

QUARTERLY REPORT #26: PERIOD TO 31 DECEMBER 2022¹

Performance and net asset value²

Quarterly gross portfolio return: +13.3%

A year ago, at the start of 2022, we noted the extreme performance over the preceding year and quarter of a basket of eight mega-cap technology stocks (AAPL, AMZN, GOOG, META, MSFT, NFLX, NVDA, TSLA) averaging 16.4% return in Q4 CY2021 and 45.3% in CY2021. We were clear in QR#22 (December 2021) that stocks in the US were expensive but that:

“for the S&P500 to have a down year in 2022, investors need to conceive a scenario where these securities retrace. Maybe price alone will be enough in a year where money may tighten in an unknown volatile fashion, or inflation expectations become embedded.”

Retrace they did. The “best” of the eight – MSFT – fell 23%. On average, the eight declined by 40% which meant that as a basket, they ended up some 13% BELOW the level at the start of 2021. Tesla and Meta Platforms both declined over 60% in CY2022 reflecting fears over management, prior excessive valuation and operational business issues.

So over the course of 2022 as ten year bond rates in the US rose from the 1.51% level at CY2021 year end to a high of 4.25% in October, the forward earnings multiple of 21.6x (4766/221) contracted sharply to a current forecast of 16.5x (3839/232) – all of the downward momentum in US equities within the S&P500 has been caused by multiple contraction – people willing to pay lesser multiples of future year’s earnings – directly resulting from higher bond rates.

Our clarity a year ago that some type of correction would ensue in US equities did eventuate, but more rapidly than we envisaged. In the first six months of the CY2022, S&P500 fell 20.6% and Nasdaq 100 –29.5%. Since 30 June 2022, S&P500 has returned 1.4%, the NASDAQ100 losing 4.9%, both before dividends.

As the December quarter progressed – almost regressed – into year end, and the inevitable reviews, the tone amongst the cognoscenti has become progressively more negative.

Bluntly, we are bemused, because if anything, 2022 has been a case of not that much really changing except for central banks catching up - with haste - on what should have been done progressively from mid 2021. The Powell’s, Lagarde’s and Lowe’s of the world – and their group thinking acolytes have been grotesque failures, responsible for ridiculous amounts of financial market volatility, when much could have been avoided. In turn, their ineptitude has reinforced economic inequality across the world, which they now need to reinforce by having as many people lose their jobs as possible. We know three candidates for the dole queue. God forbid any are offered additional contract terms.

¹ Readers are referred to footnotes 2 and 20 - 25 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 1.3% 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 17.

² Month by month tabulation of investment return and exposures is given on page 16, along with exposure metrics.

Effectively what the “sea change³” bears are saying is that the absolute cost of money will cause a shock to consumers and borrowers unused to it, set against asset prices which will not respond upwardly whilst interest rates are maintained at the new higher levels.

Investment strategists – usually bullish at the start of each new calendar year – are now, as a collective, marginally negative for 2023. This probably reflects the fact they were collectively so wrong in 2022 with an average S&P500 forecast of 4825 – about 26% too high.

We can simplify what they think. At year end with S&P500 trading at 3839, and expected earnings for CY2023 for S&P500 at 232, S&P500 trades at 16.5x forward earnings. That’s a tiny bit above average. However, the problem is that strategists don’t believe the forecast 5.3% earnings growth in CY2023 over CY2022 is likely given pending tightening economic conditions and absence of large positive contributions from major oil companies; profit growth from energy companies has been the major contributor to S&P500 profit growth in CY2022. Moreover, if the earnings forecast falls back to (say) 210, they are not confident of the P/E ratio expanding out to >18x to accommodate such an outcome at prevailing index levels.

So the strategists prognostications for 2023 broadly fall into:

- a) Bullish – the Federal Reserve will cut rates later in 2023 allowing for an expansion of P/E ratios AND more optimistic forward earnings for CY2024, which will start to be built in towards the second half of 2023;
- b) Muddle through and end up where we currently are – earnings fall away to around 2022 levels or slightly below but with the Federal Reserve having finished raising rates early in 2023, investors won’t aggressively sell (effectively this is the real consensus view as many institutional investors won’t reduce equity exposures but are protecting their portfolio values with large holdings of put options); or
- c) Bearish (in the extreme) with a mixture of reduced earnings expectations – well below 200 (or 10% plus declines from 2022) added to a contraction of the P/E ratio to produce another year of 20% falls in S&P500.

Scenario (c) is why you are observing comparisons with 2008, because the US market – measured by S&P500 - bottomed in March 2009 after a 56.8% decline⁴ at just 10.9x CY2009 earnings. At its peak, S&P500 had traded at 17.7x the 2007 S&P EPS of 87.5 but earnings fell close to 30% during the Great Recession. Whilst we’re not especially optimistic over index performance in the next twelve months, we do believe there are significant differences between the 2022/3 and 2008/9 environments. We said in our June 2022 (Quarterly Report #24) that we could see lows in the 3200-3300 area for S&P500 and haven’t really resiled from that as our thoughts on inflation (peaked) and interest rates (close to having peaked but not coming down at all quickly) haven’t changed.

It is noteworthy that two successive years of index declines in S&P500 are rare indeed: 1929-32 (3years), 1939-41, 1973-4 and 2000-2002 (3years) corresponding with Great Depression, WWII, oil price shock and dot-com bust. No surprise if this happened again (“The Great Unwind”?)

