Q2
June 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

To paraphrase the former Czech president Václav Havel on the collapse of the USSR: We have not yet had time to be astonished at the events of 2020. The fastest drawdown in history has been followed by one the sharpest re-bounds. Fear has subsided, supported by the monumental efforts of governments and central banks, leading to a rally in global equity markets.

In this context the FHC portfolio returned +18.6% in Q2-2020, whilst the MSCI AC World Ex-Us (€) returned +13.4%. YTD the FHC portfolio has returned -14.4% vs. -11.1% for the index.

Performance review

Performance was broad-based as global markets rallied off the March lows and risk sentiment started to normalise, as reflected in the narrowing of the portfolio's weighted average discount from 40% to 36%.

Kinnevik – the fund's largest position, having been added to considerably during the sell-off – was by some distance the greatest contributor to returns. In Q2 Kinnevik shares returned +48%, benefiting from both NAV growth (+33%) and a narrowing of the discount from 31% to 23%. This was led by e-commerce platform Zalando (40% of NAV), whose share price advanced +79%, and chronic disease management company Livongo (10%), which returned +164%.

COVID-19 has accelerated many existing trends, and none more so than the adoption of e-commerce and digital healthcare services. Zalando is enjoying exceptionally strong customer growth and as a result during the quarter announced it expects full year sales growth of 10-20% and EBIT of €100-200m, both of which were materially above expectations. As well as driving customer growth, the current environment incentivises brands to partner with Zalando, whose management team has been proactive, using the rock-solid balance sheet to extend attractive terms to prospective partners. The beauty of this is that the more brands who join, the wider the assortment, thereby attracting more customers, which in turn attracts more brands. This flywheel-effect is hugely powerful and helps establish Zalando as the starting point for fashion in Europe.

Similarly, Livongo (10% of NAV), which helps its users manage their diabetes and other chronic diseases, has seen accelerated growth. Growth comes in two forms: 1) expanding the corporate client base; and 2) increasing the enrolment level of the existing client base. Both have been at work, with remote health monitoring and the protection of at-risk populations (such as those with chronic diseases) having come to the fore in 2020. During the quarter Livongo announced Q1 sales growth of +115% and raised full-year guidance. With the large and growing prevalence of chronic conditions, the runway for further growth is immense.

During the quarter Kinnevik took advantage of Zalando's strong share price performance and reduced their stake by 17%, realising proceeds of €645m. Kinnevik will return a little under a third of the proceeds to shareholders in the form of a special dividend (2.9% yield). The bulk of the proceeds will be retained, and recycled into new and existing early stage investments, where Kinnevik has an increasingly strong record of value creation.

The other standout performer was SoftBank Group ("SoftBank"), which had also been added to considerably during the March sell-off, as it traded on its widest ever discount. As noted in our Q1 letter, the investment in SoftBank was predicated on the extremely wide discount at which it trades, and the prospect for this closing following the engagement of Elliot Advisors, and founder Masa Son's subsequent commitment to asset sales, debt reductions, and buybacks. The thesis has been and continues to play out as planned. SoftBank have now announced asset sales totalling $35bn, and bought back 5% of their shares, with another 16% due under the current program using the current price. The shares returned +44% in Q2 as the discount narrowed from 66% to 55%. We continue to see attractive upside from here as the process continues.

Turning to the other end of the portfolio, Prisa was the only material detractor of note. We discussed Prisa at length in the last letter, but by way of reminder Prisa is a classic case of the right attractive asset (education business, Santillana) in the wrong heavily indebted structure. However – and hence the investment – it is a not a structure we expect to exist long-term and we see significant upside through numerous potential corporate events, helping to unlock Santillana's value and reduce debt.

During Q2 Prisa's shares declined -15%. The market – not entirely without good reason – is concerned about the heavy debt load, as well as the impact of COVID-19 on earnings at the media assets. Reports of strife amongst different shareholders and board members has added a further distraction. Yet we remain optimistic. The maturity schedule and good relationship with the creditors (who also own the equity) creates flexibility; and our interests are aligned with those of controlling shareholder Amber Capital, who are exploring different ways to crystallise Santillana's immense value.

Importantly on this, operating performance and KPIs (such as student growth), coupled with the COVID environment in which digital-education is an increasingly favoured sector, mean Santillana's intrinsic value is increasing whilst we wait for an event. Patience is required, but at more than a 70% discount to our estimated NAV, the potential upside is significant. Prisa was added to during the quarter.

Q2 portfolio activity

During Q2 we continued to use the volatile environment to take advantage of opportunities and generally improve the quality of the portfolio. Notably we initiated new positions in Prosus, the European technology-focused holding spun out of Napsers, Berkshire Hathaway (which requires no introduction) and VNV Global, a Swedish holding company that makes venture capital-style investments. Together these holdings now account for 15% of the portfolio. We also continued to build our position in Christian Dior, as well as the already mentioned additions to Kinnevik, SoftBank and Prisa near the start of the quarter.

To fund these purchases, we continued to sell Pargesa ahead of the group simplification, fully exiting the position. We also exited several smaller positions in Wendel, HAL Trust, Toyota Industries and Swire Pacific.

Outlook

"*It's the economy, stupid*" James Carville, 1992

Commentators and participants alike have been dumbfounded by the disconnect between markets and the economy, or Wall Street and Main Street as some catchily put it. As cases, particularly in the US, regain momentum and the prospect of possible local lockdown measures re-emerge, not to mention concerns about unwinding of furlough schemes and the state of labour markets, these critiques are not entirely without merit.

On the other hand, the fiscal and monetary policy response has been swifter and larger than most would have imagined. Collectively this underwrote the worst of the pandemic-related economic consequences. Risk assets continue to benefit from looser monetary policy, which appears set to stay with us for the foreseeable future.

Luckily, our job is not to solve this riddle, nor to know exactly what markets will do. Rather, we aim to align capital with prudent owners of high-quality businesses, the value of which is likely to compound over time, trading at attractive discounts to their net asset value. Year to date the quality of the assets to which we are exposed has increased, and at a 36% weighted average discount the portfolio remains lowly valued, boding well for prospective returns. As such, we remain optimistic.

Please do get in touch if you have any questions.

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