Ennismore Global Equity Fund

Investor Newsletter for the month of June 2017

Issued on 12 July 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 216m as at 30th June. Total assets under management by Ennismore Fund Management were USD 822m. 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 June 2017

	Share Class			
	GBP	GBP A	EUR	CHF
NAV per Share[1]	**10.04**	**10.02**	**9.95**	**10.00**
Period	% Change			
June 17	**-1.5**	**-1.5**	**-2.2**	**-1.8**
May 17	1.7	1.7	-1.7	-1.4
April 17	-2.9	-2.9	-1.4	-0.2
March 17	-1.1	-1.2	-1.3	-0.7
February 17	-1.3	-1.4	-0.7	-1.0
January 17	-0.2	-0.1	-0.7	-1.3
2017 to date	**-5.3**	**-5.3**	**-7.9**	**-6.1**
Since launch[2]	**0.4**	**0.2**	**-0.5**	**0.0**

[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.**

Attribution %		GBP	EUR	CHF
Long	Q2 17	2.6	0.3	2.2
	Q1 17	3.8	4.0	3.7
	Q4 16	5.4	8.6	7.1
Short	Q2 17	-4.2	-4.1	-4.2
	Q1 17	-5.5	-5.3	-5.3
	Q4 16	2.7	2.6	2.6

Attribution figures exclude cash returns and are prior to expenses

Top Five Holdings as at 30 June 2017

	Company	Country	Sector	% of NAV
1	Etsy Inc	United States	Consumer Discretionary	7.2
2	Mtu Aero Engines Gmbh	Germany	Industrials	6.9
3	Inmarsat Plc	United Kingdom	Telecommunication Services	5.6
4	TripAdvisor Inc	United States	Consumer Discretionary	4.9
5	Twitter Inc	United States	Information Technology	4.4
				29.0

Exposures as at 30 June 2017

Longs %	Shorts %	Gross Exposure %	Net Exposure %
85.5 (88.7)	44.8 (45.6)	130.3 (134.3)	40.7 (43.1)

Figures in brackets refer to previous month end.

Exposures by Country, Market Cap & Sector as % NAV and Positions as at 30 June 2017

Country	Gross%	Net%
United Kingdom	35.2	16.9
United States	35.1	2.9
Germany	22.5	9.1
Australia	7.1	4.6
Canada	6.5	3.1
Netherlands	4.9	-1.6
Norway	4.5	4.5
Belgium	2.8	0.9
Switzerland	2.4	-2.1
Luxembourg	1.6	1.6
Spain	1.5	-1.5
Other	6.2	2.3

Market Cap	Gross%	Net%
>$10bn	15.1	3.2
$5bn-$10bn	33.7	21.9
$1bn-$5bn	66.3	24.0
<$1bn	15.2	-8.4

Positions	Jun	May
Long	38	39
Opened	0	2
Closed	1	0
Short	55	53
Opened	4	5
Closed	2	1

Sector	Gross%	Net%
Consumer Discretionary	37.8	20.1
Consumer Staples	10.3	-1.7
Energy	0.5	-0.5
Financials	5.1	1.8
Health Care	1.8	-0.2
Industrials	19.9	12.9
Information Technology	30.8	0.7
Materials	6.4	1.2
Real Estate	0.5	0.2
Telecommunication Servic	15.8	7.6
Utilities	1.4	-1.4
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.

The Fund's NAV per share declined between 2.7% and 5.3% in Q2, depending on currency, with the return in euro materially lower than in the other share classes. Since inception the Fund is now broadly flat whichever currency we look at.

Our long positions added around 2.6% to NAV in the sterling share class (but only contributed 0.3% in euros). The implied return, with an average long exposure of 86.7%, was 3.0%. Etsy, the worst performer in Q1, was the best in Q2. It contributed 1.9% and is a good demonstration of why we are reluctant to comment on (or react to) short term performance. We wrote about the business in some detail in our March letter and do not have much more to add here. Since then the CEO has been replaced, a cost cutting plan has been announced and two private equity firms have taken stakes in the business. The shares went up by over 40% in the quarter. The next largest long attributions came from Twitter Inc (adding 0.6%) and TripAdvisor Inc (costing the Fund the same).

