QUARTERLY REPORT TO 30 JUNE 2018[1]

Performance and net asset value[2]

Quarterly portfolio return: 0.68%

This was another difficult quarter for value style investors amidst ongoing uncertainty regarding global trade, which saw European and Asian markets extremely subdued, particularly in the month of June. Conversely, a flight to "certainty" saw ongoing buying, virtually irrespective of price, of stocks considered likely to either exhibit earnings growth or continue to build out their business models. As a consequence, the NASDAQ 100 rose by 7% over the quarter, with all the major "must-own" stocks advancing over 10% (see "Peak lunacy: 31% quarterly return for the 'Delvey' portfolio").

The domestic Australian market turned out to be a surprise returning 8% (including dividends) over the quarter after a rebound in banking shares allied to strength in major mining and gold stocks.

E72's portfolio returned 1.24% before expenses in the quarter, and 0.68% after costs but before tax. Pre-tax net asset value ended the 30 June 2018 period at **28.9c** (remember we made a significant tax payment in April); after all accrued and deferred taxes, post-tax NTA is 30.2c

For the fiscal 2018 year, the gross portfolio performance was -15.9% (-18.8% after expenses); since the inception of E72 in May 2016, the gross portfolio performance has been +26.4%, which, of course, has comprised a brilliant FY17 return of 57% gross, followed by this more difficult FY18.

The quarter has certainly been marked by more significant intra-market volatility with shifting trends relating to trade pronouncements, but also a 14% increase in oil prices. This has had a negative impact on some of our shipping stocks, notably Maersk, but surprisingly benefitted the tanker stocks due to increasing Chinese demand and subsequent impact on tanker rates. Once again, "value" stocks have been dramatically outpaced by their "growth" counterparts; the S&P Value ETF (IVV) recorded a 2% return lagging its growth counterpart (IVW) by 3.5% over the quarter. In Europe, our banking positions in Barclays and ING have been particular laggards, both down close to 10% over the quarter

Within the long side of our portfolio, we have seen nice gains in SevenWest Media (+55%), Cabcharge (+35%) and DHT (+38%); we exited KKR & Co LP and TripAdvisor/Liberty Trip Advisor after strong gains. Our short book was hampered by the factors noted below, although we did record significant gains on closed positions in Perpetual and Blue Sky Alternative Investments.

Aside from securities mentioned below, we have recently bought back into Bank America after recent weakness, and purchased a significant block of Australian mortgage franchise Yellow Brick Road after recent sharp price falls. We continue to find absurdly priced 'concept' stocks where share prices bear no resemblance to earnings power in the coming decade, and have correspondingly instituted a small number of new minor short positions.

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Peak lunacy: 31% quarterly return for the "Delvey" portfolio

There is a fascinating pending legal case in the US involving a young lady called Anna Sorokin. Ms Sorokin (aka Anna Delvey) is alleged to have engaged in various fraudulent activities in a successful (if brief) pursuit of a upscale NYC lifestyle[3]. It's very much a tale of the times. I couldn't help thinking about a modern socially-focused young lady who changes into her yoga pants, jumps in her EV, makes a few phone calls, posts on social media, orders some new consumables, books a holiday after checking the reviews, and exhausted, slumps in front of the big screen at home. This unweighted "it-girl" portfolio[4] is up a cool 31% this past QUARTER.

The outrageous future periods over which investors are required to discount estimated cash flows to justify equity (or enterprise) valuations is rather foreboding. It's acknowledged that various talented entrepreneurial teams have created new businesses and tapped into global veins of consumer desires; the virtually zero cost of equity capital provided by the prevailing market environment makes it easy for them to run capital investing strategies with massive negative cash flows, and extraordinarily lengthy "runways" before profitability.

The two poster-boys for this strategy are Netflix and Tesla, which have a combined equity market capitalisation of $228billion, net debt of ~$13billion and a combined negative free cash flow in the twelve months to March 2018 of $6.3billion - which included the benefit of over $700million of stock based compensation. Their shares rose 32% and 29% this past quarter. We are short both, far more so Tesla.

