Global Evolution Capital

February 2020

About the Fund

The world is evolving more rapidly than it has in any time in human history, and these shifts are creating opportunities for select companies to position for multi-year growth while impairing the economics of others as the world shifts from under them. Our focus is on identifying these companies, and constructing a portfolio that protects as well as grows the wealth of our investors.

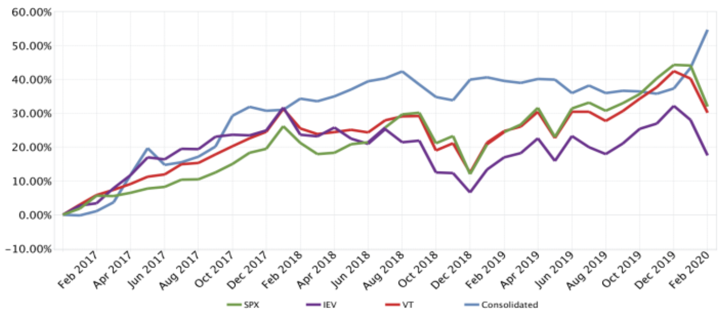
Our global focus allows our clients to access the best companies in the world. Our absolute return philosophy means that we aim to grow investor wealth regardless of market performance.

Fund Features

- Global absolute return fund
- Gross exposure range = 100% to 220%
- Net exposure range = -30% to +60%
- Long position range = 10 to 30
- Managed fx exposure
- Fees = 1.25% base fee and 20% performance fee above 5% hurdle rate subject to high water mark

Performance (gross, cumulative)

	SPX	IEV	VT	FUND
YTD	-8.6%	-11.0%	-8.7%	12.6%
1Yr	5.8%	0.6%	4.0%	10.7%
3Yr	24.7%	13.6%	22.5%	51.2%
Inception	32.0%	17.6%	30.1%	54.6%



Consolidated = Global Evolution Fund, SPX = US market, IEV = Euro market, VT = Global Market
Inception date is 1st January 2017
Past performance is provided for illustrative purposes only and is not a guide to future performance

Current Metrics

Gross Exposure	191%
Long Exposure	84%
Short Exposure	107%
Net Exposure	-27%
Total Positions	33
Long Positions	14
Short Positions	19

Risk Metrics

	SPX	IEV	VT	Consolidated
Ending VAMI:	1,319.54	1,175.69	1,301.14	1,546.47
Max Drawdown:	13.97%	19.11%	14.45%	6.01%
Peak-To-Valley:	Sep 18 - Dec 18	Jan 18 - Dec 18	Jan 18 - Dec 18	Aug 18 - Nov 18
Recovery:	4 Months	12 Months	10 Months	14 Months
Sharpe Ratio:	0.64	0.35	0.63	1.31
Sortino Ratio:	0.86	0.48	0.87	3.23
Calmar Ratio:	0.65	0.27	0.60	2.45
Standard Deviation:	3.68%	3.71%	3.46%	2.83%
Downside Deviation:	2.73%	2.67%	2.51%	1.15%

Key Positions

Key Long Positions	Key Short Positions
Alphabet (GOOGL-US)	Fedex Corp (FDX-US)
Amazon (AMZN-US)	Uber (UBER-US)
Tencent (700-HK)	Hewlett Packard (HPE-US)
Xinyi Solar (968-HK)	CVS Health (CVS-US)
Biogen (BIIB-US)	Dillards (DDS-US)

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What happened last month

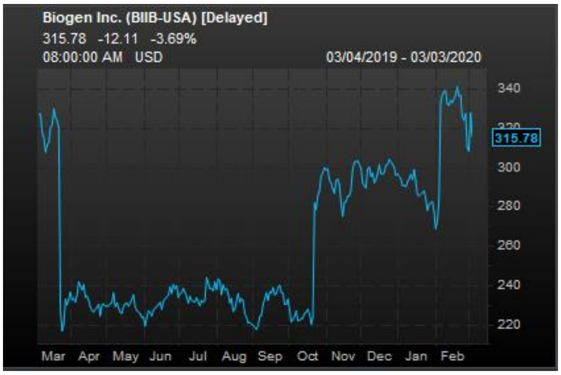
Market

It was a wild ride for markets in February as the impacts of the coronavirus began to wash through market pricing. Amongst this market turmoil, the fund had one of its best monthly performance outcomes on record, gaining 7.8% in the face of market falls of -7% to -8%.

