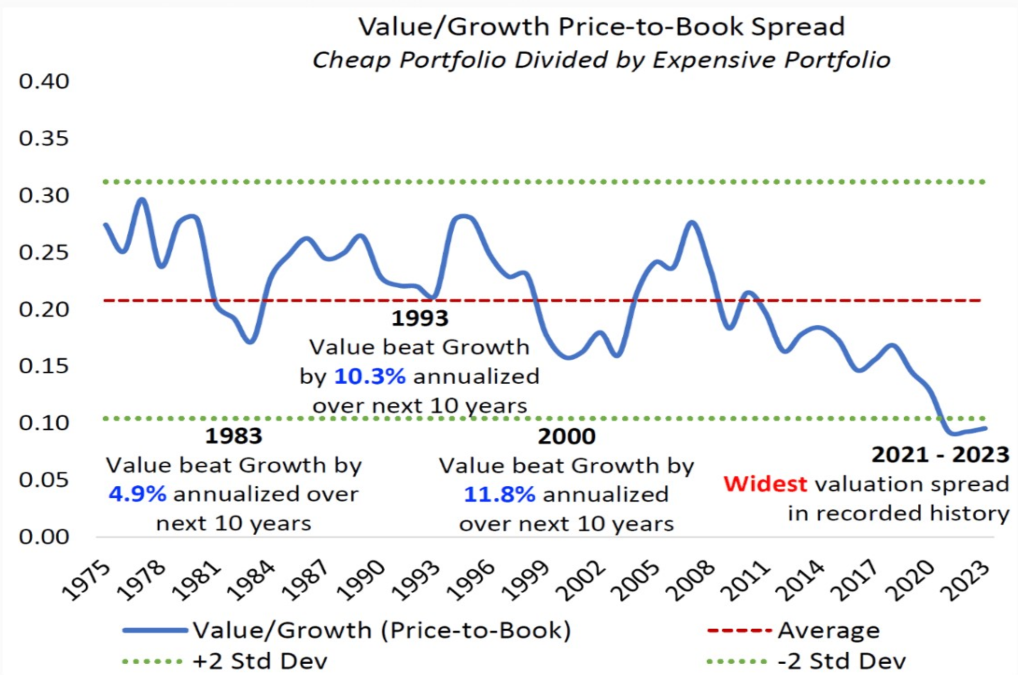
Quarterly report Q3 2023

Playing the waiting game

Value investing isn't always easy. Whereas 2022 was a year in which the investment style climbed well in value, closing a poor year on the markets at about the same level, 2023 has so far proved to be a frustrating year.

Value investors attempt to identify investments that represent a much higher fundamental value than the price at which they are trading. Ideally, these are investments that generate and pay out cashflows to shareholders, so that there's at least a cash reward for the waiting. And this is the sensitive part: the waiting. When we examine the returns earned on Value over the past few decades, we can distinguish very distinct phases. There are times when investors view the world fairly openly and quickly reassess businesses that are too cheap, rapidly yielding rewards for Value investors for the work they do and pushing incorrectly priced stocks up to more appropriate levels. There are also times, and the past few years are an excellent example, in which investors focus on specific themes, markets or sectors and are totally uninterested in other angles. It's at times like these that as a Value investor you feel like a lone voice crying in the wilderness. You can shout all you like but to no avail. This is of course frustrating and tries the patience of Value investors sorely. It's logical that some people are unable to exercise patience and drop out along the way. Cynically enough, this is precisely the reason for there being so many exceptional opportunities out there now. The graph below demonstrates how far the pendulum has swung.

