Greencape Broadcap Fund

Quarterly report - September 2023

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	-2.06	13.16	8.52	7.25	8.64	9.49	9.03
Growth return	-2.29	7.20	0.20	1.06	1.50	3.01	2.58
Distribution return	0.23	5.95	8.32	6.18	7.15	6.48	6.45
S&P/ASX 300 Accumulation Index	-0.84	12.92	10.80	6.62	7.40	7.31	6.37
Active return^	-1.21	0.24	-2.28	0.63	1.24	2.18	2.67

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'.

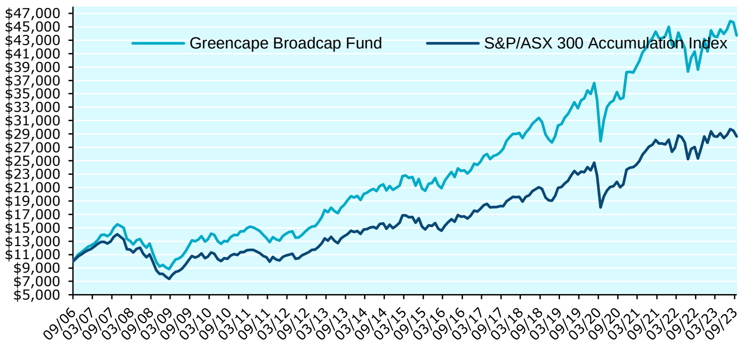
Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years

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



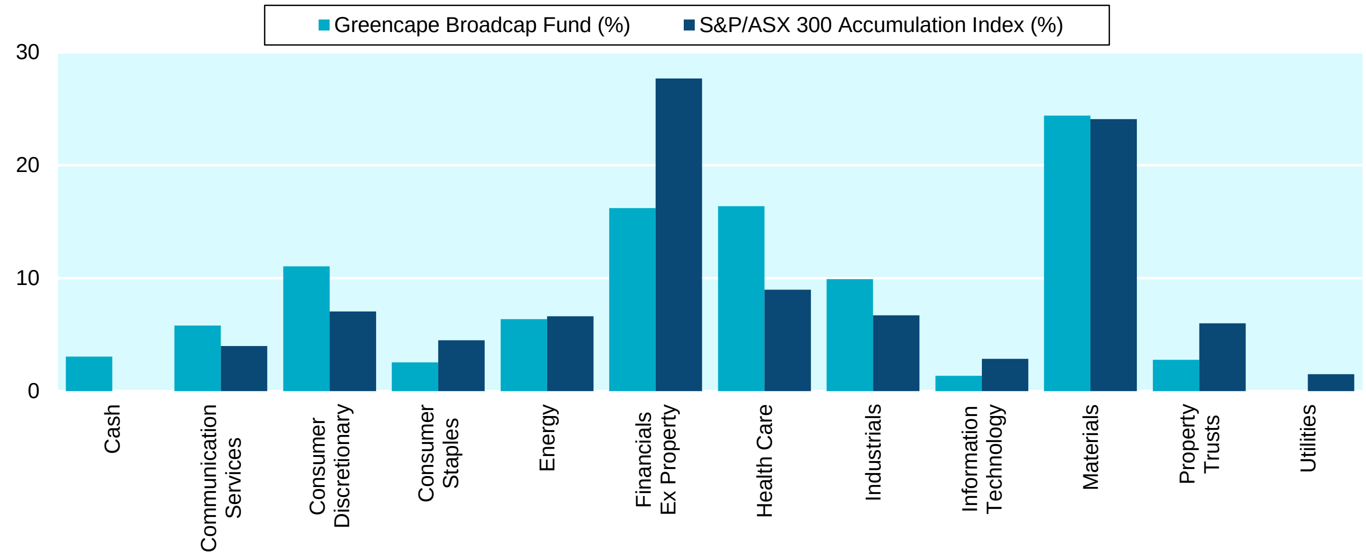
Asset allocation	Actual %	Range %
Security	96.94	85-100
Cash	3.06	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0034AU

Fees	
Entry fee	Nil
2022-2023 ICR	0.95%
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 September 2023.

