FORUM

European Smallcaps GmbH

Memorandum

To : Forum Staff

From : BW

Date : July 04th, 2019

Subject : FES Chief Investment Officer Report on Q II 2019 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 period from **January 1st, 2019 to March 31st, 2019.**

A. Overview - FFO Results Q I 2019

1. Results at Market Values

As of March 31st, 2019 the NAV stood at **€ 138,31 per share**. Compared with the NAV of € 129,15 as of December 31st, 2018 this implies **a gain at market prices of 7,1%**.

In Q I 2019 our benchmark index MSCI Europe IMI won 12,2%. Thus we have delivered **a relative underperformance of ca. 4,6% (remember we take geometric rates).**

Performance (QI 2008 = 100), p.a.	FES	OMSCI 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 YTD	11,2%	12,2%	-0,9%
IRR QI 2008 - YTD	**3,2%**	**2,2%**	**1,0%**
Cumulative Gain since Inception	**29,1%**	**12,3%**	**14,9%**

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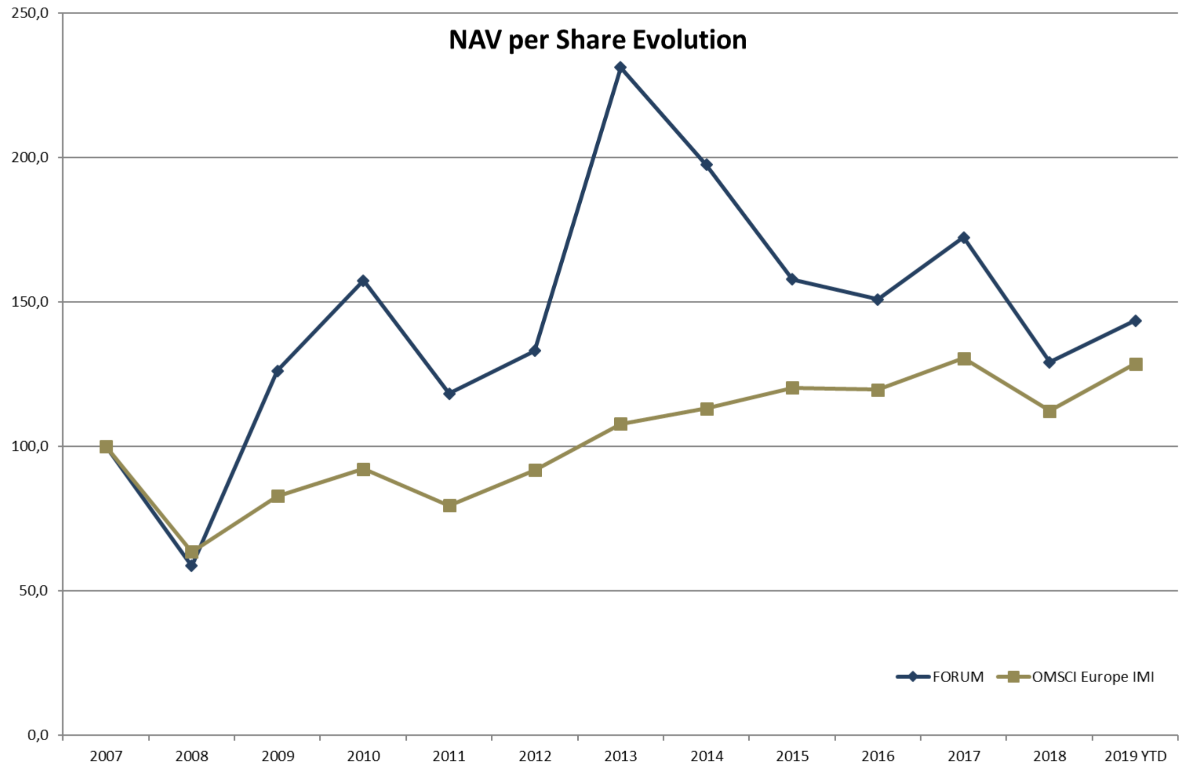
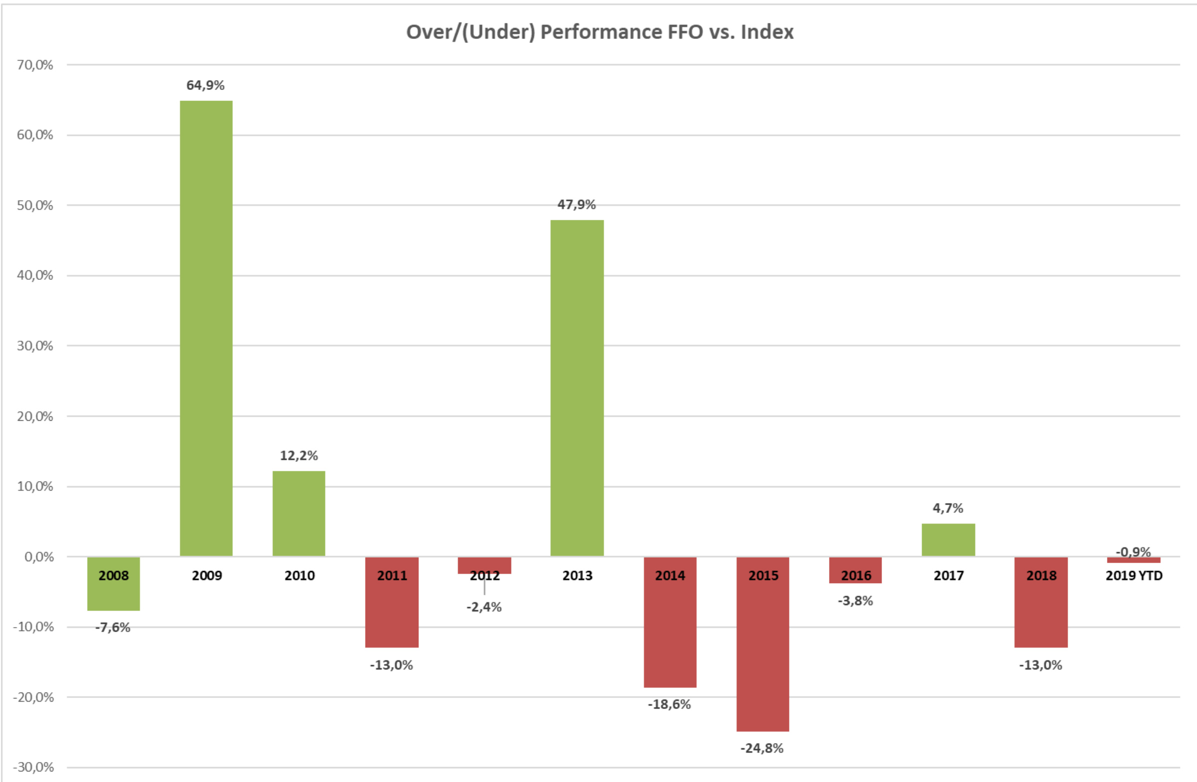
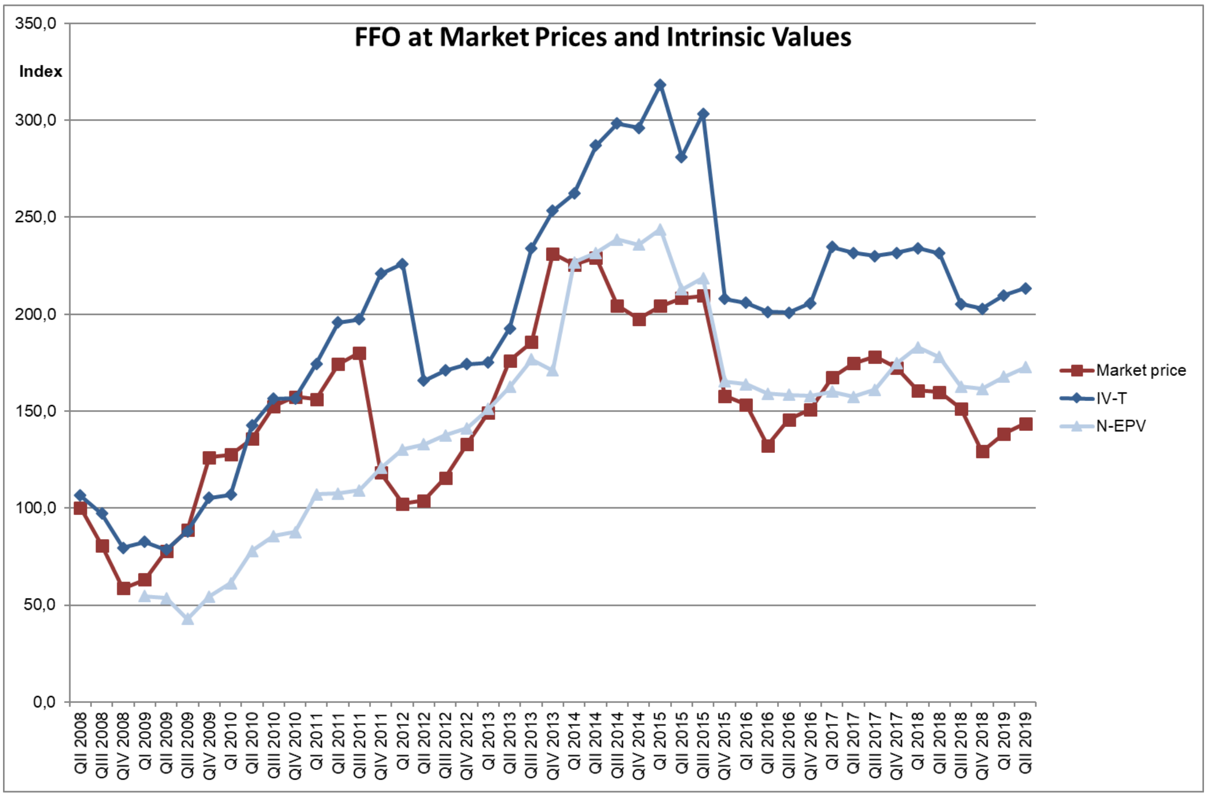




