

# Investor Letter

1 February 2024

Dear fellow investors,

For the twelve months ended 31 December 2023 (CY23), **VGI Partners Global Investments Limited** (ASX:VG1) generated a net portfolio return of **+19.8%**<sup>1</sup>. VG1's total shareholder return for CY23 was **+29.2%**<sup>1</sup> inclusive of price appreciation and dividends.

VG1 seeks to provide investors with access to a concentrated portfolio of under-appreciated, high-quality businesses, with the ambition to grow our capital at 10-15% per annum over the longer term. We are pleased with the CY23 results within this context and remain optimistic that a number of initiatives in place will enhance shareholder returns in future periods. The board of directors of VG1 (the VG1 Board) recently approved a new large-scale on-market share buy-back program for VG1 of up to 25% of the shares on issue over the next 12 months, while the dividend policy is to target a dividend of at least 5 cents per share on a six-monthly basis. Both initiatives are intended to address the current VG1 discount to net tangible assets (NTA).

The long portfolio contributed +30.3% to overall portfolio return in CY23, whilst our shorts detracted 10.6% from returns. Global equity indices rebounded throughout 2023, with the MSCI World Index returning +23.8% to 31 December 2023 and the S&P 500 returning +26.3% over the same period. Whilst equity market indices are approaching valuation levels in aggregate that are beginning to appear stretched, this has largely been driven by excessive outperformance from larger-cap technology companies, and we are continuing to find a number of situations across a variety of sectors and markets where there remain attractive opportunities in which to deploy our capital. Some of the more attractive risk-adjusted returns are presenting themselves in a number of sectors where we have been able to leverage the wider Regal Partners sector expertise to supplement the traditional VGI Partners circles of competence. Investors will see examples of this through our Energy and Metals & Mining exposures.

Importantly, the investment philosophy and approach of the strategy remains unchanged: while the concept of investing in 'quality' businesses has evolved in recent years to encompass an increasingly broad church, our preferred approach is to focus on businesses that we perceive as 'camouflaged' high-quality businesses: those which are initially ignored, under-appreciated or disdained by the broader market consensus, and which can therefore provide more attractive opportunities from a valuation perspective than more traditional (or 'overtly') higher-quality names.

However, bouts of market volatility do at times provide us the opportunity to revisit some more overtly or already well-appreciated names, particularly as expectations for future growth have been significantly revised in the face of a new rates environment and we took advantage of this in CY23.

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<sup>1</sup> Past performance is not a reliable indicator of future performance.

The portfolio has seen some evolution over the previous 12 months, and we are pleased that a number of new positions have contributed positively to returns over the period. Additionally, some existing holdings have been reduced as share prices approach our assessment of fair value, while the short portfolio has also undertaken some repositioning.

## Performance Summary

We have been pleased with the performance of the portfolio in CY23 and feel it continues to remain well-positioned for future positive risk-adjusted returns. The market has provided us with an important lesson in the value of patience, with a number of key positive contributors for CY23 coming from positions that had been performance detractors throughout CY22. We regularly go through a process of re-underwriting our investment theses on underperforming positions. We have been pleased that investors have been able to benefit from this through the recovery in share prices in the positions in which we retained our conviction. Some of the largest contributors to performance through the period have included eCommerce tech behemoth Amazon, audio streaming subscription service Spotify, exchange operator CME and defence technology company Rheinmetall (ETR:RHM).

While we had some successes with single-stock shorts, the greatest detractor to VG1's returns have been more thematic-based basket shorts, in particular within the semiconductors space. Having seen our thesis be disproved, we covered some of these short positions in the middle of the year. Pleasingly, our portfolio actions in the 2H in regard to shorts saw the drag on the portfolio decline from -7.8% in 1H23 to -2.3% in the 2H of CY23.

Shorting remains an important tool in protecting investors' capital from downside movements in markets. Our proprietary screens, which focus on identifying accounting red flags, have also displayed greater efficacy over the year, identifying a number of situations where weak cash conversion or evidence of poor capital allocation have provided opportunities on the short side. With markets back at higher levels, we continue to see this proprietary tool as a key to unearthing short opportunities.

Finally, in terms of foreign exchange (FX), VG1 remains fully hedged to Australian Dollars (AUD). As we take an active view on the currency, we may move back to an unhedged or partially hedged position, but only when we believe there is clear mispricing based on our fundamental analysis. Currently, we remain positive on the AUD because of the favourable position Australia finds itself in: endowed with plenty of commodities at a time when demand for these is growing rapidly given the global undersupply and underinvestment in commodity production in recent years.

