FORUM

European Smallcaps GmbH

Memorandum

To : Forum Staff

From : BW

Date : July 28th, 2015

Subject : FES Chief Investment Officer Report on QII_2015 Results**_V_2.1_Homepage**

FORUM does not have clients, it only invests its own funds. The report of the CIO has been put together for **stakeholders interested in what we do**, mainly

a) our **internal professional** team as a basis for a structured internal discussion

b) the **many companies** 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 work and life at FORUM is like.

We did not publish a Q I 2015 Interim Report, thus this report covers the **period from January 1st, 2015 to June 30th, 2015**.

1. Results in HI 2015

1.1 Results at Market and Intrinsic Values

Please see the graph in **Appendix 1** for an overview over our results

a) at market prices

b) at Net Earnings Power Value ("**N-EPV**")

c) at Total Intrinsic Value ("**IV-T**")

since our inception.

In HI 2015 the value of our **portfolio at market prices increased by 4,7%.** Ca. 3,9% of this performance comes from currency gains, mainly the € / GPB.

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

a) **N-EPV decreased by 8,1%.** 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") decreased by 5,0%.** IV-T 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.

A key building block of Value Investing is the **Margin of Safety**. We measure it by the discount of the portfolio at market values from the value of the portfolio at N-EPV. In the quarter the **Margin of Safety vs. N-EPV stood at 2% -** vs. 26% at the end of 2014.

The **ratio of the value of the invested part of the portfolio at IV-T to the value of the invested part of the portfolio at market prices** is a measure for the upside. At the end of HI 2015 it stands at 193%. When cash is included this ratio drops to ca. 148%. This is the upside potential of the total portfolio as of today. It does **not capture the upside from compounding of our holdings - i.e. the growth in Intrinsic Value over time.**

1.2 Benchmarking of Results at Market Prices

For an overview of **our results vs. our benchmarks** please refer to **Appendix 2**.

The benchmarks for our performance at market prices are

a) Ennismore as a successful fund with a Value Investing philosophy

b) The HSBC European Small Cap index.

In H1 2015, both of these benchmarks performed significantly better than us with YTD gains of **9,1% and 19,0% respectively.**

2. Asset Mix and Results by Asset Class

2.1 Evolution of Asset Mix

Please see **Appendix 3** for an overview of the composition of our long book. As you can see the portfolio mix by asset class is still largely unchanged from the structure it had after the disposal of our strategic holding in Pulsion Medical Systems SE in Q I 2014:

	Q IV 2014	**Q II 2015**

a)	Strategic Holdings	31%	28%
b)	Tactical Portfolio	20%	24%
c)	Cash and Cash Equivalents	49%	48%
-	*Thereof from short positions*	*0%*	*1%*
d)	**Total**	**100%**	**100%.**

Thus the key message is that the **portfolio is nearly 50% in cash and cash equivalents. This has not changed significantly either in Q II or H 1 2015.**

We always like to convert cash into good investment ideas. In Q II and H1 2015 we had a few good new ideas – but we allocated them primarily for our fund as most of these ideas were smallcaps where we could not find the liquidity required for FES. **To put it differently: in Q II and H 1 2015 we neglected FES to the benefit of the fund.**

Net long exposure is 51% (52% long ./. 1% short).

2.2 Returns by Asset Category

Below please find an overview over returns by asset category:

		Q II 2015	Return Q II	Return YTD
a)	Strategic Holdings	28%	-3,2%	-8,3%
b)	Tactical Portfolio	24%	9,1%	30,3%
c)	Cash and Cash Equivalents	48%	0%	0%
-	*Thereof from short positions*	*1%*		
d)	**Total**	**100%.**	**1,9%**	**4,7%**

As you can see H1 2015 suffered strongly from the decrease in the share price of **our strategic holding IDS**. At that point in time the share price has fallen back to the level of when we entered ca. 6 years ago. This loss has been mitigated a bit by the appreciation of the GBP vs. the €. **We have a major restructuring job ahead of us at this holding.**

Conversely, our **tactical portfolio** has been doing reasonably well with a gain of ca. 30% YTD.

As of June 30th, 2015 total short exposure was equal to -0,4% of AUM. Thus net long exposure of the portfolio can be viewed as follows:

a)	Invested Part Long	51,5%

b) Invested Part Short -0,4%

c) Net Long Exposure 51%

With an insignificant short book the net long exposure of the portfolio is ca. 50% as well.

