MONTAKA GLOBAL ACCESS FUND
QUARTERLY LETTER

MONTAKA

SEPTEMBER 2017

UNIT PRICE [1] $1.0165

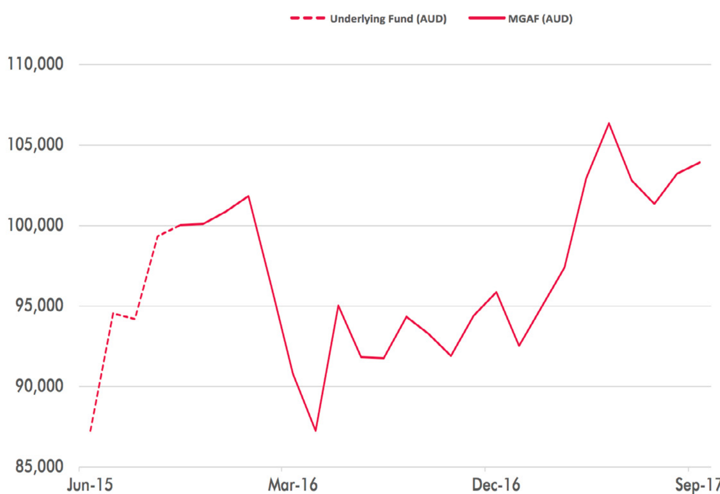
FUND COMMENTARY

In the month of September, the Montaka Global Access Fund returned 0.70 per cent, net of fees. In the September quarter, the Fund returned 1.09 per cent, net of fees. And since inception, the Fund has returned 3.91 per cent, net of fees, with an average net market exposure of 47 per cent. Over the same period since inception, the MSCI Total Return Index in Australian dollars increased by 10.86 per cent with 100 per cent net market exposure.

The September quarter included second calendar quarter earnings disclosures - which were generally kind to the Fund; combined with an unusual rally in energy stocks in the month of September - in which the Fund did not participate.

The combination of high monthly returns with very low variability has continued in global markets. Such Goldilocks conditions obviously will not last forever, though one's ability to predict the timing of a return to volatility is close to nil. And there is a very possible scenario under which strong monthly returns continue for some time yet.

FUND PERFORMANCE



PERFORMANCE (%)	1M	3M	12M	INCEPTION
Fund (AUD)[2]	**0.7**	**1.1**	**11.4**	**3.9**
Underlying Fund (AUD)[4]	0.7	1.1	11.3	19.1
Average Net Market Exposure[3]	49	42	48	47
Global Market (AUD)[5]	3.4	2.5	15.2	10.9
Average Net Market Exposure[3]	100	100	100	100

PERFORMANCE ATTRIBUTION[1]* (%)

	September 2017
Long portfolio contribution	0.36
Short portfolio contribution	(1.10)
Change in AUD/USD	1.44
Net return	0.70
Since inception[2]	3.91

EXPOSURES* (as at 30 September 2017)

	% of NAV
Long exposure	92.5
Less: short exposure	(43.2)
Net market exposure	49.3

POSITION METRICS* (as at 30 September 2017)

	Long Portfolio	Short Portfolio
Number of positions	23	32
Largest position size	6.1	2.2
Smallest position size	1.6	0.8
Average position size	4.0	1.4

Note: sizes shown as % of NAV

TOP 10 LONG POSITIONS* (as at 30 September 2017)

		% of NAV
1	Insperity	6.1
2	Facebook	5.9
3	St James's Place	5.7
4	Oracle	5.3
5	REA Group	5.2
6	Jupiter Fund	5.0
7	Alibaba	4.8
8	Union Pacific	4.8
9	51job	4.6
10	Naspers	4.5
Total top 10 long positions		51.8

FUND SIZE (NAV) ($M) (as at 30 September 2017)

Montaka Global Fund	161.4
of which: Montaka Global Access Fund	66.0

1) The fund is forward priced; you will receive the price struck subsequent to the receipt of your application/ redemption request.
2) Inception: 1 November 2015
3) Based on average of month-end net market exposures
4) Montaka Global Fund; inception 1 July 2015
5) MSCI World Net Total Return Index in Australian dollar terms
* all exposures, metrics & positions are derived from the Underlying Fund (Montaka Global Fund)

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In recent weeks, the Trump Administration released its long-awaited framework for simplifying and reducing taxation for US households and corporates. There is a lot to like by most constituents (putting aside future societal inequality which will almost certainly become worse) and the political imperative to pass some major legislation has never been higher for House Majority Leader, Paul Ryan; Senate Majority Leader, Mitch McConnell; and President Trump himself.

