Greencape High Conviction Fund

Quarterly report - March 2020

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Inception % p.a.
Fund return	-20.89	-8.88	2.70	3.31	6.32	7.81
Growth return	-20.90	-14.37	-4.93	-4.85	-0.07	1.33
Distribution return	0.01	5.49	7.63	8.16	6.39	6.48
S&P/ASX 200 Accumulation Index	-23.10	-14.42	-0.56	1.39	4.92	4.56
Active return^	2.21	5.54	3.26	1.92	1.39	3.25

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

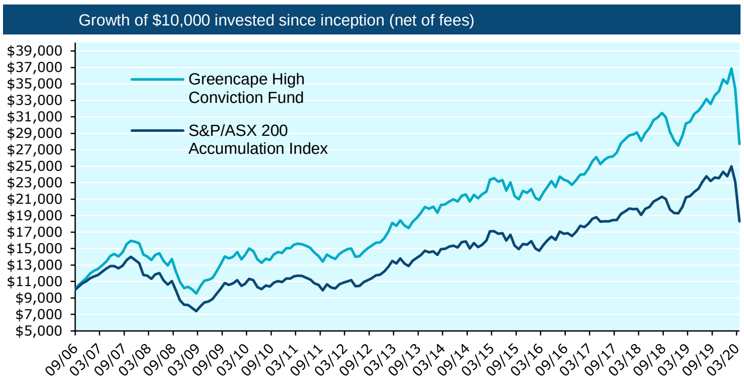
Greencape is an active, 'bottom-up' stock picker. Whilst Greencape does not target any specific investment style and will invest in stocks displaying 'value' and 'growth' characteristics, its focus on a company's qualitative attributes will generally lead to 'growth' oriented portfolios. This is an outcome 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



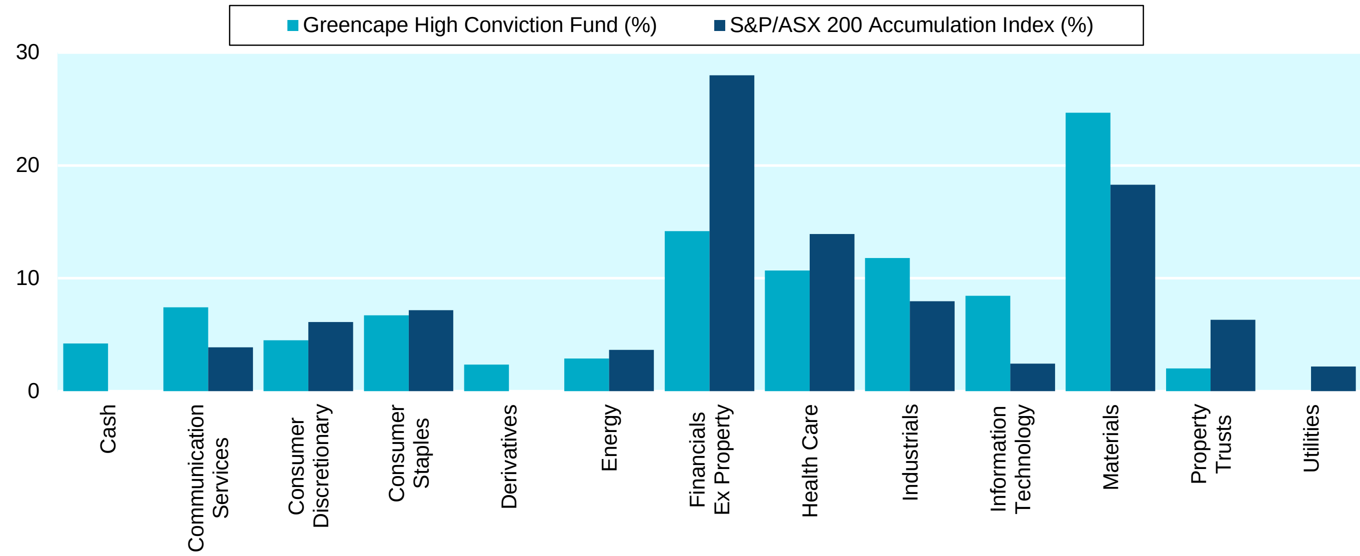
Asset allocation	Actual %	Range %
Security	95.76	85-100
Cash	4.24	0-15

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%

Data Source: Fidante Partners Limited, 31 March 2020.

