Auscap Newsletter

Auscap Long Short Australian Equities Fund

OCTOBER 2022

AUSCAP ASSET MANAGEMENT LIMITED

Is Pervasive Pessimism Presenting Pockets Of Opportunity?

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Opportunities often come at moments when fear and uncertainty are causing market dislocations and lower equity market prices. This is when stocks are on sale. Yet the inclination of many, looking at a decline in the quoted value of their portfolio, is to be a seller rather than a buyer in such markets. Elevated inflation is currently causing central banks to rapidly increase interest rates around the world. This has potentially negative implications for economic activity, corporate earnings and the discount rate used to price equities. We would make three observations in this environment.

First, negative investor sentiment and broad-based stock price declines breed opportunity. Whilst high inflation and higher interest rates are, ceteris paribus, negative for markets overall, the impact on earnings needs to be assessed objectively at the individual company level. Environments of widespread stock price declines inevitably leave some businesses sold off to a greater degree than justified by the likely impact on their earnings and valuation, which creates an opportunity to buy into these businesses at attractive long-term prices.

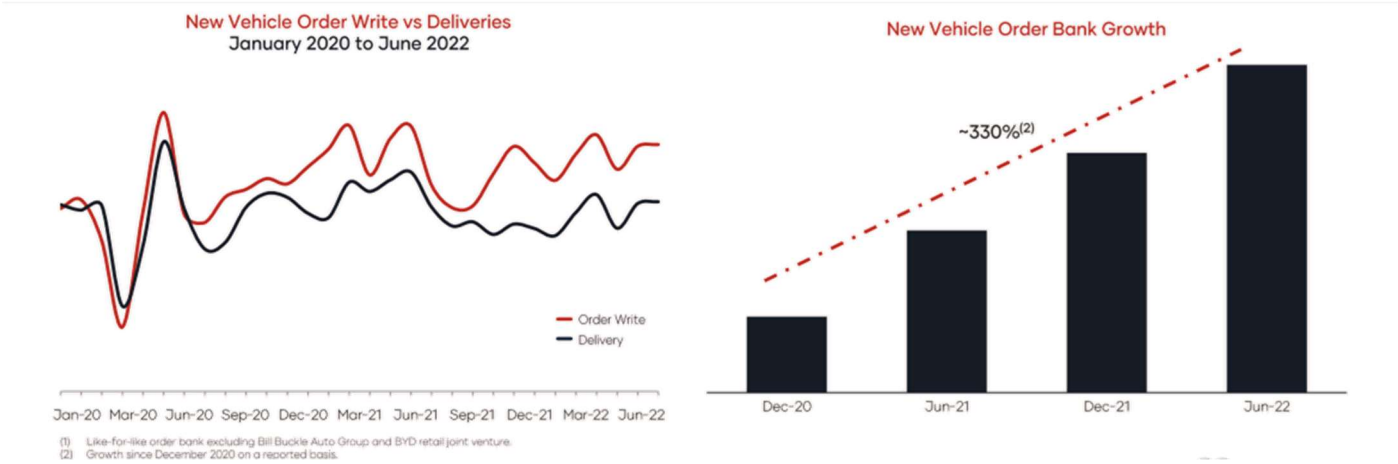
Secondly, many market participants are currently focused on predicting the actual future path of economic growth, inflation, interest rates, employment and many other economic variables. We take a different approach. Our emphasis is placed on making sure that we understand current economic and company-specific conditions and the range of likely future scenarios, whilst recognizing that many variables are inherently unpredictable. We then have a framework for thinking probabilistically about the likelihood of different outcomes going forward. This is a nuanced but important distinction. Our greatest opportunities have often appeared when market valuations start to price in a relatively low probability and considerably negative outcome, which is not supported by data or objective analysis. The converse is also true. Risk often presents at times when markets assume that the prevailing strong conditions will continue into the foreseeable future. The positive prospects encourage investment, and as a consequence the prices at such times can be high, with poor value on offer.

