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Auscap Newsletter

Auscap Long Short Australian Equities Fund

APRIL 2021

AUSCAP ASSET MANAGEMENT

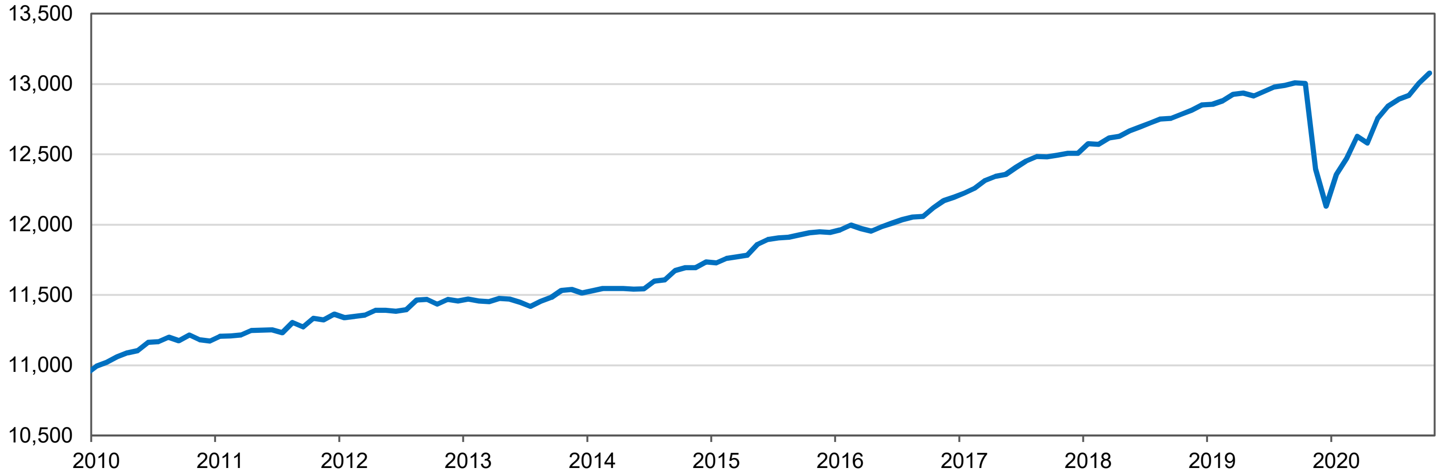
Unexpected Outcomes From COVID-19

Twelve months ago, COVID-19 was wreaking havoc on people's lives, financial markets and the economy. Significant uncertainty weighed on markets, with key questions around the probability of a vaccine, the impact on the economy and the size and duration of the global downturn, the timeline of a return to "normality" and the level and effect of government stimulus yet to be answered. While the health impact of COVID-19 is still severe in various parts of the world, developments in the interim, particularly in relation to the Australian economy, have positively surprised many market commentators and led to a number of unexpected outcomes. In this, the 100th Auscap newsletter, we discuss these developments and how they are shaping our thinking about the outlook for the domestic economy. We then take a closer look at one of the Fund's holdings, furniture retailer Nick Scali, as this quarter's "company in focus".

1. Employment rebound

Ahead of the October 2020 budget, Treasurer Josh Frydenberg pointed to a need for continued fiscal stimulus until the Australian unemployment rate was comfortably below 6%. Six months later, Australia's unemployment rate has already dropped through this level, with March unemployment down to 5.6% and more Australians currently in work than pre-COVID-19.

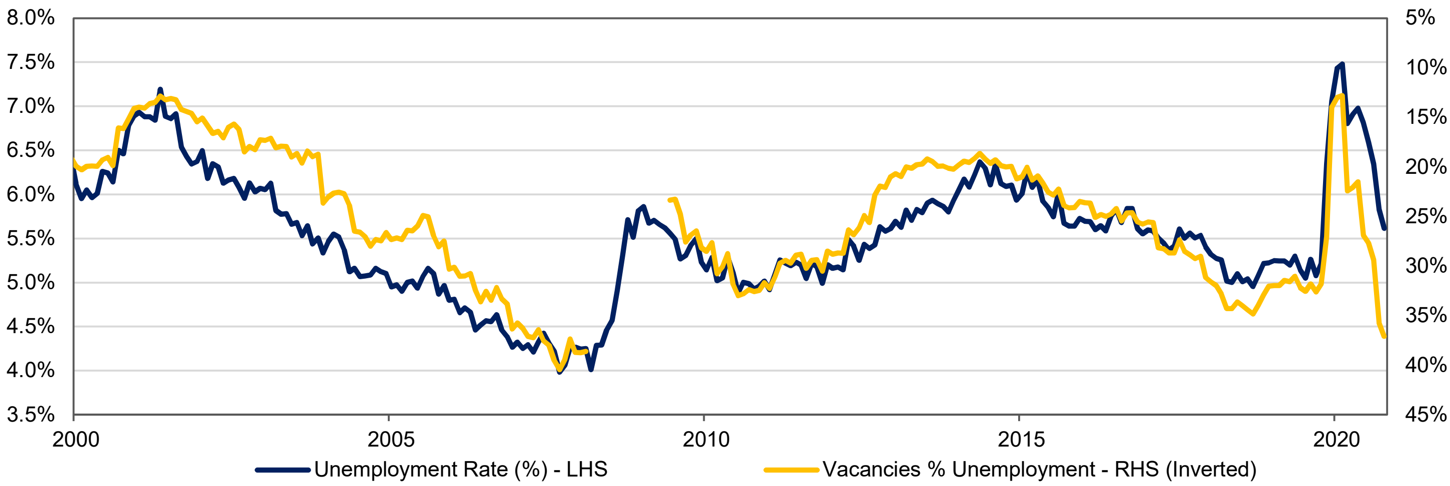
Australian Employed Persons ('000s)



Source: ABS, Auscap

This has been accompanied by an all-time high in Australian job vacancies. As per the below chart, job vacancies are highly correlated with the unemployment rate, with the latest data points suggesting the jobs recovery is likely to continue.

Unemployment and Job Vacancies Percentage of Unemployment

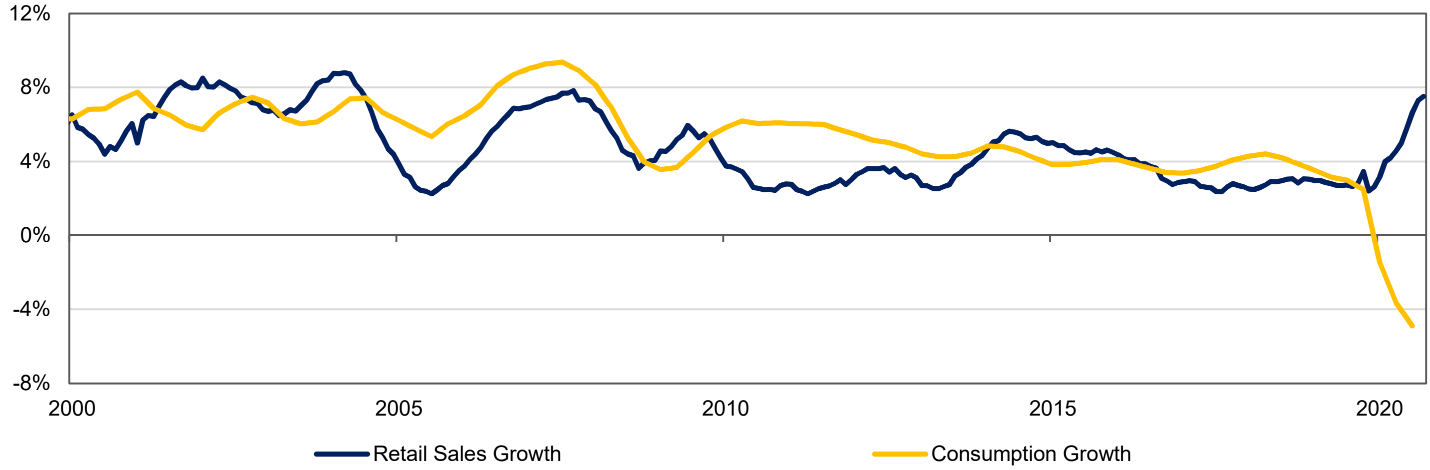


Source: ABS, Auscap

2. A savings boom, not a spending boom

A widely held view is that domestic consumption experienced unprecedented strength in 2020, underpinned by government stimulus and a reallocation of international travel spending. The data suggests that these factors supported retail spending over 2020, however whilst consumption growth in certain categories was strong, total consumption declined the most on record. In fact it is the only period that has seen an absolute decline in year on year aggregate consumption since the Australian Bureau of Statistics (ABS) starting publishing data over 60 years ago.

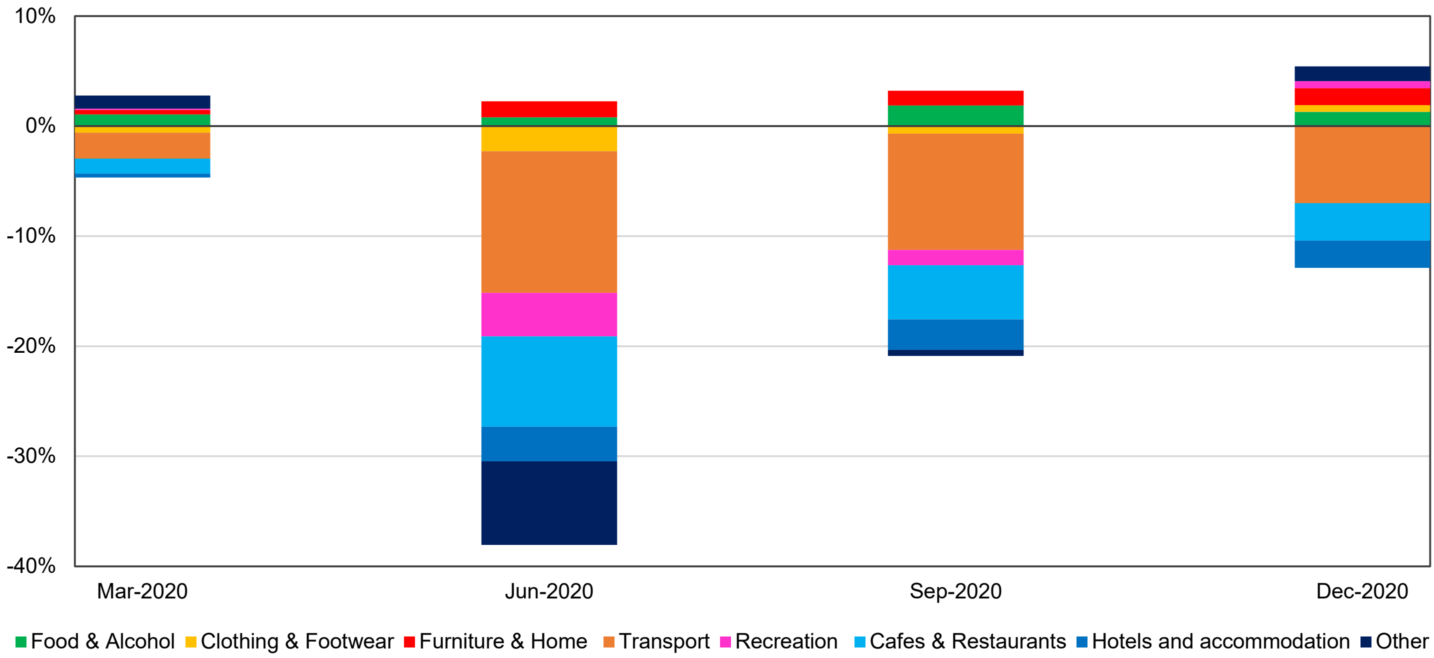
Retail Sales & Consumption Growth



Source: ABS, Auscap

This overall decline was led by huge falls in consumer spending on transportation, cafes, restaurants, hotels and accommodation.

