azValor
asset management

azValor Asset Management SGIIC SAU. CIF. A 85347557 – Paseo de la Castellana 110. Tercera planta. 28046 Madrid. info@azValor.com. Depositario: BNP PARIBAS Securities Services, sucursal en España.

February 5th, 2016

Dear Investor,

The reason for writing a letter to our investors is to summarize our investment performance. In our ideal world, this letter would be written every five years, as this is our minimum investment horizon. However we believe that our co-investors should have all the necessary information to assess the job we do. The purpose of this letter is not trumpet our achievements nor hide our weaknesses, but rather to give you the information we would like to receive if our roles were reversed.

As of January 25th azValor Iberia is down 9.2%YTD (IGBM-10.3%) and down 10.2% (IGBM-15.3%) since its launch on November 13th 2015. azValor International is down 10.4% YTD (MSCI-8.5%) and down 14% (MSCI-8.1%) since launch.

OUR PHILOSOPHY

While azValor is a new fund, Fernando and I are not new to asset management: in 2016, we will have been in the business for 20 years. Therefore, we feel it is worth giving you some insights into the philosophy that has guided us over this time:

- While we like good businesses (high ROCE) and seek brilliant and aligned management teams, our paramount aim is to buy companies that we believe are undervalued. In simple terms, we seek 'cheap' companies.
- To buy "cheap" you often have to act in a way that appears to contradict the market or alternatively, you have to look beyond the investment horizon of the average investor.
- This approach is not straightforward, and those who attempt it - in some asset management companies at least - threaten to jeopardize their careers because all too often their incentives schemes are very short term. The problem with 'short termism' is that it is very easy to get it wrong and difficult to get it right. Of course, those who do not attempt to beat an index but simply replicate one, are in no "danger".
- The reason why we can try to do better than index replication is because our co-investors enable us to do so as they have the patience to look longer term than the rest.
- Yet despite all this advantages, we have made mistakes. In fact, approximately one in every ten investments has not performed in the way we would have expected. Some two thirds of these errors were due to a debt overload while the rest were either concentrated in the retail sector or due to disruptive technologies.
- We do not include in our list of errors, 'errors of omission', by which we mean not investing in something that proves (after the fact) to be a good

investment. Of course, he who doesn't invest can't lose, but we still feel bad about many misses best illustrated by Inditex - a great company which was on our doorstep.

- We have many more errors of this type…and there will be more.
- **The key therefore, is to find businesses in which we have a clear understanding of why their stock is cheap while trying to learn from past mistakes. This requires us to put all our focus on company research.** It also means renouncing to have an "opinion du jour" on everything, in exchange of having the best one in a few things. This sounds boring but we believe it is far more effective.

This philosophy has served us well over the past 20 years despite:

- Having lost money in 1999 when everybody was making money by investing in "dotcoms"
- Having missed the real estate/banking boom in Spain between 2004 and 2008
- Having seen our NAV fall by 60% between July 2007 and March 2009.

During these 3 periods a common (and legitimate) question crossed most of our investor's minds: "are they WRONG this time?" **We believe that being able to withstand these hard times is the essence of value investing**.

If you watch the newly released Hollywood film "The big short", you will begin to understand how the manager (Michael Burry) feels when markets go against him. What the film does not show so explicitly (it does in a way too) is that some investors get excited in these same "tough" market moments at the "smell" of the profit opportunity. This is also currently reflected at azValor's offices, where many of our analysts are seen from Monday to Sunday (Thanks to all of you!) …sharks smelling blood?

IBERIAN PORTFOLIO

In all, 26 companies make up our Iberian Portfolio including:

Acerinox (8.1%): One of the most efficient stainless steel producers in the world, with a strong balance sheet. 75% of nickel producers are losing money and base prices are close to minimum. We believe it is worth 70% more than what we paid for the shares.

Arcelor-Mittal (7.9%): this business is a world leader in steel which we purchased after an 87% drop in value. All Chinese producers are losing money; we believe this unsustainable situation will result in capacity closures. If they take too long, a capital increase might be necessary. Although this is not our baseline scenario, it is a risk that we are willing to take.

