European Capital Partners

ECP Flagship European Value

Quarterly report

March 2021

This document is intended exclusively for professional or institutional clients and counterparties

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Executive Summary

- **Performance overview**
  - MSCI Europe was up 8.35% during Q1 2021
  - Strategy up 9.14% (share class A Eur), outperforming market by 0.79%
  - Performance again driven by stock picking: Increased focus on quality has started to yield results.
- **Portfolio changes**
  - One new name entered the portfolio and exit from another one brought net zero impact on number of securities.
- **Market environment & Outlook**
  - The reflation trade is alive and well.
  - European equities remain attractively valued relative to the US.
  - The underperformance of value has reached unsustainable levels.
  - We remain true to our value investment principles that we have applied over the last two decades at the same time putting extra focus on the quality of the businesses and sustainability of cash flows.
  - Median margin of safety of portfolio is 34%
  - 8% cash left to seize new investment opportunities

The first quarter of the year was dominated by rising bond yields, a surge in commodity prices and a value-led equity market rally.

The US 10-year Treasury yield rose above 1.5%, a level higher than the dividend yield of the S&P 500.

Rising yields are excellent news for value investors as it leads to a rotation from expensive momentum stocks into lowly valued, often more cyclical value names.

Global economies are improving as business activity resumes while on the other hand the monetary and economic stimulus is maintained and even increased by some central banks and governments. While inflationary pressures are starting to appear in the supply chain with rising commodity prices and transportation costs, all important labour costs appear under control. Eurozone inflation has increased to 1.3% in March, yet well below the 2% ECB target.

PMIs in majority of the developed markets are in expansionary phase.

At ECP, the full focus is on selecting quality companies with solid balance sheets and business franchises that are able to produce solid earning power in normal circumstances. However, when we will get back to normalcy remains to be seen.

MSCI Europe was up 8.35% during the quarter. No sector in particular contributed negatively to the market performance significantly. Energy, Financials and Consumer Discretionary were the biggest drivers of the performance of the market overall.

This is the fourth quarter in a row were our strategy outperformed the market. We are particularly recomforted by the fact that the outperformance was mainly driven by stock selection.

During the quarter we added one name to the portfolio and sold one. We continue to reposition the portfolio towards higher quality while not compromising on valuation.

We make all our investments on a company-by-company basis. We like to spread our investments across +/- 40 companies where a good number of companies provide high and growing cash flows in any economic environment. The other part is more of a cyclical character and we like to buy those companies when they are priced for recession.

The 3 main positive contributors in Q1 2021 were Porsche Automobil SE (+117 bps contribution), Hapag-Lloyd (+92 bps) and Publicis (+82 bps).

The 3 holdings showing the biggest negative contribution during Q1 were Ontex (-34 bps), Atos (-33 bps) and Superdry (-17 bps).

The quality-value framework we introduced during the Covid-19 crisis has been implemented and is now being applied systematically to all our holdings and portfolio management discussions. In our opinion, it is a solid supplement to our valuation models and helps us understand the fundamentals and valuation of every investments compared to its own history and the market overall.

Portfolio changes

We continue to follow our investment process as we have done for many years. We do so regardless of the opinion of Mr. Market. Our investment horizon is oriented towards the long-term with an average holding period of 4 to 5 years; the period normally needed for the market to recognise the earnings power of an undervalued company and thus for the valuation gap between the stock price and the estimated intrinsic value to close.

At the beginning of 2020, the quality score of our portfolio (ex. financials) was a little bit below that of the market. Following our journey towards quality, as of the end of Q1 2021, our portfolio (ex. financials) is now of a better-quality score than the market and we continue to look for and hold more quality companies.

The median margin of safety of our portfolio, the current discount of the stock prices to our fair value, is 34%.

Earnings for this year should not be confused with the underlying earning power of the businesses we are invested in as they are momentarily depressed due to the impact of the pandemic. Median free cash flow yield of our portfolio is 7%.

