Kairos' Federico Riggio: Shooting the Lights Out

Tomorrow's Titans 2010-2016: Revisited

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The Hedge Fund Journal has been aware of Federico Riggio's fund management prowess for nearly ten years, initially during his co-management of top performing Italian equity long/short strategies at Kairos. The precocious analyst was thrown in at the deep end, becoming a co-portfolio manager just a year after he joined Kairos in 2009 – straight after graduating. Riggio, who is now CIO of KIM Ltd. Single Manager Funds and the manager of the Pegasus strategy, first appeared in *THFJ* in 2014, when he featured in our biennial 'Tomorrow's Titans' survey of rising star hedge fund managers, in association with EY.

Kairos Group, which was set up 18 years ago in the early days of the hedge fund industry in Europe, is one of the leading alternative investment managers in Europe, now running around €11 billion in different absolute return products. The firm has a solid and stable investor base made of high net worth individuals and family offices primarily in Europe and Asia, but over time has developed strong relationship with various sophisticated institutional investors, among which are one of the largest sovereign wealth funds in the world, one of the biggest Asian asset managers, two of the largest insurance groups in Europe and several pension funds and foundations. Riggio's Pegasus strategy manages more than €1.5 billion and generated a stellar 52.99% return during its maiden year of 2014. The stellar returns were generated through a variety of winning trades, some of which were reviewed in our 2015 profile: for instance an Italian non-life insurers trading below book value; Fiat's spinoff of Ferrari and a takeover bid for Vienna Airport. This year Riggio is back on track to repeat such an amazing result despite the significant growth in AUM of the fund from the initial internal seed of around €40 million from the Kairos' partners.

After four years and significant growth in AUM, Riggio, overseen by Kairos CIO Guido Brera and assisted by six experienced senior sector specialists (Pietro Ajello, Oriana Bastianelli, Michele Fiumara, David Grazzini, and Vittorio Villa) continues to generate exceptional returns. The flagship strategy has advanced by more than 150% since inception in January 2014, which is well ahead of its stated target of 12-15% and most of his peers. Even more interestingly, Pegasus has shown correlation to equity indices of only between 0.3 and 0.4, which is explained partly from its idiosyncratic catalyst-driven trades, which tend to have a beta much lower than market indices, but also from its net long exposure limited to around 50-60% and the ability of the team to generate performance on the short side.

Volatility has been comparable to the Euro Stoxx 50 index, but crucially the return pattern is very much skewed to the upside: the maximum drawdown seen in Pegasus of 9.16% is less than half the 22.52% incurred by the Euro Stoxx 50, and the fund always recovered losses much faster than the markets. Also over the medium term his upside/downside capture has been incredible both in absolute terms and also if compared to the HFRX index.

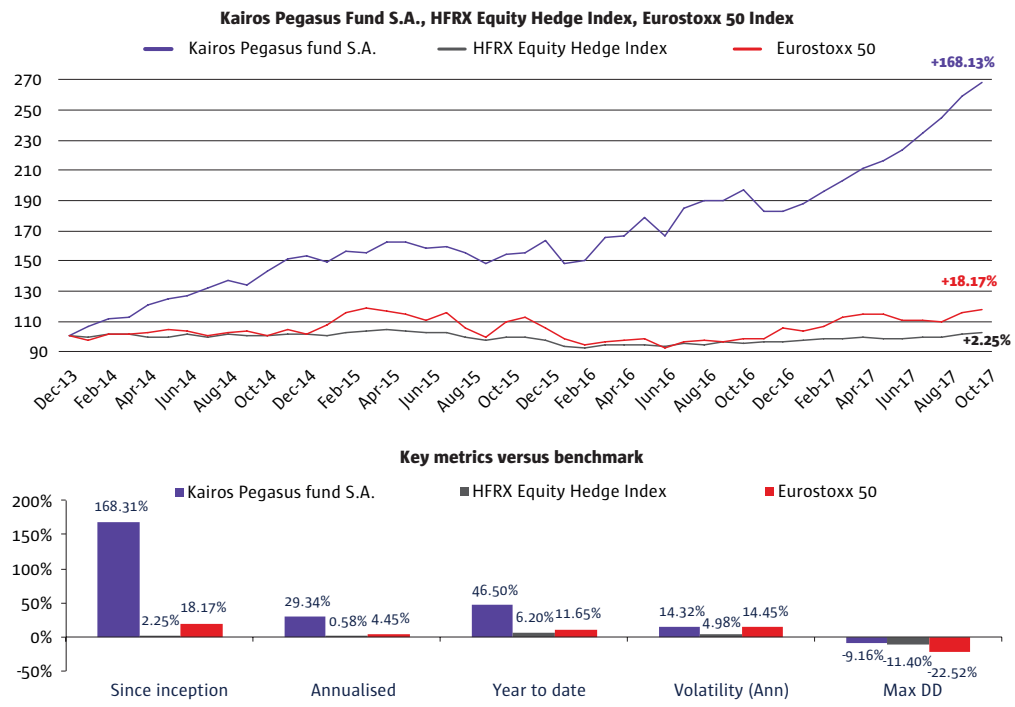
Pegasus investments can be inspired by hard or soft events including M&A, restructurings, IPOs, spin offs, rights issues and index rebalancing, or simply by anticipating earnings surprises.

