# Moerus Worldwide Value Fund

*Annual Shareholder Letter: Twelve Months Ended November 30, 2020*

Dear Fellow Investors:

We hope this Annual Shareholder Letter finds you and your families well during these challenging times. We are writing to update you on recent developments regarding the Moerus Worldwide Value Fund (the "Fund") over the twelve months ended November 30, 2020. In this Letter, we will discuss the COVID-19 pandemic and its impact on Fund performance, the Fund's positioning and outlook looking forward, notable investment activity as we sought to take advantage of new opportunities made available by market dislocations that took place in 2020, and a specific type of company that has periodically provided the Fund with interesting investment opportunities over the years.

We thank you very much for your support, and as always, we welcome any feedback that you might have.

**Fund Performance (as of November 30, 2020)***

| Fund/Index | 6-months | 1-year | Since Inception** Cumulative | Since Inception** Annualized |
|---|---|---|---|---|
| Moerus Worldwide Value Fund - Class N | 30.54% | -11.41% | 2.06% | 0.45% |
| Moerus Worldwide Value Fund - Institutional Class | 30.60% | -11.17% | 3.16% | 0.70% |
| MSCI AC World Index Net (USD) *** | 22.29% | 15.01% | 67.28% | 12.11% |

** Performance data quoted is historical and is net of fees and expenses.*
***Inception date is May 31, 2016.*
**** The MSCI AC World Index Net (USD) captures large and mid-cap representation across 23 Developed Market and 26 Emerging Market countries. With 2,990 constituents, the index covers approximately 85% of the global investable equity opportunity set. You cannot invest directly in an index.*

***Past performance does not guarantee future results. The Class N and Institutional Class returns are calculated using the traded NAV on November 30, 2020. The performance data quoted represents past performance and current returns may be lower or higher. Returns are shown net of fees and expenses and assume reinvestment of dividends and other income. The investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original cost. Please call 1 (844) MOERUS1 or visit www.moerusfunds.com for most recent month end performance.***

*Investment performance reflects expense limitations in effect. In the absence of such expense limitations, total return would be reduced. The Fund's adviser has contractually agreed to reduce its fees and/or absorb expenses of the Fund, until at least March, 31, 2022, to ensure that total annual fund operating expenses after fee waiver and/or reimbursement (exclusive of any taxes, brokerage fees and commissions, borrowing costs, acquired fund fees and expenses, fees and expenses associated with investments in other collective investment vehicles or derivative instruments, or extraordinary expenses such as litigation) will not exceed 1.65% and 1.40% for Class N and Institutional Class Shares, respectively.*

With regard to the table above, as always, please note that the Fund's performance data is noted simply for informational purposes for our fellow investors. The Fund seeks to invest with a long-term time horizon of five years or more, and it is not managed with any short-term performance objectives or benchmark considerations in mind. The investment objective of the Fund is long-term capital appreciation, and we manage the Fund with the goal of achieving attractive risk-adjusted performance over the long term. Our investment approach is predicated upon taking a long-term view and striving to take advantage of near-term uncertainty by investing in depressed and/or unpopular businesses and assets at attractive prices. Short-term market or index performance, therefore, is never a primary focus for us, except insofar as it may offer us longer-term investment opportunities.

**Fund Performance in 2020: A Tale of Two Halves**

With that said, purely for comparison purposes, we will highlight the noteworthy factors driving short-term performance during the period under review. The Fund's Institutional Class was down 11.2% during its 2020 *Fiscal Year* – the twelve months ended November 30, 2020. By comparison, the Fund's benchmark, the MSCI All-Country World Index Net ("MSCI ACWI (Net)") was up 15.0% during the same period. Needless to say, COVID-19 was the overwhelming story of the markets in 2020, and it is difficult to overstate the remarkably adverse impact the pandemic had on Value stocks *relative to Growth stocks*. For example, the MSCI ACWI *Growth* Index outperformed the MSCI ACWI *Value* Index by over 32 percentage points (!) during the period under review. As we have noted in past letters, Growth stocks have become increasingly meaningful drivers of benchmark index performance in recent years, and COVID-19 only exacerbated that long-running trend in the early part of 2020. Stopping as we must to look in the rearview mirror for the purposes of comparison, this environment clearly weighed on the Fund's short-term performance early in 2020. However, we believe this backdrop has sown the seeds for unusually exciting opportunities looking forward and over the long run (more later).

