Long Tail ASSET MANAGEMENT PTY LTD
AFSL 341 474

Annual Review: 2012

ABN 34 136 795 170 | AFSL 341 474
PO Box R 1777, Royal Exchange Sydney NSW 1225
Ph (+612) 8241 – 1000 | www.longtailasset.com

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Introduction

The fund is the primary vehicle for the investment of our capital. Its current traits are:

- Highly stock specific investments that are concentrated in our few key ideas;
- The key ideas generally relate to companies that are not well known or popular investments;
- The fund currently has a significant USD and Euro exposure as a result of individual equity investments in these geographies;
- There is a meaningful mid cap / micro cap bias to the investments;
- Managed with consideration of tax for Australian investors; and
- An outcome of the direct short and Yen positions is that the fund has a meaningful short exposure to rising interest rates.

The fund's net invested position remained relatively consistent over the year at around 60%. The gross exposure increased from 80% to 95% late in the year as a result of adding a new long investment idea and increasing the short positions. We expect these net and gross positions to be indicative of what investors should expect from the fund over time. The available cash gives us some flexibility and the concentrated nature of the individual investments means fund performance will be primarily driven by how the individual businesses perform rather than the general direction of equity markets.

Reflecting on the year, the investment landscape doesn't seemed to have changed significantly. There was generally a positive re-rating of equity investments which we think has been largely a repricing of yield rather than company specific factors or an improvement in fiscal imbalances. We believe there is still a strong degree of concern and uncertainty amongst investors but low interest rates appear to be pushing funds from money market and cash into higher yielding securities. It seems the extensive quantitative easing in the US and Europe is having its desired effect - at least on equity markets for the time being.

We are sceptical that holding the yield curve at artificially low levels will drive higher economic activity over time. We see the rate setting mechanism as creating uncertainty for individuals and businesses which is impacting their spending and investment decisions. The low level of prevailing rates also penalises individuals and businesses holding cash balances. Despite the uncertainty our preference is to own businesses ahead of cash as we perceive them as an effective asset class to manage the longer term risks of inflation and currency depreciation.

More recently, there has been significant divergence in equities performance as many high distribution/dividend paying companies have appreciated significantly and a number of large cyclical domestic focused businesses are being valued at multi year lows. We think it is reasonable for investors to prefer to own a company that is priced on a high single digit unlevered yield (EBIT/Enterprise Value) ahead of cash at current interest rates. However, this is a very different valuation metric to a highly structured or engineered dividend/distribution yield. The most significant change to the portfolio over the year was the addition of a 12.5% short position in four domestic regulated utilities we regard as being in this position. We have detailed our rationale for this investment later in the report under the section Australian Regulated Utilities. If our analysis

proves accurate, the current equity value of these businesses will materially diminish. We appreciate the yield trade but our focus is on the unlevered yield not some highly engineered or highly levered distribution yield.

Two companies owned by the fund were exposed to data security breaches during the year. In both cases the market did not react to the issues but these events have lingered with us. One company had their in store payment system hacked and the second had a data security incident where credit card details were accessed by an outside party. Both of these companies are very well established, they have each been in business for over seventy five years and receive tens of thousands of individual payments per day. A core competence for each is securing their payment systems and client details. It surprised us that such well established businesses would have these issues and at a minimum it indicates the prevalence of online theft.

In June and July we spent time in Portugal, Turkey, Austria and France. The trip included further research on a European energy / energy infrastructure related idea. The nature of the work focused on sorting through the market dynamics and companies related to the idea. While it will take more work and time before we are in a position to decide if we are prepared to invest, we consider it to be potentially a very material opportunity. The fund offering, the mandate offering and business are intentionally designed to enable and facilitate us to pursue these types of investments.

Invested Position

The fund's positioning and activities over the year are detailed in the following tables and commentary.

	Long (%)	Short (%)	Currency (%)
Australia	11%	18%	36%
United States	38%	0%	38%
UK / Europe	29%	0%	26%
Total	78%	18%	100%
Derivatives (annual cost)	2.4%	0%	0%

Notes: Totals may not add due to rounding. As at: 31-Dec-12.

Long Exposure

The fund is 78% long and invested in six discrete ideas (16 individual securities). The exposure is concentrated in the US and Europe. The two largest tenets (ideas) continue to be an investment in two US wagering businesses (19%) and an investment in three European airports (20%).

	Australia		United States		UK/Europe		Total	
	%	no/.	%	no/.	%	no/.	%	no/.
Tenet 1: US Wagering			19	2			19	2
Tenet 2: Pax Leverage					20	3	20	3
Tenet 3: Newbanco	4	1			0	1	4	2
Tenet 4			5	1	3	1	8	2
Tenet 5	7	2					7	2
Tenet 6			5	2			5	2
Other long			9	2	5	1	15	3
Gross long	11	3	38	7	29	6	78	16
Gross short	18	6					18	6
Gross invested position	29	9	38	7	29	6	96	22
Derivatives (annual cost)							2	3

Notes: Totals may not add due to rounding. As at: 31-Dec-12.

