Strategic Selection Fund – European Value

Quarterly report

June 2020

This document is intended exclusively for professional or institutional clients and counterparties

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Portfolio review

Executive Summary

- **Performance overview**
  - MSCI Europe up 12.6% during Q2 2020
  - Our portfolio performed better than market and the value index, outperformance mainly driven by stock selection

- **Portfolio changes**
  - Move to quality companies has continued during Q2
  - 4 new names joined portfolio, 3 names were sold

- **Market environment & Outlook**
  - Fiscal responses and central banks' actions appear up to the task and will help in after-Corona world
  - Stock markets are all about anticipation and market is positioning itself for an end of the crisis.
  - Our portfolio companies are solid and adapting: they will survive through 2020 crisis
  - European equities are under-owned and cheap relative to the US
  - Median margin of safety of portfolio 41%
  - 10% cash left to seize new investment opportunities

The current mood in the equity markets reminds us sometimes of the song by the Clash: "Should I stay or should I go now? If I go, there will be trouble. And if I stay it will be double. So come on and let me know …" In the first quarter of 2020 we experienced the fastest stock market correction in history. Since than, we are experiencing one of the fastest recoveries in history. The result: while still down 12.8% since the beginning of the year as of June 30th, MSCI Europe TR has rallied an impressive 29.3% since the trough on March 18th. There is a sentiment that the fear of missing out (FOMO) is driving back many (often retail) investors into the equity markets. This is mainly based on hopes for a V-Shaped economic recovery after the end of lock-down. However, while economic sentiment is clearly improving, the battle against the COVID-19 is far from won and the economic damage caused by the pandemic should not be underestimated. This will be evidenced during the Q2 result season that is approaching as we write these lines. The pandemic may also well come back with a vengeance as European countries are coming out of the lockdown and new infections are on the rise as social life starts again. 1500 new infections within days in a pork slaughterhouse in Rheda-Wiedenbrück is an example of how far we are still away from resuming our normal activities and that "smart" regional lockdowns may stay with us for a while.
Massive central bank intervention and government support explain to a large extent the recovery in financial assets. The rally has so far been concentrated on a few "leaders" while many stocks have been left behind. At the end of Q2, 45% of the constituents of the STOXX 600 had their share price down 15% or more, 35% were down 20% or more and still 19% were down more than 30% !

The recent rally had a low participation rate as most institutional investors stayed on the side-lines. Flows into equity Funds are still negative as shown by JPMorgan. We view this as a good sign as the market does not appear overbought.

At ECP, we are long term investors and we are not even trying to time the market. We are not spending much time into guessing the v, V, w or J form of an economic recovery either. Our full focus is on selecting quality companies with solid balance sheets and business franchises that are able to produce solid earning power in normal circumstances. However, when we will get back to normal remains to be seen…

MSCI Europe finished the quarter with up 12.6%. All sectors posted positive returns during Q2 with one notable exception, energy. Apart from technology, the best performing sectors were the cyclical ones with industrials, materials and consumer discretionary heading the pack. The worst performing sector was Energy, losing another 7.1%.

Our strategy strongly outperformed the market and the value index. We are particularly recomforted by the fact that the outperformance was mainly driven by stock selection.

During the quarter we added 4 names to the portfolio and sold three. We entered this turbulent period with some dry powder from positions we had sold or reduced before the panic sat in. We had of course no magic foresight or ability to predict the sharp downward draft in stock prices but raising cash was a natural consequence of our investment discipline where company valuation and fundamentals take centre place. We have re-invested some of that cash in new companies in Q2. Our portfolio is full of companies with strong balance sheets who will not only survive the crisis, but we also expect them to prosper significantly post-crisis.
We make all our investments on a company-by-company basis. We like to spread our investments across +/- 40 companies where a good number of companies provide high and growing cash flows in any economic environment. The other part is more of a cyclical character and we like to buy those companies when they are priced for recession.

The 3 main positive contributors in Q2 2020 were Anima (+125 bps contribution), Fresenius (+113 bps) and Husqvarna (+89 bps).