The Fund's performance for the year could be broken down into two dramatically different halves: during the First Half of its Fiscal 2020[1], the Fund declined sharply (-32% for each share class) as the COVID-19 outbreak and worldwide spread sent shockwaves throughout global markets; by comparison, the Fund's benchmark index (MSCI ACWI) declined by much less (-6.0%) during the First Half. The primary driver of this disparity was the benchmark's significant exposure to Technology and Growth stocks. Specifically, the nature of this particular crisis and its early results (social distancing, lockdowns, working from home) resulted in many "new economy" businesses (Amazon, Netflix, and Zoom are three obvious examples) holding up much better – even prospering – in the early months of 2020. On the other hand, businesses that depend more heavily on tangible assets or a physical presence to drive revenues (*e.g.*, restaurants, brick-and-mortar retail, real estate, etc.) suffered significant damage almost overnight as a result of pandemic-related lockdowns and restrictions. A large majority of Fund holdings declined – many significantly – during the First Half, as few areas of the portfolio (save for our uranium and gold holdings) were immune to the adverse early effects of the pandemic.

The most material detractors from the Fund's performance during the First Half fell into four general buckets: (i) holdings impacted by social distancing and mandated closures of stores and restaurants (most notably **Hammerson plc** and **Arcos Dorados Holdings, Inc.**); (ii) the Fund's Financial Services Holdings, which were punished along with the entire sector during the early months of the pandemic; (iii) the Fund's Latin American holdings, which were hurt by declines in both stock prices and local currency values (most notably in Brazil); and (iv) the Fund's Energy-related holdings, which were hit hard by a collapse in oil prices, the product of black swan-like adverse shocks to both demand (COVID-19 and resultant lockdowns), and supply (the Saudi-Russian price war).

[1] Please note that "First Half" refers to the Fund's 2020 Fiscal Year, or the six months ended May 31, 2020.

In our May 2020 Semi-Annual Shareholder Letter, we discussed the above factors and how they negatively impacted Fund performance in greater detail. We noted that, although it was undoubtedly a painful period for the Fund (looking backward), it was perhaps as important as ever, given the extreme short-term uncertainty that markets in general (and indeed the Fund itself) had been experiencing, to remain steadfastly focused on fundamentals and maintain a long-term perspective (looking forward). With that in mind, we shared our belief that the long-term outlook and prospects for the Fund remained quite attractive, and indeed became even more attractive still by mid-2020, given the increasingly discounted valuations that resulted from price declines amid the market panic early in the year.

Our optimistic outlook was based primarily on three factors: (i) the valuation of the Fund's portfolio, which we viewed as exceptionally modest, with a number of holdings at or near multi-year low prices; (ii) an emphasis on survivability (financial, competitive, etc.) – always a cornerstone of our investment approach – to withstand protracted periods of adversity and to survive to the day when short-term downside volatility hopefully turns into tomorrow's upside potential; and (iii) actual *business*-level fundamentals (as distinct from *stock price* volatility), which in many cases remained encouraging despite the broader market chaos at the time. We detailed recent business-level developments across a number of the Fund's holdings that we viewed as favorable, as well as the longer-term attractiveness of their respective investment cases – all of which, in our view, were belied by the short-term stock price volatility experienced.

Since then, the Fund's recovery from March lows, which began with some baby steps in April and May, continued in earnest during the Second Half of its Fiscal 2020[2]. Over the six-month period ended November 30, 2020, the Fund's Institutional Class was up 30.6%, outperforming the benchmark index (MSCI ACWI), which was up 22.3%. The recovery in markets was fueled by unprecedented levels of fiscal and monetary stimulus pledged by various governments across the globe, as well as (most recently) the arrival of vaccines – clearly a very positive development in the global effort to eventually return to a semblance of normalcy. The large majority of Fund holdings performed strongly during the latter half of the year, with many of the most significant positive contributions to performance coming from areas of the portfolio that had been hit disproportionately hard earlier in the year (notably our Financial Services, Energy, and Latin American holdings).

