

# NAOS Absolute Opportunities Company (NAC)

NAOS

## MONTHLY INVESTMENT REPORT AND NTA UPDATE

NOVEMBER 2015

### KEY CHARACTERISTICS

#### 1. Global, Multi Asset Class Exposure

NAC invests in a range of equity, fixed income, currency and commodity securities both in Australia and Offshore, providing significant scope for capitalising on performance generating ideas. Key themes are identified and analysed for their impact at the security level, allowing the Investment Team to take advantage of fluctuations and mis-pricing situations on a cross sector, asset class and geographic basis.

#### 2. Positive Absolute Return & Income Generation Focus

The primary focus of the Company's investment strategy is the preservation of shareholders capital and the generation of meaningful absolute returns with a lower downside volatility than traditional equity focused managed funds. NAC offers investors the opportunity to derive a targeted minimum dividend of 4% p.a., which will be franked to the maximum extent possible.

#### 3. Focus on Meaningful Long Term Performance

Investment opportunities are assessed based on their potential to generate meaningful long term performance. Of primary consideration is quality rather than quantity, resulting in a concentrated portfolio of 'Best Ideas' (typically 0-30 holdings).

#### 4. Ability to Hold +100% in Cash

It has been proven that holding cash offers the 'best hedge' during times of crisis. Holding cash also provides flexibility and nimbleness to take advantage of security mispricing opportunities as and when they arise.

#### 5. Significant Alignment of Interests with Shareholders

NAOS employees/directors own a significant amount of shares and options in NAC. Staff are remunerated on the basis of the performance of the firm's investment vehicles through the application of a Performance Based Fee.

### Net Tangible Asset Value Breakdown as at 30<sup>th</sup> November 2015

Pre Tax NTA:	\$1.12
Post Tax & Pre Unrealised Gains NTA:	\$1.11
After Tax NTA:	\$1.09

\*The above NTA calculations do not account for any potential dilution from the 21,500,000 NACO options that remain on issue (expiry 30<sup>th</sup> November 2016) and which are exercisable at \$1.00

### Portfolio Performance & Positioning

The NAOS Absolute Opportunities Company returned +3.63% for the month of November. A significant contributor to the Company's performance during the month was the portfolio's short position in VIP Shop, which is listed in the US (VIPS US). VIP Shop offers branded, out of season goods at deeply discounted prices to consumers residing primarily in Tier 2 and Tier 3 cities. Looking through the financials of the business, VIP's cash flow is not driven by earnings but by significant growth in both their Accounts Payable and Accrued Expenses balances as a result of the business not paying their bills. In February 2014, VIP acquired a 75% interest in cosmetics e-commerce retailer Lefeng and then took a 23% stake in Ovation, Lefeng's parent company. VIP paid \$55.8m for a 23% stake in Ovation, which resulted in the business owning 80.75% of Lefeng. A term of purchase for the sale of the stake in Ovation to VIP was that the business agreed to purchase a minimum of \$148m of Ovation product. VIP stated they would receive commission payments for any sales in excess of this amount. Both companies were loss-making and have accelerated the rate of loss in the time that VIP has held them. When we did our analysis, VIP was trading on a 34x calendar 2015 price earnings ratio, despite the red flags highlighted above and having negative cash flow (which management highlighted would not change in the near term). When the stock reported results in November, the price of shares in the company fell by 46%. We closed our position following the fall.

12<sup>th</sup> November marked the 1 year anniversary of the inception of the NAOS Absolute Opportunities Company. Since the portfolio's inception till November month end, the investment portfolio for the Company has produced a return of +17.42%, meaningfully outperforming the investment benchmark (RBA Cash Rate +250Bps) by +12.45%. Looking at the portfolio's risk characteristics relative to widely used Australian and International Equity Indices (the Australian All Ordinaries Accumulation Index and the MSCI All Country Weighted Index) we can also see that the returns the portfolio has generated have been achieved with much less volatility, a key indicator of risk.

