Airlie Australian Share Fund
(Managed Fund)

A concentrated, active portfolio of Australian equities.

Ticker: AASF

Fund Update: 31 December 2023 ARSN: 623 378 487

FUND FEATURES

- 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'.

FUND FACTS

Investment Objective

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

Investment Strategy

- 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'

Investment Risks

All investments carry risk. While it is not possible to identify every risk relevant to an investment in a fund, we have provided details of risks in the Fund's Product Disclosure Statement. You can view the PDS for the Fund on Airlie's website: www.airliefundsmanagement.com.au

Inception Date	1 June 2018
Benchmark	S&P/ASX 200 Accum. Index
Portfolio Size	AUD $474.2 million
Distribution Frequency	Semi-annually
Management Fee^	0.78% p.a. (inclusive of net effect of GST)
Ticker	AASF
APIR	MGE9705AU
Minimum Initial Investment#	AUD$10,000
Buy/Sell Spread#	0.14%/0.14%

^ Transaction costs may also apply – refer to the Product Disclosure Statement. All fees are inclusive of the net effect of GST.
# only applicable to investors who apply for units directly with the fund.

PORTFOLIO MANAGERS

Emma Fisher
Over 13 years investment experience. Formerly an investment analyst within the Australian equities team at Fidelity International and prior to that Nomura Securities.

Matt Williams
Matt has over 25 years industry experience. Matt joined Airlie in July 2016 managing Australian share strategies for institutional clients and is co-portfolio manager for the Airlie Australian Share Fund for retail clients.

Visit www.airlieaustraliansharefund.com.au for more information, including: fund performance, unit prices and iNAV, investment insights, PDS & forms.

PERFORMANCE*

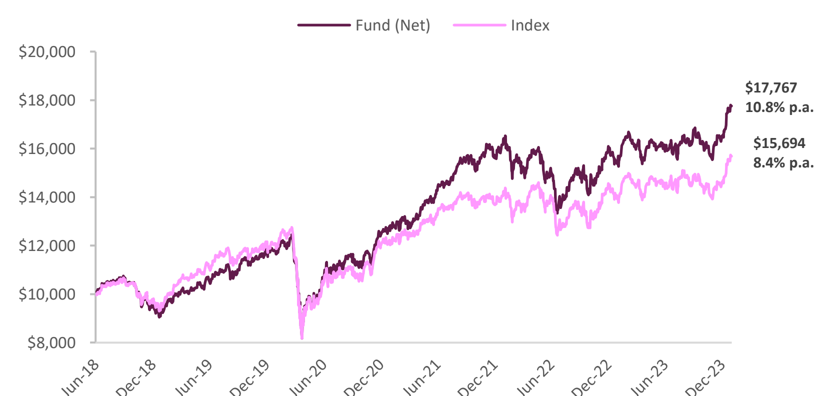
	Fund (%)	Benchmark (%)	Excess (%)
1 Month	7.5	7.3	0.2
3 Months	9.0	8.4	0.6
6 Months	10.7	7.6	3.1
1 Year	15.4	12.4	3.0
3 Years (p.a.)	12.1	9.2	2.9
5 Years (p.a.)	13.7	10.3	3.4
Since Inception (p.a.)	10.8	8.4	2.4

Past performance is not a reliable indicator of future performance.

TOP 10 POSITIONS (BY WEIGHT)

Company	Sector**
BHP Group Ltd	Materials
CSL Ltd	Health Care
Commonwealth Bank of Australia	Financials
ResMed Inc	Health Care
Mineral Resources Ltd	Materials
National Australia Bank Ltd	Financials
Ampol Ltd	Energy
James Hardie Industries Plc	Materials
Santos Ltd	Energy
Aristocrat Leisure Ltd	Consumer Discretionary

