QUARTERLY REPORT #22: PERIOD TO 31 DECEMBER 2021[1]

Performance and net asset value[2]

Quarterly gross portfolio return: 8.9%; rolling twelve month gross return +18.9%

Each of the past few years for the "Equity Mates" podcast (best use "Spotify" but now unfortunately available visually on 'YouTube" showing my extensive use of notes and a head for radio) I have done an early year "Bold Predictions". The idea is to make sensible but not necessarily mainstream financial/economic related predictions for the year ahead.

A few weeks ago, I publicly reviewed the predictions for 2021; aside from the 100% probability event NOT eventuating (an Australian Federal election) what was clear was the financial markets changed materially over 2021 as early as mid-February. A few things came together in short order to change the landscape:

- The peaking of major China-based stocks in mid-February 2021 after some eye-watering gains, partly caused by the Archegos hedge fund; as a guide, the KraneShares CSI China Internet ETF, which holds many of the main Chinese technology stocks fell from US$103 in mid-February to a recent low of $37 (pre distribution);

- The ongoing moves in China towards "common prosperity" which have dulled US investor sentiment towards that country's major companies, together with toughened accounting and disclosure requirements to maintain US listings of China based enterprises;

- In Australia, the "strollout" of vaccines, subsequent outbreaks of COVID, lockdowns, an astonishing take-up rate of vaccines then the Omicron variant which has played havoc with the economy and Governmental finances; and

- Late year pivots in monetary policy by the Federal Reserve Board belatedly recognising that US inflation does not now, in its opinion, appear to be "transitory".

With extremely cheap debt, equity markets were not surprisingly the beneficiaries of significant quantums of takeover activity, ranging from the merger of Square (now Block) – with equity priced at its peak US$125billion on the day (2nd August 2021) and Afterpay (~US$29billion) – combined making ~US$250million bottom line (>600x profit) - down to the early November acquisition of Prime Media by SevenWestMedia at an effective EV/EBITDA multiple of 3.5x.

What was quite different about 2021 against 2020 was the eclectic performance of stocks. The COVID beneficiaries of 2020 in smaller on-line retail burned out (eg Kogan from $19.40 peaking at >$21in mid-February down to recent prices around $8) was reflected in "second line" US technology companies where a genuine bear-market emerged from what in many cases was a synchronised mid-February (ish) peak with their Chinese counterparts. Our favourite short sale in 2021 took advantage of this.

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[1] Readers are referred to footnotes 2 and 20 - 25 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 0.9% 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 page 18.

[2] Month by month tabulation of investment return and exposures is given on page 17, along with exposure metrics.

The S&P500 capital (price) return of 26.9% in 2021 was the eighth calendar year return of over 13% in the past ten year; **only 2018 has been a down year in the past decade**. Around 9% of the 2021 return (so one third) came from the eight mega-cap technology stocks below; having returned an average 45% in 2021 (and over 16% in the last quarter alone) they now trade on a weighted trailing P/E ratio of 41.5x (excluding TSLA), worth nearly 4.5 P/E points to the S&P500 trailing P/E of over 27x.

	weight	P/E†	Quarter	FYTD	CY21		weight	P/E†	Quarter	FYTD	CY21
FB	2.01%	24.0	-0.9%	-3.3%	23.1%	NFLX	0.67%	54.3	-1.3%	14.1%	11.4%
AAPL	6.86%	31.7	25.5%	29.7%	33.8%	AMZN	3.64%	65.2	1.5%	-3.1%	2.4%
MSFT	6.30%	37.4	19.3%	24.1%	51.3%	NVDA	1.83%	90.7	42.0%	46.9%	125.5%
GOOG	4.19%	27.9	8.6%	15.5%	65.2%	TSLA	2.15%	342	36.3%	55.5%	49.8%
Ave			**16.4%**	**22.4%**	**45.3%**						

† trailing LTM P/E

For the S&P500 to have a down year in 2022, investors need to conceive a scenario where these securities retrace. Maybe price alone will be enough in a year where money may tighten in an unknown volatile fashion, or inflation expectations become embedded. There are obvious other difficulties in supply chains – price and volume - for four of them. The cost of hedging securities via S&P500 has been prohibitive, since these mega-caps have offered staggering returns.

Against the backdrop of these technology stocks, we find their China counterparts far cheaper after a desperate year for many of them; our exposure is currently via a "basket" – KraneShares CSI China Internet ETF outlined in the AGM presentation. Moreover, the pricing of these US tech stocks versus some of their commodity (notable gold and oil) counterparts is off the scale. We are wary of oil stocks given the volatility of the underlying product but are probing a number of majors. We have gradually increased our gold exposures via mining ETFs.

We expect 2022 to be especially eclectic with likely wild swings between "buy the dip" in growth names – mega cap AND fallen angels – continuing corporate activity, and a more concerted swing back to "value". S&P500 earnings expectations seem simplistic at ~10% growth in EPS to 223 – almost a "she'll be right mate" scenario. Unlikely.

Our Australian exposure is focused on individual special situations (such as YBR, profiled extensively later in this report) and two global companies – Ansell and Lend Lease – with increased assessment of selected commodity producers. It is very difficult to get excited about larger scale Australian companies given the multiples demanded and our non-consensus view that a debt laden economy simply won't be able to withstand a higher global inflation picture.

In this QR#22, we think it worthwhile to look backwards and highlight two lessons from securities which assisted recent performance:

a. how investors rarely obtain the returns of the funds they invest in because they "buy high and sell low"; this phenomenon provided us with an excellent short-sale opportunity; and

b. even low growth, structurally compromised businesses have a value, however modest, and sometimes the equity market prices the company even lower, in this case to an absurd extent below zero; sooner or later, at that price, someone will notice.

