Ennismore Global Equity Fund

Investor Newsletter for the month of December 2022

Issued on 11 January 2023

Fund Details

Daily dealing UCITS and Irish Central Bank regulated open-ended investment company with Financial Conduct Authority recognition and registered in Ireland. The Fund size was USD 119m as at 30th December. Total assets under management by Ennismore Fund Management were USD 592m. The number of shares issued by our funds is capped in order to limit the level of assets under management in each strategy. We currently have capacity available in the Global Equity Fund. If you would like more information or to invest please contact Adam Sullivan on +44 (0) 20 7368 4224 or email subs@ennismorefunds.com.

Performance as at 30 December 2022

	Share Class[2]					
	GBP	**GBP A**	**EUR**	**CHF**	**EUR I**	**USD I**
NAV per Share[1]	12.49	12.43	12.23	11.08	9.62	9.82
	% Change					
December 22	6.2	6.2	3.6	4.1	5.9	6.3
2022	5.2	5.2	-0.4	-5.1	2.9	5.4
Annualised return[3]	3.6	3.5	3.3	1.7	-0.9	-0.5
Since launch[3]	24.9	24.3	22.3	10.8	-3.8	-1.8
Note: All performance figures net of fees. **Past performance is not a guide to future returns.**						

Comments below on performance refer to GBP NAV per share unless otherwise stated, exclude fx and interest contributions to cash and are prior to expenses.

The Fund's NAV increased by 6.2% in December. Our long book contribution was flat for the month while our short exposure contributed 5.9%.

Top Five Contributors and Detractors for December 2022

Contributors	MTD (bp)
US automotive manufacturer	193
Bio-On SpA	63
Boa Vista Servicos S.A.	62
US electronics retailer	52
thyssenkrupp AG	42

Detractors	MTD (bp)
International Distributions Services Plc	-35
Auto Trader Group Plc	-25
US waste management company	-21
IHS Holding Limited	-20
US listed Chinese aerospace company	-17

Top Five Long Holdings as at 30 December 2022

Company	Country	Sector	% of NAV
Buzzi Unicem SpA	Italy	Materials	5.3
Schibsted ASA	Norway	Communication Services	4.9
thyssenkrupp AG	Germany	Materials	4.5
Admiral Group Plc	United Kingdom	Financials	4.4
International Distributions Services Plc	United Kingdom	Industrials	3.4
			22.5

Exposures as at 30 December 2022

Longs%	Shorts%	Gross Exposure%	Net Exposure%
76.1(79.4)	40.8(48.9)	116.9(128.3)	35.3(30.5)

Figures in brackets refer to previous month end. All exposures are calculated on a delta adjusted basis. All calculations are subject to the impact of rounding.

[1]Source: Administrator, Net Asset Value.
[2]Source: Administrator, Net Asset Value, net income reinvested.
[3]Since inception of GBP, GBP A, EUR and CHF share classes on 03/10/16, EUR I share class on 03/07/18, USD I share class on 02/01/19.

Exposures by Country, Market Cap & Sector as % NAV and Positions as at 30 December 2022

Country	Gross%	Net%
United States	37.3	-15.2
United Kingdom	27.0	24.2
Norway	7.4	3.5
Germany	7.2	7.2
Sweden	6.9	1.6
Italy	5.3	5.2
Japan	3.4	3.4
Belgium	3.2	3.2
Austria	3.2	-0.9
Mexico	2.5	2.5
Switzerland	2.2	-0.2
South Korea	1.8	1.8
Hong Kong	1.7	-1.5
Brazil	1.7	1.7
Spain	1.5	1.1
Ireland	1.0	1.0
Other	3.7	-3.2

Market Cap	Gross%	Net%
>$10bn	19.0	3.0
$5bn - $10bn	20.0	6.3
$1bn - $5bn	60.7	30.0
<$1bn	17.2	-4.0

Positions	Dec	Nov
Long	50	47
Short	74	67
Longs Opened	3	4
Longs Closed	0	3
Shorts Opened	10	7
Shorts Closed	3	9

Sector	Gross%	Net%
Communication Services	17.4	13.2
Consumer Discretionary	16.2	8.1
Consumer Staples	7.3	3.6
Energy	0.0	0.0
Financials	16.6	9.1
Health Care	5.9	-3.4
Industrials	16.6	-2.8
Information Technology	17.3	1.4
Materials	13.3	9.6
Real Estate	3.1	-0.6
Utilities	0.0	0.0
Other	3.0	-3.0

Geographic analysis relates to country of incorporation or listing. This may not represent the underlying economic exposure of the operating business.

