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Letter to investors, Q1 2024

Performance

As reported by our fund administrator, the Master Account, in which I am personally invested alongside SMA clients, returned 7.1% net in Q1 2024 vs 10.6% for the S&P500. As of March 31, 2024, the top ten positions comprised approximately 66% of the portfolio, and the portfolio held approximately 8.2% in cash.

	QTD	YTD	1-year	3-years	5-years	Inception
ACML	7.1%	7.1%	16.4%	1.6%	4.0%	6.7%
S&P500 TR	10.6%	10.6%	29.9%	9.8%	15.1%	17.1%

ACML performance is net of fees and standard costs.

Operational update

It has been five years since the inception of Alphyn Capital Management, which I embarked on in January 2019 with my capital before officially registering as an investment advisor in April of that same year. As a registered investment advisor, I focus on two strategies for clients.

Firstly, I manage the "master portfolio," which is the core subject of these letters. This portfolio functions akin to a hedge fund but through separately managed accounts. It employs a long-biased, value investing strategy, maintaining around 20 positions. Clients typically allocate a portion of their overall wealth, a “sleeve,” for me to manage under this strategy, which mirrors the master portfolio. I charge a flat 1% fee, no performance fees as many hedge funds do, and I try to be tax efficient with longer hold times and tax-loss harvesting when possible.

Second, for clients who entrust me with a greater portion of their assets, I devise more diversified portfolios, including allocations to some individual stocks, funds, fixed income, and private investments such as private equity, credit, and real estate. These portfolios are based on a family investment model, providing alignment of interests and customized to meet clients' needs and risk tolerance.

Complexity

The market has been on a tear, which might come as a surprise to some commentators who were expecting an imminent crash and speculating on the timing and degree of potential rate cuts. Considering it’s an election year in the US, the government’s continued liquidity injections wouldn’t be entirely surprising. However, I want to clarify that I generally avoid making macroeconomic forecasts.

Instead, I’ve been thinking about lessons I have learned managing the portfolio for the last five years. My primary strategy has been to identify undervalued companies whose potential isn’t fully recognized by the market. The goal is to hold onto these companies long enough to benefit from the power of compounding.

In previous letters, I've discussed the importance of seeking out quality companies with high returns on capital and the ability to sustain those returns against competitive forces. And the importance of management, especially considering the extended holding periods over which we aim to let our investments compound through their operational expertise and capital allocation skills.

However, the competitive nature of the investment market, coupled with the ease of access to information, often results in high-quality companies trading at steep valuations. This is also true for companies experiencing rapid sales or earnings growth. Market prices quickly adjust to new information, making valuations extremely sensitive to changes in perceptions or assumptions, especially for high-growth companies. Conversely, companies that seem undervalued typically are priced as such for a good reason, reflecting inherent flaws or challenges already acknowledged by the market.

As Howard Marks notes, understanding "what is reflected in the price" is "the most important thing." Echoing the wisdom of the late Charlie Munger, investing resembles a pari-mutuel betting system, where finding opportunities with disproportionate odds to payoff ratios is key. However, buying into a company with excellent odds must be unpopular, requiring a conviction not shared by most market participants.

Identifying companies with both promising prospects and reasonable valuations is challenging. As long-term value investors, we have a handful of strategic choices.

The first is extending our timescale. As I discussed briefly in the 2022 Q3 letter, typical time horizons have been compressed. The competitive landscape is crowded within the usual 6 to 18-month timeframe, making it difficult to secure a differentiated edge. Thus, one of our options is to lengthen our investment horizon, stepping outside the short-term focus that prevails in the market today and, to the extent possible, refraining from playing the earnings beat and miss game.

Another aspect to consider is our behavior as investors. Joel Greenblatt has observed that investors tend to overreact to incoming news, altering their discount rates (for example, in anticipation of changes in interest rates) and expectations of future growth (such as when a company faces new competition). This tendency leads to excessive fluctuations in a company's estimated present value and, consequently, to increased volatility in stock prices. While resisting the impulse to respond to short-term market movements, we should adopt a probabilistic approach to envisioning future outcomes, acknowledging that the future is inherently uncertain. Identify moments when assets are undervalued—much like finding high-quality merchandise on sale—and increase our stakes in such situations while continuously evaluating our investments with a clear, unbiased perspective.

