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QUARTERLY LETTER TO OUR CO-INVESTORS

OCTOBER 2021

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Dear co-investor,

The positive stock market performance that began at the end of 2020 continued during the third quarter. This period was characterized by a strong rebound in inflation, as a result of major bottlenecks that have emerged in various industries. Our portfolios are prepared for an inflationary environment such as the current one and benefited from it. Horos Value Internacional gained 3.5% over the quarter and is up 33.6% in 2021, compared to 1.2% and 17.3%, respectively, in its benchmark index. Horos Value Iberia gained 1.7% over the quarter and is up 20.4% for the year, beating the gains of 1.4% and 11.3%, respectively, of its benchmark. Since inception of the Horos funds (May 21, 2018), Horos Value Internacional has returned 17.0% and Horos Value Iberia 4.9%. Since 2012, the international portfolio has returned 186%, while the Iberian portfolio 163%, compared to returns of 204% and 69% in their benchmark indices, respectively.[1]

However, this quarter also saw the Chinese real estate sector begin a potential downturn, after years of strong growth in volumes and prices. Given the relevance of the Chinese economy in our portfolio (both directly and indirectly), I will devote this letter to explain the important regulatory changes announced by its government recently, how they fit into its economic growth model, what the current situation of the real estate sector is and how all of this impacts our investments.

Thank you for your confidence.

Yours sincerely,

Javier Ruiz, CFA
Chief Investment Officer
Horos Asset Management

[1] The data includes the performance of the portfolio management team in its previous professional period (May/September 2012 to May 21, 2018).
Past performance is not a guarantee of future performance.

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Executive summary

I think they (the Chinese) will continue to allow people to make money. They've learned it works.
— Charlie Munger

This has been a very active year in terms of regulatory interventionism in China, which has led to growing concerns among the global investment community. Such uncertainty has been exacerbated by the difficult situation of the giant property developer **Evergrande** and the domino effect it is triggering in the real estate sector. What is the reason behind this increased regulation? How does it fit into the Chinese economic model? What is going on with **Evergrande**? Will its potential fall spill over to the rest of the sector? This commentary aims to give our humble answer to these tough questions in order to elucidate the potential impact that all this may have on our investments in the Asian country.

In addition, we will discuss the most significant changes that we have made to our portfolios. Among others, we can highlight that at Horos Value Internacional we exited our positions in **Ercros** and **Infotel**. On the other hand, we initiated four new stakes in the quarter. Specifically, we invested in the oil and energy services company **TGS**, the Cambodian casino operator **NagaCorp**, the metallurgical coal company **Ramaco Resources** and the cannabis producer **Millennium Investment and Acquisition**. At Horos Value Iberia, we added the retail group **DIA** and the renewable energy company **Greenalia**, while we sold **Ercros**.

The ant that challenged the dragon

Never laugh at live dragons, Bilbo you fool!
— Bilbo Baggins ("The Hobbit")

At the end of 2020, Ant Group, a Chinese payment and financial services company, was scheduled to make its stock market debut and become the largest IPO in history. This IPO was to be the culmination of the successful business career of Jack Ma, founder of the e-commerce giant **Alibaba Group** ("Alibaba") and main shareholder, together with **Alibaba** itself, of Ant Group. However, everything went awry on October 24 of that year, when Ma delivered a speech at the Shanghai Bund Summit, a high-profile event with a global reach. At the event, the entrepreneur spoke about why the Chinese banking sector should evolve by taking advantage of advances in technology and big data, and how Ant Group would play an important role in this development. He also launched several criticisms of the Chinese banking sector and regulator, calling them "outdated" and even "inexperienced."[2] Thus, a direct attack on the Chinese Communist Party and its top representative, Xi Jinping.

The consequences of this bold speech? Within days, the Chinese regulator changed the rules of the game in the credit market, requiring drastic changes in Ant Group's business model and thus forcing it to postpone its IPO.[3] In turn, **Alibaba** began to be investigated for possible monopolistic practices and, to add more mystery to the matter, Jack Ma was summoned to Beijing to be questioned on certain regulatory issues, disappearing for several months from public life, which contributed (and still contributes) to fuel all kinds of rumors.[4] From Ma's speech to the stock price bottom several months later, **Alibaba** saw around $400 billion of its market value evaporate after correcting more than 50%.

However, the Chinese government's interventions did not end there. Since then, almost every week there has been reports of a new regulatory measure announced for different sectors in the Asian giant. Surely, one of the most talked-about moves was the order given to the **after-school tutoring industry** at the end of July, urging its companies to cease part of their activities and become non-profit organizations. The news unleashed, unsurprisingly, a virulent wave of selling in the

[2] Xu, Kevin (November 9, 2020): Jack Ma's Bund Summit Speech. *Interconnected*.
[3] Canales, Katie (December 28, 2020): China has ordered Ant Group to overhaul its goliath financial business and 'return to its payment origins'. *Business Insider*.
[4] Calhoun, George (June 24, 2021): What Really Happened to Jack Ma? *Forbes*; Cotizalia (October 20, 2021): ¿Desafío o reconciliación con Pekín? Jack Ma está en Mallorca y Alibaba se dispara en bolsa. *El Confidencial*.

shares of these entities, leading to a 70% crash in just two days for some players in the sector.[5]

Other measures announced have focused on curbing the business of the country's **technology giants**. For example, we could highlight the prohibition of exclusivity arrangements imposed by technology platforms on their merchants, preventing them from dealing with their competitors; the implementation of labor improvements for delivery platforms' employees; the prohibition of holding exclusive rights to music licenses; restrictions on minors in the use of (and spending on) video games; and greater regulation of the protection and use of personal data.[6] In short, a series of regulatory changes that will have an impact—to a greater or lesser extent—on companies in this sector, which has already led to a significant decline in their market value. Thus, **Alibaba**'s sharp correction was joined by those of other platforms, such as **Tencent Holdings** (c. -40% from highs), **Tencent Music** (c. -70%), **Baidu** (c. -55%), **Meituan** (c. -50%) and **DiDi Global** (c. -50%), to name a few.

More recently, the Chinese government also hinted at greater control over Macau's casino business, contributing to companies such as **Wynn Macau** or **Sands China** losing close to 30% of their market value in a single session.[7] Additionally, at the end of September, it informed 25 **financial institutions** of its intention to conduct a disciplinary inspection, to ensure that they are not deviating from Party guidelines, that the financial needs of the Chinese people are being taken into account and that the business is managed with a tight control of systemic financial risk.[8]

In total, from November last year to mid-October, **108 regulatory actions in 22 different sectors** have been recorded.[9] Certainly, it is very difficult to announce more measures in a shorter period of time. In case anyone is wondering, Xi Jinping's interventionist impulse does not seem to be slowing down any time soon. In fact, the new five-year plan, announced by his government last August, sets out very clear lines of greater interventionism for the coming years.[10] But why this (apparent) change of direction in a country which, in some respects, seemed even

[5] Webb, Quentin and Koh Ping, Chong (July 26, 2021): China cracks down on after-school tutoring sector, sending shares sinking. *The Wall Street Journal*.
[6] If you want to dig deeper, I recommend the latest quarterly letters from Hayden Capital and RV Capital.
[7] elEconomista.es (September 15, 2021): Consternación en Macao: China sube la apuesta regulatoria y los casinos pierden 18.000 millones de dólares. *El Economista*.
[8] Xinhua (September 27, 2021): China's anti-graft chief stresses disciplinary inspection of financial institutions. *China Daily*.
[9] The Daily Shot (October 14, 2021).
[10] Hoskins, Peter (August 12, 2021): China says crackdown on business to go on for years. *BBC News*.

more capitalist than the United States itself? Does China want to return to its communist origins? Does Xi Jinping want to become a new Mao, as some predict?[11]

Towards a new paradigm?

No matter if it is a white cat or a black cat; as long as it can catch mice, it is a good cat.
— Deng Xiaoping

China is a country that always stirs up a lot of controversy because of the way it operates at all levels. Obviously, the array of interventionist measures I have just summarized has generated a lot of debate in various academic circles, including the investment world. In particular, I would like to highlight the opinion of two macro investment legends, precisely because their views are diametrically opposed in this regard. I am referring to **George Soros** and **Ray Dalio**.

