BrightGateCapital
INVESTMENT~INTELLIGENCE

Interim letter to BrightGate Focus Fund's co-investors
1st half of 2021

July 19th, 2021, Madrid

"How can smart people so often be wrong? They don't do what I'm telling you to do: use a checklist to be sure you get all the main models and use them together in a multimodular way."
Charlie Munger

Dear co-investors,

First of all, we hope that you and your families are well. BrightGate Capital sends our best wishes to all of you during these difficult times.

We would like to start with a quick summary of the Fund. The Fund closed the first half of 2021 with a return, after management fees, of 8.2% (for the institutional share class), versus the 15.2% of the S&P500, 13% of the MSCI World and 3.7% of the BofA Merrill Lynch index. Although the Fund does not have any benchmark, the three previous indices are the ones that best encompass our investment universe. However, the focused and active management of the Fund can lead, in the short term, to wide disparities in its performance compared to those of the indices. In fact, the performance of an index in a given period, or its sectoral composition, among other things, are irrelevant aspects in the daily management.

The Fund's philosophy is to build a concentrated portfolio of international stocks with little turnover. The investment universe is not only limited to equities, but the Fund may also invest in high yield, convertible bonds, and preferred shares. Within equities, our preference is for companies operating in predictable industries (generally with an oligopolistic structure), without debt, and trading at reasonable valuations, which can compound (given the overall market valuations right now) our investments at rates of at least 7-9%. Finally, the required rate of return on our fixed income investments is 8-10% (after hedging costs), and the returns can come both from coupons as well as from capital gains.

In any case, in both equities and bonds, our *modus operandi* is always the same: understanding the profitability of the business in question and, once a clear picture has emerged, *linking those returns organically to the valuation of the business*. In BrightGate Focus we are just not happy with companies doing M&A, growing accounting profits or, even less so, the revenue line (catchy phrases that never go out of fashion in the markets), but for growth to be done profitably - that is, investments must exceed our cost of capital. Our investors can rest assured that most of our time is devoted to this task.

The first half of the year has brought some important changes to the portfolio that we will cover in detail in the following section. This is the fourth letter since the inception of the Fund in December 2019, so it is unavoidable that some features of the investment process have not been fully explained yet. Given that in a previous letter we explained our valuation framework, we will devote this letter to explain the use of checklists when making investment decisions. Checklists are a bedrock in our daily work; they are crucial when filtering potential investments and retesting companies that are already in the portfolio, but whose investment thesis may have changed. Alas, the use of checklists is not an original idea of us by any means, for they have been widely used by other renowned investors previously; however, as we hope to show, their usefulness has not diminished the least.

Main developments in our positions during the semester

Although our more cyclical investments in thermal coal, iron ore and oil have led to an acceptable performance of the Fund during the first half of the year, this period has been quite disappointing for two of the investment theses in which we are invested: memory manufacturers and the preferreds of Fannie Mae and Freddie Mac (GSEs). Whereas in the former the investment thesis has not changed, and it is still playing out as we envisioned last summer, the investment in the GSEs has simply not met our original expectations.

Gains year to date in the memory manufacturers (SK hynix, Micron Technologies and Samsung Electronics) have been almost nil, and given their relative overweight in the portfolio, they have been a burden for the overall performance of the Fund. However, the most important thing is not the share price action, but rather their operating reality and what we can expect going forward. During the first six months, DRAM memory prices had a very positive evolution, boosting the margins of the three manufacturers. In fact, memory demand (both DRAM and NAND) would have been higher if not for the bottlenecks in the rest of the semiconductor industry. The investment discipline of the manufacturers has still been good, and the difficulty in DRAM to keep miniaturising the technology at an acceptable pace and cost is still a main concern for the industry (this is known, in a poetical fashion, as 'the end of Moore's law'). For instance, SK hynix recently published that its new DRAM node, the 10nm 1α, which is going to be produced for the first time at mass scale with EUV technology (raising substantially the costs of the process), will increase by 25% the number of chips produced in the same wafer versus the previous node, the 10nm 1z. As the 1z came into production one year and a half ago, the 25% improvement from the 1α node translates into annual increments of 15% (in line with our base case), which is a considerable reduction from the annual increments of some years ago of around 30%. The end of Moore's law implies that lower supply increases are easier to coordinate for the manufacturers. And, given that DRAM memory demand is expected to grow above 10% for the foreseeable future, we think that the best is yet to come for the three incumbents.