The US wagering investment has been a significant holding within the fund since its inception in April 2010. The largest holding in this idea is a 14% investment in Churchill Downs. The fund's exposure to this idea remained relatively constant throughout the year. We are attracted to the high quality racing content this business controls, the significant level of underlying land and property ownership, the high and growing cash generation capabilities, their modestly leveraged balance sheet and a management team we consider as first rate with regards to both managing the existing business and profitably reinvesting the incremental cash flows.

The fund started accumulating the European airport investments in 2010. Through 2012, the exposure to this idea increased from 12.6% to 20% at year end. The increase was primarily due to the fund acquiring a third investment in the sector. We are attracted to the airports due to their destination nature, significant control or ownership of land and property assets, their high cash generation capabilities, reasonably geared balance sheets and a positive assessment regarding management's ability to operate within the applicable regulatory framework balancing the longer term interests of their stakeholders, including shareholders. The investment in each airport is driven by company specific factors where we perceive we have a different perspective than priced into current share prices.

We regard both the wagering and airport investments as being regulated either explicitly by a stand-alone regulator or implicitly by the relevant state governments via their taxing powers. When we consider an investment in any regulated asset we regard the regulator and the relationship the operator has with the regulator and broader stakeholders as being the key issues driving longer term returns. We look favourably where we perceive there to be a constructive relationship. Conversely where we perceive this relationship has become acrimonious, we tend to regard the asset owner / operator as being in an extremely vulnerable position. Our long regulated investments fall into a category where we regard this relationship as constructive. Our short regulated investments are in areas where we perceive for various reasons this relationship has broken down and see confirmation of the regulator realigning the economics of the relevant industries.

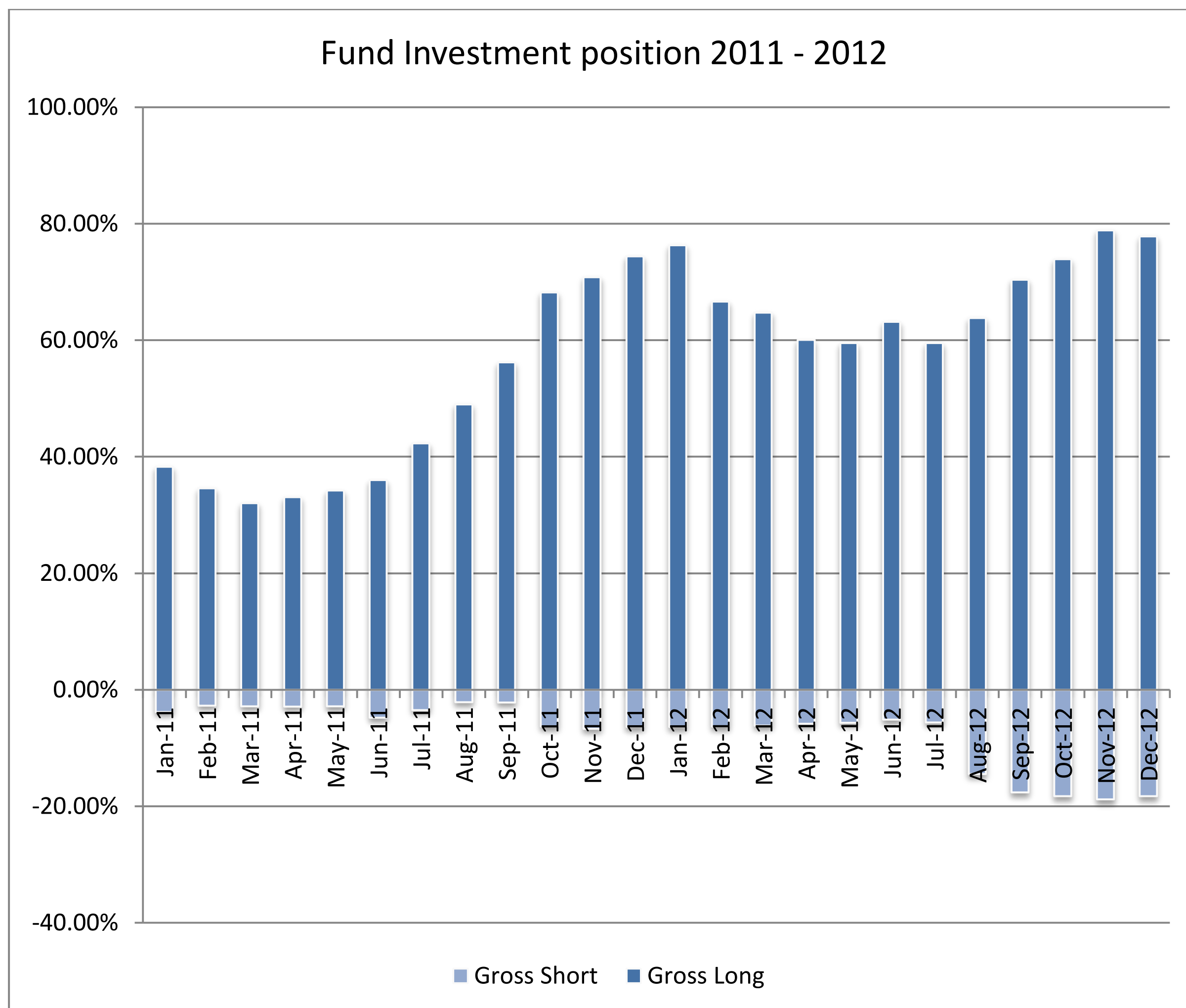
In December 2012 the fund added a new investment idea which is currently a 6.0% investment in a large capitalisation US business.

