QUARTERLY REPORT TO 30 SEPTEMBER 2018[1]

Performance and net asset value[2]

Quarterly portfolio return: (10.0%)

All of our negative return for the quarter was generated in a difficult July/August period which were covered in the respective monthly reports[3]; we added 0.7% after expenses in September. There are a myriad of themes parsing through equity markets at present; slowing Chinese growth, tensions within the EU – which have had a marked impact on our European bank exposure – and Sino-US trade tension. Arguably the most worrisome remains the apathy towards gradually higher interest rates, as central bank liquidity is withdrawn (and inflationary signs increase) and seemingly deliberate ignorance of valuations in favour of detailed justifications of business models. As we discussed three months ago, this is not a purely US phenomenon, and is a direct consequence of the belief that excess liquidity will continue.

Quarterly returns in US markets of 7 – 9% in the major indices have seen them retrace the highs seen in late January 2018; Chinese-focused markets were generally weak. Alternatively, Japan's Nikkei rose over 8% in the quarter, a function of the marginally weaker Yen. Australia was broadly flat.

E72's pre-tax net asset value ended the 30 September 2018 period at **26.4c,** post-tax NTA is 28.4c and we are also carrying the equivalent of 2c per share in tax paid franking credits.

As markets advanced over the September quarter, mainly in the expansion of growth stock multiples; – the ishares S&P500 ETF outperformed its value counterpart over the quarter by 9% to 5.2% - we have reduced our net exposure to around 42%. However, because of increased dispersion of opportunity, we have lifted our gross long and short exposure to 289% of equity.

The major positive contributors to performance were long positions in IDT Australia (+93%), which is profiled later in the report, Yellow Brick Road (+21%) which received a takeover offer from Mercantile Investment, and short positions in Tesla (-23%) and Energous Corp (since closed) falling 32%. Conversely, we conceded ground through short positions in Afterpay (+92%) and Apple (+22%), along with long holdings of Westgold Resources (-32%) and Virtu Financial (-23%).

Over the quarter we have built up a diversified short "package" – equivalent to over 11% of equity - of six well-known mid-cap Australian growth stocks which trade at egregious multiples of earnings; some have inherent weaknesses whilst others are strong companies, but which are priced for your grandchildren's domain rather than the medium term. We have added to our gold exposure, mainly through the two vanEck Vectors ETF's (GDX/GDXJ) reflecting the cheapness of unhedged North American producers relative to the metal itself[4].

---

[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 2 and 10-15 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 7, along with exposure metrics.

[3] Unaudited Monthly Portfolio Report July 2018 released 7/8/2018 and August 2018 released 10/9/2018

[4] A chart of the ARCA Gold Bugs Index (HUI) of unhedged American producers versus gold was provided in our 17 May 2018 investment presentation; this ratio has subsequently fallen further

EAST 72

Tesla: enunciating and justifying the short opportunity

Our largest portfolio position at present is a short-sale of Tesla Inc (TSLA). This is likely to cause surprise, not because of the perceived opportunity, but that portfolio positions are usually sized not only in relation to expected return, but also volatility of the shares. Usually, the higher the volatility, the smaller the position.

TSLA's stock price fluctuates dramatically reflecting sheer emotion, a large short interest (last disclosed[5] at just under 20% of the company's equity), concentration of long ownership with the top 5 shareholders (including Elon Musk) owning ~52% of the ~170million issued shares and variable news flow from the company. If these are the causes, the symptoms are not only a share price which has fluctuated from a low of $252 to a high of $387 from 1 August (Q2 results) to the end of September, but a volume which sees the entire market capitalisation of the company turn over every 14 trading days. Outside of the top few shareholders, and some rusted on aficionados, this is a trading security *par excellence*, turning over around US$3.5billion of volume a day (and twice that on "newsy" days). That means that the overall short position, which appears high versus available equity, can actually be covered in about three days trading. Compare that to JB Hi-Fi – Australia's second most heavily shorted stock, also at ~20% of equity, but where the short interest would take around 25days interest to cover.

So, given this volatile trading in Tesla equity, there have to be compelling reasons to hold such a large short position. The following dialogue attempts to provide a rationale, albeit in an abridged format. We will touch on the pricing of TSLA equity, argue the three key risks which we view as not being priced into TSLA equity – financial, operational, and competitive – before assessing TSLA's merits as a publicly listed corporation. We conclude with an assessment of our own risk in this position, against a backdrop of belief that our short will eventually be closed profitably.