The two lessons deal with our positions in ARK Innovation Fund (ARKK) (short) and Prime Media (long during the quarter). We also revisit another extreme value play, Yellow Brick Road (YBR), with a deeper assessment than we have previously made public, given the extent of transactional activity in the sector. We acknowledge the equity market's binary views of management but believe, even for the pessimists, that we are being afforded a hefty margin of safety. The lack of comprehension of YBR's structure and accounts, and investor unwillingness to spend time on a $40m equity capitalised company, where two-thirds of the shares are owned by four holders, offers an clear insight into why the shares are most likely mispriced.

Our favourite short-sale of 2021: lessons of Cathie's ARKK

In the June quarterly (QR #20) we enunciated the short-sale case for the ASX listed BNPL company, Sezzle Inc. (ASX: SZL). At the time the shares were $9.00; they closed at $3.02 on 31 December, down over 66% in six months. Sezzle was one of the worst of a bad bunch of companies with poor business models and no moats of substance, which has seen share prices in the sector fall away severely. Even Afterpay (ASX: APT) trades at $83 (down from $118 a year ago) even after the Square/Block (SQ) takeover offer.

However, our favourite short play of 2021, which added value in the past quarter (falling over 14%) was in the US ETF, ARK Innovation Fund (ARKK). ARKK is managed by ARK Investment Management (ARKIM) founded in 2014 by Cathie Wood, its (now) 66year old devout Christian portfolio manager. ARKIM focuses on investing in what it believes are the beneficiaries of disruption and innovation with a focus on AI, DNA sequencing, robotics, energy storage and blockchain technology[3]. ARKIM's viewpoints are interesting but in my opinion, potentially have a habit of falling foul of Bill Gates' famous comment that "we always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten". Moreover, this opinion is buttressed by ARKIM's publication of various financial models[4] to provide a backdrop for their extravagant Tesla valuations, which lack any kind of accounting credibility[5]

ARKIM has been a stunning success story over time but ARKK encapsulated (es?) many of the excesses of this success and issues observed in the type of market environment of 2021, notably:

- Monetary immolation when an idea or concept simply isn't enough and price paid is ludicrous against either the market opportunity or the time period to profitable monetisation;
- The impact of fund marketing outstripping full financial (as well as business) analysis;
- The impact of buying a smallish number of securities with waves and waves of inflow;
- Unrealistic retail investor expectations (buying past performance); and
- The issues when investors fall out of love with you in an open-ended structure such as an exchange traded fund.

The favourable aspect of analysing ARKK was that it wasn't a case of history "rhyming". History was repeating.

[3] ark-funds.com/about
[4] https://github.com/ARKInvest/ARK-Invest-Tesla-Valuation-Model
[5] The author wrote the original chapter (in 1995) now contained within Kaplan Professional's FIN332 Industrial Equity Analysis on the construction of a basic financial model of a company

Over time we've seen numerous growth-style mutual fund empires come apart after a period of stellar performance, overwhelmed by inflow, and eschewing financial analysis of the underlying investments. The 1990's poster-child gone to hell was Janus Funds; in the 1960's Tsai Management.

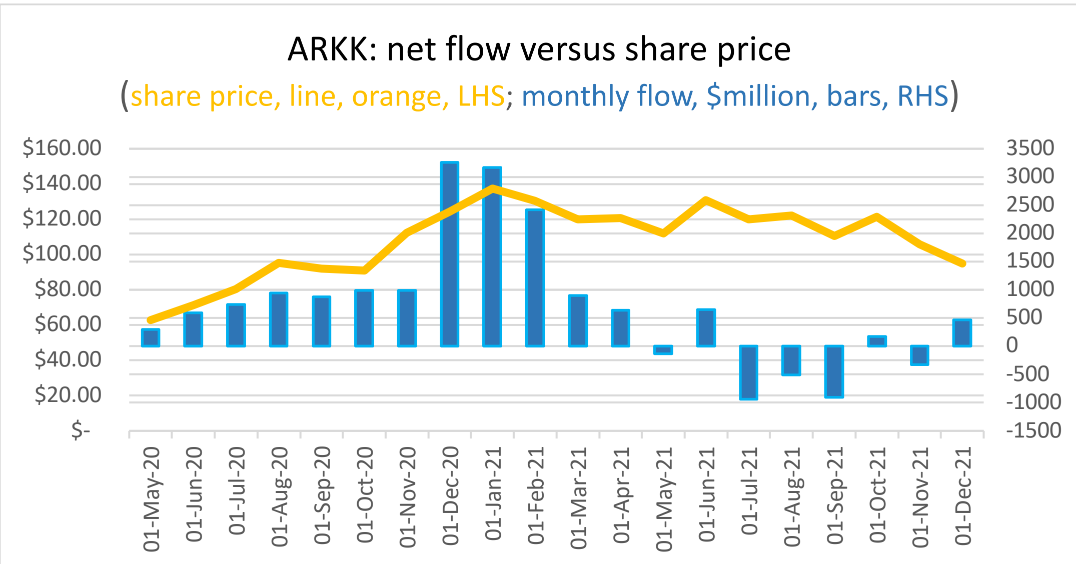
ARKK makes what happened at Janus look pedestrian. In April 1999, Janus closed its "Twenty Fund" (focused on only 20 investments) to new investors, with the size of the fund growing from just over US$6.5billion to over US$25billion in less than eighteen months. On 30 April 2020, five weeks after the bottom of the "COVID-crash" market, ARKK held net assets of US$2.9billion. Not quite synchronised with that date, but in the subsequent year to 31 March 2021, ARKK's NAV rose by 175%. Hence, had ARKK been a closed end structure and paid no distributions, the size of the fund in March 2021 would have been around US$8billion.

It was actually just over $22billion and had peaked out in mid-February 2021 at ~US$28billion. So in less than ten months, the size of ARKK, as a result of performance and inflows had **multiplied over nine-fold**.

