into a handsome profit.

Nor are we dissatisfied with the operational results of the majority of our investments to date. Heavyweights such as Petrotal, Gemfields and THG published better-than-expected revenues and earnings, which gives us even greater confidence that they are substantially undervalued.

Kurdistan

Never a dull moment in Kurdistan. Given the importance of this theme in the portfolio, it seems appropriate for us to give an update on recent events in this semi-autonomous region of Iraq. Erbil, the capital of Kurdistan, is a major base for all kinds of Western oil companies with oilfields in the region around Erbil. Although Kurdistan is a largely independent region within Iraq, it still depends greatly on the national authorities in many areas. This is most obvious in the sale of its all-important export product: oil. The Kurdistan government earns income from pumping oil into a pipeline and transporting it to Ceyhan on the Turkish coast. From there, the Kurdistan oil is sold to traders that sell it all around the world. The companies that produce this oil are paid by the Kurdistan government, at a discount versus the Brent price, for all the oil pumped into the pipeline. It's precisely this pipeline that has been in the news in the past couple of months. Ever since 2014, when the first Kurdistan oil was transported via this pipeline, the conditions under which this is done has been a source of conflict between Erbil and Baghdad. Baghdad believes that it and not Erbil should have control over oil sales and therefore that Erbil's entitlement to the income is illegal. The court of arbitration decided earlier this year that this is indeed the case. As a result of this ruling, Turkey is deemed to have conducted business with Erbil contrary to the agreement, while it should really have dealt with Baghdad. The court consequently also ruled that Turkey should pay a fine of about USD1.5 billion. And this is where the problem lies. In the run-up to the ruling, Erbil and Baghdad agreed a new deal. From now on, Kurdistan will leave oil sales to Baghdad and therefore no longer directly profit from the oil income. In exchange, Erbil will receive 12.6% of its national budget from Iraq. Although Kurdistan's autonomy has been preserved, this does mean a significant strengthening of ties. And then there's the fine that Turkey must pay. Pending negotiations on this payment, the Turks are refusing to accept any oil via the Ceyhan pipeline. As a result, the Kurdistan producers are unable to transport any oil at the moment and have had to halt production temporarily. And that's a shame as things were going well operationally. Just before the halt to production, Gulf Keystone was producing a record amount of oil - 55,000 barrels a day - and anticipating an excellent year in terms of operations. The question is how long this suspension will last. A political game is being played out behind the scenes. It's in no-one's interest to eke this out unnecessarily, as each day that goes by means lost revenue and earnings. This applies equally to the producers and countries involved, all of which take their cut. In the meantime, the US and UK are also exerting pressure to reopen the pipeline quickly. HKN, a US player in the region, has sound political connections and UK companies Genel Energy and Gulf Keystone are also trying to involve the British government in the search for a solution. Until recently there were Turkish elections and domestic Iraqi budget negotiations that could have hindered a rapid reopening. Now that these are over, we hope a deal will be reached in the near future. These events have resulted in the equity prices of both Genel and Gulf Keystone dropping substantially. The reopening of the pipeline should enable prices to recover quickly as the fundamental picture hasn't changed. Furthermore, a definitive agreement between Erbil, Baghdad and Turkey could be positive for the oil companies.

The difficult relationship between Erbil and Baghdad has always been one of the reasons that these stocks are so cheap. In addition, Erbil has in the past been forced to postpone payments to the oil companies on several occasions as it operates on a tight budget. This could mean a huge improvement for the companies when Baghdad takes over these payments and provide much greater payment security.

We've witnessed all manner of events in this exceptional region since our first investment in this theme back in 2016. The rise of IS, the coronavirus, negative oil prices, unpaid invoices, we've seen it all. Ultimately, it's always proved best to look purely at the valuations, balance sheet ratios and cashflows and realise that it's in everyone's interest to keep this sector operational. And that's what's always happened in the end. A restart to production will form one of the biggest triggers for the portfolio in the second half of this year.