**Remaining Focused on the Fundamentals**

The Fund's performance in the Second Half, reflecting a partial recovery from the decline earlier in the year, was a welcome step in the right direction. However, as long-term investors, we remain much more focused on fundamental developments affecting the businesses that the Fund owns rather than on stock price fluctuations from one quarter or six-month period to the next. On that note, as the year went on, business-level developments continued to be encouraging, in our view, across much of the portfolio, including among the aforementioned four buckets that had detracted from performance by so much during the First Half of the year. For the sake of brevity, we will talk about examples from just two of the four buckets below.

[2] Please note that "Second Half" refers to the Fund's 2020 Fiscal Year, or the six months ended November 30, 2020.

*Holdings Impacted by Social Distancing*

Returning to the Fund's two holdings that were most adversely impacted by social distancing measures in response to COVID-19, we'll begin with **Arcos Dorados Holdings, Inc.**, the largest McDonald's franchisee in the world and the exclusive McDonald's franchisee throughout much of Latin America and the Caribbean. Hit hard by temporary prohibitions on in-restaurant dining in March and April as a result of the pandemic, Arcos Dorados continued its recovery throughout 2020, as its restaurants reopen and restrictions are gradually lifted. As of November, the percentage of its restaurants operating at least one channel (Front Counter, Delivery, or Drive-Through) rose to 99% of restaurants, with roughly 70% of locations operating all channels, including in-restaurant dining. The business returned to being EBITDA-positive on a consolidated basis by July – in our view, a remarkable achievement given the havoc that COVID-19 lockdowns have wreaked on the restaurant industry worldwide – and Arcos Dorados recently issued debt (not maturing until 2027) at the lowest interest cost in its history, an accomplishment that we believe is a testament to the company's financial wherewithal.

Longer-term, we believe Arcos Dorados remains well-positioned to continue its impressive market share growth in Latin America's highly fragmented (but growing) Quick Serve Restaurant ("QSR") industry. Indeed, these market share gains seem to have accelerated in 2020, driven by the company's unmatched free-standing restaurant footprint (a key competitive advantage in servicing Drive-Through and Delivery orders), as well as its scale, financial position, brand, and formal food safety protocols – a key pandemic-era differentiator in a Latin American QSR market that is heavily informal, populated by street stalls and mom and pop competitors. These significant advantages notwithstanding, Arcos Dorados shares continue to trade at a wide discount to regional and global peers, despite what we believe to be superior long-term growth opportunities.

United Kingdom-based Retail REIT **Hammerson plc's** share price declines in 2020 have been driven by the adverse impact of pandemic-related lockdowns on the company's high-end shopping malls, outlet malls, and strip malls in the U.K. and Continental Europe. Responding to the crisis, in August, the company announced a long-anticipated rights issue, as well as the sale of one of its outlet businesses, both of which have now been completed, raising £825 million in aggregate, which has substantially strengthened a balance sheet that had been weakened by the COVID-19 crisis. Although the business has been hit very hard for obvious reasons, we believe that the rights issue fortifies the company's financial position in the immediate term, allowing the business to benefit as conditions gradually begin to moderate and return to a degree of normalcy. Hammerson has no material debt maturities ahead of 2022, and its shares currently trade at almost a 75% discount to the company's EPRA NAV (adjusted for the rights issue) and a roughly 50% discount to our more-conservatively assessed NAV ("Net Asset Value"). Given this excessively discounted valuation, in our view, and the fortified financial position that would result from said transactions, we elected to participate in the rights issue during the Second Half. In addition, the company also hired both a new Chairman and a new CEO, completing a management transition that we feel will be a significant positive for the company.

*<u>Financial Services Holdings</u>*

The most material detractor by sector from the Fund's performance during the First Half was our allocation to Financial Services holdings, which declined along with the entire sector amid adverse economic impacts from the pandemic and resultant ultra-low interest rates. An additional driver of share price declines across the sector was the postponement of capital distributions to shareholders via dividends and share buybacks, due in large part to regulatory pressure on the sector to retain capital given virus-related uncertainty. As we noted in our Semi-Annual Letter, this sector-wide, blanket regulatory (*de facto*) ban was not based at all on the financial positions of individual companies and applied to many of the Fund's Financials holdings – all of which, in our view, are extremely well capitalized. It was our view that the Fund's holdings possess more than enough wherewithal to resume distributions and that it was more a question of *when* government regulatory bodies would begin to loosen their stance on temporarily restricting distributions, rather than a question of *if* the distributions would eventually return.