The only holdings showing a negative contribution during Q2 were Ontex (-46 bps), Rolls-Royce (-34 bps) and Jeronimo Martins (-12 bps).

During the long hours in our home-office confinement, we worked 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. This screening has substantially evolved over time and is now using 2 measures:

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 fundamental valuation ratios like price-to-earnings or price-to-cash flow, but also market sentiment indicators like 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 and is now systematically applied to our investments cases.

Portfolio changes

We continue to follow our investment process as we have done for many years. We do so regardless of the opinion of Mr. Market. Our investment horizon is oriented towards the long-term with an average holding period of 4 to 5 years. This is the time normally needed for the market to recognise the earnings power of an undervalued company and thus for the valuation gap between the stock price and the estimated intrinsic value to close.

At the beginning of the year, the quality score of our portfolio (ex. financials) was a little bit below that of the market. Following our journey towards quality, as of the end of Q2 2020, our portfolio (ex. financials) is now of a better quality score than the market and we continue to look for and hold more quality companies.

The median margin of safety of our portfolio, ie the current discount of the stock prices to our fair value, is 41%.

Earnings for this year should not be confused with the underlying earning power of the businesses we are invested in as they are momentarily depressed due to the impact of the pandemic. Even on 2020 estimates our portfolio looks cheap compared to the market. For example the median current year PER of our portfolio company is 18.8 (vs 21.5 for the market).

At the same time the balance sheets are strong. It takes the median company in our portfolio 1.6 years to reimburse its debt (net debt / ebitda) vs 4.5 years for the market overall.

The investment process aims to identify companies with undervalued earnings power without any geographic, sector or market capitalisation considerations.

After a particularly busy Q1 in terms of portfolio activity with 7 new additions to the portfolio, our portfolio activity levels returned to a more normal level in the second quarter.

⇒ BUY

We have bought ASML, Total, Viscofan and Novartis during the quarter

⇒ SELL

We have sold Tecnicas Reunidas, Standard Life Aberdeen and Krones during the quarter.
During the quarter, we sold our remaining position in the Spanish engineering company Tecnicas Reunidas as we fear CAPEX cuts and freezes from their main customers in the energy markets.
We also closed our successful investment case in Standard Life Aberdeen as we believe the main benefits of the merger and subsequent restructuring of the business are now in the share price and the operating environment has deteriorated.
Finally, we sold our position in Krones as we came to the conclusion that COVID-19 is worsening tough competitive environment for the German seller of bottling machines as increased price pressure exerted by powerful customers, two aggressive peers (KHS and Sidel) and increased Chinese competition are hurting profitability.

Investment cases

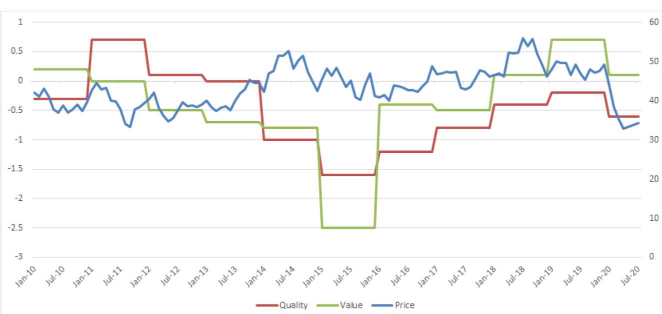
We have been less active in the second quarter in terms of portfolio activity which is normal after a period of market dislocation in Q1 that gave us many new investment opportunities. Our 4 new companies are strikingly different, yet they also share one strikingly similar characteristics, namely their quality and ability to produce strong cash flows.

