

Annual letter

2023

“History never repeats itself, man always does.”

M. de Voltaire.

@ConserValue
30 December 2023



The year in review.

Closing the second year of the ConserValue account, I am delighted to have the opportunity to write to you again.

I hope you enjoyed a great 2023 and have even better prospects for the year ahead.

Last year proved to be a great continuation to the thoughts expressed in the previous annual letter.

I have had the opportunity to interact with extremely skilful investors worldwide and, most importantly, wonderful people as well.

A special mention is due to the person who has taught me a great deal over the past year, either through direct exchanges of ideas or by sparking my thoughts on a variety of topics: Tristan Waine.

You can find him on X (Twitter) at [@hurdle_rate](#) and on the [HurdleRate](#) website. I confess to being an eager reader of whatever he writes about.

Thanks for inspiring me to become a better investor.

On a personal note, after renting an apartment since moving to the Netherlands in 2019, I decided to start the process of buying a house in the last quarter of the year. This had some impact on the overall NAV of the portfolio, following a shrinkage in size to meet the cash needs.

Market performance.

Notes:

Performance is measured following money-weighted return (MWR) principles. Unless otherwise indicated, performance values are expressed in EUR terms.

The portfolio recorded a gain of 43.4% in fiscal 2023, bringing its performance since inception to 28.4%, or 13.3% in annualised terms.

The S&P500 non-financials (SPXN) returned 24.9% last year and 11.2% since the inception of this account (5.4% annualised). With relative currency headwinds of 5.3%, the value added by the companies in the portfolio versus the indicated benchmark has been 18.6% in 2023 and 17.3% since inception (7.9% per annum).

The table below compares the portfolio's returns with those of the SPXN over the two-year period, including the impact of currency fluctuations.

Despite the satisfactory results achieved so far and how grateful I am for them, I believe a word of caution is in order, as a period of two years is not, in my view, long enough to determine whether an investor has an edge over the broader market. Honestly, I might be able to make a better judgement on this matter when the account has a record of five years or more.

There will inevitably be periods of underperformance in the future, so I can only hope to remain unaffected by Mr. Market's volatility when such times come.

HISTORICAL RETURNS (MWR)

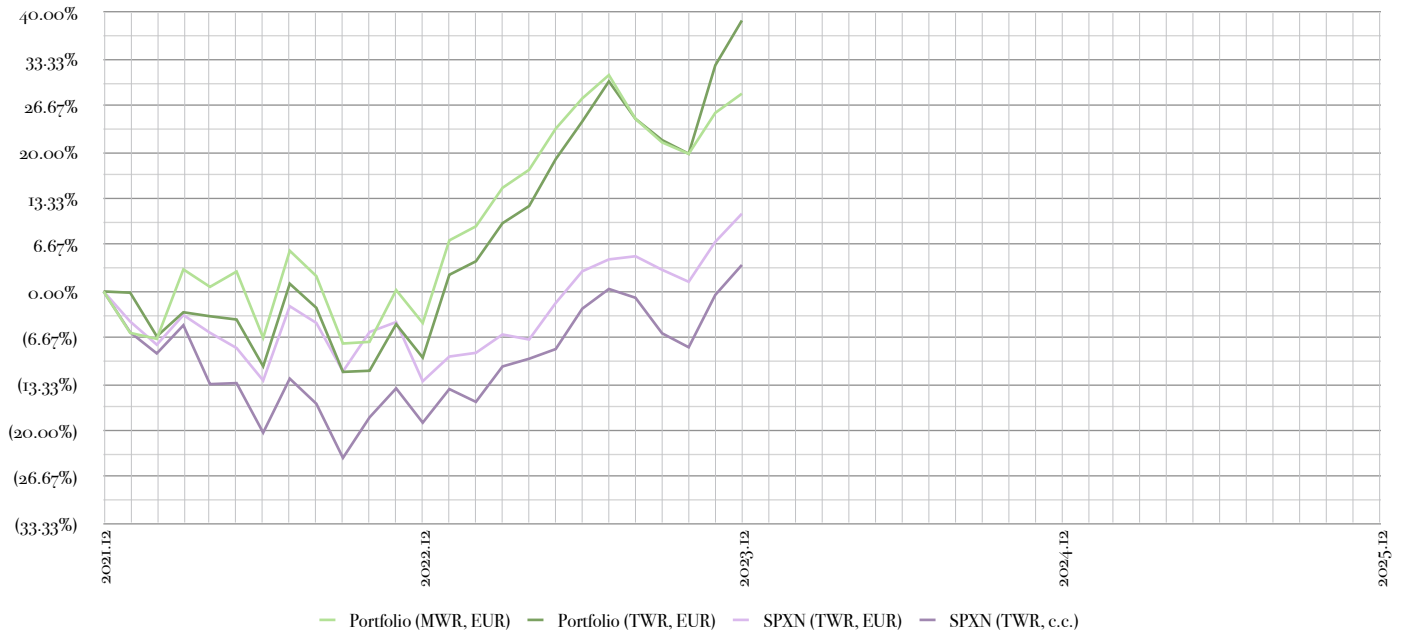
Period	Portfolio	SPXN	Difference	Currency fluctuations		Portfolio	SPXN	Difference
				Portfolio ⁽¹⁾	USD/EUR			
2022	(4.53%)	(12.90%)	8.37%	(1.00%)	6.22%	(3.53%)	(18.85%)	15.32%
2023	43.40%	24.85%	18.55%	0.94%	(2.81%)	42.46%	27.66%	14.80%
Cumulative	28.42%	11.17%	17.25%	(0.25%)	5.04%	28.67%	3.81%	24.86%
Annualised	13.32%	5.44%	7.89%	(0.13%)	2.49%	13.43%	1.89%	11.55%

Green: market performance (incl. dividends), adjusted to EUR.

Yellow: market performance (incl. dividends) without the currency impact.

⁽¹⁾ Weighted impact of holdings' currencies, adjusted to EUR.

Historical market performance



HISTORICAL MARKET PERFORMANCE (MWR)

Period	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2022	(5.95%)	(5.87%)	9.46%	(1.46%)	2.47%	(8.74%)	13.06%	(3.17%)	(9.78%)	(0.06%)	7.89%	(4.87%)	(4.53%)
2023	12.35%	1.54%	5.28%	2.63%	5.69%	4.31%	4.13%	(3.73%)	(2.05%)	(1.65%)	10.67%	4.87%	43.40%
ITD													28.42%
CACR													13.32%

HISTORICAL MARKET PERFORMANCE (TWR)

Period	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2022	(0.18%)	(6.28%)	3.70%	(0.59%)	(0.49%)	(7.00%)	13.29%	(3.42%)	(9.43%)	0.19%	7.56%	(5.04%)	(9.50%)
2023	13.15%	1.89%	5.24%	2.25%	6.00%	4.55%	4.62%	(4.14%)	(2.44%)	(1.61%)	10.60%	4.86%	53.51%
ITD													38.93%
CACR													17.87%

As mentioned in July's "ricapitolare" (monthly update), I believe MWR (money-weighted return) to be the most accurate way to measure my real performance (or that of any private investor) in the equity markets. Notwithstanding this and given the widespread use and relative simplicity of TWR (time-weighted return), this is also included in the chart and in the second of the tables above.

Using TWR principles, returns have been 53.5% in 2023 and 38.9% since inception (or 17.9% annualised), which are greater than those reported via MWR. This is mainly due to the substantial gains made in the last few months of the year, when the dollar amount of the portfolio was roughly two-thirds of its value at the start

of September (a month in which several positions were either exited or reduced to raise cash for a house purchase).

Contributors.

The table below shows the top contributors and detractors to market returns on a weighted basis and converted to EUR over different time frames: last year and inception to date (ITD).

Similarly, the individual contribution of each holding is detailed in the accompanying waterfall charts (page 5).

Other relevant contributors since inception have been Auto Partner and Mader, whose returns during 2023 have been 95.2% and 92.0%, respectively. Since inception, they accumulate gains of 106.3% and 125.1%.

