IBV CAPITAL

Q1 2022 Partnership Letter

Dear Partners,

In the last two years, we have not wavered from our rigid brand of value investing. This has had many implications. First and foremost, it has resulted in us holding a heightened amount of cash. While this cash reflects past achievements – the liquidation of our two most successful investments in FirstGroup and Ascendant Group – more recently it created a drag on our investment performance.

Usually, we would be happy to deploy available capital into other opportunities. However, the combination of uncertain underlying economic fundamentals and high valuations have made it incredibly challenging. So, instead of unnecessarily risking capital to participate in an exuberant market, we've been busy conducting due diligence on an expansive list of high-quality businesses. We anticipate that some of these businesses will become future portfolio holdings.

Our confidence that this will transpire is in part due to the marked shift in investor sentiment we have been witnessing. The unbridled exuberance of the past two years is beginning to transition to caution. This uneasiness is leading to a decline in the value of stocks and bonds and is creating a more attractive set of conditions for us to begin to invest more actively.

The root cause of the shift in market sentiment is persistent inflationary pressures. Appreciating that this ongoing price instability can become destructive to the economy, central banks have expressed a willingness to address it by purposely slowing economic growth. They'll achieve this slowdown by embarking on a quantitative tightening program that'll lead to both higher interest rates and a shrinking of their balance sheet.

We understand that the impact sustained inflation and consequently higher interest rates will have on governments, individuals, and companies will be meaningful. But how it'll affect everyone will be very diverse. Particularly if it's coupled with slower economic growth – the intended outcome of quantitative tightening. To demonstrate its impact, we have created a simple illustration using the same two coffee shops we highlighted during our Q3 2020 Partnership Letter on operating leverage.

Again, we welcome you to imagine owning a small local coffee shop chain. You have one location in your neighborhood – where you got your start – and expanded to have another one in the city. While you might do something a little different to make the best cup of joe, you're still one just one of the many coffee shops in both areas. Some shops, you begrudgingly admit, even make a cup of coffee that's just as good as yours. This brings you to an important conclusion, your customers have lots of choices.

As a result, you don't have pricing power. Meaning, when your costs go up, you can't pass those cost increases onto your customers by charging them more. You know this because when you've increased your prices in the past, you've found that your least loyal customers go next door for a cheaper cup or start making their own coffee at home.

This is precisely what's happening in the example outlined below. Your costs are increasing by 6%, but you can't increase the price of your coffee without a corresponding loss in how much coffee you sell. So, your revenues are flat. Fortunately, the cost increases you're experiencing are disproportionately impacting your variable costs. This is alleviating some of the cost pressures. For now, at least. Any dramatic increases to your fixed costs, like rent, usually take longer to surface, but they do come.

This new environment means your neighborhood coffee shop now makes 13% less. And your downtown location – with its higher fixed cost base - makes 21% less. A far worse outcome than what would have occurred in a normal inflationary environment.

	NEIGHBOURHOOD COFFEE SHOP			DOWNTOWN COFFEE SHOP		
	Pre-Inflation	**Post-Inflation**	**Change**	**Pre-Inflation**	**Post-Inflation**	**Change**
Revenues	**$250.00**	**$250.00**	**0%**	**$250.00**	**$250.00**	**0%**
Variable Expenses (eg. Coffee, Milk, Cups)	$101.00	$107.06	6%	$101.00	$107.06	6%
Fixed Expenses (eg. Rent)	$88.00	$89.76	2%	$110.00	$112.20	2%
Net Operating Income	**$61.00**	**$53.18**	**(13%)**	**$39.00**	**$30.74**	**(21%)**

Note: We have assumed rent will be 25% higher at the downtown location and both locations will experience rent increases at the previously expected inflation rate of 2%.

Unfortunately, you started your coffee shop empire by using some debt, so your situation is about to get worse. As central banks embarked on their quantitative tightening program, you've watched interest rates increase, making your debt even more expensive. If you used variable rate debt, the impact of higher rates will be immediate.

Whereas if you have fixed rate debt, you'll only experience higher rates when your debt matures, and you need to roll it over.

