Greencape CAPITAL

# Greencape High Conviction Fund

## Quarterly report - December 2019

| Performance # | Quarter % | 1 year % | 3 years % p.a. | 5 years % p.a. | 10 years % p.a. | Inception % p.a. |
|---|---|---|---|---|---|---|
| Fund return | 4.22 | 27.40 | 13.49 | 10.15 | 9.16 | 9.88 |
| Growth return | 3.58 | 19.07 | 4.90 | 1.45 | 2.54 | 3.16 |
| Distribution return | 0.64 | 8.32 | 8.59 | 8.70 | 6.61 | 6.73 |
| S&P/ASX 200 Accumulation Index | 0.68 | 23.40 | 10.25 | 8.98 | 7.86 | 6.74 |
| Active return^ | 3.54 | 4.00 | 3.24 | 1.17 | 1.29 | 3.15 |

**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'.

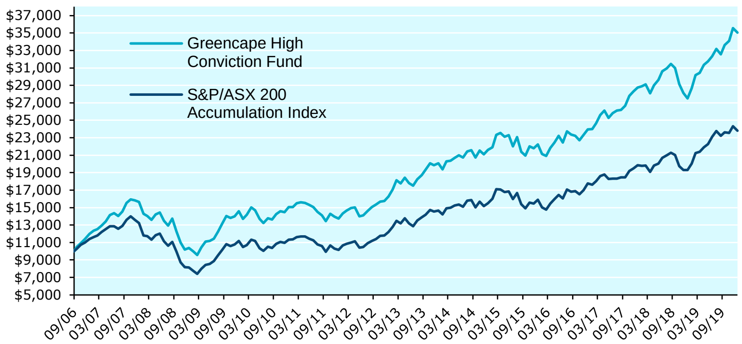
### Distribution frequency

Quarterly

### Suggested minimum investment timeframe

At least five years

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



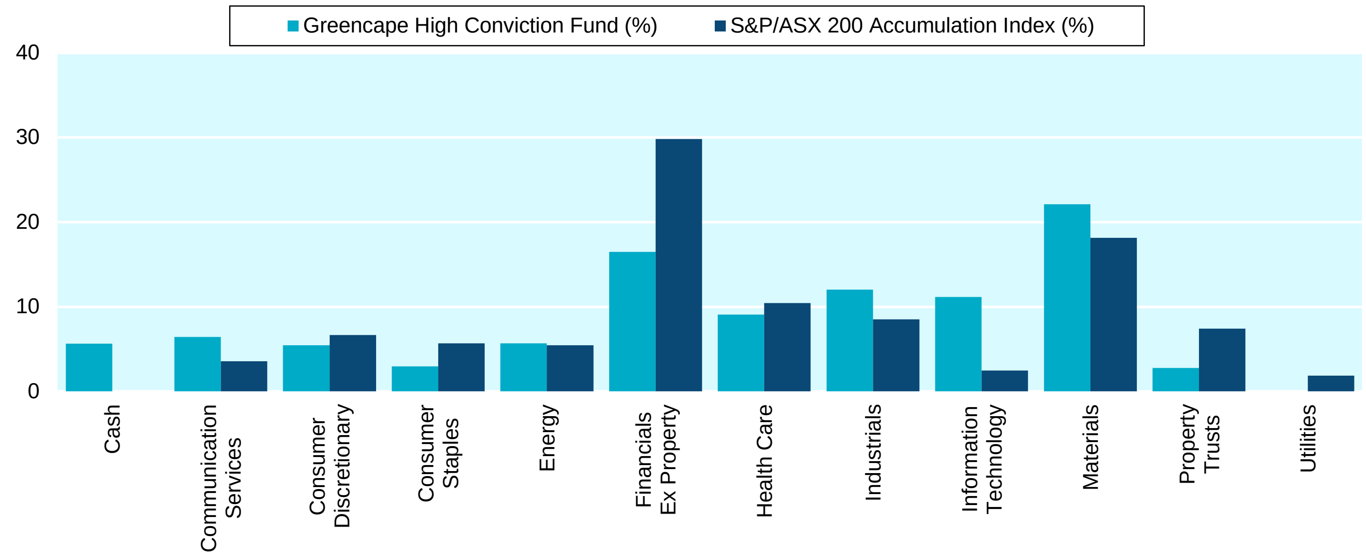

| Asset allocation | Actual % | Range % |
|---|---|---|
| Security | 94.35 | 85-100 |
| Cash | 5.65 | 0-15 |

