January 12, 2024

Parus Fund Letter – H2 2023

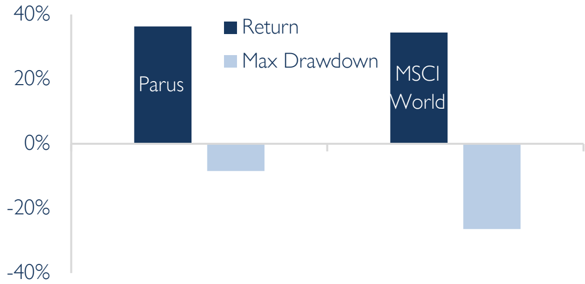
Dear Investors,

The net performance for H2 and the full year 2023 was -5.3% and -6.6% for the USD class, against +6.8% and +21.8% for the MSCI World Index and +2.5% and +3.1% for the HFR Index. The compounded net annual return since inception of the strategy in 2003 is +11.2%.

2023 was a frustrating year, as all of the PnL from the longs and more was reinvested into a short book that worked against us for most of the year. While our shorts created strong alpha between August and October, the prospect of lower Fed rates triggered a significant short squeeze in November-December, which led to the third risk reduction of the year mainly affecting our names in Real Estate.

The fund's outperformance vs global equities since 2020 has now narrowed. Returns are similar with the strategy showing a lower drawdown. As always, the investment process remains focused on the long term.

Parus vs MSCI World since January 2020



Source – Bloomberg, Parus net, MSCI World ex dividend

The price action of low-quality names in November and December reflected short covering across the board. Some of our cyclical shorts, of which the valuations anticipated further deterioration, are now pricing a healthy activity level in a benign refinancing environment. This is happening while the economy is slowing, US employment is slowly deteriorating, and consumer delinquencies are still rising at a very fast rate.

The asynchronous nature of the economy both in terms of geographies and sectors is striking. There is huge disparity of valuations and business fates within public companies. This should present a very favourable environment for stock picking.

With much frustration over a short book that has been far too costly this year and with all the introspection that goes with it, we continue to follow a process focused on growth and competitive advantage on the long side and balance sheet shorts on the short side.

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Looking backwards, like many, we were very surprised by the resilience of the US economy in a context of Fed rates raised by 5.25% in 18 months, and particularly by the low US unemployment rate despite all the layoffs of late 2022 and early 2023.

There have been many attempts to explain this outcome: the deferred impact of Covid stimulus, the change of demographic structure, a US fiscal deficit of 7% of GDP and the fixed rate nature of US mortgages? Regardless, apart from elevated and still fast-rising consumer credit card delinquencies, many cyclical metrics ended the year better than expected. The jury is still out as to the nature of the landing of the US economy; had we seen a traditional recessionary environment, many data points would have troughed by now.

We are still puzzled that after the biggest interest rate increase in 40 years and despite the 2021 equity market bubble, the MSCI World has only corrected by -27% peak-to-trough and the Russel 2000 only -33%; against -51% and -46% respectively during the 2002 bear market.

We are now entering 2024 with expensive markets (illustrated by the low equity risk premium), a soft and deteriorating economy and a better than expected yet slowing job market.

Equity Risk Premium of MSCI World

Source - Bloomberg, Spread between MSCI World earnings yield and 10 year treasury yield, 29th December 2023

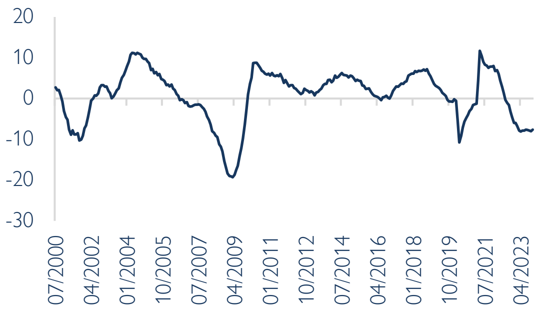
The scares of Covid and Ukraine related inflation are behind us, yet the fundamental drivers of higher rates for longer remain and the following data points are catching our attention:

Federal Reserve - Projected Median Fed Funds Rate

Source – Federal Reserve

Despite the market's recent rally with the prospects of lower Fed rates, the latest projected Fed Fund rates for December 2024 are still above the estimated levels at the beginning of 2023.

