BLUEBOAT

July 2021 update

We are pleased to present the unaudited full year results for Blue Boat Investment Trust for the Financial Year 2020/21.

Blue Boat Performance vs Indices Total Returns: 3 April 2017 – 30 June 2021:

	Blue Boat Gross Return	Blue Boat Net Return	ASX 200	MSCI All Country
FY21	39.1%	37.8%	27.8%	28.5%
Since inception	59.0%	45.2%	46.0%	80.1%
CAGR	11.5%	9.2%	9.3%	14.9%

Source: Bloomberg. Returns are presented in AUD. Index returns include net reinvested dividends. CAGR is the compound annual growth rate since fund inception.

This financial year was unusual in so many ways. It began in the depths of the pandemic, with record unemployment and big question marks regarding the effectiveness (and consequences) of the extraordinary measures that had been taken around the world to deal with the economic fallout from COVID-19. It has finished with many market indices at or near record highs. John Templeton famously said, "bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria." This quote is quite relevant to the last 12 months, which has been like a market cycle in fast forward.

Broadly our view has been deliberately contrarian to the crowd during this 'mini cycle'. As discussed in our earlier letters, at the beginning of the pandemic, we were optimistic on the basis that market prices were severely underappreciating an ultimate recovery and companies' long-term value. Subsequently, we took even greater confidence in specific sectors where the relevant customers were in excellent shape and eager to buy. We have recently turned more conservative as the 'path to normalisation' is increasingly reflected in market pricing. We think retaining this contrarian mindset will generate opportunities in the years ahead.

Skin in the game

We deliberately favour founder or family-led companies. There was no better advertisement for this type of company as an investment than in 2020. During the market downturn, 'hired gun' CEOs and boards with relatively small shareholdings issued vast amounts of equity at very low prices, massively diluting shareholders during the worst market sell-off in 12 years. These decisions were undoubtedly deemed 'prudent and necessary' and strongly encouraged by various advisers who stood to earn significant fees. However ultimately, these actions were highly destructive to shareholder value. In contrast, founders tended to show far more determination to keep their businesses running without 'selling the family jewels'.

Founders have generally grown up with their business. They deeply understand the company fundamentals, and it typically represents nearly all their family's wealth. There's a great deal at stake, much more than just money. Founders also tend to manage for the very long term, operating with relatively low debt and willing to act assertively, without hesitation, when opportunities present themselves. Together we think this is a powerful combination for stewardship of our investors' capital.

A review of our portfolio shows that over 80% is invested in founder/family-led businesses. Among these, the board's average ownership of issued stock is 31%, equating to a median of A$300m per board/family. We feel confident that the incentives for this group align with minority shareholders like Blue Boat. As Charlie Munger says, "Show me the incentives and I'll tell you the outcome."

Every business goes through hard times. When that happens, we want to be confident that our portfolio company managers will be thinking first about protecting the company and our investment, rather than their salary. Covid-19 has been an extreme test, but we have been so impressed by how our managers swiftly took action to defend their businesses and take advantage of opportunities for long-term growth presented during the crisis. In a few cases, this included transformational acquisitions, allowing our companies to make significant market share gains when their peers were just trying to stay afloat.

Turning crisis into opportunity

The best case of opportunistic assertiveness we saw during the pandemic was Lovisa's acquisition of a network of 114 stores in Europe from a struggling competitor for the total sum of 60 Euros in November 2020. Yes - that is 60 only, not 60 million! They also received 9.87m Euros in cash as consideration for taking on the leases, which converted to Lovisa between March and May 2021. Chairman Brett Blundy personally negotiated the acquisition (owns 40% of the company, today worth AUD 642m), who is based in Europe and reportedly physically inspected every site during the lockdown plagued European autumn. This deal increased Lovisa's store network by 25% and accelerated their planned expansion into Europe by several years.