At the same time the balance sheets are strong. It takes the median company in our portfolio 1.15 years to reimburse its debt (net debt / ebitda) vs 2 years for the market overall.

The investment process aims to identify companies with undervalued earnings power without any geographic, sector or market capitalisation considerations.

Portfolio purchase activity was low with the addition of 1 new name. On the sell side we needed to sell 1 position.

⇒ BUY

We have bought **Axa**

⇒ SELL

During the quarter we sold out our remaining position in **Superdry**. We have been quite confident in the abilities of the management to turnaround the company, but Covid-19 has made the task extremely difficult for them. Superdry was sold after its stock price has almost tripled since the through of the Covid 19 crisis. While we believe there is more value in the company, the company is losing precious time to reinvigorate the brand and reinforce its online presence. In its own terms, "a material uncertainty exists and may cast significant doubt on the group's ability to continue as a going concern", showing how much the business is fighting to survive. We are value investors, we come across lots of situations where the underlying companies are facing tricky business environment, but we avoid investments where company management talks of sufficiency of liquidity on quarter-by-quarter basis. In case of Superdry that sadly turned out to be true.

Investment cases

AXA

Post the acquisition of XL in 2018, Axa has traded at discount to major European life insurer peers. Part of the dislike towards Axa comes after the current management deviated from the historical track of the company and is repositioning it towards predominantly property and casualty business. Strangely enough, it is not that Axa did not have any exposure to P&C in the past, in fact, it had almost 40% business coming the P&C division, which it aims to increase to c. 50% of the business under the new strategy. Hence, all those fears around earning volatility that comes with P&C business and historical track records of the other players having difficulty in keeping combined ratio below 100% is uncalled for. What we do get in return is nimbler and more capital efficient setup that is building profitable franchises in asset management and a more diversified company across division and geographies.
At the time of building our position, market price was implying that Axa would continue to earn 5% ROE in perpetuity which we found unrealistic given it's 10-year historical median return of 8.8% and more efficient Axa that we foresee in the future.

Porsche SE

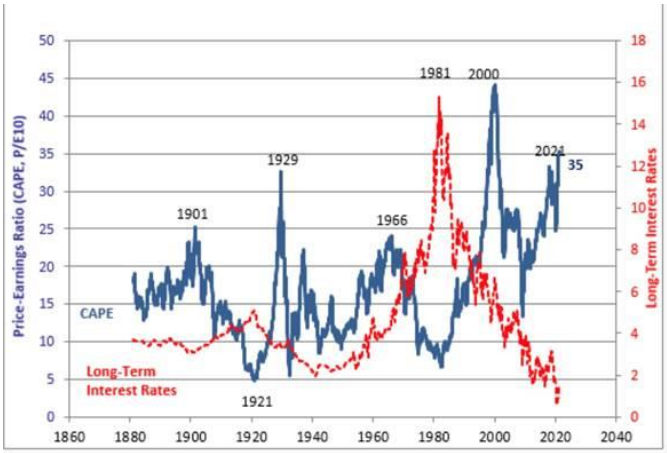
Porsche is our existing holding that we invested in back in summer last year. In the year 2020 Volkswagen, the primary holding of Porsche, proved its mantle in the electric vehicle engineering and manufacturing, thereby, putting to rest majority of the doubts that market participants had with the company. The Volkswagen stock started trading higher post the "Power Day" in January this year. The reason we are highlighting the Porsche investment is not because the stock has not contributed positively to the portfolio, in fact, it has been our top contributor this quarter. But it is underperforming the Volkswagen shares and it's holding discount has widened to more than 40% as opposed to historical levels of mid-twenties. On absolute basis that amounts to almost EUR 20 billion market cap dislocation. Porsche is continuing to be one of our biggest holdings, and we will look to add further if we see discount increasing further.

