Greencape Broadcap Fund

Quarterly report - June 2021

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Inception % p.a.
Fund return	6.98	26.66	11.74	13.60	11.37	10.30
Growth return	4.43	18.46	7.08	7.20	4.86	4.03
Distribution return	2.55	8.20	4.65	6.40	6.52	6.26
S&P/ASX 300 Accumulation Index	8.48	28.49	9.76	11.26	9.21	6.96
Active return^	-1.50	-1.83	1.98	2.34	2.16	3.33

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'.

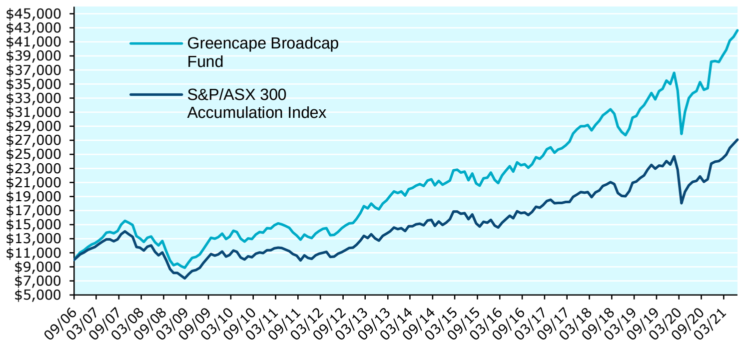
Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years

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



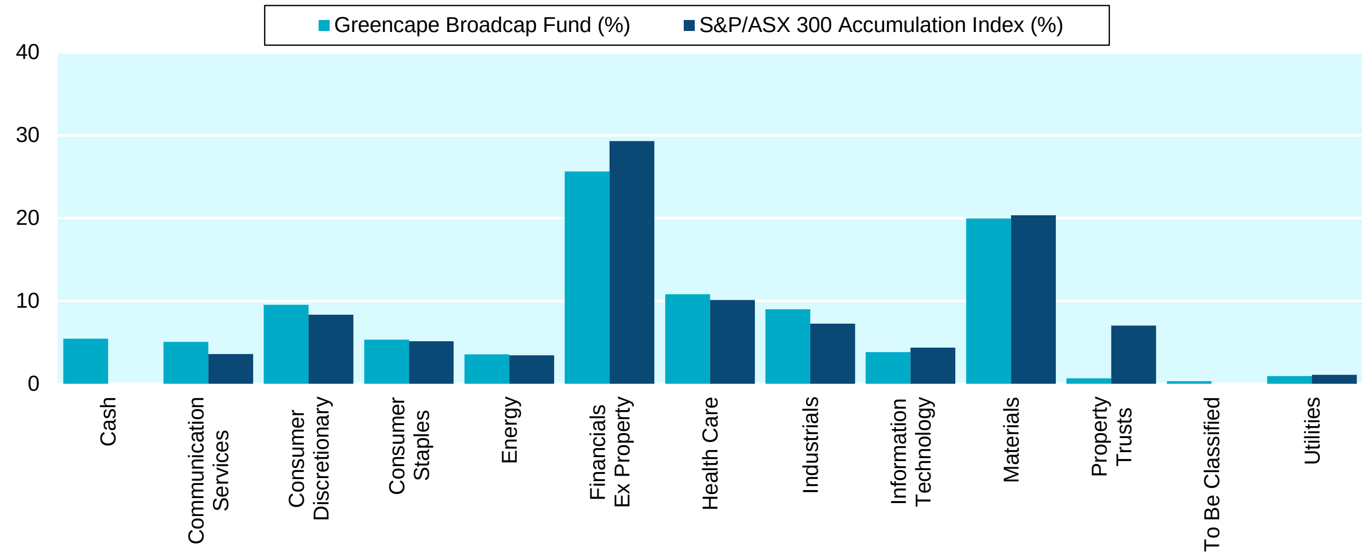
Asset allocation	Actual %	Range %
Security	94.55	85-100
Cash	5.45	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0034AU

Fees	
Entry fee	Nil
2019-2020 ICR	1.89%
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 2021.

Sector exposure as at 30 June 2021



Data Source: Fidante Partners Limited, 30 June 2021.

