QUARTERLY REPORT #10: PERIOD TO 31 DECEMBER 2018[1]

Performance and net asset value[2]

Quarterly portfolio return: (11.6%)

"*So I think that if there is any remnant left of the kind of hedge fund investment industry, I think it's going to be at the longer-term time horizon, where machines don't have the edge, where things like value do have an ability to drive returns over an extended period of time.*" Raoul Pal

This quote, from the recent 68 minute discussion[3] between the two co-founders of "Real Vision"– an SVOD site for investors – was one of very many which are highly applicable to East 72's positioning at the end of 2018. We have previously stressed the benefits of having permanent capital (through our listed structure) and being able to "time arbitrage" – a fancy term for thinking over a different (usually longer) time frame than the consensus.

Because, even by recent standards, this was an outlandish quarter.

The speed of unravelling of US equity markets in October and December had two specific derivative impacts:

- Creating a domino effect into other global markets, many of which had already fallen substantially; and
- Creating a second derivative impact on securities which were already well below intrinsic value – either not having been close to that value over the recent past, or having fallen away due to prior announcements.

Our short portfolio – except one - did very well. We covered significant tranches of our short positions as a number of concept or high valued securities were devalued by over 30%. Except one. We have also totally covered our S&P500 index hedge, and indeed have a small long position, with valuations now far more reasonable – not dirt cheap, but with acceptable return possibilities. We also covered our highly non-consensus short position in Apple which collapsed 37% from a 3 October high of $232 to a low point around $146 even before the guidance warning of 2nd January 2019.

The month of December 2018 was the second worst December on record for the S&P500; the 9.2% decline, in a period generally known for the "Santa Claus rally" was exceeded only by 1931. Amidst the benefits of a number of short positions – except one – we were disadvantaged by stock price declines in a group of core holdings; we view these securities as very cheap, with good growth prospects and where in many cases, the magnitude of losses make very little sense.

At 31 December 2018, pre tax NTA was 23.2c (after a small tax payment); post tax NTA was 26.2c.

---

[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 28-33 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 0.22% 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 13, along with exposure metrics.

[3] Quote by Raoul Pal in "RealVision" discussion with Grant Williams 28 December 2018

There were also more subtle elements of the December month decline in equities. The consensus view can be ascribed to everything from fear of Federal Reserve Board policy errors, declining forward earnings estimates, China trade tensions and their recent impact as well as heightened fears over the recent madness at 1600 Pennsylvania Avenue. Three other factors were of a second or third level nature and contributed to the most heightened bout of fear in equity markets[4] since February 2016's "China growth scare":

- Fear over the gluing up of the US high yield bond market; spreads of high yield (junk) bonds have blown out from ~3.3% at end October 2018 to 5.3% at 2018 year end[5];
- Dramatic ~35% slide in the oil price during the quarter; this has a circular impact on the high yield market due to the proliferation of energy company issuances of high yield bonds; and
- Ongoing concern regarding US$ liquidity, through the combination of growing US deficits and US Fed removing liquidity from the system through selling down its bond portfolio.

As a consequence, where we struggled in the short term (just December) was the impact of falling markets on recent purchases or core holdings, despite these securities already trading well below a reasonable assessment of intrinsic value.

Two of our core positions, Aercap Holdings and Exor, have been held since the inception of East 72 and have both added significant intrinsic value to their businesses through strong operational management combined with adept capital management. AerCap (25% decline in December; 31% in the quarter) and Exor (9% and 18% respectively) contributed around a quarter of our December month decline. Exor fell in response to the December quarter price falls of its automotive stockholdings (FiatChrysler -17%; Ferrari -27%) but trades at a 35% discount to net asset value even at these lower price levels. Not surprisingly, and with a significant dividend to come from the sale of Fiat's parts business, management have been repurchasing shares.

Except one: the inconsistency of fear

In our last quarterly report, we highlighted the strong case in favour of short selling Tesla whilst being cognisant that Q3 2018 would potentially produce favourable results. It did, albeit with a number of caveats such as the failure to disclose the quantum of non-ZEV ("green") credits of $137m in the original press release of 24 October which turned up in the statutory 10-Q on 2nd November. Tesla shares were by far and away the best performing auto stock in Q4, rising by 25.7% from $285 to $333, with a $370 high. Every other one of the eleven global automotive shares featured in QR#9 fell between 0.6% and 27.4% during the quarter[6] with an average decline of 13.1%.

This is a company which relies on the bond market – as does every other major auto company – to issue asset backed securities to ultimately finance automotive leases. With Tesla's credit rating likely to come under pressure, we find it bizarre that the equity performed so well in a period where other credit reliant companies' share prices declined sharply.

