Arauca Letter 2021/22 | July 2022

Dear Investors,

2022 has proven to be a very difficult year, not only for the markets, the economy, but the world in general. And 2022 is the perfect example of why my mental models have been developed - it is the time to use them. These are the difficult times and discipline is paramount. In this letter I am not going to explain the mental models again but highlight how they have been used.

Indices across the world are having severe corrections with the approximately declines in the Nasdaq of -28,9%, S&P -20% for the first half of 2022. Most of the developed world is in a bear market. **Arauca Capital is down -25,2% in H2-2022**. And I am painfully aware this means the fund is down -34% since July 2021. The current macro picture is dark, but our companies are doing remarkably well, and most of our portfolio companies even reported record numbers in Q1 2022. It is important to keep the focus on what matters. If we are going to be long term investors, these times are guaranteed, there is no question about it, and it is the price of admission for long term returns. The timing though, makes these results more difficult to bear than they should be, as the fund started right at the highs of the market. Despite not having allocated more than 10% to a single stock, a general correction like the current one feels worse.

All these mentions about "feelings" are deliberate, as they are momentary and ephemeral. What is permanent is any decision based on them. We can't act on them. What I must act on is on rational evaluations on the performance and development of our companies while maintaining the barometer of the "macro-economic climate" always on. There will always be mistakes (I have an important part of the letter dedicated to mistakes and how they should be classified and will explain on what I have failed); however, the questions of which companies we should hold for any macro weather condition are the important ones I need to answer.

As a reminder, my expertise and edge has been discovering small/microcap companies (these are companies with market capitalization of less than USD 1 billion for small caps and USD 500 million for micro caps) with unrecognized earning potential. These are companies, where a fund like ours has a meaningful edge as they are not in the radar of larger funds. However, stock prices of smaller companies have a much higher volatility compared to larger ones, and in periods like the current one, this higher volatility affects our fund in the ongoing mark-to-market, as fundamentals are momentarily disregarded and ignored. But by no means does this mark-to-market represent their business performance.

In the last few weeks, the fear of a global recession has increased, this belief has sent inflation expectations plummeting along with commodity prices, in some cases share prices of some commodity companies have even lost the year-to-date gains. This contrasts with the view that inflation was out of hand and Central Banks needed to raise rates for years to come, currently the market is

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discounting the Fed to cut rates in late 2023 and in 2024 after hiking them through 2022 and early 2023, it is roller-coaster. This is an illustration how difficult it is to have a long-term macro view if not impossible. At Arauca, I focus on what I can control, for example the price we pay for the companies we buy and the analysis of each business, monitoring them, and the constant assessment if facts improve or worsen my thesis. The macro picture is key to understand it, but I should respect the difficulty to be able to forecast it. I know Central Banks were late in attacking inflation and most likely will be behind the curve tackling recession. I also know the non-sensical energy policies in the US and Europe (mentioned in my last letter) that have led to a lack of supply of fossil fuels and how our leaders still fail to grasp the need to incentivize production. With these factors, I must navigate and allocate capital.

	Year	Net Returns
Arauca Capital	**2021 H2	*-11.84%*
Arauca Capital	**2022 H1	*-25.22%*
	1 Year Return	***-34.07%***

Jean Philippe Tissot full track record		
	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%*
	CAGR	***16.14%***

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

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Part 1 - Portfolio Update

How the Portfolio is constructed – Barbelling – JDC, a German gem – XPEL keeps delivering

Please find below a description on how I see our portfolio and how I divide it in order to manage appropriate the risk reward characteristics of it.

Section one - Minimal risk of permanent loss: This part of our portfolio is composed of US treasury bills, and our holdings in Berkshire Hathaway, Exor, Franco Nevada and Texas Pacific (TPL). It represents approximately 40% of the portfolio. Our holdings in TPL and Exor are volatile, specially TPL, but those are extremely safe assets.

For instance, Exor is the holding company controlled by the Agnelli family, the founders of Fiat. The company has holdings in Stellantis, Ferrari, CNH, Iveco, Juventus, the Economist, and several smaller investments. Exor recently sold Partner-Re for EUR 7.8 billion. After an unexpected tax payment of EUR 746 million, the company has EUR 8 billion in cash. Exor trades at a market cap of EUR 13.8 billion, representing more than a 40% discount to the NAV (Net Asset Value). Exor, with more than half of its market cap in cash, will be able to take advantages of this beaten down market, while the remaining holdings will keep compounding value for decades. John Elkan, Chairman, has managed to create enormous shareholder value over the years, has proven to be an intelligent capital allocator and holds the legacy of his family on top of the responsibility of managing their wealth – you cannot have more skin in the game.