Sector exposure as at 30 September 2023



Data Source: Fidante Partners Limited, 30 September 2023.

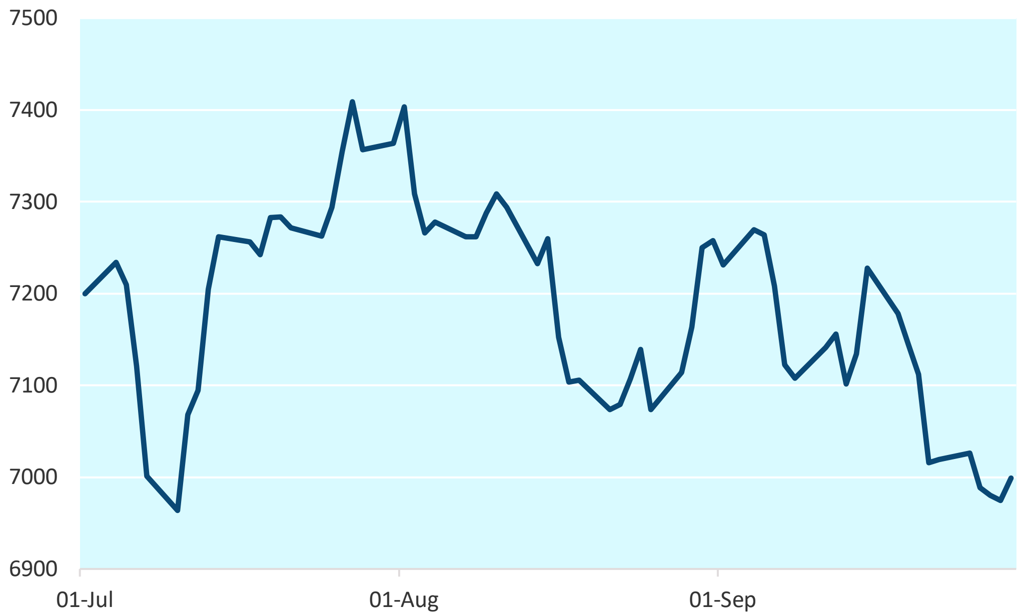
Fund performance summary

The S&P/ASX 300 Accumulation Index returned -0.84% for the quarter. The fund underperformed the market and delivered a -2.06% return over the quarter.

Market overview

The market recorded its first negative quarter for a year, as optimism around hopes for a soft (or no) landing gave way to concerns around a higher for longer inflation and interest rate environment. Meanwhile, investors (and bankers) kept a watchful eye on global Equity Capital Markets activity in the hope of seeing a reopening of the IPO window, which has been shut for the best part of 2 years.

S&P/ASX 300 Index

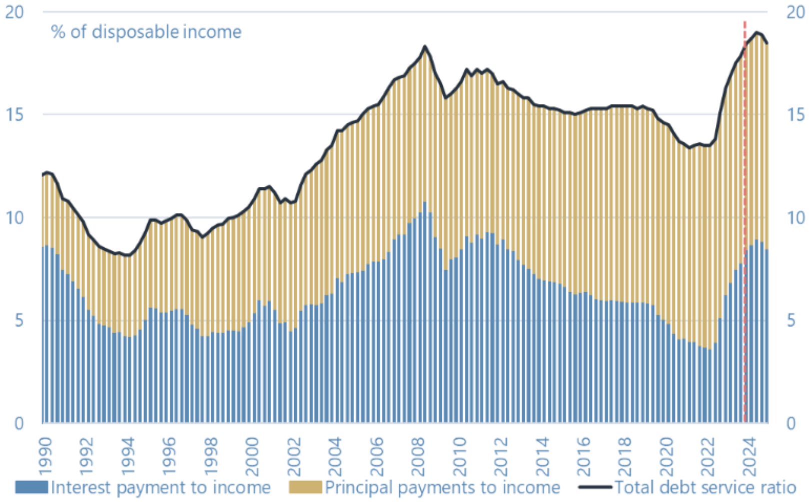


Source: IRESS

After raising rates in 12 of the 13 meetings prior to the September quarter, the RBA kept rates on hold for all 3 meetings during the period. In the Minutes following the September decision, the bank reiterated that 'some' tightening may still be required, although it will be dependent on the data. The August CPI data released in late September was in line with market expectations, despite some market commentators concerned the reading would come in higher given persistent services inflation. Interest rate futures imply the market currently expects an 80% chance of one more rate hikes in the next 12 months, after which time the cutting cycle is expected to begin.