Sector exposure as at 31 March 2020



Data Source: Fidante Partners Limited, 31 March 2020.

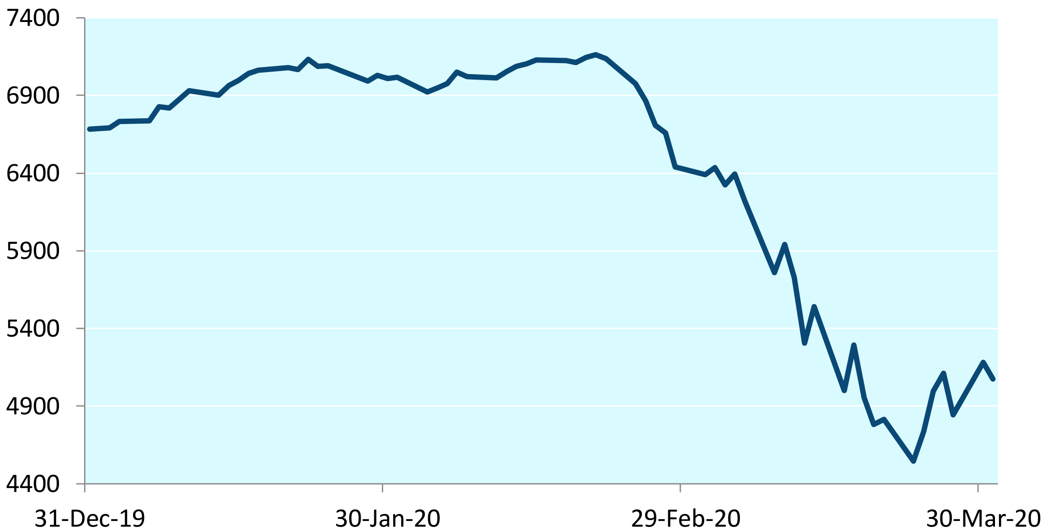
Fund performance summary

The S&P/ASX 200 Accumulation Index returned -23.10% for the quarter. The fund outperformed the market and delivered a -20.89% return over the quarter.

Market overview

The old adage of the market going up by the escalator and down by the elevator rang true in the first quarter, with the local index recording its worst quarterly performance since 1987, despite reaching an all-time high in February. Investors watched with horror as a complacent market was dealt a savage blow by COVID-19, with central banks subsequently launching coordinated and unprecedented stimulus measures in a desperate attempt to stem the economic fallout from what began as an isolated health issue in China.

