QUARTERLY REPORT #23: PERIOD TO 31 MARCH 2022[1]

Performance and net asset value[2]

Quarterly gross portfolio return: -11.4%; rolling twelve month gross return -6.0%

The past quarter has been particularly volatile, with realised volatility – as measured by the index compiled by S&P - the highest since Q2 2020. Equity markets reacted to initially changing dynamics regarding the course of higher US interest rates, exacerbated by US (and European) inflation outcomes exceeding projections. US 10 year bond yields moved from 1.51% to 2.35% over the quarter, peaking at 2.5%. From late February, the Russian invasion of Ukraine catalysed a remarkable unanimity between the rest of Europe and the USA to invoke severe economic sanctions on the aggressor, irrespective of the blow-back of further inflationary forces as selected commodity supply shortages resulted.

Implied & Realised S&P500 volatility: recent quarters

%age	Q1 20	Q2 20	Q3 20	Q4 20	Q1 21	Q2 21	Q3 21	Q4 21	Q1 22
VIX†	31.2	34.5	25.8	25.6	23.2	18.0	18.3	19.3	25.8
Volatility††	57.3	31.9	17.0	16.4	15.6	11.2	11.1	13.9	21.0
Vol/VIX	1.84	0.92	0.66	0.64	0.67	0.62	0.61	0.72	0.81

† VIX is the implied volatility built into S&P500 option prices between 23 – 37 day expiries calculated by CBOE Global Markets Inc.
†† Volatility is the three month Realized Volatility Index as measured by S&P Global
Sources: CBOE, S&P Global, Virtu Financial

As the table above shows, implied volatility typically overprices actual volatility by around one-third; this quarter, as with other periods of dislocation, the overpricing was less dramatic at ~19%. There was a respectable pull-back during the quarter with S&P500 subject to a 13.7% drawdown between end-2021 and 24 February, before a 10% rally from the intra-day low to close the quarter down 4.9%. The NASDAQ 100 was more volatile being subject to just on a 20% drawdown, before rallying to finish down 9.1% over the quarter.

In QR#22 we noted that for the NASDAQ/S&P to fall realistically required a decline in the price of a number of the top 8 mega-tech stocks: AAPL, MSFT, GOOG, AMZN, TSLA, NVDA, FB and NFLX. All except Tesla had a down quarter, though the declines in AAPL, AMZN and GOOG were minimal. Poor Q4 earnings and future guidance by Meta and Netflix saw their stock prices decline 34% and 38% respectively over the quarter, dragging the unweighted return of the group to -11.6% in the period. For others in that group, there are still substantial Q4 2021 returns which could yet be unwound.

If the NASDAQ and its larger constituents were volatile, that had nothing on the movements seen in stocks further East. The Western view of an implied relationship between China and Russia, allied to stricter US audit compliance for foreign companies with US listings – clearly aimed at Chinese entities – led JP Morgan Chase, on 15 March, to label 28 Chinese internet companies as "uninvestible"

1 Readers are referred to footnotes 2 and 12 - 17 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 14.
2 Month by month tabulation of investment return and exposures is given on page 13, along with exposure metrics.

Bad luck: you nailed the bottom. Less than 48 hours later, announcements in China regarding the overall equity market environment and tacit suggestions that the clampdown on major technology companies domiciled in China was abating, produced extraordinary volatility in Chinese and HK listed technology stocks. We have traded our holding in KWEB (KraneShares China CSI Internet ETF, which owns Alibaba, Tencent etc) for good reason. From a 31 December 2021 close of $36.49, the ETF rose as high as $39.67 (20 January) to then plummet to $20.41 as JP Morgan opined on 15 March – a 48% drawdown from the January peak, to close the quarter down 22% at $28.50.

This quarter has also marked a significant shift of investor expectations regarding inflation, growth and interest rates. But there are vast inconsistencies of market pricing across bond and equity markets, as practitioners fear the US Federal Reserve has moved from comatose to hyperactive, and likely to bring on recession. A recession accompanied by high inflation gives "stagflation" – the in-vogue jargon, last fashionable when flared pants were all the go.