On the other hand, it would be an understatement to say that our investment in the GSEs, so far, has been very disappointing. Our original thesis was based on two possible paths to monetise our preferreds. First, that the Trump Administration (through the previous Treasury Secretary, Steve Mnuchin, and the FHFA Director, Mark Calabria) cancelled the net worth sweep (which dictates that the GSEs must pay their entire profits *ad eternum*), wrote down the government senior preferreds in the companies and, finally, raised new capital in a public offering. None of this happened before the inauguration of the Biden Administration in January. Instead, Calabria burdened the companies with very punitive capital requirements (in line with the banking business, despite the fact that the GSEs' business is vastly different), and he did not get rid of the net worth sweep. Nevertheless, at least he allowed the companies to retain profits until new capital requirements were reached

– however, once reached, the GSEs would have to keep paying all their profits to the Treasury again.

The second path was the ruling of the Supreme Court in the case *Collins vs. Yellen*, which was published at the end of June, and it was contrary to our interests. The important point to settle was whether the net worth sweep, which was established in August 2012, was under the duties of a conservator or not. Given that a conservator is supposed to take care of the assets of the company and not decapitalise it as it happened with the GSEs, it seemed very likely that the Supreme Court would rule in favour of the shareholders. Instead of that, the nine judges of the Supreme Court made unanimously a very opportunistic reading, arguing that the FHFA "incidental powers" allowed it to do as it pleased with the GSEs, thus, creating a unique precedent of expropriation in the US (for those who want more details, this article gives a nice overview).

More importantly, what should we expect going forward? Again, there are two possible paths for a favourable resolution of the investment. The first path is legal, once again, because there are still two cases where a ruling is still pending (among them, the case chaired by the judge Royce Lamberth). The second path relies on the political willingness, in this case from the Biden Administration, to reach a solution for the only pending issue from the financial crisis of 2008. Given Biden's goals to advance a fairer housing market, and the GSEs impossibility to cover such needs given their high capital requirements, the imminent appointment of the FHFA director will give some clues as to how the GSEs will play in the current administration. The price of the preferreds has already baked in every possible bad news and, given that they trade at less than 10% of par, we still believe that they present an interesting optionality, and that the likelihood of a favourable outcome is reasonable. We have not adjusted whatsoever our (after the drop, reduced) position in the preferreds, nor we expect to do it (unless some relevant development emerges) over the next few quarters.

Regardless of the outcome, there are some takeaways from our investment in the GSEs: some of a general nature (such as the dysfunctionality of the political and judiciary class in the Western world, with their proverbial short-sightedness), and some related to the Fund. Regarding the latter, at the risk of sounding obvious, the most prudent approach is to limit the exposure to such situations, where the outcome relies on purely non-economic factors. We still think that the probabilities when we first invested were favourable, and even so, here we are. Such developments, with the benefit of hindsight, are less likely to occur in the rest of our positions, where the profitability of a particular investment is what really matters at the end of the day.

Main portfolio changes

We have saved the best for the end. During the first semester, we have incorporated four new compounders to the portfolio, all of them businesses with the traits that we are looking for: profitable businesses with growth runways in front of them, competent management teams, debt-free balance sheets, and reasonable valuations. These four names account for 21% of the portfolio, and we expect to be several years invested in them. Their favourable structural trends make us to be optimistic about their operating performance - regardless of interest rates, inflation, or the evolution of the pandemic. The four businesses are: North Media, Kaspi.kz, NICE Holdings and NICE D&B. The first three have already been addressed in the Fund monthly updates, so we will deal with NICE D&B here, and we invite to any investor to contact us for more information about the former three.

