Greencape High Conviction Fund

Quarterly report - September 2019

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Inception % p.a.
Fund return	3.94	8.54	13.14	10.16	9.12	9.74
Growth return	3.40	1.23	4.54	1.42	2.54	2.94
Distribution return	0.54	7.31	8.60	8.74	6.58	6.79
S&P/ASX 200 Accumulation Index	2.37	12.47	11.88	9.50	8.15	6.81
Active return^	1.57	-3.92	1.26	0.66	0.97	2.92

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'.

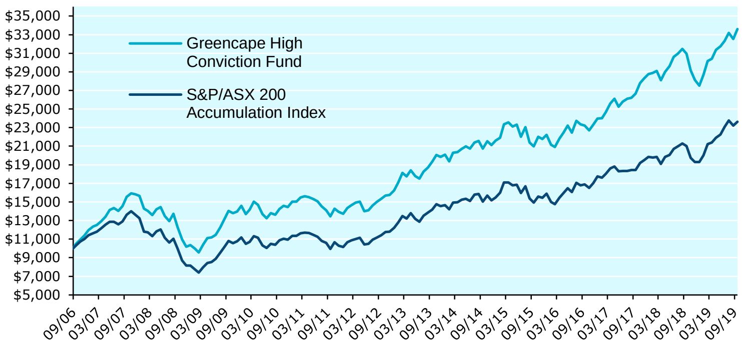
Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years

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

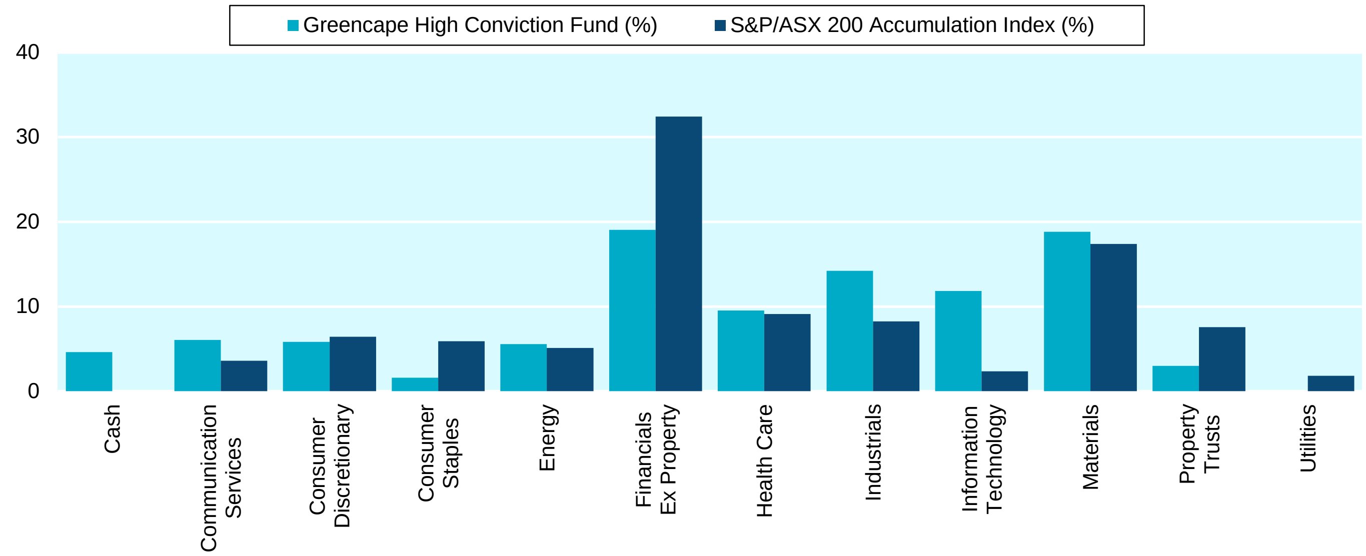


Asset allocation	Actual %	Range %
Security	95.40	85-100
Cash	4.60	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0035AU

Fees	
Entry fee	Nil
2017-2018 ICR	1.59%
Management fee	0.90% 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 200 Accumulation Index).
Buy/sell spread	+0.20% / -0.20%

