

Memorandum

To : Forum Staff
From : BW
Date : May 1st, 2016
Subject : FES Chief Investment Officer Report on Q I 2016 Results_V_2.1

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.

This Interim Report covers the **period from January 1st, 2016 to March 31st, 2016**.

1. Results in Q I 2016

1.1 Results at Market and Intrinsic Values

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**")

In Q I 2016 the value of our **portfolio at market prices decreased by 2,8%**.

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

FORUM

European Smallcaps GmbH

- a) **N-EPV decreased by 0,8%.** 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”) decreased by 1,2%.** 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.

This evolution is primarily linked to the **evolution of the GBP/EUR** exchange rate: in Q I the Pound devalued by ca. 7,8% (from 0,7340 to 0,7916), **generating a 2,3% loss at market prices on our portfolio.**

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 11% - vs. 7%** at the end of 2015.

The **ratio of the value of the invested part of the portfolio at IV-T to the value of the invested part of the portfolio at market prices** is a measure for the upside. At the end of Q I 2016 it stands at 178%. When cash is included this ratio drops to ca. 139%. This is the upside potential of the total portfolio as of today. It does **not capture the upside from compounding of our holdings - i.e. the growth in Intrinsic Value over time.**

1.2 Benchmarking of Results at Market Prices

For an overview of **our results vs. our benchmark** please refer to **Appendix 2**. Note that this Benchmarking refers to Forum Family Office, and not only FES, explaining the slight discrepancy in performance.

In Q I 2016, **our performance was -2,4%**, vs. the STOXX Europe Small 200 index dropping by 6,9%.

2. Asset Mix and Results by Asset Class

2.1 Evolution of Asset Mix

Please see **Appendix 3** for an overview of the composition of our long book. The composition is broadly unchanged vs. FY 2015. The slight change is due once again to mainly to currency effect.

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

Net long exposure is 47,8% (49,6% long ./ 1,8% short).

3. Strategic Holdings

3.1 Immunodiagnostic Systems Holdings (“IDS”)

We have commented about the **main recent changes at IDS** in our FY 2015 Report.

There has been no significant change in the meantime.

3.2 New Candidates

We did not add any new investment in our strategic portfolio in Q I 2016.

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.
- 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.

A second dimension of the **quality of businesses are their compounding economics** – i.e. the ability to re-invest free cash flow resp. equity into profitable growth at an ROIC above what an investor would be able to get from investing in a stand-alone business.

According to our Investment Philosophy **we try to allocate the majority of our tactical portfolio to Franchise Businesses – preferably those with strong compounding economics.** We will also invest in the other categories, but **only when the risk-adjusted return expectation is absolutely outstanding.**

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

FORUM

European Smallcaps GmbH

4.1 Franchise Businesses (48,6% of Tactical Portfolio)

This category consists of three positions: an FMCG company, a media company and an operator of wind mills. The **dominant position is the FMCG company called Wessanen** which we regularly discussed.

4.2 Hybrid and Execution Businesses (34,4% of Tactical Portfolio)

Compared to FY 2015 we started building up positions in two Execution businesses, both we believe are run by outstanding managers. We believe earnings at both companies will go through an inflection point in the next 2 – 3 years

4.3 Cyclical & Special Situation (1,4% of Tactical Portfolio)

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

4.4 Other (15,5% 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 Summary of Changes in Valuation in our Tactical Portfolio

In Q I 2016 we slightly upgraded the N-EPV of Wessanen due to good reported results, as well as on one of our Swedish branded Consumer Goods Company.

5. Short Book

At the end of Q I 2016 FES had four short positions. The combined weight of the short positions accounts for 1,8% of AUM, thus it is not significant. We intend to increase this weighting.

6. Risk Report

6.1 Definition of Risk

We define risk as a permanent loss of capital. We do not worry about share price volatility.

6.2 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 11% at the end of Q I 2016 (see **Appendix 1**).

6.3 Permanent Loss of Capital/Impairment of Intrinsic Value

We have not realized any impairment above 5% in Q I 2016.

6.4 Greece Exposure

At the end of Q I 2016 our economic exposure to Greece stood below 1% of AUM.

6.5 Oil Price Risk

Our exposure to oil is the following:

- 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 Q I 2016 this company **accounted for 0,3% of AUM**.

