

MANAGEMENT NEWSLETTER

BDL Convictions

1 September 2020



Dear fellow investors,

In August, financial markets spared us the twitches to which we have become accustomed. We hope that, like us, you have been able to enjoy the holidays and recharge your batteries before continuing the journey through what seems like a bad sci-fi movie.

We want to thank all those investors who continue to trust us, and welcome newcomers with even greater enthusiasm. We are fully aware of the responsibility that you have given us during a period when it has probably never been so hard to protect asset values, at least not in peacetime. There is a major risk of us losing purchasing power. The economy is reopening with the consequences of Covid-19 being felt in a great many industries. This is all mixed up with disruptive technological innovation, historic debt levels and negative interest rates.

It is now hard for us to predict how strong the economic recovery will be. There are far too many imponderables. How will Covid-19 pan out? How confident will households be? At what level will unemployment settle? How willing will business leaders be to invest in such circumstances? What new regulations will governments introduce to curb globalisation, which has reached its limits? How extensive will the positive and negative consequences of measures taken to tackle climate change be?

The Covid-19 crisis has led to changes in the stimulus methods used in the decade that followed the financial crisis. Not only has monetary creation been ramped up, but we seem to be moving from a policy of austerity to one of fiscal expansion. This method is very similar to the one pursued in the 1940s, when the United States' finances deteriorated after the country joined the war. The US Federal Reserve started to control the interest rate curve, and the budget deficit widened considerably. The combination of real growth and stronger inflation brought the United States' debt ratio down from 119% in 1946 to 78% in 1951.

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A playbook to inflating debts away

The nominal amount of debt remained constant,
while 4% real GDP growth and 5% inflation saw Debt/GDP fall from 119% to 78%

Year	Debt/ GDP	Debt(\$bn)	Nominal GDP (\$bn)	Real GDP (1942 \$bn)	Inflation (%y/y)	S&P 500 (%y/y)	House Prices (%y/y)
1942	44%	72	166	166	5.47	8.68	3.33
1943	67%	137	203	194	4.92	20.59	11.45
1944	89%	201	225	209	2.21	14.11	16.58
1945	113%	259	228	207	2.79	32.29	11.78
1946	119%	271	228	184	12.35	-12.69	24.10
1947	108%	269	250	182	10.81	-0.66	21.26
1948	96%	264	275	190	5.32	1.06	2.06
1949	91%	249	273	189	-0.17	8.89	0.09
1950	92%	276	300	206	1.10	19.41	3.64
1951	78%	271	347	222	7.27	18.53	6.05
1946 to 1951 change							
Cumulative	-41%	0%	52%	21%	26%	55%	36%
Annualised	-8%	0%	9%	4%	5%	9%	6%

Source: Exane BNP Paribas estimates, FRED "Inflation measured here using the GDP Deflator".

We think it will be the method that central bankers and governments apply to resolve the problems and absorb the debt burden.

We have therefore decided to keep our discipline and a safety margin. We are being disciplined in the prices that we are prepared to pay, even if our natural inclination towards focusing on fair value has been a source of considerable frustration in recent times. We still think that while valuations do not seem to count for much at the moment, they will - without exception - end up becoming important once again.

There are two pieces of good news for equity investors. The first is that there are few other liquid solutions for protecting the purchasing power of one's wealth. The second is that the polarisation of equity markets presents us with some massive opportunities to invest with peace of mind and, amidst the chaos, find good business models with good management teams and a good safety margin in the price paid. The gap between growth and value stocks is extreme. It is also extreme between companies that have benefited from Covid-19, and those that have suffered. We think that lots of things will ultimately return to normal, and that these gaps will narrow.