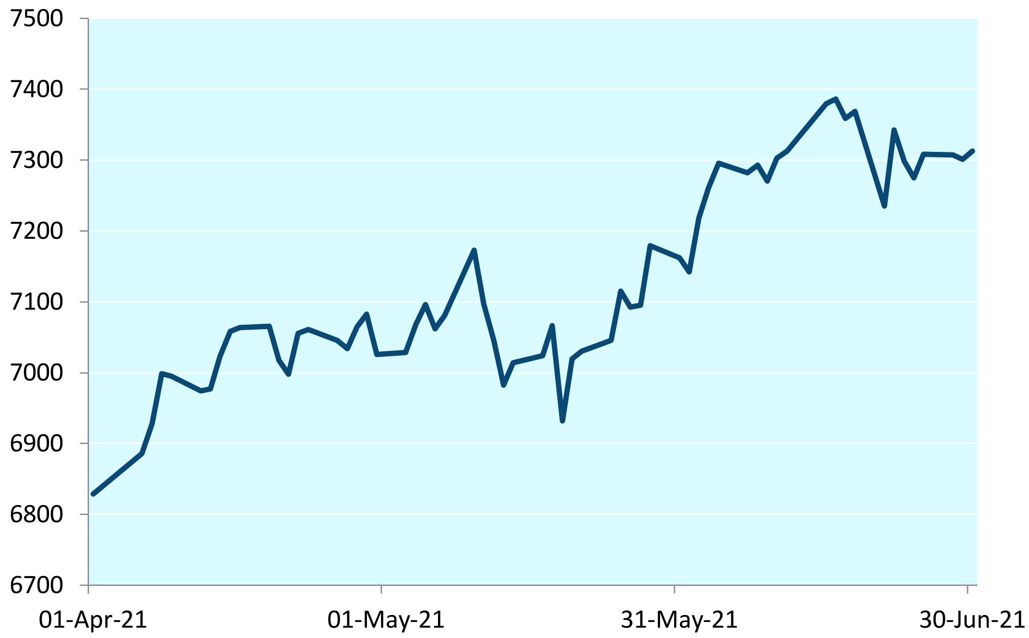
Fund performance summary

The S&P/ASX 300 Accumulation Index returned +8.48% for the quarter. The fund underperformed the market and delivered a +6.98% return over the quarter.

Market overview

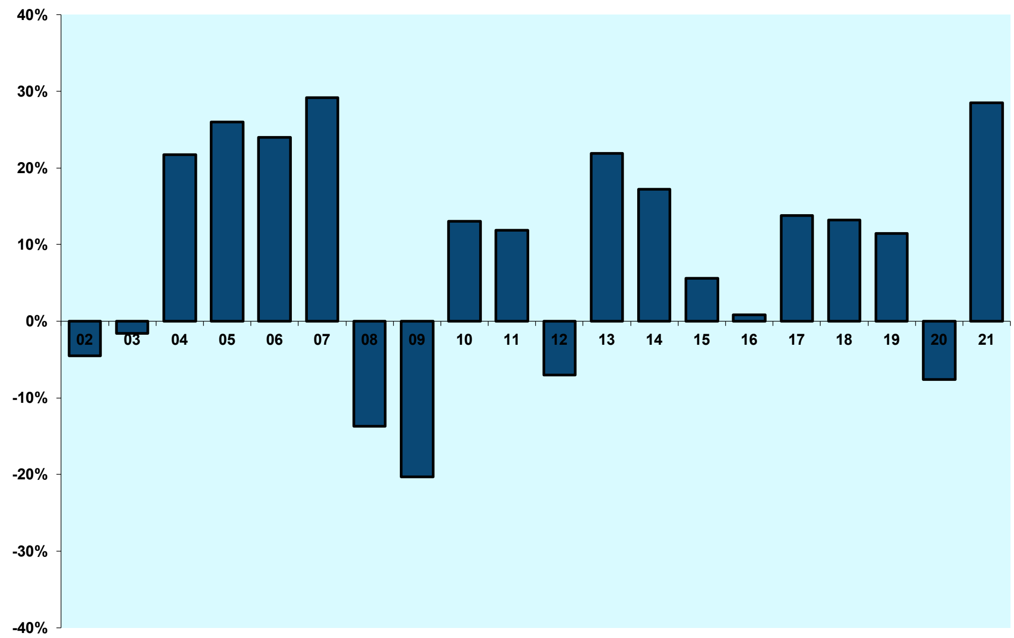
Despite the quarter finishing with half the population in lockdown, the market again managed to string together three positive months of performance, taking the streak to 9 consecutive months. As a result, the Australian market finally managed to surpass the previous high set back in February 2020, however the index still remains a distinct laggard relative to the rest of the developed world. Globally, investor debate raged on about whether the recent tick up in inflation is transitory or permanent as messaging from the Federal Reserve remained vague.

