Monash ABSOLUTE INVESTMENT COMPANY

Monash Absolute Investment Company Limited

Monash Absolute Investment Company Limited (ASX: MA1) **3 January 2019**
December 2018 End of Month Update

In the interests of keeping the market fully informed of performance on a timely basis, we release a preliminary estimate of the Pre-Tax Net Tangible Asset Backing per share. It is only a guide, the official NTA will be released later in the month.

We estimate that as at 31 December 2018 the NTA Pre-Tax was $0.8602.

Company Strategy

The Company is benchmark unaware, style and stock size agnostic, both long and short, and only invests in compelling opportunities. In keeping with the Company's absolute return objectives, if the investment manager cannot find stocks that meet the very high return hurdle requirements, the Company will preserve that capital in cash at bank.

Monthly Commentary

For the month of December, the pre-tax NTA was down -8.39% (after fees) compared to the S&P/ASX200 down -0.12% and the Small Ords which was down -4.18%. Financial year to date the portfolio is down -11.64% (after fees) compared to -6.83%% and -12.75% for the two indices, respectively.

It has been a tough month for the portfolio, however, there was no significant company news impacting the stocks held in the portfolio. In fact there are virtually no company specific news flow at all. Rather, continuing market concerns about the potential for a recession combined with thinner trading volumes saw a number of stocks in the portfolio pullback this month.

We continue to see this as a correction in valuations and not the commencement of a prolonged bear market. We are excited about the opportunities that the pullback has presented. We are currently researching a number of stocks where the pullback has provided ample opportunity for a favourable entry. In addition, a number of our current stocks should have major catalyst events over the coming months.

Company at a Glance 31 December 2018

ASX Code	MA1
Portfolio Size	$38.6m
Share Price	$0.715
Shares on Issue	44.3m

Estimated NTA (unaudited) 31 December 2018

Estimated NTA Pre Tax	$0.8602

Return Estimate to 31 December 2018

	NTA Pre Tax
1 Month	-8.39%
3 Months	-14.11%
6 Months	-11.64%
FYTD	-11.64%
1 Year	-14.07%
Since Inception p.a. (April 2016)	-2.71%

Portfolio Structure 31 December 2018

Outlook Stocks (Long)	19 Positions	66%
Outlook Stocks (Short)	1 Position	-3%
Event, Pair and Group (Long)	8 Positions	42%
Event, Pair and Group (Short)	1 Position	-6%
Cash		1%
TOTAL		**100%**
Gross Exposure		117%
Net Exposure		99%

For more information about the Company and the strategy, please refer to the Monash Investors website at www.monashinvestors.com. You can also follow us on Livewire here or subscribe to our updates he

Our View on the Macro

We see the current pullback in the equity market as a valuation correction and not the beginning of a prolonged bear market. The basic reasoning behind this view is that we do not believe a recession is likely to occur. Yes, growth is moderating, yes, there is talk of increasing interest rates, trade wars and the like, and yes, there is significant geopolitical uncertainty. We watch all of these indicators closely.

However, the fundamental economy remains in decent shape. Specifically, employment remains robust, inflation is contained and the fiscal positioning of Government (Federal and State) is sound. In short, recessions do not tend to happen against this economic backdrop. Central Banks are tightening policy right now, but should the real economy start to weaken, this approach will be reversed. No Central Bank will decidedly drive the economy into recession.

In Australia, the issue causing the greatest concern is the housing market downturn and the prospect that it will drive the economy into a recession. Housing prices are down 10% or so across Sydney and Melbourne (significantly less in other parts of the country). At first glance this is alarming, but on closer inspection it is not as bad as it seems. It is not due to oversupply or a decline in underlying demand (we suspect that millennials are cheering from the sidelines). Critically, it has been a significant tightening of credit by the Banks that has driven the decline in the housing market. This is important because if the housing downturn was driven by either supply or demand issues it would take time to resolve. However, tightening credit is a policy decision and can be changed in an instant. Evidently, the Banks have tightened credit in response to the Royal Commission and prudential moves made by APRA and the RBA to limit interest only and investor loans. Moving forward one of two things will happen, either 1) the housing market will get used to the new normal with regards to credit standards, or 2) credit standards are relaxed to some degree as the Banks.

