



Auscap Newsletter

Auscap Long Short Australian Equities Fund

JANUARY 2023

AUSCAP ASSET MANAGEMENT LIMITED

Driving Growth Is Delivering Dividends

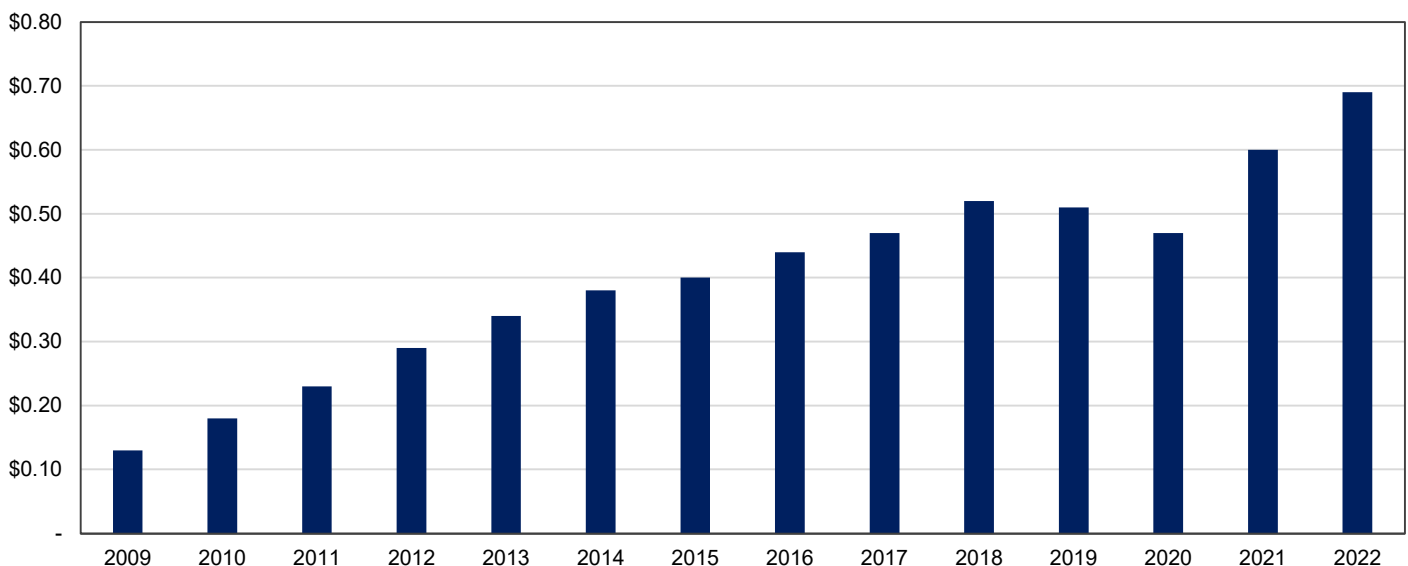
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2022 was a difficult year for listed technology businesses. Rising interest rates, slowing growth and heightened scrutiny of business models drove the NASDAQ and the Australian IT Index down 33% and 34% respectively, with many formerly high-flying stocks faring even worse. Has this created an opportunity in 2023? While we continue to find it difficult, if not impossible, to value loss making technology stocks, we do see some pockets of opportunity emerging. This includes one of Auscap's holdings in the Fund, a company that Auscap recently presented at the Sohn Hearts & Minds Conference in November 2022 – online media classifieds business Carsales.com (**Carsales**).

Overview

Founded in 1997, Carsales is a collection of digital businesses at various stages of maturity. In Australia, Carsales runs the leading online automotive, motorcycle and marine classified marketplaces, where revenue is earned through charging dealers and private sellers of vehicles for the right to list on its marketplace. Over time Carsales has added many sources of incremental revenue, such as selling advertising space on its sites and subscription payments for the provision of data and research services. Carsales dominates its home market, with over 4x the unique audience of its nearest competitor. It also owns 100% of Encar, the number one online auto classifieds business in South Korea. It has an exposure to emerging South American businesses including 30% ownership of webmotors in Brazil and full ownership of both chileautos in Chile and soloautos in Mexico. As of October 2022, it now also owns 100% of Trader Interactive, the biggest player in the US non-automotive classifieds market. Carsales' financial profile is, in our view, very high quality. Since listing Carsales has achieved an average return on equity (**ROE**) of 40% and an earnings per share (**EPS**) compound annual growth rate (**CAGR**) of 14%.

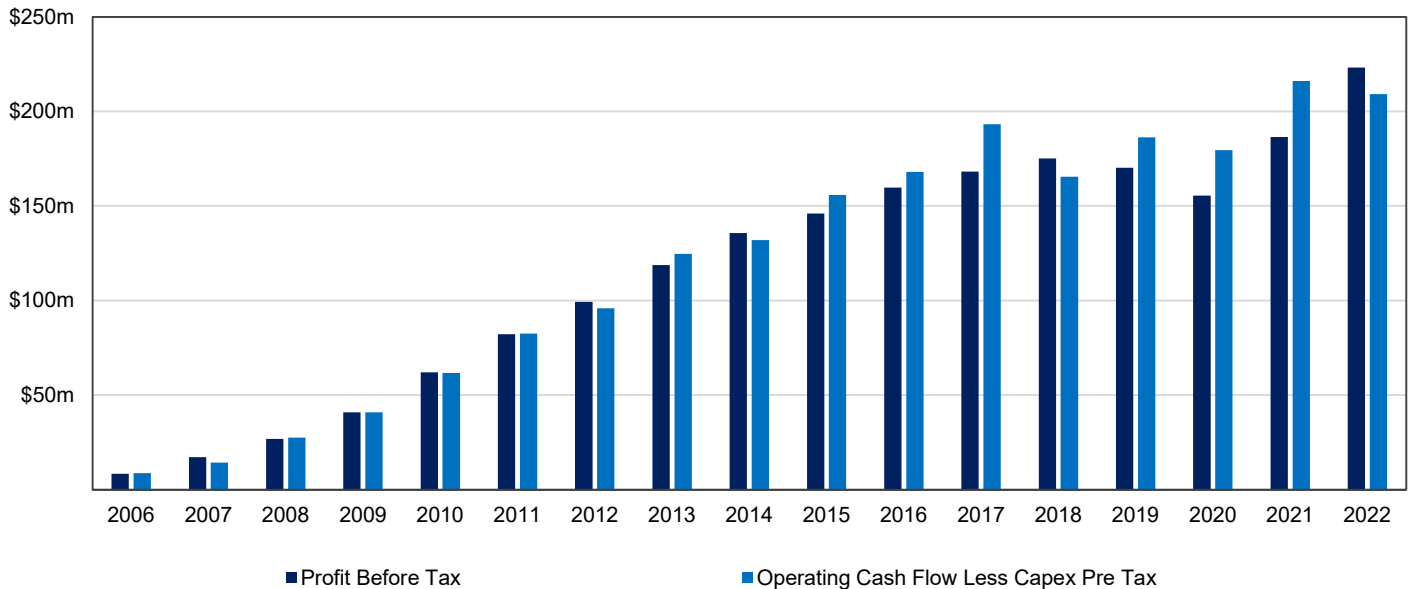
Earnings Per Share (\$)



