**Blackwall Capital**

**European Equity**

# Quarterly Newsletter
Q4 2018

| Blackwall Europe L/S Fund | Blackwall Europe L/S 1.5X Fund | Blackwall Europe Equity Fund |
|---|---|---|
| **Quarter to Date Return:** 1.25%*<br>**Year to Date Return:** 0.62%*<br>**Assets Under Management:** EUR 180.3m* | **Quarter to Date Return:** 2.50%*<br>**Year to Date Return:** 1.06%*<br>**Assets Under Management:** EUR 14.0m* | **Quarter to Date Return:** – 0.20%*<br>**Year to Date Return:** – 0.20%*<br>**Assets Under Management:** EUR 10.6m* |

**Dear Investor,**

Blackwall Europe L/S Fund finished the year at +0.62% and +13.40% since inception. Annualized volatility was just 4.15%. Our 1.5X Fund closed the year at +1.06%.

In December 2018, Blackwall successfully launched the Blackwall Europe Equity Fund ("BEEF") on the Blackwall UCITS Platform ICAV in Ireland. Same as the 1.5X Fund, it has been seeded by one of our existing investors, underlining our commitment to build long-term partnerships with our investors. The BEEF is a long-only fund, focusing on European equities. It follows the same guiding principles we successfully implemented on the long side of the L/S fund since launch; investing in companies with sustainable business models with superior economic return and longevity of reinvestments to benefit from compounding. We welcome adverse equity market conditions because it allows us to build a strong portfolio over time in order to solidly outperform our benchmark (STOXX Europe 600 Net Return Index).

## Markets and Outlook

On the investment front, the past year had started full of optimism - fueled by the globally synchronized economic growth narrative. The first quarter 2018 provided growth at full pace, which then was fully reflected in ambitious corporate growth projections for the full year 2018. The set-back in equity prices during February 2018 was considered a "financial market phenomenon", a temporary excess of risk-averse investor sentiment, but nothing more. However, in hindsight, it was a warning shot. Q1 2018 reported earnings were already mixed. While US corporates, mainly driven by tax reform tailwind, bested expectations substantially, European reported earnings beat consensus by only 3%.

European stocks recovered steadily throughout Q2 2018 from the February sell-off, however, underlying challenges began to gradually emerge. The number of poor earnings pre-announcements increased, reflecting rapid deterioration in emerging markets trading conditions as well as for example continuously declining consumer appetite for premium diesel cars in Europe, automotive market saturation in the US and slowing passenger car growth in China. Over the summer, matters deteriorated at faster pace: The Argentinian and Turkish economies suffered a severe slowdown due to a currency collapse. The US – China trade relations deteriorated with a first round of tariffs becoming effective. As a consequence, Chinese economic growth slowed further, with official YOY GDP growth data falling to 6.5%, the weakest level since Q1 2009. Obviously, European exporters were hit hard. Thus, the Q2 2018 reporting season was poor with the number of corporate profit warnings up materially (both QOQ and YOY).

The difficulty of European corporates to deliver their promises was spreading even more widely throughout Q3 2018 and the autumn. The "profit warning disease" came into full swing, hitting

*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.

small caps and large caps, regionals and globals, cyclicals and defensives. Whereas economic indicators such as PMIs and consumer confidence data retreated, most indicators remained in expansion territory in absolute terms, while European corporate earnings started to nosedive. Throughout autumn 2018, including the Q3 2018 reporting season, we witnessed an avalanche of guidance cuts and earnings misses across almost every sector in Europe (whereas US corporates in aggregate continued to deliver).

In the US share repurchases (which account for roughly 60% of total demand for US stocks) were able to hold up share prices into early October. The all-time high in the S&P 500 index was hit on 3 October 2018. European shares kept sliding through the entire late summer/autumn 2018 period. European corporates, far more moderate in terms of redeploying cash into share buybacks, were facing declining margins and earnings. The resulting dreadful share price performance for Q4 2018 has also brought about a substantial doubt among investors as to; whether the 10-year economic expansion will continue or has already rolled over and whether corporate earnings growth will match still ambitious expectations. The resulting uncertainty led to the global retreat in equity prices we have witnessed lately, down approximately 20% from the peak, including the worst month of December for the US S&P500 index since 1931.

Going forward, the economic environment has become increasingly more difficult and most likely will become even harsher as we move into 2019. In the second half of 2018, a lot of damage was done to forward economic growth and the string of adverse news from trade, politics, economics, and the corporate sector has not come to a halt, not even slowed down yet. As a result, we believe consensus earnings estimates for 2019 (and 2020) will prove overly demanding and require “right sizing” in coming months. Corporates will have to lower their projections and investors will have to cope with a new reality, meagre or negative earnings growth and probably a bear market for some time.

