Annual Review: 2013

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Introduction

I was walking through the Sydney CBD in late December and bumped into an experienced and savvy investor who I have been aware of for the best part of twenty years and known for the last ten. After exchanging the customary seasonal pleasantries he enquired about how we are going. Without thinking too much I responded along the line that I feel like the few investments we have made have been good, the focus now though is really on what we are going to do next. He responded, well yes that is the exciting part. I was a bit taken back by this comment, I would describe it as agonising, rather than exciting; but the more I reflected on his sentiment I think it probably does offer a perspective that captures where we sit.

Today our assessment of the investment landscape is:

- There is limited valuation support and a low margin of error investing broadly in equities;
- Technology is increasing transparency, reducing barriers to entry and ultimately improving price for consumers. It is hard to pick the few winners and it is probably more important to avoid the many losers;
- Interest rates are being managed at artificially low levels by governments aggressively trying to stimulate economic activity;
- A likely outcome of the aggressive stimulus policies is a loss of purchasing power in fiat currencies. We are not concerned about traditional demand led inflation due to a scarcity of assets, rather our concern relates to an environment where prices of real assets are increasing due to a reduction in the value of cash. We regard longer term sustained stimulus programs as being akin to a tax from the perspective of the private sector; and
- Volatility is likely to increase as a result of the observations above.

The points above are not unique to us. What we are trying to do in this environment is:

- Own businesses that are difficult to displace and will remain relevant longer term regardless of the environment. Businesses with a degree of pricing power have a chance to absorb and offset the loss of purchasing power of cash and generate adequate real returns for their owners;
- Use periods of market weakness to reinvest our available capital into the operating businesses we want to own longer term; and
- Maintain our investment discipline regarding business understanding, insight and confirmation of this insight. We need to be clear on the opportunity we perceive to exist. We think the risks are too high of investing in more marginal investments and hoping a rising market does the work for us.

Our combination of personnel, experience, flat decision making structure, alignment of interests with our investors and a freedom to invest in an unencumbered manner is unique. We don't think there are any easy answers about where to invest capital today but we do feel we have the freedom, experience and platform that enables our longer term success to be a function of our ability rather than the environment. We think that autonomy is exciting. Maybe that is what this experienced investor was getting at a week or so ago.

Fund Positioning

The fund is concentrated in five discrete investment ideas. Three of these are long investments, one is a short investment and the fifth is a series of Yen/USD put options:

- The three long investment ideas are US wagering (2 positions, 11%), European airports (2 positions, 12%) and an undisclosed tenet (2 positions, 8%). We have previously provided detail on the US wagering investments and below we provide further detail around the European airports;
- The short investments are four Australian utility companies (7%) where we regard the regulatory risks as higher and the cash generating capabilities as lower than their valuations reflect. Our views were detailed in the 2012 Annual Review; and
- The fund continues to hold Yen/USD put options to reflect our view on the Japanese government's solvency position.

The table below provides more detail on the fund's positioning.

	Australia		United States		UK/Europe		Total	
	%	no/.	%	no/.	%	no/.	%	no/.
Tenet 1: US wagering			11	2			11	2
Tenet 2: European airports					12	2	12	2
Tenet 3: Not disclosed			8	2			8	2
Other long	5	1	4	1	4	2	13	4
Gross long	5	1	23	5	16	4	44	10
Gross short	7	4					7	4
Gross invested position	12	5	23	5	16	4	51	14
Derivatives (annual cost)							3	4

Key activity in the fund during 2013 included:

- We narrowed the focus of the long investments. In particular, we exited a number of holdings that appreciated to our assessment of fair value, and reduced the size of some other holdings as they moved closer to fair value. The gross long exposure was reduced from 78% to 44% and number of positions from 16 to 10 (refer table below);