Hapag-Llyod

We invested in Hapag Lloyd in the 4th quarter of last year and our investment has been very profitable with returns of +135% in few months of holding period. We invested in the company with the narrative that the industry fundamentals are strengthening and as the global economy normalizes, Hapag-Llyod should be the beneficiary of it. Our narrative did play out, in fact it played out to an extreme. Container Freight rates have reached a level it has never been in last decade. From the point of view a realist, these levels of freight rates are not sustainable, but given the supply-demand dynamics in the industry we also see a probability of rates holdings at these levels for considerable time, if not going higher. In such a unique situation, we did what we preach. Safety of capital. We already divested our initial capital we had allocated to the investment; the remaining allocation amounts to the gains we made from our investment. We continue to watch industry and company dynamics closely, if we see higher probability of normalization of freight rates in coming times then we would quickly book our profits.

Market environment & outlook

With major stock indices reaching new all-time highs, it is clear we are no longer at the beginning of a bull market cycle. Anecdotical evidence that financial bubbles are appearing in some corners of the market due to excessive risk taking is abundant: think Robinhood, and Gamestop drama, the apparently unstoppable rise of crypto-currencies and lately the implosion of Greensill and Archegos.
One of our preferred quotes during the pandemic was that "Some things have to be believed to be seen." from Ralph Hogson. We are now wondering what we need to believe in order to expect high future returns on the US market overall at current valuation levels. The CAPE ratio, which divides the current price by the 10-year average inflation adjusted earnings, is now at a stunning 35 times. This level was only reached once over the last 150 years: just before the dot com bubble burst. Interest rates are still at record lows and supportive. This may change with the fiscal and monetary stimulus that is leading to some inflation. We still believe there is no real alternative to equities. However, we also believe and see that we should be selective in our investments and focus on lowly valued quality companies.



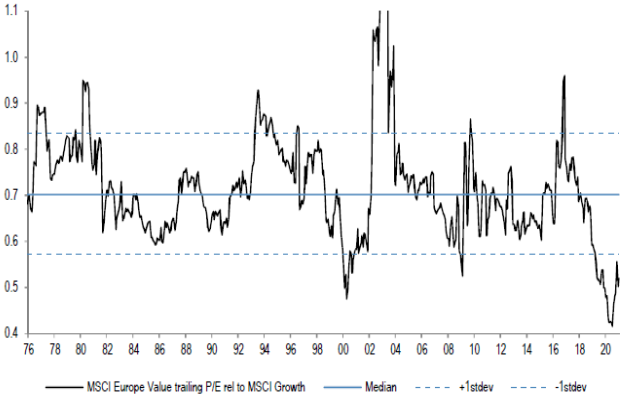
We still find these investments in our preferred hunting ground, European equities. European equities overall remain at a significant discount to their US counterparts. This remains the case even when we exclude the US technology sector.

Q1 was a good quarter for value investors in Europe as the rotation into value picked up speed. Despite the recent signs of life in value stocks we are still at the very beginning of the catch-up phase with growth stocks, though the recent outperformance does indeed not compensate for the last decade for value investors. Performance of MSCI Europe Value since March 2009, the through of the markets after the financial crisis, was +162%. Whereas MSCI Europe Growth returned +294% over the same period.

In the US where we have longer term data, the rebound of value is also hardly noticed in a historical context.

Value stocks continue to trade at discounts compared to growth stocks exceedingly even the period of the peak of the tech bubble and unseen since the seventies of the last century:

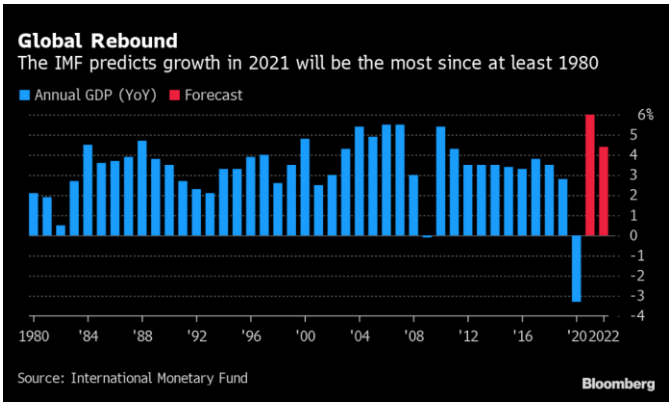
Figure 12: European Value vs Growth trailing P/E