Indeed, we began to see progress on that front in the Second Half of 2020. First, in July, the Dutch central bank dropped its call for insurers to suspend dividends. Dutch insurer (and Fund holding) **NN Group** responded in August by announcing that it would pay its final dividend of 2019 (which had been delayed due to the pandemic) of €1.40 per share and its interim 2020 dividend of €0.86 per share (both of which were paid in September). The total payout of €2.26 per share amounted to nearly 7% of NN Group's share price at the time, highlighting what we view as the company's well-capitalized position and ample capacity for future capital distributions (through dividends and share repurchases) – attributes which belie the stock's discounted valuation (at roughly 33% of book value).

More recently, the Bank of England announced that it will ease what had been a *de facto* ban of bank dividends since March in response to the pandemic. This move is a potentially positive development for our holding in **Standard Chartered**, a London and Hong Kong-listed international banking group operating principally in Asia, Africa, and the Middle East. As we highlighted in the Semi-Annual Letter, Standard Chartered's management team was successful in cleaning up and de-risking the business that had gone astray under previous management. In light of the continued internal generation of capital from the business, the bank had been returning excess capital to shareholders and had planned (pre-pandemic) to continue to do so following the sale of its Indonesian bank holding. We believe the bank possesses a very strong capital position, with which it can weather the current adversity, emerge at the other end of the downturn, and, given the Bank of England's recent announcement, resume capital return activities, which should positively impact the share price, all else equal. Given these attributes, we believe its shares remain significantly undervalued, at roughly 45% of book value.

If and as these regulatory bottlenecks to excess capital distributions continue to be eliminated, we believe there is meaningful upside potential, given the significantly discounted valuations of our well-capitalized Financial Services holdings. In all, the Fund's Financials holdings, which had been the most significant *negative* contributor to performance during the First Half of 2020, were the most material *positive* contributor to performance during the Second Half.

## Fund Outlook Looking Forward

You may recall that we had entered 2020 optimistic about the positive business-level developments across many Fund holdings. Although COVID-19 interrupted the progress that our holdings had been making, the Second Half of 2020 saw the Fund's portfolio take meaningful steps forward. Today, we observe a broader market environment in which, we'd argue, the stock prices of many of the popular, household names have run well ahead of underlying fundamentals, and indeed well ahead of any reasonably sober expectations for the future. On the other hand, we believe the Fund's portfolio – which consists of investments in some of the most disliked, discounted areas in recent years (Financials, Natural Resources, Emerging Markets) – remains remarkably undervalued relative to its longer-term fundamentals, with *stock price* performance lagging far behind underlying *business* performance. For one statistical indicator of the extent of the disparity in valuations between the Fund and the broader market, as of November 30, 2020 the Price-to-Book Value ratio (P/B) of the Fund was 0.69x, as compared to 2.64x for the benchmark MSCI ACWI[3].

In the long run, we continue to believe that the unusually attractive valuations, sound long-term fundamentals, and staying power of many Fund holdings offer attractive margins of safety and bode well for the portfolio's prospective risk-adjusted returns – particularly in a world in which broader benchmark indices trade at historically rich valuations and are increasingly concentrated in a relatively small number of popular mega-cap companies. In our view, this extremely bifurcated market, which we have commented on often in previous letters, is providing us with some very attractive investment opportunities, sowing the seeds for potentially quite interesting prospective longer-term returns.

## Investment Activity in the Fund

With that in mind, the Fund's Fiscal 2020 was a busy period, as we strove to make the most of market dislocations resulting from COVID-19, taking advantage of short-term volatility and attractive pricing to add to several existing positions in the Fund, in addition to initiating six new positions in the portfolio. Three of the new positions – **Despegar.com**, **Edelweiss Financial Services** and **Exor NV** – were purchased during the First Half, and their investment cases were discussed in detail in our May 2020 Semi-Annual Shareholder Letter. Three additional new positions – **Bajaj Holdings & Investment Ltd.**, **Dundee Corp.** and **Metro Bank plc** – were purchased during the Second Half of 2020, and we will highlight the investment case for each below.