But a view that lower long term rates will eventuate have fuelled a strong rally in high growth "technology" stocks, which had been beaten down mercilessly over the preceding year. Early in March we closed out our short positions in Freshpet (profitably) and Trupanion (so-so) but most notably in ARKK, at $60 having first shorted them in February 2021 at $143. To demonstrate the low-quality nature of the rally, AARK rallied 38% from its mid-March low of $52 to highs of $72 in a fortnight. Many of these companies do not have a strong business and generate no cash flow other than diverting staffing expenses into stock issuance. As we have seen with Meta, once stock prices crater, staff turnover increases.

Volatility in markets is often exacerbated by algorithmic trading and simplistic (programmed) trading strategies which immediately react to "events", be they political or financial such as earnings "beats" and "misses". Equity liquidity has not been particularly deep in recent periods which has ensured that as algorithms pile in or out of futures, let alone individual securities, price movements have been magnified.

When markets have extremely short time horizons – perhaps out of necessity – there is a tendency to ignore more complex or nuanced situations, which require deeper analysis to ascertain the extent of under/over valuation. These too are reduced to simplistic beat/miss traffic lights.

This quarterly looks at two such situations in our portfolio, from opposite ends of the capitalisation spectrums: a global €99billion giant in the vehicle and related industry – Volkswagen AG – and an Australian A$24million microcap which is one of few businesses of its type – residential real estate brokerage/agency - listed in the world: The Agency Group.

Portfolio structure and performance

Our performance in the quarter of -11.4% was constrained by two major factors:

- Exposure to two Russian securities – Sberbank and Gazprom – which we purchased in mid-January and which we discuss below; since the shares declined on a mark-to-market basis by close to 100%, the cost to the portfolio was approximately 5.7%; and
- The appreciation of the A$ by >5% versus € and >3% versus US$ over the quarter, exacerbated by A$ denominated margin borrowings.

These two factors alone offset the gains from selected short positions and hedging (other than in late March when the market rally reduced our return by ~3%), and some judiciously timed additions to our European portfolio via VW and Porsche.

E72's top twenty long positions in alphabetical order as at 31 March 2022 are:

Advisor Shares Pure US Cannabis (MSOS)	HAL Trust
Agency Group	Liberty Broadband (tracker stock)
Ansell	Namoi Cotton Limited
Bayer AG	Porsche SE
CK Hutchison	Regeneron
Compagnie de L'Odet	Spotify
Deterra Royalties	VanEck Gold Miners/Junior Gold Miners ETF
Discovery Inc	Virtu Financial
E-L Financial Corp	Volkswagen Group AG
Exor NV	Yellow Brick Road Limited

Of these holdings, Porsche and VW were added in the quarter, whilst we purchased additional securities in MSOS and CK Hutchison to elevate them to the Top 20. We divested our holdings in Praemium and Treasure ASA.

Russia

In mid-January (and topped up in early February) we acquired Global Depository Receipts (traded in London) in Sberbank and Gazprom, Russia's largest bank and one of its major oil/gas producers. The US$ bought ~76roubles at the time; we have bought and sold Sberbank three times previously.

As a guide, when we purchased Sberbank, it had a market value of ~US$71.5billion and had announced a preliminary net profit for calendar 2021 of $16.3bn (equivalent). The brief rationale for Sberbank was that the shares were cheap (4.4x P/E) having fallen by a third in six months, returns were strong (ROE of >25%), and the Russian economy was growing as a result of strong commodity prices and volumes. Sberbank has a strong e-commerce business which would also benefit from economic growth, as well as controlling bank market shares of loans and deposits of over 40%.

Similarly, Gazprom's then market value of ~U$102billion reflected valuations well below other oil majors with expected profits of (equivalent) $32billion in 2021 and $43billion in 2022 as a result of high gas prices to European customers and strong oil prices. We expected medium term growth arising from further growth in gas volumes. Hence, the shares were on a P/E of ~3x.

I was probably amongst the first people in Australia to come across Bill Browder's amazing book "Red Notice"[3] in early 2016, so there is no naivety on my part about the potential issues of investing in Russia, even in two of its very largest companies. Indeed, at the time of purchase, share prices of both stocks had been impacted by the Russian troop "exercises" on the Ukraine border, arising from instability in the East of Ukraine, but also (at the time) heightened awareness of Russia's concern over NATO's eastwards encroachment and potential loss of buffer.

[3] Published by Corgie Adult (December 2015) concerning Browder's "adventures" in Russia with his Hermitage Capital Management culminating in the murder of his lawyer, Sergei Magnitsky.

