Auscap Long Short Australian Equities Fund

Newsletter – September 2019

Fund Performance*

Period	Auscap	All Ords
August 2019	(3.7%)	(2.2%)
Financial Year To Date	1.6%	0.7%
Since Inception	175.4%	96.8%
Annualised Returns	16.2%	10.6%

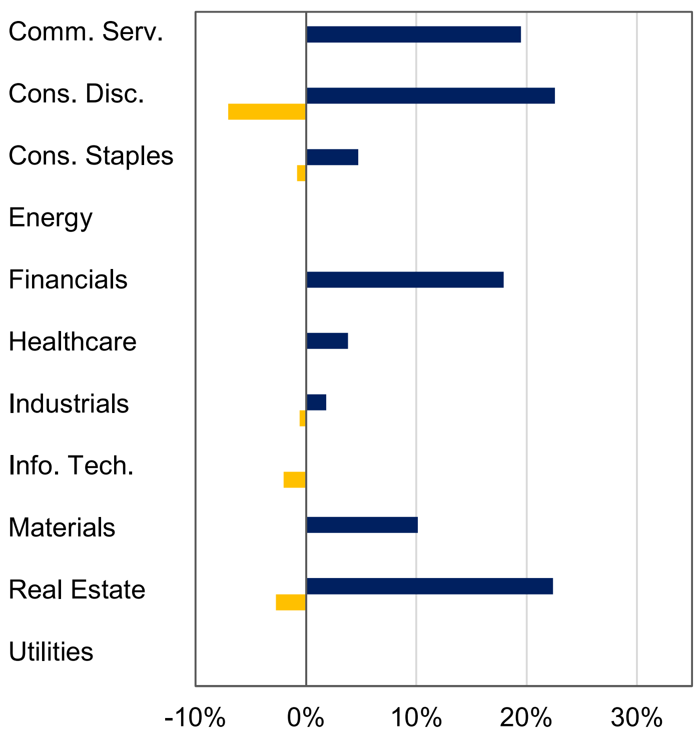
Fund Exposures

August 2019 Average	% NAV	Positions
Gross Long	102.9%	28
Gross Short	13.2%	9
Gross Total	137.0%	37
Net / Beta Adjusted Net	89.7%	75.9%

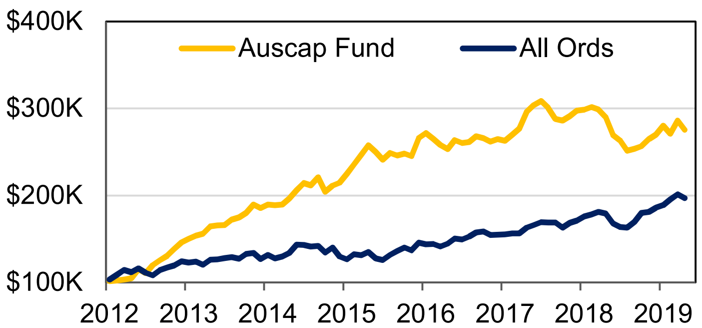
Portfolio Commentary

The Fund returned negative 3.7% net of fees during August 2019. This compares with the All Ordinaries Accumulation Index return of negative 2.2%. Average gross capital employed by the Fund was 102.9% long and 13.2% short. Average net exposure over the month was 89.7%. Over the month the Fund had on average 28 long positions and 9 short positions. The Fund's biggest stock exposures at month end were spread across the real estate, consumer, communication services, financials and materials sectors.

Sector Exposure - August 2019



Fund Performance*



Fund Financial Year Returns*

FY13	19.7%	FY18	12.7%
FY14	46.0%	FY19	(9.2%)
FY15	16.8%	FY20 (YTD)	1.6%
FY16	20.1%	CY19	9.5%
FY17	8.0%		

Top 10 Investments^

Blackmores	Mineral Resources
CYBG	National Australia Bank
GDI Property Group	Nine Entertainment
JB Hi-Fi	Super Retail Group
Macquarie Group	Unibail-Rodamco-Westfield

** Performance figures are calculated for the lead series net of all fees and expenses assuming the reinvestment of all distributions. Past performance is not a reliable indicator of future performance.*
^ Top 10 long investments in alphabetical order as at 31 August 2019.

Dealing With Volatility

Being able to deal with share price volatility is an important component of any investor's repertoire. Volatility is a consequence of the future being unknowable, and the fact that events will often unfold in a manner that no-one could have anticipated. Adding to this volatility is the mood of the market and the influence emotion can have on investment decision making and hence short term price fluctuations. As an investor there are times when your style is in and out of favour, there are times when you get an unusual number of good or bad bounces, and there are times when it is simply unclear why the market is responding in the way it is. In this newsletter we look at one such example.