3. Strategic Holdings

3.1 Immunodiagnostic Systems Holdings ("IDS")

We have commented about the **poor management at IDS** in the last Reports of the CIO.

Beginning in November 2014 the Board at IDS has been largely exchanged: Chairman, CEO and CFO have left by now. For an interim period of ca. 3 months I have taken on the role as Executive Chairman in order to get a first-hand, unfiltered and unbiased view of the company. As a consequence we have started initiatives to stop the downward trend at the company.

As of April 1st, 2015 Patricio Lacalle has started as CEO as he became available short-term from his former employer Pulsion Medical Systems. We agree on the main projects to be pushed forward and I hope that things will brighten up again. **In the short-term we will have to deal with a strong downward momentum at the company, though.**

3.2 New Candidates

We did not add any new investment in our strategic portfolio in HI 2015. We think a lot of value can be created by changing the Board, strategy and culture at underperforming public companies.

We have to devote more resources for this asset class with the goal to find new investment candidates. The effort will be headed by Till Campe, a member of our staff. The goal is to add another strategic holding in the next 6 – 12 months.

4. Tactical Portfolio

We think about our portfolio primarily in **five the following types of businesses resp. investment situations:**

a) **Franchise Businesses**: businesses with high customer stickiness, strong competitive advantage, in fate of their own destiny

b) **Hybrid Businesses**: businesses combining aspects of Franchise Businesses and Execution Businesses (see below)

c) **Execution Businesses**: businesses which need ongoing strong operating management – otherwise they degenerate quickly as they have little structural competitive advantages.

d) **Cyclical Businesses**: businesses whose earnings are primarily driven by the commodity cycle. They can have high customer stickiness and competitive advantage, but these characteristics will only play out over the full cycle.

e) **Special Situations and all other**: this category is mostly comprised of positions involving merger arbitrage, corporate restructurings or stock exchange arbitrage.

A second dimension of the **quality of businesses are their compounding economics** – i.e. the ability to re-invest free cash flow resp. equity into profitable growth at an ROIC above what an investor would be able to get from investing in a stand-alone business.

According to our Investment Philosophy **we try to allocate the majority of our tactical portfolio to Franchise Businesses – preferably those with strong compounding economics.** We will also invest in the other categories, but **only when the risk-adjusted return expectation is absolutely outstanding.**

Please see **Appendix 4 for break-down of the tactical portfolio** along the five types of businesses as mentioned above.

4.1 Franchise Businesses (29% of Tactical Portfolio)

This category consists of three positions: an FMCG company, a software company and an operator of wind mills. The **dominant position is the FMCG company.** This business could have what Charlie Munger calls **the Lollapalloza effect**: when three outstanding factors combine – in this case a business of Franchise quality, an outstanding management and very shrewd capital allocation – the results can get beyond what plain ex-ante analysis would have predicted.

In Q II the business achieved a 14% lfl. growth in its own brands and was reaping the benefits of integration of an earlier acquisition.

We think this business can continue to compound at low double-digit rates. As with most quality companies, valuation is being pushed up by the market, thus we have to monitor the risk of multiple contraction.

In Q II we **divested a position in a specialty pharma company** as we felt the main shareholder was trying to take advantage of minority shareholders with a merger proposal which we – and all other investors we talked to – found grossly unfair.

Conversely, we **added a small investment in a consolidator in software**. Unfortunately this idea was generated by looking for smallcap opportunities for our fund, thus we were unable to even build up a position of 1% of our tactical portfolio.

4.2 Hybrid and Execution Businesses (59% of Tactical Portfolio)

This category is made up of an emerging software company, a de-listed tank fraud prevention system provider, a tiny position of Berkshire Hathaway, an EPC contractor, an oil service company and a construction/infrastructure company. The dominant holding within this category is the **emerging software company** – we refer to it as emerging as it is just entering a second business line in a fast-growing software category where the endgame situation is not clear yet. As we had to report a stake we can also name it – it is **Globo plc.**

In H1 2015 the company **reported growth of 56%** mainly driven by the new business line Enterprise Mobility Management ("EMM") which grew by 126% and now represents 62% of group revenues. **EBITDA grew 55%** showing the focus of the company on remaining very profitable despite the strong growth. Finally **renewal rate of prior year's licenses was ca. 99%**, an extremely high stickiness.

4.3 Cyclicals (1% of Tactical Portfolio)

In this category we own **an operator of palm oil plantations.** The price for this commodity is presently at a multi-year low – driven by substitution economics from other vegetable oils with bumper crops (mainly soybean oil) and the lack of refining into biodiesel due to the low price for crude oil.