Soros has been very vocal in taking a stand against Xi Jinping's regime. Specifically, after **BlackRock**—the world's largest asset manager—announced an agreement whereby it became the first foreign entity authorized to market its financial products in China and that it had also decided to allocate a significant part of its portfolios to the Chinese stock market, the Hungarian investor wrote a harsh opinion article in the prestigious newspaper The Wall Street Journal, arguing why this entity was wrong to bet so decisively on China.[12] Soros believes that **Xi Jinping will use all Chinese companies, both state-owned and private, to perpetuate himself in power** and will not hesitate to despise and exploit foreign investors, if necessary. Moreover, in the same article, he criticized **BlackRock**'s massive injection of money into the country, at a time when the United States and China are competing, more than ever, to impose two opposing systems of government.

Interestingly, in response to the accusations made by Soros in the Wall Street Journal, the Chinese government was quick to label Soros, through the state-owned newspaper Global Times, as a "global economic terrorist", the "most evil person in the world" and even the "son of Satan."[13] However, in case there were any doubts about his position, Soros has proved his words with actions. Earlier this month, **Dawn Fitzpatrick**, CEO and Chief Investment Officer of Soros Fund

[11] Wei, Lingling (September 20, 2021): Xi Jinping Aims to Rein In Chinese Capitalism, Hew to Mao's Socialist Vision. *The Wall Street Journal*.
[12] Soros, George (September 6, 2021): BlackRock's China Blunder. *The Wall Street Journal*.
[13] Pao, Jeff (September 8, 2021): Chinese state media label George Soros a 'terrorist'. *Asia Times*.

Management, confirmed in a recommended interview for Bloomberg Invest Global that they had nothing invested in China and considered it risky to do so.[14]

At first glance, it is hard to argue against Soros in everything he argues. However, as we said before, there is another great investor with a different opinion. Ray Dalio, in an article published on the LinkedIn social network last July, lamented that the Western view of what is happening in China is quite incomplete, generally because it only pays attention to the headline (for example, intervention in the education sector) and misses or ignores the motivation (reducing the skyrocketing cost of education) and the ultimate objective sought with the measure (facilitating access to education for the population). Dalio also says that, if one looks at China's trajectory over the last decades, it is clear that the government has supported a "**rapid and continuous development of the capital market, entrepreneurship and openness to foreign investors.**"[15]

Also, in an interview for Bloomberg Markets and Finance, Dalio noted that by many metrics, such as the corporate tax rate, China was more capitalistic than the United States and that China would not pursue an economic model "as left-leaning" as Europe's by any stretch of the imagination.[16] In short, Dalio believes that **the Chinese government seeks to increase the country's wealth under a capitalist model, but always redirecting and redistributing that wealth among the population**. Therefore, under his vision, Dalio concludes that every investor should have part of his portfolio in the Asian country's equity market.

It is certainly impressive how, faced with the same reality, two such respected and experienced investors come to such antagonistic conclusions.[17] The moral we can draw from this polarity is that whether or not we invest in China, we should not ignore what is happening there, as it will end up having an impact on us in one way or another. That said, being as we are investors in listed companies in the Hong Kong market, some with the bulk or all their business in mainland China, it is appropriate that we give our view on what is going on, how it is affecting our positions and how we always approach investing in this market.

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[14] Parmar, Hema and Burton, Katherine (October 5, 2021): Soros's Fitzpatrick Says Firm Not Putting Money Into China. *Bloomberg*.
[15] Dalio, Ray (July 31, 2021): Understanding China's Recent Moves in Its Capital Markets. *LinkedIn*.
[16] Bloomberg Markets and Finance (September 21, 2021): *Ray Dalio on Evergrande, China, Bitcoin and the Fed*. YouTube. https://www.youtube.com/watch?v=MPNTRJxbq_w
[17] Some prominent investors, such as Kyle Bass (Hayman Capital), criticize Dalio for having a clear conflict of interest, as China is one of the main investors in Bridgewater Associates, of which Dalio is Founder and Co-Chairman. HedgeEye (October 6, 2021): *Kyle Bass: "China Is The Enemy → Wall Street Firms Are Too Entwined With The CCP" (Investing Summit)*. YouTube. https://www.youtube.com/watch?v=9Rsu-TbEm6k

Techno-socialism or the central planning dream

Over the past 100 years, we have come to believe that the market economy is the best system ... the planned economy will become increasingly big ... with access to all kinds of data, we may be able to find the invisible hand of the market.
— Jack Ma

If we had to choose one of the two visions I have outlined in the previous section, it would probably be Ray Dalio's, if only for the sake of consistency, as we have a significant weighting of our international portfolio in companies listed on the Hong Kong Stock Exchange. However, our conception of the Chinese economic model and its objectives is, in general, very similar to that described by the U.S. investor.

The fact that China is a country under the control of the government at ALL levels (as Soros criticized) is a reality. As it is also true that its development is based, to a large extent, on a more capitalist model than that of any other country, as Dalio defends. This duality has generally been called **state capitalism**. But how exactly does a system in which the yin and yang of economic models coexist work? To explain it, I will rely on the excellent book *El gran sueño de China* (**The great dream of China**) by Claudio F. González, recently published in Spanish.[18] The author draws on his experience of several years working in China's most prestigious institutions, as well as in several research, innovation and entrepreneurship centers.

In particular, González argues that there are three models of economic development or, more specifically, of technological progress and social welfare. On the one hand, there is the **United States model**. Under this system, technological progress comes, in general, from private initiative (think of how the U.S. technological giants were established or the shale gas and shale oil revolutions) and, subsequently, trial and error mechanisms will lead economic agents to adopt the technology that contributes most to their social welfare. In this final process, regulation will try to protect, in theory, the consumer's interests, maximizing the technological progress-social welfare binomial.[19]

[18] González, Claudio. F. (2021): *El gran sueño de China. Tecno-socialismo y capitalismo de Estado* (The great dream of China. Techno-Socialism and state capitalism). Tecnos.
[19] There is some debate about the role of the state in technological innovation. Possibly, the Italian economist Mariana Mazzucato has been one of the greatest advocates of the idea that all technological advances come from state research programs [Mazzucato, Mariana (2015): The Entrepreneurial State (Revised edition). Perseus]. As a counterpoint to this idea, I recommend the report "El Estado emprendedor. ¿Realmente es el Estado el impulsor de la investigación básica y la innovación?" by Instituto Juan de Mariana (August 2016).

Europe's model, on the other hand, is much more interventionist from the outset, advocating strong regulation to set the rules of the game once a technology, generally from private initiative, begins to emerge. Obviously, the (naïve) dream of European leaders is to reach the same point of technological development and social welfare as the United States, but reality is often very stubborn.

Finally, the **Chinese model** seeks to improve both systems in the following way. At an early stage, private and public initiative go hand in hand, to levels inconceivable in Western societies. Local governments support companies *as necessary* (always under the objectives set from the top levels of government), fostering a competition that, under our prism, would be illegal and unfair.[20] This system of state capitalism allows, in theory, higher levels of development and technological progress to be achieved, and certainly faster than the models of Europe and the United States, although with lower levels of social welfare. As a result of this approach, technological giants have emerged in recent years that dominate and permeate all areas of Chinese society. However, the Chinese government does not want to stop here, since this technological progress is worthless if it does not translate into greater social welfare, or what the Chinese Communist Party understands as such. We would enter here in the field of (futuristic) social engineering or **techno-socialism.**[21]

Specifically, the Chinese government seeks, through the restriction of freedoms and the common sacrifice of the society, to achieve a point of progress and social welfare superior to that of the United States and European models. Indeed, this has been tried before—and not very successfully—in China itself and in other tragic cases of central planning.[22] Moreover, economists belonging to the Austrian School of Economics, such as **Ludwig von Mises**, **Friedrich von Hayek** or **Jesús Huerta de Soto**, to cite some of its greatest exponents, have already explained at a theoretical level why the central planning (and economic calculation) of a society, or Socialism, is impossible.[23] Oversimplifying, the knowledge of society is (infinitely?) dispersed among the economic agents, so that it can *only* be organized through a spontaneous process that uses prices (profits) as a signaling mechanism of their decisions, facilitating progress and greater social welfare. Therefore, no

[20] To learn more about this "wild" entrepreneurial ecosystem, I recommend reading the quarterly letter we published in January 2020 (see here). Also, of course: Lee, Kai-Fu (2018): *AI-Superpowers: China, Silicon Valley and the New World Order*. Boston: Houghton Mifflin Harcourt.
[21] González, Claudio. F. (2021): *idem*.
[22] On the Chinese case, I recommend Dikötter, Frank (2011): *Mao's Great Famine: The History of China's Most Devastating Catastrophe, 1958-1962*. Bloomsbury.
[23] Mises, Ludwig H. E. von (1920): *Economic Calculation in the Socialist Commonwealth*; Hayek, Friedrich A. von (1948): *Individualism and economic order*. University of Chicago Press; Huerta de Soto, Jesús (2010): *Socialism, economic calculation and entrepreneurship*. Edward Elgar Publishing.

