Ennismore Global Equity Fund

Investor Newsletter for the month of September 2021

Issued on 8 October 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 250m as at 30th September. Total assets under management by Ennismore Fund Management were USD 791m. 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 Adam Sullivan on +44 (0) 20 7368 4224 or email subs@ennismorefunds.com.

Top Five Long Holdings as at 30 September 2021

Company	Country	Sector	% of NAV
Schibsted ASA	Norway	Communication Services	7.4
Royal Mail PLC	United Kingdom	Industrials	6.0
thyssenkrupp AG	Germany	Materials	5.4
METRO AG	Germany	Consumer Staples	5.1
Atos SE	France	Information Technology	4.9
			28.9

Exposures as at 30 September 2021

Longs%	Shorts%	Gross Exposure%	Net Exposure%
87.1(91.2)	49.9(49.5)	136.9(140.7)	37.2(41.7)

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 2021

Country	Gross%	Net%
United States	55.1	-6.9
Germany	18.8	12.0
United Kingdom	16.1	9.3
Norway	12.7	4.4
France	9.5	8.0
Sweden	8.2	8.2
Netherlands	2.9	2.7
Japan	2.0	1.6
Australia	1.5	-1.5
Spain	1.5	0.3
Canada	1.4	0.6
Other	7.3	-1.6

Market Cap	Gross%	Net%
>$10bn	49.2	21.6
$5bn - $10bn	30.2	15.9
$1bn - $5bn	38.8	9.1
<$1bn	18.8	-9.4

Positions	Sep	Aug
Long	46	44
Opened	2	4
Closed	0	0
Short	102	96
Opened	8	9
Closed	2	3

Sector	Gross%	Net%
Communication Services	36.1	20.1
Consumer Discretionary	15.2	0.3
Consumer Staples	16.2	10.8
Energy	0.0	0.0
Financials	7.1	3.2
Health Care	5.7	-5.1
Industrials	18.0	1.7
Information Technology	29.9	4.3
Materials	7.0	3.8
Real Estate	0.3	-0.3
Utilities	1.0	-1.0
Other	0.6	-0.6

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 2021

	Share Class					
	GBP	**GBP A**	**EUR**	**CHF**	**EUR I**	**USD I**
NAV per share[1]	**11.88**	**11.81**	**12.00**	**11.91**	**9.38**	**9.33**
Period	**% Change**					
September 21	**2.0**	**1.9**	**1.7**	**1.7**	**1.7**	**1.9**
August 21	1.2	1.2	0.7	1.3	1.2	1.2
July 21	2.2	2.2	2.9	0.9	2.1	2.1
2021 to date	**10.1**	**10.0**	**14.6**	**14.5**	**9.1**	**9.8**
Annualised return[2]	**3.5**	**3.4**	**3.7**	**3.6**	**-2.0**	**-2.5**
Since launch[2]	**18.8**	**18.1**	**20.0**	**19.1**	**-6.2**	**-6.7**
	Discrete 12 Month Rolling Performance					
To 30 September 21	**7.6**	**7.6**	**13.5**	**14.2**	**6.3**	**7.4**
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**	**-**

[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 21	1.1	0.9	-0.1
	Q2 21	6.3	5.5	4.8
	Q1 21	7.1	11.2	12.9
	Q4 20	16.0	17.1	17.5
Short	Q3 21	5.2	5.2	5.2
	Q2 21	-2.6	-2.6	-2.5
	Q1 21	-4.2	-2.3	-4.4
	Q4 20	-16.9	-17.2	-17.2

Attribution figures exclude cash returns and are prior to expenses

Top 5 Contributors and Detractors for September 2021

Contributors	MTD (bp)
Universal Music Group B.V.	141
Adevinta ASA	65
Atos SE	25
US media company	21
German steel manufacturer	19

Detractors	MTD (bp)
Royal Mail PLC	-105
Schibsted ASA	-59
Vivendi SA	-59
Pinterest Inc	-26
Nordic Entertainment Group AB	-25

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

The fund's NAV per share increased between 3.9% and 5.5% in Q3, depending on the share class. As usual, given the relatively concentrated book, most of the big moves were on the long side. But in a not unwelcome change of pace from recent quarters, shorts delivered most of the net return.

