



QUARTERLY REPORT TO 31 MARCH 2018¹

Performance and net asset value²

Quarterly portfolio return: 6.80%

Despite overall lower equity markets during the quarter, especially in Europe, the East 72 Holdings Limited (**E72, Company**) portfolio gained 7.6% during the three months to 31 March 2018, prior to costs; after cost imposts the net return within the Company over the period was 6.8%.

E72's pre-tax net asset value ended the 31 March 2018 period at **29.2c**; after all accrued and deferred taxes, post-tax NTA is 30.0c.

As a guide, despite the difficult four month period E72 experienced between October 2017 – January 2018, the **gross** performance of the E72 portfolio, prior to costs, is still 24.9% since inception in May 2016.

Our austere warnings contained in the December quarter report came to pass during the past three months, albeit with a lag after an absurd burst of equity euphoria in January. Despite knowing that market participants dug themselves deeply into an overly optimistic strategy, it is still surprising to see the damage when indices and trends unravel. The shocked response by financial pundits to a spike in equity volatility (remember the chart from last quarter?) left me rather more dumbfounded than the spike itself; the impact on short volatility ETF's such as XIV which fell from \$115 to \$5 and liquidation in two days should have been well known. More pleasantly, we had two positions – Flow Traders (FLOW.AS) and Virtu Financial (US: VIRT) – which benefit from higher volatility and spiked 73% and 80% respectively over the quarter. We have sold FLOW but retained VIRT which is now our largest position. We showed in our investment presentation of 15 February 2017 how VIRT had triple leverage to increased volatility; VIRT's earnings power has increased further via the acquisition of the market making business KCG Holdings in mid 2017.

We also had useful contributions from our increased gold exposure – notably Ramelius Resources, but the largest overall addition to performance came from short positions in major market indices. On the flip side, a number of large US shares – notably Netflix, Amazon and Herbalife where we have short positions – detracted from performance.

As a result of buying back a number of index shorts, we are more fully invested than previously. However, this apparent enthusiasm for equities has two important caveats:

- We are net short US equities to the tune of about 44% of our equity base; this is comprised of short positions in three FAANGs³ – A,A, and N – along with significant index shorts across the three major US equity indices; and
- Our long positions across the portfolio – including those in the US – tend to be comprised of low-beta⁴ securities such as investment companies and family controlled enterprises trading at significant discounts to stated NTA or our evaluation of their net worth.

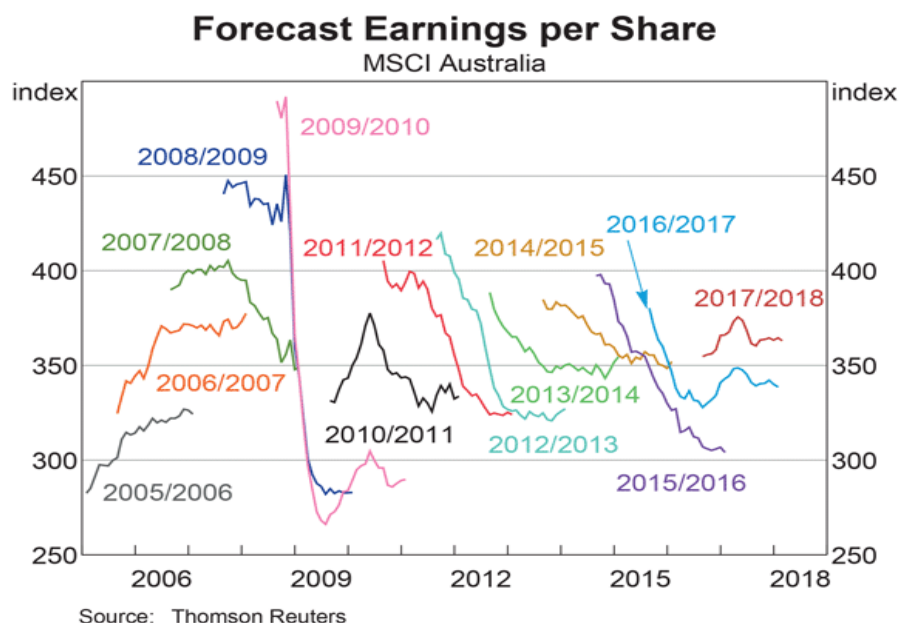
It is often the case in markets where earnings growth is hard to find, that significant bifurcation exists in respect of the pricing of shares. Investors chase high growth companies – often in newish industries – and neglect those enterprises with slower earnings, derating them down to often giveaway values. That’s generally not the case in the US at present where valuations of even mediocre businesses are generally high (think consumer products companies - still) but we are finding other markets where this phenomenon exists – including close to home. It’s why this quarterly has a large scale domestic focus.

