FORUM

European Smallcaps GmbH

Memorandum

To : FES Staff

From : BW

Copy to :

Date : October 29th, 2012

Subject : FORUM European Smallcaps Q III 2012 Results**_V_Web**

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1. Results in Q III 2012

As a starting point let us summarize our investment philosophy on performance:

a) We think **growth in Intrinsic Value** is the best metric for performance as it captures the value we own. What Mr. Market will pay in price for this value will fluctuate a lot – but in the long run it will oscillate around this fundamental value.

b) With respect to **performance at market prices** we believe that in public equity investing **any meaningful track record starts somewhere between 5 and 10 years**. Only after such a period an investment philosophy, an investment process and a team will have been tested against the vagaries of market cycles or luck from market timing or individual stock picks.

c) For performance at market prices **we target absolute returns over a cycle**: if a market is flat – e.g. many stock markets in the decade to the end of 2011 – having an overperformance of a few percentage points is not satisfactory. We ignore short-term returns at market prices.

1.1 Results of FORUM European Smallcaps

Please see the graph in **Appendix 1** for an overview of the portfolio

a) at market prices

b) at N-EPV

c) at IV-T

over time.

In Q III 2012 **the value of our portfolio at market prices went up by 11%.**

In the same period the **Intrinsic Value of our portfolio** showed a positive development:

a) **Net Earnings Power Value ("N-EPV") increased by 2,9% in the quarter.** N-EPV captures the earnings power value of the existing business in a steady-state situation, i.e. based on expected sustainable earnings over a cycle, without structural or management improvements and without growth. Thus it has a fairly high reliability, it measures "what is there".

b) Total Intrinsic Value ("IV-T) increased by 3,2%. IV-T captures the total value of the business which is the sum of its N-EPV, structural or management improvements of the business and the value of expected growth. As such it contains several critical assumptions on the future and is less reliable than N-EPV.

A key building block of value Investing is the **Margin of Safety**. We measure it by the ratio of the portfolio at market values to the value of the portfolio at N-EPV. In the quarter this **Margin of Safety narrowed to 13% -** i.e. the portfolio at market values stood at 87% of N-EPV.

The ratio of the value of the portfolio at IV-T to the value of the portfolio at market prices is a measure for **the upside**. In the quarter it dropped to 150% from 169% at the end of the last quarter - implying an upside potential of 50%.

1.2 Benchmarking of Results

For an overview of **our results vs. our benchmarks** we would like to refer to **Appendix 2**.

1.2.1 Results in this Quarter

The key benchmark for our performance at market prices is the **HSBC Smaller European Total Return Index in €. In Q III 2012 this index was up by 8%. This is largely in line with the results of our portfolio at market values.**

The second benchmark we use it the European Smallcap Fund of Ennismore Class A in € - the European smallcap value fund we deem best in class. In Q III 2012 it was up by 2% - held back by its short book.

1.2.2 Results since Inception

At the end of Q III 2012 **our cumulated performance in the 10 3/4 years from January 1st, 2002 – the date of our inception** – to September 30th, 2012 **was 17,0% p.a. – a total increase to 543% of starting value**.

Thus in the 10 3/4 years as investors we have slightly exceeded our target of a compounded return of 15% p.a. We believe these results should reflect investment performance independent of a certain market situation. We feel we have outgrown the saying "**markets make managers**".

Our IRR of 17,0% p.a. resp. to 543% of starting value since inception on Jan. 1st, 2002 compares with IRRs **for this period** of

a) **6,6%** p.a. for the **HSBC index in €** – a total increase to **198% of starting value**

b) **8,3%** p.a. **for the Ennismore fund in € –** a total increase to **235% of starting value.**

2. Development of Portfolio Mix

Please see **Appendix 3** for an overview over the portfolio mix since 2008. In Q III 2012 the two most remarkable developments were:

a) The % of assets allocated to our **strategic holdings** increased again to 87% to AUM. That creates significant concentration risk. We will comment on this below.

b) The **tactical portfolio -** excluding cash – stayed at 6% of AUM.

c) **Cash and cash Equivalents** decreased to 7%.

3. Development of Long Book

3.1 Strategic Holdings: Companies with a Significant Stake and Board Involvement

3.1.1. Immunodiagnostic Systems Holdings plc.

We have **a stake of 29%** in the company and BW is a **Non-Executive Board member** and member of the remuneration and audit committees.

