FORUM

European Smallcaps GmbH

Memorandum

To : Forum Staff

From : BW

Date : December 17th, 2018

Subject : FES Chief Investment Officer Report on Q3 2018 Results**_V_1.0**

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 **Q3 2018** period**.**

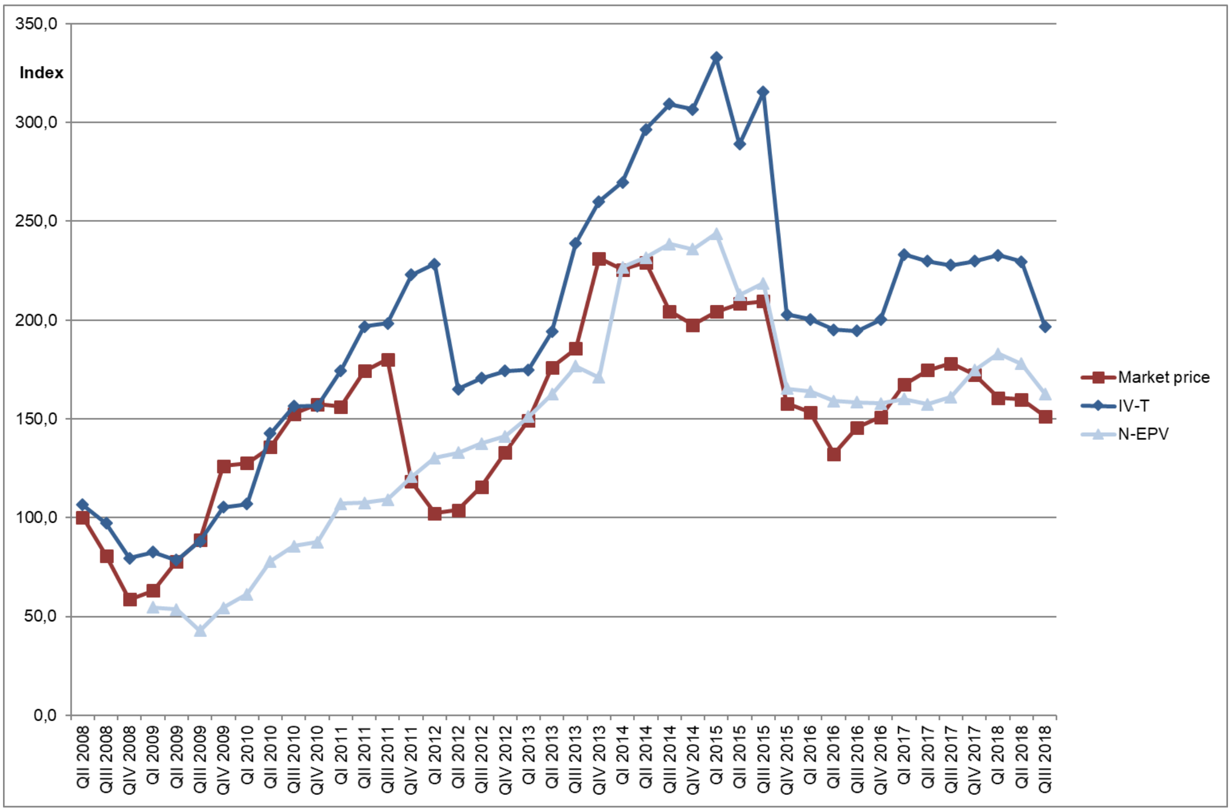
A. Results in Q III 2018

The Appendix below shows the development of your fund by **the three metrics we monitor:**

a) Results at Market Prices

b) Intrinsic Value I: Net Earnings Power Value

c) Intrinsic Value II: Total Value.



Below we will comment on these developments.

1. Results at Market Prices

In Q III 2018, our **NAV decreased from € 159,9 to € 151,2, i.e. by 5,4%.** This is the third quarter in a row with a loss, terrible. **Thus YTD, our performance was -12,3%**.

2. The Intrinsic Value Perspective

2.1 Net Earnings Power Value (N-EPV)

The light blue line in the chart below depicts 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 was no re-investment 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 decreased slightly from € 178,0 to € 162,8, i.e. by -8,5 %.** This decrease is because:

a) we **reduced the N-PV for three companies** based on new discussions with management and resulting new learnings of the businesses.

