PANGOLIN INVESTMENT MANAGEMENT

Pangolin Aviation Recovery Fund September 2022 NAV

As at 30th September 2022, the NAV of Class A shares of the Pangolin Aviation Recovery Fund was US$65.91 net of all fees and expenses, down by 17.52% from US$79.91 in August 2022.

The fund is 97% invested, with the split being approximately as follows:

Figure 1: Portfolio by sector exposure

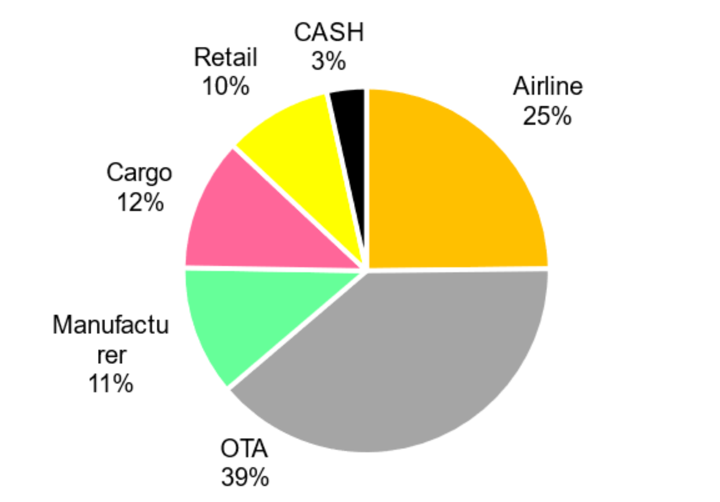
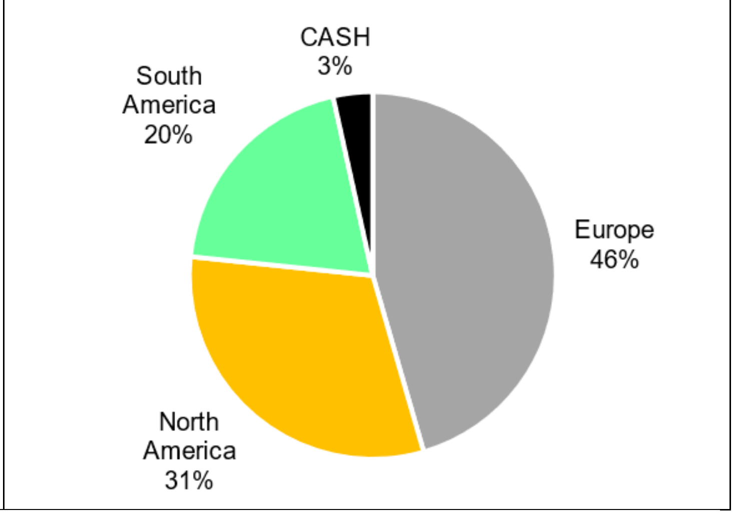


Figure 2: Portfolio by geographical exposure



September was a brutal month for the entire capital markets globally. It is one of the few times in history whereby equities, bonds, and gold collapsed in unison. Only the U.S. dollar is up, as investors run to the greenback for cover.

The aviation sector was hit extra hard as the market perceives it to be consumer-discretionary and sentiment dependent. It is an overly simplistic reaction, but these things tend to happen when the market is chaotic.

Our fund composition remains unchanged. There was a brief period whereby we sold our stake in Deutsche Post, only to reacquire them later. More detail is in the later part of the report.

Uncovering the chaos

Whenever market chaos prevails, the best thing to do is to stay calm, and take a moment to reflect. In the House of Pangolin, we recite our five commandments. Thou shall not confuse markets with investing is the sermon of the day.

We spoke to four management teams in companies we invested. The other companies in our fund are in their ‘quiet period’. The excerpts of our conversations are summarised below.

The Brits will still travel

The British Pound has slumped to a historic low against the USD and this makes foreign travel more costly for UK people. Fortunately, the Euro has not moved significantly against the Pound and European destinations are still good value for the U.K. people. Local holidays in the U.K. are not appealing as train tickets, car travel and accommodation are prohibitively expensive. Service levels have structurally declined, as migrant workers that previously thronged the hospitality industry had left due to Brexit. I don’t need to comment on the British weather. Think about it this way, would you rather spend £500 for a holiday in Cornwall or Malaga?

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There is also another angle to view the weak Pound against the USD. Long-haul holidays to the U.S. and the Caribbean ─ which use the USD as their functional currency, is more costly. These people might swap their long-haul holiday plans to travel regionally where the currency impact is less pernicious. Also, more North Americans might be tempted to cross to the other side of the Atlantic. Therefore, holiday tours might enjoy a boost from unconventional customers.