The company offers diagnostic assays for labs, both manual and automated. The automated iSYS platform is targeted for low- to mid-volume applications and has a strong technical reliability in comparison with peer products. The lead product is vitamin D which accounts for ca. 60% of revenues.

In the last Letter to Clients we reported that **Patrik Dahlen** had joined as the new CEO. Patrick brings lots of management experience in the lab diagnostics business to the task – combined with strong leadership skills. In the first quarter of his job he concentrated on getting to know the organization and form a first-hand impression on the key issues facing the company.

In the quarter **Ged Murray,** the new CFO since April 2012, informed us that he will leave us. The search for a successor will focus on a personality with a dose of entrepreneurial spirit who can assist Patrick in moving the company forward.

The **two key drivers** for building the company are unchanged:

a) placing 80 - 100 new analyzers p.a. At average revenues per box of GBP 70.000,- this adds revenues of GBP 6 - 7m to the present base of ca. GBP 50m. In this FY and to some extent in FY 2014 as well it will help to compensate the migration of manual assays to the "workhorses" as these assays - in particular vitamin D - become available.

b) enlarging the menu of automated assays from 11 in Europe/5 in the USA to a critical mass of 20 in a short time frame. This number is required to convince potential customers to give us an additional piece of "lab real estate" which is increasingly hard to get.

The company reported a Trading Update for the first five months of the current FY. According to the information given the company appears to be on track to deliver on both targets. **Thus we made no changes to our valuation.**

In Q III 2012 the **share price of IDS decreased by ca. 11%** to GBP 2,75 from GBP 3,09 at the end of June 2012. YTD the share price in local currency is **down 40% - holding back the performance of the portfolio.** We are not worried as we think the Intrinsic Value of the company is largely unchanged - we kept our IV-T largely unchanged.

3.1.1.1 Pulsion Medical Systems SE

We have a **52% stake** and **BW has been Chairman** of the company since 2009.

Pulsion is the No. 2 worldwide in hemodynamic monitoring and the No. 1 in the critical care segment of the market. It has just introduced its second product line since inception and is in the process of rolling it out.

In August the company published Q II results which showed that the **leadership of Patricio Lacalle** allows it to reach new peak levels of performance each quarter. By now operating margins have gone up to ca. 25%. We have not adjusted our valuations yet as we want more evidence that this earnings level is sustainable.

In terms of capital allocation the company did another round of share buybacks in the quarter. Since the beginning of the buybacks ca. 2 years ago the company has bought back ca. 12% of the outstanding share capital.

On the back of the outstanding Q II results In Q III 2012 the **share price of Pulsion gained 32%** to € 8,10 from € 6,11 at the end of Q II. YTD the **share price has increased by 47% -** just not enough to compensate for the share price drop at IDS.

3.1.2 Tactical Portfolio

This part of the portfolio is comprised of liquid, passive investments.

At the end of Q III 2012 it consisted of **6 positions** which accounted for **ca. 6% of AUM -** unchanged from the previous quarter.

During the quarter we decreased N-EPV of one position by ca. 25%. It is a Greek company and we believe the level of business will be structurally impaired for many years to come.

As of September 30th, 2012 the Tactical Portfolio at market prices had a **Margin of Safety based on N-EPV of 33% - down from 41% at the end of the previous quarter.**

3.1.3 Cash and Cash Equivalents

At the end of Q III 2012 **cash and cash equivalents accounted for ca. 7% (June 30th: 11%) of AUM.**

As pointed out in the last Letter to Clients **we want to get back to a level of ca. 20% as**

- this is the **standard level of liquidity** we want to hold in order to be able to take up attractive opportunities which may arise any time.
- our Macro Dashboard suggests there are **above average risks to earnings and valuations.**

4. Development of the Short Book

At the end of Q III 2012 our short book consisted of **four positions totaling 4,0% of AUM - up from 1,1% on June 30th, 2012**. During the quarter we closed one position with a small gain.

YTD the short book has contributed -0,1% to overall results.

5. Handicapping: Risk/Return Balance of the Portfolio

We would like you to refer to **Appendix 1** once more as for us it is the key tool to monitor the expected **risk/return balance** of the portfolio.

5.1 Risk Management

Our basic philosophy as value investors is **to look after the risk management of the portfolio first to avoid any permanent losses of capital – our definition of risk**. As you know by now we do not worry a lot about changes in market prices of our investments as long as we feel confident about the Intrinsic Value of what we own.

