BrightGateCapital
INVESTMENT~INTELLIGENCE

**Annual letter to the co-investors of the BrightGate Focus Fund**

January 3rd, 2025, Madrid

*'The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelop our future.'*
*J. M. Keynes, The General Theory of Employment, Interest, and Money.*

Dear co-investors,

We hope you had a happy holiday season and wish you all the best for the year ahead.

The Fund closed on 31 December with a NAV (institutional class) of 1,873, representing a return of 21.0% for the year, compared with 25.0% for the S&P500, 18.7% for the MSCI World and 8.2% for the BofA US High Yield Index – all including reinvestment of dividends or coupons, but excluding the cost of currency hedging. Although the Fund does not have a benchmark, I consider the three indices above to be a representative group of the asset universe, international equities and high yield bonds, in which the strategy invests.

The Fund's philosophy is to build a concentrated portfolio of international securities with low turnover. In equities, the investment philosophy seeks companies operating in predictable industries where past may be a reasonable guide to the future, with minimal debt and trading at reasonable valuations – that can capitalise our investments at rates of at least 7-9%. Finally, the required rate of return on our fixed income investments is similar, after the corresponding currency hedging costs are taken into account.

As I have mentioned in previous letters, annual results should be interpreted with caution. While I believe that over the long term the performance of the Fund will be in line with the targets set at inception (Euribor plus 700 basis points), short-term movements in NAV, both up and down, may be largely random and not representative of the value creation (or destruction) that has taken place in each of our companies.

Over the year, the Fund outperformed international equity indices, underperformed US indices and outperformed high yield bond indices. It is important to note, however, that *these results were achieved with a high level of cash and, as I have said since 2021, without any exposure to technology companies, meme stocks or any of the other companies that have participated in the euphoria of recent months*, be it artificial intelligence, crypto assets or quantum computing – which, in most cases, lack even the rudiments of a reasonable business plan.

The current bubble, which, using different valuation frameworks, can be aptly described as the largest in the history of Western markets, has characteristics that make it both unique and different from previous bubbles. Different because every bubble must necessarily be different from previous ones; otherwise, it could be arbitraged consistently *and the ultimate purpose of financial markets under a capitalist system, that of discovering the future bit by bit* (Keynes' precious allusion at the beginning of this letter about the importance of 'defeating the dark forces of time and ignorance'), *would be completely redundant* – in other words, bubbles would never occur.

On the other hand, the bubble is identical to previous bubbles in at least two respects. First, the bubble story is underpinned by a truly innovative technology (artificial intelligence), while at the same time valuations are being inflated by overly expansionary monetary (and fiscal) policy. It is crucial to make the story interesting so that exogenous factors, in this case monetary and fiscal policy, do not distract investors from the short-term narrative.

Second, we see every day the proliferation of 'schemes' that promise quick riches (read the whole universe of 'decentralised finance') in exchange for the naïve credulity of the 'investors' of the day.

In the second 2018 edition of his book *Engines that Move Markets*, a work that explores the most revolutionary technologies of the last two centuries and their impact on stock markets, Alasdair Nairn reflects on the great similarities that all bubbles ultimately share:

> *'However, a striking feature of each chapter is the fact that while the patterns have not been identical in each case they have been very similar. First, a new invention is greeted with scepticism from incumbent technology and potential new investors. That scepticism is gradually replaced with enthusiasm, as businessmen come to appreciate the sales potential of the new technology. Soon, new entrants are flocking to the market, and venture capital funding is made available. Companies are started; almost all do well (in terms of share price) in the market on a tidal wave of enthusiasm. So far, so good; but as the technology begins to mature, a sense of realism sets in. Inevitably, for some, cash runs out. Companies begin to fold, only the strong survive and naive investors lose money in the huge rationalisation. Pessimism begins to pervade the marketplace and stock prices fall across the board. Eventually, the market stabilises.'*

Another feature that this bubble will share with previous bubbles will be its end. In this respect, Buffett's observation in an interview with Jason Zweig at the height of the dotcom bubble is instructive. Zweig asked the Omaha investor what he thought about all that was happening, to which Buffett '*replied with two calm, simple sentences I've never forgotten: 'I know what will happen. I just don't know when."*

In this year's final letter, I would like to explore in depth the aspect of financial markets I mentioned earlier about 'discovering reality bit by bit' – that arduous Keynesian process of defeating the dark forces of time and ignorance. However, I will approach the discussion not with the insights of economic and financial theory, but with those of a computer scientist who set them out in his most famous book two decades ago. These ideas will help me to show *why the task of forecasting is fundamentally flawed and why we cannot 'jump ahead in time' and simply see the outcome of events*.[1]

According to this computational worldview, the task of making predictions is not limited simply by our cognitive biases in understanding reality, as the behavioural finance literature suggests, but simply because reality is too (computationally) complex for us to find simple mathematical solutions that allow us to see the solution of the system at some point in the future.

[1] This is one of the reasons why my letters never contain 'market predictions, 'tactical outlooks' or other such rituals.

