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MANAGEMENT

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Letter to investors, Q3 2023

Performance

As reported by our fund administrator, the Master Account, in which I am personally invested alongside SMA clients, returned -1.1% net in Q3 2023 vs -3.3% for the S&P500. As of September 30, 2023, the top ten positions comprised approximately 71% of the portfolio, and the portfolio held approximately 8.6% in cash.

	QTD	YTD	1-year	3-years	Inception
ACML	-1.1%	3.6%	24.7%	3.2%	3.2%
S&P500 TR	-3.3%	13.1%	21.6%	10.2%	13.9%

ACML performance is net of fees and standard costs.

The long game

"The daily blips of the market are, in fact, noise -- noise that is very difficult for most investors to tune out." – Seth Klarman

Investing in the stock market can often test one's patience. There are stretches of time when returns seem stagnant or even negative.

Fairfax Financial serves as an apt illustration. Throughout our almost 5-year holding period, our investment in Fairfax has compounded at approximately 17% per annum, closely matching its impressive 25-year record of book value growth. However, it did not grow over a straight line. Fairfax's share price largely stagnated for nearly five years of ownership, impacted by short-term issues, including macroeconomic uncertainties, underperforming investments, and challenges with operating companies arising from the pandemic. Yet, over the last year, the shares rallied as the market began to recognize its robust insurance business and the benefits of a favorable insurance market, and the company's patient, long-term capital allocation began to bear fruit.

Had I lost patience and sold the shares at any point, we would have given up these returns and maybe shown a loss.

It is natural to wonder if I could time my position entry better and miss the long sideways or negative periods. Unfortunately, I've found no reliable method of doing this. Despite numerous discussions with fellow investors and researching various market timing techniques—like moving averages and oscillators, interpreting short-term news, or trying to outsmart the market on next earnings "beats or misses" I haven't found a reliable, practical approach. Most attempts to time investments may offer smoother journeys, but often at the cost of overall performance. At best, it's a trade-off; at worst, it hampers overall returns.

Of course, long-term holding is no guarantee of success, and our experience with Fairfax has not been replicated with all our holdings. Still, I believe that focusing on sound fundamental analysis, identifying undervalued companies, and maintaining a long-term perspective is more likely than not to lead to satisfactory outcomes.

Portfolio – top and bottom performers[1]

Top Performers	Contribution	Bottom Performers	Contribution
Fairfax Financial Holdings Ltd	1.22%	Prosus Nv	(1.23)%
Burford Capital Ltd	0.77%	Iac Inc	(0.87)%
Kkr & Co Inc	0.76%	Carmax Inc	(0.62)%
Liberty Broadband Corp Class C	0.72%	Enovis Corp	(0.52)%
Cirata Plc	0.35%	Ashtead Group Plc	(0.50)%

As calculated by our fund administrator on the Master Account.

Fairfax Financial

As I've written on several occasions, we are being rewarded now for capital allocation and strategic decisions made by Fairfax over several years. With the benefit of hindsight, it is easier to see a systematic strategy of harvesting investments at significant gains to fund a doubling down on its insurance business, taking advantage of a hard insurance market. A few (by no means exhaustive) examples include selling Resolute Forests for $ 626m, Ambridge Partners for $400m, pet insurance business for $1.4bn, and ICIC Lombard for $1.7bn. While investing in insurance, such as Digit for $154m (now worth $2.3bn), Allied World insurance for $4.9bn, Gulf Insurance for $860m, and building out its platforms with Kennedy Wilson in real estate development, Atlas (formerly Seaspan) in shipping, allocating to short term bonds providing increasing income while avoiding significant bond drawdowns in today's higher rate environment as it did not search for yield (unlike some banks which got into trouble earlier in the year) and buying back significant amounts of its shares through $1.9bn in total return swaps (effectively buybacks).

The result of all this is a significant increase in the size and profitability of its insurance business (which now writes almost $30bn in premiums per year). As Prem Watsa takes every opportunity to remind investors during earnings calls, this business can deliver over $3bn in operating profits from insurance, interest, and dividends outside of any gains from its stock investment portfolios.

Burford Capital

Burford Capital presents a compelling investment opportunity. Somewhat similar to my investment in Fairfax, we suffered initial losses on the investment, this time due to Muddy Waters' infamous short attack. But with patience and some additions to our position at low prices, we've witnessed Burford effectively address all of the short report's concerns, expand its business profitably, and secure a significant legal victory against Argentina, worth approximately $16 billion, of which Burford is entitled to $6 billion ($28 per share). While the share price has rebounded strongly from its lows, I believe the company holds the potential for substantial further gains.

