Auscap Long Short Australian Equities Fund Newsletter – February 2014

Welcome

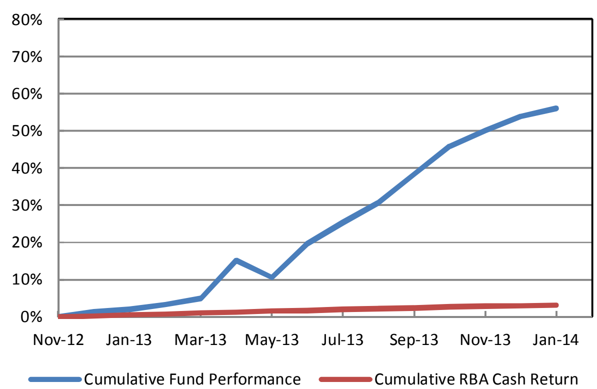
Welcome to the Auscap newsletter, an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund (“Fund”) to current and prospective investors. In each publication we will also discuss a subject that we have found interesting in our research and analysis of the market. We hope that you enjoy reading these snippets and encourage any feedback. In this edition we discuss why we are more risk averse when investing in Initial Public Offerings (IPOs) compared with companies that have been listed for a considerable period of time.

Overview

The Fund was launched in December 2012 and targets strong absolute returns in excess of the RBA Cash Rate. The Fund focuses predominantly on fundamental long and short investments while utilising a multi-strategy approach to take advantage of shorter term market opportunities to increase returns, hedge the portfolio, protect capital and minimise volatility where prudent. The Fund will typically have 25-45 positions primarily in liquid stocks in the ASX200. Further information, including access for sophisticated investors to the Fund’s Information Memorandum, is available at our website www.auscapam.com. Enquiries can be directed to info@auscapam.com.

Fund Performance

The Fund returned 1.32% net of fees during January 2014. This compares with the benchmark return of 0.21%. Average gross capital employed by the Fund was 108.6% long and 13.2% short. Average net exposure over the month was +95.4%. At the end of the month the Fund had 29 long positions and 3 short positions. The Fund’s biggest exposures at month end were spread across the consumer discretionary, telecommunications and financials sectors.



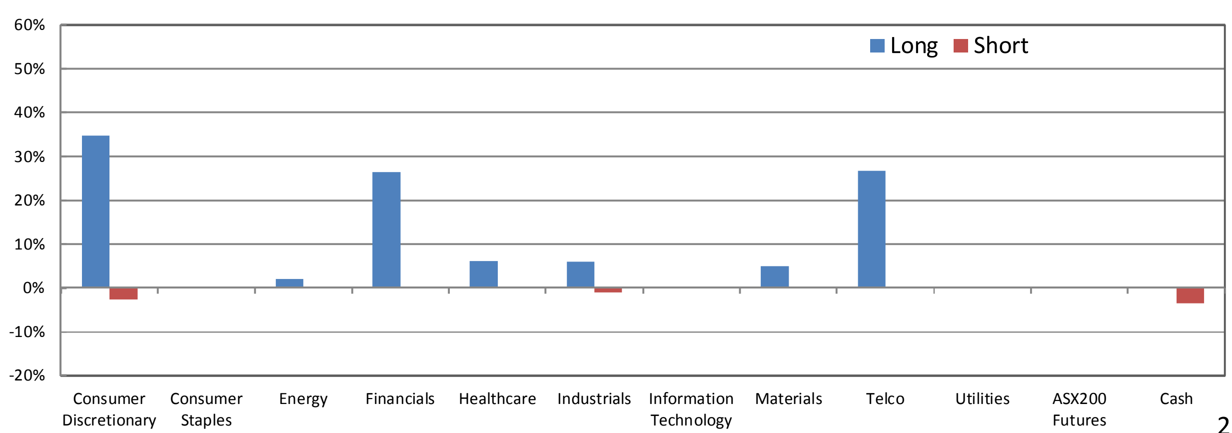
Fund Returns

Period	Auscap	Benchmark
January 2014	1.32%	0.21%
Financial Year to date	30.29%	1.49%
Since inception	55.98%	3.24%

Fund Exposure

January 2014 Average	% NAV	Positions
Gross Long	108.6%	28
Gross Short	13.2%	3
Gross Total	121.8%	31
Net / Beta Adjusted Net	95.4%	86.6%

