GEHLEN
BRÄUTIGAM

CAPITAL

Gehlen Bräutigam Capital GmbH
Kurfuerstendamm 11
10719 Berlin

+49 30 42141851
info@gbcvalue.com
www.gbcvalue.com

Letter to Partners #10

Q4 2020 *(10/01/2020 - 12/31/2020)*

January 19th, 2021

Dear Partner,

Following the announcement of positive trial results of various Covid-19 vaccines, the election of a new president in the U.S., a Brexit agreement and continued (surprisingly) positive corporate data, the stock market ended the year with another strong rally. **Our fund gained 21% in the fourth quarter and ultimately ended the year up 22%.**

Since bottoming in March, the NAV per share has risen 80% and is now well above pre-crisis levels. The cumulative growth since inception is 31.1%, and the average annual net return is 11.4% (vs. 14.4% or 5.5% p.a. for our reference index).

Portfolio

In our last Letter to Partners, we gave you a deeper insight into our view of the fair value of our portfolio. We felt that the discount at the time had been exceptionally high. Due to the very positive performance in recent months, this discount has naturally narrowed slightly (see appendix).

The month of November, in particular, contributed to this, with our fund achieving a performance of +17%. In the wake of encouragingly positive vaccine news, cyclical stocks (e.g. Akwel, SAF-Holland and JOST Werke) and (mislabeled) "Corona losers" benefited most. The share prices of our two discount gym chains **Basic-Fit** and **The Gym Group** even rose by 23% and 38%, respectively, within a single trading day. In a recent interview, we discussed the appropriateness of these exceptionally strong reactions.

Further on in this letter, we introduce our new top 10 position, **Naked Wines**. Additionally, we added **Endor** to our portfolio last quarter. Even after posting exceptional gains during the previous year, Endor is still flying under the radar of most investors, and its long-term potential remains underestimated in our view. In the coming weeks, we will also publish a case study on Endor and tell you more about how they bring the experience of racing into the living room.

The shares of both companies had already doubled and tripled, respectively, in the last year alone before our entry. We do not find it easy not to be influenced by this development. Due to our general contrarian attitude, we often prefer to acquire companies during crises or negative overreactions. However, ultimately it is the price we pay today that counts, and we firmly believe that in both cases it does not come close to reflecting the potential of the companies. Above all, we believe that both companies benefit from a strengthening of existing trends and that these developments are sustainable.

Thoughts on the market environment

We watch with fascination how some stocks with already astronomically high valuations continue to rise further and faster. Today, at the latest, many of these stocks are at levels that we find difficult to understand and increasingly no longer comprehensible at all.

Lured by the prospects of unsustainable returns and aided by the lack of alternative activities during the lockdowns, **private investors** are also increasingly participating in the stock market. Many are gambling as if they were in a casino. Companies with an interesting "story" and unprofitable companies have rarely been so popular. In fact, the shares of profitable companies have posted significantly worse relative returns in recent months.

In other respects, the signs of pronounced **bubbles** in some market segments are now increasingly difficult to ignore. Some of the best examples are provided by the hype surrounding **SPACs**. A SPAC is a special purpose acquisition company. It is a vehicle that raises capital with the aim of using it to acquire a company at a later date and take it public.

In many ways, SPACs are predestined to be bad investments (for minority shareholders). Negative characteristics include, for example, the extraordinarily high share usually allocated to management and the pressure to complete an acquisition within a predetermined time – the management team is incentivized to rather overpay than not complete a transaction.

Consequently, the performance of SPACs in the past has been, on average, disastrous. Nevertheless, 2020 was a record year for IPOs of such vehicles and, even crazier, many of the shares of these SPACs trade at a substantial premium to the money raised even before the announcement of a potential deal. After a deal is announced, prices still often skyrocket from these levels (especially if it's an EV company).

One of the most glittering examples is **Nikola** – a company with a plan to manufacture electric and hydrogen trucks. Despite having virtually no sales in 2020 and operating in a notoriously challenging industry, Nikola was valued at USD 34 billion at its peak. Even today, after Nikola's technology was "questioned" and founder Trevor Milton subsequently stepped down from his board position, the company is valued at over USD 8 billion on the stock market – just a third less than Traton, one of the world's largest truck manufacturers, which combines the MAN, Scania and VW brands under its umbrella.