³ “Sea Change” is the name of Oaktree Capital Management co-founder Howard Marks’ latest Memo dated 13 December 2022

⁴ Peak of 1565.15 on 9 October 2007 down to 676.53 on 9 March 2009



There is one thing we are more confident about. It's an environment that lends itself more to picking individual securities and "small scale" thematic, rather than being aggressively positioned for one economic outcome or another at this stage. Hence, we have been reasonably aggressive about hedging our exposures with sold S&P500 derivatives for the time being against a portfolio we are keen about.

Finally on the macro environment, we feel that whilst it is of occasional interest, you would rather hear about our portfolio exposures and why we own specific securities; future quarterlies are therefore less likely to feature market commentary unless there are events which warrant such discussion. Like a central banking catastrophe somewhere.

East 72 Dynasty Trust

Our newly established unit trust focused on companies with controlling shareholders has now been internally funded and commenced investing in early January 2023. We are awaiting one minor administrative issue and have existing firm external commitments which should fund during January 2023.

We will commence marketing the trust, which is only available to wholesale investors, during the current quarter.

Portfolio

E72's top twenty long positions in alphabetical order as at 31 December 2022 are:

Alphabet (A and C class)	Intercontinental Exchange
Amerco	IWG plc
Brunswick Corporation	J P Morgan
Citigroup	Magellan Financial Group
CK Hutchison	Manchester United PLC
Deterra Royalties	Porsche Automobil Holding SE
Dexus Property Group	UBS
Exor NV	Virtu Financial
Goldman Sachs	Volkswagen Group AG
HAL Trust	Yellow Brick Road Limited

Over the course of the quarter, we sold our holding in Agency Group, well before the AGM. Our thesis of a capital restructure to benefit shareholders along with underlying business growth was, in our opinion, not playing out, especially after the acquisition in Launceston. In our view, there is now little incentive for the employed agents to see The Agency Group equity value increase relative to the cash commissions they receive.

Our strong gross return of 13.3% during the quarter was assisted by advantageous short term trades in S&P500 derivatives, Perpetual and Tyro Payments. Within the retained portfolio, we benefitted from the 10:1 stock split in U-Haul – which gave 9 new "B" shares for each existing share - as well as switching our "B" shares into ordinary UHAL on advantageous terms. UHAL (adjusted) rose 18% over the quarter. The best performer – highlighted in QR#25 – was Manchester United plc which rose 76% in the quarter (see below).

We also were helped by US investment banking exposure in Goldman Sachs (+17%) and JP Morgan (+28%). The main negative contributors were the VW complex (VOW3.DE and PAH3.DE) and James Hardie which adjusted its forecast earnings sharply lower.

We added some smaller holdings we are not yet ready to disclose but a more significant position in Magellan Financial Group, profiled below.

Sports teams (again)

Since we wrote about Madison Square Garden Sports (MSG) and Manchester United PLC (MANU) in QR#25, the world of sports teams business has been busy:

- The Phoenix Suns basketball team is being sold for a price of \$4billion, which compares to the prior "Forbes" valuation of only \$1.8billion. This is the largest premium over the prior "Forbes" value since Steve Ballmer bought LA Clippers for \$2billion against its prior valuation of \$550million in 2014; (the "Forbes" valuation of New York Knicks is \$5.8billion – no stadium)
- The Washington "Commanders" NFL team, is under a sale process with bids apparently "over \$7billion" including surplus land; the last "Forbes" valuation excluding the land but including FedEx Field is \$5.6billion; \$7billion would be \$2.5billion over the highest ever price paid for a US sports team, being the Denver Broncos earlier in 2022;
- The smallest EPL team, Bournemouth, has sold for ~£120million to US businessman Bill Foley. The ground only holds 11,000 fans. Burnley FC, a small team with a 22,000 seat stadium who were relegated last season – but currently lead the second-tier Championship under the guidance of Manchester City & Belgian legend Vincent Kompany – sold for the equivalent value of £202m in December 2020;
- Manchester United PLC's majority owners, the Glazer family, announced on 22 November 2022, that to position the club, "the Board consider all strategic alternatives, including new investment into the club, a sale, or other transactions involving the Company." Given the changed playing field in the EPL, most pundits (myself included) read this as a likely sale. The fact the Glazers were spotted at the recent World Cup with wealthy Middle Eastern businessmen, suggests this to be the favoured (but not certain) option.

As a consequence of all this action, MSGS shares are up 39% from end September – including the special \$7 dividend - whilst MANU stock has surged 76%. We still hold both since the publicly quoted share prices do not yet reflect likely transaction prices - not that a MSGS transaction appears likely.

At the 30 December 2022 share price, MANU shares value the club on an enterprise value basis at £4.3billion, inclusive of an increased £1.1billion of "liabilities"; liabilities are up £200million at September from June due to the signing of Carlos Casemiro (£80m) and seasonal lull. The 30 September 2022 balance sheet illustrates why the Glazers either do not have the means or willingness to properly fund United and why a sale is a must, for them and supporters. The exit of the ego-centric aging Ronaldo during the quarter is a financial, emotional and on-field benefit. The significant improvement of the team during a potential sale period – hopefully heightened by interest from a brilliant ON-FIELD World Cup - is of real benefit and can hopefully continue.

Magellan Financial: where the media doesn't look.

There have been two funds management stories in Australia in 2022: the merger of Pandal (PDL:ASX) and Perpetual (PPT:ASX) and the implosion of Magellan. The less said about the former, the better with a Perpetual board of Directors offering nearly its entire issued capital to the accepting shareholders of Pandal having previously described a Perpetual share price 35% higher as “materially undervalued⁵”. The Pandal offices must be lined with undiscovered lithium perched on gold.

