NAOS Ex-50
OPPORTUNITIES
COMPANY LIMITED

ABN 49 169 448 837

N A O S

Level 34, MLC Centre
19 Martin Place
Sydney NSW 2000

T (02 9002 1576
F (02) 8215 0037
E enquiries@naos.com.au

www.naos.com.au

ASX Market Announcements

ASX Limited

20 Bridge Street

Sydney

NSW 2000

26 March 2020

Letter to Shareholders – COVID-19 Update.

Please find attached letter to shareholders from Sebastian Evans, Chief Investment Officer, NAOS Asset Management Limited, discussing the impact of COVID-19.

Laura Newell

Company Secretary

Authorised for ASX release by the Board of Directors of NAOS Ex-50 Opportunities Company Limited.

NAOS ASSET
MANAGEMENT
LIMITED

ABN 23 107 624 126

N Λ O S

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26 March 2020

Dear Fellow Shareholders,

The global events that have occurred at rapid pace over the past few weeks have led to unprecedented government policy action from major economies, including the US, UK, China and Australia among others, aiming to prevent a significant peak in COVID-19 cases and avoiding a situation where hospital systems are completely overrun and unable to treat all patients. These policies will leave many businesses across a diverse range of industries experiencing a significant reduction in revenue, or in some extreme cases no revenue at all, potentially for the next 2-6 months. We believe it will be completely irrelevant for investors to focus on a company's short term (6 months) earnings profile, in our view the next 6 months will be about a company's liquidity and solvency profile or to put it bluntly 'the ability of the company to survive'.

Within this letter I want to convey what we are seeing at a company specific level across our portfolios, as well as highlighting all the variables that I believe investors will should try and understand before making any new investment decision. I also want to share how we are positioning the portfolio to ensure that it performs well post this pandemic, as investors who went through the GFC would understand, many equities went down at a similar rate but not all recovered at the same rate for a variety of reasons.

Many of our investors would be aware that NAOS prides itself on providing investors with a long-term, concentrated exposure to Australian undervalued listed micro, small and mid-cap companies with an industrial focus. Key to our investment process is a focus on the balance sheet flexibility and cash flow generation of each investment so that they can continue to operate during times of unforeseen market stress such as the situation we are currently in. We are generally fully invested through a market cycle, but we firmly believe that on a look through basis (i.e. looking through to the balance sheets of our respective investments) our overall portfolio structure is more conservative than many would be aware. At all times we aim to minimise the potential for permanent capital loss across our investments.

We will not be commenting on when we believe a recovery will occur and whether this will be a protracted or a sharp V-shaped recovery, simply because there are too many unknown variables to consider. Such variables include the timing of when COVID-19 cases will start to reduce daily and the subsequent timing on the relaxing of recently enacted government shutdowns. In addition to this, it is unknown what effect the fiscal and monetary policy responses will have on the long-term and short-term growth prospects of the domestic and global economy.

It is important for us to remain rational in such extreme and unprecedented times. Any sudden and substantial changes to the portfolio structure may well lead to significant permanent capital loss as well as a reduction in the ability of the portfolio to generate what

we believe should be meaningful returns when conditions start to normalise. Our core focus is to ensure that all current investments have the means to remain liquid and solvent for the foreseeable future and make it through to the end of this pandemic. Business that can do this will find themselves in a much stronger position compared to those that are unable to do so and will reap the benefit of highly accommodating fiscal and monetary policies. As closed end company structures, the NAOS Listed Investment Companies (LICs) do not face the redemption risk that a traditional open ended managed fund may do in times such as these, and as such we are not forced to sell of any of our investments during a time that could be devastating to the long-term performance of the LICs.

It is also worth noting that as a large shareholder, and sometimes the largest shareholder in many of our investments, the NAOS investment team have frequently engaged with the management teams and/or Boards of all of our investments over the past few weeks. This provides us with granular insights into the changes taking place within the respective companies and the contingency plans being prepared and/or implemented to ensure these companies survive.

NAOS directors, staff, family and friends are amongst the largest investors within the three LICs and will remain aligned with all shareholders.

An investor update (webinar) will be held on the 8th of April at 11:00 am (AEST), where all investors are welcome to join as we provide a brief presentation and Q&A session, the event details and registration can be found on our website https://www.naos.com.au/investorupdate.

