AVENIR

CAPITAL

31st October 2019

Dear Partner:

The Avenir Global Fund (the "Fund") declined 1.2% (net) for the September 2019 quarter compared to the MSCI ACWI index (in AUD) which increased by 4.0%[1]. Over the past year, the Fund has decreased 2.7% compared to the MSCI ACWI index which returned 8.8%[2].

Global equities delivered a third straight quarter of gains in the three months to September as central banks continued to signal that monetary policy would be generously positioned. The market gains were supported by interest rate cuts by the European Central Bank and the US Federal Reserve, the first US rate cut in eleven years and the first time the Fed has ever cut interest rates with US unemployment below 4%.

Market gains occurred despite softening economic indicators and continued geopolitical turbulence. Markets were surprised when key oil facilities in Saudi Arabia were attacked and extensively damaged in a drone attack that has since been widely blamed on Iranian sponsored forces. Protests in Hong Kong grew in intensity and violence and the ongoing trade dispute between the US and China went through continued ups and downs. The UK continued to lurch towards Brexit, with there being no clearer guidance on what Brexit might look like under Boris Johnson's leadership than Theresa May's, and the US Democratic party initiated formal impeachment proceedings against President Trump for allegedly seeking the support of Ukraine to tarnish the reputation of former Vice President Joe Biden, one of the leading Democratic presidential nominees.

The month of September also saw a significant global rotation out of expensive stocks displaying growth, low earnings volatility and strong share price momentum, into relatively unloved and attractively priced companies. Investors moved aggressively to reposition portfolios from the higher priced and momentum-stocks that have driven the longest ever market expansion into value securities that have underperformed in recent times, like financials and energy stocks. Given that the valuation spread between expensive and cheap stocks is the widest it has been in two decades, there may be further to go for this rotation.

This notion is supported by the dramatic failure of WeWork, one of the most storied venture capital-backed 'unicorns'[3], to complete its anticipated IPO. WeWork, which raised private capital at a valuation of US$47 billion earlier this year, was to raise US$4 billion from public markets at a US$47 billion valuation. Public market investors drew the line at this price and the valuation was dramatically reduced to US$20 billion along with material changes to the terms of the IPO such as significantly reducing the voting power of the founder, Adam Neumann's, shares and eliminating the unusual ability of his wife to determine his successor in the case of his incapacitation.

[1] Performance figures refer to the Avenir Global Fund – Class A launched on 25 August 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] A term widely used to refer to a privately-owned company valued at greater than US$1 billion.

Despite this extraordinary revaluation and change in terms, the public market was still not willing to participate, and the IPO was pulled. WeWork recently finalized discussions with Softbank, its major backer, to raise emergency funds to stay out of bankruptcy, a very different proposition from its IPO at a mooted $47 billion valuation just two months ago. The high profile and humiliating failure of WeWork to achieve an IPO, along with the significant share price declines (post IPO) of other high-profile unicorns such as Uber, Lyft and Peloton, suggests that the market's willingness to accept enormously high valuations, for often unprofitable companies, has been stretched to the limit.

This may be a point of reckoning for the venture capital industry which generally has been able to push valuations of its own portfolio companies higher and higher in self-funded valuation rounds that have recently been found wanting under scrutiny by the public market. The era of 'unlimited capital' as a business strategy may be nearing its conclusion even as the wall of money finding its way into the venture capital industry continues to grow.

The private equity industry is also grappling with the effects of the inflow of an enormous amount of capital chasing the low volatility returns the industry advertises. The price paid by private equity firms for companies is now at record multiples and routinely higher than the price of similar companies in the public market all while cheap public companies are as attractive an investment opportunity as they have been for twenty years.

We continue to find compelling opportunities in the public market to acquire high quality businesses at prices we deem to be very attractive and which provide the prospect of attractive absolute returns over the medium-to-long term regardless of the fluctuations of the market in the short 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.

Select Portfolio Updates:

The major contributors to the Fund's result for the quarter were our investments in ECN Capital, Charter and TravelSky Technologies. ECN Capital climbed after delivering strong financial results and reducing corporate costs in line with previously flagged expectations. Operating earnings doubled for the quarter and the company remains attractively priced while delivering strong earnings growth. Charter surged after beating earnings expectations and illustrating its free cash flow generating power as previously elevated capital expenditure showed indications of moderating as we anticipated. TravelSky climbed as the recent slowing of growth in China air passenger bookings eased.