Another approach involves identifying opportunities that the market routinely overlooks or consistently undervalues, particularly those with the potential for future recognition of their inherent value. Generally, the market favors straightforward narratives - companies with clear revenue and earnings growth trajectories, often supported by solid industry tailwinds, clear competitive advantages, and superstar management. Investors can crowd into high-quality or momentum-driven stocks, inflating their valuations. In contrast, I've often found myself drawn to more opaque, complex scenarios less suited to rapid or surface-level analysis. These scenarios frequently obscure a company's future earnings power, leading to undervaluation. Provided my initial analysis correctly identifies an attractive underlying business, and the situation eventually simplifies enough to allow the company's earnings potential to become apparent to the broader market, these can be good opportunities for those of us looking to gain an edge.

The crucial lesson I have learned with time is to avoid the lure of unnecessary complexity that often leads to unproductive outcomes. While unraveling complex situations can be intellectually stimulating, like solving a puzzle, pursuing complexity for its own sake can lead to value traps. A good initial analysis, coupled with eventual market recognition of the company's intrinsic value, can provide attractive opportunities.

In the next section, I will further illustrate this point, where appropriate, with specific examples from our top and bottom performers.

Portfolio – top and bottom performers[1]

Top Performers	Contribution	Bottom Performers	Contribution
KKR & Co Inc.	1.93%	Liberty Broadband Corp.	-1.56%
Fairfax Financial Holdings Ltd.	1.85%	Cogent Communications Inc.	-0.41%
EXOR NV.	1.10%	Cirata Plc.	-0.11%
Amazon Inc.	1.09%	Oaktree Specialty Lending Corp.	-0.02%
ESAB Inc.	0.82%	Kingsway Financial Services Inc	-0.01%

As calculated in the Master Account brokerage statement.

KKR

While KKR's business has always been somewhat involved and complex to understand, its share price has performed strongly over the past couple of years as the company has proven its ability to drive earnings growth, approximately doubling it every five years, mainly by earning fees on growing assets under management, generating performance fees on client investments, and generating solid returns using its balance sheet.

The company's structure as a publicly listed partnership made it difficult for some institutions to own and inconvenient for retail investors as it required filing a K1 tax return. The company converted to a C-Corp in 2018, paving the way for potential inclusion in the S&P 500.[2]

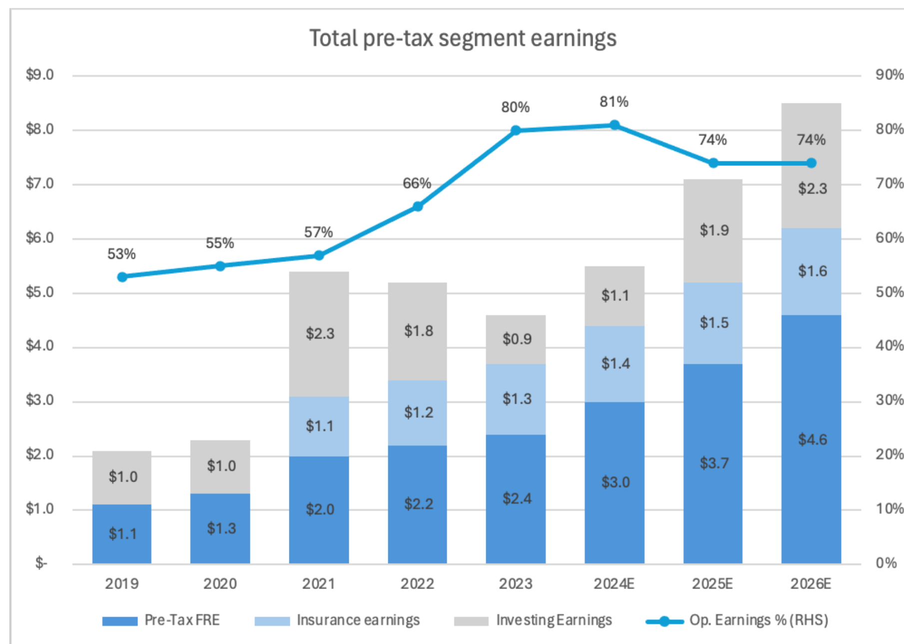
While always respected as a top-tier PE firm, a significant portion of income came from carried interest or performance fees earned when KKR sold its investments and earned performance fees. Given the irregular nature of these earnings and the potential impact of the macro environment on both the timing and the magnitude of these earnings, this earnings stream has always been valued a lot less favorably than "predictable" flat earnings on AUM.