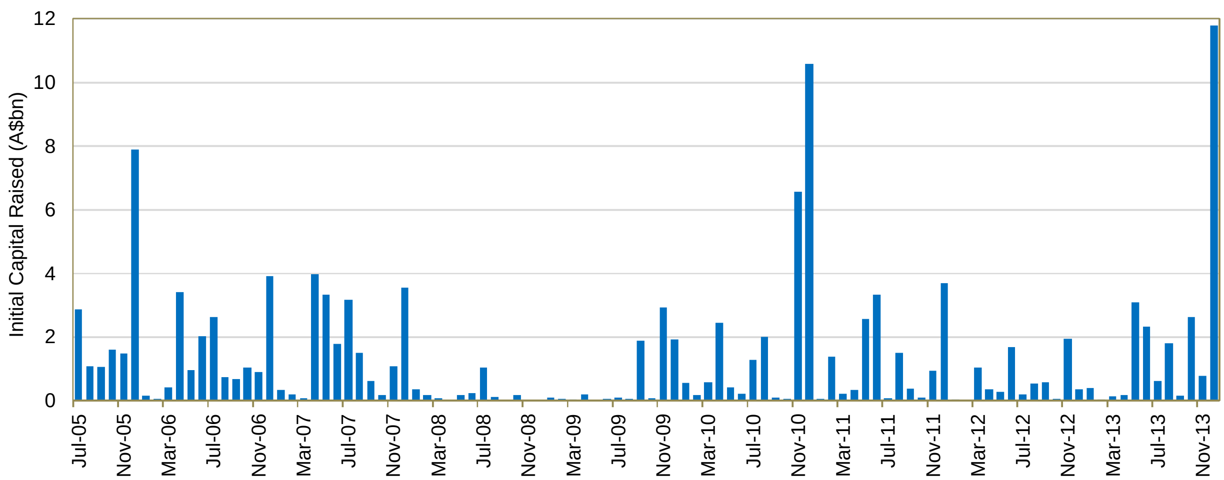
Sector Exposure - 31 January 2014



Pricing Asymmetric Information: How We Evaluate IPOs

An Initial Public Offering (IPO). A company soon to be listed on a stock exchange for the first time. It often seems like an exciting prospect, with brokers highlighting the benefits of the earnings outlook for a business that was previously in private hands. Perhaps itõs a brand that youõre familiar with? Sometimes it might be one that youõre very familiar with. That raises general interest even more. Indeed the IPO excitement was palpable in late 2013. And private owners of businesses obliged, raising $11.8 billion in December 2013 alone, the most initial capital raised in any month in the history of the Australian Stock Exchange and almost half the aggregate initial capital raised in 2013.

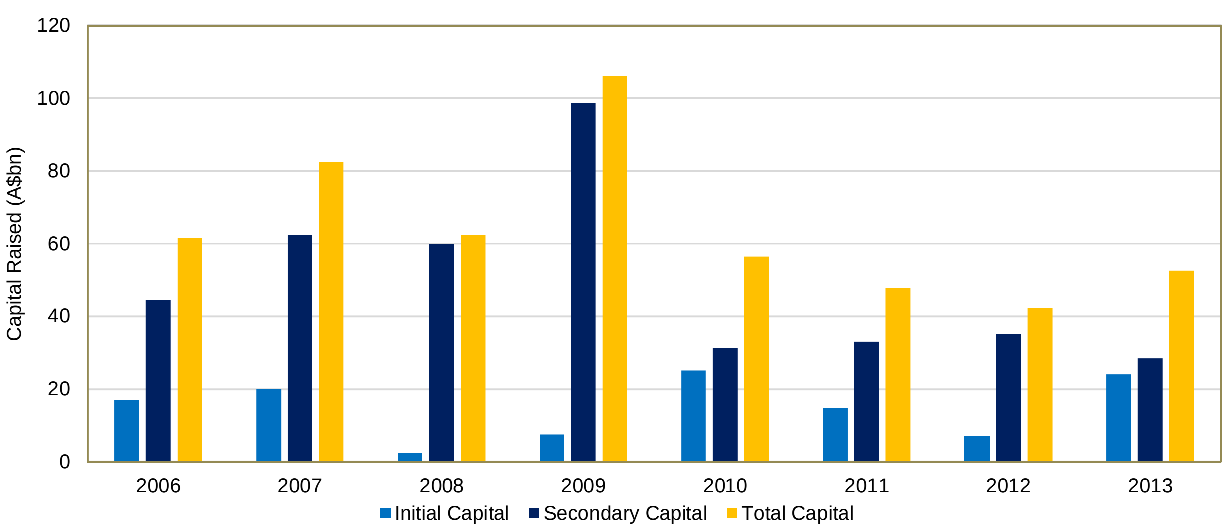
Initial Capital Raised On ASX Per Month



Source: Australian Stock Exchange

It was difficult not to get swept up in the enthusiasm of the broad investment community. Our favourite quote during this period, admittedly heard second hand, was from an experienced fund manager who opined that he thought every one of his currently held stocks should be taken off the bourse and relisted, for he was sure they would come back on at a 50% premium!

