Greencape Broadcap Fund

Quarterly report - December 2022

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	7.06	-8.12	5.72	7.34	10.10	7.01	9.10
Growth return	6.99	-17.50	-0.71	0.64	3.03	0.80	2.69
Distribution return	0.08	9.38	6.43	6.70	7.07	6.20	6.40
S&P/ASX 300 Accumulation Index	9.13	-1.77	5.52	7.10	8.62	5.02	6.44
Active return^	-2.06	-6.35	0.20	0.24	1.48	1.98	2.65

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'.

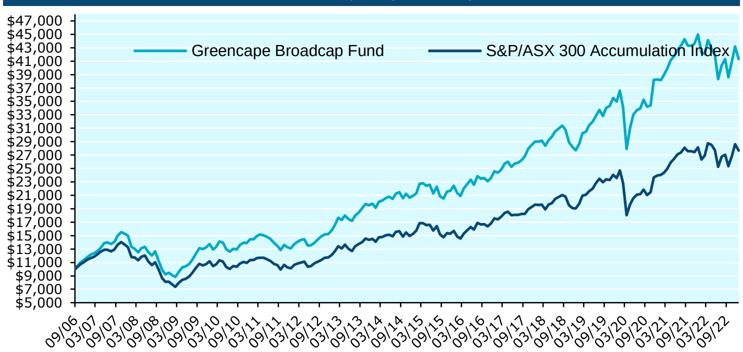
Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years

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



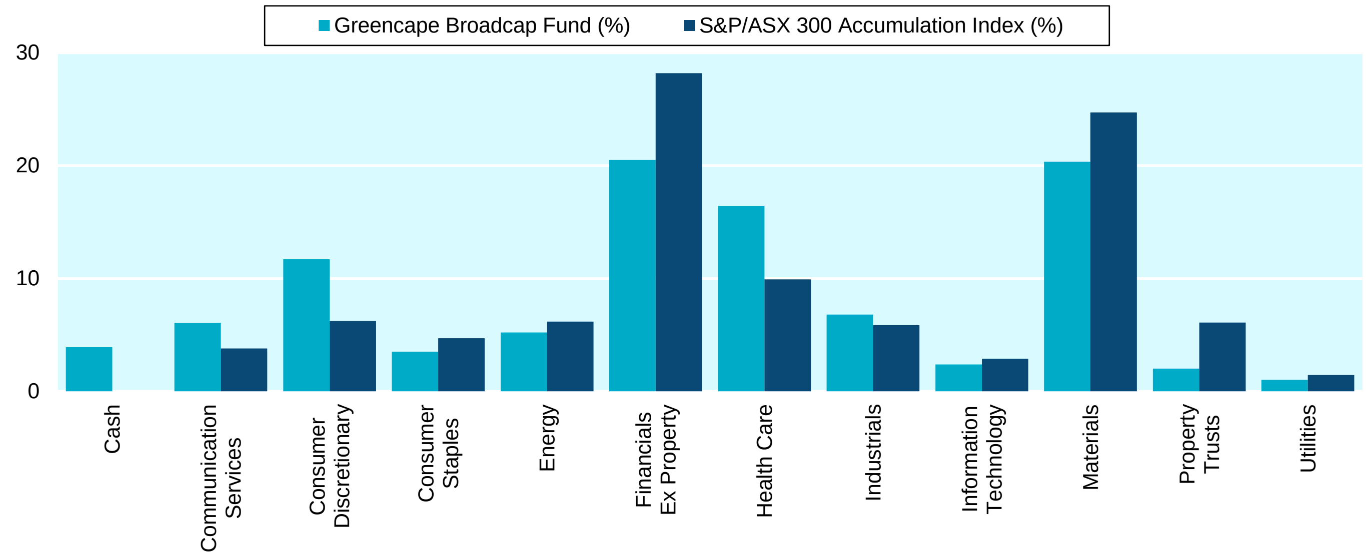
Asset allocation	Actual %	Range %
Security	96.08	85-100
Cash	3.92	0-15

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 2022.

Sector exposure as at 31 December 2022



Data Source: Fidante Partners Limited, 31 December 2022.