ASML

Source: ECP

ASML is the main supplier of Lithography equipment, a tool utilised by chip makers to imprint circuitry patterns onto silicon wafers, to semiconductor industry with over 80% market share. Lithography is key to reduce energy, cost and time required for electronic computations by microchips. As of last year, service sales accounted for 25% of group revenue, in coming years we expect the share of recurring revenue, and thus the profitability, to increase as ASML move from contract to volume based pricing for its service agreements on new launches. Optically ASML's trading multiples may seem slightly rich; however same can be said about any business that is under earning its true potential. After spending almost a decade developing a novel technology, ASML is currently in the ramp-up phase of a new product which is yet to reach a critical mass from a manufacturing perspective. In the coming years, as the learning curve of ASML in bringing this product to market declines and as its client's utilization improves, ASML should be able to achieve vastly superior operating margins than its recent results suggests. Although the graph of Moore's law is slowly flattening, it is difficult to imagine the world transitioning to bigger themes of 5G, IoT, Artificial Intelligence and sustainability without ASML.

Total



Source: ECP

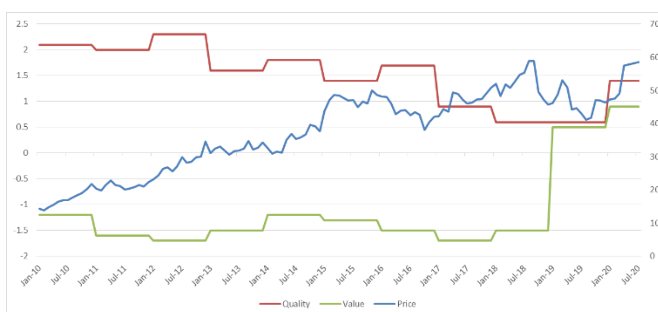
In the, seemingly, amusement park of O&G sector, a task of picking a winner could prove to be daunting given the hundreds of variables involved. But not when we aim to find a shareholder friendly and efficient capital allocator; the current management of Total ticks all the boxes for us. Since taking helm in 2015, management has brought down organic pre-dividend cash breakeven to sub- USD30 a barrel, maintained refining margin per barrel in mid-single digit(compared to Total's own volatile historical track record), maintained very conservative Capex discipline by evaluating projects at USD 50 on an average compared to peers who have invested in projects factoring in more than USD 60 prices, and pre-Covid target of achieving USD 5 Bn in Opex cost savings. In Covid crisis, management have again shown its prudency by cutting down budgeted Capex by 25% and doubling the cost savings plans for the year to USD 1Bn. With Net Debt to Total Capital of 25% (IFRS-16) Total has lowest balance sheet leverage amongst its European peers. While staying discipline on their Capex plans, Management does not let an interesting opportunity pass by, as a result we have an Oil & Major that posted highest production growth amongst comparable peers while setting an enviable bar of c. 28% downstream ROCE and more than 10% ROCE at group level.

Novartis

Source: ECP

We revisited our initial investment case in Novartis and could only come to the conclusion that it remained a core holding for us. Our quality-value framework is clearly showing to what extent the quality of the company has improved since 2017. We like the quality of the pharma portfolio after overcoming the patent cliff, the strength of the generic franchise and the portfolio optimization under the current management with the divesture of Alcon.

Viscofan

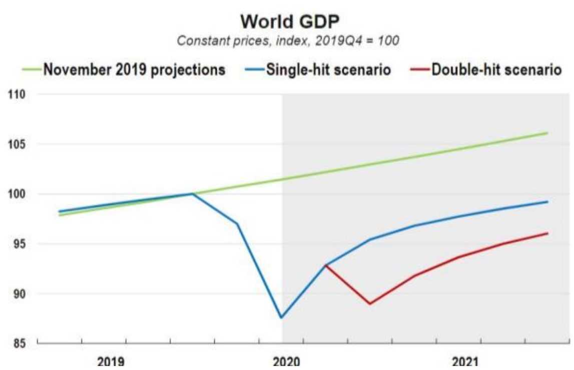


Source: ECP

Viscofan produces artificial casings for meat industry and is global leader with c. 36% market share. The company scores quite attractively on our Quality-Value framework. Strong balance sheet aided by cash flow generating capability of the business presents an optionality, which in itself is an edge in current operating environment. Moreover, we believe Viscofan will indirectly benefit from uncertain economic environment as consumer switch to cheaper sources of protein.

