

12<sup>th</sup> December 2016

Dear investor,

The underlying reason for writing a letter to our investors is to illustrate the results obtained. 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 judge our work. It is in this spirit that we address these quarterly missives.

The results obtained by our funds are reflected in the tables below. The individual return of each investor depends on the net asset value at which they subscribed:

	Jan-Sept	YTD*		Jan-Sept	YTD*
azValor Internacional FI	18.2%	20.5%	azValor Iberia FI	9.0%	14.5%
MSCI Daily Net TR Europe Euro**	-3.3%	0.8%	IGBM Total**	-5.1%	0.3%
Return vs. Index	21.5%	19.7%	Return vs. Index	14.0%	14.2%
MSCI World	3.8%	5.9%	IGBM	-8.4%	-4.3%
Return vs. Index	14.4%	14.7%	Return vs. Index	17.4%	18.8%
** Includes dividends		*09/12/2016	** Includes dividends		*09/12/2016

At the close of the third quarter and to date we maintain a very wide positive return difference with our benchmarks, both in the Iberian and the International portfolio.

The pension fund azValor Global Value (80% of azValor Internacional and 20% of azValor Iberia) shows a different return as it was launched in mid-year. In 2017, its return will be 80%/20% of azValor Internacional and azValor Iberia's performances respectively.

## The Portfolios

Both azValor Iberia and azValor Internacional have quality businesses purchased at attractive prices and with a significant upside potential.

In this third quarterly letter we have thought that it might be a good idea to illustrate the portfolios with a specific investment example, and to this end we have chosen **Hyundai's preferred shares (4% of weight in azValor Internacional)**. Before we set out our reasoning, we would like to share with you a quote with which we particularly identify ourselves.

*"All truth passes through three stages. First, it is ridiculed. Second, it is violently opposed. Third, it is accepted as being self-evident". Arthur Schopenhauer.*

Fernando and I know that, as managers, we are condemned to spend most of our lives in stages 1 and 2 if we want to continue outperforming the benchmarks. And we need our clients to withstand with us, refusing to sell in stage 1, gripped by fear, when our shares temporarily fall.

*This is why we propose below an exercise for you, dear reader, to experience a simulation of what we live every day, with a situation where the end result is still uncertain (and therefore subject to error). Our intention is to help you better understand what Fernando and I do, so that your trust does not give way in the numerous "stages 1" that we will encounter in (hopefully many) future years.*

It all begins with a simple idea: **"Hyundai's preferred shares allow us to buy FOR FREE a car manufacturer with worldwide presence and EBIT margins of 6%".**

*For this simulation to work, stop reading for a minute and make the fictitious mental exercise of thinking that you have just invested a significant percentage of your money in Hyundai's shares. Try to read very slowly, identifying **the emotions** produced by the text at the end of each paragraph.*

**Remember: You have just invested a large sum of money in Hyundai.**

During 4 consecutive years, Hyundai has been suffering downturns in profits year after year. In fact, its shares have reacted in the expected direction accumulating a fall of over 44% in this period. The remaining manufacturers have increased sales and benefits during this period, which suggests that the problem is specific to Hyundai, and not the automotive sector. In fact, it is the only company in its sector which trades at the same level reached by Peugeot just before it had to be rescued by the French Government: in a setting of 0.1x EV/sales. Such low multiples are in general a reflection of very serious problems which have historically led many companies to bankruptcy.

As we deepen in the analysis of the company, the following should be considered:

- The weakness of the Yen automatically benefits Japanese competitors who have historically started gaining market share in export markets in the immediate wake of the falls in the Yen. It is impossible to predict the long-term future of the Yen, but seeing the amount of stimuli created from scratch by its Central Bank, it would not be surprising that at some point the Yen suffers a sharp depreciation, which would pose a serious threat to Hyundai.
- China and the United States are markets that will tend to become more competitive with time, and which represent almost 40% of Hyundai's sales. In China, local manufacturers are becoming increasingly efficient; and the State is placing a lot of emphasis on the electric car, a field where Hyundai does not stand out today. In the United States, the competitive difficulty will come from the "disruptive" changes appearing

on the horizon: self-driving cars, shared mobility, or connectivity and interaction of the interior of the vehicle with personal devices such as the Smartphone. Hyundai may be lagging behind...

