Auscap Newsletter

Auscap Long Short Australian Equities Fund

JULY 2023

AUSCAP ASSET MANAGEMENT LIMITED

Financial Year 23: Finding Returns In Unusual Places

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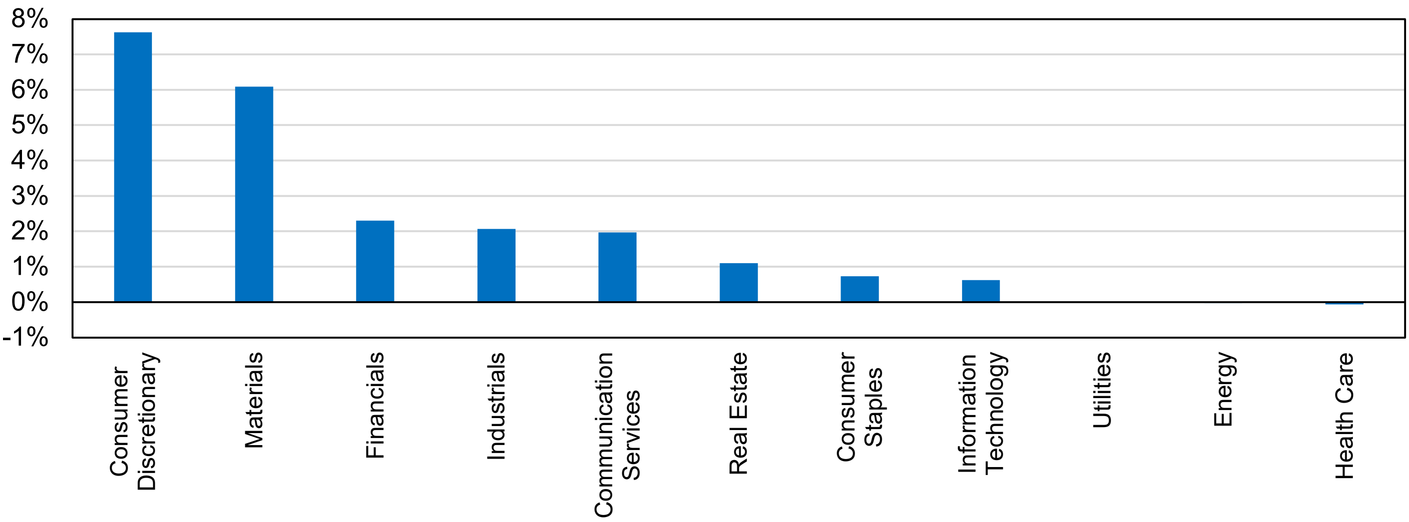
The Auscap Fund had a strong financial year, returning 21.5% in FY23. This compared to the performance of the All Ordinaries Accumulation Index which returned 14.8%. This strong positive performance was delivered in an environment in which the Reserve Bank of Australia lifted the cash rate ten times in eleven meetings, from 0.85% in June 2022 to 4.1% today. The Australian stockmarket has been extremely volatile during this period, with significant monthly swings reflecting the uncertainty in the macroeconomic environment.

It might surprise some readers to learn that consumer discretionary stocks contributed the most to Fund returns during the financial year, given the negative ramifications of higher interest rates on discretionary expenditure. This was a function of both the positive returns from the stocks and the Fund's overweight position in them. It highlights that the market is forward looking. Tailwinds and/or headwinds for a sector are generally anticipated, and these are often priced into securities well ahead of events transpiring. The market also has a tendency to overreact to changes in circumstances. Many market participants tend to view the economic outlook as being either extremely positive or extremely negative, despite the reality being that the economy is often simply trending between growing modestly and growing solidly. This can lead to overreactions in stock prices. For long term investors, this can mean that there may be enough value on offer to result in the stock price bottoming well before the company's earnings actually trough.