PERFORMANCE CHART GROWTH OF AUD $10,000*



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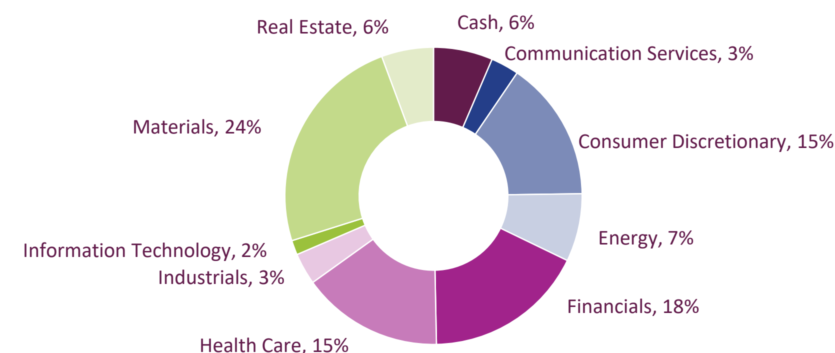
PORTFOLIO POSITIONING**



* 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.

MARKET COMMENTARY

We come to the close of another year of learning in markets, and 2023 has served to heighten our conviction that we would be terrible macro forecasters if we ever quit our day jobs. Despite the pervasive doom and gloom fed by the global rate tightening cycle, and despite the Macquarie Dictionary voting "cozzie livs" (slang for cost of living crisis) as its word of the year, global markets delivered excellent returns over 2023. The S&P/ASX 200 was only the middle of the global pack with a 12.4% annual return, trailing the significant gains of the tech-heavy US indices, with the S&P 500 +26% and Nasdaq +43%. Interestingly, the S&P 500 *equal weighted* index returned +14%, only slightly ahead of the S&P/ASX 200, highlighting the dominance of the Magnificent Seven.

The bulk of this return came in the final quarter of 2023, with the S&P/ASX 200 returning 8.4% as the market rallied in November and December. The main driver of this rally was a sharp swing in the consensus view on interest rates, with data and language from the US Fed supporting a view that the inflation genie is back in the bottle. The consensus outlook for 2024 quickly shifted to the nirvana of falling inflation, rate cuts, and the avoidance of a global recession. The markets ate it up like a plate of biccies left out for Santa.

In terms of outlook, it appears global policy makers have threaded the needle by containing inflation with monetary tightening while avoiding severe recessions. This result is rendered all the more remarkable given the backdrop of expansionary fiscal policy from most governments. Where to from here? As usual, we don't bother with predictions, but we can make some observations and consider portfolio implications. The 2023 S&P/ASX 200 return comprised a 4.6% dividend component, as well as a 17% increase in the market price to earnings (P/E) ratio, partly offset by a 9% decline in the 12-month forward EPS. Put simply, valuations went up and earnings expectations went down. The S&P/ASX 200 now trades on 16.2x P/E, above the long-term average of 14.5x. To us this suggests the market is a little bit "over its skis" from a valuation perspective. As such, we expect future positive capital gains will have to be driven by earnings. We believe the profit outlook for corporate Australia appears solid. Most companies have spent several years now taking price increases to protect margins in the face of significant raw materials and now labour inflation, and any easing in inflationary pressures should flow to the bottom line, primarily via gross margin expansion.

From a portfolio perspective, we are seeing value in stocks that have de-rated (in a year where most businesses re-rated). This list includes Aristocrat, ResMed, CSL, Orora, Tabcorp and QBE – positions we have added to as they represent value in an increasingly expensive market. Meanwhile, we have seen strong re-ratings in portfolio holdings such as James Hardie, Reece, News Corp, Seven Group and Wesfarmers. While we remain positive on these holdings and believe the earnings outlook remains strong, we have trimmed our positions here to reflect the reduced value on offer.

FUND COMMENTARY

The Airlie Australian Share Fund rose 9.0% net of fees for the December quarter, outperforming the benchmark return of 8.4%. This brings the calendar year return for the Airlie Australian Share Fund to 15.4%, outperforming the benchmark return of 12.4% by 3% net of fees.

