Airlie Australian Share Fund

A concentrated, active portfolio of Australian equities.
Accessing the Airlie investment team and Magellan's operational and client services capabilities.

Airlie Funds Management

Fund Update: 31 March 2022 ARSN: 623 378 487

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'

Inception Date	1 June 2018	
Benchmark	S&P/ASX 200 Accum. Index	
Portfolio Size	AUD $327.4 million	
Distribution Frequency	Semi-annually	
Management Fee	0.78% p.a. (inclusive of net effect of GST)	
Ticker	AASF	
Tickers	**Solactive**	**ICE**
Bloomberg (AASF AU Equity)	AASFAUIV	AASFIV Index
Thompson Reuters (AASF.AX)	AASFAUDINAV=SOLA	AASFAUiv.P
IRESS (AASF.AXW)	AASFAUDINAV	AASF-AUINAV.NGIF
APIR	MGE9705AU	
Minimum Initial Investment#	AUD$10,000	
Buy/Sell Spread	0.14%/0.14%	

 # only applicable to investors who apply for units directly with the fund

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 Fisher
Over 11 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, including: fund performance, unit prices and iNAV, investment insights, PDS & forms

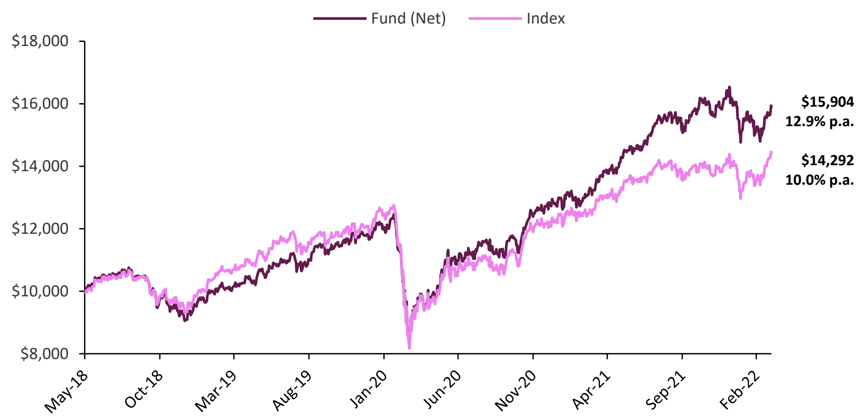
PERFORMANCE*

	Fund (%)	Benchmark (%)	Excess (%)
1 Month	5.0	6.9	-1.9
3 Months	-2.1	2.2	-4.3
6 Months	3.5	4.4	-0.9
1 Year	20.6	15.0	5.6
3 Years (p.a.)	16.2	10.6	5.6
Since Inception (p.a.)	12.9	10.0	2.9

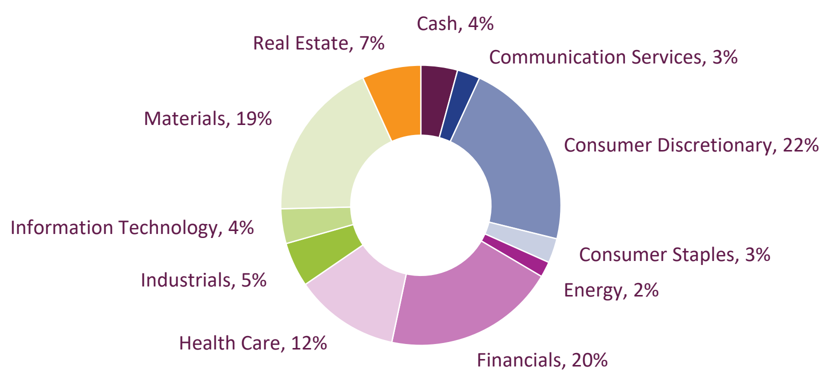
TOP 10 POSITIONS (BY WEIGHT)

Company	Sector**
BHP Group Ltd	Materials
Commonwealth Bank of Australia	Financials
CSL Ltd	Health Care
PWR Holdings Ltd	Consumer Discretionary
Macquarie Group Ltd	Financials
Mineral Resources Ltd	Materials
National Australia Bank Ltd	Financials
Wesfarmers Ltd	Consumer Discretionary
Dicker Data Limited	Information Technology
Aristocrat Leisure 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. Inception date is 1 June 2018 (inclusive).
** Based on GICS Sector classification, may not sum to 100% due to rounding.

