Auscap Newsletter

Auscap Long Short Australian Equities Fund

JULY 2021

AUSCAP ASSET MANAGEMENT

Adopting A Private Investment Mindset To Listed Markets

Why do we remember some things as clearly as the day they happened decades later, yet in other circumstances cannot remember what we did last Tuesday? The answer is generally that it depends on the significance of the event and the impact it had on us at the time. The birth of a first child is life changing and unlikely to be forgotten quickly. The plain salad sandwich that proved to be the highlight of last Tuesday less so. Dramatic events linger for longer and more vividly in the mind, often particularly so if they have negative associations or feelings attached to them. They certainly feel more recent than they are. It is hard to believe that it has been well over a year since the start of the global COVID-19 pandemic. Even harder still to believe that the Global Financial Crisis was more than a decade ago. For investors who experienced either period of turmoil, these memories are often vivid, the periods influential and even formative to their approach to investment.

In the first half of this newsletter we reflect on some of our observations from the last 18 months. We hope you find these interesting and thought provoking, whilst also giving you some insight into the way we think about investing. In the second half of this newsletter we discuss the rationale behind our investments in the real estate sector.

Time Horizons & Defining Long Term Investing

In our view all sensible investing is long term in nature and design when the investment is made. This enables the benefits of compounding returns to have good effect and, over time, provides the best opportunity to generate substantial wealth. What is a long term approach to investing? It seems a simple question with such an obvious answer. It is buying an asset today, with cash that is unlikely to be required for a considerable period of time, with the expectation that it will grow its cash flow and hence increase in value over time, either paying out or reinvesting the cash flow it generates. This is the approach we try to adopt when investing in equities. We are buying a stake in a business, that we intend to hold for a considerable length of time and where we see substantial upside from an earnings and valuation perspective, with the asset generating good cash flow to us as a part-owner. It is no different to buying a property or a private business.

Turning Advantage Into Disadvantage: The Liquidity Pitfall

Many investors in listed markets would quote the same long term approach. Yet somehow daily quotations can gradually degrade even the best of long term intentions. Daily price fluctuations convince people that they should act on them, often to their detriment. The idea that the market is there to serve you, not instruct you, is frequently quoted but less often adhered to, particularly during periods of stress. A lowball offer for your home would get little attention. In fact most people would scoff at such a suggestion. A low quote for your neighbour's house would have many wondering, assuming they have the means, whether they should snap up a bargain! And this is the correct approach. Yet listed markets are somehow different. Low and frequent quotes seem to encourage people to sell. It is difficult to imagine more frequent quotes than every second of every business day between 10am and 4pm. And in this way listed markets can do significant harm to individual investors.

Similarly, market prices are often used as the basis for valuation. Markets are assumed to be efficient, which is frequently far from reality. We suggest that at most times it is possible to find some companies that will never earn, over their lifetimes, undiscounted aggregate cash flows close to their current market capitalisation. Such stocks are definitionally overvalued, because a company is only worth the present value of all future cash flows. But when markets become enamoured with particular stocks or sectors, investors and analysts find ways of justifying the valuation. Often what they are really doing is assuming the collective market has a better understanding of the stock's value than they could, so the valuation the market is ascribing to the stock must be "in the ball park". Research price targets are inevitably clustered within 15% of the current share price. Even during market calamities like COVID-19, analysts rarely pound the table with stock suggestions where they see upside targets more than 100% above current valuations. The assumption is that such a valuation *must* be wrong, because the market could not be that far off. This mindset encourages the same behaviour, that somehow the market selloff and changed conditions justify absurdly low valuations, and therefore one should dare not think about buying at said prices.

The stockmarket is the juxtaposition of financial principles and human psychology. Having a sound understanding of both is a requirement for successful participation. Understanding one's own psychology, as much as recognising the collective psychology of others and therefore the broader market, is most important at the extremes, because extreme emotion drives extreme behaviour. The stockmarket has a tendency over time to swing from irrational exuberance to irrational fear and back again, reflecting the behavioural impulses of its participants. Recognition of this is important because it leads to the conclusion that market quotations during euphoric periods and particularly in broad market panics tell you very little about the underlying value of a business. So if not in a position to take advantage of a panic and buy, the best thing to do is nothing, particularly if you are confident in the quality of the businesses that you own a share of.

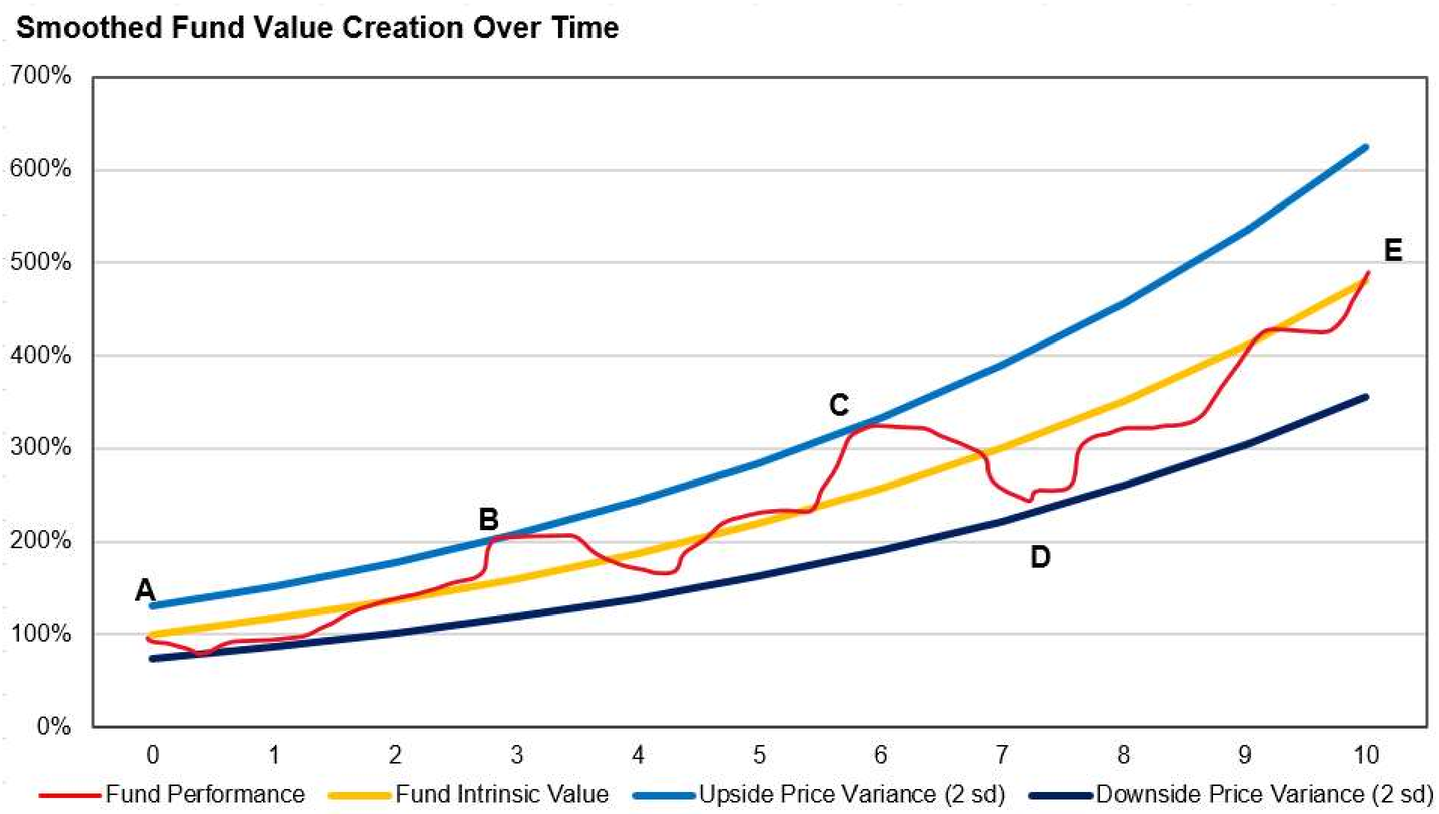
There is a certain irony in the increasing popularity of private equity funds in asset allocation. We look at many of the businesses owned by private equity and conclude that they appear to be, on average, inferior to the businesses the Fund holds in the listed market based on return on capital, market share and hence economies of scale, quality, resilience and management expertise. In any economic shock they are likely to suffer financially more than the businesses the Fund owns, and in genuine unexpected stress they are likely to have less funding alternatives available to them. Yet the perception is that many of these businesses sailed through the COVID-19 crisis. In many instances nothing could be further from the truth. What most people are referring to is the absence of marked-to-market pricing during this period of stress. Director valuations most likely outlined a modest decline in valuation and then a subsequent bounceback. But these valuations were based on rational financial analysis, absent the element of human emotion. The reality would have been very different had all of the investments been listed. The lack of regular pricing and liquidity worked to the funds' advantage and clients' advantage, preventing unnecessary self-harm.