Figure 2: European Valuation Spreads (1975–2023)



Source: Ken French data library and S&P Capital IQ

The graph shows that there are periods, and these can last for many years, in which the world views Value investing as an outdated, inferior investment style. We saw this in the run-up to the year 2000 and we're seeing it again now, in fact really from the credit crisis onwards. When we look at the absolute valuations of many of our stocks, in many cases we've reverted to the ratios from 2008. Businesses without debt that can be bought for only a few times their annual earnings and generate dividend yields of 10%, 15% or even close to 20% (DNO, Gemfields, Diversified, Petrotal) are being completely ignored by the market and prices don't seem to be able to drop low enough.

The common denominator in the total lack of enthusiasm for Value is the almost exclusive focus on growth companies. The advent of the internet sucked all the air out of Value equities at the end of the last century and then from the credit crisis on it was the availability of almost free money that fuelled the growth equity rally, at the expense of the much cheaper Value stocks. The effects of sky-high growth equity valuations can best be seen in the performance of the US markets over the past 15 years. The relatively large weight growth companies occupy in the indices has for years meant that the US markets have performed much better than other markets. It also distorts the picture of how the rest of the market is performing. The graph below shows what an investor would have earned if they held no US stocks at all over the past 15 years. The answer is clear: very little.

Some investors would interpret this as a reason to buy US stocks. Yet the opposite makes more sense in our view: opt for much cheaper non-US equities, which are hugely undervalued versus their much more expensive counterparts on the other side of the Atlantic.

A small portion of this outperformance derives from the enormous price gains of a handful of companies, such as Apple, Microsoft and Nvidia, which have been exceedingly successful at creating shareholder value. Yet the main reason for the outperformance is the result of structurally higher valuations in the US compared to valuations elsewhere in the world.

Even when you examine differences in valuations within a specific sector, there's such a large gap that European equities are simply much more attractive. In what is the most important sector for us at the moment, the oil and gas sector, investors in the US are prepared to pay 12 to 14 times the annual earnings for companies such as Exxon or Chevron.

If we look at exactly the same type of company in Europe, say Shell or BP, valuations are 6 or 7 times the annual earnings. We find it extremely difficult to explain this difference in fundamental terms as the companies are subject to the same forces. They all have fields in different parts of the world, the product is identical and their clients are also spread all around the world. The only difference is the location of the market listing. We see the same thing in almost all sectors and this is what makes European Value investments so promising. This has been the case for years though and we're often asked when this will change. The answer is of course that we can't accurately predict this either. The only thing we do know is that it doesn't matter if nothing happens. The reason is that a company that can be bought at only a few times its annual earnings earns a substantial portion of its market value. Even if valuations remain the same, this will generate dozens of percent a year for the owner of the company. These earnings can be paid out or used to fund further growth. The enormous dividend yields demonstrate that our companies pay out a substantial portion of their earnings, as a result of which we receive a cash reward for waiting for market sentiment to turn. And that this reversal will take place is one prediction we do dare to make. The biggest indicator that we hold a portfolio that is simply far too cheap comes from the large number of acquisition bids on our companies. Several companies were taken over last year and buyers are also busy this year. For example, model names such as Wentworth and Impellam are the subject of takeover bids and Renewi was added to the list this week. The common thread is that the buyers, all non-British companies, are taking advantage of the extremely low valuations on the UK market. If this British discount persists, we'll see more and more of these acquisitions, and these are ultimately a good alternative as the businesses are then taken off the market at a sound premium. In short: whatever happens, the capitalist system is a guarantee that things will eventually revert to more normal ratios and Value equities will once again come under the spotlight. What can clearly be seen in the first graph is how attractive the returns are when the market does turn. When Value returns to favour, the rewards are sizeable. An average of about 10% more per year is earned on the Value style in the ten years following the reversal than on a growth equity investment. And that's more than worth the wait.

Public Policy Holding Company (PPHC) – the art of lobbying

The US adopted a new law in 2015 that makes it mandatory for lobbying firms to publicly register their lobbying activities. Lobbying is of course as old as the road to Rome itself and things are no different in the United States. The first law aimed at restricting the influence of lobbyists and creating greater transparency was passed as far back as 1946. Legislation on this has been expanded in recent decades. PPHC was founded in Washington D.C. in 2014, the year before the latest amendment. Let's take a brief look at this company.

