VMCH Corporation

To the shareholders of VMCH Corporation,

The year of 2012 could well be considered a good one with regard to the overall result. NAV per share increased by 24.8% (after costs and fees, of course), compared with 16% for the S&P500 including dividends. One has to keep in mind two things when comparing the results of the company's portfolio with this benchmark:

1. The company pays withholding taxes on dividends received and the benchmark does not. This probably accounts for a 0.5% handicap. That is to say were the S&P500 benchmark taxed as VMCH was, it would have gone up by around 15.5% in 2012 instead of 16%.

2. Towards the end of 2012, the company acquired a put option with around 1.3% of its NAV at the time. Due to the lack of liquidity, it was difficult to determine fair value and so this option was valued at 0 as of 31.12.2012. As the option expires at December 2013, it still retains some value although I have no clue what this might be. More details further in the report.

However, I am not quite pleased as in at least one case the company took a bigger loss than was appropriate for the occasion. More on this later.

Before proceeding to the yearly overview section, I would like to make clear a matter regarding management and performance fees. In the 2011 letter these were incorrectly stated as being calculated on a yearly basis. In actuality, the management fee and performance fee are calculated on a monthly and quarterly basis, respectively. To my mind this does not make a material difference but it was misstated and had to be corrected.

As of 31/12/2012, these were the main investments of the company:

Investment	% of Assets
Cash	19.3
NRG Energy	7.3
France Telecom	10.5
Renault	13.7
Enterprise Inns	10.6
Finsbury Food Group	11.8
Fortress Paper	10.3
American International Group	9.0
Bank of America warrant A	10.4
Co. Bank of Australia P25D2013	0.0
Fortescue Metals Group	(3.0)
Subtotal	100.0

Let's first discuss the companies that were sold during the year, then go over the current holdings one by one.

Arbor Realty trust continued to perform well enough as a company, however it was sold in order to increase the positions in Enterprise Inns, Finsbury, and France Telecom. Transocean was sold at around the same time for the same reason.

SUPERVALU was sold for a simple reason – it was still cheap but no longer safe. In July 2012, the company reported that essentially, its operational plan for the last 3 years failed and they were seeking to sell and restructure large parts of the company. My assumption for valuation was a going concern and it turned out to be possibly wrong (as breakup value could be materially different). The CEO was dismissed shortly after, and operating results continued to be poor. A few days after the announcement, once I reviewed all the details the shares were sold at a 62% loss. As a result of the position being fairly large, this translated to a significant loss on the overall portfolio, around 11%.

What went wrong with the investment?

It was clear from the beginning that the business was experiencing some difficulties. This was in my mind more than compensated for by the valuation and I didn't consider the debt load particularly problematic. These observations I think are still largely true today. However, I didn't pay enough attention to some of my own "rules" regarding companies of this sort. Namely:

1. Investing in laggards in any industry during a recession is always more risky than investing in a leader. In this case, Kroger is probably a leader and SUPERVALU a laggard. As a result, the sales of Kroger increased while SUPERVALU's declined and showed no sign of improving.
   I considered the decline in sales for SUPERVALU to be acceptable considering it reduced debt, which in turn reduced interest payments and overall FCF remained reasonable. But regardless, investing in laggards is probably not a good idea because bad things tend to happen to weak companies in recessions.

2. Management didn't have a significant stake in the company. From a risk perspective this is not very important for stronger companies but it's absolutely critical for smaller/weaker ones.

3. The position in the company has grown too large as I acquired more shares when the price dropped. Instead of a 10%-12% position it was a 16%-18% position at one point and that was a bit too much. I could have saved myself a loss of 3% if the position size was more appropriate. Not that it is wrong to put 20% or even 30% in one position in some cases (Buffett even done 50% at some point), but it has to be a very low risk-high reward situation. In this case, it indeed was potentially high reward but at no point was considered to be a very low risk position. So going a bit overboard on this was inappropriate.

Another position was established and eliminated during the year. It was Greek Organization of Football Prognostics, or OPAP. A truly wonderful business that generates huge cash flows with near-zero capital investment, it was acquired right after the 2012 dividend distribution at a hugely favorable valuation of 2 P/E. It was then an 8% position for the company.

