Greencape Broadcap Fund

Quarterly report - June 2020

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Inception % p.a.
Fund return	20.62	2.60	9.43	9.59	10.33	9.20
Growth return	20.62	1.43	4.32	3.73	3.61	3.06
Distribution return	-	1.17	5.11	5.86	6.73	6.14
S&P/ASX 300 Accumulation Index	16.79	-7.61	5.24	6.00	7.71	5.55
Active return^	3.83	10.21	4.19	3.59	2.62	3.65

Past performance is not a reliable indicator of future performance.

Performance figures are calculated after fees have been deducted and assume distributions have been reinvested. No allowance is made for tax when calculating these figures.

^ Numbers may not add due to rounding

Investment objective

The Fund aims to outperform its benchmark over rolling three-year periods.

Responsible entity

Fidante Partners Limited

Investment manager

Greencape Capital Pty Ltd

Investment strategy

Greencape is an active, 'bottom-up' stock picker. Whilst Greencape does not target any specific investment style and will invest in stocks displaying 'value' and 'growth' characteristics, its focus on a company's qualitative attributes will generally lead to 'growth' oriented portfolios. This is an outcome of its bottom-up process. As such, Greencape's investment style may be classified as 'growth at a reasonable price'.

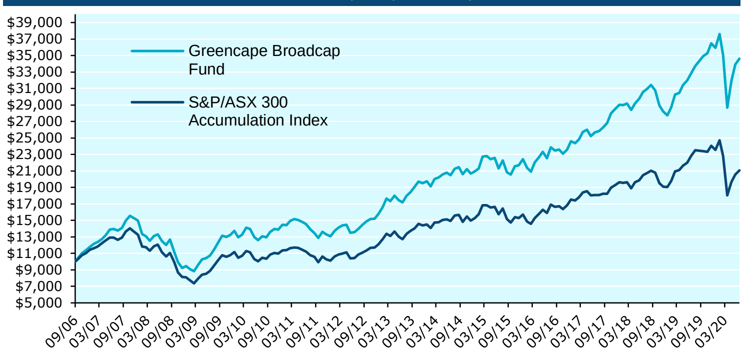
Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years

Growth of $10,000 invested since inception (net of fees)



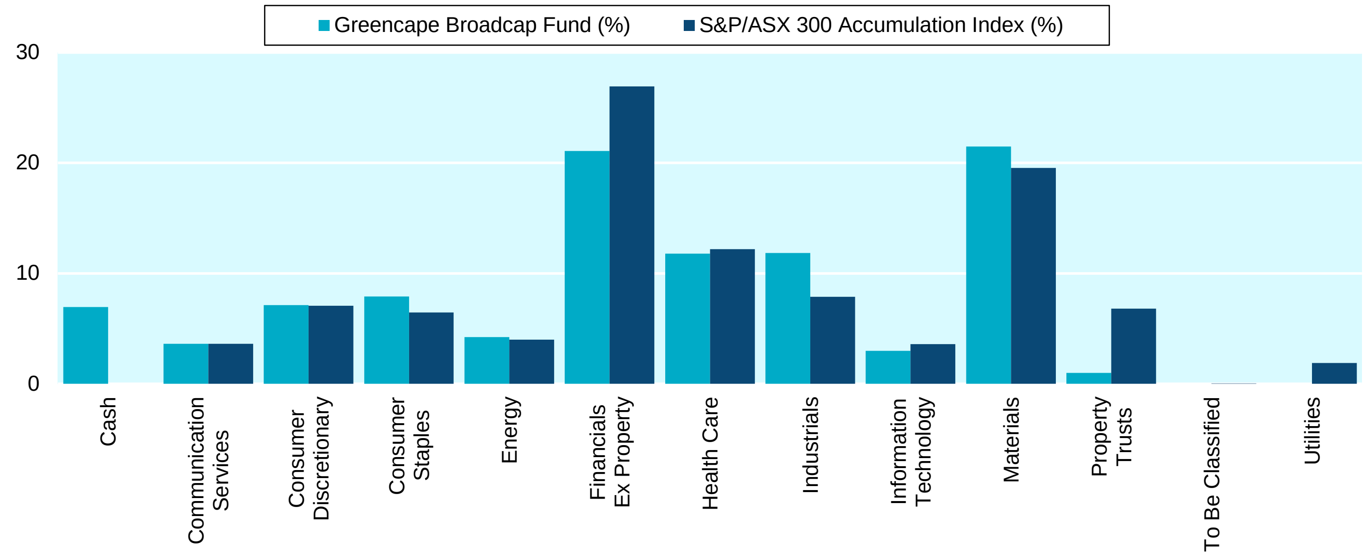
Asset allocation	Actual %	Range %
Security	93.06	85-100
Cash	6.94	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0034AU

