IBV CAPITAL

Dear Partners,

A Black Swan event is usually referred to as an unpredictable event that is beyond what is normally expected of a situation and has potentially severe consequences. So, this begs the question, is COVID-19 the ultimate Black Swan event? We are afraid the answer is no.

In the last 50 years, the world has endured seven major pandemics with four that have resulted in at least 200,000 deaths[1]. That is more than one occurrence every ten years which has resulted in a significant number of fatalities. Unfortunately, this suggests we should anticipate other similar events in the future.

From our perspective, the real Black Swan event was the unexpected globally coordinated government response to COVID-19. While nuanced, the differentiation is important because investors must adjust their focus beyond the probability of another pandemic to the more difficult question – will governments respond in a similar fashion next time.

Fortunately, the answer to this question can be formed using evidence of the devastating human toll COVID-19 has created and the tangible positive outcomes associated with the government's response measures. Importantly, these facts should be balanced against the final cost associated with addressing the virus. As financial stewards, we are acutely aware of the direct and indirect financial cost. An astronomical figure that continues to rise. As citizens, we are also deeply concerned about the rapidly rising global humanitarian impacts and the limited attention this is receiving.

As one might expect, the stay-at-home restrictions initiated at the end of the first quarter effectively pushed the global economy into a free fall. While these restrictions have started to ease

[1] https://www.weforum.org/agenda/2020/03/a-visual-history-of-pandemics

– albeit not necessarily permanently – the continuity of social distancing requirements has and will continue to be impactful.

Consider this, for over a century, humankind, primarily for survival purposes, has embarked on a mission to create economies of scale by fitting more people into less space. We call it densification. It is visible in all aspects of life; offices, condominiums, schools, stores, trains, and planes to name a few. Today, this trend has been mandated to reverse course. Immediately. Naturally, there are practical limitations associated with this directive and we are becoming increasingly concerned about the unintended, but real consequences it is having on everyone's physical, psychological, and financial wellbeing.

Today, the pandemic and subsequent government response is requiring us to consider an exponentially increasing number of investment inputs. This has resulted in a need to further broaden and deepen the already rigorous due diligence process we undertake before considering introducing a security to our portfolio. To share insights into how our core competency in due diligence will continue to thrive, we are going to pose a few questions that highlight our approach to the evolving environment.

- With school effectively acting as enhanced childcare for millions of parents, can an economy return to full potential if one parent is required to stay home to provide necessary caregiving and facilitate on-line learning?
- As universities transition to an online curriculum this fall, will doing so create regional housing crises in university towns and how will that translate to banking system stability and the national economy?
- A single Boeing 777 300ER holds 396 passengers. Once unloaded, maintaining social distancing of 6 feet will result in a half mile long line-up at customs. Will airports be capable of processing multiple flights simultaneously?
- Since business and leisure travel has effectively been halted, will the tourist regions, such as Europe, the Caribbean, Whistler and Las Vegas, be capable of offsetting the negative impacts of this once stable economic activity?
- When a restaurant is unexpectedly forced to close, it needs to dispose of all its perishable food. What is the cost of re-opening a restaurant and is the economic risk associated with a potential re-closing worth incurring in regions with a high risk of new outbreaks, such as populous city centers?
- If the maximum allowable indoor capacity of a business is well below a level consistent with its financial break-even threshold, can that business increase prices enough to offset its lower capacity or does it make more sense to remain closed?

- Since broad and efficient use of public transit has been temporarily impaired, will municipalities be able to offset the resulting budget deficit without dramatically reducing services of all types or drastically increasing taxes.
- Developing nation economies rely heavily on remittances – money sent home by expats. With global unemployment at record highs, will the resulting fall in remittances halt or reverse developing nations' economic growth?
- Since many developed nations have slowed or ceased accepting new immigrants – usually a key contributor to population growth and therefore economic growth – how will this reverberate throughout the housing sector?
- With lower incomes, remittances, and disrupted food supply chains, the World Bank has estimated that 265 million people will lack food security by the end of 2020, up 96% from 135 million before COVID-19. What is the impact associated with widespread starvation?

