FORUM

European Smallcaps GmbH

Memorandum

To : Forum Staff

From : BW

Date : October 25th, 2017

Subject : FES Chief Investment Officer Report on Q III 2017 Results**_V_2.0**

This report of the CIO has been put together for **stakeholders interested in what FORUM Family Office (“FFO”) does in the area of publicly-quoted companies**, mainly

a) our **internal professional** team as feedback how well we worked as a team – long-term investment performance is our ultimate scorecard

b) the **companies and their Executives** which share their time with us answering our questions to give them a better understanding what type of investors they are dealing with

c) the close to 1.000 p.a. **applicants to FORUM** to help them understand what they should expect when joining FORUM.

At times we will refer to our activities in the publicly-quoted space as **FORUM European Smallcaps (“FES”).**

This Report covers the **Q III 2017** period**.**

For a deeper understanding of what we do and how we think we would like you to look at the three Appendices at the end of this Letter:

a) **Appendix 1**: Methodology for calculating our results in publicly-quoted equities

b) **Appendix 2**: Summary of our Investment Philosophy

c) Appendix 3: Glossary

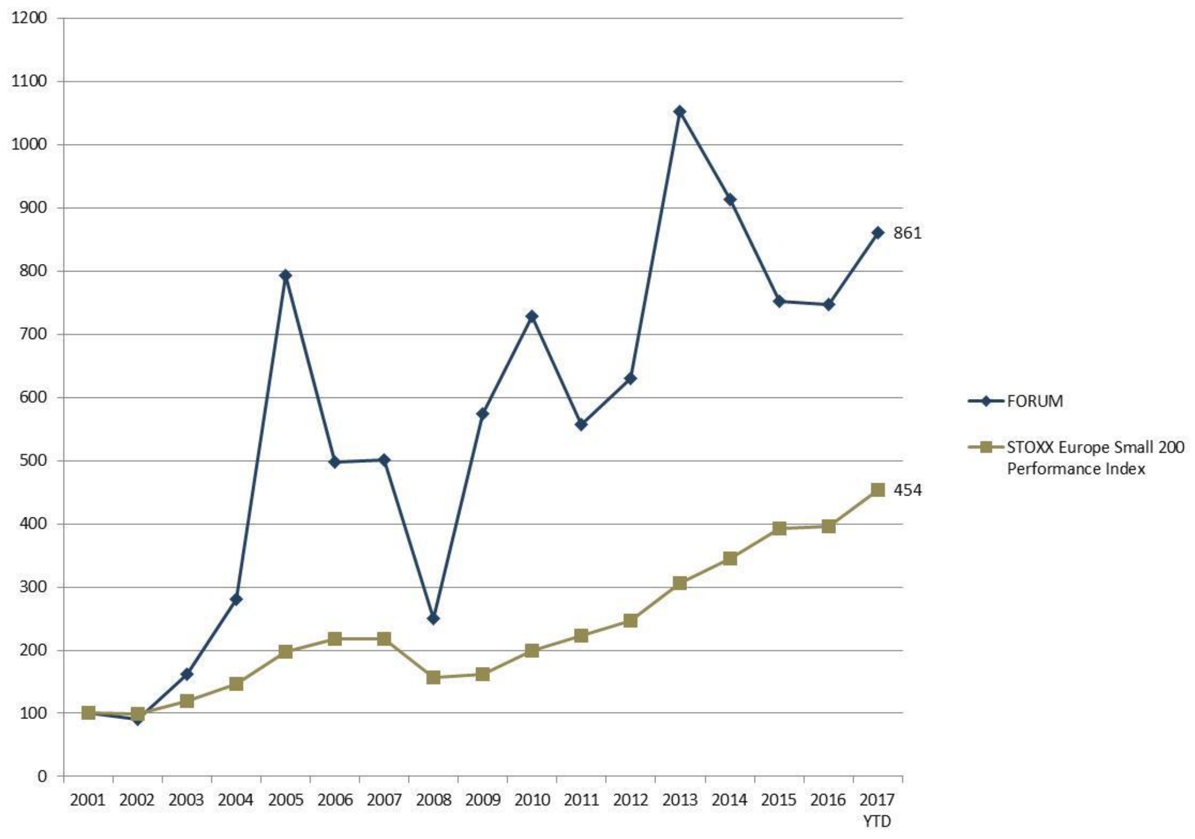
1. Results in Q III 2017

1.1 Results at Market Prices

In Q III 2017, **our NAV increased by 1,7%**, vs. the STOXX Europe Small 200 index increasing by 4,2%. This is an **underperformance of 2,4%.**