Mineral Resources (MIN, being its stock code) is a significant exposure for the Fund. The fact that it fell 18% in August made it the largest detractor from the Fund's performance in the month. Yet it reported a result that was 15% ahead of the midpoint of guidance, above most analyst expectations, and the Managing Director, Chris Ellison, pointed out that the company has the best opportunity set in front of the business right now in its history. This is a statement that for us carries weight given it comes from a company founder in a business that has compounded investor wealth at 26% pa since the business listed in 2006. So why the fall in the share price? From our analysis there is no clear answer. However these things can happen when the businesses you find attractive are not the current crowd favourites. But then again, there is rarely exceptional value to be found in crowd favourites. By definition, if the crowd is there, the bargain is not.

MIN is a business which currently has three key profit centres:

1. Mining Services: This comprises a range of services provided to miners including contract crushing, minerals processing, mining, site services and road and rail haulage.
2. Iron Ore Mining: MIN has direct ownership stakes in various iron ore mines, including current producing mines at Koolyanobbing and Iron Valley in Western Australia.
3. Lithium Mining: Ownership of lithium mines, including current producing mines at Wodgina and Mt Marion in Western Australia.

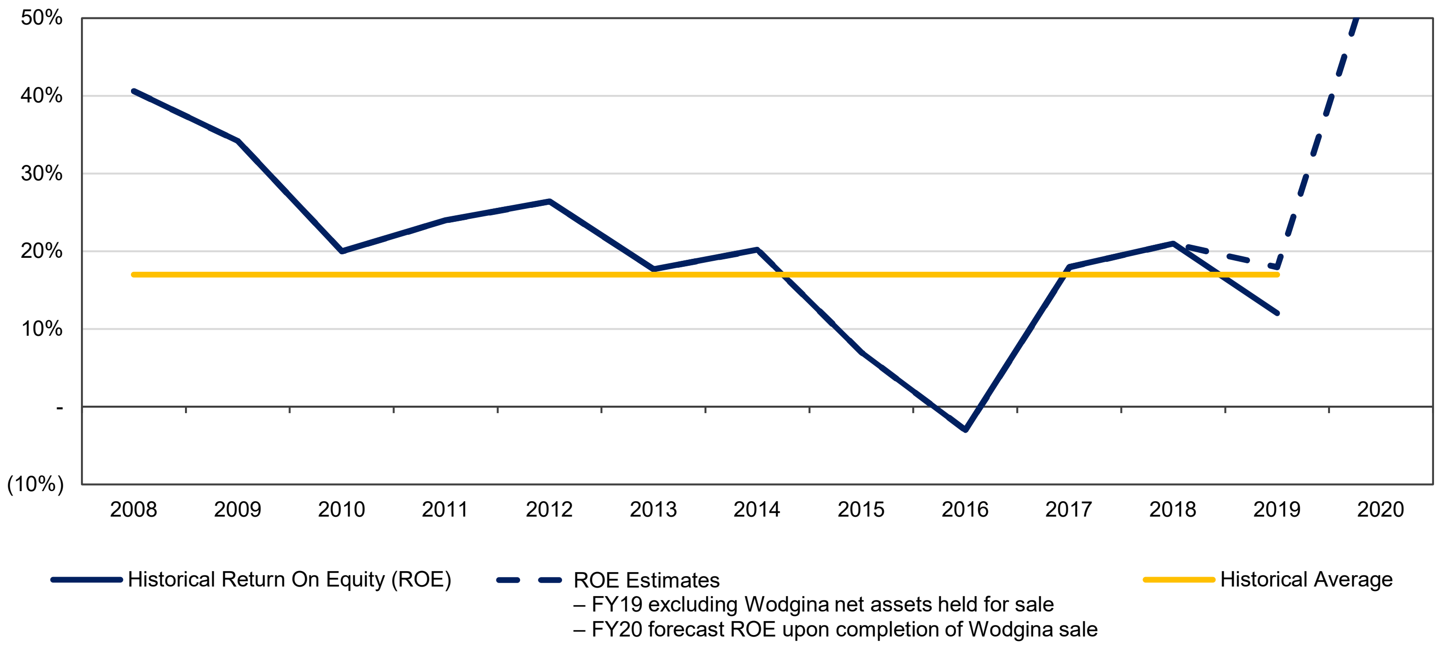
MIN also effectively has a fourth business unit focused on innovation, which does not directly appear on the P&L but drives future profit opportunities. The company has a strong track record of identifying prospective projects or processes, and is quite entrepreneurial in bringing these to fruition. From our perspective there are some parallels in this regard between what MIN does in the resources industry and what Macquarie Group does in the financial services and infrastructure sectors.

What Do We Find Attractive?

MIN possesses a large number of the characteristics that we look for in an investment:

- Quality of operations: MIN is the leading contract crushing business in the market and has a strong industry reputation for safety, results and costs.
- Quality of management: MIN's Managing Director and Chairman have been with the company for long periods of time and have amassed an enviable track record.
- High Return On Equity (ROE): MIN has averaged an ROE of 17% since listing, demonstrating a high quality track record of capital investment. We expect ROE to spike considerably higher in FY20 with the sale of 60% of the Wodgina lithium mine.
- Strong cash generation: Over time, MIN has averaged approximately 100% conversion of earnings to cash.
- Balance sheet strength: When the pending sale of part of the Wodgina lithium mine is complete, MIN will have a net cash balance sheet, giving it significant optionality and reducing risk.
- High stock ownership by company insiders: Management own approximately 15% of the company.
- Insider buying: Over the past year, there has been $54m of stock bought by Directors in the open market at prices around $14.80, which is above the current stock price of $14.15.
- Value: We see considerable value at the current share price, as we outline below.

