

Ennismore Global Equity Fund

Investor Newsletter for the month of June 2023

Issued on 7 July 2023

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 GBP 122m as at 30th June. Total assets under management by Ennismore Fund Management were GBP 467m. 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 Global Equity Fund. If you would like more information or to invest please contact Adam Sullivan on +44 (0) 20 7368 4224 or email subs@ennismorefunds.com.

Performance as at 30 June 2023

	Share Class ¹					
	GBP	GBP A	EUR	CHF	EUR I	USD I
NAV per Share ²	12.80	12.73	12.95	11.61	9.77	10.08
	% Change					
June 23	-0.9	-0.9	-0.7	-0.4	-1.0	-0.8
2023 to date	2.5	2.4	5.9	4.8	1.6	2.6
Annualised return ³	3.7	3.6	3.9	2.2	-0.5	0.2
Since launch ³	28.0	27.3	29.5	16.1	-2.3	0.8

Note: All performance figures net of fees. **Past performance is not a guide to future returns.**

Comments below on performance refer to GBP A NAV per share unless otherwise stated, exclude fx and interest contributions to cash and are prior to expenses.

The Fund's NAV decreased by 0.9% in June. Our long book contributed 1.6% while our short exposure cost 2.3% of NAV.

The fund was up 0.8% in the second quarter. The first half of the quarter was a strong period of performance and the second half more challenging. The MSCI World Index in GBP terms was up 3.2%. Long attribution was +2.1% on average exposure of 80% for an implied return of +2.7%, whilst short attribution was -0.4% on average exposure of 36% for an implied return of -1.2%. Overall, fund performance was mildly disappointing, with long-short spread of 1.5% for the quarter below our longer-term aspirations and well below our recent performance.

One obvious theme in Q2 was continued narrow breadth, with extreme divergence between performance of the very largest companies and the rest of the market. We estimate the MSCI World Index in GBP terms declined about half a per cent or so excluding the largest ten companies, whilst the weighted average performance of those biggest ten was almost 20%. In that context, the fund's performance feels a little more satisfactory – such extreme divergence is very likely to reverse before too long. The other clear theme du jour is generative artificial intelligence ("AI"). Our exposure to the more obvious beneficiaries (and victims) of generative AI has been insignificant. Semiconductors and data centre technology is not (currently) our wheelhouse. And whilst it is wonderful to position for a big theme before the market catches on to it, that period has passed in relation to generative AI. That is not to say of course that the implications of AI are now fully discounted into stock prices – far from it! But probably nothing occupies more of the investment community's brain space at the moment. To illustrate, after four mentions of "generative AI" in company conference calls before October 2022 (according to Sentieo), there were 11 in Q4 2022, 220 in Q1 2023, and 739 in Q2 2023. For context, there were 1,262 mentions of "recession" in company conference calls in Q2 2023. At this point many expected AI beneficiaries have repriced by 100-200% or more. We will of course think carefully about the first and second order implications of AI for companies we study and seek investment opportunities that are mispriced relative to those implications, as we do with other trends. We will, however, resist the temptation to "reach" to participate in the trend for fear of missing out. We will stick to our process that has served Ennismore well for 25 years.

¹Source: Administrator, Net Asset Value, net income reinvested.

²Source: Administrator, Net Asset Value.

³Since 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

There was not a lot in the way of outstanding share price movements amongst our portfolio in the second quarter, either positive or negative. The only significant contributor in the long book was Deliveroo plc, which contributed 0.7%, moving largely in line with other food delivery stocks, led by Ocado Group plc after rumours of a takeover bid from Amazon. We suffered the newsletter curse with D'leteren Group SA (featured in the [March 2023 letter](#)) being the largest detractor in the long book, costing the fund 0.5% in the period despite a pretty decent albeit fairly thin Q1 trading update.

In the short book, we enjoyed a notable gain from Samhällsbyggnadsbolaget i Norden AB (“SBB”), the Swedish residential and municipal landlord. The company blew up in May after a series of own goals brought forward a pretty inevitable denouement given the extreme leverage of the company and declining property valuations in Sweden in particular. SBB announced and then abandoned a non-underwritten equity raise, the company’s credit rating was downgraded to junk, the CEO was forced out, and some lenders are arguing covenants may have been breached. The odds are pretty high that the equity is worthless. SBB contributed 0.4% in the quarter, and 1.2% since initiation of the position in January 2022.