While I will not address this issue in this letter, the above discussion can easily be extended to the debate about whether artificial intelligence will completely replace active managers in the future, as it is already doing in many other areas. Artificial intelligence will undoubtedly bring many advances that we active managers will have to gradually incorporate into our strategies; however, from a computational point of view, *it will be as limited as we are in predicting reality and will also have to 'wait and see' how future events unfold.*

Finally, in the tradition of previous years' letters, I will set out the (summarised) theses and key developments during the year of the main positions that make up the portfolio. These summaries can be found in Appendix I to this letter.

## ¿Y 'ogo', 'ogo' qué pasa? A digression on cellular automata, computational irreducibility and the futility of predictions

Judging by the headlines in the financial press and the sell-side analysis, the US presidential election has been arguably the most momentous event of 2024. How should we position ourselves if Trump wins, what strategy should we adopt if Biden wins, what will happen to inflation and what will be the impact on the public deficit? And so on, endlessly, with other questions that seem to have no end in sight.

But the relentless 'treadmill' of the information society never stops. No sooner have we digested the outcome of Trump's victory than we are inundated with speculation about the impact on our portfolios of tariffs, inflation or the end of the war in Ukraine – to name but a few of the many unknowns that haunt us.

This psychological tendency to seek certainty in a fundamentally uncertain future is deeply ingrained in our behaviour. As the parent of a three-year-old girl, I can observe how, from a very young age, we feel the need to have some control over our destiny. Many mornings, upon waking up, my daughter asks me what the plan for the day will be, and when she finds out that it's 'only' planned up until lunchtime, she quickly follows up with: *'¿y 'ogo', 'ogo' qué pasa?' ['and what happens next?']*

While the desire to foresee the future may have certain positive aspects, *it becomes a fundamentally dangerous factor* when it comes to building a repeatable investment process.

Stephen Wolfram is a British scientist widely known as the creator of the mathematical software *Mathematica* and for having started publishing scientific research at a remarkably young age. In 2002, he published a book titled *A New Kind of Science*, a 1,200-page tome[2] that received highly polarised reviews.[3] Although the book has been extensively cited in disciplines as diverse as computer science, artificial intelligence, and philosophy, I believe it also has *profound implications for the entire forecasting industry*.

At the heart of the book lies the concept of a cellular automaton, which, despite its somewhat intimidating name, is actually quite simple.[4] A cellular automaton is a mathematical model

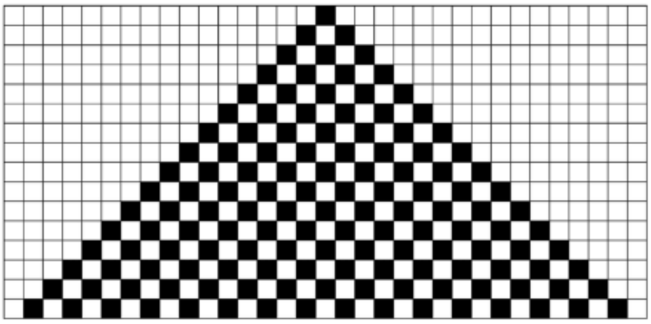
[2] For the more adventurous readers, Wolfram has published the book openly on the web, and it can be found here.

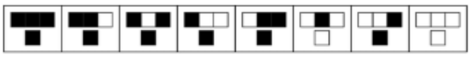
[3] Some of the most critical reviews of the book can be found here and here.

[4] The concept of the cellular automaton has a short but distinguished lineage, having been invented by John von Neumann in the 1940s. Prior to that time, scientists did not have enough computing power to process vast amounts of data, which severely limited the ability to study such simple systems. The most famous automaton is known as the

that graphically represents a system composed of cells arranged in a (typically one-dimensional) grid. Each cell can adopt one of two states, white or black, determined by specific rules. The rules define the colour of a given cell based on the colours of the previous cells. The cells are organised in rows, and the system evolves from the top rows to the bottom rows. For the first row, it is arbitrary which cells will be white and which will be black, and from there, the rules are applied to determine the state of the cells in the next row, and so on.

The best way to understand this is to look at a simple example. For instance, one of the simplest automata is one of the first ones presented in the book, called ‘Rule 250’. The rules that govern how this simple algorithm works and the pattern it eventually forms are as follows:





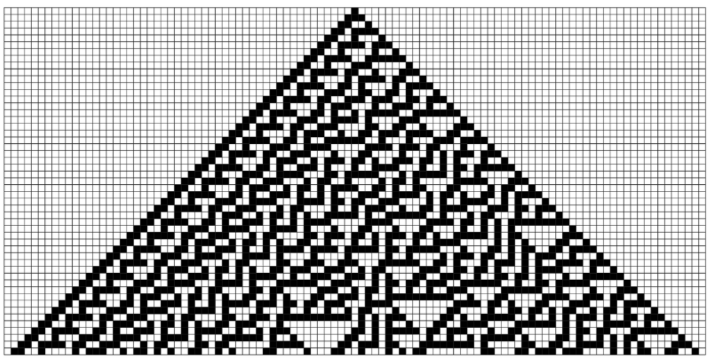
A cellular automaton with a slightly different rule. The rule makes a particular cell black if either of its neighbors was black on the step before, and makes the cell white if both its neighbors were white. Starting from a single black cell, this rule leads to a checkerboard pattern. In the numbering scheme of Chapter 3, this is cellular automaton rule 250.