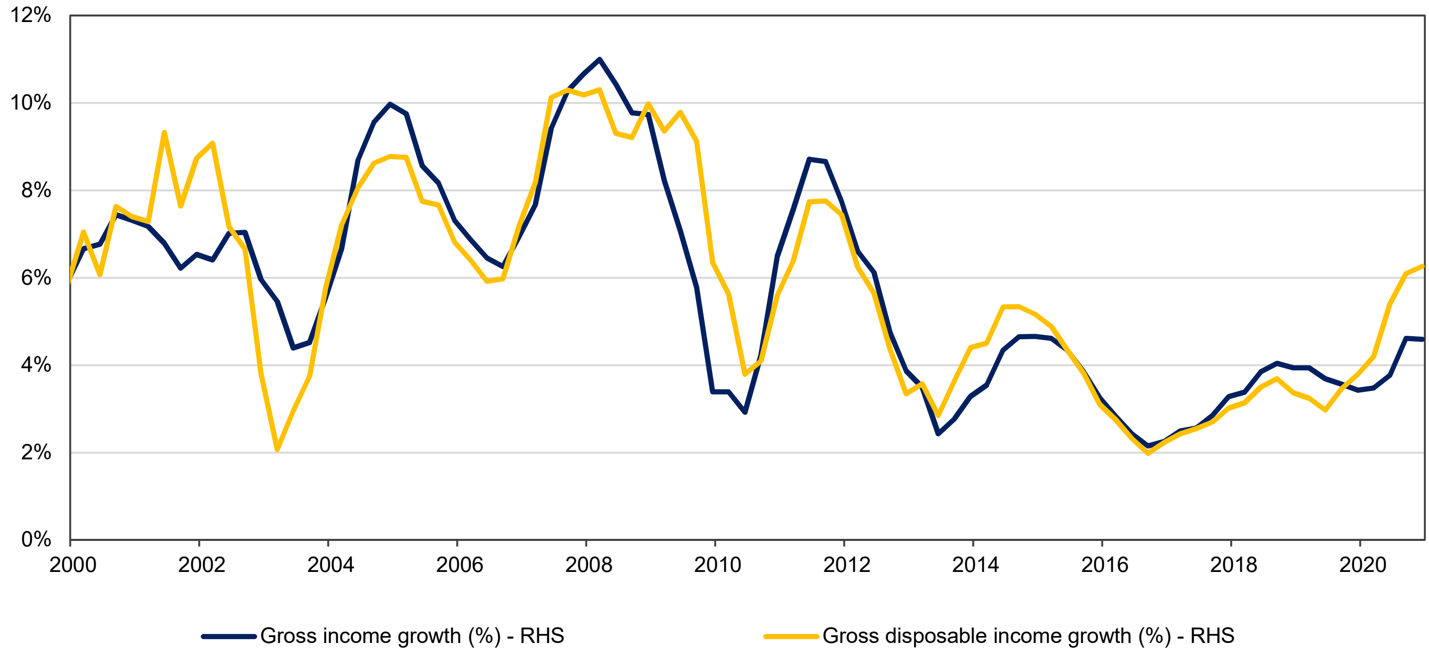
Australian Household Consumption - YoY Change



Source: ABS, Auscap

This reduction in consumption was combined with large increases in household incomes, largely due to government initiatives such as JobKeeper and JobSeeker. Disposable income experienced the fastest growth since 2011.

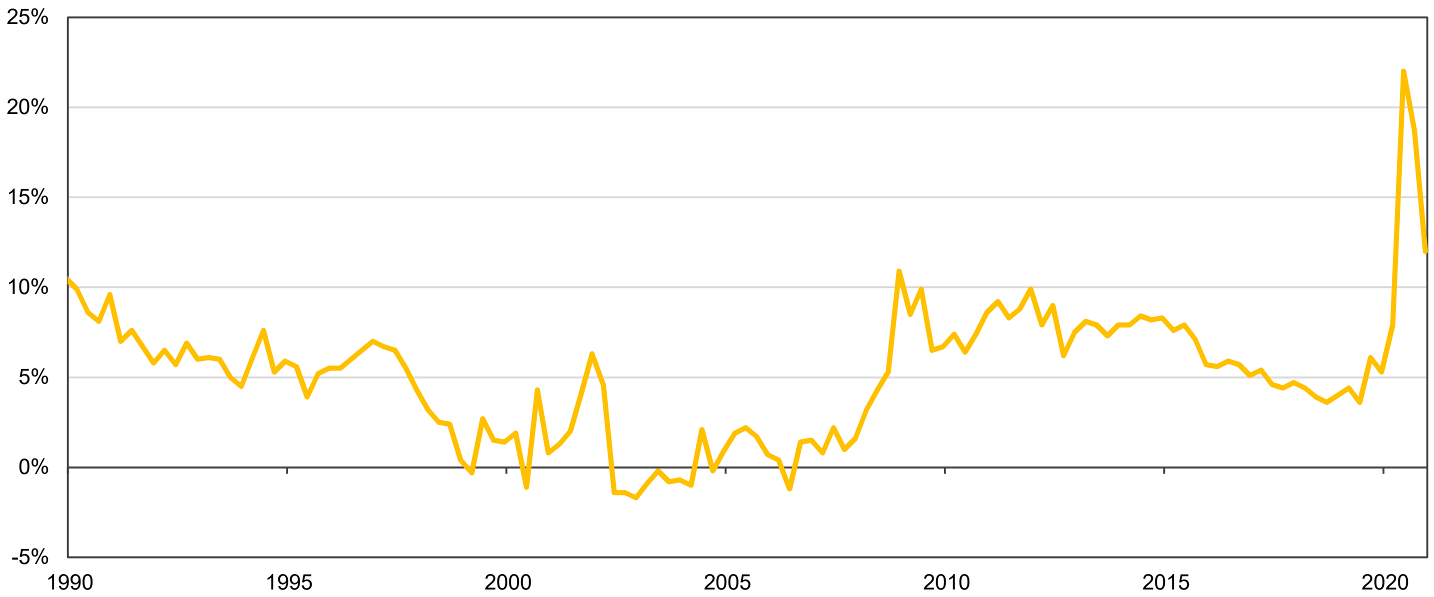
Gross Income Trends



Source: ABS, Auscap

The result was an elevated household savings ratio that peaked at 22%, the highest level since data collection began in 1959, and this is without incorporating the early access to superannuation as a savings measure.

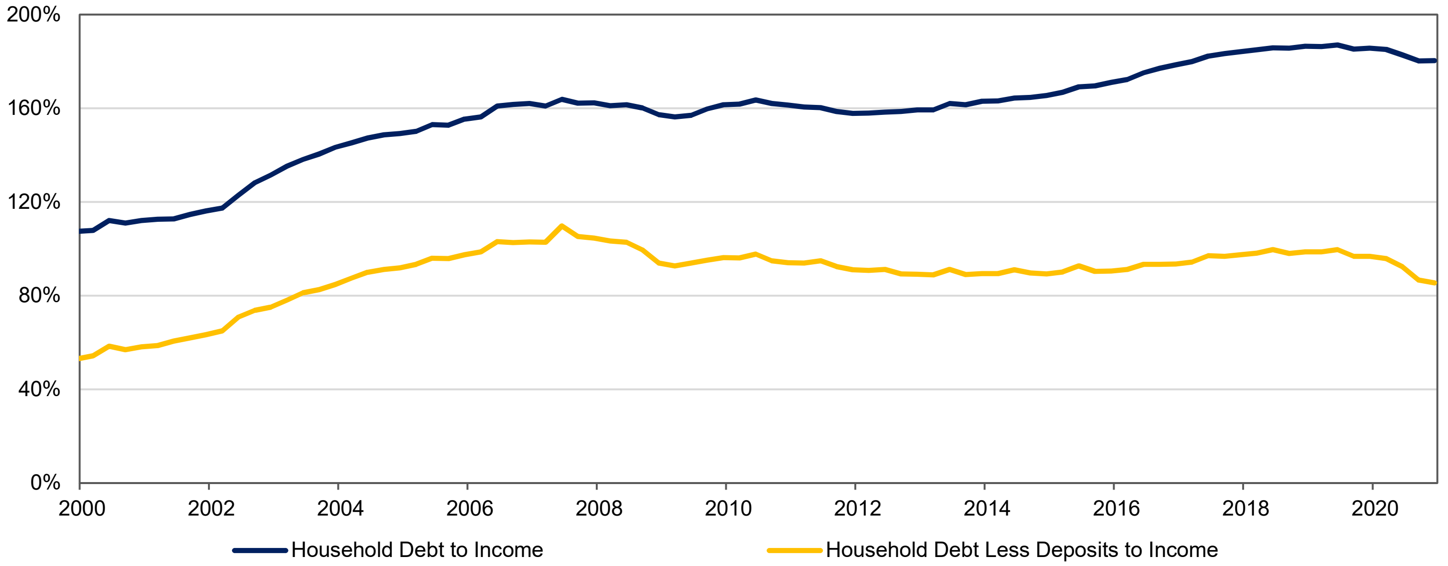
Household Savings Ratio



Source: ABS, RBA, Auscap

Instead of being a "consumption boom", 2020 was representative of a "savings boom", resulting in significant balance sheet repair and potential pent-up demand. Household debt net of deposits, an estimate of net household debt, relative to income has subsequently dropped back to late 2003 levels, at which time the Reserve Bank of Australia (RBA) cash rate was 5.25%.

