Ennismore Global Equity Fund

Investor Newsletter for the month of December 2016

Issued on 18 January 2017

Fund details

Daily dealing UCITS and Irish Central Bank regulated open-ended investment company with Financial Conduct Authority recognition and registration in Ireland. The Fund size was USD 193m as at 30th December. Total assets under management by Ennismore Fund Management were USD 753m. 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.

Performance as at 30 December 2016

	Share Class			
	GBP	**GBP A**	**EUR**	**CHF**
NAV per Share[1]	**10.60**	**10.58**	**10.80**	**10.65**
Period	**% Change**			
December 16	**5.2**	**5.3**	**4.7**	**4.0**
November 16	-0.8	-0.8	4.1	3.9
October 16	1.6	1.3	-0.9	-1.4
2016	**6.0**	**5.8**	**8.0**	**6.5**
Since launch[2]	**6.0**	**5.8**	**8.0**	**6.5**

[1]Source: Administrator, Net Asset Value. [2]Since inception on 03/10/16. Note: All performance figures net of fees.
Past performance is not a guide to future returns.

Top five holdings as at 30 December 2016

	Company	Country	Sector	% of NAV
1	Potash Corp	Canada	Materials	4.8
2	Mtu Aero Engines Gmbh	Germany	Industrials	4.8
3	Spectris Plc	United Kingdom	Information Technology	4.6
4	Etsy Inc	United States	Consumer Discretionary	4.6
5	Wm Morrison Supermarkets Plc	United Kingdom	Consumer Staples	4.4
				23.2

Exposures as at 30 December 2016

Longs %	Shorts %	Gross Exposure %	Net Exposure %
71.5 (83.5)	37.4 (42.6)	108.9 (126.1)	34.1 (40.9)

Figures in brackets refer to previous month end.

Exposures by country, market cap & sector as % NAV and positions as at 30 December 2016

Country	Gross%	Net%
United States	29.3	1.2
United Kingdom	29.0	20.5
Germany	16.3	9.1
Canada	7.1	4.4
Netherlands	3.8	-1.7
Norway	3.7	3.7
Switzerland	3.0	-3.0
Belgium	2.9	1.1
Sweden	2.9	-0.1
Luxembourg	2.4	2.2
Other	8.5	-3.3

Market Cap	Gross%	Net%
>$10bn	14.2	3.4
$5bn-$10bn	26.5	21.0
$1bn-$5bn	53.5	15.3
<$1bn	14.7	-5.6

Positions	Dec	Nov
Long	35	36
Opened	0	3
Closed	1	1
Short	46	47
Opened	6	4
Closed	7	2

Sector	Gross%	Net%
Consumer Discretionary	23.1	14.6
Consumer Staples	9.3	-0.4
Energy	2.6	1.9
Financials	5.9	1.1
Healthcare	1.6	0.1
Industrials	17.9	9.9
Information Technology	27.4	3.0
Materials	9.9	2.3
Telco Services	9.4	3.4
Utilities	1.8	-1.8
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.

We wrote the Fund's first long form newsletter in early November. As luck would have it we could not have scripted it much better. The two positions we focussed on – Mediaset SpA ("Mediaset") on the long side and our short in Sirius Minerals PLC ("Sirius") – were the largest contributors to what turned out to be a good first quarter for the Fund. We think events have shown our analysis of both companies was right. This is what should matter to you as an investor because we can repeat that trick. As for timing, it is better to be lucky than good!

It was always clear that Vincent Bolloré's Vivendi wanted to build a pan-European TV business and acquiring control of Mediaset fits this strategy. It was less obvious how that could be achieved with Silvio Berlusconi's Fininvest owning a large minority stake in the company. We still don't know the answer but Vivendi, as it often does, began forcing the issue in December by building a near 30% stake. Negative sentiment from the dispute over the sale of the premium TV business – which now seems like the side issue it really always was – evaporated, with the Mediaset share price up 80%. We sold our entire position (and closed the related short hedges in Mediaset España Comunicacion SA and EI Towers SpA) towards the end of the month.

Sirius had announced its first stage fundraising when we wrote to you in early November. The shares have since fallen further, trading below the already heavily discounted placing price. We have covered most of the position for now, with an average realised gain of 40%, but our view on the business has not changed.

Those were the two stand out investments in the quarter but the Fund's return overall was broadly based. Taking the Mediaset position as a whole, including the short hedges, it accounted for about half of the contribution from the long book. In other words about half came from across the rest of the book. On the same basis our short book delivered somewhere between a fifth and a quarter of the Fund's performance (depending on currency). Again the largest contributor, Sirius, made only about half of this.

Time

This letter seemed like a good opportunity to share a few of our thoughts on time.

The first thing to stress is that our apparent skill in timing our investments so far is mostly an illusion. Our approach gives us almost no insight on timing (there are exceptions, like Sirius, but not many). We pick stocks. To spend your life doing that you have to believe that markets are not perfectly efficient (or be mad). When we invest in a company we are saying we think the market has it wrong, that the shares are mis-priced. It is not logically consistent to believe that and to think that you can normally predict when the share will be valued fairly by the market. You can't be a stock picker and a market timer.