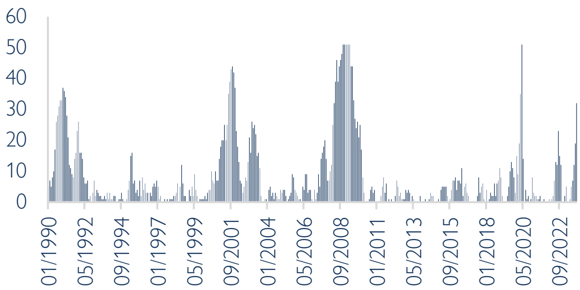
US Leading Indicator



Source – Conference Board, November 2023

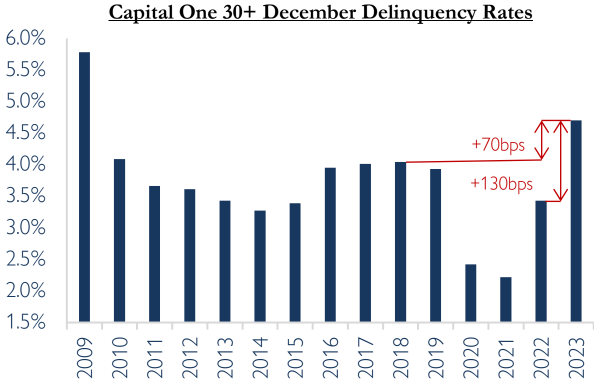
US leading indicators are still in negative territory…

Philadelphia Coincident Index
Number of states with Negative Monthly Change



Source – Philadelphia Federal Reserve, October 2023

…and the diffusion index, reflecting the number of US states in decline, is growing to a level normally indicative of recession.

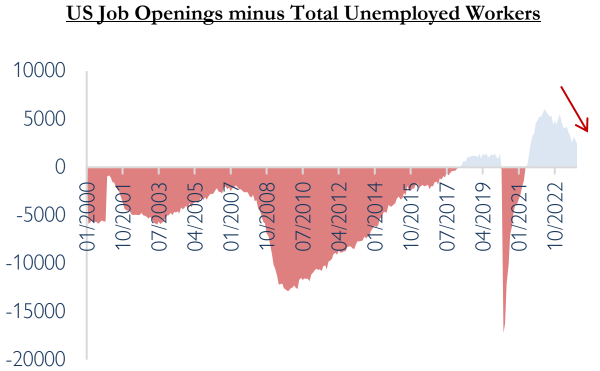


Source – Company, December data each year

Delinquencies are growing at their fastest pace (+130bps yoy) and their absolute level is 70bps above 2018 high and not far from the level of 2009, despite what is still a very strong labor market.

Consumer credit card delinquencies have often been useful to our investment process. They were a leading indicator recently in Q2 2020 proving a "real-time" proxy of the impact of government support packages. During that period, declining consumer delinquencies conveyed a contrasting narrative to the rapidly rising unemployment rates and the widespread belief in an immediate COVID-driven recession.

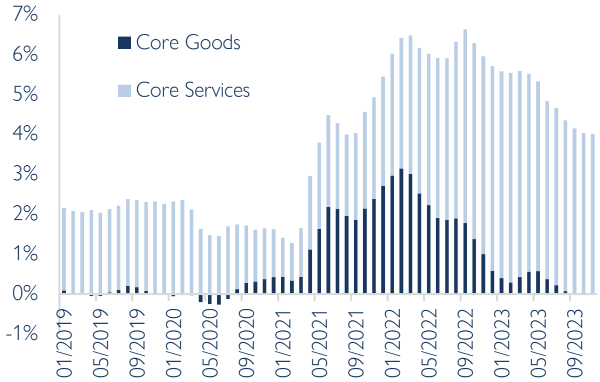
Today they are painting a different picture. The US consumer, especially at the low to mid-end faces increasing pressure, notably occurring without a substantial rise in unemployment. While holiday spending in Q4 remained robust, its sustainability is questionable as delinquencies continue to rise.



Source – Bureau of Labor Statistics, Bloomberg, November 2023

The labor demand is still in excess of the labor supply. That labor demand surplus, which is a key driver of core inflation, is still in positive territory yet declining. Low unemployment in many western economies is the data that surprised positively compared to all recessions of the past 40 years.

Core CPI – Good and Services



Source – Bureau of Labor Statistics, November 2023

Services inflation is still at 4% and mostly reflects wage inflation which has not abated, supported by the labor demand surplus.

Under that framework, history would suggest it is a low probability outcome for underlying inflation to return to the Fed's target without a pick-up in unemployment. Yet entering 2024, this is what equity markets are pricing.