It is ironic therefore that more and more frequent liquidity is being demanded of managed funds operating in the listed space. Daily liquidity to get into and out of a fund is almost a prerequisite for broad market acceptance. This liquidity demand appears completely at odds with the sensible recommended time frames for investing. In the case of the Auscap Fund, this is 5 years plus. Having a long term investment approach is very important. Most people make very considered thoughtful decisions prior to investing with a manager. But then often the decision to redeem might be made on a whim, or in reaction to an emotional response, thereby undoing the value of the thoughtful initial consideration.

Long Term Investing And The Random Walk Of Markets

At Auscap, we invest in businesses for the long term. This should be obvious to anyone who has followed the Auscap Fund and its investments over the years. We are a long term shareholder in the businesses we own. The reason a long term approach is best is because it allows the underlying value creation within the businesses to dictate returns. This is important. Over the short term the returns are far more a function of market sentiment and the random walk of the market.

To illustrate this, consider the hypothetical investment fund performance chart below.



Here we assume that the intrinsic value of this hypothetical fund portfolio is best represented by the yellow line. The good businesses the fund owns are gradually increasing their intrinsic value. In this simplified example we assume value creation is consistent over time. By contrast, the fund's actual performance is demonstrated by the red line. There are times when the manager's style and stocks are in favour, such as at B and C, and other times when this is clearly not the case, such as at D. Despite the stability of the underlying value creation, the effect daily prices can have on investor psychology is extreme. Let us take a look assuming an investment is made at the four points, A, B, C and D.

Investor A probably feels relatively comfortable for most of the investment period, potentially excluding the short period after investment when returns were negative. They might also be nervous at D, if the manager has underperformed for a few years. They might start asking whether the manager's investment approach has changed or whether they have lost their touch. Assuming the manager's approach and communication are consistent, they retain their faith and have a positive experience from A to E.

This is very different from investor B, who is happy at point C, but unlikely to be so at point D, when returns over his 4 years of investment appear meagre. Investor C is outright despondent at D. They may even assume they have made a calamitous decision investing with this manager. This is where it is most important to objectively reassess the investment rationale and seek to understand what has happened to cause the poor performance. Is the manager appearing consistent in approach? Have they faced natural headwinds or tailwinds? What is the communication like between investor and manager? Has there been any style drift or is the manager being consistent? Was the manager buying stocks at C and dumping them at D, leading to permanent loss of capital? Asking these questions will most likely lead to a sensible decision. For those who determine that the manager has remained consistent, communicative, humble and open, and therefore remain invested, there is satisfaction at point E, which should give the investor confidence to continue to take a long term approach to this investment.

How should the move from C to D be considered? Should the manager be criticised for how the portfolio of stocks performed over this period? The chances are high that the same stocks that caused the prices to move from C to D caused the move from D to E. An assessment needs to be made, on reflection, of the manager's decisions through this period. This assessment should not be based on price action, but rather on the performance of the companies in which the manager was invested. If those same companies generated the performance to E, then C to D was more likely a function of the vagaries of the market. This is why trying to time the market, or time an investment in a manager, is a futile exercise. It is also why the best approach to investment in markets or managers is to take a long term approach.

Even if a portfolio of well selected investments creates value consistently over time, as reflected by the yellow line in the chart above, daily price fluctuations mean that how this would appear to investors in a listed environment would be quite different. The example we have used assumes no moves outside of two standard deviations from the mean, the upper and lower bounds shown, in line with what might statistically be expected. In reality neither of these conditions, consistent value creation and a standard distribution of stock and market returns, exist in financial markets. This introduces further variance, particularly if a manager runs a concentrated portfolio. COVID-19 was a 1 in 100 year event, definitionally more than two standard deviations from the mean, implying a move below the downside price variance shown in the chart. Spending too much time listening to the market to select investments will more likely lead to selecting stocks or managers after they have had good performance, such as at points B and C, rather than making a decision to invest at D, when great opportunity exists. The investment manager's role is to select businesses capable of increasing their intrinsic value substantially over time. This can only be done if one takes a long term approach.

Confusing Preservation Of Capital With Price Volatility

One of the most discussed, focused on and misused terms in the market is "preservation of capital". Almost every manager quotes it as an objective of the investment process, but what does it mean? It means not buying something and then selling it later at a loss. It is reflective of an error made in purchase where the investment thesis was incorrect, the valuation was excessive and/or circumstances have changed such that the assessment of value is much lower and therefore justifies the sale of the asset even though the price is lower. A manager who purchases investments with a significant margin of safety between the purchase price and fair value will not have such an experience frequently. Whilst unfortunate surprises will still happen, buying high quality businesses with an initial margin of safety is the key way we look to protect capital over time.

Preservation of capital is *not* about minimising volatility. It is not about ensuring a portfolio does not have drawdowns in the aggregate quoted valuation of the businesses it holds. “Drawdowns” are not reflective of poor preservation of capital any more than your neighbour deciding to sell his house in a short downturn for an absurdly low price and clear capital loss would be reflective of your own capital preservation skills. It is only poor preservation of capital if you also need to or choose to sell your own house at this low price creating a capital loss. This distinction is very important. Why? Because confusing preservation of capital with stock price volatility will lead to a focus on things that are beyond the control of any manager.