Household Debt

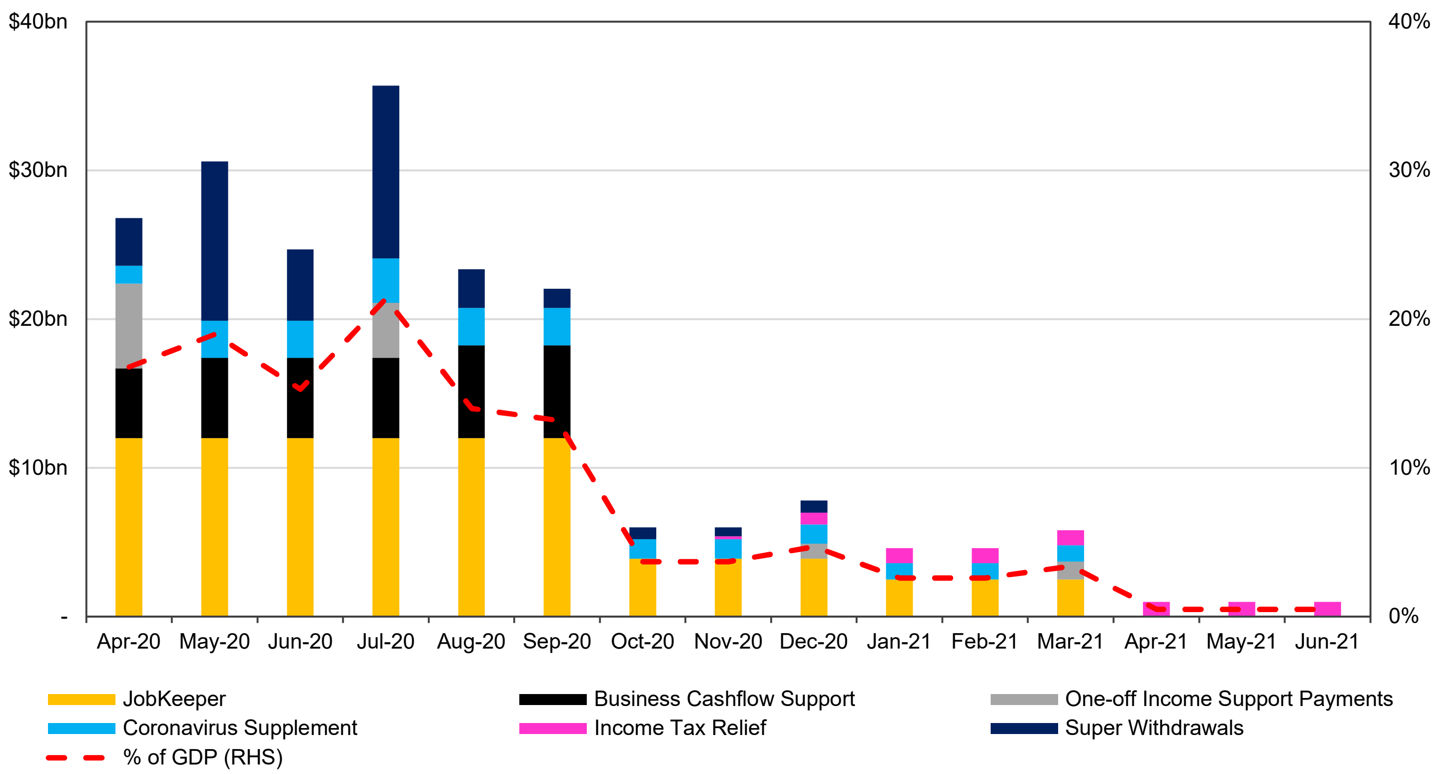


Source: ABS, RBA, Auscap

3. The "Fiscal Cliff" has been navigated

While the above data points are clearly positive, domestic household balance sheet repair was aided by extraordinary levels of support from government, the RBA and the Australian banking system. However, much of this support has already been removed. Macquarie estimates that federal fiscal support peaked at over 20% of GDP in July 2020. As of April 2021, this has dropped to less than 1% of GDP, with the biggest step change occurring between September and October 2020.

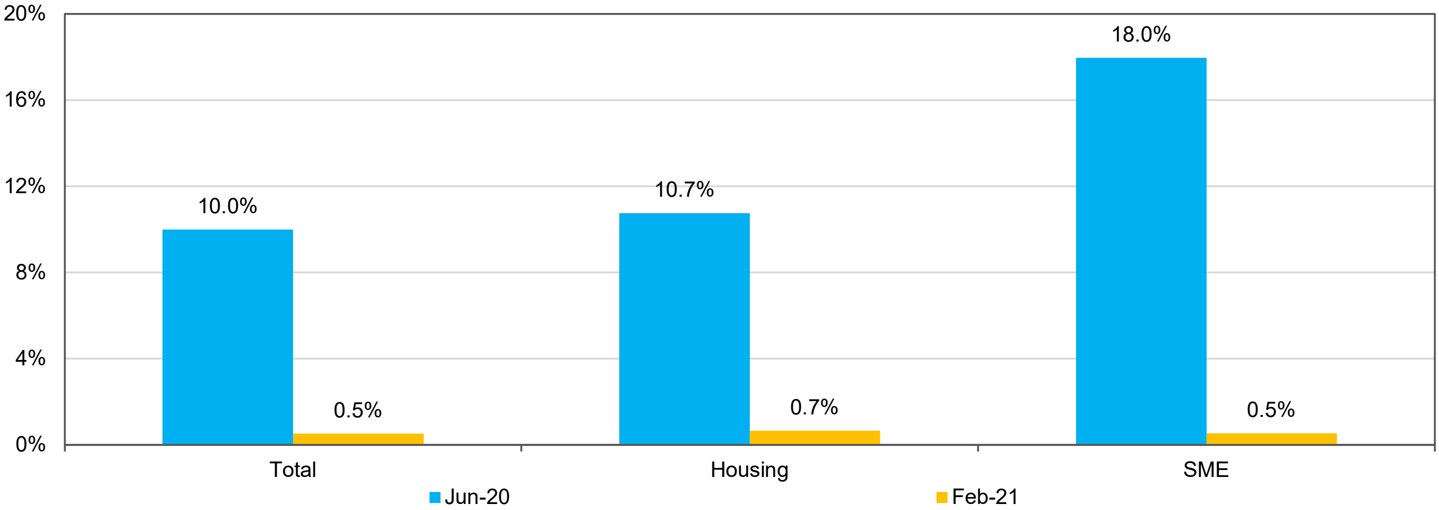
Federal Fiscal Support Measures & Super Withdrawals



Source: Macquarie, Auscap

Similarly, loan deferrals provided by banks have reduced from 10% of Australian loans in June 2020 to 0.5% in February 2021, with the largest drop occurring after the initial blanket six-month loan deferrals were wound back at the end of September 2020. Given the RBA has repeatedly committed to keeping the cash rate unchanged until 2024, the Australian economy appears to have successfully weaned itself off the major stimulus initiatives that were intended to be temporary.

Loan Deferrals % of Loan Book

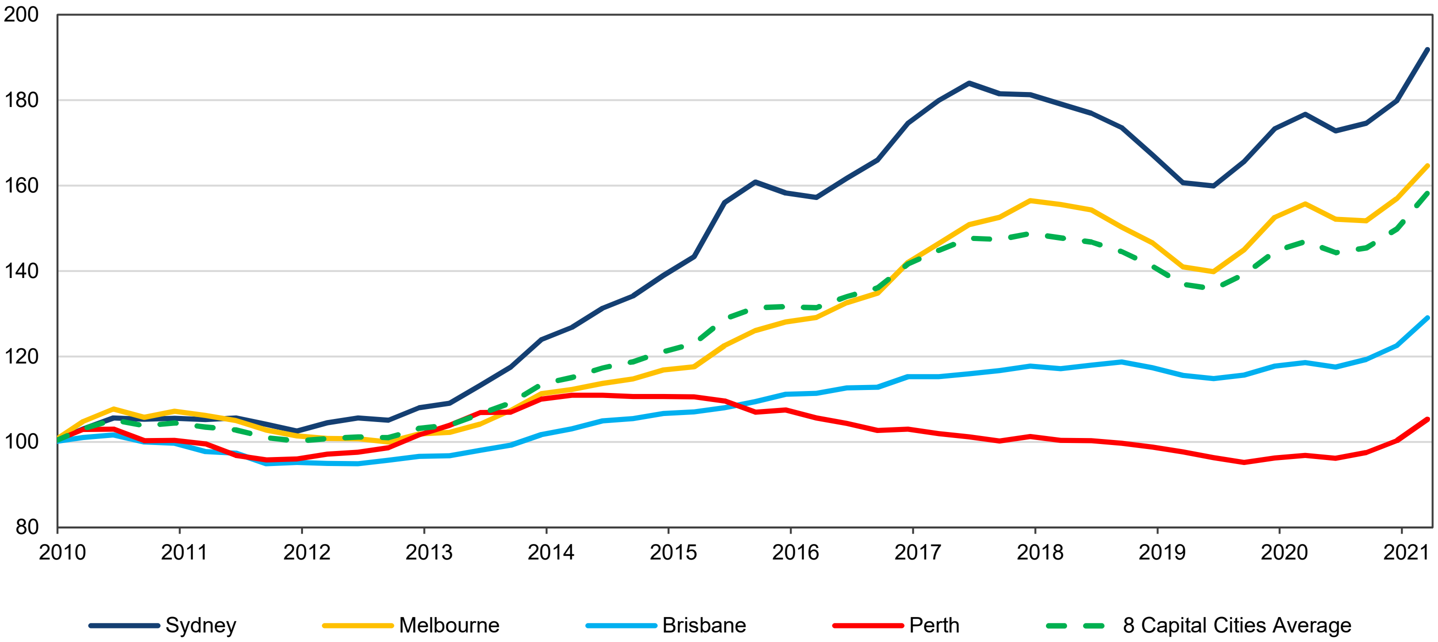


Source: APRA, Auscap

4. Housing prices making new highs

Trends in the Australian housing market are positive, with national property prices now back above pre-COVID levels. It is worth noting the multi-year softening of the housing market in the years prior to COVID-19.

