Annual Review: 2016

Published: January 5th, 2017

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Introduction

At our core we see ourselves as patient, longer term investors.

When we invest in a business we are particular about:

- The opportunity that we perceive to exist, the investment tenet.
- The confirmation that we can point to that the tenet is being realised.

Where we perceive there to be a suitable opportunity we have the flexibility and structure to be aggressive.

Once we invest in a business, we will give it space and time; to let it breathe and evolve. We are indifferent to the quarterly earnings volatility and the ebb and flow of equity markets. So long as an investment's operational performance is consistent with our expectations and investment tenet we tend to be content. Ideally, we will hold an investment for many years. By design, our structure and investment framework enable us to operate in this manner.

There was more activity in the fund in 2016 than in previous years. We exited the oil related investments for modest gains. Two holdings; Saft Groupe S.A. and UK Mail Plc were subject to takeover offers, we expanded the fund's investment in the merchant electricity generation area and we also invested in two new businesses; Akzo Nobel N.V. and Topps Tiles Plc. Our thought processes around these two investments are detailed later in this note.

There was no activity during the year in our institutional mandate offering, we did not identify an investment that we regarded as suitable for consideration. The characteristics we seek in the mandate investments are:

- Large and very liquid; effectively no capacity constraint for larger institutional investors.
- Operates in areas where we feel we have a long history and a strong knowledge base and there is an appropriate entry point for investment.

When we identify an opportunity that meets these criteria where we perceive there to be reasonably limited downside risk and a mid-teen plus three to five year annual return opportunity, we view it as appropriate for consideration. We set high hurdles for suitable mandate investments; occasionally we identify investments that meet them.

We appreciate the interest and support that we received in 2016. Please do not hesitate to contact us if you would like to discuss our activities in detail.

Best wishes for the holiday period and the year ahead.

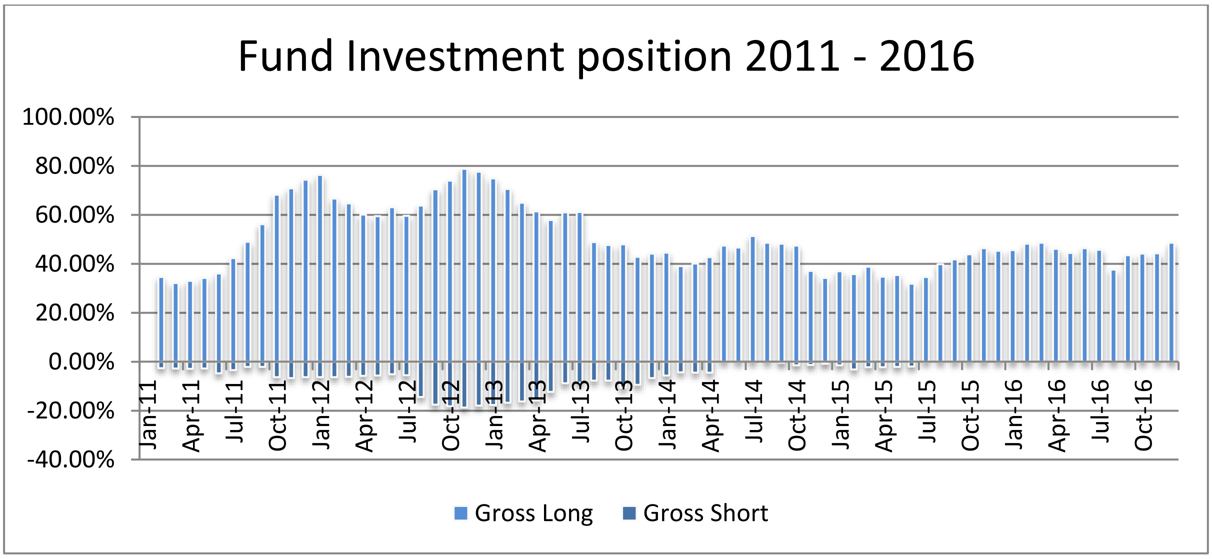
Miles, Nigel and Toby.

Fund Positioning

The following tables summarise the fund's investment position at 31 December 2016.

	Australia		United States		UK/Europe		Total	
	%	no/.	%	no/.	%	no/.	%	no/.
Tenet 1: Gen Co.:			6	1	5	1	11	2
Calpine Corp			*6*	*1*				
Undisclosed					*5*	*1*		
Tenet 2: Infrastructure related			14	2			14	2
Undisclosed			*7*	*1*				
Undisclosed			*7*	*1*				
Wholefoods			4	1			4	1
Deere & Company			5	1			5	1
Akzo Nobel					4	1	4	1
Dover Downs Gaming			2	1			2	1
UK Mail					5	1	5	1
Topps Tiles					4	1	4	1
Gross long			31	6	18	4	49	10
Gross short								
Gross invested position			31	6	18	4	49	10
Derivatives (annual cost)							3	3
Notes: Totals may not add due to rounding. Data as at 31st December 2016.								

	31 December 2016
Large capitalisation ($3 billion plus)	37%
Mid / Small capitalisation ($100 million to $3 billion)	9%
Micro capitalisation (less than $100 million)	2%
Total	49%



The fund started the year with 11 long investments and was 45% gross invested. At the end of the year it held 10 investments and was 49% invested.

Our thinking consistently drifts back to an idea we previously articulated around "tolls on the real economy". The common traits of these businesses are they have some pricing power, reasonable balance sheets, scale in the context of their individual markets and, importantly, they each have genuine and meaningful internal re-investment opportunities. The businesses we are attracted to and that the fund owns generally have these traits.

Investments Sold

Saft Groupe S.A.

The fund held an investment in Saft Groupe S.A. (Saft) from June 2012 until August 2016. The Saft investment realised an annualised IRR of 33.7% and contributed 3.9% to the performance of the fund over the investment holding period. Saft was taken over by Total S.A. for EUR 36.50.

UK Mail Plc.

The fund held an investment in UK Mail Group plc. (UK Mail) from November 2015 until December 2016. The UK Mail investment realised an annualised IRR of 65.7% and contributed 1.9% to the performance of the fund over the investment holding period. UK Mail was taken over by Deutsche Post AG for GBP 4.40.