*<u>Bajaj Holdings & Investment Ltd.</u>*

During the Second Half, the Fund initiated a position in **Bajaj Holdings & Investment Ltd.** ("Holdings" or "the company"). The company is an Indian-listed Holding Company with assets falling into three primary areas: Auto Manufacturing, Financial Services, and other Investments. In Auto Manufacturing, Holdings is the dominant shareholder in Bajaj Auto Ltd. ("Auto") through its roughly 33% direct ownership stake. Auto is a leading manufacturer of two-wheeler and three-wheeler vehicles in India, as well as a large exporter of the vehicles globally. The Financial Services activities of the company are held through Bajaj Finserv Ltd. ("Finserv"), in which Holdings owns a roughly 39% direct ownership stake. Finserv is in turn the controlling

[3] Source: Bloomberg for Fund data, MSCI for Index data.

shareholder of Bajaj Finance Ltd. ("Finance") via its roughly 53% direct holding. Finance is a leading deposit-taking Non-Banking Finance Company in India focused on the provision of a broad range of financial services to consumers (urban and rural) and SMEs, including commercial and mortgage lending. Finserv, in addition, is also the operating partner and dominant owner of two insurance-related joint-ventures with Allianz SE, providing Life Insurance through one and Property & Casualty Insurance through the other. In addition to the ownership of these operating businesses, Holdings also has a portfolio of financial investments.

In our view, the company's Financial Services and Auto Manufacturing businesses are well-run, well-respected businesses that are each a leader in their respective fields, and they have both achieved impressive rates of growth over time. Today, the Auto Manufacturing business has built up a 19% market share domestically in two-wheelers and a 59% share of the export of all two- and three-wheelers out of India. Holdings' businesses have benefitted significantly from an emerging middle class in India, which was impacted this year by the COVID lockdowns but which will likely continue to be a source of growth. Since its founding, Finance has done an impressive job of building its business, having grown its lending portfolio at a Compound Annual Growth Rate (CAGR) of 45% over the past 12 years to become a leading consumer lender in India today, with a nationwide footprint and more than 44 million customers.

By virtue of the fact that these companies operate in India – and more so because the sectors they operate in (Auto Manufacturing, Financial Services, and Insurance) should benefit disproportionately from the continued growth in the Indian middle class over the long term – the companies have historically not been attractive to us from a valuation perspective. However, following the sell-off that took place as the spread of COVID-19 became more evident and the resultant lockdown in India, Holdings, Auto, and Finserv all saw significant declines in their stock prices, resulting in Holdings trading at one of the largest discounts to the market value of its stakes in the underlying listed assets that we have seen in nearly a decade, with the underlying holdings themselves also trading at more modest valuations.

To be sure, the businesses have seen, and will continue to see, a significant impact from the lockdown. Finance took a hit to its loan book and took contingency provisions in relation to expected loan quality impacts, cash flows were impacted by moratoriums on collecting interest forced by the government (which have since ended), and the investment portfolios of the Insurance businesses had seen a significant decline in value. Auto has been negatively impacted as people curtailed spending for several months during the lockdown and likely will continue to be hesitant to spend on large ticket items in the near future – though it may benefit from a newfound aversion to public transit.

However, all of Holdings' underlying businesses are well capitalized and have significant liquidity to deal with these challenges. At both Holdings and Auto, the companies operate with no net debt and significant liquidity in the form of cash or liquid investments. Finance employs debt as is normal for a financing company, but its levels of debt are well below competitors and global norms – the company operated with a Capital Adequacy Ratio of 26.6% as of September 30, 2020.

As we have noted in the past, opportunities to invest in India with a value approach can be extremely attractive, but present themselves infrequently and are often associated with some sort of external shock that is providing a challenge to the near- and medium-term. In the case of

Holdings, because of the current challenges facing the business and the country, the Fund has been able to acquire shares of what we believe to be a well-run group of businesses with strong growth characteristics at a very attractive price.

*Dundee Corporation*

Dundee Corporation ("Dundee") is an investment holding company in the midst of a narrowing of its focus. Recently, one of the elements of this transition has entailed the monetization of a part of one of its principal holdings (Dundee Precious Metals), following exits from other areas including investment banking/capital markets, real estate operations, *et al*. While the pandemic has slowed down the process of realizing these investments, one would expect further asset sales to take place as opportunities present themselves. Nonetheless, the asset sales completed to date have resulted in a cashed-up balance sheet which will allow management to pursue other potentially more promising investment opportunities. Furthermore, the pandemic has muddied the operating results of the entities currently held by the company, resulting in the shares currently trading at unusually depressed valuations. Accordingly, management is currently in the midst of an attempt to repurchase roughly 10% of the common shares outstanding.