In another case of the newsletter curse, Atlanticus Holdings Inc (“Atlanticus”), the US subprime lender which we wrote up in the Dec 2022 letter, was the largest detractor in the short book, costing the fund 0.7% in the quarter. It is now a neutral contributor since initiation. In the wake of the US regional banking crisis not metastasising (at least so far) into a major financial event, US financials have performed strongly in recent weeks. And seemingly, the more speculative the better. For instance, Upstart Holdings Inc stock tripled in two months. Atlanticus was also a beneficiary of this wave of enthusiasm. It remains a high conviction short for us.

You will have received our [25th anniversary letter](#) in June regarding our intention to raise some money into the Global Fund over the next few months. We are pleased to note that the fund has grown a little recently, ending the quarter with GBP 122m in AUM. If you would like a copy of our updated presentation, or to add to your investment in the fund, please get in touch with clients@ennismorefunds.com. We are grateful for your support.

We have made relatively modest changes to fund positioning since the end of the last quarter. In the long book we have trimmed longstanding positions in Buzzi SpA (“Buzzi”) and thyssenkrupp AG (“Thyssen”). Buzzi remains very cheap from our perspective, but after very strong performance over the last twelve months the risk-reward profile is not quite as appealing as it was. We reduced our Thyssen position after a period of strong performance driven by the anticipation, and subsequent announcement, of the IPO of the company’s hydrogen business, thyssenkrupp nucera AG & Co. KGaA. For the first time, we have established a material exposure to Japan: 5.5% of the fund is invested in seven Japanese companies at the end of Q2, up from 3% in Q1. These investments range from the well known but under-monetised such as Nintendo Co. Ltd, to the unknown but ludicrously cheap, for instance Okamoto Industries Inc – Japan’s largest condom manufacturer – on c. 20% FCF yield to EV on our numbers.

The short opportunity set at the more speculative end of the market is the most attractive it has been since last summer. We have added some new names of that profile towards the end of Q2 and are actively scouring that universe for additional opportunities.

To limit the damage in case our recent outbreak of the newsletter curse continues, we have picked a smaller name to write on in this letter. We discuss Melrose Industries plc (“Melrose”), a new position we established during the quarter.

Top Five Contributors and Detractors for June 2023

Contributors	MTD (bp)
International Distributions Services Plc	35
thyssenkrupp AG	32
Buzzi Unicem SpA	31
Moneysupermarket.com Group Plc	30
US healthcare company	26

Detractors	MTD (bp)
Admiral Group Plc	-52
Schibsted ASA	-49
US automotive manufacturer	-41
US listed Chinese aerospace company	-41
US subprime lender	-32

Top Five Long Holdings as at 30 June 2023

Company	Country	Sector	% of NAV
Admiral Group	United Kingdom	Financials	4.6
Schibsted ASA	Norway	Communication Services	4.4
Buzzi Unicem SpA	Italy	Materials	4.0
D'leteren Group	Belgium	Consumer Discretionary	3.9
Moneysupermarket.com Group Plc	United Kingdom	Information Technology	3.6
			20.6

Exposures as at 30 June 2023

Longs%	Shorts%	Gross Exposure%	Net Exposure%
78.9 (81.2)	36.6 (35.1)	115.5 (116.3)	42.3 (46.1)

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 at 30 June 2023

Country	Gross%	Net%	Market Cap	Gross%	Net%	Sector	Gross%	Net%
United States	37.2	-12.7	>\$10bn	21.6	-3.2	Communication Services	17.3	13.6
United Kingdom	27.6	27.6	\$5bn - \$10bn	25.2	18.7	Consumer Discretionary	19.3	6.8
Germany	7.7	6.9	\$1bn - \$5bn	47.1	25.5	Consumer Staples	5.0	2.2
Norway	6.1	3.5	<\$1bn	21.6	1.4	Energy	0.0	0.0
Japan	5.5	5.5				Financials	15.2	11.5
Italy	4.4	3.6				Health Care	3.6	-3.4
Sweden	4.4	1.7				Industrials	17.2	-1.2
Belgium	4.0	4.0				Information Technology	21.3	4.9
Switzerland	1.9	0.2				Materials	12.7	8.4
Mexico	1.9	1.9				Real Estate	2.0	1.3
Hong Kong	1.8	-1.2				Utilities	0.0	0.0
Israel	1.6	-0.3				Other	1.9	-1.9
Brazil	1.6	1.6						
Austria	1.6	0.0						
Spain	1.2	0.8						
South Korea	1.1	1.1						
British Virgin Islands	1.1	-1.1						
Ireland	1.0	1.0						
Other	4.0	-1.8						

