



Belgravia Capital SGIC SA

# Letter to investors

April 2019

This report has been elaborated by:

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Dear investors:

This is the first of a series of letters aimed at explaining our investment philosophy, style and methodology.

Belgravia Capital has a team of fifteen people five of whom work exclusively in European equities management.

Belgravia’s management process is based on the use of fundamental analysis to pick the companies in which we invest. In the second section of this letter, we present the first of a number of articles explaining investment valuation and classification.

Finally, it is worth mentioning that, in addition to the products we already manage, we are in the process of creating a new compartment within the Luxembourg open-ended investment fund Belgravia Lux which, also based on fundamental analysis, will invest in European equities with a net market exposure of over 75% with the aim of outperforming the Stoxx 600 return. Currently, Belgravia has two strategies: Belgravia Delta, market neutral, and Belgravia Epsilon/Lynx, absolute return. This product range will be completed by this fully invested sub fund.

	Belgravia Delta FI	Belgravia Epsilon FI	Q. I. Belgravia Lynx	Belgravia Lux Epsilon
<b>ISIN</b>	ES0114429006	ES0114353032	LU0691314768	LU1808857905
<b>AUM (EUR millions)</b>	26	144	45	9
<b>Legal structure</b>	Investment Fund, UCITS	Investment Fund, UCITS	SICAV, UCITS	SICAV, UCITS
<b>Bloomberg ticker</b>	BELBALF SM Equity	BELEPSI SM Equity	AUBELXA LX Equity	BELLUER LX Equity
<b>Morningstar rating</b>		★★★ Bronze	★★★ Bronze	
<b>Fund category</b>	Market neutral	Absolute return		
<b>Investment policy</b>	The investment objectives are to achieve non guaranteed annual returns between 4% and 6%, with an annualized volatility lower than 8% and a R2 against the Stoxx 600 of less than 0.15.		The investment objectives are to achieve positive returns and a Sharpe ratio higher than the Stoxx 600 with a volatility of returns lower than the Stoxx 600.	



# 1Q 2019: market view and selected stocks

## FIRST QUARTER 2019

In the first quarter of 2019, Belgravia Epsilon depreciated -0.27%, with an average net exposure to equities of 1.84%, against a positive evolution for European markets with the Stoxx 600 appreciating 13.02%. In turn, US equities also performed positively, with the S&P 500 appreciating 13.47%, although the return in euros was 15.81%.

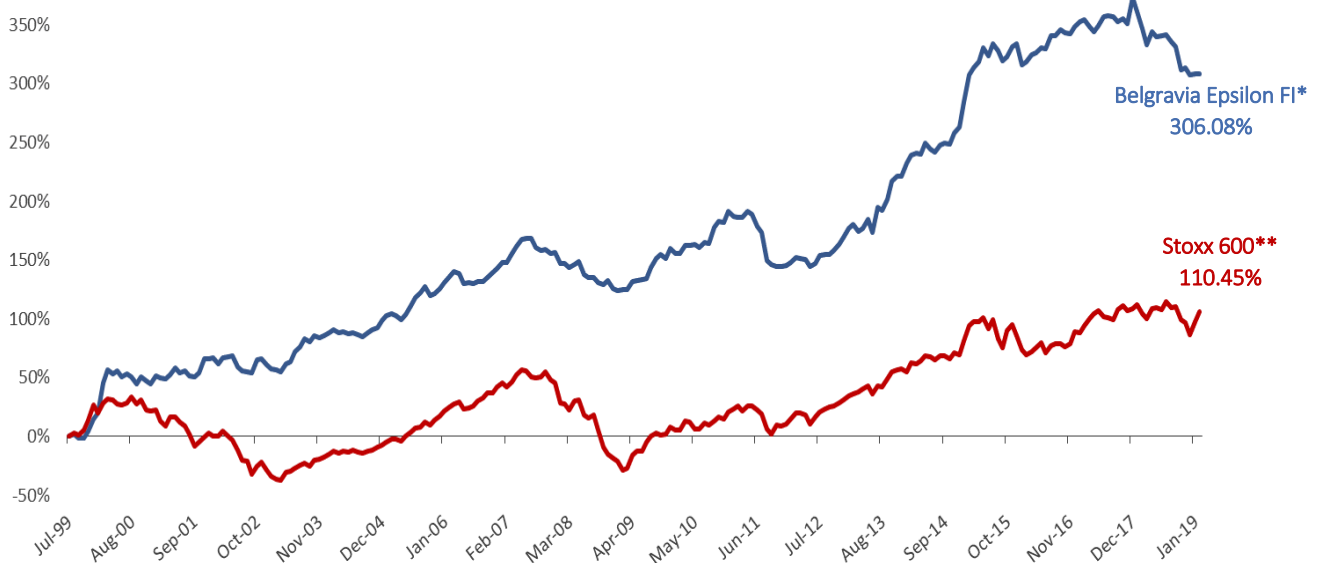
## EXPOSURE OF THE PORTFOLIO TO EQUITIES