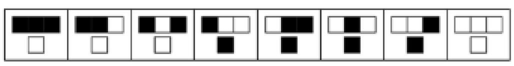
*Source: A New Kind of Science, chapter 3, p.25.*

As can be seen, the eight instructions in the box on the right (e.g., ‘three black squares produce a black square in the next row below’) cover every possible combination of cells, and end up producing a very predictable and, frankly, uninteresting pattern from the start.

Most of these cellular automata exhibit either simple or highly repetitive behaviour, and are not of much interest for what I want to explain.

Many readers may be growing impatient and wonder what point I am trying to convey with these simple games. It turns out that, under certain rules, there is a small group of cellular automata that end up producing very complex and seemingly random behaviour. For example, Wolfram shows us the result of another cellular automaton known as 'Rule 30', where the evolution of the algorithm proceeds as follows:

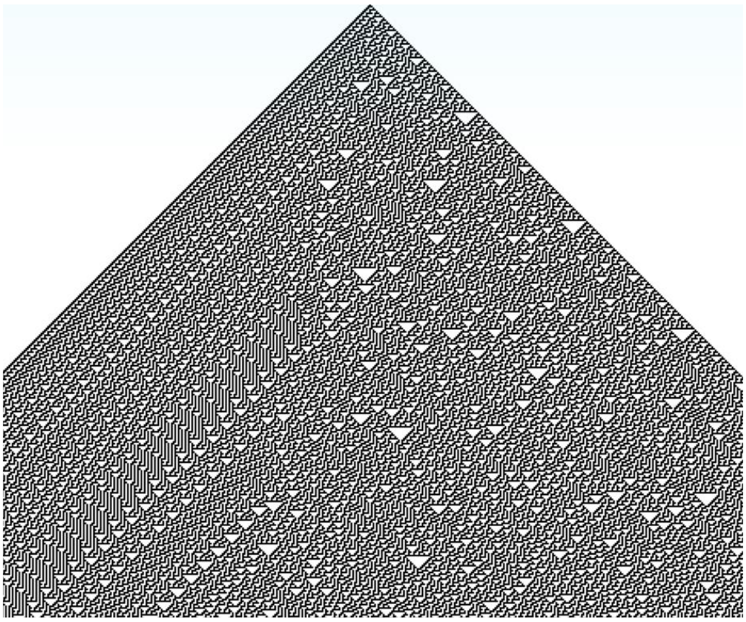




*Source: A New Kind of Science, chapter 3, p.27.*

'Game of Life' and was designed by John Conway in 1970. Readers can play with the automaton on various websites and contemplate the complexity of behaviour that follows from certain initial conditions.

Although it's clear that the automaton has parts that visually seem to follow a certain pattern (especially on the left side of the image), the overall behaviour appears completely random – even though it is generated by following a series of simple, repetitive rules. In fact, as can be seen in the next image, even if we iterate the automaton for a longer period (500 times), the system does not seem to reach any equilibrium points or predictable patterns:



*Source: A New Kind of Science, chapter 3, p.29.*

Two important implications can be drawn from this simple automaton. The first is that, although the rules governing the evolution of a system may be simple, the behaviour of the system may end up being complex. In fact, in such systems, '*it is overwhelmingly easier to generate highly complex behavior than to recognize the origins of this behavior*.' (p.551)

The second implication goes even deeper. Even if we know in advance the rules that govern the behaviour of the algorithm (a luxury we never have in the real world), *the unpredictable behaviour they generate makes that behaviour irreducible to a simpler solution by conventional mathematical or statistical techniques*. That is, if we want to know what the state of the system will be at (say) iteration 1,340, we cannot resort to a formula that gives us the solution directly, bypassing all the intermediate steps. The only way to know the solution is to simply let the system continue to run and compute all the intermediate steps to the final solution. Wolfram calls this property of some automata 'computational irreducibility', in the sense that the system is irreducible to a simple mathematical formula that would allow us to take a 'shortcut'.

It is precisely this property of certain algorithms that has *devastating consequences for our ability to make predictions in the real world*. If we accept the possibility that a large chunk of reality is generated by computationally irreducible processes, then, as Wolfram explains:

> *'Several decades ago chaos theory pointed out that to have enough information to make complete predictions one must in general know not only the rules for a system but also its complete initial conditions.*
>
> *But now computational irreducibility leads to a much more fundamental problem with prediction. For it implies that even if in principle one has all the information one needs to work out how some particular system will*

> *behave, it can still take an irreducible amount of computational work actually to do this.*
>
> *Indeed, whenever computational irreducibility exists in a system it means that in effect there can be no way to predict how the system will behave except by going through almost as many steps of computation as the evolution of the system itself.'* (p.739)

In other words, *the only way to know the future economic reality is for it to materialise*, and our job as investors is to move forward, step by step, defeating, as Keynes suggested, 'the dark forces of time and ignorance'. Who would have imagined that Keynes could have been a computer scientist!