Berkshire Hathaway, a company in our portfolio since day one of the partnership almost ten years ago and which I barely mention, has always been part of the safe side of the barbell; however, the volatility on the stock has not been muted. Berkshire shares traded at a high of USD 360 in late March and have come down to USD 268 in the last few weeks, despite having one third of its market cap in cash, an outstanding selection of business and being managed by the most consistent and disciplined investor of all time. For me to have peace of mind, and ensure I am able to deploy capital with resolution in smaller, riskier companies, I will always have some proportion in these types of safe assets, though under normal circumstances I would want to have a proportion of around 15-25% of the portfolio in this section.

Section 2 - Core companies: This part of the portfolio corresponds to the companies I know best, for a substantial amount of time (usually years), and where I trust management the most. These are companies whose business performance has exceeded my original thesis, and management and the businesses will be able to generate shareholder value for years to come.

In this segment we have our largest holdings: JDC, XPEL. IDT, Well Health. This part represents approximately 25 to 30% of the whole portfolio. Our companies in this segment have been performing extraordinarily while the share prices in some cases have had drawdowns of more than 50% for exogenous reasons.

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Section 3 - Sub core companies: In this segment I have companies that are relatively new to the portfolio or are companies that I have trimmed and now represent a smaller portion. Some positions in this segment are very small as they correspond to starter positions, to which, if management executes, I would be happy adding. Some of the holdings in this segment are Games Workshop, Evolution Gaming, Facebook, MIPS, Brookfield. This part represents approximately 25% of the fund.

Section 4 - The risky segment: This segment represents anywhere between 5% and 8% of the portfolio. At cost each individual position is very small. In this segment we have positions in companies at an early stage and in new technologies. It is a section that I consider paramount to be included in a balanced portfolio, as it has very high convexity. If we have a company in this segment that de-risks the business model, the company eventually can become a core holding. Here we have companies like Clearpoint, Maxcyte, Universal biosensors and our blockchain exposure represented in the polkadot ecosystem and KR1 (shares in a digital asset manager). This segment has experienced substantial declines in its prices. But, as I will explain, one of our companies has started to de-risk the business model in a substantial way and, to my view, will completely revolutionize the way brain surgery is performed. This company is ClearPoint.

JDC Group (introduction)

JDC is currently one of our largest allocations. We initiated the position in May 2021 during the partnership time and once we launched Arauca, we immediately acquired the position for the fund.

JDC is the most advanced and leading software provider for the insurance industry in Germany, in other words JDC is digitalizing the German insurance sector. The company also operates in other countries; however, the bulk of its revenues comes from Germany. JDC has an enormous unrecognized earnings potential with clear visibility in terms of future revenues and profitability. JDC has been investing for years to be able to provide a comprehensive software product with the front end and back end integrated (the back end, to my view, is the biggest competitive advantage of the company), which means all incoming growth in revenues does not require additional investments, and JDC has started to meaningfully show operating leverage. With a positive net cash position, top line growth rates of more than 20% for at least the next five years, continuous rapid growth rates in EBIDTA and Net Income, and a current market share of 0,5%, I believe JDC 's current value is substantially below its intrinsic value, which continues growing very rapidly.

At the time of writing JDC has been growing at 20% top line, has a market cap of EUR 256 million, has a positive net cash position, and benefits from inflation. JDC'S revenues in 2022 are expected to be approximately EUR 175 million with an EBITDA of EUR 12 million and increasing to at least EUR 17 million in 2023, implying a valuation of 15 times EV/EBITDA with regards to the 2023 numbers. However, what this valuation does not show is the additional growth coming from the contracts signed in 2021/2022, particularly with Provinzial, VKV and the pilot project with R+V. Provinzial alone can, at maturity, provide more than EUR 100 million in recurring revenues; the upside is immense.

JDC sits between the 220 insurance groups in Germany and the intermediary in the financial markets, such as independent financial advisors, insurance agents, banks, etc. JDC receives the data coming from these insurance companies (also from mortgage banks and different alternative asset providers)

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and though it's digital platform, called iCRM, JDC standardizes the data, processes it, and then provides it in visualizing systems to these financial intermediaries. JDC receives a cut from the commission that insurance companies pay to these agents selling insurance and other financial products. As long as the final clients keep the contracts in JDC's platform, it becomes a recurring revenue stream as commissions are paid every year. JDC also has 200 000 direct clients where they capture the entire commission.