Auscap Fund Performance: Sector Contribution

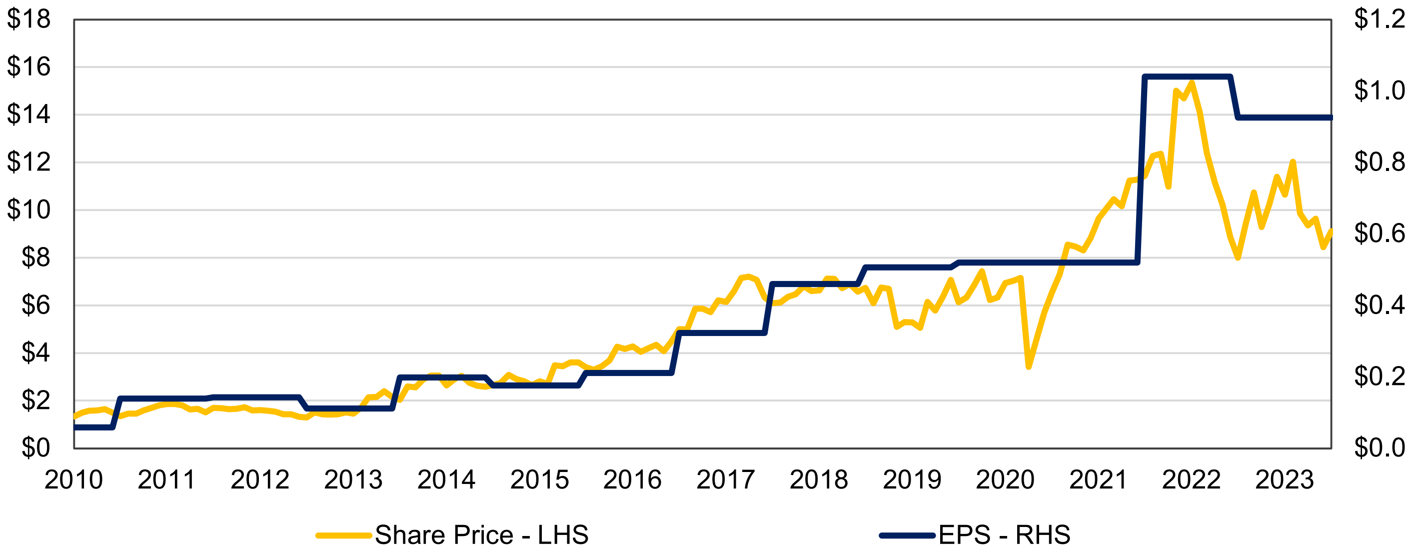


Howard Marks has frequently described the swings in market sentiment as a pendulum, with extreme bullishness and bearishness at either end. But it is an unusual pendulum. It does not always swing consistently from one extreme to the other. Indeed it might swing only back to the middle, a rough approximation for fair value for a given company, and then return from where it came. In our experience negative deviations from fair value occur most commonly in companies that investors are inherently familiar with, because their understanding of the risks is intuitive but often exaggerated. By contrast, in sectors that are new, exciting and less understood, where the risks are more difficult to comprehend, we see extremely optimistic assumptions often being made based on the powerful actual and/or perceived industry tailwinds at play.

We try to use these extreme swings in sentiment to our advantage. As we highlighted in our recent webinar, our core belief is that over time share prices will follow earnings. Meaningful deviations from the long-term earnings trajectory of a high quality business provide either an opportunity to increase or decrease the Fund's exposure to that company. For a number of retail companies, the share price declines they experienced in FY22 reflected, in many instances, the expectation of material declines in earnings in the coming years.

Nick Scali has been a strong compound earnings growth company for many years, and a long-term holding for the Fund. It has seen its share price decline ahead of the anticipated fall in earnings in FY24, following what we anticipate will be a record FY23 result.

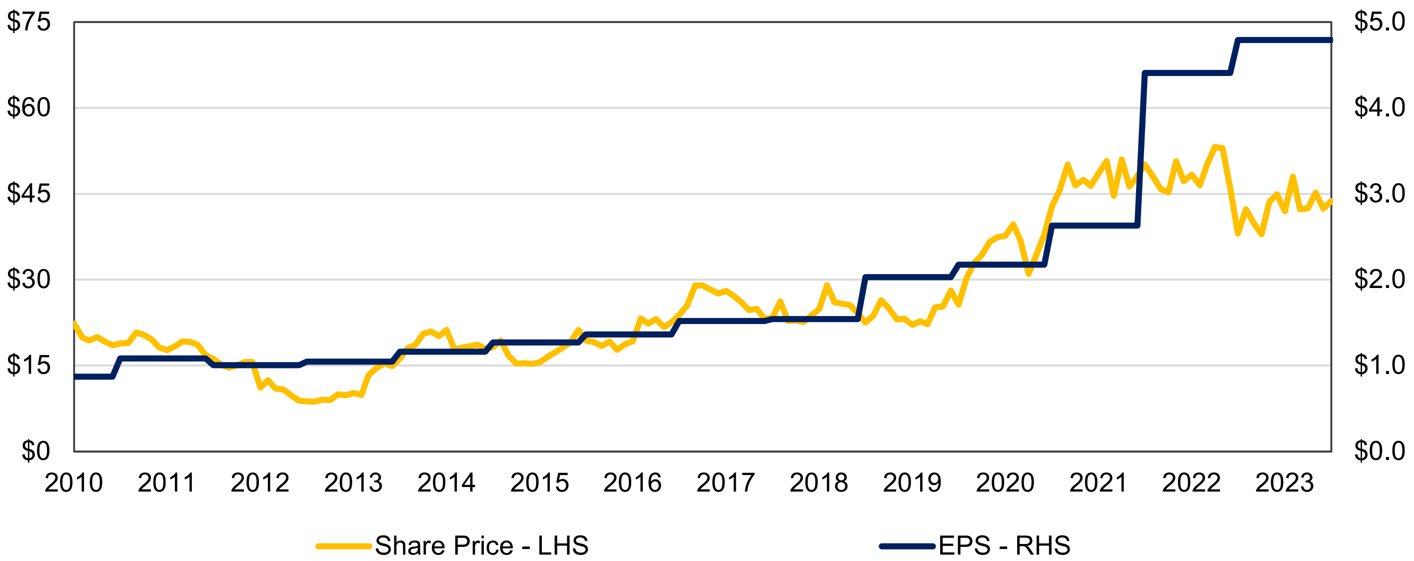
Nick Scali Earnings Per Share vs Share Price



Source: Auscap, Factset

The same can be said for JB Hi-Fi, whose share price has also not kept pace with the recent growth in earnings per share (EPS).