At the quarter close, Belgravia Epsilon’s net market exposure was 2%: i) 25% investment in European stocks and ii) 23% in short positions in Eurostoxx 50 futures to hedge market risk. The fund’s liquidity was 75%.

Our low exposure to equity is in response to the change of cycle, both monetary and economic, in which we are convinced we are immersed. In October we accelerated the reduction of market risk, minimising November and December's falls.

In the monetary cycle, surplus liquidity, measured as the difference between growth in the money supply and growth in the nominal GDP, has been negative in the US since the beginning of 2018 and close to zero in Europe since the middle of the same year. While surplus liquidity remains negative or close to zero, the performance of capital assets, as a whole, is likely to be negative.

Cumulative return of Belgravia Epsilon FI at 31 March 2019



\* From July 1999 to August 2004 the historical performance corresponds to Belgravia Beta SICAV, a company with the same investment policy which merged with Belgravia Epsilon FI in April 2017.

\*\* The Stoxx 600 series includes net dividends.

As regards the economic cycle, we are seeing a slowdown, with downgrades to GDP growth estimates and a decline in capital income in favour of labour income.

***Corporate earnings and company guidance, in addition to macroeconomic data, do not reflect an improvement in the economy but quite the opposite***

In our view, the positive performance of equities in the first quarter of 2019 was the result of a rebound, after the large losses of the fourth quarter of 2018, underpinned by the FED's announcement of a laxer monetary policy and the discounting of a positive outcome to the trade dispute between the US and China. However, corporate earnings and company guidance, in addition to macroeconomic data, do not reflect an improvement in the economy but quite the opposite.

***Unemployment levels close to lows restrict central banks' additional capacity to carry out further QE***

The FED's change of direction, announcing that there will be no rate hikes in 2019 and only one in 2020, together with the end of the reduction of the balance sheet in October 2019, makes us wonder whether our view of the change of cycles and our exposure to equities are correct. Our

management team believes that the change towards a less restrictive monetary policy reflects economic deceleration, both in the US and at a global level, with downgrades to growth and inflation expectations for 2019 and 2020, and the negative impact on corporate credit and emerging economies of less generous financing. In turn, levels of unemployment close to lows, both in the US and in northern Europe, restrict central banks' additional capacity to carry out further QE, whose positive impact on equities would be small due to the scarcity of labour supply and the potential impact in the CPI.

***We will wait for an opportunity to buy at more attractive prices***

We think our market risk is appropriate and that our current liquidity position is "profitable" if prices fall. We expect price falls in 2019, with lows below those seen in 2018, which would provide an opportunity to buy quality companies at more attractive prices.

#### THE CONFIGURATION OF THE EQUITIES PORTFOLIO

Currently, the portfolio comprises 39 stocks which together represent a level of investment in shares of 25% of the fund's assets. Some 63% of this investment is large cap stocks, with an average weighting per position of 1% of the NAV, and 37% is in small and mid cap stocks, with an average weighting per position of 0.5% of the NAV.

Among the stocks which have contributed positively to the portfolio in the quarter we would highlight: Assa Abloy, Ingenico, SGL Carbon, Siemens Gamesa and Reply.

### ***The current portfolio is weighted more towards growth and quality companies***

The portfolio is constructed bottom-up, on the individual merits of each company, without excessive bias from a sector viewpoint. At Belgravia we have an eclectic investment style, analysing all kinds of company whether they be growth-income or value-momentum, although the current portfolio is weighted more towards growth and quality companies.

The following stocks have been added to the portfolio in the first quarter of the year: Assa Abloy, Cineworld, Convatec, Holmen, Kion, Reckitt Benckiser, Ryanair, Pirelli and Umicore. Conversely, we have sold all our positions in Centrica, Marie Brizard and Sainsbury.