A good quarter for the portfolio was driven by James Hardie (+38%), after the better-than-expected 2Q result in November. We are excited about the earnings potential of the business when volumes return to the market, with demand in the US repair and remodel segment (Hardie's largest segment) described on the quarterly management call as a "beach ball being held underwater". The US housing equation is similar to Australia, with strong pent-up demand battling very high affordability headwinds. However, unlike Australia, the US can more easily supply new houses when the affordability picture ultimately improves. Portfolio holdings Reece (+20%) and CSR (+17%) also similarly benefited from the resilience of the US and Australian housing cycles.

Two of our larger portfolio positions also enjoyed a strong quarter, with Seven Group +18% and News Corp +16%. Both stocks are in our top 5 largest holdings. Seven Group enjoyed a strong quarter post its excellent FY23 result, and also upgraded its earnings guidance as the Westrac, Coates Hire and Boral divisions continued to fire. The group is an embodiment of the strength of the Australian economy – resources, infrastructure and housing – which continues to be driven by resilience from iron ore, government spending and defiant consumers, respectively. We trimmed our position size in the quarter.

News Corp was the portfolio's quiet achiever, spurred by a solid September quarter result. Since the announcement in September that Rupert Murdoch was stepping down as Executive Chairman, there is a view in the market that the company may move to better highlight and potentially crystallise the inherent value in the group. Meanwhile, we watch with interest the company's move to make A.I. platform providers pay for using News Corp content.

Interest rate sensitive companies took off late in the quarter, with Charter Hall +27%, Premier Investments +10%, and Nick Scali +12% outperforming. Meanwhile, companies the market considers "losers" from lower interest rates, such as portfolio holdings QBE (-6%) and Medibank Private (+3%), had a subdued period. We added to QBE over the quarter.

Portfolio holding **Santos** (-4%) and **Woodside** (-15%, not held) confirmed merger talks. We are sceptical of the proposed merger with Woodside because a) it is difficult to see any material synergies between the two businesses, and b) the press around the merger (and our conversations with Santos) suggests it is incredibly early days and that perhaps there is some reverse broking occurring on behalf of investment bankers. However, we do believe Santos is undervalued and the press around the merger is not necessarily a bad thing if it can ultimately flush out a legitimate buyer for parts or all of Santos's portfolio (at an appropriate price). Our thesis has always been that on a discounted cash flow basis it trades cheaply (using conservative long-run commodity price assumptions) and that as cash flow generation lifts (once the Barossa and Alaska projects come online in FY25/FY26), the balance sheet will deleverage rapidly, driving strong capital returns for shareholders. We added to Santos over the period prior to the merger speculation.

Tabcorp (-11%%) announced the renewal of their Victorian wagering licence with a possible $140m uplift in EBITDA for an $864m payment. This is a reasonable outcome, but the company will need to execute well to retain all of this earnings uplift over the medium term. Meanwhile in the short term the industry is suffering from a particularly weak period as the covid bump unwinds. Overall the stock has had a bad quarter and is challenging our thesis that all demergers lead to significant shareholder value uplift. However, it is still possibly early days and over the longer term our investment case remains that Tabcorp have plenty of self-help projects – a) lowering the cost base, b) improving flexibility, c) increasing speed of product delivery, and d) customising marketing – to generate meaningful earnings growth into FY25.

During the quarter we exited **ASX** (+10%), a position we had established only in August. As we continued to evaluate our thesis, we considered the cost and capex growth were likely to persist longer than we first considered. We also exited Region Group and recycled the proceeds in adding to our position in Waypoint REIT, which we feel has better debt tenor and better inflation protection in its rental agreements.

Finally, we have established a small position in Sigma Healthcare, after Chemist Warehouse made the interesting move to 'backdoor' the company into the pharmaceutical wholesaler. Sigma will soon provide wholesale services to Chemist Warehouse for pharmaceuticals (the contract won from portfolio holding EBOS). We initiated a small position in Sigma post its capital raise late in the quarter. We consider Chemist Warehouse a high-quality operation with potential further significant growth domestically and offshore. We concentrated our research efforts on better understanding the franchise agreements and the pharmacy regulatory environment and any potential ACCC issues.

