

Memorandum

To : Forum Staff
From : BW
Date : March 29th, 2016
Subject : FES Chief Investment Officer Report on Q IV_2015 Results_V_2.2

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 are like.

A. Overview

1. FES Investment Philosophy

1.1 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

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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.
- c) 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 decisions 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 or 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.

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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.

1.2 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.

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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 at FES has been < 5% of AUM. We would like to have it a bit larger now.

2. Financial Markets in 2015

2.1 Stock Market Indices

In the course of 2015, equity markets in Europe **continued to rise from what we considered an already high level at the beginning of the year:**

	2014	2015
a) MSCI World	+4,9%	-0,9%
b) S&P 500	+13,0%	+0,7%
c) Stoxx 600	+7,2%	+9,6%
d) STOXX 200 European Small	+4,9%	+15,7%
e) DAX	+2,7%	+9,6%

The main benchmark we use is the STOXX 200 European Small Index - it is comprised of the 200 smallest-cap constituents of the STOXX 600 index. We use the lesser known index version including dividends to have a fair calibration - we do receive the dividends, of course.

2.2 Level of Valuation

For our assessment of equity market valuations we **like to look at the Shiller CAPE** – i.e. the price/earnings ratio of the S&P 500 index based on the average earnings per share ("eps") of the last 10 years. Here is the development:

	Dec. 31st, 2013	Dec. 31st, 2014	Dec. 31st, 2015
CAPE	24,9x	26,5x	24,0x

The historical mean since 1881 is a CAPE of 16,6x. **Thus relative to this historical mean the overvaluation is ca. 45%**. Thus in 2015 it has stayed at a relatively high level.

Analyses for Europe show also a high level of valuation in the historical context- albeit not as high as in the USA – see our Macro Dashboard publications. **Thus the increase in European**

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stock market indices is taking place at a level of very high valuations when comparing them with long-term earnings and long-term multiples.

3. Results in FY 2015

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

- a) at market prices
- b) at Net Earnings Power Value ("N-EPV")
- c) at Total Intrinsic Value ("IV-T")

3.1 Results at Market Prices

In 2015 the value of our **portfolio at market prices decreased by 19,8%**. This is a very disappointing development - it implies that we underperformed our benchmark index by more than 30%. As you will see below nearly all of the negative development is due to two major events

- a) the **complete loss of our money invested in a company based on fraud.**
- b) the decrease in the share price of **our strategic holding Immunodiagnostic Systems Holding plc.**

For a benchmarking of **our results** 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 2015 the HSBC index increased by 22%. Ennismore was also up 14%.

3.2 Results at Intrinsic Values

In 2015 the **Intrinsic Value of our portfolio** showed the following development:

- a) **N-EPV decreased by 25,2%**. 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"**.

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- b) **Total Intrinsic Value (“IV-T”) decreased by 29,8%.** 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.

We significantly impaired the IV-T and N-EPV of our Tactical Portfolio as a consequence of the fraud case in Globo.

3.3 Margin of Safety

A key building block of Value Investing is the **Margin of Safety**. We measure it with two perspectives:

- a) by the discount of the invested part of the portfolio at market values **from the value at N-EPV**. On December 31st, 2015 the **Margin of Safety vs. N-EPV stood at 7% - vs. 26%** at the end of 2014.
- b) by the discount of the invested part of the portfolio at market values from **the value of the invested part of the portfolio at IV-T**. On December 31st, 2015 the market value stood at ca. 57% of our estimates of IV-T - **implying a Margin of Safety vs. IV-T of 43%**.

When cash is included the Margin of Safety from IV-T drops to 27%.

B. Discussion of Investments by Type

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 IV 2015
a) Strategic Holdings	31%	29%
b) Tactical Portfolio	20%	21%
c) Cash and Cash Equivalents	49%	50%
- <i>Thereof from short positions</i>	0%	2%
d) Total	100%	100%

Thus the key message is that the **portfolio is still nearly 50% in cash and cash equivalents**.