We detail below some examples of the various companies that comprise the portfolio and that reflect different investment styles:

- Vivendi: growth + high quality => high multiples. High upside.

A French conglomerate headed by the investor Vincent Bolloré whose main assets are Universal Musical Group (UMG), Canal Plus and Havas Media, in addition to minority interests in other businesses.

The investment idea revolves around the hidden value of UMG, one of the main record label companies, which controls musical industry rights, with a market share of over 30%. The music content is of high strategic value, with high entry barriers and growing demand. Streaming services such as Spotify, with annual growth of close to 30%, need to offer UMG's music content for which they pay a right, giving the business visibility and recurrence.

### ***Vivendi's upside could be over 50%***

Vivendi is in the process of selling up to 49% of UMG. At current prices, the market is discounting a valuation of EUR 27bn for UMG, although there are market estimates of close to EUR 40bn. In this case, upside would be over 50%.

- Reckitt Benckiser: growth + low quality? => medium/high multiples. Upside potential.

### ***Reckitt is trading in line with peers despite having better margins and the M&A option***

A UK consumer goods company, it has two divisions: i) Consumer Healthcare, producing mass consumption healthcare products with sales of close to 6%, and ii) HyHo, household cleaning and personal hygiene products, with sales growth of close to 3%.

Reckitt has always been considered one of the best quality companies in the sector due to good management and higher than industry operating margins, justifying higher than peers' trading ratios. In recent years, a number of one-off events (sterilisers in South Korea, a cyber-attack in 3Q17 and technical problems in the baby milk plant in the Netherlands) together with doubts about the sustainability of long-term growth have damaged the perception of Reckitt as a quality company.

At Belgravia we still think Reckitt is a high-quality company although less so than in the past. It trades in line with peers despite having better margins and the M&A option, especially the Consumer Healthcare division, which would give the valuation an additional plus.

- PostNL: income + low quality => low multiples. High upside potential.

### ***PostNL is trading at a discount of close to 40%***

PostNL is the leading company in Benelux both in postal and parcel services. The postal business represents approximately 50% of sales, with volumes falling by 10% a year which the company is unable to offset by price increases. In turn, the regulatory framework for postal operators in the Netherlands is one of the strictest in Europe. The parcel business, which accounts for over 50% of operating profit, continues to grow at double digits although

there are doubts about the business' operating leverage because of pressure on margins in the last two years (difficulties managing high growth with seasonal sales).

Due to the low quality of the postal business, the regulatory backdrop and lower than European peers' operating growth, PostNL trades at a discount of close to 40%. The Belgravia management team considers that at these prices we would be buying: i) the postal business for "free" and ii) a potential operating and competitive improvement in the postal business if the government approves the purchase of Sandd.

## Fundamental analysis, our view

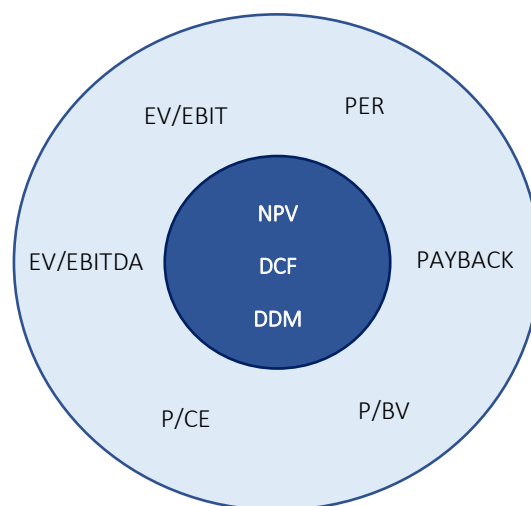
### FUNDAMENTAL ANALYSIS

Fundamental company analysis is based on the principle of Present Value (PV), also known as Discounted Cash Flow (DCF) when applied to assets, or Dividend Discount Model (DDM) when applied to equities. The principle of Present Value in fundamental analysis is also true in all financial theory and consists of converting to a single and absolute measure of prices or currency, the value of an asset taking into account the cost of money (risk-free rate) and future cash flows together with risk or uncertainty and future growth.