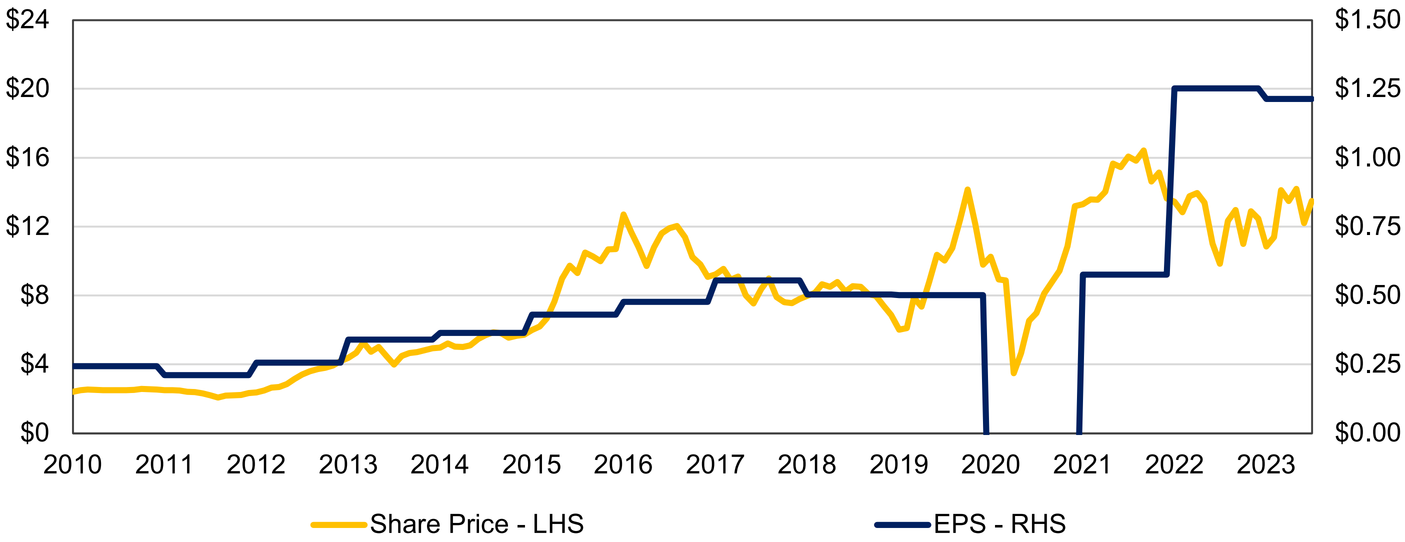
JB Hi-Fi Earnings Per Share vs Share Price



Source: Auscap, Factset

And likewise for Eagers Automotive, despite its very considerable order bank, which should continue to support earnings for a number of years.

Eagers Automotive Earnings Per Share vs Share Price



Source: Auscap, Factset

We view our role at Auscap as seeking to identify companies that will grow their earnings at attractive rates over the long term, and to then buy into those companies when they represent fair value or better. Negative deviations between a stock price and the company's earnings trajectory are an opportunity to initiate or increase the Fund's exposure. Material deviations above the earnings trajectory represent a bullish swing in sentiment that we will, if significant enough, sell into in order to reduce the Fund's holding.

One stock that we recently increased the Fund's exposure to, given the value presented following a widespread decline in the stock prices for real estate investment trusts, was HomeCo Daily Needs REIT. We discuss this investment in more detail below.

There's No Place Like Home

Three decades of declining interest rates were a boon for the listed real estate sector in Australia. Capitalisation rates used to determine commercial property valuations declined in tandem with the RBA Cash Rate Target to create a significant tailwind for the sector. Now that tailwind has become a headwind. Interest rates have risen significantly, posing a risk to asset valuations. With the ASX listed REIT Index 25% off its 2022 high, the challenges to real estate from higher interest rates, continued shifts towards work-from-home, significant new office supply, trends in e-commerce and the rising cost of debt funding are being reflected in lower listed asset prices. While we acknowledge these challenges, the collective decline in A-REIT share prices has generated a few attractive investment opportunities. In this newsletter we look at one such opportunity, HomeCo Daily Needs REIT (HDN).

