



MASSIFCAPITAL

October 5, 2018

Dear Friends and Investors,

For the quarter ending September 28th, 2018, the core portfolio returned 4.5% net of all fees and expenses compared to 4.4% for the MSCI All Cap World Index. A composite of all accounts managed by Massif Capital was up 1.9%. Year to date the core account has returned 4.5% net of fees compared to the MSCI All Cap World Index which has returned 4.2%. Since inception in June 2016 through the end of the third quarter 2018, the core portfolio has returned 28.5% net of all fees and expenses compared to 42.5% for the MSCI All Cap World Index. Returns in separately managed accounts may differ from the core portfolio based on the initial investment date.

This letter will be somewhat different than previous letters. We usually review the world as we see it, the context in which we are investing, followed by a review of the portfolio. In this letter, we take a deep dive into a position we recently closed and discuss how we have employed our process throughout the life of the position to maximize returns. This is important not only because we believe our process and approach gives us an edge but also because our process constructively shapes how we behave. This may seem a rather strange comment, but as was recently noted by Morgan Housel is his excellent article “The Psychology of Money,” “investing is not the study of finance. It’s the study of how people behave with money.”¹

One of the significant difficulties of active management is that as portfolio managers we are emotional creatures, but we often pretend not to be. Pretending not to be is a disservice to ourselves and our investors; it is sweeping under the rug feelings that permeate everything we do and thus contribute to under or over performance. Rather than ignore the emotional tension involved in investing in public markets, it is essential for managers to recognize the pitfalls of an emotional response and craft an investment process around those pitfalls. A good investment process succeeds not because a manager deploys it without emotion but rather because it allows a manager to act intelligently despite the emotional turbulence that arises from the volatility of public markets.

Exited Position and Lessons Learned

In September, we exited our sixth position, Nevsun Resources, bringing our average annualized return on closed positions since inception to 58.8%. For the core portfolio, the position returned a total of 73.2%, or 33.9% on an annualized basis, over the slightly more than two-year holding period. Nevsun was a volatile position during our holding period. This is not uncommon for many of our positions, and we always look to take advantage of continued mispricing if given the opportunity by the market.

¹ [“The Psychology of Money”](#), Morgan Housel, The Collaborative Fund

Nevsun was subject to several dramatic swings during our ownership period. Following our initial purchase (which occurred at \$2.90 a share), the stock ran up in price 17% in a matter of weeks. Nevsun then proceeded to trade mostly sideways until February of 2017 when it dropped 33% over the course of two weeks. The initial drop of 15% was driven by no news or fundamental changes in the business. The remainder of the price fall followed reporting of a delay in the release of information regarding a development project and the reworking of a mining plan for their existing mine, Bisha. We took advantage of the volatility multiple times to add to our position at progressively lower prices. When we exited the position, we had reduced our average entry price by 12%.²

In November of last year, we traveled to Serbia to visit with Nevsun's management team and evaluate the development progress of their world-class Copper project, Timok. We spent two days on the ground reviewing various aspects of the operations. We also meet with members of the Serbian government to discuss the project and members of the community in which the mine was being built. We came away from the site visit with conviction in our valuation thesis intact.

Despite our confidence, the market established a new five year low for the company in February of this year, shortly before Nevsun rallied 120% following several takeover offers, one of which, an offer by a Chinese based mining firm, was finally accepted in September. With managements acceptance of a takeover, we opted to close out the position and avoid any potential risks associated with regulatory issues that might arise during the closing of the deal. For Massif Capital, there are several lessons from this investment. The importance of the site visit cannot be overstated. Spending several days with the management and operational teams was tremendously valuable. Also, the success of the investment reaffirms a key tenet of our value strategy specific to real asset firms that are either a single asset business or involved in a significant asset development: the quality of a firm's projects trumps all else.

If it is not a top tier project, it often does not matter how strong the management team is. When a company's business model depends on large-scale capital investments into assets that have lives and cash flow streams that can last for decades, the quality of the project is of the utmost importance. A bad project cannot be rescued by a good management team. As such, the investment risks associated with companies that have marginal projects (whether they be mines, infrastructure or other large-scale projects) is not acceptable to us.

Along with high-quality projects, operational excellence is paramount and often overlooked in equity markets as it is assumed to be represented in financials, without taking into consideration the fact that financials are a mix of operating results, financing activities and capital allocation decisions. Although operations are important for all businesses, few businesses are as exposed to operational risk as real asset businesses. Up to 90% of employees in a heavy industrial operation or a commodity-focused business, typically have a role in the company's operations. Such a significant commitment of capital and human resources makes sense; operations represent the company's core process of turning raw materials into finished products. Operations are where the business adds value.

