GCQ FLAGSHIP FUND | P Class Units

GCQ
GLOBAL CONCENTRATED QUALITY

MONTHLY PERFORMANCE & PORTFOLIO UPDATE

May 2024

Returns	1 Month	3 Months	6 Months	12 Months	Since Inception Annualised (1 July 2022)
GCQ P Class (AUD)[1]	**1.9%**	**-2.4%**	**12.4%**	**25.1%**	**31.8%**
MSCI World Index (AUD)	2.0%	1.5%	14.3%	21.6%	21.5%
Outperformance	**-0.1%**	**-3.9%**	**-1.8%**	**3.5%**	**10.5%**

"I just like the great businesses."

- Charlie Munger

The portfolio's net return for the month of May was **+1.9%**. This compares with the MSCI World Index (AUD) return of +2.0% for the month.

PORTFOLIO UPDATE

Investors who watch GCQ closely will notice that while the companies in the portfolio do not change much from month to month – or even from year to year – active management of the portfolio can see the weights of each company vary quite materially over time.

There were two key changes in portfolio weights this month.

The first of these resulted from our continued selling of **Alphabet** (the parent company of Google) down to **8%** of the portfolio, having peaked at **~14%** in March 2024.

We first made Alphabet our largest single investment in the first half of 2023, during a brief period when investors questioned whether Google's monopoly position in search would be usurped by OpenAI's ChatGPT. We understand Google's business model and industry structure well, and thought we were buying the company at a bargain price when the stock was trading at an adjusted free cash flow multiple of around **10x** for the core business.

Our recent decision to reduce the size of the Alphabet position was triggered both by our portfolio risk management disciplines – we have a 15% limit on any single stock position – and our decision to redeploy capital into even more attractive opportunities. Alphabet is up **over 100%** from its lows at the start of 2023.

Portfolio Overview as at 31 May 2024	Portfolio Weight
Hemnet	11%
rightmove	7%
Real estate advertising monopolies	**19%**
VISA	9%
	6%
Global consumer payments	**15%**
MSCI	7%
S&P Global	4%
Moody's	2%
Credit rating agencies & investment index providers	**14%**
Alphabet	8%
Meta	4%
Global online advertising	**12%**
RICHEMONT	11%
HERMÈS	1%
Super-luxury goods	**12%**
amazon.com	11%
Global cloud computing	**11%**
FICO	5%
Local monopolies	**5%**
WD-40 COMPANY	1%
Branded consumer goods	**1%**
Other high-quality businesses	**10%**
Total long	**99%**
Shorts	**(3%)**
Net exposure	**96%**
Cash	**4%**
TOTAL	**100%**

1. *Net performance figures are shown after all fees and expenses and assumes reinvestment of distributions.*

The second change was to add to our position in **MSCI** at a time when it was temporarily out-of-favour. We discussed this situation in last month's update, noting that we have long-admired MSCI as one of the highest quality businesses in the world. However, we had reduced the position to **~1%** in February 2024 when the company's share price was at ~$570 – which was approaching our assessment of its intrinsic value.

At its latest quarterly result in April, MSCI recorded a modest reduction in client retention rates, prompting the share price to fall **-13%**. As a result, MSCI was trading on the cheapest valuation in many years. We believe the reduction in client retention is a short-term issue, driven largely by the merger of UBS and Credit Suisse (a one-off event).

We welcomed the opportunity to rebuild GCQ's position in MSCI in April and May on the back of these short-term concerns, with the position standing at **7%** at the end of the month.

We believe the index segments of **MSCI** and **S&P Global** are some of the highest quality businesses in the world. We will provide a detailed discussion of them in an upcoming monthly update.

One further development worth noting from May was **Richemont's** quarterly earnings result – which was released after our detailed discussion of quarterly earnings in last month's update.

At a time when investors were concerned about slowing demand for luxury products, Richemont reported a healthy result, led by its Jewellery Maisons segment (which includes the **Cartier** and **Van Cleef & Arpels** brands). The Richemont share price responded strongly to this result, increasing by more than **+10%** in the days following the result.

At today's price, Richemont trades at **~16x P/E ex-cash**. We believe this is a highly attractive valuation for a business of Richemont's growth potential, quality and durability.

Over the next 3-5-years, we expect Richemont's Jewellery Maisons to continue to benefit from the dual tailwinds of growth in global wealth and branded jewellery penetration, which should support high-single-digit revenue growth. We believe this underpins more than **+70% upside** to the share price today.

The remainder of this monthly update sets out a brief discussion of GCQ's "industry-first" approach to investing, and how this has led to the Fund's first investment in Japan.