Corelogic Property Index (rebased as at Dec-2009)



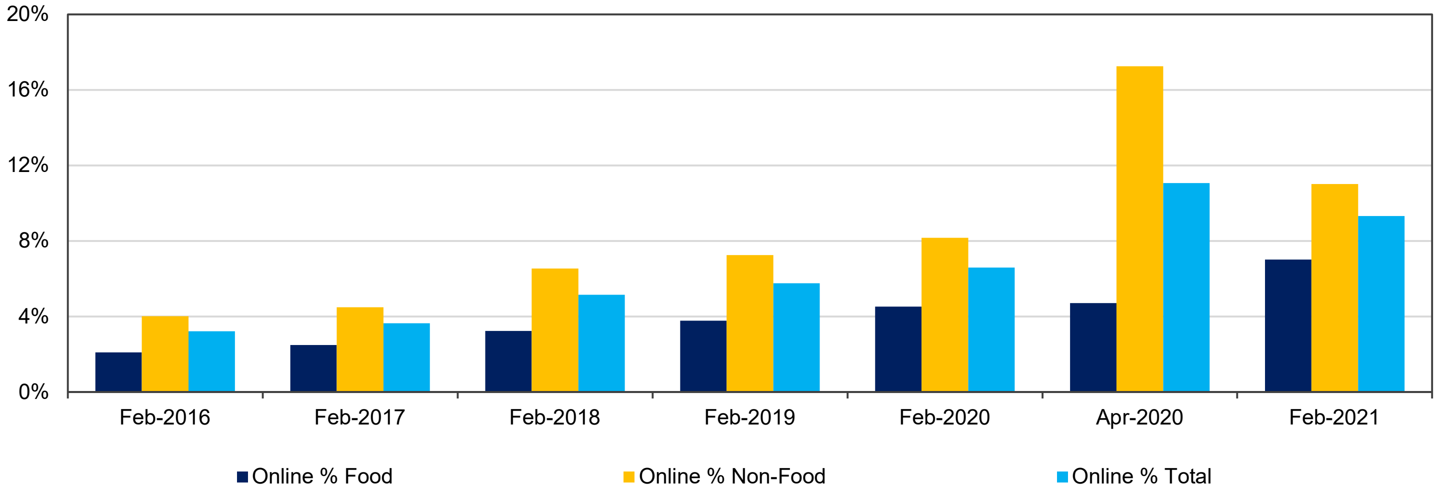
Source: Corelogic, Auscap

In addition, COVID-19 has led to record housing stimulus, record low interest rates and the aforementioned boost to consumer balance sheets. Given this environment, in the absence of another external shock, continued housing market strength might be anticipated.

5. Shopping habits have changed – but by how much?

With lockdowns sweeping the world in the early stages of COVID-19, it was no surprise to see e-commerce penetration across the world accelerate. Australian online retail penetration surged from 6.6% in February 2020 to 11.1% by April 2020. Given e-commerce penetration in Australia has lagged most other developed markets, Australian e-commerce is likely to continue to grow. However, it is interesting to note that e-commerce penetration appears to have reverted to close to its longer-term trend in recent months.

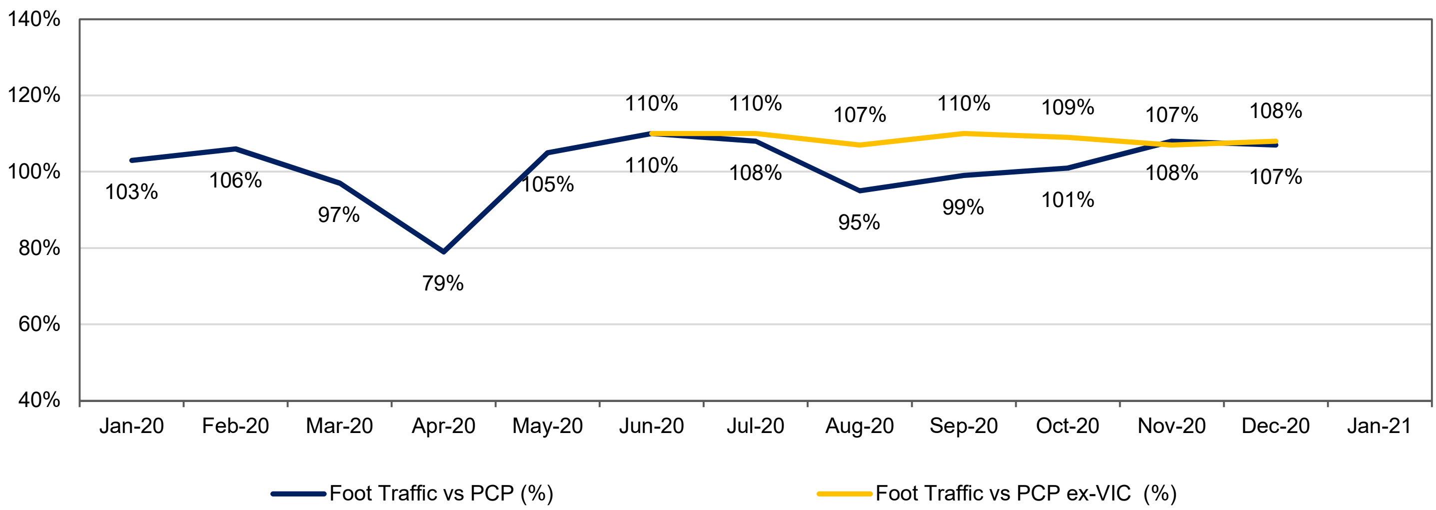
Online Retail Penetration (%)



Source: ABS, Auscap

Foot traffic in major indoor shopping centres proved heavily sensitive to spikes in COVID cases, driven by a combination of government restrictions and consumer unease. However, Australian foot traffic has since been recovering. Foot traffic at the shopping malls owned by listed company Vicinity had recovered to 93.4% by January 2021 excluding its assets in Victoria, the state which had experienced the most severe lockdowns, and Central Business Districts (CBD), which have been slow to see a recovery in office occupancy. By contrast, Aventus Group, an owner of homemaker centres and a Fund holding, has experienced strong visitation since June 2020, with like-for-like foot traffic well above the prior year. Multiple major retailers and landlords have noted that the conversion of foot traffic into sales has increased post-COVID. This data suggests that whilst CBDs continue to suffer, COVID-19's likely ongoing impact to traditional bricks and mortar retail appears to be less than feared.

Aventus Homemaker Centre Foot Traffic vs PCP (%)

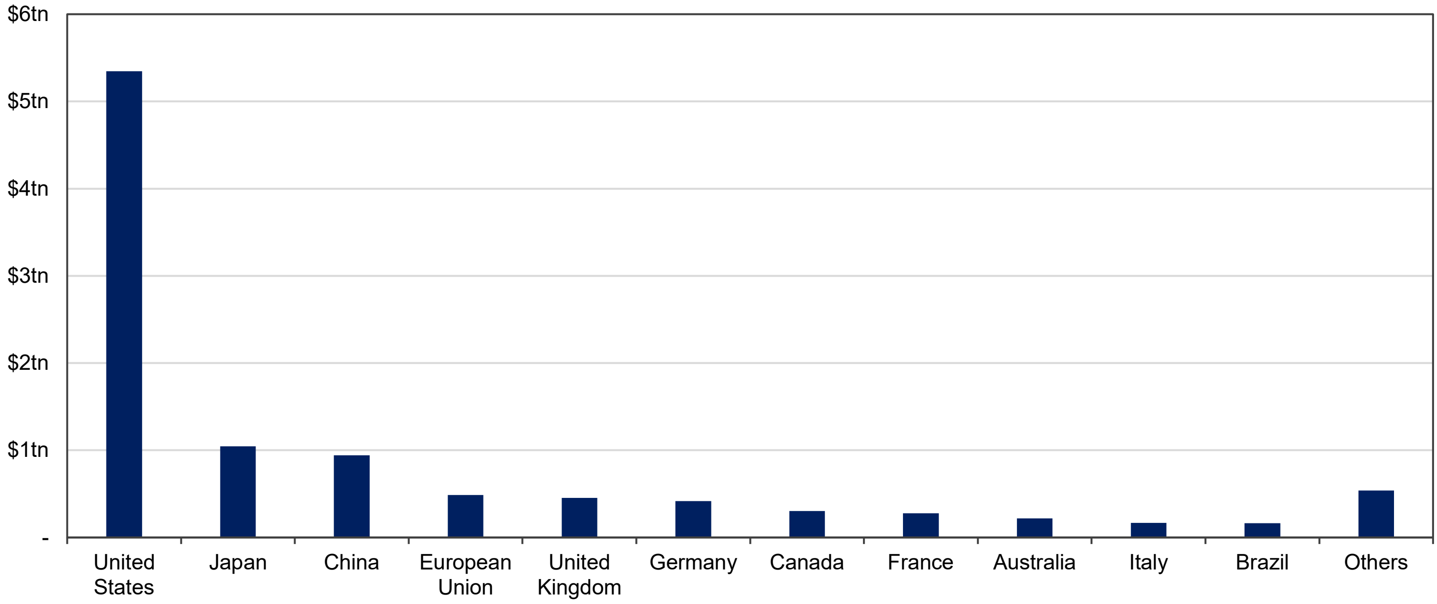


Source: Company disclosures, Auscap

6. Investment demand is lifting commodity prices

Global fiscal stimulus in relation to COVID-19 has been immense, with the G20 spending approximately US$10 trillion.

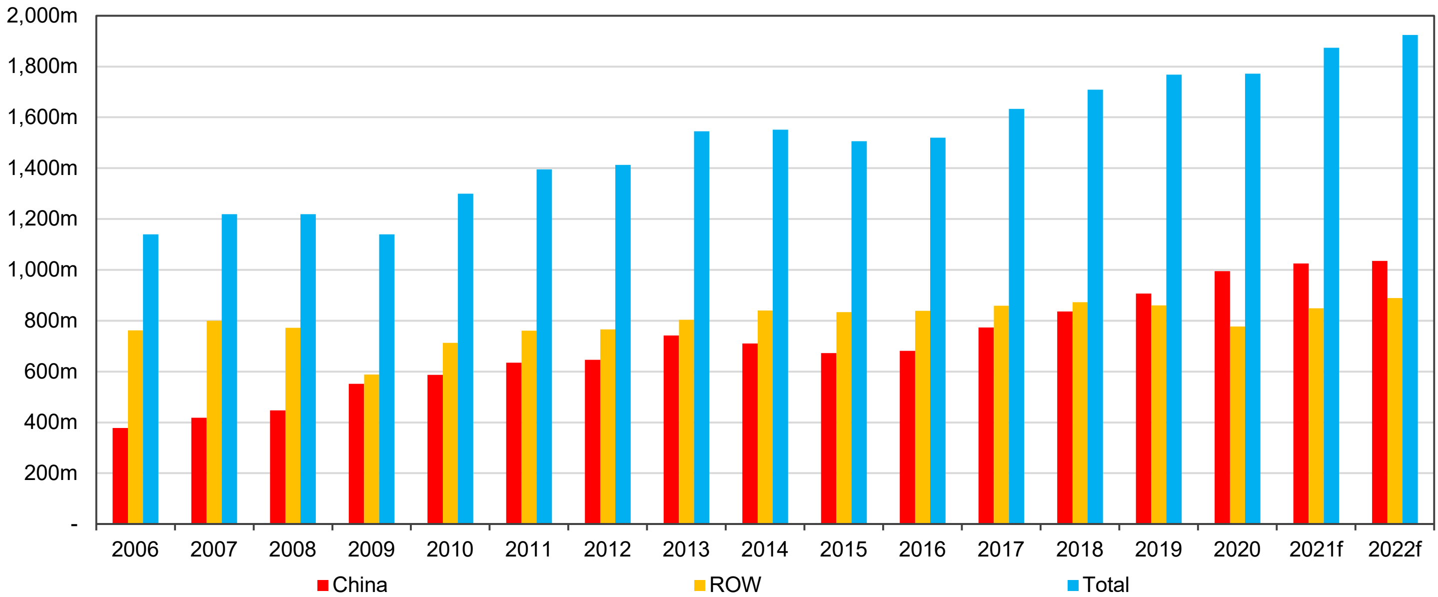
G20 COVID-19 Direct Additional Spending or Forgone Revenue (US$tn)



Source: IMF, Auscap

We expect this level of stimulus to lead to a pick-up in private and public investment globally. Such investment is likely to lead to an increase in demand for steel and various commodities. The World Steel Association forecasts that global steel demand will reach record levels over the next two years even without a meaningful increase in steel demand on pre-COVID levels for the world excluding China. Given the investment in residential property and infrastructure we anticipate as a result of government stimulus, record low interest rates and global household balance sheet repair, the demand outlook for iron ore appears favourable. Yet iron ore supply looks constrained, with limited near-term scalable substitutes and its production dominated by just four companies in Rio, BHP, Fortescue and Vale. Given this backdrop, we expect the outlook for iron ore to remain strong. Iron ore is Australia's largest export by value.

