CERNO CAPITAL

TM CERNO *Pacific*

UCITS Regional Equity Portfolio (Class B)

Q1-2023

Investment Objectives

The Cerno Pacific portfolio is a geographically specific fund, which invests primarily across the Pacific area but also the wider emerging markets. The fund's objective is to produce capital growth over the long term through a focus on companies that are judged to be innovators or are beneficiaries of innovation through their products, services or business models. The optimal route to access the full benefit of innovation is likely to be, directly or indirectly, in the form of equity, which will be the predominant asset class in the portfolio. The manager takes an active approach to currency exposures and may hedge where deemed appropriate.

Fund Data

NAV/Share (Class B Acc)	£14.88
Fund Size (£mn)	71
Currency Share Class	GBP (Base)
Investment Management Charge	0.75%
Ongoing Charges Figure	0.99%
Dealing Frequency	Daily
Legal Structure	OEIC (UCITS)
Co-Managers	Michael Flitton & Fay Ren
Inception Date Fund	2017
Inception Date Strategy	2009
Share Type	Acc & Inc

Q1 Investment Report

Fund Activity

Michael Flitton provides performance commentary and details position changes during the quarter.

Techtronic Industries

Fay Ren revisits the case for Techtronic Industries.

Fund Activity

Michael Flitton

The fund delivered a positive return of 4.0% for the quarter against 2.7% for the comparator index.

The first quarter of 2023 exhibited three very different market environments. It is a feature of markets that participants, when grouped together, struggle to practice cognitive dissonance. As a result, one narrative will dominate investor consciousness until another gains traction and is clutched just as strenuously to the heart. Often these successive narratives can be in complete contradiction to each other. The fact that three different weather fronts occurred in one quarter suggests a lack of a master trend at work. In turn, this reflects a lack of visibility around the direction of the global economy and associated policy making.

A combination of expectations for a rapid Chinese reopening and 'immaculate disinflation' in the US drove a return of risk appetite to Asian markets starved of investor interest in January. In February this gave way to a return of the 2022 regime with inflationary fears driving strong returns in the dollar and a broad correction in Asia. Finally, this past month has seen Asia tread water, acting as a relative safe haven, whilst issues emanated in developed market banks.

Primary contributors to performance during the quarter included Sea Ltd (+184bps), TSMC (+118bps), and Tokyo Electron (+70bps). The catalyst for Sea's strong showing (up 68% in USD) was an impressive set of quarterly numbers, which showcased the company's progress in moving towards profitability. Sea's management team have done an admirable job. In a little over a year, they have pivoted group strategy to successfully prioritise cash flow, while retaining a respectable level of growth. We continue to see a powerful combination in the group's core businesses of ecommerce, digital finance, and gaming.

The performance of both TSMC and Tokyo Electron reflects a level of normalisation from the deep downturn in semiconductor valuations in 2022. Market fears over a cyclical downturn for the industry was compounded by the perception of rising geopolitical risk as US-China tensions mounted. This fear reached a crescendo in October. At this time, it was possible to buy TSMC on sub 10x earnings, a level not seen for 18 years. This is extraordinary value considering the critical role both TSMC and Tokyo Electron play in delivering the fabric for the digital age.

Detractors included Kingdee (-110bps), Nihon M&A (-109bps), and Nabtesco (-37bps). Kingdee suffered a significant price decline following news that Huawei has internally developed an ERP software system. While clearly negative on the grounds of reduced addressable market size and potential competition, we believe fears are overdone. Kingdee's accumulated experience over 30+ years, large implementation team, breadth of service, and reliable track record are critical factors for potential customers embarking on a digitalisation journey.

Nihon M&A delivered weak quarterly results at a point when analysts had become convinced an inflection in profitability was imminent. The business model is still attractive and we believe management deserve time to deliver. However, visibility is low and we took the decision to prudently trim the position size to reflect this elevated risk. Finally, Nabtesco was de-rated on concerns over the trajectory of the global economy. The business is levered to capital expenditure and as optimism for growth dimmed over the quarter, so investors have shied away from cyclical businesses. We note the risks but these are well reflected in valuation, which now sits almost 2 standard deviations cheap at 1.5x Price to book.

There was only one change to portfolio companies during the quarter. Centre Testing International was sold. The holding was small, and capital was better served elsewhere.