JDC has two business lines:

1) Advisory: This segment consists of selling financial products directly to end customers where JDC captures the entire commission. The segment is not a focus for the company, yet generated EUR 36 million in revenues and EUR 7.5 million in EBITDA with +20% growth rate in the last year. Besides the numbers and impressive growth rate, the segment provides immediate feedback from the final client, so JDC can adjust its platform accordingly.

2) Advisortech: JDC offers a broker pool where the entire platform is built on. Today, the broker pool generates the bulk of the revenues, and it is where the other products and the digital platform (which I am going to mention below) are built on. The broker pool is where JDC helps insurance companies and agents selling insurance with their back office, that is updating the insurance contracts, splitting the commissions paid, being up to date in regulatory matters, conduct regulatory and legal issues. Currently JDC has more than 16,500 advisors using the platform. JDC collects the entire commission from the insurance companies and distributes around 60-70% of it to these agents, keeping the rest. The segment generated more than EUR 120 million in 2021 and EBITDA of EUR 3.3 million, which is a growth of 200% y/y, as operational leverage starts to take effect.

The integration of the front end with the backend of the platform is the reason JDC has an enormous moat. Insurance contracts have sensitive and private information that require a manual input. This is a process difficult to build in scale, is very labour intense and has been the reason JDC competitors like Clark, Friendsinsurance left the B2B2C market. JDC is years ahead of competition in this segment and its smart frontend integrated with the backend makes JDC's platform unique. In addition to the benefits for the insurance companies and insurance agents, the final client (the client of JDC's clients) is finally able to have a complete overview of all her/his insurance contracts in one place through a smart phone, tablet, or PC. Changing insurance providers or contracts is smooth and is done in the same app. JDC is making the entire space better.

Within Advisortech there is a segment called Allesmeins, which is basically JDC's platform (frontend integrated with the backend) white-labelled into third party companies that have a large client base. JDC Platform then is customized with the client logo and the final customers do not even know that they are using JDC's platform.

JCD started Allesmeins in 2018, onboarding clients such as Albatros which is the inhouse insurance broker for Lufthansa serving 150 000 employees with more than 400 000 clients. Today Sparda-Bank, Finanzguru, Volkswagen Bank and BMW are all clients of JDC's white-label service. Time is required

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until a signed contract is converted into revenues for JDC as there is an onboarding process for Allesmein's clients (the banks who are selling insurance), and only afterwards can the final client actively start using the platform. Normally, meaningful revenue is generated three years after contracts are signed. This segment already guarantees future growth and is currently a very small proportion of revenues, which highlights the enormous potential JDC has as the current growth in revenues comes mostly from the advisory segment and the broker pool.

With regards to Allesmeins, JDC had a transformational moment when the second largest public insurance in Germany, Provinzial, assigned the white-label contract for its platform with the saving banks to JDC. JDC and Provinzial eventually formed a joint venture. It is expected that more than 100 savings banks with more than 1 million customers will process and settle their insurance business through JDC's platform. To put this into context, these banks receive more than EUR 1 billion in commissions every year. Management has indicated that once all the banks are onboarded, they expect to generate at least EUR 100 million within five years, which represents only 10% of the commissions these banks receive - an underestimation in my view, but it is almost the same level of revenues the company is generating today. Out of these EUR 100 million in revenues, JDC should generate EUR 15 million in EBIT, which is more than what the company generated in total in 2021.

JDC kept winning enormous contracts, as it did with VKV, the largest public insurer in Germany. Additionally. VKV acquired a 6% stake in the company becoming a major shareholder of JDC. The potential of the VKV contract is like the one of Provinzial explained above - another EUR 100 million in potential revenues per year. This win further increases the reach of the white label platform to the saving banks VKV works with. In order for JDC to generate revenue those banks need be onboarded, and clients need to start using the white-labelled platform, and once they re-new their insurance contracts (from any provider not only VKV or Provinzial) JDC will start generating income, which highlights the asset light nature of the business model.