*Fundamental company analysis is based on the principle of Present Value, also known as Discounted Cash Flow or Dividend Discount Model*

Other valuation methods such as the Payback, and P/E, EV/EBIT, EV/EBITDA, Price/Book Value, and EV/Capital Employed ratios, etc. are just simplifications inspired by the PV which make its use and interpretation easier. These methods are useful because their calculation, interpretation and comparison is easier and less subjective than is the case for the PV, as this requires making numerous assumptions when preparing the model, while always bearing in mind the limitations implied by simplification.

The Value school of investment probably got its name from a strict adherence to the principle of PV and its use via the fundamental analysis of a company, based on its accounts, sector and geographical area of operations, and its macro and financial environment. Fundamental analysis is essential to modelling discounted cash flows, estimating their uncertainty or specific risk premium in addition to their growth, and requires a multi-disciplinary approach that includes accounting, business theory, microeconomics, macroeconomics, statistics, law, etc.



Source: Belgravia Capital

However, the predominance of the use of multiples as a valuation method, due to their being easy to prepare and compare, has given rise to a questionable interpretation of what represents a value investment, whose only unquestionable principle is the use of the PV via

fundamental analysis. For example, value and growth are often compared when talking about different investment styles, as if growth stocks as an investment were incompatible with the value style or investment because they trade at higher ratios.

***Other valuation methods such as P/E ratios, are just simplifications inspired by the PV***

**INTRINSIC VALUE**

The intrinsic value of an asset is the result of calculating its PV. This is determined by the cash flow to be discounted (operating cash flow, interest or dividend), its growth (g), and the applicable discount rate ( $R_f+p$ ), which in turn comprises the risk-free discount rate ( $R_f$ ) and the risk premium for this cash flow (p). If the intrinsic value is higher than the market price, the investment is attractive because it has a positive Net Present Value (NPV). Conversely, if the intrinsic value is lower than the market price, the investment is not attractive because it has a negative NPV.

Put simply, the intrinsic value or PV of a company's share or variable income is calculated as:

$$PV = D1 / (R_f+p-g)$$

Where PV is the intrinsic value, D1 the estimated dividend for period 1,  $R_f$  the risk-

free rate, p the specific risk premium and g the dividend's long-term growth.

This can also be expressed according to earnings as:

$$PV = (E1 \times (1-RE)) / (R_f+p-g)$$

Where E1 represents the earnings estimated for period 1, and RE the earnings retention rate (what is not paid out as dividends).

Relative to an index, it is not enough to invest with a positive NPV (PV higher than the market price), but rather the aim is to maximise the return on the investment, adjusted for risk, in order to outperform the return on the benchmark index of the investment universe, within the investment policy and the funds available for investment. Accordingly, the quotient between the market price and the intrinsic value is used rather than the spread between the two, giving rise to concepts such as the discount or upside in percentage terms instead of the NPV in absolute terms.

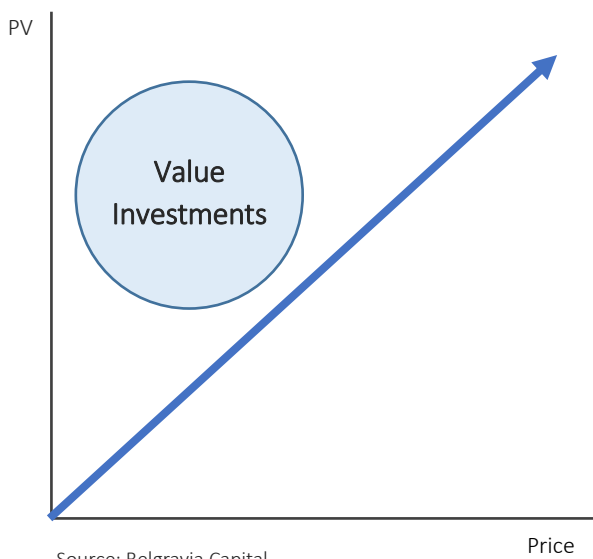
CHART 2.