Our investment approach is basically timing agnostic. We only know that in the long run most shares will trade close to their real value. On average, in time, shares in companies that generate a lot of cash relative to their enterprise value will go up. Frauds and promotions that burn money will go bust. Not always, but on average and in time, markets are pretty efficient. That is the theory we put into practice. It is one of the reasons that our ideal holding period for a long investment is forever (in practice it is several years).

It is also part of the reason the Fund's portfolio is well diversified. On average a few positions should really perform each year, if we are doing our job finding mis-priced stocks. A highly concentrated book is likely to have much more lumpy returns. That might be fine for private equity but we recognise that we need to deliver more consistent performance managing a liquid fund. No matter how well we work, though, there will be times when our approach does not generate good returns. Sometimes those times will be months. Sometimes they may be for longer. We are prepared to wait because we believe this has been key to Ennismore's funds delivering up to now.

We think the Fund has a real competitive advantage over a lot of the competition when it comes to time. The management firm is owned and controlled internally. There is no pressure to pull short term performance out of the hat or to gather assets to generate fees. The Fund's portfolio, with relatively low net exposure and short book that is expected to make money at any time in the cycle, is designed to allow us to remain solvent longer than markets can stay irrational (to paraphrase John Maynard Keynes). It is typically liquid enough to meet any redemptions without affecting the return other investors get. And last, but by no means least, we believe that you - our investors – take a much longer term view than average. All of this allows us to spend our time picking stocks.

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When we do make an investment we have to be able to justify why we think the market is wrong. Our conviction can come from doing better research. Sirius is a good example. We think we did more and smarter due diligence than our counterparties on the long side. Information is an edge. That is our favourite reason to make an investment and a lot of our short book fits this description. With Mediaset it was partly about sentiment. Benjamin Graham's manic depressive Mr Market had over-reacted to bad news. But it was also probably partly about time. We had no idea the position would work out so well so quickly. We were prepared to wait and understood it could take a long time for the issues with Vivendi to be resolved. Many investors won't or can't wait so sometimes the duration of our investment is our edge.

For the stocks in our portfolio today the average holding period across all shareholders is about 18 months[1] (that overstates the duration for investors trading the shares, and so setting the market price, as it doesn't adjust for free float). The shortest is little more than a month. Many shareholders don't care about the long term. They will often misprice a company that is investing, depressing current earnings, even if this is creating value. A few of our long positions fit this description and we have written up one of them in this letter.

To wrap up this section on time we will only add that it is nice that the Fund had a good first quarter. One of the biggest risks with a new product, especially one designed to make money over the long run, is that a period of weak performance (which is inevitable at some point) comes early in its life. Shareholders are much more likely to be forgiving when they have a stretch of good returns under their belt. We hope that for you (and us) this is a long way off but we are not arrogant enough to think it won't come.

MTU Aero Engines Gmbh

MTU Aero Engines Gmbh ("MTU") does what it says on the tin. It makes aeroplane engines. These are usually built by a consortium of manufacturers, led by one of the big three (GE, Rolls Royce and Pratt & Whitney), with each member contributing specialist capabilities and owning a percentage of the economics. MTU's expertise is in the compressors which squeeze air into the combustion chamber of a jet engine and the turbines that power them. The company is present on a number of engine platforms but we can get a very good idea of its value looking at only two. The first is the well-established V2500 engine, which mostly powers Airbus's A320 family of narrow body planes. The second is its replacement, the PW1000G. One is nearing the end of commercial production. From here it will be a very predictable and hugely profitable cash cow for at least 20 years. The other is just starting but for a number of reasons looks set to be much larger and more profitable over its lifetime. The combination of predictable cashflow from one and significant growth potential from the other makes MTU an attractive investment.

Successful engine models have attractive economics over the long run but they burn cash while they are being developed (a new engine can cost USD 2-3bn to develop). Once in production they are sold at close to zero margin. It is only several years on, as they come in to shop for maintenance and spare parts in particular, that the engine makers generate positive cash flow. Returns are heavily weighted to the second half of a plane's life. The V2500 is a very successful engine. There are around 6,000 flying today and this is expected to peak at around 7,000 in the next couple of years. The average remaining life of those engines is close to 20 years. Most have yet to have their first shop visit and may make four over their lifetime. MTU ended 2016 with about EUR 2bn in maintenance revenue ("MRO"), mostly from this engine. They make an 8-10% margin on this. This income – we estimate about EUR 150m a year pre-tax from V2500 MRO work - will grow for most of the next decade then decline slowly. We know this because it is mostly under flying hours contracts where servicing is managed by the manufacturer in return for a fixed fee from the plane owner. That is nice work but the real profits come from spares. MTU has spare parts sales today of about EUR 1.5bn, of which we estimate around EUR 650m is for this engine. The company has guided for this revenue to grow materially up to 2025, implying a peak of over EUR 1.5bn. This matters because the margin on spares is very, very high. 50% may be a reasonable estimate. The V2500 will generate a huge amount of cash over the next ten years and a lot more for at least another ten after that. We estimate it could be worth EUR 4-5bn in today's money (taking into account a liability to Rolls Royce of about EUR 500m; MTU bought 5% of its stake in the V2500 in 2012).