The cynical and experienced know what happens in these situations: whatever the stated performance of the fund itself, investors actual returns are dominated by their poor timing of buying high and selling low, driven by FOMO, then dispair.

As the chart[6] below shows, the largest monthly inflows - $3.25billion and $3.17billion – are in December 2020 and January 2021, just before the peak, with $2.4billion in the peak month of February 2021.

So whilst ARKK's share price (NAV) is up from $55.33 at end April 2020 to the current $95 (+72%) in19months, investor return over this period is actually **negative**.



[7]

[6] Source: etfdb.com

How can this be? Investors' average entry price and inflows are focused around the peaks; the average net inflow day to ARKK since April 2020 transacts at an average price of $114.75. Investors have sold shares on net outflow days at an average price of $117. But they have bought 2.2x as many units as they have redeemed, and the end-2021 price of ARKK is $94.59.

ARKK's biggest investment over this period has been Tesla, averaging around 10% of the fund. ARKK has been forced to sell Tesla shares, despite having a price target of US$3,000/share, mainly because TSLA has appreciated by around 40% since the fund peak in mid-February 2021; the residual 90% of the portfolio is cumulatively down around 44% since 18 February 2021 (see some examples on attaching table). Whatever our view of TSLA, it has been a shining beacon in a sea of detritus for ARKK.

The following table simplistically assesses securities owned by ARKK in Q2 2021 as at 30 April 2021 and other hot stocks at the time, via the change in share prices since the peak of both ARKK, and second line technology stocks, especially those in China, in the week of 16 February 2021:

	18-Feb-21	now	Δ %age	ARKK wt April 21	Fwd P/E	P/sales	US$mn Equity Cap
BIDU	298.01	149.50	-49.8%	3.12	16.1	2.8	52,100
CHWY	110.29	58.88	-46.6%	0	175	2.7	21,620
CRSP	146.66	75.04	-48.8%	2.81	15	6.4	5,630
DOCU	260.99	152.34	-41.6%	2.27	60.6	14.3	28,590
LMND	145.18	41.75	-71.2%	0	n/a	24	2,660
PINS	85.99	36.30	-57.8%	0	34.6	10.3	24,300
PLTR	25.17	18.21	-27.7%	1.49	92.6	24.7	37,970
PTON	138.45	35.74	-74.2%	0	n/a	2.9	12,720
ROKU	452.99	228.20	-49.6%	5	122	12.4	30,800
SFIX	76.79	18.89	-75.4%	0	n/a	0.9	2,080
SHOP	1,384.57	1,376.00	-0.6%	3.57	278	44	183,570
SPOT	354.88	233.70	-34.1%	3.32	526	0.3	44,680
SQ	270.85	161.53	-40.4%	4.85	85	5.9	83,640
TDOC	283.10	91.81	-67.6%	6.26	n/a	7.5	15,050
TSLA	787.38	1,062.90	35.0%	10.54	122	24.7	1,020,000
WKHS	31.22	4.38	-86.0%	0	n/a	372	778
Z	181.25	63.83	-64.8%	3.52	47	2.9	5,270
ZM	417.91	182.50	-56.3%	3.4	40.5	14.4	55,200
Average			-47.5%	50.15			
Av ex-TSLA			-52.5%	39.61			

We have slightly curbed our short position in ARKK at present, but in our view, still represents the easiest "basket" trade against the optimistic view of short term change, and continuing hefty market pricing in the "growth" arena, illustrated via the prevailing metrics in the table above.

Moreover, since ARKK is an open-ended structure, the possibilities of suffering significant outflows and encountering the difficulties of selling its "better" stocks, are now ever-present. If it can grow from $3billion to US$27billion in ten months, maybe it can do the reverse – albeit over a longer period.

Rumours of Prime's demise were ridiculously exaggerated

In QR#15 (March 2020) we noted that Prime Media (ASX: PRT) shares were trading at 10c, valuing the equity of the company at $36.6million. That pricing covered – at the time – working capital and cash of over $27million and two properties (Watson, ACT and Jones Bay Wharf in Sydney) carried in the balance sheet at less than half their market value of $12million. So the business was ostensibly valued at less than zero. We noted it should produce pre-interest, pre-tax cash flow of $20million per annum for the duration of the existing programming agreement with SevenWest Media (SWM) running until July 2023. The structure also had $75million of tax paid franking credits which were effectively trapped due to the modest earnings levels.

Of course, the programming agreement – last extended in July 2018 in exchange for a $15million up-front payment - acted as a potentially deadly poison pill with change of control clause provisions impeding anyone of whom SWM did not approve from acquiring PRT. After the fiasco of late 2019, that meant anyone other than themselves.

Hence, SWM could theoretically have forced PRT to pay an egregious upfront payment in July 2023 which would have sapped their cash pile, and insisted on an even greater proportional share of Prime's revenues. This arrangement – a more closely guarded secret on earnings calls than the numeric codes accessing the Crown Jewels – was reasonably easily calculable from public filings at around 52%. We ran various "death-style" scenarios of $20m upfront payment for a renewal, 7.5% per annum declines in nominal revenues, increasing fixed costs and a 57% revenue share with SWM - and still came up with a 13c per share valuation of the business and 16c for the company.

In FY2020 and FY2021 combined, PRT earned $65.3million of pre-tax, pre- interest cash flow, of which $11.1million came from Government incentives of Jobkeeper and a regional news grant, and expanded the cash and net working capital balance to just under $66million (including about $4million of deferred income). So our $20mn per annum was conservative and not too far off the mark.

In our opinion, SWM's efforts at acquiring PRT in late 2019 were amateurish, attempting to foist debt laden SWM shares[8] onto PRT shareholders with no cash consideration and attempting to acquire the shares of a major shareholder (Bruce Gordon) at around half the price at which SWM themselves had sold to him. In our opinion, this fiasco was one of the worst takeover offers we had seen in Australia in forty years.

