EAST 72

QUARTERLY REPORT #14: PERIOD TO 31 DECEMBER 2019[1]

Why are we so cautious when others seem euphoric?

Imagine buying an investment property for $1million where the expected rental return (ignoring costs) is $32,000. A year later, the realised rental return is only $28,800 because the market demand for renting in the area where the property resides has declined. What would you do if a buyer emerged and offered a price of $1.25million, 25% above your purchase price? Your expected 3.2% rental yield (a P/E or the number of years of rental at which the property is priced of 31.3x) has declined to 2.3%, with a corresponding re-rating of the P/E to 43.4x.

You might challenge the immediate inclination to sell. What other alternatives might be out there in which to place your funds have become less attractive. In the past year, ten year US bond yields have fallen from ~2.75% to 1.9%, whilst cash rates in Australia have fallen from 1.5% to 0.75% (2.4% to 1.56% for three month US Treasury bills).

However, to not sell, when the "payback" period had stretched out by a further 12 years in our hypothetical example, would require the holder to assume rental growth was going to re-accelerate strongly, or that alternative forms of investment were likely to yield next to zero for an elongated period of time. It might reasonably be argued that the opportunity cost of liquidating (ignoring taxes) and waiting for capital values to correct may not be so great.

Let's replace our theoretical investment property with equity markets because it's the same conundrum. Whilst we often refer to trailing (i.e. historic) numbers, we are acutely aware that equity prices respond to changing views about the future; a consensus view of the business climate and earnings (at the index level) should be broadly factored into equity prices at any given time. What we saw happen in 2019, both in the US and Australia, was a wholesale increase in equity prices despite a respectable deterioration of the consensus view of the future.

As a consequence, within the benchmark US S&P500 index, we saw the largest REALISTIC re-rating of a $1 of earnings since 1998 – twenty one years ago - during calendar 2019. In the context of the economic cycle, and even the change in interest rates, where we acknowledge declines do make future income streams more valuable, this did not seem a sensible outcome.

At the start of the 2019 year, with the S&P500 index at 2507, expected earnings for the companies within the index for 2019 were the equivalent of 174 index points, so the index was priced slightly below the long term average at 14.4 years worth of earnings for the next twelve months. However, earnings will come in over 6% lower than expected at ~163. However, the price of those earnings has increased some 29% to 3231, and the equivalent of 19.8 years worth of 2019 earnings.

[1] East 72 Holdings Limited (**E72**) provides quarterly **unaudited** updates on its company performance and exposure. Readers are referred to footnotes 9 and 21-26 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 0.6% 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 page 14.

EAST 72

"You know, businesses are worth more money if interest rates fall and stocks rise. But then eventually the market action of the securities themselves creates its own rationale for a whole — for a large crop of buyers, and people forget about the reasons and the mathematical limitations that were implied in what they — in what got them excited in the first place. And after a while, rising prices themselves alone will keep people excited and cause more people to enter the game. And therefore the good premise, after a while, is forgotten except for the fact that it produced these rising prices. And the prices themselves take over". – Warren Buffett 1997 Berkshire Hathaway AGM

The last quarter of CY2019 certainly looks as though "the prices themselves have taken over". Why would investors pay so much more for lower current year earnings and expected 2020 growth of ~9%? Remember, only a year ago, the market had fallen sharply, investors were panicked, and we were advocating that equities were respectable value and had closed down our index short positions and many stock short positions:

- Investors weren't paying much in the first place on a longer term view (average P/E); and
- Alternatives (interest rates) were starting to decline for the highs of Q3 2018.

However, the **magnitude of rerating**, from 14.4x to 19.8x is amongst the very highest seen in US equities in the past two decades, illustrated by the table below:

	EPS forecast for year		*S&P 500 index*		*Price/earnings ratio (x)*		*Point change in P/E ratio*	*%age P/E change*
Year	*start*	*end*	*start*	*end*	*start*	*end*		
1997	46.66	44.25	741	970	15.9	21.9	6.1	38%
1998	51.61	43.39	970	1,229	18.8	28.3	9.5	51%
1999	51.59	49.17	1,229	1,469	23.8	29.9	6.1	25%
2000	57.87	54.73	1,469	1,320	25.4	24.1	(1.3)	-5%
2001	62.25	45.81	1,320	1,148	21.2	25.1	3.9	18%
2002	52.93	48.39	1,148	880	21.7	18.2	(3.5)	-16%
2003	54.79	53.49	880	1,112	16.1	20.8	4.7	29%
2004	61.55	66.49	1,112	1,212	18.1	18.2	0.2	1%
2005	73.88	76.04	1,212	1,248	16.4	16.4	0.0	0%
2006	85.51	87.19	1,248	1,418	14.6	16.3	1.7	11%
2007	95.07	84.47	1,418	1,468	14.9	17.4	2.5	17%
2008	105.42	73.7	1,468	903	13.9	12.3	(1.7)	-12%
2009	79.65	62.03	903	1,115	11.3	18.0	6.6	59%
2010	79.96	87.11	1,115	1,258	13.9	14.4	0.5	4%
2011	98.24	98.99	1,258	1,258	12.8	12.7	(0.1)	-1%
2012	109.16	105.35	1,258	1,426	11.5	13.5	2.0	18%
2013	115.18	111.45	1,426	1,848	12.4	16.6	4.2	34%
2014	122.63	119.06	1,848	2,059	15.1	17.3	2.2	15%
2015	128.82	118.75	2,059	2,044	16.0	17.2	1.2	8%
2016	127.69	119.3	2,044	2,239	16.0	18.8	2.8	17%
2017	133.12	133.6	2,239	2,674	16.8	20.0	3.2	19%
2018 *	147.46	161.45	2,674	2,507	18.1	15.5	(2.6)	-14%
2019	173.92	162.81	2,507	3,231	14.4	19.8	5.4	38%

Source: Factset statistics compiled by East 72 (*) corporate tax reduction

In 2009, the massive re-rating of equities came from a very low base of pricing, whilst earnings forecasts for the prevailing year were basing out in the wake of the GFC; analysts ended up materially increasing their estimates for the forward 2010 year, and still ended up under-shooting (for once)[2]. Hence, the re-rating was more than justified.

In 1998, the re-rating was a component of the ludicrous "tech-boom" which spilled over into 1999 and until April 2000, leaving US equities priced, relative to earnings, at their highest level ever (30x). What followed was a significant slump in equity prices of 49%[3] and three calendar years of negative returns. Other strong re-ratings have generally taken place from lower multiples of earnings and expectations of respectable forward earnings growth.

At the current stage, EPS growth in the US is expected to accelerate for ~zero to 9.6% from 2019 to CY2020. The largest components of this growth come from IT (20% of S&P500 and expected to grow earnings at 9.5% despite ongoing gluts in semi-conductors) industrials (+14.8%, largely a rebound in Boeing) energy, where higher oil prices are forecast to lead to 21% EPS growth and healthcare with ~9% earnings growth expected. With forward indicators suggesting US manufacturing (not services) these forecasts appear to us to have downside risk.

The re-rating of US equities gathered pace in the final quarter of the year;

price return	Q1 CY 2019	Q2CY 2019	Q3 CY 2019	Q4CY 2019
S&P 500	+13.1%	+3.8%	+1.2%	+8.5%
NASDAQ composite	+16.5%	+3.6%	-0.1%	+12.2%

Whilst mass media may attribute the gains to greater détente in the US-China trade affair, which still does not take arrangements between the two countries back to the levels of March – May 2018, the more obvious reasoning is the very loose monetary policy run by the Federal Reserve Board ("Fed") since September 2019.

In early September 2019, the Fed noted a spike in the rate of interest being demanded for overnight money secured against Treasury notes – known as "repos". Interest rates on repos, not surprisingly given the security involved, tend to be proximate to the Federal Funds rate[4]. Whilst there are always seasonal moves in repo rates, due to cash shortages for events such as tax payments, it began to become clear that a potentially more structural force was at work, namely higher liquidity requirements for banks who would otherwise have lent "excess" reserves into the repo market.

As a consequence, the Fed (correctly) sought to lubricate the system, especially with the pending end of calendar year. However, the subtlety of "lubrication" has turned into "flooding the engine", with the Fed expanding its balance sheet by around 10% in the past four months, from $3.76trillion to 4.14trillion between early September and Boxing Day. Moreover, it offered the possibility of increasing this $380billion infusion to over $500billion if required at year end (it wasn't). This is the so-called "Not QE (quantitative easing), QE".

