Quarterly Telescope Q2 2023

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01 We are a global specialist investment boutique

Flagship is a specialist global asset manager founded in 2001.

We are 100% independent and fully owned by staff and directors.

Our mission is to be the navigators and global authority of your complete investment future, wherever it may lead.

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02 We manage global portfolios in three distinct strategies

Global Equity | Global Flexible | Global Fund of Funds

We believe in a focused approach to fund management

Our longest running Funds have track records spanning over two decades

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03 We are long term investors who manage concentrated portfolios

Our investment approach is process-driven and rigorous, and our definition of quality is demanding and exclusive.

Our equity portfolios are focused. We own a maximum of 25 shares, diversified across geography and sector.

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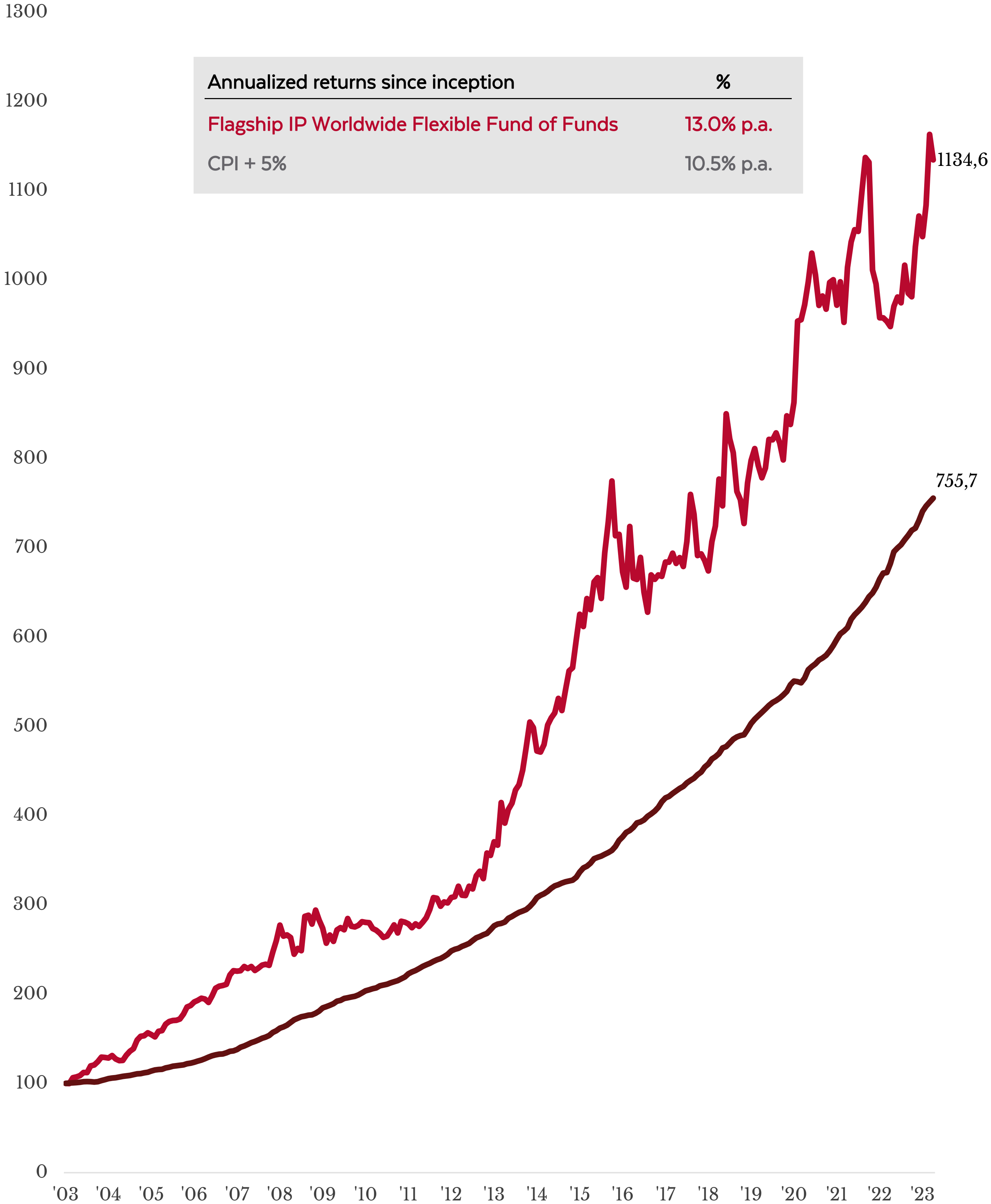
The Power of Long-term Compounding

The **Flagship IP Worldwide Flexible Fund of Funds** (net of all fees) vs. SA CPI +5%

from 3 April 2003 to 30 June 2023 (20 years)



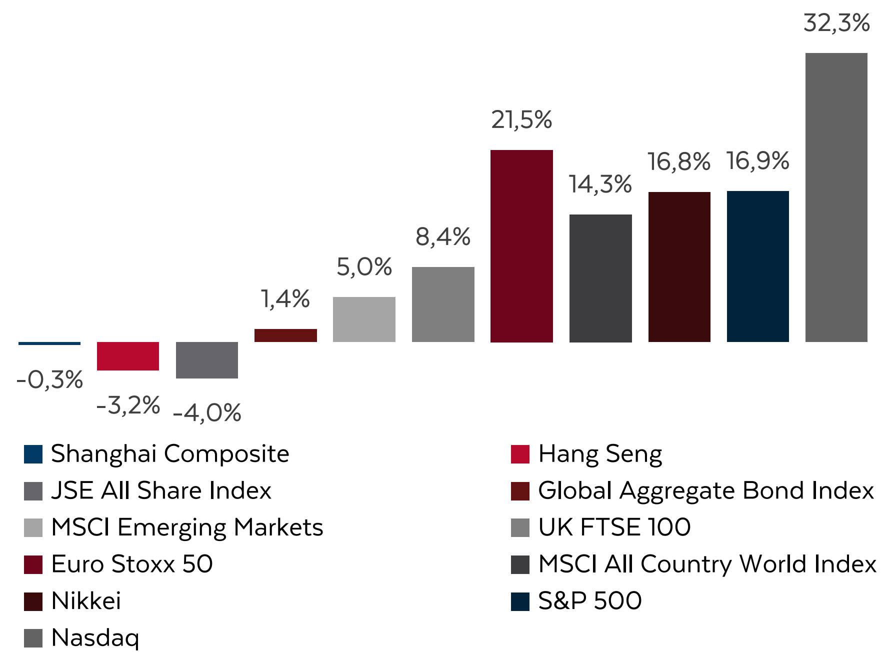
Annualized returns since inception	%
Flagship IP Worldwide Flexible Fund of Funds	13.0% p.a.
CPI + 5%	10.5% p.a.

