5th February 2019

Dear Partner:

The Avenir Global Fund (the "Fund") delivered a marginally positive 0.9% return for the full year 2018[1] after declining 8.4%, net of fees, for the December quarter. The MSCI ACWI index (in AUD) declined 10.3% for the December 2018 quarter and rose 0.6% over 2018, while the S&P 500 lost 13.5% for the December quarter and declined 4.4% for the full year[2].

Other market indices saw even more marked declines. The U.S. smaller cap focused Russell 2000 lost 20% in the quarter and was down 11% for the year. Non-U.S. markets suffered to a greater degree with the MSCI Emerging down 14.6% for 2018, MSCI EAFE down 13.8% and MSCI EAFE Small Cap down 17.9%.

Indeed, 2018 proved to be a turbulent year, certainly when compared to the unusual calm of recent years. Markets started the year well, marching steadily higher and pricing increasingly optimistic scenarios into future expectations. Markets calmly shrugged off concerns such as subdued economic data out of Europe and China, and waved away any particular interest in geopolitical red flags ranging from Brexit to trade wars between major economic powers to political unrest in certain European countries.

Then, in the fourth quarter of the calendar year, something changed. Volatility took hold and markets saw a flood of selling across all asset classes and regions. Investors, having forgotten what volatility feels like, seemed to suddenly be transported back to their emotional state in 2008/9 and, fearing the worst, rushed for the exits. All investors are 'long-term investors' when markets are heading calmly upwards, but in periods of volatility and violent market declines, the relevant time frame for many investors can shrink equally violently. It has been said before that the stock market is the only market in which people rush for the exit when things get put on sale.

When markets trend upwards with low volatility for a long time, people become complacent and assume the good times will last forever. Even more problematic, investors see others making money and feel they are doing themselves a disservice to not become even more 'long' the market. Low volatility becomes self-reinforcing as it encourages investors to become overly confident and downplay risk. Like the frog boiling in water, investors can become increasingly exposed to risks they have not adequately considered including more leverage, lower quality assets or valuation risk.

[1] Performance figures refer to the Avenir Global Fund launched on 25 September 2017. For full performance figures please see our website at www.avenircapital.com.au.
[2] Past performance is not a reliable indicator of future performance. Returns are calculated after fees have been deducted and assume distributions have been reinvested. No allowance is made for tax when calculating these figures.

Level 2, 5 Martin Place, Sydney NSW 2000 Australia
t +61 2 9994 7891 **w** avenircapital.com.au

Avenir Capital Pty Ltd ABN 40 150 790 355 AFSL 405469

So, what changed in the fourth quarter? The losses suffered across almost all asset classes and regions was not driven by markedly changing economic conditions or a catastrophic economic event. In fact, the global economy continues to be relatively robust, according to the IMF World Economic Outlook report for the 12 months to June 2018, which showed the strongest real growth since 2010. The answer, of course, is a change in sentiment, or expectations. Investors travelled through 2018 with a certain set of expectations, and then the sentiment towards the likely achievement of those expectations changed. In the case of equity investors, the expectations were continued strong economic and earnings growth, but not so strong as to persuade the Federal Reserve Bank of the United States to increase interest rates and accelerate the rate at which they unwind their balance sheet.

Markets tend to do badly when disappointed and well when positively surprised. This happens at both a market and company level. Our goal is to invest in a way to maximise the chance that the companies in which we invest are more likely to provide a positive surprise and beat the market's expectations of performance, rather than a negative. We avoid the glamour stocks, which will generally be overvalued, and seek out investment opportunities in which sentiment is less ebullient and more likely to improve. We also reduce the chance of negative surprises by investing in businesses which are less likely to subject us to negative operating and financial performance. Our primary risk management tool is to invest in high quality, cash generative companies that we have researched intensely, that we know and understand well and that we have bought at materially discounted valuations. Fortunately, the market provides us with plenty of opportunity to find such quality companies on sale. Even in the S&P 500, which includes many of the largest and most robust companies in the world, we regularly see roughly one third of the companies in that index experience a price change of more than 50% in one year. Almost three-quarters of the index experience a 30% or greater price change in any given year. It almost goes without saying that those companies are not experiencing a 50% or even 30% change in underlying value every year.

We are now in an environment where overall valuations are not extreme but neither are they overly compelling. We would not be surprised to see markets struggle to generate particularly attractive gains over the next 5-10 years. But, who really knows? Fortunately, we are not required to make forecasts about the market. Even more importantly, we are not required to rely on the markets to generate attractive returns for our clients. Our portfolio is made up of companies bought on bottom up, fundamental value, not driven by views on macro conditions or expected market performance. Even if equity markets are in for a period of lackluster medium- to long-term performance, we expect to make strong returns based on the carefully selected and, in our view, significantly undervalued companies we own in those markets.

