Ennismore Global Equity Fund

Investor Newsletter for the month of March 2021

Issued on 14 April 2021

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 245m as at 31st March. Total assets under management by Ennismore Fund Management were USD 755m. The number of shares issued by our funds is capped in order to limit the level of assets under management in each strategy. We currently have capacity available in the Ennismore Global Equity Fund. If you would like to invest please contact Jo-Anne Bailey on +44 (0) 20 7368 4231 or email subs@ennismorefunds.com.

Top Five Long Holdings as at 31 March 2021

Company	Country	Sector	% of NAV
Royal Mail PLC	United Kingdom	Industrials	8.7
METRO AG	Germany	Consumer Staples	8.3
thyssenkrupp AG	Germany	Materials	7.7
Schibsted ASA	Norway	Communication Services	6.9
Vivendi SE	France	Communication Services	6.5
			38.2

Exposures as at 31 March 2021

Longs%	Shorts%	Gross Exposure%	Net Exposure%
94.2(84.5)	46.0(47.0)	140.2(131.5)	48.2(37.5)

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 31 March 2021

Country	Gross%	Net%
United States	49.8	2.2
United Kingdom	21.8	16.8
Germany	17.7	14.4
Norway	10.8	3.1
Sweden	9.4	9.4
France	6.9	6.1
Switzerland	3.8	-3.8
Japan	3.7	3.3
Cayman Islands	3.2	-3.2
South Africa	3.0	3.0
Netherlands	2.3	2.3
Other	7.8	-5.4

Market Cap	Gross%	Net%
>$10bn	56.8	25.0
$5bn - $10bn	29.2	21.3
$1bn - $5bn	35.1	14.5
<$1bn	11.1	-4.6

Positions	Mar	Feb
Long	41	39
Opened	7	2
Closed	5	4
Short	91	87
Opened	14	18
Closed	10	10

Sector	Gross%	Net%
Communication Services	35.5	17.6
Consumer Discretionary	19.7	10.3
Consumer Staples	18.5	15.9
Energy	0.0	0.0
Financials	6.8	-0.1
Health Care	5.1	-3.3
Industrials	14.6	5.9
Information Technology	20.1	6.4
Materials	9.3	6.1
Real Estate	1.8	-1.8
Utilities	0.7	-0.7
Other	6.4	-6.4

Geographic analysis relates to country of incorporation or listing. This may not represent the underlying economic exposure of the operating business.

Performance as at 31 March 2021

	Share Class					
	GBP	GBP A	EUR	CHF	EUR I	USD I
NAV per share[1]	**10.95**	**10.89**	**11.16**	**11.33**	**8.70**	**8.62**
Period	% Change					
March 21	**2.7**	**2.6**	**4.6**	**5.3**	**2.6**	**2.6**
February 21	1.4	1.4	3.4	5.2	1.3	1.4
January 21	-2.6	-2.6	-1.4	-1.6	-2.7	-2.6
2021 to date	**1.5**	**1.4**	**6.6**	**8.9**	**1.2**	**1.4**
Annualised return[2]	**2.0**	**1.9**	**2.5**	**2.8**	**-4.9**	**-6.4**
Since launch[2]	**9.5**	**8.9**	**11.6**	**13.3**	**-13.0**	**-13.8**
	Discrete 12 Month Rolling Performance					
To 31 March 21	**-5.1**	**-5.1**	**-1.5**	**2.8**	**-6.5**	**-13.0**
To 31 March 20	**-13.2**	**-13.4**	**-15.6**	**-19.4**	**-14.7**	**-7.7**
To 31 March 19	**23.4**	**23.3**	**25.2**	**19.8**	**-**	**-**

[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	Q1 21	7.1	11.2	12.9
	Q4 20	16.0	17.1	17.5
	Q3 20	9.3	9.5	10.5
	Q2 20	25.2	23.5	23.5
Short	Q1 21	-4.2	-4.3	-4.4
	Q4 20	-16.9	-17.2	-17.2
	Q3 20	-17.7	-17.9	-18.2
	Q2 20	-18.9	-18.7	-18.7

Top 5 Contributors and Detractors for March 2021

Contributors	MTD (bp)
Royal Mail PLC	86
Schibsted ASA	43
Swedish Match	42
Swiss financial services company	36
Concentrix Corporation	33

Detractors	MTD (bp)
Russell 2000 index options	-38
Everbridge Inc	-32
METRO AG	-28
United States air transport company	-21
Vivendi SE	-19

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

The return from the fund's investments was good in the first quarter of 2021, although sterling strength detracted from performance in the GBP terms. NAV per share increased between 1.2% and 8.9%, depending on currency. The forex impact was larger than usual but remains modest since inception.