In the following pages Fay Ren revisits the investment case for Techtronic Industries.

Revisiting The Case For Techtronic Industries

Fay Ren

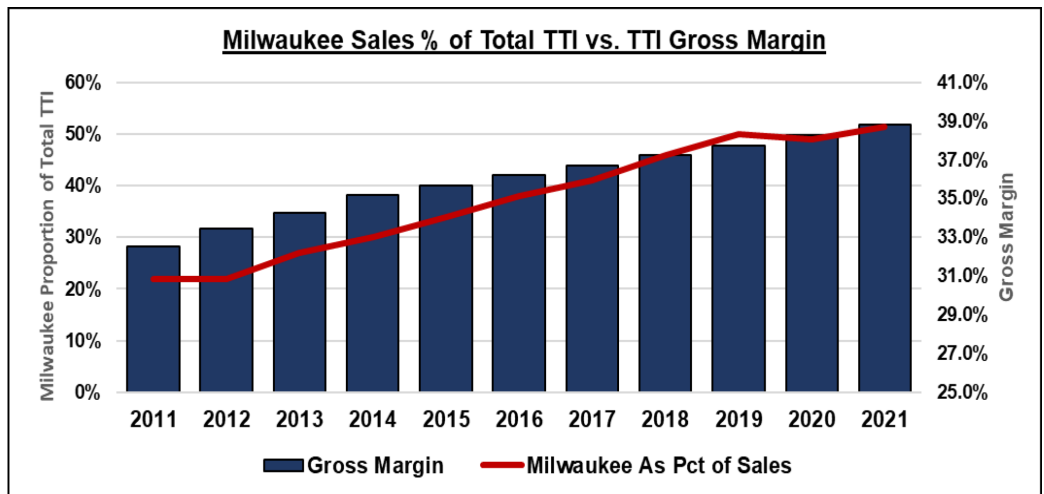
Techtronic Industries (TTI), the Hong Kong listed cordless power tool maker, was the target of a short report on the 24th of February, one week before the company was due to release its full year earnings. With the high-profile precedence of Hindenburg/Adani case still fresh, investor nerves were particularly sensitive. The short seller, Jehoshaphat Research, is not a widely recognised name, nevertheless the impact on TTI's share price was substantial, dropping 18% on the day, thereby yielding all of January's gains. The shares have partially recovered since, ending the quarter down 2.6% in local currency terms, detracting 15 bps from the portfolio in Q1. Techtronic is also held in the companion Global Leaders portfolio.

Jehoshaphat pointed out several accounting concerns that in their opinion signalled deteriorating financial and business quality. The main subject they took issue with was the divergence in gross margin in contrast to peers SWK and Makita. TTI boasts 14 years of uninterrupted gross margin expansion, while peers have been sliding. The short seller also suggested that TTI's operating profits were achieved through a myriad of accounting tricks including excessive R&D capitalisation, inventory overproduction, and snowballing various expenses.

While we acknowledge that some of the points raised do give reason for caution, in our opinion management decisions lie within the tolerance of accounting rules interpretation. We do not believe TTI has actively engaged in accounting fraud and have subsequently connected with TTI for clarifications on top of their official rebuttal. We do not attempt to regurgitate the content of the rebuttal but use this as an opportunity to revisit the thesis for this business.

The timing of the short seller campaign was chosen carefully, one day after Home Depot, TTI's major distributor in the US, released its earnings. It is no secret the external environment for the power tools industry has been deteriorating and this was duly reflected in Home Depot's numbers. Notably, TTI's largest competitors Stanley Black & Decker (SWK) and Makita have also pointed to a softening market. Nevertheless, these were fertile conditions to deliver a short seller report into.

