



## MASSIFCAPITAL

Friday, April 6, 2018

Dear Friends and Investors,

For the quarter ending March 30th, 2018, the core portfolio returned -7.9% net of all fees and expenses compared to -0.54% for the MSCI All Cap World Index. A composite of all accounts managed by Massif Capital, was down 5.8. Since inception in June 2016 through the end of the first quarter 2018, the core portfolio has returned 13.2% net of all fees and expenses compared to 31.6% for the MSCI All Cap World Index. Returns in separately managed accounts may differ from the core portfolio based on initial investment date.

### **Portfolio Review**

This past quarter was without question the most challenging we have yet to experience since Massif Capital started investing outside money. During the month of January, most of our positions were down, and in the subsequent two months the trend continued. The result was that in the first quarter of 2018 we gave back most of our gains from the fourth quarter of last year, a period in which we were up 8.9%. Our losses this quarter have principally been driven by a significant sell-off in our largest position, Diamond Offshore, and in Lucara Diamonds, which together accounted for roughly 6% of our 7.9% drawdown. Neither company announced anything but value neutral or positive news this quarter, as such we have taken advantage of the sell-off adding to our positions at lower prices.

Despite the draw down in the portfolio this past quarter very little of note occurred with regards to either the operations or valuation of any portfolio companies. Only two companies in the portfolio have had any significant news in the last quarter outside of results, all of which were generally positive or in line with our expectations. At Lucara, CEO William Lamb stepped down after a decade at the helm of the company and handed over the role of CEO to diamond industry legend Eira Thomas, who was a Lucara co-founder and long-time board member. We view this change as neutral to positive. Eira Thomas has significant diamond industry experience, as well as significant experience creating value at junior and mid-tier mining firms as CEO. We look forward to seeing what she accomplishes with Lucara.

The new Lucara management team also purchased a small technology company, for \$25 million, during the first quarter. The company aims to improve the efficiency of the global diamond supply chain through an algorithmically driven online marketplace that matches raw diamond supplier inventory with jeweler diamond needs. Should the online marketplace achieve viability it promises to improve returns for rough diamond sellers and create an alternative revenue stream for Lucara. At the current time the Clara diamond acquisition is interesting, and creates a growth opportunity for Lucara, but given its early stage, we don't attribute any value to the subsidiary. This may change in coming quarters as the company ramps up operations.

Nevsun was the only other portfolio company with noteworthy news this past quarter, specifically approval from Serbian regulators to begin the decline for the underground Timok copper-gold mine (the decline is the underground road utilized to access the ore). The company also released a very positive preliminary feasibility study for the Timok project that suggested an after-tax net present value of the mine of \$4.87 a share vs. a current share price of \$2.38.

During the first quarter we added one new position to the portfolio, Teekay Offshore (TOO), for which you should all have received a one-page investment review earlier this week. A full investment report is available on our website. Our investment thesis is as follows:

TOO provides essential marine infrastructure to the offshore oil industry. The company has a significant existing contract backlog, worth approximately \$15 per share, control of roughly 50% of global shuttle tanker fleet, and a newly recapitalized balance sheet. Teekay currently trades at a significant discount to its intrinsic value in part because the market has failed to recognize that Teekay's business model is sound, even if capital allocation decisions made by the previous management team were not. A continued negative outlook for the offshore oil industry is also likely weighing on the stock. TOO has an intrinsic value north of \$6.00 share, a minimum margin of safety of 57.6%.

Over the course of the last quarter we have also refined our tail risk protection strategy, which has proved timely. During the first quarter our tail risk hedging strategy generated a realized return of 1.58% and total return (both realized and unrealized) of 2.92%. Given our focus on avoiding the risk of permanent loss of capital we believe that our tail risk hedging strategy is an important part of our portfolio, not only as a risk mitigant but as a source of desirable liquidity when market sell-offs present attractive prices. Investors should think of this portion of the portfolio as an insurance policy that aims to overcompensate for market drawdowns of more than 30% and reduce the cost of the insurance in market drawdowns of less than 30%.

### **Market and Economic Outlook**

As our investment practice continues to evolve, we are increasingly focused on what makes our approach unique and building upon that. Much of the difference in our approach stems from the things that do not concern us, but seem to concern everyone else: earnings estimates, consensus opinions, day to day changes in the price levels, etc. These are temporal issues of little concern for those focused on finding enduring value in their investments. Unsurprisingly, this means we are not terribly interested in firms generating supposedly rich returns utilizing debt and creative financial maneuvers, both methods of management create only quantitative, but not qualitative growth. As such, we seek only to invest in companies that do not confuse the ultimate ends of productive economic activity with the creation of money.

