Blackwall Capital

European Equity Long-Only

Quarterly Newsletter
Q4 2019

Blackwall Europe Equity Fund

Quarter to Date Return: 10.71%*
Year to Date Return: 10.82%*
Assets Under Management: EUR 15.3m*

Dear Investor,

The Blackwall Europe Equity Fund ended Q4 at +10.71%.

The Q3 reporting season was as bad as the previous 3 reporting seasons, showing an earnings decline of about 4-6% for European companies. However, economic lead indicators have stopped deteriorating and some of them even begun to turn upward. Against that background we have also turned more optimistic. We now anticipate a recovery in European corporate earnings from no later than H2 2020 onwards and, as a result, we have been fully invested in Q4. In addition, next to our investment in companies with structural growth drivers we added great cyclical companies to our portfolio.

Analysis of our first 5-year period

2019 proved to be a very challenging year for Blackwall. Despite in 2018 correctly anticipating the earnings decline of European companies - with every single reporting season disappointing ever since - we were unable able to benefit from it. Conversely, we were too short in the Long/Short fund and we were too slow in building the portfolio in the newly launched Long/Only fund. We continuously strive to learn from our mistakes and work on improving our processes.

Our analysis came to the following conclusions:

1) Market structures

We believe that market structures have changed profoundly in recent years. It is not a single aspect, but the combination of major tectonic shifts including a) the increasing dominance of passive investing/ETFs; b) the massive influence of central banks providing near-zero or below-zero cost of funding; c) the emergence of algorithms and factor investing and d) increasing regulation.

All 4 of those aspects have been around for some time, but it is the magnitude that has been changing the equilibrium. With a large group of active investors in the market, overall equity prices have been quite fairly priced most of the time (note: we don't believe in the entirety of the Efficient Market Hypothesis). Passive investors have benefited from the work done by active managers. The single-minded focus on "price" rather than "value" of passive asset allocators and the increasing disembodiment from the underlying businesses they indirectly own is likely to increase inefficiencies, but only over time. Central banks are contributing to the irrational focus on price via anchoring artificially low and often even negative interest rates, encouraging ever higher leverage and more risk appetite.

We can never be as fast as a machine to trade nor do we have the desire to do so - but we do believe we can see and anticipate fundamental facts before a machine can. Therefore, the logical

*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 NAV figures (Class I EUR) rounded to two decimal places. Launch date: 13 December 2018.

area for us to have an edge and succeed are under-researched companies. This opportunity is set to increase due to Mifid II regulation as evidenced by a 20-25% reduction in sell-side research capacity in Europe just in 2018 and 2019 (across all market caps), shareholder activism and by applying a longer-term horizon – thereby gaining a fundamental advantage over the short-termism of today's sell-side and sections of the buy-side.

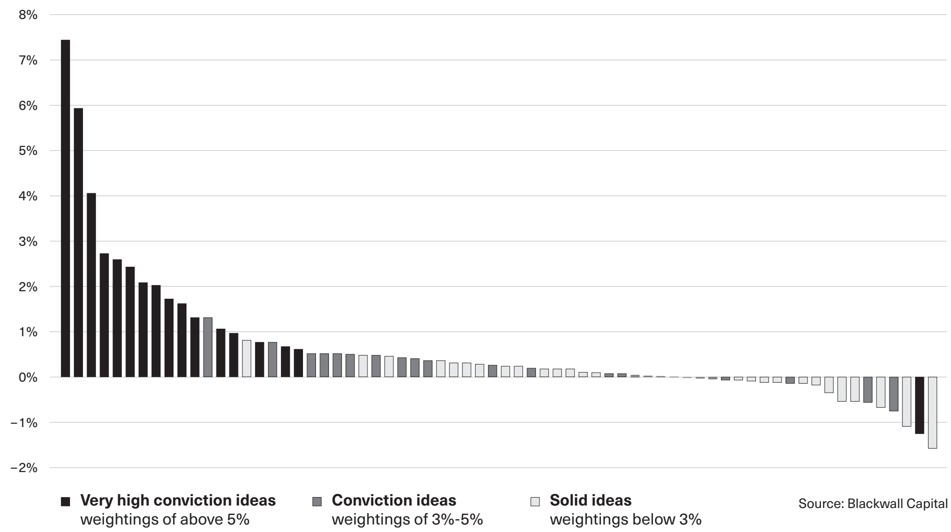
For us, the near-extinction of active investors provides a unique and exciting opportunity going forward.