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

Melrose Industries Plc – UK aerospace and defence manufacturer (1.8% of NAV)

Melrose has historically operated as a listed private equity business – specialising in acquiring, improving, and divesting manufacturing businesses. The track record is impressive: Melrose has delivered an average return on equity of 2.5x on its four exited acquisitions since listing in 2003, and investors at IPO have enjoyed a total return of 18.5% annualised. The most recent acquisition was GKN plc (“GKN”) in 2018, which Melrose acquired for GBP 8.3bn. After selling other investments and spinning off the non-aerospace parts of GKN in April, management has announced that Melrose is changing – it will no longer pursue acquisitions and will remain a pureplay aerospace operation.

We discussed spin-offs in our [March 2021 letter](#), noting that “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”. We started our position in Melrose shortly after the non-aerospace assets were spun off partly because we believed in this case the spin-off was likely to be a perception-altering drug of this kind.

GKN aerospace has two key segments: engines and aircraft structures. We have long been fans of aircraft engine businesses – we discussed the business model in our write-up of MTU Aero Engines AG (“MTU”) in [December 2016](#). Before the spin-off, GKN Aerospace had been reported by Melrose as a single segment. This was obviously going to change once the spin-off had happened, and we suspected that the market under-estimated the profitability of the engines segment. Assuming we were right, once the disclosure was provided, the shares would trade up, as engine profits are more valuable than structures profits.

Our suspicion turned out to be right. Melrose clarified segmental profitability at a capital markets day in May: while the engines business will account for c. 40% of 2023 group revenues, it will generate c. 85% of the operating profit. However, we believe the stock remains attractive, and with a similar profile to our MTU investment from several years ago: a high quality engines-focused asset going through a sharp profit inflection where medium-term profits are undervalued.

Aerospace engines are unusual business projects: they are very highly regulated given the severe implications of failure, technologically sophisticated and complex (engines may have tens of thousands of individual parts), high value and relatively low volume (there are less than 30,000 civil aircraft in service, and almost all active aircraft have just two engines). Perhaps most distinctive though is the product cycles, which extend over decades. Development takes several years before testing begins, certification is likely to require at least two years of testing, and the first commercial sale may come through some years after that – roughly a 10-15 year process altogether. Even then, engines are typically sold at a loss, or in the best case at a very low margin. And then engines are robustly made – they typically don’t see their first major service (known in the industry as a “shop visit”) for 5-10 years. The service revenues, to a captive customer base, at high margins, are what makes the business model sing – but companies have to wait 20 years or more from initial development investments to see those begin. However, service revenues are then likely to flow for almost 40 years, as engines may be produced for 15-20 years and have a roughly 25 year useful life. We like to think of ourselves as long-term investors, but all things are relative; in Ennismore’s 25 year history we have made just one investment of a comparable horizon.

In addition, engine development costs are enormous. Precise figures are not available, but we believe the cost of a new engine programme development today would be well over USD 2bn. The engine original equipment manufacturers (OEMs) use revenue and risk sharing partnerships (“RRSPs”) to distribute the R&D costs and leverage niche expertise of other companies. In a typical RRSP, partners agree to supply specific components throughout the engine programme, gaining a percentage of total programme returns from both original equipment and aftermarket sales. These agreements are negotiated based on a “should cost” basis, where the RRSP submits estimated component costs, which are then verified by programme partners. This estimate determines the percentage of the engine programme allocated to the RRSP, offering the potential for superior returns if actual costs are lower than modelled.

