Auscap Newsletter

Auscap Long Short Australian Equities Fund

JANUARY 2022

AUSCAP ASSET MANAGEMENT LIMITED

Investing In Innovation: What Does History Tell Us?

Disruption. Change. Innovation. These are terms synonymous with the current investing landscape. The developments being witnessed across a number of fields are so potentially ground-breaking it is hard not to get excited at the prospect of major technological, healthcare, energy, environmental and productivity advances that might occur over the next few decades. Indeed the developments may end up exceeding all of our expectations and progress our lives in ways that are unimaginable today. As Amara's Law suggests, we tend to overestimate the effect of a technology in the short run and underestimate its effect in the long run.

Cathie Wood, Chief Investment Officer of ARK Invest, has spoken of the 5 major platforms of innovation she believes to be currently at work. These are artificial intelligence, energy storage, robotics, genome sequencing and blockchain technology. Developments in these areas are truly exciting and each no doubt has huge potential application. It is easy to think that mankind has never seen such innovation before. The question is, are we in unchartered territory or have we seen this scale of disruption to traditional practices previously? And more importantly from an investment perspective, is investing in disruption likely to produce attractive returns for the average investor?

Carlota Perez notes in her 2002 book, *Technological Revolutions and Financial Capital: The Dynamics of Bubbles and Golden Ages*, that massive disruption has been a regular feature of capitalism over the last few hundred years of modern financial markets. There are many examples to choose from, and we briefly describe a few below.

Canal Mania

There was the Canal Mania in the United Kingdom of the 1780s and 1790s, during the first industrial revolution. It began with the success of the Bridgewater Canal in 1761, which lowered coal prices in Manchester by nearly two thirds within a year of its opening. The construction cost of the canal was recouped in just a few years, sparking the collective imagination of the possibilities for transporting other commodities and finished goods more cheaply than by a land-based route. This led to the start of a craze which saw 52 Acts pass Parliament over the next 15 years encouraging further canal building and offering exclusive tolling rights to the owners. This funded canal after canal, creating a situation where canals were being built in the 1790s that could never, and would never, be profitable. Some 3,900 miles of canals were eventually built in the UK and capital for canal building remained readily available until the Panic of 1797 which saw numerous canal businesses fail.

Rail Mania

Then there was the Rail Mania of the 1840s that resulted in more railways being built in England than could possibly be used. It started out as a good idea, with the opening of the Liverpool and Manchester Railway in 1830, the first modern inter-city railway used to transport passengers and cargo. Further railway development was encouraged by the Government which saw major efficiency benefits, resulting in 263 Acts of Parliament establishing new railway companies with routes totalling 9,500 miles. Railway companies were reportedly touted as foolproof ventures. At the peak of the mania railway companies were proposed that would have been difficult to construct and near impossible for locomotives to operate on. About one third of these railways were never built. In 1845 the Bank of England increased interest rates. The share prices of the railway companies stopped appreciating and investment capital became more difficult to obtain. This ultimately led to the Panic of 1847 and the collapse of most of the railway companies. A comparable railway building boom in the United States finished with its own Panic of 1873, which started with the collapse of a banking house, Jay Cooke and Company, over the development of the Northern Pacific Railway. By the end of the bust, 89 railroads and over 18,000 businesses had gone bankrupt.

Steel Mania and the Roaring Twenties

The Steel Mania of the 1880s and 1890s was driven by the 1857 development of the Bessemer converter, named after its inventor Henry Bessemer. This converter allowed the bulk production of steel at a cost that was previously unheard of. At one stage in 1875 the UK was responsible for 40% of global steel production. Further developments through the late 19th Century and early 20th Century led to the Roaring Twenties. Electrification prompted the large scale development and use of automobiles, telephones, radios, modern plumbing and electrical appliances, all of which changed life dramatically in the developed world.

The introduction of mass production was punctuated by the development of the Model T Ford and the associated boom in the automotive industry. Beverly Rae Kimes estimates in her book *Pioneers, Engineers and Scoundrels* that at one stage there were as many as 2800 auto companies. The automotive industry powered the development of other industries such as infrastructure development, steel production, agriculture, tourism and car related sales, servicing and development activity. Radio became the first mass broadcasting medium. Charles Lindbergh completed the first solo nonstop transatlantic flight. Penicillin was discovered. It is hard to think of a period that experienced more disruption and innovation. Rapid economic growth and strong consumer demand for the array of new products that were being developed led to a booming stockmarket. This continued until the stockmarket collapse of 1929 and subsequent Depression. From the 2800-odd auto companies at the peak, by 1930 there were less than 50 still in operation.

The Dot-Com Boom

The computer and internet revolution started in 1971 with the development of the first commercial microprocessor on a silicon chip and accelerated with the development of the internet and then the world wide web in 1994. Throughout the late 1990s, investors were hungry to invest in internet companies, fuelling speculation in technology stocks in what became known as the dot-com boom. The potential applications of the internet seemed almost unlimited. Most dot-com companies spent heavily on advertising to build market share and incurred net operating losses, making them vulnerable to funding availability from capital markets. Traditional metrics like price to earnings ratios were overlooked leading to a significant bubble by the turn of the century. When Federal Reserve Chairman Alan Greenspan raised interest rates in 2000, the bubble burst and over 50% of dot-com businesses were declared bankrupt by 2004.

Relevance for Investing Today

All of the developments that fuelled these bubbles were transformational for society. And indeed we should be grateful that it is human nature to get excited about and pursue progress. This excitement has resulted in many bubbles, and most of them are written about negatively. This misses a crucial point. The bubbles led to an excess of capital being available for investment in areas of significant innovation, which helped to accelerate human progress.

The outcome from investing in innovation however is often another story altogether. Those who invest early in successful pioneers can do very well. So too can those with the ability to successfully trade the waves of excitement. But for the majority of us, this is unlikely to be the case. History is littered with losses from investors who supplied the capital that created these bubbles. Most canal, railway, auto and dot-com companies went bankrupt, many remarkably quickly once they lost the ability to raise capital. We live in an environment where innovation in multiple fields is occurring at an incredible pace. Whether an attractive return will be generated on the significant capital being poured into the current technology boom remains to be seen. History might suggest on this front that the odds for general investors are not favourable, particularly at a time when it appears that we are moving into a rising interest rate environment.