Fees	
Entry fee	Nil
2017-2018 ICR	1.53%
Management fee	0.95% p.a.
Performance fee	15% of the Fund's daily return (after fees and expenses and after adding back any distributions paid) above the Fund's Performance Benchmark (the daily return of S&P/ASX 300 Accumulation Index).
Buy/sell spread	+0.20% / -0.20%

Data Source: Fidante Partners Limited, 30 June 2020.

Sector exposure as at 30 June 2020



Data Source: Fidante Partners Limited, 30 June 2020.

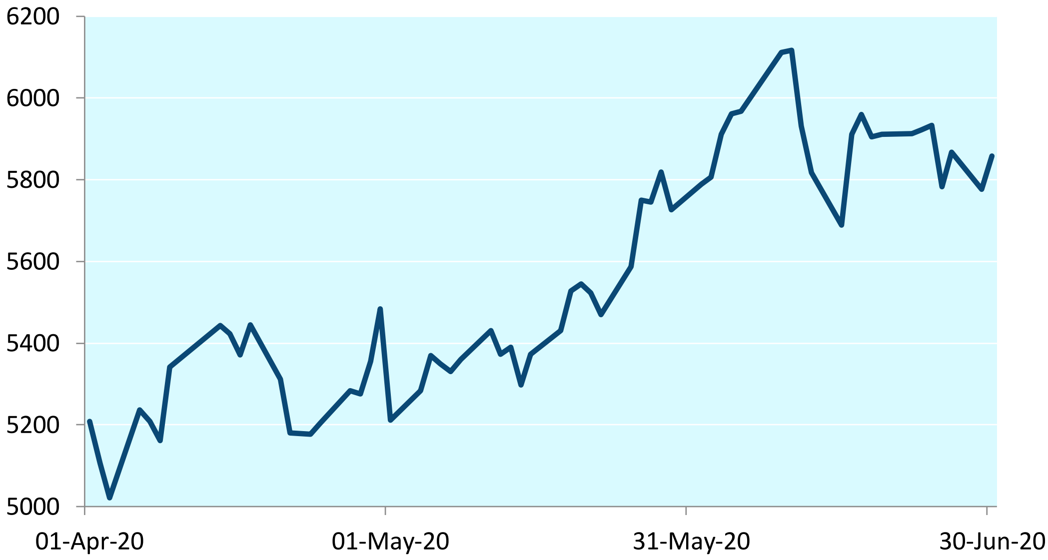
Fund performance summary

The S&P/ASX 300 Accumulation Index returned +16.79% for the quarter. The fund outperformed the market and delivered a +20.62% return over the quarter.