Given the volatility of the stock, we traded around our position in Tesla, but strongly believe that a $57billion equity capitalisation, rating Tesla as roughly equal third with Daimler-Benz amongst

[4] CBOE VIX index reached 37% on 24 December but has sustained its highest quarterly average since Q2 2016
[5] ICE Bank of America MerrillLynch US High Yield Master II Option-Adjusted Spread. Source: St Louis Fed
[6] AstonMartin Lagonda, BMW, Daimler-Benz, Ferrari, FiatChrysler, Ford, GM, Honda, Porsche, Toyota, VW

non-Korean global auto manufacturers, behind Toyota and VW, simply makes no intuitive sense. The more so given the competition now arriving from the European manufacturers, the increasing difficulties in China, and lack of a second factory.

Moreover, the enthusiasm for TSLA equity is not reflected in its August 2025 5.3% bonds, which roughly finished the December quarter where they started, as shown by trading prices on the Berlin Borse; they yield around 8.06% or a spread of ~5.5% over a US T-Bond of similar duration i.e. have a "junk" pricing :

There are increasingly other signs that Tesla is under cash flow pressure: stringing out payments to creditors, delaying registration of delivered vehicles, struggling to cope with service and starting to experience inventory build.

The <u>audited</u> 10K annual report from the company due in late February <u>should</u> be a treasure-trove of information, notably leading up to a $920m bond repayment in March, and we believe may be a pre-cursor to a far more difficult period for the company and its equity price.

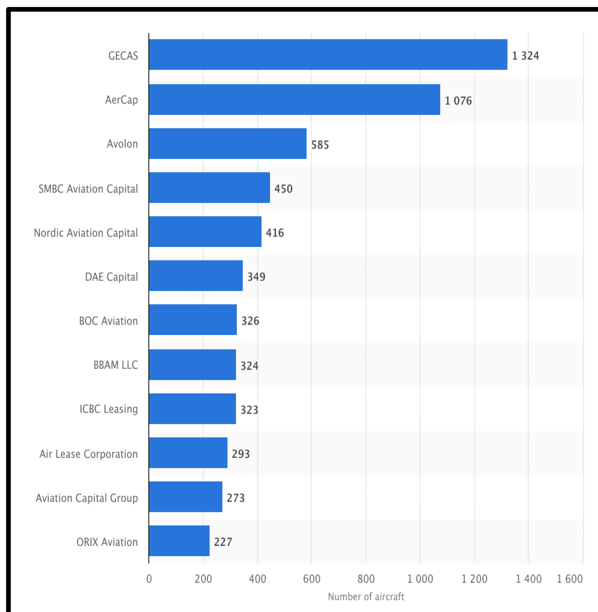
Aircraft leasing and financials: the incongruity of fear

Financial securities were notably weak in the December 2018 quarter. The de-rating of many of these securities appears to be at near panic levels, with current/prospective P/E ratios in the mid-single digits, and major discounts to tangible book value. These types of ratings suggest a major dislocation in relevant asset prices and/or near complete closure of credit markets. It is a reasonably establish fact in the world of banking that after major upheavals, it usually takes a generation or more for the lessons to be forgotten. 2008 is too close, which is why the Armageddon type scenarios being touted are less likely than normal to occur. Perhaps only in Australian home loan banking is the generational history lacking.

In contrast to Tesla, listed aircraft leasing companies reflected extreme fear of a re-pricing (or withdrawal) of credit in the area, with the two largest listed entities subject to over 30% share price declines during the December quarter. The incongruity is three-fold:

- Their clients, the lessee airlines, received a massive (if deferred) boost to their bottom lines from the oil price collapse, thereby making them arguably more credit-worthy;
- Passenger numbers are estimated by IATA to have grown by 6.1% in calendar 2018 to around 4.34billion and to increase 5.6% in the current year; and
- The airline industry is estimated to earn operating profits of ~$56billion in the 2018 calendar year and close to $60billion in 2019[7]

Hence, particularly in December 2018, speculators in aircraft leasing stocks decided these statistics within the aviation world were about to decline sharply. Given that global passenger revenue passenger kilometre growth has averaged 6.7% per annum over the past five years for obvious demographic reasons, this would seem to be a "left-field" call.



Just as importantly, in a world of growing "young" airlines, there is significant room for the industry to grow. The top 10 players (illustrated in 2017[8]) account for just less than 6,000 planes, or ~ 25% of the global fleet of passenger and cargo aircraft. Some of the majors – notably Nordic with its smaller aircraft – have specialisms. Three companies – AerCap, AirLease and Avolon (owned by Bohai Leasing and Orix) – have combined commitments for 1,100 aircraft – about fifteen months equivalent of entire Boeing production.

The damage done to share prices in the sector has meant that the four US listed players now have a combined market value just above $10billion as at 31 December 2018.

This may well provide an opportunity for private equity to enter the space at extremely low valuations; GE through its new CEO Larry Culp are seeking to shed assets, and the GE Capital business is ostensibly non-core with its higher cost of funds arising from the consolidated entity's financial pressures. GECAS isn't the greatest business – it has a large but generally older fleet, but has the benefit of diversity through helicopter and especially engine leasing. An ongoing relationship with the parent entity, which manufactures engines, would be a necessity.