UK Plc: "Things are never as bad as we fear, nor as good as we hope"

British companies have always accounted for a sizeable portion of our portfolio. There are several reasons for this. Firstly, the country has lots of listed companies, including a large number of small caps that are monitored by only a few analysts. Other important reasons are the accessibility of the management, English-language reports and relatively good corporate governance. Yet the main reason is that few people seem to be interested in the opportunities and the valuations of British companies have for some time been substantially lower than those on other markets. Although the UK market contains a large number of world-class companies that do business all around the world, the market has long been plagued by a stubborn discount. When we compare valuations in the UK to those in other major developed markets, it's striking how cheap this market has become. The graph below shows that investors are currently missing out on the biggest discount on British companies of the last 50 years. UK equities haven't traded at such a large discount as they are now since the Thatcher era in the 1980s. There are all kinds of reasons for justifying this discount, the most obvious perhaps being Brexit. Yet this doesn't explain everything. Firstly, Brexit wasn't just bad for British businesses. The British pound has become a great deal cheaper as a result of all the commotion, leading to some companies profiting from an improved competitive position. We can also argue that the effects of Brexit have now been incorporated into corporate earnings and it's no longer necessary to price them in to the multiple at which companies are traded. That would be double counting. History also tells us that pessimism doesn't last forever. As can be seen from the graph, a temporary discount can be transformed into a premium in a relatively short time. After all, there are plenty of reasons for thinking that business continues to function well in the UK and the country isn't exactly without prospects on a global scale.

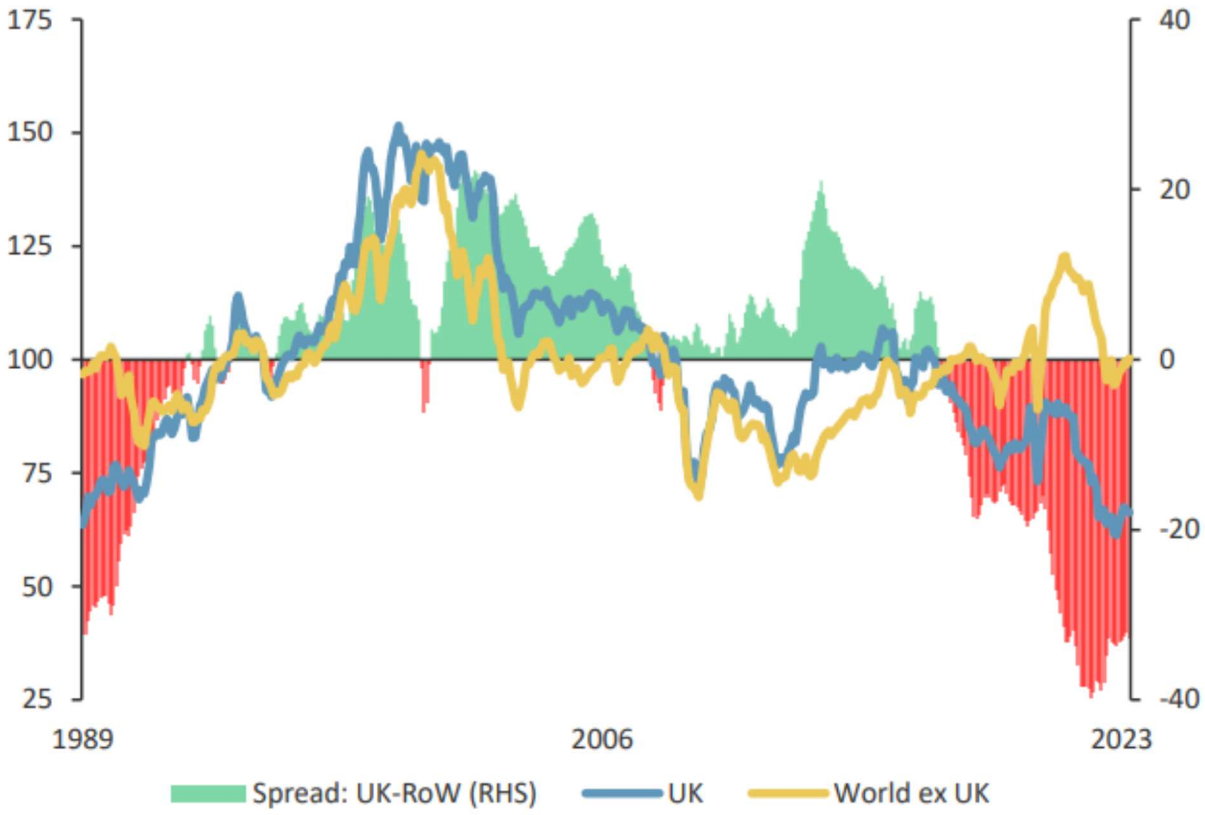
In short: quite apart from the noise surrounding the Brexit sentiment and the fact that the UK economy isn't the best-performing economy in Europe at the moment, the current discount on the UK market's total sum looks to be enormously exaggerated. What will it take to buck the trend? Firstly, acquisitions. An acquisition is a tempting option for a non-British competitor trading at a significantly higher valuation than its UK counterpart when the currency in which this competitor trades has also fallen in value. We're now seeing this happening to a greater extent. A second option is a delisting or listing on a different stock exchange.

