AROWANA AVOF

Monthly Newsletter and Net Tangible Asset Release

As at 30 September 2017

In September, the fund recorded +2.4% net performance vs the S&P/ASX200 accumulation index return of 0.0%. The largest contributors to this performance were our positions in Afterpay Touch Group (APT.AU), Equifax (EFX.US), Silver Chef (SIV.AU) and Elders (ELD.AU). Detractors included our holdings in Weight Watchers (WTW.US), Chipotle (CMG.US) and Bellamy's Australia (BAL.AU). Our hedge book made a small positive contribution, as did a weakening of the AUDUSD exchange rate.

Capital Management

As part of our commitment to shareholder returns, the Fund paid a 3.5 cent per share fully franked dividend on 29 September 2017. This represents a 7.1% annualised yield on a $0.99 share price; 10.1% including franking. It is the strong desire of the Board to grow the dividend progressively into the future.

At 30 September 2017, pre-tax NTA[1] per share was $1.08, the same figure as reported at the end of the prior month, despite the payment of the 3.5c share dividend.

In response to the Fund's share price (ticker **AWQ.AU**) trading well below NTA backing, your Board initiated a 10% on-market share buy-back, in mid-September. By month end, approximately 1.2% of total shares outstanding had been bought back and the NTA discount had narrowed.

Cash, net of funds generated from hedges, was 24.5% of funds under management at month end.

Investment Mandate

A feature of our investment mandate is that up to 25% of Fund assets are investable in securities outside of Australia and New Zealand. At month end we were approaching this limit.

A key attraction for us in investing internationally is the vastly expanded opportunity set, which manifests in a few different ways:

1. Australia and New Zealand comprise substantially less than 5% of global listed equity value. It's a big world out there with a lot of opportunity on offer.
2. The Australian domestic funds that of necessity are restricted to ASX listed stocks are in aggregate heavily concentrated in the top 200 stocks which comprise the bulk of Australian listed equity value.
    - *In aggregate*, this has been a zero-sum game for the last 10 years, because in USD terms, the market value of the S&P/ASX200 Index hasn't grown!

[1] Net Tangible Asset

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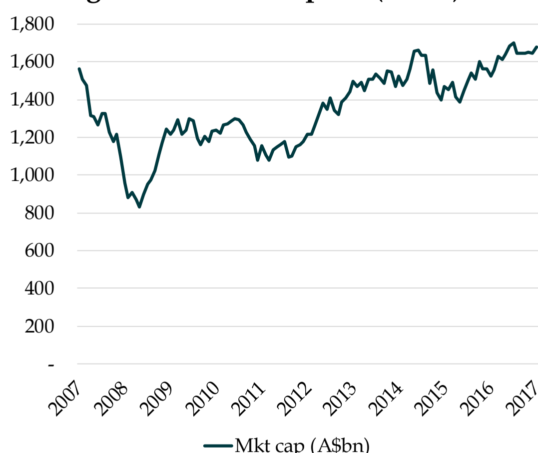
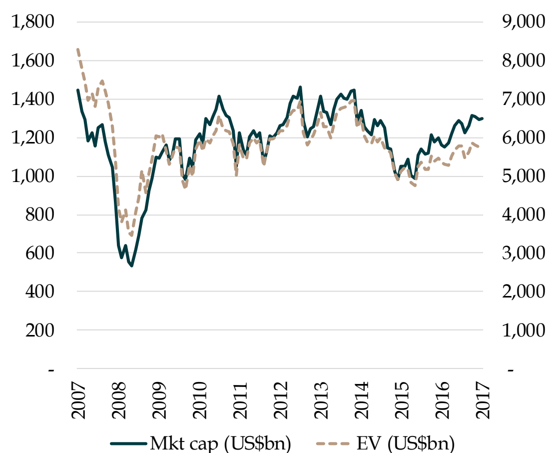
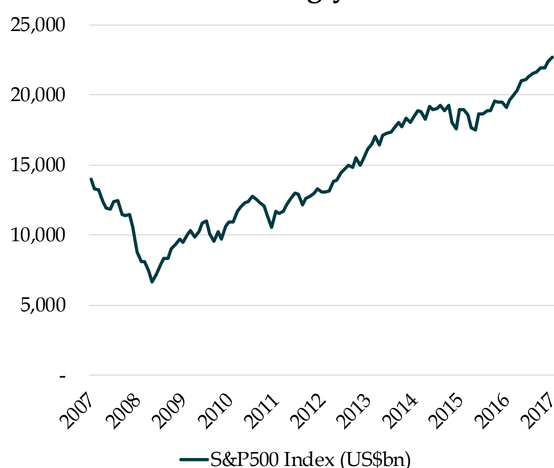
- If you dig into this further, what you find is the S&P/ASX200 Index EV or Enterprise Value (a proxy for market value of assets), has *declined* in USD terms. The bears were right – it's just that the market didn't fall, it went sideways in USD terms because in aggregate there's been some corporate deleveraging going on.

