Fund update

Perpetual Industrial Share Fund

Fund Commentary

During the month of June 2021, the Perpetual Industrial Share Fund generated a return of 1.16% (net of fees). This underperformed the benchmark (S&P/ASX 300 Ind Accumulation Index) by -1.62%. Over the 12 months to June 2021, the fund generated a return of 32.36%, outperforming the benchmark by 4.43%.

Over the 12 months to 30 June, the largest positive contributors to returns were long positions in Eagers Automotive (ASX: APE), Fletcher Building (ASX: FBU) and La Francaise de Jeux (ETR: FDJ). The biggest detractors to performance were not holding any Afterpay (ASX: APT), a long position in Woolworths (ASX: WOW) and a long position in Medibank (ASX: MPL).

Year in Review

What a crazy year it was. Apart from the fact that the market was up almost 30%, there were so many different macro phases over the last twelve months. Between July and October 2020 interest rate expectations were zero or negative and all everyone wanted to buy was structurally-growing companies, which were COVID beneficiaries with massive total addressable markets (TAMs). Then, when the better-than-anticipated vaccine efficacies were announced in November 2020, the market shifted its view on global economies from having a low-to-negative-growth outlook, to one with a sharp V-shaped recovery. Buoyed by loose monetary policy and supportive fiscal stimulus, consumer and business confidence bounced back quickly, and the narrative in investment markets shifted to reflation. In this environment, any cyclical company with some exposure to the strengthening economy was bought aggressively. Moving to the beginning of this calendar year, all the debate was about long-term inflation vs deflation and whether the signs of inflation would be sustained or transitory. At the beginning, the inflationists were winning the debate and we started seeing long-dated treasuries sell off viciously (higher yields) at the beginning of 2021. Over the last couple of months, with another spike in COVID cases and some slightly more hawkish tones from the Federal Reserve, the “transitory” inflation narrative is starting to gain more popularity.

As illustrated in this brief recap, every few months a popular macro narrative seemed to take hold and all market participants jumped on board. The one learning we take from this is to keep an open mind. What may seem completely logical and compelling one minute may completely change in a few months’ time for reasons that were not even considered before. There are so many variables driving the macro, some of which are predictable, others of which are very hard to predict. While you cannot completely divorce your macro view from bottom-up stock picking, we resisted the temptation to make investment decisions based purely on our macro view.

We are always looking at ways to improve our performance. Hence, we consistently assess historic investment decisions to determine whether we could have done better. You cannot change the past, but you can learn from it. The end of a financial year is a good opportunity to more thoroughly go through investment decisions made over the previous twelve months, to both analyse and learn from mistakes and successes. It is important to separate luck from skill. In hindsight,

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everything is obvious. Investing involves predicting the future which is an imperfect art. You can handicap certain outcomes, but every now and then you can be either lucky or unlucky when an impossible-to-predict event occurs.

So how did we go over the year? From both an absolute and relative perspective we had a pretty good year. To be up by a third is a great outcome in an absolute sense. One thing we did very well was reacting to opportunities presented to us over the last 18 months. Some examples were buying cyclical companies during the outright panic in March 2020, which were at the epicentre of COVID disruption, and buying the big four banks in September 2020 when the market was selling them on the back of dividend cuts.

So, what hurt us over the last twelve months?

As a general comment, the stocks which detracted from our relative returns over the last year were either long-term holdings, which performed pretty well but just not as well as the rest of the market (Medibank, Woolworths), or not holding some of the racier companies which performed very strongly (Afterpay). This is a pleasing outcome as we managed to avoid any blow-ups over the year. There is always a bit of luck involved, but we put this down to our quality filter which kept us out of trouble by and large.

