Talaria Global Equity Fund Foundation Units

Quarterly Update March 2023

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Signatory of:

Investment Insights

If you want peace, prepare for war

In the last quarterly we warned that the failure of crypto exchange FTX offered lessons for investors in other asset classes. What has happened in the banks illustrates the point and makes us even more concerned about global equities than we already were.

Anyone who has been in markets long enough knows that stress in financials is often the first sign of real trouble. There are many reasons for this, not the least of these being leverage. If equity is the sliver of hope between assets and liabilities, it is perhaps the thinnest sliver of all in banks.

Even if the failure of SVB and the woes at Credit Suisse do not turn into systemic problems, at the very least they will inhibit activity. Already cautious loan officers should tighten their standards further. To the extent that individuals adjust their behaviour in the face of these sorts of headlines, they are likely to increase saving and cut spending. Corporates will inevitably look even more closely at their liquidity and raise the required return of any potential investments.

These are sweeping generalisations but that does not make them wrong. Those that want detail will find it later, but, in the meantime, here is a generalisation that has held-up for more than 1,500 years: "If you want peace, prepare for war". While this has a martial context it works in investment too, with peace being peace of mind and war being conflict with hostile markets.

Things may not turn out to be as bad as we expect, but it makes sense to prepare for the worst. Our advice is to protect capital above all else because what matters is losing as little as possible when times are bad to have as much working for you when things get better.

Dark

Grim reaper might have been the dress code for writing this quarter's investment insights, but the cowl is hot and holding a scythe makes typing tricky.

Also, as we discuss later in part II, the outlook for global equities is no laughing matter. It is as bad as we have seen for years, with many significant challenges.

But it is not all grim. As we discuss in part I, we feel good about the way we have deployed our investors' capital. If our portfolio was the market then we would have a more positive message to deliver.

Part I

1. Common size analysis: portfolio equity holdings and the index

Metrics (Index 100 = Sales)	Talaria Portfolio	FTSE Developed
Income Statement Figures		
Sales	100	100
EBIT	11.4	14.5
Interest paid	0.5	1.1 (1)
Pre-tax	10.9	13.45
Tax rate	24%	20% (1)
After-tax profit	8.4	10.7
Dividends	3.2	4.0
Retained earnings	5.2	6.7
Balance Sheet Figures		
Equity (book value)	47	71
Debt	26	91
Cash	11	57
Net debt	15	34
Total capital (equity + debt)	62	105
Leverage Ratios		
Debt / Equity	56%	128%
Net debt / Equity	31%	47%
Net debt / Total capital	24%	32%
Efficiency/Profitability Ratios		
Sales / Total capital	161.7%	95.4%
EBIT / Total capital	18.5%	13.9%
ROE	17.7%	15.1%
Return on total capital	13.5%	10.2%
Valuation Figures		
Price	103.1	170.4
Price / Sales	1.0	1.7
Price / Book value	2.2	2.4
Price / Earnings	12.3	15.9
Earnings yield	8.1%	6.3%
Dividend yield	3.1%	2.4%
Retained earnings yield	5.0%	4.0%
Dividend payout ratio	0.4	0.4
Enterprise value / EBIT	10.3	14.0

Note (1) Based on Talaria estimate of index interest expense and tax rate. Source: Bloomberg

The table above treats the Talaria portfolio's aggregate equity holdings and the index as if they were each one company. With sales for both set at 100, this common size analysis gives our investors an overview of what they own and how it is different from the index.

- The portfolio has far less balance sheet risk through lower leverage than the index. Not only are interest rates rising, but spreads are also up because of the belief, justified in our view, that risk in markets is increasing. Leverage is undesirable in this environment.
- The portfolio's equity holdings deploy their capital in aggregate more efficiently than the index. Another way of thinking about this is as a measure of quality and the quality is higher in the portfolio.
- Profitability is a bit higher in the index than the portfolio. But profitability without reference to the capital required to generate it is only half the story – this again relates to efficiency and quality.
- The portfolio's holdings are better value than the index on every measure.
- The lower cost and better returns mean the portfolio offers both a higher dividend yield and a better level of retained earnings that can be reinvested at better returns on capital.

Compared to owning the index, the portfolio's equity holdings give our investors less balance sheet risk, more efficiency, greater quality, and higher retained earnings yield deployable at higher rates of return all at a better price.

2. Value investing

In part II we will explain why the future looks like it is about low long-term returns. In this environment value investing offers an added advantage that is easy to underestimate in a go-go bull market like the one from the GFC low to the end of 2021.

The arithmetic is simple. In buying a dollar of value for no more than 80 cents we have a minimum potential return of 25% if the discount to fair value closes. Of course, the discount is usually there for a reason and may take a long time to disappear; we had to be very patient with McKesson (NYSE: MCK) before it delivered in spades.

However, by way of contrast, investors who buy at fair value or at a premium have not only shut the door on this potential source of return but may have also locked in a headwind to making an overall profit.

Value investing, finding the asset that trades at a discount, relies on understanding numbers and accounting insights. Too often people buy a share at 1x book value in a company generating a return on equity (ROE) of 10% expecting to make 10% on their money. Often however they end up making more like 6%, because 4% of the ROE is an illusion created by the sort of adjusted earnings that misrepresent economic reality. As we highlighted in the last quarterly, the gap between "adjusted" and "all in" earnings is at its widest ever. Investors should brace for that gap to close.

By incorporating the consideration of items like restructuring charges, stock-based compensation and pension obligations into our process, we ensure our estimation of a company's normalised returns has the best possible chance of reflecting a true rather than a distorted picture.

