Ennismore Global Equity Fund

Investor Newsletter for the month of September 2020

Issued on 9th October 2020

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 USD 322m as at 30th September. Total assets under management by Ennismore Fund Management were USD 795m. Our funds are hard closed with the number of shares in issue capped. If you would like to invest when capacity is available through redemptions please contact Jo-Anne Bailey on +44 (0) 20 7368 4231 or email subs@ennismorefunds.com.

Top Five Long Holdings as at 30 September 2020

Company	Country	Sector	% of NAV
Royal Mail PLC	United Kingdom	Industrials	7.6
Schibsted ASA	Norway	Communication Services	7.0
METRO AG	Germany	Consumer Staples	6.1
Just Eat Takeaway.com NV	Netherlands	Consumer Discretionary	4.8
mixi Inc	Japan	Communication Services	4.5
			30.0

Exposures as at 30 September 2020

Longs%	Shorts%	Gross Exposure%	Net Exposure%
82.6(75.3)	63.7(70.2)	146.2(145.5)	18.9(5.1)

Figures in brackets refer to previous month end. All exposures are calculated on a delta adjusted basis. All calculations are subject to the impact of rounding

Exposures by Country, Market Cap & Sector as % NAV and Positions as 30 September 2020

Country	Gross%	Net%
United States	50.0	-12.4
United Kingdom	22.6	11.2
Germany	13.0	7.2
Norway	12.4	1.7
Cayman Islands	5.8	-5.8
Netherlands	5.6	5.6
Sweden	5.5	5.5
Japan	4.9	4.0
France	4.9	3.4
Luxembourg	3.8	3.4
South Africa	3.7	2.4
Other	14.2	-7.2

Market Cap	Gross%	Net%
>$10bn	53.0	2.1
$5bn - $10bn	16.0	8.5
$1bn - $5bn	59.6	19.9
<$1bn	17.6	-11.5

Positions	Sep	Aug
Long	40	42
Opened	1	0
Closed	3	2
Short	106	93
Opened	17	7
Closed	4	11

Sector	Gross%	Net%
Communication Services	41.1	16.5
Consumer Discretionary	29.9	7.5
Consumer Staples	9.2	7.1
Energy	0.0	0.0
Financials	11.5	7.0
Health Care	11.1	-3.9
Industrials	19.9	1.8
Information Technology	16.9	-13.1
Materials	2.0	-1.6
Real Estate	4.6	-2.4
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.

Performance as at 30 September 2020

	Share Class					
	GBP	**GBP A**	**EUR**	**CHF**	**EUR I**	**USD I**
NAV per share[1]	**11.04**	**10.98**	**10.57**	**10.43**	**8.82**	**8.69**
Period	**% Change**					
September 20	**5.3**	**5.3**	**3.6**	**3.8**	**5.1**	**5.1**
August 20	-10.3	-10.2	-9.4	-9.5	-10.5	-10.2
July 20	-4.5	-4.4	-3.6	-2.5	-4.6	-4.7
2020 to date	**-19.5**	**-19.5**	**-24.8**	**-25.5**	**-20.6**	**-19.8**
Annualised return[2]	**2.5**	**2.4**	**1.4**	**1.1**	**-5.4**	**-7.7**
Since launch[2]	**10.4**	**9.8**	**5.7**	**4.3**	**-11.8**	**-13.1**
	Discrete 12 Month Rolling Performance					
To 30 September 20	**-22.3**	**-22.5**	**-24.8**	**-25.4**	**-23.7**	**-22.5**
To 30 September 19	**9.7**	**9.6**	**10.2**	**6.4**	**7.9**	**-**
To 30 September 18	**27.3**	**27.4**	**27.0**	**24.5**	**-**	**-**

[1]Source: Administrator, Net Asset Value. [2]Since inception of GBP, GBP A, EUR and CHF share classes on 03/10/16, EUR I share class on 03/07/18, USD I share class on 02/01/19. Note: All performance figures net of fees. **Past performance is not a guide to future returns.**

Attribution %		**GBP**	**EUR**	**CHF**
Long	Q3 20	9.3	9.5	10.5
	Q2 20	25.2	23.5	23.5
	Q1 20	-23.8	-25.6	-27.0
	Q4 19	-1.0	3.3	3.0
Short	Q3 20	-17.7	-17.9	-18.2
	Q2 20	-18.9	-18.7	-18.7
	Q1 20	7.7	7.0	6.9
	Q4 19	-2.2	-2.5	-2.5

Attribution figures exclude cash returns and are prior to expenses

Top 5 Contributors and Detractors for 30 September 2020

Contributors	**MTD (bp)**
Royal Mail PLC	203
mixi Inc	104
Under Armour, Inc	40
UK software company	32
CryoPort Inc	30

Detractors	**MTD (bp)**
Digital Turbine Inc	-35
US healthcare company	-18
Zardoya Otis Sa	-18
Capital & Counties Properties PLC	-17
Hong Kong real estate company	-15

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

The fund's NAV decreased by between 8.4% and 10.2% in the quarter, depending on currency. That was a terrible result. We already wrote to you at the end of August to explain what was driving this, and what we were doing about it. September was a better month, but we are well aware that we owe you much more performance. This will take time.