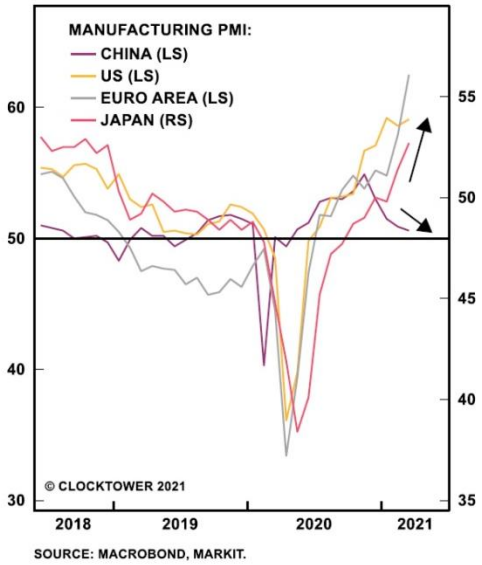
Source: Datastream

We often compare this valuation gap to a rubber band. The more it stretches, the higher the tension gets with high probability of a mean reversion.

The factors that would lead to this mean reversion to come in effect includes; first and foremost, better economic conditions and higher interest rates, in short reflation. This is now happening. IMF upgraded beginning of April its growth projections for the world economy for the 2nd time this year. IMF economists now believe the global economy will grow by 6%, up from the 5.5% estimated in January, the highest in four decades. For 2022, they believe the global economy will still grow at a healthy 4.4%.

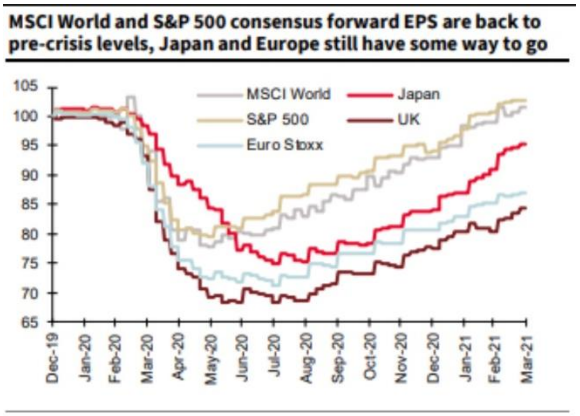


Business sentiment is also improving noticeably.



Bond markets is starting to discount a strong economic rebound with some inflationary pressure. Commodity prices are increasing. The US 10-year bond yields above 1.5% again and a yield curve steepening further. The steepening of the yield curve is implying that investors now anticipate inflation. We have stated many times that increased government spending and ultra-loose monetary policies will ultimately work and lead to higher economic activity and reflation. With the vaccinations being rolled out we should be starting to see light at the end of the tunnel.

Source : Bloomberg



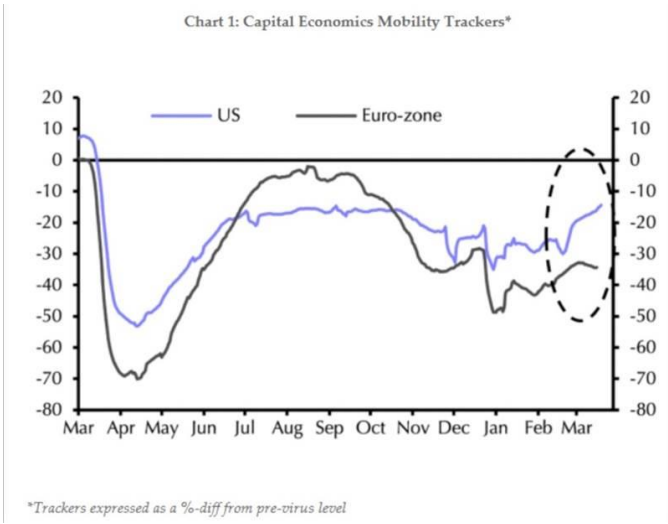
Source: SG Research

Corporate earnings are being upgraded as a result.

