

HOROS

ASSET
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QUARTERLY NEWSLETTER
TO OUR CO-INVESTORS

OCTOBER 2018

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Dear co-investor,

This month, we continue with the series of quarterly communications started last July ([read letter](#)). If in the last letter we devoted an extensive part to explaining what it is for us to be a *value* investor, on this occasion we would like to delve deeper into the concept of a "safety margin" and, more specifically, into two situations that substantially increase it: convexity and optionality.

In addition, we will review the most noteworthy movements in the portfolios of the products we manage and what we can expect from them in the coming years.

Finally, I would like to thank you, as always, for placing your trust in this management team and in the Horos Asset Management project. You can count on us working to meet your expectations and I would like to take this opportunity to remind you that the entire Horos team is fully at your disposal for anything you need.

Yours sincerely,



Javier Ruiz, CFA
Chief Investment Officer
Horos Asset Management

He who doesn't take a risk doesn't win?

A margin of safety is achieved when shares are purchased at prices sufficiently below underlying value to allow for human error, bad luck, or extreme volatility in a complex, unpredictable and rapidly changing world

- Seth Klarman

One of the basic principles taught in the portfolio management modules of almost every finance school is that, to maximize the return on our investments, we need to assume greater risk. Without going into assessing the risk measures that are commonly used - we could devote several paragraphs to explaining why volatility, beta or any other statistical measure related to the evolution of a stock are not adequate measures - this assumption tends to be deeply rooted in most investors, whether they are industry professionals or individuals. If we think about it for a moment, it intuitively makes all the sense in the world. How is it going to be possible to achieve significant returns while taking little risk? He who doesn't take a risk doesn't win, right? However, at least in the world of investment, the reality is very different: **taking risks is the best recipe for squandering our savings.**

Make no mistake, it is practically impossible to find investments in which we are not assuming some type of risk or uncertainty. Nevertheless, it is possible to strive to maximise returns, by minimising the risk of *permanent* loss of capital. The essence of value investing is precisely that: to look for investments that provide a sufficient **margin of safety**, which covers us from possible errors of analysis or unpredictable risks. The margin of safety is a concept "stolen" from other academic disciplines, such as engineering. In fact, the engineers of ancient Rome had already learned the virtue of building bridges with a high margin of safety. When the scaffolds were removed, the engineer had to remain under the bridge, so he had a clear interest in the architecture being strong enough to cover himself from the potential permanent loss (taken to the extreme in this case) or errors/risks not initially contemplated.

On rare occasions, we will find situations in which this margin of safety can be qualitatively broadened by improving the risk-return ratio mentioned above. To be precise, I would like to focus the content of this letter on two of these attractive situations: **convexity** and **optionality**.

The smile of convexity

Convexity propositions should be embraced – concave ones, avoided like the plague

— Nassim N. Taleb

Convexity is a mathematical concept popularised by Nassim N. Taleb in his highly recommended book "Antifragile". Without going into all the complicated details, Taleb argues that we have to look for situations, both in investment and in any facet of our lives, in which there is convexity or, more specifically, situations in which a little suffering can generate important and incremental benefits. Without being very purist, we have simplified this idea, trying to look for investments in which the **risk of loss is very limited and the expected profit is very significant**. Obviously, these types of investments are not easy to find, but when we find them, it is clear that we have to bet strongly on them.

This has been the case with our exposure to **uranium**. Since the launch of our Horos Value Internacional fund (and its approximate replica Horos Internacional Pensiones), we have been invested in this sector through the Canadian company **Cameco**, one of the largest uranium producers in the world and licensed to exploit some of the industry's largest and best assets. As with all other raw materials, to invest in companies in this sector it is necessary to understand its capital cycle, that is, to analyse the supply and demand situation of the industry and what we can expect in the future. In this way, we will be able to get an idea of what the price of raw material should do in the following years.

This analysis led us to the conclusion that the future demand for uranium is more positive than one might expect a priori, given the negative sentiment towards this type of energy, especially after the Fukushima accident. The emerging economies, led by China and India, need nuclear power to meet future needs, a fruit of their rapid growth and economic development, so they have a significant number of nuclear reactors under construction and a larger number of reactors planned for the coming years. In addition, Japan is reactivating nuclear reactors that have managed to adapt to the new regulatory requirements.

