FORUM

European Smallcaps GmbH

Memorandum

To	: Forum Staff
From	: BW, RK
Copy to	:
Date	: May 11th, 2009
Subject	: FORUM European Smallcaps Q I 2009 Results

In Q I 2009 we made a gain of 7.9%. This is a good start into the new year – although by any means irrelevant for judging our performance as investors.

This report will analyze and comment on this result and also comment on changes made to the investment process in the quarter.

1. Benchmarking of Results

For an overview of our results vs. our benchmarks we would like to refer to **Table 1**.

1.1 Results in this Quarter

The key observations on relative results in this quarter are:

a) **In Q I 2009 we gained 7.9%**. In the quarter we only had long positions and cash. The invested part of the portfolio returned a gain of ca. 10,2%.

b) The **HSBC Smaller European Total Return Index in € lost 3.7% in Q 1**. As this is an index it is a suitable benchmark for the long-only invested part of our portfolio. Based on this quarter only this portion of our portfolio outperformed the benchmark.

c) **The European Smallcap Fund of Ennismore in €** - the European smallcap value fund we deem the best and therefore use as a benchmark - **reported a loss of 3.3% in the quarter**. This performance is mainly due to their low net long exposure.

   Given the long/short investment policy of Ennismore we expect it to outperform in negative markets and to underperform in times of bull markets. Thus, we believe that the comparison with Ennismore should focus on the long-term performance over at least a full cycle.

1.2 Results since Inception

After adding our Q I 2009 results our **performance since January 1st, 2002 – the date of our inception** - slightly improves to **14.7% p.a.** This compares with

a) **0,3**% p.a. for the HSBC index

b) **5.8%** p.a. **for the Ennismore fund.**

Thus in the 7 ¼ years as investors we missed our target of 15% p.a. by a small margin. After the massive market correction in 2008 it certainly feels as if we have gone through a full cycle – thus these results should reflect investment performance independent of a certain market situation.

2. Sources of Results

Please refer to **Table 2** for an overview over the sources of the gain in Q I 2009.

2.1 Changes in Intrinsic Value

In Q I 2009 the **Intrinsic Value of our portfolio – before currency movements - increased by 2,4%.** This increase is the net effect of

- An increase of 1,2% based on the methodology employed in 2008
- an additional increase of 1,2% due to a change in methodology of calculating Intrinsic Value
- no contribution from portfolio management.

2.1.1 Contribution from Changes in Intrinsic Values of Holdings

In Q I 2009 we implemented the change to a new methodology for calculating **Intrinsic Values** of our holdings. The main changes are:

a) a **focus on long-term historical results**, preferable covering a least one cycle – as opposed from a previous focus on forecast future earnings

b) A **focus on free cash flow** – as opposed to reported earnings

c) **De-composing** the elements of Intrinsic Value. We differentiate between

- the **long-term Earnings Power Value** of the business reflecting the cash generated of the existing business without any growth or improvements

- the **value creation from Internal Compounding characteristics** of the business – which captures the value of any growth

- any potential contribution to increasing the two components mentioned above from **management.**

Unless stated otherwise the Intrinsic Values which we report here are the full values including all **components ("IV-T")**. In our decision-making on buying/selling and portfolio allocation we also focus on the Earnings Power Value in order to make sure this makes up the majority of the Intrinsic Value in our portfolio.

The change in valuation methodology resulted in significant changes to most individual portfolio positions. This is encouraging as it reduces the risk that we were "anchored" in our previous valuation methodology. The fact that the aggregated results of the new methodology comes out so close to our previous methodology is to a large extent a coincidence.

The main result of this change will be that **Intrinsic Values of our holdings will fluctuate much less than they used to in the past.**

2.1.2 Contribution from Portfolio Management to Intrinsic Value

In Q I 2009 **portfolio management, the second source of increasing Intrinsic Value, contributed no measurable result to the Intrinsic Value of our portfolio**.

We did not take on any new positions. Neither did we exit any position.

2.2 Currency Losses

In Q I 2009 currency gains amounted to ca. 1,2% of total assets.

During the quarter we deviated from our historical policy not to hedge any currency exposure. We felt that the value of the GBP in the near future will not be determined by the comparative advantage of the underlying economy, but by the fate of its financial sector. As we do not understand this fate and do not want to be exposed to it we decided to fully hedge the exposure to GBP we have from our investments.