Palm oil is a multi-year (precisely 20 – 25 year) crop. Thus adaptation at the supply side happens slowly: the high cost producers – first of all smallholders – do not have the funds to apply the optimum level of fertilization, and **as a result yields go down ca. 12 months later.**

On the **demand side** palm oil is the prime vegetable oil used in Asia, which creates an underlying demand growth of 2 – 3% from population growth and switch to more meat-based diets instead of rice.

The company is one of the lowest-cost producers of palm oil, thus we expect the company to recover strongly once the supply/demand equation turns.

4.4 Special Situations and all Other (11% of Tactical Portfolio)

This category consists of a Genuss-Schein of Commerzbank. The current yield to maturity in 2020 is 4,75% p.a.

According to Basle II it does not qualify as tier 2 equity; the percent counted as equity will decrease by 1/10 each year – making it increasingly unattractive to the bank. **Thus we expect an offer for early redemption.**

4.5 Summary of Changes in Composition of Tactical Portfolio

The only change in H 1 2015 was the **sale of the specialty pharma producer**. At the time of the sales the position accounted for ca. 4% of the tactical portfolio.

4.6 Summary of Changes in Valuation

In H1 2015 we upgraded the N-EPV and IV-T of **2 companies** in our tactical portfolio due to good reported results.

4.7 Outlook

The tactical portfolio is clearly comprised of **too many positions – it needs weeding**. We will reduce it back to less than 10 positions by year-end – the tail-end does not make any meaningful contribution.

5. Short Book

At the end of HI 2015 FES has one short exposure. Compared to the size of AUM, it is not significant.

In the current environment of high valuation and cheap debt (both may end at some point), we would like to increase our short position.

6. Risk Report

6.1 Definition of Risk

We **define risk as a permanent loss of capital.** We do not worry about share price volatility.

6.2 Margin of Safety

We believe the main protection against risk and uncertainty is the **Margin of Safety**. The most conservative measure of risk is the discount of the invested part of the portfolio at market prices against N-EPV, i.e. the value of capitalized cash flow generation capability without any growth. As mentioned above our Margin of Safety – based on this definition - based on N-EPV stood at 2% at the end of HI 2015 (see Appendix 1).

6.3 Permanent Loss of Capital/Impairment of Intrinsic Value

In QII 2015 and as we finally have more clarity about what's happening at IDS, we decided to **substantially impair the value of our investment** , both in terms of N-EPV and IV-T by ca. 36% and 33% respectively. As a consequence our Margin of Safety dropped from ca. 25% at the end of FY 2014 to 2% today.

Despite this impairment, IDS still has the potential to generate significant value creation in the future.

6.4 Greece Exposure

At the end of Q II 2015 the share of the portfolio invested in companies registered and headquartered in **Greece was 12,5%** - comprising four holdings. **As the two largest holdings of these operate mainly outside of Greece, the "economic exposure" of FES to Greece is < 2% of AUM.** Nevertheless their market prices did suffer and may suffer further from the sell-out taking place at the Greek stock exchange.

6.5 Oil Price Risk

Our exposure to oil is two-fold:

a) A producer of a soft commodity with the **oil price putting a floor under the price** – up to 10% of consumption is for biodiesel.

b) One oil services provider which is an Execution Business.

At the end of Q II 2015 these companies **accounted for 0,5% of AUM.**

6.6 Risks from Portfolio Concentration

At the end of Q II 2015 the **top 3 positions** – including our strategic position IDS - **represented 46,2% of the portfolio.** We feel comfortable with this degree of concentration.

7. Investment Strategy

In the course of H 1 2015 we have reviewed our Investment Philosophy by doing several post-mortems of what worked and what did not work. We admit that the disappointing results in 2014 and 2015 were key drivers – nobody likes to underperform.

As a result we have sharpened our Investment Policy – in many cases going back to a positioning we had in the past, but may have softened up since.

7.1 Original Investment Philosophy – our Roots

Historically FORUM had its focus of investments in **traditional businesses which had a broad base of variables to optimize**: they would make things or deliver services, run an innovation process, have a sales and marketing process designed for selling their value proposition, develop a sticky aftersales businesses and try to build up a strong corporate culture setting free an unusually high level of energy within their staff.

We would **understand their customers** and **know many of their competitors** from having observed them for many years. These businesses would be **in control of their own destiny**, and not exposed so much to externalities, e.g. commodity cycles.

