Blackwall Capital

European Long/Short Equity

Quarterly Newsletter
Q2 2019

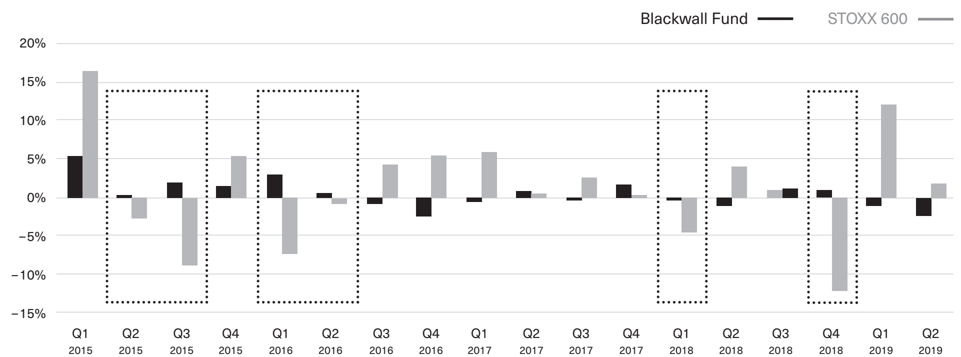
Blackwall Europe L/S Fund

Quarter to Date Return: –2.41%*
Year to Date Return: –3.58%*
Assets Under Management: EUR 154.0m*

Dear Investor,

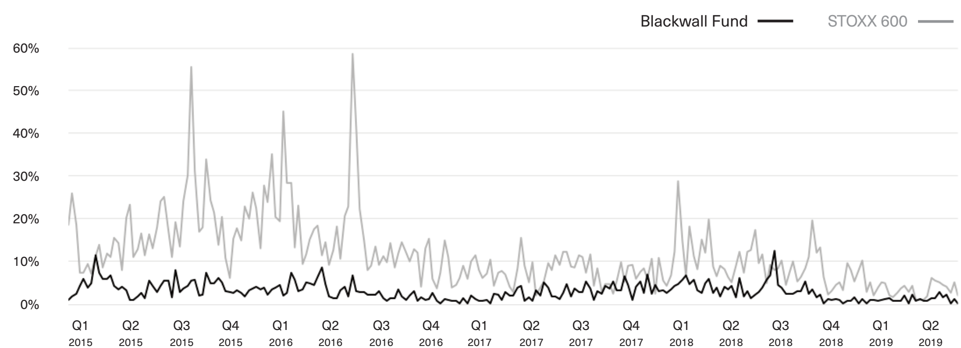
The Blackwall Europe L/S Fund ended in June –1.02% to finish Q2 at –2.41% with an annualised volatility of 4.12%.

Table 1: Quarterly Performance Stoxx 600 vs. Blackwall Fund



Source: Bloomberg, Blackwall Capital Investment AG

Table 2: Annualized Weekly Volatility Stoxx 600 vs. Blackwall Fund



Source: Bloomberg, Blackwall Capital Investment AG

*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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The market development throughout Q2-2019 can be split in three tiers. April and early May were driven by the release of corporate results for Q1-2019, which came in better than expected, but only after expectations had been slashed shortly before the release of the earnings results. In aggregate, earnings growth was negative YOY at a rate of –5% which is the first quarter of negative earnings growth since Q4-2016. With the hope of sequential improvement going forward, the market showed strong resilience.

The second development was the reinforced US-China tensions (additional tariffs on both sides) and the termination of critical US technology supply to Chinese companies listed on the US National Security Entities List) – in combination with further deteriorating fundamentals (both, leading indicators as well as actual economic data) that led to increasing concern about the rate of global economic growth.

The third driver of Q2-2019 performance has been re-igniting of hope that a more dovish central bank policy, resulting in rate cuts soon to come, together with the resumption of US-China trade talks which would reverse the economic slowdown. That hope was reflected in market recovery, with indexes finishing the quarter at the high point. However, forward earnings estimates keep on being cut, with the originally anticipated H2-2019 recovery increasingly seen as a failed hope.

Illusions

Following on from the illusion that we can go through the currently unfolding earnings recession without an appropriate market correction are two other illusions we would like to highlight:

Liquidity illusion: In this cycle, investors particularly increased their allocations to private equity funds as well as to highly liquid funds (e.g. multi-asset UCITS funds). Private equity requires long-term lock ups providing for no volatility (so, nothing to worry about – at least in the short term) and UCITS funds should guarantee immediate liquidity, if and whenever cash is needed. However, in a race to chase returns, it becomes increasingly obvious that – as recent examples show – the underlying investments sometimes might not fit the structure and there is a liquidity mismatch (any corporate bond trader will confirm significant liquidity concerns in that space). It's worth noting that we've never compromised in terms of liquidity and, for example, have used short-dated government bonds for cash management, rather than money market products where providers do not disclose the underlying products.

China growth illusion: The US-China trade dispute alters the business world permanently. Even if the parties settle, we won't return to the previous situation. That doesn't mean that China won't grow in the future. It is highly likely that it will, but not as currently expected. If China learnt anything from the current trade dispute, it is that it needs to be self-sufficient in all crucial areas. The IP transfer of recent decades will be used to build their own technologies, and 100% China-owned competitors will arise. Europe and particularly Germany (autos, machinery etc.) massively benefited from China growth in recent decades. Soon growth rates will ebb as local competitors take market shares from European (global) peers and it is only a question of time when they will compete with them in Europe and globally as well (think Huawei across many industries). The beautifully crafted DCF models will face a cruel reality check, which will be a rich source for short ideas over time though.