Source: Company disclosures, Auscap

Carsales has also achieved very strong cash flow generation that closely matches its reported earnings.

Cash Flow Conversion



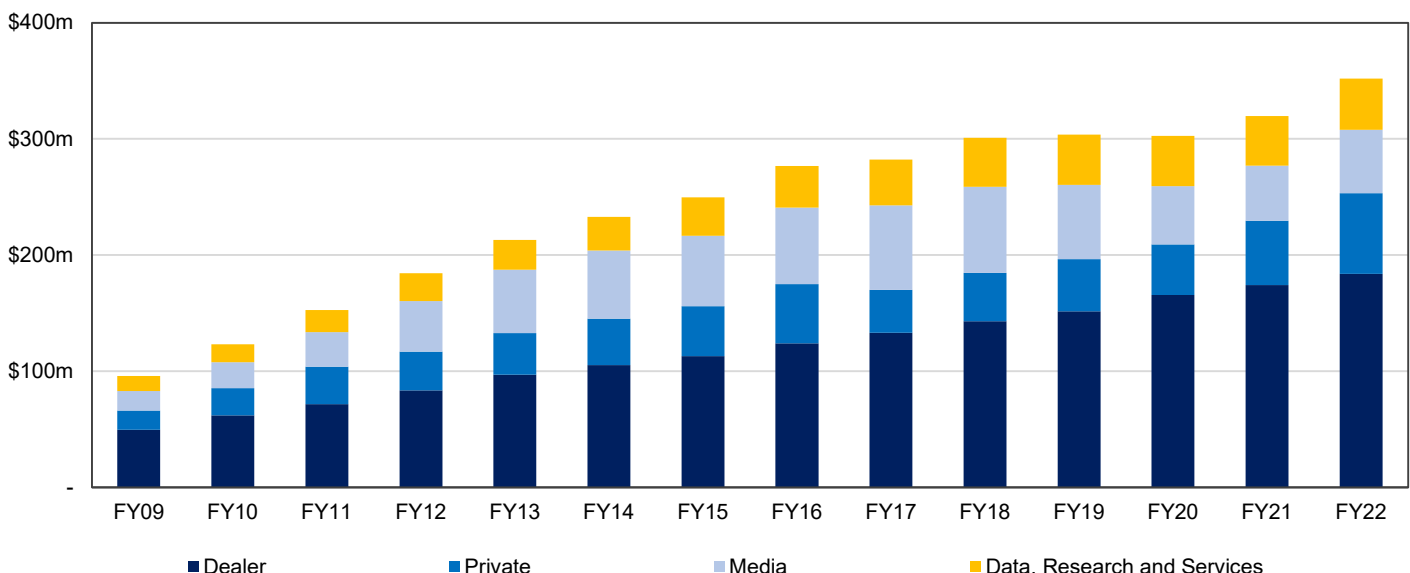
Source: Company disclosures, Auscap

Whilst Carsales' FY22 EBITDA margin of 53% would arguably be the envy of most Australian businesses, this margin has been achieved despite the group continuing to invest heavily in growing Carsales' earlier stage businesses such as Tyreconnect, Tyresales, Redbook Inspect, Placie and its international businesses. The Carsales board has an unusually high level of inside ownership and industry experience for an ASX 100 company, with directors and management owning over A\$200m of shares. CEO Cameron McIntyre joined Carsales shortly before its 2009 IPO and founding Chairman Wal Pisciotta remains on the board.

Growth opportunities

Carsales Australia has been a consistent performer, growing revenue at an 11% CAGR since listing. The business continues to grow its audience and volumes organically, whilst developing a number of promising incremental revenue opportunities.

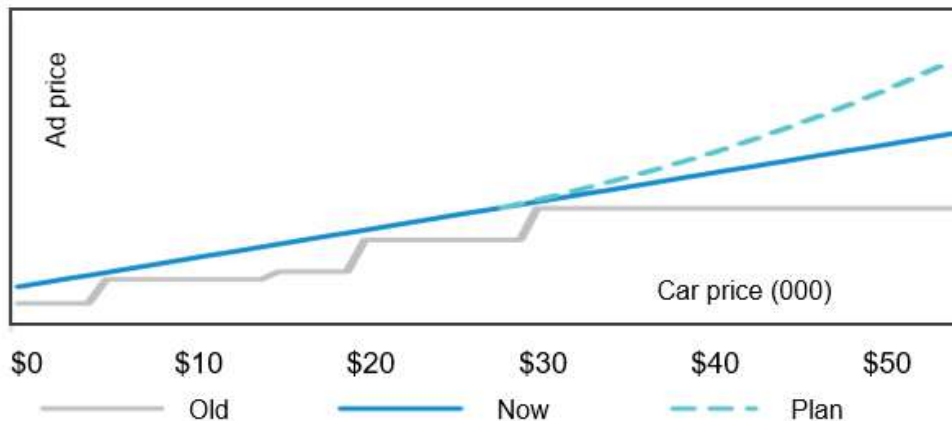
Carsales Australia Revenue (A\$m)



Source: Company disclosures, Auscap

In FY17 Carsales introduced “value-based pricing”, meaning it charged vendors more to list a more expensive vehicle on the platform, which underpinned private advertising yield (price) growth of 10% per year. In FY22, Carsales’ dynamic pricing was further expanded to include location-based pricing and micro-bracketing. The average private advertisement cost of \$130 in FY22 represents just 0.4% of a typical Carsales transaction price, leaving plenty of room for Carsales to benefit from raising prices over time.

