UBAM – EURO EQUITY INCOME

Quarterly Comment

For Qualified Investors in Switzerland or Professional Investors or Eligible Counterparties as defined by the relevant laws.

Market Comment

- Following a positive start to the new decade the change in momentum of risk markets into March was striking in both its speed and magnitude. Believing that we were already in the latter stages of this decade-long bull market, the team have been on the lookout for signs of an economic slowdown but the cycle was interrupted far more abruptly than anyone could have anticipated as the COVID-19 virus spread across the world. As of recently the disease has been declared a pandemic, causing large parts of the global economy to be idled, which will have traumatic financial consequences for many businesses and households.
- The S&P500 index was -19.6% for Q1 2020 and set a number of records on its way down – e.g. fastest -30% decline, most violent peak to trough move/ volatility change compared to 2008 despite markets only moving half as much. The MSCI Eurozone index posted a more aggressive decline, at -25.09% followed by the MSCI EM at -23.6%. The UK FTSE All-share Index was -25.1% during Q1.
- There was more of a mixed picture on the credit side – higher prices for government bonds, due to interest rate cuts and the restart of quantitative easing programs, stood in contrast to negative returns in corporate bonds from the threat of profit erosion due to potentially prolonged industry shutdowns. The resulting performance was +8.2% for US Treasuries, +6.9% for UK Gilts and +0.3% for Euro Government bonds (ranging from -1.5% for Spain to +1.6% for Germany). Corporate bonds indices were -5.4% for Global Investment Grade and -14% for High Yield, for both the Euro and US regions.
- Commodity prices were also hit hard given the demand shock from the virus-imposed lockdown. Oil dominated the headlines as prices fell ~60% due to the combination of weak demand and an untimely lack of agreement between Saudi Arabia and Russia over constraining supply. Gold was the one exception, which was up +5% in the quarter as it tends to be an asset of preference when panic engulfs markets.
- The extent of the hit to the global economy is still unknown but a selection of indicators highlights the scale of the disruption: Chinese car sales fell by -80% in February, restaurant bookings were down -100% on some mobile apps and US unemployment claims doubled to nearly 7 million. Most governments and central banks have taken material supportive action by cutting rates (where possible) and restarting asset purchase programs in an attempt to mitigate the economic consequences of the virus. We've also seen fiscal stimulus being deployed in various forms, principally to help small-medium sized businesses weather the storm.
- Overall it's been a highly challenging quarter and our first thoughts/prayers are for the families of the deceased and the workers risking their health to ensure the safety and wellbeing of our wider communities.

All performance figures are given net of fees. Past performance is not a guide to current or future returns. See full disclaimer at the end of the document.

Performance Review

- The portfolio produced a return, net of fees, of -22.62% in the first quarter outperforming the benchmark by +247bps (-25.09%). With a portfolio beta of 0.92 we would expect the fund to outperform a falling market, all else being equal. In spite of this we are broadly pleased with the fund's relative resilience, particularly following several position changes that were made during the quarter.

- From a sector standpoint within the fund, the quarter's winners were Industrials, Consumer Staples and Real Estate whilst the main detractor was Information Technology (IT).

- Once again the Industrials sector was the outstanding relative contributor at +233bps, stemming largely from strong individual stock performances via the likes of Kone Oyj, Wolters Kluwer NV and Atlas Copco AB. Kone was arguably the most encouraging as we materially increased the position size into price weakness on the back of their withdrawal from the thyssenkrupp elevator sale (see Portfolio Activity section below).

- Within Consumer Staples we were most satisfied with the performance of off-benchmark holding Cranswick Plc. This pork & poultry producer, based in Britain, has gone through a strong period of trading due, in part, to the presence of Swine Fever in China but also we feel due to the successful ramp-up of their greenfield poultry facility in Suffolk, England. This additional leg of growth diversifies the business away from pork and offers some exciting longer-term opportunities for what has been a poorly served sector of the market, with weak competitor dynamics.

- Finally the fund's only Real Estate holding, Vonovia SE, continued to perform well in part due to the limited impact of COVID-19 on the German residential property sector. Virus aside, we feel this is a particularly well-managed business and still offers considerable scope for upside given the wide gap between its NAV and the replacement cost of its assets.

- Once again the IT sector has been a source of relative weakness for the fund. This was not only due to the lack of holdings in either ASML NV or SAP SE, the 'heavyweights' of the sector, but also the poor performance of the fund's only holding in the space, Amadeus IT Group SA. We will write more in the Q2 report as the company suffered from its direct relationship to air travel passenger volumes but also conducted a placing at the beginning of April to strengthen its balance sheet (we move we see as very positive). On the former two companies, whilst neither are natural income stocks we continue to learn and understand their business models and will update investors in due course.

