2 February 2022

Dear Investor

Our objective at Tanarra is to enable our investors to make good returns on their investments irrespective of market conditions or sentiment. We do this through our diversified alternative asset investment platform, which spans venture capital, private equity, private credit, distressed debt and PE-style investing in public companies. We believe our model is one for all seasons in financial markets; it's unique in Australia; and that there is strength in diversity - for both us and our investors.

Financial market conditions at the time of this letter are exceptionally uncertain. A cocktail of rising inflation, rising interest rates, supply chain disruptions and labour market chaos from Omicron – not to mention global political instability - has severely knocked asset prices of highly rated growth stocks. It's quite unsettling. For many years now, financial markets have felt akin to living on the San Andreas fault line – occasional tremors, some of them big, but never the "big one". Governments and central banks have ensured that hasn't happened. So far.

Is this finally going to be it?

The remarkable flowering of crypto currencies and all the "picks, shovels, and marketplaces" business models being built around them look like a classic case of late-stage speculative excess - even with reassuring marketing names like "stablecoins". With, for the most part, no inherent worth or even substantive backing other than (debateable) perceived scarcity, they depend almost entirely on a "pass the parcel" investor mindset and the maintenance of collective investor belief. We respect the fact there's a lot of smart money now playing in this sector but prefer to watch this one from the spectator seats. Promoters point to the existence of cryptos for over a decade now as proof of their substance, but it's also true that there's been no serious sustained market shake-out during this time to give them a proper stress test.

No less of a bubble exists in venture capital today. A lot of investment outside the professional VC sector is in our view being driven by FOMO, buzz and cheap money rather than business models likely to be sustainably successful. A lot of investors are going to find out that it's a lot easier to get into these businesses than to get out of them. While we believe that the flourishing of the venture sector is a great long-term development, we also believe that time-tested investment principles - most start-ups fail, and caveat emptor - haven't been abolished. One of our investment associates Neil Vinson wrote an excellent article last year pointing out that VC valuations benefit from the lack of any investor mechanism to short stocks, unlike public companies, contributing to a systematic positive bias in what's publicly reported.

Even at the larger and more established end of the venture market, it's rarefied air. Some US$700bn of large privately held venture-backed companies are seeking to go public in the US this year to access the capital they need to stay alive and to give their (now slightly nervous) owners, sitting on large paper gains, liquidity and an exit. Many are putatively valued at 20x revenues or more, even taking into account the impact of the recent correction in public markets.

These valuation multiples are extraordinary by historical standards. There's no law that says unprofitable growth businesses should be valued at anything like this. It's simply become the "new normal" over time because other start-ups have been valued that way and produced happy outcomes for investors in an era of ultra-easy money. It's financial market groupthink on an unprecedented scale.

It will be short-term painful but long-term healthy for the financial system for these excesses to be corrected, as they inevitably will. Financial markets will eventually return to their traditional role as allocators of capital between sound and less-sound businesses, without the unprecedented distortions from government and central bank policies since the GFC.

But I doubt what's happening now is the big meltdown – even though the Nasdaq is off to its worst start since 2008 and many of the most expensive stocks have lost half their value.

US$10trn of negative interest rate Govt bonds and near-zero bank deposit rates in most of the Western world aren't going away any time soon, even with modest central bank rate rises. As a consequence, there will continue to be a strong incentive for investors to remain invested in risk assets. And while I advise against investing in current generation cryptocurrencies, it's worth remembering that their total global value today at c.US$2trn is less than a third of the US$6.5trn value of just Australia's housing market. The inevitable deflation of the crypto bubble should not pose a systemic threat to the world financial system, even though there will be transmission effects.

It's worth noting in this context that in the long term, cryptocurrencies portend something much larger and most likely very positive for the world financial system – national digital currencies built on the blockchain.

Financial markets and asset prices may remain relatively bullet proof for now, but ultra-loose fiscal and monetary policies pose serious hazards for future generations. Some 25 countries today have total debt to GDP ratios more than 300%. Twenty-five years ago, none did.

How exactly is this debt bomb going to be dealt with?

Reduced to its most simple terms, there's essentially only five ways an excess sovereign debt burden can be dealt with:

- cancel (possible if your central bank holds all the debt – but life's rarely that simple)
- default/restructure (that makes you Argentina, not good)
- inflate (but there remain strong structural deflationary forces at play, and adverse FX consequences for nations that need to borrow offshore)
- tax the living daylights out of your population (we've seen that movie before, and it doesn't end well); or
- grow your way out of it.