And most importantly they would have **strong compounding economics**: be cash-generative and invest the cash at high ROIC, both in organic growth and acquisitions; **and be operated by best-in-class managers**.

In terms of analysis we would be **able to apply our frameworks** for assessing best-in-class along these dimensions. A deep understanding of these frameworks is probably the strongest edge FORUM has. The second would be a Due Diligence based on talking to persons - customers, competitors or experts.

We always said that we would also invest in businesses outside of this "sweet spot" if the price was right. Our approach to valuation requires **lower multiples for these businesses and situations**. In 2014 the share of these businesses within our portfolio increased - because they were cheap.

7.2 What Went Wrong?

Looking back we may have **underestimated the risks of these lower-quality businesses**, in particular the exposure to commodity cycles and the risks from being exposed to capital spending by other players in cyclical sectors.

Assuming a Reversion to the Mean these investments may still work out. **But whereas our strong compounders keep on creating value each year, these cyclical/ “not in control of their own destiny” businesses are treading water now: to make up for this they will need to deliver outstanding results going forward**. We now view **the opportunity cost of not compounding** by these investments as so high that we will re-focus our energies on the good compounders we understand best.

7.3 Back to the Roots

After re-focusing our investment Philosophy on our roots we will increase the share of businesses within our "sweet spot". I would expect the share of Franchise Business within the Tactical Portfolio to increase to > 50% by the end of the year.

8. Outlook

We refer to our **Macro Dashboard for Q II 2015**. Since our last Macro Dashboard

a) profit levels in the USA are still near their all-time highs

b) **valuations have stayed at a very elevated level**. Market cap as a % of GDP has stayed at the level of two standard deviations for the second quarter. **This is a level we consider "bubble territory".**

This is the reason why we are fine holding cash right now if we do not manage to find outstanding investment.

9. The Firm

At the end of Q II 2015 our investment team consists **of**

a) 3 analysts

b) 3 associates with at least 2 years of seniority at FORUM or equivalent outsides

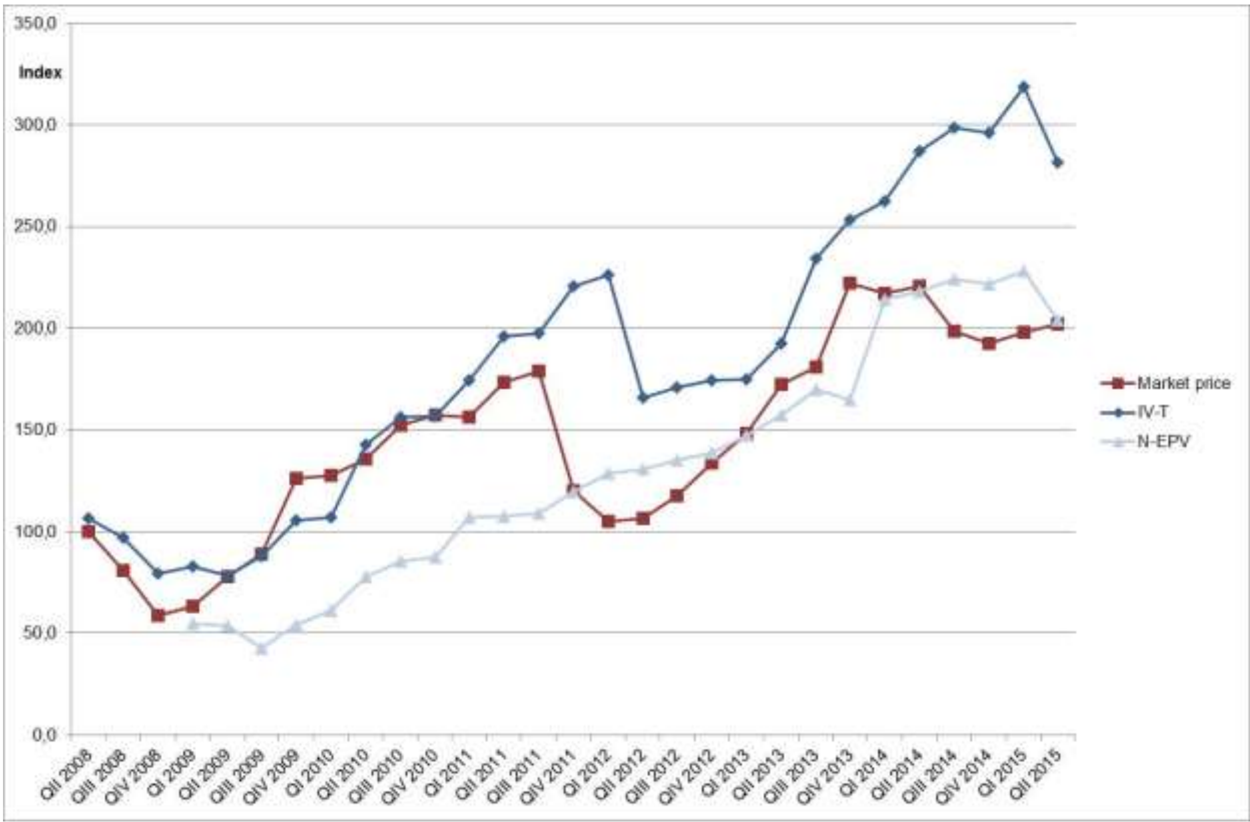
c) BW as portfolio manager.