Should such legislation ultimately pass, this would represent a significant dose of fiscal stimulus to the US economy. And it would come at a time when the US economy is currently experiencing an organic dose of monetary stimulus from its weakened dollar.

Since the beginning of calendar 2017, the US dollar has depreciated by almost 10 per cent against a trade-weighted basket of currencies. This means that US goods and services are almost 10 per cent cheaper in foreign currency terms. And this, in turn, drives incremental demand growth for these goods and services.

A potential scenario of significant household and corporate tax cuts, at a time during which a weaker currency is stimulating demand, is near-term bullish for the US economy. And from a longer-term perspective, the health of the US consumer has not been stronger since the Global Financial Crisis. And we can see evidence of this strength in the recent and significant quarterly contributions of Personal Consumption Expenditure (PCE) to US GDP growth.

Of course, the probability that Trump's tax plan makes it through the Congress is far from 100 per cent. The obvious limiting factor would be push back from Republican deficit hawks – though said hawks have been notably quiet since Trump's tax announcement. We believe the probability that a substantial portion of tax cuts make it through the Congress is 50 per cent. There are a number of reasons why the politics of this proposal look more favourable to the Trump Administration:

- According to Axios: "Tax reform is now an existential issue for House Speaker Ryan and Senate Leader McConnell. If they botch this, as they did health care, both chambers could lose their Republican majorities." [1]
- We believe Republicans may even gain some Democratic support. After all, if these measures are popular with the electorate, then voting against them will be dangerous for many Democratic Senators facing re-election in the 2018 midterm elections.
- As explained by FiveThirtyEight, in 2018 there will be 10 Democratic Senators running in states that President Trump won: five of whom are from states that Trump won by about 20 percentage points or more. Meanwhile, there are only two Republican Senators up for re-election in states Hillary Clinton came within 5 points of winning in 2016. [2]
- And let's not forget: this tax package was designed by… wait for it… a Democrat. Former Goldman Sachs Executive, Gary Cohn, is the primary architect of this tax framework. And yes, he is a Democrat, not a Republican.

In light of the above analysis, we have increased Montaka's long exposure to high-quality US dollar-denominated earnings streams; covered some short exposure to US tax paying businesses; and increased the proportion of Montaka's cash holdings that are denominated in US dollars. We continue to own a significant amount of European-exposed and Chinese-exposed businesses; however, we have pared back some Euro cash holdings following the 7 per cent appreciation in the Euro over the last six months.

As equities have continued to perform strongly with very low variability, one could be forgiven for questioning the value of a short portfolio. Yet, as we have articulated many times before, a well-managed short portfolio can act a bit like an insurance policy. In a period in which the insurance is not required, the premium is nothing more than a cost. But in a period in which the insurance provides protection, it can be highly valuable.

And so we continue to identify short candidates that have highly-favourable risk/reward skews. By holding a portfolio of such candidates, we believe we create an insurance-like feature which minimises detractions in bull markets and delivers significant downside protection in bear markets.

One such example is a Spanish-based retailer by the name of Distribuidora Internacional de Alimentacion (BME: DIA). In the case study that follows, Montaka's Daniel Wu illustrates why we believe DIA is misperceived, facing industry headwinds and exhibits significant downside risk in its stock price.

CASE STUDY: DIA

DIA is a grocery retailer spun off from Carrefour in 2011, and has operations in Iberia, Brazil, Argentina and Paraguay. We believe DIA has been over-earning through the use of factoring arrangements to boost gross margins, and by exploiting its franchisees (particularly in Iberia) to boost earnings. We believe DIA effectively captures all the profits of the franchise arrangement, and leaves its franchisees with nothing. While this has allowed DIA to maintain industry-leading EBITDA margins, we do not think this can continue indefinitely. DIA's LatAm business has also benefited from high inflation, which has allowed management to report high like-for-like ("LFL") growth rates, even though they are largely offset by currency depreciation. Now that Brazilian CPI has fallen to low single digits, we believe this will become a headwind against the growth of DIA's LatAm business.