NICE D&B is a credit corporate bureau in South Korea, founded in 2002 as a joint venture between NICE and Dun & Bradstreet to provide credit reports to Korean firms that were looking to understand the financial health of potential international partners. The credit bureau industry has traditionally been oligopolistic, with high barriers to entry coming from the difficulty to create a database and the stickiness of the client base (the annual cost of a credit bureau for a multinational company is quite cheap). The credit bureau industry in Korea is not an exception. NICE Information Services (another NICE company, and where we are also invested through NICE Holdings) and NICE D&B control more than 50% of the market share, whereas the rest is shared by two other competitors. The overall market has a size of ₩291bn. (roughly 220 million euros) and has been growing at 13% since 2012. The pandemic has not slowed down such a growth. In fact, NICE D&B competitive position is more dominant than it seems at first glance, because it gets most of its business from those credit reports that involve international relations – that is to say, Korean firms studying international partners, or international firms studying Korean partners. And in this niche market, NICE D&B leadership is indisputable, and its advantage versus peers is unreachable, thanks to its partnership with Dun & Bradstreet, which allows it to have a database with more than 400 million companies in more than 200 countries. Regarding the financial statements, NICE D&B had revenues of ₩25bn. in 2015 that grew to ₩82bn. in 2020, whereas the operating residual income grew from ₩4bn. to ₩9.6bn. in the same period. Given a modest number for net operating assets of ₩54bn., adjusting for noncontrolling interests, and assuming growth rates of 3%, we get valuations from ₩18k to ₩23k per share, roughly a double from current prices. And, most importantly, given our long-term commitment in the firm, such prices would imply return of 8% at perpetuity. Although the stock price has behaved quite well over the last few years, we believe there are several reasons for its substantial discount. First, the free float is quite low and the firm is quite small (NICE Holdings has a 35% stake company, D&B 3%, and other long-term investors an additional 36%, leaving 26% in free float). Second, the limitations of many foreigners to invest in Korea. And third, it seems that Koreans are more interested in buying an apartment in the Gangnam neighbourhood than investing in their national champions.[1]

The main divestments of the portfolio have been quite limited. We sold Pilgrim's Pride (whose shares rose too much and too fast, and whose business does not share the same traits of the businesses cited above) and some bonds, such as the HC2 Holdings (the company has refinanced the bonds) and EZCORP convertibles, and the senior bonds of PBF Logistics. We do not rule out additional disposals of our thermal coal bonds, given their current tighter spreads. The fixed income environment is quite tough right now and, although we would prefer to have a higher percentage in fixed income in the midst of the most expensive equity market in history, there are simply no good credit opportunities out there.

As of 30th June, the Fund has a 2.6% in cash, and the rest is invested as follows: *compounders* 74.8%, high yield 8.6%, special situations 12.1%, and preferreds 1.8%. Our

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[1] Despite the continuing efforts from the Minjoo Administration to promote a fairer housing market, housing prices in the Gangnam neighbourhood has risen 47% since May 2017 (when the Administration took office), versus the national average at 25%. These increases have happpened in the midst of some government measures to curb speculation: the number of transactions in Seoul have halved over the last year, from 26 thousand units in July 2020 to 13 thousand in May this year. It seems that the consequences of stupid monetary policies worldwide does not know any bounds.

portfolio of compounders is made up of 14 stocks, and it is trading at an overall EV/NOI LTM of 16.2x and EV/NOA of 6.8x. The average return on net operating assets (RNOA) of these companies over the last three years was 34.3%. On the other hand, the high yield portfolio has a weighted YTW (in euros) of 8.4%, with a duration of 2.6.

On the use of checklists

Many of our investors are already aware of the crucial role that checklists play in the BrightGate Focus' investment process, but we think it might be a good idea to devote the final part of this letter to explain in greater depth the concept and its usefulness. For those interested in a deep dive, the famous surgeon Atul Gawande wrote a book back in 2009, titled *The Checklist Manifesto*, where he explained the concept through its application in several fields. Most of the concepts explained below are directly taken from there.

First, and at the risk of sounding obvious, what is a checklist? It is simply a useful tool to avoid critical mistakes that tend to be overlooked, especially in specialised fields where the decision-making process is complex and does not depend on only one variable, but on many. With nowadays increasing complexity, the number of fields where the decision-making process has become intractable has expanded: from surgeons to plane pilots, architects and, of course, our subject, the investment profession.

It is no secret that the best investors in history have used checklists, or similar devices, when making investment decisions. For instance, this is what Monish Pabrai, the legendary Indian investor (and whom we follow regularly), had to say about checklists in his investment process:

> *"Boeing just doesn't sit around in a room and come up with the checklist for take-offs. That has been created over 60-70 years of failures that have caused things to make the checklist. Our investment checklist was designed the same way. I looked at mistakes I made since the time I invested, and I looked at mistakes that other people made that I respect like Warren Buffett and Charlie Munger, LongLeaf Partners and so on. When I look at mistakes, I would figure out what was the reason the investment lost money and was that reason visible at the outset? Was it visible before the investment was made? And, in most cases it's extremely obvious."*

Furthermore, Charlie Munger's statement at the top of this letter clearly shows that the use of checklists must have been very common in Berkshire Hathaway history.