GCQ'S INDUSTRY-FIRST INVESTMENT APPROACH

"I don't have to be an expert on every company, or even many. I only have to be able to evaluate industries and the leaders within them."

- Charlie Munger

At GCQ, we do not consider ourselves to be either pure top-down investors (who begin the investment research process at the macroeconomic level) or bottom-up investors (who start at the individual company level). Instead, GCQ takes an **industry-first** approach to our investment research. The first step in our investment process is to identify the **most attractive industries** in which to invest for the long-term. We look for industries with predictable secular growth and stable or improving industry structures – factors which we think are essential to investment success but are often underappreciated by pure bottom-up investors. We then seek to own the companies within those great industries with the **best business models** and which are trading at the **most attractive valuations**.

In the past, our industry-first approach has given us the conviction to invest in companies that are yet to reach their full earnings potential, but operate within highly attractive and improving industries.

For example, our team invested in **Amazon** in the early-2010s, when both its e-commerce and Amazon Web Services (AWS) segments were relatively nascent, and the company's cash flow generation potential was being masked by substantial growth investments.

Similarly, we invested in **Spotify** in 2022, when it was widely considered a good product, but a bad business that was destined to earn single-digit margins over the long-term. We were confident that Spotify's position at the centre of the music streaming industry gave it considerable untapped pricing power and the ability to generate margins significantly higher than other investors anticipated. This thesis has played out, with Spotify increasing prices across multiple geographies, and margins inflecting.

Our industry-first and global approach to investing also allows us to recognise high-quality **local monopoly** industries early in their maturity if we can find useful case studies of how a similar industry has developed in other countries. For example, our understanding of **REA Group** and **Domain** in Australia allowed us to recognise **Hemnet**'s pricing and premiumisation opportunity before European investors were generally able to do so.

MONEY FORWARD: THE "XERO OF JAPAN"

"Sustained structural growth is (almost always) chronically underpriced in the market."

- Steve Mandel

The GCQ team has invested in Japan for ~15 years. Due to well-understood demographic challenges, Japan is a large but slow-growing economy. Our interest is focused on a handful of high-quality monopoly and duopoly industries with secular growth. For example, Japan's cloud accounting software industry is a duopoly between **Money Forward** and **Freee** for small- to medium-sized business (SMB) customers.

We believe Money Forward, our preferred exposure within the industry, presents an opportunity similar to **Xero**'s Australasian business of ~10 years ago. Since 2015, Xero's subscribers in Australia & New Zealand have increased **~7x**, and its share price has increased **~8x**, or **~25%** CAGR.

Cloud accounting software is an industry with favourable economics, and one that has been on **GCQ's High-Quality Watchlist** since our inception.

The cloud accounting software industry typically forms national monopolies and oligopolies. For example, **Xero** has **~75%** market share in Australia, and almost **100%** market share in New Zealand. In Sweden, **Fortnox** is dominant, with **~40%** share of enterprises, and **~60%** share of businesses with 5-9 employees. In the U.S., **Intuit's** QuickBooks is estimated to have **~80%** market share of small businesses.

In Australia, Xero was quick to squeeze out MYOB as the advantages of cloud accounting software over desktop software became obvious, and as government initiatives like Single Touch Payroll provided an impetus for cloud accounting software adoption. MYOB was saddled with the "innovator's dilemma" – as is seen so often with businesses that dominate a niche, it lacked the incentive to disrupt its own highly profitable desktop accounting software with lower-cost cloud accounting software. In Japan, **Yayoi** is the dominant desktop accounting package for sole proprietors and small businesses, and we believe it faces a similar innovator's dilemma. While Yayoi has released a cloud product, the vast majority of its business remains on-premise, for which it continues to exercise its pricing power for its existing customer base, while losing share to Money Forward and Freee. Yayoi is owned by private equity; we believe the business is being run as a cash cow, and we see parallels to MYOB's (which is also owned by private equity) fading market position in Australia.

Among Japan's small- to medium-sized businesses, cloud penetration of accounting software is very low. We estimate **cloud accounting adoption is just ~20%**, which compares to ~80% in Australia and New Zealand. Today, the majority of Japan's small businesses are still using paper-based systems or spreadsheets to reconcile their accounts. Of small businesses that have adopted accounting software, desktop software accounts for the majority. Desktop software does not provide accountants with real-time bookkeeping, and often requires manual reconciliation at the end of each month.

The cloud accounting software industry is growing rapidly from a small base. Over the last five years, revenue from Money Forward's cloud accounting segment has grown **4.5x**, while Freee's revenue has grown **4.3x**.