GKN is among six non-OEM companies to be part of RRSPs on civil aircraft. It provides complex engine components such as fan blades, cases, and various engine mounts under 19 different RRSPs for various narrowbody (single aisle) and widebody (double aisle) aircraft. Its portfolio is heavily skewed to components which typically last the engine’s lifespan, meaning there is little cost per shop visit for GKN. GKN is the only company to have RRSPs on both legacy narrowbody engines (CFM56 and V2500), which currently account for half of narrowbody flight hours. Of current engines, GKN has a 4-7% share on Pratt & Whitney Company, Inc’s geared turbofan (GTF) programme that powers c. 40% of the A320 narrowbody fleet, and 2-5% of both General Electric’s GEnx and Rolls Royce’s Trent XWB programmes that power the Boeing 787 and Airbus A350 widebodies respectively.

Engines typically undergo three or more major shop visits during their lives, the first coming within 5-10 years and continuing at broadly regular intervals afterward. Lifetime spend on servicing is more than five times the initial cost of the engine. During

a typical shop visit, costs are divided into three main components: 60% for parts, 20% for repairs, and 20% for labour. Considering that approximately 80% of the parts used in a typical shop visit are new, and we estimate these parts yield operating margins between 40-50%, operating profits from materials alone can be as much as 1-1.2x the initial sale price of the engine. Currently, half of CFM56 engines and over 90% of GTF engines are awaiting their first shop visit. GKN is therefore entering the harvesting phase of its RRSP portfolio, with revenues and particularly cash flows inflecting sharply. The impact of this on the financials is exaggerated by the depressing effect of the pandemic on the business over the last three financial years.

Although GKN gets a share of the economics from the aftermarket, this exposes it to the risk of higher-than-expected repair costs in the event of reliability issues. This can have a material impact on profitability: Rolls-Royce Holdings plc will suffer a c. GBP 2-3bn hit due to issues with its Trent-1000 programme. The GTF, one of GKN's key engine RRSP programmes, has suffered reliability issues with its combustor – 13% of the fleet was grounded in May 2023. However, 60% of the fleet has now been upgraded to block D combustors that fix the issue and the fix rate will surpass 90% within the next two years. Importantly, there are no safety issues with the engine. We do not believe this will be a major financial burden for GKN.

Looking to the future, GKN is actively engaging in demonstrator programmes on both CFM International SA's next generation RISE programme and Pratt & Whitney's GTF Gen 2. It expects to invest GBP 550mn on these programmes. If it can maintain a similar share of the GTF and re-establish a RRSP on the CFMI engine, there is significant upside optionality longer term as CFMI is the largest engine OEM in the narrow body market, with a total share of c. 75%. However, these programmes are not anticipated to enter service until the mid-2030s.

GKN's RRSP portfolio will comprise 55% of the engine division's revenue in 2023, rising over time. Another 25% will come from non-RRSP content on other commercial engine programmes, 10% from aftermarket military partnerships including on the F-35, and 10% from high complexity aftermarket repairs. These are high-quality businesses, and GKN is well positioned. In the original equipment business, GKN will have content on c. 70,000 of the c. 74,000 engines expected to be in service in 2030 and the large majority of the engines revenue is from sole source positions.

The repair business, 75% of which is specialised in fan blades, is a growth opportunity. Fan blades are a complex product that require expertise and scale to effectively repair due to the large machinery required. GKN has a 30% share of the fan blade market in Asia and is expanding its repair portfolio to include blisks this year (bladed disks that help pressurise the air inside the engine).

Across the entire engines division c. 75% of business is protected from inflation, mainly by escalation clauses where prices are adjusted by contractually agreed price indices.

The structures segment will account for c. 60% of revenues but only c. 15% of operating profits in 2023. Around two thirds of this business is civil, and the remainder defence. Structures lacks the captive service revenue stream that makes engines such a compelling business model and has lower technological and investment barriers to entry – it is a substantially less attractive business. However, Melrose has a strong record of improving industrial operations, so we are hopeful on the prospects for margin improvement.

Within structures, GKN has a strong positioning as a super-tier 1 partner in over 50% of sales. This means it can design, validate, and build structures across multiple OEMs. The next 30% of revenues are tier 1, leaving only 20% of revenue in more commoditised positions. 45% of sales are high-quality design and build wing structures. Given the long-term trend of air traffic growth, and the depressed delivery rates during the pandemic, top line growth prospects for structures are decent. Margins have come under pressure in recent years, however, driven by the twin pressures of the pandemic and inflation against poorly structured contracts signed before the Melrose acquisition.

