<u>SUPERVISED INVESTMENTS AUSTRALIA</u>

<u>AUSTRALIAN VINTAGE LIMITED – INVESTMENT THESIS UPDATE OCTOBER 2015</u>

On 26 August 2015 Australian Vintage Limited (**'AVG'**) reported a full year profit slightly below guidance. The Directors declared no dividend and the share price fell more than 17% to 33c. The Supervised Fund (**'TSF'**) has invested 8.2% of unit holder capital into AVG at an average price of about 37c per share, we have received more than 2c of dividends so far. We remain bullish on the stock and think it could double over the next two years.

AVG is Australia's second largest wine producer, receiving the award for international winemaker of the year twice over the past four years. AVG runs an integrated wine business selling low to mid price range cask, bottled wine and bulk wine as well as contract processing, vineyard operating and cellar door retailing. At the current share price of 38c the market cap is $89m with net debt of $104m (5% interest rate). 2015 EPS was 4c or 3c before abnormal items. The NTA per share is $1.04 and we estimate liquidation value per share at 58c.

HOW AVG MAKES MONEY

AVG's brands

AVG sells branded products in the UK, Australia, Canada and Asia. The vast majority (95%+) of sales are in the UK and Australian markets, which we estimate have done sales of approximately A$70m[1] and $A100m respectively in 2015. In both the Australian and UK markets, AVG sells to powerful retailers like Woolworths, Wesfarmers, Sainsbury's and Tesco. The branded products segment accounts for about 70% of all revenue and is continuing to expand. Branded wine offers good margins and management has done an excellent job growing this business. Since 2010 the CAGR has been 12.7% despite tough market conditions.

During 2015 we estimate the EBIT contribution from branded sales was approximately $14.5m[2]. We think management will continue to grow the branded wine sales at more than 8% over the next three years, especially if the AUD remains comparatively low against the

[1] Note – AVG reports its UK branded and bulk wine results together. For 2015 UK revenue was ~$100m. We estimate 30% of this is bulk wine sales. Bulk wine sales are done at cost (on a Gross Profit basis) or even a slight loss- this can be confusing when one is trying to determine the margin on UK branded products. AVG sells wine to the powerful UK retailers at discounted rates in order to ensure prime shelf positioning for branded products.
[2] This implies a $3m EBIT loss on bulk wine sold in the UK (we estimate a further $1.5-2m EBIT loss on bulk wine sold in Australia).

USD and GBP. Furthermore we expect margins to improve because 2015 results bore an abnormally high vintage cost.

AVG also makes money through its various cellar door sites throughout Australia, providing grape processing services as well as servicing and maintaining boutique vineyard operators vines.

Although branded sales account for more than 70% of sales, it only accounts for slightly less than half of wine volume. The remaining volume is bulk wine. Bulk wine is a commodity-like product usually transported in large shipping container-sized ‘bladders’. The price of a litre of bulk wine is about 1/6th the wholesale price of a litre of bottled wine. We estimate AVG sells about \$50m in bulk wine or ~53m litres per annum. AVG has a negative EBIT margin of ~\$5m from these sales.

The Australian bulk wine market has been struggling for more than 10 years. The existence of a flat ‘wet rebate’ of \$500,000 per annum to grape growers regardless of their size, means the many small scale growers have a significant advantage over large participants like AVG. AVG is lobbying to change this but we do not assume they will succeed. If the Australian dollar continues to depreciate and Australian wine is marketed properly, international demand for Australian grapes may return to levels experienced during the 1990s and the oversupply could diminish. This scenario would make bulk wine selling profitable again and more than double AVG’s total earnings from 2015 levels. Many commentators believe the outlook is finally getting brighter for this market. We do not assume it will but we treat the prospect as a free option embedded in the stock.

Under current market conditions, each litre of wine sold as branded rather than bulk wine (vs the year before) brings 40c of EBIT but reduces losses on bulk wine by about 10c for a net EBIT improvement of 50c[3]. This may not sound like much, but when you consider branded sales grew by almost 5 million litres in 2015 it becomes significant.

ALL THIS SOUNDS GOOD, BUT WHY HAS THE STOCK NOT RALLIED IN YEARS?

Someone who has owned the stock for the past few years may be asking – why haven’t the earnings skyrocketed over the past three years if branded sales have grown at 12%, the AUD depreciated and the cost of debt reduced by 40%?