1 (Axios) GOP's "nightmare scenario", September 2017
2 (FiveThirtyEight) Why The 2018 Senate Elections Are Looking Bad For Both Parties, May 2017

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SUMMARY OF DIA SHORT THESIS

		Drivers	Evidence
1. Thematics/ Structural Declines	✓✓	• Deflation/low inflation in Iberia; high inflation in LatAm • Increasing competition	• Deflation/low inflation in Spain is a headwind to grocery sales • Strong LFL sales growth in LatAm due to high inflation, but largely offset by fx depreciation. Brazil CPI has fallen to low single digit % and is now a headwind to LFL growth • Competition, especially from Mercadona's investment plan
2. Divergent Expectations	✓	• Consensus margin expectations too optimistic	• Consensus sales growth expectations have moderated over the last year, but gross and operating margin expectations remain elevated, particularly in light of the reduced sales expectations • We believe DIA has used factoring and reverse factoring arrangements to expand its gross margin, and that this will ultimately prove unsustainable
3. Asymmetries	✗	• High/hidden debt burden, pension liabilities or regulatory risks	• DIA has been deleveraging and net debt/EBITDA fell to 1.3x in 2016 from 1.9x in 2015 • No regulatory risks
4. Misperceptions	✓✓	• Iberian gross sales driven by acquisitions • Double-digit LatAm LFL sales driven by high inflation • Over-earning by exploiting franchisees	• Iberian gross sales driven by acquired stores; organic growth has been negative since 2013 and barely breakeven in 2016 • LatAm LFL sales growth driven by double-digit inflation has been largely offset by fx depreciation • DIA is capturing all the positive economics of the franchise relationship, leaving franchisees with zero profits

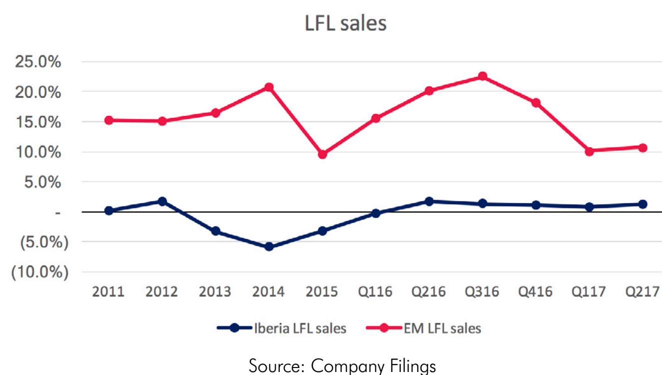
Business Overview

DIA is a grocery retailer with over 7,400 stores in Iberia and LatAm. The Iberian segment accounted for 64 per cent of net sales and 81 per cent of EBITDA in 2016; the LatAm segment accounted for 36 per cent of net sales and 19 per cent of EBITDA. DIA specialises in the "proximity discount" or neighbourhood segment, and predominantly retails food products through small-format stores of 400sqm to 1,000sqm in size that carry 2,800 to 3,500 Stock Keeping Units.

The company has two operating models: company owned, company operated ("COCO"), and company owned, franchise operated ("COFO"). As of December 31, 2016, 51 per cent of the store base were franchised. In Iberia, 59 per cent of DIA banner stores were franchised, while 68 per cent of LatAm stores were franchised.

Thematics / Structural Declines

DIA operates in a competitive and fragmented market in both Iberia and LatAm, with a stable 8 per cent to 9 per cent market share in Spain and only 2 per cent share in Brazil. The Iberian market appears to be consolidating, but has faced an extended period of low to zero inflation. DIA printed negative LFL sales for three years between 2013 and 2015, and only recovered to low single digit growth in Q2 2016. LatAm, on the other hand, has printed very strong double digit LFL sales growth due to a highly inflationary environment in both Brazil and Argentina, largely offset by local currency depreciation. LatAm LFL growth has fallen since Q3 2016 alongside the decline of Brazilian CPI.



Source: Company Filings

Separately, Mercadona, Spain's largest grocer with over 24 per cent [3] market share, is expected to further increase its share of the market after announcing an aggressive 2017-2018 investment plan. Mercadona expects to increase its capex by 70 per cent and sacrifice up to 30 per cent of full year profits to drive market share and long-term growth. Given DIA's leading margins and the likelihood that it has been over-earning, we believe it would be difficult for DIA to defend its margins without ceding market share to Mercadona.

