October 2022 update

This quarter we saw all our portfolio companies report to the market. Our ASX listed companies reported full financial year 2021/22 results and offshore companies reported either for the quarter or the half year. In a world where macroeconomic and geopolitical issues are dominating the headlines, we enjoy this time of year when company results drag investor attention back to business fundamentals… if only temporarily, as the last month has demonstrated.

We are pleased with the earnings results that our portfolio companies generated. For our top 10 positions, which account for circa 85% of the portfolio, the aggregate earnings per share growth for the past 12 months was +7.5%. However, over the same period, share prices of our portfolio have declined amid a broad market selloff. The gap between intrinsic value and that paid in the market is widening.

Set out below are results for the fund for FY23 so far and since its inception:

Blue Boat Performance vs Indices Total Returns: 3 April 2017 – 30 September 2022:

	Blue Boat Gross Return	Blue Boat Net Return	ASX 200	MSCI All Country
FY23 YTD (3 months)	-3.3%	-3.4%	0.4%	-6.7%
Since inception	28.9%	17.1%	37.0%	40.1%
CAGR	4.7%	2.9%	5.9%	6.3%

Source: Bloomberg. The returns for Blue Boat & ASX are presented in AUD, MSCI in USD. Index returns include net reinvested dividends. CAGR is the compound annual growth rate since fund inception 3 April 2017.

We own three Chinese investments in Alibaba, Ping An Insurance and Anta Sports, which have been negatively impacted by regulatory intervention and Covid-19 restrictions. Despite this disruption, over the past year they grew aggregate earnings per share by +6.5% and have increased their capital returns in the form of dividends and buybacks. This rate of growth is materially below their prior five-year compound annual earnings per share growth of 24%, but we believe the recent 40-60% declines in their share prices to be entirely irrational and unsustainable. This current period of disruption is likely to be an outlier rather than the new normal. These companies hold market-leading positions in their respective industries, leveraged to the prosperity of the massive and fast-growing Chinese middle class. We believe this demographic will grow materially in number and wealth in the coming decade, making it as attractive an investment opportunity as we can find globally.

The selloff in China facing stocks has been difficult to stomach. We note that the Hang Seng Index in Hong Kong now trades on just 0.7x price/book, the lowest ratio since records started in 1993, and the index is currently at 11-year lows. China is on an entirely different path from the rest of the world regarding fiscal policy. They are stimulating their economy, which is not plagued by excessive inflation, and are artificially suffering due to Covid-19 restrictions which will not be a permanent impairment. Meanwhile the rest of the world is withdrawing stimulus, raising interest rates and struggling with rampant inflation. Overlay this with Chinese stock market valuations at historic lows and we believe a material positive re-rating is inevitable.

We recognise that the financial world is facing a raft of very significant changes. Stubbornly high inflation, war, extreme currency moves, and energy shortages are affecting many countries and industries. We believe it is basically impossible to forecast these events and their market impact reliably, so our protection comes from investing in companies with a track record of surviving adverse market conditions and even benefiting from them.

The best market share gains and acquisition opportunities often arise during periods of economic weakness. We don't know what is ahead, but we're confident that our portfolio companies, which are well capitalised and have strong market positions, can take advantage of any potential weakness in their respective markets.

Housing: Beware the consensus narrative

In our last investor letter, we wrote about the dominant market narrative concluding that rising interest rates would spell the demise of the housing sector. We often observe that popular market views tend to play out roughly the way people expect, but the event's significance is almost always way under or overpriced in the stock market.

With housing, particularly in the US, the market appears to be pricing in declines as extreme as the 2007-9 financial crisis, which we view as highly unlikely. We agree that rising borrowing costs and uncertainty will likely weigh on property prices in the short term. However, we believe the material differences between the current circumstances and prior housing and credit cycles are misunderstood.

In the US, prior to 2007, new housing construction had been running higher than the long-term median of circa one million single-family house starts per annum for 14 consecutive years, peaking at over two million in 2005. We now know lending practices were allowed to become completely reckless, and the market was materially oversupplied, fuelled by speculation rather than actual demand. This preceded an 80% decline in activity, almost three times as severe as the next most significant cyclical decline, decimating companies exposed to housing and led to a global financial crisis. This event was so powerful that it took over a decade for new housing starts to return to the long-term average, making it the longest and deepest decline in homebuilding since World War II.

In recent years housing construction has been running at the long-term average, suggesting the market is far more balanced than in the prior cycle. Vacancy rates are at historic lows, and rents have been rising, indicating that housing markets are undersupplied. On top of this, the change in the home's role in people's lives with hybrid work schedules appears to be structural. For these reasons, along with the well-publicised delays and supply chain issues plaguing the construction industry, we believe that a sustained downturn in housing activity is unlikely.

All companies exposed to US housing, regardless of which part of the industry or their quality, have been sold off aggressively this year. Many are priced for a decline in earnings comparable to the GFC. Broad-based sell-offs like these tend to unearth terrific investment opportunities. Blue Boat owns Reliance Worldwide Corporation, an ASX listed manufacturer and distributor of market-leading, branded plumbing fittings and equipment. The US is Reliance's largest market, and their products are predominately used in the repair and remodel market which is far more defensive and resilient than the cyclical new build market. Plumbing repairs are generally not a discretionary decision for homeowners. In the US, there are 74 million homes, roughly half the total market, which are over 40 years old. Remodelling activity has increased steadily in the past 10 years, whilst ageing housing stock underpins repair volumes.

