Blackwall Capital

European Long/Short Equity

Quarterly Newsletter
Q2 2018

Blackwall Europe L/S Fund

Quarter to Date Return: –1.24%*
Year to Date Return: –1.24%*
Assets Under Management: EUR 202.4m*

Blackwall Europe L/S 1.5X Fund

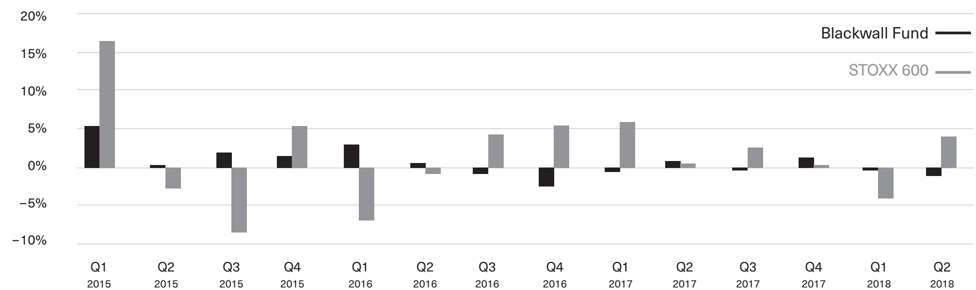
Quarter to Date Return: –1.49%*
Year to Date Return: –1.56%*
Assets Under Management: EUR22.6m*

Dear Investor,

The Blackwall Europe L/S Fund finished the quarter down –1.24% and up +11.33% since inception. Annualised volatility is 4.08%. Our 1.5x fund closed the quarter down –1.49%.

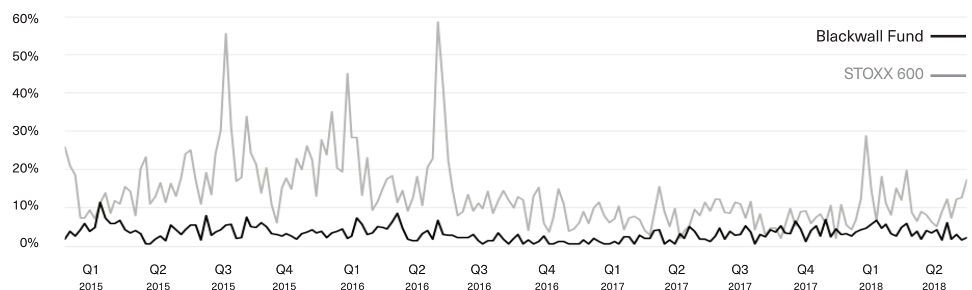
Since the inception of the Fund, equity markets have had to digest a series of disruptive events including China growth and debt concerns, Brexit, Quantitative Tapering, EUR-jitters, geo-political concerns and now trade wars. During these periods of heightened uncertainty where markets sold off for a sustained period of time, the Fund managed to achieve positive returns and protect capital – as witnessed by the very low volatility since inception.

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.

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“The temperature is going up, reaching critical levels”. No, we are not referring to summer weather conditions. We are referring to the trade war rhetoric, increasing political tensions amongst European member states, central banks QE exit plans and now the Q2 2018 corporate reporting season due to commence from mid-July.

Let’s Recap:

While the start of Q2 was more promising for equity markets, perhaps due to a coordinated short squeeze and/or reduced geo-political tensions between US and N. Korea. By the end of May there was little of this stock market revival noticeable. In Italy, when an “acceptable” government was formed, the next mini-crisis came into play in the form of the influx of refugees. The war of words between Germany and France on the one hand and Italy plus the Visegrad Group on the other, made us wonder whether we were back in the 1930s.

To make matters worse, and once again with a déjà-vu of the two darkest decades of the 20th century, the US government unleashed further trade tariffs on China, Japan, Canada and the EU, who, in return, responded with additional trade tariffs. The end of this global power play doesn’t seem to be in sight as the US reloads its tariff weaponry and China starts to devalue its currency.

