Ennismore European Smaller Companies Fund

Investor Newsletter for the month of June 2019

Issued on 5 July 2019

Fund Details

Daily dealing UCITS and Irish Central Bank regulated open-ended investment company with Financial Conduct Authority recognition and registered in Ireland. The Fund size was GBP 412m as at 28th June. Total assets under management by Ennismore Fund Management were GBP 900m. Our smaller companies 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 28 June 2019

	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]	**139.45**	**155.85**	**23.56**	**22.45**	**22.55**			
Period	% Change					% Change		
June 19	**-0.7**	**-1.9**	**-0.7**	**-1.8**	**-1.7**	**4.8**	**3.5**	**4.6**
May 19	2.2	-0.6	2.2	-0.1	-0.1	-2.4	-5.1	-4.5
April 19	0.7	1.0	0.7	0.9	0.9	4.3	4.3	4.1
March 19	1.5	0.8	1.5	0.9	1.0	1.0	0.7	2.0
February 19	-0.2	1.7	-0.2	1.3	1.3	1.3	3.1	3.6
January 19	1.4	4.3	1.4	3.8	3.7	5.6	8.7	5.6
2019 to date	**5.0**	**5.3**	**5.0**	**5.1**	**5.2**	**15.3**	**15.6**	**16.1**
Annualised return[5]	**13.9**	**12.5**	**10.7**	**10.1**	**10.2**	**9.6**	**8.2**	**4.2**
Since launch[5]	**1320.8**	**1006.7**	**135.6**	**124.5**	**125.5**	**549.8**	**403.7**	**133.3**
	Discrete 12 Month Rolling Performance - % Change							
To 30 June 19	8.3	7.0	8.3	7.1	7.2	-0.9	-2.1	4.3
To 30 June 18	5.7	4.9	5.6	5.0	5.0	8.2	7.3	4.3
To 30 June 17	11.3	5.4	11.4	7.2	7.1	31.9	25.5	20.2
To 30 June 16	16.5	-0.7	16.5	1.7	1.7	9.2	-7.2	-5.8
To 30 June 15	5.2	18.9	5.2	16.2	16.1	2.9	16.1	7.0

[1]Source: Administrator, Net Asset Value. [2]Source: Administrator, Net Asset Value, net income reinvested. [3]Source: Bloomberg, Euromoney (formerly 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. **Past performance is not a guide to future returns.**

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

Top 5 Contributors and Detractors for June 2019

Contributors	MTD (bp)
METRO AG	69
UK software company	36
UK semiconductor supplier	35
Findel Plc	34
UK auto company	25

Detractors	MTD (bp)
Costain Group Plc	-175
Cello Health Plc	-41
Norwegian retailer	-26
German retailer	-25
Jd Sports Fashion Plc	-22

Individual stock attributions relate to GBP A shares and are gross of fees and expenses (including financing/stock borrowing costs).

The Fund's NAV fell by 0.7% in June. Our long book contributed 0.5% while the Fund's short exposure cost 1.1%. Costain cost the fund 1.8% after the company announced a significant reduction in guidance for the coming years which led to a 40% fall in its share price. We were disappointed and surprised, however the reduction was due to project delay as opposed to losing money on projects won previously. We see this distinction as important and given their strong balance sheet and the already low rating it was on prior to the update we view the quantum of the share price move as unwarranted. METRO AG contributed 0.7% following a takeover bid from its largest shareholder. The small premium suggests this was made to allow it to exercise options to take its stake over 30%, in which case a bid would be mandatory under German law anyway. The company has rejected it and we don't expect a higher price will be offered. We continue to believe the company is undervalued.

Vivendi – French media company (1.2% NAV)

From its earliest days the value of the recorded music industry has varied considerably as the technology used to consume it has changed. Today this is driving a revival of music label fortunes. More than half of recorded music revenue now comes from fast-growing streaming services, where consumers pay a monthly fee for unlimited access to a vast library of recordings. There were 255 million paid subscriptions to one of these at the end of 2018, up by more than a third from a year earlier. In the US, the most advanced market for digital music, only about half of households have a subscription. In Japan, the second largest music market in the world, only about one in ten do. We expect global subscriber numbers will top 500 million within 5 years as most people in developed markets move to consuming audio this way. At the same time recorded music revenue from other sources will probably only decline modestly, with physical (25% of 2018 revenue) and download (12%) sales fading out but royalty revenue from live performance, radio and video (16% combined) still growing. All in we expect high single digit top line growth over the next decade. That would still leave recorded industry sales some way below the 2000 peak in real terms.

Music labels make money in two ways. Publishing relates to the song writing and accounts for around 15% of revenue at all of the major labels. A sale is made every time a song is played publicly as well as when it is bought as a recording, so it was always less dependent on physical revenue (even in 1999 CDs only accounted for about 60% of publishing sales). Other revenue streams like radio, TV and live performances meant that it was pretty stable and highly profitable (with margins in the 25-30% range) even as recorded music went down the pan. Sales of recorded music from the back catalogue, which we estimate are about half of the industry total, are similarly profitable because there is little cost attached to them other than the royalty share. Both publishing and the catalogue should see good operating leverage now that overall sales are growing again. The heart of a music label, though, and most of its cost base business is the artists and repertoire ("A&R") division, which scouts for new talent and develops and promotes signed artists. It's comparable to R&D, so if that part of the company isn't working the other revenue streams are just a declining annuity. New music is expensive to produce and market and a lot of it doesn't sell enough to turn a profit. To put capital at risk labels demand long term rights over the end product. That is, security over earnings from the artists that do make it. So new music is not really a profit centre. There's a lot of room for A&R costs to be variable – not just royalties but also advances, production and marketing costs as well – and if, as we expect, publishing and catalogue sales become more valuable then the investment that can be justified to acquire them will go up too. Overall the blended operating margin for the majors was about 15% last year, up from more like 10% five years ago. We think operating leverage will see blended margins increase by a similar amount over the next five years, to more like 20%.

