Moerus Capital: An Introduction

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In 2015, we founded Moerus Capital Management, LLC. Having worked together for nearly a decade identifying, researching, analyzing, and investing in opportunities worldwide, the three of us formed Moerus with the overarching goal of doing one thing, and doing it very well: applying what we believe is a unique style of value-oriented investing that we have developed and utilized throughout our careers across a global universe of securities. Moerus is, and always will be, an investment research-centric organization that is dedicated above all else to seeking to generate attractive long-term returns for our investors, while maintaining a keen focus on mitigating downside risk. In the following pages, we would like to provide a brief introduction to our investment approach and how we look at the universe of potential investment opportunities.

The Moerus Capital Approach

Through a fundamental, bottom-up value-oriented investment process, we aim to buy securities of companies that trade at substantial discounts to our conservative estimates of intrinsic value. The portfolio is unconstrained by geographic, industry, or index-related considerations, resulting in a portfolio that is built from the bottom up and based on what we believe are the best absolute value opportunities currently available. In short, we are willing to go wherever the most compelling opportunities are.

Some of the key attributes of our investment approach and philosophy are highlighted below.

Long-term investment horizon

We are patient, long-term value investors. In general, for each investment we envision a holding period in the range of three-to-five years, although we will hold investments for longer periods than that as long as the investment case remains compelling. We do not buy or sell based on quarterly earnings or other short-term considerations. We believe that this long-term investment horizon allows us to take advantage of significant stock price declines due to temporary factors such as, among others:

- Poor near-term business results.
- A challenging (but temporary) environment facing the industry and/or geography in question.
- A macroeconomic and/or capital market shock that spooks markets, but which we deem to be temporary.
- Company-specific missteps that result in sharply declining share prices, but which could be overcome over the longer term.

Focusing instead on the long-term intrinsic value of the business and its underlying assets, we can respond opportunistically to compelling bargains that occasionally become available only because of such temporary bumps in the road.

Bottom-up focus

We invest and build our portfolio based simply and completely upon our judgment of what the most attractive individual opportunities are at the time. Our investment decisions are not driven by any overarching macroeconomic view or Index-related considerations. As a very simple example, suppose 15% of Index ABC is composed of investments from Country A, or that 10% of Index XYZ is made up of stocks belonging to Industry B. While such details might be of importance to investors who try not to stray far from benchmarks, they are completely irrelevant to us. We will never invest in a security just because it is included in an index, or because we "need to be invested" in certain industries or geographies so as to not be "too different" from benchmark indices. Our portfolio consists of investments which are selected based upon their individual merits and their fit within the overall portfolio, not upon top-down or external factors. As a result, we expect our portfolio's overlap with indices to typically be very low and country/sector exposures to be very different from various indices, as we continue to pursue attractive opportunities wherever they exist, regardless of such index-related considerations.

Macro-myopic, but macro-aware

At this point, we should qualify our point regarding our bottom-up investment approach. It is extremely important to note that although our investment approach is resolutely bottom-up in nature, we do not simply ignore or neglect to consider the broader macroeconomic landscape that might be relevant to any potential investment. Far from it. On the contrary, we strive to develop a deep awareness and understanding of the wide range of macroeconomic risks (and opportunities) that might come with any prospective individual investment.

One of our main goals as analysts and investors is to identify investments that in our opinion offer compelling risk-adjusted bargains on an *as-is* basis, based on what is known here and now. Our investment analysis does not place significant weight upon assumptions or forecasts about the future – conjecture that typically comes with top-down analysis – simply because of our observation that historically, most macroeconomic forecasters have failed to consistently predict future economic conditions, most importantly the turning points in such conditions. Instead, in our experience we have found most macroeconomic forecasting to be biased towards an extrapolation of recent trends. For example, as crude oil prices generally ranged between $80 and $105 per barrel for the better part of the current decade, how many economists and investment houses warned about the sustained, dramatically lower prices to come – until of course, after prices started to collapse in the second half of 2014? By focusing on the attractiveness of a given security based on what is known here and now, we avoid the risk of basing our investment thesis upon forecasts of the future that we believe have generally proven unreliable.

