Original Purchase, Reinvestment, and Exit

Lucara Diamonds (LUC:TO) is a Canadian company which owns and operates the Karowe diamond mine in Botswana. We originally purchased stock in November 2015 for an average price of $1.85 CAD, and we reinvested in March 2017 for an average price of $2.70 CAD. We exited the position in September 2019 for an average price of $1.15 CAD. We received a significant amount of dividends over the time we held it. Specifically, we received a net total of $0.64 CAD per share on our first tranche of stock and $0.22 CAD per share on our second tranche of stock.

Why We Sold

There were two main considerations behind why we've decided to finally sell Lucara Diamonds. Firstly, even after they have changed their mine contractors (twice!) and seemingly brought the mine back to full utilization as of the end of 2018, the performance of the mine has remain below par in 2019, and revenue has remained below its 2015 and 2016 highs. Revenue and income have suffered now for three years already, and they do not seem to be improving. This adds to a string of execution misses: the failed Lesedi La Rona auction (including that they concealed that the highest bid at auction was actually from Lucara themselves!), the repeated delay of the Mineral Resource update from late 2016 until June 2018, the concomitant delay in the Feasibility study on underground mining from 2017 to (supposedly) late 2019, repeated guidance revisions, and the quiet dropping of the scheduled Pre-Feasibility study in favor of moving directly to a Feasibility study.

Some of these execution misses are more serious than others, but together they speak to some level of poor management, and a few actually indicate untrustworthy management. Which brings us to our second, and more important, reason that we sold Lucara, namely that we have lost faith in management.

In February 2018, Lucara acquired Clara in a related-party transaction (which is always at least a yellow flag) and removed the previous CEO (William Lamb) in favor of Eira Thomas, a co-founder of Lucara and an owner of Clara. Clara was supposed to offer a revolutionary new method of selling diamonds, by matching mine inventory to demand from diamond cutters and manufacturers. The potential buyers upload their requirements for what type of polished diamond they are seeking and at what price, the mines upload their inventory and what they would accept for them, and Clara sits in the middle, analyzing the rough and matching the correct rough to the highest offer.

We were skeptical of the related-party transaction, the CEO coup, and Clara from the start, but we chose to give Clara and management some time to prove themselves. The time since has done nothing to improve our confidence in Clara or in the new management. Clara does not appear to be showing any sign of significant volumes or market traction despite having had a year-and-a-half to start showing results. In the first half of 2019, Clara held five sales totaling only ~3% of their revenue over that time. Nor have the sales been on an increasing trend, with sales split basically evenly between the first and second quarter. We have also yet to see any uptake from third-party mines. We suspect that Clara is a distraction to management from their core business.

Mistakes We Made

We believe we made two errors in our handling of the Lucara investment. Firstly, we should have <u>sold this investment back in mid-2016, when the stock price came within striking distance of our then-</u>

assessed intrinsic worth. In general, we believe in holding on to our winners so as not to cut off gains prematurely and so as not be constantly involved in emotion-laden second-guessing. Therefore, we generally do not sell for purely price-related reasons, unless either the stock price has hit our assessment of intrinsic value or if an Annual Reassessment finds the valuation gap between stock price and intrinsic value to be no longer appropriate for the Fund. Please see our Strategy Paper from Q4 2017, titled Disciplined Selling, for a fuller discussion of our selling philosophy.

Despite our continuing to believe this general approach correct, we have come to realize that pure so-called value plays differ from regular companies in that they are not growing their business or otherwise improving their intrinsic worth over time, only unlocking value that is already there. Lucara is a resource company with one mine with a relatively steady valuation, and it is not and was not improving its intrinsic worth over time. Contrary to our regular practice, in such a situation, we should not have tried to squeeze all the value out of the stock. Especially without a clear and present upcoming catalyst to unlock the remaining value, we should have chosen to leave some money on the table and exited the investment when the value gap narrowed and the stock price approached close to our estimate of intrinsic worth, even if had not quite reached it.

Selling in mid-2016 would have given us about a double on our investment in less than a year. Failing to sell then was our first and more serious error in our handling of Lucara, and I take full responsibility for this mistake. I sincerely hope this is a lesson I do not have to relearn.

The second error was waiting too long to finally sell the stock after having started to sour on it towards the beginning of 2018. I firmly believe in erring on the side of inactivity, and prefer taking time to make decisions instead of acting in haste, but nevertheless, I believe we should have acted a bit sooner than we ultimately did. We should have sold towards the beginning of the second or third quarter, instead of the end of the third quarter as we actually did. I continue to believe in taking time to make decisions, and I continue to prefer to err on the side of inactivity, but I hope to calibrate a tiny bit towards the direction of taking action for the future.

Results

The end result of our investment in Lucara was a loss in dollar terms, even when adding back in the hefty dividends we received while holding the stock. This is especially so on our reinvestment in 2017, which was made at a higher price. However, as we started to sour on the stock in the beginning of 2018, we stopped reinvesting in the stock. This caused the stock to have less of a percentage impact on the Fund as it dropped, due its lower weighting in the Fund. Overall, due to this disparity in weighting, with Lucara having a higher weighting when the stock was doing well and a lower weighting as the stock fell, Lucara overall contributed positively to the Fund's percentage returns, despite the loss in dollar terms.

Despite Lucara's positive contribution to the Fund's performance, we consider it a disappointment and are disappointed in our handling of it. We hope to learn from this experience and become better investors going forward. The saying goes that a wise man learns from other people's mistakes and a fool does not learn even from his own. Although we have not risen to the level of the wise man to avoid the mistakes in advance, we hope we can still avoid the fool's fate and at the very least learn from our own mistakes for the future.