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Introduction

We invest with the objectives of protecting and increasing our capital in real terms over time.

Our investment process, investment offerings and business are designed to provide a platform to achieve these objectives. We have put considerable thought into how we want this platform to function. All we control is our work environment, the people we work with and our research process. Our results are a function of how well we execute around the things we control.

Investors in the fund are putting a dollar next to ours and investing on the same terms that we do. We regard the fund as our best expression of the issues, the uncertainties and the opportunities that we identify at any given point.

The fund invests globally from an Australian dollar and taxpayer's perspective. The majority of the fund's investments have been in listed shares. While the fund has the ability to short sell securities, buy derivatives and invest in other listed and unlisted asset classes, our focus is directed towards traditional longer term equity investments.

In addition to the fund, we have a highly concentrated mandate offering which enables larger institutional investors to access our discrete investment ideas.

Fund Positioning

The holdings in the fund are undergoing a degree of transition. During 2014 we exited a number of the fund's original investments, most notably in the US wagering and European airport sectors. The fund sold its investments in Churchill Downs and Calpine and materially reduced the investment in Flughafen Wein.

Today the fund owns a collection of businesses that we are content to hold longer term. We regard these businesses as being reasonably well positioned regardless of the macro environment that eventuates. We believe these businesses will continue to generate free cash flow and have opportunities to reinvest and earn adequate returns on capital over time.

The fund holds a considerable amount of cash. We regard cash as something that generally will not hold its value in real terms over the longer term. This value erosion is being accelerated by the various forms of quantitative easing (QE) being pursued globally. We have previously referred to QE as being akin to a tax; another way we think about it is as a transfer of resources away from the productive and responsible to the less productive and irresponsible.

Despite this steady erosion of purchasing power, cash obviously provides flexibility and there are some periods when it is highly value accretive (when real asset prices are falling). We intend to use periods of volatility to invest the available cash where we perceive opportunities.

During November 2014 we spent time in Florida, New Jersey and Texas. The trip contributed to our research effort and thought processes regarding two investments the fund holds - Saft Groupe SA and Whole Foods Markets Inc. We have detailed our rationale behind the fund's investments in both companies later in this document.

The fund has had considerable success investing across the infrastructure, logistics and utility space in both Europe and the US since we started in 2010. In previous Annual Reviews we have written in detail about some of these investments. We chose to focus on some other areas in this Annual Review.

Issues currently exercising our thinking include:

- There should be some interesting investment opportunities locally;
- Investors seem increasingly prepared to invest on the basis of a narrative;
- The weakness in oil prices;
- Incumbency is valuable; and
- The value of a network is hard to capture in a financial model but can be very important to the success of a business.

