

Fountainhead Partnerships

Mar 2023

Fountainhead Partnerships Fund
Quarterly Letter

Some 2008 banking jokes (reminders)

On the left side of the balance sheet, nothing is right—and on the right side, nothing is left!

Most people over a lifetime change their spouse more often than their bank.

Fountainhead Partnerships Fund (FHPF) was up ~8% (net of fees) in 1Q-2023 while S&P 500 and MSCI World were up ~7%. In the last 12 months, both S&P 500 and MSCI world are down ~8% while FHPF is up 2%, creating 10 % excess return vs the relevant benchmarks.

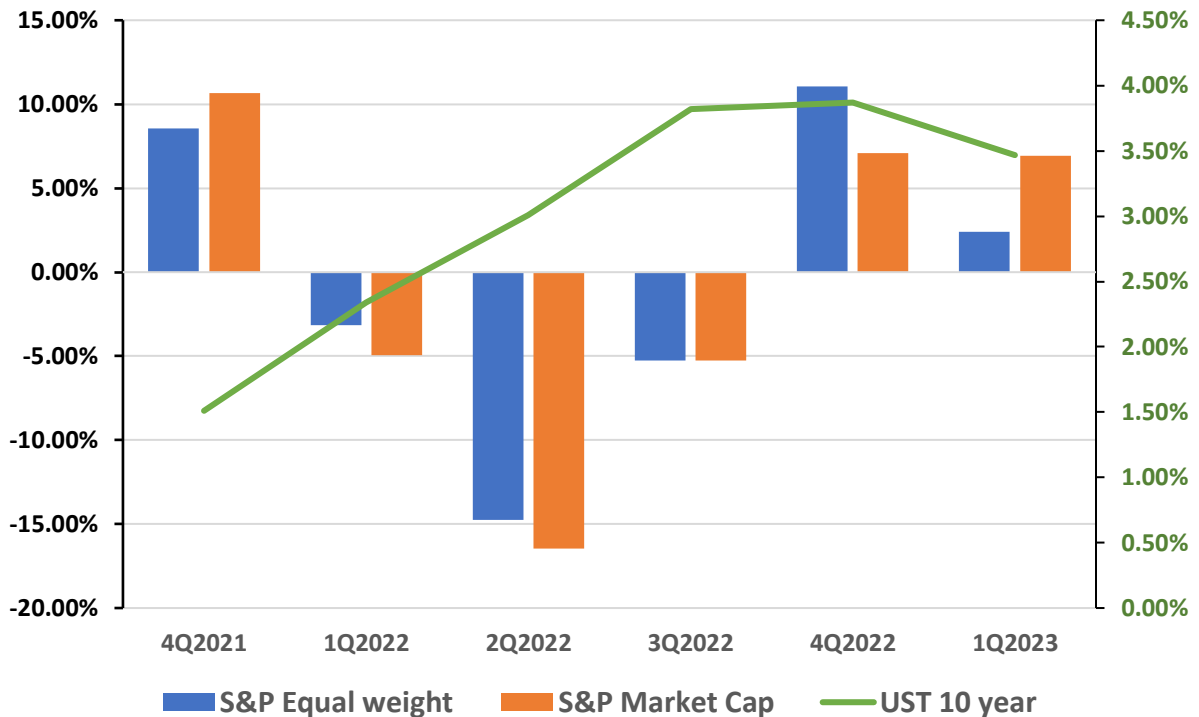
Portfolio Analysis:

Here is the Fund's comparative performance vs a few benchmarks:

	1Q-2023	Last 12 Months	Last 24 month
Fountainhead Partnerships Fund (FHPF)	8.1%	1.8%	12.2%
iShares Core S&P 500 ETF	7.5%	-7.8%	6.6%
iShares MSCI ACWI ETF	7.4%	-6.9%	-0.6%
iShares MSCI Emerging Markets ETF	4.1%	-10.3%	-22.0%
US 60/40 Balance	2.3%	-10.0%	-3.2%
Apple Inc	26.9%	-5.6%	35.0%
Microsoft Corporation	20.2%	-6.5%	22.3%
Amazon.com Inc	23.0%	-36.6%	-33.2%
Alphabet Inc Class C	17.2%	-25.5%	0.5%

2023 started off well for the equity markets and they stayed resilient despite the significant turmoil in the US banking sector in March. We hold no position in the US financial sector. The only bank we own is Intesa Sanpaolo (Italy) which was up 14% in the first quarter.