Fund Performance

Key positive contributors to performance were:

- Biogen (long): A patent win on one of its key drugs (representing 30% of sales) provides protection from generic competition until 2028. This adds to the gains in October where the news of Biogen reviving its experimental alzheimers drug sent shares higher.



- Nissan (short): distress in company performance, a poor balance sheet and ructions in the Renault JV saw Nissan shares continue to underperform. Nissan and Renault are short positions in the “Transport” theme given stressed balances sheets restricting their ability to reshape their manufacturing base for the migration to electric and autonomous vehicles

Key negative contributors to performance were:

- Alphabet (long): Results for 4Q19 were on the disappointing side as core growth underwhelmed and the cloud business showed only moderate traction

- Sensata (long): While Sensata has outperformed its core markets (auto and HVOR), these markets have been far weaker than expectations

General Observations

There was a flood of companies reporting in February allowing a reference check on some of the key industry dislocations the fund is positioned for. These included:

- Technology (cloud): The performance of Amazon and Microsoft in terms of cloud migration is remarkable, accruing substantial value to these companies while stripping it from incumbents. For Amazon, 78% of operating earnings in 4Q19 came from AWS, which is remarkable for what is meant to be an ecommerce company.
- Transport (logistics): The Amazon internalisation of freight continues, with the offering looking to expand to offer externally. This has impacted initially in UPS having to allocate more cost to improve its existing service, and we expect this impact to accelerate

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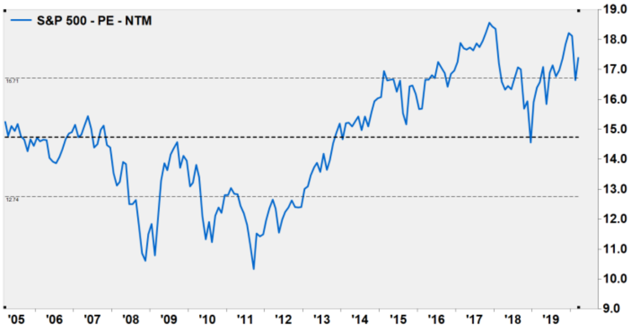
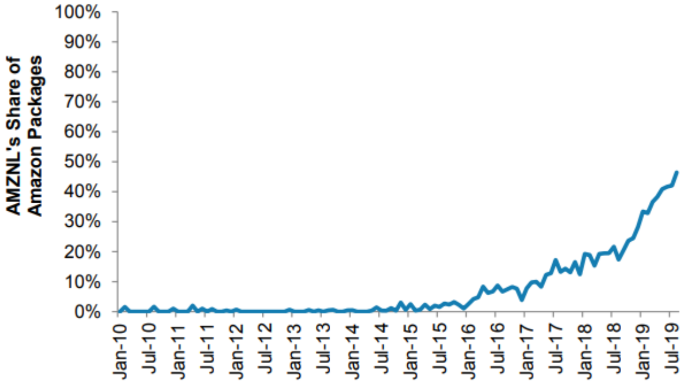
What is on our mind

At a portfolio level, while markets corrected in February they still remain elevated vs history on a valuation basis. As such we retain a defensive positioning (net short) as we head into March.



At a stock specific level, there are a number of companies in the portfolio, both long and short, that will be reporting results in the coming weeks. Among these are:

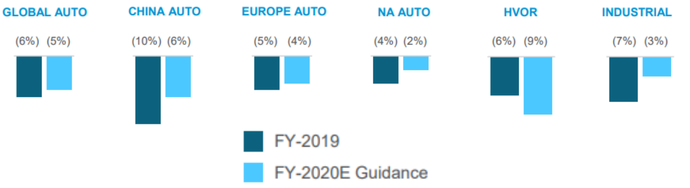
- SQM (long): What we are looking for is evidence that lower lithium pricing is driving rationality in supply additions to rebalance the market. And that SQM retains its scale, low cost position
- HPE (short): What we are looking for is continued pressure on legacy earnings coming from corporate migration to the cloud
- FDX (short): What we are looking for is pressure to continue to emerge as competition from Amazon and Uber increases. We expect costs to increase like at UPS to lift the service to an improved standard. Then we expect to see volume disappointments as new entrants build positions and take share



