FORUM

European Smallcaps GmbH

Memorandum

To	: Forum Staff
From	: BW
Copy to	:
Date	: July 22nd, 2008
Subject	: Report on FORUM European Smallcaps Q II 2008 Results

This is the second issue of our Quarterly Report. It largely follows the structure of the Q I 2008 report. We will first report results within Q II and then also comment on the cumulated results as of June 30th, 2008.

1. Results

1.1 Results and Benchmarking

In the second quarter 2008 we gained 0,4%, thus bringing the year to date return to -14,3%.

The HSBC Smaller European Total Return Index in €, which we consider the most relevant benchmark index for our investment universe **lost 6,7% in the quarter and is now at -18,6% year to date.**

The **Ennismore European Small Companies Fund** in € which we consider the best European smallcap value fund lost 1,0% in the quarter and is now at -7,0% year to date. We believe that **benchmarking against Ennismore only allows for conclusions on the relative success after a full market cycle** as any they have an investment philosophy which is different from ours. In particular they have a large short book, reducing net long exposure at present to only ca. 40%.

We have therefore attached an overview over relative results in the last 6 years as **Appendix 1.** It shows a clear outperformance over both benchmarks – 25% p.a. in the 6 ½ years since inception vs. 14% p.a. for both the HSBC index and Ennismore - concentrated on certain phases of the market cycle. As we have largely followed the same investment policy throughout this period we are confident that our results will continue to outperform both benchmarks.

1.2 Sources of Results

1.2.1 Changes in Intrinsic Value

1.2.1.1 Policy

Our goal is to increase the **Intrinsic Value** of our assets by **15 – 20% p.a. over a market cycle.** Based on a historical 10-year nominal return of our reference index of 10% p.a. this implies an outperformance by 5 - 10% p.a. In reality our return will swing with the market as we are not going for an absolute return policy minimizing price volatility.

Intrinsic Value is calculated by:

a) applying a pre-defined multiple – which have been derived from valuations paid in Private Transactions - to the forward-looking 12-months EBITA of each business to derive their Fair Enterprise Value

b) add/subtract the net financial position to get to the Intrinsic Value of the Equity.

We calculate the change in Intrinsic Value by comparing the Intrinsic Value of the Equity we own Year-on-Year (plus cash at face value). Thus it measures changes in the earnings power as well as Free Cash Flow generation.

We update the calculation of Intrinsic Values twice a year on January 1st and July 1st. Thus in Q II 2008 there is a roll-over effect that we will explain below.

There are two levers to grow the Intrinsic Value of our total assets:

a) by **growth in the Intrinsic Value of each holding**. We refer to this effect as "Internal Compounding". We expect this effect to contribute 10 – 15% p.a. to the increase in Intrinsic Value.

b) by **portfolio management:**

– if we **sell a business** at prices above Intrinsic Value we create cash value above the Intrinsic Value foregone.

– **if we buy a business below its Intrinsic Value** we add to the Intrinsic Value of our total assets as we get more Intrinsic Value than we have spent in cash.

In an average year we expect portfolio management to generate ca. 5% increase in the Intrinsic Value of our portfolio, closing the gap to the targeted 15 – 20% return.

1.2.1.2 Results in Q II 2008

In Q II 2008 the Intrinsic Value of our portfolio **decreased by 0,4%.** This brings the **cumulated decline for H I 2008 from 2,7% after Q I 2008 to 3,1%. This has been the worst result since inception or our group**.

The decline in H1 2008 is the net effect of two large changes which nearly offset each other:

- a ca. **12% reduction in Intrinsic Value based on FY 2008** earnings, which in itself is attributable to
    - a 9% reduction in earnings estimates
    - a -3% contribution from portfolio management
- offset by the half-year rollover from 2008 earnings to 2008/2009 earnings which increases earnings power by ca. 9%. This is equivalent to an annualized earnings growth of ca. 19%.

1.2.1.3 Contribution of underlying Growth in Intrinsic Value (Compounding Economics)

Specifically, in the quarter we made downward corrections to the 2008 and 2009 EBITA expectations at 6 holdings, bringing the year to date total to 8 or 62% of our investments.

In two of our holdings we increased our estimates of earnings power, but in aggregate they did not compensate for the decreases.

Because of the disappointing frequency and amount of downgrades, we analyzed their sources. We attribute the downgrades to the following factors:

a) ca. 70% of the downgrades are due to “rosy glasses” – too optimistic estimates. When we reviewed the downward revisions we saw clear cases of “Great-to-Greater Bias” working in the Franchise Businesses and “Anchoring” from management guidance and analysts in the weaker Execution Businesses.

b) (only) ca. 30% of the downgrades are due to weak execution by management. Surprisingly this happened in the stronger businesses only. As far as we can tell it has largely to do with the lack of systematic and stable systems and procedures due to the smaller size of the companies. In 1 -2 cases we fell management has systematic weaknesses.

So the key for us is eliminating the abovementioned mental biases which gave us “rosy glasses”. We will work on the following issues

a) A more systematic and in-depth process for risk analysis

b) Assuming the lack of stable systems and processes in small-cap companies as a base case

c) Assuming the working of “Murphy´s Law” whenever a business case involves the fast roll-out of an aspect of the business, e.g. new products or sales points, again in particular in small-cap companies.