Allowing for \$366million of net cash/liquidity on the PDL balance sheet and removing treasury shares, PPT have paid the equivalent of 1.40% of PDL's funds under management (FUM) of \$104.5billion at end September 2022. On the face of it, that looks cheap, but PDL lost 10% of its starting year FUM in outflows, have a predominantly institutional set of mandates, still have some legacy FUM from Westpac, and an effective series of boutiques which do rely on individuals sticking around. If we increase the “value” of the PPT shares given away to \$33.00 each, at which price the PPT Directors refused to engage with a non-binding indicative offer, the price increases to 1.82% of FUM. Looked at in this light, in our opinion, there is little wonder PDL's Directors were keen to ensure the offer was cemented.

Magellan's implosion really occurred with its “*mensis horribilis*”⁶ in December 2021 during which period, the company lost its CEO, was forced to disclose the changed personal circumstances of its Chair/CIO and lost the mandate of its largest client - \$23billion – from St James Place Capital in the UK. In that month, MFG shares tanked from \$33.16 to \$21.24 – a loss of \$2.2billion in capitalisation.

The eventual departure of Hamish Douglass as Chair and CIO, succeeded by a rocky period of little but marketing fluff, temporary roles and responsibilities, saw more customer funds head out the door, and the shares implode by a further 60% during 2022. The Board issued a series of options to employees in April 2022 with an exercise price of \$35.00 a share – when shares were \$16.62 - suggesting they had little real clue as to the underlying value of the business. In addition, MFG lent \$15m to employees over the year under full recourse loans to acquire shares at an average \$26.53. We exclude the total \$33.5m loan employee share balance from any asset calculation as it will inevitably be forgiven or restructured.

For the Australian financial media, who (on occasion) relish the dismantling of an individual placed on a pedestal – often against their wishes - it has been the equivalent of being taken to Mimi's for a long lunch every day for a month⁷. The gossip has been merciless but the subsequent real analysis? A bit lacking. The wolves have taken some big chunks out of the Magellan body, but thanks to the investment banking background of its founders, and others in its orbit, Magellan isn't dead. Far from it.

⁵ “Perpetual rejects revised conditional non-binding indicative proposal” 10 November 2022

⁶ A monthly adaptation of the contorted Latin “*annus horribilis*” used by QEII in 1992

⁷ Mimi's is an expensive restaurant owned by famous Sydney venue owner Justin Hemmes located in the beachside suburb of Coogee, which Macquarie Bank has made off limits due to expense and distance from CBD (AFR 21 December 2022)

We are not interested in writing about MFG from the viewpoint of a broking analyst capturing month-to-month fund flows, performance and refining current year earnings estimates and performance fee possibilities. They can change quickly anyway with wayward markets/stock picks. With S&P500 down over 5% in December 2022, together with \$2.6billion of outflows, funds under management (hereafter FUM) declined \$4.9billion (9.8%) over the month and have distribution liabilities of a further \$300million in January 2023.

This piece stands back and looks at longer term valuation, which as it clearly illustrates, can go from absurd optimism to “they’re dead” valuations. It’s worth noting that even Blackstone (\$BX) shares are down 50% from November 2021.

Having been a small part of teams which helped engineer turnarounds within two funds management groups⁸, one of which was very lucrative for the owners, MFG has a tasty, Mimis-like smell about it. Over the past quarter, we have quietly accumulated on down days, and will have to do more during 2023, especially if global equity markets continue downwards as this is a “beta” stock. However, there is little recognition of its inherent value, which is in excess of the share price but can be urinated away by poor management. And the new CEO, whilst intellectually smart, is, in my view, on training wheels in the public domain. But there are options galore within Magellan, from undervalued meaningful investments to future performance fees.

Smart investment banking started, and buttressed Magellan

There are few people that have the “history” with Magellan that I do. How come? Next to no-one there has ever heard of me. But I have had the benefit of following one part of Magellan before Magellan even existed, and only around 250 people can say that.

In a past life, many of my investments in tandem with a close friend involved exposures to the smallest microcap securities, especially those with cash backing or a small investment portfolio. In the late 1990’s I met the principals of New Privateer Holdings via an investment we had in common in an Adelaide based brush company⁹. We realised they were people of honour and conservatism. On 28 January 1997, we bought our first shares in NPH and by very slowly accumulating, had acquired over 5% of the company by 5 February 2002 (yep it took five years). We subscribed to subsequent rights issues and stayed as a substantial holder to late 2004, but remained as a smaller holder.

In March 2006, Chris Mackay, at that stage Chair of UBS Investment Bank in Australia, agreed a recapitalisation deal for NPH with a placement, rights issue and public offering¹⁰. This marked the start of a whirlwind of transactions, further equity issues, but in July 2006 the creation of NPH Funds Pty Limited, a 60/40 venture between New Privateer and Hamish Douglass, erstwhile co-head of Global Banking at Deutsche Bank in Australasia¹¹.

⁸ AMP Capital and Rothschild Australia Asset Management

⁹ McDonald Brushware Limited. It became MBL Holdings, Local Telecom and Internet and eventually MacArthur Cook Limited, a property based funds manager. It was acquired by AIMS in September 2009.