Most strikingly, the two larger US listed players are now at an appreciable discount to their HK-listed counterpart, BOC Aviation, 70% controlled by Bank of China. In the past, wealthy individuals from Asia have shown an inclination to be involved in the industry. Why not now? We have added to our holding of AerCap, solid in the knowledge that management are exceptional

[7] IATA fact sheet: December 2018
[8] Statistica: owned and managed aircraft, excludes commitments

and now have an opportunity to continue to retire more equity – having bought back 35% of the company's shares in the past 39 months – at even larger discounts than normal.

The following table[9] of listed lessors shows just how cheap the two largest players have become; to put the table in perspective, it is instructive (and baffling) to note that since we ran a similar exercise in June 2017 (QR #4) using March quarter 2017 figures, Aercap has:

- Reduced its share count from 166.4million shares to 137.1million (-17.6%);
- Increased book value per share from $51.20 to $61.24 – a gain of nearly 20%; and
- Seen the share price decline from $46.43 at end June 2017 to $39.60 – a 15% fall.

US$ or million	AerCap	Aircastle	Air Lease Corp	BOC Aviation[10]	Fly Leasing
ticker	AER	AYR	AL	2588.HK	FLY
Fleet BV ($mn)	33,187	6,322	15,148	16,633	3,450
Effective discount[11]	(11.5%)	(9.9%)	(8.9%)	+6.9%	(11.0%)
Planes owned	952	234	268	294	81
Planes managed	105	12	60	26	-
Commitment (no)	400	43	384	190	26
av. plane age (years)	6.6	9.6	3.8	3.1	7.1
WALE [12](years)	7.1	4.5	6.8	8.2	5.9
Issued shares (mn)	137.075	77.180	110.934	694.010	32.650
Equity Cap ($mn)	5,428	1,331	3,351	5,136	345
BV/share (30/9/18)	$61.24	$25.38	$42.17	$5.75	$20.89
Share price (31/12/18)	$39.60	$17.24	$30.21	$7.40	$10.56
Share decline QIV 18	-31.2%	-20.0%	-33.9%	-4.5%	-25.1%
P/BV	**-35.3%**	-32%	-28.4%	+26.1%	-49.4%
F/C EPS '18[13]	$6.11	$1.98	$4.57	$0.79	$1.08
P/E	**6.5x**	8.7x	6.6x	9.4x	9.8x

A word of warning: "compounders"

In the second week of the quarter we attended an exceptional investment conference in New York. As it happened the day[14] coincided with the first real "crack" in US equity markets since February with the Dow Jones falling 832 points (3.14%). There appeared no panic amongst the 100 or so participants. More worrisome to your correspondent was the extreme focus on business models, less so on valuations, and the preponderance of a word: compounders.

[9] Financials as at 30 September 2018; share prices as at 31 December 2018
[10] Converted to US$ at US$1 = HK$7.83; balance sheet figures as at 30 June 2018 (adjusted)
[11] Pre tax – calculated by adding all liabilities less assets to derive market based EV of fleet and compared to fleet book value
[12] weighted average lease expiry
[13] East 72 and other sourced estimates for calendar year 2018 excluding asset and plane sales
[14] 10 October 2018

There are various definitions of a compounding stock, but aside from mineral companies discovering a major new resource, it's generally a company able to **reinvest** capital (from retained earnings) at a very high rate of return. As a consequence, subject to dividend policy – the less paid out the better - the compounder can grow book value and earnings at rapid rates of return. In recent years, if the compounding company believes its share price does not reflect these earnings and reinvestment prospects, it can potentially accelerate such growth through share buybacks; at current low levels of interest rates, compounders may well choose to accelerate growth through low cost leverage, which can usually be gained on favourable terms.

The single best example we can cite of a compounder is a product manufacturer well known to half the population, and cited as an example in one of the great investment books[15]: Tampax Inc[16].

Tampax, originating in the 1930's, possessed the perfect investment model at the perfect demographic moment: a dominating (>60% market share), branded, necessary feminine hygiene product, at a time of increasing acceptance of consumer brands and growth in the advertising companies who promoted them via new media (where possible[17]).

Tampax is an exceptionally good example of the arithmetic of growth because its figures are not complicated by debt or preferred stocks. Here they are, for the last fifteen years.

