January 18, 2018

Dear clients and friends,

Re: LCM Annual Letter December 31, 2017

In LCM's tenth annual letter I will provide a brief overview of key events in the markets in 2017, review our results and discuss the genesis of a *buy* decision.

Year in Review

There were plenty of troubling issues in the headlines this year including the potential dissolution of NAFTA, decimation of conventional retail via e-commerce, the replacement of conventional money with cryptocurrencies, and tensions between North Korea and the US. The only clearly positive item was the potential for lower taxes in the United States. In the face of this news US stock markets were strong all year. Canadian markets got off to a slower start with weak prices for oil and natural gas in particular. Central banks continued with their agenda of measured increases in short-term interest rates, but long-term bonds remained expensive. Passive investments, such as index funds and exchange-traded funds, grew in popularity. This appears to be a virtuous circle, but there is some risk. Low cost index funds may be a great substitute for large, high-fee investment firms that shadow the index, but it is not clear that all these new passive investors will stay the course in a market correction. The idea of commingling a large amount of capital in funds with similar, inflexible, rules-based, fully-invested mandates sounds foolish as it could create a liquidity problem. Liquidity is often less noticeable when buying than selling. If it creates some disruption we will be ready. Overall this is an environment that warrants more caution than exuberance.

In terms of research and portfolio activity, in 2017 I interviewed the management of twenty-four companies, visited six companies in the field, and travelled to the U.K. and Alberta in search of opportunity. This year we sold the balance of one position that we had reduced considerably in 2015, and trimmed our stake in another business due to high valuations and increased competitive pressures in that industry. Both purchases made in 2016 have been performing well. Like the managers of many of the companies we are invested in, we have chosen not to lower our return hurdles to deploy capital, instead preferring to let cash rise so we can take advantage of future opportunities. We finished the year in a very conservative position with cash at 46% of the portfolio (up from 41% at the end of last year). We will continue to deploy our capital with the same patience and discipline we have had since inception and we are confident that the market will offer up more opportunities.

Results [i]

In 2017 we earned a total portfolio return of 10.6%. This return outperformed the Canadian market but lagged the US index. When comparing LCM to US markets, the Canadian dollar has been a headwind for the past five years, and only recently has become a tailwind. If we reported our 2017 performance in US dollars, LCM earned 18.7%. This is satisfactory from an absolute return perspective, but was still a few points behind the strong US market. Over longer periods of time the performance of our stock positions tends to make the effect of currency less relevant.

Since it was founded in 2008, LCM has earned a cumulative total return of 252.5%, or 14.2% per year on an annualized basis. In other words, $100 invested at LCM when we opened our doors before the financial crisis in mid-2008 is worth roughly three and a half times that amount today. We have accomplished our long-term goal to earn in excess of 7% annually, and LCM has beaten the market by 5.6% per year relative to a simple average of the Canadian and US stock markets since inception. We are pleased with these results and view them as a product of our patient and disciplined approach.

In this year's letter I will break with tradition and discuss a position that we recently sold. We hope this will provide greater insight into our investment process and suspect it might also make for a more interesting read.

LCM's Investment Process: Genesis of a *Buy* Decision

It starts with a simple idea

In 2010, the auto parts suppliers sector appeared to me to be a great place to look for opportunity. There was lingering fear hanging over the industry as GM and Chrysler (two large customers to the suppliers) had only recently emerged from bankruptcy, and at least 5 publicly-traded suppliers had filed for Chapter 11 protection the previous year. The financial crisis had hammered North American auto production from a 'normal' level of 15 million vehicles per year down to a low of 8.6 million in 2009, a dramatic down cycle that had not been seen since the recession of 1990. Auto sales are cyclical, and what no one could know with certainty was how long it would take the industry to recover. What intrigued me about the auto sector was the knowledge that, unlike say luxury jewelry, cars do wear out over time so over a period of a few years the fleet of cars on the road would age to a point that would necessitate new car buying. The task was to find a way to benefit from the eventual rebound in the sector with minimal risk of capital loss.

Experience

During the fifteen years before I founded LCM, I conducted roughly fifty management interviews of auto parts suppliers and invested in eight different businesses. The key metric unique to the auto parts sector is growth in Content Per Vehicle, (CPV) which is calculated as the total dollar value of parts sold by a supplier divided by the number of vehicles produced in a market. It is a measure of organic growth, and to a lesser degree, market share. One conundrum in this sector can be that the companies with the greatest potential for CPV growth have the least amount of free cash flow available for dividends, buybacks or accretive deals, as they must invest a considerable amount of capital into new equipment for production lines to accommodate that growth.

