Ennismore European Smaller Companies Fund

Investor Newsletter for the month of May 2012

Issued on 11 June 2012

Fund Details

Daily dealing UCITS and Irish Central Bank regulated open-ended investment company with Financial Services Authority approval, registered in Ireland and listed on the Irish Stock Exchange. The Fund size was GBP 188.6m as at 31st May. Total assets under management by Ennismore Fund Management were GBP 231.5m. Our funds are hard closed to new investment with the number of shares in issue capped and we have a waiting list of clients that want to invest as and when capacity becomes available through redemptions. If you would like to be included on this please call Eleanor Scott on +44 (0) 20 7368 4219 or email subs@ennismorefunds.com. Redemptions can be made through the Administrator in the usual way.

The Fund is managed as an absolute return fund with the objective of generating positive returns irrespective of market conditions rather than performing relative to any benchmark index. Index data is provided in the following table as a guide to general equity market conditions.

Performance as at 31 May 2012

	Share Class[2]					HSBC Index[3]		MSCI Index[4]
	GBP A £	**GBP A €**	**GBP B**	**EUR A**	**EUR B**	**GBP**	**EUR**	**(local)**
NAV per Share[1]	**63.61**	**79.18**	**10.74**	**11.15**	**11.22**			
Period			**% Change**				**% Change**	
May 12	**-1.9**	**-0.4**	**-1.9**	**-0.7**	**-0.7**	**-8.8**	**-7.3**	**-6.5**
April 12	-1.4	0.8	-1.4	0.4	0.4	-3.1	-0.8	-2.5
March 12	0.0	0.5	0.0	0.4	0.4	-0.8	-0.3	-0.3
February 12	2.8	1.8	2.8	2.0	2.0	6.5	5.5	4.3
January 12	0.5	1.2	0.6	0.9	1.1	7.8	8.6	3.4
December 11	-1.4	1.0	-1.4	0.6	0.6	-1.7	0.7	1.0
2012 to date	**0.0**	**4.0**	**0.0**	**3.0**	**3.2**	**0.7**	**5.0**	**-1.9**
Annualised return[5]	**15.0**	**13.8**	**5.4**	**8.5**	**9.0**	**6.9**	**5.7**	**1.2**
Since launch[5]	**548.1**	**462.2**	**7.4**	**11.5**	**12.2**	**142.9**	**110.3**	**17.9**

[1]Source: Administrator, Net Asset Value. [2]Source: Administrator, Net Asset Value, net income reinvested. [3]Source: Bloomberg, HSBC Smaller European Total Return Index. [4]Source: Bloomberg, MSCI Europe Index, local currencies, total return. [5]Since inception of GBP A share class on 27/01/99 to date , GBP B share class on 19/01/11 to date, EUR A and EUR B share classes on 31/01/11 to date.
Note: All performance figures net of fees.

Comments below on performance refer to GBP NAV per share unless otherwise stated, exclude cash returns and are prior to expenses.

The Fund's NAV fell by 1.9% during the month. Our long book cost 7.1% while the Fund's short exposure contributed 5.0%. The main negative contribution came from the Fund's investment in Xing, which cost 1.4%. The company reported first quarter results which showed continued good revenue growth but, as expected, lower profitability due to investment in the new ticketing service. As this was clearly forecast by management last year we do not see it as a cause for concern but we will be watching closely to ensure that cost growth is reduced significantly in the second half of this year. At an enterprise value of less than twelve times expected 2012 operating profit, with considerable growth forecast for many years to come, we believe the Xing franchise remains significantly undervalued.

Portfolio Activity

Figures in brackets refer to previous month end; * = positions > 0.5% of NAV.

As at 31st May the Fund was invested in 72 (73)* stocks. We sold one existing position on the long side, covered six short positions and opened two new ones. Overall the Fund's gross and net exposures were reduced.

Home Retail Group – UK general merchandise retailer (2.1% NAV)

Home Retail Group owns Argos, the largest general merchandise retailer in the UK, and the second largest home improvement chain, Homebase. Both businesses have struggled along with the UK consumer and Home Retail is now generally written off by the investment community – 15 of the 22 analysts covering the stock on Reuters rate it a sell, only four are positive. The share price is off by two thirds over the past year. We do not often invest in companies that are so well followed but, despite obvious operational challenges and continued weak UK consumer demand, we believe Home Retail's capital structure makes it a very low risk investment with the potential to more than double when the general economy improves.

To begin with the downside now seems very limited. Home Retail has a current market capitalisation of just under GBP 600m. This buys you a significant net cash position – nearly GBP 200m at the end of March this year, but on average over the year more than GBP 100m higher – and a completely self-financed customer credit book of around GBP 450m. Even if you assume that the Argos business is in terminal decline (we disagree, of which more below), winding down the business over the next decade (it has GBP 1bn of lease commitments with an average length of 7 years) should still generate enough cashflow to give you a positive return. This year we estimate it will contribute around GBP 70m to operating profit, down from nearly GBP 100m last year. With virtually no capex (if you are winding down the business) the cash contribution should stay positive for several years even with continued negative like for like sales, and we estimate closing Argos gradually would generate positive cashflow overall, including the cash coming from running off the loan book and lower working capital. In other words, in the worst case scenario, it looks as if you are paying an enterprise value of less than GBP 400m for the home improvement chain Homebase. This is the number two player in the UK market, behind Kingfisher's B&Q. The market is relatively stable and consolidated, with competitor Focus having collapsed last year. With a gross margin of 50% Homebase is highly operationally leveraged, particularly to the level of housing transactions which have been running at half their long term average for most of the last five years. Over this period Homebase's profit contribution has averaged GBP 34m, compared with GBP 85m over the previous five years. So in our worst case scenario, where you get this business plus cash of more than GBP 200m, we believe that the current market valuation of Home Retail carries very little risk of loss.