Pegasus runs a concentrated book of 5-15 themes expressed through 30 stocks. We touch on four core portfolio holdings and themes within Europe, including Southern Europe; two idiosyncratic trades outside Europe; and the short book, which is to some extent on the backburner.

Porsche and VW

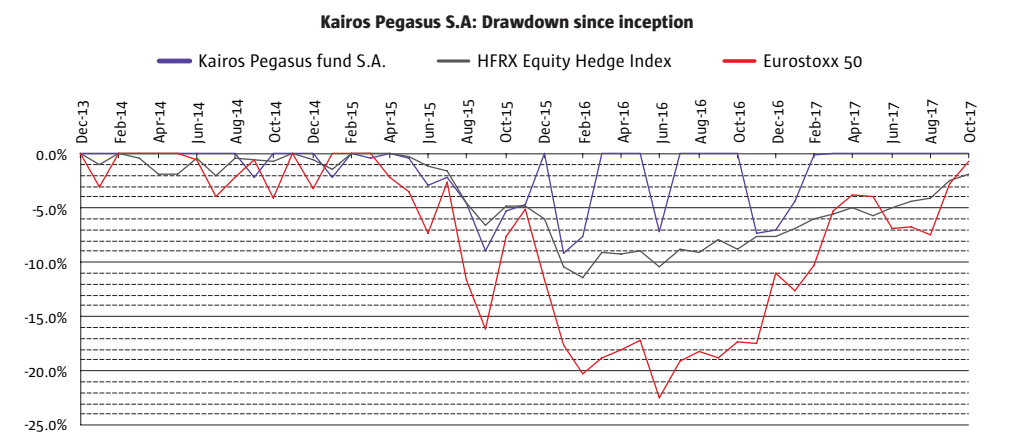
This combination is the largest position and illustrates the philosophy underlying the Pegasus strategy. "We look for dislocated situations that

Fig.1 Kairos Pegasus Fund S.A. performance *Source: Bloomberg, Kairos estimates.*



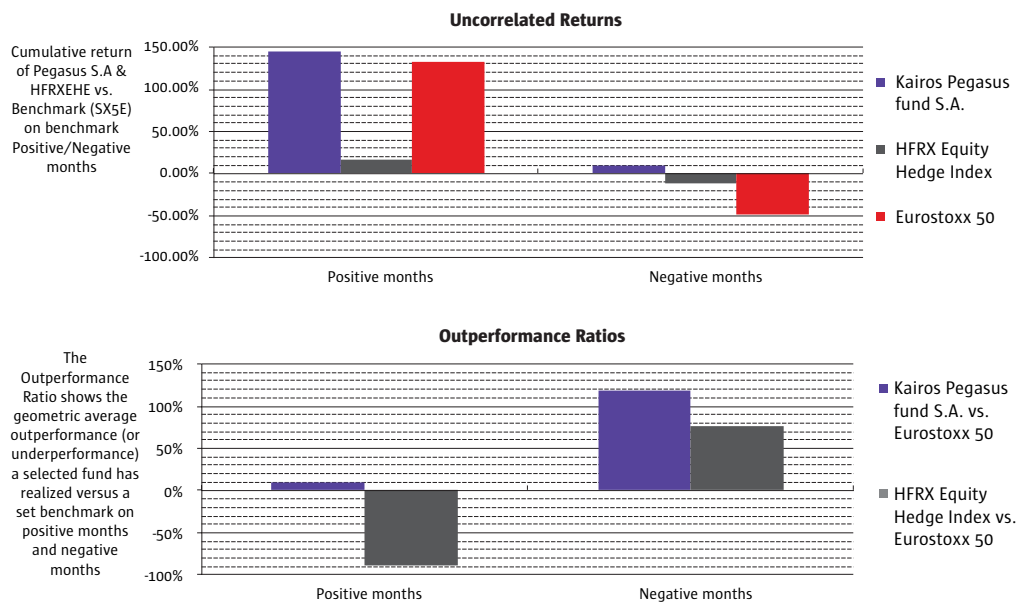
Data: monthly, from inception (January 1, 2014) to October 31, 2017 . Past performance should not be taken as a guide to future returns.