Finally, if you wish to read on, the investment team and I have put together some thoughts around:

- Key Economic and Business Issues to Consider
- Current Portfolio Structing
- Company Specific Variables to Consider for Survival
- Recovery

Thank you for your continued support and stay well,

Sebastian Evans

Managing Director and Chief Investment Officer

NAOS Asset Management Limited

Key Economic and Business Issues to Consider

Timing of a Reduction in COVID-19 Cases

Governments around the world are being very pro-active in trying to flatten their respective curves in relation to how many new cases of COVID-19 are recorded daily. The policy action taken to date has been enacted with a view to reduce the amount of new cases recorded daily and therefore the amount of people who may require hospital treatment at any one time. Based on commentary from the Australian federal government to date it is expected that the current policies that have been implemented to reduce the number of new cases may well last for 6 months.

Business Liquidity and Solvency

Given the current situation, we believe it will not be surprising to see many businesses experience a minimum 20% fall in revenue for the last quarter of the financial year with an as yet unquantifiable effect into financial year 2021. This is regardless of whether or not a business is directly or indirectly affected, with many businesses hardest hit experiencing an 80% or more reduction in revenue. This reduction in revenue will put a strain on business cash flows as companies must still meet their ongoing obligations regarding their fixed overheads. It is not unrealistic to think that businesses that operate in industries that have been hit hardest such as aviation, tourism, hospitality and gaming will be in cash burn mode even if they have been able to implement a reduced cost base structure. Businesses will require ample liquidity to fund these cash outflows until the current situation normalises. If businesses do not have the means required to meet these requirements, then we will ultimately see a number of businesses become insolvent. We have already started to see several well-known businesses such as Webjet Limited (ASX: WEB), Flight Centre Travel Group Limited (ASX: FLT) and oOh!media Limited (ASX: OML) looking for alternative ways to raise liquidity.

Bad Debts/Counterparty Risk

As per the above, if businesses are unable to meet their short-term creditor requirements then this may lead to a number of creditors not being paid either in the short term, or at all. Such an event can have a multiplier effect as creditors of all types i.e. financers or even suppliers will be more reluctant to do business and will instead look for ways to conserve cash. This may lead to businesses in all industries experiencing an increased level of bad debts in the short and medium term.

Unemployment

One of the most significant unknowns is what effect the virus will have on unemployment levels both domestically and globally. Already we have seen major businesses lay off thousands of workers whether they are full-time, part-time or casual. Part-time and casual workers are often the most financially vulnerable in society and may not have the funding to meet their basic needs for a prolonged period of unemployment. This can lead to reduced consumer spending in highly discretionary areas as well as a significant increase in bad debts for companies that operate in the consumer finance space (such companies NAOS does not invest in).

Government Relief and Stimulus Measures

Again, a significant unknown and one which is arguably the most important variable to understand is how the government will assist business and people in getting through this period of significant stress and uncertainty. We have already seen 2 stages of economic response from the government together with a significant monetary response from the RBA. The government has stated a 3rd economic response round will be coming, but in what size or shape is unknown. Many pundits have been calling for so called 'helicopter money' for consumers and small business and this may well prove to be the type of stimulus that is most effective and required in the short term. The longer the virus impacts society, the more cash consumers and business will require to meet their ongoing liquidity requirements, and this cannot be limited to tax relief.

Current Portfolio Structing

As mentioned, we firmly believe a significant majority, if not all, of our investments will make it through this highly uncertain and volatile time. Even so, this does not necessarily mean they are the most ideal investment for what may occur following this pandemic.

When looking at the investments across all 3 LIC portfolios, just four positions have an overall net debt position and one of these is backed by a substantial property portfolio on an LVR of under 40%. All investments, apart from one, are in a positive cash flow position, and all but one investment is profitable.

Importantly, when looking at our industry exposure, the investment portfolios of the LIC's have no direct exposure to the following industries:

- Aviation
- Gaming
- Retail
- Hospitality
- Consumer Finance

With regards to tourism, we have a direct exposure through Experience Co. Limited (ASX: EXP) which has been a recent addition to the portfolios. Clearly EXP will be hit hard due to a lack of inbound and domestic tourism. We remain comfortable that with a solid cash balance as at the end of 1H FY20, undrawn debt facilities and a significant asset base worth $80 million, the company will be able to make it through even the most difficult of times. Just this week EXP has been forced to close almost their entire network of skydiving operations and Great Barrier Reef cruises due to the heightened restrictions. One of the characteristics that attracted us to the EXP business was the highly variable cost base, which can be significantly reduced in times such as these and preserve the balance sheet as best as possible.