In each case, there is no clear runway to free cash flow, and the competitive moat – whilst better for NFLX – is diminishing for both. Whilst the arguments as to Telsa's ability to produce 5,000 cars a week rage on, it's worth noting that even if it can produce that number on a consistent basis, it's 260,000 vehicles a year. Fiat Chrysler (FCAU) produces 4.4million a year and has an equity market capitalisation about half of Tesla ($29.6bn versus $58bn), together with a myriad of fungible spin-off opportunities, full access to capital markets and a fraction of Tesla's debt. Last we looked, FCAU produces its cars at a profit; TSLA does not appear to at this stage.

These massive moves in growth company share prices over short periods tend to be symptomatic of a market blow-off as investors struggle with surrounding volatility and become impatient in their decision making, ignoring solid, but slow companies where inherent value can easily be found. This impatience has even infected Australia with extraordinary moves in mid-cap go-go stocks like Xero (+35%), Afterpay (+45%), Appen (+50%) and Wisetech (+66%) in the quarter. We don't know when a change in sentiment will occur, but postulate that with these kind of moves it's getting rather closer. A bit like Ms. Delvey's spending at the expense of friends, banks and hotels, it can't go on forever. And doesn't.

Investing in the owners of the longest disclosed investment track record in the world

Page 2 of the Berkshire Hathaway Annual Report contains the "table of truth": the track record of the company in per share terms since "present management took over[5]" in 1965. That is mere short-termism compared to a C$635 million Canadian listed company, Economic Investment Trust (EVT.TO) which was founded in 1927. Pages 30-32 of the 2017 Annual Report tabulate the history of the company, in per share terms, since its incorporation. The track record is very good, rather than stellar, but perfectly illustrates the power of compounding. However, management don't beat about the bush, warning that:

"the company has been a closed end investment corporation since 1927 and has never bought back its common shares ..(which).. have historically traded at a discount to their net asset value, ranging from a 40% discount to a 15% discount over the past ten years."

The exact same text is replicated in the annual report of C$1.2billion market capitalised United Corporations Limited (UNC.TO) established in 1928. Of course, there is a common linkage; UNC is (effectively) a family controlled but externally managed investment company, being 52% controlled by E-L Financial Corporation (ELF.TO), itself ~72% controlled by the Jackman family of Ontario, who have mixed successful political and business careers. ELF has a market value of C$3.2billion and was formed in 1968 as a holding company, but the subsidiary life insurance companies – notably Empire Life which is the sole remaining life investment - have their genesis in the 1920's. ELF's last major transaction was in 2013 when it sold its Dominion Of Canada insurance business to Travelers Cos for a cool C$1.125billion.

As with many family controlled companies, patience is of the essence; in addition, analysis of ELF necessitates deconsolidation of Empire Life and UNC, as well as acknowledging the two listed associates – Algoma Central Corp (ALC.TO) and EVT (above). As is usual in these situations, there is a neat little "round robin" with EVT being 24% owned by ELF, but close to half of EVT's assets being ELF securities.

On our analysis, at the current C$820/share, ELF now trades very much at the bottom end of its discount history in the 38 – 45% to NAV area, depending on the use of market values or NTA (most of the related companies trade at ~25 – 30% discounts to NTA). The key value drivers are ELF's own holdings of securities – worth a net ~$640/share – and the value ascribed to Empire Life.

Canada's three behemoth life companies[6] – Sun Life, ManuLife and Great-West Lifeco – variously trade between 1.2x to 1.7x book value, depending on return on equity, which for the two largest players is around 13%; Empire has lifted its returns to this level over the past two years and could reasonably be valued at 1.4x book, if sold. This would value Empire at over C$2.1billion, or ~$530/ELF share.

So between Empire Life and ELF's own securities, there is C$1170/share of value. Adding in the holdings of UNC, EVT, Algoma – at their market prices, not NTA - and making a small tax adjustment adds a further C$225/share in value, so that's C$1395/share all up, leaving the shares at over a 40% discount. Don't forget there is growth in NAV via the series of global equity portfolios contained within each company, so you might argue it's one of the largest investment company discounts around.

The four words you (maybe) don't want to read: "we are short Macquarie"

A 25 June 2018 piece in the "Australian Financial Review" was a good test of your psychology. "Macquarie: the market's darling" screamed the headline. For growth type investors, it's a mere vindication of what they know. For the value type (he's writing to you), little bells go off in the brain.