The long book delivered excellent returns again, contributing 7.1% (in the GBP class). This was driven mostly by two names that had already contributed well in the previous quarter. Royal Mail PLC's profit ended up so far ahead of our expectations that the stock, despite doubling, still trades on little more than ten times underlying earnings. More significantly the UK business has turned a very sharp corner. The mix shift towards its parcel deliveries has been so dramatic that, while letters continue to decline and there will be some volume reversal as the UK economy reopens, overall revenue is now likely to grow steadily over the next few years. This has transformed relations with the labour union and the bottom line.

The other big positive in Q1 was thyssenkrupp AG, although there's been less material company news than we expected so far this year. The main catalyst for the share price rise seems to have been the rapid and broad turnaround in steel industry profitability. Perhaps the market was surprised to find that it is a cyclical business? The announcement that a tentative bid from the UK's Liberty Steel, part of a loose industrial grouping controlled by Sanjeev Gupta and known as the GFG Alliance ("GFG"), had fallen through was apparently already discounted.

GFG's subsequent fall from grace has been rapid and, so far, modestly profitable for the fund. We were already quite familiar with the kind of funding Greensill Capital was providing to it through funds managed by Credit Suisse. One big user of these supply chain finance facilities had been NMC Health PLC, an alleged fraud we were short that collapsed in early 2019 (after admitting to having several billion dollars more debt than had been disclosed on its balance sheet). But by far the biggest customer was GFG. Credit arranged by Greensill allowed it to become the buyer of last resort for metal works around the world when they were put up for sale by companies more focussed on actually making money.

The roll up now seems to be unravelling quickly. Credit Suisse had been able to market the Greensill funds as safe investments because they were backed by insurance. When those policies couldn't be renewed the funds were suspended, Greensill's German bank (already under criminal investigation) was put into liquidation and GFG stopped paying back what it owed. Past political connections - Lex Greensill once had a desk in No. 10; former PM David Cameron was an adviser with options reputedly worth up to tens of millions - suddenly didn't count for much. A request from Liberty Steel for a bailout from the UK government was bluntly rejected. As of writing several entities under the Gupta umbrella are reportedly facing winding up orders in the courts.

Before this year the fund had no obvious way to bet against this. No part of Greensill or GFG was listed, not even any bonds. But now much of their risk appears to have landed on Credit Suisse's lap. The funds it ran had about USD 10bn in

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assets, of which over USD 1bn is reportedly tied to GFG. Some was supply chain financing taken to another level – not advances tied to existing invoices, but future ones (sometimes with companies that GFG might do business with, but hadn't yet!). It seems very likely the funds will incur substantial losses, probably well over a billion dollars, and we expect investors in these products to sue Credit Suisse for what they have lost. That could end up costing the bank approaching a year of profit and push it close to needing to raise capital, before we even consider the reputational damage: we shorted Credit Suisse equity in early March for that reason but in the meantime it managed to lose even more on another client.

Archegos Capital Management reportedly started 2020 with around USD 1.5bn of equity. By mid-March this year Icarus-like returns reportedly saw this soar tenfold to around USD 15bn, with leverage of perhaps five times or more driving the updraft. Come April it was underwater, with banks that handed out seemingly endless funding on the way up now taking huge losses. Right at the front of the line is Credit Suisse with an estimated USD 4.7bn hit (so far). Its stock dropped by about a quarter in March, contributing 0.4% to the fund. And this was not even the loss we were betting on.

We were tempted to write that it is better to be lucky than good (as we did back in December 2016, commenting on timing in relation to our Mediaset SpA position) but a more appropriate saying is probably that there is never just one cockroach in the kitchen. Credit Suisse risk management signed off on the Greensill lending and the Archegos funding. The real question is, how many more shoes are there to drop? We are still short the company but the biggest benefit to the fund from this saga may end up being a more profitable European steel market for thyssenkrupp now that irrational funding for uncompetitive assets has evaporated.

One perverse feature of Archegos's moment in the sun was its reputed ability to create short squeezes (unrelatedly, in 2012 founder Bill Hwang had been fined and banned from managing external money by the SEC for trading on inside information). We don't know if it had any part in the GameStop Corp story that captivated market commentators in late January, but it was key to soaking up liquidity in Chinese education business GSX Techedu Inc, which spiked around the same time. In aggregate the fund made another 0.4% in Q1 by taking the other side of some of these positions once they had started to sell off.