At the beginning of the year the fund was invested in five banking and financial services businesses located in Australia, the United Kingdom and the United States. The investment was based on a view these businesses were strongly capitalised and well positioned to organically win market share. We called the tenet Newbanco. By year end the fund's exposure to this idea had reduced from five investments and 18.2% to two investments and 3.9%. The reasons behind this change were company specific. We sold the investment in Bankunited in February 2012, shortly after management announced they were exploring the sale of the business. We viewed a corporate sale at this point in the businesses evolution as being inconsistent with our investment thesis (the position was sold at a loss of 5.1%, costing the fund 15 basis points). The second investment we sold was an investment in a large cap Australian financial services business. At its peak this investment was approximately 10% of the fund's capital. We started selling the position in February 2012 and had completely exited by the end of April 2012. We sold the position as we came to the view the success of the business was probably more reliant on the general economic environment than we desired (the gain on the investment was 13.5%, contributing approximately 1% to the fund's performance). The third investment we sold was a relatively minor position which we exited at a small profit.

In addition, the fund progressively sold its 4.3% investment in Semgroup during March and April 2012. The investment in Semgroup was described in our 2011 annual review. As its share price appreciated towards $30 we viewed the risk reward less favourably. In particular, we were concerned about the potential for increased regulatory scrutiny on the White Cliffs pipeline and the

oil storage capacity situation in Cushing. The fund realised a gain of 32% on this investment and it contributed approximately 1% to performance.

The “net exposure” of the fund was reasonably consistent through the year at around 60%. The “gross exposure” has more recently increased towards 95% as a result of an increase to the short exposure and a new investment idea being added to the long exposure.



Notes: As at: 31-Dec-12.

We regard the fund’s net and gross exposures over the year as being indicative of what investors should expect longer term. Internally we are focused on the gross exposure and this is particularly relevant today given the nature of the fund’s short positions. The shorts include a large (12.5%) exposure to the domestic regulated utility companies. These investments are generally perceived as defensive by the market and highly sought after for their distribution yield. Recently these companies have been well supported through periods of general market weakness. We focus on the gross exposure because the shorting activities are not intended to hedge the long exposure, rather we are shorting because we expect to make money from the positions regardless of the performance of the broader markets. The risk the fund carries is we get the shorts wrong, in which case the fund is effectively 95% invested (i.e. the gross exposure), not 60% as the net exposure would suggest.

The breakdown of market capitalisation exposure of the fund is presented below. The micro cap exposure is comprised of three investments in Australia and two in America. We thought this characteristic of the fund was worth explicitly highlighting. We do not actively seek investments in the micro cap space. Often we will take a precursory look at micro cap companies as we are doing background research for other investments we own or are interested in. Sometimes we identify something we think is interesting in its own right in an area we feel we have some insight. Often these businesses are under researched and the market does not tend to positively re-rate them until the opportunity is very apparent. However, given their size they tend to have less resources to manage unexpected problems when they arise.

	Long (%)
Large capitalisation (Greater than $3 billion)	28%
Mid / small capitalisation ($100 million to $3 billion)	30%
Micro capitalisation (Less than $100m)	19%
Total	78%

Notes: Totals may not add due to rounding. As at: 31-Dec-12.

Short Exposure

The gross short exposure is 18% of the fund's capital, comprised of six Australian based large and mid capitalisation companies. 12.5% of the exposure is focused on four regulated utilities. The balance of the exposure is in two highly rated large capitalisation industrial businesses. The short exposure has increased significantly through the year, primarily due to the addition of the regulated utilities.

