June 2024 Update

Profeta International Fund

June 2024

Dear fellow investors,

Our fund fell 3.1% in the June quarter, bringing the performance for the calendar year to +2.8%. Our performance for the financial year was +10%, bringing the 2-year annualised performance and performance since inception to 14% p.a.

We are in an unusual point in history in financial markets, where money continues to flow into only a handful of companies in the US market and globally equity flows have concentrated in the largest companies in each country. This has meant that well-managed, quality smaller companies around the world have been neglected. We get excited by these prospects and have been investing in small emerging leaders in a variety of sectors across the world. These companies are growing their earnings and delivering strong free cashflow, however their equity prices have not increased with the earnings growth as is usually the case. This has meant that the valuations of the companies we own continue to fall and many are trading at greater than 50% discounts to their historical averages. We expect a broadening out of equity market performance once the wave of money stops herding towards perceived artificial intelligence winners and companies that make up large parts of domestic and global ETFs.

I was in the US in June and visited a number of our investments. The US economy continues to be strong, albeit it is being driven by spending by middle to higher income earners. I will go through a number of our largest investments in this update to highlight how the underlying companies are performing.

We expect the macroeconomic backdrop to continue to improve in the second half of the year and much milder inflation will lead to the start of a rate-cut cycle. This should lead to a broadening out of equity market stock performance into lagging value stocks and small capitalisation stocks, which are areas that we have been increasing our exposures to, and have a large portion of the portfolio invested in.

Quarterly performance

Our top performers for the quarter included BT Group, Alphabet and First Solar. Our largest detractors were Alight, Nomad Foods and Stone Co.

While the large US indices continue to be driven by the magnificent seven, small capitalisation stocks have underperformed significantly. The US's S&P Smallcap 600 index is down 1% this calendar year and the Smallcap 600 Value index is actually down 5%. Alight, Nomad Foods and Stone Co are some of the small capitalised stocks we own that are listed in the US. They are expected to deliver strong earnings per share growth over the next few years, yet are currently trading on single digit PEs, as their share prices have fallen this half.

This wave of selling in smaller companies is a global phenomenon, not just that seen in the US. Certain countries' stock markets have also been impacted by elections. The Mexican stock market dropped over 10% after the recent election of Claudia Sheinbaum, the country's first female president. The stock market reaction was a surprise given that there is no change in the Morena party running the country as she takes over from her mentor and outgoing President, Lopez Obrador.

More recently, the French stock market dropped 10%, due to uncertainty in the lead up to the French elections. We have 10% of our portfolio invested in French equities, with the majority being in Euronext, a pan European

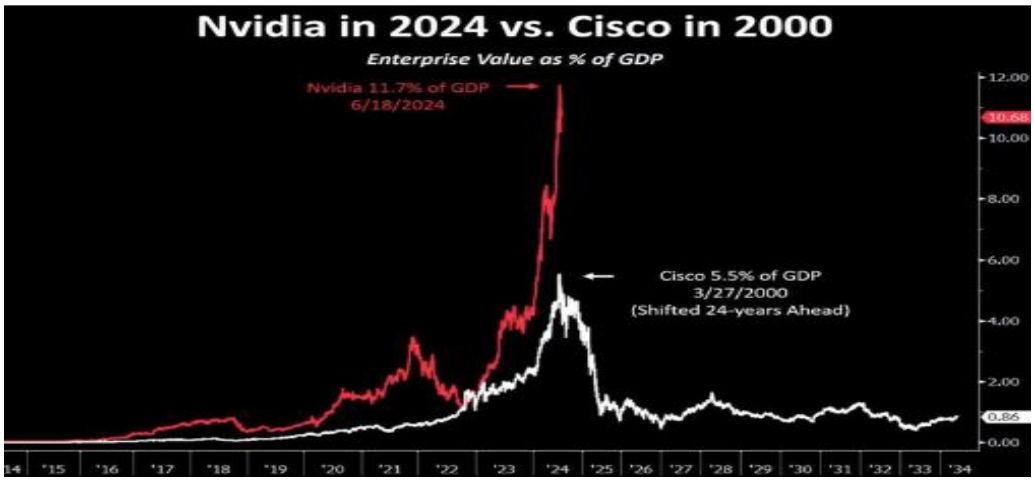
exchange. We don't expect any of our companies to be negatively affected by the outcome of the election and have taken the opportunity to top up our positions.

