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Quarterly report Q3 2024

The summer was anything but quiet for most companies. Many of them reported results over the first half of the year and any news was of course carefully analysed by investors.
In the global markets, we mostly saw effects relating to interest rates and macro-economic trends in the US. As you know, the Fed and ECB kept interest rates high for a prolonged period in a bid to curb inflation. Both central banks have now started to cut their policy interest rates, but the question remains as to how much these high rates are affecting economic growth. On top of this, there are multiple geopolitical tensions that require no further explanation here but are impacting the equity prices of many companies.

So what happened in Q3?

Yen carry trades

The date that stands out most is Monday 5 August. The Nikkei, Japan's leading index, lost as much as 12% in value on this day. This made it the worst trading day since Black Monday in 1987. The downturn was driven by macro-economic concerns, but investors learned the hard way about the phenomenon of carry trades. A carry trade is a transaction in which investors borrow money in a country with a low interest rate, such as Japan, and invest it in a currency with a higher interest rate, such as the US dollar. For instance, an investor could borrow yen at an interest rate of about 0.5 percent and find a safe US investment that yields interest of about 5.5 percent. If that sounds like a tombola that pays out every time, it's because that's precisely what it was. It's no surprise then that carry trades have become extremely popular among financial traders, companies and even private individuals who've used the technique to pay their mortgages.
The only potential problem comes when the exchange rate between the two countries starts to change. In this case, a stronger yen means that the investor needs more US dollars to repay the loan, which can potentially wipe out any profit and leave the investor with mounting losses.
This all came together on Monday 5 August when a rapidly rising yen fuelled a declining equity market, which in turn led to a greater unwinding of what are known as yen shorts, or bets that the yen will fall further. The upshot was a market crash. The Nikkei is climbing again now, although it hasn't yet exceeded the levels of earlier this summer.

Developments in the portfolio

They were changeable weeks on the markets, and we felt this in the portfolio as well. For instance, the price of a barrel of Brent oil fell from USD87 to USD71. This was triggered by the news that Saudi Arabia may abandon its target of bringing the price of a barrel oil to USD100 (source: Financial Times).

This of course affects the sentiment surrounding stocks such as Gulf Keystone, Genel, DNO, Petrotal and Diversified Energy. All these companies lost ground on the market. The oil majors likewise dropped a few percent in market value.
There are also companies that profit from macro-economic uncertainties though. The price of gold has already risen sharply this year to above USD2,600 per ounce. This gives Aris Mining a substantial boost in what was already a sound upturn in gold production over the last few years. As this equity had already noted a price gain of 45% this year, we decided to take partial profit and sell a portion of this position when prices were high.

As you've been able to read in previous reports, we've added a variety of new companies to the portfolio over the past year. This quarter we've been busy expanding the weights in the stocks of Phoenix Group Holdings, Marlowe and OneSavings Bank (OSB Group). In the Hong Kong Value Fund, we've likewise worked to introduce some great new investments, including **First Pacific, Cosco Shipping, Brilliance Automotive** and **A-Living**.

Marlowe

After splitting off the software division (GRC) earlier this year, **Marlowe** recently announced further plans to split off its **Optima Health** business unit and list it separately on the stock exchange. To us, this is further confirmation of our theory that Marlowe is worth more when divided into smaller parts than all the individual operations combined. Investors have now been paid the super dividend of GBP1.55 (from the sale of the software division). This still leaves a market value of GBP400 million. The separate listing of Optima Health and what amounts to the stand-alone listing of Marlowe's TIC division gives both business units the opportunity to pursue their own policies and create optimum value. The TIC division occupies a top three position in the UK in what is an extremely fragmented market for fire safety systems, compliance and various related services. TIC has spent years leading the way in consolidation and is well positioned to operate independently from now on but also under the wings of an external investor. Moreover, the equity valuation is still rather low compared to its competitors. Reason enough to remain enthusiastic about this group.

OneSavings Bank (OSB Group)

We took advantage of the disappointing results published by **OSB Group** to increase the weight in the portfolio. At the recent presentation of the company's interim results, the net interest margin that the bank earns on the loan book turned out to be lower than expected. The bank had already adjusted the forecast interest margin downward earlier this year. The results came as a disappointment to the market. The positive news was that the management announced it would increase the interim dividend. We believe this company will be able to improve its results again in future and this is the reason for us expanding the average weight in the portfolio to about two percent.

