July 2019 – Datt Capital Absolute Return Fund

To our valued investors,

Thank you for entrusting your capital and co-investing with us.

A final distribution for FY19 was paid to investors of 4.0649c per unit in July.

For July the Fund provided a net return of 4.85% for the month.

	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	FYTD
FY19		2.6%	-1.2%	-4.8%	3.53%	-2.07%	6.97%	1.66%	0.76%	-3.64%	-2.45	0.79	1.57%
FY 20	4.85%												4.85%

Asset Allocation for the Fund at July month end was:
CRE debt - 56%
Equities - 39%
Cash - 5%*
Derivatives – 0% (liquidation value)
*We expect our cash allocation to rise in August due to confirmed investor inflows.

Investment review

Commercial real estate debt

This month we evaluated 1 new opportunity and choose not to invest in it.

The investment in Project C was repaid as anticipated.

Proceeds from Project B were successfully rolled into Project G.

Our real estate debt exposures as at the end of July are:

Name	Location	Type	Maturity	Max LVR/LSR	Interest receivable (per annum)
Project A -Mixed use/Residential infill	Melbourne, Inner East	1st Mortgage Land Facility	June 2021	65%	11%
Project E - Residential infill	Melbourne, Inner West	Special situation	February 2020	77%	17.50%
Project F - mixed use	Sydney, CBD	Special situation	April 2020	45%	12%
Project G - Industrial*	Melbourne, Inner West	Preferred Equity	July 2021	70%	14.50%

Fixed interest

We continue to monitor a number of fixed income instruments in the distressed and special situation space.

Derivatives

We have no current derivative exposure.

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Equities

This month, we increased our equity exposure. New additions included Lynas, Valmec and an additional undisclosed holding.

Our current equity exposures are: Afterpay, Echo Resources, Argonaut Resources, Lynas, Valmec and 2 undisclosed equity holdings.

Lynas

Lynas (LYC:ASX) is a rare earth producer with operations in Malaysia and Australia; most recently in the news for being the target of an opportunistic takeover by the Australian conglomerate Wesfarmers (WES:ASX).

Whilst rare earths, contrary to their name, are not especially rare; they are difficult to produce commercially whilst being of exceptional importance in 'new age' technologies. Specific industries which rely heavily on rare earths include renewable energy, medical devices, electric vehicles among others. Demand is projected to grow strongly over the next 10 years.

There will be significant difficulty in meeting this projected new demand going forward, as rare earth production is highly capital intensive and there are large technical risks associated with a gradual ramp up to full nameplate production. Lynas have overcome a multitude of obstacles over the past decade to become the only significant producer outside China. This is underpinned by a Tier 1 resource at Mt Weld with a 25+ year mine life; an operational and efficient separation plant and valuable intellectual property obtained over a number of years. Recently, there was significant speculation that Lynas would have difficulties renewing their processing licence in Malaysia. Recently, Dr. Mahathir the Malaysian president recognised the substantial social and financial benefits to the local community that Lynas' operations bring, and clearly articulated that their processing licence will be renewed.

The existing supply structure of the rare earths market leaves it extremely vulnerable to shocks caused by geopolitical events and decisions. In 2010, the Chinese government reduced the export quota of rare earths by 40% and unofficially banned exports to Japan; the second largest user of rare earths. This led to a massive surge in spot market prices, with the price of most rare earth elements increasing by 5 times in a short period of time. The recent trade talks between China and the USA have once again highlighted the potential re-occurrence of a similar situation, with much talk in the Chinese media of 'weaponising' it's rare earth endowment by denying the US access to these essential elements. We also note the lack of spot market supply outside of Chinese sources indicated in the graph below.

Whilst, we hope that cooler heads prevail between the US and China, we believe that there is a clear shift towards diversifying sources of rare earth supply from non-Chinese sources. We have seen great evidence of this via the flexible financial support extended to Lynas by JARE, a partnership between a Japanese government institution JOGMEC and a large Japanese trading company Sojitz. JARE will also be extending their financial support to fund Lynas growth opportunities discussed further below. In addition, there has been substantial rhetoric from the US media about the need to source rare earths from non-Chinese producers.