6.6 Risks from Portfolio Concentration

At the end of Q I 2016 the **top 3 positions** – including our strategic position IDS - **represented 40% of the portfolio**. We feel comfortable with this degree of concentration.

7. Outlook

We refer to our **Macro Dashboard for Q I 2016**. Since our last Macro Dashboard:

FORUM

European Smallcaps GmbH

- a) **profit levels in the USA** have fallen "over a cliff" - after slipping already in the previous quarters. Preliminary data and estimates for Q I 2016 suggest that the drop in profit has continued.

This is a material change vs. the last 3 - 4 years when profitability was moving in a very narrow band - and at a very high level. This may indicate that the Reversion to the Mean process has started.

Data for Europe send the same signals: corporate profitability is weak, stagnating or even dropping. The anticipated boost to corporate profits from lower prices of oil and many commodities is not materializing.

- b) **valuations have stayed at a high level.** Yet all metrics continue to be below what we define as "bubble territory", i.e. two standard deviations about the historical range.

If the drop in profitability is continues - and is not a statistical blip - valuations will be hard to justify. Thus we expect equity markets to be volatile going forward.

8. The Firm

At the end of Q I 2016 our investment team consists of

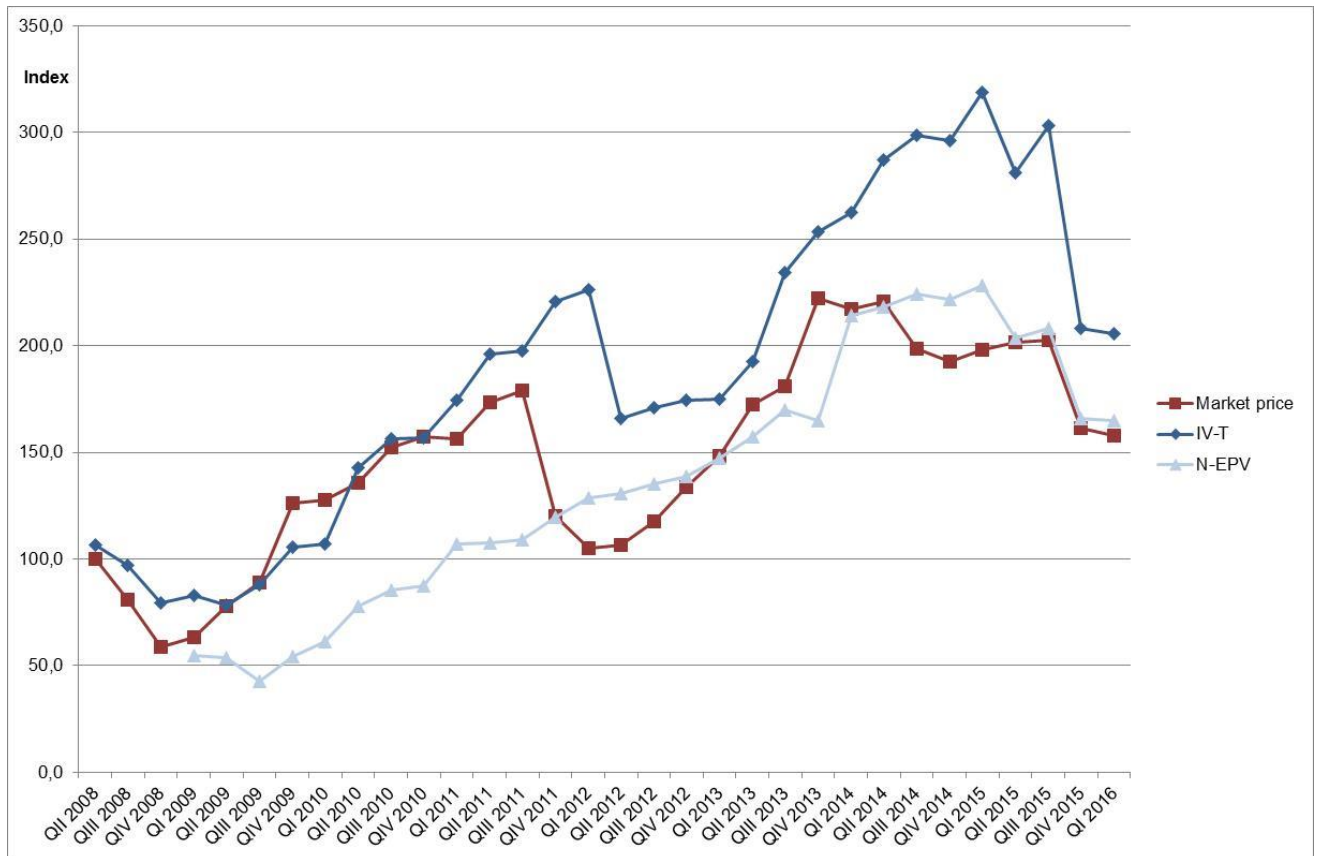
- a) 5 associates with at least 2 years of seniority at FORUM or equivalent outsides
- b) BW as portfolio manager.