Overview

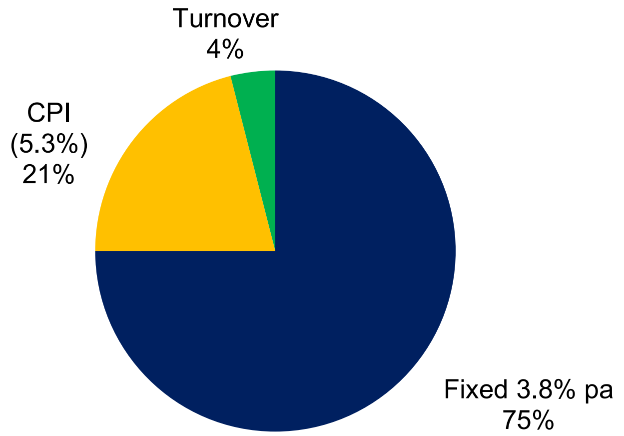
In late 2016 David Di Pilla led the acquisition of a selection of ex-Masters property assets from Woolworths, with the objective of repositioning and re-leasing the assets. Other investors included the Chemist Warehouse Group, Spotlight Group, Primewest (now part of Centuria) and various senior UBS executives. In 2019 "HomeCo", later renamed "HMC Capital" (HMC), listed on the ASX. HMC then spun out 17 of these ex-Masters assets in 2020 as HDN. This portfolio came with a very active management team. The HMC management team has had no material executive turnover since IPO and are significant shareholders in HMC, which has a 14% shareholding in HDN.

HDN merged with Aventus Group in 2022 to create the bulk of the current portfolio. Aventus, which had listed in 2015, was a portfolio of 20 Large Format Retail (LFR) centres, assembled over two decades by Australian retail industry veteran Brett Blundy and CEO Darren Holland.

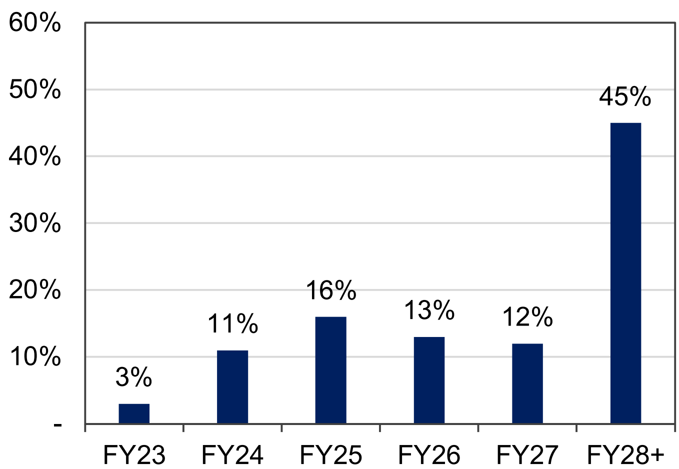
Strong Core Portfolio

Today, HDN comprises a national portfolio of 53 properties. The portfolio is greater than 99% leased, with over 99% rent collection, a 4.6 year weighted average lease expiry and unusually low tenant incentives of 5.3% as at the most recent update in February 2023. The portfolio is focused within high population growth metropolitan catchments and is over 83% leased to large national tenants. Rental growth is comprised of a mix of fixed, CPI-linked and turnover-linked arrangements. Rental growth is currently 3.8% as of December 2022.

Rent composition (%)



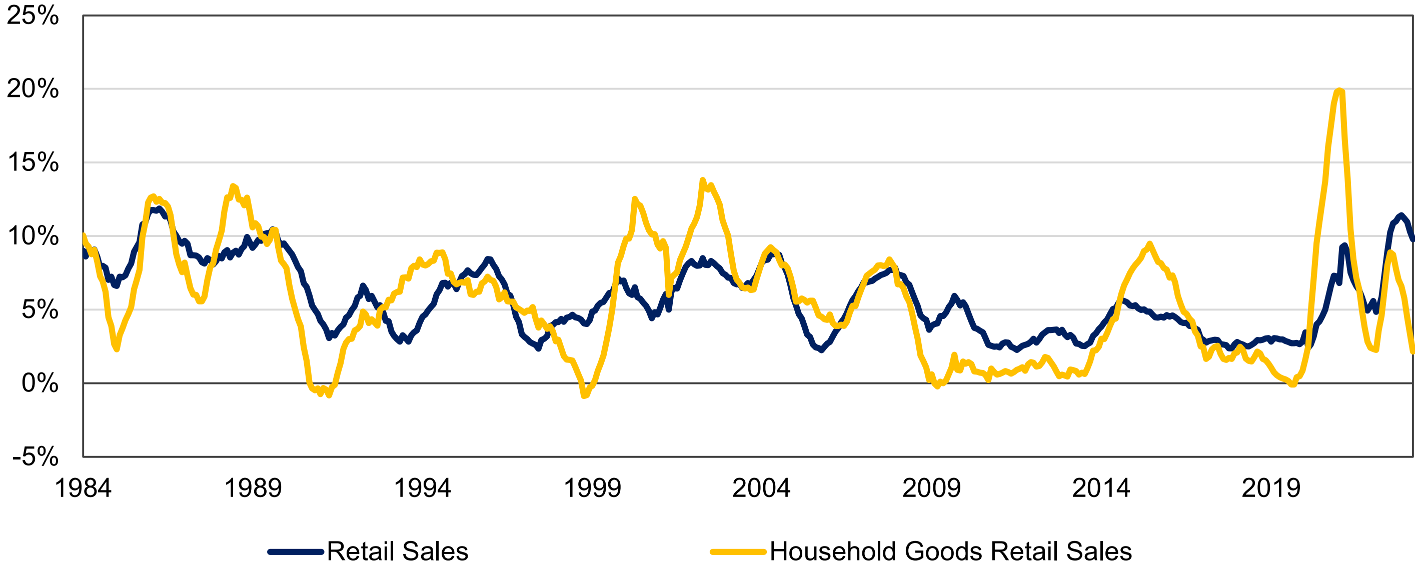
Lease expiry profile (%)