¹⁰ ASX release “NPH Announces Recapitalisation Proposal” 9 March 2006

¹¹ ASX release “New Privateer Funds Management Initiative & Senior Appointments” 26 July 2006

Six weeks later, NPH Funds and a small number of high net worth individuals recapitalised Pengana HedgeFunds Group, turning it into the current vehicle, Magellan Financial¹². By end 2006, the new Magellan had floated an LIC- Magellan Flagship Fund (ASX:MFF) raising \$350million but had created a monster. The monster? Any future success in Magellan would meant large scale success/performance fees to NPH Funds and so (directly) to Messrs Mackay (via his 36% control of New Privateer) and Douglas, via his direct ownership of 40% of NPH Funds.

The solution was of course to internalise everything and merge Magellan and NPH. Don't go back and read the documents – you will get a headache given the preponderance of options and second options – but by February 2008, New Privateer was consigned to history and the current Magellan off and running. Off and running into the perfect financial market storm.

By the time the merger had completed, MFG shares had fallen from \$1.85 post announcement to \$0.75, only around 10c/share above NTA, valuing the goodwill of the pair at a mere \$14million. By the time US equity markets had bottomed out, MFG shares were trading in the 32-35c range, valuing the enterprise at \$52.3million against net assets excluding deferred tax assets of \$95million and the small matter of \$380million of FUM.

Messrs Mackay and Douglass – the biggest new hotshots at the time in funds management - were (effectively) paying you (as shareholders) to come to work. I still have the contract notes buying a bunch in the first two weeks of March 2009 at an average price of 35c. They had doubled by August 2009 to >70c and aside from a small dip in Q3 CY2011 didn't really look back until they got to \$74.90 in February 2020. To the present date, buyers in March 2009 WHO HELD ON have had \$13.10 in dividends, the current equivalent of 74c in MFF shares plus the dividend stream from them. At its peak, MFG was a 250-bagger from March 2009 – less than eleven years.

But there is more smart investment banking put together by the group at Magellan – which in our opinion, those shareholders who have invested very recently (like us) receive the benefit. To see how smart, let's examine "peak crazy" MFG.

How absurd did MFG get at the peak?

MFG's half yearly report to 31 December 2019 is glowing stuff with pre-tax income before performance fees up 30% over the corresponding period on average funds under management having grown a similar amount.

Annualising H1FY20 profitability – which actually was the outturn for FY20 – would derive an effective NPAT from funds management of ~\$332million assuming a full 30% tax rate¹³ before "strategic initiatives".

At \$74.90, MFG's then 182.3million shares were priced by investors at \$13.65billion. Deducting the balance sheet footings before goodwill of \$890million gives a value for the funds management operation of \$12.76billion. FUM in February 2020 was \$100.7billion of which 73% was "institutional" (more below).

¹² ASX release "Proposed recapitalisation of Pengana Hedgefunds Group and establishment of Magellan Financial Group" 7 September 2006.

¹³ Pre tax profits before performance fees of \$237m. $\$237m \times 2 = \$474m \times 70\% = \$332m$

So at peak crazy, MFG was priced at 12.7% of FUM and 38.4x P/E of annualised net profit before performance fees. This at a time other listed global funds managers were priced at $\sim 10\times^{14}$ and fractions of the FUM percentage. Speculators at that price clearly perceived an ongoing flow of performance fees, running at \$80m pre-tax per annum (\$56m after tax), which they were prepared to capitalise at a hefty multiple, more acquisitions paid for with scrip (public-private arbitrage) or that the investment team really were the second coming of Warren Buffett and were prepared to pay 7-10 years in advance. That $\sim 20\%$ of FUM came from ONE CLIENT (St James Place Capital – SJP) accentuated the utter stupidity of the equity pricing.

Not at the peak, but part-way there, at a price of \$55.20/share in August 2019, MFG placed \$275million of shares with the rationale being to fund a new retirement product (since dumped) and costs associated with a new trust and other “balance sheet strengthening” purposes. Given the balance sheet at the time was replete with \$610million of tangible assets, we’ll leave you to read between the lines. The placement was priced at an enterprise value (EV) to funds management NPAT of $34.8\times^{15}$ and EV of $10.2\%^{16}$. Smart selling, except MFG shares rose a further 36% in six months at the next result.

However, the \$275million placement has, in our view, eventually been put to excellent use.

Principal investments

One of the clear indicators to MFG outsiders that objectives other than running a top class global funds manager had entered the equation emerged in September 2020, when MFG made the first of three significant external principal investments in three months. The least logical has been sold with a very good return, and the other two are an excellent fit.

In December 2020, MFG acquired what eventually turned into 11.6% of Guzman y Gomez, a fast food chain which serves “clean, authentic and fresh Mexican” food but which the author believes would be better described as “fresh authentic extremely high calorie food to help you bulk”. The eventual investment of \$102.7million was turned into \$140million (before costs) in seventeen months, being divested in May 2022. Bluntly, this appeared to be a hubristic investment, irrespective of its financial success; funds managers, particularly very wealthy ones, rarely have any concept of minimum wage workers in hospitality.

The two other investments made in that busy three month period in late 2020 are much more in keeping with what wealthy fund managers know and love: total market investment banking and stock trade clearing and equity market “plumbing” supply. They are both worth digging into and are likely to have an eventual value well in excess of the current carrying prices.

In September 2020, MFG acquired a 40% economic interest with 10% voting rights in Barrenjoey Capital Partners Group Holdings (Barrenjoey), at a cost of \$156million - \$90m cash and the residue in 1.2million MFG shares promptly sold off by the investee. (We told you investment bankers are smart; the MFG were sold at \$55/share).

