AVENIR
CAPITAL

25 July, 2016

Dear Partner:

The Avenir Value Fund (the "Fund") increased 6.6%, net of fees and expenses, in the June 2016 quarter compared to the S&P 500 which increased 2.5% and the ASX All Ordinaries which increased 3.9% for the quarter. For the 12 months to 30 June 2016, the Fund returned -1.4% compared to the S&P 500 which returned 4.0%, the ASX All Ords which returned 0.6% and the MSCI World Total Return index which returned 0.4%.

Let's get Brexit out of the way

It is hard to recall the last time a 'crises' came and went so quickly and had so many people say so much in so little time about something about which they knew so little. We are not going to add to the long list of Brexperts saying so much, none of whom actually saw it coming just a few weeks ago. We do not know what the long term effects of Brexit will be on the UK or Europe or, more broadly, the world. After markets recovered quickly from the initial shock, causing a "V" shaped move in asset prices over a number of days, there are now signs that fears over some of the potential longer-term consequences are dawning on people, for example, UK commercial property investors who have seen redemptions frozen by 7 (by our last count) property funds[1]. On the other hand, European officials and national politicians appear to be adopting a more conciliatory tone than in the early days and Theresa May, the newly appointed UK prime minister, appears to be both pragmatic and inclusive both of which will be valuable as the UK negotiates its exit.

All we will say is that it is just another reminder that nothing is certain and volatility is just a natural part of investing and should not cause the long-term investor undue distress if they avoid leverage and follow a sensible investment program of buying real businesses when they are available for less than they are worth.

As we have said in the past, we welcome short-term volatility and emotional, reactive decision making from other participants in the market as it allows dispassionate and economically rational investors (which we strive to be) an opportunity to put money to work in sound businesses at very attractive prices.

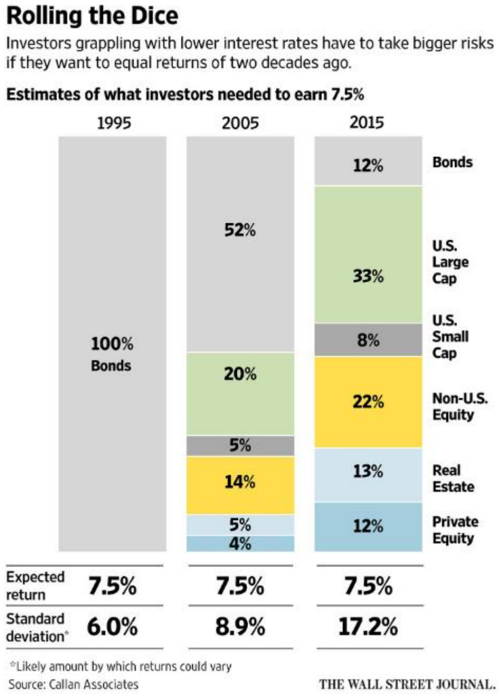
Outlook

Investors globally are in some-what of a quandary at the moment. Global growth is sluggish and people continue to treat what growth there is with suspicion. Potential recessions appear around every corner before retreating just as quickly. This state of play seems to have been going on for a long time now and central banks have dealt with it through 8-years of immense monetary accommodation which has driven interest rates to record lows. The U.S. 10-year Treasury Note yield hit 1.36% on the 8th of July, the lowest in history. While low, 1.36% is, at least, still positive. Government bond rates are now negative in many countries such as Germany, Switzerland and Japan. Bank of America Merrill Lynch estimate there is now $13 trillion globally of negative-yielding debt compared to barely none in mid-2014.

Low rates have had a profound effect on peoples investing behaviour forcing them to allocate more capital to certain asset classes than they would if rates were higher. A recent Wall Street Journal article[2] highlights this point very clearly. US Pension funds typically target 7-8% as their expected long term return. In 1995, they could achieve 7.5% per annum by investing in nothing but investment grade bonds. In 2005, they could have made their 7.5% with a portfolio of 52% investment grade bonds, 40%, mainly, U.S. equity and a sprinkling of private equity and real estate. In 2015, those same funds would have to shrink the bond portion of their portfolio down to 12% with private equity and real estate making up 25% of the pool and the rest as U.S. and

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

global equity.



It is this dynamic that has meant that while there appears to be a general lack of enthusiasm amongst investors, the main U.S. equity indices are currently hitting all-time highs. A lack of options for investors has driven the 'safe haven' U.S equity market higher.