2.2 Total Intrinsic Value (IV-T)

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

In the quarter **IV-T decreased slightly from € 229,6 to € 196,8, i.e. by 14,3%. This is based on:**

a) **a downgrade to the IV-T** of one of our major holdings.

B. Portfolio Positioning - Long/Short

In 2018 our long/short exposure has developed as follows:

	Dec. 31st, 2017	June 29th, 2018	Sept. 28th, 2018
a) Invested part long	83,6%	83,7%	85,9%
b) Exposure short	0,2%	0,4%	0,3%
c) Exposure net long	**83,4%**	**83,3%**	**85,6%**

As you can see we have left our net long exposure above 80%.

This **net long exposure** of ca. 85% is above the 70% target where we would like to have it given our assessment of the macro situation – **see our Macro Dashboard:**

a) It gives us **some protection against a correction in equity markets – for which we see not insignificant risks.**

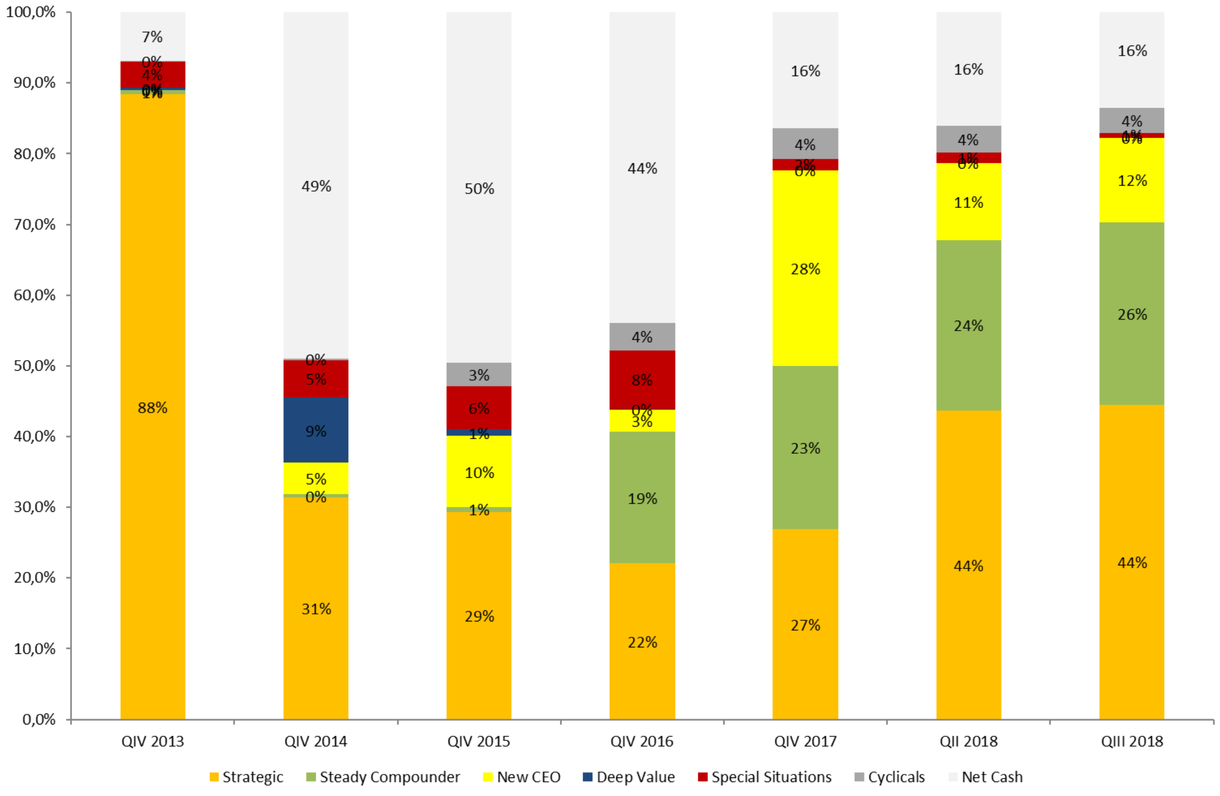
b) It gives us **enough firepower** to build up an interesting position if we find it bottoms-up.

