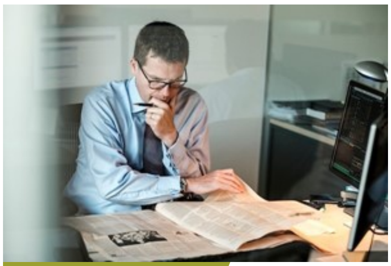

European Capital Partners

Friday Morning Coffee

Nr. 96 — Our portfolio companies will survive Covid–19

As Luxembourg has gone into a complete lock-down and our Prime Minister declared the state of emergency, I wanted first to use the opportunity to wish your families and yourselves courage in this difficult situation. Personally, I take comfort in the fact that our governments have taken such steep measures to slow the outbreak. I also take comfort in the fact that I see in my surroundings a lot of solidarity, respect and sense of duty. I am also grateful for all the dedicate professionals, from the doctors and nurses to the policemen, soldiers and supermarket store workers who take risks day by day in order to fight the disease, keep our societies running and enable us to stay safe in our home offices.

European equity markets have been particularly impacted by the rapid propagation of Corona through Italy and the now complete lock-down of most European countries. There was indiscriminate selling through all industries, countries and market capitalizations. Our value portfolio has not escaped the general market rout. This has been the quickest fall in equities experienced ever. With many forced sellers in the market, bid-ask spreads are excessively wide and volatility is extreme. <u>Fire selling the good businesses we have in the portfolio at the current prices does not make sense to us and has not been done.</u> On the contrary we are using our dry powder to build positions in new names (5 additions since Feb 19). I am convinced the **powerful measures finally taken by governments and central banks, combined with the lock-out measures taking effect and the rate of new infections peaking, will lead to a stabilization in financial markets over the coming weeks and probably to a strong relief stock rally.**

To us, the only relevant question is whether our companies can survive the loss of business activity they are currently experiencing. We do our best to ensure our companies can weather the storm. Our focus on strong balance sheets is now playing off. The companies we own have been through rough times before and we expect them to come out stronger on the other side. Some of our companies will for sure use their strong balance sheets to acquire weaker competitors, new technology etc.

In the simulation below, we tried to estimate the economic impact of COVID-19 on our average portfolio company. For the sake of simplicity, we did not consider the 4 financial companies we own in our European portfolio.

European Capital Partners

Friday Morning Coffee

Nr. 96 — Our portfolio companies will survive Covid–19

	Before Corona	After Corona
Sales	100	75
Gross Profit	44.4	33.3
Gross Margin	*44%*	*44%*
Operating expenses	30.8	26.2
Operating profit	13.6	7.1
Operating Profit Margin	*14%*	*9%*
EBITDA	18.3	11.8
EBITDA Margin	*18%*	*16%*
Depreciation & Amortization	4.8	4.8
Net debt / Ebitda	1.46	2.25

Source : Bloomberg, ECP

We assume that the average portfolio company could lose due to coronavirus up to 1 quarter of sales, this means 25% of its forecasted turnover for the year. **The average gross margin of our portfolio company was estimated to be 44% by consensus before the crisis, that number could stay roughly the same as the companies need less raw materials and services for production.** However, they need time to adjust their operating expenses to the fall in demand for their products. These operating expenses include selling, general and administrative costs and R&D expenses: we assume companies will reduce them by 15% at a heavy social cost. Depreciation & amortization could stay constant as the companies depreciate the fixed assets they have on their books over long years.

Under this simplified and arguably simplistic framework, the net debt / EBITDA of our average company will increase from 1.46 to 2.25. So, it will take the average company 2.25 years to reimburse its entire debt instead of 1 ½ years. To us this is acceptable as it compares to the 3 years for the average European company in MSCI Europe already before the crisis. **We are currently running detailed analysis on all the individual companies we own to make sure they are not bumping into covenant or liquidity issues, a lesson we learned in 2008. We conclude that our portfolio companies will survive the current crisis however painful as it is.**

I wish you a nice weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
March 20 th, 2020