However, with three smart parties having a vested interest and money locked up, something had to give; Australian media assets may not be as alluring as the mid-1980's but they still have a sparkle to many. On 1st November, our patience was rewarded with a structured corporate transaction – driven jointly by SWM and PRT - that was every bit as good as the late 2019 efforts were bad. PRT agreed to sell its business (and property) to SWM for the equivalent of 36c/share of which 26c would be paid as a fully franked dividend and 10c as a capital return.

[8] SWM shares subsequently declined 85% from ~ 40c to 6c before rebounding to a level of 70c - over 50% above prices prevailing in October 2019

This immensely tax effective scheme, worth up to 11c/share in franking credits to an eligible non tax payer, plus capital losses (maximum 12.5c) has been rewarded with PRT shares trading above the 36c notional price virtually ever since to reflect new investors desirous of the tax effectiveness.

What's the lesson? The transaction price of PRT is extremely low at roughly 3.5x EV/EBITDA[9] being less than half similar US transactions, perhaps reflecting the SWM stranglehold. However, when you are being paid to own the business, as was the case at any PRT share price below around 12c, then it doesn't really matter. PRT shares rose 67% over the quarter to our cash sale exit above the transaction price, plus we received a 2c/share fully franked dividend in September. More than a four-bagger from a business everyone decried, from end March 2020. The business may have been challenged but the price was remarkable.

Portfolio structure

We have increased our disclosure to illustrate E72's top twenty long positions in alphabetical order as at 31 December 2021:

(The) Agency Group	Liberty Broadband (tracker stock)
Ansell	Macerich
Bayer AG	Namoi Cotton Limited
Compagnie de L'Odet	Praemium
Deterra Royalties	Regeneron
Discovery Inc	Spotify
E-L Financial Corp	Treasure ASA
Exor NV	VanEck Gold Miners/Junior Gold Miners ETF
HAL Trust	Virtu Financial
KraneShares CSI China Internet ETF	Yellow Brick Road Limited

Of these securities, only Regeneron was not present in the portfolio at the end of September.

Cohort transactions emphasise extreme value in Yellow Brick Road

We have discussed Yellow Brick Road (ASX: YBR), the Australian mortgage aggregator and broker/franchisor twice previously: in QR#14 (December 2019) and at the 2020 AGM held in January 2021. In the past three months, however, the main listed comparative company, Finsure, announced its proposed sale by the parent owners. Additionally, YBR itself has done its first company presentation since October 2017 and other transactions in the industry this year bear comparison.

As a consequence, there is far more publicly available information enabling a more granular assessment of YBR and explain why we have held a position in the company since mid 2018.

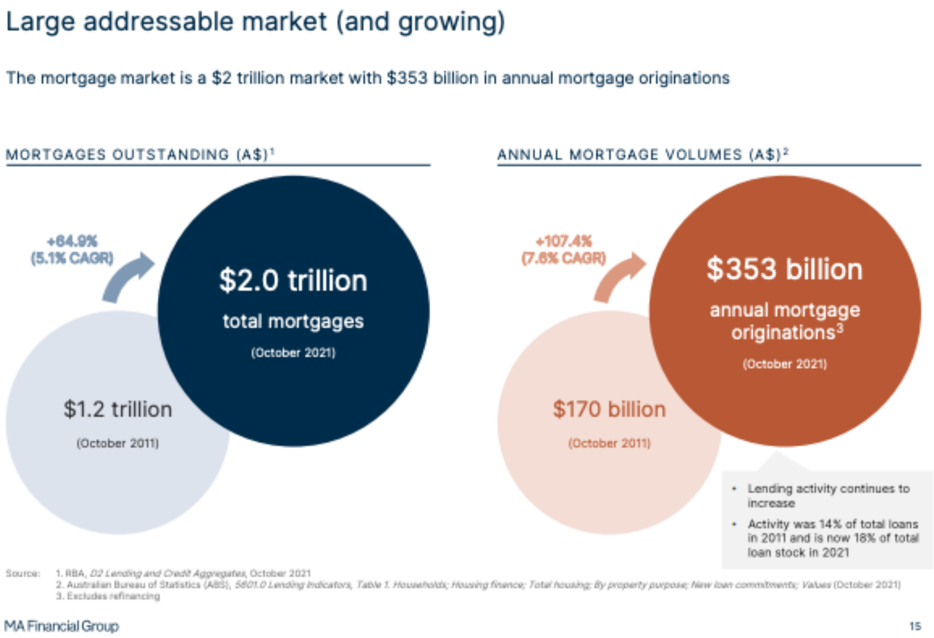
[9] Transaction price of $132million less $34million cash less $12m of property versus EBITDA of $25million (Page 40 Independent Experts Report by Lonergan Edwards dated 22 November 2021)

Positive industry changes

In January 1990, Australian nominal GDP was around A$389billion[10]; housing credit – owner occupied and investor – was $75.4billion[11] or the equivalent of 19.3% of GDP – nine months ahead of the "recession we had to have".[12]

Not quite 32 years on, nominal GDP is around $2.12**trillion** ($2,122million) and housing credit surpassed $2trillion in November 2021. So nominal GDP has grown at around 5.45% compound per annum over this period; housing credit growth over the same period is almost precisely double: 10.85%per annum compound growth.

So housing credit is just over 94% of GDP, marginally down from peaks in Q2 2018, and has not been below 90% since early 2015 – nearly seven years ago. In turn, with average loan duration before property sale or refinancing gradually coming down to below five years, this increased stock of loans is translating into a higher flow of credit, with the quantum of mortgage originations being written per annum doubling since October 2011[13]: Fees for everyone.....