	NEIGHBOURHOOD COFFEE SHOP			DOWNTOWN COFFEE SHOP		
	Pre-Inflation	**Post-Inflation**	**Change**	**Pre-Inflation**	**Post-Inflation**	**Change**
Net Operating Income	**$61.00**	**$53.18**	**(13%)**	**$39.00**	**$30.74**	**(21%)**
Interest Expense	$6.00	$12.00	**100%**	$6.00	$12.00	**100%**
Earnings Before Tax	**$55.00**	**$41.18**	**(25%)**	**$33.00**	**$18.74**	**(43%)**
Debt	$200	$200		$200	$200	
Interest Rate	3%	6%		3%	6%	

Note: We have assumed you will need $200 in debt to build each location and interest rates will increase from 3% to 6%

Suddenly, the challenging operating income environment you were experiencing has become a sustained meaningful decline in profitability. Now, you're working just as hard as you did the year earlier – maybe harder – but more of your earnings are going to paying interest on your debt rather than dropping to the bottom line.

To make matters worse, when you explored the possibility of selling your coffee shops, you realized you may not get the same price as you could have a year earlier. Not only is the coffee shop making less, but the cost of capital a buyer must use to buy it has increased dramatically. The situation would only be made worse if you overpaid for the coffee shops in the first place. What we have just described is the precise scenario we've been trying to avoid being involved in for the last two years.

In 2020 and 2021, we conducted limited buying activities because we identified very early in the pandemic that many companies would eventually experience the set of external economic conditions that we just illustrated. And it would be very challenging to earn sustainable positive investment returns if we bought shares in companies at too high a price.

From our perspective, the operating challenges caused by inflation will only be exacerbated by the incredible levels of debt that governments, companies, and individuals have taken on. This dramatic increase in gearing was either forced or encouraged.

For instance, a business that was forced to shut its doors needed additional capital to survive and may have turned to debt in order to get it. Particularly if the owners had already used up all their personal savings to keep it afloat.

Healthier companies were encouraged to take on debt because low interest rates – coupled with limited financial covenants – were far too seductive a proposition to pass up on. Now that many companies are sufficiently leveraged up, the act of quickly and dramatically increasing the cost of that leverage will create both idiosyncratic and systemic risks. And while we're pleased with our ability to have accurately identified this eventual outcome two years ago, we're disheartened by the real-world consequences this will have.

We have been navigating this market by focusing our attention on businesses that can absorb inflation and higher debt financing costs. Historically, inflation is best offset by having the underlying ability to increase the prices of your product, which is easier said than done. Whereas debt costs can simply be managed by having a modest level of debt. To make one of these businesses an attractive investment to us, it must be reasonably priced too. The combination of these two factors in today's environment is a true unicorn. But we have found a few and they're in our portfolio.

We are finding others too. And as the environment gets increasingly challenging, these quality businesses are beginning to experience declines in their market values to unwarranted levels. This can happen when all assets suddenly get repriced due to a systemic event. Once these businesses reach valuation levels we find attractive, we'll deploy more of our cash hoard to capitalize on the opportunities. We have operated in this fashion since 2010 and it's resulted in us generating attractive returns while only absorbing modest levels of risk – an outcome we continue to produce.

A Global Update

The market value of our IBV Capital Global Value Fund decreased by 2.2% (net of fees) in the first quarter of 2022. While the intrinsic value of our portfolio increased by 15.6% during the quarter. For comparative purposes, during the first quarter of 2022, the MSCI World Index decreased by 5.2%.[1]

It wasn't long ago when nearly all financial assets – regardless of their underlying fundamentals – were worthy of high valuations. Considering the challenges most

[1] "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 of the MSCI World Free NR Index. Full investment disclosures can be found on Page 11.

economies have and will face, we have been skeptical of the sustainability of the environment and these valuations.

Today, market participant attitudes have changed. Once trendy investments have fallen out of favor. Since these trendy companies weren't earning profits, it'll be particularly challenging for them to return to their former glory – creating the probability that a permanent loss of capital may have occurred.