Sector exposure as at 30 September 2019



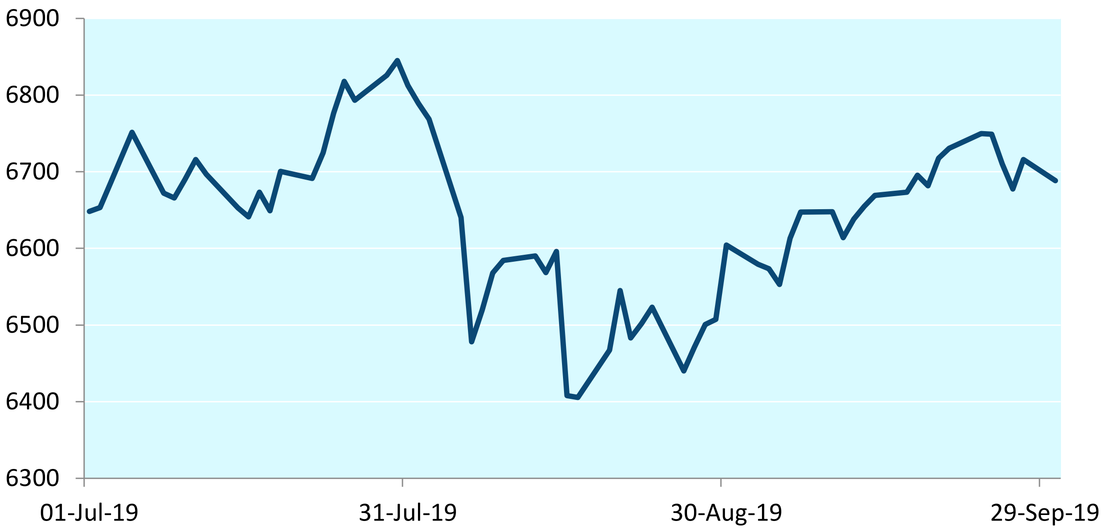
Fund performance summary

The S&P/ASX 200 Accumulation Index returned +2.37% for the quarter. The fund outperformed the market and delivered a +3.94% return over the quarter.

Market overview

The local index admirably consolidated its strong performance from the previous two quarters, recording another positive performance and taking the year to date gain for the Accumulation Index to 23%. Investor attention locally was focused on the August reporting season, whilst several geopolitical situations continued to simmer in the background.

S&P/ASX 200 Index

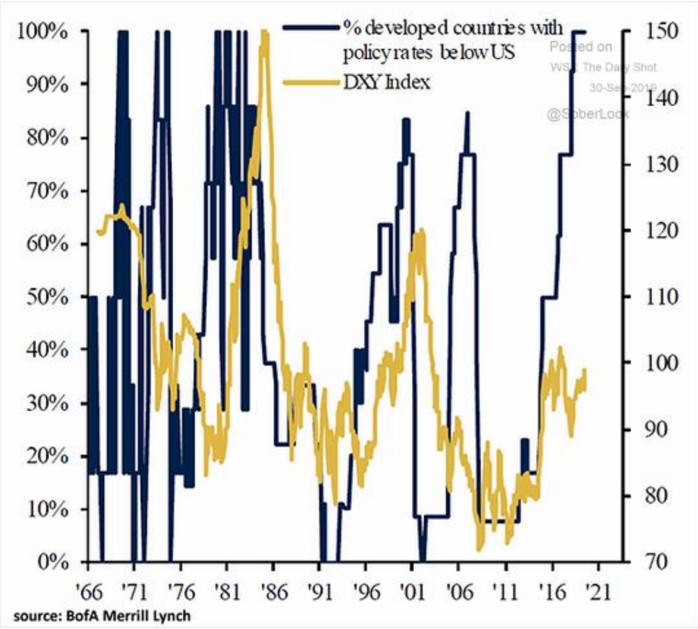


Source: Iress

The Reserved Bank of Australia (RBA) cut the target cash rate once during the period in July, and once again on the first day of the fourth quarter (Q4) in October. The cash rate now sits in unchartered territory at 0.75%. Like the June decision where weak Consumer Price Index numbers gave the RBA sufficient ammunition to cut rates, weak July employment numbers (where the unemployment rate unexpectedly rose to 5.3%, with Full-Time employment falling 15.5k) again gave the RBA reason enough to lower the cash rate. The easing cycle is far from over however, with the futures market now implying a more than 50% likelihood of another interest rate cut by the end of the year. Interestingly, given the RBA is now running out of ammunition with the cash rate, several Australian economic commentators are now talking about the RBA launching Quantitative Easing or other unconventional monetary policy in order to boost employment and inflation to the bank's target levels.

"Our floating exchange rate gives us a degree of monetary independence, but we can't ignore structural shifts in global interest rates." Philip Lowe, RBA Governor, 24/09/2019

Elsewhere, the Trade War between China and the US continued without resolution. In an encouraging sign of goodwill, Trump delayed the implementation of the latest round by two weeks as to not coincide with the 70th anniversary of the founding of the of People's Republic of China. Late in the period however, it was reported that the Trump administration was considering delisting Chinese companies from US stock exchanges as part of a broader effort to limit US investment in Chinese companies.



Much to the chagrin of President Trump, all developed countries now have central bank policy rates below that of the US. This in theory bodes well for the USD.