- Its main market is the Korean one, where it has a large market share and generates almost half of its profits. The Korean State has announced a rise in VAT which will logically lead to a decline in sales, as has already been the case on previous occasions.
- The Korean market is regulated by strong unions (Korean Metal Workers) that often call strikes to push their wages upwards. An additional complication which the company will have to deal with on a recurring basis.
- Creating a luxury brand from scratch in this sector is something very complicated. The Head of Volkswagen once said: "if we had known that we were going to end up spending to create Audi, we would not have done it". However, Hyundai has had no reservations about launching its own luxury brand, Genesis. The burden of proof is therefore against it, in the light of this sector's History.
- Finally, there are aspects in the management of the company which cast serious doubts in the investor. We just have to look back at the purchase of the new headquarters made by its main shareholder and chief executive: he paid 5 billion USD for an emblematic complex in Seoul, exceeding by far the second highest bid.

Thus, it is not unreasonable to conclude that Hyundai is a company that is not going well, as reflected by its share price, that it still cycles against the wind on virtually all fronts for the coming years, and therefore, that there are good reasons for believing that its shares will continue to fall even further, under the dubious leadership of its CEO, Chung Mong-koo.

After reading this, an investor is likely get scared and might decide to sell his shares. "After all, there many companies with fewer problems with which to make a good return, and this one does not look very good" one could think.

Well, this is where we start getting the scalpel to try to refine more, to study in depth all of the aspects above and additional ones... with the sole purpose of analysing what is key for us: to what extent are bad news already included in the price.

We start with what we call the EXTERNAL vision of the sector: the most profitable investments in automobiles historically have been when:

- a) The earnings expectations of a manufacturer are depressed, and in addition...

- b) There are doubts with regard to the impact on the balance sheet of a deterioration of the financial situation...
- c) Provided that sales end up recovering and profits end up increasing.

To this end, we analyse Hyundai's competitive position. Is it really such a bad company as everyone believes it is? The following are the conclusions of our analysis:

- In the past 11 years, Hyundai has increased its sales, EBITDA and profits at an annual rate of 5%, 7% and 13% respectively. This means that in 2015 it earned 4 times more than in 2004. This has been achieved without ever compromising the balance sheet and presenting (increasing) net cash positions at all times.
- These increases reflect the progressive penetration of very different markets on the basis of a production excellence which is difficult to replicate. Let's look at some figures as an example: Hyundai is the second largest company in the world which produces more cars per employee (40), well above other companies such as Ford (<30), Toyota (25), Audi or BMW (<20). We could detract from this data arguing the heavy weight of Hyundai's outsourcing, but we actually find this rather laudable. Especially if we add to this data another one: In revenue per employee, Hyundai reaches the fifth position worldwide, only behind Kia and Ford among the mass market players and BMW/Audi, luxury manufacturers with a much higher average price than Hyundai's.
- Hyundai has considerably increased its profit margin over the years. From its 4% EBIT in 2004 to the 10% achieved in 2010 and 2011 (a level worthy of luxury manufacturers whose average sales price is much higher!). It is true that this level has dropped to 6% in the last years, but this is very reasonable level for a mass market producer, and it allows a ROCE of 14% which compares very favourably with the rest of the sector.
- If we analyse in detail the evolution of sales, we realise that it is a highly diversified manufacturer with worldwide presence: 27% in Korea, 23% in the USA, 12% in Europe, and the rest in emerging markets. We particularly value its exposure to emerging markets where there are some interesting options which we will analyse below.

At this point, the value investor starts to get excited at the possibility of standing before an attractive investment. **Hyundai is a company that has accomplished great things in the past 11 years, so perhaps everything is not that bad.** The next step is to zoom in on each of the problems in order to analyse them in greater depth individually.

- The fall in profits in 2013, 2014 and 2015 of 1%, 7% and 9% respectively coincides with a period when the Yen went from 80 to 120 against the

USD. Hyundai had to reduce its profit margin to compete with the Japanese aided by their weak currency. This is an uncontrollable variable which later reverts to the average over time (in fact, from levels of 120 in 2015, it has significantly appreciated in the past months to around 100). However, we note the risk posed by a weak Yen in perpetuity.