"The case to raise the cash rate further was based on the expectation that inflation will remain above the Bank's target for a prolonged period and the risk that this period might be extended. This could occur if productivity growth does not pick up as anticipated or if high services price inflation is more persistent than expected. Members observed that, were inflation to remain above target for an even longer period, this could cause inflation expectations to move higher, which would be likely to require an even larger increase in interest rates in the future." RBA Minutes, September 2023

Higher interest rates in conjunction with the roll of fixed rate loans is due to see the Debt Service Ratio (first chart) reach record levels in 2024, albeit this won't be felt evenly across consumer cohorts with those aged 65 and above actually benefiting from higher rates (second table).



Forecasts assume principal repayments as a share of income remin unchanged, data prior to 1999 is estimated

% of Gross Disposable Income							
			Jun-22			Dec-23e	
Age group	Deposits	Loans	Interest income	Interest expense	Net interest income	Net interest income	Change (%pts)
15-24	49%	84%	0.9%	-1.9%	-0.9%	-1.3%	-0.4%
25-34	53%	223%	1.1%	-4.6%	-3.6%	-7.8%	-4.2%
35-44	48%	282%	1.1%	-5.8%	-4.8%	-10.8%	-6.1%
45-54	82%	221%	1.7%	-4.6%	-2.9%	-6.4%	-3.5%
55-64	120%	149%	2.3%	-3.2%	-0.9%	-1.7%	-0.7%
65+	236%	53%	4.6%	-1.2%	3.4%	8.1%	4.8%
Total	**100%**	**184%**	**2.2%**	**-4.1%**	**-1.9%**	**-4.3%**	**-2.4%**

Source: Jarden

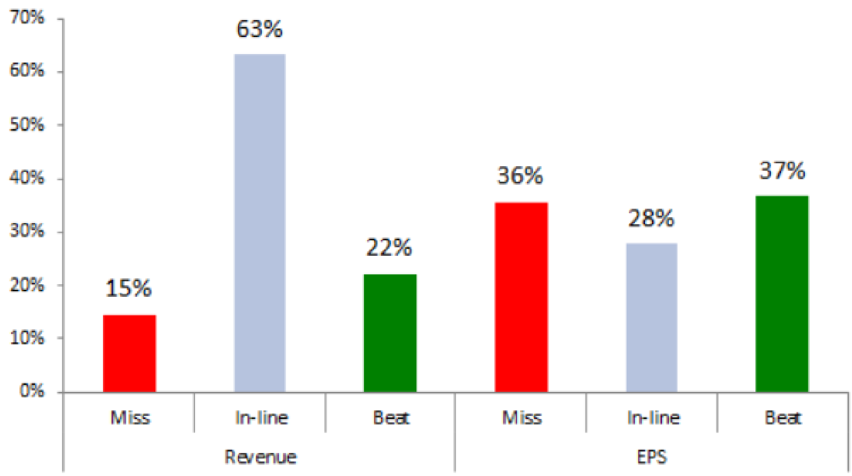
Adding to the household budget squeeze is inflation, where expectations are becoming more entrenched. If this situation persists, the RBA could have a lot more work to do get inflation back to its stated 2-3% target range.

"It may, of course, be that the neutral rate has risen. You don't see the median moving, but you do see people raising their estimates of the neutral rate. And it's certainly plausible that the neutral rate is higher than the longer run rate. Remember, what we write down in the SEP (Summary of Economic Predictions) is the longer run rate. It is certainly possible that the neutral rate at this moment is higher than that. And that's part of the explanation for why the economy has been more resilient than expected." Jerome Powell, Chairman of the Federal Reserve, 20/09/2023