A bifurcated market

"If you can keep your head when all about you are losing theirs and blaming it on you, if you can trust yourself when all men doubt you, but make allowance for their doubting too!"

- Rudyard Kipling

Chart 1: Global Index returns in USD (Dec 31, 2022 to June 30, 2023)



While markets are up, almost all the gains have accrued to a very few number of stocks whose share prices have been buoyed by positive sentiment around artificial intelligence.

In the first quarter, fears of a widely anticipated recession as a result of interest rate hikes and emerging frailties in the financial system (due to the collapse of Silicon Valley Bank, Credit Suisse and others), led most market followers to be cautious in deriving their price targets for the year. Fast forward three months and it appears all these concerns have abated. In the second quarter, the S&P 500 was up 10.3% and the Nasdaq up a massive 15%. Scratch below the surface however, and the situation becomes more complex. While markets are up, almost all the gains have accrued to a very few number of stocks whose share prices have been buoyed by positive sentiment around artificial intelligence (AI), while almost everything else has performed poorly.

Call-out: What is AI and who will the winners be?

AI is a concept that has been with us a while but, for many, it only progressed from being the stuff of science fiction movies to something that could tangibly affect our lives with the arrival of ChatGPT.

ChatGPT works similarly to automated chat services found on customer services websites, however, what sets it apart is that it uses human feedback as well as machine learning to improve future responses. Users can ask ChatGPT a variety of questions spanning from the simple ("Who was the last King of France?") to the more complex ("What is the meaning of life") and get answers of a remarkably high standard. However, its use cases are not limited to answering questions as it has been used to code computer programmes, compose music and even summarize articles.

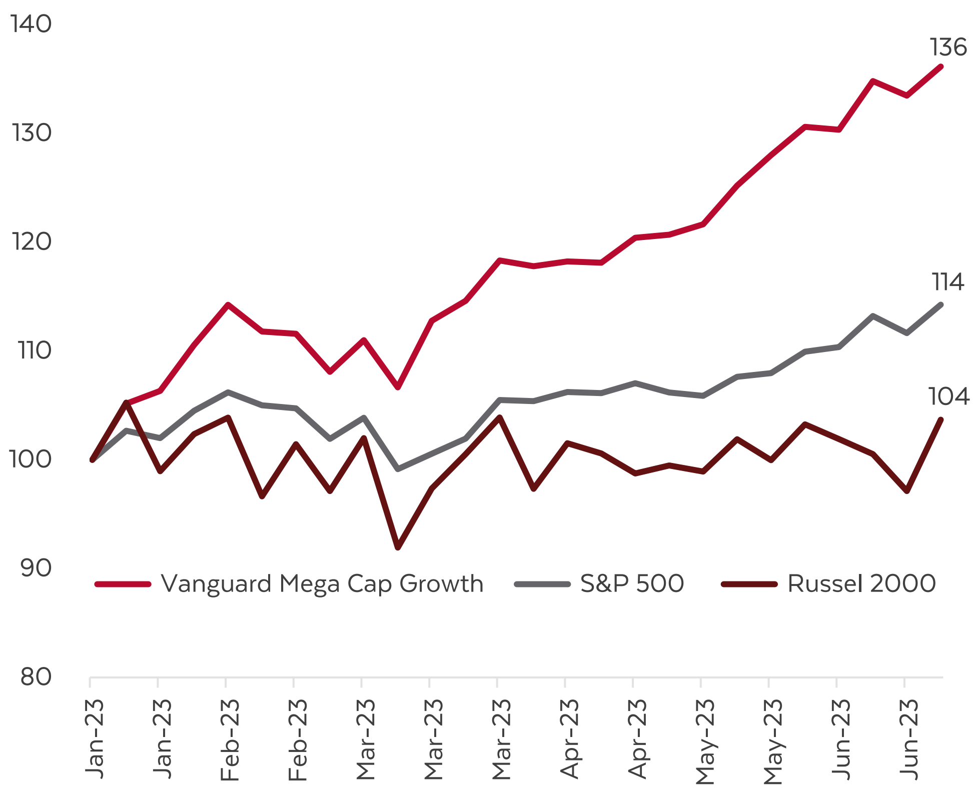
Since its launch in November 2022, it had quickly became the fastest consumer application to reach a user base of 100 million (in January of this year) and everyone's heads are spinning with the implications that this technology could have for the world – from what impact it could have on employment, to its implications for existing business models.

Businesses which are perceived as being beneficiaries of this new technology (mostly large technology companies) have seen their share prices rise, while most other companies, even those whose business models are not at risk from AI, have seen their share prices languish.

Year to date, just six stocks have accounted for 75% of the total return of the S&P 500.

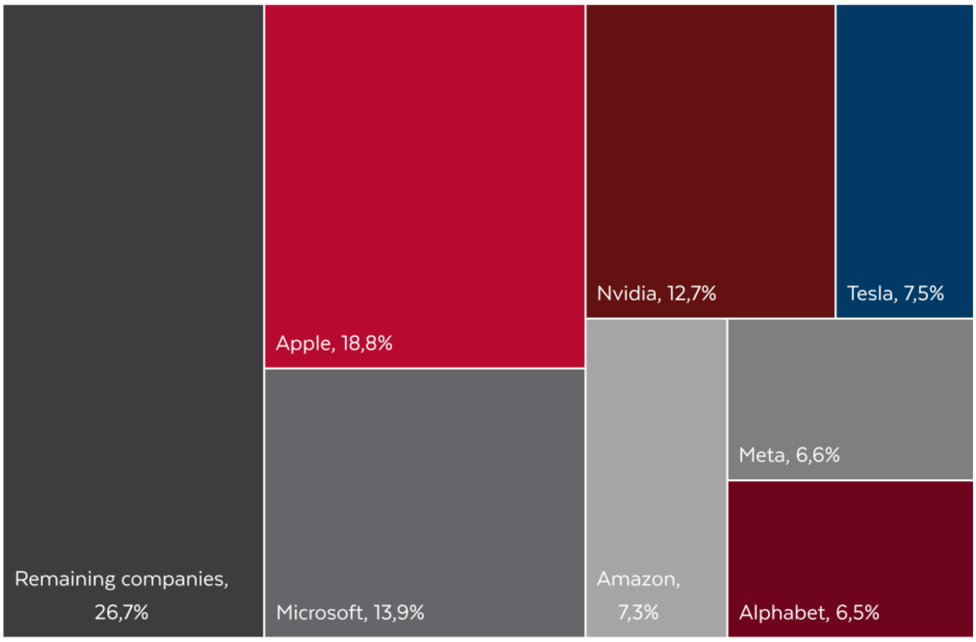
Who are the beneficiaries? Firstly, there is Microsoft, one of the early investors in OpenAI (the owner of ChatGPT) and is its exclusive technology provider. Secondly, there are the hyperscale cloud providers, as the extra-computing power that is required for AI applications will be hosted on all their platforms – AWS (Amazon), Azure (Microsoft), Google Cloud. Finally, there are the makers of graphic processing units "GPUs" which are the work horses which make AI possible – Nvidia, AMD. GPUs are more effective at performing AI applications than their cousins, core processing units "CPU's, because they can perform multiple computations simultaneously. All these companies are up more than 20% year to date. Nvidia is up a massive 53% in the last quarter alone.

