IMC INVESTORS MANAGEMENT CORPORATION

2017 Annual Review

The IMC Public Portfolio performed well in 2017 while maintaining a conservative exposure that averaged 71% net long throughout the year. The strong underlying return on capital deployed into long investments was reduced by negative returns from market hedges and a cash balance that ranged from 21% to 43% throughout the year. The market hedges remain in place going into 2018, with the portfolio currently 73% net long.

Below is a summary of the current holdings, which we view as a "conglomerate" of businesses rather than a collection of stock tickers:

Company	Category [1]	% of Portfolio	Owned Since [2]
Financial Services Firm	Reinvestment Moat	31%	2015
Internet Retailer	Reinvestment Moat	20%	2017
Software Company	Legacy Moat + Outsider	12%	2015
Media Company	Capital-Light Compounder	8%	2013
Entertainment Franchise	Capital-Light Compounder	8%	2013
Insurance Company	Legacy Moat + Outsider	8%	2013
Internet Retailer	Reinvestment Moat	7%	2017

(1) *Refer to Appendix I for definitions*
(2) *This date reflects the first purchase in the company by Connor Leonard. Purchases before 1/1/2016 reflect securities purchased in Connor Leonard's personal portfolio which pre-dates the IMC Public Portfolio.*

The Long Game

IMC is a privately-held company with internal capital, providing both the capacity and desire to invest in the public markets as a long-term business owner. This is exceptionally rare and enables everything we do as investors. We start with this advantage and work backwards.

We invest on a longer-term horizon because ***the playing field five plus years out in the public markets is far, far less competitive – giving IMC a much greater chance of success***. Rather than trying to be better than all our peers in a crowded game, we would rather play a different game with a higher probability of success. While this strategy is simple to explain, the key is that it is difficult for others to emulate.

Many investors claim to operate with a long-term view, but structural factors conspire against them, often creating an environment where looking out further than one year is impractical to impossible. The running joke is every investor is long-term oriented - as long as there is a catalyst in the next three to six months. This means the market for great ideas that will perform within one year is extremely competitive, with a concentration of immense talent and skills focused on this time frame.

The factors driving a stock's performance in the short-term are mostly ***external*** and relate principally to sentiment change on the security. It doesn't matter what the economics or long-term trajectory of a company are, but rather how it delivers against analyst estimates and the subsequent multiple change that follows. Not only is this short-term information the most sought after in the market, but with limited shelf-life the insights and securities must be recycled constantly.

If the investment time horizon is stretched out to years instead of months, the key variables begin to change. Multiples and sentiment are certainly a factor, but returns on a five to ten-year time horizon are primarily correlated with the performance of the underlying businesses. As a result, we prioritize factors ***internal*** to a business, principally focusing on a company's ability to reinvest capital internally at high rates for many years. These factors are often overlooked by the market, and insights tend to be durable, meaning a handful of them can prove to be profitable for years.

	Peers	IMC Portfolio
Time Horizon	<1 Year	5-10 Year
	↓	↓
Key Factor	Multiple Expansion, Sentiment Change	Business Performance
	↓	↓
	ROIC irrelevant	*ROIC crucial*

We believe the "long game" is the best advantage in the public markets currently, and this edge should sustain or widen over time as the market's focus continues to shorten. This approach aligns with IMC's structure, as well as my skill set and personality, and gives us the best chance of compounding capital at high rates going forward.

Portfolio Review

Investing Like an Industrialist

The IMC Public Portfolio has no restrictions on geography, sector, security type or portfolio construction. My mandate is to invest exactly as if it's my own money, which can be three stocks, three hundred stocks, or no stocks. Operating with the ***mentality of a private industrialist investing their own capital*** is a luxury compared to peers who are constrained by various silos, benchmarks, and parameters. This flexibility, if paired with a commitment to the process of constant improvement, should result in an informed allocation of capital to the best possible opportunities – regardless of whether the investment fits neatly into a style box.

As an example, while attending the *Daily Journal* meeting in February, I became interested in China given how profusely Charlie Munger was encouraging investors to spend time studying the country. Many investors nodded along to this sentiment, but did not explore it further, because they work at a fund where China or International is outside their mandate. I decided to dive in head first, going through a "China month" where I read a Chinese annual report each morning, books about China each afternoon, and spoke with several investment and operating professionals from China along the way. I emerged six weeks later fascinated with the country, and excited about one company in particular which became a new holding later in the year.