S&P/ASX 300 Index



Source: IRESS

S&P/ASX 300 Accumulation Index Financial Year Returns Since 2002



Source: IRESS

As expected, the Reserve Bank of Australia (RBA) kept the cash rate at a record low of 0.1% during the quarter. In the minutes released after the June meeting, the RBA said they would not look to increase the cash rate until inflation is sustainably within the 2 to 3 per cent target range. This suggests the RBA is comfortable to see the economy run hot and have the inflation overshoot the range before embarking upon a change in monetary policy, a scenario which the bank does not expect to occur until 2024.

"If households were to run down their additional savings quickly or if higher housing prices spurred more spending than usual, a stronger economic path than the one we have envisaged could eventuate." Philip Lowe, RBA Governor, 16/06/2020

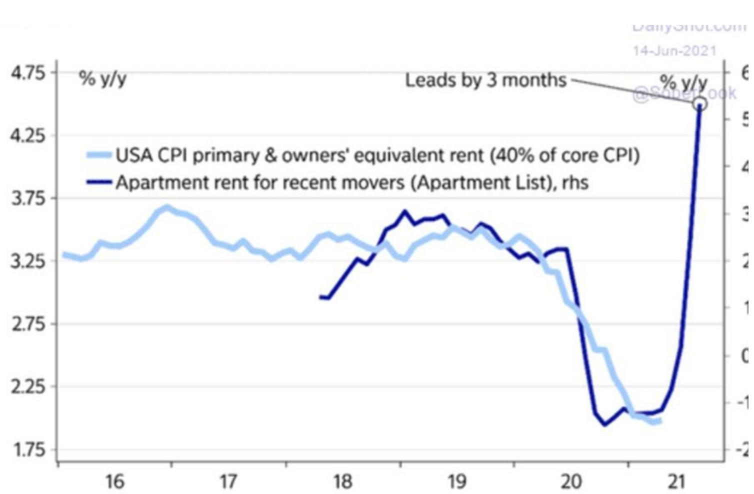
The prospect of persistently low interest rates helped put a bid under the residential property market, with prices rising at the fastest pace in recent history in most capital cities.

Source: Macquarie

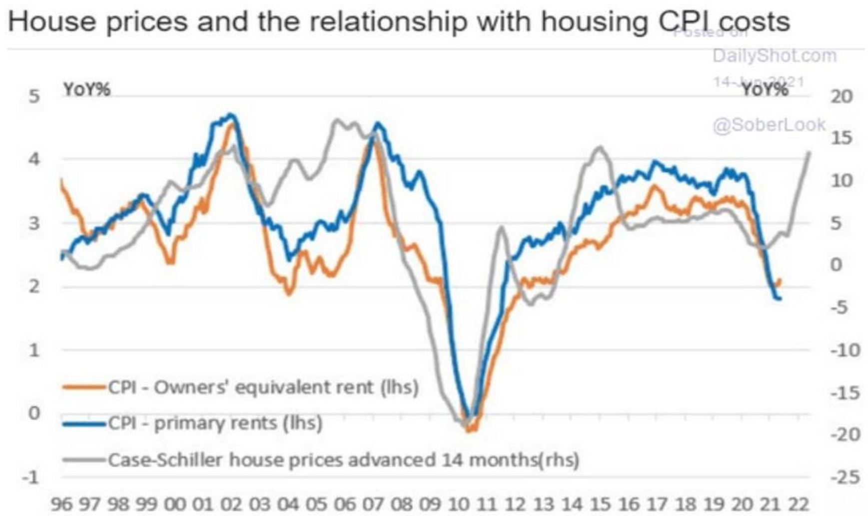
Elsewhere, more focus than usual was put on the statements released by the Fed, with the market watching closely whether the trajectory of future interest rate rises would be steeper based on a stronger than expected economic recovery. Similar to the RBA, the Fed remains comfortable with inflation running above their target of 2% for 'some time' so that inflation averages 2% over time. Fed Chairman Powell also remained of the view that the current increase in inflation is transitory, given most price gains occurred in categories such as used cars and airfares which should dissipate once the impact from the post COVID bounce-back settles down.