However, it is difficult to see the valuation destruction by only looking at the S&P 500 or NASDAQ. Over the last twelve months, both of these indices are up 14.0% and 7.4%, respectively. One the other hand, the Russell 2000 has experienced a decline of 6.8%. The Russell 2000 removes the impact of some of the largest constituents in the S&P 500 and NASDAQ. So, if it's down and the other two indices are up, you can deduct that in the last year many company values are down.

The reality check on valuations is being prompted by rising interest rates. This is the consequence of persistently high levels of inflation – a situation that's being exacerbated by the tragedy in Ukraine. As market participant shift from greed to fear, we're transitioning from fearful – we don't like environments with high valuations – to excited. Lately, we have used this market volatility to build bigger positions in companies we see great potential in. And, we have done this at lower and lower prices. History has shown that we have used this approach to great effect.

For instance, we have added to our investment in Brookfield DTLA's Preferred Shares. This has been a long-term holding that we anticipate seeing benefits from after 2023. However, it's been nearly forgotten by market participants today. After a decline in value over the last two years, which has created a negative drag on our performance, the positive return profile of the issue has become undeniable, so we purchased more shares.

The negative performance of this investment has been offset by positive contributions from Coats Plc (COA) and G8 Education Limited (GEM). COA is the world's largest industrial thread manufacturer. The company is based in the United Kingdom but sells its products in over 100 countries around the world. GEM is Australia's largest publicly listed early childhood education and care provider - with over 400 locations throughout the country.

During the quarter, COA demonstrated that they are capable of passing input cost increases onto customers through higher prices. We appreciated this ability of theirs long before inflation was a concern for market participants. It was evident as we began to decern how incredibly small COA's product costs represent to their customer's product cost inputs. So small that a price increase is almost unnoticeable to their customer's bottom line.

Equally important, should a COA customer feel compelled to use a competitor due to a COA price increase, switching would require a complete revamp of their entire supply chain. A time consuming and costly endeavor for such a small line item. We have assessed that this reality also makes for a stickier customer base. When we combine these elements with the continued release of new products in their development pipeline, we anticipate COA can continue to drive organic growth and shareholder value into the future.

As Australia transitions to a normalized environment, albeit slowly, the need for daycares will increase. GEM, Australia's largest publicly listed daycare provider, will benefit immensely from this development. However, until Omicron, flooding in Queensland, and other exogenous impediments subside, the company's strong underlying fundamentals will not shine through. We found that to be the case with the company's first quarter trading update. But, when that time does come, which it will, the company's intrinsic value can surface.

While GEM contributed positively to this quarter's performance, it has represented a detractor to returns in other periods. This is to be expected. When we begin building positions in companies it's often because the company is going through challenging times that they will eventually overcome. However, until they do, their share prices often remain undervalued and volatile for a while. This reality translates directly into our portfolio performance. Particularly as the addition of new investments is disproportionate to the maturing of exiting holdings.

We increased our investments in a variety of portfolio holdings during the quarter as their values oscillated. Since we used existing cash to make these investments, it had a marked improvement on our portfolio's intrinsic value. When combined with the modest decline in the market value of our portfolio, 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 83.8%.

During the quarter we also added 1 new position bringing the total number of investments we have to 13. Between this addition and our continued investments into 9 of our portfolio names, we have reduced our cash balance from 40.1% to 24.6% in the last three months.

While our current cash level slightly exceeds our long-term average of 23.7%, we remain comfortable with our conservative positioning. Particularly considering the market no longer seems supportive of the exuberant valuations we have been witnessing. The tide of euphoria was bound to recede and it's always a comforting feeling knowing that you're the one with a bathing suit on – tightly.

They Grow Up Fast

Over the last 17 months, we have built an investment position in G8 Education Limited (GEM). GEM is Australia's largest publicly listed early childhood education and care provider. The company welcomes over 54,000 children to one of their over 400 centres every week.

During the pandemic, the use of childcare centers fell significantly. Understandably, parents were fearful for their children's health and wanted to keep them home. But this is clearly a historical anomaly. As the healthcare crisis has waned and restrictions have eased, more and more parents are sending their children back to daycare.

