IBV CAPITAL

Q2 2022 Partnership Letter

Dear Partners,

For the last two years we've been fearful. Today, we're being greedy.

Since the beginning of the pandemic, we have articulated that the unintended consequences of global government COVID mitigation strategies would be widespread, long lasting, and severe. This observation was generated from the experience we accumulated from our successes in unlocking value in individual companies that have fallen on hard times. It ultimately fed into our overarching sentiment that asset prices had become dislocated from underlying economic conditions.

As expected, the challenges of returning to normal have persisted. Meanwhile, financial constraints have meant that fiscal and monetary support has naturally waned. Now, the impact the pandemic has had on actual economic conditions for individuals, companies, and countries is beginning to surface.

Surprisingly, it's only been recently that market participants have begun to realize that without unprecedented financial support – as fiscal deficits normalize, and quantitative tightening takes hold – economic conditions are challenged. This insight has directly translated into a rapid repricing of assets.

The evolution of financial asset valuations, from elevated pre-pandemic levels to irrational exuberance during the pandemic, followed by an abrupt return to reality, has been extreme. Consistent with historical patterns, we're witnessing indiscriminate buying converting into indiscriminate selling.

Our pragmatic and conservative nature has helped us avoid investing in boom bust situations. While it has prevented us from investing into exuberant market conditions, such as the environment we just experienced, it also encourages us to deploy capital during moments of stress. A situation we're witnessing today.

At a more granular level, our predisposition to avoid risk also explains why companies in new and trendy industries rarely enter our portfolio. We approach these companies with a healthy skepticism. Particularly when these new business models promise to quickly unseat entrenched incumbents. We have found that they rarely live up to initial expectations within the implied timeframes.

The end result of our conservative approach is a record of accomplishment that shows we rarely experience a permanent loss in capital on an investment – our definition of risk. And, in the few circumstances where we have made a mistake, the corresponding poor outcome has been very manageable.

Within this context, one can begin to understand why we maintained a cash position that hovered between 34% to 59% for the last two years. It was justifiable given the circumstances. But this is only evident with perfect hindsight.

Maintaining our discipline while most market participants enjoyed a euphoric party – where everything went up in value – made for a very uncomfortable time in our firm's history. As we have pivoted to deploying our cash hoard, while others scramble to raise cash, we feel a sense of vindication.

To indicate how contrarian we have been, it's worthwhile to consider this. During March 2020, during peak pandemic fear, we deployed all our capital. At this exact moment, the average investor was selling their investments to build a 26%[1] cash position. In 2021, during peak euphoria, we had increased our cash position to an average of 52.6%, while the average investor had deployed most of their cash. Today, we've deployed most of our cash. Again, we are seeing the average investor building their cash position to March 2020 highs.

Since January, we have deployed most of our cash. It's declined from 40.1% of the portfolio to just 4.9%. We anticipate this portfolio shift impacting the volatility of our returns moving forward. This is because we have converted a security that doesn't change in *price* – cash – to a security that constantly changes in *price* – stocks.

Exacerbating this volatility will be the types of stocks we have been purchasing. At the end of the quarter, some of the companies we have been investing in have fallen by as much as 60% from just a few months earlier. We have found that when companies are trading at such depressed levels, they often exhibit abnormal levels of volatility.

---

1 https://www.aaii.com/assetallocationsurvey

It's important to reiterate that volatility does not represent risk to us. And it never will. Risk has always been the probability we experience a permanent loss in capital. As such, by deploying capital into shares that are trading at such depressed valuations, there's a low probability that we experience a permanent loss in capital from this point forward – this creates our margin of safety. Simultaneously, we have a high probability of earning outsized returns on these investments – this creates the widening of our intrinsic value gap.

Being greedy while everyone's being fearful has worked well for us in the past. And it's exactly what we have done again.

Foundational Investments

The market value of our IBV Capital Global Value Fund decreased by 20.9% (net of fees) in the second quarter of 2022. While the intrinsic value of our portfolio increased by 23.5% during the quarter. For comparative purposes, during the second quarter of 2022, the MSCI World Index decreased by 16.2%.[2]

The capital we have invested has been concentrated around opportunities that we know exceptionally well. As they have declined in price, we have purchase more. In the case of AMA Group Limited (AMA), we purchased substantially more.

In the last few weeks, we have become the company's third largest shareholder. While we're very pleased to own shares of AMA at this price, our recent purchases contributed to most of our recent negative performance. We see this as being a temporary phenomenon.