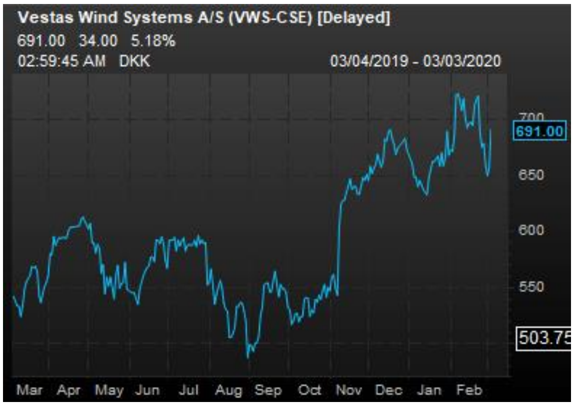
Source: AlphaWise, Morgan Stanley Research

Also at a stock specific level, we are investigating the underperformance of sensor company Sensata. We are looking to re-test the thesis of content increases for Sensata as the vehicle mix shifts towards autonomous and electric. Given recent disappointments we are also looking to validate longer term expectations for broader market volumes.

OEM Production:



And at a thematic level we are turning our attention back towards Energy. While we are comfortable with our long positions in solar (Xinyi) and wind (Vestas) we are looking to build out the short side of the book. While coal and gas company share prices have fallen heavily, we are exploring 2nd order impacts around supply chains and pipelines for opportunities.



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Item of Interest - Coronavirus

While we won't speculate as to the severity or spread of the virus we will provide our view on what we think are the implications for markets, with a focus on the US.

The impact does appear to be significant in the short term as it is a simultaneous supply side and demand side shock. As the virus spreads and the containment practices intensify it will have a material dampening effect on global activity that could have an extended duration.

However when considered in light of "long term valuations" current stock moves appear excessive. Let's consider a theoretical company generating free cash flow of $100 a year. For simplicity we'll assume a 10% WACC, $200 net debt and 100 shares on issue. Performing a DCF with these metrics implies a company value of $8.38

	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	Terminal Value
Net FCF	100	100	100	100	100	
Terminal Value						1,000
Discounted Cash Flow	**100**	**91**	**83**	**75**	**68**	**621**

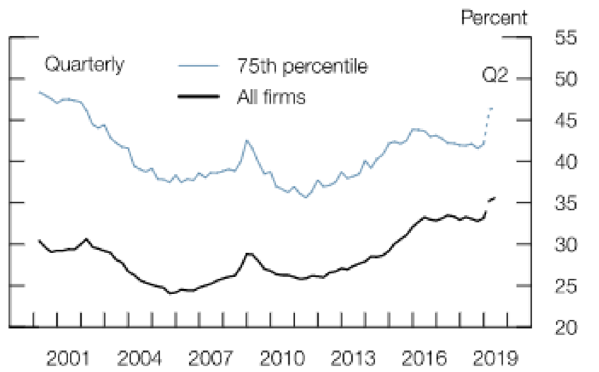
	Valuation
Defined Cash Flow	417
Terminal Value	621
DCF	1,038
Less: Net Debt	-200
Equity	$838
Shares on Issue	100
Valuation	**$8.38**

Projections for earnings impacts currently are in the range of -5% to -10%. Even if we assume this becomes much worse and results in a 20% impact on 2020 free cash flow, and with no catch-up in 2021, the resultant impact on valuation is a reduction to $8.18 per share, or -2.4%.

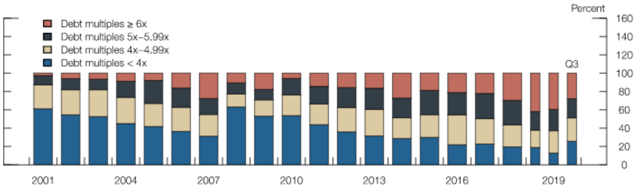
	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	Terminal Value
Net FCF	80	100	100	100	100	
Terminal Value						1,000
Discounted Cash Flow	**80**	**91**	**83**	**75**	**68**	**621**

	Valuation
Defined Cash Flow	397
Terminal Value	621
DCF	1,018
Less: Net Debt	-200
Equity	$818
Shares on Issue	100
Valuation	**$8.18**

However, this relatively benign outcome assumes that corporate balance sheets can ride through any short term impacts. But the data indicates that corporate debt levels have been escalating. Gross balance sheet leverage of public nonfinancial business in the US is at its highest level in 20 years.