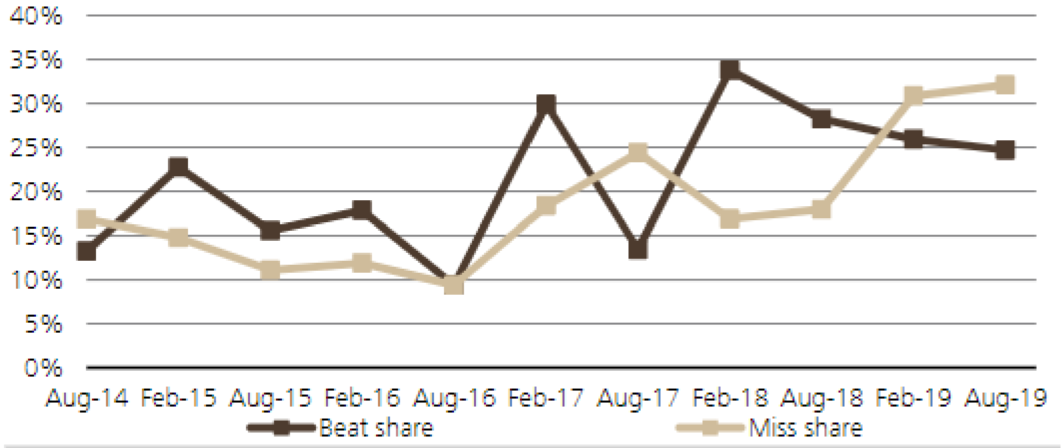
	Quarter	Year
ASX200 Accumulation Index	2.4%	12.5%
Best Performing Sectors		
Consumer Staples	11.6%	16.4%
Consumer Discretionary	8.2%	10.3%
Healthcare	7.0%	15.7%
Worst Performing Sectors		
Materials	-3.7%	16.0%
Telecom Services	-3.2%	8.8%
Energy	0.5%	-9.0%

Source: IRESS

The August reporting season was largely one to forget, with companies registering earnings misses outweighing those which beat expectations. Earnings per share (EPS) revisions across the ASX300 averaged nearly -2% in August, the highest monthly negative revision for a reporting season since February 2016. There were some positives however, with signs of life emanating from the Consumer Discretionary sector, with JB Hi-Fi, Super Retail Group and Premier Investments providing signs that there may be life in the consumer yet.

"As I predicted, Jay Powell and the Federal Reserve have allowed the Dollar to get so strong, especially relative to ALL other currencies, that our manufacturers are being negatively affected. Fed Rate too high. They are their own worst enemies, they don't have a clue. Pathetic!" Donald Trump, President of the United States of America, 01/10/2019

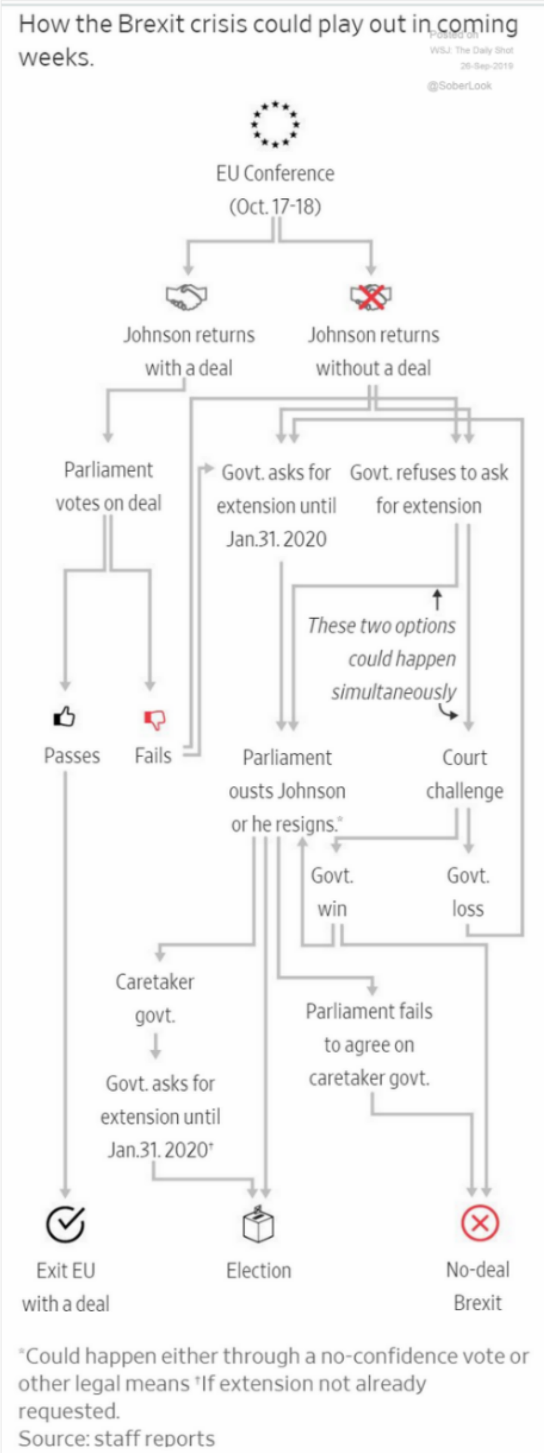
Another theme evident during August was companies with meaningful short interest staging remarkable rallies when they beat or met (or in some cases even missed) earnings expectations (e.g. James Hardie, REA Group and Kogan.com) demonstrating that investor positioning can oftentimes overwhelm an earnings result.



