Airlie Australian Share Fund

A concentrated, active portfolio of Australian equities.
Accessing the Airlie investment team and Magellan fund capacity.

Fund Update: 30 June 2019 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 $17.7 million
Distribution Frequency	Bi-annual
Buy/Sell Spread	0.14%/0.14%
Management & Administration Fee	▪ 0.78% p.a. (inclusive of net effect of GST) ▪ No performance fee
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'

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.airliefundsmanagement.com.au for more information on:

- Fund performance
- Unit prices
- Investment Insights

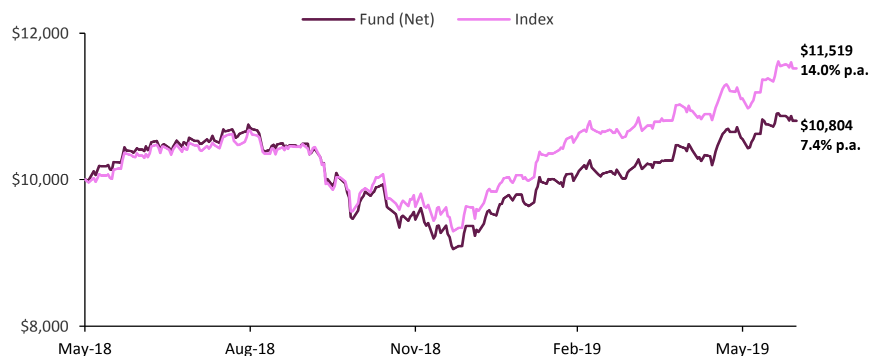
PERFORMANCE*

	Fund (%)	Index (%)	Excess (%)
1 Month	2.3	3.7	-1.4
3 Months	6.7	8.0	-1.3
6 Months	15.3	19.7	-4.4
1 Year	3.8	11.5	-7.7
Since Inception (% p.a.)	7.4	14.0	-6.6

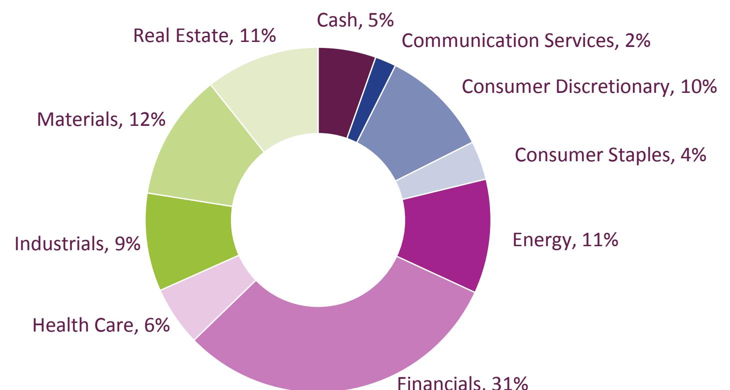
TOP 10 POSITIONS (BY WEIGHT)

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

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

Australian stocks hit record highs as they rose for a second consecutive quarter in the three months to June after the Liberal-National coalition was re-elected unexpectedly, the Reserve Bank of Australia cut the cash rate for the first time since August 2016 to prod an economy growing at its slowest pace in five years, and higher iron ore and oil prices helped commodity and energy stocks.

The government led by Prime Minister Scott Morrison that promised tax cuts defied opinion polls to claim a third consecutive term over a Labor Party pledging to raise taxes. The federal government in April called a poll for May 19 after delivering a budget that forecast a surplus in fiscal 2019-20.

The RBA in June trimmed the cash rate by 25 basis points to a fresh record low of 1.25% and signalled more declines to come, to help soften the blow from falling home prices and the uncertainty surrounding global trade. A report showed the economy expanded only 0.4% in the March quarter, and only 1.8% over the 12 months to March. Talk of rate cuts intensified in April when a report showed Australia recorded no inflation over the March quarter.

Energy stocks rose after attacks on oil tankers and other clashes in the Middle East bolstered oil prices. Commodity stocks rallied as a dam collapse and poor weather in Brazil and booming demand for steel boosted iron ore prices to their highest in five years. The Australian dollar was flat over the quarter but has fallen over 5% against the US currency over the year, providing a further boost for resource companies and other export industries while providing a headwind for retail companies and other importers.

The S&P/ASX 200 Accumulation Index rose 8.0% over the quarter to take the gain over the financial year to 11.5%. The accumulation index has now risen almost fourfold since its low in the depths of the global financial crisis in 2009.

FUND COMMENTARY

The portfolio underperformed in the June quarter. Stocks in the fund that detracted were Caltex Australia (-5%) on slower petrol sales, TPG Telecom (-7%) after the Australian Competition and Consumer Commission rejected its merger plans with Vodafone, Suncorp (-2%) after the CEO resigned, and Janus Henderson (-13%) on concerns over fund flows. Stocks in the fund that outperformed include Aristocrat (+25%) thanks to a strong profit result, Commonwealth Bank of Australia (+17%) due to a re-rating post-Royal Commission outcomes, and CSL (+10%) on strong product demand.

The quarter was dominated by the fall in the 10-year bond rate from 1.78% to 1.33% and the subsequent RBA rate cuts, continuing the demand for defensive sectors (healthcare, REITS and infrastructure). The fund is underweight these sectors.

Key Stock in Focus – Smartgroup

We recently established a position in Smartgroup, a novated lease and salary-packaging company. Smartgroup generates revenue by administrating salary packaging on behalf of employers that offer it and through novated leases. A novated lease allows an employee to pay for their car lease out of their pre-tax dollars (thereby earning a tax break).