We have no interesting in discussing the recent SEC/Musk "contest" and settlement or pending legal class actions against the company. They are magnificent media fodder, will present a marvelous future case study of corporate governance, and obviously don't inspire confidence. However, they are not the fundamental reason why we hold a short-sale position.

1. Pricing versus cohort – this is a lowly valued (multiple) industry

The starting point for this assessment is the pricing discrepancy between TSLA equity and most of its cohort; the short-sale opportunity largely exists because of the inflated pricing of TSLA equity which bakes in virtually certain commercial success, against a background which suggests this is far from the case.

The table below is illustrative; there are a myriad of adjustments required for each manufacturer (credit subsidiary, pension obligations, SIB capex versus expansionary etc) which make 100% accuracy impossible to achieve. However, there is enough information content in the table to make some key points:

- Unless you believe TSLA is the future of the universe, it is pursuing an industry which investors **<u>hate</u>**, since they bestow abnormally low EV/EBITDA (and P/E) multiples upon it;

[5] Source: NASDAQ short interest as at 15 September 2018

EAST 72

- What is more bizarre is that TSLA want to move down the curve to make cheaper cars; an arguably smarter strategy would be to make TSLA the most elite vehicle possible and restrict production, turning it into a Giffen good like Ferrari and the newly IPO'd Aston Martin Lagonda;
- These multiples largely ignore brand value, distribution networks and embedded capacity to sell the average vehicle, in favour of significant R&D spend, requisite new model introductions and high R&D/capex; TSLA has brand value (see below), but lacks the distribution and maintenance networks in favour of a futuristic strategy which patently is not working;
- Ferrari has achieved a value attributable to "irreplaceable and coveted brands" which have massive pricing power, and the most elite status; the genius of the late Sergio Marchionne is seen in Ferrari (RACE) alone having a market capitalisation $12billion higher than the parent (Fiat) at the time it was spun out (January 2016). The deal has added ~$45billion of value to shareholders!! That's why we own Exor (EXO.MI) – the ultimate "parent/beneficiary" as a core position.
- The major European makers have marquee/TSLA equivalent brands embedded within their portfolio such as Audi and Porsche (VW), Mercedes (Daimler), Maserati (Fiat), Lexus (Toyota); it is worth noting that Daimler and Toyota were TSLA investors around IPO;
- Even if TSLA could sell 250,000 cars per annum with no further capex/capital raising (unlikely in the extreme on both counts), if we attribute a generous EV/EBITDA multiple of 15x (the table shows how generous), the current share price already assumes a smooth move to an EBITDA over $3.5billion or an EBITDA margin (not operating margin) of >18% on current vehicle pricing. That scenario is highly unlikely, though not impossible with more capital.

US$mn[6]	Equity Cap[7]	Ent. Value[8]	TTM EBITDA[9]	EV/ EBITDA	Cars sold (000)[10]	ASP/car	EV/car
AML[11]	5,669	6,708	317	21.2	E5,150	$ 229,860	$1,302,524
BMW	43,543	77,134	14,238	5.4	2,485	$ 41,071	$ 31,037
Daimler	67,491	69,649	19,705	3.5	3,337	$ 49,308	$ 21,622
Fiat	34,437	33,908	14,778	2.3	4,608	$ 28,262	$ 7,357
Ferrari	26,113	26,661	1,261	21.1	9	$ 394,384	$ 3,106,563
Ford	37,648	16,434	9,220	1.8	6,422	$ 22,887	$ 2,768
GM	48,172	47,239	15,113	3.1	9,069	$ 14,425	$ 5,434
Honda	53,324	53,325	13,657	3.9	5,199	$ 18,805	$ 10,343
Tesla	45,011	54,244	(478)	na	131	$ 84,939	$ 443,646
Toyota	181,439	181,423	34,858	5.2	8,985	$ 29,735	$ 20,478
VW[12]	87,342	56,268	25,628	2.2	10.382	$ 22,677	$ 5,293

[6] All EBITDA, revenue, cars sold and average selling price numbers are trailing twelve months through 30 June 2018
[7] Prices as at 28 September 2018 converted to US$ at prevailing exchange rates
[8] Equity capitalisation plus non credit subsidiary debt minus net equity in credit subsidiary minus equity accounted investments/other investments plus pension provisions ;
[9] Trailing 12month EBITDA excluding earnings from credit subsidiary and from equity accounted and other investments
[10] Autos only – excludes motorcycles for Honda and BMW
[11] Aston Martin Lagonda priced at IPO of £19; note expected significant ramp-up of volumes to >9,000 in 2019
[12] No account taken of potential diesel litigation liability

TSLA was IPO'd at $17 in July 2010 to raise $250million (including the $50m placement to Toyota); in total, TSLA has raised just over $5.1billion in straight equity and warrants, plus issued $2.6billion of stock to acquire Solar City in 2016. Despite this, and never coming close to turning a profit, the shares have recorded >40%pa annualised return. This $7.7billion of issued stock is now[13] valued by the stockmarket at ~$45billion (plus ~$10billion of net on-balance sheet debt).

