TRIUM BLACKWALL EUROPE L/S FUND

European Long/Short Equity

MONTH: 0.09%* YTD: 2.92%*

AUM: EUR 41.6M*

Q1 2016

Dear Investor,

The first quarter of 2016 started well. All 3 months contributed positively to a YTD 2016 net return of +2.9%*. Since inception in December 2014, the Fund has generated net returns of +12.7%*. This has been achieved without leverage and, during the most recent quarter, with an average net exposure of only +7.9%.

Assets under management increased from EUR 30.8m at the end of 2015 to EUR 41.5m at the end of Q1 2016. Our investor base resides predominantly in Germany, UK, Switzerland, and Austria. Initially, it consisted of family offices and high-net-worth-individuals but during Q1 2016 we added several institutional investors – a very positive development.

Given the growing institutional interest in the Fund, we would like to remind you that we will close the founder's share class (Class E EUR) once EUR 100m in assets under management is reached.

Finally, we are delighted to announce that the Trium Blackwall Europe L/S Fund has been shortlisted for "Best Newcomer – Equity" for HFM's European Hedge Fund Performance Awards.

WHAT MAKES A GREAT SHORT?

Equity markets demonstrated a high level of volatility in recent quarters but it's interesting to note that, since the Fund launched in December 2014, overall European index levels are pretty much unchanged (+/- 3%). This compares to our performance since launch of +12.7%* derived from ca. +7.2% from the long side and ca. +5.4% from the short. The "hit ratio", defined as the number of stocks contributing positively, was 68% among the longs and 77% among the shorts and a combined total of 72% across more than 40 stocks invested. This shows that our success so far has been broad based and so underlines the value of our approach.

In previous newsletters, we have outlined how we select stocks. In this newsletter, we'd like to provide you with further details on what ingredients go into a great short position.

Valuation is like gravity. You can defy it for a while but ultimately prices comply to accurately reflect the valuation. However, sometimes the period it takes for prices to adjust to valuations can be longer than one can withstand. If prices (and valuation) are far too low, it almost becomes irrelevant what the business model of a specific company is (although in our view it always pays to select great companies). When we think about the period of early 2009, we realise that almost everything (with the notable exception of commodity-related stocks) has gone up in price. We believe that the same principle applies when the market goes down. Just like in the bull market scenario, the bear market scenario can be applied to individual stocks as well as for the entire market, especially when bubbles have formed in certain sectors.

While it is easy to agree upon this point, it is difficult to define the fair value of a specific company. There is no "right" valuation one can attach to a company but there are various methods that can narrow it down to a certain range. For example, reproduction value is a good starting point; quantifying how much it would cost to replicate a business. In the next step, it is very helpful to value the company assuming it has no further growth. If there is no significant delta between these values, there is very little point in using a DCF model to value growth. Only a massive gap between the two valuations signals there might be a sustainable competitive advantage. Only if that exists will growth investments make any sense and add value to shareholders.

Having spent more than 20 years within sell-side research, I know that one of the biggest sins of this industry is jumping right into a DCF valuation including growth estimates without applying the above two steps first. From an investor's perspective, we can make use of this bias.

In fact, in our view, only a few companies have a strong competitive advantage - maybe 10%. The vast majority of companies have no competitive advantage whatsoever and thus shouldn't be valued as if growth has a significant value. At times, the combination of DCF-based target prices (extrapolating growth forever), cyclical advances and broad-based positive sentiments can decouple prices from valuations - allowing for an interesting short-selling proposition. In the ideal case, prices should have the potential to decline by 40-50%.

So while valuation is a good starting point, it has been our experience that it is better to have many reasons for shorting a stock instead of just one. Being able to identify several good reasons, which can each stand on its own merits, has two key implications: 1) it means that there are several chances of what could be the trigger for market participants to agree with our view on fair value; and 2) if we can identify several factors, it is quite likely that we also missed out on some other unknowns that will help the short case.

So what are these other factors? Essentially there are two:

Firstly, a structurally weak business model is very helpful. We've already seen that a good short's fair value shouldn't be much higher than replacement cost. The fact that an industry is full of players without competitive edge leads to temporary advances and shake-outs and regularly goes along with cyclical companies. Furthermore, as margins are very volatile across the cycle and debt levels are generally high, the volatility of the equity values of these stocks is very high. Some investors like to buy these stocks at their lows, potentially being deep value, but we only care about the downside such stocks provide – around their high of the cycle.

*Source: Trium. The figures refer to the past. Performance is quoted net of fees based on unaudited figures. Performance from launch (22 December 2014) to 31 December 2014 was -0.10%. Inception date: 22 December 2014. All at 31 March 2016.

Secondly, new technologies are changing business models at an ever faster speed. It is not only Silicon Valley which is working on dozens of so-called disruptive technologies. China, for example, has been investing in R&D at an ever growing pace. According to a recent OECD report, China already accounts for 20% of global R&D spending (3x more than Germany) and will become the world leader within a few years. With an estimated 220m college graduates by 2030 and researchers getting 10-20% of advanced-country counterpart's wages, there is an enormous brain pool on both sides of the Pacific to disrupt all sorts of industries. Identifying great companies which are being disrupted is highly rewarding.