Growth is clearly the most – if not the only - attractive option. However, in reality, there's simply no way economies can grow organically out of these eye-watering numbers. Which means governments and central banks have a serious vested interest in ultra-low rates persisting long into the future, despite pending rate rises in response to incipient inflation. They simply can no longer afford a serious rate breakout and will in all likelihood endeavour to act to counteract bond market signals in that direction.

Which points to a combination of low growth and low rates grinding steadily higher as the most likely scenario for western economies – a version of "Japanification" of financial markets. The market is now pricing in a (consensus) estimate of 100-125bps cumulative Fed rate rises by the end of calendar 2022, so asset prices in the near term should be insulated to a reasonable degree from prospective rate rises. But the medium-term consequence is likely to be the end of the "bull market in everything" that investors have enjoyed in recent years, and a much more selective and challenging environment for returns.

Selective classes of equities should remain attractive assets in this environment in a relative sense. This should be the case for emerging markets equities where valuations are not demanding, and which will be underpinned by the rise of China to the status of the world's largest economy. That will inevitably be accompanied by an increase in its global equities index representation and a likely gradual further opening of its financial system. China today represents c.17% of world GDP but less than 4% of the MSCI ACWI index, an unsustainable imbalance in the long term. Greater index representation will over time a drive greater allocation of international capital to the China market and higher valuations, notwithstanding the government's present ultra-tight Covid policies and periodic actions that seem destabilising to the economy and some of its leading companies.

This profound shift in economic power to China brings with it an equally profound challenge to the established global political order, still in the early stages of transition to a bipolar US-China world. All of us have a serious vested interest in the US being capable of accommodating the rise of a long-term strategic rival - in fact equal. Calm and wise leadership capable of taking a long term measured perspective has never been more important than in this environment.

Unfortunately, US politics seems to be going in the opposite direction. The prospect that an individual who continues to paint the 2020 Presidential election as fraudulent has a strong chance of being re-elected in three years' time is nothing short of alarming. The United States is the world's greatest democracy, the light on the hill globally for the democratic values that we cherish, and the lynchpin of the international rules-based order that's avoided global conflict since 1945. It's not Venezuela. I lived in the US from 1987-1991, and this is not the country I recognise. How can a political system, the basic integrity of which is disputed by a large proportion of the population, cope with such a profound external challenge, let alone provide leadership to the rest of the world on it?

Thankfully, it's not all doom and gloom – far from it. I am immensely optimistic about the future of Australia, and Australia as a place to invest, notwithstanding the structural challenges of our national federation that have been exposed during Covid-19. Our country will continue to grow irrespective of "small Australia" proponents who like to worry about infrastructure and welfare costs and job displacement, seemingly unacquainted with the stories of immigrants like Frank Lowy and Harry Triguboff and how they helped build our economy and national story. Australia will continue to grow for the simple reason it's a fabulous place to live and raise a family. People want to live here, and net inbound migration will reassert itself quite quickly. And the digital revolution has created new opportunity for fearless and innovative Australian entrepreneurs to tackle global markets with global business models, overcoming the tyranny of distance that traditionally made it hard for Australian companies to expand offshore.

There are good reasons for optimism globally as well.

The relentless march of human progress has never been displayed better than during this pandemic. Technology in the form of two Vs – video and vaccines – has transformed our ability to deal with

Covid. To have such a large percentage of the world population fully vaccinated against the virus within two years of its outbreak is an unprecedented achievement of humankind – something to be celebrated. It's a great marker of progress and a cause for optimism.

And despite the enormous expectations that were raised in advance of the Glasgow COP 26 summit which were never likely to be fulfilled, the world is inching crab-like to real progress in tackling climate change. There has never been a global problem remotely as challenging as this one – with interests differing between the developed and developing worlds, between countries, between socio-economic groups and industries within countries, and between generations. Targets required to reduce warming to 1.5 degrees remain out of reach for the present and depend on unproven future technologies. Yet, bit by bit, incremental progress is being made, and that's a great thing.

Tanarra made good progress in 2021 despite the challenges presented by Covid and lockdowns.

Our Long-Term Value fund that invests private equity-style in public companies performed very well, producing a 15% excess return over the ASX300 index. This was the product of good stock selection and effective positive engagement with investee companies. We were extremely gratified that our two cornerstone investors in our inaugural fund increased their combined commitments to our follow-on fund from $700m to $1bn. There continue to be many attractive investment opportunities in this space in Australia. The current M&A boom will in our view produce many more in the years ahead, when the true value of deals done in expensive markets in an era of easy money becomes clear.

We believe our "high-touch" LTV investment style is more important than ever before, to help our public companies produce the returns that shareholders deserve. The shift from active to passive investment styles in listed markets has reduced the level of owner input available to public companies. This trend continues, so there is an increasing gap and need.