CONTRIBUTORS AND DETRACTORS

	2023	ITD (total return)
Contributors	Meta Platforms (+12.9%)	Mader (+5.6%)
	Mader (+7.1%)	Meta Platforms (+5.1%)
	Auto Partner (+5.0%)	Auto Partner (+3.9%)
Detractors	CentralNic (-0.1%)	Temenos (-0.9%)
	Kelly Partners (-0.4%)	Alphabet (-1.0%)
	Water Intelligence (-2.5%)	Water Intelligence (-1.8%)

The main contributor to market performance last year was Meta Platforms, which accounted for around a third of the total return with a gain of 177.7%.

My view of the company and the turmoil surrounding it was reflected in the 2022 letter:

“[...]”

The market seems to disapprove the increase in capital expenditures, often linking them uniquely to the new segment named Reality Labs (cited in numerous news and articles). This is just not true. Most of these expenses relate to AI R&D data centres, which aim to provide a higher add-targeting value using less personal information. This is, effectively, improving Meta’s core advertising business.

These expenditures are also self imposed. Mark has decided to invest heavily in AI. In combination with the fact that he has almost his entire net worth in Meta Platforms stock, my view is that these expenses can be cut anytime if the outcome is not satisfactory.

[...]”

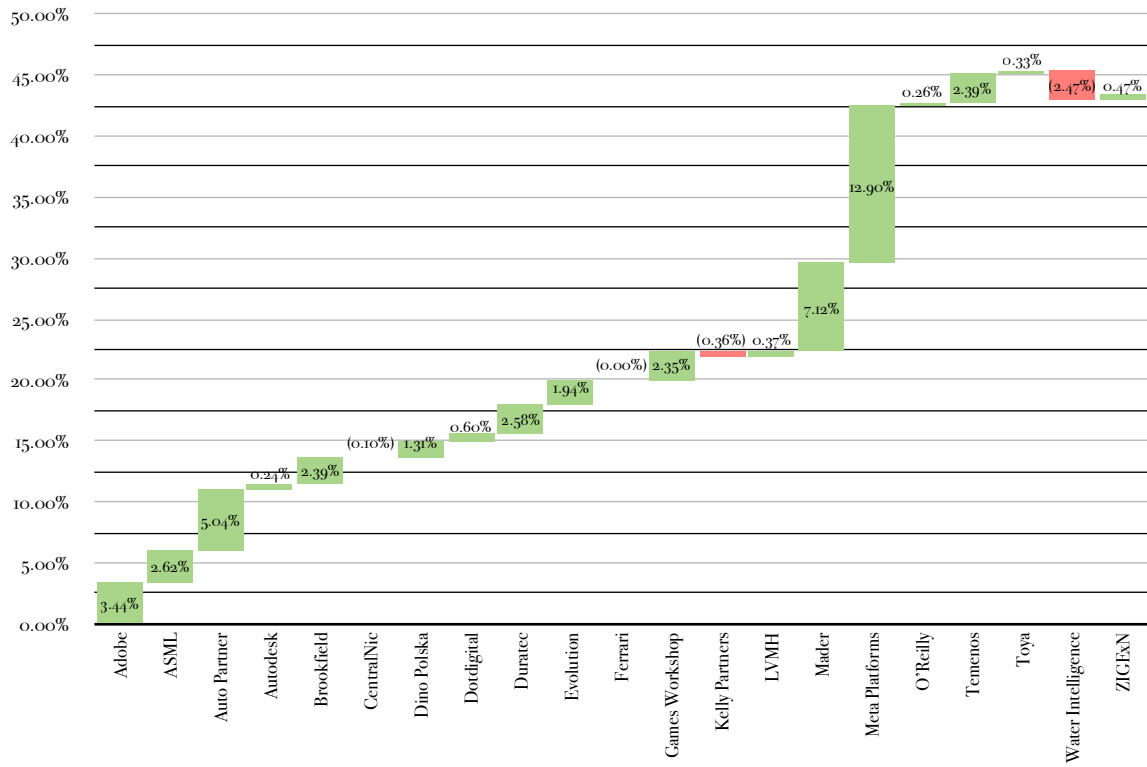
What I certainly did not expect was the announcement a few months later stating that 2023 would be “the year of efficiency” for Meta Platforms (along with a host of cost-cutting measures).

The market reacted aggressively and the stock bounced off its lows of US\$88.0/share, rallying from there and taking its market quotation up 183.8% by the end of the year.

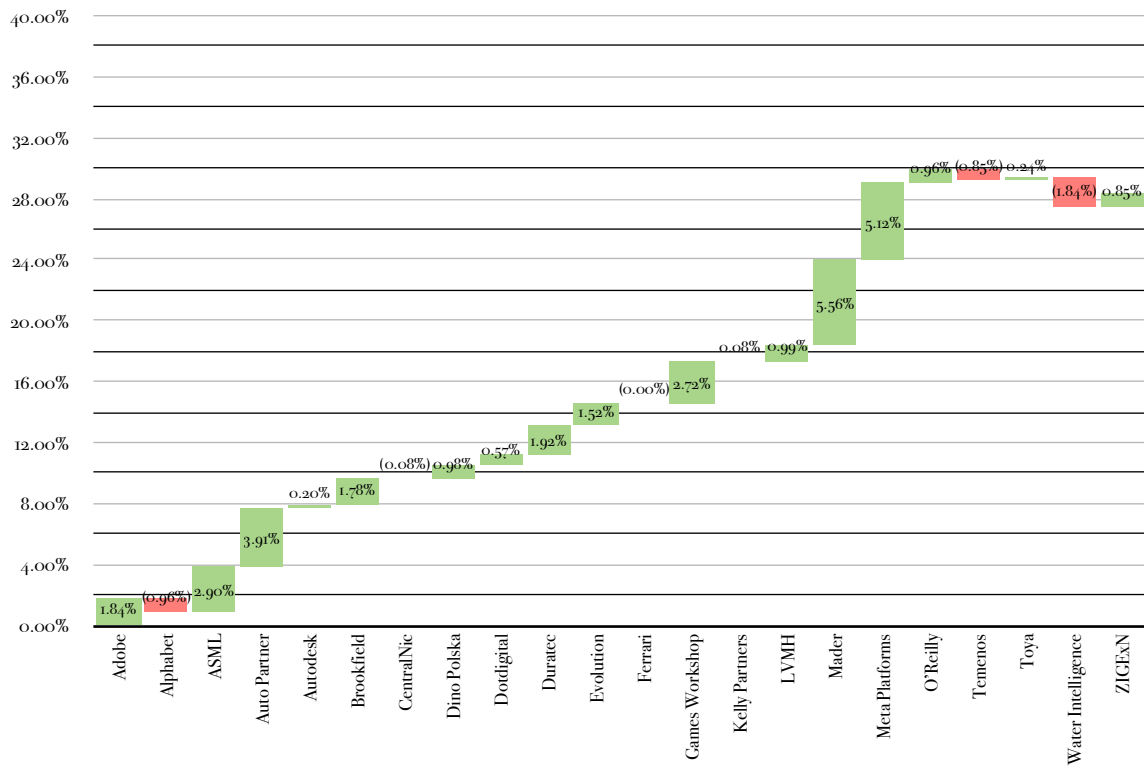
The only significant detractor to market performance last year was Water Intelligence. I do not consider myself a great market timer (nor do I pretend to be one) and, at the risk of being wrong, my belief in the potential that Patrick has within the company to continue to expand margins through selective franchise reacquisitions and the exploitation of the corporate insurance channel in the U.S. remains strong.

The unrealised loss in Water Intelligence is 42.7%, which equates a cumulative negative contribution to the overall performance of 1.8%.

Contributors. 2023



Contributors. ITD (cumulative)



Owner's earnings.

I do not see stocks as a trading vehicle, but as what they truly are: fractional ownership in real companies. I then feel a responsibility to behave as an owner of the firms I invest in. From this perspective, it seems natural to study their underlying economics, the growth and quality of their earnings and their long-term prospects.

As in the previous year, the table below shows the weighted growth in the intrinsic value of the holdings and how it compares to their market performance.

