IBV CAPITAL

Q3 2019 Partnership Letter

Dear Partners,

We took a brief hiatus from writing thought pieces in our quarterly letters over the past while to focus on a few material developments within our portfolio. Today, we're eager to return to sharing our perspective on broader themes that we believe are important to consider as a market participant.

In a 2015 partnership letter, we shared a few observations on the proliferation of "unicorns" – start-up companies being granted valuations that exceed $1 billion. Namely, we focused our attention on two items of importance: the prevalence of non-GAAP financial metrics as indicators of success, and the harrowing valuations these start-ups were being granted, thereby creating a positive funding feedback loop.

Recently, our observations have become market focus, and the impact of their interconnectedness has become evident. We have long been skeptical of the many non-GAAP financial metrics being used to describe the financial performance of companies. For instance, we've always been suspicious of using EBITDA as a proxy for cash flow – it doesn't consider working capital or capital expenditure needs. Today's start-ups have become even more creative with reporting non-GAAP financial measures. So, it should come as no surprise that to us, using "contribution margins" or "community adjusted EBITDA" as a core operating metric or relying on them for valuation purposes, is a practice fraught with risks[1]. From our perspective, these financial metrics are tantamount to earnings before nearly everything relevant to running a business and should be taken with a pinch of salt.

We appreciate that the use of these heavily adjusted financial metrics are not being put to paper to be intentionally deceiving. Instead, they are part of a natural evolution that has been created by the underlying economics of today's unicorns. While many of these unicorns have generated

[1] Contribution margin is a product's price minus all associated variable costs. Community adjusted EBITDA is a financial metric WeWork highlighted in their bond issue. For WeWork, they took the usual adjustments to arrive at EBITDA and expended them by subtracting basic expenses like marketing, general and administrative, and development and design costs.

impressive revenue growth, few have translated this early success into positive earnings or cash flows. Since applying a large valuation to a company with negative profitability is challenging – and rightfully so – investors have been forced to alter the way they approach valuations in this segment of the market.

For instance, in today's environment, an investor who uses a discounted cash flow approach to support an investment in a unicorn has had to elongate their investment time horizon. While this alone introduces a high degree of uncertainty into the valuation process, the use of aggressive long-term growth assumptions and realization of future operating leverage only acts to exacerbate the valuation risks. Alternatively, when using a multiples-based valuation approach, today's investor must gravitate further up the income statement, sometimes all the way to revenue, or even create a non-GAAP financial metric, to find a positive figure as a multiplier.

This new normal suggests that the venture capitalists on Sand Hill Road and broader investment community are focusing on financial metrics, other than profitability, as a core driver in their valuation process. Naturally, this has prompted start-ups to focus on growing the specific financial metric these investors are holding in high regard. That metric is revenue growth, and we sense that start-ups are working to achieve it at any cost. This has created a dangerous positive funding feedback loop – with capital-raising efforts generating financial capacity to fuel revenue growth, which leads to higher valuations in future funding rounds, and so on and so forth. This feedback loop works – until it doesn't. We believe the abrupt shift in sentiment that will slow or reverse this trend will be the realization that sound business models are becoming increasingly absent from the equation.

As we look at the investment landscape, we're becoming more and more convinced that investors have mistakenly assumed companies with strong revenue growth must be benefiting from fundamentally sound and sustainable business models. For instance, Peloton manufactures a stationary bike with a mounted TV – nothing novel – that allows you to stream classes for an interactive physical work-out. For consumers, Peloton's product is an exceptionally expensive financial undertaking, as opposed to buying an actual bike or participating in a local cycling class. This suggests to us that, despite the annuity revenues from their streaming service, the company's market and in turn revenue growth may be limited. This limitation is reminiscent of the challenge that Nautilus, manufacturer of the once-trendy Bowflex, experienced in its time.

We're also seeing indications that market participants are accepting bad business models under the pretense that if they're well financed, they will miraculously become good business models. WeWork (now The We Company), an office space rental company, is one such example. Despite

its mission "to elevate the world's consciousness," which is a little odd, it's still just a stylish Regus with beer taps. As a function of their core business, they have signed long-term leases, incurred heavy upfront remodeling construction costs, and matched all this with short-term leases that have been made to fickle, naturally transient, macroeconomically-sensitive customers. We don't think it's coincidental that Regus (now IWG PLC) filed for bankruptcy shortly after the dot-com bubble burst.