## Portfolio Thoughts & Positioning

VGI Partners seeks to build a concentrated portfolio for VG1 of under-appreciated, high-quality businesses that operate within (or that we believe will soon operate within) attractive industry structures. These positions are offset by short positions in companies perceived to be encountering structural or cyclical headwinds, business model weakness and/or accounting irregularities.

The following table provides a snapshot of the top 10 long holdings in VG1's portfolio as at 31 December 2023 and represents a collection of what we believe to be attractively-priced global businesses with significant potential to meaningfully grow their earnings over many years ahead.

Top 10 Long Investments as at 31 December 2023	% of Portfolio
Amazon.com Inc.	8%
Teck Resources Ltd	6%
CME Group Inc.	6%
Shell PLC	5%
Kenvue Inc.	5%
GE HealthCare Technologies Inc.	5%
Rheinmetall AG	5%
Meta Platforms Inc.	5%
The Walt Disney Co.	5%
Not Disclosed (Active Position)	4%

Source: VGI Partners analysis.

Over the last twelve months, we have made some changes to long-held investments as we have seen more attractive risk-adjusted opportunities arise. As at 31 December 2023, we see in the long portfolio, conservatively, about 25% potential upside to our estimate of fair value for the underlying stocks.

Below we provide a brief update on some of our key contributors to performance in CY23.

### Amazon (~8% weighting as at 31 Dec 2023)

Amazon has been a core holding for an extended period and we continue to see upside in Amazon. We are pleased with the recovery in the Amazon share price throughout CY23, with a share price return of ~80%. As the shares have materially appreciated, we have trimmed our position. Our long-term thesis for Amazon remains the same: the company continues to create exceptional customer experiences by leveraging its scale economics across a number of business lines, with a long runway for continued investment at high rates of return.

There have been times throughout the corporate history of Amazon where, in our view, the company's long-term investment horizon and capital allocation have masked the strong returns Amazon generates and we believe that we have been living through one of those periods recently. The Covid-19 period and accompanying pull-forward in eCommerce activity prompted a major capacity investment across the industry. Like many other tech companies, Amazon invested ahead of this curve and is now optimising its cost base for today's environment, whilst growing into the additional capacity deployed.

We believe that this is clearly evident in two important key performance indicators (KPIs) at the company – Free Cash Flow (FCF) generation and Operating Margins. FCF improved considerably at Amazon in CY23. Capex commitments within the North American retail division have declined considerably as they grow into additional capacity, whilst the company has continued to invest in its cloud computing infrastructure division, Amazon Web Services (AWS). As a result, capex spend as a percentage of Operating Cash Flow has declined from over 100% in each of the last two years to an estimated 60% in CY23. We expect further improvements in FCF going forward.

Part of the FCF improvement comes from the inflexion in margins within the retail division after a number of loss-making periods. Management is committed to restoring the margins to pre-Covid-19 levels and, given the strong growth in high margin areas such as Advertising, we believe in time they could surpass the prior peak. The North American retail business considerably increased margins throughout 2023, improving from a loss-making position in Q3 2022 to a 5% profit margin in Q3 of 2023. On a trailing 12-month basis as seen below, margins have noticeably inflected.

