Made in Italy Fund

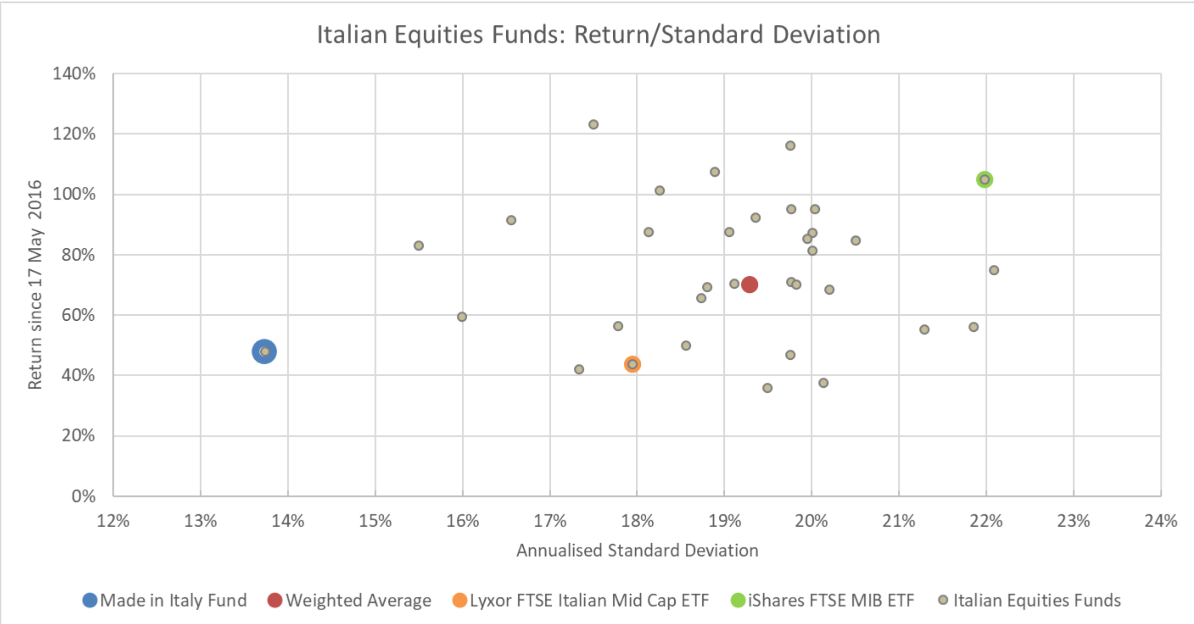
Bayes Investments

Investor letter – Third Quarter 2023

Dear Fellow Investors,

The Made in Italy Fund (MIF) had a return of -7.4% in the third quarter of 2023. The return since inception (17 May 2016) is 47.8%. Returns are net of fees and all administration costs.

Since last quarter, the MIF has fallen behind the Italian Equities fund universe, whose weighted average return since our inception is 70.1%:



Source: Factset

The MIF return remained above the 43.8% return of the most comparable ETF – the Lyxor Mid Cap Fund – but has fallen further behind the 104.8% return of the main Italian Equities ETF – the iShares FTSE MIB.

The MIF return continues to be accompanied by lower volatility. The annualised standard deviation of its daily returns is 13.7%, compared to 19.3% for the weighted average fund, 17.9% for the Lyxor ETF and 22.0% for the iShares ETF.

