Airlie Australian Share Fund

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

Airlie Funds Management

Fund Update: 30 September 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 $10.4 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.airlieaustraliansharefund.com.au for more information on:

- Fund performance
- Unit prices
- Investment Insights

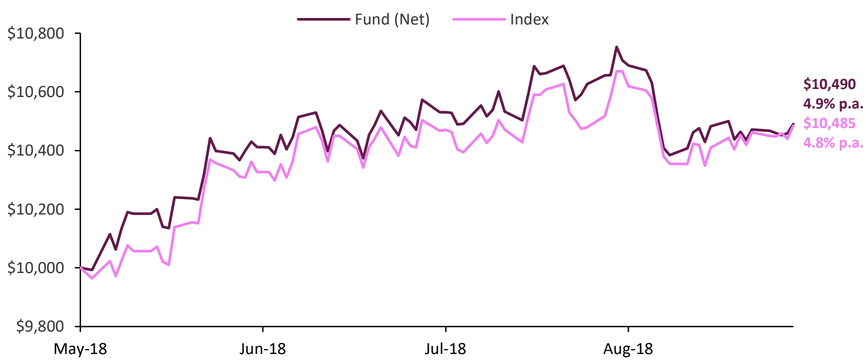
PERFORMANCE*

	Fund (%)	Index (%)	Excess (%)
1 Month	-1.9	-1.3	-0.6
3 Months	0.8	1.5	-0.7
Since Inception (% p.a.)	4.9	4.8	0.1

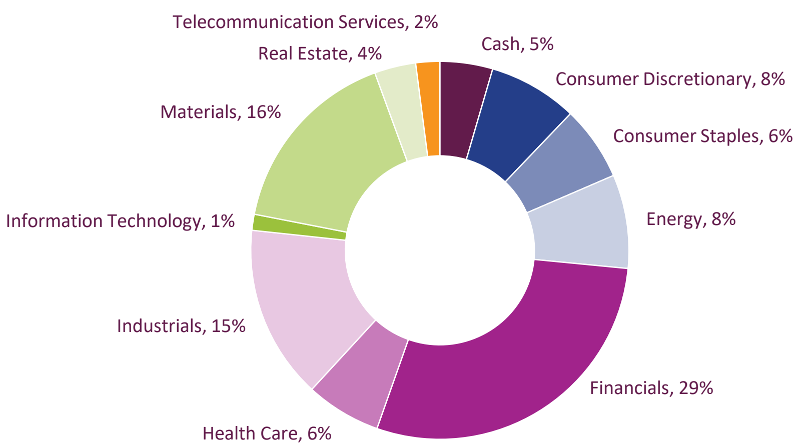
TOP 10 POSITIONS (BY WEIGHT)

Company	Sector
Commonwealth Bank of Australia	Financials
Westpac Bank	Financials
BHP Billiton Ltd	Materials
CSL Ltd	Health Care
Reece Ltd	Industrials
Origin Energy Ltd	Energy
Wesfarmers Ltd	Consumer Staples
Macquarie Group Ltd	Financials
Suncorp Group Ltd	Financials
Mineral Resources Ltd	Materials

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

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MARKET COMMENTARY

Australian stocks rose for a second consecutive quarter in the three months ended September as companies posted decent earnings, a report showed the economy expanded briskly over the June quarter, inflation stayed tame, and the Reserve Bank of Australia said it expected it would keep interest rates at low levels for a while yet. Gains were capped as higher global bond yields forced banks to raise mortgage rates and concerns grew that economic growth might cool. The Liberal Party leadership tussle that resulted in Treasurer Scott Morrison replacing Malcolm Turnbull as prime minister failed to cause any lasting concerns.

By J.P. Morgan's count of how earnings results fared against expectations for the period ended June 30, 'beats' at 29%, the lowest rate in three years, just topped 'misses' at 28%. In other stock-related news, health stocks dropped 8% in September after Prime Minister Scott Morrison said the royal commission would focus on residential and in-home care for seniors and younger people with disabilities but they still finished the quarter up 4%. Energy stocks benefited from higher oil prices, to rise 4%. The interim report from the royal commission into finance criticised banks, which lost 0.4% over the quarter.

A report in September showed that Australia's economy expanded 0.9% in the June quarter, to give a 12-month reading of 3.4%, the fastest annual pace in six years. Treasurer Josh Frydenberg in September said faster growth would help reduce the federal deficit for 2018-19 to $10.1 billion, nearly half the $18.2 billion shortfall predicted in the budget in May. Ratings company Standard & Poor's restored to 'stable' the outlook on Australia's highest-possible triple-A rating two years after it had warned of a possible downgrade.

Perhaps more telling for the economic outlook, higher global bond yields prompted several mortgage lenders to raise mortgage rates. Doubts about the outlook swelled after retail sales failed to expand in July from June, the Westpac-Melbourne Institute's gauge of consumer confidence in September lost 3% to 100.5 (where 100 is the neutral level), and capital city home prices fell 0.7% over the June quarter, which could reverse the 'wealth effect' whereby rising housing prices prompt people to spend more. Over the quarter, 10-year US government bond yields rose 21 basis points to 3.06% on inflation concerns while Australian 10-year government bond yields ended the period little changed at 2.67%.