Fishing in International Waters

One of the big themes of 2017 was exploring, researching, and ultimately investing in international markets. Currently 39% of the IMC Public Portfolio is invested in international securities, up from 11% at the start of 2017. In addition to that trend, over half of the annual reports I read this year were international, compared to nearly all domestic in 2016.

I have a passion for studying and filtering exceptional businesses that reward their owners over many years. Many companies in the S&P 500 have characteristics we admire and study, however the market's focus, research, and attention continue to shift towards these mature bellwether companies. This collection of companies is undoubtedly the most efficient, competitive pond in the world. You can still catch a good fish in there, but you will be elbowing your way through a crowded throng of the world's best anglers to do so. To counter this trend, we focus our effort and attention on investing in companies that are earlier in their development – in the "minor leagues" so to speak. Our goal is to use these major league businesses as templates or case studies to help filter and identify companies that have the potential to deliver exceptional results for years to come.

Our investment in zooplus AG in early 2017 is a good example of putting this philosophy into action. Prior study of Amazon, Costco, and others influenced our investment in an obscure German company with less than €1 billion market capitalization. Going into 2018, I am excited about and deeply researching two exceptional Nordic companies - each with a market cap less than €1 billion. Over time the IMC Public Portfolio will likely continue to trend towards smaller and more international companies where we can apply our investment filters to less efficient markets.

Financial Services Firm (FSF)

After a healthy appreciation in 2017, Financial Services Firm (FSF) has grown into its current position as 31% of the portfolio. Even for a concentrated investor, this is a large position and merits some further discussion.

While the seven businesses in the IMC Public Portfolio receive daily price quotes, we view them in the same manner as the private businesses that IMC owns. With exceptional economics, strong trends in operational KPIs, and a fortress balance sheet FSF is the best and least risky business the portfolio owns – the "crown jewel" subsidiary. ***If FSF was a private subsidiary of IMC, you would have to pry it out of our hands***. This applies to our efforts as public investors as well. We would only consider selling FSF if the operations or industry materially changed, or if Mr. Market offered a mouth-watering, irresistible price – which would need to be far above where the stock trades today even after strong appreciation in 2017.

Instead of selling FSF entirely, what about trimming the position? It is common for investors to trim successful holdings simply because they have grown too large. Selling part of a company that is performing exactly in-line with the investment thesis, has years of high growth ahead of it, and is operating with momentum makes no sense to us. So far this year, Lebron James is having one of his best seasons statistically, with high outputs in points, rebounds, and assists. Because he is playing at such a high level, should the Cleveland Cavaliers deliberately reduce his role on the team? Of course not - penalizing excellent performance with less play makes no sense in sports, and we don't think it makes sense in investing either.

While most of the investing world favors activity, we only make investment actions if we have absolute conviction that they are necessary. In absence of that, our default is to simply do nothing. In the case of FSF, we have never sold a share and have no immediate plans to do so.

Market Hedges

One of the larger investments in the portfolio is not a company, but a hedge against the broader market. Throughout 2017, but especially in the middle and back half of the year, we became uncomfortable with the valuations and general absence of risk present in the public markets. I have no opinion on 2018 specifically, but my general view is index investors should expect lower or even negative forward returns over the next five or so years given the starting point and trends in valuation, interest rates, and availability of capital. Combined with some insights we receive on financing and valuations through our private investing, I decided it was prudent to reduce exposure to the general market.

One means of doing this is simply selling the existing long positions and raising cash levels. The businesses in the portfolio were performing well, and all had unrealized gains, so the idea of selling pieces of them and paying taxes just to hopefully buy them back later did not sit well. Instead, I determined the best approach is to offset our concentrated portfolio of core long positions with selective hedging. I view this "long-biased" mindset as a means of reducing overall market exposure during a frothy period without becoming a major detractor from our efforts of finding and owning great businesses.

Just a few weeks ago the Wall Street Journal ran an article titled "*As Stocks Reach New Highs, Investors Abandon Hedges*" which included the phrase "more investors are concluding that paying for hedges is a waste of money". A recent BusinessWeek article stated, "it's clear that fear of missing out – FOMO – has jumped to the top of the fear charts". While the financial news is currently full of unbridled optimism, we plan to maintain the market hedges into 2018 with the goal of protecting capital when the sentiment inevitably turns.

