

# Emerging Value Capital Management, LLC

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## **September 2009 & October 2009 letter to investors**

Dear Partners and Shareholders,

Following is our twelfth letter to investors. Since I spent a most of October traveling and did not find the time to write until now, I decided to combine September and October into one letter. As always, I am 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 September 2009, EVCM Fund returned an estimated +5.1% (net to investors). During this same time period, the S&P500 (SPY) returned approximately +3.1%, and the MSCI All Country World Index (ACWI) returned approximately +4.9%.

During October 2009, EVCM Fund declined an estimated -0.8% (net to investors). During this same time period, the S&P500 (SPY) declined approximately -1.9%, and the MSCI All Country World Index (ACWI) declined approximately -2.7%.

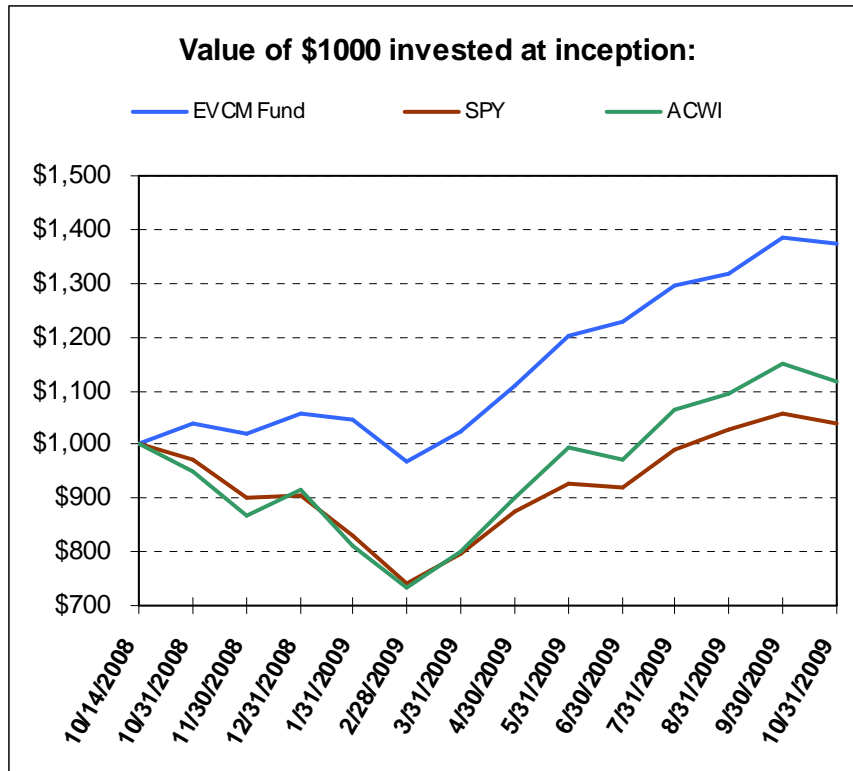
Since inception (10/15/2008), EVCM Fund returned an estimated +37.2% (net to investors). During this same time period, the S&P500 (SPY) returned approximately +3.7%, and the MSCI All Country World Index (ACWI) returned approximately +11.9%.

EVCM fund had a strong September month as two of our holdings (ORH and FACT) received buy-out offers at significant premiums to their market prices. October was a flat month with no significant developments in any of our major investments. We remain conservatively positioned with lots of cash and bonds, high quality stocks, a few shorts and hedges, and disciplined position sizes. As of today, it appears that stock markets may have started to decline again and our risk aversion is helping to protect our capital.

As before, I caution investors not to focus on monthly returns (monthly results are mostly random and should not be extrapolated). Rather, I hope you will evaluate my performance over a multi-year period.

	September 2009	October 2009	2009 YTD	Since Inception (10/15/2008)
EVCM – Net to Investors	+5.1%	-0.8%	+30.0%	+37.2%
S&P500 (SPY)	+3.1%	-1.9%	+14.8%	+3.7%
MSCI All Country World Index (ACWI)	+4.9%	-2.7%	+22.3%	+11.9%

\*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.



EVCM fund is one year old:

In October 2009, EVCM fund completed its first year of operation. Looking back I am amazed at how much has transpired in just one year. When we launched, the financial system was collapsing and the world was ending. I remember having serious discussions about whether or not ATM's would stop dispensing cash. Today the prevailing thought is that the recession is over and that a slow economic recovery has begun.