This leads us to the cohort of conventional businesses being deemed disrupters or labelled as tech company's just because they have a charismatic leader or superficial technological advantage. Often, this unchecked investor approval suggests – inaccurately – that these companies will not experience the same underlying economics or intense competitive pressures as their direct or near peers do. For instance, Compass is a "real estate technology company" backed by SoftBank. To our knowledge, Compass has limited technological advantages over existing brokerage peers, and its core business isn't designed to change the way people buy and sell their homes. To us, Compass is a well-funded conventional real estate brokerage business – not a visionary real estate tech company. We attribute their early success to their ability to afford to poach brokers from other successful brokerages, and not the technology advantages they claim to have.

To be clear, we are not suggesting any of the companies we have identified are void of good people, products, or intentions. In fact, they are quite impressive at developing products for their defined market niche, generating exceptional levels of awareness, riding the wave they have created, and using it all to capture the imagination of investors and consumers. What we're suggesting is that if you look a little harder, just slightly below the surface, there are many instances where a clear connection with existing or past business models exists. Therefore, like the force of gravity, these new businesses will inevitably be pulled towards established economic fundamentals, which in turn will force their valuations to encounter limits.

What interests us most about market dynamics of this nature is how investors will react when the positive funding feedback loop they've created slows or reverses. In this scenario, we envision capital becoming scarce, and the fuel that's been propelling revenues evaporating. This will lead to slower growth and presumably lower valuations, thus initiating a negative funding feedback loop.

From our standpoint, we have seen a build-up in the valuations of select market segments without the corresponding support from strong underlying economics. More recently, we have witnessed some of these valuations unwind in dramatic fashion. Perhaps coincidentally, these mini-bubble bursts appear to be moving along a spectrum of quality and scale.

First, we experienced the rise and fall of cryptocurrencies – an asset with few investable qualities. Then cannabis, an industry with better prospects than cryptocurrencies[2], dominated cocktail party conversations. It wasn't long before companies with no revenues and scant operations (or illegal ones) received valuations that rivaled established consumer goods companies, before pairing their gains. Today, we're beginning to see investors question the value proposition of allocating capital to start-ups that have grown revenue exponentially but have no profits to show for it. As one growth story after another comes to an unpleasant conclusion, we're seeking comfort in our predisposition to investing in companies with strong underlying economics instead of being caught in the trap of financing hype.

Continuing Tailwinds

The market value of our IBV Capital Global Value Fund increased by 4.4% (net of fees) in the third quarter of 2019. The intrinsic value[3] of our portfolio decreased by 2.8% during the quarter. For comparative purposes, during the third quarter of 2019, the MSCI World Index advanced by 0.5%.[4]

From the onset, we have extolled the virtues of investing with permanent flexible capital. There are many benefits to this approach, one being the flexibility to invest in securities with embedded catalysts and giving those securities the appropriate timeframe for the investment thesis to come to fruition. We continue to identify opportunities with these characteristics and look forward to seeing them build on our three-year annualized return of 18.1%.

Our investment in Ascendant Group (AGL) continues to provide a performance tailwind as the value of AGL's shares inch closer to the $36 per share Algonquin Power and Utilities Corp. offered to shareholders on June 3rd, 2019.