Return on Equity (%)

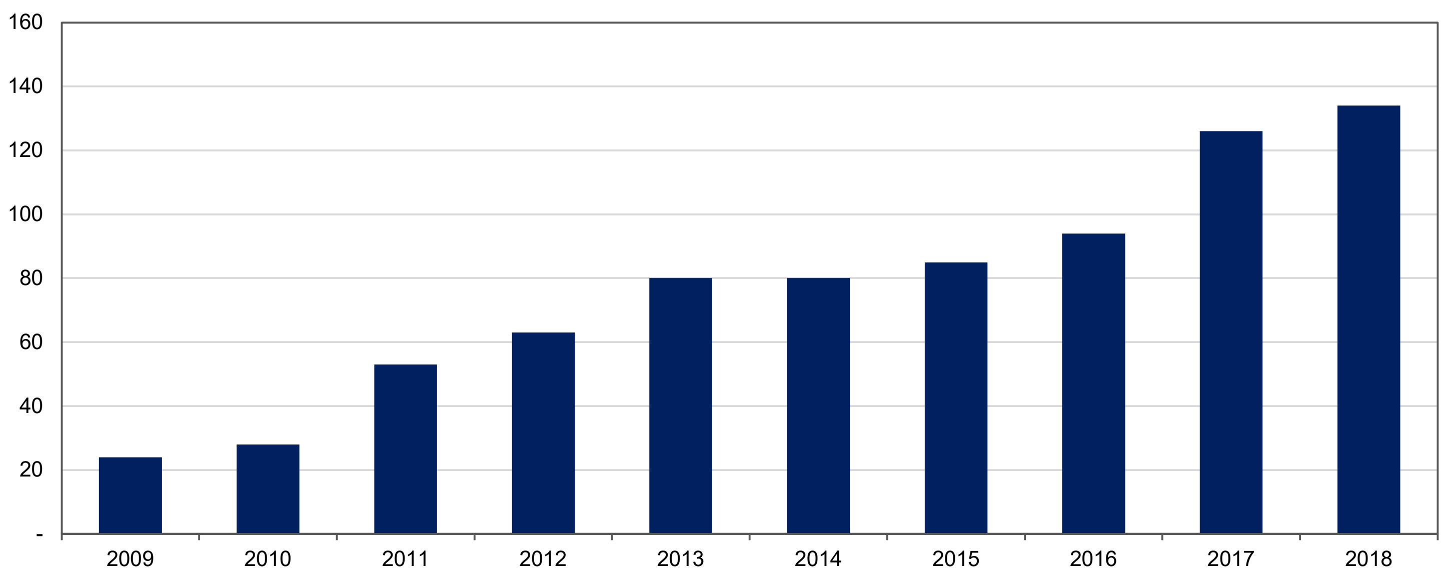


Mining Services Valuation

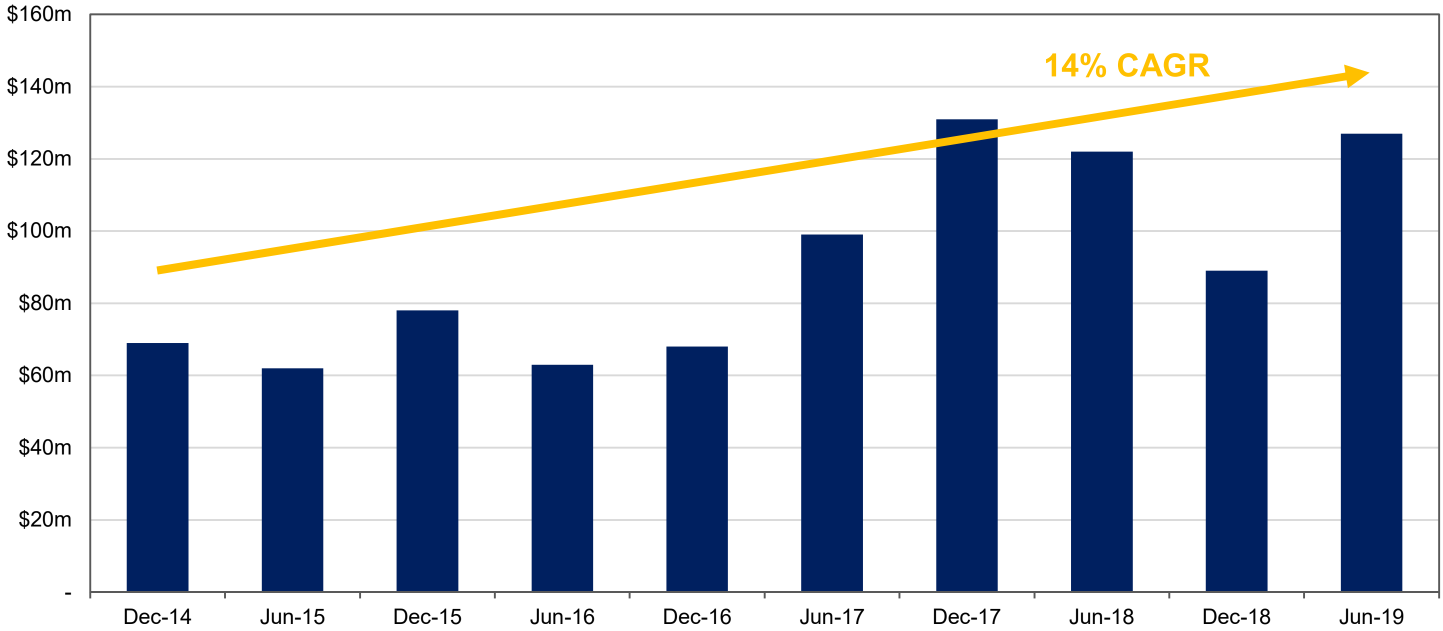
Mining Services is the heart of MIN's business and the most stable earnings stream. It governs much of the company's strategic direction. As shown in the two charts below, the Mining Services business has a long history of volume and EBITDA growth, which has been compounding at an average rate of around 15% per annum. At this rate, the business unit doubles EBITDA every 5 years.

