FORUM

European Smallcaps GmbH

Memorandum

To : Forum Stakeholders/Interested Parties

From : BW

Date : September 18th, 2020

Subject : FES Chief Investment Officer Report on Q II 2020 Results**_V_2.1**

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 200 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 period from **January 1st, 2020 to June 30th, 2020.**

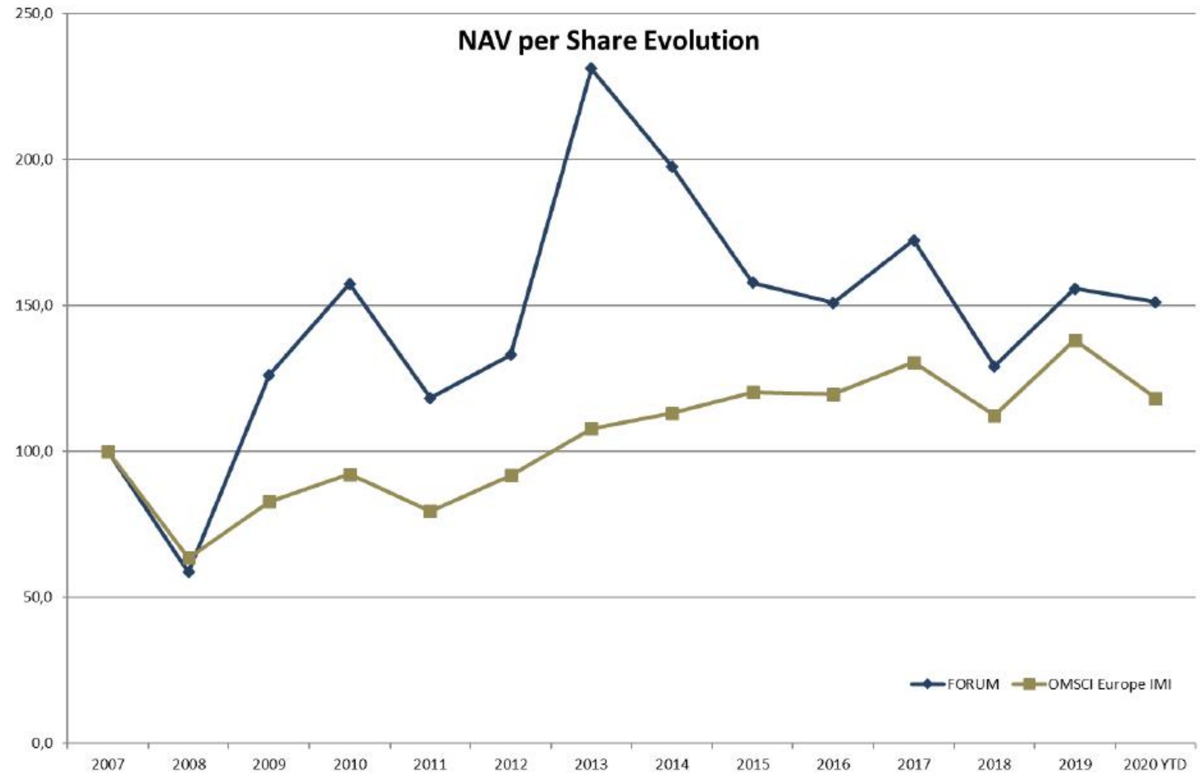
A. Overview - FFO Results Q II 2020

1. Results at Market Values

As of June 30th, 2020 the NAV stood at **€ 151,21 per share**. Compared with the NAV of € 124,60 as of March 31st, 2020 this implies **a gain at market prices of 21,4%.**

