Blackwall Capital

European Long/Short Equity

Quarterly Newsletter
Q3 2018

Blackwall Europe L/S Fund

Quarter to Date Return: 0.63%*
Year to Date Return: –0.62%*
Assets Under Management: EUR 185.8m*

Blackwall Europe L/S 1.5X Fund

Quarter to Date Return: 0.16%*
Year to Date Return: –1.40%*
Assets Under Management: EUR 18.3m*

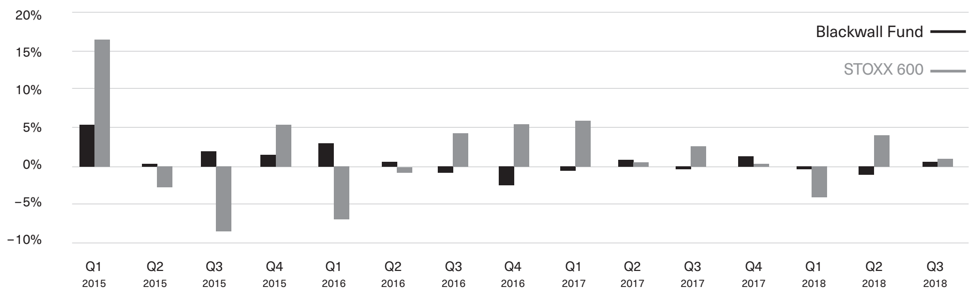
Dear Investor,

Blackwall Europe L/S Fund finished Q3 up +0.63%, and up +12.00% since inception. Annualised volatility is 4.19%. Our 1.5x fund closed the quarter up +0.16%.

European equity markets remain relatively weak compared to US markets. Across Europe equity markets are down between –5% and –7.5% year-to-date.

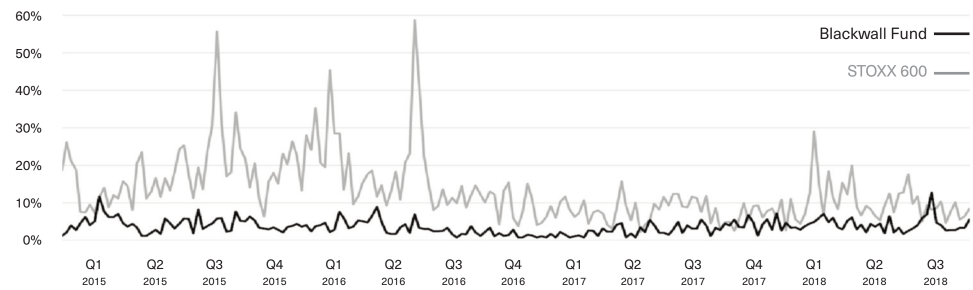
Currently, geo-political tensions and trade tariffs seem to be less of a concern to financial markets compared to the beginning of the year. With the BoJ now joining the FED in tapering (increasing to $50bn/month), and the ECB following closely after December of this year, the global net central bank liquidity will turn negative for the first time this cycle. It will be interesting to see if the equity markets upwards decoupling from fundamentals during QE can be sustained during QT.

Table 1: Quarterly Performance Stoxx 600 vs. Blackwall Fund



Source: Bloomberg, Blackwall Capital Investment AG

Table 2: Annualized Weekly Volatility Stoxx600 vs. Blackwall Fund



Source: Bloomberg, Blackwall Capital Investment AG

*Source: Northern Trust as per latest month end. The figures refer to the past. Past performance is not a guide to future performance. Performance is quoted net of fees based on unaudited figures for the current year. Performance is calculated using figures rounded to two decimal places. Performance for the Blackwall Europe L/S Fund from launch (19 December 2014) to 31 December 2014 was – 0.10%. Launch date of the Blackwall Europe L/S 1.5X Fund: 18 August 2017.

More important to us than the broad macro-economic picture is how companies are performing in terms of earnings growth, their ability to meet investor expectations and what forward guidance they are providing for the remainder of the year and for 2019.