Capital Raised Via The Australian Stock Exchange



Source: Australian Stock Exchange

There were a few indicators for investors that caution was warranted during this period in relation to pricing around the initial public offerings. These included:

- IPOs being priced at greater multiples of earnings than already listed peers, despite often a short company history of reported performance, seemingly optimistic forecasts and large existing shareholders selling down heavily through the process;

- IPOs frequently being priced in excess of 20x earnings, only to then list at huge premiums to these seemingly high prices;

- IPOs closing to new investors prior to the formal release of the company prospectus (!); and

- Commentary from equity market participants that investors "just needed to get involved" in all corporate activity, especially new floats, because stag profits were an easy way to generate returns.

The result was, unfortunately, that many investors in these IPOs suffered losses when they listed and quickly traded at discounts to their issue prices. In some cases, the risks associated with these IPOs had not been assessed properly in the pre-market period, but the market was quick to re-price the companies once listed.

There are, in fact, numerous reasons why we think *extra* care should be taken when evaluating any new float. Given the significant pipeline of IPOs on the horizon, with 26 significant potential 2014 listings identified by the Australian Financial Review on the 30th of January 2014, we thought it worthwhile to run through our process of identifying how we evaluate new issues.

Potential 2014 IPO pipeline

In train				Possible	
iSentia	Burson Auto Parts	Healthbridge	Healthscope	Medibank Private	Fleet Partners
Spotless Group	SCA Hygiene	I-Med	SG Fleet	Link Market Services	Qantas Frequent Flyer unit
3P Learning	Peters Ice Cream	Ozsale	IDP Education	RetireAustralia	Energy Australia
Mantra Group	Charter Hall Indutrial REIT	Alceon mezzanine fund	ACM	Genworth Australia	
Stag Beef	Japara	U & D Coal			

Source: Australian Financial Review, Dealogic

Every manager has an investment review process. For us this involves the following basic steps:

- Review of industry dynamics and the relevant company's position within the industry;

- Financial analysis of the company's accounts and historical returns on invested capital; and

- Valuation analysis to determine an estimate of the company's worth.

If we are looking at a new issue though, we also want to evaluate the risk associated with the information asymmetry between the buyer and the seller. This is somewhat unique to primary issuance.

Buying shares in companies that have been listed for a considerable period of time is done in an environment where, most of the time, both the buyer and the seller have access to the same publicly available information. The company's financials have been recorded in public disclosures that span many years and can be sought out and evaluated by any investor. It is the interpretation of the data and the analysis of the company that determines the success or failure of investment decisions. A transaction between the buyer and seller in this environment does not involve any information arbitrage, where the seller has significantly more knowledge about the financials and state of the company than the buyer.

This is not the case in an IPO, where shares in the company are typically purchased from a vendor, at a price that the vendor is happy to accept. In this case a few additional questions need to be answered before we are willing to participate in a float.

Where is the cash raised going?

If capital is being raised to fund business expansion, especially where the capital would not be available to the private owners of the business via the debt capital market, then we can evaluate the existing business and expansion opportunity alongside the current owners. Here our interests are aligned with those who have successfully nurtured the company and know it best. If the capital raised is to pay out existing shareholders, we have a different question to ponder.

Why is the vendor selling?

Vendors sell for a number of reasons, but one constant is that they rarely sell unless they think they are getting at least a fair price for their business. If they are selling out entirely, especially where their stake in the business is a significant amount of capital that they are unlikely to have an immediate personal use for, the price they are receiving must be a good one. We are wary of two things during this sale process. Firstly, the vendor knows the business, and most probably the industry, far better than we do as managers of capital. Secondly, a vendor typically has a personal attachment to a business that would make them reluctant to sell unless the price was significantly attractive. There are many valid reasons for a vendor selling, but investors should not be prepared to pay more than a fair price, because the risks are skewed against the buyer. Which then brings us to our final question.