MARKET COMMENTARY

The S&P/ASX 200 performed relatively better than other global markets due to its heavy resource weighting. As an indication the ASX 200 Industrial Index was down 3.4% over the quarter while the ASX 200 Resources Index surged 16%. Energy stocks, as a component of the resources, were obviously very strong, rallying 25%. Financials (+3%) performed relatively better than the industrials overall, where a divergence between the major banks with Westpac (+13%) and NAB (+12%) leading.

Macro themes dominated the March quarter:

• The period opened with an omicron wave in Australia causing supply and labour constraints. Pleasingly the eastern states dealt with this well and the worst fears of the economy coming to a complete halt (due to isolating rules) were not realised.

• The reporting season was another pleasant surprise with quite solid results despite extended lockdowns during the first half of fiscal 2022. However, companies were cautious in guiding for profit outcomes as the past few years have clouded what a 'normal' operating environment now looks like.

• Domestic concerns, however, were overwhelmed by the Russian invasion of Ukraine – causing a sharp sell-off in global markets. The S&P/ASX 200 fell 10% from its early January peak before rebounding to close at near all-time highs – a remarkable turnaround.

FUND COMMENTARY

The Airlie Australian Share Fund ('Fund') fell 2.1% over the March quarter while the benchmark (the S&P/ASX 200 Accumulation Index) was up 2.2%. For the 12 months to March 2022, the Fund returned +20.6% (after fees) versus the benchmark's rise of 15.0%.

For the March 2022 quarter, being underweight resources, particularly energy, was a major cause of the divergence between fund performance and benchmark. The best-performing stocks in the Fund included:

• BHP (+25%) – Due to strong iron ore, copper, and oil prices. Also, positive index effects of unification of the company's Australian and UK registers.

• PWR Holdings (+10%) – Solid profit result and outlook.

• National Australia Bank (+12%) – Turnaround of the franchise continues. Solid asset growth and margin outcomes.

• Northern Star (+14%) – Gold price rally on the invasion of Ukraine.

For the quarter the portfolio holdings that detracted were:

• James Hardie Industries (-27%) – Fears of the super cycle in US housing coming to a rapid end as mortgage rates shift higher.

• Aristocrat Leisure (-16%) – Fears of a looming recession in the US as the Fed hikes rates to combat inflation.

• Nick Scali Furniture (-26%) – Reversal from previous strong quarter as slowdown in consumer spending expected.

• Mineral Resources (-6%) – Disappointing 1H22 profit result due to higher costs in the iron ore business.

US housing exposure contributed to the underperformance of the Fund as James Hardie (-27%), Reece (-30%), and even Aristocrat Leisure (-16%) suffered on concerns that interest-rate increases to combat inflation will possibly send the US into recession later this year. There is no doubt the housing and consumer cycle is strong, but we believe each company has a unique quality aspect to its business that will see them outperform in their respective industries and grow via market penetration and market share increases.

Despite a poor quarter, we remain optimistic about Mineral Resources mostly due to its lithium business. As Chart 1 shows, lithium prices have skyrocketed due to expected demand from car manufacturers.

Chart 1: Fastmarkets battery-grade lithium carbonate and hydroxide, cif China, Japan and Korea spot prices.

Source: Fastmarkets.

