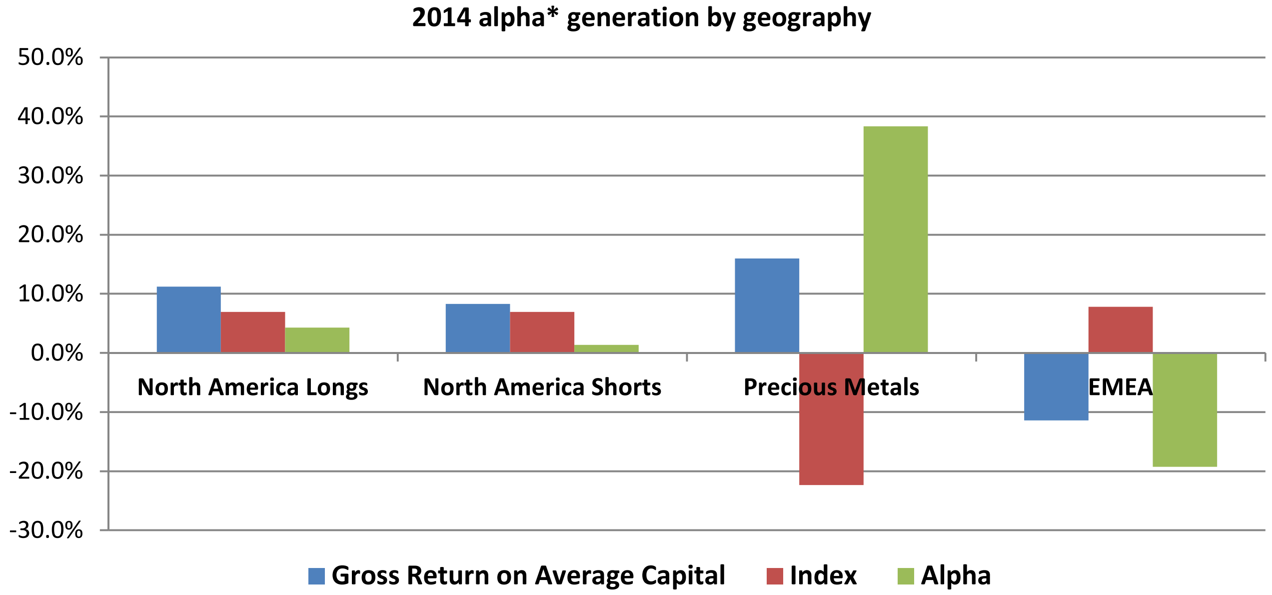
Eschler Asset Management LLP

Eschler Recovery Fund SP
www.eschlerasset.com

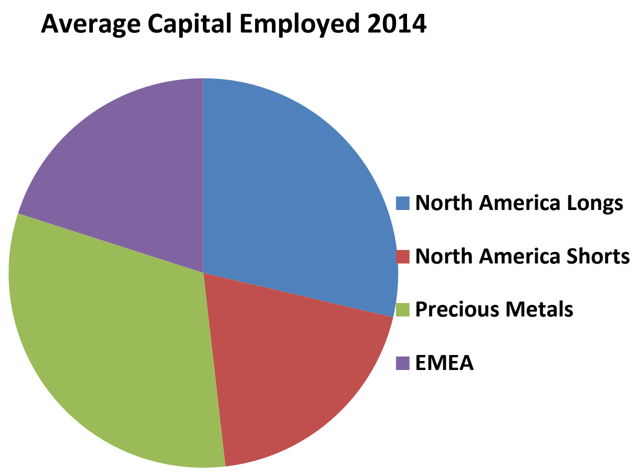
Dear Partners,

Eschler Recovery Fund ("ERF") NAV rose 7% in 2014. Through January 2015 ERF has risen +21.5% since inception in October 2012, an 8.8% compounded return. Last summer the return was compounding at twice its current pace since inception (+18% p.a.) so the calendar result is disappointing. As I will explain, current positioning guarantees a degree of periodic volatility but, I believe, reduces risk of permanent impairment. It gives the fund a good shot at positive returns in both cyclical bull phases *and* cyclical bear phases. It avoids the costs of put options, large short exposure, market timing, or significant cash drag. In this letter I will review the drivers of 2014 results, expand on the strategy alluded to above and discuss current holdings.

2014 Results



By geography, gross alpha was positive on longs and shorts in North America, positive on precious metals longs, and negative on EMEA holdings.