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central authority will ever be able to organize society better, since it lacks all the knowledge that exists which, moreover, evolves continuously and dynamically.

> *No human mind can comprehend all the knowledge which guides the actions of society.*[24]

However, one cannot help but wonder whether, with the development of artificial intelligence and the exponential rise of Big Data, we could be moving closer—as Jack Ma announced in the epigraph of this section—to the point where central planning can reach its ideal. Consider that in China EVERYTHING is done using mobile phones, which means that **the Chinese government, through the corporations, controls all the data on citizens' behavior**. What do they read? What do they write? What do they consume? How do they feel? It has access to virtually everything that goes on in their minds. And, based on this information (and its interests), it adjusts its policies as reflected in the regulatory measures mentioned at the beginning of this letter and its ultimate goal of achieving "**common prosperity.**"[25]

We do not know whether China (and other countries) will achieve this (perverse) goal of maximizing social welfare and progress over other models, at the cost of subordinating the individual to society. What we do know is that the road may not be the rosy one that on paper one might have in mind. Therefore, to conclude this review of the Chinese government's decisions and the goals of its economic system, we should also deal with the current situation of the Chinese real estate sector, given what has been happening recently with some companies in the sector and, in particular, with the real estate developer **Evergrande Group** ("Evergrande").

A dragon without fire?

If you want to conquer the world, you best have dragons.
— Young Griff ("A Dance with Dragons. A Song of Ice and Fire")

To understand how the situation of the Chinese real estate sector has become so fragile, it is necessary to briefly explain the evolution of the country's economic growth model. In the early years of the 21st century, Chinese growth was focused on the **export of goods** driven by a highly competitive export industry. These goods

[24] Hayek, Friedrich A. von (1960): *The Constitution of Liberty*. University of Chicago Press.
[25] Hass, Ryan (September 9, 2021): Assessing China's "common prosperity" campaign. *Brookings*.

were bought by Western countries, especially the United States, supported by a continuous increase in private debt. However, with the collapse of the global expansion of private credit in 2007 and the Great Recession of the following years, China found that demand for the products it exported was no longer as solid as before, leading it to shift its growth model to avoid an economic slowdown. Specifically, China encouraged a greater contribution from **domestic demand** (spending), supported (of course!) by the increase in private debt, which grew up to 220% of GDP, doubling the levels of the years prior to 2008.[26] Where was this increased spending and debt concentrated on? Yes, the real estate sector.

But how important has this boost to the Chinese real estate sector been? Is there a big bubble about to burst? Indeed, it is tempting to jump to quick conclusions if we recall the now classic images of ghost cities or videos of the simultaneous demolition of several skyscrapers. However, before venturing in this direction, it is worth reviewing the indicators and ratios that are often used to try to elucidate whether or not there is a real estate bubble in China.

Let us start with the share of the sector in the country's Gross Domestic Product (GDP), as this can give us clues as to the extent to which China's productive resources are being diverted towards this industry. Well, it has grown so much in the last decade that it is estimated to contribute **close to 30% of China's GDP**, slightly exceeding the levels reached in Spain—and by far those of Ireland or the United States—at the height of its real estate bubble.[27]

Another very relevant indicator is the affordability ratio. This is the ratio of the average price of housing to the earnings of the average Chinese citizen, which is used to estimate the years it would take to pay for the property. Certainly, the Chinese real estate sector does not fare very well in this case either. Both in aggregate terms, and looking at the country's main cities, it would take Chinese citizens more years to fully pay the purchase of a home than in other countries and/or cities of reference. Specifically, although it is difficult to compare homogeneous figures and these are data to take with a grain of salt, **it would take more than 40 years to pay the full price of housing** in Shenzhen and Beijing and more than 30 in Shanghai and Guangzhou. These are metrics close to the special case of Hong Kong (46 years) and much higher than those of Paris (20 years), Tokyo (14 years) or London (13 years).[28]

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[26] Juan Ramón Rallo (September 19, 2021): *¿Qué está pasando en China con Evergrande?* YouTube. https://www.youtube.com/watch?v=oJiTVjq62bw
[27] Batarags, Lina (October 1, 2021): The Evergrande crisis: 4 questions that explain why China's property market, which is twice as big as America's and where 20% of homes are empty, matters. *Business Insider*; Fernández, Daniel (September 27, 2021): Caso Evergrande: ¿hay burbuja inmobiliaria en China? *UFM Market Trends*.
[28] J.P. Morgan Asset Management Guide to China (2021).

Therefore, we find ourselves with an economy that is heavily concentrated on the housing sector, even though prices seem hardly affordable for the average buyer. Regardless, Chinese citizens have been buying homes all these years. In fact, China has one of the highest levels of **home ownership** in the world (over 80% in the urban stock) and of people owning more than one home (over 20%).[29] What are the reasons behind this paradox? On the one hand, state programs to support homeownership during the years of slow and progressive privatization of part of the public housing stock (in the 1990s, homeownership was not allowed), granting subsidies, forcing people to have a housing savings account and granting mortgages at low interest rates, among others. On the other hand, public schools generally accept as students only children from families who own homes near the school. In addition, there are still cultural factors that should not be ignored, such as the fulfillment of a Taoist life goal when buying a house or the prerequisite for marriage (given that there are several tens of millions more men than women in China, it is clear who has the upper hand). Finally, cases of fraud and the relative underdevelopment of the Chinese stock market may also explain the purchase of housing as an investment alternative.[30] In fact, it is estimated that housing accounts, on average, for more than 60% of a Chinese family's assets, compared to 23% in the United States, just over 35% in Japan or 50% in the United Kingdom.[31]

Obviously, all these factors are of no use if Chinese families cannot afford these homes. Hence, the counterpart to the high relative prices has been a very significant increase in **household debt** in China. Specifically, household debt already accounts for more than 60% of the country's GDP, whereas it was around 35% at the beginning of 2015. Although the rising trend persists, the figure is still below the current 75-80% of developed economies. However, the figure for the debt of Chinese households is even more alarming if we compare it with their personal disposable income. In this case, we are talking about c. 130% at the end of 2020, a historical record and a figure that is similar to the levels reached in the United States and Spain during their real estate bubbles in 2007-2009.[32]
Consequently, without going into whether we can describe the situation of the Chinese real estate sector as a bubble, we can conclude that, under various metrics, the current price levels seem unlikely to be sustainable. But how long can this high price environment last? And, more importantly, what is the Chinese government's attitude in this area?

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[29] Huang, Youqin. He, Shenjing and Gan, Li (January 2021): Introduction to SI: Homeownership and housing divide in China. *Cities. Volume 108* (102967).
[30] Sun, Li (April 2020): Housing Affordability in Chinese Cities. *Lincoln Institute of Land Policy*. Working Paper WP20LS1.
[31] Goldman Sachs Global Investment Research (2021).
[32] Huifeng, He (August 7, 2021): Could China's rising household debt threaten Beijing's consumer-led growth vision? *South China Morning Post*.

The thin red lines

There's only a thin red line between the sane and the mad.
— Old Midwestern saying ("The Thin Red Line").

As mentioned above, China's economic model seeks to maximize the welfare of society through central planning. To achieve this utopian goal, it faces two closely related vicious circles that grow worse as the years go by: negative **demographic trends** and growing **social inequality**.