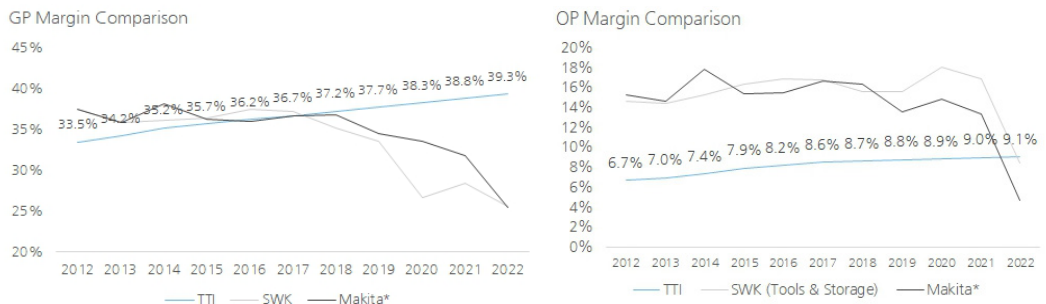
TTI's business model is centred on fast-paced innovation. Part of our initial investment thesis in 2019 was the sustainability of the impressive market share gains over peers. Since 2006, TTI moved from #6/7 position to #2 globally today. This elevation was driven by a significant expansion in product portfolio breadth as well as a first mover advantage in the nascent cordless power tool space. As a physical goods manufacturer, volume driven economies of scale and the increasing contribution of high-end flagship brand Milwaukee as a proportion of Group sales and profits from <20% to 60% were the main drivers of gross margin expansion.



Source: TTI

The power tools market historically has a slower replacement cycle compared to, say, consumer electronics. In contrast to peers, TTI's go to market resembles the high frequency approach of consumer companies, reinvesting heavily back into the business to drive new product releases that routinely making up 30-40% of total sales. Given pricing tends to increase with each new generation this approach provides a natural, mechanical tailwind to aggregate pricing.

However, operating profits have actually lagged behind peers, primarily due to TTI's heightened spending on R&D and SG&A to drive the group's high frequency product strategy.

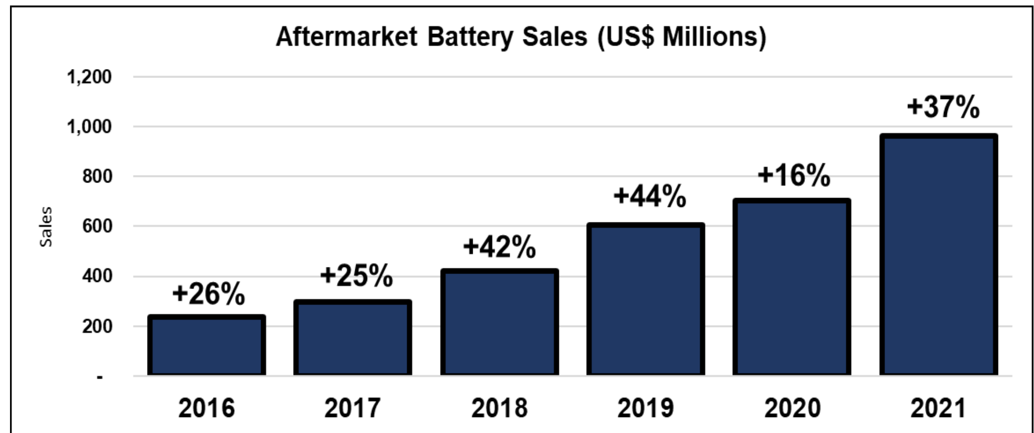


Source: UBS

The short seller was correct to point out TTI's much higher R&D capitalisation ratio versus peers, typically between 45-60% of total, where it expenses research costs and capitalises development costs. However, this is fully in accordance with international accounting rules. US listed peers using GAAP accounting must expense all R&D costs. This is a well-known international distortion and is reflected across countless companies and sectors. Adjusting for this capitalisation distortion, TTI's R&D expense as a percentage of sales is still almost double its peers at 3.7% against an average of 1.9%. This differential reflects TTIs focus on internal innovation and low contribution of inorganic M&A led growth, compared to peers, in our view.

It is notable that, even in 2022 as TTI conducted a mass layoff of 13% workforce (mostly on the manufacturing side, it also added close to 1,000 in new headcount in R&D engineers. Overall, staff costs ended higher as R&D personnel are more expensive to hire.

We have written in the past about TTI's superior proprietary design and configuration capabilities in the three core components used across the cordless power tool family: i) battery, ii) small brushless motors, and iii) electronics/software, while peers have been more reliant on third party providers. In some ways the construction of power tools analogues that of an EV, on a much smaller scale. These components are key to performance contribution although often overlooked as commodities. In this regard TTI has a clear recognition of the opportunity. Its aftermarket battery business has grown to >US$1bn sales (c.10% group) in FY22 on the back of its exclusive focus on cordless penetration and larger installed base, which has also been highly accretive to gross margins.