The long book contributed well in Q3. The main positives were social network Pinterest, Inc. (adding 1.8% to NAV), logistics firm Royal Mail PLC (1.7%) and mobile game developer mixi, Inc (1.2%).

On the short side the pain was widely spread with a large number of positions costing the fund significantly, as we discussed already in our August letter. There is not a lot more to add to what we said then, but it is perhaps worth reiterating that there is no stronger motivation for us than to recover your losses.

"The Security I Like Best"

One of the first public writings by Warren Buffett is a piece he wrote aged twenty-one for The Commercial and Financial Chronicle in December 1951, titled "The Security I Like Best". Buffett's tip was the common stock of Government Employees Insurance Co. - aka GEICO - a direct motor insurer (that is, one that interacts directly with consumers without agents or branch offices). He apparently invested half of his net worth into the stock arguing that its USD 8m market cap undervalued its huge growth potential as the low-cost operator operating in a very large market. At the time it had only 150,000 policies in force and c.USD 10m in premium income.

This early stock pick turned out to be a good runner. An investor who bought alongside Buffett in late 1951 and managed to stay on the road until today (Buffett didn't, he sold in 1952) would have received a compound return of over 21% up to the point when Berkshire Hathaway took the company private in 1995. Even since then we estimate it has delivered an annualised return of close to 15%, based on today's valuation of GEICO's close peer Progressive Corp. From Buffett's initial purchase in 1951, the total implied gain is over 100,000 times.

Almost 70 years on GEICO continues to steadily take market share. As Buffett himself said in a letter to a GEICO manager in 1976, shortly after he bought back into the company via Berkshire Hathaway:
"I have always been attracted to the low cost operator in any business and, when you can find a combination of (i) an extremely large business, (ii) a more or less homogeneous product, and (iii) a very large gap in operating costs between the low cost operator and all of the other companies in the industry, you have a really attractive investment situation. That situation prevailed twenty-five years ago when I first became interested in the company, and it still prevails."

We tell this story because it demonstrates the remarkable power of a robust and long-lasting business insight, and because it is relevant to one of the securities we like best – the equity of Admiral Group PLC ("Admiral").

In the UK, Direct Line replicated GEICO's direct-to-consumer operating model in the 1980s. Its success bred copycats, one of which was Admiral, founded in 1993 by Henry Engelhardt and David Stevens. Admiral has since overtaken its forerunner to become the UK's largest motor insurer. It completed an IPO in 2004 and has delivered a better than 20% compound return to shareholders since, benefiting from the same insight that Buffett identified almost 70 years ago: in an industry where price is a crucial purchase criterion, a sustainable cost advantage is a powerful and enduring driver of success and value creation.

Low running costs

Motor insurers protect drivers against the financial risks of being involved in a collision or other incident, typically for a year. Consumers pay a premium for this protection, normally in advance. Insurers set the premium based on their assessment of how risky a consumer is, seeking to cover their operating expenses (acquiring and serving customers, managing renewals etc.) and the cost of potential claims their insureds will make. They aim to attract and retain a lot of business relative to their cost base (that is, to have a low expense ratio of operating expenses divided by premiums) while selecting customers whose risk profile is mispriced such that claims pay-outs are low relative to premiums (a low loss ratio of claims divided by premiums). The successful direct insurers we discussed earlier have all outperformed competitors on the expense ratio and in some cases (notably Admiral) on the loss ratio as well. For many years the UK financial regulator compiled an industry dataset that allowed us to test drive Admiral directly against its peer group (it stopped publishing it after 2016). This showed that for over a decade Admiral outperformed the industry average by almost 30 percentage points, split evenly between the expense ratio and the claims ratio.

Lower expenses are achieved in three main ways. The direct to consumer model allows more efficient customer acquisition than the broker channel once scale is established, as brand advertising is a fairly fixed cost, particularly for national ads. Better retention means fewer customers need to be acquired to maintain a stable customer base. This is less relevant for an agency distribution model as agents typically take a recurring share of premium, and so the insurer has less incentive to focus intensively on keeping hold of its customers. Finally, lean overheads - for example, Cardiff was initially chosen as the Admiral headquarters because it is a cheap place to run an office. These cost differences are very large against legacy insurers. They are smaller, but still there, compared to most other direct operators. As direct insurers account for the majority of the UK market today the overall advantage of low operating expenses is smaller than it was twenty years ago. That part of the model is easiest to copy.