All-time highs for the U.S. market, however, should not make us feel good. Often, we read words to the effect of "equities remain reasonably priced compared to cash and bonds". Those five words at the end, "*compared to cash and bonds*", make a big difference when added to the statement "equities are reasonably priced". People can be lulled into thinking large dividend paying stocks or companies with predictable near-term and therefore 'quality' earnings are 'safe' despite prices rising to levels that even a rudimentary, dispassionate analysis would suggest are anything but safe.

The other effect at play here is the rise in indexing or passive investing strategies. Indexing means that something that is working will work more as more money in the index chases it. Netflix, for example, has more money seeking to invest in it every day as its price rises irrespective of the underlying performance and prospects of the company. As more money is placed into index funds, that money has to be put to work in those companies that make up the index. This can lead to upward price pressure for a period as that is how the law of demand and supply works.

Exxon provides a startling example of the distorting effect index investing can have on security prices as outlined recently by Horizon Kinetics[3]. One would assume that the equity value of Exxon, the largest oil company in the world, would be impacted by the price of oil which has seen a precipitous decline over recent years from a peak of $120 in April 2011. Exxon felt that pain with earnings falling from a peak of $9.70 per share in 2012 to $3.85 per share in 2015, a fall of 60%.

However, the share price of Exxon, as at 30 June 2016, was $93, higher than the share price at the beginning of 2012 when it stood at $85 per share when oil was at its peak. One plausible explanation is that Exxon is contained in a plethora of ETF[4] strategies including energy, dividend paying, value, large cap, quality dividend, low beta, S&P 500 ex-healthcare, defensive, covered call, etc. Horizon Kinetics note it is even a 2.04% weight in the Global X S&P 500 Catholic Values ETF. A multitude of massive asset allocators are forced to buy Exxon irrespective of the price of oil. Large and liquid companies such as Exxon and many others are "required as raw material for the industrial-scale investing…"[5] as practised by the rapidly growing ETF industry. The growth of index investing and the ETF industry's lack of reliance on fundamentals cannot end well for those invested in those indices, most of whom have very little understanding of what makes up the index they own.

So, we have a world in which low global interest rates have acted to bid prices of other asset classes up. In order to generate returns and keep perceived risk down, many investors have flocked to large cap, high 'quality' and low volatility companies in the U.S. pushing their prices higher. In addition, there has been an influx to index or passive funds at the expense of active managers creating further upward price pressure on the companies contained in those indices. So, is now the time to be increasing one's asset allocation to passive or index investing?

The argument goes that most active managers do not keep up with the market. The reality, however, is that most 'active' managers are closet indexers owning dozens or hundreds of stocks that replicate the index to a great degree. Additionally, 100% of passive managers will not keep up with the market after fees. We are of the firm view that to beat the market over time it is necessary to do something different.

At Avenir, we run a simple and repeatable investment process structured to identify mispriced securities. We run a concentrated portfolio of companies with our top 10 positions currently representing 70% of our net asset value. Each of these companies, we believe, are priced very attractively on an absolute basis (not just compared to cash or bonds) and represent increasing value that is underappreciated by the market.

The 'safe haven' status of the US has continued to push its equity markets up in a low yield, index driven world. It appears to be the last man standing, however, as other markets in which we operate have suffered severe downturns over the last twelve months including Italy down 28%, Germany down 13%, Japan down 23%; Hong Kong down 21% and China down 29%. Despite its 'home' index in Italy declining 28% over the last twelve months, the share price of El.En, one of our largest investments and listed on the Italian exchange, increased by 50% over same period. We believe our ability to hunt where the best opportunities are likely to be rather than where the index forces us to go will lead to strong absolute performance over time irrespective of the performance of overall equity markets.

Select Portfolio Updates

Our biggest winner for the year to 30 June 2016 was Service Stream which increased in value by 150% during the period. During the recent quarter the company increased its earnings guidance to full-year EBITDA of at least $35 million representing 37% growth on the $25 million EBITDA earned in 2015. The company also returned $19.3 million, or 5 cents per share, to shareholders in the form of a share capital reduction. Following two years of very strong free cash flow generation, the company has a pristine balance sheet and is growing earnings by winning new long-term contracts. Despite having owned Service Stream for less than 12-months, we have been pleasantly 'forced' to revise our initial price target upwards and believe the accelerating roll-out of the national broadband network positions the company well for continued growth.

Another big winner for the year was El.En, an Italian based laser manufacturer, which increased in value by just over 50% despite the Italian stock market being down 28%. We bought El.En in late 2014 at roughly $7 per share[6] when the company had cash and excess assets equal to half the equity value of the company. The company was growing revenue and earnings strongly but was underfollowed and relatively unknown. We acquired our position at about 5 times operating income which was a bargain for a well-capitalised and well-managed company in a strongly growing industry. The share price as at 30 June 2016 was $13.65 representing a 95% return on our investment to-date.