There are several companies within the portfolios that we believe will be somewhat resilient to the extreme external factors that are currently occurring. The most notable of these is MNF Group Limited (ASX: MNF) which has been a core holding across the portfolios for a number of years. MNF released a trading update last week which re-affirmed guidance and

stated that "there is strong demand for core products across its three operating segments". We believe that if these trends were to continue, we may see MNF exceed their earnings guidance for FY20. Secondly, we expect BSA Limited (ASX: BSA) to be a beneficiary via their exposure to the National Broadband Network (NBN). As a majority of the population will be staying at home over the coming weeks and months, the demand for high speed internet has never been greater due to a mix of people working from home, children attending classes via the internet and a general increase for streaming services as people look for more ways to keep occupied. As BSA is 1 of the 3 providers to the NBN for its network operations and maintenance, we believe the demand for such services will be significant and should be a tailwind that should boost the future recurring revenue profile of the business.

Many equities have been sold off indiscriminately and are down 30-40% from their CY20 highs, even those that were considered to be high quality businesses just 4 weeks ago. If the opportunity presents itself to acquire what we believe are the highest quality businesses with proven business models, some of which operate in duopoly type industry structures, at valuations that are more appealing on a risk adjusted basis than what we currently hold then we will look to transition out of select existing positions and acquire new ones. It is imperative that we structure all our portfolios in the way that we believe is best suited for the new future we may face.

Some examples of companies that in our view are high quality and as at the 24th March 2020 have fallen significantly from their CY20 highs include Reece Limited (ASX: REH) -31%, Lifestyle Communities Limited (ASX: LIC) -49%, EVENT Hospitality and Entertainment Limited (ASX: EVT) -57%, Magellan Financial Group Limited (ASX: MFG) -53%, and Adelaide Brighton Limited (ASX: ABC) -51%. Not all of these will be ideal candidates for our portfolios, but all could be considered leaders within their respective industries and are businesses that many would expect to be around for years to come as well as continuing to increase profitability over the longer-term.

Company Specific Variables to Consider for Survival

Demand for Products and/or Services

We are witnessing huge fluctuations in demand across certain categories. Since 2016 NAOS have compiled a newsletter called CEO Insights (subscribe here) that is shared with our investment community on a weekly basis. The newsletter contains a selection of comments made by Company CEO's, these comments are helpful in providing ourselves and our investor base with a reliable look-through into individual sectors and the overall economy. During the past week, there have been a significant number of company updates which have allowed us to gain important insights into the current impact of COVID-19.

Starting with the beneficiaries, the most obvious seem to be the sellers of consumer staples, in particular supermarkets. Brand Banducci, CEO of Woolworths, recently commented that they *"have recorded more sales in the last week than we would in the week before Christmas."* There have also been other beneficiaries, with Telstra CEO Andy Penn noting that they have seen an increase in *"demand being seen in the enterprise market for upgraded capacity and mobile broadband in the consumer and small business market."* The demand for streaming services such as Netflix has increased to the point where Netflix have agreed with the European Union to reduce streaming quality to preserve network capacity. The shift to a

nation working from home has also benefited JB Hi-Fi who said that they have seen increased demand for *"technology products that enable remote working, learning and communication, and essential home appliances for food storage and preparation."*

A further flow on effect comes from the implications of a lower Australian dollar. The Australian dollar recently traded below parity with the New Zealand dollar for the first time since it was floated. When global growth is strong and the Australian dollar is low, it has typically buoyed demand for tourism and education. Obviously, this time around that won't be the case, but consider the possible competitive benefits for our largest export, being iron ore, which is priced in US dollars and has suddenly become much cheaper for offshore customers to buy.