	1 Month	3 Months	6 Month	Inception (Nom.)
NAC Investment Portfolio Performance*	+3.63%	+9.24%	+6.43%	+17.42%
Benchmark (RBA Cash Rate + 250bps)	+0.37%	+1.16%	+2.36%	+4.97%
Relative Performance	+3.26%	+8.08%	+4.07%	+12.45%

S&P/ASX All Ordinaries Accumulation Index (XAOAI)	-0.69%	+1.27%	-7.43%	+3.05%
MSCI ACWI AC (Net, Div Reinvested, AUD Terms)	-1.83%	+1.35%	-0.05%	+15.40%

\*Investment Portfolio Performance is post all operating expenses, before fees and taxes.

**Positive Stock Attribution Analysis  
(12<sup>th</sup> November 2014 to 30<sup>th</sup> November 2015)**

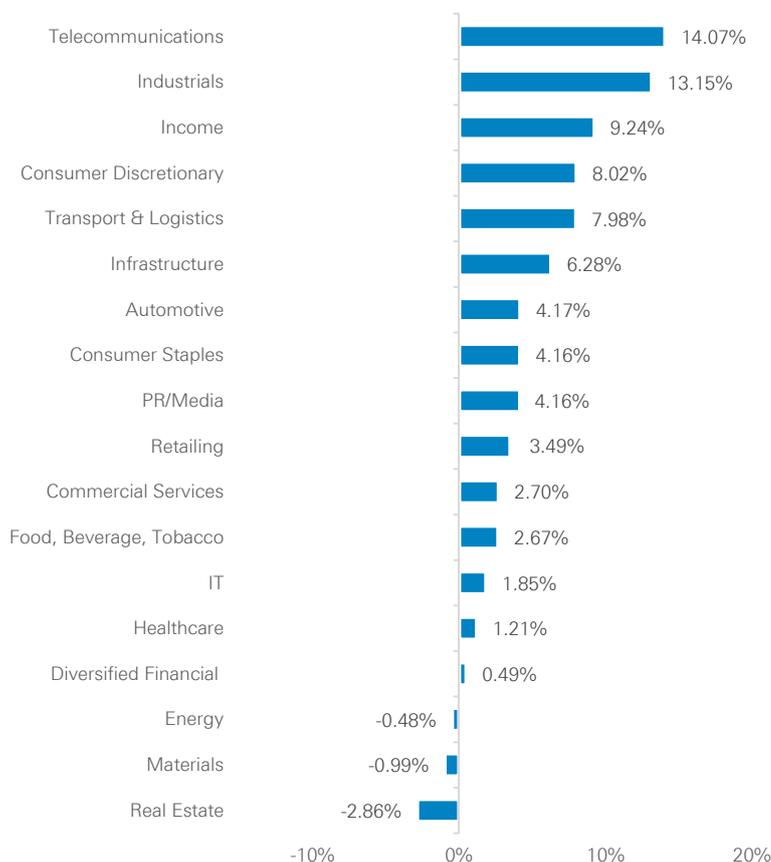
Below is a table listing the top positive contributors to NAC’s total return since inception. The purpose of the table is to illustrate that the performance the investment team derive over time is not simply from one or two positions, but from a variety of positions, even with a concentrated portfolio of investments that is generally limited to 0-30 securities at any one time. Positions in the table below may have been held either as a long position or short position at any given point in time.

Investment	Contribution to Return (%NAV)	Investment	Contribution to Return (%NAV)
US Dollar	+6.37%	Bellamy’s Australia	+1.87%
Amalgamated Holdings Limited	+3.70%	Iselect Limited	+1.53%
Sirtex Medical Limited	+3.14%	Lindsay Australia Limited	+1.06%
Macquarie Atlas Roads	+2.09%	Reece Australia Limited	+0.89%

**Portfolio Analysis as at 30<sup>th</sup> November 2015**

As at 31<sup>st</sup> November the portfolio comprised of 39 holdings, including 24 long equity positions, 11 short equity positions and 4 income instruments. The portfolio was geographically concentrated (based on net currency exposure) in Australia (~73%), however we also maintained an exposure to the US (~6%), Europe (~11%), New Zealand (~1%) and Hong Kong (~0.5%).

**Net Industry Exposure**



**Market Insight**

November is typically a difficult month for equity markets, particularly in Australia when we see a lot of larger stocks go ex-dividend. The NAOS Absolute Opportunities Company portfolio has been conservatively positioned given the uncertainty we are seeing in the markets and this helped contribute to the generation of positive performance for the month.