Market environment & outlook

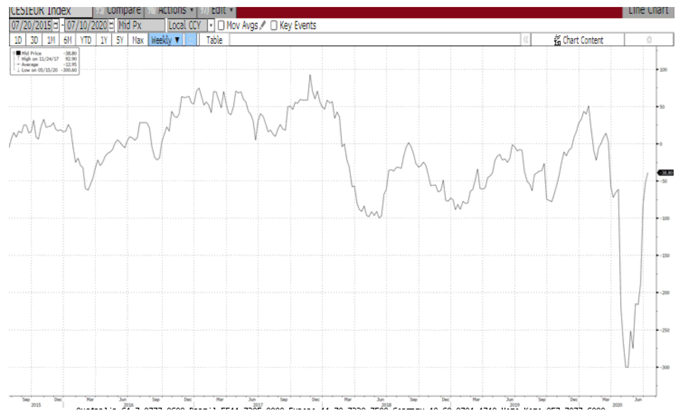
We believe the road towards recovery from the pandemic will be uncertain in terms of direction and time frame. One of the main parameter to watch is the rate of new infections as the risk of a second wave of the epidemic remains tangible.



Source: OECD

The Economist recently run a cover with the title "The 90% economy". It is clear Covid-19 has hit Europe at the core of its economic engine and its social and economic impact should not be under-estimated.

However there are reasons for optimism. **Economic sentiment is bouncing back quickly** and the economies continue to surprise positively as indicated by the Citigroup Eurozone Economic Surprise Index that is almost back to pre-crisis level.



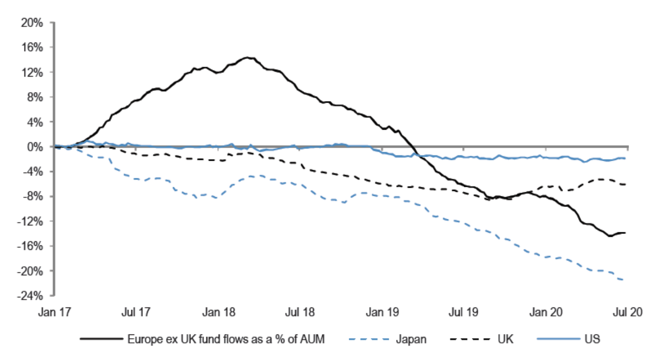
Source: Bloomberg

Explanation for this changing mood is twofold. First, European economies are coming out of the lockdown and economic activity is starting again. Second, we believe there has been decisive management by policy-makers (states, central banks, multilateral organizations) with **enormous amounts of the government and central bank support.**

To date, there have been more than 100 key rate cuts worldwide since the start of the year. The size of the balance sheets of the G10 central banks has exceeded the threshold of 20 trillion dollars, with a response twice as strong as in 2008.

Positionning in European equities remains extremely defensive with a lot of investors still on the sidelines.

Figure 40: Cumulative fund flows into regional funds as a percentage of AUM



Source: JP Morgan

In terms of relative valuation European stocks are now trading near record discount to the US despite the fact of EU coming out of the nadir of the epidemic earlier than the US. On some measures, like Price-to-Book value, European equities currently trade at a 50% discount to the US, the steepest discount since 2006!

Conclusion

We need to remember that Covid-19 is an exogenous shock. It has not been triggered by unsustainable financial excesses and the subsequent tightening of monetary and credit conditions that characterized previous financial crisis. That is important because it implies that our economies (households, governments and corporates) are not in a painful deleveraging mode. The current crisis, however difficult it is, will therefore be relatively limited in time.