---

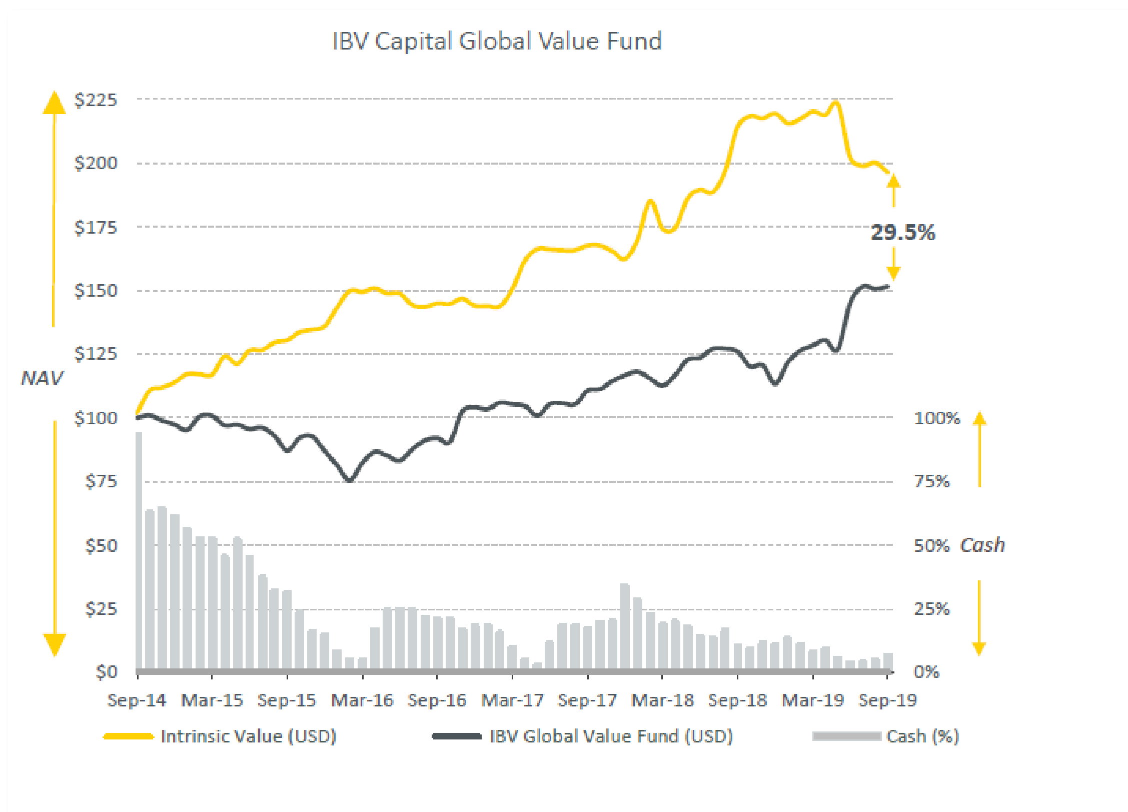
[2] For the record, we're fans of the technology that many cryptocurrencies are based upon, blockchain, but not the currencies themselves.

[3] For frequent readers, this is a friendly reminder that the intrinsic value of our portfolio is what we think our portfolio is worth. Those of you that are new to IBV Capital partnership letters, we would encourage you to visit the "Our Liquid Conglomerate" section of our Q2-2016 investment letter as it shares further insights into the meaning and importance of our portfolio's intrinsic value.

[4] "IBV Capital Global Value Fund" consists of USD$ IBV Capital Global Value Fund LP Class A unit returns, net of fees. Inception date of this class is September 1, 2014. "Portfolio Intrinsic Value" represents IBV's internally calculated intrinsic value for the cumulative securities within the IBV Capital Global Value Fund. "MSCI World Index" is based on the USD$ returns MSCI World Free NR Index. Full investment disclosures can be found on Page 9.

In August, we travelled to Bermuda to attend the company's Special General Meeting in order to vote in favor of the transaction. At the meeting, shareholders, the majority being Bermudians, voted overwhelmingly in favor of the sale. Today, the regulatory approval process is underway, and we are confident it will result in the completion of the transaction.

As our investment in AGL comes to a successful conclusion, the relative impact of our other investments will be more pronounced. Fortunately, we enjoy a diverse portfolio of securities, with embedded catalysts that will work to enhance the returns associated with our intrinsic value gap. Today, as a result of our successful investing activities, the gap between the intrinsic value of our portfolio – what we think our portfolio is worth – and the market value of our portfolio has narrowed to 29.5%.



Over the course of the quarter, our cash position increased from 3.5% to 6.8%. This modest change was a result of the partial sale of a few successful investments.

Rinse and Repeat

Historically, we've gravitated toward distressing political and economic situations with the intention of finding valuable securities that have been overlooked or discarded. Today, Brexit is providing us with an environment that's conducive to capitalizing on our opportunistic investment process.

We appreciate that Brexit is a calamitous political event that is reverberating through the U.K. and European economies, and the extent and magnitude of its economic impact will ultimately depend on the form it takes. Since accurately assessing this result is challenging – no institution accurately predicts economic outlooks with any consistency – we have focused our efforts on more predictable, microeconomic factors, instead. Specifically, we have been identifying and evaluating attractively priced companies for their specific risk exposures and determining whether they are worthwhile incurring in the face of this environment.

With this approach, we can mitigate our risk exposure to Brexit by targeting companies that enjoy specific features: recession-resistant businesses, globally diversified operations and sound balance sheets. In FirstGroup Plc (FGP), we have identified a U.K.-based company that enjoys all three characteristics. FGP participates in the business of student transportation, public transit, and passenger rail operations – all of which are arguably resilient under recessionary conditions. While headquartered in the U.K. and listed on the London Stock Exchange, FGP derives over 60% of its operating profit from North America. We also consider the company's balance sheet to be in good form, and it enjoys embedded catalysts that can further strengthen its financial position and simultaneously unlock value.