A manager who focuses too heavily on avoiding performance volatility runs the risk of missing some great long term investment opportunities, if investing in these opportunities are in conflict with their short term desire to lower fund volatility. The greatest opportunities are often present in the most volatile market conditions. Dampening investment volatility through some diversification is sensible. We think a portfolio of approximately 40 investments in listed equities is sufficient diversification to achieve a reasonable lessening of volatility in most circumstances. Similarly, some stocks and sectors exhibit lower volatility over time, and being aware of this is also sensible. But trying to lower volatility will either result in “index hugging”, largely replicating the index against which the manager is measured by sector and even large individual company weights, so that volatility is always similar to the index and therefore “acceptable”, or by trying to time the market. Index hugging is clearly not investing to maximise risk-adjusted returns, because the risk-reward for individual investments is not proportionate to their size. And we think trying to lower fund volatility by trying to time the market, investing in stocks when a manager thinks they will appreciate and exiting before they think they will depreciate, is fraught with danger.

History would suggest that it is impossible for any individual to consistently time the market in this way. Our view is that trying to time the market is a folly. One can be aware of circumstances that positively and negatively impact the outlook for individual companies, but absent new information or circumstances materially changing the investment thesis, investing, divesting and reinvesting in positions one wishes to hold for the long term to try to minimise negative short term investment performance is an impossible task. It is also tax inefficient, mentally taxing and takes time and effort away from the primary concern of selecting attractive long term investments and monitoring developments across these investments closely.

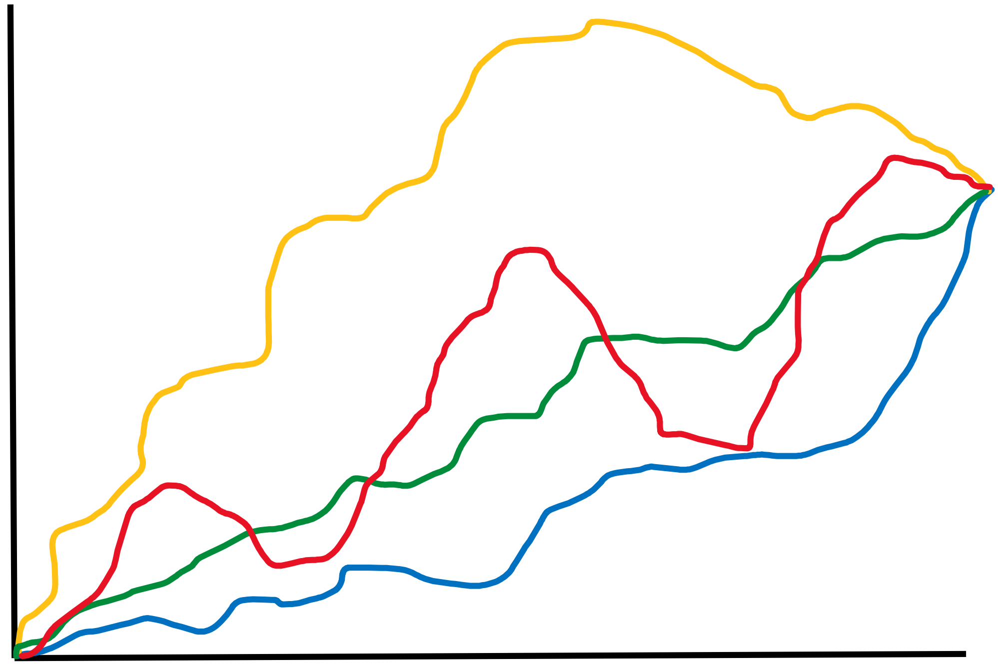
Market liquidity should provide investors with an additional opportunity to improve returns, by taking advantage of extremes in sentiment. Market liquidity may even allow an investor to exit one investment, even at a loss, because another opportunity is significantly more compelling from a risk-adjusted return perspective, an aspect of portfolio optimisation. But we are not of the view that available liquidity should be used to guess where share prices are going over short time periods, an impossible task.

Path Dependency And The Role Of Luck

The other observation we can make about the chart above is the random nature of short term performance and the role of luck in this process. Yet path dependency can create a strong perception of a manager from an investor’s perspective. People naturally focus on what happens from the point at which they invest, which is entirely understandable. However, while the path of performance will be noticed, in the short term it is beyond the control of the manager. Whether good performance occurs in clumps followed by retracements, or is reasonably even and linear, is not something the manager determines. Whether an investment style has been in favour or out of favour, and whether it comes in and out of favour quickly or has long periods in the wilderness, are also factors beyond the manager’s control. Investors frequently evaluate managers based on actual short term outcomes, without recognising that such outcomes are often a function of random unpredictable events. This is the random walk of markets. It is over the long term that investment outcomes are a function of the level of investment skill.

The investment performance path a portfolio of 40 investments takes could deviate substantially even if the portfolio ended up in the exact same spot at the end of 5 years. Anyone who has run a Monte Carlo simulation based on a number of variables would be aware of this. There are almost infinite variables affecting stockmarkets. Yet the role and impact of events on stocks prices at different points can lead to vastly different conclusions about a manager.

Take the following hypothetical performance chart and assume that the investment portfolio represented starts at point A and ends up at point B after 5 years.



The way prices fluctuate, and the random walk of markets, would result in many possible paths to get there. In this example we assume the most extreme upper and lower paths are defined by the yellow line and the blue line respectively. We have added two other paths of the infinite possibilities into the equation, the green and red lines. The valuation path of the listed portfolio might take any of these routes, or numerous others. This is the short term random walk of the market. Yet investors will take their cues from this. The yellow path might draw the conclusion that the investment manager is a high risk taker, with enormous initial outperformance followed by a significant drawdown. The blue path might lead to the conclusion the manager took their time to get going, but at point B they are now hitting their stride. The green path might be interpreted as a very stable outperforming manager who is excellent in every regard. Yet the red line might be interpreted as a manager who is very volatile, and therefore risky. Many different conclusions for the same manager invested in the same stocks that achieve the same outcome, all because of the random walk of markets. That is not to dismiss volatility as a potential indicator of risk, but it is *not the same as risk*. Understanding risk is more complicated than measuring standard deviation for the one actual performance path different managers have experienced.

But if we are not to assess investment managers on the path of returns, what should they be assessed on? The best way to assess a manager in relation to delivering outperformance is the long term investment outcomes that have been delivered. And by the performance of the stocks the manager is invested in. At Auscap we are on a continual path to improving disclosure and transparency so that investors can assess our performance based on the outcomes achieved by the companies we are invested in, as well as the consistency of our approach and adherence to our core investment beliefs. This is why we recently commenced disclosing the top twenty investments in the Auscap Fund at the end of each month, rather than just the top ten. They represent the bulk of invested capital.