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Sizing and trading of Shorts

Our investment process leads us to short companies with significant downside potential, which we often find in companies with structural or cyclical headwinds combined with a weak balance sheet.

In this letter, we will address how we build and trade around short positions and share some takeaways of 20 years of data.

Adjusting the sizing of short positions is inherent to a short investment process. Aiming for relevant contribution from the short book requires pressing the shorts on the way down (maintaining a decent position size despite the stock price declines). Similarly, a significant rebound can require containing the size of the short book to reduce risk. This mechanism of adjusting short sizes is part of the process. This is one of the reasons why we target extreme shorts, with enough decline potential to allow for such adjustments. The other sizing strategy, which consists in keeping a smaller short book without pressing on the way down can never have a meaningful impact on performance.

We sometimes receive questions as to why we keep shorts so long on the way down. With 20 years of data, we have analysed the performance of our shorts based on the point of entry relative to the 5-year peak of the stock.

For our type of shorts, in businesses with weak balance sheets, the highest probability of a good short happens when it was entered between -30 and -70% from its 5-year peak, with a sweet spot between -50 and -70% from peak. This explains why we continue to press our shorts on the way down.

Trade Price below 5 year peak	Average Price Change to Closure	Median Price Change to Closure	% of Trades Profitable
0-10%	-5%	0%	56%
10-20%	-4%	-3%	53%
20-30%	-2%	0%	49%
30-40%	0%	-21%	60%
40-50%	-3%	-11%	55%
50-60%	-18%	-27%	66%
60-70%	-8%	-20%	67%
70-80%	35%	-9%	54%
80-100%	48%	26%	37%

Source – Parus, Bloomberg

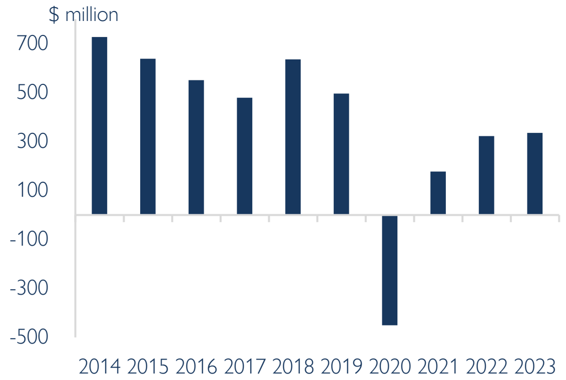
The case for long-term structural decliners

Brick-and-mortar retail is a good illustration of long-term structural decline, which although well-known, remained a good short for many years. Nordstrom, the well-run family led department store continued to grow until 2014 despite e-commerce competition. Since 2014 however, ecommerce pressure has become overwhelming and its net income declined -54% in nominal terms over 10 years, despite US nominal GDP growing over +60%.

This happened despite Nordstrom potentially benefitting from the demise of Bed Bath and Beyond and Macy's, which both experienced an even worst fate. Many large retail companies have seen their businesses cornered into a spiral of lower traffic, leading to lower investment, leading to lower traffic.

The Retail thesis was a well-known short and despite this, Nordstrom stock price over the period declined c. -70% (-58% including dividend) while the MSCI World was up c.+90% over the period. This is an illustration that long term decline theses do take many years to materialize and even though there are phases of stabilization leading to stock price rebounds, stock prices in the end reflect the earnings decline.

Nordstrom Net Income



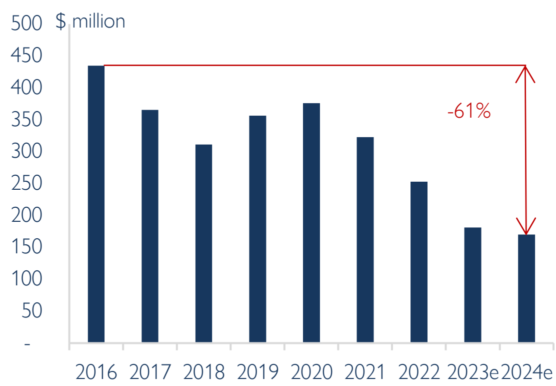
Source – Bloomberg

Nordstrom Share Price

Source – Bloomberg

Similarly, the peak of the US office REITS market was in 2016. Over time the real estate office market has evolved and the traditional downtown office market of mega cities[1], historically seen as a very safe investment, has suffered from excess supply in a context of evolving living and working habits. Migration flows favoured new geographic areas and Covid favoured working from home. Conversion of large office towers into residential is either very expensive or sometimes not even possible. Given the high amount of debt contracted at very low interest rates, refinancing is painful and sometimes selling assets is preferable. But Offices are over-represented in institutional portfolios, which can make selling difficult. This is reflected in the evolution of the funds from operations (FFOs) of SL Green which declined by over -61% in 10 years despite a nominal GDP growth of +45%. Given their high leverage, this has a meaningful impact of their ability to finance their debt and pay the dividends that investors rely on.