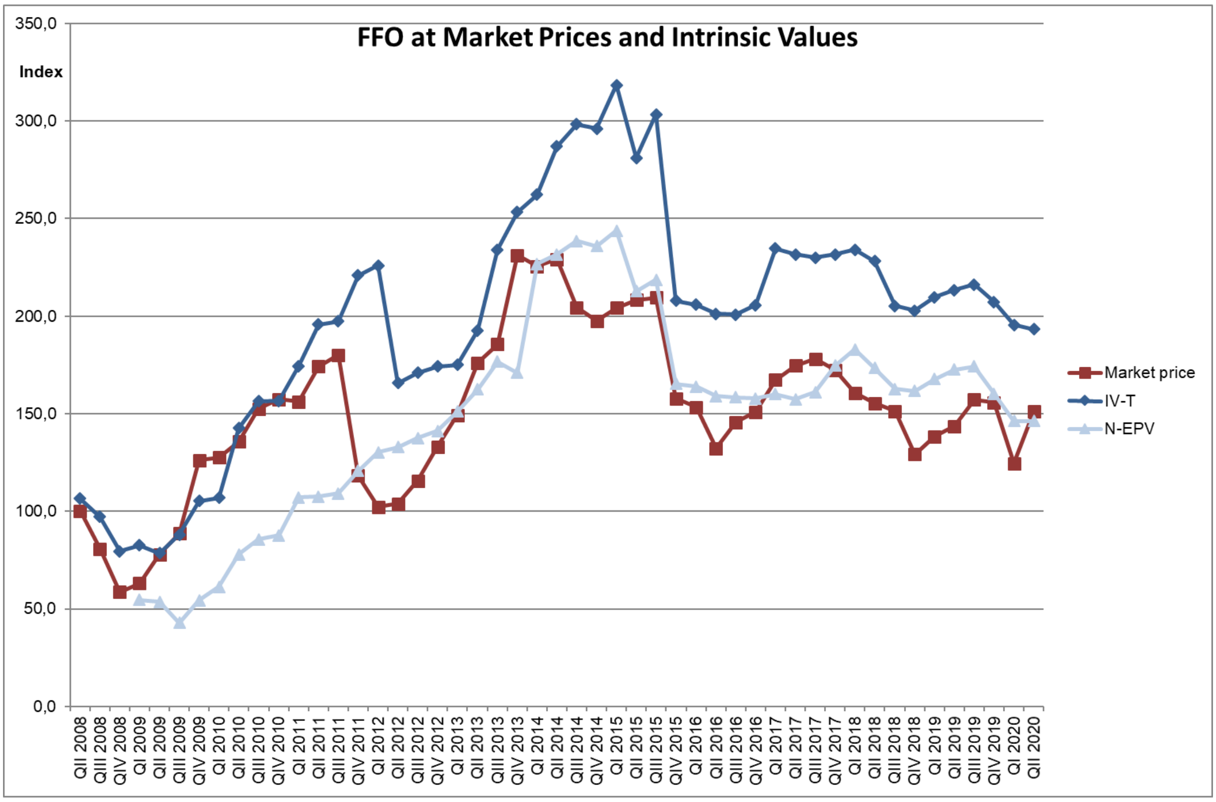
In Q II 2020 our benchmark index MSCI Europe IMI won 12,4%. Thus we have delivered **a relative outperformance of ca. 8,0% (remember we take geometric rates).**

Performance (QI 2008 = 100), p.a.	**FES**	**MSCI Europe IMI Performance**	**Over/(Under) Performance vs.**
	Percent	Percent	Percent
2008	-41.4%	-36.5%	-7.6%
2009	115.1%	30.4%	64.9%
2010	24.8%	11.3%	12.2%
2011	-24.9%	-13.7%	-13.0%
2012	12.6%	15.4%	-2.4%
2013	73.7%	17.4%	47.9%
2014	-14.6%	5.0%	-18.6%
2015	-20.1%	6.3%	-24.8%
2016	-4.4%	-0.6%	-3.8%
2017	14.2%	9.1%	4.7%
2018	-25.1%	-13.9%	-13.0%
2019	20.7%	23.0%	-1.9%
2020 YTD	-3.0%	-14.4%	13.3%
IRR QI 2008 - YTD	**3.4%**	**1.4%**	**2.0%**
Cumulative Gain since Inception	**51.1%**	**18.3%**	**27.7%**


NAV per Share Evolution
250,0
200,0
150,0
100,0
50,0
0,0
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020 YTD
FORUM
OMSCI Europe IMI

2. The Intrinsic Value Perspective

The chapters below compare the evolution of the NAV with the valuation at Intrinsic Values.



