COMMENTARY

October 27, 2017

Dear clients and colleagues,

This week, Spanish Prime Minister Mariano Rajoy announced that he was invoking a clause of the Spanish constitution which allows the federal government to give binding orders to regional governments that have been acting outside the law.

Prior to the legally debated October 1 referendum, the most recent survey (July 2017) by the Catalan government's Center for Opinion Studies (CEO) showed that 35% of Catalans supported independence, down from the 49% peak in 2013. The survey's most important number was 69%, which represents the percentage of individuals in Catalonia that identify with both Catalonia and Spain. Mr. Rajoy did exactly what the opposition wanted, which was to polarize the undecided (or 34%) of this demographic. In the event of a second referendum, only half of these undecided voters need to be swayed to the independence side as just 52% of the population is needed for Catalonia to secede.

With the potential for social unrest in the region, Catalan tourism has fallen 15% and could fall by as much as 30% if the situation worsens. Tourism accounts for 12% of Catalan GDP. Our direct exposure to Spanish tourism is through Melia Hotels International (SM:MEL). Melia is the world's leading resort hotel company and the third largest hotel group in Europe. Its portfolio consists of 380 hotels worldwide, and only eight of these properties, or less than 3%, are in Catalonia. Reservations at these Catalonian properties fell by 4% after the October 1 referendum.

Politicians are continuously polarizing citizens on highly sensitive issues (protectionism, culture, governance, etc.), but recently the strategy has been more effective. Examples can be seen in the US, the UK, Italy and Spain, and we could add many other countries to the list, including Hungary, India, Turkey and the Philippines.

As its 2018 elections near, Italy has started to show signs of heightened political risk. Strategic polarization appears in Lombardi and Veneto as these wealthy regions are now demanding more autonomy. Although regional independence seems to be off the table for now, the idea of Italy exiting the Euro may not be. This is a story to be followed closely during the unveiling of the election platforms which promise to be full of sagas with alliances and subplots.

In the UK, Brexit is advancing. A no-deal Brexit would be the worst case scenario for the UK as economic trade would slow down under grey or old trading guidelines. The UK economy remains below 2014 growth levels of 0.9%, with third quarter 2017 growth at 0.3%.

In central London, real estate prices have fallen from their high levels, retracting by as much as 4.3% in areas such as Westminster. The recent lull in London's luxury housing market may be an indicator of Brexit jitters, but it's certainly not the entire story. The underlying demographics for the UK remain favourable despite rising inflation and Brexit uncertainties. Immigration is helping to fuel demand for affordable housing in London and the surrounding areas and the undersupply of single family dwellings continues. Programs to encourage the construction of homes in London's suburbs continue to thrive. A total of £3.7bn will be spent to address London's housing crisis, with the aim of building an additional 140,000 homes by 2021.

Global Alpha has initiated a position in UK-based Urban&Civic (LN:UANC), the largest land developer and master planner in the London suburbs. UANC has an inventory of 14,000 approved building plots for a potential total EBITDA stream of £800M over the next several years.

Urban&Civic typically acquires large plots of land from governmental agencies through planning proposals that include housing, schools, civic and commercial areas. Their brand and reputation has allowed them to acquire key plots of land in the London suburbs near train stations and other amenities. The company's business model is fairly de-risked with over 1,400 lots pre-sold to major construction companies in the area.

Turning back to the US, President Trump remains effective at creating polarizing debates on many fronts: on the international stage with North Korea and locally at football games. Other key US topics we are monitoring include tax reform, Affordable Care Act reform and tariffs, three areas where government intervention will have a tangible effect on corporations.

For the most part, Global Alpha invests in the higher profitable spectrum of companies where taxation is at its highest. Our portfolio companies track on average 2x the operational margins of their reference indexes. Also, compared to their large cap peers, small cap companies are usually more focused on growing their business than on saving taxes. The Russell 2000 tax rate is at 32% versus the S&P 500 at 26%.

At the present time, Global Alpha does not own US health insurance companies or hospitals, two key areas where sharp changes in the Affordable Care Act could affect corporate revenue streams. Health insurance companies may need to remove from their roster a portion of low income Americans that are less capable of paying for insurance, and hospitals could face a higher number of non-paying customers.

Government has always intervened in trade. As inflation accelerates, tariffs need to be monitored in the short term for direct and longer term impact. At Global Alpha, we certainly consider where products are fabricated to evaluate the effects of export/import tariffs.

As an example, we are following a potential positive effect of the 31% tariff on Canadian lumber exports to the US. Global Alpha owns Rayonier, the second largest timber owner in the US with 2.7 million acres of timberland. Rayonier supplies both pulpwood (60%) and sawtimber (40%) to mills in the US South and Pacific Northwest as well as in New Zealand. A sustained global economy combined with higher timber prices would certainly benefit Rayonier.

Have a great weekend.

The Global Alpha Team