S&P 500 Market Cap Index vs Equal weight



The market returns in 1Q23 were led by the technology heavyweights. Top 20 stocks accounted for 90% of the first quarter’s 8% return of S&P 500. Excluding these mega cap growth stocks, the other 480 components of the S&P 500 were up just 1.7%. The decline in the market interest rates due to a prospective recession was the main catalyst of this rally in long duration-high growth stocks.

A lot of clients have asked why the growth stocks rally so hard with any indication of a decline in interest rates. Here is our rationale: ***In an equity valuation model the impact of a falling discount factor, or denominator on asset values is exponential, while the impact of earnings on prices is linear. In other words, lower rates are far more important than earnings as far as equity valuation is concerned.***

Unlike the S&P 500, Fountainhead’s portfolio return was generated from high quality businesses that have a long-term consistent earnings profile and are trading at a reasonable valuation.

Best and worst performers Table:

	Absolute performance	EPS growth 23	P/E 23
Top 5 stocks			
Freni Brembo SpA	29.2%	4.4%	14.4x
Kering SA	26.2%	6.1%	19.3x
Microsoft Corporation	20.2%	5.8%	28.1x
Greggs PLC	18.2%	11.0%	21.1x
Novo Nordisk A/S	17.6%	27.8%	34.6x
Bottom 5 stocks			
Eurofins Scientific SE	-8.1%	20.0%	16.2x
Agilent Technologies Inc	-7.6%	2.0%	26.x
Danaher Corp	-5.0%	7.0%	24.x
SMS Co Ltd	-4.8%	15.3%	44.8x
Ryan Specialty Inc	-3.1%	5.2%	33.3x

New additions and exit from the portfolio:

During the quarter we added two new positions in the portfolio and exited one. We have also added a large position against the US regional banks:

Sonova (Market Cap USD 17bn)

Sonova based in Switzerland is a global leader in innovative hearing care solutions: from personal audio devices, wireless communication systems, hearing aids and cochlear implants. Sonova is the biggest company in hearing care market in the world with CHF 3.3bn revenue and CHF 650mn in profits and possesses close to 20% market share globally.

Our investment thesis is based on three main drivers:

- 1) Rising geriatric population- our core investment theme
- 2) The growing prevalence of hearing loss
- 3) Rising incidence of noise induced hearing losses, particularly in children.

Global Hearing care market is divided into two main categories; primarily based on the technology:

- 1) Hearing care products and services---- USD 18bn revenue; growing at 7% annually
- 2) Cochlear Implants ----- USD 2bn revenue; growing at 8-10% annually

A recent paper by Lancet highlights that hearing loss is the biggest impediment towards extending the working career in developed world. Over 5% of the world’s population – or 430 million people – require rehabilitation to address their disabling hearing loss. It is estimated that this number can double in next 20 years– or 1 in every 10 people – will have disabling hearing loss. The Lancet paper concludes that in the next ten years an additional USD 250bn can be invested to improve hearing care in the developed world.

	Hearing impaired ppl-mn	% of Population
Europe	55	7%
US	38	11%
China	25	2%
Japan	14	11%
South East Asia	109	16%

Market Share:

Sonova is either number 1 or number 2 in most hearing care markets. It has gained market shares in all segments including Cochlear implants primarily through acquisitions. Europe is the main battle ground in terms of competition. Three other major companies in hearing care are based in Denmark. In 2019 Singapore based Sivantos merged with Denmark based Widex.