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 a business **in a steady-state situation – i.e. does not attribute any value to growth.** We calculate it by:

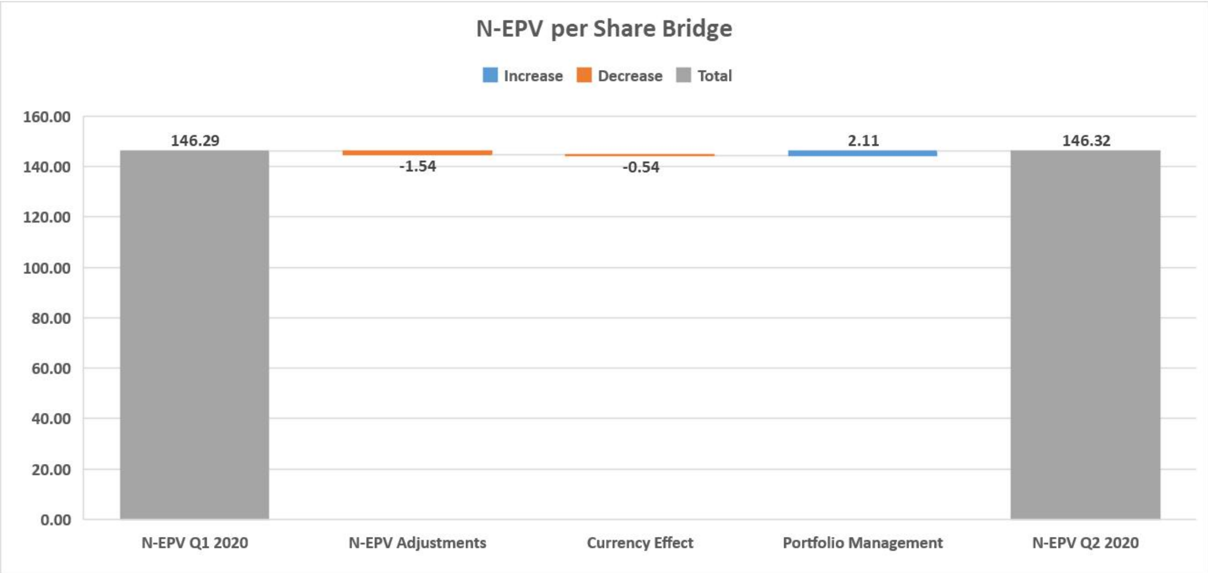
- simulating how much cash the business would generate if there was no re-investment into growth. We refer to this cash flow as “Owner Earnings”.
- capitalizing this cash flow.

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

In Q II 2020 Net Earnings Power Value (“N-EPV”) stayed unchanged at € 146,30. This result is the net effect of the following:

a) we **reduced the N-EPV of one of our holdings.**

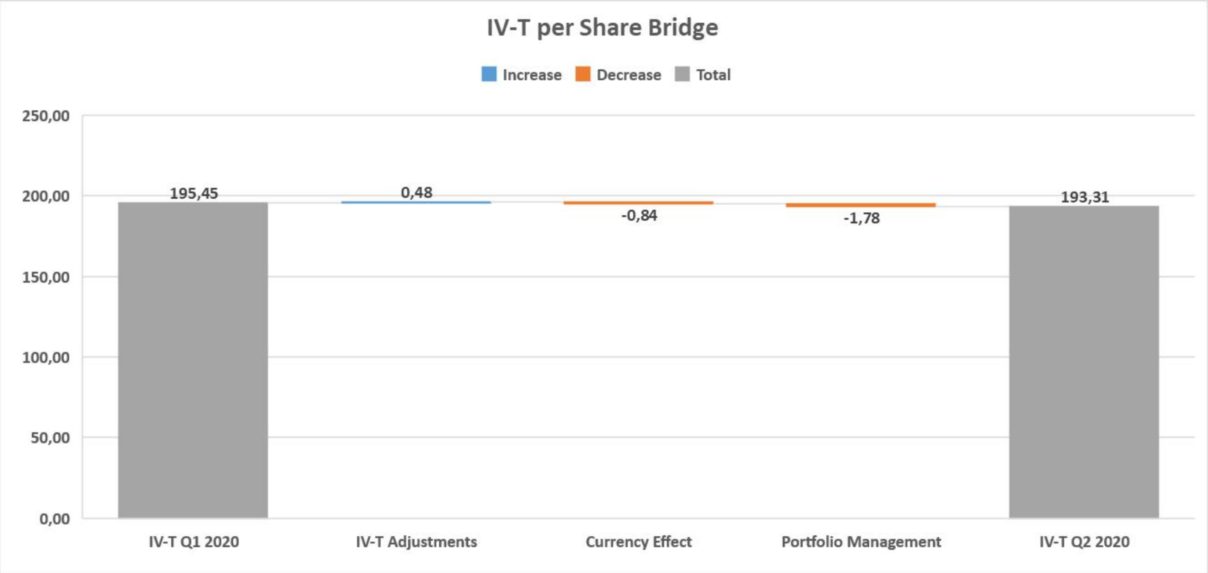
b) **We did active portfolio management**, selling down companies which had reached their Intrinsic Values and re-investing the funds into companies with a discount from Intrinsic Value.