The short book cost the Fund a little over 4%. The implied return, with an average short exposure of 45.4%, was about 9.3%. A large part of this was down to our short position in Straight Path Communications Inc ("Straight Path") which cost the Fund 2.4%. As we disclosed in the last quarterly letter, the company received a takeover bid at a very significant premium. The next largest attributions came from Flotek Industries Inc (adding 0.6%) and Tesla Inc (costing 0.5%).

At this point we could reprint the reasons we gave in the March letter for running our short book. We are disappointed by its performance this year but this has not changed our views, either on our approach to portfolio construction or on the individual stocks that make up the book. Other than Straight Path the losses are largely unrealised. Some of the larger shorts have been reduced to manage our exposure to company specific risk but this does not mean that we cannot make this loss back. A significant part of Ennismore's positive returns from shorting in the past have come from adding to positions as they implode. We will do the same in future when we think it will be profitable for the Fund.

The rest of this letter is taken up with one example from the fifty odd names in the short book. We hope it gives you confidence in the depth of due diligence we do and in the level of evidence we need to be convinced to go short. We think the bar is set very high.

Wirecard AG

Wirecard AG ("Wirecard") provides payment services. Its main business is merchant acquiring where it acts as the intermediary between a retailer and card payment schemes like Visa and Mastercard. Wirecard processes the transactions and offers related services like fraud detection. It also has smaller businesses issuing prepaid cards and taking traditional bank deposits. For 2016 Wirecard reported that it processed EUR 62bn of transactions – EUR 42bn in Europe, where it mostly serves online only retailers, and EUR 20bn in Asia, where it also has a point of sale business. From this and its other business lines it generated revenue of over a billion euros and reported earnings before interest, tax and depreciation ("EBITDA") of EUR 307m. However we estimate free cash flow was closer to EUR 135m. After acquisitions free cash flow was negative, as it has been every year since the company's reverse merger into a German listing more than a decade ago. Wirecard's current market capitalisation is approximately EUR 8bn.

We have many serious concerns about Wirecard. Most of this note will focus on only one area – its accounting – but before we take a deep dive into that it is worth mentioning what the other issues may be. One is Wirecard's customer base. For Germany it reported transaction volume of EUR 16bn in 2016, almost all online according to the company. A report by another payment processor estimates that total online transaction volume in Germany was about EUR 70bn. If we strip out Amazon, which reported sales of approximately EUR 12bn in the country, this implies Wirecard has a market share of more than 25%. However the same report also shows that less than a quarter of online transactions are made using a card, with most Germans paying by bank transfer or an online wallet like PayPal. This implies Wirecard's relevant market share would be much, much higher. We would expect it to be easy to find lots of their customers. It isn't. We tried and could identify surprisingly few German online retailers using Wirecard payment services. Even where a relationship should be clear – such as the announcement in 2014 that German pet goods retailer zooplus would be "using solutions provided by Munich-based Wirecard AG for its online payment acceptance" – the extent of it is less so. zooplus moved to the payment platform of Wirecard's competitor Adyen in 2013 and the source code for its checkout shows it is still on it today (Adyen have confirmed that they have no acquiring partnership with Wirecard).

A few customers that have become public knowledge give us cause for concern. In 2011 the FBI prosecuted German Michael Schuett for making illegal payments related to online gambling. A large proportion of these funds were transferred into the US from the Wirecard bank account of a UK company, Bluetool Limited. The registered owners of this company were two British Virgin Islands ("BVI") entities, Fermoya Limited and Lenia Management Limited. In 2014 the UK Insolvency Service wound up another UK business, Bluemay Enterprises Limited, which had credited EUR 36m to Wirecard Bank between 2011 and 2013. The owner, Ido Raviv, left the UK for Kazakhstan after an initial meeting with investigators. The registered shareholders were the same two BVI entities. Dozens of other companies with the same shareholders were wound up in similar circumstances (an article by news agency Reuters covers these in some detail). We find it surprising that the company which incorporated many of them, Brinken Merchant Incorporations, had Wirecard "Head of Sales" Brigitte Axtner and Patrick Mosbach as shareholders. Even harder to understand is that these BVI entities were also the registered shareholders of a Wirecard subsidiary in the UK that was not disclosed in the company's accounts.

There are other issues relating to Wirecard personnel too. For example, Dietmar Knoechelmann pled guilty to payment fraud late last year; the fraud took place while he was a Director of a Wirecard subsidiary. It had previously bought a business, Gateway Payment Solutions, from him. Concerns about the cost and substance of this and many of the company's other acquisitions have also been publicly raised in the past. We do not plan to get into these here. We will only note, as a way of turning to the accounting, that one of the earlier acquisitions in Gibraltar has been in liquidation for over four years but still holds EUR 58m in net assets (mostly retained profit) and reports a net profit each year. In our experience this is unusual.