KKR has successfully shown the market that by significantly increasing the number of funds it has and diversifying strategies, it has created a machine capable of significantly driving AUM growth as its new funds have matured in scale and performance. If length is any judge of complexity, the company's November 2019 "teach in" presentation to explain all this was no less than 153 pages. The diversified income stream can also smooth out returns; credit funds have helped in a rising interest rate environment.

KKR has taken a strategic approach to its balance sheet despite an environment favoring "capital light compounders" (companies valued more for leveraging client assets than their own capital). For example, it acquired General Atlantic, which provides a predictable income stream from the annuities business. It also focused its balance sheet on "core" private equity – cash flow-generative businesses with long-term holding periods (beyond the typical 5 to 7-year PE exit timeframe) that offer sustainable dividend streams.

[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://www.wsj.com/livecoverage/stock-market-today-dow-jones-09-06-2023/card/blackstone-is-finally-in-the-s-p-500-apollo-or-kkr-could-follow-PLetPrckK0liJbd6BOSl

KKR recently introduced "Operating Earnings" as a new metric to emphasize the stability of its income stream. This metric combines income from predictable sources: fees on assets under management (AUM), insurance operations income, and dividends from core private equity holdings on its balance sheet.



Source: Goldman Sachs equity research on KKR

This is a straightforward narrative that seems to have resonated with the market. To quote directly from a recent Goldman Sachs equity research note: “We estimate that the firm’s pre-tax “Operating Earnings” should account for >75% of total net income over the next 3 years... We believe the growing contribution from this earnings stream should improve predictability of KKR’s overall earnings and drive the stock’s multiple higher overtime.”

Fairfax Financial

In February, a short seller took advantage of Fairfax's complex accounting to launch a report during the company's "quiet period" before earnings - when firms are restricted in their ability to make public comments - to accuse the company of inflating "fair value marks" on its sprawling holdings. While I generally support the role of short selling in maintaining corporate transparency and accountability, this report was heavy on insinuation and light on solid evidence. Fairfax adeptly countered each point during the earnings call, and the share price recovered in a matter of days.

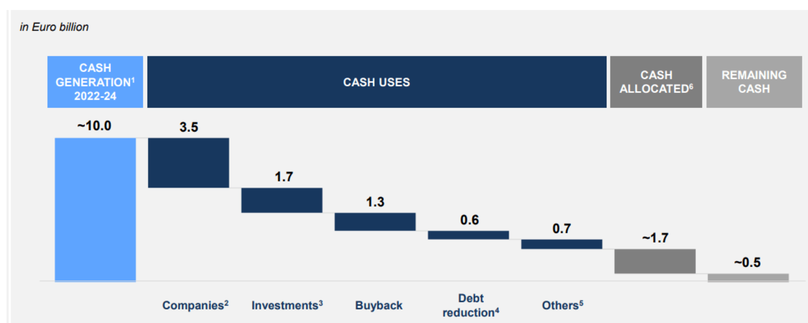
The market has started to appreciate Fairfax's streamlined story as a leading global insurer that generates "adjusted operating income (undiscounted underwriting profit, interest, and dividends plus income from associates) of $3.9 billion, which may continue at these levels for the next four years." While the hard insurance market that helped generate these profits will not last forever, I believe the company's ability to reinvest these substantial cash flows at high rates of return is not fully priced in, particularly given that with their $30 billion insurance float, they need only achieve about 7% return on investment to grow book value by 15%. The focus on its deep talent pool in the latest shareholder letter signals a strong and well-resourced team capable of driving sustained success.

EXOR

As a large holding company with multiple moving parts, just see the diagram of the various holdings in the image below from their Feb 2024 presentation; it is not entirely surprising that the company trades at a significant discount to its holdings.

Source: Exor February 2023 presentation

While this discount might be frustrating for investors who have done a deep dive into the company, the share price has performed well recently for two main reasons, in my opinion. Firstly, the strong performance of its two most significant holdings, Stellantis and Ferrari, and second, Exor's focus on intelligent capital allocation, as clearly outlined in the November 2023 investor day presentation chart.



Source: Exor November 2023 Investor Day presentation

Exor has strategically allocated around €10 billion, obtained from the sale of Partner Re and ongoing cash flow from its holdings. As a side note, while Ferrari contributes the most to Exor's sum-of-parts valuation, Stellantis, though a more cyclical company, is underappreciated for the larger dividend it provides tax efficiency for capital redeployment.

