Fairlight Capital November 06, 2024

Fairlight Alpha Fund LP

Q3 2024 Letter

Dear Partners,

Fairlight Alpha Fund's third quarter 2024 returns were -13.0% net of fees. This compares to 5.9% for the S&P 500 Total Return index. Overall, since inception the fund has returned 507.5% net of fees and 38.1% on an annualized basis.

Performance vs. the S&P 500

We track the net asset value of Fairlight Alpha Fund (the "Fund") over time as calculated by our fund administrator based on our portfolio positions and prices over time on a dollar basis. The fund financials are also audited each year by an independent auditor with the assistance of the Fairlight management company and the fund administrator.

The tables below show the S&P 500 total return and partnership net returns, after fees, for each year 2019-2024, followed by the compounded returns over the same period, as well as the annualized gains.

Annual Returns

Year		Fairlight Alpha Fund	S&P 500 (Total Return)	Difference
2019[1]	……………………........	38.1%	17.9%	20.1%
2020	…………………………	26.3%	18.4%	7.9%
2021	…………………………	146.5%	28.7%	117.8%
2022	…………………………	15.8%	-18.1%	33.9%
2023	…………………………	6.9%	26.3%	-19.4%
2024 (YTD)	…………………………	14.1%	22.1%	-7.9%

Compounded Returns

Year		Fairlight Alpha Fund	S&P 500 (Total Return)	Difference
2019[1]	……………………........	38.1%	17.9%	20.1%
2020	…………………………	74.4%	39.6%	34.7%
2021	…………………………	329.9%	79.7%	250.2%
2022	…………………………	397.9%	47.2%	350.7%
2023	…………………………	432.2%	85.9%	346.4%
2024 (YTD)	…………………………	507.5%	126.9%	380.6%
Annualized Gain	…………………………	38.1%	15.8%	22.3%

[1] The Fairlight Alpha Fund was launched on 01-Mar-2019 and so the 2019 performance and returns are presented for a 10-month period.

(1) The S&P 500 returns represent the total return index, i.e., with dividend reinvestment included. Increases in value arise from stock price appreciation as well as dividend reinvestment. This provides a fairer comparison to the fund.
(2) The Fairlight Alpha Fund performance is shown net of partnership fees and expenses.

The fund performed less well than the S&P 500 (Total Return) for the third quarter. Although the fund has subsequently recovered some of this performance. We will discuss further in the following sections and talk about existing positions and recent, new investments that have been made.

Market and Portfolio Performance

There was some volatility in the third quarter in micro caps and for the market in general, a repeat or rhyming of some of the effects in 2023 over the August-September period. We have a couple of ideas that didn't work out as well as we had analyzed, and others that did work out well. Unfortunately in this period the former outweighed the latter, but subsequently (as we will discuss further) several positions have performed extremely well for us.

In terms of existing positions two good performers for us were McCoy Global (MCB.TO) which has continued to execute well. In spite of some reports from the company about additional requirements from the market, they have continued to innovate and have remediated versus these requirements and continued to improve sales and earnings (particularly earnings). We believe this company is a great long-term prospect and although it is a more capital intensive, hardware business it has highly valuable and largely untapped data assets in the form of the drilling data that it captures through some of its new technologies (such as the smarTR™ product suite). And their increasing de-correlation from oil prices is also becoming clearer to the market.

Overall the market has continued to perform and reach new highs. In spite of this we are still seeing many areas of good value (in sectors and specific companies). Some are in North America, others in Europe and Asia. In some ways volatility and uncertainty has helped us as volatility in the lead up to the US election, and movements in equity and commodities markets have created what we believe are mis-pricings in the market.

Gone Fishing

Others have used fishing as a metaphor before, and it is useful. It requires patience, and it's important to try and fish in as many places as possible, but also being mindful to fish where the fish are (or search for investments in the right places, i.e. markets and sectors). The US is becoming a more expensive market overall, although there are small pockets of value in the less discovered corners. Canada currently appears to present more opportunities, and again Europe and East Asia are also fertile grounds at present.