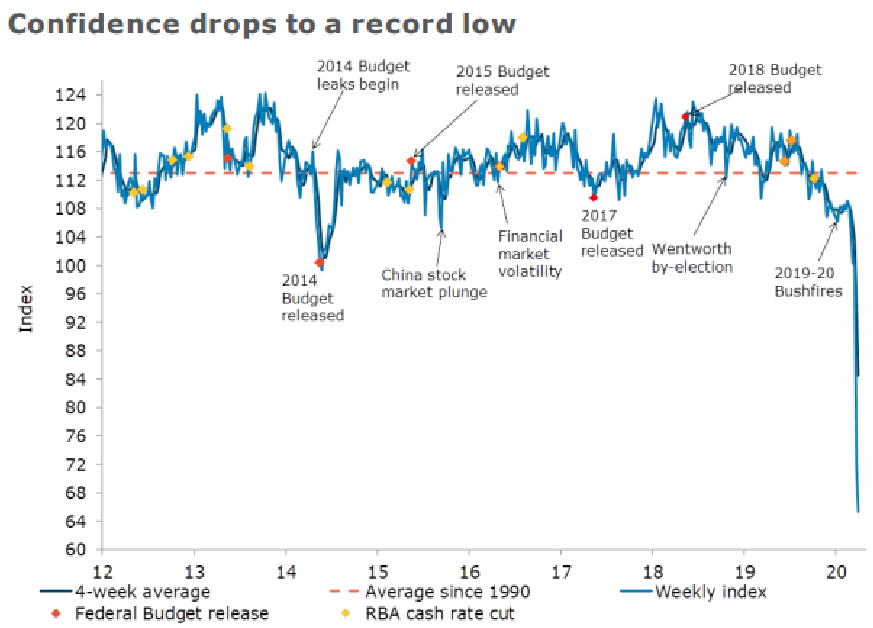
S&P/ASX 200 Index



Source: IRESS

The RBA cut the cash rate twice during March (including an out of cycle emergency cut) to a fresh record low of 0.25%, which is the previously announced floor. Whilst Quantitative Easing (QE) was discussed by the RBA last year, COVID-19 forced the central bank to fire its stimulus bullets earlier than anticipated. Following the emergency cut, the bank announced it would also target a yield of 0.25% on 3-year government bonds which would be achieved through buying in the secondary market. The monetary policy response whilst immense was eclipsed shortly after by the Federal Government's bazooka fiscal response to the crisis. The largest initiative was the $130bn Jobkeeper package, whereby 6 million workers impacted by the crisis could access a fortnightly payment of $1,500 through their employer.

Australian Consumer Confidence fell steeply to a record low in March.

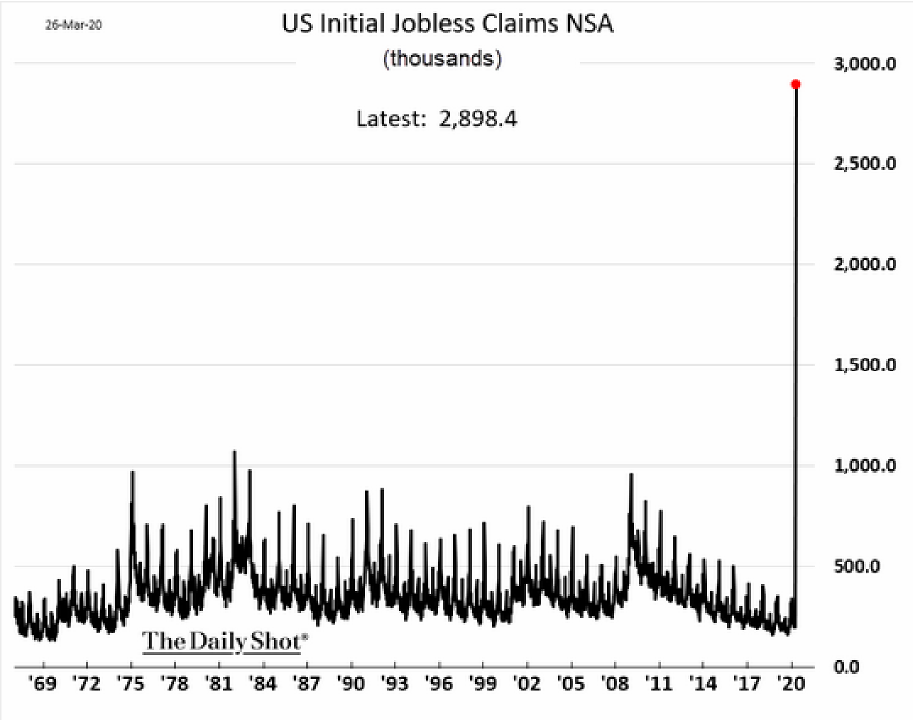


Source: ANZ

"The Treasury can make up for people's lost wages, but people need the things wages buy. So replacing lost wages and revenues will not be enough for long: the economy has to produce goods and services." Howard Marks, Chairman of Oaktree Capital, 31/03/2020