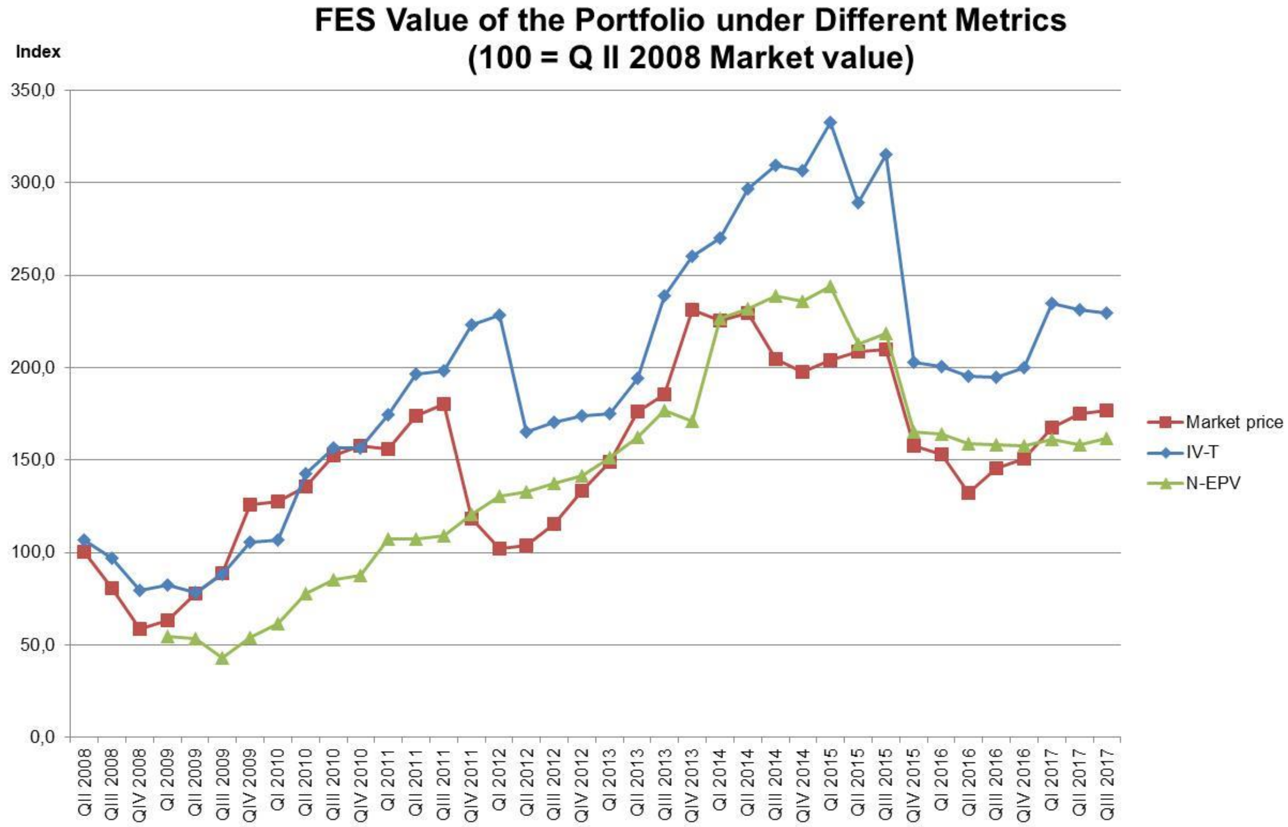
YTD, **our performance was 15,3%**, vs. the STOXX Europe Small 200 index increasing by 14,9%. This is a small **outperformance of 0,3%** (remember we use geometric ratio**).**

This brings the **IRR of the fund since inception to 14,7%** p.a. - compared with the benchmark index generating an IRR of 10,1% p.a. **As a result we have turned € 100,- into € 861,- vs. € 454,- an index fund would have produced.**



1.2 Results at Market and Intrinsic Values

Please see the graph in **Chart 2 below** for an overview of the portfolio over time:



a) **The line in green shows the value of the portfolio at Net Earnings Power Value ("N-EPV").** N-EPV captures the Earnings Power Value of the existing business **in a steady-state situation – i.e. does not attribute any value to growth.** We calculate it by

- simulating how much cash the business could generate if there were no re-investments into growth and

- capitalizing this cash flow.