Performance

The Fund had its best quarter in a long time in Q4, up 11.3% in the GBP class, with significant contributions from both sides of the book. The long book contributed 8.8%, and hence significantly outperformed the MSCI World index for the period (up 0.7% in GBP terms). The short book continued its solid year, contributing 2.7% for the quarter.

Major contributors in the long book were the large positions, mostly without particularly notable idiosyncratic drivers. Schibsted ASA (“Schibsted”) was the main exception, delivering a contribution of 1.5% net of the cost of hedging some of its underlying holding in Adevinta ASA (“Adevinta”), after the company sold a block of its Adevinta stake to repurchase Schibsted equity, prompting a sharp rerating of the stub. There were no notable detractors in the long book in the quarter.

In the short book, our long-held scepticism on the valuation of Tesla Inc (“Tesla”) was finally rewarded this quarter - our Tesla positions contributed 2.3%. Most of this return was derived from a (structurally risk-limited) put option position. In December we closed our puts and replaced them with a much smaller direct short. The drop in Tesla stock was partly driven by eroding faith in the cult leader after Musk was outmanoeuvred when trying to extricate himself from the Twitter acquisition, twice reneged on a promise not to sell any more Tesla stock, and then highlighted his capricious and reactive management style during his short tenure as Twitter CEO so far. In addition, the need to offer discounts to shift inventory (across all major markets) during the last couple of months cast doubt on the company’s long term growth goal of 50% per year. Despite having dropped 70% from its Nov 2021 peak, Tesla still sported a $389bn market cap at year end. This was more than eight times the market cap of General Motors Company, more than twice Toyota Motor Corporation’s, and almost 18x Tesla's (arguably elevated) trailing gross profit. For comparison, Microsoft Corporation - one of the world's most entrenched and most profitable companies, and no slouch either having grown eps at a 24% compound rate over the last five years - trades at under 13x gross profit. We continue to see significant downside.

Another significant short contribution was from two crypto miners (Riot Platforms, Inc and Argo Blockchain plc) which in aggregate contributed 1.0%. This is a sector where the spectre of bankruptcy emerged in recent months as falling crypto prices, more competition, and higher energy costs exposed a flawed business model. Finally, Bio-On S.p.A. contributed 0.7%. This is a legacy position which was written down by over 90% in December after an auction for its assets finally found a bidder at the eighth attempt, at a valuation well below the creditor claims, leaving no value for the equity.

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The only significant short detractor was Heidelberger Druckmaschinen Ag which cost the Fund 0.8% in the quarter. The company announced a convincing restructuring plan and we closed our position.

Our pleasing Q4 helped make 2022 an acceptable year in absolute terms, and very good in relative terms and in terms of overall alpha. The GBP class was up 5.2%, but this was flattered by Sterling depreciation. In the EUR class, the fund was roughly flat. The MSCI World index in GBP was down 9.9% for the year. Our long book performed poorly, costing 20.2% on average exposure of 86.1% for an implied return on capital of -23.5%. This was much improved in the second half, when the long book implied return was 11.5% against the MSCI World in GBP up 2.9%. Long book losses were more than offset by the short book. With a contribution of over 27% on an average exposure of 43.4%, the implied short return on capital was 64.1%.

By far the biggest long detractor was International Distributions Services plc (fka Royal Mail plc), which cost 5.5%. We were slow to appreciate the size of the UK demand reversal in the first half, and whilst we were fully aware of the challenging labour relations situation, we had hoped that management would pursue a separation – which we think would crystallise substantial value. We continue to believe a separation is the right path for the company, and one which would force the unions to engage with reality without the cushion of GLS to subsidise UK losses. We have cut the position a little, reflecting reduced confidence that management has the determination to realise the value that exists within the group.