What is also particularly remarkable is that more and more stocks are breaking down while broad indices are still holding up relatively well. This is more driven by passive investing ETF flows than by fundamentals and represents a real danger to the market going forward. Passive money is not valuation-sensitive and is therefore a dumb allocator of capital with likely severe repercussions when these passive ETFs start to sell. Who will want to buy the Russell 2000 Small Cap Index at an 88x trailing 12 months price-earnings ratio when these same passive investors wish to sell?

On top of high valuations, the ECB announced in June that it would finally stop its QE program by the end of this year. Concurrently several key ECB board members became publicly more hawkish. Even President Draghi was not concerned that the recent turmoil in Italy would have any spill-over effects. This reminds us of Chairman Bernanke who said in 2007 that subprime loans were a “contained problem”. Or a few years before Chairman Greenspan thinking that the US economy was operating at a higher level of productivity while, in reality, there was massive over investment which ended up in a deflationary bust.

With the ECB now joining the Federal Reserve by removing liquidity from the market, investors are becoming more cautious. In the 9th year of the current credit market cycle, rising credit spreads are indicating we are near the end of the cycle. Together with troubles appearing in emerging markets these are amongst the clearest leading indicators that the benefits of QE are finished. The first asset classes that benefitted from QE will be the first to feel the pain of its withdrawal.

In Q1 2018, European corporate earnings beat consensus earnings estimates by a meagre 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. This was despite strong, globally synchronized growth witnessed throughout the October 2017 to March 2018 timeframe. How different this is compared to the unanimously bullish expectations from European corporate leaders at the beginning of the year! Particularly weak sectors over those six months have been consumer staples (Danone, Heineken, Reckitt-Benckiser) and industrial stocks (ABB, AMS, Osram Lighting, Outokumpu, Vallourec), which all failed to deliver any material YoY top-line revenue growth. Share price reactions to Q1 2018 results were generally quite negative, with misses harshly penalized and beats only slightly rewarded.

Ahead of the upcoming mid-year reporting season which is set to start mid-July, we expect things will only get worse. In recent days, we have already had some pre-announcements warnings such as the one by Nexans whose share price dropped –16% on news of a rapid deterioration in emerging markets trading conditions. With the emerging world economies suffering from the collapse of several emerging market currencies relative to the USD, rising debt represents an increasing burden on corporate balance sheets. In general, economic activity in emerging markets

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is falling short of expectations, like for example in Brasil. Daimler is facing a combination of adverse effects from recently introduced US/China import tariffs, continuously declining consumer appetite for premium diesel vehicles, market saturation of demand in the US and Europe for high-end cars, and also reduced demand from emerging markets.

Of course, there may be company-specific elements contributing to the two examples above. However, we are convinced that these will prove the rule rather than the exception going forward and that other cyclical stocks will experience the same problems. Some companies may have a greater degree of resilience than Daimler and Nexans, but we believe the challenges for corporate profits have become so widespread that the risk/reward ratio has tremendously tilted toward heightened risk. In fact, that opinion has been implicitly confirmed by Fed-Chairman Jerome Powell who expressed concern at the June-2018 Central Bankers meeting in Portugal that deteriorating macro conditions will likely take their toll via postponements in corporate capex and hiring decisions. Hence, the incremental economic impulse has probably already shifted into reverse.

Considering disappointing “order intake” data in several industries across several jurisdictions (e.g. Korean exports, German manufacturing) we think Q2 2018 corporate results will likely confirm the trend of the two most recent quarters and point to a further slowdown. With the growth in order backlog stopped (in numerous cases even reversed), the days of tightness throughout supply chains are numbered. Consequently, corporate pricing power should have passed the peak. With input costs on the rise, YoY wage increases up amid tight labor markets, oil (+70% YoY) and other commodity prices substantially above year-ago levels, and cost of financing also up, we fear the recipe for a margin squeeze is in place. Any further slowdown in revenue growth can thus only result in a meaningful decline in earnings going forward.