While we don't expect this level of pricing to be maintainable over the medium term, we see strong upside for the miner even under a much lower pricing situation. Due to its conglomerate-like structure and disappointing 1H22 iron ore profits, Chart 2 shows that Mineral Resources has dramatically underperformed lithium pure plays such as Liontown, Allkem and Pilbara, despite Mineral Resources having arguably further advanced production operations.

Chart 2: Mineral Resources (Blue) vs pure play lithium comparables.

Source: Iress.

For more information on our views, please refer to our recent insight on lithium, which can be found at: airliefundsmanagement.com.au/insights/lithium-where-to-from-here/.

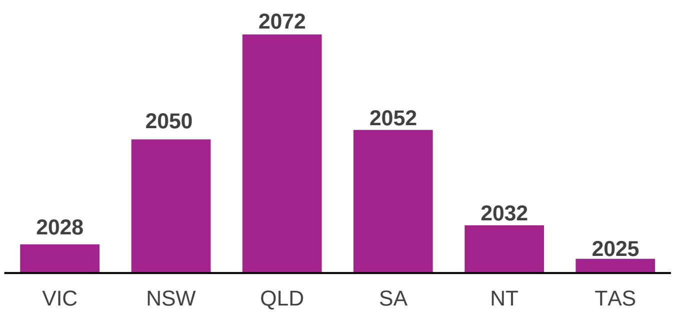
Stock Story: Tabcorp

In the search for high-quality businesses that are undervalued, one of the richest hunting grounds is a 'jewel in the crown' scenario, whereby a great business is hidden within a languishing conglomerate. One of Airlie's core holdings, Tabcorp (TAH.ASX), presents such an opportunity, operating a high-quality lottery division whose stellar performance has historically been overshadowed by a structurally challenged wagering division. Fortunately for shareholders, Tabcorp management has made the astute decision to demerge this 'jewel' into a new listed vehicle, The Lotteries Corporation. While this process has already served to unlock material value for shareholders, we believe the market is undervaluing the infrastructure-like qualities of this lotteries division.

The Lottery Corporation (Lotteries & Keno):

In Australia, lottery licences are awarded exclusively on a state-wide basis. Tabcorp holds all state licences bar Western Australia (operated by the WA government). These state-based monopolies exhibit similar traits to infrastructure concessions; licences are typically long-duration (ranging from 10 to 40 years), demand for the product is insensitive to economic cycles, they feature strong pricing power, and the businesses offer dependable and predictable cash flows. However, lottery concessions are far less capital intensive than their typical infrastructure counterparts. In fact, we estimate that Tabcorp's lotteries division generates a return on invested capital north of 50%!

Lottery Licence Expiry Dates



Source: Company filings, Airlie Funds Management.

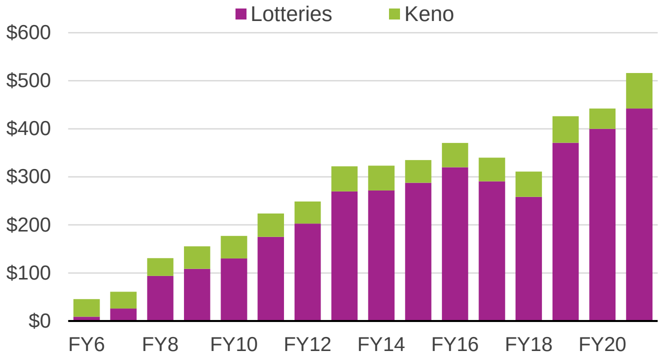
The crucial factor for a concession operator is whether future licences can be renewed on attractive terms. For lottery concessions specifically, there are some important aspects that heavily favour the incumbent during the bidding process, the most obvious of these being the benefit of economies of scale; Tabcorp is the only private operator of Lottery licences in Australia. This means that any fixed costs related to technology, systems and processes can be shared across the various state licences, resulting in higher profit margins. Given these economies of scale, Tabcorp can operate any individual licence more profitably than a new entrant and thus the company can bid a higher price for that licence.

