IBV
CAPITAL

Dear Partners,

We've been fortunate over the past few years to have presided over strong investment returns – a result of our exceptionally disciplined, value focused approach to markets. The markets have also enjoyed strong returns, but for very different reasons. In the U.S. and internationally, stock indices have continuously reached new highs. Bond valuations have also continued to be elevated globally. For instance, Italy, which just a few years ago was widely considered a default risk, can now issue new 10-year bonds at a lower interest rate than the U.S. This oddity, along with many others in the fixed income space, is a byproduct of enduring global monetary easing. Equally interesting is the duration of this seemingly endless run-up in valuations – exceeding nine years now.[1] More importantly, security valuations (both stocks and bonds) relative to historical valuation metrics are elevated, which is something we're keenly aware of.

Tax Reform

This year we witnessed Canada and the U.S. undergo some of the most dramatic changes to their corporate tax regimes in decades. In the U.S., tax rates for businesses dropped to their lowest levels since 1939.[2] In addition, by eliminating many deductions, the U.S. tax system will be much simpler going forward – even as uncertainty and complexity dominates in the short-term as intended and unintended consequences of each tax code change becomes apparent.

Alternatively, Canada, in an effort to integrate private corporate tax rates with personal rates, is set to increase taxes and heighten complexity for many businesses. Specifically, the proposed approach to taxing passive income earned by private companies is not only punitive to successful business owners, but the burden of monitoring it is incomprehensible. If enacted, this will negatively impact growth. When considering the impact of each country's tax reforms, both in isolation and combined, it is evident that the U.S. has gone from being structurally disadvantaged to holding a considerable advantage over Canada and many other developed nations. As we saw a few years ago with the proliferation of inversions, a tax-advantaged merger strategy, opposite tax regimes attract, but unfortunately there isn't always a fairy-tail ending.

After we removed the over-arching theme that the U.S. tax reforms will benefit all companies with economic ties to the U.S. through increased economic activity, it became evident that individual companies will be impacted in radically different ways. For instance, we would not anticipate

[1] http://ca.spindices.com/indices/equity/sp-500
[2] In 1939, the top corporate tax rate was 19% for taxable income over $25,000

companies that enjoy effective tax rates that are similar to the new statutory tax rate to directly benefit in the form of a lower tax bill. Instead, it's likely these companies will be indirect beneficiaries as they repatriate their foreign profits under favorable terms and use this financial freedom to bolster their capital allocation plans. Companies in the technology industry exhibit the characteristics we're referring to because of their historical ability to divert foreign profits to lower tax jurisdictions.

Conversely, companies who have high effective tax rates should see their future tax bills fall considerably. Whether the company will actually see the benefits of this tax decrease will depend entirely on the defensibility of its business model. Consider the economic implications of lower taxes on commoditized businesses that struggle to compete due to persistent pricing pressures from local and foreign competitors. Instead of their tax savings going to the bottom line, they'll likely (or at least should) be diverted to lowering prices for their customers to remain competitive. For capital intensive commoditized businesses, the savings may instead be used for capital investments that improve operational efficiencies and profits, thereby providing the company with flexibility to lower their prices. While we anticipate many businesses will fall victim to this economic reality, brick-and-mortar retailers stand out as an industry that may need to immediately pass on the savings to their customers instead of their shareholders.

Interest Rates

Interestingly, in December the Federal Reserve debated whether the positive impacts of the U.S. tax reforms would increase GDP growth expectations, and therefore the pace of rate increases. Conversely, in September, the Bank of Canada made little mention of the headwinds tax reforms north of the border will have on Canada's GDP growth trajectory – despite the unprecedented uproar by Canada's business community.

Perhaps this is fitting because in Canada, we're provided little, if any, visibility into upcoming monetary policy changes. Stephen Poloz, Governor of the Bank of Canada, rightly or wrongly suggests forward guidance is unhelpful in setting monetary policy, and therefore contrary to his well-respected predecessor Mark Carney, has created a central bank culture that provides limited guidance. The Fed, by contrast, has taken the opposite stance: clearly articulating future monetary policy expectations. We would anticipate incoming Fed Chairman Jeremy Powell to continue this practice. While these central banks deviate in their communications strategy, one important commonality is they are both data dependent in making monetary policy decisions – and we see divergences in some of the data.