There will always be some year-to-year volatility around this as individual projects ramp up or down for various reasons. The mining businesses provide long term work for the Mining Services business, as well as being highly profitable, and largely uncorrelated, earnings streams in their own right. We have seen this recently with Wodgina lithium production being a strong contributor in FY18 as direct shipping ore was produced, then a much smaller contributor in FY19 as a spodumene plant was constructed. Ignoring this noise, the underlying trend is strong.

Equivalent Installed Crushing Capacity (million tonnes per annum)

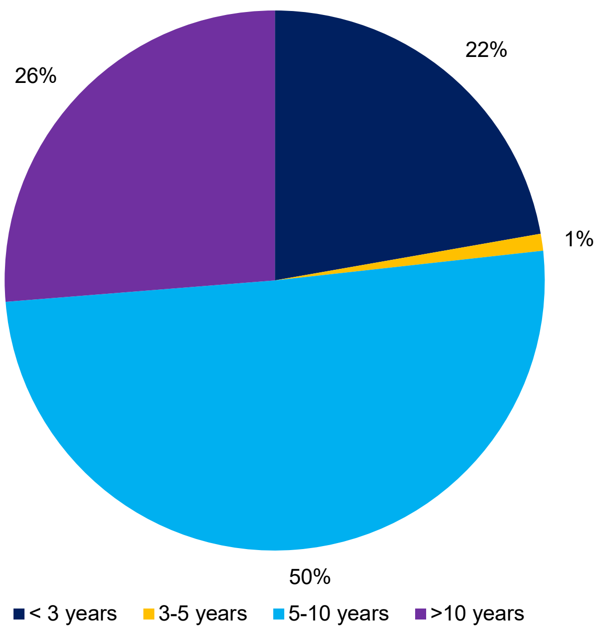


Mining Services Less Construction EBITDA



It is also important to consider the style of contracts in place. Most of the work in the Mining Services business now generates annuity-style revenue. Much of the Mining Services work is for joint-ventures where MIN is also a part-owner of the underlying mine, making the revenue recurring in nature. There is also a significant book of work for external clients. As shown in the chart below, over three-quarters of the business unit's revenue has a contract duration of more than 5 years.

Revenue by Length of Contract (June-19)



The current outlook for MIN's Mining Services business appears to be very strong. MIN has published a forecast FY20 EBITDA range of $280-300m (up from $209m in FY19). We expect this includes little contribution from lithium production at the Wodgina mine, as the near term production schedule is uncertain, so this will grow in the future as Wodgina ramps up. Recent company presentations have suggested that several new jobs are in the tendering pipeline. Also, if MIN can execute on its iron ore ambitions, there will be significant new work for these mines. Hence, there is every reason to believe that 15% compound growth can continue for at least a number of years, and it may well be higher than this in the near term.

So how should this be valued? Due to varying capital requirements for different contracting businesses, comparing them on an EV/EBIT basis would appear to be most logical. Pure-play mining services businesses generally have higher capital expenditure requirements. If we take the midpoint of EBITDA guidance for MIN's Mining Services business of $290m for FY20, and assume depreciation, amortisation and impairments in line with historical financials, we would expect EBIT of circa $185m. Below is a table outlining the current valuation of comparable companies that have an Enterprise Value over $500m.