Thus this is a very conservative valuation – making no estimates about future growth which will always be uncertain.

In the quarter **N-EPV increased sequentially by 2,1%.**

b) The line in blue shows the value of the portfolio at IV-T – i.e. including the value of growth.

In the quarter **IV-T decreased sequentially by 0,7%.**

The main reason for the slight drop in both cases are currencies, specifically the devaluation of the GBP where we have our biggest FOREX allocation.

Conversely, IV-Ts of our portfolio holdings in local currency did not change materially.

1.3 Margin of Safety

To interpret **Margin of Safety** of the fund, look at **Chart 2** above again. Now you should focus on **how the red line – depicting NAV – is moving relative to N-EPV and IV-T.**

1.3.1 NAV vs. N-EPV

NAV reflects the prices paid by the market for our stocks. **N-EPV** is the value we assign to our holdings for the steady-state businesses.

As the stock market puts some value on growth, it is **normal that NAV is above N-EPV**. At the end of the last quarter **NAV was ca. 12% above N-EPV.**

Inverting this ratio, N-EPV is at ca. 90% of NAV. A simplified interpretation of this ratio would be to say that **ca. 90% of the NAV of the fund is covered by N-EPV - i.e. the capitalized cash flows of our businesses, modelling them as ex-growth businesses.**

Historically at Forum, 90% of the NAV of the fund were covered by N-EPV, **hence this aspect of the Margin of Safety in the historical range.**

1.3.2 NAV vs. IV-T

IV-T measures the value of the businesses we own including the value of growth. We would like to see NAV below this value, as the difference between the 2 metrics gives an indication of the upside which is not (yet) priced into the share prices.

At the end of Q III 2017 **IV-T was 39% above NAV.** Historically, the upside from NAV to IV-T has been around 32%. Hence the full value of our holdings is a bit higher relative to market prices than historically.

Remember that **IV-T is calculated by discounting the future expected value of the business back to today.** Our discount rates are in the 8 – 12% p.a. range. Thus if the market price of a share reaches IV-T, you can expect an IRR of 8 -12% p.a. by holding this position.

If in addition IV-T is above NAV- which is the situation today - there is potential for additional returns from higher valuations. Thus we feel comfortable with this metric for protection/upside as well.

1.3.3 Summary of Margin of Safety

With:

a) 90% of NAV underpinned by N-EPV, giving good downside protection

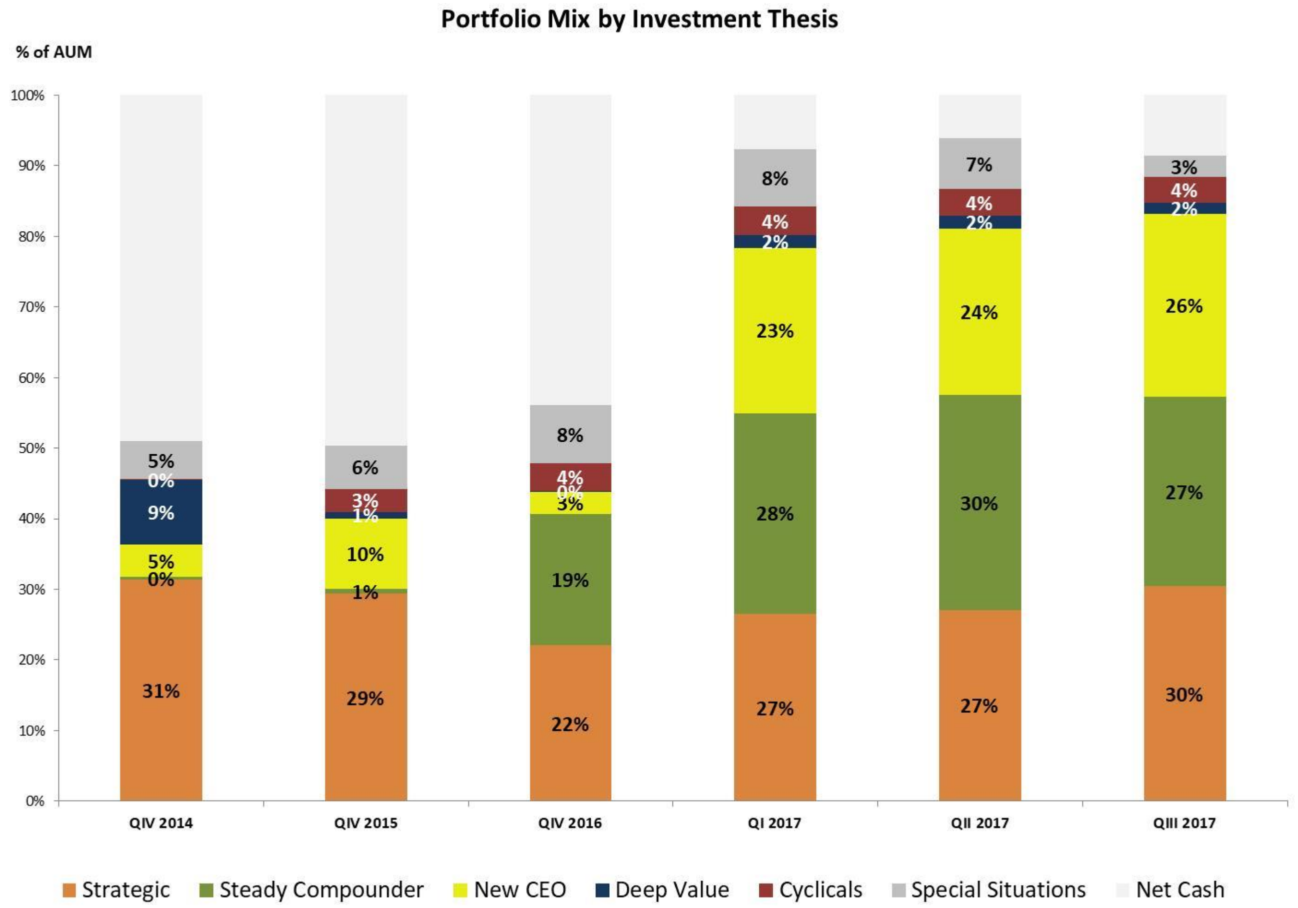
b) IV-T ca. 39% above NAV, signaling that the market prices have room to increase before they reflect the full value of what we own