Dynamic pricing opportunity

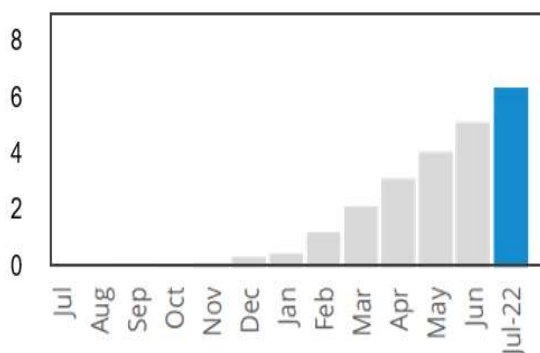


Source: Company disclosures

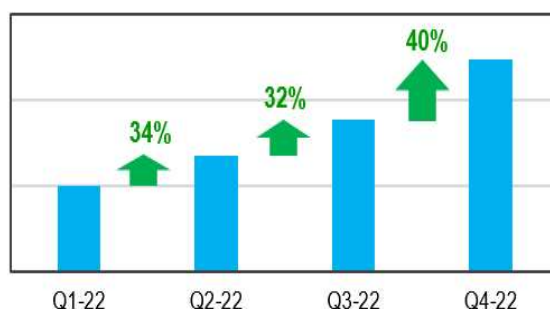
Carsales Select is a new digital retailing offering. It offers buyers algorithmically generated fixed price cars and a 7-day money back guarantee. Inventory is currently restricted to licensed dealer vehicles that have undergone an inspection and have travelled less than 120,000 km. In the first twelve months following its launch, over 6,000 cars have been sold and 2% of Carsales’ dealers have been on-boarded, with dealer participation growing every month. The offering continues to be improved, with finance and trade in capabilities recently added.

Instant Offer provides private vehicle sellers a hassle-free way to sell their car within 24 hours, with an “Instant Offer” available within minutes. After 5 years of tweaking, Carsales has finally begun to widely market the product, driving a 2.5x increase in volumes between Q1 and Q4 of 2022.

Select Inventory (000)



Instant Offer Volume



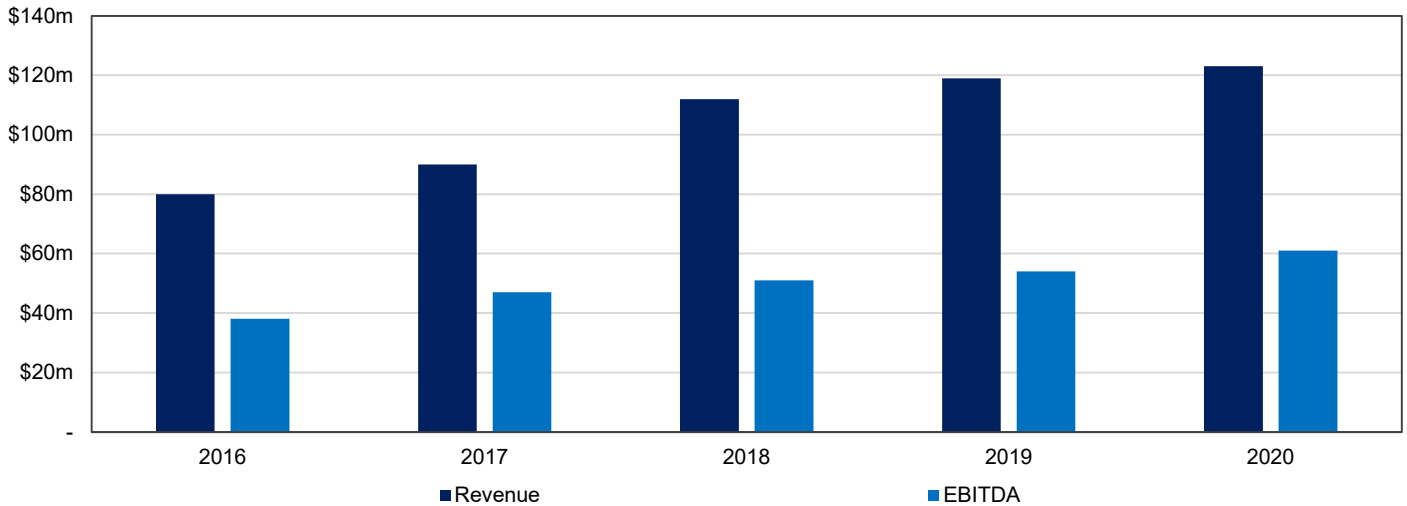
Source: Company disclosures, Auscap

We think Carsales has the ability to continue to grow its Australian EBITDA over time.

International

In May 2021, Carsales announced the acquisition of 49% of Trader Interactive, the leading US digital marketplace for recreational vehicles (RVs), powersports, commercial trucks and equipment. After 13 months of ownership, Carsales moved to 100% ownership. Trader Interactive has a strong financial track record under previous ownership.

