Greencape Broadcap Fund

Quarterly report - December 2021

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	15 years % p.a.	Inception % p.a.
Fund return	3.79	17.50	17.49	12.84	13.14	9.33	10.32
Growth return	3.34	12.76	12.58	6.63	6.69	3.11	4.17
Distribution return	0.44	4.75	4.91	6.21	6.45	6.22	6.15
S&P/ASX 300 Accumulation Index	2.21	17.54	13.96	9.93	10.78	6.21	7.00
Active return^	1.58	-0.04	3.53	2.91	2.36	3.12	3.32

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'.

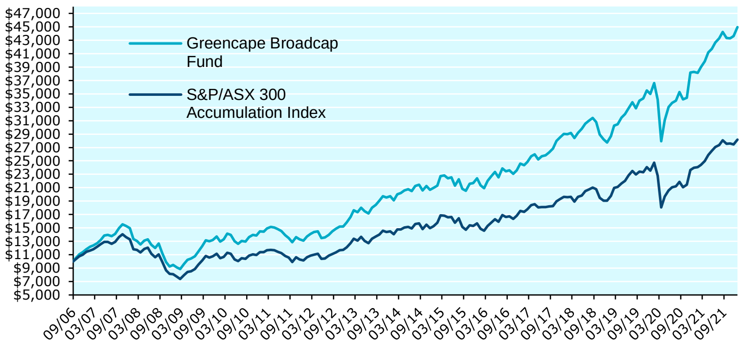
Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years

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



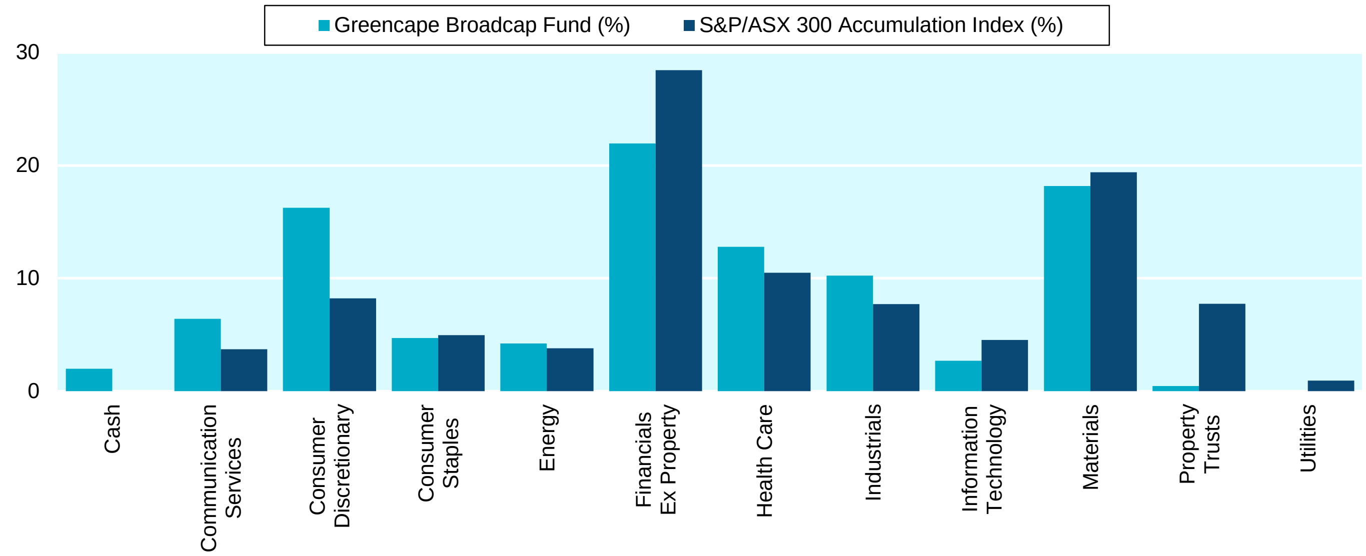
Asset allocation	Actual %	Range %
Security	98.00	85-100
Cash	2.00	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0034AU

Fees	
Entry fee	Nil
2020-2021 ICR	1.09%
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, 31 December 2021.