Currency Exposure

Currency exposures resulting from the offshore investments are largely unhedged. The US dollar exposure is unhedged. The fund does own a significantly out-of-the-money AUD / Euro call option which is intended to provide a degree of insurance should the Euro be materially devalued against the AUD.

Derivatives

At year end there were three derivative positions in the fund.

The most significant exposure is the Yen / USD put options. Our thinking around this position has not changed over the year and we have rolled this exposure as the various contracts have expired. The position is premised on concerns around the solvency of the Japanese Government. The effect of this position is the fund has a material exposure to a rapid depreciation of the Yen against the USD. The cost of the exposure is limited to the cost of the options (approximately 2% per year) and the size of the face value of the contracts is meaningful in the context of the fund. The primary drawback of the structure is it requires a rapid devaluation of the Yen to be highly profitable, rather than a slow grinding move more typical of the large currency blocks (which includes the Yen). Recently, the Yen has noticeably declined in value against the USD. The fund's position is designed to capitalise on a more significant depreciation of the Yen which we expect to occur if there are genuine concerns around the Government's solvency. We expect this weakness would coincide with a sharp selloff in both the Japanese bond and equity markets as capital flees Yen denominated assets. To date, there

has been no real confirmation of this capital flight. Rather we view the recent moves as being modest weakness in the Yen, modest weakness in the Government bond markets and strong appreciation in the Japanese equity market as investors move to build positions in the exporters.

The second derivative position is the AUD / EUR call option (as described above).

The third derivative position is a put option in the same business where the fund has a short position. The intent of this position is to increase the fund's exposure to this company should its share price fall. The cost to the fund of the derivative was about 9 basis points and its effect is to increase the fund's exposure to this company to 8.5% from the current 4% should its share price fall sharply.

Australian Regulated Utilities

The fund is short a number of Australian regulated utilities. The rationale for these positions reflects the fundamental change currently occurring in the Australian regulatory environment and our scepticism on their underlying cash generation.

Regulatory Environment

For regulated assets it is the regulatory allowances and returns that drive the earnings, cashflow and economics of the business. These parameters are currently primarily determined by the Australian Energy Regulator (AER).

The AER uses the building block approach to regulation that is widely applied throughout the United Kingdom, Europe and Australia to regulate the earnings of utilities. The approach enables utilities to earn a return on capital (debt and equity) plus recover operating expenditure (opex), depreciation and other items (for example, tax, working capital, etc). The sum of these items is the revenue allowance from which the utility pays its expenses with the residual being the earnings available to equity.

We believe under the building block approach, with an effective regulator and regulatory framework, utilities should be valued at close to their regulated asset base or RAB (the RAB is the amount of capital on which a utility earns a return). Under this framework the utilities are being appropriately compensated and incentivised to maintain and expand their networks and shareholders receive an appropriate return for their investment.

The regulation of Australian utilities has undergone considerable change over the past 5 or so years as a result of regulation moving to a national level and rule changes. This has lead to a favourable environment for utilities.

We believe that this environment is in the process of changing and see confirmation of a move to more effective regulation going forward. Some investors and utilities fear any change will lead to a fall in investor support and the utilities are threatening lower network investment. We regard this as a tenuous threat and see the central issue as current valuations are high and balance sheets significantly leveraged, meaning that more effective regulation could materially impact utility shareholders.

While regulatory change is evident in the building political pressure and press articles, we want to refer to some specific aspects:

- The Australian Energy Market Commission (AEMC) has recently modified the framework to be used by the AER to regulate utilities. Previously utilities were able to use the rigidity and other aspects of the rules leading to attractive returns. We see this as untying the AER's hands and giving it the flexibility needed to operate effectively. This new framework will take time to implement but is an important step in the future regulatory environment;

- The recent decisions issued by the AER (for example, Brisbane to Roma Pipeline final, Victorian gas distribution draft, South Australian electricity transmission draft) have clearly

shown lower future utility returns (without the benefit of the AEMC changes referred to above). In particular:

  - Lower allowed returns on capital (or WACC): A large part of this reduction is not really a change in AER attitude but a reflection of the fall in the long term Australian government bond rate from 5-6% in prior regulatory determinations to around 3% today. The utilities recognise the impact this move will have on their businesses and have proposed a range of arguments to justify a higher allowed return – we see these arguments as tenuous and to date they have been resisted by the AER. Some utilities respond to this lower return by threatening to reduce capex, however, they need to be very mindful of their license and other conditions. We believe there are aspects of the WACC that continue to be very generous, especially the cost of debt allowance which continues to be materially above recent refinancing benchmarks;