The main development in the long book was the expected spin off of Universal Music Group NV by Vivendi SE. Shares in the former spiked up by about a third from the reference price and we sold our allotment, although we retain some exposure through the remaining position in Vivendi. We added to this on the same day as it traded well below our estimated fair value for the remaining assets. All in, including a few small shorts that hedge out Vivendi's listed investments, the combined position contributed 1.9%.

Other positives on the long side were Nordic Entertainment Group AB, adding 1.0%, and our hedged position in Schibsted ASA (where we are short much of its exposure to Adevinta ASA), contributing a further 0.7%. Our holding in Royal Mail Group PLC cost the fund 1.9%. It remains the largest positive contributor year to date and we added to it recently. In fact, although the fund has owned it since late 2019, in an important sense it's really a new investment. We say that because our original thesis has largely been superseded, and explain why we are excited to own it now later in this letter.

The biggest contributor on the short side was one of the bigger financial news stories of the quarter, China Evergrande Group. We probably said all we needed to on this in our last letter. The position added 0.8% to NAV in Q3 and the stock is now suspended. As a whole the short book added 5.2% to the fund's value in the quarter with a lot of small positive contributions adding up. The next largest was on old favourite from our March 2019 letter, Remark Holdings, Inc., which added 0.5% to NAV. The story changes a bit from year to year but fair value is the same as ever, and the cash balance now very close to gone. We would not be surprised to see it contributing nicely again soon.

The cheque is in the post

In June last year we said that the Royal Mail Group PLC ("RMG") shares looked cheap to us even if most of the UK business ("Royal Mail") was worthless. We thought Royal Mail had a lot more value than that, but we weren't risking any capital on it (or spending much time discussing it in the letter for that matter). It made sense to us that the company spin off the international business, GLS, which was obviously undervalued. That may still be true but is no longer a priority. GLS benefited significantly from increased demand during lockdowns but for Royal Mail it was transformational. To understand why we need to think about organic growth and how it affects different parts of the group. What this reveals is an incredibly valuable asset that seems completely misunderstood by the market.

It remains to be seen in what ways COVID will permanently change how we live, but some things are becoming clearer. Some behaviours that were forced on people by lockdowns appear to be sticky. In general, it seems that where an already well established trend was reinforced the shift has been brought forward by two or three years. For example, penetration

For further information please contact:	Adam Sullivan, Ennismore Fund Management	+44 (0) 20 7368 4224	subs@ennismorefunds.com
For dealing please contact:	Northern Trust International Fund Administration Services (Ireland) Ltd	+353 (0) 1 434 5103	Ennismore_TA_Queries@ntrs.com

of online shopping stepped up and has mostly not reverted even though stores have been fully open for several months in most places. ONS data show online retail penetration in the UK increasing by an average of 130 basis points a year before the crisis, to 19.2% in 2019. Today it is running at 25.5%. Springboard surveys show store footfall is still running about 20% below the level of two years ago.

Home delivery services were, not surprisingly, one of the big beneficiaries of lockdowns. The shift to online shopping is a big part of this, but not the whole story. For Royal Mail specifically, domestic parcel volumes in the UK seem to be stabilising at about 30% above the level they were at two years ago. That is not dissimilar to the growth seen in GLS, which was much more skewed to B2B volumes prior to 2020. We can't disentangle exactly how much of that is down to added capacity in either part of the business but, given how quickly demand stepped up and the level of recent investment, on the face of it most isn't.

Over the last two years both GLS and Royal Mail have seen organic volume grow close to 30%. But not all organic growth is the same. What really matters is how much of it the company gets to keep. Although it appears that GLS didn't add much capacity that is largely because, like most parcel businesses, it outsources the last mile to contractors. If we looked at system level investment it would have grown a lot and that is reflected in higher operating costs for GLS. The net effect shows up as a change in return on capital because ultimately true organic growth – getting more from the same – is the only way to increase it. For the year ended March 2020 GLS reported an operating margin of 6.6%. This year it is guided to be 8%. On a capital base that has not changed materially, the return has gone up by about half. That is impressive growth but puny compared to Royal Mail. Its margin two years ago was 1.5%. This year it may well be over 6%. That's more like four times the return on capital. Some of that difference is down to pricing power not volume - GLS average pricing is a few percent higher over two years, in Royal Mail's domestic business it is up over 10%. We'll come back to that later because it is important, but the reasons for it are largely the same ones that delivered much more operating leverage in the UK business, so we'll go there first.