The problem with such developments is that no one knows when a bubble will burst. Often, share price increases even accelerate before eventually reversing. This year, some of the wildest speculators enjoyed some of the most extraordinary returns. However, as always, the result of a single year has little overall significance and should also be assessed relative to the risk taken.

Contrary to these trends, however, there are also areas with **valuations that are still depressed** today, despite situations in which the companies may benefit more from a future economic recovery. In any case, we continue to see numerous opportunities in such a market environment.

We promise you one thing: **we will stay away from the euphoria and consistently pursue our strategy**, even if this means that our returns may not match those of some market participants at times (after all, Tesla's share – one of the poster children of the current euphoria in the market – posted a gain of over 700% last year).

So, what do we do if we can observe speculative excesses but also opportunities in the market? We could keep a higher proportion of our portfolio in cash, hope for a bubble to burst in the short term, *and* speculate that the prices of solid, well-managed companies will also be affected. Then we could invest the funds at lower prices.

However, today we can expect **long-term returns of 10-15% per year** with investments in select very well positioned and conservatively financed companies – an attractive rate of return, especially considering the alternatives and the general interest rate environment. From our perspective, it makes little sense to give up these expected returns. We will not speculate that *Mr. Market* will offer us even better opportunities in the coming months.

We are often confronted, especially in the recent volatile market phase, with the question of whether and when to invest in stocks. The first part of the question is quickly answered. For us, interests in companies (e.g. in the form of public equities) are a core component of any portfolio with the aim to build wealth over the long term. On the other hand, we don't find it very sensible to hold a high cash position with the main goal of hoping for a better entry point. We have summarized some further thoughts on this in the next paragraph.

On the last two pages you will find an overview of the performance since inception and the current portfolio.

Last but not least, we would also like to draw your attention to our new website. We welcome you to click on the link and are looking forward to your feedback. In case you like it, we would very much appreciate it if you share the link. We thank you very much for your trust and for your support. Please feel free to contact us at any time with questions or comments.

Sincerely, Yours,

Daniel Gehlen *Marc-Lennart Bräutigam*

Is Cash Always King?

Many investors prefer to hold back some of their cash in order to be able to take advantage of attractive opportunities in a sharp market downturn. The year 2020 is probably the perfect template for addressing the introductory question and perfectly illustrates one of the major problems. First, those who held some cash in March last year and then invested at low prices can consider themselves lucky today.

However, investors who pursue this strategy *pay* with the missed performance during the time they are not invested.

"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves." – Peter Lynch

Today, we expect an average annual return on our investments in the double-digit range. If we assume revaluations in the next five years – which we think are very likely – then our expected return is significantly higher. Of course, we could hold cash and hope to buy stocks even cheaper in a market downturn. But the cost of doing so would be very high. Our expected return would be reduced.

"I would much rather earn a lumpy 15 percent over time than a smooth 12 percent." – Warren Buffett

The attitude of holding cash for worse times in order to be able to make even more attractive investments is nevertheless very common among value investors. That's why we found the shift of a veteran of the industry all the more impressive. The Sequoia Fund is part of the "Superinvestors of Graham-and-Doddsville," whose success Warren Buffett wrote about in a 1984 publication. Warren Buffett even recommended that his investors invest in the Sequoia Fund with Bill Ruane in 1969, when he closed his investment partnership. The fund has significantly outperformed the overall market since its inception – for over 50 years. Sequoia's 2019 Q4 Investor Letter included the following:

"[…] the good news is that we've hedged out bets by taking one evolutionary step that the fund has been far too slow to embrace: running more fully invested."

"What we know for sure is that we would gladly trade worse performance in bear markets for better performance over full cycles. Over the last twenty years, a non-taxable Sequoia investor has earned 54% more money than a comparable investor in an S&P 500 index fund. Had Sequoia's cash position during this period averaged 5% of net assets rather than 14%, the investor would have earned over 80%."

Even when assuming that an investor can correctly assess a decline and take advantage of it without much emotion, we do not think it is a particularly good idea to hold back money for a possible entry in a market decline. However, we also think that this assumption is highly critical.