  - Tougher opex allowances: Some utilities are spending much less on opex than allowed by the regulator (they have been able to pocket this saving). This benefit will end with the start of a new regulatory period as the opex allowance is rebased;

  - Realignment of volumes: Some utilities have benefitted from higher volumes than previously forecast by the regulator which has enabled higher revenues. This benefit will end when volumes are rebased;

  - Capex allowances: The Victorian gas draft decisions have severely cut back capex plans to address concerns regarding gold plating of assets; and

  - Regulatory depreciation: We note that in some cases the utilities have requested very high regulatory depreciation allowances which to date have been rejected by the AER. While the motivations for such requests are unclear, it may be an attempt to prop up near term revenue and cashflow;

- Reflecting community and policy maker concerns, there are a plethora of government and other reviews being conducted or recently completed which will impact utility regulation. They include the limited merits review, productivity commission inquiry into electricity network regulation, Senate Select Committee on electricity prices, transmission frameworks review, and others; and

- Serious questions are being asked about the role of the AER including its future as part of the ACCC, recruitment and training, etc.

But it is not all bad for the regulated utilities. In particular:

- The recent AER Victorian gas distribution decisions are still draft. While we expect the final decisions to be an improvement on the draft, we still expect material deterioration from the current determination;

- The reduction in bond rates will enable some utilities to re-hedge their interest costs at lower rates. This will provide assistance to maintain current distribution levels. Although it will be interesting to see the extent of the interest saving given prior hedge levels and margins;

- The draft decisions to date relate to only part of the utilities businesses and it will take time to roll out across all their assets; and

- The utilities can hope that bond rates go back to 5-6% in the very near term, leading to the AER increasing the allowed return.

In our mind the regulatory environment is deteriorating from a highly favourably level which has enabled attractive returns. While the impact of the recent Victorian gas draft decisions varies by asset and it is hard to be definitive, our analysis suggests at least a 15% reduction in asset EBITDA and in some cases much more. For one asset the reduction in EBITDA is more than 30%.

This is an important shift for asset and capex heavy businesses that have highly leveraged capital structures and tight distribution payout ratios. Moreover, investor search for yield has pushed valuations to 1.2-1.3 times RAB. There are precedents where a deterioration in the regulatory environment has lead to regulated utilities trading at or below 1 times RAB (for example, refer to UK experience in the early 2000s). If this precedent were to repeat here and RAB multiples fell from 1.25 to 1.0 times (assuming leverage is 80% of RAB), utility equity prices would fall more than 50% from their current level.

Maintenance Capital Expenditure and Cashflow

Maintenance capital expenditure (capex) is often an amount disclosed by utilities when showing the cash generation of their businesses (directly or indirectly). For example, operating cashflow pre interest and tax (or EBITDA as proxy) less maintenance capital expenditure less interest paid less tax paid shows the free cashflow generated by the business. Often this cashflow waterfall is used when presenting the free cashflow available to pay distributions and to make a contribution to funding expansion capex. It is important to investors as it goes to whether the capital structure and distribution is sustainable.

When we see the term maintenance capex we think of it as the essential capital expenditure required to maintain the existing assets so they can operate efficiently and generate cash into the future.

Our scepticism arises with the level of maintenance capex being communicated by some companies. From what we can tell maintenance capex is not an audited amount and typically is disclosed in result presentations.

We have seen maintenance (or stay in business) capex amounts as low as 0.6% of the written down value of ageing plant and equipment. We struggle with the credibility of such a low amount. This implies that $1,000 million of written down value of relatively aged plant and equipment requires maintenance capex of a meagre $6 million per annum.

Keep in mind that the utilities the fund is short have large regulated businesses and the building block approach outlined above is important to understanding the economics of a regulated business. One of the building blocks is the RAB (recall that the RAB is the amount of capital on which a utility

earns a return). Over time the RAB value increases with capital expenditure and inflation (the RAB can be indexed to inflation) and decreases with regulatory depreciation.[1]

If we are to accept that maintenance capex is 0.6% of the written down value of plant and equipment (an amount a fraction of the regulatory depreciation) and feed this into the RAB calculation as the capex, the RAB would decline (dramatically) in fairly short time which would quickly undermine the earnings power of the business. In effect, the maintenance capex cannot be right in both senses – i.e. it cannot be used to prop up the appearance of cashflow without recognising the impact it has on the RAB and future economics of the business.

The approach we have taken is to consider the regulatory depreciation amount which is used in the RAB calculation and to use this as a proxy for maintenance capex. Hence, for the regulated utilities to keep their RAB constant (in real terms), maintenance capex needs to equal regulatory depreciation. In this sense the economics of the business is maintained.

