VT Tyndall Global Select Fund

TYNDALL

Monthly Commentary (30th April 2020)

"Bad companies are destroyed by crisis, good companies survive them, great companies are improved by them." -Andy Grove

Historically, April is a good month for global equity markets and this year proved no different, with much of the fall experienced in March being recouped. The month was marked with numerous positives and negatives, amongst which we saw countries gradually reopening, the WTI crude oil price falling to -$37 per barrel, China returning to work and President Trump suggesting that injecting disinfectant into the body, may kill the virus. The initial stages of company reporting also have thrown up a wide variety of results and the almost universal withdrawal of guidance. Even within a similar sector the likes of Unilever and Nestlé reported marked differences in results with the later growing 4.2% organically to Unilever's 0.2%.

We have also witnessed some tentative signs of a rotation from quality to value occurring towards the end of the month, starting in the UK and Europe, but spreading to the US. We welcome these periods of rotation as, although they can lead to a period of underperformance, as we experienced in early 2009 and late 2016, they often enable us to pick up quality stocks at attractive valuations, as people sell them to chase the rotation. We believe that buying companies that can become building blocks for future growth in the Fund is a sensible strategy; if your investment horizon is more than six months, which ours is, it pays not to chase the rotation as these companies will likely outperform in the medium to long-term. Whether these signs of rotation are embedded or short lived remains open to be seen, however we will remain true to our philosophy and process.

We have continued to provide weekly updates on our thoughts, which can be found on our website at https://www.tyndallim.co.uk/news-insights/ and if you wish to subscribe to receive them directly you can do so at: https://www.tyndallim.co.uk/subscribe/.

The VT Tyndall Global Select Fund B Acc (GBP) rose 7.07% during the month, reducing the year's decline to 3.50%.

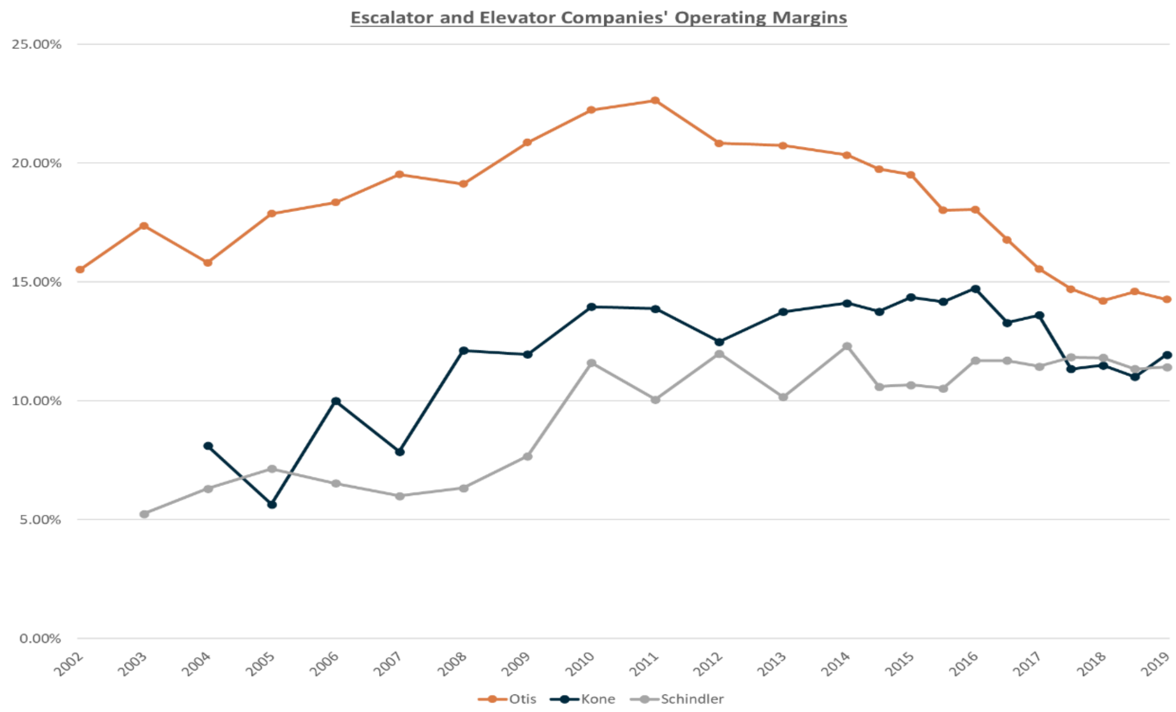
Fund Activity and News

This month we finally saw the merger of United Technologies and Raytheon to form Raytheon Technologies (UTX) with Otis Worldwide and Carrier Global being spun off in the process. The combination of UTX and Raytheon has resulted in a company that derives 60% of its operating profit from the defence sector and the remainder from aerospace.

