

Setanta European Equity Fund

Q3 2018

Fund Description

The **European Equity Fund** ('the Fund') is managed by Setanta Asset Management Limited ("Setanta") and is a representative account of the European Equity strategy.

The Fund is an actively managed equity portfolio, with a long-term investment horizon. Our aim is to invest in European companies that are trading below their intrinsic value. Our investment process seeks to invest in companies that exhibit a combination of low financial risk, low operational risk and low valuation risk. We believe that if we can invest in companies that possess these characteristics then we can reduce the risk of a permanent loss of capital and enhance our chances of outperforming our benchmark over the long term.

The investment objective of the Fund is to outperform the MSCI Europe index over the long term.

Fund Commentary

The collapse in September of the 178 year old UK package holiday operator Thomas Cook, which counted Mark Twain, Oscar Wilde and Winston Churchill among its customers, has attracted much media coverage. 21,000 people have lost their jobs and 150,000 holidaymakers have had to be brought back from overseas by the Civil Aviation Authority in the UK's biggest peacetime repatriation.

(Fund Commentary continued on Page 3)

Portfolio Managers

Fergal Sarsfield CFA & David Byrne CFA



Our Investment Principles

We do not believe the market is efficient

We aim to make investments at a price below our assessment of intrinsic value

We make an investment in a business rather than trade securities

We believe risk is the possibility of permanent impairment of value

We make investments for the long term

We invest where we see value and are not afraid to be contrarian and swim against the tide

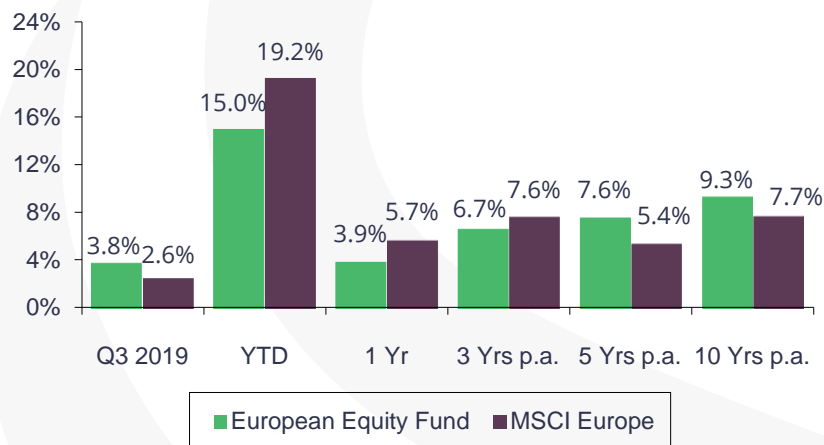
We don't make forecasts, we consider scenarios

We demand financial strength from the companies we invest in

We will act with integrity and communicate with our clients in a manner representative of our investment style

We have the humility to know we make mistakes and embrace the need to continue learning through both experience and study

Fund Performance – 30.09.19



Yearly Performance

Year %	2013	2014	2015	2016	2017	2018
Fund	23.9	6.1	19.8	4.8	8.3	-7.3
Benchmark	19.8	6.8	8.2	2.6	10.2	-10.6

Performance Source: Setanta Asset Management Limited. Benchmark: MSCI Europe. The Fund returns stated are based on the movements in the unit prices of a representative account, based on mid to mid prices, and are gross of management fees. The performance will be reduced by the impact of management fees paid, the amount of which varies. **Holdings Source:** Setanta. Sector allocations based on invested portfolio only (excludes cash). **Fund Statistics Source:** Bloomberg.