SL Green Adjusted FFOs



Source – Bloomberg, Goldman Sachs, Parus

SL Green Share Price

Source – Bloomberg

Our analysis supports the view that there are more legs to these shorts. Fundamentals remain under pressure (discussed later in the letter) and we see downside risks to consensus estimates for 2024. In reference to our previous analysis, SLG stock is now -56% below the trailing 5 year high. A move to a 70% decline (bottom end of our sweet spot) would be a further 33% downside.

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Portfolio

Long - BYD

We initiated a position in BYD in H1 2023 and we think the leading Chinese manufacturer of electric vehicles (EVs) is uniquely positioned to benefit from the growth in the sector. Over H2, BYD continued to produce very strong quarterly results and exceeded its volume forecasts. BYD also announced plan to open a factory in Hungary which could help alleviate European protectionists attempts.

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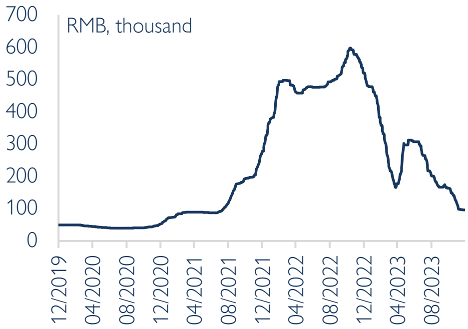
[1] New York, Boston, San Francisco, Los Angeles, Chicago, Washington

The competitive environment in China was however challenging and price cuts dominated the news flow. These dynamics of supply-demand adjustments will increasingly happen in the future, given the fixed cost dimension of these business models and the short-term mismatch of supply and demand in what remains a high growth business (still +62% this year in volume).

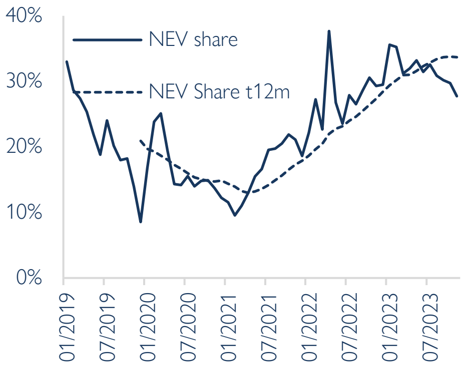
Lithium Prices



Source – Bloomberg, Asian Metal Inc , price per metric tonne

This price reduction has to be put in context of lithium prices which decreased from their very high levels of 2021-2022 this year. Lithium is an important part of a battery cost.

BYD Market Share



Source – BYD, China Automotive

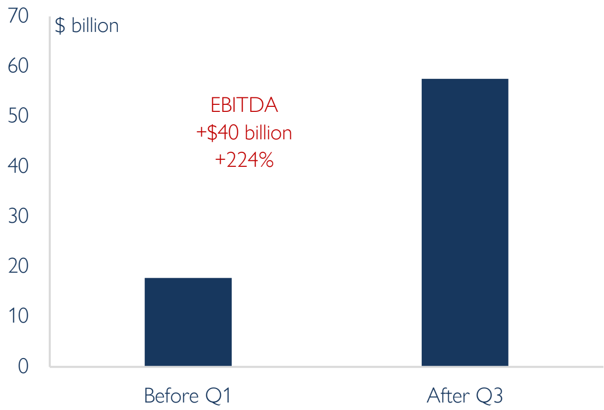
Most importantly BYD's sales figures continue to impress, in Q4 surpassing Tesla as the world's leading battery vehicle producer. BYD's unit sales grew 45% YOY in December (62% on a full year basis) to surpass 3 million of annual unit sales and exports continue to ramp, now forming 11% of total sales, growing over 200% YoY.

BYD's ability to maintain its leading market share with superior products and drive growth with new markets and model launches, is something we feel is not reflected at its current valuation (14x 2024 PE, 6x EV/EBITDA).