APRA and the RBA have zero interest in driving the economy into a recession. On the 19th of December 2018, APRA announced the removal of the interest-only benchmark for residential mortgage lending, demonstrating this point.
The construction industry remains robust with various Governments undertaking significant infrastructure projects. The consumer is weak due to the valuation impact of the downturn in the housing market. However, employment is solid and, as outlined above, we believe the housing market will stabilise. The rural sector remains weak due to the continuing drought conditions, however, it has been in this state for some time and therefore not an incremental negative.

In the USA, GDP growth has been well above trend as the economy was supercharged by tax cuts. Naturally, growth will moderate from the current inflated levels. However, the employment market remains strong, corporate earnings are also solid, and inflation is contained. The wild card is of course the trade tensions with China. Politics is extremely unpredictable, and this uncertainty breeds volatility in equity markets over the short term. Everyone has a view on the Trump Administration, but perhaps the only certainty is that Trump does not want to be a 1-term President. Running for a 2nd term after putting the economy into a recession on the back of a trade war would be extremely difficult. We therefore believe that the trade tensions will be resolved.

The other factor that concerns the equity market is understanding what the Federal Reserve will do with interest rates. It seems fairly obvious that the Fed will react to the data as it comes out, as it has already been doing, given the strength of the US economy. We are therefore confident that the Fed will reverse its currently tightening bias if the US economy needs it. In the first comments by a Fed policymaker two days after the December rate hike, NY Fed

President Williams said on CNBC[1] that "the Fed's choice of the word "judges" for the statement reflects the notion that the outlook of the Federal Open Market Committee (FOMC) officials is subject to change, and that the current stance is not a commitment or a promise in any way…the Fed's baseline is for a strong economy going into 2019, and emphasized that officials are listening carefully to markets (and hearing concerns about a possible slowdown)...there are no plans to make changes to balance-sheet approach, but said this could change of circumstances warranted."

In China, GDP growth has been easing back for some time but remains healthy in the high 6% range. For any other country on Earth this growth rate would be viewed extremely favourably, so it is therefore interesting that the equity market tends to view this level of GDP growth for China as a negative. Ultimately, as the Chinese economy continues to rotate towards more services and high value added industries, GDP growth will moderate. Then of course there is the base effect. China is no longer a developing economy and growth rates will naturally moderate. As usual, with China, there are a range of negative and positive economic data points currently. It is a difficult economy to read. However, what we do know is that the Government has demonstrated repeatedly that they are prepared to intervene whenever required. Bloomberg noted that following the annual economic meeting of the country's top leaders, China said "significant" cuts to taxes and fees will be implemented in 2019. Also said monetary policy should be "prudent" and strike an "appropriate" balance between tightening and loosening[2].

At this stage, it appears that the trade war with the USA is having a greater impact on China. The Chinese therefore have an interest in resolving the trade issues and as outlined above ultimately so do the USA. Over the Xmas New Year's break, we note several newspaper articles and social media posts from both the Chinese and the Americans pointing to progress being made.

In the UK, the BREXIT negotiations have proceeded poorly, with all sides appearing to be driven by ideology positioning rather than finding a compromise solution (a common trait amongst politicians globally). It is unclear how BREXIT is to be implemented and a bad outcome could have negative impacts on the UK economy (the 5th largest in the world). However, common sense should ultimately prevail as there is no reason why day to day functioning of the UK and European trade should be any different pre or post BREXIT.

Portfolio Commentary

We would stress that there is only one position in the entire portfolio where the investment thesis is based on favourable macro conditions, and that is Emeco Holdings Limited (ASX: EHL). EHL's outlook is dependent on the demand for construction equipment (see commentary below). For the other positions in the portfolio, the outlook for the business is largely idiosyncratic and dependent on a range of business specific milestones, for example, product rollouts; geographic expansion; major contract wins, operational improvements.

Across the portfolio, with the exception of one stock, there was no negative news flow of any kind. The one stock that did have negative new flow was Eservglobal Limited (ASX: ESV) (portfolio weight of 1.5%) which reported some slippage in the timing of contracts that will see some revenues fall into next year instead of this year.

