AVENIR

CAPITAL

22nd April 2020

Dear Partner:

The Avenir Global Fund (the “Fund”) declined 25.2% for the March 2020 quarter bringing the past 1-year return to -18.1% (net)[1]. The MSCI ACWI index (AUD) returned -9.7% for the quarter and 3% for the past year.

The last two months have been unlike anything most investors have ever seen. In mid-February, markets were at all-time highs and it was almost impossible for investors to imagine anything that could cloud the horizon. By the middle of March, we were all conducting Zoom calls from our living rooms, as we hid indoors, and watching the same market fall into bear market territory faster than ever before, reaching a trough 35% below the peak[2]. Value underperformed significantly as investors sought defensive havens, not cyclically exposed or leveraged names. Energy, in particular, was hit hard, with the oil price down 47% in March alone.

Outperformers during the month were Clear Media, Cigna, Wuliangye Yibin and new portfolio entry, Visa. We have written about Clear Media in the past but as we had hoped, the company received a tender offer from a consortium at a 50% premium. We have now exited the stock. Cigna benefitted in part from Biden's presumptive nomination as the Democratic candidate in the US presidential election. Wuliangye Yibin, our Chinese liquor maker outperformed global markets as China began its slow return to normal activity. We added Visa to the portfolio in the month, opportunistically building a position in what we believe is one of the world's great franchises when it fell 40% from recent highs.

The largest detractors to performance in March were ECN Capital, Nexstar Media, Synchrony Financial, Spirit Airlines and General Motors. In the case of ECN, Synchrony and GM, prices fell predominantly due to market concerns that a spike in unemployment would have an impact on consumer spending. Synchrony is a provider of credit to consumers and ECN is essentially a distribution channel for banks and non-bank financials to provide credit to consumers albeit not taking on material credit risk itself. In the case of GM, car purchases are large commitments predominantly made with credit and previous recessions have typically resulted in falling car sales. In the case of Nexstar, it completed an acquisition in late 2019 which has left it relatively levered and as a result indirectly impacted by the temporary seizing up of corporate debt markets, even though in Nexstar's case, the bulk of their debt is not due until 2024 and beyond.

Barron’s magazine recently featured Avenir’s analysis of the company, Live Nation. You can find the Barron’s article here.

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

[2] We refer here to the S&P 500.

Market Commentary

The Covid-19 crisis is a dynamic and rapidly evolving situation. Governments and communities around the world have taken increasingly tough measures in order to control the health emergency, and the likely outcome of these efforts is resulting in the broad-based shutdown of economic activity for a period of unknown duration but, at least, several months.

The full outcome of the economic downturn will be a function of how long the health crisis lasts, until people are able to return to work, and subsequently, how long it takes for demand to return to normal levels. No-one knows for sure if we will see a V-shaped recovery, a U-shaped recovery or, something even worse, such as a long and deep recession or even depression. At this point, following the sharp market rebound from the lows on 23rd March, the market seems to be anticipating a short, sharp V-shaped recovery, although the economic evidence for this is less than clear.

The unprecedented threat to economic activity has seen equity market around the world suffer from some of the steepest falls ever witnessed. Since global markets peaked on February 19th, they have fallen by ~30%, wiping roughly U$23 trillion from the value of global equity markets. The S&P 500 fell 34% to its lows[3], in the process, gaining the dubious distinction of being the fastest ever fall of more than 20%. Since the market low, it has bounced back strongly to be only 14% below its all-time highs[4]. During March, the Dow Jones recorded two of the top five worst one-day performances of all time[5]. Common volatility measures like the VIX have hit all-time highs, and, in fact, outside of the global financial crises, 5 of the all-time high closes for the VIX occurred in the month of March 2020, so we are witnessing one of the most volatile periods in financial market history[6].

The good news is that governments around the world are taking extraordinary measures in order to protect the global economy. The US has promised fiscal stimulus of US$2.4 trillion[7] (~11% of GDP)[8] to support both small and large businesses along with individuals and may well go higher. European countries are also promising to do “whatever it takes” announcing massive fiscal stimulus programs and support for businesses and individuals affected by the crises. The UK has pledged £350 billion[9] of stimulus. In Australia, the figure moves by the day but is equally impressive with the federal government announcing fiscal stimulus of over A$320 billion to date, or 16% of GDP[10]. These unprecedented measures should help to limit the economic fall out of the crises.