The immense $37bn plus equity "goodwill" reflects technological progress but has been brought about by the cult status afforded to the cars themselves, Chair/CEO's[14] vision and the "save the world" ethos. The pricing of its equity, and certainly enterprise value, is on another galaxy to the cohort, and does not seem to reflect the financial, operational and competitive risks to the company.

2. Financial risk: lack of cash flow and a potentially approaching brick wall

At the outset, analysing TSLA's financials necessitates a shorter term exercise than we normally undertake; there is certainly scope for TSLA to make profits in the very long term from increased production of lower cost/priced vehicles. The fundamental question is whether it will make it that far without a debt default/restructuring which will impact negatively on the price of equity. Not impossible, but highly improbable.

TSLA's free cash outflow in the first six months of 2018 is approximately $1.9billion. However, there are other aspects of financing which show that TSLA's unrestricted cash has depleted by $1.1bn over the six months whilst debt has risen by $1.3bn – a total change of $2.4bn. The major drivers of this have been:

- EBITDA losses of ~$320million;
- Capital expenditure of $1.27bn
- $1.1billion investment in inventory;
- Offset of creditors increasing by $640m over the period of which $427m was in Q2 alone; and
- Employees accepting $340m in cash preserving stock based compensation.

We do see significant scope for a far better Q3 "profit" result but question where the requisite cash flow creation will come from.

TSLA delivered some 83,500 vehicles in Q3; of which ~56,000 were the lower priced Model 3's. This suggests TSLA can generate ~$5.5billion of automotive revenue in the quarter and might easily generate >$1bn of operating margin from the whole business (including solar and services). In turn, attributing sensible increases in SG&A expenses and R&D suggests only a small loss pre-financing costs in the order of $150million.

At that level, allowing for $400million in depreciation and >$100million in stock based compensation benefit, there is a real chance that TSLA will be operating cash flow positive in Q3, possibly by over $250million. It should be noted, however, that TSLA's prediction of positive Q3

[13] Pricing at $266/share prior to the SEC/Musk settlement
[14] Elon Musk is Chairman and CEO until mid November 2018 and the terms are erroneously used interchangably

(and Q4) "cash flow" (undefined like many metrics in the TSLA universe) in the Q2 production statement[15] was notably missing in that released for Q3[16]

However, TSLA have flagged capex of $2.5bn over the year, so that item of spend will abate only slowly in the second half to a rate around $600m or so a quarter. So, on this analysis, operating cash flow less capex would still be a deficit of $350m plus. To stem this would require pull-forward of full payments for cars or further stringing out of creditors. The former seems more likely than the latter, given the stretching of creditors in Q2.

The Q3 results and reconciliation of cash flows are likely to be very complex due to:

- Understandable but significant levels of in-transit sales in Q2 delivered in Q3;
- Necessity to rework produced cars as a result of production quality issues;
- Questionable levels of inventory, based around the lack of early Q3 production of the in demand dual motor (AWD) variants rather than the rear wheel drive option;
- Pull forwards of payments – there is significant anecdotal evidence of TSLA providing delivery dates, collecting the full amount remaining on the car, and then failing delivery leaving the customer as an unsecured creditor of the company; this should show up as significant increases in either customer deposits or creditors in the Q3 balance sheet;
- If around one-third of cars in transit (a total wet finger in the air) have been paid up front, this could inflate cash/cash flow by >$225million at end Q3, albeit representing just a (very useful) pull forward of future demand/payments; and
- Highly variable sales of Zero Emission Vehicle (ZEV) and similar credits to other users, which are pure profit to TSLA; there appear no such sales in Q2 but $50m in Q1 although articles about inconsistent filings in this respect have aired[17]; there is a general belief that the ZEV credit market has virtually collapsed and it would be surprising to see any such sale in the Q3 results.

That TSLA will use every means possible to enhance Q3 cash flow is reasonable when its debt maturity profile is placed in perspective.

