Farrer Wealth Managed Solution Quarterly Update

Q1 FY2024 Returns Summary

(Quarter ending September 2023)

All values in SGD terms unless otherwise stated, data as of most recent quarter end

					Year-to-Date Returns		
Model Portfolio Returns*	**Q1**	**Q2**	**Q3**	**Q4**	**Portfolio**	**Benchmark SGD****	**Benchmark USD**
FY 2022	-0.20%	-7.40%	-20.47%	-21.96%	-42.64%	-12.39%	-15.15%
FY 2023	-3.59%	-5.71%	13.75%	1.16%	4.40%	13.05%	16.33%
FY 2024	-11.29%				-11.29%	-2.77%	-3.72%

	Cumulative	Annualized
Model Portfolio Return Since Inception***:	-46.87%	-24.50%
Benchmark (SGD) Return Since Inception:	-3.70%	-1.66%

Top 5 Holdings (Alphabetical Order)	Key Terms:	
eDreams Odigeo	Management Fees:	1% p.a, monthly
Evolution	Performance Fees:	15% p.a/bmark
Google (Alphabet)	Minimum Size:	S$250,000
IAC	High water mark:	Yes
Sendas Distribuidora (ADR)	Liquidity:	30 days notice
Total Weighting of Top 5: 64.39%	Structure:	SMA

* In order to display the most accurate representation of the returns, we use a model portfolio which has been subject to full fees since the inception of the Managed Solution. While this model account is a real client account, clients should check their own statements via their Interactive Brokers accounts to ascertain their returns as fluctuations between accounts are to be expected. Model Portfolio returns are in SGD.

** We use the iShares MSCI ACWI ETF as our Benchmark. Since this Benchmark is in USD, we convert to SGD based at the prevailing FX rates for an easier comparison. All return figures are indicative only, clients should check their own statements via their Interactive Brokers accounts for accurate figures.

*** Inception was 1st July 2021; The Managed Solutions financial year goes from July-June

Background

We launched the Farrer Wealth Managed Solution ("Managed Solution") on 1st July 2021. Through the solution, we aim to provide our clients with positive returns over the long-term using bottom-up research and asset selection. While the mandate of the Managed Solution is broad, we tend to stick to equities as it's the asset class we know best. Typically, the Managed Solution will have between 12-20 positions in businesses that we believe will outperform the relevant benchmark over time. Our investment decisions are based on deep research. Investments are sector- and geography- agnostic. We focus on businesses that are growing market share in markets that are growing. The solution does not short nor use leverage but may buy options to hedge or conserve capital on a position.

Returns discussion…

This quarter, the Managed Solution returned -11.29% versus the benchmark's returns of -2.77%. Since inception (1st July 2021), the Managed Solution has returned –46.87% versus -3.77% for the benchmark (all figures are in SGD terms).

This was a tough quarter. While some of this decline was driven by a few positions whose stock had large drawdowns during earnings (i.e. Sea and Adyen), these were relatively small positions in the portfolio. Most of the drawdown was driven by weakness in some of our core positions like Evolution, IAC, and Sendas Distribuidora (Assaí). There was no specific news that drove these stock prices down, but rather a combination of market weakness and investors discounting earnings. We still maintain conviction on these holdings but it's worth commenting on their financial performance.

- Evolution (-19% during the quarter): Evolution posted revenue growth of 28.2%, EBITDA margins of over 70%, and operating profit margins of nearly 60% during the second quarter of CY2023. With results like that one would think the stock of the company would significantly appreciate, but it seems that the market is caught up on two issues. First is the sluggishness of its RNG (slots) business whose revenues declined 4% yoy on a pro-forma basis. While we share the market's frustration with this vertical, we must also recognize that Evolution's margins have been increasing (profit margins increased 150bps yoy) due to the profitability of RNG games. The second issue was a slowdown in growth in the North American business which de-grew slightly on a qoq basis. This is certainly not ideal, but management has clearly mentioned that growth in the North American market will be lumpy. It takes time for new states to legalize online gambling, but it is in the offing. Currently only six states in the US have legalized online gambling, but 37 states have legalized sports betting. Thus, the pathway to further TAM expansion is clear in our opinion. The path to legalize online gambling will be like that of marijuana (which is legal in 23 states). Its slow at first, and then approvals happen all at once. Further, the ever-present risk of “unregulated” revenues continues to keep new investors away. However, with a clear pathway in the US and legalization of online gambling in countries like Brazil on deck, Evolution’s share of regulated revenues should increase steadily over the next few years. In any case, the stock now trades at 18x forward P/E ratio, which for the company’s financial profile, is more than reasonable.