In terms of composition of our net long exposure I would like to see **a larger gross long exposure** to good companies – combined with **a larger allocation to shorts**. But we have to find the right shorts, preferably autonomous ones with a catalyst triggering a re-rating independent of equity market momentum.

C. Development of the Long Book

1. Performance by Investment Situation

The chart below shows the portfolio mix by the **essence of the investment thesis**, **i.e. the drivers for our expected return.** We will comment on them below.



1.1 Strategic Holdings

In this category we have businesses where we **have an active Board involvement** with an agenda for improving the company performance and our returns:

a) Genomma Lab in Mexico

b) IDS Immunodiagnostic Systems Holding plc, UK.

We have a significant position in both of them and together they account for > 40% of AUM.

In the quarter this asset class **lost ca. 5,6% of average capital invested. YTD this metric stands at ca. -15,6%.**

1.2 Steady Compounders

These are **businesses with a very predictable and profitable growth.** The businesses in this category are mostly Franchise Businesses, i.e. businesses of the highest quality.

At the end of Q III 2018 this group accounted for **ca. 26% of AUM – slightly up from the 24% at the end of Q II 2018.** It consists of 6 companies – unchanged.

In the quarter this asset class **remained flat at a combined basis**. **YTD this metric stands at ca. -6,3%.**

1.3 New CEOs

These are **businesses with a new CEO** and we expect him/her to improve the business significantly in the first 2 – 3 years of his tenure. This can lead to improved fundamentals and very often a multiple expansion as well.

At the end of Q III 2018 this category accounted for 12% of our portfolio, down from 28% at the end of 2017. Ca. 15 percentage points of this decrease of 17 percentage points are due to the transfer of Genomma Lab into the "Strategic Holdings" category**.** After this change the New CEOs category is **comprised of three positions.**

In the quarter this group **gained ca. 1,2%** of average capital invested at market prices. **YTD this metric stands at ca. -16,2%.** We may have entered these positions a bit too early, but the recent quarter indicates the negative momentum has waned.

1.4 Deep Value

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 2018 this asset class accounted for **0% of AUM.**

1.5 Cyclicals

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 mining industry is losing money on a cash basis and withholding investment.

At the end of Q III this asset class accounted for 3% of AUM and is comprised of one company - unchanged for a long time by now.

In the quarter this asset class **lost ca. 11,6% of average capital invested at market prices. YTD this metric stands at ca. -44,0%.**

1.6 Special Situations

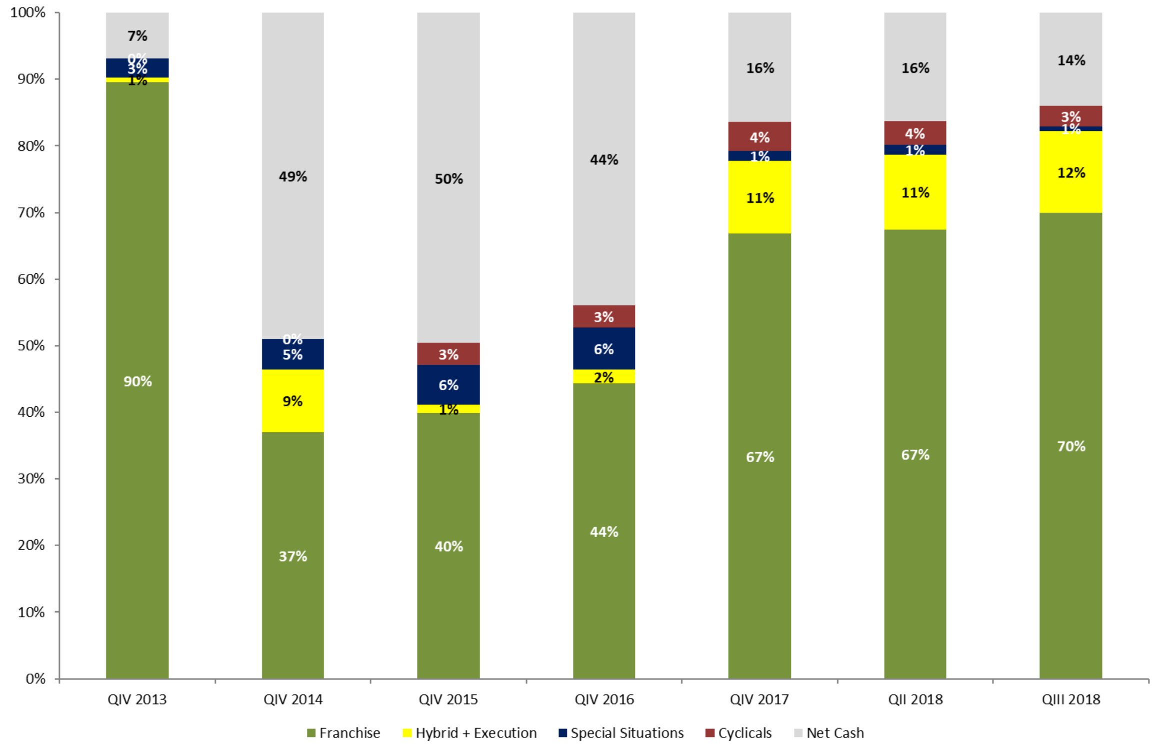
This category is comprised of **companies undergoing some sort of transition**. E.g. there may be a conglomerate divesting peripheral activities and re-focusing on the core. Or an activist investor who we know and trust tries to replace a poor management.