Moreover, whilst there is no infallible way to avoid behavioural biases that are repeatedly the cause of mistakes in stock selection, our value mentality helps to avoid the pitfalls. Against recency and representative bias, we have a process that is structurally underweight momentum and cares about what something costs not what it looks like. By not meeting management we remove the risk of authority bias and falling for an impressive communicator's spin. Against confirmation bias and group think we have a great mix of outstanding people in an investment team motivated and remunerated to arrive at the right answer not merely their own answer.

At the core of our approach is the belief that value investing is not only a process but also a discipline. In fact, if there is an edge in value investing apart from the arithmetic, it may be nothing more than sticking to the mandate.

The market, not least in the volatility and lumpiness of the factor's returns, can drive value investors to style drift, with drift being too benign a word for what is really happening. Commercial pressure also plays its part in motivating managers to change what they do. It is immensely helpful to us as practitioners that our implementation process reinforces our strong commitment to the value investing discipline.

3. Income and total return

In terms of the two components of total return, the bull market that ran throughout the last decade trained global equity investors to focus on capital growth more than dividend income. But whilst dividend income always plays a positive part, the same cannot be said of capital growth.

The table below shows the subsequent five-year returns from income at: 1. all levels of Shiller PE, 2. Shiller PEs equal to or above 15x, and 3. Shiller PEs equal to or above 30x, about the current level.

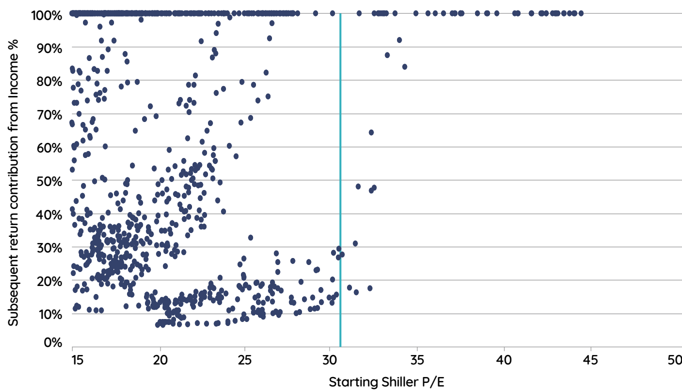
There are several highlights. The dividend income contribution is never zero or less. This is not something you can say about capital growth. At all valuations shown, dividend income can be 100% of return; of course, it is more than 100% when there are capital losses. At or above just 15x the median contribution from dividend income is a majority. At or above 30x dividend income supplies all the return 79% of the time.

S&P 500: Contribution to total return from dividend income over five year rolling periods

Shiller starting valuation	No. of monthly observations of dividend income's subsequent 5 year return contribution	Median contribution of dividend income to total returns over next 5 years (%)	Instances of dividend income contributing all positive returns in subsequent 5 years	Instances of dividend income contributing all positive total returns in subsequent 5 years (%)
At all valuations	1,644	44%	468	29%
At PE >= 15x	954	52%	361	38%
At PE >=30x	57	100+%	45	79%

Source: Shiller, Yale

Percentage of 5 Year S&P 500 Returns from Income and Shiller P/E



Source: Shiller, Yale

We value dividend income as much as the next investor, but it should be recognised that it is not a cure all and has disadvantages.

Dividends are paid out of earnings and, as we discuss later, the outlook for earnings is poor. Management can maintain a payout ratio, but the absolute dividend level will be lower if profits are too. And management can cut or pass a dividend if they want to shore up a business at a time of financial stress. Regulators can also make them cut or pass whether they want to or not, most recently in financial institutions after the pandemic. These cuts often happen when investors need dividend income most.

Another problem is that in chasing dividend income investors run the risk of concentrating their holdings in regions such as Australia and the UK and sectors such as resources and banks. It is notable that the turmoil in US regional and European banks resulted in a decline in expectations of future dividend payments in 2024 between 6 and 10 percent as witnessed in the dividend swap market.

It is a huge advantage to our investors that they can access option premium income. This source of return exists outside of corporate profits. Indeed, if falling corporate profitability goes with falling equities and higher volatility, option premium income goes up – sometimes dramatically.

Part II

Now at the worst stage in the equity market cycle

Our single best indicator of where we are in global equity markets is our bottom-up process. Every month our screen delivers about ten stocks each to the six members of the investment team. Analysts investigate their list with the initial goal of spending no longer than it takes to decide a share is not a candidate for the portfolio. If an equity makes the cut, then it takes between about five to seven weeks to work up an idea to present to the team.

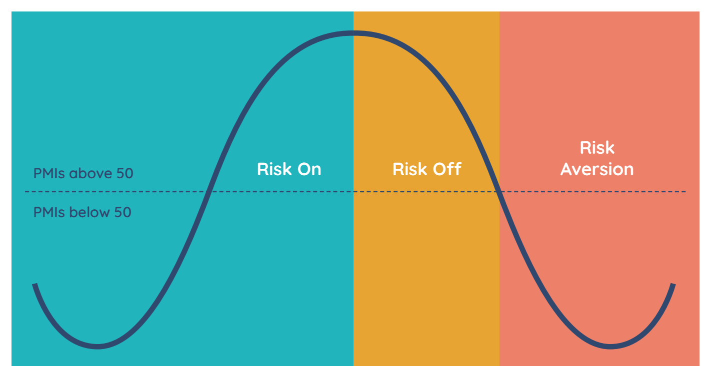
The number of ideas, their variety and the pace at which they come tells us a lot about the market. There are times when there are many opportunities, across a wide range of sectors, generated frequently. Now it is the opposite.

Among the reasons for the scarcity are valuation and upside/downside or skew. Another challenge is that at different times the future is more or less certain, in analyst-speak there is a wider or narrower range of outcomes. Currently the range is wide which makes decision making more difficult - there is no academic field entitled 'decision making under certainty' for a reason.