Reflecting these changing investor moods, stock markets declined dramatically in our first five months of operation and then rose dramatically in our next seven months of operation. In summary, during our first year of operation, stock markets completed a dramatic swing only to end just a little ahead of where they started.

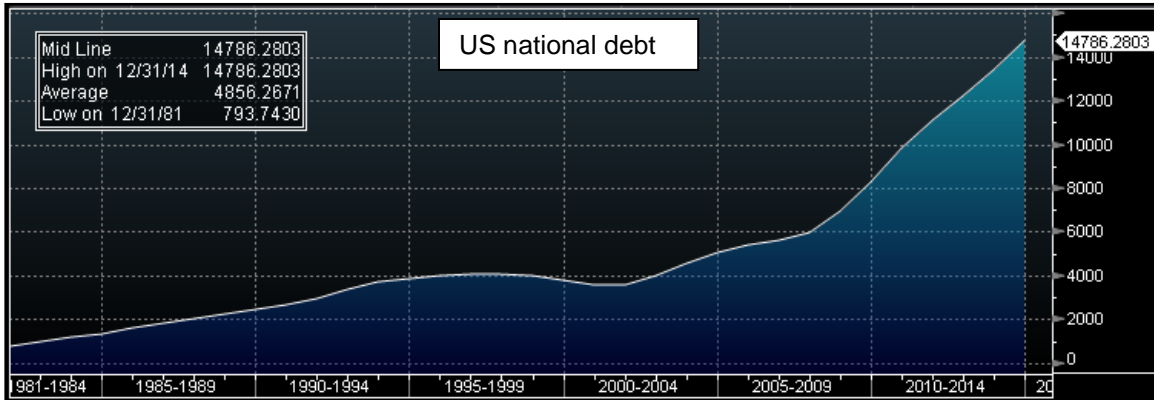
In this type of market, both a bullish and a bearish approach would have fared poorly. Bulls were devastated in the initial sell off and bears missed the rebound rally. I am happy to report that we ignored the market "noise" and did not try to time the market. Throughout the year, we remained disciplined and focused on our investment framework. We invested in a collection of exceptional businesses that all traded at significant discounts to their intrinsic business values. We protected our capital by focusing first and foremost on "not losing money" and by adhering to our risk management principles.

Several investors have asked me what are my projections going forward. Honestly, I have no idea which way markets will move from here – although I do expect them to be volatile. As a long biased fund, we will probably do better if markets continue to rise. However, falling markets benefit us as well since they give us the opportunity to buy more great businesses at cheap prices and thus set the stage for future gains. Regardless of what the stock markets do, we will remain disciplined and continue to follow our investing framework. In our second and future years of operation you can expect more of the same.

The growing US government deficit and national debt:

\* The following discussion focuses mostly on the US, but it is important to note that Japan, Western Europe and many other developed countries are facing similar issues and problems.

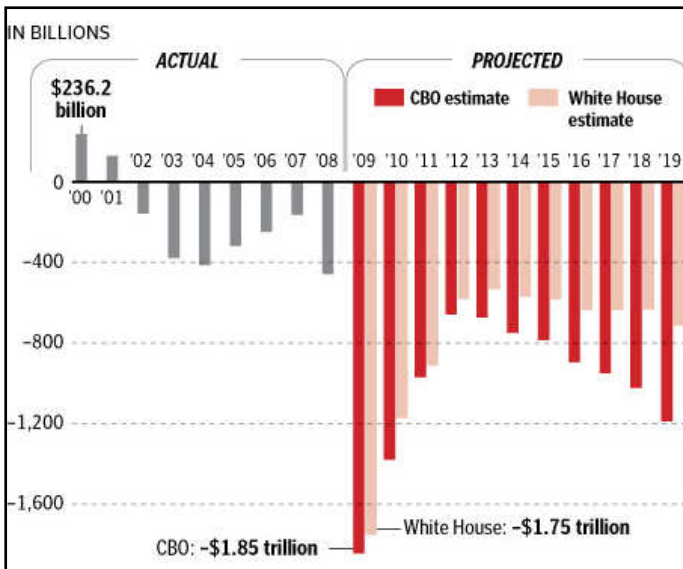
The US is in a difficult financial position. The national government debt<sup>2</sup> surpassed \$10 Trillion in 2008 and this does not even count many off balance sheet liabilities such as future pension and health-care obligations.