Some of the other factors referred to above include fraudulent accounting, serial acquisitions that overstate numbers, regulatory changes, political changes, terror attacks, and macro events. In summary, a great short is a company for which the probabilities, as small as they might be based on an individual factor, point to a high likelihood of dropping prices.

Two final remarks on the subject; firstly, we don't assume that companies will go bankrupt. While this may happen occasionally, we believe that if things get too close to the zero line, all sorts of things can happen to destroy an otherwise favourable outcome for a short position. Hence, we close out our positions well before we enter such a situation. Secondly, given the different risk-return profile of longs and shorts, our short selection of stocks focuses on (i) large cap companies or upper mid-cap stocks, (ii) an investment horizon of less than two years and (iii) a maximum single position size of half of the equivalent on the long side.

Portfolio Structure

As outlined in our previous newsletters, we consolidate our portfolio holdings on the long side into a notional combined entity allowing us to better illustrate to investors the economics of an average company in the portfolio. Commencing with this newsletter, we will not only show the long side based on this concept but also the short side. As at 31st March 2016 it looks like the following:

Long Investments: Typical Company Economics

Financials* (EUR m)	2014	2015	2016	2017E
Sales	3,852	4,178	4,382	4,553
Gross Profit	1,707	1,811	1,920	1,990
EBIT	587	623	700	740
Net Income	370	441	496	528
FCF	296	361	404	508
Net Financial Debt	1,561	1,182	965	725

Valuation Ratios* (EUR m)	2014	2015	2016	2017E
P/E	27.8	23.1	19.1	16.6
P/BV	3.5	3.3	2.9	2.7
EV/EBIT	22.4	16.5	13.8	12.4
Net Debt/EBITDA	0.8	0.3	0.0	-0.2
Dividend Yield	2.5%	2.4%	2.6%	2.8%
ROE	19.2%	24.1%	25.0%	23.6%
ROCE	16.0%	17.1%	19.5%	20.9%

Short Investments: Typical Company Economics

Financials* (EUR m)	2014	2015	2016	2017E
Sales	36,833	40,868	40,151	38,864
Gross Profit	11,289	12,457	11,792	10,436
EBIT	2,932	3,313	2,642	1,387
Net Income	1,244	2,226	1,772	861
FCF	-2804	1,077	678	600
Net Financial Debt	18,912	15,479	16,343	17,398

Valuation Ratios* (EUR m)	2014	2015	2016	2017E
P/E	17.4	19.0	25.8	68.9
P/BV	3.0	2.7	2.6	2.6
EV/EBIT	18.0	13.9	18.1	38.4
Net Debt/EBITDA	1.7	1.3	1.7	2.6
Dividend Yield	4.5%	3.5%	3.5%	3.1%
ROE	12.5%	16.0%	11.8%	8.6%
ROCE	13.2%	15.5%	10.9%	9.0%

*Source: Bloomberg, Blackwall Capital Investment AG.
[1] Note that there can be no assurance that these estimates will be achieved.

Our investment approach is to invest long in great companies, with mid-caps being the sweet spot, and short in weak companies, preferably in the large-cap area. In terms of size, as the tables illustrate, investors in the Fund hold a typically mid-sized company on the long side, while the average company shorted is about 9-10x bigger in terms of revenues.

Let's focus on 2015 numbers to compare data as 1) they are already reported and 2) we expect some recession to impact earnings in 2016/17, which may or may not come:

- Gross Margin: the average gross margin on the long side is 43.3% compared to just 30.5% of the shorts (in fact, this is close to Stoxx 600 average of 29.5%).
- EBIT Margin: the longs show an average EBIT margin of 14.9%, almost twice as high as the shorts with 8.1% (Stoxx 600 average: 8.2%). It's worthwhile to point out that 2015 was a good year for cyclical companies which comprise a larger part of shorts. Thus, their margins are rather close to their peak, certainly above mid-cycle level.
- Net Profit Margin: as for the EBIT margin, the same goes for the net profit margin. In 2015, the average long generated a margin of 10.6% versus 5.4% from the shorts.

- Return on Equity: the average long in the fund generates an ROE of about 24.1% compared to 16.0% generated by the average short. The latter isn't bad, but again, rather a peak level with the mid-cycle level being closer to high single digits.
- Leverage: compared with the broader equity market showing a net debt/EBITDA ratio of 3.4x, both longs (0.3x) and shorts (1.3x) are rather low in 2015. However, while longs are becoming net cash positive soon, shorts are likely to post higher debt levels in case of a recessionary scenario.

In terms of valuation, we use various metrics with our preferred ratio being EV/EBIT. On average our long portfolio trades at 16.5x for 2015 and 13.8x for 2016E, with the short portfolio trading at 13.9x and 18.1x respectively. On average we would argue that longs are more attractively valued, in particular when looking into 2016 and beyond.

Overall, we believe that our Fund holds companies with a strong franchise and superior margins on the long side, which generate substantially higher ROEs with almost no debt levels. As for the shorts, we believe they are weak business models that are particularly vulnerable to the next economic downturn and are liquid enough to avoid most market short squeezes.

In our view, the different components of our portfolio underscore our investment philosophy, namely to invest for the long-term in great companies while shorting over the medium-term overvalued and weak companies.

Best regards,

Thomas Karlovits

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