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 Q 2 2020 **IV-T decreased slightly** from € 195,45 to € 193,31 per share, i.e. by ca. 1,1%.

The bridge chart below breaks up the evolution of IV-T into its components**:**



We made a small adjustment to the OV-T of one of our holdings.

Changes in **exchange rates** have cost us € 0,84 in IV-T per share in the year, mainly the Mexican Peso

Finally, **portfolio management subtracted € 1,78 per share from the IV-T of the portfolio**. This is the result of the downsizing of some positions at prices below IV-T, mainly in Genomma Lab. We would like to reduce our exposure to the Mexican Peso a bit.

2.3 Putting it all Together

The best summary of where FES stand is still the first graph in this chapter 2 with the evolution of the fund at different values: The main conclusions are:

a) We have not been able to increase the Intrinsic Value of our Portfolio at the targeted rate of at least 10% p.a. for several years. This is **a structural issue** we are dealing with by re-arranging our Investment Philosophy and Process.

b) The value of FES at market prices has recovered in the last quarter to a level **slightly above the N-EPV of our holdings. This should be viewed as a return to normalization.**

B. Portfolio Strategy – Long Book

1. Portfolio Evolution by Asset Class

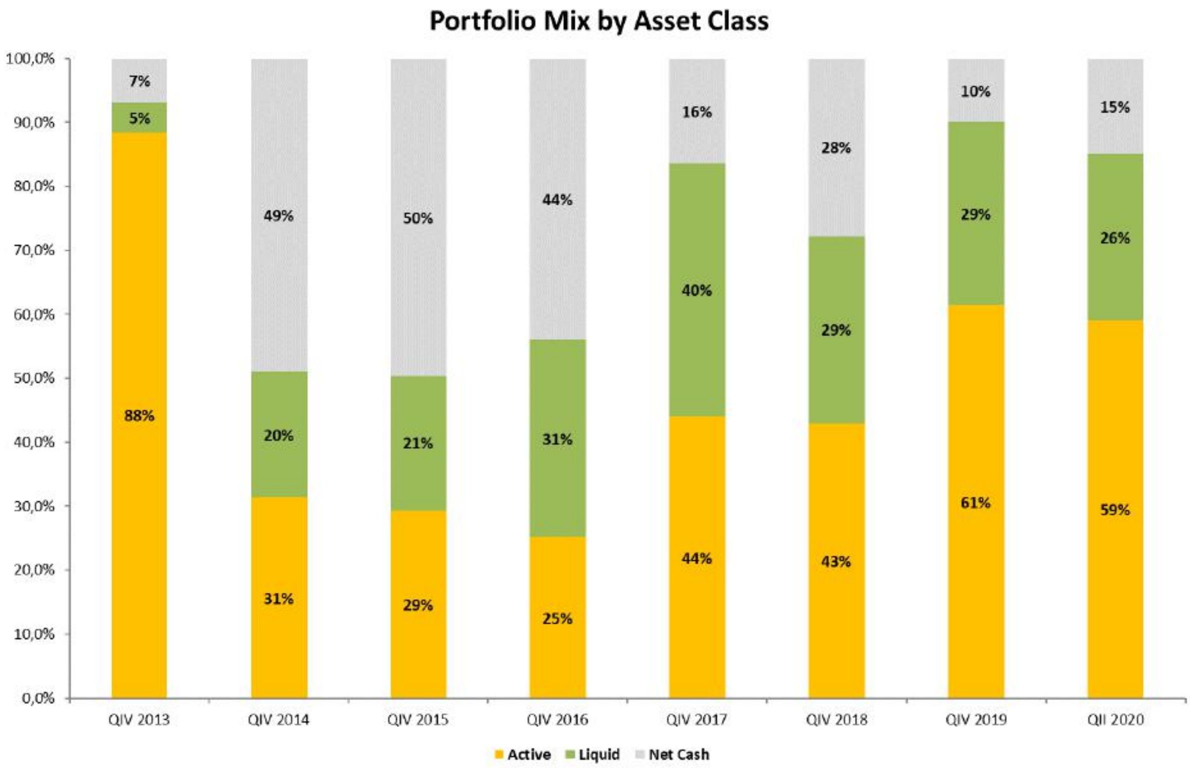
Our portfolio is comprised of **three different asset classes:**