Market overview

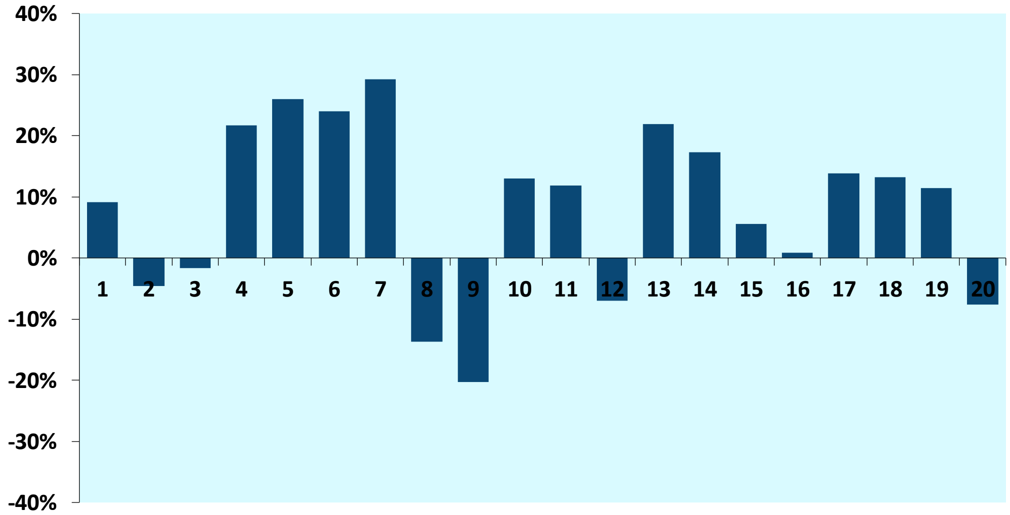
Following the worst quarterly performance since 1987 in the first quarter (Q1) of the year, Q2 saw the largest quarterly gain since 2009 (GFC). The deficit was too large to overcome for the financial year however, with the market posting its worst annual performance since 2009. The Coronavirus crisis overwhelmed all other news during the period, as the market oscillated between optimism on the prospects of a recovery and pessimism on the likelihood of a second wave.

S&P/ASX 300 Index



Source: IRESS

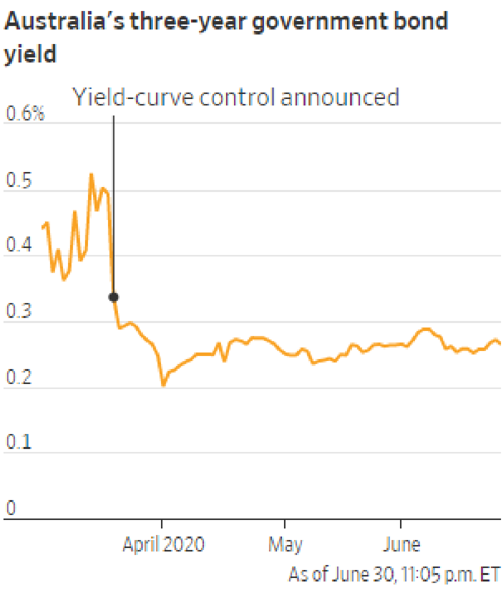
S&P/ASX 300 Accumulation Index Financial Year Returns Since 2001



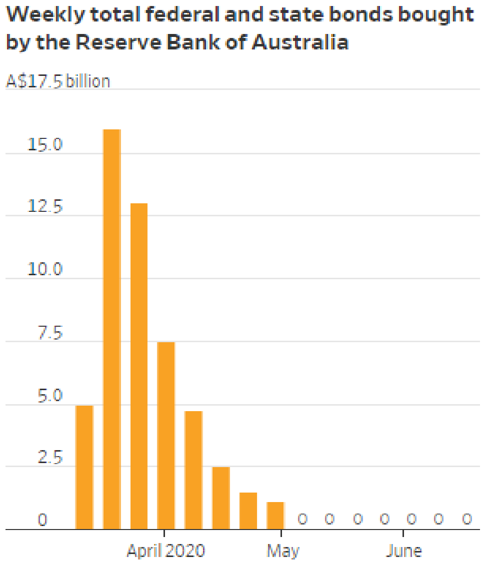
Source: IRESS

After cutting the cash rate twice in Q1, the Reserve Bank of Australia (RBA) left the cash rate at a record low of 0.25%. The central bank also implemented its Quantitative Easing (QE) strategy, targeting a yield of 0.25% on 3-year government bonds which would be achieved through buying in the secondary market.

As evidenced below, the RBA has been effective in capping the yield on 3-year government bonds.



