AROWANA AVOF

# Monthly Newsletter and Net Tangible Asset Release

*As at 31 October 2017*

In October, the Fund recorded +8.5% net performance vs the S&P/ASX200 accumulation index return of +4.0%.

Globally, equity markets performed strongly, with the stand outs by sector and region being Tech and Asia (FANG[1] stocks on average +8.7% and Japan's Nikkei index +8.1% during October).

October 2017 was the Fund's second best month ever…"ever" not being such a long time given our inception was January 2015. Top contributors included Afterpay Touch Group (APT.AU), Bellamy's Australia (BAL.AU), Emeco Holdings (EHL.AU), Weight Watchers International (WTW.US) and Platinum Asset Management (PTM.AU). Our largest detractor, which stripped 63bps from performance during the month, was Chipotle (CMG.US).

**Afterpay Touch Group (APT.AU)** advanced +24.4% during the month, largely driven by a very strong quarterly result. The stock has more than doubled since we started buying it in 2016 and we are faced with the issue that at month end it represented 19% of fund assets.

On consensus valuations, APT is firmly in nosebleed territory, trading on consensus 34.9x FY2019 forecast EPS. When we bought it the consensus valuation wasn't much lower.

The thing is consensus, or any forecast for that matter, is *always* wrong, it is just a question of degree. The objective is to spot the big errors.

Over the last 3 months, consensus FY2019 EPS estimates for APT have been revised up +60% and the stock has risen +80%, ergo most of the price rise has been earnings driven.

We have trimmed our APT holding somewhat since month end. We believe there is likely to be substantial upside to come, but we cannot be certain and so prudently but reluctantly choose to constrain sizing.

We get a little excited by this stock because it feels like it's a case study straight out of the book "*Business Model Generation*[2]". Current valuation is one dimensional and consensus forecast earnings may well be undercooked, reflecting in our view only the Australian online apparel retail opportunity. There are two other growth vectors the company is in the process of tackling, and critically, the same compelling value proposition is on offer to both merchants and consumers. Each of these nascent opportunities is an order of magnitude larger than the base business. We are intently focused on spotting the signs of success (or otherwise) in each of these growth vectors.

**Bellamy's Australia (BAL.AU)** upgraded guidance during the month, on both revenue and margins, implying a 16% EBITDA upgrade for FY2018. The basic thesis, which approximated mean reversion, has played out much faster than we had conjectured when we started buying the stock in May 2017. This has in part been assisted by favourable raw materials pricing trends which was not countenanced in our original thesis.

Because of the dynamic nature of the Chinese regulatory landscape as it pertains to Bellamy's Chinese labelled Infant Milk Formula (**IMF**), there is a chance of a revenue and earnings air pocket in the second half of fiscal year 2018. So, we have trimmed somewhat. However, what really intrigues us beyond the nearer term potential of regulatory volatility

[1] Facebook, Amazon, Netflix, Google (now Alphabet Inc.)
[2] Osterwalder & Pigneur, 2010.

is whether Bellamy's has *pricing power*; the litmus test of any brand or franchise. We think there is ample scope for this; private label IMF is virtually non-existent anywhere and there is a wide spread of branded IMF pricing in both physical and online distribution channels, especially within the still nascent *organic* IMF category in China. Should this play out over the next few years it would be transformative for the earnings power of the company.

**Emeco Holdings (EHL.AU)** was added to the portfolio back in June 2017 and features as one of our top 10 holdings. The company hires out "yellow gear" or heavy earth moving equipment typically used in bulk mining operations.

Emeco was a victim of the fall in bulk commodity prices and subsequent collapse in demand for heavy mining equipment. This downward correction in equipment demand extended from 2008 all the way through to 2016 and over this time Emeco's annual revenue fell an astonishing 73%. Revenue falls of this magnitude are often lethal for a company. In Emeco's case the cost of survival was massive equity dilution; share count increased ~300% in 2017 as part of a major balance sheet recapitalisation.