**Amazon - North America Trailing 12 Months Operating Margin (%)**

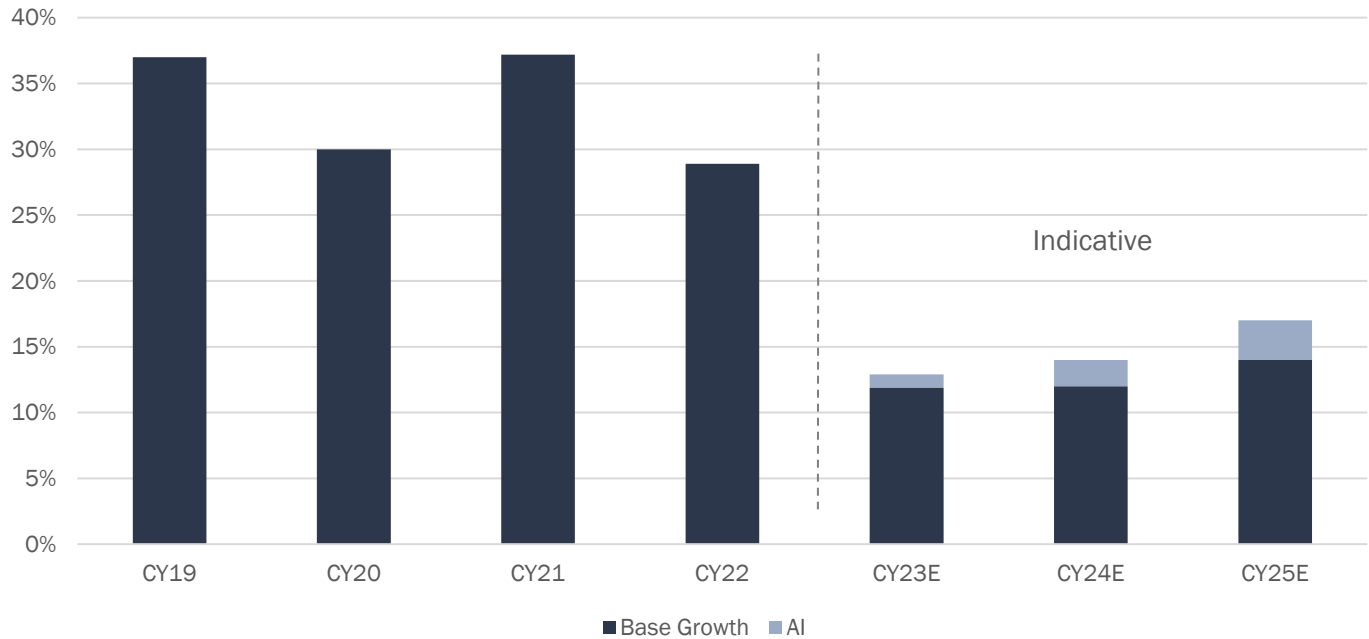


Source: Company data.

The opportunity set for Amazon’s largest profit generator, AWS, remains attractive and has been enhanced by a number of investments Amazon has made over the last decade in artificial intelligence (AI), including chip company Annapurna, which now forms the backbone of the efforts to innovate the silicon and software available to AWS customers in the AI space. Similarly, the recent investment in Anthropic, a developer of fundamental Large Language Models (LLMs), provides a material foothold in this layer of the AI technology stack.

Customer optimisations across the cloud complex saw growth rates in AWS decline in CY23, however we see this stabilising and believe that exposure to the infrastructure requirements of AI applications and continued investment in LLMs will see AI contributing strongly to AWS growth going forward. We believe that Amazon’s position within the AI complex remains under-appreciated and see it as a source of upside in the coming years, along with upside in the long-term margin profile of the AWS business.

Amazon – Amazon Web Services Growth Rates (%)



Source: Company data, VGI Partners estimates.

**Spotify**

Spotify was one of the largest contributors to returns in 2023, with the stock rallying +138%. During 2023, sentiment around the future prospects for Spotify swung from one extreme to the other. At the start of the year, Spotify was viewed as having a business model problem with no clear path to generating sustainable free cash flow and as being competitively challenged against big tech (Amazon, Apple, Google). Throughout the year, Spotify proved many of these concerns wrong.

Management continued to execute strongly across most KPIs, in particular surprising to the upside on user growth as Spotify recorded its largest annual increase in the number of users on its platform. It did so while fighting back concerns around new competitors (particularly TikTok) and concerns that higher subscription prices would lead to elevated churn.

On the latter point, in the first month of this year, we have started to see competition becoming more rational and all players in the music streaming ecosystem raising subscription prices, which is a healthy sign of a rational and consolidating industry. While only one third of the incremental revenues from price increases will accrue to Spotify (with the rest going to the music labels), it has given Spotify more flexibility in negotiations with music labels that we expect will result in greater long-term benefits. We expect this round of price increases to be only the first in music streaming in the years to come.

At the same time, Spotify’s advertising business has continued to deliver solid results, still posting healthy double-digit revenue growth, despite the more difficult backdrop for digital advertising.

Importantly, management also started to address its bloated cost structure and in December took strong action to right-size the cost base by cutting 17% of headcount. This has led to material profit upgrades, putting Spotify on its way to generate >\$1bn in operating profit by 2025 and helping to dispel one of Spotify’s common criticisms – that the business will struggle to generate meaningful positive earnings and free cash flow. Part of our original thesis was that Spotify’s earnings power was being masked by ongoing reinvestment and that the market was under-appreciating the underlying economics, so we are pleased that the market has started to recognise this.