Source: Bloomberg

We were running very large budget deficits even before the financial crisis of 2008 which forced the US government to spend additional hundreds of billions of dollars to prop up ailing banks and to stimulate the economy. As a result, the federal budget deficit<sup>1</sup> for 2009 will be about 13% of GDP, with the national debt<sup>2</sup> expected to surpass 100% of GDP in the next few years.

**US Budget Deficit**



Source: CBO, White House Office of Management and Budget  
The Washington Post - March 21, 2009

Notes:

<sup>1</sup> The federal budget deficit is the amount of additional debt that is being added every year.

<sup>2</sup> The national debt is the total amount of money owed by the US federal government. It is simply the sum of all the previous federal budget deficits.

Where is the US government getting the money to fund these budget deficits? From selling government bonds. And who is buying all these government bonds? Mostly two groups: Foreign Central Banks and the US Federal Reserve.

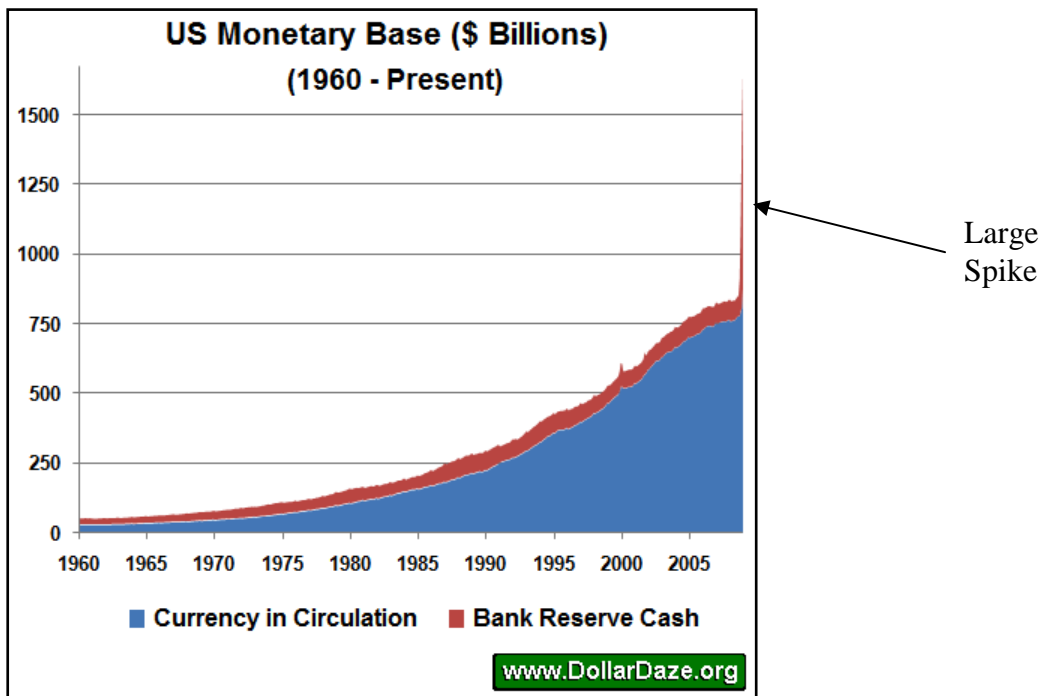
The US deficit is now so large that it is no longer clear that there are enough lenders available to lend the US the money it needs. If the US is unable to sell enough of its government bonds to others, the Federal Reserve must print money and use that printed money to purchase these bonds itself. However, The Federal Reserve will not be able to continue buying government bonds forever and may even be forced to sell the government bonds it has already purchased (see next section for details). Furthermore, foreign Central Banks have become increasingly reluctant to continue purchasing US government bonds as the US national debt has ballooned.

Luckily for the US, the Foreign Central Banks must continue to buy US bonds for two reasons: to keep their own currencies low and because they lack a good alternative in which to invest their large foreign reserves. However, with the US government deficit growing so large, the Foreign Central Banks are unlikely to purchase enough bonds to meet the borrowing needs of the US government. Therefore, to continue to attract lenders, long term interest rates will have to increase. Also, the continued massive borrowing by the US government is creating inflationary pressures and pushing down the value of the US dollar.