Chart 2: Mega Cap vs Small Cap Index Returns (YTD 2023)



Over the last quarter, Vanguard's Mega Cap growth Index has increased 36%, more than double the return of the S&P 500 and nine times the return of the Russel 2000. Year to date, just six stocks (Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta) have accounted for 75% of the total return of the S&P 500. If you had held anything other than these stocks, you probably performed poorly, and you would have performed even worse if you had held stocks with smaller market capitalizations.

Chart 3: Contribution to 6 month return of the S&P 500, +16,9% (YTD 2023)



There is no doubt that AI is a very positive vector for all the companies above. The question that remains however, is whether the increase in their share prices is justified by the improvement in their growth prospects.

Valuations still matter

There is no doubt that AI is a very positive vector for all the companies above. The question that remains however, is whether the increase in their share prices is justified by the improvement in their growth prospects. In the long run, valuation matters, because it affects the return you can expect to earn from a share.

All of the six stocks mentioned now trade at a substantial premium to both the market as a whole, as well as their own history.

Chart 4: Price-to-Forward Earnings of top 6 Tech Companies (June 2023)

	Absolute Price-to-Forward earnings	Market relative Price-to-Forward Earnings	Absolute Price-to-Forward Earnings Relative to History (since Jan 2013)	Percentile of Market Relative Price-to-Forward Earnings Relative to history (since Jan 2013)
Apple Inc	31,2	1,64	99,2%	100,0%
Microsoft Corp	31,7	1,67	88,1%	96,0%
Alphabet Inc	22,3	1,18	42,1%	20,6%
Amazon.com Inc	79,9	4,21	39,7%	39,7%
Nvidia Corp	54,4	2,87	93,7%	96,8%
Meta Platforms Inc	24,3	1,28	33,3%	100,0%

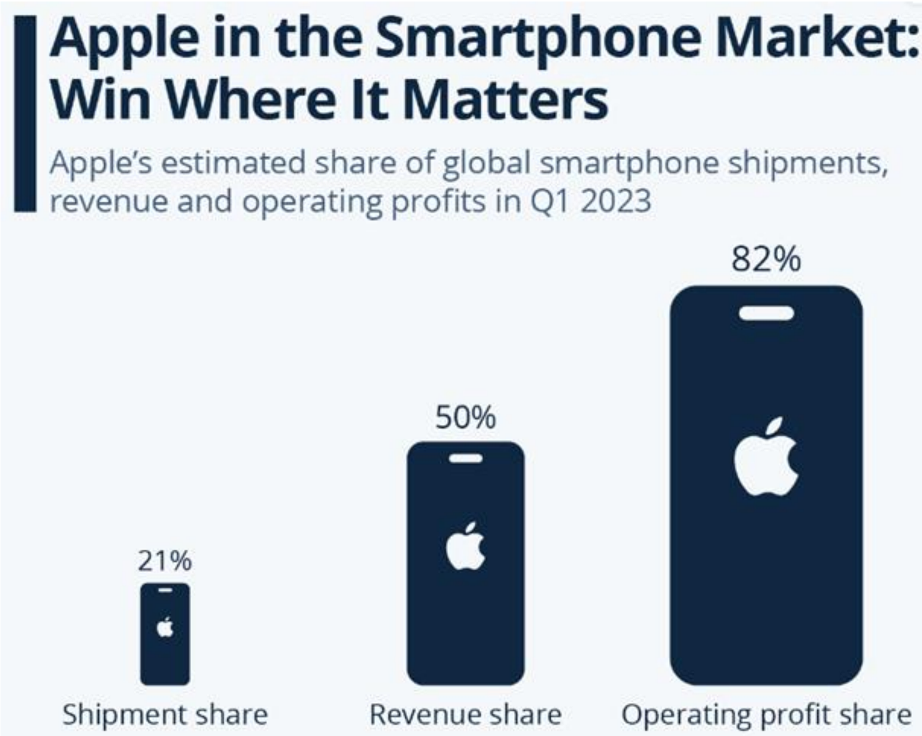
In the long run there are three sources of return from holding a share:

1. its earnings yield
2. the growth in its earnings and, finally,
3. the change in its P/E multiple, referred to as "re-rating"

Let's see how these three factors stack up for one of the best performing stocks this year, Apple, relative to our 5 year investing horizon.

- Earnings yield: Today Apple trades on a P/E multiple of 31.2X. This translates into an upfront earnings yield of 3.2% p.a.
- Earnings growth: Last year, Apple grew its GAAP earnings per share by 8.3%. I believe that Apple is likely to grow its GAAP earnings per share by considerably lower than this over the next 5 years because it is a far larger company. Today, Apple's market capitalization is a considerable USD 3.2 trillion and it already has a de facto monopoly over the *premium* smartphone market (the iPhone is its primary generator) which is demonstrated by the fact that its market share, in terms of operating profit, is a massive 82%.
- Re-rating: Finally, its P/E multiple is 31.2X, which is considerably more than its historical average. At Flagship, the highest multiple that we would use to value a company is 20X, even for Apple, which is worthy of a very high multiple due to the quality of its business. Assuming that it takes five years for Apple's P/E multiple to revert to these levels, re-rating will be a headwind of 8.5% p.a.

What we are currently seeing in markets has echoes of the dot-com bubble, except in this case, the exciting technology driving returns is AI as opposed to the internet.