How many of the investors who held their money back in recent years out of fear of, or even hope for, a market pullback went on to invest at much lower prices in March? At the market's lows, did many then possibly say, "This is currently too risky" or "The market will fall even further" and then in May, after the first recovery, "The market does not reflect the economic development" or "There is a dangerous overvaluation, and we will see another sharp setback. That's when I get in."?

In hindsight, it seems clear that March was a good time to invest. However, actually buying is never as easy as it seems when reflecting on the past. Thinking back, there was a lot of uncertainty in March and we all felt a certain amount of panic. It's not easy to keep a cool head in these situations. Last but not least, the risk was actually higher.

Then there are those investors who actively steer the cash position to "minimize risk." They call it "de-risking" when they reduce their investment quotas in times of great uncertainty. The premise that this "sell-low-buy-high" behaviour is consistent with risk mitigation is incomprehensible to us. We find it particularly dangerous when the trigger for higher investment ratios is "lower uncertainty." For it is precisely then that prices are higher, and the actual risk of an investment is in many cases higher (due to the lower risk buffer), not lower.

Last year, too, there were quite a number of investors who were almost fully invested in the first quarter and then built up a cash cushion at the beginning of and during the second quarter.

“Never bet on the end of the world. It only happens once.”

These examples do not put to the fore their performance. But perhaps the bewilderment of many market commentators at the strong recovery of the stock markets and the premise that the market does not reflect economic reality can also partly be explained by the frustration of some market participants.

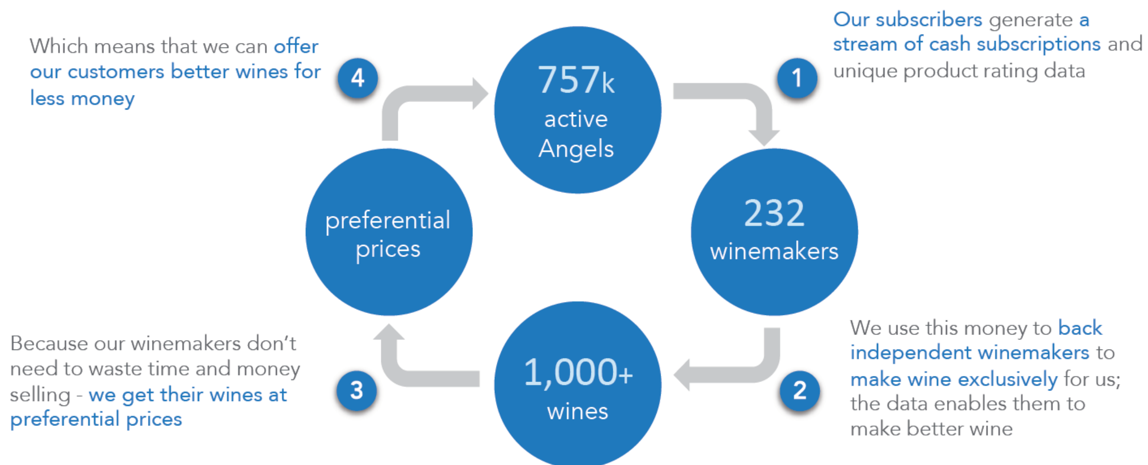
The basic expectation that weak markets coincide with weak economic numbers is, in our opinion, far too simplistic for such a complex system and contradicts financial history (in fact, correlations for the opposite are more likely to be found). To make fun of the disconnect between the two and assume that the entire market is missing something so obvious that it is pointed out by every "expert" and commentator can in many phases be naive.

Of course, it has its charm to make an investment when the uncertainty seems manageable and, at the same time, the market offers attractive prices. That is why this constellation in the stock market (as a whole) is virtually non-existent.

In summary, there is really only one reason for us to hold cash: And that is in times when we cannot find any investments that offer attractive returns with a manageable risk. That is certainly <u>not the case today</u>. For this reason, we are almost fully invested.

Naked Wines – it's wine o'clock again!
Naked Wines is a London-listed DTC (Direct-to-Consumer) provider of wine, founded in 2008. The company operates a platform that connects wine lovers directly with independent winemakers. By doing so, Naked cuts out layers of middlemen and saves the winemakers the costs (time and money) to market and sell their wines. As partners of Naked, they can fully concentrate on producing the best possible wines – a classic win-win.

