

Memorandum

To : Forum Staff
From : BW
Date : November 6th, 2014
Subject : FORUM European Smallcaps Q III 2014 Results_V_2.1

1. Results in Q III 2014

As a starting point let me 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 outperformance 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

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over time.

In Q III 2014 **the value of our portfolio at market prices went down by 11,0%.**

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

- a) **Net Earnings Power Value (“N-EPV”) increased by 2,1% 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 3,6%.** 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 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 12%** - up from - 1% at the end of Q II 2014. The main reasons for the Margin of Safety improvement is the drop in share price of our main asset.

You can interpret this metric in two ways:

- a) Mr. Market is valuing our holdings as if they had no growth. This must be too low as there will definitely be growth – see below.
- b) With the total of our portfolio at a 12% Margin of Safety there are some companies trading below N-EPV – giving us a chance to invest fund inflows with a Margin of Safety.

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 increased to 156% from 133% at the end of the last quarter - implying an **upside potential of 56% for the total portfolio including cash**. The reason has been stated above.

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

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The key benchmark for our performance at market prices is the **HSBC Smaller European Total Return Index in €**. In Q III 2014 this index was down by 4%. Thus our portfolio at market values underperformed this index at market values by ca. 7%.

The second benchmark we use is the **European Smallcap Fund of Ennismore Class A in €** - the European Smallcap value fund we deem best in class. In Q III 2014 it was up by ca. 3%.

1.2.2 Results since Inception

At the end of Q III 2014 our cumulated performance in the 12 years from January 1st, 2002 – the date of our inception – to September 30th, 2014 was **19,2% p.a.** – a total increase to **934% of starting value**.

Thus in the 12 years as investors we have 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 19,2% p.a. resp. to 934% of starting value since inception on Jan. 1st, 2002 compares with IRRs for this period of :

- a) **8,7% p.a.** for the **HSBC Smaller European Total Return index in €** – a total increase to **290% of starting value**.
- b) **9,9% p.a.** for the **Ennismore European Smaller Companies fund in €** – a total increase to **334% of starting value**.

2. Development of Portfolio Mix

Please see **Appendix 3** for an overview of our portfolio mix evolution. In Q III 2014 the mix changed relative to the mix at the end of Q I 2014:

- a) The % of assets allocated to our **strategic holdings** at 30% (June 30th, 2014: 37%) of AUM. The main reason for the decrease is the drop in IDS shares.
- b) The **tactical portfolio** - excluding cash – at 19% (June 30th, 2014: 16%) of AUM.
- c) **Cash and cash Equivalents** at 52% (June 30th, 2014: 47%) of AUM.

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 ca. 28% in the company.

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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 group revenues.

Our investment thesis is as follows:

- a) We own an emerging Franchise Business with an **increasing share of recurring revenues from automated systems**. In FY 2014 which ended on March 31st 2014 automated assays accounted for 44% of revenues, up from 37% in FY 2013. Peer and competitor Diasorin shows the path to get this to 80%.
- b) The **two key drivers** for increasing the Intrinsic Value of IDS are:
 - **placing 80 - 100 new iSys analyzers p.a.** At average revenues per box of GBP 70.000,- this adds revenues of GBP 6 - 7m to the present revenue base of ca. GBP 50m.
 - **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 ("Project M20").

The company has been performing poorly in the last 1 - 1 1/2 years, showing poor results on the key metrics of the business.

- a) net new placements in territories with a direct sales force dropped from 88 to 38 in FY 2014
- b) there were 0 new assays launched in FY 2014 - and by the way none in H1 FY 2015, either
- c) general and administrative costs are at a level far above peers.

When reading the company communication one gets the impression that the company is not focusing on any of these issues. **In the next few weeks we will therefore initiate discussions with the Board to effect changes.**

3.2 Tactical Portfolio

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

The portfolio consists of **11 positions** at the end of QIII 2014. We did not add any new positions during the quarter.

3.3 Cash and Cash Equivalents

At the end of Q III 2014 **cash and cash equivalents accounted for ca. 52% of AUM** – up from 47% on June 30th, 2014.

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Given the high valuations in most European stock markets we are shifting a part of our assets into small- and mid-cap Private Equity.

4. Development of the Short Book

In **Q III 2014** we did not initiate a short position and our short book is still empty. We have however, increased our focus on short ideas and we started developing frameworks and tools to tackle short investments.

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 – stood at 12% at the end of Q III 2014**. This says that Mr. Market

- a) prices the businesses we own **below steady-state Net Earnings Power Value** - i.e. just valuing today's cash flows.
- b) puts **no value on future growth**.

We can live well with that as we are confident that these companies will generate sufficient and profitable growth in the next few years. As we only make new investments with a Margin of Safety **each investment will add to the Margin of Safety of the portfolio**.