Today, governments and companies are beginning to encounter the practical financial and operational constraints associated with halting the economy and instituting social distancing. As we eluded to in our first quarter letter, few entities, governments included, are capable of remaining solvent if they effectively cease – or dramatically reduce – their revenues without a corresponding reduction in expenses. This obvious outcome, particularly for companies, is due to the underappreciated concept of operating leverage.

As a primer, operating leverage measures the sensitivity of a company's operating income to changes in its sales. Determining this sensitivity requires an understanding of a company's fixed and variable operating costs. With fixed operating costs being expenses that are the same regardless of the sales a company may enjoy and include items such as key employees, rent, depreciation (this is a real cost), or amortization. Variable operating costs more closely reflect sales and include expenses such as the parts and labor needed to build the product or provide the service a company sells.

A company with high operating leverage means a large proportion of the company's costs are fixed costs. In this scenario, the firm earns a large profit on each incremental sale but must maintain sufficient sales volume to cover its substantial fixed costs. Conversely, a company with low operating leverage means a large proportion of the company's costs are variable costs, so it only incurs these costs when there is a sale. In this case, the company earns a smaller profit on each incremental sale but does not have to generate much sales volume to cover its lower fixed cost base.

When an economic contraction occurs – sales usually fall, and each company's own operating leverage begins to determine its ability to absorb the fall in sales. When the COVID-19 lockdowns hit, sales did not fall for many companies – they stopped. How a decrease of this magnitude impacts a company's finances – without accounting for government subsidies or a corresponding reduction in expenses - can only be appreciated by way of example. For the neighborhood and downtown coffee shop we use in our illustration below, the key difference between them is the fixed cost associated with their location.

NEIGHBOURHOOD COFFEE SHOP
(Assume COVID-19 restrictions creates a 30% decline in sales)

	Pre COVID-19	Post COVID-19	Change
Cups of Coffee Sold	100	70	(30%)
Revenue Per Cup	$2.50	$2.50	
Revenues	**$250.00**	**$175.00**	**(30%)**
Variable Expenses	$82.10	$57.47	(30%)
Fixed Expenses	$106.90	$106.90	0%
Net Operating Income	**$61.00**	**$10.63**	**(83%)**
Per Cup Assumptions			
Coffee	$0.10		
Milk	$0.10		
Cups/stirrers/napkins	$0.18		
Variable Staff	$0.44		
Fixed Staff	$0.19		
Shop/rent	$0.88		

DOWNTOWN COFFEE SHOP
(Assume downtown rent is 25% higher and COVID-19 restrictions creates a 30% decline in sales)

	Pre COVID-19	Post COVID-19	Change
Cups of Coffee Sold	100	70	(30%)
Revenue Per Cup	$2.50	$2.50	
Revenues	**$250.00**	**$175.00**	**(30%)**
Variable Expenses	$82.10	$57.47	(30%)
Fixed Expenses	$128.90	$128.90	0%
Net Operating Income	**$39.00**	**(-$11.37)**	**(129%)**
Per Cup Assumptions			
Coffee	$0.10		
Milk	$0.10		
Cups/stirrers/napkins	$0.18		
Variable Staff	$0.44		
Fixed Staff	$0.19		
Shop/rent	$1.10		

Last year we wrote about the follies of using EBITDA (Earnings before interest, taxes, depreciation, and amortization) as a proxy for cash flows. Today, the use of EBITDAC (Earnings before interest, taxes, depreciation, amortization, and COVID-19) appears to be widespread. The magnitude of COVID-19's impact on earnings makes this practice particularly concerning.

While the income statement impact of COVID-19 on a company may be temporary – even this assertion is debatable based on the recovery timeframe – the effect it will have on the balance sheet will be long lasting. Therefore, the consequence will never appear in EBITDA, but it will be felt by every investor in the capital structure.

When a company incurs a loss, that loss needs to be financed. Regardless of whether it is financed through existing cash, new debt, or new equity, the enterprise value of that company has been negatively impacted and valuations should reflect this reality. Interestingly, since late-March, we have witnessed a meteoric rise in asset values. While some companies' reversions to their pre-COVID valuations are warranted, most are not.

Why are we seeing a decoupling of valuations and economic reality for so many companies? Particularly when so much has been written about the unfavorable macro-economic conditions we are currently faced with – record unemployment, decreasing labor force participation, plunging economic output, and rapidly rising personal, corporate, sovereign, and sub-sovereign debt levels.