The result of this operating paradigm is that most of the risk associated with the potential permanent loss of capital in our portfolio is to be found in the operations of the businesses we invest in. Our response to this reality is at odds with that suggested by modern portfolio theory (MPT), an academic theory that calls for the construction of portfolios in a way that results in idiosyncratic company-specific risks being diversified away. Although the way most managers deploy the diversification strategy of MPT reduces

² Due to timing of initial purchases, some separately managed accounts had even lower positions than the core.

company specific risk in the portfolio, it also means the portfolio gains little from taking on exposure to company-specific risks. This means that the overdiversified portfolios of most managers will struggle to outperform the market. We choose to ignore the academic advice in favor of pursuing a deep understanding of how the businesses we invest in go about making money.

Operational risks are risks that occur in the present. Thus we need not blindly trust in our forecasts of the future to understand the risks we are exposed to today. Although we believe operational risks are more readily assessable than the risks associated with other business models that are less tangible, the market does not treat all risks the same. A company's operational struggles are usually an easy excuse to sell. Our position in Nevsun provides an illustrative case.

During Nevsun's 33% slide in 2017, a key concern was difficulties the firm was having in processing ore at Bisha, the firm's Eritrean based copper-zinc mine. The issue was processing ore in a way that achieved an optimal ore concentrate outcome. The result was recovery rates of copper and zinc that were lower than had been planned for.

The problem was a difficult operational and scientific challenge, getting the right mix of chemicals, ore and processing methods to achieve an optimum outcome. The solution to the problem was to be found, over the course of 8 to 12 months, by trying different approaches to processing the ore. The timing of the operational issue was not ideal but approaches to resolving the operational challenge were numerous and well tested at every mine the world over with complex ore. The response by the market to the initial news though was to wipe out \$139 million in market value (a 17.5% slide) in 24 hours. This operational issue was eventually resolved, and Nevsun management reversed the asset write down that accounting rules forced them to take.³

It is often easier for investors to think they understand a tangible problem over an intangible problem. The result of most investors belief in their ready understanding is a rapid and often dramatic change in sentiment that is disproportionate to the real impact of the challenge on long-term value.⁴ This change in sentiment, which usually precedes a painful price reversal, is not to be feared though, this is our opportunity. The market is impatient and not interested in waiting for a problem to be resolved, or even in taking the time to properly evaluate the exact financial impact of a complex problem that may take several days and many conversations with industry insiders to understand. We, on the other hand, take the time and expend the energy to understand the situation, and in so doing can take advantage of operationally driven price swings.

Market participants are more interested in action, in quickly reallocating capital to less problematic assets regardless of the real long-term impact of the operational challenges on the company's value. This is unfortunate as action interrupts compounding. What is distinctly lacking in the stock market when it

³ For those slightly confused by the reversal of an asset write down, US GAAP accounting rules do not allow for the reversal of asset write downs but IFRS accounting rules (which are similar to US GAAP and followed by most of the world) do allow for the reversal of write downs. It is worth noting that with real asset companies this is an accounting issue that can create opportunities. If Nevsun had been a US company following US GAAP accounting rules they would have written off asset value that never again showed up on the balance sheet but did in fact exist after some focused effort to address operational issues.

⁴ It is also worth pointing out that most price reversals of this nature are the result of "traders" moving the marginal price of a firm. This is worth noting as traders are playing a different game than we are, and it would be inappropriate for us to take cues from those playing a different game than we are. We readily admit that this is not an original thought on our part and comes from Morgan Housel's previously cited report: "[The Psychology of Money](#)" which we strongly suggest all to read.

comes to real asset assessment is a recognition that complex real-world operations almost never run smoothly. The base value of a real asset is found in the quality of the project, but the final value of the asset is determined by both the quality of the project and how well management teams deal with the operational problems associated with monetizing the asset.⁵ Operational challenges are rarely existential, but implicit in the act of selling is an assumption that they are.