In my judgement, as had been the case in the recent past, when share prices fell as a result of political "instability" in Russia, these periods had been an opportune time to acquire Russian stocks, carefully, in "tranches" with due regard for the overall portfolio exposure.

Over the week of 21-25 February, the rhetoric from Moscow increased, including the unhinged Putin speech of (European time) 21 February[4]; even still, until 24 February, focus still remained on the Eastern parts of Ukraine, which had been unstable for some time. However, the Russian Army's advancement across Ukraine on that Thursday, changed the picture. Despite that, Russian stocks actually rallied sharply, from lower levels on Friday 25th.

We can all debate and analyse Putin's state of mind and speeches pre-dating 25th February, and reach differing conclusions – I and many others certainly did not believe he would invade[5]. What was totally unexpected by virtually all, given recent evidence, was the strength of unity and purpose shown across Europe, predominantly by the EU, to accept a level of economic pain in order to financially eviscerate Russia.

The unified and complete financial ostracisation of Russia announced over the weekend of 26/27th February – backed by USA and elsewhere - has changed the picture completely. Around half of Russia's central bank reserves are trapped outside the country and are frozen, along with the ability for Russian companies to transact.

Russian equities are now untradeable outside of Moscow, as exchanges, clearers and prime brokers will no longer accept transactions. The US$/rouble rate reached ~110 reducing notional purchasing power by 30%, although has rallied somewhat suggesting mandatory ruble-based transactions and linkages to gold and commodities.

The sanctions applied to Russia, in one week eliminated (on paper) the equity value of an entire generation. To suggest that Putin expected such an outcome prior to this misadventure is nonsensical; by destroying the market value of Russian assets, and then freezing other non-Russian assets of its elite, Putin's non-military support base is questioning (at least privately) his decision making, isolation and inability to understand the connectedness of Russia to the world. Whilst the iron-curtain of isolation is now being brought down again, in my view, the chances of it remaining down for too long, are not as high as the politically and emotionally charged analysis of the present would suggest.

There are numerous political options in Ukraine, well outside of the scope of this piece. However, in this new environment, I believe it is reasonable to question the ability of Russia to subjugate a country of 44million people on Western Europe's doorstep. The "New CCCP" neither has the resources, technical capability nor the will of its own population to do so, despite its expertise in repression, suggesting that Putin has probably sowed the seeds of his own eventual demise. For sure, there are other kleptocrats, murderers and totalitarians waiting in the wings, but none with his backing and persona. Even post Putin, Russian business practices won't change, but what might is the country's eventual readmission to civilized society.

[4] https://www.nytimes.com/2022/02/23/world/europe/putin-speech-russia-ukraine.html

[5] Neither did many ex-pat Russians or even Bill Browder! A brilliantly written example is from Vitaliy Katsenelson of "Contrarian Edge" https://contrarianedge.com/war-in-ukraine-why-i-was-blindsided-part-1/

VW: Complex structure, enormous discount

One of the benefits of having been a stockholder for some years in Exor (EXOR.MI) is the perspective that following Exor affords on other structures. Given that Exor was effectively created in 2009 out of a controlling shareholding in (then) Fiat, which was a grab-bag of industrial, automotive and financial assets, and which via multiple spin-offs and asset sales has fuelled the Exor/Elkann phenomenon, when an even larger (controlled) organisation looks at a nascent version of a similar strategy, it's little wonder markets get excited. The excitement was short lived, however, given this company is intrinsic to Europe, and is perceived to be impacted by the second round effects of the Ukrainian conflict and its China exposure.

Volkswagen Group AG (VOW/VOW3.DE) is one of the most complex "organisms" to analyse. What we write here is not an all embracing focus on its vehicle strategy, but an attempt to briefly conceptualise how undervalued the company's shares – especially the preferred/non-voting shares – became during March 2022. We were fortunate to acquire a position in VOW3 and PAH3 (below) during the early March sell off in European markets at prices some 7 – 20% below those prevailing at quarter end.

