VT Tyndall Global Select Fund Commentary

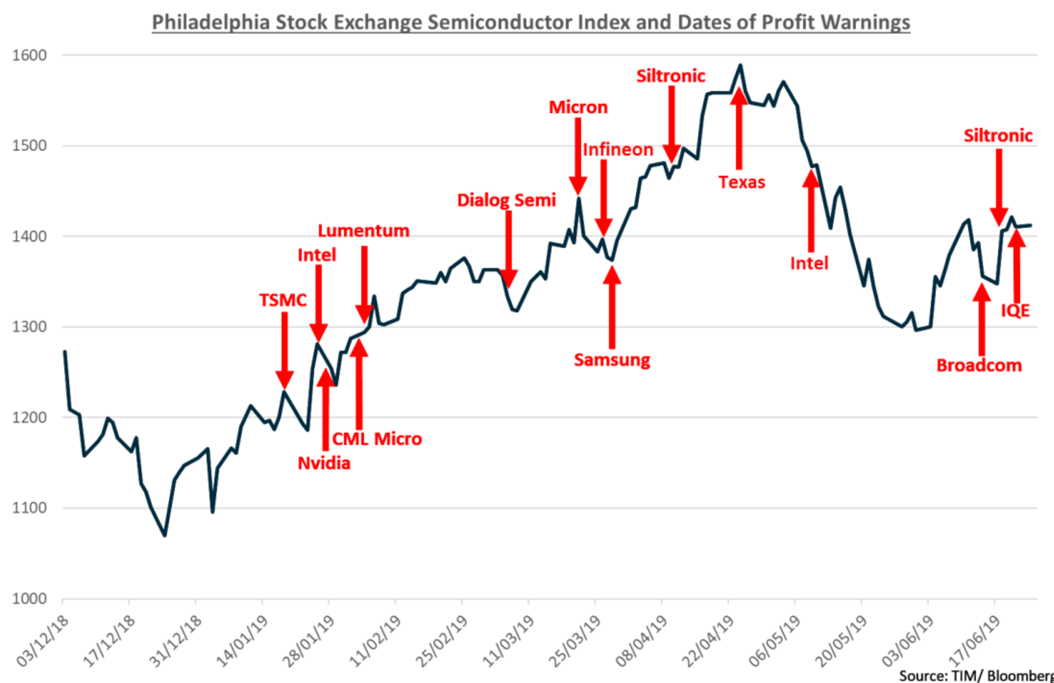
June 2019

TYNDALL

"There is nothing impossible to him who will try." – Alexander the Great

Plus ça change, investors continued to fret over trade tariffs and the implications of central bankers changing the wording of their meeting minutes. Consensus now has the US cutting rates twice in 2019, versus an expectation of at least one raise at the start of the year, and in Europe, at one of his final ECB meetings, Mario Draghi spoke of further eurozone rate cuts, drawing the ire of the Tweeter-in-Chief.

Equity markets rose to new all-time highs during the month as the signalling of interest rate cuts from both the Federal Reserve and the ECB were not seen as a worrying sign of weak macro-economic conditions, but like Lucozade, that will restart another round of increased profits. The VT Tyndall Global Select Fund rose by 4.65% over the month bringing the year-to-date returns to 18.73%.



Since the turn of the year, we have taken the opportunity of the rally in semiconductors to reduce and then completely exit our small position in Infineon. Contrary to the market performance from December 2018 to April 2019, the news flow over demand and capacity within the semiconductor market has been increasingly negative as almost without exception semi-conductor companies have warned that they were cutting back production due to oversupply in their respective end markets (see chart above). We initially invested in Infineon due to our belief in the long-term secular growth in semi-conductor content in the Internet of Things (IoT) and in particular, vehicles. The secular shift from combustion engines to hybrid to electric and then to autonomous driving should result in semiconductor content increasing from $375 for a combustion engine vehicle to $750 for an electric car and an additional $970 for a totally autonomous car.