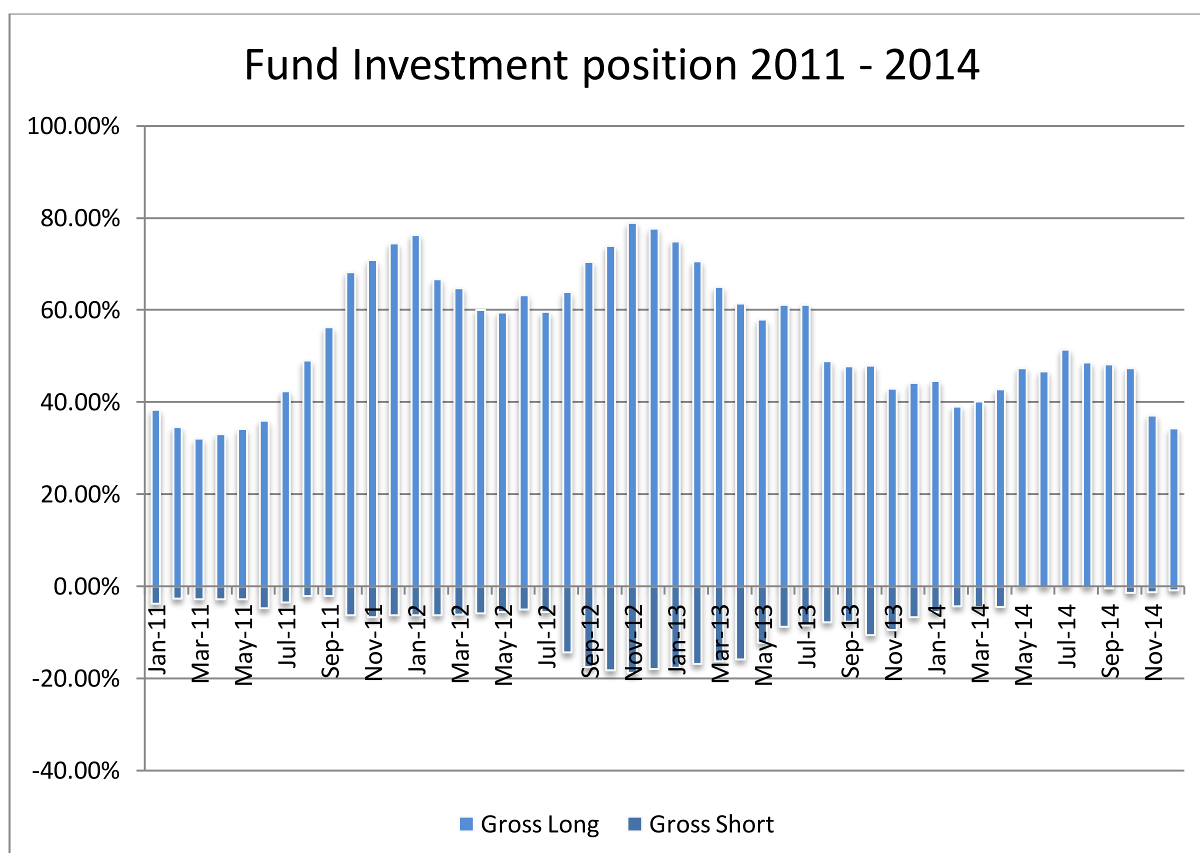
The fund continues to hold an option position shorting the Japanese Yen against the USD. During 2014 the Yen moved in the direction we wanted but there continues to be little focus on the solvency issue we perceive to exist. As such, in November and December 2014 we realised profits from our position, reduced the fund's capital at risk in this investment and reset the position by buying another put option at a higher strike. We have risked 2% of the fund's capital annually (by

cost) in this position since the fund's inception on April 15th 2010. The recent contract the fund purchased was acquired within this 2% annual cost framework.

The following tables and chart summarise the fund's positioning at 31 December 2014.

	31 December 2014
Large capitalisation ($3 billion plus)	24%
Mid / Small capitalisation ($100 million to $3 billion)	5%
Micro capitalisation (less than $100 million)	6%
Total	34%

	Australia		United States		UK/Europe		Total	
	%	no/.	%	no/.	%	no/.	%	no/.
Tenet 1: US wagering			2	1			2	1
Tenet 2: European airports					5	2	5	2
Tenet 3: Not disclosed			8	2			8	2
Other long	4	1	12	2	2	2	19	5
Gross long	4	1	23	5	8	4	34	10
Gross short	1	2					1	2
Gross invested position	5	3	23	5	8	4	35	12
Derivatives (annual cost)							3	3



Whole Foods Market Inc

5% of the fund's capital is invested in Whole Foods Market Inc (Whole Foods).

We bought this position in May 2014 following the company issuing its fourth downgrade since November 2013. The fund paid US$38.62 for the investment compared to its October 2013 high in excess of US$65. It is currently trading at US$50.

We believe Whole Foods holds a position of genuine integrity and trust with its customers and the broader community regarding food transparency and food sourcing. While we believe Whole Foods has this element of trust, we perceive there to be generally wide held mistrust and uncertainty in the US around issues such as the longer term health and wellbeing impact of GMO products, certain herbicides and pesticides, and what actually goes on behind the scenes in corporate America concerning food preparation. We think this trust is valuable, enduring and very difficult to replicate.

Whole Foods was founded in Texas in 1978 by John Mackey. At 25 he opened a single store with his 21 year old girlfriend called "Safer Way". John and his girlfriend were backed by friends and family with US$45,000 in seed capital. They lived above the store. Today Whole Foods is the leading US based natural and certified organic food retailer. It operates 400 stores, 380 of which are based in the US. We expect that in 2014 the business will generate revenue of around US$14,500 million and EBIT of US$950 million; it has no on balance sheet debt and a current market capitalisation of around US$17,000 million. The company's mission is to promote the vitality and well being of all individuals by supplying the highest quality, most wholesome foods available. John Mackey continues to work in an executive capacity in the business.