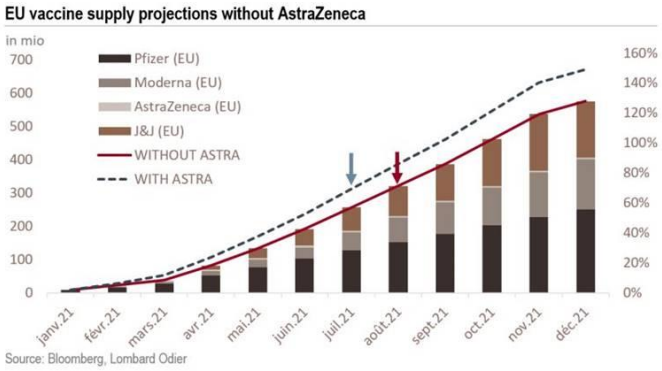
This is the turning point to a more benign environment for us value investors. Historically steepening yield curves have been positive for our investment style for 2 main reasons:

1) Rising interest rates make value stocks more attractive compared to growth stocks as discount rates increase.
2) Reflation means stronger economic activity. Here the more cyclical businesses which are preferred by value investors, like industrials, energy and materials, will benefit first. Equally, the financials, another hunting area for value investors, will benefit from rising interest rates as their net interest margins increase and credit quality improves once the pandemic is behind us.

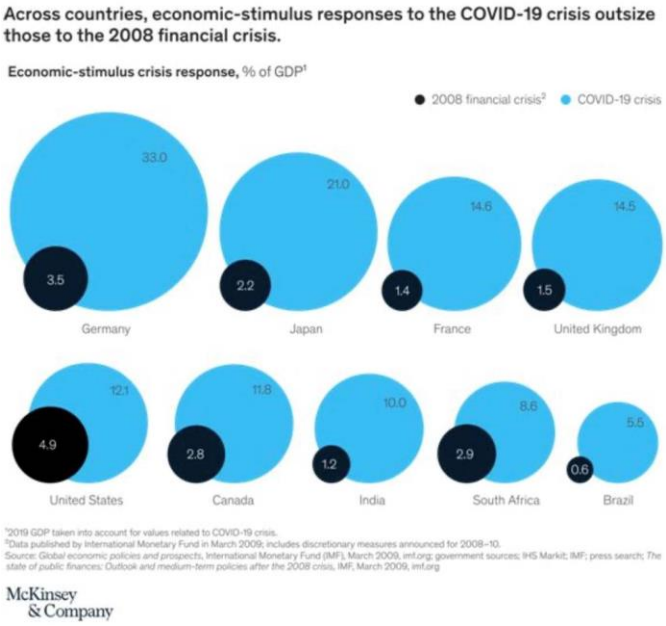
As we stated in the last quarterly report, we cannot escape the fact that any view on the financial markets is determined by the evolution of the pandemic. Here Europe has been somewhat slow in its vaccination campaign and lockdowns continue to dampen economic activity at a time when business activity starts to pick up in the other economies like the US.



Covid-19 pandemic is a major threat to mankind that will unfortunately stay with us till a vaccine or a treatment is deployed on a larger scale than it is today. For vaccinations we are still at the beginning of the journey:



We continue to believe there has been decisive management by policy-makers (states, central banks, multilateral organizations) with enormous amounts of the government and central bank support. At the start of the year, few expected further substantial US fiscal stimulus. But the Biden administration managed to secure an approval for its US$1.9 trillion fiscal stimulus package in its entirety, overcoming pressures for a far smaller package.



In this environment, the question of reflation trade is not an if but more of a when as it is mainly a function of the timing of a new vaccine.

Conclusion

We need to remember that Covid-19 is an exogenous shock. It has not been triggered by unsustainable financial excesses and the subsequent tightening of monetary and credit conditions that characterized previous financial crisis. That is important because it implies that our economies (households, governments and corporates) are not in a painful deleveraging mode. The current crisis, however difficult it is, will therefore be relatively limited in time.

