IBV CAPITAL

2015 Annual Partnership Letter
January 2016

Dear Partners,

This past year contained several significant milestones for the firm. For our original Family Office partners, it signified our 5-year anniversary. For our new Fund partners, it marked our first full calendar investment year. In addition, a few weeks into January, our total firm assets under management surpassed $50 million. As excited as we are about these accomplishments, we are squarely focused on ensuring that the next five years are even more fruitful for our investment partners, than the previous five.

2015 was another interesting year, filled with dramatic currency moves, precipitous commodity price declines, challenged global growth, geo-political events, and increasingly divergent monetary policy programs. In the face of such challenging conditions, we continue to be patient and disciplined. We maintain the view, as we always have, that this approach will ultimately lead to success.

At the time we launched our IBV Capital Global Value Fund in June of 2014, from our perspective, there were far more unattractive investments available to us than attractive ones. Our sentiment was reflected in the choice few investments we initially made, as well as the meaningful cash position that we held. As 2015 unfolded, this began to change. Select corners of the market, namely commodity and commodity-related businesses, became challenged and very unpopular investments. While tumultuous at the moment, these types of upheavals have often provided us with tremendous opportunities to make lucrative long-term investments.

While we look years into the future for our investments to bear fruit, expectedly, our portfolio has been temporarily impacted. This is a direct result of the volatile market prices of some of our recent investments, a common feature of out-of-favour securities. In addition, as we began to take advantage of these opportunities, our cash position, which acts as a natural stabilizer, decreased materially throughout the year, from 61% to 15%.

We often speak about the attractive qualitative and quantitative factors of our investments, however, we rarely illustrate just how depressed their values currently are. To show this, we've highlighted a select few key valuation indicators, namely price-to-earnings and price-to-book of our portfolio versus the MSCI World Index and S&P 500. Although this is a decidedly simplified exercise, it is extremely evident our portfolio trades at a significant discount to these market indices. We strongly believe this discount will limit the probability that we experience a *permanent* loss in capital, which is our definition of risk. It also indicates that should our portfolio return to reasonable valuation levels; substantial profit potential may be realized.

	IBV Capital	**MSCI World Index**	**S&P 500**
Price to Earnings	9.18x	17.32x	19.31x
Price to Book	1.00x	2.11x	2.73x

On a 5-year basis, IBV's annualized investment return has been +10.3%, which compares to returns of +0.2% and +9.5% for the Value Hedge Fund Index and MSCI World Index, respectively. During 2015, our investment return was -9.0%, which compares to returns of -2.9% and -0.9% for the Value Hedge Fund Index and MSCI World Index, respectively.[1] While we spent the last year building a tremendous portfolio of phenomenal companies with highly attractive return prospects, our 2015 investment performance did not reflect this fact. As I explained to my original Family Office partners in late 2011 when our portfolio was experiencing similar return characteristics, while it is nearly impossible to control short-term market fluctuations, our investments' true underlying value will be reflected in due time. The years following 2011 were unbelievably fruitful, but only because we displayed patience and discipline. The same concept applies today and we anticipate a similar outcome.

Positive and Negative Feedback Loops

This year we observed many irrational feedback loops. For reasons unknown to us, 2015 marked the year in which private technology companies would become ridiculously overpriced. Airbnb, a short term vacation rental *website* is projected to lose $150 million in 2015 and is valued at $26 billion. This compares to Hilton's $21 billion market value - shocking, considering that Hilton owns, manages, and leases more than 745,000 rooms and expects to generate over $2.8 billion in cash flow and $800 million in profits this year. Uber, a favoured taxi alternative that also loses money, commands an extraordinary $51 billion valuation. Needless to say, we're highly suspicious of the valuations currently being placed on these start-ups.

In our opinion, these valuations are reflective of a positive feedback loop. Airbnb and Uber, as well as other start-ups, are being valued using aggressively high multiples of revenues and distant future earnings. In most cases, projected revenue growth rates are very optimistic and, equally worrisome, distant future earnings are "adjusted" to such an extent that they're nearly unrecognizable when compared to earnings arrived at using conventional accounting standards. Ultimately, these revenue and earnings projections are used to justify sky-high valuations. This, in turn, leads to large fund-raisings that support faster revenue growth, which eventually leads to higher future valuation levels and so on. It's important to note that the revenue growth these companies experience doesn't guarantee they will produce profits, but it is fostering an environment that suggests every start-up with revenue growth can justify atmospheric valuations. As history has shown, this works - until it doesn't.