	31 December 2012	31 December 2013
Gross long exposure	78%	44%
Number of long tenets	6	3
Number of long investments	16	10

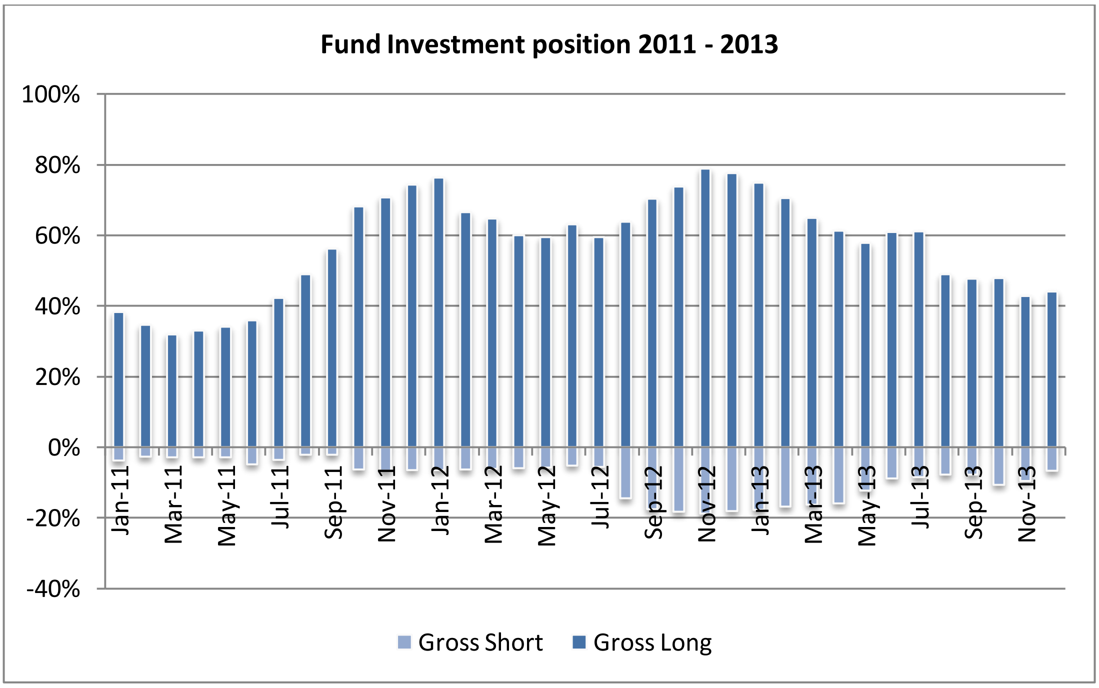
- We established a position in one new long investment idea, Tenet 3 (2 positions, 8%). We have not disclosed the detail of these two companies as we seek to add further to the current positions. We also view this tenet as a co-investment / mandate candidate;
- We maintained the short position in four domestic regulated utilities. The share prices for two of the companies are down slightly and two are up slightly over the past year. We think

this is encouraging given the general appreciation of markets in 2013, prospective corporate activity and the strong appetite of investors seeking yield orientated securities; and

- We maintained the fund's exposure to our view of the Japanese government's solvency position. The structure of the position is intended to capitalise on a sharp depreciation of the Yen/USD. We have continued to roll the exposure in varying forms, limiting the cost to 2% of the fund's capital per year. While the Yen/USD fell approximately 20% over the year, this was primarily driven by the Bank of Japan's very loose monetary policy rather than solvency concerns (although the two are linked). If our thesis proves correct, we expect to see materially more weakness in the Yen/USD, along with weakness in the Japanese bond and equity markets as capital flees Yen denominated assets.

The monthly gross long and short progression of the fund over the past three years is detailed in the chart below.

We expect the fund's investment position to remain consistent with the ranges exhibited over the past two years. We consider that the fund's returns are generated from the key investments more so than the direction of markets. If we identified additional investments we viewed as compelling, we would invest capital in them today. In the meantime, we are content to be patient rather than chase marginal opportunities.