As we pointed out, an underappreciation of the impact of operating leverage may explain some of this dynamic. For instance, the calls we are having with company management teams are focused intensely on negative operating leverage, whereas the market is more sanguine about the ordeal. However, this market optimism may reverse once investors gain insights into the financial impact that has and will continue to transpire.

Another contributing factor is the magnitude of the financial backstop of economic damage through fiscal and monetary intervention. From our perspective, this is bound to slow and eventually cease being a positive contributor. In fact, one can assume it will eventually become a detractor in the form of lower government spending, higher taxes, or a combination thereof. Even during a pandemic, the basic premise that there is no such thing as a free lunch still holds true.

Finally, we question whether the divergence can also be attributed to widely followed indices no longer representing a proxy for the economy – at least not to the same extent that they used to be. For instance, while the S&P 500 and Nasdaq continue their assent, indices with smaller or non-technology focused constituents have continued to perform poorly.

In unusual fashion, we are speaking broadly about macroeconomic conditions and market valuations. This is despite our proclivity to focus on individual investment opportunities and their underlying fundamentals. This shift stems from an optimism that society can overcome COVID-19 and the resulting financial damage has been self-inflicted. This would suggest that the economic outlook will begin to improve once restrictions are fully eased, and the crippling fear this virus has prompted no longer grips society at large. For us, these environments are particularly encouraging as they will provide intermittent waves of high-quality investment opportunities that we can deploy our capital into.

Unusual Intrinsic Value Volatility

The market value of our IBV Capital Global Value Fund increased by 2.6% (net of fees) in the second quarter of 2020. While the intrinsic value of our portfolio decreased by 10.7% during the quarter. For comparative purposes, during the second quarter of 2020, the MSCI World Index increased by 19.4%.[2]

A common investor focus, particularly during challenging times, is the return objective of a fund. Many of our industry peers address this complicated question by providing their strategy's long-term anticipated net of fee return target. Unfortunately, for investors, how this target is determined and whether it reflects the managers actual future return expectations given the environment they are in is rarely divulged.

In typical fashion, we prefer to be more transparent and specific with our investment partners. This has led us to sharing our portfolio's intrinsic value – what we think the portfolio is worth. This figure and resulting changes provide unparalleled insight into the impact our investment activities have on our future return profile.

There are a few additional intangible benefits to publicizing our portfolio's intrinsic value. Importantly, our investment partners can appreciate that while the market value of their investment may fluctuate, the underlying value of their portfolio is often more stable. It also provides a mechanism for us to share our thoughts on the future return profile of the portfolio. For instance, when our intrinsic value gap is very wide, as it is today, this is a clear indication that we think highly of our future return profile.

Since our prospective and current investment partners are relying on the portfolio's intrinsic value to give them comfort and clarity, we constantly focus on its accuracy and closely monitor its efficacy. It should be apparent that our intrinsic value gap, as a communication tool to address the question of what our return expectations are, goes above and beyond the boilerplate industry statements on the topic.

To maintain the accuracy of our portfolio's intrinsic value, when the full impact of COVID-19 came further into focus, we adjusted our expectations on the underlying fundamentals of a few existing investments. The causes centered on negative operating leverage and the anticipated pace of recovery for our different businesses.

As expected, there was a resulting impact on the valuation of a few of our investments. These adjustments reduced our portfolio's intrinsic value, offsetting some of the gains we generated when deploying our capital during the market freefall in March. While we prefer not to see this

[2] "IBV Capital Global Value Fund" consists of USD$ IBV Capital Global Value Fund LP Class A master series unit returns, net of fees. Inception date of this series is September 1, 2014. "Intrinsic Value" represents IBV Capital's internally calculated value for the cumulative securities within 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 12.

level of volatility in our portfolio's intrinsic value, the unprecedented economic environment deemed it necessary.

