

Investment Strategy – Outlook 2024

Published: December 2023

This document provides an overview of Night Watch Investment Management’s investment strategy and key investment themes for 2024.

The Night Watch Team:



Roderick van Zuylen
Chief Investment Officer



Martijn Kleinbussink
Research Consultant



Eileen Ke
Chief Operating Officer

Contents

- Introduction
- Investment Theme 1: Aerospace Order Book
- Investment Theme 2: Housing Underinvestment
- Investment Theme 3: Energy Underinvestment
- Investment Theme 4: Bargain Hunting in Consumer Stocks
- Investment Theme 5: Defensives / Counter-cyclical Investments
- Important Disclaimers

Introduction

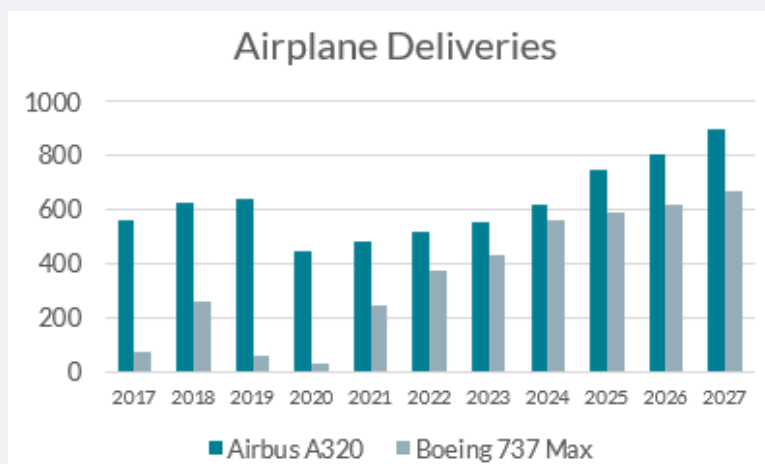
Night Watch Investment Management combines top-down macro analysis with bottom-up company research. We believe the best investments benefit from strong macro tailwinds, while simultaneously demonstrating the characteristics of strong-performing companies: generating high free cash flow, well-aligned management with a good track record, and a conservatively financed balance sheet.

Some of these macro tailwinds and their investment implications are explained in the investment themes presented here. By investing along specific well-researched themes, we ensure that our portfolio has a clearly defined strategy.

For institutional investors who would like to receive the stock-specific deep dives related to the discussed themes, please contact us.

