Arauca Letter H2-2022 | January 2023

Dear Investors,

I hope you are your families are having a positive and healthy start to the year. Arauca Capital returned (Gross) **+ 7.06%** for H2-2022 (July 01st to December 312st) period. Please note that Net returns vary depending on when the capital entered the fund; please check your individual statements. As a reminder, this is a note highlighting the most important activities of the last six months, my more comprehensive letter is always sent around July. The fund ended 2022 with a gross return of -19.54% and my 9-year track record (Partnership + Arauca Capital) shows a CAGR of +17.02%.

Jean Philippe Tissot full track record (9 Years)		
	Year	**Gross Returns****
Partnership	2014	*12.47%*
Partnership	2015	*-8.32%*
Partnership	2016	*63.42%*
Partnership	2017	*12.62%*
Partnership	2018	*0.81%*
Partnership	2019	*43.14%*
Partnership	2020	*84.21%*
Partnership	*2021 H1	*16.11%*
Arauca Capital	2021 H2	*-11.42%*
Arauca Capital	2022 H1	*-24.85%*
Arauca Capital	2022 H2	*+7.06%*
	CAGR	***17.02%***

** Arauca Capital was launched in July 2021*
*** Gross returns do not include management fee*

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General Update

I am satisfied with the results achieved in the period as this was reflected by the extreme undervaluation of some of our holdings, an acknowledgement on my side that the conditions in the financial markets have changed and the actions I took based on that (explained further in the letter). However, when I look at the year returns of -19.54% I am not satisfied. This yearly result, which is on a par with the S&P 500 and clearly outperforming the Nasdaq and Small Cap indices, could have been better if I had not made the mistakes highlighted in my previous letter (if you have not read it, please do). At the same time, I am extremely proud of the sharp focus on risk management and my utmost respect of the capital I manage, that has ensured I always follow a barbell strategy (the combination of conservatism with disciplined risk taking). This has been my approach since day one of the partnership and in periods as difficult and volatile as the current one, it has allowed our fund to be protected from the extreme drawdowns seen by several colleagues in the industry, many with negative returns of more than 50%, and some even with drawdowns of 70% or worse. It has been a difficult period for the industry.

The conditions that we - asset allocators - were accustomed to in the last decade have radically changed: Globalization is reversing, kinetic wars have returned to Europe, capital again has a cost, inflation came furiously, and our unintelligent energy policies have endangered reliable long-term supply. ***This does not mean I need to know where we are going, but I need to fully know the new world/economic conditions we are in today and based on them I need to ensure that the portfolio reflects the new facts.***

These "new" conditions are not rare, what was unique were the conditions before. We were living in "Disneyland", a period of unprecedented stability and a world economy supported by Central Banks with extremely easy financial conditions and unparalleled money printing. 2022 came and took all these trends by storm and if you study history, you realize that a correction to more normal times took place.

This correction of course affects "almost" all kinds of assets. **However, not all asset drawdowns are the same**. If you held long duration bonds, no matter how you see it you have a real loss (waiting decades to recover a 0% interest + capital is a loss in my eyes), equally with stocks of companies which were bid up based on narratives without any disciplined valuation approach. Unprofitable companies were assumed to grow infinitely, with several pitches using price to sales multiple comparison as the metric to value them. In these cases, I see the drawdowns as real losses as well.

At Arauca, we of course are experiencing a correction and will experience many over the years, but the corrections in our case should come from two fronts:

A) Corrections affecting our real extraordinary companies that I know very well and know "approximately" how much they are worth: When there are general market corrections affecting the price of sound companies, and the intrinsic facts of the companies do not change, the stocks of these companies become cheaper. These situations are an opportunity for Arauca, as fundamentally nothing major should be affecting them in the long run (or in some cases the companies have become better). It assumes the prices were paid with substantial margin of safety and with an extreme valuation discipline, as it is the case. And when it is not the case, then I should correct course as soon as I realise it.