2. The Intrinsic Value Perspective

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 I 2019 Net Earnings Power Value ("N-EPV") increased from € 161,60 to € 167,70, i.e. **by ca. 3,8%.** This increase is the net effect of the following:

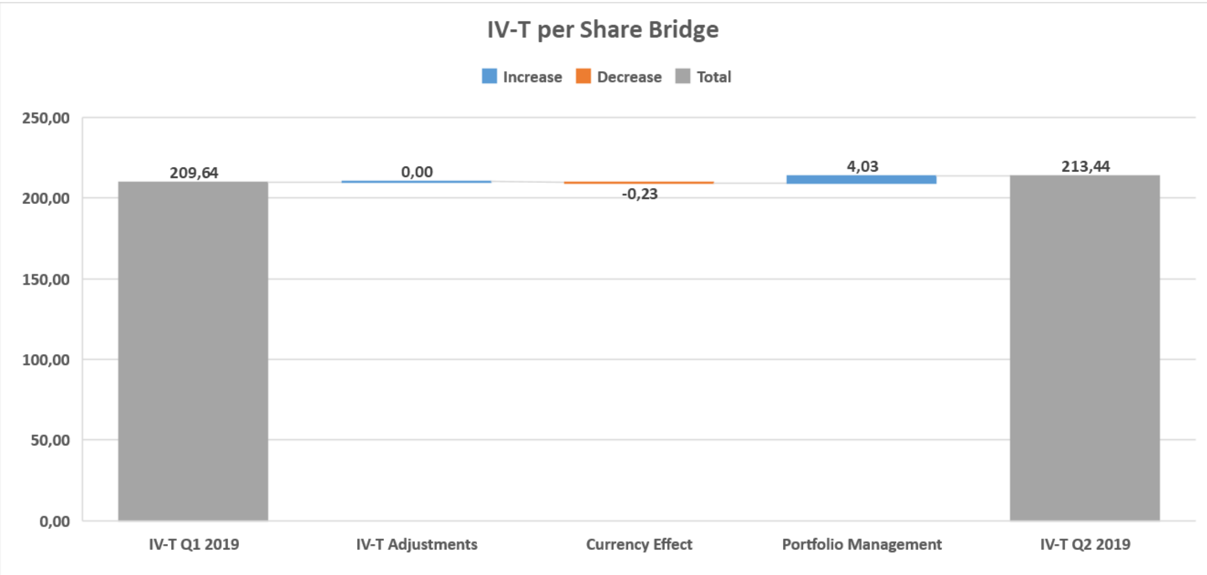
a) we **made no changes to any N-EPV of any holding.**

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 2018 **IV-T increased** from € 202,90 to € 29,60 per share, i.e. **by ca. 3,3%**.

The bridge chart below breaks up the increase in IV-T into its components**:**



We have not made any change to any IV-Ts of our holdings.

Changes in **exchange rates** have added € 3,03 to the IV-T per share in the year, mainly the Mexican Peso revalued a bit.