Lobbying may have a slightly dubious reputation in the popular imagination but it fulfils an exceedingly important role in both politics and business. Changing laws have an enormous impact on business. Companies are asked to brainstorm on legislation but at the same time are also confronted with these new laws. They also need to prepare their implementation. For this reason, talks take place daily between the government and those who represent businesses. This enables the lobbying sector to contribute to sound business management and help shape legislation. The lobbying market is extremely mature in terms of numbers.

US government expenditure increased from USD1.2tn to USD6.3tn between 1990 and 2025. The budget spent by businesses and other organisations on lobbying (and related) activities grew from USD1.4bn in 1998 to USD3.9bn in 2022.

This is the playing field in which PPHC operates. PPHC is a collection of companies in a highly fragmented market. However, three of the top-20 lobbying firms in the US are PPHC companies. Its business model is characterised by highly stable, growing and predictable revenue and earnings growth. In addition, it's anti-cyclical in nature, by which we mean that performance isn't affected by economic shocks.

A practical example of how its activities go further than pure lobbying is the solar panel campaign in the US. A subsidiary of PPHC contributed to President Biden's decision to impose tariffs (anti-dumping duties) on Asian solar panels. The principal aim was to create a more level playing field for domestic solar panel production.

PPHC was floated on the market in 2021 in order to further shape its growth strategy, on the one hand to give its partners a partial exit but also to raise more funds from investors to boost acquisition activities. The odd (but in fact logical) aspect here is that this is a US company with a stock market listing in London. Its market value is too small for a listing in the US and that's why the company opted for the UK.

After our initial contacts in 2021, a couple of partners were still looking for a partial exit in 2022. We realised this was an opportunity for us to add the stocks to our portfolio. The marketability of the equities is not high, however. Only a few thousand shares are traded per day, but in return you receive a reputable company with a generous dividend yield over 2022 of about 8% (distribution of 70% of its net profits). The net profits constitute about 20% of the company's revenue (approx. USD110m in 2022). Revenue is spread across about 1,000 clients that spend an average of more than USD100,000 a year on having PPHC represent their interests. Three-quarters of the shares are owned by the company's own personnel, which is typically American and generates commitment as well. All in all, more than enough reason for getting on board and buying a modest share in the company.

We hope we've given you a good idea of this relatively unknown portfolio company. With the presidential elections looming, PPHC will have plenty of extra work. Yet the company is also looking to the other side of the Atlantic. A total of more than 7,000 registered lobbyists for the EU alone means there's room for further growth on top of the US market (12,000 registered lobbyists). Moreover, private equity parties are also eyeing this market, which makes sense in light of the abovementioned reasons. KKR and TPG have already made debut investments in the sector.

Pareto Securities | Pareto Securities AS — Energy Conference

30th Pareto Conference (September) 2023

The prestigious Pareto Energy Conference takes place annually in Oslo (Norway). Large institutional investors, companies, government officials and analysts come together to discuss the energy market.

This may interest you as a reader and/or investor as the conference is also attended by companies in which we (potentially) invest on your behalf, both in the equity portfolio and OVMK Special Bond Fund. These include Gulf Keystone, Genel Energy, DNO ASA and HKN.

OVMK is invited to attend the conference each year. We always take advantage of this opportunity to meet our portfolio companies and examine new businesses. In two days we conducted 16 one-on-one meetings and naturally talked to a variety of people on the sidelines of these official meetings. This gives us an extremely valuable foot in the door that dates back to 2016 when we bought the first DNO bonds for the OVMK Special Bond Fund at a substantial discount. Without these contacts we wouldn't have been in a position to conduct these transactions.

