Farrer Wealth Managed Solution Quarterly Update

Q4 FY2023 Returns Summary

(Quarter ending June 2023)

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

Model Portfolio Returns*	Q1	Q2	Q3	Q4	Year-to-Date Returns: Portfolio	Year-to-Date Returns: Benchmark SGD**	Year-to-Date Returns: 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%	16.42%

	Cumulative	Annualized
Model Portfolio Return Since Inception***:	-40.11%	-22.61%
Benchmark (SGD) Return Since Inception:	-0.96%	-0.48%

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: 60.65%	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 1.16% versus the benchmark's returns of 8.30%. For the 2023 financial year, the Managed Solution returned 4.40% versus the benchmark's returns of 13.05%. Since inception (1st July 2021), the Managed Solution has returned –40.11% versus -0.96% for the benchmark (all figures are in SGD terms).

This was an uneven quarter where April and May were weak for our portfolio holdings as it seemed that several of the sectors we were invested in were sold off in favour of AI-linked stocks. However, that trend reversed in June as the Farrer Wealth Managed Solution posted a 9.34% gain outperforming the benchmark.

It has been an interesting year macro-wise with US inflation appearing to be in the rear-view mirror and we are likely to be toward the end of the rate-hiking cycle. While Europe and Southeast Asia remain weak due to a tentative consumer base, we are seeing signs of cooling inflation there too. Several events this year have been shrugged off by the market including the failure of several US banks, the US debt ceiling (which turned out to be a nothing burger), and reasonably hawkish central banks globally. Taken in aggregate, this points to a much tamer macro environment ahead.

While nothing is for sure (a US recession is still expected) we do see a good runway ahead for many of our positions and have started to rundown our cash balance as we add to current and new positions.

Portfolio Updates…

Howden Joinery: Our only new position in our long-term book was Howden Joinery. Based out of the UK, Howden Joinery ("Howdens") is a trade only supplier of kitchen and joinery products. Howdens' key differentiation is that they sell only to trade (i.e to contractors). They sell their products through one of 873 depots (mostly in the UK). The company in 2022 posted about £2.3bn in revenues, 61% gross margins (£1.4bn), 20% EBITDA Margins (£459MM), and 16% net income margins (£374MM). 95% of Howdens business comes from contractors working on refurbishments of kitchens.

As of 2022, Howdens has 808 depots in the UK, 58 in France, 2 in Belgium, and 5 in Ireland. Each depot is run by a manager who is a mini-CEO (more on that below). While the end customer (the homeowner) can come into the depot to view various kitchen designs and confer with Howdens, the sale is done via the contractor. Pricing is entirely up to the depot manager, thus giving flexibility to offer better pricing to contractors who do more volume, and to allow for regular price increases.

Howdens' depot and sample kitchen range

As can be seen from the two charts below (source: Barclays and JKMR) Howdens has about a 41% share in total kitchens installed by volume. Their market share within price ranges does change though. They have a strong market share in the budget and lower-mid categories but that share drops as they go higher in the price point (for reference budget kitchens cost less than £6,000 whereas premium kitchens can cost over £40,000). However, with the acquisition of Sheridan (which makes luxury worktops), the company is moving more into the upper and premium space where the main competitors are mom & pop shops. Based on our conversation with the company, Howdens believes they are about 30% cheaper than Mom & Pops.

FIGURE 17. **Market share by volume of kitchens installed**

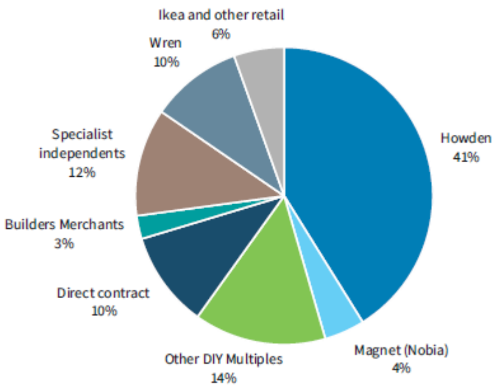
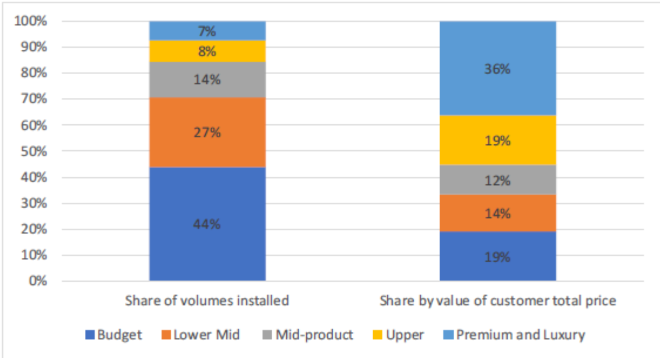