Finally, for most high-quality businesses, particularly those with structural tailwinds and high returns on invested capital, our view is that what is occurring inside the company is often more important than what is happening in the broader economy. We think this is true of most companies that are owned within the Fund. For this reason, the rest of this newsletter takes the opportunity to focus on the micro – the specific developments occurring within some of the companies owned in the Fund – providing a degree of balance to the constant headlines covering the macroeconomic environment. This newsletter discusses some developments from the last few months in relation to five current Fund holdings: Eagers Automotive, Mineral Resources, Motorcycle Holdings, Nick Scali and Reece.

Eagers Automotive

Eagers Automotive (**Eagers**) delivered another strong half year result in August 2022. The market continues to focus on the potential for a slowdown in new vehicle orders, given the widespread expectation of a softening consumer environment, although Eagers said they had yet to see a slowdown in demand as of August.

More significantly, the strong August result does not fully reflect the record demand witnessed in recent years. Instead it reflects the relatively modest level of deliveries that the industry has recently achieved. Constrained supply chains have prevented Eagers, and other automotive dealers, from delivering vehicles in line with sales since early 2020. This is important because revenue is only recognised on delivery of the vehicles to customers. As can be seen in the chart below, Eagers has delivered fewer cars than it has sold in every single month since the onset of the COVID-19 pandemic. This record order bank provides Eagers with a considerable earnings tailwind for the rest of this calendar year and into 2023.



Source: Eagers Automotive

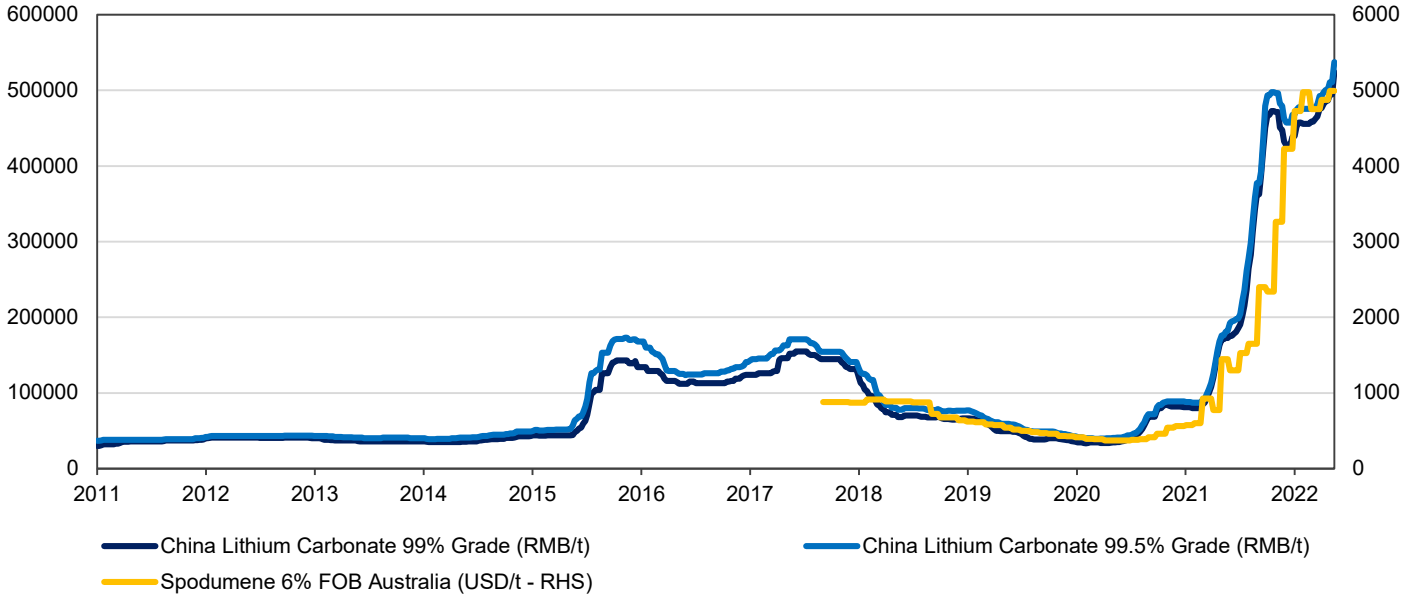
The macro focus has also distracted from significant improvements to the business in recent years, as discussed in our October 2021 newsletter. Eagers has taken advantage of COVID-19 uncertainty and current earnings visibility to improve its dealership footprint with a number of acquisitions and divestments; invest in future growth initiatives such as the AutoMall concept and omni-channel used car offering known as EasyAuto123; and aggressively right-size its cost base. Eagers has a strong balance sheet, with net debt of just $12.6m as at 30 June 2022 and over $840m of liquidity available for organic and inorganic opportunities.