As described above, we do not spend time forecasting future macroeconomic unknowns and basing investment decisions upon such predictions. However, we do spend a significant amount of time considering the macro risks to which an investment might be exposed. In particular, it is important to assess the sensitivity of a given investment to extremely adverse scenarios (macro as well as micro) that tend not to be addressed by top-down forecasts, which generally tend not to veer far away from extrapolations of the recent past. We do not trust our own or anybody else's ability to predict extremely adverse scenarios with any degree of reliability. Instead we focus our efforts on mitigating the downside risks to our portfolio from future unknowns by constantly evaluating the potential for, and the magnitude of, any negative impacts of "tail events" that could derail otherwise attractive investment opportunities.

For example, consider the vulnerability of a given company's business model or balance sheet to significant currency mismatches. Suppose a Brazilian company generates the bulk of its revenues in Brazilian real (BRL), but a meaningful amount of either the debt on its balance sheet or its operating costs is denominated in U.S. dollars (USD). We suspect that few, if any, would have predicted that the BRL would have depreciated by over 40% (vis à vis the USD) between April 2014 and December 2015, a decline which likely would have severely impaired such a company's profitability and ability to service its USD-denominated debt. But even without having the luxury of such a prescient forecast, the mere evaluation of the vulnerability of a given business model or balance sheet to severe adverse shocks in advance, before any adversity strikes, allows for a more robust awareness and understanding of the risk profile facing a prospective investment before our first investment dollar is or is not committed. In this sense, while macro-myopic, we continuously strive to be quite macro-aware.

Very risk averse
The discussion of an awareness of macroeconomic factors, and what could possibly go wrong, dovetails with another key attribute of our investment approach at Moerus: we are very risk averse. At the beginning of this memo we discussed our objective of generating attractive long-term returns, while mitigating downside risk. To be clear, the risk that we strive to limit and avoid is not market risk, *i.e.*, the day-to-day fluctuations or volatility in securities prices. Instead, the risk that we seek to avoid is the risk of permanent loss of capital or impairment to the business. We spend much of our time carefully considering potential risks to the business at the security level as well as portfolio level risks.

Risks to a business that must be considered include factors both internal to the company as well as external. Risk is a critical topic that we will discuss in the much greater detail that it deserves in a separate, forthcoming memo, but in summary, internal risks to the company include, among others:

- A weak, highly leveraged balance sheet.
- The need for recurrent access to capital markets to continue operating the business.
- Inept and/or dishonest management.
- Inappropriate corporate governance and/or the potential for self-dealing by control groups.
- Risks stemming from the business model (for example, one with embedded currency mismatches, as discussed above).

Sources of risk that are external to the company include, but are not limited to: risks of government meddling or involvement, either official or by suasion; macroeconomic shocks facing an industry or geography; and changes in industry structure. Moving beyond the individual business(es), at the portfolio level we must carefully consider and avoid any unreasonably large aggregations of overlapping risks that are shared by multiple individual holdings.

In our overall assessment of the risks facing any prospective investment, we find that the balance sheet is the financial statement that is almost always the most useful. We try to limit financial risks by focusing on companies with strong balance sheets that are rich in high-quality assets and burdened by a relative paucity of debt and other financial obligations, which can be found both on the balance sheet and off of it (*e.g.*, in the form of contingent liabilities or capital commitments). Companies that have highly leveraged balance sheets and/or have recurrent capital needs that cannot be financed internally by the business are inherently at risk of needing to access capital markets at the very time that conditions are most difficult, when financing at reasonable terms is not readily available. In good times, access to capital is usually easy to come by, but during any industry's darkest days – 2008 for banks, for example, and perhaps today for high-cost, highly indebted oil and gas exploration and production companies – sources of capital typically dry up just when companies are most in need, imperiling those which are the most highly leveraged and dependent on external financing.

We noted earlier that we do not focus on avoiding market risk, or the volatility in prices for each individual stock. In fact, while many seek to limit market risk, we actually embrace such risk as a source of longer-term opportunity. If we have done our jobs correctly, namely in selecting investments at purchase prices that represent a significant discount to intrinsic value, over the long term the discrepancy between market price and fair value is likely to be ultimately recognized, either by the public securities markets as sentiment shifts and latent value is more fully appreciated by the broader market, or perhaps in the private markets via takeovers, asset sales, liquidations, etc.