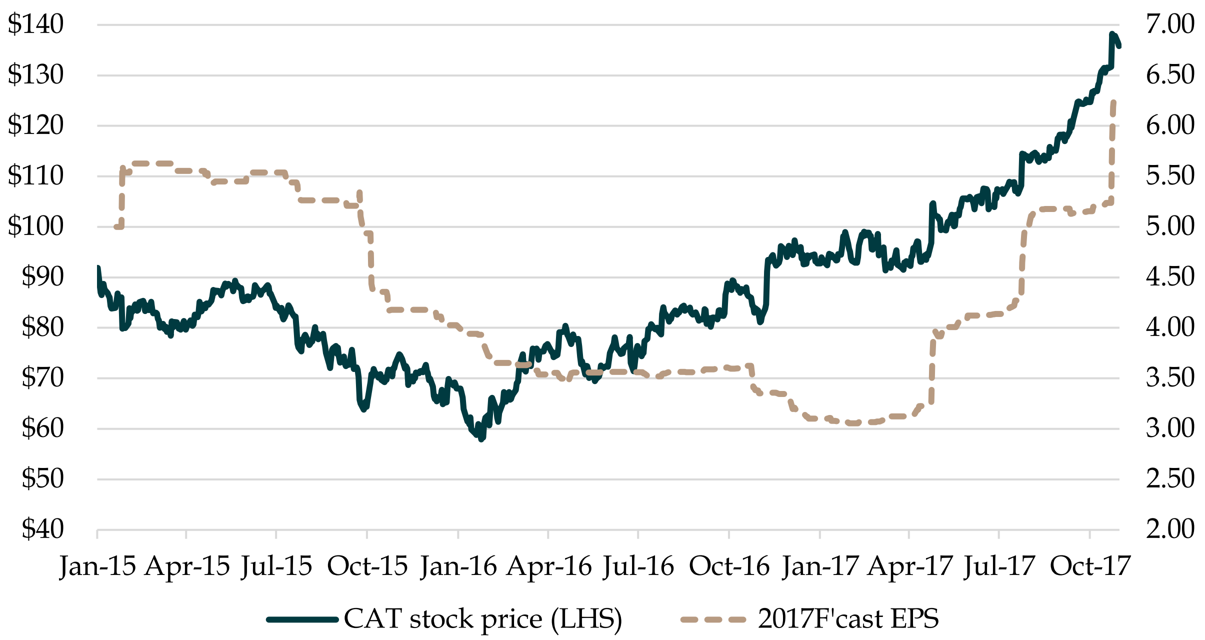
In truth, we were late to the party on a sector level. The Original Equipment Manufacturers (OEMs) that make the equipment that Emeco rents out all saw their stock prices bottom in the first half of calendar 2016.

Typical of deep cyclical stocks, the share price troughs for the major OEMs occurred as percentage year on year revenue declines were at their *deepest*. The stocks then advanced even as revenue continued to fall, albeit at a moderating pace of percentage declines.

Consensus EPS for the major OEMs didn't bottom until 5 to 12 months after the share price troughs. Had you waited to buy then, the stocks would have been 20% - 62% higher.

The rebounds have been savage. From their lows, Caterpillar's CY2017 EPS estimates have risen +106%, with the group average being +72%. Caterpillar is more leveraged to a cyclical rebound than its peers for a few reasons: its inventory accounting system of LIFO or Last in First Out tends to flatter margins as production rates lift, and its business model is to recognise sales as dealers rather than end customers take delivery.

**Caterpillar – Stock bottoms well before EPS estimates**



**Selected Original Equipment Manufacturers – Heavy Mining**

| Name | Ticker | Date of Share price trough | Trough | Share price @ 31 Oct 17 | Share price change | EPS* change |
|---|---|---|---|---|---|---|
| Caterpillar | CAT US | 25 Jan 16 | 58 | 136 | 135% | 106% |
| Komatsu | 6301 JT | 12 Feb 16 | 1,567 | 3,697 | 136% | 76% |
| Atlas Copco | ATCOA SS | 11 Feb 16 | 172 | 367 | 114% | 34% |
| **Average** | | | | | **128%** | **72%** |

* EPS is consensus current fiscal forecast year
*Source: Bloomberg, AWQ*

**Platinum Asset Management (PTM.AU)** contributed 67 bps to monthly performance and is a stock we mentioned in our August newsletter.

We first became curious upon reading a published short thesis on the stock back in April 2017.

In some ways, the crux of our thesis was that Platinum's investment performance would return; we invested as we saw clear signs of this. Provided you have a good process and stick with it, that's generally what happens.