Within Companies, Exor focuses on resilient sectors like healthcare, luxury, and faster-growing technology, shifting from its historical focus on cyclical automotive. As it ventures into these new areas, Exor is leveraging the iconic Ferrari brand to build a portfolio of luxury companies. Additionally, the company is open to collaborating with families possessing deep expertise in these sectors, exemplified by their partnership with Institut Merrieux in healthcare. Finally, Exor's value investing approach is evident in its acquisitions of Philips shares (acquired at a discount after the Respironics recall) and Clarivate. Both companies welcomed Exor's stable, long-term investment approach.

Exor streamlined the Investments segment into "Ventures," focuses on early-stage investments (core, mid-size, and 20% "moonshots"), and Lingotto, a $4.5 billion hedge fund with three main strategies (long/short equity, special situations, and long-term holdings).

Exor rounds out its capital allocation strategy with buybacks and debt reduction, again a shift from its prior focus solely on NAV growth per share, which appears to be well-received by the market.

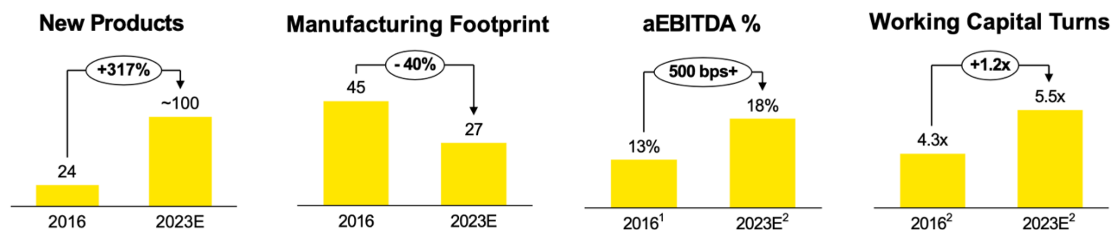
Amazon
My previous analysis (Q4 2022 letter) highlighted the significant growth in Amazon's fulfillment expenses since 2015, masking the true earnings potential of its retail business. Though initially costly, the recent restructuring into regional fulfillment centers has yielded lower fulfillment costs and faster shipping times, leading to increased purchase frequency, especially among Prime members.

Following the regionalization effort, over the last couple of years, Amazon prioritized cost control and reduced capital expenditures. At a high level, the North American segment's operating income swung from a $240 million loss in 2022 to a healthy $6.4 billion profit (6% margin) in 2023. Combined with continued strength in AWS and advertising, Amazon's free cash flow (as reported, excluding equipment finance leases and principal repayments) surged from negative $13 billion to positive $36 billion.

Amazon stands out for pioneering the public market strategy of prioritizing long-term growth through sustained low margins and reinvestment, with the ability to later "turn on the taps" for profit. While many public tech companies have tried to replicate this approach, Amazon's scale and execution capabilities make it one of the few that have successfully pulled it off.

ESAB
ESAB represents a prime example of value creation through a spin-off from the original Colfax, which had combined an industrial welding equipment company with an unrelated medical devices company.

Despite the seemingly mundane nature of a welding and industrial gas equipment company, the spin-off enabled investors to appreciate its inherent qualities and the significant improvements made since its acquisition by Colfax in 2016. Initially, both divisions faced challenges due to their subscale or regional focus, with declining sales, lower margins, limited R&D, and inefficient operations. By 2023, however, primarily driven by the implementation of the Danaher Business System, ESAB had transformed into a key player in an oligopoly alongside two other competitors. Once again, borrowing from their 2023 investor day slides to succinctly highlight these enhancements, these include product line simplification, price management discipline, manufacturing advancements, and new product development. Additionally, ESAB has grown through acquisition, focusing on expanding into less cyclical sectors, such as medical and specialty gas equipment.



Source: ESAB 2023 Investor Day slides

With its more transparent and operationally improved structure, the company aims to grow sales by 50% and increase free cash flow margins from 16% to 22% over the next five years, effectively doubling its free cash flow.

Liberty Broadband
I exited our position in Liberty Broadband. This investment was particularly frustrating, as it had been a solid performer for us in the past. When I first evaluated the company five years ago, Charter was perceived to be threatened by cord-cutting. However, my analysis was correct in predicting that this would benefit the company since broadband income is far more profitable than cable TV. As the company expanded its coverage and improved customer retention through enhanced service, net broadband additions were achieved at a high margin, driving growth in the mid-teens.

