

Airlie Australian Share Fund

A concentrated, active portfolio of Australian equities.

Accessing the Airlie investment team and Magellan fund capability.



Fund Update: 31 December 2018

ARSN: 623 378 487

FUND FACTS

Investment Objective: To provide long-term capital growth and regular income through investment in Australian equities.

AIPR	MGE9705AU
Inception Date	1 June 2018
Benchmark	S&P/ASX 200 Accum. Index
Minimum Initial Investment	AUD\$10,000
Portfolio Size	AUD \$12.6 million
Distribution Frequency	Bi-annual
Buy/Sell Spread	0.14%/0.14%
Management & Administration Fee	<ul style="list-style-type: none"> 0.78% p.a. (inclusive of net effect of GST) No performance fee
Investment Strategy	<ul style="list-style-type: none"> Long only, bottom up specialised and focused Australian equities fund Concentrated portfolio of 15-35 stocks (target 25) Active, high conviction approach - Airlie's 'best ideas'

WHY CHOOSE THE AIRLIE AUSTRALIAN SHARE FUND?

- Access to an experienced, proven investment team specialising in Australian Equities, with a long track record of prudent common-sense investing
- A conservative and robust investment process that focuses the team's energies on their best ideas
- The strategy is now available to retail investors for the first time through the partnership with Magellan

PORTFOLIO MANAGERS



Matt Williams
Over 25 years investment experience. Formerly Head of Equities and portfolio manager at Perpetual Investments.



Emma Goodsell
Over 8 years investment experience. Formerly an investment analyst within the Australian equities team at Fidelity International and prior to that Nomura Securities.

Visit www.airlieaustraliansharefund.com.au for more information on:

- Fund performance
- Unit prices
- Investment Insights

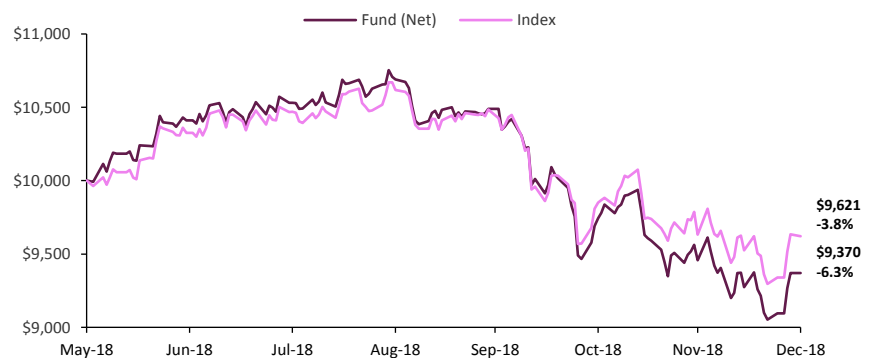
PERFORMANCE*

	Fund (%)	Index (%)	Excess (%)
1 Month	-0.9	-0.1	-0.8
3 Months	-10.7	-8.2	-2.5
6 Months	-10.0	-6.8	-3.2
Since Inception	-6.3	-3.8	-2.5

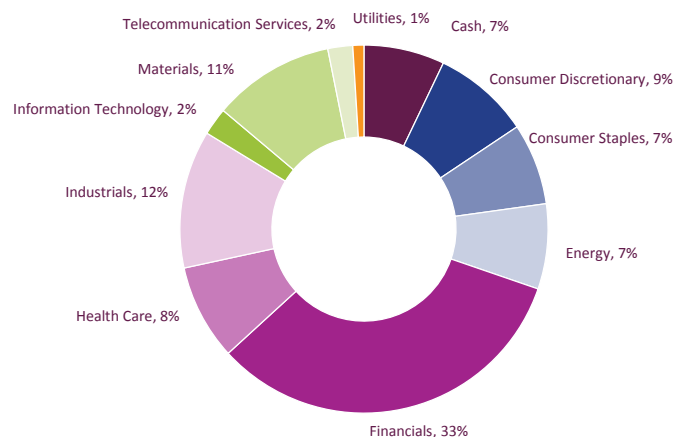
TOP 10 POSITIONS (BY WEIGHT)

Company	Sector#
Commonwealth Bank of Australia	Financials
CSL Ltd	Health Care
Westpac Bank	Financials
BHP Billiton Ltd	Materials
Wesfarmers Ltd	Consumer Staples
Macquarie Group Ltd	Financials
Origin Energy Ltd	Energy
Suncorp Group Ltd	Financials
Caltex Australia Ltd	Energy
Credit Corp Group Ltd	Financials

PERFORMANCE CHART GROWTH OF AUD \$10,000*



PORTFOLIO POSITIONING#



* Calculations are based on exit price with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). Returns denoted in AUD.

Based on GICS Sector classification, may not sum to 100% due to rounding.

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MARKET COMMENTARY

The December quarter saw the Australian market experience its largest quarterly fall since September 2011. The confluence of well-documented global concerns and the seemingly universal consensus view that a weak housing market will feed through to overleveraged households fanned talk that Australia will experience its first recession in over 25 years sometime in 2019.

Year-ahead predictions are generally useless but we could see a scenario play out that challenges the consensus bearish view. It's possible the short-term market performance could be quite strong if:

- US and China trade tensions dissipate
- A more cautious Federal Reserve changes trajectory on the normalisation of interest rates
- The UK avoids a hard Brexit and kicks the can down the road for a year or two
- The Australian consumer continues to prove resilient and the economy 'muddles through' boosted by strong fiscal spending

Medium term, though, there are significant concerns that will continue to impact markets:

- The withdrawal of quantitative easing and generally higher interest rates
- The unprecedented level of indebtedness globally: US government and US corporates; the Chinese financial system; the Italian government; and Australian households.