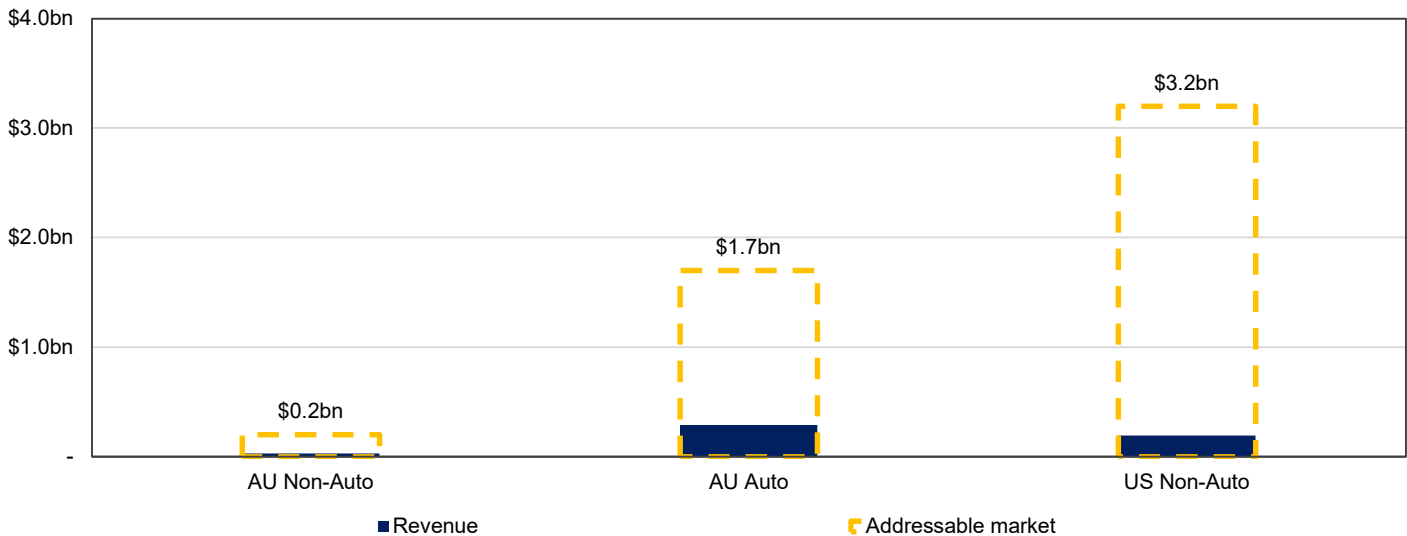
Trader Interactive (US\$m - CY basis)



Source: Company disclosures, Auscap

Trader Interactive is the market leader in end markets that are large, underpenetrated and have structural tailwinds. The US non-automotive market is 16x the size of Australia’s non-automotive market and 2x larger than Australia’s automotive market. Even with a strong market position, 7.9x and 5.1x the nearest competitor in audience in RVs and Powersports respectively (and 0.8x and 0.2x the market leaders’ audience in trucks and equipment), Trader Interactive’s revenues still represent just 6% of its addressable market. Non-automotive categories are exposed to the continued growth in recreational and lifestyle spending.

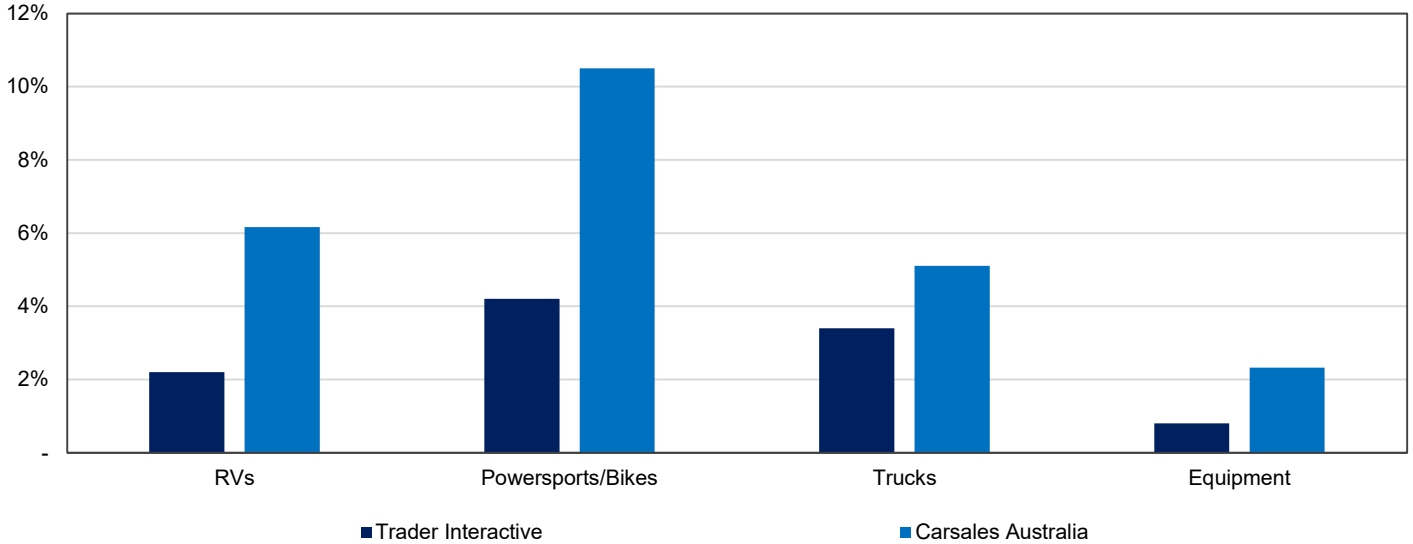
Addressable Market (A\$bn)



Source: Company disclosures, Auscap

We think there are significant opportunities for Carsales to improve the economics of Trader Interactive. Trader Interactive’s share of a dealer’s gross margin is well below Carsales Australia in comparable categories. Now with 100% ownership, Carsales can look at measures to close this gap over time.

