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VMCH Corporation - Annual Report

VMCH Corporation performance (in USD)

Year	Annual percentage change in Per-Share Book Value (NAV) of VMCH	in S&P500 with Dividends Included	in MSCI Europe with Dividends Included
2012	24.8%	16%	19.9%
2013	27.7%	32.4%	25.9%
2014	(2.7%)	13.6%	(5.6%)
2015	(1.4%)	1.3%	(2.3%)
2016	6.1%	11.9%	(0.4%)
2017	5.5%	21.8%	25.5%
2018	(8.9%)	(4.3%)	(14.8%)
2019	(12.4%)	33%	24.2%
2020	55.8%	18.4%	5.9%
2021	16.6%	28.7%	16.9%
2022	17.1%	(18.1%)	(14.5%)
2023	18.1%	26.3%	20.6%
Compounded annual gain	10.8%	14%	8.3%
Overall Gain	242%	382%	133%

"Only when the tide goes out do you discover who's been swimming naked."

Warren Buffett

Dear shareholders,

In 2023, NAV increased by 18.1% compared with an increase of 26.2% in the S&P 500, including dividends. MSCI Europe increased 20.6% including dividends during the same period.

For our portfolio it was a reasonably quiet year with one notable exception (see below). In general it is difficult to fault this year's absolute performance too much, and there are quite a few opportunities left in the market. We should normally underperform in a strong bull market, simply because we tend to avoid popular stocks and invest in temporarily underappreciated ones.

We had another good year writing out of the money PUT options as explained in our 2021 letter. We gained around 2.5% in net premiums. We expect to reasonably make at least an extra 1% per year.

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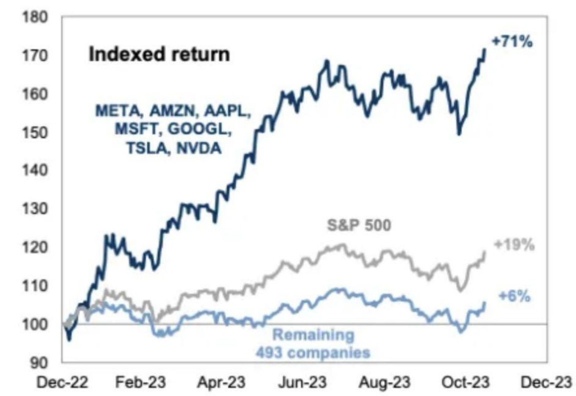
The main event of 2023 was an incredible recovery by large tech stocks:

Exhibit 22: Share of largest seven companies' market cap in S&P 500 is at an all-time high

Source: Compustat, Goldman Sachs Global Investment Research

Exhibit 23: The Magnificent 7 have led the index higher in 2023



Source: FactSet, Goldman Sachs Global Investment Research

The “Nifty Fifty'' era is back, with almost the entire stock universe trading at 12-15 PE and a small group of popular stocks at 40-50 PE. It can be seen on the left chart that these stocks have risen so much in price that they now comprise almost 30% of the entire S&P 500 index.

Usually it is of no great consequence as great businesses should receive premium valuations. However, in this case most of the price appreciation in recent years came not from an increase in profits but from a multiple expansion on these profits. For example, if a company doubles its profits you would expect the price to double. Maybe even triple or quadruple as the market gets more optimistic and values the company at 20 PE compared to 10 previously.

But surely a valuation of 40 or even 50 would be too rich for a very large company that should not be able to grow very fast for too long into the future. Hence I consider these valuations very precarious going forward into 2024.

While all of the above was going on we were invested in other companies. One of them was a special situation in Silicon Motion (SIMO), a Taiwanese company that holds an almost global monopoly on NAND flash controllers. All competitors have exited the market in recent years with the exception of a Samsung subsidiary, with Samsung also being a SIMO client.

The situation lends itself to very high profitability, with NAND usually being a growth market. In 2020-2022 the company capitalized on this trend, doubling revenues and operating profits. However, in

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2023 the industry entered a recession and results were down even compared with 2020. The business was trading at an amazingly low valuation for a quality business (around 7-8 PE on 2022 earnings).

In addition, the company was on track to be acquired for around 110$ per share by Maxlinear in 2023 while the SIMO stock was trading around 60$. Both sides approved the merger and the only hurdle remaining was approval by Chinese regulators. Given that the company had minimal China operations, and that the business was relatively small and strategically unimportant, I considered that there should not be any issues with regulatory approvals. Around 70% upside within a few months for minimal downside risk - sign me up.

We initially made it a 10% position in the stock, which later we converted to a 2% position using call options. Using options was more appropriate to minimize downside risk and tying up less capital while getting the same upside from the deal closing.

On 26th of July, 2023 8:30 ET the Chinese regulators gave their OK for the merger to proceed. The stock immediately went up to 96$, with only around 10% upside left until final closing.

As we do not deal in standard merger arbitrage where you wait several months for a 5-10% potential return, I immediately closed the position. We made around 267% on our investment, which added about 4.6% to our return for the year.

Later the same day, at 15:00 Maxlinear released a statement that they will not proceed with the merger. After some angry back and forth between the two companies, the merger was formally canceled and lawsuits are ongoing.

It appears that Maxlinear overpaid for SIMO in 2022 when the market was good, and later was hoping there will be issues with regulatory approvals in 2023 to save it the cost of backing from the merger (at least 160M$). The regulators approved, and so they had the choice of proceeding and risking bankruptcy or trying to get out.

Overall it was an interesting experience in risk management. There was a huge upside, but not a lot of downside if managed appropriately. The use of options in this case could lead to losses if I did not react appropriately, but it held less absolute downside risk and less long term betting on the business doing well. It also produced a much higher return of 267% compared with 60% for the stock.

We generally do not get involved in mergers and risk arbitrage. However, given the right situation it can end up being worth it such as in the above case.

Eduard Gorban