VW is one of the ultimate sum-of-the-parts listed enterprises, on (at least!) eight levels:

1. the equity capital is split roughly 59%/41% between ordinary shares and non-voting (termed preferred) shares, but how should value be apportioned?
2. Operational versus financial profits, on numerous levels but most notably....
3. Vehicle manufacturing versus a significant €250bn+ asset based leasing and financial services business;
4. Cars versus trucks (and power engineering) within the manufacturing business;
5. Differing brand profiles within the cars business, most notably Porsche Automotive (henceforth "Porsche AG") versus SEAT/Skoda/Audi/VW (not to mention Bentley and Lamborghini), which as we know with Fiat (now Stellantis) yield vastly different profit margins and valuations;
6. Equity accounted JV's, notably China, China generally, and contributions from other investments;
7. The implied valuation (or otherwise) of electric vehicle initiatives, noting the extreme premiums investors are prepared to pay elsewhere (TSLA, RIVN); and
8. Special factors – the past negatives of emissions measurement scandals, and the imponderable of being a special, controlled company, which created its own town (Wolfsburg)

Let's start simply before we delve into some of these factors. VW earned EPS of €29.65 in CY2021 leaving the non-voting preferred shares on a P/E of just over 5x. Improved earnings were driven by a €5billion operating improvement (€1/share equivalent) in the "core" automotive division and a stellar result in financial services with net credit from impairments aiding a €3bn boost to operating profit. This financial services result will normalise in 2022, but group consensus EPS is still above €30.50 per share – a P/E of 5x on these numbers.

So which instrument to buy? VW has two sets of equity instruments: 295m ordinary shares and 206m non-voting (termed "preferred") shares; they have identical ultimate economic interest.

Since the ordinary shares are 53.3% controlled by Porsche Automobil Holding SE (henceforth "PAH", itself publicly listed), you would imagine the votes of the ordinaries should have limited value, and that there would be a minor gap between ordinary and preferred. Mr. Market thinks otherwise!

The preferred shares trade at around a 30% discount to the ordinaries, which is close to a 12year low. So we have bought these. However, we have also acquired preferred stock in PAH (PAH3 – the ordinaries are not listed) since PAH owns 157.2mn VOW ordinaries worth some €35.6billion which added to €670m of other assets gives PAH a pre tax NAV of €118/share[6]. We entered at a 32% discount at time of purchase, when NAV was ~€100.

VW has a number of public stockholdings but the most important at present is its 89.7% stake in the "securitised' Traton SE, sold off in June 2019. Traton contains the Scania and MAN trucks business together with the newly acquired US company Navistar. The spun off company trades at a 38% discount to the IPO price of €27 as a result of ongoing restructurings and a difficult truck market. Investors remain sceptical despite management projections of strong 2022 growth.

However, the anticipated spin off which is getting investors excited was "announced" in late February, being the intention to split the Porsche AG (car manufacturing company) capital into 50/50 ordinary/preferred, spin off 25% of the preferred to investors and 25% of the ordinaries to PAH.

The excitement comes about because of a hoped-for replication of the legendary spin-off by Fiat of Ferrari (RACE) in late 2015/early 2016, where Fiat sold 9% of RACE for $52 into a NYSE listing, then span 80% more to Fiat-Chrysler shareholders on a 1-10 basis. At the time, immediately prior to the spin, Fiat-Chrysler shares were trading at $14; at 31 March 2022, RACE shares were $218 making the spin off alone worth 50% more than an investor's Fiat holding on 3 January 2016.

We have no dreams of this happening and think some of the valuations (€90billion) placed on Porsche are far too high[7]. As a guide, Porsche (excluding its finance company) has averaged operating profits of €4.2billion over the past six years, and exceeded €5billion in 2021 on sales of €30.2billion. the marque sold 297,000 units last year at an average price of €102k. That's not Ferrari. It sold 11,155 cars at an average of €321k. RACE (US$40.3billion market capitalisation at end March 2022) sells at 50x after tax earnings and EV/EBITDA multiple of 24.2. RACE is now significantly more expensive than other "luxury goods" companies, since it has high visibility of volumes and pricing over the next three years from its "waiting list".

Does an 18x EV/Operating profit multiple stack up against this for Porsche? We don't think so and have used a more conservative €60billion valuation.

On a sum of the parts basis, the figures for VW after a Porsche spin, at €60billion are compelling and reflect an ongoing issue in publicly traded securities of vehicle manufacturers, especially in Europe, of (in our opinion) not placing adequate value on the financial services businesses. VW's disclosure ensures VWFS can be adequately separated.

