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Q1 2024 Investor Letter

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Performance

Note: This document contains excerpts from the Investor Letter that was published to current and prospective LPs. In order to comply with all applicable regulations, certain performance data and portfolio data have been omitted. Please sign up for our quarterly letter on our website to receive complete updates inclusive of performance data.

Portfolio

Night Watch manages a global value strategy that differentiates on the following points:

Catalyst – We predominantly buy value companies with an identifiable catalyst for a rerating. Catalysts can include industry tailwinds or company specific catalysts (e.g., CEO changes, earnings inflection, refinancing).

Inside Ownership – We aim to find companies where management has considerable ownership in the company. We consider this alignment of interest to be an important determinant of share price performance.

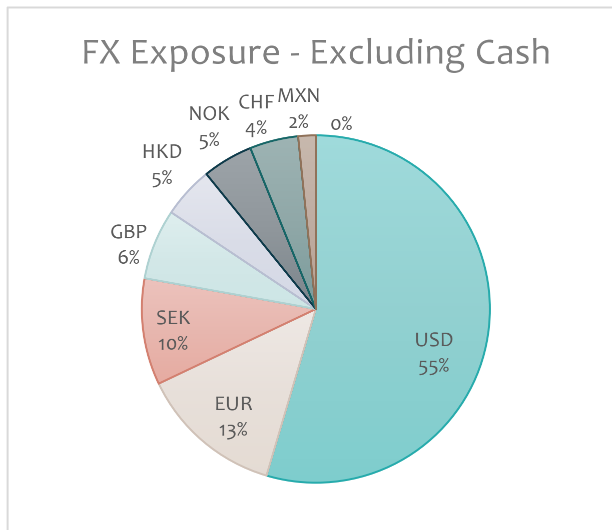
Unique Names – To be commercially relevant among a long list of other value strategies, we seek unique portfolio holdings that have little overlap with a typical wealth management portfolio. We thus aim to provide our LPs with diversification from their other investments in addition to strong performance.

The portfolio as of March 31st, 2024 is as follows:

Name	Weight	# of Positions	Insider Ownership?	Catalyst?
Housing	7.1%	1	1/1	1/1
Consumer	16.1%	4	3/4	4/4
Aerospace	15.0%	4	3/4	4/4
Counter-Cyclicals	11.4%	3	2/3	3/3
Energy	7.9%	1	0/1	1/1
US Onshoring / Fiscal Stimulus	9.2%	2	1/2	2/2
China Reopening	8.6%	3	2/3	1/3
Other	19.6%	6	5/6	5/6
Event Driven	2.0%			
Cash	3.0%			
TOTAL	**100.0%**	**24**	**17/24**	**21/24**

Largest positions:

- Valaris (7.9%)
- FlatexDegiro (7.5%)
- St. Joe (7.1%)
- Haypp (6.5%)
- Distribution Solutions Group (5.8%)



As a global strategy, we invest our money where we believe the best opportunities exist – regardless of jurisdiction. Our USD exposure is currently 55%, but this excludes companies such as Ashtead, which is listed in the UK but is effectively a US-based business. We believe the current FX exposure is reflective of how we aim to position our portfolio in the long run. We intend to keep significant USD exposure due to the stronger focus on maximizing shareholder returns in the US versus other jurisdictions.

Strategy Update

During the first quarter of 2024, the market seemed preoccupied with chasing a handful of 'hot stocks' related to trends such as AI. In November of 2023 we published a document that described our strategy for 2024. This provided us with a roadmap to build our portfolio without being distracted by the current exuberance in US tech stocks. As a reminder, the themes identified in this strategy included the following:

Aerospace – Due to the halt in production of the Boeing 737 Max in 2018/19, followed by a collapse in both Boeing and Airbus production during Covid, there is a global shortage of airplanes. Boeing and Airbus are currently sold out until 2030 and everyone within the aerospace supply chain stands to benefit from this supply – demand mismatch. We invested in 3 companies in the aerospace supply chain, as well as the largest global lessor of airplanes. During Q1, Boeing struggled with various safety related problems, causing the FAA to halt production expansion of the Boeing 737 Max for the time being. This added uncertainty meant we could purchase our shares at slightly lower prices than at the beginning of the year.

Housing underinvestment – We believe that ever since the housing downturn in 2008, the US has been underbuilding houses relative to demand. The rapid rise in interest rates during 2023 put pressure on the share prices of US homebuilders and their suppliers. Unfortunately, most of this dislocation had been restored by the time our strategy launched, meaning we have only managed to build a position in St Joe (JOE), a land developer in Florida's panhandle.

Energy underinvestment – We believe the world has vastly underinvested in energy infrastructure since the oil downturn started in 2014. Moreover, uncertain government regulation, punitive taxation and political pressure are starving European and American energy companies from the capital needed to satisfy the growing global demand for petroleum. This means that the world's growing need for petroleum will be met by production from the Middle East, Western Africa and Offshore Brazil. That's why we invest in drill rigs and offshore supply vessels that are necessary for offshore oil production.