Finally, **portfolio management added € 3,69 per share to the IV-T of the portfolio**. As described in the chapter on N-EPV this was achieved by a combination of re-shuffling the portfolio from shares trading close to or even above IV-T and re-investing the proceeds in shares with a higher upside in their IV-T.

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 value of FES at market prices has dropped even further below the N-EPV, i.e. the Intrinsic Value of our holdings without any growth.

This makes no sense, in previous periods with such a discrepancy this inversion has corrected itself after a few years at the latest. I am confident that **over time this abnormality will correct itself and the red line (Value at market prices) will end up between the two blue lines – above N-EPV/light blue and IV-T/dark blue.**

We have not changed our Investment Philosophy or Process, thus the quality of our assessments should be largely unchanged. And we have, of course, put additional effort into reviewing our estimates of N-EPV and IV-T to make sure they are valid.

B. Portfolio Strategy – Long Book

1. Portfolio Evolution by Asset Class

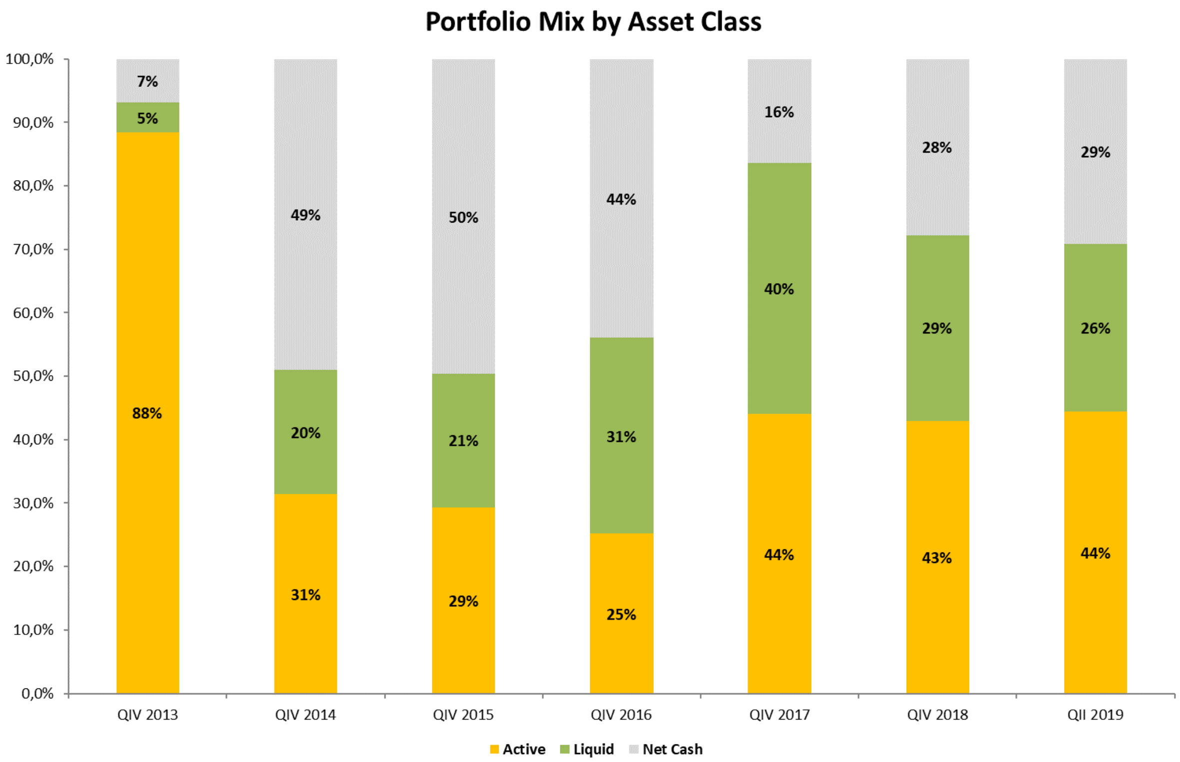
Our portfolio is comprised of **three different asset classes:**

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 – 14 of such liquid investments.

c) **Cash and Cash Equivalents.**

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



Below we will give you an update on these asset categories:

1.1 Active Ownership Holdings

In this category we have **2 positions:**

a) Genomma Lab in Mexico

b) IDS Immundiagnostic Systems Holding plc. in the UK.