Most focus is on the 1 March 2019 convertible notes which convert at an equity price of $359.85 a share[18]. The $920m unpaid principle balance plus $400million is required to be available in unrestricted cash by 1 January 2019; unrestricted cash is reasonably believed to be actual unrestricted cash ($2.236bn at 30 June 18) less customer deposits ($942m at 30 June 18). Hence, on this measure, TSLA had available liquidity of less than $1.3billion, six months out, roughly that required to avoid default.

However, aside from what cash is generated from operations, TSLA also has a $230million convertible note left over from Solar City due in November 2018. Hence, TSLA has principal repayments due within nine months of $1.15bn but must show available liquidity $400m greater than that by 1 January 2019.

[15] Tesla Q2 2018 Vehicle Production and Deliveries (2 July 2018)
[16] Tesla Q3 2018 Vehicle Production and Deliveries (2 October 2018)
[17] "Tesla: a strange case of credits" (FT 7 August 2018)
[18] It is fair to postulate that a portion of the TSLA short position (say 5 -7% of the position) arises from hedging of the convertible bonds in the event that the bonds are renegotiated by the company to a lower convertible price, to avoid default.

3. *Execution risk: production misses, quality, repair and delivery problems, management turnover*

TSLA's execution problems boil down to four key areas:

- TSLA cannot make as many cars as it promises in prior statements other than in "burst" production rates;
- When TSLA does speed up car production rates, it appears to do so at the cost of quality;
- TSLA does not use external dealerships and appears unable to properly organise the logistics of delivery to the client; and
- TSLA repair/workshop network is hamstrung by all of the above – an lack of a real network, an inability to supply parts in a timely fashion and excess demand for workshop services as a result of faulty vehicles.

TSLA seems to have moved through a series of "hells" over 2018 – production "hell"[19] when production of the new Model 3 was running at ~2,000 per week , against a projected 5,000/week, prompting CEO Musk to sleep at the factory. The last week of June saw the 5,000 Model 3 target met, but only at the cost of erecting a tent structure to have a second production line, and at the cost of significant employee disenchantment given the requirement to work ludicrous hours. It is clearly notable that on 2 July 2018 in the Q2 production report, TSLA expected to increase production of Model 3's to 6,000 per week "by late next month" (i.e. August 2018). The actual Q3 outcome was an average production rate of just over 4,000 Model 3's a week – a one-third miss.

The production target also seems to have come at the cost of quality. A businessinsider.com report[20] from mid-August suggests very low "first pass" rates of acceptable cars, around one-quarter of industry average. In turn, this appears to have created a second "hell" - "logistics" or "delivery hell" with finished or part finished but not deliverable Tesla cars parked at vacant lots away from the factory itself.

In turn, the focus on short term production goals feeds into poor after sales service; damaged Tesla cars – whether on delivery or from accidents – are spending weeks and months being fixed by authorised workshops who claim to be unable to secure parts from TSLA itself. TSLA now unofficially (via a Musk tweet) wish to bring repairs "in-house".

In a probable attempt to ramp up cash flow, TSLA have been holding one off walk-up sales of cars in an attempt to move inventory; so we have a bizarre situation of customers who have been on a waiting list for many months – but with specific specifications – being usurped by walk-ups who are prepared to buy the specced car (primarily real wheel drives) as is.

The growing stress within the company to achieve "stretch" targets on a rolling short term basis is leading to significant management change. Around 26 very senior individuals across all aspects of the company – sales, engineering, CIO, supply chain, autopilot, battery technology, reliability engineering and two Chief Accounting Officers have departed the company in the first eight months of the year. This type of high level corporate instability – and the obvious disruption it causes – is unheard of in a ~$50billion valued auto manufacturer, or successful high level technology enterprise.

[19] Interview with CBS News 13 April 2018
[20] 22 August 2018 "Internal documents reveal the gruelling way Tesla hit its 5,000 Model 3 target" (businessinsider.com.au)

EAST 72

4. Competition risk: brand damage, available versus addressable market

Luxury automakers spend billions on marketing whether directly – conventional media – or indirectly via running motorsports teams. All the advertising is designed to cultivate the relevant image. But with spends of US$60,000 and up, the "image" comes with a quid-pro-quo: quality, reliability and service.

It is hard to imagine the recent well-publicised behavior of the CEO is brand positive, other than for rich outlaws. Moreover, social media has been able to distribute the increasing tales of woe upon non-delivery at appointed time, delivery of defective models, long delays for repair, delays for returns of refunded deposits or end of lease transactions.