It will be interesting to observe how this plays out as a multi-year QE program, combined with noticeable shift towards passive investments has destroyed the diversity of the market ecosystem. The resulting lack of liquidity, resulting in fire-sale prices for many companies, should provide exciting investment returns for those who are able to benefit from it.

**Independence**

In recent months we’ve been asked many times, what makes us different from our peers. These questions prompted us to write down our Principles, our believes and core values. We will publish these in full on our website as well as in our updated company presentation soon.

While we believe that it is always a combination of values that make up the DNA of a personality or a company, there is one aspect we would like to highlight in particular these days: Independence.

At times of increasing herding mentality amongst investors with, “momentum” type investing being the most important single factor, we are – according to several investor due diligence processes and factor analysis reports) - described as one of, if not the “least factor driven house” in Europe. We take this as a big compliment because it touches upon something which is the result of a carefully designed set-up and process:

1) As a company, Blackwall is controlled by its operating partners. We value our external partners but none of them has any influence on our investment decisions.
2) Our geographic setup was chosen to allow for easy access to companies where needed and to avoid the herding mentality found in big financial centres.
3) We are continuously searching for new investment opportunities that meet our criteria. In this process we focus on our own research and our own processes, which is increasingly beneficial at times of MiFID II. We listen very selectively to other investors and analysts for whom we have good reasons to respect.
4) The process of investing includes searching for stocks, measuring their value, buying at the right price, monitoring and eventually selling. Critically, it also means reviewing

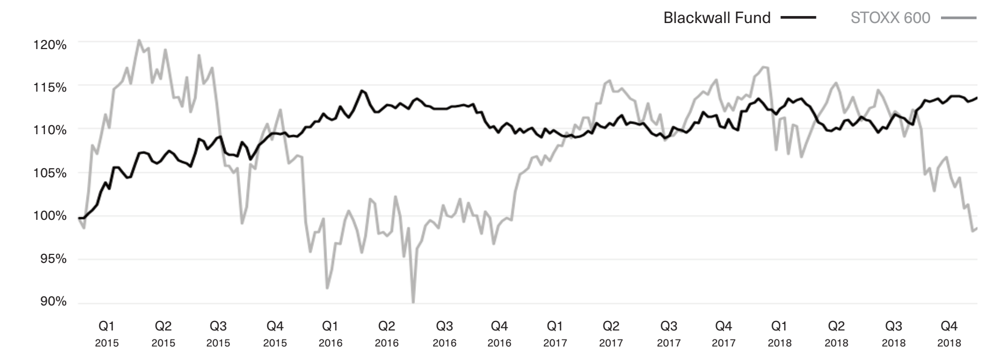
mistakes. Buying and selling, the steps most people focus on, take but a moment. Searching and monitoring are the most time intensive – and are a never-ending process.

5) We are passionate about the process of investing, but we maintain critical distance from our investments. It is very important to be able to walk away from any individual investment and not to fall in love with it. Mark Twain makes the point: *"What gets us into trouble is not what we don't know. It's what we know for sure that just ain't so."*

6) We pay particular attention to psychological biases that may impact us. While we are not immune to them, we strive to constantly improve and implement processes that guide us away from heuristic shortcuts.

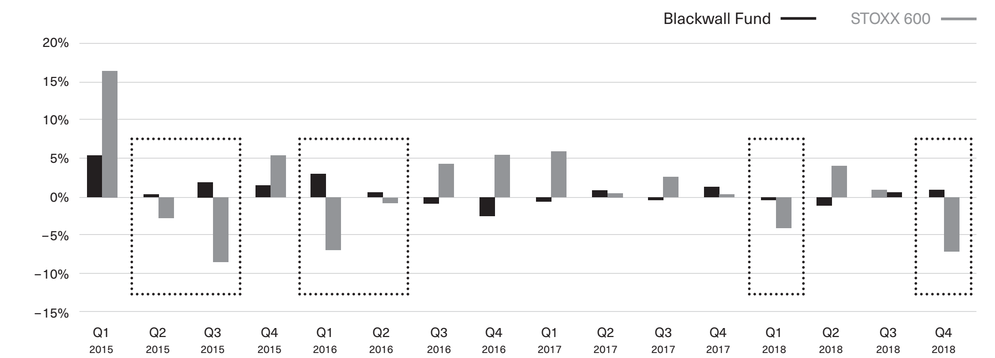
While we believe independence is important all the time, it is paramount at times when an investment or the markets in general are at turning points. Listening to corporate managers and sell-side analysts (who themselves follow more often than not the corporate narrative) is very costly on such occasions. Our independent set-up and mindset has helped us greatly to navigate through the recent topping period of the market. If anything, we were too cautious too early, but it also allowed us to stay positive in every single year since launch.

