ECP European Value strategy: outlook & positioning

October 2016

Macroeconomic backdrop

The macroeconomic environment has not significantly changed over the recent months, it remains torn between undeniably favourable factors and legitimate concerns.

Geopolitical issues are undoubtedly one of the key current concern. Indeed, the migrant crisis and repeated terrorist attacks coupled with an overloaded political agenda (US elections, Brexit, Italian reforms, Spain struggling to form a government, etc.) leave markets uncertain leading to some volatility.

Moreover, with disappointing profitability and sluggish earnings growth, the health of European corporates remains fragile while at the notable exception of Germany, European industrial production continues to stagnate at low levels.

But **is it all gloom and doom?** Not at all…there are good reasons to remain optimistic about the medium-term potential of European Equity markets.

Unsurprisingly, the persistent low rate environment makes the stock market as one of the few alternatives available for investors looking for some yield.

In addition, there are two overlooked aspects that should give some boost to European Equities.
First, the US economy, which remains the first world economy, is currently rebounding. This rebound should have a positive impact on the world economy and therefore on European businesses.
Second, when comparing the valuations of European companies with their US peers as well as relative to their historical average, we can conclude that valuations remain attractive, though not exceptionally low.

How to invest?

A guide for sound Value investing

Our investment strategy is not sharply dependent on the macroeconomic environment and focuses mainly on the selection of individual companies exhibiting strong undervalued earning power.

However, the macroeconomic context must be taken into account as it influences the operational environment of the companies included in our universe. With a final portfolio of maximum 40 names, we must be able to identify at all times those companies who meet our strict investment criteria; and, depending on the prevailing market conditions, these investment opportunities may be more or fewer.

It is therefore essential to always keep in mind two main principles

- **Stable investment approach, flexible implementation**

> ***"The underlying of sound investment should not alter from decade to decade, but the application of these principles must be adapted to significant changes in the financial mechanisms and climate"***
> ***(B. Graham)***

This first principle directly relates to the Value Investing philosophy developed by Benjamin Graham. According to him, the main principles of a sound investment approach should not be changed over time but the way those principles are implemented must be flexible enough as to adapt to prevailing conditions.

From this first observation stems **our commitment to implement an active, high conviction approach which is flexible in terms of allocation** (sector, country, market capitalisation) **in order to invest where the most interesting opportunities arise**. **We do however never compromise our key investment criteria,** namely the search of companies benefiting from strong fundamentals and earning power trading at a significant discount relative to their intrinsic value

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- **Slow and steady wins the race**

The low interest rate environment which is in place for almost a decade has led many investors to the stock markets and mainly to those companies offering a certain level of yield. In this specific context, valuations were not considered as relevant!

These companies have seen their stock price boosted by the ultra-accommodative monetary policies while their fundamentals did

generally not justify such an increase. However, the market will inevitably sooner or later, realise its error and those stocks will undergo a significant correction.

By remaining focused on the undervalued earnings capacity regardless of fads and maintaining our long-term investment horizon, we avoid us falter and stay the course towards a strong long-term consistent performance based on the quality of fundamentals and intrinsic value of the companies we invest in.

Portfolio positioning

A high quality portfolio

Our investment approach described above is translated into a portfolio of maximum 40 positions exhibiting very high quality standards compared to the broader European Market.

We constantly screen a universe of more than 1 500 companies in order to detect the hidden "jewels" that present the earning power and the necessary margin of safety of 40% to qualify as a candidate for portfolio inclusion.

It is always difficult to reduce the earning power of a company to a single accounting metrics. **The average company in our portfolio appears to be much more profitable than the market overall**. As an illustration, the median Return on Equity of our portfolio is of 11.6% while the Stoxx Europe is at 6.5%.
At the same time, **the companies in our portfolio have usually much healthier balance sheet than the market**: based on the net debt / EBITDA ratio, on average, companies in our portfolio need 7 months to pay back their entire debt, while the average European company (in Stoxx Europe) needs nearly 5 years.

As Value investors, we now see that, compared to 2015, markets are becoming more discriminant in terms of companies' quality and valuation, which creates a more favourable environment for our investment strategy. It remains a good time to be a value investor!

Focus: does the Financial sector offer strong investment opportunities for value investors?

Despite a positive contribution from financials stocks to the quarterly performance of the Fund, we remain cautious about the Financial sector as a whole. In our view, the situation remains very complicated and banking stocks may still prove to be a minefield for value investors who, from one side, are attracted by very low valuations (especially in terms of Price to Book Value) while, on the other side, recent examples (i.e. Deutsche Bank, Italian banks) have shown that this segment is still experiencing a major crisis.