So, let's tally it up: 3.2% p.a. + 8.3% - 8.5% = 3% p.a. versus our required return for equities as a whole which is 9.2%. This is not a formula for generating market-beating returns unless you believe that Apple will grow substantially faster than it has in the near past or a new normal has been set in terms of its base P/E multiple. In either case, I would argue the odds are not in your favour.

What we are currently seeing in markets has echoes of the dot-com bubble, except in this case, the exciting technology driving returns is AI as opposed to the internet. Of course, the internet was a game-changer, but it took longer for it to grow into the expectations people had for it in 2000 and many of the companies which were expected to be winners then, were beaten to the finish line by other companies which would only emerge as competitors later. Does anyone remember Excite, Yahoo, Hotbot and others? All of them had their lunches eaten by Google. Ditto a number of other companies.

Smaller cap stocks won't underperform forever

Another interesting dynamic has been how poorly smaller caps have performed. This is also a trend that should not be extrapolated into the future.

While large companies often have considerable incumbency advantages over smaller companies, smaller companies are able to compete with them because they are more nimble and innovative. After all, large companies also began as smaller companies and then grew up into large companies over time.

Smaller companies are able to compete because they are more nimble and innovative.

Finally, and to further drive home the point: it is worth bearing in mind that even among large companies, it has rarely been a one-way ride. This is best illustrated by how the top 10 companies in the world have changed over time. This shows that the behemoths of today are rarely the behemoths of tomorrow.

Chart 5: World's 10 largest companies by market capitalisation

1980: energy crisis	1990: Japan will take over the world	2000 TMT bubble
IBM	NTT	Microsoft
AT&T	Bank of tokyo-Mitsubishi**	General Electric
Exxon	Industrial Bank of Japan	NTT DoCoMo
Standard Oil	Sumitomo Mitsui Banking**	Cisco Systemms
Schlumberger	Toyota Motors	Wal-Mart
Shell	Fuji Bank	Intel
Mobil	Dai ilchi Kangyo Bank	NTT
Aatlantic Richfield	IBM	Exxon Mobil
General Electric	UFJ Bank	Lucent Technologies
Eastman Kodak	Exxon	Deutsche Telecom

2010: China will take over the world	2020: tech dominance 2
Exxon Mobil	Microsoft
Petro China	Apple
Apple Inc.	Amazon
BHP Billiton	Google
Microsoft	Facebook
ICBC	Alibaba
Petrobras	Tencent
China Construction Bank	Johnson and Johnson
Royal Dutch Shell	JP Morgan Chase
Nestlé	Exxon Mobil

In conclusion, while holding a basket of tech stocks that are exposed to AI has been the only game in town this quarter and even this year, valuations appear unsustainably high. Against this backdrop, we prefer to sit in other areas of the market where there is more value to be had.

Asset Allocation

Equities are the asset class which have been the best preserver of real (i.e. post-inflation) wealth over time and this is why you can expect your funds to be overweight equities on a through-the-cycle basis. This is not the case currently as we have concerns around equity valuations in aggregate (mostly driven by high valuations of a few mega cap tech stocks which I have discussed previously). At the same time, the risk of the world slipping into a recession is high.

Today, the Flagship Flexible Strategies have only a 55% exposure to equities. The Flagship Fund of Funds has only a 45% equity exposure.

A point we have driven home in the past is that Flagship is an offshore asset manager. This does not mean that domestic assets are "off-limits" to us when the investment case for holding them is compelling. It does, however, mean that our exposure to domestic assets will be small as South Africa only accounts for 0.7% of global GDP and most of our investors have exposure to South African assets in other ways.

Today, we have two South African holdings across the funds. The first holding is the Satrix Govi ETF which holds a basket of South African government bonds. The yield to maturity on long-term South African government bonds is as high as 12% while the SARB's inflation target is between 4 and 6%. Using the midpoint of the SARS's target range, some long-term government bonds offer a real yield approaching 7%. Our target return in the FFOF is CPI +5%. The second holding is the FNB Midcap ETF. In recent years domestically focused South African shares have been punished, and the Mid Cap Index, which excludes the large multinationals which feature so prominently in the ALSI, is the best way to play a recovery. In both cases, valuations are simply too good to ignore.

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Strategy Performance

The performance of the Flagship Strategies over the quarter, year-to-date and 1 year to 30 June 2023 are shown below.

Fund of Funds Strategy	**Q2 '23**	**%Δ YTD**	**%Δ 1YR**
Flagship IP Worldwide Flexible Fund of Funds (ZAR)	8.2%	15.6%	19.7%
Flexible Strategy	**Q2 '23**	**%Δ YTD**	**%Δ 1YR**
Flagship International Flexible Fund (USD)	1.1%	3.2%	3.2%
Flagship IP Worldwide Flexible Fund (ZAR)	5.2%	13.1%	19.4%
Global Equity Strategy	**Q2 '23**	**%Δ YTD**	**%Δ 1YR**
Flagship Global Icon Fund (USD)	-1.1%	2.8%	6.3%
Flagship IP Global Icon Feeder Fund (ZAR)	4.9%	14.0%	20.1%

Beginning with our Fund of Funds strategy, it has returned 15.6% year-to-date. During the quarter, the largest contributor was the GQG Global equity fund (+16.8%) followed by the Guinness Global Innovators Fund (+15.6%). The third largest contributor was the iShares MSCI World Value Fund, although this was mostly due to the size of the position as funds with a growth slant mostly outperformed those with a value slant. On the other hand, detractors were the Satrix Govi ETF which sold off due to negative sentiment towards South Africa (-4.8%), the Pinebridge Asia ex Japan Fund (-0.9%) and, finally, SPDR Gold, a physically backed gold ETF, which nevertheless was up 3.2% and which we would expect to lag in a strongly up-trending market.

Our Flexible strategy (for which I will use the Flagship Worldwide Flexible Fund as a proxy) has returned 13.1% in ZAR on a YTD basis versus its benchmark which has returned 10.4%. During the quarter, the largest contributors were our foreign cash holdings due to the depreciation in the Rand, Applied Materials (+25.1%), now our largest holding, and Microsoft (+25.5%) on the back of the AI euphoria. In the case of Applied Materials and Microsoft, they are approaching our fair value and we are looking to replace them. Detractors were Zalando, Capri Holdings and Rakuten group. Consumer discretionary stocks continue to perform poorly as a result of high interest rates which are expected to dampen consumer demand.

During the second quarter, unusually, there were no buys and sells in our equity strategy.