At the end of Q III 2018 this group accounted for 1% of AUM.

In the quarter **this asset class gained ca. 72,1% of average capital invested at market prices**. **YTD this metric stands at ca. -77,3%.**

2. Portfolio by Business Quality

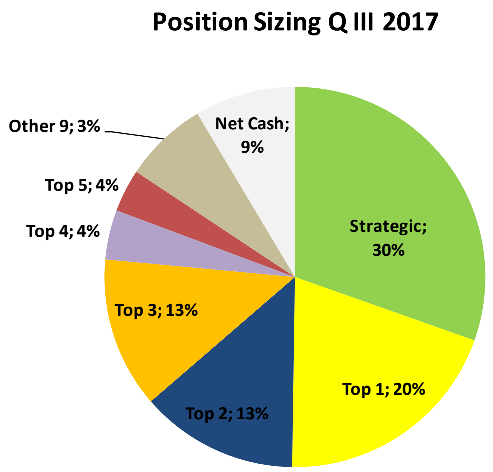
The graph below shows the **evolution of our portfolio mix by Business Quality:**

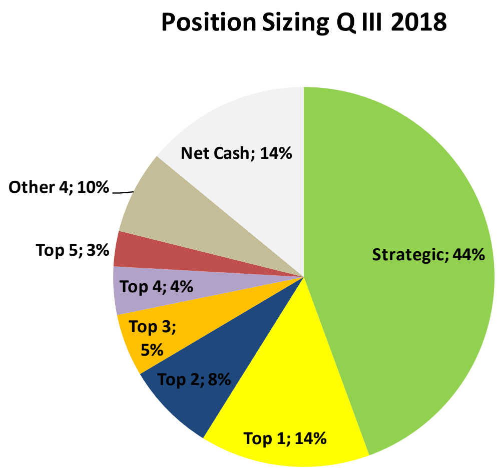


As you can see **the lion´s share of our investments remains in the Franchise Business category with 70% of AUM at the end of Q III 2018**. Otherwise there is very little change.

3. Portfolio Concentration

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





We continue to have a rather concentrated approach, but slightly less so than in the past. The distortion in the diagram above is caused by a reclassification of one of our holdings to Strategic, namely Genomma at the start of the year:

a) The strategic holdings account for ca. 44% of AUM. We currently have an equal weighting of IDS and Genomma Lab in this category.

b) The **top 3 holdings therefore account for ca. 58% of AUM vs 57% in Q II 2018**. Thus, nearly 2/3 of the performance of FFO will be driven by **three companies**.