Defence sales tend to be less cyclical than aerospace, however we worry that given the scale of governmental spending pledged to offset the effects of COVID-19, defence budgets may be scaled back. We have never owned a predominantly defence or armament company in the Fund owning to the discretionary nature of defence budgets and we are also conscious that many investors are now prohibited from investing in these sectors. COVID-19 has brought the aerospace industry to its knees and this will have a devastating effect on UTX's spare parts and engine business as orders dry up, however, once the pandemic passes and planes take to the skies once more, these orders should return. The company still looks attractive on a Free Cash Flow (FCF) basis, however, given the short- and medium-term headwinds, we don't believe that the company will be able to return to 2019 revenue or operating profit levels until 2023 at the earliest. We also believe that the market correction has thrown up more attractive long-term propositions and thus we exited the position in Raytheon Technologies.

Having owned UTX for over 10 years, we had an intimate knowledge of Otis, and believe being free from the conglomerate the prospects for the world's largest escalator and elevator business looks brighter. Under the ownership of UTX the capital allocation from the cash generated by the business was not always directed in the long-term interests of Otis and more towards maximising near-term value to offset the challenges at Carrier and increasing investment at Pratt & Whitney.

For a decade UTX encouraged Otis to price at a premium to its peers and thus missed out on a significant amount of the growth in China, allowing Kone and Schindler to capitalise on the opportunity. However, it meant that Otis maintained a significantly higher operating margin than its peers. Over the recent years, the company has been given more autonomy to prioritise its own investments and thus has made incremental strategic investments and margins have come down closer to that of the peer group.



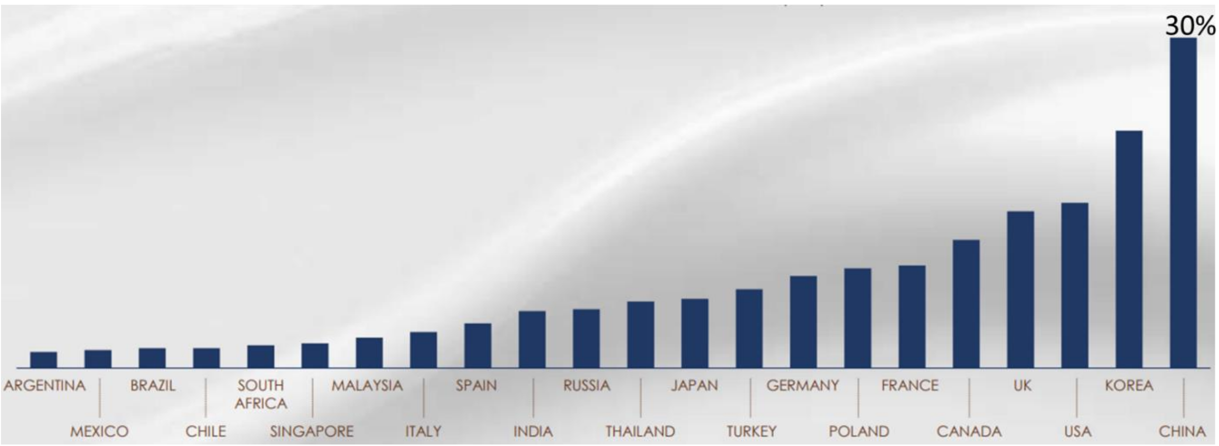
Source:TIM/Company Reports

The high margin and cash generative services business accounts for 57% of revenues and 80% of this is derived from maintenance and repair, which is recurring in nature and thus provides an a-cyclical cash stream. Otis also has an advantage over its peer group in this part of the business owing to its greater weighting towards western markets where conversion rates are better and their greater unit density, enables service technicians able to service more elevators per hour. A further advantage of having the highest installed base (1.1 million units) in western markets is the opportunity in modernisation, as approximately 1/3rd are over 20 years old; 21% are more than 30 years old, so orders should pick up once building owners confidence in the economy improves.

Despite the net debt/EBITDA growing to 2.3x owing to the separation, Otis should be able to generate approximately $1bn in FCF per year at a net income conversion rate in excess of 110%. This will enable it to rapidly reduce the net debt as well as maintain its stated dividend pay-out ratio of 40% of net income. Although we hold a position in Kone in the Fund, we feel that the opportunity in Otis given the investments that it has made over recent years warrants its inclusion too, and thus we retained, and increased our holding.