Our starting point for examining Wirecard's accounts is a series of articles published by the Financial Times ("FT") in the summer of 2015 which looked at the company's accounting for its acquiring business. Wirecard provided an adjusted cash flow statement excluding this business and, from this, it was possible to work backwards to the working capital balances (which were not split out separately on the balance sheet at the time). The FT article highlighted a potential anomaly. The reason given for excluding these flows was that they were a pass through - money is taken from a customer by a payment scheme and paid to a merchant. They should net off, but they didn't. Acquiring payables due to merchants broadly matched acquiring funds (that is money received by Wirecard from payment schemes that has not yet been paid out to a merchant) but that left an acquiring receivables balance of around EUR 250m with no offsetting liability.

Wirecard explains this balance as follows. In Europe it has a banking license and acts as the merchant acquirer and acquiring bank (that is the cash actually flows through its bank account). In Europe the payables do net off with acquiring funds and receivables. But Wirecard also reports a large merchant acquiring business in Asia where it does not have a banking license. Here it has to use third party acquiring banks. These banks have the matching payables and receivables on their balance sheet but they also demand a deposit – a rolling reserve - from the merchant acquirer (Wirecard) to cover the risk that a merchant defaults. These deposits are accounted for by Wirecard as acquiring receivables and, according to the company, explain the discrepancy that the FT found. We met with Wirecard's CFO Burkhard Ley in May this year who confirmed our understanding of this.

If Wirecard's explanation is correct then its disclosure, which is designed to exclude the transitory assets and liabilities associated with the acquiring business, is misleading as it does not adjust cash flow for the change in acquiring funds (as these are part of the cash balance and not what Wirecard define as acquiring working capital). However we do not really understand the story. In particular we do not see why it is so different to peers like Worldpay Group PLC ("Worldpay"), which is a merchant acquirer but not an acquiring bank (that is, it seems to be analogous to Wirecard's non-European business). At our meeting Wirecard confirmed that its non-European proposition is equivalent.

For Worldpay things are crystal clear. The balance sheet has three items – merchant float (which is equivalent to acquiring funds), scheme debtors (receivables from card schemes) and merchant creditors. They net off to zero:

	2014	2015	2016
Merchant float	770	696	1012
Scheme debtors	415	535	1822
Merchant creditors	(1185)	(1231)	(2834)
Delta	0	0	0

Wirecard states that its accounting for the non-European acquiring business is different because it does not have a banking license outside of the EU. In its annual report it explains that:

"If another bank is involved in the process, Wirecard is not permitted to receive and report the transaction volumes on the balance sheet due to the EU Payments Services Directive (PSD)."

This is not correct, as the Worldpay example shows. In fact we do not believe that the PSD is relevant to the accounting at all.

The Worldpay accounts also raise a much more interesting issue. We can see that from the numbers above that it does not have any deposits at third party acquiring banks, the item Wirecard refers to in order to balance their own accounting, despite not having a banking license. So the question is, why do acquiring banks require this from Wirecard but not from Worldpay?

That said, for now let's take Wirecard's accounting at face value. Since the FT articles it has changed the reporting of the acquiring business to split the balances out. The presentation appears to be designed to allay concern and, at a glance, seems to do that. Receivables and payables from the acquiring business match almost exactly every year since this disclosure began:

	2014	2015	2016
Receivables of the acquiring business	284	334	402
Liabilities of the acquiring business	(283)	(334)	(405)
Delta	1	0	(3)

The problem we have is that we cannot reconcile these numbers back to management's explanation of the accounting. We are also unable to match the accounting with management's description of how the business has grown or to reconcile it to the filings made by Wirecards's licensed banking subsidiary. The rest of this letter explains these issues in more detail.

Let's start with the easy part, the payables. This is money owed by Wirecard to merchants. It is on balance sheet, Wirecard state, because it is not just the merchant acquirer but also the acquiring bank in Europe. These payables net off against cash from payment schemes like Visa and MasterCard. Some of this is cash due (receivable), some is cash already received but not yet paid out (this is the acquiring funds line we met earlier).