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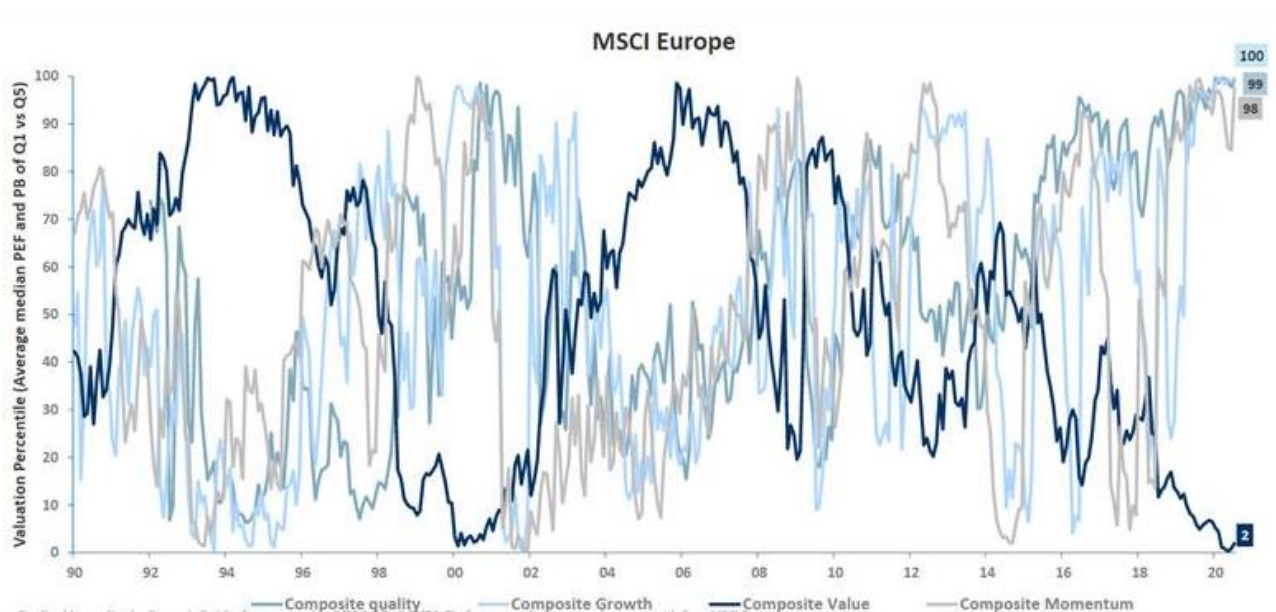
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The chart below shows the differences in valuation between the different styles (quality, growth, value and momentum) since 1990. It reveals that these performance factors are cyclical over time, and that we have returned to the extremes of the TMT bubble in the 2000s.

Percentile valuation of factor in Europe since Dec-89



Source: FactSet, Morgan Stanley Research. Pctl % of average median P/FE & P/B of Q1/Q5.