[3] https://us.spindices.com/indices/equity/sp-500. Avenir Capital calculations.
[4] https://us.spindices.com/indices/equity/sp-500. As at 16th April 2020.
[5] https://insight.factset.com/risk-waits-for-no-one
[6] https://insight.factset.com/risk-waits-for-no-one
[7] https://www.wsj.com/articles/more-stimulus-would-crush-the-recovery-11586882680
[8] https://www.statista.com/statistics/1107572/covid-19-value-g20-stimulus-packages-share-gdp/#statisticContainer
[9] https://www.euractiv.com/section/coronavirus/news/uk-unveils-wartime-e400-billion-covid-bailout-programme/
[10] https://treasury.gov.au/sites/default/files/2020-03/Overview-Economic_Response_to_the_Coronavirus_2.pdf

Portfolio Activity

So, what are we at Avenir doing during this crisis? We have taken steps to protect our investors' capital including reducing our exposure to some of those sectors most directly impacted by the crises including travel related and other more cyclical businesses, and increasing our cash weighting to approximately 15%. We have been working through each company in our portfolio to assess both the near-term impact on our companies and to determine whether they have the liquidity and balance sheet strength to weather the storm and to confirm that our long-term investment cases are intact.

Importantly, we are working to position the portfolio to both protect capital and generate attractive returns for our investors over the next 3-5 years. This can mean proactively trimming more fully valued positions in our portfolio, or those which have been less affected by the share price volatility and adding to those which have been most affected by the market downturn and in which the price-to-value gap has increased significantly.

The unprecedented volatility has also reduced the price of some high-quality businesses that we don't currently own and that have been on our Watchlist but have not previously been at valuation levels that have been attractive to us. We will continue to look for opportunities to selectively add high-quality but heavily-discounted names to the portfolio. It is at times of economic and market stress like this that some of the best long-term investment opportunities can be found.

As some specific examples, we have added Wuliangye Yibin, a Chinese baijiu or alcoholic beverage company, to the portfolio. Wuliangye Yibin has a very attractive competitive position and has delivered earnings growth of over 20% per annum over the past five years. Wuliangye Yibin has many of the characteristics we look for in investments: compelling end market growth in a defensive category, strong market share, high returns on capital and the ability to deploy additional capital at high rates of return, pricing power and a competitive moat created by long standing-consumer brands.

We have also recently added Visa to the portfolio. Visa is a duopoly business that generates tremendous returns on capital and has ample scope to continue to invest capital at high returns. Visa has been a wonderful business for a long time and the near 40% fall in price between 19th February and 23rd March this year gave us the opportunity to add it to the portfolio.

Our largest position in the portfolio currently is Charter, the U.S. broadband business. Charter's business is very resilient in the current environment where people are working and being schooled from home and the need for data connectivity continues to grow in the modern world. We believe the near term for Charter is well protected and the long term offers tremendous value creation opportunity.

We also have material positions in major health businesses like Cigna and HCA Healthcare which, while potentially affected in the near term, being at the forefront of the health crisis, are world class businesses and we believe they have enormous long-term value.

Outlook

As always, all members of the Avenir investment team are invested in the Fund alongside our investors, and while the current uncertainty and volatility can be very unsettling, we believe that the portfolio is currently trading at deeply discounted levels with the embedded margin of safety and prospective five-year returns as high as they have ever been.

The coronavirus has shut down the economy to an extent not witnessed before and economically sensitive and smaller capitalisation stocks have been severely punished. This covers a very wide range of the economy capturing banks and other financial institutions, energy, travel related companies, hotels, entertainment and restaurant businesses, home builders, auto companies, etc. The fall out has also affected companies previously regarded as infrastructure assets, including airports and toll roads, which have seen revenues approaching zero. Smaller companies have been affected much more than larger companies. The Russell 2000 was down 31% to the end March compared to the S&P 500 which was down 19%[11].