Oil Related investments

The fund started the year with 2 investments and 13% of its capital in businesses exposed to oil related activities. We exited these investments in May and August of 2016. The fund held the first investment from February 2015 and realised an annualised IRR of 10.6%. The second investment the fund held since July 2014 and realised an annualised IRR of 2.2%.

New and existing investments

During 2016, there was no material change to either our thinking or positioning around existing investments including Deere & Company, Whole Foods Market Inc, Dover Downs Gaming & Entertainment Inc and the Yen put option position (vs the USD).

The fund increased its exposure to investments in the merchant electricity generation space from 1 investment and 4% of its capital at the start of the year to 2 investments and 11%. The more recent investment is in Calpine Corporation (Calpine), a business that the fund previously owned and which we wrote up in detail at that time (Calpine 2013 Note). These investments own the type of assets we perceive to be increasingly advantaged and are located in electricity markets we want to be involved in; we perceive their generation assets are highly valuable because of the capacity they provide and positioning on the supply curve. There is clearly change in the way electricity is being generated; increasingly wind and solar are contributing more (supported by subsidies) and coal generation is or will ultimately be economically pressured due to its carbon intensity. This energy transition has enabled us to build out this investment idea into two businesses that we regard as having relevant, high quality and long life assets at a fraction of their replacement costs.

During 2016, the fund also invested in Topps Tiles Plc and Akzo Nobel N.V.; our thoughts around both investments follow.

Topps Tiles Plc

The fund bought a 4% position in Topps Tiles Plc in December 2016 at an average price of GBP 0.86.

Topps Tiles (Topps) is the largest UK based tile retailer, it is the second largest tile retailer in the world. Topps sources tiles from the UK, China, Turkey, India and South America. Topps has 351 company operated stores, which it is growing at about 10 stores per year.

The company has a 33% share of the “domestic” UK tile market and 18% share of the total UK tile market (the total tile market includes commercial tiles). Topps’ share of the domestic market has been steadily increasingly. Their core business is selling tiles to trade (52%) and retail (48%) for kitchen and bathroom renovations.

The enterprise value of the business is GBP 190m (GBP 165m market capitalisation plus GBP 25m net debt), the business generated revenues of GBP 215m and EBIT of GPB 21m in year ending September 2016. Its cash generation is consistent with its earnings (adjusting for the store rollout and refurbishment investments).

What stood out to us when we initially looked at the business was its consistent high margins (the business generates gross margins in excess of 60%), consistent cash generation and the operating performance it generated both through the GFC and in the subsequent years. This operating performance has consistently been better and more resilient than we would have expected for a retailer exposed to UK consumer spending, UK consumer sentiment and housing.

To some extent, we think this operating performance has been obscured by Topps’ balance sheet. In August 2006 management returned GBP 122.4m (GBP 0.54/share) to shareholders. Topps’ balance sheet went from a net cash position of GBP 20m to carrying GBP 100m in net debt. The timing of this capital management initiative was poor (an understatement). The business has steadily reduced debt since. As of September 30, 2016 net debt was GBP 25m. The business raised GBP 15m from an equity issue in Nov 2009, the balance of the reduction has come from internal cash generation.

More recently the company has been increasing its internal investment. In 2012, they completed the expansion of their warehouse and distribution facilities in Leicester, more recently they have expanded their store rollout and store reinvestment program. As such, annual capital expenditure is running at around GBP 11m compared to a depreciation charge of GBP 6m.

When we think about the nature of the business, the attributes we are drawn to, which also contribute to its attractive economics are:

- Tiles are generally an infrequent purchase but an important decision.
- A tile is not a branded consumer good. It is also not a homogenous commodity.
- Tiling something is an opportunity to add a design element, it is an opportunity to do something that feels unique for a relatively low cost.
- There is a tactile nature to the purchase decision. It helps to see a tile, pick it up before you decide to buy it. The store base is relevant.
- The cost of the tiles alone typically is small compared to the cost of the total job.
- Topps provide virtually no credit to their trade business; there is no real demand for it.

- Fragment customer base.

Our impression of management is positive. They appear credible, transparent and focussed. The business has a 40 year history and has wandered down a few other paths (manufacturing tiles and selling related products including paint and flooring). Invariably these related activities have in isolation contributed little and in a broader perspective detracted from their core activity. The learnings from these missteps seem to have focussed management.

We spent some time in the UK in late November going through numerous Topps' stores, competitor stores and big box retailers. Our overriding impressions were that Topps seem well positioned to continue to consistently grind out market share gains, winning share from both other tile specialists and also from the big box retailers. Specifically our observations were:

- Topps' offering is differentiated from both the other tile specialists and big box retailers.
- Their retail execution was better. Displays, store layout and organisation differentiated.
- Their staff seemed knowledgeable and dependable. They were also appropriately trained with regard to approaching prospective customers and talking about the kitchen or bathroom project we were enquiring about. This was a consistent observation we had in each of the Topps stores we visited, and it was unique to them.
- Topps likely has a cost advantage versus their specialist competitors given the location and nature of their store base. Their stores felt busier, more productive and more functional than their peers despite their locations and physical structures.
- Observing the organisation and mechanics of a store delivery of tiles from their warehouse / distribution centre reflected well on what is occurring in their warehousing and distribution functions.

There are clearly immediate macro risks around the UK economy and consumer. Topps is leveraged to both. The business is also negatively impacted by the weak Pound, due to it purchasing a meaningful portion of tiles in countries other than the UK. Our sense is the market is primarily focussed on these concerns.

The business is currently well capitalised, its stores are well presented. Its high gross margin provides a buffer against the weak Pound and resultant increase in cost of goods sold. We think the general negative macro focus is giving the fund an opportunity to invest in a defendable, high quality retailer that is differentiated from its peers at a reasonable price.

Akzo Nobel N.V.

The fund bought a 4% position in Akzo Nobel N.V. from July to October 2016 at EUR 58.52.

