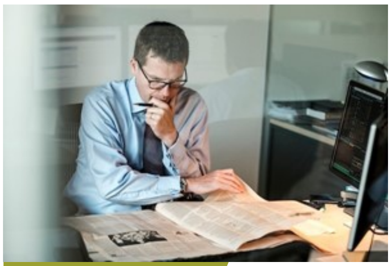


Friday Morning Coffee

European Capital Partners

Nr. 106 — Isaac Newton, social distancing and diapers

When the bubonic plague hit England in 1665 killing 100,000 people, the young Isaac Newton was forced to leave Cambridge and returned to his childhood home on the countryside. In this 17th century version of social distancing, Newton developed an unseen level of creativity and set the foundations for his greatest discoveries. The 2 years between Summer 1665 and Spring 1667 are commonly called the "years of wonder". We are working from home for a little more than 2 months now and start gradually to flock back into the office. In this short period, we were not hit by an apple and discovered the law of gravity so no "months of wonder for ECP". However, and on a much simpler scale, we had the time to work further on our investment process and can report some progress.

As most bottom up investors, we use a screening model that points our attention towards potentially interesting companies that are worth doing further due diligence on. <u>This screening has substantially evolved over time and is now using 2 measures:</u>

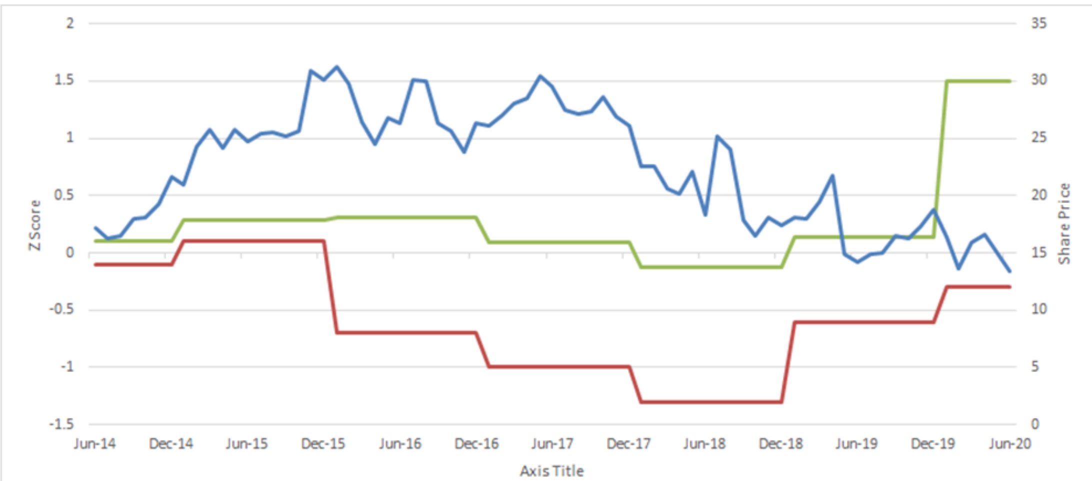
1) **The fundamental quality of the business**. Here we look at profitability measures like return on equity, dividend pay-outs, share-buybacks and leverage ratios. 17 individual factors are being used to compute the overall quality score.

2) **The valuation** where we track not only valuation ratios like price-to-earnings or price-to-cash flow but also earnings estimates revisions and upgrades. Here 13 individual factors are being used.

Our current investment universe in Europe comprises more than 1500 companies. The screening has evolved into a powerful tool to narrow down that universe to the most promising candidates.

During the long hours in our home office in the sanitary crisis, we took our framework one level further. We apply the same quality and value criteria we use in the screening to our holdings in the portfolio and track how they are evolving over time. The result provides us with a reality check on our investment cases as shown in the below graph on the Belgian diaper maker Ontex where the blue line shows the stock price over time.

Ontex in the Quality / Value Framework



Source: ECP

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The red line shows the fundamental quality of Ontex. A quality score of 0 means that the quality of the company, as measured by our factors, is in line with the market. A Z-score of 1 means the company is 1 standard deviation better than the average company. So the higher the better.

The green line shows the value score. A value score of 1.5 means that the company is one and half standard deviations cheaper than the market overall. Again the higher the value score, the cheaper the company.

What matters here is the combination of both factors. A high value score for a company that is ranking consistently low in terms of quality equates to a "value trap". The direction of travel of the quality score is also key. Mr Market will recognize over time the improving quality of the business and put a higher valuation multiple on it.

That is exactly the situation Ontex is currently in. In 2017 and 2018 the company was showing sub-par profitability. Ill-timed and ill-executed acquisitions, high leverage, distractions from a bid on the company and inflation in raw material prices like fluff pulp price explain a rapid deterioration of the quality score to a level more than 1 standard deviation below the market overall. The share price followed suit and underperformed the market by a large extent. From 2019 onwards, however the situation started to improve: the company announced an important cost savings, an investment program and raw material price pressure started easing. Not surprisingly the quality score of the company is improving since. Mr Market has not given any credit to Ontex management for their efforts. The stock price remains subdued while the valuation is becoming cheaper due to the improving earnings. **In our world, Ontex is not a value trap and our investment case is being confirmed for as long as the quality of the business continues to improve. COVID-19 serves to highlight the attractiveness as Ontex is seeing strong volume growth as consumers hoard essential supplies. We have good reasons to stay invested.**

I wish you a nice weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
June 5th, 2020