First, to recap what we have seen year-to-date starting with Q1 2018 results, European corporate earnings beat consensus earnings estimates during Q1 by a poor 3%, with only 3% more beats (totaling 36% of all reports) than misses (totaling 33%). This was softer than the Q4 2017 comparable numbers (5% beats) and the second quarter in a row when European corporates overall failed to impress investors. For Q2 2018, the market's original hope was that corporates could shift into much higher gear, accelerate growth, and thereby surpass the market's hurdle rate, not least to make up for a lackluster Q1 2018. And indeed, the raw numbers have delivered a slight sequential improvement, but the emphasis lies on 'slight' and it has not been the case for many companies. To illustrate, Q2 2018 corporate earnings beat consensus earnings estimates by just 0.1%, with 7% more beats (totaling 37% of all reports) than misses (totaling 30%), hence, Q2 2018 earnings were merely sufficient to hold European equity indices steady, in sharp contrast to the US market. This caused the failure of European markets to rebound towards the earlier 2018 highs that some were expecting.

Digging a bit deeper, we recognized that increasingly small- and medium-sized companies share prices, mainly from the cyclicals sectors, have already peaked, with the number of those having difficulty to meet expectations or outrightly missing, strongly on the rise. More recently, this 'profit warning disease' has been spreading to large caps, for example Continental and BMW in Germany. The explanation for the difficulties is typically a mix of homemade issues, industry challenges, and market or economic issues. However, no matter what mix has been the root cause, the reaction by investors confirms that investor expectations have become very demanding. Investors have severely punished those stocks that have missed. Consequently, the number of stocks priced 20% and more below their January 2018 peak has significantly increased throughout the past few months.

It is remarkable to us that despite the accelerating number of stocks breaking down, broad European indices are still holding up fairly well. We believe this reflects the passive investing phenomena into ETFs rather than investments based on company fundamentals. This represents a real danger to the market going forward because it is resting on fewer and fewer shoulders, which has resulted in a period of negative performance.

Looking forward, we are more than convinced that a dangerous divergence has developed: in recent weeks, consensus earnings estimates for corporate Europe have come down a bit, but not reflecting much more than the shortfall of H1 2018 results relative to the required run rate for the year. As a result, expectations for H2 2018 earnings growth have remained largely untouched, requiring a substantial acceleration in YoY% growth relative to H1 2018. From our perspective, that appears unrealistic given a material slowdown of economic growth in the emerging world, dominated by China, and this summer's collapse in emerging market currencies. Hence, we are afraid the QoQ trend of recent reporting seasons – less and less beats, more and more misses – will only be further reinforced by the economic reality. Subsequently, the number of corporates forced to abandon their FY2018 guidance and to lower expectations going forward should also surge as we progress through Q4.

What is even more concerning is the outlook for 2019. We fear that consensus earnings expectations, on average, are based on 'extrapolation'. The market is simply projecting 2019 corporate revenues up approximately 4-5% YoY and next year's earnings up c. 6-10% YoY, on average. In our opinion, such expectations reflect wishful thinking and will prove far from reality. With recessions in several emerging countries, China on the brakes, and US growth likely to lose steam amid evaporating benefits from tax reform and fiscal spending, overall economic growth in 2019 will fall clearly short of this year's level. On top of that, we fear US interest rate hikes, incremental tariffs on trade, lower levels of global trade, elevated debt levels as well as adverse FX cross rates will likely play out only with delay, hitting 2019 economic growth much more than 2018.

Against this background, we anticipate that Q1 2019, possibly after a typical short-lived year-end rebound, will prove particularly difficult. At that stage, corporate managements will provide market participants with their full-year 2019 guidance. We are convinced, that guidance will be well short of current market projections because corporate managers will try to prevent another miss and therefore convey a conservative outlook with an above average safety cushion built in.

Under such circumstances, we have endeavored to make our portfolio ‘weatherproof’ and will adhere in the coming months to our promise to protect investor capital.