[6] PAH has 153.1m ordinaries (owned by the controlling families) and an identical number of listed non-voting/preferred shares (PAH3) = 306.25m total shares

[7] "VW to offer only non-voting shares to public in €20bn Porsche listing" FT 25/2/2022

Our rough figuring suggests that the traditional VW ICE[8] business – which actually includes a significant electric component (see below) is attributed a negative value at end March 2022 of about €38billion (pre-tax) on a Porsche valuation of €60billion. Even placing it on a multiple of 2x operating profit suggests VW shares are worth some 50% more than the prevailing price.

VOLKSWAGEN "ROUGH-OUT"						
		price		shares		€ million
Ordinary shares	€	226.20		295.09	€	66,749
Preferred shares	€	157.00		206.205	€	32,374
Equity capitalisation					€	99,124
cash (ex VWFS)					€	28,763
ENTERPRISE VALUE					€	70,361
Porsche IPO proceeds					€	(15,563)
Porsche holding					€	(45,000)
EV ex- Porsche					€	9,798
VWFS	0.8x BV				€	(24,647)
Traton (89.7%)	448.6million		€	16.87	€	(7,568)
China & JV	book value				€	(15,531)
THESE ASSETS					€	(47,746)
IMPLIED PRICE OF ICE					€	(37,948)
2x op profit ICE					€	11,434
Implied value VW equity					€	148,505

Two other issues are highly relevant and interlinked: electric vehicles (positively) and China (potentially negatively). In 2021, VW Group sold just under 453,000 EV's (excluding hybrids) – just under half of Tesla's 936k - representing just over 5% of deliveries. Of course, EV's are an essential part of the continuing growth for VW in China, which absorbed 3.3million vehicles last year (3.04million via its Chinese JV's and the residue as imports) of which 92,700 were EV's. China sales are ~38% of total VW group sales. VW market share in China has been falling marginally, and part of the steep share price decline in early March was reasonably attributed to "China fears" over the unknown stance towards the Russian invasion of Ukraine, and investor fears over over-exposure to markets with autocratic government.

Exor has been a controlled company since its reconstruction in 2009, but that has not prevented spectacular capital management through the recognition that proper valuation of all the group's assets cannot occur if they are 100% owned; differential voting securities retain the control. Changing the structure is not an abrogation of history - the key is execution. EXOR have the record, VW don't – yet – but they now have the chance to show this to a sceptical equity market which prices word class assets and manufacturing at exceptionally low levels.

[8] Internal combustion engine

The stockmarket loathes transaction businesses: maybe it shouldn't?

Why would you invest in a stockbroking or investment banking firm? Because they make money - and lots of it - at the right time. You may find it a little "distasteful" because such intermediaries are agents who are not necessarily "adding value" but merely "lubricating the transaction". Arguably, the more they have to tell you they are adding value, then the less that may actually be the case.

There seems to be an ongoing belief that investors have no interest in "transactional" businesses; in a world where investors spout numbers on "total addressable markets", the simple facts are that whilst the overall friction costs of "transactions" may be coming down due to technology, that's not the case everywhere. Costs for stock transactions may be collapsing, but the friction costs for (example) soccer players certainly are not, despite the ubiquitous nature of Opta and other stats databases. You want Erling Haaland, you talk to Mino Raiola.

Residential property is a dominating asset class for the average person... and it transacts. In calendar 2021, A$495billion of property transacted; as a comparison, the ASX traded $1.5trillion (so three times that) in equities over the same period. But there's no comparison of what's required to transact, and hence the commission pool. For equities, it's basis points; for property, it's somewhere between 150bp to 200bp. Hence, the commission pool Australia-wide on residential property transactions was ~$7.4BILLION in 2021.

For an economy that seems so dependent on residential property, Australian equity investors have relatively little interest in many of the companies that supply the tools to keep the sector rolling. For sure, banks are an SMSF staple and the valuations attached to property portals REA Group and Domain are hefty indeed. But housebuilders have typically been on the nose, but less risky alternatives such as mortgage securitisers, mortgage brokers, and real estate brokers (agents) have not inspired investors at all. More recently, within Australia's wealth management industry, there has been a land grab for "dealer groups", companies that provide services such as compliance, training, insurance but not branding and leads to financial planners, enabling the planner themselves to remain "independent".