Of course, it is possible that reality is not the result of simple algorithms – although this is open to debate, with some scientists arguing that it is indeed a plausible hypothesis.

For our much more modest purposes, *what is crucial is to recognise that if we cannot predict how a simple algorithm will evolve, even after knowing its rules in advance, we should be all the more humble and extremely cautious about our ability to predict systems whose rules are unknown to us, such as economic reality and financial markets*. Even less should we formulate investment strategies based on predictions. Instead, I believe that the application of simple rules, such as the use of base rates that I explained in the previous letter, and the ability to adapt to observable conditions (never to predictions) as they unfold, represents a much more robust and epistemologically honest way to manage risks in an investment portfolio.

And don't forget, the next time someone (other than your little daughter!) asks you, 'And then, what happens next?' just respond with: 'No idea, we'll see.'

## Main investments and divestitures made during the year

As was the case last year, portfolio turnover has been slightly higher than I would have liked, although it is now more in line with the vehicle's philosophy of holding positions for an average of at least 3 to 5 years.

The main divestments made during the year were Allisson Transmission, Green Brick Partners, Patrick Industries, and PHINIA. With the exception of the latter, which was acquired at the beginning of the year, all the others were purchased in 2022 at very depressed valuations. Although the results ultimately have not been as bad as the market expected, much of the gains in these stocks have been due to a strong expansion of their valuation multiples – meaning that the valuations at which we sold offered lower future returns.

Notwithstanding our divestment from these companies, *it is worth noting that they all remain candidates to rejoin the portfolio in the future* – if their valuations allow us to do so again.

The main additions to the portfolio were (in alphabetical order) BRP Inc., Garrett Motion, Mr. Cooper, and Vistry. The investment thesis for BRP is detailed in the appendix to this letter. In the case of Garrett Motion, the investment thesis is similar to that of PHINIA (and, to a lesser extent, Allison), as the company is trading at a very low valuation, the business is highly profitable (probably the most profitable auto parts manufacturer I have ever encountered), and the management team is following a rigorous and aggressive shareholder return plan, using most of the profits to buy back shares.

Mr. Cooper is the leading mortgage servicer in the United States, an absolutely crucial business given the structure of the US residential mortgage market, where most mortgages are off the balance sheets of banks. Mr. Cooper is the essential link between the millions of homeowners who have to pay their mortgage every month and the investors who hold these mortgages through mortgage-backed securities. The mortgage servicing business *has enormous economies of scale* because once the technology platform is in place to process transactions, the cost of servicing an additional mortgage is minimal. Mr. Cooper has been the leader in its sector in adopting an AI platform (through its collaboration with Alphabet) to process higher volumes at increasingly lower costs, an initiative that began even before the pandemic. Mr. Cooper is trading at only one times book value, which I find eminently reasonable given its 10-15%returns on equity, its leadership position in the industry due to its lowest unit costs, and the fundamental role it plays in the proper functioning of the US mortgage market.

Finally, Vistry has been the latest addition to the portfolio. This is a UK homebuilder with a different business model to the traditional builder. In Vistry's model, local partnerships provide the land and the company simply manages the entire development process through to final delivery. Although Vistry's margins are lower than those of traditional homebuilders, it is an eminently capital-light model since it doesn't have to carry the land on its balance sheet. Despite the optimism surrounding the company in many specialised investment blogs (where it has been christened as the 'British NVR'), *my view is somewhat more cautious. While the business model makes sense, the company itself is the result of countless mergers over the past few years, and it remains to be seen whether the business will truly work as expected* – in fact, the company has issued three profit warnings (yes, you read that right) in the last quarter. My thesis is somewhat more modest: after successive profit downgrades and a sharp drop in the stock price, we bought the shares at 0.7 times their book value, which, based on recent returns on equity (which sadly are not in double digits), should provide future returns of 12-14% in a conservative scenario. Vistry is the only exception in our portfolio where the company does not have a long and easily understandable earnings history; although it is clearly not a turnaround situation (the company has minimal debt and remains profitable), it is the closest of all the companies we hold – and that makes me especially cautious about this investment.

## Structure of the portfolio

Moving on to the portfolio's main metrics, as of December 31, the Fund held 4.6% in cash, with the remainder invested as follows: 67.2% in equities, 19.4% in fixed income, 6% in special situations, and 2.9% preferred shares. Geographically, our main exposure is to North America (66.8%), followed by Europe (16.7%), the Middle East (8.3%), and Latin America (3.6%). All of the companies in our portfolio have a long and proven track record of profitability (as measured by the return on net operating assets), and most of their incremental investments exceed our cost of capital. I believe that the current combination of liquidity, attractive companies at reasonable prices, and bonds yielding 7-8% (in euros) will position us better than the indices and our competitors in the event of an overall retracement of valuations, giving us the necessary flexibility to take advantage of investment opportunities as they arise.

