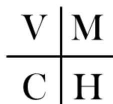


VMCH Corporation - Annual Report

VMCH Corporation performance (in USD)

	Annual percentage change		
Year	**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%)
2016	6.1%	11.9%	(0.4%)
2017	5.5%	21.8%	25.5%
2018	(8.9%)	(4.3%)	(14.8%)
Compounded annual gain	6.5%	12.6%	5.7%
Overall Gain	55.9%	130.5%	48.2%

"But who shall dare to measure loss and gain in this wise? Defeat may be victory in disguise; The lowest ebb is the turn of the tide."

Henry Wadsworth Longfellow

Dear shareholders,

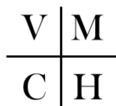
In 2018, NAV decreased by (8.93%) compared with a decrease of (4.38%) in the S&P500, including dividends. MSCI Europe decreased (14.86%) including dividends during the same period.

The past year has been a good year here at VMCH. This might sound counterintuitive considering we posted an overall loss for the year, and would require further explanation.

The reasons for my unusual optimism are the following:

1. We made a number of new investments throughout the year, one of which we exited completely before year end at a profit of nearly 100%. We made a similar profit on one other new position, and have sold half of it, keeping the rest. More on this in the portfolio section of the report.

2. We disposed of several of our holdings at a profit as we came closer to year end, leaving us with 25% of the portfolio in cash. This became very useful in November and December when markets became turbulent, and we re-deployed the funds into new investments. We were again fully invested at year end.



3. We’ve had a few opportunities to invest at lower prices in already established positions in our portfolio. We view these as long term positive. There is one exception to this, which will be discussed in the portfolio section.

Overall the message is - we took some profits, and bought some more at bargain prices. Sometimes this doesn’t translate so well in terms of overall performance, which is fine if it means more is to come later. At any rate, we at VMCH put our money where our mouth is by investing our money alongside yours. If there is money to be made, we will all be there making it together.

We have been following the US retail sector during the past several years.

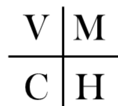
Ross Stores is a tightly packed warehouse with a lot of heavily discounted apparel brands. The really exciting part is the store design and inventory management. Stores are very tightly packed – which creates more sales per sq. foot, which is translated to more profit. Inventory moves fast, and what doesn’t move gets marked down in price again and again quite aggressively. The result 50% ROE, a massive achievement in the retail space. Some competitors, Burlington for example, have too much slow-moving inventory and huge stores, but not Ross. These guys manage one tight ship.

Bed, Bath and Beyond sells home goods primarily for the bedroom and bathroom. Reviewing it once again, I am reminded of our 2015 letter to shareholders. Then I wrote that “operating margins made no sense long term in the context of the business of the company.” Indeed, operating margins went down significantly since then, from 14% to just 4.4% today. The stores are very nice, but it it clear why margins were coming down – it is just too easy to go to a discount store and get the same stuff for half the price. The mid-market retail space is getting killed, and the discount chains are growing like weeds.

I mentioned two other companies in the 2015 letter - Horsehead Holding Corp (ZINC), and Sears Holdings (SHLD). Both went bankrupt since, more or less due to the issues discussed in that letter. Horsehead went bust due to operating difficulties with the new processing facility, and Sears went bust due to continuing losses in the business. Following the bankruptcy proceedings, it became clear that there were not much hidden real estate assets on the balance sheet of Sears, contrary to Bruce Berkowitz’s thesis.

To be clear, we are following a great number of companies that we do not invest in. It is useful to have a number of candidates “on the shelf” as well as market information complementing the reporting of our portfolio companies.

This highlights that bad and unexpected things happen, even to great investors. It should be taken as a warning that there is inherent risk in any particular investment, and as equity investors, this risk is levered both financially and operationally. Too much debt or operating issues can bring any business down.



Another note is with regard to inertia. There is a tendency to continue holding what you have already have. There is some logic to this – the research has been done, and you should know more about what you hold than anything else out there. What increases risk, however, is staying the course even when there is a major change in the thesis, or obvious major risks to the thesis.