The chart below depicts the extent of the cut in production by US based semiconductor manufacturers, which has resulted in negative year-on-year growth for almost a year as companies try to adapt to the oversupply in the market.

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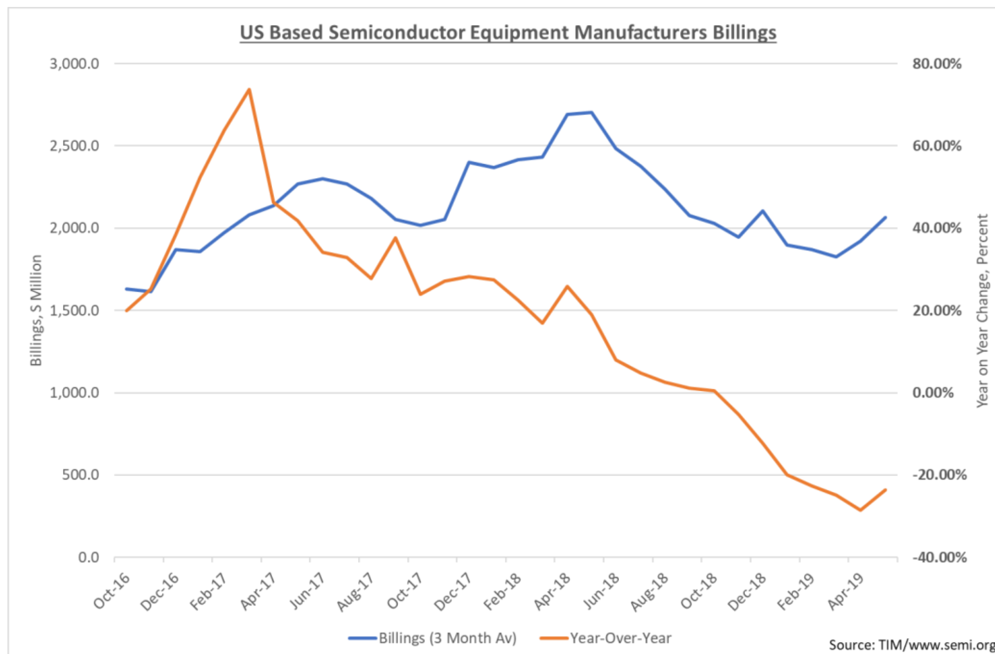


Infineon is currently the second largest supplier of semiconductors to the automobile sector; the recent announcement of the acquisition of Cypress Semiconductor Corp. means that the company will leapfrog NXP to be the leading player with a 13% share. Our rationale for exiting the position is that we believe that there has been a deterioration in the long-term financial strength of the company. Furthermore, the historical barriers to entry to the market have deteriorated and the depth of the defensive moat has decreased. The increase in debt that the company has had to take on to finance the Cypress acquisition has reinforced our conviction.

Given the price offered for Cypress, after the deal the company will move from being net cash to over 2x leveraged. The company will need to raise capital in the region of €3 billion to have enough liquidity in order to give it the flexibility to make future investments. We do not expect to see any cost benefits or synergies coming through before 2021 at the earliest and Infineon has a €500m Eurobond to refinance in 2022. [1]

Exacerbating the potential financial woes is the on-going litigation relating to Qimonda AG, the former memory chip unit of Infineon that went into administration in 2009. Infineon is accused of not making the necessary declarations to registrars while moving assets though shell corporations in the process of making the chip unit a subsidiary company. The insolvency administrator filed a request for a payment of at least €1.71 billion in December 2010 which was subsequently increased to €3.35billion. The company made a partial settlement of €260 million in 2014, and we believed that this would result in only minor future settlements. However, the litigation is on-going, and the company felt the need to set aside further funds in December; further analysis suggests that the future ruling may yet make these provisions seem insufficient.

