Q3
September 2021

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

Equity markets were mixed in the third quarter of 2021. European and North American markets were flattish, whereas the MSCI China fell -18% as investors grappled with a changing regulatory regime. Japan (finally!) played catch-up in the global recovery as their vaccine effort kicked into gear, with the TOPIX appreciating by +5%, but Asia ex-Japan lagged as investors priced in a slower return to normal.

Within this context the FHC fund returned +0.6%, versus -0.7% for the MSCI ACWI ex-US (€). This brings year to date returns to +14.3%, 2.5% ahead of the index, which has returned +11.8%.

Performance review

D'Ieteren was the largest contributor to returns during Q3, with the shares advancing +25%, adding +1.6% to returns. The key here was Belron (71% of NAV), the vehicle glass repair, replacement and recalibration company, which received a new valuation mark, at a materially higher than expected level. In July it was announced that D'Ieteren's minority partner CD&R had agreed to sell a ~13% stake in Belron to a group of private equity investors at an enterprise value of €21bn. We previously held the business at a (conservative) carrying value of €13bn, consequently adding +44% to NAV. Whilst D'Ieteren shares leapt +22% the day following the news, the discount widen from 34% to 43% as the shares failed to keep up with the NAV.

Casting our minds back to late 2017, when D'Ieteren first invited minority investors into Belron, the market took some time to start pricing in the higher than anticipated valuation. We would expect this to be the case again this time, and as such remain excited at the prospect for discount narrowing, as well as further growth in NAV.

The other major contributor to returns was Pasona, which returned +47%, on account of NAV growth (+30%) and a narrowing of the discount from 79% to 77%. Pasona owns a 50% stake in HR solution company Benefit One, which returned +51%, and now accounts for a whopping 323% of Pasona's share price. As implied by the sharp discount at which the shares trade, the market wrongly views Pasona's core HR-related service as a perennial drag on value. Recent results however have been promising, with record levels of operating profits. In situations such as this, where the market awards such extreme valuations, it only takes marginal improvements in sentiment to drive materially higher share prices. For instance, if Pasona were to trade on a 50% discount to NAV, the share price would have to increase +115%. As such we are optimistic about prospective returns.

Turning to the other end of the portfolio, Prosus returned -16% and detracted -82bps from performance. The proximate cause was China, and an increasingly interventionist approach to regulation, which saw shares in Tencent (73% of NAV) decline -21% in Q3. The FHC fund seeks to align capital with high-quality families, who own attractive quality assets and have a history of creating value for all shareholders. Alas for Prosus these attributes were no longer present. As discussed in last quarter's letter, management have taken sub-optimal steps to "fix" the discount, in our view entrenching a structurally wider discount. What changed in Q3 was regulatory risk in China – or more specifically the continued deterioration in the regulatory environment and the cumulative effect this had on our ability to assess Tencent on a fundamental basis. Whilst loathe to sell something at a beaten-up price, holding beaten up shares in the *hope* of things improving is not an investment strategy. As such we exited the position in early October. Over the life of the investment we earnt a disappointing -12% IRR, versus +21% for the MSCI ACWI ex-US (€).

Q3 portfolio activity

During the period we also took the hard decision to exit Prisa – a disastrous investment in both absolute and relative terms, generating an ROI of -52% whilst the index returned +18%. As readers will remember, the initial thesis was that Latin American K12 publisher Santillana was a hidden gem stuck in the wrong (heavily indebted) conglomerate structure, with potential value extraction either in the form of a Santillana IPO or merger. COVID and a material de-rating in the Brazilian education-tech sector means crystallising value will likely take much longer than initially anticipated. We concluded that capital is better invested in higher quality companies with more sustainable capital structures. We do not expect to make further investments in companies where so much rides on an event outside of our control, nor in companies with such high levels of gearing.

We also sold our remaining stake in Softbank. The investment in Softbank was a highly successful one, generating a +51% IRR versus +17% for the MSCI ACWI ex-US (¥). Softbank had been in our universe, and long traded at a wide discount to NAV. However, the healthy returns are a function of our patience in waiting for a catalyst before investing - in this case the pressure from activist investor Elliott, which was further ratcheted up by the collapse in markets and the leverage position of founder and controlling shareholder Masa Son – and the conviction we showed by doubling down during the March-20 lows when Softbank traded on its widest ever discount.

The cash raised from the above discussed sales was invested into making IAC and FEMSA both >5% positions. We also added to EXOR, Aker and Mandarin Oriental.

Outlook

The intertwined themes of inflation, interest rates and growth continue to dominate investor thinking and drive markets. The optimism that characterised the start of the year has subsided; hopes of reflation have slid to fears of stagflation.

We try not to get caught up in this, aware of our inability to predict the future macroeconomic landscape, and remain open minded about what might come next.

Rather, our time is spent on the things that we can control - the portfolio. And here there is cause for optimism, given the quality of the assets we own and the attractive valuations at which we own them, as indicated by the 31% portfolio weighted average discount. As we've noted before, the families we've aligned capital with have records of significant value creation over multi-generational time frames. We expect this to continue.

Investment Manager – Joe Bauernfreund

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

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