Valuation: Sonova is trading at close to 25x PE and 5% FCF yield. The stock has come down 40% from its high of CHF 380/sh in 2021 to CHF 240/sh. The last leg down for the stock was in March during the Credit Suisse crisis when the Swiss market took a significant leg down. We considered it a good opportunity to buy a position in Sonova.

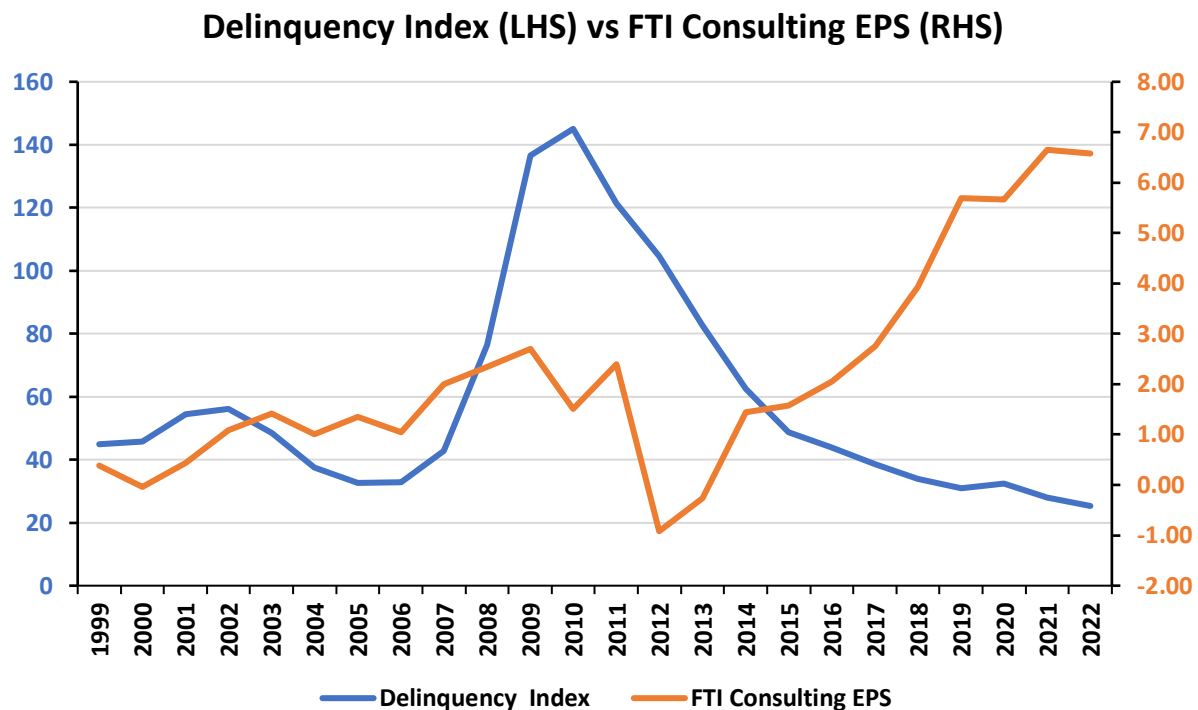
FTI Consulting (Market Cap USD 7bn)

FTI Consulting (FCN US EQUITY) is a global business advisory firm dedicated to helping organizations manage change, mitigate risk, and resolve disputes: financial, legal, operational, political & regulatory, reputational, and transactional.

A countercyclical business:

FTI’s Corporate Restructuring and Forensic Litigation Consulting is a potential beneficiary in an environment of US and Global Economies downturn / hard landing. The business has a very high operating leverage and is best described by its CEO ... as “The staircase nature business” (where) “the business never grows in a straight line.” “(it) is largely a fixed cost business in the short term and small variations in revenue may have an outsized impact on income.”