Regionally, only EMEA holdings lost money in aggregate. At the position level, the top five long contributors for the year were InfuSystem Holdings, Detour Gold, Vinaland, Fairfax and Markel. The top 5 long detractors were Forest Oil (now "Sabine Oil & Gas"), Dolphin Capital Investors, Mobile Streams Plc, Continental Gold and JG Wentworth. On the short side, winning positions included Odyssey Marine, Nu Skin, Herbalife, Voxeljet AG and Angie's List, while losers included Keurig Green Mountain, Questcor, Tesla, Zillow and First Solar.

*For this analysis I used gross returns for the numerator and average month-end capital by category for the denominator. For comparison purposes, since average market cap in ERF is $1.7bn (and the median is $162m) I used the Value Line Arithmetic index total return for North America, the STOXX Europe 600 index total return for Europe and the Market Vectors Junior Gold Miners ETF for the precious materials exposure.

The biggest winner of 2014, **InfuSystem Holding**, is a micro-cap provider provider of primarily leased mobile drug infusion pumps for chemotherapy patients. It is a high margin, cash generative business that was milked by prior management. In late 2012 I noticed that another investor I respect had assumed control of the board which got me interested. Under his new leadership team, margins improved, debt ratios fell and earning power rose into the range of 13-15m on a cash flow basis. I purchased a 5% position for ERF in late 2012 at a market cap of circa $30m (circa $1.40 per share) and an enterprise value of $55-60m. A burst of enthusiasm for the turnaround saw the shares rocket above $4 per share (equating to an EV of $115m) for a couple days in late October 2014. A degree of luck allowed me to sell what was still a 6% position then for a two-year IRR approaching 65%! As an aside, you won't see ERF pursuing any sort of activist agenda. I'm glad to jump on others' coattails though, as long as credible management is already in place.

The biggest loser, **Forest Oil (now "Sabine Oil & Gas),** lost 82% over seven months starting in May 2014. The 4% position was funded by a well-timed exit out of Chesapeake Energy at $29 per share, at the time nearly a 9% position purchased in late 2012 at $18.5 per share. But even though Chesapeake went on to fall 50%, I managed to lose more absolute dollars with Forest Oil despite half the position size. The rationale for the switch was exactly the reverse, to make more absolute dollars than I would have with Chesapeake, but with half the capital!

In May 2014 Forest Oil announced what appeared to be a compelling merger with privately-held Sabine Oil & Gas. Both were financially leveraged natural-gas weighted E&P companies with complimentary assets. Forest shareholders would contribute a large current production base and Sabine would contribute reserves and a savvy operating management. Forest shareholders would own 26.5% of a much larger de-risked enterprise which would be one of the largest leaseholders in East Texas and liquids-rich Northeast Louisiana, as well as a big player in the liquids-rich Eagle Ford Shale in South Texas.

At purchase, it was pretty easy to use the EV/EBITDA multiples of publicly-traded comps to arrive at an attributable value to Forest shareholders of nearly 2x the trading price, to be realized once the merger closed and analysts began to re-initiate coverage. In the event, the merger was delayed as bondholders and event driven funds angled for positioning, but did finally close in mid-December. Unfortunately, oil collapsed 50% with natural gas not far behind.

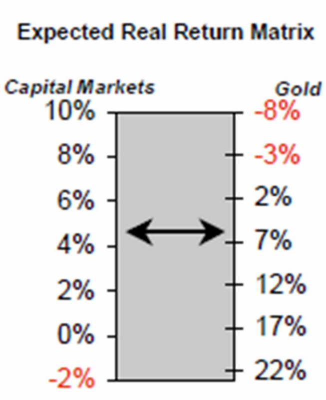
My mistake here was two-fold: First, combining commodity exposure with too much debt was a bad idea. Second, I relied too heavily on peer valuation analysis and gave too little weight to the impact of bear case commodity pricing on the equity value of the financially-geared combined entity. While I've mentally written it off, I've kept the position (now 1.5% of NAV) as a call option since Sabine is well-hedged this year and First Reserve, the new private equity owner, has a strong operational trackrecord and huge skin in the game. Boy are they going to need it!

Strategy

Portfolio construction is a key differentiator for ERF, the most unique aspect of the strategy for the foreseeable future. Think of ERF as a high-conviction portfolio deploying a value-oriented investment program, but also invested in a massive unconventional insurance policy. There are four hedging tools at my disposal: 1) holding cash or varying net long exposure ("market timing"); 2) shorting; 3) buying put options, or 4) finding an investment whose prospective return may negatively correlate with the rest of the portfolio. I have mixed feelings about holding a large cash position or changing market exposure back and forth; market timing is easier said than done.