Part of the answer lies with contract processing. Historically AVG has had a thriving contract processing business. Contract processing involves AVG using its plant to convert third party grapes to wine under an agreement with a third party. 10 – 12 years ago AVG entered into long-dated contract processing agreements. These contracts were priced at market rates at the time signed and the market price has fallen significantly over the past 10 years. This meant AVG was receiving above market margins on the deals. The contracts have been running off over the past few years which is unfortunate because they offered excellent margin because AVG would generally incur the costs of operating its machinery each year in the absence of the contracts. The last of these major contracts expired in the 2014 financial year and caused contract processing revenue to drop by more than \$7m to \$2.7m in 2015. We asked management if they expect to see this decline further and the answer was no. The company has picked up a few small contracts and thus expects 2015 levels to be repeated. Accordingly, the rise of branded sales has been offset by the decline in contract processing. Going forward however shareholders will see benefit from any increase in branded sales.

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[3] Please note this is a simple example based on margins from 2015 which were arguably depressed for branded wine.

The astute investor who has owned the stock for the past few years may however notice that despite the growth in branded sales, branded EBIT[4] actually decreased from $16m in 2012 to $14.5m in 2015. One reason for this is a $4m annual increase in marketing spend. We note this has been necessary to maintain growth and do not see it rising too much higher in the next two years. The main reason however was the abnormally high cost of the 2014 vintage. Viticulture is an agricultural business and as such is subject to the volatility of crop yields. 2014 was a poor season which increased the cost of production for AVG as it had to purchase grapes on market to satisfy its branded product requirements[5]. We estimate the high cost of the 2014 vintage reduced EBIT by $4.5m in 2015. The 2015 crush was more normal. It takes AVG 18-24 months to realise wine after the crush which means the first half of 2016 will continue to bear the costs of the poor 2014 yield.

This $4.5m in additional costs meant that the benefit of the lower AUD vs the GBP was not felt. Management defined the 2014 currency benefit of $5.2m. In a perfect world this would have all dropped to the bottom line however the powerful UK retailers tend to take about half of the additional margin for themselves, we don't think this will change in our lifetime! The average AUD/GBP exchange rate was 6% lower in 2015 than 2014. Importantly however, the AUD has depreciated a further 14% against the GBP[6] so far for 2015. We estimate this would result in a further $1m in EBIT[7] to AVG if the exchange rate remains.

To more directly answer the aforementioned astute investor's query, if we adjust for high cost of the 2014 vintage EBIT from branded sales has increased to about $19m.

THE ONEROUS CONTRACTS

AVG is party to a variety of grape supply agreements which provide for the company to acquire grapes at various prices which exceed market price. Approximately 12 years ago the prior CEO entered into these long dated agreements perhaps because he thought the Australian grape market was heading for under supply rather than the oversupply that eventuated. In retrospect the agreements created a major problem for the company and inflated very short term earnings at the time the deals were signed. Most of the contracts are beginning to roll off with an estimated 80% to have ended by 2018.

The company is currently involved in litigation which is seeking to bring forward a large proportion of the roll-offs to the present time. The litigation is in the NSW Supreme Court and we expect a decision by December this year.

In the 2015 accounts, AVG finally provided guidance as to what the cash flow lost stemming from the contracts is. It was said to be a loss of $6.9m of cash flow during 2015[8]. After taking into account the amount of this loss which has already been provided for via historic impairment charges, we believe the annual EBIT accretion to be approximately $4m through the cycle.

[4] Again assuming a $3m EBIT loss from Bulk wine in the UK is included in the UK EBIT figure reported

[5] While it may be intuitive to assume that because AVG sells bulk wine for negative margin the company must never have to purchase bulk wine on market to meet its branded product's needs – this is not the case. Wine is not all the same, when there is a poor yield AVG needs to purchase specific grape varieties from other grape growers.

[6] Using an exchange rate of 0.4556 as at 4/9/2015 compared to 0.5304 which was the average during FY2015

[7] This is arguably conservative and assumes significant margin pressure from UK retailers

[8] This pertains to only the contracts that roll off before the end of 2018.

THE COURT CASE

On 11 September 2015 Australian Vintage Limited ('AVG') were successful in an appeal made in the Supreme Court of NSW. The respondent, Belvino Investments No 2 Pty Ltd ('Belvino') was ordered to pay AVG's costs.

The matter related to the Del Rios Vineyard in Victoria which AVG has leased from Belvino since 2004 and is contracted to continue to do so until 2023. The lease terms are above market rates and AVG seems to make a loss on grapes grown on the vineyard. Given Belvino has not applied for special leave to appeal we do not expect the decision to be overruled. At this stage we believe there is a better than even chance AVG will be able to terminate the lease. AVG will update the market on a final outcome by December 2015.

We estimate the lease is approximately $1.5m above market per annum. However, it seems the company is not too interested in renewing the lease at a slightly lower cost, we think they want to terminate and walk away from the property. The 2015 accounts had some minor commentary on the dispute, included was "If successful the company will be able to terminate this long term contract" (p30). It is worth noting for clarity that there is no grape purchasing agreement associated with this lease, AVG produces the grapes for its own use.