During 2006-09, FTI's EPS more than doubled and the stock traded at PER of > 25x. FTI also gives exposure to high growth Middle East Asia as it has been expanding its operations in the region.



Admittedly, stock prices have already moved up in anticipation of strong financial performance. Valuations are not cheap at 2023 PER/PFCF of 25/26x. These are based on Mgmt. 2023 guidance. We are of the opinion that growth momentum can surprise on the upside in the next two years with the expected pickup in restructuring. We assume 2023 EPS growth of 15% (as per mgmt. guidance range) and then increase to 31% in 2024 as business pickup supports margin expansion.

Autodesk

We have made the bullish case in the past for Autodesk. An effective monopoly, ADSK reached the important inflection point for us as a SaaS business where forecast free cashflow started to look appealing compared to the valuation.

However, our investment process regularly involves difficult decisions around pricing the acceptable valuation of very high-quality companies.

Unfortunately, two things came to pass that have led us to exit ADSK.

Firstly, the company is transitioning through a period where its customers pay for the service based on their contracts over time, as opposed to up-front in advance. While this has negligible

effect on the profitability - it will significantly reduce their free cash flow in the coming years - until the customer base cycles through.

Secondly, and this is a scenario we are acutely aware of particularly in the US markets, is the overuse (abuse) of share-based compensation. With ADSK transitioning into a highly cashflow generative business, we were hopeful they would reduce their significant use of share-based compensation. This has not occurred and over the last 12 months the company issued over \$600m in share-based comp vs a free cashflow of \$2,000mn.

The effect of this is to reduce the amount of cash available for the owners of the company. The company is using their free cash to buy back shares, accreting value to the shareholders. But the requirement to buy back the significant amount of shares being issued to employees means the effective amount of cash available for shareholders is 30% lower.

Adjusting for the share-based composition and the billing cycle change we reduced our valuation and will revisit at the lower price.

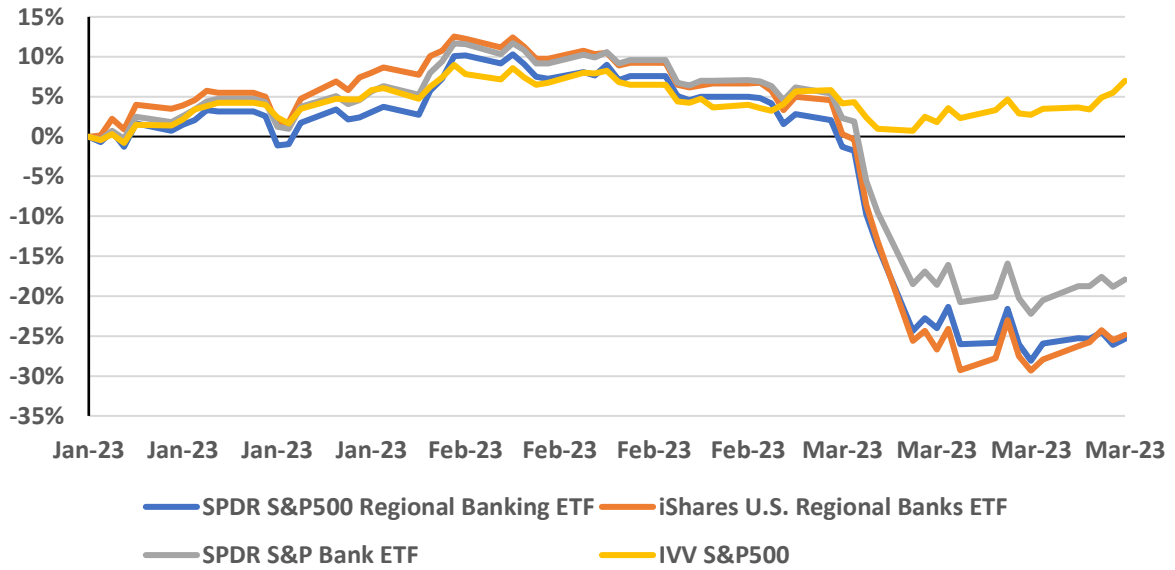
A word on US regional banking situation:

A banking crisis is a common phenomenon in a western capitalistic system based on credit. The current regional banking turmoil in the US is potentially the fourth major episode since the 1980s and each one was triggered by the rate hiking cycle from the central banks in developed world.