[1] Subsequently Infineon raised €17 billion through a share placement at a 5% discount to the previous closing price; 15% below the market price when the deal was initially announced.

We also have concerns about increasing their exposure to the automotive sector at a time when vehicle demand is waning, and trade wars are increasing. Having failed to buy Wolfspeed in 2017, management have much to prove in their ability to execute.

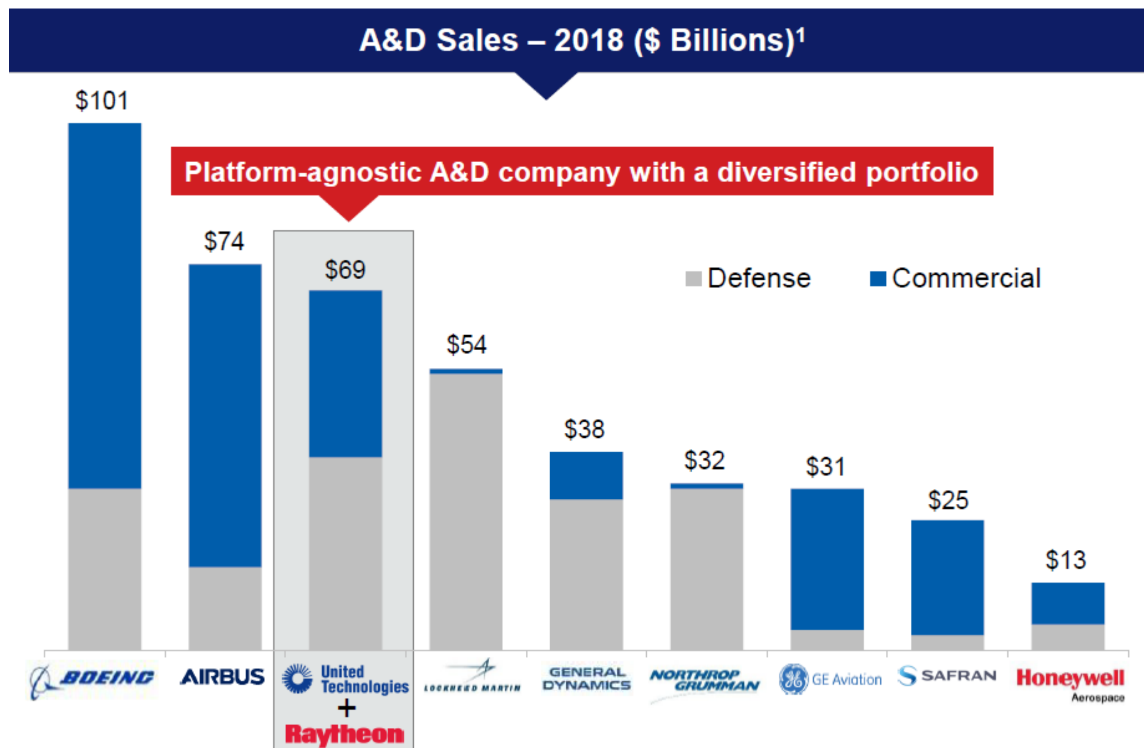
The company is also the leading supplier in Power Management Modules, as well as Security Identity Codes, with 19% and 24% shares respectively. We believe that our investment thesis in Power Management remains sound, despite currently seeing subdued demand, as the structural growth in IoT will continue to see increased demand for Infineon as the market leader, especially given that their customer base include the likes of Alibaba, Amazon, Goggle, Cisco, and Huawei. We believe that this area of stability, however, is outweighed by the concerns outlined above and thus as reduction in financial strength is one the key tenets in our sell discipline, we exited the position.

We have held a position in United Technologies since October 2008, since then the company has seen significant changes in its composition. At the end of this year the company is due to separate out its Elevator and Escalator business (Otis) as well as its Climate Controls business (Carrier) from the Aerospace operations (Pratt & Whitney, Collins Aerospace & United Technologies Corporation).