We continue to hold a position in Spotify but have trimmed due to strong performance, as market expectations are now very different to 12 months ago.

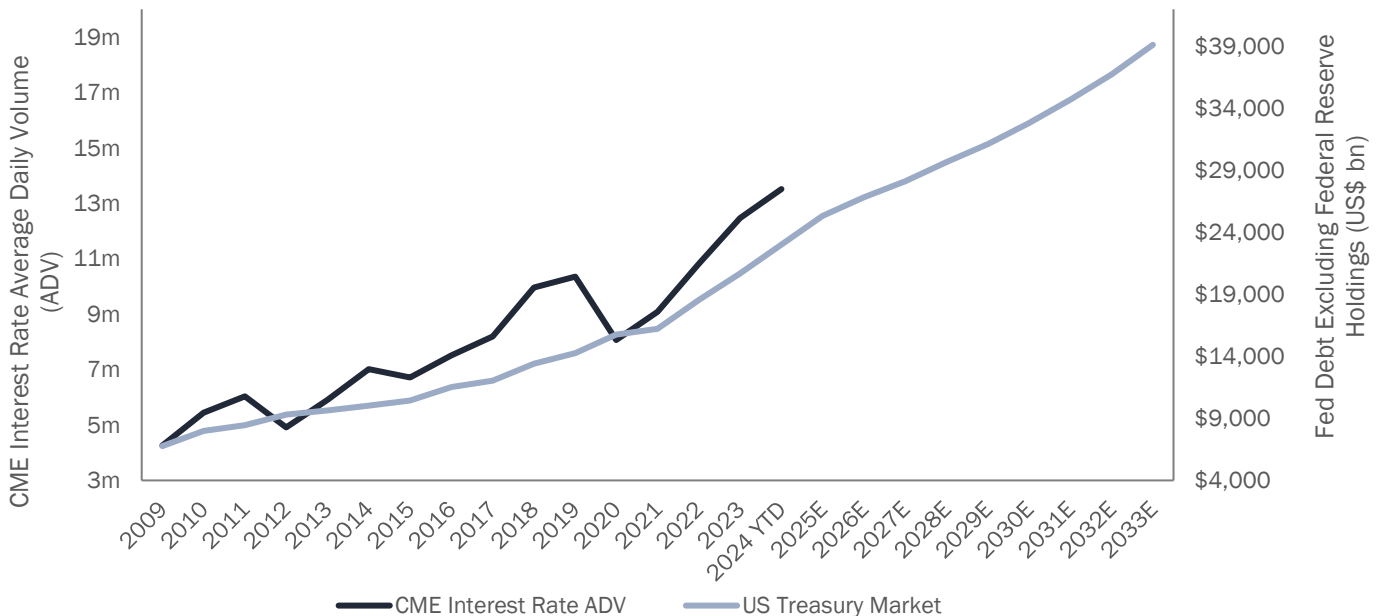
**CME (~6% weighting as at 31 Dec 2023)**

CME was again a strong contributor to fund performance, delivering a total return of just over 25% in CY23. As a reminder, CME operates the largest exchange for the trading of futures and derivative instruments, where market participants can trade interest rates futures, equity futures and derivatives of other asset classes such as foreign exchange (FX) and energy. The key driver for the business is its interest rate derivatives complex where CME has an effective monopoly in the trading of US interest rate futures.

Newsflow on the business has picked up over the last few weeks, principally regarding two separate aspects that we have been monitoring.

Firstly, debate has heightened around the timing of slowing Quantitative Tightening (QT) and the outlook for interest rate cuts vs interest rate rises (a Feb “pivot”). Fed President Logan of the Dallas Fed recently telegraphed that the Federal Reserve may need to slow the pace of balance sheet reduction (primarily Treasuries).<sup>2</sup> While these comments have been met with disagreement from some other state Federal Reserve Bank Presidents,<sup>3</sup> we are relatively agnostic to the speed of QT and believe that, as they have historically, volumes traded on the exchange will continue to be a function of the amount of US Treasuries held in public hands, both of which we (and the US Budget Office) expect to grow strongly over the long term. (Refer to the following graph to see the Congressional Budget Office projection for the US Treasury market.) In addition, prior Fed pivots have resulted in heightened volatility/disruption to the Treasury market that have provided short-term tailwinds for CME. We remain comfortable with the structural backdrop in which CME operates.