New Investments

zooplus AG

Founded in 1999 and headquartered in Munich, Germany, zooplus AG is Europe's leading online retailer of pet products. Pet food, which is over 80% of zooplus' sales, is a recurring, habitual purchase with little variance. With zooplus, customers can skip the drive to the store and avoid carrying a bulky bag of food to the car; opting instead to receive packages right at their door within 1-2 days with free delivery over €19 - €29.

In a recent survey, 95% of respondents considered their pets part of the family. Spending is following suit as pets increasingly receive the comforts matching their human companions. This broader trend towards the "humanization" of pets results in a resilient €26 Billion pet market in Europe that is growing 3% per annum. Within this recession-resistant and growing end market, purchasing online is structurally taking share from brick and mortar and should continue to do so for years to come. Currently ~8% of pet products are purchased online in Europe, compared to less than 2% in 2010, and we believe penetration will work towards 20%+ over time. ***zooplus is the beneficiary of these converging tailwinds, growing revenue at a 31% compounded rate over the last three years.***

Operating as a pure internet retailer, with no storefronts, gives zooplus structural competitive advantages against brick and mortar incumbents. While grocery stores typically offer 100 – 200 pet products, zooplus carries over 8,000 covering an array of niche, specialty, and premium products in various sizes. Pets at Home, a specialty retailer in the UK similar to PetSmart, generates 97% of revenues offline and is forced to sell at a 54% gross margin to cover the high overhead from a broad store base. Online-only and hyperefficient zooplus can sell profitably at a 25% gross margin, often undercutting prices by 20% - 30% on key items.

zooplus dominates the European market for online pet products, with market share exceeding 40% in each year since going public in 2008 and currently standing at 50%. Importantly, management is working to constantly widen this moat, incorporating the "scale economies shared" approach coined by investor Nick Sleep. This operating model, made famous by Costco, involves sharing the efficiencies of increasing scale with the customers in the form of lower prices. It takes an unusual management team to adopt this philosophy, however a long-term, owner mindset is embedded in the culture of zooplus.

Founder/CEO Dr. Cornelius Patt put this model into action, with zooplus lowering gross margin 1,000 basis points over the preceding five years in a pro-active effort to widen the company's moat. Despite these efforts, zooplus is currently operating at all-time high EBIT margins thanks to efficiencies gained along the way from increased scale. Customers clearly value this approach, with order rate, basket size, and retention rate at all-time highs and new customer growth accelerating in Q3 2017.

The big concern of course is "what happens when Amazon decides to crush zooplus?" What most investors miss is that Amazon has been attempting that for years, selling pet products online in Europe since 2005. Despite these efforts, zooplus has over 3x the market share of Amazon and the company is growing 18% - 29% year-over-year in Amazon's strongest European markets (Germany, UK, France). Broadly speaking Amazon goes after either large markets (U.S. Grocery) or high-margin markets (auto parts retailers). The online pet product market in Europe is neither, and the "scale economies shared" approach discourages new entrants by keeping the overall market's profit pool smaller in size. As a focused vertical, we believe zooplus will continue to compete effectively against a generalist in this attractive growing market for years to come.

In April 2017 Chewy.com, an almost identical online pet specialist focused on the U.S. market, was acquired by private-equity owned PetSmart for $3.35 billion. This was the largest acquisition in the history of eCommerce, with a valuation of **2.2x forward sales**. Currently zooplus trades for **0.90x 2017** sales and **0.75x 2018 sales**, a discount of 60%+ compared to a recent comparable transaction by a sophisticated buyer. As a testament to the attractive valuation zooplus currently trades at, CEO Dr. Patt purchased almost $2mm USD of shares in the open market in October 2017.

Why are the shares so cheap? Structural factors play a large role, as zooplus is a German company, with less than €1 billion market cap, thin float, and barely any coverage in the U.S. capital markets. This is a company that flies under the radar and is out of reach for many larger or domestic focused funds.

Additionally, by employing a "scale economies shared" philosophy, zooplus is consciously sacrificing current profitability to widen the long-term moat. While this approach ultimately rewards long-term shareholders, the immediate effect is a 1.8% operating margin which makes current EV/EBIT multiples look astronomical. As zooplus continues to scale, logistics costs should trend from ~20% of sales to 15% - 17% over time. Combined with continued efficiencies on fixed costs, EBIT margin should trend towards at least 5% as zooplus grows sales to €2 billion+ by 2020.