Source: UBS

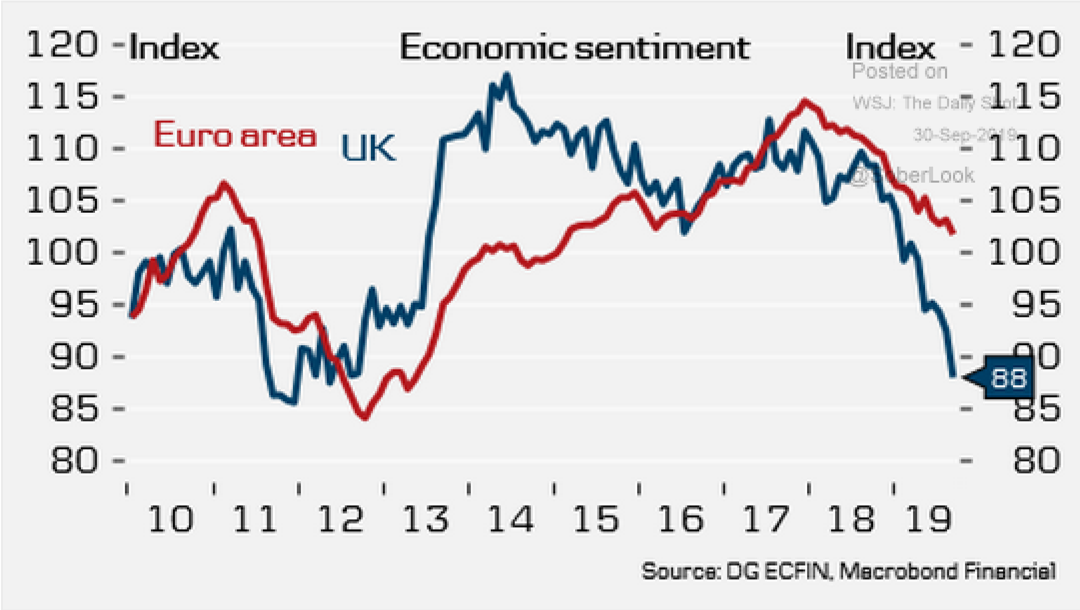
Charts which Caught Our Eye

Despite the Brexit referendum now having taken place over three years ago, it doesn't appear that we are any closer to a clear outcome with betting markets now placing a mere 23% likelihood of the UK leaving the EU by the October 31 deadline. Meanwhile, economic sentiment in the UK continues to deteriorate.



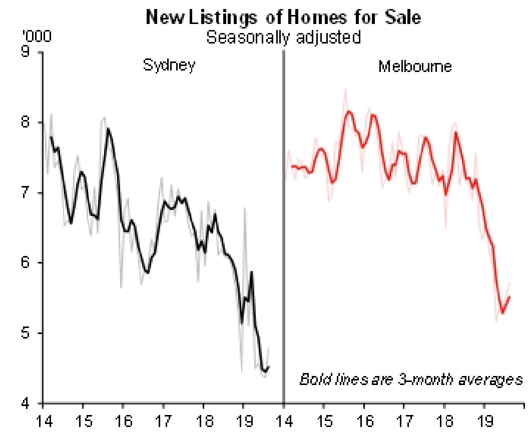
Source: Wall Street Journal

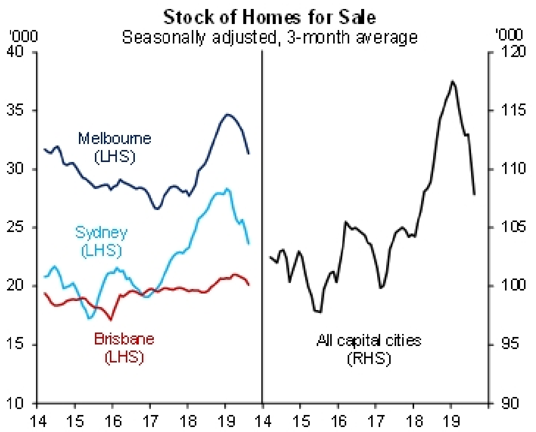
"People can feel that this country is approaching an important moment of choice and we have to get on and we have to deliver Brexit on October 31… I'm going to get on and do it." Boris Johnson, Prime Minister of the UK, 30/09/2019