We expect strong growth in customer numbers to continue for many years, underpinned by drivers including:

- Recent government reforms, such as the Electronic Bookkeeping Maintenance Act (which mandates storage of electronic invoices), and the Invoice System (which imposes higher goods & services taxes on businesses that are not registered under the new system);
- A trend towards cashless transactions (Japan's cashless penetration rate is still only 36%, but growing quickly);
- Labour market challenges (a shortage of accountants favours real-time bookkeeping to reduce the burden of manual paperwork and reconciliation on accountants); and
- Working-from-home (with cloud-based software empowering accountants to work from any location).

Money Forward and Freee are growing into a large market, with Japan **~3x** the size of Australia in terms of GDP and **~5x** the size of Australia in terms of population.

Of the two cloud accounting software providers in Japan, Money Forward acquires two-thirds of its small- to medium-sized business customers through accounting firm referrals, while Freee acquires ~80% of its customers through web marketing (i.e., through Google Ads). We believe Money Forward's focus on acquiring customers through accounting firms is the better long-term strategy.

This is the case as the cloud accounting industry typically forms local oligopolies because of network effects between accountants and their clients. Accounting firms derive significant efficiency benefits from having their clients on the same platform, and typically recommend their preferred accounting software to clients. This drives the clients of the accounting firm towards a single cloud accounting software provider. By contrast, a company like Freee that targets small businesses directly through web marketing has limited network effects.

In the accounting partner channel, Money Forward is used by 80 of the top 100 accounting firms. In terms of building relationships with accounting firms, we believe Money Forward has a multi-year lead over Freee.

Within the cloud accounting software industry, switching costs are high, and competitive churn is extremely low. For corporates (~90% of Money Forward's cloud accounting software revenue), Money Forward has **~90% retention rates**, with churn largely driven by companies going out of business or being acquired. The relatively low price and significant integration with business processes affords the cloud accounting software provider significant **pricing power**.

In Japan, we have started to see key players within the accounting software industry increase prices – a practice that is particularly rare in Japan, given prices for most daily services have remained largely unchanged since the late-1990s. Japan's two leading legacy desktop accounting software providers, **Yayoi** and **OBIC Business Consultants**, each implemented **~10-20%** price increases in 2023. In February 2024, **Freee** announced a **~40%** price increase for its small- and medium-sized business customers. **Money Forward's** software is currently priced at a **~30% discount** to Freee's equivalent offerings, and we like that we are buying the business with untapped pricing power.

Having watched Freee since its listing in 2019, the announcement of its recent price hike was a key catalyst for our renewed interest in the sector. We organised a trip to Tokyo in April, meeting several players in the industry, before initiating a small position in Money Forward. We were impressed by Money Forward CFO Naoya Kanesaka – who conducted the meeting in English – and we found Money Forward's head office more closely resembled that of a tech company in San Francisco than a traditional Japanese corporate.

The cloud accounting software industry comfortably passes through **GCQ's Industry Quality Checklist**. The key item that Money Forward does not yet tick on **GCQ's Business Quality Checklist** is "does the business generate high margins?", as Money Forward is roughly breakeven on an EBIT basis due to a period of heavy investment. However, the combination of Money Forward's untapped pricing power, and an understanding of the margins enjoyed by more mature global peers gives us confidence that Japan's cloud accounting software industry is likely to be highly profitable at maturity. Xero generates **~55% EBITDA margins** in Australia & New Zealand, Fortnox generates **~40% EBIT margins** in Sweden, and Intuit's Small Business Group & Self-Employed segment generates **~55% EBIT margins** in the U.S. Japan's non-cloud accounting software providers generate similar margins, with Yayoi estimated to generate **~50% EBIT margins**, while OBIC Business Consultants earns **~45% EBIT margins**.

Despite the long growth runway ahead, Money Forward trades at a substantial valuation discount to its global peers, as it is yet to demonstrate its margin potential. Today, Money Forward trades at ~5x forward sales, a material discount to global peers that trade between ~9x to ~14x forward sales. Evidence of pricing power gives us comfort that Money Forward's margins will inflect over the next few years, after a period of heavy investment in growth.

At the current valuation, Money Forward reminds us of **Xero ~10 years ago**, before margins inflected. We believe the business can continue to grow revenues at a mid-20% rate over the next five years through a combination of net customer expansion, product upsell, and pricing, which will drive margin expansion. At this valuation, we look forward to strong – albeit volatile – shareholder returns.

"A great company keeps working when you're not. A great company will eventually earn more and more and more while you're just sitting and doing nothing. And a mediocre company won't do that."

- Charlie Munger

CONTACT

KATHY WU
Chief Operating Officer
contact@gcqfunds.com
+61 (2) 7252 9124

GCQ Funds Management Pty Ltd
Level 9, 139 Macquarie Street
Sydney, NSW 2000 Australia
gcqfunds.com