Quarterly report Q4 2022

The year has drawn to a close, and for many investors that will come as something of a relief. For our part, we wouldn't have minded if 2022 had gone on for longer. We had a great time. It's a shame we just fell short of noting a plus in 2022 but our tiny negative result, which is entirely down to the price correction on the Special Bond Fund, certainly sets us apart from the average investment fund that was forced to digest losses of 20% over the last year.

You could describe 2022 as a year of investors coming to their senses. The air that had been pumped into all kinds of asset classes quickly drained away, as was to be expected. Former geniuses such as Elon Musk, Cathie Wood or Sam Bankman-Fried (on which more later), turned out to be mere mortals after all and a whole generation of fortune-hunters learned that the hard way. Someone who had long seen it coming from the comfort of his armchair (and was proved to be absolutely spot on) is Charlie Munger. This 99-year-old crony of Warren Buffett recently had his revenge on all those people who had last year dismissed him as an old fogey unable to keep up with the modern age. It turned out he wasn't that out of touch after all. He was right to write off crypto currencies as toxic and get worked up about the behaviour of youngsters who slavishly followed the herd into this particular trap. On the inevitable repercussions he said, "Why invent new ways of losing money when the old ones still work fine?"

His message is that the world is not so much driven by greed as by envy. One of the most sensible things people can do in his view is to try to detach themselves from feelings of envy. A few years ago, Munger admitted that even he had succumbed to envy in some periods of his life and only later was he able to recognise that envy is something best avoided. Even Munger could feel poor if he compared himself to his partner Buffett, who with an estimated fortune of over USD100 billion is approximately forty times richer than the USD2.5 billion Munger is estimated to be worth. And such a comparison makes no sense at all, as there's no tangible difference between 2.5 billion and 100 billion. And even if there were one, it would be silly to attach importance to it as there will always be someone who has more than you and you could spend your entire life being miserable.

Over the past century, average wealth has increased about fivefold in the West. Yet more people feel unhappier than ever. Internet and social media trends are exacerbating this effect. Having a continuous window to the world and being structurally confronted with what others have and you may not have only serves to reinforce the idea that many aspects of your life could be better, more fun and more beautiful. The fact that this idea generally doesn't correspond to reality and only applies to a tiny fraction of the population does little to change the negative feelings of those on the receiving end. And they are getting younger as well, as children tend to be brought up with an iPad in one hand these days. One of the best lessons a person can learn is to be satisfied with what they have and not spend too much time contemplating what they cannot have. Investors would also do well to make a plan and stick to that philosophy. It's tempting to go along with every investment trend in the endless search for grass that is greener. That search often leads to disappointment. A journalist once asked Warren Buffett why so few people are fans of the Value investment style when it has long proved to be by far the most lucrative way of looking at investment opportunities.

Buffett replied,

"Because nobody wants to get rich slowly."

That pretty well sums up how our industry works. Everyone wants to get rich quickly and is consequently highly susceptible to new technologies and innovations that offer the prospect of precisely that. Yet more often than not the pot of gold at the end of the rainbow turns out not to exist. And then the high priests of investment are suddenly revealed for what they are. This brings us back to Elon Musk, Sam Bankman-Fried and Cathie Wood. Not so long ago, all three were still placed on a pedestal but their fairy tales have since come to a rather grim ending. Elon Musk's main company, Tesla, has lost a great deal of the air that had been pumped into its shares in the last few years. We had long thought investors valuing the company at a level that was higher than all the other major car manufacturers put together to be totally unwarranted. The market has now apparently come to share our view as Tesla stocks have lost more than two-thirds of their value.

Bankman-Fried is the founder of the second-largest cryptocurrency trading platform, FTX. This clever tech dude managed to convince major investment institutions to invest billions of dollars in his company based in the Bahamas. The fact that this business was run by a group of wild teenagers who had little time for risk management, Chinese walls or laws and legislation in general apparently posed no barrier. On the contrary, it prompted them to dig deep in their pockets for this 'disruptive' way of doing business. Mr Bankman-Fried is probably heading for an extremely lengthy prison sentence and investors have no hope of recouping their money. The year could also have been better for Ms Cathie Wood, who was the subject of one of our quarterly reports last year. Her fund has plummeted over 67% in value this year and the end doesn't yet appear to be in sight. Her portfolio, which consists entirely of severely loss-making tech companies, still looks to be considerably overvalued and that's saying something after the fund has already lost two-thirds of its value.