STOCK STORY - CHARTER HALL (CHC)

(Jack McNally – Equities Analyst)

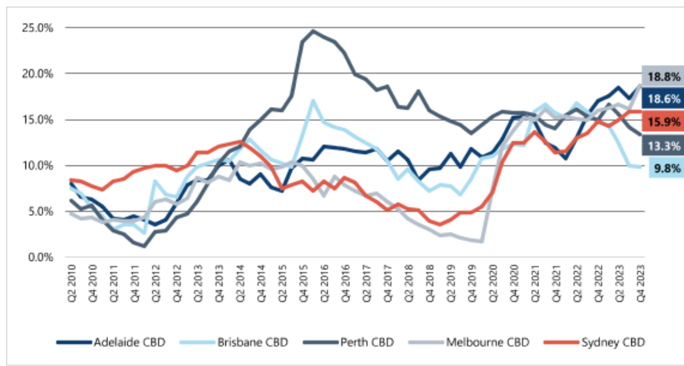
Business Quality is a key factor in the Airlie investment process, and we typically define a high-quality business as one that can earn a decent return on its capital. The Real Estate Investment Trust (REIT) sector is not typically thought of as a high total return sector due to the low-yielding nature of real estate and high capital intensity to just 'stay in business'. That said, it may come as a surprise that CHC has delivered a total return of ~11.5% p.a. since its IPO in 2006. This performance has been driven largely by CHC's transition from a traditional REIT to a fund manager, which generates fees on client capital with minimal amounts of incremental investment required.

Now, I know you are probably thinking, "Why would I want to invest in an office fund manager, particularly in the currentinterest rate environment?" We believe these risks are more than captured in CHC's current price and have provided the opportunity to invest in a high-quality business at an attractive valuation.

But Office is Dead?

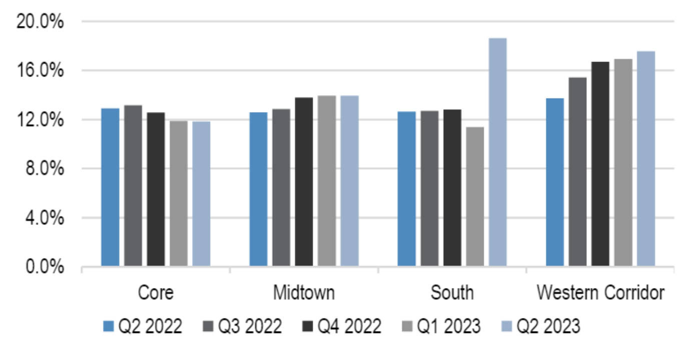
We don't disagree that the 'Work From Home' trend has created meaningful challenges for the Office sector. Corporates have quite reasonably concluded they can achieve substantial rent savings while providing their workforce with increased flexibility. This has resulted in an increase in market vacancy and placed pressure on rents.