The Discomfort Associated With Non-Index Returns

A lot of investors would like to achieve superior returns with their investment managers over time. But if the expectation is that the returns from the manager will not deviate negatively at various points from the broader market, this objective is impossible to achieve. For a manager to generate returns which are significantly superior to the relevant index, which is typically a basket of stocks weighted by size, an investment manager’s portfolio must look very different to this basket of stocks. The Auscap Fund looks nothing like the All Ordinaries Accumulation Index. This means that performance will be significantly different to this index. At different times this variance will be both positive and negative, with the objective being that *on average* it is considerably better than the index, otherwise investing in the index would be the way to go. But to achieve superior performance, investors must be willing the bear the deviation. It is an easy thing to acknowledge up front, less easy to live with when a negative deviation is occurring.

We encourage all investors in the Auscap Fund to take a long term approach. The Auscap team are significantly invested in the Auscap Fund and are committed to being invested for the long term. We invest in high quality businesses that we believe will grow their cash flows, and hence value to shareholders, over time. We modify the portfolio based on new information over time, but do not fool ourselves into thinking we can time the market by jumping into and out of a wide range of stocks. This adoption of a private investment mindset to listed markets will result in the performance over the long term reflecting the value created within the businesses we own. We think this is the only sensible approach to investment in listed markets.

Real Estate – A Sector Yielding Opportunities

Our views on investments 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 the investments will not perform as expected, which could have an adverse impact on the Auscap Fund. The below information is not general advice, personal advice or a recommendation to be relied upon when making an investment or other decision.

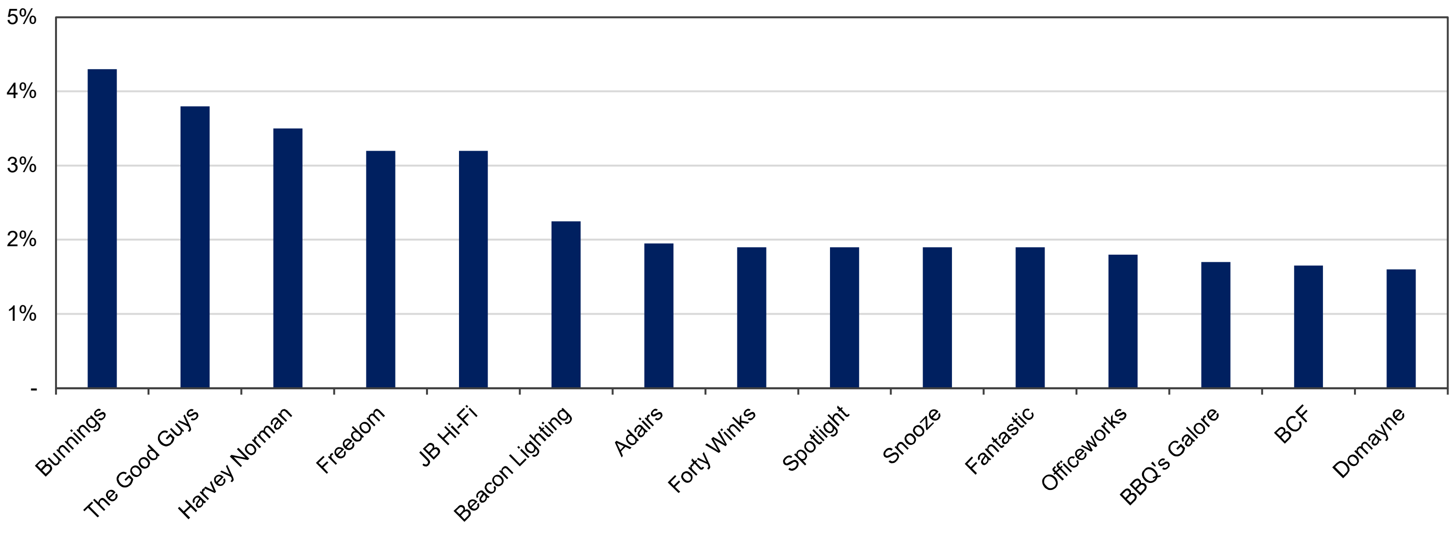
We have been attracted to the real estate sector since the inception of the Fund. The key revenue stream for real estate investment trusts (REITs) is rent, which is an essential cost for most businesses and is highly recurring and low risk in nature. The real estate vehicles held by the Auscap Fund tend to comprise a portfolio of hard to replicate assets, are relatively simple to understand and are expected to have strong and growing cash flows over time. This newsletter covers the investment thesis of six real estate investments held by the Auscap Fund across three buckets: attractive yield plays, special situations and fund managers.

Attractive yield plays

Aventus Group (AVN)

Aventus Group (Aventus) owns a diversified portfolio of 19 high quality large format retail (LFR) centres which represent 22% of the Australian large format retail sector (defined as LFR centres with >25,000 sqm of Gross Lettable Area (GLA)). 74% of the portfolio is in metro catchments and three quarters of centres are external assets which allow for better social distancing. 37% of tenants serve everyday needs categories, including Coles, Officeworks, Chemist Warehouse, Supercheap Auto and Dan Murphy's, whilst the balance of tenants sell products relating to the home, including The Good Guys, JB Hi-Fi, Bunnings, Harvey Norman & Nick Scali. 88% of tenants are national retailers, with no tenant representing more than 5% of income.