A close runner up for 'deal of the year' was Corporate Travel Management's acquisition of Travel and Transport (TNT), executed in September 2020 by CEO Jamie Pherous. He received Australian government clearance to fly to Omaha, Nebraska in the USA in person to do the deal. TNT, one of the largest privately-owned US corporate travel agencies, was crippled by the closure of international borders and the significant downturn in travel activity. Due to its ownership structure and lack of funding options, Pherous acquired TNT at a fraction of the valuation it would fetch in 'normal' times. This deal made Corporate Travel Management the world's fifth-biggest corporate travel player by transaction value. It was achieved at a time when their competitors were focussing on survival, not growth. Pherous, who owns 14.1% of Corporate Travel Management stock (valued today at AUD 415m), conducted the capital raising presentations during his quarantine from a hotel room in Brisbane upon arrival back in Australia.

Thirdly we highlight Fu Shou Yuan (FSY), China's largest death care company, which acquired Harbin Mingxiyuan Cemetery Co in July 2020. Harbin Mingxiyuan is in the north of China, where FSY had been seeking to expand. Due to the strict lockdowns and restrictions on funerals, Harbin Mingxiyuan's sales were down 90% for the prior five months compared with the corresponding period in 2019. FSY were able to secure Harbin Mingxiyuan for RMB 450m, paid from their substantial cash reserves, their most significant acquisition since the IPO in 2013. The transaction was completed at a valuation of just 9.5x PE on 2019 earnings. We think this is a bargain purchase, and with significant scope to enhance the acquired operations, we expect it to provide a great boost to shareholder value.

We firmly appreciate being 'in the same boat' as our managers. If they are heavily invested, we can be sure they will do their best to protect and grow that position. This is a principle we take to heart, which is why as managers, we are personally heavily invested in Blue Boat, so our investors do not doubt that our interests are aligned.

Portfolio positioning

We are deliberately not committed to a broad, macro-based investment view. It is not an approach that we feel comfortable following. Doing so would require navigating a highly uncertain and complex macro environment and figuring out how that might affect individual assets. This approach compounds risk, and it is hard to see where we might find an edge. We have some views on which we are basing the current portfolio construction, but we're far more excited about the individual merits of our stocks than the macro surrounding them.

Below is a summary of the portfolio by its broad category and regional allocations:

Portfolio allocation by category & region based on revenue:

Broad category	China	Aus/NZ	USA/Can	EU/UK	RoW	Total
Consumer Discretionary	13%	19%	2%	4%	2%	39%
Digitalisation	10%	1%	3%	2%	3%	20%
Travel & Leisure	1%	4%	6%	2%	5%	19%
Cyclicals	0%	8%	3%	1%	0%	13%
Financials	9%	0%	0%	0%	0%	10%
Total	**33%**	**33%**	**16%**	**10%**	**9%**	**100%**

Our view that a short-term cessation of spending on travel and entertainment would result in high levels of savings and re-allocating spending has played out as expected. We were positioned for this event at the beginning of the financial year when it was far from certain. The amount saved and the amount of cash yet to be re-allocated has exceeded our optimistic expectations. Even so, we have reduced our exposure here as optimism around the sector has increased, taking valuations with it. We think spending will normalise in the future but settle at a much higher level than the cyclically depressed levels seen in 2019.

We have a significant portion of the portfolio invested in companies serving the large and growing Chinese middle class and the digitisation of parts of the Chinese services economy. This portion of the portfolio was a drag on performance in FY21, but we believe the underlying fundamentals are performing far stronger than their share prices suggest.

The continuation of China's growth is one of the most evident drivers we see in the market. It is estimated that there are currently circa 200m Chinese households who are considered "aspirational middle-class consumers" and 26m "premium consumers". A Chinese "premium consumer" has roughly the same disposable income as the average American household of circa USD 82,000. These brackets are forecast to grow to 300m "aspirational" and 100m "premium" consumers over the next decade. That represents compound growth rates of 4% and 14%, respectively, providing significant and expanding addressable markets for our companies to continue their growth.

We are invested in market-leading companies within China, and whilst we acknowledge the unknowns and risks associated with investing offshore, we feel over time, our companies will grow significantly and reward shareholders in the process.

