GCQ FLAGSHIP FUND | P Class Units

GCQ
GLOBAL CONCENTRATED QUALITY

MONTHLY PERFORMANCE & PORTFOLIO UPDATE

November 2024

Returns	1 Month	3 Months	6 Months	1 Year	2 Year (p.a.)	Since Inception (p.a.) (1 July 2022)
GCQ P Class (AUD)[1]	**3.7%**	**5.0%**	**13.1%**	**27.1%**	**33.0%**	**31.0%**
MSCI World Index (AUD)[2]	5.3%	8.2%	13.3%	29.5%	21.9%	22.9%
Outperformance	**-1.6%**	**-3.2%**	**-0.2%**	**-2.3%**	**11.1%**	**8.1%**

"Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in corrections themselves."

\- Peter Lynch

The portfolio's net return for the month of November was **+3.7%**, which compares with the MSCI World Index (AUD) return of +5.3%. This brings the net return for P Class units to **+91.9%** since inception on 1 July 2022 (**+31.0%** annualised).

This month, we have broken out **cloud accounting software** as a new industry in the Portfolio Overview on the right-hand side of this page.

Over the past 12 months, the Fund has established a position in three cloud accounting software companies across Japan and Sweden. While we were building these positions, they were grouped in the "Other High-Quality Businesses" section of the Portfolio Overview.

Below, we outline why we like investing in this industry, and in particular, the dominant cloud accounting software players in Japan, being Money Forward and Freee.

Today, our portfolio is trading at a weighted-average multiple of ~24x forward earnings, and we expect earnings will double over the next five years. We believe the portfolio is well positioned for future performance.

Portfolio Overview as at 30 November 2024	Portfolio Weight
Hemnet	11%
rightmove	8%
Real estate advertising monopolies	**19%**
VISA	10%
	8%
Global consumer payments	**18%**
RICHEMONT	10%
HERMÈS	3%
Super-luxury goods	**13%**
Alphabet	11%
Meta	2%
Global online advertising	**13%**
amazon.com	10%
Global cloud computing	**10%**
Money Forward	7%
freee	1%
Fortnox	1%
Cloud accounting software	**9%**
MSCI	9%
Index providers	**9%**
WD-40 COMPANY	1%
Branded consumer goods	**1%**
Other high-quality businesses	**8%**
Total long	**99%**
Shorts	**(3%)**
Net exposure	**97%**
Cash	**3%**
TOTAL	**100%**

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

CLOUD ACCOUNTING SOFTWARE

"If you've got the power to raise prices without losing business to a competitor, you've got a very good business."

- Warren Buffett

GCQ's Industry-First Approach

At GCQ we take an **industry-first approach** to our investment research. The first step in our investment process is to identify the most attractive industries to invest for long periods of time. We look for industries with predictable secular growth and stable or improving industry structures – factors that we believe are essential to investment success, but are often underappreciated by other investors. We then seek to own the companies within these industries that have the most attractive business models, and 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. Two good examples are Amazon in the early-2010s, and Spotify in 2022.

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. Because GCQ is an **all-capitalisation** fund (meaning we can, and do, invest in companies of all sizes from relatively small companies with an equity value below five billion dollars, through to trillion-dollar enterprises), we can take advantage of these opportunities.

Over the journey, some of our best ideas have been smaller companies. 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.

Today, we are tremendously excited by the secular growth opportunity for cloud-based accounting penetration in Japan and Sweden. As global investors, we spend a significant portion of our time on the road meeting companies, and we have come away from numerous meetings in Japan and Sweden over the course of the past year with a high degree of conviction in the multi-year opportunity for cloud accounting software.

Cloud accounting software is an industry with highly favourable economics, and from this month, it is an industry that we have separately disclosed.

Below, we have detailed our industry-level thesis. It is important to note that while we have 9% of the portfolio invested in three relatively small companies in the cloud accounting software industry, this is part of a broader portfolio of 8-10 diverse, high-quality industries. While we see significant upside from these investments over the next decade, we also expect to experience plenty of share price volatility as the industry matures.

The Transition to Cloud

From its launch in Australia in 2009, Xero was quick to win business away from MYOB as the advantages of cloud accounting software over desktop software became obvious. This was furthered by government initiatives, like Single Touch Payroll, a government initiative that requires businesses to report pay information to the ATO digitally each pay run, which provided an impetus for cloud accounting software adoption.

Through this period, MYOB was saddled with the "innovator's dilemma" – as is often seen 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.

"It is difficult to get a man to understand something, when his salary depends on his not understanding it."