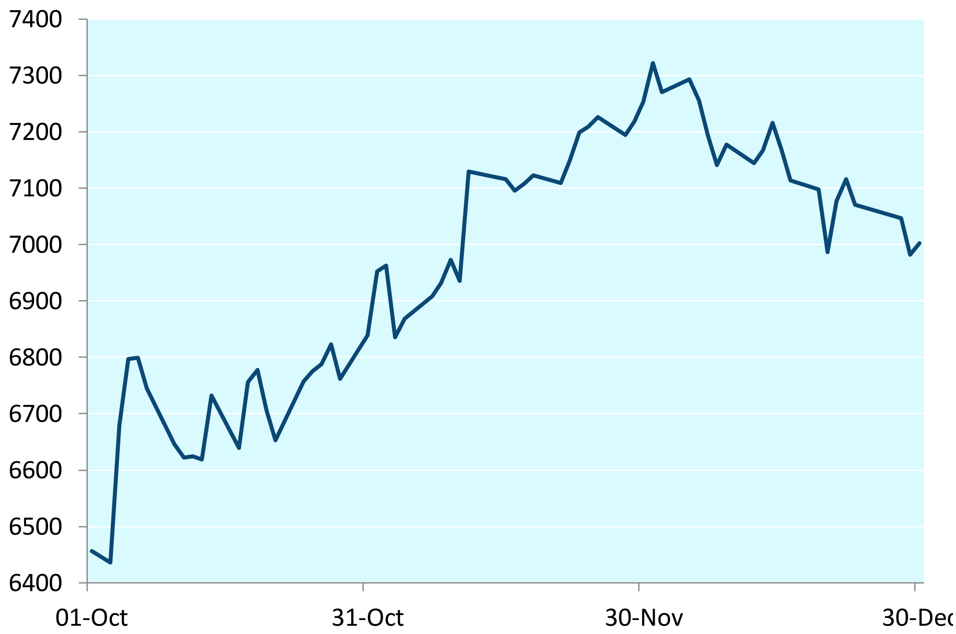
Fund performance summary

The S&P/ASX 300 Accumulation Index returned +9.13% for the quarter. The fund underperformed the market and delivered a +7.06% return over the quarter.

Market overview

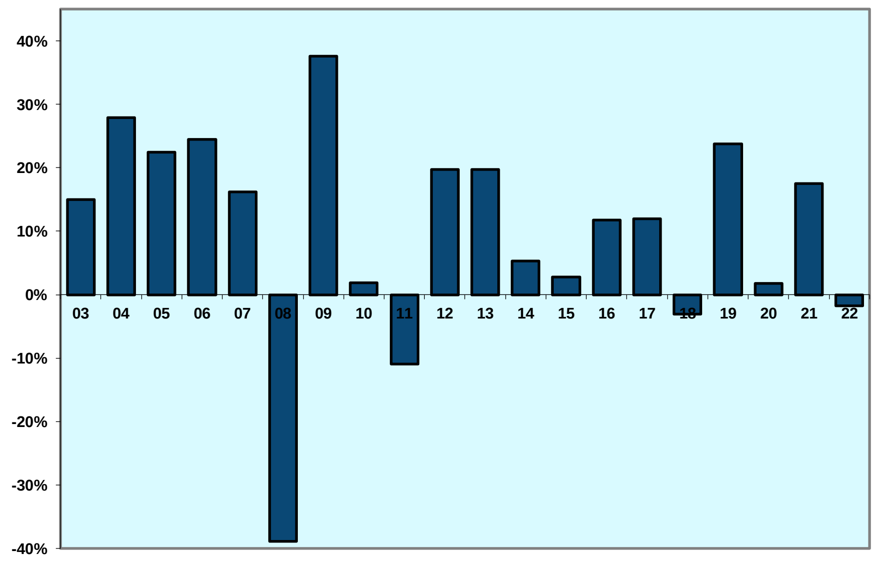
The market ended the calendar year on a high note, recording the strongest quarterly gain in 2 years. Investors remained alert to any change in language from central bank commentary, with any sign of a 'pivot' (however subtle) seeing markets trade higher. Bonds were also volatile during the period, with the Australian 10-Year Government Bond Yield trading range nearing 90 basis points for the quarter.