3 Kantar Worldpanel as at Aug-2017. Mercadona gained over 200 bps of market share since announcing its investment plan

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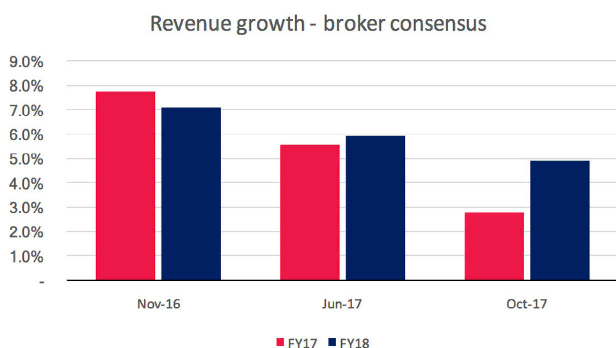
Divergent Expectations

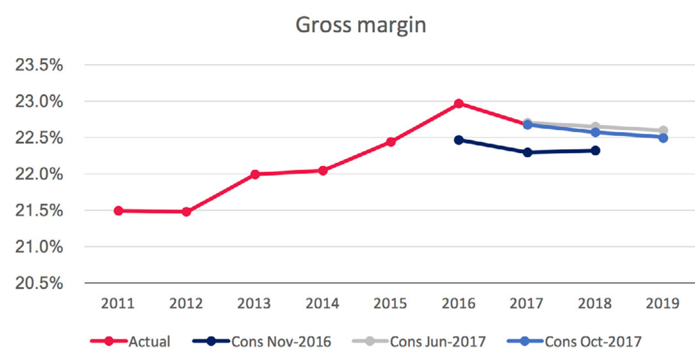
Consensus revenue growth expectations have declined substantially since late 2016.



Source: Company Filings; Bloomberg

Broker revenue estimates have rebased downwards substantially due to the greater than expected decline in Iberian selling space, and weaker than expected LFL sales in LatAm on the back of falling inflation in Brazil. This would suggest that growth in Iberia is largely driven by changes in selling space, while growth in LatAm is largely driven by excessively high inflation. Consensus expectations are now lower than management's target of 7 per cent organic sales CAGR for the 2016-2018 period.

How has DIA consistently grown gross margin in a competitive environment since 2011, and can this level be maintained?



Source: Company Filings; Bloomberg

Brokers expect gross margin to fall slightly from the peak 2016 level and then remain broadly flat, consistent with management's comments about investing in price. However, the key question is how DIA managed to grow its gross margin in a price-competitive environment from 21.5 per cent in 2011 to 23 per cent in 2016, without losing substantial market share (in Spain at least). Management attributes the gross margin expansion to the success of its purchasing alliances with Intermarche, Eroski and Casino, and efficiencies from its sourcing agreements.

We hypothesise that DIA has been using various factoring arrangements to squeeze discounts out of its suppliers, and hence increase its gross margin. Approximately 50 per cent of DIA's inventory by value comes from small suppliers, which likely gives DIA more bargaining power. DIA uses reverse factoring of payables to allow suppliers to receive cash sooner. Small suppliers are more likely to face liquidity problems, so receiving cash sooner is a benefit to them. In return, we suspect DIA receives a discount on early payment.

DIA then records "receivables from suppliers", which mainly reflect the discounts and rebates negotiated with suppliers. This means not only do suppliers get paid sooner through reverse factoring, DIA also takes an I.O.U. for the discounts and rebates, which further improves the suppliers' cash flow position, possibly in exchange for a further discount.

Finally, DIA started factoring supplier receivables in 2016, which shortens DIA's receivable days without impacting its suppliers' payable days. These arrangements could combine to accelerate both DIA and its suppliers' cash conversion cycles, and generate discounts for DIA. We are sceptical as to how much more incremental gross margin can be squeezed out of these arrangements, and gross margin appears to have peaked in 2016.

Misperceptions

Iberian gross sales growth has been driven by acquisitions.

The acquisitions of Schlecker/Clarel, El Arbol, and Eroski stores in Iberia across 2013 to 2015 helped drive gross sales growth, while organic growth across that period was negative.