We try to invest in businesses that can deliver a sustainably high return on capital. To find these we look at the large universe of potential investments around the world through different lenses. Basically this means constructing over-simplified characterisations of business models that explain most of a company's economics, and specifically why high returns are possible and not quickly competed away. We've talked in the past about network effects generally, and marketplace businesses more specifically. We've also discussed lowest unit cost operators, of which scale is the general example (but often not the most interesting one). Here we are focussing on last mile delivery (which, like most successful business models, ends up being a lowest cost story). Generically these are businesses which supply an undifferentiated product direct to the end customer in a defined geographic area. The crucial characteristics are a high fixed cost base – you have to pass every potential customer – and therefore massively differing returns based on customer density. Fixed line telcos are one example, but a slightly unusual one because most of the cost is capital investment. Where these fixed costs are really large what you get tends to be a natural monopoly. And, conveniently enough, one of the longest running is the Royal Mail in the UK (founded back in 1516).

It is fairly obvious that postal services are naturally monopolistic. Two competing players will have a very similar cost base because the marginal expense of delivering to a house is so small - you are passing right in front of them either way. As soon as one player has a larger share of volume, even by only a few percent, it can easily squeeze the other out of the market by setting pricing at its breakeven level. It is also obvious that mail delivery has been in terminal decline since the internet came along. Addressed letter volumes in the UK have been falling at mid-single digit rates every year since (COVID aside). Royal Mail may still have a monopoly there but one that is shrinking on a fixed cost base is difficult to manage. It's not that you can't extract a lot of value from it in theory, but it does require a very specific skill set targeted on consistently flexing pricing power while trimming costs. The Royal Mail has done a very good job offsetting a lot of the volume decline with higher prices, but the cost base is particularly fixed because the labour is highly unionised. The mail business alone would not be worth very much.

We are always reluctant to second guess what other people are thinking but it does seem that the market consensus is that RMG's business mix is getting worse because it is moving from a monopoly in letters to a much more competitive market delivering parcels. If so, the market is both a little bit right and mostly wrong. Parcel delivery is more competitive overall. Royal Mail only takes about half the available market, by volume, not all of it. But that misses the really important point.

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There's a pretty fundamental divide in the parcel market between items that are small enough to go through your letterbox and ones that are heavier and bulkier. It's not about demand. You want the same service either way, you don't really care how it gets to you. But the supply is very different. Small parcels fit naturally into the mail network, delivered by the postman. They are almost as much a part of Royal Mail's monopoly as letters. It's hard to overstate how much this really matters. Royal Mail's marginal cost to deliver small parcels is so much lower than peers that no one else really competes in this space (just try comparing the pricing online for a small packet). It's not hard to see why. Royal Mail posties deliver a small parcel to about one in seven homes every day, on average, as well as a letter to each. No other distributor is even close to that density so no one else can operate a comparable service. Competitors work delivering mostly larger parcels by van. But for Royal Mail it is small ones on foot that make up most of its revenue base. The company doesn't disclose just how much but we can make a decent estimate. Its average revenue for domestic parcels is close to £2.50 once we strip out the Parcelforce business (which mostly delivers larger, express parcels). The list price for a small packet sent first class is £3.70; for medium sized it is £9.02. Even with large discounts for volume customers the mix must be massively skewed to small items. Crucially, with the growth it has seen in the last couple of years, we estimate that Royal Mail's revenue from small parcels is bigger than the revenue it makes from letters. And that means that we think most of its revenue – and more than all of its profit - now comes from a monopoly that is growing again. Add to that the fact that the last mile mail delivery network can increase capacity at little marginal cost or investment (it is mostly a case of adding more trunking vans not more postmen) and even low revenue growth can increase returns significantly.

The market is not wrong that delivering larger parcels is a much tougher business. The basic economics are the same – local scale matters because density spreads your fixed costs. For B2B this often means density in a certain niche because it makes sense to have deliveries from several suppliers consolidated into one drop. But the principle is similar. The margins for Royal Mail's main competitors, while not perfectly comparable, tell the story. DPD is the largest with about GBP 1bn revenue pre-COVID. It had a margin of over 10%. Hermes, roughly three quarters its size was at 5%, and Yodel was loss-making on sales that were under half DPD's. We don't exactly know how big Royal Mail's revenue is in this part of the market, but it definitely lacks scale in B2C and almost certainly loses money on bigger parcels (just try comparing the pricing online for a large parcel). That is partly down to higher labour costs, because the workforce is mostly unionised but also because it has tended to offer this service in order to win overall contracts containing large volumes of smaller parcels, rather than as a standalone profit centre. It has underinvested too. Royal Mail only recently rolled out dedicated van only parcel routes outside of its Parcelforce division. This is never going to be a big part of its profit pool next to its monopoly position in smaller items but there is clearly an opportunity to get much better returns (as in not lose money) and a strong competitive rationale for preventing any of its competitors becoming too dominant.