Our Global Equity strategy has delivered a disappointing performance year to date. This was as much due to what we didn't hold (Apple, Nvidia, etc) as to what we did hold. As you would expect, many of the contributors and detractors for our flexible and equity strategies were the same. For this quarter, in addition to those mentioned for the flexible strategy, Amazon (+33.8%) was a top 3 contributor while Universal Music Group was a top 3 detractor (-5.6%).

During the second quarter, unusually, there were no buys and sells in our equity strategy. We added two global ETFs to our Fund of Funds strategy and bought a small position in the FNB Midcap ETF for our flexible strategy. At Flagship we have a five year plus investment horizon so turnover this low should not be that unusual, although, from a practical perspective, it is because we sell stocks when they reach fair value and replace them with alternatives which offer more upside.

We are on the hunt for new investment opportunities and to that end, JD Hayward (an analyst on our global team) and I, embarked on a research trip to Europe. Over two weeks we visited France, Germany and the Netherlands. In total we saw 35 companies in ten days. It was an excellent trip in terms of idea generation. Some of the companies that we will be making research priorities in the next few months are: BMW, Publicis (the largest advertising agency in the world), IPSOS (a market research and polling company), Euronext (the owner of a number of Continental European exchanges) and Siemens Healthineers (a manufacturer of high-end Xray and Pathology machines).

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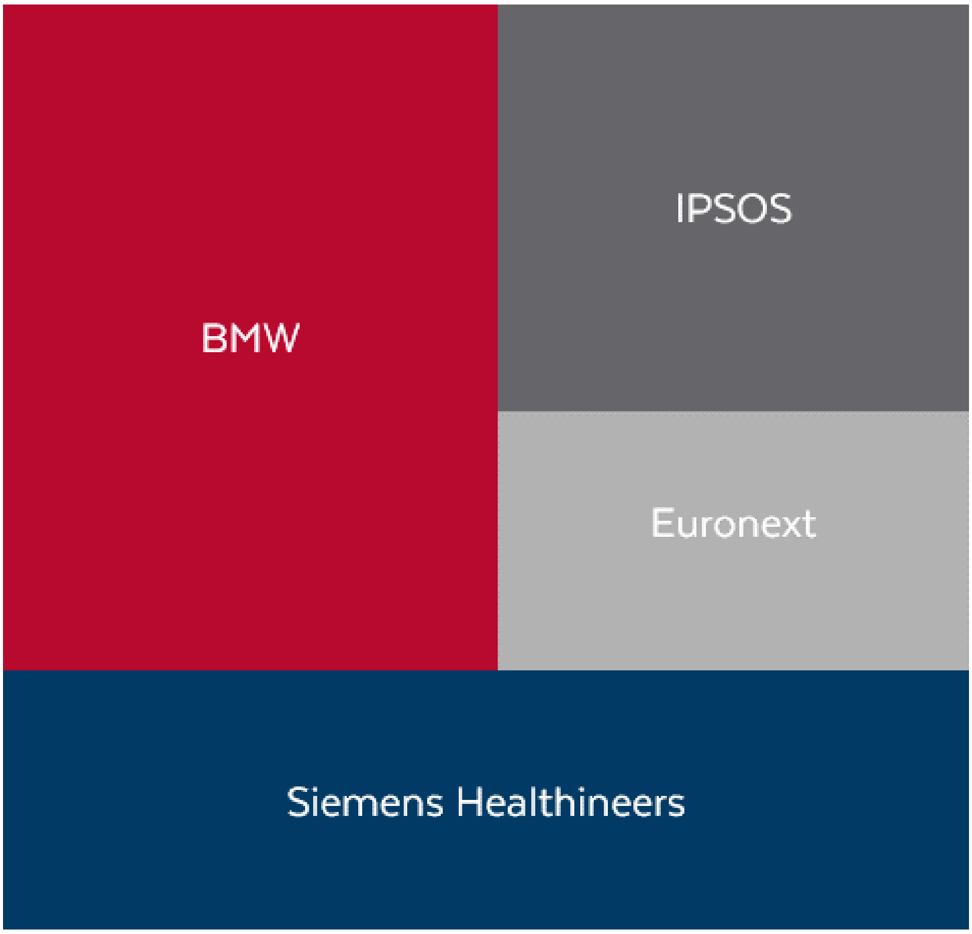
Chart 6: Research priorities



The crude oil conundrum

By JD Hayward

Crude oil is one of the most important, if not the single most important raw material input to all industrial activity. Considering this, it would be reasonable to assume that after more than 150 years of international trade, we would have a very firm, unwavering grasp on which factors have the most influence on oil prices, along with a very clear understanding of the timing and influence of these factors.

However, analysts are very divided on what the price of oil should be. Whereas one group of analysts (Facts Global Energy, Rystadt Energy, etc.) believe that crude oil prices will recover again to reach almost $100/barrel by the end of the year, another equally credible group of analysts (JP Morgan, US Energy Information Administration "EIA", etc.) have a markedly different view – they believe the oil price will fail to break through the $80 mark.

Given the importance of black gold, we seem rather unsure of what we should be paying for it. This article will consider the broad implications of oil price moves in the near and longer term, as well as discuss one possible method to benefit either way.

I do not intend, however, to add my voice to the plethora of others making incorrect (most likely) predictions about the price of Brent Crude come year end.

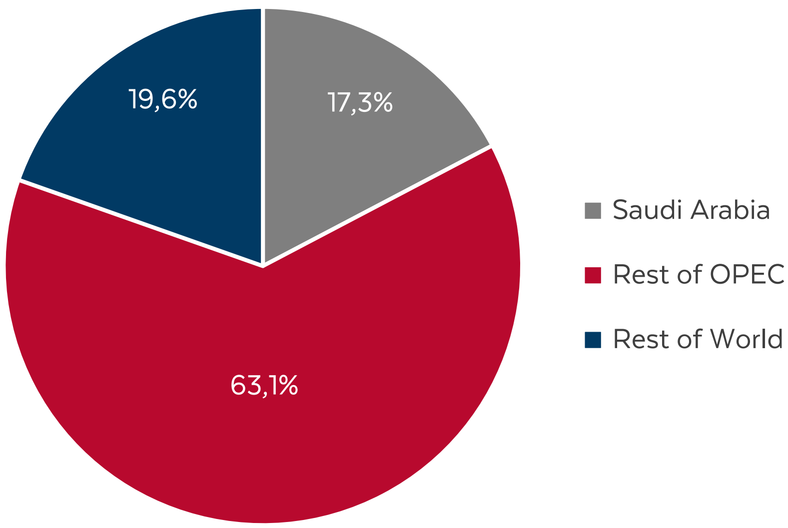
Given the importance of black gold, we seem rather unsure of what we should be paying for it.