Third Quarter 2023

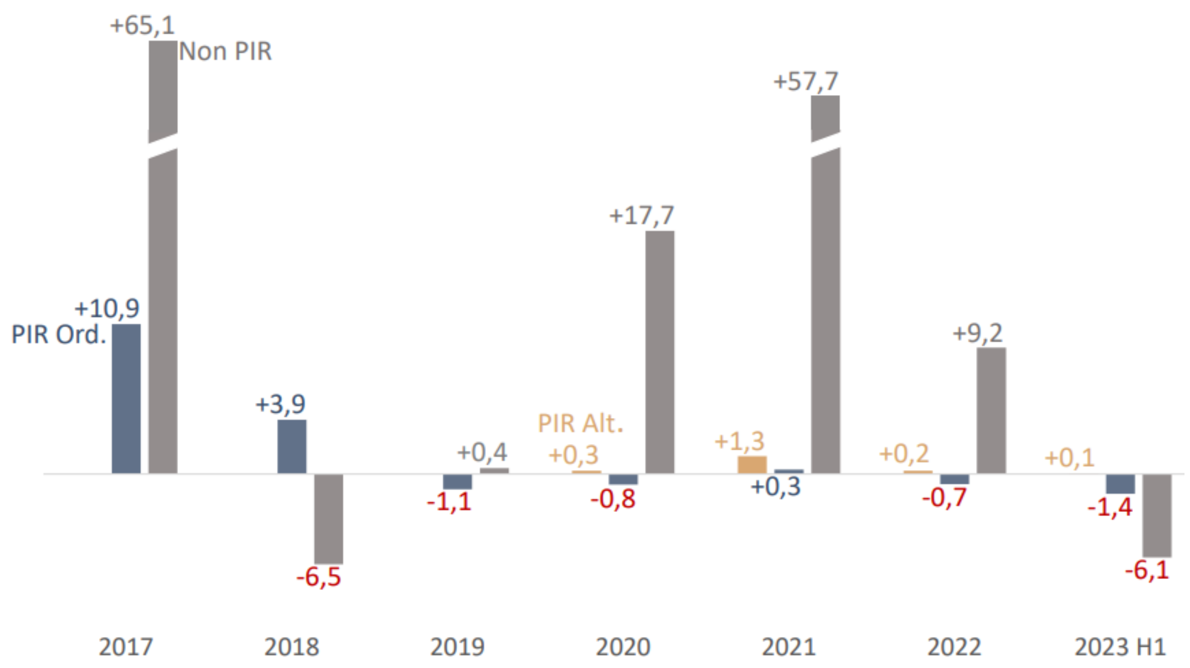
Our -7.4% return for the quarter compares with a weighted average return of -2.3% for the Italian Equities universe, -6.5% for the Lyxor ETF and 0.5% for the iShares ETF.

Year to date, the MIF return is -8.8%, versus 12.1% for the weighted average fund, 3.2% for the Lyxor ETF and 23.6% for the iShares ETF.

Unlike the last two quarters, Q3 was negative for world equities. The US S&P 500 index ended the quarter down -3% and the Nasdaq index was down -4%. European markets fell by a similar amount, with the German DAX index down -5%, the French CAC index down -3% and the Euro STOXX index down -4%. Once again, Italian stocks fared better, with the MIB index marginally up 0.6%. Italian small cap stocks, however, continued to lag for the fifth quarter in a row, with the Italia Small Cap index down -5% and the Italia Growth index down -8%. Also the Italian STAR index – which, as our regular readers know well, has substantially outperformed all other Italian indices over the long run – was down as much as -11%. As in the first half of the year, small cap stocks were also weaker in France, with the CAC Small index down -10%, whereas the German SDAX index performed in line with the main market, down -4%, and the Euro STOXX Small index did marginally better, ending the quarter down -2%.

Hence the overdue catch up between small and large cap performance we looked for in the Q2 letter again failed to materialise this quarter. Moreover, the second factor we pointed out in the letter – PIR funds outflows – continued unabated, with 610 million out of Ordinary PIRs in the second quarter, on top of the 815 million[1] in the first quarter, bringing the outflows in the first half of the year to 1.4 billion – double the 734 million outflows of 2022 – and more to be reported in Q3:

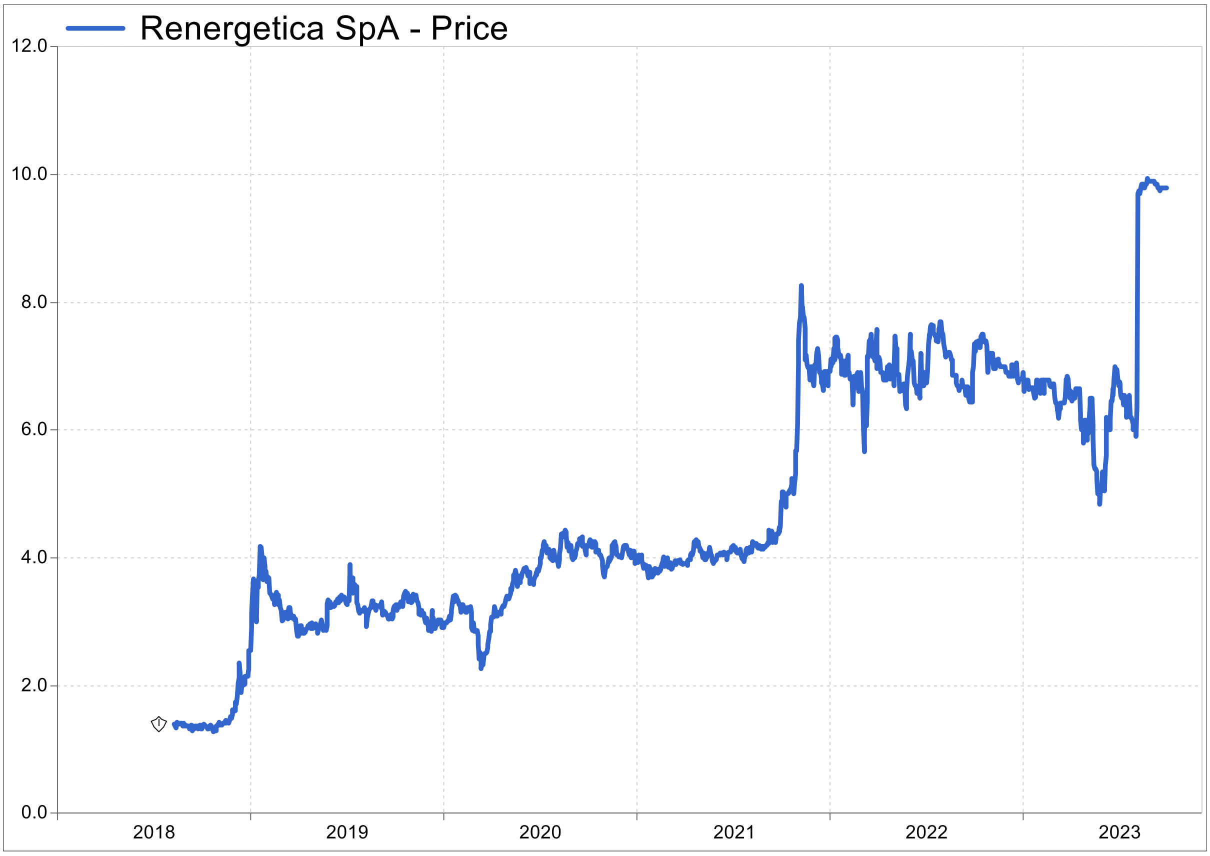
Net inflows – Ordinary PIR, Alternative PIR, and non-PIR funds (billion euro)



Source: Osservatorio PIR Assogestioni

[1] Corrected from 779 million reported in the Q2 letter. See here, Table 8.1.

Only a few of our stocks were spared the blanket Q3 sell-off. Most notably, **Renergetica** rose 46% in the quarter, after announcing in the beginning of August that its controlling shareholder was selling a 60% stake in the company at 10 euro per share, a 67% premium on the 6 euro around which the stock had been trading before the announcement:



The company operates in the renewable energy sector, acting as Project Developer, Independent Power Producer, Asset Manager and Industrial Engineer for renewable energy plants, hybrid power generation systems and energy storage solutions. You may remember that we bought the stock at IPO in Q3 2018 at 1.5 euro per share (adjusted to 1.36 euro after a 10% stock dividend distribution in November 2020). Thereafter we kept our position, only trading it occasionally at the margin, as we regularly do with all our stocks.

These are the kinds of returns we strive to achieve with all our stocks, especially those we buy at attractive IPO prices. At the time of the IPO, Renergetica was valued at 11 million. It is now worth 81 million. As it has happened repeatedly in the seven-year history of the Fund, these large returns have coincided with external events, usually conducive to companies being taken private at a hefty premium on their market price: Reno de Medici in Q3 2021, BE STF in Q1 2022, Piteco in Q3 2022, Finlogic in Q1 2023, Sebino and Labomar in Q2 2023. However pleasing these events are for the performance of our portfolio, we must recognise that they denote a market dysfunction – its inability to express an adequate valuation that would dissuade controlling shareholders from accepting and often seeking takeout offers, and opt instead to keep the company public.