Such an approach aims to resemble the idea created by Warren Buffet and its flawless application by François Rochon at Giverny Capital: the owner's earnings.

Taking into account the transactions made throughout the year, the aggregated increase in owner's earnings in 2023 was approximately 35.6%. Over the last two years, our companies have grown their intrinsic value by a cumulative 48.0%, or 21.7% annually.

The SPXN benchmark is estimated to have increased its intrinsic value by 22.8% (10.8% per annum) over the same two-year period.

Despite the challenging environment resulting from a continuation of the quantitative tightening policies adopted both in the U.S. and the Eurozone over the last two years, most of our holdings have continued to perform pleasingly.

For a company enjoying a superior return on the capital deployed on its ongoing economic activity, having the opportunity to utilise "unrestricted" profits for growth at similar rates over sufficiently long periods of time is what enables compounding at a corporate level.

I cannot emphasise this enough. As investors, if we want to enjoy the marvels of compounding, we should aim to find companies with the ability to reinvest excess profits at rates above their cost of capital (the larger the spread, the better) over long periods of time.

Durability is to compounding as water is to life.

Market returns stem from two distinct sources: things which are under the investor's control and things which are not.

The former group accounts for the increase in earnings power (in per-share terms) of the underlying business plus cash distributions, while the second one relates to the changes in market sentiment (multiples of earnings and currency fluctuations).

Over short periods of time (one to three years), market-sentiment changes tend to contribute with most of the overall performance of publicly traded securities but, over the longer term, these fluctuations cancel out each other and reveal one of the most important underlying truths about market returns: the total performance follows (almost in a magical way) the increases in economic profits per share plus dividends collected along the process.

This is why, in my view, we as investors should focus mostly on the things over which we have at least some degree of control.

This does not mean that we should ignore the price being paid, as overbidding for a great company could lead to a permanent depression of the starting multiple, making the market-sentiment component a significant brake in future returns or, even worse, materialising as a permanent loss of capital.

OWNER'S EARNINGS GROWTH

Period	Portfolio			SPXN		
	Intrinsic value ⁽¹⁾	Market ⁽²⁾	Difference	Intrinsic value ⁽¹⁾	Market ⁽²⁾	Difference
2022	9.12%	(9.50%)	(18.62%)	10.39%	(18.85%)	(29.24%)
2023	35.66%	53.51%	17.85%	11.26%	27.66%	16.40%
Cumulative	48.04%	38.93%	(9.11%)	22.82%	3.81%	(19.01%)
Annualised	21.67%	17.87%		10.82%	1.89%	

⁽¹⁾ Owner's earnings growth, measured as EPS increase plus cash distributions.

⁽²⁾ Market performance (TWR), inclusive of dividends.

In a similar fashion, the following table is included to present the individual increases in intrinsic value of the companies in portfolio and how these compare to their market performance over time.

Note that data is only tracked as of the year when the security becomes a holding.

To provide a proper comparison between the estimated growth in intrinsic value and the gain in market returns of each company, the performance has been adjusted for the timing of contributions, meaning that the actual returns earned on these securities do not necessarily match the returns shown below. This is specially true on the year that a company enters the portfolio or when substantial contributions take place.

The main purpose of the table below is to show graphically that, although the increase in a company's intrinsic value over a single year is rarely the same as its stock market performance, over longer periods (five years or more) these two elements tend to converge.

Among our holdings, some of the most striking spreads can be found in ASML and in Evolution. Although their intrinsic values are 40.5% and 90.0% higher than two years ago, their prices have barely moved, making them 28.8% and 47.4% cheaper (or less expensive).

The opposite phenomena is observed in companies like Auto Partner, Duratec, Mader and ZIGExN. While the underlying businesses have performed phenomenally over the past two years, the market has overshot their valuations on a relative basis.

OWNER'S EARNINGS GROWTH (INDIVIDUAL)

		Cumulative	Annualised	Period	
Company				2023	2022
ASML	Intrinsic value ⁽¹⁾	40.51%	18.54%	39.80%	0.51%
	Market ⁽²⁾	0.24%	0.12%	24.92%	(19.76%)
Auto Partner	Intrinsic value ⁽¹⁾	31.76%	14.79%	13.69%	15.90%
	Market ⁽²⁾	85.84%	36.32%	80.37%	3.03%
Brookfield	Intrinsic value ⁽¹⁾	3.86%	3.86%	3.86%	
	Market ⁽²⁾	0.53%	0.53%	0.53%	
Dino Polska	Intrinsic value ⁽¹⁾	36.56%	36.56%	36.56%	
	Market ⁽²⁾	23.88%	23.88%	23.88%	
Duratec	Intrinsic value ⁽¹⁾	148.77%	148.77%	148.77%	
	Market ⁽²⁾	157.03%	157.03%	157.03%	
Evolution	Intrinsic value ⁽¹⁾	90.04%	37.85%	31.01%	45.05%
	Market ⁽²⁾	(3.97%)	(2.00%)	12.29%	(14.48%)
Ferrari	Intrinsic value ⁽¹⁾	29.23%	29.23%	29.23%	
	Market ⁽²⁾	44.39%	44.39%	44.39%	
Mader	Intrinsic value ⁽¹⁾	93.62%	39.15%	34.02%	44.47%
	Market ⁽²⁾	185.20%	68.88%	88.31%	51.45%
O'Reilly	Intrinsic value ⁽¹⁾	22.28%	10.58%	15.98%	5.43%
	Market ⁽²⁾	40.09%	18.36%	14.17%	22.70%
Water Intelligence	Intrinsic value ⁽¹⁾	7.09%	7.09%	7.09%	
	Market ⁽²⁾	(37.02%)	(37.02%)	(37.02%)	
ZIGExN	Intrinsic value ⁽¹⁾	69.35%	30.14%	44.76%	16.99%
	Market ⁽²⁾	122.75%	49.25%	44.81%	53.82%

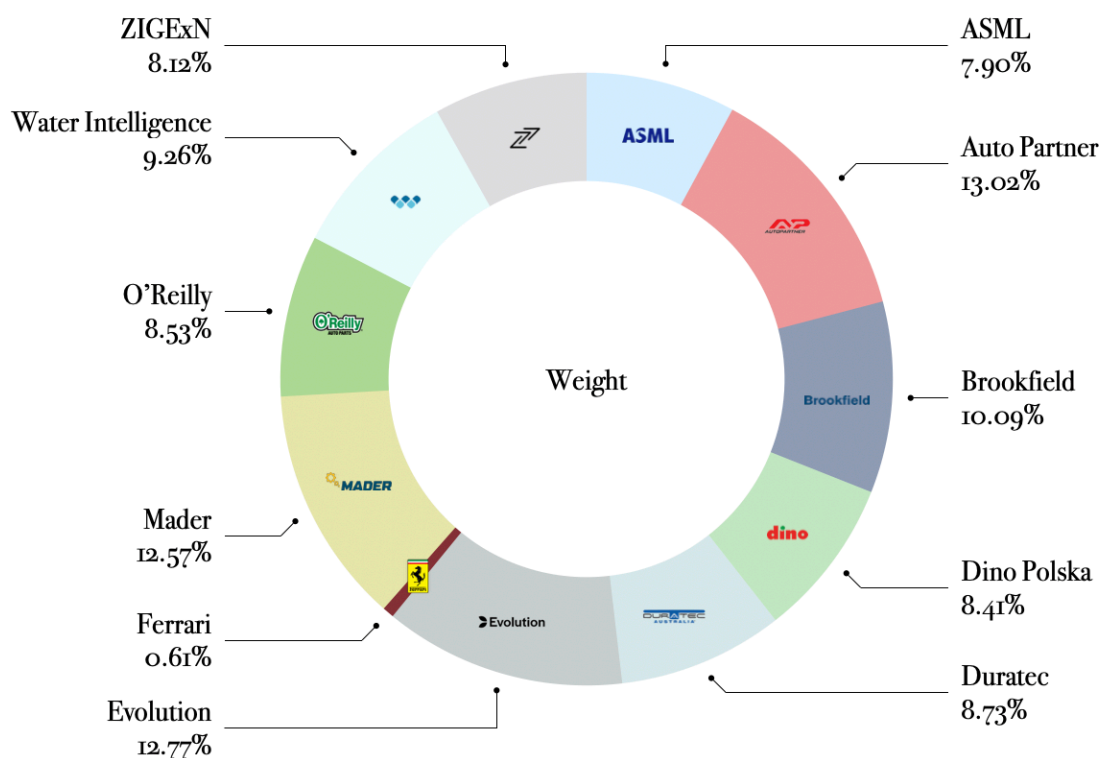
⁽¹⁾ Owner's earnings growth, measured as EPS increase plus cash distributions.