Shorting is expensive these days: There is no short rebate, borrowing costs are high and short-squeezes are a constant risk. Using put options as insurance is just another cost to the fund…

…Which leaves uncorrelated investments: It is a fact that gold has a long-term negative monthly correlation coefficient with the S&P 500. Peter Palmedo of Sun Valley Gold wrote a timeless essay on gold in 2002* in which he cites research showing that, contrary to the consensus view that gold is driven by price inflation, the relative price of gold is actually driven by (and is the reciprocal of) the real return from capital markets. Historical evidence suggests that if capital market real returns are near zero, the expected return of gold approaches 20%, with gold shares returning a multiple of the underlyer.



Gold 2002: Can Investment Consensus Be Wrong? Sun Valley Gold, 2002

With that in mind I have deployed 30-40% of ERF capital into a diversified basket of heavily out-of-favour precious metals equities. I consider this holding, at this depressed stage of the precious metals cycle, to offer minimum risk and considerable ultimate upside if broader markets get nasty. Gold is 37% off its highs and silver is 65% off its highs. Gold and silver stocks have fallen much more. ERF's precious metals holdings all trade well below 1x NAV at current metal prices (where a multiple of NAV was the historical norm for decades). The precious metals sector is also an inefficient sector where stockpicking can add value. This alpha can help defray the time decay element arising from equity dilution inherent to this capital intensive sector. The reward for buying low is that upside cycles in this industry are the stuff of legends. There is never any free lunch, and this hedge does not reduce volatility, but it does in my view minimize the likelihood of permanent portfolio impairment while preserving upside. As all my liquid assets are invested in ERF, that's all I care about.

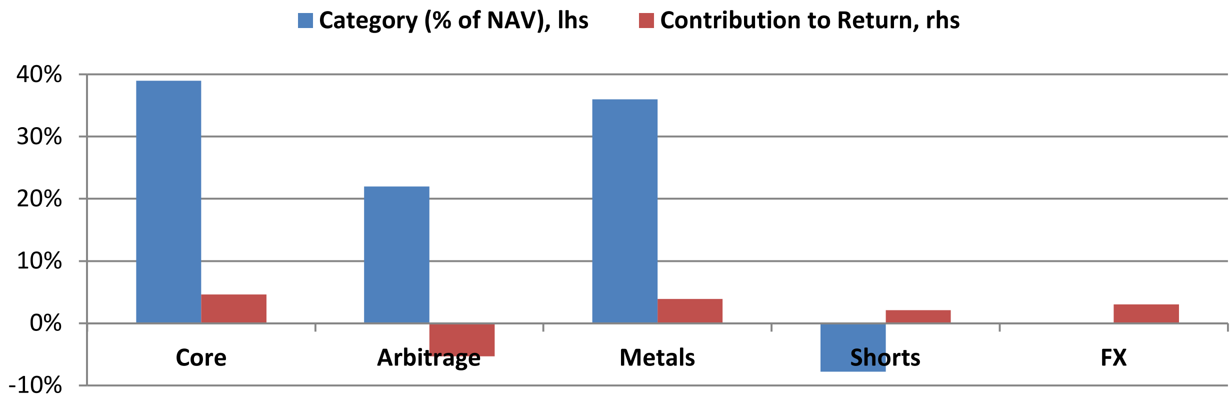
Why such an intense focus on getting the hedge strategy right? Because the air is getting thin in the US stock market. Again, this is based on hard facts, not opinion. To quote portfolio manager John Hussman, a keen observer of historical market valuation, "*across all stocks, current median price/earnings, price/revenue and enterprise value/EBITDA multiples already exceed the 2000 extreme*" (Weekly Comment, March 1 2015). The Value Line Composite (1700 stocks) is currently at a 19x P/E, right at the top of the 10-20x range over 40 years. Using the NYSE Composite, market cap/GDP is 156% compared to 179% at the 2000 peak; EV to sales is 201% compared to 215% at the peak. Market cap/GDP troughed at 35% in 1982 and EV/sales at 61% in 1980!

Blithely ignoring these apparent valuation extremes risks uprooting the most carefully executed bottom up strategy if a hedge is not in place *before* trouble surfaces. I have been actively incorporating a precious metals hedge into my strategy for the past two years. Against the backdrop of a surging stockmarket and utter disinterest in the metals, I am not disappointed with the results. My strong belief is that this hedge will be road-tested before too long, though perhaps not before the S&P 500 scales incredible, unimaginable heights! But even a bullet shot into the air falls to earth; so it will be with the market. And I don't just want to survive the next down-cycle. I want to come out ahead.

