MASSIFCAPITAL

Dear Friends and Investors,

The core portfolio for Massif Capital was up 6.2% during the third quarter of 2020. Year-to-date, the portfolio has returned 29.5%. A detailed report on individual account performance will be provided to investors in the coming days.

PORTFOLIO ATTRIBUTION[1]

The third quarter was a volatile one for the portfolio, with a significant move to the upside in July and August (roughly 12% gross of fees) followed by a sharp September sell-off (roughly -6% gross of fees). The long book drove the gains with a total contribution of approximately 11%. The short book dragged on results throughout the period, contributing -4% to the overall performance. Returns were once again driven primarily by our basic materials exposure and its heavy concentration in mining businesses.

Our two copper mining positions, Ivanhoe Mining and Turquoise Hill, and our investment in junior lithium miner Lithium America were three of our five largest contributors, producing a roughly 9.5% gain for the portfolio. Vestas Wind Systems was our second-largest stand-alone contributor, yielding a 2.8% gain for the portfolio. The book's short side produced no positive returns for the quarter, with our positions in US railroads, agriculture, and questionable cleantech companies all moving against us.

Our tail risk hedge, which helped us weather March and April's storms, created a greater than normal drag on quarterly returns. Since the fund's inception, however, it has produced a positive return due to the extreme volatility in February 2018 and the significant sell-off earlier this year. As important as the offsetting gains produced by the position during significant market events has been, the hedge has also provided an influx of cash at opportune times. The cash generated from this year's early sell-off was reinvested in our copper and lithium investments which have roughly doubled in the intervening months.

RISK MANAGEMENT

It was a relatively quiet quarter in terms of portfolio turnover. We added two equity positions on the portfolio's long side, gold miner Lumina Gold Corp and European utility RWE. Those interested in a more detailed look at our Lumina Gold thesis should read our recently published report on the firm. Also, we reestablished our short exposure to a basket of cleantech companies we think are of questionable quality and suspect staying power, having exited the same positions in the second quarter. This time around, we choose to add the exposure via long-dated out of the money put options. As we continue to improve our approach to risk management iteratively, we expect a more thoughtful use of options on the short side may play a productive role in the portfolio.

The basket of cleantech companies we have shorted are all profitless with uncertain business models that hinge on dubious management claims and concerning balance sheets. Nevertheless, they are helmed by managers skilled at telling their stories and capable of tapping debt and equity markets for cheap funding. That one or more of these firms is a bankruptcy candidate in short order in anything, but the most favorable financing environments is all but certain. The current combination of easy money and their bold green narratives have created a tendency for volatile but somewhat parabolic moves to the upside. As such, they make for difficult firms to comfortably short via equity. We believe that the opportunity to retain exposure to our negative outlook for this basket of firms while fixing the downside risk via options presents us with a better risk-reward opportunity than an outright equity short.

We also used call options this quarter to fix our downside in the portfolio's two US railroad shorts. US railroad equities have continued to appreciate despite nearly two years of contracting volumes. Although we find the idea of margin improvement via the outright shrinking of the business a questionable route to long-term value creation, the market continues to disagree with us. Companies should be sized and scaled appropriately to be economically sustainable. Still, a near-continuous shedding of employees and mothballing of assets seems an unsustainable and managerially questionable approach to improving margins.

By fixing our downside with long-dated call options, we admittedly shrink our possible gain from the short positions, but we also extend our time horizons and enhance our ability to endure upside moves. As an example, one of our railroad shorts could potentially produce a return for us of 48% should it fall to what we believe is a more realistic valuation with the addition of the call options, that potential gain is reduced to a 43% return. Between a wager with a known downside that costs us a small percentage of the potential upside and an uncapped downside with only slightly more significant upside, we are more comfortable with the former.

CHANGING BUSINESS MODELS

In August, we initiated a position in the German utility RWE. RWE is transitioning from one of Europe's most polluting and carbon-intensive electric utilities into a leading renewable energy producer, a transition that we believe the market has yet to appreciate fully. Three years ago, RWE was a coal operator, with a lignite mining and energy trading arm contending with significant uncertainty from an unsettled German regulatory environment. Following a complicated asset swap with E.ON that was completed last year, the firm has emerged as one of Europe's largest renewable energy producers and has financially ring-fenced their coal phaseout liabilities.

