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 2016 written by our sub-advisor MSA Capital GmbH.

Yours sincerely

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TGV Partners Fund
H1-2016: Memo of the sub-advisor – MSA Capital, Dr Mathias Saggau

Bonn, July 2016

Dear Partners,

On June 30, 2016, the price for the Teilgesellschaftsvermögen (TGV) Partners Fund was quoted at 103.22 Euro. Including costs, the TGV thus appreciated in value by +1.71 %. In the same period, the DAX had a performance of –9.89 %.

For an investor who invested in the DAX instead of the TGV Partners Fund in March 2015, the DAX would have needed an upturn of 27.60 % to catch up with the performance of the TGV.

Although the outperformance seems impressive, a qualitative statement about the performance still makes only little sense, since a period of just over a year is not an appropriate scale for assessing an investment manager. The ability of an investor only, if at all, becomes apparent when looking at multi-year results, which include both periods of rising and falling markets.

In recent weeks, the referendum on the withdrawal of the United Kingdom from the EU ("Brexit") has caused substantial eruptions in the stock markets, mainly because the actual consequences and the schedule of the withdrawal are not clear yet. For the allocation of companies included in the TGV Partners Fund, I ascribe only little importance to the referendum. None of the enterprises in the TGV Partners Fund would be permanently threatened in their competitive advantages or existence by a withdrawal of the UK. Cheap car insurance will still be in demand (Admiral Group) and engines for wide-body aircraft (Rolls Royce) will still be built in the UK.

Turbulent times may, therefore, be lying ahead for the European Union, I, however, do not see any reason to change horses in midstream. On September 10, 2001, the world was just as unsafe as on September 11, 2001, and even in the future, there will be unexpected shocks and events on a regular basis as well as good and bad years on the stock exchanges. I cannot predict in which order or when they will occur. Therefore, I will continue to focus on the things I can actually influence – the selection of companies according to the following criteria:

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 does it consider the shareholders to be partners?
4. Can the company's stocks be purchased at a reasonable price?

What all assets in the TGV Partners Fund have in common is that they are excellent companies whose prospects I consider to be positive in the long run and whose shares were acquired at a good price, bearing in mind the intrinsic value I calculated for them.

Companies in TGV Partners Fund

Out of the 15 companies the TGV has been invested in on 30/06/2016, I would like to list the top ten holdings in alphabetical order:

- Admiral Group
- Alphabet (Google)
- Distribution NOW
- Energy Assets
- Fastenal
- Gruppo MutuiOnline
- Leucadia
- National Oilwell Varco
- Rolls-Royce
- TGS Nopec

These ten companies account for approximately 75% of the fund's assets. The largest company the TGV is invested in currently has a market capitalization of about 500 billion US dollars, the smallest of less than 10 million euros. The TGV Partners Fund has no preferences as to the size of companies, the countries, currencies, or industries.

Changes in the top 10

Although the positions of **Microsoft** and **Amazon** no longer appear among the ten largest positions, their number of shares within the Partners Fund has been unchanged since the beginning of the year. Overall, there have been only few changes within the portfolio.

TGS Nopec

The TGV Partners Fund took advantage of the significant price slump of **TGS Nopec**[1] after an investment and profit warning in January 2016 to buy additional shares of the company. TGS Nopec is now among the top ten holdings of the TGV Partners Fund again. The funds that were needed for the purchase have been withdrawn from another holding within the oil sector so that the overall risk with regards to the oil industry as a whole within the TGV has not changed.

The essence of the investment warning regarding TGS Nopec in January was that considerably lower investment in seismic material is planned in the near future, and therefore lower profits are to be expected in the years to come. For the long-term partner, these at first glance bad news contain two positive aspects:

1) The company is and remains extremely disciplined in terms of its interest in investing in seismic material. Typically (and unlike many competitors) they invest only if certain investment criteria, such as prepayments, purchase obligations of customers, and high return expectations are met. The ability to say "no" and to not compromise these investment criteria, even in difficult times, is a great strength and of utmost importance for the long-term success of the company. Therefore, the management's actual course of action of keeping the bar up and not resorting to mediocre investment is of great value to the shareholders. Even if we have to live with lower profits in the short term.

2) The cost of creating seismic maps, mostly consisting of the day rates for seismic vessels, have more than halved since the crisis in the oil sector has begun. For example, to invest the same absolute amount of 400 million US dollars as in 2013 and 2014, today TGS Nopec would have to initiate twice as many projects as in these two years - given the reluctance to invest in the sector an impossible task. Against this backdrop, a planned investment of 220 million US dollars for 2016 is lower in recorded kilometres, but similar to 2013/2014.

