CV Capital Pty Ltd

12 April 2023

SHAREHOLDER REPORT AS AT 31 March 2023

To my fellow shareholders & partners,

Over the last few weeks, we have seen a few regional banks in America go bust because of a run on the bank. A run on a bank is caused by a loss of confidence from a large number of its depositors who withdraw their deposits at the same time. Due to a timing mismatch between a bank's assets and liabilities (assets are typically loans which have a longer tenure than its liabilities which are deposits), a bank never has enough liquid cash to sustain massive withdrawals.

A picture of massive lines of people queuing up at the bank to withdraw cash comes to mind when imagining bank runs. In the age of electronic banking, this mental picture is outdated as depositors can simply withdraw their funds online via their computer or phone. Add in the effects of social media and things can go pear shape pretty quickly.

The collapse of Sillicon Valley Bank and Signature Bank make for interesting stories but the factors that led to these events occurring are even more fascinating. One of the key causes which led to problems in the US banking industry is the liquidity injected into the economy by both the Federal Reserve and the US government. According to the Federal Reserve, following the onset of the Covid-19 pandemic total deposits at domestic commercial banks rose by more than 35% since the end of 2019 and the annual increases in deposits since the first quarter of 2020 has exceeded any of those witnessed over the past 30 years.

At the same time deposits were growing, demands for loans were softening given the weak economic conditions experienced during the pandemic. To make money, a large percentage of the deposits were invested by the banks in bonds (US government bonds or mortgage backed securities). With hindsight, it was a terrible time to buy bonds because interest rates were at an all time low and the subsequent rate hikes by the Federal Reserve were so steep. A Reuters article states **here** that the US banking may be sitting on US$600 billion of paper losses.

If the bank is able to hold the bond to maturity then it isn't that much a problem because the bank would be able to recover its investment (as yields didn't not go into negative territory) from the stream of coupon payments and redemption value upon maturity. The loss would mainly be opportunity cost from capital being tied up in a low yielding asset when interest rates on loans are now significantly higher. However, problems can arise if the bank were forced to sell the bonds at a loss to fund deposit withdrawals.

These were unintended consequences from the ultra loose monetary policy. The sudden change in interest rates are now “breaking things” and I expect more things to break.

What’s the relevance of the above? In Australia, I think there is a risk from assets which are highly levered, like real estate, private equity and infrastructure assets. A lot of these assets are not traded publicly so we haven’t seen much reporting on their losses but commercial REITS are already trading significantly below their net asset values suggesting large write downs in commercial real estate are on the way. Infrastructure assets are another area of concern where previous valuations of these assets were based on very low interest on debt where debt made up 90% of the capital structure.

Fund Activity

We picked up more Baby Bunting (BBN) as its share price continued to fall after announcing the half year results for FY2023 (1HY23). I believe the share price fell due to two reasons 1) Matt Spencer, its capable CEO for the past 11 years will move on at the end of the year and 2) it posted a poor result for HY23. The share price is currently around $2 from $6 in 2021 (>67% decline). While I think it was priced for perfection at $6, the current price is too pessimistic given that the price earnings ratio at $2 is circa 11x (normalised net profit) is very low for a growing company.

BBN is the market leader of baby products in the country with no competitor of any significant size (although there are many small competitors) so I think it will take a pretty bad manager to stuff up its market position. Obviously its not impossible but but relative to other businesses which either has bigger and/or equivalent size competitors, BBN is in a pretty good position. The odds are favourable that BBN will continue to prosper and grow with the new CEO. The poor net profit results in 1HY23 compared to 1HY22 were driven by two factors: **(1)** fall in gross profit margin (GP margins). GP margin fell about 2% between the periods. The fall in GP margin was flagged during the 2022 AGM and supply chain and logistics price increases were the key reasons for it. In the 1HY23 shareholder presentation, BBN announced GP margins were improving as January 2023 GP margins are above prior year’s margin and they expect 2HY23 gross profit margins to be better than 1HY23 margins and shipping rates have reduced. I consider fluctuations in GP margin to be part of normal business cycle and is to be expected. In a previous **report**, I showed how GP margins have actually improved over time. **(2)** Store expenses increased significantly in 1HY23. This was to mainly due to wage inflation, new store start up costs and cost associated with the New Zealand expansion. BBN has started operating a distribution centre in New Zealand which will eventually support a 10+ store network and only 2 stores have commenced operations. The NZ store footprint needs to expand to defray the cost of operating the distribution centre.

We sold all our position in Link Market Systems (LNK). One of the reasons we invested in LNK is to get exposure to Pexa, which is a fantastic business given it’s a monopoly. LNK did an in-specie distribution of Pexa shares in January 2023 and we now hold some Pexa shares directly. Over the time we held LNK, it was caught up in the takeover drama which had more twist and turns than a soap opera! I shall not bore you with all the details but in the end the potential acquirer Dye & Durham walked away from the deal. However, the deal uncovered a major concern which led me to lose my confidence in management. In 2019, the Financial Conduct Authority (FCA) launched an investigation into the Woodford Equity Income Fund (Woodford Fund), a fund which collapse and where LNK acted as its authorised corporate director. For 2 years, there were very little details provided by LNK other than they were assisting with the investigations and winding down the fund. However, in September 2022 after LNK’s shareholder voted to approve the takeover, LNK gave an update on the Woodford investigation saying that the FCA may hit LNK with a $85 million fine and restitution payments up to $519 million which killed the takeover. Given

the sums involved and the timing of the announcement, I have major concerns in relation to the management's transparency to shareholders. We about broke even on LNK so it wasn't a good use of our capital.

Fund Performance

CV Capital's return for FY2023 (1 July 22 – 31 Mar 23) is (1.0%) (including FY22 dividends and after FY22 performance fees). The underperformance for the quarter was driven primarily by a market selloff in BBN and a bad share purchase plan (SPP) trade. The aim of our SPP trades is to only participate if there is a profit margin (normally 10%) between the market price of the shares and the SPP offer and to sell it immediately after receiving the shares. In this instance there was a significant margin which caused an oversubscription in the SPP raising and the Company (given its poor financial position) accepted the entire oversubscription and issued a lot of shares. This resulted in the share price trading below our purchase price upon receipt of the shares and we held on far longer than we should have. Within 6 months of the SPP, the Company ran out of cash as the major shareholder refused to continue funding the Company. This was a very dumb trade by me. All in all this trade resulted in a loss of 2.6% for the portfolio. In the future, I will be more selective in participating in these SPPs and stick to a stricter timeframe in selling the positions regardless of profit.

Since inception our returns are 10.2% (before performance fees) and 9.4% (after performance fees) on an annual compounded basis.

The share price as at 31 December 2022 is $1.22. Details as follows:

	Per share
Securities portfolio value	$1.14
Cash	$0.10
Franking credits	$0.005
Share price	**$1.24**
Less: Estimated tax liabilities on realised gains	($0.02)
Subscription price	**$1.22**

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