Companies seeking a market flotation are unlikely to opt for the UK at the moment as there are other places in the world that consider much higher valuations to be appropriate.

Companies already listed in the UK are also increasingly looking at becoming listed elsewhere, especially when a portion of their revenue is earned in a different market, such as the US. Whereas the British market is over 30% cheaper than the global market, the discount versus the US is more than 50%. This doesn't just tell us how expensive US equities are, it also shows how tempting it is for a US company to acquire a UK peer. We're seeing this happen more and more frequently and don't view current valuations on the UK market as a problem but instead as an enormous opportunity.

Why are we so enthusiastic? Because nobody else is.

UK company valuations in terms of P/E, indexed



IRES

The year is 2013 and a group of men are sitting around a table. It's the umpteenth meeting of the NAMA (National Asset Management Agency), the body set up by the Irish government that is responsible for sorting out the banking and real estate crisis that enveloped the country a few years before.

The goal is the rapid sale of the assets acquired by the government when it bailed out the banks. These portfolios contain houses, hotels, office buildings and blocks of flats. High levels of debt caused the original owners of the assets to go under and the assets came into the hands of the banks that granted the loans. As these banks are in turn under pressure to reduce their balance sheets, some former crown jewels are being sold at knockdown prices. And some of those around the table know just what to do.

Let's remind ourselves of what happened. At the start of this century, Ireland hit on the brilliant idea of converting the excellent ties the country has always enjoyed with the United States into hard cash. Thanks to the 1990s tech boom, there was growing demand among US companies in particular for getting a foot on the ground in Europe in order to sell software and IT services from here as well. The logical proviso for doing so was identifying a suitable physical place of domicile. Ireland was one of the first to realise this and came up with an attractive proposition: not only was there a young, well-educated English-speaking population, but the country was also in the European single currency. On top of this though, Ireland offered the ultimate in temptation: it slashed its corporation tax by an enormous amount. This was the perfect strategy for convincing businesses to establish their European base in Ireland. And that was exactly what happened. One company after another decided to open its headquarters in Dublin and this triggered a huge influx of both people and capital into the Irish capital. The country, among the poorest in Europe in the previous century, suddenly found itself on the map and grew as never before. The Celtic Tiger became a well-known concept. As with every sudden appetite for growth, it was just asking for excesses. And it got them. Hairdressers with five houses, real estate developers driving Ferraris, bank managers who granted friends unlimited credit, anything was possible. Until it all went wrong. In 2006, the tiger turned out to be mortally wounded and the party was suddenly over. House prices nosedived to about 60% of their former levels and all the Irish banks were bankrupt on paper. The government was forced to intervene. Banks were nationalised in gigantic bail-outs and the Irish government as a whole even came under severe pressure. The crisis was averted using EU funds but the country paid a high price. In the years following the collapse, the Irish licked their wounds. The housing market eventually bottomed out but many of the property loans that had been granted to all kinds of project developers were never repaid. The upshot was that the nationalised banks owned a large amount of real estate that ultimately needed to be removed from the balance sheet.

Back to the NAMA meeting. Some members of the committee quickly realised it was much easier to sit on the other side of the table as a buyer. Several of them left the NAMA and set straight to work: a number of Real Estate Investment Trust (REITs) flotations took place in 2013 and 2014. Green REIT, Hibernia REIT and IRES were listed on the stock exchange after their founders had first checked out the situation at the NAMA and then raised funds in order to profit personally from this promising situation.