Company	ASX Ticker	Enterprise Value ($m)	FY20 EV/EBIT
Ausdrill	ASL	2,080	9.2x
Cimic Group	CIM	9,815	8.2x
Downer EDI	DOW	6,061	11.4x
Monadelphous Group	MND	1,314	13.x
NRW Holdings	NWH	925	8.4x
Service Stream	SSM	1,072	12.3x
WorleyParsons	WOR	9,094	11.9x
Average		**4,337**	**10.6x**

Given the growth prospects and length of MIN's contracts we believe the 10.6x average is a reasonable if not conservative multiple, valuing the Mining Services business at around $2 billion ($10.40 per share). Within a few years EBITDA and EBIT in this business could viably be $500m and $320m respectively, bringing the implied forward EV/EBIT multiple to approximately 6x, giving us confidence the valuation is reasonable.

Iron Ore Mining Valuation

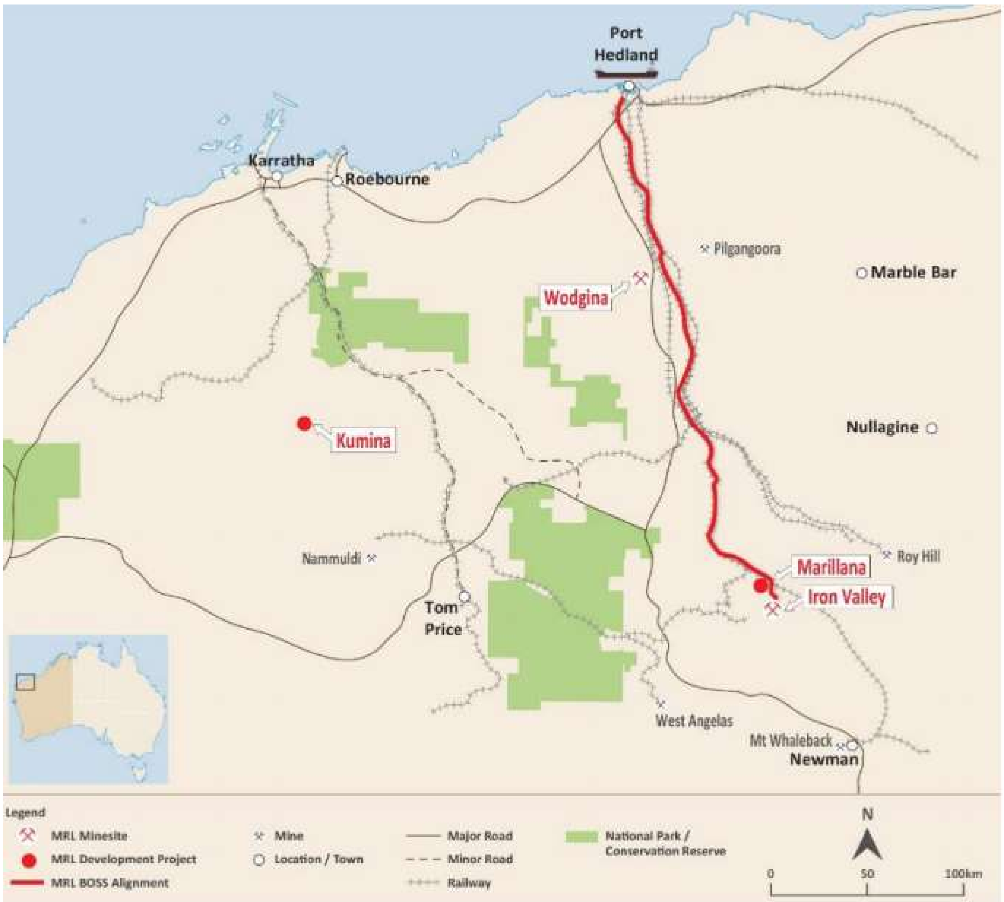
MIN has strategically purchased iron ore mines or partnered with junior mining companies several times over the last decade. It has generally been able to enter at attractive prices, as the deposits in question have had challenges that include grade, mine life, location and transportation, mine development and/or financing. Currently MIN owns the Iron Valley mine, which is low grade and only profitable when iron ore prices are elevated. It also has a more profitable operation at Koolyanobbing, where it is increasing output to 11.5Mt per annum, although there is only visibility on 6 years of mine life at this stage.

As it stands, the iron ore part of the business is fairly marginal, albeit very profitable when prices spike, as they have done over the last 9 months. In the 12 months to 30 June 2019, the iron ore business made $215m of EBITDA. MIN also has interests in deposits at Marillana and Kumina that are currently not producing.

The real opportunity and optionality in this part of the business comes from MIN's Pilbara Infrastructure Project. MIN's plan is to build a light rail system from Iron Valley and Marillana to link to new shipping berths at Port Hedland, as shown in the diagram on the following page. MIN has been working on the design and approvals for this project for many years. They are now getting close to making a final investment decision and unveiling the capital structure they will employ, which we suspect may involve third-party infrastructure-style investors. The aim of the project is to provide economic export pathways to mines that are otherwise stranded or very high cost. MIN believes it will be able to transport 40Mt/year (plus another 20Mt for third party users) of iron ore onto ships for circa US$30/tonne, bringing an asset like Iron Valley substantially down the cost curve compared to its current position.

