Blackwall Capital

European Equity Long-Only

Quarterly Newsletter
Q1 2019

Blackwall Europe Equity Fund

Quarter to Date Return: 2.20%*
Year to Date Return: 2.20%*
Assets Under Management: EUR 15.8m*

Dear Investor,

We finished the first quarter of 2019 (Q1 2019) at 2.2%. After launching in December we are still in the ramp up period of our portfolio. We currently are 43% invested and continue to increase our exposure cautiously over the upcoming months as intended at the launch.

From an investment perspective, the first quarter 2019 has been a tale of two worlds.

On the one hand, leading economic indicators across the world kept on deteriorating to date (e.g. German manufacturing PMI at 44.1 in Q1 2019, down from 51.5 in Q4 2018), with manufacturing in Europe and China being the hardest hit. At the same time, real economic data has begun to gradually follow the leading indicators. Industrial production has entered a material cyclical slowdown, led by the Automotive industry (Q1 global car production estimated at −6% YOY) and Electronics/Semiconductors as well as Capital Goods not too far behind. The global slowdown in growth has been confirmed by declining bond yields, moving the amount of debt trading in negative yield territory up from USD6trn to USD10trn within a quarter. All of this has scared central banks from China to Europe and the US to such an extent that they felt obliged to quickly stage a complete U-turn of their monetary policies. Within Q1 2019, China has provided major additional monetary stimulus, the European Central Bank has pushed out its timing to start increasing rates, and the US Fed has stopped its rate hike trajectory and decided on the early termination of its balance sheet tightening.

On the other hand, there is the equity market which delivered a stellar quarter shaped by a) a steep recovery of Q4 2018 losses from 26-Dec-18 until end-February 2019 and b) a more volatile move up throughout the month of March. Equity indices effectively ignored the big macro issues as well as the multitude of dismal corporate news. Despite some companies were punished harshly, including ABB, BMW, Inditex, Kühne&Nagel, Leoni, Osram and Vallourec for both reporting relatively modest Q4 2018 results and underwhelming initial 2019 guidance, the broad markets did not react significantly. Hence, equities followed the abundant liquidity flows, continuously betting on the re-written "Central Bank Put". Furthermore, the surprisingly rapid recovery of share prices caused those investors who had parked higher than normal cash on the sidelines to be squeezed back into equities for fear of missing out on the rally.

Before we delve into current earnings expectations, we'd like to discuss some observations about the past cycle:

1) Our industry has developed a remarkable system to ensure that earnings beats have become the norm – even in Q2 and Q3 2008, consensus forecasts were beaten. Frankly, we can't remember anyone who forecasted an earnings decline of more than 80% for 2008 in Europe. Since 2009, on average there was a net beat of about 10% on a quarterly basis. This again is remarkable, as total Stoxx 600 earnings on an aggregated level declined by

*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.

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about 8% between the top in 2007 and today (compared to a plus of about 70% for the S&P 500, although buy-backs, accounting/reporting changes and tax reform contributed heavily). Lowering earnings forecasts a few weeks prior to reporting and beating such numbers doesn't create growth!

2) At major turning points, one should be extraordinarily cautious when it comes to statements from company leaders or analysts – who too often follow the corporate narrative. Analysts significantly upgraded their ratings following the decline in prices early in 2008, just ahead of the real crisis that started in Q2 2008. The same goes for cutting their ratings throughout the cycle. It was Q2 2009 when analysts finally posted the strongest recommendations to sell (again based on companies seeing further collapses), after the market already turned around.

We are still convinced, thinking independently from the crowd and focusing on investment cases that are driven by their own merits, allow for a certain decorrelation. Staying course throughout April 2018 was essential for our positive full year performance in 2018. We think this might also apply to Q1 2019, even when it temporarily hurts. We continue to believe that economic growth will keep on falling short of market projections, with the bottom still ahead of us (de-stocking has yet to come!) and any recovery being delayed towards next year and being slow. Hence, the 'profit warning disease' is set to go on for longer. Against that background, our conviction is that corporate guidance for 2019 performance remains too optimistic. In general, companies argue that the low point was hit in Q1 2019, but crucially lack facts as to where the drivers for the H2 2019 recovery should come from. Investors following this narrative base their investments on hope, which has rarely been a good strategy.

Lackluster to non-existent economic growth will prevent corporates in Europe from achieving any meaningful top-line expansion this year. Hopes for pricing power appears to have evaporated rapidly in light of stabilized/retreating raw material costs as well as sub-optimal capacity utilization (e.g. Infineon just hinted at a drag from "idle capacity costs"). With cost cutting largely maxed-out, there is little room for compensation, not least as global wage inflation is on the rise (a phenomenon that we see only at the beginning of a protracted journey). While in the US share repurchases may "do the trick" for a little longer and provide some small EPS growth owing to a shrinking denominator, few European corporates have similar firepower and cash-return-plans in place. Hence, European EPS growth for 2019 is set to be negative (compared to an expectation of +10.3% based on current consensus).

In brief, our opinion remains: share prices cannot decouple from fundamentals for much longer. An already poor Q1 2019 reporting season, starting later this month, may well take share prices back to reality. The lack of any meaningful recovery near term is poised to result in the evaporation of hope for a H2 2019 recovery. In addition, the fact that bond yields have recently declined on growth fears is not, at least in our opinion, a justified reason to push share prices higher on account of multiple expansion. Hence, we have entered Q2 2019 with a consistently cautious portfolio positioning based on what we see bottom up from our company analysis.

Alongside this we continue to build a portfolio of great companies when prices are attractive.

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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 1: Blackwall 'average company' portfolio example

Long Investments:
Typical Company Economics

Financials* (EUR m)	2017	2018	2019E[1]	2020E[1]
Sales	4,241	4,443	4,567	4,730
Gross Profit	1,528	1,679	1,750	1,846
EBIT	550	656	696	738
Net Income	343	398	429	465
FCF	303	307	350	385
Net Financial Debt	172	168	150	132

Valuation Ratios*	2017	2018	2019E[1]	2020E[1]
P/E	15.5	18.1	16.1	14.6
P/BV	2.1	2.9	2.5	2.3
EV/EBIT	12.2	13.7	12.1	10.9
Net Debt/EBITDA	0.2	0.2	0.1	0.1
Dividend Yield	1.6%	2.0%	2.1%	2.3%
ROE	15.9%	18.4%	19.0%	19.9%
ROCE	10.8%	12.4%	13.0%	14.1%

* Source: Bloomberg, Blackwall Capital Investment AG
[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 38.3%, an EBIT margin of 15.2% and an FCF margin of 7.7%, demonstrating strong business models.

EBIT growth: We expect the average company to grow EBIT in the magnitude of around 6% p.a. in 2019E and 2020E 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 0.1x. 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 12.1x for 2019E and 10.9x for 2020E. In summary, we argue that the companies invested are attractively valued with a solid growth profile and low leverage.

Best regards,

Thomas Karlovits

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