The weighting of the fixed income portfolio has fluctuated throughout the year, although it has decreased in recent months due to the revaluation of some of our bonds. Since the construction of the portfolio is based solely on the individual characteristics of each of our investments, it is impossible to predict whether the fixed income weighting will increase in the coming months. Given the poor returns I expect from the major equity indices over the next few years, coupled with high volatility, *I have a preference for high-coupon fixed income instruments. Unfortunately, such bonds are increasingly difficult to find in the current economic environment*.

It is interesting to note that of the aforementioned 19.4% in fixed income, almost 10% is invested in a position we initiated at the end of the year in 30-year US government bonds. Although the stocks that make up our portfolio are far from the typical stocks that populate the indices, there is no reason why they should be exempt from short-term volatility in the event of turbulence, and I therefore thought it prudent to have a portion of our portfolio in these bonds – I believe that the current combination of extreme euphoria, extreme valuations and record high profit margins makes this to a prudent stance. It is important to stress that *this investment is not simply a macroeconomic bet on the long-term direction of interest rates* (especially after writing several pages on cellular automata and computational irreducibility in this very letter!), but rather a complement to the rest of the portfolio. Unlike most financial protection products on the market, which always have a cost, these bonds will generate a reasonable carry in the meantime.

As you know, the currency of the equities of the portfolio has been partially hedged since last year, given our increasing exposure to the US, while the bonds are fully hedged. Although I believe that the dollar will structurally appreciate against the euro in the coming years, these macroeconomic considerations are irrelevant to the construction of the portfolio, which is based solely on my conviction in each individual security and not on the currency in which they are denominated.

I remain at your disposal to answer any questions you may have or to discuss any of the securities in our portfolio in more detail.

*Nullius in verba*,

Javier López Bernardo, Ph.D., CFA
*Portfolio Manager*

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## Appendix I. Summary of the theses of our main positions

### Auto dealerships: Asbury Automotive (ABG:US), AutoNation (AN:US), Lithia Motors (LAD:US)

Our position in US dealerships remains the largest weighting in the Fund one year later. This exposure is spread across three positions which, in order of importance, are Asbury Automotive (ABG:US), AutoNation (AN:US) and Lithia Motors (LAD:US). AutoNation is the only new position in the portfolio, as both Asbury and Lithia are positions we already held at the end of 2023 and have held with minimal changes over the year.

While I consider all three companies to be attractive investments, I continue to believe that Asbury is the one that best captures a combination of an attractive valuation, an excellent management team and, as I will explain below, the most straightforward business plan of the three.

I explained my thesis on dealerships in some detail in the 2023 letter, and things haven't changed much since then. In summary, dealerships have historically been a profitable business in the US (it is always said, half-jokingly and half seriously, that it is one of the businesses that has created the most millionaires), helped by legal barriers to entry that regulate distribution at the state level (*franchise laws*), by a largely variable cost base, and by a repair and maintenance business and the sale of financial products that have high margins, require little capital to operate, and are stable throughout the economic cycle. All this means that a well-run dealership enjoys high returns on capital and, most importantly, on a recurring basis – unlike, for example, other companies operating in the automotive value chain.

All six of the listed dealer groups, with the exception of Sonic Automotive, are profitable and well-managed businesses, suggesting the benign competitive intensity that prevails in the industry. While an outsider might think that an investment in one of these companies would be interchangeable with another, a closer look at the companies reveals at least three differences that I believe are important.

First, most groups (Lithia, Group 1 and Penske) have chosen to diversify part of their business outside the US. Given that international operations are generally inferior to US operations (lack of franchise laws being one of the main reasons) and that there are no synergies from operating in multiple geographies, as dealerships are businesses with few economies of scale given the low proportion of fixed costs in total costs, *I find it difficult to justify allocating capital to geographies other than the US*. Asbury and AutoNation are the two exceptions in this regard - although AutoNation recently attempted to enter the UK with the acquisition of Pendragon, which was eventually acquired by Lithia after a bidding war (!).

Second, the allocation of capital within the group has varied, from allocating capital primarily to buy back shares (the case of AutoNation) to growing by acquiring other groups (the case of Lithia and, to a lesser extent, Asbury). In particular, I believe that Lithia's M&A aggressiveness in recent years is already reflected in the group's financial statements (in the form of an excessive amount of intangible assets) and will have a lasting impact on its return on capital going forward.

Finally, I believe that any attempt to allocate capital outside the core dealership business creates additional risks and does not generate incremental returns that are better than those already available to dealers. In particular, initiatives such as AutoNation's move to build huge stores dedicated to the used car business, or Lithia's move to launch its own finance company, add noise and offer diversification whose benefits are questionable. In my view, simple business plans (such as Asbury's or Group 1's) are the ones that investors should prioritise.

2023 was a transitional year for the entire industry, which enjoyed very high margins as a result of supply chain problems during the pandemic. In those years, gross margins on new and used car sales soared, artificially inflating dealers' profits for a time. Asbury, for example, went from a return on net operating assets of 15% (its historical average since 2010) to 20% in 2022. A similar story was repeated across the other groups.