- IAC (-20% during the quarter): IAC earnings were uninspiring, and the company continues to be a work in progress. While DotDash Meredith grew its EBITDA to $54MM (its highest since the merger), revenue growth has been disappointing due to sluggish online traffic in some key properties (Parents, InStyle, Shape). We must concede that while we initially were pleased by the Meredith acquisition, it's clear now that IAC paid peak earnings for the business, and it's going to take a while to return to that peak. That said, digital revenue was up during the last month of the quarter, so we should see a return to growth in 2024 as the overall advertising market improves. Further, Angi continues to be a distraction with management guiding to declining revenues until H1 2024. To be fair, much of this decline is due to IAC ridding itself of unprofitable growth, and thus making the right long-term decisions. The overall earnings IAC however were not all bad, and in fact on a consolidated basis, EBITDA increased by 88% yoy. The company has been smartly buying back stock at cheap levels (both at the IAC and Angi level), and we expect them to have continued to do so in Q3. As of this writing, the stock trades at around 8x expected 2023 Adj. EBITDA (ex-MGM) and has a FCF yield of around 9% (adjusting for the one-off purchase of headquarters). Overall, we think IAC management is doing the right things. They are right sizing their various businesses, improving cashflows and profitability, and buying back stock. Financials are moving in the right direction, and with the combination of smart capital allocation and growth returning in H12024, we should see the stock do quite well. Lastly, in early September, Bloomberg reported that Turo (of which IAC owns 31%) could go public before the end of the year. Turo, a car-sharing platform, posted revenues of ~$750MM and adj. EBITDA of of ~$62MM in 2022. A successful IPO should unlock significant value for IAC.

- Assaí (-15% during the quarter): We thought Assaí posted a strong set of results this past quarter. Revenue grew 20%, EBITDA was up 16% (margin was up 60bps sequentially), and while same-stores sales were down -1.7%, the company mentioned that they recorded growth again in June (about two months earlier than competitors indicated they would). We think the stock is now de-risked. The Casino group (the much-hated controlling shareholder) has left the building, same-store sales are growing again, the balance sheet will naturally deleverage as the newly converted Extra stores mature, and declining Brazilian interest rates will increase profit margins over the next several quarters. The stock currently trades at an 11x 2024 PE, which seems low for a company posting 20%+ returns on capital.

We feel much of the sell-off in our portfolio was unjustified, but drawdowns are normal parts of the process of unlocking long-term value.

Portfolio Updates…

New Positions:

Digital Bridge (New Position) – We began to buy stock in Digital Bridge ("DBRG") this quarter. DBRG is an American alternative asset manager focused on digital assets namely data centres, fibre networks, cell towers, small cells (cellular radio access nodes), and edge infrastructure (small data centre sites located near populations). It currently has $72.2bn in AUM and $29.1bn in Fee-Earning Equity Under Management ("FEEUM"). DBRG has 30+ Portfolio companies (including advised companies) across the Americas, Europe, and Southeast Asia.

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DBRG's global investments

DBRG was founded in 2013 by Marc Ganzi (CEO), Ben Jenkins (President and CIO), and Alex Gellman (Senior Advisor) after Ganzi's several successes as a digital infra. Ganzi has had many forays in the digital infra space, but the most notable was his founding of Global Tower Partners in 2003 which was the largest privately owned telecom tower operator in the US. In 2005 Blackstone took a majority stake in the business, after which it was sold to Macquire in 2007 for an enterprise value of US$1.43bn. Eventually Macquire sold this business to the American Tower Group for $4.8bn in 2013.

Initially the founders of DBRG were doing deals on an adhoc basis, but after a successful partnership with Colony Capital, the two companies were merged in 2019 and Marc Ganzi was named CEO. Now, this is where things get interesting. Due to this merger, DBRG was a confusing story for many years. It had several legacy assets on the balance sheet including hotel properties. It had to transition from being a REIT to a C-Corp, it also had to clear up its shareholding by buying out investors in its asset management business. Almost all of this was cleared up by early 2023, however, the final step is the deconsolidation of two businesses – DataBank and Vantage Data Centers (both operate Data Centres) which currently sit on DBRG's balance sheet. The DataBank deconsolidation has occurred as of this writing through a recapitalization of the company, and the Vantage Data Center sale should happen before the end of 2023. While DBRG will maintain stakes in these companies, their shareholding will fall below the 10% threshold which requires them to consolidate. Post this transaction DBRG will be transformed into a pure asset management business (just like a Blackstone).

