Investor Update

Q2.2022

WUNALA CAPITAL

Wunala Capital Emerging Opportunities Fund

The Fund invests in late-stage growth capital, bridge/Pre-IPO financing and select listed opportunities across high growth technology, financial services, data and digital companies.

Performance Summary

Returns	3 months	12 months	Since inception (annualised)	Since inception (total)
Wunala Capital Fund	**-12.7%**	**21.2%**	**10.0%**	**17.2%**
Benchmark (5% hurdle p.a.)	1.3%	5.0%	5.0%	8.3%
ASX All Tech Index	-25.2%	-36.0%	-15.9%	-25.1%

Performance is reported net of all fees and assumes reinvestment of distributions. Past performance figures may be subject to rounding and are not necessarily a reliable indicator of future returns. Total returns are cumulative from inception date of 31 October 2020.

The Fund closed out FY22 with a net return of +21.2%. Our strong performance in the first half of the financial year more than offset the decline in the last few months. In comparison, the ASX All Tech Index[1] - a reasonable listed proxy for the types of investments that we make - lost 36% over the same period. Measured against this index, we have delivered a relative outperformance of +57% for the year. We also comfortably outpaced our benchmark.

This investor update covers the following topics:

- Year end portfolio summary
- Valuations and mark-to-market commentary
- Understanding the fundamentals of the boom-bust cycle
- How VC funding is affected in a slowdown
- …and putting it all together, how we are poised to benefit from this at Wunala.

Portfolio summary

As of 30 June 2022, the Fund had positions in 5 listed and 13 unlisted companies. We did not make any new investments in the latest quarter, with only 1 new investment closed since October 2021 (which was a structured debt-like security with full redemption rights and seniority to all equity). This was a deliberate strategy as over this period we just could not find an opportunity we liked, at the right price, with the right structure, to deploy capital towards.

I therefore believe that we largely avoided the speculative excess and irrational valuations that characterised the private market last year, and that our portfolio remains high quality and well priced with upside potential. Investors in the Fund will soon receive a detailed portfolio overview which summarises our analysis of each investment, their prospects, risks and valuation estimates. Without spoiling too much of the news, based on our analysis and a recent mark to market exercise, our fair market value if we marked up the relevant positions would be approximately <u>+25% higher than our current book value</u>. This indicates the strength of our companies in a tough market, and the upside potential inherent in the Fund for investors.

Valuations and mark-to-market

During July (and therefore not included in the 30 June numbers) three of our portfolio companies confirmed that they were closing new funding rounds at a significant premium to our current valuation. I look forward to sharing more details on these in the next quarterly update and the positive impact that means on the Fund's NAV. Furthermore, several other portfolio companies are the subject of M&A or strategic buyer interest which may also lead to valuation increases and/or liquidity events.

While the IPO window remains firmly shut for the near term, portfolio companies such as Xpansiv (which raised US$400m from Blackstone at a price that was more than 3x our entry level) shows that the best companies - which we immodestly believe we have backed in our portfolio - still offer the opportunity to make attractive long-term gains through the cycle.

An important point to reiterate is that we assess valuations monthly on both our private and public positions. Therefore, the Fund's performance comes after we updated our analysis on every unlisted position we hold in the portfolio as at 30 June. Our approach uses listed market peers and comparable transactions to calculate a reasonable proxy for how we should consider our valuations. We also revalue a position when a portfolio company completes a material capital raise, or for any other material changes.

To be conservative, our policy is to not mark up the value of our unlisted positions simply because of public market peer outperformance, but we do have a mechanism to adjust these valuations downward when there has been a sustained period of discrepancy. This analysis resulted in marking down two unlisted positions over the quarter which contributed -2.3% to the fund's decline over that period. One company is performing in line with its forecast but has been partially marked down due to the floor price of conversion of the note being slightly higher than its listed peers, while the other has been written down due to poor operational performance.

Financial instability in private markets

With the majority of the Fund's investments made in companies that have received early-stage funding from venture capital funds, we spend a lot of time analysing the broader state of tech entrepreneurship and VC. My working theory is that the well-known boom and bust cycle that has characterised public markets since time immemorial has now become established in the VC markets (which has hitherto been largely immune from this for structural reasons). This has interesting implications for the Fund's portfolio today and our future investments as the pullback of VC investing actually increases the opportunities for Wunala.

Firstly a brief explainer. As technology increases efficiency through the rapid sharing of data, any information asymmetry can be arbitraged faster. In financial markets this results in outperformance reducing over time. You can see this where a new niche of investing may generate significant profits initially, but as more participants find out about and emulate these strategies, returns dwindle as a relative percentage. Counter-intuitively, rather than reducing the allocation of capital to a lower-performing strategy, institutions tend to <u>increase</u> their exposure (in order to maintain a similar level of outright $ profits).

An unintended consequence of the additional capital deployed is that this weight of new money decreases volatility and therefore reduces the perceived risk. The driver for market booms tends to be the additional money entering a market, which increases returns with lower volatility, which leads to attractive performance. This attractive performance draws in even more capital, which improves performance further, and so forth.