[1] *A detailed description of the business model of TGS Nopec is included in the report for the first half-year of 2015.*

Furthermore, TGS Nopec is currently the only company in the entire industry that has plenty of cash and can use the current “distress at sea” to their advantage. It allows, for example, for securing shares in other companies or databases at distressed prices. During a visit to the EAGE conference (European Association of Geoscientists & Engineers) in May this year, it was very impressive to see how much the competitors are driven by their own debt. Kristian Johansen, CEO of TGS Nopec, however, can act free of debt and loan commitments and is apparently already laying in the course for tomorrow and the future.

Energy Assets:

Our position in Energy Assets Plc can only be described with mixed feelings: due to an acquisition of the company which was announced shortly after our investment, it has delivered an exceptionally high rate of return, but will be sold only a few short months after the purchase.

Energy assets is a Scottish company, which installs and operates "intelligent" or Internet-enabled gas meter (so-called "smart meters") for larger industrial and commercial clients. After changes in the regulation a few years ago, in Britain, there is a nationwide plan, according to which all the gas meters have to be replaced or renewed. As part of this new regulation, the rules for the operation and ownership of the meters have changed significantly. Whereas almost all gas meters were owned by the state-owned energy utility, in the future, free competition and private companies are taking over this role as so-called "Meter Asset Managers".

Over the past years, Energy Assets has exchanged a large number of old gas meters with new equipment and by the end of the fiscal year in March 2016, it owned a portfolio of approximately 150,000 gas meters. Due to already concluded contracts for future exchanges with multiple providers, the number of installed gas meters owned by Energy Assets is very likely to increase sharply in the coming years.

Fees for the provision of the gas meter incur as part of the operating costs in the supply of gas. The installation and the value of the unit - on average only little over 800 GBP per gas meter - entail a turnover of around 130 GBP per unit per year. Therefore, once the devices are purchased and installed, they produce very stable revenue for the coming decades. A fantastic business for Energy Assets.

I have known the company and its management for several years, and prior to purchase by the TGV Partners Fund, the Investmentaktiengesellschaft für langfristige Investoren TGV was one of the major shareholders of Energy Assets. Fortunately, the TGV Partners Fund was able to use a price weakness in the spring of 2016 to slowly increase a position despite the very illiquid trading of shares at a price around GBP 4.75.

In April 2016, while the TGV Partners Fund was still in the process of slowly building up a position, the shareholders of Energy Assets received a takeover bid from an American private equity company in the form of a so-called "scheme of arrangement" at a price of GBP 6.85. Similar to a squeeze-out procedure in Germany, this scheme of arrangement forces the shareholders to sell their shares when the substantial majority of 75 % of shares agrees to this scheme.

When the bid documents had been published and unexpectedly did not contain annual results for the fiscal year that had ended in March 2016 and under these conditions the offer price appeared to be too low, the Investmentaktiengesellschaft für langfristige Investoren TGV teamed up with other major shareholders of Energy Assets against this offer. These four shareholders controlled 23 % of the shares at that time and voted against the Scheme of Arrangement in the form it was presented.

After the latest figures have been published in mid-June 2016 and the offer price was increased to 7.225 GBP, an agreement with the buyer was reached. The scheme of arrangement will, therefore, be settled within the next few months and the purchase price will be paid in cash to the shareholders. Therefore, by the end of the year, Energy Assets will no longer be included in our portfolio.

The price increase of around +50 % in local currency (after Brexit only +40 % in Euros) in the shares of Energy Assets since the first purchase by the TGV in March 2016 corresponds to a profit contribution of just over 2 % yield, based on the total assets of the TGV Partners Fund. It will likely remain an extremely rare exception that the value of an investment is realized within such a short time.

On the other hand, the buyer of Energy Assets has certainly not made a bad investment. He receives an excellent company with an outstanding management team at a fair price and will, granted the business continues to develop as planned, generate a very decent return on the capital invested - despite the paid takeover premium.

„Don't be a Dividend-Monkey"

In the article *„Don't be a Yield Pig*", published in 1992 in Forbes Magazine, the investor Seth Klarman calls other investors to maintain a reasonable balance between risk and return.

Any investment promising a rate of return above that of government bonds also entails a higher risk. In 1992 the federal interest rate in the United States was at around 5 % and had fallen sharply since the mid-1980s. Many investors, who still wanted to achieve above-average profits in spite of falling interest rates, fell back on far riskier investments. Investors displaying this behaviour were mockingly called "yield pigs" on Wall Street.