TSLA's difficulties with production ramps potentially start to feed into reduced demand, especially if alternatives are available from the conventional car manufacturers[21][22]. A bigger potential problem for TSLA is the difference between what the optimist would term the "addressable" market and the realist would call the "available" market. The base plan for TSLA enunciated in a Musk tweet[23] has been to produce enough higher price cars, not only to feed cash flow, but to achieve target costs for the lower priced $35,000 Model 3, which we would assume makes up the bulk of reservations[24].

Clearly, a $35,000 is a very large *addressable* market, if (quality) production can be achieved. However, at the present time, the *available* market for Model 3 is reasonably perceived to be in the $50-$75,000 area; Model 3's start at ~$53,000[25]. But most options take the car into the mid $70,000's area.

TSLA has arguably done an excellent job in establishing a niche for its early Model S and X vehicles, with stable production/deliveries at around the 25,000/quarter mark. However, at their price levels, the new Audi i-tron (lower price) and Jaguar i-pace (~US$89,000) present new immediate 2019 conventional maker EV competition.

There are a myriad of statistics on the US auto market, although obtaining appropriate granularity is not always easy. Luxury cars make up just over 20% of the 6.1million (and declining) annual car sale market[26] – down 18% in the two years between 2015 and 2017 as SUV's have boomed in popularity. Work in segmenting the $50-$75,000 area suggests an available US market of around 460,000 cars last year. Hence, for TSLA to sell out of its Model 3 production each year at current rates, would give it over a 50% market share! Not tenable, in a declining sedan market

The proximity of debt repayment has been a known TSLA negative for some time; likewise, so have production problems. More recently a belief that demand is simply not there at these price points is becoming a more common view. TSLA's own downbeat comments about Chinese exports in the Q3 production release of 2 October 2018 may even lend some support to this.

---

[21] Audi (part of VW) has announced its e-tron SUV priced at US$74,900 in the US; note the growth in SUV's versus sedans
[22] BMW notes sales of ~83,000 "electrified" vehicles in first 8 months of 2018 with target of over 140,000 for full year; cites aim of 25 electrified vehicles by 2025 of which 12 fully electric (BMW Investor Factbook September 2018)
[23] Elon Musk tweet 20 May 2018
[24] US$2,500 of credit risk if you so desire
[25] Model X is a US$96k car; Model S ~ US$94k
[26] Total US vehicle market in 2017 ~ 17.5m of which cars 6.1m; crossovers (SUV) 6.4m and trucks 5.0m (GM 10K CY2017)

EAST 72

5. *Remember Virgin Group PLC?*

There are numerous entrepreneurs who find grave difficulties in having their holding company, or even specialized subsidiaries as publicly listed vehicles. The major (perceived?) pressure from external public company investors – impatience for returns – is often matched by difficulties working with heightened corporate governance practices; these require documented paper trails for decisions, which become discoverable in class action suits where share prices have fallen, perhaps as a result of short term profit pain in pursuit of longer term value.

One of the great cases of this was the short lived public listing of (now Sir) Richard Branson's Virgin Group PLC (Virgin) in 1986; Virgin encompassed all the empire except the fledgling Virgin Atlantic airline – music, retail stores, broadcasting, book publishing and communications. Virgin was floated in November 1986 with a market value (at 140p) of £250m. In the wake of the 1987 stockmarket crash, Virgin's share price fell as low at £0.82, and with impatient analysts and Branson's obsession of not tarnishing his brand by losing money for small shareholders, the maverick entrepreneur privatised Virgin in November 1988 at the float price – 140p.

On privatization, the bid valued Virgin at an enterprise value (£249m equity + £92m net debt) of £340m or 13.1x EV/EBITDA for a very down year to July 1988, but only 9.3x EV/EBITDA the previous year. And that was after a generous bid premium, given the shares were only £1 when the first public comments were made.

The point of the Virgin tale is the stark difference between Branson's desire to rid himself of a mistaken public listing and the futile attempt by Elon Musk on 7th August. Branson was struggling to make use of the encumbrance of public markets; TSLA on the other hand, as we have discussed, has derived enormous benefits given the price investors have been willing to pay for the future cash flow from the company – effective "goodwill" of nearly $40billion relative to the pricing of stock issuance at the time. Why would a company wish to lose that? Of course, why would TSLA not wish to continue to use such an attribute, unless legally prevented from doing so?