5.1.2 Impairment of Intrinsic Values

There were no impairments to our Intrinsic Values in Q III 2014 - just the two small downward revisions mentioned above. We will review our valuation of IDS in Q IV 2014.

5.1.3 Southern Europe Exposure Risk

Our **exposure to Greece** at the end of Q III 2014 stayed largely unchanged at ca. 1% (June 30th, 2014: 1%) of AUM.

5.1.4 Risks from Portfolio Concentration

At the end of Q III 2014

- a) our largest position - which is a Strategic Holding - accounted for ca. 30% of AUM
- b) our three largest positions combined accounted for 42% of AUM.

This portfolio concentration is **part of our Investment Policy**.

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 increased to 56% from 33%. This is primarily due to the decrease in the share price of IDS.

The **upside potential from the invested part of the portfolio stands at 115%**.

6. Outlook

6.1 Macro Outlook

We refer to our **Macro Dashboard for Q III 2014**. Since our last Macro Dashboard not much has changed, i.e.

- a) profits in the USA continue to be at historical peaks
- b) so do valuations. CAPE is overvalued by ca. 50%.

In Europe valuations are lower, but we see significant macroeconomic risk from the lack of structural reforms in the Southern European countries.

As a **conclusion of this Macro Outlook on our asset allocation** we have retained our previous conclusions:

- a) cash quota of at 20% - 30%.

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- b) net short position of 0 – 10%. We are presently evaluating several shorting candidates, but are not yet ready to invest.

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

6.2 Status of Watchlist

We feel comfortable with our present portfolio.

The **watchlist** of investment candidates is up to **19 candidates** (Q II 2014: 14).

6.3 Target Structure of the Portfolio in one Year

At this point in time our primary goal in portfolio development is the re-investment of the proceeds we received from the Pulsion exit. This will happen gradually and carefully as present valuations are high by most of our standards.

7. The Firm

7.1 Professional Staff

At the end of Q III 2014 our investment team consists of **the following professionals:**

- a) **Four analysts** covering Western Europe for equity long positions. They work on a T-model - combining full responsibility for several countries with in-depth knowledge and experience in selected sectors/practice areas. By the end of 2014 we will be 5 plus one person which has signed-on, but will start in early 2015 – giving us a chance to enlarge our in-depth understanding of sectors.
- b) We are still looking for an additional analyst covering **special situations/shorting**.
- c) BW as **portfolio manager**.

7.2 HR Development

We are presently developing the firm more strongly towards a **sector focus**. In the last quarter and the rest of the year, the staff will spend time in sector conferences and similar know-how transfer mechanisms.

7.1 Fund for External Investors

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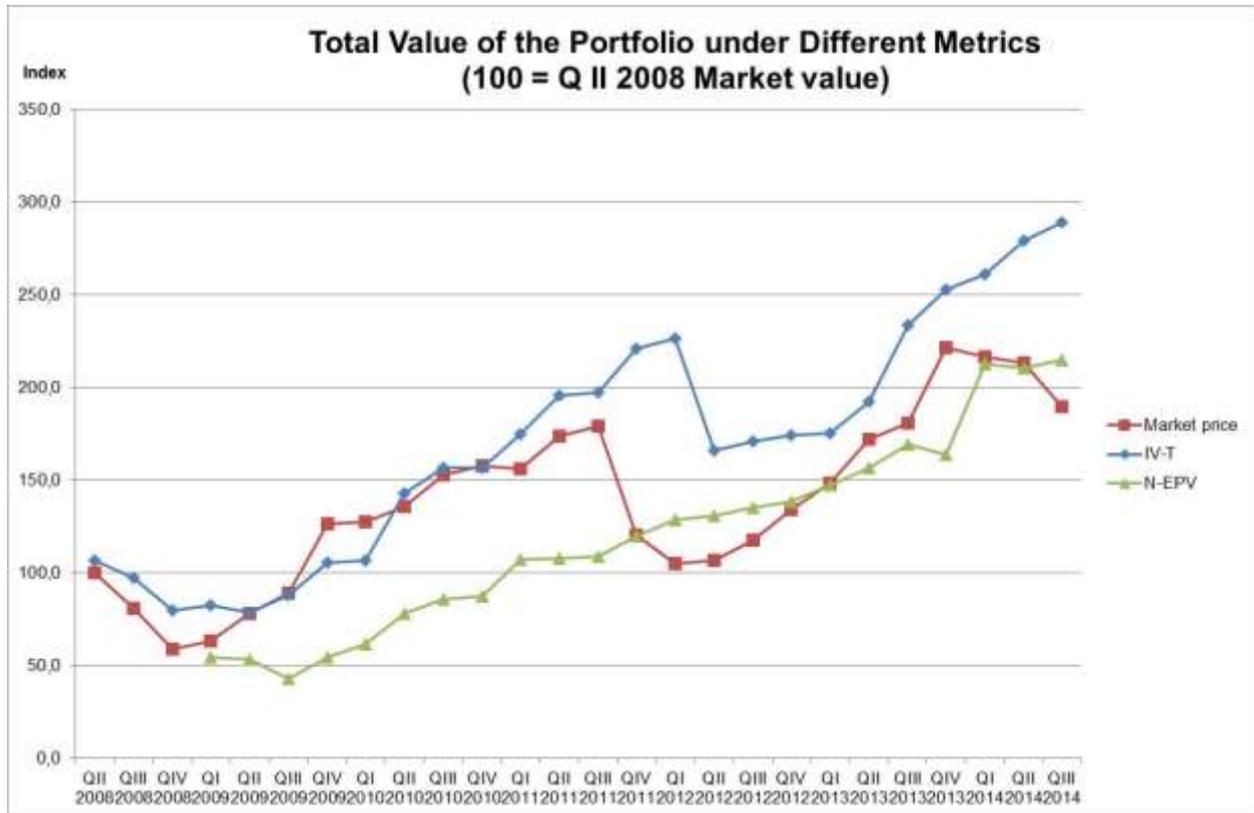
A fund for external investors has been set up by another FORUM company. Regulatory requirements do not allow us to comment any further on it **as it is restricted to qualified investors.**