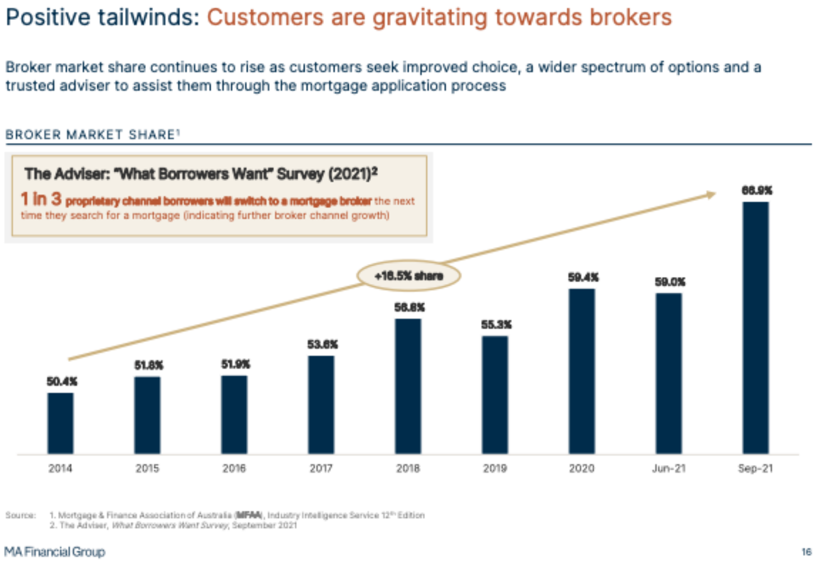
There are two key changes in the Australian mortgage industry over the past six to seven years:

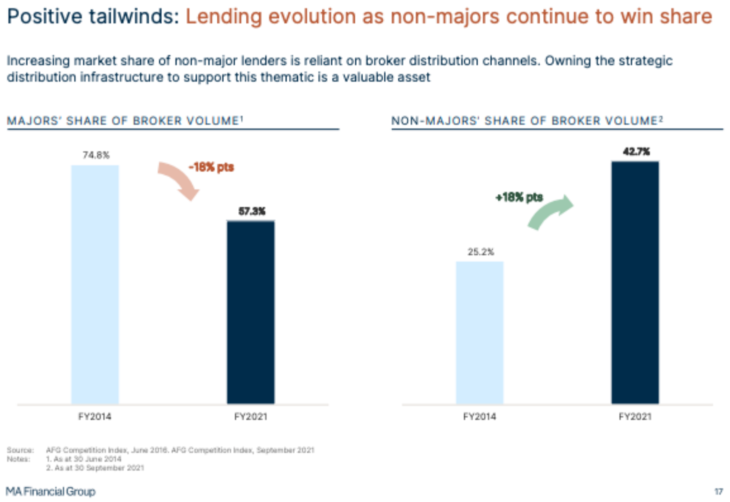
- A long standing one of brokers taking an increased market share of mortgage originations, now as high as two-thirds, up from a half in 2014; and

[10] Australian Bureau of Statistics
[11] Reserve Bank of Australia
[12] Paul Keating, Federal Treasurer 25 November 1990 to Press Gallery. Just to prove nothing changes, Australia beat England by 10 wickets in the 1st Ashes Test in Brisbane that day.
[13] Source: MA Financial presentation on acquisition of Finsure 15 December 2021 (ASX Release)

- The sources of finance to the mortgage market are diversifying rapidly away from the major banks with behemoth global players such as Blackstone (LaTrobe) and KKR (Pepper) now operating in the securitisation/warehouse market in Australia. Like any global entrant, they need one thing: distribution.

These features are illustrated on two charts below, again sourced from the MA Financial acquisition of Finsure presentation:





Given these changes, the role of a mortgage aggregator has become far more important. Mortgage aggregators act as intermediaries between mortgage brokers and lenders, by providing brokers with access to lenders on their aggregator's panel. "Brown the Broker" is not going to to be able to write business into a securitised warehouse structure operating independently and needs access to a wide variety of product to properly service his client base. Aggregators can operate either as a straight service arrangement or have the underlying broker operate as part of a franchise system eg. Mortgage Choice where the services provided to the broker are greater, and the margins for the aggregator are correspondingly larger. We will return to this later.

So how do brokers get paid, and how is this payment stream accounted for?

Brokers – via the aggregator - receive an upfront payment from the institution successfully funding the mortgage loan, on origination as well as a trail fee for as long as the loan remains on the funding institutions books. This component of financial services was virtually the ONLY one which allowed future trail commissions after the Hayne Royal Commission, despite the Commissions' recommendation[14] against such a structure. Put bluntly, whilst much of the commission's work was of a high standard and vindicated the decision to institute such an enquiry (and the banks desire NOT to have one), this recommendation would have decimated the home loan market.

The aggregator collects a small fee and passes through the bulk of the commission – up front and future trail as received – to the underlying broker.

The latest MFAA Survey[15] illustrates that the "average" broker earns an upfront fee of around 65bp and a trail fee of ~15bp. From an accounting standpoint the upfront is easy: it is booked as written by the aggregator/broker. On average, broker remuneration (before shares with franchises or aggregators) is around 58% upfront and 42% from trail fees on the existing book of mortgages which are written.

This can be illustrated transparently from YBR's accounts where the business generated origination commissions of $85.1million in FY21 on mortgages written of $13.6billion (62bp) compared to $67.6million on $11.6billion in FY20 (58bp) (see comparative table below).

The bit that I like - but investors (and Kenneth Hayne QC) don't - is trail, because it's insurance accounting. Literally. The trail figures in the books of aggregators are verified by actuarial analysis and must match up with the experience of the loan book. When trail is booked to the accounts, it is booked as a "net present value" which gradually unwinds each year as the cash trail is paid to the broker by the bank with whom the loan is written. At a 6% discount rate with a six year loan using principal and interest repayments, the first year trail booked to profit equates to around 18% of the booked value of trail, falling to around 15.4% in year 6.