US Banking sector 1Q-2023

Banking sector share prices nosedived in March 2023, reversing their outperformance of Jan-Feb 2023 into a significant underperformance during Q1 2023. Large cap banks performed relatively better compared to the smaller (Regional) banks. SPDR S&P Bank ETF that includes larger banks was down 19% during the quarter while ETFs of Regional Banks declined 25+%.

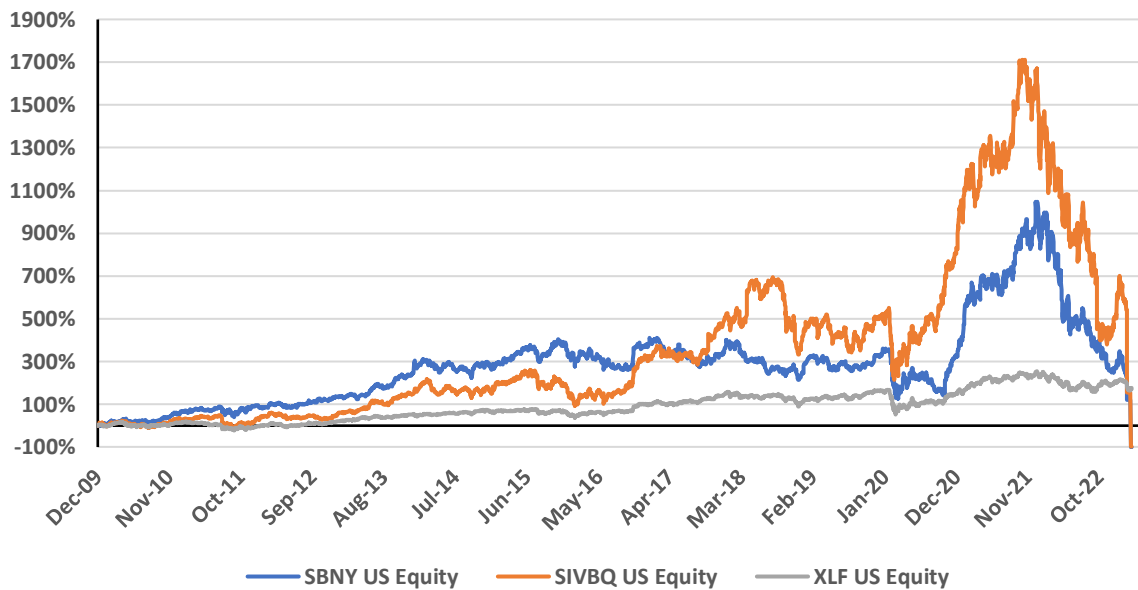
U.S. Bank ETF Shares Plunge Performance YTD through March 31,2023