Chinese property developers: a happy accident

In retrospect, it was a magnificent moment. The year is 1979 and the diminutive Deng Xiaoping is standing on a podium at a train station in the Southern Chinese city of Shenzhen. At that time, about 300,000 people live in what is, in Chinese terms, a very small city. Deng had become leader of the Chinese Communist Party in December of the previous year and is giving a speech that in retrospect was a crucial turning point in China's growth in the last century.

Deng tells his audience that great change is coming, that China is opening up to the rest of the world and that so-called Special Economic Zones are to be set up to facilitate free trade. The primary message for his audience though is that the party has no objection to people making money. "To get rich is glorious." Fast-forward more than 40 years and we can see that Deng's words didn't fall on deaf ears. Not only does the city of Shenzhen now have thirteen million inhabitants, but the country also has over 1,000 USD billionaires, many more than the US.

One of the most profitable ways of achieving this is purchasing and developing real estate. Chinese property prices have rocketed due to a combination of migration from rural areas to cities and population growth that in spite of the single-child policy has added more than 500 million Chinese to the planet in the space of four decades. The Chinese government openly encouraged this for many years. It was in the country's interest to build apartment blocks quickly and encourage everyone to buy their own home. For your average Chinese it's also the most logical way of investing your savings, as the Chinese equity markets have really only been opened up to ordinary citizens fairly recently. The Chinese are, understandably, generally reluctant to hold large amounts of savings as the country has a long history of monetary depreciation and sudden state intervention in the banking system. In that respect a home is an alternative that retains its value. An enormous property sector sprang up to realise all these projects via a never-ending stream of project developers. Rapid growth prompted these companies, often set up locally, to expand across the country and the sharp rise in property prices led them to earn high profits. All kinds of spin-offs emerged from these developers as well, including the companies that provide services to the finished projects, such as building maintenance, childcare, gardening, concierge or cleaning services. These service companies originally started out as full subsidiaries of the project developers but over the years were sometimes also given their own market listing. All these companies needed large amounts of financing, as property development is of course a capital-intensive business. As a result, they started to borrow large sums from banks and issue all kinds of bonds. Some of these bond issues were aimed specifically at the foreign investors that had become very interested in this fast-growing market. These so-called offshore bonds were issued almost exclusively in US dollars and formed a standard part of the balance sheet. It's precisely this type of instrument that piqued our interest at the end of last year. The biggest project developer of all in China, Evergrande, had already been in the news for some time by then. The company had simply borrowed far too much money and was starting to collapse under this mountain of debt. The real estate market began to cool as a result and property investors panicked, afraid of the potential fall-out if Evergrande were to go bankrupt. The equity prices of many other project developers also came under severe pressure because of this. The price pressure on the bonds was initially not that acute though. The prices of these bonds - which often have coupon rates of 5% to 10% - held up well, in part because interest rates were still negative across the globe. This all changed at the start of this year, however. In a swift chain reaction, one project developer after another began to get into difficulties.

A toxic cocktail of cautious homebuyers and the sudden withdrawal of Chinese banks caused the bonds to crash. By definition, a project developer gets into difficulties if existing credit lines are suddenly cancelled. However robust a balance sheet may be, when a lender doesn't extend a loan or suddenly calls it in, a developer simply cannot react fast enough to pay it back. This triggered a major liquidity crisis throughout the sector to which no-one was immune. At the beginning of this year we started to take positions in this extremely interesting sector. In retrospect we acted too soon. While we thought it a good idea to buy bonds issued by the most creditworthy developers at prices that were far below par, there were much better times to buy later in the year when the market panic was at its height. Our position in Zhenro bonds in particular squeezed performance early in the year when price losses occurred. Prices fell so much more during the year though that we were able to create a highly promising position by buying these same bonds at prices that were only a few percent of the par value.