During June 2019, the company announced a merger of equals with Raytheon Technologies, one of the leading US defence companies, with significant US Department of Defense contracts for products such as Patriot and Tomahawk missiles and the key air defence product, THAAD (Terminal High Altitude Area Defense). The combined company, to be known as Raytheon Technologies Corporation, will become the third largest aerospace and defence company in the world (behind Boeing and Airbus), with pro-forma $69 billion of sales as at the end of 2018. Having met with the management of both Lockheed Martin and Northrup Grumman recently, we are reassured by the future spending plans on defence by the current US administration and believe that Raytheon is significantly exposed to the missile defence and precision weaponry that the US DoD has singled out as the areas where they intend to request for an uplift in investment.

The merger is highly complementary because there is very little overlap between the two companies: Raytheon is predominantly defence-focussed and United Technologies has a high weighting in commercial operations. Unlike Infineon's purchase of Cypress, which was done at a 46% premium, United Technologies is not paying a premium for Raytheon's business that makes the deal

much more value accretive from the outset. The combined Free Cash Flow is expected to grow from $6bn today to $8 billion by 2021, enabling the company to return $18-$20 billion of cash to shareholders through dividends and buybacks during the first three years after the deal closes.



Source: Company Presentation

With Greg Hayes at the helm, the United Technologies management have a good track record in M&A and extracting cost synergies ahead of their initial estimates. The announced pre-tax synergies from this merger amounts to ~$1 billion, so we would not be surprised if this figure is revised upwards in due course.

We believe that the conglomerate nature of United Technologies does not properly reflect the true value of the future cash flows of the underlying businesses. As such, despite the initial fall in the value of the shares after President Trump's comments about the Raytheon deal, we believe that the company will begin to be valued as three individual companies as the date for the separation approaches, which should be beneficial for us as shareholders.

As well as the position in Otis (through United Technologies), the Fund has a long-standing position in the Finish elevator & escalator (E&E) company Kone. Last month, ThyssenKrupp's planned JV with Tata fell apart after the European competition watchdog ruled against the plan, thus sending the company back to the drawing board for its future strategy. With United Technologies planning to spin off Otis next year and Thyssen having a profitable elevator unit also, there are various merger possibilities that have arisen.

Analysing the market shares by region and assessing the overlap, we believe that the most likely combination would be a Kone-Thyssen merger, should Thyssen agree to spin off the unit; indeed

both Kone and Otis have expressed that they would be interested in looking into the viability of doing a deal with Thyssen's elevator business. Either combination would create a new global leader in the field. In Kone's case there is surprisingly little overlap that would require divesting operations to satisfy competition authorities; however, this would not be the case with Kone-Otis or Thyssen-Otis combinations, given the overlap. We do not believe that Schindler would look to take part in any significant M&A.

Units under Maintenance Market Positioning

	Current Market Positions			Under a Kone-Thyssen Merger		
Region	#1	#2	#3	#1	#2	#3
EMEA	Otis	Schindler	Kone	Kone/Thyssen	Otis	Schindler
North America	Otis	Thyssen	Schindler	Kone/Thyssen	Otis	Schindler
South America	Otis	Schinlder	Thyssen	Schindler	Otis	Kone/Thyssen
APAC	Kone	Schindler	Otis	Kone/Thyssen	Schindler	Otis
China	Kone	Otis	Schindler	Kone/Thyssen	Otis	Schindler

Source: TIM/ Berenberg/ Company Data

Drilling down in the major markets where the companies do have overlap, the rationale for a Kone/Thyssen merger becomes clearer and the reasons why we do not see major obstacles for the competition authorities having an issue with such a combination are evident too. Post the combination Otis would continue to have larger market shares in Spain, Italy and France, while Schindler would be bigger in Brazil.