We have followed this business and its shopping experience for many years. Until 2012, we would have described Whole Foods as a super premium natural, organic niche food offering with price points so high they make your eyes water. We regarded it as too niche, too high end and too expensive. We perceived it as vulnerable and ultimately an unsustainable (economic) proposition due to these traits.

In 2012 we covered some ground in the US looking at the quick service restaurant segment, including Wendy's, McDonalds, Burger King, Chipotle and Five Guys. Much of this involved a rental car and a GPS and we visited as many restaurants as we could to get a sense for the different offerings, the quality of the store bases and, where relevant, the impact of the various remodelling initiatives. Invariably we would visit the Whole Foods stores that were located in the areas we happened to be. Our overriding impression from these visits was this is a business on which we needed to do more detailed analysis. The shopping experience was great, which was what we expected. The key shift we observed was the business seemed to have extended its range and had far more products that were priced at levels equivalent to similar products in typical supermarkets. This observation shifted our thinking from Whole Foods being a super premium niche retailer to possibly something that could translate more broadly into the mass market. It was clear from walking through the stores that there had been a meaningful shift in price points. We were impressed by the extent of this change. It is unusual to find businesses that are so adaptive and given the fickle, competitive and dynamic nature of retail, this seems a necessary trait for longer term success.

On subsequent analysis the key points that stood out to us were:

- Its footprint is surprisingly small. Today it has 400 stores compared to mature national US based supermarkets which regularly have in excess of 2,000 stores;
- Whole Foods financial settings and accounting classifications struck us as conservative. We think this is appropriate given the nature of the business. It also reflected well on the internal culture. It is unusual for us to think this. Most of what we look at smacks of management pushing as hard as they can to maximise next quarters "normalised" earnings.
- The financial disclosure is very good;
- Management seem to make genuine long term decisions regarding the business. They look at the business far more holistically than as an entity whose sole purpose is to maximise returns for its owners. Their philosophy seems to be if we treat all stakeholders fairly, including employees, suppliers, customers and shareholders, Whole Foods will be ultimately more successful as we will increase the size of the economic pie for all stakeholders. Another way of thinking about their culture is, if you have genuinely loyal customers, loyal suppliers and loyal employees, these intangible factors mean shareholders will own a pretty special business that is more robust and resilient than generally appreciated;
- There are a number of interesting and unique structures within the business around how staff are organised, how decisions are made on aspects such as employee benefits and how individuals are compensated;
- The company is not rolling out "boxes" for their store expansion program. Stores are tailored with regard to size, design and product selection depending on the particular community where they are located;
- Roughly 25% of each store's product is sourced "locally"; and
- The business has a history of extraordinary financial success. The historic consistent cash generation of the business, and the returns it is earning on its existing asset base and incremental investments are compelling.

Our greatest concern regarding the merits of the Whole Foods investment is the idea that food transparency, food integrity and leadership positions in natural and organics are obvious and highly desirable market positions to hold. Consequently, capital from all fronts is chasing these positions, whether through smaller listed entities that have been funded specifically with a mandate to roll out boxes selling natural and organic groceries, incumbent traditional supermarkets expanding their organic offerings or regional operators that have a footprint and customer loyalty to build from. When an opportunity is so obvious and capital is being aggressively deployed to realise it, returns are only going to decrease.

After spending considerable time working through the historic results, conference calls and evolution of the business it was also very clear the market's expectations for Whole Foods' gross margins and same store sales were materially too high.

Weighing up the situation, we perceived there was a very valuable business in Whole Foods, if we were right regarding the durability of its trusted position relating to food transparency and sourcing. If this observation is correct, there is the opportunity to continue to reinvest free cashflow into new and existing stores earning highly attractive rates of return. Our view was if we could obtain an appropriate entry price then this was a business we wanted to own.

The way we approached the valuation was to determine what the existing store base was worth (i.e. paying zero for the future store rollout opportunity). If we could achieve this entry price, we were prepared to invest.

We framed the valuation of the existing store base as follows:

Simplified investment summary	2013	2014
EBITDA	US$1,220m	US$1,310m
Less capex (pre new store spend)	US$200m	US$260m
Coupon (pre interest and tax)	US$1,020m	US$1,050m
Core business enterprise value (using 8% cap rate)	US$12,800m	US$13,100m
Less net debt (plus net cash)	US$1,080m	US$740m
Implied equity valuation	US$13,880m	US$13,840m
Existing store base value per share	US$38	US$38

We then sat patiently waiting for an appropriate entry point.

