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MANAGEMENT

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Letter to investors, Q3 2021

Performance

The Master Account, in which I am personally invested alongside SMA clients, returned -3.6% net in Q3 2021, as reported by our fund administrator. As of September 30th, 2021, the top ten positions comprised approximately 66% of the portfolio, and the portfolio held approximately 5.3% in cash.

	ACML	S&P500 TR
2019	18.9%	31.5%
2020	4.6%	18.4%
2021 YTD	9.6%	15.9%

ACML performance is net of fees and standard costs.

Discussion on a selection of portfolio positions with an average weight over 1%:

Positions with an average weight of over 1% of the portfolio throughout the quarter were: Alphabet Inc., Amazon Inc., Brookfield Asset Management Inc., Burford Capital Ltd., CarMax Inc., Colfax Corp., Countryside Properties Plc., Crossroads Systems Inc., Exor NV, Fairfax Financial Holdings Ltd., IAC/Interactivecorp, KKR & Co Inc., Liberty Broadband, Naspers Ltd., Oaktree Acquisition Corp. B, Pershing Square Tontine Ltd. Prosus NV, Tencent Holdings Ltd., Trebia Acquisition Corp., VanEck Vectors Gold Miners Etf and Junior Miners Etf, Vimeo Inc., and Wandisco Plc.[1]

It has been a busy quarter, so I'll dive straight into the changes made in the portfolio.

Pershing Square Tontine Holdings – new position

PSTH is a high-profile SPAC created by noted hedge fund investor Bill Ackman. I initiated a position soon after the company announced a deal, since abandoned, to buy a 10% stake in Universal Music Group ahead of its spin-out from parent holding company Bollore. PSTH had been widely expected to pursue a marquee deal with some trophy tech company, such as Bloomberg L.P. or Stripe, the payments company, valued at $95bn in April, [2] and the shares traded at a 60% premium during the SPAC frenzy of the early part of the year. Instead, PSTH announced a complex, multi-part transaction for an old-school music business, and we were able to purchase shares at a small premium to NAV. PSTH intended to buy 10% of UMG for $4bn and spin this into a separately traded company listed in Europe, creating a tracking stock that presumably would have merged into UMG at some future point. PSTH "remainco" would still have access to approximately $3bn to pursue another deal. Finally, PSTH shareholders would be given 5-year warrants to a new company called a "SPARC," which would seek a 3rd acquisition target.

I believed PSTH's components were worth more than the approximately $21.80 a share that PSTH traded for at the time. More importantly, UMG is an attractive asset with a 31% share of the global music market, the largest operator in a 3-way oligopoly with Sony Music and Warner Music. Streaming has transformed music into a growth industry, as companies like Apple, Amazon, Spotify, and TikTok have invested significant sums in building global music

[1] There is no assurance that any of the securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable. See "Disclaimers" at the end for more details.
[2] https://news.crunchbase.com/news/under-the-hood-a-closer-look-at-stripe-the-most-highly-valued-venture-backed-private-company-in-the-us

distribution platforms. UMG earns attractive high-margin royalties, and its extensive, irreplaceable back catalog of some of the most popular songs globally, valued as much as $50bn,[3] positions it well within this ecosystem.

Unfortunately, the SEC did not approve the deal,[4] and a subsequent shareholder lawsuit has further complicated matters. The net result is that PSTH abandoned the UMG deal and now wants to return cash to shareholders at $20/share and still issue SPARC warrants.[5] Thus, assuming PSTH gets approval for its latest plan, we would receive most of our investment back and retain a 5-year option on a future deal, which is not a bad consolation prize.

Countryside Properties – new position

Countryside Properties is a £2.5bn market capitalization UK homebuilder with two distinct divisions, traditional housebuilding, and a more exciting Partnerships business. In December 2020, US-based hedge fund Browning West launched an activist campaign to replace Countryside's Chairman and split off the traditional business. Countryside has since hired John Martin, who has a successful record as CEO of Furguson Plc, a £22bn market capitalization plumbing and heating products distribution business. By July 2021, Countryside further announced it would run off the traditional business, thereby generating £450m of surplus cash by 2023 to be used in share repurchases. As of September 30th, Countryside has already repurchased 7.1m shares or approximately 1.35% of the company. Finally, it would expand Partnerships to the Home Counties region of the UK (counties that surround the Greater London area), which will add £60m in operating profits by 2023. I felt this presented an attractive opportunity to invest in a refocused and growing company.