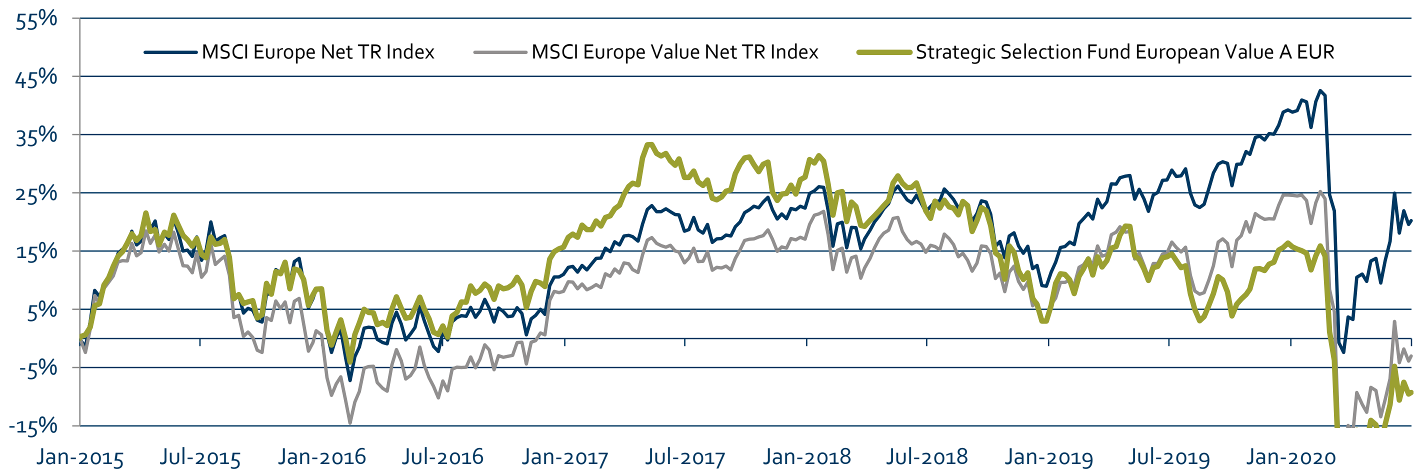
Mr Market is excessively focusing on 2020 earnings and extrapolates the earnings produced this year to perpetuity. While the current crisis is severe and it is difficult to estimate its lengths and therefore its economic impact, we can be certain of one thing: it is an external shock that will last months and not years. For those investors taking a longer-term view on the earning power of the companies they analyze, a sea of opportunities is opening in the current market correction. To date, ECP has not been a forced seller, on the contrary we have new high-quality names while keeping some dry powder in terms of cash.

Market timing does not work for us and we have again seen investors selling ownerships in great businesses (called stocks) at the nadir of the crisis missing the rebound. Staying invested in solid undervalued business is key to long term investment success.

Portfolio profile

Performance analysis

Cumulative performance since inception[1]



Performance statistics

	European Value (A EUR share class)	MSCI Europe NR	MSCI Europe Value NR
Since inception	-9.27%	20.25%	-3.01%
3 years	-28.92%	1.54%	-14.15%
1 year	-20.44%	-5.48%	-15.44%
YTD	-21.64%	-12.83%	-21.56%
6 months	-21.64%	-12.83%	-21.56%
3 months	14.51%	12.6%	10.82%
1 month	2.35%	3.07%	4.2%

Risk statistics (3 years rolling- annualised)

	European Value (A EUR share class)	MSCI Europe NR	MSCI Europe Value NR
Standard deviation	21.00%	19.09%	22.15%
Sharpe ratio	-0.68	0.04	-0.22

		MSCI Europe NR	MSCI Europe Value NR
European Value	Tracking error vs. index	6.66%	7.26%
	Active share vs. index	85.8	90.2
	1 yr Beta vs. index	0.895	0.755

[1] The sub-fund Strategic Selection Fund European Value has been managed by the same investment manager, with the same investment strategy and a comparable fee structure since 1 January 2015. The sub-fund has been managed under the legal form of an Alternative Investment Fund according to EU Directive 2011/61/UE until 8 August 2015 when it was converted into its current UCITS status according to EU Directive 2009/65/EC. The historic performance, return and risk data presented herein cover the full period from 1 January 2015 to date.