*Metro Bank plc*

Metro Bank plc ("Metro") is a London-listed bank that opened its doors in 2010 as one of the recipients of new banking licenses awarded to increase competition in the U.K. banking market. The bank has grown its deposit base rapidly by providing banking services at its branches during normal *retail* business hours (seven days a week) rather than the more limited conventional "bankers' hours". This customer-centric orientation has paid off in the form of rapid deposit growth and high levels of customer satisfaction. Despite this success in growing its deposit base as a relatively young bank, Metro has been dogged by anemic profitability as it continues to foot the cost of expanding its branch network while having a limited offering of higher-margin products. The recent expansion by Metro into unsecured lending through the purchase of RateSetter (an online provider of unsecured financing) is a first step in attempting to leverage the strength of its customer relationships to address this. As additional products broaden customer engagement with Metro and the branch build-out ends, one can envision a gradual path to profitability for the bank. Metro's current lack of profitability allowed the Fund to purchase Metro shares at a fraction (around 0.25-0.35x) of tangible book value, which we believe represents a very attractive entry price for a bank with a stable financial position and attractive growth prospects.

*Other Notable Buying Activity*

In addition to the three new purchases above, during the Second Half of 2020, we also repurchased a holding that we had previously sold from the Fund: **Copa Holdings S.A.** ("Copa"). Based in Panama, Copa is a leading Latin American provider of airline passenger and cargo service from its Panama City hub. In our opinion, Copa has long stood out as one of the most efficiently, profitably, and prudently run Latin American airlines – no small feat, given the industry's relative proneness to macroeconomic and currency-related shocks. Even before COVID-19, in recent years, Copa had been confronted by a very challenging macroeconomic backdrop in Latin America, but the company performed admirably in the face of adversity. In our view, this is a testament to high-quality management, in addition to a well-located hub at

Tocumen International Airport in Panama City that allows for convenient connections to destinations in the Caribbean and Americas that do not generate enough demand to justify direct service (allowing for leadership of numerous thin, underserved markets). Although the pandemic has obviously been extremely difficult on airlines, we believe a well-run survivor such as Copa should be able to operate relatively profitably under normal conditions. Due to the pandemic, Copa's two closest competitors (Avianca and LATAM Airlines Group) entered bankruptcy in 2020, highlighting a competitive field littered with numerous gravely wounded players, which should leave Copa well-positioned to benefit when the current crisis conditions moderate. Despite its recent challenges, we believe that Latin America continues to offer meaningful potential for above-average long-term growth when we get past this crisis, and we were able to invest in this high-quality company at what we believe is an attractive price.

Among the additions we made to existing positions, the most notable was the Fund's holding in **Hammerson** by virtue of our participation in the company's rights issue. As discussed earlier, we believe that although the pandemic has resulted in an unusually hostile operating environment for the business, this adversity is more than reflected in the current valuation of the shares, which in our view are excessively discounted. Further, the rights issue has significantly bolstered the company's financial position, which should serve Hammerson well as it navigates its way through the currently turbulent period.

*Selling Activity*

Moving on to activity on the sell side, as discussed in recent Shareholder Letters, in our opinion, the investment cases supporting many of the Fund's core positions (in particular, with regard to valuation) have grown increasingly compelling following the dislocations experienced in 2020. Given that view, in Fiscal 2020, we eliminated eight positions: **Atlas Mara**, **Bolsa de Valores de Colombia**, **Franklin Resources**, **GP Investments Ltd.**, **Gran Tierra Energy**, **Hellenic Exchanges**, **Lundin Gold**, and **Royal Gold**. Almost all of the holdings sold entered 2020 among the smaller positions held in the Fund, and, in general, were sold primarily as part of our continued effort over the past couple of years to more narrowly focus the portfolio on our highest conviction ideas, such as the six new holdings and the several existing core positions that we added to this year. The two notable exceptions to this were our early-2020 sales of **Franklin Resources** and **Gran Tierra Energy** – both of which, in our view, saw their margin of safety diminished by developments in the early days of the pandemic (these sales are discussed in greater detail in the May 2020 Semi-Annual Letter).