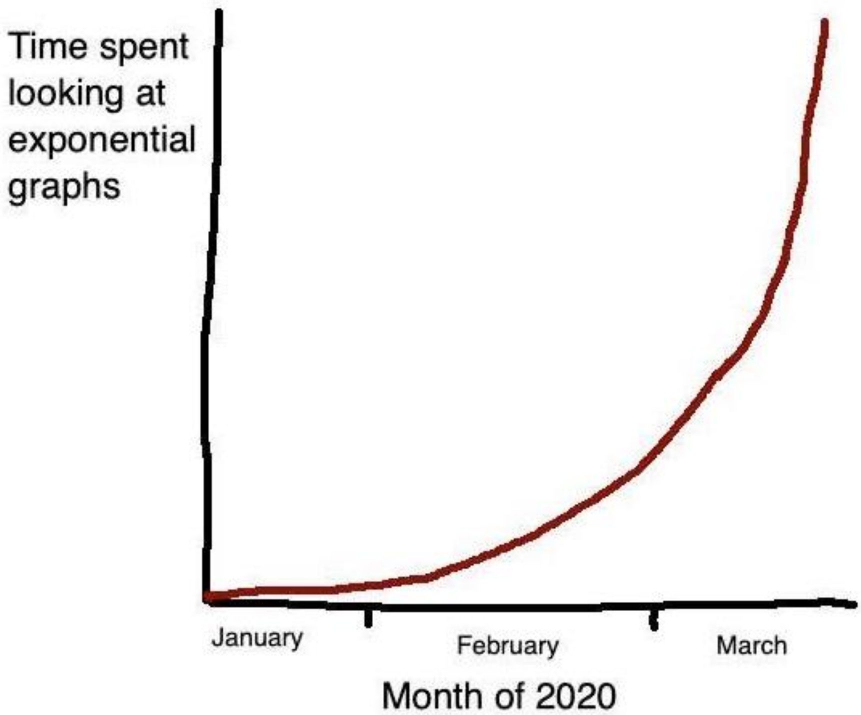
Despite President Trump dismissing the threat of the virus in January, at the time of writing the country now holds the record for the most infections with more than double the second largest country, Spain. The state of New York alone with 130,000 infections would be the fourth most infected country if it was split out, just behind Spain and Italy. The US fiscal response has been huge, with the largest measure costed at 2 Trillion USD, which includes $425bn worth of loans for business and $300bn in cash payments to individuals.

Despite these interim measures, the scale of Americans filing for unemployment benefits was staggering.



Source: The Daily Shot

In the past month we have witnessed unprecedented use of the word 'unprecedented'. In a similar vein, the chart below appears accurate.



Source: Unknown

"Already you are looking at this crisis on top of what was very clear rising discontent around the world. This makes the most vulnerable hit the hardest and you are going to see a lot of very serious tensions, social tensions, political tensions." Angel Gurría, Secretary General of the OECD, 31/03/2020

A total of 135 companies on the ASX withdrew earnings guidance during the period, with many also either deferring or alternatively cancelling their dividends. Balance sheets are now receiving a laser focus from the market, as equity investors suddenly find themselves cast in the role of credit analysts. To assist company efforts to repair balance sheets, the ASX lifted placement capacity to 25 per cent of shares on issue from 15 per cent and also removed the cap on non-renounceable rights issues.

	QUARTER	YEAR
ASX200 Accumulation Index	-23.1%	-14.4%
Best Performing Sectors		
Healthcare	2.1%	37.8%
Consumer Staples	-3.1%	11.4%
Utilities	-9.1%	-5.3%
Worst Performing Sectors		
Energy	-47.9%	-44.5%
Property Trusts	-34.4%	-31.7%
Consumer Discretionary	-29.1%	-16.6%

Source: IRESS

The Sector performance on the Australian bourse was widely variable, with the market discerning between those which stand to benefit or are relatively insulated from the impact of the virus, versus the sectors which stand to suffer supply and/or demand shocks. Healthcare was the only sector to post a positive absolute return, with the best performing stock within the sector Fisher & Paykel Healthcare issuing an earnings upgrade in March on the back of strong demand for respiratory humidifiers and consumables, along with favourable currency movements. Consumer Staples, particularly Supermarkets, also benefitted from the well-publicised panic buying with Toilet Paper acting as the canary in the coal mine for shoppers.