Although we believe that the central bank will do everything in its power to save the European banking system, **low valuation levels do not compensate sufficiently the risks and the resulting excess volatility.**

The European banking sector is suffering from the collateral damage from quantitative easing policies while it sees its interest rate margins under pressure and regulation increasing. **We still have some targeted investments in the Banking area, each one of them being based on a solid investment case linked to the fundamentals of each company and not on a more global sectorial view:**

- For *Credit Suisse*, we continue to believe in the earning power that will be released by a "UBS-like" restructuring and the strength of the wealth management franchise.
- *Caixabank* is one of the best managed and most conservative Spanish banks benefitting from the reduction of cost-income ratio after the BPI acquisition.
- *Danske Bank* has been through a long restructuring period and now emerges under the new CEO as a much leaner bank with a large captive mortgage customer base and a solid capital position.

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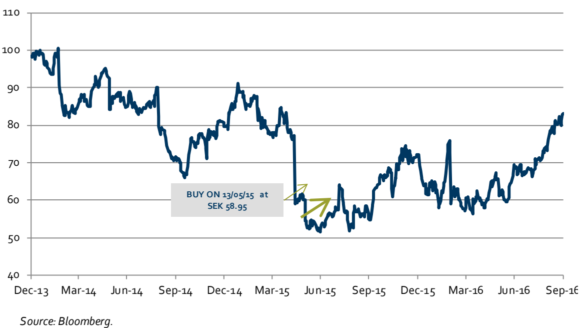
Investment cases

As at end of September, ***Elekta*** was the biggest position in the Fund.
This Swedish company provides radiation therapy, radiosurgery, related equipment and clinical management for the treatment of cancer and brain disorders. It is one of the two market leaders in conventional radio therapy equipment /technology in the world at c.34% market share. Elekta is a market leader in cranial surgery equipment market; its Leksell Gamma Knife remains the gold standard.

The market of cancer treatment equipment is growing by 4% to 5% per year. Ageing of population and rising number of new cancer cases diagnosed globally creates a solid long-term demand. As illustration, in China the number of cancer patients has increased by 40% over the last 5 years.

The company has recently on-boarded a new CEO and the Management has now a clear focus on cash-flow generation. The new strategy might hurt in the short-term (no pre-manufacturing, working capital control, and lower capitalization rates of R&D expense), but would bring more discipline and transparency in mid-long term.



Source: Bloomberg.

One of our core holdings, ***NKT Holding*** has had an important news flow during the month of September which impacted positively its stock price.

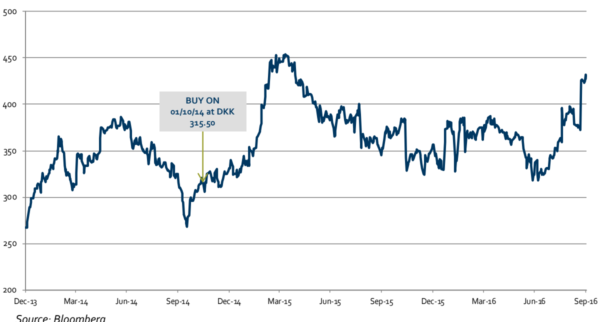
This Danish company is a conglomerate with business interests in manufacturing of industrial cables, Professional cleaning equipment and Fiber optic cables. Fiber optic cabling has a small contribution to the revenues and earnings, whereas Cabling and Cleaning equipment businesses have a larger contribution.

The company was up 13% end of September after the announcement of a split of the company's activities in professional cleaning equipment and energy cables. In addition, NKT Holding bought the high voltage cable unit from ABB making the combined group the dominant global player for energy cables.

From our side, we have seen for a long time the company split as a way to unlock value. We also consider the deal to buy the high voltage cable unit from ABB as very interesting.

The order books for the cable providers are full for 2017 and part of 2018 and the underlying demand for cables is growing together with the renewable energy sector and the need to transport power generated from renewable sources. This creates a better operating environment than has been seen in the last 3 years. We still see more value to be unlocked over the next couple of years.

The divestment of this activity by *ABB*, also a holding in the portfolio, is part of a strategy were the company is refocusing on the activities where it has market leading positions.



Source: Bloomberg.

During the quarter, we decided to sell our position in ***Jeronimo Martins*** as fair value was reached.

Jeronimo Martins (Portugal) is one of the most profitable food retailers in Europe generating a ROIC above 20%. The company has its main operations in hard discount in Poland (Biedronka) which accounted for 65% of the Group's sales and 76% of Group EBITDA in 2013. In Portugal, the company operates over 370 supermarkets (Pingo Doce banner), and has a cash and carry business, Recheio, as well as some food manufacturing interests in a venture with Unilever, mainly supplying Gallo olive oil.

We bought the stock when the Portfolio was built up end of 2014. At that time, the difficult operating environment in Poland has depressed the share price which created an interesting investment opportunity for us.

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Our opinion was that, thanks to its market leader position in Poland (20% market share, higher margins than competitor), the Polish market still offers high potential for Jeronimo Martins as Polish consumers are still far behind European average in terms of basket spent per inhabitant.

In addition, we identified some additional operational leverage within the Portuguese business due to an improvement in the distribution process, market share gains and underlying volume growth as deflation eases.

Source: Bloomberg

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