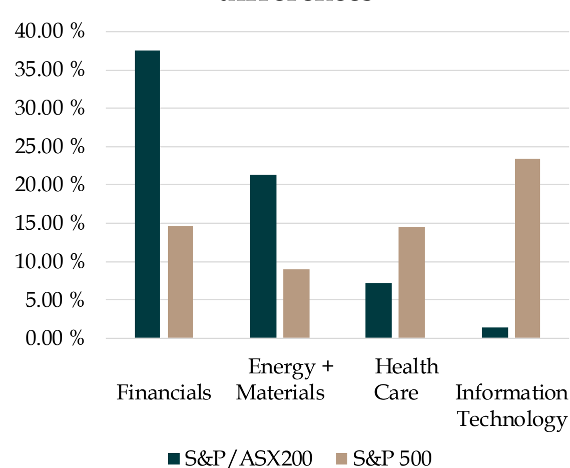




Source: AWQ analysis, Bloomberg data

3. In contrast, in USD terms, the market capitalisation of the US S&P 500 Index, as but one example outside Australia, has grown extremely strongly. A lot of this *value creation* has come from sectors that are heavily under-represented in Australia – tech has been a big part of this. A consequence of this scarcity of tech stocks in Australia is that they are arguably extremely expensive for what's on offer. The obvious question then becomes: *why play an international theme by buying an expensive ASX listed proxy; why not go direct and buy the real thing?*





Source: AWQ analysis, Bloomberg data

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Returns generated from our international portfolio represent approximately 45% of total Fund returns over the last 12 months, despite the international portfolio comprising substantially less than 25% of assets over that same period.

After in-principle consultation with major stakeholders, your Board has approved an increase in this limit to 45% from 25%. In part, the Board has taken this decision because your Portfolio Manager has spent more than half his career offshore covering global equities and your Co-Manager previously worked at an international hedge fund. Contributing to the Board's decision is the fact that realised gains on our overseas security portfolio give rise to an Australian tax liability, which when paid generates franking credits the Fund can distribute to shareholders via franked dividends.

Portfolio

We exited our position in **Costco (COST.US)** during the month for a small profit. Our entry was prompted by an opportune sell off in the stock on the news that Amazon had acquired Whole Foods. Analysis we outlined in a prior letter showed that Costco has the lowest cost to serve in store by a very wide margin. The conclusion we reached was that Amazon would not impact Costco's business for some time and that many others would become victims of Amazon before that fate could befall Costco. The existing Costco business is truly quite impressive.

However, the flaw in that logic was the analysis was somewhat static. I visit my local Costco, which is a 20-minute drive away probably once a month. It's a schlep…best case scenario a 2-hour round trip on the weekend when I'd much rather be doing something else.