In May 2014, the company issued a downgrade which made evident the market's expectations for gross margins and same store sales were too high. This didn't really surprise us as these issues were evident in the prior results and disclosures from the company. However, we were a bit stunned to see the share price fall 20% upon opening the next morning - to the level that we framed as fair value for the existing business. We invested 4% of the fund's capital into Whole Foods that day.

In November 2014, while we were in the US we went through numerous Whole Foods stores and more stores of their various competitors including The Fresh Market, Sprouts, Trader Joes, incumbent traditional supermarkets and various regional (unlisted) stores. This process was constructive however we are reticent to detail our views of the various operators. Our conclusions were the Whole Foods franchise and position is based on significantly more than just a first mover or scale advantage.

We expect Whole Foods will be a long term investment for the fund. It will likely take several years to prove out our investment thesis. Recent share price appreciation has been the result of just one okay quarterly number and doesn't really get us any closer or give us any direction or confidence on whether our long term rationale for the investment will ultimately prove correct. While we have undertaken considerable analysis to understand Whole Foods' financial and general fundamentals, our attraction to the business is quite subjective (albeit supported by the financial progression). This doesn't worry us too much when we are investing in an established retailer. We tend to think that the returns thriving retailers can earn on their incremental capital investment are very attractive and probably sustainable for longer than markets tend to value. Conversely, we can't imagine ever being attracted to a retailer on the basis the valuation looks cheap. We think the dynamic nature of retailing means economic value can shift between retailers rapidly, persistently and quite often unrelentingly.

Saft Groupe SA

2% of the fund's capital is invested in Saft Groupe SA (Saft).

The fund bought this position during June and July 2012 at €18.44.

Saft is a French based industrial battery manufacturer with an enterprise value of around €700 million.[1] We do not have a natural affinity towards investing in small cap French or industrial battery companies. However, we were able to get past these biases given Saft's long operating history, strong cash generation and dominant leadership positions in various high end niche industrial battery applications.

Saft has been producing batteries for almost 100 years, beginning with production of nickel-based batteries in 1918. The business was acquired by private equity from Alcatel in 2004, leveraged and then exited through an initial public offering in 2005 at an enterprise value of €830 million.

Saft's primary battery chemistries are Nickel Cadmium, Primary Lithium and more recently Lithium Ion.

We do not expect Saft to build a world-beating, mass market car battery, in fact it would scare us if they were pursuing this goal. We regard these obvious mass market battery applications as a race to the bottom activity that is highly susceptible to commoditisation.[2]

Since Saft's IPO in 2005 the business has consistently generated a pre interest and tax cash coupon of around €70 million per annum. This amount has ebbed and flowed a bit but has been reasonably stable in the context of the macro environment. While there has been no consistent earnings growth the business has a history of generating strong cashflow. This was initially used to pay down the private equity inspired debt burden and then in the latter years towards funding a new Lithium Ion production facility in Jacksonville, Florida. Saft's cash generation contrasts to a number of other listed battery companies that seem to be developing technology, selling nothing and burning lots of cash.

We spent considerable time trying to understand the business and what enabled the cash generation. The key characteristics include:

- Intellectual property in the battery chemistry and battery manufacturing / production space;

[1] We have maintained an interest in the economics of the battery space as an adjunct to our focus on the utility sector where batteries are increasingly being used to manage and time shift electricity demand and supply. In 2011 we spent some time sorting through investment opportunities directly in the battery space and this led us to Saft.

[2] Saft did have a joint venture with Johnson Controls Inc which was established in 2006 with the intention of using Saft's battery IP to develop and manufacture lithium ion batteries for the automotive sector. Saft sold their 49% interest in the JV back to Johnson Controls in September 2011. Saft then spent some further time reviewing the automotive opportunity but at the end of the first half of 2012 they dramatically narrowed the company's focus to limited areas in the space, seemingly being of the view there were niches that were interesting but the risk reward did not line up investing in the broader opportunity. We were encouraged that they would back away from this space given the broad interest from the media and investment community. This discipline reflected well on the company's internal culture.

- Research and development significantly funded by external customers for specific applications;
- Some brand value from delivering a reliable, high quality product. As one customer commented to us, “Saft batteries tend to be more expensive but you get what you pay for”;
- History and reputation pre qualify Saft as a supplier to multinational original equipment manufacturers; and
- Business focused on various niches. The majority of revenue comes from activities where Saft holds the market leadership position and purpose built battery systems that have been designed by Saft.