In addition to the housing affordability issue we have just seen, families are also faced with the extremely high cost of providing for their children's education. In China, all the incentives lead to a rise in the cost of education. On the one hand, we have already mentioned that, in order to access school, one requirement is to own a house near the school, which raises the prices (and, therefore, the cost of education) of the properties closest to the most sought-after institutions. On the other hand, access to university is limited to those students who successfully pass the **Gaokao** (higher education entrance exam), marking their destiny with this single test.[33] This makes high school students spend more than 12 hours a day preparing for that exam, relying on all the resources they can get their hands on. This is where the after-school tutoring companies we mentioned at the beginning of this letter come into play, benefiting from this inelastic demand for their services by charging prices that are practically unaffordable for the average Chinese family.

This is undoubtedly one of the reasons behind China's negative demographic trend—even though it already lifted the ban on having more than one child per family—and its growing economic inequality. To alleviate the situation and avoid potential growing discontent among the population, the government took the regulatory measures we have highlighted, in addition to others aimed at cooling the real estate sector, in a difficult balancing act to avoid a price collapse. Thus, after years stimulating the housing sector, in 2017 Xi Jinping began to show signs of concern about the rise in prices, transactions and debt in the real estate sector. Interestingly, he stressed at the 19th National Congress of the Communist Party of China that **"housing is for living in, not for speculation."**[34] Subsequently, measures were taken to tighten the cost and granting of mortgages.[35] However, the most

[33] Ash, Alec (October 12, 2016): Is China's gaokao the world's toughest school exam? *The Guardian.*
[34] Xinhuanet.com (November 3, 2017): Full text of Xi Jinping's report at 19th CPC National Congress. *Xinhua Net*.
[35] Reuters Staff (July 24, 2021): PBOC asks Shanghai lenders to raise mortgage loan rates. *Reuters*.

resounding announcement was certainly the progressive implementation, from the launch of the draft in August 2020, of the so-called **three red lines.**[36]

These lines are three limits to be complied with by the country's real estate developers. First, liabilities cannot account for more than 70% of assets. Second, net debt cannot exceed equity. Finally, the third limit is that available cash must exceed short-term debt. Depending on the number of limits complied with, the developer will be able to increase its debt up to an annual maximum of 15%, if the three red lines are respected. Obviously, developers who do not comply with any of the limits will be prohibited from increasing their debt, and this is precisely where a potential perfect storm has begun.

Chinese developers, like those in the rest of the world, support their growth with high financial leverage. In the case of China, the companies have taken this idea as far as conceivable, even borrowing from their builders and service providers (through promissory notes) or from their own employees (through wealth management products, or WMPs). At the same time, they have managed to get homebuyers to pay the bulk of the cost in the pre-sales of the development, years before construction is even completed. In short, developers get a very large inflow of cash at the start of their real estate projects, thanks to their indebtedness and favorable working capital, which allows them to repeat the process over and over again, increasing their profits each year and their stock market value.[37] It goes on and on, until the wheel stops and the debt becomes unsustainable. What can lead to this outcome? A decline in the cash inflows.

This contraction can occur for two reasons: a lower value of pre-sales and/or the impossibility of increasing debt to cover the company's needs (operational and financial). The first reason depends on the number of homes sold and, of course, their price. If fewer homes are sold and/or their price falls, the income from presales will fall. The second depends on the developer's access to funding. Both ultimately depend on the ability and willingness of all involved to continue to do business as usual. Well, **the announcement of the three red lines was the stick that stopped the wheel turning, or at least slowed it down**.

[36] Bloomberg (October 18, 2020): China's three red lines for home developers. *The Straits Times*.
[37] Arteaga, Jacobo. BrightGate Capital (September 23, 2021): Crónica de una crisis: cómo se han gestado las grandes inmobiliarias chinas. *FundsPeople*.

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Evergrande or how the virtuous circle becomes vicious

The nail that sticks out is the first to get hammered down.
— Chinese proverb.

If there is one Chinese company that has sparked concerns in the investment community in recent years, it is undoubtedly **Evergrande**. The developer has been the largest player in the Chinese real estate sector in terms of revenue for several years, which is a clear sign of the scale that this company has reached. Its founder and chairman, **Xu Jiayin**, is one of the country's most high-profile people. He has even occupied the throne of China's richest person, as well as received the *China Charity Award* eight times due to his large donations.[38] To achieve these achievements, Xu based the development and growth of **Evergrande**'s business on the debt model mentioned above and, in addition, he knew how to take advantage of the perverse incentives with which the rulers of the provincial capitals operated, rewarded with rapid promotions if they achieved greater economic growth (and revenue) for their city. Although this factor was surely taken advantage of by the bulk of the sector, Xu was particularly well connected with the Party elite. In fact, there are documents that could prove that **Wen Jiabao** (former Premier of China) became the second largest shareholder of the development company.[39]

> *All I have and all that Evergrande Group has achieved were endowed by the party, the state and the whole society.*[40]

Let us look at some figures to help us understand **Evergrande**'s scale and current situation. On the one hand, the company saw its sales multiply by around 11 times between 2010 and 2020 up to close to $79 billion. On the other, this surge in revenue also translated into earnings, which reached over $10 billion in 2018. As his real estate business grew, Xu decided to diversify the company, in a classic megalomaniac impulse, and launched or invested in businesses as diverse as electric vehicles, bottled water or a soccer team. For years **Evergrande** seemed like a colossus of relentless growth. However, the announcement of the three red lines by the Chinese government changed everything.

As we have already explained, strong growth in the Chinese real estate sector has always been accompanied by higher debt, and **Evergrande** has been no exception.

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[38] Asianometry (September 20, 2021): *The Rise and Fall of China's Evergrande Group*. YouTube. https://www.youtube.com/watch?v=3GgE_Uzpofo
[39] Stevenson, Alexandra; Forsythe, Michael and Li, Cao (September 28, 2021): China and Evergrande Ascended Together. Now One is About to Fall. *The New York Times*.
[40] *Idem*.

At the end of the first half of 2021, the developer's financial debt was around US$90 billion. A dizzying figure, but one that compares with a (hypothetical) value of its real estate assets of around $225 billion. However, these two figures show a very different reality for the company if analyzed in a little more detail, and especially if we consider that **Evergrande** did not initially comply with any of the three red lines imposed by the government, which prevented it from increasing its debt. **When your business relies on growing debt and debt slows down, the apparent virtuous circle becomes a vicious one that is difficult to escape**.

One of the first problems comes from the company's debt maturity structure: more than a third of the debt (about $38 billion) matures in less than a year. What are the implications? Basically, that **Evergrande** has to refinance its debt every year to keep the current business running, unless it can generate that cash or has it available on its balance sheet. Given that it has less than $14 billion in cash, the company needs about $25 billion to meet the maturity of this short-term debt. Where could this cash flow come from? Excluding other alternatives that we will discuss later, from selling properties. As we have said, **Evergrande** owns real estate assets valued at $225 billion, well in excess of its liquidity needs. However, the bulk of these assets are projects under development. The company has only 10% of its real estate assets completed and ready for sale, with a book value of just over $23 billion. This figure is nevertheless close to the $25 billion it would need to refinance, assuming that **Evergrande** is not forced to sell the assets at a significant discount. Therefore, the situation does not seem to be as dramatic as the crash in the share price (over 80% YTD at the time of writing) or the financial panic it has triggered in the country would suggest.

Why this fear? Because we have not considered the company's total debt in our simple analysis above. The developer faces **short-term liabilities** (ex-financial debt) of nearly $210 billion in 2021. Here is another problem, much more relevant than the previous one: where is it going to get the cash to meet these liabilities maturing in less than a year? One option would be to increase the financial debt and kick the can down the road again. However, since the announcement of failing to comply with the three red lines, bank funding began to dry up for **Evergrande**. Thus, at the end of June, several banks decided to reduce funding to the entity because of its credit risk.[41] Subsequently, several Hong Kong banks (such as HSBC) decided not to grant mortgages to homebuyers in projects still under development by **Evergrande**.[42] Consequently, without this option, the developer had no choice but to look for other alternatives, although it has not been very successful. Specifically,

[41] Bloomberg (June 22, 2021): Several Chinese banks reduce Evergrande funding on debt risk. *The Business Times*.
[42] Reuters (July 21, 2021): Some Hong Kong banks decline mortgages for Evergrande's off-plan projects. *The Business Times*.

it has put up for sale some of the businesses in which it invested in recent years, such as the electric vehicle manufacturing subsidiary (**China Evergrande New Energy Group**) or the mineral water company (with a failed IPO), among others. It has also announced the sale of its stake in the Chinese bank **Shengjing Bank** for 1.5 billion dollars, unsuccessfully tried to sell its headquarters for 1.7 billion dollars and part of its stake in **Evergrande Property Services** (a real estate services subsidiary) for 2.6 billion dollars to the developer **Hopson Development Holdings**.[43] [44]

In short, these figures are tiny compared to the company's financial needs and do not reduce its liquidity risk at all. In fact, in mid-September, **Evergrande** hired legal advisors to "explore all available solutions" for its fragile situation and initiated, at the end of that same month, a series of coupon defaults on its offshore debt—the one in the hands of its foreign creditors. In the end, **maturity mismatch** (short term funding for long term investment) **as a business model always becomes unsustainable and Evergrande is another proof of this.** Now, what is happening with the rest of the Chinese real estate sector, is there a real contagion, and how is the government reacting to this earthquake?