This normalizing environment is a positive development for GEM, since occupancy levels are fundamental to the functioning of their entire operation. Higher occupancy levels lead to improved pricing power, staffing ratio optimization, and fixed cost scale benefits that translate directly into elevated operating margins and more free cash flows.

Since occupancy is so critical, it's important to appreciate that the Australian government has long provided support to improve it by making childcare available to every family that needs it. The government accomplishes this through rebates to families that come in the form of discounts to their weekly daycare fees. The magnitude of the discount is based on how many hours the child's parents work every two weeks and the family's annual income.

At GEM, we anticipate a continued transition to a more normal operating environment, along with robust federal government support, will lead to a return to stable and growing occupancy. This growth will be accelerated at GEM due to the benefits of their four-year capital expenditure program that has seen many of their centers receiving a refresh. A newer looking daycare is one of the characteristics parents seek out when choosing where to send their children.

There is also a concerted effort to divest 31 non-strategic centers, down from the 52 centers originally announced, to boost operational efficiency and profitability. This divestment program is in line with their renewed focus on the efficient use of their capital. We highlighted a shift in their capital allocation methods as a material upside opportunity to the company's intrinsic value. Specifically, returning capital to shareholders in the form of a fully franked dividend (a tax advantaged dividend for local investors) and thoughtfully executed share repurchase program.

On the latter, we shared detailed thoughts with management and the board about their ability to conduct a meaningful share buyback while simultaneously distributing a fully franked dividend. Our stance was supported by our assessment that GEM's free cash flow would increase meaningfully during the coming years as occupancy increased and their expansive capital expenditure program to refresh centers fell to normalized levels.

When we couple these operational tailwinds with a valuation at historical lows and a balance sheet that has very little debt, it is clear that conducting a buyback will unlock tremendous value over time. To the company's credit, they have recognized the merits of this advice and proceeded with a buyback program – purchasing about 10% of shares traded each day since the program's inception. Overall, we're very pleased with GEM's future prospects.

Another investment that has enjoyed tailwinds is Vertu Motors Plc (VTU). We first encountered VTU five years ago after studying the North American automotive retail market. At the time, most United Kingdom peers had a valuation well below their American peers, despite having many of the same strong underlying fundamentals.

After assessing all the United Kingdom automotive retail companies, we invested in VTU. We appreciated the management team's endless pursuit of efficiencies and balance sheet conservatism. While we thought highly of the management team then, incredibly, they have only improved over time.

Prior to the pandemic, VTU underwent a shift in priorities from aggressively using equity issuances to support dealership growth to cherishing the value of equity. This pivot was made after recognizing that the latter approach would lead to higher earnings per share and an increased probability they could generate outsized returns for shareholders over time.

They're now more focused on capital allocation than ever before. Today, they balance the need to grow the business through acquisition – which they have opportunistically done in the last two years – with efficiently returning capital to shareholders through a dividend and tactical share repurchase program. We're really encouraged at how the management team has added another arrow to their quiver of shareholder value enhancement.

Currently, the benefit of this capital allocation approach is being temporarily aided by the supply demand imbalance most automotive retailers are experiencing. With car manufacturers unable to deliver new cars to satisfy demand, due to supply chain constraints, used cars are selling at a rapid pace. This is giving pricing power to automotive retailers – like VTU – and boosting their margins.

While we recognize that equilibrium will eventually return, when supply chains normalize, there are few signs that this will happen immediately. Until it does, VTU will continue to enjoy outsized margins as a result of a robust used car sales market. We're confident VTU's management team will use this profit windfall to further strengthen the company's fortress balance sheet while opportunistically looking to expand their chain of dealerships.

New York New York

Over the last few years our travel has been more limited than we would have liked it to be. Particularly international travel. This is changing as we have a few trips abroad planned for the coming months.

In June, we will be meeting with the management teams of a few portfolio companies in New York. After getting to know these teams virtually, we're looking forward to meeting them in person so we can learn more about their businesses while also sharing our thoughts on how value can be created for all shareholders.

Sincerely,

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