Clearly there are a lot of uncertainties and risks involved with the project, and there remains the possibility that it may not proceed. Nevertheless, the potential upside for MIN shareholders could be quite considerable. If we assume an iron ore price of US$50/t (currently the price is over US$90/t), MIN's share of production as 30Mt, and a total cost to get iron ore onto a ship of US$35/t, the EBITDA from this operation would be around US$450m, which is currently A$660m. We expect that MIN may also be able to earn an attractive return for a partial ownership stake in the infrastructure assets.

We will not attempt to specify an exact valuation for the iron ore business due to the number of assumptions required, but suffice to say it appears to have the potential to be worth several billion dollars. In contrast, most of the work we see in the market on the iron ore part of MIN's business gives it a value somewhere between $50-300m, with no value ascribed to the Pilbara Infrastructure Project. This provides a very positive asymmetric risk/reward trade-off for investors in MIN at current market prices.



Lithium Mining Valuation

MIN has grown aggressively in the lithium market over the last few years, buying immature ore bodies from junior miners and bringing them into production. Their major asset is Wodgina, which is one of the largest and best quality hard rock lithium mines globally. The company is nearing completion in the construction of a spodumene plant at Wodgina (spodumene is a downstream product made from lithium ore). They also own 50% of the smaller Mt Marion lithium mine.

Lithium is a key component in the manufacturing of lithium-ion batteries. Very substantial growth is expected in this market, particularly as the production of electric vehicles increases over time. Lithium prices and sentiment have ridden a rollercoaster over recent years, with sharp rises as the demand story became better appreciated, followed by equally sharp falls as new supply emerged. We suspect the market view on lithium has now swung back too far in the negative direction, but this is not the forum for a lengthy debate on this topic.

Instead, the key point is that MIN has agreed to sell 60% of Wodgina to Albermarle, a global leader in lithium and currently the largest lithium producer in the world. This transaction should complete imminently. This will result in MIN receiving US$820m in cash (eliminating all existing MIN debt) and 40% of Albermarle's Kemerton lithium hydroxide plant, which is currently being built. Of course, MIN will also continue to own 40% of Wodgina.

To keep things simple, we will not attempt to independently value these assets, but will use the price paid by Albermarle as a guide. This gives approximately A$1.9b ($10/share) for MIN's remaining stakes in Wodgina and Kemerton. Many in the market would argue that Albermarle overpaid and/or paid a premium for control. We do not necessarily agree, but at the current MIN share price the argument is moot, as it is clearly already valued at a substantial discount.

Similarly, in March 2019 MIN and Ganfeng Lithium purchased Neometals' 13.8% equity interest in the Mt Marion lithium mine for $103.8m in cash. Assuming this represents a fair price between two willing buyers and a willing seller, this implies a valuation of $752m for 100% of Mt Marion, which equates to $376m ($2/share) for MIN's 50% stake.

Company Valuation

Given the varied nature of the different parts of the organisation, a sum of the parts valuation would appear to be most appropriate. Following completion of the Wodgina sell-down to Albermarle, MIN should be in a net cash position, however for simplicity we have assumed net debt is zero. We have also assumed the corporate overhead cost is put on the Mining Services business multiple, and have ignored the investments MIN has in multiple other projects and listed companies, although some of these could be very material over time, further enhancing the valuation.

Mineral Resources Valuation	Low Valuation ($m)	Median Valuation ($m)	High Valuation ($m)
Mining Services Business	1680	1960	2240
Iron Ore Business	200	500	2000
Lithium Business	1725	2300	2300
Corporate Overhead	-150	-170	-190
Net Debt	0	0	0
Total	3455	4590	6350
Shares on issue (m)	188	188	188
Valuation per share	**18.37**	**24.40**	**33.76**
Current Share Price	14.15	14.15	14.15
Upside	**30%**	**72%**	**139%**

Irrespective of how we look at valuation, or discount the future unknowns, we arrive at a number substantially above the current share price. Potentially, we reach a valuation at a multiple of the current price. Our downside valuation assumes a below peer multiple for the Mining Services business, that the Iron Ore business is worth little beyond current year earnings and a 25% reduction in the price implied by recent transactions for the lithium assets. Our upside valuation captures a higher multiple than the average for the Mining Services business given the duration of the contracts, a conservative valuation for the Iron Ore business assuming the Pilbara Infrastructure Project comes to fruition but no upside estimate for what the lithium business might be worth in an environment where lithium demand strongly exceeds supply.

