Q3
September 2020

Investment Objective: To achieve long-term capital appreciation and to exceed the returns of the MSCI All Country World (ex U.S.) Index through the active management of a focussed portfolio of listed equity investments in family-backed holding companies.

Introduction

Global equity markets continued their rebound from the March lows during the third quarter. The volatility witnessed in the first and second quarter of 2020 tempered slightly but a general sense of caution remained.

In this context the FHC portfolio returned +9.2% whilst the MSCI ACWI ex-US (€) returned +1.8%. Year to date, the FHC portfolio has returned -6.6% versus -9.5% for the benchmark.

Performance review

Kinnevik contributed over 460bps to returns and as such was the largest contributor by a considerable distance. This accounted for most of our outperformance and highlights the power of a concentrated portfolio – when things work they really move the needle. During the period Kinnevik's shares returned +52%, benefiting in roughly equal parts from NAV growth (+24%) and a narrowing of the discount from 23% to single digits. Having added to the position significantly (at SEK 171) during the sell-off, in Q3 we trimmed this back down (at SEK 328).

In our last quarterly letter we discussed how COVID-19 has led to an acceleration in digitalisation, driving NAV growth in Kinnevik's digitally-enabled holdings. This continued into Q3. Zalando – Europe's leading e-commerce platform which accounts for 43% of NAV - returned +27% during a quarter in which it reported +27% sales growth, adding 3 million new customers at the fastest rate since 2013. Their platform strategy – where Zalando in-effect becomes a digital storefront, integrating inventory, giving brands merchandising freedom and bundling higher margin fulfilment and marketing services - is gaining traction, with a reported 180 new Partners joining. We have long been optimistic about this strategy on the basis that a) the inventory-light model allows Zalando to scale to a wide assortment, attracting more customers and in turn attracting more brands in a virtuous cycle; b) it creates attractive long-term margins. The former is borne out in the strong sales growth we witness, and on the latter we note sell-side revisions for medium term EBIT have been creeping up as commentary has started to turn to the higher margin nature of ZFS and ZMS.

Shares in chronic disease management company Livongo (15% of NAV) returned +86% during a quarter in which a merger with Teladoc the leading US telehealth company was announced. This is a sector we have done considerable work on over the last year and believe the combined company will offer a strong value proposition to clients, with an unparalleled breadth of offering. The combined company will have ample cross selling opportunities and a vast runway for growth.

We benefited strongly from the narrowing of the discount, as risk sentiment at a market level dissipated, and investor's appreciation for Kinnevik's attractive exposures and investment model increased. FHC took advantage of this by trimming the position. We do note however that – given Kinnevik's policy to distribute excess capital to shareholders – the "fair" discount might be narrower than it has been historically. In this context we remain excited by the prospect of future NAV growth, as well as over the longer-term, further distributions.

Softbank Group, Investor AB and Pershing Square Holdings also made sizable positive contributions, with share price returns of +19%, +19% and +17% over the quarter.

Turning to the other end of the portfolio, Prisa and EXOR were notable detractors. We have discussed Prisa at length in our previous two quarterly letters and to an extent there is nothing new to add. If media reports about the hiring of banks to lead a refinancing and splitting of the company are to be believed, we might well have more to discuss by the time of the next letter.

EXOR shares declined -9% during the quarter, as NAV growth of +7% was offset by a widening of the discount from 34% to 43%. We took advantage of this dislocation and added to the position.

On the NAV front FCA (24% of NAV) was the key driver, with its shares returning +17% during a quarter in which the pre-PSA-merger distribution terms were revised. FCA will now pay a dividend of €2.9bn versus the previously planned €5.5bn; however, FCA shareholders will now also share in the distribution of PSA's 46% stake in Faurecia, meaning total distributions equate to €4.6bn – of which €1.4bn will flow to EXOR. Coupled with Dongfeng Motor Group completing a partial sale of their PSA stake, and constructive commentary on appeasing EU probes into the competitiveness of the LCV market, investors now view the merger as significantly de-risked. As such, the narrative has shifted to looking at what the combined company looks like - which is a well-capitalised, diversified auto maker, led by an impressive management team likely to realise valuable synergies, trading at a lowly valuation. In this vein we are excited about FCA's future and the prospects for high returns.