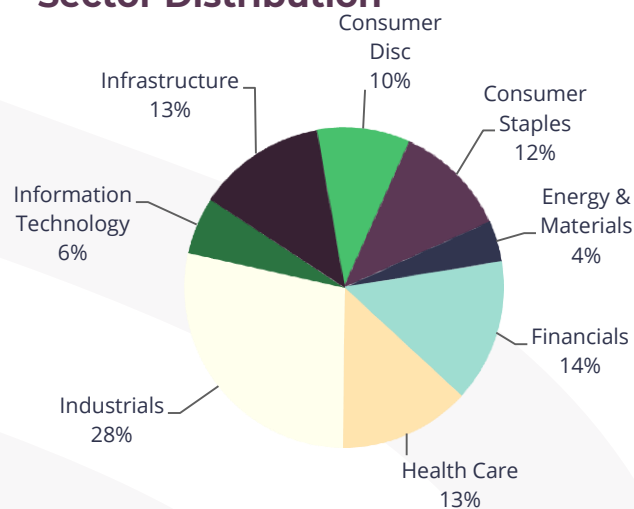
Top 10 Holdings

COMPANY	SECTOR	% OF FUND
MELROSE INDUSTRIES	INDUSTRIALS	6.9%
DCC	INDUSTRIALS	6.6%
GPE BRUXELLES LAMBERT	FINANCIALS	5.2%
GLAXOSMITHKLINE	HEALTH CARE	4.6%
UNILEVER NV	CONSUMER STAPLES	4.6%
CRH	INDUSTRIALS	4.2%
NOVARTIS AG	HEALTH CARE	4.1%
DIAGEO	CONSUMER STAPLES	4.1%
SMITHS GROUP	INDUSTRIALS	3.8%
SANOFI	HEALTH CARE	3.6%

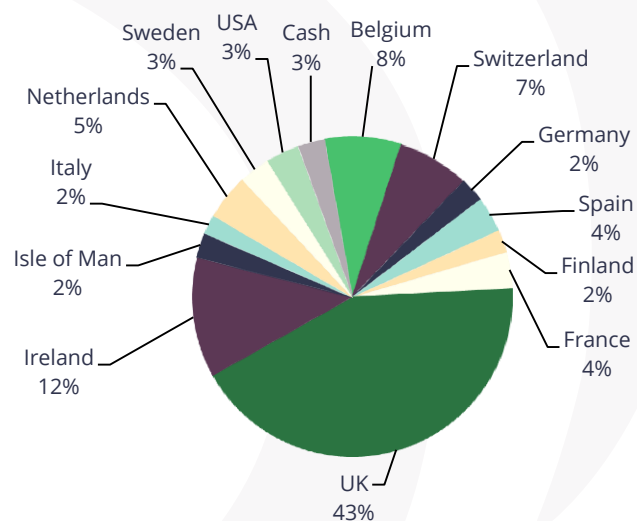
Fund Statistics

PRICE/BOOK	1.9
PRICE/EARNINGS RATIO (FY 1)	15.4
DIVIDEND YIELD %	3.5
AVERAGE MARKET CAP €BN	39.6
NO. OF HOLDINGS	29
ACTIVE SHARE RATIO %	87.7
DEBT/EQUITY %	73.9

Sector Distribution



Geographic Distribution





Commentary

The inability to secure an injection of £200m ultimately triggered the company's liquidation but the underlying root causes had built up over a number of years. While we did not have any exposure to Thomas Cook, there are always learnings to be taken from unfortunate business failures such as this.

At Setanta, we look to avoid certain characteristics in the companies in which we invest. These include 1) High levels of debt 2) Empire building management 3) Opaque accounting 4) Intense competition 5) Risk from technology and 6) Bad governance. All of these factors, to a greater or lesser degree, contributed to Thomas Cook's eventual liquidation.

Thomas Cook had been saddled with a large debt load as a result of sizeable acquisitions in 2007 and 2010. The company only narrowly survived a collapse in 2011. Harriet Green took over as CEO from 2012-14 and described the debt pile she inherited as "a cancer". The company's recovery under her stewardship was the subject of a Harvard Business School case study "Thomas Cook on the brink". However, the balance sheet leverage was never fully addressed and the company could not outrun this issue for ever. Terrorism fears in Egypt and Turkey, the 2018 UK heatwave and consumers cutting spending because of Brexit added to a highly competitive market environment over the last few years. High levels of debt leave a company less able to deal with stressful market environments and increase the risk of permanent capital impairment. Excessive leverage can sow doubt in the minds of customers and suppliers and accelerate the company's demise. By the end, there were allegations of some hedge funds buying bonds looking to vote down a rescue to benefit from credit default swap positions.

The company's debt problems stemmed from the 2007 merger with MyTravel and 2010 acquisition of Co-Operative Travel under the stewardship of Manny Fontenla-Novoa. The Financial Times quotes an advisor from his time as CEO as saying "Manny liked doing deals". Our gut reaction when we see acquisitions is guilty until proven innocent and we are suspicious of empire building management. Increased complexity, integration difficulties and culture clashes combined with the potential for over-payment can make takeovers problematic. The MyTravel deal turned Thomas Cook from a privately owned catalogue holiday provider to a group with retail estate, tour operator and an airline. The Co-Operative acquisition added significantly to the high street presence just as customers were increasingly booking online. In the same Financial Times story, a person close to the liquidation process describes Thomas Cook as the "most complicated simple business I've ever seen".