We are quite comfortable paying a relatively high multiple of current earnings for a growing business when we think it has a defensible competitive position that will give it a high return on capital in future. So we are not sure what to make of RMG, trading on about six times current year earnings. But we have bought a lot of it. With a former state monopoly like this you might expect an underfunded pension or stranded assets. There is none of that. So why is the market so down on the stock? It could be we're wrong and a lot more of the volume growth from the last couple of years reverts as the world gets back to normal. We don't have a crystal ball but time is passing and there's no sign of it yet. It is certainly possible that growth will stagnate for a couple of years, with the dramatic shift seen in 2020 being mostly a pull forward of already established trends (although to the extent that that is true it would also imply letter revenue will be better for a while too). And, as we have outlined already, the last mile delivery model for letters and small parcels is hugely operationally leveraged, so even small revenue declines would have big consequences. Another concern may be that previous periods of good returns have been eroded away by cost inflation or over investment in capacity. The former is certainly on people's minds in the UK today. But is it really relevant to Royal Mail? Firstly, as we explained earlier, the mix has changed now so the context for managing cost inflation is a growing pot. Secondly, we believe Royal Mail has limited competition and significant pricing power in its main product lines. Much of the decline in mail volumes has been offset by pricing over the last decade and we expect that to continue. The same pricing power is also evident in smaller parcels, with the list price increasing at a 3% compound rate over the last 10 years. There is so much headroom between RMG and potential competitors here that we expect it to comfortably pass on cost inflation. If we are right and the top line keeps growing RMG could trade at three times the current share price and still not be overvalued. If not earnings will fall but the valuation should protect us.

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Grow your own

Organic growth is one of the most important and hardest to define financial metrics. The Royal Mail highlights how significant the impact can be when it really is a case of getting more from the same. It is the kind of growth that can transform the economics of a business. But often reported organic growth is not all it's cracked up to be.

We focus a large part of our short book on stocks where we think the business is being materially misrepresented (usually but not always by management). Hard to define metrics like organic growth are often where this shows up. By way of example, the rest of this letter breaks down the gap between what Upland Software, Inc. ("Upland") reports as organic growth and what we think the right number is – and why that really matters for the value of the shares.

Mind the gap

In March 2019 we wrote on Upland, highlighting its December 2018 acquisition of email marketing firm Adestra Limited ("Adestra"). Upland paid over five times the valuation at which Adestra had raised money a year earlier, and planned to transform a $1.6m EBITDA loss on sales of c.$15.5m into an EBITDA profit of $8m on run rate revenue of $18m. We speculated that cost cuts were unlikely to be enough and that Upland's secret sauce might be a tech sector favourite: a large dollop of stock-based compensation. Two years and eight more acquisitions later, we are catching up on this and taking a broader look at the business model.

On the face of it, Upland hasn't fared too badly. Its strategy is to build a portfolio of software products, providing clients across a broad range of sectors with tools to help them market to, survey and communicate with customers, especially via digital channels. Alongside these products comes a steady stream of project and consulting revenue. Revenues are sticky (net revenue retention rates are in the mid-90%s), there are opportunities to cross sell and Upland's corporate backbone can handle central functions more efficiently.

The plan for Adestra at acquisition exemplifies Upland's playbook: acquire growing but minimally profitable businesses with $5-25m in sales, centralise whatever possible, cut costs and run them at much higher margin. Achieving mature margins on subscale software businesses means forgoing some growth though: Upland's reported organic growth figures come to c.4.2% per year over the last five years, compared to market growth in the mid-teens. But include acquisitions and annualised growth since 2016 is 41%. With an (adjusted) EBITDA margin north of 30%, closing in on Upland's 40% target, the strategy is working.