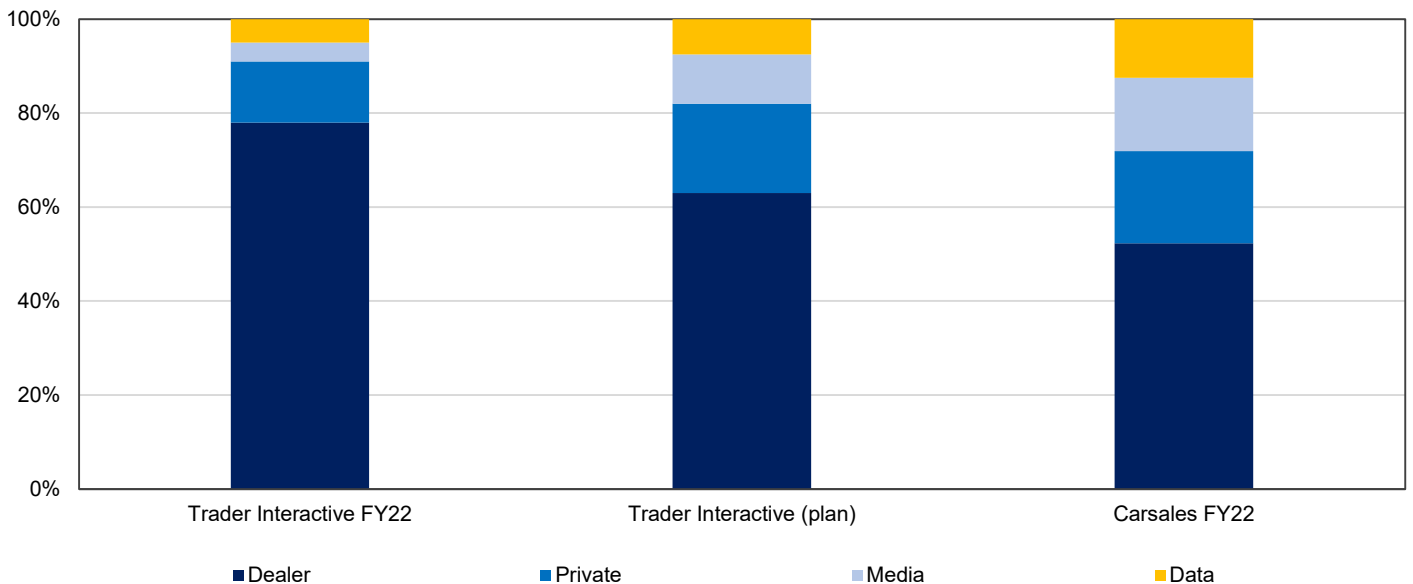
Share of Dealer Gross Profit Margin (%)



Source: Company disclosures, Auscap

Carsales has already identified multiple growth initiatives, all of which leverage what Carsales has already implemented in Australia. Dynamic pricing is perhaps the most exciting of these opportunities, with Trader Interactive still offering a single fixed price for all private sellers on the platform. Other opportunities include digital trade-ins, media optimisation, dealer systems improvement and cost synergies. This should also create a more diversified and less cyclical revenue base.

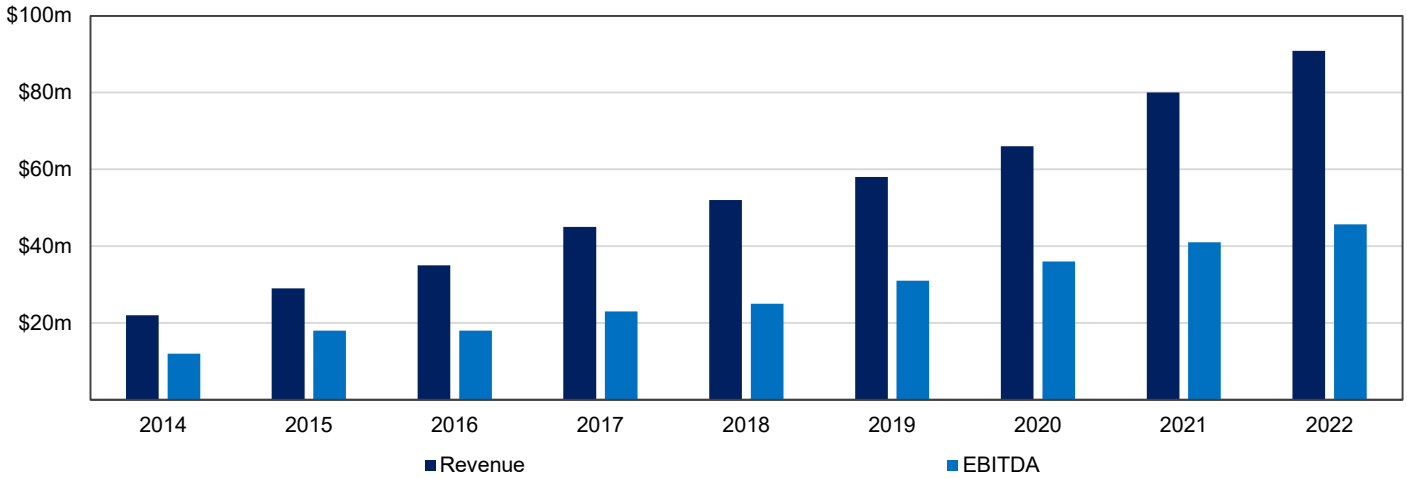
Revenue Contribution



Source: Company disclosures, Auscap

We have seen this scenario play out well before. Carsales purchased 49.9% of Encar in 2014 and the remaining stake in 2017. Since 2014, Encar's EBITDA has grown at an 18% CAGR.