Australia: a great example of bifurcation

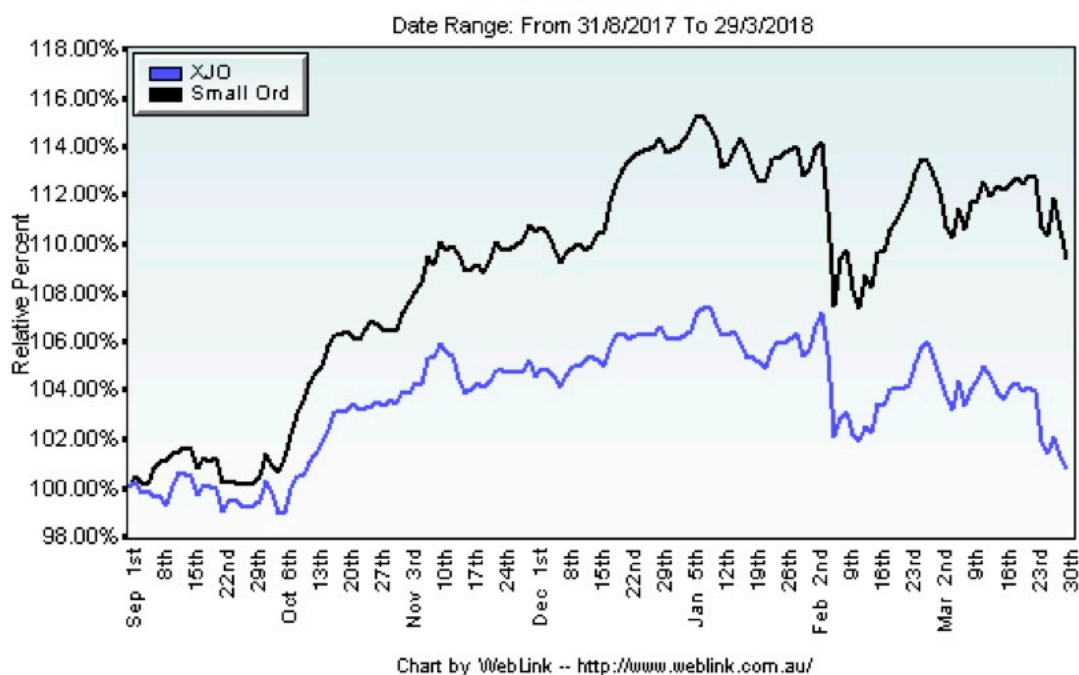
One of the overriding issue for domestic investors has been the inability of the ASX indices to come close to their pre-GFC highs reached in November 2007. There are several reasons for that:

- The indices at the time had a big component of REIT’s, many of which were decimated by their over-gearing and short term debt; remember, for example, the GPT you see at \$4.70 today is not the same GPT at \$5.00 in October 2007. You are actually down 40% in capital terms even if you took up the emergency 2008 rights issues (and 80% if you didn’t)⁵
- The proliferation of large capitalisation “financial services” businesses which went to God – Allco, Babcock & Brown, MFS and their associated vehicles; and
- Large companies which were so overvalued at the time, they haven’t been able to make it back – Telstra, Wesfarmers, Brambles et al.

One of the issues faced since that moment in time is that Australia has turned into a high cost, high compliance arena, but where real growth is extremely hard to come by. Where it exists, these areas have become inhabited by overseas entrants (financial services for one) and technology has diminished a number of previously high returning oligopolies. These factors have been particularly pronounced in the stockmarket. My favourite chart (c/- RBA Chart Pack) shows earnings per share for the MSCI index in Australia. You might observe the forecast number for 2018/18 **is still below the levels of eleven years ago**. In that context, it’s hardly surprising our stockmarket is also lower despite low interest rates and generous P/E multiples.