"These effects have been larger than we expected and they may turn out to be more persistent than we expected." Jerome Powell, Chairman of the Federal Reserve, 22/06/2021

Whilst the categories which have spiked the most may be seen as temporary, one interesting dynamic to note is the impact of housing on the CPI. Forward indicators suggest housing inflation (rent and owners equivalent rent) is about to accelerate. This could have a meaningful impact on overall CPI as these components represent 40% of the index.

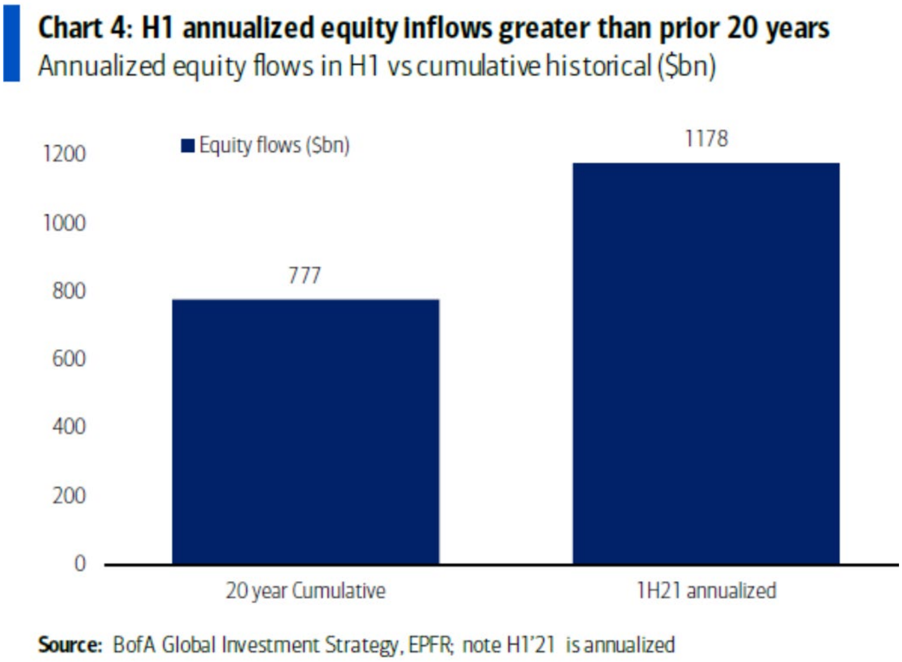


Source: Macrobond



Source: ING

Despite the potential for inflation and higher interest rates, investor appetite for equity exposure has not diminished. As per below, the annualised equity inflow for the first six months of 2021 surpassed the past 20 years combined.



Source: BAML

Local news flow was relatively muted during the period, however periodic COVID breaches of hotel quarantine continued to keep Australians on their toes. These breaches morphed into an outbreak in Victoria, plunging the Garden State into a 2-week lockdown at the end of May. Various other breaches then occurred nationally at the end of June which resulted in most Australian capital cities ending the financial year in lockdown.

	QUARTER	YEAR
ASX300 Accumulation Index	8.5%	28.5%
Best Performing Sectors		
Information Technology	12.1%	39.6%
Consumer Discretionary	11.5%	48.6%
Telecommunication Services	11.1%	33.1%
Worst Performing Sectors		
Utilities	-4.5%	-18.6%
Energy	-2.2%	10.2%
Consumer Staples	5.4%	7.6%

Source: IRESS

Information Technology stocks reversed their poor performance from Q1, bouncing back strongly as the Growth to Value trade reverted somewhat. Within the sector, financial software firm Iress rallied strongly following media reports suggesting an investment bank was seeking to purchase a 10% stake in the company. Conversely, after strong performance following its IPO last year, the share price of intelligence software firm Nuix fell significantly as the company issued multiple earnings downgrades, announced the departure of both the CEO and CFO and also confirmed ASIC was investigating the historical financial statements lodged by the company in the IPO prospectus.