As ever it is difficult to untangle and ascertain precisely why EXOR's discount has widened. One possible theory is that EXOR is still perceived as a European cyclically exposed industrial holding company. Not only would such a perception be wrong (given Partner Re is at the foothills of a hardening cycle and Ferrari is not subject to economic vicissitudes), but it would of course be double counting (the business environment is already reflected in FCA and CNH's share prices). As such we added to EXOR at what we consider a highly attractive valuation. We note John Elkann seems to share our assessment, with EXOR re-starting its buyback program just before the end of the quarter.

Q3 portfolio activity

During the quarter we initiated a new position in Mandarin Oriental (2.9% weight), the hotel property group which accounts for 8% of Jardine Strategic's NAV, itself a 2.9% position. Mandarin Oriental offers attractive exposure to a rebound in travel and tourism, with potential further upside if the Jardine Group were to pursue something more structural, such as selling the ex- Excelsior Hotel development site, which is being developed into an office led scheme. The current market valuation of this property alone is $2.7bn, about the same as Mandarin Oriental's enterprise value, and in the long term we don't believe this belongs in the hotel group which is moving to an asset light model. Alternatively with a small free float and at close to a 60% discount, the Group might conclude that a listing is no longer suitable. Of course, we are not in control of such events – they happen as and when they suit the controlling family – but at such a wide discount we can afford to be patient.

As well as this we made additions to Christian Dior, VNV, Prosus, Berkshire Hathaway, and EXOR (as discussed above).

During the quarter we exited Cosan Ltd. ("CZZ") as plans to collapse the structure – as had always been our thesis – led to significant tightening of the look-through discount. The fund earned a +7% ROI / 17% IRR on CZZ, versus +4% / 10% for the MSCI ACWI ex-US (€).

Outlook:

"My mama always said, life is like a box of chocolates. You never know what you're gonna get." – Forrest Gump

The ex-post narratives that get applied to markets are always pleasingly simple. Ex-ante though, things are less clear. Investors were caught off guard at the pace and depth of the decline, before being quickly dumbfounded as markets rebounded. Scepticism at the sustainability of the recovery in markets remains prevalent. This critique is not entirely without value; however, we are generally of the view that – with government's and central banks having eliminated tail risks through their herculean efforts – things will continue to get better. As equity investors we are natural optimists.

At the portfolio level, we have not let the bear market go to waste, significantly increasing the quality of the portfolio during the year. This is crucial, as in the long-run NAV growth will be the key determinant of our success. The portfolio weighted average discount remains elevated at close to 33% versus 31% at the start of the year. Taken together, we remain optimistic about future returns.

Please do get in touch if you have any questions.

Investment Manager – Joe Bauernfreund

AVI Ltd. +44 20 7659 4800 info@assetvalueinvestors.com

Information may be found on the following websites:
www.assetvalueinvestors.com

IMPORTANT INFORMATION

All figures are as at the period under review unless otherwise stated. All sources Asset Value Investors Ltd ("AVI") unless otherwise stated. AVI is authorised and regulated by the Financial Conduct Authority of the United Kingdom (the "FCA") and is a registered investment adviser with the Securities and Exchange Commission of the United States. While AVI is registered with the SEC as an investment adviser, it does not comply with the Advisers Act with regard to its non-U.S. clients. This document does not constitute an offer to buy or sell shares in AVI Japan Opportunity Trust plc (the "Trust"). The contents of this message are not intended to constitute, and should not be construed as, investment advice. Potential investors in the Trust should seek their own independent financial advice. AVI neither provides investment advice to, nor receives and transmits orders from, investors in the Fund.