AVENIR

CAPITAL

8 February, 2017

Dear Partner:

The Avenir Value Fund (the "Fund") increased 6.4% in the December 2016 quarter and 20.4% for the full year to December 2016. By comparison, the ASX All Ordinaries increased 4.4% in the quarter and 11.6% for the full year and the MSCI World Total Return index returned 7.0% for the quarter and 8.9% for the full year. Since inception in August 2011, the Fund has returned 103% net of all fees and expenses.

2016 – Expect the Unexpected (but what else is new?)

2016 was a year of surprises with the most significant financial events being Brexit in the middle of the year and then the election of Donald Trump as the 45th President of the United States in November. Short term vicious movements in asset markets highlighted the unexpected nature of these events and there is nothing markets hate more than a surprise. In the case of the US presidential election, markets were expecting Hillary Clinton to be elected the first female president of the United States. The confusion caused by the election of Donald Trump was highlighted by futures on the S&P 500 falling 5% during the night of the election, as it became increasingly apparent Trump was going to steal a surprise victory, followed by the markets ending the next day's trading up 1%. Since then, markets have continued to react favourably to Trump's business-friendly agenda which calls for tax cuts, fewer regulations and a large dose of government spending leading to a powerful "Trump Rally".

Our goal is to compound our investor's wealth at a well above market rate while carefully managing the risks to which we are exposed. In doing this, we don't spend a lot of time trying to predict the unpredictable because (i) it is not easy and (ii) even if you get it right, as shown above, it can be even harder to correctly determine what the impact will be on markets and when. So, we stay focused on what we believe we can do which is to search the world for quality companies that are available to us at a bargain price for reasons we understand.

We have also learnt to look lazy. That doesn't mean that we are lazy, but if you judged our effort simply by the changes in our portfolio you might wonder whether we are putting in a full effort. In 2016, we achieved pleasing results largely by sticking with what we already owned rather than chopping and changing to appease a need for action. There will be times when we feel it worthwhile to make multiple changes to the portfolio in relatively short order, and there will be times when the most useful thing we can do is to get out of our own way and be patient.

We do not know exactly what Brexit or a Trump administration mean longer term but they are likely to lead to bouts of volatility which will be good for us. We ended 2016 with cash equal to 20% of net assets and will be quick to act when we find worthwhile opportunities.

New Partnership

Before discussing some specific developments within the portfolio, I wanted to update you on an exciting new development at Avenir Capital. You may have noted in the press recently the announcement that Avenir Capital has entered into a partnership with Fidante Partners (Fidante). Fidante is a boutique asset management platform wholly owned by Challenger Limited (ASX:CGF). This is a very exciting development for us and you, our investors, and I want to take this opportunity to give you some background to this new partnership.

While we had good investment returns of 26% (gross) in 2016 and have returned 19% per annum since our inception over 5 and a half years ago, I have also had a growing realisation that operating as a small fund manager was getting increasingly difficult in today's world. The regulatory demands on all funds, irrespective of size, grow continually and become increasingly time consuming and financially burdensome. Ultimately, this can only detract from the time we are able to devote to clear-headed thinking on investment decisions. This is, of course, what we prefer to be doing with our time and, even more importantly, what we implicitly promise to our investors that we will be doing.

So, during 2016, I become more open to exploring different paths to ensure that we were going to be able to build Avenir to last and to deliver ongoing superior returns to our investors. One of these paths led to Fidante Partners which is a multi-boutique platform that forms long-term partnerships with fund managers to support and grow asset management businesses.

While we were flattered that an incredibly high quality and successful organisation wanted to learn more about what we did, we were also very cautious as we have thus far resisted the overtures of a range of hedge fund seeding and incubation groups. Fidante's sterling reputation preceded them, however, and so we approached our early conversations with an open, if somewhat reserved, mind. We also recognised that a meeting with Fidante has a very low probability of success. Fidante receives calls continually from fund managers seeking to partner with them, and they are extremely disciplined in their selection of firms with whom they partner.