The purpose of a business is, and should always be, fulfilling a real economic need of society. Real value is after all not the result of dollars made yesterday and last year, but a consequence of today's expectations with respect to tomorrow's wants and possibilities. If a business addresses a real economic need, strong earnings and cash flow will follow. The purpose of a business though is never earnings and cash flow, regardless of how much management focuses on bottom line numbers and addressing the modeling questions of Wall Street analysts. This distinction is subtle but significant. Recognition of the

distinction means we always seek to understand businesses as tangible operations managed by individual practitioners, not abstractions of aggregated financial data.

We have recently outlined some of our thoughts on valuation in a one-page strategy document that is available on our website. Within that document we laid out a few of the key concepts that underpin our views on value at the current time, specifically the necessity that a company/business model must have endurance, independence and scarcity to create value.

- **Endurance:** We look for purposeful behavior on behalf of management to build a business capable of surviving not only for multiple generations, but also surviving the proverbial one in a hundred-year storm. Growth is of little value if a firm cannot endure.
- **Independence:** We are looking for an unencumbered balance sheet and business model with limited outside dependence in operations. Independence in this way allows a company to focus on its core competencies and organic growth strategies. Furthermore, independence allows management to act opportunistically without the imposition of outside constraints.
- **Scarcity:** We ideally want to invest in companies that either produce goods or provide services that only have very specific means of employment. The word investment comes from the Latin term for clothing, “investire.” We seek companies that tailor and transform capital (cloth) into difficult to duplicate high specificity assets. The economic opportunities to do this are as scarce as the companies that do it well.

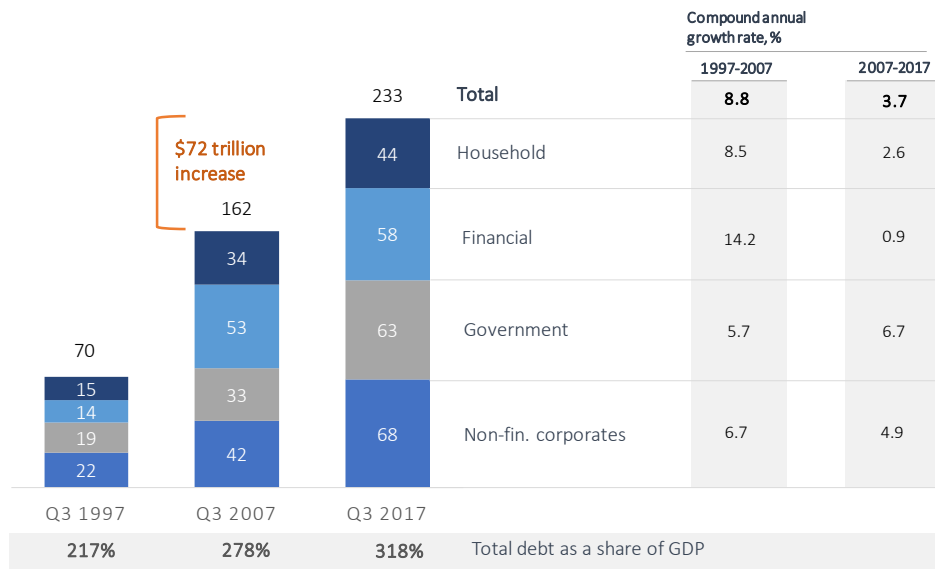
Given the bottom up approach to business valuation we take, and very distinct traits articulated above, we have often been asked why our letters include a section on macro-economic issues. The macro landscape serves as context in which we operate and it is important for us to convey how we are viewing the world we are making investment decisions in. At the same time, any macro observations must, if they are to be useful, tie back to business fundamentals.

At the current time we view the macro-economic landscape as rife with potential landmines that are likely to negatively impact the endurance and independence of many firms. Despite this fact we do see some pockets of investable scarcity that will position the portfolio to succeed in an environment of deteriorating business fundamentals.

Unlike in previous letters, in which we have often focused on concerns regarding interest rates, or more specifically central bank manipulated interest rates, our concern today is the resulting debt that manipulated interest rates have allowed for. The historically low interest rates of the last ten years are in themselves an issue, as we have discussed many times before, but interest rate cycles are long, often running 30 to 40-years. Debt on the other hand, tends to have short cycles, and lest we forget (as so many often do) our last recession was caused by debt.

