Ennismore Global Equity Fund

Investor Newsletter for the month of June 2018

Issued on 12 July 2018

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 232m as at 29th June. Total assets under management by Ennismore Fund Management were USD 854m. 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.

Important Notice

In July 2018, an additional share class ("EUR I") was created in the Fund. The new share class did not result in an increase in the cap on the number of shares in issue for the Fund as a whole. EUR I seeks to hedge the currency of the share class, (EUR) to the base currency of the Fund, (GBP). The currency hedge is specific to the EUR I share class only and is not in any way intended to act as a currency hedge for the portfolio of the Fund as a whole.

Top Five Long Holdings as at 29 June 2018

	Company	Country	Sector	% of NAV
1	SES SA	Luxembourg	Consumer Discretionary	7.3
2	Etsy Inc	United States	Information Technology	6.7
3	Schibsted ASA	Norway	Consumer Discretionary	6.6
4	METRO AG	Germany	Consumer Staples	6.0
5	TPG Telecom Ltd	Australia	Telecommunication	5.7
				32.3

Exposures as at 29 June 2018

Longs %	Shorts %	Gross Exposure %	Net Exposure %
100.5 (95.4)	56.9 (54.7)	157.4 (150.1)	43.6 (40.7)

Figures in brackets refer to previous month end. All exposures are calculated on a delta adjusted basis.

Exposures by Country, Market Cap & Sector as % NAV and Positions as at 29 June 2018

Country	Gross%	Net%
United States	41.9	1.9
United Kingdom	33.0	13.3
Germany	23.0	6.0
Luxembourg	8.3	8.3
Australia	8.1	4.7
Norway	6.6	6.6
Cayman Islands	5.9	-5.9
Netherlands	5.5	5.1
South Africa	5.0	3.4
Ireland	4.7	4.7
Japan	3.2	-2.2
Other	12.2	-2.3

Market Cap	Gross%	Net%
>$10bn	33.0	-6.1
$5bn-$10bn	56.6	44.9
$1bn-$5bn	52.1	13.3
<$1bn	15.7	-8.5

Positions	Jun	May
Long	46	43
Opened	3	3
Closed	0	2
Short	71	70
Opened	3	6
Closed	2	7

Sector	Gross%	Net%
Consumer Discretionary	44.6	27.3
Consumer Staples	12.3	9.7
Energy	0.7	-0.7
Financials	4.0	0.4
Health Care	3.8	-3.0
Industrials	25.0	12.1
Information Technology	46.9	-5.2
Materials	4.0	-4.0
Real Estate	1.8	-1.1
Telecommunication	13.5	8.9
Utilities	0.8	-0.8
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.

Performance as at 29 June 2018

	Share Class			
	GBP	GBP A	EUR	CHF
NAV per share[1]	**12.12**	**12.09**	**12.00**	**12.59**
Period	**% Change**			
June 18	**5.9**	**5.9**	**5.3**	**6.1**
May 18	2.9	2.9	2.8	-0.6
April 18	3.2	3.3	3.4	4.6
2018 to date	**12.8**	**12.8**	**13.6**	**12.2**
12 month rolling	**20.7**	**20.7**	**20.6**	**25.9**
Annualised return[2]	**11.7**	**11.5**	**11.1**	**14.2**
Since launch[2]	**21.2**	**20.9**	**20.0**	**25.9**

[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 18	20.4	19.4	17.9
	Q1 18	0.6	1.8	2.3
	Q4 17	6.6	5.8	7.8
	Q3 17	2.4	2.0	6.0
Short	Q2 18	-3.9	-3.9	-3.9
	Q1 18	1.2	1.2	1.2
	Q4 17	0.9	0.9	0.8
	Q3 17	0.0	0.1	0.0

Attribution figures exclude cash returns and are prior to expenses

The Fund return was in the range of 10 to 12% in Q2, depending on currency.

Long positions added 20.4% to NAV (in the sterling share class). Large contributions came from Etsy Inc, adding 3.9%, Twitter Inc (2.3%), Under Armour Inc (2.2%) and TripAdvisor Inc (1.9%). All of these shares had also performed well in the first quarter.

The most significant news came from Etsy, which increased the basic commission it takes on sales from 3.25% to 5%. Few businesses have that kind of pricing power. It shows how valuable the marketplace is to its sellers (and Etsy is still cheaper than Amazon or eBay). Most of the incremental revenue will be reinvested in marketing to drive volume on the site. This is, we think, a huge opportunity. The number of people who know about Etsy, let alone have bought from it, is still relatively low.