After a strong first half of the year which saw the S&P500 and NASDAQ indices surge 16% and 32% respectively, the US market sold off during the quarter as treasury yields rallied across the maturity curve. Following the September meeting where the Federal Open Market Committee (FOMC) kept rates on hold as expected, Chairman Powell made comments around the 'neutral' rate rising, and the plausibility that the neutral rate is higher than the long run rate. The interpretation of these remarks was that the US Federal Reserve (Fed) underestimated the real-time neutral rate, and this contributed to higher than expected growth i.e. rates should have been higher. Following the press conference, yields were repriced higher as the market assumes that the Fed will need to keep rates higher for longer in order to apply appropriate tightening pressure. Interest rate futures imply the market expects a less than even chance of one further hike, which is less hawkish compared to numerous Fed members who have spoken to the possibility of one or even more rate hikes in the future.

Locally, investor attention was focused on the bi-annual reporting season in August. Whilst results were ahead of expectations at revenue, they were more balanced at the bottom line.

% of companies beating/in-line/missing Revenue and EPS consensus

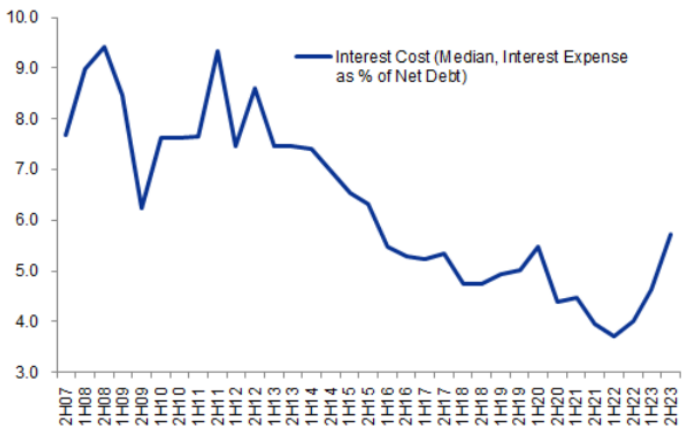


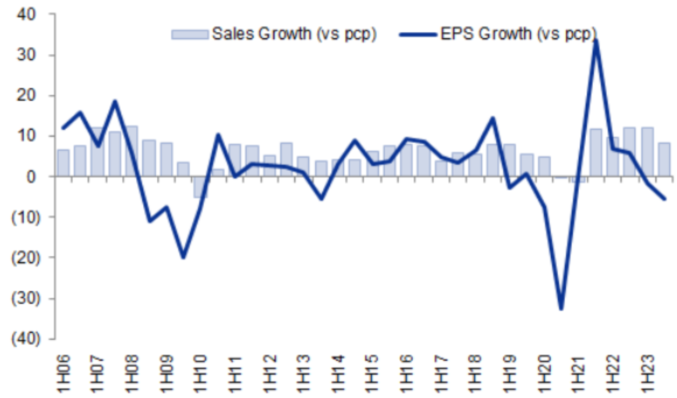
Source: Goldman Sachs

"I continue to expect that further rate increases will likely be needed to return inflation to 2% in a timely way… I see a continued risk that high energy prices could reverse some of the progress we have seen on inflation in recent months." Michelle Bowman, Federal Reserve Governor, 03/10/2023

"The government could be doing more to assist the Australian public. They've got to get serious and realise where the Australian public is at the moment." Soloman Lew, Chairman of Premier Investments, 28/09/2023

This dynamic of companies meeting (or exceeding) expectations higher up the profit and loss statement and then missing at the net profit line was partly attributable to higher interest costs, which was a common call out from companies during reporting season. Despite sales growing 8% on average, earnings per share declined 6% year-on-year, as shown in the second chart below.





Source: Goldman Sachs

Energy was the best performing sector during the period, with higher oil prices driving mark to market upgrades for the upstream producers. Qantas, a consumer of jet fuel, saw negative earnings revisions as the company saw fit in the current environment to absorb higher fuel costs rather than manage through capacity or price changes as it ordinarily would.