When faced with slow earnings growth equity markets, investors have a habit of becoming impatient. To some degree, that is driven by companies who see acquisition as the means to spur growth along. In many cases, this has seen Australian companies acquire similar businesses overseas, with extremely mixed results – that’s being generous. So things get worse, even for the “better” companies. Hence, what manifests itself is a more exaggerated level of risk taking: a desire to find growth in smaller companies. Since global equity markets really took off in Q3&Q4 2017, the smaller company component of the Australian market has comprehensively thrashed the larger ASX 200 stocks by over 8% in capital terms:



This risk-taking is often lubricated by other factors:

- Perceived rapid technological change providing opportunities for smaller companies as challengers to the domestic elite (eg financial services);
- Perceived rapid technological change providing opportunities for smaller companies as players on a global stage, and requiring cheap capital (ie. nosebleed valuations) (eg ASX mid cap technology companies);
- A threat to major companies – regulation, tax policy;
- New market opportunities (eg organic/baby foods to Asia); and
- New resources to mine – new conventional discoveries or a new element (eg. lithium).

Time and again we see that Australian investors vastly overprice growth and conversely accelerate “fade” rates, thereby underpricing conventional company cash flow. Just fifteen months ago, investors were so down on the prospects of domestic media, they were happy to value a well managed pre-tax and funding cost cash flow of ~\$200m pa generated by Nine Entertainment at less than \$900m. As it turns out, the cash flow has grown strongly to around ~\$250million this year, but the total debt and equity price of buying it is now c.\$2billion.

Unfortunately there are not so many Nine Entertainment's around at the present time; there are, however, numerous mid-cap companies across industries with nosebleed valuations and assumptions of certain success. We are carefully short-selling a select number of these.

Short selling: an essential part of what we do

Short selling has been a particular topic of conversation over the past quarter in respect of a number of "situations" including:

- retail investors owning short volatility ETF's (funds which benefit from ongoing low equity volatility and the contango pricing of volatility futures⁶), to gain significant return until early February 2018;
- the specific situation pertaining to Tesla (US: TSLA) where the company's projected cash flow needs are a matter of significant conjecture for bond and equity investors⁷; and
- more locally, the furore regarding an offshore issued research document by Glaucus Research putting forward an argument suggesting significant overvaluation of Blue Sky Alternative Investments (ASX: BLA)⁸.

At the individual security level, there are six rationales behind short selling, excluding the use of short selling in an arbitrage or exposure regulation context:

- Deteriorating company business model not reflected in share price;
- Deteriorating industry prospects not reflected in participant share prices;
- Individual company performance difficulties not reflected in share price;
- Unrecognised financial difficulty (lack of cash flow/balance sheet analysis);
- Excessive valuation; and
- Perceived fraud, potential future fraud or insider individuals with past "form".

E72 is driven by valuation analysis, which is transparently reflected in the securities where we have a long position. These include groups of investment companies trading at large discounts to NTA but where we see some recognition of capital management in retiring such expensive equity. We also focus on companies where there are differing streams of income which are not adequately recognized in the share price, or where a valuation of the company encompasses a mixture of "asset" and "earnings" type valuations⁹.

Of course, this valuation analysis can all be done in reverse to show cash flow negative companies heading to a brick wall without a capital raising, companies reliant on continual acquisitions, and others where the valuations require them to be astoundingly successful over a long period of time – which few Australian companies really are.

The first four areas of short selling provide inbuilt catalysts; you can model out when you expect cash/debt to be squeezed to the extent of either debt covenant breaches or near death without a debt/cash raising. In essence, this has been the story behind Tesla over the past few months. The sixth area is without a doubt the best, since it will effectively encompass many, if not all of the first four rationales, with the added catalysts of knowing that individuals with ethically dubious past track records are at the helm.

The fifth is the most contentious – put crudely, shorting “fad stocks”. You know they will eventually correct, but the question is when. Weaknesses are usually easy to spot – exploration ground valued at eight figures, expectations of selling product to everyone in the emerging world, capacity to take on America with a handful of sales agents or a distribution agreement.

We’ve all heard the stories, and indeed these securities can obtain quite astonishing valuations before they fall to earth ; think Getswift (peak \$460m) or the appallingly named BigUn (peak ~\$1.5billion). As noted, we have recently initiated another series of small shorts in the mid-cap sector in Australia and have generally been happy to hold our existing ones.