We maintain a portfolio that is well diversified not only by the country and industry in which our companies operate, but also by the investment drivers we believe will accrue value to our investments over time. We are firm believers that a concentrated and highly selective investment approach is the best way to generate attractive absolute returns over time, regardless of broad market performance. It is still possible, however, to achieve prudent diversification in such a portfolio by ensuring the investments contained within the portfolio are not all 'cut from the same cloth' and exposed to the same risks.

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In our opinion, our portfolio is deeply undervalued, currently trading at 60% of our view of the underlying (and growing) value of the companies within our portfolio. We think the risk / reward balance contained within our portfolio is much more attractive than that contained within broad equity market indices and remain confident that we will be able to continue to generate attractive returns over the medium-term regardless of the performance of overall markets indices.

The fund made no new investments during the quarter.

<u>Select Portfolio Updates:</u>

Our biggest gainer for the quarter was **Spirit Airlines** (NYSE:SAVE) which was also amongst our top 3 gainers in the previous quarter. Spirit increased in price by 23% in the quarter to end at US$57.92 per share and is up 67% from the low reached in April 2018 of US$34.68 per share. Spirit reported better than expected 3Q results and increased guidance, twice, for growth in unit revenue in the fourth quarter, now expected to be up 11% year over year as non-ticket revenue initiatives and higher load factors drive better than expected performance. Fuel prices have also trended down further improving the outlook. Spirit's capacity growth is expected to slow slightly to a still robust mid-teens percentage rate per year. This rate of capacity growth should allow Spirit to maintain unit revenues and profitability allowing earnings to increase at a mid-teens rate with capacity and revenue growth. Spirit trades at only 9x forward P/E, well below historical levels and is well set up to grow earnings from here.

Our second biggest gainer for the quarter (albeit marginally so) was **Clear Media** (HKSE:0100) which increased in price by 1.8% to end the quarter at HK$6.11 per share. 2018 was not a smooth year for Clear Media which uncovered some insider malfeasance that had resulted in the theft of roughly HK$77 million (US$10 million) from the company, most of which was taken as long ago as 2010. Due to an active criminal investigation into the matter and the inability of the auditor, Ernst & Young, to give a clean opinion on the accounts while the investigation was underway, the Hong Kong Stock Exchange (HKSE) put the company into a trading halt on 3rd April 2018. The company was also required to provide confidence to the HKSE that they had reviewed their internal control systems and put in place adequate internal controls to minimise the chance of a similar event taking place again.

Clear Media remained in the sin-bin until 19th November 2018, when trading was allowed to resume once the company had strengthened their internal controls and Ernst & Young was able to pass a clean opinion on the accounts. Predictably, the stock fell precipitously (down 20%) upon the resumption of trading. While the fall was partly driven by the actions of spooked shareholders who had been waiting for the chance to get out at any cost, the situation wasn't helped by the company announcing, shortly before trading resumed, that sales for the month of October were down 25% compared to the same month the prior year. Not a great way to recommence trading but we think that needs to be considered in the context of Clear Media's long-term history of growth and its unassailable market position.

Clear Media has grown revenue, since 2000, every year except one (2009 when sales fell 11%), resulting in an overall growth rate of 11% per annum. Since 2010, the company has grown revenue by 59% at 7% per annum while operating income has grown by over 80%.

Clear Media is an advertising driven business which leads to potential cyclicality (despite only one year of sales decline in the last 17 years) and short-term periods where advertising clients may delay or defer the expenditure of advertising budgets in periods of economic uncertainty. More than 50% of Clear Media's revenue comes from Chinese technology heavyweights such as Alibaba and Tencent, along with a range of other e-commerce and technology companies, with a good chunk of the rest coming from relatively stable food and beverage companies. We think this makes for a higher quality and arguably less cyclical revenue stream than in the past and we are not overly concerned about the short-term variance in sales in October. Clear Media delivered 12.4% revenue growth in the first half of 2018 with third quarter sales up 9.5%, so even with a poor fourth quarter, we are unlikely to see a decline in revenue in 2018.

Clear Media also has a strong history of free cash flow generation, much of which has ended up in the hands of shareholders. Since we acquired our stake in 2014, we have received HK$1.84 per share in dividends or 25% of our purchase price.

We took advantage of the steep decline in the share price upon the resumption of trading and increased our position size by 20% at attractive prices of around HK$4.75 per share. In our opinion, Clear Media is unquestionably and deeply undervalued. At the quarter-end price of HK$6.11 (up 29% from our recent purchases), the company traded at 3.4x 2017 EBITDA or a little over 6x operating income. A major global player in the outdoor advertising space, JCDecaux (EANXTPA:DEC) currently trades at 10.9x trailing EBITDA and just completed the acquisition of APN Outdoor (ASX:APN) in Australia for roughly 11x EBITDA. Even Clear Media's highly leveraged 50.4% majority owner, Clear Channel Outdoor (NYSE:CCO), trades at a multiple of over 12x trailing EBITDA. We only need to achieve a multiple of 5.5x EBITDA for Clear Media for the share price to double from the quarter-end price.