2. Returns by Asset Category

Below please find an overview over returns by asset category:

	Share of AUM EOY 2015	Return 2015
a) Strategic Holdings	29%	- 26,2%
b) Tactical Portfolio	21%	- 15,6%
c) Cash and Cash Equivalents	50%	- 12,1%
d) Total	100%.	- 16,3%

As you can see both investment categories underperformed strongly. As mentioned above the drivers for this performance are nearly all due to two investments which fared very poorly - which we will explain below.

3. Strategic Holdings

3.1 Immunodiagnostic Systems Holdings (“IDS”)

The required restructuring at IDS appears more fundamental than I had hoped for: the company needs to re-establish some core processes, mainly

- a) new assay development process
- b) sales process
- c) general management of efficiency
- d) corporate development process

These are also the 4 pillars of the strategy IDS has been pursuing.

The **biggest bottleneck is probably the new assay development process** as the assay menu is sub-critical in size - few labs will install a separate machine to be able to run up to 17 assays with a CE mark resp. 8 assays with FDA clearance. The company had guided for 6 - 8 new assay launches in the Fiscal Year ending on March 31st, 2016. But with one week missing in the Fiscal Year the company has only announced the launch of 1 new assay - implying difficulties in this process.

The **sales process** is focused on placing new analyzers which should then generate new recurring revenues. In the past the rate of gross new placements has decreased - largely due to the lack of menu - and conversely returns have decreased. Thus at H1 2016 (ending September 30th, 2015) the company only reported a negative placement of 10 instruments - vs. a positive 8 in H1 2015. Thus there is no change in momentum visible.

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As a result the downward momentum in the company is continuing. The new CEO Patricio Lacalle, who has been working on the turnaround since April 1st 2015, is doing his best to establish the required changes, but it will take some time before we see results.

At FORUM we still believe that IDS is a company with the opportunity to build up a razor-/razorblade business model in automated IVD - and to get back to growth. This business has been managed very poorly in the past and missed the big opportunity it had while the market for its core product was still growing.

But in the end fixing it is not rocket science, it just takes what it always takes when such a business has to be turned around: change not only in processes, but also in the culture of the company and probably several top management positions. Patricio was able to turn Pulsion from a mediocre business to an outstanding business with a 27% EBIT margin. Thus we are confident that we will also be able to turn IDS from a poorly-executed business to a good business (in the first stage...).

In 2015 the share price of IDS dropped by 26,2%. With this drop it is now for the first time below our entry level in 2009 and subsequent years.

Given the deeper problems than anticipated we have also reduced our Intrinsic Values for the company.

3.2 New Candidates

We did not add any new investment in our strategic portfolio in 2015.

The one investment where we wanted to enter the Board and effect changes was **Globo** - and the CEO confessed fraud a week after we demanded the Board seat. We believe our request was one of the triggers of the fraud being confessed by management. **Thus we will report it under Tactical Portfolio.**

4. Tactical Portfolio

We think about our portfolio primarily in **the following five 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.

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- 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.

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

4.1 Franchise Businesses (50% 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 called Wessanen.**

In 2015 we sold down part of the operator of wind mills to reduce country risk exposure (guess where the company is located...).

4.2 Hybrid and Execution Businesses (31% of Tactical Portfolio)

In Q4 2015 we added one capital goods business with a strong share of aftersales. We took this investment decision mainly after a new manager arrived who committed to strengthen the aftersales portion of the business. His track record at his previous employer makes us confident that we will be able to drive growth and margin expansion.

4.3 Cyclical & Special Situation (2% of Tactical Portfolio)

This segment consists of one company exposed to soft commodity prices.

4.4 Other (17% 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 Structure of Tactical Portfolio

Our liquid portfolio suffers from too many positions with very few big enough to make a difference:

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- a) our largest holding Wessanen accounts for 10,0% of AUM, the second-largest for 3,7%. Thus the **two largest positions account for a combined 13,7% of AUM.**
- b) there is a tail-end of **10 other positions with a combined weight of 7,1% of AUM.** Thus they make no difference.