Managing portfolio risk for our investors requires methods of orientation in addition to the bottom-up approach. Our macro framework is a map that helps us to know whether the path around the next bend is smooth, bumpy or dangerous. Those that invest without the map can still move but with less idea of what is waiting around the corner.

A top-down navigation tool that provides a lot of value to us is the equity market cycle. This cycle has three stages which have well established histories. The market direction and returns associated with each is different: 1. risk-on, likely up and positive; 2. risk-off, likely mixed and breakeven; 3. risk averse, likely down and negative.

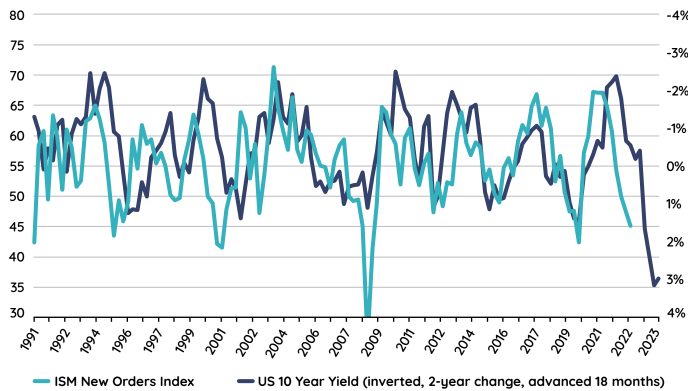
Since July 1997	Risk On	Risk Off	Risk Aversion
Number of cycles	7	8	3
Annualised return	17.6%	-0.7%	-21.6%
Hit Rate	100.0%	62.5%	0.0%



The landmarks we look out for in the cycle are leading economic indicators. The most important of these is the Institute of Supply Chain Management's (ISM) manufacturing survey which leads the outlook for US corporate profitability both in terms of level and direction. A manufacturing ISM above 50 signals the economy is expanding, suggesting an increasing level of future corporate profitability, below 50 suggests a decreasing level.

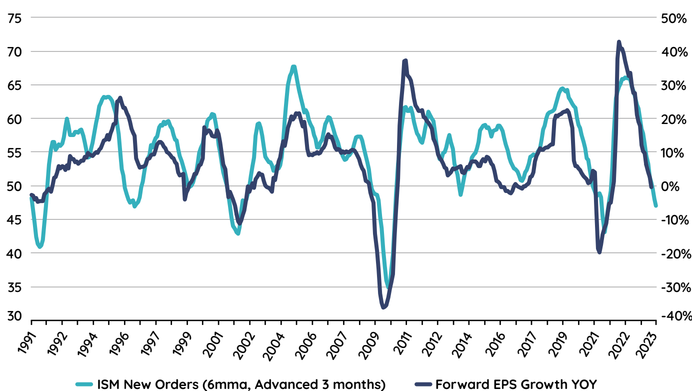
Relating ISMs to the equity market cycle we arrive at the following: risk-on, below or above 50 but rising; risk-off, above 50 but falling; risk-averse: below 50 and falling. The associated intuitions are simple: risk-on, the outlook for corporate profits is improving; risk-off, profits are growing but slowing; risk-averse, profits are falling and deteriorating.

Working out where we might be headed in cycles starts with monetary policy because interest rates flow through to the economy with a lag of 12-18 months. Looking at the United States, the key Fed Funds Rate was first raised in March 2022, which means its effects are only beginning to bite around now. Since the Fed is still raising rates, the impact will be felt as far out as 2024.



Source: Bloomberg

Putting this all together, with the manufacturing ISM in the US below 50 and trending downward since June 2022 and with interest rate increases yet to work their way through the system, we are in the risk-averse stage of the cycle. The balance of probabilities therefore is heavily weighted towards falling indices and negative returns.



Source: Bloomberg

High valuations compound the problem

Given our view that we are at a bad point in the equity market cycle, it would be helpful if valuations could offer some support. But the best you can say is that some of the extremes have been worked off.

The most recently available Shiller PE for the S&P 500 was still an expensive 30.4x. Looking at more than 140 years of data, the valuation has only been higher for 5.4% of the time or a total of 7.5 years. If 140 years is too long a period, in the last 20 years the valuation has only been higher for 16% of the time or a total of 3 years.

For a variety of reasons there are those that may not like Shiller's cyclically adjusted PE, no valuation measure is perfect, but other metrics with good predictive power when it comes to long term returns are also extended.

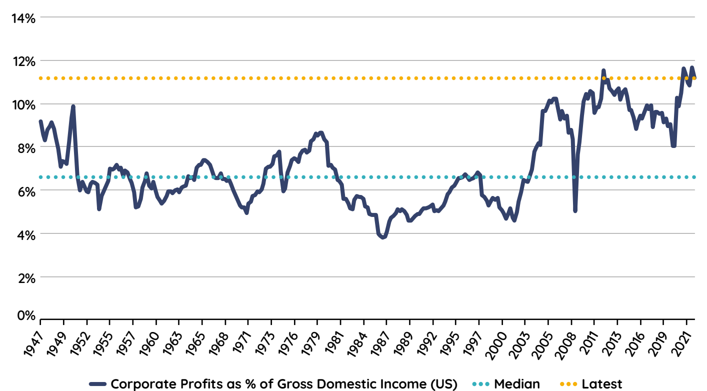
Going back and forward over whether such high valuations are justified distracts from the point. The corollary of higher valuations is lower returns, and lower returns may be something an investor is prepared to accept for any number of reasons. But a buyer of the S&P 500 at this level should not do so expecting to make a standard average annual return of, say, 8%.