Sector exposure as at 31 December 2021



Data Source: Fidante Partners Limited, 31 December 2021.

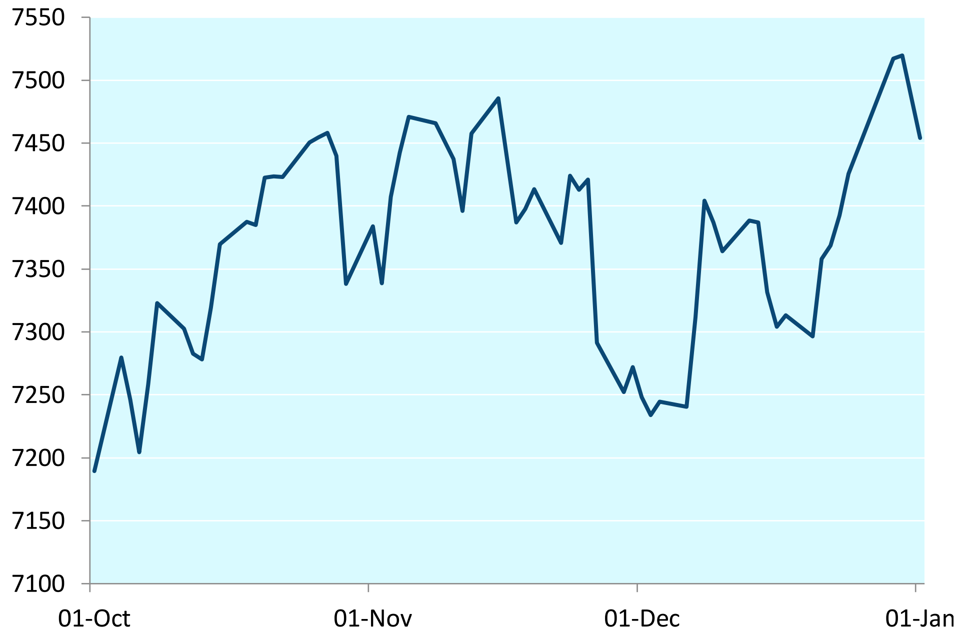
Fund performance summary

The S&P/ASX 300 Accumulation Index returned +2.21% for the quarter. The fund outperformed the market and delivered a +3.79% return over the quarter.

Market overview

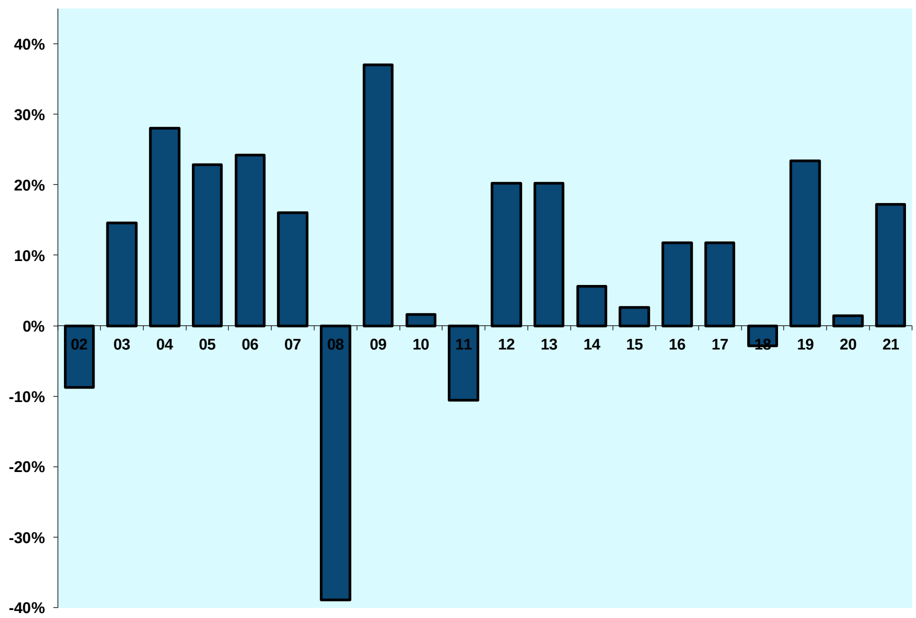
The ASX300 posted its fifth consecutive quarterly gain in a row to end the year, a feat which has not been achieved since 2006. The COVID-19 pandemic continued to throw up surprises, with a new variant becoming globally dominant in a matter of weeks. In contrast to the beginning the pandemic, central bank policy became markedly more hawkish in light of increasing evidence of persistent inflationary drivers.

