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Andrew Brown's hedge fund East 72 and the global hunt for value

by **Vesna Poljak**

Most fund managers assessing a company like Cabcharge Australia would follow a tried and tested model: read the financial statements, consider the earnings outlook, evaluate the industry structure and intensity of competition.

But not Andrew Brown, who took his research to the extreme. To understand the impact of significant disruption on the taxi industry he became an Uber driver for three months.

"I reckon Uber drivers clear the very, very low twenties an hour, minimum wage is $24. What you're seeing is a lot of people are saying 'It sounds good, you've got flexibility', but other than that it is no way to make a living. A lot of guys are going back to cabs," he says.

The hedge fund manager has a position in Cabcharge, which is up more than 50 per cent over the past three months, and one of his best performing Australian longs in the small but unique listed investment company, East 72, that he manages.

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"Uber's grown the personal transport market, there's no question about that. The big thing for Cabcharge this year is, can they get revenue to grow?" The company "just mints cashflow" and has enjoyed a resurgence of interest after a long period of underperformance partly as consumers return to taxis, fed up by surge pricing.

"I've been a bit critical of the company's capital management policies because they should have been buying the shares back. Now people are starting to recognise the fact that Uber is not a Cabcharge killer," concludes Brown. "It's a real transition stock but it's so cheap."

He was motivated to try out ride-sharing to understand the drivers' perspective. "You now have to pay GST. There's other little things you forget about – how much petrol you use, wear and tear on your car, traffic fines. If you drive four or five times every day, you're going to be a bit quicker through the red lights."

The hedge fund model

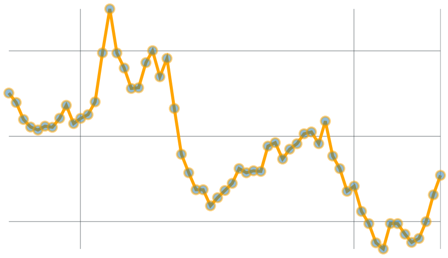
East 72 is listed on the NSX, and is a hedge fund in the classic sense: Brown can be up to 5 times leveraged and invests globally. After tiring of being asked for stock ideas, he started a private investment company in 2010 pooling his own and some friends' funds which returned 22 per cent a year before tax and paid out all of the initial capital in fully franked dividends. Then in 2016, he happened upon a shell company with a reserve of franking credits on the NSX. With $350,000, that became East 72, which has grown to exceed $5 million of capital and the franking credits are still sitting there.

Part of his style is "very deep value" and the strategy utilises contracts for difference and margin loans.

"I'm not interested in building a funds management business on the back of the LIC, I'm just not interested in it," he declares. East 72 has no management or performance fees so Brown makes money by growing net tangible asset (NTA) value. He will consider a prime broker relationship if he's successful.

The former AMP fund manager and Rothschild Australia head of equities says his hedge fund is "more enjoyable than anything I've ever done".

"[It] sounds flippant and it's not meant to, but it is. It's what I enjoy doing, I can pretty much name all the shareholders. We do want to grow from here, but we've only been going a couple of years.



"In 2016-17 we were pretty much long and leveraged the whole period of time," he says. "The NTA went up before any expenses about 57 per cent. But basically post-Trump stocks really started to blow off a bit and things started to get silly. We started to take some short positions and we've paid the price a little bit. We really struggled in the final quarter of 2017 but made a chunk of that back in the first quarter of this year."

East 72 finished down 18.8 per cent after expenses or 15.9 per cent gross in the 2018 fiscal year.

"I don't have asset consultants to be accountable to, I have shareholders to be accountable to. Most of the people on board know that this is a five-year exercise," the fund manager says.

Shorting Tesla, Amazon

In essence the company is long value and short growth, including a large short in Tesla and a small short in Amazon – "the price is crazy".

"People say, 'Don't short valuation', I agree – it's better to short frauds and crap business models, but it's not until later on people realise paying 35 times earnings for that just wasn't very sensible. I've been in the market since 1980 so I've seen this before."

Holding onto his early longs has been rewarding for East 72, including a core position in Exor which is run by Italy's Agnelli family. "It's not an Italian version of Berkshire Hathaway, the only coincidence is they have a reinsurance company which they bought cheaply. That stock's done phenomenally well, mainly because of Fiat Chrysler going up so much."

The Agnellis are "just excellent capital allocators".

Another winner has been AerCap Holdings, the world's largest lessor of aircraft. "That's how we know quite a but about Macquarie's leasing," Brown adds with a nod to his highly non-consensus short in Macquarie Group.