This is **70% of the team size of Pershing Square (Bill Ackmann) which manages ca. US-$ 15bn** in AUM. We do not intend to match its size, we believe our team has reached its optimum size.

We continue to follow our process formalizing continuous learning via post-mortems, sector specialization/trainings and our various review meeting formats.

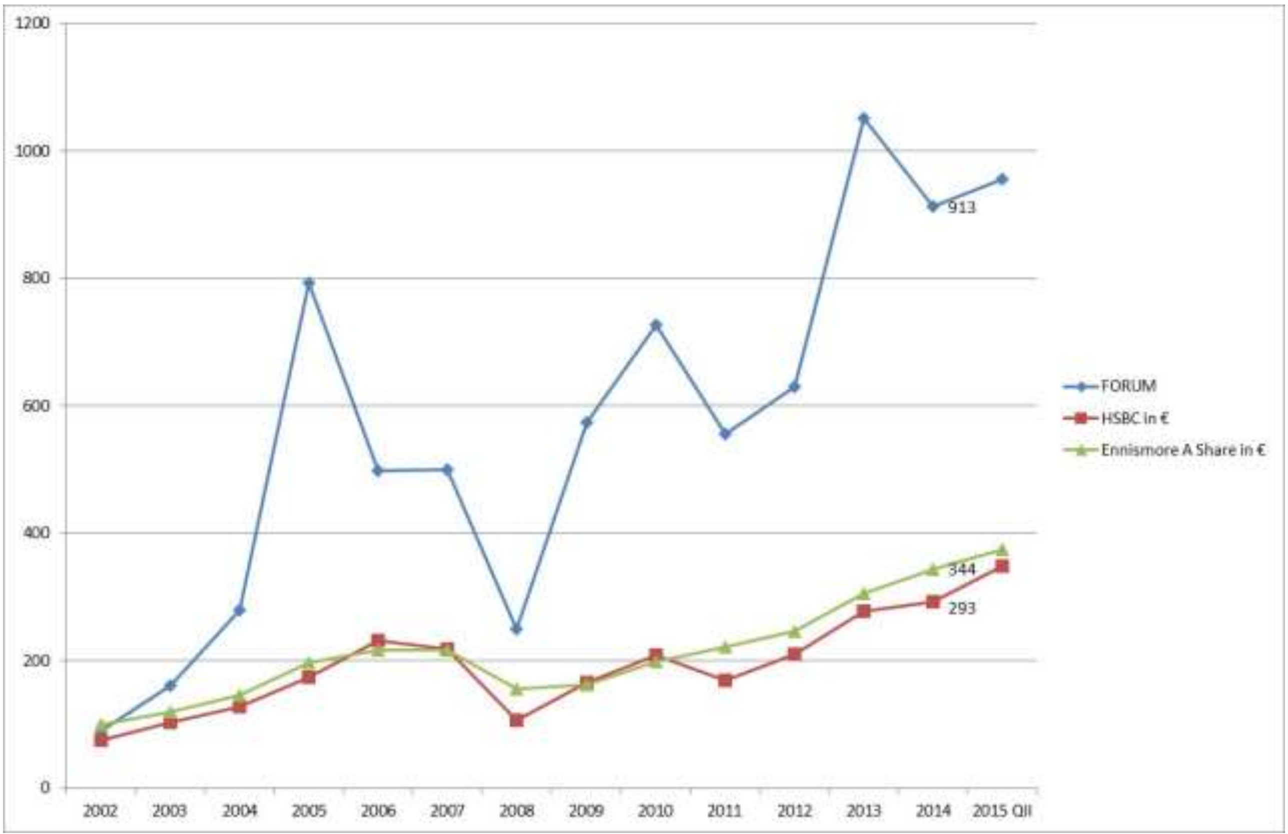
Appendices

Appendix 1: Portfolio at Market Prices and Intrinsic Values in per Share