Galp (7.6%): Galp's assets in Brazil have continued to positively surprise us over the last four years. However during this period the shares have dropped by 40%. We believe it is worth 60% more than its current value.

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Semapa (7.4%): Semapa is the mother company of Portucel - one of the most efficient integrated paper producers in Europe. Mark-to-market of Portucel's stake yields a 40% upside, and we believe Portucel is undervalued now.

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INTERNATIONAL PORTFOLIO

Turning to our International portfolio we have 43 companies which we can divide into three groups:

- 37% of direct commodity exposure; those with indirect exposure; and those invested in good businesses which are not particularly cheap.

Antofagasta (6.5%). Purchased after a 72% fall from the peak 5 years ago. It is one of the world's most efficient copper producers, has a strong balance sheet and is led by a family which has proven a careful capital allocator, – which is rare in this sector.

Range Resources (4.6%): Purchased after a 73% fall over the last 18 months. With a good balance sheet, it is one of the most efficient gas producers in the USA in a market where all players lose money at the operational level (AISC). Although there may be enough production for another couple of years, there is no investment incentive until at least double of today's gas price.

ALS (4%): Purchased after a 70% fall since May 2012. It is the world leader in inspection and certification for the mining industry. With a strong balance sheet, it is an undervalued play on the depressed mining market with a much better (28%) ROCE than pure mining firms.

Rio Tinto (4%): We bought after a 60% fall since its 2011 peak. It is the world's most efficient producer of iron ore. Discounting spot prices yields a 10% downside risk. Using our normalized ones gives us 2-3x the current price. As matters stand, 25% of world production loses money at current prices.

In each of the above examples there is a lot of pessimism due to doubts about China's future consumption. We share these doubts in some cases (steel) but we believe the analysis is far more complex and should include:

- A comprehensive analysis of the costs for each company.
- A calculation of the probability of capacity closures among those who are losing money.
- An estimate of the IRR the future capacity would access at current prices.
- An estimate of future supply and demand in view of the above.

Taking these points into account, one can be negative about Chinese steel consumption, but positive about Arcelor!

I would recommend a book I read some time ago by R. Napier ("Anatomy of a Bear"). It explains a sign of bottom in a bear market is when the first good news after years of depression have hardly any positive impact on share prices. It strikes us that the announced closures of Votorantim (nickel), Glencore (copper

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and zinc), Alcoa (aluminium) etc. have had no impact on share prices. The fact is commodities' companies have been falling in value for the past 5 years with the best ones having fallen 70% since 2011. We do not have a clue whether we have reached the bottom or not. But we like the expected IRR at current prices.

- **The second part of portfolio – some 7% has indirect exposure to commodities.** These are high ROCE/ net-cash businesses, indirectly affected by the lethargy in commodities.
- **45% of the portfolio is invested in better businesses, although not as cheap as the former two groups. The following examples stand out:**

BMW (4.6%): We still believe it is the best managed company in the sector. Through the preference share, we paid 4x 2015 profits. If profits fell by 30% the multiple would only increase to 6x given its huge net cash pile. We value it 90% above the current price.

Dassault Aviation (4.4%): we paid 5x PE for an 80% ROCE business which we have known for 13 years, and whose management we highly admire. We value it 50% higher.

Danieli (3%): After falling by 50% in 24 months, the price we paid valued this world leading company in steel plants engineering at zero. Yet it has generated an average FCF of EUR 150m/year since 2005. We believe it is worth 80% more.

The economy and the future of markets

Much as the financial press tries to connect facts and explanations our position is:

1. The economy is the sum of very complex interconnections that are impossible to predict. We are sceptical of the official narratives and correlations without a proven causality.
2. We are particularly sceptical of the torrent of opportunistic opinions expressed following breaking news and we are bewildered by the conviction in which these views are expressed.
3. No one has systematically been right when it comes to economic predictions. Imagine someone does, he would still have to guess how and when the market will discount it.