The AI boom and large capitalisation stock concentration

As I have mentioned before, artificial intelligence has been around for decades, mainly focused on improving factories and automating processes. The current excitement around its potential to be applied in large language models to improve efficiency in white collar labour and provide additional services is warranted, but its application will benefit many companies, not just the handful of large companies around the world which are either selling chips or building out cloud infrastructure to run AI models. The large infrastructure investment currently being made by a handful of technology and cloud providers has driven Nvidia to being the largest company in the world.

Nvidia's chips have been the workhorses of the AI boom, bought by Amazon, Microsoft, Meta and Alphabet to power their cloud infrastructure in order to develop compute heavy solutions involving artificial intelligence and machine learning. Nvidia's revenue has surged from $26 billion in 2023 to $61 billion in 2024 and analysts expect it to double again to $120 billion in 2025. It is very hard to predict the level of investment in one particular company's chips and it assumes competing chips don't take any market share. Alphabet has developed its own chips to power its cloud infrastructure and AMD intends on launching a new chip in this area at the end of 2024. Nvidia has nearly tripled in value this year alone and is currently worth over $3.1 trillion.

The last time a big provider of computing infrastructure was the most valuable U.S. company was in March 2000, when networking-equipment company Cisco took that spot at the height of the dot-com boom. Cisco was riding the wave of a different revolution—the internet—where its products powered that budding industry. Like Nvidia, Cisco also surpassed Microsoft to become the most valuable company. However, Cisco currently is trading below the share price it reached in 2000, twenty-four years ago. Semiconductor companies are usually cyclical businesses where competitors tend to catch up and develop competing chips and erode the price of the chips as the technology advantage fades. The other thing that is being ignored by the current hype is that although $50 billion has been invested in Nvidia chips over the past year, generative AI start ups have only brought in $3 billion of sales.



The Magnificent Seven stocks have driven two thirds of the S&P 500's gains this year. Moreover, small caps are now underperforming large cap stocks by the largest margin since January 2001, while the Nasdaq is now outperforming the S&P 500 by the largest margin in almost 30 years surpassing the peak of the Dot Com Bubble.

Our Technology Investments

We have 30% of the fund invested in technology companies. The majority of which are small, capitalised companies. These companies are growing their revenues and earnings quickly but are being neglected at the moment because they are not being chased by investors looking to try to get exposure to artificial intelligence. This does not mean that they won't be artificial intelligence winners over the medium term, it just means that their work in this area is being ignored.

We have been investing in software providers over the past few decades, that have been adding machine learning into their software and products and continue to focus on these businesses as they generally are not cyclical businesses and therefore don't see a boom/bust nature in their revenue and earnings streams. We are currently invested in technology leaders like Adobe, Siemens, Microsoft, Alphabet, Baidu and Alibaba that will benefit by providing software and cloud services that implement artificial intelligence. Most of the services companies we have invested in are also implementing artificial intelligence in their processes and products to either improve internal efficiencies or provide additional functionality in their products.