AVG produce on average 20,000 + tonnes of low quality irrigated grapes from Del Rios. These grapes are then processed at AVG's Buronga Hill facility and ultimately sold as bulk or low quality branded wine. We estimate it costs AVG $450 per tonne to produce at Del Rios, this compares to the current market price for this type of grape of $250-300. There is ample supply of grapes which AVG could purchase for its own requirements at Burronga Hill.

Accordingly by terminating the contract AVG would **save $3-4m in COGS per year**. Of course if the wine cycle does turn for the better and grape prices increase these savings will be no more. However under such a scenario the swing in margin on AVG's other bulk wine operations from negative to positive would much more than outweigh the additional costs incurred.

Furthermore, given AVG currently generates losses on bulk wine sales, by terminating the contract and not substituting the grapes with on-market purchases they could theoretically reduce their exposure to bulk wine and its associated losses. We estimate this could result in a further $0.5m in EBIT savings.

In addition, AVG expensed the $1.005m of legal expenses pertaining to this matter (which most probably have increased to $1.2m). This means there will be an immediate write-back of a similar amount in the 2016 interim accounts.

NORMALISED EARNINGS

The below table represents the effect of what we have discussed so far on EBIT and earnings. Please note these are our estimates.

AVG EBIT CONTRIBUTION (A$M)	2015 actual	ADD Adjustments for abnormal 2014 Vintage costs	ADD Adjustments for subsequent depreciation of AUD	ADD Adjustments for release of Del Rios and subsquent savings on purchsing grapes at market rather than growing	ADD Adjustments for onorous contracts	ADD 2 years branded sales growth at 7%	ADD change in bulk wine margin if and when cycle turns or wet rebate is cancelled
Australia / North America Packaged	7.19	9.44	9.44	11.19	13.19	15.11	15.11
UK Branded	7.46	9.71	10.71	10.71	12.71	14.55	14.55
UK Bulk	-3.00	-3.00	-3.00	-1.25	-1.25	-1.25	1.00
Cellar Door	1.43	1.43	1.43	1.43	1.43	1.43	1.43
Australia/ North America Bulk	-1.50	-1.50	-1.50	-1.50	-1.50	-1.50	1.50
Australia Contract Processing	1.62	1.62	1.62	1.62	1.62	1.62	1.62
Vineyards	3.51	3.51	3.51	3.51	3.51	3.51	3.51
CATALYSTS/ADJUSTMENTS		4.50	1.00	3.50	4.00	3.75	5.25
Total	16.71	21.21	22.21	25.71	29.71	33.46	38.71
Net finance costs	-6.35	-6.35	-6.35	-6.35	-6.35	-6.35	-6.35
Profit before tax	10.36	14.86	15.86	19.36	23.36	27.11	32.36
Tax	-3.23	-4.64	-4.95	-6.04	-7.29	-8.46	-10.10
Normalised Net Profit	7.13	10.22	10.91	13.32	16.07	18.65	22.26
2015 Adjustments after tax	2.23						
Net Profit after tax	9.36						
Normalised EPS	$0.03	$0.04	$0.05	$0.06	$0.07	$0.080	$0.10
Price to normalised earnings	12.4x	8.6x	8.1x	6.6x	5.5x	$4.733	4.0x
Return on tangible equity (not including tax assets)	3.4%	4.8%	5.2%	6.3%	7.6%	8.8%	10.5%
Share price at 15x earnings	**$0.46**	**$0.66**	**$0.70**	**$0.86**	**$1.04**	**$1.20**	**$1.44**
Upside	21%	74%	85%	126%	173%	217%	278%
SHARE PRICE	$0.38						
EBIT	16.71	21.21	22.21	25.71	29.71	33.46	38.71
D+A	6.63	6.63	6.63	6.63	6.63	6.63	6.63
EBITDA	23.34	27.84	28.84	32.34	36.34	40.09	45.34
Net Debt	106	106	106	106	106	106	106
Market cap at 35c	$88.27						
EV	194.274						
EV/EBITDA	8.32	6.98	6.74	6.01	5.35	4.85	4.28

The column shaded in blue represents our base case scenario. We do not necessarily expect a turn in the wine cycle in the short term but believe it is possible over the coming 3-5 years. It's appropriate to note that this scenario of 8c annual EPS does NOT rely on an improving outlook for Australian wine, nor does it count on further devaluation of the AUD. Please note the adjustments for onerous contracts will take 18 months to hit the P+L once the contracts expire. We include it here because it is appropriate to do so when using a multiples approach to valuation. Also note this reflects what we think of as an average vintage year. The worst case scenario would involve a loss of key customers, a significant rally of the Australian dollar and continued poor vintage yields. In the very worst scenario AVG would not generate enough cash flow to cover finance expense. In this case we would expect AVG to raise capital if it wanted to remain as a going concern. While this scenario is possible we think it is unlikely and are comforted by the asset backing of AVG.