However, not all transactional businesses are dismissed as easily. Three listed Australian insurance brokers – Steadfast Group, AUB Group and PSC Insurance – have all been excellent business and equity market performers over the past nine years, as they have proceeded to expand by acquisition of smaller players and expand their business lines, with a healthy dose of technology. All trade on P/E ratios well above 20x trailing twelvemonth earnings.

In general, however, why are transactional businesses valued so lowly? We can advance six real reasons:

a. The underlying businesses can be cyclical, some especially so with both price and volume influences on the revenue line;
b. Transaction businesses tend to have fixed costs – personnel, rents etc – expanding the cyclicality of the bottom line;
c. These businesses tend to be driven by high selling/high achieving individuals who can be extremely mobile, if not mercenary, and be hunted away to the next best deal;
d. Who really (not legally) owns the client list – the "mercenary" or the listed company?

e. What happens to the "mercenaries" – and their shares and options – if the strategy doesn't work out?
f. Given the nature of the contractual obligations, are employees contractors or fully employed individuals – big difference in margin!

With all this in mind, East 72 holds an investment in The Agency Group (ASX:AU1) which is subject to many of these issues.

The Agency: When you know why the business is underpriced

The Agency is an Australian real estate broker with a market capitalisation of ~A$24million, where six shareholders hold 58% of the undiluted equity. So there is less than $10million of "freely tradeable" stock.

We perceive six reasons why The Agency Group (AU1) is fundamentally undervalued by the stockmarket:

a. Lack of free float
b. Past history of the company and new model
c. Dilutionary overhang of 111million convertible notes, which are also complex from an accounting viewpoint because of the need to mark to market the embedded equity option within them
d. Investor distate for and lack of analysis of publicly listed real estate brokers
e. Three sets of opaque income streams which investors will not bother to analytically break apart for such a constrained float microcap
f. Fear of housing price dislocation from peak levels

AU1's life as a public company has been torturous, presenting a formidable hurdle for prospective investors to surmount. The company used the shell/RTO route to list on ASX in December 2016 with the Perth based real estate broking and rent roll business as the foundation asset with a view to adding assets beyond that. In early 2017, AU1 Agreed to acquire Top Level, a private company formed by a group of ex-McGrath real estate executives with funding from John Kolenda, the CEO of the large mortgage aggregators, Finsure; however, as Top Level expanded privately via acquisitions of Sydney rent-rolls, completion of the acquisition by AU1 took two years, until early 2019. Equity for the acquisition of Top level was issued at $0.30 – **over six times the current price**. By that time, Top Level had incurred significant taxation and debt obligations, which when brought into AU1, severely weakened the public company, which required further equity injections. After an aborted attempt by Magnolia Capital, a Sydney-based asset manager to acquire control which foundered on its unwillingness to fully recapitalise AU1 – and led to its sale of 16% of the company through the market - the company was refinanced with a mechanism that continues to hold back the pricing of AU1 equity.

Bob Peters, a West Australian businessman (and well known racehorse owner) used a distressed debt/equity mechanism to inject $6million into the business at an effective price of 2.7c per share – 91% below the original foundation transactions. Peters took placement and converted convertible notes to give him 129.6million shares out of the current 428million (undiluted) - 30.2% - but still has 111mn convertible notes which convert at 2.7c. The notes expire on 31 March 2023 and will most likely be converted to shares.

Hence, on a fully diluted basis (ignoring management options) AU1 has 530million shares on issue, at 4.6c for a fully diluted $24million market capitalization. However, only 37% of that is freely floating when executive shares are deducted, leaving a $10million "free float".

Investors don't like listed real estate brokers – at all.

There are three significant US listed <u>residential</u> real estate brokers or franchisors:

- Re/Max (RMAX: market capitalisation US$511million + >$450m of debt) which operates a 100% franchise system encompassing 142,000 agents plus a mortgage franchise business; RMAX hands out significant equity compensation and the business trades at ~11.3x EV/EBITDA for 2021;
- Reology Holdings (RLGY: market capitalisation US$1.8billion + >$2.1billion of debt adjusted for the recent title insurance underwriting sale) which is a traditional real estate broker/franchisor operating under the Century 21, Coldwell Banker, Sotheby's and ERA (differentiated) brands with some 335,000 agents globally across 119 countries. RLGY business trades at a mere 4.5x operating EBITDA for 2021 reflecting the operating leverage, perceived state of US residential property market and high debt;
- eXp World Holdings (EXPI: market capitalisation US$3.03billion less $108m in cash) with 72,000 agents connected via the eXp World and Virbela platforms; EXPI earned ~$41million in operating profit in 2021, after $144million in stock based compensation!