The fact that operational challenges are rarely existential is another opportunity for us. The goal of investing is not to earn the highest returns possible but rather to earn consistently high returns for as long as possible. Many people make investments that have favorable odds, but despite the favorable odds they have a downside scenario that an individual investor cannot tolerate either behaviorally, or financially. Anyone who has read any of Nassim Taleb's work will be familiar with this concept. Morgan Housel makes a note of this in his recent essay, by highlighting that although the odds are in your favor in Russian Roulette, you are still not going to play. The operational risks in the companies we invest in rarely risk a permanent impairment of capital, operational risks usually delay the realization of value. As Warren Buffett has noted, "in order to succeed, you must first survive." Lucky for us we can survive operational risk, and frequently we can take advantage of it.

The lack of market patience for operational challenges can be juxtaposed at the current time with the endless patience the market has for appealing narratives, regardless of the operational complications that are glossed over in that narrative. This juxtaposition is suggestive of the degree to which stories drive market action rather than solid analytical work. One might go so far as to rewrite the famous Ben Graham quote: in the short run markets are voting machines and in the long run weighing machines to in the short run markets are narrative driven and in the long run operationally driven. This is an important point for investors to understand as the significance of narratives in the market underpins a source of edge we try to cultivate.

Specifically, we try to operate based on what behavioral economists refer to as public knowledge while we let the market operate on what is referred to as common knowledge. Nevsun had operational challenges at Bisha, this was common knowledge and spurred a selloff in the stock. A combination of patience and due diligence on our part to understand the nature of the operational challenges faced by Nevsun meant we operated on the basis of public knowledge that was available but not commonly understood. With our approach to investing we seek an early and uncommon understanding of a firm via a focus on aspects of the business that are secondary for most (operations) and which are driven by public but not common knowledge.

The appreciation of our position is thus based on a shift in common knowledge brought about by information dispersion over time or specific catalysts that reveals to a broader audience that the common knowledge is no longer valid. In the case of Nevsun, that was a buyout offer, the first of which occurred before the firm had even fully resolved all the operational challenges at Bisha. One might go so far as to say a buyout offer occurred because a distinct gap between public and common knowledge regarding the value of Nevsun existed.

The importance of discipline in this approach to investing cannot be overstated. When market events occur, we must first ask ourselves what has changed in how the company is executing its operations, even if price action in the market begs us to act. If we can find an operational change or issue, we then track that change until we understand how it impacts the aggregate financial statements. We can then

⁵ Note that the value of a company (made of several assets) has additional value drivers.

appropriately distinguish between issues that will cause a lasting impact on a company's value and those that won't.

This process differs significantly from a financial statement first approach, which takes changes in financial statements as the core issue, when in fact they are simply a reflection of real-world events. The differences sound subtle, but we believe focusing on what is occurring at the operational level provides a clearer picture of how events impact long-term corporate value. The in-depth examination of financial statements is important but studying a derivative representation of real-world events without spending equal if not more time on the events themselves can only take an investor so far. One is watching shadows on a wall; the other is watching full-color HD.

We made money with our investment in Nevsun by recognizing the quality of a project the company owned (Timok in Serbia). This was not a unique insight though; others understood the value of the project. A divergence in the investment process occurred after that recognition though. Nevsun experienced operational challenges at Bisha that did not impact the value of Timok but did stoke fear amongst investors that prompted selling. Volatility ensued, and we respond to that same fear and volatility differently, we dug deeper.

Because of digging deeper, we learned two things. First, our operational focus led us to conclude that issues at Bisha could be resolved over time, so they were not existential. Second, we learned although operational issues at Bisha would impact free cash flow earmarked for the development of Timok, Timok was a project of such high quality that the delay and or loss of free cash flow from Bisha would only marginally impact the final value of the company.

The Balance of the Portfolio

Beyond Nevsun, the portfolio proved almost equally volatile this quarter. Graftech, a new position this quarter (our research report can be found [here](#)), moved up and down from the mid \$17-dollar range to the plus \$20-dollar range three times despite the fact that this year's production capacity is 95% contracted and roughly 65% of production capacity for the next five years is already booked at known prices. The most recent roundtrip from \$20 to \$17 and back again is likely attributable to a poorly managed offering of stock by a large (75%+) owner. Nevertheless, multiple moves of between 12% to 15% in a single quarter is impressive. As in the case of Nevsun, we have taken advantage of this volatility to add to our position at lower prices. Graftech contributed 0.48% in gross returns to the portfolio in the third quarter.

At the current time, the most significant drag on the portfolio remains Barnes and Noble Education. While the position contributed a positive 0.19% in the third quarter, it has remained our poorest performer of the year with a -2.86% year-to-date attribution to a composite of all accounts. Here too the market appears impatient, the summer months should be slow for a store operator that focuses on college and university campus, unsurprisingly it was. At the same time, the seasonality was in line with all previous summer quarters for the company and should have come as little surprise.