In terms of supply, after years of expansion, as a result of Kazakhstan's entry into the market or the opening of Cigar Lake by Cameco, the market entered an "anomalous" situation, in which mining companies did not reduce their production, despite the fact that the price of uranium did not cease to fall due to the slowdown in demand after Fukushima and the entry of new supply. The reason for this can be

found in the long-term contracts that the mining companies signed with the utilities demanding uranium, at prices much higher than the spot price. Once these contracts near their end, mining companies have seen that the situation is not sustainable and have initiated a series of very significant production cuts. Cameco itself has indefinitely stopped production of McArthur River, the world's largest high-grade mine, waiting for the price to return to more attractive levels.

In this incipient environment of supply restriction, utilities have not yet felt the urgency of signing long-term contracts again. However, as the excess inventories in the market are consumed, the supply will have to be guaranteed again for the following years, which should significantly push up the price of uranium. For all these reasons, we decided to invest in Cameco, one of the companies in the sector with the best financial profile and cash generation capacity, first-class management team and trading at very attractive prices, with conservative future assumptions for the price of uranium. However, at the beginning of July we reconsidered this position, after "discovering" another form of investment in this mineral with a much more limited risk of loss and, depending on one's future assumptions, even greater potential. We are talking about **Uranium Participation Corporation (UPC)** and **Yellow Cake**, two companies that act as a vehicle for direct investment in uranium, with the aim of storing the holdings and selling them in the future at higher prices.

The interesting thing about these two companies is that they very significantly limit the risk of loss compared to our previous investment in Cameco. On the one hand, Cameco already discounted on its market value part of the expected recovery for the price of uranium in our selling price. On the other hand, both UPC and Yellow Cake have a very controlled cost structure (corporate overhead and management), so that a significant delay in the uranium price increase has a much smaller impact than in the case of a company that has to assume the operational costs (and risks) of operating the mines. In short, these are **two investments that increase the convexity of our international portfolio, without giving up the appreciation potential**. For this reason, we increased our exposure to uranium to almost **8% of the fund**, compared to approximately 3% at Cameco.

The value of optionality

Optionality is a substitute for intelligence

— Nassim N. Taleb

The other great ally of the margin of safety for an investment—also widely popularised by Nassim Taleb—is optionality. In essence, we are talking about situations in which the share price is so attractive to the investor that he gets a “free” series of options that can further increase his appreciation potential. The interest in these situations stems from—as with convexity (given that they are closely related concepts)—the possibility of increasing the potential profitability of the fund, assuming very little risk of loss.

One of the clearest examples we have in our portfolio would be **Keck Seng Investments**, a company based in Hong Kong and specialised in the real estate sector, especially in the acquisition and management of hotels. The company has two hotel assets in the United States, the New York Sofitel and the W San Francisco, whose theoretical value is approximately 20% *greater* than the market cap of Keck Seng at the time of writing. In addition, the company owns hotel assets in Canada, Japan and Vietnam. The combined value of these assets could be somewhat lower than that of hotels in the United States, but also higher than the market cap of Keck Seng. Therefore, by investing in Keck Seng we would be acquiring two quality hotels in the United States at a discount and we would take the rest of the group's hotel assets for free, whose value could bring an additional 100% of potential to the stock. An investment with very limited risk, thanks to the assets in the United States, and very attractive profitability, thanks to the rest of hotel's assets. So far, what we are describing is a position of **convexity**, similar to the one we commented on a moment ago.

So, where's the **optionality**? In Macao. The company has residential assets valued at the acquisition cost of fifteen years ago, while the current market price is twenty-five times higher. We are not specialists in the Macao real estate market, but we are convinced that the market value of these assets is much higher than the value recorded on their balance sheet. The good news is that, without knowing how much these assets may be worth in the future, all that we gain will be without assuming any risk and, at market prices, their contribution to the valuation would be even higher than that of hotels in the United States.

In short, we are talking about a company whose U.S. hotel assets could already justify investing in it, in which we would take the rest of the group's hotel assets for “free” (convexity) and with the option of substantially increasing the expected

return on the investment, without increasing the risk, thanks to the Macao residential assets. **This attractive combination of convexity and convexity has led us to place Keck Seng Investment as one of the main positions in our international portfolio.**

Current Affairs

This quarter we have participated in different events with the purpose of publicising our investment philosophy. As we always like to emphasise, it is very important that you understand how we invest so that you understand what you can expect from our funds as a co-investor. For this reason, in July we collaborated with the Complutense University of Madrid in the Summer Course "Active management of equity: investment methodologies that lead to better results (theory and practice)" organised by the fund management company azValor and in which we explained our investment methodology ([watch video](#)). In addition, in September we had the opportunity to give a company valuation class at Value School, in which we explained our valuation of Tencent Holdings, of which we are shareholders through Naspers ([watch video](#)).