Although the position continues to be substantially underwater, we've managed to reduce the cost price enormously. An average cost price of between 10% and 20% of the par value creates sizeable upside now that a restructuring of these bonds is imminent. We eagerly await this restructuring of Zhenro's debt and expect greater clarity on the future structure at the start of 2023. The core of the investment case is that we are the creditor of a company that may be experiencing liquidity problems but has had no solvency issues to date. In laymen's terms: on paper the company owns more than enough assets to pay everyone off but cannot do so at the moment because it has no cash. However, if it can obtain an extension from bondholders to redeem the bonds at a later date and in the interim only needs to pay a small coupon amount over these bonds, then the company has a very real chance of restoring its liquidity positions. On this basis, the prices of these bonds could climb sharply.

Throughout the year we also took positions in a number of other project developers, including Agile and Country Garden. The gains on these bonds go some way towards compensating for the loss we incurred on the Zhenro bonds. In the event of a successful restructuring, however, we believe we're in an excellent position to convert the loss on Zhenro into a profit. Lower prices may hurt at the time but can sometimes drop so far that new opportunities arise for buying more bonds and averaging the cost price at a level that ultimately allows the whole position to realise a profit.

As we said, a happy accident.

Strix

Market leader in the manufacture of kettle safety controls: to us that sounded like an investment so niche that no-one else in the investment community was likely to have noticed it.

In October we were approached about taking an interest in this distinctive company. At the time, it was negotiating the acquisition of another company, Billi, and sought capital to complete the transaction. The background to this deal was interesting. Earlier in the year, a major merger had been announced between two Australian companies, Culligan and Waterlogic. Yet as the year progressed it became clear that the local competition authorities objected to this merger. The solution was to sell off subsidiary Billi. Buyers initially queued up to do so. Both private equity firms and sector peers displayed great interest in this business that manufactures products similar to those made by Dutch company Quooker. And rightly so. The company is growing fast in the market for taps, which can now produce much more than just boiling water. Filtered or carbonated water can now also easily be obtained from a tap, giving Billi a premium position in the market. These taps cost an average of between EUR2,000 and EUR3,000 and yield sound margins. After the first round, in which valuations of 11 times EBITDA were offered for Billi, more and more bidders backed out of the race. The deteriorating market climate and rapidly rising interest rates made it increasingly difficult to finance this transaction. In the end, only Strix and one other party were left. The upshot was that the valuation ratio had fallen further to 7 times EBITDA. Then the other party dropped out as well. Strix used that to reduce its bid even further to GBP38 million, just 3.8 times EBITDA. The deal was finally struck and in order to finance it a private share placement was held, of which we were one of the buyers.

Why are we so enthusiastic about Strix?

Strix manufactures a small but extremely important component for products that heat water. These might be kettles but also baby bottle warmers, the Quooker boiling water taps mentioned above or even elements for water purification. The crucial aspect of this component is that it switches off the electricity supply when the water boils. The slightest defect in this component has the potential to cause hazardous situations, something manufacturers of the end product (brands such as Siemens, Philips or Smeg) naturally want to avoid. Strix therefore holds an exceedingly large market share and would be difficult to topple from this position. This tiny component makes little difference to the overall cost price of the kettle and the company can rely on a loyal customer base. As a result, Strix has realised very sound margins for many years and is largely unaffected by competition from e.g. China. The addition of Billi will also move it up a step in the value chain. Strix's revenue has been growing for years and soared when the world went into lockdown in early 2020. Many people suddenly found themselves working from home and bought new coffee makers or kettles. Its stocks reached a record high of more than GBP4 per share. The opposite was true in 2022, however. The return to something close to normality led to Strix reporting revenue and earnings that were still sound but down slightly on the preceding boom years. This undid all the coronavirus gains and the stocks dropped back to GBP1.25. Then a share placement (the one we participated in) pushed the price down to GBP0.80, a discount of 80% on the previous year's price. We see an enormous opportunity in the company's current equity price. It occupies an excellent position in a market with a positive outlook. Not only can it grow rapidly in those parts of the world where kettles are still seen as an innovation, but its products are also becoming increasingly high-end and in Billi the company has acquired a wonderful new growth pillar. At a valuation of only about six times the company's earnings, its stocks have never been so cheap and there's every chance they'll recover to levels of GBP2 or more. A nice addition to the portfolio.