This is not a matter of opinion but of arithmetic. The dividend yield + compound annual growth is the simple nominal long-term return calculation and (dividend yield + compound annual growth) x (ending valuation/starting valuation) is the valuation adjusted calculation.

We dug into this in last September's quarterly but here is a current rough estimate of a point-to-point ten-year return profile: 1.8% + 4.0% = 5.8% simple nominal return. If the Shiller PE reverts to the 20-year average of 26.1x then the prospective valuation adjusted nominal annual return is 5.8% - 1.6% or 4.2%. Assuming the Fed hits its annual inflation target of 2% from here, which means inflation will have to be less than that target for some of the time, then the valuation adjusted real return should be 2.2%.

The model above is generous given that the prospective dividend yield is a function of earnings estimates that we believe are too high, that growth is partially a function of margins that are too high, and that the 20-year average PE is materially above averages that have more than this somewhat brief history.

The outlook for corporate profitability makes things worse



Source: FRED, St Louis Fed

The outlook for corporate profitability in the United States is poor for a variety of reasons, some of which are likely to be structural.

The so-called sugar rush to profits from pandemic related budget deficit expansion and household saving reduction is in the past. Trends in the labour market are towards an upward shift in unit labour costs. Interest costs are rising as zero and negative interest rate policies (zirp and nirp) are consigned to history. With the Biden administration reversing his predecessor's 2017 tax gift to business, rising tax on corporates is likely to be one more challenge to margins.

In terms of scaling the potential downside, ISM manufacturing new orders lead forward EPS growth. At 44.3, the index suggests that EPS could fall by as much as 10% year on year. Using the historical relationship between rising interest rates and the level of the ISM suggests a year-on-year earnings decline of 25% or more is not out of the question.

1. Government deficit and household savings falling

At the highest level, corporate profitability is a national accounting truth or an accounting identity to give it its proper name. This identity says that corporate profitability is a function of net investment, household savings and the fiscal deficit. More investment, more deficit and less savings are positives for corporate profitability. The pandemic and its aftermath had pronounced effects on the deficit and on savings that helped to boost corporate earnings to record levels.

For context we would note that the last surplus was in 2001, that the biggest deficit before then was 1992's USD 290 billion, and that the deficit in 2019 was USD 984 billion. The three years following the pandemic saw deficits of 2020: USD 3132 billion, 2021: 2775 billion, and 2022: USD 1375 billion. Looking at Congressional budget forecasts, the deficit is set to remain at between 5-6% of GDP, growing slowly in absolute terms but providing no sugar rush to business profits.

Also supporting corporate profitability has been a vast reduction in personal saving with the rate falling to 4.7% in January 2023 from an eye-watering 33.8% in April 2020 at the peak of the Covid-19 panic. If anything, the current rate is below normal and certainly provides no reason to expect corporate profitability to continue to benefit from material reduction.

2. Unit labour costs rising

The US Bureau of Labor Statistics gives data on the ratio of job openings to the unemployed. This is a simple but effective measure of whether the labour market is tight or loose. Currently there are twice as many job openings as unemployed persons, which is about as high as it has been since the GFC. The consequences of worker shortages are showing up in median wage growth which has accelerated since the start of 2021.

For those that like the sweep of history, the fall of communism in the eastern bloc and the accession of China to the World Trade Organisation provided a vast and unrepeatable boost to the global labour force from which the benefits have substantially been reaped. In fact, trends now are in the opposite direction through negative demographics, geo-political tensions, on-shoring, friend-shoring and pandemic related behavioural changes such as the great retirement.

3. Interest rates rising

Looking at Moody's seasonally adjusted Baa credit yields since 1980, the trend has been top left to bottom right, starting at more than 17% in the early 1980s and reaching lows of just over 3% in 2021. There have been sharp increases within that trend, for example during the GFC the yield went from 6.4% to 9.2%. More recently the yield has risen from 3.2% to 5.5%.

Investors, businesses and government agencies use the yield and yield spreads as risk indicators and early signals of economic strength or weakness. But at the most basic level the Baa credit yield shows how much it costs for a medium risk business in the United States to raise debt capital. The falling cost of corporate debt has played its part in boosting business' margins and may do again. But for now, interest costs are rising, and it is hard to imagine an imminent and indiscriminate income hunting environment that will again push interest costs to all time low levels.

4. Taxation rates rising

Business taxation is yet one more recent tailwind in the United States that is set to subside or, more likely, reverse.

The Tax Code and Jobs Act (TCJA) of 2017, which cut the marginal tax rate on US derived profit from 35% to 21% is being addressed by a current administration that has proposed raising the marginal rate to 28%. Estimates suggest the TCJA added one percentage point to US profit margins, which is material given an S&P 500 net margin in that year of 9.9%. The introduction of global minimum tax of 15% is indicative of the likely upward direction of future corporate tax policy.

5. The impact on earnings per share

Scaling the impact on earnings per share does not require modelling a P&L for the S&P 500 because the strong correlation between the ISM new orders index provides a useful short cut. Looking at the chart below it is reasonable to anticipate that forward EPS growth will fall by 10% given the latest 44.3 level of ISM new orders.

According to Bloomberg, current year S&P 500 EPS estimates peaked in June last year at $248 with the latest at $220. As discussed above, EPS could easily fall to below $200, perhaps materially below. This may seem fanciful, but it is easy to forget that the 2019 pre-pandemic peak high was just $164. Reversion to that level would put an S&P 500 index at 4000 on a PE of 24x.