S&P/ASX 300 Index



Source: IRESS

S&P/ASX 300 Accumulation Index Calendar Year Returns Since 2003



Source: IRESS

The RBA raised rates by 25 basis points in all 3 meetings held during the quarter with the rate settling at 3.1% to end the year. The October decision was interpreted as a dovish pivot by the market, as the median forecast for the meeting was for a 50-point raise. The ASX rallied strongly in the wake of the decision whilst bond yields and the AUD retreated. The futures market currently implies the RBA rate will peak at 3.9% in late 2023.

One of the many considerations for the RBA is the looming reset of the large volume of fixed rate mortgages which were taken out over the last two years. An estimated $700bn of these loans are due to reset 200-300 basis points higher, with over half expected to reset by the end of the September quarter.

Fig 1 While ~35% of *outstanding* mortgages are still on fixed rates, most *new* mortgages are now at variable rates

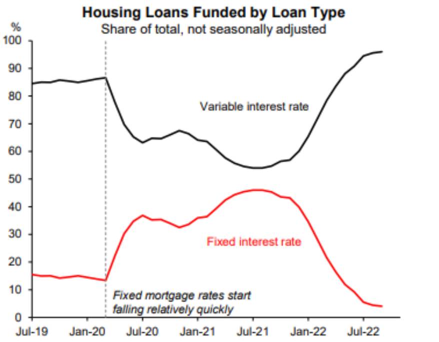
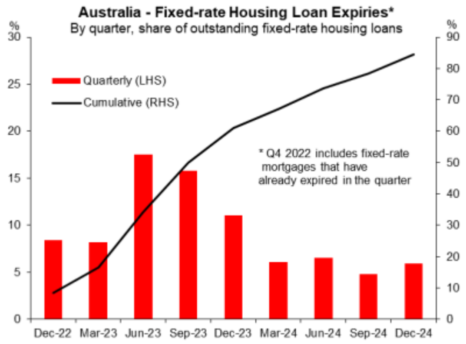


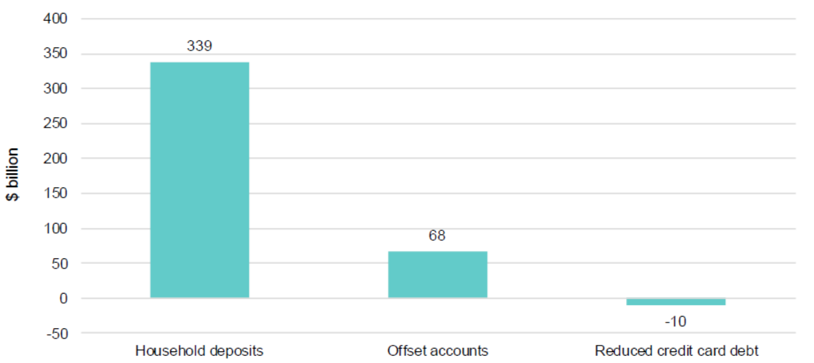
Fig 2 Fixed-rate mortgage resets will step up materially in Q2 and Q3 2023



Source: Macquarie, APRA

The growth in household deposits could provide some cushion however, with aggregate household savings up $339bn (or $16,000 per household) since the start of the pandemic.