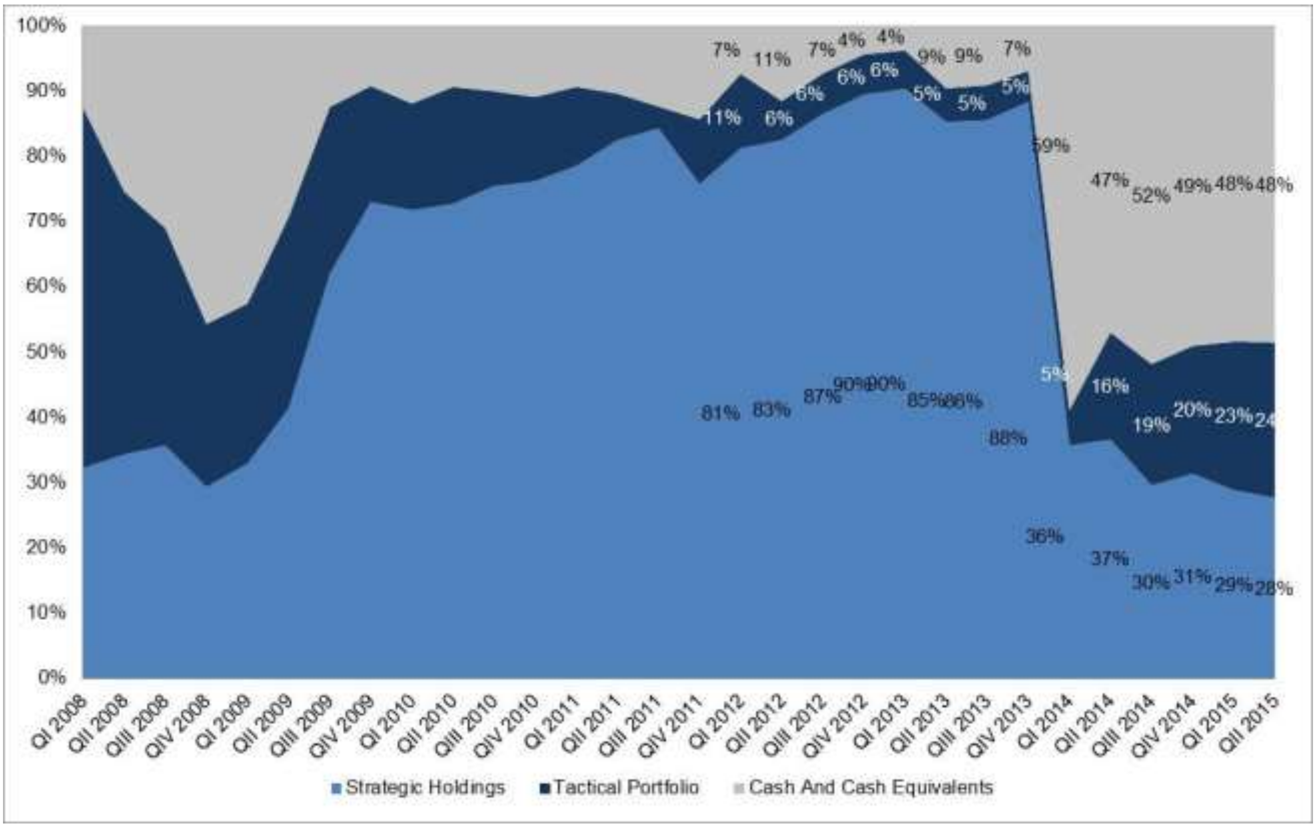


Appendix 2: Benchmarking of Results Since January 1st, 2002

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	13%	630	24%	210	11%	246
2013	67%	1052	32%	278	24%	306
2014	-13%	913	1%	293	3%	344
2015 QI	3%	940	17%	343	3%	353
2015 QII	2%	956	1%	348	6%	376
IRR 2002 - YTD	**18,2%**		**9,7%**		**10,3%**	



Appendix 3: Portfolio Allocation



Appendix 4: Tactical Portfolio as of H1 2015