About 2 months later, it turned out that the Greek government decided to heavily tax gambling. This had the effect of eliminating most of the margin of safety (although not all) and created in my mind a lot of uncertainty regarding profitability going forward. After thinking the matter over, I concluded that the potential upside is not big enough as compared with some other investments and that it was worth not the trouble. The shares were sold, luckily at a significant profit.

Regarding the portfolio as it is at year-end:

Cash is significant due to several reasons. First, half of the position in Enterprise Inns was sold at year end, because the relative pricing compared with other positions was no longer good enough to warrant a position much larger than 10%. Second, some funds were contributed by shareholders and not yet invested. Third, it is my impression that currently the market is not exactly bursting with obvious opportunities and I am happy holding a bit of cash for a short while. For most of 2012 cash was well under 10%.

The position in NRG was largely maintained since price/value didn't change much, even considering the GenOn acquisition. Not much to say really.

France Telecom continued to perform fairly well. The dividend was lowered and fixed for two years in order to free capital for CAPEX + debt reduction. In 2014 and going forward FCF generation is expected to significantly improve over 2012-2013 which will probably be low point in this regard. Valuation as compared to AT&T is looking extremely cheap, and also on an absolute basis. It is probably worth around 3 times its year-end market value.

I was very pleased with the developments in Renault, despite the recession in Europe. Today, over 50% of sales originate outside of Europe, and 40% of all vehicles sold are low cost, very competitive Dacia models (branded as Renault outside of Europe). Recently, the company began negotiations with the French unions and a positive result is expected considering the government did not resist planned layoffs in Peugeot. A lot of the model range is going to be refreshed in 2013, starting with the new Clio. Nissan is doing fine as well.

The situation continues to steadily improve in Enterprise Inns, and some sort of return to growth is expected in 2013. The share price has risen by about 250% in 2012, and this was a main driver for the return of the portfolio in the past year. However, with the current valuation the company is probably trading at half its value, which is not exceptional, compared with other holdings in the portfolio. Half of the original position was sold in late December 2012.

For Finsbury, it was a great year. Revenues were up by 9.5% and net profit by 11%. Some debt was repaid.

Fortress Paper is a new holding. The first thing to realize is that it is not a plain paper company. It is an investment company which holds 3 different businesses.

1. Landqart - a Swiss company that produces paper substrate for banknotes. In the last 2 years it has been losing a lot of money, and will probably lose some more in 2013. However, it has some assets and patents and the business could probably be sold for a few tens of millions of dollars.

2. Dresden Papier - a German wallpaper manufacturer. This is an extremely profitable company (over 20% operating margin), currently making over 30M$ in yearly operating profit and growing at around 15% a year. The company has an advantage in machinery, which the competition will find hard to replicate due to currently too small scale of this market.

3. Two Canadian paper mills, one in LSQ and another in Thurso. Thurso has been converted to producing paper pulp, used as a cotton substitute for apparel, mostly. LSQ has not started the conversion process yet. Thurso has a 200K tons of capacity and LSQ will have around 250K tons in 2 years when converted. Most of the conversion is funded by non-recourse debt.

The first 2 holdings are probably worth 300M$ together. When subtracting net debt at the parent level, one arrives at a probable equity valuation of around 200M$ for the public entity (Fortress Paper) even without the Canadian paper mills. These paper mills are somewhat hard to value and could be considered an option on future cotton prices. If they remain depressed, the equity in the mills is probably worth 100-200M$. If, on the other hand prices return to a more reasonable level on par with food prices, one could see valuations such as 1B$-2B$ in the future. For more information on dissolving pulp, see the following thesis: http://www.fmhaemmerle.com/downloads.html

Considering the market cap of 120M$, it looks like a very attractive investment which could be worth anything between 300-400M$ to 1-2B$. Half the position was acquired at around 200M$ and the other half at around 100M$. In the last 2 years the company lost most of its market valuation due to a sharp decline in cotton prices. Anything higher than a 500M$ valuation must mean higher cotton prices.