We have only covered a small part of what went on in an eventful first quarter here, but we're pretty sure a lot of people are swimming a long way out from normal market conditions. There were, for example, about as many US IPOs in Q1 as in the whole of 1999. We remain very cautious about our short exposure overall, for now. The book cost us 4.2% of NAV (in the GBP class) in the quarter. While March returns were positive we don't yet see a fundamental shift from the position we outlined in our December letter, with most relevant equity indices trading at or around record highs.

A change is as good as a rest

We spilled plenty of ink discussing the short book in our 2020 letters. For a change, we're focussing on the long side in this letter: we briefly review performance so far, what worked and what we could improve, and examine the current book (both in aggregate and a few individual investments specifically).

The story so far is a good one. The return on our long book has been nearly 20% annualised over the life of the fund, with a fairly broad spread of different types of idea among the winners. Despite further strong performance over the last six months, and a broad market rally since November, we are (perhaps surprisingly) positive about the prospects for the portfolio today too. A sizeable part of the book – mostly businesses that have been growing solidly, are relatively predictable and modestly valued – is more attractively priced than it was six months ago.

Long Attribution and Average Long Exposure by Year

	GBP	EUR	CHF	Average long exposure
2016	5.4%	8.6%	7.1%	77%
2017	15.0%	11.5%	19.3%	84%
2018	18.1%	16.7%	13.2%	94%
2019	23.6%	30.6%	27.1%	93%
2020	18.6%	14.3%	13.2%	89%
2021	7.1%	11.2%	12.9%	88%

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The table above gives a summary of the fund's long book performance since inception. Annualised return on capital employed (attribution divided by long exposure) has averaged over 20% across the currencies the fund is priced in. Annualised return on capital has been double digit positive in each calendar year, including 2018 when the broader market declined. 2020 was no different, averaging 17%. Less arbitrarily, perhaps, the only 12-month periods when the return was on average negative were those ending in March and April 2020. We are satisfied with this track record but, of course, look back and think we could have done better.

Top 10 Long Contributors

Company	Attribution
Etsy Inc	18.4%
Royal Mail PLC	9.0%
Twitter Inc	7.1%
Under Armour Inc	6.6%
Schibsted ASA	6.2%
thyssenkrupp AG	5.8%
JD Sports Fashion PLC	5.0%
Mtu Aero Engines Gmbh	5.0%
Fevertree Drinks PLC	4.1%
Pinterest Inc	3.9%

Top 10 Long Detractors

Company	Attribution
Rolls-Royce Holdings PLC	-4.6%
Bayer AG	-2.5%
SES SA	-2.2%
TripAdvisor Inc	-1.9%
CarGurus Inc	-1.3%
Ryanair Holdings PLC	-1.2%
Nokian Renkaat Oyj	-1.1%
Intelsat SA	-1.0%
SINA Corporation	-1.0%
Metro Bank PLC	-0.6%

This table lays out the top contributors and detractors. It's not easy to find a theme unifying the winners. They span the developed markets we invest in, as you'd hope they would (this is now starting to include some decent returns from work on companies in Japan and Korea, countries we previously had little experience in). They run from very high growth, loss-making digital assets such as Pinterest Inc to asset plays like thyssenkrupp. It is notable that, German steelmakers aside, a lot of the winners are consumer facing. It's also a matter of internal disappointment that none come from one of the biggest commercial trends of the last few years, enterprise software. We think we should have profited more from that. We are a lot more comfortable with the fact that none have obviously been hanging on the coat tails of currently popular investment themes like ESG either. Overall, we don't see the mix of past successes as much of a guide to where our long returns will come from over the next few years. We remain generalists who try to focus our attention and your capital wherever we think we can find an edge.

We have also been pretty successful at avoiding large negatives in the long book. Among the losers, several were travel related companies which we sold off early in the pandemic, when the risk profile became too hard for us to sit comfortably still owning them. We are okay with that. Some were special situations, notably the C-band satellite spectrum play in the US and Bayer AG. We will set the bar a little higher for those in future. But, of course, we will continue to make new mistakes. We have to be honest with ourselves too and recognise that bullish equity markets in recent years have allowed us to get away with some (and we doubt we are alone in that). That probably flatters the overall long book return.

Perhaps the most useful conclusion we can draw is a reminder not to get in the way of a good idea. A large chunk of the fund's long returns are derived from just a handful of names. We successfully held onto these through substantial share price rises. Even so, some of our biggest mistakes were selling several of them much too early in 2020. The overall return from our long book, and the concentration of it, could (perhaps should) have been higher still. We think we have learnt the right lesson from this experience.