I envision the company achieving normalized earnings of $1.5 to $2 per share. At a 10x multiple, this would value the core business at $15/share. In addition, while it is doubtful that Burford will collect the full $28 per share from the Argentina case, a negotiated settlement and payments spread over a few years could yield a present value of anywhere between $5 and $10 per share.

Combining the $15 core business with the potential $5+ from Argentina results in a valuation far exceeding the current trading price. Burford represents a classic instance of the market not crediting "uncertainty." While the exact amount and timing remain unknown, I am confident our patience will be rewarded.

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KKR
While KKR's traditional private equity business could face challenges in a higher-rate environment due to higher debt service costs and lower valuations during exits, the firm's vast platform and diverse range of investment vehicles provide it with exposure to a broad spectrum of strategies, some of which could thrive in the current environment.

For example, KKR has a strong track record in private credit, with over $200 billion in assets under management. The firm is particularly bullish on asset-based finance (ABF), a $5 trillion+ addressable market with significant secular growth potential and direct lending. Higher rates have put pressure on bank balance sheets, so their presence in the ABF market has diminished. KKR is well-positioned to fill this void, given its $45bn footprint, relationships with insurance companies, and one-stop service combining origination, capital markets underwriting, and distribution capabilities. KKR recently acquired €40 billion of receivables from PayPal, and I anticipate more deals in the pipeline.

Overall, management remains highly confident in reaching its target of $4+ FRE and $7+ DE by 2026. I find this target credible, and it should continue to underwrite our investment.

Liberty Broadband
In the third quarter, Charter and Disney engaged in a highly publicized carriage dispute, resulting in a blackout of Disney channels, including ESPN, ABC, and FX, for Charter customers. This disruption deprived Charter customers of popular programming such as college football and "Monday Night Football." Driven by years of declining video profitability, Charter resolved to challenge the ever-increasing programming costs and the common practice among content owners of bundling less-viewed channels with more popular ones while still charging full price.

While bundling and increasing content costs have been a significant factor in the rise of over-the-top (OTT) streaming services over the last few years, Charter has been relatively shielded, economically, from these issues due to the low profitability of video and its ability to generate high-margin revenue from broadband services. Nevertheless, video is an integral part of the total package of services the company offers its customers, including internet access and phone service, and helps with customer retention even if it is not profitable in and of itself. About a week into the dispute, Charter and Disney reached a compromise, which market participants took as an affirmation of Charter's relatively strong negotiating position as a content distributor through its hard-to-replace cable assets.

In the short term, fixed wireless has posed a more significant challenge to cable operators than initially acknowledged, capturing many new customer additions in urban areas at the lower end of the market. However, the company's government-subsidized rural expansion efforts and rapidly growing mobile segment offer ample growth opportunities to mitigate this threat. At the current single-digit FCF multiple, the market appears to be overstating the threat posed by fixed wireless.

Cirata
Wandisco rebranded as Cirata in August and will soon trade under the CRTA ticker. Although the position showed a gain this quarter following its resumption of trading at 50 pence per share, it remains our largest year-to-date drag. New leadership has been rebuilding the company from the ground up, focusing on stabilizing cash flow, implementing more robust governance, and developing an effective sales force. Despite the turmoil of the past year, the overall thesis on the company remains unchanged – it possesses 45 patents and proven technology. It is well-positioned to capitalize on the explosive growth of cloud data. However, it now benefits from a significantly improved management team. I purchased additional shares, viewing them as inexpensive call options, considerably lowering our break-even price with minimal additional capital expenditure. I am closely monitoring the new team's execution of its sales growth strategy, recognizing that such transformations require time.

Prosus NV
Despite Prosus's extensive efforts to address its substantial and persistent discount to its assets, currently hovering in the high 40% range, the discount appears stubbornly resistant to closure. The company's numerous actions have yielded only temporary reprieves. These included separating Prosus from its parent company, Naspers, and listing

in Europe, simplifying the holding structure, and implementing share buybacks totaling $13.7 billion since June 28. The discount tends to narrow briefly following the announcement of a new initiative, only to widen again. Recognizing the market's evident dissatisfaction, Prosus Chairman Koos Bekker, renowned for transforming Prosus/Naspers from a local cable company into a significant global internet investor through strategic acquisitions like Tencent, has taken decisive action by initiating a CEO change.