¹⁴ For example, see E72 AGM Presentation, 8 November 2018

¹⁵ Pre-placement equity capitalisation of \$9,775m less NTA of \$610m = EV of \$9,165m. Funds management pre-tax profit before performance fees of \$376m in FY19 = \$263m after notional tax.

¹⁶ FUM in July 2019 was \$89.7billion

At the same time, Barclays acquired a 10% economic interest with 5% of the votes, for \$45million. Barclays has subsequently invested \$75million and the economic interest now is split 18.2% Barclays, 36.4% MFG with the remaining 45.4% owned by employees. Both Barclays and MFG provide loans to Barrenjoey for working capital as required.

MFG have numerous personal linkages with Barrenjoey, mainly from the coterie of highly talented ex-UBS personnel who formed the new business. These folks know each other and know their skills. From a standing start, Barrenjoey had 348 employees by 30 June 2022.

Even with the benefit of Barrenjoey's audited accounts, it is difficult to ascertain how the "economic" and "voting" interests operate, since both MFG and Barclays own different classes of preference shares. What we do know is that MFG paid \$39,008 for each of their 4,000 "M" preference shares. Barclays paid \$45,000 each for their original 1,000 "B" preference shares but invested a further \$75million to obtain 819 new "B" prefs – a staggering \$91,575 each. Has the real value of Barrenjoey doubled in two years?

Barrenjoey's accounts break the company into "established business" – corporate advisory, equity capital markets and cash equities/research. That business generated \$227m in revenue in the latest year and an operating profit of \$57million – before IT establishment expenses - and \$44million of IT is expensed, not capitalised. However, the fixed interest sales/trading part of the business only operated for three months, whilst the cleared derivatives and equities financing was non-operational – that's a big "tech" spend, so the "being established" businesses virtually absorbed all of the equity/ECM business profit with a \$56m pre-tax loss. Hence, overall, Barrenjoey lost \$43m before tax in FY 2022.

Based on compensation expenses in the FY2022 year, the business is built for revenues of well over \$300million even in mundane markets, using US peer group comparisons. That should categorically take the business to profitability. Moreover, with some global brokers pulling away from equity financing (prime broking) – notably Credit Suisse – and others constrained by global parents, Barrenjoey should be able to find a real niche, since, in essence, many of the personnel operated within a highly decentralised UBS Australia, which had "special dispensation" from Zurich. Because they made so much money.

Any outsider given the opportunity to invest at the ground floor in UBS Australia would have done so. Yet, because of the hefty FY2021 loss of \$114million and despite the Barclays investment, MFG carry the Barrenjoey investment using equity accounting at \$133million in the accounts – below the cost of their \$156million commitment.

It might be accounting standards but makes no sense. Based on the **total** Barclays investment (\$120million for 1819 preference shares), MFG's investment could notionally be valued at \$264million, valuing Barrenjoey at \$725million based on economic interest or 4.5x book value. Is it unrealistic to envisage Barrenjoey earning (say) \$70million pa in two years from a far greater range of activities¹⁷? We think not.

¹⁷ We have some insights into investment banking profitability – in differing environments in Australia – but the accounts are obscured by "head office charges" and other transfer costing and hence have limited value in the public domain.

Magellan invested \$20million for ~17% of Finclear in November 2020. Finclear was founded in 2015 and has grown organically but also by two significant acquisitions, notably that of the largest clearing broker in Australia, Pershing Securities in 2021. Finclear executes, clears, and settles between 15 and 50% of all retail transactions that go through the Australian ASX on any given day. Finclear has also benefitted from providing broking and “plumbing” access to newer retail players such as Superhero and Stake. Numerous mid-tier Australian brokers outsource their clearing function due to the significant capital demands required by ASX.

We estimate MFG paid around \$5.40/FinClear share for around 3.7million shares in November 2020; we believe share issuance by Finclear in FY2022 has diluted MFG to 15.6% but recent issues have been at ~\$11.20/share suggesting the MFG stake could be worth in excess of \$40million despite being carried in the books at an upgraded ~\$29million.

Finclear has been a leader in the use of distributed ledger technology which it is starting to introduce for the management of private company registries. Finclear is not yet profitable, losing around \$11million in 2022 at the operating level on revenue of \$45million.

Given the difficulties being experienced by the monopoly clearing agency in Australia (ASX) in replacing its main holding system (CHESS) we see Finclear as having intriguing opportunities over the medium term and a highly complementary investment to that of Barrenjoey for Magellan.

We believe Magellan’s disclosures on these two investments (especially Barrenjoey) – which represent ~10% of equity market value and hence are material – are opaque and need to be upgraded. There is little way to establish the carrying values of either from the investee accounts.

Conservatively, 45% of MFG market capitalisation is investments

We estimate MFG to be holding over \$4/share in cash, seed and other investments as follows:

	\$million	Comments – adjustments from 30/6/22
Cash (E)	326	y/end \$420m less dividend (\$125m) less buyback (\$39m) + earnings (~>\$70m)
Option liability	(133)	Liability to cover 7.5% discount on option exercise of MGF LIC (expires March 2024) – see later
Working capital	-	Receivables less employee liabilities & creditors and tax
Cash net of option liability	193	\$1.06/share
Seed investments unit trusts	379	\$2.09/share
Barrenjoey (at book)	133	\$0.73/share (potentially up to \$1.45/share)
Finclear (at book)	29	\$0.16/share
TOTAL INVESTMENTS/CASH	734	\$4.04/share

All growing funds managers seed new vehicles, the larger ones in larger ways. But the massive decline in MFG’s equity capitalisation, along with the Guzman y Gomez investment sale and some innate conservatism, has left MFG with cash estimated at >\$1.00/share, seed investments in MFG funds of over \$2.00 a share and the two (in our opinion) really smart “market plumbing” investments, on the books (combined) at \$0.90/share, but in our view worth much more. All up, on our estimates, ~\$4.04/share or \$737million against an equity capitalisation below \$1.6billion.