Two highlights in the long book in 2022 were acquisitions of Swedish Match AB (the Swedish smokeless tobacco specialist) and Boa Vista Servicos SA (a Brazilian credit bureau) by US strategic buyers. Having said these were highlights, both deals trigger mixed feelings as in each case we would have preferred to be long term owners and think the buyers have achieved pretty attractive prices. However, if we are doing our job well, we'd be surprised if these are the last occasions where strategic or private equity buyers see more value in our companies than public markets attribute to them.

Fundraising

We've been pleased to see some inflows into the Fund in the last couple of months, after a fairly extended period of one-way traffic in the other direction. As we have said to many of you in recent months, the Fund is economically viable at small scale and supported by its strong foundation of internal money, which accounted for over 40% of AUM at year-end. However, we would like it to be somewhat larger as we seek to expand our PM team by one or two over the next 12-18 months. We will spend some time fundraising this quarter for the first time in over three years – if you're interested, please get in touch!

The chart below shows rolling four-quarter long-short spread for the fund since inception. This is calculated by subtracting the implied return on capital (gross contribution divided by average exposure) for the short book from the implied return on capital for the long book. A large positive number is what we are after, clearly! The chart illustrates that after a very poor 2020, the Fund has returned to form over the last year and a half. Excluding the five quarters from Q2 2020 through Q2 2021 (the zero commission / COVID stimulus mania period), long-short spread has been almost universally positive on a rolling four quarter basis and has averaged 21% points over those sixteen periods. This doesn't mean that the fund has been delivering 21% gross returns in those periods – the outcome depends on net exposures, and we very seldom run the fund at zero net. But it demonstrates solid and fairly consistent alpha generation outside of the COVID period – which is roughly in line with the achievement of the European Smaller Companies Fund over a longer period. We will continue to work very hard on delivering a significant spread between our longs and our shorts, and if we can continue to perform as we have outside of the mania period, your results should be competitive, almost regardless of what the market does.

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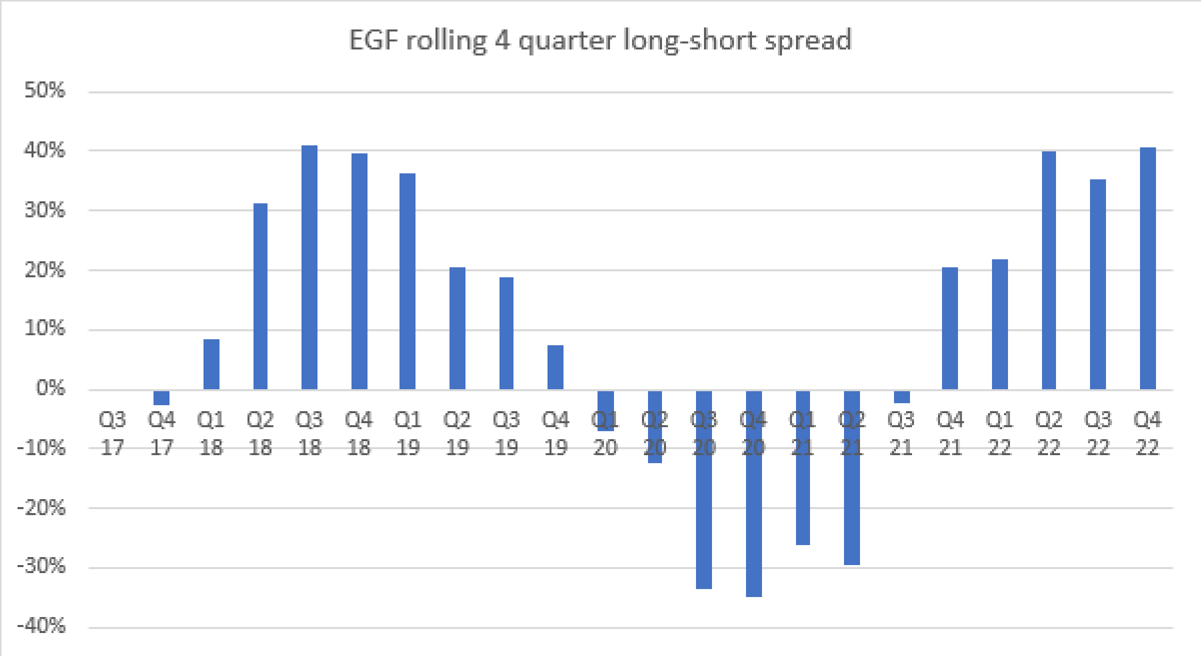