A better offer, more convenience and a good feeling for the "angels"
Naked is not just another wine club in which customers pay a monthly fee to receive wine at market prices. Its business model, unique in the wine industry, allows Naked to offer better quality wines at lower prices to its customers.



Naked offers more than good value for money. Customers get the benefit of participating in an active community in which they can interact directly with winemakers and other "angels". Many thousands of customer reviews help them find the best wines, and Naked further supports them with a data-driven tool that recommends wines based on individual preferences - needless to say, these algorithms get better as the customer base grows.

Beyond that, the "angels" also get the positive feeling of supporting independent and talented winemakers. In fact, Naked has found that it is much more effective to attract new customers by showcasing each winemaker's story than by simply advertising "cheap and good wine". Being close to the winemakers also leads customers to enjoy their wine more consciously and, moreover, to know and be able to tell its story.

It comes as no surprise to us that in September 2020 Naked Wines was named **"Best Wine Club"** out of a list of the nation's top wine clubs by the magazine USA Today for the second year in a row.

A rewarding partnership and fewer headaches for winemakers
The monthly subscription fees of the "angels" are combined in a pool. From this, the winemakers can receive advance financing and thus limit their investment risk. This also gives them the opportunity to afford the best grapes and tanks/barrels to make the wine. In addition, and even more important in our view, Naked gives winemakers immediate access to over 750,000 customers with the knowledge of which wine tastes which customer and takes care of many administrative steps such as bottling, labeling and delivery of the wine, all with the cost benefits of a large organization.

All of this allows winemakers to fully focus on making the best wines possible using some of the best ingredients. As they already have the customers and ship directly – with Naked taking a small cut – winemakers can also offer better prices than through traditional channels (especially in the US), while making higher profits for themselves.

High profitability thanks to loyal customers, and a huge market
Although offering the wines at attractive prices, Naked is still able to achieve good margins and highly attractive returns due to the above-mentioned advantages of the business model as well as a lean, digitally focused organization. Since the subscription model pre-finances a part of the business activities, the balance sheet commitments are limited.

What we like a lot is the very systematic approach to acquiring new customers. Over the last decade, the company has tested an incredible amount to maximize the efficiency of its operations – down to seemingly small details like the color of the coupon sent to potential customers. Naked manages its operations along a small number of transparent KPIs. If return requirements are not met, marketing spend can be scaled down quickly. This limits the risk of value-destroying investments.

Naked attracts loyal customers through trust and quality service on one side and talented and renowned winemakers on the other. The platform and community that Naked has built over the years have created barriers to entry and long-term competitive advantages that are difficult to replicate by newly emerging competitors.

The world's biggest wine market, the US, is ripe for disruption!
Even though Naked is listed in the UK – where the company's origins lie – the biggest opportunity is in America. Already today, the US is the largest geographic segment, contributing ~45% of total revenue in 2019/20. The country also represents the fastest growing segment and offers the opportunity to accelerate growth in a $20 billion addressable off-premise market.

The U.S. wine market's specific laws create the ideal framework and provide additional competitive advantages for Naked. The so-called "three-tier system" mandates that alcoholic beverages in the U.S. must be sold through three different tiers: 1. importers or producers, 2. wholesalers/distributors, and 3. retailers. Since each tier takes a margin, the average price of a bottle of wine in the US is $15 and thus much higher than in Europe.

However, because of its classification as a winery, Naked is exempt from having to sell its wine through the traditional system. The company can distribute its wines directly to consumers in 43 US states. By bypassing the three-tier system and eliminating unnecessary costs, Naked can offer its wines at significantly lower prices than traditional retailers while earning higher margins.

The Corona pandemic has given the development towards online retailing a new velocity especially in the rather traditional US wine market. Since the outbreak of the pandemic, Naked has shipped one out of every five (!) bottles of wine in the USA. This puts the company in the pole position to benefit from the structural changes in the world's largest wine market.

Covid-19 – a strong but sustainable boost?
Unlike many other businesses, Naked Wines is benefiting from the restrictions which go along with the Covid-19 pandemic. Lockdowns are leading people who have never purchased wine online to experience the benefits of shopping online. This caused a major shift from offline to online channels. In the US, the market even experienced a 20-year channel shift in a single month!