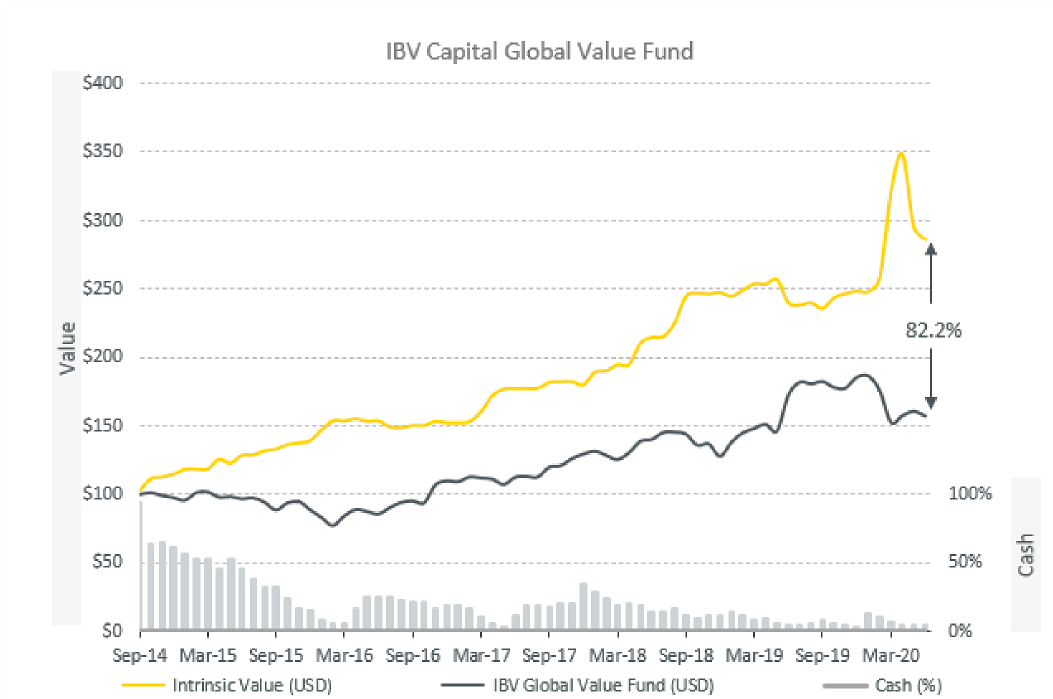
The notable detractor of our portfolio's intrinsic value was FirstGroup (FGP). As schools shuttered and companies sent workers home, it became evident FGP's underlying fundamentals had been negatively impacted. However, these impacts have since been offset by some positive factors.

For instance, while ridership has broadly declined, the importance this company has to the re-opening of the communities it serves has been acknowledged by both federal and local governments. As a result, FGP is being provided with considerable financial support – effectively ensuring the company is cash flow positive during this period. While this support counteracts the negative impact associated with virtual schooling and empty office towers, a temporary phenomenon, its magnitude and duration are uncertain. As a result, we have altered our intrinsic value downward to reflect this new reality.

Ironically, FGP was a modest contributor to the positive performance of our portfolio in the quarter. During the intense days following the lock-down, FGP's shares were falling dramatically on high volume. We suspected the high volume was a result of forced selling. Nevertheless, we began rapidly buying shares as the price no longer reflected the underlying fundamentals of the company.

Shortly after we completed our share purchase activities, we learned that FGP's second largest shareholder, Robert Tchenguiz, was addressing a margin call. Unfortunately, his bank was forcibly liquidating his position to cover his outstanding loan. Almost immediately after his forced selling ceased, FGP's shares increased in value. While a pleasant near-term performance contributor, we are more interested in unlocking the considerable long-term value we have identified in FGP.

Collectively, the amendments to the expectations we have for a few current investments offset our positive investment activities and have resulted in a decrease to the intrinsic value of our portfolio. When combined with the increase in the market value of our portfolio, it's narrowed the gap between the intrinsic value of our portfolio – what we think our portfolio is worth – and the market value of our portfolio to 82.2%.



It should be noted that our investment activities in the second quarter were muted as opposed to the selling and buying that we participated in during the first quarter. The driving force of this reduced activity can be attributed to the rapid return to pre-COVID-19 valuations of many companies, despite the significantly increased risk profile associated with the virus's economic impact.

Patience Is A Virtue

Since 2017, we have had an interest in real estate brokerages. Our first investment in the industry was Realogy (RLGY) in March 2019. RLGY owns Century 21, Coldwell Banker, Sotheby's International, and Corcoran Group. In addition to great brands, we were attracted to their franchising segment, which enjoys wonderful economics and is considered the largest franchisor of residential real estate brokerages in the world.