2.3 Multiple Contraction/Expansion

By definition the remainder or our results are due to Multiple Contraction/Expansion. IN Q I 2009 we observed **a Multiple Expansion by 4,0%.**

2.4 Margin of Safety

As a result of these changes – an increase in Intrinsic Value by 2,4%, but an even larger effect from Multiple Expansion by 4,0% the **Margin of Safety on AUM decreased to 20%.**

This is comprised of

a) **a Margin of Safety of ca. 31% on the invested portion of the portfolio**

b) **a cash portion of ca. 35%** - with no Margin of Safety due to its nature.

A **Margin of Safety of 20% on AUM** implies that the sum of the market prices of the invested part of our portfolio plus the cash stand at 80% of the sum of the Intrinsic Value of the invested part of our portfolio plus the cash.

Thus a reversion of market prices to Intrinsic Values implies **an upside potential of ca. 25% on AUM. Unfortunately this is by far not enough to make up for the 52% loss registered in 2008. The – sad – conclusion is that**

a) some of the downward adjustments of Intrinsic Values registered in 2008 were overdue – correcting rosy glasses

b) it will take several years until increases in the Intrinsic Value of our partfolio due to growth, profitable compounding and management actions will drive Intrinsic Values sufficiently up for the required ca. 90% return we still need to get back to the AUM as of December 31st, 2007.

3. Special Aspects of Q I 2009

3.1 Total Number of Holdings

In Q I 2009 the total number of positions stayed unchanged at 11.

No companies entered of left our portfolio during the quarter.

3.2 Mandatory Take-over offer for Pulsion Medical Systems AG

During the period we decided to make a takeover bid for Pulsion Medical Systems AG, one of our two holdings in the medtech area. With the bid we want to increase our control over the company which was one of the biggest contributors to our loss last year due to massive mismanagement of the previous CEO.

Since October 14th, 2008 BW is acting as interim-CEO of this company.

3.3 Liquidity of Holdings

At the end of Q I 2009 liquidation period of our holdings – defined as the period required to liquidate 50% of our stake – was at **97 bank days** – up sligthly from the 92 days at the beginning of the year.

In our last newsletter we stated that we wanted to manage this down by two actions:

a) **Seeking negotiated deals to exit**: we cannot report progress on this issue

b) **New investments only in companies with ADTV > € 500.000,-:** The small addition to our position in Pulsion does not meet this liquidity requirement. But it helps to get to a third option to reduce the risk inherent in the low liquidity

c) **Seeking control**: The tender offer on Pulsion gives us the option to increase our position at any time in order to increase the majority in the AGM we already have now. We have slightly over 30% of votes now.

If we define Pulsion as a control position and exclude it from our liquidation period analysis, the period required to liquidate 50% of our investments drops from 97 days to 63 days.

3.4 Cash

At the end of Q I 2009 **cash and cash equivalents accounted for ca. 35.1% (33.1%) of AUM.**

3.5 Shorting

Short exposure was 0 during the reporting period.

Our tops down asset allocation model proposes an allocation of 0 – 10% to shorts to reduce our net long exposure. So far we have not found promising candidates,

In the future we will most likely resort to shorting an index if the allocation suggests building up a short position and substituting this later with company-specific shorts.

4. Discussion of Risk Management

4.1 Margin of Safety at Investment Portfolio Level

The most important risk management variable is certainly the Margin of Safety. As mentioned above it stands at 31% of the invested portion of our portfolio – leaving sufficient room for errors in the assessment of the businesses we own.

We should point out, though, that the Margin of Safety of 31% is based on an Intrinsic Value which in turn is strongly driven by Compounding Economics and Management Contribution.

Both of these factors are based on assessment of what might happen in the future. When we take only the Earnings Power Value of the businesses we own, market prices are 59% above.

In the portfolio management this year we will try to add businesses which offer a Margin of Safety on Earnings Power Value alone.

4.2 Company-Specific Risks

4.2.1 Risks Modelled (“Known Unknowns”)

At the level of risks modelled in our risk assessment **no significant new risks were added to our watchlist in any of our portfolio companies during the period.**

4.2.2 Risks Materialized

At the level of **risks materialized** we do not have to report any significant risks becoming reality in Q I 2009.

4.2.3 3% Risk Tolerance

At the end of Q I 2009 none of the risks modeled in our risk assessment would reduce the Intrinsic Value of our Portfolio by more than 3%.