AIG is an idea I lifted directly from Bruce Berkowitz. He has a very nice presentation on the company in the Fairholme website. Simply put, the company is trading at half book value and according to management is expected to generate 10%+ return on equity in 2015: http://www.fairholmefunds.com/presentations

Bank of America is another Berkowitz idea and is basically the same story all over again. Trading at half of book value, no reason not to expect 10% return on equity in 2015. In this case, there is a nice enhancer in the form of a warrant, which was acquired for the portfolio (In the case of AIG I found the warrant somewhat overpriced). The nice thing about this warrant is that both the strike price and the conversion ratio are favorably adjusted in the event of a dividend above 1 cent per quarter. This could easily result in 100% more in profit over a few years as the warrant expires in early 2019.

Commonwealth Bank of Australia is the largest bank in… Australia. It seems to be a well-managed business with very low losses on loans (around 0.5%). Return on equity is at almost 20%. So what's so wrong with it to make me buy a put option?

I believe this to be one of the cheapest forms of protection against a China/Japan slowdown and/or collapse. Japan is obviously in trouble with its enormous debt and switching finance ministers every 6 months. China has an enormous real estate bubble fueled by credit. Australia also has a significant real estate bubble fueled by credit growth. China and Japan are Australia's main trade partners. Anything goes wrong in these 3 countries and the Australian banks will be sure to feel it.

Let's say there is a recession in Australia tomorrow. What might be the valuation of Aussie banks in such a scenario? Just take a look at Europe and the US. A lot of banks still trade at half of book value, even after this book value has been reduced by losses. At some point big banks traded at 30% of book. In contrast to this, Commonwealth Bank of Australia (CBA) is trading at the lofty valuation of 2.4 times book value, similar to a lot of banks in the EU and US before 2008.

Another way of looking at it – CBA has 25% market share in Australia, a country with 20M population. Bank of America has a 12% market share in the US, a country with 300M population and it has an international presence. Both companies trade at almost the same valuation! Also, looking at the balance sheet of CBA, around 60% of the entire balance sheet are home mortgages, a ridiculously high number. This is usually around 15-20% in most banks.

The book value of CBA is around 25$ per share. The stock is currently at 62$. 70%-80% of earnings are distributed as dividend so this book value is unlikely to increase much over time. In a recession scenario, it is likely that the stock will drop to half book value or 13$. 2 months ago, a put option with a strike of 25$ expiring at December 2013 cost 0.1$ (per share). It means that in the event the stock goes to 13$, this 0.1$ turns into 12$. This payoff is 120 times the price of the option, and I think it is quite reasonable to expect such an event in the next few years, or the next 10 years at most. You can buy this option much cheaper today as the stock price increased since then. The company will probably buy some of the December 2014 options quite soon as the price looks ridiculous.

This is not considered an investment but more of an insurance policy against a major event in Asia Pacific. In such an event the portfolio could lose 20%, but will be more than compensated by an increase in the price of the put option. The plan is to take 1% of the total portfolio each year, and buy such an option. This will probably cause a loss of 1% each year for several years until the event occurs, and at such a time the payoff could be 100% of the original portfolio value. Sounds good to me.

The final constituent of the portfolio is a small short position in Fortescue Metals Group. Considering the China fixed asset bubble, it looked like a reasonable posture to be short iron. Fortescue is a highly levered, relatively high cost, junior iron producer and as such is an ideal iron short. This position is kept fairly small due to the risks in being short and since the put option on CBA pretty much covers this angle with zero risk.

Some further comments about macro issues and portfolio management as a result.

First, let me say that I believe in investing in specific companies and assets, not in abstractions such as markets or countries. However, I also believe that it is unwise to invest in some random Chinese company just because it looks cheap. It is a basic requirement for investment that the company you invest in operates in a legal system that effectively enforces property rights. Only in a select group of countries can you be fairly certain that your property will not be confiscated at some point in the future.

