Investmentaktiengesellschaft für langfristige Investoren TGV

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Dear Investors

We are enclosing the shareholder letter for our Teilgesellschaftsvermögen "Partners Fund" for the first half of 2017 written by our sub-advisor MSA Capital GmbH.

Yours sincerely

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Sub-Fund Partners Fund
H1-2017: Memo of the sub-adviser – MSA Capital, Dr. Mathias Saggau

Bonn, July 2017

Dear Investors,

The share price of the sub fund (TGV) Partners Fund as of June 30, 2017 amounted to EUR 129.79. For the first half of 2017, the change in the net asset value (NAV), including all costs, was + 10.30%. The DAX achieved a performance of + 7.35% over the same period.

Year	TGV Partners Fund	DAX	Delta
2015 (9 months)	+ 1,48 %	– 10,22 %	+ 11,70 %
2016	+ 15,95 %	+ 6,87 %	+ 9,08 %
1st half 2017 (6 months)	+ 10,30 %	+ 7,35 %	+ 2,95 %

Per annum	+ 12,28 %	+ 1,32 %	+ 10,96 %
Total	+ 29,79 %	+ 3,00 %	+ 26,79 %

At first glance, the first half of 2017 went well for the TGV Partners Fund as well as for the entire market. Most broad indices also rose moderately and under historically exceptionally low volatility.

However, for the individual stocks in the portfolio of the TGV Partners Fund, the picture is much more differentiated.

Only rarely there are such unusually high spreads between positive and negative price development in 15 individual positions within a short period of time. At one point, the best performance was at around + 70% the worst at around - 30% within just six months.

A key driver of TGV's positive overall performance in the first half of the year was the excellent price performance at the highest-weight positions. In euro, **Alphabet rose by +15%, Gruppo MutuiOnline by +40% and Tucows by +40%** as well. This performance was also accompanied by an equally excellent operational development of the companies.

However, especially the companies in the oil and gas sector marched to a different tune. In 2016, they had still risen sharply, but in the face of weak oil prices in 2017, they followed a consistently negative price trend, again.

As approximately half of TGV Partner Fund companies are denominated or closely tied to the US dollar, the depreciation of the US dollar against the euro caused a decent headwind for the portfolio.

So far, 2017 has been a classic example of how a high concentration on relatively few stocks, which then develop very positively, has an impact on the entire portfolio. At the same time, however, this should also be considered a warning: the highly weighted positions in the TGV Partners Fund will not always show a better performance than the broad market. Phases of underperformance will be inevitable in the future since I am not trying to anticipate or minimise the price fluctuation of individual stock recommendations.

The companies in the TGV Partners Fund

Of the 15 companies, the TGV was invested in on June 30, 2017, as usual, I listed the ten largest positions in alphabetical order.

- Admiral Group
- Alphabet (Google)
- amaysim
- NOW Inc. (Distribution NOW)
- Gruppo MutuiOnline
- National-Oilwell Varco
- Microsoft
- Rolls Royce
- TGS Nopec
- Tucows

These ten companies account for approximately 85% of the fund's assets. The largest company the TGV is involved in currently has a market capitalization of around 650 billion US dollars and the smallest of less than ten million euros.

The core investment principles of the TGV Partners Fund have not changed and will not change in the future. I recommend the following criteria when recommending potential investments:

1) Does the company have a reasonable business model?
2) Does the company have a lasting competitive advantage?
3) Does the management act rationally, with integrity, and do they consider the shareholders to be partners?
4) Can we purchase the company’s stocks at a reasonable price?

Changes in the Top 10

Since the turn of the year, there have been minor changes within the portfolio that have not changed the composition overall substantially.

Since the TGV Partners Fund was launched, **Admiral Group** has been an integral part of the portfolio and has returned to the top 10 in the last few months thanks to a good price performance.

The shares of **amaysim** have been part of the portfolio for almost a year. While they have not been among the Top 10 so far, they are now among the 10 largest positions in the TGV Partners Fund due to a significant increase in the position in recent months.