It is important to mention that the banking sector in Germany is composed of three pillars; the saving banks, which are around 380 different banks with 13,800 branches and have approximately 50 million customers, the cooperative banks with 870 banks, 10,500 branches and roughly 20 million clients, and ultimately the private banks which are the Deutsche Bank and Commerzbank with roughly 13 million clients. The win with the public insurances means that JDC is becoming the main provider of the insurance platform for the saving banks. Recently, the insurer of the cooperative banks R+V signed a pilot project with JDC onboarding five banks onto the platform, which is the first door for JDC for entering these 20 million client market potential.

There is roughly EUR 220 billion in insurance premiums paid annually in Germany, of which EUR 17 billion is paid in commissions. JDC, with its estimated revenues of EUR 170 million for 2022, has less than 1% of the market - imagine if JDC is able to only capture 5% of the market.

Insiders own around 16% of the company, Great-West, the large Canadian insurance group, is the majority shareholder with 27% ownership, and, as mentioned before, VKV, the largest public insurance in Germany, has taken a 6% stake in the company. These are quality shareholders and insiders which are completely aligned with us. At 15x EBITDA on 2023 numbers, no net debt, and the contracts with Provinzial, VKV, R+V yet to start generating revenue, I am confident JDC will create shareholder value for years to come.

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XPEL (update)

XPEL's business performance keeps exceeding all my estimates. While the stock has been cut in half during the last year, given the current market environment, it gave us an extraordinary opportunity to add to the position at less than 18 times my estimate of next year earnings. As a reminder, XPEL is a core position in the fund and a company we are shareholders of for more than five years, one with an outsider CEO that has won my entire trust during those years. If you are new to the fund, I recommend you read our previous commentary on XPEL (in the previous annual letters) during the time of the partnership.

As an illustration on how exceptional XPEL is, we just need to look at the latest quarter. Q1 2022 was a period with the lowest new car volume in a decade, with sales in the US down 16% year on year (meanwhile XPEL US business grew 62.4%). Europe experienced a similar situation, while China was again in a hard lockdown in several parts of the country, stopping car sales in those regions almost completely. Combine that with supply chain issues, lack of car inventories and you would imagine XPEL should have experienced a similar fate. XPEL's results show it is gaining market share and attach rates (upselling rates) are growing.

In Q1 2022, XPEL experienced records in terms of revenue and gross margin, it was (once again) the best quarter for the company, revenue grew by 38.6% y/y with a record gross margin percentage of 38.6%. This result is even more impressive as Q1 is generally the weakest quarter for the company. Imagine what the results can be in a more benign environment for the automotive industry? The auto industry has pent up demand that XPEL is primed to benefit from. To illustrate how this result is achieved I need to remind you that the core business of XPEL is selling paint protection film (PPF). This market remains extremely unpenetrated with less than 2% of total new car sales applying PPF, and less than 5% in luxury cars, providing years if not decades of growth ahead in XPEL's core market. XPEL has become the synonym of paint protection film and is the reference in this market.

In order to become a market leader and create an extraordinary business, XPEL has had to perform in several aspects. The first is the ability to innovate and constantly create new products, exactly as the company has been doing. The latest example is the release of ULTIMATE FUSION which is a hydrophobic film that can repeal water and road grime, and enables protection against rock chips, bug acids, bird droppings and light scratches with a ten-year warranty. ULTIMATE FUSION started selling in the US and the response has been fantastic. Global roll-out is imminent. XPEL has been innovating and I expect it to continue doing so, increasing the company's moat even more.

The second aspect is the possibility to increase margins through time. Currently XPEL is experiencing the highest gross margins (38.6%) of the company's history and the company is guiding to 40% for 2022. The latest push for obtaining higher margins is the renegotiation of a new contract with Entrotech, XPEL's largest supplier. XPEL's original contract with Entrotech was initiated when the company was a fraction of what it is today, in financial terms as in size, and the new contract needs to reflect terms that are substantially better for XPEL. The message here is very important, as a few years ago when XPEL was a smaller company, the reliance with Entrotech as main supplier was a big

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risk in my opinion. Today XPEL can walk away and has different substitutes if the company choses to. I know the relationship with Entrotech has been mutually beneficial and I expect it to continue for years, just with better terms for XPEL.

The third key aspect is the ability of XPEL to increase its verticals. XPEL started exclusively selling PPF, then offered its software with the car designs to installers, and subsequently XPEL expanded the range to commercial and automotive window films and ceramic coatings. With the acquisition of Perma-Plate, XPEL entered the medium range price car market and the acquisition of invisFRAME in the UK allows XPEL to enter paint protection film patterns for bicycles. XPEL is constantly increasing its verticals.