- Lastly, we wanted to update investors on one of 2019s winners yet one of Q1's poorest performers, Melrose Industries Plc. We first met management in 2005, shortly after the founding of the business, and were struck but the simplicity of the business model and the absolute focus on shareholder value-creation. In essence Melrose buys good manufacturing businesses with strong fundamentals whose performance has been sub-standard for some time, largely due to weak stewardship. The company finances its acquisitions using a low level of leverage, improves the businesses by a mixture of significant investment and changed management focus, sells them and returns the proceeds to shareholders. For us this represented a refreshing departure from the 'typical' private-equity acquisition model: deploying large quantities of leverage, stripping assets, squeezing cash from every corner and generally starving the business of investment. Melrose's track record speaks for itself: 2.6x average return for shareholders since the first acquisition (~2003), a 17% CAGR in ordinary dividends and $4.7bn of total cash returned.

- In the wake of the virus the market has rightly focused on:

  1. Business models that are most vulnerable to the implications of a suspension in economic activity : airlines, leisure & hospitality companies (cruise liners, cinemas, restaurant operators etc).

  2. Any other cyclical company with a perceived weak balance sheet and/or high operational gearing.

- Melrose falls into the second bucket having acquired GKN, an automotive and aerospace parts business, in 2018. Ending 2019 with 2.25x net debt/EBITDA it was felt that the management team had performed well, materially increasing the free cash flow generation of the business. Further, with one of its other businesses up for sale (Nortek Air Management) in 2020, any proceeds would restore the balance sheet to great health whilst also providing a trade-mark return of capital to shareholders. However, with the likely material fall in demand in both automotive and aerospace end markets the shares fell heavily (despite having ample liquidity) over concerns that banking covenants could be breached. Melrose subsequently reported that discussions with their bankers concluded with the agreement of a covenant waiver (for a modest fee) for the June and December 2020 testing periods.

- Having spoken with the company and conducted our own analysis we feel the shares have been treated harshly and believe that management will be able to accelerate cost and cash conservation measures to ensure the business not only survives but thrives once demand returns to a more normal footing. As a result we have added to our position during March.

Portfolio Activity

We recognise that there has been a ‘heightened’ level of portfolio activity over the course of the last few quarters and we want to assure investors that this is not normal practice but more part of a longer-term shift in stance. A high proportion of this shift has now been made and going forward there should be a lower level of turnover, with some exceptions of course.

The following portfolio changes took place during the quarter:

- Increased position size:
  - Kone Oyj: The shares reacted negatively to news that the company had withdrawn from bidding for the Thyssen elevator business. Now that we understand the circumstances surrounding the withdrawal we fully agree with the decision (onerous terms etc). However, when added to the general market sell-off we felt that, in aggregate, the reaction was too severe and presented an opportunity to materially increase the position in one of the world’s finest industrial businesses.
- Reduced position size:
  - ING NV: The position has found itself to be a funder of other, higher-conviction names within the portfolio.
- New Positions
  - Novartis AG: After 10 years of unprecedented R&D success, Novartis has created peer-leading breadth and depth of innovation in terms of both therapeutic areas (oncology, cardiovascular, neuroscience and ophthalmology etc) and drug modalities (cell therapy, gene therapy, radioligand, biologics, small molecule). Moreover, that success has created a moat around Novartis’ key franchises which has allowed it to defend itself against the competition. This deep focus on R&D (with an estimated ~35% ROI since 2012) allied to a strong corporate structure, culture (e.g. one where bonuses are dependent not on a drug progressing but where the science conducted is deemed to be of excellent quality) and development/commercialisation process we find this to be one of the superior European, if not global, pharmaceutical businesses. With the high likelihood of success given a long cycle of visibility, we believe Novartis stands some distance apart from chief index peers Sanofi and Bayer:
  - Sanofi SA - we believe that Paul Hudson will make a strong impact on Sanofi’s floundering strategy but this will require radical change in an organisation that has resisted such a thing for over a decade. This is likely to cause upheaval and thus adds operational risk to the business. Further, the perception of quality [innovation] will take materially longer to fix, in our view.
  - Bayer AG – we struggle with the company on a number of levels. Whilst we accept the asset base is typically well-invested we find the corporate culture to be far too centralised and hierarchical, ultimately leading to poor allocation of resources and weak decision-making. In addition, we think the risk-reward profile of adding Monsanto to the company is asymmetrically skewed to the downside.