The fund's positioning carries various risks. These include company specific risk, which arises directly from the concentrated long and short equity investments, and "resultant risks" (e.g. liquidity, currency and general equity risks) that arise as a consequence of the equity investments. We think about these various risks as follows:

- We are comfortable taking company specific risk. Our due diligence process seeks to understand and assess these risks before establishing a position. Moreover, we try to size initial positions appropriately for the company specific risks we perceive and are subsequently conscious of not adding capital to investments that are weak after we have acquired the initial position. This discipline is intended to offer an element of protection to the fund's capital, that is, to stop us from turning a mistake into a much larger mistake;

- Liquidity risk arises from the current micro to small/mid cap skew of our long investments (refer table below). This is the risk that troubles us most. We expect the fund's current skew towards these smaller companies will cause our long positioning to be more volatile in a falling market than the invested position would otherwise suggest. We seek to manage this risk by reducing the size of initial investments in these companies, however, we are also prepared to let these investments run if we continue to believe in the opportunity; and

	31 December 2013
Large capitalisation ($3 billion plus)	21%
Mid / Small capitalisation ($100 million to $3 billion)	15%
Micro capitalisation (less than $100 million)	9%
Total	44%

- Currency risk arises from our investments being concentrated primarily in the US and Europe. Also, general equity market risk arises from the gross and net long positioning. The fund currently holds one equity option and two currency options intended to mitigate exposure to these risks. The equity option relates to a major Australian bank (we regard the domestic banks as good proxies for global risk due to their funding bases and leverage to the domestic economy). The currency and equity options are intended to offer a degree of protection against a material (10% plus) adverse movement. Each of these contracts will expire worthless in a benign environment.

Finally, the Yen/USD position, the utility shorts and the equity market put option may all profit from rising interest rates. Our basis for acquiring these positions was a fundamental view regarding the underlying assets rather than a view on rates but when we consider these exposures an outcome is the fund has meaningful short exposure to a number of assets that have been beneficiaries of arguably artificially low interest rates.

European Airports

We are attracted to airports due to the monopoly (or near monopoly) characteristics of the aeronautical operations, the opportunity to take advantage of unregulated retail, real estate and other operations, and the ongoing propensity for travel. However, these characteristics are generally well understood by many investors and create little opportunity for us. Nevertheless, from time to time there are genuine company specific factors that can create opportunities.

During the year the fund had investments in three European airport companies. Below we have outlined the general characteristics and investment tenet for two of these opportunities.

Flughafen Wein AG

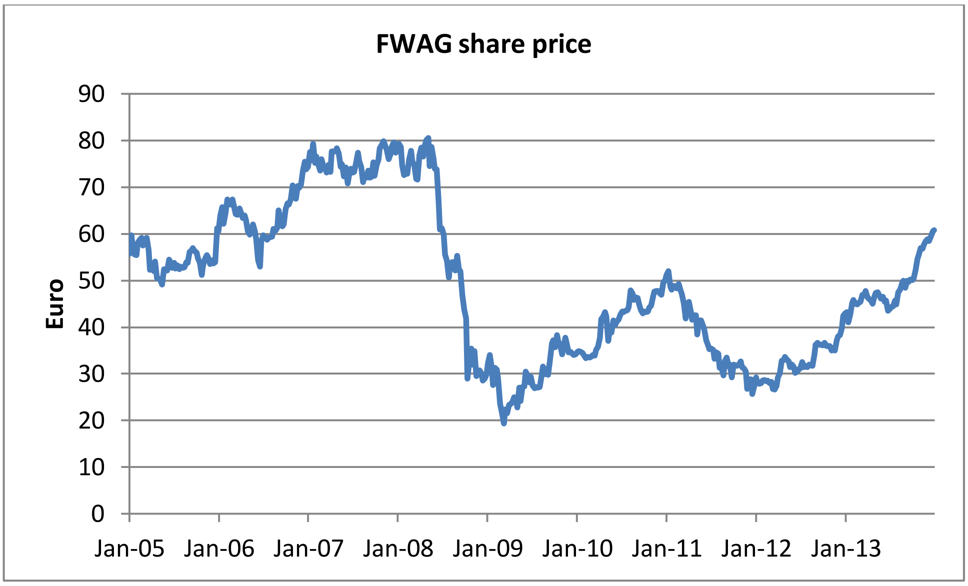
The fund currently holds a position in Flughafen Wein AG (FWAG) which it acquired in March 2012 at an average price of E27.38. In November 2013 the fund trimmed the position from 6% to around 3.5% at a price above E57. FWAG is currently trading around E60 per share. The investment has delivered an annualised internal rate of return of 60% to date.

