TRIUM BLACKWALL EUROPE L/S FUND

EUROPEAN LONG/SHORT EQUITY

Q3 2015 NEWSLETTER

QUARTER: 2.08% YTD: 7.91%*

HOW WE SELECT STOCKS

With a large variety of investment and trading styles out there, it's no surprise that the most common question from investors is how we select stocks.

In order to provide some context for our answer we would like to highlight a couple of basics:

First and foremost, we are proponents of a value-based research and investment process. Within this group we are not looking for deep value or turnaround stocks, but rather for good companies at a good price.

Second, we like to short single stocks.

Third, irrespective of long or short, we believe there are two principal routes one can take; selecting stocks to either maximize return or minimize risk. Although our preferred choice is always the latter, this doesn't mean we must compromise on return. It's a matter of which principle we use as a starting perspective.

Everything should be made as simple as possible, but not simpler
- Albert Einstein

Our universe is Western European companies. We split this universe into 3 distinct categories:

- Companies we don't understand
- Great companies that constitute our long portfolio
- Weak companies that constitute our short portfolio

The number of companies we don't understand is significantly bigger than the other two categories combined. In our view it includes mostly companies where (i) the CFO is (at best) the only person who knows what really goes on financially, and/or (ii) the business model is too complex to understand. This basket includes banks, insurance companies, construction companies etc. Our conclusion on such companies is very straightforward; don't touch either on the long or on the short side.

Great companies are rare. Great companies at good prices even more so. However, this is the breed of companies which we like to include on our long side of the portfolio. The defining factor is the existence of a sustainable competitive advantage, which goes hand in hand with superior margins. We believe that such an advantage must be rigorously tested – in particular in the light of the many disruptive technologies that are out there and ready to change entire industries in the years to come (e.g. 3D-printing, autonomous driving, big data, virtual reality). Only after passing this process, are we ready to model reasonable growth elements and discount it by a cost of capital of 10% - applying an additional margin of safety afterwards. We don't consider bond markets as a reference, nor do we believe in optimum capital structures for companies, but rather prefer our own 12-15% return target for the Fund as a guide. Prices below such an intrinsic valuation have a fair chance of compounding exceptional returns over our typical investment horizon of 3-5 years.

Weak companies are plentiful. And structurally weak companies will grow in numbers over the years due to the disruptive technologies aforementioned. Essentially they are the opposite of great companies; missing a competitive advantage (or are about to lose one), often combined with high financial leverage and cyclicality. Due to their latter quality, some investors like to buy these stocks at their (supposed) lows, aiming for an exit at higher levels. We do not want to "play" the upside part of the cycle. We only care about the downside potential such stocks provide - once they reach a point of significant overvaluation. In our experience, weak companies tend to surprise negatively and we prefer such news to work in our favour. Given the different risk-return profile of longs and shorts, our short selection of stocks focuses on (i) large cap companies or upper mid cap stocks, (ii) an investment horizon of less than 2 years and (iii) a maximum single position size of half of the equivalent on the long side.

The resulting portfolio is very simple, strictly differentiating long and short characteristics and never crossing over (i.e. a short idea doesn't become a long candidate after its close). Furthermore, we don't speculate on M&A on our long side nor on bankruptcies on our short side – they come from time to time, but are rarely, if ever, predictable. In terms of instruments we use cash equities and CFD's (replicating the underlying for shorts) – but no options or futures.

We believe that the clean separation of the long and short side and the extensive use of the "no-clue" basket not only increases the return of the portfolio but also significantly reduces the risks that comes with each and every investment.

Portfolio structure

The intensifying market decline in Q3 and subsequent losses on the long side were more than compensated by our short book. In total the fund added +2.1% of performance in Q3 to an YTD total of +7.9%. As we believe the economics of our stocks selected in the long book are solid, we now benefit from more attractive valuations and potentially higher upside.

As outlined concept wise in the March 2015 Newsletter, we "consolidate" the company holdings on the long side into a "combined entity" allowing us to illustrate the economics of a typical company in the portfolio.

*Source: Trium. The figures refer to the past. Performance is quoted net of fees based on unaudited figures. Performance from launch (22 December 2014) to 31 December 2014 was -0.10%.
Inception date: 22 December 2014.

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Typical Company Economics

Financials*	13	14	15E	16E
Sales	3784	3831	4111	4302
Gross Profit	1906	1945	2063	2182
EBIT	689	680	803	870
Net Income	473	477	549	602
FCF	332	357	474	519
Net Financial Debt	1649	1833	1301	1063
Shareholder Equity	2559	2745	3141	3477
Capital Employed	4703	5192	5200	5377

(Data in EUR m)

Valuation Ratios*	13	14	15E	16E
P/E	18.0	20.9	17.1	14.9
P/BV	2.7	2.7	2.6	2.4
EV/EBIT	11.5	17.7	12.6	11.0
Net debt/EBITDA	1.2	1.4	0.9	0.6
Dividend Yield	3.6%	2.8%	3.0%	3.3%
ROE	26.9%	24.0%	30.1%	30.5%
ROCE	22.7%	19.1%	20.2%	22.2%

Source: Bloomberg, Blackwall Capital Investment AG

On average, investors hold a mid-sized company with sales growing around 5-7% annually, EBIT compounding between 8-18% annually and net profit growing about 10-15%. On all 3 categories we believe the mid-term growth rates are more likely on the lower end of the range, which still implies a healthy 10-11% on EBIT and net profit. These growth rates are similar to the consensus estimates for the Stoxx 600 (all consensus data from Bloomberg).

However, we strongly believe there are significant differences in terms of

- Margins: the average gross margin is at 50%, compared to only 29% for the Stoxx 600; and the EBIT margin is at 20% compared to just 9% for the market.
- Return on Equity: the average company in the Fund generates an ROE of about 30% compared to a market average of only 9%.
- Leverage: With 0.6-0.9x EBITDA, net debt remains low – compared to the Stoxx 600 net debt/EBITDA at 4.0-4.3x.

Overall, investors in our Fund hold companies with a strong franchise and superior margins, generating substantially higher ROEs at much lower debt levels.

Equity market declines in Q3 lowered valuations across the board. In terms of valuation, our long positions display an EV/EBIT at 12.6x for 2015E (11.0x for 2016E) – this is still below the market average of 15.4x and 14.1x respectively.

Best regards, Thomas Karlovits

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