

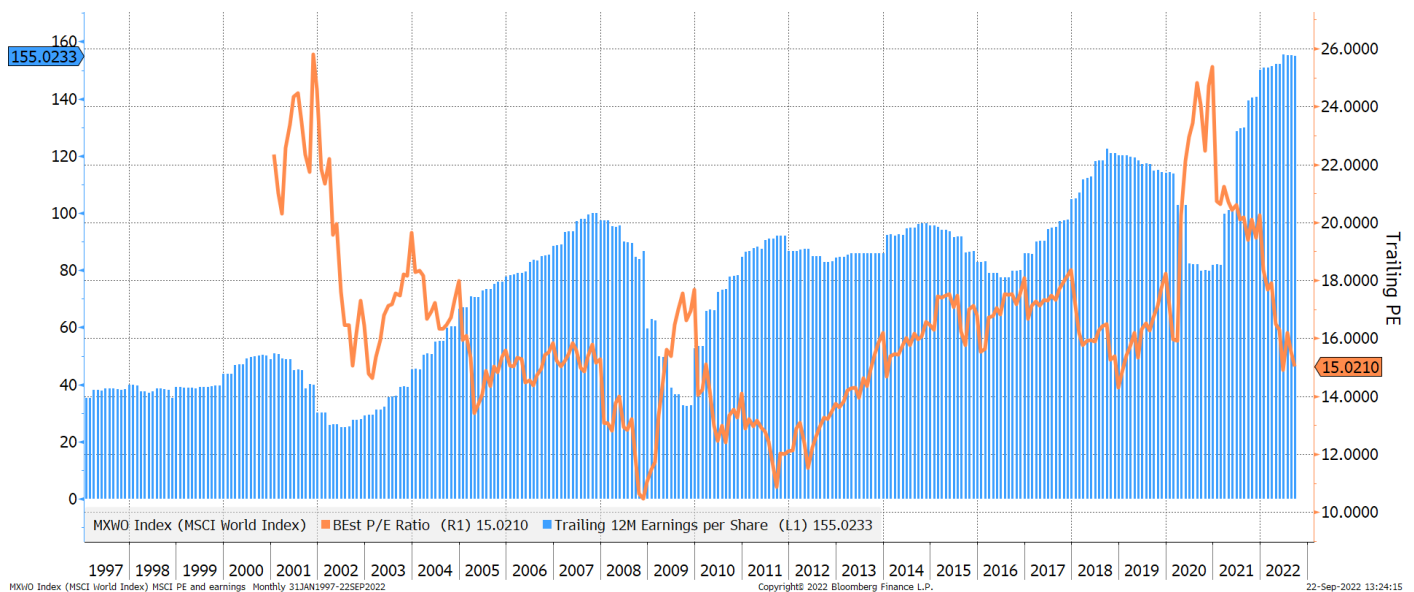


Manager's Letter 3rd Quarter 2022

Jacques Berghmans

1. Economic and Market Environment

Unfortunately, there hasn't been a significant improvement in the economic situation over the last three months and energy inflation continues to rage in the Western world and particularly in Europe. Our recent newsletters covering **investing in a high inflation environment and the importance of a global approach** continue to be very relevant today. 15 months ago, we analysed the implications of higher inflation and looked at the performance of major stock markets during the last inflation shock in the seventies¹. Since then, inflation has nearly doubled and the end of Russian natural gas delivery in Europe makes the current situation even more similar to the oil shock in the seventies. Our key recommendations at the time were **global diversification, holding enough cash but not too much** and to be prepared for **volatile times** knowing that **global stocks tend to act as a decent inflation hedge over long periods of time**. We have certainly had the volatility, and we don't expect plain sailing going forward, but global earnings have proved remarkably resilient so far. Generally, most global businesses have been able to protect their margins underpinning their earnings.