The traditional homebuilding division develops homes on greenfield sites in London and Southeast UK. This is a decent business with approximately 20% ROI but requires a significant amount of capital to purchase land, has low-to-mid single-digit revenue growth, and is subject to traditional housing market cycles. Meanwhile, the Partnerships division forms joint ventures with local government housing associations to build both affordable and private housing. Local housing authorities provide land at no charge to Countryside, resulting in a 60%+ ROI and favorable working capital, enhancing cash flow generation. Partnerships has reduced, though not eliminated, exposure to the housing cycle as half its revenue comes from local government-mandated affordable homes. Partnerships further de-risks revenues by pre-selling homes to institutional investors such as Goldman Sachs, EQT, and Sigma Capital.

Partnerships benefits from industry tailwinds and competitive advantages. The UK "housing crisis" has been well document by the British media.[6] The UK suffers from a chronic shortage of affordable housing, numbering in the millions, while the housing industry produces fewer than the 250,000 homes that the Ministry of Housing estimates must be built each year to keep up with household formation. Local housing authorities are charged with developing the land yet lack the skills to do so, and therefore contract with developers who can manage the entire development process.

A significant focus of the work involves regenerating "council estates," British public housing built by local authorities, often with poor living conditions and higher crime rates. It is a delicate task to achieve buy-in from skeptical lower-income residents, which requires extensive public outreach efforts. "Community management" is a skill set missing from many traditional homebuilders, resulting in some highly publicized failures.[7] The politically sensitive nature of these developments means that local authorities prefer to award bids to well-established developers with successful track records, such as Countryside. Furthermore, the bidding process can take 5-years which deters new entrants given their low chance of being awarded the project. As a result, Countryside enjoys a 40% bidding win rate.[8] Countryside's record of successful projects provides significant financial incentives to local

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[3] Former Chairman and CEO of Sony Music UK in an expert network interview published by In Practice

[4] https://pstontine.com/wp-content/uploads/2021/07/Letter-to-Shareholders-from-PSTH-CEO-Bill-Ackman.pdf

[5] https://pstontine.com/wp-content/uploads/2021/08/8.19.2021-Press-Release-PSTH-Letter-to-Shareholders.pdf

[6] For example: https://www.bbc.com/news/uk-49787913 and https://www.theguardian.com/business/2021/apr/01/how-do-we-fix-the-uk-housing-crisis-experts and https://www.theguardian.com/society/2019/nov/20/housebuilding-data-shows-dearth-of-homes-for-affordable-renting

7 For example: https://www.london.gov.uk/press-releases/mayoral/mayor-refuses-loss-of-social-homes-on-estate

[8] Company filings

authorities, as the regeneration increases the book value of the land, which raises tax revenue and lowers local government borrowing rates.

Countryside aims to increase its annual housing completions from the current rate of 4,000 to approximately 8,000 by 2023/4. It has a large pipeline of 40,000 units and previously invested in construction facilities that allow for modular housing design. Based on £250k average selling price per home, 15% operating margins, reduced share count after buyback to around 435m shares, and 25% tax, this implies EPS of approximately £0.50 or only a 10x forward P/E multiple. Assuming a normalized P/E of 15x (not aggressive for a business growing sales at 30% per year with 50% ROI) implies a share price of roughly £8, vs. £5 today, with plenty of room to continue compounding, provided the company executes. There is room for significant upside should the company prove effective at selling its story to investors (there is an investor day planned in November), leading to a multiple re-rating of the business. Still, we do not need this to happen for the investment to be a success.

As with all investment theses, there are some risks. First, homebuilders are subject to market cycles, albeit slightly less so in the case of Partnerships. Second, while Countryside certainly has competitive advantages over most traditional homebuilders, high ROIs will eventually attract competition. Finally, Countryside will likely suspend its dividend, which may lead to some shareholder turnover with dividend-focused investors. In keeping with my usual practice, and because the share price had run significantly from the December activist presentation to the 3rd quarter, I bought a starter position with plenty of room to increase size as the story unfolds.

Crossroads Systems - add

I discussed Crossroads at length in my last letter. Within days of the end of the second quarter, management disclosed that following its large PPP loan origination windfall, Crossroads would not get regulatory approval for its purchase of Rice Bancshares. Now overcapitalized, the company returned cash to shareholders through a $40/share special dividend (approximately 2/3s of the entire company's value).[9] Crossroads became a negligibly small part of our portfolios following the dividend distribution. I, therefore, added to the position, as I like investing with effective management teams who have demonstrated integrity and good capital allocation.