We are where we are

We sometimes hear from investors that we are long the value factor. It's certainly true that we have a contrarian bias. Our first instinct is more likely to be searching among 52-week lows than stocks making new highs (although we do screen for those with the highest long term total shareholder returns too). But the list of top contributors belies that perception. Most would not be classed as typical value stocks, either now or when we owned them.

We look at our portfolio risk by investment type internally too. We don't necessarily agree on the categorisation of every position, and some clearly fit in more than one bucket, but there's not a strong value bias that we can see. We estimate that about 30% of our long exposure fits that bill. Most of the rest is growth stocks of one speed or another, with special situations making up a balance of about 10%.

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To make this point more clearly, we considered presenting you with a summary of the weighted aggregate financial statements for our long book, based on reported numbers and forward consensus. That is, a high-level, independent look through to exactly what you own with your investment in the fund. Nice as this would be, reality is never so clean cut. Absent a portfolio of very similar assets, which the fund's long book deliberately is not, you either get numbers that are grossly distorted by a few unusual investments (yes, that German steelmaker again) or an exercise in discretionary adjustments. Neither is particularly useful.

The same exercise for a subset of the fund can be revealing though and helps to show why we are so positive about the long book today. Taking only long positions with a reasonable weighting in the fund (above 1.5%) and filtering for those that underperformed the relevant local index in Q1, we are left with fifteen investments accounting for just over half the long book (two of the smaller positions we then excluded from this exercise because one has no sell-side estimates at all and the other only one). These positions have on average seen share price declines over the last six months while major developed world indices went up around 18 to 20% (the Russell 2000 small cap index in the US is up just the 48%). However relatively weak stock prices have generally not been down to disappointing operational performance. These are mostly recurring revenue or habit-driven businesses, with little exposure to cyclical trends and solid to very good growth prospects. We are not disappointed to have well over half of the book in these names today.

Turning to the promised numbers: on a weighted average basis, this half of the long book grew revenue per share by over 9% annualised between 2017 and 2019 and consensus forecasts annualised growth of around 9% for the 2019-22 period too (all but three are expected to grow revenue per share by 5% or more). The median pre-tax return on net operating assets in 2019 was 30%; weighted average free cashflow yield, based on 2022 consensus estimates, is over 6%. All except three of these companies are valued below twenty times that 2022 free cashflow (exceptions are Admiral Group PLC, at a touch over twenty times, and Just Eat Takeaway.com NV and Amazon.com Inc, which are growing much faster and operating at margins below what we would expect at maturity). In aggregate we would categorise this as growth at a reasonable price.

Having made almost no contribution to the fund over the last six months we are (almost) excited about the prospects for these positions over the next year or two (and the rest of the book might not do too badly either). To put more flesh on the bone we've included brief write ups on a handful of them in this letter. Looking further out we don't see anything that has changed the opportunity for the fund's long book to generate good returns, like it has so far for, many years to come.

Swedish Match AB

Swedish Match is a tobacco company with a difference (and not just the fact that it was originally formed by legendary fraudster Ivar Kreuger). It was ahead of its time moving on from cigarettes, selling that part of the business almost a generation ago, helped by Sweden's long tradition of using snus (a pouch or pinch of loose tobacco placed under the lip). Today smokeless products account for almost two thirds of revenue, most of the rest is cigars.

Selling nicotine has some textbook attractions as a business: the product is addictive, making demand cyclically resilient and price inelastic (just look at the cost of a pack of cigarettes today). Consumers tend to be hugely brand (or, more accurately, SKU) loyal. Distribution is mostly physical, largely through a dense network of small convenience retailers, which results in scale economies that help to defend incumbents. High excise taxes don't deter consumption much but do mask price differences, limiting the effectiveness of price competition – the end result being very high margins, particularly for premium brands.

Snus has been consumed widely in Sweden for hundreds of years. It declined in popularity as cigarettes came in but that trend has long since reversed. Snus use has been growing for several decades as consumers turn to safer, smokeless sources of nicotine. The United States also has a long tradition with smokeless tobacco, thanks partly to over a million Swedish immigrants in the late 1800s and early 1900s. Swedish Match has been building up its business there over 20 years and today the US is its largest market accounting for over 60% of group revenue. Scandinavia is most of the rest. The two geographic segments have quite different growth profiles, though.

The Scandi business is all smokeless but the market is relatively mature, growing mid-single digits, and Swedish Match is steadily losing share from a very dominant position (it was once a monopoly, thanks partly to Kreuger). Market share loss is mainly down to a shift in mix as a new category of snus called nicotine pouches (which contain no tobacco) is now driving growth. Swedish Match lacks many of its incumbent advantages and has a much smaller share in this category, so overall its Scandinavian business is only growing low single digits with flat margins.