Even with extremely low margins today, zooplus earns a 36% return on capital employed (ROCE) because it's efficient model turns over capital 20x per year. If the company can maintain capital efficiency while attaining the long-term EBIT margin potential, ROCE should trend towards 100% - an enticing prospect when combined with high growth. For investors willing to take the 2020 view, a 10% yield on today's enterprise value seems very fair for a rapidly growing Reinvestment Moat.

2018 Goals

I consider 2017 a marked improvement in both investment process and idea generation. My primary objective at the outset of the year was to find one to two new investments that were "punch card" quality. To accomplish this, I prioritized deeper forms of research, and set the goals of reading 100 annual reports and 25 books for the year. All internal goals were met or exceeded in 2017, including two new investments. Going into 2018, my process goals remain the same, with an additional target of meeting with at least ten business professionals. Conversations with knowledgeable operators typically yield durable insights on business and industries, and hopefully setting and tracking a goal will encourage more of them going forward.

Closing Remarks

No review of 2017 is complete without some thoughts on Quinton Maynard, our Chairman and CEO who unfortunately passed away in September. Outside of my family members and my wife, no one has impacted my life more positively than Quinton. To call him a boss, co-worker, or even a mentor is a vast understatement; Quinton was more like a big brother.

Despite this loss, my mission at IMC remains the exact same as the one I outlined a year ago:

"I am extremely appreciative of the opportunity that IMC and Quinton have given me. I want nothing more than to put together a stretch of incredible results that benefit IMC shareholders and prove that Quinton made a wise decision."

Best,

Connor Leonard

January 28, 2018

Appendix I: Category Definitions

Legacy Moat – Returning Capital
These businesses have an entrenched position within current markets that enable strong and consistent profitability ***relative to the prior invested capital***. However, there are few opportunities to deploy incremental capital at similarly high rates, so the management team elects to distribute the majority of earnings back to the owners at the end of each year. Well known examples include Coca-Cola and Hershey's. Both companies have protected and predictable earnings, but without compelling investment options they justifiably distribute over 80% of earnings to investors through dividends. These are wonderful companies, but with limited growth opportunities they are not a good fit as a Core Holding.

Legacy Moat – "Outsider" Management
This group of businesses has all the characteristics of a Legacy Moat, but the management team decides to ***retain all of the capital and deploy it into new businesses through a focused Mergers & Acquisitions program***. The home office effectively serves as an internal private equity fund, using the permanent capital supplied by the operating companies to fund a disciplined acquisition effort. William Thorndike's book "*The Outsiders*" does an excellent job of detailing these unique management teams with a talent for capital allocation. When the right businesses are paired with an exceptional capital allocator, the result can be remarkable compounding of shareholder capital. If I find a Legacy Moat – "Outsider" Management run by a world-class capital allocator, and with a long runway for acquisitions, the company is a candidate for a Core Holding.

Reinvestment Moat
This is the rare company that has all the benefits of a Legacy Moat along with ample opportunities to ***deploy incremental capital at high rates within the current business***. At the end of each year the profits are simply plowed right back into growing the existing business, simplifying the task of capital allocation. Reinvestment Moats tend to have self-reinforcing business models, such as scale advantages or network effects, which widens the company's competitive advantage over time. The best example is Wal-Mart in the early 1970's, when there were only 51 locations and the company was aggressively growing. Today the company has 11,000 locations, and both sales and net income are up over 5,000x from 1972 levels. An emerging Reinvestment Moat, with a proven model and a long runway for expansion, has the potential to be an exceptional Core Holding.

Capital-Light Compounder
These businesses can increase revenues and earnings over a long period of time while ***requiring minimal or zero incremental capital investment***. Typically, the competitive advantage for these businesses is rooted in intangible assets or network effects, so future growth is not contingent on large capital expenditures. As these businesses grow, they are also able to distribute a very large amount of cash to the owners - a dream combination. Prominent examples include See's Candies, Visa, and Moody's. If I can acquire a Capital-Light Compounder, with industry tailwinds and shareholder-friendly management, it could be an ideal Core Holding.