If it's not apparent from what's happening at Australia's four large banks as they shed fund management type businesses at varying prices, banks are no different to other companies. They have high growth, attractive ROE components, low growth regulated components, but have the capability to rack up one off asset sales. Folks with long enough memories will realise that when

Macquarie Group (ASX: MQG) peaked out in 2007, the then earnings base of $1.9billion pre-tax was comprised of $1.15billion of asset sale profits. Such was the love of the "Millionaires Factory" that the market at the May 2007 peak of $97 (unadjusted) was valuing a conservative post tax estimate of recurrent earnings of ~$2.40 a share at a 38x P/E. It didn't need a financial crisis to adjust that.

Euphoria is back, though not to the same degree. In the past two full years, MQG has racked up pre-tax gains of $878m in the year to March 2018 (2017: $1,155m) from asset sales and fair value gains after impairments. That's about a quarter of pretax profit last year and over a third the prior year. Forward estimates for MQG simply assume a continuation of this type of contribution. Of equal note is the stellar profitability of leasing – over $900m pre tax each year. The largest contributor by far to leasing is aircraft leasing, where Macquarie are a third tier player, and the profits of the biggest player, excluding asset sales, are valued at ~8.5x pre tax in an equity value of about US$8billion.

We can also value other parts of the MQG business which are not unique – trading, core banking etc at peer multiples and capitalise the centralised corporate costs. From an equity market capitalization of $42billion, by the time we remove these parts ,we believe the "jewel in the crown" Macquarie Asset Management business – which made $1.45bn in 2017 excluding one offs but <u>including</u> performance fees - is valued at over $33.5billion by the market. Remember performance fees across the group were $595million in FY2018, up from $264million in FY2017.

So on our analysis, the market is valuing the sexiest bit of Macquarie at 29x P/E (assuming a notional 20% tax charge) where one-third of last year's profit was performance fees.

So the standard spiel on Macquarie is that it's in a sweet spot for its core business, infrastructure build is booming around the world (on the back of a low borrowing rate environment which may just be changing) and it's a smart, connected player which benefits from a lower A$. And that it's only trading on a P/E of 15.5x forecast earnings for the year to March 2019, which include all sorts of very low multiple streams, and where as one broker puts it "the company has shown it has enough levers available to pull across its business, and has extended its track record of exceeding its own guidance". Couldn't have put it better!

When you pull away the one-offs, and properly assess the low valued but profitable components, where Macquarie has no competitive advantage, then you are paying mightily for the bit where it maybe does. Analysis of the company verges on eulogistic, and the shares have returned nearly 46% including dividends in the last year. Six months ago we were long; we're now short.

Eighty year olds try a millennials turnaround

If you're into experience, have I got a board for you. 14 members, 3 of whom are over 80 years old, and another 5 are over 70. Nothing wrong with that, in the right business. But what if the business is selling clothing/fashion/design and the market they need to target are millennials? Oh and your major strategy involves taking your brand out of your discount stores and moving it into the full price equivalent? But in your largest market discount stores are 80% of the network. Welcome to the US$10.3billion market value turnaround, which at one point just over a month ago was up 112% in a year, so investors are "expectant". Welcome to Ralph Lauren (NYSE: RL). Well, not in our case – we're short.

In the past three years, RL has racked up US$1.15billion of restructuring charges, made the accounts so opaque you can barely calculate a realistic gross margin (let alone the retail/wholesale split) and whilst carrying a net US$1.4billion of cash/marketable securities, also have a bunch of accrued liabilities which offset prepayments by over US$750m. So the balance sheet is OK but not as impregnable as it may appear. But let's assume enterprise value is around US$8.9billion

RL's sales have fallen 19% over the past three years to ~US$6.2billion, and operating income is down 37%, to around $650m prior to restructuring charges in the year to March 2018. In early June, after a positive response to the FY18 results (the shares rose 40% in five weeks), RL held an investor day to enunciate the turnaround strategy. In our view, despite 160 very stylish slides (well if you like teddy bears and polo logos), it looked more aspirational than detail.

RL's high society country club dream looks dated against immense transformation in consumer behaviour, with fleeting fashion trends, heavy consumer segmentation and reliance on social media marketing. In addition, RL has managed to devalue its core products through off price channels and discounting, but is now trying to replicate similar successful strategies at Michael Kors and Tapestry (Kate Spade/Coach). However, RL are trying to do so from a position of having proportionally far more factory stores than these peers, and where they expect wholesale to fall from 33% to 24% of total sales in five years – wholesale margins are believed to be more than twice retail. RL aims to increase net sales by US$1billion over five years, driven extensively by new distribution (stores) and digital – areas where to date the company has not delivered.