- A key aspect is the operating profit generated per vehicle. This is particularly affected by the type of cars sold. One of the variables that has most helped manufacturers to improve their figures recently has been the increasingly higher weight of the so-called SUV (4x4) in their sales. In the case of Hyundai, we can see that there is a strong initiative to continue increasing the weight of SUVs, which will help the margins.
- The company has withstood with presence and investments in various corners of the world in recession, such as Brazil and Russia. These markets have suffered a flight of international manufacturers, but Hyundai has remained, significantly gaining market share (and surely losing money). This year, in a Brazilian market falling by over 22%, Hyundai's sales have barely dropped 7.5%. We believe that when these markets rebound, the economic value of Hyundai's market share will appear in the form of positive contribution margins which will help boost the result.
- The initiative of launching Genesis (the luxury brand) has cost a fortune, but this development expense has already been incurred, passed through results and come out from the company's cash-flow. What is generally costly and complicated in this industry (launching a luxury brand) can make sense in a market such as the Korean one where Hyundai has a very high market share and has successfully sold high-end automobiles in the past. Moreover, Genesis will only be sold in Hyundai's authorised dealers, which will reduce the costs of promoting the brand. So far, in all of 2015, 39 thousand units of Genesis G80 and G90 were sold, a figure that has been exceeded in August this year (44,500 at the close of August). The contribution margin of a model such as this one, with higher price levels, will also help the profit increase, while the majority of costs belong to the past. Hyundai's ultimate intention with Genesis may well be to build a higher brand image in Korea which allows it to increase the price of other products.
- In India, Hyundai is the second largest car manufacturer, with a market share of 15%, more than double that of the next foreign manufacturer, and with a very extensive dealer network. India is a country with huge potential due to the low penetration of the automobile (half that of China, 4 times less than in Brazil, and 5x less than in Russia). This is perhaps why

the n°1 manufacturer, Maruti, trades at over 20x EV/EBIT, by anticipating the market possibly many years of tail wind in sales and profits. Hyundai is already profitable in India, and is increasing its margins from 3% in the first half of 2015 to >5% in the first half of 2016. Valuing it similarly to how Maruti trades, we get that the Indian operation alone (with UPWARD sales and margins) could be worth 50.000 KRW/share, or half of the entire current capitalisation. We do not do this exercise automatically, as Maruti is more profitable for the time being, but we make a note of it..

- One of the most serious challenges the sector faces is the one regarding regulatory compliance with regard to emissions. This regulation will be particularly onerous for manufacturers selling in the developed world. Fortunately, Hyundai sells mostly in emerging markets: in fact, Hyundai "only" sells 450 thousand cars in Europe (9.5% of the total) and 750 thousand in the USA (16% of the total). Assuming an average compliance cost of EUR 850/car in Europe/USA, the cost of achieving the regulatory objectives of 2020 could stand at 1 trillion KRW, equivalent to 1% of the group's total revenue.

Thus, it seems that Hyundai has a lot of "investment" that has already been made but which has not had time to appear in the profit and loss account yet (Genesis, Brazil, Russia, the greater weight of large –and more profitable– vehicles in the mix), and it is not unreasonable to expect a rebound of profits in the medium term.

With regard to the management team, the CEO Chung Mong-koo has a direct shareholding of 5.17% in Hyundai, and an additional indirect shareholding of 1.45%, worth approximately 2.500 million USD in the market. This quantity is high enough to think that something "is at stake" and that, in this sense, it is on our side.

Hyundai's development (profitable growth in market share historically without compromising the balance sheet) is a reflection of excellence in the operations management. In terms of the other necessary aspect in a management team, i.e. capital allocation, we did not agree with the million-dollar purchase of the headquarters in Seoul referred to above. There is no reason to think that they will not harm the minority shareholder again, and this is the main risk in our opinion. We understand, however, that the main shareholder is somehow in the same boat, that the purchase of the headquarters in Seoul has meant for him some degree of public scorn, and that, as a result, the future risk of similar "errors" is possibly reduced. We believe that there is a certain margin to carry on aspiring to make money even in the event that some other episode of value destruction occurs due to a misallocation of capital.

Through preferred shares, we are paying about 26 trillion KRW for the company. The net cash of debt and provisions alone amounts to 24 trillion KRW. And we

have seen that the Indian operation can be worth another 13 trillion KRW. Thus, there is a 42% potential in Hyundai's shares if we simply add up India and the cash (net of all other liabilities). The rest, free, is a very efficient operation (6% EBIT) of production and sale of cars worldwide which generates today over 4 billion USD in profits.

*The fear that a first reading of this reality could cause becomes something else when, in the analysis, one moves the magnifying glass closer to each negative element pointed at by the market players. This is what Fernando and I do 95% of our time: We dissect reality with an imaginary scalpel to see if things are what they appear to be or not (i.e. what the market says they are!). And although we will still make mistakes occasionally, it is essential that investors do not give way when times get hard and the market seems to temporarily prove us wrong. We hope that this exercise helps in this sense.*

## The setting

Let's remember our "trio of aces" with regard to macroeconomic predictions;

1. We are unable to predict what is going to happen,
2. We believe that any attempt to do so is a waste of time... and
3. No one has ever managed to do it well sustainably.

