Blackwall Capital

European Long/Short Equity

Quarterly Newsletter
Q1 2018

Blackwall Europe L/S Fund

Quarter to Date Return: 0.00%*
Year to Date Return: 0.00%*
Assets Under Management: EUR 220.7m*

Blackwall Europe L/S 1.5X Fund

Quarter to Date Return: –0.07%*
Year to Date Return: –0.07%*
Assets Under Management: EUR 22.9m*

Dear Investor,

The Blackwall Europe L/S Fund finished the quarter at 0.00% and 12.70% since inception. Annualised volatility was just 4.11%. Our 1.5X Fund, launched in summer 2017, closed the quarter –0.07%.

Until the last week of January, markets looked like continuing their path of the year before, featured by low interest rates and low volatility combined with ever growing equity valuations. There was a rather blind belief that US tax reforms were as strong a tool as previous QE measures, which could drive equity markets to further all time highs.

Over the last two months there were several factors which came into the spotlight and made investors, at least for the time being, more cautious. The trading environment turned from buy-the-dips (to the extent there were dips) to sell-the-rallies. The most important of these factors were:

- A new, more hawkish FED chairman
- Tech stocks, which have been contributing substantially to the latest bull market, coming under pressure from several angles (Facebook's data abuse, Uber's autonomous driving issues, Amazon's dominance)
- Trump's first steps towards unleashing a global trade war
- Increased credit risk reflected in both Libor-OIS and TED-spreads.

Whether the bull market has come to an end remains to be seen, but some cracks have surfaced and caused a higher volatility environment.

The optimized bull market

Being a father of two teenagers made me listen to the songs of Taylor Swift. The recent equity bull market brings to mind one of her lines: "Darling, I'm a nightmare, dressed like a daydream".

We have already written at length in previous newsletters about high valuations and assets being priced across all asset classes to perfection - on the basis of artificially low interest rates. However, record high multiples are only part of the story.

The other part, which may prove at least as important going forward, is likely to be the questionable quality of earnings on which all valuation metrics are based. The increase in corporate earnings over recent years, basically throughout the economic up-cycle following the global financial crisis, has been financially engineered to a significant degree. According to our own findings, up to 60% of European corporates were able to expand their operating margins throughout the past decade. However, the lion's share of efficiency gains has come from cost optimization as opposed to growth driven economies-of-scale. What makes matters even more questionable regarding the

*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.

sustainability of that trend is the stable-to-falling capex-to-sales ratio. We conclude that roughly 30% of corporates' management has squeezed operations on both sides, cutting opex (lower R&D as well as SG&A spending) and capex (capacity upgrades, capacity expansion, etc.). The result is a highly optimized corporate landscape with very little flesh on the bones and not much left in reserve to meet continuously increasing investor expectations. Thus, the recipe for disappointment is apparent and the recent reporting periods have proven that the number of corporates unable to deliver against high expectations is on the rise. From our vantage point, that observation represents only the beginning and any deceleration of global economic growth will inevitably result in an avalanche of further shortfalls versus expectations.

Another source of risk comes from financing; particularly in the US, but also in corporate Europe. Corporate management has applied the tool of share repurchases to fuel earnings-per-share growth, triggering favorable share price development. Academic research has repeatedly confirmed, share buy-backs are an effective means to boost the value of shares, and we do not want to argue against this practice. However, share buy-backs are only appropriate if the shares are being bought back at prices below their intrinsic value (which becomes increasingly difficult amid recent asset price inflation). It appears to us that many of the companies who took advantage of QE-induced cheap debt financing in recent years did so at inappropriately high valuations. Those corporates are now left with net debt well in excess prudent levels. This is evidenced by US corporate debt reaching new all-time highs at 45% of GDP. Even though the comparable ratio in Europe stands below that level, balance sheets on the Old Continent appear as stretched as in the new world, with very little cushion left. For the time being corporate default rates are still hovering close to record lows but for how long? We fear the divergence between record high corporate debt and record low default rates is temporary and unsustainable. In fact, the first signs of a potential reversal may already have become visible: corporate bonds have performed poorly year-to-date, credit funds are facing outflows, and smart management has begun to prepare for much tighter access to capital.