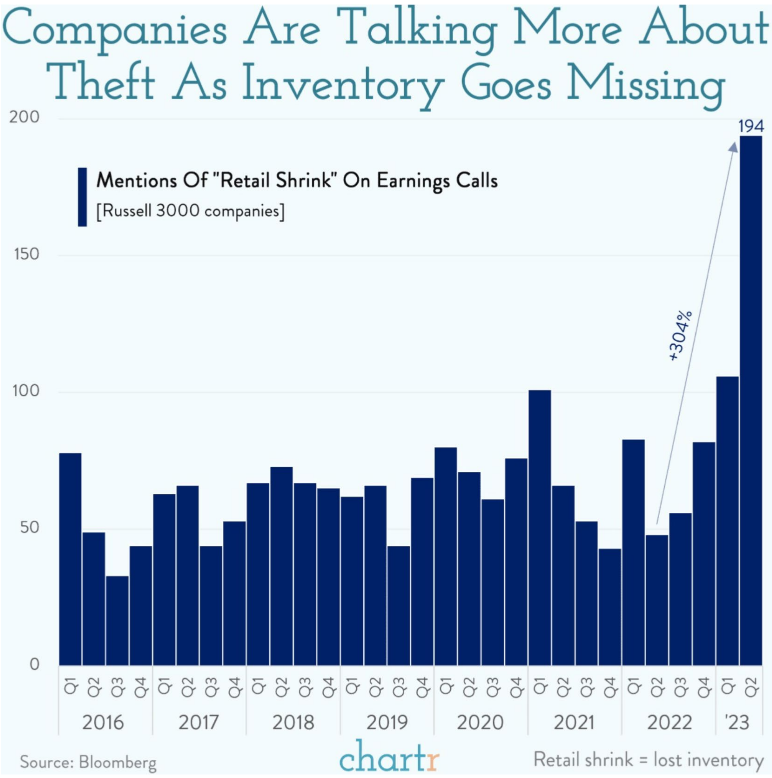
	QUARTER	YEAR
ASX300 Accumulation Index	-0.8%	12.9%
Best Performing Sectors		
Energy	11.6%	23.6%
Consumer Discretionary	5.6%	19.7%
Financials ex-REIT	2.3%	13.7%
Worst Performing Sectors		
Healthcare	-9.0%	-6.3%
Consumer Staples	-5.8%	2.8%
Information Technology	-4.9%	22.4%

Source: IRESS

Healthcare underperformed during the quarter, predominantly driven by an earnings downgrade from CSL, where the company guided to a larger currency headwind in FY23 and lower than expected earnings in FY24. Elsewhere in the sector, the increasing prevalence of GLP-1 or anti-obesity drugs saw a de-rating in the multiple of companies' who are leveraged to diabetes and obesity, as the market reassessed the addressable markets which these companies service.

Consumer Staples stocks lagged as companies in the sector were unable to sufficiently pass through the impost from higher costs. Coles were hit by a triple whammy of higher theft, higher implementation costs of supply chain projects and higher interest costs whilst Endeavour Group also guided to higher interest costs in FY24.

Theft is a common occurrence throughout the globe, as evidenced by the uptick in mentions on company conference calls.



"All this work around pharma and their work on obesity drugs is driving patients into the funnel. Markets are laser-focused on, will that impact 2030 or 2040 TAM? We're actually seeing patients get activated into the health care system." Michael Farrell, Chairman and CEO of Resmed, 12/09/2023

Trip Snippets

During the period we visited the US on four separate occasions, as well as New Zealand.

US observations:

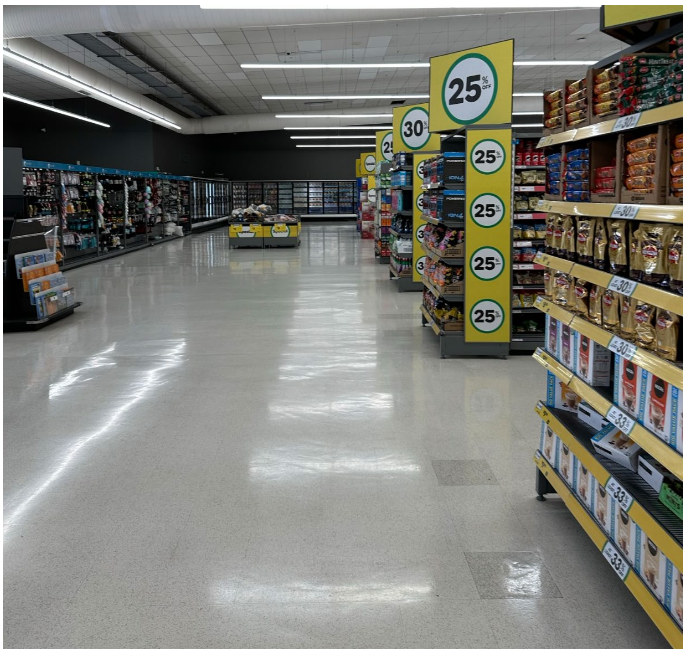
- Whilst a number of categories which benefited from COVID have seen spending reduce, others have shown resilience. For example, Sleepwear which benefited from the Work From Home/Casualisation trend is down 14% versus 2022 according to spending data, whilst Speciality Kitchen Electrics are up over 11%.
- Cohort activity continues to show great variability, with spending from consumers aged 55 and above increasing 2% year on year, compared to 18-24 and 25-34 year old's which declined 13% and 7% respectively.
- The contribution of new items to unit sales continues to decrease. Today, around 2% of stock-keeping units (SKU) count is new items, down from around 5% in 2019. This speaks to the lack of innovation investment during the pandemic, with demand being largely self-sufficient during that period. In the current environment, companies who invested throughout COVID are relatively well positioned as they are better able to provide 'newness' to customers.
- Consumers are more willing to spend on experiences with 55% of surveyed consumers planning to 'treat themselves' to make up for time lost over COVID. Furthermore, consumers are relaxing self-imposed spending restrictions in order to fund spending on experiences. A manifestation of this is restaurant spending, which is up 23% on last year whereas grocery spending is up only 5%.
- Meal patterns are changing, with snacking increasing in prevalence as the line between meals and snacks continues to blur. Lunch is the meal most susceptible to replacement with a majority of consumers now making at least one lunch out of snacks per week.

New Zealand

We did a retail tour of Auckland, with a focus on Supermarkets given Countdown's (Woolworths) issues over recent years. We first visited New World and Pak'NSave supermarket sites, both part of the Foodstuff co-operative. The stores were well merchandised and clearly invested in with Electronic Shelf Labels throughout. Traffic levels were strong.

We then travelled 1km down to the road to Countdown. We have never seen such an empty Supermarket. The sample prices we observed were also higher than those in the other stores.

These photos were taken at midday on a Friday.



It appears Woolworths has an enormous task in winning back customers and turning the New Zealand business around.

Fisher & Paykel Healthcare

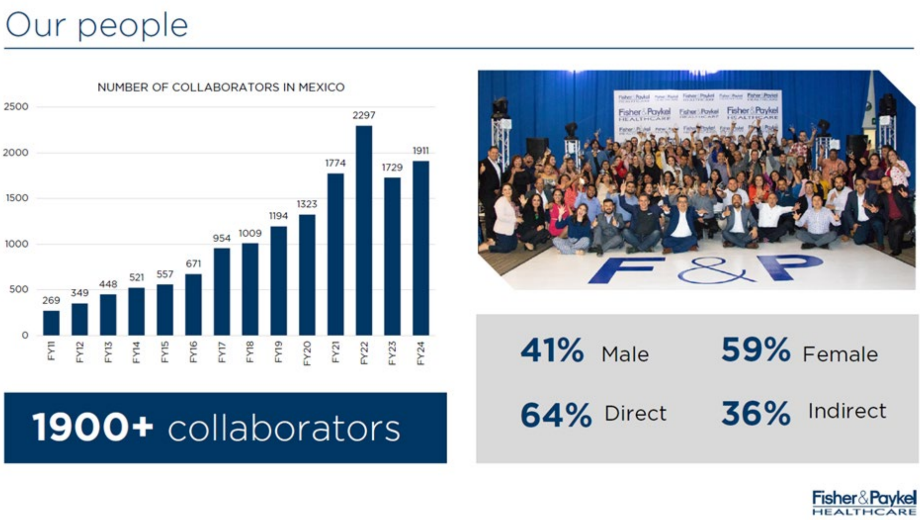
We last wrote about Fisher & Paykel Healthcare (FPH) five years ago following a visit to their Mexico manufacturing operations. This quarter we visited their manufacturing operations for the third time.