Long - Nvidia

Q3 strong results led the consensus to revise EPS for CY 2024 by another +19% taking the total EPS revision during 2023 to a staggering 263%. After a very strong run in H1, the stock price was only up +17% in H2. CY 2024 Revenue/EBITDA estimates now stand at $92b/$57b, against $37b/$17b before Q1 earnings.

NVIDIA EBITDA CY 2024 Estimates



Source – Bloomberg

YoY growth will come down progressively and the inherent short-term cyclicality of the semiconductor sector will affect the stock price. However, we believe that we are in the middle of an exceptional secular trend for semiconductors of which Nvidia is a major beneficiary, illustrated by the fact that the company continues to be supply constrained. It is currently trading at 24x CY 24 earnings and still has significant growth ahead over the next decade.

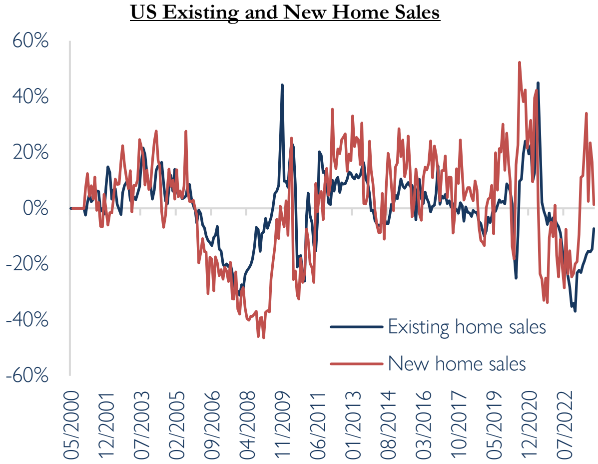
Short - Office REITS

SL Green and Vornado both saw FFO's continue to deteriorate by mid to high single digits over the quarter. Office space utilisation has gradually recovered from the lows, but occupancy rates (as measured by Kastle) have settled at 50% below pre pandemic levels. Renewal lease spreads continue to be pressured which materializes sometimes at the headline price levels and often in additional costs/capex to be borne by the company. Refinancing rates are still roughly 2ppt above the companies' average rates.

The stocks rallied in H2, particularly in Q4 as the US 10Y yield fell from 5% to 4%. They now trade at an excess[2] FFO yield which is on the very high side of the historical 20-year band, valuations which fail to reflect both the leverage of these names and the challenged nature of their business. The dividends have and are likely to continue to be reduced.

Short - Homebuilders

US Existing and New Home Sales



Source – Bloomberg

The US homebuilders were more resilient in 2023 than expected. New home sales were supported by a lack of existing home inventory for sale. Average 30-year mortgage rates briefly touched 8% in Q3, before trending down with the outlook for the Fed rate to the end of the year, settling at 7% and could probably move down to 6%. This move down was taken as positive for the housing market activity, though mortgage applications show activity remains very weak compared to normal. Even at 6%, rates are far above

[2] Defined as FFO Yield minus US Treasury 10Y Yield

the 3% rates of two years ago. Overall affordability remains extremely poor for both existing homeowners and even more so for first time buyers, both of which are at the worst levels since 2006. We continue to expect tough market conditions for the housebuilders to prevail.

KB Home, one of our shorts, is displaying lower profitability than its peers and is more leveraged. The lack of secondary supply benefits the company currently, and it is still showing margins which are far above the levels of 2015-2019 despite a low growth rate. It is trading at historically high P/E and EV/Sales multiples despite the tough environment. We don't see the combination of economics and valuations as sustainable.

KB Home Valuation Metrics

Source – Bloomberg

Source – Bloomberg

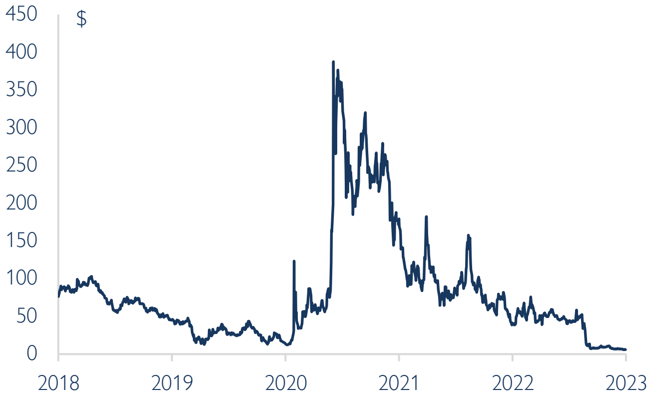
%	2015-19	2023
Revenue CAGR	12%	-8%
Gross Profit Margin	17%	21%
Net Income Margin	4%	9%

Short - AMC

In August, we closed the AMC short position that we had held since June 2021. AMC, the cinema chain company, became extremely overvalued during the meme stock craze, while ironically at the same time, the deterioration of its fundamentals made it a proper bankruptcy candidate.

