

## VMCH Corporation - Annual Report

### VMCH Corporation performance

Year	Annual percentage change		
	in Per-Share Book Value (NAV) of VMCH	in S&P500 with Dividends Included	in MSCI Europe with Dividends Included
2012	24.8%	16%	19.9%
2013	27.7%	32.4%	25.9%
2014	(2.7%)	13.6%	(5.6%)
2015	(1.4%)	1.3%	(2.3%)
<b>Compounded annual gain</b>	11.1%	15.3%	8.6%
<b>Overall Gain</b>	52.9%	76.3%	39.2%

“Spend each day trying to be a little wiser than you were when you woke up” - Charles Munger

To the shareholders of VMCH Corporation,

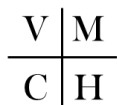
In 2015, NAV decreased by 1.4% compared with an increase of 1.1% in the S&P500, including dividends. MSCI Europe decreased 2.3% including dividends during the same period. Our 4-year annualized return to date was 11.1%.

2015 was a tough year looking at investment returns, but a good year looking at the investments. When a stock in the portfolio goes down, it affects the return negatively for the year, but it also creates an opportunity to invest again at a more attractive price. In addition, if the management of the company in question is competent, they will buy back shares as well. In seemingly tough times the profits of the future are sown, and so we soldier on.

During the year we sold an Renault SA, one of the first investments we made for a profit well over 100%. We first bought the shares at EUR 38 and sold at EUR 98, with around EUR 100 per share as our conservative fair value for the company. Well bought and well sold, a true example of an original investment idea gone right.

We also had two opportunities to invest more funds in companies already in the portfolio and already well known to me. After making certain that nothing changed, I doubled the share of each company in the portfolio. This makes me very happy as we have a large share of the portfolio now invested in high quality businesses, with high ROIC figures and good growth prospects.

This bias towards good or great businesses will allow us to enjoy the long term benefits of compounding, and reduce portfolio turnover. Buying what you already know is always better than making an investment into something new and less familiar.



I would like now to delve a little into the investment decision process, how myself and Ronit use our checklist in looking at potential investments, how we learn from our mistakes and avoid certain pitfalls. It is also interesting to note how we use our own judgement even as sometime-famous value investors think differently.

In early 2015 I was making a review of investments made by other investors. I encountered an original idea by Mohnish Pabrai to invest in Horsehead Holding Corp (ZINC). The company is a producer of zinc which has been building a massive zinc production facility, which came online around that time. The new plant was supposed to raise profitability to a very significant level, which if materialized would mean that the company was worth twice or more the share price at the time. The plant was already built, and seemingly everything was ready for the company to make a tidy profit from 2015 onwards.

However we refrained from investing, keeping in mind that bringing online a large processing facility is no small matter. It could be years before every problem is sorted and the plant is 100% operational. In addition, profitability is very sensitive to the price of zinc. Finally, the company had some debt on the balance sheet. And indeed, one by one operational problems surfaced, the price of zinc plummeted, and the debt became a problem.

We were not prescient, just learning from past mistakes. For a time, we held shares in Fortress Paper (FTP), a similar situation where the company was in the process of bringing a large facility online, with many operational difficulties. It also was exposed to the price of a certain commodity (dissolving pulp, a cotton substitute), and was burdened by some debt. We took a loss and moved on, but this loss likely prevented a bigger one in the future and prompted us to raise the bar for quality higher. As a result one of the questions we ask ourself is - "Is this company highly exposed to commodity prices?".

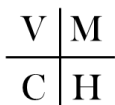
If it is, we are not likely to invest.

Another case is Bed, Bath and Beyond (BBBY) which I reviewed about one year ago. The company is a retailer of domestic merchandise and home furnishings. It had a very good track record of growth, above 20% ROE, little debt, and great operating margins (10-15%) which is massive for a retailer. It was buying its own stock and the price was reasonable.

However, the company has grown very large, which doesn't bode well for future growth. In addition, operating margins made no sense long term in the context of the business of the company. Sure, they could achieve great results, however there is nothing in the business that inherently protects it from competition, which is sure to come with such handsome numbers.

As the year progressed, that notion seemed to hold up and growth has stopped. Furthermore, the company reported a like for like decline in sales. Again, the sense of what is reasonable and likely in the retail sphere was based on past investing experience that was costly enough to remain firmly in mind.

When investing in an industry where there are no competitive barriers to entry, and products are very similar or identical, profitability should be low and only the lowest cost operators survive and



sometimes thrive. This was the experience of Wal-Mart, and similar discount retailers. Bed, Bath and Beyond doesn't seem to fit that bill.

Lastly is the case of Sears Holdings Corp, a Bruce Berkowitz favorite. This is a very curious case. I first encountered the company when reviewing some presentations by Bruce Berkowitz. He laid out quite a compelling case that in fact, the real estate value of Sears is likely to be 20B\$ or even more, and it is a simple case of waiting patiently until that value is extracted by CEO Edward Lampert. Lampert is certainly a very smart individual and seemingly there was no reason to assume he should delay in extracting that value as quickly as humanly possible. So there seemed to be an "easy" 4-bagger (a Peter Lynch term for an investment returning 4 times the original investment) plainly in sight.

Doing some more digging however and not making due with powerpoint slides, I found a few disturbing issues. Lampert acquired Sears in late 2004, so he had around 10 years to execute his vision. So what did he do? Did he close unprofitable retail locations, sold the real estate and reinvested the proceeds in better businesses, like Buffett did with Berkshire? No, not really.

Lampert continued to operate the business, and as it began to lose money, he started to dispose of assets and to spin off certain divisions. The proceeds generally went on to support the turnaround of the retail business via reducing the debt to a manageable level. So that was one giveaway that maybe capital was not allocated rationally. Lampert even went on to explain his ideas regarding the future of retail in shareholder letters and a personal blog, although his past experience as a hedge fund manager doesn't quite make him a retail guru. So that was slightly odd.

The other big thing were the massive losses the company was producing, the latest of which are in the order of 1B\$ loss per year. Now, this is even worse than that, as the company has a lot of below market rents, so that 1B\$ loss is a "low rent included" number. The problem with that loss is that over time, it eats into the value of the real estate remaining in the company. Ten more years of that, and there could be not much left.

So the conclusion was - invest only if certain that the company would substantially get rid of its retail operations and either sells or rents the real estate, and that has to happen quickly. However based on past management behaviour, that seemed an unlikely proposition and so I passed on this "golden opportunity". I still watch for any developments though, as it is an interesting situation to follow.

Ronit and I review hundreds (sometimes thousands) of companies, which do not pass our checklist process, or fail on the basis of our and other investors experience in similar situations.

A word of thanks to our long time investors, who understand that value investing takes time and patience to see to a fruitful conclusion.



Edward Gurban