Online employment marketplace Seek also performed well during the quarter, with the company benefitting from an unprecedented number of job postings over the past 12 months.

Source: Bell Potter

Wesfarmers

Earlier this year we increased our position in Wesfarmers (WES) despite the share price nearing all-time highs. We previously held the opinion that whilst the company had several quality attributes, the valuation which the stock traded on left little room for error, hence its lower weight in the portfolio. In the wake of quantum government stimulus targeted at residential construction and international borders being closed for longer than initially anticipated, we reassessed the investment case for the stock.

Wesfarmers is a Perth based conglomerate, best known for its wholly owned retail franchises which include Bunnings, K-Mart, Target and Officeworks. The Coles supermarket chain was spun out in 2018 with the company now retaining a sub 5% stake. WES also owns various businesses in the Chemicals, Energy, Fertilisers, Safety and Industrials sectors.

Despite there being a long list of business within WES, it's Bunnings which is central to the investment case for the stock. In FY20 Bunnings ANZ (BANZ) contributed 64% of Group earnings. The higher quality nature of the BANZ business relative to the rest of the portfolio means that it represents a higher share of group value than its profit contribution i.e. it's earnings should trade on a higher multiple. This is evidenced by the BANZ Return on Capital (RoC) profile relative to the other divisions.

Rolling 12 months to 30 June[1]	2020		
	EBT[2] ($m)	Cap Emp[3] ($m)	RoC (%)
Bunnings	1,852	2,997	61.8
Kmart Group	413	1,978	20.9
Officeworks	190	969	19.6
WesCEF	393	1,941	20.2
Industrial and Safety	40	1,447	2.8

Source: Company reports

Bunnings is the highest quality retailer of scale in Australia and New Zealand. It is dominant in its key categories, to the extent that many customers would struggle to know where else to source the products they can find in a Bunnings store. Furthermore, a key indication of any good retailer is the tendency for customers to walk out of the store with more than they planned to buy walking in. As the reader can surely attest to, this is an extremely common outcome from a Bunnings visit (we would also argue K-Mart also strongly exhibits this attribute). Regardless, these factors are well established and understood by the market and therefore have minimal scope to provide upside to valuation.

We believe the following factors are under appreciated by the market and could provide significant upside to Bunnings (and WES by extension) over time.

1. **Increased share by category and customer type, assisted by data**

Despite Trade customers representing around 30% of total sales, Bunnings tends to be underrepresented in most categories in the Trade segment. For example, an industry contact told us Bunnings has 85% of the retail paint market but a mere 1% share of the trade market. There are a number of issues which Bunnings face when serving the Trade market. Most importantly, Trade customers value speed/convenience and reliability over price. Various key Trade brands (e.g. Milwaukee) also choose not to supply to Bunnings. Whilst the 'share of ute' will remain low and likely has a natural ceiling based on the aforementioned issues, Bunnings does have the ability to unlock a greater share over time. We believe the PowerPass program is key to this. PowerPass is Bunnings' Trade membership program, and the penetration rate for the program amongst Trade professionals in ANZ is extremely high, as Trade customers will still tend to use Bunnings for one reason or another. Bunnings should be able to better leverage the data generated from PowerPass to better serve the Trade segment and take incremental share over time.

Whist Bunnings dominates in many retail categories (e.g. paint, garden, tools), it still under indexes in many others. In a presentation in 2019, Bunnings management noted that its share in Kitchens, Bathrooms, Window Furnishings and Floorings were all below 10% as these categories don't necessarily lend themselves well to DIY (Do It Yourself). Bunnings continues to expand their offering in these categories, e.g. via the Special Orders desk. There is also potential to take more meaningful share in these DIFM (Do It For Me) categories if Bunnings can manage to properly connect the retail customer with the Trade professional to complete the service for the customer with products purchased in store. Bunnings has the relationship with both the customer and the Tradie, and the opportunity is significant if they can figure out a way of 'closing the loop'.