Steel Use (Tonnes)

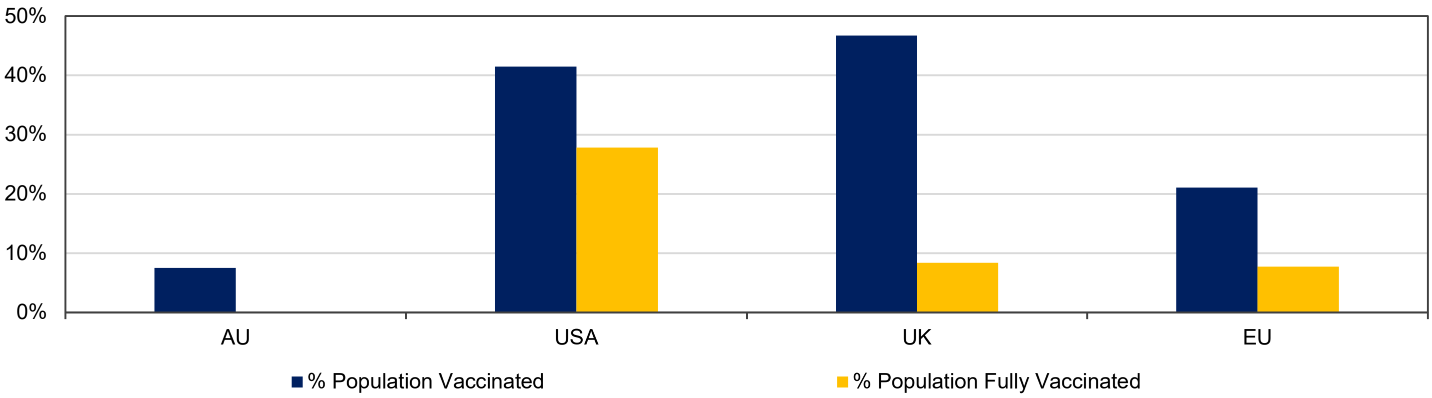


Source: World Steep Association, Auscap

7. The impact of closed borders has been less than expected

Australia has had considerable success in controlling COVID-19, partly due to the closure of borders. By contrast, the vaccine rollout has been slow to this point. This month, Prime Minister Scott Morrison admitted that "*while we would like to see [first] doses completed before the end of the year, it is not possible to set such targets given the many uncertainties involved*." At present less than 8% of Australians have received their first dose of a vaccine.

Vaccinations



Source: Our World in Data, Auscap

This raises the obvious question of whether closed borders are, in aggregate, hurting the economy. While undoubtedly negative for particular businesses, the impact on the overall economy is surprisingly small. In 2019, Australian GDP received a $39.8bn contribution from net education-related travel exports. This was offset by a drag from travel related net imports, with Australians spending $26bn more overseas than international tourists spent in Australia. Given international travel has fallen considerably further than education related-travel, the direct impact of closed borders was a net *benefit* to Australia. In addition, the ABS estimates that three quarters of domestic Australian tourism spend is consistently by Australians. So while acknowledging the lower near term net immigration, the short term impact of closed borders appears manageable.

Net travel exports / (imports)	CY19	CY20	*Change*
Travel ex-education	**($25.9bn)**	**($3.8bn)**	***+$22.0bn***
Education travel	**$39.8bn**	**$31.5bn**	***($8.3bn)***
Total	**$14.0bn**	**$27.7bn**	***+$13.7bn***

Source: ABS, Auscap

In contrast to the dire health and economic forecasts as the COVID-19 threat emerged, the current outlook for the domestic economy, assuming the health threat remains well managed, appears remarkably robust. Household and corporate balance sheets have experienced significant repair, hence retail spending appears likely to remain elevated. Job vacancies are pointing to continuing declines in the unemployment rate. Government debt remains manageable with coming budgets expected to be stimulatory. Interest rates are at record lows, seeing an improvement in property prices, consumer confidence and business conditions. Business forward orders recently reached multi-decade highs. Australia's terms of trade are extremely beneficial due to elevated commodity prices that show no signs of abating, and closed borders are not having the negative impact on the economy in the short term that many envisaged. This would appear to be a powerful cocktail of economic drivers for strong growth over coming years. In this context we remain enthusiastic about the Fund's portfolio of market leading businesses. One example of such a business is Nick Scali, which we discuss below.

Nick Scali – No Time To Recline

Our views on Nick Scali discussed below are based on factual information available to us at the date of publication of this newsletter. Our views and market conditions as expressed below may change. There is a risk that Nick Scali will not perform as expected, which could have an adverse impact on the Fund. The below information is not general advice, personal advice or a recommendation to be relied upon when making an investment or other decision.

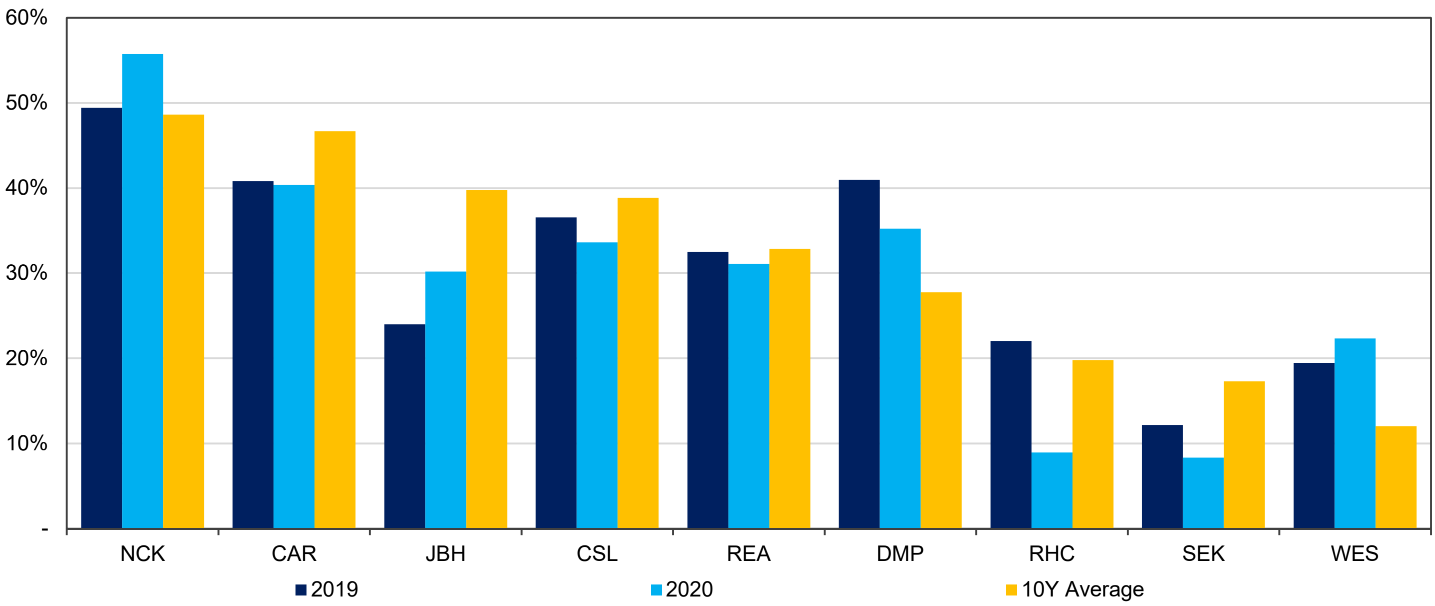
Nick Scali is one of Australia's leading furniture retailers. The company specialises in contemporary leather and fabric lounges, as well as dining room and bedroom furniture. It was founded in 1962 by Nick Scali and is run today by his son, Anthony Scali. Their passion for their product and focus on their customers has translated to a track record of very strong financial returns for shareholders since Nick Scali listed on the ASX in 2004.

The financial profile of the business is compelling for a few reasons. First, unit economics are attractive given the combination of high gross margins and high average selling prices found in the segment. Secondly, the unit economics are complemented by a relatively fixed cost base, underpinned by material property ownership, which creates the potential for significant operating leverage. Thirdly, customers pay upfront deposits for their often made-to-order furniture. This capital-light business model generates strong cash flow and provides a high degree of forward visibility of earnings given revenue is only recognised on delivery of the product. Nick Scali is a reasonable size player in a highly fragmented market, constituting less than 2.0% of furniture, floor coverings, houseware and textile goods sales in Australia in 2020.

Nick Scali is a high quality business

Over the last decade the company has delivered an average return on equity of 48.7% and an average return on assets of 31.5%. These are numbers that will likely be bettered in FY21 given the results we anticipate management will deliver. There are very few companies listed on the Australian stockmarket that have delivered these sorts of return on capital metrics. Nick Scali compares favourably with some of the highest return on invested capital businesses in the domestic market. And Nick Scali's return on equity metrics have been achieved with net cash on balance sheet at financial year end every year.