Source: Company Filings; MGIM

DIA is using its franchise business to over-earn by redistributing store profits to itself at the expense of its franchisees.

DIA's Iberian segment had an industry-leading adjusted EBITDA margin of 8.8 per cent in 2016, despite being a discount grocer in a fragmented and highly competitive market. For comparison, Mercadona, the largest supermarket operator in Spain, posted an EBITDA margin of 5.5 per cent in 2016 and has rarely exceeded 6 per cent over the last decade.

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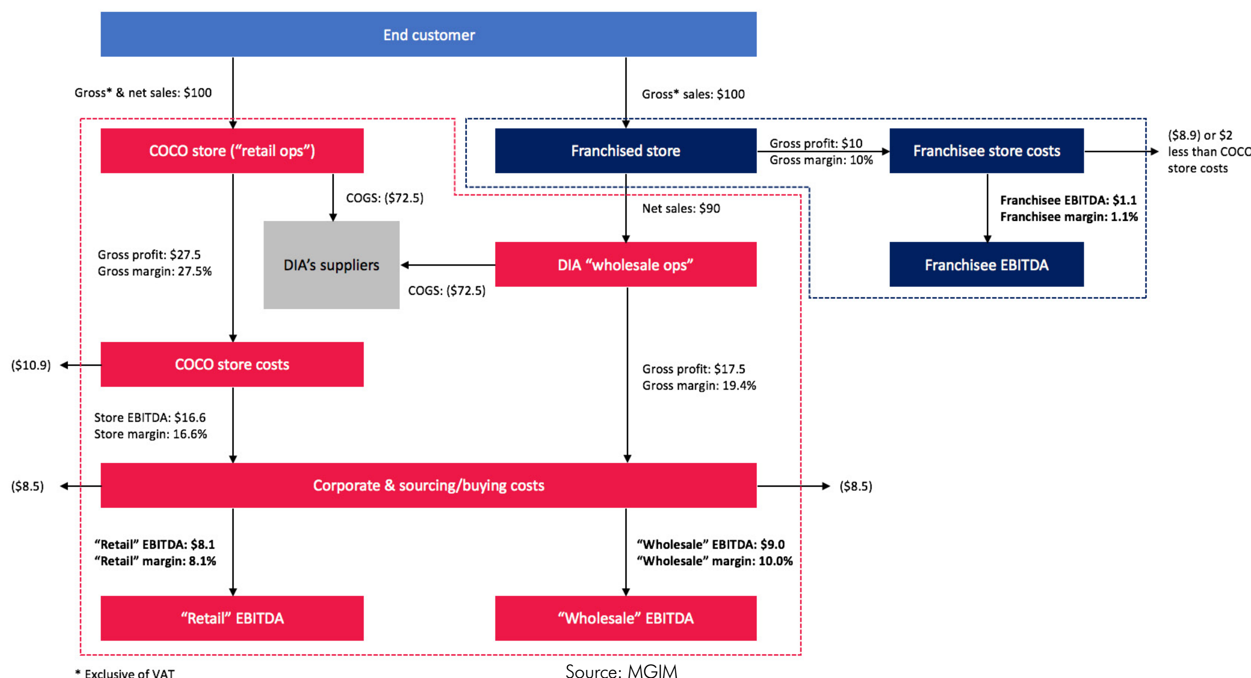
ECONOMICS OF DIA BUSINESS MODEL



Source: MGIM

As mentioned earlier, DIA has two operating models. It has a retail business comprised of its COCO stores, and a franchise business where it wholesales inventory to franchisees of COFO stores (references to "wholesale business" refers to the franchise business). DIA does not break out franchise sales vs company sales, nor does it disclose any information about the economics of the franchise business. From our conversations with industry consultants, the relationship between DIA and its franchisees is strained, as DIA captures all the profit in the relationship and leaves franchisees with essentially zero profit.