Swedish Match is in the opposite position across the Atlantic, where it is a small challenger in a smokeless market dominated by Altria. It spent years seeding the snus market in the US and finally hit gold in 2016 with its nicotine pouch, branded Zyn. Ironically, Zyn helps Swedish Match to escape some of the disadvantages it otherwise faces in the US - lower brand recognition and less heft in distribution and marketing – because it created a new category where it is the clear leader. Zyn has really taken off. Volume more than doubled in 2020 and the product is now about a third of Swedish Match's US sales. Overall, its US business has grown 24% compound since 2018, but the remaining opportunity for Zyn is still huge: nicotine pouches today are only about 15% of the US oral tobacco market, or just over 1% of overall tobacco consumption, and Zyn retains over 70% share of its niche. Growth will slow, but Zyn volume could easily triple over the next 4 or 5 years. That alone would increase group profits by about a half. We are not just guessing blindly on this. Zyn has been rolled out in stages in different regions of the US and the national market is following a similar profile to the early launches. Longer term there may be a lot of blue sky too, if nicotine pouch adoption becomes more mainstream or if they take off in other large markets.

Swedish Match trades at 18-19 times expected 2021 earnings. If we extrapolate recent trends in Scandinavia and make fairly conservative assumptions for nicotine pouch category expansion in the US, the company should grow operating profit at around 10% a year. Relentless share repurchases (which averaged 3.5% annually over the last 20 years, reducing the share count by almost 60%) will boost this further for equity holders. This valuation is a large discount to much slower growing consumer staples businesses. We see two main reasons for this. First, it's tobacco. Investor sentiment towards it is unlikely to change, but it's worth noting how much better relevant health outcomes are for snus users compared to smokers (expert opinion seems fairly settled that cigarettes are something like an order of magnitude riskier). Our investment case assumes further derating over the next few years. Second, the competitive threat in the high growth nicotine pouch category in both Scandinavia and the US. We look at this three ways: Scandinavian profits have continued to go up despite rapid growth in the nicotine pouch category where Swedish Match is weaker; the evidence so far in the US is encouraging where Zyn has held its market position in the face of aggressive price discounting in recent quarters; and, most importantly, the two risks somewhat offset each other - despite its incumbency in Sweden, and a great deal of effort, Swedish Match has been unable to increase its share of the nicotine pouch category above 20%, which suggests its position with Zyn in the US could also be much more defensible than the market is expecting.

Swedish Match is a very high quality business that is growing well and available to buy at a reasonable valuation. It benefits from a huge structural trend towards healthier nicotine consumption that could even see it grow way, way beyond its current size.

Schibsted ASA

We discussed Schibsted in our Q4 2017 letter. Schibsted shares have returned about 22-25% annualised since then (depending on share class), but we still think they are significantly undervalued. This time we'll be brief, but a quick review is worthwhile as a lot has changed since. As a reminder, the company has two key pillars - online classifieds or marketplaces and news media. There are smaller, earlier stage fintech operations and venture capital investments too, but we'll ignore them here.

The key change from within was the spin-off of the ex-Nordic marketplaces as Adevinta ASA in 2019. Schibsted retained 59% ownership but this will drop to 33% once Adevinta's merger with eBay Inc's classifieds business completes in a few months. The market value of this stake accounts for 66% of Schibsted's market cap today, leaving an implied enterprise value of EUR 3.2bn for the Nordic businesses. This is roughly 16 times our estimate of 2022 operating profit from just Schibsted's classified / marketplace businesses (for comparison, pure play listed peers trade at multiples between 21 and 24 times). These are still growing nicely - management is targeting 8-12% top annual revenue growth – and are totally dominant in Schibsted's core markets. To give you a sense of just how well entrenched they are, classified site Finn is the fifth most visited website in Norway (behind only Google, Youtube, Facebook and a news site that's also owned by Schibsted). The Finn brand is so strong that it has almost zero traffic acquisition costs. And yet usage is still increasing, up over 10% in 2020. We think there's a lot of latent pricing power too because management has historically been much more cautious than similarly dominant peers in other countries.

What about that news media business? A few years ago we described it as "largely irrelevant". We are not going to be quite so flippant now. After all it brought in over EUR 700m of sales in 2020, almost 60% of the group total. More important it grew in the second half of 2020 for the first time since 2011. Revenues were up 2% in Q3 and 5% in Q4, passing the inflection point between growing digital and declining print audience. Margins were also up sharply. It is not so easy to know how

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to value it now. Writing it off as terminally declining is probably a mistake as, well, it isn't declining! The only real listed peer is The New York Times Company trading on 4.4 times 2020 revenue. That seems a bit rich for Schibsted's news assets – there are, for example, obvious differences in potential reach – but the fact remains that a large revenue pool that we once blithely ignored looks today like it could become a steadily rising profit stream again. A valuation of one and a half times revenue would account for almost half of the Schibsted stub's implied market cap today.