Fig.2 Kairos Pegasus Fund S.A. performance (continued) *Source: Bloomberg*



Data: monthly, from inception (January 1, 2014) to the 31st of October, 2017. Past performance should not be taken as a guide to future returns

Fig.3 Kairos Pegasus Fund S.A. performance (continued) *Source: Bloomberg*



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give us the opportunity to buy good assets at distressed prices that do not discount the quality of the business," says Riggio, who sees a sea change in the VW business model. "Even before 'Dieselgate' VW was a value trap. It was cheap on a PE basis but had very low cash conversion of net profit due to a huge amount of capitalised R&D and depreciation expense that ate up half of net profit." Ironically, Dieselgate is arguably a blessing in disguise that "has galvanized VW into negotiating better terms with trade unions and reducing its capex and R&D to 6%. This will allow for much higher cash conversion than in the past," explains Riggio. "The market was very quick to price in the negative NPV of the diesel scandal but not nearly as quick to price the positive NPV of restructuring. We think VW's 2018 and 2019 numbers will be high, and better than expected, and may already achieve what is targeted by 2020."

Opinions differ over whether VW's margins are at mid-cycle or peak-cycle levels. VW's headline margin figure is of course a weighted average across multiple brands and geographies. Starting with brands, though VW may be perceived as a mass market manufacturer, it occupies a premium segment within that market. Riggio points out that "most of the profit comes from the premium brands of Audi and Porsche, and from trucks. And VW trades at a big discount to Daimler and BMW." Moving to geographies, Riggio acknowledges that VW's margins in China may come down, but points out that Brazil and Russia are loss-making, while the US could improve margins from SUV sales. All in all, Riggio appraises VW's 7% margin as being mid-cycle and is perplexed by the much higher valuation multiples ascribed to auto suppliers. Though component makers are less capital intensive, Riggio is researching the space as a potential hedge for long auto exposure.

Tesla: a valuation short

In contrast, the short position in Tesla is an outright short (held by a number of other hedge fund managers, such as David Einhorn's Greenlight and Alex Roepers' Atlantic). Riggio freely admits that the position has cost money so far (although more than compensated by long positions in the same sector). Losses have been contained by actively trading around the position. Riggio heeds market technical as well as fundamentals. He will not let it grow bigger than 5% of NAV, and has therefore been regularly covering part of the short as it appreciated. This is clearly a momentum stock and the PM is certainly aware of its danger. Riggio's goal, as in general with his short positions, is to resize and press the position when the story is broken in order to maintain its size on what he expects will be the way down. "I sense that we are close to that inflexion point," he commented.

"The market capitalisation is attached to the perception that Tesla is unique in the disruptive electrification trade. From an investment universe angle, it is indeed unique in being the only liquid large capitalisation stock available to thematic investors. But from a competitive perspective, it is far from unique as much competition is coming in premium EVs. When 20 competitors exist for model X and model S – and they are better built – we will see a real decline. For instance, Porsche has a new electric vehicle, Mission E, coming soon. And other manufacturers have scale, production expertise, customer service, and distribution that Tesla lacks. No structural barrier to entry or competitive advantage makes Tesla unique. It may be expensive for other OEMs to develop EVs but Tesla cannot profit from the investment being made by others," says Riggio.

Riggio reckons Tesla's valuation of $60 billion is priced for perfection, particularly since it may need to raise cash again in 2018. He judges that Tesla's share price is already in effect an 'exit price' valuation assuming that story goes to plan. Today's valuation should instead be a net present value allowing for billions of cash outflows in additional investment, and of course a risk premium if there are mishaps or delays along the way.

Other shorts

Tesla is not in fact typical of the Pegasus short book, which has lost very little overall. Other shorts are not egregiously expensive but rather face shorter term headwinds. Riggio thinks that oil refining margins are near a cyclical peak and therefore expects Finland's Neste Oil could see its valuation multiple contract. He is well aware that Pegasus has shorted a number of cyclicals, including Neste Oil, too early.

Conversely, profitable shorts have included Spanish utilities focused on the supply business where margins were being squeezed. Pegasus has also been short of banks ahead of capital raises.

So strong is the momentum behind some potential short candidates that Riggio, capitalising on lessons learnt during the last few years, has refrained from shorting them and is instead using indexes and futures for now. Once he feels that popular equity trades are losing momentum, and investors are no longer prepared to countenance further multiple expansion, Riggio expects to resume more single stock shorts.