As I've mentioned before, my underlying thesis has more to do with the performance of the fundamental operations of Prosus's businesses rather than playing a discount game. Still, the company seems to be tuning into the market's apparent skepticism over Prosus's capital allocation strategy, particularly its practice of selling Tencent shares to finance its portfolio of fast-growing but currently unprofitable internet firms. Operationally, Tencent has resumed revenue growth, with a renewed focus on capital allocation, following a rough few years. Prosus has made notable progress toward profitability in its e-commerce businesses.

IAC

IAC's stock price will likely remain under pressure until DotDash Meredith's advertising revenue rebounds and until Joey Levin demonstrates clear progress in reviving Angi. In time, DotDash should benefit from IAC's new intent-based advertising platform that helps deliver scaled targeting to advertisers without relying on cookies (given their recent ban by Apple). While Angi's turnaround effort hinges on enhancing both the professional and consumer experiences, simplifying fixed-price services, boosting liquidity, improving search engine visibility, and implementing cost-reduction measures, facets the company is making measured progress on. There is further upside potential from advancements at Turo, Care.com, and the astute investment in MGM.

Carmax

CarMax's share price performance has been underwhelming in recent years. While the company is well-managed, it operates in a cyclical industry that has been profoundly affected by several factors. The COVID-19 pandemic disrupted supply chains, driving up car prices, which initially boosted the stock price but later weighed on as affordability became a growing concern. Additionally, rising interest rates have made car financing more expensive, and increased investment in building out CarMax's omnichannel offerings has been necessary to compete with new digital-first companies like Carvana.

In hindsight, some of these challenges could have been foreseen, prompting an earlier exit from the investment. However, as a long-term investor, I recognize that all companies face periods of difficulty, and economic cycles are inevitable. The more pertinent question is whether CarMax, with its experienced management team, strategic investments, substantial scale, and customer-centric service offerings, is well-positioned to retain its leadership position and resume growth when the cyclical tide turns in its favor. I am willing to hold my position for now, but I am closely monitoring the company's performance.

Enovis

Enovis' share price has remained relatively stagnant since it spun out ESAB. While, perhaps counterintuitively, ESAB has flourished in what many consider the mature welding industry. With the dedicated application of its rendition of the Danaher Business System (DBS), the company expanded margins, launched innovative products, and ventured into aligned sectors like medical gases.

Enovis, on the other hand, is earlier in its DBS journey and has a little way to go until it achieves similar margins and returns that ESAB currently enjoys, thereby presenting the investment opportunity. The company competes with large companies such as Stryker and Smith & Nephew, and so decided to focus on faster-growing extremities niches within the medical device market. Investment has concentrated on complementing its strong market position with its reverse shoulder line by building out its foot and ankle business through bolt-on acquisitions.

It has further built out distribution capabilities with the acquisitions of Mathis and, more recently, the $800m purchase of Lima. Mathis's acquisition is poised to facilitate Enovis' penetration into the European market. With the purchase of Lima, Enovis has created a $1 billion revenue reconstruction enterprise. Lima's orthopedic product portfolio has grown sales in the high single-digit CAGR over the past decade. Enovis anticipates meaningful cross-selling avenues and projects about $40 million in cost synergies within 36 months.

Ashtead

Ashtead's performance continues to be robust, with notable growth figures in the US market—17% in the Specialty division and 14% in the General equipment sector. These segments are thriving due to the positive momentum from large-scale projects and an increasing shift towards equipment rental, a trend we believe is not only reactive to current inflationary and supply chain pressures but also indicative of a broader structural move from ownership to rental. The company is making significant strides in expanding its market presence through new location openings and strategic bolt-on acquisitions. These initiatives are proving to be critical drivers of Ashtead's sustained growth.

Moreover, Ashtead's free cash flow characteristics are particularly compelling amidst the dynamic economic environment. Should we encounter an economic downturn, the company's business model exhibits counter-cyclical attributes, which positions it well to weather adverse conditions.

Kingsway Financial Services - New Position

I added a new position to our portfolio: Kingsway Financial Services (KFS). KFS is a holding company with two primary segments: a warranty business and a search fund accelerator business, which I'll discuss in more detail below.

KFS has a checkered history, as evidenced by its volatile stock price. The company's roots lie in the warranty business, which provides extended warranty services covering repair or replacement costs for vehicle service agreements, HVAC systems, standby generators, commercial LED lighting, and refrigerators. This business experienced a rapid growth of 60% per year, accompanied by a soaring stock price. However, lax underwriting standards were exposed during 2006-2008, leading to catastrophic losses and a staggering $1 billion in net operating losses (NOLs). Activist investors intervened and brought in new management. It took two attempts to stabilize the company. The first CEO attempted to build a merchant banking-type business, but instead of creating a mini-Berkshire Hathaway-style conglomerate, he ended up with an opaque, conflict-ridden business with poorly performing investments.