Fund Key Facts

- **Legal Form**: UCITS Compliant Luxembourg SICAV
- **Investment Manager**: European Capital Partners
- **Management Company**: European Capital Partners
- **Custodian**: Banque de Luxembourg
- **Administrator**: European Fund Administration
- **Auditor**: Deloitte Audit
- **NAV frequency**: Daily

European Value

	A EUR	I EUR	C EUR
ISIN Code	LU1169207518	LU1277321912	LU1768645753
Investor focus	Retail	Institutional	Retail
Inception date	08/08/2015 (*)	28/08/2015	28/02/2018
Max. Mgt fees	1.50%	0.80%	0.90%
Performance fee	-	-	-
Min. subscription	-	EUR 1mn	-
Registered in	LU, DE, CH, SE, FR, NL		LU, DE, NL

Synthetic Risk and Reward Indicator

Lower Risk
Potentially Lower Reward

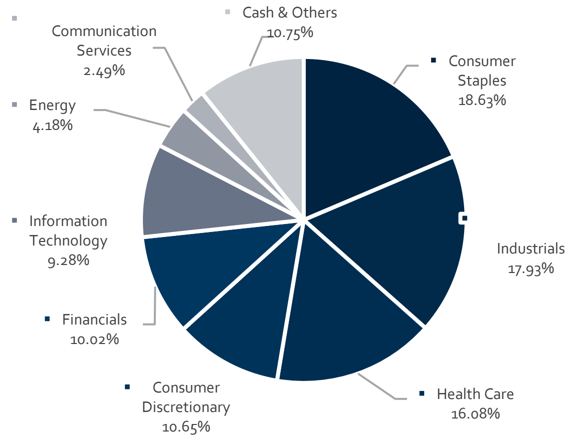
Higher Risk
Potentially Higher Rewards

1	2	3	4	5	6	7

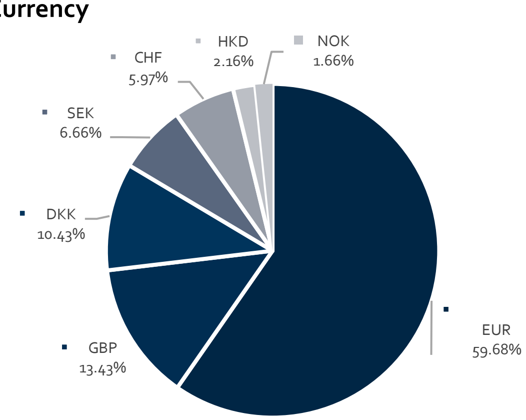
(*) Transformed from an AIF launched on 01/01/2015

Portfolio's breakdown (%)

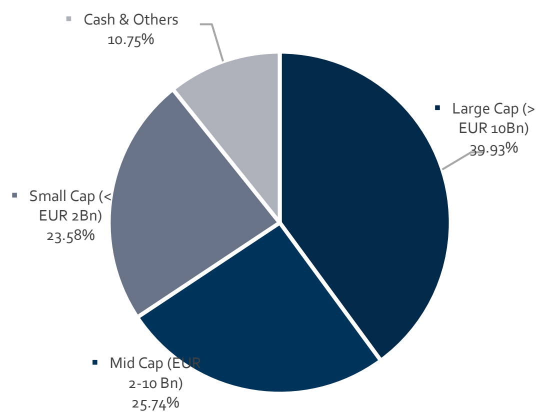
By Sector



By Currency



By Market Cap (*)