Voltabox

This quarter, we wish to present one of our high conviction small-cap growth investments: German rechargeable Li-Ion battery systems supplier Voltabox. The company develops, manufactures and distributes customized high-performance battery systems with integrated proprietary battery management for a wide range of industrial applications, in particular intralogistics, mining, trolley buses, agricultural/commercial vehicles, motorbikes, and going forward some selected automotive applications. The company is about to expand its portfolio to supply its customers not only battery systems but also complete electrical drivetrain solutions including chargers, etc.

Our investment thesis for Voltabox is: due to investor misperception and one-time issues Voltabox shares are substantially underpriced, neither reflecting the company's mid- to long-term growth nor its return potential. In light of Voltabox's EUR1.1bn 5-year order backlog (equaling 9x 2019

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revenues), a continuous flow of incremental new customer acquisitions, the steadily rising number of applications for Li-Ion battery systems, and Voltabox being a pioneer in its field, we are convinced that the company will be able to sustain its high double digit % YOY growth rate for much longer than it is being credited for. Given very stable pricing, due to mostly multi-year sole supplier contracts and the supply of non-commoditised high-performance battery systems, we are convinced Voltabox will be able to further expand profitability over the coming years, with operating returns getting a boost from economies-of-scale and hence moving up from the high single digits well into the teens.

The company's massive 2018 cash burn, which scared investors, has been a one-off, related to a temporary contractual change with its formerly dominant customer Triathlon whom Voltabox provided with some cash support. After the terms of trading with Triathlon have been reversed to "normal" as of 2019, the cash burn of the previous year should be widely reversed over 2019-20. Hence, Voltabox has forecasted a zero-to-slightly positive free cash flow for this year, in spite of 70+% YOY revenue growth. With management's strong focus on cash preservation/generation, market concerns about tight liquidity appear misplaced, not least in light of EUR15.6m in net cash at end-Q1-19.

Finally, worries related to Voltabox's accounting, reflected in an objection of the German Accounting Standards Board released last April, had been justified. However, the accounting errors were exclusively related to the 2017 accounts and had already been corrected and communicated by Voltabox with the 2018 Annual Report. Furthermore, they were fully non-cash effective. Consequently, we even took advantage of the related short-term market uncertainty and added to our position at depressed prices.

Trading currently at EV/EBITDA multiples of 9x and 6x as well as EV/EBIT multiples of 12x and 8x for 2020 and 2021, respectively, does not adequately reflect Voltabox's prospects for generating earnings growth well in the mid double digits for years to come. We regard Voltabox as an underestimated pioneer in the rapidly rising battery sector that is set to capitalize on the electrification wave in industrial applications thanks to its differentiated skills and first mover advantage.

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:

Table 3: Blackwall 'average company' portfolio example

Long Investments:
Typical Company Economics

Financials* (EUR m)	2017	2018	2019E[1]	2020E[1]
Sales	2,811	2,914	2,994	3,104
EBIT	317	370	395	417
Net Income	233	243	264	286
FCF	187	159	182	202
Net Financial Debt	190	167	59	67

Valuation Ratios*	2017	2018	2019E[1]	2020E[1]
P/E	16.5	19.0	16.7	15.4
P/BV	2.4	2.8	2.6	2.3
EV/EBIT	12.1	15.6	13.4	12.7
Net Debt/EBITDA	0.4	0.3	0.1	0.1
Dividend Yield	1.9%	2.0%	2.1%	2.4%
ROE	16.7%	19.3%	20.0%	20.9%
ROCE	11.6%	12.1%	13.0%	14.1%

Short Investments:
Typical Company Economics

Financials* (EUR m)	2017	2018	2019E[1]	2020E[1]
Sales	11,935	12,342	12,018	11,716
EBIT	986	1,088	999	916
Net Income	876	825	671	613
FCF	589	525	356	174
Net Financial Debt	2,366	1,796	1,649	1,924

Valuation Ratios*	2017	2018	2019E[1]	2020E[1]
P/E	17.6	17.0	19.5	21.3
P/BV	2.1	3.3	3.2	3.1
EV/EBIT	16.1	15.4	16.3	17.7
Net Debt/EBITDA	1.6	1.1	1.1	1.4
Dividend Yield	3.6%	3.4%	3.1%	2.7%
ROE	17.3%	18.7%	16.8%	15.1%
ROCE	8.1%	8.8%	8.0%	7.2%

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

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Our investment philosophy is to go long on 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 an EBIT margin of 13.2% and an FCF margin of 6.1%, demonstrating solid business models. In comparison, the average short company only generates an EBIT margin of 8.3% and an FCF margin of just about 3.0%. In economic downturns their business models are particularly vulnerable.

EBIT growth: We expect the average long company to grow EBIT in the magnitude of around 6% p.a. in 2019E and 2020E. Furthermore, the vast majority 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. In contrast, the average short company is likely to decline by 8% in 2019E and 2020E. This is even more pronounced on a FCF level.

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 1.1x.

Valuation: In terms of valuation, we use various metrics, with our preferred ratio being EV/EBIT. Our average long portfolio trades at 13.4x for 2019E, which is well below the average short portfolio trading at 16.3x. Due to stronger growth expectations going forward, the spread is likely to widen further with longs trading at 12.7x for 2020E and shorts at 17.7x 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.

Best regards,

Thomas Karlovits

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