Positioning

The Fund continues to be cautiously positioned, with beta adjusted net exposure of 29% at the end of December, albeit this is up somewhat from our recent lows, and gross exposure materially lower than our typical levels at 117%. As always, our positioning is an output of what we find in our search for ideas, not a top-down decision. However, we believe caution is merited given how weak economic leading indicators and corporate earnings momentum are, the trajectory of liquidity and financial conditions as quantitative tightening begins and banks tighten lending conditions, and with margins and valuations still elevated relative to historic levels. Significant themes in our exposures continue to be our net long position in the UK, net short position in the US, a small and mid-cap bias and promotion-skewed short book (albeit much less so than a year ago).

Holdco investments

It is jarring to come across what seems like an obvious mispricing given the level of competition in public markets. One that seemed to fit this bill earlier this quarter was Schibsted. After spinning off a stake in its non-Scandinavian assets as Adevinta, Schibsted became a holding company. Most of the value of the holdco is accounted for by the Adevinta stake, the Scandinavian assets we would describe as the “stub”. At one point in Q4 the stub was trading at an implied market cap (Schibsted market cap less the market value of its Adevinta stake) of EUR 475m implying at enterprise value of c. EUR 1bn.

Finn.no (Norwegian online classified site of which Schibsted owns 90%) is the most valuable asset within the stub. If it was listed separately, Finn alone would probably be worth at least EUR 1.5-2bn based on peer valuations. Schibsted also owns the largest classifieds sites in Sweden and Finland, the largest car classifieds site in Denmark, a substantial and profitable loan comparison site, as well as many of the largest news media assets in Norway and Sweden and a VC portfolio. If anything in public markets is ever obvious, surely this is it? Yet the stub traded at below EUR 1bn implied market cap for several months during 2022. After reaching a low in mid-October, the stub appreciated as the market rallied, but then jumped when the company took action. At the end of November, it sold a block of Adevinta and announced it would repurchase 4% of its own shares – this prompted the stub to jump by more than 50% overnight. Even after it tripled in value since mid-October, we continue to believe the stub is worth at least double the value the market attributes to it. With Adevinta also an attractive investment, Schibsted was the Fund’s second largest position at year-end.

We observe numerous similar, if less extreme, situations in the market today and have made several investments. What we see as undervalued holdcos accounts for a little under 15% of the fund at year-end, including Schibsted (4.9% of NAV), D'Ieteren Group SA (3.2%), Berkshire Hathaway Inc. (2.3%), Nelnet, Inc. (2.0%), News Corporation (1.2%), and IAC Inc. (0.7%). Two unifying features of these positions are share prices at significant discounts to underlying value, and control or de facto control by a long-term founding shareholder. We discuss this theme briefly here and outline the rationale for our investment in Nelnet.

What is a "holdco"? We define it as a company where a material proportion of the assets are not directly under the control of the corporate management team – i.e. a company which has significant, often non-controlled, financial or strategic investments. There are a few different characters of holdco structure: some have stakes in one or more listed companies that account for a significant part of the valuation (offering scope for hedging out parts of the portfolio), others are simply conglomerates of wholly owned businesses. In some cases, one business dominates the group so the holdco investment is primarily a proxy for investing in that asset; in others the portfolio is diversified, sometimes so diversified that the prospect of diligencing all of the constituents in any detail is intimidating. Quite often holdcos are controlled or heavily influenced by a single major shareholder, making them analogous to a public family office vehicle.

How managers deploy capital is vital to the outcome of any investment - as Buffett noted, "after ten years on the job, a CEO whose company annually retains earnings equal to 10% of net worth will have been responsible for the deployment of more than 60% of all the capital at work in the business". But most companies explicitly or implicitly constrain the potential uses of capital in advance (shareholders would mutiny if Unilever plc acquired a steelworks, for instance). This means that for most businesses' capital deployment should be somewhat predictable. This is less true with holdcos - obviously so, given the willingness to own multiple different businesses within the group. And investors hate to be surprised. That said, holdcos have more capital allocation options than typical companies - for a high quality, disciplined team, more flexibility should be an advantage. A controlling permanent or quasi-permanent shareholder is strongly supportive of good capital allocation. Of course, it doesn't prevent mistakes, but it almost certainly means that the decision-maker is, like us, focused on long-term value, and that is a good place to start.