Despite the above, over almost 8 months of discussions, it became clear that there was something exciting to be done here. As it became increasingly clear that we might be given the opportunity to partner with Fidante, it became more real that we were going to have to actually make a decision as to whether we wanted to or not.

Why Fidante Partners?

So, what was important to me in considering whether to form a long-term partnership with Fidante? Several things, the first of which was, are they the type of people that I wanted to forge a long-term partnership with? People who would be pleasant to work with and who were professional, diligent, hard-working and operated with the utmost integrity? As I met more and more of the team at Fidante, I was highly impressed by what I saw and increasingly confident and excited by the thought of working alongside them. While individually they are very impressive, what struck me most is the culture that appears to run through the organisation which is both hard working and enthusiastic about what they do, but also very collaborative and supportive.

Also important, was their ability to deliver on their promise of providing a world class operational, governance, risk management and compliance environment, thereby freeing us to devote the bulk of our time to investing which is how it should be. What Fidante can deliver on this front is without peer and is something that we could not hope to achieve in our current form. Fidante is a wholly owned subsidiary of Challenger Limited, an ASX 200 publicly listed company, which also owns Challenger Life which is Australia's leading provider of annuities and retirement solutions. Challenger Life is 'A' rated by S&P and operates in a highly regulated field and is regulated by the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investment Commission (ASIC).

Finally, it was critical that Fidante were true believers in our investment philosophy and approach which we have no desire to change. Countless hours of discussion during the last year give us confidence that we are fully aligned on the merits of our investment approach and strategy. Our investors can have the confidence that our investment philosophy and approach will not change but that there will be much stronger checks and balances to ensure that we stay firmly within the parameters of what we have outlined in our offering documents.

While I prefer to be unemotional, analytical and data driven when investing, in certain other matters, such as this, I allow my emotions to come to the surface and play a slightly more prominent role. I have found that unless I am extremely excited about a change such as this, the correct answer is probably ‘No’. In this case, the more time I spent with the Fidante team and the more I saw the powerful benefits we could bring by working together, the more excited I became. Ultimately, it is that personal excitement for what’s next that drove my decision to partner with Fidante. I am trying to build Avenir to last and to deliver superior investment results to both current and future investors and, after a lot of thought, I can’t think of a better way nor better partners with whom to do that.

Isn’t Small Good?

You might rightly ask, what do Fidante want out of the partnership? Well, they want to be part of a growing and sustainable asset management business. That, in turn, gives rise to the question will the relationship make our assets under management grow meaningfully? A common argument in funds management runs that increased fund size can be detrimental to returns. Large funds simply have a reduced opportunity set and need to invest in larger businesses and/or become more diversified in order to allocate the capital.

Firstly, we have never had an interest in investing in very small companies as they are generally quite fragile. They are often reliant on one or few people, products or customers, which does not sit well with a concentrated investment strategy. So, losing very small companies from our opportunity set would be no loss at all.

Additionally, since we operate in the international equity space we are fortunate in that we are a very long way from scale being of concern to our investment operation. There is a large number of companies from which we can hunt for ideas. Quality companies of all sizes go through circumstances that lead to wonderful opportunities for us to buy at bargain prices. Being larger than we currently are can be very beneficial in providing increased resources to cover the ideas we identify and to provide us with a bigger seat at the table to assist in our interactions with portfolio company management. We are going to remain as a small, focused team using the same investment process to assemble a concentrated portfolio of our best investment ideas.

Finally, while we love talking about what we do, we spend much more time than we should talking to potential new investors at the expense of investing the capital of existing investors. Fidante will take a huge weight off our shoulders in relation to interacting with potential investors which will free up a great deal of our time.

Changes to Back Office Arrangements

We finalised and formalised our arrangements with Fidante over the Christmas break. I remain as majority owner of Avenir Capital and look forward to continuing to execute on our existing investment strategy as we have done in the past. While I personally give up some of the “upside” from Avenir, I gain a powerful new partner and I couldn’t be more excited.