Naked's management responded to this opportunity by increasing the investments in new customer acquisition and managed to grow its customer base by 37% to 757,000 active customers in the first half of 2020 (March to September). During the same period, **sales grew by 80%.**

The big question, of course, is how much of this development is attributable to an extraordinary one-time effect and will reverse once stores and restaurants reopen. In this regard, we are encouraged to see the first datapoints which suggest that customers acquired during the pandemic have similar characteristics to existing customers. In addition, Naked's growth rates have remained high even when stores reopened in the summer.

In our view, Naked's model offers a high value-add compared to purchasing wine through traditional channels and we are therefore confident that many of the "angels" acquired during the pandemic will remain loyal to the company. Naked is more than just an online wine store. It is a community where a loyal and engaged customer base meets independent and talented winemakers to share experiences and the passion for fine wine, with financial benefits for all involved. We will be watching closely to see if the company sticks to its DNA and stays true to its competitive advantage of being more than just an online wine store.

Value in an unlikely place
Today, Naked does not generate any meaningful profits. A fast-growing, unprofitable online business is not what you might typically expect to see in our portfolio, especially in a time when the demand for such business models among investors is huge.

We took a closer look at what profit Naked could generate if it stopped investing in growing its customer base and just invested enough to keep the number of customers constant. At the time of our entry, we expected that Naked could generate an EBIT of GBP ~30m in this way in 2022 already (when the Corona effects have normalized).

By comparison, Naked traded at an enterprise value of GBP ~290m. Paying ~10x EBIT for an excellently managed company operating in the stable and defensive wine sector is not expensive if the results can only be kept stable. However, considering Naked's tremendous growth opportunities, the high profitability of the growth and its current competitive advantages, we believe that the price we paid was very cheap.

Even after the share price has already risen decently after our entry, we believe that investors are undervaluing the quality and prospects of the business.

All three tranches of our fund are currently open for investment:
The -S- tranche is closed to new investors. Existing investors can order additional fund units with a minimum investment of EUR 10,000. The -R- tranche can be invested in without a minimum investment amount. In the -I- tranche, the minimum investment amount for new investors is EUR 200,000. Existing investors in the -I- tranche can order additional fund shares without a minimum amount.
You can find the respective tranche using the following **security identification numbers**:

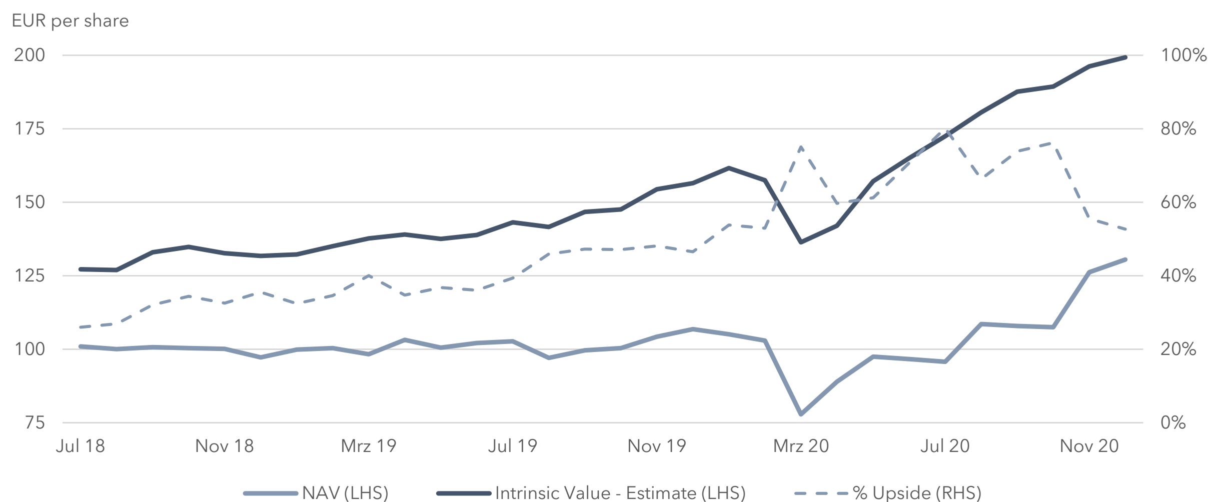
-S- Tranche: A2JF8Z **-R- Tranche: A2JQHQ** **-I- Tranche: A2N811**