Most notably, our short position in Blue Sky Alternative Investments (ASX: BLA) has come to fruition. The company has been opaque in its disclosure of funds under management which significantly overstate the equity component managed upon which annuity fee streams are earned. Moreover, there is inadequate granularity in disclosure of “management fee revenue” with annuity streams mixed in with undisclosed establishment, transaction and other (at times) egregious fees. On any analysis, the shares of BLA trade at a massive premium relative to the four large US alternative investment managers¹⁰. BLA’s poorly thought out reaction to the negative research report - errors and all – issued by Glaucus Research will damage their reputation and make additional fund raising difficult. The use of the other listed “affiliate” (BAF) as a receptacle for BLA is now unhinged by its share price collapse. We have held this short for nearly two years, and have suffered being bought in¹¹ at inopportune times so figure we are owed a payoff, albeit one which won’t be as large as the idea and work deserves.

A proud family owned company at a 30% discount to book value

Gowing Brothers (ASX: GOW) will celebrate its sesquicentennial¹² this year, and has transitioned from the previously well-known small store group, headquartered on the corner of George and Market Streets in Sydney’s CBD into an investment company 39% controlled by Managing Director John Gowing, but with a number of like-minded long standing investors on the register. In the period since the GFC, Gowings has evolved into a quasi-Scandinavian style investor, owning a series of strategic equity investments, with a clear “environmental” feel, a recently acquired surf hardware business, purchased from the ill-fated Surfstich, but with an envious portfolio of retail and land development properties with an emphasis on the mid-North coast of NSW.

GOW acquired four shopping centres , respectively in Port Macquarie (Nov 2009), Kempsey (Feb 2010), Moonee Beach (April 2010) and Coffs Harbour (November 2011) for a combined cost of ~\$121million. The properties were acquired at cap rates between 8.75% - 10% and had significant development or leasing up potential. Two were acquired from distressed sellers and two from larger property companies (Dexus, AMP) where the properties didn’t fit.

GOW have invested in the centres to refurbish and expand where possible; on my estimates they have spent around \$40m on additions since acquisition., to take the total cost up to ~\$161m. The latest full year accounts show the carrying value to be just under \$220million for a ~35% capital value uplift – plus the running yield of gross rentals of ~\$19.5million per annum.

This is a wonderful example of a company making use of its liquidity (with a small equity raising in 2010) to opportunistically acquire and develop an excellent set of assets. In addition, the company has other development in the area.

What's amazing is that GOW has grown pre-tax book value per share from \$3.00 three and a half years ago to the current \$4.42; book includes a small amount of intangibles and around 30c/share of assets attributable to the surf hardware business. If we back out all of the other GOW assets, at current prices around \$3.14, we are effectively paying a 36% discount (before tax it should be stressed) to current values for the four shopping centre assets; on a look-through basis we would be receiving a 14% gross yield on the centres or around 8.7% after costs – with growth from the new additional attractions and significant expansion in Coffs Harbour to come.

This pricing has been partly brought about by an institutional seller of shares (after a mandate loss) into a thin market. Unfortunately with expansion to the centres, GOW would be hard pushed to buy back shares in the company without moving to debt levels it wouldn't be comfortable with. This provides the opportunity for shareholders like us to do so – but patience will be required.

The ASX's most reviled stock?

Everyone's got a view because the name, rather than the person himself is rather well known. McGrath. That's John, not Glenn.

I've been lucky enough in the past to work for folks whose name is over the door. It's not a brand, it's your reputation and heritage. Especially in the case of the people I worked for: Rothschild. Unfortunately for John McGrath, some of that has peeled away since the decision to publicly float the eponymous real estate agency in December 2015. Many commentators rightly saw this as representing a peak in the real estate market in Sydney, and an IPO you could well do without. I didn't disagree on either point. However, subsequently seeing the share price more than halve as the number of listings in the Sydney market dried up, a reasoned analysis of McGrath suggested the shares were reasonably cheap and an acceptable play on greater activity arising from financial distress in the buy-to-rent market or on an expansion of the rental market per se, a phenomenon seen in other world cities as property prices themselves have risen to astronomical levels on the back of absurdly low interest rates.