Another good performance came from **Circle**, up 19% in the quarter to 5.95 euro. The stock is up 58% year-to-date and 173% since we first bought it at IPO in Q4 2018 at 2.4 euro (adjusted to 2.18 euro after a 10% stock dividend distribution in May 2019). The company provides technological services and software solutions for the automation, digitalisation and optimisation of supply chains for ports, maritime and intermodal transport logistics and infrastructure. This highly scalable business, led by founder and CEO Luca Abatello, is set to expand at a rapid pace across the Mediterranean basin and beyond, internally as well as through M&A. At the time of the IPO, Circle was worth 10 million. Its current market capitalisation is 24 million:

Other stocks that did well include **Expert.ai,** which continued its run, up another 14% in the quarter and 59% year-to-date. **Abitare In** was up 10% and **Cembre** 8%.

Such advances, however, were not sufficient to stem another batch of declines in the quarter. The stocks highlighted in the Q2 letter continued their downward moves: Farmacosmo -5%, Tecma Solutions -6%, Solid World -9%, Matica -7%, Datrix -14%, Giglio -11%. This quarter they were joined by Doxee -34%, Estrima -32%, Destination Italia -30%, and many other stocks, whose only problem is to have been caught in a vicious spiral of PIR redemptions and illiquidity, where the more illiquid the stock the stronger is the pressure from PIR fund risk managers to liquidate the position, thereby aggravating the fall and the illiquidity.

In such disorderly conditions, it would be useful to have cash available and pick up bargains. But in a fully invested portfolio, and with existing and potential investors sitting on the sidelines, there is limited room for manoeuvre.

Nevertheless, we did manage to gather some resources – including the sale of Renergetica – to participate in three new IPO:

RedFish LongTerm Capital. It is an industrial holding company specialized in acquiring significant stakes in small to medium-sized enterprises, particularly family-run businesses. The company focuses on long-term investments, securing majority shares or qualified minorities through club deals with a strong emphasis on companies generating over €2 million in EBITDA. Operating within Italy's SME market, Redfish collaborates with company management, providing comprehensive advisory services such as financial guidance, performance audits, management control, and assistance in M&A strategies and transactions. Led by a seasoned management team, led by founder Paolo Pescetto, the company leverages its expertise to support subsidiaries in optimizing financial structures, growth strategies, and managerial capabilities. Amidst competition from investment entities with shorter holding periods, Redfish stands out due to its long-term commitment, tailored investment strategy focusing on family-led SMEs, independent governance, comprehensive advisory offerings, lean cost structure, and an experienced management team with extensive industry experience.

The company has a market capitalisation of 25 million euro and an estimated equity value of 45 million. We bought the stock at IPO at the end of June paying 1.50 per share. The stock ended the quarter at 1.44.

AATech. The company operates as a tech builder specialising in the Italian Fintech and Energy Transition sectors. It has two divisions: The Tech Builder division utilizes indirect sales channels and charges setup fees, usage costs, and occasional royalties; the Operational Services division relies on direct sales with recurring fees, and specialized consultancy contracts. Additionally, the company has five participations: the subsidiary companies PreviOn Srl and Brand Italia Srl, and as is a shareholder in Termo SpA (16%), Ulixes SGR SpA (20%), Aion Tech Srl (10%), and SCM SIM SpA (1.5%). AATech's strategy involves collaborating with partners or distributors to establish vehicle companies, effectively channeling developed technological solutions. This approach assures quality for acquirers due to shared risk capital and accelerates the investees' development.

The company is in a start-up phase with a market value of 7 million euro. We paid 1 euro per share at the IPO at the end of June. The stock ended the quarter at 1.34.

Green Oleo. The company specializes in processing waste from meat and vegetable oil industries, particularly olive oil, and transforming it into high value oleochemical products, including distilled fatty acids, glycerines, esters, and stearic acids. Their forte lies in the intricate processing of olive waste, a technically complex yet sought-after raw material. With an expansive 64,000m² plant and an annual capacity of 65,000 tons, Green Oleo employs sophisticated, sustainable processes. By transforming waste into raw materials, it adheres to the circular economy, underpinning its focus on ESG principles. Employing batch and continuous production methods, Green Oleo crafts over 100 diverse products tailored for industries like cosmetics, detergents, and polymers. Their strategic differentiation stems from their ability to process olive oil derivatives, ensuring higher-quality and sustainable products. The company fosters enduring relationships with 90% recurring customers by customizing offerings and ensuring quality standards. While they function as price takers in some markets, their leadership in olive-derived products affords greater control over pricing. This unique dual position aids their revenue stability, bolstering long-term growth prospects.