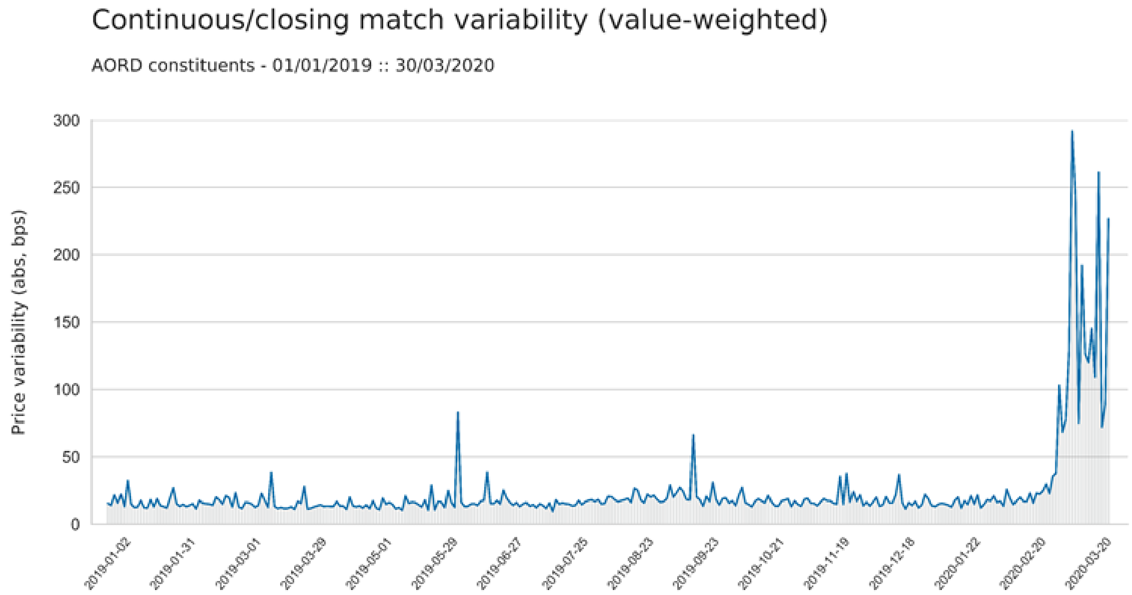
Energy was by the far the worst performing sector during the period. Already suffering under the weight from a demand shock from the world’s biggest importer of oil (China), the oil price fell off a cliff in March after OPEC+ could not agree on a 1 million barrel per day cut to production. As a result of the non-agreement, Saudi Arabia went the nuclear option of flooding the market in an effort to force the other members (particularly Russia) back to the negotiating table. With oil demand forecast to decline year over year for the first time since 2009, a supply glut has now compounded the price decline.

COVID-19 and the function of the market

There is no shortage of opinion in the market on both the health and economic impact of COVID19. Whilst we offer no proprietary insight on the health aspect of the virus, we nonetheless have found ourselves forced to grapple with the economic implications of a situation with a lack of truly comparable precedents. Granted whilst pandemics have occurred in the past, the global economy is now far more inextricably interconnected, with the frequency of air and sea travel meaning a virus has the ability to become significantly more pervasive in a shorter period of time relative to past outbreaks.

When the issue first came within the purview of the market in late January, COVID19 was largely thought to be considered a Chinese issue, with the impact to western economies centred around a short-term supply shock, and at worst also a temporary hit in demand for Western companies which served that market. This complacency was smashed with a sledgehammer in early March when the virus spread beyond Chinese borders and it became evident the demand shock was far greater than initially anticipated.

Similar to the novel invention of 'Portfolio Insurance' which exacerbated the 1987 crash, the proliferation of ETFs and quantitative strategies magnified the intraday volatility in the market, with massive price swings becoming the norm during March. On March 13th (a Friday no less), the market experienced its largest intraday swing recovering from the low of -8% to close +5%.