1.1.1 Genomma Lab

We discussed this company in detail in the Letter to Clients for Q IV 2018. My **two goals** for the company are:

a) Accelerating **lfl. revenue growth to at least 10% p.a.**

b) Improving **Free Cash Flow after currency adjustments**, but before the investment in the new plant **to a level of at least MXN 1,2 bn.**

As I only joined the Board in April 2018 there are no results on these goals yet visible – **I would expect them at the earliest on mid-2019. Thus no news to date.**

1.1.2 ids Immundiagnostic Systems plc

This position accounts for ca. 20% of AUM and I have the Chairman role of the company. The company is just preparing its Annual Report, thus I would prefer not to comment on this position at this point in time.

1.1.3 Summary of Active Ownership: Performance Attribution

In summary we left both N-EPV and IV-T of our two strategic holdings unchanged in the quarter.

Conversely, they have been marked down by the market, thus based on share prices **we have lost ca. 40% with this asset category.** Most of it is due to the strong share price drop at our main holding Genomma Lab, it saw its share price drop by 43% in 2018. As explained in our last Letter to Clients we see the current price as a clear case or undervaluation and expect this to correct in 2019 already.

At the end of 2018 the two positions in this group accounted for 43% of AUM, down from 44% a year ago.

1.2 Liquid Portfolio

This part of the portfolio decreased from 42% to 29% of AUM. It is comprised of **9 positions.**

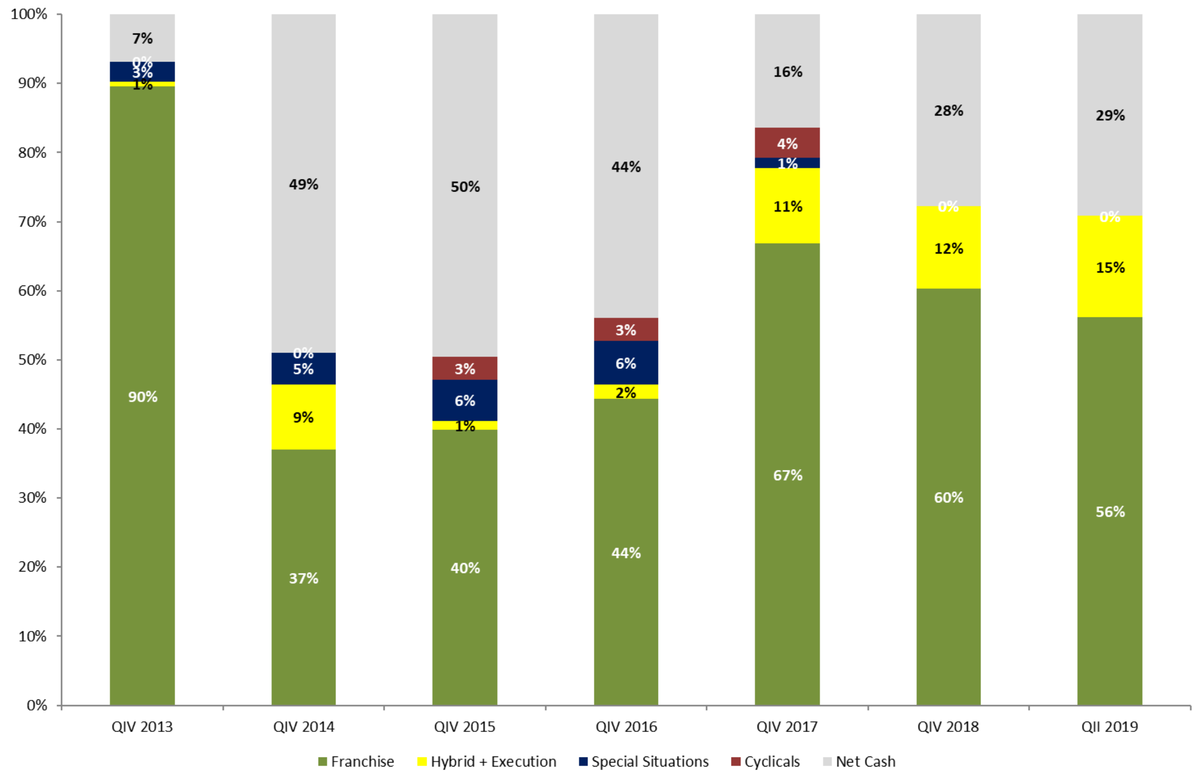
1.3 Cash and Cash Equivalents

At the end of 2018 our **net cash position –** i.e. the cash we would have left after covering all of our short positions - including the cash generated from shorting **- stood at 28%.** This is largely unchanged from the 14% a year ago.