	Return on Invested Capital	Book Value per Share	Earnings per Share	Dividends per Share	Reinvested Earnings per Share
1970	36.7%	$17.89	$6.58	$4.10	$2.48
1969	34.6	15.41	5.34	3.55	1.79
1968	35.3	13.62	4.82	3.10	1.72
1967	36.6	11.90	4.36	2.80	1.56
1966	36.8	10.34	3.81	2.50	1.31
1965	37.6	9.03	3.39	2.00	1.39
1964	36.0	7.63	2.15	1.75	.40
1963	34.1	6.63	2.26	1.35	.91
1962	37.4	4.92	1.84	1.18	.66
1961	37.9	4.26	1.61	1.03	.58
1960	38.8	3.67	1.42	.93	.49
1959	37.4	3.35	1.25	.80	.45
1958	37.5	2.90	1.08	.70	.38
1957	39.0	2.52	.97	.63	.34
1956	39.7	2.18	.86	.56	.30

The excerpt (left) from Phelps' book (pp253) shows the massive benefit of earning an average ROIC of 37% over a fifteen year period, even paying out some 60-65% of net earnings.

Phelps points out the benefit of buying such a stock in 1956 at a low of $9.50 (11x P/E) but the incredible re-rating of the company after this period of growth to a 50x P/E in 1971, at its peak share price of $329 – nearly 35times your money in fifteen years.

Tampax appears in the midst of a plethora of consumer goods companies[18] which made long term investors over 100x their original stake, if they held on![19]

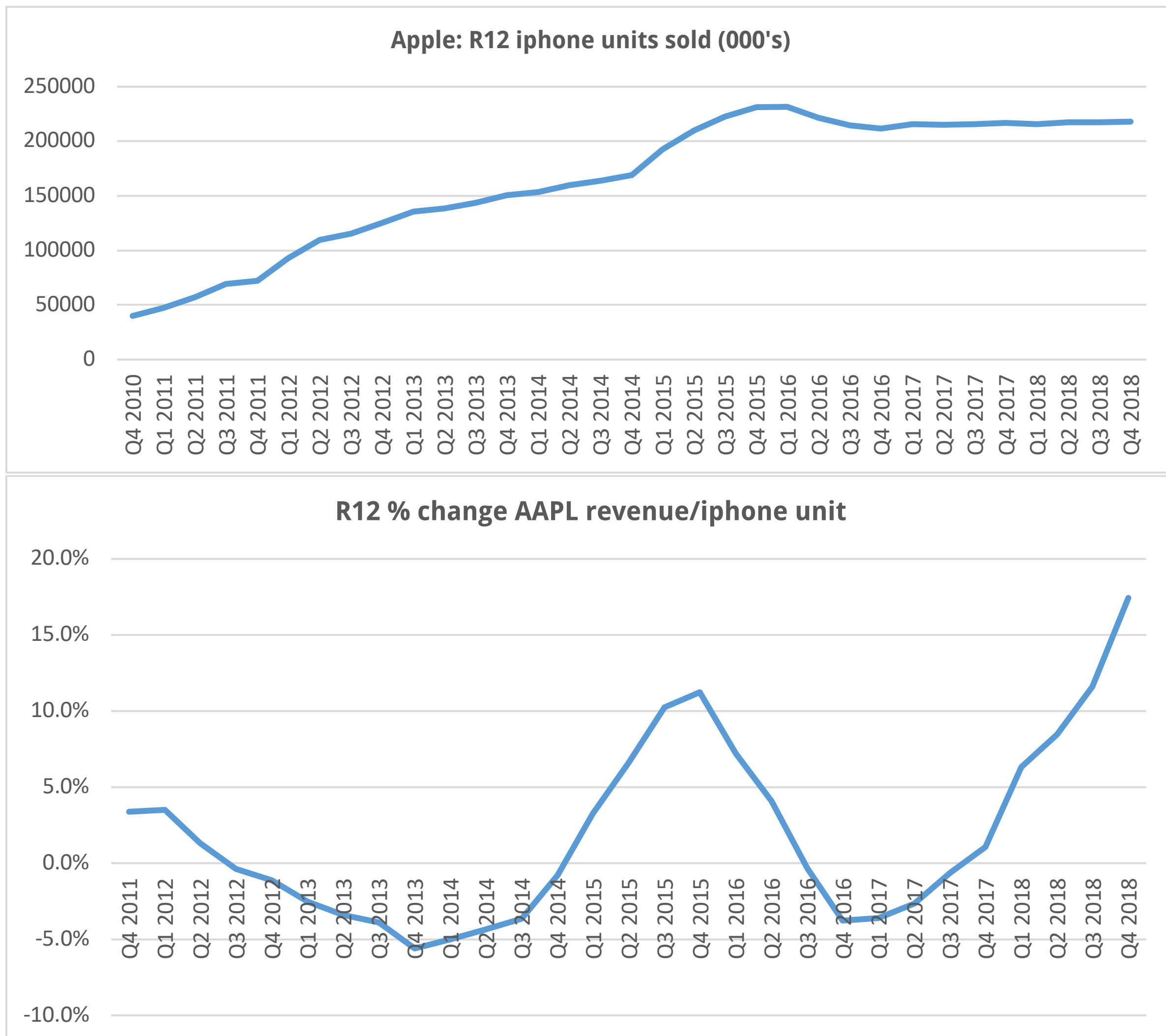
[15] "100 to 1 in the stock market" by Thomas W. Phelps (1972; republished by Echo Point books 2014)
[16] Tampax (and latterly Tambrands) was a publicly listed company from 1936 to its acquisition by Proctor & Gamble in July1997
[17] US TV advertising of "menstrual" products was banned until 1972.
[18] Most of these companies 100-bagged from the early 1960's through the 1970's as illustrated in Christopher Mayer's "100 Baggers" (2015 Laissez Faire Books)
[19] Tampax 178-bagged between 1949 and 1971

