

October 21st, 2020

Dear co-investor:

During this last quarter, the Azvalor Internacional and Azvalor Blue Chips funds have consolidated their strong performance recorded from March's lows to the end of the second quarter of the year (+41% and +59%, respectively). Their net asset values have appreciated by slightly less than 1% during the third quarter, while Azvalor Iberia lost 10%. Year-to-date, however, all three funds have reported negative results (Azvalor Internacional -24%; Azvalor Iberia -37%; Azvalor Blue Chips -22%, all as of October 16<sup>th</sup>, 2020) leading the funds to a negative total return since inception. This is common to most value strategies, as we pointed out in our [previous letter](#).

Although we understand that patience is a virtue, which can be difficult for investors to master, we remain convinced that those of you who continue to trust us will achieve very significant returns in the years to come, as has been the case on every occasion the market has put us to the test over the past 23 years.

The most profitable and least risky time to buy our funds is precisely when they go down. Falls in the fund's net asset value reflect that the price of the shares in the fund have fallen. This is not something permanent, but temporary. There is a business behind every stock and the market values this business every day through the daily fluctuation of its share price. In a calendar year, many businesses fluctuate at least 50% between the highs and lows as measured by their stock price. But the value of their business does not fluctuate so much in the real world as price is not value. The cause of these stock market fluctuations is due to psychology: investors as a group exhibit herd behavior and their mood shifts quickly from euphoria/ambition to pessimism/fear. Our strategy is to try to take advantage of this changing psychology to buy when there is pessimism and sell when there is euphoria, always hand in hand with an in-depth study of the companies and their valuation. For this to work, patience is essential, as businesses stock prices only reach their intrinsic value in varying periods of time. Sometimes it is a matter of just a few months and sometimes it takes a few years. There are some cases (between 10% and 15%) in which, as humans, we inevitably make mistakes, and the value is never reached. This error rate, which has been stable for the last 20 years, has not prevented us from generating good returns historically. **All of this is a very basic summary that most of our co-investors are familiar with, but we feel it is appropriate to recall it from time to time as it is the heart of our investment philosophy.**

Thus, although the net asset value of the International fund rose by only 0.5% in the third quarter, **its estimated value increased from EUR 219 to EUR 230<sup>1</sup>**. This figure is subjective – it cannot be looked up in a newspaper – and has “value” insofar as you can trust that our business valuations are generally correct. For us, the estimated value of the fund is **the most important figure we can share with you: it reflects not only what has happened in the quarter, but also what we can expect in the future.**

**Our estimated value of the fund reflects what has happened in the quarter** because, if the figure increases (good news), this means we have been able to sell shares that have gone up (and therefore offered less potential) and with this money buy other shares that have dropped (and therefore have a strong upside potential ahead). If the figure falls (bad news), this means we have not been able to replace the shares that were sold, or that the valuation of some businesses has been reduced for some reason. In this quarter, a value of EUR 11 has been created for every stake in Azvalor Internacional, which represents a 5% increase in the previous target value and, perhaps more importantly, 13% of the current net asset value of EUR 87.

**Our estimated value of the fund reflects what we can expect in the future** because, when we compare the estimated value with the net asset value, we see how much we can expect to earn in the coming years. Thus, we believe that behind the EUR 87 per stake that we would pay today to buy the fund, there exists EUR 230 in value. We do not know when this value will be reached, but we do know it has been reached over the last 20 years, sometimes faster and sometimes slower, despite some unavoidable investment mistakes. If, for example, this value is reached in 5 years, the return would be 21% per year from current levels. However, for those who purchased the fund at EUR 100 per stake when we launched Azvalor almost 5 years ago, return on investment would be lower, i.e. 8.6% annually.

We will detail below the factors related to value in our two main portfolios.

## Iberian portfolio

We have not added any new companies to the Iberian portfolio this quarter. The main increases in positions were in Indra and Logista, and the main divestments in Prisa and Sonae Capital.

**Indra** is a company that we have followed since its IPO in the late 90s and which we have had in the portfolio on numerous occasions. At the end of the second quarter, we had a position of 1.8% bought

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<sup>1</sup> The upside potentials indicated in this document have been obtained as a result of the difference between the estimated value of each of the underlying assets of the portfolios, based on our internal valuation models, and the prices at which each of them is currently traded on the stock markets.

at an average price of EUR 7.3 per share. During the third quarter, the market penalized the company with a further 16% fall. In our opinion, this is a unique opportunity in 5 years' time. Indra is currently trading below the lows hit in 2012, when Spain was on the verge of a bailout. Since then, its financial situation has improved, and new managers with an excellent track record and our full confidence have joined the company. Our average purchase price means paying between 7 and 8 times the profits we estimate the company will generate in two/three years' time. We expect an upside potential of more than 70% in the next 3-4 years.