These investments, making up 45% of equity market value, distinguish MFG from other ASX listed funds managers – Pendal (before takeover) had ~20% of equity value in working capital and investments, with Platinum Asset Management (ASX: PTM) around 31%.

On that basis, at current prices of \$8.94/share, MFG's three funds management businesses are priced by the equity market at a maximum \$4.90/share or \$889million, or 1.77% of FUM. Is this realistic?

Retail funds management takes a long, long, long time to die.

In the early – mid 2000's funds management businesses crudely changed hands with rules of thumb: 1% of fum for institutional, 3% for “masterfund/wrap” and 5% for “pure retail”.

These might have been rules of thumb, but they had a basis in analysis based on simple discounted cash flow metrics centred around fees, client tenure, costs and margin. Effectively, a LTV¹⁸ calculation divided into prevailing FUM.

The three classes of investment customer are certainly morphing into each other, especially the latter two. So retail is not quite as sticky as it once was, as groups of advisers, aided by “best interest” laws and shielded under their professional indemnity insurance by ratings agencies, do see money move around.

However, even a cursory analysis of the company who did it all before MFG – Platinum Asset Management (ASX: PTM) – shows that despite substandard marketing and inconsistent medium term performance (below) there is still a substantial and lucrative business.

As at 30 Nov 2022											
	1 mth	3 mth	6 mth	1 year	2 yrs p.a.	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.	Since inception p.a.	Inception date	Portfolio value (A\$ mil)
Platinum International Fund - C Class	7.9%	9.3%	5.1%	4.1%	6.3%	5.3%	4.3%	11.5%	11.5%	30 Apr 1995	6,802.5
Platinum International Fund - P Class	8.0%	9.4%	5.3%	4.4%	6.6%	5.6%	4.5%	-	6.5%	3 Jul 2017	24.6
MSCI AC World Net Index in A\$	2.9%	5.8%	4.4%	-6.4%	7.7%	7.0%	9.1%	13.6%	7.2%	30 Apr 1995	-

A year after its celebrated IPO in mid 1997, PTM's retail open ended funds (i.e. excluding the closed end Platinum Capital) in June 1998, were around \$12.5billion. Since then, net OUTFLOWS from these funds have amounted to ~\$8.6billion in the 14years to June 2022. But thanks to the gradual nature of the outflows – though the past four years are all significant outflow periods (\$5.7billion) – FUM at 30 June 2022 was still \$11.4billion!!

As we will see, this is a striking contrast with what happens when institutional mandates disappear.

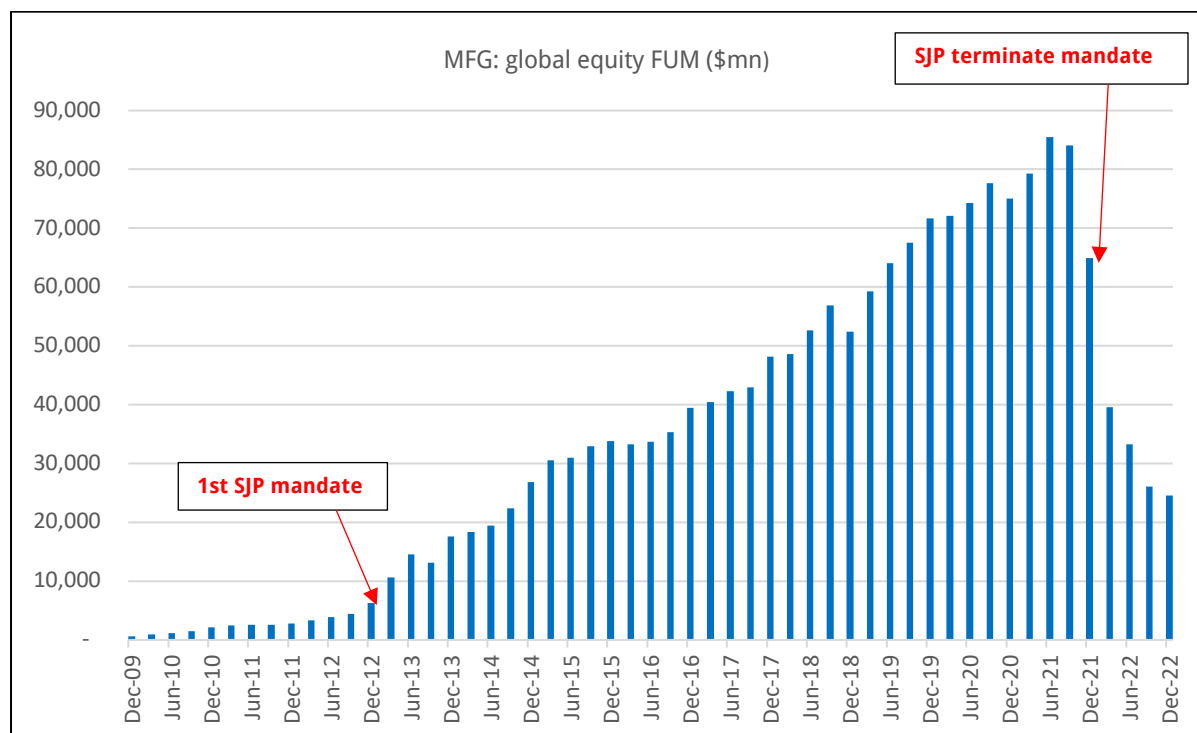
At the closing price of \$1.79 on 31 December 2022, PTM equity is valued at \$1,050million; deducting cash, working capital and seed investments we estimate to be \$322million suggests a value for the funds management income streams of \$728million – equivalent to 4% of last stated FUM (November 2022) of \$18.2billion. This high number reflects higher fees charged by PTM and the “quality” FUM composition (\$11.4bn retail, \$5.5bn institutional, \$1.2bn closed end).