The diagram above shows our estimate of the economics of DIA's COCO stores, the wholesale business, and the franchisee stores:

- Under the retail business, a COCO store sells directly to the end customer and records €100 of gross and net sales at a gross margin of 25 per cent to 30 per cent. Assuming an industry-leading wholesale EBITDA margin of 10 per cent [4] and given the consolidated Iberian margin of 8.8 per cent, we estimate the retail EBITDA margin to be 8 per cent.
- Under the wholesale business, DIA sells inventory to COFO franchisees typically at a 10 per cent discount to retail price. Assuming €100 gross sales and 10 per cent gross margin for the franchisee, DIA records net wholesale revenue of €90 and gross profit of €17.50. However, because the store is franchised, store operating costs are borne by the franchisee, leaving only the corporate overhead and sourcing costs for DIA to cover. Despite the lower gross margin of 19 per cent, DIA generates a higher EBITDA margin under this franchise model.

Thus DIA over-earns by extracting all the value out of the franchisees. The franchised store has only a 10 per cent gross margin, while typical store operating costs are higher than 10 per cent. This forces the franchisee to cut store operating costs just to break even at the EBITDA level. DIA extracts its value from the wholesale price charged to the franchisee, and doesn't care about the profitability of the franchised store beyond that point. This explains why the company continues to increase its franchise mix.

A question remains over how sustainable this strategy of squeezing franchisees is. The industry consultants we spoke to mentioned that franchisees were very dissatisfied and were handing back stores, and believed that DIA would be forced to address the situation, e.g. by giving franchisees a better share of the economics. This would undoubtedly cause DIA's high margins to contract. However, many of these franchisees are relatively uneducated and unskilled, and operating their own DIA franchise remains superior to the alternative of unemployment or working as an employee in a similar store. It could be a while before DIA is forced to remedy the situation, but we do not believe management can keep kicking the can down the road, especially in light of weak top-line performance.

* * *

4 Morgan Stanley estimate; also in line with our consultant discussions. For comparison, Metcash' wholesale EBITDA margin is 2 per cent to 4 per cent

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In recent weeks, we have met with many investors across Australia. A topic of considerable interest is the current boom in indexation and low-fee passive investing. It is certainly worth thinking about, given the global exchange traded fund (ETF) space has grown to more than US$4 trillion, according to data provider ETFGI.

A lot of thought-provoking work on the space is currently being conducted, and we would recommend the insights of Steven Bregman as an interesting place to start. For value investors who believe that assets should only ever be acquired for less than they are worth, the primary flaw of indexation is that no concern for the price being paid for the underlying assets is given by the investor. Without concern for the price being paid for an asset, the probability that one is consistently underpaying for assets must surely be close to zero.

Yet US$4 trillion has already accrued to this style of investing, so there must be some attractive feature. Is it the low fees that are typically associated with index funds and other passive ETFs? All else being equal, lower fees are naturally desired by any investor. Yet, at least in the world of active investing, there is an interesting argument as to why low fees are not always optimal for investors (believe it or not).

The one sentence summary of this argument goes like this: lower fees means higher required funds under management, which means a smaller opportunity set and finally, a lower probability that outperformance will be generated for the end investor.

The link between fee, fund size and opportunity set is not entirely obvious, but one well worth considering. Here is the rough mathematics behind it. Since Montaka's inception, we have said we will only buy businesses with market capitalizations of at least US$700 million and daily liquidity of at least US$3 million per day. This gives us around 5,000 businesses listed on the major global stock exchanges from which to choose. And we do invest right across the size spectrum: six out of our top 11 holdings have market capitalizations of less than US$10 billion; while at the same time, we own Facebook, Apple and Alibaba, which all have market capitalizations greater than US$400 billion.

Now, we believe we will close our global strategies to new investors when funds under management reach the high single-digit US dollar billions, in today's dollars. Our decision to do this is based on two ideas: (i) by remaining (relatively) small, we can maintain our large opportunity set which we believe increases the probability we can compound returns at the highest possible rates sustainably into the future; and (ii) the Montaka team plans to continue to reinvest their earnings into this strategy over time - so, selfishly, we also want to maximize the time horizon over which we can compound returns at the highest possible rates.

Imagine, now, if we were to pursue an alternative strategy under which we cut our fees significantly to compete with passive ETFs. Let's say we were to cut our fees by a factor of 5 or 10. Then, naturally, it would take 5 to 10 times the assets to generate an equivalent revenue line to that of our current strategy. But here is the rub: our opportunity set would shrink materially. For instance, if we woke up tomorrow and found ourselves managing US$40 billion of capital, our opportunity set would be down to around 300-400 global businesses. Add another US$40 billion, and the we would have only around 150 global businesses from which to choose. With significantly fewer businesses from which to choose, the probability we can compound returns at rates as high as we can today has surely diminished significantly.