a) **Active Ownership** – significant positions in companies, combined with Board involvement in which we hope to enable positive changes. Thus we are active owners, but unlike the likes of Cevian or Elliott Advisors **we work constructively with our holdings and try to achieve long-term, sustainable change.**

b) **Liquid Positions** – positions that we can build and exit at fairly short notice. We normally own 10 – 12 of such liquid investments.

c) Cash and Cash Equivalents.

The chart below shows the evolution of our portfolio by type of class:



As you can see the portfolio is dominated by strategic holdings, at present there are two of them. Relating this allocation back to the evolution of Intrinsic Values leads one to the conclusion that this strategy has not been particularly successful. Specifically, the long-term evolution of IV-T of the two holdings since inceptions has been as follows:

a) **Ids**: from GBP 5,17 in 2017 to GBP 3,90 today, i.e. a decrease

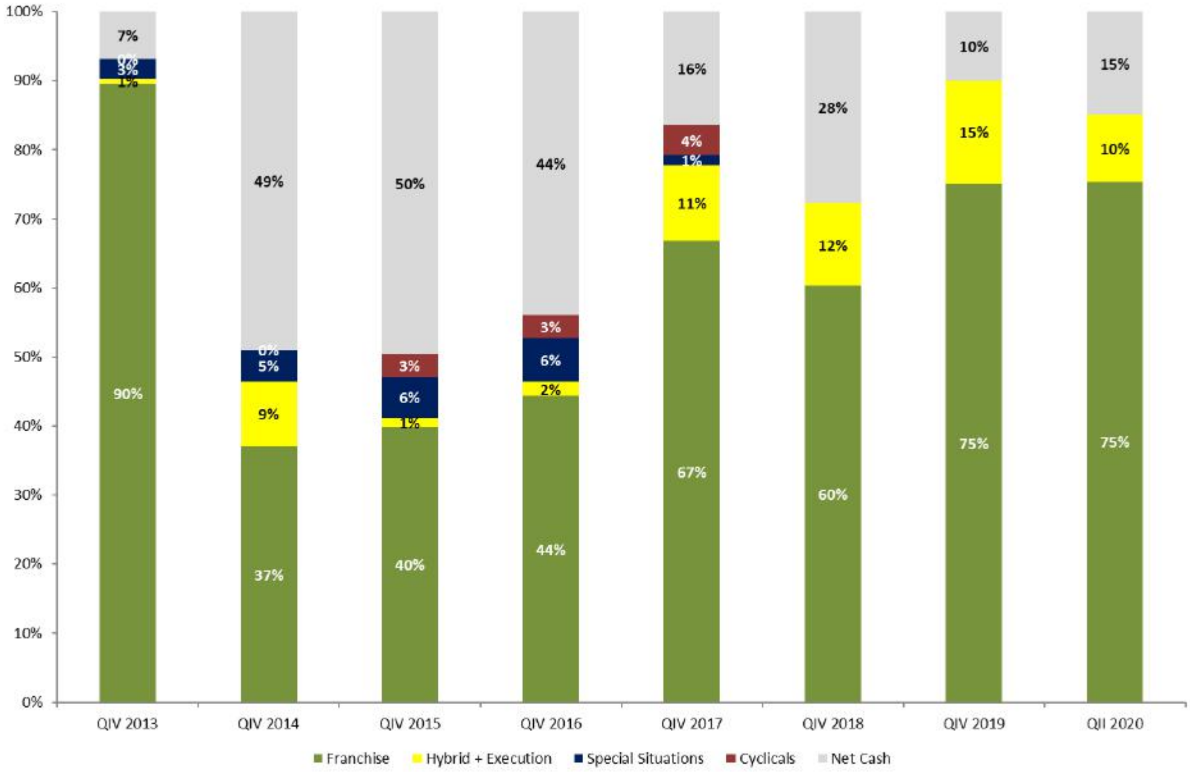
b) **Genomma Lab**: from MXN 35,64 at the time of entry in 2017 to GBP 35,00 today.