Looking for compounders where others aren't... Beacon Lighting

Many sectors of the market are overlooked by investors searching for compounders. Due to the volatility in short term earnings and cyclicality, retailers are regularly overlooked despite the number of success stories in the retail sector globally. Australia has produced some very successful retail businesses in some of the most competitive niches, including JB Hi-Fi (consumer electronics), Dominos (takeaway pizza), Bunnings (home improvement) and Woolworths (grocery).

One company that has slipped under the radar in Australia is Beacon Lighting. Founded in Melbourne in 1967 as a single store operation, Beacon Lighting was acquired in 1975 by Ian Robinson. In the subsequent 46 years, Beacon has grown to industry leadership with 115 stores across Australia. Today, Ian Robinson, Chairman of the listed company, has never sold a single share in the business, owning 55.3% of Beacon Lighting's stock.

Positioned in the middle-upper end of the lighting market, Beacon designs and sources all their own products. This allows them to operate a vertically integrated business model, resulting in higher margins and better supply chain control. Under Ian Robinson (Chairman) and son Glen Robinson (CEO), Beacon has recently expanded into several new emerging businesses, which include expanding internationally into the USA via direct to consumer online, ownership of direct property where they can be their own landlord, increasing penetration into the commercial and trade lighting market and a street lighting business targeting large public tenders.

These four emerging businesses target massive market opportunities that may surpass the core Australian retail business in time. Beacon Lighting's growth and cash dividends have been funded by earnings rather than issuing shares to fuel growth or acquisitions. Since the 2014 IPO, the only shares issued have been for the dividend reinvestment plan (DRP). Of the circa 8 million issues under the DRP, Ian Robinson has accounted for circa 5 million of them. His percentage ownership of Beacon has increased since going public, a rare feat for majority owning founders post IPO.

Since the IPO, Beacon has faced a property boom-bust-boom housing cycle, resulting in significant volatility in the share price. We think this 'noise' obscures a hidden compounder with great potential in large and growing markets.

If we look back to the IPO prospectus, Beacon Lighting benefited from favourable operating conditions, growing sales and profit significantly from the prior year. In August 2014, four months after IPO, Beacon recorded FY14 sales of $151m and $12m net profit after tax generated from 83 stores.

That day, the PE ratio was 21x historical FY14 earnings, yet the share price doubled in the next 12 months. The following six years saw the share price range from $2.25 in mid-2015 to as low as 40c in March 2020, yet sales kept growing, stores kept opening, and Beacon Lighting kept expanding into new growth markets.

Recently Beacon has issued profit guidance for FY21 – we expect sales of $292m (1.9x 2014) and net profit after tax of $37m (3.1x 2014) generated from 115 stores. This means that in the last eight years, during which time Beacon barely issued a share or failed to pay a dividend, they were able to increase sales at a compound growth rate of 9%pa and net profit at 15%pa. The PE ratio has shrunk from 21x to just 11x today, a significant discount to the ASX 200 industrials index. In 2014 it would have been a bold prediction to foresee such growth in sales and profits and even bolder to predict the expansion into new business lines.

Given Beacon's 45-year growth trajectory under Ian Robinson, we query why this can't repeat itself in the next eight years? It's certainly possible. The past eight years of growth have been primarily produced by growing and improving the performance of the core retail stores; whilst reinvesting those profits into seeding their emerging businesses. Looking ahead, the retail business has room to grow further, but the emerging businesses are now positioned to be a significant driver.

This 'focus on the core plus make several investments on new ventures' strategy is one we always look out for when looking for compounders.

To illustrate Beacon's potential, suppose they can continue their performance for the next eight years. Their sales could grow as high as $565m and profit to $114m. Applying a reasonable PE multiple of 15x (BLX has ranged between 30x and 5x), we get a market cap of $1.7bn, which is $7.66 per share. This share price tripling would represent an IRR of 19%pa from today's share price and the c4% dividend yield the company is paying.

We are looking for businesses that compound and can grow into large addressable markets. We see many companies forecast to achieve this, but very few have a track record of actually delivering compound growth and are trading at an attractive valuation. Despite seemingly unpalatable volatility for short term investors, Beacon has proven that they can allocate capital and grow in large and ever-changing markets. Beacon is a company that we believe is a beneficiary of technology. The changing trends in lighting and customer expectations drive sales for Beacon who have the most extensive ranges at the best prices. With the Robinson family at the helm, we think anything is possible for this business with substantial growth plans currently being ignored by the market.