¹⁸ Life time value

Simple NPV analysis shows why the rules of thumb noted above are not so ridiculous. Assuming retail fees of 1.3%, cost to income of 80% (marketing events and dinners are expensive) 9% annual return of which half is distributed out to investors each year, the DCF of such an example yields a DCF/FUM of ~3.1%. Similar DCF analysis of institutional money at 0.3% but with a 50% cost/income ratio gives an outcome equivalent to 1.75% of FUM – but the money won't be as sticky as the retail dollar.

Magellan FUM and a rough valuation

The jealousy that pervades analysis of MFG stems from the chart below, which shows that from December 2009 when funds were \$602million, global equity FUM (measured quarterly) peaked at \$85billion in June 2021 – just under 54% CAGR through 11.5 years.



We estimate MFG now has global equity institutional funds (excluding infrastructure) of below \$7billion at December 2022 – around one-third of the SJP mandate; we estimate infrastructure funds to be ~\$1billion less than this. All but ~\$400million of Airlie's \$8.5billion of FUM is institutional. The rapid decline of MFG institutional funds shows the domino like effect of this type of money. When one goes, especially in Australia due to the small number of gatekeepers, the rest goes very quickly. It's why institutional money should be priced by managers on a (just above) marginal cost (+ performance fee) basis, and should be accordingly valued lowly by investors. When markets run hard, it rarely is – as the prior idiotic valuations for MFG show clearly.



Airlie, an exclusively Australian equity manager was acquired in March 2018 for \$97.1m – exclusively in MFG shares issued at \$25.18. The acquisition price was consistent with our metrics for institutional managers at 1.61% of FUM. Airlie’s performance has been excellent over a three year period, and FUM has grown to \$8.5billion, including \$400million in the retail fund.

30 November 2022					
Performance	3 Months	6 Months	1 Year	3 Years (% PA)	Since Inception (% PA)
Airlie Australian Share Fund	6.12%	5.92%	1.33%	10.45%	10.94%
Benchmark**	6.04%	3.51%	5.00%	5.93%	8.48%
Excess Return	0.08%	2.41%	-3.67%	4.52%	2.46%

Based on interpolating the same metric to current FUM, despite the 5% FUM retail component, implies a value of ~\$137million for Airlie.

Hence, the guts of MFG’s valuation has to be the price applied to the “retail” global equity business, which as we saw with PTM is still ~4% of FUM.

We estimate MFG has just over \$14billion of retail global equity FUM, of which \$2.7billion is contained within the closed-end version of the Magellan Global Fund (ASX: MGF). MGF will struggle to raise new equity even via option exercise. Whilst MFG has covered the 7.5% discount to NTA of exercising the options, the MGF shares themselves trade at an 18% discount to NTA (as at 31 December 2022) suggesting the chance of option exercise is limited unless there is a veritable bout of enthusiasm before March 2024. Hence, as illustrated below, we think the option liability to MFG is probably very conservative.

We estimate using simple industry metrics that MFG’s fund management stream can be valued at just under \$1billion, as at 31 December 2022, as follows:

Global equities – institutional	65	6,500 @ 1% FUM
Global equities – retail	345	11,500 @ 3% FUM
Global equities – closed end	108	2,700 @ 4% FUM
Infrastructure – blended	324	16,200 @ 2% FUM
Airlie - blended	137	Per above acquisition metric
FUNDS MANAGEMENT STREAM	979	\$5.40/share

This fund management valuation can be cross-checked very simply against MFG’s consolidated operating metrics. MFG’s consolidated revenue from funds management averages a base management fee of ~62bps; on the current level of FUM (\$45.3billion as at 31 December 2022) this equates to annual revenue of \$281million (average FUM of \$53.8billion and hence annualised revenue in H1 FY2023 will be above this). In recent presentations¹⁹, MFG have reiterated funds management business operating expenses of \$125m - \$130m.

¹⁹ FY2022 results 17 August 2022 and AGM 20 October 2022



Hence, at the \$45.3billion level of FUM, MFG's funds management business should produce pre-tax "cash" profit of ~\$151million, or \$106million after notional tax, excluding performance fees. Our valuation cross check therefore equates to 9.2x notionally fully taxed funds management profit at current FUM. That is in the lower echelon of the cohort group.

Our valuations imply that at the margin, every \$1billion loss in FUM impacts valuation by ~\$21million or 11.6c/MFG share.