We always view the actions of insiders as a useful indication of whether a stock is attractively priced. In July 2022, Eagers announced a buyback of up to 10% of its share capital, and Nick Politis, the company's 28% shareholder and a major automotive player in his own right, has purchased over $4m worth of shares on-market since July. Chairman Timothy Crommelin and board member David Blackhall have also bought shares in recent months.

Mineral Resources

Mineral Resources (**MinRes**) was the Fund's best performing holding over the September 2022 quarter. While many commodities have pulled back over recent months in response to a softening global macroeconomic environment, the lithium price is an outlier as it continues to make new highs due to an incredibly strong structural demand outlook.

Lithium Carbonate and Spodumene Prices



Source: Bloomberg, Auscap

Global demand looks reasonably likely to exceed supply for the foreseeable future. Since February 2022, MinRes has transitioned into a producer and seller of lithium hydroxide, a key manufacturing input into lithium-ion batteries, rather than simply being a producer of the input commodity lithium spodumene. MinRes is therefore able to monetise more of the downstream lithium supply chain through a vertically integrated model. MinRes intends to convert all of its share of the mined lithium spodumene into lithium hydroxide. This conversion delivered EBITDA of US$154m on lithium hydroxide sales of 6.7kt in the last quarter of FY22. MinRes is targeting the production of 118ktpa of lithium hydroxide over the medium term.

Having just visited MinRes' lithium assets, we remain enthused about the prospects for this business. After restarting trains 1 and 2 of the Wodgina mine in the last 12 months, MinRes is now in the process of restarting Wodgina train 3. Separately the company expects that lithium hydroxide at Kemerton, a hydroxide facility run by Albermarle in which it has a 15% stake, will commence production shortly.

Wodgina Mine Pit

Source: Auscap

Wodgina Processing Plant (Trains 1, 2 and 3)

Source: Auscap

Wodgina Lithium Spodumene Stockpiles

Source: Auscap

Mt Marion Mine Pit

Source: Auscap

Mt Marion Mine Pit with Resource Drilling

Source: Auscap

Mt Marion Processing Plant & Lithium Spodumene Stockpiles

Source: Auscap

Current lithium prices are very favourable for existing lithium producers, resulting in the whole sector re-rating globally. MinRes' two JV partners, Albermarle and Ganfeng, are trading at greater multiples of forecast EBITDA than MinRes. A similar multiple for MinRes' lithium business would have the stock trading considerably higher than it is today. There is speculation that MinRes has been mulling a potential partial listing of its lithium business internationally, to both recycle some of its capital and so that its lithium assets will be properly reflected in the group's valuation.

MinRes has also started its transition from a low volume, high cost and short mine life iron ore operator to a low cost, high volume, long mine life owner. The Final Investment Decision (FID) on the 30mtpa Onslow Iron Ore project was made to proceed in August 2022, with first ore targeted by December 2023. Separately, a MinRes JV with Hancock Prospecting for a 20mtpa iron ore operation was awarded the rights to develop a cape-size carrier berth at Port Hedland for the South West Creek Project in the Pilbara in November 2021, which will unlock the resource base of stranded deposits in the area. First ore is expected in 4–5 years. These developments should provide MinRes with a 30 year plus, large scale and low-cost iron ore mining operation.