Over the course of the last 10 years there have only been 3 Novembers where the ASX200 Accumulation Index generated positive performance for the month; those being 2006, 2009 & 2012. The good news is that December usually sees a bounce back which many have dubbed the ‘Santa Claus Rally’. This momentum can often continue into January and February. Consider the following stats for the ASX200 coming into the month of November;

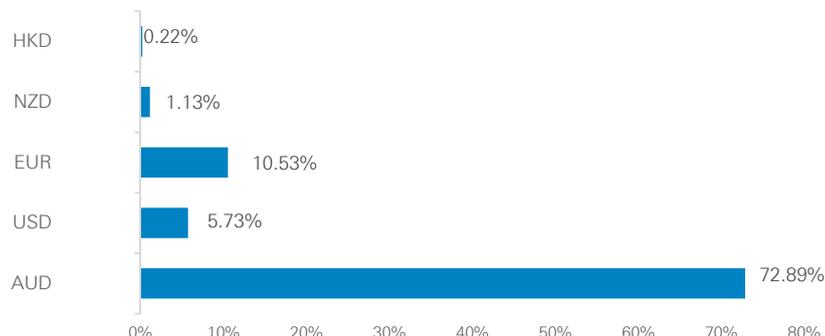
- 2009 high was 15<sup>th</sup> October followed by a 8% sell off and then a 10% rally to the 12<sup>th</sup> of January
- 2010 high was 5<sup>th</sup> November followed by a 6% sell off and then an 8% rally to the 9<sup>th</sup> of February
- 2011 high was 28<sup>th</sup> October followed by a 10% sell off and then a 9% rally to the 5<sup>th</sup> of December
- 2012 high was 18<sup>th</sup> October followed by a 6% sell off and then a 19% rally to the 12<sup>th</sup> of March
- 2013 high was 28<sup>th</sup> October followed by a 8% sell off and then a 7% rally to the 1<sup>st</sup> of February
- 2014 high was 7<sup>th</sup> November followed by a 7% sell off and then a 16% rally to the 3<sup>rd</sup> of March
- 2015 high was 26<sup>th</sup> October followed by a 7% sell off and at time of writing had rallied 6% so far into December

The below chart illustrates the stats above;

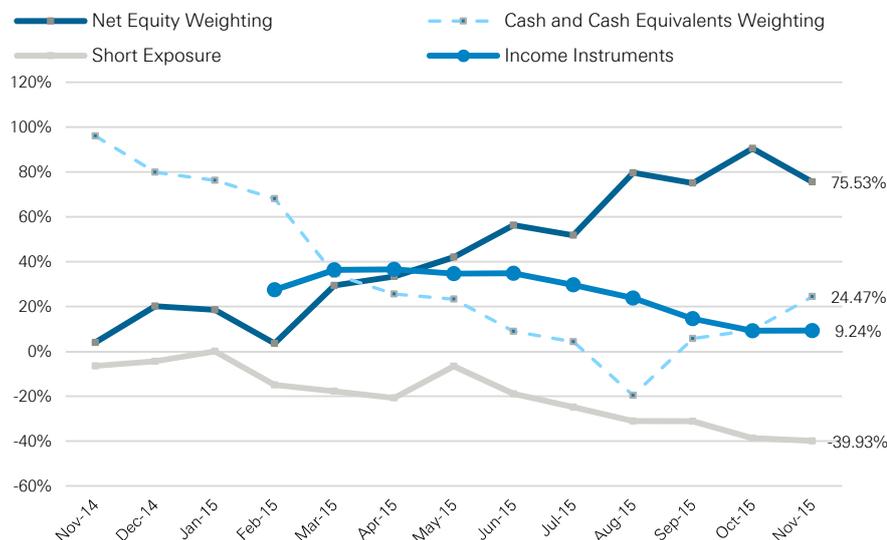


Continued...