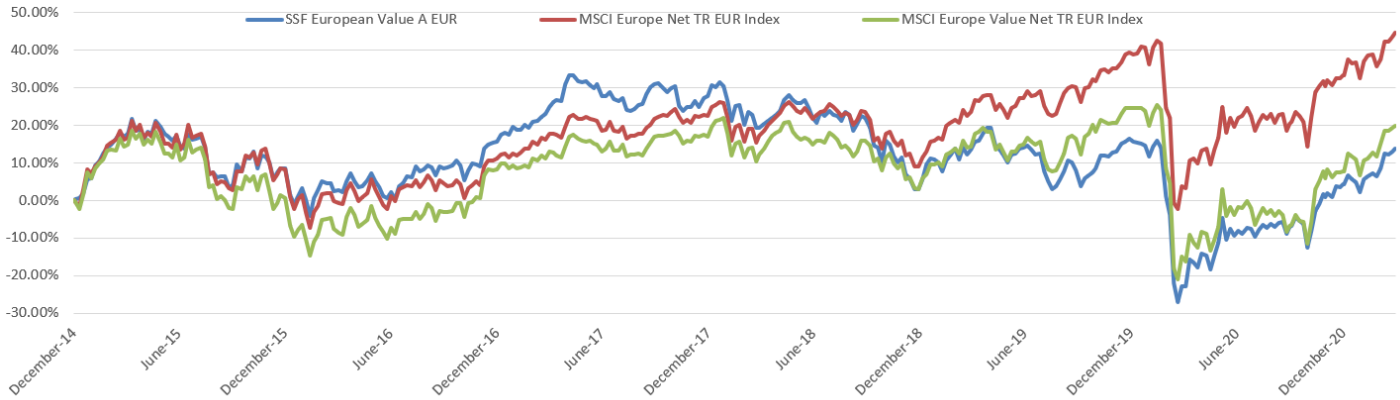
Benjamin Graham stated that in the short run, markets are a voting machine and in the long term a weighing machine. To us, there is no doubt the reflation trade is alive and the earning power of the companies we hold in the portfolio is recovering.

We can only repeat that "All that's required is the passage of time, an inner calm," as began a sentence in Warren Buffett's 2020 letter to the shareholders of Berkshire Hathaway. This is exactly our mindset when we look at our portfolio of businesses and invest for the long term.

Portfolio profile

Performance analysis

Cumulative performance since inception[1]



Performance statistics

	European Value (A EUR share class)	MSCI Europe NR	MSCI Europe Value NR
Since inception	13.70%	44.51%	19.84%
3 years	-4.65%	23.39%	6.91%
1 year	43.51%	35.32%	36.93%
YTD	9.14%	8.35%	11.29%
6 months	22.23%	20.06%	28.38%
3 months	9.14%	8.35%	11.29%
1 month	6.98%	6.47%	7.43%

Risk statistics (3 years rolling- annualised)

	European Value (A EUR share class)	MSCI Europe NR	MSCI Europe Value NR
Standard deviation	22.03%	20.13%	23.95%
Sharpe ratio	-0.06	0.37	0.10

		MSCI Europe NR	MSCI Europe Value NR
European Value	Tracking error vs. index	6.82%	7.53%
	Active share vs. index	87.1%	89.6%
	1 yr Beta vs. index	0.955	0.753

[1] The sub-fund ECP Flagship European Value has been managed by the same investment manager, with the same investment strategy and a comparable fee structure since 1 January 2015. The sub-fund has been managed under the legal form of an Alternative Investment Fund according to EU Directive 2011/61/UE until 8 August 2015 when it was converted into its current UCITS status according to EU Directive 2009/65/EC. The historic performance, return and risk data presented herein cover the full period from 1 January 2015 to date.