Further, the prior table (section 1) shows numerically why no other cohort vehicle manufacturer would have the faintest interest in an LBO of TSLA (at an $82bn enterprise value!!), given the significant proportional investment required (versus their EV) and the massive value dilution it would entail.

6. Short sale issues and the risk to our position

The opprobrium heaped on TSLA's short selling, including (stunningly) by one of TSLA's largest equity holders[27], is difficult to understand. Short-sellers cannot kill TSLA in the way that they can murder a financial institution by sullying interbank trust and starving the institution of its lifeblood. It is the interplay between investigative research – often including drones and shoe leather photography – and the repeated overly optimistic projections of the CEO which has brought about the social media debate over the company.

If TSLA were more accurate with sales and production projections, this research would be rendered largely irrelevant. The ongoing suspicion that TSLA hides adverse news, is less than forthcoming with analysts and "closed shop" about why the egregious pricing of equity is not

[27] "James Anderson: 'vicious' short sellers are Tesla's big problem, not Elon Musk" (citywire.co.uk 14 Sept 18)

used to issue further capital compounds this suspicion.; such factors are seen in many other failing corporations.

The major risk to our position is that TSLA pull out all the stops in the current quarter, re-ignite genuine investor (not trader) interest in the company, and are able to access a suitable capital raising. This would largely depend on a positive, if potentially erroneous assessment of cash flow when the Q3 results are released.

The movement of TSLA shares – rising from $290 to $340 - in early August to a higher than expected cash balance derived from stringing out creditors, shows the low quality of the initial reactions to TSLA results. Achieving an equity price above $360 on a sustainable basis to effect equity conversion of the convertible notes appears a long bow to draw, but an illustration of "stability" may be enough to achieve an expensive debt, other hybrid raising, or restructuring of the March 2019 convertible.

Will TSLA go bankrupt? Probably not. There is likely to be enough value in the IP, design and technology (remember the battery technology belongs to Panasonic) to warrant a positive equity value, which can be brought about by a strategic partner recapitalisation. But not at a ~US$50billion equity value. And as we noted at the outset, we won't have to wait long into 2019 to find out whether our thesis is correct.

A potential shovel in the weed growing business

Australia has a small clump of weed stocks – cannabis producers or THC synthesisers – with a combined market capitalization of ~$1billion. Dime bags compared to their Canadian counterparts where the boom sector has an equity capitalization of ~C$62billion (and moving every day). Its erstwhile largest player, Canopy (WEED.TO) – fueled by a $5billion investment from alcohol producer Constellation Brands (STZ) is capitalised at C$14.4bn, now behind the absurd C$19.7billion equivalent valuation of Tilray (TLRY) . On the third rung is $12billion Aurora (ACB.TO) , which is negotiating a tie-up with Coca Cola (KO) but also owns 23% of Cann Group (CAN.AU) – of which more below.

All these billions might be leaving you hazy and hungry, so let's tone it down a bit. A year ago we started acquiring stock in IDT Australia (IDT.AU) at around 9-10c a share. IDT owns a state of the art pharmaceutical manufacturing facility in Boronia (Melbourne) and is now cashed up with $14million of liquidity, against the ~$24million equity capitalization at our entry point.

The idea behind this value play was that the company had failed to execute its 2014 acquistion of a package of 23 generic drugs from Sandoz (part of the CHF210bn Novartis (NOVN.SWX) pharma giant. The US$18million package saw only three drugs make it to market, and the efforts involved effectively required IDT to sell off its Adelaide based clinical testing facility (CMAX) to the Japanese company I'rom (2372.JP), as well as largely conceding defeat on the generics portfolio in April 2018. The timing of its acquisition, in retrospect could hardly have been worse, with generics pricing coming under sustained pressure from 2016 onwards. IDT is left with one drug – temozolomide – used in chemotherapy and distributed by Mayne Pharma in the US, together with a short term profit share on one other and manufacturing rights to two others. It has retained full rights to certain cytotoxic drugs (i.e. those which are toxic to cells and prevent replication such as in cancers).

This has left IDT with sales of around $12million from a facility which was ascribed a replacement value of $75million[28] in 2015!! Capacity utilization, which includes manufacture of drugs for the multi-national pharma giants is around 30%.

After roughly a year at the helm, the reconstituted board have formulated a strategic plan to increase the utilisation of the plant, and appear to have been successful in retaining contracts for manufacturing active pharmaceutical ingredients, providing a base from which to grow.

