MAGALLANES

VALUE INVESTORS

**Quarterly Letter to Investors**
3rd Quarter of 2015
MAGALLANES VALUE INVESTORS, S.A. SGIIC

Dear Investor,

European stock markets close the worst quarter in terms of performance since 2011. Economic slowdown in China, uncertainty about current monetary policy and cooling of profit growth of companies explain most of these corrections. Europe drops close to -9% in the quarter, minimizing accumulated returns in the year to hardly over 0%. In the particular case of Spain, Ibex 35 drops around -11%, aggravated by political turmoil. Special mention deserve the strong declines in some emerging markets like China (-30%) or Brazil (-35%), in Euros.

As you may know, the main objective of Magallanes is the preservation of capital in the long-run. In this regard, our funds close the quarter with declines of around -3.5% (see Annex of returns by funds and classes). Investing in equities and preserving capital may seem counter-intuitive approaches, especially in convulsed markets as we can find these days. Preserving capital, within investment in equities, consists of losing the least when market conditions are unfavourable. When waters calm down and tailwind picks up, may our boat sail further if we had managed to save the sails. Much of the success in stock investment involves minimizing errors but not guessing what the next bullish movement will be.

It is interesting to see how recent strong declines have placed the investor community in an uncomfortable situation. When the market goes up good humour reigns, happiness is spread out and the shares of most of the companies rise in varying degrees. Tolerance, permissiveness and optimism dominate the buying attitude of investors. On the other hand, when the market goes down fear takes control of the reins. Intolerance to loss is maximized, lack of trust increases and irrational pessimism transforms the same investor that in the previous months was buying equities. This is how the market works: a continuous swinging between greed and fear. What happened in the past few months looks very much like the situation just mentioned.

Despite corrections, at Magallanes we remain quiet. It will never stop fascinating me the bipolar behaviour of the stock market. I am convinced that the key to achieve good long-term returns resides in taking advantage of the changes of mood of the market. In fact, it is in current moments of pessimism when the best investment opportunities usually arise. This is the reason for us being quiet and excited.

In some sectors the market is giving us the opportunity to purchase good companies trading well below their intrinsic value.

As you may know, the average liquidity of our funds has been at high levels during a large part of the year. In our previous letter we remarked that "liquidity is a consequence of the lack of opportunities that eventually may be converted into a valuable option when markets decline". The reason to keep high liquidity levels is by no means because we anticipated the corrections that in fact ended up taking place but because the lack of good investment ideas. It was not until the meaningful declines of the last and a half month that we increased once again the investment level of our funds closing at levels of 85%, which represents an average increase of more than seven percentage points compared to close of June.

The overall situation in the world continues to be featured by the same clashes we mentioned previously: slowdown in China, warlike tensions in Russia-Ukraine and Middle East, Greece or the unconventional monetary policy of low interest rates. It is curious to see how fast the spotlight regarding current issues changes. Just as few months ago people had only been talking about Greece, Ukraine or the low interest rate policy as risk sources today these concepts have pretty much been forgotten to now talk about China and its much discussed economic slowdown. What today looks so important, the next month looks normal and the following quarter is simply forgotten.

This is why at Magallanes we do not spend more time than the strictly necessary analyzing the world's current economic and social issues, and much less do we base our investment decisions on such scenarios. It is sufficient to understand what is going on and not to forget what happened in the past. In this regard we do not analyze companies based on the cash flow they will generate in the next two quarters, surely affected by the circumstances at the time. When we analyze a company we take into account its business model along with its capacity to make profits from today until doomsday, thus considering good, bad and regular cycles over such analytical process.

Two of the characteristics we look for in a company are: good financial health and ethical quality of the management team. Two recent catastrophes demonstrate the importance of following these basic principles: steep declines in share prices of Glencore and Volkswagen. Magallanes did not invest and has no position in any of these two companies.

Good financial health, companies with low debt or net cash in the balance sheet. We frequently say a company with no debt cannot go bankrupt; at least it is impossible from a financial point of view. Therefore when looking at two companies within the same sector the one with less debt should be more valuable. Glencore is the largest mining company in the world, with activities that go from minerals and metals trading to sale of agricultural products. It was listed for the first time on the 19th of May, 2011 with a valuation of 76,300 million pounds. At the end of September its valuation was 12,700 million pounds. Yes, it is correct, in just over 4 years 63,600 million pounds "disappeared" (approximately the size of Slovakia). During the same period its debt doubled to over 30,000 million pounds, with leverage of 10 times its estimated operating profit for 2015, of 3,000 million pounds. First lesson: excessive leverage combined with heavy declines in operating results, caused in this case by price declines in commodities sets off the perfect storm to lose all the money. In fact, with its heavy price decline since listed being -85%, it seems the only ones that earned money were those that sold at the IPO. Second important lesson: as a general rule not buying at IPOs when owners "get rid of it" because it has to be you the one to make them rich.

