AVENIR
CAPITAL

22nd July 2019

Dear Partner:

The Avenir Global Fund (the "Fund") declined 2.1% (net) for the June 2019 quarter compared to the MSCI ACWI index (in AUD)[1] which increased by 4.9%. Over the past year, the Fund has increased 5.0% compared to the MSCI ACWI index which returned 11.3%[2].

With US markets recently reaching all-time highs we believe that now is not the time to be complacent. The S&P 500 index is up 17.3% in the first half of the year, the best six-month performance in 22 years. In June alone, the index increased 6.9% making it the best June since 1955.

Importantly, however, 90% of the year-to-date increase has been driven by multiple expansion, not growth, in underlying earnings per share. Expectations for earnings in the US are subdued, with consensus forecasts indicating a roughly 1% decline in earnings for the June quarter followed by a flat to slightly declining September quarter earnings outlook. The second quarter decline in earnings, should it occur, would represent the first year-over-year decline in quarterly earnings in three years.

Economic indicators are also mixed. The U.S Markit Purchasing Managers' Index (PMI) was at 50.7 in June 2019 down from 55.4 in June 2018, continuing the decline seen since mid-2018 (a reading less than 50 indicates a contraction and above 50 an expansion). Euro area Markit PMI was 47.6, down from 54.9 at the same time last year, continuing the decline since the beginning of 2018, with Japan Markit PMI coming in at 49.3 down from 53.0 last year. On the other hand, Japanese real GDP growth surprised in the first quarter of 2019 coming in at 2.1% when most expected a decline and, on the 5th July, the U.S reported a very strong jobs growth number which sees unemployment at 3.9%, a multi-decade low. But, Japan's machine tool orders plummeted 38% year-over-year in June and last week, BASF, the German industrial and chemical company, announced that earnings in its second quarter declined by 47% versus the prior corresponding period citing "significantly weaker than expected industrial production", a downturn in global auto manufacturing and weakness in US agriculture.

The strong surge in the equity market, without a corresponding broad-based improvement in economic indicators or earnings expectations, added to the woes of active managers with less than a third of U.S. active managers keeping up with the market for the month of June. Only 41% of U.S. active managers have kept pace with the market for the first six months of the year[3]. In the June quarter, growth stocks continued to beat their value counterparts with the Russell 1000 Growth Index increasing 4.64% compared to the 3.84% gain of the Russell 1000 Value Index.

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[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.
[3] Financial Times; "Big Market Rally in June Wrongfoots US Active Fund Managers"; 9 July 2019

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One possible explanation for the above developments is that true active managers, those that generally consider price an important input to their investment decisions, are seeing reason to be cautious and, at the least, more selective in where they chose to allocate capital. Flows of capital into passive index products, on the other hand, allocate increasing amounts to the equities that are 'working' at any point in time, regardless of price, which in our view can, at least for a while, cause the richly valued to become even more richly valued.

We continue to invest in accordance with our investment philosophy which is to buy competitively entrenched businesses with strong underlying economics and the ability to grow over time, when we can do so at attractive prices. In a business environment in which the threat of technological disruption is arguably as high as it has ever been, it is not always easy to find companies with sustainable and entrenched competitive positions and the ability to grow earnings. It is even harder with the added challenge of buying them at "attractive prices", yet this last part of the equation is critical, in our view, if one is to achieve long term compounding of returns at attractive rates. The side of the investing highway is littered with the roadkill of investors who took comfort in investing in a company because it was "a great company" but who paid no regard to the price they were being asked to pay.

Sir John Templeton, in our view one of the world's greatest investors, whose Templeton mutual funds outperformed the vast majority of his peers during his career, divided the investment community into those who focus on the market trend or economic outlook and those who focus on the relationship between the price and value of individual companies. The former seeks to determine the future economic outlook for the economy and therefore the trend in the market, while the latter try to determine the value of individual companies and compare that to the price at which it is available in the market. In Sir John's estimation, 90% of investors fall into the trend and outlook camp; "*all too many investors focus on the market trend or economic outlook*[4]". In Sir John's view, that was the wrong approach as "*it is individual stocks that determine the market, not vice versa.* [4]"

Sir John's investing mantra was: "*When buying stocks, search for the bargains among quality stocks.*[4]" That sounds eminently reasonable to us and is what we strive to do each-and-every day. While the 'trend' has the market increasing 17% in the first half of this year on a deteriorating earnings outlook, there are still multiple opportunities to uncover quality companies whose valuations are weighed down because their share price is not currently 'acting right'. While these out-of-favour companies may not be receiving much love or attention from the 'outlook and trend' investors today, they can be purchased at very attractive prices by those focused on the longer term opportunity providing both meaningful upside potential and material down side protection, both of which are important to long term compounding of capital.