Another notable gainer for the Fund was Dart Group, whose share price increased by 22% in September (and is up another 38% in October to-date). Dart is a UK-based airline and tour holiday operator we have owned since the beginning of 2018. We were attracted to its growth, high returns on capital and high customer loyalty to their great value-for-money holiday packages. Despite these characteristics, it was trading on single-digit PE multiples.

Dart has been steadily taking share from weak competitors such as Thomas Cook, which failed spectacularly on 23rd September and filed for bankruptcy leaving an estimated 150,000 customers stranded in overseas locations[4]. Dart shares a lot of departing airports and destinations with Thomas Cook and is likely to pick up further market share from Thomas Cook, as well as benefit from a less competitive operating environment. Even with the September gains, Dart is still only on a 10x price-to-earnings multiple.

We initially acquired Dart at what we considered to be a very attractive price, on the back of Brexit concerns, and the share price has doubled since our first purchases. Dart provides a useful illustration that company specific developments, in carefully selected long-term investments, will generally be more important in driving value creation than the macro issues getting headlines at any point in time.

The biggest detractors to the Fund's result were Spirit Airlines, Bluegreen Vacations and Cigna (a new investment for the Fund discussed below). Spirit declined after the company guided to higher than expected unit costs for the rest of the year. Bluegreen Vacations fell as a dispute over contract terms with a distribution partner interfered with sales during the quarter. That dispute has since been resolved with limited adverse long-term financial impact to Bluegreen and, in fact, has allowed Bluegreen to expand its distribution opportunities with that partner. Cigna dropped as the Democratic presidential candidate nomination process raised political uncertainty around potential regulatory impact in the US health system.

New Investments:

Infineon Technologies (XTRA:IFX)

Infineon is a unique power semiconductor manufacturer with a significant electric and autonomous vehicle opportunity.

> *"We always overestimate that change that will occur in the next two years and underestimate the change that will occur in the next ten. Don't let yourself be lulled into inaction"*
>
> – Bill Gates, The Road Ahead

While the promise of electric vehicles (EVs) has teased investors for some years now, the reality has disappointed somewhat – poor product variety, high price tags, range anxiety, long charging times and poor charging infrastructure frustrating potential buyers. That short-term disappointment has presented an opportunity to own what we believe is one of the biggest beneficiaries of this transition, Infineon Technologies.

Infineon was once part of the German conglomerate Siemens, and, after being spun off, went through some difficult restructuring, exiting uncompetitive (and more commoditised) products, then focusing on power semiconductors. Power semis are a niche sub-segment of the broader chip market that has very different market dynamics to the memory and logic chips most think of when they think of semiconductors. The products are less commoditised, end markets are very different (less smartphone and more automotive and industrial, for example) and as a result tend to be less competitive and prices more stable. Technological barriers to entry are very high and the very different manufacturing process makes the risk of competition, even from other chipmakers, very low.

[4] *U.K Launches Massive Tourist Airlift After Thomas Cook Collapse*.com, Bloomberg.com - 23 September 2019.

We believe the conditions are right for the transition to EVs to surprise on the upside. The reasons are varied, including increasingly strict emission standards in both Europe and China, attractive prices and overall better product features such as longer range and much shorter charging times. Infineon is arguably the dominant manufacturer of the components that control the flow of electrons from the battery to the electric motor and back again. Each EV represents US$400, or more, of potential incremental revenue for Infineon and from products where reliability and performance trump price, unlike the commodity materials such as lithium or nickel used in the batteries.

We are also comfortable that should the EV transition happen slower than we might have hoped, Infineon is supported by a broader semiconductor business that benefits from the increasing semiconductor content in cars generally (exclusive of EVs), investment in renewable energy (both wind and solar) and low exposure to fickle, price-sensitive smartphone makers. Infineon is due to complete the announced acquisition of Cypress Semiconductor later this year or early 2020 which will make Infineon the largest automotive semiconductor maker globally and the company will have more than 40%[5] of revenues from automotive applications. Longer-term, Infineon should also benefit from incremental autonomous driving features, which require a significant complement of sensors, computing power and microcontrollers.