Today, FGP's most profitable business is First Student. First Student is the largest provider of student transportation in North America – twice the size of the next largest competitor – and has very attractive economics. Despite its market share and economic potential, First Student hasn't received the focus it deserves from FGP's U.K.-based management team – or market participants for that matter. As a result, margins are below peer levels and the division is being ascribed a particularly low valuation multiple. After speaking with management and industry experts, it's apparent that operations can and should improve.

In addition to the environment in which we sourced FGP from, the company itself shares a theme with other successful investments we've made. They have a very attractive business that's being financially overshadowed by a poor business. For instance, relative to First Student, First Rail, FGP's passenger rail operation, is very accretive to revenues, but ultimately remains a low-margin business that brings with it risks to profitability that in some instances are entirely outside FGP's control. Greyhound, FGP's intercity coach subsidiary, has similar performance characteristics. It's an unprofitable business that fails to generate shareholder value and is therefore a distraction to management. For shareholders, it is important that management address the financial drag associated with these less desirable businesses quickly and concisely.

Since we made our investment, a new, more experienced chairman has been appointed, and management have announced far-reaching changes to the company's strategic direction. Importantly, FGP will refocus their attention on their North American student and public transportation business in order to improve its financial performance and unlock shareholder value. Part of this focus entails selling Greyhound, separating First Bus (their U.K.-based public transit division) from the parent company to address the subsidiary's pension issues, and ceasing to bid on future rail franchises – effectively winding down First Rail over time. We're pleased with the company's new direction, and we're confident these progressive steps will unlock its full potential.

Five Years in The Making

This year we reached the coveted five-year milestone – and we did so with some gusto. In year five, we were recognized by BarclayHedge as having best-in-class performance[5] and ranked fourth in terms of three-year annualized returns by Canadian Hedge Watch.[6] Having already experienced investment results that have generated tremendous firm growth and made us proud, we're excited to see what the next five years brings us.

As we see it, there was no better way to celebrate our achievements than to give back to our local community. This year, we were eager participants in Junior Achievement, an outstanding not-for-profit organization that's focused on elevating the financial literacy of children around the world. As part of IBV Capital's contribution, we split into teams and spent a day teaching a few grade 7 classes around the city of Toronto the ins-and-outs of finance. It was great to see how

[5] IBV Capital Global Value Fund was ranked number 1 in Barclay Hedge's Equity Long Only category for June 2019.
[6] CHW QUARTERLY REPORT - Volume 19 Issue 09 - September 2019. Retrieved from http://canadianhedgewatch.com/reports/CHW_Vol19_Issue09.pdf

enthusiastic the students were on the topic of finance. For us, it was an equally rewarding experience, and we're looking forward to our next classroom sessions.

Sincerely,

Talbot Babineau, CFA
President & Chief Executive Officer
T: 416.603.4282 | tbabineau@ibvcapital.com

Disclosures:

This material is not meant to be, nor shall it be construed as, an attempt to define all terms and conditions of any transaction or to contain all information that is, or may be, material to an investor. IBV Capital Ltd. is not soliciting any action based upon this material, and this material is not meant to, nor shall it be construed as, an offer or solicitation of an offer for the purchase or sale of any security or advisory service. This material is not meant to be, nor shall in be construed as, a representation as to past performance, and no assurance, promise, or representation can be made as to actual returns. Past performance is not indicative of future results. Certain assumptions, data and projections have been made in the analyses that resulted in return scenarios and forward-looking statements included herein. No representation is made that all such assumptions, data, or projections have been considered or stated or that any of them will materialize. Changes to the assumptions, data, or projections may have a material impact on the returns shown by way of example. Forward looking statements should not be read as a guarantee of future performance or results and will not necessarily be accurate indications of the times as, or by, which such performance or results will be achieved. Forward-looking statements are based on information available at the time the statements are made and/or good faith belief as of that time with respect to future events and are subject to risks and uncertainties that could cause actual performance or results to differ materially from those expressed in, or suggested by, the forward-looking statements. The Fund's actual results or activities or actual events or conditions could differ materially from those estimated or forecasted in forward-looking statements due to a variety of factors, some of which may be beyond the control of the fund