Today, offshore wind makes up about 69% of the group's earnings. Onshore wind and solar make up the rest with a small contribution from hydro and biomass. We expect earnings to rise through 2022 as projects under construction should expand their renewable power base by ~50% over the next two years, and the returns from legacy assets in runoff produce strong cash flows.

Power generation margins should continue to recover after bottoming out in 2018. The company has sold 90% of its expected electricity output for 2020, 65% for 2021, and 45% for 2022 at much higher prices than it did from 2017-2019. This should help offset the broader decline in wholesale prices across continental Europe in part caused by the sharp drop in natural gas prices and the deployment of zero marginal cost renewable capacity. Although the company has a multi-year transition ahead of them, we believe the renewable build-out acceleration, combined with increasing clarity in the European Union around mandated asset closures and clean energy targets, is a powerful tailwind. Earnings quality has improved as they have rotated into lower marginal cost resources, resulting in both an increase in earnings and potentially a higher market premium on those earnings.

Corporate transitions from high carbon footprint business models to low carbon footprint business models represent some of the more intriguing long-term opportunities currently on offer in public equity markets, but they are not without their challenges. Transitioning firms, recently discussed in our white paper on ESG investing, face the challenge of presenting their strategic shift to the market in such a way that the future potential from the transition is understandable and easy for the market to discount.

Although equity markets now appear ready to believe any story startup firms' management tells them, they remain less willing to discount the changes being made by larger incumbents. In some regards, this is the reason our portfolio is overweight firms that enable a transition and underweight firms that must transition. Over time, we expect this ratio to shift as the value add of transition strategies becomes more accretive to many firms' bottom lines.

For some industries, the shift is still some years off. We believe the European utility sector may be an exception to the market's slow recognition of strategic transition value in part because of the more settled (and co-operative) regulatory environment. Some exceptions exist, and several US firms have caught a bid from environmentally concerned investors. However, many utilities are still sorting out their transition strategies, and the market is penalizing them for it. The U.S. utility sector has a 3.5% dividend yield is ~270 basis points above the 10-year U.S. Treasury yield, a ratio nearing historic highs. On average, balance sheets and earnings outlooks appear to support both the current payout ratios and transition strategies, assuming they remain well-sequenced transitions.

From now on, we expect to see developed world utilities focus on scaling their customer base as large as possible and moving aggressively to change the composition and value proposition of supply as they grow their customer base. Sequencing the two changes properly is essential; to date, shifting supply towards renewables in the absence of a growing customer base has eroded the traditional utility earnings power relative to capital expenditures despite improving margins. As renewables become a larger percentage of total capacity, utilities need to decouple the production cost and value of a MWh. Continuing to frame an electricity contract's value in terms of operating and maintenance cost is deflationary in the presence of renewable generation.

Suppose regulators and management teams continue to peg the value (revenue) of a MWh to the declining maintenance expenditures. In that case, the pricing for electricity will fall at least as fast as the cost curve. Revenue will continue to decline as the need for additional capital expenditures rises. Management teams will be forced to increase their customer base to outpace the assets' declining revenue-generating ability. Viewed through this lens, the reported NextEra takeover bid for Duke Energy makes a lot more sense. NextEra wants to buy Duke Energy's 8.9 million customers.

As generation cost drops, utilities will likely need to offer MWh's for free in exchange for alternative grid services or non-utility revenue sources. With enough renewables on the grid, cost curves will hit a price point that requires some value to be provided other than through the sale of electricity. Volta Charging, an EV charging station network, provides an example of what might be coming down the pipeline – offering free vehicle charging and monetizing advertisement, land value, and partnerships.

Today, the supply composition change is well underway as many utilities switch from fossil generation to renewable generation. Although the switch is often accretive to the bottom line immediately, too much of a good thing is, well, too much of a good thing. Margins expand as high OPEX generation (coal) is replaced with low OPEX generation (renewables). Still, revenue shrinkage can overwhelm margin expansion, and smaller earnings can often be overwhelmed by growing capital expenditures.

Utilities have long played second fiddle to oil and gas companies in the energy system when it comes to value creation, but this is changing. Tesla overtaking Exxon Mobil's market cap this summer was an interesting story not because Tesla surpassed Exxon in market value but because EVs will enable utilities to surpass oil and gas in value creation. Utilities providing energy to power EVs represent a massive transfer in ownership of the total energy supply from oil companies to electricity generators. It is a generational value transfer we seek to capture.