Wentworth Plc

In the second quarterly report of 2022 we wrote about the UK's Wentworth Resources Plc, which produces gas at the Mnazi Bay gasfield in Tanzania. A simple but profitable business case that also yields a tangible result for locals and the environment. The supply of gas means that locals have no need to generate electricity using diesel, which is much more of a pollutant. Earlier this year, Wentworth announced its intention to take a 25% stake in neighbouring gasfield Ruvuma. This provided a home for the large amount of cash Wentworth had accrued despite paying out sizeable but sensible annual dividends to its shareholders. There have recently been some new developments that we want to bring to your attention in this quarterly report.

The Ruvuma acquisition never happened because other parties ended up exercising their buy options on the Ruvuma gasfield. It would have been a great way for Wentworth to increase its scale without having to invest large amounts and would have guaranteed gas supplies far into the 2040s. Unfortunately, the company was unable to grasp this opportunity.

Upscaling is important for several reasons because it could act as a catalyst to crystallise the company's undervaluation. For example, upscaling would give it access to the UK's FTSE 250 index. This would in turn mean exposure to bigger investors and more attention from market parties compared to a local market listing.

Promotion to a bigger index in itself means that you're growing in size and if more investors hear of you then there's an even greater chance of the undervaluation being reversed, which in turn pushes up your market value. Wentworth is certainly undervalued if we examine the almost guaranteed cashflows that are adjusted for inflation. This was the reason we bought our position in Wentworth in 2021 and 2022

The payment of a 13 pence per share super-dividend versus a share price of 24 pence (as of 1 November) in order to give the surplus cash a home is profitable for shareholders but also a one-off extra bonus. At the same time, it substantially reduces the company's market value, which has repercussions for the listing itself. Moreover, the current asset (Mnazi Bay) also requires investment just to keep its current (record) production at the same level. This type of investment is also complex. Wentworth isn't the only partner operating in the Mnazi Bay gasfield. This led to the board having to perform a tricky balancing act that could best be described as awkward.

On 5 December 2022 came the news that the main operator of the Mnazi Bay gasfield, France's Maurel & Prom S.A. (M&P), had put in a bid for Wentworth at a premium of 30% versus the closing price on 2 December 2022. At first sight not a particularly generous premium, as it means M&P is paying about three times the company's annual dividend to withdraw Wentworth from the stock exchange.

However, the acquisition market doesn't take cash into consideration when defining the takeover premium. If we look purely at the company's operations and assets, the premium is over 62%.

Wentworth's board has recommended that shareholders accept the bid and a number have already done so, pending approval. It therefore looks as if Wentworth's time as a listed company is coming to an end. It's unlikely that an outsider will put in a higher offer. M&P and Wentworth already enjoy close ties as the two largest operators of the Mnazi Bay gasfield. Any hostile bid would result in the acquiring party having to work together with M&P in the coming years and it follows that the latter wouldn't be that willing to cooperate on its own turf.

Overall, we're pleased that a portion of Wentworth's undervaluation has been crystallised so quickly. The flipside is that after Hunter Douglas, Yew Grove Plc, John Menzies Plc, CareTech Plc, Hibernia Reit and RAK Petroleum we're once again 'losing' an investment that could have yielded stable cashflows for many years to come. By investing in Wentworth we also contributed to developing the local economy and making African diamond in the rough Tanzania's energy supplies more sustainable. Luckily, that process will continue but without us as a shareholder and supporter.

Information: https://www.wentplc.com/investors/offer-for-wentworth/

TomTom 2.0

On 2 November 2022, TomTom N.V. organised its first capital markets day in Amsterdam since 2019. It's a while since we devoted pages of our quarterly report to navigation specialist TomTom and the investor meeting is a good occasion for an update.

There was of course a reason for the event. TomTom's transformation from a hardware (physical devices) navigation specialist to a software tech-driven company could already be described as an astonishing feat but an even more exciting sequel is now in the offing. TomTom wants to open up its maps platform so that anyone can use it. That may seem an odd move but there's a well thought-out plan behind it. TomTom has spent the past few years working on a more in-depth version of its geographical map database.