| 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% |

**Source: Fidante Partners Limited, 31 December 2019.**

## Sector exposure as at 31 December 2019




**Source: Fidante Partners Limited, 31 December 2019.**

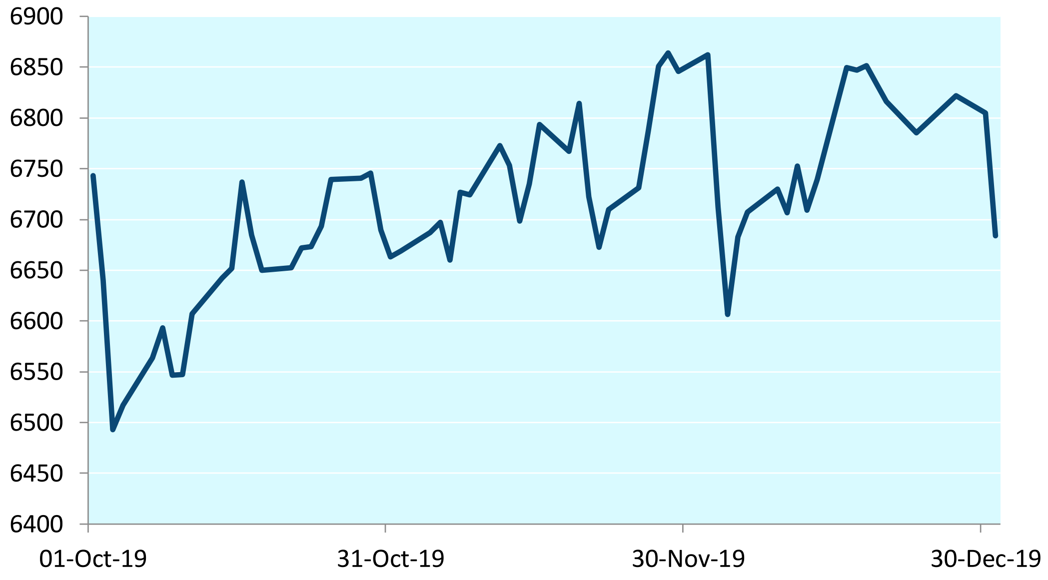
## Fund performance summary

The S&P/ASX 200 Accumulation Index returned +0.68% for the quarter. The fund outperformed the market and delivered a +4.22% return over the quarter.

## Market overview

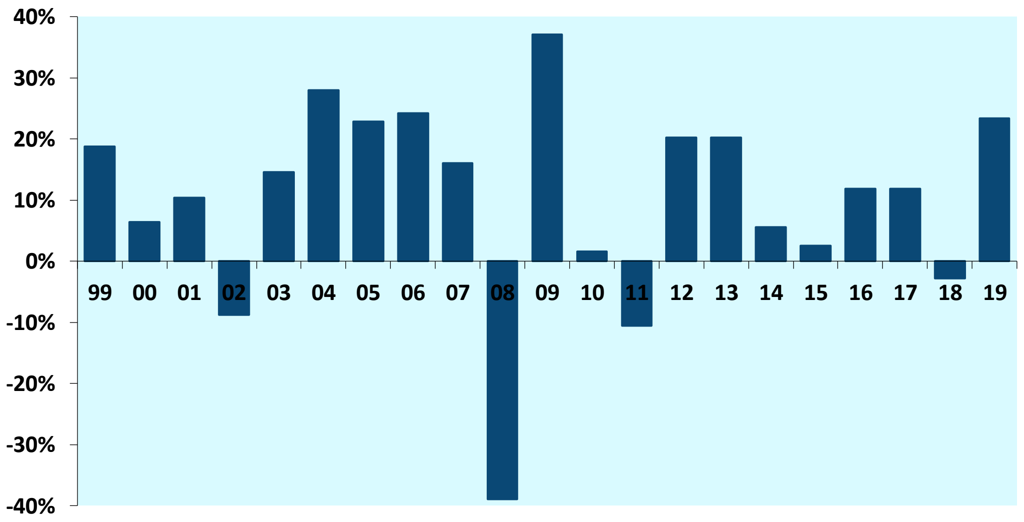
The market managed to consolidate the strong year-to-date performance in the final quarter of the calendar year, recording the biggest annual gain since 2009, at which time the world was exiting the GFC. The local index also finally managed to record a fresh all-time high, surpassing the previous record set in 2007.

