PURE
ASSET MANAGEMENT

Investor Newsletter

April 2020

Dear Investor,

We enclose the April 2020 update for the PURE Income and Growth Fund. An overview of our returns and portfolio comments are detailed below. For those of you struggling to adjust to the new paradigm of financial modelling while your kids throw tennis balls at you, we can highly recommend Netflix's new Tiger King documentary as a soothing mental balm once the workday has drawn to a close.

As always, thank you for your support.

Portfolio Returns

The PURE Income and Growth Fund returned -3.8% in March, with the decline attributable to the remaining warrant value in the NAV. After the 'washout' of February and March, the portfolio NAV is now 96% credit and cash, and therefore unlikely to suffer a similar decline in April.

	1 Month	3 Month	6 Month	1 Year	Since inception
Returns (%)	-3.8%	-3.3%	0.9%	7.4%	9.7%
St Dev (Annualised %)		9.6%	9.3%	7.9%	7.3%

After fees and assuming reinvestment of all income distributions

Market Conditions

If you thought February was bad, March was a doozy for equity markets, and we're pleased our credit-based approach to position origination is delivering what we'd hoped – the ability to gain exposure to microcap and smallcap equity upside whilst earning a cash return with lower capital risk than equity.

The gross capital loss in the PURE NAV cumulatively since COVID-19 started to rock equity markets has been 6.8%. Compared that to the declines in the ASX 200 Index and ASX Small Ord below:

	Performance 1 Jan – 31 Mar 2020	Performance 20 Feb – 31 Mar 2020	Performance 1 Mar – 31 Mar 2020
ASX200 Index	-27.4%	-31.8%	-22.8%
ASX Small Ordinaries	-24.1%	-29.1%	-21.2%

While the market needs to go up for equity funds to deliver a positive performance this year, PURE is now largely agnostic on how equity markets perform for the remainder of the year to deliver positive returns. While we have suffered two months of warrant NAV decline this should be more than recouped by the end of the year through:

i. the cash interest payments on the bonds.
ii. the continual march back to par of the bonds each month (remember, we discount the value of the bond by the value of the 'free' warrants on entry into the portfolio – so all our credit positions are written down by on average 10% on entry to the portfolio and gradually return to par value over the life of the bond).
iii. Any bond write-ups for positions we exit (we have one company currently seeking to redeem early, and not as a forced redemption – they now have access to a lower cost Government-sponsored loan)
iv. Any early exit fees realised
v. Any arrangement fees realised
vi. Any upside on warrant positions where the warrant price has reset to TERP as a result of an equity raise (Swift, SW1.AX, was one such example this month – discussed further below).

While we're alive to the risks of a protracted lockdown and its likely flow-on effects to companies and markets, with the information to hand we're comfortable our portfolio companies are well positioned for disrupted trading through calendar 2020, and are now turning our focus back outward to the opportunities arising from this crisis.

Portfolio Summary

Portfolio overview as at 31 March 2020:

Funds Under Management	$36.2m
Since Inception Return After Fees (distribution re-invest)	+9.0%
Total Distributions Paid After All Fees	+7.0 cpu
Total Committed Capital	>$50m
Number of Investments	11
Average Loan Size	$3.0m
Weighted Average Portfolio Interest Rate	+10.7%
Total Arrangement Fees Paid to Investors	$0.7m

PURE added no new positions to the portfolio during March.

Current Portfolio NAV Composition

PURE's Income & Growth Fund is designed to deliver positive absolute annual returns in good and bad markets.

We aim to achieve this through a predominantly credit-based NAV, with returns augmented by equity warrants derived from the origination of a transaction.

Each month when valuing the portfolio, accounting standards require us to mark-to-market the value of the warrants in the NAV. This is an objective process; the method of valuation is Black & Scholes, and the inputs are:

i. The trailing 12-month volatility for the stock
ii. The month-end risk free rate (10-year Australian Government Bond)
iii. The month-end share price of the underlying security

If the underlying share price over which we hold a warrant rises, and all else remains equal, the mark-to-market on the warrant value will increase. Conversely, if the underlying share price declines, the mark-to-market on the warrant value will decline, but as the warrant value diminishes its impact on the value of the fund diminished rapidly too. This is what we have seen driving the NAV decline in February and March.

Here's the portfolio NAV as at end-March – the value of Warrants is now significantly reduced, and unable to impact the NAV negatively to the degree of the prior two months:

NAV Components (A$M)	29-Feb	% of NAV	31-Mar	% of NAV
Value of Fixed Interest	26.9m*	80.3%	29.6.m	81.6%
Value of Warrants	3.2m	9.4%	1.3m	3.6%
Value of Equities	0.3m	1.1%	0.2m	0.5%
Cash at Bank	3.1m	9.3%	5.2m	14.3%

*Excludes new portfolio addition FiscalNote

Portfolio Yield to Maturity

The events of February and March have seen the warrant / equities exposure decrease from 15.4% to 4.1% of the portfolio. While some of this fall has been a result of equity liquidations to raise cash, most has been derived from falling warrant values. The silver lining here is that we are now seeing a highly asymmetrical risk / return event in the portfolio. For example, this exposure can only fall another 4.1% but the upside is not bound.