Unfortunately, however, it appears the businesses negatively affected will far outweigh the beneficiaries. The most obvious initial impact is on the airlines and the travel industries with Alan Joyce, CEO of Qantas commenting that "*this is the worst crisis the travel industry has ever gone through."* Regional Express have cancelled all passenger air services with demand expected to *"nosedive to around 80% from the 60% we are experiencing today."* The impact has obviously also been felt across the wider tourism market. To put into context how unprecedented the current events are Chris Nassetta, CEO of Hilton Hotels commented *"Hilton has been around 100 years. We've never closed a hotel that wasn't going to be demolished or rebuilt. The bulk of our hotels in the major cities are closing as we speak".*

In the retail space, Russell Zimmerman, Executive Director of the Australian Retailers Association noted that *"early reports were that revenue across the board was down 30% for March compared to last year".* Given that retailers survive on small margins, it could mean that rent is not paid on time, and as a result we expect to see landlords come under pressure. We have since seen most of the large shopping centre trusts withdraw their earnings guidance. We are also witnessing the first stages of capital expenditure being reduced with two examples of this being Sydney Airport (ASX: SYD) and oOh!media Limited (ASX: OML) both announcing their planned spend would be significantly reduced, along with a number of Real Estate Trusts (REITs).

Recurring Revenue Base and Potential Variability

Over the past 12-18 months we have noticed a significant increase in the number of companies reporting 'annual recurring' revenue. The bulk of this has stemmed from newly created companies offering their products on Software as a Service (SaaS) business models, where their clients are charged a subscription fee. An example of this change has been the accounting software space, where Xero Limited (ASX: XRO) offers their accounting service entirely online, meaning easier integration with your accountant and easier compliance with any changes to taxation laws.

Following this significant shift in the revenue model, most of the industry now operates in this way, and we have seen numerous examples of companies adjusting their business model to a subscription-style offering. Not only does this benefit the customer, but also the company as they now have a more predictable revenue stream and they can become more fully integrated with their clients, who are then even more reluctant to switch providers. Pro Medicus Limited (ASX: PME) is another example of a company offering a very sticky subscription-style revenue stream. PME provide a tool for radiologists to view scanned images remotely with extremely high levels of quality. The contract with the hospital usually stipulates a minimum percentage of the total amount of scans each year to be viewed using

their technology. The sales cycle is long, but if a client wanted to leave, the switching costs would be very high, and the company estimates the process would take close to two years. This business model should provide investors with a high degree of certainty relating to future revenue streams.

With the increasing popularity of 'annual recurring' revenue as a reporting metric comes a possible muddying of the waters in relation to the revenue which can be considered long-term recurring revenue, and the revenue that can easily disappear. It is in economic environments like the one we are currently experiencing that we find out how recurring the revenue really is. Another example of a company who offers a recurring revenue service to business customers is Nearmap Limited (ASX: NEA). Nearmap provides geo-spatial mapping solutions for their customers via images that can be viewed over the internet with a high degree of accuracy. In our view, a small business customer is much more likely to cancel this service than they would their accounting software, and hence what looked like a recurring annual fee, could turn out to be a significant fall in revenue.

Fixed Cost Leverage

Fixed cost leverage can be a benefit to a company on the upside, however it can equally be a cause for concern on the downside. Today, companies in industries facing challenges can simply not shed cost quickly enough. The notion of 'getting very small very quick' is all about survival. The profit margin reduction that is experienced on a slowing top line and a fixed cost base can be drastic.

The rapid changes in economic conditions are such that the reductions in revenues are occurring at such a rapid pace that many fixed cost businesses will simply not be able to adjust accordingly to the new landscape and losses will occur very quickly. The make-up of a cost base will vary drastically from industry to industry, however those with a high percentage of staff costs are likely to have a higher degree of flexibility in terms of ability to reduce the cost base quickly, as are those companies which have a significant portion of their cost base geared towards growth initiatives as these initiatives can be quickly wound back.

All companies are likely to have a degree of costs which are fixed regardless of circumstances – rent, utilities, insurance, audit, utilities, etc, but those companies that can scale their cost base up and down with growth are going to stand a better chance of survival.

Balance Sheet Flexibility

A sound balance sheet has always been a core pillar of the NAOS investment process. Never has it been so important to judge a business on the cold hard facts of their balance sheet. In our view it will become binary, many companies will not survive this period, whilst companies that do survive will be those with enough existing liquidity and reserves to simply outlast the unknown duration of these unique circumstances and capitalise upon the opportunities on the other side.

When considering which existing balance sheets might survive this crisis, the following available pockets of liquidity to draw upon will be key:

- Cash – is king, it is times like these when we are most reminded of this. The more the better.