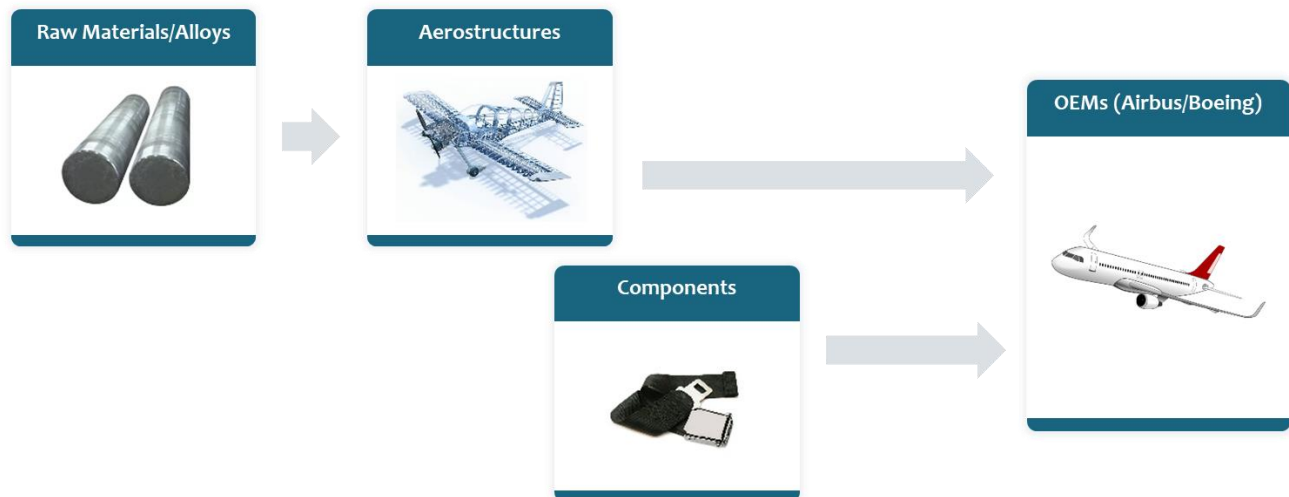
Theme 1: Aerospace Order Book

Investment Thesis in One Chart



Demand for narrow body airplanes such as the Airbus A320 and Boeing 737 Max far exceeds supply. This means that the OEMs have a full order book until 2030, and it is impossible to order a new plane for delivery before that date. The shortage is caused by 1) discontinued production during Covid, after which disrupted supply chains kept production low 2) continued growth in air travel 3) safety issues with the 737 Max in 2019 4) soft demand in 2016-2019 due to the expectation of new airplane models. Simultaneously, demand from the defense sector is increasing following geopolitical turmoil in 2022/23.

Value Chain



Investment Implications

Night Watch has identified companies in all parts of the aerospace supply chain that benefit from the increase in demand. This includes a manufacturer of aluminum and titanium structural parts and a manufacturer of USB charging points and power distribution systems for airplanes. Both companies trade at a fraction of replacement cost and both should benefit from operating leverage when their production increases. The bottleneck to higher profits is not demand, it is the industry's ability to ramp up production.



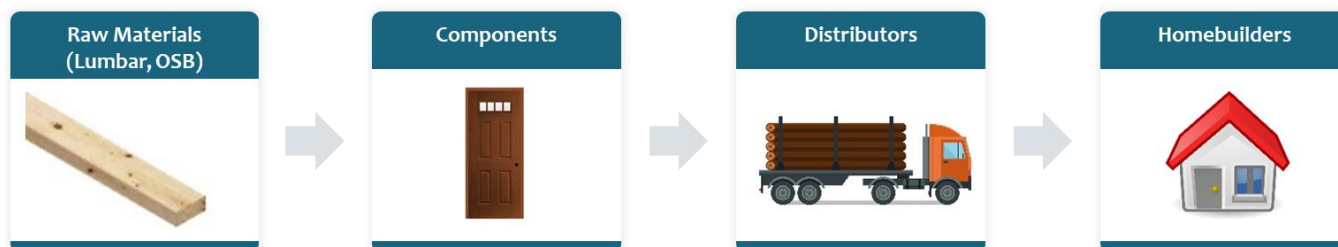
Theme 2: Housing Underinvestment

Investment Thesis in One Chart



Household formation requires the annual construction of ~1.6 million houses per year, of which ~1 million houses are single family. While the industry was overbuilt in 2008, a deficit of 3-5 million houses has been created from 2008 to 2020, leading to an aging US housing stock. The recent increase in mortgage rates makes affordability an issue and will put pressure on housing prices, or the margins earned by homebuilders. However, after a potential correction in price, volumes of constructed houses should remain high for the next decade. Meanwhile, the average US house is over 40 years old and will require renovations.

Value Chain



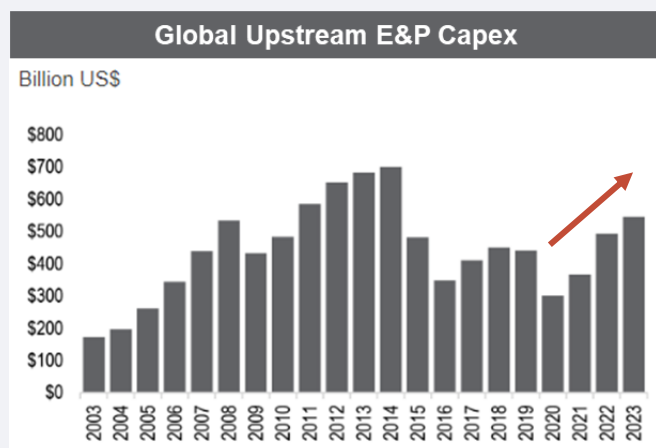
Investment Implications

Night Watch invests in companies that benefit from housing volumes and avoid price risk. Homebuilders will therefore be avoided, as will lumber producers which are too commoditized. Our preference goes towards the value-added distributors, which we believe to be the highest quality business models. Companies like Builders FirstSource help homebuilders through the delivery of pre-manufactured housing components. The duopoly of insulation installers Installed Building Products and TopBuild have a combined 65% market share and continue their rapid growth. Even an industry seemingly as simple as doors is a duopoly with Masonite and Jeld-Wen making up 71% of the market. Such industry concentration makes for attractive returns on capital.