Source: TTI

TTI spends on average 10ppts more than peers on sales and marketing, which forms an important aspect of their go to market strategy. This sales-focused philosophy is driven by long-time CEO Joseph Galli Jr., whose early days were spent as a floor salesman.

Longstanding customer relationships with major distributors such as Home Depot (going back to 2001) play a symbiotic role in the R&D cycle. Direct feedback from the salesfloor and customer-led product requests ensures a close understanding of changing demands in the market and higher rate of success of new product launches. TTI remains one of the few tool companies that does not sell directly through generic platforms like Amazon, which can increase sales volume but does not breed brand loyalty in the long-run given bigger focus on the professional tradesman market where the Milwaukee brand targets.

Since the 2018 tariff war, TTI has been active in diversifying its production base outside China. The subsequent pandemic and Russian-Ukraine war placed further strains on the supply chain to speed up this transition. It executed well in early 2020 to shore up inventory in the onset of the pandemic which allowed it to keep deliver and take market share while its peers initially struggled.

The current growth landscape is mixed. In 2H22, revenue growth was -7%, ending the year on a flat footing. The consumer segment was notably challenged, given the pull-through demand from the pandemic and inventory destocking taking place across the industry. The Pro market was more resilient, Milwaukee pulled through +17% growth in H2, below its long-term 20%+ track record but still impressive given a generally wounded battlefield. TTI guided mid-single digit growth for FY23, including mid-teens growth for Milwaukee, where the pro market is more exposed to non-residential trends including infrastructure spending. The recent ConExpo (largest industrial machinery trade show in Las Vegas) participants indicated continued momentum in mega infrastructure projects.

Valuation is trading at the bottom of its long-term range at 15x forward 12 month price to earnings, which we believe is attractive given further structural growth in cordless penetration, industrial reshoring capex, and infrastructure spending.

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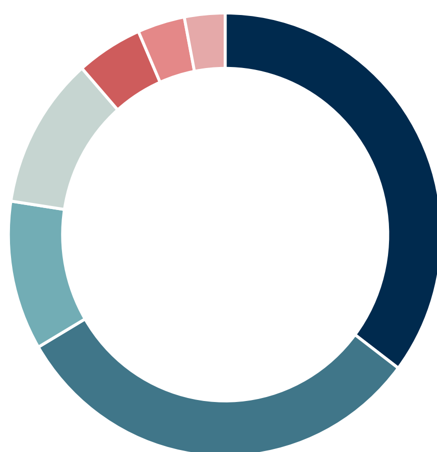
FUND FACTS



Geographic Exposure

- Japan - 33%
- China/Hong Kong- 32%
- Taiwan- 12%
- Australia - 8%
- Singapore - 7%
- Korea - 5%
- LATAM - 3%

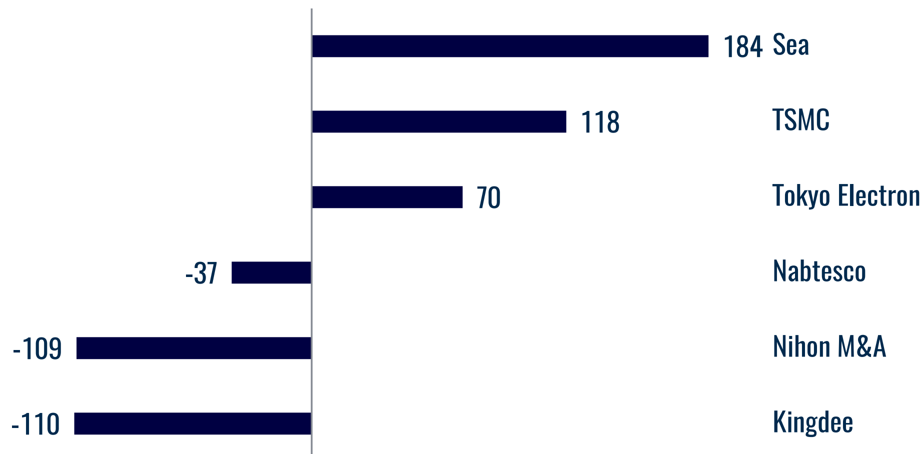
Top 10 Holdings

TSMC	5.9%
Hamamatsu	5.1%
Samsung Electronics	4.9%
CSL	4.8%
SEA	4.6%
Nabtesco	4.5%
Denso	3.8%
Tokyo Electron	3.7%
Midea	3.6%
Kingdee	3.4%