It's never been more challenging in many ways for directors in the public company sphere. One example is the inability in 2021 of our national parliament, due to intense lobbying by the class action industry, to pass legislation to reign in opportunistic shareholder class actions against public companies, despite improvements in continuous disclosure laws that were secured. Australia has gained a deserved reputation as one of the easiest markets globally to bring these actions. Investors don't realise how much of an impost this represents on their returns, over and above the impact on companies on the receiving end of such lawsuits. We estimate that the aggregate annual D&O insurance bill for ASX300 companies has blown out in recent years by a factor of three to $1bn or more, in no small part due to the rise of such class actions. Put a market PE multiple on that and you're talking a serious value impact across the entire market. And that's without factoring in the impact of greater policy exclusions on public company policies, and the flow-on impact to private companies.

Our Tanarra Restructuring Partners team raised c. $375m commitments for their inaugural distressed debt and special situations investment strategy in 2021. They are now reviewing a number of potential investments. TRP is the only Australian-owned fund of this type. It has a highly experienced team, a unique business model which has an active focus on the interests of all stakeholders (in particular employees) in a restructuring situation, and a model where 10% of business profits are reinvested in social enterprises. That's something we're proud of.

Tanarra Credit Partners – our private credit team – continued to grow and now has $750m of funds under management. The investment portfolio of 25 credits has performed very soundly, consistent with the low-risk defensive yield-producing returns sought in this asset class. The debt is floating rate, so it's protected against both inflation and rising rates. It's truly an investment product for the times. The team is poised for further growth this year with the launch of Fund II and the expansion of our Asian team.

Our private equity team made a new investment in 2021 in Health Metrics, Australia's leading software platform for the aged care sector. We also made follow-on investments to accelerate the growth of our organic dairy business Barambah Organics and HSE and workforce management technology business INX Software. We now have a portfolio of five businesses weighted to technology and growth sectors of the economy, where we're backing great business founders in businesses with excellent products that customers love. That's a good place to be in private equity we believe.

In venture, we continued to make selective investments at reasonable valuations in standout companies globally, in partnership with our trusted network of partners and co-investors. We invested in five new companies – Ascenium (Palo Alto), Revela (Boston), Kirmada (Oxford), Oxford Advanced Surfaces (Oxford) and Access Telehealth (Melbourne). We were delighted that Vicinity Centres, a partner of the highest calibre, chose to invest in one of our domestic investee companies, Global Marketplace, allowing them to make a significant growth investment in New Zealand.

Our venture activities differ from almost all Australian VC investors in that they are genuinely global – the portfolio of 26 companies spans the US, UK, Norway, China, Thailand as well as Australia and NZ. In all offshore investments, we co-invest with trusted partners with relevant domain expertise. That is the product of decades of personal relationships. We love these investments – they're based around future technologies, we've invested at sensible valuations, they're performing well, and they give us a window – an information edge – into future technologies and trends that helps our investing across all our asset classes. Very few Australian equities or debt investment firms have an in-house global venture capital arm as well.

This year we will be raising a "Founders' Fund II" that will give investors the opportunity to invest with us in founder-led businesses in both private equity and later-stage venture and growth capital, following on from our well-positioned Fund I. These will be predominantly Australian investments, but also international in VC given our track record and relationships in this space. It will be assisted by our proprietary in-house Tanarra Advanced Analytics team. We think this is an exciting and strongly differentiated proposition and will provide more detail in the coming months.

Last but by no means least, our pro bono philanthropic advisory arm Tanarra Philanthropic Advisors had another impactful year providing strategic and financial advice to many charities. One highlight was the launch of the Board Health Check, a survey tool developed by TPA to help not-for-profit boards analyse clearly, and have an honest conversation about, how well they're achieving their goals. This survey is different from run-of-the-mill board surveys which often paper over crucial disagreements due to politeness, score inflation or generalities; the BHC has questions designed to expose real views on priorities and progress, and generate important conversations. It's sponsored by the Governance Institute of Australia, it's free, and it can be downloaded here https://www.boardhealthcheck.org/.

Overall, we are very positive about the future for Tanarra. We believe that times of capital market inefficiencies, dislocations and uncertainty like these provide excellent opportunities for our firm, with

our diversified alternative asset investment model and a skilled, experienced team that has invested through many previous market cycles and corrections.

We are exceptionally grateful for the support from our investors and thank you for it. We wish you and your loved ones all the best for the year ahead, a year in which we all hope to put this wretched pandemic behind us.

With best wishes

John Wylie AC
Founder and Principal