

## Bennelong Australian Equities Fund

### Monthly performance update

As at 30 September 2018

#### Performance review

After a lengthy period of strong returns, the Strategy had a tough time of it in the September quarter. This is disappointing, but we believe it should be put in context.

Over time, the quarter-to-quarter performances have averaged out to provide clients with very attractive returns. By holding to our tried and tested investment approach, we expect to continue to outperform in the future. Indeed, right now, we believe the portfolio is very well set up in terms of the risk/reward proposition.

#### Performance attribution

Most of the action in the September quarter took place during earnings season in August. This is when almost all ASX-listed companies report their full year financial results.

In general, the companies in the portfolio reported strong results and gave reasonable guidance. However, in the case of a number of our larger positions, the market nevertheless reacted negatively. Their share price falls weighed heavily on the Strategy's returns. The main culprits here were stocks like **Costa Group** and **Flight Centre**. Admittedly, these stocks have all been very strong performers for the Strategy in recent times, and we are reminded that share prices do not always rise in a nice straight line up.

**Costa Group**, Australia's largest agricultural produce company, reported financial year results that were in line with expectations. Specifically, it reported profits of \$77 million, amounting to very strong growth of 26%.

For the 2019 financial year, the company guided to earnings growth of at least 10%. The market was underwhelmed by this guidance and consensus forecasts were downgraded, as seen in the graph below. Its shares sold off as a result.

Consensus EPS Forecasts for Costa Group



Source: BAEP, BAML. As at 30 September 2018.

We believe this guidance could well prove conservative. After all, the initial guidance for last year was also for 10% and it ultimately delivered 26%. Our more optimistic view of near term earnings is based on our research into production growth and price increases, particularly in respect of berries, mushrooms and avocados. That said, we expect the first half to be soft, with the second half of the financial year to more than make up for the difference.

As to the longer term outlook, the company guided to annual growth of 10% over a 3-5 year timeframe. This long range guidance reflects upon the predictability of its growth agenda.

In basic terms, this longer term growth is underpinned by growing demand, which Costa is feeding by growing production. Specifically, the company is investing material sums in capex to expand production of blueberries, mushrooms and tomatoes, and it is looking to continue building out its avocado business via acquisitions. In addition, the company is expanding its acreage of blueberry farms in China, and it has recently taken over full ownership of its Moroccan venture.

As an agricultural company, Costa is exposed to agricultural risks, including to the vagaries of weather and the up's and down's of produce prices. The company has mitigated this exposure, including through geographic diversification of its farms and the use of protected cropping practices. For example, frost conditions in NSW from July/August have caused reduced industry supply of blueberries. Costa is largely immune from this given its use of frost fan technology, and it will therefore benefit from the higher prices that have come as a result of limited supply. Based on our research, wholesale blueberry prices are materially higher in this 'peak' season versus last year – this is also reflected in higher retail prices at Woolworths and other retailers – and this will materially add to earnings. Costa is the dominant producer of blueberries in Australia, and has developed unique varieties that allow it to supply produce all-year round, including outside of peak season.

While Costa's share price fall hurt performance over the quarter, it also presented us with the opportunity to materially increase our weighting in the portfolio at what we considered very attractive prices. In our view, Costa is a high quality, strongly growing company that we have high conviction in based on our more optimistic view of its near and longer term earnings prospects.

**Flight Centre**, the diversified travel and leisure company, also reported its 2018 financial year results in August. The company reported underlying profits of \$384.7 million, which amounted to 17% earnings growth for the year and was at the top end of its previous earnings guidance of \$360-385 million.

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It seems the market was expecting even more than what was delivered, and the shares sold off.

Flight Centre is currently undertaking a five-year Business Transformation Program. This program is focused on more tightly managing costs, cutting out unprofitable businesses, turning around under-performing ones, and maintaining strong growth in travel bookings, particularly by emphasising its online operations. The program comes with ambitious financial targets that, if met, would come with very strong earnings growth and material earnings upgrades. Importantly, the company was able to confirm in its latest results that it was on track in respect of these targets.

Flight Centre was able to achieve very strong growth in its international operations. This included growth of ~120% in the Americas region and 30% in Europe. On the other hand, the Australian operations were soft, and in fact underlying profits declined by approximately 4% in the second half of the financial year. It is likely that this also played on investors' minds in their selling down the stock post the result.

We believe this soft Australian performance mostly owed itself to the distraction of the transformation program. In Australia, it required a system overhaul, retraining its sales force, and the rationalisation of its various brands. It is expected that the Australian business will have started to bed down these issues and started to gain momentum as it progresses into the 2019 financial year.

With the recovery in Australia, continued momentum in its international operations, and execution of other growth opportunities, we believe earnings growth will surprise the market on the upside.

As with Costa, we took advantage of the share price fall to materially increase our weighting in the stock at attractive prices. On consensus numbers, its shares trade on approximately 17 times this year's earnings. However, the company has a net cash position of approximately \$520 million - this is after deducting all debt and client funds – and the value of this cash pile is ignored in the calculation of its PE multiple. Indeed, the PE multiple would be closer to 15 times on an ex-cash basis.

