April 2023 update

Set out below are results for the fund for the first 9 months of FY23 and since its inception:

Blue Boat Performance vs Indices Total Returns: 3 April 2017 – 31 March 2023:

	Blue Boat Gross Return	Blue Boat Net Return	ASX 200	MSCI All Country
FY23 YTD (9 months)	12.8%	12.3%	13.6%	10.1%
Since inception	50.4%	36.2%	55.1%	65.4%
CAGR	7.0%	5.3%	7.6%	8.8%

Source: Bloomberg. The returns for Blue Boat and 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.

Complex and Confusing…. But Not All Negative

It has been another eventful quarter, resulting in heightened volatility in stock and bond markets. March 2023 marked the third anniversary of the Covid stock market crash and the first anniversary of the beginning of the rapid interest rate tightening cycle. These were two significant events that continue to be deeply impactful, often in unexpected ways.

The immense Covid-support expansion of money supply in 2020 created bubbles across various asset classes. This, in combination with surprisingly strong employment and heavily constrained manufacturing and freight, drove a major increase in inflation. Central banks worldwide have since directed the most aggressive period of interest rate tightening ever.

Covid and the subsequent tightening cycle continue to cast a profound influence. Today we are again in the throes of a noisy and potentially significant moment in the banking sectors of the USA and Europe.

The human response to such events can make it difficult to forecast the outcome. In the case of Covid, a terrible pandemic was met with an epic scientific and stimulus effort so forceful as to create an employment, consumption and inflation boom. Similarly, that inflation boom has been met with the most aggressive tightening ever seen, with its knock-on effects which are well publicised. In recent weeks, regulators have sought to support the banking system by flooding the system with such liquidity that bond yields have dropped materially.

Another example is in European energy prices. Even though the war in Ukraine continues, European gas prices are now at their lowest level since 2020. The popular narrative was of course that energy prices will remain elevated so long as the war continues and sanctions hold. The reality shows that there are many offsetting interventions in place.

John Templeton once said, *"bull markets are born on pessimism, grown on scepticism, mature on optimism and die on euphoria."* Once again, complex macro forces seem to be moving markets contrary to the widely accepted consensus narrative of late 2022, making many forecasters look foolish. At Blue Boat, we prefer intense observation of the present and reference to the past than to making future predictions and forecasts.

Some present-day observations include:

- Many inflation inputs are receding or appear transitory, but heightened wage inflation appears more entrenched.
- The banking crises in Europe and USA have the potential to bring forward the conclusion of the interest rate rise programs. They have a deflationary impact.
- China has reopened its economy and has re-focussed on long-term structural growth for its middle class. Consumer confidence is improving from a depressed base, and government messaging now supports the technology and property sectors. Since January Chinese average home prices have started rising again.
- Still no material weakness in asset quality for Australian banks. Mortgage arrears remain historically low despite rates rising faster than anticipated.
- US and UK mortgage rates have declined for several months, suggesting the peak is behind us. Australian fixed mortgage rates are now moving lower.
- Parts of Australia are now seeing house prices increase after a 12-month decline. Auction clearance rates are high, indicating a rational and liquid property market.
- Oil prices have declined 40% from the 2022 peak. Natural gas futures are at their lowest level since 2020, 75% below March 2022 peak.
- Earnings have been robust in Australia, Europe and USA. Some pockets of weakness, but nothing like what was feared.
- Since the banking crises started in early March, US 10-year bond yields have declined from over 4% to 3.5%.
- The tech-heavy Nasdaq index has entered a new technical bull market, closing +20% above the low in late December 2022.

After considering these facts, we concede we are still determining how the complex macroeconomic and banking dilemmas will play out. The worst-case scenario, whereby earnings collapse and mortgage arrears spike in the face of inflation, and the best-case scenario, where inflation proves entirely transitory and interest rates can be lowered quickly, appear highly unlikely.

Portfolio Positioning

The last quarter's events have not altered our bottom-up view of our current portfolio holdings. Whilst macro developments tend to heavily influence market prices in the short term, company fundamentals matter in the long term. This is where we maintain our focus.

We retain three core positions in market-leading Chinese consumer-facing companies, holding our conviction that the headwinds experienced in 2022 have become tailwinds that will strengthen as 2023 unfolds. In Australia, the significant discount being applied to small/mid-cap companies remains, albeit beginning to narrow. We view this discount as unsustainable; therefore, this market segment is very attractive.

Each time a company reports, it helps us update our picture of its fundamentals and intrinsic value. This quarter we were pleased with the earnings delivered by the portfolio, which were roundly positive. Market expectations were relatively weak in several cases, and our companies delivered better-than-feared results. We like this setup because, often, the best returns come when expectations improve from cold to lukewarm. Some of the highlights (in alphabetical order) are set out below:

<u>Highlights from Portfolio Earnings Results</u>

Alibaba – Expectations for revenue and earnings were exceeded with significant margin improvement across each of their businesses. The December quarter was negatively impacted by Covid lockdowns/caution, which continued into January. CEO Daniel Zhang cited that platform activity has improved markedly since the middle of February, and he expects a continuation of this trend in the future. Heightened savings from the pandemic, removing Covid restrictions and a positive shift in government policy combine to create a tantalising setup for Alibaba in 2023. The balance sheet continues to strengthen with US$55bn of net cash, now making up 21% of their US$264 market cap. The free cash flow yield is running at about 10% at the current share price. Circa half of this free cash flow is returned to shareholders via buybacks for a 5%pa capital return.