The fourth aspect is the ability to expand geographically. XPEL started off as a North American company, in 2014 initiated its international expansion with the establishing of the UK office and today XPEL operates on every continent, having become a truly global company.

The fifth and last aspect that I consider crucial in order to be an exceptional business is the ability to realize accretive acquisitions. XPEL started acquiring businesses in 2017 with the acquisition of Protex Canada and since then XPEL has not stopped. 2021 was the busiest year with the acquisition of Perma Plate, invisFRAME (PPF for bicycles) and five other businesses that range from distributors of PPF, installers to a software company providing patterns for cutting paint protection film.

XPEL is currently working with two OEMs (car manufacturers) on two programs that aim to install paint protection film at the time of manufacture. One of the partners is Rivian, as XPEL announced just a few days ago. These projects are not generating revenue yet and one of these projects is XPEL's largest program to date. I am truly excited with these programs as they will meaningfully increase the awareness of the benefits of PPF. Ryan Pape, CEO, has mentioned that in his view 60% of all new car buyers can be open to paint protection film; this coming from a current penetration of just 2%.

At the time of writing XPEL is trading at USD 47 per share, hence a USD 1.3 billion market cap. My estimates for XPEL's earnings in 2023 are at least USD 2.5 EPS, which valuates the company at roughly 18 times 2023 earnings - a valuation not demanding for a truly exceptional business with decades of growth ahead and with an extraordinary CEO.

Bioventix (sold)

Bioventix is a good example for the discipline that is required in this business. It was a position I took in 2016 for the original partnership and have explained in detail in my previous letters. I thought I knew the company and management extremely well; therefore, it was a total surprise for me to learn that the Troponin contract was not perpetual but expires in 2032. The understanding of the market was that all Bioventix royalties, except for Pro-BNP, were perpetual.

Management never disclosed that the Troponin contract expires in 2032 in any report, nor in any public presentation. There had been questions if Bioventix had contracts like Pro-BNP (with an expiry date) and management always emphatically denied. Ambiguity on that answer plays a role as management can defend itself by saying the answer was forward looking. In any way, the fact that

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such material information was never disclosed during all the time Bioventix has been a public company is unforgivable. More disturbing for me was to learn that the disclosure of this information came in a closed event of a particular investing society. Management decided to throw that information to only a few shareholders, disrespecting the rest.

I raised my concerns to management and was told that management did not disclose "forecasts" for more than two years and management "believed that shareholders did not care of an event that happens in 2032". Management never answered why the information was shared in a closed event for the first time. That answer (and lack of) resulted in the sale of our entire position, as this was not a forecast but material information. I completely lost trust of the management team and it would be hard for me to believe anything they say going forward.

At Arauca I act immediately when I lose trust in management. We had an approximate 2.5% weight in Bioventix; therefore, the effect of selling is practically immaterial. However, it was emotionally hard for me. I had a completely different perception of management and of the company, I was following it practically since the IPO in 2014. I am surprised the market did not react once the Troponin information became public, as the intrinsic valuation of the company does change. Yet, this is the end of our story with Bioventix.

Well Health (update)

Well Health (WELL) has been one of our largest underperformers since July 2021 with a drawdown of more than 50% from our purchase price. However, WELL is a much better business than a year ago. To illustrate the valuation disconnect, WELL currently trades at CAD 3.00, equivalent to a market CAP of CAD 690 million, while the company is expected to have CAD 525 million+ in revenues, will generate adjusted EBITDA of more than CAD 100 million+ for 2022 (without any new acquisition) and free cash flow is expected to be more than CAD 44 million. Gross Margins have increased to above 50% for the first time in the company's history and WELL has become the largest clinic operator in Canada.

Well Health is firing on all cylinders. Circle Medical, for example, a US company in the Telehealth space acquired by WELL in 2020 was making USD 5 million in revenues at the time, today Circle has a run rate revenue of more than USD 40 million. WISP, a company involved in reproductive and sexual healthcare, was acquired when their revenues were USD 20 million and today's run rate revenue is estimated at more than USD 35 million. These are just two acquisitions; WELL has made more than 45 acquisitions to date and offers a comprehensive solution divided in two main sections, Virtual Services (Digital Patient Services, Billing and RCM, Digital Health Apps, WELL EMR Group) and Omni-channel Patient Services (Primary Care, Specialized Care and Diagnostics).

12.7% Of Canada's GDP is spent on healthcare, in addition the sector is in urgent need of modernizing and digitizing. Well's technology and reach is prime to improving the sector and patient's experiences, which will translate in shareholder value for decades to come.