Leading property and travel advertising portals like Rightmove and Expedia have been neglected by investors over the past five years, despite them delivering consistent earnings growth. In 2017, both Rightmove and Expedia were trading on PEs of 27x, viewed as leading technology companies with good earnings growth prospects. This has been the case yet their stock prices have not followed their earnings trajectory. Expedia is expected to grow earnings per share by over 20% per annum, yet it is now trading on a PE of 8.5x 2025 earnings. It launched its artificial intelligence-powered travel planner called Romie in May, yet the stock market has barely blinked. Romie can assist with group chat trip planning when travellers invite it to be their virtual assistant in group chats. The technology can help build travel itineraries, aggregate travel information from emails and suggest activities, dining options and hotels, bookable in Expedia's travel booking websites. While these technology companies are being ignored by today's retail investors and institutions, preferring to hug indexes and chase meme stocks like Gamestop, we expect stock prices to eventually rebalance back to reflect underlying fundamentals.

The professional services technology companies that we have invested in are also leaders in the employment sectors in their respective countries. They are also expected to grow their earnings at a double-digit rate over the next few years and some of them like Alight in the US and Learning Technology Group in the UK have de-rated to single digit price to earnings ratios. Alight in the US and Visional in Japan are providing their customers with data driven human capital management software that integrates all aspects of human resource management from payroll, expense management, benefits management, performance tracking and applicant tracking. The stock prices of these companies have been very volatile recently, yet the management teams have a strong track record of delivering for their shareholders.

Visional was founded by Soichiro Minami in 2007 and he has built up a leading online direct recruiting platform with 2.5 million job seekers in Japan and growing, in their Bizreach platform. These services are combined with their HRMOS human capital management software solution to provide companies with a wholistic approach to recruiting and managing their staff. We expect the business to continue to grow at a double-digit rate and like to invest alongside founders like Soichiro Minami, who still owns 35% of the company. I recently spoke to their chief financial officer, Risako Suefuji, who was optimistic the company's prospects and their ability to grow revenue at 15% per annum over the medium term. They are integrating generative AI into their products to provide improved functionality, allowing companies to automatically post job ads using standard language for position specifications. They are also integrating AI into their CV summary tool for job seekers, enabling them to generate their career summary in minutes.

Our investments in China's technology leaders are yet to pay off, but our conviction in these investments has not waivered. We have investments in Alibaba, Baidu and JD.com. JD is our largest investment of the three. They all trade on single digit PEs despite large net cash balance sheets and very strong free cashflow generation.

JD.com

JD.com is China's second largest ecommerce company. It is the leader in direct sales consumer electronics and appliances and has its own logistics unit, which provides a differentiated service of quick and predictable delivery. The company is the leader in online retail of large appliances and has been expanding its categories to include general merchandise and fast-moving consumer goods. They source products from over 50,000 suppliers.

JD differentiates with its large range of products at affordable prices, delivered reliably and quickly. They have 1600 warehouses covering all districts in China. The company continues to invest in smart logistics and is experimenting with unmanned warehouses, drone delivery, self-driving vehicles to improve the efficiency of their logistics. Artificial intelligence is also being used to improve customer satisfaction with features such as

“snapshop” that allows users to identify products through uploaded pictures. They are also using AI for customer big data analysis, enabling better predictive offers and product recommendations.