So RL are attempting to wind down existing profitable channels, and in their own words "recruit several million new customers annually (esp. Millennials/Women)", and reset their offering in the newly growing – but highly competitive – denim market. But RL already has massive channel conflict with multiple price levels for similar product, suggesting sales contraction may be far greater than expected. Based on current share price levels, it appears to us that the recovery is already well and truly baked in, and we have limited confidence it can be executed.

Concrete jungle where dreams are made of.

After discussing RL, in case you think we are ageist, think again. Here's one 75year old executive Chair who has his finger right on the pulse.

Google "Vornado" and there's a fair chance you'll get advertisements for fans or throw up a bunch of stories surrounding Donald Trump's son-in-law Jared Kushner and his company's ill-fated investment in 666 5th Avenue, NYC. It won't be the first time Vornado's vaunted Chair, Steven Roth, has outdone a "Trump"; the current US President had his holding in one of NYC's most sought-after blocks – now containing the Bloomberg building – foreclosed by Citibank in 1991. The effective Trump holding - in Alexanders Inc (NYSE: ALX) - now resides in the NYSE listed Vornado Realty Trust (NYSE: VNO)[7].

VNO has one of those classic company histories: started in 1947 by two brothers as an electrical retailer (Two Guys), acquiring one of its suppliers in 1959 (Vornado) and changing its name. The expansion of the company continued, including ill-fated growth in California, until in a typical old-style retailer storyline, a smart real estate investor figured that the value of the underlying buildings dwarfed the implied value of the retail business. Enter Mr. Roth in mid-1980, acquiring

18% of the company before closing the last of the stores in February 1982 to become a pure real estate investor.

Fast forward to 1996, and VNO – having converted to a REIT in 1993 – began a focused expansion into Manhattan office space, with scrip based acquisitions of the Mendik portfolio (focused around Penn Station) in 1997.

Roth stepped down in 2009 after 20 years as CEO, but returned in 2013 to oversee a shareholder friendly – through spin-offs - focused shedding of non-core assets outside of the NYC core (plus key buildings in Chicago and San Francisco).

So why would we be interested in NYC office real estate at a time of low growth in demand and rising long bond yields? In our view, VNO is cheap, has significant positive rent reversion possibilities and a major development possibilities, especially in the area of Penn Station[8]. To get to the guts of this requires a few accounting adjustments, to take out the value of investments, residential units, and existing on balance sheet developments.

At the current US$73.92, VNO has an equity capitalisation of just over US$15billion; taking careful account of the debt within the portfolio (US$13.3billion adjusted) as well as preferred stock ($925m) gives an gross enterprise value of US$28.4billion.

However, VNO has US$1.4billion in cash, US$640million market value of equity in ALX, and close to US$2.5billion of other assets; that is offset by just over US$2billion of other liabilities. In addition, VNO has a conservative US$980million of (highish end) residential properties in NYC.

So taking account of all this to get to a market value of the core office portfolio of just over US$25.8billion. That gets us 1.636million sq. m of core NYC office space together with 237,000 sqm of retail and significant office space in San Francisco and Chicago. All up, we are paying around US$11,073/sqm in capital value (~ A$15,000). Remember this is property with massive development potential and significant positive rent reversion. Latest rental deals amount to an effective >8% gross yield!

As a guide, the latest Savills quarterly[9] reckons the capital value of "A" grade Sydney office property is between A$18,000 – A$21,000/sqm; we are buying VNO with all of its fantastic embedded options and a driven CEO at a value per sq. metre less than recent transactions in the grungy Southern part of the Sydney CBD, well below "A" grade Sydney CBD property and miles below premium grade Sydney CBD. We reckon that's mispricing and now own VNO.

Conclusion

Sorry, it's been more of the same. Crazy prices for some good companies, some others which have the use of zero cost capital to make more losses and pure concepts. Low prices for older companies with some threats but real cash flow or assets. We'll stick to the latter given their place in the real world.