More recently, fixed wireless and fiber competitors have challenged the broadband business. The original thesis held that cable's entrenched position would render it ROI-negative for competitors to enter the market, assuming they would avoid burning money in a venture against cable's dominant, cost-effective, high-speed connection. Yet, fixed wireless surprisingly captured a significant share of incremental business from cable in this mature industry, impacting Charter's growth narrative.

As I dug into modeling potential returns in more detail, a few things stood out: Firstly, Charter's investments appeared more defensive, aimed at stemming customer losses rather than pursuing significant growth opportunities, and the ROIs were not as attractive as I would want. Second, the modeling was highly sensitive to small assumptions, not least on the discount rate and small changes in terminal growth rates – which meant the range of potential outcomes was too wide for comfort (the exact opposite of Buffett's "one-foot hurdle"). Third, the company's mechanical leveraged buyback strategy had likely destroyed value buying at much higher prices than today's, adding leverage risk. The last straw for me was when the company announced negative broadband additions without a seemingly robust plan to address the issue rather than just continue what they were doing, which was not working. Going forward, I intend to be more vigilant when a company's core business is under sustained competitive threat.

Cogent Communications

While Cogent's latest earnings disappointed the market, I remain optimistic about future earnings growth as the company integrates the acquired T-Mobile Wireline business. As previously discussed, Cogent acquired this business for a nominal $1, with T-Mobile covering operating losses through a $760 million payment spread over 4.5 years.

Cogent believes it can turn this division's $300 million in reported EBITDA losses into $90 million in profits by streamlining unprofitable contracts and strategically migrating T-Mobile's data traffic onto Cogent's network. While T-Mobile offloaded 93% of its traffic to expensive third-party networks, Cogent relies on 3rd party networks for only 25% of services. This shift should generate significant cost savings from reduced third-party fees, driving most of the anticipated synergies.

The real motivation for the acquisition is for Cogent to become a player in the high-capacity wavelength services market, targeting hyper scalers and large corporations. By combining both company's fiber networks and gaining access to 800 carrier-neutral data centers (CNDCs), Cogent will be able to offer dedicated point-to-point fiber connections, ideal for the massive data needs of these customers. While the company encouragingly has a backlog of orders from 600 customers, it cannot fulfill orders until it replaces outdated equipment within these CNDCs, installs its own systems, and establishes physical fiber connections. While none of the work is incredibly complicated, managing work in all these locations is unsurprisingly a logistical challenge. The CEO recently mentioned the company currently has ten thousand active workstreams.

So, while the company aims to generate $500m in revenues at 95%+ margins, it is currently frustrated by the bottleneck of work at the CNDCs and has generated only $3m in revenues.

Further complicating matters, CEO Schaffer's detailed disclosures, while intended for transparency, may have confused analysts with complexity. This was evident during the recent earnings call, where one frustrated analyst, confused by all the one-time adjustments and revenue reclassifications, requested simpler EBITDA figures and another skeptical analyst debated margins with management.

Assuming Cogent executes its plans and completes the integration, I expect to see clear evidence of earnings growth presented in a much simpler format over the next 1-2 years. The company also disclosed the pricing of its IPv4 portfolio, potentially worth up to $2 billion but not currently reflected in its stock price

Cirata
Since my last update, there hasn't been notable news or movement in the share price. Theoretically, the company's unique technology should be highly relevant today, where the need to manage exponentially growing data is critical. They now have more experienced leadership that can hopefully unlock this potential.

After the quarter ended, the company reported lackluster results, although within their guidance. Transforming and training a sales force is lengthy, yet our patience is finite. The company has restated its objective to become cash flow breakeven by the end of 2024, a reasonable measure for tracking their progress.

Oaktree Specialty Lending (OCSL)
We previously owned the company but exited after Brookfield acquired its parent, Oaktree, and redeployed the capital at the top of the ownership stack in Brookfield. I reinvested in the fourth quarter of last year, given the attractive yield of 11% in the current high interest rate environment, approximately double that of treasuries, but not double the risk in my view.

OCSL's $3 billion portfolio consists primarily of fixed income investments across 146 companies, with a strong focus on senior debt (78% first lien, up from 54% when Oaktree first took over management of the portfolio) and a flexible mandate that allows them to invest in liquid credit markets and secondaries, enabling them to capitalize on market dislocations. As part of the Oaktree group, it benefits from access to the parent's extensive syndication platform, credit expertise, and resources to manage and work out the occasional loan delinquency.