However, their company owned brokerage segment, which is a less attractive business, remains the driving force of the company's profitability. This segment earns revenues (and profits) in a way you would anticipate a real estate brokerage earning its revenues – through the volume of homes bought and sold (known as sides) and a share of the commission earned on each side.

Our investment thesis was simple, the meaningful cash flows the company was generating from its franchising and owned brokerage businesses would be used to de-leverage its balance sheet. This de-leveraging activity was a more important consideration than usual because the company was saddled with debt following a take private transaction and subsequent IPO by private equity firm Apollo Global Management.

Considering the United States was enjoying a balanced residential real estate market, the execution of this de-leveraging strategy was possible and would achieve two objectives – financially de-risk the business while simultaneously enhancing the value of its shares. All was tracking in the right direction until COVID-19 hit.

For a conventional real estate brokerage, the most damaging environment for their business is when transactions stop. As one would expect, the pandemic froze transactions in a way we have never seen. This not only halted RLGY's forward progress on de-leveraging but created a scenario whereby financial leverage would increase and therefore the risk that our intrinsic value would not be met, increased. As a result, we sold our position, but not before replacing it with RE/MAX Holdings (RMAX).

As mentioned, we have followed brokerages for a while and RMAX always stood out to us as best in class in the industry. Instead of the brokerage earning a split of the commission on each side, as RLGY does, RMAX charges a franchising fee to its independent brokers and a "desk fee" to its real estate agents. These fixed fees are applied regardless of how many deals an independent brokerage or RMAX agent has completed.

As a result, RMAX agents enjoy very high operating leverage – see our discussion on operating leverage above – effectively taking on transaction volume risk in leu of higher earnings potential. This offering attracts high performing seasoned real estate agents as opposed to agents that are new to the industry. From RMAX's perspective, their business model is designed to earn stable recurring cash flows from some of the best agents in the industry.

While RMAX enjoys a completely different business model, that is well insulated from current conditions, its market value fluctuated in line with other conventional brokerage businesses. We were able to seize this dislocation to initiate a position in an industry leading company.

Over the course of the quarter, HC2 made considerable progress towards its deleveraging objectives. In doing so, it has brought us closer to the realization of our investment thesis. As a reminder, HC2 is a holding company that owns numerous disparate businesses – from broadcasting to insurance to steel fabrication. One business that we identified as having considerable value was Global Marine Holdings, a subsea cable installation and maintenance service provider.

In 2018, HC2 committed to selling this business in two phases. First, they would sell their joint venture with Huawei Marine Networks. Afterwards, they would execute the sale of their ownership in Global Marine Group. With the closing of these two deals, the funds generated were immediately used to reduce pension obligations and redeem a portion of the 11.5% 2021 senior secured notes of which we are owners.

Effectively, HC2 redeemed 28% of our note position for $104.50 despite it being marked at a value in the mid-90's. While this represented an attractive partial exit, it also means HC2 has de-levered its balance sheet, increasing its overall credit quality.

This financial improvement was followed by operational improvements in the form of a change in management. Former CEO, Philip Falcone is a highly intelligent investor, but he also has a checkered history. While his business acumen led to the formation and growth of HC2, his reputation has also negatively influenced market participant perceptions. We believe this has made it more difficult to unlock the company's underlying value.

With a new CEO search underway and plans to continue selling assets to de-leverage the business, we are confident these represent positive credit enhancements that will make our senior secured notes position a more attractive investment proposition. We will continue to hold this position until such time as its market value aligns with our intrinsic value or the note matures in 2021. Until then, we are comforted by the substantial asset coverage and attractive coupon rate we enjoy.

When Words Are Not Enough

Over the years, society has witnessed unacceptable acts of discrimination of all types, in all countries. It is deeply disappointing that the voice of those who have been marginalized has long struggled to pierce the deafening silence of societies' willingness to be complacent. Today, their long simmering whispers have finally been amplified and they are demanding change. It is incumbent on everyone to listen to the message, hear it, and act.

For those who have visited our office, it would have been immediately apparent that we are indifferent to gender, race, and religion. Our vision limits us to only see talent, passion, performance, and integrity. Our commitment to equality and inclusion is simple, we will continue to walk the walk because talking the talk is not enough – and it never has been.

Sincerely,

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