These are the cases when I have been able to build a strong conviction in our investment thesis, and these corrections become a normal course of business. This is what happened in June 2022, when I mentioned that I did not know where markets were heading but I knew that our holdings had never been cheaper (I also mentioned they could become cheaper, too). These corrections mostly happen in the bulk of the portfolio, section two and three (explanation of sections was given in my last letter, H1-2022).

B) Corrections coming from more risky assets, particularly from section 4 of the fund (again, please refer to last letter, for a detail explanation of this section): Here is where positions are extremely small as they are placed in early-stage companies and alternative assets, it is the most speculative section of the fund, and as such, it is the smallest (less than 5% in total for all positions today). Portfolio Management is key (especially sizing), as positions in assets with these characteristics must be minuscule - when things go wrong, there is no real harm for the portfolio.

Therefore, the kind of corrections we have had at Arauca (A & B) are normal and because of my laser-focus risk management approach, they leave us well positioned for the future. Remember, not all corrections are the same.

Portfolio Update

2022 saw the collapse in price of mostly all bonds, creating the emergence of that asset class as an investible one once again. Short selling, whether as an outright view on a company or as a hedge is likely to be more profitable without Central Banks pumping money, and finally in turbulent market conditions, special situations offer an interesting way to diversify away from the market and could bring a source of excess returns. I have not been too active on these fronts over the last few years; however, it is paramount that I expand my horizons, uncover any rock, and adjust to the ever-changing market conditions. Rest re-assured that the core of Arauca will always be finding the best companies to hold for the long run, but I also should be eagerly looking to opportunities where I can sense a decent risk-reward for Arauca.

I have the perception that a lot of investment records and rationales of holding some stocks have been a result of the most easy financial conditions the world has ever experienced. In addition, most of us - asset managers - started managing capital after the Great Financial Crisis, which means most of us had not experienced a prolonged real bear market until now (the COVID correction lasted three months). <u>Once you are only under such a "benign" environment, the risk to develop false permanent truths from temporary exceptional conditions is high.</u>

Examples of that is the nonsense that cash is "always" trash, or the perception to "always" be fully invested in stocks, or the indiscipline to never take some profits, because stocks always go up right? Or the lack of due diligence when investing, or the lack of maintenance once a position has been taken. And lastly neglecting completely the learning and understanding of other key asset classes such as bonds. How can that be true in an environment where the risk-free rate is approaching 5%? It simply is not. In addition, being fully invested always implies a lack of perception that the world is risky and is a disregard to the possibilities of unforeseen emergencies or even additional opportunities. I have seen a correlation between the most stubborn attitudes of people on the topics above with the worst performances in 2022. I will keep my mind open and maintain a respect to history and to the risk that this profession entails. I have been vocal about this since the early times of the partnerships, and because of my respect to the capital and awareness of risk, I implemented the barbell strategy (extremely low risk combined with rational risk taking). <u>A permanent truth that I have is: Investing is a lot harder than it seems, therefore downside protection is what matters most.</u>

At the end Arauca is where I have the biggest portion of my net worth and it is where everything that is not in real estate, small start up investments and liquidity is placed. Hence, I will never focus on single industries nor single assets classes, I need to be increasing my circle of competence in all fronts. The preservation and the compounding of our capital is my sole focus.

Below you can find some notable moves over the period:

TPL (sold): TPL was the largest contributor to our returns in H2-2022, the stock moved +77% in the period reaching a price of more $2700 USD, which meant a valuation of more than 60 times cash flows with an oil price of $90 USD. I sold at an average price of $2620 USD. TPL was an asset I have held for more than 6 years and is one of my best investments to date. It was also one of the best inflationary beneficiaries and a ten bagger since first purchased in the partnership. However, holding TPL at 60 times cash flow was not possible, it does not fit my valuation discipline. TPL has large random price movements, which means that with time and patience, I believe we will be able to be shareholders again. I love the asset, but I need to keep the discipline.