In other corners of the market, such as oil and gas, the opposite irrational feedback loop is occurring. Poorly performing companies are losing access to financing. This loss of financing requires the companies to scale back existing operations and even sell assets, thereby shrinking their future revenue and profit outlook. The market then projects lower earnings expectations into the future, leading to lower valuations and again, less access to financing options. Eventually, the most poorly run companies go out of business or are purchased by their competitors at substantial

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[1] "IBV's" returns consist of: 1. Jan 1'11 – May 31'14 CAD$ Family Office gross returns managed by Talbot Babineau. 2. June 2'14 – December 31'15 USD$ IBV Capital Global Value Fund LP Class M units, gross of fees and net of all other investment expenses.
"MSCI World Index" is based on the returns MSCI World Free NR Index; "Value Hedge Fund Index" is based on the returns of the HFRX EH: Fundamental Value Index and both indices consist of: 1. Jan 1'11 – May 31'14 CAD$ 2. June 2'14 – December 31'15 USD$. 5-year annualized returns contain a combination of CAD and USD performance. All returns and benchmarks are shown in CAD from Jan 1'11 – May 31'14 and in USD from June 2'14 – December 31'15.

discounts. In both cases, the surviving companies often increase their market share, lower production costs, and generally face brighter future prospects. It takes time before the depressed environment the survivors operate within improves, but once it does, the remaining companies represent excellent investment opportunities.

Deciphering whether the feedback loop - positive or negative - is irrational, is the crux of our decision to invest in these situations. As for our recent investments in equipment manufactures that sell to oil and gas producers, among other industries, we see today's environment as being entirely irrational. Crucial to our investment thesis is the lack of evidence that suggests the world is transitioning away from oil, or natural gas, any time soon. A long-standing argument that the world will consume less oil in the future is the growth rate of electric car sales. While growing, globally, electric vehicle stock represents only 0.08% of all passenger cars. Even if this were to double, it's hardly a number that will meaningfully affect oil consumption. Conversely, a strong argument can be made that the world is shifting towards using more oil and natural gas. In China and India annual oil consumption per capita is around 2.5 and 1 barrel, respectively, as opposed to the 22 barrels the average US citizen consumes in a year. As well, we believe natural gas consumption is structurally on the rise as developed nation's transition electricity generating capacity away from coal, and in some instances, nuclear power, to gas fired power plants.

By dispelling the misperceptions about demand, we can shift our focus towards fundamental supply and demand dynamics. In the case of oil, today the world produces 95.5 million and consumes 94 million barrels of crude per day, thus creating a 1.6% oversupply. So, does today's oversupply justify a price collapse of 61%[2], and a price per barrel that remains far below average global production costs? We don't believe so. This is not to say oil, or the value of our investments, will go higher or lower in the short-term. It simply provides us with confidence that our investments will pay-off handsomely in the long run.

Contrarian with a Calculator

In last year's annual letter, I spoke at length about our aversion to investing in bonds under the conditions at the time. This stance proved accurate as the vast majority of investment grade and junk bond funds, ETF's and indices, posted meaningful declines. The junk bond space, with its high exposure to precariously positioned oil and gas producers and mining companies, fared particularly poorly. This is evident in the performance of commonly followed SPDR Barclays High Yield Bond ETF index, which fell 7.2% in 2015. With increasing interest rates, rising commodity company defaults, and a lack of liquidity in the debt space (an unintended consequence of post-recession regulatory changes), it's entirely possible we've yet to see the worst of this high-yield market rout.

However, naturally, our investment approach did prompt us to cautiously search this unloved market for opportunities. One investment we felt very comfortable participating in comes from a small corner of the pseudo fixed income space, rate-reset preferred shares. Preferred shares are technically equity, but have bond-like features, and are often issued by financial institutions, utilities, and real estate investment trusts.

[2] Based on the price decline of WTI from July 2015 ($94) to December 31, 2015 ($37).

Rate-reset preferred securities are unique in that they offer their owners a dividend that is fixed, usually for five years at a time, which resets at the end of every fifth year. At the reset date, the new dividend that will be in place for the upcoming five years is determined by applying a pre-determined premium (spread) typically to a five-year government bond yield.

Enbridge, where we found an attractive opportunity, is a Canadian based company with a dominant position in generating electricity and transporting crude and natural gas throughout North America. We're quite familiar with Enbridge and we like its durable business model, healthy financial position, and geographical diversification. Enbridge has considerable US operations, and to finance these operations, they have issued a select few rate-reset preferred shares denominated in US dollars. These preferred shares therefore have dividends tied to US five-year government interest rates, not Canadian government bond rates. This is important because it provides us with a distinctly different interest rate exposure relative to what is commonly found in the Canadian rate-reset market. Since we are of the opinion that Canadian government bond yields will likely remain low, and may fall even further, while US economic activity is supportive of increasing interest rates, we much prefer this interest rate exposure and ultimately expect to benefit from it.

At our purchase price, which is significantly below the $25 par value, this security yields 5.7% today. In June 2017, its dividend will reset, and based on current five-year US bond rates, it will reset to yield 7.0%. Since the premium (spread) is fixed and we anticipate US bond yields to continue to increase before the dividend actually resets, our yield should improve even further. With a limited chance of default and benefits tied to rising US interest rates, we anticipate this investment will provide very strong returns considering the limited risk we're undertaking.

The Right Company at the Wrong Time

We don't believe in celebrating wins and ignoring losses, and in 2015, we had a few positions that caused a drag to our returns - the most notable being National Oilwell Varco (NOV). We don't believe that this is cause for concern as we are focused on long-term returns, however, we do acknowledge when a position we hold could have been purchased at a lower price than we entered it at. In the case of NOV, specifically, it's had a meaningful drag on our portfolio's performance, which is a by-product of its falling share price and our tendency to hold concentrated positions.