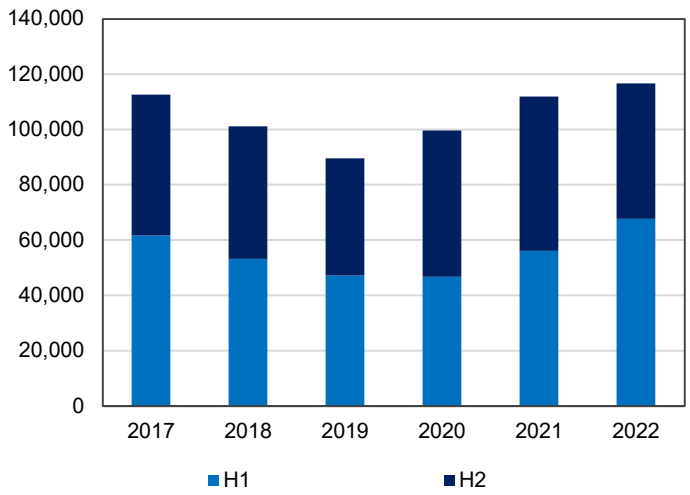
The growth of MinRes' lithium and iron ore operations should underpin MinRes' mining services business for many years to come. Lastly, MinRes has also made a significant gas discovery in the Perth basin, with the potential to supply all of MinRes and its customers' gas needs for many years, at a substantially lower cost than current contract gas prices. We continue to be very positive about MinRes' outlook and we anticipate many years of transformational progress across each of MinRes' four divisions: Mining Services, Lithium, Iron Ore and Energy.

Motorcycle Holdings

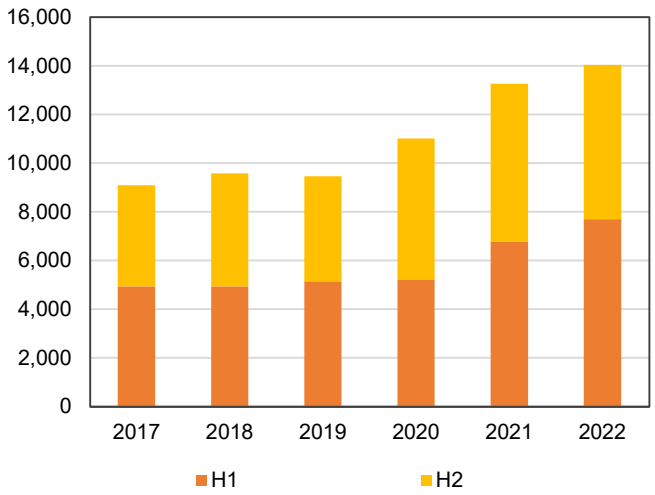
Motorcycle Holdings (**MTO**), one of the few ex-ASX 300 holdings in the Fund, is Australia's largest motorcycle dealership group. MTO represents 12% of Australian new motorcycle sales and all ten of the top selling Australian motorcycle brands. David Ahmet, MTO's CEO and Founder, owns 18.5% of the shares on issue, worth approximately $28.7m. While the motorcycle industry does experience cyclical swings, MTO has consistently grown share through both organic and inorganic means since listing in 2016. MTO has made two major acquisitions since listing, and both vendors received shares in MTO as part of the acquisition consideration and have Board representatives.

In addition to growth, MTO has been focused on diversification, which we think is underappreciated. MTO has greatly expanded its capabilities in used motorcycles; acquired a large motorcycle parts and accessories business; developed a consistently profitable finance JV; and expanded into new geographies such as New Zealand. In late September 2022, MTO announced the acquisition of MOJO, one of Australia's largest importers and wholesalers of motorcycles and parts. MOJO is a specialist in scooters, all terrain vehicles (ATVs) and electric motorcycles. These are categories experiencing structural market share growth where MTO has been underweight. While businesses focused purely on distribution can tend to have key supplier risk, we think MOJO has the potential to fit in well and grow strongly within a diversified MTO.