Prime CBD Office Vacancy Rates



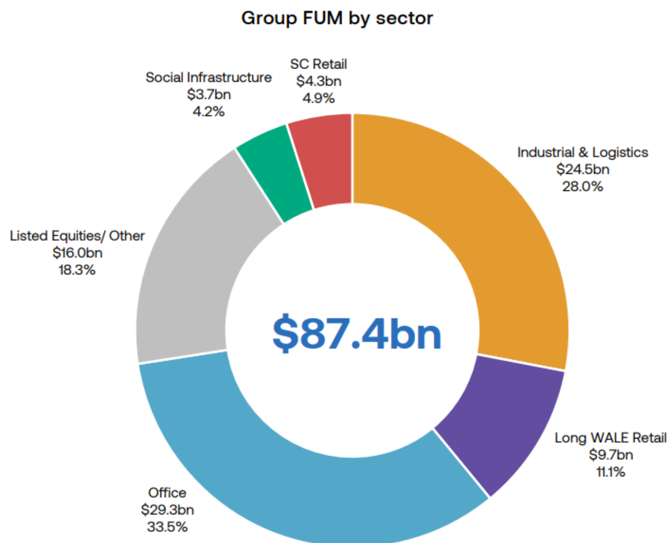
Source: Jefferies, JLL

Figure 2: Sydney CBD vacancy rate, by precinct



Source: JLL Research

This has understandably weighed on Charter Hall, with the share price down 48% since its peak of $21.83 in 2021. While Charter Hall will undoubtedly be affected by weakness in Office, we believe the criticism is not entirely fair given roughly two-thirds of its Funds Under Management (FUM) is in 'non-office' sectors, including Industrial and Logistics (28%), Equities (18%), Retail (16%) and Social Infrastructure (4%).



Source: Charter Hall

Further, the real estate cliché "location, location, location" remains as relevant as ever. The fundamentals for well-located, new and environmentally friendly buildings are markedly different from those that do not have these characteristics. The figure below highlights the divergent vacancy trends seen between core and non-core regions of Sydney CBD. Equally, the vacancy rate for buildings in Sydney that are less than 10 years old is ~6% versus ~13% for those over 10 years old (source: JLL and Charter Hall Research).

CHC's Office Portfolio skews to newer, better-located buildings, which has led to superior outcomes including 96% occupancy (vs 85% national average), 89% leasing retention rate and a high-quality tenant base like the Australian Government, multinationals and listed companies (which account for 56% of the Group's property platform income).

High Interest Rates?

It wouldn't be an investor communication without a quote from Warren Buffett, who said, *"Interest rates are to the prices of assets like gravity is to the function of earth"*. As such, it's no surprise that the 10 Year Australian Government Bond Yield rising from <1% during the pandemic to almost 5% weighed on an asset manager like CHC. Most obviously, it has reduced the value of the assets that it manages and charges fees on.

Australian 10 Year Government Bond Yield %

Source: Federal Reserve Bank of St Louis

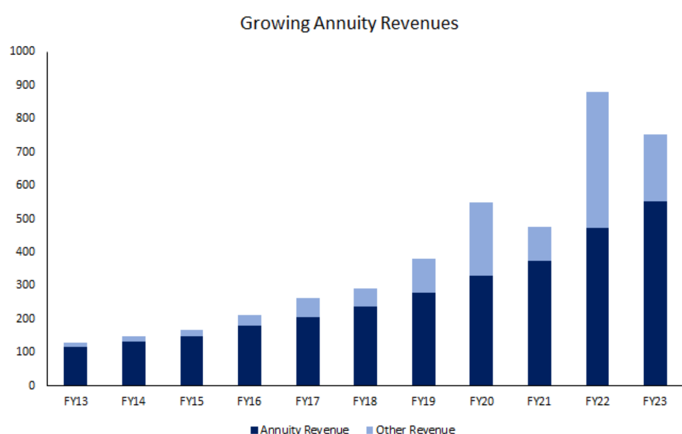
Second, the rapid increase in interest rates has frozen transaction activity in the sector with investors unwilling to make long-term, illiquid investments for fear the price of the asset could fall in the near term. This is not ideal for Charter Hall where transaction activity allows it to acquire new assets, increase its FUM and thereby grow earnings.

While we don't claim to be economic forecasters, we'd argue that with interest rates at 10-year highs and inflation measures falling, it seems more likely than not that interest rates have peaked. We believe this peaking of interest rates is likely to see transaction activity begin to return and allow CHC to mitigate devaluations in its FUM. From FY19 – FY23 CHC added $5.7b

per year to FUM from acquisitions and $2.0b p.a. from developments. Therefore, a return to average transaction and development activity would sufficiently offset a 10% decline in current Property FUM of $71b due to devaluations.