In terms of portfolio composition, the outcome of these price movements has been an increase in the proportion of the portfolio attributable to Fixed Income. With this in mind, we have undertaken an exercise to calculate the Yield to Maturity of our Fixed Interest investments. Our workings suggest that provided the portfolio doesn't have failures, the Weighted Average Yield to Maturity of the PURE's Fixed Interest exposures currently sits at 14.26%. Put another way, our credit positions will generate a gross return to unitholders of 14.26% per annum until maturity. This, coupled with the fact our warrant book cannot fall much further, presents a strong case to suggest the portfolio is well positioned to perform irrespective of how equity markets trade throughout 2020.

"They Always Find a Way to Survive"

When we were establishing the PURE Income & Growth Fund, a central piece of analysis that supported the validity of a Microcap convertible debt fund as an investment thesis with merit was the loss rate analysis that we conducted.

We examined the 2008 financial crisis and the two years ensuing, posing the question: how often *do* Microcap companies in our investible cohort (Industrials stocks, no exploration, no biotech/biopharmaceutical 'discovery' stocks) go into administration, voluntary or otherwise.

Turns out, not often. In fact, the loss rate (which we define as companies who left the ASX as a result of going into administration, within our investible cohort) through the GFC was 1% per annum – approximately 4 companies a year.

Which is to say, if you were conducting stock selection randomly, with no due diligence, then in a severe market downturn you could expect to have 1% of your positions go into administration in any given year.

Corporate Failures – PURE Investible Cohort* (c.400 Companies, 2008-2010)		
FY08	3	1.11%
FY09	7	2.58%
FY10	2	0.74%
Total	12	4.43% (c.1% pa)

*Industrials $20-200m market cap – no resources, drug discovering or biotech

This loss rate, for our intents and purposes, is very low. And it doesn't include overlaying actual due diligence on position entry, which should reduce the loss rate further. This has already been proven in practise in our fund – within the >100 companies we have now conducted some level of due diligence on in the last 18 months, we have seen administration occur in businesses that we have conducted due diligence on, and not liked what we have seen.

There is a nuance here though, and that is that administration doesn't necessarily mean capital loss.

Administration – voluntary or otherwise – is a process whereby an independent third party, the administrator, is engaged to assess the viability of restructuring a company to the satisfaction of creditor claims, such that the entity can re-emerge from administration as a going concern, or, if achieving going concern status is too difficult, an orderly wind-up of the business is conducted, with the first focus of satisfying secured creditor claims.

When PURE is assessing a new position for the portfolio we always ask, "What are our options for full capital recovery were this company to end up in administration?". We consider:

-Is the company's equity ultimately underwritten by a significant founder/shareholder?
-Is total equity invested to date significantly greater than our loan (goes to vested interest)?
-Is there IP value that could be realised in the event of liquidation?
-Are there wholly owned subsidiaries with critical value to customers/distributors/original founders/competitors/other stakeholders?
-Is there a logical acquirer of the business in any scenario?
-If we were to run this business for cash, is the revenue realisable with skeleton staff? What are the characteristics of revenue realisation in the business, and how does that change in administration?

Amongst other points.

The overarching point we're making here is companies in the cohort we're investing in go into administration far less often than you may think, even in times of significant economic decline. Once in administration, there are many options still available for capital recovery, and we enter each position considering what options will be available to us in such a scenario ahead of time.

That said, we're cautiously optimistic that the portfolio is adequately positioned to trade through this downturn.

Deal Outlook

Making sure our house was in order was the focus for March. This involved early dialogue with all portfolio companies to ensure they had the liquidity at hand to survive COVID-19. It is pleasing to say that all have acted promptly to ensure they exit the shutdown in a stable position.

While we are still finalising some solutions, our mind now turns to the new opportunities available. If companies were unhappy with their equity valuation prior to COVID-19 they are less happy now. We expect this to result in a fruitful period of deal origination and we continue to see attractive opportunities presented. Management teams still have growth aspirations requiring capital, yet little interest in diluting shareholders at current levels. While no new positions were initiated in March, we believe this fertile operating environment will last for 12-24 months. A protracted recovery should follow a growth shock such as this, and we see no reason why ECM activity should return at a faster rate.

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In Closing

We would also like to acknowledge the significant impact the current crisis is having on the lives of those who have lost, or potentially face losing, loved ones to COVID-19. Stay safe, do your bit by staying inside, and we'll get through this together.

Kind regards,

Nick, Mike and Tim