Akzo Nobel N.V. (Akzo Nobel) is a Dutch based business with three core operating divisions; decorative paints, performance coatings and specialty chemicals. The origins of Akzo Nobel date back over 350 years. The Nobel prize is funded from the estate of Alfred Nobel, the founder of business interests that were ultimately acquired by Akzo Nobel from a Swedish state owned entity in 1994.

The enterprise value of the business is EUR 16.5B. It carries net debt of EUR 1.1B and generates around EUR 1.5B in EBIT from revenues of EUR 14B. (These headline numbers ignore the pension cash flows and economics; unfortunately.)

Akzo Nobel holds leading (#1 or #2) positions in decorative premium paints in various developed and emerging markets globally including UK, Ireland, Netherlands, Scandinavia, China, India, Indonesia, South Africa, Brazil and Argentina. Decorative paint businesses have long standing widely recognised brands. Akzo Nobel's brands include Dulux, Flexa, Sadolin, Nordsjo and Coral. The businesses tend to be highly cash generative, defendable and produce reasonably stable and growing real cash coupons over long periods. Their success is dependent on locally focussed market execution; there is competition, the paint won't sell itself. The businesses need to be supported through marketing and some product development. Trade customers are also cultivated and supported with credit, training and loyalty incentives. Well run, established decorative paint businesses with strong market positions are highly desirable investments.

Akzo Nobel's performance coatings business holds leading global market positions in various lines including powder, marine, yacht, aerospace, coil, wood and protective coating markets. Coatings are branded, they carry genuine IP, they provide a solution to their users. Coatings are usually sold in bulk amounts directly to customers, who are often large global OEMs. There are meaningful barriers to entry to get onto approved product lists. Global end markets tend to be reasonably small from a revenue perspective (circa USD 300m – 2B) and dominated by two or three global players at the top end (Akzo being one of the three) and more fragmented local players in the various geographies. Akzo Nobel's performance coatings products are highly regarded globally. In 2015, the division generated revenues of EUR 6B, EBIT of EUR 790m and a pre-tax return on invested capital of nearly 30%. It is a highly desirable business.

Two-thirds of Akzo Nobel's business is reflected in the decorative paints and performance coatings divisions. Other large businesses with exposures to decorative paint and / or performance coatings activities include PPG Industries Inc (US:PPG), Valspar Corp (US:VAL), Sherwin William Corp (US:SHW) and locally listed Dulux (ASX:DLX). Each of these four businesses operationally performed reasonably well through the GFC and recovered strongly in the subsequent years. These businesses have been defendable and resilient. Their capital investment requirements have been modest through the cycle and they have delivered stable and growing real coupons for their owners. These attractive characteristics and strong operating performances have also been reflected in the share price appreciation of each of these four businesses over the past 10 years.

The steady progress and performance of these four other businesses is in contrast to Akzo Nobel's performance (in decorative paint particularly) over this period. This is more curious to us given arguably Akzo Nobel holds more attractive assets.

Akzo Nobel has been involved in numerous mergers, acquisitions and disposals over the years. The current business was meaningfully shaped by Akzo Nobel buying Imperial Chemical Industries Plc (ICI) in 2008. Akzo Nobel paid an EV of GBP 9.7B for ICI, a business that at the time was generating GBP 500m in EBIT. In addition, ICI came with large employee pension plans and obligations. Akzo Nobel's attraction to ICI was to:

- Expand its decorative paint business, ICI's key decorative brands included Dulux, Glidden, Coral, Cuprinol and Polyfilla; and
- Gain access to the emerging market exposures that ICI held. At the time of the acquisition, ICI "Decorative" positions in emerging markets were China #2, India #3, Indonesia #2, Malaysia #1, Pakistan #1, Thailand #2, Vietnam #2 and Argentina #1.

We regard the strategic intent around the acquisition as being reasonable. The trouble was they paid a very high price and in hindsight the timing has proved to be poor. The operating performance of Akzo Nobel has been disappointing since. This lacklustre operating performance has been further complicated by the large pension assets and obligations Akzo Nobel assumed as part of the ICI acquisition. The combination of mixed operating performance and high underlying financial risk has caused the company to be too difficult for most investors.

Since the ICI acquisition there has been a meaningful turnover of Members of the Board (5 of the current 8 members of the Supervisory Board joined after the ICI acquisition). In 2012, Mr Ton Buchner was also appointed CEO. His focus has been on realising a reasonable return from the existing asset base; with an objective of generating financial returns that reflect the apparent quality of these assets. This refocus has involved a number of steps including the sale of their North American Decorative paint business in 2012, and an extensive multi-year internal restructuring program articulated in 2012 which to date has involved significant cost reductions, systems rationalisations, standardisation of work practices, transparency and accountability for the financial returns across business areas, and focus on supply chain rationalisation and efficiencies. There has been some confirmation of gains from these initiatives in the recent financial results of the business.

We regard this internal refocussing as an ongoing multi - year process and genuine longer term opportunity. Akzo Nobel's decorative paint business holds strong, well established brands and market positions in highly desirable developed and emerging markets. The restructuring to date has been about flattening out the cost base and aligning the business practices. It is an incredibly broad geographically exposed portfolio, where the success in each market is dependent on locally nuanced, in market, on the ground execution. There needs to be consistent brand reinvestment, product development, meaningful engagement with both their retail and trade customers and adequate supply chain and distribution to support the operations. The prize is huge though. If they can get this execution right, they should deliver consistent volume growth through the cycle, real price increases in addition to volume and a positive mix shift as the market increasingly trades up to premium paints. There is clear confirmation of operating improvements in Akzo Nobel's recent results; we view this progress as encouraging. At the current valuation, we don't think we are paying anything for the longer term investment opportunity that we perceive.

Investment Results

The fund provided a return of 10.8% for calendar year 2016.

The contributors to the return were as follows:

- Long equity investments (in local currencies) contributed 12.1%;
- Movement in the Australian dollar cost 1.4%;
- Yen options contributed 2.2%[1];
- Currency hedges cost 0.4%; and
- Equity derivatives and short positions cost 0.5%.