Inmarsat PLC contributed 2.0% to NAV after it received a preliminary takeover approach from US satellite company EchoStar Corporation. The bid was rejected in early July.

We significantly reduced our position in Twitter during the quarter and sold out of Boston Beer Company Inc. We added two new large positions, satellite operator SES SA and grocery wholesaler Metro AG.

The short book cost 3.9% of NAV in the quarter. About half of this (1.9%) was due to a short position in Intelsat SA. We explain this, and our related long position in SES, later in this letter. Most of the rest was, again, down to Wirecard AG (1.8%).

We have (not for the first time) taken a significant short position in Sirius Minerals PLC shares and the next part of this letter explains why.

Sirius Minerals PLC ("Sirius")

We went through our reasons for being short Sirius in our first quarterly letter, back in October 2016. The company had just raised hundreds of millions of dollars to begin building a mine to extract the fertiliser polyhalite. Nearly two years on Sirius has, not surprisingly, dug a hole in the ground. To finish the project, it needs more money – up to USD 3bn of debt financing – so now seemed like a good time to review our investment case. Having done so, we have again taken a material short position in Sirius shares (we covered most of the original short in 2016 when the shares fell below the

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placing price). As a quick recap, the company is building a mine under the North York Moors National Park that could eventually produce up to 20 million tons of polyhalite a year. Our thesis has not changed from two years ago – there is nowhere near enough demand in the world to make a mine of this scale economically viable. Evidence supporting this appears even clearer today.

In 2016 total global sales of polyhalite was only 197,000 tonnes. In 2017 this increased to 292,000 tonnes, still less than 1.5% of the capacity Sirius wants to build. Today only one company, Israel Chemicals Ltd. ("ICL"), mines polyhalite commercially (from the same geological seam in northern England). ICL plans to increase production over the coming years, initially to 1 million tonnes by 2020, but its view on potential demand in the long run is sobering. A chart from its most recent presentation puts it at only 3 million tonnes. At a conference this year, CFO Kobi Altman commented on polyhalite, describing it as a niche fertiliser. He went on to say, "we don't believe this is ever going to be a huge product" and "others might think the potential of this product can be 10, 15 million tons; we don't believe that". To be clear, this is coming from the only company in the world that is selling polyhalite today.

Back in 2016 we also questioned the pricing assumption Sirius made in its model of mine profitability. The company argues that polyhalite will be priced in proportion to the underlying nutrients it contains - not only highly valued potassium, but also a significant amount of magnesium, sulphur ("S") and calcium. Again, ICL management disagrees: "the fact of the matter is, there probably aren't a large amount of companies looking to buy those in the ratio that's in the molecule itself. And so I would anticipate that it might be a product with a little bit more variable pricing than just a simple – the value of P [potassium] plus the value of S is equal to the value of the product." Sirius based its forecasts on a weighted average price of USD 158 per tonne over the first ten years of mine life. In 2016 polyhalite actually sold for an average price of c.USD 127. In 2017 that was down to c.USD 110, 30% below the price assumed by Sirius.

In a July 2016 presentation, Sirius stated that it had offtake agreements for 3.6 million tonnes of polyhalite. Since then it has added two more. One with Wilmar Group, for up to 750,000 tonnes, and a smaller one in Nigeria. ICL's view on demand is hard to square with this. If there really are large customers wanting to buy the product in bulk it begs the question, why aren't they getting it from ICL today? For the 1 million tonne agreement with Dian Huang Peony we know the answer – its management did not believe that there was a binding commitment. We know this because, as we detailed in our October 2016 letter, Dian Huang Peony's CEO told us in person and in writing. Since then things don't seem to have been going well for the company (a business with little more than a few field trials today that Sirius expects to buy over USD 100m of polyhalite a year). In 2017 it was taken to court over an unpaid bill for seedlings of only c.USD 35,000. It lost. The CEO is also on the black list in China for an unpaid personal debt of about USD 350,000; his shareholding in Dian Huang Peony is frozen as a result.