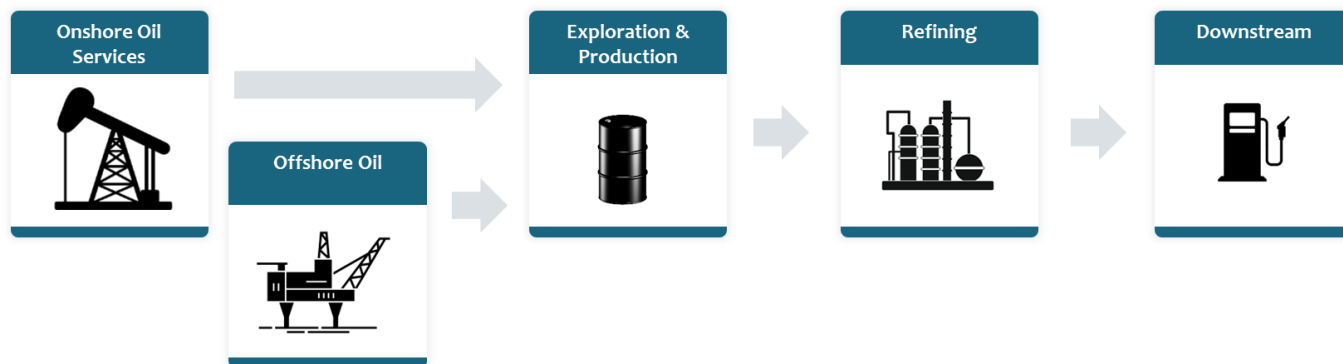
Theme 3: Energy Underinvestment

Investment Thesis in One Chart



Global spending on new oil & gas projects has been subdued since 2014, when an increase in US share oil production put pressure on the price of oil. Meanwhile, demand for oil continues to increase at around 0.4 x GDP growth, or ~1.5 million barrels per day, every year. This increase in demand is driven by emerging markets, where the population ambitions a quality of life similar to ours. US shale oil production appears to have peaked in 2019 as the best areas have now been drilled. Excessive regulation of the fossil fuel industry in the developed world is pushing production away to other nations. In particular, offshore Brazil and offshore West Africa are the fastest growing oil producing regions in the world. The future of oil production is offshore. Offshore production also happens to have one of the lowest carbon footprints.

Value Chain



Investment Implications

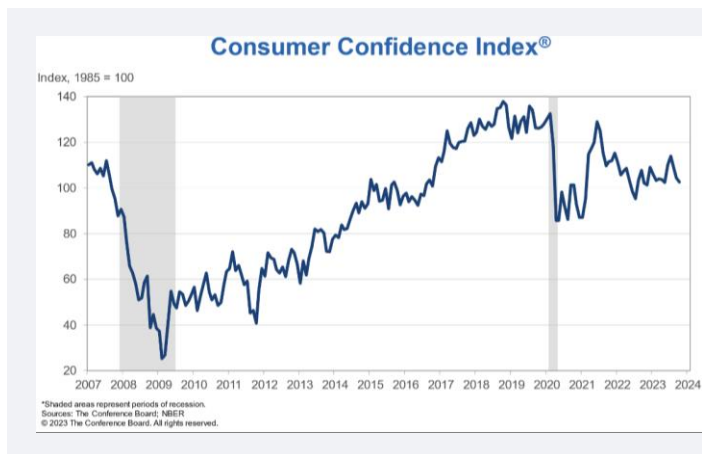
With production of oil moving to offshore, the obvious place to invest is in offshore oil services. Luckily, many companies in this vertical trade at bargain valuations. 10 years of oversupply of drill rigs and offshore supply vessels has washed out the industry. Scrapping of rigs during this period has brought the market back into equilibrium.