Green Oleo’s current market capitalisation is 32 million, with 2023 expected revenues of 75 million and EBITDA of 4 million, temporarily affected by adverse market conditions but expected to grow at a healthy pace in the coming years. We bought the stock at 1.15 euro per share at the IPO in early July. The stock ended the quarter at 1.07.

The current sector composition of the Fund is the following:

	Number of companies	% Weight
Producer Manufacturing	7	13.9%
Electronic Technology	2	3.9%
Process Industries	2	3.0%
Consumer Non-Durables	0	0.0%
Consumer Durables	5	16.1%
Industrial Services	1	2.0%
Commercial Services	4	12.0%
Consumer Services	3	6.1%
Technology Services	9	18.5%
Distribution Services	1	4.5%
Health Technology	1	2.4%
Retail Trade	1	3.2%
Communications	1	1.9%
Finance	4	7.3%
Utilities	1	0.9%
Warrants + cash		4.4%
Total	42	100.0%

Two proposals

The wide gap that has opened between Italian large and small caps since the second half of last year has taken an increasingly heavy toll on our absolute and relative performance. Remember that most funds in the Italian equity universe are benchmarked against the MIB index and that even Ordinary PIR funds are preponderantly invested in large caps, whereas our Fund is an Alternative PIR mostly invested in small caps.

It has been increasingly evident in the course of this year that the ongoing market dislocations are indicative of a systemic problem that requires a top-down intervention at the institutional level. As mentioned in the previous letter, we have taken the initiative of carrying two proposals aimed at directing Italian savings towards listed SMEs and expanding the size and liquidity of the Italian stock market.

There follows the document that illustrates the proposals, which we have recently had the opportunity of presenting to the Ministry of Enterprises and Made in Italy (MIMIT).

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Executive Summary

- SMEs are a driver of growth, innovation and internationalisation of the economy. Their listing on the stock market plays an important role for an advanced economic system thanks to the multiplier effect deriving from the injection of Italian and foreign institutional capital.

- The Italian stock market is modest in size compared to the country's economy and the major European and world stock markets.

- To increase the size of the market, there is a need to encourage new companies to list. But it is also necessary to promote the participation of individual and institutional investors.

- Two strategic interventions are proposed in this regard:

  1. PIRs incentivise Italian savings to invest in the domestic economy by channelling resources to companies, but have so far played an insufficient role, which should therefore be strengthened. We propose to raise the minimum share of investment in listed SMEs in Ordinary PIRs, currently 3.5%, to a significantly higher level, and to direct Alternative PIRs, in which the minimum share invested in SMEs is 70%, to focus more on listed SMEs.

  2. Pension savings have so far played an even more modest role that, following the example of France, should be decisively enhanced. It is proposed that a state-participated PIR fund of funds be created – along the lines of similar vehicles managed by Cassa Depositi e Prestiti and the European Investment Fund for investments in Private Equity and Venture Capital – that would be able to attract Italian and foreign institutional investors and encourage participation in it by social security institutions.

Introduction

As highlighted in the Green Paper on The Competitiveness of Italian Financial Markets in Support of Growth and in the OECD Capital Market Review of Italy 2020 – Creating Growth Opportunities for Italian Companies and Savers, the Italian stock market is small compared to the country's economy and to the major European and world stock markets.

A large and efficient stock market is an important driver of growth, innovation and internationalisation in an advanced economic system, resulting from the multiplier effect generated by the injection of Italian and foreign institutional capital to support the PNRR.

Thanks to the commitment of Borsa Italiana for SMEs, combined with that of other market players and the presence of tax incentives for listing, at the end of 2022 there were 414 listed companies in Italy, with a total capitalisation of €662 billion, or 34% of GDP. Of these companies, 334 were SMEs, defined as companies with capitalisation below 1 billion, of which 144 were listed on the main market EXM (Euronext Milan, Ex-MTA) and 190 on EGM (Euronext Growth Milan, Ex-AIM Italy). The total capitalisation of SMEs was about €45 billion[2], of which €10.6 billion was in EGM companies.