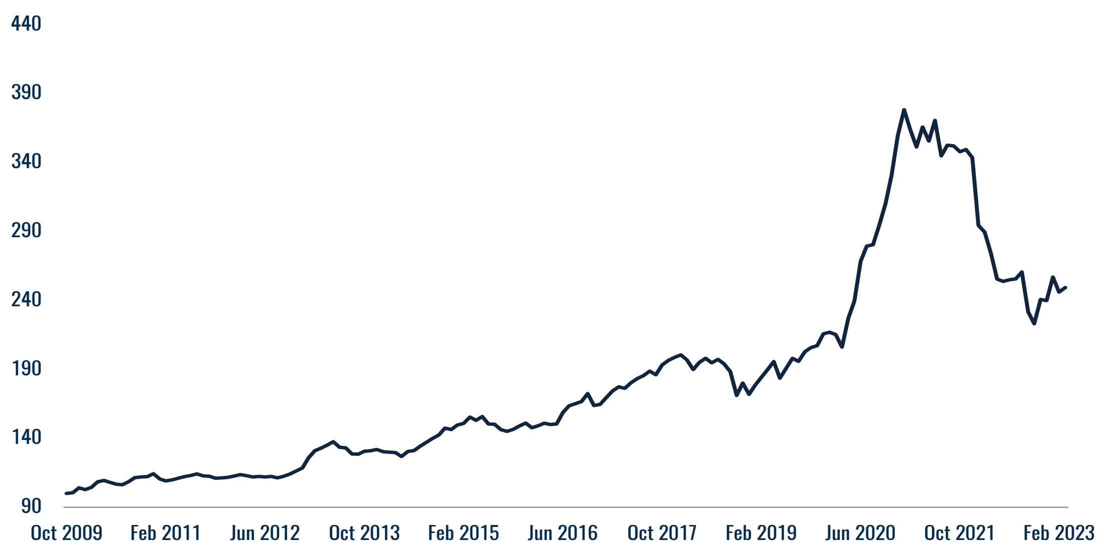
Allocation by Sector

Information Technology	34%
Industrials	27%
Health Care	20%
Consumer Discretionary	9%
Communication Services	5%
Materials	1%
Cash	4%

Top/Bottom Quarterly Contributors (bps)



Performance Since Inception



Performance is based on a Net Asset Value (NAV) price basis with income reinvested, net of fees. Past performance is not a guid to future performance.

Performance

Year Ended	Mar 2023	Mar 2022	Mar 2021	Mar 2020	Mar 2019
Net Performance	-9.2%	-21.9%	+70.4%	+8.9%	+0.1%

*Inception as a UCITS: 27 January 2017

Fund Codes

	ISIN:	SEDOL:	Bloomberg:
A Acc	GB00BDCJ9Z32	BDCJ9Z3	TMCPEAA LN
B Acc	GB00BDCJB138	BDCJB13	TMCPEBA LN

Key Fund Information

NAV/Share Class (Acc)	£14.88
Fund Size (£mn)	71
Currency	GBP (Base)
Authorised Corporate Director	Thesis Unit Trust Management (Authorised and regulated by FCA) Exchange Building St John's Street, Chichester, West Sussex PO9 1UP
Fund Custodian	The Northern Trust Company
Auditor	Pricewaterhouse Coopers LLP
Fund Legal Structure	UK OEIC (UCITS)
Inception Date - Fund	January 2017
Fund Saving Structures	SIPPs, ISAs & JISAs
Key Fund Documents	cernocapital.com/cerno-pacific
Ongoing Charges - Class A (incl. Management Fee)	Management Fee 1.00% Other Fees (incl. running costs) 0.24% OCF 1.24%
Ongoing Charges - Class B (incl. Management Fee)	Management Fee 0.75% Other Fees (incl. running costs) 0.24% OCF 0.99%
Transaction Costs	Explicit Costs 0.06% Implicit Costs 0.10%*
Initial Charge	5% - waived as standard
Contact	Tom Milnes 020 7036 4126 tom@cernocapital.com

*We have only started calculating this data from 1st July 2021, and as such this is an estimate based on the available data so far

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