---

[2] 2010 year earnings rose over 40% rather than the consensus early year estimate of 29% during

[3] S&P500 fell from its March 2000 peak of 1527 to an October 2002 low of 777; the NASDAQ composite index fell 78% over the same period (5049 to 1114)

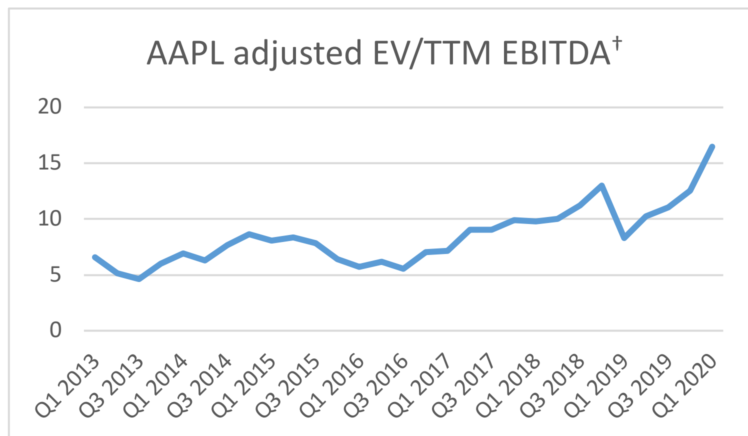
[4] The rate at which US banks and other credit institutions lend money to each other overnight on an non-collateralised basis, compensated for by reserves at the Fed. Changes to the "price of money" by the Fed are through changing the Fed Funds rate.

If the numbers seem mind-boggling, that's because they are. The Fed's balance sheet is now the equivalent of 19.2% of US GDP(!!); the change since September, the equivalent of a near 1.8% of GDP infusion.

It has also become increasingly clear that since 2017, hedge funds (for technical reasons) have been engaging in the repo market (as borrowers) using a bank or broker-dealer as sponsor and credit risk taker. This has increased the demand for repos, and, of course, assisted in causing the spike in rates in September 2019 when funds were in short supply.

Likewise, with the Fed's excessive "lubrication" of the repo market, hedge funds have found it easier to borrow, and have been able to juice their returns over this short period of time. Needless to say, we would expect some unwinding of this position, gradually over the next few months.

The best example of the impact of the "just buy equities" phenomenon was hinted at in the table above showing the 12% gain in NASDAQ composite over the final quarter; the second largest weighted stock in the index is Apple (AAPL) at around 8.5%. Its share price rating has exploded to the highest since smart phones were invented over the past year, notably with the 38% equity price rise in the past quarter. Notwithstanding the obvious financial strength (and engineering) of the company, does the "highest rating ever" (16.6x trailing EV/EBITDA) seem reasonable in the context of a low-growth company, with China market difficulties? We have no position, but think not.



† enterprise value (equity less cash + negative working capital) / trailing 12 months EBIDA

We discussed the Tesla phenomenon in detail at our AGM[5]; suffice to say the unbridled enthusiasm for this intermediator of "green credits" from other auto manufacturers seems unbridled with a $30BILLION addition to equity market value over the last quarter. It remains our largest stock position, as a short.

These types of euphoric re-ratings, seen over CY2019, are not just a US phenomenon.

[5] http://east72.com.au/wp-content/uploads/2019/11/EAST-72-2019-AGM-PRESENTATION-15-NOV-2019.pdf

EAST 72

Australians have been salivating over their >20% equity returns in 2019. But where have they come from? Answer: an even BIGGER rerating of current earnings than that of the US equity market! And the future earnings prospects for Australian non-resources companies? Utterly pedestrian.

Australia's ~ A$2trillion equity market is broadly composed of four areas:

- Real estate investment trusts (~7%)
- Other financials such as banks and insurers (~28%)
- Resources companies (~21%)
- "non-bank" industrials (**NBI**) (~44%)

Other financial shares have generally been modest performers over the past year, as a result of regulatory change, slow credit growth and bad debts rising from abnormally low secular levels. These features, as previously discussed[6] are unlikely to change or abate any time soon. Resources shares gained over 20% in 2019 as a result of higher iron ore and gold prices accompanied by a generally favourable A$ and capital discipline from the larger companies.