Yes, securities prices rise and fall, sometimes rapidly and dramatically, but in focusing heavily on the potential risk factors facing any investment before we buy our first share, we aim to create a portfolio of investments that possess the wherewithal and staying power to weather difficult conditions, survive and thrive into the future, when we believe intrinsic value will eventually be recognized. Thus we <u>embrace market risk as a source of opportunity</u>, as it periodically provides bargains in the form of panicked sellers, and also conversely as it, from time to time, enables us to sell investments at attractive prices that no longer reflect the fundamentals to overly exuberant buyers.

The Moerus Approach: Valuation

Along with a keen awareness of the risk factors facing a potential investment, we believe that valuation analysis, and the ability to buy as cheaply as possible (*i.e.*, at a deep discount to intrinsic value), is of paramount importance in meeting the objective of attractive risk-adjusted returns over the long run. Indeed, we believe that <u>buying as cheaply as possible is a key principle of risk mitigation, in addition to being imperative in maximizing potential long-term returns</u>.

We imagine that every value investor could talk at length about how cheaply they buy a given security; after all, value investors pride themselves on purchasing securities at lower valuation multiples than those which other investors (growth and otherwise) are willing to pay. Value investors aim to identify and make investments at significant discounts to their estimate of intrinsic value – in effect, they strive to buy what they see as dollar bills in exchange for sixty cents (or fifty cents, or whatever the case may be). Thus, in principle, we believe that in this sense, most if not all value investors are generally similar. However, value investors buy when prices are at discounts to <u>their estimates of intrinsic value</u>. Indeed, the specific valuation methodology that they employ comprises a key area in which individual value investors distinguish themselves from each other. Simply put, although value investors buy at what are, by their estimation, discounts, <u>not all discounts are equal</u>.

Many investors estimate intrinsic value through various forms of discounted cash flow (DCF) analyses, which (in general) involve forecasting cash flows years into the future, before valuing those future cash flows in "today's" dollars by applying a discount rate to them. DCF analysis makes perfect sense theoretically, but like most academic concepts that we all have encountered in our studies, in practice the end result is heavily influenced by the assumptions that go into it – and there are many assumptions. Just to name a few, an estimate of future cash flows (*i.e.*, the numerator in a DCF analysis) must either explicitly or implicitly incorporate a forecast of revenues, operating costs, capital expenditures, taxes, and interest expense years into the future. Additionally, the discount rate (the denominator) used is a function of numerous additional assumptions. The upshot is that relatively small changes to either set of assumptions can result in meaningful changes to estimated intrinsic value. Therefore, estimates of future cash flows or other key variables, if they prove overly optimistic over time, could result in considerable downside risk for investors as intrinsic value estimates are adjusted downwards.

How We're Different: A Conservative, Asset-Based Methodology

As discussed earlier, our estimates of intrinsic value weigh much more heavily what is known here and now, and involve minimal assumptions or guesses about the future, due in part to our skepticism of the ability to forecast accurately. Further, our valuation estimates focus much more often on actual balance sheet-based data than on the income statement and current or estimated future earnings or cash flows. In general, our valuation methodology includes the following principles:

- Typically, we try to deconstruct a company's balance sheet and value each of its components (both assets and liabilities) conservatively, with net assets typically valued at a significant discount to what we believe a reasonable strategic or financial buyer would currently pay for them in an arms-length, cash transaction.

- We then make various adjustments to this net asset value as needed, such as when the company has assets or liabilities of material value that are either not present or not appropriately reflected on the balance sheet. Examples of off-balance sheet liabilities include any significant ongoing capital commitments for future investments that are necessary for the company to continue operating as a going concern, or future operating lease commitments that often are not reported on the balance sheet as a financial obligation.

We must emphasize that at all points in the process, the recurring theme is conservatism. This principle also applies in other instances in which, when we deem it appropriate for the particular business, that our valuation estimates weigh the earnings or cash flow of the business more heavily than the balance sheet data. In these cases we endeavor to base such valuation estimates upon the following:

- Little, if any expectations or assumptions of future growth.

- Conservative capitalization rates or multiples of earnings/cash flow.

- A wariness of the possibility that current earnings or cash flows might be cyclically elevated or unsustainable.