our Margin of Safety is close to the historical average, making us confident for the future.

2. Asset Mix and Results by Investment Thesis

2.1 Evolution of Asset Mix

The chart below is a modification of the way we categorize our businesses: it focusses on the essence of the investment thesis, **i.e. the drivers for our expected return.** We will comment on them below.



Previously we would have shown a categorization of our businesses by their quality. But that does not capture so well what you should expect from these investments – it looked comforting to own a high share of Franchise Businesses – but as they are getting increasingly into overvaluation territory they may not be good investments.

In Q III 2017 we did not do any significant change to the portfolio composition. At the end of the quarter, the portfolio mix is:

		% Portfolio
a)	Strategic	30%
b)	Tactical Portfolio	61%
c)	Cash and Cash Equivalents	9%
d)	**Total**	**100%**

Net long exposure is 90,5% (91,5% long ./. 1,0% short).

3. Strategic Holdings (30% of NAV)

3.1 Immunodiagnostic Systems Holdings (“IDS”)

On October 20th the company published preliminary Numbers on the H1 FY 2018. Quite frankly, numbers were disappointing

a) **New analyzer placements in direct sales territories - gross and net -** were only slightly up YoY. The current level of placements applies 2 gross new placements per sales rep - totally unacceptable! Conversely, the number of analyzers sold via the distributor channel grew - indicating that these sales **organizations which tend to be close to their markets can** find a niche for the IDS offering.

b) **Growth in the automated specialty** menu - i.e. the source of future growth excluding vitamin D 25 OH slowed down to 10% lfl. This signals weakness in up-selling.

c) On top in a company shrinking by ca. 10% YoY as reported **headcount increased.**

We will have to review these results and draw conclusions.

3.2 New Candidates for Strategic Holdings

We did not add any new investments to our strategic portfolio in Q III 2017.

4. Tactical Portfolio (61% of NAV)

4.1 Steady Compounder (27% of NAV)

These are **businesses with a very predictable profitable growth.** Nearly all of the businesses in this category are **Franchise Businesses**, i.e. businesses of the highest quality - combining high customer stickiness with a strong competitive advantage. Other than the attractive business characteristics most of these companies have CEOs which we would rate as outstanding (that is at least 57/60 on our scoring model).

At the end of September this group accounted for **ca. 27% of AUM**. The biggest positions within this group are **Wessanen and Novo Nordisk** – they will continue to create value from compounding at the rate of 10 – 15% p.a.