So where did the REAL return come from? A massive rerating of earnings of the NBI area from~19.5x FY20 EPS to a stunning 26.8x at the end of the year[7], despite a slowing of expected FY20 earnings growth from >7% to around 6% (and likely to be downgraded further). In 35years of investing in Australia, I have NEVER seen mid-late cycle profits in this sector priced at ~27years worth of earnings. Likewise, I haven't seen bond rates this low either, but that merely presages the fact that the economy is slow and outside of specific stocks with robust, monopolistic businesses (or stellar management) won't produce significant earnings growth. (think about our house analogy). Indeed, with outlandish personal debt/income ratios and slow wages growth, let alone natural disasters, it's becoming increasingly difficult not to avoid the view that Australia's economic growth will go through a more sluggish than normal period.

To put some clear visibility around this, here's a table of seven well-held NBI companies which broadly retained their structures over the 2019 calendar year, to show the extent of re-pricing of a similar earnings base which took place:

	FY20 earnings estimate ($)		*Share prices ($)*		*Fwd P/E ratio (x)*	
	31/12/18	*31/12/19*	*31/12/18*	*31/12/19*	*31/12/18*	*31/12/19*
CSL	6.727	6.782	185.16	275.76	27.5	40.7
Woolworths	1.544	1.472	29.42	36.16	19.1	24.6
Brambles	0.632	0.496	10.15	11.72	16.1	23.6
Telstra	0.212	0.208	2.85	3.54	13.4	17.0
Aristocrat	1.622	1.643	21.84	33.67	13.5	20.5
Ansell	1.548	1.680	22.04	29.03	14.2	17.3
Ramsey Health	3.146	3.046	57.73	72.53	18.4	23.8
AVERAGE					**17.5**	**23.9**

[6] East 72 Holdings Quarterly report #12 (30 June 2019)
[7] Source: UBS Australia

It can't have escaped anyone's attention that when adding these quality companies at ~24x forward P/E to the crazily priced perceived growth companies on the Australian market (so called WAAAX[8] stocks and their cohorts) provides the 27years of forward earnings – a full seven P/E points more than a very over-priced US equity market.

In conclusion, across the two markets where we have the largest exposures, we believe we are being asked to pay extraordinary multiples of earnings, which have expanded dramatically over the past year, for pedestrian future growth (Australia) or over-estimated future growth (both). We view the final three months of 2019 as approaching a zenith in the re-rating of equities, and have taken an more aggressive approach in expectation of a correction in equity values. But what magnitude? Are we just "perma-bears" speculating on a "crash"? No.

Performance[9] and company development

Portfolio performance before expenses in the three months to 31 December 2019 was -6.15%; of this, our large short position in Tesla cost 12.3%, as the shares rose 73.7% in the quarter (adding close to US$31billion to equity capitalisation).

I'm fully aware we can't say this, but it implies the performance ex-Tesla was +6.15%, in a market where we were hedged (on average) to the extent of 178% of equity against market indices, which rose from 5.8% (DAX) to 12.6% (NASDAQ 100). We did gain benefit from the minor losses in the Australian market in the final quarter. It does suggest our other stock picking was pretty decent in the final quarter.

We discussed Tesla at some length at the 2019 AGM and don't propose to recover old ground; nothing about our thesis that the shares are rabidly overvalued, produce low quality cash flow, have quality and safety issues and are struggling to grow in their home market has changed in the intervening two months.

Our current index hedging profile at 31 December 2019 is as follows:

	% equity	Av. level	Level vs 31/12/19
ASX 200	87.3	6241	-6.5%
S&P 500	86.7	2895	-10.4%
DAX	27.1	11756	-10.6%
Other US	18.8	-	-16.0%
TOTAL	**219.9**	**-**	**-9.3%**

The adjacent table shows we have hedged the equivalent of ~220% of our equity through short index positions at an overall level around 9.3% below that prevailing at 31 December 2019.

It does suggest we moved a little too early, but hardly marks us out as "perma-bears" who expect (or need) a market catastrophe to "put things right". But we would clearly benefit if a reasonable pullback in equity prices becomes "unreasonable".

As a guide to the differing performance influences on our results over each of the past three half years, the following table helps to illustrate a few facets of E72's operation at the present time:

[8] Wisetech, Appen, Afterpay, Altium, Xero
[9] Month by month tabulation of investment return and exposures is given on page 13, along with exposure metrics.