Based upon our experience, we believe that if we are able to invest at a price that reflects a meaningful discount to a conservatively estimated intrinsic value – one which weighs the value of current, balance sheet-based net assets more heavily than future earnings or cash flow projections – we can establish a "margin of safety" with mitigated downside risk over the long term. We believe this, of course, provided that such an investment satisfies our stringent criteria in regard to risk mitigation, which we briefly touched on earlier. A deep discount in itself, while necessary in contributing to an adequate margin of safety, is not sufficient, and we will not subordinate our principles of risk mitigation in the pursuit of a cheap buy price alone.

With that said, we believe that buying very cheaply does contribute meaningfully to downside protection, and can help investors stay out of trouble. Our philosophy is that if done well, such a conservative methodology often yields a "bedrock" (lower-bound) valuation, and that buying at a steep discount to such a bedrock valuation may provide a cushion against unexpected adversity that can and will confront a business at various points in its existence. Emerging and frontier markets, where growth-driven stock valuations often leave investors particularly exposed to the risk of a slowdown, offer examples of places where insisting on a "bedrock" valuation could be especially valuable in protecting against downside.

As noted earlier, not all discounts are equal. In our view, a 30% discount to an intrinsic value estimate that is based upon what a business might fetch if it shut its doors today and sold all of its assets, in our opinion provides much better downside protection and is more "storm-tested" than, for example, a 30% discount to an intrinsic value estimate that is based on projections of future cash flows for years to come, which may or may not prove optimistic. In our view, the problem with weighing heavily the income statement, earnings and cash flows (both current and future) in our valuation methodology can be summarized in several points:

- We believe that it is very difficult to accurately, consistently forecast the future.

- In trying to forecast the future, many analysts and investors weigh the recent past heavily and tend to extrapolate from past data. For example, if Company ABC had grown earnings per share at a 10% annual rate over the past three years, we suspect that an analyst might be inclined to forecast future growth rates based upon the robust growth observed in the recent past.

- That analyst may or may not be correct to do so, but we are skeptical of valuation methodologies based upon such forecasts because: (a) they are based upon recent growth, and typically investors are required to "pay up" for growth; and (b) historical results are not always indicative of future results. What if a new competitor gains ground, or technological change two years down the road erodes Company ABC's competitive advantage? If you base your valuation upon optimism that past results, more or less, will continue on into the future, then we believe you expose yourself to greater downside than if you base your valuations on conservative estimates of current, as-is asset liquidation values.

Conventional and academic wisdom dictates that risk and expected return are positively correlated: in plain English, to generate greater investment upside, you will have to tolerate a higher degree of risk, whereas conversely, lower levels of risk are associated with lower expected returns. Based on this thinking, some might believe that one implication for us might be that because we are very risk averse and conservative in our valuation of assets, then we must be sacrificing considerable upside potential. We disagree. Let's return to the earlier example: the 30% discount to an asset-based, as-is intrinsic value estimate, as opposed to the 30% discount to an estimate of intrinsic value that is based upon projections of future earnings or cash flows. In addition to being much more conservative and protective on the downside, we believe that the former discount also may provide significant upside potential in the event that business conditions improve or if sentiment shifts and the market better "appreciates" the company's net asset value.

This is simply because whenever you are able to buy at a deep discount to a conservative, bare-bones, asset-based valuation, many optimistic scenarios – among others, unexpectedly meaningful growth in earnings or cash flows in the future, an unanticipated industry or geographic recovery, or a sale of assets or businesses at a premium to their value as stated on the balance sheet – are typically <u>not priced in</u> at such discounted levels. On the other hand, valuations that are heavy on assumptions and/or that bake in growth in cash flows far into the future may expose investors to <u>much more painful</u> downside potential if the future doesn't play out as favorably as expected – think, for example, 4% actual growth in cash flows rather than 6% projected growth – let alone if the business is subject to any variety of more significant external shocks, which far too often are not "anticipated" until they happen. Further, when an optimistic vision of a company's future is already priced into its current stock price, a company typically must subsequently outperform these great expectations in order to generate above average returns for investors who bought in based on assumptions of continued growth and prosperity.

It is worth making one final point about the asset-based approach to valuation as compared to the earnings or cash-flow-based approach. Generating ongoing earnings <u>is not</u> the only way that a corporation can build value over time. Significant value can be created over the long run by skillful management teams through other, <u>non-earnings centric means</u> such as, among others, shrewd buying and selling of businesses and/or assets, repurchasing shares when they are trading at a material discount to intrinsic value, and issuing shares when they are trading at a material premium to intrinsic value. Li Ka-Shing's CK Hutchison Holdings Ltd. of Hong Kong is an example of a company that has grown intrinsic value at impressive rates over the long-term through means other than earnings from continuing operations.