We will therefore try to **reduce our allocation to these strategic holdings in the next months.**

2. Portfolio Evolution by Business Quality

2.1 Overview

We think **business quality** is the most important determinant of risk and return in public equity investing. Below we will therefore discuss the evolution of our portfolio along this dimension. In doing so, we will **combine the positions in the active ownership and liquid portfolio buckets, i.e. look at the total the invested part of AUM.**



As you can see **in 2020 is the share of Franchise Businesses stayed unchanged at 75%**. This contains the two strategic holdings, Genomma Lab and ids. Our Investment Philosophy stays unchanged that Franchise Businesses should account for **at least 50% of AUM.**

We reduced our allocation to businesses in the Hybrid and Execution Category. These are the businesses of **medium and lower quality**.

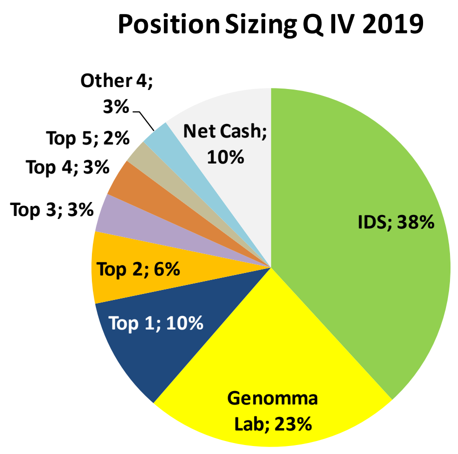
C. Short Book

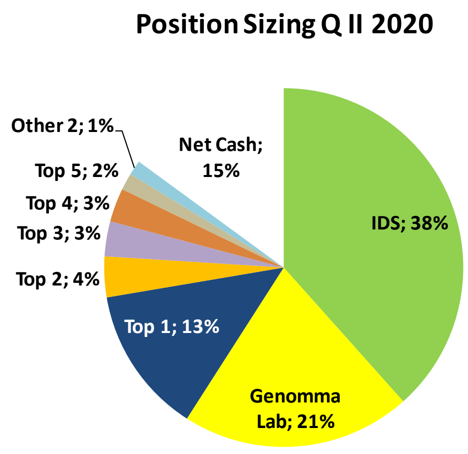
During Q I 2019 we covered all of our short positions. We have not opened a new short position since but are actively looking for new ideas.