The market disagreed, prompting a 15.7% slide in the stock when earnings were reported. We were not caught off guard by results or by the fact the company sold off; both have historical precedent, we were caught off guard by the significance of the selloff. Despite the unwarranted sell-off, we remained pleased by the continued efforts of management to extend their relationships with and become a dedicated channel for, academic publishers to get material to students. Also, we see progress made by the firm in

broadening their suite of digital products for students via accretive, bolt-on acquisitions. Both trends support our thesis and conviction that Barnes and Noble Education is turning itself into an essential piece of infrastructure within the evolving academic ecosystem of the United States.

Several pieces of news came out of Norwegian Cruise Line (NCLH) this past quarter that strengthened our conviction in our short thesis. Of note, NCLH has redeployed a Chinese focused ship to service the Alaskan market. From our perspective, the firm's ongoing departure from Chinese waters, along with similar moves by peers, suggest that the Chinese market is not nearly as rich an opportunity as many industry participants had hoped; a situation highly supportive of our thesis that the supply of new ships will outpace demand in the coming years. NCLH has also started offering free and discounted flights to customers interested in Alaskan cruises. We believe this expensive marketing maneuver may be the first sign of weakening demand, especially given that it is targeting what has historically been one of the more popular cruising destinations. We continue to have confidence in our assertion that the fixed cost structure of the business is not sustainable and survives only in the presence of recent significant, but unsustainable, demand growth.

The portfolio remains underinvested on the short side, a point of concern for us at the current time. We continue to search for good opportunities but find ourselves frequently confronted with companies that appear ready to tip over from a valuation and financial perspective but lack a catalyst to trigger the fall. This observation is supported by a [recent study conducted by the Bank of International Settlement \(BIS\)](#) into the prevalence of “zombie firms” in advanced economies. The study found that out of the 32,000 nonfinancial advanced economy companies in the Datastream Worldscope database, 12% were at least ten years old and had experienced at least three consecutive years of an interest rate coverage ratio (IRC) of less than 1, up from around 2% in the late 1980s.

The BIS attributed the growth in “zombie firms” to the fact that they seem to face less pressure to reduce debt and cut back activity than firms used to. In short, they seem to persist, and the tendency to persist has increased over time. “Zombie firms” today are 85% more likely to survive and remain zombie firms for another year following the initial fall in their IRC to below 1 than they were in the late 1980s when they were only 60% likely to survive. The increasing persistence of “zombie firms” means the importance of a hard catalyst for a short has only increased in importance. The BIS also note that this trend is not correlated with the 2008-2009 financial crisis but has its origins in the late 1990's and early 2000s. We have many thoughts, as does the BIS, as to why “zombie firms” have become more prevalent but the key takeaway is that there are a lot of short opportunities at the current time, we just need to maintain our standards and keep digging. Caution remains the watchword, markets at the current time are volatile and tricky; we refuse to let a rush to short imperil investors capital.

Looking Ahead

In closing, we continue to search for value in unloved and out of the way sectors of the economy. We see significant value in the Uranium sector but are challenged to deploy capital to the industry because there are ample speculative opportunities but few investable opportunities. Although we also see significant value in Gold companies, here the challenge is slightly different. There are investable opportunities, but few companies that don't just trade with the price of gold. We are also looking at several infrastructure opportunities in Europe, but they all have significant political risk due to their location, Eastern Europe.

During the third quarter, we read two recently published books we believe are worth suggesting. *Crude Volatility*, which was published last year, is a unique history of oil that focuses on the price volatility of the

commodity. Unlike some of the other wonderful histories of oil that are available (the most noteworthy being Daniel Yergin's borderline definitive work *The Prize*) the price action lens through which *Crude Volatility* contextualizes the boom and bust nature of the industry is insightful and results in a different but fresh interpretation of past events.

The second book, published this year, is *Taming the Sun*, by Varun Sivaram. *Taming the Sun* is an in-depth study of the role of solar power in our current and future energy system. Although at times the book is overly optimistic about the potential of solar, the author does achieve a balance lacking in other works on the topic. *Taming the Sun* is a must-read for anyone who looked into the solar industry earlier in the decade and found it uneconomical. Solar is a difficult and complex source of power to monetize effectively, but progress addressing some of the solar industries more pressing challenges has been made. In the right places, with the right deployment, solar is now more economical than almost any other source of power.

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 an 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

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