Source: Company Disclosures

Given HDN's exposure to household goods, many investors view the portfolio as having highly cyclical characteristics. However, its tenants are predominantly large, well-funded and highly profitable retailers who we think are low covenant risk, high quality operators. Further, the actual volatility of spending on household goods is, in our opinion, considerably less than perceived. Total nominal retail sales in Australia have never grown at less than 2.2%. Expenditure on household goods has only rarely and briefly gone negative year on year.

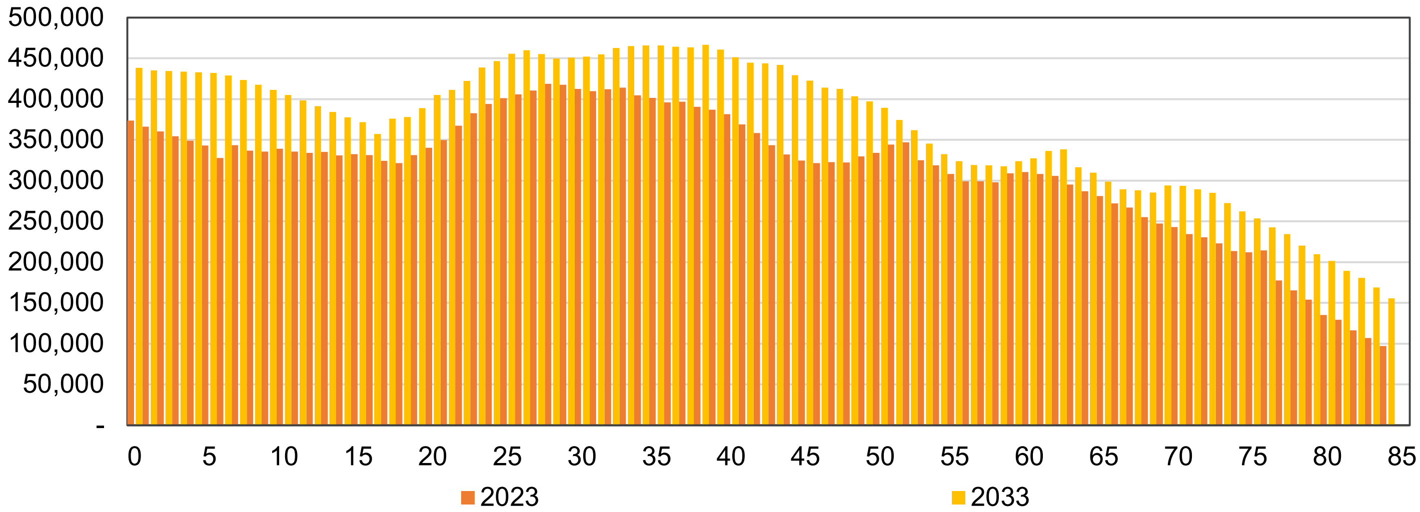
12 Month Rolling Nominal Retail Sales (%)



Source: ABS

HDN, with a 79% metropolitan portfolio focused on high growth corridors, is a likely beneficiary of two mega trends: Australian population growth and increasing e-commerce. The Federal Government is forecasting Australia's population to grow strongly in the coming decades, most of which is expected to be driven by strong net overseas migration. Whilst there are variations by visa class, the median age of migrants into Australia is in their late 20s. In addition, Australia's large millennial cohort are increasingly moving into their mid-30s, an age when consumption of household goods increases, demonstrated by the fact that the average age of a first home buyer in Australia is approximately 36.