Many of the companies most affected by this pandemic are those that were already trading at heavily discounted valuations. At the same time, the market has bid up those companies that will benefit, at least temporarily, from the current crisis, including supermarkets, Netflix, Amazon, etc. Many of these companies had already benefited from 5 years of market conditions that favoured high growth companies with potential high future earnings in a world of low interest rates.

Consequently, the valuation dispersion between the most expensive and the cheapest, which was already high, has now grown even more pronounced. Many of the market leading firms, even after recent falls, are still trading at valuations near, or in excess of, their long-term averages. McDonalds, for example, has fallen 20% from its highs but still trades at a trailing EBIT multiple[12] of 20x compared to its average over the past 5-years of 18.3x. In other words, the recent price decline has not made it particularly cheap compared to its own history. We don't highlight McDonalds, which is a very high-quality and resilient company, for any reason other than it is well known.

Apple is another example, which has fallen 17% from its highs (after having fallen as much as 32%, to a recent low of $224, before rebounding) but still trades at 18x EBIT, a 38% premium to its 5-year average of 13x. Much of this multiple expansion occurred during 2019, and we commented in our December 2019 letter that it was difficult to see exactly what had changed during 2019 to justify the market rewarding Apple with an extra $560 billion of market capitalisation and a multiple that is 4-standard deviations greater than its average for the past decade.

[11] https://www.ytdreturn.com/russell-2000/
[12] Enterprise value (market capitalisation plus net debt) divided by earnings before interest and tax.

There are many similar examples of companies that have fallen by substantial amounts to still sit well above their own long-term trading multiples. This is, of course, due to the elevated level at which markets (the U.S. in particular) were trading at the end of 2019. Prior to the recent abrupt market crash, the Shiller PE was in excess of 30x, a figure only breached twice before in market history, in 1929 and in the 1990-2000 dot.com peak[13]. Even today[14], the Shiller PE sits at 27x compared to its long-term average of 17x. Despite the pandemic we are facing and the near total economic shut down, ongoing geopolitical tension, oil price crashes, the potential for inflation following $7+ trillion of money printing by global central banks, potential decoupling of supply chains, etc, the S&P 500 trades nearly 60% **above** its long-term average trading multiple.

At the other end of the spectrum is Univar Solutions, one of our portfolio companies. Univar is a chemical distribution business and so is impacted by the level of underlying economic activity. Its share price has been significantly impacted by the coronavirus induced economic slowdown. From its quarter opening price of $24, Univar's share price declined 74% to its low of $6.40, before rebounding 68% to its quarter-end price of $10.72. At that price, Univar traded at 12x trailing EBIT, a 37% **discount** to its 5-year average of 19x trailing EBIT. While Univar is, no doubt, somewhat economically sensitive, it is exposed to a range of industries and is largely a consumbles business so revenue is recurring and not subject to dramatic swings like a capital equipment provider.

During the 2008/2009 financial crises, Univar's rolling twelve month EBITDA declined by only 12.4% from the peak in 4Q2008 to the trough in 4Q2009. Twelve months later (4Q2010) EBITDA had rebounded to its previous high. Univar has market leadership positions in a relatively stable and high return market, limited capital intensity and high free cash flow generation. The company has many suppliers, and even more customers, reducing the potential for unexpected shocks. It is hard to see the chemical distribution industry being disrupted in any meaningful way. Univar also has a high working capital position so, any revenue decline leads to high cash generation as the working capital unwinds, adding to the economic resilience of the business.

In fact, the chemical distribution industry has been a favourite hunting ground of the private equity industry due to its underyling resilience and lack of secular or disruptive threats. Univar, itself, was only returned to the public market in 2015 after a lengthy period in private equity ownership. As of 2013, 5 of the top 7 global chemical distribution businesses were owned by private equity firms highlighting the suitability of these firms for PE ownership. It is quite possible (likely?) that private equity make another play for Univar at some point and that possibility alone should help to provide some kind of a floor under the share price. If Univar were to simply return to its 5-year average multiple, on our view of normalised earnings, we think it possible for the share price to climb to $30 per share or 150% higher than the current price. Univar currently trades at close to a 20% free cash flow yield based on normalised earnings. While the company does carry some debt, it has no major debt maturities until 2024 and its average interest rate is 4.25%, so, we believe it is well placed to weather thes storm and deliver very attractive returns from here.