⁽²⁾ Market performance, inclusive of dividends and at constant currency.

Holdings.

Most of our holdings increased their earnings in 2023 in a satisfactory manner, especially given the uncertain economic environment.

ASML is one of those rare companies with a unique set of characteristics that enable it to generate extremely attractive returns on the capital that is deployed in its operations.



ASML. ASML

It will soon be my fifth year as an ASML engineer. In the early months of 2019, I was given the opportunity to join the company and, even though it meant moving abroad and starting a new life in the North Brabant region (Southern part of the Netherlands), today I feel fortunate to say, with the benefit of hindsight, that it was a great decision. Realising the extreme-ultraviolet (EUV) patterning process with such a talented team of colleagues has been both a challenge and an invaluable experience for which I will always be grateful.

The Dutch manufacturer of photolithography machines grew revenues by 27.1% and EPS by 35.9% last year while its order backlog shrank by 9.8%. Even though semiconductors are a commodity-like product, eventual slowdowns in customer spending are less likely to affect those businesses in the industry that enjoy a significant spread between supply and demand for their goods and services.

High-ROIC enterprises justify a higher price for each dollar of their economic profit than low-ROIC ones. The reason lays on their ability to sustain similar growth rates than the latter group while retaining a greater proportion of their distributable earnings.

In fiscal 2023, ASML generated a net operating profit after tax of €8,078.2M (a 32.3% increase compared to the previous year) on €11,658.8M of invested capital (including intangibles), effectively earning an ROIC of 69.3%.

To achieve this growth, the company had to reinvest roughly 40.0% of its fiscal 2022's economic profit, leaving the remaining 60.0% left for distribution to shareholders.

ASML gave €2,318.7M back in the form of dividends and €1,262.6M through share repurchases (equating a share count decrease of 1.2% after adjusting for stock-based compensation programs).

Regarding total shareholder return, ASML did not increase shareholder value during fiscal 2023 by the aforementioned 32.3% but by 24.9%, of which 39.8% came from underlying business performance (growth in economic profit plus distributions) and the remaining detraction of 14.9% from market-sentiment fluctuations (contraction of the earnings multiple).

Although the valuation seems rich at a first glance (36.5 times its fiscal 2023's earnings), the Gordon Growth Model suggests that a fair multiple on earnings for a company with the characteristics of ASML could be closer to 35.0 times.

Contrary to popular belief, ASML's value proposition is not just enabling the highest resolution available in the market during light exposure (i.e. highest transistor density), but doing so while offering compelling levels of throughput and system availability.

Without the latter two you are left with a very expensive hardware which makes you lose (a lot of) money when powered on.

Bringing EUV capabilities to chip production has widened the company's moat significantly.

The knowledge required to operate EUV machines is difficult and time-consuming to acquire and extremely scarce, so a future non-incumbent EUV player would not only need to succeed in generating EUV light in a controlled environment (a titanic challenge by itself that would require investments measured in the tens of billions of dollars spanning over multiple decades), but also to outcompete ASML in machine's availability, meeting volume requirements at the clients' facilities, flexibility in operations, energy consumption, price, maintenance expertise and the creation of relationships with the few meaningful clients in the industry (namely Global Foundries, Intel, Micron Technology, Samsung, SK Hynix or TSMC), as well as other critical stakeholders that intervene in the production chain.

And even then, each cubic meter of cleanroom space at the customer's fabs is extremely valuable (high fixed costs), maybe too valuable to spend it in "trying out" or "playing with" other products whose future viability and contribution to the client's bottom line is doubtful.

In the final months of the year, the company announced flat (no growth) guidance for fiscal 2024 as the order book replenishes.

I came across some comments suggesting that EUV technology may never grow its current market share, or even announcing the death of Moore's law. This is not the first time this happens since the invention of the transistor in 1947. On several occasions, Moore's law was thought to have come to a permanent halt. The good news is that, on average, we did not need to wait long (only about two years) to discover the accuracy of such predictions.

At the risk of being biased, I can only feel enthusiastic about the ongoing developments and the years ahead for the company.

Auto Partner.

Our Polish distributor of aftermarket parts for light-weight vehicles had a great year, growing revenues by 32.8% and EPS by 21.4% during the twelve-month period ending in September 2023.

I estimate EPS to come around PLN1.8 for the entire fiscal 2023 (up from PLN1.5 the previous year).

The group continued to earn a more-than-attractive return on its invested capital for the industry (26.1%), employing almost its entire fiscal 2022's economic profit to fund working capital.

Aside from these investments, shareholders received c.10.0% of the excess earnings as dividends (a yield close to 1.1%).

Trading at 15.2 times its estimated fiscal 2023's profits, there continues to be, in my opinion, ample room for attractive returns moving forward.

Brookfield.

After spinning out a quarter of its third-party asset management business (BAM) at the end of fiscal 2022, Brookfield Corporation (parent) started trading under the ticker BN in both the Toronto and the New York stock exchanges.

I looked into Brookfield for a few months (getting one's head around its capital structure is no easy task) and I was appealed by the company's culture and Bruce Flatt's disciplined approach to investing.

The more I read about him and his ability to stay calm when others panic (the lack of what François Rochon refers to as the "tribal gene"), the more interested I became in partnering with him. A position in the parent company was initiated in the second quarter of the year at around US\$32.0/share.

While Brookfield Asset Management is a wonderful business (light in capital requirements), the valuation of the parent entity seemed more compelling at the time.

During fiscal 2023 and adjusting for the distribution of its asset-management vertical, Brookfield increased its distributable earnings per share to US\$3.2 from the US\$2.9 figure in fiscal 2022 (10.3% growth).

This was achieved through a contribution of the three main segments: asset management, reinsurance and its four operating businesses (energy, infrastructure, real estate and private equity), with none of them lacking behind.

Since the early months of 2022 when central banks in both the U.S. and the Eurozone shifted to stricter

monetary policies, Brookfield's stock has experienced a drawdown of 16.7% from its US\$48.0/share highs. In the meantime, the company's distributable profits before realisations (i.e. excluding gains from the disposition of assets) have increased by 67.1%.

While it is true that the new interest-rate environment bears a higher cost of capital and may diminish the fair value of Brookfield's underlying assets over the short term, most of the company's liabilities represent non-recourse debt and the group's assets are placed at the core of the global economic activity, so both their cash flows and market value should prove to be resilient over the coming years.

Dino Polska. **dino**

One of the latest acquisitions is Dino Polska, a leading supermarket retail chain of mid-sized stores in Poland which is expanding at a pace of three to four hundred new locations every year.

The company puts a special focus on commercialising branded products at attractive prices. This is reflected on the strategy outlined since the final months of fiscal 2021 when inflation began spiking throughout Poland.

Instead of translating the cost increases in full to its customers like most of its industry peers, Dino opted for smoothing the impact on its clients by introducing several promotions across its product portfolio.

In turn and at the expense of lowering its returns on sales, the company achieved a greater growth in same-store-sales and customer traffic, fostering the pace of market capture. The result: while year-over-year inflation in Poland reached 17.3% at the end of fiscal 2022, Dino's stores experienced a like-for-like growth of 28.9%.

These greater volumes, coupled with the company's effectiveness in controlling costs enabled it to benefit from economies of scale in the form of more favourable terms with suppliers and thus in offsetting part of the decrease in profitability caused by the decision to absorb a portion of the price spikes. This has continued throughout fiscal 2023 as inflation in Poland remains at 9.7%.