Doing the hard work to value a company on its fundamentals and only allocating capital when the opportunity exists to do so at a large discount to the underlying value requires discipline, patience and a rigid adherence to investing with a margin of safety. It has been often said in military, political and business affairs that 'hope is not a strategy', and that can be applied equally well to investing. The price investors are being asked to pay for many "great companies" today seems to us to be relying

[4] Sir John Templeton (1993) "*16 Rules for Investment Success (and for your family, house, tuition, retirement...)*", Franklin Templeton Investments

on hope as an investment strategy and on the current trends to continue indefinitely, more so than on any unemotional, economically disciplined and risk weighted view of underlying value.

Our private equity heritage encourages us to view every investment we make as if we are buying the whole company. This helps to keep our focus on the quality of the underlying business, its long-term prospects and the price we are being asked to pay, rather than trying to speculate as to what the market or individual company prices may do over the short-term.

We remain very excited about the prospects for our portfolio, and the attractive embedded upside to our estimate of underlying value allows us to sleep well at night.

Select Portfolio Updates:

Our biggest gainer for the quarter was Charter Communications (NYSE:CHTR) which increased by 13.9% to US$395.18 per share. Charter is up 36% year-to-date as the company continues to deliver solid operational results, and the extreme fear of cable TV cord cutting that was prevalent a year ago has somewhat dissipated. The share price move upwards may also be a greater understanding amongst investors that Charter's main investment merit is not its traditional cable TV business but its internet broadband business. Charter provides cable broadband to residential customers which far exceeds the speed and data capacity available from other technologies.

Charter has an attractive industry structure in which it is generally able to provide the fastest broadband in the markets in which it operates. While a consumer signing up to the likes of Netflix, Hulu, HBO, Amazon Prime, or the numerous new and soon to be new streaming services available including Disney, Apple and CBS Now, may mean one less cable TV customer, it means a broadband customer that will generally use 2-3x more data than non-streaming customers. The best place to get that high data requirement is via Charter's broadband cable connection with 80% of the customers in Charter's footprint subscribing to 100Mbps or more of internet speed. In addition, if a customer 'cuts the cord' and no longer wants Charter's cable TV offering, Charter no longer needs to pay ever-increasing content costs to serve that customer. There are no content costs involved in the provision of broadband connectivity generally making this product more profitable for Charter than a stand-alone cable TV customer. Nearly 40% of Charter's customers only subscribe to internet, up from 28% four years ago (June 2015), and we expect this trend to continue which should increase margins over time.

Charter is also controlled by a major shareholder, board and management team that in our view understand effective capital allocation and the need to drive shareholder returns. The company takes advantage of its highly recurring revenue base to utilize a leveraged capital structure that ensures little to no tax is paid and maximises cash flow that can be used to buy back shares, generally driving free cash flow per share higher. Charter's free cash flow increased by nearly 6x in the first quarter to US$645 million, driven by lower capital expenditure as Charter finished converting their footprint to digital. Charter has been putting that free cash flow to work and reduced share count by 20% over the past three years and bought back nearly $1 billion worth of shares in the first quarter. Charter's free cash flow could exceed $30 per share in several years which, at a 6% free cash flow yield, implies a share price of over $500 per share.

Our second biggest positive contributor for the quarter was Synchrony Financial (NYSE:SYF) which continued its strong run of the past six months and ended the quarter up 8.7% to $34.67 per share. In the first quarter of 2019, the company grew its receivables book 17% and earnings per share grew 20%, primarily due to the addition of the PayPal receivables portfolio that was acquired in July last year. As part of the results announcement, management provided greater clarity on performance of the PayPal portfolio, giving the market greater confidence in the company's prospects. The general economic environment is also a tailwind, with lower interest rates likely to increase earnings and low unemployment expected to curtail bad debts.

The company generated a 22% return on equity over the past twelve months yet its stock trades at an attractive P/E multiple of 8, which is below its average P/E of 10.3x. The board thinks similarly, recently approving a share repurchase program of up to US$4bn over the next year (equal to 16% of the current market capitalisation).