The main goal of the conference is to boost investment in both the fossil and renewable energy sectors. Increasing investment in fossil fuels may sound controversial in these times of energy transition. Yet as we've frequently explained in our quarterly reports, the two don't need to be mutually exclusive. It's a fantasy to think that the world will run completely on renewable energy in 20-30 years' time. The biggest climate benefit will derive from replacing coal in the global energy mix. However, this won't be achieved using wind turbines and hydro-electric power alone.

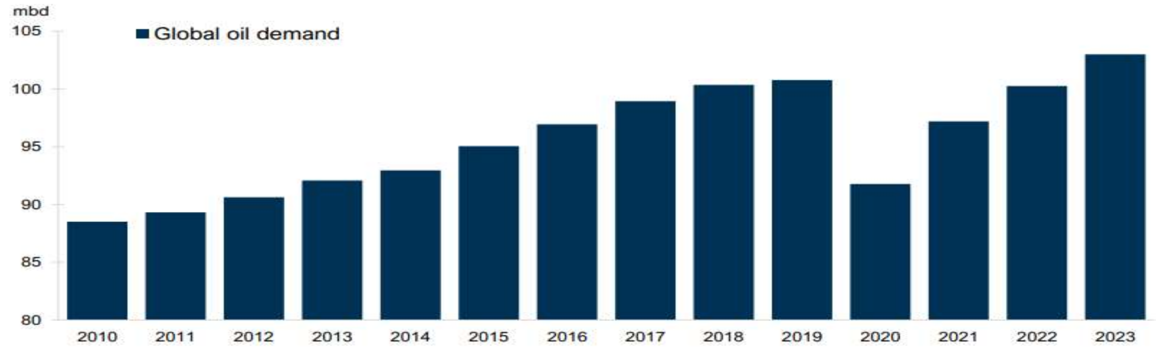
The policy of discouraging oil and gas companies from investing has resulted in nine years of underinvestment, which in turn has pushed up prices owing to growing scarcity. Scarcity of oil? Yes, there is indeed a scarcity. At the moment the world consumes 102 million barrels of oil (containing 158 litres) a day. The fourth quarter of this year, however, is expected to see a shortfall of 2 million barrels on this daily demand for oil. Production is unable to keep up with global demand.

The best way of pushing down prices is to invest more to meet the growing demand and keep fuel affordable for consumers and industry. The world is (unfortunately) extremely dependent on oil. Even at the height of the coronavirus crisis, the world still used in excess of 90 million barrels of oil a day (as can be seen from the blue bar for 2020 in the chart below). Global dependence on oil goes far beyond just cars, ships and aircraft. The manufacture of plastic also requires large amounts of oil, for example.

And on top of this OPEC+, headed by Saudi Arabia, has further reduced oil supplies to keep prices high. Meanwhile, the US now holds its lowest strategic oil reserves since the 1980s. The important thing is to invest in oil now, especially in existing facilities (and not search for new deep-sea oilfields) as these facilities yield less oil when investment declines.

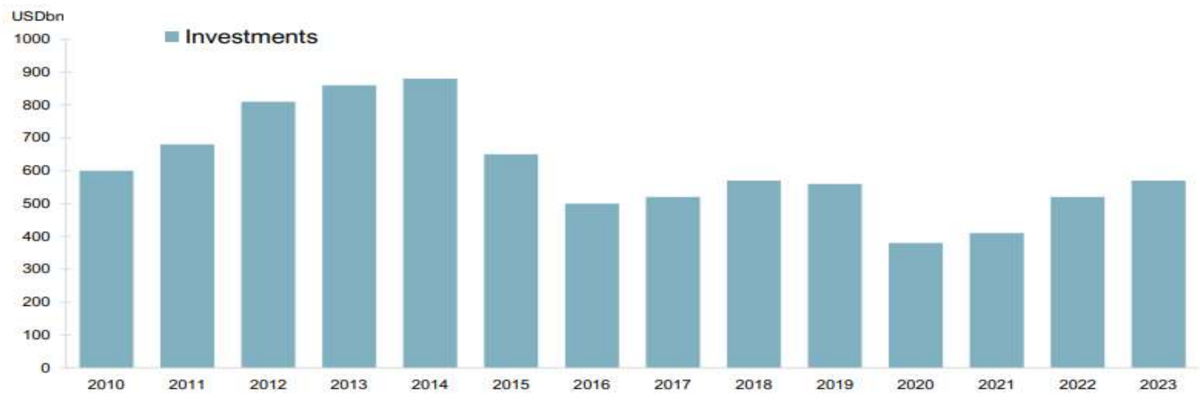
This is shown by the chart with the light blue bars. Conclusion: investment has lagged behind for years and demand is growing (see the chart with the dark blue bars).