Other than the precious metals "special situation", I divide the portfolio into two further categories: "Core" and "Arbitrage". Core holdings tend to be companies with franchise characteristics sporting a temporarily depressed share price. Hence the "Recovery" in Eschler Recovery Fund. This category will generally be the largest in the fund. Examples of companies I look for include those with a strong brand; a unique hard asset; a sustainable cost advantage; a

*Gold 2002: Can Investment Consensus Be Wrong? Sun Valley Gold, 2002 network effect or high customer switching costs. Such characteristics should produce an above-average return on capital, or at least a path to improved returns. The goal is to generally purchase such companies when their shares are available below 8x EV/EBIT, that is, at a large discount to what a private buyer would pay for control in an arms-length transaction. I measure financial companies in this core category by their ability to compound book value per share at above average rates.

The “Arbitrage” category emphasises holding companies and listed closed-end funds trading at large discounts to readily ascertainable NAV. I look for situations where NAV growth is in prospect, or where an investment policy has been amended to gradually liquidate holdings and return cash to shareholders. Managers of these holdings must have a lot of skin in the game. The large discounts to NAV more than offset what can often be hefty management costs. In this category I also include occasional announced merger situations such as the aforementioned Forest Oil. Results in this book have been a bit disappointing recently. To reduce the risk of “digging a deeper hole”, I generally plan to wait and see how things play out in this area as opposed to adding on weakness.



Holdings

Top 10 Long Holdings (as of February 27th 2015, as % of NAV)

	% of NAV	(cumulative)
Precious Metals Basket	36.2%	36.2%
Vinaland	9.3%	45.5%
Avon Products	8.1%	53.6%
Dolphin Capital Investors	5.4%	59.0%
Leucadia National	5.2%	64.2%
Markel	4.8%	69.0%
Chesapeake Energy	4.5%	73.5%
JG Wentworth	4.5%	78.0%
Mobile Streams Plc	3.8%	81.8%
Fairfax Financial	3.7%	85.5%
Cash and Other	14.5%	100.0%
Seven Short Holdings	-1.1% (avg)	-7.8%
Total Gross Exposure		108%
Total Net Exposure		92%
Total Net Exposure ex-Precious Metals		56%

Precious Metals

> *For investors, gold is the single best hedge against the risk of low real capital returns, regardless of what may cause it: inflation, deflation, dollar weakness, credit, systemic, geopolitical risk, etc., or any combination thereof. That is the power of gold. It often defies investment classification, whether it is cultural or religious, Eastern or Western, ornamental, industrial, or monetary. Yet in an age where there seems to be an infinite supply of consumable commodities from DRAM to bandwidth to cars to money, **what defines gold is scarcity**.* (Gold 2002: Can Investment Consensus Be Wrong? Sun Valley Gold, 2002)

So how did gold perform in 2014 against the backdrop of a seemingly "infinite supply" of paper money? Pretty well: Gold was the second best performing "currency" in 2014, rising by a double digit percentage on average compared to almost all major paper currencies. Gold was only exceeded (slightly) by the US dollar. As we move into 2015, I see some constructive elements supporting gold. To name just a few: investment demand has picked up (GLD ETF tonnes held up ~9% year-to-date). Negative interest rates have become more widespread (encompassing over EUR 2 trillion worth of sovereign debt now according to Bloomberg). More countries want to repatriate their central bank gold from vaults in New York and London (Austria, The Netherlands, France, Switzerland, not to mention Germany). Even the mainstream media has started to rediscover gold (see, for example, "*Negative Yields are everywhere*" by Merryn Somerset Webb in FT Money, January 30th 2015).

Central bank gold leasing, bullion bank re-hypothecation and gold futures trading have created multiple claims on each ounce of physical gold. So I want ERF to have a claim on unencumbered physical gold, rather than own paper gold securities like ETFs or futures. Equity ownership in gold and silver miners provides ERF with proportional ownership in *physical* gold. For ERF shareholders, what is the leverage here from owning the miners instead of the physical? I calculated that ERF has an ownership claim on circa 35,500 proportional ounces of gold (M&I basis, excludes inferred resources). The fund has 31,496 shares outstanding. This means that **each share of ERF worth $121.50 controls 1.13 ounces of gold in the ground worth $1,356 ($1200/oz). Leverage of over 11x!** And only one-third of ERF capital is deployed in this holding. The caveat is that these ounces run the gamut: high grade, low grade, producing, non-producing etc. Some projects will never get built. Others will require a lot of dilution. But if the gold price rises, ERF leverage here is exciting.