The quality of Sirius's counterparties may not be getting better. Last month it announced a new offtake customer in Nigeria, Dubai-based entity Intercontinental Trade DMCC Dubai ("ITL Trading"). ITL Trading has its own website but this discloses very little information about the company. Helpfully a Whois? query reveals that the site was registered in the UK by a company named DSV Pipetronix Limited ("DSV"). Companies House records confirm that ITL Trading MD Preetpal Walia was also a founding Director of this entity, meaning that ITL Trading and DSV were related parties. DSV had two Nigerian officers, Nzeribe Edeh Okoli and Ben Ifeanyi Okoye. We think this is the same Nzeribe Edeh Okoli as the one convicted of defrauding Brazilian Banco Noroeste of USD 242m, one of the largest scams ever perpetrated against a financial institution. Ben Ifeanyi Okoye was charged in relation to a separate fraud involving a land sale in Nigeria but we have been unable to ascertain if he was convicted.

Today Okoye is running another venture, a proposed petrochemical plant named Brass Fertilizer ("Brass"; the legal entity is Brass Petrochemical Limited). The company behind it is again an entity named DSV, although this one is incorporated in Nigeria (it appears to be related to the UK entity, with Okoye's LinkedIn profile showing him as Chairman of DSV since 1997). When we first looked at the website for the proposed plant, it listed five private investors – Danish contractor Haldor Topsoe AS and the charity IFU, German investors MPC Capital AG ("MPC"), an African private equity firm called Lionworks Capital (which has links to General Electric Company) and Engro Corporation Limited, a Pakistani conglomerate. A press article quotes a Director of Brass stating that MPC will own 20%, that the GE-linked entity is considering the same amount and Haldor Topsoe AS another 10%. We contacted each of the private investors to ask if they could confirm their interest in the project. Within a few days all of them except Engro had disappeared from Brass's website. MPC Capital got back to us to confirm that the statement was false. They have no investment in Brass and are not currently planning to make one.

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Finally, we note that in April this year a Nigerian entity named DSV Pipetronix Limited was closed down by the Federal Inland Revenue for not paying its taxes (the UK entity of the same name was forced into liquidation by a creditor in 2005). What does all this tell us about ITL Trading's ability to buy tens of millions of dollars of polyhalite a year? We honestly don't know, but if we were about to finance Sirius's mine we would want to.

The financing Sirius needs is contingent on it signing more offtake agreements. In a May 2018 presentation, Sirius outlines six steps forward, the third being additional offtakes – the plan was to get to 6-7 million tonnes this year. This has to come before not only the debt financing but also, it seems, drawdown of USD 300m tied to a royalty agreement signed in 2016. The Sydney Morning Herald reported in April that the source of this financing, Australian mining investor Gina Rinehart, was very keen to stress that the investment was only due "when specific milestones are reached". Without more substantial offtake agreements we think Sirius could run out of cash soon.

Even with the royalty cash, Sirius needs to raise up to USD 3bn in debt financing to build out its mine. This may be a struggle and without government help, we do not believe it will happen. Sirius Chairman, Russell Scrimshaw, described a Treasury guarantee of USD 2bn as "essential" back in March. We don't understand how a guarantee of that size can be provided. The UK Guarantees Scheme ("the Scheme") is designed to support private investment in critical infrastructure and the Infrastructure (Financial Assistance) Act 2012 is explicit about what this includes:

> (2) "Infrastructure" includes—
> (a) water, electricity, gas, telecommunications, sewerage or other services,
> (b) railway facilities (including rolling stock), roads or other transport facilities,
> (c) health or educational facilities,
> (d) court or prison facilities, and
> (e) housing.

Even if the Government wanted to support the project politically, we do not think it would be within the scope of the Scheme to subsidise a fertiliser mine. Only some redevelopment at Teesport, a small part of the overall cost, is likely to be approved for a Government guarantee (we understand that the mine project pre-qualified as eligible for the scheme but that the application has not yet been assessed). We expect the level of guarantee will be relatively small in relation to the total funding requirement. The total estimate for "Materials handling facility and port" was only c.USD 200m in Sirius's budget. That size is quite typical for the Scheme, which has issued 9 guarantees to date totalling GBP 1.8bn (the only outlier is GBP 2bn approved, but not yet issued, for Hinkley Point nuclear power plant). We do not think the government will be prepared to risk more on a speculative project that does not fit the definition of critical infrastructure. If, as Sirius claims, a USD 2bn Government guarantee is "essential" for the project to go ahead then we do not think it will happen.