We have also tightened our philosophy on dealing with management weakness: if we are convinced that a management team has very weak capital allocation skills we will sell –

independent of the overall rating of the management team and the quality of the business. In these cases all the potential from wonderful businesses is wasted at least as fast as it has been generated.

1.2.1.4 Contribution from Portfolio Management to Intrinsic Value

In Q II 2008 portfolio management, the second source of increasing Intrinsic Value**,** contributed a -3% result to Intrinsic Value. This is comprised of:

- Selling a large position at a price that we feel was below its 2008 earnings power value. Although we count this as a negative 4% contribution to portfolio management, we feel that it was the correct decision because we eliminated our exposure to a large risk in the business. In fact we are sure that nearly all of the financial progress reported by the business was made up by unsustainable financing policies. Thus the "true Intrinsic Value" is most likely much lower than calculated by us.

- Three other small transactions which in total added 1% in value:

    - we reduced the French position mentioned above as our investment policy prescribed a downsizing of the position. We may have not have done it decisively enough. This is the only position where our model suggested selling.

    - we bought a very small initial stake in a German large cap which we view as a hybrid Franchise/Execution business.

    - we bought a very small starting stake in a Greek infrastructure group at 1/3 discount from a conservatively calculated NAV as of December 31st 2007. We deem this business a hybrid business as there is real estate and construction in it as well.

Other than the French position which we reduced our model did not generate more "reduce" or "sell" signals in Q II 2008.

The same applies to additions: we bought in the cases when we received a signal and there were no missed opportunities from buy signals which we did not act on. If capital markets stay volatile we hope to be adding significantly to the two new positions in Q III, thus growing Intrinsic Value.

1.2.2 Currency Losses

In Q II 2008 **currency losses amounted to ca. 0,2%** of total assets, bringing the year to date currency loss to -3,6%. They are all attributable to the devaluation of the GBP against the €.

Our policies on currency management as outlines in the Q I 2008 newsletter are still unchanged.

1.2.3 Multiple Contraction

The remaining portion of the half year period loss – i.e. - 7,6% - was therefore attributable to Multiple Contraction. Specifically the forward twelve month EV/EBITA multiple of our holdings decreased from 7,4x at the beginning of the quarter to 7,3x at the end, still down from 8,3x at the beginning of the year.

We believe that over time multiples will tend to revert to a mean. Short-term fluctuations around this mean are an expression of the fear and greed of Mr. Market. Therefore we do not really care about such fluctuations.

In the years 2003 – 2006 we had massive multiple expansion and pointed out that this was not sustainable. In 2007 we had a multiple contraction which brought the multiples towards the long-term mean observed in the market and towards what we deem fair multiples.

As you will see below in the chapter on risk analysis the multiple contraction in H1 2008 puts the market valuation of our holdings at a discount of ca. 14% below what we consider fair multiples. This discount increases the Margin of Safety of our operations. We are confident that this contraction will reverse at some point in the future.

1.2.4 Summary of Results Contributions

The following table summarizes the composition of results after 6 months:

	Q I 2008	**Q II 2008**	**Q II YTD**
Change in Intrinsic Value	-2,7%	-9,3%	-3,1%
Currency Changes	-3,4%	-0,2%	-3,6%
Multiple Contraction/Expansion	-8,4%	9,9%	-7,6%
Total Result	**-14,5%**	**0,4%**	**-14,3%**

The table makes clear that we have not delivered on the Intrinsic value part of the results. We expect that the downgrades will not repeat themselves, so the underlying growth of the earnings power of our Franchise Businesses in particular should become visible in H2 2008.

2. Aspects of Our Investment Strategy

2.1 Buying

2.1.1 Investment Policy

We restrict our purchases of new businesses to Franchise Businesses or Execution Businesses with strong competitive advantages. A review of the returns in both types of businesses made in the last 5 years revealed that in the past our record from Execution Businesses was checkered: we had 1 -2 outstanding winners, but also many business in which we made no money or even ran up losses. Together with our Advisory Board we have therefore decided that in 2008 we should restrict ourselves to **acquiring only strong Franchise Businesses.**

We also demand that we are convinced of the management quality of any holding. We will not invest in an outstanding business if we have doubts about management. Our view has evolved here after some disappointments in H 1 2008: we put more trust on a track record than on promises.

Thirdly each new investment has to pass several hurdles on valuation:

- discount of at least 1/3 from Intrinsic Value
- risk-adjusted expected return for the next 3 years < 30% p.a.
- risk of the permanent loss of capital in the worst-case scenario less than 3% of total AUM.

And finally at this point in time we have set a minimum liquidity requirement for new investments as the portfolio has become more illiquid than we would like.

With other words **we will only swing if the opportunity is truly outstanding**.

2.1.2 Outcome in Q II 2008

In Q II 2008 we found 2 investment opportunities that met these criteria and started building positions. **In total we invested 1,6% of AUM in these opportunities** and will continue to allocate to them, given prices remain attractive.