Independent of these issues Lynas also have some fantastic growth options, including a recent MOU signed with a small US producer who owns an existing site permitted for rare earth production. We anticipate that there will be significant US government support for this project; which may speed the commercialisation of this project. We believe the company's strategy to move into manufacturing higher value, downstream product is a sensible move and will greatly increase the strategic value of the company in the coming years.

We rate the management team led by Amanda Lacaze very highly. Amanda has very ably and astutely led the company from the brink of insolvency at the time of her appointment to its transformation into the world-class rare earth producer it is today.

Valmec

Valmec Ltd (ASX:VMX) is a diversified energy and infrastructure services group that provides essential services to the oil and gas, resources and infrastructure sector in Australia. We like the company's exposure to the growing sectors in infrastructure and energy pipeline; along with the clear revenue growth over time and its continued success in winning work contracts whilst maintaining disciplined margins.

There has been an emphasis on growing recurring, higher-margin revenue from the service division which contributed >50% of revenues for the latest half-year. This division was bolstered in 2018 by the purchase of a distressed specialist pipeline testing company which Valmec funded out of working capital. This acquisition has successfully been integrated into the company and now contributes a material amount of revenue to Valmec's service division.

There is a culture of capital discipline and risk control evident within the group itself. In particular, the enforceability of contracts in this sector is very important and Valmec have strong discipline in this aspect. We also noted the best in class personal safety rates, the company has gone almost 7 years (2,500+ days) with a LTIFR (lost time injury frequency rate) of Zero.

We attribute this to a culture of ownership and accountability driven by the fact that the Board and Management team own approximately 45% of the company providing good alignment with other shareholders. The company has a tight register with the top 20 shareholders holding ~74% of the shares on issue.

The company holds a 'hidden asset' in a potential settlement with John Holland over a disputed contract. The company made an announcement recently guiding to $110 million in revenue and approximate EBITDA earnings of $8 million. They also confirmed that the John Holland litigation amounts are held at nil value on their balance sheet

The value of the summons is circa $11.6 million, plus costs and interest. John Holland has made a $2 million payment in 'good faith' previously. Any amounts recovered will drop straight to the bottom line and may result in capital management measures.

In their recent half-yearly, Valmec reported EBITDA of $3.2 million on revenue of almost $48 million. They have guided that significant growth is expected for the 2nd half of the year, along with a solid order book of work to the value of $80 million as well as over $500 million in potential contract revenue opportunities.

We note that the company's growing scale has allowed it to bid on larger scope of works which provides greater visibility in terms of earnings.

We see Valmec as a sound opportunity to obtain conservative, profitable exposure to the infrastructure and pipeline industries, along with a potential large kicker in the settlement of the John Holland litigation.

We had the opportunity recently to catch up with Valmec's MD, Steve Dropulich, and Chairman, Stephen Zurhaar. Both are substantial shareholders in their own right.

Broadly, we were able to get more colour around the nature of the 'hidden assets' discussed above as well as understand their thoughts on the company's growth strategy as well as possible capital management initiatives going forward.

We were impressed by the onus on disciplined tendering practices and not chasing revenue growth at the expense of margin. We also felt their growth strategy into profitable niche spaces will lead to much greater opportunities for the company further down the line. It was very evident that the board and management team know their competitive space intimately, and run the company according to the principles of an 'owner-operator'; a very attractive attribute in a public company context.

We look forward to sharing in Valmec's exciting future.

Commentary

We are finding plenty of good equity opportunities at present, with recent market volatility assisting in this regard. We expect to selectively add to our existing holdings in the month ahead, as well as potentially add some new positions.

Our portfolio is well balanced, with our equity exposure to gold, the US dollar and rare earth production expected to provide ballast in stormy markets should the US-China trade war escalate.

The Fund remains open for investment.

To schedule a time to discuss your interest in the Fund with the Investment Manager, please follow this link: http://bit.ly/dattcapital-call

To register your interest in the Fund and receive preliminary information please register via this link: http://bit.ly/datt-register

Please click the link below to view the Fund disclosure documents and apply for an investment online.

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