**Logista** is a quasi-monopoly in the wholesale distribution of tobacco in Spain, France, and Italy. It is a solid business with strong barriers to entry, a renewed (and excellent) management team, and which we already bought in the second quarter after it fell by almost 40%. We have increased our position from 3.3% to 4.9% of the fund during this quarter, as its stock price has fallen by a further 10%.

With regard to divestments, in the case of **Sonae Capital**, the controlling family proposed a takeover bid, and the sharp rise in the stocks led us to sell and invest more capital in Indra and Logista, where we see greater upside potential.

We invested in **Prisa** at an average price of EUR 1.62, estimating a value of more than EUR 2.5 per share. This is a case where temporary negative elements (COVID-19) have converged with permanent ones. We believe, however, that the share price (-70%) has fallen more than the value (-50%), yet this has also happened in Indra and Logista, where we see less risk and similar upside potential.

The estimated value of the Iberian portfolio amounts to **EUR 187 per stake**, which suggests an upside potential of 150% compared to its current level.

## International portfolio

During the third quarter, our estimated value **has increased from EUR 219 per stake to EUR 230**.

The main movements with an impact on value have been the following: we have completely sold our position in Gold Fields, Southern Copper and Sprott, and part of our position in Agnico, Barrick, Pan American Silver, Hyundai and SOL SpA. With the proceeds from the sales of these businesses, we have invested in 4 new companies: SQM, CF Industries, OCI and Suncor; and we have increased our stake mainly in New Gold, Euronav and Maersk Drilling. Finally, we have reduced the intrinsic value of Transocean and Valaris.

**Gold Fields** is a globally diversified gold producer. We bought our position at an average price of USD 6.2 per share and sold it entirely in the third quarter following its sharp rise to almost USD 15 per share, the level at which we were calculating our intrinsic value.

**Southern Copper** is a copper producer that we bought at an average price of USD 34 per share and sold during this last quarter after it rose to USD 48/share. In this case, we estimated the intrinsic value at USD 60/share and, with a remaining upside potential of only 25%, we preferred to sell our position and use the money in companies with a longer track record, thus creating more value for the fund.

**Sprott** is an investment manager specializing in commodities, especially precious metals. We bought its shares 4 years ago at an average price of USD 21/share. This quarter, its price hit USD 56/share and we decided to sell our position entirely, having reached our estimate for the stock's intrinsic value.

**Barrick Gold, Agnico** and **Pan American** shares rose by 13%, 34% and 30% respectively in the quarter, spurred on by the rising price of gold. In this case, we have **partially** sold our positions to finance the acquisition of businesses with greater upside potential. The target prices, despite the accumulated appreciation to date (+125% for Barrick, +86% for Agnico and +139% for Pan American), still present upside potentials of over 50%, using a price of gold of USD 2.000 per ounce.

The case of **Hyundai** reflects particularly well the non-linear effects that occur on the stock market. We bought the position almost 5 years ago, and its stock has been falling every year until March 2020. We swapped our preferred stock for common stock in January, in view of their similar performance and the much greater liquidity of common stock. Our average price was 112.000 Korean won. Between the end of March and the end of July, the stock price rose by 157% in just three months, to 180.000 won. We sold our position with an accumulated performance of 53%, equivalent to an annual internal rate of return of 9.8% over these almost 5 years. Thus, the total return on investment was achieved in 3 months in a business that had been in the portfolio for 54 months. In other words, in 6% of the time the entire return was achieved, which is why we always emphasize the importance of "patience", knowing that often the mere mention of this word can be exasperating. The important thing is to buy below the intrinsic value. If anyone had tried anything else in Hyundai, such as waiting "for the right time" to buy, we believe the result would have been disappointing, to say the least; unless, after 51 months of waiting, they had decided that March was the right time to enter (when nothing special happened at that time!).

With the proceeds from these sales we have invested in 4 new companies:

**Sociedad Química y Minera** is a producer of specialty fertilizers and lithium. It has a healthy balance sheet, a great management team and we have acquired its shares at an average price of less than

USD 30 per share, after a 50% drop from the USD 62 per share it reached only two and a half years ago. Its competitive position is very strong, and its end markets are in the low phase of the cycle. We believe it will be an excellent investment in 5 years' time.

**CF industries** is a low-cost producer of nitrogen-based fertilizers. Just over a year ago its shares were trading at over USD 50 and we decided to start analyzing it after its stock collapsed by more than 40%. It has a robust balance sheet, a strong management team, and our average price means we paid less than 8 times our estimated normalized profits.

**OCI** is a company that produces methanol and nitrogen-based fertilizers. It has very competitive costs, an excellent logistics network, and is backed by a family that owns more than 40% of the capital and has proved over the years that it knows how to invest well. Its financial position, without being bomb-proof, is solid for the low phase of the cycle we are in, there are no major short-term debt maturities and a possible sale of the methanol business would correct the balance sheet at once. At our average entry price, we estimate a FCF yield of 14%, which is attractive enough for the risks that we anticipate.