So, what if I could get that stuff delivered to my door rather than go in person. Here's the thing. Costco, in our discussions with management, are at the very early stages of wanting to invest more in delivery. They stressed in our interactions the benefit of their ~500 existing US stores in future fulfilment. The problem with that logic is those stores aren't set up for stock picking in a cost-effective way. Even Amazon wouldn't be able to send their army of Kiva robots around Costco stores whilst the human shoppers are walking around filling their carts. Our interaction with a fulfilment expert made us think that what Costco *really* needs to do is spend a lot of money in developing an entire stand-alone distribution business capable of providing low cost fulfilment. In short, we think there's a material risk Costco decides at some point to spend a lot of money on delivery because they have to as a strategic imperative. So, we sold.

Equifax (**EFX.US**) was a name we added during the month and it has been a solid performer for us to date. Equifax has the dubious distinction of being a hacking victim that unwittingly surrendered personal information including social security numbers, birth dates and addresses for ~143 million US residents (I'm one of them…). In addition, credit card numbers for ~209,000 US consumers were lost. The data theft occurred over a period of months because it appears Equifax failed to update an open source application framework called *Apache Struts* that supports an online portal for dealing with customers.

If you're reading about the loss of critical information related to the F-35 warplane by an Australian defence contractor, the description of the attack vector sounds eerily similar.

To us, Equifax is a classic example of what we call an "*injured athlete*".

When I was a boy Dennis Lillee was the greatest fast bowler that had arguably ever been. But then he injured his back…and people wrote him off. The thing about truly great athletes is that they tend to have *incredible drive and determination*. It is typically better to bet *on* these

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types of folks than against them. Lillee came back…he never bowled quite as fast again, but he got a lot smarter and *moved the ball* to the chagrin of the batsmen he faced off against. His comeback was complete and sustained.

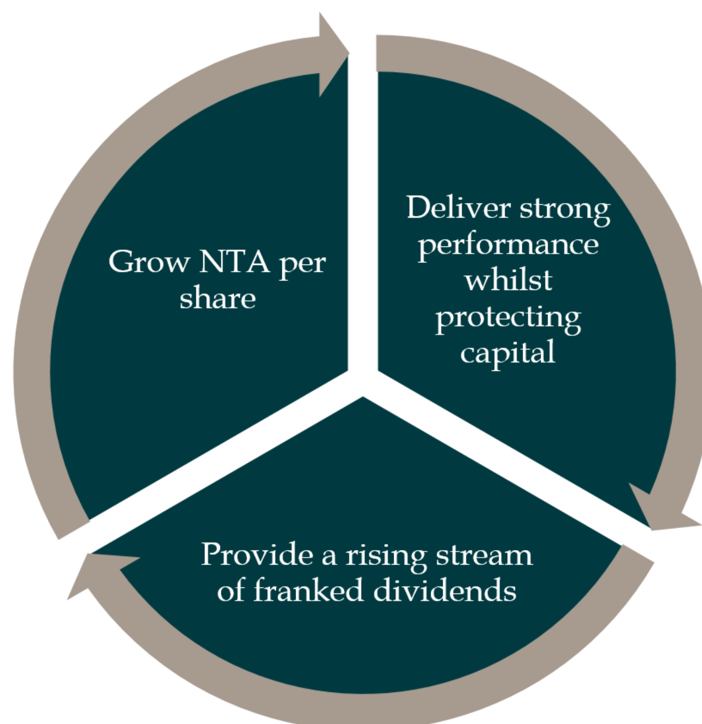
A lot of great companies during their lives suffer similar mishaps. The market tends to write them off. We actively seek out these situations because if you can identify a franchise with an *enduring competitive advantage* that's trading at a bargain basement price because the market thinks its permanently damaged, you're looking at a wonderful opportunity. In these situations, earnings and multiple expansion typically ensue and returns tend to be outsized.