Analytical review of the sector

When analyzing the companies across any sector, a key question is what is the size of the potential opportunity in front of each company and to what extent does each business model fund that growth? For auto parts suppliers, the capabilities of the supplier and the degree of outsourcing from the customers delineate the opportunity, and this varies over time and by product line. Outsourcing has been a longstanding trend in the auto industry, and one impetus for this over the last few decades was to escape burdensome labor rules and high wages at the car companies themselves, as most suppliers are non-unionized with more flexible labor forces. Outsourcing also grew as entrepreneurs developed exclusive new manufacturing processes and technology in areas like hydroforming, powertrain, or mirrors. Manufacturing costs typically follow a "learning curve" and decline over time as a function of cumulative production, but the customers are aware of this and expect to share in these benefits through annual price givebacks. Some parts of a vehicle, such as the exterior, change more often and thus benefit less from the learning curve due to shorter production cycles. The capital intensity of business models varies widely across the sector, yet the investment industry somewhat nonsensically uses EV/EBITDA[ii] as a comparative metric of value, which can create opportunity for someone willing to dig a little deeper. There is a widely held belief in the investment business that astute value investors should avoid cyclical businesses. What is incorrect about this generalization is that cycles can sometimes provide investors with better buying opportunities, and able management teams better reinvestment opportunities, than less cyclical industries. There are often attractive business models hiding in these industries that get overlooked. In the case of auto parts suppliers, despite the cyclicality and capital intensity of the business, returns on capital can be attractive over a cycle. To paraphrase a famous investor, I'd take a lumpy 15% return over a smooth 12% return every time. [iii]

Identifying an opportunity

In 2010, Exco Technologies was a Canadian small cap company with 2 divisions and it derived about two thirds of revenues from sales to the automotive industry. While I had followed the company since the late 1990s, I had never owned it. The Automotive Solutions division made a high volume of low price point auto parts (such as netting) in low labor cost jurisdictions like Morocco and Mexico. This division stood to benefit in an environment of rebounding auto production. Growth in this business is more people intensive than capital intensive; expanding a trained workforce requires management expertise and time rather than capital. The second division, Castings and Extrusion, comprised of a commercial extrusion business which was depressed due to weakness in the commercial construction market, and a castings business with one key plant which manufactured large moulds for the production of vital engine blocks and transmission housings that were then made by the car companies themselves. The only North American competitor was in receivership due to the recession and over-indebtedness. The mould business had been hit hard by the dire finances of the car companies, which had delayed coming out with new vehicle styles/models due to the financial crisis. These delays, along with legislation mandating the introduction of more fuel efficient internal combustion engines, had the effect of creating pent-up demand for this business. A key insight was that this was a business with high fixed and low variable costs, thus the bottom line would benefit disproportionately from any rebound in sales. The lack of variable costs was observable when I toured the large mould plant in Ontario in May of 2010. At one end of the plant a giant solid cube of high-grade tool steel would enter, and a group of salaried engineers would machine and drill the cube in a complex series of processes until the completed mould would emerge several weeks later at the other end of the facility. The process involved few purchased components, and was all done in-house. To grow this business, some working capital was required, but as the facility was already in place it was more a case of filling up existing capacity than spending more money on new production lines.

Investment thesis

The investment thesis for Exco in 2010 was that the inevitable rebound in North American auto production would benefit the bottom line disproportionately due to the high fixed costs in the key large mould division, and the company would exhibit the unusual attribute of throwing off free cash flow as revenue grew, which is atypical for the sector. As for the likely use of this free cash flow, despite some deals done in 1999/2000 the company had been focused predominantly on organic growth for the previous decade. The management was talented, and the board owned roughly one third of the company so our interests were aligned. When an entire industry is cheap and washedout, you need to be sure that what you are buying is demonstrably better than its peers or you can end up in what's called a value trap, which is a cheap stock that stays cheap and often turns out to be junk. In the case of Exco, over the 10 and 15 year periods leading up to 2010, the company had generated the highest average earnings before interest and tax (EBIT) margins versus the peers I had studied. Furthermore, calculated prospective return on equity was in the mid-teens on an unlevered balance sheet. This illustrated that the business fit our quality criteria. A key requirement for an investment to qualify as a good idea is that there is limited downside at the time of purchase. At the price we paid for our first hundred thousand shares (CAD$2.55), the stock was trading at a 10% discount to accounting book value. There was no debt, $0.43 in net cash per share on the balance sheet and no goodwill. Exco owned all of its ten manufacturing facilities and all of its production equipment. The company was making money, had generated free cash flow every year, even during the most recent downturn and was trading at a 10.2% current free cash flow yield at the time of purchase.

Action and outcome
We made our first purchase of Exco at $2.55 per share in March of 2010, and over the next 19 months to October of 2011, we quietly accumulated shares in 5 more transactions paying between $2.70 and $3.80 per share. Due to our understanding of the fixed cost nature inherent in the large mould business, our analysis projected that street estimates of future profitability were understated. This indeed turned out to be the case and the fixed cost leverage was demonstrated in the first two years we owned it. In 2011 and 2012, revenue growth of 21% and 22% generated earnings growth of 44% and 67% respectively. Our expectation that free cash flow would rise along with earnings was confirmed in the first year of ownership. Over our seven year holding period the dividend was increased by roughly 400% as a direct result of this free cash generation. It took five years for annual North American auto industry production to rebound to a new 'normal' level of 17 million units, where it remains today. Following the *sell* discipline outlined in LCM's 2015 annual letter, as the investment thesis was proved out and the position size grew in our portfolios, we trimmed the position in 2013, selling the bulk of the position in 2015, and the balance last summer. From May 2013 to August 2017 we sold the position in 9 tranches at prices ranging from $5.80 to $17 per share.