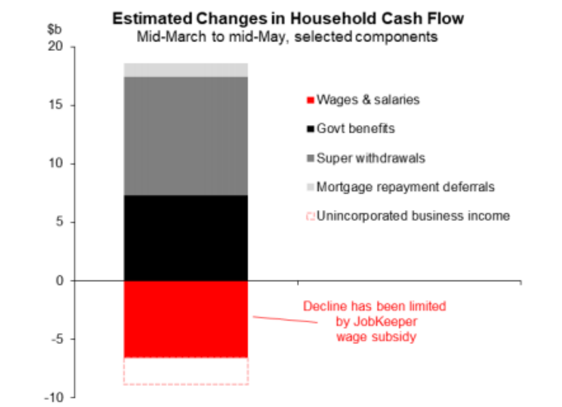
Source: Tullett Prebon



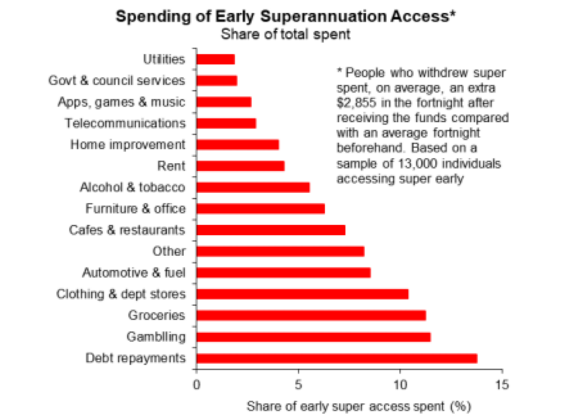
Note: A$1 billion=$689 million
Source: Australia and New Zealand Banking Group

Source: Wall Street Journal

The Federal government also played its part in stimulating the economy with a range of subsidies designed to enable the economy to cross the 'bridge' to the other side of the pandemic. These included but were not limited to a $550 per fortnight Coronavirus Supplement and a $1,500 per fortnight JobKeeper payment for eligible recipients. The government also enabled early access to $20,000 from superannuation over FY20 and FY21. These withdrawals proved popular, with the ATO website reportedly crashing on July 1 as superannuants rushed to access their second $10,000 withdrawal. There were some interesting outcomes (some of which we assume were unintended) which arose from these measures. Aggregate household cashflow actually increased and of those who accessed Super early, 64% of their incremental spending was directed at discretionary items such as gambling and alcohol.



Source: ABA, ABS, APRA, DSS, Treasury, Macquarie Macro Strategy



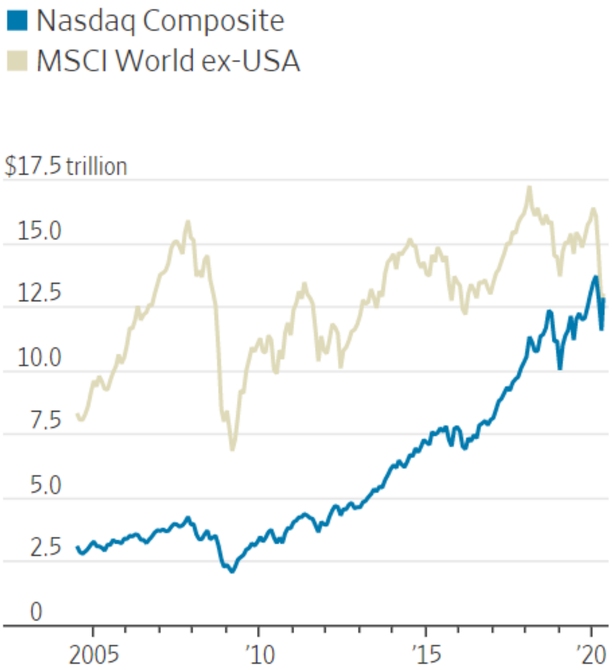
Source: illion/AlphaBeta, Macquarie Macro Strategy

Source: Macquarie

"I think we should all be worried about what happens post-September." Rob Scott, CEO of Wesfarmers, 25/06/2020

"We are facing a cliff and we'd prefer a slope." Paul Zahra, Australian Retailers Association, 25/06/2020

Whilst the recovery of the Australian market was admirable, it was modest relative to the staggering rally seen in the US market. In April, the NASDAQ even surpassed the rest of the world in terms of market capitalisation.