There are some laudable companies you know should not be publicly listed due to four main factors:

- Family control and dynastical aspirations;
- Public disclosure of financial and operating data is a commercially competitive disadvantage;
- Extreme entrepreneurship in probable contravention of listing rules; and
- Inability to cope with bureaucratic governance requirements.

McGrath Holdings Limited (ASX: MEA) probably fits two of those. Then superimpose:

- the clear desire of some rapacious agents to fly the coop when their shares granted at the IPO came out of escrow;
- disclosures of high turnover gambling activity by the founder Director;
- a seemingly mutual departure of the majority of the board and departure of the CEO brought in to provide an executive framework and ASX governance; and
- a series of sensationalist articles by credentialed journalists from both major Australian media groups.

Apart from fraud or crucifixion, it's difficult to envisage a lousier set of circumstances. Taken alongside slowing activity in residential real estate sales, not surprisingly, the shares have slid precipitously from the float price of \$2.10 to the current \$0.40.

MEA has an equity capitalisation of \$57million but has a positive working capital balance of ~\$21million, providing an effective value for the business of \$36m. The "business", however, is made up of 4-5 distinctly differently valued segments – company-owned property management (highest valuation), franchised sales and property management, corporate centre costs and the highest profile but arguably lowest valuation – company owned sales.

In our view, based on valuations in the private sector, the company owned property management business – servicing just under 7,500 lettings at an average just over \$2,500/annum in revenue - is worth at least \$10m in excess of the enterprise value alone. The total franchise business is still making over \$6.5m EBITDA annualised per annum, and should be capable of significant growth. The problem for MEA is that unallocated corporate costs are far too high, an area the company is systematically addressing, and can partly be attributed to the "bloat" incurred at ASX-listing time.

On our figuring, using sum of the parts analysis, we are paying next to nothing for the company owned sales business. Sure, it's making next to no money at present but generated EBITDA of \$15.5m last fiscal year to 30 June 2017!

As a guide, we also have exposure to Foxtons PLC, the London estate agent which is more heavily influenced by its lettings revenue. Converting Foxtons numbers for the calendar 2017 year at A\$1.832=£1 and comparing with MEA over the same time period is most instructive:

A\$m converted at £1=A\$1.832	Foxtons	McGrath
Equity value	406	57
Net working capital	23	21
Enterprise value	383	36
Commission on property sales	78.0	71.0
Properties sold (number)	2,962	3,672
Recent peak properties sold (number)	5,525	5,216
2017 Commission/property	\$26,338	\$19,339
Company letting revenue (\$mn)	121.5	19.4
Lettings	19,806	7,470
Revenue/letting	\$6,134	\$2,600

Source: Company statistics recompiled by E72

It's clear from the table what drives values in this business: property management. Sales are arguably a means to an end, but are essentially a low P/E operation. The challenge for MEA is to ensure the franchises, property management and deductions from centralised costs provide a highly profitable "cake" upon which the profits from property sales are a vast lashing of cream and cherry. Given the cream appears to come free at present, we see it as a free option on the founders getting their act back together as volumes improve.



Conclusion

I apologise for the very “domestic” nature of this quarterly report. As you will see on the table on page 9, by comparison with that prevailing at end December 2017, we have significantly increased our exposures to the Australian market over the quarter, by buying back index hedges and also adding a few new positions.

The decline in US markets is also providing new opportunities and we have added three new stock positions – all more than 20% off their 2018 highs in the few days after the month end. Interesting times!