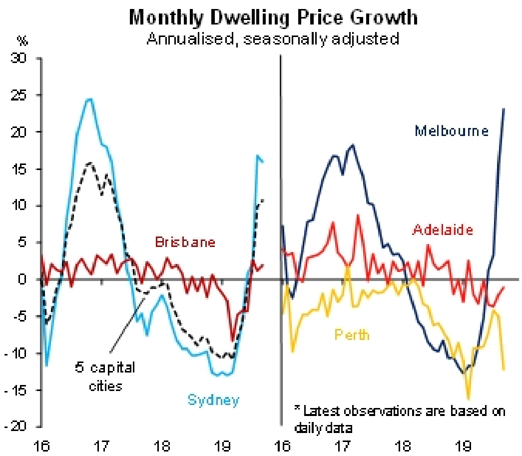
Source: Danske Bank

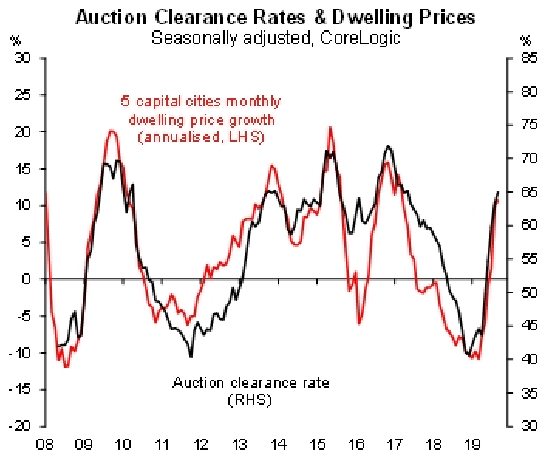
The strong rebound in house prices in Australia has party been a function of lower listing volumes (which has also helped clearance rates). We will be monitoring closely whether the uptick in dwelling prices entices more housing stock to come to market.





Source: CoreLogic, Macquarie Macro Strategy





Source: CoreLogic, Macquarie Macro Strategy

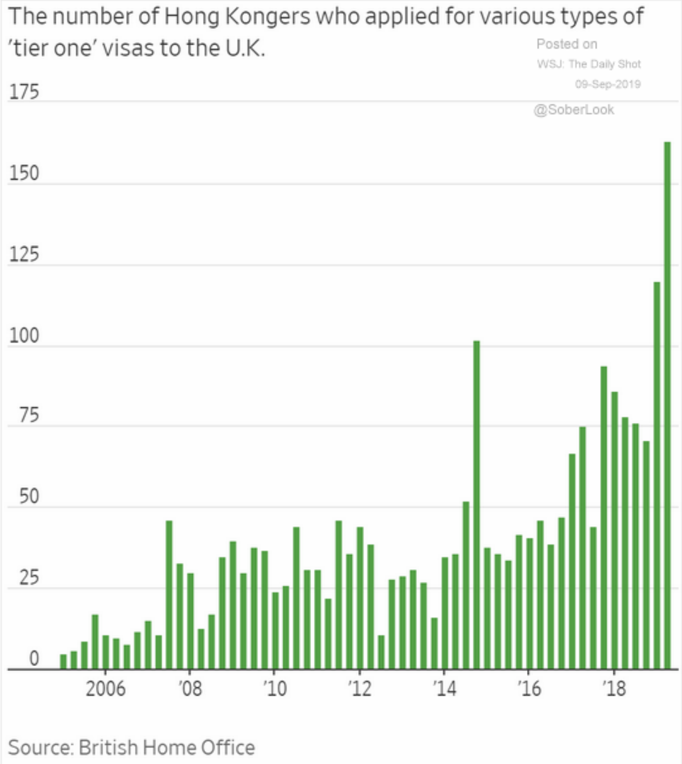
Source: Macquarie

We visited Hong Kong twice during the quarter and were surprised at how quiet the city was. Anecdotally, we heard that one of the city's most popular 5-star hotels had a mere 20% occupancy rate over the time we visited. The actual numbers paint a similar story, with Retail Sales and visitor numbers down 23% and 40% respectively. A record number of Hong Kong residents have also been applying for UK visas.

