Blackwall Capital

European Long/Short Equity

Quarterly Newsletter
Q3 2017

Blackwall Europe L/S Fund

Quarter to Date Return: 0.18%*
Year to Date Return: 0.73%*
Assets Under Management: EUR 214.7m*

Blackwall Europe L/S 1.5X Fund

Quarter to Date Return: 0.08%*
Year to Date Return: 0.08%*
Assets Under Management: EUR22.5m*

Dear Investor,

During the last quarter Blackwall established a few more milestones; in August we launched our second fund based on investor demand for a leveraged version of our flagship fund. The fund will apply a similar strategy to the original one but with a leverage of 1.5 and will be available also on the Trium UCITS platform. The leveraged fund will be more suitable for investors who wish a more enhanced exposure approach compared to the low-volatility current fund (i.e. less than 4%).

On a company level, we were pleased to announce that Gino Landuyt has joined us as of September 1st. Prior to joining Blackwall Capital, Gino was already closely involved with the build-up of our fund at Trium Capital where he was a managing director for 5 years. Before that he worked at an alternative asset boutique, Luxembourg Financial Group, where he focused on the selection and screening of hedge fund managers. Prior to that Gino held several asset management and investment banking positions at EAB, ING and KBC Bank where he acquired a multi-asset class expertise in various fields such as FX, Fixed Income, (structured) credit, derivative structuring and hedge funds. At Blackwall, Gino will be focusing on the trade execution of the funds and also streamlining the distribution efforts of the firm.

After obtaining the FINMA licence and approval from the Central Bank of Ireland, the Fund was rebranded "Blackwall Europe L/S Fund".

Finally, for the second year in a row we have won the Sauren Golden Award in the category of Equity European Long/Short.

Market comment

We are no enthusiasts of quarterly company reporting as it generally creates much noise and offers many market participants an excuse for focusing on short-termism instead of working on in-depth research. Occasionally however, reporting seasons add insight into the health of equity markets and we believe Q3 2017 might have been such a period. Across the board, European companies reporting in line with expectations but missing on a further increase of guidance were faced with share price declines of 5% or more. Outright misses sometimes resulted in a loss of 10% or more in the day! The combination of high earnings expectations and high valuation levels has always been fertile ground for disappointments, and Q2 results were no exception. This does not mean that markets can't "kick the can further down the road", but the behavior is typical for the start of a cycle turning. If lowered expectations are being missed again, it would strongly suggest that markets are turning decisively.

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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It’s tough being a company

We recently enjoyed reading an interesting book, called “Scale” by author Geoffrey West. The Harvard historian Niall Ferguson sees West as one of the most brilliant independent thinker of our time, and I suppose readers of the book will understandably agree. Among the various concepts he brings as a physician to biology and the science of cities, he also applies it to companies.

A crucial aspect of the scaling of companies is that many of their key metrics scale sub-linearly like organisms rather than super-linearly like cities. This has profound implications suggesting i) that size and economies of scale have their limits and ii) that companies also eventually stop growing and ultimately die.

On the later aspect, the half-life of US publicly traded companies seems to be about 10.5 years, meaning that half of all companies that began trading in any year since the 1950s have disappeared in 10.5 years. The majority of them obviously disappear through M&A (recognizing that a high proportion of M&A results in value destruction is no comfort), while others simply go extinct. Richard Foster underpins this point in his research on S&P membership in which he points out that in 1958 a company could expect to stay in the S&P 500 index for about 61 years, whereas today it is more like 18 years. From the Fortune 500 list of companies in 1955, only 61 were still on the list in 2014. That’s a survival rate of only 12%, the other 88% having gone bankrupt, merged or fallen from the list because of underperformance.

Here is an extract from Howard Marks’ latest newsletter, quoting from a company’s 1997 letter to shareholders:

“We established long-term relationships with many important strategic partners, including America Online, Yahoo!, Excite, Netscape, GeoCities, AltaVista, @Home, and Prodigy.

How many of these “important strategic partners” still exist in a meaningful way today (leaving aside the question of whether they’re important or strategic)? The answer is zero (unless you believe Yahoo! satisfies the criteria; in which case our answer is one). The source of the citation is Amazon’s 1997 annual report, and the bottom line is that the future is unpredictable, and nothing and no company is immune to glitches.”

Bear in mind, that all this data is based on the past 60 years, the longest and fasted growing period of wealth creation. The speed of decay is likely to accelerate in the years ahead with disruptive technologies progressing at an ever-increasing speed. It’s tough being a company!