Today's versions of compounders tend to be in the technology area:

- Exhibit types of oligopolistic characteristics and pricing power;
- High returns on capital, which may also be shrunk by share buy-backs;
- Network effects; and
- Significant negative working capital (using other people's money)[20].

However, unlike the 1960s and early 1970s, the more rapid pace of technological change, and global movement of capital – often low cost, "no return required" capital - suggests a less, not more conducive environment for the creation of these types of companies.

Moreover, as we arguably saw in January and September 2018, "investors" committed the same mistakes as their 1970's antecedents – paying too much. More worryingly, perhaps the companies themselves also did.



[20] Apple was using ~$46billion of other people's money at 30 September 2018 in the form of $35.6bn of negative working capital and $10.4bn of deferred revenue

EAST 72

These are two of my favourite and very simple charts. They show that Apple – absent major product innovation or a disaster by a competitor – is unlikely to sell much more than 240million iphones in a rolling 12month period, and only then coinciding with a new product launch. Moreover, the comments by Warren Buffett on CNBC in late August regarding the "value" of the iphone of US$1,000 being "enormously underpriced", seems to have coincided with a mass belief/hysteria that iphone "inflation" rates of 17.4% seen in the twelve months to September 2018 were in some way sustainable. It is now clear – they are not.

Having said that, we covered our highly non-consensus short position in Apple (AAPL) during the December washout; we did so at around the same price that the company spent US$135billion buying back around 931million shares (16.7% of opening share count) over the three years to September at an average $145/share. The company's shares purchased in the past two years have been at an average P/E of 15x and EV/EBITDA multiple of 9.6x. Cheap if you have very low cost capital but relative to past history in the sector, maybe not. And it's difficult to believe that Apple's past compounding will continue at any kind of pace.

Unless they are legislated monopolies, with amazing calibre management, all compounders – like Tampax – come to a logical conclusion. Competition, patent expiry, management hubris and ineptitude, technological change or legislative intrusion are the usual antedotes.

Our observations have been to see too many investors trying to fit too many companies into a very small mould, with an excessive focus on capital management as a form of advantage, when the real compounders of the past were happy to distribute dividends or hoard cash. Somewhat surprisingly, perhaps, as we discussed in the September 2018 quarterly (#9), we feel there is more prospect of finding compounders in selective niches of the financial industry, as the barriers to entry to their businesses grow larger. We highlight an excellent example – Virtu Financial – below.

Virtu Financial[21]: Building a bigger, better money machine

We have held an exposure to Virtu Financial (VIRT) since January 2017, when we started acquiring at around $17.65; the current price is $25.76 providing for an equity market capitalisation of $4.9billion. We have traded around gains in the shares, selling a few in the low $30's in early 2018. However, what we now hold is a superior business to that of two years ago.

How does Virtu make money?

Those of you reading our AGM presentation will have picked up the fact that the companies involved in the financial services supply chain who have tended to benefit the most over five years have been the stock exchanges themselves, rather than funds managers or investment banks. So whilst the value of the "house" (the exchange) has increased significantly over this period, one of the most essential components – the plumbing – has increased in price to a far lesser extent. In a stock exchange, the "plumbing" is the technology and expertise which provides liquidity to investors (and speculators) by market making, algorithmic trading or other execution services like dark pools and off exchange transactions.

[21] All figures are in US$

As a guide, over the past five years on US equity markets, roughly 6.8billion shares a day trade at a most recent average price of ~ US$49, for around $330billon of daily turnover. Virtu processes around one in four **retail** orders in US equities. Like any other market maker, Virtu's net trading income is advantaged by four key influences, namely:

- Increasing prevalence of electronic trading, especially with growth in exchange traded funds;
- A larger number of exchange venues in which to operate across foreign exchange, commodities, equities and fixed interest;
- Its own capability to grab higher market shares and "capture" – the latter being a higher return per dollar traded; and
- Volatility; in general, the more volatile the market, the greater the opportunity for profit.

These four facets were laid out in early Virtu presentations[22], together with a fifth driver of overall profitability: the ability to utilise a common platform to reduce costs and improve margins. It is this latter feature which is now starting to take centre stage and which we will discuss later.