Mistakes, we've made a few…

We want to use this letter to talk about mistakes. There are lots of things we can get wrong. Some have no visible effect on the Fund: we can do nothing when we should have put money to work, or sell too early - sometimes the most expensive mistake of all. But this letter is about getting our thesis wrong. In the second quarter we (well one of us) made the first, clear cut, big mistake of this kind since the Fund started. That's not to say it is the only one we've made. It's certainly not the only position we have realised a loss on, there have been several of those and some will probably prove to have been mistakes. Time will tell, but a loss doesn't necessarily mean we made a mistake in our analysis.

To explain this a little more we need to step back and look at what makes a good investment. The obvious answer is one where we make money. We don't completely agree. That is the definition of a good trade. If we bought shares in a company that doubled in value and then sold that would be a good trade. If the company turned out a year later to be a worthless fraud it would still have been a good trade, but a disastrous investment decision. Making money is necessary but not sufficient. The investment return is what a company actually delivers in discounted free cash flow back to its owners over its lifetime; everything before that is trading on expectations of what those cash flows will be. By that definition we have to be honest and say that almost every position the Fund owns is likely to be a trade, rather than an investment. Of course, the longer a trade is open the more closely profit on it is likely to match the real investment return (we don't expect to turn the book over much so our average holding period on the long side is likely to be several years), especially if a company pays out a lot of its capital to shareholders.

You might be wondering why this matters. Returns are what you get and a rose by any other name would smell as sweet. Well we didn't bring it up to be pedantic, or to fill up the letter with endless semantics. The point we are trying to make is

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this: it matters more for the long-term success of the Fund that our investment thesis for any individual position is correct than if we make money trading on it. To go back to the previous example, we would seriously question ourselves if any long holding turned out to be a fraud – no matter how good a return we made on it. It's not that we care more about being smart than making money. We don't. We hate losing money. It's just we hate getting our thesis wrong even more. Here and there we may get lucky on a trade but over time that should even out. Over time and over a large number of positions, the Fund's actual returns will approach the real returns our investments deliver, and that depends on getting our analysis right in the first place.

We make mistakes from time to time. We work hard and not too fast, to try to make sure we don't. But we will inevitably make some. How we manage these may be as important for returns as what we get right. It starts with our research method. Investing is not a science, not by a long chalk, but we approach it as if it is. Science is limited to ideas that can be tested. A thesis that cannot be proved may be right, but it's not science. We treat an investment idea, a stock pick, as a thesis. If we cannot come up with a way to test that idea, with a set of facts that would disprove it, we should not be risking money on it because we will not know if we are wrong until it is too late. One important part of our investment process is to lay out, in black and white, key data points that will indicate if our thesis is proving right or wrong. We monitor these consistently over time. For example, last quarter we wrote about TPG Telecom Limited. The crucial part of our thesis is that it can build a high-speed, high-volume mobile phone network across large Australian cities for only AUD 600m. We think it can do this because it has a fibre network that allows it to deploy a new technology (small cells) much more cost effectively than incumbents, giving it a materially lower price per bit. We plan to test the quality and coverage of this service, and so have a good indication if we are right, long before the answer shows up in its financial statements. If tests show our thesis is wrong we will sell the stock, whether the price is going up, down or sideways.

An alternative way to test the strength of an idea is to make as strong a case as you can, for and against. If you can come up with a weightier pile of evidence for one point of view you might conclude it is right. This is how the legal system approaches the truth (and, we think, most sell-side analysts and the media too). The problem is humans are not great at staying objective. Once we start down a path it is hard to step off. We tend to suffer from what psychologists call confirmation bias or biased assimilation. We look for, and attach more significance to, information that supports a conclusion we have already drawn but find it very hard to see when we are doing this. MRI scans show we seem to react emotionally to information that contradicts us, which may make it harder to weigh up fairly. There is a real danger this means we compound a mistake instead of correcting it, because we are less open to facts that reveal it.

Confirmation bias is particularly strong when we have already made a decision, and investing means we have to make a few. The act of choosing is like setting an idea in stone. We get locked into believing things matter, even if they are wrong or irrelevant. The most obvious example for an investor, is the magic power the price paid for a holding can assume. Behavioural finance experiments suggest a loss hurts about twice as much as a gain feels good (some of us here feel it much worse than that). It is harder for most people to bring themselves to sell below cost even though the price paid is irrelevant to what a holding is worth.