4.2 New CEOs (26% of NAV)

These are **businesses with a new CEO** and we expect him/she to improve the business significantly in the first 2 – 3 years of his/her tenure. This can lead to improved fundamentals and often a multiple expansion as well. The key edge we seek in this type of businesses are speed in getting to meet the new CEO and an elaborate process to assess him/her, mainly from an analysis of the track record and extensive reference checks.

At the end of Q III 2017 this category accounted for 26% of our portfolio, comprised of 3 positions. This position has increased its weight. The underlying businesses can be of any quality.

We think we have identified a few CEOs who are outstanding. We think that the market has not yet recognized this because these CEOs will not go to roadshows etc. before they have a firm view of the future. They will nevertheless take the time to talk to long-term investors who take up the effort to meet them at their companies – like us. **Thus we hope to have an informational edge in this group of investments.**

The **largest position in this bucket is GenommaLab in Mexico** where Max Juda is the new acting CEO. Personally I find this combination of an outstanding CEO and a Franchise Business my favorite investment case. It worked perfectly in the case of Wessanen, let´s see how this case is working out.

As mentioned above we keep businesses in this category for a maximum of 36 months. E.g. Wessanen was in this group when we met Christophe Barnouin in the first few weeks of his tenure. **And the return he generated was highest in the first 3 years of his tenure**. By now improvements are getting more incremental and the high valuation induces the risk of multiple contraction.

4.3 Deep Value (2% of NAV)

In this bucket we aggregate all businesses where the investment thesis is based on **a very low valuation.** This bucket represents largely the Graham style of investing, thus the quality of the companies tends to be low – we make our money from a re-valuation of these companies. There is compelling evidence that this style of investing works. **The key is to invest when the businesses are "really cheap" resp. "dead-cheap" – not just cheap.**

At the end of Q III 2017 this asset class accounted for **2% of AUM**. Expect this group to grow.

4.4 Cyclicals (4% of NAV)

We add cyclicals to our portfolio as we believe they can add good returns when the market has written them off - e.g. a mining supplier when a significant part of the commodity supply is losing money on a cash basis.

In Q III 2017 we re-classified one holding as cyclical – from being in the "New CEO" category.

It also has a new CEO, he has effected significant change, in particular by lowering the cost base and by focusing on aftersales. Yet going forward our expected return will only materialize when the demand for the machinery offered by this company will recover. As the product made on the machinery has commodity characteristics demand tends to be cyclical. Thus the share price of this company may stagnate for several more years, and then shoot up. We are ready to live with this return pattern.

At the end of Q III this asset class accounted for 4% of AUM. It is comprised of this company only.

4.5 Special Situation (3% of NAV)

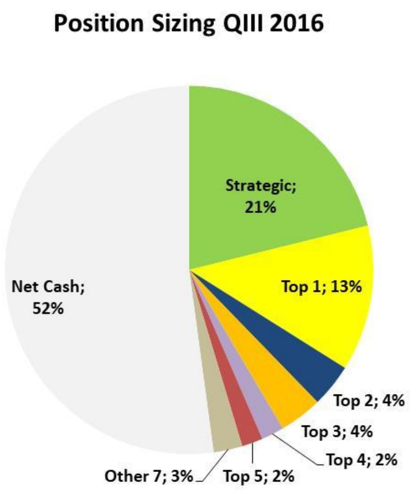
In this category we have one holding which was delisted some years ago.

In addition we have some smaller holdings for which we are still doing the BDD, or where we are still undecided whether we either dispose of or increase the positions.

5. Other Aspects of Portfolio Management

5.1 Portfolio Concentration

Please see below an analysis of our portfolio by size of holding.



Thus in the last quarters we significantly increased the concentration of the portfolio:

a) Our strategic holding account for 30% of AUM (Q III 2016: 21%) . the increase is largely due to the increase in the share price, we did not add any shares.