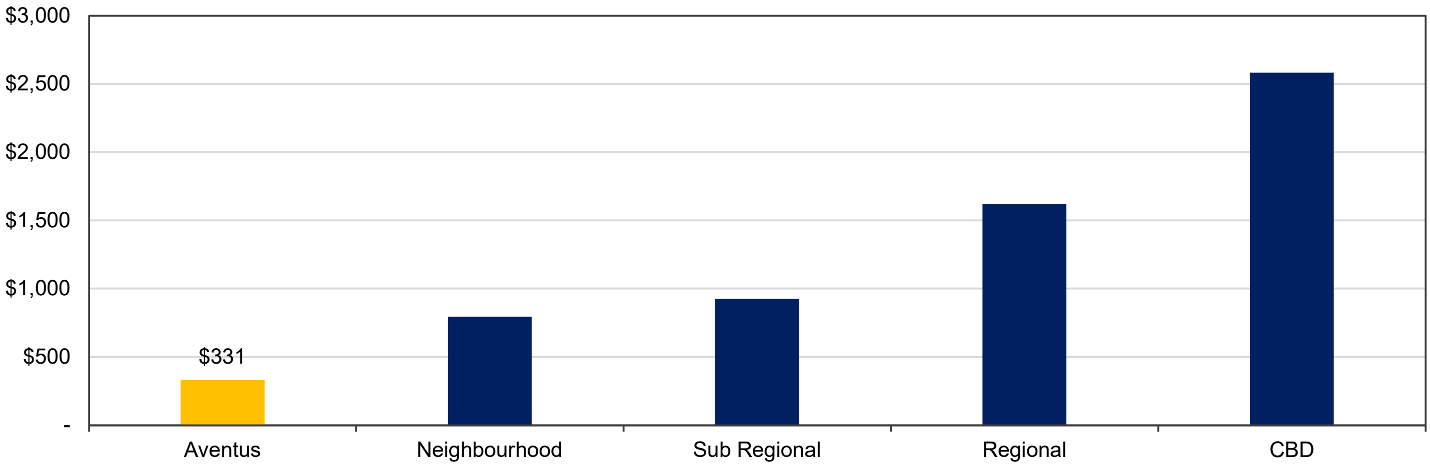
Top 15 AVN Tenants by Income



Source: Aventus, Auscap

All Aventus leases include annual rent escalations, 77% of which are fixed at a weighted average rate of 3.8%, with the balance being CPI linked. Crucially, Aventus charges an average gross rent of just $331 per sqm, materially lower than the other large scale retail destinations that a leading national retailer might consider. This low comparative rent has allowed Aventus to maintain consistently high occupancy, currently 98.5%, whilst also providing a long runway of rental growth. Bulky home products are especially reliant on stores, given they are notoriously difficult to sell online, providing resilience to the e-ecommerce threat. We expect stores to remain highly relevant for omni-channel retailers given the large proportion of sales likely to remain in-store, the branding benefits of stores, the cost advantages of fulfilling online orders from stores and the margin accretion of click & collect orders.

Average Gross Rent Per Sqm p.a.



Source: JLL Research, Aventus, Auscap

In addition to a strong underlying financial profile, Aventus offers significant optionality. Across its 1.2 million sqm land bank, only 44% is currently covered by retail sites. Aventus has identified development opportunities at 88% of its assets, with 39% of the portfolio currently having zoning for other uses. Aventus has achieved an average return on capital of 9% on developments since IPO. Aventus has also identified incremental income opportunities in solar panels, ticketless parking and signage. In addition, Aventus has a nascent funds management platform which can be further leveraged to expand Aventus' presence into smaller bulky goods retail centres or to lower Aventus' cost of capital for future acquisitions. Aventus has room to grow with its balance sheet currently below management's target gearing range of 30-40%, providing firepower for accretive acquisitions.

Aventus' longstanding CEO Darren Holland began building Aventus with Brett Blundy in 2004 following a career involving homemaker centres starting in 1992. Following a 2018 internalisation, management's incentives are strongly aligned with shareholders. After accounting for a recent upward revaluation, we estimate Aventus is trading approximately 15% above its net tangible asset value and at a mid-single digit premium to its net asset value, which includes the capitalised value of the Aventus management rights following the internalisation. Aventus has a forecast FY22 distribution yield of 5.8%, which we believe should grow sustainably at 3% plus per annum. For an asset with much lower risk than the broader market, we think this provides investors with an attractive total return before allowing for upside from redevelopment opportunities, acquisitions, balance sheet optimisation or potential future income streams.

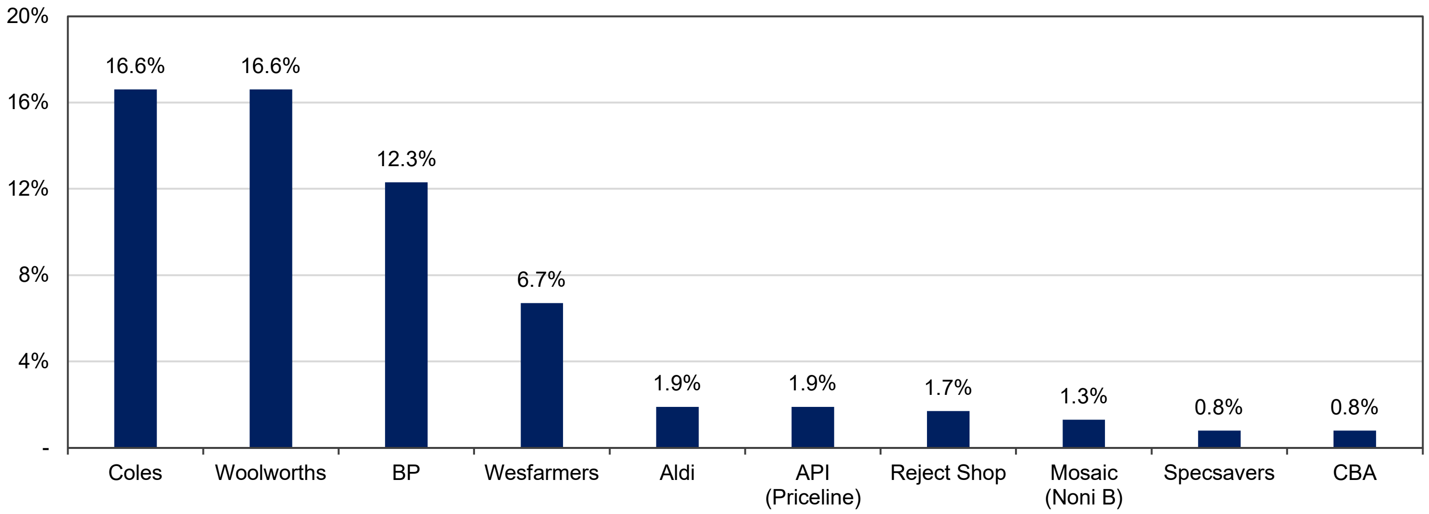
Charter Hall Retail REIT (CQR)

Charter Hall Retail REIT owns $3.5bn of "convenience retail" locations across Australia. Its portfolio consists largely of:

- 27 "Convenience" assets: Assets with a single supermarket and some complementary specialty offerings;
- 24 "Convenience Plus" assets: Assets with multiple supermarkets, or a supermarket and a discount department store, with some complementary convenience specialty and retail offerings;
- A share of Charter Hall's 49% interest in 270 BP service stations (the other 51% retained by BP), representing the majority of BP's owned assets across Australia and New Zealand. These are multi-decade leases with annual CPI rent increases. Leases are triple-net-leases, meaning BP retains responsibility for all repairs, outgoings, site remediation, maintenance and capital expenditure on the sites; and
- A 52% holding in Coles' Adelaide Distribution Centre on a 14.5 year lease with fixed annual rent increases of 2.75%.

54% of CQR's rent comes from Coles, Woolworths, BP and Wesfarmers (Kmart, Target, Bunnings & Officeworks). 65% of supermarket leases currently pay turnover rent, meaning CQR benefits from the sales growth of these tenants. Occupancy across the portfolio is 97.8% with positive leasing spreads of 2.5% as at the latest update.

CQR Top 10 Tenants (%)



Source: CQR, Auscap

As at 15 July 2021, CQR was trading at $3.69 relative to Net Tangible Assets of $4.02, with a forecast FY22 dividend yield of 7.0% that we expect will grow at a reasonable rate over time. At current prices, we view CQR as a simple, low risk and attractive yield and growth proposition.

Special situations

Some of the Auscap Fund's real estate holdings fall into the "special situations" bucket. These vehicles own high quality portfolios, which are currently trading at a discount to the independent value of their assets and have highly aligned management teams who have clear plans to close the discounts to fair value. Two holdings within this bucket are Unibail-Rodamco-Westfield and GDI Property Group.

