Investmentaktiengesellschaft für langfristige Investoren TGV

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Dear investors

Attached, you will find the annual report for the year 2016 provided by our sub-advisor JMX Capital GmbH for the sub-fund „Truffle“.

Yours sincerely

Investmentaktiengesellschaft für langfristige Investoren TGV

Annual Report 2016 of the Sub-Advisor

Dear Investors,

Since the middle of 2016, the stock markets have risen sharply, and at the same time, the US dollar has been significantly stronger than the euro. Since most investments in TGV Truffle are listed in US dollars, the performance of the past months appears very positive. However, this is by no means a result of surprising news from the portfolio companies or even exceptional truffle-finding capabilities of your sub-adviser in the second half of the year. Much rather stock prices simply fluctuated faster than corporate values, and while market participants may have perhaps been a little too pessimistic in the first half of the year, they popped the bottles in the second half of the year. In particular, the comparison to our benchmark Berkshire Hathaway A Share (in EUR) shows that other investors have also recently benefited from rising prices. The goal of TGV Truffle remains to both substantially outperform Berkshire Hathaway over decades and to reap in an annual rate of return of well above 6%. At the same time, the expectation is to ride out Mr. Market's mood swings stoically and to use them occasionally for my advice.

There was very little new insight or special events connected to the portfolio companies. Operationally, things are going according to plan, and it is a pleasure to follow the entrepreneurial performance of the management teams. The stock prices of some of the companies have, however, changed considerably, so TGV Truffle has been very active in terms of its composition over the second half of the year. More about that later.

In the second half of the year, TGV Truffle built three new positions (amaysim, Majestic Wine, and Tucows) and sold one (Aggreko). Furthermore, more Alphabet and Rolls-Royce were purchased, while DNOW and Leucadia were somewhat reduced. In most cases, the reallocations between the companies were attributable to changes in stock prices. For example, in the last few months, Leucadia has risen about 30 percentage points more than Alphabet – without their business developments being significantly different – and thus it only makes sense that more capital is allocated in Alphabet.

Measuring and weighing

Analogous to prior reports, please find the most important portfolio and performance data about TGV Truffle in the following table.

NAV as of 12/31/2016 in EUR	103.35
Total number of investments	11
Weighting largest investment	19.7%
Weighting of the top 5 investments	63.7%
Weighting cash / fixed deposit	2.2%

Alphabetical Listing of Top 5 Investments:

Alphabet

Microsoft

National-Oilwell Varco

Rolls-Royce

Tucows

Period	TGV Truffle	Berkshire (in EUR)	*Difference*	6% p.a. Benchmark	*Difference*
Since 04/01/2015	+3.3%	+14.7%	*(-11.3%)*	+10.8%	*(-7.4%)*
2016	+18.1%[1]	+27.5%	*(-9.4%)*	+6.0%	*(+12.1%)*

Three Young Guns

I am very pleased that over the last few months the opportunity arose to build positions in amaysim, Majestic Wine, and Tucows. Although the three companies are active in different fields of business and regions, they share some substantial qualities:

- They are all relatively young, agile, and lean organizations that compete in industries that are often set in their ways and thus quite inflexible. Majestic Wine subsidiary "Naked Wines" distributed wine much more efficiently than established channels and hence offers a more relevant selection at lower prices. Amaysim disrupts the Australian mobile communication

[1] The performance according to so-called BVI-method is c. 0.1% higher due to a tax repayment to investors in Q1/2016.

markets with simple and cheap mobile plans. Tucows wins in different markets (domains, mobile communications and internet infrastructure), because the firm found methods to leverage customer service as a retention tool (rather than seeing it as a mere cost factor).