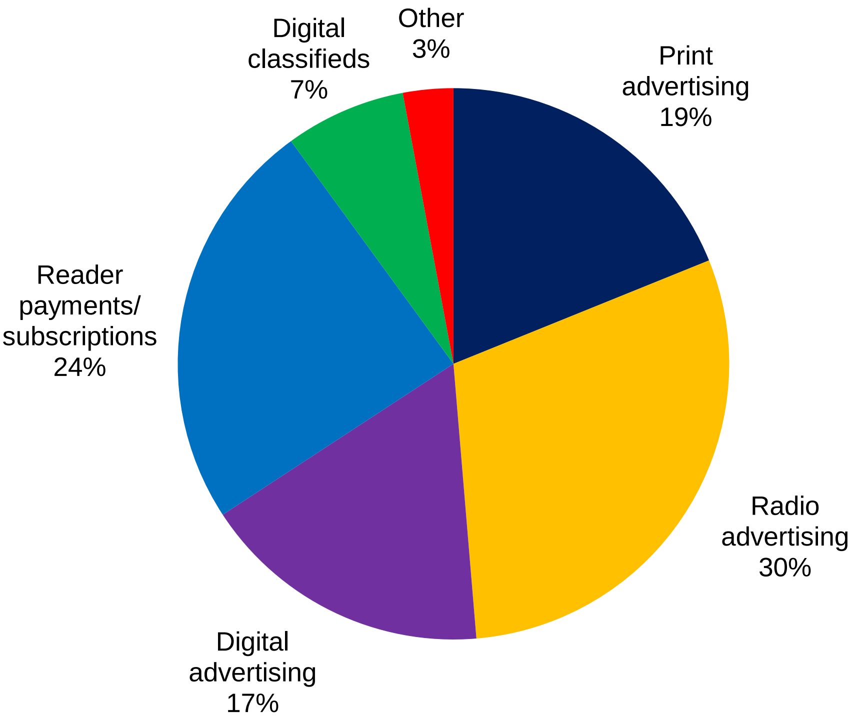
One company that has been impacted by industry disruption over the last few decades is NZME, one of New Zealand's largest traditional media organisations that has had nearly every part of its business model threatened by the digital age, with a decline in physical newspaper readership, the loss of classifieds revenue and challenges to the dominance of radio as the audio platform of choice. Yet the business has survived, is currently attracting record audience and we now think is in a position to thrive going forward. We discuss our investment thesis on NZME in the next section.

NZME: A Digital Transformation

Auscap's views on NZME 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 without notice. There is a risk that NZME 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. While all reasonable care has been taken to ensure that the information below is complete and correct, no representation or warranty is given as to the accuracy of any of the information provided.

NZME (New Zealand Media and Entertainment) is New Zealand's most established media business, reaching a total audience of over 3.4 million New Zealanders. NZME demerged from APN News & Media in 2016 and has a market capitalisation of approximately NZ$240m. Its portfolio includes the nation's largest newspaper by circulation, The New Zealand Herald, New Zealand's most popular commercial radio station Newstalk ZB, and the country's leading digital audio/podcast platform with iHeart Radio. Incredibly, NZME reaches over 85% of Kiwis. For 2021, NZME management expects 49% of group revenue will have come from print and audio advertising, 24% from reader payments and subscriptions, 24% from digital classifieds or digital advertising and 3% from other sources.

FY21 Revenue by Type



Source: Company Disclosures

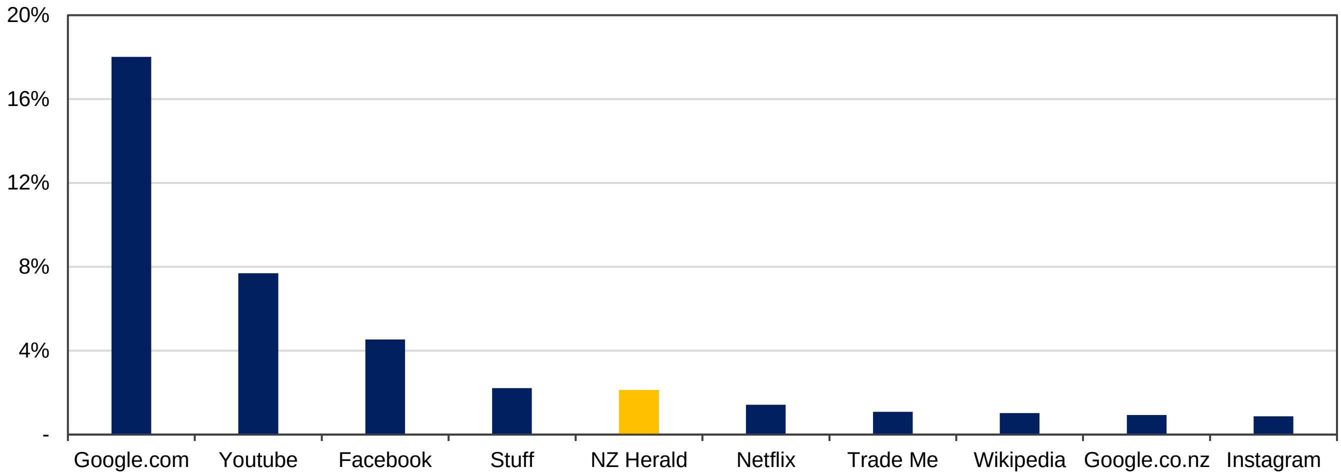
Despite a growing market position and increasing consumer demand, traditional media businesses have long been considered poor investments due to the disruption that has challenged business models across the sector. In relation to news media specifically, print circulation has declined and the corresponding advertising spend has largely moved online where digital platforms, most notably Google and Facebook, have taken a large portion of the previous revenue base.

In this context, what would make NZME an attractive investment? In this newsletter we discuss Auscap's investment thesis for NZME, including the multi-year transformation that the business has undergone and the opportunity as NZME emerges as a modern, digital, subscription-led business with growing profitability, free cash flow and significant reinvestment opportunities.

Business Overview

NZME has a very well established market position within New Zealand. NZME represents 47.8% of New Zealand print advertising revenue, 41% of radio revenue and 25.2% of digital display advertising revenue. These market shares have consistently grown in recent years. The New Zealand Herald, founded in 1863, is analogous to the Sydney Morning Herald or The Age in an Australian context. It is the fifth most popular website by views in New Zealand. It has only one scale competitor, Stuff, a rational player comparable to Newscorp's Australian tabloids, which Stuff management recently acquired from Nine Entertainment. NZME's journalism also serves an important public service and we support NZME's continued investment in local journalism, with NZME dedicating almost 300 editorial staff across more than 20 locations to "keeping Kiwis in the know".