Largest Banking collapse since GFC

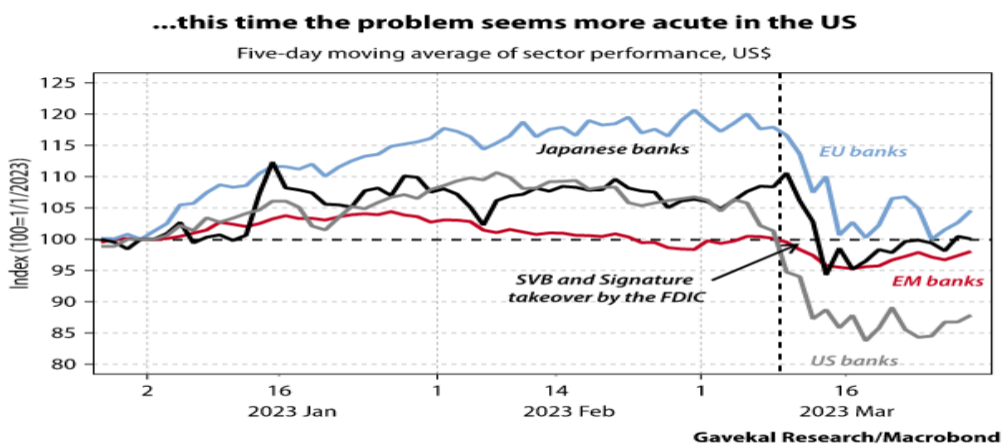
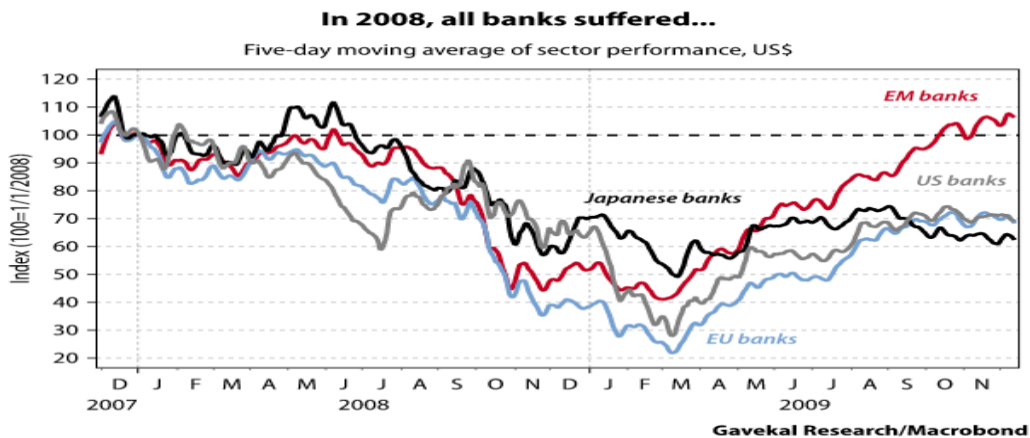
The share price plunge in March followed the collapse of 2 Regional banks, Silicon Valley Bank followed by Signature Bank. The collapse of Silicon Valley Bank was triggered by deposit run as investors became concerned about its asset quality (exposure to crypto and venture capital). This triggered similar deposit runs in some other Regional banks as deposits became concerned about unrealized losses in their investment portfolio funded by large proportion of uninsured deposits.