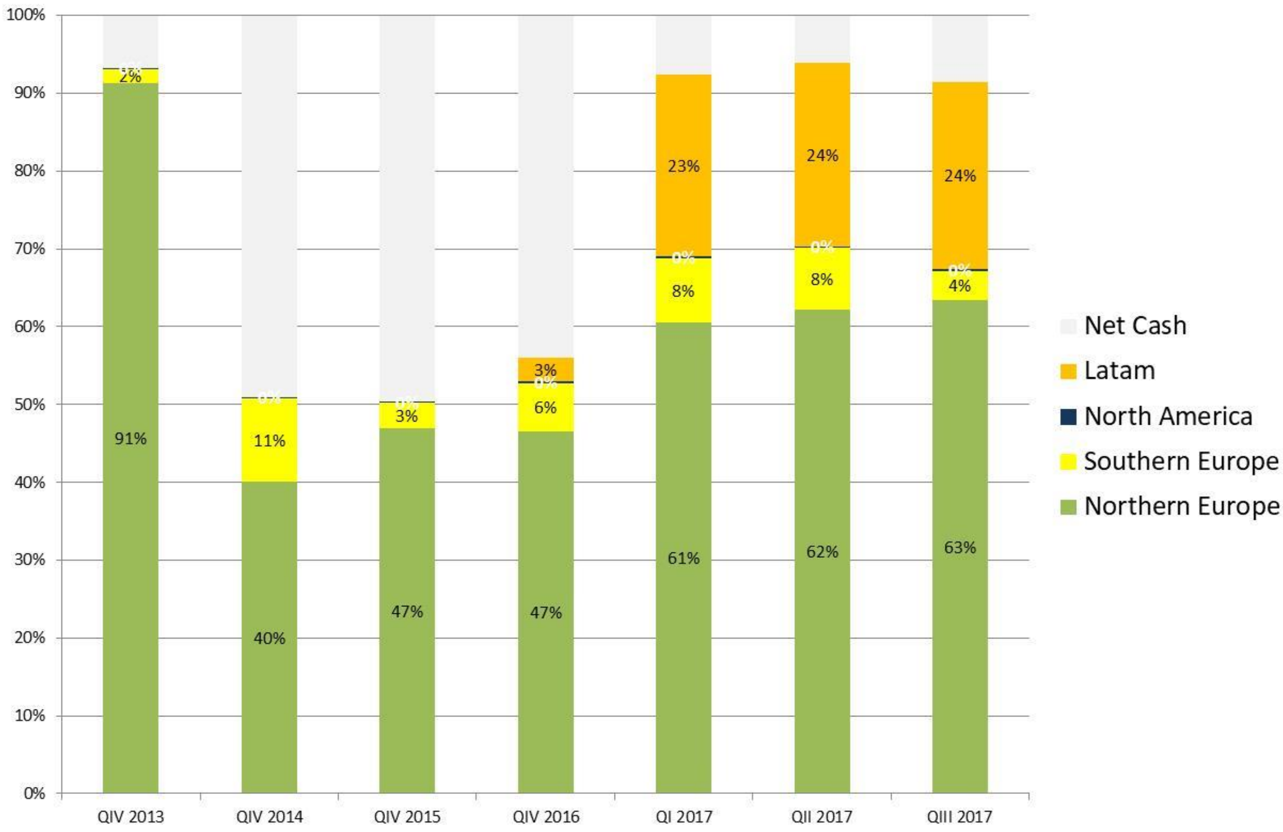
b) The **top 3 holdings of the tactical portfolio account for ca. 46% of net AUM (Q III 2016: 20%).**

Compared with a year ago we have built-up strong number 2 and 3 positions. Overall we feel portfolio concentration this is very healthy.

With respect to the "tail end", i.e. our smallest positions below the top 5 tactical holdings we have increased their weight to 7% of AUM, up from **3% a year ago.** Some of these are positions where we initiated a small stake and wait until we have finished our Business Due Diligence ("BDD"). We will strive to avoid and get out of such insignificant positions.

5.2 Portfolio Composition by Region

Please find below an overview of FES allocation by regional area (depending on Headquarter location):



We continue to be **focused on Northern Europe** – this area includes the Nordics, UK, Germany/Austria/Switzerland and Benelux. This is where we meet managers and co-owners with a strong business sense, ambition and strong execution skills.

Nevertheless we **continue to screen all of Europe including Southern Europe** – for opportunities. There are wonderful companies as well, often with strong ownership by an entrepreneurial family.

6. Short Book

At the end of Q III 2017 FES had 1 short position. The weight of the short position accounts for 1% of AUM, thus it is not significant. We intend to increase this weighting.