Opening up the maps platform is really the prelude to rolling out new, much more detailed national maps that aim to contribute to the company's goal of creating the smartest map on the planet. A geographical map providing better global coverage, more data on buildings, traffic information, altitude differences, non-road areas such as parks, public transport and much more. TomTom's new mapping system comprises several layers, of which the top layer of (most basic) maps will be opened up to other users. Below that will be a level containing much more detailed information for a fee. This detail is needed because of the acceleration in increasingly location-driven apps and services that has occurred over the past three to five years.

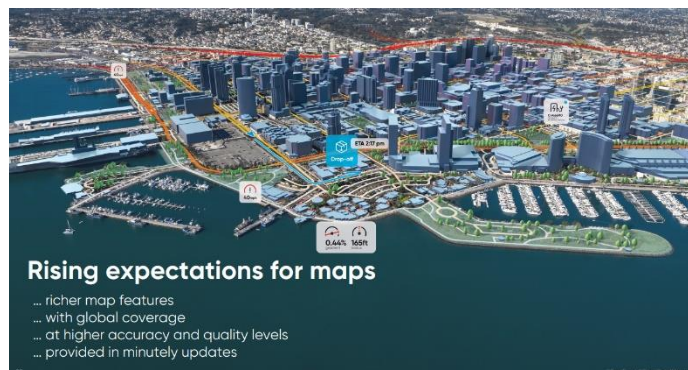
With the new maps TomTom believes it has found an answer to demand for better navigation options. Many business partners say that Google Maps isn't really a solution for them and on top of that it pushes all kinds of other unwanted services.

Competitive edge

The acquisition of the Tele Atlas map division in 2008 was a difficult and ultimately financially painful experience but it has helped to put TomTom in a unique position just as location-related services are set to grow further. Why are we so enthusiastic? Because TomTom has something unique that is a) difficult to copy and b) in short supply, and c) because the company is positioned for a growth market and d) has already invested a great deal and can therefore realise operating leverage. The updating and maintenance of the maps is partly done by its customers and partners! After all, customers provide TomTom with free data in return. This removes the need for old-fashioned techniques (driving around in cars that store an enormous amount of data for a kind of Street View). TomTom was consequently able to cut this part of the workforce. On the other hand, TomTom has recruited many new employees from e.g. Apple, Google and Microsoft, which make a good match when combined with experienced staff. Map-making is no easy task and a great deal of knowledge and data are required from users.

Business market

It's essential that TomTom targets the business market. Ten years ago, about 60% of its revenue still derived from hardware. And by then the hype surrounding TomTom devices had already passed.



In 2022, only 20% was hardware/consumer-driven revenue, which means that 80% of the company's revenue comes from supplying data software. Although the consumer division is profitable, its margins are low and competition is high. Google Maps, for instance, offers its services for free in exchange for data and the mandatory purchase of other software services. Competitor HERE also offers free navigation to consumers. TomTom offers consumers its TomTom Go app for EUR19.99 a year.

Consumers receive multiple extras as an incentive to buy this service and TomTom still needs to be left with something on the bottom line.

This is why TomTom is increasingly focusing on the business market, such as taxi platforms, food/shopping/parcel delivery services and (partially) self-driving cars.

The new interface will enable TomTom to navigate a parcel delivery service accurately to the correct destination, exact building entrance and correct floor. This saves time and is what makes it worth customers paying for the service.

Other more general applications are also possible: an efficient route through a theme park or holiday-related services such as planning a hiking route or navigating in a National Park in the US or Africa. The new interface goes many times deeper than the current standard maps and has many potential applications as well.

TomTom of the future

Investors have been extremely negative about TomTom for many years. The type of transformation that TomTom is undergoing takes time and involves the usual missteps that are all just part of doing business. TomTom itself calls its new interface version 2.0 of the company and has also launched a new logo. We stand on the threshold of exciting new developments. In light of these we remain extremely enthusiastic about the opportunities open to this company, which also enjoys sound fundamentals.

We've recently seen a range of private and institutional investors rekindle their enthusiasm for TomTom. The more investors recognise the potential of this company the better. We look forward to the roll-out of the new platform in 2023 and to the first tangible results of the new TomTom. One tangible result came as recently as December 2022 when TomTom announced a partnership with Meta, Amazon and Microsoft under the name Overture Maps Foundation.

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