So the trail commissions you see in the accounts of YBR (and Finsure) are effectively a change in NPV calculation; if the assumptions don't change and new business is written quicker than it runs off, the trail revenue will increase. In YBR's case in FY21, it fell sharply as a result of the weighted average loan life declining from 4.8years to 4.2years; the table below shows the impact of this with gross trail falling to the equivalent of 67bp of the loan book (cf Finsure at 89bp)

The net present value depends on the expected length of loan and a discount rate. The longer the expected loan life and lower the discount rate, the higher the trail value. There is respectable consistency between the two closest cohorts, Finsure and YBR from the stated accounts as follows:

[14] Recommendation 1.3 "Mortgage Broker Remuneration" effectively replaced by a "Best Interests" duty (ASIC RG 273)
[15] Mortgage and Finance Association of Australia (MFAA) Industry Intelligence Service12th Edition (Oct 2020 – March 2021)

Three year comparison[16]: Finsure versus YBR

$ million	FY2019		FY 2020		FY 2021	
Periods to 30 June	**Finsure**	**YBR**	**Finsure**	**YBR**	**Finsure**	**YBR**
Upfront commission	63.438	64.020	94.490	67.577	129.76	85.141
Loan volume originated	12,613	11,300	15,600	11,600	22,000	13,600
Commission rate	*0.50%*	*0.57%*	*0.61%*	*0.58%*	*0.59%*	*0.63%*
Gross trail earned	55.075	110.133	78.183	90.346	90.902	101.128
Average loan book	35,675	49,000	42,625	49,875	51,625	50,650
Trail as % av. loans	*0.15%*	*0.22%*	*0.18%*	*0.18%*	*0.18%*	*0.20%*
Period end loan book	38,100	49,400	45,400	50,200	56,600	51,700
Balance sheet gross trail	269.36	359.24	387.20	372.37	505.71	348.09
Trail as % year end loans	*0.71%*	*0.73%*	*0.85%*	*0.74%*	*0.89%*	*0.67%*

Source: BNK Bank accounts, YBR accounts

Of course, this is the analysis of the "gross" money coming INTO the aggregator; the bulk of it ends up being paid OUT to the underlying broker or franchisee. The same analysis works (effectively) in reverse. For example, the individual brokers' future trail value will decline in the event of higher discount rates or early prepayment of loans by the underlying client. Hence, whilst the asset on the aggregator's book would fall in value, so would the corresponding liability to pay out, but not by quite as much (see table below).

All aggregators and franchisees also provide other services to their broker members – advertising promotion, insurance, as well as the administration of the commissions under their purview, and attract significant sponsorship dollars from the underlying mortgage providors. As the table below illustrates, each company pays out 95-96% of upfronts, and 88-90% of trail but derive significant other fees:

Three year pay-away comparison: Finsure versus YBR

$ million	FY2019		FY 2020		FY 2021	
Periods to 30 June	**Finsure**	**YBR**	**Finsure**	**YBR**	**Finsure**	**YBR**
Upfront commission	63.438	64.020	94.490	67.577	129.76	85.141
Paid away	60.021		90.345		125.68	
Paid away %	*94.6%*		*95.6%*	*94.5%(E)*	*96.9%*	*95.6%(E)*
Gross trail earned	55.075	110.133	78.183	90.346	90.902	101.128
Trail paid away	47.089		68.496		82.354	
Paid away %	*85.5%*		*87.6%*	*86.4%(E)*	*90.6%*	*88.3%(E)*
CASH MARGIN	8.403		13.832	16.8	12.63	14.7
Services fees & sponsorships	6.271	9.253	7.764	9.730	9.504	9.932
Gross trail NPV	269.36	359.24	387.20	372.37	505.71	348.09
Payable trail NPV	230.41	314.37	342.95	327.73	453.38	307.32
Net/gross	*85.5%*	*87.5%*	*88.6%*	*88.0%*	*89.7%*	*88.3*

(E) estimates from presentation, not statutory accounts

Source: BNK Bank accounts, YBR accounts/presentation of 20 October 2021

[16] The three year comparison is relevant given the history of both companies, but also the changed accounting standard AASB 15, w/e/f 1 July 2018, which broke down the various accounting pieces appropriately.

Who are the key aggregators?

To help facilitate all this transactional activity, there are roughly 17,000 mortgage brokers in Australia who affiliated with the 12 aggregators or franchisors making up the bulk of the Mortgage and Finance Association of Australia[17]. The "12" aggregators are not really twelve since:

- four are owned by "White Family Holdings", the parent group of Ray White (real estate franschisor) being Loan Market and Choice, Fast and Plan which were all acquired from NAB in November 2020, with effect from 1 March 2021 – details confidential;

- two franchisee groups – Smartline and Mortgage Choice – are owned by REA Group (realestate.com), the on-line real estate behemoth. Smartline was acquired in two tranches in June 2017 and 2019 for $87m with Mortgage Choice being acquired for $244m in May 2021.

This culls the list down to eight players, two of which are private, one mainly owned by a set of large scale banking institutions, and the remaining five being publicly listed companies with market capitalisations all over $700million. Except one, which has a market capitalisation of $40million. The industry has been consolidating, with a mixture of new capital and existing players, and valuations have been rising for good reason. Which means investors seem to think the "one" is strategically weak and will be put out of business.