- In the coming five to ten years, all three companies will have more than enough opportunities to reinvest the profits in their business operations profitably. Those investments will primarily be expenses for customer acquisition costs (advertising, referral bonuses, recruitment of new marketing staff, etc.). The value of an acquired customer for any of the three companies is much higher than the customer acquisition costs.
- The capital market currently assesses these companies as if there were no growth opportunities. This seems very pessimistic, as all companies in the relevant segments have grown strongly in the last few years, and the most key drivers of their growth persist or have even grown stronger.
- The management teams of all three companies show a deep understanding of capital allocation, are themselves among the largest shareholders of their respective companies, and are extremely data driven in their decisions.
- All three companies are subscription-based business models, which makes them more predictable and reduces risks.
- The capital structure of all three companies is currently suboptimal and is expected to improve in the coming years. Simply put, this means that while, for example, Tucows should finance some projects with more leverage, a purely internal financing would be more beneficial for Majestic Wine. Both companies will implement this in the coming three years.
- Most importantly, all three companies have a deeply rooted focus on customer satisfaction in their corporate culture and made it their main distinguishing feature against their competitors. A good example of this concept is amaysim from Australia, which purchases mobile phone capacity and bundles it into simple, affordable, and customer-friendly tariffs. To this end, amaysim uses the mobile network of Optus, one of the largest network providers in Australia. Ironically, for many months now, amaysim has been substantially better placed in a customer satisfaction survey in the category "network quality" than Optus itself. Although the customers use the same infrastructure, the simple product, the favorable prices, and the outstanding service outshine even exogenous influences on the business. In a world in which customers communicate on social media and are accustomed to high user-friendliness due to Netflix, Amazon, and Google, a company culture like that of amaysim can become a sustainable competitive advantage.

Currently, the weighting of the three companies in the TGV Truffle is quite different. Although per my analysis, all three trade around more or less the same discount from the fair value, the magnitude and probability of occurrence of losses at Tucows is, for example, considerably smaller than at Majestic Wine. Therefore, Tucows is the largest position in the TGV Truffle, and Majestic Wine is among the smaller positions.

Finding the Truffle in the Dirt – Investing During Transformation Phases of Companies

In the assessment of companies in the transformation phase, I have developed the most as the investor in 2016. When a healthy company with a great business model undergoes a transformation, this is a great chance to go truffle-hunting.

Often, the word "transformation" is a euphemism for "tidying up", and in the rarest of cases, transformations begin when things have been going particularly well for a company. The classic example often looks like this:

A long-time market leader has been languishing for some time without any significant increase in turnover; the management has been the same for quite a while, and the profitability is mediocre. Although in general, everyone involved would like to see something going better, there is also no urgent necessity for change. One day, however, the tired giant experiences an – often exogenous – shock, and the mediocre profit suddenly turns into a loss. The organization stands like the proverbial deer caught in the headlights and decisions ought to be made.

Correctly assessing the subsequent decisions is one of the most fruitful analysis fields in capital markets. In any case, it plays directly into the hands of an investor like TGV Truffle, since all the necessary prerequisites for the utilization of a mispricing resulting from the transformation are present.

Firstly, an investor must be able to look ahead and see through short-term uncertainty in transformation situations. The long-term investor base of TGV Truffle is fully capable of that.

Secondly, investments in transforming companies are often controversial and unpopular and are therefore only suited for institutional decision-making processes to a very limited degree. My daily work as a sub-advisor is almost the opposite of institutional. I am sitting alone in quaint Hamburg-Eimsbüttel, can take my time to think things through, and am not exposed to any group dynamics.

Thirdly, the analysis of a transformation requires considerable research effort, which can only be fully projected in a concentrated portfolio. TGV Truffle can invest in a very concentrated manner and thus, the individual investments can be analyzed in-depth to a degree that may not be possible elsewhere.

Fourthly, qualitative judgment is crucial in transformations (e.g. assessment of the decision-making power of a family of owners or the communication skills and style of a CEO). Social norms, however, often prohibit the public mention of such an assessment if it is negative. Moreover, even if it is positive, many capital market participants prefer to base their judgments on bare figures, even if they are irrelevant. Yet many investment ideas have failed – despite excellent figures – because of the banal reality that someone has bolted with the money. Since I do neither publish my analyses nor make them public, I can deliberately add my intuition and my gut feeling about the acting persons to the judgment.

Fifthly, in individual cases, it may be necessary and useful to take on the shareholder's role actively and to facilitate a transformation through participation, e.g. when appointing a supervisory board.

While the five factors mentioned above are difficult to implement for many investors, the structure of TGV Truffle and the philosophy of JMX Capital as a sub-advisor are ideally suited for looking for the most delicious truffles in the muck of transformations.

