

# NAOS Absolute Opportunities Company (NAC)

NAOS

## MONTHLY INVESTMENT REPORT AND NTA UPDATE

DECEMBER 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 31<sup>st</sup> December 2015

Pre Tax NTA:	\$1.17
Post Tax & Pre Unrealised Gains NTA:	\$1.18
After Tax NTA:	\$1.14

\*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 +7.93% for the month of December, making it the strongest month of positive performance generation since the Company's inception in November 2014. For the Calendar Year 2015, the portfolio returned +28.87%, significantly outperforming the portfolio's Benchmark, the S&P/ASX All Ordinaries Accumulation Index and the MSCI ACWI AC Index over the same period. Positive performance for the month was generated across a number of the portfolio's holdings, with the notable contributors being Smart Group and MNF Group. As part of this month's positioning commentary, we will provide more detail on these two companies and why we maintain our level of conviction in terms of their attractiveness.

	1 Month	3 Month	6 Month	1 Year	Inception (Nom.)
NAC Investment Portfolio Performance*	+7.93%	+15.62%	+16.67%	+28.87%	+27.41%
Benchmark (RBA Cash Rate + 250bps)	+0.40%	+1.18%	+2.37%	+4.91%	+5.65%
Relative Performance	<b>+7.53%</b>	<b>+14.44%</b>	<b>+14.30%</b>	<b>+23.96%</b>	<b>+21.76%</b>

S&P/ASX All Ordinaries Accumulation Index (XAOAI)	+2.65%	+6.62%	+0.45%	+3.78%	+3.00%
MSCI ACWI AC (Net, Div Reinvested, AUD Terms)	-2.64%	+1.04%	+0.30%	+9.78%	+16.11%

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

### Smart Group (ASX:SIO)

Smart Group provides salary packaging administration, novated lease and fleet management services to employees of State and Federal Government departments, Public Benevolent Institutes and corporate employers.

When analysing Smart Group's business and operating environment four key factors became apparent, supporting a positive investment thesis;

1. The business is trading at ~8% free cash flow yield and has minimal debt
2. Management have a strong track record winning work without going through formal tender processes
3. Industry analysis identified that there has been significant consolidation in the finance leasing space, providing the company with the opportunity to become a dominant participant in the space.
4. In August of this year, post results reporting, Management bought >\$5m worth of shares, adding to their already significant stakes in the business and further aligning their interests with those of shareholders

As a result of the factors outlined above, we are presented with a business that is generating an exceptional amount of cash, has not undertaken a capital raising since inception, has minimal debt on the balance sheet (which has the potential to turn into no debt very quickly), is operating in an industry that has been through significant consolidation and which is led by a management team with a proven track record in deploying capital.

Based on our positive assessment of the attractiveness of an investment in Smart Group we initiated a position in the company on the long side of the portfolio and subsequently were rewarded when management announced a decision to use their balance sheet to undertake an acquisition that would prove highly accretive to earnings. At the same time, management upgraded their earnings expectations for the existing business and as a result of both events the stock price rallied by 42% to 31 December.

#### MNF Group (ASX:MNF)

NAC's holding in MNF Group (My NetFone) also produced significant positive performance for the month of December. MNF Group is Australia's largest provider of hosted voice and data communications services, including VoIP Phone and DSL internet for residential and commercial businesses. NAOS have been following the MNF Group for some time and formed a positive investment thesis for the company on the basis of the financial, management and industry analysis we have undertaken. The key factors that we believe make the business attractive include:

1. The proprietary ownership of operating infrastructure, which is unique amongst peers, many of whom rent infrastructure from larger industry players such as Telstra and Optus
2. Unique product offering which ties in with many digital offerings from large clients, providing significant scale for future business growth
3. Based on our financial analysis, an attractive and growing earnings profile and significant margin growth
4. Management have demonstrated a proven ability to execute strategy and beat expectations, with results exceeding market expectations for the past 3 years. Management also continue to hold ~40% of all shares on issue, significantly aligning their interests with those of shareholders.
5. Very high free cash flow generating business due to low capex nature of the telecommunications industry

The share price of MNF Group has been relatively flat recently, largely as a result of management's focus on running their business rather than entertaining the market with constant announcements.