Global oil demand is record-high



Source: Pareto Securities Equity Research, IEA, Bloomberg, Rystad

Global E&P spending is still down 35% from 2014



Source: Pareto Securities Equity Research, Company data

Many investors (such as pension funds) are currently avoiding the fossil fuel sector. They've switched to investing in green energy, which should of course be applauded from a moral perspective. However, higher interest rates (the end of the era of free money) means that many projects are no longer profitable and enormous losses are being incurred by companies such as VESTAS Windsystems. We're obviously not against investing in green energy, but such companies often lack a fundamentally profitable business model.

While in Oslo we naturally also spoke to our existing portfolio participations about the ongoing impasse between Kurdistan, Turkey and Iraq. In February/March of this year, a Paris court ordered Turkey to make payments of USD1.5bn and since then the pipeline between Turkey and Iraq has been closed.

This is depriving the world of about half a million barrels of oil a day. In other words, one half of one percent of global demand is absent from the market at the moment, a gigantic amount on a global scale.

In our view the situation has now gone beyond the realm of rationality. By this we mean that it ought to be relatively simple to resume exports and continue discussing terms and conditions afterwards. In the meantime, the Iraqi government has already missed out on USD5bn of income, while it could start things moving by dropping its USD1.5bn claim on Turkey. Many political interests and forces are at play in this conflict though.

It became clear during the conference and from conversations that a solution is even being sought at higher diplomatic levels in the US. The interests are self-evident. The resumption of oil exports could help ease the tightness on the oil market and generate the lower prices so fervently desired by the US. Joe Biden is after all up for re-election in 2024, and this process will be somewhat easier if the average American doesn't feel too much pain at the petrol pump.

What is good to see is that Gulf Keystone, for example, is making operating profits as a result of scrapping costs and increasing domestic sales. It may not be the ideal situation but the company is certainly no longer making a loss. We have every faith in all the parties involved reaching agreement in the near future as everyone stands to gain. When that will be is of course more difficult to say. The latest developments (2 October 2023) give us hope though. On the Turkish side most of the objections for resuming exports have now been removed (source: Reuters and Bloomberg - Turkey says to re-start operations of Iraq oil pipeline this week).

Renewi – Anglo-Dutch waste processor receives takeover bid

Finally, some brief portfolio news. Renewi was added to the portfolio in 2021 and we wrote about it in the quarterly report. We've not been idle in the meantime and have kept in touch by paying regular physical visits to the company. On Wednesday 4 October 2023 we'll also attend Renewi's capital markets day. This will of course already have taken place by the time you read this report.

This event will be particularly interesting as a takeover bid was launched on the whole of Renewi at the end of September. Australian investor fund Macquarie put in an offer of GBP7.75 per share. This offer has been rejected by Renewi's management team. It looks as if the story won't end there, however. The current bid values Renewi at 8.4 times the company's earnings before interest, taxes and depreciation. Acquisitions in the sector in recent years have averaged a bandwidth of 9-12 times a company's earnings. We suspect Renewi would be prepared to discuss a possible delisting at the right price and under the rights terms and conditions.