As % opening period equity[10]	H1 FY 19	H2 FY 19	H1 FY20
	(July – December 18)	(January – June 19)	(July – December 19)
Realised gains[11]	3.4%	(3.1%)	5.7%
Change in unrealised gains[12]	(24.7%)	11.6%	(8.8%)
Index hedges	2.3%	(9.2%)	(6.8%)
Net interest costs[13]	(2.7%)	(3.2%)	(3.5%)
Net dividends[14]	1.3%	0.4%	(0.5%)
Other derivative expenses	(0.4%)	(0.4%)	(0.2%)
Operating expenses	(1.5%)	(2.8%)	(3.8%)
TOTAL RESULT	**(22.3%)**	**(6.7%)**	**(17.9%)**

Of note in the above table:

- We generated significant realised gains in equities in the half year to December 2019;
- Over 100% of the unrealised loss (row 2) in H1 2020 is accounted for by Tesla;
- The cost of index hedges shows we did move a little early;
- All costs have increased as a percentage of equity due to a decline in the notional capital in the business – we do need to get larger;
- Operating expenses have increased due to employee hire;
- There are significant costs involved in hedging and short selling as result of needing to pay away dividends on indices, as well as the interest costs on borrow;

It's obviously not our preferred stance to be in a leveraged short position, but the large scale re-rating of equities versus future earnings prospects over the course of 2019, along with other signs of euphoric behaviour suggest an equity price retracement to be the most likely next move from which we wish to benefit.

Placement

To continue the growth in East 72, as well as (obviously) reflecting my views on our investment strategy, there is an accompanying announcement to this quarterly that I have taken a placement of new equity in East 72. This is to the maximum extent possible (570,000 shares, being 3% of capital) without having to make a takeover offer, at $0.20/share, as approved at the 2019 AGM.

The next chapter of a massively lucrative capital management story

Imagine (again!) but this time starting out on 1 March 2009 with a number of investments, like majority control of one of the world's largest real estate services firms (Cushman & Wakefield) and a 15% stake in SGS, a world leader in testing and certification. However, your investment portfolio was dominated by 332million shares of an up and down auto manufacturer founded by your great-great grandfather in 1899. This is Fiat, whose shares were trading at €4.55 on the appointed day, equivalent to US$6 at the time and a holding value of US$2,002million.

[10] Not annualised; H1 FY 19 audited reviewed; H2 FY19 audited; H1 FY20 unaudited.
[11] Equities AND derivatives
[12] Equities and derivatives, excluding indices
[13] Equities AND derivatives
[14] Equities AND derivatives

By early 2021, twelve years later, you will have had pretty much your entire investment in Fiat – including another $886million you invested in December 2014, on the full merger with Chrysler, returned to you in dividends[15].

That's a very lumpy effective 8% or so "yield". But look at what you have left from this $2.9billion "investment" as at 31 December 2019 – around $16billion on a pro-forma basis:

	Shares owned	***Price (US$ - 31/12/19)***	***US$mn value***
Fiat Chrysler	449.4m	14.49	6,511
CNH Industries	366.7m	11.17	4,096
Ferrari	43.3m	166.73	7,218
TOTAL			17,825
		Less expected dividend Fiat in 2020/21	(1,779)
NET TOTAL			**16,046**

The owner of this portfolio is the Italian listed company Exor NV, controlled by the family of the Fiat founder, Giovanni Agnelli. The current Exor was created in March 2009 via the merger of IFI, the listed "Agnelli vehicle" containing the Fiat shares and other investments and its controlled entity IFIL, which held a diverse investment portfolio. Net asset value per share at the time was €12.33 a share; at market values, our estimate of NAV at 31 December 2019 is just under €93, and would be nearly €98 if a more 'liberal' (but not stupid) valuation of the reinsurance business was adopted. The share price at "inception" in March 2009 was €5.79; at year end it was €69.

So why are we still heavily invested in Exor, which we have held since inception of East 72[16] if it has appreciated so much? There are six key reasons:

1. EXOR is now moving to extract added value from CNH, through an intended spin-off of its US$13billion "on-highway" bus and powertrain business, best known through its respective "Iveco" and "FPT Industrial" brands; this will leave behind the US$16billion revenue "off-highway" business focused primarily on agricultural equipment (Case, New Holland) and specialty construction vehicles;

2. CNH has been placed on a path to far higher margins across the two businesses intended to double pro-forma earnings over four years; if achieved this would give scope for a significant $4-$8billion uplift in the value of Exor's holding;

3. EXOR continues to reduce its dependence on the value of the traditional ICE (internal combustion engine) auto business of Fiat via more capital extraction (two dividends paid in May 2019 and the further $1.78billion attributable dividend payable late in 2020 on merger with Peugeot), but should see benefits from the merger over a four year period; an uplift in the merged entity's stock price, given that Exor is subject to a three year lock-up, might be seen as "useful" rather than "essential" for progress in improving Exor's NAV;

4. EXOR's debt to gross asset value is down around 13% (gross) and 10% (net) – the lowest since the PartnerRe acquisition in 2016 providing ample financial flexibility in the event of market dislocations and declines in prices for potential investments.