Regarding professional integrity of management teams, may we highlight the case of Volkswagen, with value loss of over 28,000 million Euros hardly in one week, due to the fraud in the diesel emissions of some of its vehicles. Warren Buffett once said that in looking for people to hire, you look for three basic qualities: integrity, intelligence, and energy. In the light of what happened it seems former management team at Volkswagen were intelligent, hard-working people but not so honest. Lesson: at the time of investing do not only focus on data of annual reports, even though fraud and deception are not always identifiable or predictable.

In respect of our investment activity, during the quarter it should be noted it essentially focused on the purchase of shares we previously did not have in the portfolio; we were especially active in the German and Austrian electric sectors, as well as in some shares of mining companies. All of these companies are trading at historic lows and belong to out-of-favour sectors which are very penalized by the market.

Within the European portfolio is should be noted the purchase of Verbund AG, unique Austrian electric company in Europe due to its extraordinary hydroelectricity assets. This is certainly the only and largest electricity generator expert in this type of technology – approximately 95% of electricity generation comes from its more than 120 water power plants – with annual production of 31.2 TWh. Furthermore, Verbund owns the Austrian national grid of electricity distribution, with more than 3,500 km, stable, regulated and highly-visible business. The company sells its electricity in equal proportion between Austria and Germany. The current issue is that wholesale electricity price in Germany is at its lowest level of the last few years, MWh being below 30€. This heavy decline mainly occurred due to the steep decline of coal price, technology that fixes electricity prices in Germany. We do not know what the electricity price in the next few months will be, but we are convinced it will be higher than current price in the next decades. The main competitive advantage of Verbund resides on its hydroelectric plants, unique and irreplaceable, with economic lives of more than 50 years. At current prices, it is possible to buy these unique, real and productive assets below their book value.

We also bought shares of the largest European electric company by income, the German E.ON, holding with more than seven business lines like electricity generation, exploration & production or global commodities. Furthermore it owns the largest grid in Europe, with a length of more than 1 million km. Low electricity prices and the obligation to close their nuclear power plants made their share drop to 25-years-ago levels, E.ON dropping over -80% from maximum price of 2008. At the current price, the company trades at two thirds of its book value, after closure of its nuclear power plants. A valuation of its different business lines at market prices would give us an intrinsic value of roughly twice its current price.

It is also worth mentioning the purchase of Antofagasta, copper production company. Antofagasta accumulates a decline close to -70% over the past four years, in such period copper price has decreased about -50%. At first sight, the decline looks disproportionate. It is true the main copper buyer in the world is China, which makes up 40% of world demand. Thus it is not debatable copper prices to drop when the world's biggest consumer is in trouble. If we add to the equation a weak balance sheet situation, as the case of Glencore, the disaster within the copper sector is served. Going back to our original approach, we believe that in the worst market situations, when everything seems to be lost, it is possible to find good investment ideas, as in this case of the copper market.

It is important to clarify that our investment thesis is not based on the immediate recovery of China, neither on a sudden rise in copper prices during the next few weeks. We just try to identify, within a highly penalized sector, those players in best conditions to finish the run with no injuries, and if possible, to win it. We believe Antofagasta is one of them.

Antofagasta is a mining company based in Chile, natural geography for the production of copper, controlled by the Luksic family (65%), acknowledged by their good reputation as entrepreneurs and good treatment to minority shareholders. There are three factors that make the difference between Antofagasta and the rest of the mining companies: no debt, cheap producer and small. With hardly 3% of global market share, it stands within the first third of cost-producers, which does mean that in case copper prices continue to drop, something on the other hand we do not rule out, two thirds of global production will disappear before them. Besides, not having debt is very valuable in this market situation: Antofagasta is capable of holding much more time than competitors in case copper prices continue to drop over a long period. Copper has no economically viable substitute to serve so important and necessary sectors like electric energy transmission, telecommunications or fluid conduction. From a valuation point of view, at current prices, buying Antofagasta would cost around 11,000 dollars per ton of annual production, which compares to the 20,000 dollars required to start up a copper mine from scratch, according to a Bernstein's report.

There has been less activity in the Iberian portfolio. It is true that Ibex 35 registered the steepest decline among European comparables, great part of such decline is due to the Spanish banking sector, industry on the other hand which we still do not see attractive enough to invest in for the long-term, even after recent declines. Common sense indicates current low interest rate environment is not the most appropriate for a sector that lives from the difference between the rates charged to clients and the rates paid for deposits. Think for an instance what the profit of a business selling its products at even would be; the answer is immediate. But it is not just that the price at which they sell the product is low, it is also that the quantity of products sold is minimum, which obviously in the case of the banks is represented by the credit. An economy in the process of debt reduction is difficult to register meaningful increases in credit.