The shares of **Leucadia** and **Fastenal** were sold at the beginning of the year. Both companies are still outstanding companies with excellent management. However, after the election victory of US President Donald Trump, the prices of both companies have made such extraordinary and little-substantiated jumps for joy that a substantial part of the increase of **amaysim** was financed by shifting the funds away from these two companies.

amaysim

amaysim is an Australian company, which has many similarities with Tucows presented in the last letter in terms of business model and philosophy. I wrote in the last letter that Tucows' brand, Ting, is comparable to the Simyo brand in Germany, but the affinity with amaysim goes even one step further. After all, the company practically has German roots. The business model that has been tried and tested here was exported from Germany to Australia by the former founders of Simyo and launched in the market towards the end of 2010.

Just a few years ago, the Australian mobile communications market was distinguished by little competition, poor service, and exceptionally high costs for users. With a straightforward and fair no frills model, significantly lower prices, and excellent service, in no time amaysim has now roughly one million customers under contract. This business model of the so-called MVNO (mobile virtual network operator) without its own mobile network was – up to this point – an unfamiliar concept in Australia and evidently fell on a very fertile ground.

The shares of all telecommunications companies in Australia, including those of amaysim, have suffered a sharp downturn in recent months as the competition has increased sharply. In April, amaysim announced a major and not exactly uncontroversial acquisition of "ClickEnergy".

Shortly after that, TPG, another Australian telecommunications company, announced that it would continue to heat the competition by building a fourth, entirely new mobile phone network in Australia. And as if all this were not enough, Australia is currently experiencing a fundamental change in the way the country's Internet is supplied, which is a source of uncertainty, especially for long-established companies, as the existing structures will be completely turned upside down in the future.

The multitude of news, many of which were about the sharpening competition in the Australian market, but also some about the company itself, made the whole industry in general and amaysim in particular extremely unpopular among many investors. In my opinion, the baby was thrown out with the bath water. In euro, the shares of amaysim fell by almost 25% since the beginning of the year.

Increasing competition does not necessarily have to be bad for the livelihood of amaysim. amaysim has the lowest customer acquisition costs, the lowest volume of complaints, and excellent customer reviews. This combination, along with an extremely competitive price structure, increases the likelihood that customers willing to switch providers will choose amaysim in the future.

Fierce competition is dangerous especially for those companies that keep their customers hostage, are inert due to historically high margins and prevented from treating all customers equally fair by a naturally-evolved tariff jungle. A situation emerges that is comparable to the "*Innovator's Dilemma*"[1]: A young competitor finds a profitable niche. For established competitors, it is difficult to change their organisation as radically as it would be necessary, or at the same time to cannibalise the basis of the present profits.

[1] Clayton Christensen's book "*The Innovator's Dilemma*" clearly illustrates that competitive advantages are anything but static, and is worth reading for all those who are interested in the topic.

Mergers and Acquisitions (M&A)

In the past six months, several companies among the holdings of the TGV Partners Fund have announced to buy other companies or to increase existing investments. That is why I consider it useful to address the topic and call attention to my guiding principles, based on which I assess M&As within the framework of capital allocation.

The purchase, sale, and merger of companies, or short M&A, is a controversial issue not only among investors. Even in science, the media, and within the companies itself much is being discussed about the sense and nonsense of acquisitions. The opponents of acquisitions often argue that more than half of all transactions destroy value for the buyer, and depending on the study, around 70-90 % of all transactions fail to live up to the expectations.

It is a proven fact that many acquisitions, indeed, destroy value. On the other hand, acquisitions that are carried out well and economically can significantly increase the value of a company. As always, it depends on the circumstances.

In the past few months, the TGV Partners Fund had to assess the following transactions:

- In January 2017, Tucows acquired “eNom” from Rightside for approximately 80 million US dollars.
- amaysim acquired “Click Energy” in April 2017 for around 120 million Australian dollars.
- In the case of Gruppo MutuiOnline, in the next months, it will be decided, whether the subsidiary 7Pixels will be taken over completely.
- NOW Inc. used the last two years of the crisis within the oil and gas sector and invested nearly 700 million dollars in several acquisitions. In light of the fact that the company today has a market capitalization of approximately 1.7 billion US dollars and no substantial debt, the extent of the investments was extraordinary.
- Since the beginning of the crisis, TGS-Nopec has purchased the multi-client databases of distressed competitors (Dolphin and Polarcus) for more than 30 million US dollars.
- National-Oilwell Varco has acquired over 200 (!) companies over the past 17 years.