Here is the problem. Acquiring payables should match the sum of acquiring receivables from payment schemes and acquiring deposits (as they do for Worldpay). That is, money owed to merchants is the same as money due and money already received from payment schemes (less the fees taken as the money flows through). The only way this is possible in Wirecard's accounts is if the other line item in the acquiring receivables balance - the deposits Wirecard makes at acquiring banks outside of the EU - is coincidentally almost exactly the same as the acquiring deposit balance. We know this because we have the total amount (payables) on one side, the rest is just an accounting identity:

	2014	2015	2016
Liabilities of the acquiring business	(283)	(334)	(405)
Receivables from payment schemes (implied)[1]	43	52	171
Deposits at acquiring banks (implied)[2]	241	282	231
Acquiring deposits	240	282	234
Delta	1	0	(3)

For these two unrelated items to be essentially the same one year is not that likely but would not be that surprising either. For Wirecard it happens three years in a row, in fact ever since they began this disclosure. Think about what this is telling us for a minute. We see the two numbers as essentially uncorrelated. One is how much money Wirecard have taken in from payment schemes in Europe but not yet paid to merchants (which is contractually determined). This is mostly a function of transaction volume in Europe. The other is how much acquiring banks outside of Europe are requiring Wirecard to deposit with them as security. This is mostly a function of transaction volume outside of Europe. We think that the probability of these items closely matching each year end, three years in a row, is extremely low.

We can also check if the numbers make sense another way. The balancing item is, remember, funds on deposit at other acquiring banks. It is there, according to Wirecard, to provide these banks with protection in the event that a merchant defaults. If they do, the merchant acquirer (Wirecard) not the acquiring bank picks up the bill. The deposit is described as a rolling reserve and so would normally be a function of the size of the merchant flow and the risk that merchants will default on it. It ought to go up as the volume of business being done increases (but not necessarily in line as the risk mix is

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[1] Equivalent to acquiring liabilities where the offsetting cash has not already been received by Wirecard from the payment scheme (i.e. it is acquiring liabilities less acquiring deposits)

[2] Total acquiring receivables less receivables from payment schemes

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not likely to stay exactly the same). Wirecard are clear about this. They state that, whatever business model is used, in "all cases […] the transaction volume significantly influences the item trade receivables." But for Wirecard's non-European acquiring business the numbers don't fit with that narrative – volume has ballooned but the receivable associated with it is shrinking:

	2014	2015	2016
Wirecard non-EU transaction volume (bn)	7.4	14.0	22.7
Deposits at acquiring banks (implied)	241	282	231
Deposit / volume	3.3%	2.0%	1.0%

Another oddity is the amount due in from payment schemes in Europe at the end of 2016. In its annual report Wirecard discloses that the year end cash balance is boosted by "a very sharp increase in the operational cash flow in the fourth quarter which is mainly due to delayed payouts on account of public holidays". This claim is made several times in the accounts. The only way we can see that this would make sense is if payment schemes continued to pay on time (boosting Wirecard's cash) but Wirecard paid out less promptly than usual (boosting payables). However this is not what happens in Q4 16. Payables are up a lot in the quarter, from EUR 317 to 405m, but we do not see this matched by cash in. Instead cash due from payment schemes goes up even more, from EUR 68 to 171m. That is, the working capital effect is actually negative for Wirecard. Our analysis implies that the narrative given repeatedly in the annual report is inconsistent with the reported numbers..

The large step up in receivables from payment schemes in Q4 16 is also not simply a timing issue. At the end of Q1 17 the balance remained elevated at EUR 162m. It does, however, appear to be an accounting issue. Wirecard's acquiring business is carried out by its regulated banking entity, Wirecard Bank ("the Bank"). Working capital relating to this activity has to be on its balance sheet. While Wirecard's claims imply it has EUR 171m in receivables due from payment schemes at the end of 2016, the Bank's accounts show this balance is only EUR 69m. We are unable to account for more than EUR 100m. Some of this may be receivables from banks rather than credit card schemes, but the total for receivables from banks that are due in less than three months but are not on demand is only USD 20m (Wirecard states that receivables relating to transaction volumes where they are the acquiring bank are "generally received between one day and one week after the transaction"). Even if these all relate to the acquiring business they are not big enough to explain much of the shortfall. This is, after all, mostly a card processing operation.