[15] Fiat paid an ordinary dividend of $0.7345/share in May 2019, a special dividend later in May 2019 of $1.456/share resulting from the sale of Magneti Marelli (parts business) later in May 2019. A further dividend of US$3.96 equivalent per share is expected just prior to the completion of the Fiat-Peugeot merger.

[16] We discussed Exor in an investment presentation on 15 February 2017 available at http://east72.com.au/wp-content/uploads/2018/12/15-Feb-2017-Adobe.pdf when the shares were €43.60

5. The equity market's pricing of Exor shares seems to have ignored the significant uplift in the price of reinsurance company stocks in the past year. Thanks to a generally more benign claims environment, cohort stocks like Everest Re (NYSE:RE) +27.6% in 2019, RenaissanceRe (NYSE:RNR) + 46.6% and Alleghany (NYSE:Y) +28.3% have all performed at least in line with broader equity indices. On average, these securities now trade at around 1.48x tangible book value (TBV) at year end, well up from ~1.23x a year ago. Exor carries PartnerRe at 1.26x TBV in its accounts, in-line with the lowest rated peer, Everest Re: and

6. Exor is still cheap on the basis of the price of current portfolio investments without imputing any uplifts from the initiatives highlighted, as highlighted below:

(US$ or €million)	***Shares***	***Price***	***value***	
Fiat Chrysler	449.4m	$10.53 (ex PSA divi)	4,732	
CNH Industries	366.7m	$11.17	4,096	
Ferrari	43.3m	$166.73	7,218	
Juventus	680.0m	$1.39	945	
NET TOTAL			16,991	
PartnerRe			7,650	Tangible book ex-prefs = $6.062bn as at 30/9/19 so valuation = 1.26xTBV
Economist			395	At Exor valuation
Welltec			105	At Exor valuation
Other investments			148	At Exor valuation
Treasury shares			183	
TOTAL EX-CASH			25,472	
Convert to €	**1.1160**		**€22,824**	
Gross debt			(€3,313)	
Cash			€807	
Pre PSA merger dividend			€1,591	Subject to completion
NET DEBT			**(€915)**	
NET ASSET VALUE			€21,909	Revalue PartnerRe to 1.48x = €23,093
Shares issued	**236.3**	**PER SHARE**	**€92.72**	**€97.73**

At year end prices around €69, at between a 25-30% discount to market value NAV, we still see Exor as well worth holding. The roll-forward low debt position offers scope for share buy-backs and other forms of capital management. Alternatively, we may need to be patient as the controlling shareholders may opt to maintain cash, like another well-known value investor[17], in expectation of lower stock prices ahead.

You're hired. Following the Yellow Brick Road to Wizard 2.0

The global franchise "The Apprentice", created by Mark Burnett and originally aired in 2004 has spawned numerous individual country editions. Most have been helmed by big-name immensely wealthy entrepreneurs and one US President. Aside from Donald Trump, the UK series is still

[17] Warren Buffett – Berkshire Hathaway at 30 September 2019 is sat on a cash pile of US$128billion, equivalent to 23% of equity market capitalisation.

highly popular with Lord (Alan) Sugar in charge. Other offshoot bosses have included Air Asia founder Tony Fernandes (Asia) and controversial mineral investor Vladimir Potanin (Russia)[18].

In Australia, the series has not aired since 2015 and then only in "celebrity" versions; all of the series were hosted by Mark Bouris, who founded Wizard Home Loans in 1996, subsequently sold to GE in October 2004 for just over $400million of which Bouris' share was 25%[19].

In 2007, Bouris established Yellow Brick Road (YBR) to provide integrated wealth management advice to retail and SME clients in Australia, perceiving a need for an all-inclusive offering from mortgages through to managed funds.