Since its listing in 2016 Reliance has grown sales at a compound annual growth rate of 20% and has improved its operating margins by 24%. Last year they demonstrated the value of their brands as price increases to offset higher input costs were well accepted by customers. Today Reliance shares trade at just 12x trailing net profit after tax, less than half the P/E ratio of the 2016 IPO and roughly a third of the peak multiple set in 2018. We feel the current pricing does not reflect the growth potential, the quality, or the stability of the company's earnings. We have added to the position in the last quarter, capitalising on what we believe will be another mispriced and misguided market narrative.

Tech sector – looking for diamonds in the rough

From 2019 to early 2022, we experienced a period where companies, particularly those in the software, technology, and biotechnology sectors, attracted what we believed was bubble-like pricing. No price was too high to pay for a leading business in a strongly growing market. We consider attributes of a bubble to include consensus acceptance of a popular and easily understood growth narrative, excessive valuations and innovative valuation metrics, investor euphoria and a fear of missing out, frenetic IPO/venture capital activity and a view that this time is different. All of these occurred during this period, much like the fabled 'Nifty 50' bubble in the late 1960s and early 1970s, where leading US growth companies were valued similarly.

When the Nifty 50 bubble burst in 1973, stock prices fell as much as 90% and, in some cases, never recovered. Many of the greatest companies of the 20th century, such as Coca-Cola, McDonald’s, IBM, Gillette, Walt Disney and American Express, experienced share price declines in line with those of mediocre companies such as Emery Worldwide Airlines, Simplicity Pattern and Heublein. In the subsequent 49 years since the bursting of the Nifty 50 bubble, many of these companies went on to be genuinely great, delivering shareholders over 100x their money, whilst many others faded into insignificance.

The unwinding of the recent bubble has not been quite as severe as the Nifty 50, but we have seen the decimation of share prices in unprofitable tech and biotech companies, along with falls of over 50% for many of the largest and widest held stocks on the Nasdaq. In our view, many of the best-performing stocks of the recent bubble were overrated companies with questionable business models that would likely prove vulnerable to competition and had a complicated pathway to profitability. There are also many companies with dominant market positions and a proven competitive advantage that have been sold off just as aggressively and will likely become the great companies of the 21st century. Blue Boat may have deliberately avoided this sector during the recent bubble, but we think ignoring the opportunities on offer during the current market capitulation would be as foolish as ignoring the fallen Nifty 50 stocks in 1973/74.

One such company we have taken a new position in the last quarter is Spotify Technology.

Spotify Technology – An audio giant

Spotify has evolved into a remarkable business built on a service that its customers cherish. We believe that most users value its service far above the cost, and this 'consumer surplus' has allowed Spotify to build a dominant global market position in music streaming with a very loyal customer base.

The company also monetises its reach by helping content makers to market their content to prospective users. Rather than try to leverage its dominant position to squeeze for tighter prices, Spotify takes the view that better monetisation can come from offering more valuable services and a virtuous circle of supportive users and publishers will result.

The business is well placed to address the very fragmented marketplace of audio content. Better than any other provider, they can provide a global audience to content producers and allow users to discover new content from all over the world. Spotify has deliberately positioned itself to be a ubiquitous platform by integrating itself across virtually all types of devices, which is an important differentiator from the likes of Apple and Amazon.

The company has been adopted worldwide and continues to grow strongly, particularly in emerging markets. Future growth will come from new verticals as Spotify expands from a music streaming platform to a more comprehensive audio ecosystem. Following a successful entry into podcasts, where they are now market leader, they announced their entry into the audiobook market last month.

Even with strong growth and investment, Spotify has consistently generated positive free cash flow, meaning it is genuinely creating shareholder value and is not beholden to capital markets to fund its future growth. This positive free cash flow generation contrasts with many high-profile tech companies that rose to prominence during the bubble.

Spotify shares have fallen sharply along with the sector-wide selloff in 2022. Today, they are down 76% from their November 2021 high and 40% below their 2018 IPO price. The company recently hosted an investor day to set out its medium-term ambitions. Via expansion of their core music business and new verticals, they hope to build a US$2.5bn EBIT business by 2026, which if achieved could value Spotify between US$60-80 billion. Compared with the current market valuation of US$17 billion, this presents a very appealing opportunity for a founder-led company that is a global leader in its industry.

Looking forward

Market conditions remain extremely volatile, with most major global indices in a technical bear market. As difficult as this is in the short term, we believe the fundamentals of our portfolio companies are intact and improving. We vow to keep an open mind toward new investment opportunities to strengthen the portfolio and maximise future recovery.

China has been a significant drag on our performance in the last two years, but we retain our conviction in the long-term value proposition on offer in our current positions. As a result, we have further increased our position in Alibaba during the last quarter, now clearly our largest holding. Alibaba stock fell 30% during the quarter, currently trading 15% below the price it traded on its first day as a listed company in 2014. Alibaba has an active US$25bn share buyback, which is 12% of the current market capitalisation at current prices and is trading on just 11x the consensus forecast for FY23 earnings. We see tremendous upside from current prices in the medium term.

We are confident that the Australian economy, bolstered by high commodity prices and a well-capitalised banking system, will continue to grow despite the pressures from inflation and rising interest rates. Our ASX listed holdings are mostly founder-led industrial and consumer companies, which we have the utmost confidence will exceed expectations in the years ahead whatever is thrown at them.

During the September selloff, we fully invested all available cash into our best ideas and believe the portfolio is trading at the most significant discount to intrinsic value since March 2020.

Yours sincerely,

David Nelson and Tim Evans