Our largest detractor for the quarter was Clear Media (HKSE:0100) which declined in price by 34% to end the quarter at HK$4.54. Clear Media has had a turbulent past year with the company exiting from an almost eight-month trading halt in November 2018 following the discovery of an insider theft of roughly US$10 million. Upon exiting from the trading halt, the company dropped 20% in price to the low $4's per share, before climbing again to HK$7.50 in January of this year. Since then, the share price has fallen to end the quarter back at HK$4.54. Clear Media has been impacted by concerns of a slowing Chinese economy but is also wrestling with a changing customer base that sees the Chinese internet giants, including Alibaba and Tencent, become its major customers as they grow much faster than Clear Media's traditional food, auto and entertainment company customer base. This has led to increased volatility and less predictability of monthly and quarterly revenue which has caused investors some concern. In our view the company remains well positioned in the Chinese outdoor advertising space and continues to trade at very cheap levels compared to its international peers.

Our second biggest detractor for the quarter was TravelSky Technology (HKSE:0696) which saw its price decline by 24% from HK$20.75 to HK$15.70. TravelSky's recent operational results have been subdued rather than poor but in our view sentiment towards the company has been affected negatively by the ongoing US/China trade dispute and concerns over a slowing Chinese economy.

TravelSky is a Hong Kong-listed, Chinese provider of IT services to airports, airlines and travel agencies in China. Its closest peers globally include Amadeus and Sabre. Two-thirds of TravelSky's revenues are generated through booking fees paid by the airlines when travel agents (both online and offline) book flights through TravelSky's Global Distribution System (GDS). TravelSky has almost a monopoly of the domestic market, with around 95% share. While the company started out as a state-owned enterprise and competition was prevented from entering the market, those barriers have now been removed and TravelSky has maintained its market share. In addition to the booking fee, TravelSky provides IT services to airports and airlines, such as check-in counters and airport IT systems.

We believe there is a long runway of growth in air travel in China driven by a growing middle class. As consumers move into the 'middle class', they not only spend more but their spending patterns change. As an example, the average Chinese flies just once every two years compared to three flights a year for an American or an Australian. We expect this gap to narrow over time. China is also investing in significant airport infrastructure, with plans to build ten new airports every year over the next decade. TravelSky benefits from both traffic growth and the construction (and upgrade) of airports.

We first built a position in TravelSky in late 2018 upon a pull-back in the share price as the company disappointed on growth in a mobile app some investors were pinning hopes to. We added to our position recently when the stock was caught up in trade-war tensions as well as announcing disappointing earnings driven, partly, by what we think is transitory weakness in the Chinese economy, which has resulted in air travel growth slowing to about 3-4%, rather than the >10% seen over the longer term.

TravelSky has been a detractor to performance in the last quarter but we remain excited about the long-term opportunity in the stock. It has a monopoly-like position in its space, is unlikely to be disrupted by new entrants and generates attractive returns on capital.

The team at Avenir are pleased to be one of the fund management teams entrusted with helping invest on behalf of the Future Generation Global Investment Company (ASX:FGG). FGG is an Australian stock exchange listed investment company that is designed to combine the important goals of investing along with raising funds for eight philanthropic organisations[5] doing great work in the areas of youth and mental health.

FGG outsources the investment function to thirteen fund managers, including Avenir Capital, who provide that service for no fees. FGG, in turn, contributes 1% of assets under management each year to the eight philanthropic organisations. FGG has a domestically focused sister listed investment company, Future Generation Investment Company (ASX:FGX) doing a very similar thing, both under the auspices of Future Generation Invest. To date, Future Generation (made up of both FGG and FGX) have donated approximately A$20 million to a range of philanthropic organisations and are likely to exceed roughly A$30 million in total donations by June next year. The entire team at Avenir is delighted to be able to do our small part to support the great work being undertaken by FGG and its philanthropic partners.

More information on the Future Generation business, including the two listed investment companies, FGG and FGX, can be found at https://futuregeninvest.com.au/.

During the quarter, we presented our investment thesis on General Motors (GM), one of our portfolio companies, at the Future Generation Investment Forum held at the Westin Hotel in Sydney. The video of this presentation can be found here (1:04).

Our GM thesis and other investment ideas from the Future Generation Forum were covered in the Australian Financial Review article *"Experts' Pick: General Motors 'way to cheap' and Myer set to hit $1"*. Our thinking on GM was also featured during the quarter in Barron's magazine, which can be seen here.

[5] The eight charitable philanthropic organisations are: Beyondblue; Black Dog Institute; The University of Sydney Brain and Mind Centre; Butterfly Foundation; headspace; Orygen National Centre of Excellence in Youth Mental Health; Reach Out.Com and Sane Australia.

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.

"Buy low."

- Sir John Templeton

Best Regards,

Adrian Warner
Managing Director