**S&P/ASX 200 Index**




Source: Iress

**S&P/ASX 200 Accumulation Index Calendar Year Returns Since 1999**

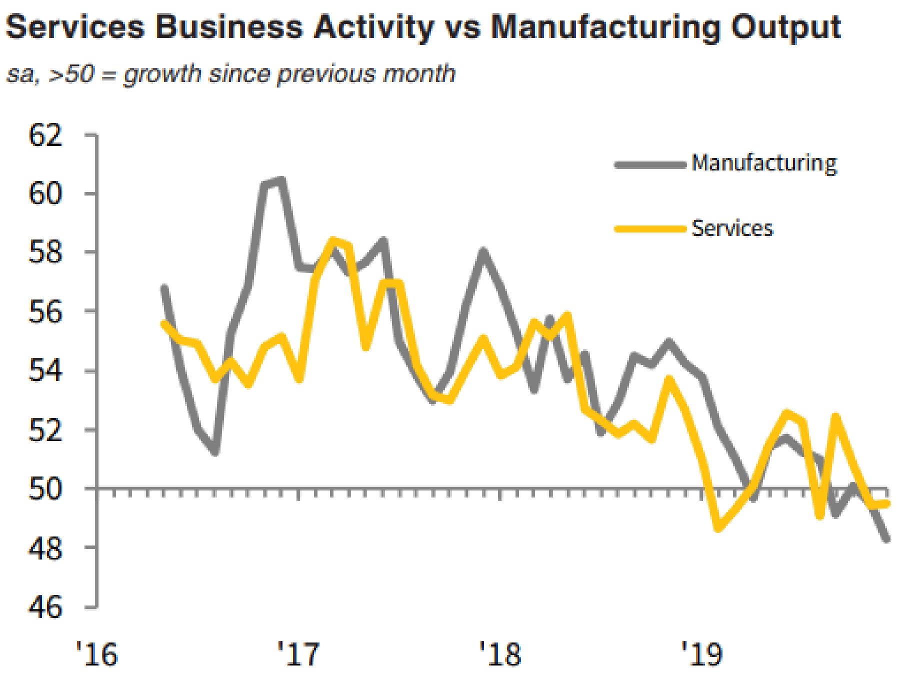



Source: Iress

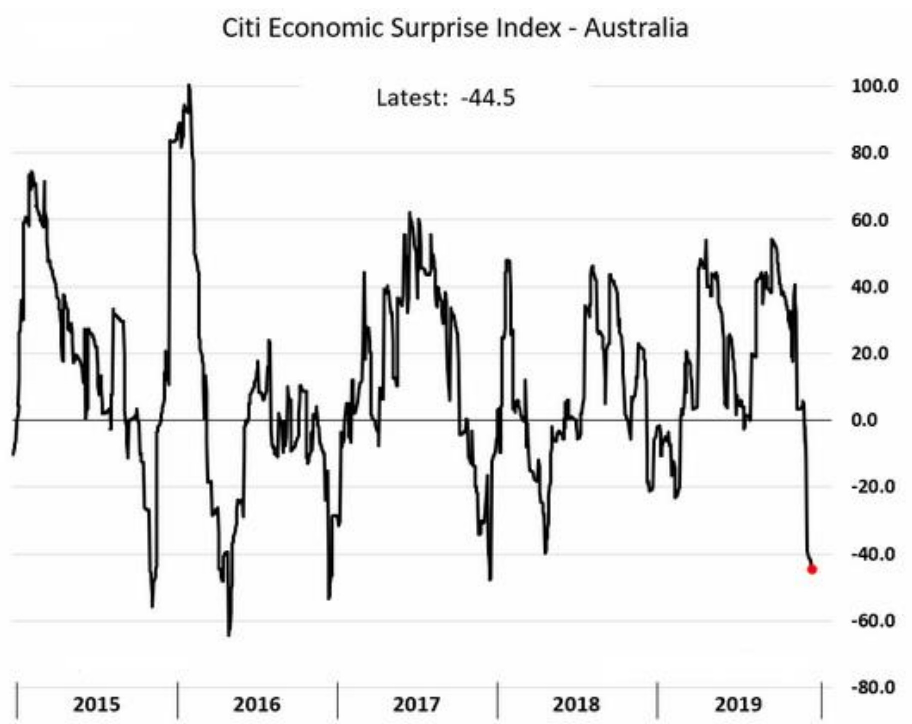
The Reserve Bank of Australia (RBA) acted only once during the period, cutting the cash rate to a new record low of 0.75% at the October meeting. Interestingly, the RBA Governor indicated that 0.25% was the level where the central bank would consider Quantitative Easing (QE), which suggests that the bank only has 2 cuts left up its sleeve. The futures market currently implies a 58% chance of a cut at the bank's next meeting in February, with a full rate cut not priced in until June.