JET2 had a very strong summer despite the operational challenges of severe delays, long queues and flight cancellations across UK airports. The situation has abated and people who avoided traveling during the chaotic summer period are doing so now. Therefore, JET2 is getting some spillover peak summer traffic into its traditionally shoulder period. The management firmly believes that holidays are a necessity for its core customers, and they will continue to do so under the current economic backdrop. Furthermore, JET2 has variable duration offerings that can appease any budget.

JET2 is trading at 6.7x one-year forward PE and is in a comfortable net cash position. It has hedged its FX exposure at attractive levels. We think it’s a bargain given its strong market position, top-quality management, and good risk management practices.

On-the-Beach also enjoyed a reasonably strong summer and forward demand is stable. Oddly enough, it has seen a higher-than-normal demand for Mediterranean destinations in the upcoming winter months. They think people do this to avoid paying expensive heating bills in the U.K. and relocate to ‘warmer’ locations. Stranger things have happened.

OTB’s share price has been under immense pressure and is the fund’s worst-performing stock. OTB is trading at 7x one-year forward PE and is in net cash position. We like its robust asset-light business structure and low-cost operations. Recently, Simon Cooper (CEO) raised his stake to 5.64% and so did the other senior management team.

Deutsche Post and the misadventure of FedEx

FedEx shook the market on 15 September when it made highly unusual preliminary first quarter results, exactly one week before the actual results were to be released. It makes for grim reading. FedEx said business conditions deteriorated so much that they need to retract, close 90 sales offices worldwide and consolidate operations. FedEx also withdrew their FY2023 earnings forecast that was provided only two months earlier, and the profit guidance for 1H-FY23 was well below even pre-pandemic.

We have done extensive work on FedEx and Deutsche Post for over a year. We concluded that both are well-managed companies, and we would be happy to invest in either one of them. Ultimately, we chose Deutsche Post because they have a better IT system, more exposure to high growth e-commerce segment, and satisfactory level of their delivery service through our personal experiences. So, when FedEx gave the dumbfounding announcement, it was truly a WTF moment.

We exercised our prudent approach to liquidate our entire stake in Deutsche Post. A week later, we tuned in to FedEx's 1QFY23 results and spoke to the Deutsche Post IR team. We had a comprehensive view and concluded that it was all FedEx’s misdoing and does not represent the overall industry. We happily bought back Deutsche Post shares after that.

Deutsche Post is trading at 8.5x one-year forward PE with a sumptuous dividend yield of 6%. It is the most versatile logistics company that we have come across. The market is discounting Deutsche Post on global recession risk. I think it is overdone as the logistics cogs and jigs will still be moving in any market condition.

Embraer, just produce produce produce

My colleague Vinchel had the good fortune of meeting the Embraer IR team at their corporate headquarters in Sao Paolo, Brazil. Demand for Embraer's product range is strong, driven by replacement cycles and new route launches. Executive jets are selling like hot cakes, "ditch the Ferrari give me a Phenom[1]" is the new tagline among salesmen. The industry is facing some components shortages and therefore production cycle and delivery numbers will only reach the pre-pandemic levels in 2024.

Embraer is trading at 12.2x one-year forward PE, which is well below its historical average and is also lower than its global peers. Its gearing ratio is receding, thanks to improving product deliveries to customers and improving margins. Embraer offers high earnings visibility and low risk profile given that order books are full for over two years

Outlook

After talking to management and looking at industry operational statistics, we should be able to relax a bit. The world is becoming efficient again as seen by the improving supply chain and air transport industry — airport congestion and airline on-timeliness are gradually improving. Most telling, many aviation company managements are saying that customer purchase patterns are reminiscent of demand recovery, and not demand destruction.

The market is acting as if the sky is falling, but it will figure out soon that there are positives underway and will be constructive with stocks again. Remember, when the market is in full panic mode while industry captains remain sanguine about their businesses, it presents buying opportunities.

Mohshin Aziz
7 October 2022

[1] A single pilot certified light business jet developed by Embraer.

Year	Details	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2022	***NAV***	110.60	108.72	106.42	103.80	97.14	76.62	79.66	79.91	65.91				**-37.86%**
	MoM %Δ	*4.28%*	*-1.70%*	*-2.11%*	*-2.46%*	*-6.42%*	*-21.12%*	*3.97%*	*0.31%*	*-17.51%*				
2021	***NAV***	93.38	112.20	116.33	116.30	119.97	113.86	109.74	108.43	115.97	109.28	93.87	106.06	**6.06%**
	MoM %Δ	-6.62%	20.15%	3.68%	-0.49%	3.16%	-5.09%	-3.62%	-1.19%	6.95%	-5.77%	-14.1%	12.98%	

Figure 9: Pangolin Aviation Recovery Fund NAV (USD/share)

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