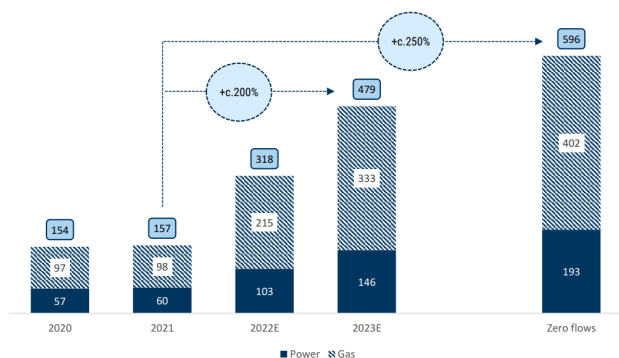
In our 1Q22² & 2Q22¹ newsletters, we focused on the importance of US stocks in global indexes and the relative resilience of the US economy. More than ever, we think that American stocks, and to a lesser extent Asian stocks, will be the key driver of global equity performance going forward. As this crisis is showing, one of the key issues of the European economy is its reliance on external countries for a significant part of its primary energy needs. As most European energy providers are in historically unstable regions (Middle East, Africa) and/or are run by autocrats (Russia, Saudi Arabia), Europe tends to be more exposed than other parts of the world to major energy shocks. Energy cost in

¹ <https://treetopprivate.be/fr/nos-publications/paroles-dexperts/la-lettre-de-jacques-berghmans-2e-trimestre-2021>

² <https://treetopprivate.be/fr/nos-publications/paroles-dexperts/la-lettre-de-jacques-berghmans-1er-trimestre-2022>

the best of times are an important part of household's and companies' budgets but can quickly become a humanitarian crisis in the worst of times. Trying to quantify the impact of the current energy crisis, the American investment bank Goldman Sachs, wrote in a September report that:

Exhibit 1: Based on current forward curves, household energy bills in Italy could reach nearly €500/month
Italian power and gas household bills evolution (€/month)



Source: Eurostat, Goldman Sachs Global Investment Research

“At current forward prices, we estimate that energy bills will peak early next year at c.€500/month for a typical European family, implying a c.200% increase vs. 2021. For Europe as a whole, this implies a c.€2 tn surge in bills, or c.15% of GDP, we estimate.”

Closer to home, the Belgian economist Bruno Colmant estimated that higher gas & electricity prices in Belgium could lead to 40% of Belgian households having no discretionary income left³. Beyond household poverty, very high energy prices also threaten the long-term economic potential of countries and even food security. Industrial production and farming/food production requires a lot of energy. A recent article in the French

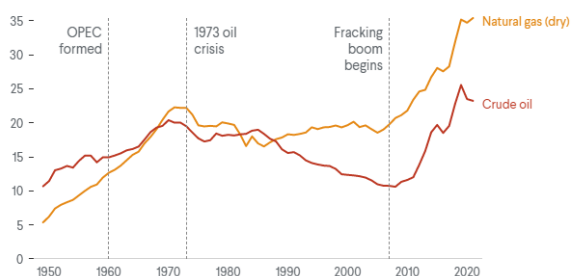
newspaper Capital.fr noticed that bread prices in Europe recently increased between 8% year on year (y/y) and over 60% y/y in Hungary!⁴ A number of European steel plants, which are also energy intensive, had to shut down in recent months leading to an overall y/y production decline of 6.7% in July 2022⁵

There are short- & long-term solutions to these problems but, before exploring those, it is interesting to understand what made the European situation so precarious and how the two other industrial superpowers, the USA and China, managed to be in a much better situation. The U.S. Energy Information Administration collects statistics on primary energy consumption/production (or energy in its raw form like coal, gas & renewables) across most major economies in the world and the numbers speak volumes.

	Energy Production (qBtu)	Consumption (qBtu)	Self-sufficiency ratio	Per capita cons. (million Btu)	Natural Gas Cons. (% total/qBtu)
United States	101.4	100.5	100%	304	32.2 (32%)
China	123.8	151.8	82%	107	11.3 (7%)
France	5.1	10.1	50%	151	1.6 (16%)
Germany	4.4	13.4	33%	161	3.5 (26%)
Belgium	0.6	2.7	22%	234	0.6 (22%)
Japan	2.3	18.7	12%	147	4.1 (22%)

Source: EIA, 2019 figures, TreeTop calculations

U.S. Oil and Gas Production Soared With Fracking
Annual production, quadrillion British thermal units (Btu)



Source: U.S. Energy Information Administration.