Portfolio holdings

Company Name	Sector	Industry Group	Country¹	Market cap
ABB LTD-REG	Industrials	Electrical Equipment	Switzerland	Large Cap
ADIDAS AG	Consumer Discretionary	Textiles, Apparel & Luxury Goods	Germany	Large Cap
ANIMA HOLDING SPA	Financials	Capital Markets	Italy	Small Cap
APPLUS SERVICES SA	Industrials	Professional Services	Spain	Small Cap
ASML HOLDING NV	Information Technology	Semiconductors	Netherlands	Large Cap
ATOS SE	Information Technology	IT Services	France	Large Cap
BAWAG GROUP AG	Financials	Banks	Austria	Mid Cap
CAIXABANK SA	Financials	Banks	Spain	Large Cap
CLOETTA AB-B SHS	Consumer Staples	Food Products	Sweden	Small Cap
DANONE	Consumer Staples	Food Products	France	Large Cap
DUERR AG	Industrials	Machinery	Germany	Small Cap
ELEKTA AB-B SHS	Health Care	Health Care Equipment & Supplies	Sweden	Mid Cap
EXOR NV	Financials	Diversified Financial Services	Netherlands	Large Cap
FLSMIDTH & CO A/S	Industrials	Machinery	Denmark	Small Cap
FRESENIUS SE & CO KGAA	Health Care	Health Care Providers & Services	Germany	Large Cap
G4S PLC	Industrials	Commercial Services & Supplies	United Kingdom	Small Cap
HENKEL AG & CO KGAA	Consumer Staples	Household Products	Germany	Large Cap
HUGO BOSS AG -ORD	Consumer Discretionary	Textiles, Apparel & Luxury Goods	Germany	Small Cap
HUSQVARNA AB-B SHS	Consumer Discretionary	Household Durables	Sweden	Mid Cap
ISS A/S	Industrials	Commercial Services & Supplies	Denmark	Mid Cap
JERONIMO MARTINS	Consumer Staples	Food & Staples Retailing	Portugal	Large Cap
JOHN WOOD GROUP PLC	Energy	Energy Equipment & Services	United Kingdom	Small Cap
JOST WERKE AG	Industrials	Machinery	Germany	Small Cap
KONINKLIJKE PHILIPS NV	Health Care	Health Care Equipment & Supplies	Netherlands	Large Cap
MATAS A/S	Consumer Discretionary	Specialty Retail	Denmark	Small Cap
NORMA GROUP SE	Industrials	Machinery	Germany	Small Cap
NOVARTIS AG-REG	Health Care	Pharmaceuticals	Switzerland	Large Cap
NOVO NORDISK A/S-B	Health Care	Pharmaceuticals	Denmark	Large Cap
ONTEX GROUP NV	Consumer Staples	Personal Products	Belgium	Small Cap
ORIGIN ENTERPRISES PLC	Consumer Staples	Food Products	Ireland	Small Cap
PRADA S.P.A.	Consumer Discretionary	Textiles, Apparel & Luxury Goods	Italy	Large Cap
PUBLICIS GROUPE	Communication Services	Media	France	Large Cap
RECKITT BENCKISER GROUP PLC	Consumer Staples	Household Products	United Kingdom	Large Cap
ROLLS-ROYCE HOLDINGS PLC	Industrials	Aerospace & Defense	United Kingdom	Large Cap
SAGE GROUP PLC/THE	Information Technology	Software	United Kingdom	Large Cap
SANDVIK AB	Industrials	Machinery	Sweden	Large Cap
SANOFI	Health Care	Pharmaceuticals	France	Large Cap

Company Name	Sector	Industry Group	Country[1]	Market cap
SAP SE	Information Technology	Software	Germany	Large Cap
STABILUS SA	Industrials	Machinery	Germany	Large Cap
SUBSEA 7 SA	Energy	Energy Equipment & Services	United Kingdom	Small Cap
SUPERDRY PLC	Consumer Discretionary	Specialty Retail	United Kingdom	Small Cap
SWATCH GROUP AG/THE-BR	Consumer Discretionary	Textiles, Apparel & Luxury Goods	Switzerland	Large Cap
TOTAL SA	Energy	Oil & Gas	France	Large Cap
UNILEVER NV	Consumer Staples	Personal Products	United Kingdom	Large Cap
VISCOFAN SA	Consumer Staples	Food Products	Spain	Mid Cap

[1] Country of Risk as defined by Bloomberg

Key risk factors

- **Equity**: The Fund may be affected by stock price variations, the scale of which is dependent on external factors, stock trading volumes or market capitalization.
- **Currency**: Currency risk is linked to exposure to a currency other than the Fund's valuation currency, through direct investments.
- **Liquidity Risk:** A decreased or insufficient liquidity in the markets could negatively impact the prices at which positions are bought or sold by the sub-fund.

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In **Germany**, the paying agent is Marcard, Stein & Co, Ballindamm 36, D-20095 Hamburg.