Return on Equity (%)

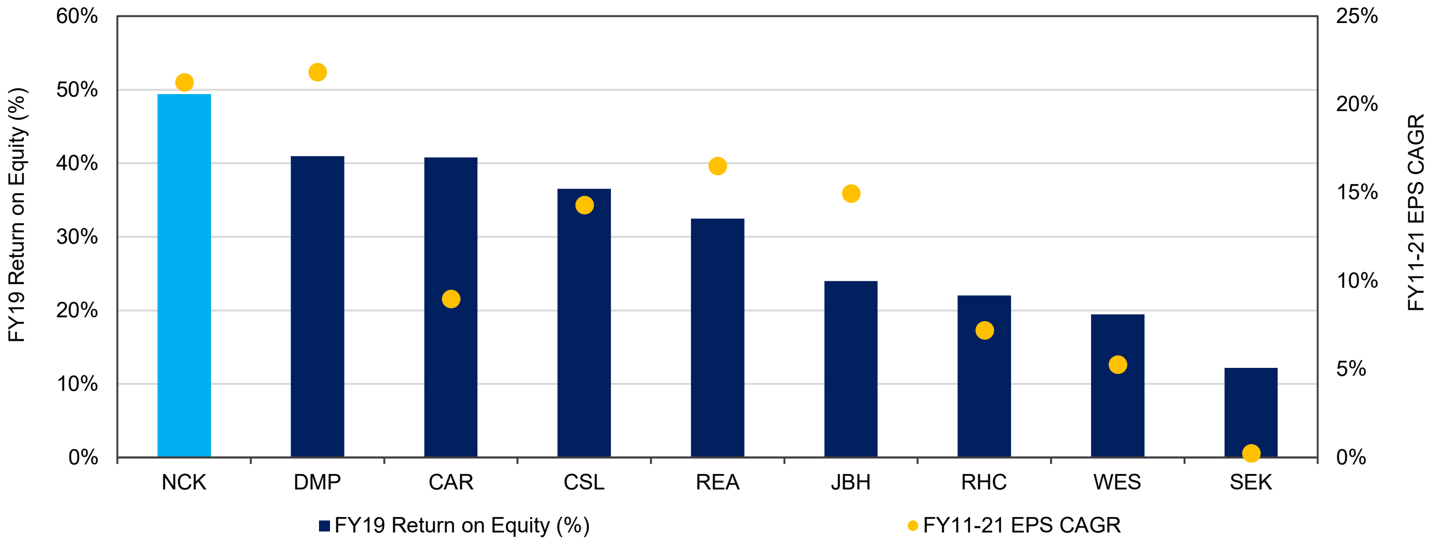


Source: FactSet, Auscap

Nick Scali has grown earnings considerably over the last decade

Nick Scali has grown earnings considerably since listing. Consensus analyst estimates for FY21 are for earnings of circa $80m. While we anticipate earnings will exceed this forecast, a result in line with these expectations would represent ten year compound earnings growth of over 21% per annum. Very few companies have achieved this level of earnings growth.

FY19 Return on Equity vs FY11-21 EPS CAGR (%)



Source: FactSet, Auscap

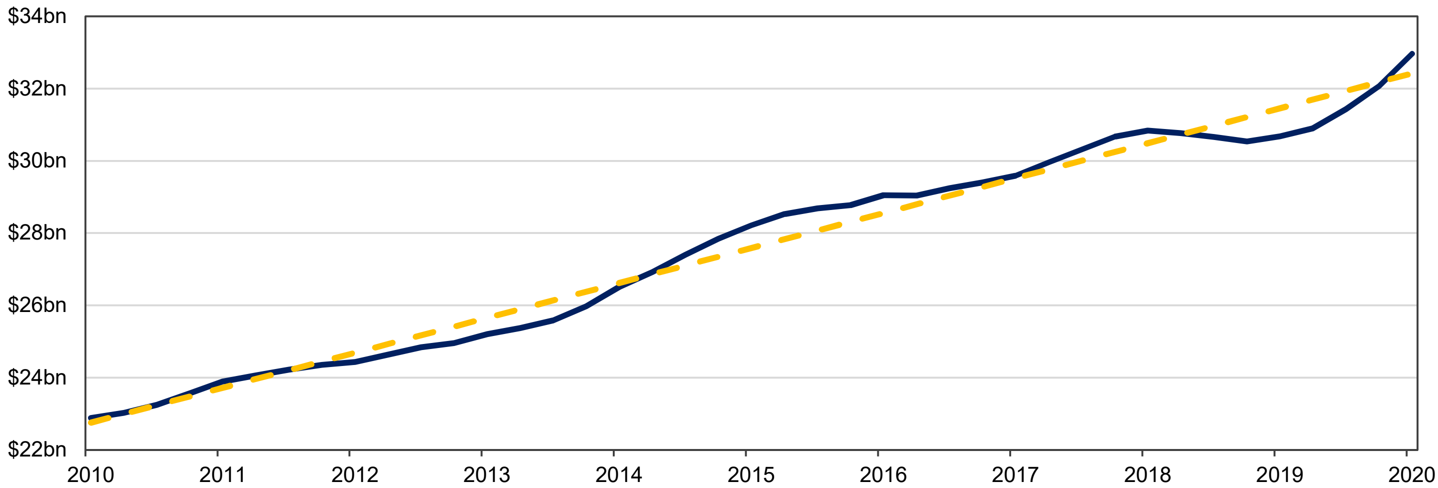
Nick Scali has significant opportunities for growth

So given the well-publicised "furniture boom", are the best years of Nick Scali behind it? We expect Nick Scali's growth outlook to remain positive, given there are multiple avenues of growth that they are currently pursuing.

(i) Industry tailwinds

The furniture industry experienced a significant downturn over 2017-2019 in line with the decline in property prices in many of the major metropolitan markets around Australia. Falling house prices and property market turnover over this period reduced aggregate furniture sales in Australia. The recent bounce in furniture sales has only taken furniture sales modestly back above their longer term trend, with aggregate sales over the last two calendar years being below trend.

Furniture & Floor Coverings Consumption (Chain-Volume)

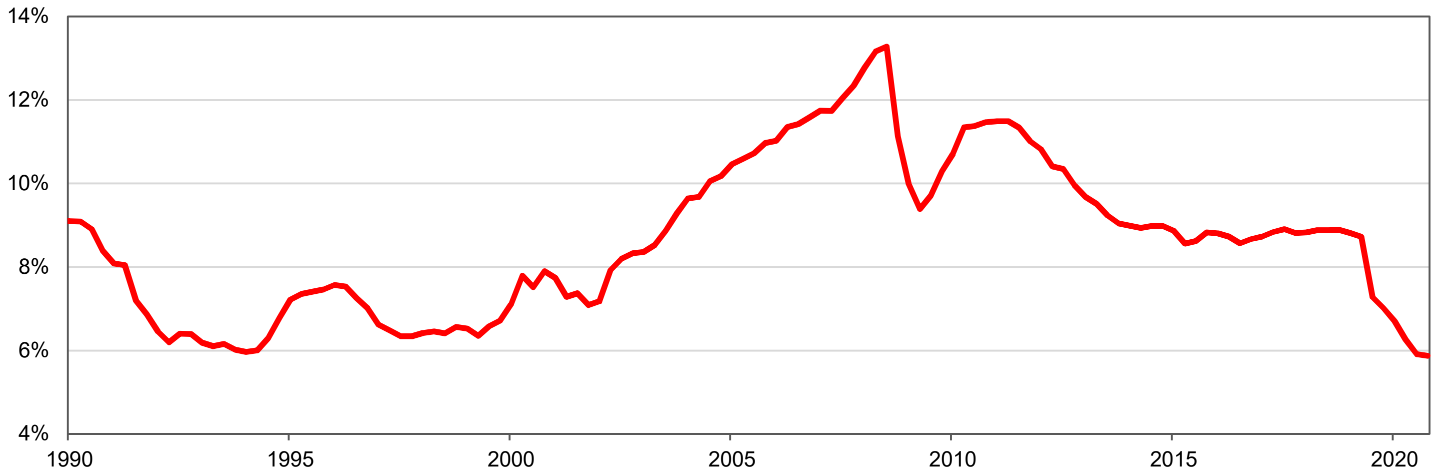


Source: ABS, Auscap

There are a number of reasons to expect the current positive outlook for furniture consumption to continue over coming years. As outlined in the previous section, increases in incomes, predominantly as a result of government stimulus, and a significant decline in consumption during the pandemic has led to an increase in the savings rate to record levels, resulting in significant household balance sheet repair.

Household debt less deposits as a percentage of disposable income is at the lowest it has been since late 2003. This strong financial position is coupled with record low interest rates, resulting in interest costs for households that are the lowest in over thirty years relative to incomes.

Household Interest Payments as a Percentage of Income

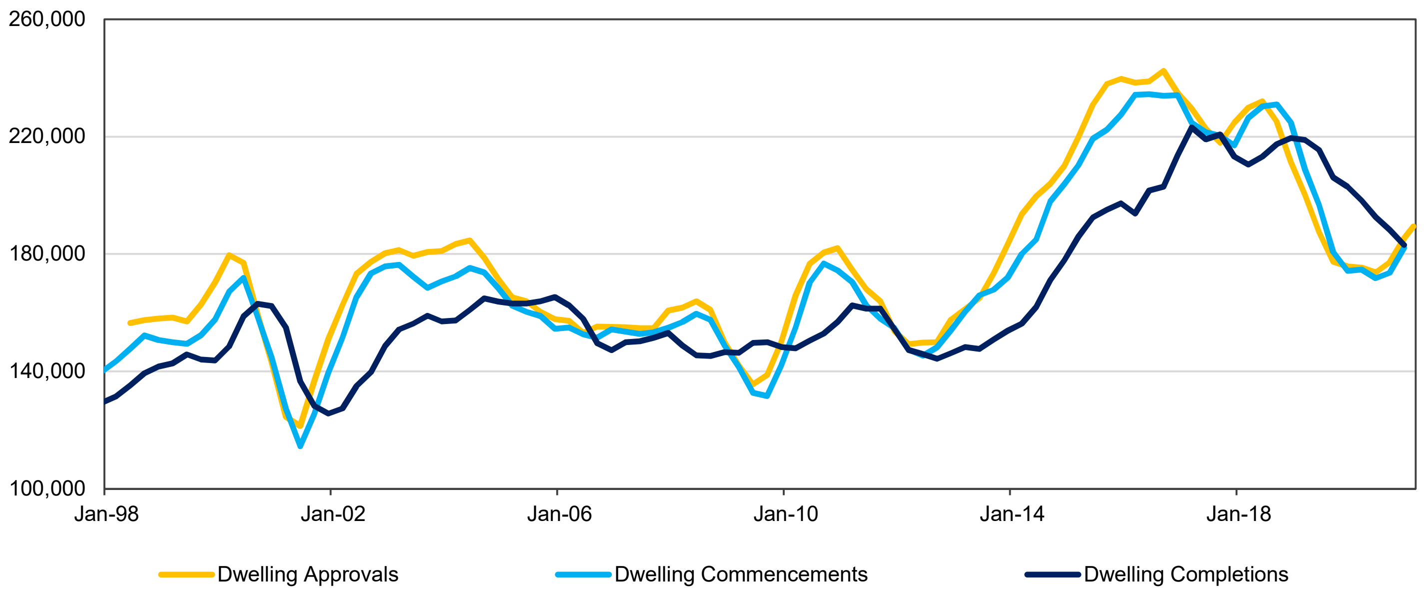


Source: RBA, Auscap

Improved household balance sheets, falling unemployment and low interest rates are resulting in rising property prices, leading to positive household wealth effects and higher consumer confidence, which should benefit discretionary retail. This leaves Australian households in a good position to continue to spend on discretionary goods, particularly while alternative avenues of expenditure, such as international travel, remain restricted.