Arguably, Canada and the U.S. are working with very different economic environments. Canada is facing many economic sectors that are elevated by historical measures – namely residential real estate, new car sales, and increasingly government spending. When coupled with the uncertainty of increased private business taxes, tightened mortgage lending rules and the uncertain outcome of a contentious and asymmetrical NAFTA negotiation, it is clear the BoC is in a quandary. Determining the precise pace of interest rate increases and how they'll impact economic activity will be difficult with all these cross-currents.

Conversely, the U.S. is facing improving business and regulatory conditions, an attractive new tax regime, reasonably strong and sustained economic expansion, and below-target inflation – despite record-low unemployment. The Fed's predicament is contending with future inflation and asset prices, both in equities and bonds, trading above historical average levels, presenting a potential risk to the animal spirits that have been unleashed.

A Year of Positive Developments

The market value of our investment portfolio increased by 9.8% in the fourth quarter, and we finished the year up 17.8% – building on our 23.5% return in 2016. The intrinsic value[3] of our portfolio remained flat in the quarter and increased by over 17% during 2017. For comparative purposes, during the fourth quarter and all of 2017, the MSCI World Index increased by 9.3% and 22.4%, respectively.[4]

We enjoyed multiple wins throughout the year. During the summer, Scripps Networks Interactive entered into an agreement to be purchased by Discovery Communications. We sold our shares just prior to the deal being consummated, resulting in a healthy profit for the year and on the position since we entered it in the fall of 2015. We also realized our investment in Enbridge Rate Reset Preferred Shares after their price reached our intrinsic value expectations. We were very pleased with the 43% return on this investment.

Our investments in Bank of America ("BAC") and Citigroup ("C") produced another year of superb returns. A confluence of events including higher interest rates, aggressive share repurchases, tax reforms and resulting quality earnings outlooks were responsible for the appreciation in value.

It's worth mentioning that few companies will benefit as much from the U.S. tax reforms as BAC and C. However, the transition to the new regime will create some messy accounting. We've already witnessed large write-offs of deferred tax assets, giving the appearance that both banks are generating lower earnings. We're not concerned about this accounting treatment because in the future, lower tax rates will improve the earnings power of both companies. All things being equal, lower tax rates will also spur economic growth, which should eventually drive interest rates higher – two additional value-enhancing benefits accruing to these companies so long as they unfold in a controlled manner.

We've held our position in BAC and C for years. While not the most unique names one can hold, they have performed exceptionally well. This begs the question: How can two companies so well

[3] We would encourage all new readers to visit the "Our Liquid Conglomerate" section of our Q2-2016 investment letter to assist them in understanding the meaning and importance of our portfolio's intrinsic value.

[4] "IBV Global Value Fund" consist of USD$ IBV Capital Global Value Fund LP Class M unit returns, gross of fees. Inception date of this class is October 1, 2014. "Portfolio Intrinsic Value" represents IBV's internally calculated intrinsic value for the cumulative securities within the IBV Global Value Fund. "MSCI World Index" is based on the USD$ returns MSCI World Free NR Index. Full investment disclosures are found on Page 7.

followed by the investment community produce such outsized relative returns year over year? Said differently, how could they have been so mispriced?

For one, occasionally, large institutions are used as proxies for entire industries. We witnessed this first hand in BAC and C when Greece was supposedly leaving the eurozone, when the United Kingdom did, and when Europe placed a ban on short selling their financial institutions. Clearly, being used as an industry proxy can produce valuations that deviate wildly from the underlying economic fundamentals of the individual institutions themselves.

A more broad-based explanation is the notion that not every market participant that follows and invests in a security is looking at it through the same lens. For instance, IBV views all securities through our exceptionally disciplined value investment lens. Other investors may be using charts and technical pricing considerations. Still others are focused on momentum trading, using securities to express macroeconomic trends, capturing growth at a reasonable price, dividend payers, and so on. Case in point: if you look up what ETFs include BAC, you'll quickly find it is included in dividend, rising rate, value, and momentum-styled funds, to name a few.