5.1.1 Margin of Safety

We believe the main protection against risks and uncertainties is the **Margin of Safety**. As mentioned above our **Margin of Safety based on N-EPV decreased to 13% at the end of Q III 2012.** This says that

a) Mr. Market prices the businesses we own **with a 13% discount from the current Earnings Power Value** - i.e. just valuing today´s cash flows…..

b) …and there is **no value to growth**.

As shown in our numbers we happen to have a strong belief that this is **a massive undervaluation.**

Of the 6 companies we own **none is trading above N-EPV** – thus we feel well-protected.

5.1.2 Impairment of Intrinsic Values

We reported above that **we had to downgrade the Intrinsic Value of one tactical position -** with the impairment largely driven by our assessment of the Greek macroeconomic situation.

5.1.3 Company-Specific Risks

Our **exposure to Greece** at the end of Q III 2012 increased slightly to ca. 0,8% of AUM.

5.2 Upside Potential

As you can see from the relation between the portfolio at market prices and IV-T the upside potential of the portfolio continues to be attractive: **IV-T stands at ca. 150% of the portfolio at market prices - implying an upside potential of 50%. If that materializes within two years it would yield an annual return of more than 20% p.a.**

6. Outlook

6.1 Macro Outlook

We refer to our Macro Dashboard for Q III 2012. The highlights from the US-perspective are:

a) The level of US **Corporate profitability has increased once more:** the median of the positive deviation has increased to 42% from 22% at the end of Q I 2012. The median has increased to **ca. 1,5 standard deviations -** thus this deviation is moving in the direction of a "bubble" (which we define as a standard deviation of at least 2x).

b) **At the same time valuations** have continued to increase and now stand at a level of **26 – 55% above their historical averages** depending on the metric used. As valuations have been volatile in the past this implies a **standard deviation of 1,1x** on most metrics. Thus this is still not becoming statistically significant.

c) This implies **expected returns on equities in the next cycle below average, ca. 2 – 3% p.a. in real terms**.

d) We continue to see major risks to the global economy. As of now we feel that the €-crisis appears to be culminating and could lead to a sudden sequence of events which are hard to predict any more: we feel that we have moved out of the space of Bayesian logic into the area of uncertainty ("known unknowns").

History as a guide suggests that outcomes for investors have not been positive. In particular the likelihood of very negative outcomes appears to be higher now than a few months ago ("tail-end risk). We therefore propose to increase our level of caution even more.

As a **conclusion of this Macro Outlook on our asset allocation** we have modified the goals set in the last Macro Outlook:

a) cash quota of 20%

b) net short position of 10 – 20% (up from 5 – 10%).

As always we will mostly be driven by such opportunities – and not by the tops-down allocation model.

6.2 Status of Watchlist

Our watchlist equities long prio 1 - which contains investment candidates trading below Net Earnings Power Value - has evolved as shown in **Appendix 4**. In total the number increased to 11 from 8. The key points are:

a) **Three (June 30th, 2012: five) positions are in Greece**. We continue to be cautious. Our base case scenario is that Greece will have a default and exit the €. It is very hard to assess the outcomes of such a course of events as there are very few historical precedents.

b) Five (June 30th, 2012: three) positions are outside of Greece. This increase is largely the result of our increased research capacity. Of the five, two are in Italy and France - implying macro risk again. We continue to do Due Diligence on these positions, in particular the three outside of Italy and France.

6.3 Target Structure of the Portfolio in one Year

At this point in time our goal in portfolio development is a further diversification of risk.

This involves the following actions – sorted by priority:

a) As a matter of policy we do not comment on our **Strategic Holdings.**

b) In the last quarter we reported that our second priority is the **build-up of our short exposure**. Due to being slow - and some luck - we did not implement this decision fully. After the three central banks of the USA, Europa and Japan all committed to an unlimited easing of money markets are "risk-on" again.