This week Alibaba announced a significant business restructuring. The centrally controlled conglomerate will be broken into six individual companies with independent management, each with the ability to raise capital or spin-off via an IPO. Alibaba will become a holding company. This is designed to unlock value, forcing each business to be valued in its own right, and Alibaba is then valued as a sum of the parts. We are very supportive of this move.

Anta Sports – Lockdowns and restrictions in China negatively impacted sales in the prior quarter. Nevertheless, with good cost control, Anta's profitability outperformed market expectations. Anta management observed that conditions are now rapidly improving, and Alibaba management confirmed this as they highlighted that sportswear was a category that had especially picked up since February. As the number 2 player (after Nike), Anta Sports is well placed to benefit.

Beacon Lighting –Record sales were generated for the first half, but with softer margins reflecting higher input costs. This was entirely expected. Beacon's primary focus is its trade business, progressing well with 21% year-on-year sales growth for the December half-year. The market treats Beacon as a mature retailer, but real growth is embedded within. Trade sales account for roughly a third of total sales, and if current growth rates are maintained, trade sales will exceed retail within the next five years.

Also, management gave an update for the first seven weeks of 2023 saying sales are 'holding up well' and close to the record level set in the prior year. Analysts have been anticipating a severe property-related slowdown, so this update was much better than feared. Beacon's trade sales will prove far less cyclical than their retail business. Beacon trades at roughly half the valuation it reached in January 2022, an irrationally low price.

BYD – Emerged as the world's number 1 electric vehicle producer. In 2022 they <u>tripled</u> their EV production to 1.86m units (Tesla was 1.31m) and are now guiding to further double production in 2023. They also doubled their profit margin on the Autos operations from 3.5% in the June half to 6.9% for the last six months. Together, the results show BYD is delivering enormous growth and positive operating leverage. Looking to 2023, we see the stock is trading at 15x NPAT, which is very attractive for this kind of profitable growth.

Corporate Travel Management – Confidently reported record revenue with guidance for the next half year, expecting significant growth in profitability. We also appreciate that they changed their profit reporting measure to Net Profit Before Tax, away from EBITDA, a far more realistic estimate of profitability. Management gave a January update noting that their North American booking volumes were the highest since Covid began, despite typically weak seasonality. Europe is trading at a record profit level, and China has reopened with a bang. The company has invested ahead of the recovery in staff, so significantly higher margins are expected as activity strengthens. Our thesis that Corporate Travel Management will emerge from the Covid disrupted era as a much bigger, better diversified and more profitable business is well intact.

Livechat Software – Produced an impressive 60% annual increase in profit in the December quarter, thanks mainly to a price increase that offset cost inflation and improved profitability. Critically, despite the higher pricing, churn was roughly stable. This highlights how essential Livechat's products are to its customers. Annualising this higher level of profitability in the future is very encouraging. Livechat is not experiencing the slowdown experienced by other high-profile 'Covid winners' in the tech sector.

Lovisa – Market expectations were high, but Lovisa delivered perhaps our portfolio's strongest half-year result. Their global store expansion is accelerating, and despite the inflationary environment, they were able to increase gross margins and reduce their cost of doing business relative to sales. Together this produced an outstanding profit and cashflow result. The outlook statement showed this momentum is continuing, with 31 stores opened in the first seven weeks of the second half and total sales up +24% compared to the same period of 2022. South America and Asia loom as significant growth opportunities. We think Lovisa has many attributes held by fast-fashion and fast-food giants that have achieved global status.

Reliance Worldwide – Consensus expected a weak result driven by an apparent property slump, forecast to hurt demand, and cost inflation to impact margins negatively. Instead, the report showed demand is proving resilient, underpinned by volumes tied to non-discretionary repair work, plus a significant backlog of demand still being worked through. Margins also came in better than expected despite high input costs and the company guided to further improvement ahead. Reliance launched two significant new product ranges in late March, reminding us of its culture of innovation, research and development. Reliance shares gained +24% during the quarter.

Spotify – Investors had been bearish on Spotify following a narrative that a potential recession would hurt their prospects of attracting and holding subscribers and advertisers. Spotify's long-term vision and global ambition saw them prioritise growth over near-term profitability, which was not a popular position in the tech bear market of 2022. This under-monetisation is, in fact, a key pillar for our interest in its shares. That Spotify offers a low price relative to its value to the customer creates an army of devoted users who are unlikely to unsubscribe. In addition, today's low price point gives them the potential to raise prices over time for significant future profitability. The December quarter report surpassed market expectations and the company's guidance across each of its KPIs. This was an encouraging result showing that the company is progressing. Spotify was the best performer in the Blue Boat portfolio for the quarter.

Outlook

There is no shortage of things to worry about and no easy fix for the many problems in the world. Conditions are far from perfect, but the quality of our portfolio companies' management and fundamental strength will see them prove resilient again and even prosper from some of what is happening. We are particularly bullish on the outlook for our Chinese portfolio positions.

Blue Boat moved to a fully invested position in late 2022, which we have retained. We see material upside in our portfolio companies and believe our concentrated portfolio approach is appropriate for current market conditions.

Yours sincerely,

David Nelson and Tim Evans