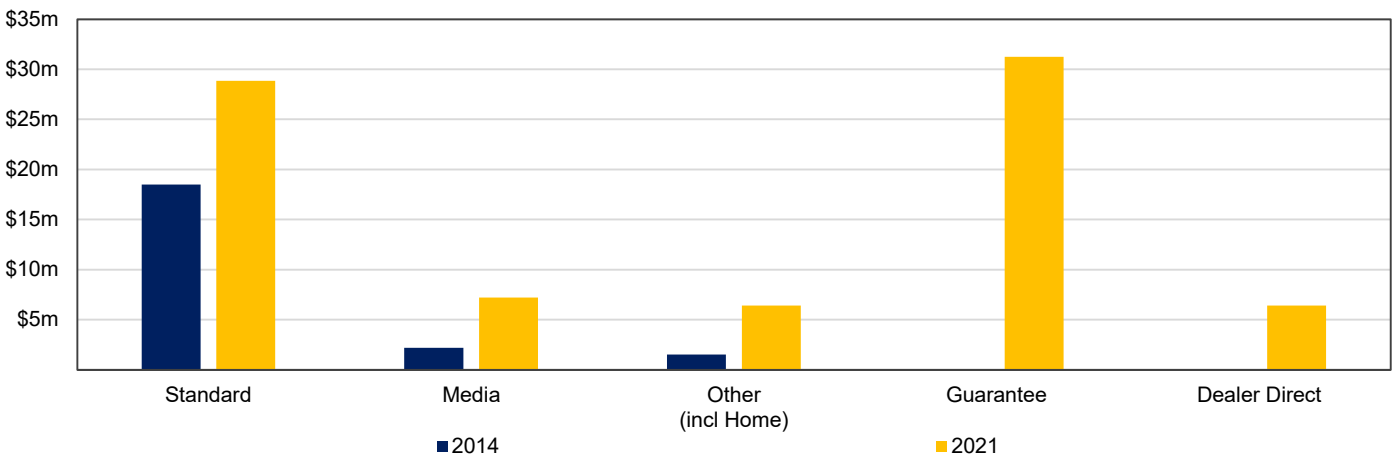
Encar Financial Track Record (A\$m)



Source: Company disclosures, Auscap

This has been achieved largely by adding new revenue streams to the business, as shown in the comparison below.

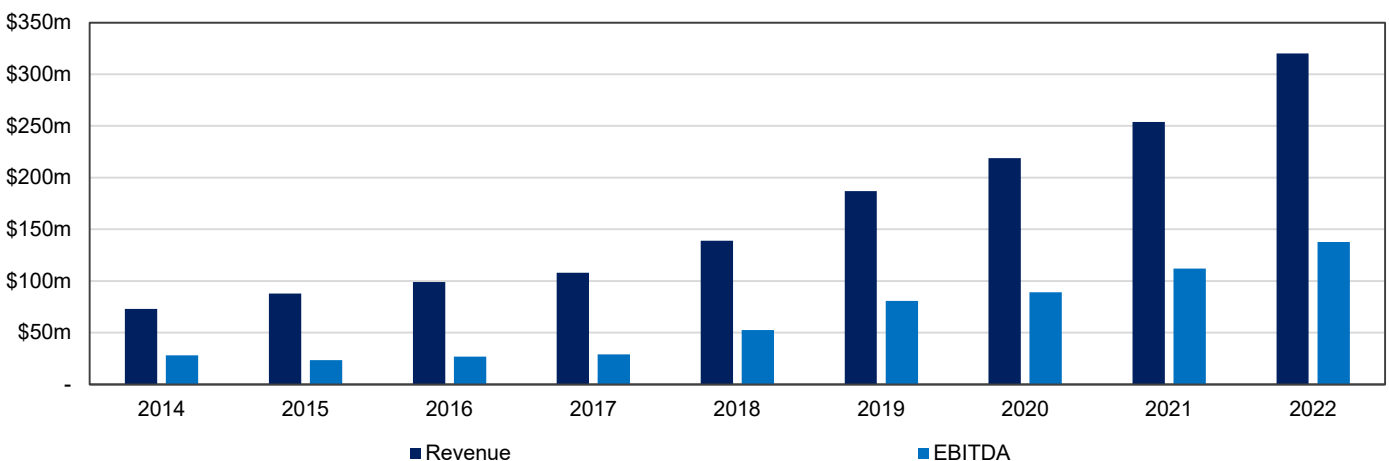
Encar Revenue by Product (A\$m)



Source: Company disclosures, Auscap

Similar success has been achieved with Webmotors.

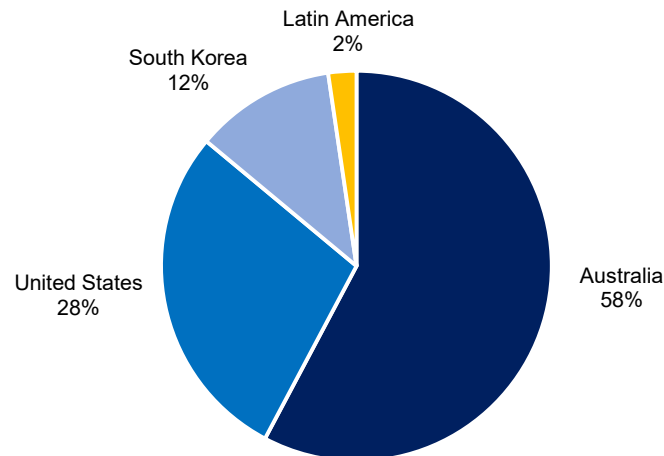
Webmotors (BRL\$m)



Source: Company disclosures, Auscap

But the difference this time around is scale – Trader Interactive operates in a market far larger than Korea or Brazil. The US business is already more than twice the size of Encar, representing 28% of group EBITDA on a pro forma basis.