Through companies such as Valaris, Seadrill and Noble you can currently buy oil rigs for 20 to 30% of replacement value: no new oil rig will ever be built unless those companies trade at a premium to said replacement cost, or 5-6x their current share price. Meanwhile, free cash flow generation ramps up as rigs are contracted at current day rates.



Theme 4: Bargain Hunting in Consumer Stocks

Investment Thesis in One Chart



Consumer confidence has been pressured for various reasons, including 1) an increase in inflation, 2) purchases being pulled forward during the Covid-aftermath, made possible by fiscal stimulus checks, 3) higher interest rates making the financing of high-ticket items (e.g., cars, boats, RVs) more expensive and 4) a resumption of student debt payments lowering discretionary income.

The sell-off in consumer stocks provides investment opportunities.

Investment Universe



RVs



Boats and Propulsion



Automotive Components

Investment Implications

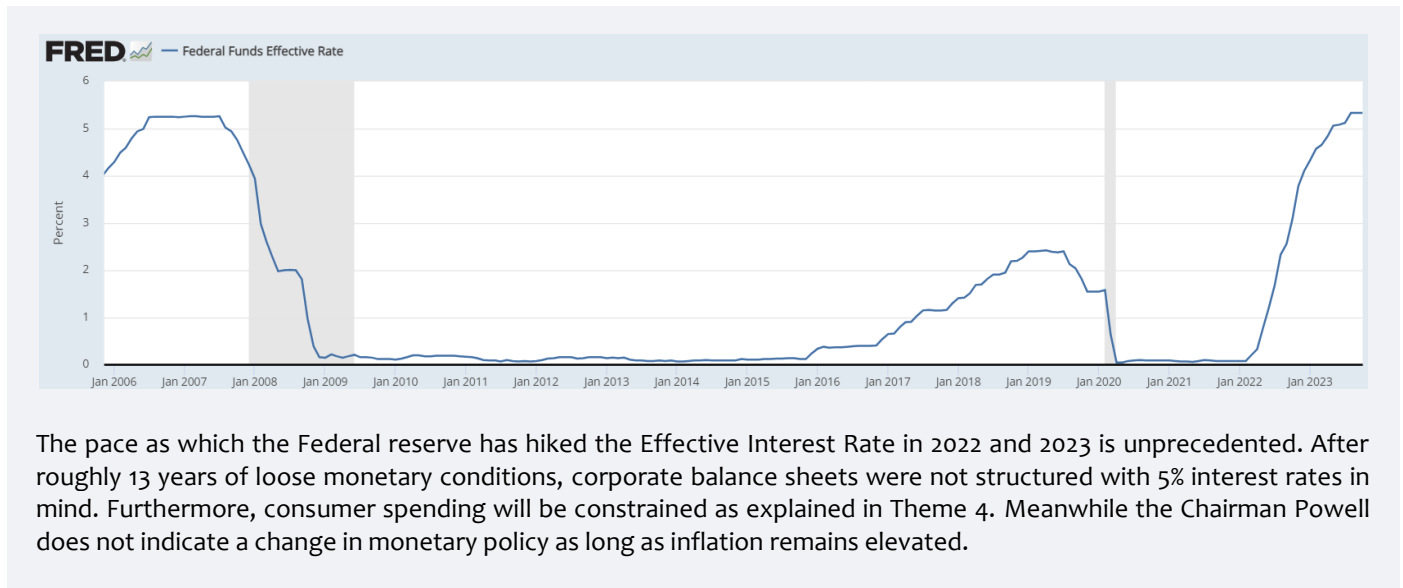
At Night Watch we are not calling for an immediate rebound in consumer spending. Instead, we realize that there are many industries that have a high percentage of recurring income in the years after selling a boat or RV. Mercury (owned by Brunswick), as the largest producer of outboard engines, earns around 50% of their income from after-market services such as boat maintenance. Similarly, RV dealers make money on maintenance, but can also shift their business model from selling new RVs to selling used RVs.