People are not stupid. There are good reasons we evolved this behaviour. If you stopped to re-evaluate all the facts every time you went grocery shopping you wouldn't get much else done (if you did it on the plains of Africa 200,000 years ago the outcome would probably have been even worse). Shortcuts, like being consistent in what you believe, are helpful for most things we need do in life. That's the problem really, we never needed to be long term investors until now. Little about the way our ancestors lived involved decision making on that kind of timeframe, so we are stuck with brains that aren't built for the job. This has some dangerous consequences. Gamblers feel more sure of their chances after they place a bet, just because they have now made a decision. Investors are not a different species. There is an unconscious temptation to change the facts you think are important rather than go back on a position, especially when a trade seems to be working. One of the reasons we like to write long (some might say boring) stock comments is that it makes it harder for us to do this. We commit ourselves to the thesis - specifically to the facts we think can disprove it - not to the name. The devil is in the detail and we like to have it in black and white so we can't hide or hold (or even hodl) if we are wrong.

In the end maybe the most important thing we can do to avoid making really big mistakes is to come to terms with the fact that we will make some. The desire to not be seen to have been wrong, to avoid losing trust or reputation, can be a strong motivation for not facing up to a mistake. So can over-confidence in your own ability. That's one reason we are writing this letter. We made a big mistake this last quarter and we want you to know about it, because facing up to it might help us avoid making even bigger ones in future.

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These are not the mistakes you're looking for…

Before we get on to the mistake we did make, let's go through a few we don't think we did (even though they have cost the Fund). At this point we were obviously going to write about Inmarsat, the one long position that had really underperformed for us. We didn't know when we were drafting this if Echostar would make a formal bid or, if it did, how much it would offer. Either way wouldn't change what we say. When we invest in a business it is because we are reasonably confident we understand what the range of future cash flow from it is likely to be. The range is always quite broad and it's very unusual for it not to include a realistic scenario where the investment loses money (a few of the Fund's positions do fit that bill by having no real downside, generally because they are backed by a relatively easy to value asset like real estate, and we are prepared to accept a lower return for taking less risk when they are). Since we bought our position in Inmarsat, the company has traded poorly. Results for most its business units have come in at the low end of our expectations but none have been below what we thought possible. Our analysis hasn't proved wrong, so far, Inmarsat just delivered the low end of what we thought it might (feel free to check against what we said in the September 2017 letter).

Long Wirecard has been an unbelievable trade for several years. Our analysis still leads us to believe that its equity is worth little or nothing at all. We think it is a disastrous investment. We try hard to prove our thesis wrong. Most recently we went through the websites of more than a hundred of the largest online retailers in Germany, to see who they use for processing card transactions. This information is now easily available for most, either explicitly in the privacy disclosure or in the source code for the checkout. We could only find five that use Wirecard (none were in the top twenty). We can't reconcile this with its claims to process nearly EUR 20bn of online transactions for German merchants and we have never heard anyone offer any explanation for its apparent shortage of customers.

Our short in Straight Path Communications Inc cost the Fund dearly in 2017. As it was acquired by Verizon Communications Inc you might think we would accept it was a bad investment call as well as a bad trade, but the evidence is not there yet. Being acquired does not mean a company is valued fairly, it is just another trade (ask HP Inc. about the 75% write down it took on Autonomy PLC the year after buying it or, closer to our own hearts, look at what happened to Slater and Gordon Limited when it acquired the bulk of Quindell PLC's assets). We may never get to know in this case as the asset Verizon bought was wireless spectrum. We are not convinced the particular bit it acquired will deliver anything close to the cash flow needed to justify the price (if not expect a writedown a few years from now), but we may well be wrong. Which brings us neatly onto the mistake we know we made.

Intelsat SA ("Intelsat")

Intelsat is a satellite operator. It made an operating profit of USD 957m in 2017 on sales of USD 2.1bn. By year-end, its backlog of contracted revenue was USD 7.8bn, down 10% on the previous year and more than a quarter compared to 5 years earlier. Net debt was USD 14bn, costing USD 1bn in interest expense. Free cash flow to equity was basically zero. If that was the whole story Intelsat shares would probably be close to worthless, and they traded that way for most of 2016 and 2017 (even a bid from Masayoshi Son's cash rich SoftBank Group Corp only valued the equity at about USD 500m).