Figure 10: APRA data on change in monthly household deposits



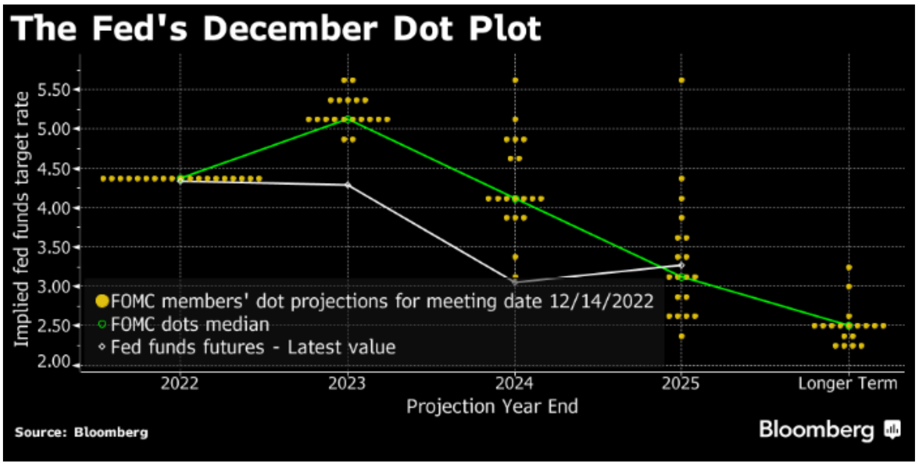
Source: MST Marquee, APRA

In the US, two consecutive lower than expected CPI prints for October and November saw markets rally, with the expectation that the Federal Reserve would soon start to moderate the hawkishness of its monetary policy stance. However as has seemingly become routine over 2022, the market was again left disappointed, with the Fed's expected trajectory of interest rates actually *steepening* in the December meeting.

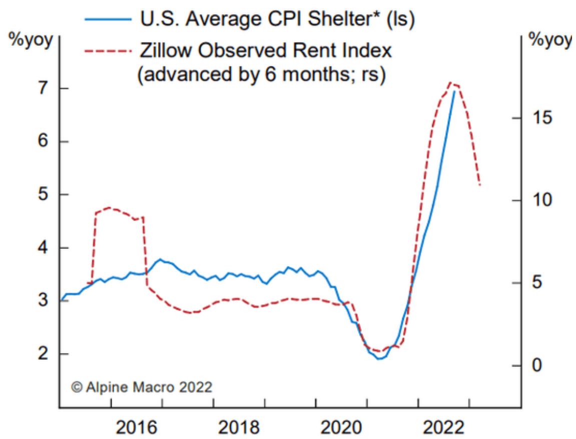
"People broadly are pretty pessimistic about the global economy. I'm optimistic about our economy, but we've got to get through some pretty choppy waters." Jim Chalmers, Treasurer of Australia, 06/01/2023

"Looking back, we would have chosen different language. People did not hear the caveats. I thought it was clear … but the community didn't think it was clear. Well, they thought it was clear we weren't raising rates until 2024. That's a failure on our part." Philip Lowe, RBA Governor, 28/11/2022

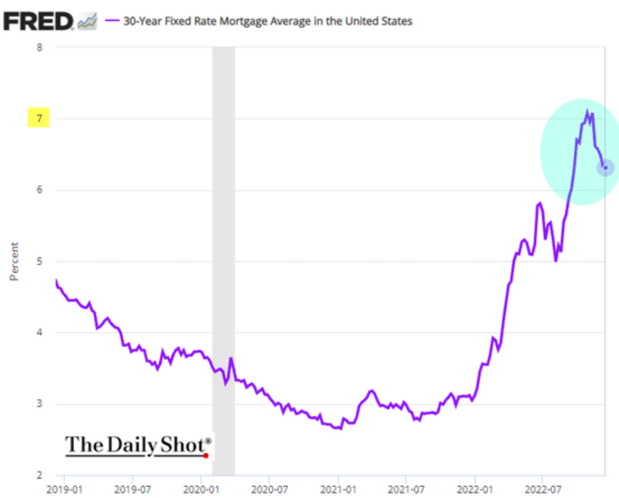
Despite the Fed signaling an interest rate path which is higher for longer, the market continues to expect rate cuts in the second half of 2023.



A key swing factor for US CPI is services inflation, in particular housing. There are now a number of data points which suggest housing inflation has peaked.