On 7 August, IDT announced it had signed a manufacturing agreement with Cann Group (above); Cann is Australia's largest "weed" company – market capitalization ~ $380m - with integrated cultivation of cannabis, research and manufacture of medicinal cannabis and other cannabinoids. Cann has a well respected board and strong financial backing – this is no hippy play.

Medicinal cannabis has been legal in Australia since early 2017, as it is in numerous other countries and 29 states of the USA. Where Canada is moving ahead is the legalization of recreational cannabis, under Bill C-45, to be effective on 17 October. Nine US States, Uruguay, Switzerland and Colombia have already legalized recreational use. The sheer market capitalisations awarded to the Canadian companies give them a serious headstart in the cultivation of cannabis, but we are starting to look where additional opportunities exist down the value chain.

Things are likely to move far more slowly in Australia than Canada. The latter has massive raw consumption estimated at 800,000kg (must be the cold winters) creating a $6billion market. Prevailing social-conservatism within Australia's Federal Government (matched in NSW) suggests any process to free up more "raw" material will take time; attitudes within the ALP are unclear although Victoria was the first state (under an ALP Government) to legalise medicinal cannabis. It suggests it may be a while before cannabis (and its derivatives) become widely available, in other than medicinal form.

IDT has the capacity to be a manufacturing player, and the deal with Cann Group is non-exclusive. Even at prevailing prices around 17c, the plant – adjusting for cash - is valued at just over $27m, and there are early signs the company has a clear strategy to improve utilisation. This seems to be borne out by the latest announcement of a 10% share buy back and hints of "improved financial performance over the recent period"[29].

How a messy Q2 report makes a cheap stock even cheaper

In December 2016, Wilh. Wilhelmsen Holding ASA (WWI.OL) set in train the transaction to further simplify the group into three significant industry related holdings, and a series of mainly wholly owned, profitable related activities in shipping services. At the time, the share price was NOK220; it's now NOK 180.

[28] July 2015 presentation to "BioShares" conference
[29] IDT Australia ASX announcement 26 September 2018

Since the consummation of the deal to merge the operating business of WWI with Wallenius Lines in April 2017, leaving WWI with its diluted 160million shares or 37.8% of the listed WWL.OL (Wallenius Wilhemsen Logistics), WWI has had an *annus horribilis* with:

- WWL forced to pay a fine of €207million in February 2018 to settle anti-competitive behaviour allegations in the car carrying industry (WWL has ~22% market share by capacity of global car carrying 873,000 car equivalent units out of 4.05million);
- The proposed restructuring of the Hyundai Motor group through a merger of Hyundai Mobis (012330.KRX) and Hyundai Glovis (08620.KRX) announced in March 2018 was shelved in May 2018 after protests from Mibis shareholders about the value depletion they would suffer, effectively in favour of Glovis. Through the listed 72.7% subsidiary Treasure ASA[30], WWI owns 12.7% of Glovis whose share price has fallen from KRW188,000 to KRW130,000 since the cancellation of the deal;
- In July 2018, the proposed acquisition by WWI of the technical solutions business from US company Drew Marine was blocked by US Federal Trade Commission; and
- Oil prices have increased making bunker more expensive.

Here's where the messy Q2 report comes in; there were accounting adjustments in respect of writing down the Glovis stake and US$27m of non-recurring charges relating to the failed Drew Marine acquisition. Everything is explained, but the market has chosen to focus on the headline numbers which show a US$240m "comprehensive income" loss. When your market cap is ~US$1bn, that seems a significant amount.

At current prices, WWI has an equity market capitalisation of US$1022m; the parent has ~ US$542m of net debt for an enterprise value of US$1564m. For that we get:

- 160m WWL shares (37.8%) worth US$650m; WWL has a high debt load, with net debt of US$2.5bn against equity capitalisation of US$1.7bn, but trades at ~ 7.1x EV/EBITDA in a tough year, with car carrying capacity starting to abate. Having ascended from NOK43 to NOK64 after the April 2017 merger deal, WWL shares are back at NOK33;
- 160m shares (72.7%) of Treasure ASA worth US$247m even at Treasure's 35%+ discount to NTA;
- 50m remaining shares of QUB.AU worth US$93m; and
- Other investments and associated companies worth ~US$265m.

Hence, we are getting the remaining 100% owned businesses for a price of ~US$309million. The wholly owned businesses of maritime services (ship service, vessel management, crewing for 360 vessels) and supply services (supply bases and logistics to offshore industry) should record EBITDA (before associated company contributions) around US$89m this calendar year. There is respectable growth in both areas, especially supply services.