What are the best practices when drafting checklists? At the risk of simplifying Gawande's book, I would highlight three points:

- The checklist should be precise, get to the point, and avoid explaining everything – a checklist cannot invest "on its own". As Warren Buffett pointed out, "[a] checklist is no substitute for thinking". According to Gawande, useful checklists have between 5 and 9 major items (and the subitems), although it depends on the field in question.
- They must be easy to use in tough situations and stressful conditions.
- One needs to define the time to use the checklist, for instance, before or after the investment decision.

The checklist used in BrightGate Focus is divided in six items, which are: knowledge of the business, sectoral exclusions (or “circle of competence”), financial leverage, management team, valuation of the asset and whether the investment will have any catalyst or not. The relative importance of each of these items varies depending on the asset class: for instance, in our compounders we usually do not pay too much attention to the existence of catalysts, whereas in fixed income (and in special situations) such a feature is crucial (i.e., bonds are refinanced, they may be called, coupons are paid, etc.).

As a detailed explanation of every item would be exceedingly long, we will focus on a point that we believe is fundamental and is usually misunderstood in the investment community: a firm’s amount of leverage.

It would not be an overstatement to say that the capital structure is the first feature that we consider when filtering for potential investment ideas. When investing in fixed income, it is obvious the importance of leverage (if a company does not have any debt there is nothing in which we can invest!), but that is not generally the case when investing in equities. The filters mostly used by other managers are quantitative, such as multiples (a practice that one must be wary of, as we will explain in a future letter) or magnitudes from the financial statements, and sometimes qualitative (in which sector does the company operate?), but in any case, the amount of leverage hardly appears in any of these filters. There are at least three reasons why such a practice might be reckless.

The academic wisdom, embodied in the Modigliani-Miller (M&M) theorems, proposed five decades ago, suggests that (assuming no taxes) capital structure is irrelevant for the valuation of a company. According to M&M, in a world of perfect foresight and rational agents, when leverage changes, investors will automatically adjust the rate of discount applied to future cash flows, leaving valuation unchanged. Investors can obtain higher cash flows with a higher leverage, but such a leverage entails risk, which is perfectly captured in the discount rate. In this sense, investors look through the “corporate veil” and make an unbiased (and correct) valuation of such cash flows. In turn, corporations choose freely their capital structure, depending on their preferences. In the real world, although many managers will have not heard about the M&M propositions, their ways to proceed approve them indirectly, because they buy companies regardless of the amount of debt they have: such managers generally justify, in a superfluous way, that the capital structure is “sustainable” given the nature of the business, and then they move on quickly to other things.

Reality, however, is more complex. Whereas in the mythical world of M&M, corporations can choose freely their capital structure, *in real life, capital structure is not an exogenous variable, but it is given by other factors – among other, the quality of the business*. This study by GMO, written many moons ago, shows that companies with higher leverage are those with more mediocre businesses (this is measured, in this case, through the return on equity). That is to say, the amount of debt is not simply a discretionary variable chosen by the management team (as it may happen in private equity transactions), but an important clue of the quality of the business at hand.

Second, debt has perverse effects on valuation models, amplifying the inherent uncertainty present in every valuation. Consider, for instance, a fictitious company without net debt that, after some time studying it, we reach the conclusion that its enterprise value (and equity value as well, given there is no debt) is between 8 and 10 euros. As we may see, it is a considerable range, being the upper limit 25% above the lower limit, but this is a typical case when valuing companies. If now we assume a similar firm, but with net debt of 6 euros, equity values would be now 2 and 4 and euros, respectively, yielding a variability of 100% in our estimations. In other words, whereas in the first case one can make a reasonable estimation of the value for shareholders, in the second case is basically like tossing a coin, even though in both cases the business is exactly the same. Since most of the time it is impossible to reduce our valuation range (following Keynes' idea of "radical uncertainty", which is the impossibility to even define a statistical distribution for most of the events), it is better to avoid this kind of situations.

A third and final consideration purely comes from conventional wisdom, and it is the fact that all successful managers have mentioned leverage as one of the most important factors behind their worst investment decisions. Just to quote an example, you might be aware of Buffett's famous anecdote about one of his friends, Rick Guerin, who was forced to liquidate his portfolio in the 1973-'74 massacre due to several *margin calls*. Other investors such as Keynes, Greenblatt, Pabrai, Munger or Gayner have mentioned similar thoughts in the past.

As always, thank you for your trust and support. We will be happy to address any doubts or requests you may have. In the meantime, have a nice summer.

Yours sincerely,

Javier López Bernardo, Ph.D., CFA
Portfolio Manager

BrightGate Capital, SGIIC
c/ Génova, 11 – 28004 Madrid
Tel. +34 91 441 00 11
www.brightgatecapital.com

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