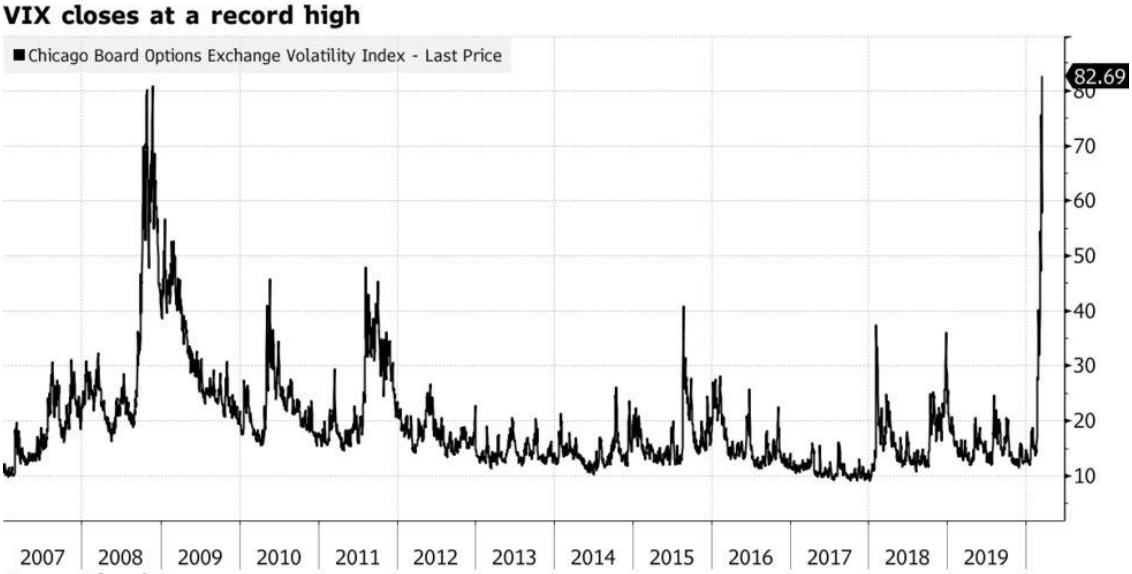


Source: Macquarie

Whilst no definitive news flow could explain the move, a number of market sources pointed to 'risk parity strategy' (RPS) rebalancing as the culprit. The aim of RPS is to produce equity-like returns while providing a risk profile closer to that of fixed income securities. At risk of over simplifying the strategy, essentially when the volatility of either bonds or equities relative to one another shifts, these strategies will need to buy or sell equities or bonds in large volumes to rebalance the portfolio to the new risk adjusted paradigm. As the volatility index (VIX) traded at an all-time high, and the MOVE Bond volatility traded an at 11-year high, the requisite rebalancing flows triggered unprecedented moves in both asset classes.

Peak Fear

VIX closes at a record high



Source: Bloomberg

"We have it totally under control. It's one person coming in from China, and we have it under control. It's going to be just fine." Donald Trump, President of the United States of America, 22/01/2020

"It's going to disappear. One day, it's like a miracle, it will disappear." Donald Trump, President of the United States of America, 28/02/2020

"I felt it was a pandemic long before it was called a pandemic." Donald Trump, President of the United States of America, 17/03/2020

Whilst it would be easy to bemoan the influence of these strategies on asset prices, we have found that the violent swings in volatility in meaningful volumes offer up incredible opportunities for the fundamental investor. After all, it's unlikely the intrinsic value of a stock can change by as much as the intraday share price swings would suggest. Stay alert!

Orora

Orora (ASX:ORA) is a packaging company with operations in both ANZ and North America. The company was originally Amcor's (ASX:AMC) Australasian and Packaging Distribution division before being spun out as a standalone company in 2013.