It should be noted the increase of exposure in Corticeira Amorim. World leader in cork manufacturing, with over 35% market share, the company is twice the size of the second largest manufacturer. Corticeira is controlled by the Amorim family, with a stake of 84.9%. One of each three wine bottles sold all around the world is sealed with cork stoppers produced by Corticeira. Several competitive advantages make Corticeira a profitable business and unique. Although it is a Portuguese company, only 4% of its sales come from this country; the most interesting thing about its location is that the Iberian Peninsula represents one of the biggest areas of natural resources of cork-oaks in the world. This allows them to have a great source of supply, as well as low transport costs. Corticeira also has direct exposure in the main wine producer countries and controls one of the largest distribution networks of the sector in the world, with over 42 sales channels. Company which is not on the radar screen of the investor community, managed and controlled by a family, profitable, sound balance sheet and clear competitive advantages that allow them to grow over the cycle.

After nine months down the track investing with all of you, our clients, once again let me pass on to you our enthusiasm in this project. Recent declines in the market, far from causing us discouragement, have reinforced even more our degree of commitment, encouraging us to continue discovering good long-term investment ideas. The path of value investors like us is lonely, willing to buy in moments of pessimism and waiting patiently when market prices are high. Only taking extraordinary decisions may we achieve extraordinary results.

Thus many thanks for your trust.

MAGALLANES IBERIAN EQUITY FI

The fund closes the quarter with an investment level of 85%, made up of 26 Spanish and Portuguese companies compared to the 24 of the last quarter.

The portfolio has a clear bias towards the consumer and industrial sectors, standing out positions in Barón de Ley, Semapa SGPS SA, Iberpapel Gestión, Inmobiliaria Colonial SA and Sonae SGPS SA. Top ten holdings account for 51.5% of the fund.

With recent increase in Corticeira Amorim we increase exposure in Portugal to 22.2%. The rest is comprised of Spanish companies.

The predominant size of the companies in the portfolio does not exceed €3.500 million market cap, with weight of 76.4%. A 4.2% of the fund is invested in companies with size of over €10.000 million.

Current investment level of the fund seems adequate to us. The number of companies in the portfolio will not vary significantly in the medium term.

MAGALLANES EUROPEAN EQUITY FI

The fund closes the quarter with an investment level of 84.1%, made up of 32 companies.

The portfolio has a clear bias towards the industrial manufacturer, distribution and consumer staples sectors; sectors which are represented, for example, through holdings like Orkla ASA, C&C Group Plc, Buzzi Unicem SPA, Thermador Holding SA and EMMI AG. Top ten positions account for 41.1% of the fund.

Due to the holdings in the portfolio the result is greater exposure to France, Germany and Switzerland compared to other countries.

The predominant size of the companies in the portfolio does not exceed €3.500 million market cap, with weight of 57.6%. a 9.6% of the fund is invested in companies with size of over €10.000 million.

Current investment level of the fund seems adequate to us. The number of companies in the portfolio will not vary significantly in the medium term.

Once again, many thanks for your trust.

Iván Martín Aránguez, CFA
Chief Investment Officer

## ANNEX of RETURNS

### MAGALLANES IBERIAN EQUITY, FI

| FUND | 1 M | 3 M | 6 M | SINCE INCEPTION | INCEPTION DATE | INVESTMENT LEVEL |
|---|---|---|---|---|---|---|
| **Magallanes Iberian Equity FI "M"** | **-4.24%** | **-4.04%** | **-6.88%** | **0.25%** | 29/01/2015 | 85.0% |
| *Iberian Benchmark* | -6.50% | -10.51% | -15.63% | -6.86% | | |
| **Magallanes Iberian Equity FI "P"** | **-4.20%** | **-3.91%** | **-6.64%** | **-1.46%** | 26/02/2015 | 85.0% |
| *Iberian Benchmark* | -6.50% | -10.51% | -15.63% | -12.33% | | |

NAV performance after fees. Iberian Benchmark: 80% Ibex35 Net TR + 20% PSI20 Net TR. Data as of 30/09/15

### MAGALLANES EUROPEAN EQUITY, FI

| FUND | 1 M | 3 M | 6 M | SINCE INCEPTION | INCEPTION DATE | INVESTMENT LEVEL |
|---|---|---|---|---|---|---|
| **Magallanes European Equity FI "M"** | **-2.37%** | **-3.64%** | **-5.27%** | **-0.65%** | 27/01/2015 | 84.1% |
| *European Benchmark* | -4.31% | -8.86% | -12.43% | -4.65% | | |
| **Magallanes European Equity FI "P"** | **-2.33%** | **-3.52%** | **-5.04%** | **-0.06%** | 29/01/2015 | 84.1% |
| *European Benchmark* | -4.31% | -8.86% | -12.43% | -4.64% | | |

NAV performance after fees. European Benchmark: MSCI Europe Net TR. Data as of 30/09/15