FIGURE 20. **The budget segment accounts for the largest segment of the total market by volume, but much less by value**



Howdens has a unique culture where they treat their depot managers as mini-CEOs. They are fully in charge of pricing (unless there is a significant market scenario such as 2008), inventory, and day-to-day operations. They are also incentivised well, and are given as bonus, 5% of depot profits (essentially the company's gross margin). Another 5% is split among employees of the depots. This is paid monthly to maintain high throughput throughout the year. This model has resulted in gross margins staying consistent at the ~60% range. Depot managers are also responsible for local customer acquisition and maintain relationships with the tradespeople in their areas.

The street expects low to mid-single digit revenue growth for the next few years. However, the company is working on several initiatives that could prove these forecasts conservative. These include:

- International expansion: Howdens has been slow to get its international expansion going, especially in France. This was partly because of having the wrong leadership team in place (i.e. sending English mgmt. to France) and partly because of a lack of focus. However, Howdens is now ramping up its expansion with a goal of ~66 depots in France by the end of 2024 (up from 28 in 2020). Ireland is also the next large international location with 6 depots scheduled by the end of this year.
- Further UK Expansion and Refurbishments: Management believes that the UK has a capacity of about 1000 depots. Further the UK depots are in the midst of refurbishments with 50% trading on new formats that allow for more throughput.
- New products: In the past Howdens was seen as a bit of a follower when it came to new products and ranges, however in recent years they have stepped up their game and launched

several new products. Sales from new products made up 22% of UK sales in 2022 and are growing at 69%.
- Online accounts: The company is trying to shift trade to interact more with their online accounts. 45% of their customers now have online accounts, with online customers on average spending more than regular customers.
- Unprompted brand awareness: As discussed above, this is being pushed by social media followings, advertising, etc. Howdens has a significantly larger social media presence than its competitors. For example, on Instagram, Howdens has 278K followers whereas competitor Magnet has 96K and Wren has a little less than 199K.

What excites us about this investment is its rarity. It's rare to find a business that has a 40%+ (and growing) market share in a growing industry. It's rare to find a business that can continually increase prices without losing market share. It's rare to find a physical goods business that has 60%+ gross margins, 20%+ EBITDA margins, and 30%+ returns on equity (with no debt). It's rare to find a business that thinks clearly about capital allocation and returns all free cash flow to the shareholders. All these individual elements are rare on their own, but what makes this opportunity most rare is that the company is trading less than a 10X trailing EBIT multiple.

Now the question is, why are we receiving this opportunity? We believe that it is for a few reasons for 1) the UK economy is weak. GDP growth is below 1% and unlikely to rise much above that in 2023. Inflation is sticky, and consumer confidence hit rock bottom at the end of 2022. 2) There is no doubt Howden received a covid-bump and we saw its revenue/depot jump from ~GBP 2MM/depot in 2019 to GBP 2.7MM coming out of 2022. Obviously, people stuck at home led to more kitchen refurbishments than usual. So, 2023 is a critical year to see if the covid-bump will last or if we will see weak sales during the key months of the year (around October). All of this leads to the market having depressed views on future revenue growth for the company. However, we believe that the market is too myopic/short-term on this point. We don't think the company needs break-neck growth to do well. Even in our model we are only predicting about 6% average revenue growth (conservative compared to pre-covid growth of 8-10%) over the next few years, but the business's economics, valuation, and overall capital allocation will take care of the rest.

Overall, we believe we are buying a great business at a great price. The only major drawback we see is that Matthew Ingle, the company's visionary founder retired going into the pandemic, and the new CEO, Andrew Livingston, does not have enough skin in the game (he owns just 0.1% of the company). That said, Livingston does come to Howdens after a successful role as CEO of Screwfix (a retailer of trade tools) where he properly executed a similar strategy that he is employing at Howdens. Thus, while we don't love management's alignment, we do trust they will execute well. We think they are incentivised well as most (70%+) of compensation is driven by targets linked to cashflows, profitability, and total shareholder returns.