Source: The Daily Shot

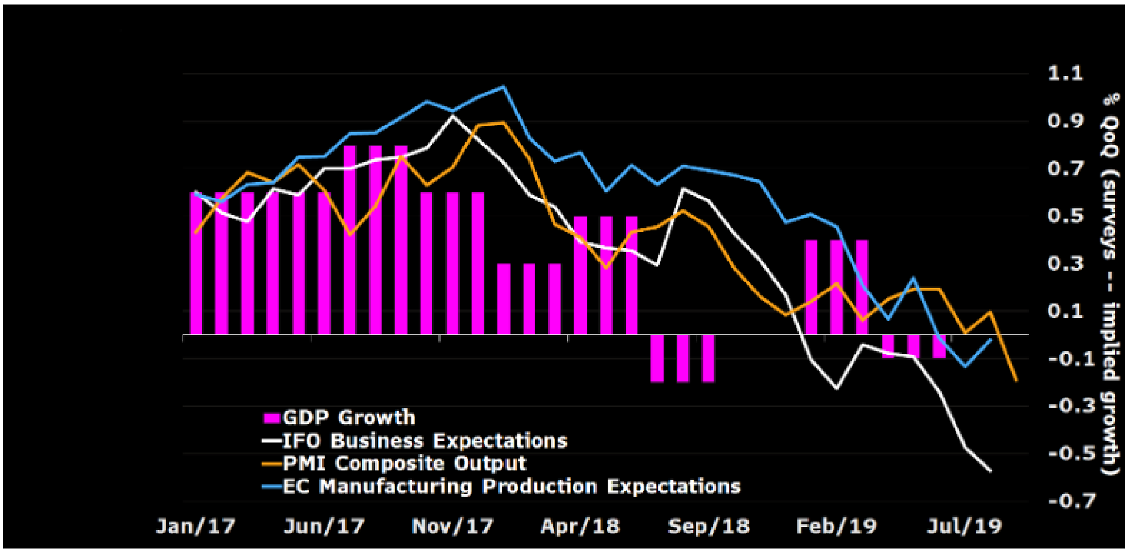
"The travel trade has reported that the number of forward bookings in September and October has also dropped significantly." Hong Kong Tourism Board, 30/08/2019

Source: Bloomberg



Source: Wall Street Journal

Germany, the economic engine in Europe, appears to be struggling with the Manufacturing PMI sliding to its lowest level since the GFC, putting the country at risk of its first technical recession in six years.



Source: BTIG

Finally, the rise of online dating has been meteoric over recent decades.

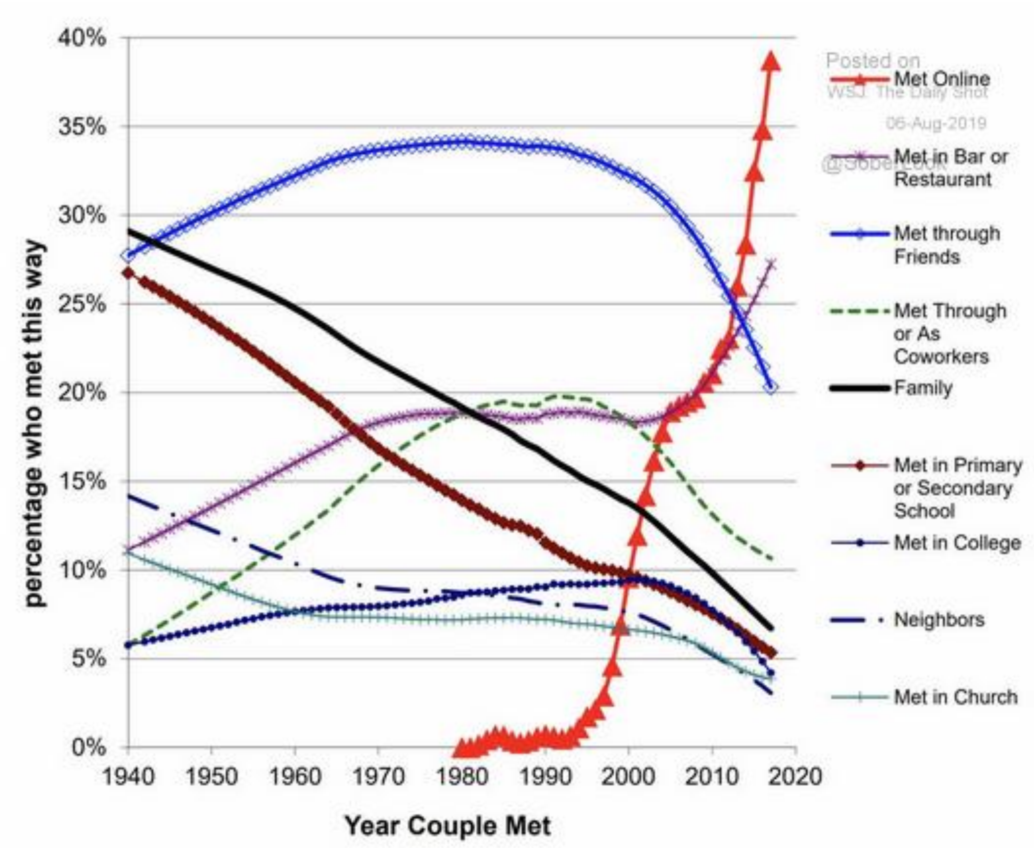


Figure 1: The continued rise of meeting online for heterosexual couples.