Afterpay (ASX: APT)

Not owning any APT was the biggest single stock detractor to relative performance. Over the period, the stock doubled and, given it is now in the ASX 200, not owning it cost us from a relative perspective. Given APT is not in the Perpetual universe since the company is unprofitable, we don't view this as a mistake. Some tell us that it is profitable as Afterpay made $47.7m normalised EBITDA in H1 21. However, I have a problem with people quoting EBITDA, let alone normalised EBITDA as a demonstration a company is profitable. This is especially the case in a post-AASB 16 world (a recent change in accounting standards which moves rental expenses to below the EBITDA line). So while Afterpay made $47.7m EBITDA in the half, this does not take into consideration share based payments ($25.5m) which may not be cash but dilution to existing shareholders ownership of the company. In effect this is a cost to existing shareholders. Another important cost is deprecation ($17.7m), which is well below the cash capitalised for intangible development - $28.6m. Then there is the net interest expense of $9.3m, which for a consumer credit company is pretty important, as well as international expansion costs of $4.1m, which for some reason have been excluded from the normalised EBITDA. Taking this all into consideration, the company continues to lose money.

Having said this, as the company grows and if the fixed cost leverage comes through, then Afterpay may be profitable at some point in the future. We will then need to ask ourselves whether this is something in which the fund should invest. When considering buying into a company valued at $30bn with little to no profitability, we need to ask ourselves the following questions. What will the competitive environment look like in five years? How will that environment impact merchant fees and margins generally? What is Afterpay's competitive advantage? Does Afterpay have the ability to pivot to another stream of income with its strong brand name and data collected on its customers?

In my opinion, there is no doubt that the level of competition in the buy now, pay later (BNPL) sector is going to grow exponentially. Just last week, Apple announced it was getting into the space and offering an identical product. Given the dominant market share Apple has and the ease of use, that is something I thought even the bulls may have to take seriously. The bulls however waved the threat away (Apple, Shmapple) saying that one needed to have a credit card in order to apply for the Apple BNPL product. This contrasts to Afterpay which does not need to do any responsible lending credit checks on its customers because it is not credit – go figure. This brings me to one of the other questions. What is Afterpay's competitive advantage? To some in the industry, the key competitive advantage for Afterpay is the fact it can offer credit to consumers who are unable to get credit anywhere else due to their lack of creditworthiness. To others its competitive advantage is its first mover status, service levels and strong brand name. I suspect it is a bit of both. The issue

is that I believe the first competitive advantage is not sustainable. If it looks like a duck and sounds like a duck, it is probably a duck. While Afterpay has managed to convince regulators its credit product is not a credit product, I believe that this regulatory arbitrage will close at some point. At that point in time, Afterpay will need to walk the responsible lending path like its competitors. For me, as competition increases and the regulatory arbitrage closes, the big question investors need to ask themselves is whether or not Afterpay has the ability to pivot its business to new and more lucrative revenue streams. This is really important. One could have been negative on Amazon for being expensive for an online bookstore twenty years ago and been extremely wrong. We need to consider what Afterpay could be in 10-20 years, not what it is now. That is the area I am spending my time on when looking at Afterpay. When you are looking at a $30bn value company which is not making money and has competitive pressures in its core business, the only justification is the potential pivot. We are keeping an open mind but, at this stage, we see no justification for this business to be worth anything close to its current valuation.

Woolworths (ASX: WOW)

Another large detractor from relative performance was our investment in Woolworths. It was not a bad performer over the twelve months generating a return of 18.5%. That is a good annual return, however was a drag on relative performance given the market was up just under 30%.

Woolworths has been a great investment for us over the last five or so years. We started buying it in mid-to-late 2016 and have been holders to varying levels since that time. Our initial interest was aroused as the share price waned in light of the over-earning, complacent core supermarket business making an ill-fated venture into the hardware market through Masters, made possible by a weak management team and Board. The core grocery business still retained much that was good, but its high margins were not only unsustainable, they had also attracted competition from the likes of Aldi and Costco. From our perspective that changed with Board refreshment and appointment of the current management team. We looked favourably on the overall operating assets, balance sheet and turnaround strategy of the company. Initial strategic steps included selling out of Masters, replacing store roll out with upgrades to the existing supermarket store network and sacrificing short term margins for longer term sustainable growth. More generally, Woolworths under this new (current) leadership took short, medium and long term strategic decisions centred around resetting itself as a genuine value proposition to customers. This meant becoming increasingly sustainable and defendable over time through sound behavioural practices and solid investment across all aspects of business. Investment has been very substantial over the past five years and while never 100% without hitch, Woolworths is increasingly effective in presenting the most compelling customer offer in the marketplace. Woolworths is now beginning to grow its overall and already market leading food market share. Woolworths has a 50%+ market share in the online grocery market in Australia despite having *only* 37% market share in the traditional land-based grocery market.