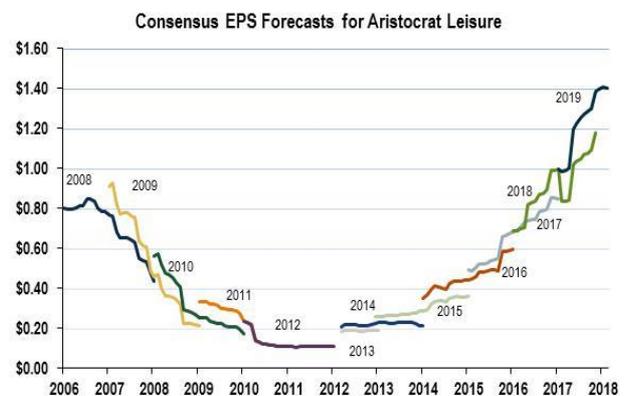
As it is, Flight Centre could return excess cash to shareholders, via a dividend or buyback. In this respect, we note the company has ample franking credits. Alternatively, it could use the cash to invest further in growing its business, including via acquisitions. An example is its acquisition in September of Unmapped, a Canadian-based technology company that provides travel documentation, communication and itinerary management software to the travel industry.

**Aristocrat Leisure**, the slot machine manufacturer and online social games developer, was another significant detractor for the quarter.

The company has a September year-end and so does not report its full year results until November. There was no other significant news flow during the quarter to explain its weak returns.

Based on our research, the company remains on track for decent growth for the 2018 financial year. This includes from its digital division – where results among the various businesses are mixed but positive overall – and its land-based slots division, where it continues to take market share and grow into adjacent market segments.

Aristocrat Leisure remains a large holding within the portfolio. As seen in the graph below, it has been in an earnings upgrade cycle in recent years, as the market has come to better understand its potential. Whilst earnings have grown strongly, its PE multiple has been largely unchanged. This is despite the increasingly predictable nature of its business, where a majority of its revenues now derive from recurring revenues. Today, it trades on 19 times consensus earnings for the 2019 financial year, which we believe undervalues its quality and growth prospects.



Source: BAEP, BAML. As at 30 September 2018.

One of the largest contributors for the quarter, and the largest portfolio position, was **CSL Limited**, the global biopharmaceutical company. The company reported its 2018 financial year results in August, with profits growing 29% to of US\$1.73 billion.

At last year's results announcement, the company guided to full year profits of \$1.48-1.55 billion, which guidance was upgraded in February, and then again in May to US\$1.68- \$1.71 billion. Thus, this year's result was well ahead of its initial guidance and slightly ahead of its most recent guidance upgrade.

In addition to its core plasma-derived therapeutics business, CSL operates a flu vaccines business called Seqirus. In 2015, CSL significantly expanded its flu business with the low-cost acquisition of Novartis'



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loss-making business. CSL had guided to getting the expanded flu business to break-even this year, but it actually made a \$54 million profit.

CSL spent US\$700 million (A\$1 billion) on research and development in the 2018 financial year, and expects this to rise to US\$800 million in 2019. A large part of this has been directed at developing new 'specialty' drugs that can be extracted in the same fractionation process at low incremental costs and that can therefore be sold at high incremental margins.

One big opportunity here is a new drug called CSL112, which the company is currently seeking to prove up via a large-scale Phase 3 trial. This drug helps heart attack patients by cleaning out the cholesterol from their arteries and significantly reducing the risk of a repeat heart attack. The trial will take four years, cost approximately US\$500 million all up, and involve 17,000 patients globally. The potential market is huge. For context, over 50,000 people in Australia alone are estimated to suffer a heart attack each year.

CSL is also investing significantly in growth elsewhere, including in opening new collection centres and building out fractionation capacity. Together, this investment should ensure it has the product available to meet the strong growth in demand for its products.

The company has guided to profits for 2019 of between US\$1.88-\$1.95 billion, implying 10-14% growth. We believe this could well prove conservative, particularly if current sales trends persist.

Investors reacted positively to the result, and then continued to bid its shares up. Some of this excitement has settled down, and the stock has drifted back somewhat. The round trip was however beneficial to the Strategy's returns.

In addition, the Strategy benefited from its underweight position in the **Banks**. The portfolio has less than 5% in the sector, compared to the benchmark's weight of approximately 23%. The Bank's underperformance was therefore beneficial to the portfolio's relative returns.

## Portfolio positioning

### Portfolio action

In constructing the portfolio, the inclusion and weighting of any particular stock will depend on our conviction levels. For us, conviction comes from our belief in the company's ability to meet or beat the market's earnings expectations. Most of our conviction comes from undertaking very detailed research and analysis. This involves meetings and follow-ups with the company itself, as well as 'channel checks' with other industry sources such as competitors, suppliers and customers.

During the quarter, we took the opportunity to up-weight our highest conviction ideas, including stocks like Costa Group and Flight Centre. We very much like the potential in these stocks, particularly given where their shares prices currently sit. On the other side, we trimmed positions where our conviction levels reduced. Specifically, there was a couple of portfolio companies that reported what we considered to be underwhelming results, but which nevertheless saw their shares rise higher.