7. Risk Report

We would like to refer you to the extensive discussion of the major risks facing the firm in the full-year Report of the CIO for 2016. **Since then there have been no significant changes.**

8. Outlook

8.1 Macro Outlook

We refer to our **Macro Dashboard for Q III 2017**. Since our last Macro Dashboard:

a) little has happened **in Europe**: corporate profitability has stayed around its historical averages, valuations have gone up slightly.

b) Both profit levels and valuations **in the USA** have expanded once more: profits are now 20 – 30% above their historical averages and both of the metrics we use for **-** Shiller´s CAPE and market capitalization as % of GDP – **are at ca. 180% of their historical averages, implying standard deviations of 2,1-2,2x**. **This is what we define as a bubble.**

Thus we feel **with our focus on Europe we sit in the right region in the world to deliver reasonable investment results**. But if the overvaluation in the USA starts to correct it will definitely also affect our European holdings - **in price, but not in Intrinsic Value – which is the ultimate indicator for the value of what we own.**

8.2 Portfolio Positioning

As a result of the balance between upside and risk we target the following allocation top-down**:**

a) **Net cash** (i.e. after offsetting gross cash in the accounts against our short exposure) should be ca. 20% (it was at 19% at the end of the last quarter).

b) We are targeting **a short exposure of 10 - 15%**. We will continue to restrict ourselves to "autonomous shorts" - i.e. investments with a clear company-specific catalyst. This makes it difficult to reach this allocation.

Thus net long exposure should decrease to 65 - 70% - below the 82% we had at the end of Q III 2017.

And as always we will be driven by opportunities - bottoms up - if an attractive investment opportunity emerges we will take it.

9. The Firm

At the end of Q III 2017 our investment team consists of **5 professionals plus myself.** In the quarter we welcomed one new analyst, Kawaldeep Chawla, an Indian who grew up in the UK, Kawal impressed us from the ground-level work he performed on the two case assignments we gave him as tests. He will cover part of the UK where we have been under-represented.

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Burkhard Wittek

Appendix 1: Methodology for Calculating FES Results

1. Segregation FES and FPE

FORUM Family Office ("FFO") has an Investment Philosophy to **only invest in companies.** We have no real estate, no hedge funds and own no shares in forests etc. We do this in **several sub-classes of assets:**

a) Publicly-Quoted: controlling Stakes/Strategic Positions with Board Involvement

b) Publicly-Quoted: tactical positions which are liquid

c) Private Equity.

To hedge our exposure to the cyclicality equity markets we also **have a book of short positions in publicly-quoted companies.**

To calculate the results of the publicly-quoted part of our portfolio – i.e. long and short positions – we use the following methodology:

a) We value our PE holding at Investment Cost, i.e. their value is constant over time

b) The change in market value between 2 periods is calculated as the difference between the full value of our wealth

c) The gain /loss in percentage is calculated as the ratio between the change in Market Value, divided by the Value of our portfolio excluding the PE portfolio at the beginning of the period.

Below is an example of the calculation (fictitious numbers):

	Year N	**Addition to PE** (at cost)	**Year N+1**
Cash	10	-10	0
Listed Portfolio	80		90
PE Portfolio	10	+10	20
Total Wealth	**100**		**110**

Performance of the Listed Portfolio + Cash:

$$\frac{Total\ Wealth\ (N+1) - Total\ Wealth\ (N)}{List\ Portfolio\ (N) + Cash(N)} = \frac{110-100}{80+10} = \frac{10}{90} = +11{,}1\%$$

Appendix 2: Summary of Forum Investment Philosophy

1. Long Book

Our Investment Philosophy has **the principles of Value Investing as interpreted by Warren** Buffett at its core: we invest with a Margin of Safety in businesses which we understand well.

We think about our ability to understand a business well - i.e. **our Circle of Competence** - as follows:

a) We have an "**outer Circle of Competence**" which defines the limits of what we do. Regionally this is Western Europe. In terms of type of businesses we have to be able to understand their products, business models and the "systems" of customers and competitors they are operating in. **We do not invest outside of this outer Circle of Competence.**

b) There is also an **"Inner Circle of Competence**" - companies which we understand particularly well. These are companies which have a more or less simple product or service offering, we have been following their industries for many years or even decades and we can assess the CEOs. **This is our "sweet spot",** here our confidence in any valuation and risk assessment is the highest. This sweet spot should constitute the majority of what we do.

c) We will be willing to pay more for companies in the sweet spot than for companies within the outer Circle of Competence, but outside this sweet spot.

In terms of company size **we focus on small- and mid-cap companies** – which we define as companies with market capitalizations in the € 300m to € 2bn range.