As highlighted in our previous newsletter, equity markets are trading at elevated levels. In the US the cyclically adjusted Shiller PE stands at 32x (only exceeded in 2000). Other ratios like Price/Sales or Price/Assets are pointing to similar extremes. As for Europe, headline ratios are lower and somewhere closer to 20-24x, but adjusted for sectorial biases, getting quite close to US levels.

Central bank policies led to extremely low interest rates, which in return triggered investors to bid up all asset classes in a never-ending chase for yield. While properties might still exist in 32 years from now (though we can’t judge the future asset taxes on it) – on the back of the research outlined above – the majority of companies today are in fact quite unlikely to exist over the long-term horizon. We believe that this is a very important aspect of risk, which is not reflected in today’s equity prices, but is an inherent component of our investment process.

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A brief recap on Panalpina

One of our key investment holdings, Swiss freight forwarder Panalpina, experienced a true roller-coaster ride throughout this past quarter. Heading into Q2 2017 results in July, the shares performed poorly for the following reason; the company simply could not take advantage of strong market demand and therefore was unable to grow its top line at the same rate as its main peers. Panalpina also underdelivered in terms of margin progression. While earnings improved QoQ, volatility in rates and the still missing benefit of its IT restructuring led to a further decline YoY. Consequently, Panalpina shares were punished and pushed down to levels not much above their low for the year.

However, progress in implementing the new SAP-based IT in Germany (the transition is taking place smoothly), and the preparation of the IT handover in the important US market signaled the first light at the end of the tunnel. That progress made management confident in accelerating its strategy to expand the company's small "perishables segment" by further bolt-on acquisitions in Kenia, the Netherlands, and Germany. With market demand for freight forwarding services continuously strong and Panalpina's stronghold air freight growing at approximately 10% YoY, investors started to regain trust in Panalpina's imminent turnaround.

This, in combination with increasingly explicit ambitions of market leaders Kuehne&Nagel and DSV to further consolidate the market by way of accelerating M&A (with Panalpina being the most obvious and attractive target) caused the shares to reverse and enter a new uptrend which brought them back to the highs of the year by the end of Q3 2017. In our opinion, that should only be the beginning: we expect Panalpina's fundamentals to improve very substantially in coming quarters, beginning to narrow the performance gap relative to best-in-class peers. In addition, the speculation on M&A within the freight forwarding sector is there to stay and Panalpina is the bride to get.

Adidas – our biggest mistake

In recent newsletters we introduced some of our high conviction long ideas. This time we would like to highlight our single biggest mistake on record, our short position in Adidas.

In Q2 2015, we initiated a short position in Adidas based on the following analysis:

Globally, sporting goods were growing in line with global GDP over the past 10 years. Within the segment, athletic goods have been doing slightly better, with both Adidas and Nike gaining market share against their smaller peers. This basic trend was likely to continue, temporarily even strengthened by big sport events like the Olympics and the European Football Tournament in 2016 - although there had been potential risks related to such mega-events on the back of recent terrorist attacks. In addition, Adidas launched some new products, but in general the brand kept lagging Nike, reflected in relatively lower pricing (about 20% cheaper than Nike) and lower scores in brand surveys across the board. Overall, Nike had outgrown Adidas in 13 out of the past 16 quarters.

However, following a difficult period in 2014 (i.e. in Russia), Adidas reaccelerated growth throughout 2015, allowing the stock to rerate substantially. Thus, its valuation arrived at a point where it seemed to be very high, both in terms of its own history as well as compared to peers, notably Nike. In particular, the latter seemed not justified given the consistently widening gap in between the two based on ROCE over the past 10 years. Finally, on a very long-term view, we have been convinced 3D-printing would disrupt the sports shoe industry with lot-sizes of one becoming the norm. Although Adidas is on the forefront of this technology, over time we may all become designers of our own shoes manufactured by outsourcing providers and not necessarily current brands such as Adidas.

Based on this thesis, we calculated a fair value of about EUR50 per Adidas share, which was about 30% below the share price at time of initiating the position.