Ecopetrol USD BONDS SEP18-2023 (Bought): Colombia (my country) unfortunately is currently led by an extreme left government that is bringing policies detrimental to the economy. I am/have been bearish over the long-term Colombian assets; however, the market panicked in September/October and Ecopetrol, the Colombian (89% state owned) oil and gas producer and the most profitable company in the country saw its 1-year duration bonds in USD reach a yield of more than 8%. I put a decent sized position. This is essentially country risk (equivalent to owning Colombian Government bonds without currency risk), extremely short duration and yielding very attractively. In September 2023 I should get the capital back, giving us a lot of new dry powder. You can expect me to look and hopefully find more of these investments in bonds, given the new rates environment.

Special Situations: As mentioned before, it is important to be agile and recognize new opportunities in changing market conditions. I have not been too involved in special situations until 2022, when I started in H1-2022 with Western Areas, and where we made more than 17% on our investment. I entered in another situation at the end of 2022. A company called **Startek**, where MCI Capital made a tender offer for $4.2 USD for 4 million shares. I bought the stock at $3.7 which was a price with a substantial discount to the existing offer. Then already in 2023, the tender went through. We sold to MCI for $4.20 USD. I will continue spending time looking for situations with attractive risk-rewards as those two.

Gaming Innovation Group (Re-Bought): If you remember, we were shareholders of GIG during the time of the partnership. We almost doubled our money back then. Since I sold, the company has been executing better than expected, growing revenues, expanding margins, opening new markets, and increasing its business lines with great acquisitions. As an example, GIG just made an incredible acquisition on the cheap from a large competitor. GIG paid 45 Mio. EUR, which meant 4 times EBITDA for several assets sold by Catena Media, and most importantly the transaction had vendor financing. GIG will pay less than 20 Mio. EUR at closing, while paying 10 Mio. EUR in 12 months and 15 Mio. EUR in 24 months, a period where the assets (without growing) should generate 11 Mio. EUR, essentially reducing the multiple to two times EBITDA.

In July 2022, I bought back GIG and added over the course of August. GIG is one of our positive contributors for the returns of the period. The company is expected to grow yearly at more than 20% and in 2025 management guided for EBITDA margins of at least 50%. Almost every week, the company signs new deals for the platform business. The super-profitable media segment is one of the few in the industry, where most of the revenues have perpetual royalty agreements. The company trades around 5 times my 2024 estimate of EBITDA. Finally, GIG has multiple opportunities to continue unlocking value, such as a spin out or full sale of one of the divisions, in the meantime every day the company becomes more valuable. I expect to talk more of this holding in my next letters.

Positions Sold (MIPS, CLPT, GAW): I sold MIPS, given the fact that the position was extremely small, and the results of the company post our investment highlighted that I had assessed wrongly the margin of safety. MIPS is a good business, but not with a stock trading at a correct price. We had a minuscule realized loss, and it was my mistake.

CLPT: CLPT belonged to section 4 of our portfolio (the smallest section with the highest risk) and hence was a small position. I still think it offers a good opportunity, as you saw in my commentary on H1-2022. However, I believe there will be years until the company is able to be cash flow positive, and I do not have a strong sense of estimating the timing of the cash flows. All estimates are simple guesses, and what triggered the sale was the high valuation it trades at, the positive correction it had from the lows and the opportunities elsewhere in other assets that I am finding, where I have a much higher conviction. We had a small realized loss here as well. I considered this investment one of my mistakes as well.

GAW: While the company continues to make records in revenues for the core segment, I believe the company will have a big difficulty increasing the earnings at least in the coming years (as it was shown in the trade update published in January 2023). The franchise is fantastic, but I do not agree with how management has been executing lately, that combined with the company trading at high multiples, which implies the market is pricing the continuation of the profit growth of the past. I think allocating more to our core positions was the right decision instead of holding onto GAW. Time will tell.

Core Positions: No major change in our core holdings, we have been adding when prices fall. Our core holdings continue to execute phenomenally. XPEL had the best year in history, the same happened for WELL Health and JDC. IDT had a more interesting result when we consider the latest numbers coming from NRS. Q3 numbers for NRS showed revenues growing 134% with EBITDA margins of 36%, this is one of the best quarterly reports I have read of any company. NRS is proving to be one of the best business available in the public markets, though we have to own it through IDT until the spin out is finalized. JDC and IDT are buying back shares, XPEL never issues a share. These three companies treat their shares like gold. I love that.