The understanding and assessment of acquisitions and, above all, their economic sense play an extraordinarily important role in the valuation of companies in which the TGV Partners Fund typically invests.

The handling and assessment of acquisitions by the respective companies give a good insight into how they deal with the issue of capital allocation in general and what priorities they set. “Good acquisitions” are an indicator that management is prudent in handling shareholders' capital and “bad acquisitions” are a reliable indicator that a rational and sound capital allocation is not a priority.

Furthermore, an average company in the TGV Partners Fund generates much more free resources than necessary to maintain its own business. Ideally – good reinvestment possibilities provided – these free resources are fully reinvested into their own core business.

However, few companies are able to reinvest steadily growing pile of cashflow into their own core business permanently and at excellent rates of return. This is by no means due to the fact that companies do not want to invest, but the niches and the competitive environment, which ensure a high or even excellent profitability, are simply limited to most companies. And thus, reasonable reinvestment possibilities for most companies from a certain point in time or on a certain scale are limited.

From this point of view, acquisitions are a sensible way to invest free capital, and thus, an additional and valuable tool for the capital allocation toolbox. In the best case, they can even have a positive influence on the “moat” of a company, i.e. its protection from competition, even beyond the mere use of capital.

But it is similar to investing in general: it is more an art than a science, and many small details have to come together to make acquisitions successful. Among the factors of a successful acquisition are above all the art of saying “no”, a lot of patience, a reasonable process, and an in-depth knowledge of the selection and integration of the companies to be bought.

A few years ago, a friend who happens to be a value investor, shared his thoughts about the circumstances under which acquisitions made sense. I have shamelessly copied this relatively straightforward mental model, and I have been using it ever since as a basic framework for the assessment of the respective M&A strategy. In the following, I would like to introduce you to the basics of this model.

For good acquisitions, I regularly see at least one of three reasons for the transaction:

1) <u>The acquiring company can strike a structurally and financially favourable deal.</u> The reasons for structurally low prices are manifold. A distressed seller, a general crisis in the industry, or a lack of competition when buying are just some of the factors that can lead to systematically low prices.

2) <u>The merger leads to genuine sales synergies:</u> For example, the products of the purchased company can be rolled out over the already existing own sale infrastructure, or the sales infrastructure of the purchased company can also be used for own products.
This does not mean that the revenues simply add up (1 + 1 = 2), but the combined company achieves considerably more sales after the acquisition than both companies had achieved on their own (1 + 1 = 3).

3) <u>The acquiring company can generate genuine and substantial cost advantages.</u> Cost synergies are almost always mentioned in the context of acquisitions, but only a few are “real” and even fewer synergies later actually turn out to be substantial. There are, nevertheless, many potential synergies: for example, the better utilisation of distribution networks, one's own infrastructure, or the more efficient use of marketing costs per customer. However, these savings are rarely taken into account and all too often offset due to a growing complexity, restructuring costs, and the high focus an integration can demand from the management.

A purchase price is not necessarily favourable if – while lower than comparable transactions – it was still too high in absolute terms. Often, ailing competitors are bought in order to acquire customer relationships and increase sales. All too often only the problems but not the market shares add up. Whenever the words “transformative”, “merger of equals”, or “auction” fall with respect to an acquisition, I get my hackles up.

Ever since, I have observed in practice that most of the good acquisitions that I have seen over time have been based on one or more of these pillars, and many of the bad acquisitions that I have studied ignore them completely while there were usually entirely different reasons for the merger.

There are, of course, numerous examples for all three scenarios, in which the acquisitions were not successful. And even though one or more conditions were fulfilled, the intricate part of the integration can still fail.

Nevertheless, this framework helps me assess how the management of the respective companies thinks about acquisitions in principle. It helps to evaluate past acquisitions and judge whether companies have a systematic and structured process of acquisitions, or whether they only buy companies because it is en vogue and “that’s how the industry does it at the moment”.