The factors are the top versus bottom quintile from MSCI Europe

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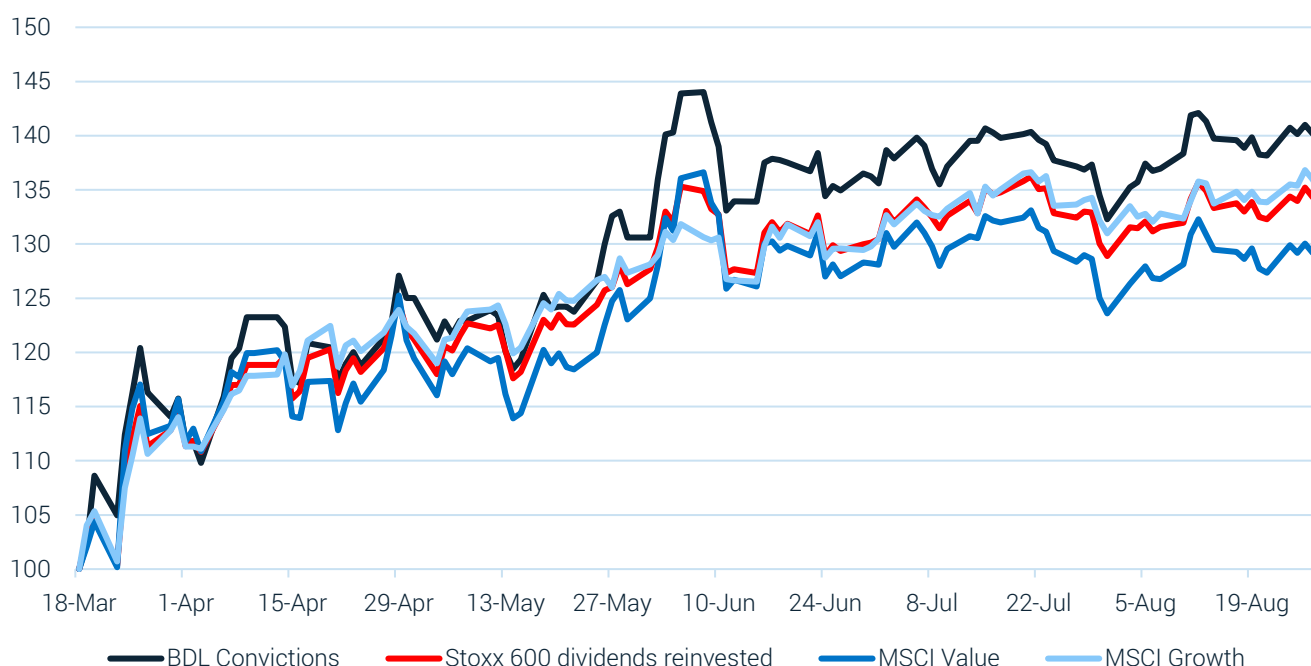


Performance:

During the crash in March, we explained that we had rebuilt the portfolio with an emphasis on European countries with the most robust finances, and large caps with the strongest balance sheets, splitting our money between defensive sectors and more cyclical industries that had fallen a long way.

Obviously, we are still unhappy with our YTD performance of -17.07% (BDL Convictions – I) and -17.48% (BDL Convictions – C), as of 28/08/2020. As we have written in previous correspondence, our investments in companies affected by lockdown continue to weigh heavily on our annual performance. However, since 18 March (market trough) and 1 June (European reopening) we have managed to close the gap on indices. BDL Convictions is outperforming the Stoxx 600, dividends reinvested. The fund has beaten the MSCI Growth and MSCI Value over both of these periods. We think we have struck the right balance between quality and price to keep making up ground and get back the money we have lost.