Food for thought: very low fees means very large scale; and very large scale - at least in the world of active management - means a very small opportunity set. And a smaller opportunity set must surely lower the probability of very high compounded returns.

As we enter the final quarter for calendar 2017, we once again wish to thank all our investors and supporters. As the discussion above suggests, we will not be all things to all investors. And we will not have capacity to serve everyone as a client. For investors we do serve, however, we continue to work hard with discipline and integrity to deliver the best possible outcomes across the dimensions of performance, education and all-round client experience.

Sincerely,

Andrew Macken

MONTAKA GLOBAL ACCESS FUND
QUARTERLY LETTER

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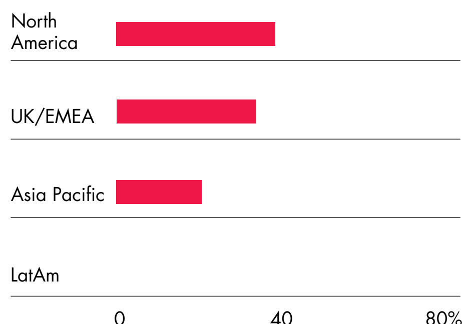
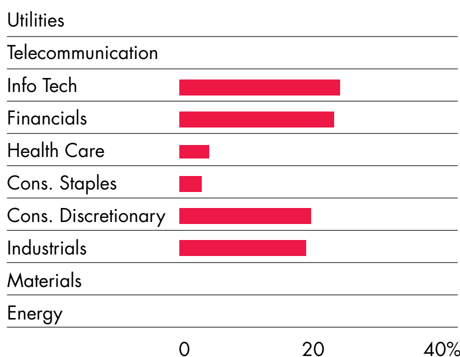
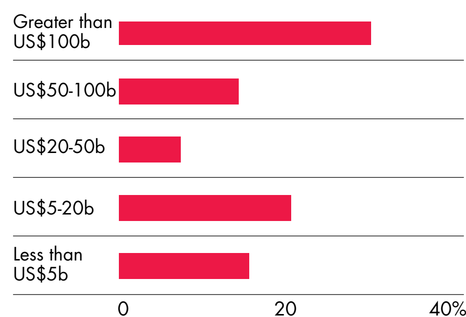
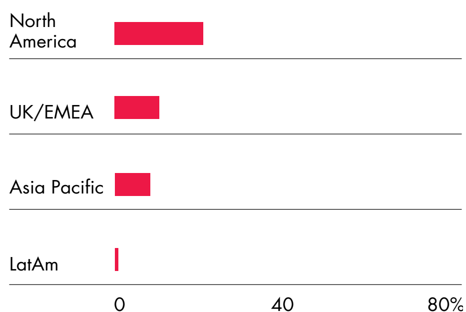
LONG PORTFOLIO

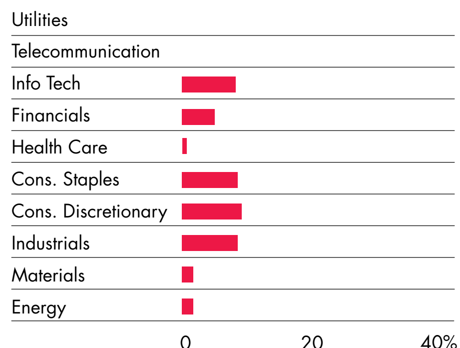


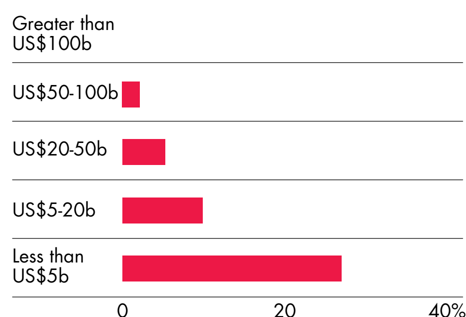




SHORT PORTFOLIO







Note: exposures shown as % of NAV

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DISCLAIMER

#Fund performance is calculated after fees and costs, including the investment management fee and performance fee. All returns are on a pre-tax basis.

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