The company was forced into a series of dilutive corporate actions. Reaching the limits of the number of common shares it was authorized to issue, the board opted to issue quasi equity under the form of Preferred Equity Units (APE). Given that these APEs traded at a large discount to common shares, the two prices were set to converge. This scenario made AMC a popular short, at times pushing up incremental borrow rates to over 200%. This made AMC a tough short to hold and not financially viable to increase. After a series of legal challenges, the issue was authorized and resulted in massive dilution of existing shareholders. We closed the short completely after the conversion occurred. The stock price lost 90% of its value following the conversion.

AMC Stock Price



Source – Bloomberg

Short - Lucid and Rivian – too little too late

We continue to believe that these companies will be part of the losing camp when it comes to EV competition. Their lack of scale is now insurmountable with an annual production of less than hundred thousand compared to 1.6m and 1.8m battery vehicles respectively at BYD/Tesla. In a time of such intense competition in the EV space, scale and cost efficiency through vertical integration is already becoming the differentiating factor to reach profitability.

Both Lucid and Rivian made it so far thanks to abnormally favourable financing conditions a few years ago, which are unlikely to be reproduced as the competitive landscape of the industry is now much more established. As a result any further refinancing is likely to be quite dilutive. We did however close our positions in Lucid and Rivian in H2 mostly due to the volatility of the stock at current valuations which prevents meaningful sizing (both stocks down >85% from open of the position to close price).

Short - Carvana

We have reintroduced a short position in Carvana, the US company retooling and selling used vehicles online.

The stock rebounded significantly earlier this year following a debt renegotiation that will create an interest free period until mid-2025. Thereafter interests will amount to over $500M pa, for a company that will likely generate less than $250M of EBITDA-Capex in 2024.

With this renegotiation Carvana has gained time, but remains cash constrained and must choose between protecting cash flows and investing in growth but cannot do both. Infinite financing as a strategy is most likely no longer an option. The inability to grow would mean that the amount of debt is just too big for the size of the company and should lead to recapitalization and significant dilution.

	Carvana	Carmax
EV/Sales	1.3x	0.5x
EV ($b)	14.5	13.9
Net Debt - Receivables ($b)	5.2	0.8
Retail Units Sold (000's)	81	175
YOY Used Units Sold	-21%	-3%
Retail GPU ($, t12m average)	1,793	2,292
Advertising per Unit ($)	691	362

Source: Bloomberg, Company – latest reported quarter, trailing 12 month average for GPU

Independent of the financing issues, Carvana trades at a significant premium to Carmax (2x EV/Sales), despite operating at a much lower scale and profitability.

Short - Wayfair

Wayfair, the online furniture marketplace, remains an interesting short position. It has an EV of $9.4Bn of which $4.0B is Financial Debt for c. $500M of EBITDA and $200M of EBITDA-Capex. In a tough economic environment and being financing constrained given the amount of debt, Wayfair must also choose between profitability and growth. The recent focus of the former happened to the detriment of the latter with an annual growth in the low teens. With similar metrics of Debt/Gross Profit and similar EBITDA margins, Farfetch, the European fashion marketplace, was forced into an unpleasant refinancing exercise and the equity went to zero, despite having received earlier funding from Richemont and JD Com.

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Over the long term "price follows earnings", and we continue to believe that companies with strong growth characteristics and competitive positions will continue to grow their earnings much faster than the market and those with a weak balance sheet will underperform.

Markets have been very responsive to the prospects of lower rates and are now pricing a Goldilocks scenario with recovery while it is too early to make a call on the nature of the economic trough. The disparity of valuations among businesses remains a good environment for stock picking.

We remain cautious with our positioning and entry points but flexible in reacting to data points and changing the portfolio. As always, we recommend investors to pay more attention to the process with a long-term horizon than to the positioning of the portfolio at a given point in time.

With this mind, we wish you all a good year.

The Parus Team