Conclusion
Including all purchases, sales and dividends, over the 7.4 years between our first purchase and final sale, this position earned an internal rate of return of 36.7% per year compounded for LCM clients.[iv] Of the 16 investments LCM has made in the last 9.5 years, this has been the third best performer to date. This is also one of the smallest companies we have ever purchased, having a market cap of $100 million when we first bought it. One might get the mistaken impression from this example that small capitalization stocks are where all the opportunities are; however, in our experience, one is equally likely to find good investment ideas in large companies as in small companies. In fact, two of the current holdings of LCM were over $25 billion market cap at the time of purchase. Often small companies appear attractive on the surface, but in reality contain many more undisclosed risks than large companies.

<u>Lower Custody Fees</u>
Last summer we were able to renegotiate the fees that our clients pay to the custodian to hold securities, provide statements and settle trades. At our new lower fee schedule we rival or beat most

of the large managers, especially for larger accounts. If you want to know how to calculate how much you are saving under the new deal please give me a call.

What can clients expect going forward?

One of the main questions I get from clients today is whether "now" is a good time to invest more capital. As this is inherently unknowable, I would be suspicious of anyone who has a quick answer. That said, some discussion of this topic might be useful. There is always the possibility that stocks could fall in the next year or two. This possibility, however, must be weighed against the certainty that the value of our cash will erode substantially due to inflation if we look ahead twenty years or more. Perhaps, then, the most intelligent response to the unanswerable question of "when to invest" is to consider your time horizon. It is important that investing is approached with a long-term mindset so that when turbulence arrives it will be viewed correctly as opportunity. From the outset at LCM, I have asked each client to consider only investing capital with LCM that has a five year minimum horizon. Because the short term is unknowable, this can guard against the scenario where a client needs to redeem capital at a low in the market. While we are conservatively positioned with a high cash position today and we do not own the market, in every letter we caution that losses on an annual basis are unavoidable from time to time. Given that owning shares in a company is analogous to being a part owner of a business, and just as no business owner can expect to increase their net worth in a straight upward line, neither can an investor in stocks. Despite this fact, owning stocks remains one of the best ways to protect and grow one's capital. Although we expect our performance to be different from the market from year to year, we continue to anticipate generating returns in excess of 7% annually over the long term.

I wish you all the best for 2018. If you have any questions please call me at 604-558-0070.

Sincerely,

Daniel Lewin CFA
President

P.S. We are grateful for referrals to friends with whom our approach might resonate. Due to our segregated model we have minimum of $5 million in investable capital for new clients.

[i.] All stated returns are gross of fees. We take pride in ensuring that our fees are fair and reasonable for the service LCM provides. If you would like a copy of LCM's Investment Management Agreement that outlines our fees and services in more detail please contact us. Returns for LCM are from a representative account as all client assets are held on a segregated basis. Small differences will occur between accounts due to rounding and the timing of cash flows. The S&P TSX Composite Total Return Index is used to represent the Canadian stock market returns, and has returned 4.3% per year over the nine and a half years ended December 31, 2017. The S&P 500 Total Return Index translated into Canadian dollars is used to represent the U.S. stock market returns, and this index has earned 12.8% per year in Canadian dollar terms over this same period. Thus LCM's total portfolio return of 14.2% per year has beaten a simple average of the Canadian and U.S. Stock Markets by 5.6% per year since inception. "Since inception" refers to the nine and a half year period from June 30, 2008 to December 31, 2017.

[ii] EV/EBITDA, or enterprise value divided by earnings before interest, taxes, depreciation and amortization, is the most popular metric used to value companies in the investment industry, but is deeply flawed. While a corporate buyer who can change the capital structure after buying the whole company might use it to compare businesses in a similar industry, it fails badly when equity investors use it as a proxy for free cash flow. Taxes, interest and depreciation are real expenses, so a low EBITDA multiple does not necessarily equate to a low valuation for a business. And comparing businesses with varying capital intensity is pure folly as depreciation is often a significant (and real) expense, rendering EBITDA multiples useless. For instance an asset-light software business trading at 10X EBITDA might actually be cheaper than a capital-gobbling steel mill trading at 5X EBITDA. Charlie Munger summed the issue up nicely at a Berkshire annual meeting – in his opinion every time you see the word EBITDA you should substitute the word "bullshit" earnings.

[iii] In his 1996 Berkshire Hathaway annual letter to shareholders, Warren Buffett's exact quote was "Charlie and I would much rather earn a lumpy 15% over time than a smooth 12%".

[iv] Internal rate of return or IRR is the only way to accurately measure the performance of an investment with multiple purchases and sales and growing dividends. As IRRs can be hard to conceptualize, consider these facts: from our first purchase to our average sale price in 2015 when we sold the bulk of our holdings ($2.55 to $15.29) represents a capital gain of 6X, and the $1.40 per share in total dividends received over the 7.4 years we held the stock represents a return of approximately 55% of our initial purchase price ($1.40/$2.55).