In March 2018 (QR#7), we discussed two non-US listed agents, Foxtons[9] (London: FOXT) and McGrath Holdings (ASX: MEA) which have more conventional structures of sales and rent rolls, with add-on services such as mortgage broking. Since that time, Foxton's shares have more than halved (from 96p to 44p) whilst MEA, which were 45c at the time[10] have been as high as 70c and currently trade around 50c. Both shares look especially cheap but are clouded by past history, low property transaction statistics in London (Foxtons) and management instability/uncertain strategy (McGrath)

Foxtons is predominantly a "rent-roll" business ("letting agency" in posh London speak) which provides a strong annuity stream; Foxton's shift this way has been a necessity as London area property sales continue to trend well below past levels. In the 2021 year, around 88,000 London properties transacted versus the 2002 peak of 180k (including new builds); Foxtons own transaction levels in 2021 at 3,122 transactions is still 44% below the recent peak of 5,525 but well up on the COVID impacted 2020 (2,034).

Foxtons revenue per letting reflects the fact it resides in a global city, now recovering from COVID; it is the equivalent of A$5,850 per letting compared to that of MEA at less than A$2,500. On most measures, Foxton's shares are very cheap with a market capitalisation at end-March 2022 of £140million, with £21million of net cash and working capital.

Assuming <u>no value for the sales business</u>, and 8x operating profit for mortgage broking suggests the lettings business to be valued at ~£107million or 12x fully costed operating profit. In an inflationary environment, that's interesting in our opinion.

[9] Ironically Foxtons largest shareholder is Australian based funds manager, Platinum Investment Management with 11%
[10] Geoff Lucas, Managing Director of Agency Group had just returned to MEA for his second spell as CEO, before departing in August 2020

Likewise, MEA shares are also exceedingly cheap given a market capitalisation of $84.3million, but with $36million of net cash/working capital, prior to a $6.5million investment in "Honey" an insuretech business. Thankfully for MEA shareholders, this strange investment is also accompanied by a share buyback, which seems wise given the farcical pricing of the company's equity.

Valuing MEA's franchise business at 8x EV/EBITDA ($65m), the rent roll at 3.5x net revenue ($49million) the mortgage book at $5million but attributing centralised costs at 5.4x EV/EBITDA yields a pricing for the real estate sales business of MINUS $15million; in the past twelve months, that business has sold over 4200 properties, revenue of $81million and EBITDA of ~$17million.

Hence, with Agency Group, we are delving into an area where the much larger comparator companies – notably Reology, Foxtons and McGrath - are effectively priced to fail.

Agency Group income streams

One of the obvious difficulties in being a listed real estate brokerage group, is that you face public company disclosure and transparency, whereas virtually all of your competition do not. Hence, disclosure, whilst great for analysis, equals competitive disadvantage.

The difficulty for AU1 is compounded by the fact it has three streams of income before corporate costs that can be valued differently given their annuity nature (rent roll) and two differing margin businesses as follows:

- West Coast[11], where AU1 are #3 in the WA market (~5% market share) with 132 agents (plus project marketing) operating out of a single large Perth office, but which operates on an **employee** basis, with around 5% of top line revenue going in payroll tax, and an approximate 20% retention;

- East Coast, with >213 agents split across 2 offices in Melbourne, 9 in provincial NSW, 8 in Sydney, and 1 in Brisbane, **who all operate as independent contractors on commission only**

This makes the assessment of AU1 more difficult, since the East Coast revenues are shown solely as the amount payable to the Agency, not the full commission; we estimate the top line for East Coast to be close to $70million in gross commission income over the course of FY22, of which about $27million (share of commission and fees for hubs) would go to the actual AU1 revenue line. The WA businesses shows the whole commission base, which we estimate to be around $43million. Property management fee run at around $6.6million per annum and other fees (marketing fees, recoupment from agents etc.) over $3.3million

The attraction of the AU1 model is that top performing agents keep 80% of the commission revenue; in turn they build teams where the less experienced members earn around 60% of the property sale fees, meaning that the "principal" member of the team earns up to 20% of the revenue of the junior members. From the AU1 perspective, they are not maintaining a network of "shop-fronts" at expensive rents, and should not be as impacted by a downturn in volumes as a traditional agency.