COUNCIL OF FOREIGN RELATIONS

As we can see in the table above, the American economy, while highly energy intensive with the highest energy consumption per capita, is also the only major industrial economy that can cover its energy needs. It hasn't always been the case and a major reason behind the self-sufficiency is the oil & gas shale boom over the last 15 years, making the country the biggest oil & gas producer in the world today⁶. When it comes to hydro-carbon production, freewheeling capitalism and a culture of wildcatters certainly helps.

Interestingly though, the United States has also seen a boom in renewable energy, with renewable electricity generation making

³ <https://www.lecho.be/dossiers/crise-energetique/bientot-40-des-belges-sous-le-seuil-de-pauvrete-selon-bruno-colmant-vraiment/10411613.html>

⁴ <https://sustainability.emory.edu/wp-content/uploads/2018/02/InfoSheet-Energy26FoodProduction.pdf>

⁵ <https://gmk.center/en/infographic/eu-decreased-steel-production-by-6-7-y-y-in-july-2022/>

⁶ <https://www.cfr.org/backgrounder/how-us-oil-and-gas-industry-works>

up 21% of total electricity production in 2021 from 13.4% in 2014⁷. Even the very conservative Texas has seen a boom in wind and solar electricity generation.⁸

China, unlike its American rival is more exposed to external energy shocks and very reliant on carbon intensive coal. At the same time, the country is also a champion of nuclear energy and renewable investments. Unlike the US, where the free market is paramount, China has more of a command economy with long term energy goals, combined with a pragmatic investment approach, which tends to under-promise but overdeliver in large infrastructure projects. In its last five year plan, the country's Politburo clearly stated that:

“China plans to reach its CO2 emissions peak by 2030 and to reach carbon neutrality by 2060. As part of this goal, plans include increasing the share of non-fossil fuels in primary energy consumption to 25% and to bring the total installed wind and solar capacity to 1,200 GW by 2025. However, China’s 14th Five-Year Plan considers coal a necessary energy source for the next several years for energy security and economic efficiency.”

A strong-willed government does not mean there is no room for private enterprises. A key success factor in China's ability to achieve its goals is the existence of a very dynamic private sector. China has two of the largest battery makers, **BYD** and **CATL**, has over 80% of the solar panel supply chain⁹ and a number of companies active in key elements of the green supply chain like rare earth materials. For those interested to learn more about China's green energy transition, I recommend watching the following video issued by Bloomberg, which gives an excellent overview of the scale of green investments in China (<https://www.youtube.com/watch?v=b1LQSezKxnA>). For those in a hurry, the two key figures to remember are that China plans to build 150 new nuclear plants by 2037, or more than the world built between 1987 & 2022, and wants to have 1.2TW of solar & wind capacity by 2030, enough to meet today's US demand of electricity.

Unfortunately, Europe appears to have suffered from a dramatic blind-spot in recent years, shutting down its traditional power generation units - mainly coal and nuclear - and replacing them with gas-fired powerplants, mostly supplied by Russian gas and renewables. Fortunately though, gas power plants account for only a fraction of the electricity generated in Europe, which according to the American bank Goldman Sachs creates an opportunity for a near-term solution:

“(…) we noted that the main critique of the current system is that gas plants, which currently produce c.25% of the electricity needed, set prices c.75% of the time. Moving away from “marginal pricing” and towards a system based on ‘weighted average’ prices could lower current forward curves from c.€500/MWh to €210/MWh, a c.55% reduction. If we were to increase the share of RES production in the system to 75% (consistent with the REPowerEU plan), we estimate that power prices would drop further, to c.€140/MWh (a c.70% reduction) using this weighted average approach.