FORUM

European Smallcaps GmbH

Appendices

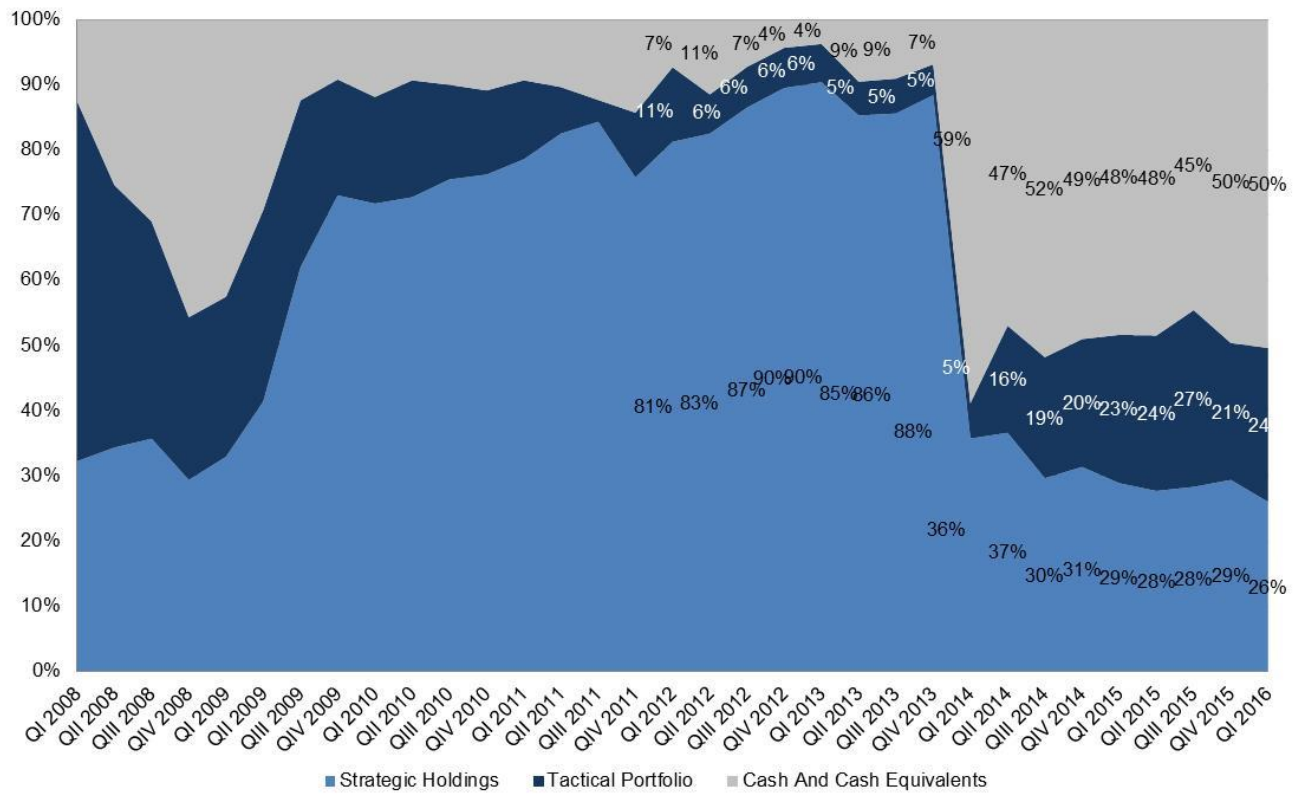
Appendix 1: Portfolio at Market Prices and Intrinsic Values



FORUM

European Smallcaps GmbH

Appendix 3: Portfolio Allocation



FORUM

European Smallcaps GmbH

Appendix 4: Tactical Portfolio as of Q I 2016