**Size of the US Federal Debt Held by the Public vs Average Daily Volume of CME Interest Rate Contracts**



Source: CME Group, Congressional Budget Office.

<sup>2</sup> Panel at annual meetings of the International Banking, Economics and Finance Association and the American Economic Association on 6 January 2024.

<sup>3</sup> For example, John Williams, President and CEO of Federal Reserve Bank of New York, at Bronx EDC and BICNY’s 2024 Regional Economic Outlook, White Plains, New York on 10 January 2024.

Secondly, concerns around competition have grown with a new entrant into the industry offering the same interest rate derivative products as CME. Whilst we are not dismissive of the potential threat, this is not the first time CME's dominance has been challenged (the prior attempt also by a Howard Lutnik-led group no less) and we believe that CME's position is now stronger than ever. Since the last attempt to break the company's dominant position, CME's leading market liquidity and established client base have grown significantly, and the exchange has introduced cross-margining capabilities to greatly improve efficiency for traders. These changes, alongside ownership of the underlying clearing house to which the trades are settled (which the competition does not have) means that CME offers what we believe to be the superior entrenched platform for trading, and we are confident in the quality of the business and continued favourability of the industry structure going forward.

CME operates in a number of other futures product areas that are likely to see growth as market conditions normalise, including equity and energy. Incremental futures contracts generate an extremely high drop-through rate to cash earnings and provide the company an ability to grow its dividend and increase shareholder returns. We view current conditions as favourable for CME and we see upside risk to consensus expectations.

### **Rheinmetall (~5% weighting as at 31 Dec 2023)**

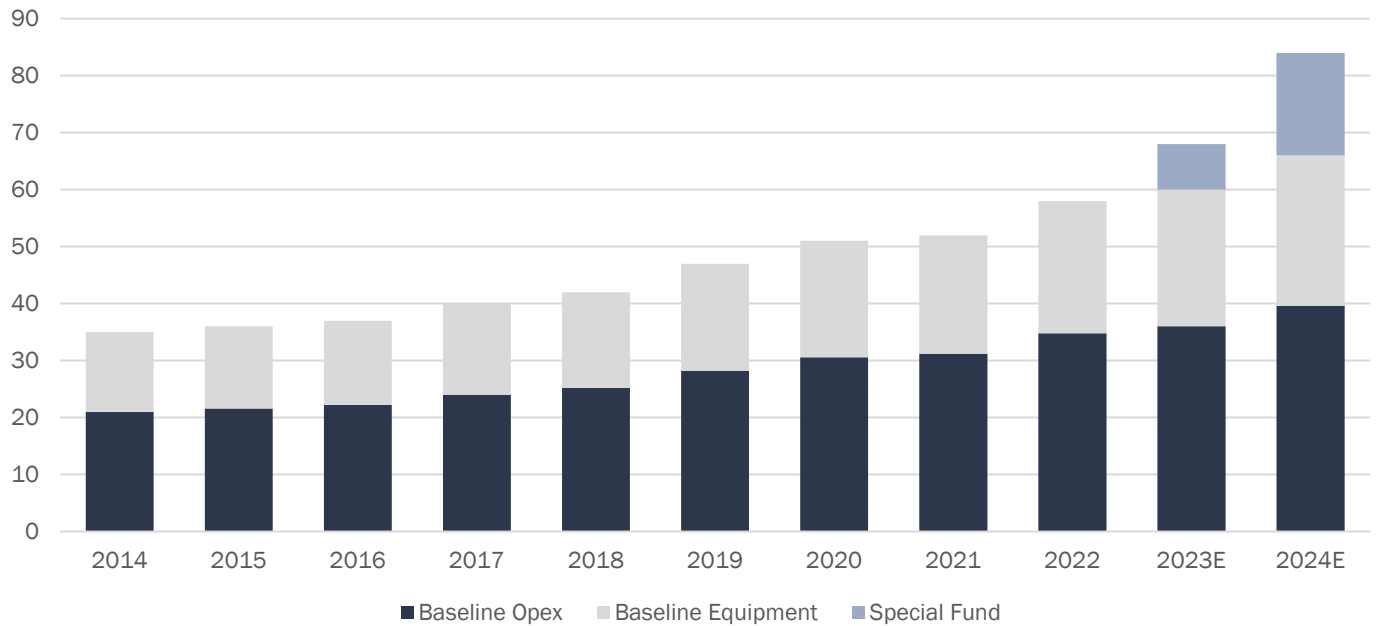
RHM's 2023 results were pleasing, particularly the significant increase in backlog orders from €26.6bn at FY22 to ~€40bn at FY23, positioning the company for sustained earnings growth over the coming years. As future earnings visibility increased, investors have realised, like we had, that Rheinmetall is a mispriced compounder with an attractive industry structure; the stock rose over 50% in CY23. We still see upside to the stock and recent meetings with management have strengthened our view about the attractive investment opportunities available to the company in the coming years. We have trimmed our position slightly as the stock has traded closer to our assessment of fair value.