In my opinion, every investment has to be accompanied by a specific thesis that explains why are we holding this investment. The thesis cannot slip or change in a major way – if we bought because we expected an increase in profitability within 2 years, and it never happened, we would have to treat the investment as a new, fresh investment that is being proposed – without regard to profit or loss for the previous years of holding the investment.

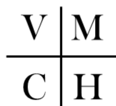
To myself and Ronit at VMCH, what we do not buy and why not is just as important as the things we do buy. One current example is PHI, Inc (PHII), a helicopter service company. This time, oil went down and all the oil sector service companies went along for the ride. So here is this company that has around 240 helicopters. Half are used for Air medical, half for Oil services. The medical part is doing well, the oil not so much, and the clock on the debt is ticking. However, there is a thesis that the helicopters can be easily sold for much more than the value of the debt, so there is nothing to worry about. The stock should be easily worth 15-20$.

Usually I don't get involved in situations with negative cash flows (remember Sears!). However, the bonds might be good at a certain price and the stock is way down, so I took a closer look. Just like with Sears and the real estate values, I can't figure out how the helicopter values would save the day here. Looking on secondhand helicopter prices, I could only reach a total value of 300-400M$, while the debt is over 600M$.

Even if half of the helicopters are sold as a business (Air medical), it would barely cover the debt value, and the stock might still be a zero. It is quite fascinating following this debate, which will come to a conclusion on March 15, 2019 as the 500M$ in bonds come due. The bonds are currently trading around 70 cents on the dollar, which incidentally reflects my own valuation of the value of the helicopters.

One good asset base investing case this year was The Cato Corporation (CATO). This is a retailer of low-cost fashion, with in house design. The operation is quite large and profitable, with over 1,000 stores and an operating profit of 80-90M$ in most years. In the past two years they initiated some changes to the business model, which did not go to well, and profits fell. They went back to the previous model, but it might take a year or two to translate into higher profitability.

The really amazing thing about this situation is how low risk it was. The entire company was at one point valued at 300M$, while it had 200M$ in cash and no debt. In addition, the business still made around 30M$ in free cash flow even after the slump. We bought some, and it worked out well for us. Recently the price is down again, so we might just rinse and repeat if it gets low enough.



Towards the end of the year, the markets declined around 15%, with some stocks going down 30-40%. This was a great time to have some cash to invest, and invest we did. We made 5 new investments in the past 3 months, which should give you a sense of the opportunity we have seen, and continue to see.

Writing in early 2019, myself and Ronit are hard at work sifting through companies. After the market dislocation late in 2018 there is a lot to look at and these are great times to be a value investor. Don't let the P/E ratio of the S&P500 fool you – there are a lot of undervalued companies out there. The market is very bifurcated, with a small number of very overpriced companies pulling up average valuations, and inflating index returns.

We look at the other half of the market, where you can find car companies trading at less than 5 P/E, reasonably profitable banks trading below half their book value, and regional monopolies with 6-7% growth trading for 5 P/E or less.

The last topic I would like to discuss is a technical one. I was recently asked by our fund administrator why don't we have a separate share classes for each investment. This would allow to have a different high-water mark for different investments, based on its timing. For example, if Jack got in at 1,500$ per share and the shares went down to 1,300$, he will not pay performance fees until the share price crosses the high-water mark of 1,500$.

However, if Jack bought additional shares later at 1,300$ he will pay fees all the way to 1,500$ on the new investment - because it wasn't around when the shares were at 1,500$. So, in effect, the fund might not have made a positive return at all but will still collect some "performance" fees.

We here at VMCH believe in simplicity and fairness. This is why we have only one class/series of participating shares. This means that we provide a benefit to our shareholders by giving them an opportunity and the incentive to invest after a downturn, knowing they would not pay performance fees until the same high-water mark is reached for the company as a whole. As far as I am aware, we are the only fund with this feature.

This feature also provides an additional incentive for new shareholders to join following a down year. Although we are already up 6% in January, there is a bit more to go. If you are interested in more details, please contact us at info@vmchcorp.com.

Ronit and I would like to thank you, our shareholders for your continued support and express our excitement for the future.

Eduard Gorban Ronit Ezer