Historically we have been able to get conviction on a few companies and allocated 10 - 30% to each. This is something we have to target again.

In our last report we said that we wanted to **clean out this tail end of small holdings.** By the end of 2015 the number of positions in the tactical portfolio was 12, unchanged vs. Q3 2015.

4.6 Summary of Results by Source

As mentioned above at market prices our portfolio lost 19,8% in 2015. By source of result we think about this drop as follows:

Source	Result % of Asset	Result % Portfolio
a) loss of Globo: permanent loss of capital	- 97%	- 16,9%
b) Share Price drop IDS	- 26,9%	- 8,2%
c) All other		+ 5,3%
d) Total		- 19,8%

Thus as you can see, the loss is strongly correlated to the Globo write-off.

C. Short Book

At the end of Q IV 2015 FES has 3 short positions. The position accounts for 2% of AUM, thus it is not significant.

In the current environment of high valuation and cheap debt (both may end at some point), we keep on looking for ideas in this segment.

D. Errors in 2015

1. Errors of Commission - Globo plc.

1.1 History of Investment

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The “error of the year” was our 2015 investment in a company called **Globo plc**. The investment case was described in our Letter to Clients Q III 2015. In Q IV 2015 the company filed for bankruptcy as apparently **the accounts had been falsified**.

We had made our first investment in this company in Q II 2014. When the company announced in the summer of 2015 that it was applying for a loan of US-\$ 180m at an interest rate of 8 – 9% we decided to

- a) **sell down** the complete position. This was executed by the end of August 2015.
- b) do an **in-depth Due Diligence** to exclude the risk of fraud.

We kept pursuing this opportunity because the **risk-/reward ratio was highly asymmetrical**: if the company was a fraud it was worth nil, if there was no fraud its market value would be ca. 4x its actual value.

Please note that up to this investment our Investment Philosophy allowed to do such asymmetrical odds with the risk of complete loss of capital - provided there was an upside of several 100% - and odds leading to a probability-weighted highly positive outcome.

1.2 Investment Process

Our Due Diligence consisted of interviews with ca. 15 employees, ex-employees and customers as well as a long meeting with the CEO and its top staff in Athens. At the end we decided that the risk of a fraud case was tiny.

1.3 Outcome - What Went Wrong?

By now we know there was fraud. As is the case in cases of fraud like this the likely recovery value will be very low or nil.

Why were we wrong – why did we overlook the fraud case? Our Post-Mortem of this case revealed several the following issues:

- a) **Sample Selection**: many of our interview partners were **selected based on being named by the company**. This applies particularly to customers. Thus the selection was flawed for the purpose of the interviews.
- b) **Sample Size**: the **number of 15 personal interviews was probably not sufficient** to identify a well-disguised fraud in a company operating globally.
- c) **Confirmation Bias**: the analyst promoting this idea was personally invested in it and probably suffered from Confirmation Bias – looking for facts confirming the decision he had already taken. The investment was made already several years ago, before this became a project for FFOVF.

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This problem was aggravated after a few other analysts had invested as well personally – and decided not to sell down in summer.

- d) **Mixing Business and Risk Due Diligence:** We did not have separate teams for Business Due Diligence and Risk Due Diligence. A significant of the Due Diligence was spent understanding and verifying the upside from the business case.

1.4 Implications for Investment Process

As a learning we have **tightened our Investment Process**. The most important changes are

- a) The definition of

- **sample size**
- **sample selection**

for the personal interviews will be specified in a work plan before the start of the project and reviewed by me as well. In general the number of interviews will go up.