Rising property prices have been accompanied by an increase in dwellings approvals, which should lead to higher levels of dwelling completions and higher property turnover, and hence demand for household goods.

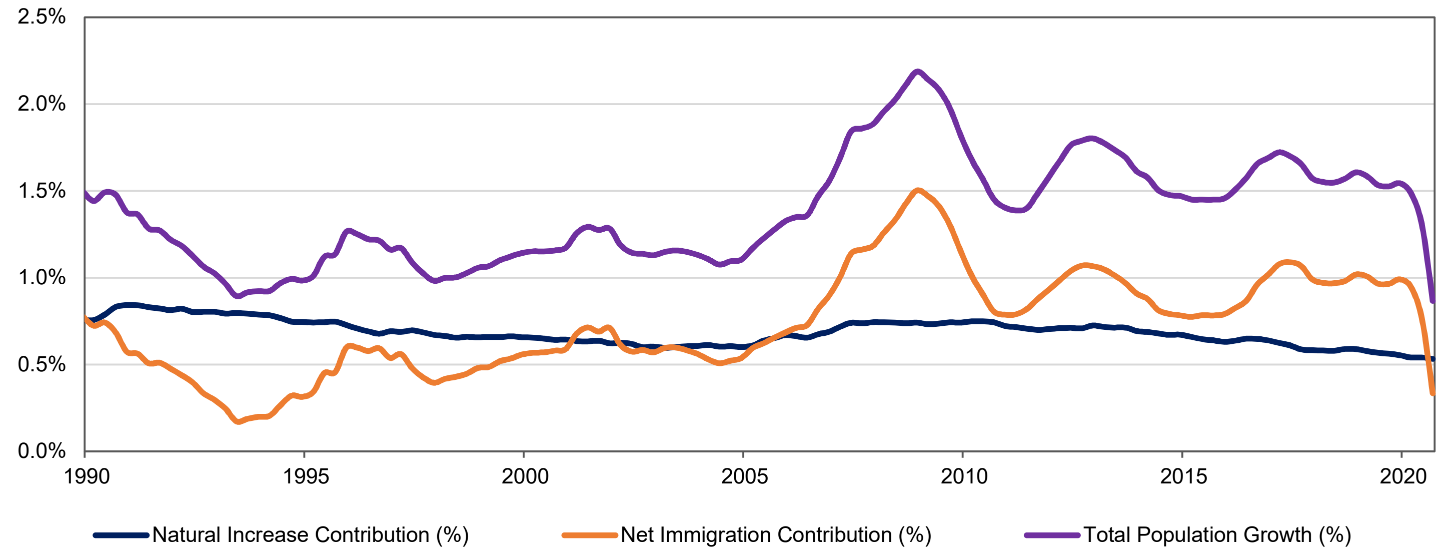
Dwelling Approvals



Source: ABS, Auscap

Further, population growth in Australia has been a very consistent economic tailwind over the long-term. While the currently reduced level of net immigration is a short term headwind, we expect this to rebound following the reopening of international borders.

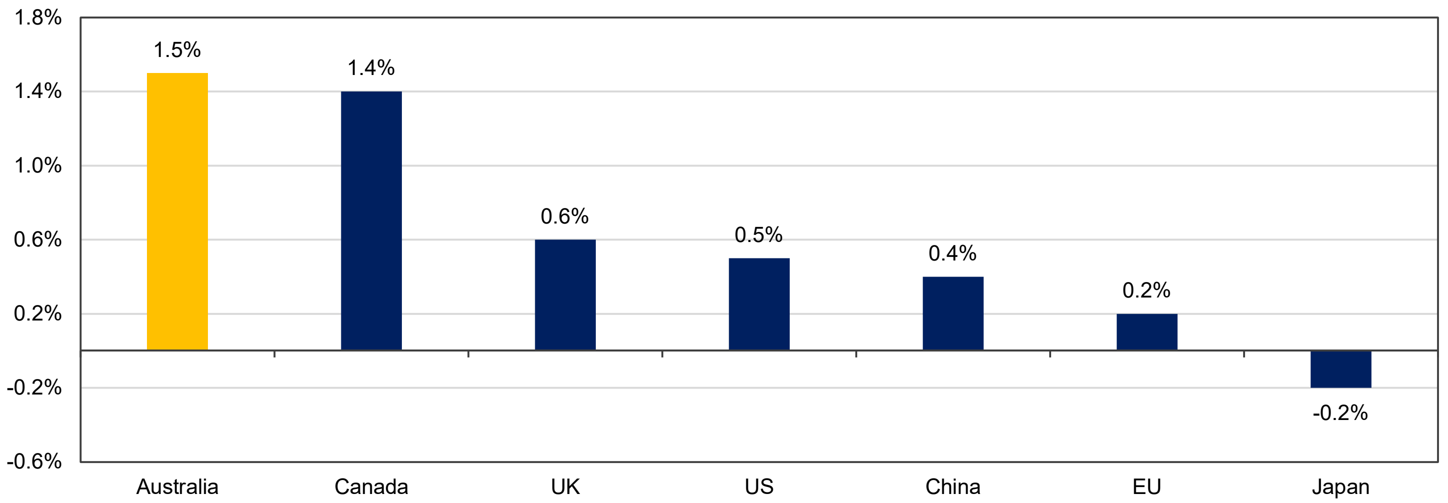
Australian Population Growth (Rolling 12M Annualised - %)



Source: ABS, Auscap

Prior to COVID-19, Australia had a track record of considerably faster population growth than most developed countries, a trend that should only accelerate post-pandemic given the quality of the response by the Federal Government and its demonstrated ability to protect the health of the population. In fact Australia's historical natural rate of population growth *excluding immigration* is comparable to the total population growth *including immigration* experienced in the United States and United Kingdom and well above other developed economic regions such as Europe and Japan.

2019 Population Growth (%)



Source: World Bank, Auscap

Proposed changes to stamp duty in New South Wales could provide a further tailwind for demand. The NSW Government is considering giving home buyers the choice to pay either stamp duty and land tax or a new annual property tax. Stamp duty has been found to now represent over 75% of NSW property transfer costs, with NSW Treasury estimating that property transactions could increase by approximately 50% per annum in the long run as a result of the proposed change. Increased property turnover should benefit companies that provide household goods. The consultation period in relation to the proposed change has now passed. Should New South Wales implement the change, other states may be emboldened to pursue similar changes.

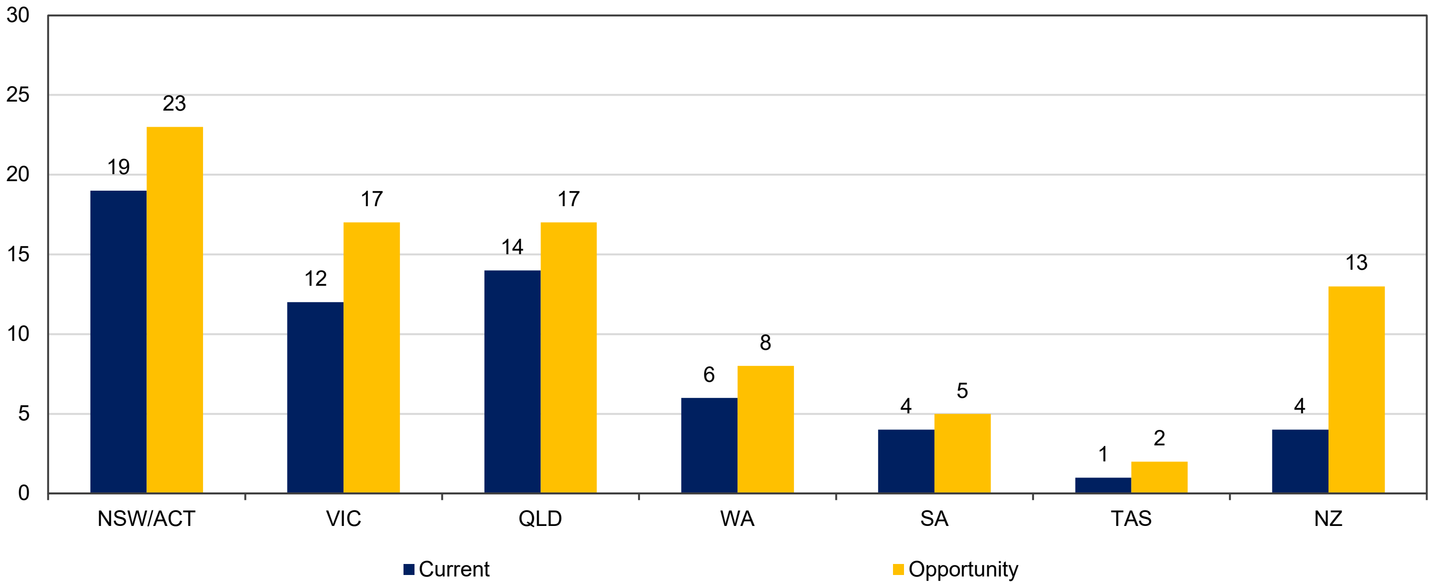
(ii) Adjacent categories

Nick Scali is expanding its range into adjacent categories. It successfully launched a bedroom category in FY19, and continues to see opportunities to expand its range of casegoods.

(iii) Store network expansion

Nick Scali had a store network of 60 stores as at the end of December 2020. They are targeting at least 85 showrooms across Australia and New Zealand, based on detailed catchment modelling. Our expectation is that their store footprint could be larger than this, given their low current category market share.