One of the applications Saft dominates is aircraft batteries. Saft supply 100% of Airbus’ batteries and the majority of Boeing’s batteries. As was evident by the problems Boeing had with the Dreamliner battery system (supplied by GS Yuasa Corp), there are applications where the performance of the battery is vital.

We felt there were some highly attractive characteristics regarding the activities, customer base and positioning of the business. There is reasonable confirmation of these activities in the financial results of the company. There is also confirmation of their IP in the applications and market positions Saft holds across various industries.

In 2010, Saft commenced the construction of a Lithium Ion battery production plant in Jacksonville, Florida. The cost of the plant was approximately US$200 million, US$95 million of which was funded by various government grants. The first batteries were produced in 2012 and the majority of the capex was completed by 2013. The sales of Saft lithium ion batteries from the Jacksonville plant are steadily ramping up. While the plant will run at a loss in 2014, management expect volumes will build to achieve a close to breakeven financial result in 2015. Given the nature of the economics of the manufacturing process, incremental sales above the breakeven point are highly cash generative.

In November 2014 Saft held an investor day in Jacksonville to give investors a better sense of the plant and the business more broadly. This provided us the opportunity to access a wide range of management, tour the facility and obtain more detail around some of the newer activities.

Today Saft’s enterprise value is approximately €720 million. We expect Saft’s existing business that currently generates around €70 million in cashflow (including the small loss for Jacksonville) will grow at mid single digits per year. In addition, we expect they will get an adequate economic return from the US$200 million invested in the Jacksonville plant. Moreover, their reputation, brand and activity in the battery space positions them well to participate in new and growing battery applications. While these contributions will be lumpy and we don’t have any real transparency or expectation regarding the timing, they have the potential to make a meaningful contribution over time.

Below is a chart of Saft's share price since the IPO in 2005.

Investment Results

The tables below show the fund's performance.

The fund provided a return of 22.4% for calendar year 2014.

The fund's long investments contributed 10% in local currencies, the weakness in the AUD contributed 2% and the Yen put options contributed 12%.

Returns (to 31/12/2014)	Fund
Since inception* (annualised)	14.8%
Since inception* (cumulative)	92.2%
Rolling 3 year (annualised)	24.7%
Rolling 1 year	22.4%
Standard deviation	9.8%

Financial Year	2010	2011	2012	2013	2014	2015
July		1.14%	-1.95%	-3.06%	2.03%	1.98%
August		-0.33%	-0.32%	0.45%	1.42%	-0.39%
September		0.60%	-2.18%	1.89%	0.52%	4.18%
October		2.12%	0.83%	1.30%	1.43%	2.53%
November		0.47%	-1.22%	-2.46%	3.97%	11.10%
December		-0.24%	0.27%	6.93%	1.13%	3.00%
January		0.31%	0.84%	9.92%	-0.54%	
February		1.78%	0.02%	2.69%	-0.81%	
March		1.06%	5.59%	-0.44%	-1.45%	
April	0.04%*	-1.94%	1.62%	4.45%	0.08%	
May	-0.78%	1.01%	-0.37%	8.63%	1.29%	
June	-0.76%	-0.70%	-2.58%	1.68%	0.02%	
Financial Year	-1.5%	5.3%	0.3%	36.1%	9.3%	
Calendar Year		-3.1%	10.1%	44.0%	22.4 %	

* Inception date: 15/04/2010

Conclusion

Genuine investment ideas are difficult to find and we remain committed to ensuring the fund is limited to a small number of high quality investments. While the current environment is generally making new ideas harder to find, our research continues to uncover prospective opportunities. Over time we expect this work will broaden out the portfolio and periods of volatility will enable us to add to our existing holdings. Moreover, there are areas where we have undertaken considerable work which is not yet reflected in the fund - the Whole Foods and Saft summaries presented above demonstrate that we are prepared to wait for an appropriate entry point.

The intent of our Annual Review is to provide clients and interested parties with a level of transparency that enables them to better understand our offerings and investment process. Prior year reviews can be downloaded from our website www.longtailasset.com.

Please contact us if you are interested in investing with us or you would like to discuss our business or offerings in detail.

Best wishes for the holiday period and the year ahead.

Miles Webster & Nigel Trewartha

January 5th 2015

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