The ANZ business consists of the manufacturing of cans and glass packaging for beverage end markets. The canning division operates six plants across Australia and NZ, producing a range of aluminium cans and can ends for alcohol and CSD (Carbonated Soft Drinks). This division enjoys a strong market position with Orora occupying over 60% share of the Australian market. The four major customers are split between Orora and Visy, with Orora supplying to Coca-Cola and CUB and Visy supplying to Cadbury Schweppes and Lion. These contracts are typically long term and sticky in nature. Demand trends have been evolving in Beverage cans, with mainstream beer volumes in decline due to lower consumption, offset by a switch from bottles to cans and the emergence of craft beer. Craft beer is typically packaged in cans given the larger printing surface relative to bottles, with product image incredibly important in a category which is difficult to navigate for consumers. Craft cans are a higher margin product for Orora given shorter production runs relative to volume beer or CSD.

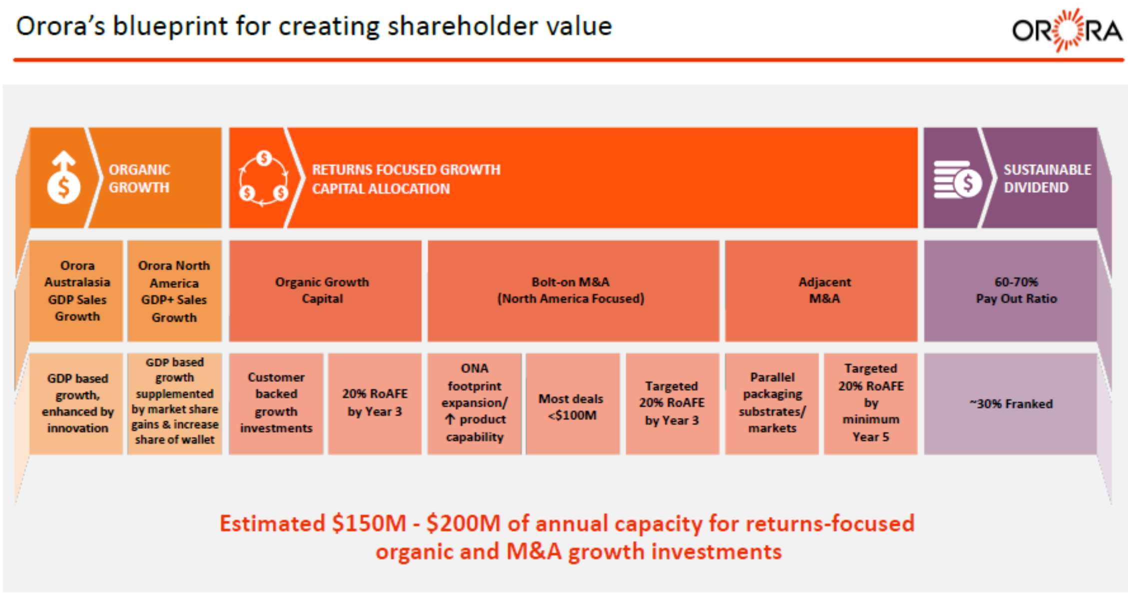
"Orora is fortunate to be on the right side of trends in sustainable packaging, particularly in Australasia, and we believe we will continue to benefit from this as customers switch to sustainable glass and aluminum substrates." Brian Lowe, CEO of Orora, 12/02/2020

The glass business was originally formulated to produce wine bottles but has since expanded to also produce bottles for the beer market. The division is based in South Australia (hence the wine skew) and is a three furnace operation. The wine bottle market is currently a duopoly between Orora and Owens Illinois (O-I), whilst O-I dominates the volume beer market with Orora holding a <10% share. Wine bottle demand is largely dictated by the export market, as Australia exports the majority of its wine production. The export market has been weak over the past 12 months, declining by 12% in 2019 which has impacted Orora's volume output. Orora also operates a small closures business which produces wine capsules.