Why have we not seen much inflation yet:

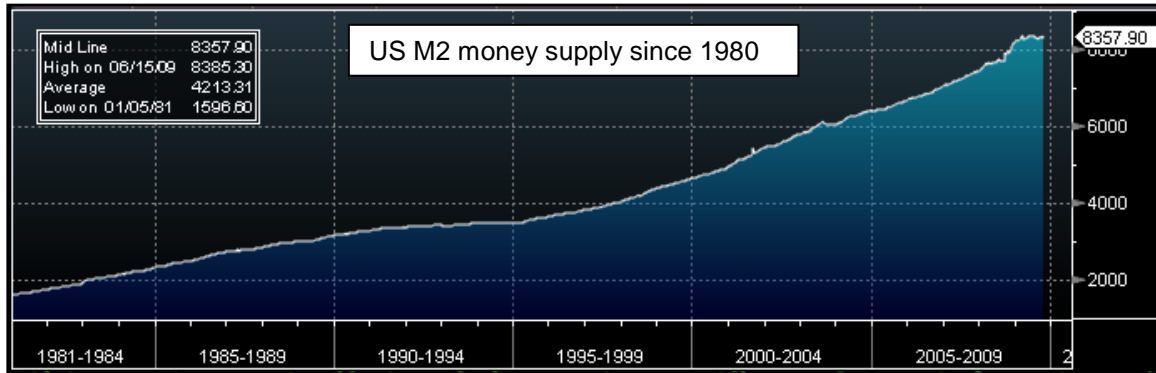
*“Inflation is always and everywhere a monetary phenomenon.”*  
-- Milton Friedman

As we have seen, the US Federal Reserve has been one of the main buyers of US treasuries. To fund these purchases, it prints money. The result is that in the US, the monetary base has more than doubled since the middle of 2008.



Source: [www.DollarDaze.org](http://www.DollarDaze.org)

You may ask “so what”? We have been hearing about this growth in the monetary base for over a year now and so far it has not resulted in significant inflation. In fact, as you can see from the chart below, it has not even caused a major increase in the money supply. Note from the charts above and below that while the monetary base has more than doubled since 2007, the M2 money supply has not increased by very much.



Source: Bloomberg

Recall that the monetary base consists of bank reserves and tangible currency (the bills and coins in our wallets). The M2 money supply consists of currency, travelers checks, demand deposits, other deposits against which checks can be written, savings accounts, time deposits of under \$100,000, and balances in retail money market mutual funds. Increases in the money supply (not in the monetary base) are ultimately what cause inflation.

We have not experienced significant inflation so far because the money supply has not increased much. Banks have effectively been absorbing the increase in the monetary base by increasing their reserves without additional lending and thus without significantly increasing the money supply. As long as banks don't lend, the money supply growth will remain muted and inflation should stay muted as well.

So far this seems like a “happy” scenario. We get to print money with minimal negative consequences. Can this continue for the long run? Not likely.

At some point, banks will increase their lending. When that happens, the money supply will grow rapidly and the US Federal Reserve will need to reduce the monetary base to prevent inflation (the opposite of printing money). To do this the Federal Reserve will need to sell government bonds and other assets. But doing so will increase interest rates (choking off an economic recovery) and will also compete with the US treasury trying to sell bonds. Therefore, when the time comes for the Federal Reserve to reduce the monetary base, it will find it very difficult to actually do so. The monetary base and the money supply will both keep growing and inflation will rear its ugly head.

At that point, with both the US government and the Federal Reserve trying to sell government bonds and with Foreign Central Banks unable or unwilling to absorb the large supply of bonds, a currency crisis could ensue.

How is EVCM fund protecting our capital from the effects of a currency crisis?

My ultimate long term goal is to preserve and grow your wealth (purchasing power). It will be of little comfort if we make money in nominal dollars if the purchasing power of those dollars declines significantly.