- Rational AG: The company is a leading provider of cooking systems (combi ovens) for professional chefs globally. Essentially they automate the cooking process, thereby providing savings for the owner in terms labour, raw materials and energy. The company has been on our radar screens for a long time but we have always been put off by the expensive valuation. We believe the recent pull-back offers a rare opportunity to own one of Germany's finest businesses, with an enviable track record of strong organic growth and very high returns on capital. Whilst the shares are not glaringly cheap, on ~20x 2021 EBIT they sit at the bottom end of their 5-year range. We believe that for a business with a 20-year track record of 8-10% organic growth, 17% free cash flow margin and 35% return on invested capital, this presents reasonable value.

- Elisa Oyj: Elisa is the traditional Nordic ‘safe haven’ telecoms company with a great track record of growth and high return on invested capital, along with consistent and growing dividends. Finland is arguably one of the best telecoms market in Europe – concentrated, with three players having close to 90% combined revenue share. All three have both fixed and mobile exposure, and have roughly similar subscriber market shares (the problem markets are those with sub-scale operators aggressively trying to win share with lower prices). Finland has also had a history of largely rational spectrum auctions, which has helped to support Elisa’s sector-leading ROIC (c17-18% pre-tax). The company is justifiably proud of its track record of paying out consistent and growing dividends, driven by reliable EBITDA and cash flow growth and underpinned by a conservative balance sheet (net debt/EBITDA ~1.7x).

- Sold Positions

  - Orange SA: We sold the remainder of the position during the quarter as it rallied into a weaker market. As explained previously, we have a preference for companies with simple, easily-understood business models, with stable returns and visible cash flow generation. At its December capital market’s day Orange disappointed at almost every level, with higher capex guidance, lower cost cutting targets and lower profit growth in France. We think there are more interesting alternatives in the sector, with Elisa (described above) being a prime example.

  - Deutsche Telekom AG: Sold as part of a strategy to consolidate the fund’s Telecoms holdings between KPN and Elisa and well as part-fund the recent position in Diageo (see Q4 2019 report for further details).

  - Acerinox SA: We sold the position in order to make way for the purchase of Rational. We have nothing against Acerinox, believing to be a well run-company, possessing high quality assets but sitting within a challenged sub-sector (stainless steel).

  - Faurecia SE: We believe the management team have done an excellent job of turning the company around and repositioning Faurecia for the next decade. However, when assessing the fund’s automotive-related exposure we find considerably more upside in Melrose and also prefer one other Spanish company (that the fund is yet to invest in).

- AIB Group PLC: Having spent some time looking at the business we no longer viewed the position as robust enough to endure a meaningful downturn in Europe. Further, we were somewhat disappointed to see the company recently miss on cost levels, an area that we were looking to be firmly within its control.

Outlook

- We wanted to take some time in this section to discuss the outlook for dividends in the coming year. It's somewhat unprecedented in our investment lifetimes to have seen such deep and sweeping dividend cuts/suspensions, particularly to final 2019 dividends which had already been announced but were pending payment post AGMs. Whether it's to secure liquidity, has been directed by regulators or simply a question of moral duty, companies have been quick to cut payouts to shareholders, even those with strong balance sheets.

- Thus far, 2020 dividends have been cut for 130 companies in the EuroStoxx600, a 20% share, dominated by the Financials, Industrials and Consumer Discretionary (retail/luxury/autos) sectors, although note that many Energy companies have yet to make announcements. European dividend futures are already implying that 2020 dividends will be cut by ~50%. By way of comparison, in the global financial crisis of 2008/9, 73 EuroStoxx constituents cut dividends, and these fell cumulatively by 28%, vs earnings which fell 42%.

- Where does this leave the portfolio? Unsurprisingly we have a number of holdings that have passed on the 2019 final dividend and in all likelihood will follow suit in 2020. However, given that few sectors will go untouched in the coming quarters to us it appears simply impractical to make material changes to the portfolio and discard all companies that have passed on their dividends – the result would leave the fund devoid of balance and heavily weighted towards just a few sectors (e.g. almost zero bank ownership and significant holdings of pharmaceuticals and utilities). Further, and more importantly, it would also involve buying companies that we do not fundamentally believe in over the longer-term.

- So at this point in time we have not and do not intend to shift the portfolio in a material way in response to widespread dividend cuts – we simply have to go through this challenging situation alongside many other income-based strategies. Rest assured however, that we are monitoring the situation on a day-to-day basis and if we come across portfolio holdings whose prospects are more than temporarily impaired by the current state of affairs, then we are prepared to take decisive action.

- Ultimately, given that our focus rests heavily on bottom-up stock picking - building a portfolio of long-term, high quality, resilient, well-capitalised businesses run by managers who think and act like owners - we believe that those fund holdings impacted by current events will be in a position to emerge as leaders in their respective sectors as and when normality resumes.

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