**Table 1: Weekly Performance Stoxx600 vs. Blackwall Fund**




Source: Bloomberg, Blackwall Capital Investment AG

**Table 2: Quarterly Performance Stoxx 600 vs. Blackwall Fund**




Source: Bloomberg, Blackwall Capital Investment AG

## 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 (note: this is for the long short funds; the long only fund is still early stage to build but will look similar to the long investments highlighted below):

**Table 3: Blackwall 'average company' portfolio example**

## Long Investments:
**Typical Company Economics**

| Financials* (EUR m) | 2017 | 2018E[1] | 2019E[1] | 2020E[1] |
|---|---|---|---|---|
| Sales | 1,675 | 1,694 | 1,765 | 1,855 |
| Gross Profit | 822 | 823 | 859 | 910 |
| EBIT | 332 | 351 | 378 | 407 |
| Net Income | 207 | 213 | 231 | 256 |
| FCF | 208 | 174 | 205 | 237 |
| Net Financial Debt | 94 | 68 | 63 | 31 |

| Valuation Ratios* | 2017 | 2018E[1] | 2019E[1] | 2020E[1] |
|---|---|---|---|---|
| P/E | 19.6 | 23.9 | 19.5 | 16.7 |
| P/BV | 3.0 | 3.3 | 2.9 | 2.6 |
| EV/EBIT | 18.5 | 18.8 | 14.9 | 12.7 |
| Net Debt/EBITDA | 0.2 | 0.1 | 0.1 | 0.1 |
| Dividend Yield | 1.7% | 2.6% | 2.7% | 2.9% |
| | | | | |
| ROE | 18.2% | 18.7% | 19.5% | 20.8% |
| ROCE | 12.7% | 13.1% | 14.2% | 15.7% |

## Short Investments:
**Typical Company Economics**

| Financials* (EUR m) | 2017 | 2018E[1] | 2019E[1] | 2020E[1] |
|---|---|---|---|---|
| Sales | 7,267 | 7,176 | 7,080 | 7,035 |
| Gross Profit | 1,497 | 1,614 | 1,345 | 1,207 |
| EBIT | 728 | 679 | 1,346 | 412 |
| Net Income | 569 | 521 | 397 | 217 |
| FCF | 114 | 133 | 88 | 68 |
| Net Financial Debt | 1,419 | 1,429 | 1,426 | 1,556 |

| Valuation Ratios* | 2017 | 2018E[1] | 2019E[1] | 2020E[1] |
|---|---|---|---|---|
| P/E | 17.5 | 16.2 | 14.9 | 19.2 |
| P/BV | 3.1 | 2.5 | 2.3 | 2.1 |
| EV/EBIT | 12.9 | 12.0 | 13.3 | 16.4 |
| Net Debt/EBITDA | 1.4 | 1.5 | 1.7 | 2.5 |
| Dividend Yield | 2.8% | 3.6% | 3.8% | 2.8% |
| | | | | |
| ROE | 21.4% | 20.0% | 17.1% | 12.1% |
| ROCE | 10.5% | 9.8% | 8.4% | 6.0% |

* 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:** The average long company is showing a gross margin of 48.7%, an EBIT margin of 21.4% and an FCF margin of 11.6%, demonstrating strong business models. In comparison, the average short company only generates a gross margin of 19.0%, an EBIT margin of 8.2% and an FCF margin of just about 1.2%. In economic downturns their business models are particularly vulnerable.

**EBIT growth:** We expect the average long company to grow EBIT in the magnitude of 6-8% p.a. in 2018E and 2019E. 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. In contrast, the average short company is likely to decline by 7-15% in 2018E and 2019E.

**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 0.1x. At times of rising corporate 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 1.5x, although this is still well below the market average of 3.2x

**Valuation:** In terms of valuation, we use various metrics, with our preferred ratio being EV/EBIT. Our average our long portfolio trades at 14.9x for 2019E, which is slightly above the average short portfolio trading at 13.3x. However, given stronger growth expectations going forward, the spread reverses quickly with longs trading at 12.7x for 2020E and shorts at 16.4x for 2020E.

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

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

Thomas Karlovits

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