S&P/ASX 300 Index



Source: IRESS

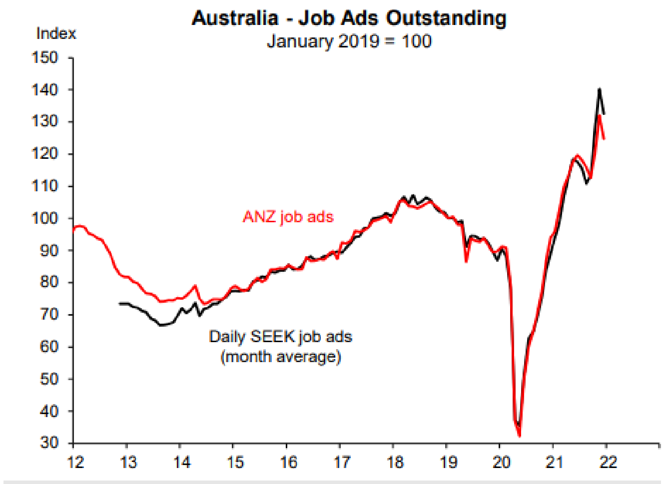
S&P/ASX 300 Accumulation Index Calendar Year Returns Since 2002



Source: IRESS

As expected, the RBA didn't move on rates in any of its three meetings during the period. In a December speech, RBA Governor Philip Lowe said the bank's central case was to not raise the cash rate in 2022. This is in stark contrast to the futures curve which implies the market is expecting there to be at least three rate rises this year. In the same speech, Governor Lowe also outlined three options for the current $4bn per week bond purchasing program; further tapering with an expectation to cease purchasing in May, taper and assess in May or cease purchases in February altogether. These options will be assessed at the RBA's first board meeting for the year in February.

Australian job ads staged a remarkable recovery at the back end of the year. The gains were broad based, with the hardest hit sector in 2020 in Hospitality and Tourism bouncing back the strongest.

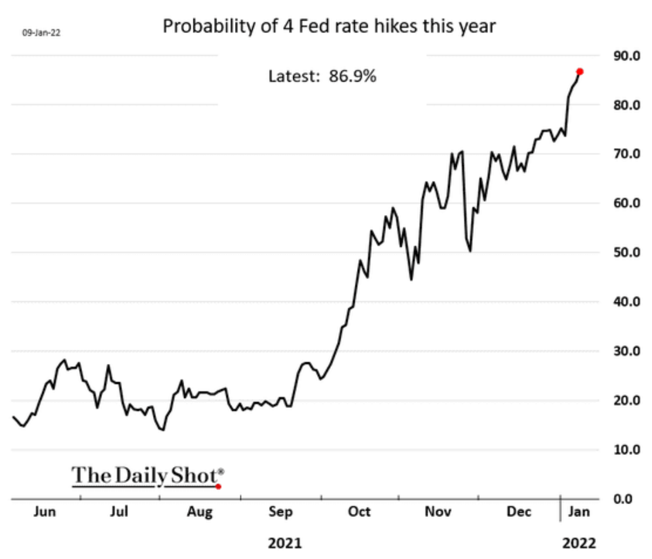


Source: Macquarie

"Spending was more resilient than we had expected, providing further evidence that households and businesses are adjusting to living with the virus." Philip Lowe, RBA Governor, 16/12/2021