Top 10 New Zealand websites by views - December 2021

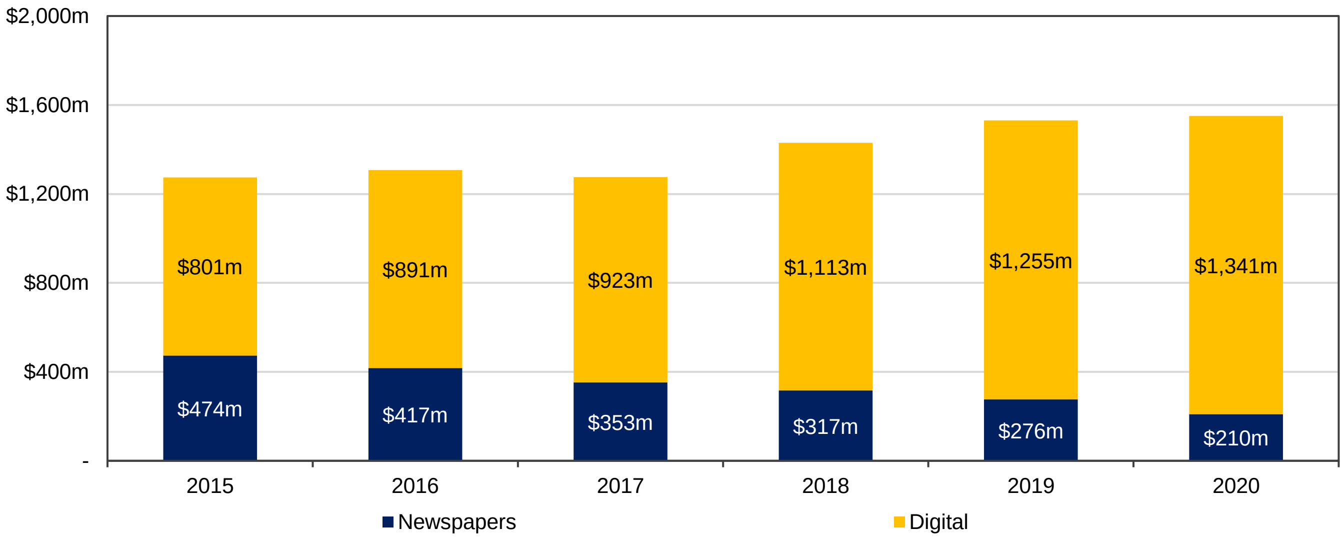


Source: Similarweb

Traditional Media Structural Dynamics

Print circulation across the globe has dropped materially over the last 15 years, with The New Zealand Herald's circulation more than halving from its 2006 peak. This has placed significant ongoing pressure on NZME's print advertising, subscription and newspaper sales revenue.

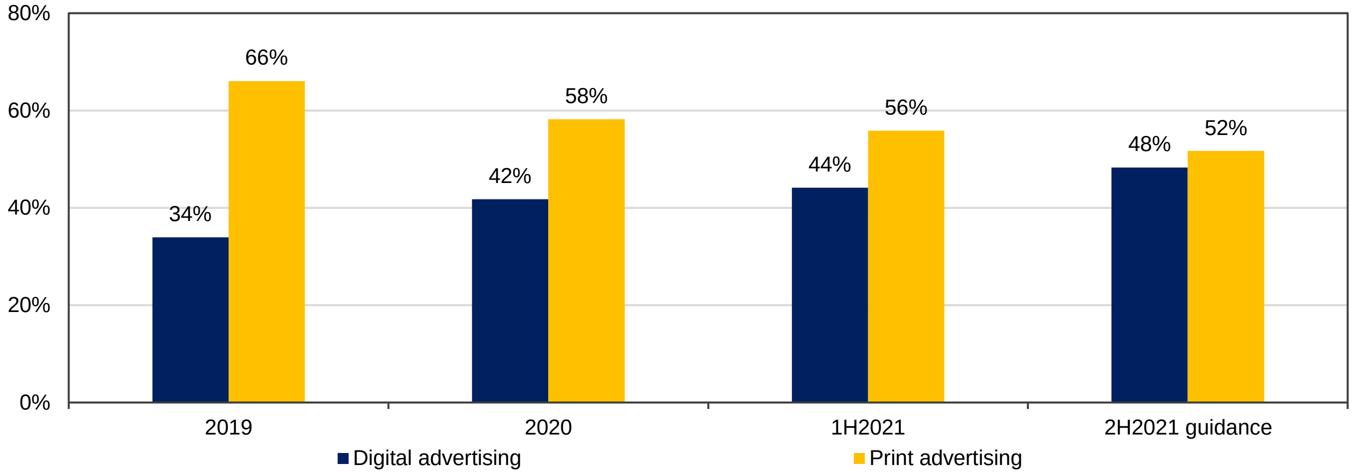
New Zealand Newspaper and Digital Advertising Expenditure - NZ$m



Source: IA Revenue Report, Company Disclosures

NZME has responded to these challenges with firm cost control and investments into its digital presence. There are now some signs suggesting NZME could be emerging from these industry challenges. Management has guided for 48% of NZME's 2H21 publishing advertising revenue to be digitally derived, suggesting NZME's publishing advertising revenue is on the cusp of becoming predominantly from digital sources. Digital display advertising is still exposed to the swings of the advertising market, as is the case with a large part of Google or Facebook's advertising revenue, but its long-term trajectory has been strongly positive. Should publishing advertising revenue become predominantly digital, then we would anticipate overall publishing advertising revenue to move back into growth.

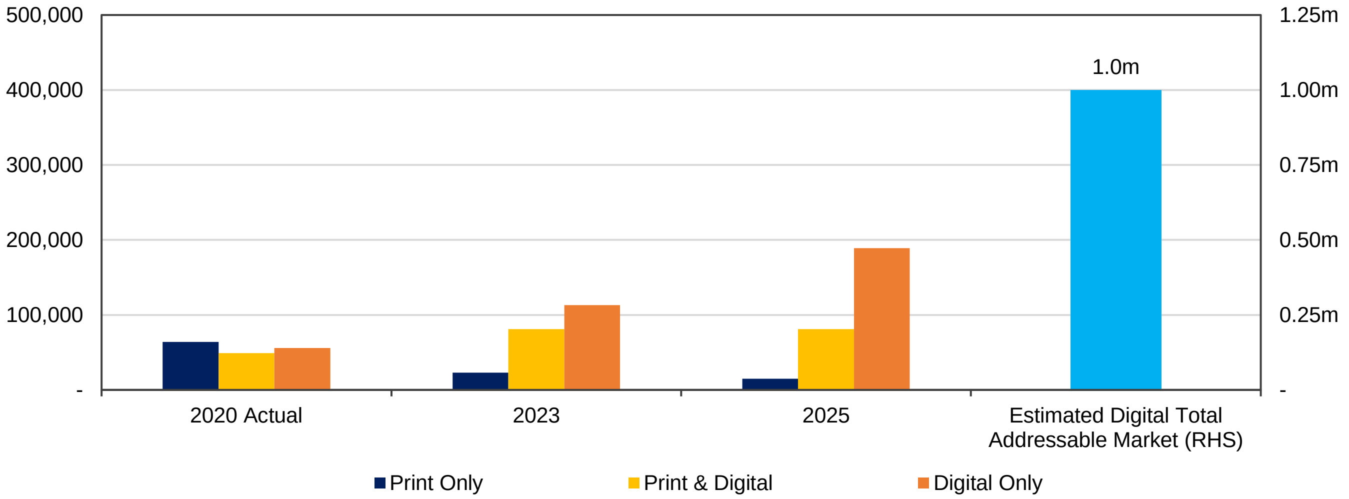
NZME Publishing Digital Advertising Revenue vs Publishing Print Advertising Revenue (%)