**A Cheat Sheet on Holding Companies for Value Investors**

Three of the six new investments made in the Fund in 2020 can be categorized as Holding Companies: **Exor NV**, **Bajaj Holdings & Investment Ltd.**, and **Dundee Corp**. In addition to these new investments, four existing Fund investments could likewise be characterized as Holding Companies: **Aker ASA**, **Jefferies Financial Group**, **The Straits Trading Co. Ltd.**, and **The Westaim Corp**. It is not particularly unusual to see so many Holding Companies in the Fund's portfolio, as this class of company has provided us with numerous investment opportunities over the years. Given their preponderance in the portfolio, we thought it might be helpful to discuss what a Holding Company is, why they sometimes provide attractive investment opportunities, and which attributes we look for (or seek to avoid) that separate the truly compelling opportunities from the larger group.

Investing is a crowded field filled with many intelligent, industrious bargain hunters who often compete away most exceptional opportunities available in plain sight. Holding Companies ("HoldCos"), however, tend to fall under the radar of those who focus their efforts exclusively on "pure plays" or on quantitative screens of accounting-derived statistics (*e.g.*, earnings or book values). In part because they are overlooked by many, HoldCos can sometimes provide fertile grounds for discerning value investors in search of attractive opportunities. In the following discussion, we will outline our approach to investing in HoldCos.

For the purposes of this discussion, a HoldCo is a company that has partial or complete ownership of multiple entities (assets or businesses) that are either public (listed), private (unlisted), or both. "HoldCos" refer to neither an industrial sector nor a type of business, *per se*, but rather the term refers to an ownership structure of one or more businesses, which could include disparate and usually separable entities. Berkshire Hathaway is perhaps the most well-known example of a HoldCo, but many others exist, operating in relative obscurity. Among the attractions of the HoldCo structure are its usually disparate and separable components that lend themselves to opportunities to build and crystallize value, which we explore in the following.

The first order analysis followed by most investors in HoldCos entails a simple arithmetic exercise – adding up the value of the HoldCo's component assets and netting out its liabilities to arrive at an aggregate net asset value that, when divided by the shares outstanding, yields a NAV per share. The NAV is then compared with the stock price to judge whether the stock is trading at a premium or a discount to its NAV, and if the latter, whether the discount is attractive enough to warrant purchase.

Although not mathematically incorrect, we believe that such an analysis is insufficient to arrive at a considered investment judgment, and that relying upon a premium/discount calculation alone could be quite misleading and lead to the wrong conclusions. Consider a hypothetical situation with two HoldCos, one valued at a discount of 20%, and another at a discount of 35% of their respective NAVs. Clearly, if measured by discount alone, the latter would ostensibly appear to be a more attractive investment candidate. However, this overly simplistic line of reasoning ignores a variety of important factors, including the nature and valuation of the underlying businesses, the potential for growth, and the likelihood of realizing these estimated values – items we explore below.

Although it falls far short of telling the whole story, what the HoldCo discount <u>does</u> tell you is *what you are paying for what you are getting*. That is, in the case of a 35% HoldCo discount, you could buy $1.00 worth of assets for $0.65. Alternatively, the ratio of assets (what you get) to equity (what you pay) indicates "leverage" of 1.54x (or 1.00/0.65). One can think of this as being akin to owning the underlying securities on margin through shares in the HoldCo – because you would be buying $1.00 of assets while paying only $0.65 "out of pocket" – but without any interest charges or the possibility of a margin call. Curiously enough, when the underlying holdings are out of favor (and by implication more cheaply valued), it is possible that the HoldCo discount to the depressed values of the underlying holdings might also widen, increasing the operating "leverage." Conversely, improving valuations of the underlying holdings (when they come back into favor) are often associated with a reduction in the discount at which the HoldCo trades, adding to the potential upside in the HoldCo's share price.

However, an arithmetic calculation of the HoldCo discount alone *does not* tell you anything about the standalone valuation or the attractiveness (or lack thereof) of the HoldCo's *underlying holdings*. Accordingly, a careful analysis of a HoldCo entails *at least two layers* of analytical understanding – first, that of the underlying companies/entities, and second, that of the entity that "holds" them (the HoldCo) – with the analytical insight afforded by this work being reflected in the ultimate investment decision.