Returns (to 31/12/2016)	Fund
Since inception* (annualised)	11.2%
Since inception* (cumulative)	105.0%
Rolling 5 year (annualised)	15.7%
Rolling 3 year (annualised)	9.3%
Rolling 1 year	10.8%
Standard deviation	9.1%

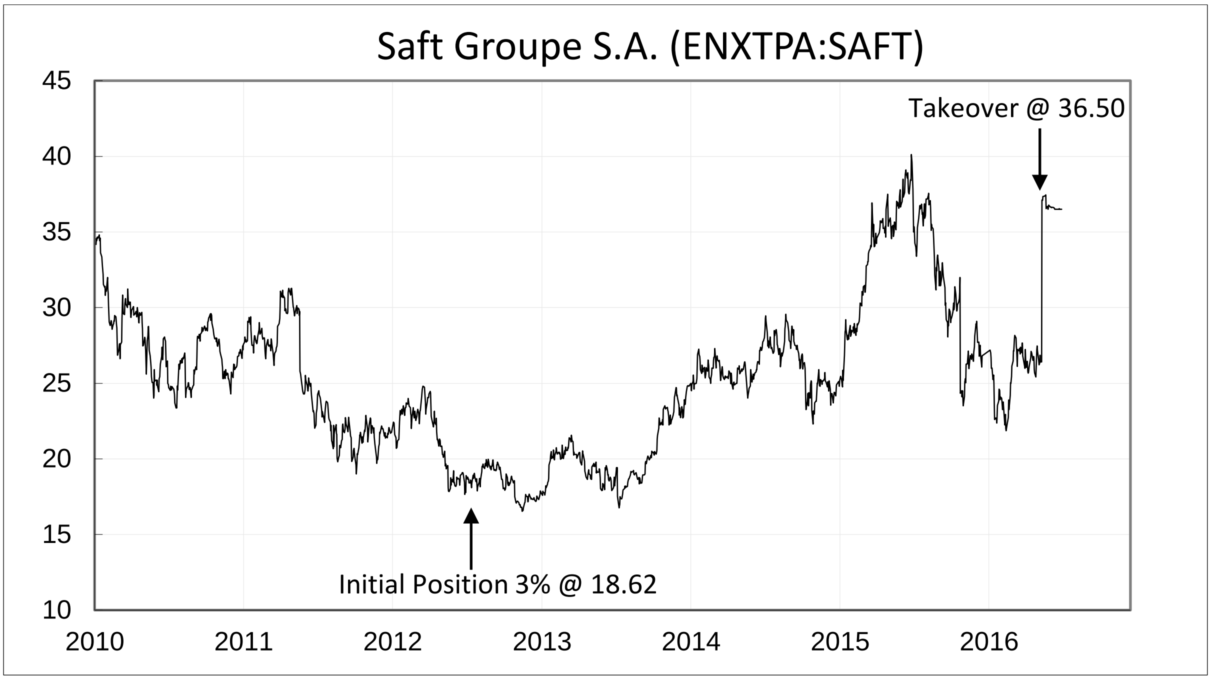
Financial Year	2010	2011	2012	2013	2014	2015	2016	2017
July		1.14%	-1.95%	-3.06%	2.03%	1.98%	0.45%	-1.62%
August		-0.33%	-0.32%	0.45%	1.42%	-0.39%	-1.39%	-0.18%
September		0.60%	-2.18%	1.89%	0.52%	4.18%	-1.19%	1.34%
October		2.12%	0.83%	1.30%	1.43%	2.53%	0.27%	-0.21%
November		0.47%	-1.22%	-2.46%	3.97%	11.10%	0.60%	4.50%
December		-0.24%	0.27%	6.93%	1.13%	3.00%	-3.07%	2.46%
January		0.31%	0.84%	9.92%	-0.54%	0.97%	-1.77%	
February		1.78%	0.02%	2.69%	-0.81%	1.57%	1.77%	
March		1.06%	5.59%	-0.44%	-1.45%	-0.04%	-0.84%	
April	*0.04%	-1.94%	1.62%	4.45%	0.08%	0.32%	1.72%	
May	-0.78%	1.01%	-0.37%	8.63%	1.29%	0.47%	4.12%	
June	-0.76%	-0.70%	-2.58%	1.68%	0.02%	-2.61%	-0.79%	
Financial Year	-1.49%	5.33%	0.29%	36.06%	9.33%	24.95%	-0.31%	
Calendar Year		-3.10%	10.12%	43.95%	22.40%	-3.70%	10.76%	