Store Network and Opportunity



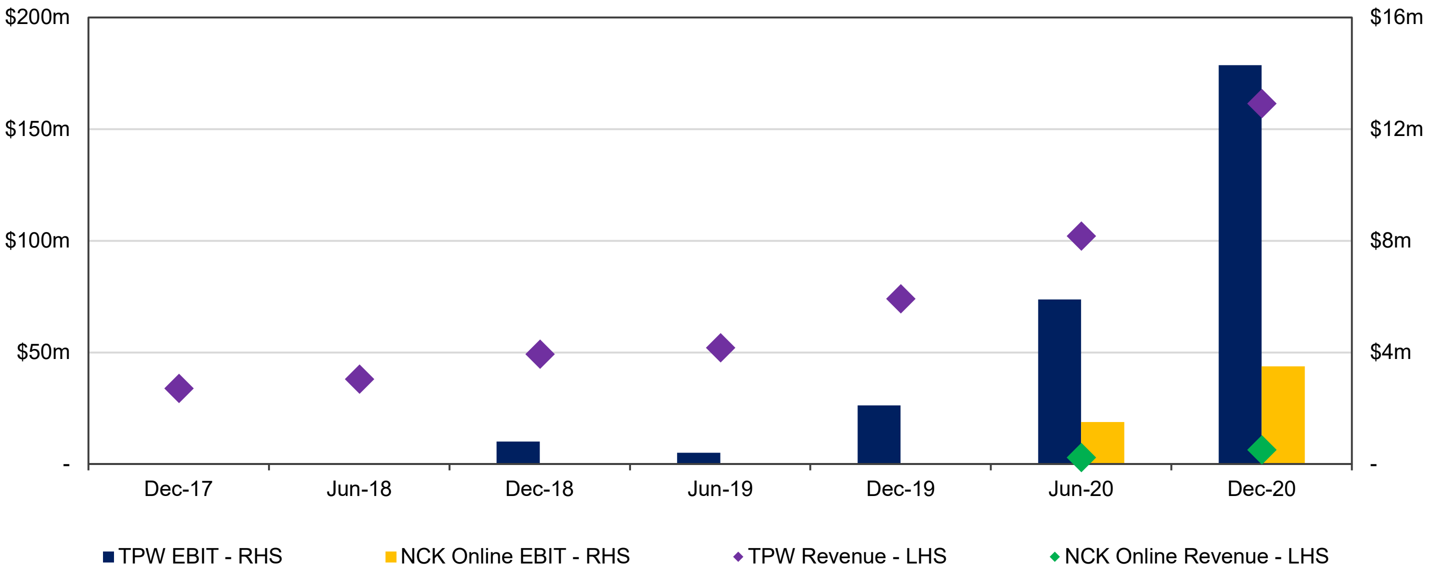
Source: Nick Scali, Auscap

(iv) Growth in the digital offering

Prior to COVID-19, Nick Scali did not have a functioning digital offering to complement its in store network. The company was quick to respond to the pandemic, with online functionality up and running by April 2020. Crucially, Nick Scali's online offering is *significantly* more profitable than the offerings of listed furniture peers and most other omni-channel retailers. Pure-play Australian e-commerce players tend to either provide a marketplace, where buyers and sellers are connected in exchange for a commission, or have a "drop shipping" business model, where third-party suppliers ship product direct to consumers. Whilst these models are scalable and capital light, they have relatively small gross margins, creating a need for large sales volumes before operating leverage is achieved.

These models are options that remain open to Nick Scali down the track. But for now, Nick Scali's online presence is largely leveraging the fixed costs of its bricks and mortar presence and the Nick Scali brand name, whilst maintaining the significantly more favourable unit economics and capital-light benefits that its bricks and mortar network experience. The result is that in the first half of FY21, with relatively limited investment, Nick Scali produced EBIT of $3.5m from online sales at an EBIT margin of greater than 50%. By contrast, the pure-play e-commerce category leader Temple & Webster produced EBIT of $14.3m on sales of over $161m at an EBIT margin of 8.9%, and they recently indicated that future investment will see EBITDA margins return to 2-4% in the near term.

Online Revenue and EBIT Benchmarking ($m)



Source: Company disclosures, Auscap

The opportunity for Nick Scali to successfully scale its online presence is significant. Products that might be unsuitable for showrooms or where customers are happy to purchase the product without a physical inspection can now be offered online. This should accelerate the company's expansion into adjacent categories using existing suppliers, who are often under exclusive arrangements. In February 2021, Nick Scali announced it was in the process of refreshing its current basic online interface, with plans to add an online configuration module in September 2021, expand categories and continue to experiment with digital marketing. We estimate that this online opportunity could achieve $50m-$100m in revenue in the medium term, which would add meaningfully to business profitability given the high EBIT margins that the online offering is already delivering from a small revenue base.

(v) Acquisitions

There are a number of complementary furniture businesses reported to be for sale in the domestic market. We believe these businesses would see improved performance under Nick Scali ownership, while also benefitting from the synergies associated with being part of a larger group. There is also the possibility of an eventual international expansion outside Australia and New Zealand, potentially via an acquisition of a similar business, which would provide the company with a runway for many years of growth.

Nick Scali has a very strong balance sheet, with net cash of nearly $54m at 31 December 2020. Despite paying a record $32.4m dividend during the half, we anticipate the net cash position will be higher by 30 June 2021. The company also has $80.6m worth of property on its balance sheet at cost, which we estimate to be worth 50-100% higher than this if it were revalued.

Nick Scali is attractively priced

Nick Scali produced an underlying first half 2021 net profit after tax of $40.5m, on like for like sales revenue growth of 24%. We expect a stronger second half, driven by a continuation of the elevated spend on household goods and the delivery of an order book which had grown 58% on a like for like basis, with $103.1m worth of sales waiting to be delivered at 31 December against first half revenue of $171.1m. In other words, more than 60% of first half sales revenue was already locked in for the second half before the start of January.

Analysts are expecting a meaningful pullback in Nick Scali's sales and profitability in FY22 as furniture demands normalise. We suspect this underestimates the organic growth in the store network, the rapid acceleration in earnings in the online channel, the expansion of the network to more profitable stores in New Zealand, and the underlying strength of the household consumer. On our estimates Nick Scali is trading on a Price to Earnings ratio of less than 10x FY22 earnings on a cash adjusted basis. We expect earnings to grow materially from this point over subsequent years.

On consensus forecast metrics Nick Scali still looks attractively priced given the quality of, and prospective growth within, the business.

	NCK	ADH	HVN	JBH	KGN	BBN	TPW	MYD	ASX 200
FY22 P/E	15.9x	12.8x	14.2x	15.8x	21.5x	26.9x	85.1x	NA	19.1x
FY22 div yield (%)	5.2%	5.2%	5.4%	4.3%	3.5%	2.6%	0.0%	0.0%	3.5%
FY20-22 EPSg	10.4%	20.7%	-0.9%	1.8%	19.7%	15.8%	-0.4%	NA	6.0%

Source: FactSet, Auscap

Summary

Finding an extremely high-quality listed business in a familiar sector that has multiple growth drivers and industry tailwinds, trading at a price to earnings ratio that is considerably lower than the broader market, is extremely rare. The business is run by Anthony Scali, whose family owns 13.6% of the company, ensuring alignment of interests with investors. From our experience with management over a number of years, we have observed an outstanding track record of performance, diligence and corporate governance. We are enthusiastic about the outlook for the business and look forward to continuing to support the management team and Board as long term shareholders.

Auscap Long Short Australian Equities Fund

Fund Performance*

Period	Auscap	All Ords
March 2021	3.8%	1.8%
Financial Year To Date	61.9%	19.9%
Since Inception	251.7%	117.7%
Annualised Returns	16.3%	9.8%

Fund Exposures

March 2021 Average	% NAV	Positions
Gross Long	132.5%	49
Gross Short	4.6%	2
Gross Total	137.1%	51
Net / Beta Adjusted Net	127.9%	149.2%

Portfolio Commentary

The Fund returned 3.8% net of fees during March 2021. This compares with the All Ordinaries Accumulation Index return of 1.8%. The Fund's biggest exposures over the month were spread across the consumer discretionary, real estate, materials, financials and communications services sectors.

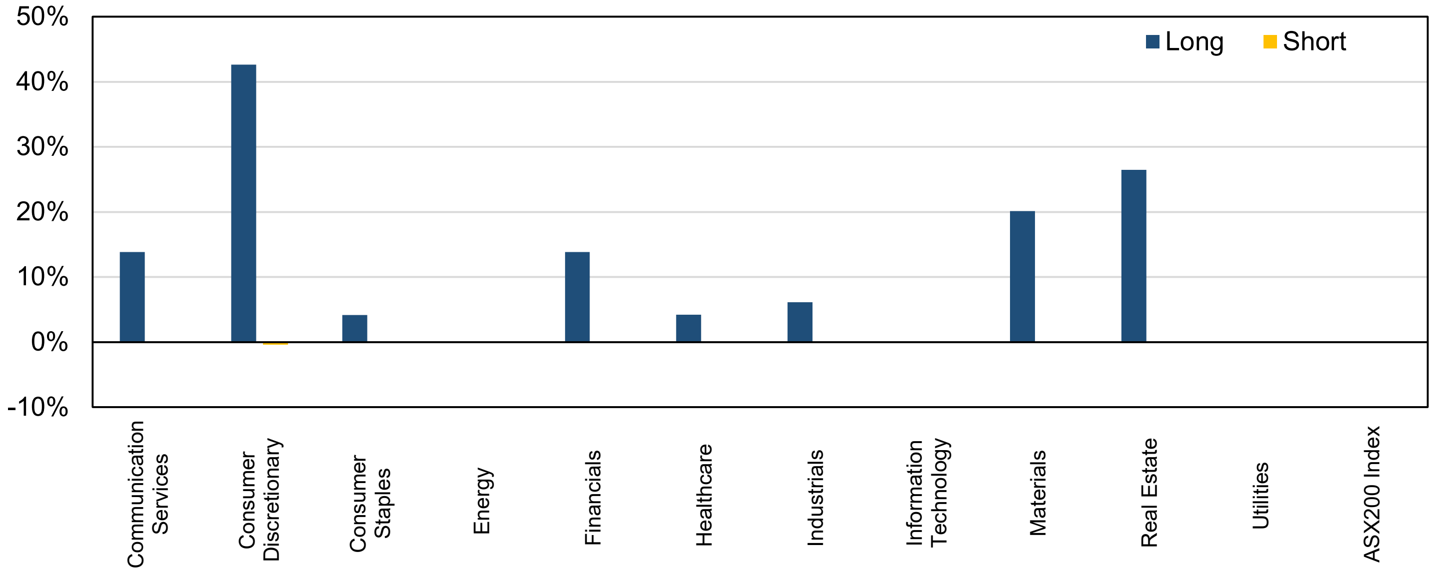
Fund Calendar Year Returns*

CY13	51.9%	CY18	(18.5%)
CY14	23.2%	CY19	18.1%
CY15	36.0%	CY20	10.6%
CY16	2.2%	CY21	7.2%
CY17	17.1%		

Top 20 Investments^

Atlas Arteria	Motorcycle Holdings
Aventus Group	News Corporation
Blackmores	Nick Scali
Carsales.com	NZME
Charter Hall Retail REIT	Reece
Eagers Automotive	Rio Tinto
GDI Property Group	Super Retail Group
Home Consortium	Unibail-Rodamco-Westfield
Macquarie Group	Virgin Money UK
Mineral Resources	Virtus Health

Sector Exposure - March 2021



**Performance figures are calculated for the Monthly Class net of all fees and expenses assuming the reinvestment of all distributions. Note, as at 1 January 2021, the Series Class was consolidated into the Monthly Class. Past performance is not a reliable indicator of future performance.*
^ Top 20 long investments in alphabetical order as at 31 March 2021.

Newsletter – April 2021

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