In the US, the Federal Reserve (Fed) pivoted its stance at the December Federal Open Market Committee meeting to a more hawkish view. The Fed retired the word 'transitory' from communications, doubled the pace of bond purchase tapering and showed three hikes on their 2022 interest rate dot plot.

The market is now pricing in nearly 4 Fed rate hikes in 2022.



Source: The Daily Shot/Bloomberg

"Participants generally noted that, given their individual outlooks for the economy, the labor market, and inflation, it may become warranted to increase the federal funds rate sooner or at a faster pace than participants had earlier anticipated." FOMC Meeting Minutes, held 13/12/2021

Merger and acquisition (M&A) activity continued to feature strongly in Australia, as a late flurry of deals saw activity surpass already heightened 2020 levels. The largest deal came the latest, with CSL raising over $6bn in equity to fund the acquisition of Swiss listed healthcare company Vifor Pharma.

	QUARTER	YEAR
ASX300 Accumulation Index	2.2%	17.5%
Best Performing Sectors		
Materials	12.7%	14.6%
Utilities	11.4%	9.8%
Property Trusts	10.1%	27.0%
Worst Performing Sectors		
Financials Ex-REITs	-2.1%	25.5%
Information Technology	-4.6%	0.6%
Energy	-7.5%	0.8%

Source: IRESS

Surging commodity prices (particularly those in the Electric Vehicle value chain) buoyed Materials stocks during the quarter. Bond-like equities in the Property Trusts and Utilities sectors also performed strongly as the Australian 10-Year Bond Yield retreated over 40 basis points from its recent high of over 2%. Tech stocks reversed recent gains, with expected rate increases in 2022 pressuring the valuations of long duration growth companies. Energy stocks continued to whipsaw, driven by volatility in the underlying oil price which at one stage was 23% off its recent high before rallying to finish the year.

Telstra

Telstra has dealt with a number of material headwinds over recent years, from the transition to NBN broadband off its own infrastructure, heightened mobile competition (which has capped mobile pricing), to legacy and inefficient internal systems and processes.More recently, COVID-19 has significantly impacted high margin roaming revenues. Compounding these issues were complexity in the accounts, with a persistent gap between core and underlying earnings which historically made analysis difficult. Consequently, there has been some conjecture in the market as to the level of dividends the company would be able to pay out over the long term, a key value driver of the stock.

Around 18 months ago we made a number of observations which caused us to reassess the forward investment case for Telstra. In aggregate, we felt that there was a good probability that the worst was behind the company, and therefore our market milestone scores turned more positive. Over the following period as some of these headwinds reduced, we expected core and underlying earnings to converge and earnings growth to return, which would ultimately mean the dividend could find a floor. In theory, this would be well received by the market and be supportive of a higher valuation, especially in light of the increasing discussion around realising latent infrastructure value within the business.

Some of these aforementioned observations included:

- From an operational standpoint, the NBN transition was nearing its conclusion and with the bulk of customers on reseller margins, the dilution to group margins had by and large run its course. This was a material structural headwind and one that had driven earnings lower for a number of years.
- Telstra invested heavily and early in 5G whilst TPG and Vodafone were distracted with their merger, and Optus was focused on profitability under the direction of Singaporean owners. The outcome was sensible mobile pricing with industry citing the need for rational behaviour in order to earn a return on 5G investment. It also helped that COVID-19 and working from home favoured a quality network and speed, both attributes of Telstra. Encouragingly, we observed price rises across mobile plans, with the pace of average revenue per unit increases aided by the transition to a subscription based model from the prior plan based model. Mobiles could now be considered a segment that could grow and given the size of this segment, it would likely be material for the group.
- Management had undertaken an effort via the T22 plan to re-platform the business with the goal to simplify and take cost out. We've seen over the years many attempts to do this but as we approached the end of the plan, genuine momentum was achieved. There was reasonable evidence that systems were becoming more automated alongside the introduction of 5G which heralded soft switching and software defined networks. This in turn would further help reduce costs and capital expenditure driving Free Cash Flow higher, a strong signal with respect to the dividend.
- Whilst we noted good things were happening operationally, the value of Telstra's underlying infrastructure was arguably being missed by the market, especially when compared to observed transaction multiples for telecom infrastructure assets globally. Our valuation when taking this into consideration was materially higher than the current share price at the time and remains higher today. Whilst Telstra achieved a great outcome with the minority sale of its Tower's assets last year, the larger sale of InfraCo remains a key catalyst going forward. The recent purchase of Digicel by Telstra in conjunction with the Australian Government arguably helps smooth this path politically.

There is now a clearer view towards stronger earnings growth for Telstra and with the recent update to their capital management framework, some bias towards dividends rising in the future. Notwithstanding some degree of uncertainty around how long the mobile market can remain rational for and whether broadband margins can continue improving, today the company is in the best position it has been for quite some time. We expect continued operating momentum, upside to the dividend and further action on the asset base to realise latent value, which in turn should help drive the share price higher over time.

"The third pillar (of T25) is to create sustained growth in value for our shareholders. As we move forward from a period of the transition to the NBN and out from underneath that economic headwind, the significant interventions that we have made in turning around our business and taking out costs are now starting to flow through to our bottom line." Andy Penn, CEO of Telstra, 16/11/2021

Offshore Trips

The Greencape investment team were avid travelers prior to the pandemic. As the vast amount of the companies in our addressable investment universe operate globally, we find it valuable to 'kick the tyres' offshore by not only meeting with management teams who are based overseas, but also other participants in the value chain, such as suppliers, customers, competitors etc.

Throughout the past two years we frequently made the commitment that we would travel offshore as soon as the borders were open. We took that commitment seriously and in mid-December we risked spending Christmas in quarantine to travel to the US.

Merely travelling interstate in Australia at the moment comes with a degree of difficulty and unsurprisingly international travel proved to be another level of complexity. The key requirements to enter the US are being vaccinated, a negative PCR test within 24 hours of departure, an attestation form (confirming fulfilment of the aforementioned requirements) and a contact tracing form. Importantly, the PCR test could not be obtained from a government site – hence why the first question when you get a local PCR test is "are you going overseas?".

We obtained our test from the dedicated international travel testing site within the airport terminal, which for $80 promised a result within 90 minutes (it came within 30). It's worth noting the documents were verified only at the check-in desk by airline staff and not at the destination.

Those requirements were relatively easy to fulfil compared to the key re-entry requirement for Australia, which is a negative PCR test within 72 hours of departure. We scheduled our test before we departed to the US, which was a process in itself given we had to set up a virtual US phone number to book an appointment. For the princely sum of USD$150 you are able to receive your results within an hour. Unfortunately, we received a call on the morning of the test informing us the clinic had "run out" of PCR tests and that we had been booked in for a test at another clinic 25 minutes away. Thankfully we were able to get a Lyft (Ubers are not great in LA) to the alternative clinic and get tested. Whilst we have been tested many times in Australia, the suspense of waiting is amplified when you are returning home, as a positive result means we would have spent the next ten days (including Christmas) in a US hotel room. Thankfully the test was negative, and we were able to board the plane back to Melbourne two days later.