Crossroads Chair and owner Robert Alpert also runs a listed private equity firm, P10 Holdings. On September 14th, both companies announced a partnership to originate $250m of loans to women and minority-owned businesses and loans to renewable energy and community redevelopment projects over the next 18-24 months.[10] The partnership will use Crossroads' CDFI designation and P10's credit investing skillset, providing yield to Crossroads and fees to P10. On September 28th, Crossroads further announced the acquisition of an asset-based lending firm with a "scalable platform."[11] It would seem that management, undeterred by the Rice disappointment, continues to pursue its goal to expand Crossroads from a single-family mortgage lending institution in Texas to a nationally recognized small business lender. I look forward to seeing how they grow the business in the future.

Colfax - add

I discussed my reasons for initiating a starter position in Colfax in the 2021 Q1 letter. In August, Mitch Rales, founder of both Danaher and Colfax, purchased $11.5m of shares on the open market at approximately $46 per share, and I increased our position size soon after.

I continue to believe Colfax's prospects are attractive over the long term as the company demonstrates its ability to execute. For example, the MedTech business expanded its shoulder/knee line with the acquisition of Mathys, opening the European market to the rest of the company. It also created a new business focused on the fast-growing foot and ankle segment through three further acquisitions. Meanwhile, the ESAB welding business increased EBTIDA margins from 15% to 18% through the application of the Colfax Business System processes.

[9] http://www.crossroads.com/wp-content/uploads/2021/07/CRSS-FQ2-2021-Shareholder-Letter.pdf

[10] https://www.globenewswire.com/news-release/2021/09/14/2296576/0/en/P10-Holdings-Announces-Strategic-Relationship-with-Crossroads-Inc-to-Promote-Impact-Credit.html

[11] https://www.prnewswire.com/news-releases/crossroads-systems-inc-announces-merger-with-rise-line-business-credit-301386483.html

We may also have a shorter-term catalyst from the planned separation of MedTech and ESAB through a tax-free spin in Q1 2022. Assuming the spin "forces" the market to value each business unit independently and based on an EV/EBITDA multiple of 15x,[12] less debt, and corporate expenses, the group could be worth approximately $62 per share, an attractive price compared to Mr. Rales' (and our) recent purchase.

Naspers, Prosus, Tencent – update

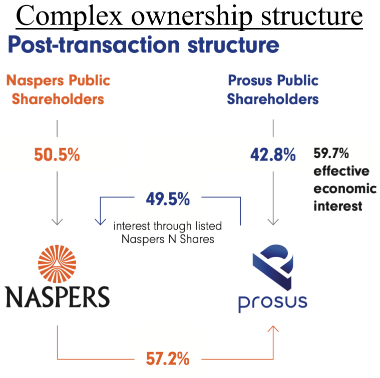
On August 16th Prosus acquired 45.4% of Naspers for newly issued Prosus shares. Naspers thereby reduced its weighting on the Johannesburg Stock Exchange, which management believed was a fundamental cause of its persistent discount to NAV. Prosus increased its free float on the Amsterdam Exchange, increasing liquidity and index inclusion, and bought shares in a cheaper entity which was value accretive, in theory.

Unfortunately, this share exchange introduced further complexity with a circular cross-holding situation. 36 South African institutional shareholders published an open letter criticizing the plan for its complexity. In an interview in June, a few of these investors accused management of "using Tencent as a crutch" to support their other investments and asked management to address the discount by simply spinning out Tencent to shareholders.[13] The market has not responded to the share exchange, and as of September 30th, Naspers and Prosus trade at approximately 57% and 44% discounts to NAV, respectively.[14]

While I agree with the complexity argument, the situation is more nuanced. Naspers owns Prosus, which in turn owns Tencent and most of the other internet businesses. Tax laws in South Africa are such that Naspers benefits from a "participation exemption" from any capital gains taxes from selling Tencent shares but would incur a 20% dividend withholding tax for any distribution of shares from its Prosus subsidiary. As a result, Naspers was able to sell $10bn and $15bn of Tencent tax-free in 2018 and 2021, respectively, but cannot distribute Tencent shares to shareholders without incurring approximately $35bn of tax liabilities. Moreover, to continue benefitting from the participation exemption, Naspers must continue to be a South African company and own over 50% of Prosus.