Unibail-Rodamco-Westfield (URW)

Unibail-Rodamco-Westfield (URW), formed via the 2017 merger of Unibail-Rodamco and Westfield, is the owner and developer of the world's premier portfolio of flagship retail assets. It has a €56bn portfolio of 87 shopping centres, located across Europe and North America. URW owns 19 of Europe's top 30 retail assets by footfall.

Its assets include, among many others:

- Westfield London, the largest shopping centre by size in Europe;
- Les 4 Temps, the largest shopping centre by footfall in continental Europe;
- Westfield Stratford City, the largest shopping centre by footfall in the UK;
- La Maquinista, the largest shopping centre in Catalonia;
- Shopping City Sud, the largest shopping centre in Austria;
- Westfield Mall of Netherlands, the largest shopping destination in the Netherlands;
- Westfield Valley Fair, the largest mall by revenue in California;
- Westfield World Trade Centre in New York; and
- 5 retail airport operations, including Los Angeles, John F Kennedy and Miami airports.

URW boasts a premium collection of assets which would be near-impossible to replicate, but these assets were unfortunately hit extremely hard by COVID-19 and the associated movement restrictions. Significant tenant relief was required, vacancies increased from 5.4% to 8.3% over the course of 2020, leasing negotiations were delayed and incremental convention centre income disappeared, down 92.3% on 2019. URW's assets were subsequently revalued downwards 11.3% over 2020 leading to somewhat elevated gearing with a 44.7% loan to value ratio against a target of 30-40%. The URW share price is down over 40% from €126.95 in February 2020 to €72.93 as of 14 July 2021, less than half URW's net asset value of €166.80.

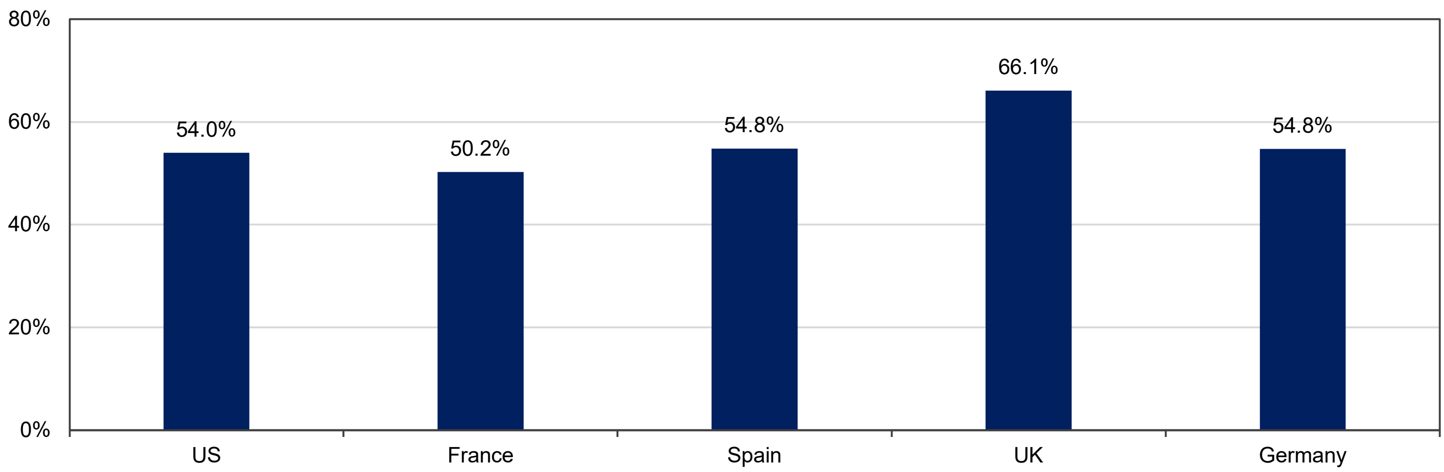
In the face of an incredibly challenging scenario, current URW management have acted prudently. Actions include:

- Raising debt and extending URW's debt maturities, ensuring no near-term liquidity concerns;
- Announcing a plan to divest assets opportunistically over the coming years, including €4bn of disposals in Europe and material US disposals. Over FY20, €2.3bn of assets were sold at an average *premium* to book value of 0.3%;
- Pausing the URW dividend until the end of FY22 and reducing capex to preserve cash;
- Ruling out the prospect of a highly dilutive equity raise; and
- Replacing the management team responsible for the unsuccessful Westfield merger, whilst adding experienced executives to the Board. New leadership includes Chairman Leon Bressler, former URW CEO between 1992 and 2006, and Board Member Xavier Niel, a French billionaire technology entrepreneur and founder of Illiad.

Xavier Niel and Leon Bressler's firm Aermont Capital have purchased approximately 20% of URW shares on market, with Xavier Niel indicating to regulators in March 2021 that he intends to continue to purchase shares. Xavier Niel has spent over €900m purchasing URW shares since joining the Board in November 2020, a clear indication of the value he sees given the share price.

Over 2020, Europe and the United States were amongst the worst affected regions by COVID-19. But the governments within these regions have responded with aggressive vaccine rollout plans that lead the world. As investor focus begins to shift to a post-COVID world, we see tremendous opportunity for URW to close its steep discount to NTA. URW owns a very high-quality portfolio, has not raised equity, has very aligned and capable leadership and is trading at below half the independent value of its assets. We view URW as an exciting global economy reopening trade as vaccination rates improve across Europe and the United States and lockdown conditions are eased.

Vaccination Rates Of URW's Top 5 Countries (74% of 2020 Income)



Source: Our World In Data as at 30 June 2021, Auscap

GDI Property Group (GDI)

GDI is a fully integrated, internally managed property and funds management group with capabilities in ownership, management, refurbishment, leasing and syndication of properties. GDI's Managing Director Steve Gillard is a substantial GDI shareholder, holding just over 5% of shares on issue. GDI has a significant exposure to Perth core CBD office assets and its single largest tenant exposure is the West Australian Government. GDI has a track record of acquiring assets counter-cyclically, with most of its major assets acquired below replacement cost or at land value.

GDI's latest Net Tangible Assets (NTA) is $1.27 per share, against a share price of $1.10 as at 15 July 2021. The vast majority of this NTA is comprised of:

- Mill Green Office Complex (197 St Georges Terrace, 1 Mill Street and 5 Mill Street) in Perth ($326m)
- Westralia Square (141 St Georges Terrace) in Perth ($345m)
- 47% of a portfolio of 17 Perth Car Dealerships, 100% occupied on long-term leases ($106m)
- 50 Cavill Avenue in Surfers Paradise ($101m – Held for sale)

GDI has identified many opportunities to materially increase the value of its NTA. These include the dramatic DA approved redevelopment of 1 Mill Street (artist's impression below left, currently a 3 level building with plans to develop 45,000sqm of office space) and the low-cost expansion of Westralia Square ("WS2" – artist's impression below right, currently vacant land). They are also continuing to re-develop and lease the other assets, with current occupancy ranging from 63% to 91%, and expand their funds management operations.

