ELCANO SICAV returned 24.2% so far in 2016. Since inception in December 2009, cumulative performance is 54.0%, net of fees and expenses, equivalent to a compound annual return of 6.4%.

The portfolio of 19 stocks trades at 7.7x 2017E earnings and 5.2x normalized, 1x book value and carries a 60% discount to our fair value estimate. We are confident that the combination of good quality and low price will translate into attractive compound returns over the medium and long run.

As there hasn't been any changes in the portfolio, we will share in this report the framework we employ in assessing an industry.

The central idea is that the "invisible hand" leads to a return equal to the cost of capital in each stage of the production structure. If it is higher it will attract new capital, and the increased competition will lower the return. The opposite happens when it is below: capacity is closed, softening competition and pushing up returns. It is important to understand that the adjustment process is not immediate, its speed depends on the time it takes to create or remove capacity and on how fast demand grows.

In investing, it is key to differentiate whether this imbalance is structural (as discussed below) or it is just a temporary phenomenon, as often happens with new technologies or in cyclical sectors. We can affirm that most things prove to be cyclical, in the sense that in the long run market forces prevail.

That said, it is a fact that some industries seem capable of consistently achieving returns above the cost of capital (called "economic returns"). The opposite situation of persistently subpar profits is quite exceptional and in most cases due to government intervention, as we have witnessed in the steel industry with the Chinese government keeping afloat loss making mills, although this is currently changing.

In ELCANO we think that there are three main factors that determine the structural profitability of any given industry:

1. **Vertical position in the value chain**.

   It is extremely difficult to make economic profits when selling to a concentrated clientele or buying from a monopolist supplier. An example is found in auto suppliers. Being generally oligopolies, they are forced by their concentrated customer base (the automakers) to lower prices to a market level.

2. **Rivalry**, or how easy and profitable it is to steal a customer, has two components:

   - The number of competitors, a function of barriers to entry, and collusive behavior. We distinguish between five markets:

     - Perfect competition. The typical situation, a fragmented market with no economic profits.

- Niche. Competition is softened with differentiation, as the customer becomes less price sensitive. An example is TimkenSteel, capable of obtaining superior returns to the commoditized steel industry by tailoring its offering to each client.
- Oligopoly: a limited number of competitors.
    - Generally speaking, when capacity is unlimited (as in telecommunications), profitability will be the same as in perfect competition. With capacity constraints, economic profits are achieved, as it is often found in the chemical industry.
    - However, frequent interaction and long term orientation make tacit collusion possible, even with unlimited capacities (aka Folk's Theorem).
- Dominant Firm. In some industries there is a low cost producer that has captured a large share of the market, becoming the price setter at a level where economic profits are achieved.
- Monopoly.

- Switching costs, such as:
    - Learning, searching, transaction or uncertainty.
    - Compatibility, as it is typically found in software.
    - Contractual, for instance loyalty programs.

  In the presence of switching costs, locked in customers are charged a high price and there is a fierce battle for new ones. The net effect is usually a relaxed level of competition because customers take into account total lifetime costs and thus become less sensible to poaching tactics via a low initial price, enabling companies to differentiate their offering.

3. Entry Barriers.

- Economies of Scale found in activities like capital expenditures, purchasing, R&D, technology, advertising or distribution. Scale advantages leads to the number of competitors being equal to the size of the market divided by the minimum efficient scale.

  As an illustration, the high capital intensity found in semiconductor manufacturing (with the cost of a single fab in the billions) acts as a powerful barrier to entry and results in an extremely concentrated market.

- Economies of Scope or Shared costs. Producing an additional different product reduces the average unit cost. This includes the savings that are realized by the customers (e.g. convenience) with a full line of products. It can be substantial in chemical companies capable of commercializing co-products or integrating into downstream applications.

- Permits.

• Cumulative investment or production, leading to a reduction in unit cost with learning (a powerful effect found in aircraft manufacturing) or to commercial differentiation as found in consumer goods.

• Reputation, a strong barrier to entry into professional services and other experience goods.

• Network economies both direct and indirect, that causes a market to tip towards a dominant firm (“winner takes it all”). Real Estate websites are a current example.

The combination of the above explain why some industries are capable of achieving economic returns and why it it is reasonable to pay a premium above replacement value.

A shift in one of the factors due to a change in the customer or technology can destroy the economic moat of an industry, create or strengthen it. So we should always be vigilant to change, even if it is slow.

Thank you for your trust and please do not hesitate to contact us should you have any queries.

All the best,

Marc Batlle, CFA
Partner

JJ Fernández
Partner

ELCANO SICAV

Global Value Investing

Adding Value Through Research

Report nr. 41 | Year VII | 1st November 2016

Net Asset Value: €15,22 euros (10/31/2016)
Source: Credit Suisse Gestion S.G.I.I.C., S.A.

Investment Approach

Elcano Inversiones Financieras, SICAV, S.A. seeks to acquire shares in exceptional businesses at a discount to its intrinsic value. Elcano looks for companies with a sustainable competitive advantage that we can understand, a strong financial position and an honest and skilled management team. Decisions are based on financial and strategic analysis, and we are not restricted to any particular asset class, geography or sector.