Source: Wall Street Journal

The gains were not broad based however, with the S&P500 rally index driven by a select number of mega cap Technology stocks.

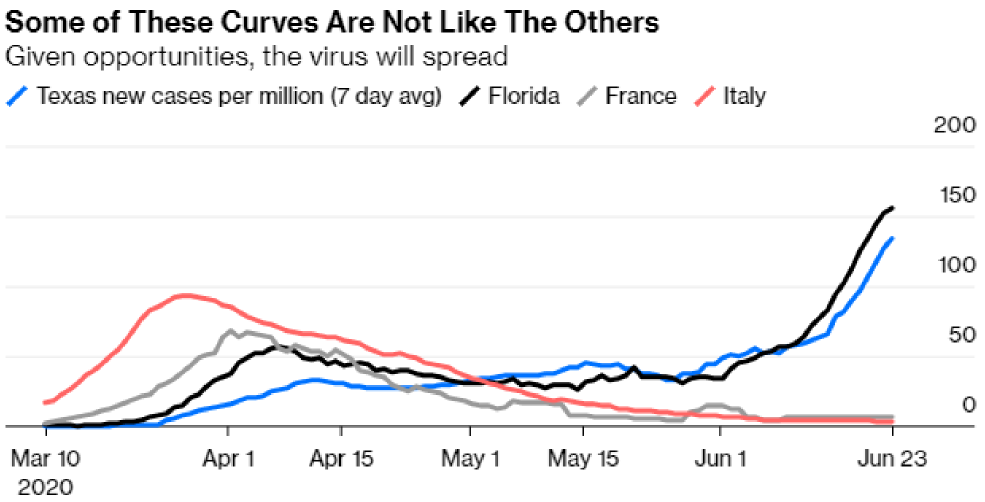
Source: The Daily Shot

"Actually, I had a mask on. I sort of liked the way I looked, OK? I thought it was OK… It was a dark, black mask, and I thought it looked OK. Looked like the Lone Ranger." Donald Trump, President of the United States of America, 02/07/2020

"THE LONE WARRIOR!" Donald Trump, President of the United States of America, 30/06/2020

"LAW & ORDER!" Donald Trump, President of the United States of America, 07/06/2020

Regardless, the rally in the US equity market has continued unabated despite alarming increases in case numbers. Florida and Texas (which cumulatively contribute 14% of US gross domestic product) are currently in the midst of a second wave where daily new case numbers are dwarfing the initial daily numbers in March.



Source: Bloomberg

Whilst some restrictive measures have been reintroduced, the mid-teens positive test rate in Florida and Texas suggests these efforts may be futile.

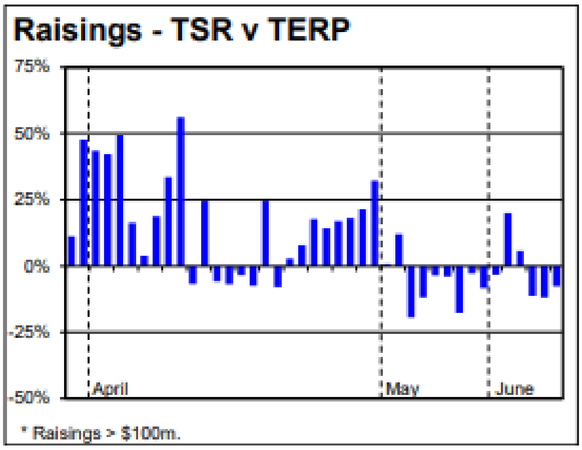
European countries with similar peak average cases were able to flatten the curve effectively after relaxing lockdown restrictions. This has not been the experience in the US hotspot states.