France has already moved in that direction, capping electricity prices and vastly limiting inflation as a consequence. This is no miracle solution though and countries like Germany with more gas-fired power capacity won't be able to take this measure. The analyst at Goldman Sachs also notices that most of the higher bills for EU households will not come from higher electricity prices, but from higher gas costs used to heat homes and water. The same problem exists for companies relying on gas as a chemical and/or energy input. There is probably no short-term solution there, except lowering the temperature of buildings and scrambling for alternative gas supplies from the Middle East and the United States. In the long term, most analysts think that European countries will need to improve the thermal efficiency of houses as the European Union itself claims that European buildings are responsible for 40% of the bloc's energy consumption and 36% of greenhouse gas emissions. Some countries have been more successful than others; the Baltic countries, for example, are successfully renovating their Soviet housing blocs with the help of European institutions and reducing household energy consumption by up to 80%¹⁰. We will also need to massively invest in renewables,

⁷ <https://www.eia.gov/energyexplained/electricity/electricity-in-the-us-generation-capacity-and-sales.php>

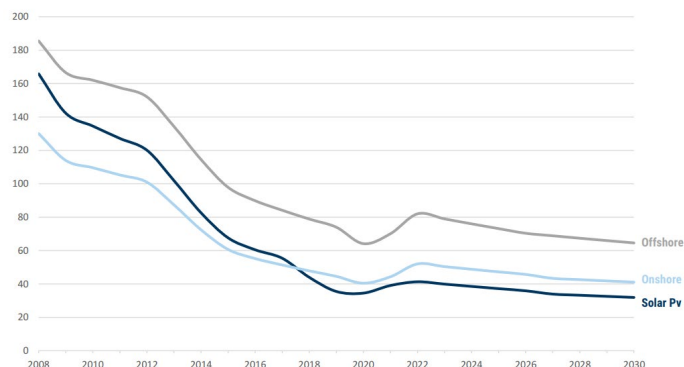
⁸ <https://www.youtube.com/watch?v=jfcbYwn8okY>

⁹ <https://www.iea.org/news/the-world-needs-more-diverse-solar-panel-supply-chains-to-ensure-a-secure-transition-to-net-zero-emissions>

¹⁰ <https://www.bloomberg.com/news/articles/2022-09-21/why-lithuania-leads-europe-in-mobilizing-green-building-retrofits?srnd=premium-europe>

especially if we want to decarbonize transport, which mostly relies on oil right now. Luckily, Europe has a strong expertise in onshore and offshore wind power generation and good engineering capabilities in high voltage electric grids. As we can see on the graph below, renewables cost has come down dramatically in recent years, partially thanks to China. The good thing with solar panels is that even if the relationship between the West and China turns ugly, which we hope not, solar panels, unlike gas supply, cannot be turned off.

Exhibit 37: The cost of renewable generation has decreased by c.60%-80% since 2008
Wind and solar LCOEs (€/MWh)



Nuclear power has a number of advantages, the main ones being a low carbon footprint and its ability to generate a lot of electricity in any weather and using very little space. Key issues are the major consequences of accidents and very toxic long-lasting waste. A debate about nuclear power is beyond the scope of this newsletter, but we just want to point out that nuclear power is anything but a silver bullet. Extending the lifetime of existing plants, if done safely, is certainly an attractive proposition in the short/medium term, but we will need to eventually build new power plants. Another problem in Europe is that we seem to have lost the ability to build nuclear power plants on time and on budget. In recent years, EDF & Areva, the only remaining companies trying to build nuclear power plants in Western Europe started three new projects, one in Finland, one in France and one in China. The projects in Finland and France faced very long delays and extreme budget overruns and basically bankrupted Areva, which had to be bailed out by the French state. Tellingly, the only successful project was the power plant in China.

In conclusion, the energy crunch in Europe is here to stay and it will impact households, companies and ultimately our investments. Cheap and plentiful energy has been the bedrock of development since the industrial revolution and the lack of it creates deep economic problems. On a more positive note, a short-term crisis can become a long-term opportunity if the right decisions are taken. As we have seen with COVID vaccines and treatment, some major scientific progress can materialize in years instead of decades when there is strong political will. Europe could become a leader in frugal innovation and the circular economy. Mercedes already has one of the most efficient electric cars¹¹, French architects won the Pritzker prize (Nobel prize of architecture) for renovating social housing at low cost and making them much more energy efficient¹² and recycled plastic could become an important feedstock for the industry instead of cheap natural gas¹³. In the meantime, at TreeTop, we will continue to have a global approach to investments looking for companies and indices that are protected from the worst of the European energy crisis and/or with business models offering solutions¹⁴ to this energy crunch.