On the other hand, a seemingly expensive or risky acquisition later turns out to be an excellent purchase. At the time, there were only a few investors who were not critical of Google's acquisition of YouTube in 2006. Back then, many considered the price of 1.65 billion US dollars to be utterly obscene. In 2006, YouTube had only about 15 million US dollars in revenue and made massive losses. At first glance, everything looked like a really crazy deal. The fact that, in hindsight, this acquisition was viewed as a fantastic steal is frequently ignored.[2]

eNom: a good deal?

At first glance, Tucows’ acquisition of the eNom seems to follow the pattern of an excellent acquisition. If the results are only half as good as it looks so far, we can only emphasise how lucky we are to have Elliot Noss and his team as a partner.

With the acquisition, Tucows buys a direct competitor in the domain business, which the company has been familiar with for almost 20 years. Tucows knows the business processes, customers, opportunities, and risks well. It is a comparable company within its own core business. In the course of the acquisition, the number of domains managed by Tucows has doubled from around 14 million to around 30 million domains.

From the three criteria mentioned above, at least two are apparent:

1) <u>The price:</u> Tucows expects that the future additional yield without synergy effects and before taxes will be about 15 million US dollars and including realistic synergies at about 20 million US dollars per year. This revenue, compared to a purchase price of approximately 80 million US dollars, is a factor of 4 to 5 – this day and age an extraordinarily favourable value for a relatively stable business, which justifies the transaction all by itself.

2) <u>Revenue synergies:</u> Tucows does not expect significant revenue synergies, but rather expects stagnating, perhaps even shrinking sales.

3) <u>Cost synergies:</u> The business of Tucows and eNom overlaps significantly in many aspects, in some cases, it is even identical. In addition to the typical synergies such as the combination of double functions (“back office”), the daily business can now be scaled over a much larger volume. Especially in a business model, which is based on compartmentalised processes, workloads, and efficiencies, there is an excellent opportunity to realise genuine synergies.

Why was Rightside, the previous owner of eNom, sold this business so cheap?

The reasons for this are manifold: Rightside has been undergoing radical changes for several years. The company was set up as a spin-off of a larger company in 2014. Since the spin, Rightside has been unprofitable across all divisions and lacked capital for growth initiatives. ENom in itself has always been

[2] The YouTube acquisition was fully paid in October 2006 with shares priced at around 200 US dollars. These shares now have a value of approximately 7.2 billion US dollars. The value of YouTube, however, is undoubtedly many times that amount.

profitable, but it did not offer much growth and was anything but “sexy”. The new management wanted to shift the focus of the company's own business in the future and wanted to use the funds from the sale for that purpose, among other things. Even after eNom had been up for sale for a while, Tucows was the only seriously interested buyer.

And that there were obviously serious frictions within the selling company Rightside and little consensus on the future direction, has become apparent even for outsiders over the past few weeks. Rightside approved a full acquisition of the remaining company by Donuts Inc. towards the end of June 2017.

For Tucows, however, the lack of growth at eNom is not such a big negative. The company can channel the funds generated in the future into its newly established business units and make good use of them. This strengthens the basis for future growth.

Whether the acquisition was actually “excellent” will only become evident in a few years. After all, we are still in the integration phase. However, I assume that the chances for a successful integration are good. David Woroch, who is responsible for the integration on the part of Tucows, is an “old hand”, an experienced manager and a founding member of the industry. He commutes enthusiastically between Seattle and Toronto, and on our last visit, he displayed a positive attitude that the cultures of Tucows and eNom are a good match, which makes a successful integration easier.

As with Tucows, there is a history behind each of the above-mentioned acquisitions by the companies in the TGV Partners Fund, how the transaction came about, what the reason for the purchase was, and there will be a result in the foreseeable future. It is one of the tasks of every active investor to think about it on a regular basis and to evaluate the acquisitions.

I come to the conclusion that the overwhelming majority of the acquisitions of the TGV Partners Fund companies were positive for their owners and that value was clearly created for the shareholders.

Although not all of the above-mentioned acquisitions were as spectacularly favourable as the one of eNom currently seems to be, they make sense on the second glance and should – measured over a sufficiently long period – contribute in an undeniably positive manner to the respective value of the companies. And this value will soon be reflected in the prices of the respective shares of the companies.

In this spirit, I wish you a good summer and thank you for your continued trust.

Kindest regards from Bonn,

Mathias Saggau