	Peak cases per million (7 day avg)	At reopen	1 month later	Most recent
France	67.7	16.6	7.4	6.8
Germany	67.4	13.7	5.2	7.4
Italy	93.5	30.9	6.4	3.7
Spain	168.3	23.2	8.4	7.3
The Netherlands	64.4	17.0	11.2	5.0
Arizona	53.6	52.4	177.2	374.5
Florida	55.9	31.7	45.9	155.6
California	47.0	47.6	71.0	106.7
Texas	32.7	30.3	38.6	133.8

Source: Bloomberg

Locally, 'Deal Mania' gripped the market as the balance sheet re-capitalisation cycle kicked into overdrive. Companies took full advantage of the ASX lifting share placement capacity from 15% to 25% to shore up balance sheets, ensuring they had sufficient liquidity to ride out the pandemic. The quantum of capital raised was nothing short of astonishing, with over $23bn raised since late March. Investor appetite proved ravenous for placements, with most books well covered soon after launch. Importantly these deals were also well supported in secondary market trading, with stocks on average trading at a 25% premium to their placement price as at the end of June.

A great deal of the positive share price performance post raising was front loaded however, with most companies who hesitated to pull the trigger early on raising capital seeing subsequent lacklustre share performance. The increase in the placement cap expires 31 July, and we imagine the performance of recent raisings is an active discussion point at the board level and amongst equity underwriters for companies looking to beat the 'deadline'.



Source: Diogenes Research

	QUARTER	YEAR
ASX300 Accumulation Index	16.8%	-7.6%
Best Performing Sectors		
Information Technology	44.4%	19.7%
Consumer Discretionary	30.8%	2.2%
Energy	28.4%	-29.4%
Worst Performing Sectors		
Healthcare	2.9%	27.3%
Consumer Staples	6.9%	12.0%
Utilities	7.3%	0.0%

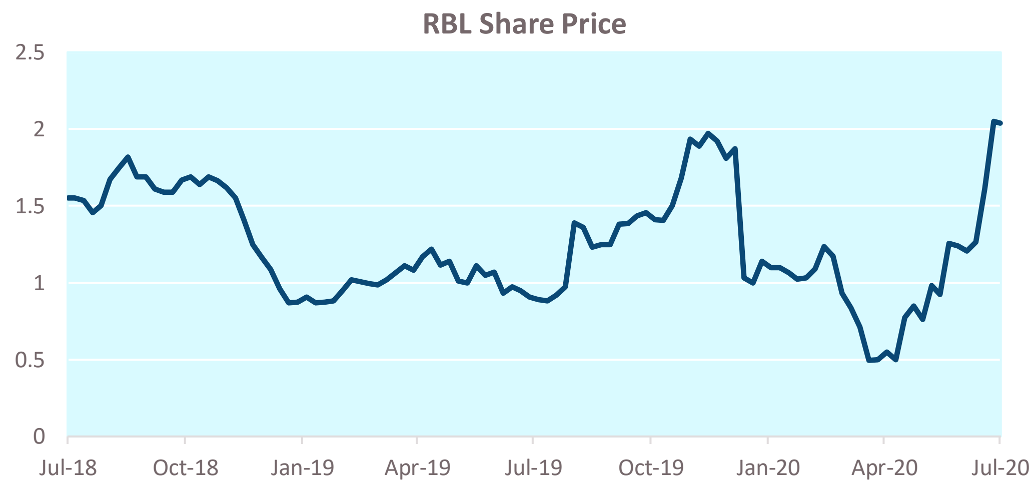
Source: IRESS

At a sector level, similar to the US experience the Technology sector led the market recovery. After reaching a low of $8 in March, Afterpay staged a remarkable rally to close the quarter over $60. At the time of writing, the company's market capitalisation now stands at over $18bn, surpassing the likes of Brambles and Aristocrat. Consumer Discretionary and Energy, two of the biggest detractors in Q1 also bounced back strongly. Again, like we have seen in the US, these sectors were strongly influenced by retail investor behaviour, with broker share data indicating that Commsec and other retail stockbrokers dominated trading activity in names such as Flight Centre, Webjet and Zip Money.

The three best performing sectors in Q1 found themselves in the exact opposite position on the performance tables in Q2. Whilst investors rushed into Healthcare and Staples for their relative defensiveness during the market downturn, investors used these sectors as funding sources in Q2 to buy higher beta names.

Redbubble

Redbubble (RBL) operates a Print on Demand (POD) marketplace where independent artists upload their artwork and customers can purchase various products that have that artwork printed on it. RBL holds no inventory; when a customer purchases a product, their order is automatically sent to the closest RBL fulfiller partner to manufacturer and ship that product direct to the customer.