***"Our current thinking is that QE becomes an option to be considered at a cash rate of 0.25 per cent, but not before that." Philip Lowe, RBA Governor, 26/11/2019***

Whilst the equity market has performed admirably this year, the local economy ended the year on a sluggish note.




Source: CBA



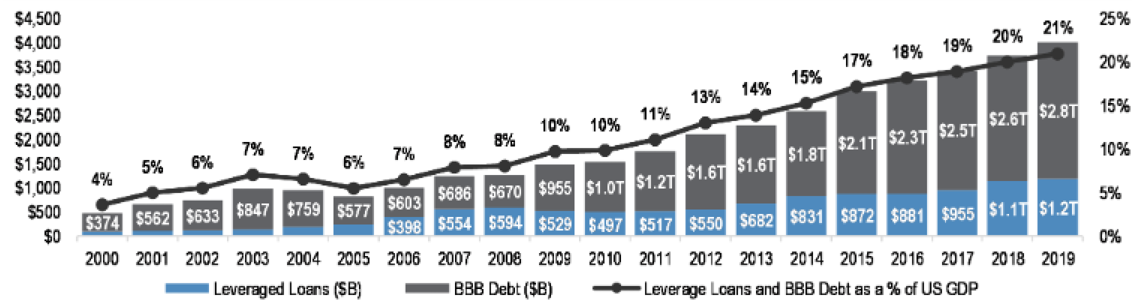

Source: The Daily Shot

***"The RBA's "gentle turning point" for the economy remains elusive. And the weakness in private spending evident in the Q3 GDP data looks to have continued in Q4, with a flow on to labour demand as well. There were also some early indications that the disruptions associated with the terrible bushfires around Sydney and elsewhere are having some impact." Michael Blythe, Chief Economist at CBA, 16/12/2019.***