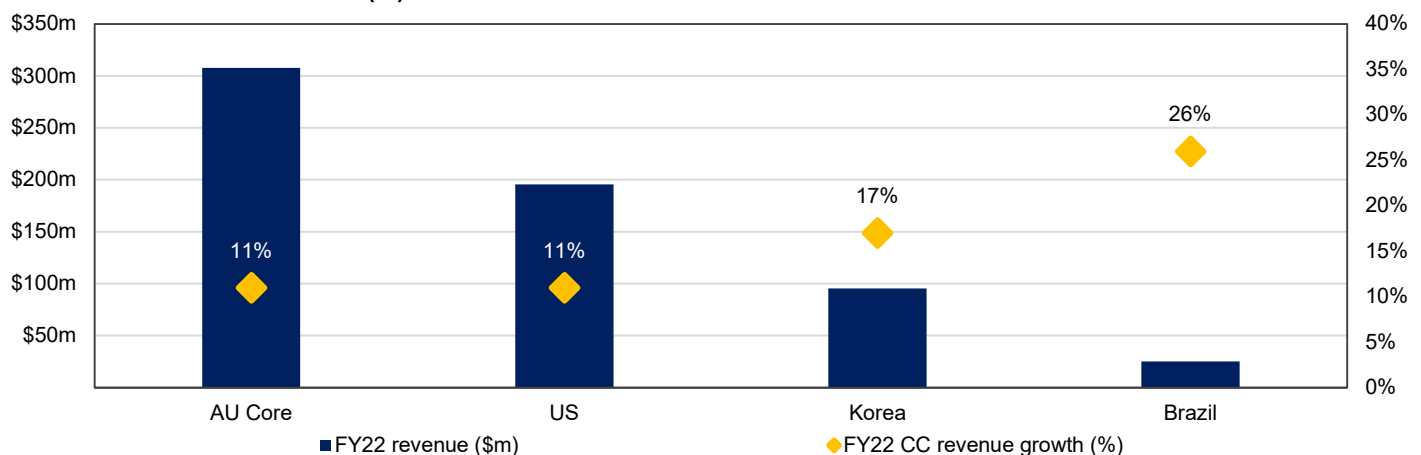
FY22 Pro-Forma Adjusted EBITDA contribution (%)



Source: Company disclosures, Auscap

48% of Carsales’ revenue is now sourced internationally, providing Carsales with a diversified and significantly extended runway for growth. In 2009 Carsales’ Australian operations were delivering EBTIDA margins in the mid 40s. That is similar to the international business today. Since then, Carsales Australia has grown revenues at 11% per annum and expanded core EBITDA margins from the mid-40s to mid-60s, resulting in powerful operating leverage. We think this is the opportunity for Carsales in this international division.

Revenue & Revenue Growth (%)



Source: Company disclosures, Auscap

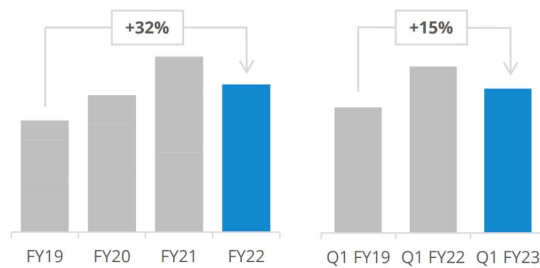
Risks

Our understanding is that there are a number of market concerns which have weighed on Carsales’ valuation recently. Higher interest rates have led to lower listed company multiples, particularly for technology enabled businesses. Whilst earnings multiple movements are inherently difficult to predict, following the 2022 sell-off our focus is primarily on the medium-term earnings outlooks for reasonably priced businesses like Carsales.

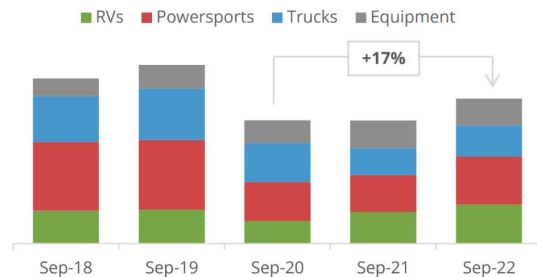
More specific to the company, used car prices have been elevated in recent years due to new vehicle supply chain constraints. If Carsales now links its prices to vehicle prices, the question is whether they are exposed to a drop in used vehicle prices. We see a couple of likely mitigants to this risk but it is something we will continue to monitor. First, dynamic pricing allows Carsales to adjust pricing quickly in response to market changes to protect yield. Secondly, Carsales’ data suggests a large portion of car buyers shop to a dollar budget rather than a vehicle model, meaning a drop in used vehicle prices might not see a corresponding drop in revenue. Further, in late October 2022, Carsales reported that it had experienced dealer yield increases, continued strength in private ad volumes and strong private ad yields.

The US consumer is likely in worse shape than the Australian consumer, leading to concerns that Trader Interactive’s leisure-exposed end markets are vulnerable to a US economic slowdown. This is true, with Trader Interactive’s website traffic and lead volumes already well off their peak. But Trader Interactive is currently charging dealers based on listed inventory rather than leads. Inventory was dramatically depressed over the COVID period due to supply chain challenges and is only now recovering, which we suspect provides a counter-cyclical support to earnings.