Orora's North American businesses do no enjoy the same competitive position as the ANZ operations. The business comprises of two divisions, Orora Packaging Solutions (OPS) and Orora Visual (OV). OPS provides 'on-demand' fibre packaging manufacturing and distribution services across a national supply chain with 16 manufacturing plants and 62 distribution centres. Whilst formerly being held by the market in high regard as a division where Orora could deploy capital at attractive rates of return to take share in a fragmented market both organically and via M&A, a number of missteps in the OPS business has seen the market lose patience with the business. Whilst some of these issues were self-inflicted (SAP implementation), the division also suffered from a downturn in US manufacturing, particularly in California. OV provides Point of Purchase retail displays/signage and visual communication products to the retail sector. It is an amalgamation of 4 acquisitions merged under the single Orora Visual banner. Similar to OPS, the business has suffered from a number of self-inflicted and market headwinds.

In October, Orora announced the sale of its Australasian Fibre Packaging (AFP) business to Nippon Paper following an unsolicited approach. We view the sale price of $1.72bn as highly attractive at 11.5x FY19 earnings before interest, tax, depreciation and amortisation (EBITDA). The divestment is accretive from a return on capital perspective, with AFP earning an EBIT margin of mid-single digits compared to Beverage packaging which earns a margin of over 20%. Following Foreign Investment Review Board (FIRB) and Australian Competition and Consumer Commission (ACCC) approval, the company intends to return over $1bn to shareholders through a yet to be determined combination of a cash return (comprising part capital return and a partially franked special dividend) and an on-market share buyback.

Orora post AFP divestment will be comprised of two disparate business. One being Beverage Packaging in Australia which holds privileged assets operating in stable market duopolies, and the North American businesses which operates in a more challenged environment. Whilst the impact of COVID-19 is yet to be determined on the business, at the current share price of $2.50 we see the business on a circa mid-teens multiple in FY21, with the North American business diluting the multiple the market the willing is to pay for the stock. We rate Orora management highly and are backing them to either turn the North American business around or alternatively find another solution, after which time we would expect a material re-rate in the multiple.



Source: Company reports

Outlook

Our high cash weights and cautious stance which we have previously articulated, finally aided relative performance (albeit we never predicted a pandemic would be the cause). The question we are posed with now is timing around the deployment of cash and prioritising our targets. At the moment, information is coming from all directions and the situation remains fluid. We keep reminding ourselves to observe and verify, rather than predict and theorise. Every day we are talking to numerous contacts within various industry supply chains to obtain first hand and relevant information of what's happening on the ground.

With the COVD-19 crises, it's interesting to observe which data points are important. We identify government policy is largely targeting hospitalisation rates, so it is this less widely quoted data point that we are tracking particularly closely. However, we do note the market is clearly reacting to new case numbers. As hospitalisation rates clearly lags case numbers, and social isolation policies lag hospitalisation outcomes, we are careful not to get too bullish on the market's reaction to new case rate deceleration.

We are finding that the previous work we have done around shareholder stewardship has become incredibly valuable. The best management teams make the best decisions whether it be raising equity, pivoting to a click and collect or online model, taking advantage of network effects or working with regulators to shape advantageous policy. Another feature of our thinking that we have mentioned previously is liquidity. And indeed, it's volatile times like these when stock stories have the potential to materially change that the value in liquidity is realised.

Our conversations with numerous participants in the real economy suggest the mechanics involved in a recovery phase could represent a handbrake to the speed of a return to normality. We are also contemplating the potential slope of recovery for consumer and industry sentiment, and to what extent the crisis will remain permanently in the psyche, possibly to be borne out by new approaches to spending and the propensity to borrow.

Greencape have been active participants in numerous capital raisings and we have played a role in giving quality management teams confidence in decisively raising capital. As you would expect, we have been very selective with respect to our targets. We favour companies that will be in a position of strength and have an ability to emerge as a better business as assessed by our Business Evaluation framework. With unemployment rapidly rising for the first time in years and huge disruption facing many sectors, it's clear there will be big winners and losers to come out of this, with some businesses facing temporary disruption to emerge stronger due to industry consolidation. Greencape are confident such an environment is conducive to our fundamental active management approach.

"To help us get to the other side we need a bridge. Without that bridge, there will be more damage, some of which will be permanent, to the economy and to people's lives." Philip Lowe, RBA Governor, 19/03/2020

More information

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

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