D. Additional Perspectives on Portfolio Mix

1. Portfolio Concentration

Please look at the two pie charts below to show the **evolution of the portfolio by position sizing:**



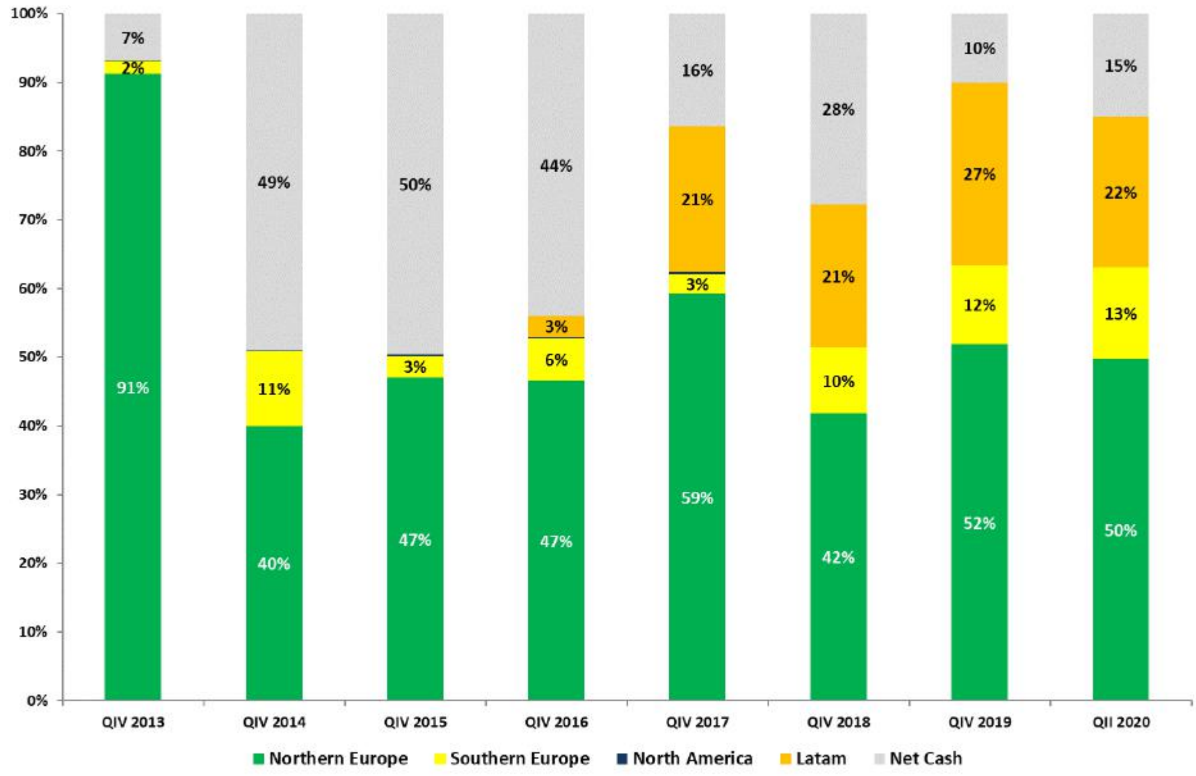


The number of names with an allocation of 10% is unchanged at 3. **The top 3 position combined account for 72% of AUM, slightly up from 71% at the end of 2019.**

The "tail end" of the portfolio – defined as positions with an allocation of less than 10% - remained unchanged at 9 positions.

2. Regional Portfolio Mix

Please see the chart below for the evolution of portfolio mix.



There was little change in the regional composition of our portfolio:

a) **50%** (31.12.2019: 52%) **is invested in Northern Europe**

b) **13%** (31.12.2019: 12%) **is invested in Southern Europe**.

c) The share of **LatAm decreased from 27% to 22% as we sold down our holding in the only position in this region, GenommaLab.**

E. Risk Exposure

We believe that the risk chapter presented in our Annual Report of the CIO 2019 is still relevant today, please refer to the respective chapter.

F. Conclusion

Q II 2020 was a quarter with **few major developments**. The current relationship between

a) Portfolio value at market prices

b) Intrinsic Value – both N-EPV and IV-T implies **both a significant Margin of Safety and a potential for upside.**

The key task for portfolio management for the rest of the year is to **find a way to profitably reduce our exposure to the two strategic holdings** and to re-invest the proceeds into liquid businesses which have a strong and reliable track record of Internal Compounding. This is the safer route to getting back to the growth in Intrinsic Values of our portfolios which drove the good performance in the years to ca. 2014.

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Burkhard Wittek

Appendix 1: 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.

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 decision 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.