A consolidated portfolio view

For better transparency, we consolidate our portfolio holdings on the long side – as well as on the short side – into a notional combined entity allowing us to better illustrate to investors the economics of an average company in the portfolio. Our ‘average company’ looks like the following:

Table 3: Blackwall ‘average company’ portfolio example

Long Investments:
Typical Company Economics

Financials* (EUR m)	2017	2018E[1]	2019E[1]	2020E[1]
Sales	3,638	3,648	3,772	3,976
Gross Profit	2,026	2,039	2,118	2,246
EBIT	911	983	1,045	1,134
Net Income	470	512	583	644
FCF	557	598	660	747
Net Financial Debt	190	−778	210	122

Valuation Ratios*	2017	2018E[1]	2019E[1]	2020E[1]
P/E	26.4	24.1	23.5	19.2
P/BV	3.4	3.7	3.5	3.3
EV/EBIT	18.6	20.6	18.0	14.7
Net Debt/EBITDA	0.1	−0.5	0.1	0.1
Dividend Yield	2.4%	2.6%	2.7%	2.9%
ROE	10.7%	12.3%	14.6%	16.5%
ROCE	6.6%	10.5%	12.2%	14.6%

Short Investments:
Typical Company Economics

Financials* (EUR m)	2017	2018E[1]	2019E[1]	2020E[1]
Sales	8,383	8,393	8,440	8,546
Gross Profit	2,212	2,211	2,055	2,086
EBIT	910	944	830	773
Net Income	666	654	571	450
FCF	263	477	286	277
Net Financial Debt	3,142	3,063	3,232	3,289

Valuation Ratios*	2017	2018E[1]	2019E[1]	2020E[1]
P/E	23.8	20.3	20.2	25.6
P/BV	4.7	3.9	3.5	3.2
EV/EBIT	18.6	16.8	17.3	18.6
Net Debt/EBITDA	2.3	2.3	2.9	3.7
Dividend Yield	2.2%	2.6%	2.8%	2.5%
ROE	14.2%	12.8%	11.5%	10.1%
ROCE	9.4%	9.2%	9.1%	8.8%

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

Our investment philosophy is to go long great companies at attractive valuations, with mid caps being our sweet spot, and to short weak and overvalued companies, preferably in the large cap area. The difference in size of the companies on either side, is well underpinned by the average revenues and other fundamental data provided in the tables above. However, there are significant differences when it comes down to margins, EBIT growth, leverage, and valuation:

Margins: Among others, a great business is characterized by high margins growing over time, while commoditized/cyclical businesses are only showing reasonable margins towards the peak of the cycle. On average, for 2018, our long companies have a gross margin of 56%, an EBIT margin of 27% and a FCF margin of 16%, all likely to grow in the years ahead. In comparison, the average short company shows 26%, 11% and 6% respectively – and likely to decline further in the years ahead.

EBIT growth: We expect the average long company to grow EBIT in the magnitude of 6-8% p.a. in 2018E and 2019E. Some of our key holdings show profiles of growth accelerating in the years ahead, benefiting from multi-year restructuring programs and/or structural growth drivers. On the contrary, the average short company is likely to face a collapse of growth rates in 2018E (+4%) and 2019E (−12%) respectively.

Leverage: Most of our long companies are operating with low net debt positions or net cash positions, thus posting an average net cash/EBITDA of about 0.5x. At times of potentially rising interest rates, this might provide strategic optionality while others are constraint. In comparison, the average company on the short side is posting a net debt/EBITDA of 2.3x.

Valuation: In terms of valuation, we use various metrics, with our preferred ratio being EV/EBIT. On average our long portfolio trades at 20.6x for 2018E and 18.0x for 2018E. This is above the level of our short companies (16.8x and 17.3x respectively). However, short companies are likely at cyclical peak and their earnings are likely to decline in the years ahead as illustrated in the 2020E forecasts.

In summary we argue, the companies we invested on the long side are of substantially higher quality, more attractively valued due to a much higher growth profile and with lower leverage than the ones on the short side.

Best regards,

Thomas Karlovits

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