Another investment that has been a drag on our performance is Brookfield DTLA Preferred Shares (DTLA). DTLA has declined steadily since our initial purchase in 2018, despite our investment thesis remaining intact.

Brookfield DTLA has ownership rights on 7.5 million square feet of Class A rated office towers in downtown Los Angeles. They also partially own two residential rental buildings – one currently under construction with the second in the application phase. Combined, the value of these assets greatly exceeds all the liabilities of the company, including the preferred shares we own and the accumulated dividends that are outstanding on them.

[2] "IBV Capital Global Value Fund" consists of USD$ IBV Capital Global Value Fund LP Class A master series unit returns, net of fees. Inception date of this series is September 1, 2014. "Intrinsic Value" represents IBV Capital's internally calculated value for the cumulative securities within IBV Capital Global Value Fund. "MSCI World Index" is based on the USD$ returns MSCI World Free NR Index. Full investment disclosures can be found on Page 10.

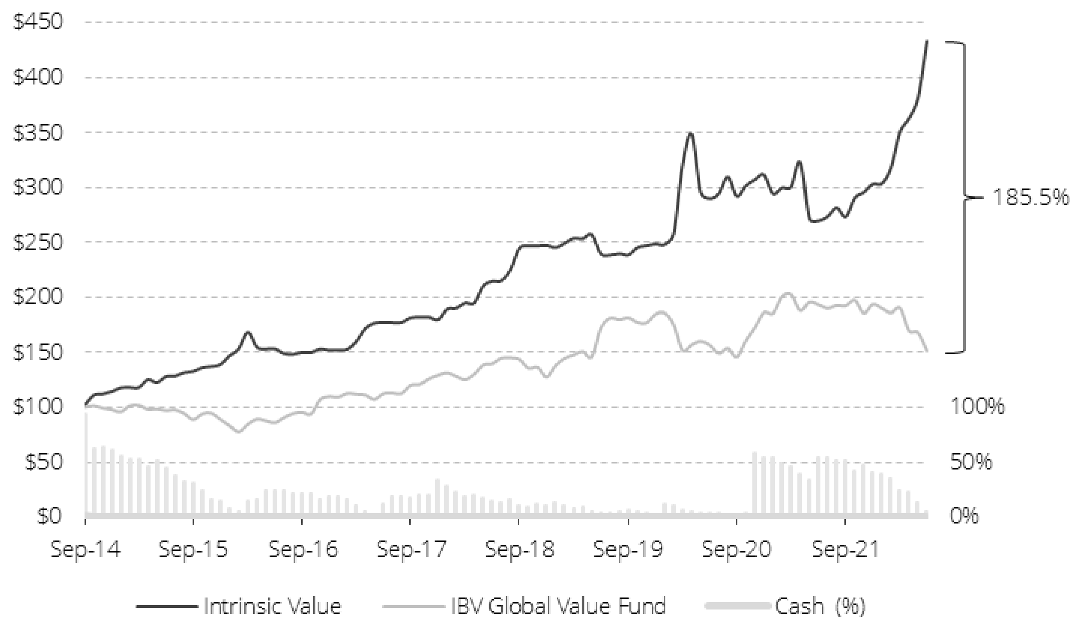
So, while there is $48.80 of value between the $25 par value of the preferred shares and accumulated dividends of $23.80, we have witnessed the shares fall to $8.75. This represents a negative attribution of -5.1% on our total portfolio's performance over the last two-and-a-half-years.

While an unpleasant near-term return development, we purchased these preferred shares knowing that the optimal profit outcome would not be realized until after 2023. This represents the year that the private equity vehicle these preferred shares are embedded within is set to be liquidated. Presuming it takes until then or shortly thereafter to begin the value unlock process – by selling the entire portfolio of buildings or one building at a time – we anticipate over a 450% return from today's valuation.

While all data points to AMA and DTLA contributing to positive returns in the future, their recent declines in price have offset the positive returns we have realized from our other investments.

Specifically, FirstGroup Plc (FGP) was the second most profitable investment in our firm's history. The returns from our investment were crystallized in 2021. It contributed to the building of realized capital gains. We're looking forward to the moment AMA and DTLA transition from unrealized losses – where they stand today – to join our long list of investments that have generated realized gains.

When we combine the recent performance of these two investments with deploying 19.7% of our cash in the last 90 days into highly accretive investments, it's widened the gap between the intrinsic value of our portfolio – what we think our portfolio is worth – and the market value of our portfolio to 185.5%.