While we have sold some of our El.En holding, we still believe the company has good prospects and is attractively priced given its strong operating performance. We are well aligned with management, who own a substantial portion of the company, and US-listed peers trade at twice the multiples of El.En. Management are taking positive steps to expand the company's manufacturing and distribution capabilities to accommodate ongoing growth. For the March 2016 quarter, the company grew revenue by 14% and operating income by over 50% compared to the prior year quarter with operating income margins continuing to strengthen to 12.2% compared to 9.2% in the prior corresponding period.

Another positive performer for the year was Communications Sales and Leasing (CSAL) which we acquired in the second half of 2015. CSAL was a spin-off from Windstream, a US rural telecommunications company. CSAL owns 3.9 million optical fibre strand miles and 85 wireless towers, among other telco assets, used by Windstream and is the first US telecommunications focused REIT[7]. The spinoff appeared to have been structured to be as complicated as possible and CSAL, being the first REIT of its kind, was like a new and unknown Pokémon, confusing analysts and investors alike with no-one knowing quite what to make of it. We took advantage of the uncertainty, immediately post-spin, to buy into the company on a 12%+ dividend yield. Since then we have been rewarded with a 55% return (including dividends) as the company has traded to an 8% dividend yield.

One of our big decliners for the year was BFC Financial (BFCF) which declined by 22% during the year. Since we have owned it, BFCF has increased EBITDA[8] in its vacation ownership interest business by 40%, its portfolio of real estate assets has grown in value, it has restructured its affairs to be able to utilise its substantial tax losses faster, thereby increasing the present value of the tax savings generated, and it has initiated a dividend (albeit somewhat token). Despite this improvement in operating performance and fundamentals, BFCF's share price has declined 15% from our purchase price over two years ago to $2.88 per share as at 30 June 2016.

BFCF is the cheapest company we own trading at less than 1-times EBITDA, after netting off the value of its owned real estate assets, and at 60% of book value so we are prepared to be patient and endure some of its complications. Last month, Diamond Resorts, one of BFCF's peers, announced it was being acquired by the private equity group, Apollo, in a $2.2 billion all-cash deal representing roughly 7x EBITDA. In May 2016, Interval Leisure Group completed its acquisition of Starwood Hotels and Resorts' vacation ownership interest business in a $1.5 billion deal at a roughly 9x EBITDA valuation. At the lower 7x EBITDA multiple, BFCF is worth $8 per share or almost 3 times the current price.

Another decliner was our holding in the warrants of General Motors which declined in price by 35% during the year from $15.95 to $10.44. This price decline was despite GM delivering a record calendar-year 2015 with Adjusted EBIT of $10.8 billion and a record quarter in the first quarter of 2016 with Adjusted EBIT of $2.7 billion (up 29% from $2.1 billion the prior year). At the price of $28.30, as at 30 June 2016, GM was trading at a 4.3x price-to-earnings ratio and a 5.4% dividend yield. On 21 July, GM announced that the June quarter was another record quarter with Adjusted EBIT of $3.9 billion, up 37% over the same quarter last year, and record Adjusted EBIT margins of 9.3%. GM also increased its earnings guidance for 2016 for the second time in six months.

In 2015, GM returned $5.7 billion to shareholders (13% of GM's market capitalisation as at 30 June 2016) via $2.2 billion in common stock dividends and $3.5 billion through the GM common stock repurchase programme.

There are some clouds over GM, such as questions over where we are in the auto cycle and what the long term impact of autonomous driving might be on the mainline auto companies. At the current price, however, and with $20 billion of cash on the balance sheet we think we are being well compensated for those risks.

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 business at great prices, patience and the courage of our convictions.

The next investor intake will be on 1 August 2016. 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.

"The best argument against democracy is a five-minute conversation with the average voter."

-- Winston Churchill

Best Regards,

A Warner

Adrian Warner
Managing Director

[1] Some of these funds have since 'reopened' redemptions.
[2] WSJ: Pension Funds Pile on Risk Just to Get Reasonable Returns, 31 May 2016.
[3] Horizon Kinetics: *Under the Hood: What's in Your Index; July 2016*
[4] ETF = Exchange Traded Funds
[5] Horizon Kinetics: *Under the Hood: What's in Your Index; July 2016*
[6] 4:1 split adjusted.

[7] Real Estate Investment Trust.
[8] Earnings before interest, tax, depreciation and amortisation.