The partial normalisation that occurred in 2023 (and 2024) has led the market to question the normalised profitability of these companies going forward. Investors using discounted free cash flows (FCF) to value these companies face the additional challenge that cash flows are highly volatile and do not reflect near-term shareholder value creation. In times of expansion, this metric is usually depressed, while in times of recession it tends to expand. Additionally, it also penalises those companies that have grown and reinvested in the business – as in the case of Asbury.

The sector as a whole continues to trade at very attractive valuations, both in relative and absolute terms. Recall that in the case of Asbury, return on net operating assets (RNOA) has averaged 16% over the years, while return on equity (ROE) has risen to 35% as a result of the (moderate) financial leverage with which these businesses are managed. With Asbury currently trading at 1.5x book value (1.2x net operating assets), *I still think the probability of 15-18% annualised returns over the next few years is quite high*. Lithia's returns should be similar, although as I have pointed out, the risks of integrating all its acquisitions to date are much higher. Finally, the returns I expect from AutoNation are lower (in the 12-14% range), although if there is a sharp market correction (as there was during the pandemic), we should benefit disproportionately given the company's aggressive share buyback programme that has been in place for years.

## Northeast Bank (NBN:US)

I explained the Northeast Bank (NBN:US) thesis in detail in the H1 2023 letter, and added some thoughts on why its different business model is superior to most of its competitors in the letter a year ago. Readers unfamiliar with the investment thesis should read those comments first, as here I will simply summarise the main developments of the year.

NBN closed 2024 as another year of exceptional results.[5] Return on equity (ROE) was 17% and, remarkably, this was achieved with very conservative leverage, as the return on assets (ROA) was close to 2%. The efficiency ratio remained low at around 40% and credit losses, as usual, were close to zero. Finally, the loan portfolio grew from $2.5 billion to $2.7 billion, which was remarkable given that the strong growth of the previous year (from $1.3 billion to $2.5 billion) might have suggested that Rick and his team would struggle to find

[5] NBN's financial statements close in June, so when I say 2024, it should be understood as June 2023 to June 2024.

opportunities to replace maturing loans in their portfolio. Fortunately, this has not been the case.

As a consequence of the strong performance and the financial markets becoming more bullish on banks (and thus expanding their multiples), NBN's share price rose 65% during the year, closing at a valuation of close to 2x book value and becoming one of the Fund's top holdings.

However, the two most relevant news of the year came in the last few months and have been responsible for the strong share price performance since then.

First, NBN announced a significant loan purchase of $805m in September, representing almost 30% of total loan volume at the end of June 2024, which will significantly increase the bank's earnings power going forward, not only because the leverage ratio will increase, but also because the incremental volumes have almost no additional fixed costs. How profitable are these additional volumes? Assuming net interest margins of 5%, zero credit losses (in line with NBN's track record) and tax rates of 25%, the $800m of loans should contribute around $30m of net profit. With a 10x leveraged capital structure, *ROEs should be over 35% (30/80), well above the bank's current ROE.*

Secondly, in its October results, NBN provided details of its new lending vertical under the Small Business Administration (SBA) programme, a government initiative that provides financial support to small businesses in the United States. The SBA does not lend directly, but guarantees a portion of the loan made by banks (such as NBN), thereby reducing the risk for lenders and encouraging lending to small and medium-sized businesses. The average loan size is $150,000, which makes it cumbersome for large banks as the paperwork often does not compensate them for the hassle of getting into a business where volumes may not be large enough for them. Although the borrowers are small businesses, credit losses have historically been limited to 3%. The SBA business is capital light as the NBN sells the 85% guaranteed by the SBA to other institutions at a premium of around 10% (as this portion is guaranteed and carries no credit risk). This premium, received shortly after the loan is made, allows it to generate the necessary equity to keep the remaining 15% of the loan amount on its balance sheet, which is currently earning interest rates in excess of 10%. All this means that, according to my figures, the return on equity for this business can be over 50%.

After several years of building up the origination platform, recent data (available [here]) shows that NBN's volumes have risen sharply in recent months and it is already one of the largest lenders in the SBA programme in the entire US. I do not know how sustainable this additional source of profit will be for NBN, not so much because of regulatory changes by the government,[6] but because of the entry of new entrants into this lucrative niche market. Apart from being an attractive short-term growth opportunity for the bank, *the moral of the story is that, as always, Rick and his team under-promise and over-deliver.*

What do I see as the biggest risk to the investment thesis? Quite simply, the continuity of the current management team. Rick Wayne is 72 years old, and while he still has a lot of energy and loves what he does,[7] the period over which we will be able to capitalise at attractive rates

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[6] In fact, the trend has been the opposite, as the recent changes (elimination of an origination fee, elimination of collateral requirements and an increase in the guaranteed portion from 75% to 85%) have been designed to generate more interest in the programme.

[7] A very amusing recent anecdote about Rick's fitness was told by Sam Haskell in [a recent post] on his Five Points blog (a must-read for regional bank investors). In it, Haskell relates the following: *'Wayne was just finished with dinner when I*

is obviously very different to when he was 55. However, given that Rick and his team have tripled the book value of the bank in the last five years alone, it is not unreasonable to expect them to do so again in the next five years, given higher ROEs in their traditional business (thanks to the economies of scale I mentioned earlier) and higher ROEs in the new SBA business.