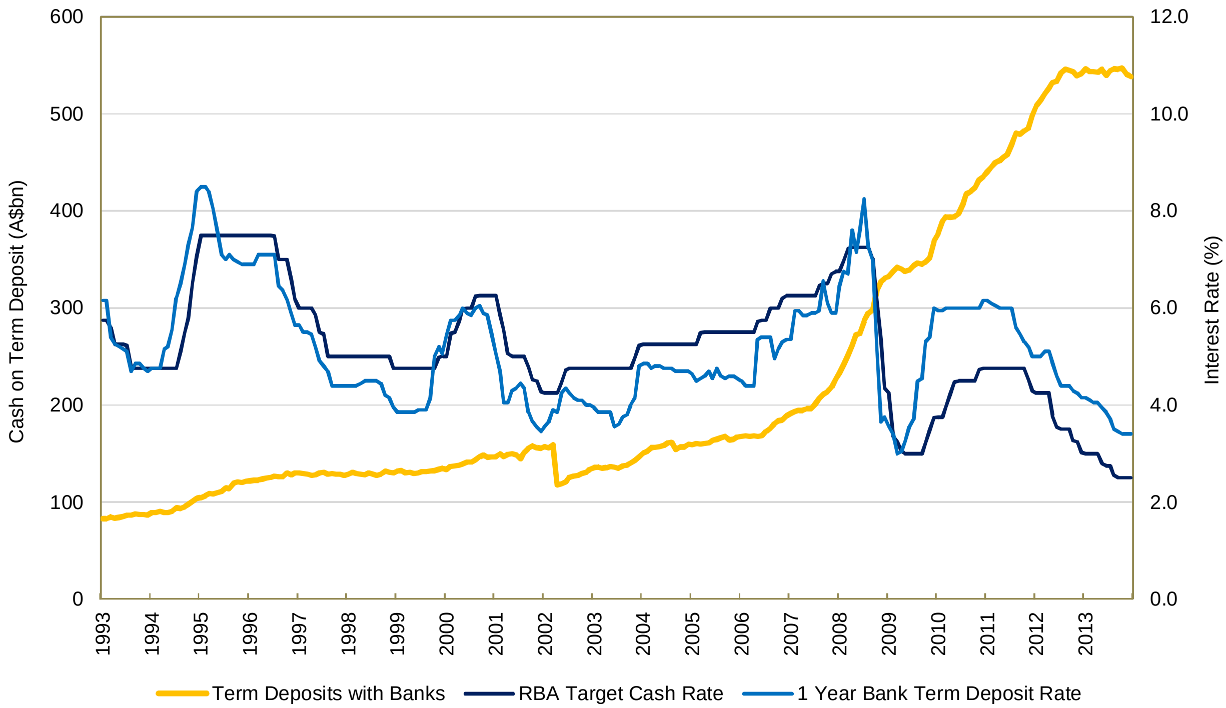
How are the interests of shareholders aligned with those of management?

If the vendor is selling, how are management's interests aligned with the shareholders? Do they have sufficient skin in the game? We might add at this point that we would not consider an allocation of free shares or options as an appropriate way to ensure an alignment of interests. A manager is aligned by investing a significant amount of his or her own capital, be it human capital (labour) or monetary capital, in the company. Managers can be aligned by basing a *significant* part of their pay on performance, but only if the dependent variable is *actually* good performance, as opposed to simply being in the job for a period of time.

Clearly the answers to these questions affect our view of the risks associated with purchasing shares in an IPO. That said, we are still reluctant to become involved in new floats that aren't issued at a discount to both existing comparable companies *and* our base case valuation, if not only because of the information disadvantage that we are faced with in this transaction. This information asymmetry equates to additional risk for an investor, for which additional prospective return is the only available remedy. In situations where we don't believe that we have received compensation for any additional risk taken, we are happy to pass on the opportunity. After all, there is no compulsion to purchase from a willing vendor when a secondary market will subsequently exist.

After reporting season finishes at the end of February, we are confident that there will be an abundance of IPO's in the offing. With relatively few opportunities in the market that currently represent compelling value, and the market more broadly not only concentrated but trading on multiples that are fair to full in nature, there is the risk that, as in late 2013, the IPO market will overheat. This is particularly so given the relatively few liquid alternatives to equities available to investors for generating real returns in an environment where the RBA target cash rate is 2.5% and term deposits are at record levels, as per the chart below.

Cash on Term Deposit with Australian Banks vs Term Deposit Interest Rates



As a general rule we are cautious when investing in new floats, particularly where there is a large disparity between historic and prospective earnings, because of the risks outlined above. In any environment, particularly when sentiment is bullish, as investors we try to make sure that we are adequately compensated for the additional risk we are taking by purchasing stock in any initial public offering.

If you do not currently receive the Auscap Newsletter automatically, we invite you to register. To register please go to www.auscapam.com/ and follow the registration link.

Interested wholesale investors are encouraged to download a copy of the Information Memorandum from the website, www.auscapam.com/information-memorandum.

We welcome any feedback or comments you have. Please direct them to info@auscapam.com.

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