   We took this experience as a trigger for **tightening our Investment Policy for Shorting** again - after having released it in the meantime: going forward **we will restrict ourselves to "autonomous shorts" - i.e. shorts which have a catalyst for a negative share price development independent of how the market moves.**

   We will limit shorting for hedging purposes to situations where the positive deviation of valuation exceeds two standard deviations - which is our definition of a bubble.

c) As our third priority - up from fourth - we plan to **re-build the Tactical Portfolio.** We are a full team now and should be able to come up with promising candidates. For the rest of 2012 we target 1 – 2 additions to our tactical portfolio.

d) We continue to try to clean out some "**deadwood**" in the Tactical Portfolio which fits the saying "A long-term investment is failed short-term investment". We have two illiquid positions which fall into this category.

e) We would like to get **cash and cash equivalents up to our standard level of ca. 20% of AUM.**

7. The Firm

7.1 Professional Staff

The team consists of the following positions/professionals:

a) **Three analysts** covering Western Europe for equity long positions. They work along three regions with a few sectors allocated to them as well across Europe. During the quarter we moved one professional from PE to this area.

b) **One analyst** for special situations. We are trying to fill this position.

c) BW as **portfolio manager.**

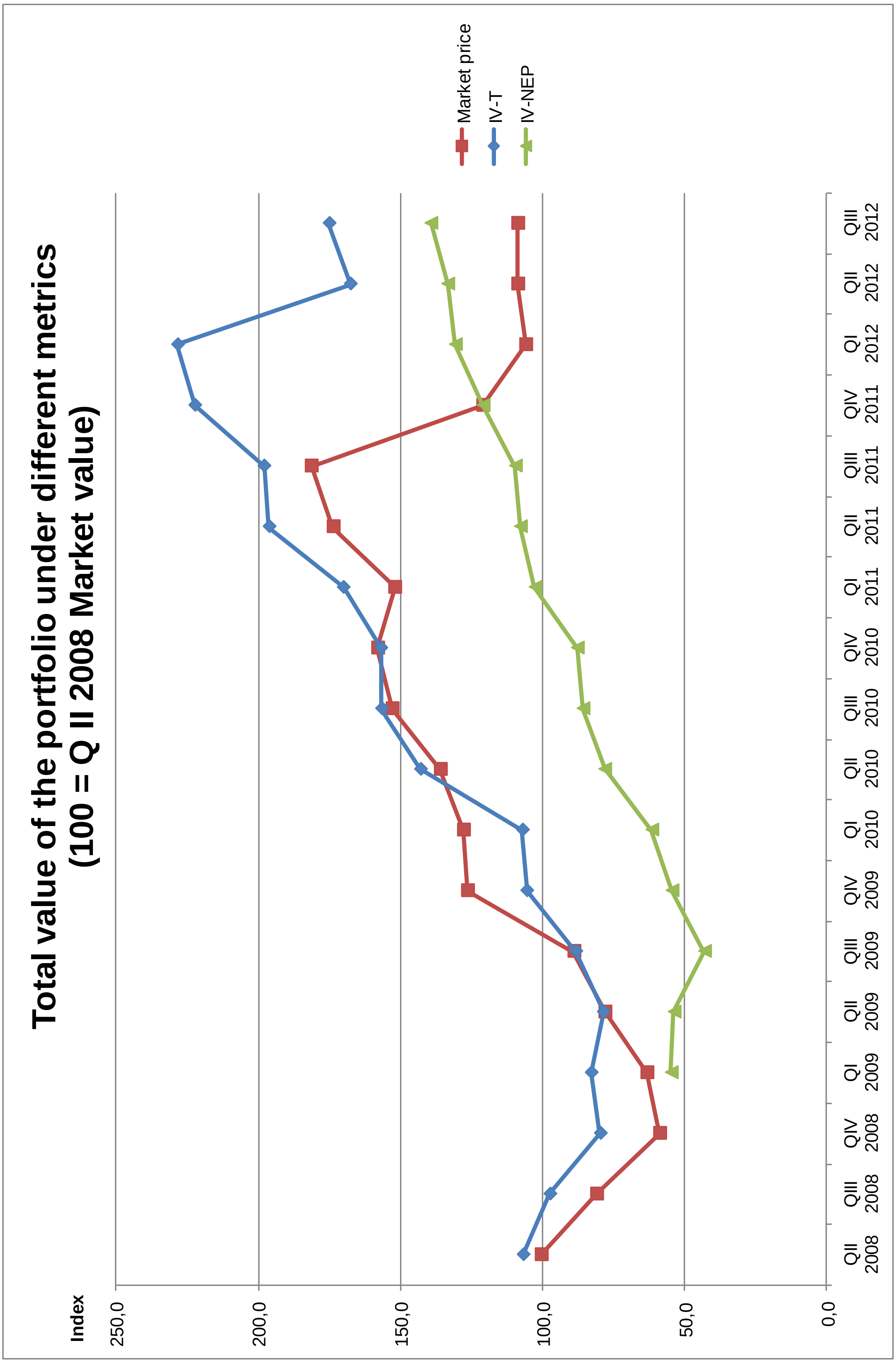
7.2 Fund for External Investors

Our fund had yet another slippage. The final launch **will now take place in the first half of Q IV 2012.**

As the first size level we target € 20m.