On the other hand, we continue to add content to our YouTube channel ([watch channel](#)), with interviews that we have been carrying out for different media, as well as our investment thesis in some of the companies that we have in our portfolio. Specifically, our manager Miguel Rodríguez has posted a video in which he talks about our investment in the Portuguese company Ibersol ([watch video](#)). In the future, we will be adding new content that we hope will be of added value.

Finally, it fills us with joy to see that the Horos family continues to grow, after a five-month journey. We already have more than 1,500 co-investors and manage nearly 38 million euros. Thank you all for your trust. I would also like to thank Juanjo Ferrer for his contribution during these months to the Horos project. We wish him the best of luck in his future, both professionally and personally.

Horos Value Iberia

The fund can invest up to 20% in holdings listed in Portugal and at least 80% in holdings listed in Spain. In addition, it can invest up to 10% in Spanish or Portuguese companies listed on other markets.

Horos Value Iberia returned -4.6% in the fourth quarter, compared to its benchmark index, which returned -2.0%. Since its inception on 21 May to 30 September, the fund's cumulative return has been -2.3%. In the same period, its benchmark performance was -5.2%. The results obtained in such a short period of time are merely anecdotal and should be considered as such.

In this period, the holding that has contributed most positively is **Ercros**. The company, which produces chlorine derivatives, continues to benefit from its position in a sector that is still suffering from the crisis in recent years, which has led to capacity closures. In addition, it continues to benefit due to regulatory requirements in production processes, which have forced a change from mercury technology to membrane technology that not all players in the industry have been able to implement.

As for losses, three companies really stand out: **OHL**, **Sonae Capital** and **Renta Corporación**. While in the latter two we have not found any reason to justify their poor performance, with OHL, the investment thesis has significantly deteriorated. On the one side, the company announced in the publication of second quarter results (unexpected) losses of 77 million euros, due to additional costs linked to one of the legacy projects (problematic projects from years ago) that are still pending completion. On the other hand, though already in October, OHL sold its Mayakoba assets for 88 million euros when their book value was around 150 million euros. Obviously, we are not at all satisfied with the evolution of the holding, nor with the losses connected with this investment so far. Although we have not increased the weight with the drops and the margin of safety (potential) has been reduced very significantly we believe that the price at which the stock is trading disregards an excessively negative scenario. That's why we're still invested in the company.

The fund's portfolio had two new entries in the quarter (Meliá Hoteles, which we will discuss later, and Elecnor) and no departures.

Elecnor is a company that has been managed and controlled (52% of shareholders) by ten families for sixty years. The business is focused on two lines. On the one hand, project and infrastructure engineering and, on the other, the operation of wind farms and electricity transmission concessions. Elecnor has one of the most highly valued teams in its sector, both by customers and by the competition itself. It seems to us that the current valuation of the company does not include the quality of its assets (electricity transmission concessions in Chile, for example, are non-replicable), nor does it include a model based on maximising the profitability of projects without incurring debt in order to grow.

At the end of the quarter, **the fund's theoretical potential for the next three years was around 52%**, equivalent to an annualised return of 14.9%. For the calculation of this potential, we performed an individual study of each security that makes up the portfolio. These theoretical returns are no guarantee that the fund will perform well over the next three years, but they do give an idea of how attractive the current time is for investing in Horos Value Iberia.

Portfolio Structure

At the end of December, Horos Value Iberia's portfolio is made up of 27 holdings and is concentrated in two relevant blocks. One block, almost **61%** of the invested part of the portfolio is made up of companies that we have known for years, managed by **families with an important presence in the shareholding** (which guarantees an alignment of interests with their shareholders) and with prices that are still attractive in a market that is increasingly difficult to invest in.

The second block (**17%**) is made up of **companies that have been forgotten** or even "hated" by the investment community, because they have historically been unfulfilling for shareholders, but that are very attractive to invest in today.

Horos Value Iberia also invests in **Horos Value Internacional (5.6%)**. In this way, the potential of the Iberian fund is increased, elevating the quality of the portfolio and generating greater value for our co-investors in the long-term. Of course, NO commission will be charged on that percentage invested in the house funds.

Lastly, the **cash position** of the fund at the end of the quarter stood at **11%**.