There will be some changes to our back office and operational arrangements. Firstly, our fund administration will no longer be provided by Apex Fund Services and will be handled internally by Challenger. Apex have served us admirably since our inception over 5 years ago and have been nothing but professional and extremely helpful during that time. We will be sorry to leave but will be in very capable hands given that Challenger has over $55 billion in assets under management and operates in the extremely demanding and highly scrutinised life and retirement solutions market.

We will also be moving custody of the fund from Australian Executor Trustees (AET) to Citi. Again, we have been impressed by the service provided by AET but Citi are fully integrated into Fidante’s operational processes and we look forward to establishing our new relationship with them. Citi is the custodian of over

U.S. $12.8 trillion (yes, trillion) in assets, so we have confidence they know what they are doing. These changes will take place over the next several months and will be imperceptible to investors.

Should anyone wish to discuss these changes with me please feel free to contact me directly. Otherwise, we will just get on with things here at Avenir now we are able to spend even more time doing what we love to do which is hunting for high quality investment ideas.

Select Portfolio Updates

During the quarter we exited our position in **El.En**, an Italian based laser manufacturer, which we acquired over 2 and a half years ago. While El.En is firing on all cylinders operationally, the valuation has grown much more quickly than intrinsic value. Since our purchase in early 2014, at approximately $7 per share, the company's share price has tripled to end the year at $23.47 representing a gain of over 200% on our investment. An important part of our process is to be disciplined in relation to exit which means not being too greedy even when things are going well. We want to be fully rewarded for our investments and so not sell too soon, but it is a fine line between being patient and slipping from the realm of sensible and prudent investing to that of speculating on price movements. At $23 per share, El.En is trading at 16x trailing earnings before interest and tax (EBIT) which, to our mind, builds in a lot of future operational performance. We would rather take our money off the table at this point to be ready to recycle it into the next undervalued asset we find.

We also fully exited from our Service Stream (**SSM**) investment during the fourth quarter. Service Stream was a downtrodden and forgotten company that had spent several years recovering from some operational difficulties. We felt that the company had turned the corner and was operating at an earnings run rate not yet recognised by the market. The company had net cash on the balance sheet, following two years of very strong cash flow generation, giving us confidence that the company was on a solid financial footing that would soon be more widely recognised.

As with El.En, we more than tripled our money in our investment in Service Stream and, while the company is delivering strong operational results, we feel that the year-end price of $1.10 per share reflects reasonable value, given the quality of the company, and so we have liquidated the position.

Our biggest contributor for the quarter was **BFC Financial (BFC)** which increased in price by 25% following its 35% increase the prior quarter. During the period, the company finalised the acquisition of the remaining 19% stake in the publicly listed BBX Capital (NYSE:BBX) which BCF didn't already own. We have been urging the company to take this action for some time and, now that it has happened, the market finally seems to paying some more attention to the company.

BFC (which has now changed its name to BBX Capital) is still one of the cheapest companies we own and has delivered very strong operational performance since we first bought it. Operating income has grown over 40% and its portfolio of real estate assets has grown in value. The simplified organisational structure will also allow the company to more quickly utilise existing net operating losses to reduce tax payable on current profits which is of real value to us. The company is slowly working its way through the catalysts we identified at the time of our initial investment. While we have been urging faster progress on the catalysts during this time (for example, the original merger with BBX was first announced in May 2013 but the full joining of the two companies was only recently finalised), the right steps are being taken and value is gradually being realised. We are now up over 40% on our investment in BFC/BBX Capital, but we still believe there is material upside so we will remain patient.

Our second biggest gainer for the quarter was a position which we have not discussed to date which is Spirit Airlines (**SAVE**). Spirit's share price increased by 39% during the quarter from $41.66 to $57.86. Spirit is the largest ultra-low cost airline carrier (ULCC) in the U.S. and makes industry leading margins by pursuing a disciplined and ruthlessly focussed ultra-low cost model. We acquired our position in Spirit right at the tail end of 2015 after the company's stock price had fallen over 50% from its high of $85 in late 2014.