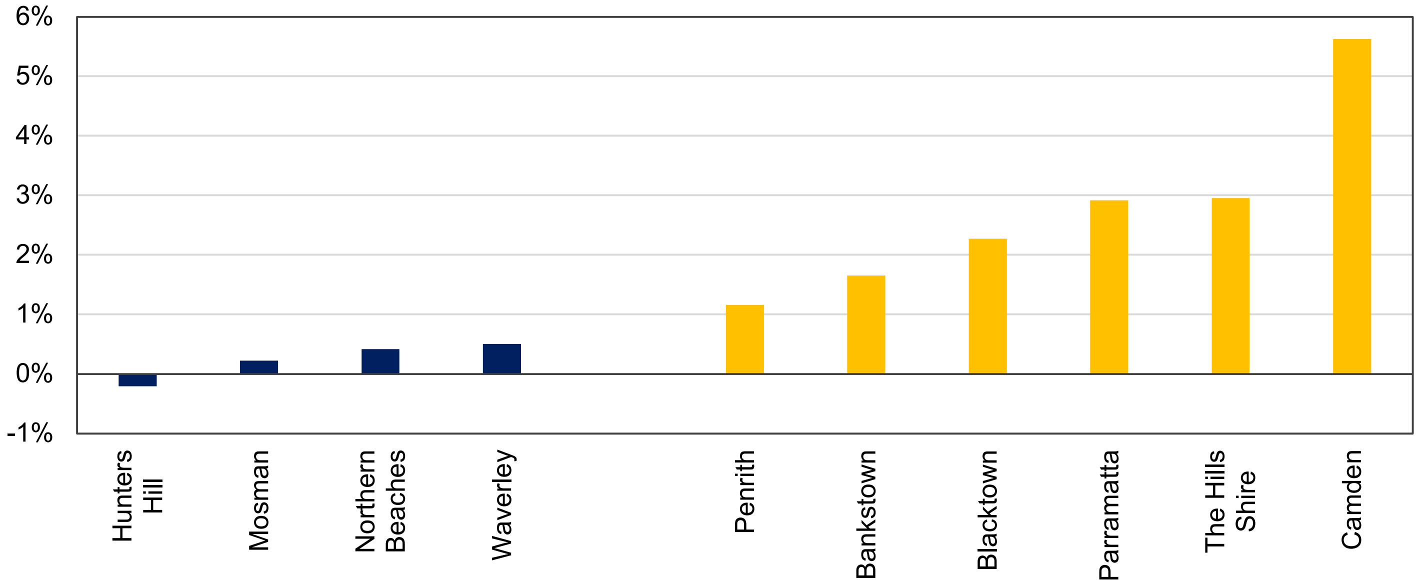
Australian Population by Age



Source: ABS

Given the extremely tight supply of housing in inner-metro locations, population growth is likely to be focused on the Greater Sydney, Melbourne and Brisbane metropolitan areas. HDN's portfolio is well positioned, with the population growth in its catchments expected to grow by 1.9% per annum in the next 5 years, which compares favourably to the national average of 1.5%. With Australia's recent immigration boom these figures may well prove conservative.

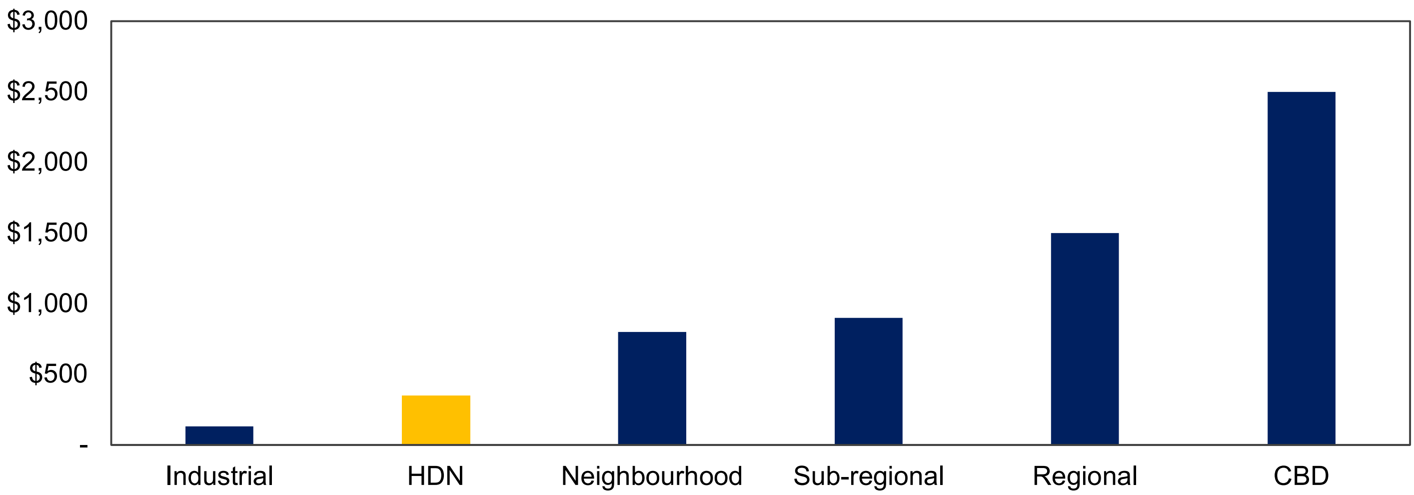
Long Term Population CAGR in Sydney Council Local Housing Strategy Plans



Source: Greater Sydney Councils' Local Housing Strategies

HDN's tenants are likely to be either beneficiaries of, or resilient to, greater e-commerce penetration. Health & Services providers are somewhat indifferent to e-commerce, given the full offering of a gym, childcare centre or primary healthcare provider is impossible to replicate online. Large format retail is similarly resilient, as non-entry level consumers generally want to touch and feel high value items like couches or mattresses before buying them. By contrast, neighbourhood tenants such as supermarkets, as well as some large format retail tenants, have customers that are increasingly demanding a seamless omni-channel retail experience with the option of fast delivery. To meet this consumer demand and fend off Amazon, these tenants need a portfolio of affordable and well-located sites, with integrated direct to boot facilities. HDN's portfolio is increasingly being viewed as critical "last mile logistics" infrastructure, a vital complement to the industrial logistics warehouses of large Australian retailers. At approximately $350 per square metre, HDN's starting rents are a fraction of other retail rents.