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Appendices

Appendix 1: Portfolio's Development

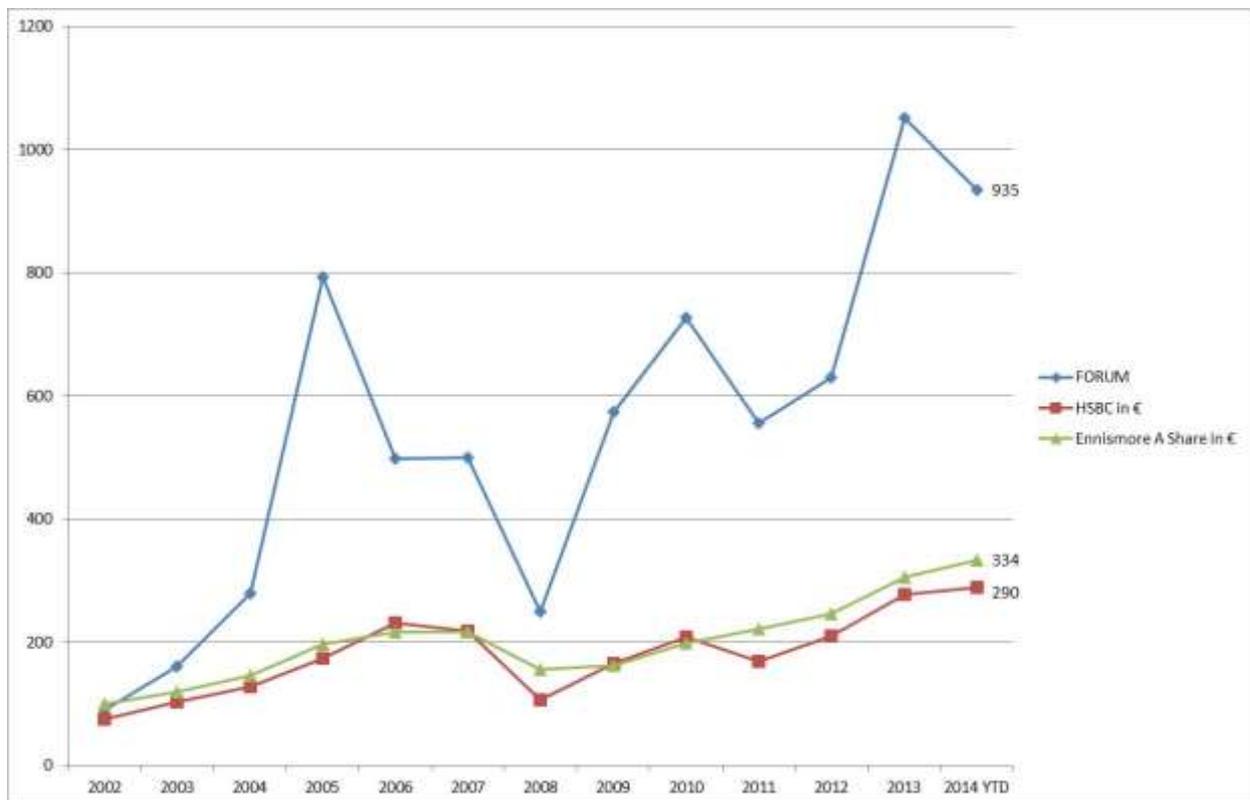


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Appendix 2: Benchmarking of Results