Underappreciated Business Quality

CHC trades at ~15x FY24 EPS guidance, which is a large discount to the ASX 200 of ~22x (excluding financials and resources) despite a track record of growing EPS at 15.1% p.a. over the last 10 years.



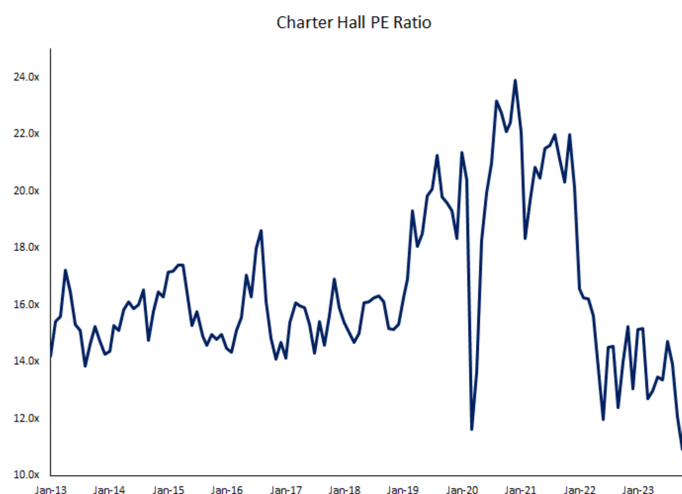
Source: Charter Hall

We believe CHC is a higher-quality business than it is given credit for, with several factors often overlooked:

- ~73% of its revenues are highly recurring, creating a stable, lower risk earnings stream for shareholders, which therefore should warrant a higher multiple.
- CHC's FUM are relatively 'sticky', meaning they cannot be easily or quickly redeemed. This is somewhat a by-product of redemption terms being structured to align with the fact that the underlying investments are large and illiquid:
    - ~72% of FUM is in 'Wholesale' (unlisted) strategies where institutional investors typically have redemption windows every 5 – 7 years, meaning they cannot pull their money out quickly.
    - ~15% of FUM is in 'Listed' vehicles, which more or less cannot be redeemed.
    - ~12% of FUM is in 'Direct' (unlisted) strategies for HNW individuals, which can typically be redeemed only every 5 years.
- Many of CHC's 'wholesale' investors have a lower cost of capital (return requirement), which means CHC can pay more for assets, providing it with an advantage in an auction for an asset.
- There are few other Fund Managers in Australia with the ability to purchase large assets worth more than >$1b, which further reduces competition in auctions for CHC.
- Funds Management EBITDA Margins have grown over the last ten years to 73%, highlighting the business's scalability. Even after removing the more volatile transaction and performance fees, the EBITDA margin is 62%, which reduces operating leverage and creates a stable earnings stream.
- As Charter Hall's funds management business has delivered strong performance, and its relationship with equity partners improved, CHC has not needed to 'seed' its investment vehicles with the same proportion of capital. This reduces its overall capital requirements of the business, allowing for both a higher return on capital and greater returns to shareholders.
- While there is implied leverage related to Charter Hall's investments in its own funds, at the group level, CHC has a very clean balance sheet with virtually no net debt, which provides it with optionality, particularly in a more difficult real estate market.

Attractive Valuation

Despite CHC's rising margins, decreasing capital requirements, proven earnings growth and business quality, it still trades at ~14x 1-year forward EPS which is well below the ASX 200 multiple of ~22x (excluding commodities and banks). Furthermore, we view the company's FY24 guidance of 75 cents per share as 'trough' earnings given it implies virtually no performance or transaction fees. If we normalise FY24 performance and transaction fees to a level that is in line with historical averages, CHC would be trading at ~10x FY24 EPS. We believe that if inflation continues to fall, interest rates stabilise and there is discussion of rate cuts – as we have seen in recent months – CHC's multiple should re-rate to account for the cyclically low earnings and depressed multiple.



Source: FactSet

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