We've always monitored these stock market flotations closely. We participated in the IPOs for Hibernia REIT and Yew Grove and in subsequent years always took an interest in these names whenever they were for sale at a substantial discount on their underlying value. The only name we never bought was IRES. In contrast to Green, Hibernia and Yew Grove, all of which operate in the office real estate sector, IRES only buys and leases residential properties. As a result, its equities have been much more stable over the years and never traded far below their NAV.

At times both Hibernia and Green could be bought at a discount of a few dozen percent. This is precisely what we did, after which they were both removed from the stock exchange by a takeover bid. As a result, until six months ago we no longer had any exposure to the sector as all our former names, including Yew Grove that had been listed in 2018, had since been delisted. Something interesting happened to IRES in 2022 though. The stocks, which in the first eight years of their existence had always traded close to their NAV and had therefore been rejected by us as an investment opportunity, started to trade at a discount owing to the rapid rise in interest rates. The NAV, which from 2014 when the equities were placed at a price of EUR1 climbed from EUR1 to EUR1.70, has now fallen to about EUR1.60. The equity price has completely collapsed, however. Whereas investors were still paying about the NAV of EUR1.70 in 2022, the equities are currently trading at 96 cents. And that's a discount of approximately 40% on the value of 4,000 flats and houses that IRES owns in and around Dublin. It's hard to explain this discount. When we examine house price growth in Ireland, or in Dublin in particular, we see a totally different picture. House prices in Ireland haven't come down at all. What has happened is that prices have stopped rising rapidly, but this is quite different from prices actually falling. Although this could of course still happen, it's fairly unlikely that prices would plummet by anywhere near the implied expectation that has worked its way into the share price. The main reason for the sharp drop in equity price is the substantially higher interest rates and in turn the higher discount rate that investors apply to the portfolio's value. The cashflow derived from leasing the portfolio (and IRES has an occupancy rate of over 99%) is worth less when interest rates are high than when they are lower. While this is all true, it remains a peculiar reason. If we zoom in a bit then IRES is nothing more than the sum of 4,000 homes in Dublin, financed out of a combination of its own capital and loan capital. These homes have risen in value by an average of about 60% since 2014 (NAV of 1.60), but the equity market is currently only prepared to buy this group of assets at a price that is 4% lower than the initial value back in 2014. If this ratio persists, IRES would be wise to stop leasing out the homes and sell them on the open market. There's plenty of demand for homes and the market is in extremely good shape, as can been seen from the sharp upturn in house prices. The Irish economy also continues to perform well. This means there's a clear mismatch between what investors think about the total real estate and what private individuals think about the underlying properties. Vision Capital, an activist shareholder from Canada, has also noticed this. It holds an interest in the company and wants IRES to put itself up for sale. It would be the logical final chapter in a sector in which IRES is now the sole surviving party and all its peers have already undergone the same process. Until now, there's never been a window of opportunity for delisting IRES as its share price was close to the NAV and paying a premium on top of that wasn't an option. That has now changed: even at a premium of a couple of dozen percent it would be possible to acquire the company for less than the value of the underlying real estate. It would be a profitable deal for both the buyer and for current shareholders. We've expanded our position in the company in the run-up to this inevitable outcome.

THG Plc (The Hut Group)

Company with unwavering management becomes market plaything

We first wrote about THG Plc in the first quarterly report of 2022.

A great deal has happened since then and that makes it time for an update on this online retail, nutrition and cosmetics business from Manchester in the UK. At the time, we closed our report on this company by looking forward to the Beauty division receiving a separate market listing and further growth towards profitability. At the time of writing, the Beauty division still hasn't been given a separate listing but there's been no lack of drama in the interim. Let's take a peek behind the scenes at THG.

Transition to three separate business units

In the second decade of this century, THG conducted a large number of small acquisitions in the cosmetics and health food sectors and the company is increasingly reaping the rewards of this strategy. Its revenue doubled to in excess of GBP2 billion between 2019 and 2022. In 2021, when THG was floated on the stock exchange with much fanfare at a price of GBP5 per share, the company became a market darling thanks to this rapid growth and was seen as an example of a true growth equity.

