Blackwall Capital

European Long/Short Equity

Quarterly Newsletter
Q4 2017

Blackwall Europe L/S Fund

Quarter to Date Return: 1.90%*
Year to Date Return: 2.64%*
Assets Under Management: EUR 210.3m*

Blackwall Europe L/S 1.5X Fund

Quarter to Date Return: 1.42%*
Year to Date Return: 1.50%*
Assets Under Management: EUR22.9m*

Dear Investor,

The Blackwall Europe L/S Fund finished the year at +2.64% and +12.70% since inception. Annualised volatility was just 4.07%. Our 1.5X Fund, launched in the summer 2017, closed the year at +1.50%.

In December 2017, Blackwall turned 3 years old – a milestone made possible by the support and trust of our partners for which we are very grateful.

I started Blackwall as a one-person start-up with an investment philosophy, distinctive analytics, and EUR 1.9m of AuM. The initial start-up has evolved into a fully-fledged independent investment management company, with personnel, structures, and systems in place to keep growing. During 2017, Blackwall became a regulated FINMA entity in Switzerland and was approved as an investment company by the Central Bank of Ireland. The team is comprised of 5 senior people: Bernd Laux (research), Heinrich Lammer (CFO, risk management), Richard Mueller (COO, legal & compliance) and Gino Landuyt (marketing & trade execution). AuM has increased to EUR 210.3 m for the Blackwall Europe L/S Fund and EUR 22.9 m for the 1.5X levered Fund.

Building a sustainable business

When I founded Blackwall Capital Investment AG three years ago, I did so with the deep sense of conviction that it will become the center of the next 45 years of my professional life (or longer if life expectancy keeps rising!). The support of my wife Eva, whom I met 20 years ago on a personal level, has been important to the launch of Blackwall. On a professional level, Bernd Laux whom I have known for 21 years and who joined us in 2016, has added to my conviction that we are on the right track. I couldn't imagine a more brilliant analyst. Three years is well short of 45 but I would like to take this opportunity to reflect on the initial steps we have taken.

Just like a body or a brain can be 'wired' differently, building a company for the long-term rather than the short term will almost certainly lead to different decisions. This is embodied by what we call "HAILDIP". One of the most important decisions taken early on relates to the acronym "HAIL" presented by Julian Treasure in one of his TED Talks, which we extended by "DIP". It stands for Honesty, Authenticity, Integrity, Love, Diversity, Intelligence, and Passion. These are the guiding principles we use to interact with our investors, operational partners and within the Blackwall organisation. We are fortunate to have so many great people involved in making our business prosper.

Focus: Our focus is on equity investments. This is our core strength and the area we will continue to add resources to as we grow. Our fund is a long/short European equity fund, focusing on fundamental single stock investments. While we launched a levered version of the fund in 2017, and maybe over time also might do a long-only version of it, we will not deviate into other asset classes.

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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Independence: Successful investing requires independent thinking and the confidence to be comfortable going against the crowd. Good results come primarily from a properly calibrated balance of boldness and humility. Bold enough to think we have insights that are superior to the collective wisdom of the market and yet humble enough to understand the limits of our abilities and be willing to change course when errors are recognized. We strive to reflect this balance in our communication with investors and partners where we share both great investment cases as well as our biggest mistakes. With MIFID II starting in 2018 we feel well prepared because we've always done our own research, using third parties only to a limited extent (and at our own cost) for example for forensic research. Market inefficiencies are likely to increase over time and we should benefit from them handsomely.

Patience: Patience is the key element of every compounding process. We like to see our investors benefiting from compounding returns which means, most importantly, avoiding losses in market downturns and over time achieving better returns at lower risks. In a similar way we like to compound our wisdom over time leading to better investment decisions.

Antifragility: At times of record low volatility and record high market fragility, the idea behind our processes is best described by Nassim Taleb's concept of "Antifragile". Throughout market cycles, we should gain from disorder and become stronger, not least by placing the protection of investors' wealth as a top priority in cyclical bear markets. A major part of the antifragility concept is also having skin-in-the-game by management which, in line with Taleb's idea, reduces risks to investors becoming a victim of "heads-I-win-tails-you-lose".

The essential characteristics of great companies that we are looking for are those with a sustainable competitive edge that can deliver compounding returns to its shareholders. It is rational that we strive for achieving the same for ourselves – or as Benjamin Graham once said: "Investment is most intelligent when it is most businesslike, and business is most intelligent when it's most investment-like." .

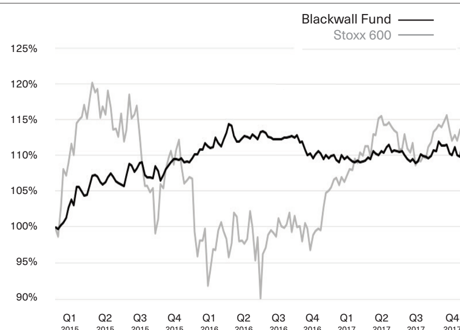
Uncorrelated Returns

Our investment philosophy has been strictly bottom-up fundamental research of European companies. In general, during recent years, the rising prices paid for equity reduces the pool of companies available at attractive valuations and low risks, while increasing the opportunities on the short side. As a result, the Fund has run a net exposure of between –5% and +20% for about 90% of the time since launch – with 12.4% net long on average since inception and 6.3% net long over the past 12 months (beta adjusted numbers are about 0-5% net long). Being positive in 64% of the months reported, we achieved a performance net of fees of +12.70%.