Overall, we think the Schibsted stub is worth perhaps three times the current equity value implied by its share price. As noted above, though, as a Schibsted shareholder, 66% of the equity value today sits in its Adevinta stake. Post the eBay transaction the largest assets in that entity will be in France, Germany and Canada, with smaller businesses in Brazil and Spain (and a long tail that management has been steadily cleaning up). We like these assets too; the French business Leboncoin is one of the few classifieds businesses worldwide with a market position approaching that of Finn. The weighted growth rate is a little faster than the Nordic businesses but this is reflected in a substantially higher valuation: Adevinta trades at about 30 times our estimate of 2022 operating profit, even after targeted cost savings from the eBay deal are taken into account. We hedge out most of the Adevinta stake that comes with our Schibsted position, leaving us 2.3% net long the Schibsted stub (with a small 1.0% look-through position in Adevinta). Just to confuse things a little more, we hold almost half of our Schibsted position in B shares that trade at a 15% discount to the A shares. With a EUR 5bn equity stake in Adevinta up for disposal in the longer term, the original logic of creating a second share class (offering a currency for acquisitions without diluting the Blommenholm foundation's voting control) no longer applies so this structure may well be reversed, collapsing the share class discount.

Schibsted faces various constraints on selling its Adevinta shares over the next three years. Looking out beyond that, as we do, we expect to see it in the process of divesting its stake, leaving two main business units both growing solidly, a much more consolidated Nordic classifieds market and some value being realised from the longer tail of the fintech and venture capital portfolio. It is hard to believe that Schibsted will then trade at anything like the valuation it does today.

Metro AG

Metro has been selling and spinning off problem children for years. Its fashion retail presence went in 2008, department stores in 2015 and electronics retailing a year later. Last year it off-loaded grocery retailing. From a broad retail conglomerate, a focussed grocery wholesaler has emerged. We think it's very misunderstood by the market, or perhaps just unloved. A reliable grown up with solid prospects living within its means in a stock market dominated by prodigies riding cash incinerating unicorns to the moon (or is it the sun?)

Metro wholesales about EUR 25bn of groceries across much of Europe and Asia. It serves three types of customer: the catering trade, convenience stores and small businesses. The mix varies alot a by country but overall restaurants and hotels accounted for about half its pre-COVID sales, generally higher in western Europe and declining as you travel east. This is the best part of market because it is growing and requires higher service levels. A lot of these sales are delivered so local scale provides a strong competitive advantage, because the economics of last mile delivery vary hugely depending on drop density. The independent convenience store channel has less attractive prospects (and has largely disappeared in some developed markets), but in many countries Metro supplies not only the product but also the franchise fascia. This adds value for its customers and ties them in more. Overall, though, the grocery wholesale sector has struggled to grow in recent years as demand from smaller businesses (think, for example, of the office kitchen) has waned. Customers that don't need fresh produce or big bulk have less and less need for the wholesale channel given the delivery options now available from retailers. This will continue to drag on Metro's top line for some time. Once the recovery from COVID-related restrictions is out of the way the business as a whole will not grow like-for-like sales faster than low single digits for the foreseeable future. But that's okay, at the current valuation it doesn't need to.

The pandemic impacted a large part of Metro's customer base significantly, although not always negatively, and overall trading has been a lot more resilient than we expected. Whatever, we don't think the underlying demand for its products will be materially different once economies fully reopen (which, incidentally, may not prove to be the case for some of the most popular reopening story stocks like cinemas). Metro's continuing businesses reported revenue of EUR 27bn and an operating profit of around EUR 550m in the year ended September 2019. There's been a big change to the accounting since, which we'll come to, but the underlying cash flow hasn't changed. The one thing that really has is Metro's capital structure. At the end of September 2019 net financial debt (including pension liabilities) was EUR 2.5bn. Today it's only EUR 1bn thanks to proceeds from the sale of the Real supermarket business in Germany and the Chinese wholesale operation (and the property it sits in in particular). With a market cap of EUR 3.3bn we estimate Metro's enterprise value is about eight times operating profit, with a free cashflow yield of something like 10% (the dividend yield alone is 7.5%). This one probably is fairly described as a value investment. What's less clear, perhaps, is the quality of the business.