The second attempt to right the ship brought in JT Fitzgerald as the new CEO, who remains in place today. Along with CFO Kent Hanson, he has initiated a multi-year strategic plan to streamline the business, divest non-core assets tax-efficiently utilizing the NOLs (of which approximately $600 million remain), strengthen the balance sheet by converting outstanding warrants, and secure inclusion in the Russell 3000 index. These actions have revitalized KFS as an attractive investment opportunity. Crucially, the turnaround was substantially accomplished before our investment, considerably mitigating our risk.

Today, the company operates two divisions – the warranty business, which generates $20m of cashflows per year, which it uses to fund its second, more exciting Search Fund Accelerator business.

For those who are unfamiliar, a search fund is a subset of private equity where MBA graduates, usually from top schools, raise capital from investors to acquire businesses. They initially secure modest funding for a 2-year "search phase" to cover salaries, legal fees, and office expenses. Once they identify a suitable business, they raise the rest of the funds from investors and, following the acquisition, take on the CEO role. Target companies are often small, stable, family-owned enterprises with $3-5 million in EBITDA, low capital expenditure, recurring revenue, and a service-oriented focus. Search fund operators aim to earn the majority of their compensation through a 20-25% carry-on successful exit within 5-7 years.

While this model has proven successful, there is a risk factor in the initial year post-acquisition, as relatively inexperienced operators, albeit intelligent and driven, assume control and institute changes within an existing business.

Stanford Business School publishes a bi-annual report on the industry, which shows collectively that search funds have generated an impressive 35% IRRs to investors. While this headline figure might appear enticing, it masks that around one-third of search funds fail to secure an investment or generate losses for their investors. The inherent risk of changing ownership in a business becomes amplified in search funds, where new management often consists of MBA graduates with impressive academic credentials but limited practical experience. This lack of industry knowledge, operational expertise, and cultural understanding can hinder unglamorous businesses' successful acquisition and management.

To address this, KFS employs a three-pronged approach. Firstly, they seek out individuals with impressive resumes, often featuring a mix of strong academic credentials, military officer experience, and humility. The thought is that such individuals will have the intellectual capacity and a proven ability to confront challenging situations successfully, combined with the right mindset to enter an existing business and learn how to operate it. Secondly, they establish a robust operating structure to support functional partners throughout the acquisition process, encompassing deal closing and operational management, thus eliminating the need for partners to navigate these challenges alone. Lastly, KFS's entrepreneurs benefit from the guidance of two distinguished advisors: Will Thorndyke, a highly regarded figure in search fund investing, who is also the author of "The Outsiders" on effective capital allocation, a book that value investors widely recognize, and Charles Joyce, the former CEO of Danaher, where the renowned Danaher Business System is known for its effectiveness as an operating process.

KFS has already made several acquisitions, which have performed well, and has a robust pipeline of deals in the works. Each acquisition it makes adds to the cash flow available to the company, and the company is near an inflection point where it will be able to fund acquisitions from internally generated cash flows. Traditional search funds typically exit after five to seven years, providing cash lump sums to investors. In contrast, KFS can retain companies more like a Holdco and merge them when it makes sense. Unlike a search fund, which is an independent entity with separate shareholders for each investment, KFS recently folded CSuite, a financial executive services and search firm, under Ravix Financial, a provider of outsourced accounting and human resources services, and will look to build out a platform through further bolt-on acquisitions. Though very different, this reminds me a little of much larger private equity giants like KKR diversifying from the 5-7 year buy and flip cadence of traditional PE to more "permanent capital" with its "core private equity" portfolio designed to hold onto companies, and their cashflows, for much longer peridots of time.

If KFS executes its strategy well, we could be rewarded for our investment. The closest comparable company, Mediqon, trades at a 17x EBITDA multiple in Germany. At its current trajectory, KFS could generate over $30m in a couple of years with minimal net debt, implying an approximate $500m value, double its current market capitalization of $200m.

This investment carries certain risks due to the company's smaller size, relatively concentrated shareholder base, and less liquid shares. Having recently undergone a significant restructuring, the company's management team must now execute their plans, and the board must help them prioritize capital allocation to maximize returns. I have taken a starter position.

Samer Hakoura
Alphyn Capital Management, LLC
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