Performance since 18 March 2020



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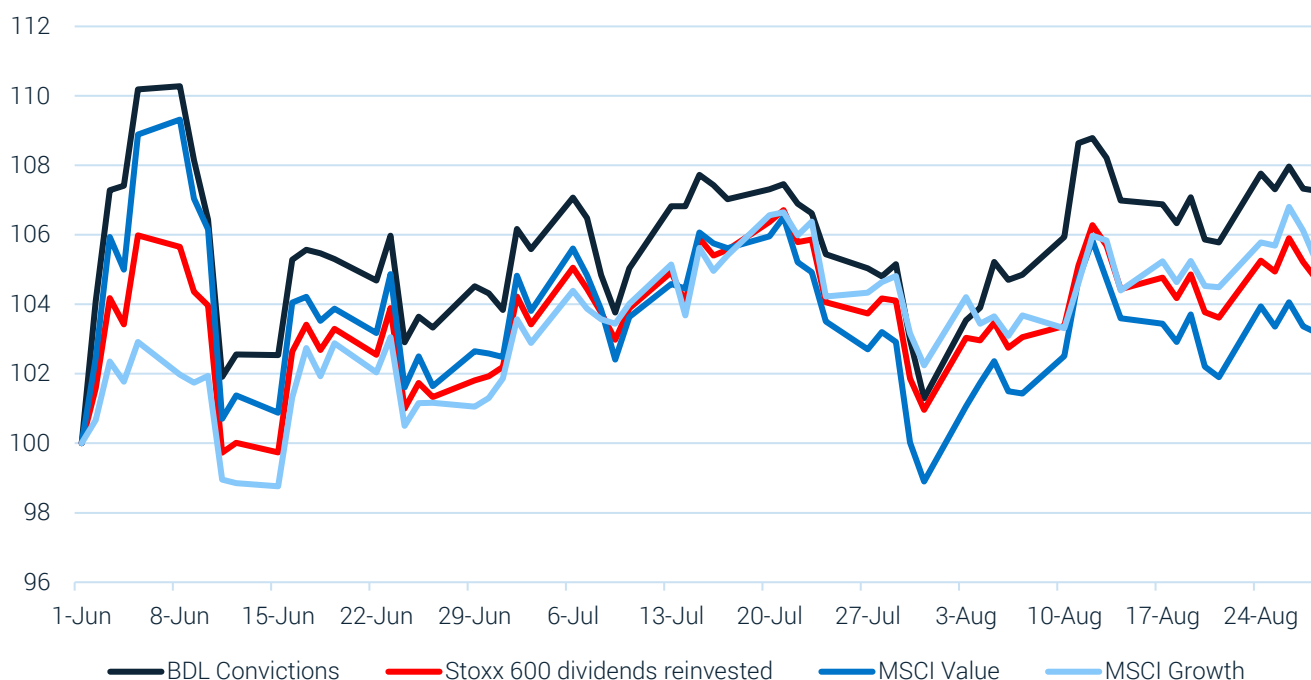
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Performance since 1 June 2020



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Investments:

We decided to take profits on northern European cyclical stocks showing healthy balance sheets, following average gains of 30% and share prices returning to their pre-Covid-19 levels. Their valuations no longer give us the kind of safety margin that we need given the uncertainty over the future of the economy. We closed our positions in Siemens, Akzo Nobel and CRH.

However, we still have 35% exposure to companies for which valuations remain very low and which will benefit from governments' rescue packages. Examples include Eiffage, Vinci, Bouygues, Heidelbergcement, Peugeot, Volvo, Continental and Autoliv.

Unfortunately, with the exception of RWE (2% of the fund), we cannot find any stocks linked to the Green Deal that meet our requirements in terms of management, business quality and reasonable valuation.

We also sold the investments that we had made when Airbus and Safran bottomed out. The resurgence of the virus and lockdowns in place continue to weigh on the air travel industry. The destruction of capacity could last longer and be more drastic than we initially thought. To some extent, their valuations already suggest a return to better fortunes, but we have our concerns. For all that, we think that we will all have to adapt to and learn to live with Covid-19. We have therefore held on to our economically defensive investments whose share prices are far from reflecting a return to normal. They make up around 25% of the portfolio: Eiffage, Vinci, Elio, Elis, Signature, Whitbread.

Financial companies account for 8.5% of our investments. We recently invested in BNP Paribas, which is trading at only half its book value and is the only bank whose business diversification seems able to counter the shock of negative interest rates over the long term. We are comfortable with the modelling of Covid-19 losses for insurers, and have yet to factor large price hikes for non-life insurance into our models. We hold shares in AXA, Allianz and Zurich.

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Let's now look at the details of a few investments:

Eiffage (8% of the fund): the business is resilient with motorway revenue inflation-linked. 80% of cash flow is recurrent for the motorway and energy divisions. The construction order book is the fullest it has ever been, mainly as a result of Grand Paris work. 100% of sites have reopened, and productivity is now close to its pre-Covid-19 level. Motorway traffic was down 31% over the first half of the year, but back to 2019 levels in July and August despite the near absence of foreign tourists. Price multiples still show a 30% discount on the historical average. We are paying only 11x forward earnings for 2021, and 9.3x for 2022.