Virtu deploys around $1.3billion of net trading capital, which is "geared" around 4.4:1; the asset side is broadly comprised of cash, shares borrowed, shares held, and amounts owed by broker-dealers. Liabilities are represented by amounts payable, shares sold (under repurchase agreements or otherwise), and stocks loaned out. This net trading capital increased substantially after the purchase of Knight Capital Group in early/mid 2017 from under $400m to a high of over $1.8billion. In LTM through Q3 2018, Virtu earned net trading income of ~ $960m – a 69% return on average net trading capital – of which 61% came from Americas equities. The benefit from volatility is clear: Q2 2018's market making income of $314m in a high volatility environment was nearly double Q3 2018's $159m in a less wild quarter. Around the time of the public listing, with a significantly lower level of trading capital, Virtu regularly recorded quarters with annualized return of well over 100%pa net trading income to capital.

An important aspect of volatility is that Virtu benefits from realised volatility, not the volatility implied in the pricing of options contracts, measured by indices such as CBOE's VIX. In calendar 2017, the VIX implied volatility of 11%pa – very low already – saw realised volatility averaging 6.7% - 61% of that "predicted". This type of absurdly low volatility environment, consistent with market complacency, was why we took a large short position in US equities in late 2017 and early 2018.

History and the Knight Capital acquisition

Virtu was founded in 2008 by Vincent Viola and Doug Cifu, both of whom remain with the firm. In 2014, Virtu moved to enact an IPO, and submitted an S-1 filing on 10 March 2014 – a document which created no little comment, notably in respect of a famous chart on page 3 showing that of 1,238 days between 2009-2013, the firm had lost money trading on only one.

The advent of two books – Scott Patterson's "Dark Pools" in July 2012 but specifically the more widely read and marketed "Flash Boys" by Michael Lewis (March 2014) caused a degree of controversy, leading to the original IPO to be postponed.

The public offering was regenerated in April 2015 with a float at $19/share (pre costs) of just under 14% of the capital, raising $360m. The shares generally traded in the mid $20s for most

[22] (for example) Sandler O'Neill presentation 15 June 2015

of the first year, before commencing a downward trend in the latter part of 2016, reaching a low of ~$13.25 in October 2016. This decline in the share price broadly corresponded with the commencement of a period of extremely low realised volatility in US equity markets, despite the fact that for a few quarters, VIRT's net trading income as a percentage of net trading capital held up very well.

This share price decline presaged a tumultuous calendar 2017 for market makers, with the afore mentioned extraordinarily low volatility measures. As a response to these conditions, in April 2017, VIRT acquired the publicly listed Knight Capital Group (KCG) for ~$1.4billion, funded by a new debt issue and $750m stock placement to selected parties.

KCG[23] had been publicly listed since early 1999, with a split adjusted IPO price of $17.50 reaching heights of $60 in early 2000. The company morphed through various different eras of market making, and the growth of hedge funds, with the shares generally being moribund, reflecting the significant decline in profitability of the company from its calendar year 2000 peak pre-tax income of over $400million. Profitability did start to improve in the mid 2000's until a fateful day on 1 August 2012.

That day, KCG's automated order routing system experienced a significant failure, effectively stemming from a failed new software deployment; the firm lost $440million in a single day and the shares fell from $10.25 to $2.58 over two days. KCG was rescued by an effective consortium of Jefferies Financial[24], Blackstone and GETCO five days later with the use of preferred stock.

The aftermath of Virtu's KCG purchase is a near master-class in cost and capital management within the financial sector. Estimated cost synergies at the time of purchase of $208million have been vastly exceeded[25], with the saving run-rate now estimated at $340million annualized; moreover, VIRT has freed up significant portions of trading capital between the merged VIRT/KCG entity as follows, as well as paying down long term debt, through capital release and the sale of a major subsidiary, Bondpoint:

US$mn	30 Jun 17	30 Sep 17	31 Dec 17	31 Mar 18	30 Jun 18	30 Sep 18
Net trading capital	1848	1358	1313	1494	1441	1308
Long term debt	1628	1435	1389	1157	1047	931