[11] Agency in WA sold more properties (2,306) than any other Australian agent office in 2021.

The opportunity for AU1 is to leverage this model to much higher market shares by building agent numbers; the listed structure potentially provides the opportunity to lock in the agent with listed currency, as well as the modern set-up of the company. The good news is that this is happening; agent numbers have grown consistently from 272 at end September 2019 to 345 at end December 2021

Assuming the convertible notes as equity, we can assess AU1 as follows:

523m diluted shares @ 4.6c =	$24.4million
Debt to Macquarie	$ 5.0million
Cash net of working capital deficit	($ 4.9million)
VALUE OF BUSINESS	$24.5million
Value of rent roll business	($17.3million) valued at 3.2x net revenue
Value of mortgage book	($ 4.7million) per company valuation
EFFECTIVE VALUE OF AGENCY SALES	**$ 2.5million**

In the year to December 2021, from quarterly cash flow statements, AU1 have generated some $3.9million in cash flow before interest & tax, giving the entire business an effective EBIT multiple of 6.1x. Unlike Foxtons and MEA, we are actually paying for the agency sales business, but the implied valuation remains extremely low, and there is , in our opinion, a stronger defined strategy for the group in this arena.

We believe the following events would assist in AU1 shares being priced at a more appropriate level:

- A capital reconstruction to consolidate the AU1 shares, improving the "penny-dreadful" share price and remove the overhang of the convertible notes via exercise or part cash settlement;
- Continuation of growth in agent numbers with corresponding profit/cash flow benefits;
- Scrip based acquisition of a similar business; and
- Time. When you've had this company's public history, there is a natural disinterest by potential investors.

Outlook

We have rebuilt some of our hedges against the larger capitalised securities in the portfolio, but continue to find significant new opportunities; we are increasingly emphasising stronger businesses which have the capacity to combat a far higher inflationary environment, but still trade at attractive valuations.

For further information:

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STATISTICAL APPENDIX: QUARTER & FYTD TO 31 MARCH 2022

1. Monthly performance, exposure and NAV

	Investment return[12]	Cost imposition[13]	Net Return[14]	R12 Return	NAV/share pre tax (c)	Gross Exposure[15]	Net Exposure[16]
30 Jun 17				46.6%	35.5	276%	-6%
30 Jun 18				-18.8%	29.0	278%	81%
30 Jun 19				-25.8%	21.6	395%	0%
30 Jun 20				-68.0%	7.0	185%	122%
30 Jun 21				+20.3%	7.3	297%	67%
				R12 return			
31 Jul 21	(0.5%)	(0.7%)	(1.2%)	25.0%	7.2	356%	74%
31 Aug 21	(4.1%)	(0.7%)	(4.8%)	29.5%	6.9	341%	122%
30 Sep 21	7.0%	(0.8%)	6.2%	24.2%	7.3	339%	125%
31 Oct 21	(1.2%)	(0.8%)	(2.0%)	11.0%	7.2	429%	56%
30 Nov 21	14.2%	(0.8%)	13.4%	12.4%	8.1	400%	41%
31 Dec 21	(1.7%)	(0.6%)	(2.3%)	8.3%	7.9	259%	183%
31 Jan 22	4.2%	(0.7%)	3.6%	15.8%	8.2	251%	229%
28 Feb 22	(15.7%)	(0.7%)	(16.3%)	(8.9%)	6.9	224%	224%
31 Mar 22	0.7%	(0.8%)	0.0%	(14.0%)	6.8	309%	133%

2. Equity exposure as at 31 March 2021[17]
(as % month end pre-tax shareholders funds):

	percent	exposures
LONG	221%	26
SHORT	(2%)	1
FUTURES/INDEX DERIVATIVES	(86%)	
TOTAL	309%	27
NET	133%	

[12] 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
[13] All accrued expenses for company administration (eg. listing fees, audit, registry) divided by opening period net asset value and time weighted for equity raisings
[14] Calculated as 2 (above) minus 3 (above)
[15] 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
[16] 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
[17] Figures may not sum due to rounding

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