Main Positions

Sonae Capital (6.2%, family-owned) is a Portuguese investment vehicle managed by the Azevedo family, which owns real estate assets and operates in the tourism, energy and industrial sectors. The company seeks to invest in Portuguese niche companies that may have an export potential. We believe that the value for the sum of parts of the different businesses is substantially higher than Sonae's current market cap.

Meliá Hoteles (6.2%, family-owned): hotel group with a presence in more than 40 countries, of which the Escarrer family controls 52% and has been a shareholder for more than 60 years. The company is the leading hotel chain in Latin America and the Caribbean and is the largest global player in resorts and bleisure (a combination of business and leisure). Meliá's objective is to migrate to an asset-light business model, which focusses on the management of hotels without owning them. Currently, hotel management accounts for nearly 30% of EBITDA and they expect to reach 50% in seven years. The interesting thing about this investment lies in the valuation of its hotel assets, (much higher than its current market capitalisation, which allows us to take the hotel management business "for free") and what this business can contribute to the company in the future.

Renta Corporación (6.1%, forgotten): the company, focussed on acquiring real estate assets for transformation and sale, has gone through a restructuring process, both financial and business (they use options to purchase the properties to be reformed), which avoids the risks to the balance sheet that are typical of this industry. In addition, it has recently reached an agreement with the Dutch pension fund APG to manage its SOCIMI specialised in residential assets. This SOCIMI has the goal of reaching 1,500 million euros in assets and Renta Corporación, in addition to owning 3% of the SOCIMI, charges a 1.5% fee for its management. Finally, it should be noted that we are working hand in hand with a professional and highly experienced management team, which has been able to reinvent its business toward a model of high returns on capital employed.

OHL (5.4%, forgotten): already mentioned.

Talgo (4.8%, family-owned): a company specialising in the design, manufacture, technological development and maintenance of rolling stock, especially high and very high-speed trains and passenger cars. Talgo outsources the less critical parts of manufacturing its vehicles, which means that it has fewer investment needs and increases its cash generation capacity. Investors are penalising the absence of new orders signed by the company, which undermines the current future outlook.

However, maintenance contracts cover a large part of the current value of the company, so the scenario discounted by the market seems to us to be excessively negative.

Horos Value Internacional/ Horos Int. PP

Our international portfolio can invest without geographical restrictions in most of the world's stock exchanges, including the Iberian market. Therefore, Horos Value International and Horos International PP are the products that count on the best investment ideas that this management team finds currently available.

Horos Value Internacional returned -3.4% in the quarter, compared to its benchmark index, which returned 4.8%. Since its inception on the 21st May until the 30th September, the fund's cumulative return has been -3.6%. In the same period, its benchmark performance was 3.2%. In the case of Horos Internacional PP, the return has been -4.3%. The difference between the fund and the plan comes from the fact that the plan started its investment process days later. The results obtained in such a short period of time are merely anecdotal and should be considered as such.

In this period, the holdings that have contributed the most to the fund's portfolio are **Uranium Participation Corporation** (UPC), **Yellow Cake** and **Enscor**, all of which benefited from the significant appreciation of uranium and oil in the period.

On the negative side, **OHL** and **IWG** are notable. In the case of OHL, the investment thesis has significantly deteriorated. On the one side, the company announced in the publication of second quarter results (unexpected) losses of 77 million euros, due to additional costs linked to one of the legacy projects (problematic projects from years ago) that are still pending completion. On the other hand, though already in October, OHL sold its Mayakoba assets for 88 million euros when their book value was around 150 million euros. Obviously, we are not at all satisfied with the evolution of the holding, nor with the losses connected with this investment so far. Although we have not increased the weight with the drops and the margin of safety (potential) has been reduced very significantly we believe

that the price at which the share is trading disregards an excessively negative scenario. That's why we're still invested in the company.

IWG, for its part, has presented a poor stock market evolution following the rejection by Mark Dixon, CEO and main shareholder, of all the takeover bids received by the company in recent months. Our investment thesis, with or without a takeover bid, remains the same. Although the competitive environment is becoming tougher and tougher for the shared workspace business, with the emergence of new players like WeWork, we think that as the new centres mature, we will see the company's true capacity for cash generation. In addition, we fail to understand how WeWork was valued in the last transaction at a price almost fifteen times higher than the capitalisation of IWG, when WeWork does not generate a single euro of cash.

The international portfolio had three significant entries (UPC, Yellow Cake and Meliá Hoteles) and three departures (Cameco, Pershing Square Holdings and Técnicas Reunidas) in the period.