Kingsway Financial
The theme should now be clear. Kingsway, a holding company, has undergone significant changes under rejuvenated management in the past few years. While the share price has already increased significantly from extreme lows in the last three years (before our involvement with the stock), there remains scope, in my view, for continued and long-term compounding. Currently, Kingsway operates two divisions: a legacy warranty business, which, despite facing a challenging year in 2023, remains a reliable source of cash flow. A search accelerator division operates under the "search fund" model. This model focuses on identifying talented, early-career managers to source, acquire, and oversee their businesses with Kingsway's backing—essentially, an operationally focused private equity model.

Kingsway owns the following companies: Ravix, acquired in 2021, is a business that offers outsourced accounting, fractional CFO services, and advisory services in Silicon Valley. It completed the acquisition of CSuite, an executive services firm, in 2022. SPI software, acquired in September 2023, provides software for managing vacation properties. DDI, acquired in October 2023, offers cardiac monitoring services for long-term acute care patients and has been increasing its revenues at an annualized rate of 30% by revamping its sales process. Secure Nursing, which arranges per diem and travel nurse employment, has contracts with approximately 70 hospitals in California and is experiencing strong demand due to the general nursing shortage.

Kingsway's companies are small, previously family-owned entities that are not usually associated with the scale or caliber of public corporations. However, under the stewardship of dynamic young managers and with guidance from seasoned advisors at Kingsway, they collectively make a diversified, capital-light, cash flow generative portfolio, expected to grow through internal development and strategically invest surplus cash flows into acquiring new businesses. Kingsway generates approximately $15 million in after-tax cash flow on a pro forma basis, enough to finance the acquisition of 2-3 companies annually, targeting those with $1.5-$3 million in EBITDA at 5-7x EBITDA multiples, leveraging 50% debt financing.

The timing of acquisitions is unpredictable, leading to irregular growth. However, as the company successfully implements its strategy, it stands to gain from being recognized in the market as a proven serial acquirer with compounding cash flows.

New Positions:

Distribution Solutions Group
I recently initiated a starter position in Distribution Solutions Group (DSGR), a private equity-owned specialty distributor. Unlike broadline distributors, DSGR focuses on niche products with a high-touch "vendor-managed inventory" (VMI) model. They operate a route-based business where customers outsource inventory management for essential, high-volume, low-value parts to DSGR's employees. These employees build long-term relationships with customers through frequent on-site visits.

DSGR resulted from a three-way merger in April 2022, combining Lawson (maintenance and repair organizations), Gexpro Services (VMI for OEM customers), and TestEquity (test and measurement equipment and VMI for electronics production supplies). While some complexity exists due to the recent merger, the company aims to nearly triple free cash flow by 2028 through organic growth, margin expansion, and accretive acquisitions.

Organic growth initiatives include salesforce maturation (seasoned salespeople generate significantly more revenue, and the company has focused on training and retaining its best employees) and cross-selling, as the company has identified a $50 million revenue opportunity. For instance, TestEquity recently acquired a competitor, Hisco, which opened the Mexican market for cross-selling by other DSGR divisions.

Luther King Capital Management, the controlling private equity firm, boasts a 20-year track record in specialty distribution with over 100 related transactions. Since 2017, DSGR (and its predecessors) have completed 14 acquisitions, leveraging the LKCM's business development resources at no cost to the firm. DSGR is LKCM's largest holding, incentivizing them to drive significant value creation for DSGR, as its success will heavily influence their portfolio returns.

Bitcoin ETF call option
I initiated a small position, less than 0.5% of the portfolio, in call options on a bitcoin ETF. The SEC approved the first Bitcoin ETFs in January. These ETFs make retail ownership of Bitcoin much simpler and more accessible, seemingly lending institutional credibility behind the "asset class." The result is over $60 billion has flowed into Bitcoin since the start of the year. This demand, combined with the inherent finite supply of bitcoin and the upcoming "halving," which will double the cost, potentially creates a scenario of restricted supply meeting growing demand. While the price has risen substantially, some models project a price exceeding $200,000 in the coming year, which could attract further inflows. To be clear, I do not have a strong view on Bitcoin, whether it will cement itself as a future store of value against fiscal irresponsibility, remain a leveraged play on global liquidity, or simply a mechanism for retail gambling. I am taking measured speculation based on the anticipated demand-supply thesis, using call options to limit the downside while exposing us to the potential for significant gains.

Samer Hakoura
Alphyn Capital Management, LLC
April 2024

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