Pockets of the global economy are clearly exhibiting myopic behavior. Since 2007, global debt has increased by \$71 trillion and no major economy has meaningfully decreased their debt-GDP ratio. The debt issue is particularly potent in the United States where every major class of U.S. debt (corporate, auto loans, student loans, sovereign and unsecured household) are at all-time highs. As Figure 1: Global Stock of Outstanding Debt illustrates, a similar trend is occurring at the global level as well. At \$233 trillion, global debt represents 318% of the global annual economic output.

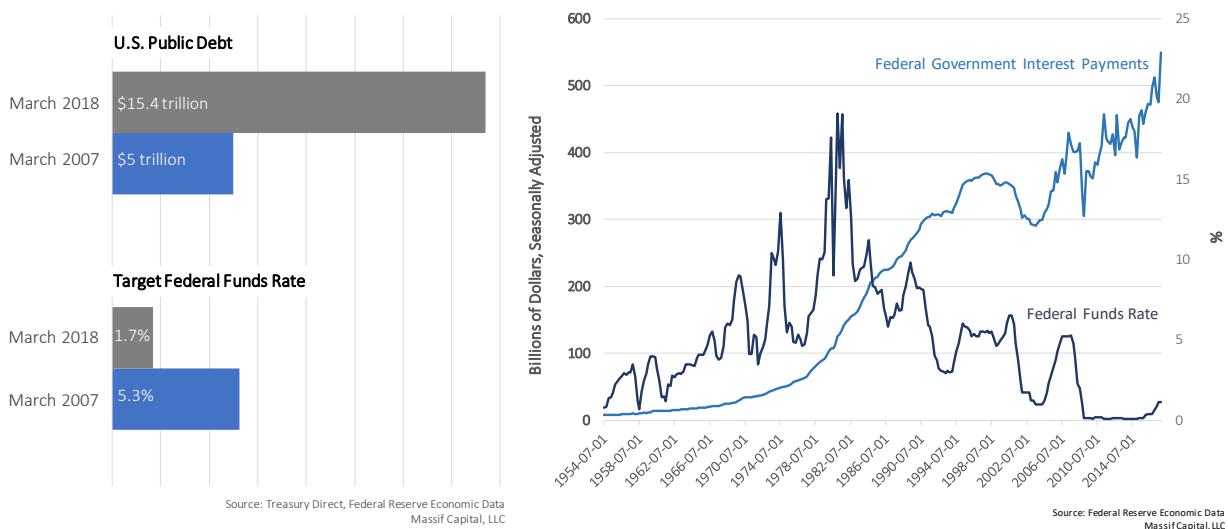
Figure 1: Global Stock of Outstanding Debt



Source: IIF, BIS, IMF, Haver Analytics. Image inspired by McKinsey & Comp. Massif Capital, LLC

Increasing our concern regarding this impressive debt load is the ongoing interest rate transition that appears to be underway. The European Central Bank and the Bank of Japan have not yet begun tightening but the U.S. Central Bank certainly has. Corporate, government and household debt may have grown during the low interest rate environment of the last ten years, but will likely have to be paid back during a rising rate environment. In the last six months we have observed the two-year borrowing costs on the US Treasuries rise to nine-year highs. The three-month London interbank offered rate (LIBOR) climbed to 2.29%, the highest it has been since 2008 and a 358% increase from 2016. The British Bankers Association estimates that debt equivalent to 12.8% of global GDP in nominal terms has variable rate interest tied to LIBOR.

Figure 2: The Cost of Servicing US Government Debt



Source: Treasury Direct, Federal Reserve Economic Data Massif Capital, LLC

Source: Federal Reserve Economic Data Massif Capital, LLC

The cost to service these debts is about to get a lot more expensive. Looking at Figure 2, one can envision how burdensome the increasing servicing cost will be even for supposedly top-notch sovereign credits

like the United States, let alone for corporate borrows that lack a printing press. As the cost to borrow and service debt increases in the coming months we can expect a growing number of supposedly enduring and independent business to be unmasked as anything but.

We are confident that we do not need to fear such events though, as many of the companies in our portfolio have no debt, and the handful that do, have manageable sums, with mostly fixed interest rates, real asset security and maturity dates far in the future.