[2] Source: Factset

By comparison, however, on Euronext Paris there are more than 800 listed companies – twice as many as on Euronext Milan – with a total capitalisation of more than €3 trillion, more than four times that of Italy and equal to more than 100% of French GDP. Of these, more than 600 are SMEs, with a total capitalisation of 82 billion.

France is the leader in asset management in the Eurozone, with more than €4,800 billion under management, more than 700 asset management companies, of which more than 450 are independent companies and more than 200 have been created in the last five years. The industry employs 85,000 people, of which 26,000 work in asset management companies.[3] There are currently around 80 funds specialising in domestic SMEs in France, managing total assets of over 6 billion.

The Green Paper calls for

> a structural 'change of pace' in the relationship between companies and the capital market; on the one hand by removing regulatory and operational constraints on companies' access to the market, and on the other hand by introducing measures to stimulate, on both the demand and supply side, the channelling of investments to companies via the markets (p. 2).

SMEs are the companies most in need of the change of pace called for in the Green Paper. The wide gap between France and Italy will not begin to close until this aspiration is translated into ambitious and effective practical measures aimed at increasing the participation of individual and institutional investors in the Italian stock market.

Individual investors: the PIR

The most important initiative aimed at stimulating Italian savers to invest in SMEs was the introduction of Individual Savings Plans (PIR) in 2017. Although it has gone through alternating phases, it has been a successful initiative: according to the latest PIR Observatory compiled by Assogestioni, at the end of 2022 PIRs promoted by the association's member companies were worth €18.9 billion, of which €17.4 billion in Ordinary PIRs and €1.5 billion in Alternative PIRs. This is an appreciable sum: 1.9% of the assets promoted in open-ended and closed-ended real funds, amounting to 989 billion, but almost double the total invested in Italian Equity Funds (8.2 billion) and Italian Bond Funds (1.6 billion).

On balance, however, it is clear that Ordinary PIRs have responded only minimally to the objective for which they were created: to channel Italian savings towards SMEs. Contrary to what is commonly imagined, barely 5% of the value of Ordinary PIRs is invested in securities of listed SMEs – slightly above the minimum level of 3.5% set by the law.

In response to this shortcoming, Alternative PIRs were created in late 2020, for which the minimum investment in SMEs was raised from 3.5% to 70%. But the value of Alternative PIRs is still low compared to that of Ordinary PIRs. In addition, the PIR Observatory estimates that, out of the 1.5 billion value[4], 0.9 billion is in cash/commitments and feeders, while only 0.5 billion is actually invested in stocks, bonds and other 'vehicles'. Of these, no less than 82% is invested in unlisted securities, while the percentage invested in listed SMEs is only 15%, amounting to just 75 million –

[3] Data at end 2021

[4] To this sum we must add the funds of companies that are not members of Assogestioni, first and foremost Azimut, which, according to the latest PIR Monitor prepared by Equita SIM, managed EUR 731 million in Alternative PIRs (third quarter 2022 data). Adding these funds together, the value of Alternative PIRs rises to 2.5 billion.

30 million on EXM and 45 million on EGM. This is just 5% of the total invested in Alternative PIRs, far from the 70% required by the law.

It must therefore be acknowledged that even Alternative PIRs have largely failed to meet the objective of increasing Italian savers' participation in the capital of listed SMEs. While Ordinary PIRs are predominantly invested in securities of medium-large companies, Alternative PIRs are predominantly invested in unlisted securities.

The result is that, out of a total of 18.9 billion invested in PIRs, only 5%, or 0.9 billion, is invested in listed SMEs – barely 2% of their capitalisation. Paradoxically, the companies that should be the main beneficiaries of the PIRs are those that benefit the least.

Institutional investors: pension funds and social security funds

Another important potential source of financing for SMEs is pension savings. As shown in the latest COVIP Report and in the COVIP Report on the investment policies of pension funds, at the end of 2021 total assets invested by the Italian social security system amounted to €321 billion, of which €213 billion in pension funds and €108 billion in social security funds.

Of these, 72 billion were equity investments: 51 billion in pension funds, or 29% of the total (see Table 1.21 of the Report)[5] , and 21 billion in social security funds, or 19% of the total (see Table 4 of the Report).