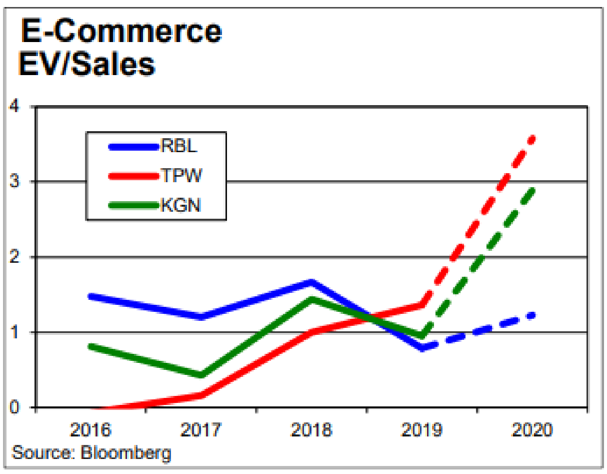


Source: Iress

We invested in RBL October 2018 as part of their equity raising to acquire a competitor, TeePublic. The issue price was $1.50, but shortly thereafter the share price fell after they announced a significant hit to sales from a change to Google's search algorithm. In July 2019 the share price recovered on improved sales growth, only to disappoint in December with surprisingly weak sales growth during the key November-December period. Whilst the sales hit was short lived (growth resumed in January), the company disappointed the market yet again when it reported greater than expected cost growth for the recent December and March quarters. The CEO Barry Newstead was forced to step down in February this year, replaced by founder Martin Hosking as interim CEO.

Notwithstanding the above issues we note that RBL still averaged ~10% sales growth from FY19 through to Q3 FY20[1], whilst the acquired TeePublic business averaged ~40% growth. In the June quarter to date (up until 22 June), RBL recently reported group sales growth of 96%[2], with ~ $12m earnings before interest, tax, depreciation and amortisation (EBITDA) for the first 11 months of FY20. RBL also announced a $5.6m cost-out program and committed to future cost growth being less than revenue growth, signalling a turning point in their history by now being sustainably profitable.

Despite all of this, RBL currently trades below its prior EV/Sales multiple, and at its widest discount to its nearest comparable companies as shown in the chart below.



"We're progressing work to better understand our audience data, drive repeat customer purchases and increase loyalty. We have acquired millions more customers over the last few months. They are our most fertile ground for further sales and we are increasingly leveraging the assets we have and can develop to ensure they return." Martin Hosking, CEO & Founder of Redbubble, 25/06/2020

[1] Redbubble market place standalone, averaged constant currency sales growth
[2] Constant currency

The discount RBL trades at relative to comparable companies (comps) is even more stark when you consider the margin RBL earn after cost of goods sold and marketing expenses (GPAPA margin[3]) is ~ 60 % greater than Kogan (KGN) and Temple & Webster (TPW)[4], hence on an EV/GPAPA basis RBL is less than one third the multiple of these two comps, as highlighted in the table below. If RBL were to trade on the same forward multiple as TPW, its share price would need to more than triple to $6.75.

RBL E-commerce & Marketplace Comparable Companies at 30/06/20

	Share price	Mkt cap $m	Sales FY21	FY21 EV/ Sales	GP	GPAPA*
KGN	14.72	1,546	582	2.4	10.1	15.6
TPW	6.31	730	240	2.9	9.9	17.0
RBL	2.06	556	400	1.3	3.4	4.8
Etsy	106.23	12,604	1,373	8.5	12.6	20.6

Etsy in USD and Calender year end
**GPAPA or Contribution margin*
Source: Capital IQ, FactSet, Canaccord, RBC

Whilst the above highlights the valuation disparity on a simplistic multiples comparison, the key question for us is do the forward looking prospects of RBL warrant a re-rating of the business?