For its final full year set of results for the period to September 2018, Thomas Cook reported underlying EBIT of 250 million pounds. However, reported EBIT was just 97 million pounds, while free cash flow was a negative 148 million pounds. Over the six years to September 2018, the cumulative reported EBIT amounted to just 45% of "underlying" EBIT. EY, the auditor since 2017, "had strongly recommended to management that they strengthen the process over the identification and approval of separately disclosed items". Moody's had noted in its December 2018 rating downgrade that a "high and growing amount of transformational expenses contrasts sharply with Moody's expectation of their gradual decline". We need to be able to assess the sustainable cash earnings of a business to properly value it. Opaque accounting complicates that significantly. Ultimately Thomas Cook required cash rather than "underlying EBIT" to meet expenses and pay down debt.

Technology and intense competition also played its part in the company's demise. Consumers have increasingly shunned package holidays in favour of direct online bookings. Travel agent trade body ABTA states that just one in seven people booking a holiday now pop into a high street travel agency. Those who do tend to be over 65 and in lower socio-economic groups with less money to spend. Thomas Cook struggled to compete with smaller, online-only rivals due to fixed costs from its network of high street shops.



Commentary

The ease of direct online booking and emergence of low cost airlines has also facilitated a shift in consumer habits to shorter breaks and away from the longer getaways which tour operators specialise in. Low cost airlines have become an increasing feature of the European travel market over the last decade. The likes of Ryanair and Wizz Air compete aggressively with low fares to fill their expanding fleets. A highly and increasingly competitive market with minimal switching costs for consumers makes for an unattractive investment case.

Hindsight may be 20-20 vision but governance questions are also likely to arise in the wake of Thomas Cook's collapse. Was there sufficient questioning by the board of the acquisitions which lumbered the company with an excessive debt pile in the first place? Should the board have acted with greater urgency to tackle the balance sheet through disposals or a rights issue given its history? The business still had an equity value of over £2bn in May 2018. Much has been made of the financial packages earned over the last decade by senior management. Bonuses were paid on the basis of pre-exceptional adjusted earnings. Should there have been much greater scrutiny of what counted as "exceptional" costs? EY, as auditor, believed so. They also drew attention to the link between "underlying" earnings and compliance with banking covenants.

Avoiding costly mistakes is critical to building a successful long term track record. In evaluating any stock, the key to risk is the likelihood of the permanent destruction of capital. We have made mistakes in the past and will again in the future but seek to ensure that we avoid business collapses like Thomas Cook through our focus on unfavourable business characteristics and what can go wrong.

Transactions during the Quarter

During the quarter we initiated a position in Booking Holdings. Formerly known as Priceline, Booking Holdings changed their name to reflect the fact that their Dutch subsidiary Booking.com generates the vast bulk of sales and profits in this business. Booking.com is an online travel agent (or OTA) that is focused on the accommodation segment and has a particularly strong position in Europe with independent hotels. Independent hotels rely on Booking.com to bring customers to them. Incremental margins on hotel rooms are massive (they could be 60% or more) and the return the hotel gets from the booking.com outlay is very attractive. Booking.com should maintain their dominant position with European hotels and use this to expand aggressively to alternative accommodations and widen their geographic base to the Americas and Asia. Growth rates in rooms nights booked slowed significantly in the last couple of years as CEO Glenn Fogel adopted a strategy of focusing on quality leads from Google whilst pulling some spend from the metasearch channel (Trivago). With a fortress balance sheet, mid teens multiple and attractive profitable growth prospects we think we should have a successful outcome with Booking Holdings.

We sold our small position in Kingspan. As a reminder Kingspan mainly manufacture insulation materials that are used in the construction industry for commercial, industrial and residential applications. Kingspan is a very well run business, however we were concerned that their end markets were due for a probable slow down which was not reflected in the price of the stock at a P/E in the mid 20s. We'll keep an eye on this business and if the price/value relationship changes we'll consider reinstating the position.

David Byrne & Fergal Sarsfield – Portfolio Managers



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