Similarly, the underlying rationale for engaging in buying and selling a security isn't the same for all market participants. Indeed, many individual and institutional investors face both artificial and actual constraints that must be managed. These may include security concentration limits, portfolio re-balancing requirements, or liquidity needs – like margin covering and funding redemptions. These practical situations are always present, so it's not difficult to imagine a scenario where the price of a security can become a secondary consideration when entering into a transaction. As well, it's important to note that buying and selling securities is not done by the masses, but a small subset of investors. By acting versus doing nothing, this subset of shareholders is expressing the most extreme investment views of all market participants.

Our investment in Trinity Industries provides an excellent case study for why our returns can appear to follow the market closely, and then abruptly be idiosyncratic and volatile. More importantly, it displays precisely why we don't mind this portfolio characteristic – and neither should our Partners.

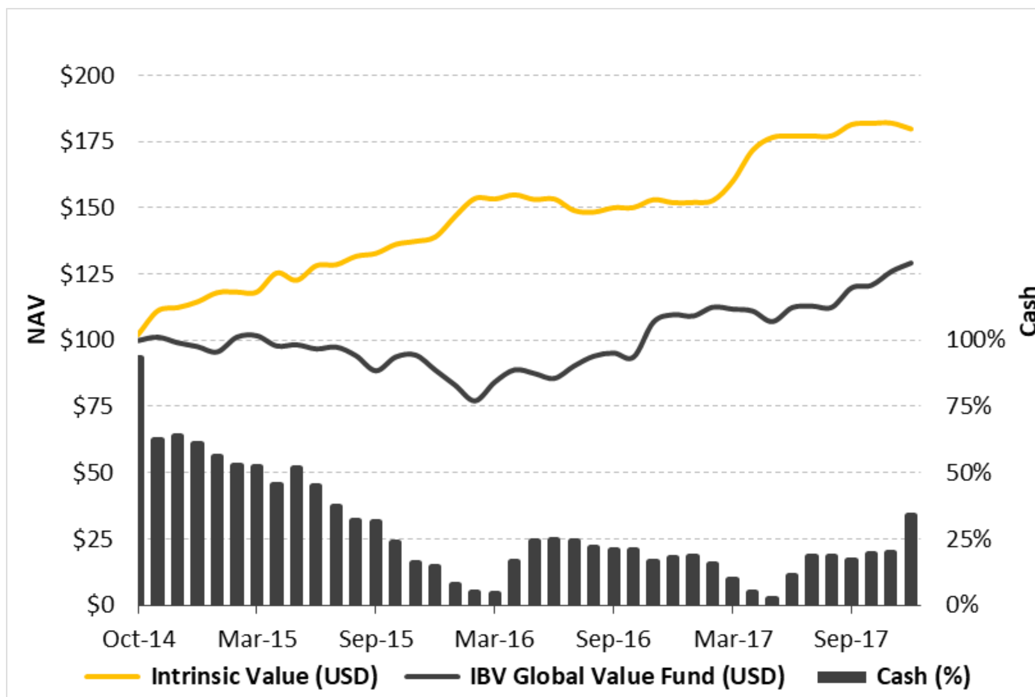
By all accounts, from January through September, Trinity's stock performance appeared reasonably stable in relation to the S&P 500. It's volatility, or standard deviation (σ) – a conventional measurement of risk used by most market participants – was 4.2%, while the S&P 500's was 3%. As we pointed out in our last quarterly Partners letter,[5] at the end of October Trinity announced the overturning of a material whistleblower lawsuit. This not only released the company from a $663 million lawsuit liability but provided them with a renewed level of operational and financial stability and flexibility. It also instantly increased their stock price, thus bringing on a higher level of volatility – or as the market views it, risk. Since the announcement, Trinity's volatility has increased by 50%. In relation to the S&P 500, Trinity is now 192% more volatile, up from a more modest 40%. In short, by using conventional risk-measuring metrics, an

[5] http://ibvcapital.com/wp-content/uploads/2014/09/IBV-Q3-2017-Partnership-Letter.pdf

investment in Trinity this year would have been less risky from January through September than from October to December.

Interestingly, the exact opposite was true from a business standpoint. During the first nine months of the year, Trinity was most risky as the ongoing lawsuit presented a meaningful business risk with large financial consequences and was preventing the company from taking actions to unlock shareholder value. Once the financial liability was eliminated, the level of business risk fell considerably, and management was then able to announce a doubling of their share repurchase program and spinoff of their infrastructure-related businesses to shareholders, isolating their railcar business. Naturally, we applauded both announcements because they will unlock shareholder value, as we've long felt their railcar business (manufacturing and leasing) wasn't being fully optimized and was ultimately being undervalued by the market. We find it is worthwhile applying conventional approaches to measuring risk to the realities of investing to see if they make common sense, because in most cases they don't.