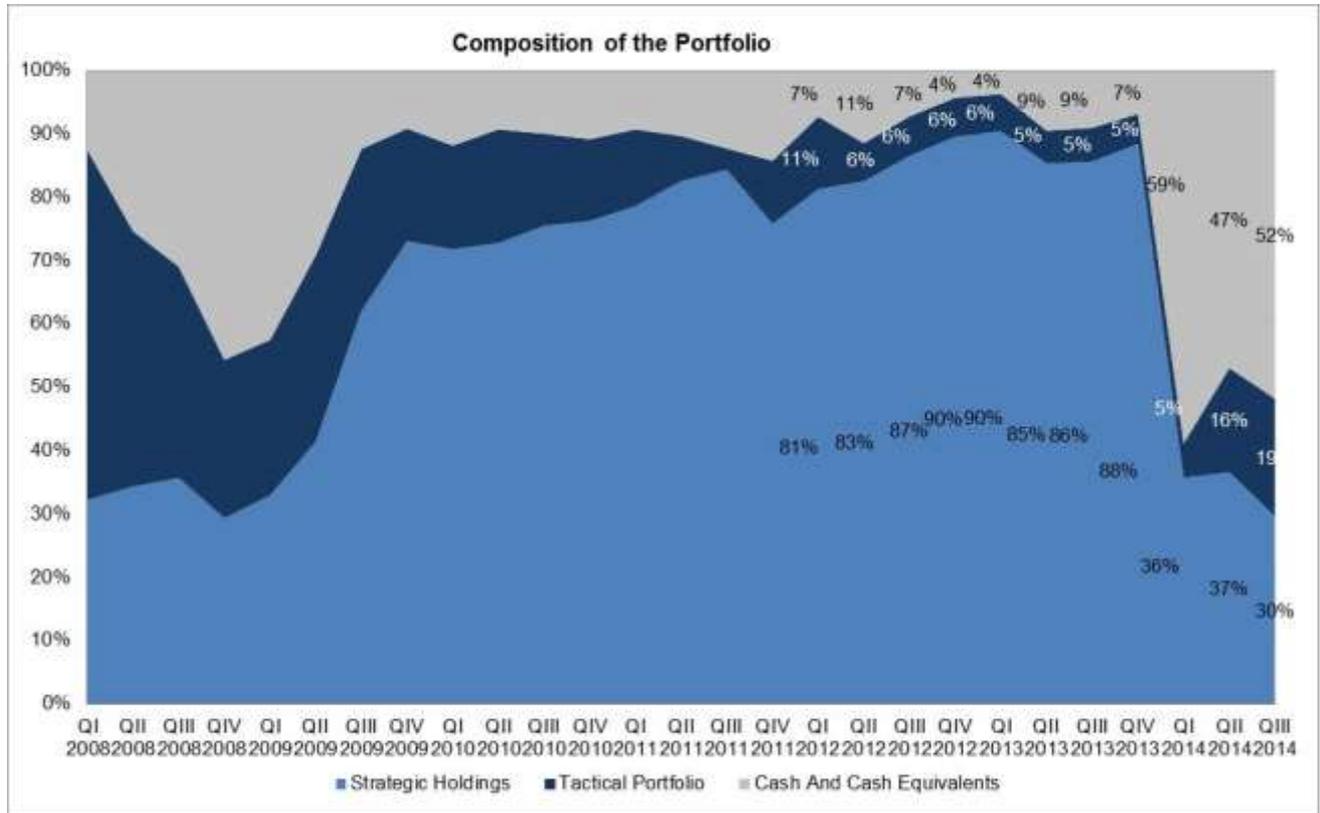
Since Inception (2002), p.a.	FORUM		HSBC European Smallcap Index in €		Ennismore A Share in €	
	Percent	Index	Percent	Index	Percent	Index
2002	-9%	91	-25%	75	0%	100
2003	77%	161	38%	104	20%	119
2004	74%	280	24%	128	23%	147
2005	183%	794	36%	175	34%	197
2006	-37%	498	33%	232	11%	218
2007	1%	501	-6%	219	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	13%	630	24%	210	11%	246
2013	67%	1052	32%	278	24%	306
2014 QI	-3%	1024	8%	299	5%	322
2014 QII	5%	1076	1%	301	1%	323
2014 QIII	-13%	934	-4%	290	3%	334
IRR 2002 - YTD	19,2%		8,7%		9,9%	



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Appendix 3: Development of Portfolio Mix



Appendix 4: Development of Watchlist Prio 1 End of Quarter