Everything began to change in October 2017, although it took the market several months to realise. Intelsat filed a proposal with the Federal Communications Commission ("FCC"), the US telecoms regulator, to allow it to lease or sell a part of the spectrum it uses. The mobile phone companies are very keen buyers. Historically the satellite industry fiercely resisted pressure for spectrum allocated for space use to be made available for terrestrial players, with any concession seen as the thin end of a wedge. Intelsat's proposal only worked if other satellite operators came on board as well, as they also have rights to the spectrum. By early this year that had happened and Intelsat's share price went on a tear, nearly tripling in April.

At this point we thought we understood the value of what Intelsat had to offer, in something like a best-case scenario. There is 500 MHz of spectrum between 3.7 and 4.2 GHz (the "C-band") allocated for space use in the US. Intelsat's proposal was for the satellite operators to free up 100 MHz to sell or lease to telcos and it pitched this as a way to preserve most of the rest for space use (another c. 50 MHz would have to be left empty as a buffer to avoid interference). Telcos value spectrum on a price per head of population ("MHz/pop") basis. The UK auctioned similar spectrum in early April, achieving a price of c.USD 0.16 per MHz/pop. US spectrum has historically sold at a large premium to other markets. At a USD 0.30 price 100 MHz of C-band in the US would be worth about USD 10bn. That's a big number but it is only one side of the equation.

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To get to Intelsat's bottom line there are a few more very important steps. Firstly, it only has rights to about half that spectrum, so its share would be more like USD 4.5bn. Step two is the cost of moving existing customers out of the spectrum it wants to sell. Today C-band in the US is mostly used to beam TV signals to cable head ends, from where it runs over fibre to consumers' homes. Moving these customers into a narrower part of the spectrum requires significant investment, probably including new satellites, and compensation running into hundreds of millions of dollars. There is also likely to be some opportunity cost from lost revenue as not all customers will be accommodated in a narrower part of the spectrum. Then there is tax to be paid. There's no real detail on how any transactions would be structured but we assume, to be conservative, that Intelsat can use carried forward losses to offset most or all of this. Finally, there's timing. Even Intelsat says it will take two to three years to clear spectrum, from when the FCC makes a decision. Net net we thought Intelsat would get c. USD 3bn in today's money if things went really well for it.

Against this there was (and is) a very real risk that Intelsat gets little or nothing for this spectrum. For starters, satellite companies don't own it. They have a right to use it but the licences they have been granted do not allow terrestrial use. There is political pressure, including from former FCC Chairman Tom Wheeler, for satellite companies not to receive a windfall from C-band reallocation. After all, they paid nothing for it in the first place. Intelsat's proposal is not the only one on the table and any other approach would see it benefit far less. For example, the FCC could reallocate the spectrum using a reverse auction that would do little more than compensate incumbents for lost profit, as it did with spectrum formerly owned by TV stations. Using a reverse auction, the current rights owners bid to clear spectrum, with the lowest bids winning. In this process, the seller should only get the opportunity cost of giving up the spectrum plus some profit (otherwise why bother?), which will be marginal if the auction is competitive. From another direction, comments from SES SA, another owner of C-band spectrum, did not exactly seem encouraging. Its management said on a call in April that it was "not focussed at all on any potential financial opportunity", instead the priority was protect "what we consider to be an incredibly important neighbourhood" of existing customers. SES management also stated that "there is 0 megahertz available for any other application or any other uses as of right now and today."

We know Intelsat's existing business pretty well (we'll spare you most of the detail here). One half is facing slow structural decline - think TV via satellite being replaced by streaming. That is the good part, and most of the backlog. The rest suffers from industry overcapacity that will probably last as long as the satellites that are in space now (10 to 15 years from today) and the existential threat of existing and planned mid and low earth orbit ("MEO" and "LEO") constellations that may have much better economics. We doubt it is worth more than USD 10bn, and probably a lot less. Add in USD 3bn from selling C-band spectrum and you still don't get enough money to pay back the debt it owes today. We shorted the stock in April.