To put the reasoning above in numbers, the average Dino store generated PLN10.6M in sales during the twelve months ending in September 2023, compared to PLN8.7M a year before and PLN6.9M in fiscal 2020 (when Polish inflation data came around 2.8%). What is even more impressive, the group's profitability at the operating level was only reduced from 8.4% to around 7.4% in the meantime.

Arguably, one of the most sustainable ways to increase the scale of a business is by achieving what Charles G. Koch, CEO at Koch Industries, refers to as "good profit" (i.e. generating economic profit by benefitting customers and society as a whole).

While there are other bigger players in the industry such as Eurocash, Jerónimo Martins or Lidl, scale by itself does not necessarily materialise as a source of competitive advantages.

Typically, scale is most effective in sectors where a high portion of the total expenses is fixed (such is the case of Dino's industry) so these can be diluted over a greater number of customers. There is a nuance to this though, as scale only poses an upper hand in those scenarios where it can be considered local.

What does this mean for the supermarket industry?

Let's suppose we have an incumbent supermarket retailer dominating a particular market and a smaller, non-incumbent player that wants to disrupt the sector.

At a first glance we would be inclined to think that the non-incumbent company does not have any chance. We may reason that, all things being equal, the leader would not find many difficulties in driving its smaller peer to bankruptcy by lowering prices in the area where the latter is opening new stores. But there is a detail we would be taking for granted in such thought process, and that is the fact that the size of the incumbent company puts it in some sort of advantageous position. That is not necessarily true. It is not the total size of the business as a whole, but the size of the sales generated in that particular geographic region that favours it over the non-incumbent player.

This detail changes the dynamics of the game subtly and leaves an open door to competition in those urban areas where the leader has no presence or where its store concentration (local scale) is lower.

There are several examples of such disruptions across history: from Walmart in the U.S. to Mercadona in Spain, they both became behemoths in industries that were once believed to be tightly consolidated.

For the twelve months ended in September 2023, Dino increased revenues by 28.1% and EPS by 25.0%, ending with a total of 2,340 locations throughout the country.

From the PLN485.0/share highs at the beginning of the summer, Dino's market quotation experienced a correction and by October the company was available at around PLN355.0/share (a 26.8% drawdown). Having generated earnings per share of PLN13.6 for the previous twelve months, I roughly paid 26.1 times statutory profits or a PEG of 1.1.

Although definitely pricey, I was probably biased not to repeat the same mistake as with Fair Isaac a year before (more in the last section of this letter).

Dino happens to be, in my view, a company of superior quality with attractive reinvestment opportunities at above-average rates (historical ROIC of around 35.0%) and with its founder (and owner of 51.2% of the shares outstanding: Tomasz Biernacki) still present in the day-to-day operations.

The other recent addition to the portfolio is Duratec, an engineering contractor offering construction and remediation services for infrastructure in different sectors (defence, mining and industrial, buildings and façades, energy-related and marine assets) across the Australian and New Zealand markets.

Duratec's approach to business is not purely driven by volumes but by fostering the creation of sustainable relationships that may last for years with any customer. This often means not tendering for certain projects if their profitability prospects or expected returns are not sufficiently attractive -at the expense of giving away some top-line work. In turn, this disciplined approach is rewarded by a recurrent and growing client base that trusts Duratec as a reliable partner.

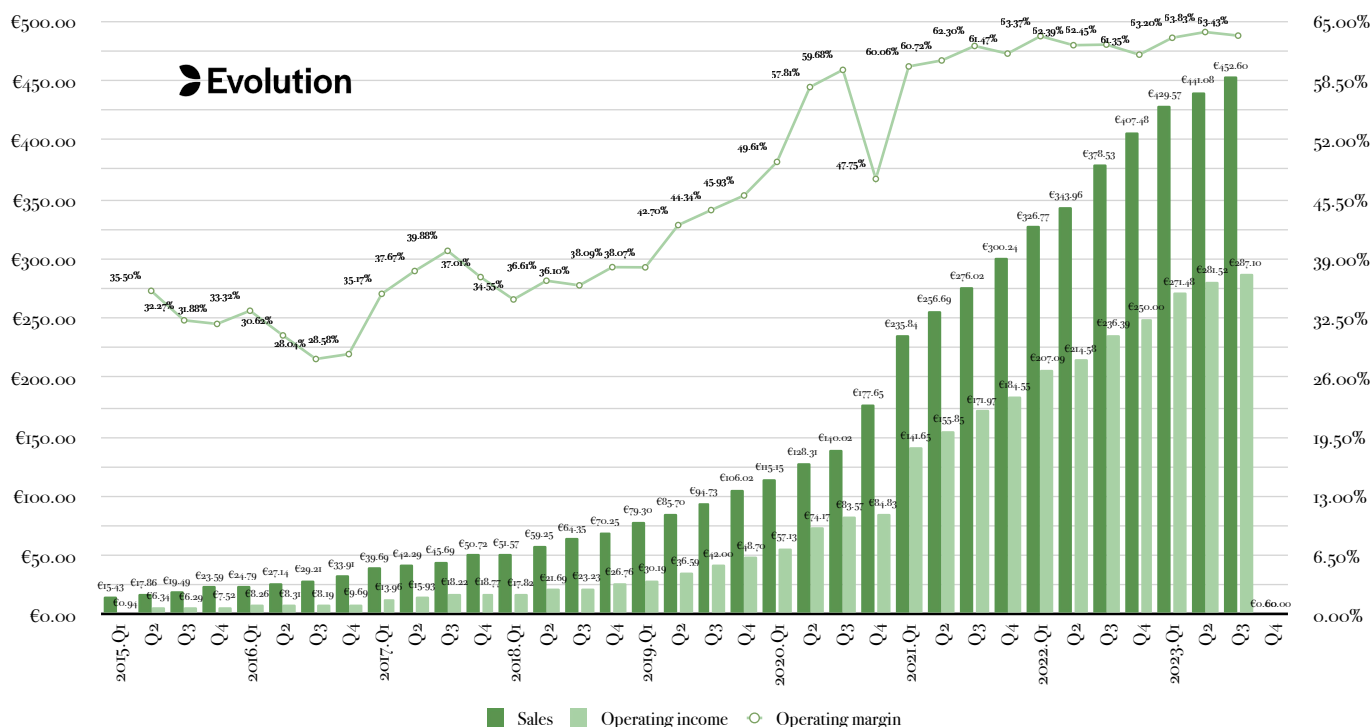
Over the past 14 years, Duratec's sales have increased at an annualised pace of around 34.0%. Specifically, in fiscal 2023 the group grew its revenues by 58.6% and its EPS by 142.0%, undertaking a total of 1,944 projects and ending the period with a healthy order backlog of A\$458.2M.

Evolution continued to execute pleasingly last year across all geographies -especially via its Live segment-, increasing revenues by 19.6% and EPS by 23.8% while returning €427.4M in dividends to shareholders (2.3% yield).

Operating margins increased to 63.4% in fiscal 2023 from 62.3% the previous year. To provide a better picture of the operating leverage at play in Evolution's activities, EBIT profitability was "just" 27.6% in fiscal 2015.

This ability to increase profits at a faster pace than sales derives from the scalability of Evolution's business model: personnel wages of game presenters become a fixed cost since, aside from a few traditional offerings (such as Live Blackjack) that only allow a given number of users to play simultaneously, most of its games are designed to host a virtually limitless amount of users at any point in time. As a consequence, revenues per Live table have more than doubled from €0.4M in fiscal 2016 to €0.9M in fiscal 2022.

Since its IPO in March 2015, Evolution has increased its market quotation by an impressive 6,478.0% without considering dividends (almost sixty-six times in just 8 years!). That is a 63.9% return per annum. It should not come as a surprise to know that EPS have increased in a similar fashion, starting shy of €0.1 in fiscal 2014 and ending fiscal 2023 with €4.6 (sixty-three fold). Few companies across the globe can afford to present quarterly performance charts like the one below:



The overseas expansion in the U.S. (initiated in fiscal 2019) and more recently in Canada have proven to be an exceptional decision in recent years.