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STATISTICAL APPENDIX: QUARTER & FYTD TO 30 JUNE 2018

1. Monthly performance, exposure and NAV

	Investment return[10]	Cost imposition[11]	Net Return[12]	FY17 Return	NAV/share pre tax (c)	Gross Exposure[13]	Net Exposure[14]
30 Jun 17	1.3%	-0.2%	1.1%	46.6%	35.5	276%	-6%
				R12 return			
31 Jul 17	1.3%	-0.6%	0.7%	35.8%	35.8	283%	-22%
31 Aug 17	-5.0%	-0.4%	-5.4%	23.7%	33.8	320%	-28%
30 Sep 17	2.8%	-0.3%	2.5%	29.2%	35.2	359%	-31%
31 Oct 17	-7.3%	-0.2%	-7.5%	14.1%	32.8	412%	-42%
30 Nov 17	-9.1%	-0.3%	-9.4%	-5.6%	29.7	437%	-73%
31 Dec 17	-7.1%	-0.2%	-7.6%	-18.4%	27.4	436%	-99%
31 Jan 18	-9.1%	-0.2%	-9.3%	-30.1%	24.7	497%	-135%
28 Feb 18	15.6%	-0.3%	15.3%	-19.2%	28.0	346%	48%
31 Mar 18	2.4%	-0.3%	2.1%	-18.6%	29.2	310%	95%
30 Apr 18	4.1%	-0.2%	3.9%	-15.3%	29.9	262%	91%
31 May 18	-0.8%	-0.3%	-1.0%	-16.0%	29.5	272%	88%
30 Jun 18	-2.0%	-0.1%	-2.1%	-18.8%	28.9	278%	81%

2. Equity exposure as at 30 June 2018[15] (as % month end pre tax shareholders funds):

	AUSTRALIA		OVERSEAS		TOTAL	
	percent	exposures	percent	exposures	percent	exposures
LONG	96.8%	28	83.4%	36	180.2%	64
SHORT	(11.7%)	6	(25.9%)	11	(37.6%)	17
INDEX	(4.1%)	-	(57.0%)	-	(61.1%)	
CRYPTO	-	-	-	-	-	
TOTAL	81.0%	34	0.4%	47	81.5%	81

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Endnotes & sources:

[1] East 72 Holdings Limited (**E72**) provides monthly **unaudited** updates on its company performance and exposure supplemented by a more substantial quarterly note. Readers are referred to footnotes 2 and 10-15 explaining the derivation of the numbers. All returns are pre-tax unless stated otherwise. At the current level of net assets, cost imposition is estimated at 0.25% per month over the course of a full year (excluding capital raising related expenses) and is fully accrued monthly according to the best estimates of management. Readers are explicitly referred to the disclaimer on pages 9&10.

[2] Month by month tabulation of investment return and exposures is given on page 7, along with exposure metrics.

[3] Lengthy and highly entertaining exposes of Ms. Sorokin/Delvey are contained in "Vanity Fair" of 13/4/18 and "New York" magazine of 28/5/18.

[4] The "Delvey" portfolio is unweighted shares of Lululemon (LULU), Tesla (TSLA), Apple (AAPL), Twitter (TWTR), Amazon (AMZN), Trip Advisor (TRIP) and Netflix (NFLX)

[5] Messrs Buffett and Munger

[6] Empire Life ranks #6 by premiums

[7] The entire city block bounded by 58th & 59th Street, 3rd Avenue and Lexington containing the Bloomberg Building and a massive Home Depot is owned by Alexanders Inc (ALX) which is managed and 32% owned by VNO

[8] Investors might note the stellar performance of Madison Square Garden (MSG) up 46% in less than six months. MSG owns the building, the sports teams in the building (value mainly Knicks and Rangers), plus part of the air-rights above Penn Station. The air rights in the area are roughly 48% MSG/52% VNO.

[9] Savills Quarter Time National Office Q1 2018

[10] Change in market value of all investments – cash and derivatives – after interest charges, dividends receivable, dividends and fees paid away divided by opening period net asset value and time weighted for equity raisings

[11] All accrued expenses for company administration (eg. listing fees, audit, registry) divided by opening period net asset value and time weighted for equity raisings

[12] Calculated as 2 (above) minus 3 (above)

[13] Calculated as total gross exposures being nominal exposure of all long and short positions (cash and derivative) divided by end month pre tax net asset value – assumes index ∂ of 1

[14] Calculated as total net exposures being nominal exposure of all long minus short positions (cash and derivative) divided by end month pre tax net asset value – assumes index ∂ of 1

[15] Figures may not sum due to rounding