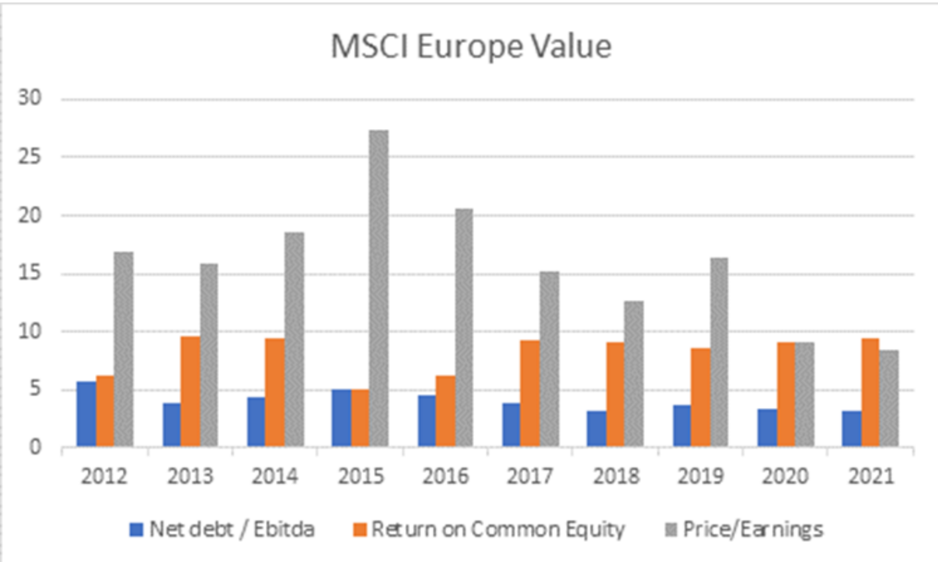
Friday Morning Coffee

Nr. 95 — Welcome to the candy shop!

Low valuation has till now not provided capital protection in the recent market turmoil, as value has done worse than growth. The MSCI Europe Value total net return index is down 25.7% from the peak of the market on February 19th up to Wednesday this week while the MSCI Europe Growth index lost "only" 20.4%. Since the beginning of the year, value underperformed growth by 9.3%!

In our view this is a clear exaggeration by Mr Market that has created a rare opportunity for the value investors we are. **We invest with a long-term investment horizon while Mr Market takes the opinion that perceived defensive growth would be the safer bet in these difficult times**. Investors prime concerns appear to be the quality of the balance sheets and the avoidance of cyclical and financial sectors. To us the situation now feels like March 2009, where we were in a candy shop where Mr Market provides us with ample investment opportunities.

In the table below, we summarize the **profitability**, the **leverage** and the **valuation** of the MSCI Europe Value index to illustrate the difference between investor perception and the reality on the ground.



Source : Bloomberg, 2020 and 2021 are consensus estimates

<u>At the end of 2019, it took the average company in the value index roughly 3.5 years to pay back its debt</u> with its cash flow as measured by EBITDA. Unlike popular belief, the balance sheets of these value companies have not deteriorated over the last years, on the contrary. At the end of 2015 it took 5 years to reimburse their debt.

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While deleveraging, these companies have nevertheless increased their profitability as measured by the return on equity that went from 4.9% to 9.2% within this time period. The Corona virus will have an impact on the operating environment of these companies and the current ROE is hardly sustainable in the short term. What is important to understand however is the fact that these are not zombie companies and that they will continue to meet their debt covenants despite the current headwinds while, in the medium term, restoring their earning power. In the current markets, we can access these companies at record low valuations: the average value company now trades at 9 times forward earnings, an unseen valuation discount of 50% towards their growth counterparts.

At ECP, we are not replicating the value index, we pick individual stocks. Here, in our candy shop, babies are currently being thrown out with the bathwater to an extent that makes hardly any sense to us. <u>One example is our holding G4S that was severely punished in the stock market yesterday after coming out with results on worries on their debt level and a goodwill write-down. 3 facts about G4S:</u>

1. It is a growing company that won 1.5 bn GBP in new business last year
2. Free cash flow generation is strong, operating cash flow was 633 million GBP last year
3. The debt level is due to investments into growth segments. The company is currently deleveraging by selling 65% of mature capital-intensive cash handling solutions to Brinks. While the debt covenant on latest bond placement is 3,5x EBITDA, the leverage post this transaction is 2.4x.

G4S currently trades at 5.1 times forward earnings and carries an estimated dividend yield of 10.4%. To us, **this investment looks more like a candy than a zombie and certainly merits a place in our portfolio despite the disappointing stock price performance.**

I wish you a nice weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
March 13 th, 2020