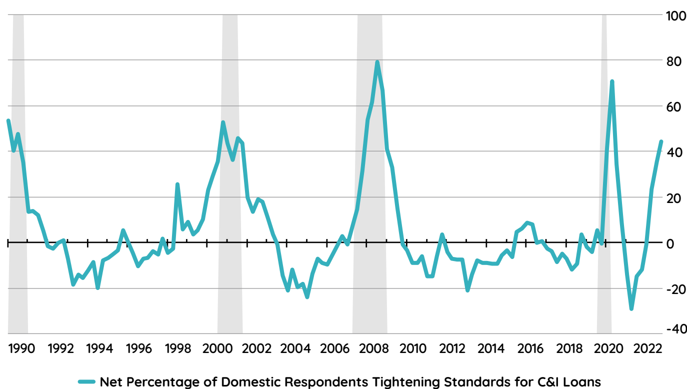
Inflation and its impact on growth, margins and valuations

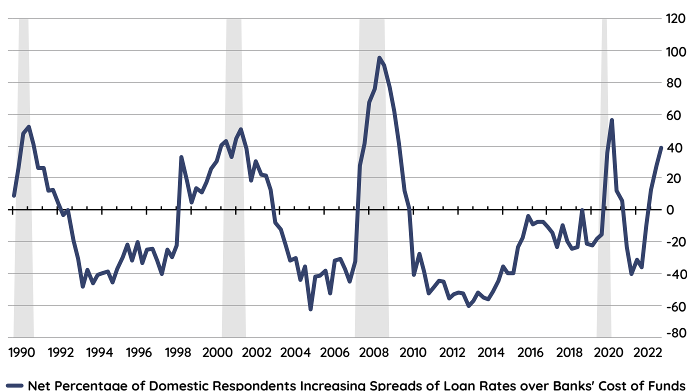
We are always looking for ways in which we might be wrong. In the last quarterly we contrasted our view with "an argument that inflationary recessions are different from their deflationary equivalents. In inflation, nominal growth in sales and earnings can mitigate a derating. Solid nominal wage and corporate profit growth alongside higher but still low interest rates could mean it makes sense for consumers and corporates to borrow to spend, thereby supporting further growth.

Having considered this further, we have four points.

1. In the 1970s the CPI grew at a compound annual rate of 7.3% and the Shiller PE had a high, low and mean of 18.7x, 8.3x and 12.7x respectively. It is true that nominal growth can mitigate lower valuations, but it will not cancel out their effects. We are not forecasting, but if you plug even 18.7x into our return model above, the average annual deduction from the return is -5.0%.

1. Looking at earnings releases across numerous sectors we are seeing top-line growth being boosted by higher prices. But this is often accompanied by low volume growth. In the price/volume mix, the latter is more important because it reflects end demand. Whilst pricing power is different across industries, companies cannot lean forever on price increases for top line growth.
2. What earnings releases are also showing is that cost inflation can be stickier than revenue inflation. Partly for reasons we discussed above, wage inflation is high and persistent, which in turn is driving layoffs, most notably in tech. Layoffs will likely persist until revenue growth exceeds wage cost growth, but the sequence matters for margins and currently the risk is that inflation may drive top line growth, but at the expense of lower margins and lower demand.
3. The fourth quarter of 2022 saw a dramatic tightening in bank lending standards and an increase in rates charged to borrow as evidenced by the Federal Reserve's Senior Loan Officers Survey. Events this quarter would have only exacerbated the trend. This argues against the idea that banks are confident in their corporate customers and that bank credit can help to fill the gap caused by central bank tightening. Along with the spike in Baa yields, this phenomenon gives weight to the perception amongst lenders that risks are rising.





Source: FederalReserve.gov

Summary

As we discuss in the performance review, the first quarter was strong for global equities at the index level, but the strength was founded on only a narrow range of stocks and sectors. Our view is that the outlook is poor and our conviction in this view has only grown

One of our themes in previous publications has been to "own different", shorthand for our advice to hold equities that do not have the same characteristics as those that prospered between the March 2009 GFC low and the end of 2021. Where we are in the cycle supports that view. We say again, equity investors should prize income, good value, short duration and rapid payback periods. They should avoid high beta shares, those with prices that can be largely or more than fully explained by overall market moves, and they should avoid financial leverage. This remains a time to play defence.

March 2023 Quarterly Performance

On the face of it global equities had a good first quarter, extending a rally that began last October. Dig deeper, however, and a more complex picture emerges. Sticky inflation initially kept pushing bond yields up, which eventually contributed to the demise of banks in the US and Switzerland and to further tightening in monetary conditions. This, coupled with warmer European weather and underwhelming Chinese growth, dampened global demand prospects, pushed commodities lower and eventually led to lower bond yields. The equity rally that ensued was notably narrow with just eight US mega-cap tech stocks driving two thirds of the entire quarter's worth of MSCI World index gains.

An eventful first quarter of 2023 was a tale of two halves. The first half started with a cyclicals and growth equities' rally in January supported by lower yields and lower commodity prices. A risk-off February quickly followed as yields rose on the back of renewed inflation worries and hawkish central banks. The second 'half' came abruptly at the start of March when three regional banks in the US failed. The result was a drop in yields, underperformance in financials and a bounce in a concentrated set of big-winner, rate-sensitive growth stocks.

Despite the noisy start to the year, all regions saw equities close the quarter in the green. In the US, the epicentre of the banking crisis, the tech-heavy, rate-sensitive (and financials-lite) NASDAQ returned 16.8% and significantly outperformed the broad-based S&P500 Index (up 7.0%). In Europe, one of the main drivers was a collapse in gas prices which pushed all major indices up despite weakness in financials. Germany's DAX and France's CAC were up 12.2% and 13.1%, respectively. UK's FTSE100 (heavy in both financials and energy stocks) was notably weak, up just 2.4%. In Asia, Japan's Nikkei delivered a solid 7.5% while China's Shanghai Composite returned just 5.9%. Initial excitement of China reopening in January was a damp squib and gave way to weak performance in February and March.

