Mistral Value Fund:
Investment Philosophy & Process

Our investment approach is based on a disciplined and rigorous, research-driven process and our investment philosophy is that of value investors. This means that we aim to buy companies with a significant discount between the price we are paying and our estimate of the intrinsic value of a business. Another core element of our philosophy is a long-term ownership view. The details of our approach and some insights into the kind of variables we focus on in our process are presented in the following sections.

Businesses Characteristics

We aim to own companies that have stood the test of time and have strong durable competitive advantages. We search for businesses that serve large addressable markets and benefit from favorable secular trends. We favor business models that have high levels of recurring revenue, generate attractive incremental margins, are cash generative, and are not dependent on third-party financing. We exclusively invest with management teams that we consider exceptional and invest in their businesses to generate long-term profitable growth.

How we generate Investment Ideas

The process is a negative art – meaning identifying what not to do is as important as what to do. Investment ideas are like an assembly line putting together a large number of factors and, subsequently, one invests. We feel great investment ideas need a considerable amount of preparation, due diligence and patience. The key is understanding different business models, and for what reason(s) some companies are better than others. We use a combination of screens, industry seminars, interviews of the management, corporate visits and research trips. Additionally, we read a lot of annual reports and listen to podcasts, which is all part of the process of being curious. All the time invested in reading and research may not directly contribute to today's portfolio – but it may support the construction of tomorrows. In particular, the goal is to get to an investable universe or a "circle of competence" that acts like a watch list of companies that we know well and for which we wait for the market to give you the right price - it needs a lot of patience. For long-term investors the best investments come from the best companies.

How we build an investable Universe

We start with a screening process of over 5'000 companies and end up with an investable universe of about 250-280 names. Do we really want to own this business is the key question. Do we really understand it? How long has it been around? What has been the predictability of this business during previous recessions or times of stress? These characteristics and parameters should be well defined – including aspects as the risk of obsolescence in products. Every business has an element of cyclicality. Thus, cyclicality does not preclude us from focusing on businesses which grow but not in a staircase fashion. Ultimately one has to try to ascertain whether the results are repeatable and how much certainty one needs of that. These questions just try to assess the quality of the business and do not address the valuation aspect. These should be as much quantifiable as possible, especially the performance of the

management such as the rate of change in ROE, ROA, high returns on capital employed, and the retained earnings. Every company, thus, should meet certain characteristics before it is included in our "investible universe". Every once in a while, a new name could be added or old names deleted from the universe, but the list does not change on a monthly basis. The names should be picked one at a time to be included in the "universe". The end goal of our process is to own a universe of stocks that retains four key characteristics. First and foremost, we want to own a portfolio of attractively priced companies. Second, we want high-quality businesses with sustainable long-term competitive advantages. Third, we are looking for companies with strong balance sheets. Fourth, we are looking for management teams that have a history of adding value over time.

What are suitable Business Profiles

Businesses should be expected to have asset-light qualities and thus perform better during periods of normal inflation. They should display high ROI or ROC, strong balance sheets and they should be re-deploying their cash flows back into these core activities, to support the growth as opposed to favoring high dividend payments and/or share buybacks. By looking at ROC, we tend to discover businesses that consistently portray high profit margins and tend to have limited need for additional investments and are consistently generating high levels of cashflow. Such financial characteristics in turn reflect business fundamentals, including the level of competition in an industry, the relative concentration of suppliers and customers, and the degree of regulation facing an industry.

What Businesses we avoid

Typically, we avoid commodity-based industries where companies are price takers, and other mature sectors, such as banks, industrials operating in the field of general engineering, automotive stocks and those businesses in a similar vein. We also tend to avoid asset-heavy industries such as the names found within the utility and telecoms sectors as well as overly diversified business models that do not excel at any kind of leadership or have little or no pricing power. And, last but not least, we refrain from investing in non-grata industries which are deemed harmful to society.

What Businesses we favor

Adaptability to change is key since change is a constant now. The well-known investor Warren Buffet likes to say that he invests in companies that are resistant to change. We believe that companies that are capable to be adaptable to change are key – if you are not willing to embrace change – the industry might force you to. Thus, management and its attitude is essential, but so is the human capital. It’s important for the company to be able to retain and attract great people since they help enable the change in a company.