Some regulated utilities have used a similar approach to us, and use regulatory depreciation as a proxy for maintenance capex in the cashflow waterfall. However, they have made an adjustment - from regulatory depreciation they have subtracted the RAB inflation indexation amount to derive "net" regulatory depreciation. We do not believe in this approach as it results in the RAB declining in real terms (thereby eroding the real value of the asset), versus our methodology which maintains the RAB in real terms. This is an important issue as regulatory depreciation (without inflation deduction) is approximately double "net" regulatory depreciation (with inflation deduction).

What we found is that the regulatory depreciation amounts are typically materially larger than company stated maintenance capex. In some cases the regulatory depreciation is multiples higher. When we use regulatory depreciation as a proxy for maintenance capex in the cashflow waterfall and in the context of the deteriorating regulatory environment, we found a very material negative impact on valuations, distributions and capital structure sustainability.

Conclusion

The issues we are concerned about regarding regulation and maintenance capex are both very material in our minds. Some utilities appear highly susceptible to these circumstances given their high valuations, highly geared capital structures and high distribution payouts.

[1] While regulatory depreciation is added to the building block revenue allowance, it is subtracted from the RAB (a return of capital).

The Wendy's Company

Five percent of the fund's capital is invested in The Wendy's Company (Wendy's). Wendy's is the third largest quick service restaurant (QSR) company in the hamburger sandwich segment globally (McDonald's is the largest). The business has 6,543 restaurants of which 1,447 are company owned and 5,096 are franchised. The company owns the underlying property of approximately 700 restaurants.

The fund started accumulating this position in October 2011 and has added to the holding periodically. The fund's average cost is $4.68.

We regard the investment opportunity in Wendy's as a longer term business reinvigoration opportunity. We believe Wendy's holds a uniquely positioned brand and provides a differentiated higher quality food offering. We view these characteristics as strong enough to reinvigorate the core operations and provide a viable platform to profitably extend the business into a national breakfast offering, international markets and underpenetrated areas of the US market.

Wendy's was founded in 1969. Its offering is generally well known in the US because of the prevalence of its restaurants and the prominent media profile its founder Dave Thomas built as the company spokesperson in various television commercials until he passed away in 2002. We have been familiar with the business since 1990, initially as consumers and then as financial analysts observing its (then) seemingly unstoppable financial and share market progress. Wendy's was successful because of the higher quality of its food offering and its ability to innovate relative to its peers.

As the chart below illustrates the share market performance of the company was very strong until 2006. Initially this performance came from the strong performance of the core Wendys' offering. However, from 2005 their sales and operating performance declined markedly. Nevertheless, the share price continued higher as investors were attributing significant value to Tim Hortons, a Canadian based coffee and baked goods business that Wendy's spun out in September 2006.

It strikes us as odd to drive past QSRs in the US and see lines of cars waiting at Burger King and McDonald's drive throughs for their breakfast and coffee and then to drive past a Wendy's that is invariably closed. We think Wendy's is interesting because they have no national breakfast offering, an extremely underdeveloped level of international operations and market positions that are under-represented in some areas of the US. To some extent we consider the company has an obvious road map of opportunities looking forward and a brand and food offering that will ultimately enable them to expand into these areas. The key issue in our mind is the performance of the core existing operations since 2005 and an assessment of whether there is a structural problem or if it can be reinvigorated. If the later, there is a significant investment opportunity.

Wendy's motto of "A Cut Above" is consistent with where we perceive their brand and food offering to sit amongst their QSR peers. These observations are supported by various industry surveys. Despite these seemingly positive traits, we consider that the operating performance of the business has been mixed to poor from 2005 until 2010. Over this period, Wendy's has generated volatile and often negative same store sales performance and variable earnings contributions.

	2005	2006	2007	2008	2009	2010	Cumulative
North American system wide same store sales	-3.2%	0.6%	1.3%	1.0%	-0.7%	-0.6%	-1.7%

Wendy's performance sits in stark contrast to the sector and particularly McDonald's, which has realised significant success via improving the quality of its food offering, improving its service and restaurants, innovating across menu options, establishing a breakfast offering (now accounting for 25% of revenues) and leveraging its business model into offshore markets. Accordingly, Wendy's enterprise value has languished at around $3 billion which contrasts to McDonald's at around $100 billion and Burger King around $8.5 billion.

We consider the QSR sector as being low margin, high volume and generally a capital intensive industry. There is also the need for consistent menu innovation and promotions to keep the offerings fresh and front of mind for consumers. The franchisor also needs to maintain an economic balance that is sustainable for both them and the franchisees. Given the nature of the business we feel the quality of management can make a big difference to the profits shareholders ultimately earn. It is certainly not the sort of business that can just be left to run itself. When we looked at the troubles Wendy's had encountered since 2005, we felt the issues were more around execution and our impression was that Wendy's did not really move forward in comparison to their peers. The food seemed consistently good, the restaurants while clean and functional felt dated, and our impression was there didn't seem to be successful innovation in their menu. Our view was Wendy's continued to do what they had always done well but the market was getting more competitive and their competitors were improving. Given the nature of the business these missteps were magnified through their operating performance.