The V2500's success is closely linked to Airbus's A320 which has become the dominant single aisle aircraft used for short-haul flights. Its replacement, the PW1000G, should be much more profitable for MTU over its life time for a number of reasons. The first is that demand for air travel continues to grow with mid-single digit annual increases forecast for the next twenty years. Secondly narrow body planes will deliver more of this growth than long-haul planes, because

[1] Calculated by dividing number of shares in issue by historic average daily trading volume and weighting by portfolio position size

increased demand is more from flights within continents. The third reason is that Airbus's A320 is expected to take more like 60% share of the narrow body duopoly this generation, compared to a more even split during the V2500's production life. So far the A320neo has 5,069 orders to 3,449 for Boeing's 737 MAX. You can already see this growth in MTU's order book. In October 2016 they had more PW1000G engines on order than there are installed V2500s. By 2020 they forecast production will be double the peak V2500 run rate. Fourthly, MTU expects 70-80% of the PW1000G fleet to be under OEM maintenance contracts compared to 60% for the V2500. That is, it will make more service margin per engine on the new platform. And finally, most obviously of all, MTU owns an 18% stake in the PW1000G platform. This compares to 16% for its predecessor. So even without any growth MTU would make 12.5% more from the new platform because it has a higher ownership interest. For all of these reasons PW1000G engines on the A320 look set to provide MTU with significant growth over the lifetime of the platform.

Those two engines alone are enough reason for us to invest. That is before we have even considered the industry leading technical innovation built into the PW1000G. It is a geared turbo fan ("GTF") engine. This is technology pioneered by Pratt & Whitney and MTU and they are the only manufacturers that have it ready for this generation of aero engines. Put simply, by adding a gear GTFs can run three critical components (the fan, low pressure compressor and turbine) at their optimal speeds on separate shafts. Traditionally they have all run on one shaft with the fan limiting speed. The benefits are better fuel economy (a 16% improvement on the V2500), fewer components (higher speed means less stages are needed in the compressor and turbine) and significantly less noise pollution (the GTF design allows more air to go around the outside of the combustor cancelling out three quarters of the engine noise). Fewer components is significant because MTU believe it will mean the engines need less maintenance over their lifetime, while the revenue they generate from this work stays the same under flying hours contracts. GTF engines have also allowed MTU to enter the market for smaller, regional jets for the first time. They forecast GTFs will take a 90% share in this segment of the market, with around 15% of sales coming from regional jets by 2025, from none today. This is not insignificant.

The forecast commercial outperformance of GTF engines in general remains to be seen and is more speculative than the outlook for the two platforms we detailed above. The technology has had some teething issues so far and it will take years to see how they run over their lifetime. For that reason we don't rely on it for our investment case which is clearly based on V2500 and PW1000G engines installed on the A320 family. What are the threats to this outlook? The V2500 cashflow is pretty secure. A downturn in a major economic region (or the return of a very high oil price) might see more planes grounded, delaying maintenance revenue, but it would not significantly reduce lifetime value. It would also temporarily reduce demand for new engines. The bigger question (one we can add nothing to) is whether long term forecasts for air travel growth are correct. If they are over-optimistic it is possible that V2500 cashflow falls off more quickly as older planes are taken out of service. From a competitive standpoint it is very difficult for new entrants to enter aero engine manufacturing because the level of technology and upfront investment required is huge, while the main revenue streams are tied into existing platforms for the next fifteen to twenty years. It is possible (but not likely) that the Boeing / Airbus duopoly in narrow body planes will be broken. This could be significant because the plane manufacturers specify the engine options (typically a choice of two) that the airlines can make. Most of the threats to the duopoly use a GTF engine but the Chinese C919 is going with the LEAP, produced by a GE /Safran joint venture. This is also the competing engine on the A320 platform and a more likely risk is that it sells better than the PW1000G on these planes. We won't pretend to be able to predict any of these outcomes with any real accuracy but we are very comfortable that the range of possibilities is relatively small. It is hard to see a future in which the PW1000G is not significantly more profitable for MTU than the V2500 will have been over its lifetime. We are also comfortable that MTU's enviable current positioning won't be squandered on less lucrative investments. The company has repeatedly stated that it does not see acquisition opportunities and next year it looks set to deliver on its promise to reduce research and development spend for several years now that the main GTF engines are in production. We expect to benefit from this as shareholders, hopefully for as long as the engines we have been discussing are flying.

We picked MTU to write up this quarter because it is a clear example of how a business can increase returns over the long run by spending money today. It is an investment where duration should provide an edge. The total market capitalisation is a little under EUR 6bn with net debt about EUR 850m (including the deferred payments to Rolls Royce) and a pension deficit of similar size. Current earnings are almost irrelevant as a measure of value because so much is to come over the next decade, but for what it is worth 2016 operating profit guidance was EUR 500m with net income of about 340m. By 2025 we think operating profit could be EUR 1.5bn. That is not a forecast. We can't predict the future that accurately, but we don't need to. If we are only half right about MTU's profit growth we should still make a good return on our investment.

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