Industry New Motorcycle Sales



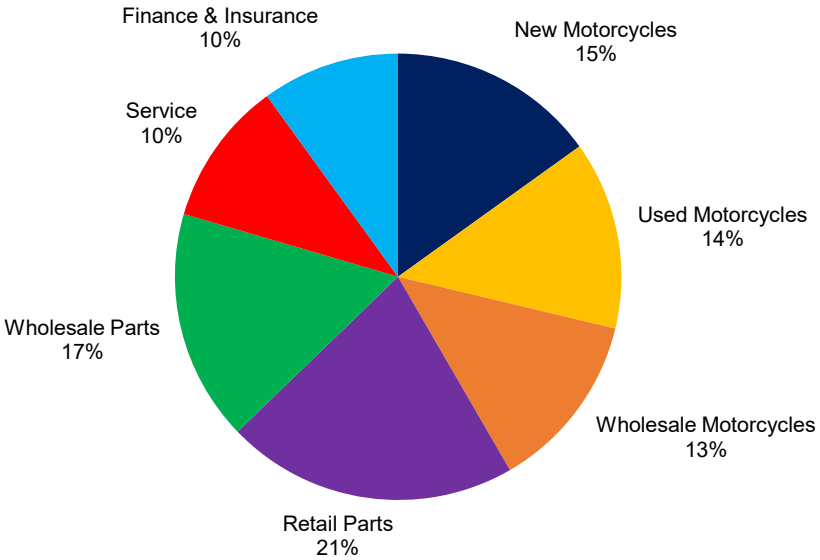
MTO New Motorcycle Sales



Source: Company Disclosures, Auscap

MTO's sources of gross profit post the MOJO acquisition are now neatly balanced and diversified. The company flies under the radar and is currently trading on just 5.6x pro-forma FY22 net profit after tax pre-synergies. It has Net Debt/EBITDA of just 0.6x and management expects MOJO to experience strong earnings growth in FY23. MTO has also announced that Martin Ward, the former Eagers Automotive CEO who grew Eagers' Profit Before Tax by more than 8x between 2005 and 2020, is joining the MTO Board. It is not surprising to us that the MOJO vendors took as much of their acquisition consideration as possible (50%) in MTO stock.