We have also had some recent success looking at less analyzed sectors, perhaps because Value or GARP investors have not historically favored these. As well as previous investments in financials, Citizens Bancshares (CZBS) being one of our favorites here, we have been looking at commodity or commodity-adjacent businesses. As stated above McCoy Global has been a successful investment for us, and we have also been building positions in junior gold miners. These are discussed further in the next section.

A Review of Some Specific Ideas

We recently discussed a new idea for us in a new sector, Monument Mining Limited (MMY.V). Gold has been rising in price for over 8 years now, with an acceleration in the last two. Commodity companies are often difficult long-term investments and have typically been avoided by Value and GARP investors, but the situation here is highly unusual. The underlying commodity price has risen by 134% over the last eight years and the sub-sector of junior gold miners has underreacted. For example, the junior miner ETF GDXJ increased by 36% over the last five years whereas gold spot price has increased by 84%. In fact the discrepancy is even larger, because the profit and value of a producing junior gold miner is proportional to the difference between gold selling price and AISC:

Profit($)production volume(oz) × (Gold selling price ($/oz) – AISC($/oz)[2])

Thus these companies have call option-like characteristics. Like a call option the upside is theoretically unlimited as the gold price rises, and the downside is limited to operating costs. The strike for the call option is where the gold selling price (the price of gold sales the company achieves) passes the AISC. The AISC is the company's estimate of all costs (including corporate) required to produce that gold. Multiplied by the production volume this gives a rough measure of profit before tax and then a multiple of this would imply the company value. Monument is one of the lowest cost junior miners, in part due to the local workforce at their mining operations in Malaysia.

So, in the case of Monument mining in 2018 the AISC was $957/oz and gold selling price $1,320/oz, or a net of $363/oz. Q3 2024 this had increased to an AISC $1,273, gold selling price of $2,097/oz and net price of $824/oz. Estimating selling prices now for the gold price as of the time of writing would be a net price of $1,227/oz. This would imply profitability has increased by 440% since 2018. While the price of Monument has increased since we first discussed, we believe there is still more room to run and that at current prices it's trading at a forward value to earnings of 3x (also factoring some increases in production that will come through their refinement of gold sulphide processing which is underway). Monument also has a great capital structure with no debt and shouldn't need to raise debt or equity in the current environment.

Commoditized businesses are disliked because of their lack of pricing power, but the flipside of this argument is the certainty of the selling price received. There will be no new competitor, change in technology or flood of product into the market (total gold production increases available gold by approximately 2%). And so the current gold price gives a guide to what is happening and what has already happened. Monument, and many other junior gold miners reporting up to 30 June, 2024 reported record cashflow generation. We already know that Q1 2025 (to September 30, 2024) saw gold prices 3% higher than the average in Q4 2024 (to June 30) and we are now over halfway through Q2 2025 with gold prices even higher than Q1 (by approximately 5%).

Our estimate of forward valuation is 3.0x (2.2x including cash balances). Part of this mispricing in our opinion is that the market is lagging the impact that gold prices will have in the last, current and future quarters, combined with increase in production. Monument mining has restarted mining production switching from gold Oxide to Sulphide production. This process is now largely complete and the next few quarters will see close to full production, which will highlight the level of cashflow production.

Another idea that has been overlooked outside of the gold sub-community is Serabi Gold (SRB.L), which is even cheaper at this point. This is a UK headquartered junior gold miner with operations in Brazil and listed in the UK (AIM) and US (OTC Markets). This company has been taking advantage

[2] All-in sustaining cost (AISC) is the total cost of producing the gold output that the company sells. In the case of Monument Mining this is gold concentrate sold to the market for onward processing.

of increasing gold prices and cashflow generation to accelerate production and bring forward growth capex, using free cashflow to expand. They are targeting increased production to 60,000 oz per annum from the current levels around 30,000 oz per annum. Another tailwind is the de-risking process the company has followed, with a lower-cost single processing plant at Palito being used, to the awaited decision on the Installation License at Coringa, where Serabi extended its current mining license by three years in January. If this permanent license is granted then Serabi's ownership of Coringa will be derisked and the implicit value to Coringa will increase by over $400 million.