- b) To handle the enlarged work load in the **Business Due Diligence teams will be larger – 2 – 3 persons each**. This reduces the maximum number of such “Deep Dive Projects” the firm can handle to two at a time. During such projects trips to new prospect companies will be reduced.
- c) Any staff member has to **publish any personal investment in an investment candidate**. Staff members who are personally invested in an investment candidate **will not become members of the DD team**.
- d) We will **separate teams for Business Due Diligence from Risk Due Diligence**. This is common practice in Private Equity – for good reasons.

1.5 Implications for Investment Philosophy

In addition we have **also tightened our Investment Policy: we will not invest in asymmetrical bets anymore if the risk of a permanent loss of capital is more than insignificant**. Put differently: we do not want to have a small probability of losing money – even if the good/best case promises us riches.

One of the foundations of Value Investing - **“never lose money” should be a rigid rule – with no exceptions or grey zones**. We and you will rather get rich later – but make sure we will get rich.

2. Errors to Omission

In early January we reviewed the winners in the main stock markets we cover to see if we could have invested in some of them. In fact we had met several of these companies in the past. The Post-Mortems analyzing these errors of Omission **revealed similar conclusions why we missed these opportunities:**

- a) We **did not meet new CEOs** in the first six months of taking office. And what a difference they made – not to be seen or modeled using just 21st screen analysis.

We now screen regularly for all CEO changes in the territories we cover. We will try to meet all of them if the company appears reasonably interesting.

- b) **Focus too much on valuation too early – not asking first "what we get"**. At the beginning of 2015 we put much more emphasis on valuation – not being willing to pay slightly above N-EPV for an outstanding combination of what we would get.

I have described the adjusted investment philosophy at the beginning of this paper, it is much broader on assessing what we get – before we look at valuation.

- c) **Focus too much on operational detail**, e.g. peripheral risks which would not “kill” the investment case. The right focus requires an entrepreneurial mindset seeing the “big picture” – which was apparently not present when we discussed some cases in the Monday Morning Meeting.

To strengthen this perspective we have **sharpened the role of the commentator** of each investment idea in the Monday Morning Meeting to **taking a contrarian approach – i.e. argue why we should invest if the author of the investment idea is cautious, and vice versa**. Secondly, this is my role as Investment Manager and it was good to be reminded of the opportunities in certain constellations for which there are patterns from experience.

- d) **Follow-up work not done thoroughly** – we did not prioritize these investment candidates correctly. We have now established firm review processes of the follow-up process to the Monday Morning Meetings to handle this operational point as well.

E. Risk Report

1. Risk Exposure at EOY 2015

At the end of 2015 these are the main risks we see. **Please remember that we define risk as “Permanent loss of Earnings Power Value”**. A decline in stock prices is not a risk for us, thus we will not comment on the weak start into 2016 at most stock exchanges.

1.1 Greece Exposure

At the end of FY 2015 our economic exposure to Greece stands below 2% of AUM.

1.2 Oil Price Risk

Our exposure to oil is one-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.

At the end of 2015 this company **accounted for 0,4% of AUM**

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 - stood at 7% at the end of Q IV 2015 (see **Appendix 1**).

3. Risk Realization: Permanent Loss of Capital

We wrote down completely Globo (N-EPV and IV-T of 0).

F. The Firm

At the end of Q IV 2015 our investment team consists of

- a) 5 associates with at least 2 years of seniority at FORUM or equivalent outside
- b) BW as portfolio manager.

In 2015 one analyst joined and left the firm.

G. Outlook

2015 was an "**annus horribilis**" for FORUM:

- a) our only **strategic holding IDS** took longer than expected to achieve a turnaround. We are confident that eventually this investment will work out positively for us.
- b) we made an **investment into what turned out a fraudulent company** - and lost the complete money.

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We have learned from our errors of commission and omission and evolved our Investment Policy and Investment Process to integrate these experiences. This will help us to be better fund managers going forward.