MTO FY22 Pro-Forma Gross Profit



Source: Company Disclosures, Auscap

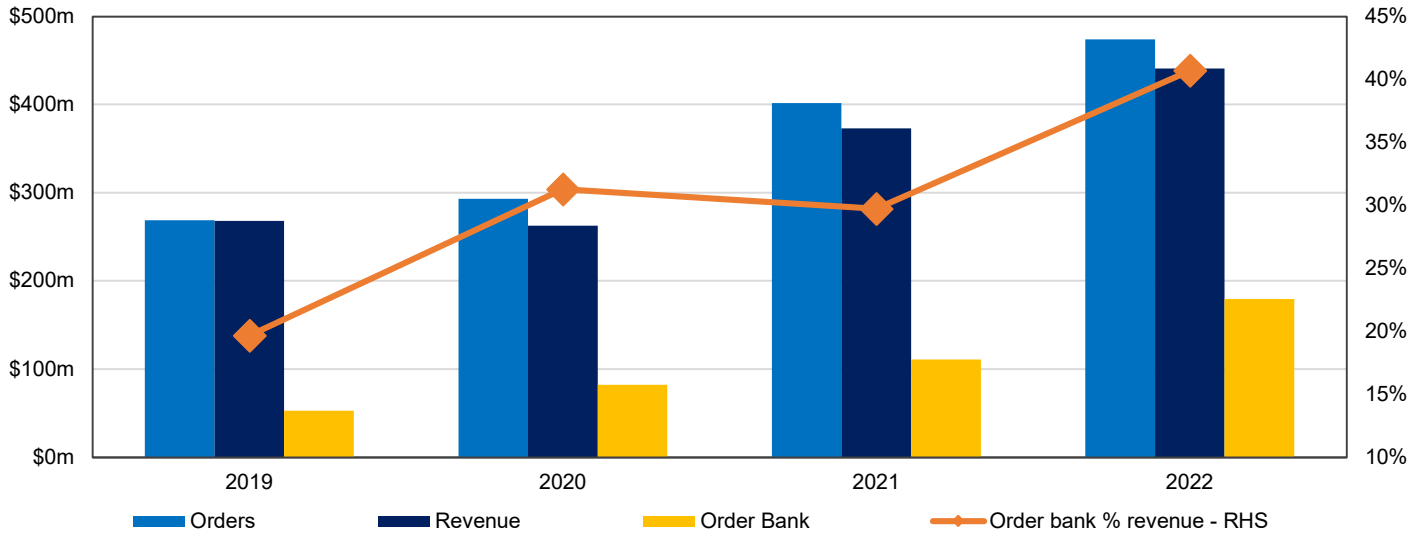
Nick Scali

Nick Scali (**NCK**) delivered an FY22 result ahead of consensus estimates and experienced a continuation of very strong trading conditions in July 2022, with new sales orders up 60% on pre-COVID-19 levels for the NCK stores despite macroeconomic uncertainty. At its FY22 results presentation, NCK management flagged upside to its estimates for Plush synergies, continued strong double digit online order growth of 59.9% year-on-year and an aggressive store rollout plan, with targets to nearly double the store network across its two brands over time.

Despite having an outstanding track record of delivering earnings growth and very high returns on capital, NCK trades on less than 10x forecast earnings. Most analyst concerns centre on an interest rate and housing related slowdown in furniture sales following the COVID-19 induced boom. While we are cognisant that this may occur, we suspect that the impact of any slowdown in sales is overemphasised.

The majority of NCK's sales are from made-to-order lounges. The lead time between an order being placed and the furniture being delivered creates an "order bank" and an indication of future revenue, as revenue is only recognised on delivery. COVID-19 created huge global supply chain challenges, including extended shutdowns in Vietnam and China, which are key manufacturing hubs for the global furniture industry. This has meant that NCK's orders have disconnected from revenue in recent years. As at the end of FY22, NCK's orders have outpaced revenue since FY20 by a cumulative $92.1m. In addition, NCK inherited a $42.1m order bank from Plush, which is similarly elevated. All signs are pointing to supply chains significantly improving over FY23. As supply chain pressures ease, the order bank should normalise, with positive implications for NCK's near term revenue and earnings.

Nick Scali - Group Orders vs Revenue



Source: Company Disclosures, Auscap

NCK's management have also discussed the impact of container availability and exorbitant shipping rates on NCK's gross margins since late 2020. However, global shipping rates peaked in September 2021 and are currently falling quite considerably, down over 66% from their peak. In fact, these rates are currently down 44% since NCK reported in late August 2022. NCK has revealed that because of exorbitant shipping rates, shipping costs have represented as much as 35% of the cost of goods sold on certain lounges in the most recent period. While the falling Australian dollar is a potential headwind, this should be more than offset by a decline in freight costs. Consensus estimates are anticipating a small decline in group gross margin this year, which we think is looking increasingly unlikely.

NCK has a very strong balance sheet, with Net Debt of just $17.1m as at 30 June 2022, despite purchasing Plush with cash and debt in October 2021. The company is on track to have a net cash position by the end of the 2022 calendar year, with its Plush synergies bedded down in FY23. If the macroeconomic environment weakens, we expect that multiple owners of domestic and international furniture businesses will see NCK as their natural owner. We would not be surprised to see NCK engage in further inorganic growth in the years ahead.