You may think we are missing the obvious - streaming is the new technology and the labels don't control it. Won't that be the disruption that cuts into label profits? We don't think so. The largest music service is Spotify, which estimates it has a 38% share of the market. But this share doesn't seem to be growing, and in the US it's just been overtaken by Apple. That's actually a similar level of concentration to the recorded music industry, where the three major labels control about 70% of the market. There's a big difference though – the streaming services are all selling a homogenous product, each label has a unique catalogue. If a major label refuses to supply a streaming service it will lose a lot of sales, but it will get them back - because the streaming service will lose almost all of its customers if it can't deliver 20-30% of the music they want to hear. The labels have the power here.

We have talked a lot about the music industry as a whole so far but, as with all of our investments, we started from the bottom up. The major label we are interested in is Universal Music Group. It's the biggest of them all, bringing in about 30% of global music sales, and has the best product mix - about 70% of its recorded music sales are from the back catalogue. Unfortunately you can't buy a share of it directly, only through owning its parent company, the conglomerate Vivendi (although if that wasn't the case it might not be available to buy for what we think is a good price). Because it's a conglomerate, a share gives you other assets as well. We'll get them out of the way first because we don't think they are material relative to the value of the music business. There are two large minority holdings in listed companies (Telecom Italia and Mediaset) and, through Universal, a stake in Spotify (which it has promised to distribute the value of to its artist roster). We hedge these, in effect freezing their value at about EUR 3.5bn. Vivendi's main unlisted assets are French pay-TV business Canal+, media agency Havas and book publisher Editis. We value these at around EUR 5bn (c.13 times operating profit), EUR 2bn (10 times) and EUR 900m (cost of acquisition in January) respectively. These are not particularly precise estimates but we don't think they need to be. In 2018 Universal made EUR 0.9bn operating profit, on EUR 6bn of sales. We forecast more like EUR 2bn on about EUR 9bn sales five years out, and EUR 3bn on over EUR 12bn after another five – delivering close to EUR 15bn in free cash flow in the meantime. These are, of course, not likely to be the real numbers they report but we think the direction and scale are about right. We estimate Universal is worth EUR 30-35bn. That adds up to total group assets of EUR 40-45bn in the Vivendi conglomerate, compared to a current market cap of EUR 31bn with about EUR 3bn net debt. One of the attractions of making this investment today is that we will probably soon know if we are right about how much the Universal asset is worth (or, at least, what price tag potential buyers are willing to meet). Management has committed to offloading half of the music label and the sale process is well underway. It is likely to be done within the next year. Given the upside we see relative to Vivendi's current market capitalisation, we think the risk of ownership is now well worth it.

Top Five Long Holdings as at 28 June 2019

	Company	Country	Sector	% of NAV
1	Jd Sports	United Kingdom	Consumer Discretionary	4.5
2	Sto	Germany	Materials	3.3
3	METRO	Germany	Consumer Staples	3.2
4	Renk	Germany	Consumer Discretionary	2.7
5	Costain	United Kingdom	Industrials	2.5
				16.2

Exposures as at 28 June 2019

Longs %	Shorts %	Gross Exposure %	Net Exposure %
72.3 (72.2)	47.9 (44.9)	120.2 (117.1)	24.4 (27.3)

Figures in brackets refer to previous month end.

Exposures by Country, Market Cap & Sector as % NAV and Positions as at 28 June 2019

Country	Gross%	Net%
Austria	2.5	0.7
Belgium	1.1	1.1
France	7.1	2.2
Germany	30.2	5.0
Hong Kong	1.6	-1.6
Ireland	1.4	1.2
Italy	4.5	2.2
Luxembourg	0.9	0.8
Netherlands	2.2	1.0
Norway	4.4	0.5
Sweden	2.2	-0.2
Switzerland	3.9	-3.9
UK	47.3	19.5
US	7.6	-2.7
Other	3.3	-1.4

Market Cap	Gross%	Net%
>£2bn	39.0	2.4
£700m - £2bn	16.6	-9.7
£200m - £700m	44.6	17.0
<£200m	20.0	14.7

Positions	Jun	May
Long	78	79
Short	89	92
Longs Opened	2	2
Longs Closed	3	3
Shorts Opened	1	4
Shorts Closed	4	3

Sector	Gross%	Net%
Consumer Discretionary	33.0	6.7
Consumer Staples	5.8	3.0
Energy	0.6	0.5
Financials	9.8	7.8
Health Care	7.3	-0.9
Industrials	18.2	7.8
Information Technology	30.8	-8.3
Materials	4.3	4.0
Real Estate	6.1	1.3
Telecommunication	4.3	2.5
Utilities	0.0	0.0
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.

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