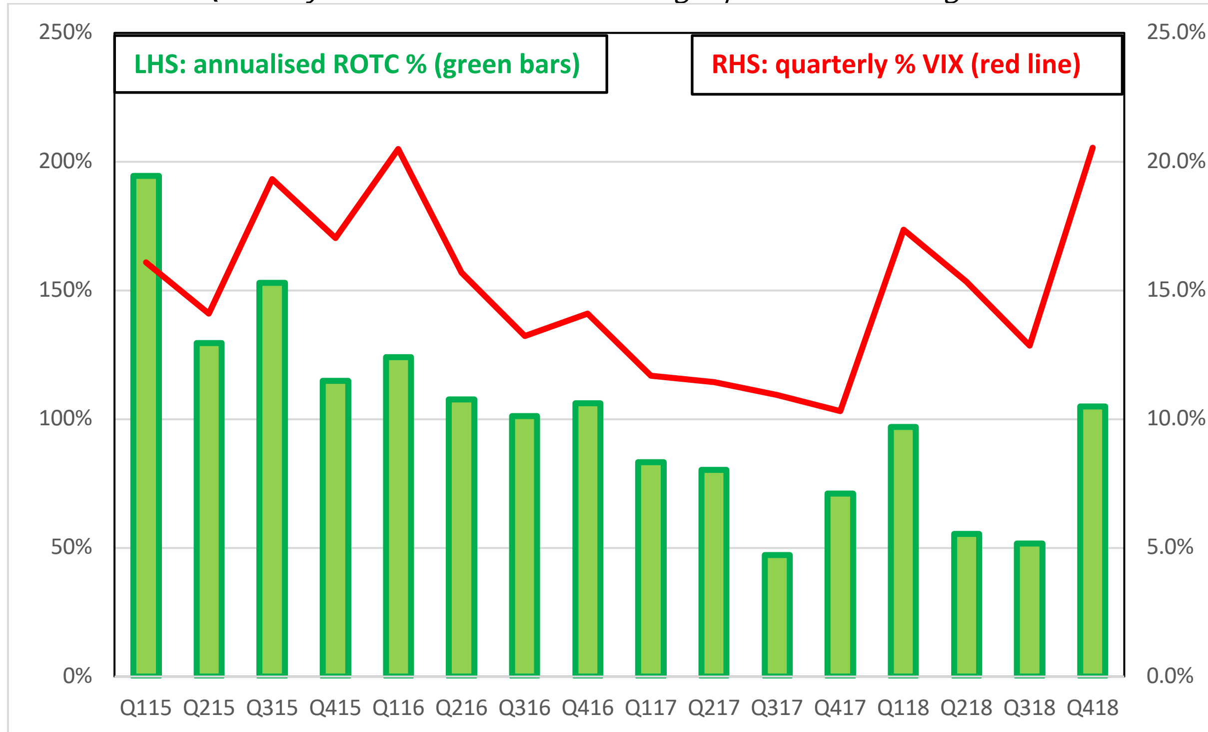
A potential re-run: acquisition of Integrated Technology Group (ITG)

The acquisition of KCG made Virtu a slightly greater hostage to market volatility than management felt was desirable; the degree to which this is the case can be seen the following chart:

[23] An excellent piece on the history of KCG by Bishr Tabbaa can be found at https://hackernoon.com/the-rise-and-fall-of-knight-capital-buy-high-sell-low-rinse-and-repeat-ae17fae780f6
[24] Leucadia, the Jefferies parent – to which we have an exposure - repeated the exercise in January 2015 on FXCM, a fx dealer caught out by the SNB "unpegging" surge in the Swiss franc on 15 January 2015
[25] VIRT's compensation ratio ran at ~23% of net trading income; KCG's was >40%.

EAST 72

Virtu Financial: Quarterly annualised return on trading capital versus average VIX[26]



The sharp dip in Q3 2017 reflects the increased capital arising from the acquisition of KCG; however, there is a clear decline in the returns available on capital from a given level of implied VIX volatility, partly as a result of competitive pressures.

In its own words: "ITG is a global financial technology company that …empowers traders to reduce the end-to-end cost of implementing investments via liquidity, execution, analytics and workflow technology solutions." On VIRT's analysis, ITG will increase the level of execution services as a percentage of net trading income from ~ 10% currently to around 37% on a pro-forma basis.

As was the case with KCG, there are significant personnel and rental cost synergies to be gleaned in the first year of the acquisition – some $123million, primarily composed of personnel and occupancy savings, along with data processing and IT savings; all up, VIRT see the acquisition being after tax earnings accretive (after funding costs) by some $127million in full year 2020 – equivalent to $0.67 per VIRT share[27].

Strong outcome in Q4 ahead of ITG acquisition

Q4 2018 will represent the highest VIX reading by quarter since Q1 2016; more pointedly, realised volatility has broadly mirrored the CBOE VIX contracts, and US equity volumes have picked up suggesting a very strong Q4, with potential annualised return on trading capital at ~100%.

[26] Source: Virtu Financial, CBOE. Q4 2018 is E72 estimate
[27] Virtu Financial Inc. 8K announcements 7 November 2018

Imputing this into the first three quarters of CY2018, we conservatively think VIRT will earn net income (excluding the gain on BondPoint) of $265million ($1.41per share) in the 2018 calendar year; adjusting for other non-recurring items (including significant lease termination costs) and adding back share-based compensation, adjusted EPS (as defined by VIRT) should come in above $1.94 for the 2018 year, leaving the shares on a LTM P/E around 13x. This is in a year with two strong quarters of realised volatility, together with two more mundane periods.