With unfortunate conflicts breaking out on several continents, coupled with increased regional tensions, governments have carried out major assessments of their military capabilities and this has created a renewed willingness to invest in defence capabilities and deterrents. We expect Rheinmetall will be a key beneficiary of the increase in German and other NATO defence budgets over the next several years.

In particular, NATO signatories are likely to significantly increase spend, including contributions from new members in the Nordics. NATO expenditures stagnated between 2014-2018 (with growth of just 0.3% in USD), but subsequently grew 23% to FY22. This has been driven by major spending commitments from member countries – for example, both Spain and Italy have committed to increasing defence spending from 1.4% of GDP to 2.0% by 2030.

In Rheinmetall's 'home' market of Germany, the government has committed to a defence spending goal of 2% of GDP by establishing a €100bn special fund to accelerate equipment procurement over the next four years. This is a substantial commitment from a baseline defence budget of just under €60bn. Given the budget allocations to equipment versus opex, this increased spending commitment represents a ~100% increase in the investment budget over time – areas where Rheinmetall is a key supplier.

**German Defence Budget (€Bn)**



Source: German Federal Budget, IFO Institute.

Rheinmetall and other companies in the sector are answering the call from governments to increase capacity and have accelerated capital investments. We were able to meet with management in September of last year, at which time CEO Armin Papperger described the positive change in government attitudes to procurement, which has been reflected through long-term procurement contracts. Given this, we believe that Rheinmetall can confidently make investments with attractive payback periods of less than four years.

**Meta (~5% weighting as at 31 Dec 2023)**

Similar to our commentary regarding Spotify above, Meta has gone through a powerful turnaround over the last 18 months, with sentiment moving from completely unloved and an assumption that the business was in terminal decline to an even more dominant position in digital advertising with accelerating revenue and earnings growth.

The turnaround in revenue growth has been helped by the broader digital advertising market remaining healthy this year, but also by investments the company has made to improve content recommendations, and in turn monetisation, particularly its ‘Reels’ (short-form videos). Meta has responded to competitors like TikTok by demonstrating yet again the stickiness of its user base, which is only the latest example of how Meta can copy and even improve features as a “fast follower”.

Meta has also finally started monetising its Messenger and Whatsapp applications through click-to-message advertising, particularly in emerging markets, which has also allowed the company to increase market share of advertising budgets.

Meta has also cut costs aggressively and has let go of nearly 20% of its employees in 18 months, which has helped drive significant operating leverage at the same time as the business has seen a revenue growth inflection that the market underestimated.



Meta has been able to achieve a lot of this success because of its investments in AI, which they have been doing since well before AI became a buzzword. Meta has been investing in its cloud infrastructure and recommendation engines for many years, which have all been very important in improving engagement and growing Meta's user base.

Despite the share price rally, we think valuation remains appealing with the stock trading on ~21x P/E, making it the cheapest of the Magnificent 7. When we look at the true earnings power of the business – and avoid capitalising the losses from the Metaverse investments – the valuation is even more appealing, with the stock trading on a P/E in the high-teens despite a mid-teens revenue growth profile.

## **In Closing**

We have been pleased with the performance delivered by VG1 in CY23. Our portfolio changes throughout the year have left us with a high quality, well diversified portfolio. We remain very optimistic about the current shape of the portfolio and opportunities for the strategy and look forward to continuing to keep investors updated with our progress. We have been very pleased with the continued benefits accruing from the merger of the VGI Partners business with Regal Funds Management and believe this was demonstrated to our investors via improved returns in CY23.

We have always viewed the opportunity to manage our investors' capital as a privilege, and we thank investors for their continued support and encouragement.

Yours faithfully,

**VGI Partners**

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