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 2018 is the share of Franchise Businesses** dropped slightly from 70% to 60%. This contains the two strategic holdings, Genomma Lab and ids. We will explain below that the decrease is based on sales of holdings which had reached their full value. Our Investment Philosophy stays unchanged that Franchise Businesses should account for ca. 50% of AUM.

1.1.1 Franchise Businesses

These are **businesses of highest quality - combining high customer stickiness with a strong competitive advantage**. Historically they have been at the core of what FORUM does, mostly accounting for ½ - 2/3 of the invested part of our portfolios.

With **60% of net AUM** this class of businesses continue within the traditional range.

Thus today our portfolio consists of **5 Franchise Businesses:**

a) Genomma Lab

b) Ids plc.

c) EDP-R

d) Terna Energy

e) Novo Nordisk.

In Q I 2019 we left the Intrinsic Values of these businesses unchanged. Their market value increased by ca. 5%.

1.1.2 Hybrid and Execution Businesses

These are the businesses of **medium and lower quality**. They have in common that they are largely in control of their own destiny – unlike the commodity/cyclicals businesses in the next category.

The industries in this group range from machine components to online fashion. In these businesses the quality of **management is immensely important and we spend a lot of time in our Due Diligence to verify it**.

At the end of Q I 2019 we had **5 companies in this group**. We are currently building up a new position in one Execution Business, it is currently accounting to ca. 1,6% of AUM and we would like to increase it to ca. 5 – 7%.

In Q I 2019 we made **no changes to the Intrinsic Values of our holdings in this category.**

1.1.3 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 I 2019 we had **1 investment in this category. In the quarter its value increased by ca. 23%.**

C. Short Book

1. Overview

At the end of Q I 2019 we had **2 open short positions.** In total our **short exposure at the end of 2018 was ca. 0,3% of AUM.**

The short portfolio is **composed of stochastic bets** – each of these companies has its investment case, but we prefer to **allocate not more than 1% to each** as there are residual event risks.

We prefer not to discuss individual positions as they are **particularly sensitive.**

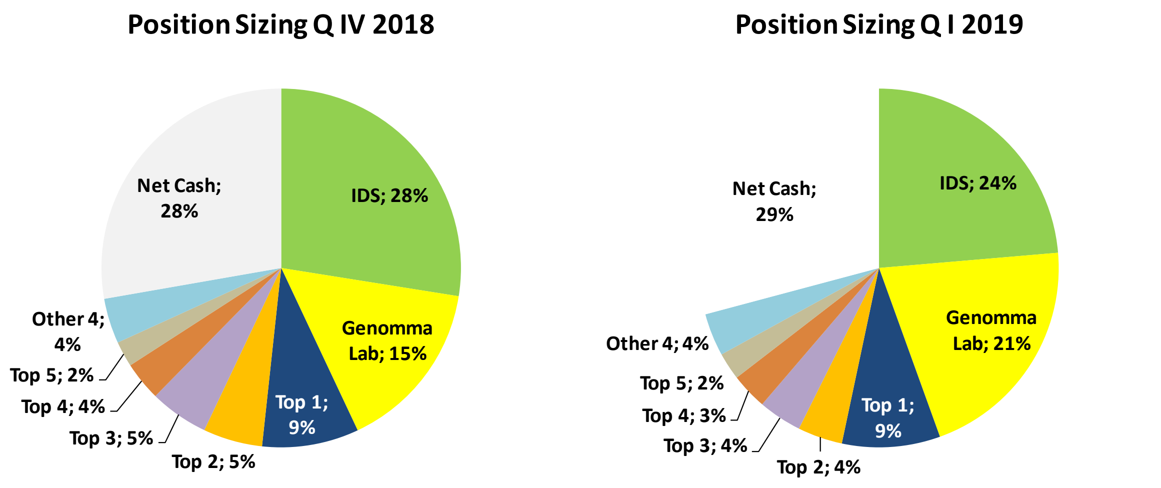
2. Results

In Q I 2019 the short book contributed **a slightly positive result.** As positions are so small the impact on overall performance is negligible.