Electricity producers in Asia, Europe, and North America are not the only ones experiencing pressures to change or attempting to take advantage of new opportunities. In July, we initiated a position in Polaris Infrastructure (PIF), a small-cap energy developer focused on the fractured but growing South American market. The firm currently operates 72 MW of geothermal capacity in Nicaragua and 33 MW of run-of-river hydroelectric capacity in Peru. PIF is conservatively capitalized and trading at a discount to the operating value of its current power contracts. We believe PIF will double their generating capacity over the next five years, financing the transition via organic cash flow while maintaining a strong balance sheet and robust dividend (currently yielding 5.7%).

Over the summer, PIF completed a debt financing with the Brookfield Infrastructure Debt Fund. While the credit facility was quite expensive, the arrangement structure suggests that Brookfield may use PIF as a platform partner for smaller deals in select South American jurisdictions. PIF would inject equity into a pre-commercial project and extract their capital through an increase in the facility backed by the new asset once stabilized. If they continue to execute, they may have relatively stable, non-dilutive access to non-recourse capital from which to grow.

The renewable energy market in South America is poised for growth, and so the project opportunities for PIF appear plentiful.

Recent reporting by IRENA and the US Department of Commerce noted that many of the top markets for renewable energy investment are in Latin America. Planned renewable capacity in the region represents just 6% of total renewable power potential. This contrasts with Europe, which sits at ~15%, the U.S. at ~13%, and Southeast Asia at ~25%. Solar generation is expected to grow at an annualized rate of 53% over the next decade. Wind and geothermal are also anticipated to expand at 50% and 39% annualized growth rates, respectively. About half of that total capacity expansion is already earmarked and in some stage of the development process.

Furthermore, energy auctions have been adopted across the region, and costs are incredibly competitive with global averages; Argentina has settled contracts at 4 cents/kWh for wind. Brazil has seen solar projects average 2 cents/kWh. The region continues to remain one of the most active and competitive hydropower markets in the world. Low prices combined with land availability has led to increased competition and a wave of megaprojects. Solar and wind assets with capacities ranging from 50 MW to 300 MW have dominated the auction markets since 2018. Lastly, Latin America leads the world in aggressive decarbonization targets, setting a collective mark of 70% renewable energy use by 2030, more than double what the European Union is anticipating.

Utilities and developers are not the only firms in our portfolio transitioning their business models. Altius Minerals, a base metal royalty and streaming firm we have been invested in for eight months, is also hard at work adjusting to a changing operating environment. For several years, the core business has been focused on providing financing to mining firms focused on metals essential for electrification & storage, lower emission steel making, and soil quality and agriculture yield improvements.

Before expanding and increasing the firm's focus on transition metals, they also had an extensive portfolio of royalties associated with coal. The portfolio of coal royalties continues to produce good cashflows, and management has made the correct decision, in our opinion, to retain those royalties rather than sell them at a loss. Many ESG concerned investors may critique such a decision on a carbon footprint basis but doing so represents a failure to consider how such capital can be redeployed productively by a skilled management team.

As we have touched on previously in Altius's related discussion, management is recycling coal royalty revenue into a newly formed subsidiary, Altius Renewables. In doing so, they are turning carbon-heavy royalties into long-term green royalties. The strategy has significant positive momentum, and management is in the enviable position of having more project opportunities to deploy capital into then they have capital, allowing for this management team's excellent capital allocation acumen to shine.

In early October, they announced a joint venture with Apollo Infrastructure funds that acquired a 50% stake in the operating subsidiary, committing $80 million to the joint venture.[2] As noted in our initiation report on the firm, Altius is a first mover in porting over the royalty model commonly used as a financing mechanism in natural resource industries to renewable energy development. Apollo expects to invest up to $200 million in the subsidiary.

We remain extremely confident in the management team at Altius and in their transition model. It remains the only publicly traded royalty company that we know of trading below its net asset value. Over the next few years, the firm's differentiated strategy will result in a unique, and we believe highly remunerative, trajectory for the company relative to its peers.

As always, we appreciate the trust and confidence you have shown in Massif Capital by investing with us. We hope that you and your families stay healthy over the coming months. Should you have any questions or concerns, please don't hesitate to reach out.

Best Regards,

WILL THOMSON

CHIP RUSSELL

FOOTNOTES

[1]Attribution of the core portfolio, gross of fees. Results in individual managed accounts will vary.

[2]Altius has funded $66 million to-date.