In terms of our positioning in the company, in October of last year the group announced an earnings guidance figure that was below what some analysts were expecting, largely due to a significant investment spend on new staff in key areas of the business. As a result of the announcement, some investors lost patience and sold their holdings. Being a long term investor, we saw this as an opportune time to increase our exposure, particularly leading into February reporting season, which we believe will be a positive catalyst for the stock.

#### **Positive Stock Attribution Analysis (12<sup>th</sup> November 2014 to 31<sup>st</sup> December 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 overleaf have been held either as a long position or short position at any given point in time.

#### **Market Insight**

Financial commentators have been busy providing their predictions on what we can expect to see from Financial Markets this year over the past few weeks. Whilst some of these may prove to be correct, the chances are that many will not. As we have seen in the past, it is usually the events that people don't see coming which affect the markets the most, both on the upside and the downside. So instead of predicting, let's instead focus on what we believe are the key issues investors should be aware of as we start the New Year.

#### **1. Management's 'Cost Out' attitude and falling Capex**

Much of the earnings growth that has driven the market over the past couple of years has been as a result of companies reducing costs within their business and winding back the amount of capital expenditure they undertake. This can work well up to a point, but it has to end eventually. Capex is a requirement for most companies to maintain their competitive advantage and after having gone through a period where this has been significantly reduced, it could be time to face the music, particularly for those companies that have a large amount of debt on their balance sheet. We prefer to own companies who have high levels of free cash flow and a strong balance sheet to be able to cope with not only maintenance capex but also expansion capex.

#### **2. Commodities**

Numerous investors have lost a significant amount of capital trying to pick the bottom of the commodity price cycle during 2015 and, as such, we will continue to tread very carefully when analysing any potential investment opportunities in this sector. A consensus trade over the past few years in Australia has been long financials, short materials. This has worked exceptionally well and we feel a lot of people still have their portfolios positioned for this scenario. We are not trying to pick the bottom, but we are watching closely for signs of life. If there is a reversal in consensus it is likely to cause significant volatility.

#### **3. Interest rates & Housing**

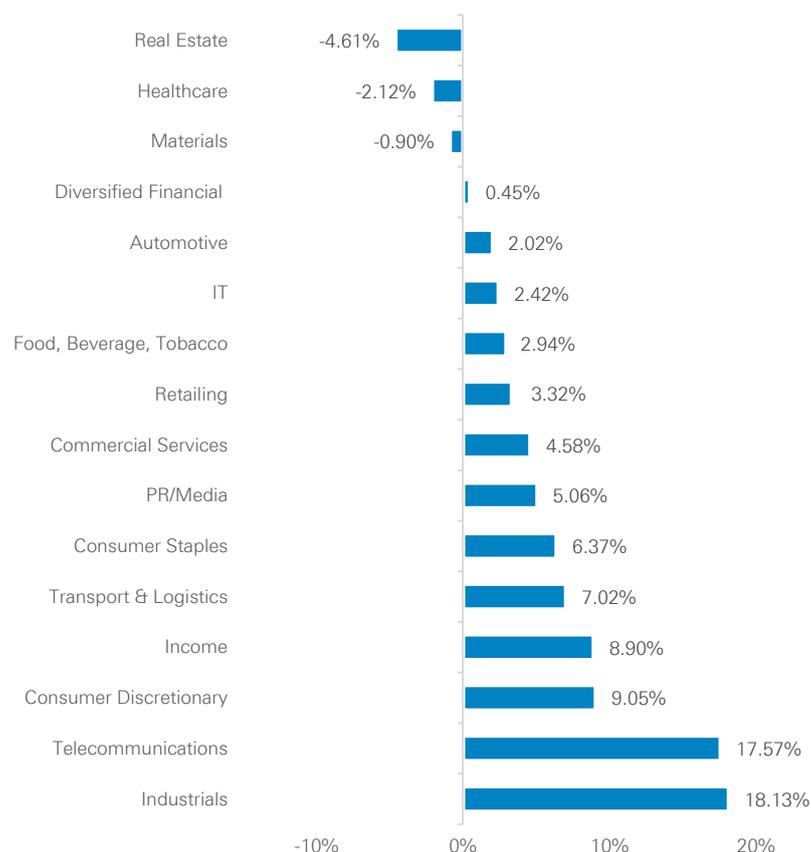
The RBA has continued in its conservative approach to setting monetary policy, particularly as house prices have been strong and the second tier of our economy has been able to show resilience. Housing however is starting to show signs of weakness. Currently the market is pricing only a 25% chance of a rate cut in the next quarter.

