INVESTMENT MANAGER COMMENTARY

PALM CAPITAL

Q3 2022

November 2022 | Mahomed Ibrahim

At Palm Capital, we look for businesses with durable competitive advantages run by exceptional managers. We patiently wait to invest when their prices are less than we think they are worth, aiming to benefit as they compound economic value over time. We only sell if fundamentals deteriorate, or we find others offering potentially better after-tax returns.

Our performance

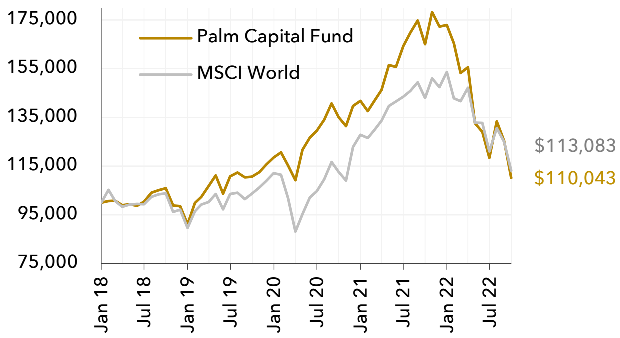
Over the three months ending 30 September 2022 our portfolio fell by 7.1% after management fees & trading expenses.

Since we started, just over four years ago, our portfolio has returned 2.0% per annum after management fees & expenses. We have underperformed the MSCI World Index by 0.6% per annum.

Period ending 30 September 2022	Our Return[λ]	MSCI World	Out-performance
Quarter	-7.1%	-6.6%	-0.5%
1 year	-37.1%	-20.9%	-20.4%
Since inception (annualised)	+2.0%	+2.6%	-0.6%

[λ]after management fees & trading expenses

Growth of US$100,000 investment



Company results

Most of the companies we own have now reported their latest quarterly results for the period ending September. For many, these results were met with large falls in their share prices indicating that they were below the market's expectations. This shows how much emphasis the market places on short term results and how it extrapolates these into the future. As long-term investors, we were actually pleasantly surprised by most of the results given how much these businesses grew over the COVID pandemic. The table below shows the latest annual revenue growth of these companies versus this growth over the preceding two years:

Company	Revenue growth over the last quarter (y/y)[1]	Revenue growth over the preceding 24 months	Share price fall YTD[2]
Adobe Systems Inc	+15%	+39%	-44%
Alphabet Inc	+11%	+61%	-35%
Amazon.com, Inc	+15%	+58%	-40%
ASML Holding NV	+10%	+75%	-41%
Constellation Software Inc.	+11%	+48%	-15%
KKR & Co Inc[3]	+14%	+39%	-34%
Meta Platforms Inc	+2%	+64%	-72%
Microsoft Corp	+14%	+37%	-31%
Salesforce	+26%	+59%	-36%
ServiceNow Inc	+29%	+71%	-33%

[1]constant currency
[2]Share price change to end of October 2022
[3]For KKR, these are growth rates in fee paying AuM as opposed to revenue. We have adjusted these figures for the acquisition of Global Atlantic.

While the growth rates are lower than we became accustomed to, we think these are temporary slowdowns due to the macro-economic environment we are in as well as a return to post COVID normal. We think that the long-term outlook for these companies is bright.

The share price falls of Adobe and Meta in the table above do deserve more commentary.

In September, Adobe announced its intended acquisition of rival Figma for $20b – more than 50x its projected revenue in 2022. The market expectedly reacted badly with the share falling 14% on the day. It is a staggering price that even with Adobe's powerful distribution advantages will take many years to justify. While we had researched Figma before, it forced us to relook at the business.

Adobe dominates photo editing and illustration with its Photoshop and Illustrator products. However, its Adobe XD product lags both Sketch and Figma in collaboration. While Sketch only has a first mover advantage over and is not a significantly different product to Adobe's XD, Figma has a structural advantage over both. Figma is cloud-native whereas Adobe is desktop native. And this makes it a much better tool for collaboration.

While this seems obvious, in Adobe's defence, as a company, its aim was always to prioritise performance to enable powerful features for designers. And to do this, desktop was the clear solution. It naturally missed the fact that performance was not as important in collaboration.

As a result, Figma now dominates designer workflows. And Adobe's products (along with numerous other products used by designers) are a part of this. Figma therefore has a stronger hold over the customer. This is what Adobe's proposed acquisition has helped us understand. Adobe realized the risk that if Figma – or third-party developers on its platform – invest in photo editing and illustration, it could steal customers.

Although we now understand that Adobe's advantages are not as strong as we initially thought, we have not sold our holding. This is because the current share price discounts both possible outcomes of the deal. If it passes regulatory approval, Adobe's advantages are strengthened, and at the current share price, the expensive deal is priced in. If on the other hand, the deal is not approved by regulators, then Adobe's current share price makes allowance for a business with weaker advantages than we initially thought.

Meta has been our worst performing stock this year. In addition to a slowdown in its advertising revenue, the market is unhappy with the company's significant investments in the metaverse – which have no evidence of yielding a return. While we share the market's concerns about the metaverse, as long-term investors, we know that at some point these investments will either yield returns or, if not, will end. And – as proven in recent results – the company's network effect advantages will likely outlast this. At a 9x P/E multiple, we think we are being more than compensated for this.

Turbulent markets will continue to throw up opportunities and we will continue to switch into better quality businesses at similar discounts to the ones we own or cheaper businesses that are of the same quality. Equities are a long-term asset class. They perform well over long periods of time, but they are characterized by years of good returns punctuated by years of poor returns. This is a bad year, but in five years' time, we are confident we'll look back at this time as a good time to be investing.

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Performance figures are quoted after the deduction of all costs (including manager fees and trading costs) incurred within the fund. Annualised performance figures represent the geometric average return earned by the fund over the given time period.

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