Although still small, Mader is the biggest enterprise in its niche worldwide and has no real comparable (aside from segmental operations in a handful of companies), so the potential for capturing market share is, in my opinion, immense.

The company has grown its EPS at 25.0% compounded annually since it was founded by Luke Mader back in 2005.

The group started its operations in Canada in the second half of fiscal 2022 as part of its international expansion plans. The first twelve months in this new market have set great prospects and point to replicate the behaviour being experienced by its U.S. segment.

The second half of fiscal 2023 and the first half of fiscal 2024 (Mader's fiscal year ends, consistent with the Australian tradition, the last day of June) constitute another great period for the company, delivering an increase in revenues of 51.3% and in EPS of 41.6% over the previous twelve months.

Although Australia (its core geography) accounts for most of the turnover (78.1% in fiscal 2023), the U.S. and Canadian markets grew sales by 197.9% during the year and now have a combined weight on total revenues of 20.4%. Quite remarkable considering that (a) the sales in the Australian territory are still increasing by around 30.0% p.a. and (b) Mader only entered the U.S. and Canada within the last three years.

Our leading automotive parts distributor in North and Central America (together with AutoZone) grew sales by 10.7% in fiscal 2023 and, after repurchasing 5.1% of the shares outstanding throughout the period, EPS by 17.0%.

O'Reilly is one of the primary examples of what is often referred to as "stock cannibalism".

Starting with a total of 142.0M shares in fiscal 2010, the company has reduced this number to 60.6M units by the end of fiscal 2023: a shrinkage of 57.3%.

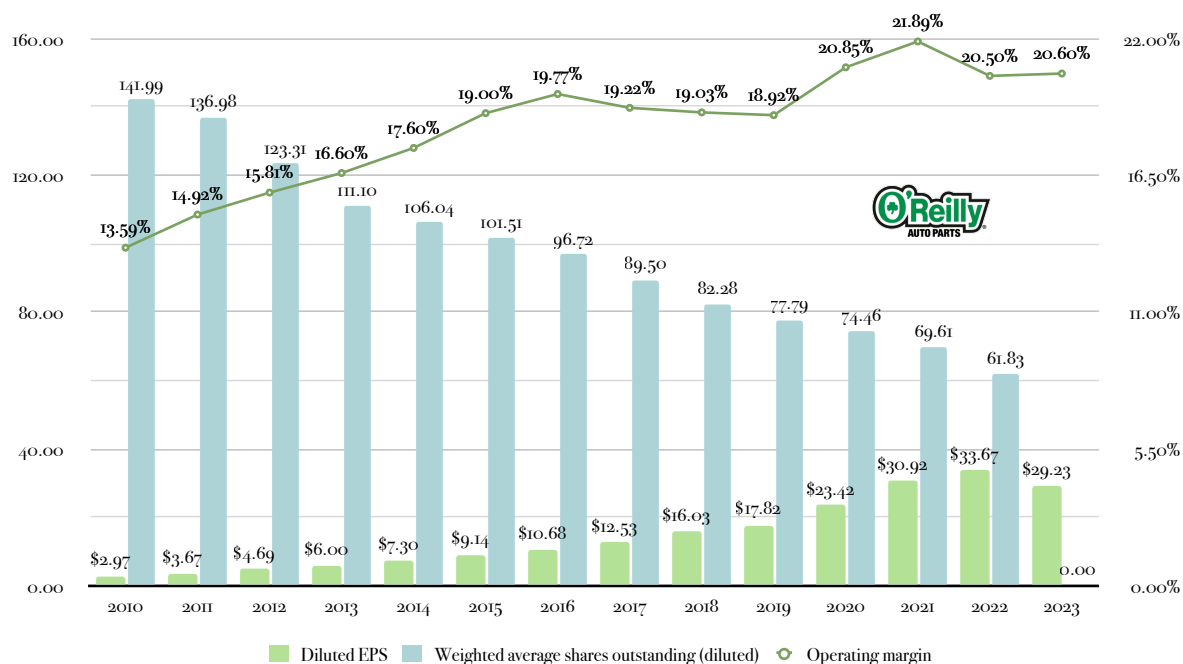
The power of share buybacks lays in their inverse relationship with per-share metrics. In other words, to keep up with a share-count reduction of 57.3% profits per share have to increase by 134.2% -everything else being equal.

For the past thirteen years, O'Reilly has generated shareholder value at an annual pace of 6.8% solely due to its cannibalistic approach to capital allocation.

Furthermore, the company has grown sales at 8.5% per year during the same period and has managed to derive another 5.1% annually from profitability improvements. Combining these three engines (revenue growth, share repurchases and margin expansion) we arrive at the compounded figure of 21.7% that has enabled O'Reilly to increase its EPS from just under US\$3.0 in fiscal 2010 to US\$37.8 last year.

As we should expect, shareholders have been rewarded in a similar fashion: the person who bought O'Reilly's shares in 2010 and held onto them until present days enjoyed a 1,528.0% return, or an annualised 24.3%.

The chart below shows how share count, EPS and EBIT margins have evolved since fiscal 2010:



Water Intelligence.

The parent company of American Leak Detection (in the U.S.) and Water Intelligence International (in Australia and the United Kingdom) went through a margin contraction at its operating level recently due to the combined effect of the investments made in a Salesforce automation software and in the training of new technicians who are not revenue-generative for the group yet.

For the past years, the group has dispatched jobs and generated reports “manually”, leaving ample room for productivity enhancements.

The implementation of a Salesforce automation system within the organisation (expected to be completed in the first half of fiscal 2024) should improve efficiencies in how Water Intelligence handles its relationships with customers and increase the pace of market capture.

In my view, Patrick DeSouza is a great CEO and an honest individual with sophisticated capital-allocation abilities.

After stepping into the company as executive director in 2010 following the merger with Qconnectis, he took good notice of the hidden potential that the franchising segment has within American Leak Detection.

He promptly drew a strategy based on organic growth combined with an opportunistic M&A approach that has a special focus on its own franchising locations. For every franchise that is converted into a corporate store, operating profitability to the group increases nine fold. Over the last five years, American Leak Detection has reacquired 22 franchising stores (out of a total of 105) and, quite remarkably, the franchising revenues are still higher today! This is not due to an increase in the royalty fee charged to franchisees (it has remained constant around 6.5% of sales volume) but a like-for-like growth of 10.1% per year.

In the second half of fiscal 2022 and the first half of fiscal 2023, each franchising location generated £1.3M in gross sales compared to £0.8M in fiscal 2018. That says something about the organic performance of the brand.

Those 22 stores (now directly operated by American Leak Detection) effectively add to the group’s bottom line the equivalent of 198 franchising locations (about £4.4M before taxes, instead of £0.5M had they not been reacquired).

I estimate that around £105.7M out of the £155.1M of the group’s network-wide sales are currently generated by franchisees. If roughly right, this would mean that Water Intelligence could unlock up to £15.3M in additional annual pre-tax income without growing the size of its system-wide sales in the event that it would turn every franchising store into a corporate location.

To put this number in context, pre-tax income over the past twelve months has been £6.2M and the company’s market capitalisation is, as of this writing, £76.5M.

It is difficult not to be pleased with the way Patrick runs the business.

Much of the North American’s potable and wastewater systems were built in the 1970s and 1980s.

The need for investment in water infrastructure across the U.S. is at an unprecedented level. With the average age of water mains at 45 years, it is estimated that 14.0% to 18.0% of total daily treated potable water is lost through leaks -and up to 60.0% in some systems.⁽¹⁾

The longer these replacements are delayed, the older and less efficient the installed materials become, so the required maintenance expenditure continues to grow both in absolute terms and in frequency. With such tailwinds, it is reasonable to expect companies like Water Intelligence to benefit even more in future years.

In the period comprising the second half of fiscal 2022 and the first half of fiscal 2023, the company increased revenues by 13.8% and EPS by 7.1%.

The market tends to dislike short-term results that do not look all that shiny even when these follow rational actions that further increase shareholder value over the longer term.

This inability to delay gratification, combined with the “flavour of the day” in the markets (i.e. staying as far as possible from small capitalisation companies) and with the negative sentiment towards the United Kingdom and the companies trading in the LSE, has created the perfect storm surrounding Water Intelligence.