We think Equifax fits this bill for a variety of reasons. First, our study of similar data breaches indicates the penalties, monetary and procedural, are typically not franchise threatening. Second, Equifax fulfils a truly vital role in the operation of the US economy. As a developed economy, consumption comprises ~60% of GDP by mix and consumer credit is critical to the continuation of that situation. Equifax is but one of three large credit bureaux that are central and essential to the credit underwriting decisions of almost *all* US credit providers. Third, it's bad, but it's also going to be difficult to prove actual damage because unfortunately there have been so many data breaches. There was Yahoo which lost ~1 billion user names and passwords (I made that list too…). Who is to say I didn't stupidly email my social security number and credit card details via a scanned form? A Health Insurance company, Anthem lost 78 million social security numbers (I have health insurance from Anthem!). We can reel off dozens of similar situations to this one.

In fact, this situation is likely to make Equifax a better company. Because at the depth of a crisis what you need to remember is that management typically don't sit like deer in the headlights…they react. Equifax will improve its systems and processes. It may ultimately even benefit via new business lines. It will almost certainly remain as a critical piece of the US and Australian credit industry architecture (Equifax acquired Veda, an Australian credit bureau, in 2016). And we bought cheap...what we think is still a wonderful business.

Arowana Australasian Value Opportunities Fund Limited
as at 30 September 2017

AAVOF Core Objectives



AAVOF Asset Allocation

Asset class	A$m	%**
Australian Equities	38.4	50%
AUD cash and equivalent	21.9	29%
USD cash and equivalent	2.3	3%
CAD cash and equivalent	2.1	3%
Australian Hybrids & Bonds	-	0%
International Equities	18.5	24%
Hedges	(6.8)	(9)%
Portfolio Value*	**76.4**	**100%**

* *Totals may not sum due to rounding*
** *Percentage of gross portfolio value*

Top 5 Equity Holdings

Ticker		%**
APT	Afterpay Touch Group Limited	18%
WTW.US	Weight Watchers Int'l Inc.	12%
SIV	Silver Chef Limited	11%
CMG.US	Chipotle Mexican Grill Inc.	6%
ELD	Elders Limited	6%
Top 5 as % of Gross Portfolio		**53%**

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Net Performance

At 30 September 2017	1 Mth	3 Mths	6 Mths	1 year	Since Inception (5-Jan-15)
AAVOF (AWQ) Investment Portfolio*	2.4%	7.4%	16.6%	8.7%	27.7%
S&P/ASX 200 Accumulation Index	0.0%	0.7%	(0.9)%	9.2%	19.1%
Out/(under)performance V Index	**2.4%**	**6.7%**	**17.5%**	**(0.5)%**	**8.6%**

** Net return after all fees, costs and company tax and before providing for estimated tax on unrealised gains.*

Net Tangible Assets (NTA) per Share

At 30 September 2017	Basic NTA per share ($)
NTA after tax and before estimated tax on unrealised gains	1.08
NTA after tax and after estimated tax on unrealised gains*	1.04

** The Company is required to estimate the tax that may arise should the entire portfolio be disposed of on the above date and show the result per share after deducting this theoretical provision. Any such tax would generate franking credits, whose value would not be lost but rather transferred to shareholders on payment of franked dividends*

About Arowana Australasian Value Opportunities Fund Limited (AAVOF)

AAVOF (ASX ticker: AWQ) offers investors an opportunity to gain exposure to a concentrated portfolio of securities built from a bottom up research process. Whilst the majority of the portfolio is built around Australian listed securities, AAVOF is able to invest in overseas listed securities and to hedge its portfolio.

The core objectives of the fund are to:

1. Generate superior returns over the medium to long term,
2. Provide shareholders a rising stream of dividends, and
3. Grow Net Tangible Assets per share

Ordinary Shares	
ASX ticker	**AWQ**
Last price	$0.99
Number on issue	69,204,727
NTA per share*	$1.08
Market capitalisation	A$68.5m
Gross portfolio value	A$76.1m
Final dividend**	$0.035/share

** Before estimated tax on unrealised gains*
*** Final dividend declared in August 2017, paid 29 September 2017, fully franked.*

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