> *"The gold stocks—just like in 2001—are at absolute rock bottom. In fifteen years, they have not been so low. So I think there's a historical opportunity, a once-in-a-generation opportunity, right now."* (Pierre Lassond, co-founder and Chairman of Franco-Nevada)

Let's back up the above opinion with facts. Just how cheap are these stocks? I estimate that the average holding in the precious metals basket has circa 160% upside (2.6x) to 1x NAV and over 400% upside (>5x) to 2x NAV. A comprehensive study I have seen of over 70 M&A transactions in the precious metals industry since 2000* shows the average buyer paid $180 per ounce of resource in the ground (M&I basis). The median market cap / resources (M&I basis) of ERF's 33-stock precious metals basket is $82 per ounce, a 54% discount. Corporate activity is improving: Goldcorp just paid a 49% premium to buy ERF holding Probe Mines (unfortunately only a 60bp position) equating to an enterprise value to resources of $124 per ounce. Since 2000 industry price to book averaged 2.4x compared to 1x today, a 58% discount. Going further back, the Barron's Gold Miner Index trades at 0.45x the price of gold compared to an average of 1.6x since 1939. This

*www.centman.com/insights/all-commentary/114-stephen-w-shipman-from-the-2014-austin-client-review is the lowest this ratio has been since 1942, a 72% discount to the average. I really feel the stars are aligned with the only unknowable the timing of recovery.

How do I frame the risk-reward? Over the past forty years, it's been feast and famine in the industry: There is only a bear case and a bull case. The gold mining index has fallen over 60% peak to trough 5 times. The average drawdown was -69% (the worst was -83% from '94 – '00) and the average recovery was +355%. Over the past 3 years, the index has fallen -75%. I could imagine a bear case in which the index reaches -83% peak to trough matching the '94-'00 period. This would imply *another* 45% downside. For a bull case let's assume the worst of the five recoveries: +142%. The very worst imaginable combination based on the historical record gives me a 3 to 1 upside vs downside. I think the risk-reward is better than this by an order of magnitude. Importantly, a recovery in this industry could realistically be triggered by weakness in the broader stock market.

Core Positions

Markel (market cap $10.5bn): returned 17.7% in 2014 and is up another 10% this year. Book value per share has risen 18% since I initiated the position 18 months ago. The shares are up 45% so it's now at 1.4x price/book. Not as cheap as it was and I have trimmed the position a bit.

Chesapeake Energy (market cap $10.6bn): I sold the shares in May of 2014 at $29 and bought them back on October 14th at $17.80. The external environment has changed a lot so the position is smaller now, but the focus on improving returns, "harvesting" assets and reducing debt as opposed to empire building is welcome for this richly endowed E&P company. Chesapeake is the second-largest producer of natural gas in North America with a growing liquids business. The current market cap matches the quarterly average in Q4'08 at the depth of the financial crisis. A dubious accolade to be sure, but the equity story has improved and been de-risked since then.

JG Wentworth (market cap $264m) is the dominant industry leader (60-70% market share) in structured settlements. The company provides liquidity to personal-injury plaintiffs, lottery winners, and others who are entitled to long-term payment streams but have near-term financial needs. Each settlement is court-approved. Essentially this company lends at 11% and borrows at 4%. It takes little credit risk as insurance companies guarantee payment of the structured settlement payment streams, though there is some interest rate risk. Because of its scale the company is able to securitize its deal flow, thereby maintaining a low cost of capital and offering by far the best deal to its customers. Its securitizations never experienced any problems at all even during the financial crisis. What did happen is that it got into trouble by relying on only one bank for its credit line. It has since diversified its temporary sources of funding used to bridge the gap until they can issue securitizations (normally 3x per year). Scale also allows the company to vastly outspend its competitors' marketing budgets. The shares are out-of-favour: The market cap is small, there is little trading history, a low float, a private equity overhang, some modest concerns about court approval rates etc. However, the shares trade at a 6x P/E while private market transactions occurred at 16x in the past. Time should close this gap.

Mobile Streams Plc (market cap £3.5m) sells mobile apps and games direct-to-consumer via its website www.appitalism.com primarily to customers in Argentina which represents 86% of revenue. Apple's "app store" doesn't work in countries like Argentina where banks don't offer credit cards due to high inflation. Mobile Streams has negotiated with telecom operators to bill its customers through their monthly invoice. Revenue is expanding in Brazil, Mexico and Columbia (funded by pesos that can be moved into those countries without penalty) and the company is signing deals in India and Nigeria. Following the peso devaluation a year ago, shares are down about 85% due to currency translation effects on sterling-denominated accounts as well as costs to repatriate stranded cash last year. Net cash of £3.4m (77% outside Argentina) is now the same as the market cap while the company generated profitable revenue of £18.5m in the six months to Dec 31st 2014 (£37m run-rate). The company has over 4.5m paying subscribers, including 35,000 brand new paying subscribers in Brazil. The fund owns the shares at 17p compared to the current price of 10p. It's been and will continue to be a wild ride with Mobile Streams Plc. One reason I like this deeply mispriced micro-cap is because nobody seems to be evaluating it. To quote a fellow micro-cap investor, *"I'm not the smartest guy in the room, but I'll tell you what — I like it when I'm the only guy in the room."* There is no other holding in the fund with a higher probability of becoming a ten-bagger.