### **The Second Quarter**

As important as endurance and independence are, scarcity is equally important. Rather than steering us away from potentially risky debt laden investments (as our search for endurance and independence does), scarcity steers us toward potentially value added and fruitful investments. Natural resource companies look increasingly interesting. Not only are commodity producers trading at record low valuations but several high demand resources appear increasingly scarce. Take for example oil, as recently highlighted in our investment report on Teekay Offshore, the oil markets appear to be heading towards a supply situation supportive of higher prices.

Furthermore, although the success of U.S. fracking has dramatically increased domestic production, fracking appears unlikely to produce equivalent success internationally due to the nature of shale deposits. Conventional oil finds have also failed to keep up with consumption for at least a decade. Last year conventional oil finds accounted for just 3.4 billion barrels of new oil, while about 30 billion barrels of conventional oil are produced each year, that is a reserve replacement ratio of only 11%.

Regarding scarcity and natural resources, it remains essential to unpack the conventional narrative that surround many commodities. We are very interested in the process of global electrification and the battery technology required to adequately increase the share of renewable energy to support this transition. At issue, is that investments in all the associated industries are currently narrative heavy and value lite. This will change, but separating the wheat from the chafe is a research heavy endeavor. For example, Lithium, most media and financial reporting suggests Lithium is not simply an important resource for batteries but the essential resource.

In the Lithium Industry there are roughly 200 lithium exploration companies trading on global exchanges and they all have a vested interest in suggesting that lithium is in short supply. The reality is that globally there are currently four primary lithium producers, all of which have reserves and resources that vary between 30 years and 120 years of supply. There is no lithium shortage, lithium is very common. What is seriously lacking is processing capabilities. There is no scarcity to the business models of Lithium miners, Lithium processors on the other hand address a very specific and real economic need with a very scarce asset.

What this means is that the many early stage/exploration lithium companies have lithium assets on the balance sheet that should really be thought of as liabilities. The reason for this is that development of the lithium assets will consume significant capital only to supply a common resource into a market experiencing a temporary supply/demand imbalance due to issue unrelated to mineable supply. The lithium story is similar to the rare earth metals (which are not in fact rare at all) story from a few years ago. Just as that narrative came to naught in terms of enduring value creation, the lithium mining story likely will as well.

We would be remiss if we envisioned scarcity through such a narrow lens. Teekay Offshore is an example of a different type of scarcity. Shuttle Tankers and Floating Production and Storage vessels are essential, critical marine infrastructure. The operation of this critical infrastructure requires both vessel and ocean specific knowledge. Furthermore, the infrastructure requires a significant investment of time and capital; the first of which is a scarce resource, the second of which less so in recent years. The fact that capital has been less than scarce in recent years means it is more important for it to be invested in irreplaceable assets that have long lives, predictable cash flows, and that ideally address a very specific, and in its own way, scarce economic need. Ports and some airports (specifically in Latin America) appear to us to share many of Teekay's critical qualities.

### **Our Business & Looking Ahead**

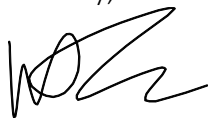
As we look forward to the rest of 2018, our focus is not only on producing strong absolute returns but also on building a business that can endure and facilitate our shared goal of long term capital appreciation. We are active through several capital distribution channels and our research is picking up significant interest across various investment platforms.

As we grow, we are cognizant of how important implementing a top-notch back office is to you, our investing partners. Our goal is a painless, intuitive and informative statement and billing process and we are working hard to improve that functionality. We are also actively working to establish an Advisory Board for Massif Capital. The Board will be comprised of individuals in the fields of finance, economics and geopolitics. Their experience and expertise will help provide us with an independent assessment of investment opportunities, allocation decisions and corporate growth strategies. The Board will also ensure that Massif Capital abides by the highest ethical and corporate governance standards. We look forward to providing more information on the boards roll out and membership as the year goes on.

Finally, as of July 1, 2018, Massif Capital will be officially moving its headquarters to Charlotte, North Carolina. This move will not impact our service to you in any way, but will provide us an opportunity to escape the echo chamber that is Wall Street. As such, expect ever better and more differentiated investment ideas and thought from us.

As always, we appreciate the trust and confidence you have shown in Massif Capital by investing with us. We know that entrusting hard-earned capital to a young emerging fund is difficult and hope that you will not hesitate to reach out if you have any questions or concerns about what we are investing in.

Sincerely,



Will Thomson



Chip Russell