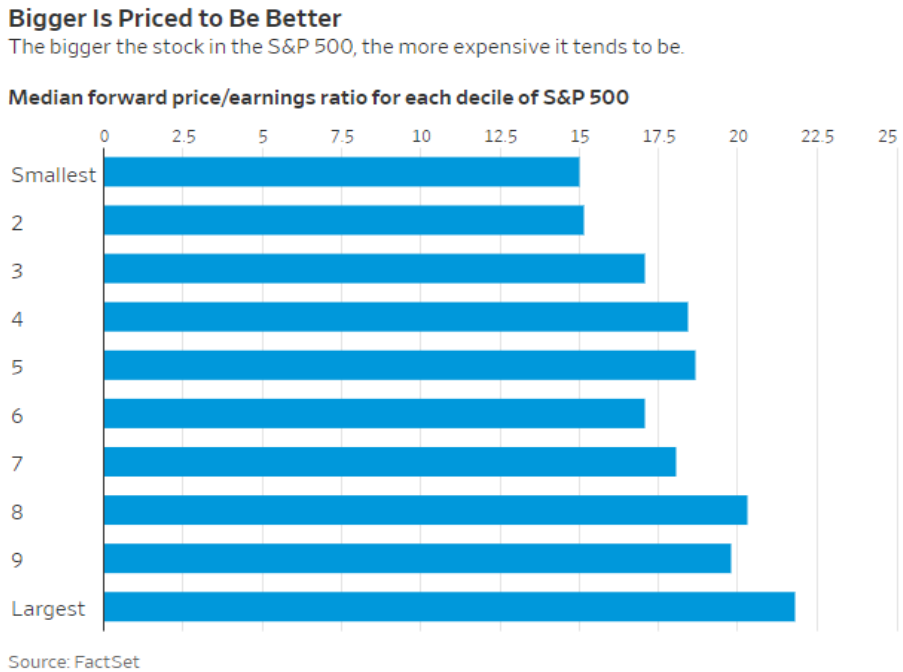
Richard Liu, the company’s chairman, launched the business in 2004 and still has 70% of the voting power of the company. JD now has 17% share of China’s ecommerce market. Since 2014, JD has had a strategic agreement with Tencent, giving the company prominent access points on their mobile apps Weixin platform. They also have a strategic alliance with Walmart after acquiring their Yihaodian marketplace. Walmart currently own 9.4% of JD’s outstanding shares.

While most technology companies listed in the United States have seen their stock prices appreciate with their rising earnings profiles, Chinese technology companies have seen the exact opposite. JD.com, like most ecommerce companies, benefitted from the covid period in 2020 and 2021. Its stock price peaked at $100 in 2020, when its earnings per share reached $1.63 in that year. Since that time, earnings per share have doubled again to an expected $3.30 this year, yet the stock price has dropped 70% to the current $26.76. The company generates strong free cashflow of approximately $5 billion per annum. It has a net cash and short-term investments balance of $18 billion, half its current market capitalisation. The company spent $1.3 billion buying back shares this year, representing 3% of shares outstanding. We think the shares are worth double the current stock price and have been accumulating shares over the past quarter.

While China’s housing market has been weak over the past few years as the government has tried to curtail speculation in property, JD has managed to continue to grow sales in the appliance market. Group revenues grew 7% in the first quarter with double-digit earnings growth. We expect the company to grow earnings per share at a double-digit rate over the next few years as they build out other product categories like the supermarket category.

Increasing Exposure to smaller capitalization companies

We have been increasing our exposure to smaller capitalization companies as I can’t remember a time when there has been such extreme discrepancies in how companies are being valued. We are currently accumulating shares in Enquest, an energy company based in the United Kingdom, which is trading on a PE of 1.5x. Its market capitalization is under 300 million pounds and it is generating over 200 million pounds of free cashflow and will be close to debt free by the end of next year. The company is buying back shares and it feels like it’s just us and the company buying shares at the moment. We don’t know what the catalyst will be for the share price to rise, but it shouldn’t take much for the stock price to double. At the moment we are just taking advantage of this stock price dislocation with fundamentals to accumulate as many shares as we can for Profeta’s clients.



I recently met with Stefan Descheemaeker, Nomad Foods' CEO and continue to be puzzled by how the company is valued by the current equity market. I have followed Nomad Foods since it listed in 2014. Stefan and the team have delivered on their promises to build out a leading frozen foods business in Europe and the earnings per share of the business has doubled over this period. Yet the stock is the same price it was in 2015 as the valuation multiple has effectively halved to a PE of 8x. We agree with most analysts that the stock is worth 50% more than the current share price and have recently made it one of our largest positions. We like Nomad's attributes of owning market-leading brands, like Birds Eye, in a defensive industry, where earnings per share is expected to grow at 10% p.a. We are waiting patiently for the stock price to reflect the underlying fundamentals of this business and are happily collecting a 3.5% dividend yield while we wait.