However, in the year immediately following the IPO the company struggled to communicate its forecasts clearly and to live up to them. THG was ill equipped to deal with the explosive growth and investors didn't always understand what the company was doing. This frequently led to negative market responses to quarterly updates. It was therefore unfortunate, to put it mildly, when Matt Moulding (CEO and founder) let rip during a meeting with analysts and investors last year. A successful British entrepreneur who briefly loses his temper is fodder for all kinds of sensational stories in magazines and newspapers. THG became a sitting target. Hedge funds that speculated on its share price dropping pushed it into a downward spiral. We decided this was a good time to take a look at the company that as a result of all this commotion had nosedived from a record price of GBP8 to below one pound, after which we acquired our first shares.

Yet THG's performance tells a different story. THG has recently worked hard to create a sound organisational structure. One important aspect here was separating the company's activities and setting them up as independent divisions. The three business units - Beauty, Nutrition and Ingenuity (e-commerce platform solutions) - now all operate completely independently under their own CEO. This makes it easier for investors to assess and value them. It also paves the way for separate market listings or creating value from the units in some other way by selling parts or entering into a strategic partnership with another party. For the time being, THG continues to be the overarching parent company for all these operations.

Governance

In addition, THG brought in several experienced employees to the all-important Investor Relations department. Investor Relations (IR) are important in contacts with investors and the press. This department needs to be able to get the company's message across properly to existing and new investors as well as analysts.

Apart from enhancing the IR department, we've also seen the appointment of an overarching Chair who supervises the board of directors together with other non-executive board members. This is a common corporate structure in the context of good governance.

Importantly for the market, CEO and founder Matt Moulding has relinquished his 'golden' share that basically meant he held all the voting rights. New heavyweight CFO Damien Sanders joined the company in 2022-2023. He comes from accountancy powerhouse PwC, where he worked for 20 years.

We view all these developments as positive and they serve to make THG a considerably more mature company.

Visit to THG Campus sets us apart from other investors

Throughout 2022 we were in touch with the company more and more. We talked to the newly-created Investor Relations department, the newly-appointed CFO and also held strategic sessions with the entire board of directors and CEO.

The contacts were frequent and high-quality. No surprise then that we were also invited to visit the THG Campus in Manchester, which we subsequently did in May 2023. It proved to be an extremely valuable, open and inspiring visit.

The THG Campus in Manchester is a hotbed for creative employees. Each day they're given the chance to channel their energy and enthusiasm into doing things in a more fun, better or different way than the day before. In Manchester we were able to see for ourselves how e-commerce platform Ingenuity is positioning itself. Ingenuity is like a digital highway for your brand strategy. If a brand wants to launch a product, for example, THG Studios can create and roll out an online campaign in 24 hours. This takes several weeks at advertising agencies and is much more expensive. The employees we met enthusiastically explained the opportunities for using cooking shows, fitness adverts or influencers. All this in studios where everything is done by the company itself. Even sets are built in the company's own workshop.

We also visited THG's logistics hub. Here, we saw the work of about 350 robots powered by AI (Artificial Intelligence) that process the tens of millions of orders for THG. The robots recognise the product packaging, even when it changes, and adjust the order selection process and stock management accordingly. Even more valuable was our 90-minute meeting with the management in which we talked in detail about the company in order to refine our outlook.

AI robots collect the orders at the THG logistics hub

We like to be close to the companies in which we invest on your behalf and this sets us apart from other investors that often don't bother to make the effort.

Our aim is to go that little bit further and understand all the ins and outs of the company. Such visits and conversations with management are a great help here.

No-one stops to think about the fact that THG has no need to use an expensive payment provider such as Adyen or Klarna for processing its online orders, as a result of which there's no erosion of profit margins. THG has developed all of this itself in-house and already made the investments. The same goes for automation of the order processing. This is the kind of thing you only hear and see when you conduct more in-depth research and go a step further than other investors. You don't read it in an annual report. Marketing costs are a significant expense for all the companies in this sector. For this reason it's unique to witness what THG Ingenuity has done to develop expensive brand strategies in-house for itself as well as for third parties, such as Coca-Cola Europe, Nestlé, Mondelez and Matalan. Its external client base is growing each quarter.