In late 2010, YBR agreed to be acquired in a RTO transaction by the listed ITS Limited, via a scrip takeover and subsequent prospectus issue at $0.40/share. The move assisted in leveraging the publicity generated by "The Apprentice" and brought on board Channel Nine as substantial holders as part of a contra-advertising deal. The model was different to Wizard insofar as the company was publicly listed and wished to have an all-embracing product suite, but had common features of aligned strategic shareholders. This facet was further strengthened by two cash placements to Macquarie Group, in December 2012 at $0.40 and June 2013 at $0.70/share, giving the bank a 15% holding in YBR.

Whilst the YBR franchise business has grown gradually, major leaps were made by the twin acquisitions of mortgage aggregator Vow in May 2014 for $17.6million in cash and shares followed by the wholesale mortgage financier Resi Mortgage Corporation shortly thereafter for a cash consideration of $36million. These acquisitions were part funded by a $42m share placement (60m shares at $0.70/share).

Over the past two years, YBR's inability to consistently produce a profit, partly brought about by unsustainable overheads designed to grow the group, allied to a decline in the home loan market, has seen the company's share price decimated, falling by over 90% at one stage from the placement price in 2014. Moreover, previously supportive shareholder Macquarie Group divested its shares at prices between $0.09- $0.14 in mid 2018.

Around half of the Macquarie shares ended up in the hands of activist shareholder Mercantile Investments who subsequently made a failed takeover offer at $0.09/share in August 2018. YBR shares were further impacted by the one of the February 2019 recommendations of the Hayne Royal Commission to ban trailing commissions for mortgage brokers. This was one of the few of the 76 recommendations not be to taken up by the LNP Government, acknowledging the impact on the mortgage market given the ~55% share of home loans written by the mortgage broking sector.

The Hayne Royal Commission has turned into a watershed for YBR; aside from the Government not pushing through the ban on mortgage trailing commissions, the significantly increased compliance requirements in the wider financial planning arena has convinced YBR to exit all of their businesses other than mortgage broking and administration. Effectively, YBR is morphing into Wizard 2.0.

[18] Lord Sugar (latest estimated net worth: US$1.5billion); Fernandes (US$650million); Potanin (US$21.6billion)
[19] After commencing in 1996, Wizard received a $25million injection from PBL/e-corp in 1999 to make the business a 50/50 venture between the media company and Bouris, a further $40m from Deutsche Asset Management clients in May 2001 for 25%, an additional $20m later in 2001 for 8.3% and then a merger with ABN Amro's mortgage finance company in October 2002 leaving each party with 25% of the parent Australian Financial Investments Group.

When all proceeds of the non-mortgage business sales are collected over the next 18 months, YBR should have a pro-forma cash position of $8.4million (prior to working capital shortfalls), against a market capitalisation of ~$32million.

Subject to finalisation of an agreement with its major banking financier, YBR should be able to commence writing mortgages from a $120m residential mortgage backed warehouse facility in Q2 CY2020; this will facilitate income from four areas of the mortgage market, in increasing order of revenue and profitability:

- Vow, a lower margin high volume mortgage aggregator which collects trail and upfront commissions from the lending institutions to whom independent brokers have introduced loans, remits these fees on a monthly basis to the broker and supplies other services;
- YBR franchisees, acting as brokers;
- Resi Mortgage Corporation (RMC), a mortgage manager and originator which sources funds from lending institutions and manufactures its own mortgages; and
- Resi Wholesale Funding (RWF - 50% owned) which will manufacture mortgages in a similar fashion to RMC but with additional margin from acting as a securitisation and servicing agent for the pool of residential mortgage backed securities (RMBS) created from these home loans.

To facilitate the creation of RWF, YBR has been prepared to cede 50% equity to Magnetar Capital, a US$13billion US based alternative asset manager with credit specialisms. Magnetar has accepted a $2.4million share placement in YBR (40m shares at $0.06) and is providing A$18million for 50% equity in RWF, along with $6million in funding for subordinated notes in RWF.