Why do holdcos sometimes (often) trade at large discounts to their underlying value? Confidence in capital allocation is undoubtedly a big part of it – we've sometimes observed uncertainty or surprises on this issue prompt worse stock market reactions than pretty clearly negative information of similar magnitude. Where a public company comprises a large part of the value of a holdco, many investors prefer to invest directly in that vehicle, which can leave the holdco orphaned – the public company stake is the primary reason to invest in the holdco, but investors have another option, explicitly preferred by many, for precisely that purpose. Debate or differing views about the underlying value is another factor. The financial reports of holdcos can be confusing and / or noisy too – for instance, public equity stakes are marked to market through the P&L every period. A holdco with lots of parts can be intimidating and time-consuming to diligence and may not fit well within the investment industry's standard sector analyst framework. In summary, there are plenty of reasons – although most of them are rather "surface" reasons.

With a standard company, returns come from three sources: dividends, growth or decline in earnings, and changes in the multiple at which those earnings are capitalised. Similarly, the return on a holdco investment comes through dividends, growth or decline in the underlying value, and the changes in the discount (or occasionally premium) at which the listed entity trades to that underlying value. And as with a standard company investment, whilst the short term is dominated by movements in the discount, underlying value growth is the primary long-term driver. Time is the friend of the wonderful holdco, the enemy of the bad, to abuse another Buffett quotation!

The two most important criteria for us then, in considering a holdco investment, are the underlying assets – these should be dominated by decent businesses or investments that we would want to invest in standalone – and confidence in the capital allocation of the management team. We generally prefer to view the potential return from closing of the discount to value as icing on the cake. It's worth noting though that specialists in this area (see for instance the chart on p31 of Asset Value Investors' annual report, for instance) of the market highlight that discounts are current elevated vs. history. We think the odds in the medium term are in our favour here too.

To be bolder than this and consider the "discount return" as part of our base case requires catalysts. Returning briefly to Schibsted on this point – one of the reasons the company traded at an extreme discount to underlying value was doubts over capital allocation. Management is seen as lacking ruthlessness and cost control, and there remain questions over two acquisitions executed to consolidate the Nordic classified market in 2020 as well as the rationale for deploying so much capital into the VC portfolio. And whilst the discount to underlying value was obvious, the prevailing view was that no mechanism existed to close the discount in the short term as the company lacked balance sheet capacity to repurchase its own shares. With a slightly longer-term view though, from October 2023 Schibsted is free to divest or distribute its stake in Adevinta, which it has always made plain is a financial, not strategic investment – thus opening up balance sheet flexibility. Given the quality of the underlying assets and the history of PE interest in online classified businesses we were fairly confident that if management failed to create its own catalyst, one would be forced upon it – perhaps via a bid, or an activist investor. In the event, management action (under shareholder pressure) created a catalyst sooner than we expected. We continue to see good returns ahead, however – both from the underlying assets, and further closing of the discount.

We noted above that high quality management teams of holdcos enjoy greater breadth of capital allocation opportunity than most corporate managements. We discuss Nelnet below, which we think is a good example of a company profitably exploiting that flexibility.

Nelnet, Inc. - US financial holding company (2.0% NAV)

Nelnet, Inc. ("Nelnet") is a slightly odd (and perhaps boring) beast. It has a market cap of USD 3.4bn and is essentially a multi-asset investment company (but without any fees). It eschews much received wisdom about how to operate as a public company – it doesn't provide financial guidance and has no quarterly earnings conference call. It does have an aligned management team (insiders own almost half of the company) with a strong track record and provides a thorough and relevant letter each year with its annual report. It also trades at a substantial discount to intrinsic value.

We came across Nelnet initially as a peer of Tucows, Inc. when researching the US fibre broadband roll-out. In 2015 it had purchased Allo Communications, LLC, which was a small fibre network operator in western Nebraska, near where Nelnet is based. Nelnet funded a much larger roll-out in its hometown Lincoln, Nebraska (population c. 290k), which was completed in early 2019. Researching Allo led us to study Nelnet more broadly, and we invested in early 2020.