Serabi had earnings of $5.6 million in the last announced financial quarter (Q2) and announced they now have cash balances of $20 million as of the end of Q3. This is after the acceleration of growth capex which has allowed Serabi to build out their classification plant at Coringa (crusher and ore sorter) which will improve the grade or ore and reduce transportation volumes to their processing plant at the Palito complex.

Serabi currently trading at C$1.63 (US$1.17) and market cap of C$124 million (US$ 89 million). Our estimate on a forward basis to 2025 this values the company at 3.5x and 2.3x (including cash). The company is on track to have over half its current market cap in cash in a little over a year with high levels of cashflow generation, and many avenues to grow production. Even if the price of gold was to fall significantly from current levels this business appears to us to be too cheap.

There is also another junior gold miner we are still building a position in that we will discuss in future letters.

As of the time of writing the post-election gold price fell and has then held above $2,550/oz which takes the price back to September 19, 2024. Reducing interest rates are likely to continue the bull market, but at current prices the above ideas still have a significant margin of safety.

Apple of Antarctica

"It's a cracked screen world" — Damon Albarn, Greg Kurstin.

Logic Instrument is a manufacturer and integrator, distributor of rugged laptops, tablet and smartphones headquartered in Igny, France that has operated since 1987 (ALLOG.PA). Their product lineup includes durable laptops, tablets, and smartphones engineered to perform reliably in challenging and extreme environments. These devices are tailored for industries such as defense, industrial sectors, and field services, where robust and dependable equipment is essential.

The company's offerings are known for their adherence to military and industrial standards, ensuring durability and reliability. Features of their products include outdoor-readable screens, long-lasting batteries with options for hot-swappable units, and customization capabilities to meet specific client needs. Their products meet a variety of standards such as MIL-STD-810, the U.S. Department of Defense Test Method Standard.

The MIL-STD-810 standard, officially titled "Environmental Engineering Considerations and Laboratory Tests," is a United States Military Standard that outlines a series of tests to evaluate the environmental durability of equipment. It encompasses a wide range of environmental stresses and conditions to ensure that materials and products can withstand the rigors of their intended operational environments.

The key environmental stresses and conditions covered by MIL-STD-810 include:

- Temperature Extremes: High and low temperatures, including rapid temperature changes (temperature shock).
- Humidity: Effects of high humidity and condensation.
- Altitude: Low pressure conditions simulating high altitudes.
- Rain: Exposure to rain, including wind-blown and freezing rain.
- Sand and Dust: Resistance to sand and dust ingress.
- Vibration and Shock: Mechanical vibrations and shocks encountered during transportation and operation.
- Salt Fog: Corrosion resistance due to salt-laden environments.

As an example the product Fieldbook P80 can operate at temperatures ranging from -20ºC to 60ºC, up to relative humidity of 95%, vibration resistance over a range of frequencies, rain exposure of 450 mm/hr, and dust concentrations up to 10.6g/m^3, and withstands drops from 1.2m. The company is now growing its own products (in the Fieldbook range) over distribution/integration of other manufacturers lines, which is likely to expand margins in the near future.

In terms of financials Logic Instrument has grown very quickly in the last twelve months. Partly this is due to the purchase of Elexo, which expanded their products, range of distribution and customer base with complementary business lines in rugged devices. But there is also healthy double-digit growth on internal sales prior to this purchase (revenue growth was 26% ahead of the purchase). This growth is still working through the financials, but revenue increased 136% in cumulative sales up to Q3 for 2024 as compared to 2023. Although the Elexo business has lower margins the leverage effect of the larger scale of the combine business has increased margins (from 5.3% to 7.1%). It appears likely that this trend will continue as the business grows.

The valuation of Logic Instrument is very cheap given the growth and runway for the company. It trades at the current run rate and price (as of the time of writing) at 5.3x earnings and 4.9x enterprise value to earnings (even after the Elexo purchase). The valuation combined with growth and business opportunities, appear far too cheap to us. The CEO Loïc Poirier has also stated that the target for revenue for full-year 2024 is 32 million Euros and he is targeting 50 million Euros revenue for 2025. This may depend on internal growth as well as additional opportunistic M&A activity, but if he is only partially successful Logic Instrument is extremely mispriced.