A significantly different way of trying to make sense of what is happening, and to try to understand the causes that have led to current market conditions, is to turn for enlightenment to the Austrian School of Economics. It reveals the following:

- **It appears to us that most central bankers are Keynesians. As such, they seek to promote 'Aggregate Demand' and fear deflation caused by excess capacity. As these parameters are debatable, we are particularly concerned about their application.** On a desert island, two people have infinite 'aggregate demand' but they always understand that they won't

be able to start trading (nor eat!) until they start hunting or fishing. If this example of Austrian school thinking is too simple for you, we can easily complicate it: print money, the USD drops, oil price rises and the interest rate is set at zero. Result: a siren call to entrepreneurs flocking to invest in shale gas in the USA + a million jobs created. Bingo! Now fast forward: QE is withdrawn, the USD goes up, oil prices drop, and all firms bleed at the EBIT level. Interest rates rise (energy high yield exceeds 15%) and the next stop is chapter 11.

We try to understand the a-priori risks created by central bankers so we avoid succumbing to these siren calls. Specifically, we feel more comfortable investing in equities that have dropped significantly since the second round of QE.

- **We believe debt and deflation do not get along.** It is our view that politicians will make every effort (now called "stimulus") to keep the free market from naturally clearing past excesses (mirrored in historic high debt levels in developed countries). Although these efforts in Japan have yet to work (=get inflation) take for example this pearl of political wisdom:

  "There are no limits to our action to bring inflation up to its target."
  Mario Draghi, on the front page of the Financial Times of 22nd January 2016.

  At least we cannot say that the politicians haven't warned us (future possible list of actions: Public works policies?, Negative interest rates?, Additional QE?, Basic citizen income?

- Historically (and in particular since Keynes "rules") the easiest solution is inflation/currency devaluation. When it occurs, fixed-income securities, (currently at an all-time high) become worthless scraps of paper. If inflation finally comes in, we believe our portfolio will protect our purchasing power. If it doesn't, we think our stocks will fall less than the average because their prices already discount very pessimistic scenarios.

We would like to thank you for your trust and your support at all times. The commercial team, led by Beltrán Parages, will be pleased to answer any questions you may have.

I wish you a Happy New Year 2016.

Álvaro Guzmán de Lázaro Mateos

Chief Investment Officer

PS: We have included as an appendix to this letter an attempt to explain in simple terms the "Austrian template" we use to follow (not to predict!) the economy, should it be of any interest to you.

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Appendix 1:

Our Austrian economic template

1. How do crises arise?

Credit growth above the growth in savings produces an economic boom which in turn creates the perception among entrepreneurs of an abundance of opportunities. So they invest and after some time they realize their mistake: there are not enough savings in the economy to both buy the units/pay the prices they expected to get. They have made an investment mistake! (also called "Malinvestment")

2. How are they "fixed"?

They are fixed by liquidating these misdirected investments and letting factors (workers, land, capital) flow where they are "re is demand for them. To do so requires:

1. Closures of insolvent companies (To this end, layoffs must be readily achieved).

2. Fewer regulatory barriers in the creation of new companies, fewer taxes, a respect for private property and legal certainty (all this in order to attract investments).

3. Why aren't they fixed/do they take a long time to be fixed?

When the mantra of political leaders from all over the world is to avoid the necessary short-term pain of, say, unemployment they tend to block the main doorway to the solution. In an environment of high debts, the effect is that crises last longer, recoveries are less solid…. and nobody can explain why!

4. How does this "template" help us?

Unfortunately, this template offers next to nothing when it comes to predicting what may happen. However, we find it useful to orient ourselves with regard to the consequences of political decisions that are being adopted. Below are some examples of such decisions: (the list is not exhaustive):

In **Spain**, if the new government fosters legal certainty and factors mobility, controls public spending and reduces taxes, capital will be attracted and the economy will grow. If it doesn't, we will grow less and some businesses could suffer more than others (namely the banking sector). As long as we continue in the Euro, there is less margin than is thought for very harmful measures (take the Greek example and the promises of Tsipras and his subsequent acts). If we leave the Euro, unless it is with very wise leaders, there will be devaluations and expansive public speeding - both very negative.

In the **USA**, we will monitor if the Fed is able to withstand its plan of raising interest rates if markets were to fall further or if growth would slow down. If it doesn't, or even returns to stimulus measures, we will analyse the possible impact on future inflation as well as the measures adopted by the new government after this year's elections.