Vinci (7% of the fund): the industry arguments are the same as for Eiffage, plus there is the air travel option. The valuation is in line with past multiples, but the discount is 25% with airports reopened. The valuation is 15x 2022 earnings with airports still at 70% of capacity over the next three years.

Peugeot (6% of the fund): PSA has the best margins in the sector, a very solid balance sheet and, in our opinion, the best management team. The Covid crisis proved to be an investment opportunity. At first we were very worried about the scale of the crisis for the auto industry, and the impact that it might have on automobile groups. In the end, the government furlough schemes introduced in France and Germany until the end of 2021, and help for buying less polluting vehicles, changed the deal. Our research shows that inventories have been cleaned out and prices have not fallen. PSA produces few or no cars without a purchase order. The production apparatus could be adapted in an ad-hoc way, given the furlough measure in place until the end of 2021. For the moment, press articles are reporting plans to recruit massive numbers of temporary workers to bring production back up to 2019 levels. Cars are becoming the preferred means of transport, to avoid overcrowded public transport.

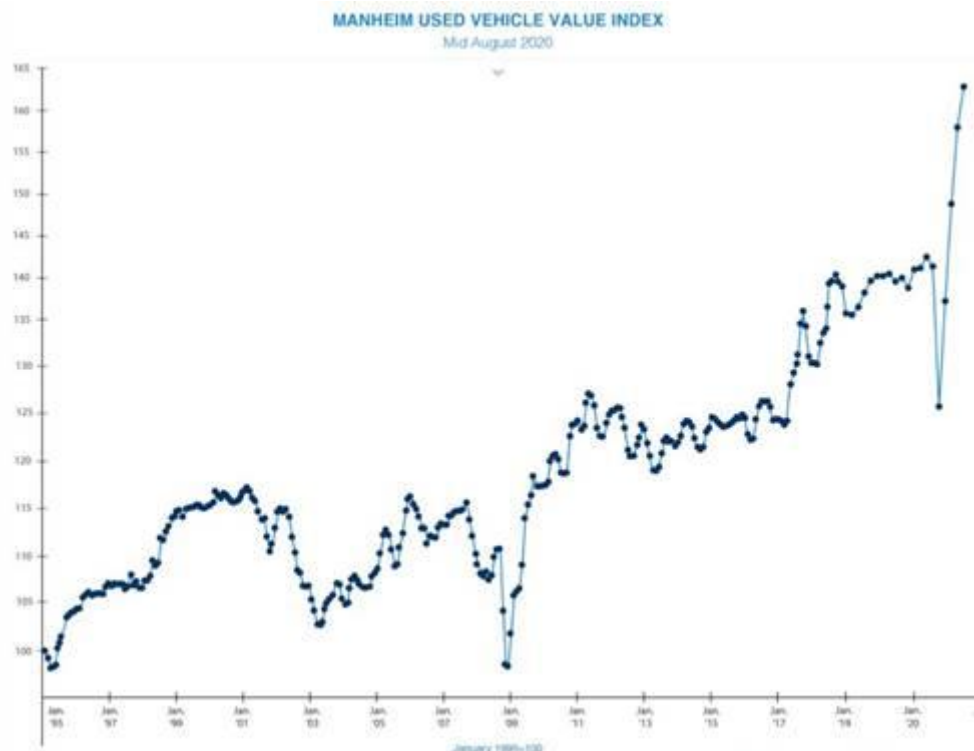
There is a lot less uncertainty about the merger with the Fiat-Chrysler group. We think it will go ahead, and the synergies that it would produce are considerable. We estimate them to be worth more than €5 billion. It would seem that there are not enough cars available in the United States as the price of second-hand vehicles is at a high, as the graph below shows. The valuation is extremely low at less than 5x earnings in 2021, and analysts' figures suggest a FCF/EV ratio of between 25% and 50%. Our safety margin therefore looks considerable. This is the complete opposite of Tesla with its \$400 billion market capitalisation. We think that PSA's share price should double, and there's none of Elon Musk's megalomania.