ASSET	CASH FLOW	GROWTH	RISK-FREE RATE	+	RISK PREMIUM	DISCOUNT RATE
COMPANY	OPERATING CASH FLOW	G <sub>1</sub>	RISK-FREE RATE		RISK PREMIUM 1	DISCOUNT RATE 1
DEBT	INTEREST	G <sub>0</sub>	RISK-FREE RATE		RISK PREMIUM 2	DISCOUNT RATE 2
EQUITY	DIVIDEND	G <sub>2</sub>	RISK-FREE RATE		RISK PREMIUM 3	DISCOUNT RATE 3

Source: Belgravia Capital

A value investment is one whose intrinsic value, calculated by a PV based on fundamental analysis, is higher than the market price, regardless of whether or not it is a growth, high quality or low quality financial asset.

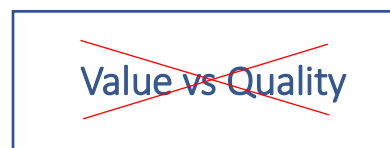
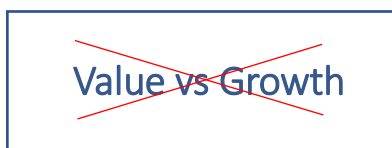
CHART 3.



Source: Belgravia Capital

The widely used classification of investments into Value and Growth is debatable. The reason for this questionable classification lies in the use of valuation methods inspired by the PV, but greatly simplified, forgetting the limitations of interpretation that this simplification implies: typically, valuation methods based on ratios such as the P/E, EV/EBIT, EV/EBITDA, P/Book value and Price/Capital Employed.

*A value investment is one whose intrinsic value, calculated by a PV based on fundamental analysis, is higher than the market price*



The market tends to classify as value investments those which have low valuation ratios based on imperfect cash flow estimates that taken in isolation ignore future growth and differences in companies' specific risk premiums. Consequently, the widespread but doubtful interpretation of the concept of value tends to underestimate higher growth investments and to overestimate investments of lower, zero or negative growth. This leads to the also widespread and questionable classification of value versus growth. At the same time, the comparison of ratios in isolation tends to underestimate investments with deservedly low specific risk premiums and to overestimate those with deservedly high specific risk premiums. This leads to the not so widespread but also questionable classification of value versus quality.

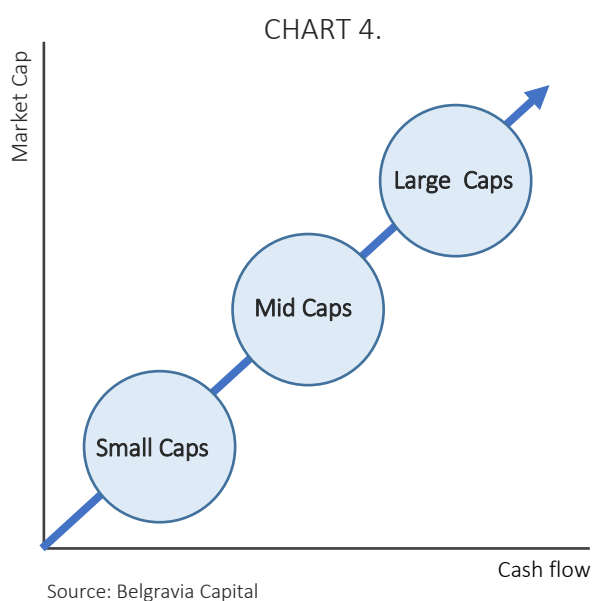
In fact, investment classifications are more consistent and can be better understood if they take into account the specific variables of the asset in the PV model: growth, the risk premium and the company's total cash flow. This leads us to distinguish between high growth (growth) and low growth (income) companies and between low risk premium (quality) and high risk premium (non-quality) assets, and also among small, medium and large companies, depending on the size of the company's cash flow to be discounted.

#### GROWTH VERSUS INCOME

If Growth should not be compared with Value, with what should it be compared? With Income.

*Growth investments are characterised by a low dividend yield, high earnings growth and high ratios*

A growth company is one whose sales growth is higher than that of its comparison universe, either due to geographical (India), sector (technology) or specific (Inditex) factors, and that sustains medium/long-term growth in its earnings or in the flows to be discounted in its intrinsic value that is higher than its area of comparison (GDP of the economy, of the geographical region or global).



Sustained growth in sales requires growth in capital employed or production capacity and, so, a higher level of investment than that of maintenance or depreciation. Given a stable financial structure, this requires a greater retention of earnings to finance the investment necessary to sustain growth than the area of comparison. And so, a lower level of dividend payment in relation to the earnings generated.