**Net Portfolio Currency Exposure**



**Net Equity Exposure**



**Company Meetings**

The NAOS investment philosophy is based around the belief that for a company to succeed and generate strong returns for shareholders it must be led by a motivated, proven and experienced management team. That is why the NAOS Investment Team has contact with many listed and unlisted companies across a wide range of industries and geographies. A selection of the unlisted and listed companies the team had contact with during the month of November were as follows:

- APN Outdoor (APN)
- Adelaide Brighton (ABC)
- Ooh! Media (OML)
- DR Horton (DHI US)
- Bega Cheese (BGA)
- Elders (ELD)
- SG Fleet (SGF)
- RCG Corp (RCG)
- Macquarie Atlas (MOA)
- CarePlus (Unlisted)
- Surfstitch (SRF)
- BWX Limited (BWX)

**Market Insight Continued**

While it is not our intention to try and determine what we think markets will do in the short term, it can be interesting to note seasonal behaviour. The NAC portfolio is currently positioned to hopefully produce a positive return regardless of whether global markets rise or fall.

A second point of discussion in the media recently has been around the downgrades in companies where private equity has been involved. The two companies that have sparked the debate have been Spotless and Dick Smith. Spotless was acquired for about \$720 million by Pacific Equity Partners in August 2012 and then re-floated with a valuation of close to \$2 billion in April last year. Dick Smith was bought from Woolworths by Anchorage Partners for what ended up being \$74m in November 2012 and floated a year later in December 2013 with a valuation of \$345m. In Dick Smith's own words "You don't need to be very bright to realise that a company worth \$90 million one moment is unlikely to be worth \$500 million 12 months later just because it had a change of ownership". The lesson here, particularly in the case of Dick Smith is that companies don't turn around on a dime. Take Billabong for example, where the turnaround is being played out in a much more public view. It takes time...and often a long time. In the case where there has been a turnaround off-market, over a short time frame and a there is a large valuation uplift, then buyer beware. Every time you buy a stock in the market you are asserting that you know more than the seller. When you buy from private equity that is unlikely to be the case.

Portfolio Characteristics – Summary Data as at 30<sup>th</sup> November 2015

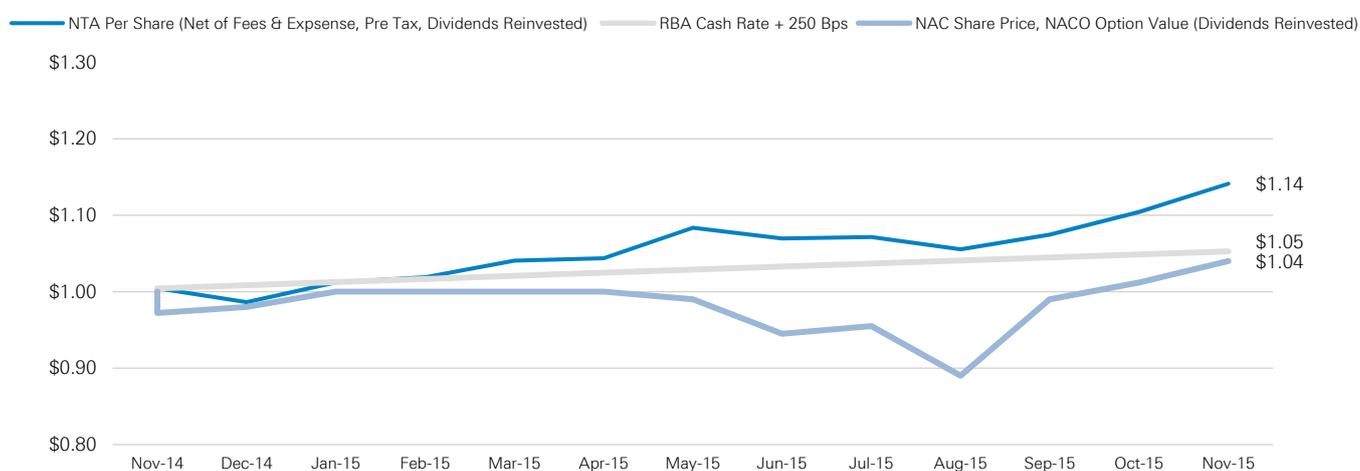
Total Number of Equity Holdings (Long & Short)	35
Total Number of Income/Debt Instruments*	4
Total Number of Holdings	39
Portfolio Weighted Market Capitalisation (AUD)	\$16.2bn
Percentage of Positive Months (NAC)	77%
Percentage of Positive Months (XAOAI)	46%
Standard Deviation of Returns (NAC)	7.03%
Standard Deviation of Returns (XAOAI)	13.56%
Correlation of Returns to XAOAI	36.69%
Sortino Ratio	7.71
Downside Deviation	2.23%
Downside Deviation (XAOAI)	7.89%
Current Estimated Portfolio Beta	0.19

\*Listed and unlisted bonds, convertible notes, preference shares and other income securities – both domestic and international.