Our biggest detractor for the December quarter was **Motorcar Parts of America** (NYSE:MPAA) which declined by 29% to end the quarter at US$16.64 per share, giving back more than the 25% share price increase it delivered in the previous quarter. The reason for the decline was the company's 9th November announcement of a need to delay filing its financial accounts. This was necessitated by a large customer win that raised questions about the suitability of the company's accounting policies. The share price decline was definitely a case of "shoot first, ask questions later" by many investors as the accounting changes resulted in a slight increase in reported earnings and no change to underlying cash flow.

While we believe the change in accounting treatment was a non-event, MPAA's recent operating performance has been lackluster as its major customers have gone through a period of inventory destocking as they deal with subdued operating performance of their own. While MPAA is often lumped in with OEM (Original Equipment Manufacturer) auto suppliers, MPAA's sales are not linked to new car sales and derive, instead, from repairs to cars already existing in the fleet. The size of the existing car fleet in the US continues to grow, now over 260 million cars, and continues to get older, now approaching 12 years old on average. The sweet spot for MPAA is cars over 8-11 years old. Given the material decline in new car sales in the financial crises of 2008-2009, cars in this age bracket saw a reduced 'wave' come through which we believe has led to softness in business and to MPAA's major retail customers initiating inventory reductions which has exacerbated the issue. We believe this destocking period has passed and expect to see the benefit of recent customer wins increasingly show through in improved financial performance. MPAA continues to increase its market share and improve its competitive position, now holding roughly 45% share in its major business.

We have been urging the company to increase its rate of share buybacks as we feel the company's own shares represent very good value. Pleasingly, the company recently increased its share buyback authorisation, but, unfortunately, was not able to take advantage of the quarter's low share price while its accounts were under review.

The company reaffirmed guidance for fiscal 2019 (and guided to double digit sales growth in 2020), which implies the company ended the quarter trading at a multiple of 7x 2019 Adjusted EBIT which we regard as well below fair value.

Our second biggest decliner for the quarter was **Synchrony Financial** (NYSE:SYF) which fell 25% from US$31.08 per share to end the quarter at US$23.46 per share.

Synchrony suffered from the loss of one of its major private label credit card customers, Walmart, and the fear that it may subsequently lose another of its major customers, Sam's Club, which is owned by Walmart. Matters were not helped by the company being sued by Walmart for US$800 million dollars for breach of agreement. While the loss of the sizeable Walmart contract, which the company had held for 20 years, was bad news, the company has been growing business with other accounts and would be able to offset part of the earnings loss by using the significant capital to be freed up (by potentially selling the related receivable book to the company that had won the contract) to buy back shares at attractive levels, thereby boosting earnings per share.

Post quarter end, Synchrony announced that it had retained the Sam's Club business, along with a number of other sizeable customer accounts, thereby removing this near-term overhang on the share price. The company also announced that it would be selling the Walmart receivables book to Capital One, the new private label credit card provider to Walmart, and would free up over $2 billion of capital, much of which could be used to buy back shares at very depressed levels. Finally, Synchrony announced that Walmart had dropped the $800 million law suit, which was likely a negotiating ploy, once the two companies agreed the sale of the Walmart receivables book to Capital One.

Synchrony is a leading player (38% market share) in the U.S. private label credit card business and was separated from General Electric via an initial public offering in late 2014. Synchrony is highly cash generative and earns very high returns on equity. The company has retained excess capital since the IPO and is now starting to use that capital to drive earnings growth as well as return capital to shareholders via share buybacks at attractive prices. We believe Synchrony can grow earnings per share at double digit rates over the next several years via a combination of organic growth and share buy backs. At the quarter end price of $23.46, Synchrony is trading at 6x forward P/E, paying a 3.6% dividend yield and earning 18.5% return on equity while holding excess equity that can be used to fund growth or to return capital to shareholders.

We have confidence in the underlying value in the companies in our portfolio and believe they are competitively well-positioned in their markets. We believe they are priced at attractive absolute levels with prices well below our estimates of underlying value offering us what we believe to be an attractive margin of safety.

We believe that our value-oriented and concentrated investment approach will continue to generate good investment outcomes for our investors over time, regardless of overall market performance, and the team at Avenir remain energised and focused in our search for the next great investment.

"There is nothing stable in the world; uproar's your only music."

- John Keats

Best Regards,

Adrian Warner

Managing Director