When we make an investment decisions we start by looking at "**What we Get**": to us the most important aspects are:

a) **Business Quality:** the category we like most are **Franchise Businesses** with a strong customer franchise and a strong competitive advantage. Second in rank come **Hybrid Businesses**. And the businesses requiring the biggest management attention and having the lowest visibility are **Execution Businesses.**

We try to have a significant part of our assets in Franchise Businesses. At the same time this is not a dogma: there are periods where these businesses are grossly overvalued by the market, allowing no attractive returns - just peace of mind. E.g. the so-called "**Nifty-Fifty**" favored in the 1960 had a great run until 1972, then the bubble burst. In the subsequent 7-year period this group of highest-quality stocks underperformed the S&P 500 by 30%.

We do not go for "peace of mind" - but for risk-adjusted returns. At this point in time it is increasingly difficult to find such businesses at valuations allowing our target returns. In this interest rate environment such businesses are priced like "bond-substitutes".

b) **Management and Governance:** in any business the CEO, the rest of the management team and the Non-Executives on the Board can make a huge difference to what shareholders will earn over time. A business with 15% ROE **will double the equity base it has built up in its lifetime in the next 5 years**: how this money is spent/re-invested can create of destroy a lot of value.

c) **Internal Compounding,** i.e. the ability **to grow profitably**: in the long-run a business which has the option to grow at high rates while requiring little capital will generate enormous value from compounding - and current valuations do often not reflect the difference in sustainable growth rates between businesses.

   Therefore we look for **visible growth with a long runway**. With real GDP growth in Europe at 1 -2% at best this is not an easy task. Companies able to pick up bolt-on acquisitions at value-creating multiples and the ability to do Post-Merger integration have created such a system, **sometimes referred to as roll-ups**. We have several of them in our portfolio.

Based on the results of "what we get" we will then decide "**what we pay**". The principles are:

a) At the core of our valuation is the **Net Earnings Power Value ("N-EPV")**. We define N-EPV as the capitalized value of the cash flows the business can achieve on a sustainable basis assuming no growth. This value anchors us on paying only for "what is there today".

b) Even for the best businesses - Franchise Businesses, high management quality and visible profitable growth - we will not pay substantially above N-EPV. This is our definition of the **Margin of Safety.**

c) In any case we **require an expected return of 20% p.a.**

We define **risk as the permanent loss of capital.** If the risk of permanent loss of capital is more than insignificant we will not invest - even if the upside appears promising.

Conversely**, share price volatility is not important to us** - we consider these fluctuations mostly statistical noise. Instead we review the underlying earnings power of the businesses regularly: is it unchanged or has it been impaired?

We are looking for investors who share this definition of risk - they will have a long-term perspective on investing like we do.

2. Short Book

Our **short investments** serve three purposes:

a) Autonomous opportunities from overvaluations with a catalyst

b) Hedging of company-specific risks in long positions

c) Hedging of the overall portfolio against market overvaluation.

Within the short investments we have

a) conviction bets

b) stochastic bets.

As in shorting the long-term trend is against us and there are non-calculable event risks, e.g. a takeover - we have so far only had one conviction bet - **otherwise we do stochastic bets, spreading event-risk over many positions which will work out "on average".**

Appendix 3: Glossary

Execution Business: a business which needs the right management decisions every day to perform well. Conversely, it has little customer stickiness and low competitive advantage.

Franchise Business: a business with high customer stickiness and a strong competitive advantage. Companies in this group would be strong brands in FMCG, software companies with critical applications and a revenue model based on recurring revenues or companies with network economics

Hybrid Business: a business which has characteristics both of Franchise and Execution Business

Net Asset Value ("NAV"): the value of the fund at market prices.

Net Earnings Power Value ("N-EPV"): it captures the Earnings Power Value of the existing business in a steady-state situation. It is calculated based on after-tax cash flow to enterprise value (i.e. before interest rate) after eliminating expenses/cash out for growth. We also base it on a level of earnings considered mid-cycle earnings, i.e. we adjust actual earnings we consider them peak or trough earnings.

We then capitalize this cash flow metric – we refer to it as "**Owner Earnings**" or "OE" – with a cap factor based on business quality and market capitalization. E.g. for a large-cap franchise business we capitalize Owner Earnings with a factor of 12x.

Total Intrinsic Value ("IV-T"): it captures the total value of the business which is the sum of its N-EPV, structural improvements of the business and the value of expected growth. As such it contains several critical assumptions about the future and is less reliable than N-EPV.

IV-T discounts the future expected value – thus if the market price of a share reaches IV-T you can expect an IRR of 8 -12% p.a. – this is the range of discount rates we use.