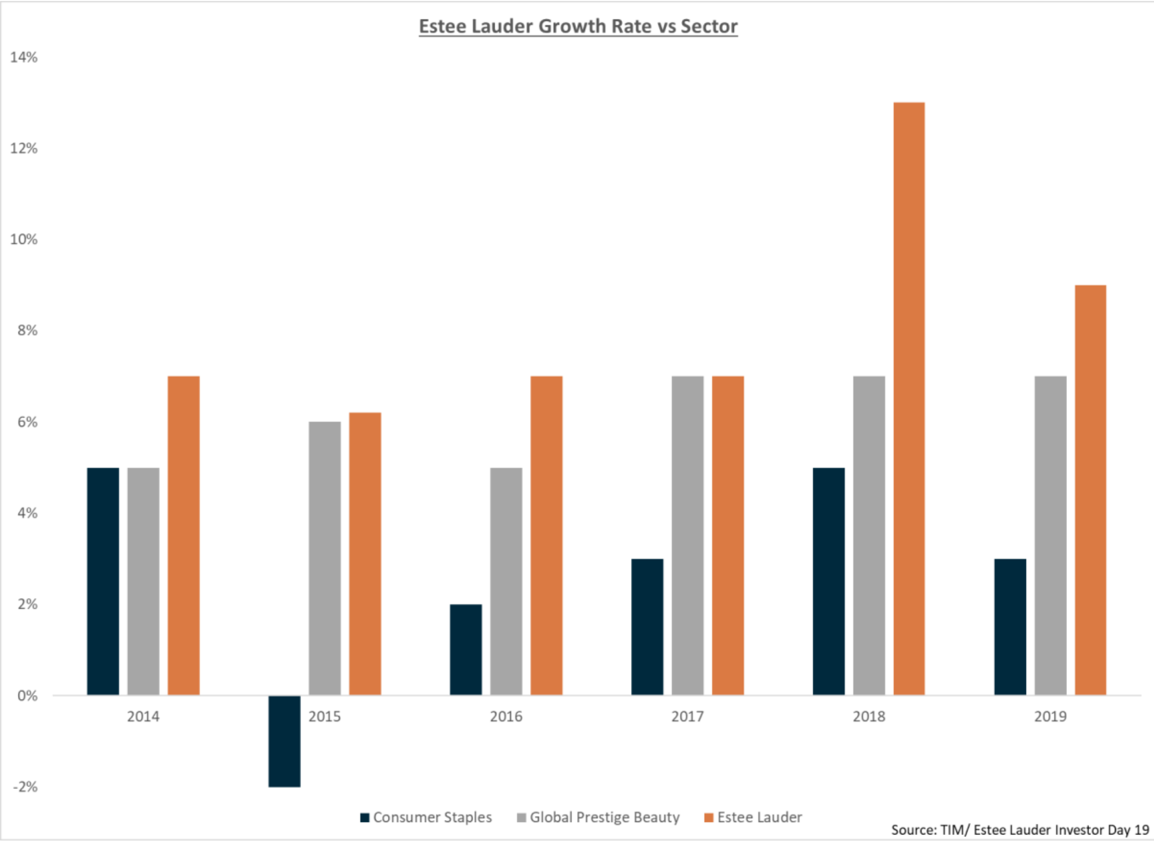
Having met with the impressive management team last year, we have been waiting for a suitable entry point to initiate a position in Estée Lauder, and the market correction provide such an opportunity this month. Although we expect COVID-19 to disrupt Estée's core operations in a significant manner due to a reduction in global travel retail and store closures. We see these issues as only transitory factors and, as we are already seeing in China, consumer spending returns in force once the restrictions are lifted. Like L'Oréal, Estee has invested heavily in its online capabilities and we expect that the company will see a significant uplift from this channel helping to offset the temporary weakness in its offline outlets; The company has registered 30% Compound Annual Growth Rate (CAGR) in ecommerce over the past 5 years and 40% of its sales in 2019 came through either this channel or travel retail.

Weight of e-commerce in the beauty market (%)



Source: L'Oréal CAGNY presentation 2020

Estée is the leading cosmetic company in prestige beauty, which is more resilient than mass beauty owing to the secular trend towards desirable brands. In the period 2009-2017 the growth in spending on prestige beauty grew 123% in China, 151% in India, 49% in Brazil and 36% in the US and continues to outgrow the growth in consumer staples by a few percentage points per year.



This is supported by the company's innovation, where the company has a best in class record, with 30% of sales from products launched in the past year. For a company with a through-the-cycle Return on Capital Employed in excess of 20% and reliable FCF generation of approximately $1.5bn per year the share price correction of 35%, implying a growth rate of less than 3% on an ongoing basis, undervalued the future value creation potential. As we believed that this provided the opportunity that we had been waiting for to invest in this exceptional company we initiated a position.

Richard Scrope, Fund Manager, VT Tyndall Global Select Fund, 30th April 2020