Acoro Global Ltd. – Semi-annual Portfolio Insight – September 2020

Dear Investors, Dear Friends

We are happy to share two additional investment cases, AMS and Hexagon, in our semi-annual portfolio letter, providing insights into the selection of these two holdings.

AMS (AMS SW) – Long position

We started to aggressively invest in AMS in the second quarter 2020 below CHF 14 per share, while having followed the company for many years previously. Our AMS investment position has grown through performance and further share purchases to a core holding of Acoro Global at around 7% of the fund's Assets under Management. AMS is a typical case of our fundamental bottom-up investment approach in the IT space where we follow companies that have superior products and a proven business model. Nowadays, these companies are often priced for perfection and we are therefore timing entry points based on stock price corrections driven by execution missteps or sentiment shifts as well illustrated in AMS' case.

Short history

AMS is a leading Swiss-listed analog semiconductor company headquartered in Austria (Unterpremstätten), with more than 9'000 employees and achieving roughly USD 2bn of annual sales. The company was founded in 1981 under the name American Micro Systems Incorporated-Austria GmbH as a joint venture of Voestalpine and American Micro Systems (AMI) driven by Austrian economy policy to build its own semiconductor industry. The company listed as austriamicrosystems (AMS) at the Swiss Stock Exchange in 2004 after years of strong growth as a European foundry business. A key shift to AMS' business happened through the acquisition of the US company TAOS (Texas Advanced Optoelectronics Solution) in 2011 that brought the company unique assets in the field of light sensor technology. AMS is a leading supplier for optical semiconductors in the smartphone, automotive and medical industry. Apple is by far the largest client accounting for more than 60% of AMS' revenues in 2019 due to optical technology used in its FaceID solution and ambient light sensors built into the display of the iPhone, iPad, AppleWatch and AirPods. The largest acquisition by AMS was announced in 2019 with the takeover of the nearly twice as large German LED-company OSRAM for roughly EUR 4.6bn. Timing could not have been worse as the subsequent capital increase of the size of EUR 1.65bn took place in the midst of the Corona crisis in March 2020. The offering price was at EUR 9.2, roughly four times lower than at the announcement of the deal in late 2019 and some subscription options were not even executed despite the massive dilution. As we have followed AMS for many years, these massive swings in the stock sentiment were not new to us and we decided to take a closer look at the company.

Investment case

Key driver for AMS' strong underperformance into the capital increase was the general investor fear of high indebtedness in combination with volatile end markets such as consumer hardware and automotive. However, our experience has been that the market regularly underestimates the cash flow printing capabilities of semiconductor companies and especially AMS which runs a business model based on both a capital-intensive inhouse manufacturing model (high operating leverage) and a fabless model (minimal capital investments). Therefore, we felt very relaxed about AMS' core business as there were no indications that Apple would replace AMS core components (i.e. FaceID in the iPhone 12). What kept us on the sideline in March was the OSRAM deal where we lacked confidence into the cash flow preservation capability of its business model. Our extensive research into OSRAM indicated though that the LED lamp business is rather less cyclical than usual automotive suppliers, allowing for higher variability of costs and operational leverage. In combination with intensified cost cutting measures it seemed that the company could very well manage its cash drain in this downturn. Additionally, OSRAM has many potential quick wins at hand, such as the sale of the Digital Business, the closing of the loss-making joint-venture with Continental and the divestment of the stable high-margin legacy light bulbs business. On the back of OSRAM's sales having shrunk by 20% in two years (despite strong content gains of LED in new cars), we got the impression that sales were tracking below replacement levels.

We expect AMS to continue to see decent sales levels from the smartphone business (e.g. Apple) as we do not see any content change. Huawei's weakness should be offset by strength of other smartphones vendors. AMS is still well positioned to gain more content in new technologies such as under-display light sensors or sensors (i.e. VCSEL) for virtual reality in 2021. On the OSRAM side, we expect more content gains as the LED auto market is still growing and LIDAR solutions for autonomous driving might slowly get into the mass market.

In the long term, we see continued attractive growth opportunities for the optical sensor market. Optical sensors have many advantages over other sensors like 1) a broader spectrum of application fields such as light, temperature and even gas measurement, 2) high environmental robustness due to closed captions, 3) high accuracy, 4) relatively low cost of production. Even though the combination of AMS and OSRAM might not lead to immediate market-ready products, we see quite some potential in the mini-LED and later in the micro-LED market. The two companies could create a unique player that combines display know-how with integrated optical sensor technology know-how.