Comments on Recent Activity

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Top Holdings

Company	Sector
Chemours	Chemical
Eastman Kodak	Office/Business Equip
Worley Parsons	Engineering
Diamond Offshore	Oil & Gas Services
Vallourec	Oil & Gas Services

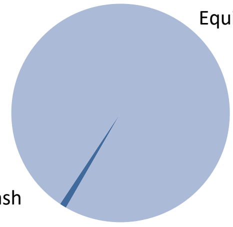
Portfolio Recent Actions

Increase/ In	Decrease/ Out
N/A	N/A

Main Terms

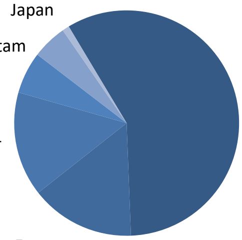
Investment Universe	:	Global equities
Asset Management Company	:	Credit Suisse Gestion, SGIIC
Depositary	:	Credit Suisse AG, Suc. España
Advisor	:	Batlle & Fernandez Partners EAFI
Auditors	:	Deloitte
Regulator	:	CNMV
Listed Market	:	*Mercado Alternativo Bursatil*
Management & Advisory Fee	:	1.50% per annum
Annual Performance Fee	:	10% above 5% level (with HWM)
Depositary Fee	:	0.075% per annum
ISIN Code	:	ES0118626037
Inception Date (new Board)	:	1st December 2009
Currency	:	EUR
Liquidity	:	Daily
Asset Under Management	:	€54,081,500 (10/31/2016)
Number of Shareholders	:	535 (10/31/2016)
Bloomberg Code	:	CIF SM <equity>
Ticker	:	S0646

Asset Distribution



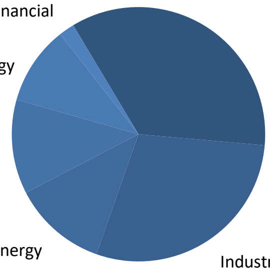
Asset Class	
Equities	100%
Fixed Income	0%
Cash	0%

Geographical Distribution



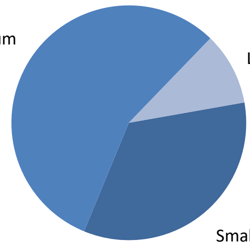
Region	
US	59%
Europe	15%
Asia ex-Japan	14%
UK	6%
Latam	5%
Japan	1%
Switzerland	0%

Sector Distribution



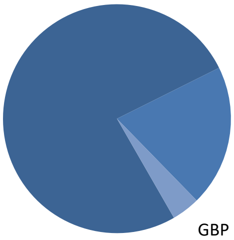
Sector	
Commodities	37%
Industrial	29%
Energy	12%
Consumer Cyclical	10%
Technology	10%
Financial	2%
Consumer Staples	0%
Insurance	0%
Telecom	0%
Utilities	0%
Health & Pharma	0%

Capitalization Distribution



Capitalization	
Below €1bn	34%
€1bn to €5bn	58%
Above €5bn	8%

Currency Exposure

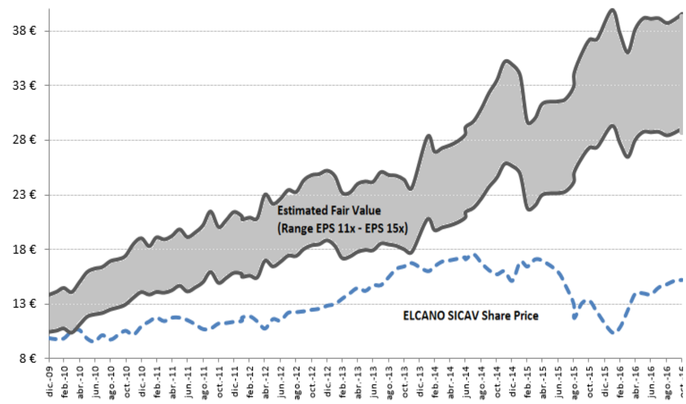


Includes FX Hedge	
EUR	78%
USD	18%
GBP	4%
CHF	0%

ELCANO NAV vs. Other Major Equity Indices

Source: Bloomberg (Last 5 years).

ELCANO Share Price Vs. Estimated Fair Value (Range PE 11x - PE 15x)



Source: ELCANO SICAV, Bloomberg.

Return and Volatility Data

Return	
2016 (Year-to-date)	+24.2%
Year 2015	-23.5%
Year 2014	-4.2%
Year 2013	+32.6%
Year 2012	+10.4%
Year 2011	+3.8%
Year 2010	+10.7%
Year 2009 (From 1st to 31st Dec 2009)	+0.4%
Since inception (1st Dec 2009)	+54.0%
Volatility	18.6%

Source: Credit Suisse SGICC, Bloomberg, ELCANO SICAV

Risk & Reward Profile (SRRI)

Lower risk ⟷ Higher risk

Potentially lower rewards — Potentially higher rewards

1	2	3	4	5	6	7

ELCANO SICAV's "SSRI" rating: **6** in a risk metric going from 1 up to 7.

The SRRI represents the risk and return profile present in the Key Investor Information Document (also called "DFI", or "Datos Fundamentales para el Inversor"). The lowest category does not imply that there is no risk. The SRRI is not a guarantee and may change over time. Current risk level based on the historical volatility data for the last 5 years.

Source: DFI Document ("Datos Fundamentales para el Inversor"); www.cnmv.es

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