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Verde Agritech

Arauca produced an extensive write-up on Verde Agritech just a few weeks ago. Unfortunately, the facts have changed since then and I sold all the position; we are out, and I most likely will not buy back. For all of you who want to read the write-up regardless, please let me know. I want to draw special attention to a bright young guy, Itai Parnes, who helped me on it. Itai is a twenty-year-old man who loves investing. We met in Omaha earlier in April. I got impressed by his knowledge, energy, and intelligence, and therefore asked him if he wanted to help me in a little project, which was Verde Agritech's write-up. I am very grateful to Itai and hope to work more with him in the future.

As a disclosure: I bought Verde back in January 2022 and started buying in the highs CAD 3's, the stock then moved up to the high CAD 11's. I managed the risk accordingly, and after the recent changes I sold the entire position; it was a profitable investment. Verde is a micro-cap, involved in commodities, hence it requires careful observation. In addition, the CEO who had never sold a share since the company going public in 2008, sold a decent portion of stock just now and after heavy promotional campaigns, which included twitter adds directed to the investor site (a red flag), we followed him selling. Selling before an announced ramp up with massive promotions is extremely suspicions and makes me doubt his words on other aspects as well as the future execution of the company.

Update on section four of the portfolio

As mentioned before this is the smallest part of the portfolio and around 5% to 8% in total.

Here, I must start with our exposure to blockchain. As disclosed, I had a small exposure reflected in shares of KR1, Coinshares and our direct exposure in crypto assets through Kraken. I sold 100% of Coinshares, we had a small realized gain. I sold this position entirely as I lost trust in management, and in addition, the management team is very young and to my view lacked humility, a risky attitude when managing a business. Coming into the release of Q1/2022's results, I had cut the exposure substantially, and those results showed that the capital market's segment made no money despite a very volatile environment, which should be substantially positive for this segment. In addition, Coinshares reported GBP 7 million gain in DEFI (decentralized finance), which is an activity the company had never been involved and creates unquantifiable risks. Once I saw that, I decided to completely exit the position. A few weeks later, the company released the annual report where it disclosed a loss of GBP 17 million related to the DEFI operations. This outcome highlights the importance of always monitoring if facts improve or worsen our thesis. When those facts worsen our thesis, I must act and never rationalize.

We continue with our holdings of KR1, the most successful asset manager in the blockchain space, and our direct holdings in the Polkadot ecosystem, the 3.4% we put in Kraken. Here I must confess to

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you that, while I do not think it was a mistake to enter into this position in blockchain, my execution probably was. I entered in Q3-Q4/2021, which was one of the most vibrant times in the crypto market and with the benefit of hindsight, I could have spaced the purchases better. Today our exposure in KR1 and Kraken is less than 2% combined, given the price declines.

I want to share with you my rationale why I think the fund should have a small exposure in blockchain expressed in the Polkadot ecosystem. I wrote the foreword of the first book explaining Polkadot, please find it in this **link** and read it when you find the time (the foreword is enough).

On a more positive note, one of our positions in this segment, ClearPoint, is performing far better than any of my estimates and deserves a small explanation.

ClearPoint (CLPT) is a navigation guidance platform for minimally invasive brain surgeries. The navigation platform is a software powered workstation that guides a physician in pre-surgical planning, aligns devices that are mounted to the patient, helps navigate surgeons to targets with sub millimetric accuracy and provides real-time imaging during the surgery. It is currently installed in over 65 locations worldwide. Brain surgeries normally are performed in the operating room (more than 85% of them), while ClearPoint's platform is the only FDA approved platform for MRI guidance, that is surgeries in the MRI room, which is advantageous as when patients are moved from the MRI room to the operating room, the brain can move, thus making surgeries more complicated and riskier. Important to mention that ClearPoint will also also be able to offer its platform in the operating room with an improved version of the platform and will enable the company to target most brain surgeries.

ClearPoint ´s business model is composed of the sale of the platform, the recurring revenue stream of the sale of the disposables needed in the procedures which range anywhere from USD 5-18 thousand per surgery, and finally by services provided to biotech companies.