[13] Multpl.com/shiller-pe.
[14] 14th April, 2020.

Regardless of the short-term impact of Covid-19, we believe that the prospects for broad based market returns over the next 5-10 years remain subdued. Over the near term, returns are likely to be determined by investor psychology and behaviour as much as they are by fundamental outcomes. Over the long-term, the fundamental performance of businesses and the price investors pay for those business will win out. Current market stress and volatility, and the wholesale selling of anything with any kind of economic sensitivity, is setting up some extraordinary long-term investment opportunities.

O'Shaughnessy Asset Management (OSAM), a U.S. based quantitative investment firm, calculate that the spread between the earnings yield[15] on small cap value and the yield on the U.S. government 10-year bond, which is normally 3-6%, is currently 20%[16]. Less than 1% of all data observations show a higher earnings yield spread, so the spread is at truly historic proportions. OSAM calculate that in the 10-year period following past observations of such a high spread, small cap value returned 27.9% per year. While the current market dynamics make for a chaotic and, indeed, frustrating period, we believe that it increases the potential for our value-based strategy to outperform the market over the next 5-10 years.

Is Inflation a Thing?

People have long been talking about the central bank 'experiment' that has been taking place around the world with the enormous expansion of central bank balance sheets and generational low interest rates. The central bank balance sheet expansion that has occurred post the global financial crisis, however, has been a drop in the bucket compared to the money printing that is being undertaken now as a response to the coronavirus crisis and the unprecedented shutdown of the global economy. Dare we raise the prospect that inflation may rear its head at some point following the extraordinary money printing we are witnessing?

Inflation has also, arguably, been low due to the globalisation that the world has benefited from for the last 30-years. We are now likely to see a reduction in those benefits as companies and countries increasingly 'decouple' to avoid being strategically disadvantaged by having supply chains deeply embedded in another country that may turn against them for political reasons. We don't know the answer, but is it out of the bounds of possibility that inflation and higher interest rates may follow from these factors at some point? If that is the case, then long dated options, like unprofitable but fast-growing companies, may not be valued in the future the way they are today. These, and many other companies, despite recent falls, still appear priced for perfection, even though we are in the middle of one of the greatest economic shocks we have ever witnessed. Now is a time for operating with a scalpel not a sledgehammer, and we prefer the make-up of our concentrated portfolio to the broader market that appears to be doing its best to ignore the current economic conditions.

[15] The earnings yield is the inverse to the PE ratio. For example, a PE ratio of 20x would imply an earnings yield of 5%.
[16] https://www.osam.com/pdfs/research/OSAM%20Update_Blizzard,%20Winter,%20or%20Ice%20Age_FINAL.pdf

Portfolio Positioning

The type of business we favour has not changed and we would still rather buy high quality but appropriately priced businesses than businesses priced for perfection in the current uncertain environment. We are value-oriented investors but we don't simply buy 'cheap' companies. Robust, well-capitalised businesses that can grow underlying value are still, and always will be, our hunting ground. Periods of volatility are also a sweet spot of ours as it allows us to continually improve our margin of safety by reallocating capital from companies with a higher price-to-value ratio to those with a lower price-to-value ratio. By doing so, we aim to substantially reduce risk and increase the prospective returns for the portfolio.

We consider that the Avenir portfolio currently trades at 50%[17] of our view of underlying value positioning the portfolio for robust returns over the next 3-5 years. We have not seen such attractive portfolio positioning for many years and investors may consider this as an opportune time to allocate capital to Avenir Capital.

It is important for investors to maintain a long-term view and not have long-term investment goals derailed by short-term events. This is a complex, fast moving and unprecedented situation and we will continue to take thoughtful and measured action to best position the portfolio for the current conditions and to deliver attractive investment returns over the longer-term.

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 believe that our fundamental research-driven and concentrated investment approach will continue to generate attractive investment outcomes for our investors, and the team at Avenir remain enthusiastic and focused in our search for the next great investment.

"There is nothing more deceptive than an obvious fact."

- Arthur Conan Doyle

Best Regards,

Adrian Warner
Managing Director

[17] Avenir Capital analysis.