Since March 2016, I have been a member of the supervisory board of Grafenia plc. The motivation for this task is the learning experience of living through a transformation "from the inside". In the past year, this role has proven extremely helpful for me to create an understanding which success factors promote a transformation and what could impede it. At the same time, the work in small companies only gives me a vague notion of the tasks the management teams in multinational corporations are facing. In any case, I appreciate the work of Satya Nadella at Microsoft and Warren East at Rolls-Royce even more since I have seen what it means in practice.

Over the last few months, I have systematically integrated my experiences in the transformation of companies into my analysis. I have come across five factors that have shaped the success of a transformation:

1) A clear and visible leader who acts as "evangelist of change" and personifies this change. Satya Nadella at Microsoft, Dr. Blaschke at Washtec, Jack Byrne at Geico, Carlos Brito at AB Inbev, Vicent Bollore at Vivendi - change seems to work better if it is clearly personified.
2) Simplifying the organization and strengthening existing employee roles. Warren East says that some decisions at Rolls-Royce needed 70 (!) signatures. A good transformation entrusts the existing employees with more responsibility, reduces bureaucracy, and awakens entrepreneurial spirit.

3) Focus on the customer rather than on the organization. Many organizations lose touch with their customer base over time. One of the best transformation managers I know said: "We used to treat our customers like hostages."
4) Data does not lie. In established corporate cultures, often pseudo-truths prevail, which can be revealed by applying quantitative measurement. Good transformation management sets measurable goals and creates more transparency.
5) The supervisory board is pivotal for any successful change. It appears that a committed and influential supervisory board has the power to promote a transformation significantly. Some companies attract attention, in which the supervisory board members themselves are taking an active role and switch to the executive board to tackle the transformation. The perhaps most promising situation arises when a supervisory board member decides to join the management board and then becomes the leader described under criterion 1).

Some of the aspects mentioned above may sound like copied from a management textbook and read like banalities from a business management lecture. If someone knows narrower or more specific success factors, I would be keen to hear them out. Any contradictions to the above aspects would also be of interest to me (it may well be that my list is based on an entirely subjective perception).

Applied to the portfolio of TGV Truffle, I see Microsoft, Majestic Wine, and Rolls-Royce as the best examples of companies in transformation phases that meet the five criteria mentioned above. Microsoft has apparently progressed furthest; Majestic Wine is already on the right track and Rolls-Royce still in the early stages. Rolls-Royce, however, is also the most exciting example of a transformation, as it will take a long time and change the company to the positive on a massive scale. The company's capital market day in November, during which I had the opportunity to question the acting persons of the transformation for hours at a time for two days, was especially enlightening. Everything I learned from and about Warren East and his team is consistent with my ideal of a successful transformation team.

The current development at Aggreko, however, is a sharp contrast to the developments at Rolls-Royce. Here, too, I was able to get to know the management team in Scotland in June and got a deeper understanding of the strategy. In fact, the acting persons are competent, honest, and committed. It seems, however, that when it comes to criterion 2), the exact opposite is happening.

Instead of focusing on the existing and outstanding culture of Aggreko (known as "Orange Blood"), the organization is currently becoming much more complex and positions are filled with external managers. This may work, but I consider the probability of success at Microsoft, Majestic Wine, and Rolls-Royce to be considerably higher. Therefore, the position of Aggreko was sold, and the allocation of e.g. Rolls-Royce was increased.

Book Recommendation and Investor Day

One of the best books on transformation is "Onward" by Starbucks founder Howard Schultz[2]. After many years in the management of the company, Schultz originally joined the supervisory board but returned as CEO when things went south for the company. In his company biography, (which is his second, by the way), he reveals his psychology during the restructuring and reflects the soft aspects of a transformation - an excellent read.

This year, too, the investor meeting of the Investmentaktiengesellschaft für langfristige Investoren TGV will be held in Bonn in June. You will receive your invitation in the coming months. You are more than welcome to bring your families[3], and of course, please feel free to ask our team in Bonn as well as the sub-advisors of the TGV any question that may come to your mind.

I wish you a great start into the year 2017 and thank you for the continued confidence.

Kind regards,

Jan-Hendrik Mohr

JMX Capital GmbH

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[2] Schultz, Howard: Onward, 2011. Rodale Books, New York

[3] …chances are good we'll have chocolate again this year…