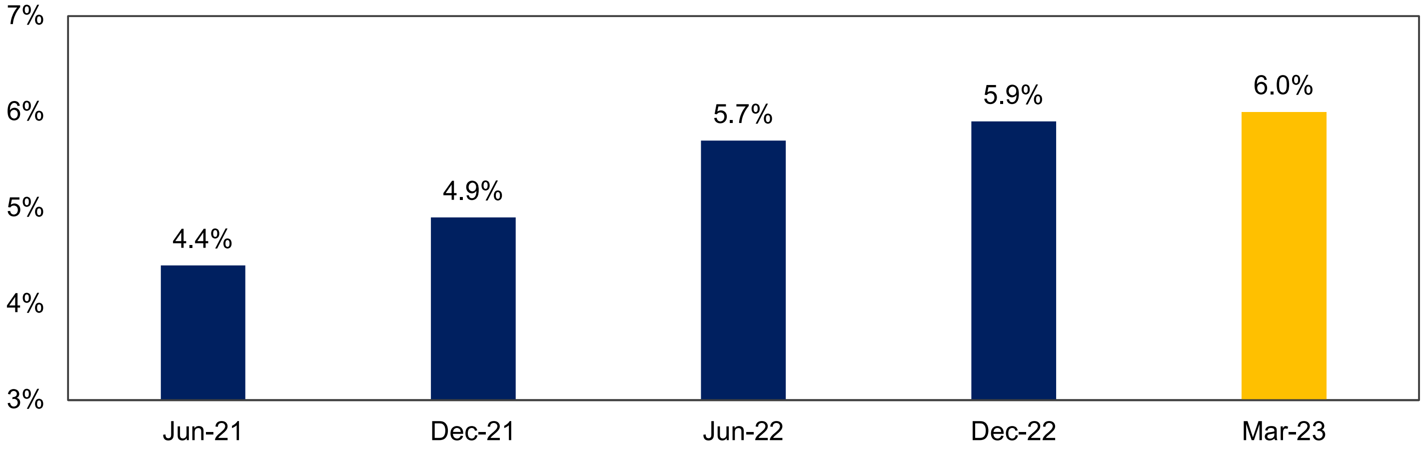
Average Gross Rent / SQM



Source: Auscap estimates, Colliers, JLL

Evidence of the value offered in HDN's portfolio is in its re-leasing spreads, being the growth in rent for new or re-signed leases. E-commerce, COVID-19, work from home and expensive rents have created a multi-year headwind for the rental growth of large retail malls. As a result, many retail A-REITs have experienced low or even negative re-leasing spreads in recent years. Yet HDN's re-leasing spreads were north of 6% as of March 2023. The significant positive re-leasing spread is quite distinct from its peers and suggests the sites are attractively priced and in demand from current and prospective tenants. These re-leasing spreads have been increasing in recent reporting periods. We expect HDN to have a long runway of sustainable rental growth.

HDN Re-leasing Spreads (%)



Source: Company disclosures

Development Upside

Further, there is significant upside within the portfolio. Currently only 37% of HDN's 2.5 million square metre land bank is being used as Gross Lettable Area (GLA), which provides management with a long runway of profitable development opportunities. These development opportunities are largely tenant-led low-risk initiatives such as adding complementary retailing or childcare pad sites. Since listing, HDN has delivered an average return on its development cost exceeding 9%. At the 2021 merger announcement, HDN had identified a pipeline of greater than $300m of development opportunities, which has since been expanded to over $600m. We expect incremental development opportunities to remain a feature of HDN for many years to come.

Headwinds

HDN will be impacted by higher interest rates on borrowing costs. The move in HDN's average borrowing rate from 1.44% in December 2022 to 2.75% in 2024 will temporarily offset the portfolio's strong rental income growth, reducing HDN's ability to grow its distribution in the near term. We take some comfort from HDN's 70% hedging across its drawn debt out to 2026 and current gearing at the lower end of its 30-40% target range. Further, senior management are incentivised through their remuneration to focus on growing both HDN's Funds from Operations (FFO) and Distribution per Unit (DPU) over time.

Attractive Implied Valuation

HDN's portfolio is currently valued at a capitalisation rate of 5.48%, following a modest negative revaluation in June. Interestingly, this negative revaluation was due to internal revaluations; independent valuers actually applied a small valuation increase to the circa 50% of the HDN portfolio they revalued. However, HDN is trading materially below this valuation at an implied capitalisation rate of 6.4% with a current dividend yield of circa 7%. The current dividend yield spread to the yield offered by the 10 year Australian Government Bond is approximately 3%, roughly in line with the average spread over the last few years, despite the dramatic increase in interest rates during this period.