Continuity is also an important consideration during the bidding process. The state government issuing the licence generates material tax revenue based on the value of lottery tickets sold. Any new entrants would need to replicate Tabcorp's existing retail network, customer lists, infrastructure, systems and processes while ensuring no drop in turnover (and tax revenue) for that respective government. These state governments are larger stakeholders in the lottery operations than even Tabcorp; over just the past three years, the lotteries segment has paid over $5.1 billion in state taxes, dwarfing Tabcorp's estimated profits of less than $1 billion. It is clearly in the best interest of the various state governments to maximise the turnover performance of the lotteries licences rather than attempt to squeeze extra margin by switching operator.

The only material upcoming licence renewal is the Victorian lottery licence in 2028. Interestingly, while Victoria is one of the highest lottery turnover states, it is also one of the lowest margin licences given the state's higher lottery tax rate. In 2012 when Tabcorp acquired the South Australian Lottery licence, the company disclosed Victoria's 'operator margin' at 3.9%, compared with 9.2% and 10.5% for NSW and Queensland respectively. Importantly, any new entrant seeking to gain material economies of scale in the market would need to wait until 2050 for the opportunity to bid on the NSW licence. Tabcorp has lost a portion of the Victorian licence before, when Intralot was awarded the instant scratchies portion of the licence in 2007. However, after six years of operation and a reported $63 million in losses, Intralot forfeited the licence and it was awarded back to Tabcorp.

Due to these structural advantages, Tabcorp's lotteries and Keno business has one of the most impressive track records of any listed ASX business, growing earnings before interest and tax (EBIT) at a compound annual rate of 9% over the past 10 years.

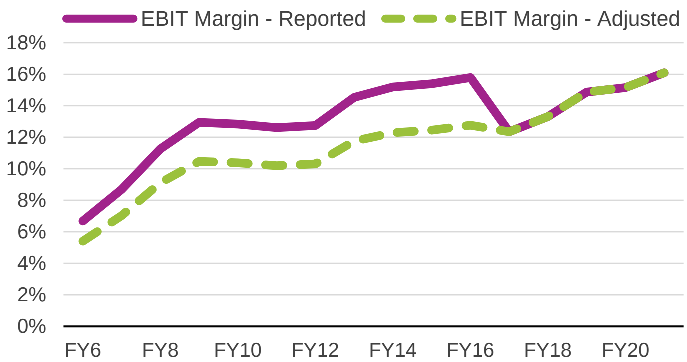
Lotteries & Keno EBIT ($m)



Source: Company filings, Airlie Funds Management.

As impressive as this track record appears, the earnings momentum here is actually understated; during the Tabcorp and Tatt's merger in 2018, $65 million in costs were reallocated to the lottery segment, hurting earnings. As can be seen in the chart below, this change in accounting policy had the effect of materially reducing profit margins in FY17 despite having nothing to do with the fundamental performance of the business.

Lotteries & Keno Margin (%)



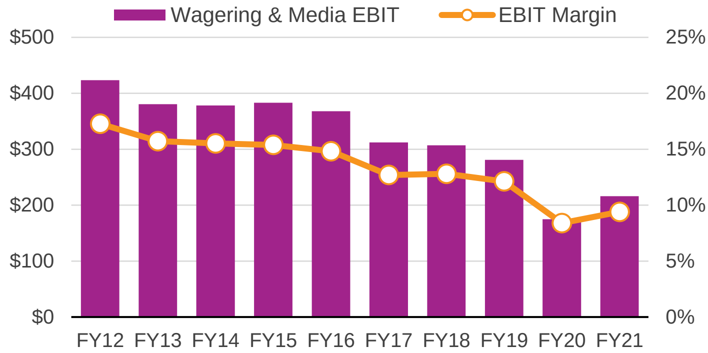
Source: Company filings, Airlie Funds Management estimates.

