AVENIR CAPITAL

Avenir Capital Pty Ltd
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Dear Partner:

The Avenir Value Fund (the "Fund") increased 1.1%, net of fees and expenses, in the December 2015 quarter leaving the fund up 2.8% for calendar year 2015. The ASX All Ordinaries (including dividends) increased 3.8% for the year while the S&P 500 delivered 1.4%.

It was a rather frustrating year for our research driven, value-based approach. The companies we own continued to deliver against our investment thesis, solidly increasing underlying value throughout the year. Despite this, the market price placed on those companies showed little forward progress at best, or, in some cases, substantial declines. An investment strategy based on the simple principle of investing only when one is able to do so at a material discount to a conservative assessment of underlying or intrinsic value (broadly known as value investing) has suffered an unsatisfying few years.

Momentum investing, on the other hand, based on following trends without regard to fundamental value has worked all too well. As Seth Klarman, the famed Boston based value investor, noted in his recent 2015 letter for his Baupost fund:

"Momentum investing…worked brilliantly in 2015…buy what's been performing well and watch it go even higher…By contrast, bottom up bargain hunting – which requires fastidious research, endless patience, pattern recognition skills derived from hard won experience and the application of sound judgement – didn't prove profitable for us last year."

Like many value investors, the public equity portfolio within Klarman's $27 Billion Baupost fund suffered, declining 6.7% in 2015.

Now, it is not new to suggest that value investing does not deliver strong results in all periods. Value investors are known to require deep reserves of patience and discipline and can go for long stretches of time with no positive market affirmation of investment decisions. As Klarman says: *"You don't become a value investor for the group hugs"*. It is this very fact however that makes value investing so powerful. If it worked all the time then it wouldn't work over time because everyone would do it. Because only a few have the necessary temperament **and** operate in a business structure that allows them the luxury of acting consistently through the good times and the bad, the opportunity to make money by following a value strategy will always persist.

So, why have the eclectic, value-laden and increasingly valuable companies we, and other fundamentally based investors, own not yet been recognised by the market in a manner we feel appropriate?

The rise of the ETF

One important factor is that short term money flows have not been in our favour. The always insightful Horizon Kinetics, in their 4th Quarter 2015 market commentary, highlight the fact that over the past few years, there has been a massive shift of investment capital away from individual stocks and active management into index driven baskets of securities – over $1 trillion into ETFs and indexed mutual funds while a half-trillion dollars left equity mutual funds.[1] The flow of this wall of money into ETFs has acted to push up the prices of the securities in the index in a self-fulfilling cycle. The more the index moves up, the more money flows to index funds and the more the index moves up, and so on. Index funds appear to have moved from the realm of providing passive participation in markets to, in fact, driving the prices of the securities in those markets thereby reducing the legitimacy of the indices.

An added twist is that as the ETF industry (dominated by extremely large, well-funded marketing machines) seeks to swallow up every last dollar of investment capital, it has developed momentum funds designed to purchase more of those securities which have already outperformed. As a consequence, the wall of money that has flowed into securities that reside within the main indices has flowed into ever fewer securities.

Horizon Kinetics provide the example of Netflix that increased in price by over 130% in 2015 to a market cap approaching $50 billion. We were amused by their observation that should you pay the current price for Netflix and should Netflix increase earnings per share by **24% per annum for the next 6 years** and then should you apply a **30x multiple** to the earnings in 2021, you would **lose 80% of your money**.

According to analysis by Horizon Kinetics, in 2015 the S&P 500 return was 1.4% but the best-performing 10 stocks (2% of the companies in the index) had an average return of 44%. Without those 10 stocks, the S&P 500 return was negative 2.7%. The Baupost Group provides a similar analysis noting that in 2015, the 10 largest stocks in the S&P 500 by market capitalisation gained nearly 23% while the other 490 stocks in the index fell 3.5% on average.

This was the largest gap in performance since 1999 when the internet bubble was nearing its peak, a period which saw Baupost's fundamental, value driven approach yield a loss of 16.3% in 1998.[2] If you exclude the S&P 500's top performers of last year, as of mid-December, the average stock was about to enter its own bear market, trading 18% below its 52-week highs – hence the term "stealth bear market".[3]

It is not just the index funds that drive the above trends. The vast pool of supposedly active fund managers that are actually closet indexers act as the ground troops doing much of the heavy lifting, mimicking the ETFs in their portfolio construction to avoid any chance of underperforming in the short term (of course, also avoiding any chance of outperforming in the long term).