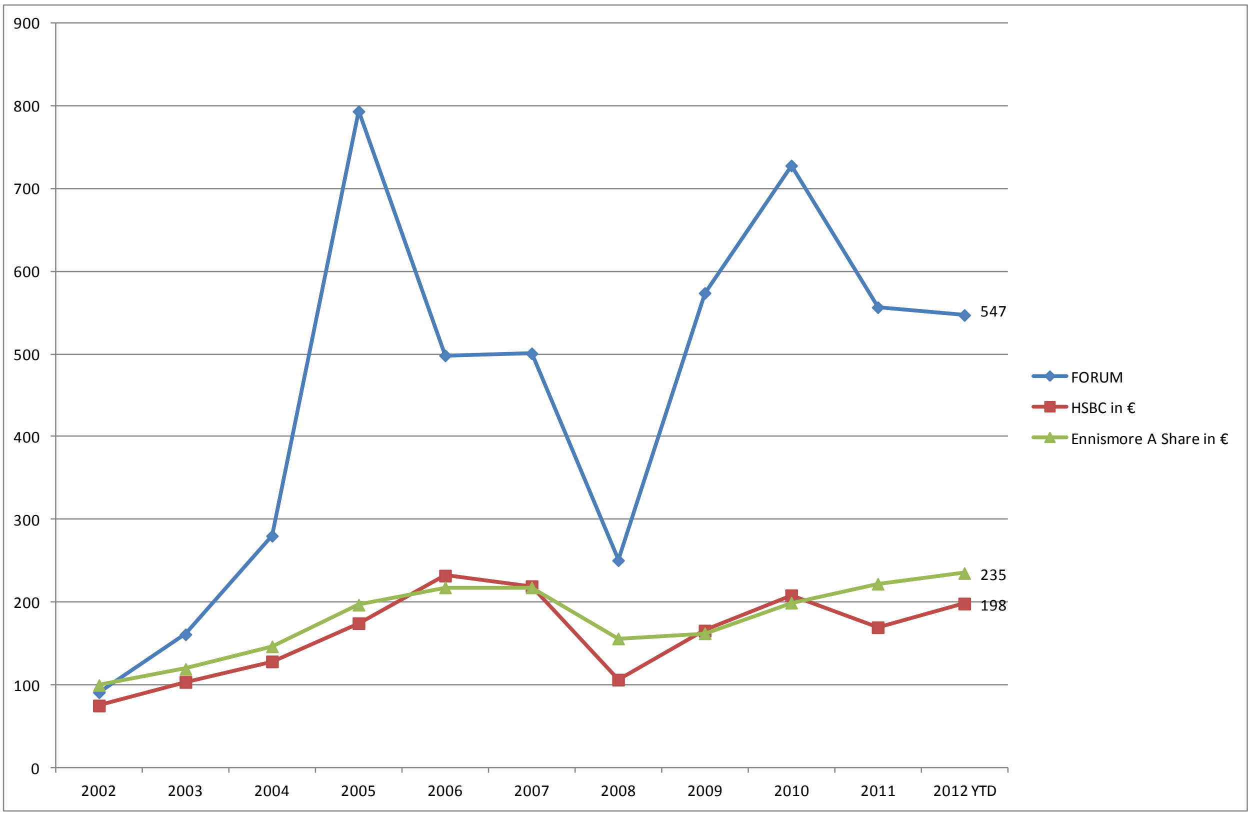
Appendices

Appendix 1: Portfolio’s Development

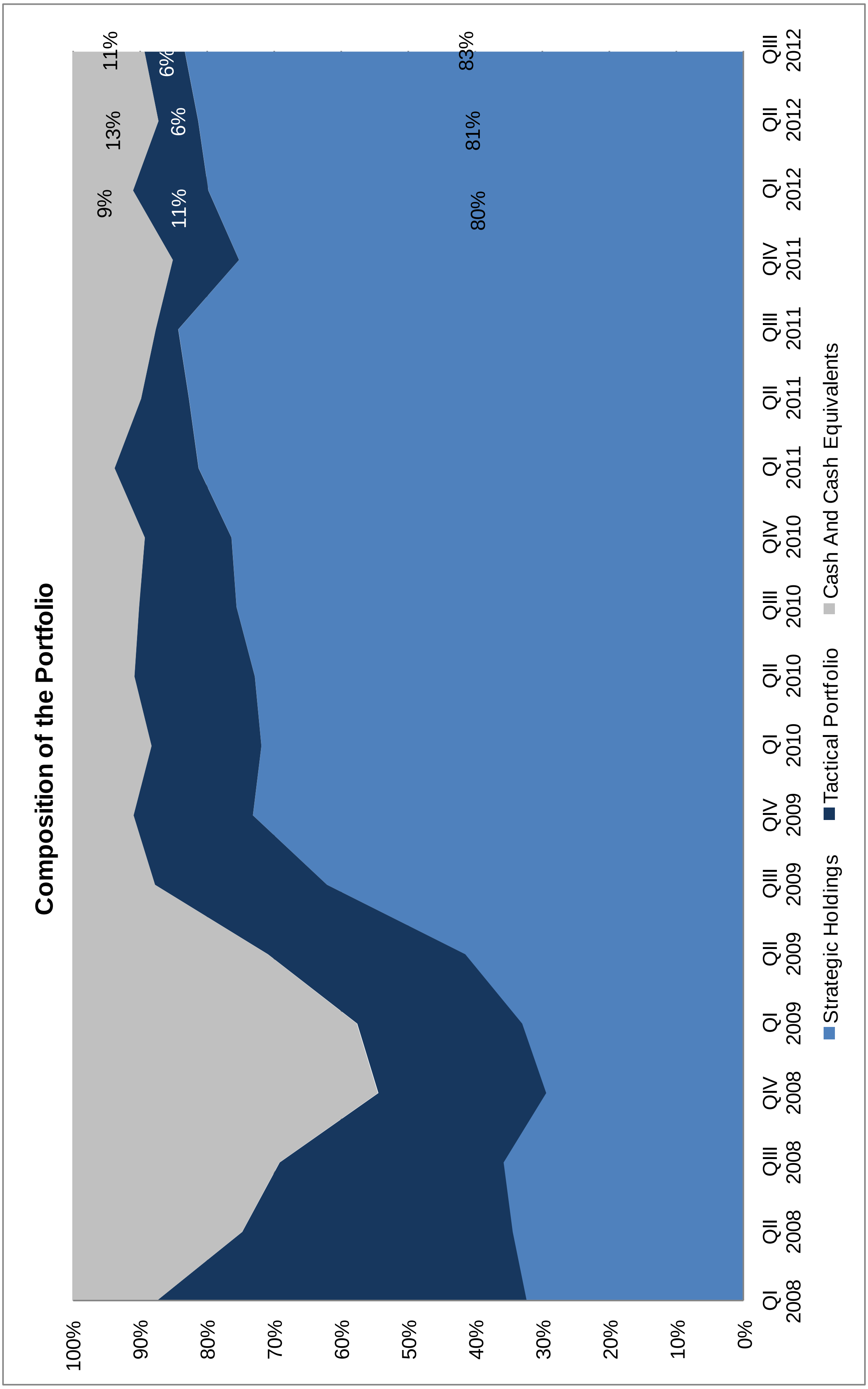


Appendix 2: Benchmarking of Results

Since Inception (2002), p.a.	FORUM		HSBC European Smallcap Index in €		Ennismore A Share in €	
	Percent	Index	Percent	Index	Percent	Index
2002	-9%	91	-25%	75	0%	100
2003	77%	161	38%	104	20%	119
2004	74%	280	24%	128	23%	147
2005	183%	794	36%	175	34%	197
2006	-37%	498	33%	232	11%	218
2007	1%	501	-6%	219	0%	218
2008	-50%	251	-52%	106	-28%	156
2009	129%	574	56%	166	4%	162
2010	27%	728	26%	208	23%	199
2011	-24%	557	-19%	170	12%	222
2012 QI	-12%	491	14%	194	3%	230
2012 QII	2%	503	-5%	183	1%	231
2012 QIII	9%	547	8%	198	2%	235
IRR 2002 - YTD	**17,1%**		**6,6%**		**8,3%**	



Appendix 3: Development of Portfolio Mix



Appendix 4: Development of Watchlist Prio 1

	March 31st, 2011	March 31st, 2012	June 30th, 2012	Sept. 30th, 2012
Greek	3	5	5	3
Non-Greek	6	3	6	5
Total	**9**	**8**	**11**	**8**