Chart SVB/Signature Vs US Bank Index



The situation seems different from 2008, and more US specific so far

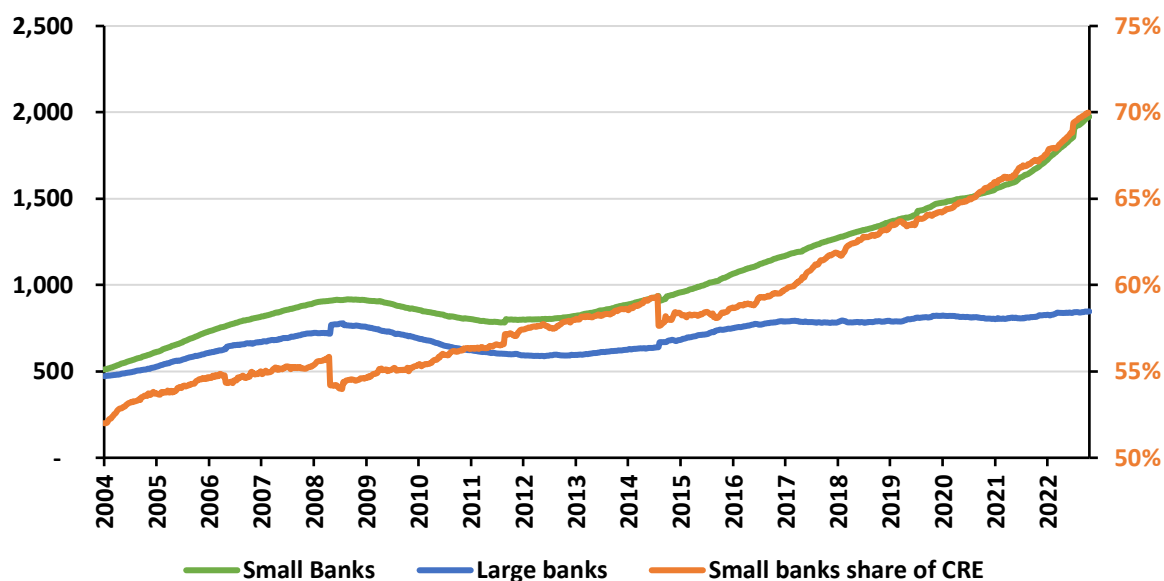
US regional banks have undeniably been taken to the woodshed, this time around, the problem still seems to be mostly a US affair. Banks in Japan, Europe and emerging markets are essentially flat for the year (Mar 31st), even as the broader US bank sector has shed -15%, and regional banks more than that.



Monetary Policy Reversal cycle

The current upheaval in the Regional banks is the consequence of a prolonged period of Quantitative Easing by US, low interest rates, relatively lax regulatory environment and sustained economic growth. During Covid 19, these already loose monetary and fiscal policies reached to their extreme.

CRE Loans - Small vs Large (LHS) & Share of Small Banks (RHS)



Since 2009, these supportive policies resulted in strong deposit growth at low-cost incentivizing banks to push for aggressive loan growth while operating on relatively thin capital particularly at the smaller banks. Low loan losses encouraged risk taking. Management have also taken duration risks to further boost margins. Real Estate has been the preferred sector to lend to by Regional Banks, especially Commercial Real Estate (CRE). These banks have increased their loans to CRE to 2.4x in 10 years (CAGR 9%) and is now 44% of their loan portfolio and 67% of banks loans to CRE.

The tightening of Monetary Policy via Quantitative Tightening and sharp increase in policy rate has reversed the cycle, resulting in,

- Cost of funds pressure due to Deposit contraction and a shift to higher yielding products
- Large unrealized losses on investments (estimated USD620bn in Dec 2022 or around 3% of total assets)
- Potential asset quality risk as borrowers will have to refinance loans at a higher rate in an environment of slower top line growth and tightening credit standards.

Regional Banks: Higher Risks

Regional Banks face bigger risk due to,

- High Loan to Deposit Ratio at 84%
- Large portion of cheap deposits including those above the insurance ceiling size of USD250,000 of US Federal Deposit Insurance Corporation (FDIC). The insured deposits

as of Sep 2022 for the entire banking system were c~USD10trn (55% of total deposits) in 4,755 institutions.

- Aggressive pricing of loans.
- Significantly large exposure to Commercial Real Estate (CRE) loans that most at default risk, especially those to Offices and Retail. E.

Market has so far penalized those banks that are, 1) more dependent on uninsured deposits, 2) carrying a larger mark to market losses relative to capital and 3) exposure to CRE loans. The Consensus view is that the current episode is more of an “adjustment” to higher rate environment rather than a broad asset quality issue like Global Financial Crisis (GFC) of 2008 when SPDR S&P Regional Banking ETF lost 2/3rd of its value. This though can become a significant asset quality crisis if the US economy suffers “Hard Landing,” of which Regional Banks will be both catalysts and victims.