In automotive, we foresee an increase in automotive volumes, which should lower margins of the OEMs. Meanwhile, manufacturers of automotive components (especially in Electric Vehicles) such as Phinia or the Belgian Melexis and X-Fab should benefit from the higher sales volumes combined with their business' operating leverage.



Theme 5: Defensive / Counter-cyclical Investments

Investment Thesis in One Chart



The pace as which the Federal reserve has hiked the Effective Interest Rate in 2022 and 2023 is unprecedented. After roughly 13 years of loose monetary conditions, corporate balance sheets were not structured with 5% interest rates in mind. Furthermore, consumer spending will be constrained as explained in Theme 4. Meanwhile the Chairman Powell does not indicate a change in monetary policy as long as inflation remains elevated.

Investment Universe



Pawn Shops



Precious Metals Retailers

Investment Implications

There are few investments that actually perform better during a recession and they are often valued at a premium by the market due to this scarcity. At companies like Firstcash Holdings, an operator of 2900 pawn stores in the US and Latin America, the number of loans outstanding per store has inflected upwards in 2023. A-Mark Precious Metals has already benefited from the renewed investor interest in physical gold and silver coins which they sell through their platform JMBullion.com, and which they procure cheaply through their distribution agreement with the US Mint. The question is whether their strong margins of the last 3 years can be sustained.

Stockbrokers who earn the higher interest rate on their customer’s deposits, or business who receive large upfront payments on which they can now earn interest are other potential beneficiaries, although the risks to their core business should be taken into consideration.



Important Disclosures

This document was prepared by Night Watch Investment Management, LLC (“NWIM”) on December 6th, 2023, based on information available as of December 6th, 2023, and is subject to amendment. The information and opinions contained in this document (including information obtained from third-party sources) are for background purposes only and do not purport to be full or complete, and do not in any way constitute personalized investment advice or an investment recommendation on the part of NWIM. No representation, warranty, or undertaking, express or implied, is given as to the accuracy or completeness of the information or opinions contained in this document, and no liability is accepted as to the accuracy or completeness of any such information or opinions.

All investments involve the risk of a loss of capital. NWIM believes that its proprietary investment program, research and risk-management techniques moderate this risk through the careful selection of portfolio investments. However, no guarantee or representation is made that NWIM’s investment program will be successful, and investment results may vary substantially over time. Past performance is not a guide to future performance. This publication makes no recommendations whatsoever regarding buying, selling, or holding any specific security, class of securities, or securities of a class of issuers. You are required to conduct your own due diligence, analyses, draw your own conclusions, and make your own investment decisions. Commentary is provided without reference to any investment strategy or product offered by NWIM. NWIM or entities managed by NWIM may be invested in any of the industries or securities mentioned. They may trade in and out of those positions without providing any updates.

Certain information contained in this document constitute “forward- looking statements,” which can be identified by the use of certain terminology, such as “may,” “will,” “should,” “expect,” “anticipate,” “project,” “estimate,” “intend,” “continue” or “believe” or the negatives thereof, or other variations thereon or comparable terminology. Any projections or other estimates in this document, including estimates of returns or performance, are “forward- looking statements” and are based upon certain assumptions that may change. Due to various risks and uncertainties, actual events or results, or the actual performance of any investment vehicle, portfolio or product described herein may differ materially from those reflected or contemplated in the forward-looking statements. Actual events are difficult to project and often depend upon factors that are beyond the control of NWIM.

TO THE FULL EXTENT PERMITTED BY LAW NEITHER, NWIM NOR ANY OF ITS AFFILIATES, NOR ANY OTHER PERSON OR COMPANY, ACCEPTS ANY LIABILITY WHATSOEVER FOR ANY DIRECT, INDIRECT, OR CONSEQUENTIAL LOSS ARISING FROM, OR IN CONNECTION WITH, ANY USE OF THIS PUBLICATION OR THE INFORMATION CONTAINED HEREIN. NWIM AND ITS AFFILIATES EXPRESSLY DISCLAIM ANY GUARANTEES, INCLUDING, BUT NOT LIMITED TO, FUTURE PERFORMANCE OR RETURNS.

Copyright 2023 Night Watch Investment Management, LLC. All rights reserved.