Source: The Daily Shot

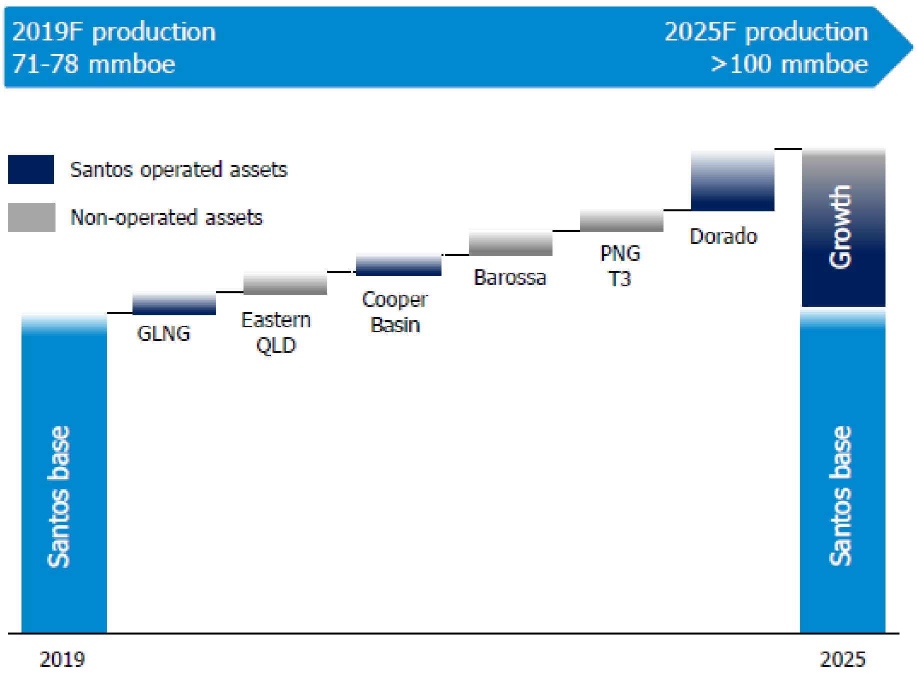
Santos

The transformation of Santos Ltd (STO) over the past 4 years from a high-cost and over-levered oil and gas company with 'low quality' assets to a low-cost, streamlined company with multiple growth options and a robust balance sheet today has been remarkable. Having rejected an opportunistic bid for the company of $6.88 in October 2015 (when the stock was trading at $5.44), the Board announced the completion of a strategic review in November 2015 which started the transformation process. The two key pillars of the strategic review were the announcement of $3bn of capital initiatives to start repairing the balance sheet (including a $2bn rights issue at $3.85, $0.5bn strategic placement to financial investor Hony Capital at $6.80, a $0.5bn asset sale and dividend cut) as well as the appointment of Kevin Gallagher as CEO in November 2015. Gallagher had been the CEO of Clough Ltd, an energy and mining contractor, for 4 years and before that had spent 13 years at Woodside Energy Ltd (WPL) where he ran the North West Shelf JV. He had a strong reputation for operational excellence and cost discipline and was well suited to lead STO through this transformation. By the time Gallagher started as CEO in February 2016, the STO share price was languishing around $3.00, a level not seen since the early 2000's.

Gallagher moved rapidly to transform STO after commencing as CEO. Through 2016 he replaced most of the executive management team, established a new operating model and started to change the culture towards a low-cost, high-performance mindset. In order to make STO a more robust business through the oil price cycle, Gallagher focussed the company on reducing one key performance metric, being the 'free cash flow breakeven' point for the business. This had the effect of lowering both operating and capital costs in the business such that STO would be free cash flow breakeven at an oil price in the low US$30's per barrel and thus protected at the low point of the oil price cycle. Having stabilised STO through 2016, Gallagher then announced his new strategy in December 2016 which centred on simplifying the business around 5 core long-life asset hubs (which necessitated divestment of non-core assets), developing growth options around these 5 key hubs (both organic and acquisitive options) and further de-levering the balance sheet (which saw a further $1.2bn in equity raised at ~$4.00 that month).

Within 12 months of this new strategy being announced, STO had again been approached by a potential acquirer. This time it was Harbour Energy (an energy focused private equity fund) who offered $4.55 per share in August 2017, which was again rejected by the STO Board. Harbour returned in March 2018 with three revised offers, with their final offer being $6.50 (inclusive of a $0.37 dividend). With the share price at $5.07 before this offer and with over $3bn of new equity raised at ~$4.00 over the previous 2.5 years, the Board felt the $6.50 offer was sufficiently high enough to engage with Harbour. On 21st May 2018 Harbour presented a final binding offer to STO at an effective share price of $6.95. This final offer however was highly conditional, including a requirement for STO to hedge 30% of 2018, 2019 and 2020 oil-linked production and support the debt raising required by Harbour to fund the acquisition. Ultimately, the STO Board rejected the offer given the conditionality and the belief that they could deliver a higher value for shareholders by delivering on their stated strategy. Three months later in August 2018 STO made a transformational debt-funded acquisition of Quadrant Energy for $3bn to add scale to their existing offshore WA gas assets and deliver them 80% of the Dorado oil discovery, the most promising oil discovery in Australia in the last 20-30 years. Over the subsequent 12 months, STO has continued to deliver on their strategy with a further lowering of their free-cash flow breakeven point, further de-leveraging and continuing to build out the growth optionality around their 5 key asset hubs.