With hindsight Intelsat is not a short; for us it is uninvestable. The range of outcomes from the C-band process is so wide that the equity could be worth anything from zero to several times its current market value. It could be a great investment or a terrible one, we just don't know. We should have passed. We realised this quickly, but not before it cost the Fund. Events moved faster than we did. The FCC has begun the decision-making process - it will issue a Notice of Proposed Rulemaking in July – and the draft text reads like it favours Intelsat's approach. That didn't negate our thesis, but another part of the draft meant we could be even more wrong than we thought possible. The FCC seems to be pushing for a solution that will work to free up more than 100 MHz, and potentially all, of the C-band over time. If that happens the windfall to the satellite incumbents could be huge, as in tens of billions of dollars. Under previous US administrations this would never have happened, but it fits well with current FCC leadership's ideology of letting the market decide value without the regulator getting involved. Somehow, we don't think the satellite operators will push back very hard this time!

We knew the FCC favoured opening up as much of the C-band as possible for mobile phone companies. This was clear from public comments made by some Commissioners. Our mistake was thinking that other satellite companies would fight against this, as they have in the past. We fell victim to some confirmation bias here. For example, we probably read too much into SES's comments about protecting existing customers. We are no longer sure they are opposed to freeing up the whole of the C-band and, once that was the case, our thesis on Intelsat was wrong. Our process did not prevent us from making a mistake but we think it helped us to recognise it quickly and clearly, and to act. We closed the short position and, at the same time, bought SES. We think this investment could make much more money for the Fund than we lost on Intelsat.

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SES SA ("SES")

SES is a satellite operator. It made an operating profit of USD 832m in 2017 on revenue of USD 2.4bn. By year end its backlog of contracted revenue was USD 9bn, flat on the previous year and compared to five years earlier. Net debt was USD 4.3bn, costing USD 170m in interest expense. Free cash flow to equity was c.USD 900m. If that was the whole story SES would probably be worth several billion dollars, which is how the market values it today.

Everything began to change in October 2017, although the market still doesn't seem to have realised it. As we discussed earlier in this letter, Intelsat filed a proposal to be able to sell the C-band spectrum it uses in the US which may be worth tens of billions of dollars. Intelsat only has the rights to about half of that spectrum; SES has most of the rest. If the FCC allows the satellite operators to sell this spectrum SES could receive a windfall worth more than its current market cap. If it doesn't we think its existing business is fairly valued. For us this is a great investment, one where we could more than double our money if things go well, or not lose much if they don't. We've said enough, and as much as we can for now, about the FCC process. Let's look at SES's business.

SES operates two fairly distinct telco networks today, SES Video and SES Networks (although some of its satellites provide capacity to both). SES Video broadcasts TV signals. Historically this has been one of the best business models available for satellite operators. For broadcasters, satellite is the most efficient way to distribute a large number of channels to a large number of homes. They pay a fixed price to cover a whole geography for a given number of channels. Consumers that sign up to a broadcaster have a dish fitted at their home and this points at a specific satellite located at a fixed point in the sky. Over time neighbourhoods of homes build up. The more successful a broadcaster is, the more expensive it becomes to change satellites. Switching would mean it has to re-point consumer dishes at a new satellite, which requires sending an engineer to every home in the neighbourhood. The average SES video broadcast customer pays about EUR 2.5m a year to serve a little under a million homes. Even if re-positioning each dish only cost a few euros it is obvious broadcasters are almost never going to switch.

High switching costs give SES extremely long visibility on its video business. Contracts typically run for 10 years and the backlog is 5 years of current revenue. This business is not going away any time soon. That said, it may now be in terminal decline. Historically leading satellite TV neighbourhoods claimed to have good pricing power, as you would expect when their established customers really can't go to anyone else. This may no longer be the case. Although the number of channels is still growing globally, overall demand is a little more complicated. Broadcasters buy data capacity on satellites, (transponders that receive signals from a ground station) and then amplify and retransmit them back to earth on a frequency that is picked up by the dish at a consumer's home. The number of channels they can fit through each transponder depends on the quality of the signal, and what technology is used to compress that data. For the past decade two competing trends have largely offset each other. On the one hand, MPEG-4 compression allows about twice as many channels per transponder as the previous standard. Against this, high definition ("HD") channels need roughly double the capacity of standard definition, and Ultra HD twice as much again. As TV sets get bigger (screens of 40 or more inches were about a third of the total sold in 2009, nearly two thirds by 2014 and even more today) a higher definition picture is more important. It's hard to predict which trend will be stronger in future but we expect overall demand to decline modestly each year from here for a different reason. Video streaming is likely to make some TV channels, particularly the long tail with a small audience, less commercially viable. Broadcasters won't be able to do without satellite distribution for a very long time but its relative importance has probably peaked in developed markets.