Source: Company Disclosures

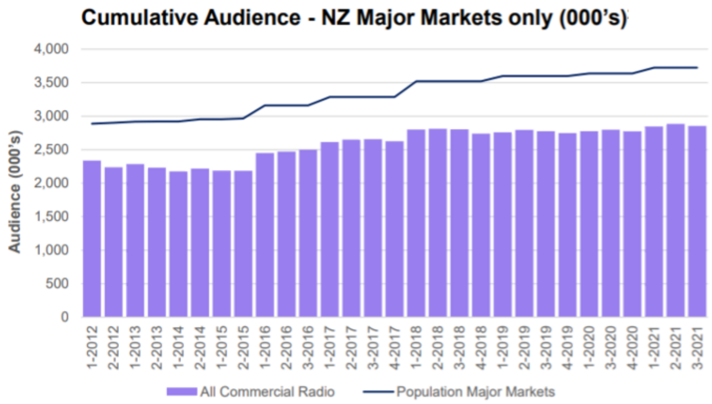
Similarly, NZME is making significant progress in converting its print subscriber base to digital subscribers. In April 2019, The New Zealand Herald launched a digital paid premium subscription option, combining its best proprietary content with third-party content from partners such as The New York Times, The Financial Times and Washington Post. This product has been highly successful, with The New Zealand Herald now having almost as many digital only subscribers as print only subscribers. The growth of the digital subscription offering has allowed NZME to stabilise its publishing subscription revenue in recent years, whilst also providing NZME with the data to improve its digital advertising monetisation. In the coming years, management expects digital-only subscriptions to more than triple and we anticipate price increases will follow improving yield. If this outcome eventuates, it would likely result in subscription revenue being another source of publishing revenue growth in the coming years.

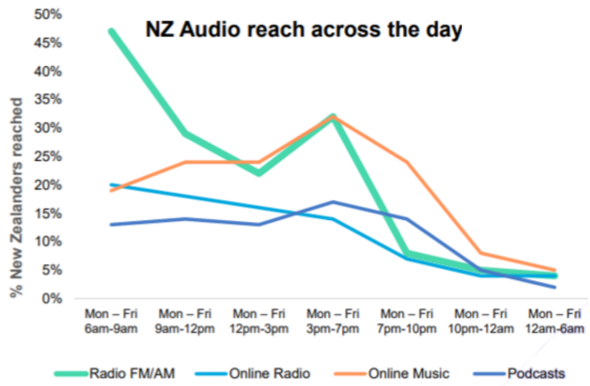
Management Publishing Subscriber Growth Targets



Source: Company Disclosures

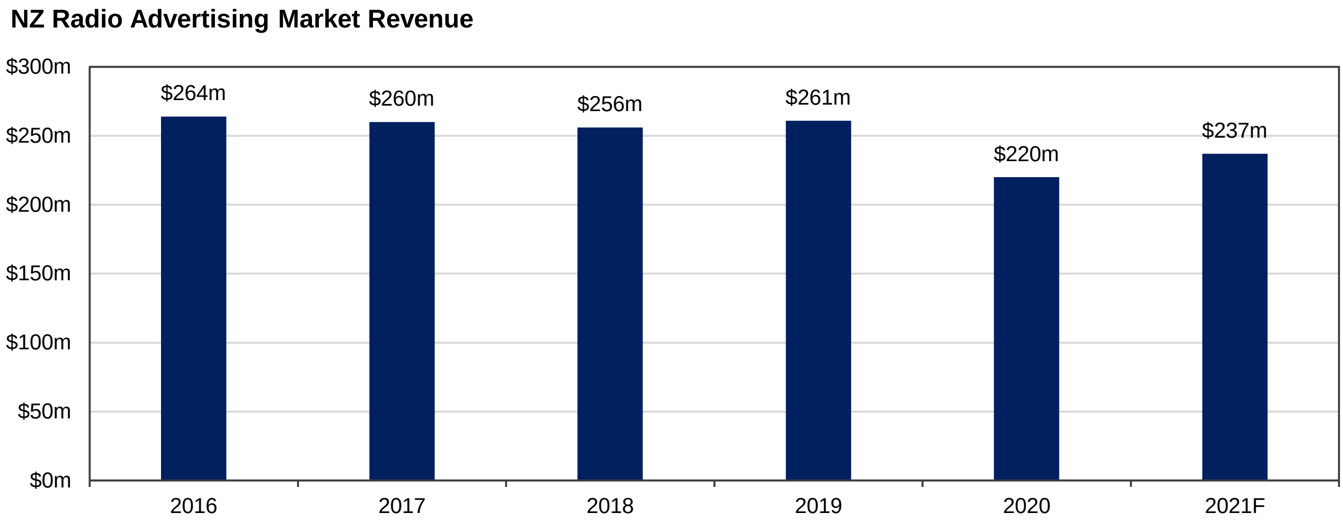
In contrast to print, radio in New Zealand has proven relatively resilient, maintaining its position as a particularly popular medium for consuming news and other audio content during morning and afternoon commutes. Radio audiences in New Zealand have grown steadily, recently reaching a weekly audience of 3.7 million, representing over 70% of the New Zealand population.





Source: Company Disclosures, GfK, RAM

This resilience has led to NZME's radio advertising revenue holding constant over time, excluding the recent COVID-induced drop.