Against this messy backdrop, Talaria's Global Equity Fund delivered a positive quarter, gaining 5.11% in AUD while maintaining substantially lower market risk. Strong positive portfolio breadth (24 stocks advanced and only 6 declined), a few positive idiosyncratic stock events and limited exposure to financials and energy stocks helped drive the performance.

Distributions: The Fund paid a March 2023 quarterly distribution of 5.37 cents per unit taking its 12-month income return to 7.29%.

Growth sectors, dominated by a narrow list of mega-cap Tech stocks, were the biggest winners in the quarter as rates fell. IT, Telcos and Consumer Discretionary all returned strong numbers in the range of 16-21% in the quarter. Next were traditional cyclicals that started the year strong but eventually weakened as banking wobbles and recession fears resurfaced. Industrials and Materials closed the quarter up 5-7%, with European Industrials a standout, up 12.5% and helped by much lower gas prices. On the other extreme within cyclicals were energy (down –4.3%, impacted by lower oil and gas prices) and financials (down –2.2%, impacted by banking woes in the US and Switzerland). Defensives underperformed with healthcare notably weak at –2.1%.

Warmer weather in Europe, weaker China and banking sector worries in the US dampened demand and drove commodity and energy prices lower in the quarter. The Bloomberg Commodity index declined –6.5% while the benchmark WTI Crude oil price fell –5.7%. Rates also fell on the back of a deteriorating economic outlook while policy uncertainty remained high. The US ten-year bond yield was down 40bps to 3.47% in the quarter. The US Dollar also weakened 2-4% against several other major currencies. Paradoxically, policy uncertainty has driven rates and FX volatility higher while volatility in equities has declined with the VIX down to 18.7, 3 points lower than at the start of the year.

The fund's holding in Mexican-based retailer Fomento Mexicano Economico (FEMSA) was the biggest contributor to performance this quarter (see our Stock in Focus section). Other large contributors to performance for the quarter include Hong Kong listed Alibaba (announced plans to split into 6 business units), French-based pharmaceutical giant Sanofi (successful Phase 3 result on Dupixent drug) and Japanese-based automation manufacturer Mitsubishi Electric (improved demand for its products).

The list of detractors this quarter was notably short with only two that carried a material impact to performance. Both were pharmaceutical giants with negative idiosyncratic outcomes. US-based JNJ announced a large potential financial hit for a litigation case in relation to talc. Swiss-based Roche had poor outcomes from its drug pipeline that drove the price lower. Despite weakness, we continue to see upside to both names and have been increasing our exposure.

During the quarter, the Fund initiated a position in US-based HRB (an undervalued franchisor that provides assisted income tax return preparation services in the US, Canada and Australia) and re-initiated positions in CF (a US-based fertiliser manufacturer that benefits from a wider spread between European and US gas prices), Loews (a US-based holding company with a stake in CNA, a US-listed insurer, that trades at a significant discount to book value) and Henkel (a European Household and Personal Care products manufacturer). The only exit at the very start of the quarter was Italian-based bank Intesa.

Stock in focus: Fomento Economico Mexicano (FEMSA)

Fomento Economico Mexicano (FEMSA) operates the largest chain of convenience stores in the Americas and is a long-term holding for the fund. We see upside from the recently announced simplification of the capital structure and renewed focus on core business activities. Sustainable and profitable double-digit growth will drive shareholder returns.

FEMSA (NYSE: FMX) is a Mexican holding company with a listing in the US. It generates two thirds of operating income from its retail business – Oxxo convenience stores, pharmacies and fuel stations in Mexico and other Latin American countries. The other third of operating income comes through a 47% stake in Coke Femsa, the largest Coca-Cola bottler in the world.

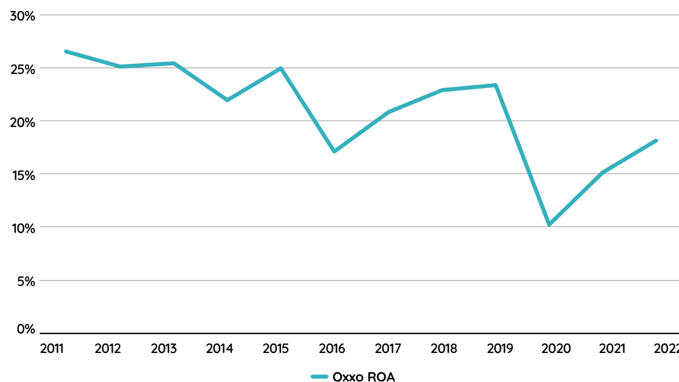
Growing market for convenience stores in Mexico and the region

We like FEMSA because it has an impressive track record of deploying capital into its core business at an attractive rate of return.

It has expanded its existing network of convenience stores from just over 7,000 in 2009 to over 21,000 today, a nine percent per annum growth. New Oxxo stores generate very high returns on capital of over 30% with fast payback times. While it is difficult to disentangle the Oxxo stores from the rest of the company on the invested capital metric, we can do it on assets and the return on these assets is high and still below pre-COVID-19 levels (see Exhibit 1).

The market for convenience stores in Latin America is far from saturated. In Mexico, FEMSA sees scope to add at least 800-1,000 stores per year for the next ten years and ithas recently begun expanding into other Latin American geographies. One example is Brazil where it already has a distribution presence through Coke Femsa and has been able to add stores at a rate of approximately 200 per annum.