**Suncor** is a producer of oil and refined products based in Canada. Its stock price has plunged from USD 53 to USD 15 in just two years due to the sharp drop in the price of crude oil. We believe that the robustness of its operations, a reasonable balance sheet, and boasts very low marginal production costs (below USD 30/barrel) will generate a normalized profit (with crude oil at USD 55/barrel) for which we barely paid 6 times at our average purchase price.

Regarding our increases in existing positions, we would like to highlight our substantial increase in **New Gold's** stock. It is interesting to analyze this case: we bought it almost 4 years ago at a price of about USD 4 per share. Due to problems in one of its gold mines, its stock plunged by 90% to USD 0.46/share. On numerous occasions we have referred to New Gold as one of our investment errors due to such sharp drop. However, we did not sell it at the time because we felt that the drop in the price was much greater than that of its intrinsic value. The arrival of a new CEO with the right ideas and determination led us to increase our position significantly, very close to the lows. From these lows, the share price has multiplied by 4 in only 6 months, and today we can already say that we are profitable with our average price of USD 1.8 per share. New Gold's stock trades above USD 2.1, and we believe that it still has an upside potential of more than 60% at the current prices of gold and copper, its main products.

The impact of selling securities at prices close to our estimated value and reinvesting in undervalued companies has resulted in a "gross" value creation of EUR 19.5 per stake.

However, this quarter it is not all good news from the point of view of value. Although we are often right, we also make mistakes. For instance, we have substantially reduced our estimated value of **Transocean** and **Valaris**. In both cases, the impact of the COVID-19 pandemic on short-term oil demand has caused a delay in the recovery of the oil platform market. Due to the high levels of debt of both companies, this impact has led to a very significant reduction in the intrinsic value of their shares. **The impact on the value of the fund amounts to EUR -0.9 per stake in the case of Valaris and EUR -7.6 per stake in the case of Transocean.** In other words, we have lost the quasi-totality of the investment in these two companies. Although this is obviously something that frustrates us, unfortunately it is also an element inherent to this profession and, much to our regret, the probability of continuing to make some of these mistakes from time to time is close to 100%. This is the bad news. The good news is that if, as in the past, these errors are the exception, we can continue to create value in spite of them, as reflected in the table below which shows the net impact of value creation and destruction in the quarter.

Evolution of the fund's value	in EUR per stake
Sales at prices close to the estimated value and reinvestment in undervalued companies	19.5
Reductions in the estimated value	-8.5
<b>Net impact</b>	<b>11</b>

Some clients ask us, logically, if we expect future reductions in the estimated value of companies such as Petrofac, Tullow Oil or Consol Energy, whose prices have fallen significantly from our purchase levels. The sum of these three positions currently represents 4% of our international fund, so the impact in case of a further deterioration of their business would be limited to that amount. They remain in the portfolio because we believe that their stock prices have fallen significantly more than their estimated values, and therefore the risk-return skew is attractive at these levels.

Beyond what you can see (additions and exits from the portfolio), there is something very important that you cannot appreciate from the outside: the list of companies that we are looking at but for which we have not yet made a decision. Using a football analogy, it is as if these companies were sitting "on the bench" waiting to take the field at any time. The Coronavirus pandemic has caused a drastic drop in stock prices in many quality companies, and some could represent interesting investment opportunities. **The number of potential companies on the bench is now larger than ever since we launched Azvalor.** This inventory of companies, for the most part, does not belong to the commodities sector. They are businesses that meet the following characteristics:

1. They have some barrier to entry, which is sustainable, and returns above the cost of capital are generated because of it; there is room to continue investing the generated profits at high rates of return.
2. They have an owner and the right corporate culture.
3. They have solid balance sheets and credible accounting.
4. The reason why they are cheap is a problem of a temporary nature.

Some of the companies on this bench are at a very advanced stage, and we only need to wait for their stock price to fall a little more to enter with the desired margin of safety, while others are still being analyzed with regard to the 4 previous points.

The most important thing is that the quality of the companies on the bench ensures that investment discipline is maintained (especially when selling) and creates a very healthy competition between the different investment alternatives. The quantity and quality of the bench depends on our productivity at work (studying the businesses) but also on what the market offers us (in the form of low prices) and, in this sense, the current situation with the COVID-19 pandemic is providing more alternatives than any other time in the last 5 years (except for specific short-term situations such as the few days of sharp falls following the Brexit announcement).

## Azvalor news

In terms of inflows and outflows from our funds, during this third quarter of 2020 subscriptions have amounted to EUR 22M while redemptions have reached EUR 29M, meaning net outflows of EUR 7M. This is a small figure (less than 1% of total assets) which reflects the confidence of our client base in our investment process.

We would like to conclude this letter thanking you again for your trust and reminding you that you may contact us at any time through the various communication channels or directly reaching our investor relations team.

Sincerely,

Azvalor Team