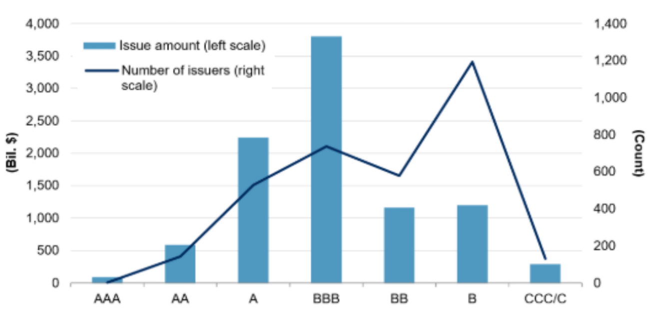


Combined with an escalation in debt levels, the quality of this debt has been deteriorating. While corporate credit has been growing at 5.1% pa for the past 12yrs, the higher risk leveraged loan component of this has been growing at 15.4% pa. And within these leveraged loans, the share going to corporations with high leverage (net debt / EBITDA > 6x) exceeds previous peak levels in 07.



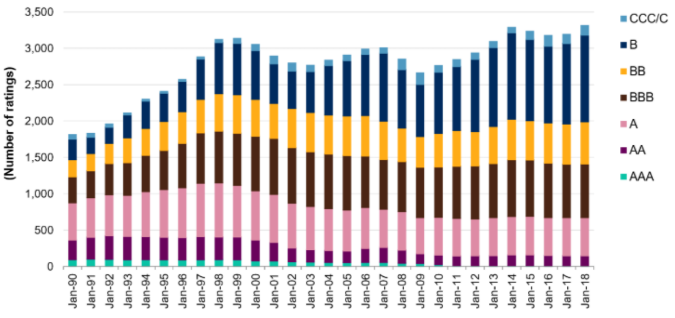
Turning to investment grade corporate debt, most of it sits in the lowest investment grade level of BBB, leaving little room if material financial pressures do emerge.

Distribution Of U.S. Corporate Debt By Rating Category



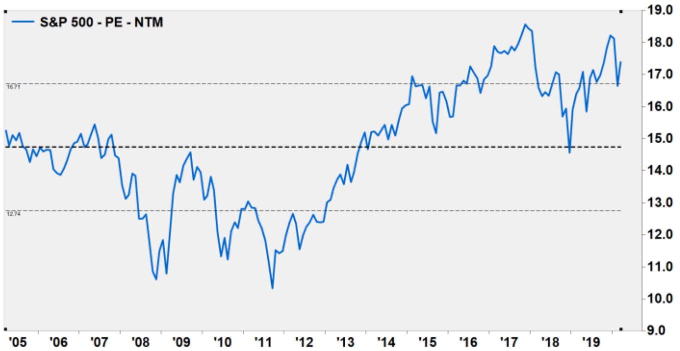
Looking at the overall mix of credit ratings, deterioration has been evident for a number of years. The proportion of “A” grade ratings and above has declined materially while the share of non-investment grade ratings has lifted materially.

U.S. Corporate Rating Distribution



So while the theoretical impact on company value of a short term cash flow decline is negligible, the decline in the quality of US corporate balance sheets creates an amplification effect, as well as throwing up a range of unknowns. Companies appear to have structured their capital bases for continuing blue skies, which is always tempting when debt is so cheap. It is a dangerous game to play.

Throw into the mix what have appeared to be excessive market valuations vs long term averages. Heading into February 2020 valuations based on PE NTM, PE 2Yr and CAPE ratios have been approaching 2 standard deviations above average. Markets appeared to be pricing an absence of risk, with an implicit assumptions that any issue that does emerge could be dealt with by Central Bank intervention. As such when a material issue did emerge that optimism underpinning asset pricing had to be tempered.



Conclusion

While the theoretical impact on stock valuations of short term cash flow reductions flowing from coronavirus is minimal, we feel that both corporates and markets have been excessively discounting risk. This is evident in the structure of corporate balance sheets and in what appears to be excessive company valuations vs historical standards. For us it is not about coronavirus specifically; it is about a shock to the prevailing view that business and investment had become almost “riskless”.

As such we remain positioned for a continuation in market reversion. If the impacts linger we expect company distress to begin to emerge, particularly given the structure of corporate balance sheets. And even if coronavirus is contained quickly we would expect that this episode should lead to the market once again beginning to appreciate and price for risk appropriately. For this to be reflected accurately, we feel that share prices have further to fall.

Global Evolution Capital – 4th March 2020

Sources:
- S&P Global Ratings – US Corporate Debt Market: The State of Play in 2019
- Federal Reserve – Financial Stability Report November 2019