TRIUM BLACKWALL EUROPE L/S FUND

EUROPEAN LONG/SHORT EQUITY

QUARTERLY NEWSLETTER

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"WE LOVE REGULATION AND ETFS!" – PART I

A few weeks ago, we were invited, as one of the top "Newcomers of the Year", to present our investment strategy at a big European alternative investment event. Having spent 25 years in research, most recently heading the largest European equity research team, it's quite a long time anybody called me a "newcomer". But certainly for the fund we are advising it holds true, and as such we were delighted to present at the conference.

Here was our opening line:

"We love regulation and ETFs! Regulation IS the ultimate destroyer of efficient markets and ETFs will be the FUTURE graveyard of investors ..."

Instantly we had the audience's attention. Nothing raises the temperature these days in the investment world more than debates on the merits of ETFs versus stock selection and the burden of regulation. In our view it is never the intended consequences that investment professionals should look at, rather the unintended consequences. It's these distortions of the equity investment landscape that get us excited and especially how we can use them to benefit our investors.

The aim of these quarterly newsletters is to provide you with an insight into our investment approach in a plain-speaking way. Kicking off with regulation seems to us a good starting point.

There are many facets of regulation that have an impact, for example on banks and insurance companies, but the one impact that interests us most at this point is "regulation related to equity research" – after all, this is a long/short European equity fund.

A brief history of equity regulation

The sell-side (broker) and buy-side (asset manager) research relationship has its roots in the Securities and Exchange Act (1934), the Investment Advisor Act (1940) and the Investment Companies Act (1940) – all US. In particular, the widely quoted "Safe Harbor" provision of these statutes meant asset managers would not be in breach of their fiduciary obligation to clients if they used equity trading commissions to purchase both brokerage services (execution) and research. The modern "sell-side buy-side" relationship was born out of this concept.

We'll spare you the regulatory episode related to (dis-)integrated investment banking models and focus attention upon the announcement by the Financial Services Authority (FSA), CP-176 in 2003, which allowed UK asset managers to continue to use commissions to purchase brokerage and research. However, it also mandated that research and execution commissions must be split. Starting in the UK, it spread to the US (2006) and across Europe (MiFID 2007), generally known as "best execution" and triggered the development of the unbundling model (CSA, Commission Sharing Agreement).

MiFID II proposals, which will get final approval in 2015 and be implemented by 2017, conclude that full unbundling of research and execution costs must be adopted, and that external research costs shall be borne by the asset manager. Only under strict limits and full transparency can these research costs be recharged to end investors in a fund. In the run-up to MiFID II, there were several consultation papers by the European Securities and Markets Authority (ESMA) and the Financial Conduct Authority (FCA), suggesting that asset managers should no longer pay for any external research through client commissions. This would have been similar to the corporate roadshow case, whereby brokers historically enriched their service by road-showing corporates to asset managers, receiving in return commission payments. Following the FCA ruling in 2014 this is explicitly forbidden in the UK and is likely to spread over time to other countries too and, it seems, to the research industry as well.

The turkey phenomenon ...

All else equal - lower fees charged to the fund should allow investors to achieve higher returns - a quite rational conclusion. However, all else doesn't stay equal in this process and the unintended consequences are not so different from what one can describe as the "turkey phenomenon".

You know how it goes:

A turkey gets fed every day, he grows every day and life is great, until ... Thanksgiving.

While the first part has held true for about 60 years, the final episode for the sell-side buy-side research model is rather a protracted diet – for many however with the same outcome.

Competition has always been around in this industry, but with best execution and its subsequent regulatory pressures, the economic model for the sell side has changed dramatically and led to a serious consolidation. MiFID II, if adopted as the proposal reads, will intensify this process, reducing the analyst pool on the sell side dramatically – not only in numbers but even more so in talent. In our opinion this has two major consequences; (i) less coverage of small and mid cap companies and (ii) the need to upgrade buy-side research.With the remaining research houses focusing on liquid stocks, many small and mid-cap companies – representing the vast majority of European stocks – will notice a serious decline in their coverage and subsequently in liquidity. This phenomenon is likely to become a vicious circle and we don't believe sponsored research (i.e. paid for by the issuers) is going to change this trend.