As of today, our intrinsic value gap has never been wider. Historically, when our intrinsic value gap gets wider, our future performance gets better. This gives us confidence that our decision to hold cash over the last two years, so we could deploy it under the present distressed market conditions, will generate very attractive future returns.

Opposites Attract

We're contrarian in our approach to investing because it aligns with our objectives of producing attractive rates of return without incurring the risk of a permanent loss in capital. As you may expect, we find companies that share our contrarian approach very appealing and, accordingly, our portfolio is composed of companies that exhibit these values.

For instance, today, most companies are beginning to pause their organic growth initiatives. We don't have a single company in our portfolio that's pressing pause. In fact, we have one that is accelerating their expansion plans. They intend to grow organically through new site openings.

Similarly, while merger and acquisitions activity has plummeted 40% in the second quarter on a year over year basis, one of our investments just completed a strategic acquisition that will grow their revenues by 9.4% and should be immediately accretive to their bottom line. Another is exploring a financing strategy that would allow them to resume their previously active roll-up strategy.

At the same time, five of our thirteen investments are conducting material share repurchase programs. These programs have been either initiated or accelerated of late because the management teams have excess free cash flow and are convinced the market is undervaluing their companies.

To be clear, this is precisely opposite to what we witness most other management teams doing with their share repurchase programs. Usually, we see buybacks being aggressively deployed when the economy is booming, and company share prices are at all-time highs.

On the dividend front, while most companies are undertaking measures to conserve cash, one of our companies is re-initiating a dividend that's been absent since March 2019 and another is restarting theirs after pausing it during the pandemic.

We're really pleased with the strength of the businesses we have invested in and the contrarian approach they are all exhibiting.

G8 Education (GEM) – Australia's largest daycare provider – is a perfect example of a company that's getting stronger daily. As a result, our investment thesis continues to proceed as planned. The volume of children returning to daycare is improving month-on-month.

Furthermore, the Australian government – at both the federal and state level – has laid out expansive plans to support daycare affordability. This is being achieved by providing greater subsidies to help parents with their monthly payments – allowing daycare operators to pass along rising costs through fee increases.

To slow the monthly fee increases parents have been experiencing, the government's longer-term objective is to reduce the cost of operating a daycare by increasing the number of daycare professionals in the workforce. To achieve this, they're providing education subsidies for those looking to become early childhood educators.

We anticipate this program being complimented by a re-opening of immigration. A lack of immigration, which usually consists of welcoming low-cost labour from developing countries, has been a contributor to labour constraints for many companies in developed markets. GEM has not been immune to this state of affairs.

All of these operational developments are positive. Further advancing our investment thesis in GEM is their decision to initiate a share repurchase program to compliment a fully franked dividend that is being restarted. We encouraged management to conduct the repurchase program and are pleased they have recognized the tremendous value it would add to shareholders. They're currently purchasing nearly 10% of shares traded each day.

A company that's also poised to enjoy improving underlying fundamentals for at least the next twenty-four months is AMA Group (AMA). AMA is Australia's largest collision repair company. Naturally, a key driver of their revenue growth is repair volumes, which is highly correlated to miles driven.

In the United States, miles driven has already returned to pre-pandemic levels[3], despite the prevalence of work from home accommodations. While this return to normalcy has been delayed in Australia due to their more onerous pandemic mitigation strategies, we're seeing rising demand for driving in the country by the day.

This improvement will be coupled with price increases for parts and labour that are currently being negotiated with their customers. This will positively impact the current year's profitability. Next year, we will see another material boost to free cash flow generation as a three-year fixed price contract for their Capital SMART business rolls off. Repricing this contract will better reflect the parts and labour inflation that the company has witnessed. This contract has created tremendous margin pressures over the last few years, for which there has been limited relief.

Another business in our portfolio that's improving as economic conditions deteriorate is Lincoln Educational Services (LINC). LINC is a national leader in hands-on transportation, skilled trades, and healthcare training. With 22 campuses, in 14 states, and 13,000 students attending classes each year, LINC has become one of the largest for-profit universities in the United States.

Unlike most for-profit universities, LINC focuses almost exclusively on training the next generation of automotive repair and nursing professionals. Importantly, these are on-site training programs that can't be replaced by online learning. And, through their partnerships with local employers, LINC has made it very hard for Community Colleges to compete against them as students seek the most well-equipped institution to help them build a career in their respective fields. This places LINC in an enviable position within the higher education system.