THE BALANCE SHEET

So far we have only explained the earnings potential. AVG has significant hard assets as follows:

AVG (AUDm)	Liquidation Value	Replacement value	Book
ASSETS			
Buronga Hill Winery	60	115	
Yaldara Winery (sold for 15.5m announced 7/14)	0	0	
Hunter Winery	2	2	
Nepenthe Winery (SOLD)	0	0	
Merbein Production facility	7	18	
Cold Ridge Vineyard	10	18	
Grand Junction Vineyard	8	12	
Nepenthe/ Barossa Vineyards	4	6	
Total Vineyards	22.00	36	
Total Assets	91.00	171	126.17
Water Licenses	6	7.5	7.5
Total	97.00	178.5	133.67
Inventory	Liquidation Discount	Bk value	Liqu Val
Current Inventory			
Bulk Wine	15%	123	104.55
Bottled Wine	-10%	33.182	36.5002
Other	50%	3.97	1.985
WIP	75%	5.4	1.35
Non-Current			
Bulk Wine	15%	31.797	27.02745
Bottled Wine	5%	1.746	1.6587
Total Inventory	13%	199.10	173.07135
Other Working capital			2
Onerous Contracts payout			-6
FX positions close			1
12 months interest			-6
Staff wind up			-12
Liquidation expenses and commisions			-8
Net Debt			-106
Net Asset Value (Liquidation)			135.07
Shares on Issue			232.3
Liquidation per sh.			**$0.58**
UPSIDE			76%
Replacement value			260.60
Replacement value per share			**$1.12**
LIQUIDATION VALUE PER SHR IF BURONGA ONLY SOLD FOR $15m			$0.39
NET ASSET VALUE AS PER BALANCE SHEET			$292.36
Market cap at 33c			$76.66

Accordingly the stock is trading at a significant discount to its tangible asset backing and even a discount to its fire-sale asset backing. Many market participants are aware of this, however are not attracted to the stock because they do not believe the management nor current shareholders will ever place the company in run-off. We think this is right as long as there is no further deterioration in the cycle.

With this in mind we think the reason the stock trades at such a discount to its asset backing is because it is simply not generating a sufficient return on equity capital. We believe the stock will trade closer to replacement value if and when the market sees good scope for earnings growth. As per our arguments detailed above, we believe earnings will grow but in the meantime feel comfortable buying stocks at significant discounts to asset value.

WHAT DO THE BEARS SAY?

The bears do not like the $106m of net debt. It is true that the debt is high, however when compared to current inventory $165m it does not seem too high. The outlook for cash generation is also improving which may help mitigate this risk.

The bears also do not like that the CEO is not in the market buying shares although he is paid a base salary of AUD600,000. The CEO has been purchasing shares over the past 12 months and spent $40,000 on shares in December 2014. He has over 1m shares and rights and continues to be well incentivised through new share rights. While it's true that it would be nice to see him purchasing more shares, we understand he has several teenage children which may provide some excuse. It is however worth noting that the CEO is regarded by all as an excellent salesman and the right man for the job if this is to remain a going concern.

The bears do not like the lack of turnover in the Board and the fact that the prior CEO[9] remained on the Board despite being responsible for the crushing onerous contracts. We have to agree with the bears here, but were comforted to see the prior CEO resign from the Board in June this year. It was also good to see other Board appointments and natural turnover during the 2015 financial year.

The bears think wine producers are at the mercy of the all-powerful alcohol retailers who seldom allow for natural price increases. We agree with this point, but expect AVG to continue to grow by winning market share, as they have done over the past four years. Furthermore, we see proof that the retailers only take half the additional margin from favourable FX movements. We also like that AVG has a growing footprint in China and ambitions to enter the US market. These endeavours should allow for continued growth even if prices do not grow with inflation. This is particularly relevant as AVG are effectively operating at 50% branded capacity. As explained, each new litre sold as branded rather than bulk has an immediate impact on the EBIT margin. We think this will provide sufficient margin protection over our investment horizon.

The bears note that the Australian wine industry seems to have been in a depressed state and is probably never coming back. We are not counting on the industry conditions improving but do believe the wine cycle will turn for the better at some unknown stage in the future. The bears also do not like the long-dated working capital cycle and the high capital intensity of wine production – this is a fair but we think the current price justifies investment.

CONCLUSION

We remain comfortable with our 6.5% weighting in AVG. We like the management, exposure to a declining AUD, high probability of earnings growth and attractive valuation.

[9] Who is the older brother of the current CEO and founded the company

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