The changes have greatly improved the risk/return dynamics of the portfolio, and we believe the portfolio is well positioned for attractive returns ahead.

### General portfolio themes

Stock selection is predominantly a bottom-up process, with the portfolio put together one stock at a time. That said, there are a number of themes that come through in the portfolio:

- We naturally have a very heavy weighting in relatively lower risk, predictable and defensively positioned stocks. For example, we have a heavy weighting in the portfolio to the consumer and healthcare sectors, with examples such as Costa Group and CSL.

- Also consistent with our investment philosophy, we naturally have a heavy orientation to growth.

The value versus growth debate has been divisive. For us, it is ultimately stock fundamentals rather than labels that matter, with growth just a component of the value equation. We are particularly focused on those companies whose earnings growth prospects are underestimated, and therefore undervalued. In the portfolio, we hold stocks like Flight Centre and Aristocrat that trade on very attractive PE multiples for the quality and growth they offer.

- We have significant exposure to offshore earnings, through global businesses such as CSL, Aristocrat Leisure and Reliance Worldwide.
- Compared to the benchmark, we have a bias away from large caps, with a significant



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underweight to the top 20 stocks, and an overweight bias towards small caps.

- We continue to avoid the pure bond proxies such as the Utilities and Infrastructure stocks, as well as less obvious proxies such as blue chips like Telstra that offer little if any growth but generous dividends. In general, these stocks have been popular for their yield, which in turn has pushed up valuations, and without growth, future returns appear lacklustre.

### Outlook

We remain constructive on the market, being neither outright bearish nor bullish.

We believe the market is acting in its normal orderly way. Indeed, we believe Australian equities look relatively attractive, although there is the need to remain selective.

There are always bull and bear arguments on the market. In an attempt to simplify our thinking, we would point out three reasons for being constructive on the market.

#### 1. Stock fundamentals look solid

This was confirmed by the recent earnings season. Aggregate earnings growth for the market last year was 8%. This year another 7% is expected. After a grind in corporate earnings since the GFC, it seems ASX-listed corporates are starting to see some earnings momentum finally start to build.

As well, corporate balance sheets have in general been strengthening over the years and now look very strong. On consensus numbers, the aggregate gearing ratio will fall from about 22% two years ago to 18% by the end of this year (excluding the banks, in respect of which prudential capital levels have also strengthened).

#### 2. Valuations are relatively attractive

The market trades on less than 16 times consensus earnings, which is only slightly above its historical average of 14-15 times. The market yields approximately 4.5%, which after grossing up for franking credits, gives investors a 6% yield. This appears very attractive in the context of low rates and the growth equities also offer on top.

Indeed, cash, bonds, property and most other classes sport valuation metrics far beyond historic averages, quite in contrast to Australian equities.

Many point to the length of the current upcycle. However, from the very depths of the GFC almost 10 years ago, the market index has not yet doubled (the US market is up over 4x). Over that time, the Australian market has had two corrections of 20% or thereabouts – in 2011 and

2015/6 - which hits up against the argument we have enjoyed a bull market for far too long.

#### 3. Investor sentiment is supportive

Share prices naturally discount the prevailing investor sentiment. Sentiment is far from euphoric. Indeed, many investors still seem to be cautious and wondering when the next correction is coming?

Reflecting this sentiment at the institutional level, many fund managers have significantly upped their cash holdings, according to BAML's most recent investor survey. At the retail level, there is little stock talk at BBQs, nor are Uber drivers given to stock tips, and margin lending has plateaued at historically low levels.

Of course, there is always a need to be diligent and manage risk. Importantly, our investment approach is as much about reducing the downside risk as it is about upside returns. Right now, we believe the portfolio is well positioned on a risk/return basis.



## **Bennelong Australian Equities Fund**

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#### **About BAEP**

Bennelong Australian Equity Partners (BAEP) is a boutique fund manager focused on Australian equities. It was founded in 2008 in partnership with Bennelong Funds Management. BAEP is a genuinely active fund manager with a consistent and disciplined investment approach.

BAEP's investment philosophy is to selectively invest:

- in high quality companies;
- with strong growth outlooks; and with
- underestimated earnings momentum and prospects.

BAEP's investment process is research-intensive with a focus on proprietary field research and is supported by economic and quantitative insights.

#### **About the Fund**

The Bennelong Australian Equities Fund typically holds 25-60 stocks across the entire spectrum of the Australian share market. It primarily holds stocks from the S&P/ASX300 Index, although it is not limited to holding stocks in this index.

#### Benefits of the Fund

- BAEP is an award winning and highly rated equities fund manager with an experienced and performance-orientated team.
- BAEP is a genuinely active and high conviction fund manager, meaning potentially significant deviation from the benchmark and with prudently concentrated portfolios.
- The Fund has a track record of adding value by outperforming the market over the long term.
- The Fund is managed in accordance with BAEP's robust, disciplined and proven investment philosophy and process.

The Fund is managed by Bennelong Australian Equity Partners, a Bennelong Funds Management boutique.

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