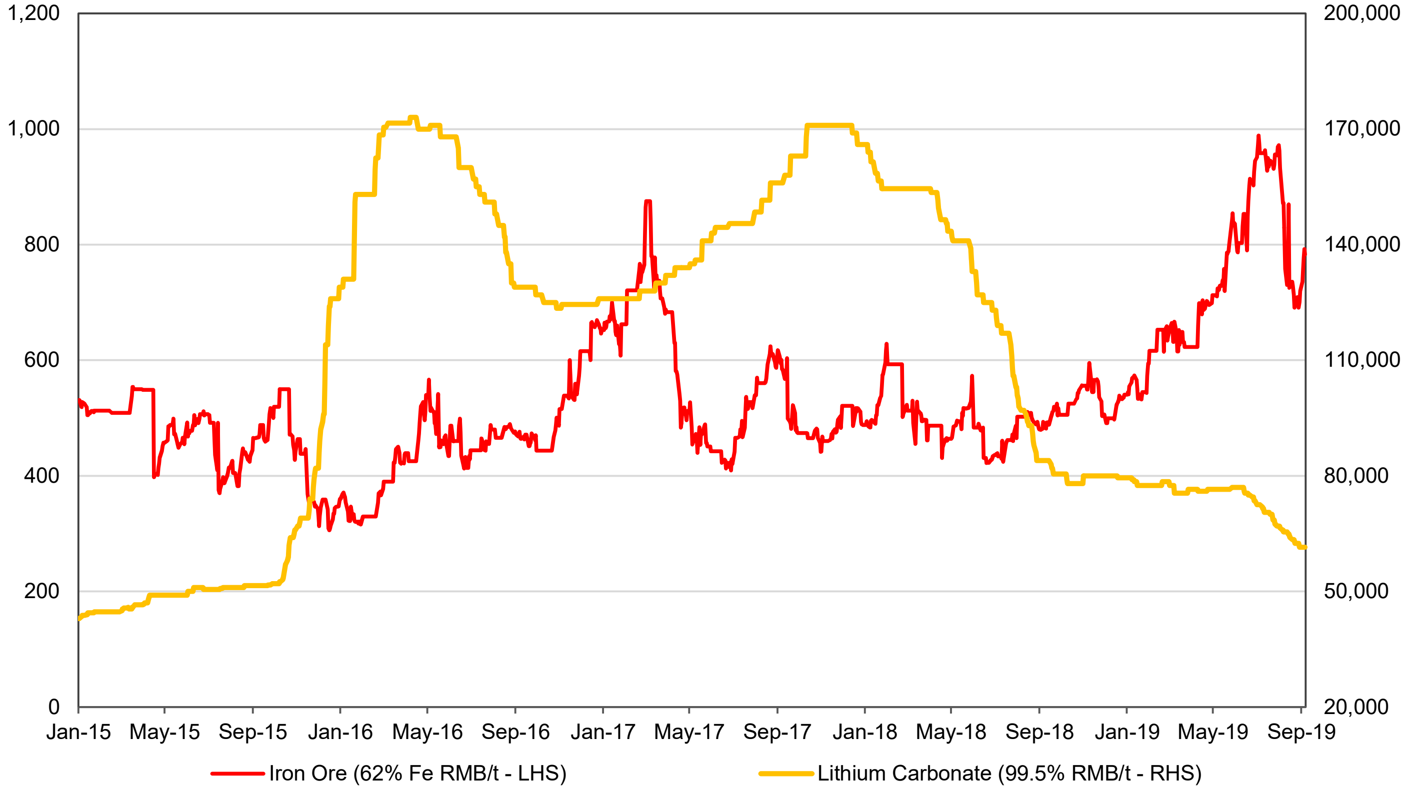
Alternatively, if we just look at simplistic ratios of FY20 analyst consensus forecasts, MIN is trading on a Price to Earnings multiple of circa 7x and a dividend yield of approximately 7%. While short term earnings are somewhat hostage to movements in the spot prices of iron ore, lithium and the Australian Dollar, creating significant earnings volatility, this applies in both upwards and downwards directions. It is also why MIN is focused on becoming a low cost producer that can make a return in almost any price environment.

Why Is It Cheap?