Synopsis

For readers not familiar with the industry, it is worthwhile taking a brief step back in order to sketch the scenario.

Global oil supply, and as a result oil prices, is to a large extent controlled by the OPEC group – which effectively operates as a cartel. This has been the status quo for more than 7 decades since the creation of OPEC in 1960. The group currently has 13 members, almost all of whom are located in the Middle East and Africa with the exception of Venezuela. This alliance is so powerful because between them, they control about 30% of the world's oil production, but they own a massive 80% of oil reserves (according to both the oil company British Petroleum (BP) and OPEC's internal estimates).

Chart 6: OPEC share of world crude oil reserves (2021)



Saudi is a major cog in the global oil supply chain – and even more so within OPEC.

At about 35% of the total production, Saudi Arabia is by far the largest contributor to OPEC's output, more than double the size of 2nd placed Iraq. Given this dominant position, there is little doubt that Saudi Arabia has an outsized amount of control over decision making within OPEC. This was quite evident when assessing the actions of US President Joe Biden, travelling to Saudi Arabia to fist bump Saudi Crown Prince Mohammed Bin Salman, only a year after he said the kingdom should be treated like a pariah state due to its human rights record (which includes the assassination of critic-of-the-Kingdom journalist, Jamal Khashoggi on the sovereign soil of another country). So, what might have been the reasons for the much-improved attitude towards the gulf state?

1. To try and improve relations,
2. in order to ask them to pump more oil,
3. leading to lower gasoline prices for US citizens,
4. which would boost midterm election performance.

There are 2 big takeaways here. The 1st being that despite all the shifting rhetoric to renewables, old fashioned fossil fuel is in no hurry to make a swift exit from the scene. The 2nd is that Saudi is a major cog in the global oil supply chain – and even more so within OPEC.

Glancing in the rear-view mirror

The price of Brent crude oil has been a roller coaster over the last 3 years. The Russian invasion of Ukraine in February last year sent it rocketing to an intra-day high of $130/barrel, only to come crashing back down to low $70's/barrel at the time of writing. Not to mention the brief dip below $0 for future contracts in April 2020 as demand collapsed during the pandemic.

Chart 7: Brent crude oil price per barrel (Feb 2020 – June 2023)

This fluctuating price is not ideal for countries whose entire budget relies on the oil price. OPEC thus adjusts supply, within reason, whenever they feel the price is too low.

This has happened on a number of occasions over the last couple of months.

- October 2022 – group wide cuts of 2 million barrels per day.
- April 2023 – voluntary cuts by 8 OPEC members of 1.6 million barrels per day.
- June 2023 – Saudi Arabia announces a further reduction of 1 million barrels per day – which comes into effect in July, and OPEC members agreed to extend earlier cuts.
- OPEC+ (a larger group including Russia), also announces they will reduce production by another 1.4 million barrels per day starting 2024.

Global oil demand is roughly 100 million barrels per day so, in total, these cuts add up to almost 6% of global supply. On the opposite end, Russian oil - vital for financing their war effort - has continued to find a way into the market, mainly via Asian buyers. Data from Kpler Research indicates that Chinese imports of Russian crude averaged 1.59 million barrels per day in March 2023, up 68% from the same period in 2022. The result is that prices have perhaps not reacted as fast as OPEC would have liked, but at some point, they must. Once recessionary fears abate and when (if) Chinese manufacturing numbers finally ramp up, the normal economic principle of demand outweighing supply, leading to rising prices, must prevail.

After the April cuts, the International Energy Agency "IEA", released the following statement:

"*The significant new cuts in oil production announced by OPEC+ countries come during a period of heightened uncertainty for global oil markets and concerns about the outlook for the world economy. Forecasts by the IEA and other relevant institutions, representing consumers and producers alike, all indicate that global oil markets were already set to tighten in the second half of 2023, with the potential for a substantial supply deficit to emerge. The new OPEC+ cuts risk exacerbating those strains and pushing up oil prices at a time when strong inflationary pressures are hurting vulnerable consumers around the world, especially in emerging and developing economies.*"

Clearly the market expects the imbalance to flow through to price at some stage, but trying to time this is a difficult task. One factor alone – the duration of the Russian war – could impact this timeline by months, if not years. Trying, therefore, to pinpoint the price of Crude come 6 months from now seems like a futile exercise.

Trying, therefore, to pinpoint the price of Crude come 6 months from now seems like a futile exercise.

Near vs longer term prospects

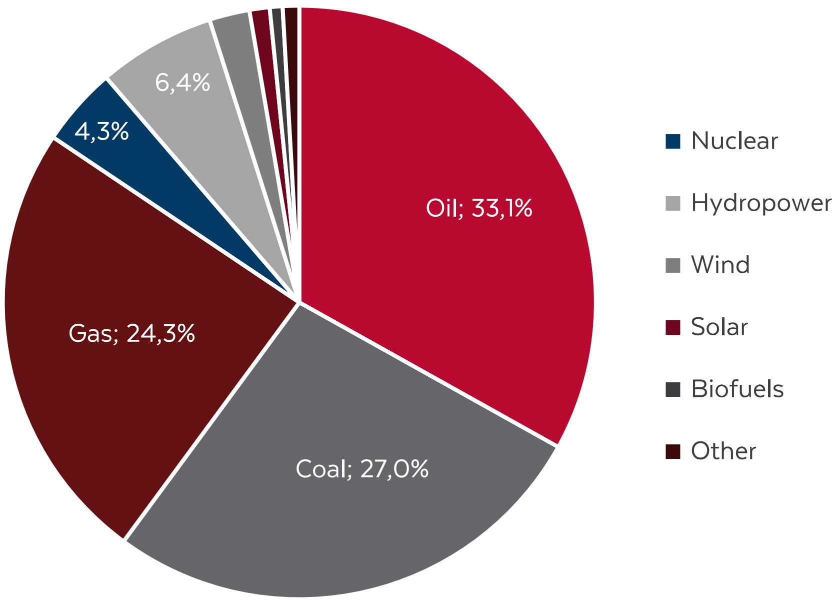
Given our reliance on OPEC oil in the near term (and by near, I mean the next decade), the price of oil will likely gravitate towards whatever Saudi Arabia, as OPEC's producer-in-chief, needs it to be. Oil is by far the largest contributor to the Kingdom's fiscus. In the last few years, it accounted for about 40% of real GDP, but around 75% of their total budget. This number was as high as 93% in 2011 and as low as 53% during the Covid pandemic. Today, Saudi is clearly trying to shift their economy to be less oil reliant, with ongoing efforts to position themselves as a global travel and events hub. This transformation does not come cheap though, and Saudi will be reliant on oil for years to come.