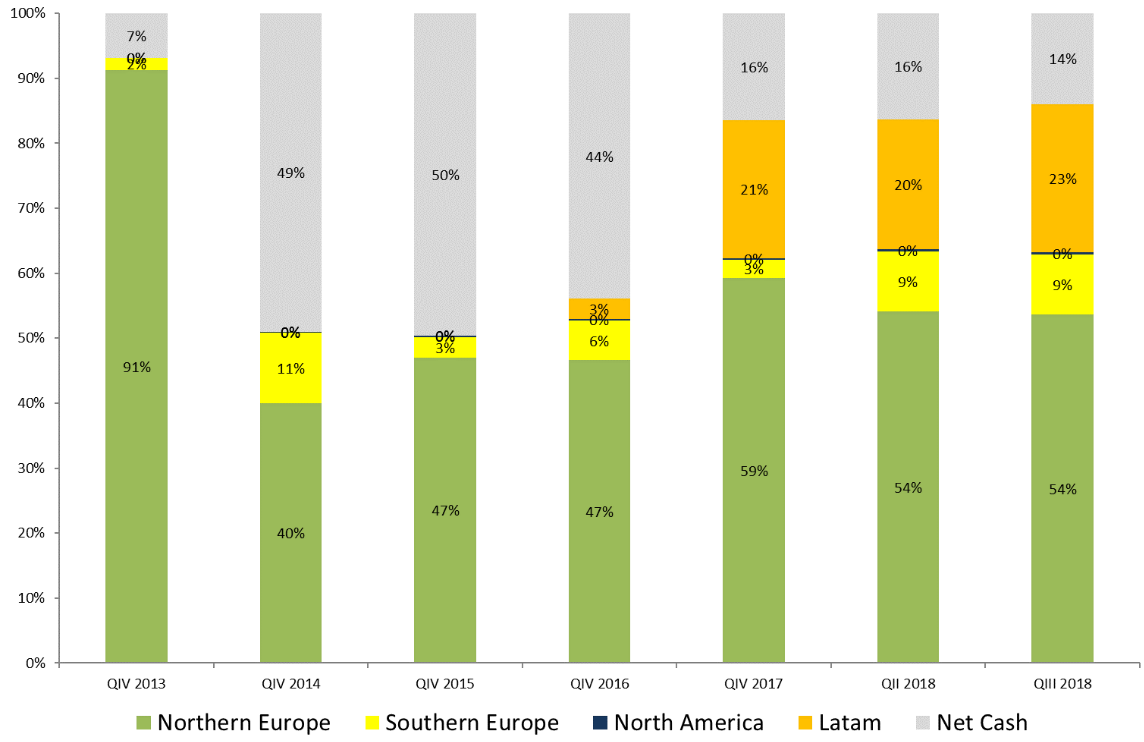
c) With respect to the **"tail end",** i.e. our smallest positions below the top 5, we have decreased the number of positions to 4, but maintained their weight to 10% of AUM**.**

In the previous letters I told you that this tail-end is too long, we should increase some positions and exit others where we have less conviction. I prefer a portfolio with no more than 10 positions.

I have to confess that I did not act on this true self-advice – this is considered **"Endowment Bias" at work** (this bias describes the propensity to love what you own and become uncritical). **I promise to clean out the tail end until the end of 2018.**

4. Portfolio Composition by Region

Please see the chart below for the evolution of our regional exposure:



As you see we have increased our Northern European portfolio to slightly above 50% and in **the medium-term Northern Europe will continue to account for ca. 50% of what we do.**

D. Development of the Short Book

1. Portfolio Structure and Evolution

At the end of Q III 2018 we had **only 1 short position**, down from 2 at end of Q II 2018.

2. Results

During Q III 2018 the value of our short portfolio at market prices was down by ca. 7,0%, thus we earned money. **This contributed towards a gain of ca. 0,1% to the fund.**

YTD 2018 the value of our short portfolio at market prices was up by ca. 22,8%. This contributed towards a loss of 0,1% to the fund.

E. Risk Report

We would like to refer you to the extensive discussion of the major risks facing FFO in the Annual Letter to Clients 2017. **Since then there have been no significant changes other than the trade war between China and the US initiated by Mr. Trump.** At first glance we cannot see much exposure within our portfolio to such an outcome.

F. Outlook

We continue to be worried about the risks in the world economy and in financial markets. As a result we position the portfolio to be **able to weather a downturn in global financial markets. This includes the following targets:**

a) **Net cash** (i.e. after offsetting gross cash in the accounts against our short exposure) should be ca. 25 - 30% (it is 14% now).

b) We are targeting **a short exposure of 5 -10%**.