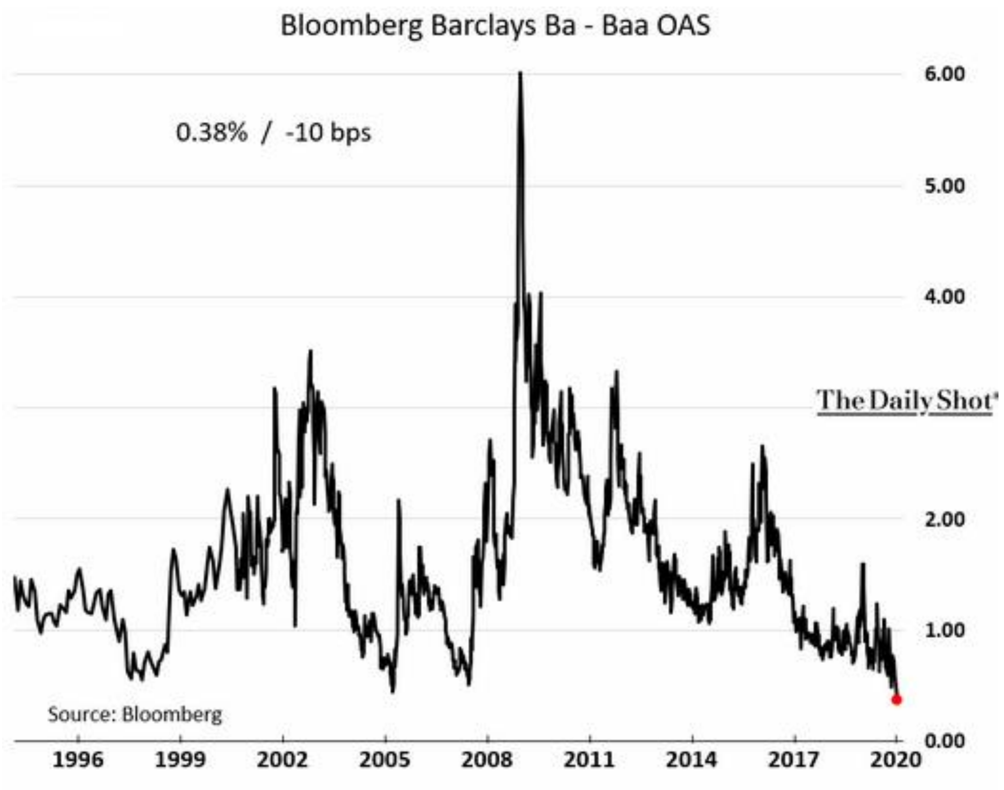
Elsewhere, the US markets continued to make fresh all-time highs despite continued volatility in the geopolitical landscape, which in December featured the Impeachment of President Trump. Meanwhile, the US high credit market expansion continues unabated, with Leveraged Loans and BBB Corporate Bonds as a percentage of US Gross Domestic Product (GDP) climbing to 21% in 2019. Leveraged Loans are now USD$1.2tn, which compares to USD$1.3tn in subprime mortgage loans at their peak. The US corporate BB - BBB spread (the divide between investment grade and high yield) is also the tightest in history.

*"If you look at the credit markets, it's very obvious you've got a lot of bad apples out there that are not being exposed because the interest costs are so low." Stanley Druckenmiller, founder of Duquesne Capital, 19/12/2019*

**Figure 1: Leveraged Loans and BBB-Rated Corporate Bonds as a % of GDP, 2000 – 2019**




Source: JP Morgan




Source: The Daily Shot

*"China is not our problem, the Federal Reserve is! We will win anyway." Donald Trump, President of the United States of America, 30/10/2019*

Locally, financial stocks struggled during the quarter after the Australian Transaction Reports and Analysis Centre (AUSTRAC) applied to the Federal Court for civil penalty orders against Westpac relating to over 23 million breaches of the anti-money laundering code, with each breaking carrying with it a potential fine of up to $21m. Healthcare was the best performing sector over both the quarter and the year. CSL, which constitutes over 60% of the Healthcare index added a remarkable $45bn in market capitalisation in 2019.