Irish Residential

Irish Residential Properties (IRES) published the outcome of a strategic reorientation this summer. The company had in fact been up for sale for some time. The outcome is that the management will continue along the current path and the company will therefore continue to exist in its 'old' form. The discount of over 30% on the Irish real estate (consisting of apartments and houses in Dublin) is still significant. The downside is that the company is bound by strict rental regulations and only some of the higher expenses can therefore be passed on via the letting price. Our case has always been that there was a need to reduce this discount on the real estate versus the company's market value. There would perhaps have been candidates for buying all 3,700+ properties, such as a pension fund or private investor. Momentum for this now seems to have subsided and so we sold some of the stocks that we'd previously purchased at 90 eurocents per share from a Canadian investor, after receiving a dividend of 1.1 eurocent net. We continue to believe that Irish Residential is attractively valued and that there's little downside risk, while investors also receive an annual dividend yield of 4% to 5%. Furthermore, the Irish economy enjoys a strong outlook for growth over the coming years and the Irish government has a budget surplus of as much as EUR9 billion. However, there's an enormous housing shortage in this market, which could benefit the IRES portfolio if rental regulations were eased somewhat.

THG Plc

We've devoted a great deal of attention to **THG Plc** over the past three years. THG published results over the first half of the year on 17 September and these were unfortunately worse than expected. The Nutrition division experienced a strong headwind from the weak yen and repositioning of the brands. The Beauty division performed adequately. THG announced plans to split off the marketing division (Ingenuity) from the other two divisions to retain a core that generates robust cashflows. Although this is a sound plan for revealing the true value of the individual divisions, in our view it will only have substance if another investor is willing to participate in the group. To date, THG has fended off all potential bidders on (parts of) the business because it wants to retain control itself. It's worth noting that this strategy hasn't yet led to the valuations for the existing group that we anticipated when we started investing in it back in 2021. Things could quite easily have turned out differently when Apollo Private Equity came close to agreeing a deal in 2023.
The group is working tirelessly on further strengthening the brands and we'll just have to wait and see when this pays off. We get the impression that the management is finally ready to show the market that it's got the wrong end of the stick about the company. These developments will certainly be noticed now that there are tangible plans to split the group up and the THG core group (Nutrition and Beauty) is moving to the UK's leading index.

Pareto Energy Conference

We paid our traditional visit to the **Pareto Energy and Renewables conference in Oslo** in September. This afforded us the opportunity to talk to the companies we already hold in the portfolio as well as some potential future candidates. The talks we conduct here are always valuable as it's possible to say and discuss more in person than via a video link or press release. Over 160 companies participated in the conference, which was attended by more than dan 2,000 investors. In summary, the conference called for increased investment in both the fossil and green energy sectors to keep up with burgeoning global demand and further reduce reliance on countries such as Russia and China. Another topic of conversation was of course the unresolved problem of the Ceyhan pipeline between Kurdistan, Iraq and Turkey. Although a breakthrough could occur at any moment, the patience of all the stakeholders is being sorely tested. However, all the companies actively involved in this have generated positive cashflows for some time by selling the oil locally. This has led to **DNO ASA** raising its dividend even higher, for example. **Gulf Keystone** announced a share buyback programme and dividend payment, and **Genel** grasped the opportunity to reduce its debt by over USD100 million by repurchasing bonds. This is tangible proof of how robust the balance sheets of these companies are. Anyone who takes the trouble to do the sums will conclude that these companies are valued very cheaply on the market even under current circumstances. And there's still the possibility (if we can believe those in the know, it's not a question of if but when) of a solution being found to the stalemate and exports to Turkey resuming. The companies' equity prices declined in the past quarter, partly due to the downturn in the oil price mentioned earlier and the absence of a solution to the export problem. In contacts with the managements of the companies named above, we nevertheless note that they're working hard on solutions that could potentially create an even better situation than prior to the ban on exports. This includes faster payment for the supplied product and shorter political lines.