Traffic is lower than height of COVID but robust



Inventory levels are improving

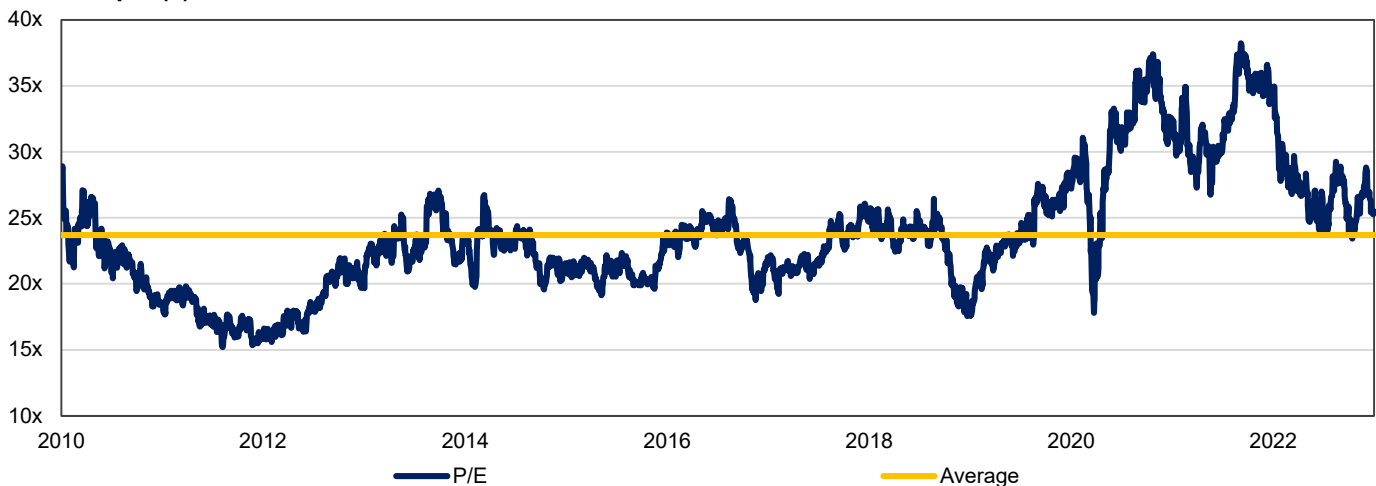


Source: Company disclosures

Valuation

While we are constructive on the business, a great company bought at too high a price can still make a poor investment. The business is currently trading on approximately 25x P/E. This is around the midpoint of the historical valuation range over the past decade.

P/E Multiple (x)



Source: FactSet, Auscap

During periods of market turbulence, we try to focus on the fundamentals of the companies that the Fund owns or would like to own. This includes 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 looking for opportunities to grow strongly through, and despite swings in, the economic cycle.

Carsales is one such business. It has a strong and growing market position, a track record of high returns on capital and multiple organic growth opportunities to reinvest to increase profits. It is a business with which we are familiar as both a customer and shareholder. We believe that the market is currently affording investors an opportunity to buy into this great business at a fair price. As Warren Buffett would say, “it’s far better to buy a wonderful company at a fair price than a fair company at a wonderful price”. We look forward to the Fund’s continued ownership in the company.

Auscap Long Short Australian Equities Fund

Fund Performance*

Period	Auscap	All Ords
December 2022	(5.8%)	(3.3%)
Financial Year To Date	17.4%	9.6%
Since Inception (Dec 2012)	311.5%	140.0%
Annualised Returns	15.1%	9.1%

Fund Exposures

December 2022 Average	% NAV	Positions
Gross Long	90%	34
Gross Short	0%	1
Gross Total	90%	35
Net / Beta Adjusted Net	90%	111%

Portfolio Commentary*

The Fund returned negative 5.8% net of fees during December 2022. This compares with the All Ordinaries Accumulation Index return of negative 3.3%. The Fund's largest exposures over the month were spread across the consumer discretionary, materials, real estate, financials and communication services sectors.

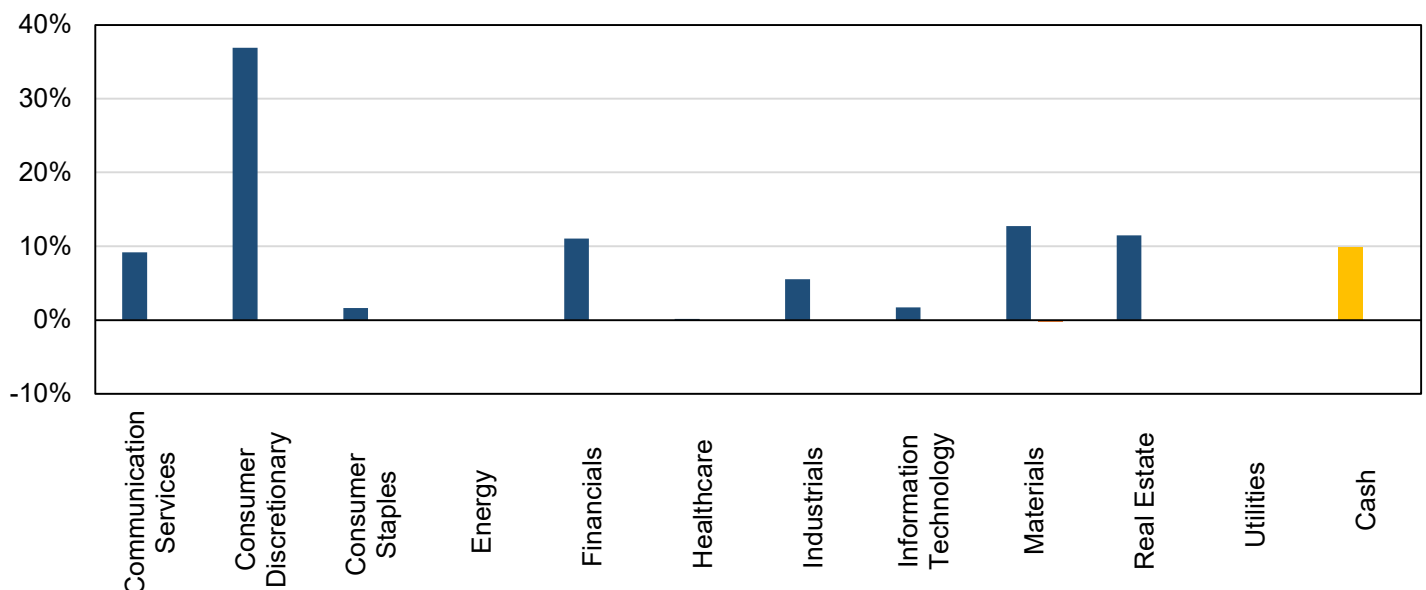
Fund Calendar Year Returns*

CY13	51.9%	CY18	(18.5%)
CY14	23.2%	CY19	18.1%
CY15	36.0%	CY20	10.6%
CY16	2.2%	CY21	43.2%
CY17	17.1%	CY22	(12.4%)

Top 20 Investments^

ARB Corp	Macquarie Group
Blackmores	Mineral Resources
Carsales.com	Motorcycle Holdings
Centuria Property Group	NIB Holdings
Eagers Automotive	Nick Scali
HMC Capital	NZME
HomeCo Daily Needs	Praemium
Hub24	Premier Investments
JB Hi-Fi	REA Group
Lovisa	Reece

Sector Exposure - December 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 31 December 2022.

Average Sector Exposure during December 2022.

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