SES does not disclose the margin its video division makes, but we can infer from various disclosures that it is most of its total profit and probably almost all of its free cash flow. We estimate about EUR 650m a year. Even if this is a declining annuity, it will only go away slowly. Future spend on satellites will also be lower if less capacity is needed. We think the present value of SES Video is about two thirds of the company's EUR 11bn enterprise value ("EV"), even in a fairly pessimistic scenario.

That leaves about EUR 4bn for the Networks business, which has run rate revenue of about EUR 650m. Today most of that comes from the same fleet that supplies broadcasters. We value this income stream very conservatively because we don't think it is viable for another generation of satellites. Overcapacity has driven down pricing and returns. Cashflow will be positive, though, because capex won't be repeated. There is probably a few hundred million euros attributable to the SES Networks division still to come over the remaining life of these satellites.

The cause of most of this pain is a new generation of high throughput satellites ("HTS"). The fundamental shift in technology is moving from having one beam covering a wide area to a large number of spot beams, each reusing the same radio frequency, in the same space. Cost per bit can be orders of magnitude lower. SES has entered the new era in two ways. It has a handful of new satellites with high throughput capacity that are largely replacements, but has taken an increasingly low risk approach to new HTS investment. It initially planned for a global geostationary ("GEO", meaning orbiting in a fixed position about 40,000km above the earth) constellation with three pure HTS but then backed away, only adding one (SES-17 will launch in 2020) where the risk is largely underwritten by its end customer (Thales SA will use it to supply aeroplane cabin Wi-Fi to its customers in North America). In fact, the whole industry made few new GEO satellite orders in 2017; only 10 compared to an average of more than 20 a year over the past two decades. That said, overcapacity is not likely to be absorbed for a very long time. The business case for some of SES's current and planned GEO HTS is clearly weaker than when they were procured. At cost they are worth about EUR 2bn. We assume fair value is half that.

The tail that wags the dog for SES is its new constellation, O3B. These are HTS but because they operate in a medium earth orbit ("MEO"), about 8,000km up, the economics are very different. The satellites are much smaller and cheaper to build and launch. They are 5 times closer to earth which means they need 20 times less power to transmit the same signal, and have much lower latency as well. Unlike GEO they don't sit at a fixed point in the sky, so one is no good (they orbit every 288 minutes). O3B is the only broadband MEO constellation today, with 16 satellites and another 4 coming next year. You can get some idea of the capacity this network has by looking at its customers – more Pacific islands use O3B for telecoms than use undersea cables; it delivers 350Mb per second to cruise ships, allowing everyone on board to have broadband comparable to fibre at home. No other existing satellites can offer that kind of concentrated capacity cost effectively. Although it only accounted for about a quarter of the SES Networks division revenue in 2017, O3B is growing fast enough to more than offset declining sales for the older GEO fleet. Each satellite costs less than USD 100m (compared to around USD 500m all in for SES-17) and is expected to generate revenue of over USD 30m p.a. over a 12-year life. Adding in the cost of ground stations and operating the network, the total investment comes to about USD 2bn for the first 20 satellites, yielding a pre-tax return on capital of c.15% p.a. None of this is in SES's earnings today, with O3B at best breakeven in 2018, as newer satellites build up their customer base. Things get even more interesting after 2021 when another seven O3B satellites will make its coverage global (today it is only really effective between 45 degrees north and south of the equator, which means it doesn't serve most of North America, Europe or Russia). Overall, we value O3B at somewhere between EUR 2.5bn and EUR 4bn.

In summary, we think SES's existing businesses are worth close to its current EUR 11bn enterprise value. EUR 7bn for Video, based on the assumption that it's now in decline, but only quite slowly for the next decade. Another EUR 0.5bn for Networks revenue on legacy satellites and EUR 1bn for HTS (effectively a write down of about 50%). We think O3B is worth the rest and probably a fair bit more, but wouldn't pay up for it as it still has to fill up its current capacity, global coverage is some way off and competition from low earth orbit constellations will come in the 2020s. Any windfall from selling US C-band spectrum rights is close to a free option that could be worth between one and three times SES's current market cap. It might not come but we are certainly not betting against it any more.

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