Source: Alpine Macro



Source: The Daily Shot, The Federal Reserve Bank of St. Louis

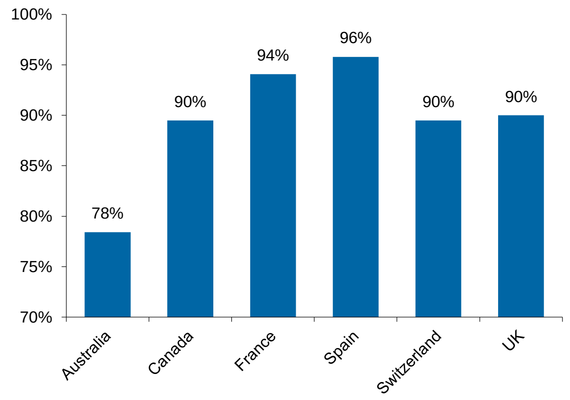
"In my view ... it will be appropriate to continue to raise rates at least at the next few meetings until we are confident inflation has peaked… To be clear, in this phase any sign of slow progress that keeps inflation elevated for longer will warrant, in my view, taking the policy rate potentially much higher." Neel Kashkari, President of the Minneapolis Fed, 04/01/2023

"No participants anticipated that it would be appropriate to begin reducing the federal funds rate target in 2023." Minutes of the Federal Open Market Committee, December 13-14, 2022

In Australia, October saw the beginning of the annual AGM season. The voting outcome data suggests shareholders were slightly more agreeable in 2022, with 7% of companies receiving a strike on their remuneration report compared to a historical high of 9% in 2021.

Whilst gathering momentum, Australia lags other developed market for support for the 'Say on Climate', an initiative which calls for an annual disclosure and strategy to reduce emissions, along with an annual vote on the plan at company AGM's.

Fig 9 Avg support for Say on Climate by Country



Source: Macquarie

Utilities was the standout sector in the period, largely driven by takeover offer for Origin Energy in November at $9 a share from a Brookfield-led consortium. The certainty of the deal was called into question in mid-December however, with the Federal Government announcing it would intervene in the energy market by implementing a temporary price cap on gas for 12 months, as well as introducing a mandatory code of conduct which will in effect act to regulate returns on domestic gas projects. Despite the intervention, the Consortium announced it had not identified any material adverse matters in an announcement later in the month.

Materials stocks were also strong in the period, driven by optimism in the recovery of Chinese demand as the country progressively winds back its zero COVID policy. Within the sector, Lithium stocks underperformed with spot pricing indicating that prices have peaked, at least in the short term.

	QUARTER	YEAR
ASX300 Accumulation Index	9.1%	-1.8%
Best Performing Sectors		
Utilities	28.0%	30.0%
Materials	14.7%	11.7%
Property Trusts	11.6%	-20.1%
Worst Performing Sectors		
Consumer Staples	1.7%	-5.1%
Info tech	1.9%	-33.4%
Healthcare	2.1%	-7.4%

Source: IRESS

Both Healthcare and Consumer Staples sectors underperformed during the period, as the low beta profile of the underlying stocks saw them lag a strongly rising market. Technology stocks (despite having a higher than market beta) also underperformed, partly driven by a weaker than expected half year result from cloud-based accounting software provider Xero. Whilst revenue was in line with market expectations, the mix of subscriber growth was seen as sub-optimal, with ANZ continuing to exhibit strong growth whilst UK subscriber numbers were below consensus forecasts.

Offshore Trips

We travelled to the UK in November.

- The sentiment was more positive than we anticipated. Whilst electricity prices were an issue, the weather was unseasonably warm for that time of year and the consensus was that a combination of high gas inventories and a mild winter would see the region avert a complete energy crisis.
- Although cost of living pressures were only anticipated to become more extreme in 2023, it was expected to be a 'YOLO Christmas' where consumers would suspend disbelief and open their wallets to treat themselves given the difficulties they've had to endure. It's expected that a slowdown will begin in earnest in the new year when energy bills step up again and consumers properly evaluate household budgets.
- There was a clear theme of a bifurcation in consumer behaviour based on demographics. The premium end of the market was still holding up well given cost of living inflation has had a smaller impact to their discretionary spend relative to the rest of the market. One example of this dynamic was a large multinational liquor company noting that their premium spirits business continues to trade well, with Tequila sales particularly strong (up 44%). Spirits and cocktails are expected to continue taking 'share of throat' from beer and wine.
- Whilst inflation to date has predominantly been driven by Cost of Goods Sold (i.e. raw materials), the next wave of inflation will be driven by operating expenses, namely utilities as hedges roll off, and labour costs as new contracts are negotiated. Inflation is therefore expected to remain elevated for at least another 12 months.
- There does not appear to be any silver bullet to help generate margins in online grocery which are analogous with those achieved from the physical store. Whilst automation helps in theory, there appears to be an issue in reaching sufficient utilisation in Fulfilment Centres, with online penetration now well down on COVID peaks. One major grocery chain we spoke to noted they are now undertaking a program where they will look to raise online pricing to help improve the economics of the channel. This could be done with 'store only' promotions, which in effect generates the same outcome.
- There were a large number of retail vacancies in high profile locations. For example, the iconic location on Oxford St which formerly housed Topshop remains empty.