When such companies create value through the buying and selling of businesses, this value is often not highly visible on the income statement or in its earnings reports, except sporadically and in lumpy sums that cannot be modeled by an analyst (for example, after the sale of a business at a premium to its balance sheet value). For those who select investments based heavily upon analyses of past and future recurring earnings, opportunities to invest in quality companies that add considerable value over time through means other than reported earnings from continuing operations might fall under the radar. In short, an asset-based investment approach can periodically provide clues that would otherwise be difficult to find for those focused primarily on earnings from ongoing operations.

<u>The Moerus Approach to Valuation: Implications</u>

As detailed above, at Moerus our approach to both valuation and risk aversion always starts with, and typically emphasizes throughout, the balance sheet and the assets and liabilities that could be found both on and off of it. This approach has several key portfolio management related implications.

First, conservative intrinsic value estimates, and the insistence upon buying at meaningful discounts to such values, lead to a portfolio of investments that are bought at extremely cheap prices. For a quality long-term investment to become available at such modest prices, it often falls into one of the following categories:

- Its short-term outlook, either for the company itself, its industry or main geographic market, can be characterized as anywhere from lackluster to downright grim.

- There has been a company-specific misstep that has resulted in the share price being punished.

- The company is underappreciated, underfollowed, complex and/or misunderstood.

- There is hidden value that could potentially be unlocked through an event-driven scenario (*e.g.*, liquidations, corporate reorganizations, industry consolidation, key changes in shareholder structure, etc.).

Many investment opportunities that we find attractive share some of these characteristics, and our long-term, risk averse focus allows us to look past temporary, but what we believe are surmountable patches during which they are out of favor. One key attribute that this approach requires – perhaps more than anything else – is patience. Opportunities which meet strict valuation and risk characteristics often take a long time to develop, and they may only become available fleetingly. Patience is required, first, to hold cash in the absence of irresistibly-priced ideas and wait until an investment is selling cheaply enough, and then when it is (typically because it has fallen out of favor for one reason or another) and the investment is made, patience is also needed to hold it through short-term difficulties in order to potentially profit when the underlying value is ultimately realized.

Summary Conclusions

To recap, the broad principles of the Moerus investment approach can be briefly summarized as follows:

- Our goal is to, through a fundamental, bottom-up process, invest in the securities of companies at prices representing substantial discounts to our conservative estimates of intrinsic value.

- We are patient, long-term investors who are willing to take advantage of temporary challenges facing a company, its industry, or its geographic market, as they may periodically offer opportunities to invest in assets and businesses at compelling valuations.

- We are bottom-up investors who will not select investments based upon any index-related considerations or overarching macroeconomic views. We'll only invest in a security if we believe it offers an unusually attractive value and mitigated downside risk over the long-term.

- Our bottom-up focus notwithstanding, we strive to develop a keen awareness of the macroeconomic world in which each individual investment operates, with a strong emphasis on the vulnerability of each given business model to extremely adverse macro scenarios.

- We are extremely risk averse, but the risk we seek to mitigate is that of permanent loss of capital, not market risk. In fact, we embrace short-term share price volatility as a periodic source of excellent long-term investment propositions.

- We believe that buying as cheaply as possible is both a key principle of risk mitigation and a vital contributor to maximizing potential long-term returns. Our conservative estimates of intrinsic value weigh the balance sheet and what is known here and now much more heavily than the income statement and forecasts of future earnings and cash flow, which we find to be inherently unreliable and sensitive to even modest changes to assumptions.

We hope that this introductory memo has been helpful in at least beginning to acquaint you with how we approach investing here at Moerus. We will be sharing more detailed thoughts on various components of our investment philosophy and on how we view the world in the weeks, months, and years to come. For those interested in learning more, we invite you to visit our website at www.moeruscap.com and to visit the Moerus Capital Management page on LinkedIn.

Many thanks – your interest and curiosity are very much appreciated.

Sincerely,

Amit Wadhwaney, Portfolio Manager and Founding Partner

Michael Campagna, Research Analyst and Founding Partner

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