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However, Adidas shares have proven us wrong; Adidas kept on gaining market share at an accelerating pace, not least thanks to several of its new product launches becoming big hits, and the brand regaining its "cool" again. Our thesis at that time was that Nike and Under Armour (UA) would quickly strike back was also a false assumption, despite both of them being run by "fanatics". The performance of Adidas shares moving higher and higher kept working against us. Our subsequent hope was that the upcoming management change with retiring long-time CEO Hainer passing the helm on to new CEO Rorsted would be a catalyst to stop Adidas' ascent. The view was: new CEO Rorsted had a strong reputation for cost cutting but not for brand-building, and the latter is what we thought Adidas would need. The market has proven us wrong again, taking the conclusion that CEO Rorsted would successfully combine both cost savings and solid brand building.

Throughout Q3 2016, Adidas shares took a breather and corrected from a peak of EUR160 to EUR135. At that time, we gave up on our Short position, headed for the exit and concluded our thesis had just been wrong from the beginning. By then Nike and UA were still not finding a recipe against Adidas' astonishingly strong momentum and we saw increasing odds that CEO Rorsted would get plenty of credit by investors, thereby igniting a further step in Adidas shares' re-rating. With Adidas shares almost worth EUR200 a piece today, we realize our losses could have become even worse. In total, our mis-judgment in being short Adidas cost us a –2.4% negative contribution: far more than any other short position. We subsequently made a risk management decision to cut losses more quickly. Hence, ever since, no one investment lost more than 1.1% for the Blackwall portfolio.

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 1: Blackwall 'average company' portfolio example

Long Investments:
Typical Company Economics

Financials* (EUR m)	2015	2016	2017E[1]	2018E[1]
Sales	6,240	6,411	6,632	6,937
Gross Profit	3,108	3,210	3,391	3,579
EBIT	1,117	1,043	1,290	1,426
Net Income	804	677	793	904
FCF	793	649	740	832
Net Financial Debt	1,916	1,555	1,416	1,281

Valuation Ratios*	2015	2016	2017E[1]	2018E[1]
P/E	29.2	26.6	18.7	17.2
P/BV	3.5	2.1	2.4	2.2
EV/EBIT	19.0	16.4	13.5	11.7
Net Debt/EBITDA	0.8	0.6	0.5	0.4
Dividend Yield	2.1%	2.1%	2.0%	2.2%
ROE	16.5	14.8	18.4	20.7
ROCE	12.6	11.4	15.3	17.2

Short Investments:
Typical Company Economics

Financials* (EUR m)	2015	2016	2017E[1]	2018E[1]
Sales	23,578	24,447	26,027	25,905
Gross Profit	5,920	5,705	6,600	6,207
EBIT	1,259	1,400	1,890	1,778
Net Income	1,347	1,350	1,473	1,249
FCF	67	258	1,112	836
Net Financial Debt	7,086	7,127	7,012	6,744

Valuation Ratios*	2015	2016	2017E[1]	2018E[1]
P/E	29.7	21.7	18.4	18.5
P/BV	4.1	4.1	3.6	3.6
EV/EBIT	17.2	16.7	16.2	15.7
Net Debt/EBITDA	1.5	1.4	1.2	1.1
Dividend Yield	2.7%	3.1%	3.2%	3.4%
ROE	18.8	20.9	26.7	25.2
ROCE	12.8	13.6	16.0	16.9

* 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

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differences when it comes down to EBIT growth, leverage, and valuation:

EBIT growth: We expect the average long company to grow EBIT in the magnitude of 11-24% p.a. in 2017E and 2018E. Furthermore, 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. Although the average short company seems to grow at a similar rate in 2017E, we expect growth rates to collapse towards the zero/negative level in 2018E.

Leverage: Most of our long companies are operating with low net debt positions (some are net cash), thus posting an average net debt/EBITDA of just 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 1.2x, although this is still well below the market average of 3.4x.

Valuation: In terms of valuation, we use various metrics, with our preferred ratio being EV/EBIT. On average our long portfolio trades at 13.5x for 2017E, with the short portfolio trading at 16.2x. Given stronger growth expectations going forward, the spread increases further with longs trading at 11.7x for 2018E and shorts at 15.7x for 2018E.

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

Best regards,

Thomas Karlovits

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Blackwall Capital Investment AG, Gubelstrasse 24, 6300 Zug, Switzerland

Tel: +41 41 555 1111
info@blackwallcapital.com
www.blackwallcapital.com

Trium Capital LLP, 60 Gresham Street, Level 4, London EC2V 7BB, U.K.

Tel: +44 20 7073 9250
ir.trium-blackwall@trium-capital.com
www.trium-ucits.com/blackwall