**Kaspi.kz (KSPI:US)**

One year on, we continue to hold our position in Kaspi, which we have not sold since our initial purchases over three years ago. Of our main holdings, Kaspi's share price has undoubtedly been the worst relative performer during the year versus the company's good operating performance.

What happened during the year to make this performance so poor?

Let's start with the negative news – really the only negative piece of news of the year. In September, short selling manager Culper Research published a 30-page report explaining why it was short Kaspi and why it believed the stock was grossly overvalued at then current prices (around $130 per share). The report speculated that Kaspi would eventually be affected by the imposition of international sanctions, based on alleged allegations of money laundering and links to Russian citizens. It also argued that some of the company's recent growth was due in large part to the influx of Russian migrant funds following the outbreak of war in Ukraine in 2022. Finally, he argued that the company was trading at a very high valuation (!).

In general, my general stance on these types of reports is to be extremely conservative *and assume from the outset that the short seller is right*. Although the type of companies in which the Fund invests are not typically targeted by the short-selling community, I always follow a handful of short sellers because I have long believed that, on average, they do a far better job of analysis and research than we long-only managers do. In fact, history shows that short sellers are often the only ones who bring down fraudulent companies and act as the 'police' in the markets.

However, Culper's report was riddled with inaccuracies and outright misstatements of fact – so gross, in fact, that it misspelled the names of certain people who were crucial to the plot. The arguments that were easiest for outside investors like us to prove, the recent growth and the valuation of the stock, were easily falsifiable; for example, the report used the price-to-sales multiple as a valuation metric, ignoring the fact that Kaspi has the most profitable business model among its 'comparables'. [8] On the other points, Kaspi published a strong note refuting the main points of Culper's report – in fact, Culper did not publish a response, which is typical of short sellers.

*asked him, and promptly faked a heart attack. He then yelled out something like 'As long as these knuckleheads will work with me!' and pointed to his executive team. Notably, after dinner Wayne visited a cigar bar with his team for several hours. He later returned to his hotel, met some other friends, and returned to the cigar bar without his two executives who couldn't keep up. He got home at 1:30am. He met me the next day and I could not tell he had been out.'*

[8] I could not resist pointing out that the use of such a multiple also shows a serious lack of understanding of how accounting and valuation work. The 'sales' metric is an 'unleveraged' metric because we use both equity and debt to achieve those sales, while 'price' is a metric that includes the leverage of the business – it is the price per share, which accrues only to the company's shareholders. If we were to use a multiple of sales (a practice which, as I explain in the text, is misleading anyway), the correct multiple to use would have been enterprise value (EV) divided by sales.

However, as I write this, the share price is about 25% below where it was at the time when the report was published. The only silver lining in all this is that if a short seller who spends (or should spend) countless hours trying to find a company's weaknesses is all he has found so far on Kaspi, then we should feel more comfortable with the analysis we have done so far.

Let us now turn to the positive news, of which there was plenty. The first is that in October Kaspi announced the acquisition of 65% of Hepsiburada, Turkey's second largest marketplace, for $1.1 billion. The transaction represents about 5% of Kaspi's market capitalisation, so I see it as a very asymmetric and affordable bet with limited downside risk and immense potential. Although synergies will be limited initially (for example, the companies will operate under different brands and platforms), I believe the Kaspi team's execution, based on its obsession with creating products that consumers value, will allow Hepsiburada to continue to grow its business profitably and gain market share from its competitors. Although the business will not initially be as profitable as its Kazakh counterpart, given the absence of the other two legs of the business (fintech and payments), the potential future integration of the fintech business will be an event to watch closely.

Secondly, the company moved its ADR listing from London to Nasdaq in March. While such a move obviously has no impact on the value of the company, it does reflect management's commitment to a high level of transparency and a desire to make the company's story better known to a wider universe of investors.

Third, in Kazakhstan, the company will end the year with net profit growth of 25%. All recently launched initiatives (B2B payments, online supermarket, car buying and selling platform and financial products in the automotive sector) are still maturing and will bring (profitable) growth to the company in the coming years. In all these verticals, there is still a lot of growth ahead given Kaspi's current low penetration (e.g. Kolesa, the online car portal, was acquired last year) and the sheer size of these markets. As I said in last year's letter, *'[i]rrespective of how much this or that business contributes, I think the above shows that the management team has a clear roadmap ahead, that they are extraordinary performers in the day-to-day operations of the company, and that the Kaspi app is so integrated into the lives of the Kazakhs that the company is able to enjoy network effects that are simply unattainable by any competitor.'*

Given the strong earnings growth this year and the 20% I estimate for 2025 (excluding Turkey's contribution, which will be modest given Hepsi's lower margins), the valuation at which Kaspi is trading is the most attractive it has been for some time. At the time of writing, its market cap is around $19bn, which, on earnings of $2.5bn, implies a trailing 12-month P/E of around 8x – lower if we include forward earnings in 2025. Even assuming no future growth (a completely unrealistic assumption), *the investment returns at current prices should be in double digits for many years to come*, and even higher if management executes flawlessly the international expansion.