On our first visit to Mexico in 2016, we toured FPH's leased manufacturing facility that at the time accounted for 27% of FPH's total manufacturing output (with 73% from Auckland). Mexico was chosen by FPH in 2009 to be their second manufacturing location given the proximity to their largest market (the US, which today is 43% of revenue), to access the plentiful supply of skilled labour at a more competitive cost than New Zealand and to mitigate geographical risk. Also in 2016, we visited the 15 hectares of land that FPH had recently acquired at La Encantada in Mexico to provide for decades of growth in manufacturing output (first photo below). At that time, the land was just a large patch of dirt. On our subsequent visit to Mexico in 2018, the first building on the FPH land was nearing completion, impressive progress in only two years (second photo below).

Source: Company reports

This visit, we were again impressed by the progress. The first building was running close to full capacity with the second building recently completed and starting to be fitted out with manufacturing equipment. In the space of five years, FPH has tripled its manufacturing capacity in Mexico (each building are of a similar floor space) through a period which included the COVID pandemic. During this period the FPH team impressively managed the build of a new manufacturing facility whilst managing an unprecedented surge in demand for their respiratory care products from hospitals globally.

Currently, Mexico accounts for 39% of FPH's manufacturing output and we expect this to continue to increase with the second new building ramping output and with space on the land for two more buildings of similar size to be built. Over the 2010-2019 decade, the increase in manufacturing output from Mexico helped FPH expand its gross margin given the more competitive labour cost in Mexico compared to New Zealand. Although this labour cost advantage has narrowed in recent years, we still expect to see the increasing Mexico manufacturing mix to assist FPH's gross margin recovery to its long-term target of 65%, which was achieved prior to COVID which had a negative impact on gross margin.



FPH continues to be a core holding for the portfolio. It ranks towards the top of our Shareholder Stewardship and Business Evaluation rankings across our investment universe. In particular we think it has one of the most attractive long-term growth runways in the portfolio (we expect it to double revenue every 5-6 years for decades to come) and we love the unique culture focused on superior patient outcomes. The COVID pandemic saw a doubling of FPH's installed hardware base and a substantial increase in awareness of their respiratory support products in hospitals globally, as high-flow oxygen therapy became the front-line defence against COVID across many hospitals globally. The opportunity (and challenge) for FPH is to now leverage this increased hardware base and awareness to accelerate their hospital consumables growth (consumables were 85-90% of their hospital revenue before COVID).

"Last year, our products were used to treat about 6 million patients, and we've estimated about 50 million patients a year would benefit in the hospital respiratory support category and about another 50 million a year would benefit in the anesthesia category. So when you add that all up, you can see that our therapies would potentially benefit over 150 million patients a year. Last year, which didn't have a lot of COVID in it, our products were used to treat 15 million to 16 million patients. So you can see, there's a long way to go." Lewis Gradon, CEO of FPH, 29/08/2023

Outlook

We observe that stickiness in inflation combined with increase in bond issuance and a reversal in quantitative easing has pushed Treasury yields higher. This is weighing on longer duration growth stocks and risk appetite more generally. This dynamic alongside an explosion in the awareness and uptake in anti-obesity drugs has especially weighed on a number of Healthcare stocks. We expect the divergence in sector performance will create some attractive opportunities in the coming period.

We see emerging signals of weakening demand, with trends more notable in Australia relative to the rest of the developed world. The recent de-rating of various mid and small cap names reminds us that attractive opportunities will present themselves, although we are of the view that we are closer to the beginning than the end of this process as negative earnings revisions have only just begun. Whilst we will be selectively opportunistic, we will not be attempting to pick the bottom during the cycle.

"Going from zero to 2% was almost no increase. Going from zero to 5% caught some people off guard, but no one would have taken 5% out of the realm of possibility. I am not sure if the world is prepared for 7%." Jamie Dimon, Chairman and CEO of JP Morgan Chase, 26/09/2023

More information

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

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