We started to take a closer look at the business early in 2011 when the company began to post positive same store sales numbers. We saw this as an encouraging initial sign, and this has continued for the last six quarters. It is still very early days in our minds, but we regard this recent trend as encouraging.

Year ending		Q1	Q2	Q3	Q4	FY
1999	Company	9.9%	8.3%	7.1%	6.4%	7.9%
	Franchised					
	Systemwide					
2000	Company	3.5%	2.8%	2.8%	3.2%	3.1%
	Franchised					
	Systemwide					
2001	Company	1.4%	2.8%	1.6%	2.4%	2.1%
	Franchised	1.1%	3.1%	2.3%	3.6%	2.6%
	Systemwide					
2002	Company	5.6%	6.6%	5.0%	1.0%	4.7%
	Franchised	8.1%	9.5%	7.8%	3.0%	7.1%
	Systemwide					
2003	Company	-3.1%	-2.3%	0.5%	8.6%	0.9%
	Franchised	-1.7%	-2.0%	0.9%	7.6%	1.1%
	Systemwide					
2004	Company	9.1%	5.9%	2.0%	-4.3%	2.9%
	Franchised	7.6%	3.7%	0.9%	-4.0%	1.8%
	Systemwide					
2005	Company	-2.2%	-4.6%	-5.0%	-2.9%	-3.7%
	Franchised	-1.0%	-3.9%	-5.6%	-1.9%	-3.1%
	Systemwide					
2006	Company	-4.8%	0.7%	4.1%	3.1%	0.8%
	Franchised	-5.2%	1.0%	3.9%	2.7%	0.6%
	Systemwide					
2007	Company	3.8%	0.7%	0.2%	-0.8%	0.9%
	Franchised	3.7%	0.4%	1.3%	0.2%	1.4%
	Systemwide					
2008	Company	-1.6%	0.1%	-0.2%	3.6%	0.5%
	Franchised	-0.1%	0.8%	0.2%	3.8%	1.2%
	Systemwide	-0.4%	0.7%	0.2%	3.7%	1.0%
2009	Company	0.3%	-1.2%	-1.4%	-4.1%	-1.7%
	Franchised	1.2%	-0.1%	0.4%	-2.6%	-0.3%
	Systemwide	1.0%	-0.4%	-0.1%	-3.0%	-0.7%
2010	Company	0.2%	-2.9%	-3.1%	-0.9%	-1.7%
	Franchised	1.0%	-1.4%	-1.3%	0.6%	-0.3%
	Systemwide	0.8%	-1.7%	-1.7%	0.2%	-0.6%
2011	Company	-0.9%	2.3%	1.8%	5.1%	2.0%
	Franchised	0.4%	2.3%	0.7%	4.2%	1.9%
	Systemwide	0.1%	2.3%	0.9%	4.4%	1.9%
2012	Company	0.8%	3.2%	2.7%		
	Franchised	0.7%	3.2%	2.9%		
	Systemwide	0.7%	3.2%	2.8%		

What really got us engaged in Wendy's as a prospective investment was the approach the new management team led by Emil Brolick was taking to drive the business forward. They have clearly identified the need to reinvigorate their existing North American operations as the priority. They see an opportunity to revive an iconic brand whose problems since 2005 have been self inflicted. The strategy they have enunciated involves a significant capital program of refitting existing company owned restaurants, lifting the bar on employees and service, revisiting their pricing levels and putting more resources behind their advertising and marketing initiatives. As they are getting confirmation of the sales uplift from the new stores they are accelerating their capital spend into the store refit program and encouraging franchisees to do the same. The aggressiveness they are approaching this program with is more typical of an owner operator or private equity environment.

The path they are taking the business forward in resonates strongly with us because it is aimed at addressing the crux of what we suspect are the problems within the business. We also appreciate their directness and transparency as they align the organisation towards what is important and set a clear benchmark for accountability. We suspect it would have been easier and more palatable to shift their focus towards building a national breakfast offering or getting more aggressive in international markets but without fixing the core ultimately this would have just proved a short term fix. The approach they have taken sits consistently with our view of the brand and the longer term opportunity for the business. If they can revive the core operations then they have a truly unique and enviable base to leverage into these related areas.