Fund Key Facts

- **Legal Form**: UCITS Compliant Luxembourg SICAV
- **Investment Manager**: European Capital Partners
- **Management Company**: European Capital Partners
- **Custodian**: Banque de Luxembourg
- **Administrator**: European Fund Administration
- **Auditor**: Deloitte Audit
- **NAV frequency**: Daily

European Value

	A EUR	I EUR	C EUR
ISIN Code	LU1169207518	LU1277321912	LU1768645753
Investor focus	Retail	Institutional	Retail
Inception date	08/08/2015 (*)	28/08/2015	28/02/2018
Max. Mgt fees	1.50%	0.80%	0.90%
Performance fee	-	-	-
Min. subscription	-	EUR 1mn	-
Registered in	LU, DE, CH, SE, FR, NL		LU, DE, NL

Synthetic Risk and Reward Indicator

Lower Risk
Potentially Lower Reward

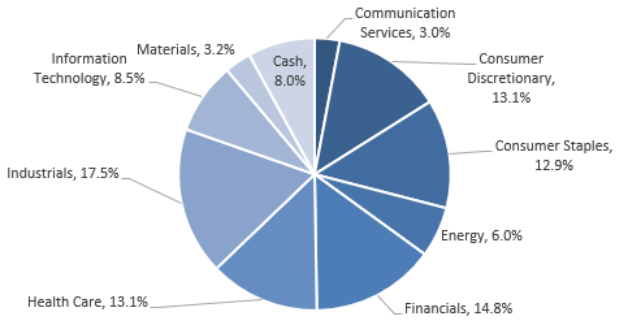
Higher Risk
Potentially Higher Rewards

1	2	3	4	5	**6**	7

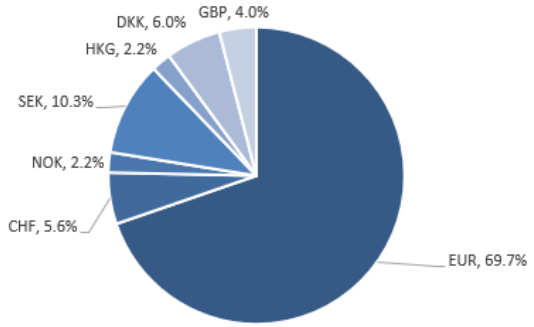
(*) Transformed from an AIF launched on 01/01/2015

Portfolio's breakdown (%)

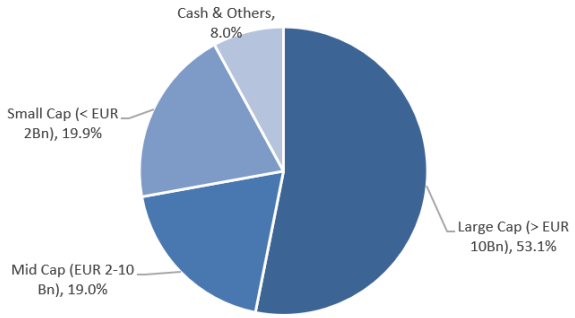
By Sector



By Currency



By Market Cap (*)