| | QUARTER | YEAR |
|---|---|---|
| ASX200 Accumulation Index | 0.7% | 23.4% |
| | | |
| **Best Performing Sectors** | | |
| Healthcare | 14.0% | 43.5% |
| Energy | 6.4% | 22.9% |
| Materials | 4.3% | 27.2% |
| | | |
| **Worst Performing Sectors** | | |
| Financials Ex-Prop Trust | -6.4% | 13.5% |
| Consumer Staples | -2.7% | 21.0% |
| Prop Trusts | -1.0% | 19.4% |

Source: IRESS

## The A2 Milk Company

We last wrote about the A2 Milk Company (A2M) in our March 2018 quarterly report in which we outlined the reasons why we had reduced the size of our position in A2M across the portfolios at around $12 per share.  We took this action at the time due to the strong share price run post the first half financial year 2018 (1H18) financial results (where in our view the share price was subsequently factoring in a more realistic range of future outcomes) at the same time as we were becoming nervous about the impending CEO transition from Geoff Babidge (the long-serving CEO and architect for much of A2M's success) to Jayne Hrdlicka (an external hire and unproven as a public company CEO). We sold out of the stock completely in late 2018 after Hrdlicka sold a material potion of the shares she was granted upon being appointed as CEO. We had held a view based on extensive channel research that the Board has erred in the appointment of Hrdlicka and the magnitude of the remuneration package offered to her, and this share sale event crystallised our view. Our Shareholder Stewardship rating on the stock was substantially reduced and we removed the stock from the portfolios.

*"There is a balance of investment which we agree with as well as managing the profitability of the business. As a board, we are committed to targeting a 30 per cent net margin." David Hearn, Chairman of A2 Milk, 10/12/2019*

Given our long held positive view on the strong competitive position of the company and its future growth opportunities, we continued to engage with the company and research the industry through 2019. We became more comfortable with the leadership and strategy of Hrdlicka and our Shareholder Stewardship rating recovered somewhat (but still well below the levels when Babidge was CEO). However, we believed the market was being too optimistic on future margin expansion potential (despite management trying to temper expectations) and we remained on the sidelines as the stock ran hard from below $13 into the 1H19 result in February to over $17 into the financial year (FY19) result in August.

An opportunity to again establish a position in the stock presented following the FY19 results in August and the inaugural Investor Day in Shanghai in September, after which the share price fell from $16 down towards $12 on a resetting of margin expectations. Post the Investor Day we believed that the market was becoming too bearish on margins (consensus was forecasting earnings before interest, tax, depreciation and amortisation (EBITDA) margins in the mid-to-high 20% range over the medium-term vs. our belief the business could deliver ~30% EBITDA margins given its pricing power) and too bearish on short-term revenue delivery (our channel research had indicated that they were on track to deliver at or above market expectations for 1H20). As such, we were able to establish a meaningful position in the stock at around $12 before the AGM trading update in November, albeit a smaller position then we would have historically held in the stock given the lingering Shareholder Stewardship issues. At the AGM update, A2M delivered a revenue ahead of market expectations and upgraded margins for FY20 which saw the stock recover back to over $14. Importantly, the Board also outlined a new remuneration structure for the CEO which was more aligned with favourable shareholder outcomes and helped to lift our Shareholder Stewardship rating again.

In a surprise move in early December, the Board reinstalled Babidge as interim CEO after Hrdlicka agreed to step down as CEO. Whilst strong on strategy, we believe Hrdlicka lacked some of the operational and soft skills required to fully execute. We also believe that Hrdlicka didn't have the right balance between growth and investment (as evidenced in the company's uplift in medium-term margin expectations accompanying the announcement). Given his skillset and experience with the company (and its people and culture), we believe that Babidge is the perfect choice to steer the company through this next period until a permanent CEO is found. Our Shareholder Stewardship rating has been restored to its former levels and we have continued to increase the size of the A2M position across the Greencape portfolios. In our view, A2M continues to be an outstanding business with differentiated products and a strong brand (which exhibits pricing power), a unique culture, a long growth runway, a strongly growing China-direct business, long-term value optionality, exceptional free cash flow generation and a very strong net cash balance sheet.

## Offshore Trips

This quarter we travelled to the US on three occasions and the UK twice, in addition to trips to Continental Europe and New Zealand.