We don't believe that equity markets are efficient at all times. However, if there is a pocket of efficiency, we believe it can be found in the large cap area with 30+ research houses covering a stock. Equally we assume even the sturdiest supporter of the efficient market hypothesis will agree that massively under researched companies can deviate significantly from their intrinsic value.

This is the sweet spot of our investment philosophy and thanks to regulation and its unintended consequences, our investment opportunities should grow significantly in the years ahead. In return for this, we are happily paying the price for overregulation, seeing it as an investment into future performance for our investors.

The pen is the tongue of the mind (Horace, 65 – 8 BC)

To exploit the renaissance of market inefficiency an investment process needs to be fully proprietary – from the idea generation to the final investment conclusion; from the risk analysis to the exit strategy.

In our view the "model" is equally as important to an analyst and an investment manager as the pen is for a poet in the eyes of Horace (Roman Poet and Philosopher; later on repeated by Miguel de Cervantes). Blackwall does all modelling work ourselves.

With an ideal investment horizon of 3-5 years on the long side, we clearly see our fund holdings as investments and not as short term speculative positions. So rather than describing individual investment cases and overloading you with data, we apply a different concept to help illustrate what an investor into the fund owns.

Financials	13	14	15E	16E
Sales	982	1003	1019	1067
Gross Profit	461	482	495	522
EBIT	119	142	166	193
Net Income	66	102	117	136
FCF	91	101	125	142
Net financial	212	182	95	48
Equity	822	871	926	990

(Data in EUR mio)

Valuation Ratios	13	14	15E	16E
P/E	18.4	23.5	17.2	14.5
P/BV	3.9	3.1	2.4	2.1
EV/EBIT	16.6	15.8	10.6	9.0
Net debt/	1.1	0.5	0.4	0.2
Dividend Yield	2.1%	2.0%	2.6%	2.8%
ROE	11.1%	13.7%	14.3%	14.5%
ROCE	10.4%	10.7%	13.0%	14.6%

Source: Bloomberg, Blackwall Capital Investment AG

Assuming that the fund would "consolidate" the company holdings on the long side into a combined entity, the economics of the typical pro-forma company looks as illustrated above.

So in effect, on average, investors hold a mid-sized-company with sales growing at 2-5% p.a., EBIT running at 16-17% p.a. and net profit of around 15-17% p.a. quite likely to grow at a similar rate to the 2015E and 2016E Stoxx 600 average (all consensus data from Bloomberg).

However, there are significant differences in terms of:

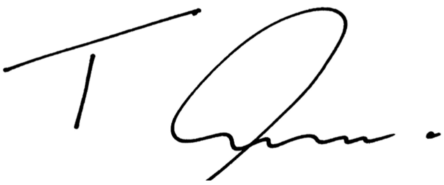
- Margins: the average gross margin is at 49%, compared to only 32% for the Stoxx 600; and the EBIT margin is at 16-18% compared to just 11-12%
- Return on Equity: the average company in the fund generates an ROE of 14-15% compared to just 8-9%
- Leverage: With 0.2-0.4x EBITDA, net debt is almost negligible (gearing of 5-10% of equity) – in fact many are net cash – compared to the Stoxx 600 net debt/EBITDA at 4.0-4.4x and a gearing of 194%. (Source Bloomberg)

In a nutshell, investors in our fund hold companies with a strong franchise (often without correlation to GDP – after all, who knows whether Europe really recovers in the years ahead) and superior margins, generating substantially higher ROEs at much lower gearing, yet still growing FCFs by 15-20% annually.

Finally, in terms of valuation – our preferred ratio, EV/EBIT, is at 10.6x for 2015E (9.0x for 2016E), substantially below the market level of 15.2x and 13.9x respectively.

We currently hold 13 stocks on the long side and we intend to grow this portfolio to a maximum of 15-20 stocks over time. If we identify a new company to enhance the current profile, we'll invest in it.

Best regards, Thomas Karlovits



Contact details

Investment Manager
Trium Investment Management LLP

60 Gresham Street, Level 4
London EC2V 7BB
Tel: +44 20 7073 9250
ir.trium-blackwall@trium-capital.com
trium-capital.com

Investment Advisor
Blackwall Capital Investment AG

Baarerstrasse 135
6301 Zug, Switzerland
Tel: +41 41 763 5181
info@blackwallcapital.com
blackwallcapital.com

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