During the quarter, Saudi Arabia announced that they now aim to grow their production to 12 million barrels per day, versus the 13m barrels previously indicated. Since Saudi Arabia's current oil production hovers around 9m barrels and they have never sustainably produced over 11m barrels, we believe this to be a non-event. The uncertainty caused by this event meant that we could build our positions at even more attractive valuations.

Bargain hunting in consumer stocks – Consumer stocks have rightfully suffered in the last two years, as high inflation and higher interest rates lowered discretionary income of the global consumer. We have acquired positions in several consumer stocks that have been able to offset these macro pressures by market share gains. We will remain nimble in our sizing until we have more insight into when consumer spending is expected to recover.

Defensive / Counter-cyclical investments – We have bought shares in 3 different companies that we believe will grow their earnings faster during economically difficult times. We intend to discuss some of those names in more detail in future updates.

Position Highlight

The majority of our portfolio consists of names that we have followed for many years. One position that was new to us, and incidentally also ended up as the biggest contributor to our performance, is the Haypp Group.

The Swedish **Haypp Group (HAYPP SS)** is the most dominant e-commerce platform for snus and nicotine pouches. The latter is better known in the US under its most ubiquitous brand name Zyn, although there are a growing number of competing brands. The industry is characterized by a ban on online advertisement for tobacco and nicotine products. As a result, players can't buy market share by spending on Google ads. To compete, every e-commerce player needs to focus on Search Engine Optimization. Through an aggressive M&A strategy, Haypp has acquired a dominant market share in Sweden (85%), Norway (80%), the US (85%) and the UK (65%). They have the highest percent of returning customers and 2 out of the top 3 Google search results are generally websites owned by Haypp. In the US, they do business under the names Nicokick.com and Northerner.com.

This is probably the best e-commerce business we have come across. Haypp does not need to spend on marketing (only 0.6% of sales), does not deal with frequent returns, and has a dominant market share. Meanwhile they are growing >20% per year while their margins expand.

So, let's talk about growth. Most growth is expected to come from increased online sales of nicotine pouches in the US and the UK. As a reduced harm product, demand for nicotine pouches is growing rapidly as they offer smokers a similar buzz to smoking without containing tobacco. Zyn has 76% market share in the US and is currently growing >70% per year. However, only 2.5% of all US sales currently happen online, compared to around 30% in more mature markets like Sweden. In most states online penetration is only 1.5%, but in Texas this grew to 6.0% after Haypp recently opened their own warehouse and can guarantee 1 or 2-day delivery. This shows that there is potential for other states to catch up to Texas as the US market matures and Haypp rolls out its own logistics network. Therefore, Haypp's US sales should outpace the current 70% growth in end user demand. It must be noted though that Haypp's mature markets Sweden and Norway have considerably lower growth, as nicotine pouches cannibalize sales of snus, which are similar but do contain tobacco. Overall growth is therefore projected to be in the 20-25% range.

On sales and margins, Haypp is guiding to 5B SEK in sales in 2025, at a 5-7% EBIT margin excluding growth investments of 1-2%. Longer term, Haypp sees margin potential of 8-9% as they build scale. This is based on their experience in Sweden, which is a competitive market where gross profit margins are around 13%. However, industry margins in the UK much higher, so the potential margin uplift can be huge if Haypp uses their 80-90% market share to increase price. For example, Haypp sells a can of Zyn for $4 per can, while a convenience store charges $7-8 per can; we see potential for Haypp to close the price gap. We acquired our shares at just over a $1.5B SEK market cap, or close to 5x 2025 pre-growth EBIT.

We expect Haypp to reach close to 10B SEK of sales by 2028. At a 10% EBIT margin and a 7.5% Net Income margin, EBIT would be 1b SEK and Net Income 750m SEK. We believe a 15x EBIT / 20x P/E valuation is reasonable given the long growth runway, dominant market position and capital light nature of the business. This leads to ~15b SEK in market cap, which is around 9x our acquisition price, or 6x today's share price.

We have done considerable due diligence on the company. In addition to talking to Haypp management, we have spoken to various industry experts who deal with Haypp on a regular basis. They not only confirmed the company's strong reputation and management's track record, but also highlighted how much they value the consumer insights that Haypp provides its suppliers. In their words, manufacturers of nicotine pouches can't do without Haypp.

The risks to this investment are obvious. Any day you could wake up to read that an overzealous politician has chosen to ban nicotine pouches, or simply the online sale of those products. Because there is hard data to support the reduced harm claims of those products – Sweden has the lowest cancer rate and the lowest percentage of smokers in Europe – we only consider this a tail risk. Our downside protection comes from the fact that the business in Sweden and Norway already justify today's valuation. Especially in Sweden, the consumption of Snus and nicotine pouches is ingrained in the culture, making regulation less likely.

Conclusion

We believe we are well positioned to benefit from various long-term investment trends, as well as from some stock specific investment opportunities. We look forward to updating you after Q2.

On behalf of the Night Watch team,

Roderick van Zuylen
Chief Investment Officer

Important Disclosures

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