In Platinum's case, the stock clearly trades like a cyclical, meaning that the share price tends to bottom well before EPS estimates do. The key here is investment performance. When investment performance turns positive after a period of underperformance, investment inflows tend to follow…but with a lag. Subsequently, you tend to get the multiplicative relationship of positive investment performance multiplied by greater assets under management driving rapid earnings growth.

Platinum is net cash and enjoys high margins, so whilst the operating and financial leverage is modest, there is pretty decent valuation multiple leverage through a cycle, which has played out with gusto this time around, no doubt helped by a healthy short interest now running in reverse.

We bought this one *into the teeth of the selloff* in calendar 2Q 2017 as the first clear signs of a turn in investment performance emerged. Valuation is now stretched on consensus forecast earnings albeit consensus likely has upgrades to come. We have trimmed the position somewhat but recognise we may be a bit too early here, as Platinum's FUM is still well below the prior peak level. If that picture were to change it might have broader implications in the listed fund manager sector.

**Chipotle (CMG.US)** was our key detractor for the month. The Company reported 3Q results in October, with EPS missing market expectations by a mile. After adjusting for a number of one off items (most defensible) the miss was quite small. The bigger issue was weak LFL (like for like) sales growth guidance offered for the 4th quarter and the absence of any LFL guidance for 2018.

Quite simply, management don't know when the customers are coming back. Which when you study fast food and food industry health scares is the unfortunate pattern.

After a systemic spate of health scares in 2015, we figured operations would be improved to prevent future episodes and that this would take around two years to execute. Our work supports the notion that operations have been significantly improved in the area of health safety. In 1H 2017 there was a clear rebound in LFL sales, only to be followed by a health scare (this time an isolated norovirus incident rather than 2015's systemic spate of E.coli episodes).

Our view here is we aren't in busted thesis territory yet, just the realm of our own imprecise timing. The downside risks typical in this sort of situation simply aren't there – Chipotle is net cash, free cashflow positive (more so due to a slower pace of store roll out expected in 2018) and the new stores being rolled out are still generating extremely attractive returns on capital despite the depressed unit sales levels. Structurally we think there is significant, albeit long dated, upside from business model migration to a franchisee system in the years ahead once Chipotle *finally* reaches saturation levels. The only real trouble is we probably aren't alone in waiting for the visitation and earnings rebound…waiting for what feels like Godot.

**What's in a name?**

When the Fund listed in 2015 it was named the *Arowana Australasian Value Opportunities Fund Limited* ("AAVOF"). The ASX assigned the ticker *AWQ*.

The challenge with that name is it is cumbersome, not particularly descriptive of how we make money for our shareholders and doesn't distil neatly into its ASX ticker for ease of recollection.

At the Fund's AGM on 29th November 2017, shareholders will be asked to vote on a change to the Fund's name.

If shareholders approve, the Fund's name will become the **Contrarian Value Fund Limited**. The ticker under which the Fund is listed would also change to **CVF**.

The term "contrarian" is typically used as a noun, to describe "*a person who opposes or rejects popular opinion*[3]". We don't use the term in that dogmatic context, because often popular opinion is right; when it is, why express a different view?

We simply seek to find and exploit situations where a security is materially mispriced and the risk of owning it is positively asymmetric (more upside than downside).

Mispriced securities only occur due to market error. Because the collective of individuals we call "*the market*" habitually over emphasises current conditions in pricing the shares of a company, *there are always opportunities*!