We consider the risks of the fund's investment in this company to be relatively high - there are multiple execution risks, we have acquired the position at a point where the capital expenditure program is ramping up and there is just tepid confirmation of the returns from this spend. We regard the risks as worth taking because of the nominal enterprise value of the business and our regard for the brand. We also feel there is a management team and shareholder base that is aligned with realising this reinvigoration. If our thesis is right this will be evident initially through an improving trend in the company's same store sales followed by improving earnings and cash flow. Given the nature of the business this dynamic will be sustained for many years as they initially drive more activity and better returns through their core operations and subsequently leverage this footprint into a national breakfast offering and international rollout. Should our view prove correct, the business will be worth many multiples of its current $3 billion enterprise value.

Investment Results

The following table summarises the fund's results since inception.

Financial Year	2010	2011	2012	2013
July		1.14%	-1.95%	-3.06%
August		-0.33%	-0.32%	0.45%
September		0.60%	-2.18%	1.89%
October		2.12%	0.83%	1.30%
November		0.47%	-1.22%	-2.46%
December		-0.24%	0.27%	6.93%
January		0.31%	0.84%	
February		1.78%	0.02%	
March		1.06%	5.59%	
April	0.04%*	-1.94%	1.62%	
May	-0.78%	1.01%	-0.37%	
June	-0.76%	-0.70%	-2.58%	
Financial Year	-1.49%	5.33%	0.29%	
Calendar Year		-3.10%	10.12%	

During calendar 2012, the long investments positively contributed 15% to performance. The US wagering tenet contributed 3.5%, the European airports passenger tenet 4.5% and the Newbanco tenet 2%. The micro cap investments also positively contributed, although month to month they showed volatility. Wendy's was the only significant long investment that detracted from performance costing the fund less than one-half percent.

The short investments cost the fund 2% for the year. One short position cost the fund 1% - the fund has been short this company since April 2010 and since that time the fund has realised a positive return from the investment, however, frustratingly, the losses in 2012 largely offset earlier gains. The regulated utility shorts cost the fund 1%. We significantly increased and broadened the regulated utility short positions in August and September.

The derivative positions cost the fund 1.5%. The Yen option positions cost less than 1% and the balance came from put option positions intended to offer some broader downside protection (from time to time the fund will acquire short dated well out-of-the-money put options to hedge a significant portion of the fund's gross long exposure. We tend to enter these positions around result announcements, dividends and similar).

Given the concentrated nature of the fund we continue to expect greater volatility in the unit price than has been exhibited to date. When we look at the underlying attribution of the monthly returns there is often considerable volatility at an individual security level, however to date, there has been positive and negative movements that have largely offset each other. The outcome has been a monthly unit price that has been more stable than we would anticipate. We wanted to explicitly

highlight this view, as we think it is a mistake to look at the relatively low realised volatility and consider this to be a likely characteristic of the fund longer term.

Mandates

The structure of our mandate offering is designed to enable investment in the few discrete large capitalisation ASX listed ideas we identify. Since we formed the business we have had two ASX large capitalisation investments. The performance and characteristics of these investments is shown below.

	Start date	End date	Realised IRR - Annualised	IRR - ASX 200 Accumulation Index	Characteristics
Mandate 1	April 2010	June 2011	24.5%	9.0%	• Two investments focused on a single idea • $9 billion combined market capitalisation • Capacity to invest up to $750m • Gaming and wagering sector
Mandate 2	June 2011	April 2012	15.3%	5.3%	• Single investment • $10 billion market capitalisation • Capacity to invest up to $1 billion • Banking and financial services sector

Over the year we exited “mandate 2”. This investment was in a large cap financial services organisation. The investment realised an annualised IRR of 15.3% versus the ASX 200 Accumulation index return of 5.3%. We sold the position as we saw the investment being more reliant on general market conditions than our initial thesis.

We regard the mandate offering as being appropriate for large domestic investors that are seeking a concentrated exposure to the ASX large capitalisation ideas we identify, without this exposure being diluted by diversification or business risk considerations.

Please contact us if you would like to discuss our mandate offering in detail.

Summary

We think of the business as an investment partnership. We are significant investors in the fund and our focus is to invest our personal capital through the fund. Our clients are effectively investing their capital alongside ours. We feel this genesis and focus stops us drifting towards a broader more mainstream style of investment and portfolio offering.

We feel the investment risks we take are primarily company specific risks rather than general equity market risks. Likewise the returns we generate are a function of the performance of the underlying companies we invest in more so than the broader markets. We are quite uncertain about the economic outlook longer term but despite this uncertainty our preference is to invest our capital into businesses where we can generate reasonable absolute and inflation adjusted returns.

Please contact us if you would like to discuss investing with us.

Best wishes for the year ahead.

Miles Webster and Nigel Trewartha

January 2nd, 2013

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