Impellam - HeadFirst

Before we go into more detail on a few of the new names in the Hong Kong Value Fund, we'd like to look briefly at portfolio company **HeadFirst**. This relates to two (originally three) bonds that emerged from the acquisition of **Impellam Group** by Dutch company HeadFirst. This acquisition consisted of a large amount of cash, a couple of split-offs (Heather Ventures and Tapir Holdings) and the issue of three bonds. It was positive to see one of the bonds being redeemed early only one month later at a premium versus the par value (108%). The other two bonds will mature in 2025 and 2027. Both will make attractive payouts on reaching maturity. The tradability of these instruments is currently exceedingly limited as the company doesn't yet have an official listing but is listed on a UK trading platform. Anyone who was enthusiastic about Impellam can certainly feel the same about HeadFirst, but we first need to see how the company evolves over the coming years.

As a result of the acquisition, there are no longer any 'perpetual' shares but bonds with a maturity date and this creates a new dynamic when you look at the investment in Impellam that has since become HeadFirst.

HONG KONG

Despite the headwind on equity prices, we're also busy introducing some wonderful new investments to the Hong Kong Value Fund, such as **First Pacific, Cosco Shipping, Brilliance Automotive** and **A-Living**. To finance these, we've slimmed down some larger positions with the aim of further diversifying the portfolio. Below you'll find a brief introduction to these companies and an explanation of our motives for including them in the fund.

First Pacific

First Pacific is an investment company with strategic interests in defensive sectors, such as telecom, nutrition and toll roads. These companies, which include PLDT, Indofood and Metro Pacific, are displaying sound growth and pay attractive and growing dividends. Yet the combined value of these interests is much higher than First Pacific's equity price and its stocks are trading at a discount of about 45%. In the fourth quarter of 2023, First Pacific acquired the Philippines' Metro Pacific in its entirety, and this gives it the opportunity to split off parts of that company and float them at higher valuations on other stock exchanges in coming years. This will have a further positive effect on First Pacific's valuation. The dividends it receives will also create capacity for the company to pay an attractive and growing dividend itself. At the current equity price, the dividend yield already stands at 6.3% and we expect this to climb further in the next few years.

Cosco Shipping International

Cosco Shipping International is a subsidiary of Cosco Shipping and provides services and coatings to the shipping industry. This sector is performing well and Cosco Shipping International is profiting greatly from this. In addition, the company holds a large cash position that's almost as big as its market value and on which an attractive rate of interest is finally being paid thanks to the higher rates. As the company already has an extremely robust balance sheet, it has decided to pay all the profit to its shareholders. At the current equity price, this translates into a dividend yield of over 10%.

Brilliance Automotive

Brilliance has been the joint venture partner of BMW in China since 2003. In 2022, half of this interest in the joint venture (BBA) was sold to BMW for RMB29 billion. Brilliance has paid the proceeds from this sale to shareholders in phases in recent years.

We added these stocks to the fund after the company announced it was again considering paying a dividend in the third quarter of 2024. The size of the dividend was announced after we'd made our purchase and was higher than expected, causing the equity price to respond extremely positively to this news.

A-Living

A-Living provides services to homeowners and real estate developers. The real estate crisis in China has put an end to the revenue from real estate developers and it remains to be seen whether the outstanding receivables will be paid. The equity price has been decimated in recent years because of all this and it's now reached a level that does no justice to the value of the company. This makes it a good time for us to buy these stocks. This is because the company holds a net cash position that's larger than its market value and the services it provides to homeowners (property management) are relatively stable and recurring in nature. Many of the outstanding receivables have already been written off in the past reporting period and this has led to large losses. Once these have largely disappeared from the balance sheet, the company's underlying profitability will become more visible and should push up the equity price.

Macro-economic developments China

We've seen sharp price gains on the various Chinese markets in recent weeks. As you're probably aware, the Chinese economy has been experiencing severe difficulties for some time now. A major real estate crisis has left deep marks and, partly because of this, consumer confidence has hit historically low levels. The fact that the Chinese bureau for statistics has stopped publishing youth unemployment figures is a telling indication of the state of the job market too. The Chinese government recently announced a few substantial interventions aimed at stimulating the demand side. Until now, it had only looked to help the supply side (i.e. businesses) but everyone will benefit from consumers regaining enough confidence to make major and minor purchases. Lending conditions have been eased and banks are being offered access to additional capital. Equity markets responded very positively to the news. We're naturally monitoring the recent developments to see how much effect the stimuli have and how far the economy improves after a few tough years.