Or is it? Upland's adjusted numbers don't tell the whole tale, so we'll make a few adjustments of our own to answer this question. First, the company enjoyed a non-recurring boost to sales in 2020 from text and email marketing spend around the US election, which is largely reversing this year (guidance indicates Q3 and Q4 will see more of the same). Look instead at the five years to 2019, and organic growth drops to 1.4% per year.

Second, we need to adjust for a quirk of acquisition accounting that's especially relevant to Upland: deferred revenue valuation. Cash sales that have been received in advance of a service being delivered are normally booked to the balance sheet as a liability, deferred revenue. This is released to the income statement as the service is provided. But when the balance is acquired it first gets written down to the estimated cost of delivery. So when Upland book these sales to revenue the reported number is lower than it otherwise would have been (although Upland is still careful to adjust its EBITDA numbers to compensate). But that is only a one time effect. Future sales are accounted for as normal so the following year the reported revenue line will appear to have grown even if the acquired company's sales are unchanged. If we strip this effect out it gives a more accurate view of how the underlying business has performed, and Upland's 2014-19 annual organic growth rate falls from 1.4% to -1.0%.

Third, in recent years Upland has excluded "sunset assets" from its organic growth figures. These are non-strategic website management services it has chosen to wind down. But we suspect that when your business model is to buy small software assets and milk them by aggressively cutting costs – including product development – underperforming assets are part of the deal. We aren't convinced this is one off at all. Including these assets in Upland's organic performance would lower sales growth further, to -2.2%.

Our final adjustment is for stock-based pay. It's a big one: over 2017-20 43% of Upland's $87m increase in annual adjusted EBITDA came from paying compensation in stock and adjusting for this expense (i.e. pretending it did not exist). But stock based comp is a real cost for shareholders. In recent years, Upland's share count has expanded by over 4% per year as

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employee stock awards have vested. That means our estimate of Upland's underlying organic growth in revenue per share is about negative 6% per year.

For what it's worth, a simple sense check of whether our estimate or the company's disclosed organic growth is more realistic is to look at revenues in 2016, add on the disclosed revenue of each company acquired since, and compare with the current revenue run rate. This suggests we're not far off.

Upland finds itself in the company of many roll ups of questionable quality. It can only grow by acquisition and as it grows, the number and/or size of acquisitions has to increase to sustain the growth rate. Pressure to deliver these can stretch management's valuation discipline – but acquisitions only add value at the right price. And Upland's deals have been getting more expensive: the revenue multiple paid has risen from an average of 2.4 times in 2017 to 3.5 times since the start of 2019. At Upland's target margin this is c.10 times operating profit. With prices like these and negative growth Upland may struggle to even earn its cost of debt over ten years, and end up owning subscale software and consulting businesses that have been starved of investment.

Upland does generate cash thanks to that stock-based comp (14% of sales in 2020) but remains loss-making. It has significant, if not yet onerous, debt. But its structural decline is far and away our biggest concern. A shrinking business is a dramatically different prospect to a growing one. And, as we discussed earlier in this letter, that is especially true when there are high levels of fixed costs, where every dollar of sales gained or lost has a big impact on the bottom line.

We certainly don't think this is a business that deserves its current enterprise value of $1.5bn, equivalent to 5 times sales. For a high fixed cost business shrinking 6% a year, even 2 times might be a stretch – and with $373m of net debt that would only leave about $200m for equity, against a current market cap of $1.1bn. It appears management might be aware of the problem too: just as Upland's legacy businesses are really shrinking beneath all that bought in growth, so management's stockholdings – despite the penchant for stock-based pay – remain static amidst dilution. Achieving this has required $22m in sales so far this year.

Over the long term we expect management will find it increasingly difficult to mask the organic decline. Near term risks include the loss of election-related revenue and a disrupted acquisition pipeline in 2020: management is guiding to sales growth of -1.4% and -4.2% for Q3 and Q4 this year, well below its target. We don't think Upland plays a good long game; just now the short game doesn't look too good either. Its acquisition strategy may yet see it grow through this turbulence but if a roll up's deals destroy economic value, especially where there's financial leverage, sooner or later it is only likely to end one way.

PS And Adestra, how is that working out? Well the accounts for 2020 just got filed as we're writing. They disclose revenue of £10.6m ($13.6m) for the year, about 25% lower than the $18m a year run rate Upland talked about in its press release announcing the deal. That's sounds a lot like the definition of negative organic growth to us.

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