Investment	Contribution to Return (%NAV)	Investment	Contribution to Return (%NAV)
US Dollar	+6.60%	Smart Group Corporation	+2.20%
Amalgamated Holdings Limited	+5.06%	Macquarie Atlas Roads	+2.19%
Sirtex Medical Limited	+3.34%	Iselect Limited	+1.66%
Bellamy's Australia	+2.55%	RXP Services	+1.15%

### Portfolio Analysis as at 31<sup>st</sup> December 2015

As at 31<sup>st</sup> December the portfolio comprised of 36 holdings, including 21 long equity positions, 10 short equity positions and 5 income instruments. The portfolio was geographically concentrated (based on net currency exposure) in Australia (~75%), however we also maintained an exposure to the US (~5%), Europe (~8%), New Zealand (~1%) and Hong Kong (~2%).

### Net Industry Exposure



### Market Insight Continued

If housing does slow down, it is one more growth engine that Australia may lose. We remain open minded about which way the next interest rate move will go and we will be following the indicators very carefully.

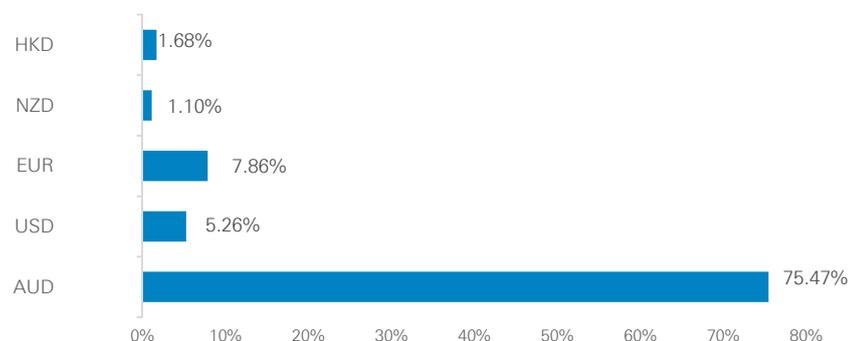
### 4. Low earnings growth environment

The 'low growth environment' that concerned the market at the beginning of 2015 has not really changed much as we enter 2016. We want to position our portfolio to be long companies who have a strong balance sheet and can grow by acquisition or have excess cash to return to shareholders. We also want to be owning companies in sectors that have a strong economic tailwind (e.g. tourism in Australia & Europe).

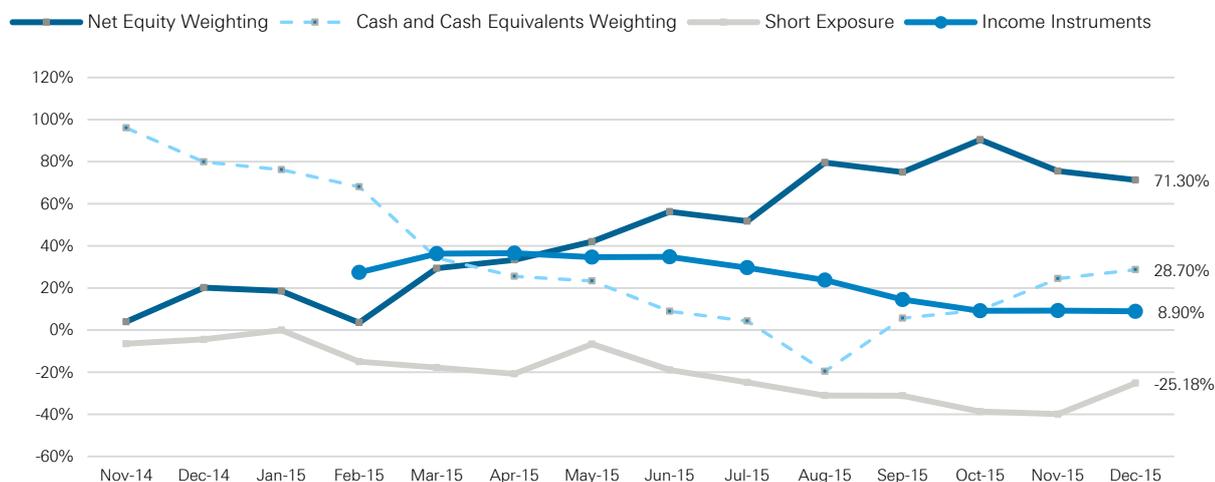
As we mentioned above, most of the big moves in markets come as a result of an event which few have predicted. Adhering to our investment style, we will endeavor to position the portfolio to protect investors' capital during times of crisis and to take advantage of gains where they arise. We will also be keeping at the front of our minds the Noah principle "predicting rain doesn't count, building arks does."