We believe that as far as loyalty, digital, data, supply chain and store footprint, Woolworths is materially ahead of any of its national competitors. Just the Australian Woolworths food business has almost 13m active loyalty customers, 12.5m weekly visits to its app or online and almost $4bn annual online sales (growing up 92% in H1 21). The numbers are mind-blowing. The most interesting aspects for me are the customer loyalty and further aligned activities possible for Woolworths within a growing ecosystem of interconnected goods and services. Potentially future developments and innovation will further fortress the Woolworths core food operations with adjacent earnings and unlock the value that is inherent within this enormous customer database. Extensive infrastructure built out over time including important consumer protections, embedded behavioural practices and management accountability added to now incrementally growing scale is expected to offer increased leverage and earnings growth into the future.

Despite underperforming in FY21, the stock has performed very strongly already in FY22 following the spin-off of the Endeavour Drinks division. While the share price may have gotten ahead of itself in the short term as the market looks for

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more disclosure from Woolworths around these adjacent opportunities, we continue to believe that Woolworths has a good growth outlook which should be able to deliver earnings no matter what the macro environment supported by a stellar balance sheet.

What worked well for us?

Eagers Automotive (ASX: APE)

We spend a lot of time looking at cyclical companies. We are not afraid to own companies where the company is exposed to a cycle. The opportunity generally arises in the stock market when, at the low end of a cycle, earnings momentum is negative. This is generally met with a weak share price as momentum investors, passive funds and quant funds tend to sell when a company downgrades short term earnings. The opposite also happens. When there is an up-cycle, earnings momentum is positive, and this is usually combined with a strong share price and positive analyst recommendations. This is despite the mid-cycle valuation not really changing. APE is a good example of this. In February and March 2020 there were on average four buy recommendations despite the share price languishing between $3/share and $4/share. Currently with the share price over $15/share the number of buy recommendations from sell side analysts has doubled to eight.

The important formula is to make sure you own the best managed company in the space, which has a strong balance sheet to take advantage of bargains at the lower end of the cycle − either through mergers and acquisitions or strategic investments. Going into COVID, the auto retailers were already going through recessionary conditions. There had been more than two years of negative industry new car sales and regulatory changes made it more difficult to generate commission from finance products. In the middle of this, APE took advantage of its strong balance sheet and excellent management team to buy its biggest competitor AHG. We like this sort of move at the low end of a cycle, however, it is easier said than done. During the middle of COVID, APE fell below $3.00/share in March 2020. For our sins, we continued to buy all the way down. We got comfort from the strength in the management team, the strength of the balance sheet and the experience of the board. We felt that mid-cycle earnings for APE would be around $0.60/share conservatively, and hence we thought we were getting a good price at $3-$4/share. The stock rallied hard over FY21 and finished the year at over $15/share. While we were happy that we kept our nerve when everything was looking bad and everyone was selling the stock, we also got a bit lucky. For a variety of reasons, there is a global shortage of microchips which are essential for new car manufacturing currently. This has stifled supply of new cars. At the same time, change in consumer behaviour has seen a big spike in demand for cars. This has resulted not only in car volumes bouncing back (something we thought would naturally occur as the cycle turned) but margins are at record highs (something we didn't predict). So, while we can pat ourselves on the back for buying well when it was not an obvious trade, we were also a little bit lucky too.

La Francaise de Jeux (ETR: FDJ)

While the Industrial Share Fund is a fund which invests primarily in Australian listed stocks, the fund can invest up to 10% of the funds under management (FUM) in global stocks. One of these stocks is La Francaise de Jeux (FDJ). The fund bought into FDJ after its IPO in November 2019 at just over €20/share and the stock is now trading just under €50/share less than two years later. This has been a good investment for our unitholders.