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:**



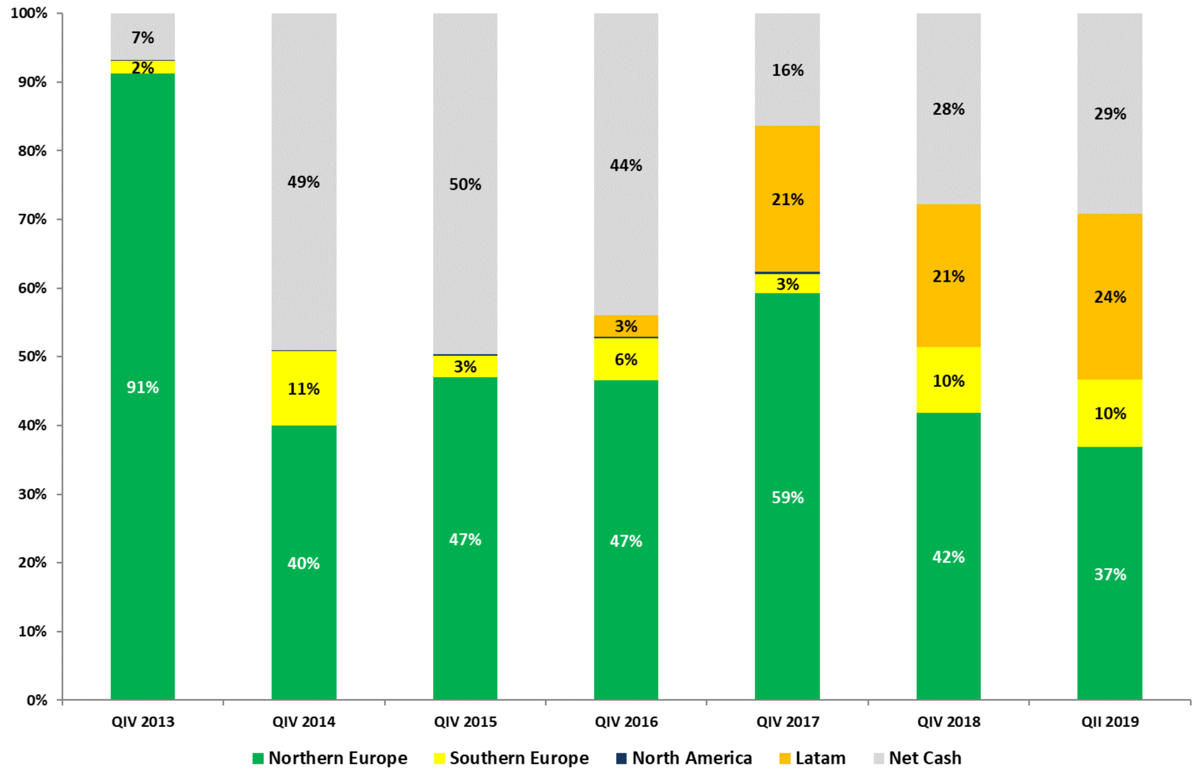
The number of names with an allocation of 10% is unchanged at 2. **The top 3 position combined account for 53% of AUM, slightly down from 58% at the end of 2018.**

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

In the end portfolio concentration is an expression of conviction, and a high concentration indicates high conviction. **The current allocation signifies a lack of conviction in many holdings.**

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) **43%** (31.12.2018: 42%) **is invested in Northern Europe**

b) **10%** (31.12.2018: 10%) **is invested in Southern Europe**. Of these 10% ca. 8% are attributable to EDP-R. EDPR itself has ca. 50% if its assets and earnings outside of Southern Europe. **Thus economically our exposure to Southern Europe is only ca. 6%.**

c) The share of **LatAm increased from 21% to 23% due to share price increases.** We will not make any new investments in this region until we have made good money with our existing two investments.

This mix suits our tops-down preferences.

E. Risk Exposure

We believe that the risk chapter presented in our Annual Report of the CIO 2018 is still relevant today, please refer to the respective chapter.

F. Conclusion

Q I 2019 was a quarter with few major developments: market prices, N-EPV and IV-T all went ups slightly. The current relationship between these 3 metrics implies both a significant margin of Safety and a large potential for upside. **If our assessment of these Intrinsic Values is correct, we will have a good year 2019.**

I would like to take the opportunity to thank all of you for your continued support and commitment. We hope we will continue to generate good increases in your wealth. We are always glad to answer any questions you might have about the fund and your investment.

....
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.