What all this means is that there has not just been 'the market'. There is the 'other market' which is made up of all those securities that do not fall into the index and/or are not amongst the momentum stocks that have disproportionately attracted the incremental investment dollar. When money flows excessively into one sector it must come from some 'other place' and can wreak havoc on usual levels of valuation causing egregious mispricings both too high and too low. One of those 'other places' the money has come from is the unloved, overlooked and ignored special situation investments that attract the likes of us.

Of course we are not alone and there are others who follow a similar path. How have they fared in recent times?

[1] Horizon Kinetics: 4th Quarter Market Commentary; January 2016.
[2] Baupost Group 2015 Investor Letter.
[3] Baupost Group 2015 Investor Letter.

	2015 Return	Versus S&P 500
Gabelli Value 25 A (GABVX)	-9.5%	-10.9%
Fairholme (FAIRX)	-11.5%	-12.9%
Berkshire Hathaway (BRK-A, B)	-12.1%	-13.4%
Icahn Enterprises (IEP)	-15.5%	-16.8%
Pershing Square Holdings	-20.5%	-21.9%
Greenlight Capital	-20.1%	-21.5%
Royce Micro-Cap (RMT)	-13.6%	-15.0%
The Baupost Group	-6.7%	-8.1%
Pzena Investment Management	-6.3%	-7.7%

Source: Horizon Kinetics, Morningstar, Bloomberg, Manager websites and letters

The above investors are some of the most successful investors over a prolonged period of time. Mario Gabelli is a 2000 inductee into *Barron's* All-Century Team of most influential mutual fund managers and has been a member of the *Barron's* roundtable since 1980; Bruce Berkowitz of Fairholme was named mutual fund manager of the decade in 2010 by Morningstar; Berkshire Hathaway needs little introduction; Carl Icahn's multi-decade returns exceed even that of Berkshire Hathaway's and so on.

So, what do all these investors have in common? They care about the fundamentals of assets in which they invest and they believe that **valuation matters**. In the short-term however, and in environments such as this, money flows rule and can render any fundamental analysis futile while at the same time creating even more compelling longer-term opportunity.

The companies we own we acquired at what we believe to be bargain prices. As their performance and underlying value has continued to grow and the market price has not followed, they have become even cheaper. That can also be said for many of the stocks owned by the investors above. We own businesses that we expect to yield attractive returns for us, indeed, in some cases multiples of our investment, simply by the market price more accurately reflecting the value of the cash generating assets they own. The fact the cash generating power of these assets is growing over time simply gives us even more comfort.

We can't be sure when the cycle will turn and the currently high flying stocks will come undone, but when they do, people will quickly begin the search for value in the 'other market' where they will find us already positioned.

Our results will be effected in the short term by the extreme market volatility (read steep price declines) which will be amplified by the concentrated portfolio we run. But, now is a period where individual stock selection anchored by conservative fundamentally-based valuations will both reduce risk and deliver attractive absolute returns over time.

Select Portfolio Updates

Service Stream (SSM:ASX)

One of our best performing positions in 2015 was Service Stream. Service Stream provides contracted labour for the build out of telecommunication and utility infrastructure and services. The company had a very difficult period in 2013 when a complicated joint venture with Lend Lease (LLC: ASX) resulted in a withdrawn contract to provide services as part of the buildout of the National Broadband Network (NBN). This led to a period of suspended trading while Service Stream had to restructure $65m of debt. The price fell over 65% during this period which included the suspension of the dividend payment.

The company has since repaid their debt entirely through an equity raise and improved net cash flows from operations. Net profit has grown sequentially over the past four half-year periods and in fiscal 2014 and 2015 combined, the company generated $50m of free cash flow against a market capitalisation of $115m. The company's return on capital employed was 35% in fiscal 2015 while return on equity was over 17% highlighting the cash generative power of the business when well managed.

The company has hidden assets including net operating losses that ensure the company's cash flows will be protected from the ravages of the tax man through 2018. While we do not argue that the business is of the highest quality, it is exposed to growing markets not reliant on general economic activity, events in China or the commodity market and it was being given away.

We started buying Service Stream at $0.30 per share which represented 4.4x operating income and about 6x net income on our pro forma earnings estimate for fiscal 2016. The company ended the year at $0.47 per share up 56% from our starting purchase price.