The company was founded in 1996 by the current executive chairman (and 25% shareholder) Mike Dunlap and became a vehicle for accumulating federally guaranteed (but privately originated) student loans (FFEL program, or "FFELP" loans). This has been a very profitable activity for the company but is a slowly dying one. New issuance under the FFELP ceased in 2010, so Nelnet's FFELP portfolio is in run-off. Whilst management has been continually replenishing the FFELP carcass by purchasing loan portfolios, it has dedicated most of its effort to ploughing new business furrows to replace the historic core. The FFELP portfolio throws off a huge amount of cash each year as it winds down, which makes deployment of the resulting capital particularly important for Nelnet's prospects.

And Nelnet has proved itself highly flexible in deploying those prodigious cash flows. Over the seven years from 2015 through 2021, the company has deployed around $5bn, split as follows.

	2015	2016	2017	2018	2019	2020	2021	7 year total
Lending-related	**313**	**61**	**75**	**293**	**132**	**312**	**182**	**1,368**
FFELP loan / residual acquisitions	140	-	-	105	71	141	39	496
Private and consumer loan / residual acquisitions	173	61	75	188	61	71	143	772
Nelnet Bank	-	-	-	-	-	100	-	100
Operating business-related	**64**	**68**	**156**	**278**	**93**	**143**	**59**	**861**
Business acquisitions	-	-	-	153	-	30	-	183
ALLO acquisition and capital expenditures	47	39	115	87	45	48	-	381
Other capital expenditures (non-ALLO)	17	29	41	38	48	65	59	297
Non-lending investments	**94**	**22**	**29**	**67**	**103**	**422**	**731**	**1,468**
Hudl investment	41	-	10	-	-	26	5	82
Other investments (including capital / real estate / solar)	53	22	19	67	103	396	726	1,386
Financing-related	**157**	**167**	**274**	**85**	**69**	**131**	**499**	**1,382**
Debt repurchases	42	77	181	13	-	26	407	746
Stock repurchases	96	69	69	45	40	73	58	450
Dividends	19	21	24	27	29	32	34	186
Total	**628**	**318**	**534**	**723**	**397**	**1,008**	**1,471**	**5,079**

Source: Nelnet 2021 Annual Report

Nelnet's management has a strong track record: book value per share has grown at a 13.5% compound rate since the end of 2012, and 10.7% since the end of 2017, both of which are 4-5% points ahead of broad-based US indices for the same periods. And with the hundreds of millions in cash flows that the FFELP portfolio will produce over the next few quarters, it is in the unusual position of embracing the opportunities that the current market dislocation is creating. This capital allocation track record of the management team, allied to the very cheap valuation of the stock, is the core of the investment thesis.

Nelnet trades at just 1.06x book value. This is surprising given the long and pretty consistent track record of book value growth. But there are four important reasons why book value materially under-states the intrinsic value of the business.

First and most importantly, Nelnet owns asset-light operating businesses which we value at a little under USD 2bn but account for well under USD 0.5bn of book value on the balance sheet (the precise number is unclear as Nelnet discloses assets but not liabilities at segment level). The crown jewel is the education sector software and payments business. This is a well-positioned, high margin, asset-light business that has grown the top line at a mid-teens annual rate over the last five years, and which benefits from positive float so will enjoy a sharp jump in interest income on the float balance over the coming quarters. Run-rate net income for this business is c. USD 70m. Listed separately, we believe this business would conservatively trade at 20x earnings, i.e. it would command a USD 1.4bn+ market cap, but the segment's net assets are not much more than USD 0.1bn. The other main operating business is a loan servicing operation. This is much lower quality and lower growth, mainly serving government tenders, but it is still highly cash flow generative - worth perhaps another USD 0.1bn or so over book value based on a mid-high single digit multiple of cash flow.

Second, the FFELP loans are securitised, and the Nelnet's equity in those securitisations are what appears on the balance sheet. But whilst the company anticipates $1.1bn of distributions from these securitisations over the next six years, the book value is currently $800m. Given the Federal guarantee and the portfolio history, we can be pretty confident in this equity value accrual.