This "confusion" with the balance sheet has led to a mispricing in the stock price that we believe is trading at a 25-30% discount to fair value. Further this is fair value based on current assets, which assumes that DBRG does not raise any more capital from Limited Partners. However, given their focus on digital infra (which we will discuss below) and Marc Ganzi's salesmanship (just read one earnings call transcript and you'll see what we mean), we do not think this will be the case.

Digital Infra is an exciting space and we highlight three points to capture the potential of the investment opportunity:

- 5G subscriptions are set to expand from 1.5 billion at the end of this year to over 5 billion by the end of 2028 globally.
- Data Center capex is likely to hit $1.3 trillion/year by the end of this year to support the ongoing AI boom.
- By 2025, globally, we are likely to see over 50 billion connected devices, increasing the demand for Data Center and Edge Infrastructure.

DBRG has investments spread across all these spaces as highlighted by the infographic below.

Thus, the thesis for Digital Bridge is quite clear. It's a rapidly growing asset manager, trading at significant discount to fair value, investing in sectors which have a long runway of growth. We believe that alternative asset management, at scale, is a fantastic business. Capital is locked up for typically 8-12 years or in some cases is permanent, fees are linked to committed/invested capital giving high visibility on cash-flows, and most asset managers operate across asset classes providing for diversification (DBRG along with private equity investments has capital allocated toward credit and public equity). The key here, as mentioned, is scale. Digital Bridge is likely to hit ~$34billion in FEEUM by the end of 2023 (a growth of 30% yoy) and is guided to hit $45bn by 2025. The company has guided that distributable earnings (essentially cashflow) will be around $170MM by 2025, valuing the business at 15x multiple, which for a growing asset manager is very reasonable (Blackstone and KKR trade at around 25x).

Now the case against DBRG is two-fold. 1) They have overpaid for assets and 2) They are riding on the "AI" boom and any cutback in Data Centre spend will hurt. On the first bear case, criticism mostly revolves around the price they paid for the Switch (Data Centres) deal, and the issues they are having in Zayo (fiber). On the Switch price (around 31x adj. EBITDA), which was a rallying call for bears on the stock, Ganzi has laid out his rationale for that price based on pending contracts, cost elimination and growth which we find compelling (his defence of Switch can be found here at the 20:40 mark). On Zayo, even the company must admit that the investment is likely to yield just a single digit return overtime. While that's disappointing, there isn't an alternative manager in existence that has not had a bad investment. On the AI boom point, we believe the potential risk here to be valid, and while the company is diversified across asset classes, all investments are in the digital infra space. This is unlike Blackstone (which we also own) that is differentiated across sectors as well as asset classes. Thus, given this risk, we will keep the DBRG position size modest in our portfolio.

Overall, though, we find that DBRG is a niche, but fast-growing alternative asset manager, focused on a rapidly expanding space, with a highly experienced operator/investor at the helm, rounded out with a stock trading far below fair value.

Positions exited

We sold two positions in our portfolio this quarter, TaskUs and Spotify.

TaskUs – We sold our stake in TaskUs as a series of poor earnings made us doubt the strength of the industry over both the short and long-term. At the start of the year TaskUs had guided to 0.5% growth in revenue for 2023. Alas, this guide was reduced in Q1, and again this last quarter where they guided to a revenue reduction of 5.8% for the year. This was disappointing as during the Q1 call management had stated confidently that they could hit their revised revenue number (and mentioned it was conservative). After the initial 2023 guide in February this year we felt that the slow consolidated growth, driven by its largest customer (Meta) moving from onshore to offshore services, was masking rapid underlying growth, and displayed this chart in our subsequent letter.