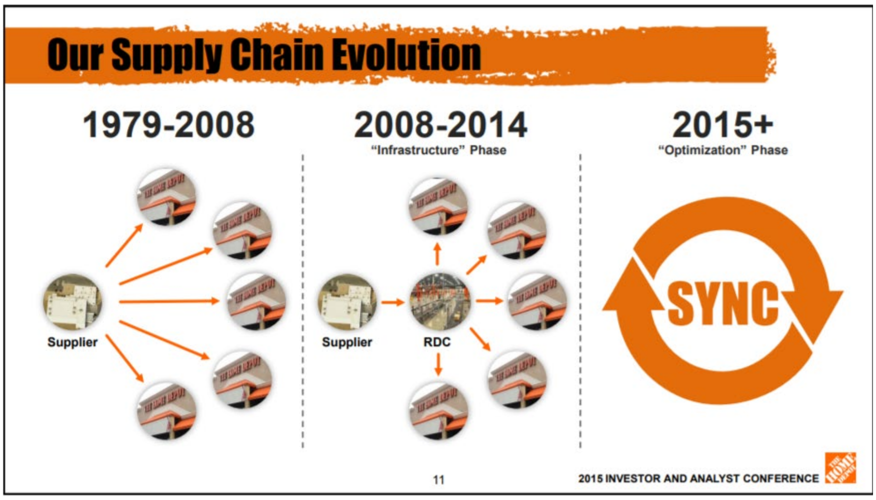
Whilst Bunnings only launched online transactional capability relatively recently, its website is the most visited of any omnichannel retailer in Australia. With less than 5% of Bunning sales online, this means that customers are predominantly coming to the website for inspiration, shopping trip planning, price checking etc. The behaviour of customers on the website is valuable data to Bunnings, and similar to PowerPass, we believe the company has the opportunity to create significant value via properly leveraging the data the business generates from its online real estate. We note that in the recent WES strategy day, the company announced the establishment of the 'Advanced Analytics Centre' and employment of 400+ data, digital and analytics specialists across the group. Over time, we also expect a significant increase in the range of products sold online as a function of it being an 'endless aisle' and not constrained by the four walls of a warehouse. Decisions around which products to add will be driven by the data and could represent meaningful incremental sales to Bunnings.

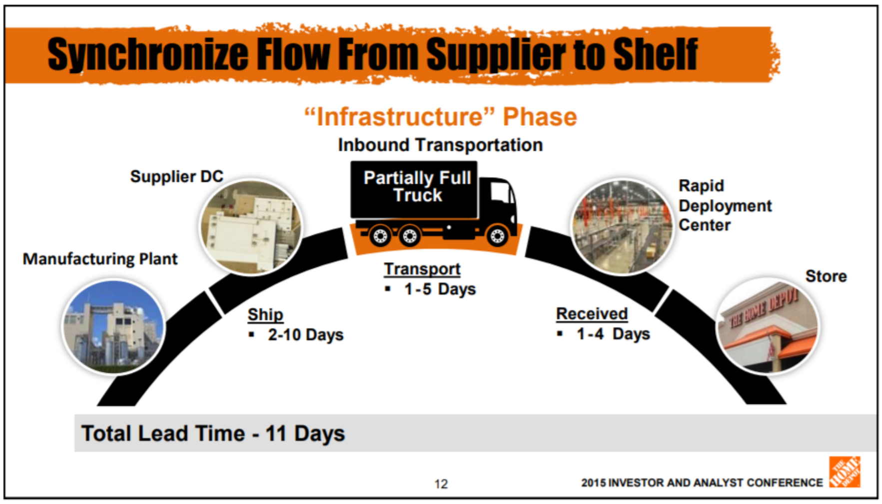
"Our technology, digital and analytics teams, who've done such amazing work in a short period of time, continue to grow, and we're using this talent and technology to understand areas where we can improve customer experience, drive operational efficiencies across all channels as well as make smarter business decisions." Michael Schneider, MD of Bunnings ANZ, 03/06/2021