Looking at domestic investments (see Section 3 of the Report), these totalled 77 billion: 40 billion in pension funds, or 23% of the total, and 37 billion in social security funds, or 34% of the total. But of these, 42 billion (or 54%) were invested in government and other debt securities (81% for pension funds and 25% for social security funds) and 21 billion (or 28%) in real estate, including real estate UCITS (8% for pension funds and 50% for social security funds). Only the remaining 14 billion – 18% of domestic investments and 5% of total assets – were invested in equities, OICVM units and units in other security OICR: 6 billion in pension funds and 8 billion in social security funds. Of these – which the COVIP Report defines as 'the financial resources destined for Italian companies' (p. 23) – 4 billion were invested in bond instruments, 5 billion in equity instruments, and 5 billion in securities UCITS.

It is therefore clear that, as the Report itself comments below, 'When compared to the total financial liabilities of Italian companies, the contribution made by pension savings remains modest, at around 0.4%'. A similar comment is made in the Report (p. 49):

> Excluding Italian government bonds, the contribution that the complementary forms system makes to the Italian economy is limited, also by international comparison. The reference to market benchmarks diversified on an international scale, in which the weight assigned to Italy is marginal, given the small number of Italian listed companies and the limited development, at a national level, of private equity and debt markets, are still valid as possible braking factors.

This reproduces, in extreme form, the situation of PIRs. Retirement savings, already underinvested in the Italian stock market, are not invested at all in listed SMEs.

[5] The total net assets of pension funds shown in Table 13 are 176 billion lire, corresponding to investments directly attributable to supplementary pension schemes.

The two proposals

1. Strengthening PIRs

For PIRs to play the important role for which they were created, it is necessary that Ordinary PIRs are directed to invest a significantly higher share in listed SMEs.

The minimum quota, currently at 3.5%, should be raised to a significantly higher level, to be agreed with the trade associations.

Alternative PIRs, in which the minimum share is 70%, should **focus more on listed SMEs**.

2. Targeting retirement savings

In order for pension savings to make an appropriate contribution to the strengthening of the Italian stock market, pension funds and social security funds should be directed to adopt a consistent *Home Country Bias* – an allocation to domestic equities significantly greater than that of benchmarks, allocating an appropriate portion to SMEs. This investment could conveniently be in place of the currently prevailing domestic assets: government bonds for pension funds and real estate for social security funds, allowing access, among other things, to the same tax benefits of PIRs (see Circular 19/E 2021 of the Agenzia delle Entrate).

As stated in the Green Paper (p. 34) and the OECD Report (p. 16, 21, 45), the most suitable form of investment in listed SMEs is that of a **fund of funds.** Such a fund would invest in a selected portfolio of PIR-compliant equity funds – both in existing ones and in new listed funds and investment vehicles that would thus be stimulated to emerge and grow – allocating a portion of the total to each, so as to ensure greater liquidity and diversification.

A fund of funds of, say, €3 billion would amount to a modest 1% of the total assets of funds. The fund could be created within Cassa Depositi e Prestiti and/or the European Investment Fund, along the lines of similar initiatives in the field of Private Equity and Venture Capital.

The fund would have three important positive effects:

1. It would provide resources for the financing and growth of SMEs that have had the ability to complete the listing process and the merit of opening their capital to public investment.

2. It would create an important natural source of demand, encouraging the listing of new companies and expanding the size, value and importance of the Italian stock market.

3. It would facilitate the creation and growth of investment funds focused on the Italian stock market, increasing their liquidity and efficiency, and developing research, knowledge and analytical capabilities.

Not least, the fund would allow the social security system to invest in Italian companies with the greatest growth potential, to the benefit of members and the Country.

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Such is the document, which was well received by the MIMIT, with the intention of following up the proposals with concrete actions.

Subsequent discussions with market participants – notably the managers of the larger PIR funds – have highlighted the fact that the relaunch of PIRs would require more than just boosting existing Ordinary PIRs. Further increasing funds that are already too large to invest in small caps is not a viable solution. New PIRs would be required, with a higher quota of mid and small caps but a smaller size, and therefore better suited to investing in SMEs without incurring into intractable liquidity problems. These would be the same new PIRs that would make up the institutional Fund of Funds – hence the link between the two proposals.

We will keep you updated on the progress of our initiative.

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