Source: GDI

We are admittedly cautious towards most Australian office markets, given the ongoing impact of COVID-19 on CBDs. The Perth office market continues to have high levels of vacancy, however given the performance of the West Australian economy since the onset of COVID-19 we anticipate strong net absorption once borders reopen and companies are able to hire staff from interstate and internationally to deal with critical labour shortages. The Perth office market has also not seen the same upward revaluation of office assets as the East Coast pre-COVID, with many central CBD assets still trading below replacement cost, and therefore has little supply coming online in coming years. GDI has a conservatively positioned balance sheet, high insider ownership, significant exposure to any improvement in the Perth office market and multiple controllable opportunities for asset growth.

Fund Managers

The Auscap Fund also has exposure to a select group of fast-growing real estate fund managers. We are attracted to these businesses for a variety of reasons.

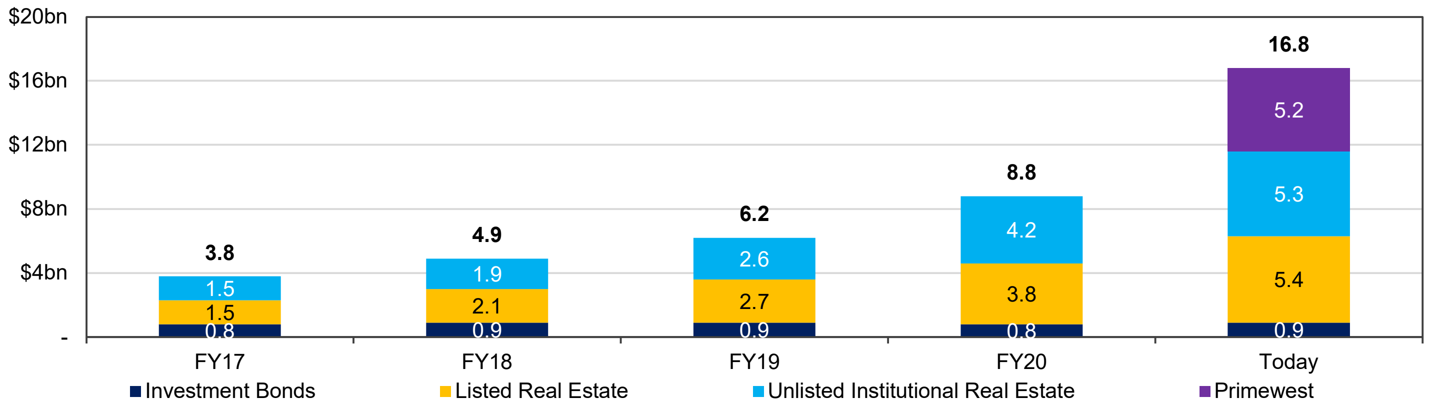
- **Structural global tailwinds**: These fund managers have direct exposure to the growing institutional and retail demand for yield products, which we expect to remain strong.
- **Emerging asset classes**: Whilst popular asset classes like office, retail and industrial are relatively well established, many others are still emerging, with long runways for growth. These include healthcare, wellness, daily needs and agriculture.
- **Low risk FUM**: Relative to equity fund managers, real estate fund managers tend to have a large portion of closed end assets under management, through both listed vehicles (which have minimal risk of outflows, particularly when the fund manager retains a substantial stake in the vehicle) or closed end unlisted property funds that own a specific asset or group of assets (which often have waiting lists of clients willing to invest). This greatly reduces the risk of the fund manager losing assets under management.
- **Success reinforces success**: Fund managers who have been able to demonstrate an ability to grow are rewarded with greater institutional investor relevance, better access to capital markets, access to new capital pools and a lower cost of capital. This in turn allows the fund manager to continue to grow through launching new vehicles, raising equity and acquiring assets at attractive prices.
- **Operating leverage**: A fund manager which doubles its assets under management generally does not need to materially increase its head count or cost base (unless it is adding capabilities across a new asset class), which means profit growth has the potential to greatly exceed revenue growth.

Two real estate fund managers held by the Auscap Fund are Centuria Capital and Home Consortium.

Centuria Capital (CNI)

Centuria Capital (Centuria) is the 4th largest ASX-listed Australian real estate fund manager, with $15.9bn of external AUM. Centuria has grown rapidly in recent years, with its AUM growing at an impressive CAGR of 45% since FY17. Its AUM is highly diversified, with 34% in listed vehicles, 31% in unlisted retail vehicles, 25% in unlisted wholesale vehicles and 10% in unlisted institutional vehicles.

Centuria Total AUM ($bn)



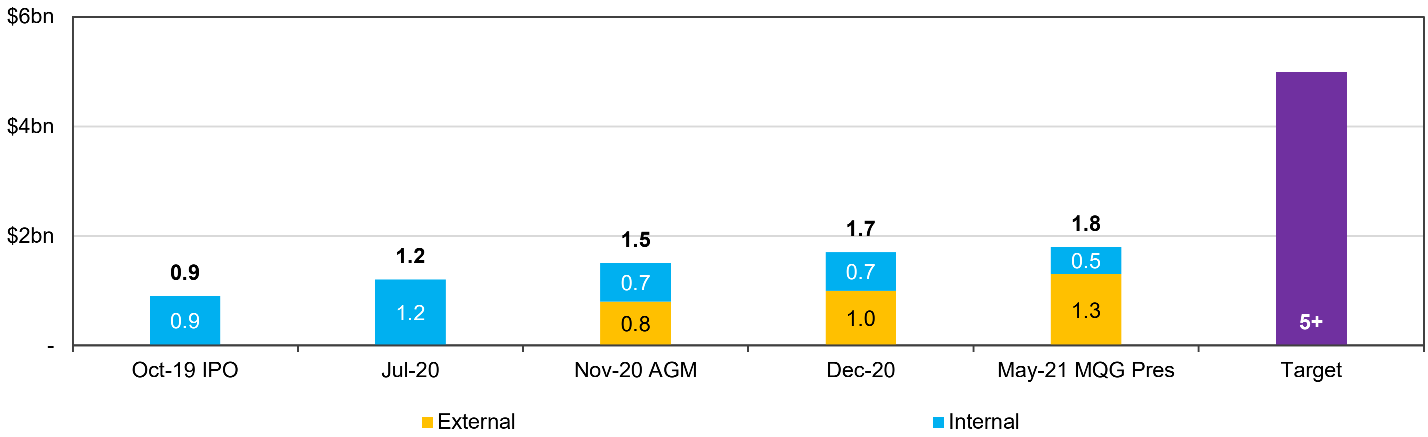
Source: Centuria, Auscap

Centuria is led by longstanding executives John McBain and Jason Hulich, who are aligned and motivated to continue Centuria's strong growth. Centuria's long-standing core competencies have been office and industrial real estate. However, recent acquisitions (Heathley, Augusta and Primewest) have materially expanded the Centuria offering, with new platforms now spanning Healthcare, New Zealand, Daily Needs, Large Format Retail and Agriculture. The key executives of each acquisition have remained at Centuria and generally have very large Centuria shareholdings. The three Primewest founders now own approximately 14% of Centuria. The Auscap Fund has had exposure to Centuria or its vehicles for many years.