Magellan's core fund performance appears to be levelling off, but not yet significantly improving – that takes time. The clear hole left by the ill-fated Chinese-tech play can be seen in the 3year per annum numbers, below:

30 NOVEMBER 2022

PERFORMANCE	3 MONTHS	6 MONTHS	1 YEAR	3 YEARS (% PA)	5 YEARS (% PA)	7 YEARS (% PA)	10 YEARS (% PA)	SINCE INCEPTION** (% PA)
Magellan Global Fund (Open Class) (Managed Fund) (ASX:MGOC)	5.70%	5.08%	-7.77%	1.87%	8.03%	8.25%	13.40%	10.44%
Benchmark*	6.44%	5.21%	-5.62%	7.88%	10.08%	10.15%	14.50%	7.17%
Out/Under Performance	-0.74%	-0.13%	-2.15%	-6.01%	-2.05%	-1.90%	-1.10%	3.27%

* MSCI World Net Total Return Index (AUD)

** Inception date 01 July 2007

MFG valuation and concluding thesis

We conservatively value MFG at \$9.44/share based on 31 December 2022 FUM; being more liberal, we see scope to lift this to just under \$11/share based on eliminating the option exercise liability and revaluing the Barrenjoey investment to reflect the entry price of Barclays:

	base	uplift
Investments/cash per table	734	734
Uplift Barrenjoey	-	131
Eliminate option liability	-	133
Funds management stream per table (9.2x P/E; 2.16% FUM)	979	979
TOTAL VALUATION	1,713	1,977
Per share (181.5million)	\$9.44	\$10.89

Whilst the 31 December 2022 MFG share price is only marginally below our base valuation, we see multiple areas of optionality for MFG to add shareholder value. Our valuations offer nothing for the capacity to generate performance fees, nor the inherent beta to equity markets – which we acknowledge may take time to play out.

However, we suspect equity markets are moving to a dynamic where stock picking rather than index-beta – which MFG have used to advantage in the past – will be a more important determinant of fund performance relative to benchmark. This does suggest Magellan have an above average chance of improvement (as do Platinum) and thereby start to redeem their reputation. The chance of new institutional mandates is virtually nil in the next three years, but the slowing of retail redemption is far more important.



And what about those investment banking skills?

Is it beyond the realms of possibility that Magellan may get together with Barrenjoey to build a FULL investment banking “powerhouse” with funds management, broking, M&A/ECM, stock lending and a strong capital base to boot? Given that the investments and funds management businesses of MFG make up roughly 50/50 of the current valuation, a separation and merger of Barrenjoey is hardly rocket science for smart bankers with a clear motivation. As we know from the extravagant rating of Macquarie (MQG) Australian investors would likely relish the thought. That clearly is an option not priced into MFG at current levels.

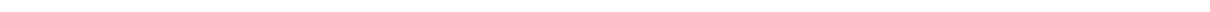
Hence, we have built a moderate portfolio position, with scope to add further if (very) sloppy equity markets derail FUM, which we see as the main risk to the position.

Our strategy

We have increased our gross exposures over the December with more securities hitting our valuation targets despite the volatility of indices; correspondingly we have added to our hedging strategy, mainly through S&P500 derivatives (in A\$, not US\$). We aim to grow the new East 72 Dynasty Trust to provide an initially very small management fee stream to reduce net expenses of the company.

For further information:

Andrew Brown
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STATISTICAL APPENDIX: QUARTER & FYTD TO 31 DECEMBER 2022

1. Monthly performance, exposure and NAV

	Investment return ²⁰	Cost imposition ²¹	Net Return ²²	R12 Return	NAV/share pre tax (c)	Gross Exposure ²³	Net Exposure ²⁴
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%
30 Jun 20				-68.0%	7.0	185%	122%
30 Jun 21				+20.3%	7.3	297%	67%
30 Jun 22				-34.0%			
				R12 return			
31 Dec 21	(1.7%)	(0.6%)	(2.3%)	8.3%	7.9	259%	183%
31 Jan 22	4.2%	(0.7%)	3.6%	15.8%	8.2	251%	229%
28 Feb 22	(15.7%)	(0.7%)	(16.3%)	(8.9%)	6.9	224%	224%
31 Mar 22	0.7%	(0.8%)	0.0%	(14.0%)	6.8	309%	133%
30 Apr 22	(14.8%)	(0.9%)	(15.7%)	(22.1%)	5.8	322%	202%
31 May 22	5.5%	(1.4%)	4.1%	(22.0%)	6.0	268%	207%
30 Jun 22	(19.0%)	(0.8%)	(19.7%)	(34.0%)	4.8	290%	226%
31 Jul 22	11.3%	(1.1%)	10.2%	(26.3%)	5.3	303%	196%
31 Aug 22	(5.4%)	(1.0%)	(6.4%)	(27.6%)	5.0	345%	174%
30 Sep 22	(10.5%)	(1.1%)	(11.6%)	(39.7%)	4.4	336%	138%
31 Oct 22	1.2%	(1.6%)	(0.4%)	(38.7%)	4.4	367%	196%
30 Nov 22	11.1%	(1.3%)	9.8%	(40.7%)	4.8	401%	134%
31 Dec 22	0.8%	(1.2%)	(0.4%)	(39.4%)	4.8	412%	154%

2. Equity exposure as at 31 December 2022²⁵ (as % month end pre-tax shareholders funds):

	percent	exposures
LONG	283%	34
SHORT	-	-
FUTURES/INDEX DERIVATIVES	(129%)	
TOTAL	412%	34
NET	154%	

²⁰ 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

²¹ All accrued expenses for company administration (eg. listing fees, audit, registry) divided by opening period net asset value and time weighted for equity raisings

²² Calculated as 2 (above) minus 3 (above)

²³ 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

²⁴ 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

²⁵ Figures may not sum due to rounding



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