An unstoppable domino effect?

Overall, the risk of the spillover to the financial industry is controllable.
— Zou Lan (People's Bank of China).

As expected, the contagion to the rest of the sector is very real. On the one hand, the loss of confidence, both on the part of buyers and their lenders, has led to a slump in the volume of homes sold in the country (some developers have reported drops in their sales of between 20 and 30 percent).[45] On the other hand, this effect is aggravated by the fear of a bankruptcy and/or restructuring in **Evergrande** that would force this entity to liquidate its huge stock (however, **Evergrande** recently reported a 90% drop in its sales for the month of September), offering large discounts in its sales prices and, therefore, forcing its competitors to also make discounts to be able to compete against this strong selling wave.[46]

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[43] Tan, Weizhen (October 4, 2021): Indebted Evergrande set to raise more cash from partial sale of its property services unit. *CNBC*.
[44] Bloomberg News (October 20, 2021): China Evergrande Ends Talks on Hopson Deal, Asks to Resume Trading. *Bloomberg*.
[45] Yifan Xie, Stella; Yu, Elaine and Bao, Anniek (October 12, 2021): China Home Sales Are Falling Sharply. *The Wall Street Journal*.
[46] Cheng, Evelyn (October 20, 2021): China Evergrande shares briefly plunge more than 10%, after $2.6 billion asset sale falls through. *CNBC*.

If this scenario materializes, other developers will also see their liquidity risk increase, as they will have less cash to be able to meet their immediate debt commitments. At the same time, financial institutions aware of this potential scenario may anticipate and reduce their credit risk with the entities with the greatest liquidity problems, which feeds back into the forced discounting of sales prices in the sector, **becoming a self-fulfilling prophecy and triggering a severe housing deflation**.

Based on the performance of Chinese real estate equities and debt, we can certainly conclude that this potential scenario is beginning to be priced in as a reality. The case of **Sinic Holdings** is an extreme example. On September 20, the real estate company's share price plummeted nearly 90% without any apparent news to justify it. Since that day its shares have not traded and in mid-October, like other companies in the sector the previous days, it announced missing bond payments that had just matured. Therefore, as the days go by, more pieces continue to fall in the Chinese real estate domino and if nothing (nobody) prevents it, the contagion will continue.

For this reason, the entire investment community is watching the statements and actions of the Chinese government with bated breath. For now, the **Central Bank of China** has made several liquidity injections in the financial sector as a firewall and, after several weeks without making any statement, on October 15 Zou Lan (director of the financial markets department of the Central Bank of China) issued a statement in which he assured that "China Evergrande Group's problems in the real estate industry are an individual phenomenon" and that "most real estate businesses are operating stably and have good financial indicators".[47]

Obviously, these statements are hard to believe given what is happening in the sector, both at the market level as well as in terms of debt defaults. Therefore, it is most likely a strategy on the part of the Chinese government. They have taken weeks to make some kind of statement and all they say is that everything is going well. But what strategy is this? Precisely the one they have been following for the last four years: trying to cool down their real estate sector to make it more affordable for the Chinese population and to seek a greater redistribution of wealth ("common prosperity"). It does not appear that bailing out **Evergrande** or other entities with taxpayer money fits within this objective. That said, they cannot afford a disorderly collapse either, since, first, there are many citizens who have bought unfinished homes or directly financed these developers and, second, this would create a massive hole in the country's banking sector. Therefore, we can

[47] Cheng, Evelyn (October 15, 2021): China's central bank says Evergrande is unique and most real estate developers are stable. *CNBC*.

venture to think that a selective bailout is most likely, focusing first on Chinese citizens and creditors, while leaving foreign creditors and shareholders of these entities in second place (to their fate?).

As a corollary to this detailed commentary on the current situation in China, we do not know whether the Chinese real estate sector and the country's economy will experience an outcome similar or close to that of such bubbles in the United States or Spain. Nor can we anticipate the moves that the Chinese government will make, although we can have an opinion on the most likely scenarios. What is clear to us is that we will not invest in companies whose business is severely affected by this difficult environment and whose liquidity (financial) risks are unaffordable. In our opinion, all our investments meet these criteria, which does not mean, of course, that some of them will not be affected. Furthermore, we have had to adjust their expected upside potential and our position sizing, as discussed in the next section.

Main changes to our portfolios

Since no one has privileged access to the future, forecasting the market is a waste of time.
— Bill Miller.

The following is a summary of the most significant changes to our funds' portfolios:

HOROS VALUE INTERNACIONAL
Stake decreases & exits:

HONG KONG (21.8%)
Holdings discussed: Kaisa Prosperity (4.6%) and Asia Standard International (2.6%)

As we have just seen, the current state of the Chinese real estate market is quite worrying, so we have reviewed the potential impact of this deterioration on our companies' businesses, adjusting our valuations in those companies where appropriate. I proceed to highlight the two most paradigmatic cases.

First, one of the companies that may be most affected in our portfolio is **Kaisa Prosperity**. The real estate services company depends, in part, on new housing starts in China, so a standstill in developments and sales of finished homes will

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negatively affect the high sales growth expected by the company. **Kaisa Prosperity** is also c. 68% owned by **Kaisa Group Holdings** ("Kaisa Group"), the developer group to which it belonged until its IPO. Although less dependent than in the past, part of the expected future growth and about 47% of its current revenues are related to its parent company. While it is true that **Kaisa Group** is one of the developers that did comply with the three red lines set by the government, it is also true that the bond market discounts a significant and growing liquidity risk. As an example of this, the company recently announced a large debt issuance in which it had to use its entire stake in **Kaisa Prosperity** as collateral.

Against this looming scenario for **Kaisa Prosperity**, we find a company that maintains a high net cash position of 45% of its market value. Additionally, if we assume the worst-case scenario for its parent **Kaisa Group**, in which **Kaisa Prosperity** does not collect the portion of receivables (net of payables) linked to its services to **Kaisa Group** and no longer receives income from the services provided to the parent's unsold properties (pre-delivery and consulting services), the company would generate 270 million Hong Kong dollars, with an adjusted net cash of c. 1.15 billion. Therefore, with a current market capitalization of 2.9 billion, we would be paying less than 6.5x its free cash flow in a very negative scenario and would get all future growth for "free." Although we do not rule anything out and prefer to err on the side of conservatism, we do think that these prices represent a great investment opportunity. That is why we maintain the company among our fund's top holdings.