Consensus is that they need the price of Brent crude to be more than $80/barrel in order to cover the government's spending bill – but this number is hard to verify. And while further cutting production would assist in achieving the required price, it has to be balanced with maximizing revenue, i.e., maximizing volume.

Luckily for Saudi Arabia, despite the massive investment into renewable energy sources over the last decade, we are far from quenching the global economy's thirst for fossil fuels. In fact, demand is proving to be much stickier than what many would have expected.

In 2019, fossil fuels accounted for 84.3% of global energy consumption. Two decades ago, in 2000, it was 86.1%. That means a drop in market share of only 1.8% over 20 years, despite the substantial investment into lower carbon sources.

Chart 8: Global primary energy consumption (by source)



The longer-term (decade+) equation is even murkier, and will to a large extent depend on how successful countries are in achieving their long-term sustainability goals as well as whether there is sufficient oil production to meet demand.

While there is no shortage of commitments from major governments and corporates around the world – executing on all of these is another story. Oil's day in the sun is not yet done.

While there is no shortage of commitments from major governments and corporates around the world – executing on all of these is another story. The International Energy Agency (IEA) has identified 3 different scenarios for future energy usage, based on how effectively these commitments are met:

- STEPS: Stated Policies Scenario (reflects current policy settings)
- APS: Announced Pledges Scenario (assumes all climate commitments made by governments around the world, and longer terms net zero targets, will be met in full and on time)
- NZE: Net Zero Emissions 2050 Scenario (assumes the global energy sector achieves net zero emissions by 2050, without relying on emissions reduction from outside the energy sector to complete its goals

Their base scenario considers current industry plans, government policies as well as existing energy transition initiatives. Based on this scenario, global oil demand is still forecast to rise by 3.5 million barrels per day by 2025, a far cry from the decline of 3 million barrels/day required to meet World Energy Outlook's Sustainable Development Scenario – which follows a trajectory consistent with the climate goals of the Paris Agreement. The pathway to the NZE scenario would require a much sharper decline in oil consumption – a prospect that currently looks unlikely.

Aside from this, there has also not been enough investment into minerals and materials to support the planned energy transition. Over the last few years, reports from the IMF, IEA and World Bank have pointed this out. Minerals like copper, for example, have seen their prices skyrocket. These minerals will play a crucial role in any energy transition as they are used in a number of reduced-emission products, like solar panels, wind turbines and lithium batteries.

While there is little doubt that renewables like wind and solar will increase its share of the energy budget in the coming years, it is also clear that oil's own day in the sun is not yet done.

Underinvestment in supply

For the last decade, the fossil fuel industry has also seen underinvestment in supply, as Western oil conglomerates face increased pressure from activist shareholders to clamp down on any new non-renewables capex. This has not had a major effect on the profits of the big oil conglomerates which have actually benefitted from capex spend being slashed. It has, however, had a clear effect on downstream oil services companies, like Schlumberger, Halliburton, and Baker Hughes whose profits have collapsed as they are tied to oil exploration.

In the short-term, oil prices are largely a function of OPEC's decision to "open or close the taps." In the long-term, market fundamentals will come to the fore.

Underinvestment in supply will eventually self-correct as markets respond to higher-for-longer oil prices, even if this investment is not made by Western oil conglomerates. National oil companies, not beholden to activist shareholders, have already started to increase their exploratory capex based on their favourable long-term projections for oil prices and oil service companies stand to benefit disproportionately as demand for their services ramp up.

Schlumberger stands to benefit

An example of this would be Schlumberger (now renamed SLB). If there is one region that would want oil to remain the world's go to energy commodity – it would be the Middle East. SLB has a large overweight exposure to this market, more than double that of their closest peer. This bodes well for them, given their CEO's statement last year that the current investment cycle in the region is the largest in history, supporting the view that National oil companies, like Saudi Aramco, will be much more willing to spend on Capex, compared to publicly listed conglomerates.

SLB finds itself in a crucial industry with a poor ESG reputation, while they manage to deliver peer leading scores. This is a factor that will likely become more important as the energy transition develops and puts SLB in a good position to continue offering their services. Aside from traditional fossil fuel services, SLB has also pivoted into providing services for more sustainable forms of energy generation – basically covering both ends of the spectrum.

This puts them at the forefront of the industry, with innovative solutions to help address the climate crisis, weaving decarbonization and digital solutions into a future growth driver, while still capitalizing on their core area of expertise in traditional oil field services.

In summary, while in the short-term oil prices are largely a function of OPEC's decision to "open or close the taps", in the long-term market fundamentals will come to the fore. These are likely to be favourable as a result of sticky demand and a decade long underinvestment in oil exploration - which is only now beginning to correct itself - and oil services companies, which are a geared play on the rebound of oil capex spending, stand to benefit disproportionately from this trend.

Investment Case: Becle

By JD Hayward

- ⇒ Becle, via its ownership of Jose Cuervo, is the world's largest tequila brand – with almost a third of global sales volumes.
- ⇒ Within the global alcoholic beverage market, spirits have gradually been taking share from beer, and within the spirits industry, tequila has been taking share.
- ⇒ The rapid increase in demand for tequila, combined with the length of time required to cultivate the Agave plant, has led to shortages in supply, rising raw material costs and putting pressure on margins.
- ⇒ We believe Becle is well placed, as a pure play on tequila, to capitalize on a growing market.

Over the last 20 years, beer's market share of revenue has, in fact, declined from 54% down to 41.9%, while spirits increased from 30% to 42.1%.