"When you look at the fundamentals on employment, savings and bad debt rates they all look OK. A lot of the worry is about what will happen, rather than what is happening." Lord Simon Wolfson, CEO of Next (UK), 05/01/2023

We also took the chance to visit the flagship John Lewis department store in High Wycombe, about an hour's drive from the centre of London.

At 10am on a Saturday six weeks out from Christmas, the carpark was completely full.

Traffic levels inside the store were strong.

Sage (Breville's brand in the UK and Europe) had their products on showcase in a high traffic area next to the entrance.

Given it was a busy day in a flagship store, there was a Sage team member to help demonstrate the products. The newest Espresso machine the Barista Express Impress (pictured) had been selling well in the lead up to Christmas.

In the event there is not a demonstrator in attendance, there is an interactive display to help assist customers in familiarising themselves with the products.

Goodman Group

Goodman Group (GMG) is a specialist, integrated property group. They focus on owning, developing and managing industrial property in key, high demand locations globally. Being founder led by Greg Goodman, and with key executives owning significant shares in the business, we believe the management team and shareholders are in strong alignment.

There is little doubt that GMG (along with many other real asset owners) benefited from the low interest rate environment prior to the Fed raising rates in early 2022. Whilst this low rate environment was a significant tailwind and one which contributed to GMG's earning multiple significant rerating to over 30x, there were also a number of other fundamental factors which meant that the core business continued to generate strong growth and returns. Since the start of the interest rate rightening cycle, the GMG earnings multiple has derated the point where today it trades under 20x. The previously elevated multiple has seen us watch the company from the sidelines in the past, but our view today is that the GMG share price more than adequately reflects the risk of higher rates longer term, and we have thus recently added the name into the portfolio.

"Buildings in good locations with good cash flow are in the main showing improving valuations." Greg Goodman, CEO of Goodman Group, 02/11/2022

Due to the quality and location of its product, its position in the various industrial markets, and the underlying demand for its product in those specific locations, we believe GMG is in a strong position to continue to deliver solid earnings growth over the medium to long term. Our investment is premised on the following operational aspects:

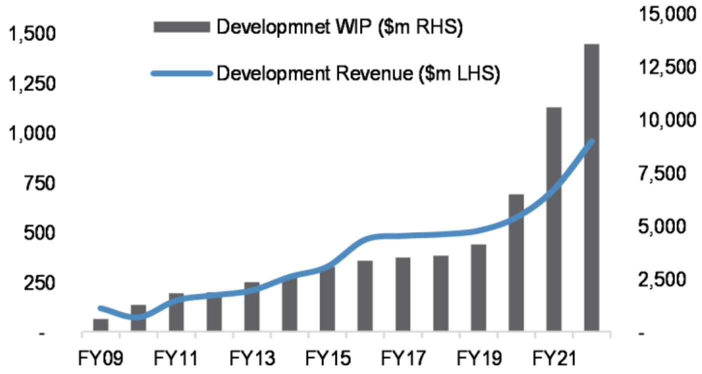
1. Growth in Assets Under Management (AUM) is likely to continue. AUM increased by just under $5bn (or around 7%) in the last 3 months despite concerns of a market wide slowdown. Whilst a FX was a tailwind, the majority of the growth was driven by portfolio acquisitions, developments and continued revaluation gains. The latter occurring despite rising cap rates globally.
2. GMG's assets currently earn below market rents given the rising demand for their specific sites. Low vacancy is driving this growth in market rents and our expectation is for this to continue as the global theme around 'on-shoring', being closer to customers, the need for faster logistics, and the demand for more specialised, technology focused sites as the world continues to shift towards online fulfilment and distribution. GMG anticipates upward rental revisions of 20%-60% upon lease expiry. This should help cash flow growth over time as well as underpinning asset values for their portfolio. This can already be seen in like-for-like net operating income growth improving in 1Q23 to 4.0% from 3.9% in FY22, and occupancy rates rising from 98.7% to 99% over the same period.
3. GMG's assets are currently earn below market rents given the rising demand for their specific sites. Low vacancy is driving this growth in market rents and our expectation is for this to continue as the global theme around 'on-shoring', being closer to the customers, the need for faster logistics, and the demand for more specialised, technology focused sites as the world continues to shift towards online fulfilment and distribution. GMG anticipates upward rental revisions of 20%-60% upon lease expiry. This should help cash flow growth over time as well as underpin asset values for their portfolio. This can already be seen in like-for-like net operating income growth improving in 1Q23 to 4.0% from 3.9% in FY22, and occupancy rates rising from 98.7% to 99% over the same period.