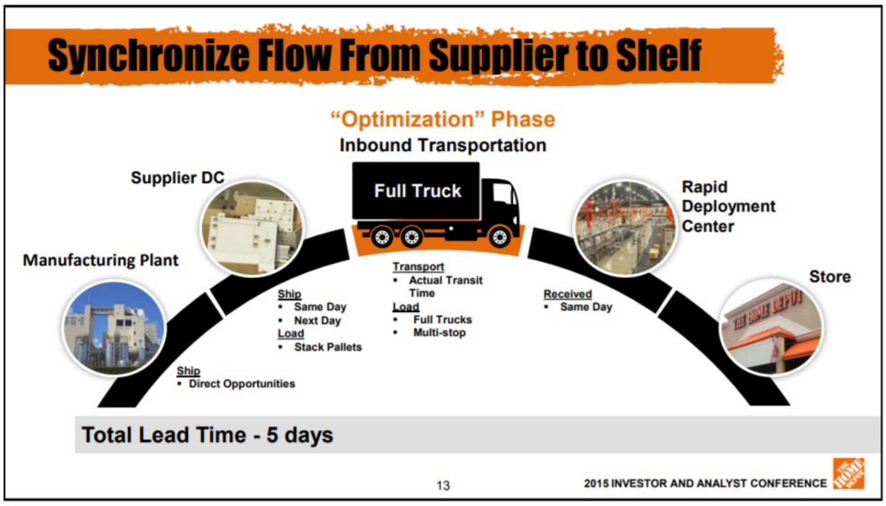
2. **Supply chain**

Whilst Bunnings has some centralised distribution centres, the overwhelming amount of goods are currently delivered direct to store from suppliers. To date this model has been fit for purpose, but as online penetration continues to steadily increase, we believe Bunnings will seek to better optimise the supply chain to better suit an omnichannel offering.

We're able to look to Bunnings' offshore hardware peers in Home Depot (US), Lowes (US) and Kingfisher (UK) for clues as to what the strategy may look like as all have undertaken supply chain investment in recent times. Historically, Home Depot had a decentralized model (like Bunnings do now) and the tasks of ordering, replenishing and managing inventory took up 60% of store labour. The company then built a replenishment system that took stock management responsibilities away from individual stores and placed them with a centralised department. It also built a series of Rapid Deployment Centres (RDCs) where suppliers shipped to, and then Home Depot were able to control the dissemination of product into the store. As the name suggests, these centres were engineered to improve the speed by which inventory moved through the supply chain. Upon arrival at an RDC, products can be cross-docked and allocated to stores based on real-time demand.







Source: The Home Depot

"The shopping experience often starts online, and we're seeing that it drives footfalls in the stores, but that approach also decreases the burden on floor space inside the stores. Instead of a huge assortment of appliances in the showroom, we can offer a much deeper selection online. Most importantly, the supply chain allows customers to transact how they want to." Scott Spata, VP of Supply Chain Direct Fulfillment, The Home Depot, 01/02/2015

The benefits from undertaking such a project could be material to Bunnings. These include lower working capital (from holding less stock and turning it faster), improved store labour productivity, more efficient use of store space (particularly the backroom) and better in-stock rates. The customer experience will also be improved though better stock availability and access to additional services such as delivery to home when purchased instore. Assessing the net financial benefit of this optimisation strategy is a more difficult exercise however, given the tendency for Bunnings to reinvest any gains back into lower prices. As a rough guide of what's possible, we note that Lowe's have guided to a 200-basis point expected improvement in operating margins by the end of their 5 year investment horizon. Consensus estimates assumes Bunnings earnings before interest and tax (EBIT) margins peak in FY21 before settling 100bps lower into perpetuity. Therefore, any benefits which Bunnings allow to drop to the bottom line could trigger long term earnings upgrades.

3. The power of compounding combined with a high return on incremental capital

As shown earlier, Bunnings RoC as a standalone measure is impressive. However, if you consider the return on *incremental* capital, then numbers become even more remarkable. Bunnings is able to grow earnings with relatively minor growth in capital due to its successful property recycling program.

Bunnings - Incremental Return

$m	2012	2020	Δ
EBITA	841	1,852	1,011
Funds Employed	2,863	2,997	134
ROFE	**29%**	**62%**	**754%**
Tang Funds Employed	2,012	2,120	108
ROTFE	**42%**	**87%**	**936%**

Source: Diogenes research

The usual comparison investors make for Bunnings is to The Home Depot as it operates in the same sector. However, that may be slightly off the mark as The Home Depot has a scale competitor (Lowe's) and it also doesn't have a store roll out program, which Bunnings has.