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STATISTICAL APPENDIX: QUARTER & FYTD TO 31 MARCH 2018

1. Monthly performance, exposure and NAV

	Investment return ¹³	Cost imposition ¹⁴	Net Return ¹⁵	FY17 Return	NAV/share pre tax (c)	Gross Exposure ¹⁶	Net Exposure ¹⁷
31 Mar 17	1.6%	-0.2%	1.4%	45.3%	35.2	171%	1%
30 Apr 17	-2.3%	-0.2%	-2.5%	41.7%	34.3	227%	-18%
31 May 17	2.6%	-0.3%	2.3%	45.1%	35.1	251%	-19%
30 Jun 17	1.3%	-0.2%	1.1%	46.6%	35.5	276%	-6%
				R12 return			
31 Jul 17	1.3%	-0.6%	0.7%	35.8%	35.8	283%	-22%
31 Aug 17	-5.0%	-0.4%	-5.4%	23.7%	33.8	320%	-28%
30 Sep 17	2.8%	-0.3%	2.5%	29.2%	35.2	359%	-31%
31 Oct 17	-7.3%	-0.2%	-7.5%	14.1%	32.8	412%	-42%
30 Nov 17	-9.1%	-0.3%	-9.4%	-5.6%	29.7	437%	-73%
31 Dec 17	-7.1%	-0.2%	-7.6%	-18.4%	27.4	436%	-99%
31 Jan 18	-9.1%	-0.2%	-9.3%	-30.1%	24.7	497%	-135%
28 Feb 18	15.6%	-0.3%	15.3%	-19.2%	28.0	346%	48%
31 Mar 18	2.4%	-0.3%	2.1%	-18.6%	29.2	310%	95%

2. Equity exposure as at 31 March 2018 (as % month end pre tax shareholders funds):

	AUSTRALIA		OVERSEAS		TOTAL	
	percent	exposures	percent	exposures	percent	exposures
LONG	88.1%	28	86.2%	28	174.3%	56
SHORT	(18.1%)	11	(26.4%)	7	(44.5%)	18
INDEX	3.4%	-	(38.5%)	-	(35.1%)	-
CRYPTO	-	-	-	-	-	-
TOTAL	73.5%	39	(69.5%)	35	94.7%	74

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Endnotes & sources:

- ¹ East 72 Holdings Limited (**E72**) provides monthly **unaudited** updates on its company performance and exposure supplemented by a more substantial quarterly note. Readers are referred to footnotes 3 and 17-21 explaining the derivation of the numbers. All returns are pre-tax unless stated otherwise. At the current level of net assets, cost imposition is estimated at 0.25% per month over the course of a full year (excluding capital raising related expenses) and is fully accrued monthly according to the best estimates of management. Readers are explicitly referred to the disclaimer on pages 9&10.
- ² Month by month tabulation of investment return and exposures is given on page 9, along with exposure metrics and unaudited attribution for the quarter.
- ³ Facebook Inc, Apple Inc, Amazon Inc, Netflix Inc and Alphabet Inc (Google)
- ⁴ Low beta crudely means that the expected share price reaction of these shares will be less in percentage terms than the overall market index; these might be classed lower volatility securities
- ⁵ GPT peaked at \$5.10 in October 2007, then had a 1-1 rights issue at \$0.60 in October 2008, another 1-1 rights issue at \$0.35 in May 2009 and then consolidated the shares 5:1 in May 2010.
- ⁶ Contango is where the price of a commodity or asset in the future is higher than the prevailing spot price; volatility products which are long volatility erode in value very quickly under this scenario due to their necessity to replace "spot" expiry month products with higher priced "future" month products. Hence, shorting such products has yielded exceptional returns in recent years until volatility spikes overall. Exchange traded funds such as XIV and SVXY shorting volatility were essentially blown away inside two days on February 5 & 6 2018.
- ⁷ E72 has a short position in derivatives representing Tesla equity
- ⁸ E72 has a short position in derivatives representing BLA equity
- ⁹ I acknowledge "asset" and "earnings" type valuations should converge in the medium term.
- ¹⁰ Apollo Management, Blackstone Group, Carlyle Group, KKR & Co. LP
- ¹¹ Short sellers have to borrow securities to sell. This "lend" comes from existing holders who receive a fee for facilitating the service. However, such holders can recall their shares at any time. BLA holders seem to have a history of doing so far more so than other mid-cap sized companies listed on ASX.
- ¹² 150th anniversary
- ¹³ Change in market value of all investments – cash and derivatives – after interest charges, dividends receivable, dividends and fees paid away divided by opening period net asset value and time weighted for equity raisings
- ¹⁴ All accrued expenses for company administration (eg. listing fees, audit, registry) divided by opening period net asset value and time weighted for equity raisings
- ¹⁵ Calculated as 2 (above) minus 3 (above)
- ¹⁶ Calculated as total gross exposures being nominal exposure of all long and short positions (cash and derivative) divided by end month pre tax net asset value – assumes index ∂ of 1
- ¹⁷ Calculated as total net exposures being nominal exposure of all long minus short positions (cash and derivative) divided by end month pre tax net asset value – assumes index ∂ of 1