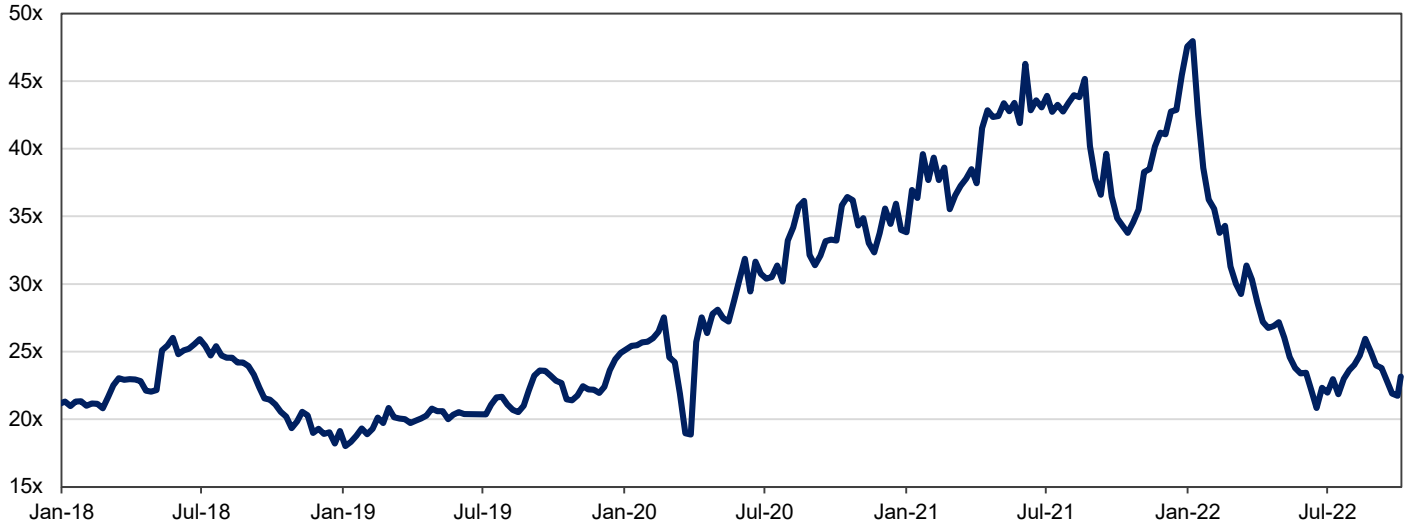
Reece

We view Reece as one of the highest quality industrial businesses on the ASX, with a long history of resilient growth through market cycles. It is the clear market leader in Australia, where it focuses on the construction, renovation and repair plumbing markets. In 2018, Reece expanded into the US, a large and highly fragmented market, with a focus on the growing "Sun Belt" region. The group has been led by the founding Wilson family for over 100 years, who have a long history of always prioritising the long-term interests of the group.

Reece delivered what we consider to be a very strong result during FY22, with net profit after tax up 37% on sales growth of 22%. The US business continues to demonstrate that it is a huge opportunity for the company, with sales growth of 33% for the year. Reece has 645 store branches in Australia compared with 204 in the US, and domestic margins are currently roughly double that of the US division. Reece has a significant opportunity to become a leading player in the US market.

Sentiment towards Reece has changed dramatically this year. The stock has halved since January 2022 on concerns about the impact of cost inflation and a downturn in global housing markets due to higher interest rates.

Reece forward P/E multiple



Source: FactSet, Auscap

Whilst we are well aware of global macroeconomic uncertainty and had reduced the Fund's holding in Reece at the start of the year, we now think these conditions are well known. Although there is currently cyclical uncertainty across all of Reece's end markets, we have taken advantage of the recent market sell off to rebuild the Fund's Reece position at what we believe to be attractive long-term prices.

Conclusion

During periods of market turbulence, we try to focus on the fundamentals of the companies that the Fund owns or would like to own and understanding the range of probable and possible outcomes for these companies given present economic conditions. To the extent that we get to increase the Fund's exposure to what we consider to be high quality businesses trading at attractive prices, we try to take these opportunities when they present themselves. Our view is that many of the companies currently held in the Fund's portfolio continue to perform well, and are also looking for opportunities to grow strongly through, and despite swings in, the economic cycle.

Auscap Long Short Australian Equities Fund

Fund Performance*

Period	Auscap	All Ords
September 2022	(8.5%)	(6.4%)
Financial Year To Date	8.1%	0.8%
Since Inception	279.0%	120.7%
Annualised Returns	14.5%	8.4%

Fund Exposures

September 2022 Average	% NAV	Positions
Gross Long	94%	35
Gross Short	0%	0
Gross Total	94%	35
Net / Beta Adjusted Net	94%	113%

Portfolio Commentary*

The Fund returned negative 8.5% net of fees during September 2022. This compares with the All Ordinaries Accumulation Index return of negative 6.4%. The Fund's largest exposures over the month were spread across the consumer discretionary, materials, communication services, real estate and financials sectors.