FDJ was a privatisation by the French government of the country's Lottery and offline sports betting business. The main asset is a 25-year monopoly licence to operate both online and offline lottery and instant win (e.g. scratchies) games in France. Having analysed TABCORP over the years, we have built up a good understanding of the key drivers for lottery businesses which we consider to be very high-quality businesses. They are typically government-supported monopolies which are asset light with infrastructure-like qualities. While everyone likes to focus on the latest and greatest digital start-

ups, we believe that there are several “old-school” businesses which are beneficiaries of digitisation. The lottery industry is one of them. Traditionally, lottery tickets have been distributed offline through newsagencies in Australia. The lottery operator would have no contact with the end customer, but would indirectly through providing systems, terminals and tickets to these outlets. The newsagents take a 10% commission for providing this service. Increasingly around the world, lottery operators are going directly to the end customer by servicing these customers through digital channels and enabling customers to buy lottery tickets through a website or app. This has two benefits for the operators. The first is to save money on the commission historically paid to the newsagent, and the second is the direct relationship the lottery operator builds with the end customer. This enables the operator to more effectively market to its customers. Over the last five years we have seen the proportion of revenue generated online at TABCORP increase from 10% to 30% of revenue, which has been a massive driver of earnings growth.

The industry structure in France is very similar to Australia. Rather than distributing lottery tickets through newsagents, in France tickets are distributed through tobacconists. When it listed in late 2019, less than 5% of tickets were sold digitally. That is where we saw the opportunity. We saw no reason why FDJ couldn’t increase its percentage of online sales to 30%, where TABCORP was, or even higher over time. Our thesis at the time was that this shift in channels would result in revenue growing at a faster rate than historic trends and would also materially increase margins over time. To put it into perspective, 75% of FDJ’s controllable costs are commissions paid to the tobacconists and thus online margins for FDJ are more than double offline. What we especially liked when we bought the stock was that we felt management was aware of this opportunity and was competent enough to execute. We also liked the fact that none of the analysts covering the stock really mentioned this in their research reports nor did they reflect this opportunity in their earnings forecasts. With a valuation multiple half that implied by TABCORP and a net cash balance sheet, we thought that this was an excellent investment opportunity.

The investment case has started to play out. The company has increased the percentage revenue coming from online from less than 5% to 12% in 18 months, the earnings have surprised materially on the upside, despite COVID-19 and the share price is up 2 ½ times.

The lesson here is that sometimes trends happen in Australia before other parts of the world. We like looking for opportunities globally in sectors where we have a very good understanding through our internal fundamental research of Australian companies. While our research starts in Australia, the best investment opportunity for our unitholders may well be in a country other than Australia. This was most definitely the case with FDJ.

Avoiding value traps

As a value manager, generating alpha from being maximum underweight a company like CSL Limited (ASX: CSL) when it underperforms should be a given. No value manager can look at you with a straight face and tell you that buying a specialist pharmaceutical company at 40x + P/E (double its overseas equivalent companies) is a value investment. We have been maximum underweight CSL as we are value managers and no matter what way we look at the valuation, we have and continue to believe that CSL is overvalued. Generating alpha from not owning CSL when it underperforms is pleasing given the alpha which it has detracted on the way up, however, this should be a given and hence we don’t take credit for that. As a fundamental value manager where we think we can add value is avoiding some stocks which cosmetically look cheap but are in fact value traps.

The fund was short or did not own AGL, AMP, Aurizon, Coles, Lend Lease, Cimic, Amcor and QBE for most of this year. These are all traditional value-style companies and all underperformed the market materially. We spent a lot of time analysing these companies and, for one reason or another, felt that while cosmetically cheap a lot of them were value traps. Take AGL. In our heads the red flag came when they revealed they were looking to buy Vocus and then quickly

back-peddled when the shareholders revolted. This revealed two things. First, that the company could see a weak operating environment in its core business and a need to diversify. Secondly, given the speed of the back-pedal, it also showed a weak management team and board. For us, it was hard to be anything but negative wholesale electricity prices given the amount of renewable energy under construction. On top of this, there is consistent regulatory risk as governments want to keep retail electricity prices low and phase in renewable energy as quickly as possible. AGL is the meat in this regulatory sandwich. Until the government works out that they need reliable base load generation and if the market price is forcing generator closures, the government will need to motivate the coal and gas fired generators to stay open. Until this happens, there will continue to be regulatory headwinds for AGL.