"AerCap are just brilliant managers of capital," he explains of the NYSE-listed Dublin-based company. "They sell off aircraft at a premium to what they're in the books at and they buy back shares at a discount, they pretty much know where every plane in the world is."

Touching on his "deep value" roots, East 72 has some interests in shipping, which Brown describes as "one of the most bombed out industries in the world". His AP Moller-Maersk Group is down around 25 per cent but Wilhelmsen Holding is up 40 per cent. Maersk "unfortunately has fallen away but is dirt cheap".

NYSE-listed DHT, an oil tanker, is on the right side of shipping. "The rates for them were barely profitable two months ago and this thing's just exploded. It's got massive operating leverage, the stock's up about 30-odd per cent."

Another prolific source of ideas is in funds management and East 72 owns several listed investment companies which it entered at double-digit discounts to NTA. In Australia, those are PM Capital Global Opportunities Fund ("I like the portfolio a lot"), Watermark Global Leaders Fund, and Monash Absolute Investment Company.

In the US, they are David Einhorn's Greenlight Capital Re, Daniel Loeb's Third Point Reinsurance, and the Amsterdam-traded units in Bill Ackman's Pershing Square.

"The brilliant thing about Pershing is simply this, Ackman now represents half of his funds under management in crude terms it's $US4 billion of his $US8 billion in funds under management. They're all at 20-ish per cent discounts to NTA and I get their investment expertise, if there is any."

Naturally, one of Brown's biggest holdings in Australia is a small cap, Namoi Cotton. "The management of the company are really good, they're fantastic at what they do," he says. "You've got a board that's being modernised." As well as cotton ginning, for which Brown estimates he's paying 3.5 times enterprise value to EBITDA, Namoi has a marketing joint venture with Louis Dreyfus and oil seeds interests linked to Cargill.

Idea generation

Brown gets his ideas by reading hundreds of hedge fund letters, broker research, trade publications and online articles.

"There's companies I've followed for years and years," such as Leucadia National Corp, the investment company parent of Jefferies which is simplifying by selling non-financial assets such as its beef business. Australian investors would know Leucadia better as the company that made more money off Fortescue than anyone except Andrew Forrest.

"Probably the most off-the-wall thing that we own is Vulcan International, it's basically a company that owns some forest, it owns some buildings and it still has a business in there which makes rubber and foam, but when you look at the balance sheet the rubber business makes no money whatsoever."

Vulcan is no AerCap when it comes to capital management but it's trading at a 40 per cent discount after tax to NTA.

Understanding aircraft leasing and how profitable it is is key to Brown's Macquarie short, which is predicated on the conclusion that the market is paying too much for the investment bank's earnings. Aircraft is the biggest part of Macquarie leasing.

"If you then start disassembling Macquarie into things you know they don't have a competitive advantage in – trading and banking – then take out the one-offs, what it means is the bit you know they are fantastic at you're paying through the nose for it, 30 times earnings for the hero business and that's too much," referring to the asset management arm. He estimates the market is valuing asset management at more than $33.5 billion or 29 times earnings.

"At the end of the day, there's a price for these things, the market is prepared to say 'Hey, these fantastic asset sales and accounting changes are going to be ongoing things'."

East 72 was on the right side of Blue Sky Alternative Investments (short), but its best performing Australian short was in fact Perpetual.

"Once the shares had fallen from low $50s to $40 and with a new MD in place as well I suspect there's going to be changes afoot at Perpetual in terms of the structure of the company. It would make a bit of sense potentially to break it up," says Brown, who has closed his position.

Decades of investing at the big and small end of town has led the fund manager to believe that Australian investment culture is lacking in two areas: it is too tolerant of companies which treat workers unfairly (specifically underpayment of workers and bad workplace culture), and true independence is still compromised by the directors' club.

"When you start to exercise your votes what you find is the old boy network act against you. When I was at Rothschild I had to put up with a meeting with two of [a director's] best mates, and we had very good reason to vote against the individual at the time. The old boy network is alive and well and kicking and fund managers can't do anything about it if they're at a big shop," because chairmen of target companies take it upon themselves to go above a fund manager's head and interfere.

"You can only do it if you're a real activist and you don't give a shit. There are a few, but they're still quite small and certainly the big guys don't tend to do it, and I'll absolve Perpetual because they certainly had a go [at narrowing the value gap at Brickworks and Soul Patts]."

Passive investing is only making the issue worse, he says.

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