No claims bonus

Admiral's loss ratio advantage is more challenging to understand, but also much more difficult to replicate. Simply put, it is more effective at selecting mispriced risks, and then better at managing the cost of claims when customers notify about an incident. We believe this comes from a combination of mostly intangible factors which are difficult to quantify individually, but very powerful in aggregate.

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One significant factor today is economies of scale. As the biggest UK motor insurer, Admiral has a larger proprietary dataset to work with when it is matching customer profiles to risk characteristics. This means it can segment customers more precisely and with greater confidence than smaller insurers. Admiral has a particular advantage in the higher risk segments which are much less heavily competed for.

To explain this better we need to first take a brief detour around the UK motor insurance market. Motor insurers in the UK take on unlimited liability for their insureds. Most claims are small but the largest - relating to personal injuries which trigger lifetime compensation payments - can stretch into tens of millions. In the five years up to 2010 (we don't have as detailed data for more recent years) almost all of the top ten motor claims each year were for GBP 5m or more. They will have become significantly more expensive since as the government reduced the discount rate used to calculate settlements in 2017. In aggregate large personal injury claims account for over 40% of total UK motor claims payments and so the varying probability of being involved in an accident that generates this kind of claim is a major driver of premium pricing.

Many insurers respond to the risk of large individual claims by closing their doors to the customer segments where these tend to cluster, such as younger drivers. Admiral's philosophy has always been to be prepared to take on any business where it can price the risk accurately. Over time this is self-reinforcing, with smaller players unable to break into the higher premium end of the market. For one thing scale means that Admiral can manage the risk better in aggregate against its UK motor premium base of GBP 2.2bn, even a GBP 10m claim is relatively modest. For a competitor like AA PLC, with an underwritten book of GBP 130m, one big claim could knock it off the road. But Admiral's advantage is more subtle than this. Although there are almost 30 million motor insurance policies sold in the UK each year, only a couple of hundred of these will lead to a claim of over GBP 1m. A small firm with say 5% of the market with have only a handful of datapoints to refer to when it is pricing this risk. Admiral, with c. 16% market share and more presence in the riskier segments, may have five or ten times as many. With samples so small, and these claims so pricey, we think Admiral has a sustainable advantage over most of the competition when it comes to pricing the most lucrative part of the market. Importantly, we don't see this changing even if a proposal by the current regulator that requires insurers to offer the same pricing to current customers as they do to new ones comes into effect.

Two careful owner-managers

Admiral's business model generates a virtuous cycle of barriers to scale in the UK market: given its lower unit costs and more effective risk pricing, it is able to profitably under-price competitors, fuelling further volume share gains, which in turn reinforces its scale economies on marketing and data. We expect this to survive the upcoming management transition - from early next year, for the first time since launch, Admiral will not have one of its founders behind the wheel. CEO designate Milena Mondini was chosen from a deep bench. She led Admiral's successful Italian business since launch (more on that below) so is well qualified to take over, and unlikely to make any strategic handbrake turns. We also value the company's culture of widely shared ownership. Admiral distributes roughly 1% of its equity to all of its employees each year. We believe that, combined with it being widely recognised as a great place to work, helps to motivate employees better than at a lot of comparable businesses.

It's also worth noting another reassuring aspect of Admiral's business. Its accounting is the most conservative in the sector (to be fair we would probably jointly award this title to its smaller competitor Sabre Insurance Group PLC as well). That's particularly important in insurance as there is more complexity and more management discretion than for many businesses. At year end insurers report an estimate of their profitability, but there is a great deal they don't know at that stage: for example, policies written late in 2019 still have almost a year of cover outstanding , and drivers in the UK legally have two years to notify their insurer of a claim. Even after notification, large claims can mean several years of negotiation before a settlement is reached. The end result is that at least a quarter of 2019's ultimate claims will probably still be awaiting payment at the end of 2021! To adjust for this lag insurers will re-estimate profits on 2019 policies (and, of course, earlier years as well) each year. Admiral's approach is to make very cautious initial estimates incorporating a large buffer, and then release that buffer as profits as time passes and uncertainty reduces. Because they are so conservative most of the profits from 2019 policies won't be recognised until 2021 or later – we estimate the average lag is about three years. This has two implications: we can have more confidence that Admiral's profits are real than with many other insurers, and the number we use below for Admiral's excess capital is significantly underestimated – there's another two or three years of profits hidden in the balance sheet. Or, to put it another way, if Admiral stopped writing new policies today, it would keep reporting profits for several years to come as it released the buffer in its claims estimates for past years.