Our view is that FY23 guidance of 11% EPS growth has upside and whilst consensus sits at around 15% (dropping to ~8% thereafter from FY24), GMG are normally conservative and upgrade as the year progresses. We expect this trend to continue for this year and next.

GMG also holds what we believe as a good amount of flexibility that can either augment or support its earnings growth as and when required.

1. Our understanding is that there's c$1.2bn in performance fees that are yet to be booked. Some of these fees are dependent upon interest rates, however others are more absolute or relative to index in nature. A reasonable proportion of these embedded performance fees have the potential to be released over time.
2. We believe that GMG has held back over $600m in development revenues which can be booked in future periods. GMG has tripled its development workbook over the last 3 years' however the corresponding uplift in development revenue has lagged, implying GMG has been under-earning based on its activity levels.

3. Given its relatively low gearing, the company has the ability at the right point in the cycle to develop more on-balance sheet. This change in mix will likely help margins should it wish to do so.



Source: JP Morgan

Overall, we view GMG to be a high quality business that is now trading at a more attractive valuation. It's well positioned within the sector given the underlying demand for its product supports continued rental growth and asset values. Given the conservative balance sheet combined with embedded performance fees and development revenues, we believe management has flexibility to upgrade earnings over time and continue to deliver a better than expected growth profile over the medium term.

Outlook

Despite the abundance of bearish top down and bottom up indicators, the market has generally remained resilient. As we see it, either the market has got ahead of itself, or the bearish indicators turn less bearish, and a recovery pathway becomes more obvious.

Greencape remains focussed on bottom up observations. We maintain a portfolio with a defensive bias towards recession proof earnings and cash flows. Healthcare names feature heavily in the portfolio, as the combination of longer duration growth characteristics and solid earnings outlook is considered particularly attractive in the current environment. Amongst more cyclical growth names, we have been buying dips as valuations have become more attractive. Funding sources for buying have been banks and lower growth defensives, and consequently our active share has increased.

Whilst earnings expectations across the market are now starting to better reflect the cyclical downturn, we see the prospect for further negative earnings revisions. We once again look forward to reporting season which we expect to heavily feature cautious outlook commentary, and we are positioned accordingly.

"I can't over emphasise the impact that cost-of-living pressures are having in the community." Shayne Elliot, CEO of ANZ, 15/12/2022

"With interest rates higher than many people have experienced in their working lives, economic growth weakening, increased volatility in markets, some worrying signs of market illiquidity, heightened geopolitical risk around the world and the ongoing and increasing effects of climate change – the risk of something 'breaking' is high." Stephen Halmarick, Chief Economist at CBA, 04/01/2022

More information

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

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MONEY MANAGEMENT
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AUSTRALIA'S FIRST INDEPENDENT AND WHOLE OF MARKET AWARDS
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Australian Large Cap Equities

ZENITH FUND AWARDS
2020 WINNER

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