There is a similar discrepancy on the liability side of the Bank balance sheet. Liabilities to customers, excluding demand deposits, were EUR 224m under three months and EUR 113m between three months and a year. Even if all of these relate to merchant customers of the acquiring business there is still a significant shortfall of EUR 68m compared to the EUR 405m reported by Wirecard. We wondered if this difference of EUR 68m could be under callable liabilities. The total here is EUR 463m, less EUR 57m due to related parties, so a net EUR 406m. Wirecard discloses that customer deposits total EUR 734m and that these are held at Wirecard Bank and their prepaid card operation, Wirecard Card Solutions ("WCS"). For WCS the 2016 year end balance was about EUR 335m (GBP 286m). That leaves about EUR 400m in customer deposits at the Bank. In other words, the callable liabilities appear to be customer deposits unrelated to the acquiring business and so cannot explain the discrepancy.

And so it goes on. We cannot match up line items in Wirecard's adjusted cash flow statement with the balance sheet. For example, the change in trade liabilities is adjusted by EUR 57m when the acquiring payables are stripped out, but the equivalent change on the balance sheet was EUR 71m. In fact the whole adjustment makes does not seem to make sense to us. Before adjustment cash flow from operations is EUR 266m. After the adjustment it is up to EUR 283m. But what is being adjusted out here is "Receivables and liabilities from acquiring". And we know from the balance sheet that these were equal and opposite at the start of 2016 and at the end. That is, the net effect on cash flow should be zero. Once again Wirecard's accounts do not seem to be consistent.

In fact, the more we look the more questions we have. For example, if you take customer deposits and acquiring funds away from gross cash you are left with about EUR 566m of own cash. But all of this is borrowed from banks (EUR 595m) and the gross debt balance keeps on rising, from less than EUR 100m two years ago to EUR 820m by the end of Q1 this year. This begs two questions. Why borrow all this money, just to hold it as cash? And where is this cash held?

We feel more comfortable commenting on Wirecard's net debt position. While there is no standard definition of how to calculate this we believe there are better ways than the one used by the company, which appears to show a business flush with excess cash. Our definition is simple. We take cash and fixed deposits relating to customer deposits to get gross cash.

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We take away customer deposits, acquiring funds and bank debt. That is it. This is what it looked like at the end of last year:

	2016
Cash	1333
Fixed deposits	202
Customer deposits	(734)
Acquiring funds	(234)
Bank debt	(595)
Net cash (debt)	(28)

This is a little different to the net cash position of EUR 379m disclosed by the company. How is this possible? The difference is mostly working capital, which Wirecard classifies as cash. That is, the rolling reserve held by acquiring partners (which we estimated above to be EUR 231m) is part of their own cash calculation. We note that, like us, Wirecard's lenders deduct the rolling reserve when they are calculating the net equity covenant. Wirecard's definition of net cash also includes EUR 175m of loans to unspecified fintech companies (of which about half are long term) and EUR 28m of sales partner financing (again long term). We think including these gives a misleading picture of how cash generative Wirecard really is.

In reality we think Wirecard has burnt cash every year:

	2010	2011	2012	2013	2014	2015	2016
Net cash (debt)	21	(12)	41	(101)	132	10	(28)
Change in net cash		(33)	53	(142)	233	(122)	(38)
Equity issued			(137)		(361)	(2)	
Dividends out		10	11	12	15	16	17
Cash burn		(23)	(73)	(130)	(113)	(108)	(21)

Of course it has made many acquisitions. In fact it makes them every year (it also sold its share of Visa Europe Limited to Visa Inc in 2016). But even after adding these back cash flow has still been very low:

	2011	2012	2013	2014	2015	2016
Cash burn	(23)	(73)	(130)	(113)	(108)	(21)
Outflows for acquisitions	21	41	38	91	169	156
Cash flow (burn) pre acquisitions	(2)	(32)	(92)	(22)	61	135

Finally, because there is only so much you can read about accounting in one sitting, we note that we have been unable to reconcile the cash flow implied by the balance sheets it publishes to the cash flow statements given in the accounts. This is not normal for a large listed company.

We have spent a lot of this letter taking you through Wirecard's accounts. If you are still reading we appreciate your patience! Based on the inconsistencies and anomalies in the financial statements alone we think the shares are uninvestable. However our short position is not based solely on this analysis. Our due diligence in other areas, such as those touched on earlier in the letter, is at least as significant. Taken together our research leads us to us to believe that Wirecard is worth only a tiny fraction of its current EUR 8bn market capitalisation.

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