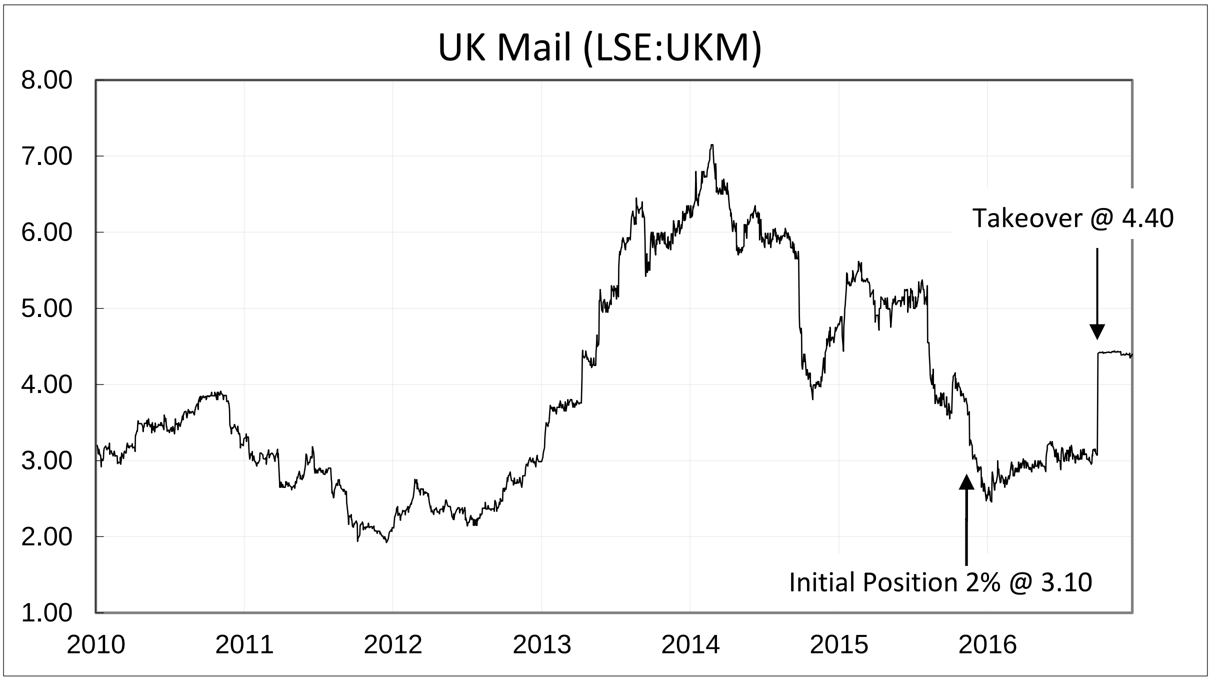
* Inception date: 15/04/2010

[1] At Dec 31, 2016, the market value of the Yen put options (vs USD) was approximately 3.5% of the Fund's NAV. The options currently held expire in a few weeks. IT IS LIKELY THESE OPTIONS WILL EXPIRE WORTHLESS.