Fairfax Financial's (market cap $11.7bn) total return since I purchased it in late 2012 is about +88% while book value per share has risen +30%. Like Markel, at 1.45x price to book the shares are not as cheap as they were and I have trimmed the position. Underwriting and investment results have been strong. Frankly, it was slightly concerning to see Prem Watsa issue shares to help fund the purchase of Brit Plc though maintaining a strong credit rating is key. Still, with less than 5% equity dilution, Watsa has increased cash and investments per share by 15%, and keeps a strong underwriting team in place. Hard not to like!

Arbitrage Positions

Vinaland (market cap $224m) is an AIM-listed, Cayman-domiciled closed-end fund with a diversified property portfolio of primarily development projects in Vietnam. I purchased the shares two years ago at circa 41c per share. Shares currently trade at 52c and NAV is 92c. The two key catalysts remain: 1) Vietnam macro fundamentals have and continue to improve which is stimulating property market transactions. 2) the Manager, VinaCapital, has been instructed by the board to gradually liquidate the portfolio and return cash to shareholders. There are high hurdles they have to reach in terms of cash return this year in order to start receiving part of an accrued incentive of $28m earned pre-GFC. It's feast or famine for the Vietnam closed end fund asset class. We look to be coming off the trough.

Dolphin Capital Investors ($250m market cap) is also an AIM-listed closed-end fund involved in developing large-scale leisure integrated luxury resorts in Southern Europe and the Caribbean. The Manager harnesses the skills of top designers, architects, builders and hotel management partners to create world-class leisure properties. The strategy is to upsell private residences to guests; this is where the profit margin is. The Manager continues to make progress but externalities such as Greek politics and Euro weakness have been unhelpful. Also, it is clear that the Manager's ambition is not matched by access to reasonably priced capital. A new board of directors should help re-focus on streamlining operations to narrow the yawning discount to NAV. Fund cost is 27p, shares trade at 26p and NAV is 77p. The fund has owned these shares since inception 2.5 years ago and made no money so far. This was always going to be a long-duration investment. But my patience has its limits. This is a sentiment clearly shared by the largest shareholders as well.

Leucadia National ($8.7bn market cap) is a holding company consisting of a nimble investment bank, Jefferies; a merchant banking business invested in several unrelated activities; and a large deferred tax asset. The company has no Wall Street coverage. The investment case is quite straightforward: Historically, the shares have traded between 1-2x price/book, book value being a conservative evaluation of the company's intrinsic value. This was because prior management compounded book value per share at 18.2% over 34 years (http://www.leucadia.com/c-p_letters/luk_c-p2012.pdf), one of the finest records in investing. Over the past couple years the price/book multiple has ranged from 0.8x to 1.2x as the market remains sceptical about new management which took over two years ago when Ian Cumming retired. Today the shares trade at 0.8x. On the one hand, the new corporate structure provides much improved liquidity and the potential for rapid growth in book value driven by improved investment opportunities and the use of the deferred tax asset against Jefferies earnings. On the other, until CEO Richard Handler proves that he can materially grow book value per share, the multiple will be held back. I feel investors are being paid to wait. In the meantime, shares have a very transparent fair value of around $30 per share under conservative assumptions. This is just a slight premium to current book value. When book value begins to grow consistently, I have little doubt the multiple can expand beyond that. We need look no further than the last couple years of multiple expansion at fund holdings Markel and Fairfax (not to mention Berkshire Hathaway) as a blueprint for what can happen when the market gets excited again about management's ability to intelligently allocate capital. All in, to me it looks like we can earn a 35-40% return on fund cost of $21.85 per share without making any growth assumptions.

Recent Activity

In January I purchased for ERF an 8.5% position in Avon Products at $8.5 per share. As Avon is now the second largest individual equity holding in ERF, I would like to provide my thorough rationale. Avon is the largest direct selling organization in the world with 6.4 million representatives and $9bn in sales. Worldwide, a lipstick by Avon is sold every 3 seconds. The investment case rests on the following assumptions: Avon's best days are ahead of it; Avon's main problem is a strong US dollar; most of its other challenges are within management's control to deal with; the bear case has been largely priced in; private market value provides a large margin of safety.

History

The "California Perfume Company" was founded by David Hall McConnell in 1886 in New York City. McConnell recognized from the start that a business allowing women to earn a wage filled an important gap. He also saw business advantages in having women sell fragrances, toiletries and beauty products to other women for their ability to add a personal and understanding touch to the exchange. McConnell presided over the business for half a century until his death in 1937. Sales had reached $4.2m. Three years later in 1939 sales had doubled to $8.4m. That year, his son (and president), David McConnell Jr., recalling his father's fondness for the beauty of Stratford-upon-Avon in England, renamed the company Avon.