Infineon is a leading manufacturer of power semiconductors, a market that in turn has characteristics that make it attractive to long-term investors, such as few substitutes, significant IP barriers to entry, and low capital requirements. It has significant growth opportunities from the shift to EVs but is supported today by diverse and stable income streams from existing automotive, industrial and consumer end markets. Recent short-term market concerns around automotive weakness in China and elsewhere has presented an opportunity to own the company at much cheaper multiples than in recent years.

Cigna Corporation (NYSE:CI)

Cigna is a health maintenance organisation (HMO) company, otherwise known as a health insurance company. The major HMO companies in the US have seen recent price weakness on fears of adverse regulations should certain US democratic presidential nominees win the democratic nomination and, ultimately, become the US president in the 2020 presidential election. High profile nominees such as Senators Elizabeth Warren and Bernie Sanders have been vocal with their distaste for the HMO industry and their plans to introduce Medicare For All (M4A) in which the US Government would assume all health costs potentially making the health insurance or HMO industry redundant.

The four major HMOs made roughly $20 billion combined in net profit last year and, based on Senator Warren's passionate televised debate performances, you would think that profit was, firstly, something to be ashamed of and, secondly, that the $20 billion in combined profits was single handedly responsible for pushing the $4 trillion annual US health care bill out of balance. Even if the HMOs made zero profit, the annual US health care bill would still be $4 trillion.

[5] Avenir analysis.

There is compelling evidence that the HMOs do a very effective job in helping to reduce health care costs through using scale to negotiate with other participants in the health care sector, including hospital and drug manufacturers, and having the capacity to spend on technology that is increasingly important in managing health care costs and providing better health outcomes.

It is not new for the HMO industry to be the punching bag of politicians looking to score easy points in debates and TV interviews. The industry regularly underperforms the broad market leading up to a US presidential election, and generally outperforms the market once the election is settled and the newly elected president, senators and congress men and women no longer have the political need to attack the industry.

Since February of this year, the major HMO players have seen their share prices decline ~15-25% in price. The industry currently trades at approximately 70% of the earnings multiple at which the US market currently trades, compared to the usual 90-110% of the market multiple. This is despite the industry having strong long-term track records generating high returns on invested capital and prodigious free cash flow.

Cigna, a recent entrant to the Avenir portfolio, currently trades at 53% of the market price-to-earnings multiple or just 9x the earnings we expect the company to earn in the next twelve months. Over the past nine years, Cigna has grown revenue at 11% per annum and net income per share at 15% per annum. The company is highly cash generative with free cash flow exceeding reported net income.

Cigna has been able to deliver these outstanding financial results while also benefitting its members in terms of cost management and health outcomes. Cigna is one of the leading HMO's in terms of health outcomes with a medical cost trend of 3.5% per annum, well below the 4-6% most of its peers deliver, and a target of medical cost trend in line with inflation (~2-3%) by 2021. Cigna recently acquired Express Scripts, one of the leading pharmacy benefits operators which negotiates pharmaceutical costs on behalf of employers. Cigna's Express Scripts business saw commercial drug prices increase only 1.5% and 0.4% in 2017 and 2018 respectively and more than 50% of Cigna's members benefited from a decline in average pharmaceutical costs in 2018.

Cigna, along with other HMOs, are working with providers such as hospitals to increase the proportion of members that are on value-based plans. Under value-based plans, the health provider receives a fixed amount per member and must deliver care within that cost rather than the traditional cost-plus system. In our view, the actual results achieved on behalf of members are substantial and beneficial to the goal of delivering quality health care while controlling costs.

It can be unsettling and uncomfortable for companies and industries to become the centerpiece of intense political discussion and debate. Such situations, however, can provide opportunities to make above average returns once the spotlight moves on to other areas and the market ultimately rewards the underlying operational and financial success of these companies.

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 fundamental research-driven 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 enthusiastic and focused in our search for the next great investment.

"The first principle is that you must not fool yourself –
and you are the easiest person to fool."

- Richard Feynman

Best Regards,

Adrian Warner
Managing Director