Thus **net long exposure should be around 70%** - lower than the level we had at the end of Q III 2018.

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

FORUM

European Smallcaps GmbH

Kind regards

Burkhard Wittek

Appendix 1: Summary of FFO 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.

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".**

Historically our short book has been 5 - 10% of AUM. We would like to have it a bit larger now.

Appendix 2: 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.

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.

Appendix 3: FT Article

Investors should not be complacent about all-conquering techs

FT, July 12th, 2018

Peter Tasker

Markets Insight

The internal workings of global stock markets are giving a flashing red signal. Cheaply priced stocks have been underperforming richly priced stocks for most of the past 10 years but the predilection for high-flyers has intensified sharply in the last eighteen months.

The phenomenon is particularly noticeable in US and Asian markets, excluding Japan, because of the enormous scale of the Faangs, (Facebook, Apple, Amazon, Netflix, Google) and "Bats" (Baidu, Alibaba, Tencent, Samsung) that dominate the market capitalisations. On some measures, the gap between unloved value stocks and hot growth ones matches the excesses of the peak of the internet bubble in 2000.

Why is this happening? Not because stock markets are becoming more efficient and the value factor has been competed out; if that were the case, the result would be a trendless "random walk" rather than an increasingly precipitous decline in the relative performance of value stocks.

Rather, such polarisation is typical of a very late stage bull market. Average stocks of average companies are being shunned in favour of an elite group of stocks that appear immune to economic headwinds and competitive pressures.

MSCI indices of value and growth, which use the single metric of price book value, show the degree to which the latter has outperformed. It is sometimes argued that book value is no longer meaningful in a world in which companies are increasingly reliant on intellectual property and brand value.

Intuitively, that seems possible. But if off-balance sheet assets were indeed making a greater contribution to profits, there should be a structural rise in return on equity. No such rise is visible in either the US or ex-Japan Asia.

Needless to say, there are significant differences between the investment environment at the turn of the century and now. Back then, the internet was new and investors had to grapple with a large number of companies with vague and untested business models.

Many of the "dotcoms" became "dot bombs"; a few survived and an even smaller number prospered. Of the Faangs and Bats, few were listed companies at the time and some had not even been founded.

In today's world, the tech giants have settled business models and have become part of the daily lives of millions of people. Yet much remains uncertain.

> 'We believe we understand the past, which implies that the future should also be knowable'

What is the sustainable level of profitability for such businesses? Could they end up competing against each other? What are the political and regulatory risks? Most important of all, what is the duration of their business models in a time of constant disruption and technological change?

In recent history, there have been few periods of severe underperformance by value stocks that have ended well for the overall market. One counter-example might be the US market between 1988 and 1991, when value did poorly in the context of a weak US economy and a stock market gradually shaking off the effects of the Black Monday crash.

A closer parallel might be the Nifty Fifty mania in the early 1970s in the US. That was also a time of mounting economic stress when it was felt that only exceptional companies were capable of thriving. Of the fifty "one decision" stocks (meaning that you bought them and never sold), several have disappeared off the radar screen.

Wharton School finance professor Jeremy Siegel revisited the Nifty Fifty in the late 1990s and concluded that their long-term performance was reasonable.

What is undeniable is that the Nifty Fifty were viciously de-rated in the ensuing 10-year bear market and the worst performers were in the technology sector, including such raves from the grave as Polaroid, Burroughs, Eastman Kodak and DEC.

In *Thinking, Fast and Slow*, Daniel Kahneman says we exaggerate the role of skill and underestimate the role of luck in the rise of a company like Google.

"We believe we understand the past, which implies that the future should also be knowable," he writes. "But in fact we understand the past less than we believe we do." The higher the valuation you pay for a stock, the more you are betting on an unknowable future.

Benjamin Graham, the pioneer of investment analysis and mentor of Warren Buffett, writing in the shadow of the market meltdown of 1929, came up with the concept of "the margin of safety," a bulwark of fundamental value that would limit downside risk.

That is the very opposite of the "this time it's different" — story-driven speculation that characterises major market tops. The value philosophy will have its time again — though some harsh lessons may have to be relearned first.

Peter Tasker is a Tokyo-based analyst at Arcus Research