Net performance figures (including distribution), after deducting all costs, the -S-, -R- and -I- tranches:

	-S- Tranche	-R- Tranche	-I- Tranche	MSCI Europe S&M Cap
2018	-2.9%*	-2.5%**	-	-17.2%*
2019	+10.3%	+9.2%	+8.3%***	+30.6%
2020	+22.3%	+20.9%	+21.3%	+5.8%
Seit Auflage	**+31.1%**	**+29.0%**	**+31.4%**	**+14.4%***

* Since the -S- tranche was launched on July 2nd, 2018 until the end of 2018 (approx. 6 months). ** Since the -R- tranche was launched on September 7th, 2018 until the end of 2018 (approx. 4 months). *** Since the -I- tranche was launched on January 2nd, 2019 until the end of 2019.
Note: Due to the different starting times and fee structures, there may be deviations in the performance of the individual tranches..

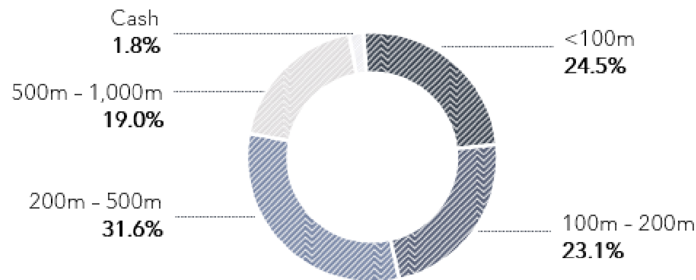
Development of the intrinsic value determined by us in comparison to the development of the current price of a unit (NAV) since inception:



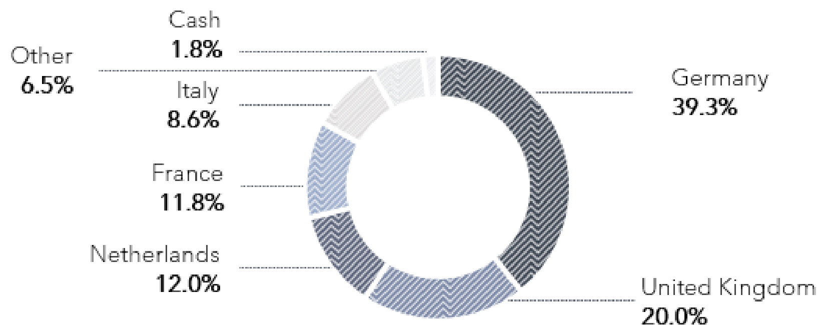
Top 10 positions with respective weightings as of December 30th, 2020:

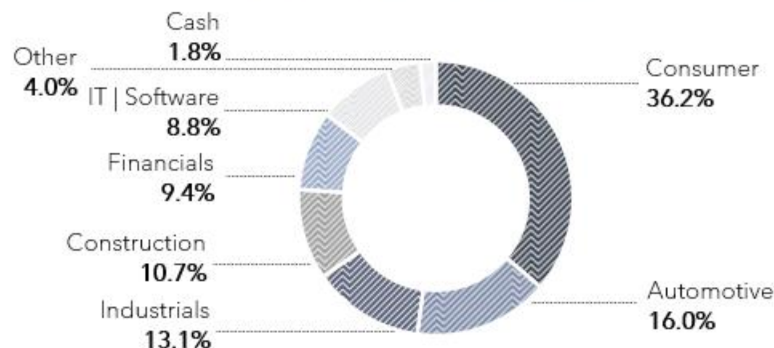
1	Akwel	8.4%	6	Naked Wines	4.9%
2	Sto	7.4%	7	Ferronordic	4.8%
3	The Gym Group	6.7%	8	SAF Holland	4.5%
4	Basic-Fit	6.4%	9	Italian Wine Brands	4.3%
5	Gamesys	5.0%	10	CIR	4.3%

Allocation based on free float market capitalization (EUR) as of December 30th, 2020:



Allocation according to country and sector as of December 30th, 2020:





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