Moreover, in the early part of 2018, many corporates hinted at a relatively modest start to the year. Based upon the assumption of reacceleration of growth throughout 2018, managements still felt comfortable with their full-year guidance. Investors trusted corporates to deliver on their promises and consequently bought up equities in anticipation of improvement in subsequent quarters - beyond the uninspiring Q1-2018 reporting in April/May. That optimism may be bitterly disappointed. We would not be surprised if the earnings outlook for H2 2018 started to discount the multitude of risks noted above. Given that most corporations already have very lean set-ups, we doubt there is much room to easily reduce costs. At the same time, we are concerned that a weakening of the Euro against other key trading currencies will not come to the rescue this time. With the usual time-lagged impact of Euro currency weakness feeding into competitiveness (not least due to currency hedging in place), it is unlikely to represent a noticeable factor of support before late 2018.

In light of still very high equity valuations due to investors’ excessively optimistic market positioning (e.g. US call option ownership is at previous highs like in early-2000 and late-2007 and active investors’ average cash ratio is close to historical lows) and with the “buy-the-dip”-mentality prevailing, we regard the coming summer months as full of risk for equities. Increasingly, small- and medium-sized company stocks, mainly from the cyclicals sector, have already rolled over, trading 20+% below their January-2018 peak. Consequently, as already stated above, the market rests on fewer and fewer shoulders, a phenomenon that historically has spelt trouble ahead.

Under the 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 illustration, 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 (see next page):

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Table 3: Blackwall 'average company' portfolio example

Long Investments:
Typical Company Economics

Financials* (EUR m)	2017	2018E[1]	2019E[1]	2020E[1]
Sales	3,555	3,602	3,740	3,948
Gross Profit	2,005	2,052	2,152	2,297
EBIT	917	1,021	1,105	1,190
Net Income	458	536	606	672
FCF	556	651	612	685
Net Financial Debt	250	−612	253	255

Valuation Ratios*	2017	2018E[1]	2019E[1]	2020E[1]
P/E	26.6	23.1	21.4	17.5
P/BV	3.5	3.4	3.2	3.0
EV/EBIT	18.0	18.6	15.7	13.4
Net Debt/EBITDA	0.2	−0.4	0.2	0.1
Dividend Yield	2.6%	2.8%	2.9%	3.1%
ROE	10.8%	12.4%	14.6%	16.9%
ROCE	6.6%	9.5%	11.7%	14.3%

Short Investments:
Typical Company Economics

Financials* (EUR m)	2017	2018E[1]	2019E[1]	2020E[1]
Sales	8,426	8,478	8,593	8,720
Gross Profit	2,220	2,377	2,223	2,205
EBIT	866	898	869	787
Net Income	641	639	579	489
FCF	226	572	433	369
Net Financial Debt	3,360	3,183	3,156	3,164

Valuation Ratios*	2017	2018E[1]	2019E[1]	2020E[1]
P/E	22.5	20.9	18.9	19.2
P/BV	3.1	2.7	2.4	2.1
EV/EBIT	16.6	15.5	15.2	15.7
Net Debt/EBITDA	3.1	2.8	3.1	4.3
Dividend Yield	2.2%	2.5%	2.6%	2.4%
ROE	14.1%	14.1%	12.7%	11.5%
ROCE	9.0%	9.3%	9.6%	9.3%

* 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 midcaps 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 57%, an EBIT margin of 28% and a FCF margin of 18%, all likely to grow in the years ahead. In comparison the average short company shows 28%, 11% and 7% 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 8-11% 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 (-3%) respectively.

Leverage: Most of our long companies are operating with low net debt or net cash positions, thus posting an average net cash/EBITDA of about 0.4x. 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 2.8x.

Valuation: In terms of valuation, we use various metrics, with our preferred ratio being EV/EBIT. On average our long portfolio trades at 18.6x for 2018E and 15.7x for 2019E. This is above the level of our short companies (15.5x and 15.2x respectively). However, short companies are likely at cyclical peak and their earnings are likely to decline in the years ahead.

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.

Wishing you the best to enjoy the summer's heat.

Thomas Karlovits

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