However we do not agree that Argos is clearly in terminal decline. While like for like sales have fallen in each of the last four years it seems that most of this can be explained by declining disposable incomes, particularly for lower income families who benefit least from lower mortgage rates and are hardest hit by cuts in government spending. We do not believe that online retail is a significant issue for Argos for several reasons. Firstly it is already the second largest online retailer in the UK with about 40% of sales made online. Crucially, though, only about 10% of sales are ordered online for home delivery and this has not changed much over the last ten years (other than that people now order online rather than over the phone). Instead most online sales are collected in store by the customer, 40% within 4 hours and all of them by the next day. Argos is, as it has always been, a convenience retailer (the stores are little more than warehouses with collection points for customers, which also makes them more efficient than retailers with large display areas). Aside from convenience and speed, the product range is also mostly unsuitable for online retail. About 80% of the items they sell cost less than GBP 30 but are too big to go through the letterbox, which means they are not economic to deliver to home at a cost of around five pounds (plus the opportunity cost of someone making sure they are in to take delivery). This amounts to about half of their sales by value but, we estimate, more like 75% of their gross profit. The main area where Argos is exposed to online competition is in consumer electronics, which accounts for about a third of sales and was by far the worst performing category last year (down 15%). Importantly the gross margin here is low at only around 15%-20%, compared to an average of over 35% across the other categories they sell (homewares, furniture, toys, jewellery and leisure equipment are the main ones). Over time the average margin should therefore improve as the mix shifts away from consumer electronics and as their value, own label brands (Alba and Bush) become more important within this category. Finally we believe that Argos will increasingly begin to benefit from other, less diversified retailers exiting the high street. The scale of retail insolvencies has increased significantly this year but in many cases this has not yet lead to significant store closures, two large examples being electricals retailer Comet and computer games retailer Game. Having faced increased competition for several years as the supermarket chains moved into non-food this could provide a welcome boost to Argos's market share in future, allowing revenues to stabilise ahead of a recovery in consumer spending.

If we are right that Argos's troubles are mostly cyclical and that in a better consumer environment it can return a higher level of profitability then Home Retail Group's shares are very significantly undervalued. Over the last decade Argos's profit contribution averaged close to GBP 300m a year. We cannot make any firm estimate of what this will be over the next ten years but if half that level proves to be sustainable in future it would imply Home Retail is worth perhaps three times its current market capitalisation. As the downside appears so limited we believe this is an investment that is well worth making despite the huge level of uncertainty over exactly how much profit the Argos business will make in future.

Top Five Holdings as at 31 May 2012

	Company	Country	Sector	% of NAV
1	Sto	Germany	Materials	5.2
2	Xing	Germany	Information Technology	5.0
3	Howden Joinery	United Kingdom	Consumer Discretionary	4.5
4	Vib Vermoegen	Germany	Financials	4.1
5	Informa	Jersey	Consumer Discretionary	2.8
				21.6

Exposures as at 31 May 2012

Longs %	Shorts %	Gross Exposure %	Net Exposure %
80.2 (84.8)	34.0 (36.9)	114.3 (121.7)	46.2 (48.0)

Figures in brackets refer to previous month end.

Exposures by Country, Market Cap and Sector as % NAV as at 31 May 2012

Country	Gross%	Net%
Austria	1.0	1.0
Bermuda	3.2	-0.4
Denmark	2.7	1.7
France	3.5	3.5
Germany	27.4	21.7
Ireland	3.4	3.4
Italy	4.3	3.2
Jersey	5.8	0.8
Netherlands	1.0	0.0
Singapore	1.7	1.7
Sweden	4.8	-0.3
Switzerland	6.6	-0.1
UK	40.7	9.0
US	5.8	-0.9
Other	2.4	1.9

Market Cap	Gross%	Net%
>£2bn	3.9	1.7
£700m - £2bn	19.2	0.7
£200m - £700m	49.4	7.6
<£200m	41.8	36.2

Sector	Gross%	Net%
Consumer Discretionary	44.7	11.8
Consumer Staples	2.7	-0.9
Energy	1.6	1.6
Financials	13.6	11.1
Health Care	0.5	-0.4
Industrials	13.2	7.2
Information Technology	22.5	8.5
Materials	10.0	10.0
Telecommunication	5.0	-2.2
Utilities	0.5	-0.5
Other	0.0	0.0

Geographic analysis relates to country of incorporation or listing. This may not represent the underlying economic exposure of the operating business. Sector analysis is based on the Global Industry Classification Standard ("GICS"). Source: Bloomberg.

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