As governments around the world continue to print money, run budget deficits, and increase their national debts, the risk of a currency crisis has grown. There are at least three negative consequences that are likely to result from such a currency crisis. These are:

- Inflation
- Currency depreciation
- Increase in interest rates

While there is no perfect defense, EVCM fund has taken several steps to protect our capital from these three negative consequences. Specifically, we have been doing the following:

- Diversifying our cash balance into multiple currencies including the US dollar, the Euro, the Norwegian Krone, the Australian dollar, the Canadian dollar, The Swiss Franc, and the Israeli Shekel.
- Purchasing low cost long dated call options on gold that will do well if the price of gold skyrockets as a result of a currency crisis.
- Keeping our bond positions small and our bond maturities short.
- Increasing our investments in commodity related stocks that should do well in an inflationary environment.
- Investing in high quality businesses that can increase their prices along with inflation and that do not require large future capital expenditures.
- Diversifying our investment portfolio to include businesses from different countries with a particular preference for good businesses located in emerging markets.
- Giving preference to investment opportunities that are backed by tangible assets and not just by future earnings power.

### Investment Analysis: Hilan Tech:

Hilan Tech LTD (Tel Aviv: HLTC) is Israel's leading payroll processing and reporting service provider. US investors might think of it as the "ADP of Israel". The company provides an array of solutions for organizations: payroll, human resources, time & attendance and pension administration. Hilan Tech possesses the most advanced and comprehensive system of its kind in Israel, rendering services to 700 organizations and companies, which together employ over 500,000 employees. Company customers include leading Israeli organizations and companies from a variety of fields: banks, universities, industrial companies, telecommunication companies, high-tech companies, the press and the media, medical institutions, municipal authorities, etc.

Payroll processing and HR services is the core of Hilan Tech's business. It comprises about 58% of company revenues and 86% of operating profits (based on 2008 numbers). Customers in this business segment are very "sticky" since it would require a lot of time, effort, and expense to switch service providers. It is a predictable, slow growth business which generates a lot of recurring free cash flow, requires minimal capital investments, is recession resistant, and provides a high return on capital invested.

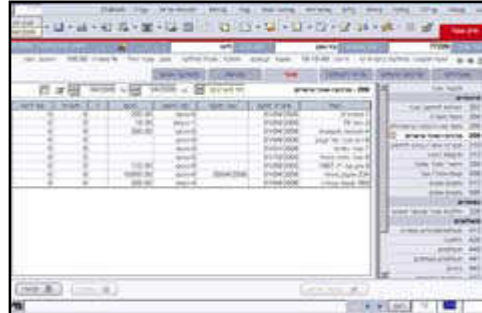
Hilan Tech has leveraged its customer relationships in the payroll processing and HR segment to enter two other related business segments. These segments are IT product sales and business data services. The IT product sales segment sells software and hardware solutions for data security and for server infrastructure. The business data services segment provides information, consulting, and business simulation tools in the areas of taxes, payroll, and pension planning. These new segments currently generate low margins since they are just starting to ramp up. Company management believes they will be able to significantly improve the profitability of these segments over time.

Hilan Tech has a strong balance sheet with about 76M ILS of cash and about 110M ILS of debt in the form of long term bonds. This cash was originally ear marked for an acquisition that did not go through. Company management has indicated that they are looking for other acquisition targets but will only buy something if they find a strategic fit and can get it at a reasonable price.

The current recession has slowed down business somewhat since payroll processing is sensitive to the unemployment level and since corporate customers are more reluctant to spend money. Despite this slowdown, I believe that in 2009 Hilan Tech will earn over 50M ILS in operating profits from revenue of over 230M ILS. This implies over 20% operating margins and an almost 60% pre-tax return on equity. Hilan Tech's financial results remain impressively strong and one can only imagine how much stronger they will be once economic growth resumes.

Current market cap is 265M ILS. Enterprise value is about 300M ILS. So we are paying about 6X EV to Operating Income and about 5X EV to EBITDA. That is a cheap price for such a high quality cash flow generative business. EBITDA is a good proxy for pre-tax free cash flow since CAPEX (capital expenditures) requirements are minimal. Dividend yield is about 6.5%. Given the very high quality of this businesses and the 6.5% dividend yield, I am happy to own it for the long term. I think it is reasonable to expect dividend growth of 10%+ per year for the foreseeable future.

### **Screen shot of one of Hilan Tech's payroll processing systems**



**Source: Hilan Tech Website**

Conclusions:

EVCM Fund remains conservatively positioned with capital preservation our top priority. We fear that there is a serious risk for a future currency crisis. Three negative effects of such a crisis would be inflation, currency depreciation, and higher interest rates. We have been taking several steps to protect our capital from these negative consequences.

At EVCM, 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. Also, thank you for the referrals!

Sincerely Yours,  
Ori Eyal  
Portfolio Manager

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.