4.3 Risks from the Present Financial Crisis

The current massive economic crisis creates **risks from primary as well as from secondary effects.**

4.3.1 Short-Term Risks/Survivorship Risks

In the short term the financial crisis has magnified the risk of insolvency at companies which **need refinancing of existing debt or have additional working capital needs**. Our two most endangered holdings appear to be:

- **a)** one Execution Business in a retailing specialty with **a very high operational gearing**
- **b)** one small Hybrid business in media with a **high net financial debt position from acquisitions.**

Both holdings together **represent 1,9% of AUM**. In both cases there is extremely low liquidity.

4.3.2 Medium-term Risks/Economic Downturn

As the recession deepens, the number of **secondary effects** increases. We feel relatively relaxed about **a general drop in demand**. This is mostly due to the industry mix or our portfolio. The invested part is comprised of

a) ca. 55% medtech

b) ca. 15% gambling.

But we have a couple of companies which have **exposure to emerging market currencies**. Specifically we have two Greek companies with exposure to the Balkans which would suffer from devaluations. Together **they accounted for ca. 10,8% of AUM at the end of Q I 2009.**

4.4 Long-Term Risks/Inflation or Deflation

On a macro level, we have to consider the impact of deflation or inflation, should such movements occur. Thus far we have not achieved any conviction in belief of which way this might go.

5. Outlook

5.1 Macro Outlook

We describe our Macro perspective in Macro Dashboard. The macro Dashboard for Q I 2009 contained the following highlights:

a) At the present level of the S&P 500 of 767 valuations based on Shiller's CAPE and Tobin´s q are **slightly below historical averages.**

b) Given that the market is correcting for a combination of the biggest profit bubble as well as the biggest overvaluation since 1900 **we see a significant risk that the correction will "overshoot" below these historical averages.**

Based on this assessment we would like to have a cash quota of 20 – 30% and a net short position of 0 – 10%. As mentioned above we hold slightly more cash, but have not reduced the long exposure from the invested part of our portfolio with short positions.

As a consequence we will try to slightly increase our invested portion in the next few months if we find opportunities which meet our investment requirements. **As always we will mostly be driven by such opportunities – and not by the tops-down allocation model.**

5.2 Specific Plans

As always we feel no pressure to spend our money and **will only swing if the opportunity appears outstanding.** Given the turbulence in markets we are however hunting with greater intensity. Our focus is on:

a) **adding to existing positions**. In this case we expect to add to Pulsion as a result of our outstanding offer. In the next period we will report how much we are eventually tendered.

b) **long established businesses that are steeply discounted** in the market due to near term expectations. We have a short list of 2 to 3 candidates that we are getting close to in this arena. As reported in the Q IV 2008 newsletter these investments will have the following characteristics:

   - within our Circle of Competence
   - ADTV > € 500.000,-.
   - Margin of Safety on a conservative Earnings Power Valuation based on a long-term track record, preferably 10 years
   - Management teams with at least a 5-year track record.

6. The Firm

As of March 31st, our equity analyst Ryan Krafft has left us.

Ryan had joined us in September 2007 and has been a big contributor to the evolution in the investment process which we have defined and implemented in the 1 ½ years since then. His departure is a severe loss and we will need time and luck to find an appropriate replacement.

We wish Ryan luck and success in this new position.

Burkhard is spending his time as interim CEO of Pulsion. We hope that we will have found a full-time successor before the end of the year.

Both developments imply that activities at FORUM will be at a lower level than in the past. We will mostly draw on the watchlists and experiences which we have built up in the last 7 years and hope that Mr. Market will allow us to swing on one or two of the outstanding companies on this list – that would be an outstanding outcome.

Appendix

Table 1: Results and Benchmarking

Period	FORUM	HSBC European Smallcap Index	Ennismore
Q I 2009	7.6%	-3.3%	-3.7%
FY 2009	7.6%	-3.3%	-3.7%
Since Inception (2002)			
Return p.a.	14.7%	0.3%	5.8%
Index (1.1.2002 = 100)	270	151	102

Summary of Results

Table 2: Sources of Results

Period, FY 2009	**Q I**	**Q II**	**Q III**	**Q IV**	**FY 2008**
Change in Intrinsic Value	2,4%				2,4%
thereof Earnings Power	1,2%				1,2%
thereof Methodology	1,2%				1,2%
thereof Portfolio Management	0,0%				0,0%
Currency Changes	1,2%				1,2%
Multiple Expansion / Contraction	4,0%				4,0%
Total	**7,6%**				**7,6%**