### US observations

- We continued to be surprised with how popular President Trump is on the ground in the US, particularly outside California and New York. Expectations were also low regarding the prospects of the current line-up of candidates gunning for the Democratic nomination.

- We spoke with a range of manufacturing contacts in the US, and the consensus view appeared that a recession is due for no better reason that the current cycle has run longer than any other. The risk therefore is a slowdown or recession becomes a self-fulfilling prophecy. This degree of cautiousness extended to consumer behaviour, which we observed as patchy at best.

- The casualisation of America continues in earnest, with most contacts we met with not wearing a suit or formal business attire (a trend slowly infiltrating the offices of Australia). This trend has been a boon for athleisure over the recent times, however there was a consensus that 'peak athleisure' has been reached which suggests denim could recoup some lost share.

- The maniacal focus from companies to provide free and fast delivery may be misguided. Whilst Amazon has conditioned shoppers to expect free two-day delivery, testing from a major omnichannel retailer we met with noted this approach risks over servicing the shopper which sees retailers give up margin unnecessarily. A more effective approach is properly incentivising the customer to delay their shipping, which in this retailer's case is funded by the supplier.

- We spent a day touring food and liquor retailer outlets in the mid-west of the US. A noticeable difference we observed was the prevalence of in-store dining in higher end supermarkets, which when executed properly significantly increases dwell time and spend (albeit with an added degree of difficulty). We are sceptical on whether this will permeate local supermarkets to the same extent, however we did observe with interest the recent launch of Coles 'grocerant' concept in their Tooronga store, which offers ready to eat food offerings through third party providers on site.

***"The Greatest Economy in American History!" Donald Trump, President of the United States of America, 30/10/2019***


Whole Foods, Chicago. The ready to eat food offers included pre-made salads, pasta, and proteins. This was in addition to Poke, Pizza, Mexican, Chinese and sandwich stations where the food was made to order. To increase dwell time further, the supermarket also featured a bar serving wine and draught beers – grocery shopping is clearly thirsty work for some!


Binny’s, Chicago. Whilst beer consumption is in slight decline both in Australia and the US, a clear premiumisation trend has been taking place towards higher value craft beer. At this big box liquor retailer we visited, domestic craft beer had a dedicated six aisles which were organised by region. Whilst penetration of craft beer in Australia has been slower to manifest (partly as a function of our mainstream beer being of higher quality relative to the US), we forecast craft beer continuing to take share and expect it to be an increasingly larger focus for our local liquor retailers in the future.

## Outlook

We acknowledge the strong market performance over the last 12 months, however note that it has been driven largely by a multiple re-rating rather than earnings growth. Our cautious stance with higher than usual cash levels proved costly, however pleasingly this was offset by stock selection with a bias towards solid management teams allocating capital to add value. Looking forward, we are not tempted to reduce our level of caution. The tragic and very early bushfire season is expected to weigh on consumer sentiment domestically in the short term, which comes at a time when domestic demand was already patchy and somewhat fragile. Offshore, we observe more of the same. Europe remains flat and resilient, China keeps growing albeit at a slower rate (which appears manageable) and the US maintains its moderate momentum.

We are monitoring several key macro developments offshore. In line with the market, we expect positive developments on trade talks between the US and China leading up to the US election, which will likely boost sentiment regardless if the resolutions are more symbolic in nature than anything else. Another key situation we are keeping an eye on is the Middle East tensions between US and Iran, which as we write are already driving oil and gold prices higher.

We do not expect lower interest rates to drive a further multiple re-rate in the market. We maintain our discipline in stock selection and still consider liquidity undervalued and given copious levels of cheap funding available, consider effective management undervalued also.

***"Stimulus may be somewhere between unneeded and counterproductive at times like today, when the economy is growing acceptably, the unemployment rate is at a 50-year low, wages are rising, and the recovery has just become the longest in history." Howard Marks, Chairman of Oaktree Capital, 26/07/2019***

## More information

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

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