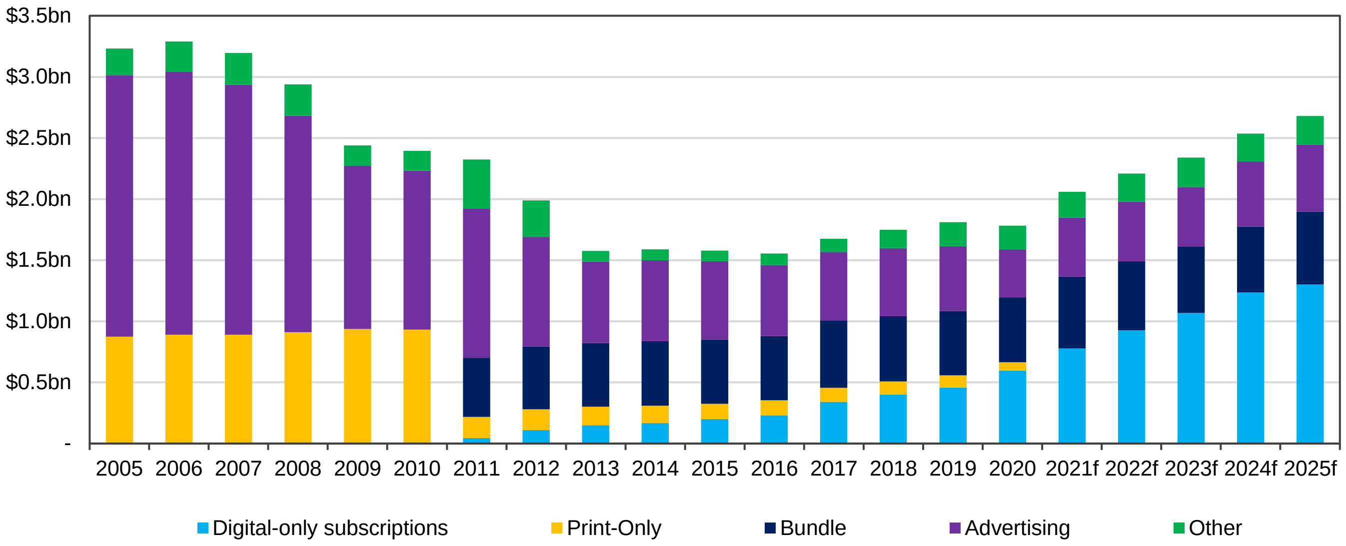
Source: Company Disclosures

There is some risk that the continued integration of apps like Apple CarPlay or Android Auto into new vehicles will cause audio streaming platforms such as Spotify to threaten NZME's dominance of the commute over time. However NZME's local news content is difficult for global peers to replicate. NZME's leading iHeartRadio offering is a beneficiary of the growth in digital radio consumption and New Zealand's automotive parallel import model has led to the country structurally having one of the oldest car fleets in the developed world, with an average age of 14.5 years.[1] NZME is targeting continued growth in radio audience share, revenue share and digital audio revenue, along with margin expansion.

In our view, the combined result of the above dynamics is that after a long period of facing structural headwinds, NZME's core media businesses appear to be on the cusp of transitioning to a higher margin, digitally led business with recurring revenues and potential exposure to structural growth tailwinds. If NZME can continue to execute on this ambition, we believe there are significant valuation implications.

[1] New Zealand Transport Agency Vehicle Register, Light Passenger Vehicle Fleet

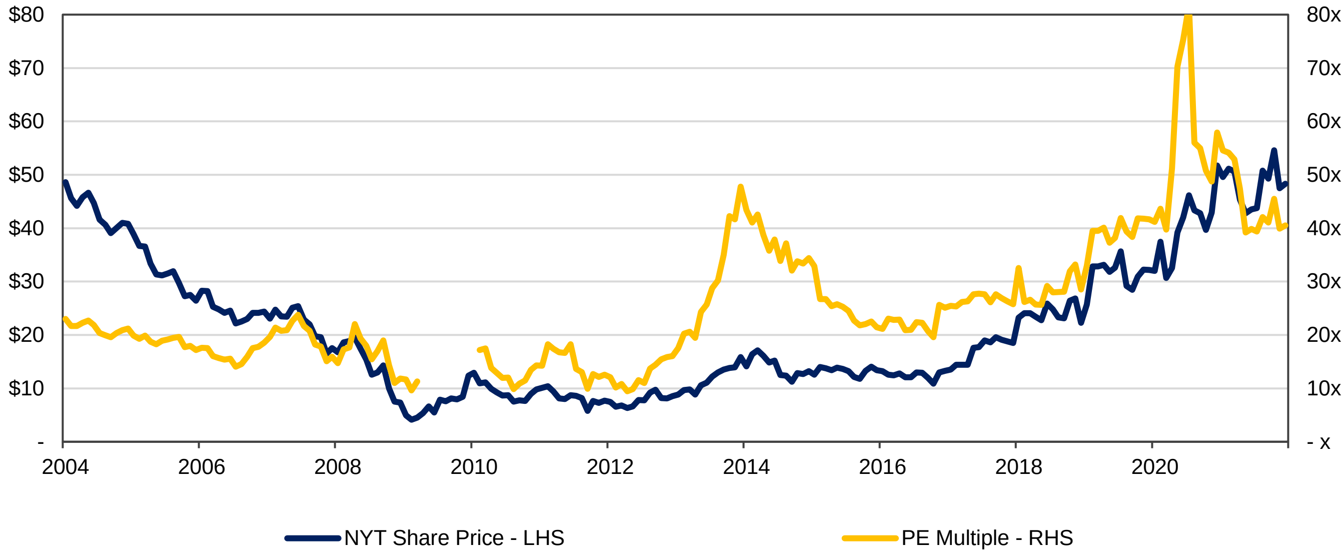
New York Times Revenue (US$m)



Source: Company Disclosures, FactSet

Whilst not a perfect comparison, The New York Times (NYT) serves as an interesting case study. In 2011 the analyst community was bearish, with one analyst writing "*weak print trends and expense pressures will lead to downward estimate revisions and pressure on the stock… Sell.*" But growth in digital subscriptions and digital advertising eventually returned the business to growth. In addition, the NYT's digital subscribers proved *incremental*, with the NYT recently reaching over 8 million subscribers relative to circa 1 million subscribers before it launched digital subscriptions. The analyst community now praise the business' digital growth outlook, high incremental digital margins, recurring subscription revenue and favourable content costs relative to Spotify and Netflix. Over this period, the P/E multiple of the NYT has expanded considerably from 10x to 33x, partly reflecting a change in perception around the longevity, profitability and growth outlook of the business. Whilst The New Zealand Herald does not have the global brand strength of the NYT, we think it shares many of its attractive characteristics: strong market position with leading brand recognition, high incremental margins, largely fixed content costs and a positive digital growth outlook.