Acquisition attempts and other scenarios

The company's market price continued to slide throughout 2022, which prompted a variety of wealthy individuals, consortia and Private Equity parties to put in bids for acquiring part or all of THG. The first acquisition attempts failed because the management and a majority of shareholders were unconvinced by the offers and corresponding structures.

An offer of GBP1.70 was said to have been rejected and around October 2022 the equity price hit an absurd low of 31 pence. This was shortly after Asian tech investor Softbank, a champion at destroying capital, sold its interest in THG for 38 cents to Qatar Investment Trust and CEO Matt Moulding. From that moment, things started to look up again and in April this year private equity company Apollo put in a bid for the company. This offer was rumoured to involve a highly complex construction of minority interests and demergers at a total price in the region of GBP2-2.50 per share. After much consideration, this offer was likewise rejected.

Some interesting information that came out of the negotiations was that in the eyes of Apollo the Ingenuity division alone merited a valuation in excess of GBP1.2 billion. According to this keen buyer, this business unit, which we're least able to value accurately and for the sake of convenience put at zero in our calculations, represents almost the whole current market value of the company.

We certainly cannot rule out the possibility that THG will no longer exist in its present form in a few years. THG is now the parent company of three business units that can also be run separately. The units could be given separate market listings and other third parties could acquire an interest or take over a unit in its entirety. Unilever, P&G or Nestlé could pay GBP2-3 billion for the Nutrition division. Such valuations are conservative in view of what's happening on the market. Overall we're already talking 1.5 to 2.5 times the total market value for the second largest division of THG. However, THG has no wish to take that step yet as it firmly believes in its own unique strategy.

Another option that is the source of much speculation is that Matt Moulding (together with a few partners) delists the entire company again at an acquisition premium. This would calm the waters for THG and remove the pressure of having to perform each quarter.

Moulding has already made regular hints about this option. For anyone interested, Moulding writes several posts a week on LinkedIn. Well worth reading!

True value

We have urged the management to demonstrate the company's true value to investors. This could be done by e.g. selling (part of) a business unit. It would immediately become clear that the market is underestimating the total market value and moreover cause short parties considerable panic. The nightmare scenario for short parties is a sudden upturn in equity prices (as they then need to buy back shares at a higher price, while they profit from lower prices).

As another way to push up the market price, CEO Moulding has indicated that THG might buy back shares or bonds. Financial headroom has been created as many costs have already been incurred, THG now looks to have reached operating breakeven point and cashflows are growing sharply thanks to declining input costs. This would emit a strong signal to the market. We naturally examine the reasons why all these positive points are not resulting in a higher valuation. When you take a closer look, a great deal still has to be done before the true value of the company can be revealed.

Inspiring texts on the wall of THG Studios

The main reason for both the success and scepticism is the presence of Matt Moulding. He runs the company as if it's his own personal business and has so far shown little interest in what others would like to see. What's been achieved to date is extremely impressive, yet as long as the market fails to estimate the company's true value this is of no use to investors. The fact that he owns a very large number of shares doesn't help either. The small portion that is traded on the market has become the plaything of hedge funds and speculators. Giving up his 'golden' share last month is the first sign that Moulding is starting to realise that a market listing brings obligations with it and that the company needs to listen to external shareholders. Earlier this year we were in touch with the most vocal external shareholder, Kelso Plc. Like us, this recently-founded activist fund has recognised the extreme undervaluation of THG and is doing everything it can to unlock it. We have sound contacts with Kelso and share its vision that things need to change. Moulding has, in part under pressure from Kelso, already indicated that he will apply for a premium listing on the FTSE.

The company is listed locally at the moment and therefore not included in all kinds of FTSE indices. A premium listing could be accomplished later this year. Furthermore, we can identify a tailwind from the lower commodity prices that will give the Nutrition division an additional boost.

We've spent months asking ourselves how long the market can persist in undervaluing this company. All the facts mentioned above seem to endorse our opinion that this company is worth several times its current market value. We're in touch with a growing group of other investors who share our view. At one point in 2020 the market value stood at over GBP8 billion versus GBP1.2 billion at the moment. The peak 2020 value was far too high, yet the current valuation is much too low. The company is now in much better shape than it was in 2020. If the market doesn't wake up to this soon, someone else will come along who does. An exceedingly promising equity that has an especially fascinating six months ahead of it.