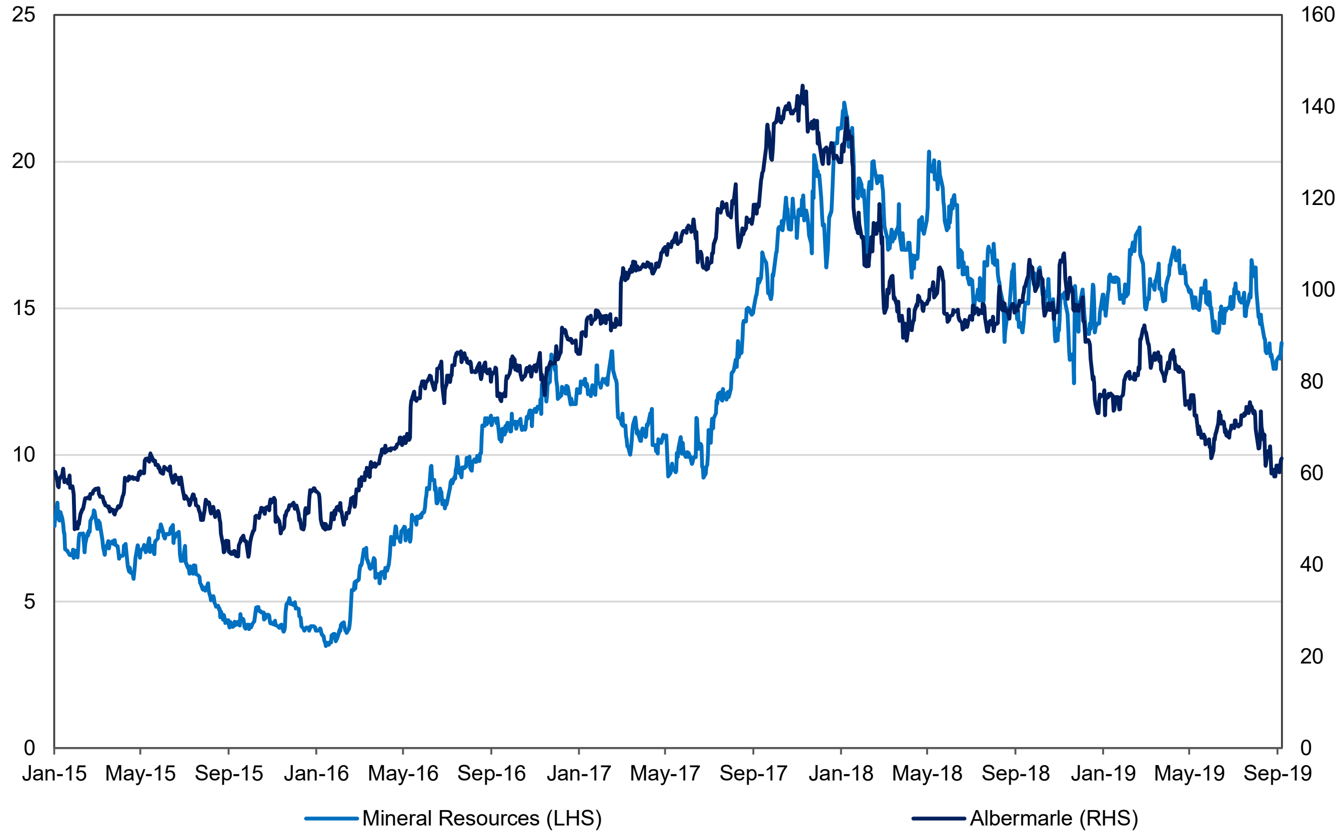
We have been closely following this stock for over a decade. It is hard to recall a time when the outlook for the business has been this strong, so it is somewhat surprising that this outlook corresponds with a time when the share price is weak.

Over the last two years, the lithium business has dominated the market commentary in relation to MIN. This is for good reason, as it has been by far the biggest driver of value for the stock. This was initially a positive, with the emergence of Wodgina from a niche asset to a major project. More recently, it has been a negative, with the much-publicised fall in lithium prices due to current oversupply. Largely, MIN's share price has followed lithium spot prices and sentiment. As shown on the chart below, there has been a close correlation between MIN and Albermarle (ALB). MIN has tended to perform better than ALB when iron ore prices have been strengthening due to its exposure to both commodities.

Iron Ore and Lithium Prices: 2015 to current



Mineral Resources and Albermarle Prices: 2015 to current



We believe MIN has been trading largely as a lithium stock with a modest overlay mirroring spot iron ore prices. However, this trend ignores the evolution of the company, in particular:

- the continued growth of the Mining Services business;
- the sale of 60% of Wodgina, which both crystallises value and downweights the importance of lithium to MIN; and
- the potential value of new projects, such as the Pilbara Infrastructure Project.

Recent history has encouraged the market to think of MIN as a near pure-play lithium stock. It is taking time to realise this is not the case. At its heart, MIN is a contractor, with complementary mining project investments.

We remain cognisant that the market may be right, and there may be something we are missing. The collective wisdom of the market is often greater than the individual investor, and it is important not to be too stubborn to listen to what it might be telling you. At the moment we do not believe this is the case, but we will remain vigilant to the emergence of new information that might change our minds. The very substantial recent director purchases give us some comfort in this regard.

Dealing with volatility is not just an important tool for a professional investor. It is an important tool for every investor. The temptation to exit an investment when its recent performance is poor is high. This is often the case irrespective of the longer term performance of the business and the management team. At the moment of maximum pain, you often doubt everything you previously knew to be true. At these points we think it is critical to evaluate the circumstances based on the facts. If the facts have not changed, and the investment thesis still holds, then patience is the most necessary discipline. These are the times when it makes sense to hold the position. More often than not, at these moments the smart money is buying. Those able to think objectively in the face of uncertainty and market volatility are able to scoop up the bargains being offered by those investors panicking out of their exposures.

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Auscap Asset Management Limited

ACN 158 929 143 AFSL 428014
Lvl 30, 9 Castlereagh St, Sydney

Email: info@auscapam.com
Web: www.auscapam.com

Service Providers

Prime Brokerage: Citi Global Markets
Administration: Link Fund Solutions

Tax & Audit: Ernst & Young
Legal: Norton Rose Fulbright