TASK Rev Breakup	Q1CY22	Q2CY22	Q3CY22	Q4CY22	FY22	Q1CY23E
Revenue (US$MM)	240	246	232	242	960	232
% from FB	*24.0%*	*22.0%*	*22.0%*	*20.0%*	*22.0%*	*20.0%*
% from crypto	*15.0%*	*13.0%*	*6.0%*	*4.0%*	*9.5%*	*2.0%*
FB	58	54	51	48	211	46
Crypto	36	32	14	10	92	5
Other Revenue	146	160	167	184	658	181
Other Revenue Growth						**24%**

However, as of this most recent results call, the company mentioned that the "Other Revenue" growth had essentially fallen to about 7%. This implies a broad-based deterioration in the market. It also called into question our thesis that when a recession hits, companies would outsource more work to BPOs to save costs. It seems that the opposite is happening, and clients are either automating processes themselves or delaying/cancelling new projects all together. Further our conversations with industry experts illuminated that the "AI" threat is real, and that the expectation is that ~30% of revenues in the BPO space will get cannibalized, which at best implies flat growth for the next few years. Now TaskUs' management has stated that they expect to see growth again in 2024, however their credibility is a bit shot at this point. To be fair to them, the typical visibility that BPOs get from customers has become far murkier, as the entire industry will undergo significant change. This makes future cashflows difficult to predict, and thus we decided to sell our position.

Spotify – Spotify's stock has had a good year, with up ~88% for CY23 (through September). Unfortunately, we feel that the companies' financial economics have not followed in tandem. While the company has done a great job growing users, the crux of the thesis for this stock was improved gross margins driven by podcasting and new product launches. Afterall, the biggest bear case against Spotify is that their margins are structurally impaired. The company disagrees with this and has promised improved margins in the offing. However, it seems to me the goal post keeps shifting. Toward the end of CY2023, Daniel Ek (CEO of Spotify) stated that "this heavy investment that we've done on the podcasting side is going to reverse in 2023 as it starts moderating." However, this year's returns have shown anything but. For Q123 Gross Margins came in at 25.2% flat on a yoy basis, followed by 24.1% in Q2. Further, the Ad-supported Gross margin came in at -5.7% (podcasting costs are included in Ad-supported gross margins). Thus, the "improvement" that Ek has promised is yet to materialize. Further for Q3, the company guided to a 26% gross margin. An improvement for sure, but a marginal one. Considering that the margin performance has been lacklustre, but the stock performance has been stellar, we get the feeling the market is putting the 'cart before the horse.' Given the above, we had been trimming the position along the way, and finally sold the last tranche this past quarter. We continue to monitor the company, as we remain big fans of the product itself, and are interested to see how the foray into audiobooks helps margins (although from our initial read, investors should not hold their breath).

Large Corrections

We had two positions, Adyen and Sea, experience significant corrections during Q3.

- Sea saw a near 46% drawdown (peak to trough) during the quarter. While the stock price recovered around 22% toward the end of the quarter, the stock is still struggling this year (down 17%). We have written in length here and here about what we thought about earnings, so we won't repeat ourselves. But to summarize the stock was sold off due to the company indicating that it will start reinvesting in the business (and thus lowering profitability) and tough competition. However, the competition threat has decreased rapidly with TikTok Shop receiving a ban in Indonesia and subsequent articles about how they may experience the same in Vietnam and Malaysia. This implies that Shopee (Sea's ecommerce arm) will gain significant market share over the next few quarters. While earnings for the period will be rocky (we still expect that Shopee will lose money in the short-term) we think the risk/reward at this price is highly attractive and we have added to the position. Street estimates put Sea's stock at a 10x 2025 PE multiple.