Example of one of our Investments

Facebook (FB) is an example of a company that is very adaptable to change. Instead of FB continuing to “milk up” the cash coming from advertising post its IPO, Zuckerberg - CEO and Co-Founder - bought Instagram, which is a mobile application. He reassigned engineers and he figured out how to incorporate advertisements without making it feel like an ad. FB also made a shift when they realized what Snapchat was doing by managing messages. They intended to buy Snapchat but were unsuccessful. Thus, they created their own version of Snapchat. In the end, Instagram-Stories created more revenues for FB, by itself exceeding the revenue of Snapchat. Now they try to adapt again with the editing process after TikTok came along. Zuckerberg is creating something similar to TikTok, called Instagram-Reels. This flexible culture is another example for an attribute of their good management, next to their high growth margins. Moreover, FB does not have to spend money to create content, because its users are creating their own content. Besides, FB doesn’t need as large of a sales staff as traditional advertisement agencies, because most of its advertising is automated. FB has 80% growth margins, versus Snap, which has 40% growth margins. These are considerable differences, which saves a lot of money for FB to pay their engineers for R&D, sales as well as marketing and still leaves a lot of money for shareholders.

Another important aspect to consider are economies of scale: a lot of great companies exhibit these characteristics. Let’s have a look at **Amazon**. They successfully developed the warehouse concept infrastructure in the early days. They initially built the infrastructure, which was expensive to build and to maintain. Amazon and its subsidiaries in theory have fixed costs and very high margins on a certain amount of revenues over that fix cost base, but in reality, what they end up doing is reinvesting the high margin dollar back into the business. That does two things: it adds more fixed costs to the initial base, which delays the ability to reach the high margins, but it also makes it harder for competitors to attack their business, because now the fix costs to compete against Amazon are even greater, which helps to widen their margins and will earn an above-average return on investment.

Both, Facebook and Amazon, are great franchises with totally unique offerings in growing markets with high quality management teams. We entered each of these investments and we held them as they continued to compound capital over time.

What Business Fundamentals tell us

Quite often an industry analysis is done on a stock-by-stock basis. This gives us a good sense of the level of competition in an industry, the relative concentration of suppliers and customers, and the degree of regulation facing an industry. In situations where a company continues to re-deploy capital at a high rate of return, the value of the business is bound to grow over time. Financial strength is probably the easiest of the four characteristics to recognize. We like companies with little to no debt recognizing that there is very little margin for error when investing in heavily indebted companies. When a leveraged business is doing well and profits

are growing, returns to equity holders can be enormous, as every incremental dollar of profit accrues to the equity owners. But of course, the opposite is also true.

How we value a Business

A business is worth the sum of its future cash flows, discounted to today. Mathematically, that's the only truly accurate way to value a company. We estimate a business's pre-tax, pre-interest cash flows (assuming a normal margin), apply an estimated tax rate, capital required for growth, and a projected capital structure, then estimate an intermediate growth rate. These factors, combined with an appropriate discount rate, tell us what multiple of cash flows the business likely deserves. Calculating intrinsic value is neither easy nor objective. It depends on an estimation of future cash flows, normalized earnings, cost of capital and interest rate movements. But it is what ultimately matters about a business. Book value, in contrast, is easy to calculate, but of limited use. The same holds true for market price, at least for most companies. The differences between intrinsic value, book value and market price may be hard to pin down, but there will almost certainly be differences and they can be in either direction.

On Market Timing and the Power of Compounding

Since one cannot accurately predict when economic and market cycles start or end, there is no good timing to time the market. Over the past four market cycles, missing the best five trading days would have resulted in a 36.7% lower value of a hypothetical $10,000 investment, and missing the best 10 days would have even resulted in a 53.6% lower value. As big down days are often closely followed by big up days, those who panic and sell on the down days are likely to miss out on the ensuing up days. The purchasing power of the dollar has fallen about 50% every 17 years over the past 50 years. While inflation causes currencies to lose value over time, it has a positive impact on tangible assets, businesses, and economic growth. This means that stocks are the best hedge against the devaluation of your money. While the simple answer to combat inflation is to invest your money over the long term, the concept of compounding tells us why. When your savings earn returns (e.g., bank interest, dividends), compounding allows these returns to earn even more returns. Over time, this effect snowballs, and earnings grow at an increasingly fast rate. In year one the amount you earn on your investments will not be a lot. However, in year 10 or 20 you will not believe the impact of the "power of compounding."

Conclusion

We view our long-term investment horizon as a source of our competitive advantage. Most investors focus on short-term results. By concentrating on long-term results, we are often researching a less efficient area of the market or act as a contrarian investor. We believe this enables us, along with our team of analysts, to uncover high-quality businesses that can compound revenue and earnings at more a consistent rate for far longer than others prospectively recognize. Our long-term orientation also allows us to act opportunistically. We can evaluate these situations dispassionately and assess the fundamentals of the opportunity or the expected return of an investment. Ideally, this allows us to buy a best-in-class business

at a more attractive valuation. We devote as much time researching investments, as we devote to consider purchasing, and as we allocate to investments that we have owned for many years. When we determine that the growth prospects or the valuation parameters of an investment are impaired, we move to sell the stock and reinvest the proceeds into more compelling opportunities with a more favorable risk/reward profile. We are open to and look forward to discussing in more detail some of our work assumptions and investment principles.