HDFC Bank (ADR): We sold our remaining position in HDFC Bank throughout the quarter. While we think it remains one of the best run banks in India (and the region) its merger with parent HDFC will cause an overhang on the stock. We also think the valuation became full, in comparison to alternatives such as State Bank of India (which trades at 1.18x P/B vs HDFC Bank's 3.15x[1]) given similar growth rates and asset quality. Thus, we decided to allocate capital elsewhere. For the portfolio, HDFC Bank was a minor success but given that most positions were transferred into the Managed Solution form our advisory days, the overall gains to our clients were more significant. We started buying HDFC bank during the depths of covid around ~US$50/range and sold the last of the position around the ~US$70 range.

Tactical Book…

Going into Q1FY24 (click here to read last quarter's letter about the tactical book); we held two positions in our tactical book. The first, was State Bank of India which we discussed in our previous letters. The second is a new position in a European Industrial business with a strong balance sheet, reasonable growth, and entrenched customers. The stock is trading at cheap levels due to issues entirely related to its largest shareholder which have had unintended consequences for the company. We believe that the company has nearly fixed the damage to its business and the stock should start trading in line with peers as the company returns to growth allowing for a 50% upside (the stock currently trades at a 33% discount to peers).

We previously had held Atento which we sold after an upcoming dilution greatly reduced the risk/reward ratio on the trade from 1:5 to 1:1. We sold the stock around the $2.30 level and it currently trades at ~$0.50.

Valuation of the Portfolio…

With regards to our portfolio, with few exceptions our companies posted strong Q1 numbers. Thus, I believe the quality of our portfolio is stronger than it has ever been and while we make 1 or 2 changes, we mostly just need to wait for the market to recognize the value embedded in our holdings. On that topic, on the below table we map out the evolution of our portfolio compared to the benchmark. As a refresher, at portfolio inception, some of our portfolio positions were unprofitable either because they were recovering from covid (like eDreams) or going through an evolution (like IAC does every few years). Thus, we focused more on revenue growth at the time. However now that those companies have become profitable, we also focus on earnings per share (EPS).

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[1] On a standalone basis

	30 June 2021 - 30 March 2023	CY 2022 - CY 2025		
	Revenue Growth	Est. EPS Growth	Est. Revenue Growth	1Y FWD P/E
eDreams Odigeo	117%	113%	56%	33
Evolution	67%	69%	78%	22
Google (Alphabet)	13%	32%	32%	21
IAC	31%	184%	-2%	18
Sendas Distribuidora (ADR)	50%	98%	68%	19
Weighted-Average	**63%**	**103%**	**31%**	**23**
MSCI All-World Index	19%	16%	9%	17

In the chart above we compare the benchmark and our top 5 positions (weighted by size in the portfolio) over two time periods. The first period, the past two years (inception till now), our portfolio revenues grew significantly faster than benchmark revenues. In the second period we compare expected EPS and revenue growth versus the benchmark and display a similar result[2]. Lastly, for reference we include 1 year forward valuations, and we can see that while our top 5 positions trade at a 36% premium to the benchmark valuations, they are growing both their top and bottoms lines 3.5x and 6.5x faster.

We display the results of this exercise to illustrate that not only have our portfolio holdings grown their revenues much faster than the benchmark (and continue to do so), but now they will also grow their profits at a more rapid pace. So given enough time, we strongly believe the market should recognize this and award our holdings with higher stock prices accordingly.

Reflections…

The end of this quarter marks two full years for the Managed Solution. While returns have not gone to plan, with the drawdown larger than expected and the recovery a bit slow, I am seeing clear signs of improving conditions. This improvement permeates the macro environment, our portfolio companies, and in our overall returns. While April and May slowed our portfolio's momentum from the first quarter of this calendar year, June put us back on track as the market started to get behind our picks.

We are still in the early days of this portfolio, and as usual we remind clients that investments need to be made over a minimum of three-years and ideally five-years. While we cannot guarantee anything, we are both optimistic and confident for the next year and onward.

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[2] For eDreams we use 2019 EPS (pre-covid) instead of 2022 EPS to not skew results highly in our favour. For IAC we 2024 EPS figures as 2022 was still an unprofitable year for the company, and using 2023 figures would again highly skew results in our favour

In Conclusion…

We've said this before, and will repeat it often, but it is an immense privilege to manage our client's hard-earned money. It is a privilege we do not take lightly and work daily at earning and keeping our client's 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
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