FWAG is the owner and operator of Vienna airport. It is responsible for the aeronautical, retail, real estate and handling operations. The aeronautical operations account for around 50% of operating profit, retail and properties 35% and handling / other 15%.

Vienna airport operates under a dual till regulatory environment. The regulated aeronautical charges are indexed to inflation less a portion of passenger growth using an approach established in 2004. There is no regulated asset base or allowed returns mechanism. The retail, property, handling and other revenues are unregulated.

FWAG's ownership of Vienna airport is not subject to a concession arrangement; that is, FWAG own the airport and associated facilities outright. Vienna airport is a relatively large facility with a history of growth - passenger traffic grew by approximately 5% pa on average from 2004 to over 22m passengers in 2012.

FWAG has endured a fairly tough period after getting itself into trouble between 2005 and 2010 when it decided to significantly expand its airport terminal capacity with the construction of Skylink. During construction it became apparent that there were some significant issues, including major cost over runs, delays and serious allegations of mismanagement. This led to a lengthy halt in construction and a government audit. In the end the project cost over E700m compared to the original expectation of around E400m and was delivered three years late, finally opening in 2012. Moreover, the expansion increased FWAG's net debt significantly from around E100m to over E700m - this occurred at the same time as the global financial crisis and an 8% decline in passenger numbers (2009). As a result, FWAG's share price fell from a pre-financial crisis E80 to below E30 in late 2011 / early 2012 (initially hit by the financial crisis and then by the concerns over Skylink).



Our FWAG investment tenet was that the project issues were being resolved and there was significant value in Skylink. In particular:

- A new management team was put in place in late 2011 which oversaw the completion of Skylink and brought a better focus to growing revenue, cost control and debt reduction;
- The project was nearing completion and the worst case capital cost was being progressively revised down as the final milestones were met;
- Skylink made significant operational improvements to the airport, especially in relation to the layout of the retail operations and new retail floor space; and
- We were patient to allow the returns to accumulate over time (rather than step up more immediately as per a regulated asset base approach).

We also viewed the debt load as manageable.

When we acquired the investment we thought about the numbers as summarised in the table below. We prepared 2013 estimates in order to capture the first full year of the Skylink operations and derived a pre tax ungeared yield of 10.0%.

Simplified investment summary[1]	
Shares on issue	21m
Our average buy price	E27.38 per share
Implied market capitalisation	E575m
Estimated net debt	E725m
Estimated enterprise value	E1,300m
Estimated pre tax ungeared coupon	E130m (2013 estimate)
Estimated pre tax ungeared yield	10.0%

Notes: (1) This is a simplified valuation which does not consider equity interests and other assets, pension and other liabilities, etc.

The successful opening of Skylink in mid 2012 removed significant uncertainty and provided improved financial results, helping to move the share price from around E30 to around E60 at December 2013.

Vienna airport's financial performance has been better than our initial expectations and we now expect the 2013 coupon to be around E150m. Based on the current share price of E60, the implied enterprise value is approximately E1.9b and ungeared pre tax yield is approximately 8%.

FWAG has performed very well over the past two years and from here we think gains will be more incremental, reflecting refinements to Skylink's retail operations, passenger traffic growth and other factors. We have trimmed the position from 6% to around 3.5% to reflect this.

Save SpA

The fund initially acquired a 4% position in Save SpA (Save) around mid 2011 and added to it opportunistically up until January 2013. After a strong move in the share price in early 2013 the position size reached 7.5% from which we progressively sold down the position. The average entry price was E7.24 and average exit E12.53. The investment delivered an annualised internal rate of return of 40%.

Save is the operator of Venice Marco Polo and Treviso airports in Italy. These two airports account for around 75% of Save's EBITDA (Venice Marco Polo is the majority). The balance is from passenger railway station property, airport / toll road retailing and other businesses.

The opportunity we saw in Save relates to its Venice Marco Polo (Venice) airport operations – this is the focus of the discussion below.