Major mortgage aggregator & franchise owners

Ownership groups	status	Mkt Cap	Brokers	Brands
Australian Finance Group	ASX listed	722	3,050	AFG
Connective	Private: (Slea P/L, Millsave P/L, Haron)	n/a	3,700	Connective
Lendi	Private: major banks, Unisuper, private individuals, instos	n/a	1,000	Aussie Home Loans
Liberty Financial	ASX listed	1,670	550	National Mortgage Brokers
Loan Market	Private: White Family Holdings	n/a	~5,000	Loan Market, FAST, Plan, Choice
MA Financial†	ASX listed	1,512	2,064	Finsure
REA Group	ASX Listed	22,148	MC 516†† SL ~400††	Mortgage Choice Smartline
Yellow Brick Road	ASX listed	40	Vow 1321 YBR 108††	Vow YBR Home Loans

†: subject to completion ††: franchisors
Source: various company filings compiled by East 72

The "one" is, of course, Yellow Brick Road (ASX: YBR); every time I post up a tweet on YBR, I get pretty much the same response: "*what about the Bouris discount?*" In other words, prospective investors – since they are never shareholders – are frightened off by their perception of two brothers - Mark and Adrian Bouris - who comprise two thirds of the board. As we discuss below, if you think there should be a discount, it's a damn big one.

[17] 16,968 as at 31 March 2021 within the MFAA "Industry Intelligence Service" publication above

Recent aggregator transaction metrics

There have been a slew of recent mooted and completed transactions in the arena which now enable us to line up YBR against peers in a more robust fashion:

- September 2018 acquisition of Finsure by Goldfields Money (renamed BNK Bank) for $52.975million, paid with 40.75million BBC shares at $1.30 – a price at which they have never since traded. In our view – and that of the equity market since BBC shares traded consistently below $0.80/share prior to the announcement of a strategic review in September 2021 – the $1.30 seemed a chimera which aimed to bolster the perceived value of Finsure;

- The attempted acquisition of Connective by AFG for $120million in August 2019 which was scuppered by complex and long running legal action relating to tensions between Connective's shareholders[18];

- The agreed takeover by Mortgage Choice in May 2021 by REA Group for $244million; and

- The agreement in mid-December 2021 by BNK Bank to resell Finsure Holdings Pty Limited for $145million (plus its cash) to MA Financial (ASX: MAF), the old Moelis Australia, a fast growing funds management and financial services concern: a 175% uplift for the business[19].

We can line up these four transactions with some comparable metrics – stock and flow - to see how the market has developed and look to ascribe some cohort values to YBR.

$million	**Finsure Sept 2018**	**Finsure Dec 2021**	**Connective Aug 2019 (aborted)**	**Mortgage Choice May 2021**
Acquisition price	53	145	120	244
Prior 12months production	12,313	25,900	42,000	10,000
Loan book on acquisition	33,200	60,800	144,000	54,000
Broker numbers	1,435	2,064	3,600	516
NPV of loan book trail	35.2	52.3	n/a	100.1
Net cash commission	n/a	12.6	n/a	41.4
Price/loan book	0.16%	0.24%	0.083%	0.45%
Price/NPV trail	1.51x	2.77x	n/a	2.43x
Price/broker	$36,934	$70,252	$33,333	$472,286
Price/LTM settlements	0.43%	0.56%	0.29%	2.44%
Price/LTM NCC	n/a	11.5x	n/a	5.9x

Sources: Goldfields Money 2018 announcements, MA Financial December 2021 announcements, AFG company presentation August 2019, Mortgage Choice Target Statement May 2021 compiled by East 72

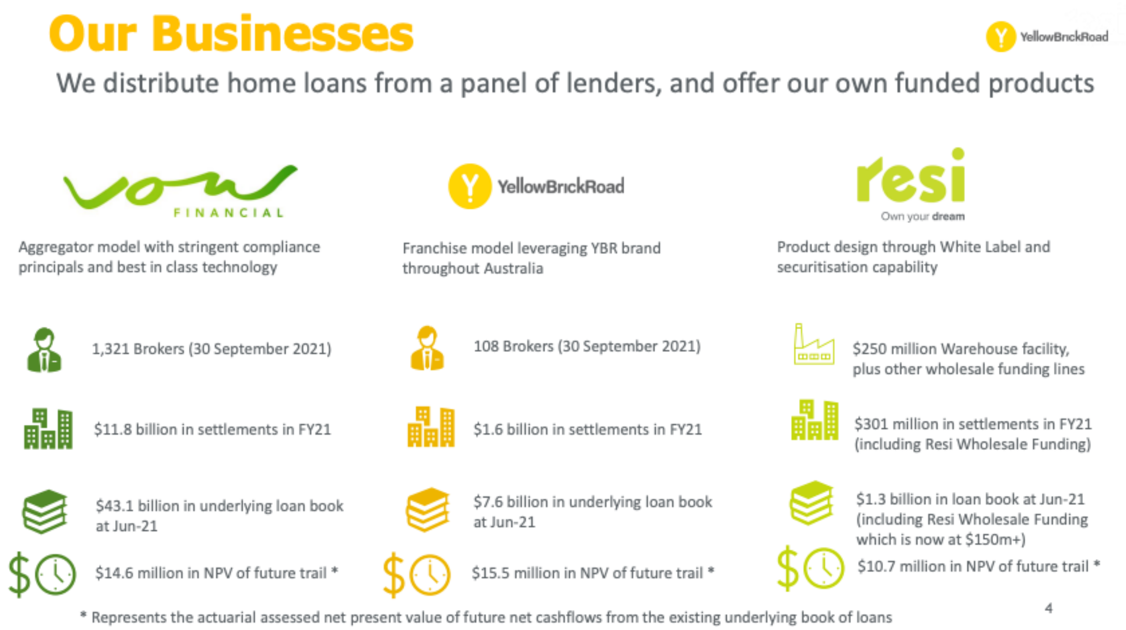
The Mortgage Choice metrics differ from the three other transactions given they are a franchise business, rather than an aggregator. This is notable in respect of the price/broker and the size of the quantum of trail NPV relative to loan book size. This has relevance for YBR.