A European road trip

Based on its track record in the UK, Admiral was also able to launch in several other countries with the support of reinsurers. We expand on this more later, but the key point is that it significantly reduces the firm's capital requirement in the early years operating in a new market. Between 2006 and 2010 Admiral entered Spain, Italy, the US and France and these account for a quarter of its motor insurance customers today. Admiral has lost a little over GBP 150m opening up these new markets but in aggregate it broke even in them in the first half of this year. This might sound unexciting but in fact we believe the group has built substantial value in these international operations, particularly in Europe.

Let's consider Conte in Italy, the largest of Admiral's non-UK businesses, which was set up in 2008. 11 full years after launch it is following a very similar path to the UK business based on a similar strategy (although there are certainly quirks to the Italian market). Conte had 690,000 policies at the end of 2019, having grown by 22% compound over the last four years; Admiral in the UK had 1,008,000 at the same stage in its development. By 2013 Conte had achieved an advantage of at least 10% points relative to the market average loss ratio helping make it consistently profitable and the very clear leader in market share of Italian price comparison referrals to insurers. In most aspects it seems to be on a path towards replicating the unit economics of the UK business, albeit at a lower average premium per policy.

Two factors make us think Conte will deliver extraordinary profit growth over the next five or so years. First, having established a solid underwriting track record, and with highly competitive pricing, it is well placed to push for volume growth that will leverage its expense base. More importantly, the business hasn't renegotiated its reinsurance arrangements since it was founded. We compared Admiral to GEICO and Progressive earlier but it's worth dwelling on one distinctive feature which turbocharges its business model relative to the Americans. Insurers are regulated and are required to hold sufficient capital, so that a firm can still meet claims even if it misjudges its underwriting. Capital requirements provide a constraint on growth or returns, because they need to be funded from profits or new equity. Admiral solves this dilemma by transferring most of the underwriting risk off its own balance through co-insurance and reinsurance. The beauty of these arrangements is that in its UK motor business it only retains 22% of the risk but makes c.85-90% of the overall profits. This is only possible because of its exceptional long-term underwriting track record. In Italy Admiral keeps 35% of the risk and we estimate less than half of the overall profits. Given its growing track record we expect to see its reinsurance contracts moving in the same direction as the UK operations within a couple of years. If and when this happens Admiral will recognise a much higher share of a rapidly growing overall profit pool.

Take it home today, sir?

We believe Admiral's non-UK businesses are worth around GBP 500-700 per policy (assuming a 10-15% profit margin on an average premium of GBP 400), which equates to about GBP 2.50-3.50 per share. This is before pricing in growth and the international policy base is increasing c.15% per year. We would not be surprised to see this accelerate now that these businesses have turned profitable and with the high-speed French operation (it has grown at 42% compound since 2015) becoming a larger part of the mix. Within four years, we expect the international businesses to be worth c.GBP 7-8 per share. In addition, we estimate the group has close to GBP 500m of excess capital on the balance sheet (almost GBP 2.00per share) which will be freed up once it moves to a new solvency capital model, appears likely to sell its price comparison operations that could fetch several hundred million pounds (perhaps another GBP 1.50-2.50 per share), and has a rapidly growing UK home insurance operation that may be worth another GBP 1 per share today, and closer to GBP 2 per share in 3-4 years. All this translates to around GBP 7-10 per share of value today outside of the core UK motor operation, and GBP 12.50-15 in the medium term. With the current share price of c.GBP 26.50, this implies the UK motor business is valued by the market at roughly GBP 15-19, or about 10-12 times earnings. That gets you ownership of a defensive, highly cash generative business: use of reinsurance has seen excess cash consistently returned to shareholders (at its IPO in 2004 the share price was GBP2.75; it has distributed GBP 13.35 in dividends since, nearly half in the last five years). Admiral continues to grow its UK motor customer base (by 7% a year over the last five years) and profits (by 8% annually over the same period). Looking at valuation the other way around, we think it is easy to justify a valuation in excess of GBP 30 per share for Admiral today. And we conservatively expect that valuation to grow by mid-high single digits per year. In the meantime the fund gets an annual dividend yield starting at >6% today that should continue to grow in line with the business, with the likely added bonus of an exceptional return of excess capital of perhaps GBP 3-5 over the next couple of years (assuming the price comparison business is sold and the proceeds plus existing excess capital is distributed). Between the distributions, the compounding of value, and the potential for an increase in the multiple, we expect Admiral Group to deliver a total return in the region of 15% per year over the next few years.

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