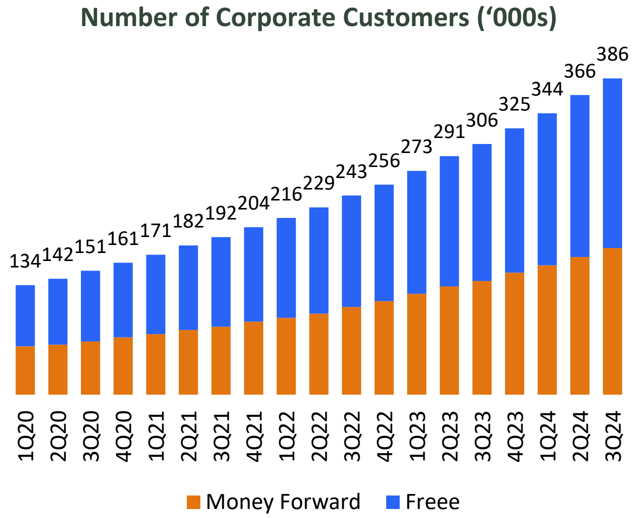
- Upton Sinclair, 1934

In Japan, Yayoi is the dominant desktop accounting package for sole proprietors and small businesses, and we believe it faces a similar counter-positioning problem. While Yayoi (like MYOB) has released a cloud product, most of its business remains on-premises. This results in a relatively minor proportion of Yayoi's resources (time and money) being allocated to its cloud product, enabling Money Forward and Freee – whose businesses have been cloud-based from day one – to dominate the cloud accounting software market.

Yayoi is owned by private equity, and we see parallels to MYOB's market position in Australia. Low levels of voluntary customer churn, particularly for more complex medium-sized businesses, in combination with regular price hikes, have proven to be a profitable recipe for private equity owners, particularly when combined with financial leverage. In Australia, MYOB has had four owners since 2009, including a stint on the ASX from 2015 to 2019, while Yayoi has had four owners since 2007. Meanwhile, Money Forward and Freee are both founder-led and owned; Money Forward CEO Tsuji Yosuke owns ~17% of the business, while Freee CEO Sasaki Daisuke owns ~19% of the business.

Today, most of Japan's ~3.7 million enterprises are still using paper-based systems or spreadsheets to reconcile their accounts. Of small- and medium-sized businesses that have adopted accounting software, desktop software still accounts for the majority, and we estimate only ~20% of small- to medium-sized businesses are using cloud software accounting. This level of penetration is low relative to other developed markets, with cloud-based accounting software penetration in Australia and New Zealand close to 80%. However, adoption in Japan is growing quickly. To put this into context, over the last five years, revenue from Money Forward's back-office software segment has grown ~6x, while Freee's annual recurring revenue has grown ~5x.

Today, each of Money Forward and Freee have ~200k corporate customers, and are adding ~10k customers per quarter (which translates to ~20-25% annualised customer growth), compared to a total addressable market of ~2 million corporate customers (including both SMBs and medium-sized companies).



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.

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

- Recent government reforms, such as the Electronic Bookkeeping Maintenance Act (which mandates retention 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 39%, but growing quickly);
- Labour market challenges (a shortage of accountants favours real-time bookkeeping, facilitated through automated bank feeds that connect a business' accounting system to their bank, which reduces the burden of manual paperwork and reconciliation on accountants); and
- Working-from-home (with cloud-based software empowering accountants and their clients to work from any location).

Highly Concentrated Industry Structures

The cloud accounting software industry typically forms local monopolies and oligopolies. For example, we estimate Xero has ~75% market share of total businesses (excl. trusts) in Australia, and almost 100% market share of businesses in New Zealand. In Sweden, Fortnox is dominant, with ~60% share of small businesses with 5-9 employees. In the U.S., Intuit's QuickBooks is estimated to have ~80% market share of accounting software for small businesses. While earlier in its journey, it is hard to envisage a new entrant disrupting the duopoly for cloud-based accounting software that Money Forward and Freee have established in Japan.

The cloud accounting industry typically forms local oligopolies because of network effects between accountants and their clients. For example, in Japan, Money Forward acquires two-thirds of its small- to medium-sized business customers through accounting firm referrals.

Accounting firms are significant beneficiaries of the move to cloud-based software. The more primitive alternative, desktop accounting software, does not provide accountants with real-time bookkeeping, and often requires manual reconciliation at the end of each month. In comparison, accounting firms derive significant efficiency benefits from administering their clients on the same cloud-based platform, facilitated through automated bank feeds – and typically recommend their preferred accounting software to clients. This drives the clients of an accounting firm towards just one or two cloud accounting software providers.