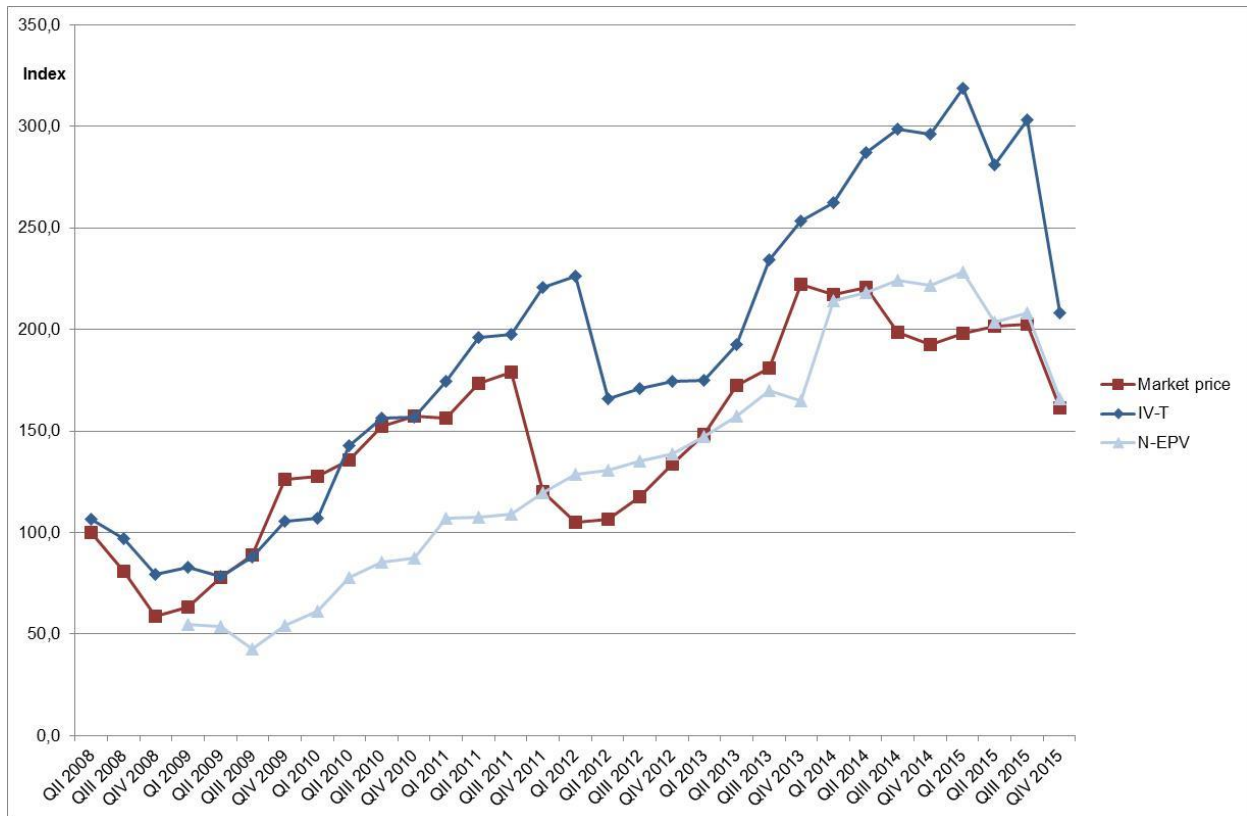
An additional change we will implement going forward is to focus our research more strongly on companies with a larger market capitalization to be able to trade in and out of significant positions.