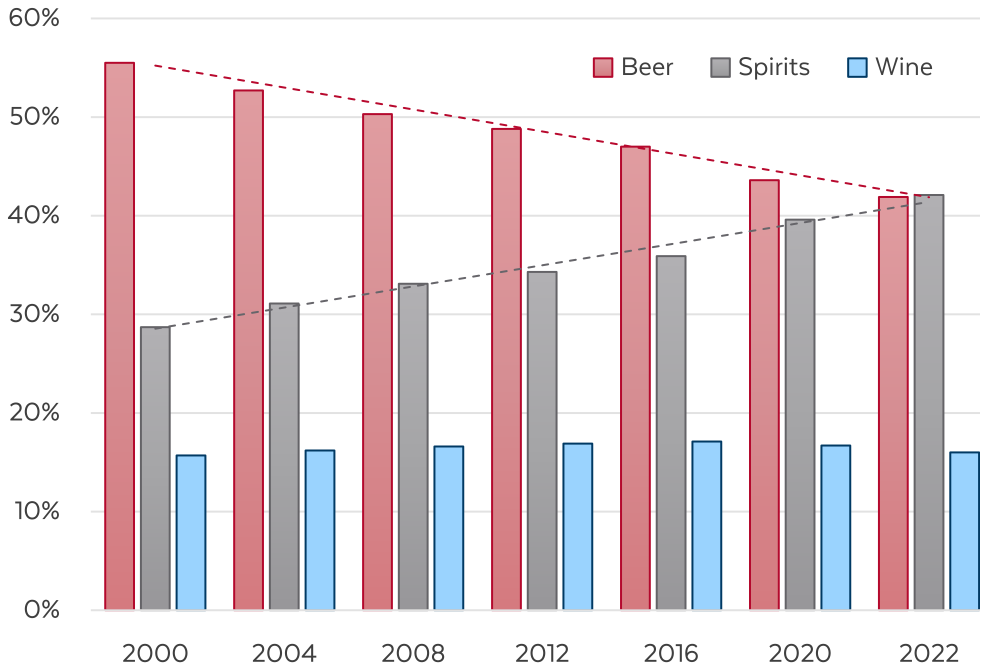
While there is a multitude of liquid vices available to adults of LDA (legal drinking age) enabling them to sit back and relax after a long week, one in particular seems to be gaining fans at a rapid rate. Blue Agave juice, Mexican fighting water, Tequila – call it what you will - people seem to like it.

Spirits continue taking share

The global alcoholic beverage industry can be broken down into 3 main segments – beer, spirits, and wine. Local investors have always had access to at least one beer brewer, previously via SABMiller and more recently via Anheuser-Busch InBev (ABI). They do, however, have very limited access to spirits listings, and post the Heineken takeover of Distell – even less so. This means they are potentially missing out on a major secular shift in the industry. Throughout modern history, beer has been the dominant segment – but this is starting to change in some markets. By only considering the amount of pure alcohol per serving, comparison across segments becomes possible and, in the US market, spirits have overtaken beer for the first time in 2022.

Over the last 20 years, beer's market share of revenue has, in fact, declined from 54% down to 41.9%, while spirits increased from 30% to 42.1%.

Chart 9: US Alcohol Beverage Market Share



Tequila's growing slice of the pie.

One of the big drivers behind this trend is Tequila, which in 2022 recorded volume growth of 11.5%, vs 4.8% for the spirits market in total. The difference is even more pronounced in terms of sales, where the tequila market grew at 17.2% vs the overall spirits market at 5.1%. In the US, tequila has now increased its market share from 7.2% to 10.6% over the last 5 years and while it still lags American whiskey and vodka in terms of volume, it is set to overtake vodka this year to become the best-selling spirit, by value. In fact, tequila volume is still only about 1/3 of vodka, but its sales value is already at 83%. This indicates the premium price tag tequila commands.

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According to data from IWSR (the global benchmark for beverage alcohol data and intelligence), this is not a once off, nor is it limited to the US, with tequila having increased its share of global spirits volume from 1% to 1.6%, leaving considerable room for growth.

What is driving the trend?

Several factors have contributed to tequila's rising stature, not least of which is celebrity endorsement. George Clooney was the first and, thus far, most successful celebrity to enter the tequila market after founding Casamigos tequila in 2013. The star power and social media combination proved hugely successful. Within 5 years, Casamigos was bought by London-based spirits giant Diageo, reportedly for a cool $1 billion. Others have followed in his footsteps, with Dwayne "The Rock" Johnson and Kendall Jenner both launching their own brands. Other factors that have contributed include a strong trend to premiumization (this is the case with a number of different spirits); tequila's use as a base ingredient in the popular ready-to-drink cocktail segment; shifting consumer preferences; and the increasing influence of Mexican culture in the US (restaurants, bars, etc).

Too much of a good thing is…bad?

Contrary to what one might think, the incredible boom in tequila has not been good for profitability. Demand has increased at such a rate that prices of the Blue Agave plant, tequila's main ingredient, have shot the lights out – leading to plummeting gross margins for tequila makers. There is not a quick fix, as these plants take at least 7 years to reach maturity, upon which they can only be harvested once. In other words, there is a substantial lag between supply catching up to demand, but there should be strong margin recovery once it does.

Finding the winners.

One of the problems investors face when trying to capitalize on such niche trends is the consolidated nature of the large players in the industry. Diageo would be an example of this. Even though they own two fast-growing, premium tequila brands in Don Julio and Casamigos, their tequila portfolio is still minute when assessing the company on a consolidated basis.

Becle is the undisputed industry leader – controlling almost 30% of the global market.

A better pure play on the tequila industry is Becle, probably better known to most readers as Jose Cuervo Tequila. Becle is the undisputed industry leader, controlling almost 30% of the global market, more than double that of its closest competitors - Patron parent Bacardi, and Diageo. And, while Becle is also diversifying its portfolio, it still generates circa 70% of sales from tequila.

Becle also has the major advantage of vertical integration by virtue of being the largest producer of Blue Agave within the Appellation of Origin Tequila, the only area where Blue Agave can be grown and used for tequila production (similar to Champagne in France). This vertical integration should see them generate superior margins going forward. The combination of this, together with Becle's comprehensive distribution network, wide range of tequilas covering all value propositions, and competitive advantages, puts them in a great position to capitalize on the growing demand and outperform their peers.

In conclusion

We write these Telescopes so that our investors know what it is we are doing, and why we are doing it. For many of you, we are the caretakers of your global investments, and we would like to use this opportunity to thank you for the trust you place in us, and emphasize how deeply committed we are to the responsibility you have placed in our hands.

We believe it is of the utmost importance that all clients feel a true sense of the word "Partnership" in how we are aligned. Our portfolio management team reflects this with significant personal investments in the Flagship strategies.

Flagship funds own a selection of businesses that we believe to be of unusually high quality, and will prove to be financially resilient whatever the prospects of the global economy.

We expect the value of these businesses to rise at an attractive rate over the coming years, and that owning these businesses at a discount to what they are worth will make an additional contribution to your returns.

While we believe that Flagship funds will continue to outperform over longer-term periods, there will inevitably be shorter-term periods over which our funds will not outperform. This is the nature of markets – one's alpha (or excess performance relative to one's benchmark) is lumpy and doesn't accrue in a straight line.

Warm Regards,

Kyle and the Flagship Global Team

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