Riggio has no problem to admit that "market valuations are less attractive than they were 24 or even 12 months ago," so he doubts that returns in 2018 will match those in 2017. However he is not ready to reduce his gross or net exposure, but has instead switched capital away from more leveraged and aggressive business models. Nonetheless, Riggio is still confident in the potential of his long book.

German commercial property

After the Porsche/VW combination, German commercial property is the next largest theme. Riggio judges the commercial property market to be fairly valued or even more so, due to yield chasing. Nonetheless, he sees strong scope in both rent increases and multiple expansion. Riggio expects "reversionary" potential – for rents to increase by at least 2% per year in the commercial sector, which is more or less an open market (political obstacles do exist to raising rents in the residential space, where Pegasus has very little exposure). Property stocks can be quite interest rate sensitive, at least in the near term, but Riggio argues that if Eurozone rates rise due to inflation – which is already picking up in Germany – that would make it easier to raise rents. Riggio also expects that the FFO ('Funds From Operations') rate – essentially the discount rate or capitalisation rate used to value property – could come down from 8% to 6.5%, implying multiple expansion from 12 to 15 times.

Italian multi-utility consolidation

One of Pegasus's top performers has been multi-utility Iren. Riggio likes the growth story, which has seen earnings beat expectations, and the valuation, which has expanded. Iren is part of a broader portfolio theme of consolidation amongst smaller local utilities in Italy. The country has over 300 companies, which are being combined by aggregators.

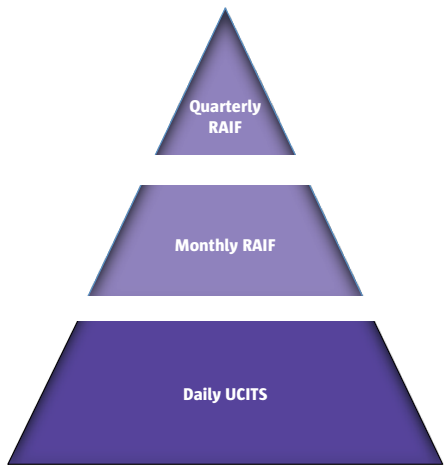
Most of Iren's earnings are regulated or semi-regulated, and Iren is one of several positions in Pegasus that overlap with those in the Kairos Equity Yield (KEY) fund. The daily-dealing UCITS won *The Hedge Fund Journal's* 2016 UCITS Hedge award for 'Best Performer Over 2 Years' (2014 and 2015), in the category of Long/Short Equity- Regulated Utility Sector Specialist.

Italian banks

Riggio and the Pegasus strategy have a long history of trading Italian and Spanish banks' equity from long and short sides. Pegasus can also opportunistically invest in fixed income. Most recently Pegasus bought into financial paper that benefited from the Italian government's choice of insolvency regime – but would have also performed well under other scenarios that Kairos used as stress tests for the investment (not to be confused with the European Banking Authority's stress tests for European banks!). Similarly to the interaction with the manager of KEY, Federico can also tap into other experienced teams in Kairos, particularly the one focused on Italian equities and the one investing in European Fixed Income, exploiting the synergies of the 35+ Kairos' investment professional team located between London and Milan.

A Luxembourg UCITS and RAIF structure: the best of both worlds?

Fig.4 A safe co-existence between the RAIF and UCITS vehicle



Quarterly dealing share classes – RAIF
- Quarterly dealing with staggered redemptions of max 25% per calendar quarter, with two months notice.
- 5/12/70 self-imposed concentration limits
- AUM at 02.11.17 was €16.8m, open to subscriptions with target capacity of €250m
- 1.0% management fee and 15% performance fee

Monthly dealing share classes – RAIF
- Monthly liquidity with one calendar months notice for redemptions
- 5/12/70 self-imposed concentration limits
- AUM at 02.11.17 was €262.2m. Soft closed.
- 1.5% management fee and 20% performance fee

Daily dealing vehicle – UCITS
- Daily liquidity
- 5/10/40 regulatory concentration limits
- Retail share classes closed to all subscriptions; institutional share classes are soft closed, redemptions can be replaced with subscriptions subject to approval
- AUM as at 31.10.17 was €1.31bn
- 1.5% management fee and 20% performance fee

Kairos Pegasus provides an interesting case study in reconciling the preferences and interests of different investor groups for liquidity and investment freedom.

Kairos has on 30 June 2017, re-domiciled, and converted by continuation, Pegasus from the Cayman Islands to a Luxembourg RAIF (Reserve Alternative Investment Fund) largely for marketing purposes, as the Cayman fund was proving hard to market since some allocators are unable to invest in offshore vehicles. Some investors were also concerned about potential for liquidity mismatches between the UCITS and the Cayman vehicle, which was not investible by some of those in the UCITS.