**BRP Inc. (DOO:CA)**

BRP (DOO:CA) is the only major position that has entered our portfolio in 2024. BRP (Bombardier Recreational Products) is a Canadian powersports company that designs and manufactures snowmobiles, personal watercraft, all-terrain vehicles (ATVs) and side-by-side vehicles (SSVs).

The company has a long and distinguished history of innovation since its inception. Founded in 1942 by Joseph-Armand Bombardier in Quebec, the company's original business was the manufacture of snowmobiles, a mode of transport first invented by Joseph-Armand himself in 1935. In 1958, the company produced its first light snowmobile under the brand name Ski-Doo, due to a typographical error that should have read Ski-Dog. In 1968, the company expanded into the manufacture of personal watercraft, it acquired Rotax (the engine manufacturer for Ski-Doo) in 1970, it acquired the Lynx snowmobile brand in 1989, and in 2003 the company was spun off from Bombardier's industrial business and was acquired by Bain Capital, the Bombardier family and a Quebec institutional investor.

Over the past two decades, BRP has entered the off-road vehicle (ATV) and side-by-side vehicle (SSV) market, the largest sub-segment of the motorsport industry where BRP was not present. Today, BRP is one of the largest players in this sector, especially at the premium end of the industry, operating under its Can-Am brand, which is expected to continue gaining market share in the coming years.

Taking a step back, BRP's business is attractive for several reasons. Without going into too much detail, the powersports industry is oligopolistic (especially in the snowmobile and personal watercraft sub-segments), where the major manufacturers enjoy certain economies of scale (the proportion of fixed costs is higher than in similar industries, such as recreational vehicles, due to the higher degree of automation in the production processes), brand is a very important consideration for consumers (who are looking for excellent performance and product reliability) and, finally, it is crucial to have a consolidated and dense dealer network that can serve the customer on a recurring basis throughout the life of the product.

BRP has a senior management team *with arguably the best track record in the industry*. The CEO is José Boisjoli, an engineer by training, who has held the position since December 2003, when the Bombardier business was spun off. Boisjoli is a motorsport fanatic, having had his first Can-Am bike at the age of twelve and having met his best friend using BRP products. Under Boisjoli's leadership, the company has thrived through a series of bold bets that have contributed on both the cost, product and distribution sides.

On the cost side, the main milestones have been the gradual transfer of some production to Mexico (where most of the units are now manufactured) and the increased overlap between platforms, which has reduced the number of parts in the catalogue despite the increase in the number of products the company makes. Boisjoli borrowed the idea of standardising parts and processes from German carmakers (Volkswagen), spending two days in Europe in 2010 to understand the system and a couple of years implementing it. The result is that, to take just one example of many, all the power steering mechanisms on a BRP ATV, SSV or Spyder are now the same.

The management team has also demonstrated over the years a consistent philosophy of innovation, understanding customer needs and the importance of maintaining brand image. BRP is known in the industry *for not cutting its R&D budget (the highest among its* *competitors, both in dollars and as a percentage of sales) during the inevitable industry downturns*. This commitment to R&D extends to the way it protects the value of its brands. For example, in the last earnings call with investors, Boisjoli openly addressed the potential loss of market share in SUVs in the short term, arguing that it is better to protect the brand's image in the long term than to temporarily compete with competitors' models from previous years that are being sold at deep discounts:

> *'And the reason why I ask is I'm curious, how do you address retaining loyalty if consumers are baited by the promo on the heavy non-current of competitors? Because the entire industry is challenged until this clears, correct?'*
>
> *'Yes, but at the end of the day, there are so many customers, and some who shop for a price, could buy a Can-Am, but if we don't have any concurrent, non-current, they will buy another brand. But again, we've been able to grow market share by the quality of our product, by the innovation with our product, the technology, and this is the bet that we take. We push technology and innovation to attract more customers and gain share. Then, we grew from 0% in 2010 to 20% last year -- to 30% last year, and we still believe that we can continue to grow. But we cannot gain any or every customer who shops for a price. This is not who we are.'*

Although BRP holds leading positions in most of the sub-segments that make up the motorsport industry, the industry as a whole is in a slump following strong sales during the pandemic period and the consequent increase in the volume of inventories accumulated in the distribution channel.

Previous short-term macroeconomic concerns have penalised BRP's valuation in recent months, leaving it at a very attractive level in my view. Firstly, it is interesting to note that the company has a low level of debt, which will allow it to withstand adverse conditions should the downturn last longer than usual. In terms of returns, the company has achieved an average RNOA of 40% over the past decade, *all of which has been achieved organically with very few acquisitions* – in other words, the balance sheet is not distorted by goodwill and other intangibles that could depress RNOA going forward. Given the 2.5x EV/NOA valuation at which the company trades at the end of the year, I estimate a double-digit yield in the region of 15%, which I consider extremely attractive given the quality of the business, the outstanding quality of the management team and the low leverage with which the company operates.

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