Risks

Main concerns about AMS are the loss of business with Apple that accounts for 60% of AMS standalone sales, but this should be shrinking to roughly 25% after the acquisition of OSRAM. Nevertheless, content loss at Apple might still be a potential threat that needs to be closely watched.

Conclusion

AMS trades at just 1.2x sales and 14x earnings 2021 and trades at basically 50% discount compared to its analog semiconductor peers such as Analog Devices, STMicroelectronics and Infineon. We think with the recovery of Automotive and a stable Apple business in 2021, the combined AMS entity could easily reach high-single digit sales growth and strongly growing margins due to cost measures at OSRAM and operational leverage in both businesses. Accordingly, we derive a fair value of the combined AMS entity that is above CHF 30.

Hexagon (HEXAB SS) – Long position

We started to invest in Hexagon in mid 2020 while having followed the company from the perspective of an industrial software and metrology company for several years.

Short history

Hexagon is a leading industrial software and hardware company listed and headquartered in Stockholm, Sweden. It employs 20'000 people and achieves approximately EUR 4bn of annual sales. The heart of what Hexagon does and has been built on is "measuring" and "visualizing" things which goes back to two bigger acquisitions such as Leica Geosystems in 2005 for approx. USD 1.2bn and Intergraph in 2010 for approx. USD 2.1bn. Hexagon has been an early mover to develop the concept of the digital twin by connecting the digital and physical world through software capabilities. The focus has been on a few domains or so called "digital reality verticals" such as positioning/autonomous control, reality capture/mapping and industrial design/simulation. Over the last decade, Hexagon has been transforming into an industrial software company with software sales accounting for more than 60% of sales.

Investment case

Hexagon is a leading provider of design, measurement, and visualization technologies along the product lifecycle in the above-mentioned domains geared to end markets such as surveying, construction, electronics and auto manufacturing as well as city traffic and security management. The company has successfully executed a decade-long growth strategy with a software-centric focus thereby growing the sticky software and services business to >60% of sales in 2020E compared to 15% in 2009. In the meantime, two thirds of this business is pure software business, not tied to hardware/devices. Given its software and digital product focus, Hexagon is a key beneficiary of megatrends such as 1) the accelerating digitalization and automation in manufacturing, 2) the reshoring of supply chains out of China, 3) the increasing penetration of software across industrial processes.

Hexagon has a strong growth and M&A track record with average sales growth of 9% (whereof 50% is driven by acquisitions) since 2010 and an operating profit growth rate of >15% while the profit margin has expanded to 25% in 2019 (15% in 2009). With swift structural cost actions overcompensating adverse cost and volume effects from Covid, contributions from new products picking up in 2H20 as well as the resumption of activity in construction markets (>30% of sales) and China especially (10-15% of sales), Hexagon is well on track to meet its strategic 2021 EBIT margin target of 27-28%, paving the way for new more ambitious targets ahead of expectations. Hexagon has a strong balance sheet and high free cash flow conversion (>90% of net income) is funding an aggressive M&A strategy as well as high R&D expenditures (10% of sales). The firepower is approx. EUR 3bn for a potential earnings per share contribution of >20%. The company's strategy is set to re-accelerate M&A activities post Covid while acquisitions should remain a source of technology enhancement, synergy opportunities as well as revenue and margin upside.

Given its superior earnings profile and rebound prospects as well as a rising 60%+ software/service mix relative to industrial quality stocks, Hexagon's valuation discount of 10-15% should turn into a premium (implying an earnings multiple of 30x), though not reaching pure (industrial) software peers at earnings multiples of 35-40x.

Risks

Hexagon's business profile contains a cyclical element given its 30% sales exposure to physical supply chains and volatile capex cycles in industries such as auto, aerospace and oil&gas. Moreover, the large influential stake held by the trust of former Chairman, Melker Schörling, with 27% of capital and 47% of votes, could be used to change the current strategy in the future. Though, recently two children of the former Chairman took a seat in the board.

Conclusion

Hexagon has been a successful equity story for more than ten years which, we believe, should continue. The company has all the ingredients of being a secular high quality company (superior growth and margin profile, strong execution track records with regards to cost and M&A management, beneficiary of accelerating digitalization of manufacturing) which, though, is not recognized by the market given a valuation discount of 10-15% relative to high-quality industrial stocks.

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Acoro Asset Management AG

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