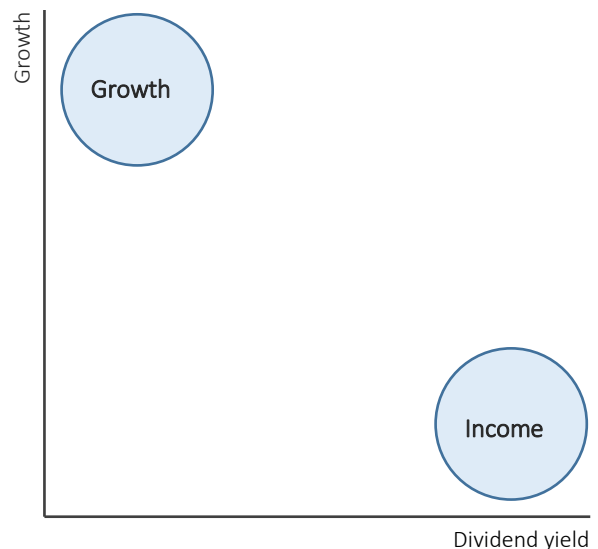
*Income investments are characterised by a high dividend yield, low earnings growth and low ratios*

Conversely, a mature company is one whose sales growth is lower due either to geographical (Japan), sector (European telcos) or specific (Marks & Spencer) factors that restrict medium/long-term growth in its earnings or in the flows to be discounted in its intrinsic value to below that of its area of comparison (GDP of the economy, of the geographical region or global). Low, zero or negative sales growth only requires maintenance of production capacity or depreciation level investment. Given a stable financial structure, earnings retention is barely required to maintain the production capacity necessary for growth, if there is any, below that of the area of comparison. And so, a higher level of dividend payments in relation to the earnings generated.

As was to be expected, growth investments are characterised by a low dividend yield, high earnings growth and high ratios, in

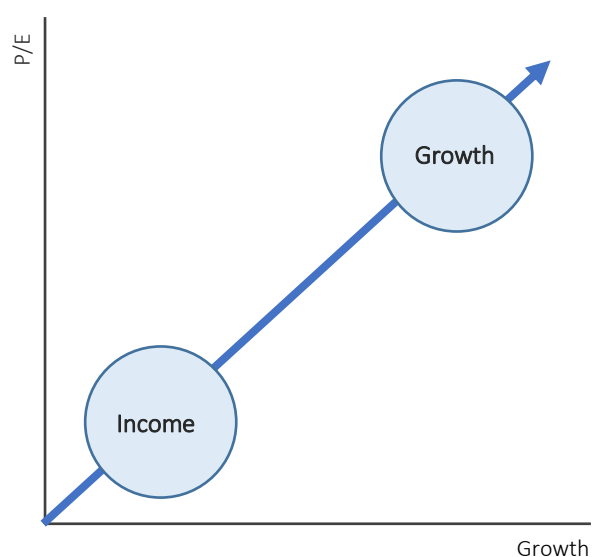
their context. Income investments are characterised by a high dividend yield offset by low or even zero or negative earnings growth, and low ratios, in their context.

CHART 5A.



Source: Belgravia Capital

CHART 5B.



Source: Belgravia Capital

### QUALITY VS NON-QUALITY

In addition, stocks can be classified as quality (high quality) and non-quality (low quality), and this classification is often confused with the questionable one of value versus quality.

### *A quality company will trade at higher ratios than those of a lower quality company*

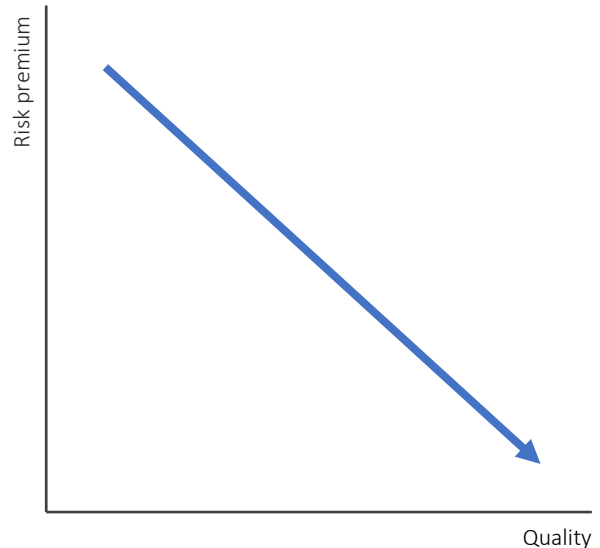
In theoretical terms, the difference in quality between assets is reflected by the difference in risk premiums which, added to a single risk-free rate, gives rise to different discount rates to be applied to the cash flows to be discounted in order to calculate the PV. As was to be expected, the better quality company from a fundamental analysis point of view, either because of its management, financial structure, market structure, or regulatory environment, etc., deserves a smaller specific risk premium than the comparable company of worse quality. This is independent of the growth versus income classification, which does not replace but rather complements the quality one.