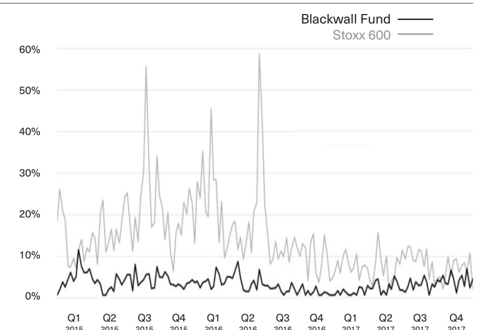
This is almost as high as the market performance, with the Stoxx 600 at +13.60% over the same period, but at a significantly lower volatility (Fund: 4.07% v. Stoxx 600: 16.70%) and noticeably with a negative correlation of –0.10.

Table 1: Performance and Volatility

Weekly Performance Stoxx 600 vs. Blackwall Fund



Annualised Weekly Volatility Stoxx 600 vs. Blackwall



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Market Assessment

Currently, most asset classes seem to be priced at or near all-time highs, referencing artificially low, administered interest rates. In a similar way, volatility levels are also at all-time lows, suggesting a low risk environment. The opposite is most likely to be true.

In his very first partnership letter (1956), Warren Buffet described the equity market as follows: "My view of the general market level is that it is priced above intrinsic value. This view relates to blue-chip securities. This view, if accurate, carries with it the possibility of a substantial decline in all stock prices, both undervalued and otherwise. In any event I think the probability is very slight that current market levels will be thought of as cheap five years from now." In our view, this might as well be an accurate description of today's environment.

We intend to generate about 12-15% net of fees annually over a full market cycle. The performance of 12.7% over three years looks short of those expectations. However, the returns so far have been generated toward what we believe is the peak of the market cycle and which is the weakest spot for our investment strategy. We feel very confident our targets will be achieved once we are through the full cycle.

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 2: Blackwall 'average company' portfolio example

Long Investments:
Typical Company Economics

Financials* (EUR m)	2016	2017	2018E[1]	2019E[1]
Sales	5,580	5,729	5,985	6,257
Gross Profit	2,909	3,024	3,181	3,356
EBIT	1,056	1,225	1,357	1,478
Net Income	632	740	848	942
FCF	688	692	865	933
Net Financial Debt	−679	−870	−632	−682

Valuation Ratios*	2016	2017	2018E[1]	2019E[1]
P/E	35.8	23.1	18.9	15.7
P/BV	3.4	4.5	4.2	3.9
EV/EBIT	16.0	17.8	14.8	12.9
Net Debt/EBITDA	−0.4	−0.5	−0.3	−0.3
Dividend Yield	2.3%	2.0%	2.2%	2.4%
ROE	9.2%	12.9%	16.3%	18.7%
ROCE	7.4%	8.2%	10.5%	13.1%

Short Investments:
Typical Company Economics

Financials* (EUR m)	2016	2017	2018E[1]	2019E[1]
Sales	14,639	15,711	16,202	16,375
Gross Profit	4,535	4,944	5,049	5,060
EBIT	1,266	1,510	1,518	1,414
Net Income	972	1,012	1,020	876
FCF	462	808	862	726
Net Financial Debt	4,933	4,966	4,819	4,714

Valuation Ratios*	2016	2017	2018E[1]	2019E[1]
P/E	23.5	16.8	15.5	16.5
P/BV	4.4	4.2	3.9	3.4
EV/EBIT	16.7	14.3	13.3	13.3
Net Debt/EBITDA	1.5	1.4	1.3	1.1
Dividend Yield	3.1%	2.9%	3.1%	3.1%
ROE	13.8%	23.1%	20.1%	17.7%
ROCE	12.1%	11.8%	12.8%	12.9%

* 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 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 9-11% p.a. in 2018E and 2019E. This is lower than in 2017 (expected at 16%), but still high on conservative assumptions. 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.

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On the contrary, the average short company is likely to face a collapse of growth rates towards the zero/negative level (1% to –7%) in 2018E and 2019E respectively.

Leverage: Most of our long companies are operating with low net debt positions (some are net cash), thus posting an average net cash/EBITDA of about 0.3x. 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 1.3x.

Valuation: In terms of valuation, we use various metrics, with our preferred ratio being EV/EBIT. On average our long portfolio trades at 14.8x for 2017E and 12.9x for 2018E. This is quite similar to the 13.3x for the short portfolio, despite the long companies operating on much stronger growth metrics.

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

We wish you a prosperous and healthy 2018!

Best regards,

Thomas Karlovits

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