There are a number of elements to this exercise, including the following:

- First, understanding the investment attraction of the underlying holdings: Are these businesses one might wish to invest in, preferably for the long run?

- Second, cheapness: Are the underlying holdings valued attractively (*i.e.*, are they individually cheap on a standalone basis)? Is the HoldCo trading at enough of a discount to a conservatively estimated NAV to constitute an attractive investment? The idea behind buying shares in a HoldCo is to buy attractively valued underlying holdings at a *further* discount via the HoldCo, with a view of benefiting from the appreciation of the underlying holdings *along with* a shrinkage in the HoldCo discount.

- Third, financial strength: Are the underlying holdings financially and operationally strong enough to cope with periods of adversity without requiring access to external financing sources (be they capital markets, banks, or reliance on the HoldCo)? In addition, a relatively under-levered balance sheet and low operating costs at the HoldCo level are *sine qua non* for investing in a HoldCo. In our view, those attributes are a must, given that the bulk of cash generation usually takes place not at the level of the HoldCo, but rather at the level of its underlying holdings; typically, dividends received from its underlying holdings are what allow a HoldCo to meet its own expenses, both operating and financial. During periods of adversity, these dividends may be curtailed or eliminated, potentially putting at risk the HoldCo's ability to meet its expenses, hence it is important that the HoldCo be under or preferably unleveraged and parsimoniously run. Excessive costs, either compensation-driven or otherwise, could erode shareholder value over time, even absent adverse events.

- Fourth, the quality of the dominant or controlling shareholder's stewardship: Are they creating value for HoldCo shareholders or destroying it? Given that the control of many HoldCos is vested in a family or a group of related parties, usually for historic reasons, it is of paramount importance to gauge the quality of the controlling shareholder's stewardship of the holding company and the entities it controls. At one end of the spectrum, a HoldCo might have a very engaged owner who has built and realized value over the years through opportunistic purchases and sales of businesses, or alternatively has invested in and grown companies owned by the HoldCo organically. This would be the preferred controlling shareholder we would seek to partner with. Less desirable are controlling shareholders who do little other than collect dividends and whose presence in the company only represents another operating expense. Quotidian expenses aside, the greater damage from such ownership is the cost of foregone opportunities in this mode of "do-little/nothing" ownership. Even less benign are control parties who engage in self-serving, related-party transactions between the HoldCo and other outside entities in which the control party also has interests, to the detriment of minority shareholders in the HoldCo. We endeavor to identify and invest with the first type of shareholder and strive mightily to avoid the latter two.

Successful value investing sometimes requires going off the beaten path and looking under rocks for opportunities that few choose to stop and consider. For many investors, HoldCos – which by their nature have disparate holdings and a tendency for latent value to sometimes be obscured by accounting convention – do not lend themselves well to analyses that are heavily focused on screens and easily modelled forecasts of future earnings.

However, for us at Moerus, HoldCos represent an attractive area to search for bargains. For one, a HoldCo structure lends itself well to our asset-based analysis: an investment approach focused on the assets/businesses, notably on the valuation side of the individual constituent businesses, along with the Holding Company itself. Also, within the right HoldCo structure, with multiple businesses/assets owned in the hands of a skilled owner, *multiple, disparate opportunities* for both value creation, as well as value realization, are apt to present themselves over time.

**A Parting Note**

In closing, we'd like to reiterate some points that we made in our previous letter. Looking forward, it is important to note that the *stock prices* of the Fund's holdings seem likely to continue to be volatile in the coming months in both directions as markets react to news flow on virus cases, government actions in response, and the success and timing of the vaccine roll-out effort in real-time, likely without much regard to valuation and underlying, longer-term business strength and fundamentals. While this makes for unpredictability in terms of short-term share price fluctuations, the positive effect of this is that such an environment seems likely to continue to periodically offer us opportunities to invest at very modest prices in businesses that have many of the attractive characteristics discussed herein. We believe this will serve the Fund's portfolio well over the longer-term.

As always, many thanks for your continued support, interest, and curiosity. We look forward to writing you again later in the year. Best wishes for a healthy, happy, safe, and prosperous 2021.

Sincerely,

**Amit Wadhwaney**

Portfolio Manager

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