To highlight the potential for value creation, Costco may be a better comparison. Similar to Bunnings, Costco operates a warehouse model with a high degree of loyalty, it typically grows store space ~2.5% p.a. and reinvests scale benefits back into price. From a financial perspective, Costco also has a history of growing top line at high single digits and earnings at mid-teens, and its Return on Invested Capital is around 30%. Granted, there are also major differences. Costco's Gross Margin is much lower than Bunnings at only 13% and their EBIT tends to align to their membership fees. Regardless, from a warehouse perspective they are well ahead of the competition in a similar vein to Bunnings.

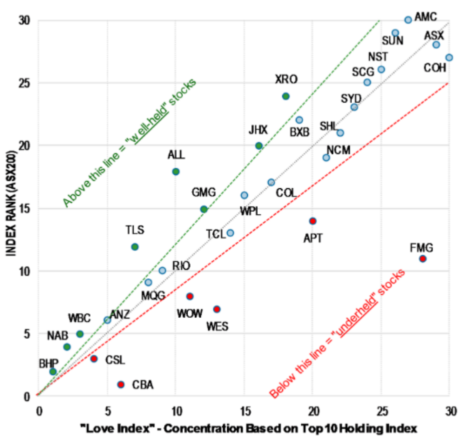
As the business continues to grow, the value is set to compound. To demonstrate the potential value creation on offer from the ability to deploy capital at high incremental returns, we can look at the performance of Costco's stock. At the start of 2015, Costco's forward PE multiple was 28x, similar to where WES trades today. Since then the stock has rerated to 34x, but the power of earnings compounding has seen the stock price more than triple.

Costco Share Price

Source: Iress

In the short term, the WES retail businesses will be well supported by heightened building activity and Australians spending more at home, increasing the propensity to invest in their house. These are dynamics we expect to persist for the foreseeable future. This is not just positive for Bunnings, but also for K-Mart and Officeworks. Furthermore, the WES balance sheet is significantly undergeared (net cash at December 2020) and therefore the board has the ability to undertake significant capital management. We believe the board is more inclined to return capital to shareholders in the short term rather than embark on large scale M&A, as they are cognizant the latter has the potential to dilute shareholder exposure to Bunnings, and could therefore drag down the trading multiple of the group. We do note WES announced a proposal to acquire Australian Pharmaceutical Industries post quarter end, but this only represents around 1% of market cap.

We also view it as a positive that WES is a consensus underweight for active managers, based upon JP Morgan analysis.



Source: JP Morgan

Anecdotally speaking, the commonly held belief among fund managers is that WES is a quality business, but the stock is too expensive (a view formally held by us as well). We see potential for investor sentiment on the stock to turn more positive over time as the Bunnings growth story plays out, which should see WES continue its long-term track record of outperformance.

Outlook

When considering this quarter's outlook, it was tempting to simply repeat what we published three months ago, although a few additional comments can be made. The enormous liquidity injected by central banks is observed to remain in place, however noise regarding tapering is increasing. The Canadian central bank for example has flagged it will need to accelerate the timeline of expected cash rate increases. Globally, investors have now brought forward their expectations of rate increases. The combination of strong economic data and fiscal stimulus has seen equity markets take the timing change in their stride thus far.

Last quarter we noted our observation of an increased appetite for M&A, and we have already seen a number of significant transactions announced. Vocus and Sydney Airport are recent examples of portfolio stocks that have been bid for, whist Telstra and the banks have been able to monetise assets at attractive multiples.

Our focus on backing effective stewards of shareholder capital has never been more important as such management teams tend to take advantage of a crisis to position the business in a stronger position than it otherwise would have been. As investment positioning shifts to a post COVID new normal environment, company strategy will be the key differentiator for performance. Much value will be created by effective management teams, whilst others will ultimately destroy value. At Greencape we expect active stock picking of names where conviction is greatest will be increasingly rewarded from here. The rising tide has lifted all boats, but only the well prepared will get to sail away.

"My message to business is very clear: employ Australians; employ the workers today that you need; be confident about your future; invest, grow, hire and innovate." Josh Frydenberg, Federal Treasurer, 16/06/2021

More information

To find out more about investing with Greencape, please contact:

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