Another report showed consumer prices only rose 0.4% in the June quarter, to give a 12-month rate of 2.1%, an outcome at the lower end of the Reserve Bank's 2% to 3% target range for inflation. Over the quarter, the central bank's policy-setting board kept the cash rate at the 1.5% on which it has sat since August 2016. Central bank Governor Philip Lowe in August said the key rate is likely to remain at a record low "for a while yet".

FUND COMMENTARY

The Airlie Australian Share Fund generated a positive return for the quarter. Stocks that contributed included Bingo, which rose 21% on the acquisition of Dial-a-Dump industries, funded by an equity raise. The business re-rated as a greater proportion of earnings now come from the higher-quality post-collections assets. Other contributors included Metcash on news of a customer renewal, Incitec Pivot on higher fertiliser prices and Bapcor, which delivered a solid result for fiscal 2018.

Key detractors for the fund included Reece, which fell 10% post-result. We recently met the management team of the recently acquired US business, MORSCO, and believe the acquisition offers a long-term opportunity to replicate Reece's strong profitability and market-leading customer service proposition in the much larger market of the US. Origin detracted after falling 17% following a below-expectations full-year result, as well as the perception of heightened regulatory risk as the federal government abandoned its National Energy Guarantee policy. With oil prices rising 15% in Australian dollars over the quarter, we added to our position in Origin in anticipation of a resumption of dividends next year as significant cash comes back to the business from the company's stake in APLNG.

James Hardie is a rare find: a building products manufacturer with pricing power.

One of the best – and rarest – attributes a company can possess is pricing power. Such an ability allows a company to grow margins and profits when times are good (via price increases) and allows it to absorb input cost increases and pass these onto others (usually consumers) when times are tougher. Typically, building-materials companies have low pricing power unless construction is running hot. This is because the products most building-materials companies sell are so alike. If people find one brand of plasterboard to be expensive, they'll buy another.

In the building-materials sector, James Hardie Industries stands out as a rare business with pricing power. The company founded in Melbourne in 1888 has been able to keep its gross margin steady at about 35%, despite large fluctuations in end market activity, because the fibre-cement products for home exteriors it sells have superior attributes to alternative products, and have little viable competition. The company has 90% share of its category of the fibre-cement market in the US, the source of US$1.6 billion of its US$1.9 billion of revenue for fiscal 2018.

The best test of the resilience of its business came during the trough of the housing downturn in the US, when construction activity had fallen 75% from the peak. At this point, when many of James Hardie's building-material peers were losing money, James Hardie made over US$200 million in earnings before interest and tax and enjoyed over 20% profit margins. Albeit, we note the resilience of James Hardie's profitability is important when you consider that 35% of the company's free cash flow is set aside for an Australian asbestos victims compensation fund until 2045.

For the past two decades in the US, fibre cement has been taking share from other forms of siding (vinyl, brick, wood) because of its superior durability and 'kerb appeal' – it looks better on the house than cheaper alternatives such as vinyl. We think James Hardie's siding can increase its share of the US cladding market from 20% to 30% over the next decade. Management have an even more aspirational target of 35% market share in the long term.

We believe James Hardie shares are undervalued as the market focuses on short-term issues. The first is that investors are waiting to see how the transition goes later this year when long-serving CEO Louis Gries retires and is succeeded by Jack Truong, who will be new to the company. The second is that growth in siding revenue is falling towards the growth rate of the overall cladding market. James Hardie used to record sales growth about 6 percentage points higher than the market; now that's down to about 2 percentage points, below management's target of being 6 points higher. The last is that investors are concerned that rising US interest rates are slowing housing activity in the US. Even allowing for some merit in these cyclical concerns, we believe the structural market share shift to fibre cement is intact and are happy to own the shares at these prices.

To be sure, a US economic slowdown is always a risk for James Hardie, which is now domiciled in Ireland. However, we take comfort in a few data points. Over the past 100 years, the US has built 1.5 million new houses (including units) per year on average. At the peak of the housing boom in 2005, the US built 2.1 million houses. At the moment, new housing starts are 1.2 million, 20% below the historic 'mid-cycle' level. Further, James Hardie's US business has a higher exposure to the repair and remodel market, for which demand remains strong.

On our estimates, James Hardie is priced at 16 times on a price-earnings multiple based on expected earnings for fiscal 2020. We think it unusual that James Hardie is cheaper than Dulux, another high-quality building-products company, but one with steady rather than growing market share. This says to us that investors overall don't believe that James Hardie can gain greater share in US siding.

We think such a view is too pessimistic. James Hardie's US sales force of 350 people is bigger than the combined sales teams of its siding competitors, and it has the highest profit margins, which gives the company more scope to lean on pricing to drive sales volumes, if necessarily. Such is the benefit of having pricing power.

Sources: Company filings and website.