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Vivendi (5.5% of the fund): There is nothing to report, other than that the share prices of every company in a similar line of business remain in the stratosphere. The Vivendi group is still trading at less than its subsidiary, Universal Music, whose €30 billion valuation has been confirmed by Tencent's acquisition of a 10% stake, with the option of buying another 10%. Vincent Bolloré continues to buy out minority shareholders on the cheap after the company resumed its buyback programme.

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Bouygues (4% of the fund): Here too, price multiples are at rock bottom, and the balance sheet is solid following the sale of a stake in Alstom. Our safety margin is very big. We are paying just over 10x projected earnings for 2021, and have a dividend of 5.5%, even this year. Order books are full and prospects for construction operations encouraging given the numerous recovery plans that we can expect. The telecom division is growing again with an increase in new subscribers and price hikes of 30% for basic mobile packages in recent months. The acquisition of CIC's mobile division is a very good deal at the reasonable price of 4x EBITDA. There are lots of synergies from the absorption of fixed costs on networks, switching CIC clients who had been on the SFR network over to the Bouygues network. CIC branches will continue to market this offer, adding all of the fixed telephone products for businesses and individuals that are now available from Bouygues Télécom.

Elior (3.8% of the fund): This is our biggest loss of the year-to-date, having cost the fund's performance 3.75%. The price has gone from €14 to €5. By investing in Elior, we were looking at the resilience of catering and improvement in margins, which the new management initiated in 2019. We bore the full brunt of the lockdown crisis. The group burned just €18 million of operational cash over the first nine months of its financial year. We hope that, with children going back to school, the share price will return to a level that better reflects the industry's cash generation. We think the price has the potential to double in the near future. We are paying only 6x forward earnings for September 2022.

Heidelbergcement (3.55% of the fund): Here too, we will benefit from infrastructure-based recovery plans through this global leader in cement and aggregates production. We are paying less than 10x earnings for 2022. 73% of EBITDA is generated in the United States and Europe. We think it has the best management in the industry, and its technological advances with carbon capture have led to it opening its first zero carbon factory in Norway.

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Elis (3.25% of the fund): Elis is the European leader in textile leasing and maintenance solutions. Like Elior, the investment has been very costly for our fund, detracting 2.5% from performance. It is a generally resilient industry, which did not suffer any dip in revenue or margins in 2008/09, but which felt the full impact of lockdown and the closure of hotels and restaurants. High debt has become an issue, but the group has shown its ability to generate cash flow during this period. The stock is trading at less than 10x earnings for 2021.

Fnac-Darty Group (3% of the fund): This is a European leader in the retailing of cultural goods, entertainment products and household appliances. It was the only chain to keep offering a full sales and repair service during lockdown. Sales growth has stayed above 10% since the end of lockdown, thanks in particular to households' digital needs. We are still convinced that this major retail chain will remain a leader. It alone can provide a full bricks & mortar and online offering alongside a comprehensive advice and repair service. We are paying less than 7x normalised earnings for 2021.

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We would like to take this opportunity to tell you that we have added the following to the BDL Convictions fund's exclusion list:

- no funding of companies in the tobacco industry
- no funding of companies whose coal operations account for more than 25% of revenue
- no funding of companies whose manufacture or distribution of civilian weapons accounts for more than 30% of revenue.

To round off, equity markets' rebound at a time when the economy is suffering and visibility over a return to normal is very poor, requires us to maintain our discipline. The implications of this crisis are still far from being fully understood. In the circumstances, we prefer buying into proven cash flows at prices that give us a decent safety margin. This seems more prudent than investing in concepts with non-existent cash flows, or in companies whose valuations leave no room for comfort.

We wish you a pleasant autumn.

The BDL Capital Management team

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