Third, two of Nelnet's major investments in recent years have been in Allo Communications (the Midwest fibre network operator we mentioned earlier) and several tax-advantaged solar developments. The accounting method management has adopted for these investments (to optimise tax efficiency) results in material balance sheet impairments (at least in the first couple of years for the solar investments), even whilst intrinsic value is compounding nicely. So, there is a relatively large (we believe over 10% of reported book value), and growing, divergence between book value and intrinsic value on these assets. A quirk in the accounting means that as the solar investments mature, this gap will close, whilst at the current rate the book value of Allo equity will probably be fully written off by 2024. Therefore, book value growth should accelerate, all else being equal, from next year.

Finally, some of Nelnet's other investments are likely held below fair value - most notably a VC investment in a tech company called Agile Sports Technologies, Inc. which trades under the name "Hudl", into which Nelnet first invested in 2014. Hudl helps more than two hundred thousand sports teams from school to professional organisations capture, analyse and learn from video and data. To illustrate the company's position: every NBA basketball team uses Hudl's "Sportscode" product as their video editing and analysis tool, whilst Hudl has league-wide deals for video capture and analysis with several national football leagues, for instance in Belgium. Bain Cap is a co-investor in Hudl, of which we believe Nelnet owns just over 20%. The stake is on the balance sheet at a $134m valuation based on a May 2020 fundraising. There is very little financial information available, but we believe the next funding round could see a significant uplift.

All in, we believe the assets are worth well over USD 5bn, against the EV at year-end of a little over USD 3bn. So, whilst we expect the current market environment to present Nelnet management with the best investment opportunity set it has faced in a decade, should it be unable to consummate attractive external investments, continuing to repurchase its own shares represents a very attractive alternative. In just under 8 years, the share count has fallen by almost 20%. The bigger the discount to intrinsic value at which buybacks are executed, the better for remaining shareholders.

From the current standpoint, we believe Nelnet represents a very robust and defensive investment. Reported book value is at a larger discount to intrinsic value than in the past, yet the stock trades at a similar multiple of book value as it has over the last eight years. We expect book value accretion to accelerate over the next few years, as the education software and payments business throws off increasingly large amounts of cash to be reinvested and the accounting quirk relating to the fibre and solar investments reverses. Since we first invested in Nelnet in February 2020 the stock has delivered a c. 20% IRR from our average entry price. We would hope for a high-teens annual return from the current level for the years ahead.

Atlanticus Holdings Corporation - Short position - US subprime lender (-1.2% NAV)

Atlanticus Holdings Corporation ("Atlanticus"), formerly known as Compucredit, is a US subprime lender. It lends mostly through partners, both retailers and banks, which issue store cards and general-purpose credit cards to consumers with poor credit histories. We have been short since Q1 2022, and the position was one of our top short contributors in 2022. We believe the short thesis remains compelling even with the stock down 70% from the peak, however, and retain a significant short position.

You can imagine that this is not a great environment for a subprime lender. Average earnings are not keeping pace with inflation, and inflation is skewed to essential items which weigh heavier on the basket of lower income consumers: rent and debt service, food, heating and electricity, and until the last couple of months, fuel.

Unsecured loans typically take time to go bad. Unless the borrower spends all the money immediately, the loan itself should fund payment of the initial instalments. And the business model is designed to permit substantial loan losses – the interest rate on Atlanticus' portfolio ranges from the high teens to the mid-thirties. Lenders have significantly levered balance sheets, however, such that underwriting miscalculations don't have to be all that extreme before loan losses start eating into equity. Atlanticus, for instance, supports a $2.05bn loan book as of September 2022 with tangible equity capital of $307m. The remainder of the funding is from wholesale financing markets. Particularly given this leverage, the model is problematic: barriers to entry are low, and returns are extraordinarily (but transiently, and misleadingly) attractive in the good times. This naturally attracts capital, restricting pricing and putting pressure on underwriting standards. Loan performance tends to be highly correlated and pro-cyclical - i.e. a trickle of defaults has a tendency to turn into a flood, and the flood defences in the form of equity capital are rarely built solidly enough to withstand the flow. Wholesale financing markets are also pro-cyclical, so funding tends to dry up and become more costly at just the wrong time. Atlanticus' share price over the last twenty three years aptly demonstrates the pro-cyclicality of the business model.