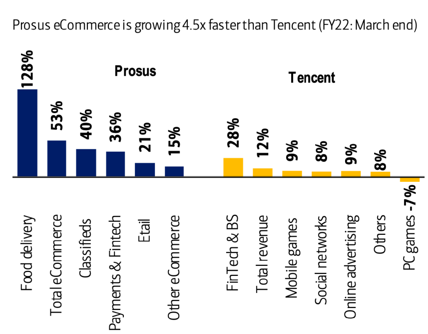
Management instead seems to be playing the long game by building valuable businesses that are growing much faster than Tencent (see chart). For example, its food delivery platform operates at scale in fast-growth markets globally (see graphic). In payments, subsidiary PayU recently acquired BillDesk for $4.7bn, creating a global top-10 company that manages $150bn in total payments value, focused on India's $5tr fintech market. Naspers/Prosus has a good record for capital allocation. Between 2009 and 2021, it invested $22bn and generated an ex-Tencent IRR of 18% per annum.[15] Highlights include a 32% IRR on the sale of Flipkart, a 2x markup in the last funding round on Swiggy, and a 9x return on the recent IPO of Remitly.

Complex ownership structure



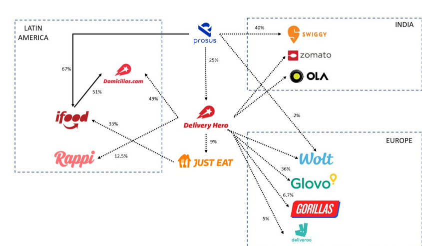
Source: Company

Fast-growing ex-Tencent



Source: BofA equity research

Prosus' food delivery investments



Source: Bernstein via @PandaValue on Twitter

[12] Comparable co's: Stryker and Zimmer Biomet for MedTech; Illinois Toolworks, Eaton, Enerpac and Lincoln for ESAB
[13] https://www.biznews.com/global-citizen/2021/06/11/naspers-activist-investors
[14] https://www.naspers.com/news/net-asset-value and https://www.prosus.com/news/net-asset-value
[15] Bank of America research report dated October 4th, 2021

As for Tencent, others have written at length about regulation in China, but it is worth a brief mention. The Big Tech crackdown started in November 2020 when the government blocked the IPO of Ant Group, Alibaba's fintech affiliate. Since then, China has increased regulation on online gaming, music, fintech, social networks and data security, and Big Tech's anti-competitive practices, primarily under its "common prosperity" campaign.[16]

It is helpful to remember that Beijing regards capital as a tool to enhance and accelerate society's goals, not as an end goal itself.[17] For example, decades of the one-child policy have resulted in an impending demographic cliff[18] that threatens the country's future economic growth. However, reversing the policy will not be enough as high living costs deter young couples from procreating. Moreover, the outsize impact that a single national college admission test (the Gaokao) has on a young person's prospects has led many parents to pay for years of after-school tutoring, further exacerbating the stress and expense. Therefore, from the government's perspective, reigning in online education companies, viewed by many as expensive and exploitative, serves the greater good.

Similarly, in August, a newspaper tied to China's state-run newswire Xinhua described online gaming as "spiritual opium," shortly before China's government implemented new restrictions for children. Given that 32% of Tencent's revenues come from gaming, the market reacted negatively, despite the fact the company has been proactively working with authorities to reform rules and under 3% of revenues come from games played under 16-year-olds.[19]

These regulatory risks are real but, I believe, are reflected in the valuation as Tencent trades for a low-teens EBIT multiple after netting out its investment portfolio (valued at approximately $250bn). As regards our investments in Naspers and Prosus, the steep discounts to NAV give us a large margin of safety, with exposure to an exciting collection of fast-growing businesses. Prosus' private companies are worth at least $40bn, and ex-Tencent publicly listed investments are worth $12bn, significant compared to Prosus' $120bn market capitalization. I believe these assets will compound in value over time regardless of any narrowing of discounts. With some patience, we may also benefit from some further simplification or asset unbundling.

Samer Hakoura
Alphyn Capital Management, LLC
October 2021

[16] https://www.brookings.edu/blog/order-from-chaos/2021/09/09/assessing-chinas-common-prosperity-campaign
[17] Credit my friend Fed Liu from Hayden Capital for this helpful framework
[18] https://www.reuters.com/breakingviews/chinas-population-peak-hastens-fiscal-reckoning-2021-05-05
[19] https://www.wsj.com/articles/tencent-to-work-with-chinese-regulators-to-limit-minors-online-game-time-11629305504

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