While Venice airport has a long history, the airport terminal and runway facilities are relatively new. It is also well located with only a short drive from the airport to Venice (Treviso by comparison is a hour away). Venice is one of three major international airports in Italy (the others being Rome and Milan) and has experienced passenger growth of 4% pa on average from 2004 to over 8m passengers in 2012.

The challenge for Venice airport has been the lack of an economic regulatory regime which has severely limited its ability to increase aeronautical charges over time (i.e. passenger and landing fees for use of run way, terminals, etc). Any increase in these charges needs to be approved by the regulator and the government and there was no framework in place to facilitate such an increase. While Venice airport was able to increase its earnings from unregulated areas such as the retail, property and car parking, the lack of progress on the aeronautical side of the business limited its value.

Our work on Save suggested limited downside to the share price if the status quo was maintained. It was a nice business with a strong balance sheet, good management and was trading on an ungeared pre tax yield of around 9.8% (prior to any uplift from a new regulatory regime). The enterprise value of less than E500m also looked low compared to other similar size and favourably positioned airports around the world (refer table below).

Simplified investment summary(1)	
Shares on issue	53m
Our average buy price	E7.24 per share
Implied market capitalisation	E384m
Estimated net debt	E76m
Estimated enterprise value	E460m
Estimated pre tax ungeared coupon	E45m (2011 estimate pre any new regulatory regime)
Estimated pre tax ungeared yield	9.8%

Notes: (1) This is a simplified valuation which does not consider equity interests and other assets, pension and other liabilities, etc.

Our Save investment tenet related to the progress being made on implementation of a regulatory regime for aeronautical charges. We saw this in a number of areas, including:

- The high level agreement concluded in 2007/2008 provided a basic structure that we viewed favourably (although significant time had elapsed since);
- The regulator was progressively approving Venice airport's capital expenditure, environmental, traffic and other plans that formed part of its regulatory proposal;
- Venice, Rome and Milan airports were all being considered by the government as a priority for a new regulatory regime;[1]
- The government, recognising the absence of any price increase since 2000, allowed small price increases from 2009-11;
- The regulator approved a fee increase of up to E3 per passenger, which needed Ministerial approval. This suggested to us that the regulatory body was endorsing the higher fees and putting more pressure on the government to act;
- Milan airport concluded its regulatory agreement with the government on what we viewed as very favourable terms; and
- A deadline of December 2012 was put in place (although these often slip).

Moreover, we are familiar with the workings and how the regulatory regimes for the Italian energy infrastructure and toll road sectors have evolved. The progress of Venice airport appeared consistent with this history.

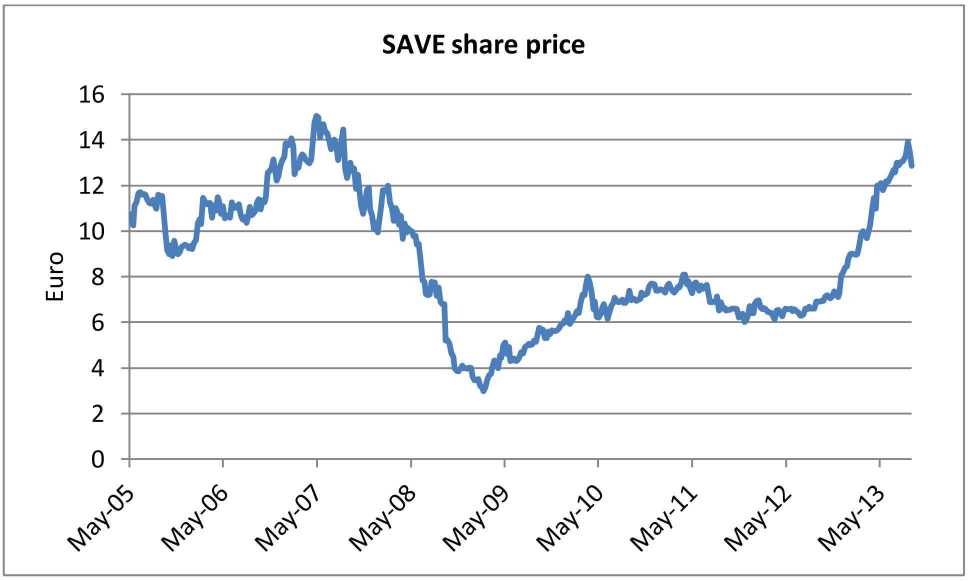
As part of our work we prepared our own estimates of the key regulatory financial parameters, including the regulated asset base (RAB), allowed returns, operating expenditure and depreciation – from this we could see the earnings potential of a new regulatory arrangement.