"One of the things I believe sets Santos apart is that we have growth opportunities across all of our assets. Our growth is not beholden to one project, one product market or one region. Ours is also a brownfield upstream growth strategy leveraging existing infrastructure to deliver superior shareholder returns." Kevin Gallagher, CEO of Santos, 22/08/2019



Source: Santos

Greencape funds held a modest position in STO through the early years of the transformation under Gallagher. Following the Harbour offer rejection and Quadrant acquisition last year, our investment view of STO became more positive as we had observed more tangible evidence of the operational turnaround and growth optionality being built into the company. With the declining oil price in late 2018 we were able to increase our holding in STO such that it is by far our largest Energy exposure. With the stock in the $7.00-7.50 range at the time of writing, we see good value in the stock both in absolute terms and on a relative basis compared to its large Energy peers WPL and Oil Search Ltd (OSH).

STO is cheaper on both a multiple of current earnings and discounted cash flow model (in our view) and has more near-term growth optionality that should ultimately generate higher, self-funded returns (as a higher proportion of the company's growth is brownfield in nature vs. the more greenfield growth options of WPL and OSH). We believe that STO has the best free cash flow generation and most flexible balance sheet of the three which puts it in a strong position to pursue additional accretive acquisitions. In addition, we rate Gallagher and his management team as the best in the Energy sector in Australia, especially in light of recent news that OSH's long-standing CEO Peter Botten is retiring after 25 years of exceptional service. We expect that with further evidence of the STO transformation being demonstrated to the market that the STO stock will be re-rated, both absolute and relative to peers. The stock is a high conviction position across the Greencape funds.

Offshore Trips

During the period we visited the both China and the US twice, as well as Europe.

China observations

- Whilst the Trade War is being blamed for the current slowdown, some contacts we spoke to fear the underlying issues are more structural in nature and therefore a rebound in consumer spending is not expected if a deal is struck.
- The mood on the ground was relatively upbeat on the prospect of a deal being struck between China and the US before the end of the year.
- Australia is seen as a relatively 'boring' place to travel by young and adventurous Chinese travellers. i.e. a place where your parents or grandparents would typically travel.
- The Vitamins market (and health products more broadly) in China have not yet recovered from the government's 100-day crackdown on illegal marketing practices earlier this year, which stemmed from allegations of one product giant of operating a pyramid scheme among other scams.
- There are over 110k Independent Speciality Mother and Baby Stores (MBS) in China. Relative to National & Regional chain MBS, the proprietors of the independent stores individually curate the range of stock in their store and are more likely to have closer relationship with their customers as they are generally located in smaller towns.

"China wants to make a deal so badly. Thousands of companies are leaving because of the Tariffs, they must stem the flow. At the same time China may be hoping for a Democrat to win so they could continue the great ripoff of America, & the theft of hundreds of Billions of $'s!" Donald Trump, President of the United States of America, 11/08/2019

Outlook

The recent reporting season was a timely reminder that fundamentals are the most critical driver of share price performance over the long term. However, it also reminded us that volatility is the new normal. Market moving news flow continues to come at us thick and fast, whether it be related to Trade Wars, tensions in the Middle East, Brexit, Hong Kong protests, climate change activism, US presidential instability or monetary policy.

Our research observations highlight slowing growth in the US, but growth is still evident. Western Europe has slowed, although in aggregate it remains flat with Eastern Europe maintaining moderate growth. China has also slowed but is still growing, whilst Australia remains patchy depending on sector and geography. This continues to highlight that in a world of slow growth and cheap money, shareholder value creation depends on astute capital allocation and solid management execution.

Greencape’s assessment of Shareholder Stewardship will continue to be key in our stock picking and portfolio management, with the combination of cheap money and good capital allocation proving to be a powerful driver of value creation. This drives our confidence that portfolio position exploiting this combination will continue to deliver attractive returns.

“When you think being invested in aggressive securities is a sure thing, it’s easy… you’re probably missing something.” Howard Marks, Chairman of Oaktree Capital, 26/09/2019

“We should start by transforming the private equity industry — the poster child for financial firms that suck value out of the economy.” Elizabeth Warren, Democrat Senator, 18/07/2019

“"I think if you listen to the Elizabeth Warren plan, it is 100 percent recession, if not worse," Steve Mnuchin, US Treasury Secretary. 12/09/2019

More information

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

Fidante Partners Investor Services team on: **13 51 53**

Visit the Greencape website: **www.greencapecapital.com.au**

Email Greencape at: **bdm@greencapecapital.com.au**

Financial advisers

For more information, please contact:

Fidante Partners Adviser Services

Phone: **+61 1800 195 853**

Email: **bdm@fidante.com.au**