Another company that is clearly being affected is **Asia Standard International** ("Asia Standard"). As a reminder, the company is a Hong Kong real estate investment and development group that invests in prime areas of Hong Kong as well as major cities in China. More specifically, **Asia Standard** focuses on real estate development, rentals, hotels and travel, as well as invests in financial instruments related to this activity. It is precisely in the latter area where the company may be most impacted by the current Chinese real estate turmoil.[48]

Asia Standard has, according to the latest information reported in July this year, financial investments with a market value of c. 14 billion Hong Kong dollars, almost all of this portfolio being debt of Chinese real estate developers. Of the 14 billion, we know that at least c. 56% (8.27 billion) was made up of debt issued by the developers **Evergrande**, **Scenery Journey** (a subsidiary of **Evergrande**), **Kaisa Group** and Guandong Pearl River Investment ("Pearl River"). Therefore, at least 33% of these financial investments are concentrated in **Evergrande** debt and this is where

[48] I recommend the video of our portfolio manager Alejandro, in which he explains in more detail the potential impact of Evergrande on Asia Standard International (see here).

the greatest risk of its portfolio is today. Regarding the rest of the issuers, we have already commented on the case of **Kaisa Group** and, as for Pearl River, we would point out that it is a company controlled by the Chu family (owners of 71% of the **Hopson Development Holdings**) that, it would seem, have the capacity to support the company financially if the case arises.[49]

In any case, if we perform a stress test with an unlikely scenario where not only **Evergrande**'s debt default, but **Asia Standard**'s total financial investments, how would it impact our valuation? As a quick summary, **Asia Standard** owns 82.7% of **Asia Standard Hotel Group**, which we value at c. 3.5 billion ex financial investments and debt. It also owns office and retail properties which we value at c. 4.3 billion and, finally, properties under development, JVs and associates which we estimate could be worth around 9.5 billion. In total, around 17.3 billion, from which net debt of c. 14.2 billion should be subtracted, for a NAV (excluding financial investments) of 3.1 billion Hong Kong dollars. Therefore, if we assume that the 14 billion in financial investments is worth nothing, the company would be worth 160% more than its current market value—and we are very conservative with the yields we apply to its real estate assets.

As we have explained many times, **Asia Standard International**'s valuation has an extraordinary margin of safety and the biggest problem we have always seen is the paralysis of its management team when it comes to unlocking its value.

In conclusion, we believe that the high margin of safety that we always require for our investments protects us, also in this market, from a highly unlikely negative scenario.

COMMODITIES (22.8%)

Holdings discussed: Teekay Corp. (4.4%), Teekay LNG (2.1%), Warrior Met Coal (1.4%) and Ercros (exited)

Although released in October, it is worth starting by commenting on a very relevant piece of news for **Teekay Corp.** and its subsidiary **Teekay LNG**. Specifically, on October 4, the acquisition of **Teekay LNG** by Stonepeak (an alternative investment manager specializing in real assets and infrastructure) was announced, including in the transaction the 36 million shares of **Teekay LNG** controlled by **Teekay Corp.** and 100% of the *General Partner* (Teekay GP), which includes another 1.6 million shares. The offered price was $17 per share in cash (excluding subsequent distributions), representing a premium of 8.3% over the previous closing price.

[49] FitchRatings (June 20, 2021): Fitch Rates Hopson Development's Proposed USD Senior Notes 'B+'. *Fitch.*

How do we value this deal? As shareholders of **Teekay LNG**, we have sold our position, since, although the price was below what we believe the company is worth, it allows us to use that cash in other investment alternatives that are currently much more attractive and which we will discuss later. As shareholders of **Teekay Corp.** however, the transaction has been very negative for our interests, as it has significantly reduced the upside potential of this holding company, in which we have been invested for several years. In summary, although it will continue to hold a c. 29% stake in **Teekay Tankers**, the entity becomes a typical cash box, where its net cash will account for around 90% of its market value. This provides a clear valuation floor, but also creates uncertainty for us about the future of **Teekay Corp.** Will they distribute the cash as a dividend? Will they buy back their own shares at their current discount? Will they invest in other businesses? Of course, we prefer the share buyback option because it is the one that helps to create direct shareholder value at these prices, but we will have to monitor and analyze the decisions that the management team will make in the future.

In addition, we trimmed our stake in the U.S. company **Warrior Met Coal** ("Warrior"), following its excellent recent performance. The metallurgical coal producer, which is necessary to produce steel in blast furnaces, benefited during the quarter from the sharp rise in the price of this commodity. Specifically, the price of **Warrior**'s metallurgical coal, referenced to Australia's Premium Low-Vol FOB Hard Coking Coal, rose by 100% in the quarter and is up 300% from the lows of the beginning of the year, when it was trading at around 100 dollars per tonne. The reason for the huge price increase can be found in the bottleneck that this industry is experiencing, due to a few factors. On the one hand, the recovery of economic activity after the worst of the pandemic ended and the extra boost given by the huge fiscal and monetary stimuli from governments globally and, on the other hand, the lack of investment in new supply in recent years due to the hangover from previous overcapacity, the poor situation of some players in the industry and, especially, the political and social agenda against climate change.

This rise in the price of metallurgical coal has seen **Warrior**'s share price appreciate by more than 70% from last summer's lows, contributing significantly to our fund's performance. However, the downside of the story is that **Warrior** has had the bulk of its employees on strike since April, which means that the company is not producing at one of its two mines and the other is not at 100% capacity, so it is not benefiting from the current positive dynamics like other players in the industry. In fact, we will talk later about **Ramaco Resources** ("Ramaco"), another company in the sector in which we invested and which has fully benefited from the current bottleneck.

Finally, it is worth mentioning the exit of our investment in the Spanish chemical company **Ercros**. This was purely due to its good performance and the consequent decline in its upside potential.

OTHER
2.0% of the fund
Holding discussed: Infotel (exited)

This quarter we also sold our stake in the French consulting firm **Infotel**, following its strong returns.

Stake increases & new stakes:

COMMODITIES (22.8%)
Holdings discussed: TGS (2.1%) and Ramaco Resources (1.2%)

We added **TGS**, the oil and energy services company, to our portfolio. This is the fourth time we have invested in this company in our professional career, always taking advantage of the most negative moments to invest in it and obtaining significant capital gains. **TGS** has been providing geological, geophysical and engineering data to companies for four decades to facilitate investment and operating decisions in oil and gas fields. Unlike other competitors, **TGS** does not own the vessels and machinery needed to analyze these fields, which allows it to operate its business with no capital employed. This is a very important factor, because in times of capital constraint in the industry, **TGS** continues to generate cash. This allows the company to get through the low phase of the cycle without major issues and to take advantage of potential investment and growth opportunities as they arise.

The oil industry has been significantly underinvesting in new supply for several years, especially in deep water, after experiencing a period of low prices due to the U.S. shale oil revolution (among other factors) and as this industry clashes with the political agenda against climate change. Although we believe that the situation is unsustainable and that significant increases in supply will be needed to meet future oil demand, we do not know when that tipping point may come. Therefore, investing in a player like **TGS**, with a solid financial position, a management team that makes the right decisions and has historically created value for its shareholders, as well as the ability to generate cash in any environment, gives us the opportunity to benefit from the sector recovery without the risks inherent in a delay of the investment thesis of companies with higher financial and operating leverage.

As mentioned above, we also initiated a position in **Ramaco**. The decision to invest in this U.S. metallurgical coal producer stems from our positive outlook for this commodity, given its supply and demand dynamics—which we have already explained in the past because of our **Warrior** investment. The company is in a phase of expansion of its production capacity, which could lead it to produce more than 4 million tons per year, compared to the current c. 2.5 million. It concentrates part of its production on customers in the United States, where its mines are located. Finally, unlike most listed coal mining companies, the Board and management team control more than 75% of the shares, so they are fully aligned with the rest of the shareholders. Although the upside is now much lower, following the rally that **Ramaco** had since investing at the beginning of the quarter, we believe that it is still attractive in the current market context.

OTHER

2.0% of the fund
Holdings discussed: NagaCorp (1.9%) and Millennium Investment and Acquisition (0.1%)

NagaCorp is an integrated entertainment resort (casino and hotel) in Cambodia and listed on the Hong Kong Stock Exchange. As an anecdote, we have known about the company for more than three years now, when we met in Madrid with the then Investor Relations to introduce the company to us. At that time we dismissed the idea because of the regulatory uncertainty that threatened **NagaCorp**. However, the situation has changed radically, as our colleague Gabriel Castro, fund manager at Singular Bank, kindly pointed out to us. Specifically, the Cambodian government has approved a draft that will be effective next year, reaffirming the company's monopoly license (until 2045) and a tax law that consolidates the company's cost advantage over other South Asian casinos. This greater certainty has encouraged us to invest now, taking advantage of the share price crash due to the pandemic.