Trip Observations

- To state the obvious, international travel is difficult at the moment. Not only are there added requirements when exiting Australia, but there is now the clear risk you will not be allowed back home if you contract COVID whilst abroad. The anxiety of waiting on that test result is hard to model in a spreadsheet. There are also additional explicit costs. We took the cautious approach and purchased extra travel insurance which covered us in the event we contracted COVID overseas. Along with the additional PCR tests, the extra costs summed to over $500 for a 6-day trip per person. If you extrapolate this over a family, it's conceivable to imagine the additional costs running into the multiple of thousands. You are also required to wear a mask for the whole flight (aside from when eating and drinking) which for a long-haul trip can be quite uncomfortable. These added points of friction we observed firsthand have made us more cautious on the trajectory of international passenger recovery.
- Whilst the 'transitory' inflation rhetoric has now largely dissipated due to the increasing realisation in the market that current inflation dynamics are more persistent, anecdotal evidence from our meetings suggests the risk remains to the upside. A number of the packaging companies we spoke to were seeing over 20% price rises on their products as a basket. Durable goods retailers and manufacturers were also expecting to increase price early in the new year after having already taken price rises multiple times in 2021.
- Although we are still in the midst of a pandemic, activity levels felt buoyant in the US. Consumer balance sheets are in good shape and it seemed people were using the holiday season as an opportunity to spend.
- We toured the Port of LA with management to get a better handle on the issues. There is a confluence of factors still impacting velocity ranging from issues at the ports of origin to staffing at destination warehouses. The situation has incrementally improved over the past two months, however it is not expected to fully alleviate in the near term.

"You see, you know how to *take* the reservation, you just don't know how to *hold* the reservation. And that's really the most important part of the reservation: the holding. Anybody can just take them." Jerry Seinfeld, Comedian, 1991

"Even though you have a good filtration system (on planes), I still believe that masks are a prudent thing to do." Anthony Fauci, Chief Medical Advisor to the President of the United States, 19/12/2021

"I think the case is very strong that masks don't add much, if anything, in the air cabin environment. It is very safe and very high quality… An aircraft is the safest place you can be." Gary Kelly, CEO of Southwest Airlines, 17/12/2021

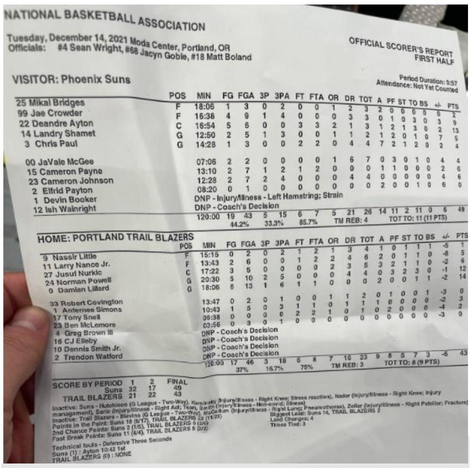
The trip in pictures

The international terminal in Melbourne remains eerily quiet. There were definitely no Love Actually moments of reconciliation to be seen in the arrival hall.

We were UMG's first physical one on one meeting since they demerged from GNC in March 2020. We visited their global headquarters in Vancouver, Washington as well as touring Processing and Distribution sites.

They are serious about mask protocol in Portland.

This ad for bus drivers was one of many examples we saw of companies needing to offer generous incentives to attract staff.



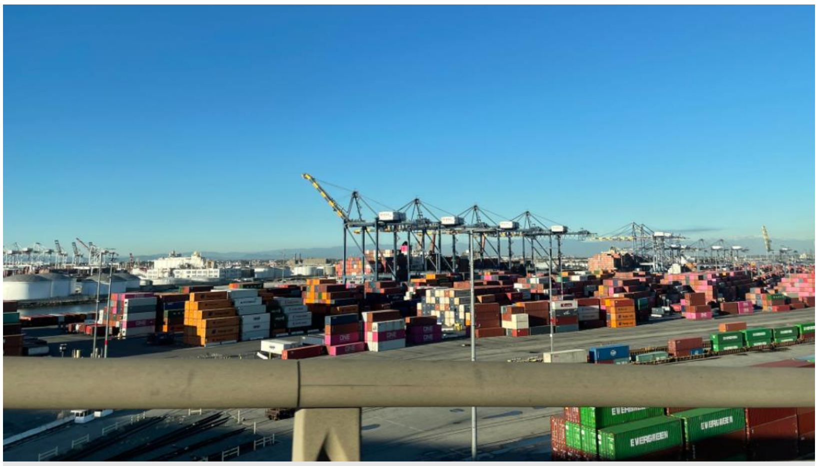
The official stats are handed out to the crowd at half time at Portland Trail Blazers game in the NBA – a much appreciated gesture!