FUND COMMENTARY

These concerns led to a disappointing result for the fund this quarter. We generally expect our investment process to produce portfolios that outperform in heavily falling markets. We believe our process is still leading us in the right direction and we own stocks that meet our investment criteria:

- Financial strength
- Business quality
- Management strength, and
- Relatively attractive valuations.

However, the concentrated nature of the portfolio and hence significant position sizing has worked against us in the short term. High active weights in reasonably cyclical companies such as Aristocrat Leisure, James Hardie Industries and Origin Energy in particular have hurt. Added to this, we had the Australian Competition and Consumer Commission expressing concerns over the individual merger plans for two companies in the portfolio, TPG Telecom and Bingo Industries. Both stocks fell heavily on these concerns. However, we believe these five stocks, among others in the portfolio, are well above average quality companies that will ultimately win out over the market averages in the medium to long term.

As always, we think the soundest strategy through any market conditions is to own a collection of companies with strong financial positions, good management and attractive valuations. In recent years, potential investment ideas have often failed at that last hurdle of valuation – so we are encouraged to see more opportunities following the recent market fall to buy good companies at more attractive prices.



The Airlie investment process weighs four factors when considering a company: financial strength, business quality, management and valuation. Our analysis recognises that industries and companies aren't static, they are dynamic. As such, we are always looking for businesses where conditions (whether balance sheet, industry structure or management quality) have improved or will improve, and where this improvement isn't yet reflected in the valuation.

We think Origin Energy fits this bill. In our view, Origin's **financial strength** and **business quality** are set to improve, neither of which is reflected in current valuation of 9.5x PE. Origin comprises 2 main businesses: an energy utility and gas producer via its stake in the APLNG project in Queensland.

1. Improving financial strength

While we have followed the Origin story very closely over the years since it was spun out of Boral in 1999, in recent years we have been unable to invest in the company as it failed our "financial strength" test. As per below, Origin's net debt to EBITDA peaked at 7x in 2015, as the ill-timed APLNG project came online, just as oil prices fell from a peak of US\$115/barrel in June 2014 to under US\$30 by Feb 2016.

in oil prices, we are attracted to the cost out opportunity at the APLNG project, which means this asset is not solely reliant on the prevailing oil price. Origin and its partners are confident of attaining a 10-15% reduction in operating costs by June 2019. This further lowers the oil price at which the project is cash break-even to US\$39/barrel, which management believe they can get to US\$35/barrel long term. Current spot Brent oil prices are US\$53/barrel. While we have no skill at picking where oil prices are going, we take comfort from the fact that Origin's APLNG stake will be returning a cash distribution to the group at any price above US\$39/barrel, a price at which most of the world's oil producers are not making money.

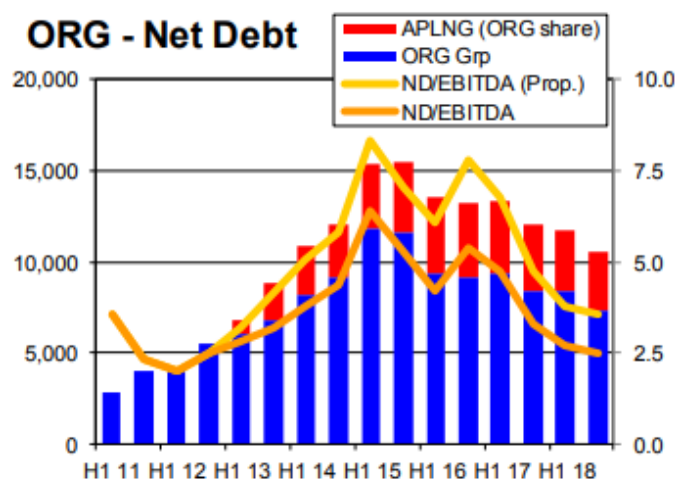
On our estimates, the business could fund a c60cps dividend by FY20/21, which would put the current share price on >10% dividend yield.

2. Peak utility risk = improving business quality?

Origin generates the bulk of its EBITDA from its utility business. We would consider a vertically integrated energy wholesaler/retailer business such as Origin a pretty average business. While legacy wholesale assets are unique and expensive/difficult to replicate, it is unlikely that a utility business could earn a sustainable excess return above cost of capital through the cycle, given the political and social sensitivities. Put simply, high electricity prices are only good for shareholders, not consumers and definitely not governments. As such, periods of rising electricity prices are likely to lead to heightened political risk/negative sentiment weighing on the sector.

That has certainly played out in Australia, and throwing in a government focused on delivering lower electricity prices ahead of a 2019 election, we believe there is a possibility that government intervention into pricing could reduce earnings in the order of 10-15%. However, we would expect the industry would be able to mitigate some of these effects, and a more stable political environment post-election would also be a good thing. We think Origin is currently in the midst of peak political risk/ peak negative sentiment weighing on the utility business. Further, at its recent investor day, management announced intentions to reduce cost to serve in the retail business by \$100m. As such, we think any price decline could largely be mitigated by lower cost to serve + reduced churn costs. With the balance sheet now strong enough to absorb these political risks, and with the valuation on a sub-10x P/E (vs 10 year average of 15x), we think the valuation is pricing in peak utility risk.

Sources: Company filings and website.



Since then, a combination of rising oil prices, improving energy earnings and the sale of non-core assets has put the balance sheet in much better shape, with net debt to EBITDA falling to 3.4x by FY18. While still elevated for our taste, we anticipate further balance sheet repair driving an equity re-rate as debt is paid down and dividends reinstated.

The business is entering a phase of significant free cash flow generation, driven by its interest in the APLNG project in QLD, which will return an increasing cash dividend to the group. While the share price has fallen with the recent 25% decline