Atlanticus share price – April 1999-January 2023

Atlanticus is arguably tougher to analyse than most of its peers. First, management has skewed the portfolio towards higher risk borrowers over the last 3-4 years and shifted its accounting methodology to "fair value" from "amortised cost" from 1 Jan 2020. We will resist the temptation to offer a detailed discussion of the differences here, however the key points are that the financials have been in transition for three years (the transition is now complete), and management has more discretion on balance sheet provisions under the adopted standard. Second, Atlanticus' loan book has grown at a breakneck pace over the last several years. New loan cohorts take at least a few months to become delinquent, and then charge-offs are typically after 180 days of failure to pay. Thus, rapid growth flatters Atlanticus' delinquency and charge-off performance relative to underlying performance.

Even with the support of its exponentially growing loan book, however, Atlanticus has seen delinquencies and charge-offs increase rapidly over the last year. And as growth fades (management reined in loan growth a little starting in Q2), this will likely continue even without increasing pressure on consumers' pockets.

We have described a terrible economic environment for the business, and significant increases in delinquencies within Atlanticus' loan book. So why does the company continue to report near-record earnings (last 12m net income as of Q3 2022 is only down 10% from the peak in Q1 2022)? Management has a lot of discretion over what assumptions are made with respect to loan losses on the balance sheet. Put simply, the company is currently assuming that the delinquent loans will see only modest default rates. We beg to differ.

The story here pre-dates the pandemic. Atlanticus had recognised large loss provisions in late 2019 as the higher risk loans it had started testing in 2017 started to perform badly. It added further to these provisions in Q1 2020 in expectation of COVID-prompted economic distress. In fact, governments stepped up with furlough schemes and direct stimulus, limiting unemployment and making consumers flush even whilst their spending options were constrained. Personal savings rates hit record highs and loan delinquencies and default rates collapsed. Atlanticus' problem cohorts were rescued, and it ended up with a large excess provision on its balance sheet. It gradually ran this provision down over the next four or five quarters, thus boosting profits beyond what we would view as the underlying operating performance. By late-2021, we would assess that the accounting stance was balanced - i.e. the excess provision from early 2020 was gone.

However, the pattern of boosting reported profits continued even when delinquencies started to increase rapidly from Q2 2021. Loan charge-offs jumped, but the loan loss provision was lifted much more gently than the increase in delinquencies: against an increase in delinquent loans since Q2 2021 of USD 303m, or 225%, the loan provision increased by just USD 80m, or 33%. Meanwhile, insiders sold almost 8% of the company for net proceeds of well over USD 50m. Unless a remarkable turnaround happens in the consumer environment, we expect the company will be forced to announce a large exceptional write-off of its loan book within the next few quarters, perhaps in the order of $200m or so. We would expect more scrutiny of disclosures from the auditors in association with the annual accounts, so perhaps Q4 reporting will prompt a reckoning? It's difficult to predict timing, but such a provision would cut equity capital by more than half and could well lead to the wholesale financing market closing to Atlanticus absent a significant equity issuance. In that scenario, at the current share price, Atlanticus would trade at over 3x book value. We think such a valuation is unlikely. So, although the stock is down over 70% from its peak, we continue to see significant downside.

Monthly percentage return for the GBP A share class of the Global Equity Fund

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2022	-1.7	-3.2	-3.3	3.4	0.4	-5.2	4.6	0.4	-0.4	0.5	4.2	6.2	**5.2**
2021	-2.6	1.4	2.6	3.0	0.7	-0.9	2.2	1.2	1.9	-3.9	1.8	2.3	**10.0**
2020	-4.7	-6.6	-5.4	4.6	-0.9	2.2	-4.4	-10.2	5.3	-0.7	-3.6	2.2	**-21.3**
2019	2.9	1.0	0.3	1.7	-0.2	0.5	1.0	1.8	1.9	0.0	-4.4	0.7	**7.3**
2018	-4.4	5.9	-0.9	3.3	2.9	5.9	1.9	4.0	0.9	0.8	0.5	-3.0	**18.6**
2017	-0.1	-1.4	-1.2	-2.9	1.7	-1.5	1.0	3.2	-2.8	1.3	-1.2	5.5	**1.3**
2016										1.3	-0.8	5.3	**5.8**

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