New York Times Share Price & Price to Earnings Ratio

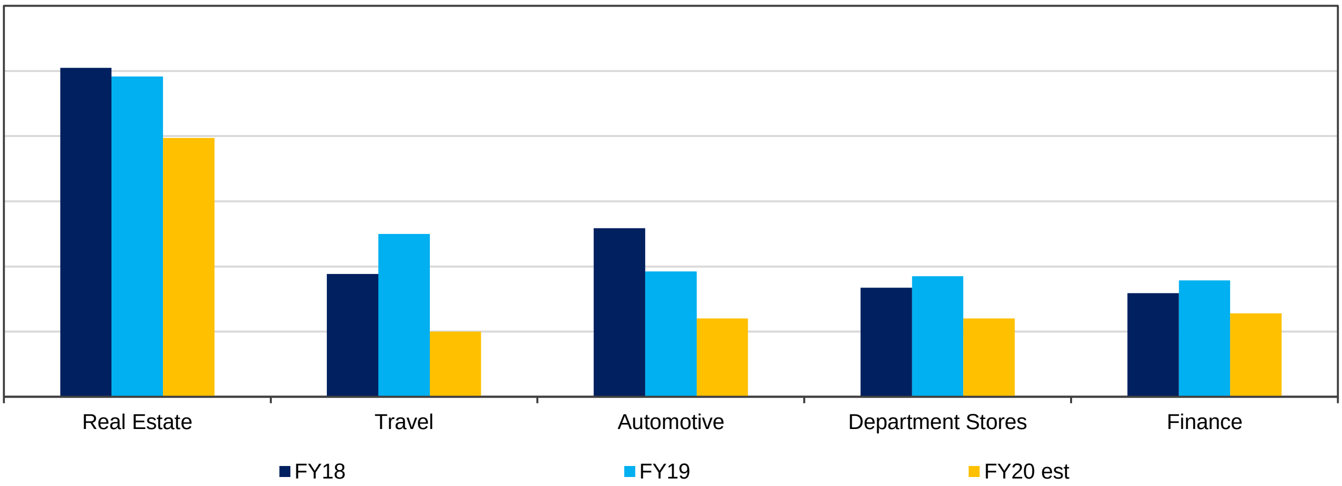


Source: IRESS, FactSet

COVID-19 Impact

We have seen three significant impacts from COVID-19 on NZME. The first impact was a large hit to the New Zealand advertising market. The three largest advertising categories in New Zealand are Real Estate, Travel and Automotive. Travel advertising has more than halved over the last 18 months, due to the impacts of closed borders and lockdowns. Real estate and automotive advertising have also been somewhat depressed as the recent property and auto booms reduced the need to advertise. NZME's recent earnings growth has been achieved despite these cyclical advertising revenue headwinds, with further upside likely if these trends reverse.

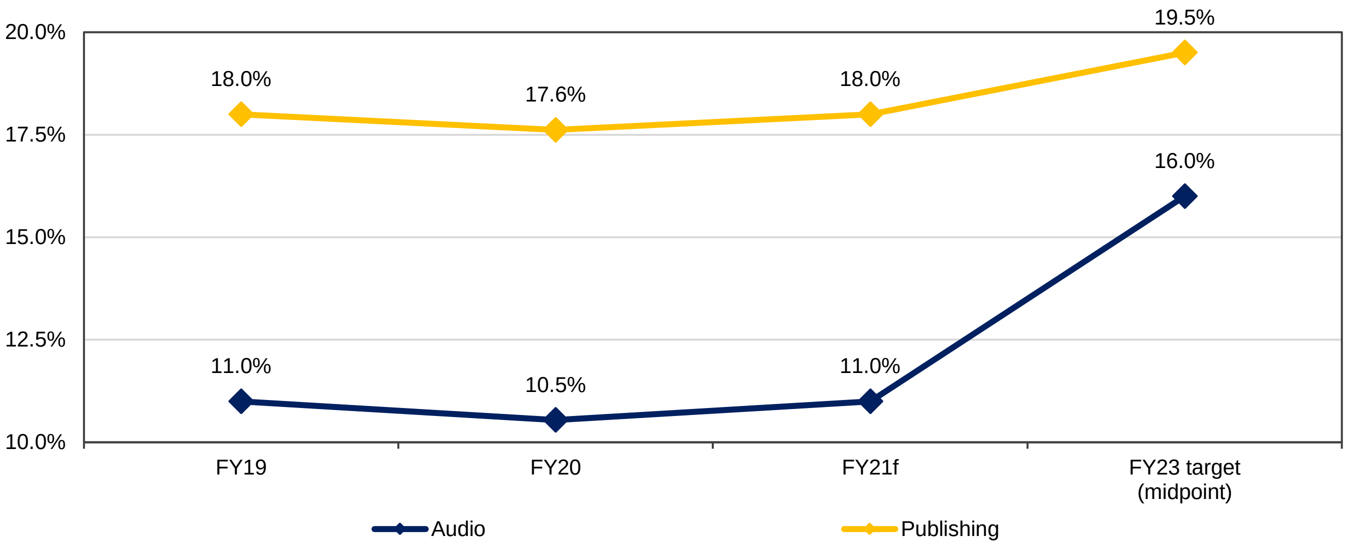
Top 5 New Zealand Advertising Categories by Revenue



Source: Company Disclosures. FY20 estimate as at November 2020 NZME Investor Day

Secondly, NZME used the COVID-19 period to make NZ$20m of permanent cost reductions, which is material in the context of 2021 EBITDA of NZ$49m. Importantly, a permanently reduced cost base leads to greater leverage to a recovery in the major New Zealand advertising markets and future digital growth. Management reaffirmed at NZME's November 2021 Investor Day that they are targeting a meaningful uplift in EBITDA margins in the coming years.

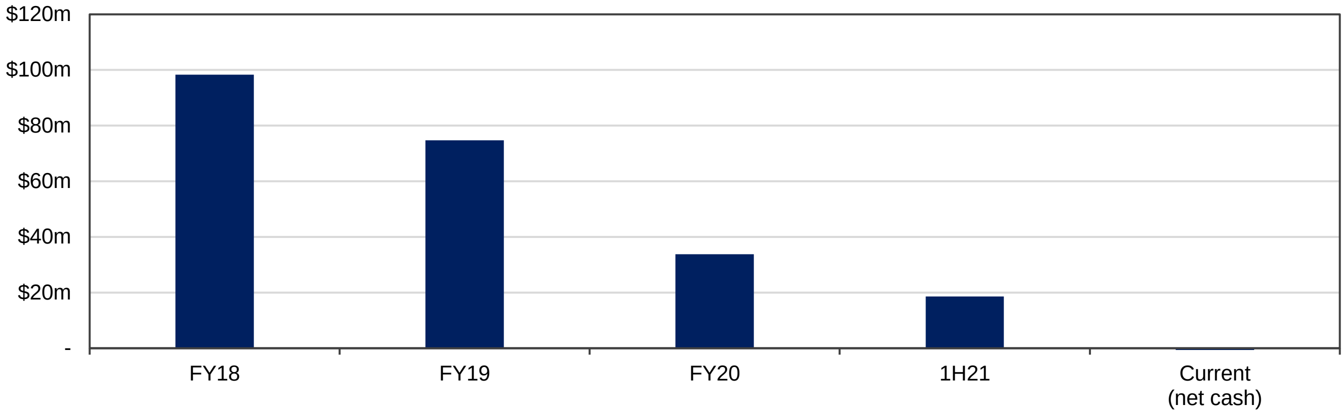
NZME Divisional EBITDA Margins (%)



Source: Company Disclosures

Finally, NZME has used COVID-19 as an opportunity to fortify its balance sheet. To achieve this goal, NZME has aggressively cut costs, sold its non-core daily deals business GrabOne and temporarily suspended dividend payments. The result has been a move from net debt of almost NZ$100m (1.8x net debt / EBITDA) to a current *net cash* position. This has put NZME in the position to restart dividend payments and launch an up to NZ$30m on-market share buy-back, representing approximately 12% of NZME's current market capitalisation. Based on NZME's target leverage range of 0.5 – 1.0x historical EBTIDA and FY21 EBITDA guidance of NZ$49m, NZME has scope to almost double the size of this buyback in the future.