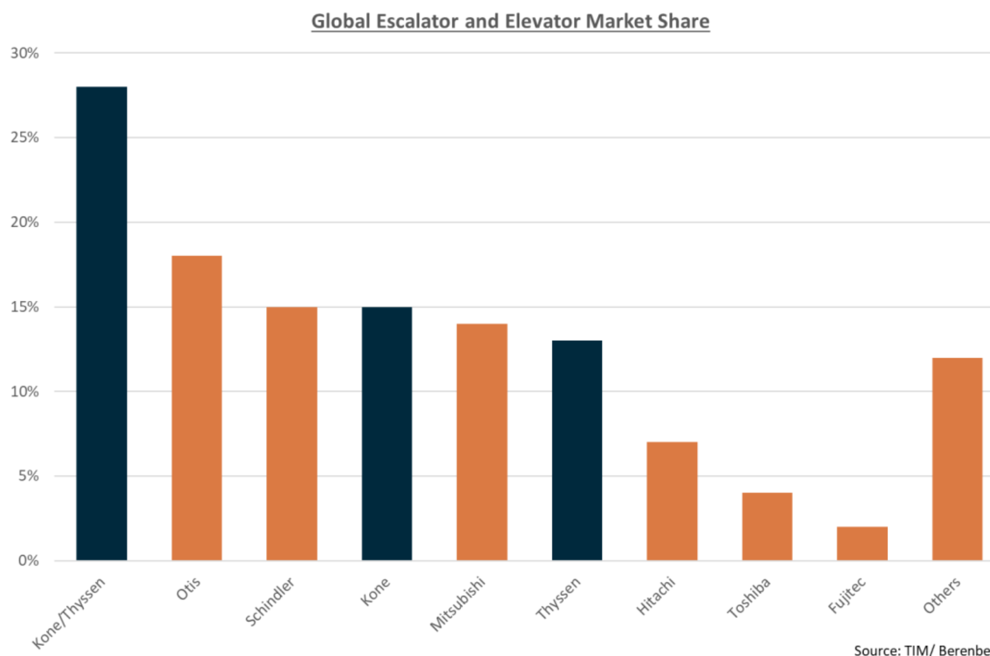
While such a company would be the market leader in German, given that this is Thyssen's home market we expect that the German authorities would promote a homegrown champion. Although Kone is the market leader in China, the market is very fragmented so given its 8% share and Thyssen's 3% share the combined entity should not raise any major competition concerns there either

The US is the region where we have the most concerns, especially given Donald Trump's promotion of American companies as combined Thyssen/Kone would command a 31% share supplanting the US based Otis as the market leader as currently has a 25% market share.

	Kone		Thyssen		Combined		Otis		Schinlder	
	Share	Position	Share	Position	Share	Position	Share	Position	Share	Position
Spain	4%	5	19%	2=	23%	2	**30%**	**1**	12%	4
Italy	13%	2	3%	4	16%	2	**20%**	**1**	7%	3
Germany	12%	4	13%	3	**25%**	**1**	15%	3	**20%**	**1**
France	16%	3	11%	4	27%	2	**36%**	**1**	17%	2
Brazil	1%	5	17%	3	18%	3	22%	2	**30%**	**1**
China	8%	1	3%	4	**11%**	**1**	4%	**3**	5%	2
US	13%	4	18%	2	**31%**	**1**	**25%**	**1**	17%	3

Source: TIM/ Berenberg/ Company Data

The combined company would end up having a 28% global market share, with an installed base of 2.5 million units. 50% of revenues would come from new installations and maintenance and modernisation would represent 36% and 14% of revenues respectively.



We believe that the synergy potential from such a deal is very significant, due to the operational leverage obtained from having greater density. There is a lot of technical know-how, such as Kone's Ultra Rope technology, that could be shared between the two companies. While this may not come to pass, given the recent set-back for Thyssen we would be very surprised if the respective management teams at Kone and Thyssen are not evaluating this possibility, especially given the amount of press speculation recently.

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