When people talk about quality businesses what they are really saying is they have some monopoly power which allows them to return more than they would in a perfectly competitive market. The most objective measure we have of this is return on capital. That is, how much each dollar invested pays back annually. We prefer to look at this in relation to just the operating assets, keeping an eye on how it can be distorted by accounting. On the face of it the returns we expect for Metro – about 10% a year – are not stellar. But what qualifies as good depends a lot on how secure those future returns are, which is reflected in turn in how much it costs the company to raise capital. Owned real estate gives a good demonstration of this. Today 4% is an attractive yield for property in developed markets because mortgage debt can be raised against it for less than 1% looking a decade out. Metro still has a lot of freehold property on its balance sheet and we need to take this into account. If we hypothetically adjust the financials to reflect a Metro where all that real estate has been sold and leased back then the return on assets looks more like a solid 15%. We think that about reflects the quality of the business: good rather than great.

Earlier we mentioned an accounting change and said we would come back to it. Sale and leaseback frees up a lot of cash. You swap sunk capital for a future promise to pay: and there's the rub. Returns go up but so does the risk. In the past this liability was recorded off balance sheet, in a footnote. International Financial Reporting Standard 16, which came into effect on the 1st January 2019, changed that. Leased property is now held as an asset, for the period a company is contractually guaranteed use of it. The balancing item is a financial liability of the total future rent it is committed to pay.

As always with accounting, the new standard isn't the truth any more than the old one was. We would always look at rent liabilities as part of our assessment of a company's financial position (and in fact our analysis of the whole value chain for an industry), so the new standard doesn't give us much new information. The question remains how close that liability might get to becoming debt-like and we think the answer depends a lot on how desirable the underlying asset is. An unwanted property can usually be sub-let, making the net liability quite small, provided it is not over-supplied. For that reason it matters what the real estate is, or can be, used for. High street and mall retail today, for example, is much more risky than the commercial sites Metro often operates from. The value of these is clearly demonstrated by the profits it continues to generate from selling property for development, with management guiding for EUR 100m a year from this for the foreseeable future. To be conservative we haven't included this in our own estimates.

Metro equity is obviously cheap if pre-COVID operating profits are sustainable. There's a lot of downside protection from owned real estate too (less than when we bought in originally, though, after the Chinese disposal). It doesn't need to grow much for our thesis to play out but we still need to be confident that like-for-like sales will be positive in future. For wholesale this was true for each of the five years before 2020. Management is in fact guiding for growth to accelerate, partly because the Russian unit is no longer a drag. We are more cautious but there are obvious tailwinds from its exposure to delivery, catering and faster growing markets in eastern Europe and Asia, which make today's share price today look like very good value to us.

Vivendi SE

We set out the investment case for Vivendi in our June 2019 letter. Briefly, almost all of the value was down to its record label Universal Music Group ("UMG"), which we estimated was worth EUR 30-35bn at the time. We thought it likely that would be realised within a year or two either through a sale or spin-off. In fact the parent company has done a bit of both, selling 20% of UMG to Tencent Holdings Limited at a EUR 30bn valuation and announcing it will spin off three quarters of the rest to shareholders before the end of 2021. Vivendi shares spiked on this news but then fell most of the way back to our original purchase price, so we added a little more to our position in the first quarter.

Current revenue and profit numbers for UMG are very similar to what we modelled a couple of years ago. The sales mix is a little different as revenue linked to live shows fell last year, but overall, it is still growing operating profit close to 20% a year. We expect another couple of similar years before that trend slows, as streaming penetration levels off. This may be too conservative. Pricing for music streaming hasn't gone up in over a decade and the labels are starting to apply some pressure on services like Spotify to change this. The risk of them disintermediating labels seemed unlikely to us a couple of years ago. It seems even less so today with Spotify Technology SA's market share continuing to fall.

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Vivendi's current market cap is EUR 32.5bn with net debt of about EUR 2bn being rolled into UMG. That implies almost no value for pay TV firm Canal+ (worth roughly EUR 5bn on a 10 times operating profit multiple) and various other smaller businesses and equity holdings that comfortably add up to EUR 7.5bn in aggregate. All in there should be about 30% upside once the spin off goes through later this year and the conglomerate discount on the main asset is removed.

Essity AB

Essity was spun off from SCA in 2017, separating a consumer products company from forestry and pulp assets (bringing us neatly back to Kreuger, who founded the company in 1929). SCA was a commodity pulp, paper and packaging business until the 1970s when it acquired Swedish personal care company Mölnlycke, a manufacturer of tissues, diapers and feminine hygiene and incontinence products. This is the core of Essity's business today.