Exhibit 1: Femsa - Oxxo ROA (%)

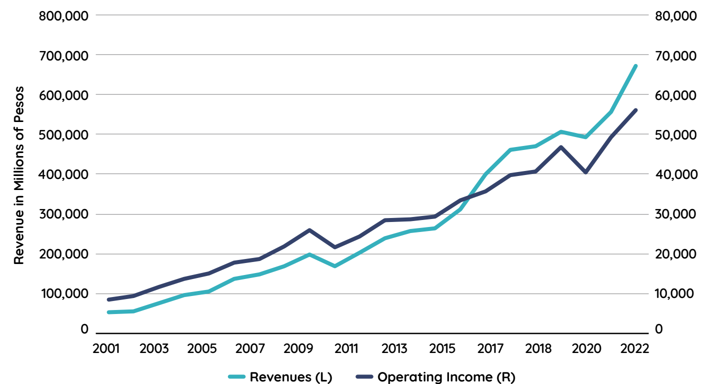


Source: Femsa annual accounts, Talaria

Double digit growth in group revenues and profits

Strong deployment of new stores coupled with mid-single-digit growth from same store sales (SSS) and Coke Femsa have contributed to high levels of growth for the group. Revenues have expanded at a CAGR of almost 12% since 2010 or over seven percent in US$ terms (see Exhibit 2). Group operating income has grown at a slightly lower but still solid rate of seven percent CAGR. We expect a combination of top line growth coupled with a recovery in margins to drive double digit earnings growth well into the future.

Exhibit 2: Femsa Group, Revenue and Operating income (m MXN)



Source: Femsa annual accounts, Talaria

Capital allocation has been a weakness

Despite strong top and bottom-line growth, management has occasionally misallocated capital. Exhibit 3 presents how operating cash flows have been spent since 2010.

Of the MXN490bn in cash from operations, half was spent on capex (two-thirds on maintenance capex and a third on growth capex). The remaining MXN261bn plus 64bn of debt was split between dividends and acquisitions. It is the latter that has proven to be a significant drag to share price performance and a distraction from the core business.

Management has taken notice and has recently signaled a re-focus. Indeed, simply investing in new Oxxo stores and pharmacies is to be the core idea going forward. This, along with Coke Femsa and digital banking initiatives, will form the three pillars of future growth. Femsa will sell its remaining 7.5% stake in Heineken, as well as other non-core holdings like the janitorial-sanitation distribution businesses in the US. Capital will now be focused on the three pillars and any excess will be returned to shareholders in the form of increased dividends or buybacks. These actions should greatly simplify the company and make the value more apparent.

Exhibit 3: Femsa Group – Cashflows 2010-2021 (MXN bn)

	2012-2021
CF from Ops total	490bn
CAPEX total	229bn
FCF	261bn
Acquisitions net of divestments	-190bn
Dividends	-135bn
Debt issuance	64bn

Source: Femsa annual accounts, Talaria

Downside risks

Exposure to Mexico and other emerging markets in the region is a major risk to the business. A global economic slowdown or geopolitical tensions with the US can impact trade flows and in turn the currency and the overall economy. While FEMSA's underlying business has defensive characteristics the price of the US listing can still suffer from a devaluation of the peso. Violence in certain parts of Mexico where FEMSA has a footprint presents a different kind of risk that can cause a disruption to operations.

Another risk to our investment thesis is FEMSA making further acquisitions of non-core activities. Management has outlined their intention to refrain from such actions in their recently announced plan, but it is nevertheless something to be mindful of.

Finally, the main growth driver for the business is the rapid rollout of new stores in Mexico and the region. A slowdown in new store openings will impact on the bottom line and the valuation multiple.

Valuation

Like most holding companies Femsa has a relatively complex capital structure, however the business can be split into roughly three distinct segments.

First is the core business of convenience stores and pharmacies. This is the fast-growing and highly profitable part of the group. We forecast 12% growth per annum in net income by 2026 and value the business on a P/E multiple of 15.4x (implying a 6.5% earnings yield). The implied 2025 value per share in US$ is $58.5.

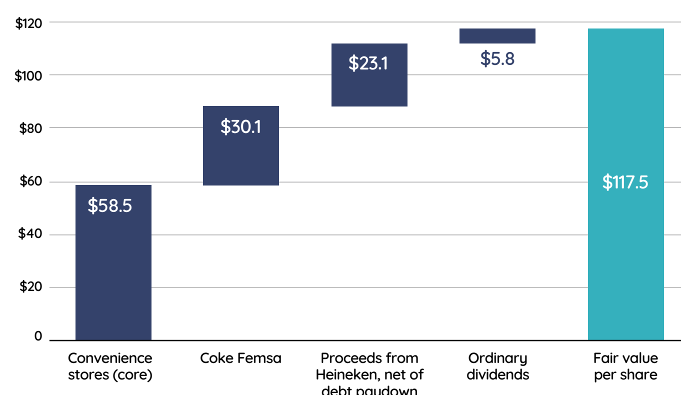
Next is the 47.2% stake in Coke Femsa. While growth here is a more modest 7% per annum the business offers the benefits of scale and stability. We apply the same P/E valuation multiple of 15.4x that implies a 2025 value per share in US$ of $30.1.

Third, we capture all the non-core holdings that the company is either selling (the Heineken stake and logistics business) or that are currently unprofitable net of a debt paydown to a target ratio of 2x Net Debt to EBITDA. The current market value per share of Heineken and the logistics business net of debt paydown is US$23.1 today. We give $0 value to other non-core businesses held by the company.

Finally, we assume FEMSA will continue to pay a 2% yield in the form of an annual dividend which adds up to US$ of $5.8 per share.