Margin expansion has driven much of the segment's historical growth in earnings, but importantly there are several reasons to believe this can continue: (1) continued economies of scale as the company's fixed costs are spread across a larger revenue base; (2) increasing digital penetration, which avoids the roughly 10.3% commission paid to newsagents; and (3) the superior terms recently negotiated with lottery reseller Jumbo Interactive (JIN.ASX).

The new Tabcorp (wagering, media and gaming services):

The remaining Tabcorp stub will include the wagering, media and gaming services businesses. The lion's share of value here is in the wagering and media operations. Under the TAB brand, Tabcorp holds the exclusive licence to conduct wagering operations in retail venues across all Australian states and territories excluding Western Australia. This retail monopoly is facing structural disruption as punters increasingly elect to bet with online bookmakers such as SportsBet, Ladbrokes and Bet365. While Tabcorp has its online channels, these digital-first competitors offer superior customer functionality, products and branding, as well as enjoying structural opex and tax advantages. The earnings track record of the wagering and media business reflects these difficulties.

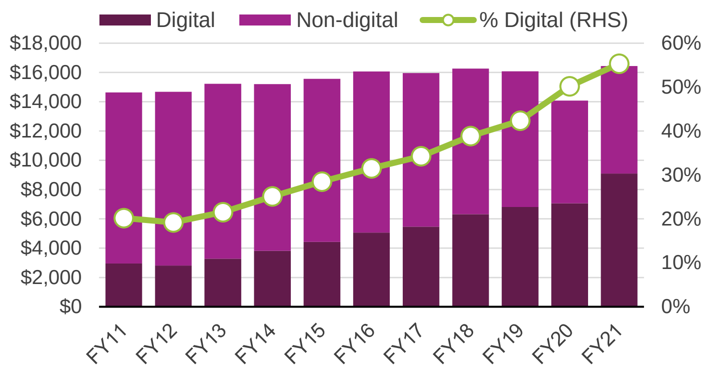
Wagering & Media EBIT ($m)



Source: Company filings, Airlie Funds Management.

But there are glimmers of hope emerging; Tabcorp now generates more than $9 billion in digital wagering turnover, representing about 55% of total wagering turnover for the group. On a digital-only basis, Tabcorp is the second-largest player in the market, with a 21% share of turnover. Furthermore, recent regulatory changes have helped to level the playing field between Tabcorp and its online competitors by reducing structural tax disadvantages.

Wagering Turnover ($m)



Source: Company filings, Airlie Funds Management.

Clearly other interested parties see value here; Tabcorp has received multiple bids within the last year valuing the wagering and media business at $3.5 billion ($4 billion including the gaming services business). While there are significant impediments to completing a transaction (change of ownership provisions and racing body approvals), this does give some indication of the underlying value within the segment not reflected in the current earnings momentum.

Valuation:

If we ascribe a valuation of $3 billion to the Tabcorp stub (a material discount to the recent $4 billion bid from Apollo Global Management), we get an implied earnings multiple for The Lottery Corporation of 19 times fiscal 2022 EBIT. This reflects a 24% premium to the median EV/EBIT of the ASX 300 ex-financials and resources. However, on a normalised cash flow basis – adjusted for return on capital employed – The Lottery Corporation is trading about in line with the market despite its superior growth outlook. As can be seen in the table below, the company compares favourably on a number of metrics with listed toll toad concession operators, Transurban and Atlas Arteria. For this reason, despite the strong share price performance, we see material upside in this core holding.

	ROIC	Est. weighted concession expiry	Net debt/ EBITDA	Forward EV/ EBITDA
The Lottery Corporation	**>50%**	**2050**	**3.2**	**16**
Transurban (TCL)	<15%	2046	8.4	31
Atlas Arteria (ALX)	<15%	2039	6.1	13

Source: Company filings, FactSet, Airlie Funds Management estimates.