

# Emerging Value Capital Management, LLC

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## **December 2008 letter to investors**

Dear Partners and Shareholders,

Following is our third monthly letter to investors. I am always happy to speak with partners (and potential new partners) so please do not hesitate to call me with any questions, thoughts or comments.

### Fund Performance:

During December 2008, EVCM Fund returned an estimated +3.6% (net to investors). During this same time period, the S&P500 (SPY) returned approximately 0.0%, and the MSCI All Country World Index (ACWI) returned approximately +5.5%.

Since inception (10/15/2008), EVCM Fund returned an estimated +5.7% (net to investors). During this same time period, the S&P500 (SPY) declined approximately -9.6%, and the MSCI All Country World Index (ACWI) declined approximately -8.5%.

While I am fairly happy with our results so far, I do not focus on monthly returns (monthly results are mostly random and should not be extrapolated). Instead, my focus is on performance over a multi-year period.

	December 2008	Since Inception (10/15/2008)
EVCM – Net to Investors	+3.6%	+5.7%
S&P500 (SPY)	0.0%	-9.6 %
MSCI All Country World Index (ACWI)	+5.5%	-8.5%

\*Please note that individual investor net returns will vary due to the timing of one's investment. The results reported above are unaudited estimates and may be subject to change.

In previous letters, I discussed our market outlook and how we preserve capital and manage risk. In this letter I will focus on our investment strategy. As usual, I will also take you through one of our investments and illustrate how it fits with our investment strategy.

### Four Main Investment Categories:

When evaluating a potential new investment, it helps us to have a "model" for guidance as to what we are looking for. We can then compare each potential new investment to the ideal "model" investment and evaluate how closely it does (or does not) meet our criteria. At EVCM, we usually seek to invest in companies that fit into one of four main investment categories. Each category provides us with a generalized model for what investments in that category should look like.

### **Great Businesses:**

Great businesses are long-term winners with a deep moat and a durable competitive advantage. These are businesses that we can confidently say will be worth much more 10 to 20 years in the future. They should have a long history of profitability and high returns on equity and should be at

least partially recession resistant. Most great businesses are large caps with a strong balance sheet and free cash flow. We seek to buy great businesses when they are selling at multi-year lows either because of an economic slowdown or because of temporary (and fixable) problems with the business. Examples of great businesses that we own include: Nestle, Kraft, Berkshire Hathaway, and MasterCard.

**Cheap Growth:**

Cheap growth businesses are good (not always great) businesses that we expect to achieve rapid (and profitable) growth for years ahead. We make sure that we are highly certain of the future growth prospects and that we are not paying for this future growth. Most cheap growth businesses are small caps and they are often found in emerging markets where they benefit from the rapid growth of the economy. Examples of cheap growth businesses that we either own or are evaluating include: China Marine Food Group, Zhongpin, China Cast Education, Hekmann Corp, Raffles Education, Chipotle, and Lojas Renner.

**Global Macro:**

Global Macro investments are the most difficult to categorize. They are usually based on long-term macro-economic analysis. We look for situations where we have a high degree of confidence in our analysis based on multiple macro economic indicators. Our global Macro analysis may lead to specific investments or may affect investments that we make in other investment categories. For example, our current global macro analysis indicates that the RMB (the Chinese currency) is almost certain to appreciate significantly (vs. a basket of other major currencies) over the next decade. This has led us to favor investments that are likely to benefit over the long term from this expected currency appreciation. A second example is our recent analysis that corporate bonds (as a group) were priced far lower than they should be even given the global slowdown. This analysis led us to invest in several closed end bond funds that effectively let us purchase baskets of very cheap corporate bonds at a discount to their (already cheap) net asset value.

**Special Situations:**

Special situation investments typically depend on some external event to unlock their value. They often present situations that are low risk despite having a highly uncertain outcome. We seek to invest in special situation where we may not know which of several outcomes will happen, but we expect to make money in any reasonable outcome. Special situation investments usually have a limited holding period based on an expected future catalyst. Examples of special situation investments that we own include: Elron (see below) and QLTI (where we may get \$2.50 per share in a tender offer, but feel that the shares are worth at least \$5 in any case).