Founded by Dr. Chen in 1995 as a casino on a boat moored on the Mekong River, **NagaCorp** launched its first land-based casino (Naga 1) in 2003, going public three years later. It was the first company to go public in Cambodia and the first, also, gaming-related company to be listed in Hong Kong. Several years later, in 2017, **NagaCorp** launched the Naga 2 complex. Between the two assets, the company operates a combined area of 222 square kilometers, integrated into a resort with around 1,660 rooms. Naga 1 and Naga 2 enabled **NagaCorp** to generate normalized free cash flow of about 600 million US dollars in 2019, the year before the pandemic. Also, driven by the strong outlook for tourism in Cambodia and the necessary increase in accommodation capacity in the country, **NagaCorp** has two expansion projects in Cambodia. Specifically, the company is developing Naga 3 and Angkor Lake of Wonder.

Naga 3 is a complex that will provide 545 square kilometers and 3,500 additional rooms to NagaWorld (the brand under which the three "Nagas" are grouped). The investment required for its development is 3.5 billion dollars and it is expected to be completed in 2025. On the other hand, its final size is flexible and will be adjusted according to the company's financial situation and the prospects of Cambodia's economy and tourism. The Angkor project is a non-gaming resort, which would include a water park in Siem Reap, two 700-room hotels, a canal system for boats, a China Town and an interactive technological theme park. In this case, the investment required for its construction is 350 million dollars. This complex would benefit and strengthen the flow of tourists traveling to Phnom Penh and Siem Reap. Although the intention was also to finish it in 2025, UNESCO has blocked the project because of its proximity to the famous Angkor Wat. The company is working with all parties to accommodate the requirements necessary to move forward. Finally, **NagaCorp** has a third expansion project in Vladivostok. It is a casino that will operate in this Russian port city near China. The project has been postponed several times due to problems related to the construction company and is expected to open next year.

As for the management team, Dr. Chen, founder and CEO of the company, owns more than 65% of the shares. In addition, given **NagaCorp**'s difficulty in borrowing at attractive rates, Dr. Chen has a commitment to finance 50% of Naga 3 (1.75 billion dollars) through a capital increase at 12 HKD per share (today trading at around 7), which will increase his control of the company to 73%. Thus, a very real alignment of interest with the rest of the company's shareholders.

Finally, despite the clear risks inherent in a country like Cambodia and highly dependent on China, we believe that we are buying **NagaCorp** with a very high margin of safety. For example, assuming none of the three expansion projects are developed, the company would trade at around 6x normalized free cash flow (pre-pandemic level).

The other company we added this quarter is **Millennium Investment and Acquisition** ("Millennium"). This is an investment idea coming from **Power REIT**, a holding in our portfolio. As a reminder, **Power REIT** is primarily engaged in the purchase of greenhouses which it then leases to cannabis producers, earning high returns by taking advantage of the difficulty these companies still have in obtaining funding through the traditional mechanisms. Well, one of the latest producers to join **Power REIT**'s list of clients is, precisely, **Millennium**.

The attraction of this U.S. company is threefold. Firstly, we join the same management team that has created tremendous value for **Power REIT** shareholders, increasing its share price tenfold in just over two years. Indeed, David Lesser is also the CEO of **Millennium** and controls c. 19.5% of the shares. Secondly, we are buying the shares at very attractive prices. The company has three greenhouses and one outdoor cultivation facility that it has acquired mostly by taking advantage of the forced sale of their previous owners. It has a greenhouse in Michigan that it is adapting to start its cannabis production in 2022, another in Colorado and the remaining facilities in Oklahoma. The company expects to generate around 35 million dollars in pre-tax profits with the four assets (using conservative assumptions). This figure compares to the c. 75-million-dollar market cap at quarter-end. Finally, although we do not take it into account in our numbers, **Millennium** has a plant that they are working on for obtaining activated carbon from macadamia nut shells, with applications in the energy industry, such as storage. The asset was acquired, again, at a deep discount due to the bankruptcy of its owner.

In short, this is a company with an excellent management team, trading at very attractive prices and with a free option that we are not valuing.

HOROS VALUE IBERIA
Stake decreases & exits:

OTHER
3.4% of the fund
Holding discussed: Ercros (exited)

Following the stock's solid performance since the beginning of the year, benefiting from the economic recovery, as well as its lower relative potential compared to other alternatives that we added to the portfolio, we sold our entire stake in the **Ercros** chemical group.

Stake increases & new stakes:

FOOD DISTRIBUTION (9.6%)
Holding discussed: Grupo DIA (2.0%)

One of the new additions to the portfolio this quarter is **Grupo DIA** ("DIA"). This is a company in which we were already shareholders in our previous professional stage. We sold our position at around 6 EUR, due to our concern about the sustainability of the company's economic relationship with its franchisees and the remuneration policy of the company's Board of Directors. Our exit coincided with the entry into the share capital of the Russian investment group **LetterOne**, controlled by businessman Mikhail Friedman (one of the wealthiest people in Russia and the world), and a short squeeze that pushed the stock price up by around 20% in a single day.

Since then, **DIA** has been going through a real ordeal. Throughout 2018, the company had several consecutive quarters of falling revenues and profits and ended up firing its CEO, Ricardo Currás, who was replaced by Antonio Coto, until then head of the business in Argentina and Brazil. Coto remained in that position for a few months, until he was replaced by Borja de la Cierva. In October of that year, the company plummeted 42% after lowering its EBITDA expectations by c. 40% and announcing the need to restate the 2017 accounts. To end that terrible 2018, in which its share price dropped by c. 90%, **DIA** announced a capital raise of 600 million euros (double its market capitalization) and initiated a renegotiation of its debt with various banks.

The following year was not very quiet either. LetterOne, which had increased its position in the company throughout 2018, launched a takeover bid at 0.67 EUR per share, taking nearly 70% of the shares. Since then, **DIA** established a roadmap to carry out a radical transformation of its business, laying the foundations for future growth based on three pillars: operational excellence, a new commercial offering and a solid capital structure. In May, the company managed to renegotiate its bank debt in extremis and appointed Karl-Heinz Holland as CEO to lead this transformation. In October 2019, **DIA** again raised capital by more than 600 million euros (an additional 90% dilution). Following this, LetterOne took control of c. 75% of the company’s shares.

In May 2020, Holland was replaced by Stephan DuCharme, Friedman's trusted man in the distribution area of the LetterOne group, who became executive chairman of **DIA**. The financial situation of the group required a third capital raise, announced in November 2020 for 500 million euros and finally approved in 2021 for more than 1,000 million euros. Precisely, the company's capital situation after this raise and the changes being made by the current management team are the factors that encouraged us to initiate a stake in **DIA**.

On the one hand, we believe that **DIA**'s financial position, after this capital raise, significantly reduces the liquidity and solvency risk that the company was facing, by reducing its debt by c. 75%, while drastically lowering its financing costs. On the other hand, the current management team, which is fully aligned with shareholders (LetterOne controls almost 78% of the company), is implementing changes that focus mainly on supermarket reform and a sustainable model for its franchisees. Regarding the reform of supermarkets, with changes in formats and renovations, we expect sales per square meter of each reformed store to increase between 10 and 20 percent, closing the gap with competitors and improving margins because of operating leverage. As for the changes in the relationship with franchisees, it is worth highlighting the improved profitability of the latter due to higher margins and a more flexible working capital system. At quarter-end prices, the company has a high margin of safety, protecting us against scenarios in which the management team's business targets for the next three years are not achieved.

OTHER

3.8% of the fund
Holdings discussed: Greenalia (2.9%) and Prim (2.0%)

In the case of **Prim**, we continued to increase our position initiated at the end of last quarter.

On **Greenalia**, we took advantage of the correction in its share price in recent months (around 50% from its highs) to reinitiate an investment in the renewable energy company. At current prices, we believe that the market is not pricing in the attractive projects that the company has in its portfolio.