Looking for compounders where others aren't… LiveChat Software

Compounders can also be overlooked because of where they are located. A prime example is LiveChat Software. LiveChat is a global business with over 33,000 clients (including Beacon Lighting!) across more than 150 countries, where the US is by far their biggest market with c40% of total revenue. However, LiveChat happens to be domiciled and listed in Poland, a region accounting for just 2% of revenue. Notwithstanding, we believe the Polish setup is a significant advantage to the business as Eastern Europe has emerged as a major home for technical talent at a much lower cost than the US or Australia.

The pandemic accelerated an already strong trend of companies investing in their online capabilities. Tools such as LiveChat's have been widely adopted to help merchants engage with their customers in an online environment.

For many, the LiveChat product is a mission-critical tool. It improves the online customer experience and drives revenue from higher conversion rates and basket size for a relatively low cost. Moreover, as it is more efficient, it can reduce the cost of support staff. As users, we regularly see the benefits from a customer perspective. As analysts, we routinely hear companies mention how online chat tools have been an important area of focus and improvement for their online business.

As with Beacon, LiveChat has developed and grown its core proposition very strongly. In the nine years since FY12, company revenues have grown at a fantastic 47%pa compound growth rate, with returns on invested capital running at more than 100%. In addition, the company has been investing, and its automated ChatBot product has begun to show very promising results.

Another distinguishing feature is LiveChat's founders & key management, who together hold 41.9% of the company's shares. This team have built an incredibly profitable company whilst simultaneously maintaining high growth and investment. This is best highlighted by the company's growing dividend (something which is virtually unheard of among US tech companies) and speaks to the cost & profitability advantage LiveChat has by operating in a lower-cost environment.

LiveChat's focus is to provide a premium product to serve larger clients. These clients have very high traffic volumes, which warrants investment in high-quality online engagement and thereby validate LiveChat's value proposition. Within this segment, LiveChat is likely the #2 player to US rival Zendesk (which is not profitable), but LiveChat is generally better rated as a product. We believe there is ample overall market growth to accommodate both players.

What makes LiveChat compelling to us as an investment is the valuation. LiveChat Software shares trade on the Warsaw Stock Exchange at a 35x historical PE, based on the recently reported FY21 earnings. Compared to other fast-growing tech companies of this quality, we can comfortably say that it would be trading on a far higher multiple if it were listed in the US or Australia. The reality is that the Warsaw exchange is off the radar for most investors, and many don't have access to the market.

The company has said it is considering a dual listing on the Nasdaq exchange, which would be a significant positive catalyst for the stock. Plus, we think it's likely Warsaw will become more accessible to investors over time. In the meantime, with regular dividends and growing intrinsic value, we are very happy holders.

Looking forward

We enter the new financial year with mixed feelings. We are very excited and optimistic about the growth opportunities for our portfolio but remain concerned about the speculative excess that is lingering in corners of the market. The two apparent bubbles, in our opinion, SPACs and cryptocurrency, appear to be deflating. The latter, which had a combined market capitalisation of US$2.5 trillion at the peak in May, has the potential to create a significant economic event should it collapse quickly. We note the devastating effect the bursting of the 'Dotcom bubble' in 2001-02 had on the US economy. Should several trillion dollars of value disappear, it will have a ripple effect whatever the form of investment. We are watching this situation closely, but at the moment, we merely identify this as a potential future shock to the system.

We think owning a high-quality portfolio of attractively priced businesses is the best protection against any adverse economic or political event (because if not crypto, it will be something else!). We take great confidence in the strength of our portfolio companies and their competent managers who have skin in the game.

We are committed to Blue Boat's concentrated, long-only, unhedged, zero leverage strategy and promise to be responsible and assertive stewards of your capital.

Yours sincerely,

David Nelson and Tim Evans
blueboatcapital.com.au