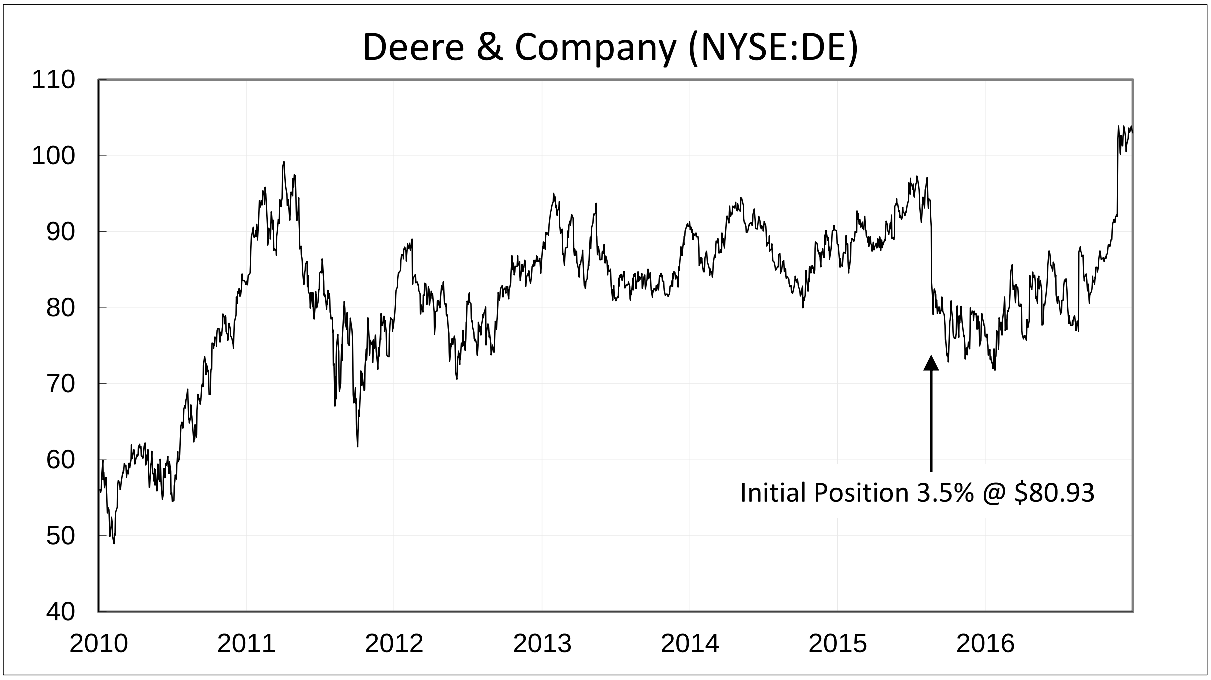
Appendix A: Chart Pack

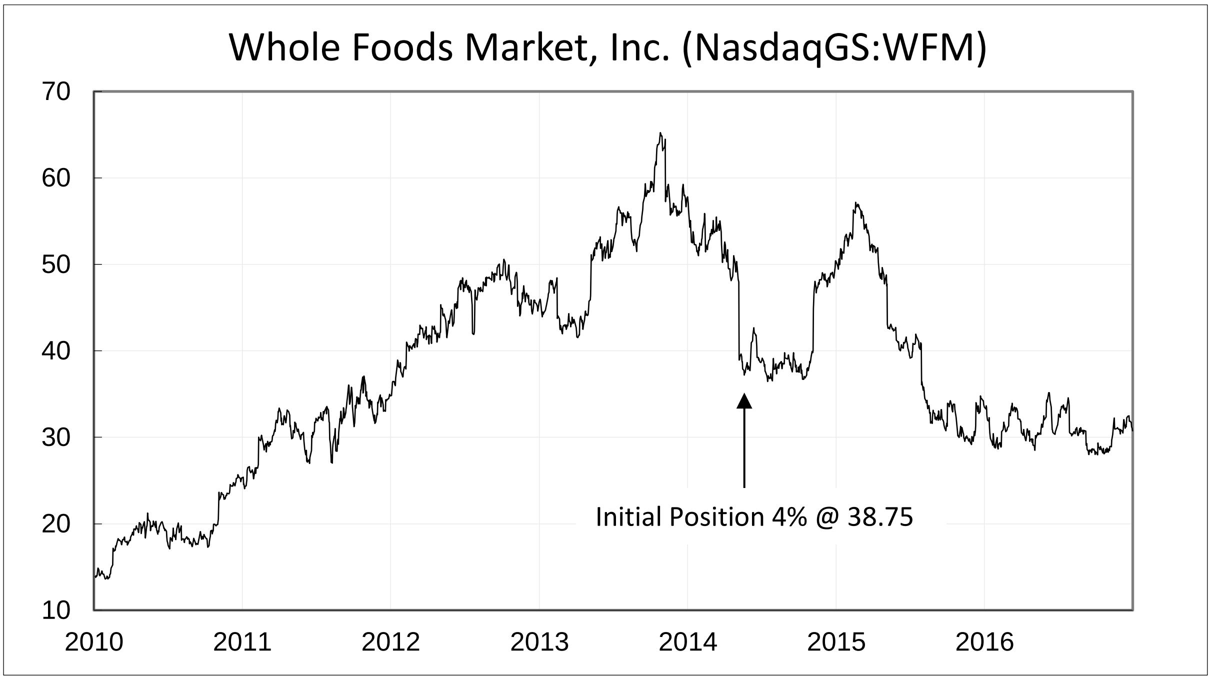
Investments Realised

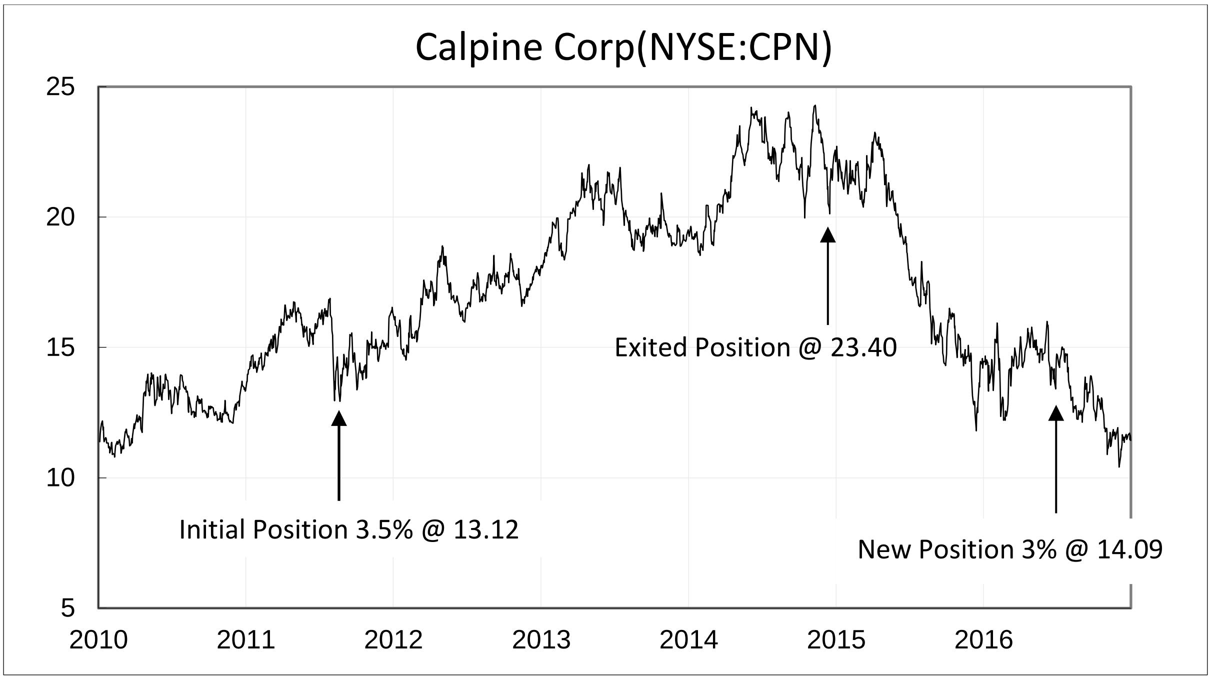


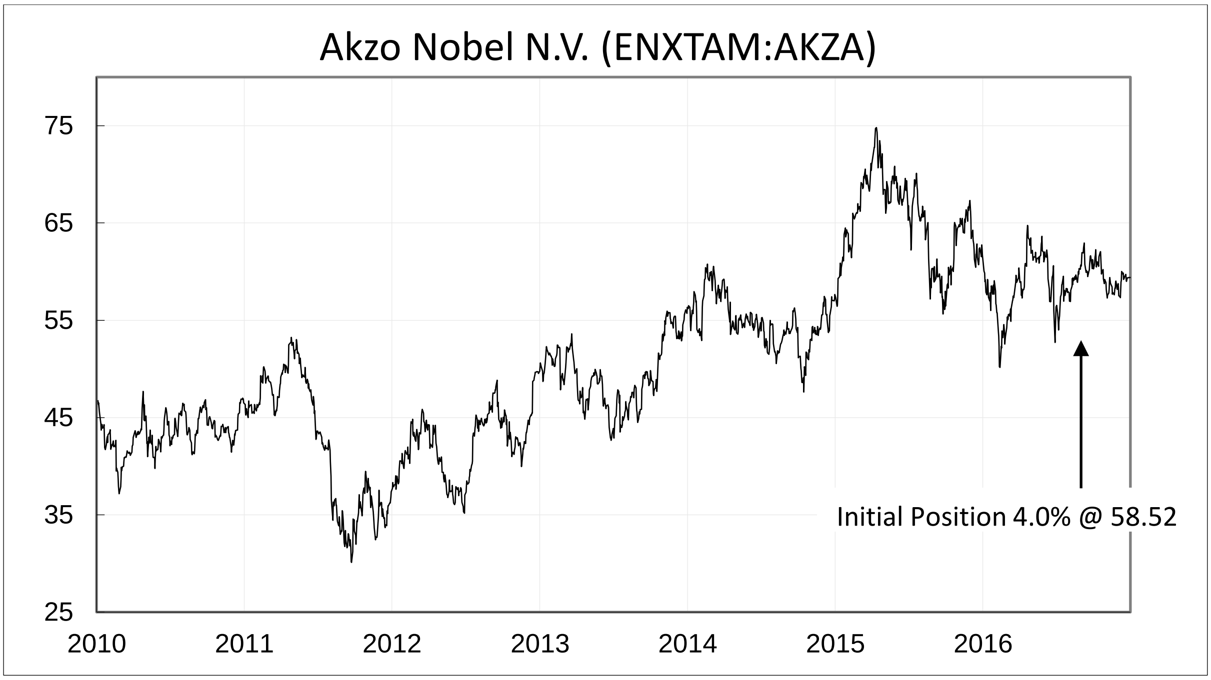


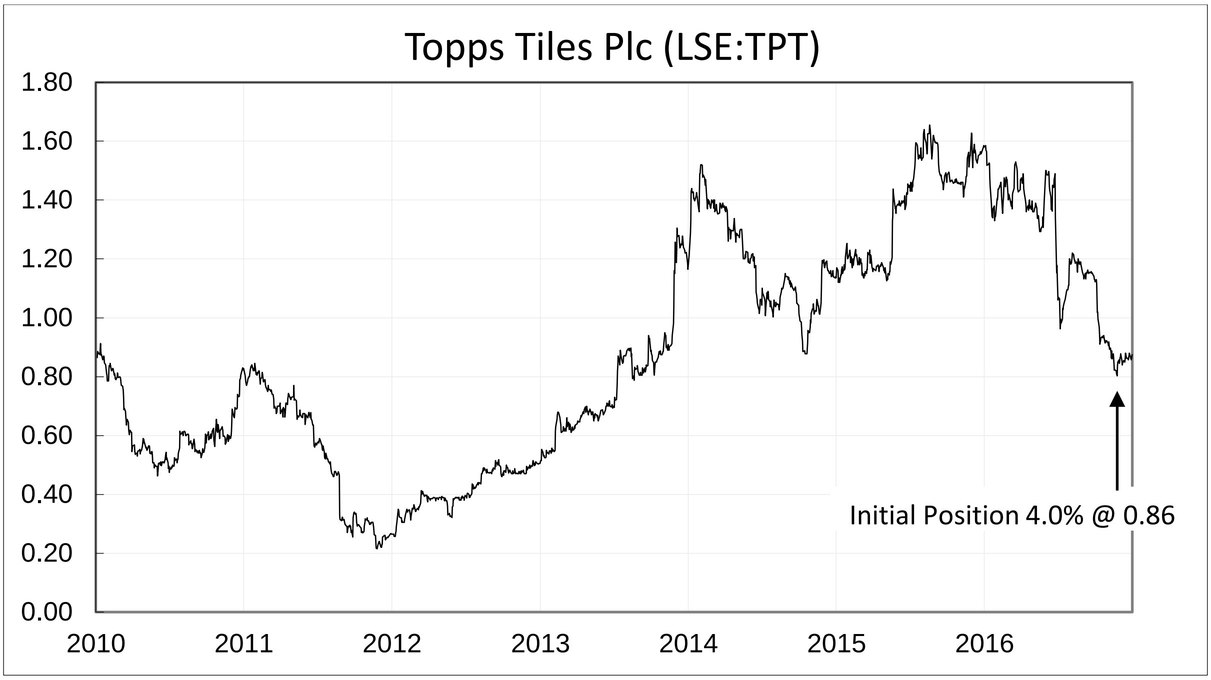
New and Existing Investments



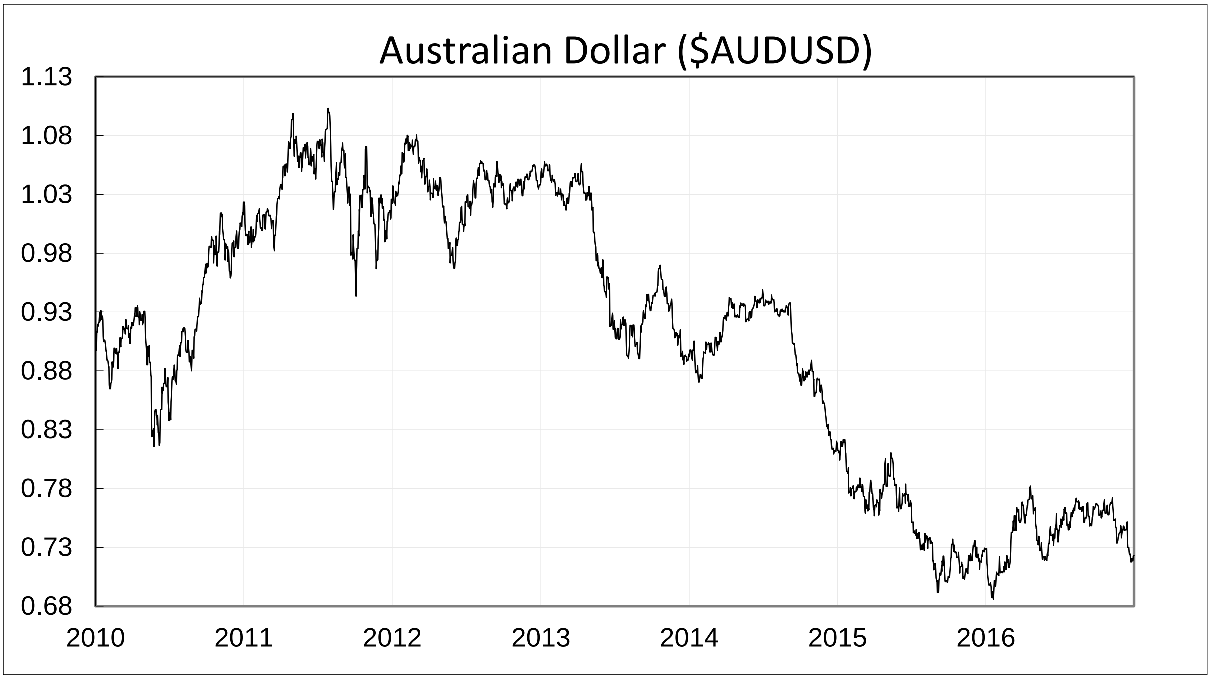


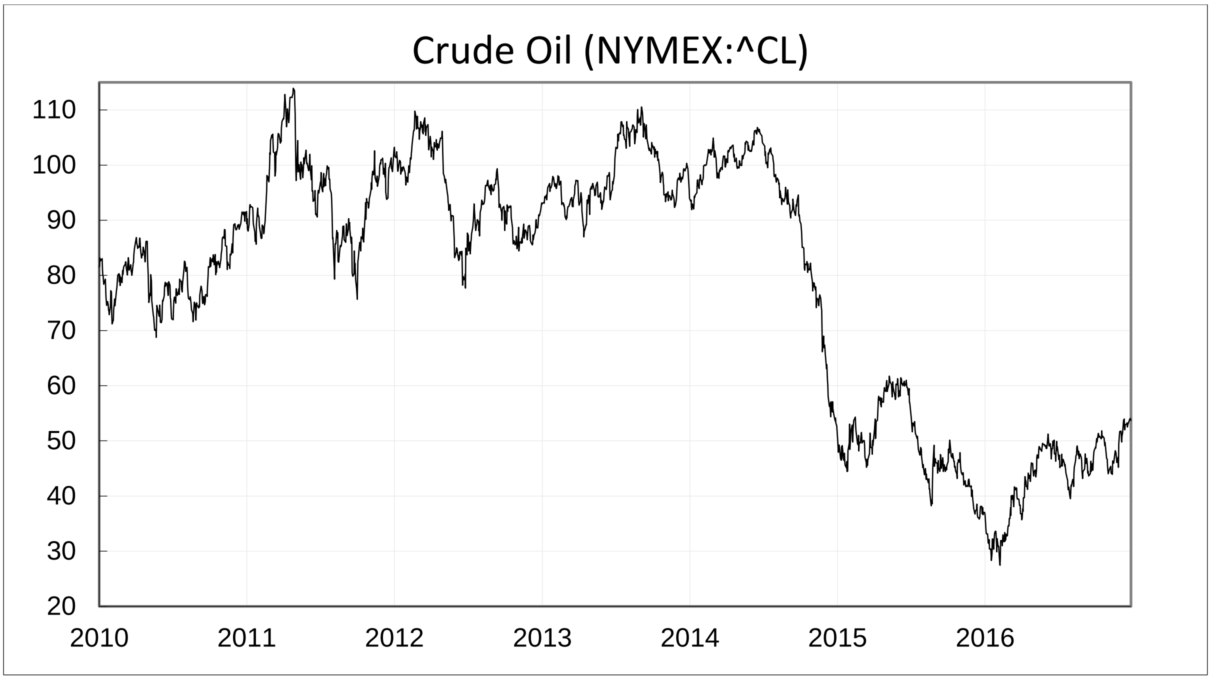

Calpine Corp(NYSE:CPN)
25
20
15