Tecnoglass (TGLS:NASDAQ)

Tecnoglass is a vertically integrated manufacturer of hi-spec, architectural glass, windows and associated aluminium products for residential and commercial construction. The company sells to more than 800 customers in North, Central and South America. The company is based in Barranquilla, Colombia but senior management have been based in Florida for many years as the fastest growing and now largest market, at over 60% of revenue, is North America.

The company listed on NASDAQ via a reverse merger with a special purpose acquisition vehicle (SPAC) which is a process that can often provide interesting investment opportunities. SPACs are vehicles which raise money for a future but, as yet, unknown acquisition. Early investors in the SPAC get common stock and often warrants that provide the option to acquire more shares at a future date at a fixed price.

Because the acquisition target is generally unknown at the time of the initial capital raise, investors may not like the eventual acquisition which may result in selling pressure once an acquisition is announced/completed. Additionally, it may take a while for the SPAC to be discovered by the market and get a following of investors and analysts as most are not interested in a SPAC until it has put the acquisition war chest to work. These dynamics mean that there is often less competition to buy these hidden or off-the-beaten-track SPACs which can make them a good hunting ground for bargains.

Tecnoglass is growing rapidly with an expanding back log that is currently at record levels. The company is well placed to benefit from the ongoing strength in the US residential construction market. The company has a strong base in Florida which is expected to grow strongly in the medium term. Another favourable trend is the move to more value-added glass products in commercial and residential construction, such as curtain walls, which should benefit Tecnoglass which is proficient in these technologies.

In May 2012, the US-Colombian Trade Promotion Agreement, a free trade agreement, was put in place thereby making 99% of Colombian industrial goods tariff free. This allowed Tecnoglass to be materially more competitive on pricing and has allowed the company to win US municipal and government business which now account for over 10% of it US revenue.

The company's main manufacturing facilities are near the port in Barranquilla, Colombia which gives the company a significant cost advantage over its competitors and great export access to North America. Products can be transported from Barranquilla to Miami in two hours by air and within four days by sea. The shipping cost via sea is lower than the cost of trucking the goods for its US competitors to the same location. This advantageous cost position is evidenced by Tecnoglass earning

EBITDA margins of 18.7% compared to its two main US competitors whose margins are 12.4% and 15.8% respectively.

The company has spent approximately $120m in capital expenditure over the past four years and is yet to receive the full benefit of this spend. As an example, the company just completed a $40m investment in a new soft coat line which is commencing operations now. This line should run at 15% capacity initially to satisfy internal demand and management expect $6-8 million in waste related cost savings from this line in the first year alone. Once at full capacity, which could take 3-5 years, the new line could generate $200-250 million in additional revenue per year compared to current revenue approaching $300 million.

As the company firmly establishes its position in the North American market, it is demonstrating rapid growth and improving margins due to operational leverage. Tecnoglass has increased operating income by a factor of five in three years growing from $11m in 2012 to an estimated $53m for the year just ended December 2015. In mid-November 2015, management increased their guidance for 2016 operating income to be in the range of $65-70 million, a further 30% increase over 2015. The company will soon initiate a dividend that will provide a yield of 4.5% at the current share price. Tecnoglass is led by two brothers who founded the company and moved to Florida in 2005 to drive its North American growth. Between them they own 80% of the company providing a nice alignment of interest.

Despite a strong market position and rapidly improving operating momentum, this position is currently costing us (and you) money. The share price is currently hovering around $11 and heading south. For a company that appears to have a material and sustainable cost advantage, has increased revenue by 65% and EBIT 400% in 3 years, expects a further 30% EBIT growth in the current year and has seen return on invested capital grow from 11% in 2012 to 26% currently (despite an aggressive capital expenditure growth program) the market is attributing a value of roughly 6.5x EBIT or under 10x P/E to Tecnoglass. As they say in the US – “Go figure...”

Investing in the face of volatile and declining markets is a nerve wracking exercise, but we are seeing some of the most compelling investment opportunities we have seen for some time creating a strong platform for long-term compounding of value.

The next investor intake will be on 1 March 2016. We are glad to be your largest partner in the Avenir Value Fund and appreciate your long-term investment commitment. Thank you to those who have recommended us to others.

Should you have an interest in discussing the fund in more detail please do not hesitate to contact us.

“Don’t do something…Just stand there!”

-- Jack Bogle; Vanguard Founder

Best Regards,

Adrian Warner
Managing Director