[1] https://www.cnbc.com/2018/12/21/cnbc-exclusive-cnbc-transcript-new-york-federal-reserve-president-john-williams-speaks-with-cnbcs-steve-liesman-today.html

[2] https://www.bloomberg.com/news/articles/2018-12-28/pboc-chiefs-warn-monetary-policy-won-t-ease-as-much-as-some-hope

Emeco Holdings (ASX: EHL) fell 21.6% and was a major negative contributor this month. The fall in the share price is unrelated to the underlying business, which continues to perform well. The feedback we obtained from the company indicates that utilisation remains strong. Even more importantly, as equipment is coming off lease, it is leased out again at higher pricing due to strong demand. The balance sheet is in sound shape and management is highly regarded with a proven track record. We have seen a number of broker reports on the company this month all expressing the same points. Yet the share price fell 21.6% during the month and places the stock on a 2019 PE ratio[3] of 7.6x and an EBITDA[4] multiple of just 3.5x.

Afterpay Touch Group Limited (ASX: APT) was also a meaningful negative contributor down 14.0% for the month. This poor performance was driven by 2 factors: 1) the general market de-rating of growth stocks due to the misplaced macro fears we discussed above, and 2) various negative newspaper articles concerning regulatory risk. APT continues to achieve extremely strong growth rates in Australia and while it is early days in the USA the start has been spectacular. We remain confident that APT will continue to grow strongly especially as the millennial cohort increasingly enters the workforce. We have modelled APT extensively and given the operating leverage in its business over time, any valuation questions will be put to bed. For more information on our views on APT please refer to our blog available on our website at this link.

On the issue of regulatory risk, we note an alarmist approach by newspapers to APT that demonstrates a thorough gap in understanding of the APT product. ASIC completed its review of the ‘by now, pay later’ arrangements in November 2018[5] and concluded that all that is required is the industry to be brought under its supervisory powers. In other words, APT got a clean bill of health as it should. A consumer simply cannot get into a debt spiral using APT. As soon as a consumer falls behind on any payment their account is suspended, there is no interest charged. If a consumer can’t pay, APT writes the debt off. Even better, the likelihood of increased debt write-offs is negligible due to APT’s limits on transaction amounts per consumer.

Lovisa Holdings (ASX: LOV) fell 21.6% during the month. Back in October at its AGM management indicated that like for like sales growth had stalled, largely on the back of the exceptional strong growth over the previous few years. However, the real driver of earnings in LOV is the store rollout program, particularly in the new and massively larger markets of the USA, UK, France and Spain. Each one of these markets has the potential to be larger over time than LOV existing Australian operations. This is why we are invested in LOV and expect strong earnings growth over the foreseeable future. The share price has also been negatively impact by the general market aversion to retail stocks and its high valuation multiples. It is now trading on a 2020 PE of 15x, we believe is very attractive given its growth outlook.

A number of other stocks in the portfolio fell on light volumes, demonstrating the lack of confidence in the equity market. Obviously, market sentiment towards growth stocks is negative at the moment. As outlined above we do not believe a recession is likely and ultimately the performance of the actual businesses we have invested in will prevail over market sentiment. We monitor these unfolding events closely, and if required we will revisit to best position ourselves to benefit from the current market volatility.

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[3] PE ratio is calculated by dividing the current market price of the stock by its earnings per share (EPS).
[4] EBITDA is earnings before interest , taxes , depreciation and amortization
[5] ASIC report 600 Review of buy now pay later arrangements https://asic.gov.au/regulatory-resources/find-a-document/reports/rep-600-review-of-buy-now-pay-later-arrangements/

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Below is a table of the five largest positions in the portfolio and consensus estimates for Revenue and EBITDA.

	2018	2019	2020	Growth Yr1	Yr2
Revenue (A$m)					
EML Payments (ASX: EML)	71.0	83.7	95.9	17.8%	14.6%
AfterPay (ASX: APT)	142.3	241.4	462.3	69.7%	91.5%
Lovisa (ASX: LOV)	217.0	243.7	284.4	12.3%	16.7%
Nearmap (ASX: NEA)	53.5	73.8	94.7	37.9%	28.4%
Emeco (ASX: EHL)	381.0	513.4	565.4	34.8%	10.1%
EBITDA (A$m)					
EML Payments (ASX: EML)	20.9	26.9	33.2	28.8%	23.4%
AfterPay (ASX: APT)	33.8	37.1	93.9	9.7%	153.2%
Lovisa (ASX: LOV)	58.3	61.5	72.4	5.5%	17.7%
Nearmap (ASX: NEA)	4.9	15.5	27.6	219.5%	77.6%
Emeco (ASX:EHL)	153.0	230.6	261.6	50.7%	13.4%

Source: Factset

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