In December 2012 the new economic regulatory arrangement for Venice airport was approved by the government. Overall, it was better than we expected.[2] The arrangement included a dual till

[1] While progress was slow we could see that Rome airport was under significant financial pressure – it was highly leveraged and faced a significant capital expenditure program, which we doubted could be funded in the absence of a favourable regulatory regime. While Venice was not under financial pressure, it could leverage off the position of Rome airport in getting a favourable decision from the government.

[2] The RAB was lower but the allowed return was higher than our expectations. We also thought there was a risk that unregulated earnings may be subject to some type of sharing arrangement above a certain level but this was not the case.

regulatory framework, a defined RAB (around E150m at 2012)[3] and an allowed return of 12.51% real pre tax WACC, with "strategic investments" receiving an additional return of 2-3%. In broad terms, the decision would increase operating profit for the airport segment[4] by 25% from the 2012 level. In addition, it provided a framework for future investment in the airport – given the attractive allowed return, Venice airport is strongly incentivised to roll out its capital expenditure plan.



With the announcement of the new regulatory regime the share price moved fairly quickly to E12-14 where we progressively exited, selling the last of our holding around E13.50. At E13.50 the enterprise value had increased to around E800m and the ungeared pre tax yield was less than 7%. In addition, the share price implied that the regulated airport business was priced at a meaningful premium to its regulated asset base (reflecting the high allowed return). We see some risk in this as ultimately we think that the allowed return of 12.51% (real pre tax WACC) may prove too generous and come under regulatory pressure.

[3] We think the RAB of around E150m is very low given the existing aeronautical assets (terminal, runway, etc). We suspect this amount may have been influenced by the high allowed WACC such that the implied tariff increase was up to E3 per passenger. We would have preferred a higher RAB and a lower (more reasonable) allowed return to get to the same result.

[4] This segment is much broader than the regulated activities of Venice airport. It also includes Treviso airport (which was not part of the regulatory decision) and the unregulated airport retail, property, car parking etc operations.

Mandates / Co-investments

Our mandate / co-investment offering enables investors to get exposure to a single investment tenet in the fund. These are typically large capitalisation and highly liquid equity opportunities that we regard as appropriate for such a concentrated offering.

The large capitalisation ideas scale up well for larger institutional investors seeking active investments, with capacity to the idea being a function of the market capitalisation of the specific opportunity we identify.

Mandate clients receive a concentrate exposure to the idea, with no dilution from relative positioning or diversification considerations. Effectively the client manages their exposure to the investment through the size of the mandate they award to us.

Please contact us if you wish to explore this offering further.

Investment Results

The fund provided a return of 44% for calendar year 2013.

The fund's long investments contributed 25% to the 2013 performance. Ongoing investments in the European airports and US wagering positively contributed, as did investments in Wendy's Inc, Steinway Musical Instruments Inc and Save SpA which we exited during the year.

Short positions cost the fund 1.5% over the year. This loss is largely attributable to a short position in Seek Limited, which we have subsequently given up on and closed out.

The Yen/USD put options contributed 12%. Other derivative positions cost the fund less than one percent.

Weakness in the AUD/USD and AUD/EUR contributed 7% to the results over the year.

Returns (to 31/12/2013)	Fund
Since inception* (annualised)	12.8%
Since inception* (cumulative)	57.0%
Rolling 3 year (annualised)	15.4%
Rolling 1 year	44.0%
Standard deviation	9.3%

The table below shows the fund's performance on a monthly basis.

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

* Inception date: 15/04/2010

Conclusion

We recognise that our offerings are quite different from the mainstream, significantly due to their concentrated nature. 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 2nd 2014

Terms and conditions