Q2
June 2023

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.

Global equity markets marched higher in the second quarter, led by an increasingly narrow band of US-listed technology companies as excitement about the potential of artificial intelligence has exploded. The market capitalisation-weighted S&P 500 returned +8.6% whilst the equal-weighted equivalent returned a more meagre +3.5%.

Within this context FHC returned +2.0% in the second quarter, which was bang in-line with the benchmark, the MSCI ACWI ex-US (€). Year to date we have lagged the index, with a return of +3.5% versus +7.1% for the benchmark.

Performance review

As was the case in Q1, during the second quarter **FEMSA** was the standout contributor, adding +177bps to returns. The shares rose +18%, as +5% NAV growth was complimented by a narrowing of the discount from 32% to 25%. At the end of May the company took further steps in its simplification process, fully exiting Heineken (bar the shares underlying the exchangeable bond), selling $3.4bn of Heineken / Heineken Holding stock. FEMSA also announced the sale of Jetro Restaurant Depot (“JRD”) for $1.4bn.

FEMSA shares have now moved nearly +90% off the lows they hit last July (where we averaged down!). The stub has re-rated considerably from the all-time-low 5.7x EV/ NTM EBITDA to 8.8x currently, and earnings have also grown significantly (EBITDA for the next twelve months +21% today versus then).

It is this latter point which is particularly important to us – asset quality and the prospect for NAV growth are key to our style of investing. Q1 results show Oxxo to be in rude health, with the fastest rate of Same Store Sales growth in Mexico in more than 20 years at +19%. Both ticket and traffic contributed to this and there is likely more to come from both, with a continued mix-effect to higher priced items such as spirits and pantry items, where Oxxo started to gain traction during the pandemic, and a continued recovery in traffic. New store openings are now running above >1k on a trailing twelve-month basis once again, and we believe the company can reach c.30k units in Mexico by the end of the decade (from just shy of 22k currently). As well as this, we are increasingly encouraged by the company's operations in Brazil, a notoriously difficult market but one where FEMSA and their JV partners are showing a high and consistent level of performance. Success here would significantly extend the growth runway, and we expect investor attention to increasingly turn to this as the business scales and disclosure improves. Despite strong performance we believe the shares remain cheaply priced, trading at a 25% discount to our estimated NAV and with the stub at an inordinately wide discount to Walmex (8.8x vs. 12.3x). Pro-forma of the above transactions, we estimate that net debt to EBITDA stands at c.0.4x vs. management's target of 2.0x. This implies the company has “excess” capital equating to c.13% of its market cap. Investors, not entirely without reason, are cautious over how this will be deployed, and we have been encouraging management to use the proceeds for share buybacks.

Other strong contributors include **IAC** (+99bps,) **EXOR** (+49bps) and **News Corp** (+41bps).

D'Ieteren – the Belgian holding company – was a material detractor, shaving -70bps from performance as the shares declined -8%. The shares have underperformed, with the discount widening to 42% since the company reported what we considered to be a strong set of full year results in early March. Whilst operating profit for D'Ieteren's underlying assets “beat” consensus expectations, investors were perturbed by significant working capital build-up and correspondingly low free cash flow generation. We believe such fears are undue, with the key culprit being D'Ieteren Autos (9% of NAV), where free cash flow swung from €108m to negative €101m as VW accelerated deliveries during the last two weeks of the quarter. This led to a €155m working capital outflow – or as management described it on the earnings call “a photo finish that was not very pleasant”. This is a heavy-handed tactic we have seen from VW before (e.g. 2018), but one that normalises over time. As such we took advantage of the decline in the shares and added to the position.

The key assets Belron, TVH and PHE collectively account for 79% of NAV and exhibit largely non-discretionary demand drivers; combined with the prospect for margin expansion at Belron and accretive bolt-on acquisitions at TVH and PHE, we believe the prospects for NAV growth are attractive, with potential further upside from discount narrowing. Given the presence of private equity co-ownership at Belron we believe some form of corporate event is probable in the coming years, with management highly incentivised to increase the equity value, which should act as a catalyst for D'Ieteren shares.

Other notable detractors were **Aker** (-84bps) and **Digital Garage** (-77bps).

Q2 portfolio activity

Portfolio activity was relatively modest during the quarter.

As well as adding to **D'Ieteren**, we also added to **Aker** and **Haw Par** as their discounts widened.

These were funded by reducing **Investor**, **EXOR** and **Christian Dior**.

This left us with a 6.4% net cash position at the end of June. Post quarter-end we have started to deploy some of this capital into a new position, which will be discussed in the next letter.

Outlook

"the last mile to price stability may be the most challenging" – Bank for International Settlements (BIS), June 2023

The contention of the BIS – the central bankers' central bank – is becoming increasingly well understood: inflation may well prove more persistent and elevated than many previously thought, and the path back to the sacred 2% target level is a precarious one. The risks around this and the timing and magnitude of a slowdown remain the topic du-jour and there is a sense that we are in something of a holding pattern waiting for a recession that is yet to fully manifest.

Of course, markets are not the economy, and the AI-frenzy has added in an additional layer of noise, particularly at the index level. We have no direct exposure to this "theme" and continue to assess and understand the threats and opportunities such technological developments might present for our underlying companies. As ever investors are prone to over excitement and extrapolation, and Johnny-come-lately's who chase such returns will likely find themselves in undesirable positions. Suffice to say this is not something we will be doing!

Rather our attention remains focused on the concentrated yet diverse collection of attractive, high-quality yet lowly-valued companies we have assembled. Valuations, both in the portfolio and wider universe are attractive, with discounts having widened year to date. History and experience show that these are the ingredients for attractive long-term returns.

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