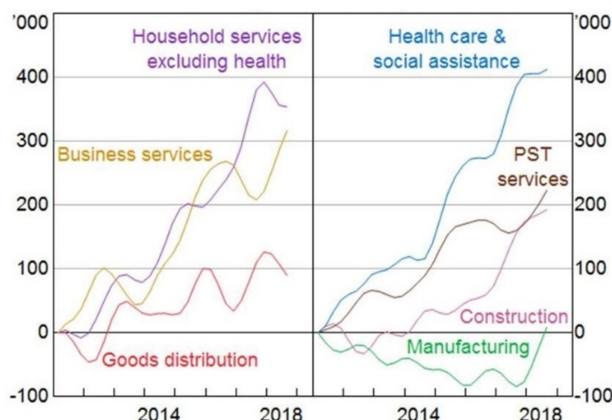
Salary packaging and novated leases are fringe benefits, essentially tax breaks that are designed to give a non-wage benefit to mostly public servants and workers in the charity sector.

Industry growth

The industry has been around since fringe benefits tax legislation was introduced in the late 1980s. Smartgroup has been around since 2002 and, with MacMillan Shakespeare, shares the market – they each have about 50%. It is a growing industry. Excluding acquisitions, Smartgroup has grown salary-packaging numbers organically by 12% p.a. and novated leasing by 4% p.a. in recent years.

There are two key drivers of growth for Smartgroup. The first is whitespace conversion and employee take-up (which we expect to account for 50% of Smartgroup's growth). This aspect of the growth is about convincing organisations to outsource their salary packaging and employees to take up the offering. The key driver for this is employment. About 96% of Smartgroup's customer base are charities and government workers. As per the chart below, employment in healthcare and social assistance has grown strongly over the past eight years. A big driver has been the rollout of the National Disability and Insurance Scheme, as well as the growth in aged care. We consider this a structural tailwind for Smartgroup.

Employment by Selected Industry (cumulative change since February 2011, trend)

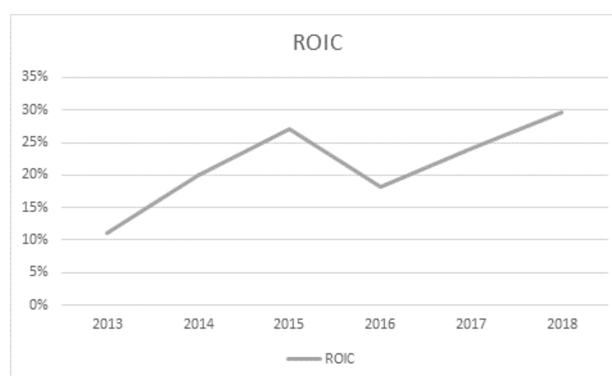


Sources: ABS, RBA

The other driver of growth is gains in market share. To do this, Smartgroup has bought competitors and taken share organically as it has the best service and tech offering. It is a scale game. When Smartgroup buys small stand-alone salary-packaging and novated businesses, it buys sticky customer bases and rolls the packages onto better terms (Smartgroup gets the best rates from car dealers and financers, etc.) so it can basically double the profitability of these smaller players by rolling them onto its terms.

Generation and use of cash

Smartgroup generates phenomenal returns on invested capital because it basically doesn't have capex or working capital needs. It fully expenses all IT spending so debt doesn't accumulate on its balance sheet.



The core business generates a lot of cash and Smartgroup has used it since listing to acquire smaller competitors. As per below, Smartgroup could have funded these acquisitions plus an 85% payout ratio almost all through internally generated cash. The company, however, has undertaken two equity raising to keep debt to close to zero.

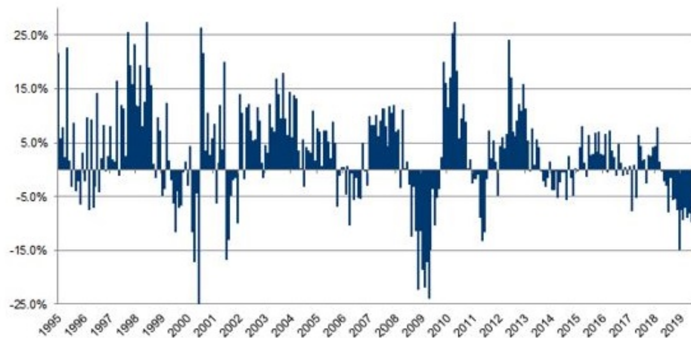
6 Year Cumulative:	
CFO	240
Capex	-4
Acquisitions	-174
Dividends	-125
Debt/equity funded shortfall	-63

The opportunity

New vehicle sales (the key driver in any one year for novated lease sales) are down over 20% this year. With this weak industry backdrop, Smartgroup's share price has fallen by 40%. We believe this is an opportunity to buy Smartgroup at an attractive price (11 times free cash flow, 6% dividend yield).

The chart below looks at growth in new car sales over the past three decades. Clearly, new car sales do decline from time to time but they have always rebounded.

Historical Australian new vehicle sales



Source: Morgans research, VFACTS data.

Further, despite a 20% decline in new car sales, Smartgroup's volumes are flat, which is a solid achievement considering the market backdrop.

Vehicle sales relative to Q1 2016

Source: Smartgroup presentation

While we can't predict the timing of a rebound in new car sales, we take comfort from Smartgroup's low level of gearing (0.1 times net debt/earnings before interest, taxes, depreciation and amortisation), low multiple paid (11 times free cash flow), excellent management and the business model's healthy cash flows.