Portfolio holdings

Company Name	Sector	Industry Group	Country[1]	Market cap
Anima Holding Spa	Financials	Diversified Financials	ITALY	Small Cap
Applus Services Sa	Industrials	Commercial & Professional Serv	SPAIN	Small Cap
Asml Holding Nv	Information Technology	Semiconductors & Semiconductor	NETHERLANDS	Large Cap
Atos Se	Information Technology	Software & Services	FRANCE	Mid Cap
Axa Sa	Financials	Insurance	FRANCE	Large Cap
Bawag Group Ag	Financials	Banks	AUSTRIA	Mid Cap
Caixabank Sa	Financials	Banks	SPAIN	Large Cap
Cloetta Ab-B Shs	Consumer Staples	Food, Beverage & Tobacco	SWEDEN	Small Cap
Duerr Ag	Industrials	Capital Goods	GERMANY	Mid Cap
Elekta Ab-B Shs	Health Care	Health Care Equipment & Servic	SWEDEN	Mid Cap
Exor Nv	Financials	Diversified Financials	NETHERLANDS	Large Cap
Flsmidth & Co A/S	Industrials	Capital Goods	DENMARK	Small Cap
Fresenius Se & Co Kgaa	Health Care	Health Care Equipment & Servic	GERMANY	Large Cap
Hapag-Lloyd Ag	Industrials	Transportation	GERMANY	Large Cap
Henkel Ag & Co Kgaa	Consumer Staples	Household & Personal Products	GERMANY	Large Cap
Husqvarna Ab-B Shs	Consumer Discretionary	Consumer Durables & Apparel	SWEDEN	Mid Cap
Ing Groep Nv	Financials	Banks	NETHERLANDS	Large Cap
Jeronimo Martins	Consumer Staples	Food & Staples Retailing	PORTUGAL	Mid Cap
John Wood Group Plc	Energy	Energy	BRITAIN	Mid Cap
Jost Werke Ag	Industrials	Capital Goods	GERMANY	Small Cap
Koninklijke Philips Nv	Health Care	Health Care Equipment & Servic	NETHERLANDS	Large Cap
Lafargeholcim Ltd-Reg	Materials	Materials	SWITZERLAND	Large Cap
Loomis Ab	Industrials	Commercial & Professional Serv	SWEDEN	Mid Cap
Matas A/S	Consumer Discretionary	Retailing	DENMARK	Small Cap
Michelin (Cgde)	Consumer Discretionary	Automobiles & Components	FRANCE	Large Cap
Norma Group Se	Industrials	Capital Goods	GERMANY	Small Cap
Novartis Ag-Reg	Health Care	Pharmaceuticals, Biotechnology	SWITZERLAND	Large Cap
Novo Nordisk A/S-B	Health Care	Pharmaceuticals, Biotechnology	DENMARK	Large Cap
Ontex Group Nv	Consumer Staples	Household & Personal Products	BELGIUM	Small Cap
Origin Enterprises Plc	Consumer Staples	Food, Beverage & Tobacco	IRELAND	Small Cap
Porsche Automobil Hldg-Prf	Consumer Discretionary	Automobiles & Components	GERMANY	Large Cap
Prada S.P.A.	Consumer Discretionary	Consumer Durables & Apparel	ITALY	Large Cap
Publicis Groupe	Communication Services	Media & Entertainment	FRANCE	Large Cap
Reckitt Benckiser Group Plc	Consumer Staples	Household & Personal Products	BRITAIN	Large Cap
Rhi Magnesita Nv	Materials	Materials	AUSTRIA	Mid Cap
Sandvik Ab	Industrials	Capital Goods	SWEDEN	Large Cap

Company Name	Sector	Industry Group	Country[1]	Market cap
Sanofi	Health Care	Pharmaceuticals, Biotechnology	FRANCE	Large Cap
Sap Se	Information Technology	Software & Services	GERMANY	Large Cap
Stabilus Sa	Industrials	Capital Goods	LUXEMBOURG	Small Cap
Stmicroelectronics Nv	Information Technology	Semiconductors & Semiconductor	SWITZERLAND	Large Cap
Subsea 7 Sa	Energy	Energy	BRITAIN	Mid Cap
Swatch Group Ag/The-Br	Consumer Discretionary	Consumer Durables & Apparel	SWITZERLAND	Large Cap
Total Se	Energy	Energy	FRANCE	Large Cap
Unilever Plc	Consumer Staples	Household & Personal Products	BRITAIN	Large Cap

[1] Country of Risk as defined by Bloomberg

Key risk factors

- **Equity**: The Fund may be affected by stock price variations, the scale of which is dependent on external factors, stock trading volumes or market capitalization.
- **Currency**: Currency risk is linked to exposure to a currency other than the Fund's valuation currency, through direct investments.
- **Liquidity Risk:** A decreased or insufficient liquidity in the markets could negatively impact the prices at which positions are bought or sold by the sub-fund.

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In **Germany**, the paying agent is Marcard, Stein & Co, Ballindamm 36, D-20095 Hamburg.