NZME Net Debt (NZ$m)

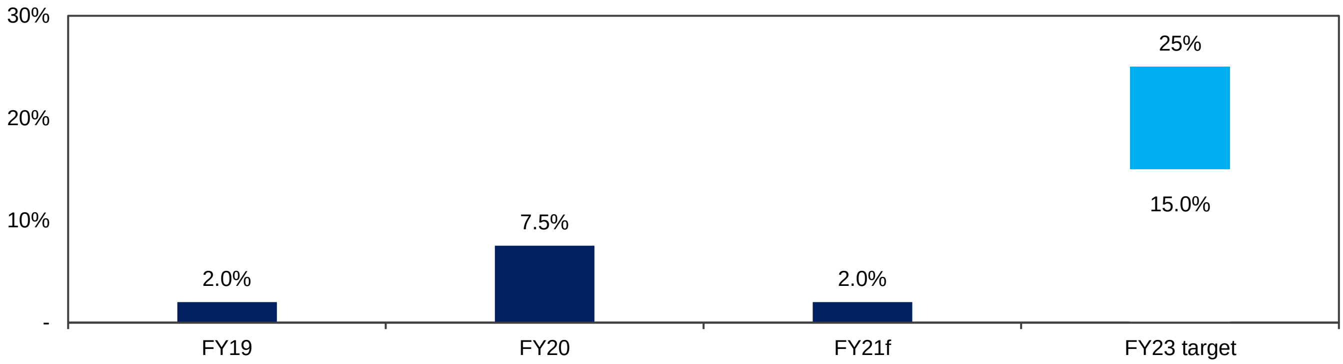


Source: Company Disclosures

Digital Classifieds

We consider one of the most exciting aspects of NZME to be the trajectory of its online property classifieds business OneRoof, launched in 2018. Leveraging a traditional media presence to launch leading digital businesses is a well-worn path in Australia - think REA Group, Domain Holdings and Stan. OneRoof has already become the second most popular property portal in New Zealand and reached 89% of the residential listings of market leader, TradeMe, largely through promotion to The New Zealand Herald's audience. However OneRoof is currently significantly under-monetised. The depth and yield levers are yet to be pulled. COVID-19 temporarily impacted property listings and the incredible strength of New Zealand's property market reduced the need for agents to advertise or digitally upgrade property listings. Only 12% of OneRoof listings (30% in Auckland where The New Zealand Herald is based, 8% elsewhere) currently pay for a premium depth upgrade, well below management's 2023 targets (50% in Auckland and 22% regional). OneRoof has also been run at an essentially breakeven level since inception. However, management has recently announced that it is targeting a 15-25% EBITDA margin by 2023. If OneRoof delivers on this plan, we expect it to receive much more investor attention. Australia's number two property portal, Domain, currently trades at a 26x EBITDA multiple and a 9x revenue multiple. Applying these metrics to OneRoof's 2023 targets leads to a 9 figure valuation, which is clearly material in the context of NZME's market capitalisation. NZME also has a nascent automotive portal called 'Driven', where further optionality exists.

OneRoof EBITDA Margins (%)



Source: Company Disclosures

Digital Platforms

In July 2019 in Australia, the ACCC released its landmark Digital Platforms Inquiry report[2]. Some of the key findings were:

- Google is a critical source of traffic for news media businesses, and Facebook is a vital distribution channel for a number of media businesses;
- News content is also important for Google and Facebook:
  - Google benefits because the inclusion of news stories in search results increases the general consumer attractiveness of the search engine. 8-14% of Google searches trigger “Top Stories” results, typically being news articles;
  - Facebook benefits as consumer engagement towards news stories leads to higher retention of consumer attention and therefore advertising revenue;
- Google and Facebook can change key algorithms with a lack of warning, implement policies and formats, and provide summary “snippets” of third-party articles – all of which can reduce the ability of publishers to fully monetise their digital content;
- The bargaining position between the digital platforms and news media businesses is imbalanced, as news platforms need the platforms more than the platforms need the media businesses;
- News media businesses risk losing a significant source of revenue if they prevent Google from providing links to their articles in search results, with Facebook also holding substantial market power; and
- A significant and adverse impact on the ability of a news media business to monetise its content or build or sustain a brand has implications for news and journalism, both of which generate important benefits for society and play a role in the healthy functioning of the democratic process.

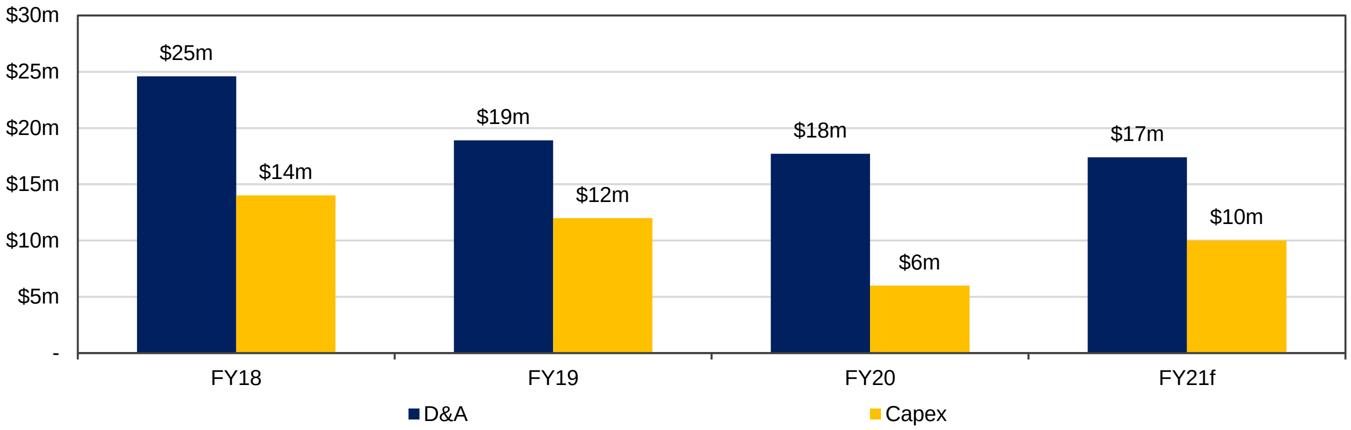
The eventual result of these findings was the implementation of an Australian News Media Bargaining Code, the announcement of Google News Showcase including a global US$1 billion commitment towards paying publishers for journalism and deals between the digital platforms and Australian publishers. This led to the digital platforms agreeing to pay News Corporation over A$100m and Seven West Media and Nine Entertainment over A$30m per annum. Our understanding is that these payments should grow over time. Having watched this process with interest, New Zealand media publishers have begun the process of attempting to replicate this outcome, with New Zealand regulators appearing sympathetic to the cause. The New Zealand Publishers’ Association has sought Commerce Commission approval to collectively bargain with the platforms to achieve a favourable outcome. If NZME were to achieve a similar outcome to its Australian peers on a population adjusted basis, payments could equate to an 8 figure annual sum, a material uplift to NZME’s earnings. Whilst negotiations are in their early stages, a favourable outcome could lead to an additional income stream with little associated cost, sustainably boosting profitability.