Since 1992, the interest rates have continued to fall, and this summer the yield of 10-year German government bonds fell below 0 % for the first time. A development nobody would have expected some years ago. The pressure to generate any kind of positive return is enormous for all investors. A (last) resort many market players are considering now is the reallocation into stocks or even better dividend stocks as a supposedly safe source of income.

This trend of always favouring dividends is highly questionable and leads to bizarre excesses. There are plenty of companies that pay a dividend (which is subject to taxes at the shareholder's end) and increase their capital through the simultaneous issuing of shares (during which high transaction fees incur). What is truly alarming, however, is that even many professional investors are applauding this trick.

At its core, this behaviour is very similar to the "yield pigs" of the article mentioned above, and I think that it is quite appropriate to call investors who exclusively focus on dividends "Dividend-Monkeys".

The main problem with this type of investing is that you only look at one area of the various possible uses of capital allocation and often overlook significant risks. Dividends should be the result of lack of other uses for the capital and not the preferred use per se.

Apart from evaluating competitive advantages of a company and its management, one of the most significant judgments a long-term investor has to make is the assessment of the quality of capital allocation. In the selection process of companies that qualify for a recommendation for the TGV Partners Fund, a good part of the analysis focuses on the evaluation of this aspect of corporate management.

What does this mean?

Good companies typically generate more free resources than they need for the continuation of their own business dealings. Excellent companies generate much more free resources than they require for the continuation of their own business dealings. Therefore, good and excellent companies regularly face the question of how to sensibly use surplus funds.

There are various possible uses for this excess capital: it can (1) be reinvested to expand business activity. It can (2) be used to repay debt or (3) make acquisitions. Moreover, the excess capital can be used to (4) repurchase shares or to (5) pay a dividend to the shareholders.

In considering which of these alternatives generates the greatest value for the company, there can be no cookie cutter solution. Growth typically requires capital. Strong growth usually requires even more capital. But not all growth is profitable, desirable or even makes sense. The same applies for acquisitions, share buybacks or dividends: not everything that is possible in principle should be done.

It requires a lot of work, understanding of the people involved, and often a period of observation until an investor can fully appreciate what makes a company tick and how and why these decisions are made. Personally, I prefer companies that use a simple strategy in their capital allocation, *namely the rational choice of capital allocation based on the best alternatives currently available, taking into account all possible uses.*

This principle seems straightforward and logical – and many partners may wonder whether there are even any deviations from this principle in the "real world". In this case, the same applies as in investing: in principle, it is very easy - but far from child's play to actually accomplish.

In reality, these decisions about capital allocation are made under varying circumstances and always under conditions of uncertainty. Often committees consisting of people with different skills, experiences, and intentions decide on the use of capital together or in opposition to each other. Add to that that different shareholders have different interests and that it has become trendy to demand a "solid dividend policy" – jus to mention a few additional factors.

In my experience, it is actually more of an exception than it is the rule that a company's capital allocation efficiently and continuously follows the above-mentioned principle. Usually, companies declare regular dividends and a stable dividend policy is preferred. Most often the expected rate of return of internal investments is not compared to the potential return of repurchasing own shares.

The principle of rational capital allocation described above also means that there can be *no such thing as* dividend continuity, fixed pay-out ratios, or general share buybacks to reduce dilution, since it is necessary to decide situationally and on a case by case basis which of the available alternatives makes sense at the given time.

When I recommend companies that qualify for investment in the TGV Partners Fund, I stick to the above principle and look for businesses that adhere to it. I tend to prefer companies that have excellent reinvestment opportunities within their core businesses and for whom dividends, therefore, play a subordinate role. In other words: who in their right mind would withdraw money from a savings account that still bears interest at a rate of 10% or more to pay himself a dividend? However, if a company has no reasonable reinvestment opportunity, I welcome dividends as a last resort of capital allocation.

Hence, my call to active investors is: don't be a Dividend-Monkey! Get an overview of every alternative use of capital and take it into account for your investment. Sometimes lower dividends may mean more value.

Outlook

The TGV Partners Fund has the opportunity to invest in a focused manner when a particularly good opportunity with a low inherent risk arises. It is in the nature of things that such extraordinary opportunities are particularly rare. I understand it to be a part of my daily work to look out and carefully assess those rare gems.

Unlike many other funds, the TGV Partners Fund is prepared to invest even in the smallest and/or illiquid companies if the associated disadvantages and risks are compensated in a more than adequate manner.

This is only possible because the unusual structure of the TGV and its outstanding investor base allow for this course of action and therefore grant more freedom of decision-making than most other investors – for this, I would like to thank you.

Kind regards from Bonn,

Mathias Saggau