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Appendices

Appendix 1: Portfolio at Market Prices and Intrinsic Values

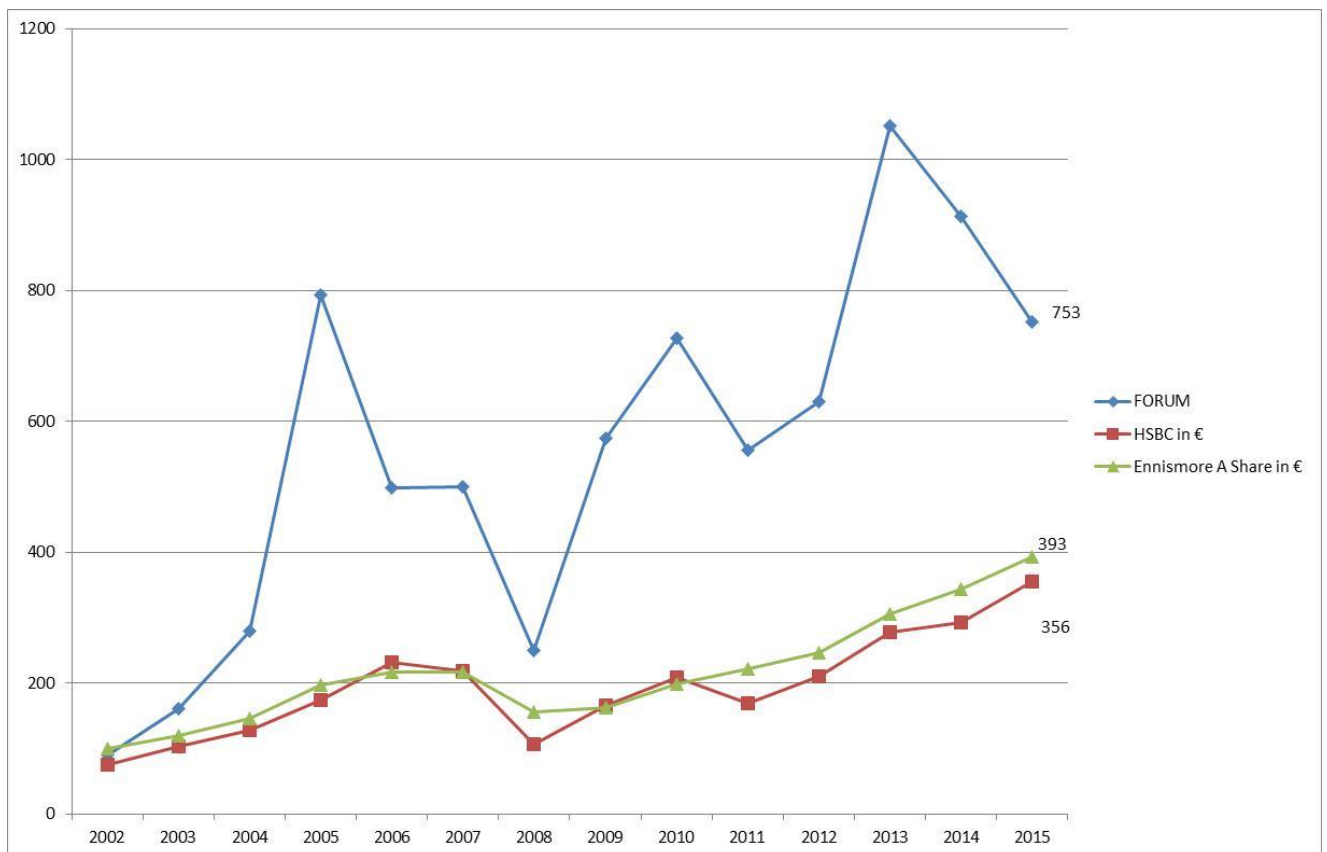


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Appendix 2: Benchmarking of Results Since January 1st, 2002