WWI illustrates perfectly what seemed to happen in many markets in the Q2 reporting season; "growth" stocks which matched expectations were "bid-up" aggressively (accepted those which didn't were sold off); but perceived "value" stocks, where there is an observable gap between share price and fundamental value were sold down even further if results were not quite up to scratch or "messy". WWI are now down from NOK245 in April 2018 to ~NOK180, pricing the wholly owned businesses at an EV/EBITDA multiple of ~3.5x. We have added to our long position.

[30] E72 owns shares in Treasure ASA (TRE.OL)

Conclusion

We hope this note has illustrated some of the “conflicts of credibility” apparent within the E72 portfolio: a new age vehicle manufacturer struggling to find efficient production and network techniques, with critical loan repayment dates looming versus other companies with key roles trading at absurdly low valuations. Anomalies of this magnitude have a tendency to presage major turning points in markets, as they did in early 2000. We would be gratified to see a mini-reprise.

For further information:

Andrew Brown
Executive Director
(02) 9380 9001 / 0418 215 255

EAST 72

STATISTICAL APPENDIX: QUARTER & FYTD TO 30 SEPTEMBER 2018

1. Monthly performance, exposure and NAV

	Investment return[31]	Cost imposition[32]	Net Return[33]	FY17 Return	NAV/share pre tax (c)	Gross Exposure[34]	Net Exposure[35]
30 Jun 17	1.3%	-0.2%	1.1%	46.6%	35.5	276%	-6%
				R12 return			
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%
30 Apr 18	4.1%	-0.2%	3.9%	-15.3%	29.9	262%	91%
31 May 18	-0.8%	-0.3%	-1.0%	-16.0%	29.5	272%	88%
30 Jun 18	-2.0%	-0.1%	-2.1%	-18.8%	29.0	278%	81%
31 Jul 18	-3.8%	-0.3%	-4.1%	-22.5%	27.8	276%	63%
31 Aug 18	-6.4%	-0.4%	-6.8%	-23.7%	26.2	285%	48%
30 Sep 18	0.9%	-0.2%	0.7%	-25.0%	26.4	287%	42%

2. Equity exposure as at 30 September 2018[36] (as % month end pre tax shareholders funds):

	AUSTRALIA		OVERSEAS		TOTAL	
	percent	exposures	percent	exposures	percent	exposures
LONG	85.8%	24	79.3%	28	165.1%	52
SHORT	(12.8%)	8	(26.1%)	12	(38.9%)	20
INDEX	(14.0%)	-	(70.0%)	-	(84.0%)	
TOTAL	59.0%	32	(16.8%)	40	42.2%	72

[31] 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

[32] All accrued expenses for company administration (eg. listing fees, audit, registry) divided by opening period net asset value and time weighted for equity raisings

[33] Calculated as 2 (above) minus 3 (above)

[34] 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

[35] 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

[36] Figures may not sum due to rounding

Disclaimer

While East 72 Holdings Limited (**E72**) believes the information contained in this communication is based on reliable information, no warranty is given as to its accuracy and persons relying on this information do so at their own risk. E72 and its related companies, their officers, employees, representatives and agents expressly advise that they shall not be liable in any way whatsoever for loss or damage, whether direct, indirect, consequential or otherwise arising out of or in connection with the contents of an/or any omissions from this report except where a liability is made non-excludable by legislation.

Any projections contained in this communication are estimates only. Such projections are subject to market influences and contingent upon matters outside the control of E72 and therefore may not be realised in the future.

This update is for general information purposes; it does not purport to provide recommendations or advice or opinions in relation to specific investments or securities. It has been prepared without taking account of any person's objectives, financial situation or needs and because of that, any person should take relevant advice before acting on the commentary. The update is being supplied for information purposes only and not for any other purpose. The update and information contained in it do not constitute a prospectus and do not form part of any offer of, or invitation to apply for securities in any jurisdiction.

The information contained in this update is current as at 30 September 2018 or such other dates which are stipulated herein. All statements are based on E72's best information as at 30 September 2018. This presentation may include forward-looking statements regarding future events. All forward-looking statements are based on the beliefs of E72 management, and reflect their current views with respect to future events. These views are subject to various risks, uncertainties and assumptions which may or may not eventuate. E72 makes no representation nor gives any assurance that these statements will prove to be accurate as future circumstances or events may differ from those which have been anticipated by the Company.