The company has a history of rapid and profitable growth and the share price collapse was likely caused by investor concerns over increasing industry capacity and declining prices or revenue per available seat mile (RASM) for both the industry and Spirit. We believe the market is misinterpreting the declining RASM in knee jerk fashion. During 2014, the oil price declined by 50% and, given the high proportion of an airlines cost structure made up by oil, all airlines could reduce prices materially while still earning strong margins.

We also felt that there was likely a turnover of investor type as growth investors, attracted initially to the company's rapid growth of 20%+ per annum, sold on the first sign of potential challenge to that growth in the form of declining RASM. At the same time, Warren Buffett has well known disparaging views on the merits of investing in airlines including his numerous references to having a '1-800' number that he calls whenever he gets the urge to invest in the airline industry so they can talk him out of it. This may have led to a slow pick up in interest by traditional value investors as what self-respecting, value-oriented investor would want to invest in an airline given the strong words of warning from the Great Man himself ringing in their ears. Ironically, in the third quarter of 2016, Berkshire Hathaway itself invested something like US$1.28 billion in the airline industry in the form of investments in American Airlines, Delta and United Continental[1]. This does not include an investment in a fourth airline, Southwest, that Buffett informed CNBC he had also acquired[2].

It is always pleasing when a well-regarded investor sees opportunity in the same place as us and there is no better regarded investor than Warren Buffett. Some have suggested that the above Berkshire airline investments may have been made by Ted Weschler or Todd Combs, the two investment 'lieutenants' appointed by Buffett in the last five years, but Buffett stated in a recent interview with Charlie Rose that the decision "was in large part my decision"[3,4]. It can be dangerous to draw investing analogies but in Spirit we see some of the same attributes displayed by Ryanair which increased operating income almost 50x over the past 20 years by following a business model that provides a sustainably strong competitive advantage in what has historically been a tough industry. While we do not expect Spirit to achieve 30% per annum revenue growth (as it has done for the past five years) nor 20%+ returns on invested capital forever, we believe that the company has significant growth potential and is available at an attractive price.

Our largest detractor for the quarter was Videocon (**VDTH**) which declined by 17% during the quarter. VDTH is the fastest growing Indian satellite TV operator in the world's fastest growing pay TV market. During the quarter, Videocon announced it was merging with Dish TV, the largest pay TV provider in the Indian market. The merger combines the largest direct-to-home (DTH) satellite pay TV operator in India and the fastest growing DTH Pay TV operator in the country. The merger terms were favourable to VDTH and we believe the merged entity is extremely well placed to gain share and grow even more rapidly than the overall market which has several strong growth tail winds. We also expect further consolidation in the industry which should be favourable to the company.

We remain highly confident that the value of our businesses will grow over time. The market may ignore this progress for periods of time but, ultimately, this value will be reflected in higher stock prices. All we need is a collection of good businesses at great prices, patience and the courage of our convictions.

An important prerequisite for our investing strategy is an investor base that is aligned with this approach. Over the past five years we have built an investor base of which we are incredibly proud. Our investors have entrusted Avenir Capital with the important task of both protecting and growing their wealth. We take this task seriously and work hard each day to improve the manner in which we go about it. We are excited about our new partnership with Fidante and look forward to working with them to compound our investor's wealth over the long term.

The next investor intake will be on 1 March 2017. We are glad to be your largest partner in the Avenir Value Fund and appreciate your long-term investment commitment. Thank you to those who have recommended us to others.

Should you have an interest in discussing the fund in more detail please do not hesitate to contact us.

"Coming together is a beginning; keeping together is progress;
working together is success."

-- Henry Ford

Best Regards,

Adrian Warner
Managing Director, Chief Investment Officer

1. The investment figure is estimated based on the average price for each company during the quarter ended 30 September 2016 and the number of shares acquired by Berkshire Hathaway as reported in SEC filings.
2. "Buffett's Berkshire takes stakes in four major airlines"; CNBC, 14 November 2016.
3. Charlie Rose Interview: Warren Buffett and Bill Gates; 27 January 2017.
4. Airline stocks are up 25-40% since the end of the third quarter 2016 and we do not know if Berkshire have maintained or sold their positions in the airlines.