Closer to home, we have been accumulating shares in NobleOak Life. NobleOak is a good example of a small founder run company, that is winning market share in its core area of competence and growing earnings quickly. Yet it has been completely neglected by the Australian equity market since listing in 2021. We have been following the stock since its listing and have been speaking to its founder and chief executive officer, Anthony Brown over the past few years. We remember Anthony from his days at Suncorp and have been impressed by what he has managed to achieve with NobleOak.

NobleOak is an Australian life insurer with 3% market share of inforce premium. It is growing inforce premiums at over 20% p.a. as it is winning 13% market share of new business written. Australian investors are shy to invest in life insurers after the poor underwriting in income protection books about five years ago. We think the industry has learnt from its mistakes and pricing has adjusted to achieve strong, sustainable returns. Higher interest rates over the past few years are also boosting returns for the industry.

I recently changed my life insurance over to NobleOak to see why they are winning market share and see what the service was like. I was really impressed with the customer service through the internet and call centre. They also sent over a nurse to my house to do a health check before quoting on the policy. Interestingly the nurse said that her husband is a financial planner and he writes a lot of Noble Oak policies for his clients as the administration and technology is very good from the financial planner's perspective. This explains why they continue to win market share through the strategic planner channel as well as the direct channel. They have a strategic alliance with Neos, which launched in 2018 and benefits from new technology, which gives financial advisers quick underwriting decisions. It is a top-rated life insurer in terms of overall adviser satisfaction.

I went to the reinsurance group of America's recent investor day in New York and they highlighted that we should see improvements in mortality rates over the medium term through better medicines and the introduction of obesity drugs like Ozempic. While our thesis does not depend on this benefit to insurance margins, we do expect these benefits over the medium term. In the below table we highlight the earnings expectations for Nomad Foods and Noble Oak over the next three years and expect the stocks to rebound from current depressed levels.

Current disconnect between stock prices and earnings in small caps and Asia

In the table below you can see that the valuations of the stocks that we have mentioned above are hitting levels that we think are unsustainable. These are well managed companies with leading products and services in their respective countries trading on single digit PEs. While their stock prices have been falling, the underlying earnings of these companies are expected to grow, and their stock prices should eventually follow.

	FY21	FY22	FY23	FY24e	FY25e	FY26e
Noble Oak						
Market Capitalisation ($m)	172	172	154.8	120.4	120.4	120.4
NPAT ($m)	7	9.5	10.3	16.1	18.3	20.2
PE	24.6	18.1	15.0	7.5	6.6	6.0
Nomad Foods						
Market Capitalisation ($m)	4,900	3,480	3,078	2,673	2,673	2,673
NPAT ($m)	307	311	300	312	338	350
PE	16.0	11.2	10.3	8.6	7.8	7.2
JD.com						
Market Capitalisation ($m)	118,104	93,780	58,164	41,075	41,075	41,075
NPAT ($m)	2,722	4,049	4,889	5,114	5,588	6,161
PE	43.4	23.2	11.9	8.0	7.4	6.7

Your sincerely,

GARRY LAURENCE

Profeta International Fund	
Unit price $ (30 June)	1.30
1 month return (net)	-2.3%
3-month return (net)	-3.1%
6-month return (net)	+2.8%
Financial YTD (net)	+10%
12-month return (net)	+10%
2 year (net) p.a.	+14%

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FX exposure	
AUD	35%
USD	25%
Euro	15%
GBP	8%
JPY	4.5%
MXN	2%
HKD	10%

Portfolio Characteristics	Profeta
PE (FY1)	14.5
Cashflow Return on Invested capital	29%
Net debt to EBITDA	0.8
Portfolio beta	0.8

Regional Breakdown	
	% of Portfolio
North America	23.5
Europe	29
Australia	6.5
Asia	16
Latin America	13
Cash	12