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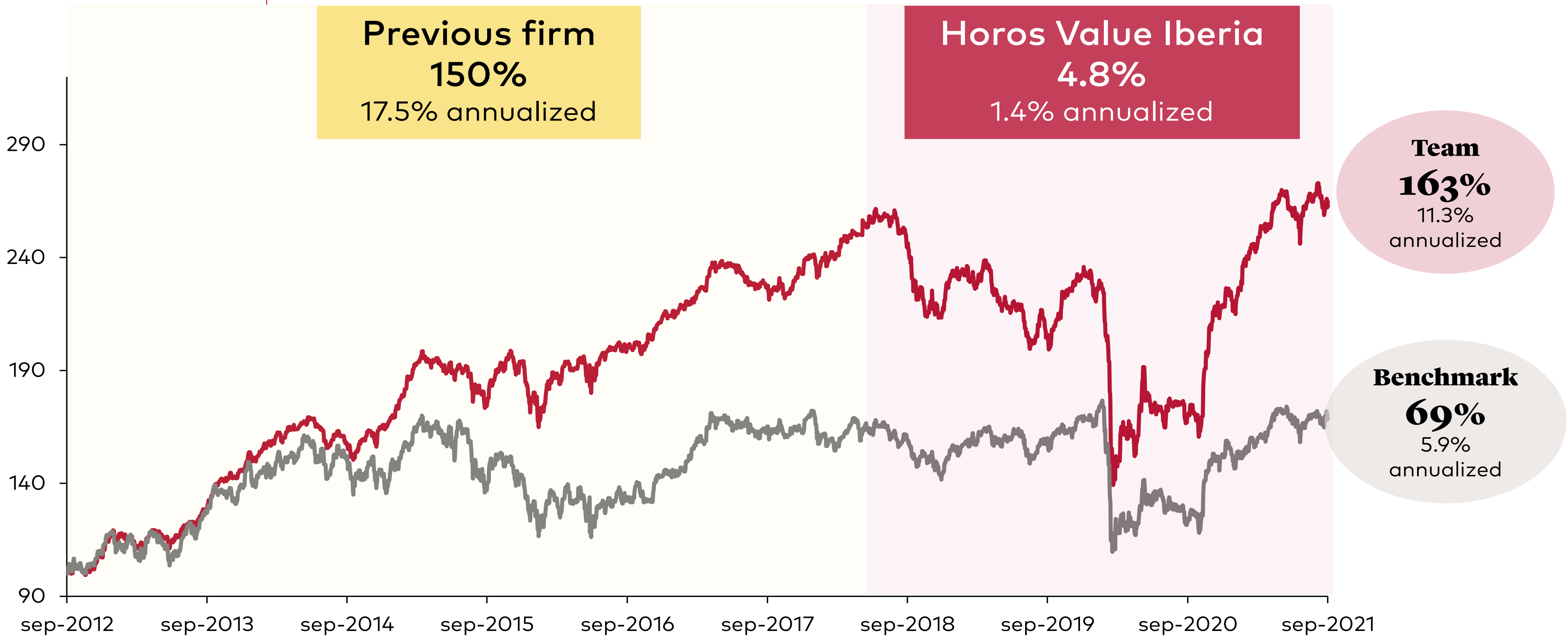
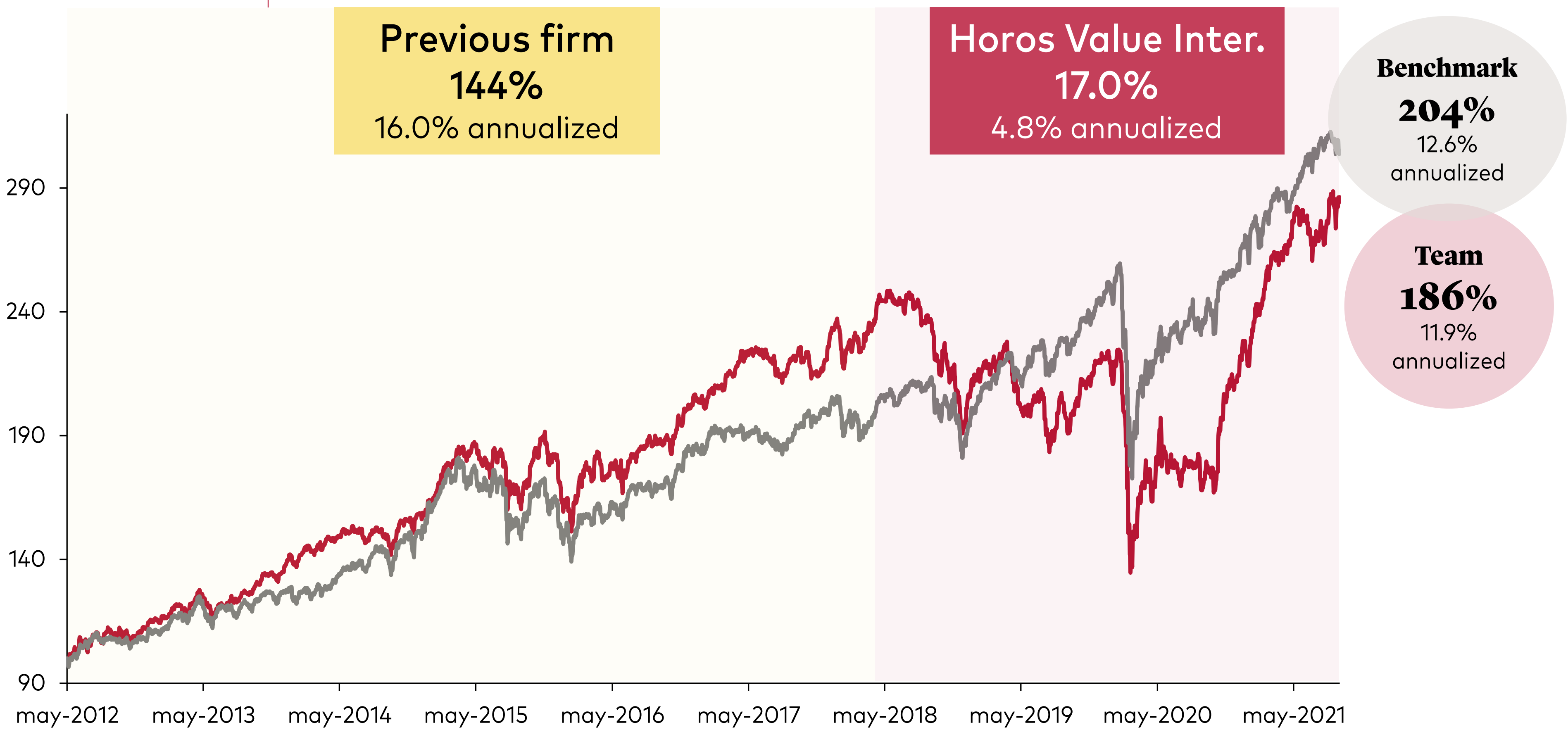
Annex

Returns | Historical returns of the management team in the **iberian strategy**



Past performance is no guarantee of future performance. The Fund's investments are subject to market fluctuations and other risks inherent to investing in securities. so the acquisition of the Fund and the returns obtained may vary both upwards and downwards and an investor may not recoup the amount initially invested. Decisions to invest or divest in the Fund must be made by the investor in accordance with the legal documents at all times. and in particular on the basis of the Regulations and the Fundamental Data for the Investor (DFI) of each Fund. accompanied. where appropriate. by the Annual Report and the last quarterly Report. All this information. and any others. will be available to you at the headquarters of the Manager and through the website: www.horosam.com

Returns | Historical returns of the management team in the international strategy



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Top 10 Holdings
Horos Value Iberia

Holding	%	Theme
Semapa	7.2%	Financial
Horos Value Internacional	7.0%	Financial
Sonae SGPS	6.6%	Distribution
Merlin Properties	6.3%	Real estate and construction
Renta Corporación	5.6%	Real estate and construction
Iberpapel	4.5%	Industrial
Catalana Occidente	4.4%	Financial
Gestamp	4.4%	Industrial
Talgo	4.4%	Engineering
Elecnor	4.4%	Engineering

Top 10 Holdings
Horos Value Internacional

Holding	%	Theme
Aercap Holdings	5.8%	Financial
Kaisa Prosperity Holdings	4.7%	Real estate and construction
Semapa	4.6%	Financial
Teekay Corp.	4.4%	Commodities
Sonae SGPS	3.7%	Distribution
Fairfax India	3.6%	Financial
Power Reit	3.4%	Real estate and construction
Sun Hung Kai And Co	3.3%	Financial
Keck Seng Investments	3.2%	Real estate and construction
Sprott Physical Uranium	3.0%	Commodities

Upside potential

Historical potential of the management team

Data from 31 March 2014 to 30 September 2021

**Until 21 May 2018 includes the potential of the management team in its previous firm and since then in Horos AM.*