Strong Cash Generation

NZME is highly cash generative and has high incremental margins, a net cash balance sheet and a double digit return on tangible assets. NZME’s accounting depreciation tends to meaningfully exceed capital expenditure, meaning that accounting profit understates the cash generation of the business. After a lengthy period of declining earnings, management has guided for the core NZME business to return to profit growth from CY21 onwards.

[2] See a copy of the report here: https://www.accc.gov.au/system/files/Digital%20platforms%20inquiry%20-%20final%20report.pdf

NZME Capex vs D&A (pre-AASB 16) - NZ$m



Source: Company Disclosures, Jarden estimates

Valuation and Conclusion

Since listing, NZME has been viewed as a business in structural decline. An attempted tie-up with its peer, Stuff, proved to be an expensive distraction, leverage concerns forced NZME to pause its dividend and earnings have declined. The market has responded by applying a price to earnings (P/E) multiple of less than 10 times (COVID-impacted) 2021 cash net profit. However we believe that there are signs of a meaningful improvement in the outlook for the business. Demand for NZME content has continued to increase. NZME's core business is on the pathway to becoming predominantly digital with exposure to structural and cyclical growth tailwinds. Margin expansion is within management control and the business is highly cash generative. NZME's balance sheet is strong, with a net cash position and large buyback in place. In addition, management has begun to make announcements which we think appear to signal growing confidence in NZME's outlook, including a material buyback, the acquisition of digital publisher BusinessDesk, proactive engagement with digital platforms and the public announcement of detailed medium-term targets. Overall, we think a sub-10x cash P/E multiple for the core business is compelling, particularly with New Zealand's flagship NZX 50 Index currently trading on 33.5x P/E[3]. This is before accounting for the valuation upside if OneRoof continues to deliver on its objectives and a favourable digital platform outcome is reached. We remain excited by the Fund's investment in NZME.

[3] S&P Dow Jones Indices, as of 31 December 2021

Auscap Long Short Australian Equities Fund

Fund Performance*

Period	Auscap	All Ords
December 2021	4.3%	2.7%
Financial Year To Date	17.7%	4.6%
Since Inception	369.8%	147.3%
Annualised Returns	18.6%	10.5%

Fund Exposures

December 2021 Average	% NAV	Positions
Gross Long	97.8%	43
Gross Short	0.0%	0
Gross Total	97.8%	43
Net / Beta Adjusted Net	97.8%	115.0%

Portfolio Commentary

The Fund returned 4.3% net of fees during December 2021. This compares with the All Ordinaries Accumulation Index return of 2.7%. The Fund's largest exposures over the month were spread across the consumer discretionary, real estate, communication services, financials and materials sectors.

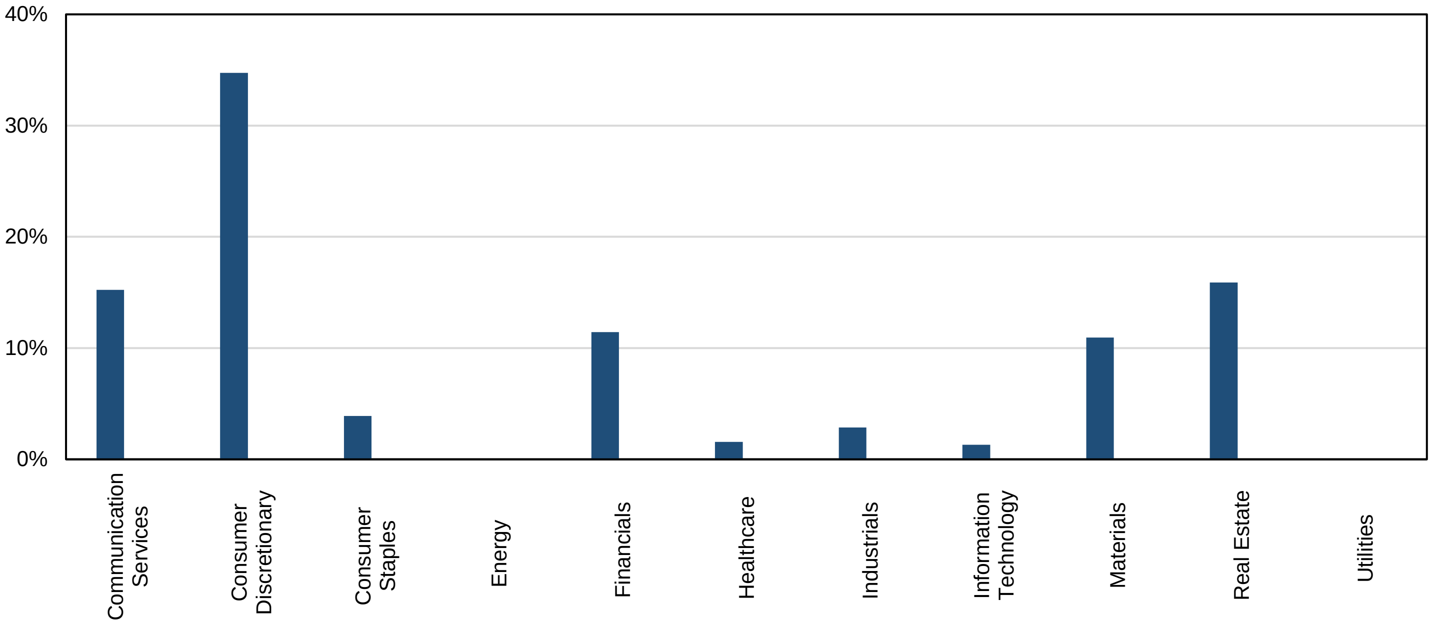
Fund Calendar Year Returns*

CY13	51.9%	CY18	(18.5%)
CY14	23.2%	CY19	18.1%
CY15	36.0%	CY20	10.6%
CY16	2.2%	CY21	43.1%
CY17	17.1%		

Top 20 Investments^

Adelaide Brighton	Jumbo Interactive
Aventus	MA Financial Group
Blackmores	Macquarie Group
Carsales.com	Mineral Resources
Centuria Capital	Motorcycle Holdings
Charter Hall Retail REIT	News Corporation
Eagers Automotive	Nick Scali
GDI Property Group	NZME
Home Consortium	Reece
JB Hi-Fi	Unibail-Rodamco-Westfield

Sector Exposure – December 2021



**Performance figures are calculated for the Monthly Class net of all fees and expenses and assume 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 December 2021.

Disclaimer

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