In 2015, after oil prices had declined significantly from their peak of $107 in June 2014, we began purchasing the shares of NOV. The rationale for this investment was quite simple. Oil prices had fallen considerably as a result of an approximate 1.6% global supply overhang, largely caused by the proliferation of shale oil findings in North America. This seemed irrational considering a World Bank study showed that at $60 per barrel, roughly one-third of current oil production and more than two-thirds of the expected increase in global oil production could become uneconomical. As well, the geological make-up of shale oil findings, which was driving production growth, results in production decline rates that are 8 to 10 times faster than conventional oil basin findings. In short, we believed that the supply overhang we were experiencing would be relatively short-lived, especially as production slowed due to significant oil rig count reductions, and that the end result would be price stabilization at or above production cost levels. At the time of our investment, we felt the environment and sentiment was quite dour and being both contrarians and opportunists, we sought to exploit the situation.

At the company level, NOV dominates the offshore oil and gas rig equipment manufacturing space. This domination has led to an increasing large rig kit installation base that requires frequent replacement of high-margin aftermarket parts and general servicing. We considered this to be an attractive razor/razor-blade model, though on a much larger scale. Further, NOV's equipment is a critical component of production, which means when it breaks down, it must be replaced. Since their equipment breaks down over time due to harsh conditions and production volumes, we believe NOV's equipment sales over time will be more tied to oil demand volumes versus oil prices, and we see overwhelming evidence that world oil demand will continue to grow. While at the time we did anticipate a slowdown, NOV enjoyed a sizeable rig kit back-log that would "buffer" the slow-down in new equipment sales, mitigating the immediate impact and providing time for recovery.

So why with all these positive attributes associated with this company has it declined in value since we purchased it? Unfortunately, oil production has not declined at the rate we anticipated, and correspondingly, oil prices have continued to be depressed. While a few developments can explain this dynamic, we attribute much of it to hedges that allowed high-cost producers to continue pumping even while spot oil prices fell well below production costs and, until more recently, relatively easy credit conditions. At NOV, this meant orders from end customers declined, which was exacerbated by their distributors slowing orders to reduce their own inventory levels. This double-hit to sales is a common feature in business cycles. Fortunately, when activity returns, the increase in sales is brisk as both end customers and distributors will look to re-fill their inventories at the same time.

NOV's management was also a key factor in our investment decision. Clay Williams is one of the best CEOs I have come across. Being in a cyclical business, he ensured that his balance sheet was pristine - which it is - to take advantage of these types of industry-wide disruptions. The oil industry is notoriously volatile with price declines exceeding 30% on 5 occasions over the last three decades (1986, 1990/91, 1997/98, 2001, and 2008), which were highly damaging to some firms. Since oil prices began their precipitous decline, Clay has reduced their weighted average share count by over 11%, meaning we own a larger portion of the company without having to invest more money into it. He is also positioning the company for a large transformative acquisition. In this environment, we couldn't be more pleased about his strategy and the company's long-term prospects.

Road to Redemption

In our 2015 semi-annual letter, we touched on our investments in Bank of America and Citigroup by highlighting their potential prospects in the face of our anticipated increase in US interest rates. Finally, after years of scorn, both look poised to capitalize on improving business conditions. Their loan-growth has strengthened and credit default rates have shrunk. Further, well-executed cost control strategies are also boosting their bottom lines. While they're doing everything within their control to improve profits, low interest rates have been a meaningful drag on revenue growth and earnings. This is now about to change. In December, the US Federal Reserve increased their short-term interest rate from zero to 25 bps. Immediately thereafter, both banks increased their lending rates by the same amount. Importantly, they have not increased their deposit rates in kind, meaning their margins should continue to improve with time.

With the US economy on sound footing, we anticipate higher interest rates in the future, which will continue to drive both banks profitability. While the pace of increases from the Federal

Reserve may be slow, this actually bodes well for both institutions. The benefits of controlled increases far outweigh the unknown prospects associated with uncontrolled increases - a nuance that may be lost on the market. Slow and steady always wins the race.

<u>Stewards of Your Investment</u>

In the fall, we announced that Andrew Papierz had joined IBV's corporate advisory board. Our advisory board plays an important role in overseeing and further enhancing the many operational components that make up IBV. Prior to joining IBV, Andrew was Managing Director at BMO Nesbitt Burns in the Financial Products Group and President & CEO of the Canadian Derivatives Clearing Corporation. Andrew provides us with over 30 years of financial industry expertise and he represents a central corporate governance building block.

Continuing to build upon our robust compliance practices was a critical goal for us this year. We made significant progress that was culminated in November when we named Ryan Perillo as our Chief Compliance Officer. In addition to exhibiting honesty and integrity, characteristics that we highly value, Ryan possesses a deep understanding of the Canadian regulatory environment. Our progress in both our operational and compliance regimes provides us with an institutional quality infrastructure, and it allows us to focus intensely on investing.

If you have any questions or would like clarity on anything we have covered in this letter, I would be happy to hear from you.

Sincerely,

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