Home Consortium (HMC)

In late 2016 David Di Pilla led the acquisition of a selection of ex-Masters property assets from Woolworths, with the objective of repositioning and re-leasing the assets. Other investors included the Chemist Warehouse Group, Spotlight Group, Primewest (now part of Centuria) and various senior UBS executives. In 2019, "HomeCo" listed on the ASX with a $663m market capitalisation, owning a subset of these ex-Masters assets valued at $925m comprising 21 stabilised assets and 9 development assets. The Auscap Fund invested in HomeCo soon after the 2019 IPO. Since then David and his team have continued their frantic pace. They have more than doubled HomeCo's AUM, listed a vehicle (HomeCo Daily Needs ("HDN")), progressed the establishment of a fund focused on health and wellness ("HealthCo") and have set a goal of growing AUM to $5bn+.

Home Consortium AUM ($bn)



Source: HomeCo, Auscap

The building blocks for HomeCo achieving its $5bn+ AUM target are already largely in place. First, there is significant optionality within HomeCo's existing portfolio, which has just a 31% site coverage ratio across more than 1.5 million square metres of land. Secondly, HomeCo is well progressed in its strategy to list large real estate vehicles. These vehicles are seeded with assets already owned by HomeCo, with the gradual selldown of these assets to external investors making HomeCo more capital light and releasing capital for HomeCo to recycle into new growth initiatives. HDN and HealthCo are also at a sufficient scale and have sufficiently broad mandates that they should have no issue continuing to grow through accretive acquisitions, an opportunity that HomeCo has sized at $5bn+. HomeCo currently has a net cash balance sheet, putting it in a good position to take advantage of opportunities. HomeCo management take great pride in their ability to think outside the box to create value in interesting ways. Should HomeCo achieve its $5bn medium-term AUM target, we would be very surprised to not see more ambitious AUM targets being announced with HomeCo broadening its mandate into new sectors.

Using FactSet consensus, Centuria trades on 23x FY22 P/E with a dividend yield of 3.5% and HomeCo trades on a 32x FY22 P/E ratio with a 2.6% dividend yield. These yields are clearly lower than some of the Auscap Fund's other real estate holdings and the multiples are elevated. However, these businesses are capital light, catalyst-rich, have very significant growth opportunities ahead of them and are led by highly capable and well-aligned founders. The Auscap Fund's holdings in both Centuria and HomeCo were acquired at very attractive prices. We currently put both holdings in the "long term compounder" bucket.

Conclusion

The Auscap Fund's real estate exposures are each unique in their value proposition for investors. While they are exposed to factors that affect all real estate, the real opportunity for value creation in each case is stock specific. We are attracted to the prospective total returns on offer in what is a relatively straight forward and historically resilient sector.

Auscap Long Short Australian Equities Fund

Fund Performance*

Period	Auscap	All Ords
June 2021	5.5%	2.6%
Financial Year	87.4%	30.3%
Since Inception	307.2%	136.6%
Annualised Returns	17.8%	10.6%

Fund Exposures

June 2021 Average	% NAV	Positions
Gross Long	117.4%	41
Gross Short	0.6%	1
Gross Total	118.0%	42
Net / Beta Adjusted Net	116.8%	137.0%

Portfolio Commentary

The Fund returned 5.5% net of fees during June 2021. This compares with the All Ordinaries Accumulation Index return of 2.6%. The Fund's biggest exposures over the month were spread across the consumer discretionary, real estate, materials, financials and communication services sectors.

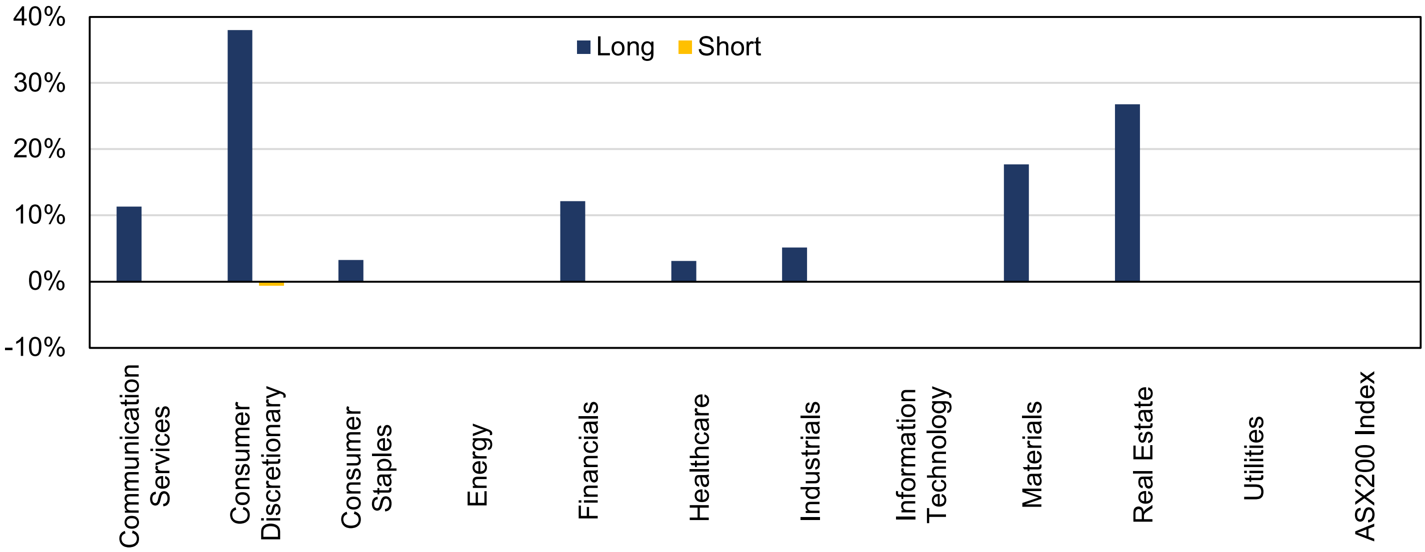
Fund Calendar Year Returns*

CY13	51.9%	CY18	(18.5%)
CY14	23.2%	CY19	18.1%
CY15	36.0%	CY20	10.6%
CY16	2.2%	CY21	24.1%
CY17	17.1%		

Top 20 Investments^

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

Sector Exposure - June 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 30 June 2021.

Newsletter – July 2021

Auscap Asset Management

If you do not currently receive the Auscap Newsletter automatically, we invite you to register. To register please go to the website www.auscapam.com and follow the registration link on the home page. Interested investors can download a copy of the PDS for the Auscap Long Short Australian Equities Fund at www.auscapam.com/auscap-fund/pds. We welcome any feedback, comments or enquiries. Please direct them to info@auscapam.com.

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