UPC and **Yellow Cake** are two investment vehicles that buy and store uranium for later sale. Given our positive outlook for uranium prices and the limited cost structure of these vehicles, we have decided to invest close to 8% of the portfolio in both companies and liquidate our investment in **Cameco**. Although the Canadian uranium mining group continues to enjoy significant appreciation potential, we believe the risk-return binomial is more attractive with UPC and Yellow Cake at this time.

Meliá Hoteles is a hotel group with a presence in more than 40 countries, of which the Escarrer family controls 52% and has been a shareholder for more than 60 years. The company is the leading hotel chain in Latin America and the Caribbean and is the largest global player in resorts and bleisure (a combination of business and leisure). Meliá's objective is to migrate to an asset-light business model, which focusses on the management of hotels without owning them. Currently, hotel management accounts for nearly 30% of EBITDA and they expect to reach 50% in seven years. The interesting thing about this investment lies in the valuation of its hotel assets, (much higher than its current market capitalisation, which allows us to take the hotel management business "for free") and what this business can contribute to the company in the future.

The departures of **Pershing Square** and **Técnicas Reunidas** are down to having found other more attractive investment opportunities, such as the ones we have just detailed.

At the end of the quarter, **the *theoretical* potential of the international strategy for the next three years was around 102%**, equivalent to an annualised return of 26.4%. For the calculation of this potential, we performed an individual study of each holding that makes up the portfolio. These theoretical returns are no guarantee that the fund will perform well over the next three years, but they do give an idea of how attractive the current time is for investing in Horos Value International and Horos International PP.

Portfolio Structure

The portfolio has 34 holdings and four blocks that account for the bulk of it. The main one is made up of **companies linked to raw materials (22%)**, especially uranium and stainless steel. Another important block is the one that includes **forgotten emerging stocks (18%)** or stocks scarcely followed by the investment community, mainly from Asia. Investment in **technology platforms (12%)** with powerful network effects that are still trading at very attractive prices and in UK companies **(12%)**, impacted by the Brexit, are the other two important investment blocks.

Lastly, the **cash position** of the portfolio at the end of the quarter stood at **8%**.

Main Positions

Keck Seng Investments (5.0%, forgotten emerging company): is a Hong Kong family company founded in the early 1940s by the Ho family, owner of 75% of the vehicle, so its interests are aligned with those of its shareholders. The holding company specialises in the ownership and management of hotels in the United States, China, Japan, Vietnam and Canada. Keck Seng also has an important residential portfolio in Macao that we hope will benefit from the upcoming opening of the bridge that connects Hong Kong with this city. The poor liquidity of the share or the fact that the assets are valued at acquisition cost on the balance sheet have contributed to a market inefficiency, which in our opinion is unjustified.

Zeal Network (4.3%, others): this is a company specialising in the online lottery business, with the bulk of the business in the German market. Following the 2008 ban on online advertising in that market, Zeal Network converted into a secondary lottery operator in the UK. Since January 2015, the German regulator has insisted the company must pay VAT on the sale of electronically provided services (such as lottery) in Germany, which has placed the valuation of the company at very depressed levels, which more than accounts for the worst possible scenario for the holding.

Aercap Holdings (4.2%, others): one of the world's leading aircraft leasing companies. This is a business with a high recurring revenues and good future prospects, given the expected growth in aircraft production and demand for the coming years, mainly derived from the needs of developed economies and the expected growth of emerging economies. Although this is a business with significant financial leverage, we believe that the stability of the revenue streams generated by the business, as well as the correct capital allocation in recent years, acquiring ILFC at very attractive prices in 2013 or repurchasing shares at a significant discount, justify investing in a company that achieves historical ROEs of 12% and is trading today with a discount on its book value and at less than 10x earnings.

Uranium Participation Corporation (4.2%, raw materials): Already discussed.

Asia Standard International (3.9%, forgotten emerging company): is a Hong Kong investment and property development group that invests in prime areas of Hong Kong as well as major cities in China. More specifically, Asia Standard focusses on real estate development, rentals, hotels and travel, as well as financial instruments related to this activity. The bulk of the ownership is controlled by the Poon family, thus, like Keck Seng, the management team is fully aligned with its shareholders. Being invested in by other companies traded by the Poon family, in addition to an accounting valuation of the assets at acquisition cost far removed from reality led to an extraordinary undervaluation of this stock.