Money Forward dominates the accounting partner channel, being used by 80 of the top 100 accounting firms in Japan. Distributing software through the accounting partner channel was the playbook deployed by Xero, and was a key driver of its tremendous success. To illustrate, since 2015, Xero's subscribers in Australia & New Zealand have increased ~7x, and its share price has increased ~11x, or ~28% CAGR. The similarity in distribution strategy is one of the key reasons Money Forward is GCQ's preferred exposure within the Japanese cloud accounting software industry.

Extreme Pricing Power

Within the cloud accounting software industry, switching costs are high, and competitive churn is extremely low. For corporates (~90% of Money Forward's back-office 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 point, which is less than US$40 per month for SMBs – the equivalent of just two working hours in Japan; and 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 rare in Japan, with prices for most basic products and services having 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 ~30-50% price increase for its small- and medium-sized business customers, which was implemented in July 2024. Having watched Freee since its listing in 2019, the announcement of this price hike was a key catalyst for our renewed interest in the sector. Importantly, in the first quarter following its price increase, Freee saw no impact to churn, and saw record customer additions.

In October, Money Forward followed with a ~30-50% price increase for small- to medium-sized businesses, which will come into effect in July 2025. This is the first time that Money Forward has raised prices in several years. Pertinently, the timing of the price increase (~9 months after Freee's announcement) signals rational behaviour by both Freee and Money Forward.

Given the low absolute dollar cost of cloud accounting software for small- and medium-sized businesses; significant switching costs; and local network effects with accounting firms, where price hikes provide a high-margin kicker for accountants (accountants often receive meaningful ongoing financial incentives for referring clients), we believe the industry is likely to benefit from significant price hikes in the future, which should drop to the bottom-line at very high incremental margins.

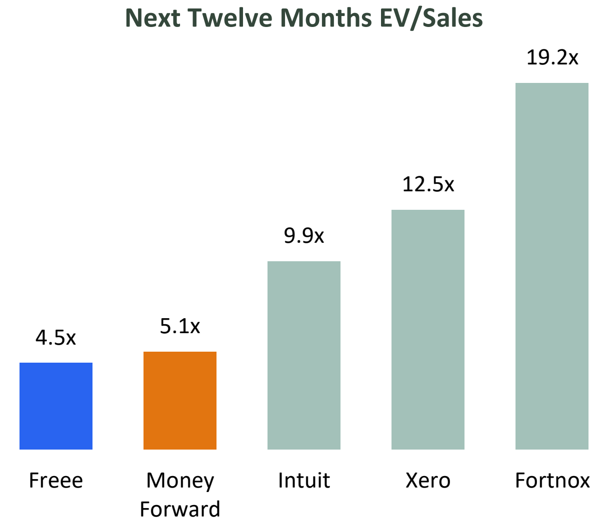
Margins

The cloud accounting software industry sails comfortably through the GCQ Industry Quality Checklist. However, our GCQ Business Quality Checklist is not easy to satisfy for companies that are relatively early in their corporate journey. The key question that Money Forward and Freee do not yet tick on this checklist is "does the business generate high margins?", as both companies are roughly breakeven on an EBITDA basis following a period of heavy investment.

In the early stages of cloud accounting adoption, attractive unit economics can often be masked by high fixed costs, because unlike the sale of a perpetual license, revenue is recognised over the life of a customer, typically paid monthly or annually.

While a cross on the checklist always stimulates debate amongst our investment team, the combination of 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 ~50% EBITDA 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% EBITDA margins, while OBIC Business Consultants earns ~45% EBITDA margins.

Despite the long growth runway ahead, Money Forward and Freee trade at a substantial valuation discount to global peers, with both yet to demonstrate their margin potential. Today, Money Forward and Freee trade at just ~4-5x forward sales, a material discount to global peers that typically trade at a double-digit multiple of sales. Evidence of pricing power gives us comfort that Money Forward and Freee's margins will inflect over the next few years.



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 believe the stock can increase ~4-5x over the next five to seven years, and we look forward to strong – albeit volatile – shareholder returns.

"It takes remarkable patience to hold on to a stock in a company that excites you, but which everybody else seems to ignore. You begin to think everybody else is right and you are wrong. But where the fundamentals are promising, patience is often rewarded."

- Peter Lynch

GCQ Funds Management[1]	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2022							8.9%	-4.1%	-4.8%	2.9%	5.9%	-5.7%
2023	10.0%	1.6%	8.2%	4.4%	5.1%	2.5%	2.2%	2.9%	-3.9%	-1.1%	8.7%	1.8%
2024	6.7%	6.0%	0.0%	-4.3%	1.9%	2.5%	5.4%	-0.3%	0.6%	0.6%	3.7%	

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