[18] If you want a headache, put "Connective Services and Slea Pty Limited" into the search bar of the legal database "austlii.edu.au". Make a donation to them whilst you are at it.

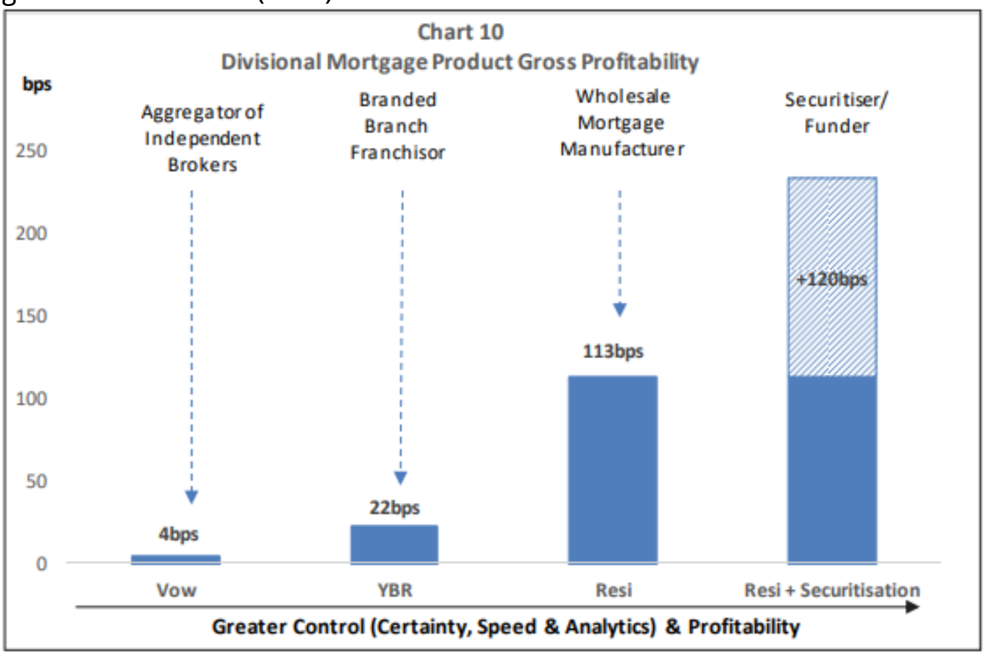
[19] It's actually a greater uplift given Finsure had debt when acquired in 2018 but now has net cash.

What might YBR be worth in a corporate transaction?

Unlike Finsure, YBR is an amalgam of four businesses within the mortgage "broking" space – including the 50% share of Resi Wholesale Funding, a securitisation warehouse -as represented by slide 4 of the corporate presentation of 26 October 2021:



This is relevant insofar as the businesses do not have equivalent values, a feature illustrated in the 20 September 2018 schematic – reproduced below -from the YBR Target's Statement defending the takeover offer (at 9c) from Mercantile Investments:



Typically within the life insurance industry, companies are assessed more from an asset value viewpoint, since the head company owns a series of actuarially assessed future income streams. This makes earnings multiples less significant – though not irrelevant. In this respect, over the past three years, YBR has done an excellent job of bringing down operating and corporate overhead. Based on 4C cash flow statements lodged with ASX, **this** definition of overhead (including advertising) – some of which can be capitalised – was running at a peak $34.5million in the year to June 2017. From the March quarter of 2019, there has been a distinct reduction from $34million to a rolling twelve month low of $22million (March quarter 2021) now running at ~$25million in the twelve months to September 2021.

On a simple cash flow basis, which does NOT take account of additions to trail, or fluctuations in the future value of trail, the business is making around $2-$2.5million per annum EBITDA, based on ASX 4C cash flow lodgments.

On an **asset based** valuation – which captures corporate overhead within the businesses - we view YBR as having a potential **corporate** value of $110million or 34c per share (324.5m shares) as follows:

$million	Comments	Metric chosen	Value
Vow	Settlement and loan book valuations – high ($65-$100m); p/trail more appropriate. Acquired May 2014 for $17.6m	P/NPV trail 2.77x	41
YBR Franchises	All metrics line up between $34m - $39m based on p/loan book, p/trail and p/LTM settlements	Average of three metrics	37
Resi “white label”	Assumed NPV of trail + small goodwill; acquired for $36million in 2014	NPV trail+ (non distributor)	14
Resi Wholesale Funding	50% share of balance sheet at 30 June 2021 + subsequent $3million note investment	50% share of balance sheet =$8.6million	12
Cash less debt	Per ASX 4C September 2021	$9.2 - $2.9million	6
TOTAL			**110**

Based on this assessment, we believe YBR is trading at a 63% discount to a reasoned corporate valuation, which has validation from four recent agreed transactions. In our view, whilst some discount to a corporate valuation is justified – partly by past performance (detailed in QR#14) – that prevailing at the present time, appears unreasonably high.

YBR fulfills many of our favourite criteria for why a security may be underpriced:

- A tight share register with four holders currently owning two thirds of the shares;
- A family controlled board and board controlled company through relationships;
- Tension between YBR and its largest shareholder, Sandon Capital (ASX: SNC) who voted against the 2021 AGM Remuneration Report and re-election of Adrian Bouris;
- Only two other professionally managed fund shareholders; and
- No sell side coverage whatever.

Outlook

We are more actively using hedges against the portfolio i.e. trading them based on increased market volatility, the likely near term shifts between “growth” and “value” – favouring the latter as long bond rates likely reflect a more progressive view of inflation prospects. Our position at year end is towards the outer-bounds of where we would like to be at present.

However, it should be noted that the portfolio carries a significant weighting to either microcap, value or low-beta “controlled holding company discount securities” (eg. E-L Corporation) so we would hope the impact of the prevailing leverage will be dampened by the underlying assets.

For further information:

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