10
5
2010
2011
2012
2013
2014
2015
2016
Initial Position 3.5% @ 13.12
Exited Position @ 23.40
New Position 3% @ 14.09

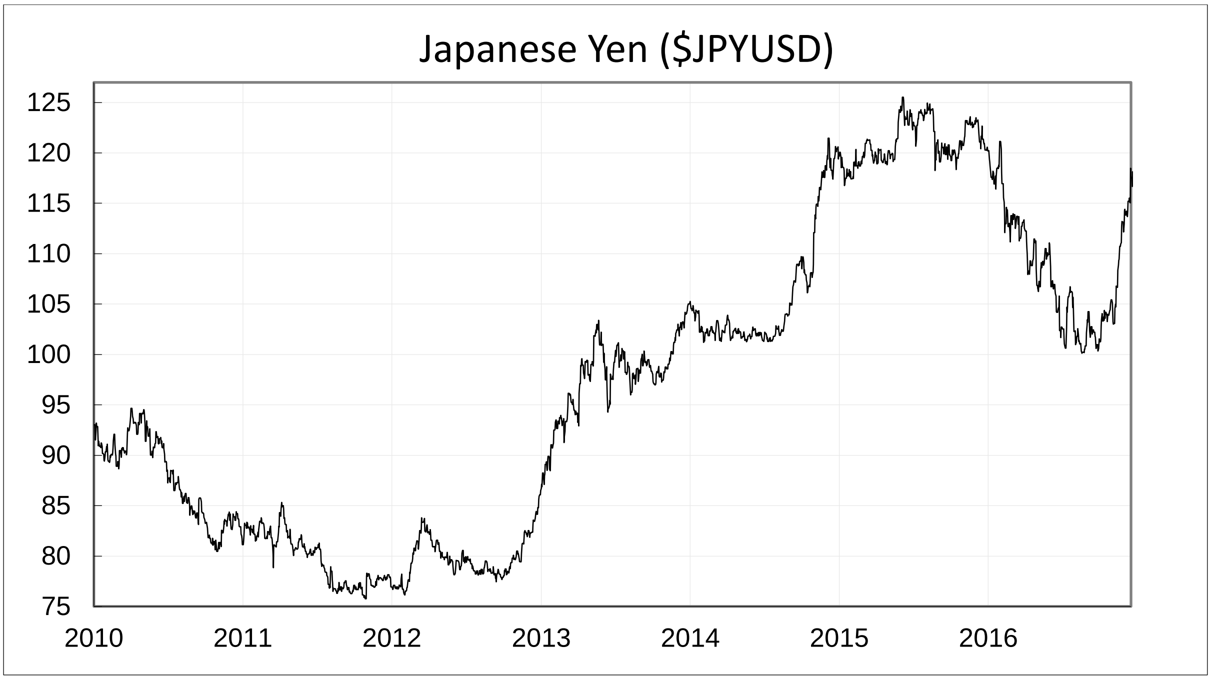

Akzo Nobel N.V. (ENXTAM:AKZA)
75
65
55
45
35
25
2010
2011
2012
2013
2014
2015
2016
Initial Position 4.0% @ 58.52


Topps Tiles Plc (LSE:TPT)
1.80
1.60
1.40
1.20
1.00
0.80
0.60
0.40
0.20
0.00
2010
2011
2012
2013
2014
2015
2016
Initial Position 4.0% @ 0.86

Macro


Australian Dollar ($AUDUSD)
1.13
1.08
1.03
0.98
0.93
0.88
0.83
0.78
0.73
0.68
2010
2011
2012
2013
2014
2015
2016


Crude Oil (NYMEX:^CL)
110
100
90
80
70
60
50
40
30
20
2010
2011
2012
2013
2014
2015
2016


Japanese Yen ($JPYUSD)
125
120
115
110
105
100
95
90
85
80
75
2010
2011
2012
2013
2014
2015
2016

Terms and conditions

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