Regarding WELL Health - the results have been phenomenal; however, debt has increased and the increase in shares outstanding does not make me comfortable. As a result, WELL Health has been the only company of our core holdings where I did not add in the last six months. The position has organically become smaller. I am watching it closely.

SHORTS/HEDGES: While the core of Arauca is to identify, buy and hold the best companies, it is important that I occasionally engage in hedges or small short positions. I have had three relevant shorts over the last six months. The first was Mesabi Trust (MSB), a trust we were shareholders a few years ago and the reverse of what made me buy back then happened in 2022. The earnings and dividends were expected to collapse because of the actions taken by the only client MSB has. The market did not seem to realize what was happening for a while. We made more than 20% on the brief period that the fund was short. These situations occur because of the compound knowledge that is built over time. Once you know an asset well, you can identify different opportunities over time.

The fund was also short Kinsale, a company involved in the exotic area of insurance called excess and surplus, basically these companies insure what traditional insurances do not. The stock was trading at incredible prices (around than 50x P/E), and with a complicated environment to keep growing earnings. The position is practically closed at the time of writing having generated almost 18%. We had calls protecting the shorts, as you might remember my risk aversion on short selling.

The only fully open short we currently have (with its respective call options capping the downside) is a company involved in predatory lending in the automobile space with a complacent investor base. It is a horrible company where the traditional source of funding has been removed and now the new terms make the company very vulnerable to equity impairments. In addition, higher rates should help collapse margins as the funding cost increases. Adding negative issues, the used car market is in free fall, which means that the value of repossessed cars will be a fraction of the cost at where they were lent. Finally, the company has been sued by US regulators for its “predatory” lending practises. Let’s see how it plays out.

Outlook: I remain more cautious than I have been in the past, of course because of the current geopolitical conditions. At the same time, I have been able to take advantage of the volatility and add to my core holdings. The current horrible invasion into Ukraine keeps me worried for all the negative unintended consequences that this conflict can bring. I prefer to be more cautious than usual in this environment, as a result the safe side of the portfolio (where I include all the bonds and Berkshire) remains the largest section.

Relationships – Compounding as a Person – Final Note

During my school days as a teenager (from 15 years till 17 years old) I belonged to two urban groups in my city Bogota that probably were one of the early tests for me with regards to risk management, knowing when to stop, the importance of the people you surround with and the need of personal evolution. I was a member of the fanatic football supporters of the local - and best - football team Millonarios and I listened and belonged to metal music groups (mostly black metal).

These are urban groups with extreme diversity in terms of people and where I saw real danger for the first time in my life. I had a difficult childhood where listening to this music and going and shouting as loud as possible in the stadium was a great escape from real-life problems and frustrations. Also, it was a way to express my rebellion at school (which was extremely religious and never answered my questions) and saw listening to black metal as a direct route to something the school authorities called "hell".

Simultaneously, I always knew very clearly that this attitude and the belonging to these groups were temporary; I knew, I was going to stop the moment I was about to enter University (which I did). As you can imagine, a lot of members of those groups engaged in very risky attitudes and recurrent dangerous behaviours that I knew were terrible for the long term; some who could not stop on time had devastating consequences. My close friends at the time all belonged to some sort of urban groups as well; however, only the ones who did not engage in these risky behaviours remained close over time. Since then, I have been paranoid to taking silly risks. I had to be very disciplined in saying no, in choosing my friends and not let myself be influenced. There was a lot of danger.

As time passed, I left those groups and I entered and focused on university. Some of my close friends remained members. After some months at the University, I started working at the Stock Exchange and these friends who remained in the urban groups wanted to continue dressing with our black clothes full of skulls and spend time on the things of the past. I felt they were not evolving; I certainly did not want to become a 30-year-old guy always wearing black shirts full of skulls. Evolving as I was growing up was important. The people who evolved with me remain close friends till today; in fact, my best friend is a friend from the early days at school. But the pattern was that we have evolved together.