ZIGExN.

Our search-aggregation roll-up business resumed its growth trend as the Japanese economy reopened during last year, increasing sales by 33.0% and EPS by 43.5% in the twelve-month period ending in October 2023.

Notwithstanding such an impressive performance and the corresponding reward by the market (returns over the same period were 42.4%), the truth is that we did not enjoy any of these, as ZIGExN was not a holding between January and late November.

I consider this mistake to be the most visible one last year and an equally good teacher, so I have attempted to cover it in detail in the following section.

⁽¹⁾ Water efficiency for water suppliers. U.S. Environmental Protection Agency.

Mistakes “de la giornata”.

“Mistakes are the usual bridge between inexperience and wisdom.”

Phyllis Theroux.

Revisiting some of my (many) mistakes may result in a painful experience at first, but I have come to discover that if we manage to leave the emotional load aside, it can reward us with insights and, hopefully, the virtue of not repeating them.

CentralNic (Team Internet Group).

CentralNic (recently rebranded as Team Internet) is a British company operating in the online marketing space across two different segments: a provider of top-level domains (the group refers to this vertical as Online Presence); and a pure online advertising play, where it places adds in web browsers and social media on behalf of its customers for which both fixed and variable fees are collected based on the success of such marketing campaigns.

I was attracted by the underlying economics at play in its Online Presence segment, where the customer just cannot outrightly purchase a domain name but is forced to rent it through upfront payments that are collected on an annual basis. In plain English, Team Internet’s business in this niche is quite similar to VeriSign’s operations involving the .com, .net or .name top-level domains (TLDs), but with other TLDs for which Team Internet is designated as the official registry by the Internet Corporation for Assigned Names and Numbers (ICANN) -the industry’s regulator.

Due to sector requirements there can only be a single registry for any given domain extension, and in all fairness I consider Team Internet to be the industry leader of the so-called new generic top-level domains (ngTLDs), which are being rolled out since late 2013 (the most successful one of them being .xyz).

If the reader feels skeptical about the commercial viability and prospects of these ngTLDs (so did I before studying the sector), I would like to extend an invitation to visit Alphabet’s website (Google’s parent company). You may discover that it contains a strange extension at the end of the URL.

After initiating a small position in March, the company started over promoting the use of artificial intelligence in their activities. This added to the main concern I had at the time (management’s commitment to creation of shareholder value) and the position was terminated just a month later. A trade I am not overly proud of.

The experience taught me not to decide prematurely and to let management prove whether they are on the same boat as shareholders. Interestingly enough they removed the term AI from the description of their

operations just a couple of months later, but I did not enjoy the attempt to gain interest from investors by chasing trends so I have kept myself on the sidelines ever since.

Fair Isaac. FICO

I do not believe Fair Isaac Corporation to need much of an introduction. Its rating algorithms are to the U.S. credit-risk industry what Coca-Cola is to sodas, the .pdf extension to documents or Google to the search-engine space.

I originally became familiar with Fair Isaac’s operations and its FICO score in 2021 and have followed the company since, so when it fell from US\$515.0/share to US\$400.0/share in the summer of 2022 I considered investing.

The business had grown EPS by 62.6% in the previous twelve months to US\$15.2/share (implying a price of US\$26.3 for each dollar of profit). Furthermore, the company had just started repurchasing c.US\$300.0M of stock in the first quarter of the year, suggesting that -in management’s view- the shares were trading at a discount to intrinsic value.

I decided to wait for it to fall a bit more as I considered that a PER of 26.3 times was too pricey.

It was not long after when the stock started recovering and I was left watching it slip away.

Today (eighteen months later), Fair Isaac trades at US\$1,164.0/share and even if it does not show up in the statements, this is one of those omission mistakes that end up being indeed very costly.

We could have realised a 191.0% return in less than two years should my mind not be so blurry.

ZIGExN.

If my mistakes were in a competition, ZIGExN would get the gold medal and be the employee of the month for a year straight.

ZIGExN is a Japanese aggregator whose main purpose is to bring together two parties with a common interest. The company does this through various digital platforms that cover different segments: job portals for specific sectors, life service platforms and websites for renting and buying real estate.

Think LinkedIn (albeit without the social networking component): companies looking for people who meet certain criteria can post their vacancies and, in turn, potential employees interested in the jobs may apply.

The catch is that Microsoft charges companies a fix fee for allowing them to post their vacancies on its platform and other variable commissions depending on the type of services contracted by their professional recruiters.

ZIGExN's job platforms are the go-to (the "LinkedIn") sites in Japan when looking for a job in these particular niches.

Being the operator of the leading platform in this kind of environment is such an advantage. If we think about it, network effects play a huge role in the dynamics of the industry.

Where do companies want to post their vacancies? In those places where candidates abound. And where do employees look for new challenges? Where most opportunities are available.

This creates a feedback loop in which more users (employees) attract more customers (advertisers) to post their vacancies, who in turn attract more users, who attract more customers, and so on.

And ZIGExN sits in the middle, collecting fees to keep the mechanism running with minimal capital needs.

The story does not end there. Joe Hirao (the company's founder and CEO) realised that the core differences between software-aggregation platforms from radically different industries (such as employment consultancy services and real estate) are virtually inexistent.

In essence, LinkedIn serves the same purpose as Funda in the Netherlands, Idealista in Italy and Spain, Zillow in the U.S. or Realestate in Australia: to connect two parties with a synergetic goal. Leaving aside the nuances and specifics of the industry (mostly related to the user interface), for a software developer, the code required to bring these platforms to life looks pretty much the same.

This is why ZIGExN enjoys being the leading Japanese aggregator in several industries without the additional costs that one would originally anticipate. Most of the code among platforms can be reused!

This translates into numbers in the form of low capital requirements, high margins and exceptional returns on organic investments.

If I knew this and acted on it back in the last quarter of 2021 when I invested in the business, where was my mistake? Earnings per share had been ¥20.9 for the previous twelve months, so I paid ¥13.6 for each yen of profits (around ¥285.0 per share).

At the time, the company was recovering from the impact that the pandemic had on sales and profitability levels (unemployment increased sharply and the overall economy slowed drastically during 2020, especially in Asian countries where stricter policies, such as the so-called Zero-Covid, were adopted and maintained well after Western nations resumed their economies).

I was confident that the company's competitive position was sound and that it would come back to the path of growth as the Japanese economy reopened. In fact, by the end of 2022 growth had already begun and ZIGExN had increased its revenues by 14.8% and its EPS by 18.7% over the previous year.

The business was doing great. Nonetheless, that did not stop me from selling all my shares in January 2023 at roughly ¥365.0/share as I believed that the risk of a Japanese yen's devaluation was strong. In other words, I based my assessment of an individual company on a forecast about the movement of a currency (remember the commentary about focusing on the things that are under our control? I could not even stick to my own advice).

I have followed ZIGExN closely for the past year and it has continued to perform nicely, increasing revenues by 29.0% and EPS by 39.9% (the group now generates ¥29.8 per share). Its market quotation has appreciated in a similar fashion, ending the at circa ¥531.0/share.

Analysing the result of my forecasting abilities, I left a 45.5% return on the table in less than one year, or 36.5% if we adjust for the yen's devaluation during 2023.

Acting on a macroeconomic opinion saved me from a 9.0% loss in currency movements (this being luck, by the way) and prevented me from enjoying a 45.5% gain over the course of a year on a sound business that I happened to know well. Such a trade-off.

The beauty of the small.

In recent years, the valuation gap between large- and small-cap companies has continued to widen, ending 2023 with one of the biggest spreads ever seen.

At year-end, the S&P500 traded at circa US\$19.8 for every dollar of earnings, while the S&P600 was quoted at a PER of 15.7 (a discount of 20.7%).

Historically, small companies receive a premium when compared to their larger peers, which makes sense given the greater runway and potential for expansion of the former group.

The chart in page 7 shows the weekly forward PER of some of the main S&P indices over the past two decades.