The year ahead

As we head into the new financial year, we feel really excited by the stocks we own in the fund. Picking the macro trends from here is incredibly difficult and if FY21 has taught us anything it is to keep an open mind. We consistently stress test the portfolio against various macro scenarios to understand where our exposures may be and discuss if we are happy with these exposures. While we will continue to do this, the core of our investment decisions will remain our fundamental bottom-up stock picking.

What are we most excited about?

Flutter (LON: FLTR)

We continue to hold strong conviction in Flutter Entertainment. During FY21 the stock marginally outperformed the market, however, this was after a very strong performance in FY20. In terms of our thesis, FY21 was a strong year of operational performance and delivery against strategic targets. FLTR's US business, Fanduel, continues to dominate the US market, which is proving to be larger than even the most bullish analysts had expected. Despite increasing competition as further states regulate, Fanduel has continued to hold >35% market share in sports betting with this increasing over recent months to >40%. The core business in the UK and Australia continues to take market share and has been very successful in continuing to grow the active customer base with profitable retail customers. The company is also making significant investments in the Pokerstars division. While this is impacting short-term earnings, it is setting the platform up for sustained long-term growth. FLTR is a proven market leader in the largest sports betting markets globally in the UK, US and Australia. The Pokerstars division will be the platform for FLTR to take this sports betting expertise to other large global markets that are regulated or will likely be regulated in the future. FLTR is investing up-front in increasing brand marketing and improving the technology platform such that when it integrates its market leading sports betting technology, the business is in a strong position to aggressively compete in these new markets. We continue to believe FLTR has a very long runway of growth and we expect it to compound EPS growth at >10% for the next 10 years. At current levels we believe the stock is materially undervalued. If we assume that Fanduel is worth the same as the current market capitalization of key competitor Draftkings (NASDAQ: DKNG), it is worth ~$US19.7b or £85/share for FLTR (FLTR owns 95% of Fanduel). We believe this is conservative given Fanduel is a materially larger business – Visible Alpha has consensus revenue forecasts for Fanduel in 2021 40% higher than Draftkings. This implies that the rest of FLTR's business ex the US is being valued by the market at the current share price at £44 / share, which translates to a 9x PE multiple on our FY22 earnings forecast (ex the US) falling to ~7.5x in FY23. For the global leader in online sports betting with a long runway of earnings growth we consider this to be a very attractive opportunity.

Good Management Teams

One thing COVID highlighted was how important a good management team in your investment thesis. On the one hand, some management teams were like a deer in headlights and were incremental with their operational response and, when things got tough, diluted shareholders with deeply discounted capital raisings. On the other had there were other management teams which responded quickly operationally, did everything possible to maximise liquidity without diluting shareholders and capitalised on opportunities so as to come out the other side of the pandemic in a stronger position. A few stand-outs in our investee companies are Seven Group (ASX:SVW) who didn't miss a beat operationally and used the volatility during COVID-19 to make a raid on international building and construction materials company Boral at what we consider to be a very good entry point. Another company, Premier Investments (ASX: PMV), moved quickly during COVID and leveraged its investment in online fulfilment to transition customers to online and did it in a way which was materially more profitable than its retail network. It then took advantage of its strong position to shut down unprofitable stores and re-base its operating leases, meaning its retail network will be more profitable on the other side of COVID. We believe that it is no coincidence that companies like SVW, PMV and APE (mentioned above) all performed strongly during the COVID downturn. The one thing they all have in common is they have a major founder/shareholder who is on the board. This generally means that longer term value accretive decisions are typically made rather than decisions made by agency style boards and management who do whatever seems to be a good idea at the time to appease shareholders in the short term.

While we have reduced our position in APE due to the stock trading materially above what we consider to be mid-cycle valuation, we continue to believe the outlook for WOW, SVW and PMV is very exciting. They have made excellent investments both organically and inorganically and we have faith in the management team combined with a strong balance sheet and high quality assets will be able to generate strong returns in almost every macro scenario which we think is likely to occur. Who knows what macro scenario will play out during FY22, but we will continue to monitor our core investments and scour the market to either take advantage of market panic to get good entries into quality companies or look for changes in industry or companies which we believe could materially change the underlying value of a company over time. We look forward to the year ahead.

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