Putting this all together implies a fair value per share of ~US$117.5 in 2025 (closing price as of 31/3/2023 is US$95.19).

Exhibit 4: Valuation



Source: Femsa annual accounts, Talaria

Our valuation approach gives US$0 value to the emerging digital banking initiative. We believe this is an area which can bring meaningful positive value in the future and is an upside risk to our investment thesis.

Talaria Global Equity Fund - Foundation Units

Top 10 Holdings*

Company name	% weight
Johnson & Johnson	5.2%
Nippon Telegraph & Telephone Corp	5.2%
Novartis	5.0%
Alibaba	4.8%
Sodexo	4.7%
Roche	4.6%
Sanofi	4.4%
Femsa	4.1%
Secom	3.9%
Gilead	3.7%

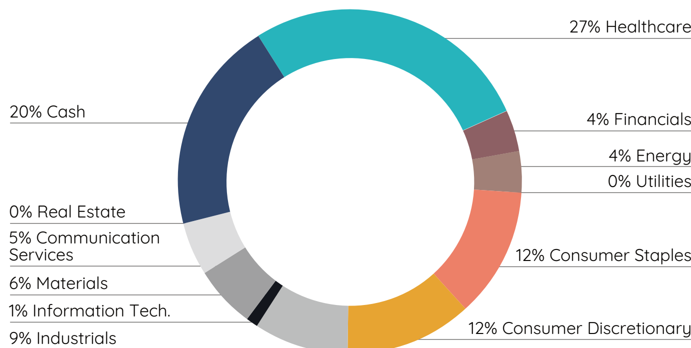
* Weightings include option positions held and cash backing put options. It assumes that put options will be exercised.

Performance at 31 March 2023

Period	Total Return	Average Market Exposure
1 month	3.30%	57%
3 months	5.11%	57%
6 months	9.14%	55%
1 year	13.38%	54%
3 years p.a.	12.39%	54%
5 years p.a.	8.99%	57%
7 years p.a.	9.01%	57%
10 years p.a.	9.71%	58%
Since Inception p.a.	7.65%	61%

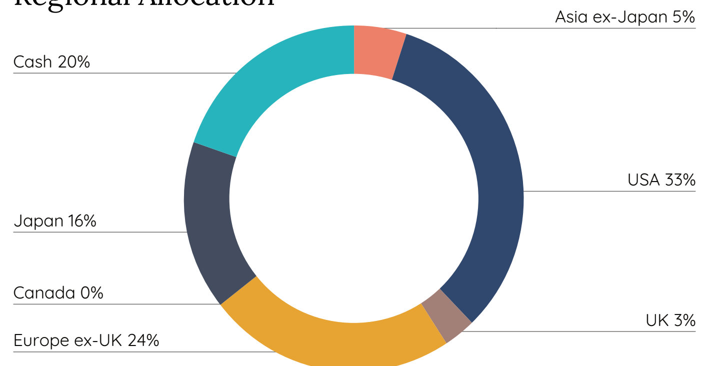
1 Fund Returns are calculated after fees and expenses and assume the reinvestment of distributions
2 Inception date for performance calculations is 18 August 2008
3 Income Return includes realised capital gains
4 Past performance is not a reliable indicator of future performance
5 Average Market Exposure based on delta-adjusted exposure of underlying portfolio

Sector Allocation



* Weightings include option positions held and cash backing put options. It assumes that put options will be exercised.

Regional Allocation



Quarterly distribution

Period	Cents per Units	Reinvestment price
March 2023	5.3700	$5.3080
December 2022	5.1000	$5.1454
September 2022	8.9725	$4.9652
June 2022	14.1354	$5.0013
March 2022	5.5215	$5.0036
December 2021	5.2967	$5.0779
September 2021	6.1245	$5.0000
June 2021	8.8760	$4.9180
March 2021	7.9530	$4.7585

Asset allocation

Asset allocation	% weight
Global equity	54.0%
Cash – put option cover	26.0%
Cash	20.0%
Total	**100.0%**

Portfolio contributors	Portfolio detractors
Femsa	Johnson & Johnson
Alibaba	Roche
Mitsubishi Electric	CF Holdings
Sanofi	NN Group

1 Portfolio contributors and detractors are based on absolute quarterly contributions to return, including option positions

Talaria Global Equity Fund - Foundation Units

Fund snapshot

Management Fee	Nil	**Inception Date**	1 October 2005
Performance Fee	20% - subject to High Watermark	**Liquidity**	Daily
Distributions	Quarterly	**Availability**	Wholesale Clients Only
Minimum Investment	$50,000	**Buy / Sell Spread**	0.20% / 0.20%

Important Information

Foundation Units in the Talaria Global Equity Fund are issued by Australian Unity Funds Management Limited ABN 60 071 497 115, AFS Licence No. 234454. Foundation Units are currently available to what the Corporations Act 2001 (Sections 761GA and 761G) defines as Wholesale Clients. Talaria Asset Management Pty Ltd ABN 67 130 534 342, AFS Licence No, 333732 is the investment manager and distributor of the Fund. References to "we" means Talaria Asset Management Pty Ltd, the investment manager. The information in this document is general information only and is not based on the financial objectives, situation or needs of any particular investor. In deciding whether to acquire, hold or dispose of the product you should obtain a copy of the current Information Memorandum and consider whether the product is appropriate for you. A copy of the Information Memorandum can be obtained by calling Talaria Asset Management on (03) 8676 0667. Investment decisions should not be made upon the basis of the Fund's past performance or distribution rate, or any ratings given by a rating agency, since each of these can vary. In addition, ratings need to be understood in the context of the full report issued by the rating agency itself. The information provided in the document is current at the time of publication.

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