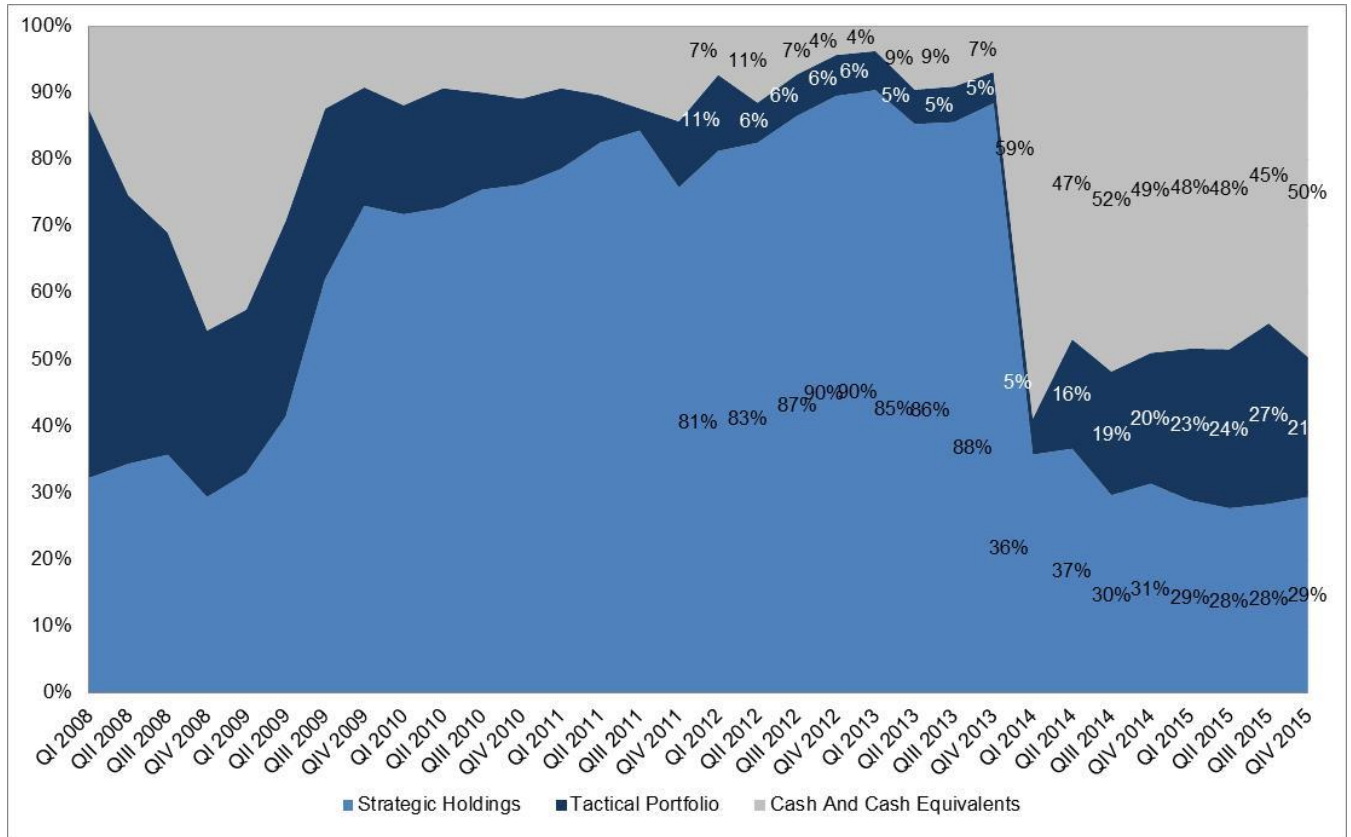
Since Inception (2002), p.a.	FORUM		HSBC European Smallcap Index in €		Ennismore A Share in €	
	Percent	Index	Percent	Index	Percent	Index
2002	-9%	91	-25%	75	0%	100
2003	77%	161	38%	104	20%	119
2004	74%	280	24%	128	23%	147
2005	183%	794	36%	175	34%	197
2006	-37%	498	33%	232	11%	218
2007	1%	501	-6%	219	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	5%	293	12%	344
2015 QI	3%	940	17%	343	3%	353
2015 QII	2%	956	1%	348	6%	376
2015 QIII	0%	959	-5%	329	0%	375
2015 QIV	-22%	753	8%	355	5%	393
IRR 2002 - YTD	15,5%		9,5%		10,3%	



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Appendix 3: Portfolio Allocation



Appendix 4: Tactical Portfolio as of Q IV 2015