Capital Management - Summary Data as at 30<sup>th</sup> November 2015

Share Price	\$0.985
Share Price Discount to NTA (undiluted, pre tax)	12.05%
Fully Franked Dividend Yield	4.06%
Gross Dividend Yield	5.80%
Shares on Issues	21,507,500
Options on Issue	21,492,500
Directors Shareholding	1,480,203

NTA & Share Price Analysis



### Description of Statistical Terms/Glossary

**Portfolio Weighted Market Capitalisation** – The portfolio weight of each individual position multiplied by each companies respective market capitalisation.

**Standard Deviation of Returns** – A historical analysis of the volatility in monthly returns also known as historical volatility.

**Correlation of Returns** – A statistical measure of how two securities move in relation to each other. In this case the two securities are NAC and XAOAI. If the correlation is 1 then the two securities should have the same monthly returns and if the correlation is -1 and XAOAI had a return of -1.00% then NAC would be expected to have a return of +1.00%

**Sortino Ratio** – A modification of the Sharpe ratio that differentiates harmful volatility from general volatility by taking into account the standard deviation of negative asset returns, called downside deviation. A large Sortino may potentially indicate that there is a low probability of a large capital loss.

**Downside Deviation** - A measure of downside risk that focuses on returns that fall below a minimum threshold or minimum acceptable return (MAR). For our calculations, we use returns negative to zero for the calculation of portfolio downside deviation.

**Portfolio Beta** – A measure of the volatility, or systematic risk of a portfolio or security. A beta of 1 indicates a portfolio/security's price will move with the market. A beta of less than 1 indicated that a security/portfolio should be less volatile than the market.

**XAOAI** – All Ordinaries Accumulation Index (XAOAI)

#### Disclaimer:

This report has been prepared by NAOS Asset Management Limited. Information provided in this report is for general information purposes and must not be construed as investment advice. In preparing this report we have not taken into account the investment objectives, financial situation or needs of any particular investor. Past performance is not a reliable indicator of future performance. Before making an investment decision investors must read the offer documents and should seek their own financial product advice. Returns are compounded for periods greater than 12 months. The Investment Manager of the Company is NAOS Asset Management Limited (ABN 23 107 624 126, AFSL 273529). NAOS Address: Level 4 Domain House, 139 Macquarie Street Sydney NSW 2000. NAOS Telephone: 61 2 9947 2566

#### CORPORATE DIRECTORY

##### Directors

David Rickards (Independent Chairman)  
Warwick Evans (Director)  
Sebastian Evans (Director)

##### Company Secretary

Julie Coventry

##### Investment Team

Sebastian Evans (Chief Investment Officer)  
Jeffrey Kim (Portfolio Manager)  
Robert Miller (Portfolio Manager)  
Ben Rundle (Portfolio Manager)

##### Chief Financial/Operating Officer

Richard Preedy

##### Business Development Team

Anneke Senden  
Julia Stanistreet

##### Share Registry

Boardroom Pty Limited  
7/207 Kent Street  
Sydney NSW 2000  
Telephone: 1300 737 760  
Facsimile: 1300 653 459

##### Investment Manager

NAOS Asset Management Limited  
Level 4, Domain House  
139 Macquarie Street  
Sydney NSW 2000  
(AFSL: 273529)  
Telephone: (02) 8064 0568  
Facsimile: (02) 8215 0037

##### Auditor

Deloitte Touche Tohmatsu  
Level 25, Grosvenor Place  
225 George Street  
Sydney NSW 2000

##### Registered Office

Level 4, Domain House  
139 Macquarie Street  
Sydney NSW 2000  
Telephone: (02) 9947 2566  
Facsimile: (02) 8215 0037

##### ENQUIRIES

Anneke Senden or Julia Stanistreet  
Telephone: (02) 9947 2567  
Email: [asenden@naos.com.au](mailto:asenden@naos.com.au),  
[jstanistreet@naos.com.au](mailto:jstanistreet@naos.com.au)  
[www.naos.com.au](http://www.naos.com.au)