And Finally

We hope you find something of interest in these letters. Over time we will discuss ideas, markets, businesses and stocks. And of course if you would like to know more about Fairlight Capital, feel free to reach out to us. We wish everyone a happy and successful Q4!

Yours,

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AN INVESTMENT IN THE FUNDS IS SPECULATIVE AND INVOLVES A HIGH DEGREE OF RISK. OPPORTUNITIES FOR WITHDRAWAL, REDEMPTION AND TRANSFERABILITY OF INTERESTS ARE RESTRICTED, SO INVESTORS MAY NOT HAVE ACCESS TO CAPITAL WHEN IT IS NEEDED. THERE IS NO SECONDARY MARKET FOR THE INTERESTS AND NONE IS EXPECTED TO DEVELOP.

THE FEES AND EXPENSES CHARGED IN CONNECTION WITH THIS INVESTMENT MAY BE HIGHER THAN THE FEES AND EXPENSES OF OTHER INVESTMENT ALTERNATIVES AND MAY OFFSET PROFITS. NO ASSURANCE CAN BE GIVEN THAT THE INVESTMENT OBJECTIVE WILL BE ACHIEVED OR THAT AN INVESTOR WILL RECEIVE A RETURN OF ALL OR PART OF HIS OR HER INVESTMENT. INVESTMENT RESULTS MAY VARY SUBSTANTIALLY OVER ANY GIVEN TIME PERIOD.

THE PERFORMANCE DATA SHOWN HEREIN REPRESENTS THE PERFORMANCE OF THE FUND. THE RESULTS REFLECT THE DEDUCTION OF: (I) AN ANNUAL ASSET MANAGEMENT FEE OF 2%, CHARGED QUARTERLY; (II) A PERFORMANCE ALLOCATION OF 20%, TAKEN QUARTERLY, SUBJECT TO A “HIGH WATER MARK;” AND (III) TRANSACTION FEES AND OTHER EXPENSES ACTUALLY INCURRED BY THE FUND. THE RESULTS REFLECT THE IMPLEMENTATION OF THE INVESTMENT STRATEGY DESCRIBED IN THE FUNDS’ OFFERING DOCUMENTS AND APPLIED IN THE FUNDS’ TRADING ACCOUNTS. ALL INVESTMENTS INVOLVE RISK, INCLUDING THE LOSS OF PRINCIPAL.

RESULTS ARE COMPARED TO THE PERFORMANCE OF THE S&P 500 TOTAL RETURN INDEX (THE “COMPARATIVE INDEX”) FOR INFORMATIONAL PURPOSES ONLY. THE FUND’S INVESTMENT PROGRAM DOES NOT MIRROR THE COMPARATIVE INDEX AND THE VOLATILITY OF THE FUND’S INVESTMENT PROGRAM MAY BE MATERIALLY DIFFERENT FROM THAT OF THE COMPARATIVE INDEX. THE SECURITIES OR OTHER INSTRUMENTS INCLUDED IN THE COMPARATIVE INDEX ARE NOT NECESSARILY INCLUDED IN THE FUND’S INVESTMENT PROGRAM AND CRITERIA FOR INCLUSION IN THE COMPARATIVE INDEX ARE DIFFERENT THAN THOSE FOR INVESTMENT BY THE FUND. THE PERFORMANCE OF THE COMPARATIVE INDEX WAS OBTAINED FROM PUBLISHED SOURCES BELIEVED TO BE RELIABLE, BUT WHICH ARE NOT WARRANTED AS TO ACCURACY OR COMPLETENESS. UNLESS NOTED OTHERWISE, THE RETURNS OF THE COMPARATIVE INDEX PRESENTED HEREIN DO NOT REFLECT FEES OR TRANSACTION COSTS, BUT THOSE RETURNS DO REFLECT NET DIVIDENDS, IF ANY.

PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.