What we can (and must) try is diagnose the current situation, contemplate the multiple scenarios that may occur, and, **without wasting time trying to predict which one of them will end up taking place**, protect ourselves with a robust portfolio that is adequate for almost any eventuality.

The assessment of the economic situation does not change as frequently as the media tries to make us believe. Thus, the main points we would highlight are the same that we have mentioned in previous letters:

- The developed world (USA/EUROPE/JAPAN, etc.) is drowning in debt, and is therefore **FRAGILE** in the light of unforeseen events. The uncomfortable (and correct) solution involves reducing public spending, taxes, and excessive regulation. The most comfortable (and wrong) temptation would be to pump money into the economy, generate inflation and thus alleviate the debt burden.

The United States seems to choose fewer taxes and less regulation, both of which are excellent news for its economy. The problem is that they also want to increase public spending at the same time. This equation generates inflation, unless the Fed increases rates far more than expected, something which is very unlikely due to the high indebtedness of the US economy.

- In the developing world there is a higher demographic growth, less debt, fewer promises to the population that are difficult to keep (education,

health, pensions), more working hours per week, and the same or greater access to productivity.

This is why we believe that in the next 5-10 years these parts of the world will grow more. Although they are economies that have other problems, and are therefore not free from suffering one-time setbacks, in general we like our companies to have a high percentage of their sales in emerging countries.

- The policies of central banks have created a bond bubble, many of which are producing negative returns. This has forced many investors to buy shares that "similar" to bonds (defensive businesses in large companies with less volatile share prices), causing very high valuations in the majority of them.

But at the same time, shares in smaller, less well-known companies, outside the indices, and with more volatile share prices, have become "orphans" and therefore stand at very attractive prices: we have several "free" companies that have more cash (net of debt) than what they are worth in the stock market.

- Have central banks' experiments finished or can they continue?

Over the past 5 years, we have witnessed monetary experiments the effectiveness of which we try to summarise in the following table:

The ECB's intention was to...	... and it managed to...
Fuel inflation	Bring the CPI today below the value recorded when QE started.
Relaunch stock markets	Have the EURO STOXX 50 moving in the same level as when the QE started.
Revive credits to families	Maintain the same credit to the private sector as when it started.
Stimulate growth	Maintain the same growth which started the QE.

To our mind, the only real effects of QE have been:

- To reduce the States' cost of financing, in order to facilitate the issuing of debt and give them more time to balance the budget,
- To depreciate the EURO around 15% in favour of exporters (and to the detriment of importers!)

When we analyse the possibility that QE ends some day, the only relevant questions in our opinion are:

- Will States withstand higher interest rates?
- Will exporters be able to compete with a higher Euro?

The policies adopted by each country will be of great importance, and we are unable to predict them; but detecting fragile areas helps us build a robust portfolio. Thus, in the liquidity part of our portfolio, before 100% in Euro, we



have diversified in a basket of currencies which in our view offer less fragility than the EURO.

- In conclusion: in light of high valuations, we protect ourselves by buying cheap companies; faced with such a high and increasing sovereign debt, we prefer companies without excessive debt; in light of central banks' monetary experiments, we take refuge in management teams/owners with their money at stake and who have demonstrated prudence in the past. And we do this because we believe it is the best way of managing the complicated context we live in today. When they are frightened, many investors turn to fixed income, but today this is the most frightening area...

### azValor news

During the anthropology course I studied in my non-compete year in 2015, they said that "human beings can only grow in **adversity**, because it is then, and only then, that they become aware of their weaknesses". I studied the theory well in 2015, but I did not know the practical test would be a few months later, between September and November 2016. Both Fernando and I would like to thank the **unprecedented support** we have received from various media, the vast majority of our almost ten thousand investors, and our 30 employees.

**In the analysis department**, we have welcomed 5 new members who are already working at full stretch. They have broadly demonstrated that they will help us do great things and their enthusiasm is contagious.

Having completed the first year of azValor, we have honoured the promise of appointing a first group of employees as partners. A total of 5 new partners join the quartet formed by Fernando, Beltrán, Sergio and myself. Our idea is to shape a company where each employee owns a portion thereof. We are already 9 partners out of 34 employees, and we are confident that in our second anniversary there will be a lot more.

Once again, we thank you for the trust you have placed in our management. The commercial team, led by Beltrán Parages, will be pleased to answer any questions you may have.

Álvaro Guzmán de Lázaro Mateos

CEO and Chief Investment Officer