- Adyen saw an even more drastic drawdown of nearly 63%. We always knew Adyen's stock traded at expensive levels, so we kept the position size small going into this year. Coming into earnings it was about a 2% position, which got cut in half due to the drawdown. Adyen, which is a leader in the payment processing space, has for a while been guiding to 25-30% revenue growth and 65% EBITDA margins over the long-term. Thus, the market was willing to give its 50x EBITDA valuation a pass. However, Adyen's H1 earnings showed revenue growth of just 23% (with North America revenues shrinking on a qoq basis) and EBITDA margins of 43%. The market understandably freaked out and sent the stock tumbling. However, we need to look at what caused both revenue and margins to drop. The margins are much easier to explain. Adyen has gone on a hiring spree, increasing their headcount by 16% just in the first half of this year. Adyen, wisely refused to hire alongside other tech companies during 2020/2021 as they found salaries too high. They waited, and as other tech companies started to fire staff, Adyen could have their pick in a much 'saner' market. Their margins thus decreased as they integrate this new staff and launch the new projects they have hired them for. While this is a short-term stress on margins, it seems to me that this is the absolute right long-term decision. On the revenue side, much of the slowdown was driven by increased competition in North America, namely by PayPal's payment arm, Braintree. It seems to us that PayPal is "loss-leading" with Braintree to maintain PayPal as a key payment option for customers on merchant websites. This strategy seems quite odd to us, after all the consumers will make their choice of what payment option to use based on what they are used to (and there are many options including credit cards, Apple Pay, etc). Thus, just ensuring the PayPal option exists is no guarantee that it will be used (and thus offsetting the Braintree losses). So, this strategy seems unsustainable. That said, the short-term price competition will hurt Adyen volumes in the region, as Adyen typically does not compete on price. More likely, it will take a few quarters for Adyen's platform and omnichannel business to grow in the region to replace lost volumes from their digital business (where they compete with the likes of Braintree). Still questions remain if Adyen can hit their long-term targets. However, at a price of less than Euro 700/share our assumptions of future cashflows did not require much imagination, and thus we bought more shares and brought the position back to a 2% position.

Valuation of the Portfolio…

Given the changes in the portfolio during the year we feel that the quality of our portfolio, determined by both valuation and growth, has greatly improved. As can be seen from the chart below, on a 2025 basis, the portfolio is trading both cheaper and growing faster than the market.

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Name	FY24 PE (x)	2024 Rev Growth	FY25 PE (x)	2025 Rev Growth
		Street Estimates		
eDreams	63	17%	13	16%
Evolution	16	20%	14	17%
Assai	11	18%	7	11%
IAC	20	5%	11	7%
Alphabet	20	11%	17	11%
Sea Limited	19	11%	14	12%
Blackstone	18	35%	16	16%
Basic-Fit	22	33%	13	22%
Howden Joinery	14	6%	13	6%
State Bank of India	9	13%	8	10%
Digital Bridge	NA	4%	NA	12%
Adyen	28	24%	22	24%
MedMix	19	8%	15	9%
Weighted Average	**24**	**16%**	**12**	**13%**
Benchmark			**14**	**5%**

*IAC valuation is ex-MGM stake, Medmix and SBI are tactical positions

Further, we assess that 'fair value' for our portfolio holdings, on a weighted average basis, are conservatively 114% higher than current levels. If this valuation gap is realized, we will not only make back our losses, but also produce reasonable overall returns.

Upcoming Catalysts…

With regards to overall portfolio returns, the past six months have felt like Sisyphus rolling a boulder up a hill, and any progress has been rolled back due to a bad month or two. However, we do think that the 'hill' might be flattening out over the next six to nine months. Several of our core positions should experience what we believe to be catalyst events that period. These events, if realized, will help 'unlock' the value of our portfolio. For example:

- eDreams, which has been executing flawlessly, is expected to start buying back shares in Q1 next calendar year.
- Sea Limited will show both strong revenue growth and reasonable group profitability within the next quarter's results as they step up their game and the competition backs down.
- Assaí becomes even more profitable as recently converted stores mature, Brazilian interest rates fall, and the balance sheet automatically deleverages.
- IAC continues to buy back stock (for both IAC and ANGI), and rumours of Turo's much delayed IPO come to fruition.
- Basic-Fit and Adyen hold investors days in November that remind the markets of their profitability and guidance going forward.

- Digital Bridge hits is year-end targets of $8bn in FEEUM added.

In Conclusion…

To summarize, while the last six months have been frustrating, the horizon seems much clearer. We know what the upside to our portfolio looks, see several catalyst events over the next six to nine months, and own a portfolio that both trades cheaper than the market, and is set to grow faster. Thus, I continue to ask for your patience. As repeatedly mentioned, it usually takes between 3-5 years to realize the value of a portfolio (we are after all investing in the long-term).

We've said this before, and will repeat it often, but it is an immense privilege to manage our clients' hard-earned money. It is a privilege we do not take lightly and work daily at earning and keeping our clients' trust. If you are a current client and ever have any questions or just want to chat, please do not hesitate to reach out.

Lastly, for non-clients reading this letter, if you are interested in learning more about Farrer Wealth, please reach out at pratyush@farrerwealth.com. All interested parties must be based in Asia and must be Accredited Investors (as per MAS' definition).

Pratyush Rastogi
CEO – Farrer Wealth Advisors