Second, one has to account for government intervention in markets when investing. A good example is the fixed asset boom in China. A Chinese real estate developer or bank might look very cheap, but it is probably unsafe at any price. Business culture is also important. When a Japanese company reports a profit, there's a good chance they're telling the truth. Not so in some Eastern European countries and China.

After taking all those issues into account in building a portfolio, one has to take a good look at possible low probability, high impact events (or "black Swans") which the market seems to ignore. I can think of two obvious ones. The China fixed asset bubble and the western debt bubbles.

Over the last 10 year, China has been building an enormous amount of office and residential space, and other infrastructure. This has really accelerated following the 2008 financial crisis and the numbers are so huge compared with the probable future needs of the population that some sort of restructuring is almost certain to happen. This will probably be through a financial crisis of some sort as real estate prices adjust downwards, probably by at least 70% in some large cities. There will be big shockwaves that would affect major trade partners such as Japan and Australia.

In the last few decades, overall debt levels in the EU, US, and Japan have been increasing. I am considering all kinds of debt – private debt, corporate debt, government debt and other government obligations such as social welfare programs. These obligations amount in aggregate to huge numbers which are many multiples of GDP in those countries and the chance of carrying these obligations (not to say repaying) is slim to none. This is also driven by the decline in population growth in these richer countries. To give in example, just the financial assets (and liabilities) of the banking system in the EU countries is 4 times their combined GDP.

I believe that the debt problem is too big to gradually inflate out of. Probably, at some point there will a partial default, maybe a cascading debt restructuring with a lot of social programs cut. It is only a matter of one major country to follow this route for the others to jump on the bandwagon. Some countries will suddenly default and some will voluntarily restructure. I believe that the US is in relatively good shape, but Japan and some European countries are well past the point of no return.

So considering all that, there are two things an investor can do. One is to avoid some countries, asset classes such as bonds, etc. The second is to buy protection, since avoiding them altogether is in many cases not practical. With regard to the portfolio:

1. NRG Energy operates in Texas and northeast US which are higher income, stronger markets.

2. France Telecom has most of its operations in Europe but they are located in relatively stronger countries and telecoms are somewhat recession resistant.

3. Renault has already experienced a major recession in Europe in 2012 and is rapidly expanding internationally. At this point it could actually be beneficial to the company if the Eurozone restructures as it might get cheaper to manufacture in Europe and sales will rebound. The exposure of Nissan to China and Japan has been identified as a potential problem.

4. Enterprise Inns and Finsbury have already weathered a severe recession. Both do not seem very vulnerable at this point.

5. Fortress Paper has operations in Europe with the wallpaper business doing great selling to Eastern Europe (not a problem), and the banknote business which is struggling. This is not a concern since closing it will actually improve results. The big concern is the dissolving pulp business since a lot of the demand for rayon is located in China and India. This is a potential problem in case of a China recession.

6. AIG and BAC are well capitalized, strong companies primarily operating in the US. They should survive pretty much anything however AIG have some exposure to China which might pose some problems. Also, the assets of these companies are mainly financial, another concern.

My main solution for dealing with my China and Japan concerns is by making an asymmetrical bet on a recession in Australia, which is close enough to the epicenter to be impacted. I looked at Japan and China but found no easy ways to do the same. This bet is essentially against a major Australian bank. It costs nearly nothing to make compared with the potential payoff in the case of a China recession. Australian banks have most of their assets in domestic real estate loans on overpriced real estate. This will hold as long as exports to China and Japan hold up and profits coming in. In fact, the Australian real estate might blow up regardless of what happens elsewhere since it's so overpriced and fueled by credit growth. The Australian banks have almost doubled their balance sheets in the last 5 years.

I have no such easy solution for my EU and US concerns. At this point it seems this is a risk one has to take. The fact they have already experienced a severe recession gives me some comfort, as everyone is already aware of the issues I raised and will probably tend to act on those on some level. Although, it could be argued that by buying a put option on an Australian bank one has partial protection for other financial institutions such as AIG and BAC.

To conclude, I would like to thank the shareholders who have put their trust in me and express my hope for further positive results in the future. I am a shareholder too, you know.

Edward