Dear fellow shareholder,

As I wrote in my last letter the sudden increase in interest rates is starting to take its toll, in the first instance on banks. One of the largest banks in Europe, Credit Suisse, and three mid-sized American banks have failed and the cause in each case has been significant falls in the value of their bond portfolios. Most of our holdings are cash rich or have low leverage but no doubt we have not seen the last of the effects of both the interest rate rises and elevated inflation.

Aside from our relatively safe portfolio, we have good levels of cash and an appetite for well-valued securities. A few bargains are appearing, after a long period of high share prices, and I would like to tell you about a new purchase.

Stellantis

We spent some time on Exor, the Italian holding company for the Agnelli family. Exor itself is interesting but we have for now invested in its chief holding, Stellantis. (Hat tip to Jonathan Tanne for underlying its virtues in a recent case study.)

History

Stellantis makes cars and trucks. It is the result of a series of mergers between well-known automobile manufacturers, mainly Fiat (hence the involvement of the Agnellis), Chrysler and Peugeot. It is the second largest car maker in Europe (accounting for 20% of the market) and the fourth largest in the US (11%).

Operations

The company's strong CEO, Carlos Tavares, and his management team have lead the industry in collaborating with employees, such that merger rationalisations have both reduced costs and saved jobs. Stellantis has operations in 30 countries and works hard both to invest and take out cost. Its operating margin of 13% is industry leading as is its return on capital of over 50%. Half of its operating income is generated in North America, where larger cars, such as SUVs, are particularly profitable.

Finance

Stellantis has €24 bn net cash. Although it has a 50/50 joint venture with banks to finance receivables, with borrowings of €30 bn, this looks well covered by its own assets and does not appear to be guaranteed on either side. With rapidly moving inventories and receivables, it is easily able to finance itself with equity and trade creditors.

Drawbacks

We have only owned one car company in the past, BMW, bought in the Lehman crisis. Before doing so, I read through the history of the car industry, especially as reflected in the rise of the American majors. Two themes stood out: consolidation and technology. Because of the economies of scale inherent in large scale manufacturing, manufacturers have been merging into larger players for one hundred years. The largest companies have used these economies to keep retail prices down, establish dominant distributor networks and bargain with suppliers (who have always been weak). Stellantis has been a modern leader in this trend.

Even though I admired BMW's brand and marketing position I also had to concede that cars are primarily technology platforms that are susceptible to waves of progress, from energy consumption to consumer features. Indeed, BMW's brand is dependent on its engineering prowess. The latest technology waves are the move from combustion to electric engines, the increasing importance of software and the likely advent of autonomous driving. Although Tesla has drawn the headlines, it is actually a low spender compared to its rivals, and there is no way to know who will be the leaders of the future. Stellantis is certainly spending to remain relevant.

Another negative feature of the industry is its customer financing model. A car or truck is still a relatively major purchase and not many customers buy them for outright cash. Financing has therefore always been a requirement alongside the sale. It has also been the industry's Achilles heel. General Motors has assets of $264 bn and net tangible assets of $63 bn. Most of the big companies now actually look like banks with car companies attached. Stellantis is an exception (see *Finance*).

Finally, labour relations have been a bugbear for many decades. Depending on your point of view this was either because employers were large, profitable and lazy and made improper concessions to employees from the 1950s on, leaving them vulnerable to the more efficient Asian manufacturers who arose in the 1960s to 1980s; or employers were brutal to employees in the cost-cutting 1980s and after. In either case, the European and American car industries have suffered from industrial unrest and a very specific aftereffect of poor negotiation – long-term pension and healthcare liabilities that again dwarfed their balance sheets. The latter was a major cause of the wave of bankruptcies that brought down the largest manufacturers twenty years ago. Stellantis' labour relations have remained positive.

Valuation

Stellantis' market cap is €46bn. Net of cash that makes an enterprise value of €22bn, or about one times taxed operating income. There is also a specific asset, Maserati, which if spun off or sold is likely to be worth several billion euros on its own. (Stellantis owned Ferrari and spun it off in 2016.)

Stellantis is truly a multinational organisation, with profits earned mainly in dollars and euros, and throughout the world. We have bought it in both funds. Although it has only minor operations in the UK we think world class businesses should have a presence in our UK fund, especially as these days so few world class businesses, alas, are UK based.

Thank you for supporting Derby Street. We look forward to speaking to you all soon,

Richard Simmons
Portfolio Manager
Derby Street Investments

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