The attraction of YBR at just below prevailing prices is five-fold:

- Cynicism over the past track record, Bouris' profile and remuneration[20] and lack of a company investor presentation since 2017 means the shares have no sell-side coverage and no conventional institutional (non-activist) ownership – they are thoroughly neglected;

- The business is now focused in an area where management have proven expertise and profile, and asset sales have been at respectable prices to create a cash buffer;

- Overall housing credit growth has moderated significantly – aggregate housing loans grew only 0.4% in the year to November 2019 – the broker share of new lending continues to be around the 55% mark. As banks remain constrained by past behavior and management/cultural realignments, we expect to see broker lending and RMBS issuance structurally grow in such an environment;

[20] There is a high degree of debate about Mr. Bouris' remuneration (>$1million pa) and lack of director independence given his brother is also part of a three person board. These aspects were the subject of a lengthy discussion at the recent YBR AGM led by East 72 to ensure a full justification of the remuneration was made.

- Signs that management are reining in overheads; in recent quarters, based on cash flow lodgments, trailing twelve month revenues are running at ~$33million, whilst the past two quarters results suggest an expense base closer to just over $30million. After divestments, we estimate operating profit at present to be running in the vicinity of $1.5mn annualised; and

- Valuation. We have assembled our shareholding in YBR at around one-third of the estimated 22c/share capital cost (plus operating losses) of the current structure. In our view, if YBR can establish its securitisation business, investors will place a more reasonable value on the existing trail stream (actuarially valued at $49million or 15c/share) as well as the equity within the RWF business of $18m – ostensibly the value of YBR's distribution franchise – equivalent to a further 5.5c/share. In total this suggests YBR to be worth ~$0.20/share, prior to proving the existing structure can provide sustainable growth.

Conclusion

We acknowledge that performance of the company has not been acceptable over recent times, but make the obvious point that where valuation is a key criteria of the investment decision, then an arbitrary increase in pricing of stocks by ~ 35% relative to earnings is hardly an environment where we would be expected to do well. Our process and style of investing has proven itself over a longer time period.

However, unlike "long-only" funds, we do have the benefit of gearing and other mechanisms which may serve to repair under-performance – just as they helped produce it - in a quicker timeframe.

Andrew Brown & Marc Lerner

For further information:

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

EAST 72

STATISTICAL APPENDIX: QUARTER & FYTD TO 31 DECEMBER 2019

1. Monthly performance, exposure and NAV

	Investment return[21]	Cost imposition[22]	Net Return[23]	R12 Return	NAV/share pre tax (c)	Gross Exposure[24]	Net Exposure[25]
30 Jun 17				46.6%	35.5	276%	-6%
30 Jun 18				-18.8%	29.0	278%	81%
30 Jun 19				-25.8%	21.6	395%	0%
				R12 return			
31 Jan 19	9.1%	-0.3%	8.8%	2.6%	25.2	256%	138%
28 Feb 19	-1.7%	-0.4%	-2.1%	-12.9%	24.7	313%	90%
31 Mar 19	-3.3%	-0.5%	-3.9%	-18.1%	23.7	359%	48%
30 Apr 19	1.7%	-0.6%	1.1%	-20.2%	24.0	386%	43%
31 May 19	0.4%	-0.5%	-0.1%	-19.4%	24.0	382%	24%
30 Jun 19	-9.4%	-0.4%	-9.8%	-25.8%	21.6	395%	0%
31 Jul 19	-1.8%	-0.7%	-2.6%	-24.7%	21.1	413%	-13%
31 Aug 10	-7.9%	-0.6%	-8.5%	-26.0%	19.3	416%	-15%
30 Sep 19	0.9%	-0.6%	0.3%	-26.4%	19.3	415%	-31%
31 Oct 19	0.6%	-0.7%	-0.1%	-25.7%	19.3	429%	-55%
30 Nov 19	-2.4%	-0.8%	-3.2%	-27.8%	18.6	440%	-76%
31 Dec 19	-4.4%	-0.6%	-5.0%	-23.4%	17.7	446%	-106%

2. Equity exposure as at 31 December 2019[26] (as % month end pre tax shareholders funds):

	AUSTRALIA		OVERSEAS		TOTAL	
	percent	exposures	percent	exposures	percent	exposures
LONG	64.3%	13	105.5%	26	169.8%	39
SHORT	(4.2%)	2	(52.0%)	14	(56.2%)	16
INDEX/FUTURES	(87.3%)	-	(132.6%)	-	(219.9%)	
TOTAL	(27.1%)	15	(79.2%)	40	(106.3%)	55

21 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

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

23 Calculated as 2 (above) minus 3 (above)

24 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

25 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

26 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 31 December 2019 or such other dates which are stipulated herein. All statements are based on E72's best information as at 31 December 2019. 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.