The path towards the Essity we own today began with the appointment of Magnus Groth as CEO in March 2015. Within six months, he announced the separation which formally came into effect two years later. The group also launched a process of improving capital and operating discipline, focused particularly on raising the bar for acceptable performance - business units unable to meet the threshold after a turnaround attempt are disposed of. This led to operating margins doubling since 2015 in the emerging markets divisions that had been underperforming, and more recently to a raised long-term return on capital target. Groth's other major move was the acquisition of BSN medical GmbH which added a medical products leg to the group's portfolio. Revenue and profit grew at a compound 8% and 9% respectively between 2016 and 2019, with Essity improving its market position substantially during that time. Under Essity's analysis, over 90% of its branded sales are derived from geographies where its brands have number 1 or 2 positions and in 2020 it gained or maintained market in most of these. Brand investment stepped up in 2020 and we expect further share gain in the coming years.

A consumer staples business like Essity is not the most obvious candidate to be hurt by COVID and it is true that it got some benefit from loo rolls briefly becoming something of an asset class. But one of the largest units is Tork, which serves the professional hygiene market – supplying tissue and paper towels for commercial customers like offices, airports, hotels and restaurants. This is capital light and high margin, effectively operating as a duopoly with Kimberly-Clark Corporation's professional division in many countries. Tork's revenue was down 27% in the last three quarters of 2020 with an even bigger profit hit (we estimate incremental margin is c.30%). That weakness will obviously have continued into this year, but we expect a solid recovery as economies reopen and potentially a bigger market than was available to them going into the pandemic as concerns over airborne infections are likely to damp demand for air-dryers for some time to come. The professional business also highlights the continuing margin opportunity within Essity. Although it is the global market leader, and has more than double the market share of the number two in Europe, Essity's professional division has operated with a much lower operating margin than Kimberly-Clark's comparable business (in 2019, for example, reported margins were 14.5% and 20% respectively).

Having raised its long-term return on capital target, and with underlying demand growth in the low to mid-single digits and opportunities to lift operating margins, we think a 2022 free cashflow yield of about 6.5% for a solid, decent quality and well-managed business like this is too cheap.

Tying up loose ends

As you can tell from these comments, a disparate band of businesses fell under the umbrella of recent underperformers. But step back a little and four of the five do have something important in common too (we'd be stretching it a little too far to include Swedish Match as well).

It's often said that spin offs, where a company splits up the businesses it runs but keeps the same owners, provide better than average returns for investors. The story to explain this is sometimes that even in an amicable separation, owners are not all going to have equal preference for the constituent parts. The less favoured children will be sold down, depressing their price and providing an entry point for the fabled better returns. To the extent that this is true, it should logically apply more to relatively smaller spins (because they are statistically more likely to differ more from the original whole).

We are not so sure. We'd suggest there is a more general truth driving most of the excess returns from spin offs. You won't be surprised to hear that we don't think markets are perfectly efficient. In the very long run they have to be (the second law of thermodynamics being what it is), but while we are all very much alive the evidence that they aren't can be breath taking. It's easiest to see this by anecdote. Why, for example, did shares in Clubhouse Media Group Inc jump by nearly a half on

1st February, giving it a market value of well over a billion dollars? Apparently it was because Tesla Inc CEO Elon Musk tweeted that he would appear on the Clubhouse audio app the day before. The problem? The app has nothing to do with the listed company.

Extrapolating from individual cases can be hugely misleading, of course, but we could go on and on and with enough of them what you have is empirical evidence. There are a lot of examples of the market massively mispricing change in the short run, so much so that one of the screens we run is designed to highlight stocks that have recently been dramatically volatile in both directions. It doesn't tell us whether a company is over or under priced today, but it's a strong indication that market participants massively disagree on what the right valuation is. Occasionally that provides us with an opportunity to do a better job with our own analysis, to see clear change where the market is finding uncertainty, and to take a position on the back of it.

What's that got to do with spin offs? Well, they can represent big change of the kind we think the market often struggles to price properly. Even though the sum of the parts remains the same, a spin can radically alter how the now separate businesses are run and, perhaps more commonly, how they are perceived by investors (which in turn can, of course, affect how the business is run). All of this may be the flip side of other studies showing that merger and acquisitions activity is, in aggregate, value destructive. That's counter intuitive because economies of scale are often a very significant source of competitive advantage. But the trade off, particularly where the parts that make up the whole are quite disparate, may be an even more expensive loss of management focus and capital discipline (see thyssenkrupp, again). Four of the five stock examples in this letter are businesses that we think have really benefitted from negative M&A. As for Swedish Match, underestimating change is still key to our thesis there too, but in this case it's a sustained but absolutely fundamental shift in how the product is consumed.

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