HDN Dividend Yield Spread to 10 Year Australian Government Bond

Source: Auscap, Bloomberg

HDN provides investors with exposure to a high-quality portfolio of assets with a bright outlook for growth due to tenant demand and development opportunities. At a dividend yield of circa 7% and with sustainable growth anticipated, we view the total shareholder return as attractive given the risk profile. We are also enthused by management's growth initiatives and the potential for HDN to benefit from any future improvement in sentiment towards the listed real estate sector.

Auscap Long Short Australian Equities Fund

Fund Performance*

Period	Auscap	All Ords
June 2023	2.4%	1.9%
Financial Year 2023	21.5%	14.8%
Since Inception (Dec 2012)	325.9%	151.2%
Annualised Returns	14.7%	9.1%

Fund Exposures

June 2023 Average	% NAV	Positions
Gross Long	94%	41
Gross Short	0%	0
Gross Total	94%	41
Net / Beta Adjusted Net	94%	111%

Portfolio Commentary*

The Fund returned 2.4% net of fees during June 2023. This compares with the All Ordinaries Accumulation Index return of 1.9%.

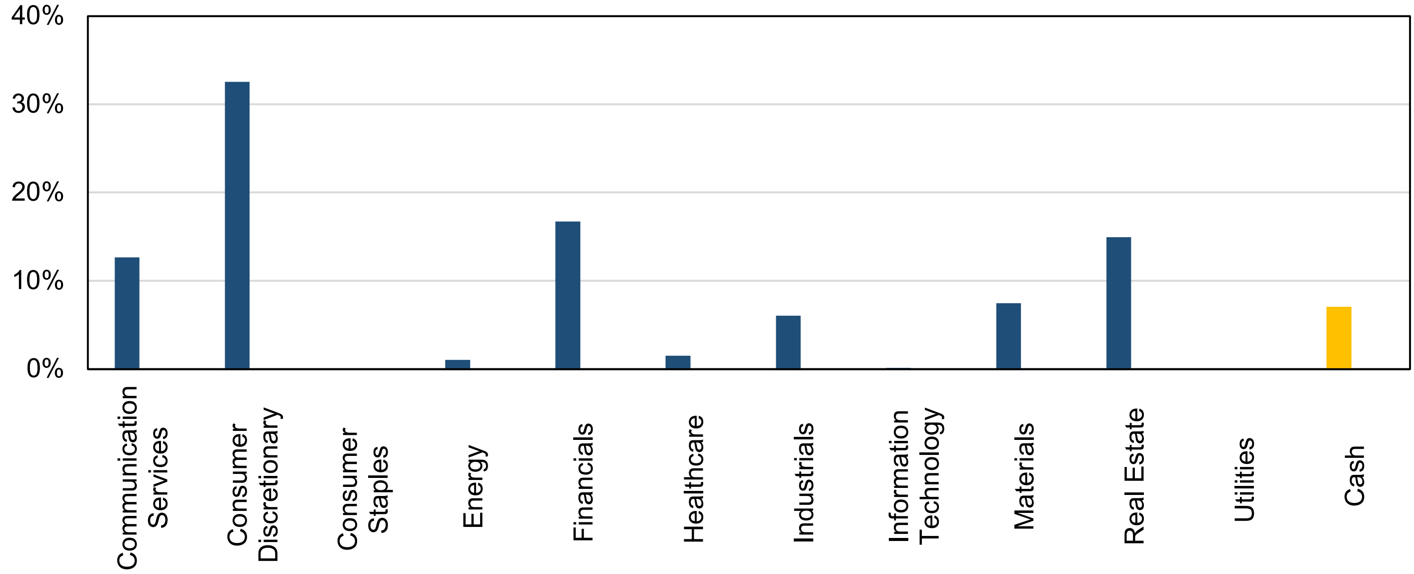
Fund Calendar Year Returns*

CY13	51.9%	CY19	18.1%
CY14	23.2%	CY20	10.6%
CY15	36.0%	CY21	43.2%
CY16	2.2%	CY22	(12.4%)
CY17	17.1%	CY23+	3.5%
CY18	(18.5%)		

Top 20 Investments^

ARB Corp	Mineral Resources
Breville Group	Motorcycle Holdings
Carsales.com	NIB Holdings
Centuria Capital	Nick Scali
Eagers Automotive	PSC Insurance
HMC Capital	Premier Investments
HomeCo Daily Needs REIT	REA Group
HUB24	Reece
JB Hi-Fi	Reliance
Macquarie Group	Telstra Group

Sector Exposure - June 2023#



* *Performance figures are calculated for the Monthly Class net of all fees and expenses and assuming the reinvestment of all distributions. Note, as at 1 January 2021, the Series Class was consolidated into the Monthly Class. Past performance is not a reliable indicator of future performance.*
^ *Top 20 long investments in alphabetical order as at 30 June 2023.*
+ *To 30 June 2023.*
# *Average Sector Exposure during June 2023.*

Newsletter – July 2023

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