We wish all of our investors a prosperous 2016.

**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 December were as follows:

- NBN Co (Unlisted)
- Macquarie Atlas Roads Limited (MQA)
- Xero Limited (XRO)
- BWX Limited (BWX)
- Arthur J Gallagher (AJG US)
- Spotless Group Holdings (SPO)
- MNF Group Limited (MNF)
- Collins Foods Limited (CKF)
- Transport Investments Limited (TIL NZ)
- APN Outdoor (APO)
- Smartgroup Limited (SIQ)
- OOH! Media Limited (OML)

Portfolio Characteristics – Summary Data as at 31<sup>st</sup> December 2015

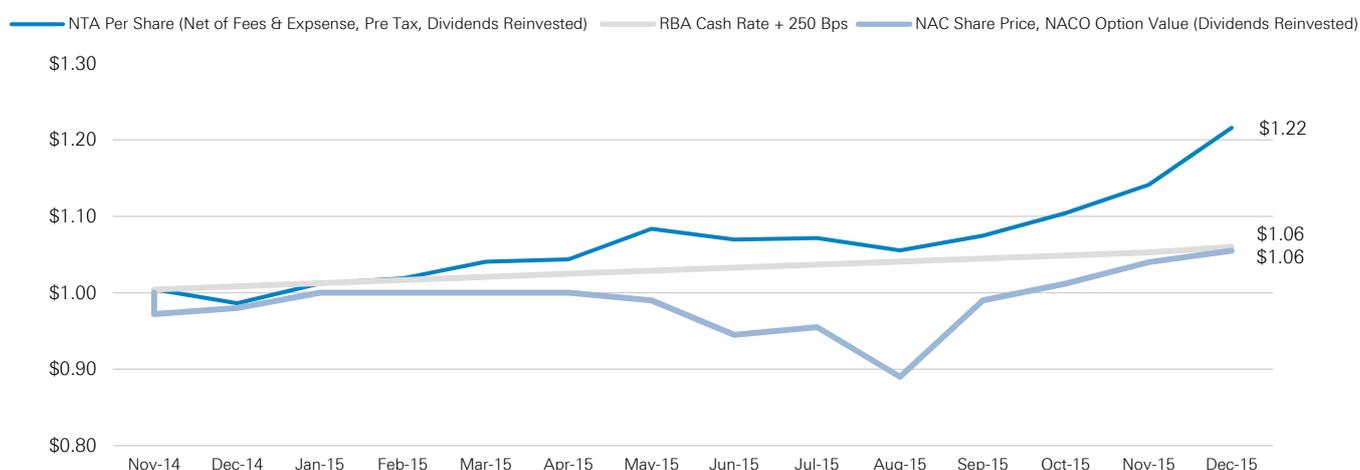
Total Number of Equity Holdings (Long & Short)	31
Total Number of Income/Debt Instruments*	5
Total Number of Holdings	36
Portfolio Weighted Market Capitalisation (AUD)	\$16.5bn
Percentage of Positive Months (NAC)	79%
Percentage of Positive Months (XAOAI)	50%
Standard Deviation of Returns (NAC)	9.51%
Standard Deviation of Returns (XAOAI)	13.26%
Correlation of Returns to XAOAI	37.76%
Sortino Ratio	11.40
Downside Deviation	2.17%
Downside Deviation (XAOAI)	7.72%
Current Estimated Portfolio Beta	0.214

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

Capital Management - Summary Data as at 31<sup>st</sup> December 2015

Share Price	\$1.00
Share Price Discount to NTA (undiluted, pre tax)	14.53%
Fully Franked Dividend Yield	4.00%
Gross Dividend Yield	5.71%
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 variables move in relation to each other. In this case the two variables 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

#### 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 Manager

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

Julia Stanistreet  
Telephone: (02) 9002 1576  
Email: [jstanistreet@naos.com.au](mailto:jstanistreet@naos.com.au)  
[www.naos.com.au](http://www.naos.com.au)