A good example of what could happen to seemingly stable businesses when financial engineering is overamplified is the UK funeral company Dignity. The company optimized earnings with a combination of M&A deals and debt financed buy backs, boosting net debt by 110% since 2007. As long as earnings grew in a similar pattern there seemed nothing amiss. But looking more closely one could see top line revenues were mostly driven by price increases and when competition increased, the company was forced to substantially lower prices in early 2018. A supposedly reasonable 4x net debt/EBITDA multiple turned into a whopping 6-7x net debt/EBITDA literally overnight, limiting M&A and any future operational flexibility. We were investors in Dignity from day one of the Fund but sold out close to the share price top in Q4 2017 on the very first signs of growing competition. The subsequent derating of the stock by -70% is a strong reminder of what can happen when financial engineering is overplayed even with one of the most stable business models one can imagine.

Finally, another topic has started to gain increasing traction: the unequal distribution of income and wealth has likely reached its limits. The compensation of management relative to employees has surged to a multiple (on average) of 140x in the US with some companies standing above 1000x. Over the past five decades that pay gap has widened by a factor of 10x. Due to increasing transparency, the consequence has been a public outcry and eager politicians have entered the fray. Moreover, throughout the past decades there has been a steady decline in the share of labour relative to the share of capital in relation to income. Here also, the trend appears unsustainable (though robotics and AI will continue to support it), not least because it is seen to prevent the young generation from building a better quality of life by accumulating income from labour. In the US, the backlash of labour has already found political support (and not only by voters for President Trump): Senator Cory Booker, for instance, has brought up the Worker Dividend Act, a law proposal that requires corporates to provide the same amount of funds they spend on share buy-backs also for staff bonuses or alternatively earmark 50% of all profits beyond USD250m for employee bonuses. While Senator Booker's Worker Dividend Act is unlikely to be signed into law by the current government, it represents a clear signal. The public and politics will not tolerate any prolongation of recent trends. Corporates will no longer be allowed to be a tool to boost the compensation and grow the wealth of the top 1% or top 10%. They will be forced to also serve the bottom 90% of society so those people too will receive a share of the wealth creation.

Some tailwinds we have enjoyed in the recent bull market might very well turn into headwinds in the years ahead.

Before we turn to the consolidated portfolio view, we are proud to announce, in March we received an award at the UCITS Hedge Awards 2018 as the Best Performing Equity Market Neutral (Europe) Mid Cap Specialist over a 3 year period.

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:

Table 1: Blackwall 'average company' portfolio example

Long Investments:
Typical Company Economics

Financials* (EUR m)	2017	2018E[1]	2019E[1]	2020E[1]
Sales	5,360	5,378	5,605	5,924
Gross Profit	2,950	2,989	3,146	3,384
EBIT	1,106	1,323	1,433	1,577
Net Income	698	803	888	991
FCF	765	890	958	1,089
Net Financial Debt	884	972	597	855

Valuation Ratios*	2017	2018E[1]	2019E[1]	2020E[1]
P/E	26.0	20.6	19.7	16.1
P/BV	4.1	3.9	3.6	3.3
EV/EBIT	17.9	17.1	14.8	12.9
Net Debt/EBITDA	0.5	0.5	0.3	0.4
Dividend Yield	2.1%	2.7%	3.0%	3.3%
ROE	11.7%	15.7%	18.1%	20.7%
ROCE	6.4%	11.9%	14.6%	17.8%

Short Investments:
Typical Company Economics

Financials* (EUR m)	2017	2018E[1]	2019E[1]	2020E[1]
Sales	11,000	11,544	11,692	11,681
Gross Profit	2,729	2,913	2,850	2,627
EBIT	1,019	1,095	1,041	921
Net Income	757	753	691	559
FCF	355	613	518	376
Net Financial Debt	3,378	3,182	3,261	3,223

Valuation Ratios*	2017	2018E[1]	2019E[1]	2020E[1]
P/E	13.9	12.7	13.3	14.8
P/BV	2.7	2.3	2.1	1.9
EV/EBIT	11.7	10.9	11.5	11.7
Net Debt/EBITDA	2.6	2.4	2.7	3.6
Dividend Yield	2.8%	2.7%	2.9%	2.8%
ROE	17.2%	18.0%	15.5%	13.6%
ROCE	9.4%	10.5%	10.3%	9.4%

* 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 commoditised/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 25% and a FCF margin of 17%, all likely to grow in the years ahead. In comparison the average short company shows 25%, 10% and 5% 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 8-20% 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 (+8%) and 2019E (-5%) respectively.

Leverage: Most of our long companies are operating with low net debt positions (some hold net cash), thus posting an average net debt/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 2.4x.

Valuation: In terms of valuation, we use various metrics, with our preferred ratio being EV/EBIT. On average our long portfolio trades at 17.1x for 2018E and 14.8x for 2019E. This is above the level of our short companies (10.9x and 11.5x 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.

Best regards,

Thomas Karlovits

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