This year, the increase in the intrinsic value of our portfolio essentially mimicked the increase of the market value of our portfolio. This means the gap between the intrinsic value of our portfolio – what we think our portfolio is worth – and the market value of our portfolio, stayed relatively flat at 39.1%.



The overriding theme this year was realizing gains from investments we made that reached our intrinsic value and replacing those investments with a select few new opportunities and cash. It's worth reminding our Partners that we consider the intrinsic and market value of cash (and cash-like investments) to be one in the same. Therefore, all things being equal, cash narrows the intrinsic value gap of our overall portfolio. That said, we're comfortable with our current cash

position of 33.8% because it places us well to deploy capital quickly and opportunistically, all while maintaining a defensive investment stance.

A Monopoly in Paradise

Since the summer of 2014, we've been following a company called Ascendant Group. It wasn't until June of 2015 that we began purchasing shares, increasing our investment to a meaningful level in 2017. Today, we own approximately 5% of the company, and count ourselves as one of its largest shareholders.

Ascendant Group (AGL) is an investment holding company based in Bermuda and trades on the Bermuda Stock Exchange, which is partially owned by the Toronto Stock Exchange. Ascendant has a collection of companies, but the most prominent and valuable is the Bermuda Electric Light Company (BELCO). Since 1907, BELCO has essentially enjoyed a monopoly on the transmission, distribution and generation of electricity for the island of Bermuda.

We were attracted to BELCO because of our familiarity with Caribbean Utilities Company (CUP), the Cayman Island's sole integrated electric utility that is partially owned by Fortis. Our detailed knowledge of CUP not only informed us of how a well-run island utility could financially perform, but also what its fair value should be.

After performing exhaustive due diligence, we determined that BELCO was undervalued, and that its true value could eventually be unlocked. At the time, BELCO was generating twice the electricity sales that CUP was producing, due to healthy electricity rates, but earning operating profits that were 24% lower than their island peer. This was largely due to a bloated cost structure, so we recognized there was room for considerable improvements. Importantly, BELCO also enjoyed tremendous financial flexibility because it had almost no debt on its balance sheet – a true anomaly in the utility business.

While we hold the staff of the Bermuda Stock Exchange in high regard, it's a stock exchange that garners limited investor attention – likely the result of its relatively small size and how difficult is it to conduct share transactions. The transaction challenges are a byproduct of trading and custody restrictions and explains why the IBV team had to build considerable internal infrastructure and operating policies just to invest in AGL. Once we were finally able to invest, we expectedly found that trading there is almost entirely done by appointment. These barriers to entry have made the Bermuda Stock Exchange a very inefficient market, which is a great environment for investors like ourselves.

First and foremost, to unlock the true value of AGL, the company must re-list or dual-list its stock on a globally recognized exchange. Furthermore, while much of the heavy lifting on regulatory reform has been completed, the current nascent regulatory environment must continue to improve. BELCO's management must keep championing this evolution. We also envision a more appropriate return on rate base being captured. To achieve this, operational improvements need to be made. Specifically, expenses must be culled, and inventory management improved. The balance sheet must also be optimized so it resembles one of a well-functioning utility. Once regulators approve BELCO's capital investment plan, which should be done immediately so that

desperately needed generation investments can be made, debt can be used to finance the investment program. Finally, the few remaining non-utility companies that AGL owns and aren't producing an appropriate rate of return should be restructured or sold. All of these steps are achievable and can be accomplished at a reasonable pace, and we look forward to seeing immediate improvements.

IBV Capital

We're pleased to announce the addition of Corey MacGregor to our team. Corey comes to us from the Private Funds Group at Brookfield Asset Management. Her deep institutional investing background compliments the CPA designation she earned while in PricewaterhouseCoopers' financial services audit group. We're excited to have her running IBV's finance and operations.

IBV's investment team exerts a tremendous amount of effort and energy into exploring new investment ideas to find the select few that will safely grow our capital. The team has remained diligent and focused, and I'm proud of them and the impressive returns we've been producing for our Partners.

Sincerely,

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