### *The difference in quality among assets is reflected by different risk premiums*

*Ceteris paribus*, a quality company will trade at higher ratios than those of a lower quality company, due to its having a smaller risk

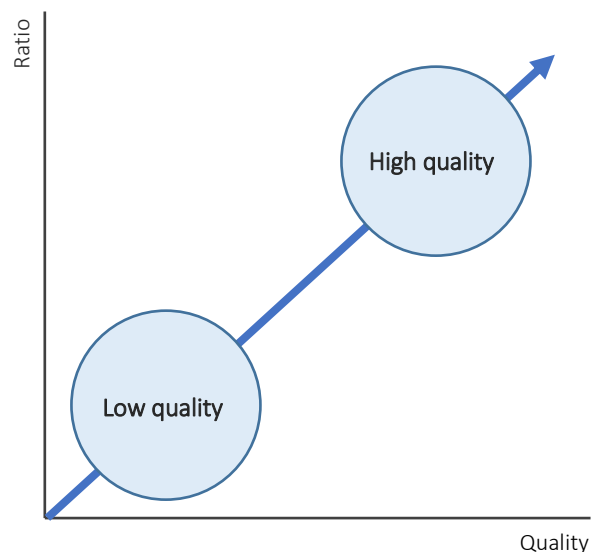
premium. As a result, high quality is often confused with growth and low quality with high dividend yield. The reason being that, *ceteris paribus*, growth companies warrant higher ratios than income companies, given the higher PV associated with higher earnings growth, as do higher quality companies with respect to their lower quality peers, given the higher PV associated with a smaller risk premium.

CHART 6A.



Source: Belgravia Capital

CHART 6B.



Source: Belgravia Capital

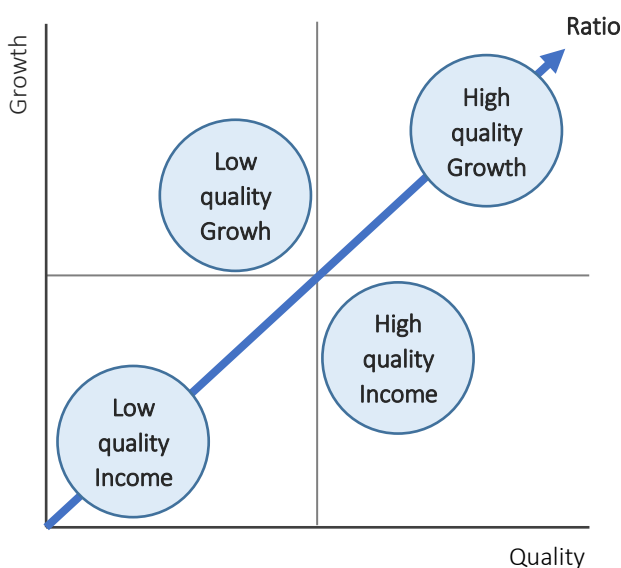
## CONCLUSION

In general, the application of the PV principle, based on fundamental analysis, coincides with the characteristics of the ratios of the four categories resulting from the two complementary, not substitutive or excluding, classifications of growth versus income and high quality versus low quality. In other words, the following decreasing order can be expected in terms of discountable flows ratios (P/E, EV/EBIT, EV/EBITDA, EV/FCF, etc.).

1. Growth with high quality have the highest ratios.
2. Growth with low quality and income with high quality have medium ratios.
3. Income with low quality have low ratios.

All this is aside from the value versus momentum classification that we will talk about in our next quarterly letter in which we put this into context with the classifications mentioned above, although we have already said that value investments are those whose market price is lower than their intrinsic value or PV.

CHART 7.




Source: Belgravia Capital

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