Investment Thesis: Elron Electronic Industries:

Elron is a special situation investment that EVCM fund recently made. It is a publicly traded, Israel based, venture capital firm that invests only its own capital (no outside capital). Elron has been operating since 1962 and is considered to be one of the top venture capital firms in Israel with multiple past successes. It invests in fields such as medical devices, medical imaging, defense electronics, information technology, software, telecommunications, clean technology, and semiconductors.

Elron got hit very hard by the credit crunch. It has run out of cash and is having difficulty monetizing assets in the current environment. The market is anticipating a worst case scenario so the stock has collapsed at which point EVCM fund made its investment.

If Elron can get through this difficult period then investors should be richly rewarded. Elron's market cap has fallen to only \$48M. It holds a portfolio of publicly traded companies worth over \$115M (using today's depressed stock prices) and its portfolio of private companies is valued at about \$200M (based on valuations from the last private placement for each company in the portfolio). Elron has only \$36M of debt.

To be conservative, I have given the private company portfolio a "50% haircut" and value it at \$100M. Please note that my "50% haircut" to the private company values may be too conservative as it appears that many of the private companies in Elron's portfolio are making good progress, have innovative products with large potential markets, and are increasing their value over time.

*Net Asset Value Calculation:*

Public companies at today's market prices:	\$115M
Private companies (after 50% haircut):	\$100M
Debt:	<u>-\$36M</u>
New Asset Value:	\$179M
Market Cap:	\$48M
Upside Potential:	273%

Elron is owned by Discount Investments (49% owner) which is a well regarded Israeli holding company that is itself indirectly owned by Nochi Dankner. Nochi Dankner is considered to be an honest and capable Israeli business man. In my opinion, Discount Investments will either infuse additional capital into Elron or it will buy Elron outright. There has already been some speculation in the Israeli press that a buyout of Elron is being planned, but no specific information has been disclosed yet. Please note that Discount Investments recently lent Elron \$8M at a very reasonable 6% annual interest rate.

Cash burn rate at the company is about \$6M per year. Elron also needs cash in order to keep investing in and supporting its portfolio of growth companies. So one way or another, Elron will need to get more cash in order to continue operating.

Elron has at least \$215M of assets (probably more) vs. \$36M of debt. It simply does not make sense for Elron to fail just because capital markets are temporarily frozen. It is very likely that they either find a way to monetize some of their assets, issue equity, or they get a cash infusion/ takeout from their parent company. Any of those scenarios will likely prove very profitable for current investors. Even in a forced liquidation scenario (which I view as unlikely), I believe that we will end up making a good return from today's low stock price.

When investing in "special situations", I often look for companies that exhibit both "high uncertainty" and "low risk". Elron is a good example of such an investment. Its final outcome is highly uncertain (buy-out, equity issue, asset sale, liquidation, etc), but it is a low risk investment since we are likely to make a good return in any reasonable outcome.

Conclusions:

While remaining focused first and foremost on risk management and capital preservation, we have been utilizing our four main investment categories as an aid for evaluating potential investments. Using our four categories as a guide, we are carefully constructing a portfolio of investments with excellent long term prospects. Even though I expect the economic slowdown to intensify, I believe that our portfolio will preserve our capital and will appreciate over time.

At EVCM we consider it a great honor and solemn duty to protect and grow your capital. We always remember that many of you (including myself) have a large part of your life savings invested in the fund. We strive to treat our partners and shareholders the way we would like to be treated were our positions reversed.

Please feel free to share this letter with prospective new partners and with other interested investors.

Sincerely Yours,  
Ori Eyal  
Portfolio Manager

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Disclosure:

This document does not constitute an offer to sell or the solicitation of an offer to purchase any security or investment product. Any such offer or solicitation may only be made by means of delivery of an approved confidential offering memorandum. Past results are no guarantee of future results and no representation is made that an investor will or is likely to achieve results similar to those shown. All investments involve risk including the loss of principal.

An investment in the Fund may be deemed speculative and is not intended as a complete investment program. It is designed only for sophisticated persons who are able to bear the risk of the substantial impairment or loss of their investment in the Fund. The Fund is designed for investors who do not require regular current income and who can accept a certain degree of risk in their investments. Prospective investors should carefully consider the risk factors specified in the Offering Memorandum before making a decision to invest in the Fund.