¹¹ <https://electrek.co/2022/06/23/mercedes-benz-ultra-efficient-vision-eqxx-electric-car-traveled-750-miles-1200-km-range/>

¹² <https://www.pritzkerprize.com/laureates/anne-lacaton-and-jean-philippe-vassal>

¹³ <https://www.nweurope.eu/projects/project-search/transform-ce-transforming-single-use-plastic-waste-into-additive-manufacturing-and-intrusion-extrusion-moulding-feedstocks-and-creating-a-new-circular-economy-model-for-nwe/>

¹⁴ No guarantee of results or performance

2. Our convictions

While the beginning of the year was generally positive for our strategy, with a number of our investments outperforming the market, the recent three months have been harsher, with our strategy generally performing in line with the poor performance of the overall market. Very few asset classes had positive performance this year and most economies performed poorly, be it Europe suffering from the energy crisis, China suffering from repetitive COVID lockdowns and a real estate crisis or the US economy affected by rising rates and high inflation. Some of our major investments held up very well during the quarter like **FUFENG**, but nothing performed sufficiently well to compensate for losses elsewhere. The poor performance of most stocks resulted in a major divergence between the company's financial fundamentals and their stock performance. **FUFENG** for example, a leading producer of amino acids based in China and a very large investment for us, released incredibly good results but the stock was down on the day despite the outstanding operational performance. The stock now trades just on 2x price/earnings with a 15% dividend yield, a valuation level lower than we have ever really come across before.

As we have explained in our two recent newsletters, we adjusted our strategy over the last 18 months to increase our exposure to large American value stocks, which had underperformed their high growth tech counterparts. We used the **DOGS of the DOW methodology**, which consists of buying the 10 Dow Jones stocks with the highest dividend yield and adjusting the positions annually. It gave us exposure to large pharmaceutical companies (**MERCK**, large chemical businesses (**3M**, **DOW**), some oil exposure (**CHEVRON**), a number of large consumer names (**WALGREENS BOOTS**), and large IT/telco businesses (**INTEL**, **VERIZON**, **CISCO SYSTEMS** and **IBM**). Overall this strategy, while still down in recent months, clearly outperformed the overall market.

We continue to hold a number of entrepreneurial, mid-sized businesses in our strategy with a number of them being based in Asia. Some of these investments, like **UPLL**, a leading herbicide and pesticide company in India, are doing much better than the market. However, most of these investments haven't done very well this year. Mid-sized companies, especially if they have any supposedly cyclical components, tend to sell off aggressively at the mention of a potential recession. For instance, two UK-listed companies, **IWG** and **ASHTEAD**, have seen their stocks perform very poorly so far this year. This is somewhat surprising to us, as these two companies continue to deliver good results and should benefit from the very strong dollar as most of their businesses are in the United States. **ASHTEAD**, a leading rental equipment company has seen its market value drop from USD28bn at the end of 2021 to USD18bn today, despite higher profit and revenue per share. We think that American companies and the US government will continue to invest more in the next decade, which should ultimately benefit **ASHTEAD**. **IWG** (ex-REGUS), the owner of the largest network of serviced offices in the world, is another company that we think has been unfairly penalized in this downturn. While the Company suffered from the absence of employees going to offices during COVID lockdowns, business is now recovering quickly, and the pandemic has likely boosted the demand for hybrid office solutions which **IWG** offers. The stock trades on 10x forward PE and its USD1.4bn market cap is a fraction of the Company's peak market capitalization of USD5bn in 2019.

Finally, most positions in China didn't escape the heavy sell-down in recent months. We recognize that China is facing some of its biggest problems in recent decades with COVID lockdowns and a real estate crisis. However, the country continues to have a very educated and entrepreneurial population and is likely to see the emergence of very big businesses in the years to come. Most stocks trade on low valuation multiples, **MAN WAH**, a leading luxury sofa brand, trades on 6.6x forward PE, **VIPSHOP HOLDING**, the largest online apparel discounter, trades on 7x forward PE and **CHINASOFT**, a leading IT outsourcer, trades on 9.6x forward PE. We think that any reversal of sentiment could quickly lead to a re-rating of these stocks.

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