(2) Outstanding performance with long conviction ideas

We went through a deep analysis of our investment process and results. The conclusion is: we have had an outstanding performance with our 'high conviction' and 'conviction' long ideas. Note: this analysis derives from the long side of our L/S fund, which shares the same principles as our European Equity Fund, but allows to draw conclusions over a much longer time span.

As illustrated in the graph below, 94% of our high conviction ideas (weightings of 5%+ in the Long Short fund) contributed positively to the fund performance. Some of them have increased by 3-5x since our initial investment. Including our other conviction ideas (weightings of 3-5% in the LS fund), the hit ratio is still about 85%. Of course, occasionally we also have our misses! But when our thesis isn't working out we move to cut the position as quickly as possible to avoid significant losses.

Table 1: Performance contribution ranked by single stock in the long portfolio of the L/S fund:



We cannot quantify the impact of the above-mentioned changes in market structure on the performance of our conviction ideas, nor if there was even an impact at all. However, we can say the performance was achieved at a time when European equity markets were rather in a broad side-ways period (2015-2019), and clearly haven't illustrated the bullish behavior of their US peers. For example, the level of European markets in Q4 2019 is still at roughly the level it was at in Q1 2015.

The common pattern of our successful conviction ideas has been: (1) under-researched companies discovered through our own independent process; (2) predominantly small-/mid-cap stocks in terms of market size; (3) continental European companies including Nordics; (4) identifiable moat with strong growth perspective and good management; (5) sticking to our circle or competence. All this can be replicated again and again. With fewer and fewer active investors around as time passes, our opportunity set will likely increase significantly and become easier to exploit.

3) The rational consequence: focus on the Blackwall Europe Equity fund

Identifying a strong skill set on the long side, leads to a very logical consequence: focus on the long-only fund. By this we will not only increase the time we can spend thinking on generating long ideas, but it also allows investors to benefit much more strongly from our underlying skill set. At the same token we learnt a lot from managing the LS fund, and some of the valuable experience will become part of the active management of the Blackwall Europe Equity fund.

A consolidated portfolio view

For better transparency, we consolidate our portfolio holdings 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)	2018	2019	2020E[1]	2021E[1]
Sales	3,389	3,611	3,738	3,880
Gross Profit	1,286	1,403	1,466	1,531
EBIT	415	444	485	532
Net Income	315	310	347	382
FCF	238	242	277	336
Net Financial Debt	210	388	293	156

Valuation Ratios*	2018	2019	2020E[1]	2021E[1]
P/E	14.5	20.0	21.1	17.3
P/BV	1.9	3.6	3.1	2.5
EV/EBIT	9.6	12.7	14.0	11.9
Net Debt/EBITDA	0.3	0.6	0.4	0.2
Dividend Yield	2.7%	2.6%	2.8%	3.0%
ROE	21.3%	21.9%	22.3%	22.7%
ROCE	12.6%	11.5%	13.4%	15.2%

* Source: Bloomberg, Blackwall Capital
[1] Note there can be no assurance that these estimates will be achieved

Our investment philosophy is to invest in great companies with a sustainable and superior economic return at attractive valuations, with midcaps being our sweet spot.

Margins: The average company is showing a gross margin of **39.2%**, an EBIT margin of **13.0%** and an FCF margin of **7.4%** (all 2020E), demonstrating strong business models.

EBIT growth: We expect the average company to grow EBIT in the magnitude of around **9-10%** p.a. in 2020E and 2021E based on conservative estimates. 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. This allows for additional resilience against any economic downturn.

Leverage: Most of our companies are operating with low net debt positions (some are net cash), thus posting an average net debt/EBITDA of just **0.4x**. At times of rising corporate interest rates, this might provide strategic optionality while others are constraint.

Valuation: In terms of valuation, we use various metrics, with our preferred ratio being EV/EBIT. Our average portfolio trades at **14.0x** for 2020E and **11.9x** for 2021E.

In summary, we argue that the companies invested are attractively valued with a solid growth profile and low leverage.

We wish you a Happy, Healthy and Prosperous New Year,

Thomas Karlovits

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