GKN structures is currently eliminating 40% of its manufacturing sites and plans to exit 15% of defence business that it considers non-core and renegotiate other contracts, such that 85% of defence contracts are sustainably priced by 2025. Management is guiding that these strategic measures will improve segment operating margins from 3% to 9% by 2025 compared to a baseline of 7% pre-COVID. Upon a full repricing and repositioning as a design-to-build structure provider, we believe there is a path to double digit operating margins in structures longer term. For reference, Spirit AeroSystems Holdings, Inc, a pureplay structures business with weaker intellectual property and a higher skew to more commoditised revenue streams, was able to achieve 11-13% operating profit margins pre-pandemic. By 2025, we project revenues of GBP 1.8bn in engines and GBP 2.2bn in structures. Segmental operating profits should reach GBP 500mn and GBP 200mn respectively, representing a 6% point margin expansion

in both divisions. At the group level, a GBP 680mn 2025 EBITA is achievable, with the potential for it to reach GBP 900mn by 2027, translating to unlevered free cash generation of c. 15% of 2027 sales, or GBP 700mn.

After the spin-off, Melrose has been left with modest leverage. The business is cash generative and will be increasingly so as profits inflect over the next year or two. With the commitment to eschew major acquisitions in future, cash flows will be largely distributed to shareholders. Management plans to run the balance sheet with leverage of c. 2.5x EBITDA. Combined with the growth in profits, we estimate this means the company could buy back 25% of its shares by the end of 2025.

We note one significant reason for caution: CEO Simon Peckham sold 2mn shares (just under half of his holdings) in mid-June. The management team are still highly incentivised to deliver value for shareholders, however: Melrose senior management has an equity incentive agreement where management takes 7.5% of value generated above a 5% hurdle rate, which could run into some pretty big numbers in our more optimistic scenarios. Aside from the equity incentive agreement, the broader management team still owns almost GBP 50mn of the stock. It's worth noting that Peckham's disposal was at a price c. 10% higher than the price as we publish this letter.

Factoring in the equity incentive agreement and valuing the business at a range of 15-18x EV/NOPAT, we anticipate an IRR of high teens to mid-20s through 2027. Given the quality and relative predictability of the engines business, we see this as highly attractive – particularly so given the relatively low downside risk we see to our profit projections.

Monthly percentage return for the GBP A share class of the Global Equity Fund

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2023	0.7	0.8	0.1	3.4	-1.7	-0.9							2.4
2022	-1.7	-3.2	-3.3	3.4	0.4	-5.2	4.5	0.4	-0.4	0.5	4.1	6.2	5.2
2021	-2.6	1.4	2.7	3.0	0.7	-0.9	2.2	1.2	1.9	-3.9	1.7	2.3	10.0
2020	-4.8	-6.6	-5.4	4.6	-1.0	2.2	-4.5	-10.3	5.3	-0.8	-3.6	2.2	-21.3
2019	2.9	1.0	0.3	1.7	-0.2	0.5	1.0	1.8	1.9	0.0	-4.5	0.8	7.3
2018	-4.4	5.8	-0.9	3.3	2.8	5.9	1.8	4.0	1.0	0.7	0.5	-3.0	18.6
2017	-0.1	-1.4	-1.2	-2.9	1.7	-1.5	1.0	3.2	-2.8	1.3	-1.2	5.5	1.3
2016										1.3	-0.8	5.3	5.8

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We hereby disclose that as at the date of first issue of the report to which this is an Appendix, we held positions in the companies discussed in that report and we are thus subject to conflicts of interest in respect of these companies. The analysis presented on these companies has not been prepared in accordance with legal requirements regarding the independence of investment research and as such is considered non-independent research, as defined by COBS 12.3.2R of the FCA Handbook and as a marketing communication.

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The examples of specific investments included herein are not representative of all of the companies purchased, sold or recommended for the Fund. The Fund’s portfolio contains a much larger number of positions than the examples set forth herein and, accordingly, the examples are not intended to indicate the overall composition of the Fund’s portfolio. It should not be assumed that investments in the companies identified will be profitable, that recommendations made in the future will be profitable or will equal the investment performance of those discussed herein, or are representative of investments that will be made in the future. There is also no guarantee that any of the positions are currently or will remain in the Fund. The information included in this document should not be considered a recommendation to purchase or sell any particular security or other financial instrument. All statements and expressions are the sole opinion of Ennismore and are subject to change without notice.

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