From 2020, the aforementioned gap not only closes completely but reverses, effectively making the large-cap group more expensive. This trend has accelerated in recent months, with the S&P400 and the S&P600 ending the year trading at a discount to the S&P500 not seen since the dot-com bubble.

What happened from 2000 through 2010 was remarkable: while the S&P500 experienced its “lost decade” (with flat returns over the ten-year period), the S&P600 gained 72.6% in value. Although it is true that the S&P500 is not as richly valued as it was back then, the relative cost compared to its smaller counterparts is similar (c.30.0% more expensive in both cases).

Since the turn of the millennium, the adoption of the internet has brought the equity markets closer to the retail investor than ever before. In conjunction with this, the fintech movement, which began in 2015 with the publication of the PSW2 directive in the EU (giving birth to what we now know as Open Banking), has made low-cost, fully digital brokerage firms to be available to anyone with a bank account.

This, combined with the proliferation of index-tracking investment strategies and their relative ease of implementation, has enabled index investing to attract a growing following over the years.⁽¹⁾

The most popular TIFs (traditional index funds) among retail investors tend to be those that focus on large and well-established companies (such as the S&P500 or the MSCI World), which typically emulate market-cap weighting (i.e. if, on any given day, Apple’s market capitalisation represents 7.5% of the largest 500 publicly traded securities in the U.S. as a group, Standard & Poor’s and Dow Jones Indices will make the necessary adjustments to reflect this within their S&P500 index).

There are exceptions to this rule (such as the DJIA, where the weight is based on the individual share price of its constituents), but the most common approach is to use total market capitalisation as the decisive factor.

Within a given large-cap index, this scheme further reinforces the allocation of capital, in absolute terms, to the biggest companies in it.

The dominance of large holdings over smaller ones is also observed in the so-called “magnificent seven” (i.e. Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia and Tesla) which, as of this writing, present a combined capitalisation of US\$12.0 trillion (30.0% of the total S&P500).

Let’s think about this for a moment.

The 7 largest constituents of the index have a combined market cap equal to 42.9% of the other 493! The last time such a thing happened was... never.

Had we weighted the index equally (0.2% per company, regardless of size), the S&P500 would have returned 11.7% last year, instead of 24.7%.

⁽¹⁾ As a general rule I do not oppose to this. In fact, there is extensive research suggesting that most active investors actually underperform their benchmark (typically the S&P500) over any given 5-year period.

I believe the effort required by the investor aiming to outperform the major indices by just a few basis points a year to be huge in comparison with the one needed to simply match the relevant benchmark, requiring a strong foundation of common sense, humility, a patient mind and, often, a bit of luck to accomplish the task.

If you are a retail investor with no financial background wanting to put some hard-earned savings to work, why would you sacrifice so much time and effort into analysing individual securities when you could obtain (at least statistically) better returns by dollar-cost averaging into the S&P500? The same reasoning holds true for investing your money with any actively managed fund. Naturally there are nuances to this, because even if a passive investment approach can help in relieving part of the emotional load inherently attached to investing, it does not erase it completely, so the retail investor willing to follow this type of strategy should equally maintain a long-term horizon (given the natural volatility of stocks). Most retail investors seem to either (a) not being aware of this or (b) fail in handling the psychological stress caused by such volatility, as even if the annual compound rate of the S&P500 has historically been around 8.0% nominally, the average retail investor has fared much worse (around 2.9% p.a.). The hypothesis is that most private investors stop contributing (or even worse, sell) when the market is at its bottom, either fostered by fear or attempting to time it.

In any case, I certainly understand this pragmatic approach to investing, so I can only provide an answer on why I do not follow it. Personally, I do not experience the process behind analysing companies as something requiring tough work or sacrifice, quite the contrary. Thinking about business models in terms of their unit economics is just a hobby which happens to have a practical application in the equity markets. Had I gone through a struggle in learning accounting or reading reports and call transcripts on a daily basis for the past years I would not be, most likely, writing to you at this moment.

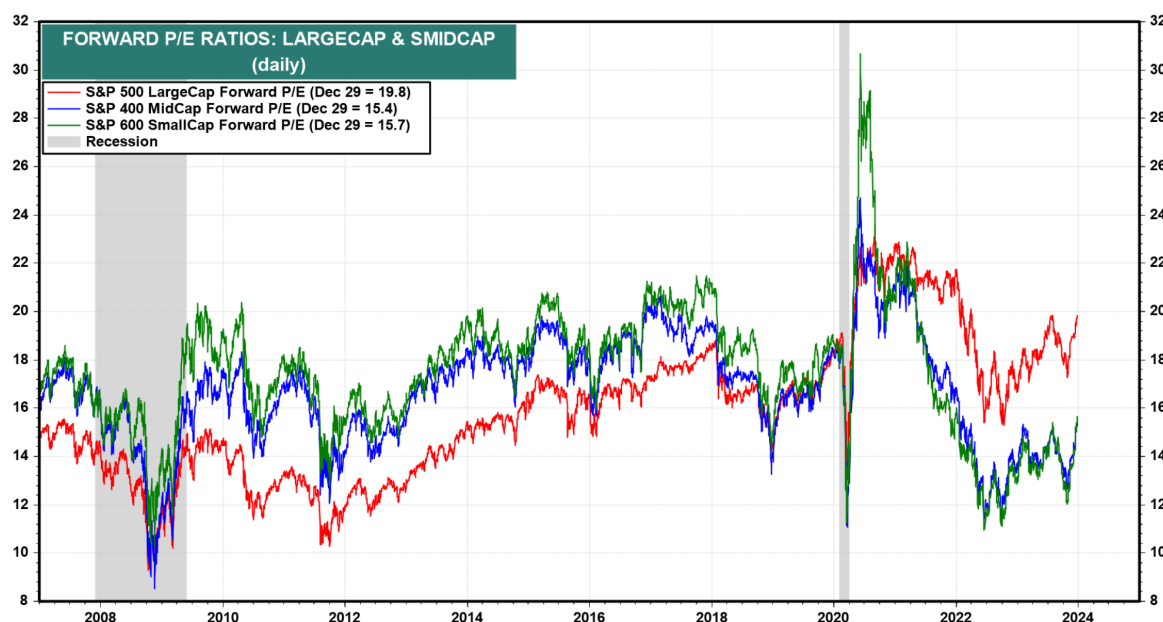
Arguably, the U.S. has become the de facto investment destination for most institutional and private investors around the world.

Given the overwhelming preference for blue-chip companies that has developed in recent years, the small capitalisation enterprises in the U.S. itself and in other developed countries nowadays pose, in my view, one of the best investment opportunities for the past decades.

The list below provides some examples of the valuation reached, at year end, in some of the small- and mid-capitalisation segments in these markets:

- Australia: PER of 14.3.
- Germany: PER of 13.4.
- France: PER of 9.7.
- Italy: PER of 9.0.
- Japan: PER of 13.6.
- Poland: PER of 8.7.
- Spain: PER of 8.8.
- Sweden: PER of 12.6.
- United Kingdom: PER of 11.0.

We have exposure to these economies through Duratec and Mader in Australia, Auto Partner and Dino Polska in Poland, ZIGExN in Japan, Evolution in Sweden and Water Intelligence in the United Kingdom.



Source: Yardeni Research.

Readings.

For the curious reader, below is the list of texts that I consider were most enjoyable last year:

- 100 to 1 in the stock market (Thomas Phelps).
- A short history of financial euphoria (John K. Galbraith).
- Chip war (Chris Miller).
- Good profit (Charles G. Koch).
- Grinding it out (Ray Kroc).
- Just keep buying (Nick Maggiulli).
- Principles for success (Ray Dalio).
- Quality of earnings (Thornton L. O'Glove).
- Same as ever (Morgan Housel).
- Speculation as a fine art and thoughts on life (Dickson G. Watts).
- The art of learning (Josh Waitzkin).
- The black swan (Nassim Nicholas Taleb).
- The Dhandho investor (Mohnish Pabrai).
- The joys of compounding (Gautam Baid).
- Why we sleep (Matthew Walker).

Wish you a great 2024,
ConserValue.



To the memory of Charles T. Munger (1924-2023).
Rest in peace.