The professions and trades LINC focuses on will be in high demand for a very long time. While technological innovation and automation has made some professions obsolete, it's only enhanced the need for more training in automotive repair and nursing.

[3] https://fred.stlouisfed.org/series/M12MTVUSM227NFWA

These professions are also resilient to broader employment offshoring trends. The likelihood either are exported to lower cost jurisdictions – as would be the case in manufacturing and now white-collar jobs – is highly improbable.

This reality, along with a dearth of new workers entering these professions has created a long-lasting deficit in the number of workers with these skill sets. This worker deficit and skill gap is increasing the wages for these careers which in turn is creating more demand for these career paths. Since LINC is best in class at educating these professionals, we anticipate that they will continue to experience high levels of student enrolment.

However, we recognized that this broader trend was overcome by the realities of the pandemic. LINC was required to reduce student enrolment during the pandemic to promote social distancing. Equally impactful was high employment levels. When it's easy to become employed, incurring the cost of higher education seems unnecessary to most, and enrolment has historically fallen.

Fortunately for LINC, we're already seeing the frothy economic conditions that's caused this tight labour market beginning to shift. As a result, we anticipate the broader drivers of filling the deficit of workers in these two professions will prevail. Particularly if a recession were to occur.

In addition to favorable long-term revenue trends, the company's financial position is very strong. They continue to generate a high level of free cash flow and their balance sheet is pristine. Their balance sheet is a byproduct of the conservatism ingrained from 75 years of being a responsible for-profit educator. Without the need to use this cash for deleveraging, management will focus on its organic expansion opportunity. Specifically, developing new locations in geographies with attractive demographics and future growth prospects.

More recently, as a result of the decline in the company's share price, management announced a $30 million share repurchase program. This would be equivalent to purchasing 17% of shares outstanding at today's prices. Considering the company is currently trading at an EV/EBITDA of 3.8x or a free cash flow yield of 11.5%, a buyback is very accretive to remaining shareholders. We're encouraged by management's decision – and confidence – to undertake a program of this magnitude in such an environment.

Infectious Enthusiasm

We're excited to introduce Arshan Kawasia to our team. Arshan will work with the investment team to identify new investments and monitor the existing portfolio. His enthusiasm for investing is infectious and we're excited to have him onboard.

We have also been enjoying the return to in person meetings with our investment partners as well as traveling more freely to see the companies we have invested in. Our company visits continue to give us confidence that our investment decisions will result in strong performance moving forward. We couldn't be more excited about our future prospects.

Sincerely,

Talbot Babineau, CFA
President & Chief Executive Officer
T: 416.603.4282 | tbabineau@ibvcapital.com

Disclosures:

This material was prepared exclusively for information and discussion purposes. This material is not meant to be, nor shall it be construed as, an attempt to define all terms and conditions of any transaction or to contain all information that is, or may be, material to an investor. IBV Capital Ltd. is not soliciting any investment based upon this material, and this material is not meant to, nor shall it be construed as, an offer or solicitation of an offer for the purchase or sale of any security or advisory service. If in the future any security or service is offered or sold, such offer or sale shall occur only pursuant to, and a decision to invest therein should be made solely on the basis of, a definitive disclosure document, and shall be made exclusively to qualified investors in a private offering. Any such disclosure document shall contain material information not contained herein, and shall supplement, amend and/or supersede in its entirety the information referred herein. "Intrinsic value" represents IBV Capital's internally calculated value of an investment. Intrinsic value is calculated based on, among other factors, quantitative and qualitative business analysis, industry research, and assumptions that we believe are fair and reasonable under the circumstances. This material is not meant to be, nor shall in be construed as, a representation as to past performance, and no assurance, promise, or representation can be made as to actual returns. Past performance is not indicative of future results. Certain assumptions, data and projections have been made in the analyses that resulted in return scenarios and forward-looking statements included herein. No representation is made that all such assumptions, data, or projections have been considered or stated or that any of them will materialize. Changes to the assumptions, data, or projections may have a material impact on the returns shown by way of example. Forward looking statements should not be read as a guarantee of future performance or results and will not necessarily be accurate indications of the times as, or by, which such performance or results will be achieved. Forward-looking statements are based on information available at the time the statements are made and/or good faith belief as of that time with respect to future events and are subject to risks and uncertainties that could cause actual performance or results to differ materially from those expressed in, or suggested by, the forward-looking statements. The Fund's actual results or activities or actual events or conditions could differ materially from those estimated or forecasted in forward-looking statements due to a variety of factors, some of which may be beyond the control of the Fund.