This investor feedback has been addressed through a three share class structure whereby each share class has predefined criteria for liquidity (and concentration) and different fees. Now, professional investors have been able to choose amongst three share classes (though as of November 2017, only the quarterly dealing RAIF remains open with the daily class of UCITS and the monthly dealing class of RAIF both soft closed, i.e. replacing redemptions with subscriptions, subject to approval).

The UCITS is less volatile, and has smaller gross and net exposure ranges, with the RAIF typically running 30-40% higher gross exposure. Some positions are simply sized smaller in the UCITS, which has 9.5% in Porsche against 12% for the RAIF. Italian financials paper has also been sized smaller in the UCITS and it is in fact very rare for positions in the RAIF to be excluded from the UCITS. But some positions in the RAIF are completely off limits for the UCITS, primarily driven by liquidity matching requirements. The risk team supervises the liquidity requirements and monitor the matching of asset and liabilities for the different funds. An example is the Italian small cap apparel firm BasicNet, which has brands including Kappa and Superga shoes, and has a market capitalisation of around €200 million. It is important to stress that it is not only the market cap per se, but rather the liquidity that is the deciding factor. A €4 million rights issue from Spanish media group Prisa was not liquid enough for the UCITS as daily trading volumes averaged only around €100,000 – 500,000. Two dedicated traders (Flavio Russo and Mereme Kupe) and three risk managers (Andrea Panzeri, Stefano Ceccato and Alessandro Veca) help Riggio to assess the liquidity of the positions.

The quarterly liquidity RAIF share class, with a 25% gate offers lower fees (of 1% and 15%) and has the most investment flexibility, but it does not have unfettered freedom as Kairos has self-imposed diversification criteria. Both the monthly and the quarterly RAIF share classes have diversification limits of 5/12/70, allowing for larger position sizes than the UCITS which has the standard 5/10/40. "Our concentration limits are a good discipline so we cannot become overstretched in terms of what we do. The limits encourage me and the team to be disciplined when taking positions above 5%, as they go into the 70% bucket. This creates healthy competition for capital since we can only build a new position of large size by substituting something else. There has to be a really compelling case to go over 5%. We feel this is the correct framework that we feel very comfortable accepting.


Federico Riggio

Turkish gold

Western Europe is Kairos's main focus, but Riggio searches for value in unexpected places such as Turkey (where Istanbul is said to divide Europe and Asia). He has been following Kozal Gold for some years, visiting the mines and getting to know the previous management well. Kozal has remarkably low costs of around $500 per ounce and, rather like South African miners, costs in local currency and revenues in hard currency mean that it benefits from the ever-weaker Turkish Lira, which just made another new all-time low in November. Riggio's first excursion into the stock was in 2014, but he sold out in 2015 after a clash between the Government and the owner, who is a political opponent of Erdogan, who revoked some mining licenses. The situation has deteriorated further for the owner, as his majority stake has been nationalised. In what is a rather unique situation, Riggio saw value in becoming a minority shareholder of what is now a state-owned company – but only after getting comfort on many important details. "We only increased the position to 3-4% when we had visibility on the process, following a legal and fiscal investigation, and fines levied on the owner. Since the situation became clear, the stock has seen a massive re-rating, yet it still trades on only four times cashflow, and has net cash." Elsewhere in Eastern Europe, Riggio views Russian airline Aeroflot as a cheap stock.

Chinese cables

Further afield, Riggio has opportunistically invested in a Chinese company – but one with strong European connections. Yangtze was a hidden gem within Italian group Prysmian, which owns 40% of it. Yangtze was like a neglected orphan, with its potential for growth from fibre optic rollouts in China largely unrecognised by patchy and superficial sell side coverage. Riggio put one of his junior analysts to work on the case for five months and realised that the company was going to shoot the lights out versus consensus estimates. Pegasus has now taken profits on the Yangtze trade.

After showing that the exceptional performance recorded in its first year was repeatable with a bigger AUM, Riggio is already thinking ahead. "The job of a PM unfortunately is similar to the one of a football manager, every year you start fresh and you need to reset any past success. Investors don't judge you on your past performance, but on what you are delivering to them in that particular time. There is no time for celebration, you need to stay focus and challenge yourself every day," says Riggio. He also praised his team: "I feel blessed to have the support of a group of seasoned analysts who have been in the firm for at least 10 years and have a range of 12-18 years of experience covering European equities. Especially when I face the daily stress of the markets and we incur periods of volatility having the support of trusted and tested partners is simply priceless." **THFJ**