Looking forward, properly executed, the ITG acquisition should not only be very highly earnings accretive, but the strong cash flows generated by Virtu will hopefully serve to pay down debt relatively quickly. VIRT charges off around $64m pa in amortisation, whilst investing approximately $50million in capitalised software and equipment capex; additionally, share based payments should save a further $25m pa in cash outflow.

Hence, in a reasonable (not high) volatility environment in 2020, VIRT should be capable of earning an adjusted $2.30 - $2.60 per share, paying out $0.94 in dividends ($0.24 per quarter) and leaving over $300million for debt repayment or share repurchase.

In our view, Virtu is an extremely well run, near unique listed entity. The company is at the forefront of equity (and other market technologies), has a strong insider shareholder base, and has proven very capable at acquisition integration and capital release. In an equity market still likely to provide bursts of volatility, VIRT represents a cheap – if variable earnings stream – with significant optionality. Even in the short term, with the shares up $4 or so since the 7 November 2018 announcement of the ITG deal, along with wild volatility for two months thereafter, it would be surprising not to see further upward re-rating of VIRT shares, early in 2019.

Conclusion

We have significantly increased our equity exposure over the past four months. We may have moved a little early in some areas, but feel there has been genuine panic in certain sectors. This is notably the case in financials where we can buy numerous banks on single digit P/E's (and discounts to book) as their credit improves; none of these are based in Australia. That we can also buy Goldman Sachs at below tangible book value ($191.71) and KKR (on 31 December 2018) at an 18% premium to book ($16.68) with an implied value of 1.76% of fee paying assets under management, suggests Raoul Pal's machines may have run a bit too hot in December.

For further information:

Andrew Brown
Executive Director
(02) 9380 9001 / 0418 215 255

STATISTICAL APPENDIX: QUARTER & FYTD TO 31 DECEMBER 2018

1. Monthly performance, exposure and NAV

	Investment return[28]	Cost imposition[29]	Net Return[30]	FY17 Return	NAV/share pre tax (c)	Gross Exposure[31]	Net Exposure[32]
30 Jun 17	1.3%	-0.2%	1.1%	46.6%	35.5	276%	-6%
				R12 return			
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%	29.0	278%	81%
31 Jul 18	-3.8%	-0.3%	-4.1%	-22.5%	27.8	276%	63%
31 Aug 18	-6.4%	-0.4%	-6.8%	-23.7%	26.2	285%	48%
30 Sep 18	0.9%	-0.2%	0.7%	-25.0%	26.4	287%	42%
31 Oct 18	-0.8%	-0.2%	-1.0%	-19.8%	26.2	217%	145%
30 Nov 18	-0.2%	-0.2%	-0.4%	-12.1%	26.0	233%	152%
31 Dec 18	-10.3%	-0.2%	-10.4%	-14.5%	23.2	243%	185%

2. Equity exposure as at 31 December 2018[33] (as % month end pre tax shareholders funds):

	AUSTRALIA		OVERSEAS		TOTAL	
	percent	exposures	percent	exposures	percent	exposures
LONG	87.0%	24	105.7%	33	192.7%	57
SHORT	(5.1%)	2	(22.6%)	9	(27.7%)	11
INDEX	8.9%	-	11.1%	-	20.0%	
TOTAL	90.8%	26	94.2%	42	185.0%	68

[28] 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

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

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

[31] 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

[32] 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

[33] Figures may not sum due to rounding

Disclaimer

While East 72 Holdings Limited (**E72**) believes the information contained in this communication is based on reliable information, no warranty is given as to its accuracy and persons relying on this information do so at their own risk. E72 and its related companies, their officers, employees, representatives and agents expressly advise that they shall not be liable in any way whatsoever for loss or damage, whether direct, indirect, consequential or otherwise arising out of or in connection with the contents of an/or any omissions from this report except where a liability is made non-excludable by legislation.

Any projections contained in this communication are estimates only. Such projections are subject to market influences and contingent upon matters outside the control of E72 and therefore may not be realised in the future.

This update is for general information purposes; it does not purport to provide recommendations or advice or opinions in relation to specific investments or securities. It has been prepared without taking account of any person's objectives, financial situation or needs and because of that, any person should take relevant advice before acting on the commentary. The update is being supplied for information purposes only and not for any other purpose. The update and information contained in it do not constitute a prospectus and do not form part of any offer of, or invitation to apply for securities in any jurisdiction.

The information contained in this update is current as at 31 December 2018 or such other dates which are stipulated herein. All statements are based on E72's best information as at 31 December 2018. This presentation may include forward-looking statements regarding future events. All forward-looking statements are based on the beliefs of E72 management, and reflect their current views with respect to future events. These views are subject to various risks, uncertainties and assumptions which may or may not eventuate. E72 makes no representation nor gives any assurance that these statements will prove to be accurate as future circumstances or events may differ from those which have been anticipated by the Company.