- Drawn Debt – whilst banks are likely to be lenient on covenants for a period, this cannot last forever. Given the already low interest rate environment, many companies were already highly geared. With many industries now seeing a significant/entire loss of revenue, the ability to service existing debt has become significantly more difficult. Debt levels have become an amplified problem without an immediate solution as equity markets generally are not yet willing to fund emergency capital raisings. Keep in mind that at their February 1H FY20 presentation, Webjet Limited (ASX: WEB) described their borrowings levels as conservative.

- Lease Obligations – whilst we would hope that landlords are providing flexibility, lease obligations will be one of the cash outflows that are hardest to structurally or cyclically reduce.

- Undrawn Debt – having a (relatively) substantial amount of incremental debt headroom available under existing facilities will be crucial for many companies going forward. Mindful of the abovementioned comments on drawn debt, any liquidity can be good liquidity. Obtaining a new debt facility and/or raising equity will be a lot more challenging, if not impossible until market conditions begin to improve.

- Assets – hard assets such as plant, property & equipment, possibly even account receivables, will become a valuable source of survival. If/when the banks are considering funding again, they will be looking for the highest quality security; hard assets. Furthermore, hard assets may end up being a valuable source of capital if they are sold, even at depressed prices, to ensure business survival. Event Hospitality and Entertainment (ASX: EVT) is an example of a company with a high-quality property portfolio, including some of the most premium land in Sydney's CBD. This likely provides a level of flexibility to the company and its lenders.

- Dividends – the reduction/cancellation in dividends is already being seen across the market. As an example, Flight Centre Travel Group Limited (ASX: FLT) have cancelled their interim $40m dividend, a responsible move given the revenue reduction they are facing. Whilst shareholders lose out in the short term, it is a responsible and effective measure to protect cash balances. If the company can survive, the long-term benefit of not paying an interim or final dividend is multitudes greater.

Recovery

We cannot say when a recovery will occur, but we do believe that a recovery will eventuate at some time in the future. Our focus at NAOS will always be on the stock specific opportunities that are presenting themselves to us at any given time.

To highlight an example of the movements we have seen within our portfolio, Enero Group Limited (ASX: EGG) has seen its share price fall by approximately 60% from its CY20 high. NAOS sold a circa 10% stake in the company just 6 months ago to several larger institutional investors. The business now has a market capitalisation of just $74 million or an enterprise value of just $60 million taking into account their net cash position of $14 million. This is a business that generated free cash flow after all capital requirements of $8.20 million for 1H FY20, which equates to a free cash flow yield of circa 25% on an annualised basis. Even if the revenue base was to fall by 50% and EBITDA margins from 16% to 10%, then the EV/EBITDA ratio would still only be around 4 times. Clearly public relations spend will be

reduced significantly in the short-term, but in our view, B2B PR will remain and Enero has a client base that includes some of the largest technology businesses in the world, such as Facebook and Adobe. As such, we believe it may soon be an ideal time for us to start to acquire some of the shares we sold at much higher levels.

There are many examples similar to Enero both within and outside of our portfolios. To try and remain rational in such extraordinary times I believe it is important to keep a simple and relevant framework. Investors must ask themselves that if a company's share price is down by anywhere between 25%-60% does this represent a fair reflection of the long-term value of that business? For share prices to remain at such levels over the long term either the earnings of the business would need to fall permanently by 25-60%, or the valuation multiple would need to fall by the same amount. As I mentioned earlier, no one knows how the earnings of a business will rise or fall over the short to medium term. Regarding valuations, it is somewhat easier to take a view, we believe interest rates will remain at record lows for the foreseeable future, which in theory should be positive for equity valuations over the long-term. If the wider market can start to see a base in a company's earnings profile, there is potential for a significant re-rate based on valuation differentials, especially for high quality and self-funding businesses.

The NAOS team and I will continue to communicate with all our investors on the developments we are seeing within the current portfolios as well as the actions we are taking to ensure we are ideally positioned for a post COVID-19 world.

NAOS directors, staff, family and friends are amongst the largest investors within the three LICs and will remain aligned with all shareholders.

An investor update (webinar) will be held on the 8th of April at 11:00 am (AEST), all investors are welcome to join as we provide a brief presentation and Q&A session, the event details and registration can be found on our website https://www.naos.com.au/investorupdate.

Thank you again for your support and stay well,

Sebastian Evans

Managing Director and Chief Investment Officer

NAOS Asset Management Limited

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