What keeps me very excited is the use of the platform by biotech companies that are creating drugs using regenerative medicine; this is gene therapy, gene editing and CRSPR. These companies are partnering with ClearPoint to use CLPT's platform to deliver the drug into the brain. If drugs get approved, the future of ClearPoint can dramatically change as the numbers of procedures will substantially increase. Currently the company has 40 partners and one of them, PTC with its drug treating AADY, has received positive opinion from the European Medicines Agency Committee for Medicinal Products for Human Use recommending the gene therapy to treat AADC Deficiency. CLPT provides the SmartFlow Neuro Ventricular Cannula for minimally invasive infusion. This is major milestone and illuminates the potential of CLPT.

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Part 2

How I view mistakes as a capital allocator – My mistakes – Thoughts on Microcaps

It is almost a decade that I devote to managing capital and every day I learn how hard this profession is and how little I know. At the same time, I enjoy the journey even in the difficult times. Previously I have explained the importance to differentiate skill and luck in our results, today I am going to expand and explain you how I see mistakes, which ones are bound to always happen, and which ones are simply not allowed.

I see two main categories of mistakes that occur to capital allocators:

- Type 1 - Unjustifiable mistakes: These are actions that are against the risk parameters that I have framed for the fund, particularly, entering in concave position where the probability of gain is high but limited, while the probability of loss is small but unlimited. Examples are losses coming from large short positions without an option limiting the loss (small short positions are allowed and shorts with options limiting losses), the use of leverage, the allocation at cost of more than 20% to a single name, laziness in estimating if my thesis remains valid, personalizing my positions (trying to be right rather than maximize the outcome). These actions can blow-up a fund, and mostly all major losses result from concave exposures. At Arauca I am simply not allowed to even consider them and my promise to you is my consistency.

- Type 2 - Unavoidable mistakes: These are mistakes that are bound to occur. Incorrectly sizing an investment at cost, misestimating the margin of safety, having a flawed analysis of the business, failing to discover and act upon facts that alter my investment thesis (please note that failure to act after discovery is un unjustifiable mistake).

I work hard to get better through time, and I am satisfied with my evolution and the development of my mental models. Structuring Arauca with a promise to avoid making type 1 mistakes (unjustifiable mistakes) gives me enormous peace of mind. I will always be making some unavoidable mistakes. But as the magic of compounding teaches us, avoiding large mistakes and dumb decisions will ensure that my good decisions take us far. As an illustration, the compounding rate I achieved in the partnerships was because of good investment decisions accompanied with several small mistakes. The small mistakes, when they are type 2 mistakes, become rounding errors over time. At the same time, it is important for me to explain and highlight them, to ensure transparency and to rob my nose to not repeat them.

Some of the type 2 mistakes I have made in the last 12 months, where I could have done better:

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- More time in the conversion of partnership to fund: The fund was initiated just at the peak of the market and speculation was rampant. I took three months to allocate the capital and was anxious to have the entire allocation at least in our top holdings. With hindsight this could have been done better, as valuations were high, and I could have spaced the purchases over a year rather than three months.

- Sizing: Given the high valuations, some positions were a couple of points bigger than they should have been, even though I know the companies extremely well.

- Timing of purchases into the Blockchain space: Explained in Part 2.

Thoughts on Microcaps

Investing in microcaps - companies with market cap below USD 500 million - has been the source of most of the partnership returns. However, from the companies that I have owned only a handful are part of the fund. The reason is that investing in microcaps is risky and few companies manage to become larger and a better business as time passes. It is a dangerous space that requires extreme discipline.

At the same time, it is the most exciting area to uncover, and you can discover true gems if management executes and remains consistent, the company produces higher earnings over time and dilution is minimal; then those companies will likely be the source of most of the returns. In our case the best example is XPEL. Yet not all positive returns that I have generated from microcaps have come from owing great business. In many cases the execution fades and the gained value is destroyed for remaining shareholders. Selling when the facts change is of utmost importance.

An example is GAN, one of the best investments I made, a realized 8-fold on the investment. I invested in 2017 and sold in 2020. GAN has had a recent deterioration of the business accompanied with, to my view, not smart acquisitions. This was compounded by heavy management disposition of shares once the company listed on Nasdaq, the stock subsequently has lost 90% of the value. Imagine if I had not identified the new facts and sold on time. This is just one example of many I have had. Immunoprecise Antibodies is another example of a positive result due to selling on time, but the company never executed.