There are several attributes of RBL's business we view as attractive:

- **Global marketplace of independent artists** – Competition exists but RBL have the largest catalogue of independent artwork and their lead on competitors such as Society6 has increased over time.
- **Print on Demand (POD) industry growth** – the POD industry is still in its infancy. Amazon's entry (Merch by Amazon) in 2016 is helping drive investment into printer technology. Kornit Digital's latest printer achieves apparel single print unit costs equivalent to a traditional 500-unit batch[5]. Print quality continues to improve and close the gap on traditional printing. New POD categories are becoming available, e.g. shoes, furniture.
- **New products** – As at 31/12/19 RBL sold 94 different products. Since then they've launched face masks, back-packs, duffle bags and athletic wear apparel as examples. Management have estimated the potential number of products they could produce is greater than 500.
- **New geographies** – RBL currently fulfils its products from 8 countries (US, UK, EU, Canada, Australia) and translates its site into German, French and Spanish. In time RBL will enter additional geographies which it can initially fulfil from nearby countries until the sales volume warrants localised fulfilment.
- **Current sales growth momentum** – RBL reported 96% sales growth for the recent June quarter. We estimate that face masks (launched in late April) contributed ~16% points to that growth rate, and hence ~80% of the reported growth came from other products. The company is clearly benefiting from the shift to online retail that COVID-19 has accelerated, a large part of which we view as structural/permanent.
- **Attractive economics** – RBL have $56m in net cash. They hold no inventory and have negative working capital as RBL receives cash upon a sale but pays its fulfillers on delayed trading terms. Customers acquired via digital ads are profitable on first purchase. Greater numbers of RBL products increases the immediate sales opportunity to RBL, but also attracts new first-time customers to the website and increases the revenue opportunity for artists displaying their work.

"The Group is well positioned for future growth. Redbubble Group is committed to aggressively pursuing the global opportunities through effective focused execution, delivering profitable growth." Martin Hosking, CEO & Founder of Redbubble, 25/06/2020

[3] Gross Profit After Paid Acquisition
[4] FY21 estimates: RBL 26.1%, TPW 17.2%, KGN 15.5%
[5] Kornit Digital Q1 2020 Financial results presentation

This further entrenches RBL as the preferred destination for artists to distribute their content through.

- **High cost base** – Including capitalised costs and share-based payments the total cost base exceeds $100m per year. This appears too high to us relative to RBL's stage of growth and we believe it reflects management's lack of commercial focus to date. However, it is reassuring to hear management's latest market communication that they have taken shareholder feedback on-board and are addressing this going forward.

In summary, we view the prospects for RBL positively. Consensus sales growth forecasts for FY21 (+10-17%) appear modest in the context of RBL's historic growth rate, combined with the tailwinds from new product launches (particularly face masks) and retail shift to online driven by COVID-19. If management can deliver greater consistency in top line growth whilst demonstrating cost control, there is the potential for both analyst forecast upgrades and a significant re-rating in the multiple of sales and GPAPA that the stock can trade on.

Outlook

The market strength and positive sentiment throughout the quarter came as a genuine surprise to us. The momentum in the market appeared at odds with the apparent uncertainty regarding medium term consumer demand and clear caution demonstrated by corporates with respect to capital management. As always, the benefit of hindsight provided commentators with the ability to explain the apparent drivers. The most commonly parroted explanations for market strength included unlimited liquidity injections from central banks, retail day traders punting their stimulus payments, negligible bank deposit rates and re-opening news flow (including hopes for a vaccine). We believe that most of these drivers should in time prove temporary. With this in mind, Greencape has become more cautious. This results in a preference for greater liquidity in positions and higher than typical cash weights.

We believe the scarcity of sustainable dividends will be front of mind for investors during forthcoming reporting seasons. We therefore expect there to be some rotation towards those companies who are able to pay out an attractive distribution without risking the balance sheet.

As always, Greencape will continue to favour our higher scoring shareholder stewardship companies. We believe effective management teams become more valuable in such uncertain times, given the abundance of cheap funding sources magnifies capital allocation outcomes in both positive and negative directions.

"The outlook, including the nature and speed of the expected recovery, remains highly uncertain and the pandemic is likely to have long-lasting effects on the economy. In the period immediately ahead, much will depend on the confidence that people and businesses have about the health situation and their own finances." Philip Lowe, RBA Governor, 02/06/2020

More information

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