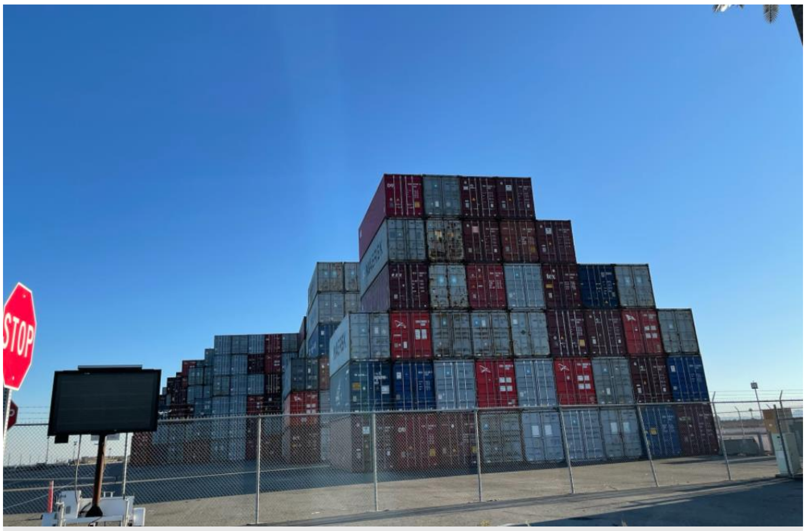
We toured a Home Depot and Lowe's. Traffic was strong in both stores.

We met with Breville at their offices in LA.

The Breville espresso machine line up at Williams Sonoma.

The Barista Pro has been popular at Best Buy.





There were empty containers scattered all over the Port of LA.

The Grove mall in LA was extremely busy on the last weekend before Christmas.

Outlook

COVID-19 remains the topic du jour with the Omicron variant having emerged aggressively throughout the quarter. With cases spiking globally (except in China at this stage), many economies have behaved in a lockdown like way - either forced or voluntary. Consumer confidence has faltered as people alter their behaviour to avoid crowds and spend more time outdoors. This is acting to stall the recovery. In this environment, premiums should be ascribed to more capable management teams who should be better able to execute on any strategic pivots they may need to embark upon. Conversely, less capable management teams or inherently lower quality companies may struggle during this renewed bout of volatility.

We expect some cautious commentary at the coming results season in February. We observe inflation remains heightened, and companies are telling us they expect inflation to remain elevated for some time. We note the Fed finally adopted a more hawkish tone in its latest minutes, with the market reaction beginning to reflect lofty valuations, recent strong returns and prevailing bullish sentiment.

Greencape expects the market will increasingly focus on the reduction of liquidity, cost inflation (and related impacts to earnings) and the ability for companies to execute on an M&A pipeline over the coming year. Management skill and shareholder stewardship is the key factor driving our stock selection, with amplified value creation and destruction to be expected as the market transitions from the strong bull market.

"Today's economic and market dynamics look similar to the late 60s. Then, like today, economic growth was strong, inflation was rising and fiscal spending programs were large. That period also featured market volatility and rising rates. If the 10-year yield follows the pattern of the late 60s, it would rise by about 1.7%." Joe Zidle, Chief Investment Strategist at Blackstone, 21/12/2021

More information

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

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