If a company remains a microcap forever, then the company is not a good business. Microcaps are business that are on the path of greatness (less than 1% of microcaps), companies that will eventually make it but require years and some dilution (less than 10%) or are companies that don't have a sound business model and require perpetual funding, mostly happening by dilution. Some of the microcaps are not listed on the main exchanges, which allows them to have a low level of disclosure, implying a higher risk for the investor. At the same time, this segment of the market has had several cases of frauds and of companies which are used by management as piggy banks. CEOs can raise cash from investors, promise that the company will conquer the world, pay themselves attractive salaries and bonusses or be paid in shares and then sell them in the market.

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Therefore, the filters and discipline required to be successful investing in microcaps must be of the highest standards.

In most microcaps the investment thesis comes from narratives, that is a story mostly told by management of what the company can do in a few years' time. For some reason there tends to be a tailwind for the company on a specific current macro theme (COVID; commodities, new regulations etc). The more the valuation is based on future cash flows that have not been generated by the company, the higher the risk. I need to remind you, management teams can easily explain upsides, but creating a new product, being able to sell it and make money out of it is very hard. Management plays a more crucial role the smaller the company is, therefore trust in them must be paramount. One of the most common facts that change the thesis is losing trust in management.

I have decided to be tolerant (but not too much) on execution (execution can take longer than expected) but I chose to be completely intolerant if I lose trust on a management team. I invest other's people money; I rather pay the price of missing opportunities when I have identified something wrong and exit, than rationalize actions contrary to my standards and hold into it. If I do not have the right habits, only large permanent losses can be the teacher; I avoid that at all costs. Investing is hard enough when holding flawless businesses, so why adding an additional strain by holding businesses where you have lost trust in management?

Microcaps are an exciting space, and I will always be uncovering rocks there. I can tell you there is nothing more satisfying that seeing your microcap execute and evolve; when this happens, everything is worth it.

I have recently been invited to Bobby Kraft's renowned podcast "Planet MicroCap", a podcast series aimed to educate the next generation investors by discussing various Microcap investing strategies and philosophies with a wide range of entrepreneurs and investors. On his podcast I have been able to share some of my background, my 3-pillar investing philosophy and more. If you are interested in listening/watching, you can find the full episode here on **Spotify** and **YouTube**.

Part 3

Being a fund manager – Pressure – Gratitude

The first year as a fund manager brought a challenging environment for financial markets and my largest drawdown as a capital allocator in my close to ten-year track record. That, with the responsibility to have outside capital and most importantly capital from people who I know and appreciate, brings pressure. The pressure, however, is inflicted to me by me, as this year proved that I have the best partners. Not only you, dear partner, have not added any pressure on me, but have supported me and encouraged me on this journey. Hence, it has been easier for me to focus on the long term, on our companies and evaluating our decisions in the long term under any macro-

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economic scenario. This first year has encouraged me to ensure I always maintain the quality of the partners. So, to my partners a big thank you. And the biggest thanks of all to my wife Laura.

I have focused completely on my capital allocation decisions, meaning I am not spending time making the fund more known. I certainly want to grow it, but I want the new people to join to be like my current partners. The price to pay is that the fund will grow more slowly, but the advantage is I do not spend time marketing or on roadshows, which is a distraction.

At the same time, given the correction of the markets, I have seen letters from other fund managers calling this time the best opportunity to invest and calling for capital. I disagree, I will never call a specific time, “the best opportunity” as that would imply that I know what the future will bring. I have no idea if in a month there will be a better opportunity. What happens if a missile by mistake reaches Poland and NATO has to get involved? Or inflation in the US reaches 15% or a recession starts and lasts for years? Would the call for the “best opportunity” still be valid? I rather tell you that today, with the companies we hold, at the prices they trade, our companies are at the cheapest valuations we have had them. However, in the short term, they can even become cheaper. What I do know is the moment market participants “feel better”, the market will be a lot higher. Investing “right” never feels good.

Over the last six months I have been busy visiting management teams of our companies. I had the opportunity to be in Dallas and meet with Chris Steddum, CFO of TPL. I met several other management teams of companies I am researching and developed a stronger communication channel with our holdings management teams. I had the pleasure to be back in Omaha during the Berkshire meeting, where I met old friends and made new ones. It has been very fruitful time in terms of real interactions.

I close this letter with a very optimistic view when I see our portfolio and the business performance of our companies; however, when I see the geopolitical environment and the macro picture I am concerned. As I have mentioned, the truth always lies in the middle. The pendulum of the market will gyrate based on the theme of the day, and I will continue finding the best businesses out there to place our capital and carefully monitoring their execution and the actions by managers.

Yours truly,

Jean Philippe Tissot
Founder of Arauca Capital

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