The problem is that feedback loops tend to overshoot. In the case of financial markets, the 'boom' cycle requires inflows of additional capital to continue marking up prices and reducing risk. The longer it continues, the more sensitive the reaction when some external trigger catalyses a change in sentiment. A small dip in prices can lead to a reduction in new capital inflows, causing a further reduction in prices. This heightens the sense that the market is unattractive, reducing capital allocated which results in worse performance, and so on. (The irony is that the feedback loop then overshoots in the other direction as investors become overly risk averse - and when assets are mispriced to the downside, it opens up the opportunity for significant profits as the cycle turns the other way.)

Is VC susceptible to the boom/bust cycle?

An influx of capital to 'traditional' venture capital over the last few years has driven early wins mostly through the compression of time. Rapid markups of private positions abounded as startups raised ever-larger rounds at increasingly higher valuations. On the fund side, this boost in unrealised IRRs and increased velocity of capital deployment made their performance seem more attractive. This led to VC funds raising new capital faster (even before the previous fund had been deployed), which led to more money chasing ever larger deal sizes with a pressure to mark up value higher and faster… all drivers for a classic boom.

Pick your favourite theory as to the initial trigger - interest rates, war, supply chain issues - but there has been a well-publicised, rapid and material pullback in VC investment since late 2021. Estimates range from 60-80% less capital being deployed per quarter with significant anecdotal evidence of more stringent terms, lower valuations, down rounds and so on. Some high-profile companies are sadly failing, and many others are facing difficult decisions (such as the one we wrote down in our portfolio this quarter). By any measure we are well and truly in the 'bust' part of the cycle.

In today's environment, many startup companies are not yet breakeven or profitable, despite significant growth and/or capital raised. In order to avoid a dreaded 'down round' and potentially triggering a death spiral, most founders and managers are waiting it out. They are cutting costs, focusing on short term revenue, raising a smaller amount of capital with valuation deferrals (ie. venture debt) and hoping to either grow into their valuation and/or pray that valuation metrics improve.

The problem for VC funds is that this increase in time between revaluations is a structural unwind of the drivers that boosted their performance. The longer it takes for a VC fund to mark up or exit their investment, the worse their IRR. Lower performance makes raising new funds more difficult, further reducing the capital inflow to the sector. Investment rounds in their portfolio companies are done at flat values, or as extensions to prior closes. Companies are extending their runway and looking at self-funding where possible, further delaying the opportunity for deployment of VC dollars. In this part of the cycle, uncertainty reigns.

And do you know what… that's great news for us.

What it means for Wunala

Almost all of our investments come in VC-backed companies that have grown and matured significantly. We operate in the space after VC and before the listed market, bridging the two. The choice for our investee companies is typically a) take another round of VC money at a high valuation and stay private, or b) shift the business to prepare for a liquidity event or exit. Wunala backs those choosing door number two.

We tend to invest in highly de-risked companies, and help them navigate scaling challenges, as well as do what we can to help prepare them to go public or become acquired. A slowdown in late-stage venture capital funding has significantly reduced the number of price- and term-insensitive investors who just wanted to close the highest number of deals as fast as possible.

That means that we can now invest into some fantastic companies, at prices that we believe can deliver appropriate risk-adjusted returns in the medium term, with structures that compensate us for the risks of time and valuation (via a coupon and a conversion discount).

Never waste a good crisis

In short, as an investor looking to deploy capital, we have the opportunity to make some appealing investments over this part of the cycle:

- Transaction structure is back in fashion (just like wearing black, we always kept doing it): sensible valuation caps, appropriate conversion discounts, interest accrued so that we effectively get paid to wait, liquidation preferences and so on;
- We reiterate our focus on companies with strong revenue generation that have near-term catalysts and liquidity events; and
- Note that there are multiple levers for liquidity incl. strategic/trade sale, sponsor/PE exit etc

We believe that our current portfolio is of high quality, and even at today's depressed prices has significant upside potential. Dealflow is starting to pick up. In contrast to the last year or so, we are seeing a number of compelling transactions as high quality companies meet the market on terms for financing. We believe that certain investments made during this trough will deliver attractive returns through the cycle.

To take advantage of this imbalance (in our favour!) we have decided to keep the Fund open to new capital until 31 October 2022, subject to capacity. I really do believe that after sitting on the sidelines for much of the last year in deploying capital, the opportunity set over the next 6-12 months will generate a number of great investments that meet our strict screening criteria. If you would like to learn more, please reach out to us directly or on the details below.

Thank you again for your interest and support of Wunala Capital.

Scott Wilson
Managing Partner

Footnotes

1. All index references are used for comparison only as the Fund is not measured against this for its calculation of performance fees. The ASX All Tech Index is more appropriate than the ASX Small Ordinaries Industrials shown in previous quarters due to the constituent companies more closely aligning with the portfolio companies of the Fund.

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