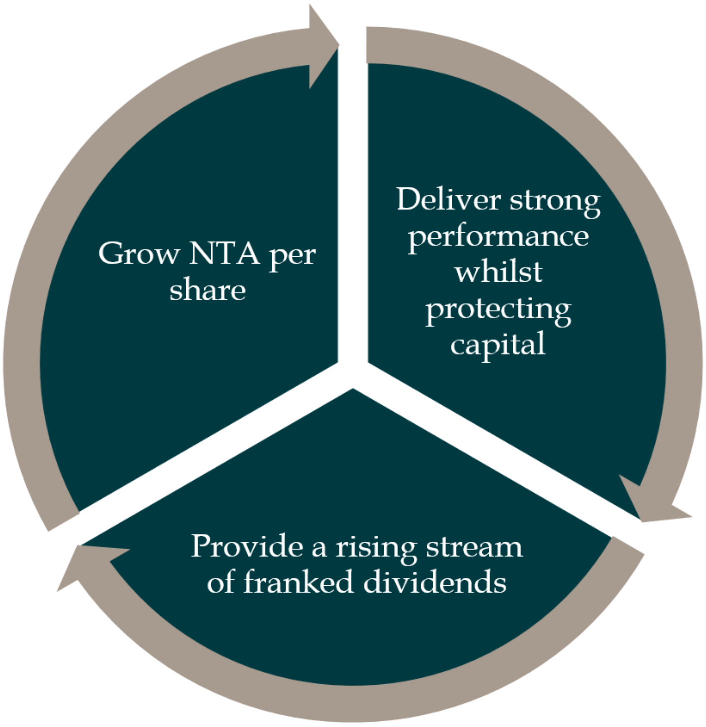
Gary Hui

Portfolio Manager & Lead Analyst

[3] Google dictionary

Arowana Australasian Value Opportunities Fund Limited
as at 31 October 2017

## AAVOF Core Objectives




## AAVOF Asset Allocation

| Asset class | A$m | %** |
|---|---|---|
| Australian Equities | 46.9 | 56% |
| AUD cash and equivalent | 12.7 | 15% |
| USD cash and equivalent | 5.2 | 6% |
| CAD cash and equivalent | 2.5 | 3% |
| Australian Hybrids & Bonds | - | 0% |
| International Equities | 23.1 | 28% |
| Hedges | (6.9) | (8%) |
| **Portfolio Value*** | **83.5** | **100%** |

* *Totals may not sum due to rounding*

** *Percentage of gross portfolio value*

## Top 5 Equity Holdings

| Ticker | | %** |
|---|---|---|
| APT | Afterpay Touch Group Limited | 19% |
| SIV | Silver Chef Limited | 10% |
| ZG.US | Zillow Group Inc. Class C | 7% |
| BAL | Bellamys Australia Limited | 6% |
| WTW.US | Weight Watchers Int'l Inc. | 6% |
| **Top 5 as % of Gross Portfolio** | | **48%** |

Arowana Australasian Value Opportunities Fund Limited
as at 31 October 2017

## Net Performance

| At 31 October 2017 | 1 Mth | 3 Mths | 6 Mths | 1 year | Since Inception (5-Jan-15) |
|---|---|---|---|---|---|
| AAVOF (AWQ) Investment Portfolio* | 8.5% | 14.6% | 22.2% | 15.5% | 38.6% |
| S&P/ASX 200 Accumulation Index | 4.0% | 4.7% | 2.0% | 16.1% | 23.9% |
| **Out/(under)performance V Index** | **4.5%** | **9.9%** | **20.2%** | **(0.6%)** | **14.7%** |

** Net return after all fees, costs and company tax and before providing for estimated tax on unrealised gains.*

## Net Tangible Assets (NTA) per Share

| At 31 October 2017 | Basic NTA per share ($) |
|---|---|
| NTA after tax and before estimated tax on unrealised gains | 1.17 |
| NTA after tax and after estimated tax on unrealised gains* | 1.11 |

** The Company is required to estimate the tax that may arise should the entire portfolio be disposed of on the above date and show the result per share after deducting this theoretical provision. Any such tax would generate franking credits, whose value would not be lost but rather transferred to shareholders on payment of franked dividends*

## About Arowana Australasian Value Opportunities Fund Limited (AAVOF)

AAVOF (ASX ticker: AWQ) offers investors an opportunity to gain exposure to a concentrated portfolio of securities built from a bottom up research process. Whilst the majority of the portfolio is built around Australian listed securities, AAVOF is able to invest in overseas listed securities and to hedge its portfolio.

The core objectives of the fund are to:

1. Generate superior returns over the medium to long term,
2. Provide shareholders a rising stream of dividends, and
3. Grow Net Tangible Assets per share

| Ordinary Shares | |
|---|---|
| ASX ticker | **AWQ** |
| Last price | $1.07 |
| Number on issue | 69,069,727 |
| NTA per share* | $1.17 |
| Market capitalisation | A$73.9m |
| Gross portfolio value | A$83.5m |
| Final dividend** | $0.035/share |

** Before estimated tax on unrealised gains*

*** Final dividend declared in August 2017, paid 29 September 2017, fully franked.*