# Setanta EAFE Equity Fund (CAD)

Q3 2019

## Fund Description

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

The Fund is an actively managed equity portfolio which holds c.30-35 stocks in the European, Australasian and Far East regions. The portfolio is managed in accordance with the Setanta investment philosophy. The Fund is managed by three portfolio managers, who also look to leverage off the experience and knowledge of their colleagues. The aim is to achieve a sensible level of diversification on a sector and geographic basis. The Fund can hold up to 10% cash where investments of sufficient quality cannot be found.
The investment objective of the Fund is to outperform the MSCI EAFE benchmark 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. 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.

*(Fund Commentary continued on Page 3)*

## Portfolio Managers

Rowan Smith; Fergal Sarsfield, CFA & Conor Walshe

## Our Investment Principles

We do not believe markets are efficient

We invest below our estimate of intrinsic value

We invest in businesses rather than buying stocks

Preservation of our clients' capital is key

Investing is a marathon, not a sprint

We are not afraid to swim against the tide

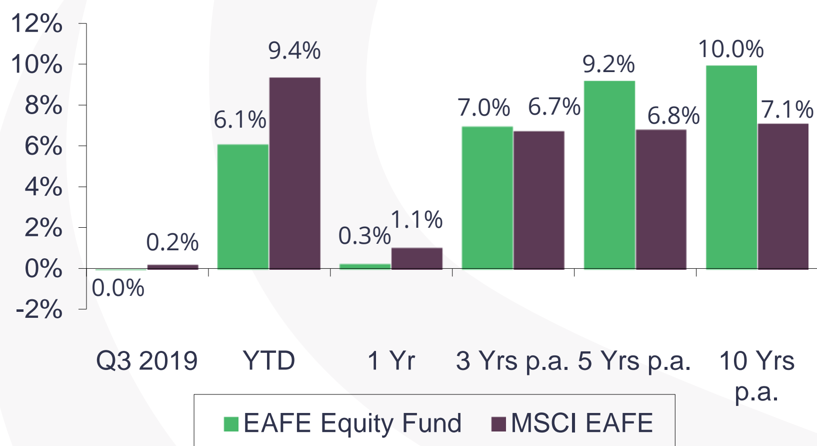
We consider scenarios rather than making forecasts

Businesses we own must have strong balance sheets

We make mistakes and always endeavour to learn from them

We will act with integrity in everything we do

## Fund Performance – 30.09.19




## Yearly Performance

| Year % | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| **Fund** | 4.5 | 25.2 | 7.0 | 16.7 | -2.7 |
| **Benchmark** | 3.7 | 19.0 | -2.5 | 16.8 | -6.0 |

**Performance Source:** GWL Unit Prices. Based on CLA EAFE Equity (SF035). Returns are in CAD and are gross of management fees. Benchmark is MSCI EAFE. 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

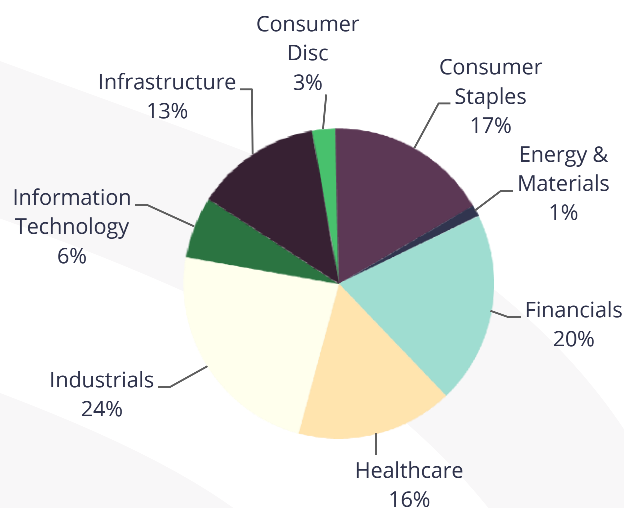
## Top 10 Holdings

| COMPANY | SECTOR | % OF FUND |
|---|---|---|
| DCC | INDUSTRIALS | 5.7% |
| GPE BRUXELLES LAMBERT | FINANCIALS | 5.4% |
| MELROSE INDUSTRIES | INDUSTRIALS | 4.1% |
| UNILEVER | CONSUMER STAPLES | 3.9% |
| COCA-COLA AMATIL | CONSUMER STAPLES | 3.7% |
| SANOFI | HEALTHCARE | 3.6% |
| ALFRESA HOLDINGS | HEALTHCARE | 3.5% |
| DIAGEO | CONSUMER STAPLES | 3.4% |
| NOVARTIS AG | HEALTHCARE | 3.2% |
| RYANAIR | INDUSTRIALS | 3.2% |

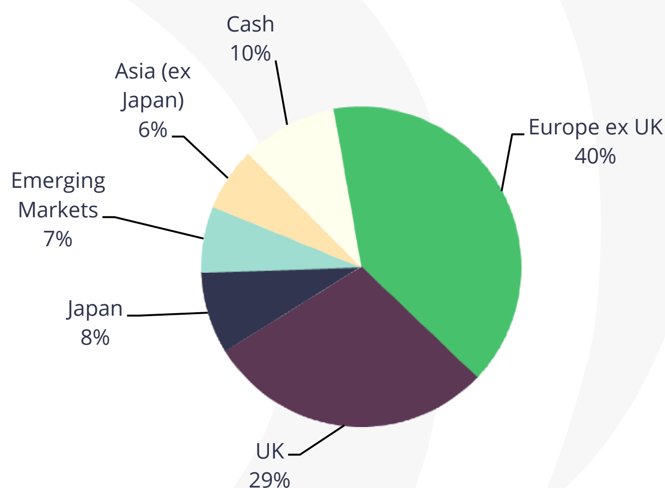
## Fund Statistics

| | |
|---|---|
| PRICE/BOOK | 1.7 |
| PRICE/EARNINGS RATIO (FY 1) | 14.6 |
| DIVIDEND YIELD % | 3.5 |
| AVERAGE MARKET CAP C$BN | 51.6 |
| NO. OF HOLDINGS | 35 |
| DEBT/EQUITY % | 64.7 |
| ACTIVE SHARE % | 89.0 |

## Sector Distribution




## Geographic Distribution




SETANTA
Asset Management

# Commentary

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. 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.

# Commentary

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" earning 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.

The Fund marginally underperformed the benchmark during the quarter. Melrose was a significantly positive contributor during the quarter. Results for the first half of 2019 demonstrated that management's operational improvements are taking effect in both GKN's Aerospace and Automotive businesses. Margins increased by 200bps in the former and were notably resilient in the latter despite cyclical headwinds. Balance sheet leverage was also better than market expectations and new targets to reduce GKN's working capital give further comfort on this front. Management has a superb track record in applying its Buy, Improve, Sell model to underperforming industrial businesses and this set of results provided reassurance on its ability to deliver again with the GKN business acquired in 2018.

Bank of Ireland was the largest detractor from fund performance during the period. Management flagged a deteriorating Net Interest Margin trend at the H1 2019 results due to the interest rate backdrop which has led to earnings forecast downgrades. There are rising concerns about a potential hard Brexit as we approach Prime Minister Johnson's target date of October 31st for the UK to leave the European Union. Increasing capital requirements and anaemic loan growth have also been headwinds for the business. Clearly Bank of Ireland faces some challenges but we feel this is more than reflected in the large discount to book value which the stock currently trades at.

**Portfolio Activity**
There were no transactions during the quarter.

*Conor Walshe – Portfolio Manager*

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