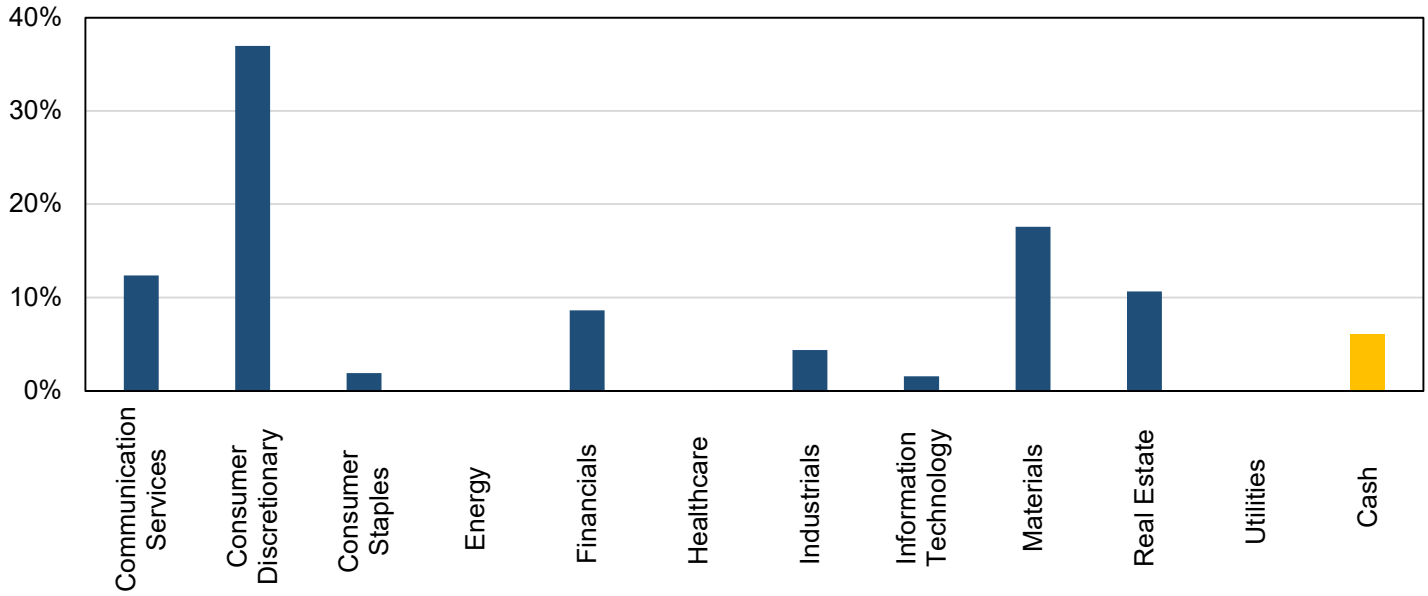
Fund Calendar Year Returns*

CY13	51.9%	CY18	(18.5%)
CY14	23.2%	CY19	18.1%
CY15	36.0%	CY20	10.6%
CY16	2.2%	CY21	43.2%
CY17	17.1%	CY22	(19.3%)

Top 20 Investments^

ARB Corporation	Macquarie Group
Blackmores	Mineral Resources
Breville	Motorcycle Holdings
Carsales.com	News Corporation
Charter Hall Retail REIT	Nick Scali
Eagers Automotive	NZME
Home Consortium	Praemium
HomeCo Daily Needs REIT	Premier Investments
JB Hi-Fi	REA Group
Lovisa	Reece

Sector Exposure - September 2022



** Performance figures are calculated for the Monthly Class net of all fees and expenses and 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 September 2022.

 # Average Sector Exposure during September 2022.

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