Profitability Risks for Regional Banks is Very High

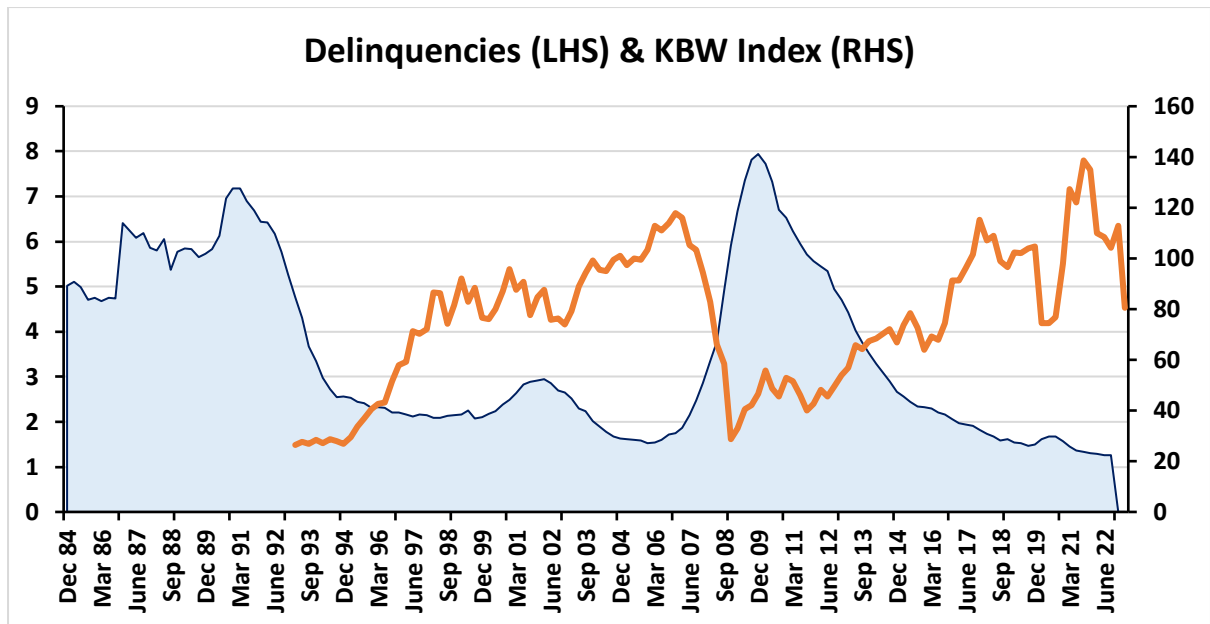
The operating environment will be more challenging in the future for the Regional Banks even without Hard Landing. Profitability will be impacted by slower deposit growth, narrower interest margins and higher normalized credit cost trajectory. Further downside can come if they are forced to sell investments at a loss and suffer sharp upturn in delinquencies. Potential Regulatory risks in terms of more restricted operations, higher Capital requirement etc. can further dilute their Return on Equity and lead to de-rating of valuation multiples.

In the last 4 recessions, delinquencies increase by,

- 250bps in early 1990s
- 87bps in early 2002
- 641bps in GFC of 2008-10
- 22bps in 2020

Share prices of all banks start correcting before the delinquencies hit their peak in each previous cycle. And rebound only after the cycle has started downward trend.

US Banks Delinquencies vs KBW NASDAQ Bank Index (Quarterly)



FHF Portfolio Strategy

Our fund had “zero” exposure to US Banks due to unattractive risk/return profile. We have been maintaining a position in Intesa Sanpaolo in Italy based on, 1) rising per capita income in Italy, 2) exposure to Central and East Europe, 3) a turnaround story with declining Non-Performing Loans and 4) attractive valuation with high dividend yield.

Since regional banks are right in the eye of the storm and given their weak profit outlook and elevated survival risk, we have also built a large position through options against the regional banks as a hedge to the portfolio.

Thank You.