By the time the company listed its shares in 1947, sales were up to $17.2m. By 1950 sales were $31m, by 1960 $186m, by 1970 $759. In 2014 sales were nearly $9bn. Notice a trend? Since the listing 68 years ago in 1946, sales have grown at 9.5% per annum. The 1950s saw the company go international: Venezuela in 1954, Mexico in 1958, then Brazil, the UK, Belgium, Australia, West Germany. By the early 1960s the international business was profitable and by 1970 it reached $1bn in sales. International continues to be the growth engine for the company today. For example, Avon paid $7.8m to enter the Philippines in the late 1960s and the country has contributed upwards of $40m in annual profit in recent years. Sales in Russia were $22m in 1999 and are now ~$700m (26% cagr). By 2004 Avon's 1 million representatives in Brazil exceeded the total personnel of the Brazilian army and navy combined.

The history of Avon has been one of progress through thick and thin. But the share price fluctuations have been epic! Avon stock has been manic-depressive for the past half-century. The 1970s saw women enter the workforce and Avon failed to adapt. In 1971 not one Avon vice president was female! Avon shares peaked in 1972 at $140 per share, a darling of the "Nifty Fifty" trading at a 65x P/E. By 1978 the shares languished at $20! During the 1980s Avon embarked on a disastrous decade of diversification under CEO Hicks Waldron. He considered the core beauty direct sales business to be "ex-growth" and bought into apparel, men's and children's catalogues, plastic homewares, outpatient healthcare, medical devices, nursing homes, retail beauty (Liz Claiborne) and fragrances (Giorgio Beverly Hills). Did you know that Avon owned Tiffany from 1979 to 1984? Everything was divested by the end of the decade. But the adventure left Avon with a bad balance sheet and vulnerable to takeover. Avon had to fend off a bid by a Mary Kay-backed investment vehicle in 1989. Belatedly, Avon re-focused on its profitable core. Over the past 25 years sales have grown at 4% per annum, still very much a growing business.

Business Model

The direct-selling business model requires little capital and enjoys high returns on capital. It is global, often thriving in countries with social and family-oriented cultures. It is largely recession-resistant as economic weakness forces women to look for alternative sources of income. It can be seen as a bit too intrusive for many but, in the case of Avon, there is something fundamentally less offensive about women marketing beauty products to other women. Mysterious potions and weight-loss pills this is not.

The direct selling industry has come in for some well-deserved criticism in recent years though. What was once an industry where each rep only sold product directly to her customers has turned into elaborate "multi-level-marketing" schemes promising penury to the masses and riches to only the very few. Most Avon reps, on the other hand, still earn incomes from their direct sales effort. In the late 1990s Avon did introduce a "leadership track" allowing ambitious reps to build a wider network and earn higher incomes. This has created a hybrid model combining traditional direct sales with a leadership track that has grown the rep count. But by no means is Avon a pyramid structure. Sales leaders can only have up to three down-lines and even the best sales leaders' incomes cap out in the low hundreds of thousands range in annual income.

My understanding is that at Avon, the reps are the stars of the show. Nothing happens without their consent. This is no doubt one reason the company has preferred to stay independent for so many decades. Every effort is made to make their experience successful. This is important because rapid rep turnover is a fact of life in the direct sales industry. Avon reps earn approximately 40% of firm-wide revenue in commissions. Membership costs a token amount and reps never have to finance their own working capital: orders are invoiced only after sales have been made. Selling cycles repeat every 2-4 weeks requiring constant product innovation. Avon was the first to use vitamin C as a key anti-aging ingredient; the first to use AHA as an exfoliant that is lauded for smoothing skin; the first to put UVA protection in its facial moisturizers; and the first to ban animal testing in 1989—even before The Body Shop. The brand may be tired in the USA but the product is solid.

Outlook

At a high level Avon, while moving slower than investors would like, appears to be putting some of its problems behind it. Active rep growth globally is still negative 4% but it is not worsening. This weakness has been driven by continued negative active rep growth in the USA of -16% yoy in Q4'14. Cost cutting should finally see the USA achieve a profit this year though. The direct selling industry in the USA grew +5.7% last year so Avon has no excuses. The Brazilian economy is weak but the beauty market there keeps growing. Avon's Brazil share has been falling but the share of its key competitors' is stable or growing. A new joint venture with Coty should help drive better results there. Retail build-out in Brazil is a longer-term issue. In both the USA and Brazil, resolving what appear to be company-specific issues appears to be within management control. Importantly, Avon has now definitely put to rest the SEC's FCPA (Foreign Corrupt Practices Act) investigation into its China business. Fines totalling $135m have been paid to the SEC to settle the case.