Why do I bring this long story? Because something similar is happening on my journey as an investor. And it has been one of the most difficult aspects to deal with. I saw very risky behaviour and investing indiscipline from several investors I used to read, talk, and/or follow. Not necessarily did I have to know them personally, but I have been exposed to their messages.

In 2022 I saw people who invested most of their net worth in pre-revenue micro-cap companies without any regard to risk. I saw investors who, despite clear change of facts in some companies, doubled down and personalized the position without even acknowledging the changing facts. I saw a disregard to even look at the effects on changing macro conditions in a portfolio. I continued being pitched by investors who were long (and that matters) companies without any regard to valuation and without doing proper work; many times, the "entire" pitch was: "I read this thesis on twitter", or "look, this guy has 10% position here" or "it was on a podcast", and in almost all cases it was about the upside, upside, and upside. Not once, the downside was mentioned.

I learnt something very important about me and it was a lesson from the story above. If I had respect to the investor and the investor engaged in very sloppy/risky behaviour, I could be influenced, not in behaving riskily and foolishly, but in looking into the wrong types of companies. Which means if I had a high regard for these investors, I had a tougher time to recognize sloppiness than usual, and it made me spend a lot of time looking at companies or situations which I should not have.

I evaluated the companies I have been long over the last years that, despite me selling on time, ended up being terrible businesses (or in some cases these companies do not exist anymore) and the group of investors who looked at these companies, and later ignored the facts and ended holding the shares (please both actions need to be together) were from groups where some members were not evolving. Especially after making mistakes that were supposed to be learning lessons to all.

The pattern was lack of downside protection, focus on the upside and, the most difficult to me, personalize the positions. The latter meant that these investors could get defensive/angry if they learnt that you changed your mind, or if you challenge their thesis.

As a result, I need to do the same I did back in school. I learnt that if I wanted to ensure I keep evolving, I need to choose carefully how I spend the most of my interactions. With whom I talk most and from who I read. I realized the need to spend the most time with investors who want to always evolve. I learnt that we all say "we love finding contradictory evidence" but few react calmly and rationally when this evidence is found. It is rare to find those who walk the talk. Importantly, if these investors are close friends, it is paramount that I highlight my concern (I hope my friends always highlight my sloppiness directly), but if the close friend is not receptive, there is no need to keep bringing the topic and a distance is preferred (on investing topics at least).

That is why, if I want to keep evolving and as said in my old letters, constantly improve the quality of my decisions, I need to be more selective on how I spend my time. Which means I need to really evaluate the consequences on myself of belonging to wrong groups. Also, I do not need to become hermetic, but I need to know when I must move away or reduce exposure to certain environments. As I have always said, investing is a lot more than just analysing businesses.

I hope my friends help me remain consistent and on course. I also realized the importance of the relationships I have is probably a lot more impactful than I imagined. I am so thankful to my friends and investors, some of whom are fund managers themselves and have pushed me to look in better directions, my colleagues who love to challenge me and do not get upset when I challenge them with my directness. My young student friends who knocked on my door and have thought me a lot of lessons, to my non-investors life friends who have evolved together with me.

Lastly, as my friend Andreas Aaen wrote in his letter with regards to the importance of the person we marry. Nobody is more important, and I cannot be more grateful to Laura, my wife. She helps me constantly and unconditionally in my life and our projects and is aware of all what I do, especially in the fund, which brings a silent and beautiful pressure to not disappoint her and be consistent.

I hope this letter reflects to you what I have been through, what I have in my head, my evolution, and my decision-making progress. Thank you, dear partner, I wish you and to your family good health.

Sincerely,

Jean Philippe Tissot

"I've got to keep running the course, I've got to keep running and win at all costs, I've got to keep going, be strong. Must be so determined and push my self on"

IRON MAIDEN

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