The first company is an automotive manufacturer in the luxury segment that was "kiolled" by the market based on expected bad news flow from rising oil prices, rising commodity costs and consumer spending in the US. We agree with the consensus that there is a strong likelihood of a short / mid term dip in the earnings power of the entire sector, but we have confidence of a reversion to the mean in the luxury segment given the long term track record of the company. In addition we found the valuation screamingly low with the industrial part of the business valued an EV/EBITA 2009 of less than 4x

The second of these companies – the Greek infrastructure group - was mentioned in the Q I letter as a missed opportunity. With global markets in a state of panic, the price again dropped below our buying limit and we were happy to pick it up at a substantial discount to fair value.

2.1.3 Outlook for the Buying Aspect of our Investment Strategy

Given the strong share price declines our watchlist has grown. We have to make sure, though, that the the Intrinsic values will not suffer temporarily as well from a severe recession.

2.2 Position Sizing/Portfolio Rebalancing

2.2.1 Investment Policy

We try to increase the Intrinsic Value of our portfolio by

a) reducing positions **priced significantly above Intrinsic Value or with relatively moderate IRR expectations**

b) increasing our allocation to positions **priced at a discount from Intrinsic Value and with an expected IRR above our hurdle rate**

while maintaining the quality of the business mix in the portfolio.

We only rebalance if the gains in Intrinsic Value are significant to not get into a habit of day trading or trying to time the market.

2.2.2 Outcome in Q II 2008

In Q II 2008 we only had a minor reduction in our French position. In this quarter portfolio management was not hampered by the lack of liquidity of many positions as we received no other Sell signals.

We have increased our hurdle for liquidity in any new names to an average daily trading volume of € 1,0m. Over times this should increase the overall liquidity of the portfolio and allow for a more active portfolio rebalancing.

2.3 Selling

2.3.1 Investment Policy

We sell if

a) a business is **priced above a certain premium above Intrinsic Value**

b) **expected return drops** below our opportunity cost of cash (which is above the level of money market funds as we focus on the probability of investment opportunities arising unexpectedly).

We will also sell if the quality of the business or management or our assessment of these deteriorates to unacceptable levels.

2.3.2 Outcome in Q II 2008

We sold one major UK investment during the quarter. The sale was made to eliminate our exposure to a large risk which we identified in the company earlier in the year. We were satisfied with our ability to exit the illiquid position in a short period of time and with a reasonable discount from the market price.

2.4 Other Aspects of Portfolio Management

2.4.1 Total Number of Holdings

In Q II 2008 the total number of positions remained unchanged at 14, which is a residual of two sales and two purchases.

2.4.2 Liquidity

Liquidation period – defined as the period required to liquidate 50% of our holdings further decreased in Q II to 85 bank days from 108 at Q I and 116 at the start of the year. This is still too illiquid and we target a significantly lower level. At the end of Q II 2008 cash accounted for 20,3% of AUM.

3. Risk

3.1 Margin of Safety in Holdings

We entered the year 2008 with a Margin of Safety of 4% in our holdings - defined as the discount of market prices from Intrinsic Values. As the net effect of the changes in Intrinsic Value and multiple contraction this **Margin of Safety in our holdings increased to 14% at the end of the quarter after the roll-over to 2008/09 earnings.**

This is the highest Margin of Safety we have had since 2005. It makes us confident that we have a good protection against the risks of deterioration of the Intrinsic Value of Businesses or overoptimistic projections.

3.2 Company-Specific Risks

As mentioned we were successfully able to sell a position that we associated significant risk to within the quarter before the risk materialized, thus at a price we considered to be adequate.

Currently, we see no comparably large risks within the portfolio – with any individual risk materialization expected to create a permanent loss of capital with an impact on total assets of less than 3%.

4. Outlook

4.1 Expected Increase in Intrinsic Value

At the beginning of the year we predicted that for the full year 2008 the Intrinsic Value of our holdings as of January 1st would increase by 22% over 2007. Having to shave 12% off our projections in H I reduced the projected increase for the full year 2008 to 10%.

We also believe that the currency loss of ca. 3,6% in H I 2008 is permanent. Subtracting this from the revised expected increase in 2008 earnings of 10% reduces the expected return in expected growth in Intrinsic Values 2008 over 2007 to ca. 6%.

We expect that in the course of the year portfolio rebalancing and new investments resp. sales will add to this increase. We feel unable to put a number on this contribution.

Thus we conclude that we expect the Intrinsic Value of our AUM in € to increase by ca. 6% in the full-year 2008. Since market multiples have come down 8% in H1 2008, this implies a negative full year result unless multiples increase between now and the end of the year.

4.2 Implication for Total Return

To get to a positive result we would need multiples paid by Mr. Market to recover to what we deem fair – but nobody can put any probability on this happening in the next 6 months. It could even be that the market generates further multiple contraction – leading to a negative result for the full year.

Achieving our level of long-term return in the range of 15 – 20% p.a. would require multiple expansion towards what we would deem fair values. As a matter of fact we – and anybody else - are unable to forecast whether the markets will produce such a reversion to the mean.