At the risk of simplifying, the only thing that really matters for Avon in the near-term is the US dollar. In the past eight months the US dollar has risen 20% and Avon shares have fallen nearly 40%. Avon does not hedge its foreign currency sales, now more than 85% of revenue. Direct costs of production are tilted toward the US dollar. So there are negative transactional effects, partially mitigated by pricing, and translational effects. Excluding the impact of US dollar appreciation, constant-dollar revenue is growing (up 5% yoy in Q4'14) though reported revenue fell 12% yoy. Margins recovered to 9.3% in Q4'14, up 110bp yoy, and would have risen to 11% in constant dollars (net of a 90bp tax benefit in Brazil). It is not a stretch to think that a falling dollar will catapult the shares higher as investors "look through the valley".

Valuation

To value Avon I assume a modest level of growth and a more normalized valuation based on a stable US dollar. I look at historical valuation ranges, private market value and peers.

Price/normalized FCF: Over the past 10 years Avon's free cash flow margin has averaged 4.2% and shares have traded on average at 28x trailing free cash flow. Assume 4% revenue growth over three years and a 20x price/free cash flow multiple and the shares would be worth $19.2 in 2018, a 31% IRR.

Private market value: Avon has received two cash bids, the first in 1989 and the second in 2012. Both came after a period of disappointing results. The bid in 1989 (remember the "deworsification" and bad balance sheet of the 1980s?) came at $4.60 or 0.9x EV/sales and the bid in 2012 came at $24.75 or 1.14x EV/sales. This suggests a private market value of $14.5 - $19.4 which takes into account Avon's financial leverage and reduced sales base compared to 2011 due primarily to US dollar strength.

Peer analysis: For comps, I use Tupperware, Nu Skin, Oriflame, Natura, Pola Orbis and Herbalife. In aggregate these peers' average price to sales multiple is 1.09x which would put Avon shares at $22.3. Lastly, Bloomberg recently valued $9bn in revenue direct-seller Amway at $6.5bn using the average EV/sales and EV/EBITDA of Tupperware, Avon, Herbalife and Nu Skin. While there is some circularity here with the inclusion of Avon in Amway's valuation, a similar approach would value Avon at $14.9 per share. Putting it all together, I am very confident that Avon shares are worth $15-20 per share, and maybe more. I expect the shares to produce a compound return of 20-30% over the next few years, plus the dividend.

Summary

It is my hope that this letter has assisted a further understanding of my approach to markets and investment. You will notice I have a healthy appetite for risk if risk is defined by volatility. Balancing this is a concerted effort to avoid permanent capital impairments.

I would also like to convey my approach toward investors:

Transparency: As you can see, I prefer to show my partners what the fund holds and why, as long as I have established a full position. Some investors I admire believe avoiding any discussion of current strategy provides a psychological, or competitive, advantage. I tend to downplay this supposed disadvantage of being transparent. My approach is more in sync with that of David Einhorn at Greenlight Capital: *"though the hedge fund industry is generally known for secrecy, I saw no reason to be secretive. I felt that if we explained our investment program…our investors would have greater confidence in us…this would lead to a more informed, confident, and stable partner base".**

Only one letter per year though!

Alignment: "How much of your liquid net worth have you personally invested in your fund" is the first question I would ask if I were interviewing managers. I score well on this question: Almost all of it. I would also ask if the incentive structure is fair. Investors in ERF pay zero management fee and earn a 6% annual preferred return net of fund costs, before any incentive is assessed. This is pretty unique in the industry. I can count on two hands the managers that have implemented a similar arrangement. Out of 9000 funds in the HFR database, only two have zero management fee and a >6% hurdle.

As an aside, alignment extends to my family. Why "Eschler"? It is my wife's maiden name. Sticking with David Einhorn, "*Cheryl named the firm, giving me the green light. When you…go off on your own and don't expect to make money for a while, you name the firm whatever your wife says you should*."*

Over the past couple years I have closely analysed and purchased a small collection of disparate businesses with solid prospects at cheap prices. For the most part, I've stuck with them and the portfolio remains pretty out-of-favour. If my judgements prove correct, returns will take care of themselves over time as the market comes around to my point of view. To quote Jim Grant, "*Investing is about having people agree with you… later*."

I look forward to updating you on the fund in one year's time. Thank you for your continued support over the past year.

Sincerely,

Theron de Ris
Portfolio Manager,
6 March 2015

*Fooling Some of the People All of the Time, David Einhorn, 2008, p12-13