

Perpetual Pure Equity Alpha Fund

Fund Update

During the month of December 2022, the Perpetual Pure Equity Alpha Fund was flat (net of fees). The short book performed strongly during the month, however, this was offset by the drag from the long book. The largest positive contributors to returns were two shorts that fell >35% on company specific news. The largest detractor to returns was the long position in HMC Capital.

Over the three months to 31 December 2022, the fund generated a return of +1.5% (net of fees)

Over the twelve months to 31 December 2022, the fund generated a return of +7.5% (net of fees).

Year in Review

Looking at the Australian market, which was down just over 1%, you would have thought that 2022 was a pretty boring year in the markets. However, nothing could be further from the truth. Global stock markets were hit hard with the NASDAQ down 33%, S&P down 19% and bond markets getting decimated. This has rendered the traditional 60/40 portfolio pretty much useless as a smart way to hedge your portfolio.

While 2022 seemed to be an atypical year relative to the previous decade, we think that there is a decent chance that it could be the new norm for markets. For the last decade – and more acutely in the last five years before 2022 – momentum was the strongest factor and narratives were more important than earnings and cashflow. As a result, passive and momentum strategies worked superbly well up until late 2021. However, with interest rates now materially above zero (and central banks likely to be gun shy about zero interest rate policy (ZIRP) for the foreseeable future), business models, cashflows and balance sheets are going to matter again. With these momentum strategies working so well, the most popular stocks were extremely crowded longs despite ridiculous valuations. As a result, when the bubble burst in the first part of 2022 and with so much money in momentum style strategies, the rest of the year was characterised by massive inter-sector swings. The market lurched from one macro narrative to the next as it tried to work out which sectors and stocks would provide the next area of momentum. The nice thing about this type of market for fundamental, value focussed investors is that it throws up opportunities as the masses reject the old narratives to chase the shiny new macro theme.

This made for a particularly tricky year in markets but one which was extremely stimulating intellectually. The one thing we try to always stick to is making sure our portfolio is not tilted too much to any one macro outcome. Especially if that is the consensus macro view of the day. Sentiment and markets can change very quickly, and you can quickly go from the penthouse to the poorhouse. We do tend to like this volatility as it spits out plenty of opportunities on stock-specific ideas as the market has had the tendency to sell anything which is not fitting the popular macro narrative of the day. This allows us to pick up good businesses at good prices. While it may feel that the last year was the exception as far as the market is concerned, we feel that it will be the norm over the medium term. We feel that with sustainably higher interest rates and a volatile

geopolitical set-up, we are likely to see ongoing volatility over the next few years as the consensus macro view continues to swing all over the place and operating environments remain challenging.

One of the themes which we believe has had a massive impact on sector performances over the year – and will continue to play a major role in returns in the coming years – is the decarbonisation trend. Given this, it is an area that we have and will continue to spend time researching.

Decarbonisation

Whether you believe in its merits or not, the popular view around and momentum of decarbonisation continues to build. As investors of other people's capital, it is important that we take away our own biases and try to generate a return wherever the opportunities may be. We may feel strongly about the need for policies on climate change and we may dislike the unintended consequences of some of these policies, however, our goal is not to complain about how fast or slow this energy transition will be. Our job is to try and do our best to predict the future and then look for money making opportunities for our unit holders.

This played a role in some of our stock picks over the last twelve months and will likely play a part in some of our long and short ideas in the years to come. For us, there are two multi-year themes from which we think there will be money making opportunities on the long side.

The first angle we have identified is that there seems to be a level of over-optimism about the speed and efficacy of renewable sources of electricity in Australia. Even if we were to get to the Federal Government's 82% renewables target by 2030 (which is a massive stretch), this will require an enormous amount of firming capacity, which will likely be gas-fired generators (unless battery storage improves exponentially). Given Australia does not have much hydro (and for whatever reason has rejected nuclear as an option), Australia's move to clean energy, more so than pretty much every other developed country, is a shift from baseload power generation to intermittent energy. We are in an environment where there is tremendous political and popular intent (in our democracy the former lags the latter) to shift from carbon to renewables. Large scale electricity generation and distribution is extremely complexed, however in this age where good long-term policy plays second fiddle to vote winning soundbites, we are going to end up with some irrational policies in the shorter term. Where we have a differentiated view from the consensus is that we are probably a little less optimistic about the speed of transition and the efficacy of intermittent energy, especially in light of the likely under investment in gas reserves likely to persist. The big unknown is that as it becomes clear that 82% renewable target is unlikely to be met and how unstable the grid will be as renewable becomes a larger proportion, how will this impact popular opinion and following this, how will this impact government policy in a few years from now. We don't have the answers but these are the things we are trying to work out the different scenarios.

In any future scenario, gas supply is absolutely vital. Whether it be for base load or for firming capacity from renewables. The hard part is that while Australia has a lot of gas, developing these gasfields would take around five years. In order for a commercial entity to spend the significant upfront capital, there would need to be some confidence that there will be sufficient demand in 20 years to justify the upfront capital spend. Given the massive underinvestment over the last decade (for ESG reasons) in gas supply, it holds that that the natural market forces of lower supply, higher prices should be a sufficient motivator to spend this upfront capital, despite the massive medium-term uncertainties. Unfortunately, late last year the government capped gas prices and hence removed the market signal for new supply to come on stream.

Therefore, in the event that the speed of renewable roll out is slower and the effectiveness of intermittent energy disappoints in some way, the transition will be slower and hence the demand for gas in Australia and thermal coal in Asia will likely be stronger and longer than is the current consensus view. Combine that with the complete lack of new supply and, in this scenario, the existing resource owners are very well positioned. The first chart I learnt in economics was the demand/supply chart and for both Australian gas producers and thermal coal miners this looks extremely attractive. Given that over 90% of our high-quality thermal coal is exported – and hence not under any price caps set by the Australian government – they are probably cleaner plays to this phenomenon than gas.

It may seem counter intuitive that one of the ideas coming from our work on decarbonisation is a thermal coal company, however, when thinking completely objectively and playing it forward, this is how we viewed the world at the beginning of last year.

With that in mind, one of the best contributors in 2022 was our position in New Hope Corporation. Usually when thermal coal prices sky-rocket companies like New Hope start spending to increase capacity to build to new mines. However, with the world decarbonising, cost of capital for fossil fuel emitters increasing and governments under pressure, there is no motivation or approval pathway for these companies to spend the immense free cashflow on new projects. And so they return it to shareholders. We have reduced our New Hope position more recently as we think that thermal prices got a little hot leading into fears of a cold European winter and we think there could be a decent destocking event from the Asian coal fired generators. However, we still think the outlook in the next 5 years is extremely attractive.

The other side of the decarbonisation strategy is to look to invest in what is needed to build all these wind farms, solar farms and battery technologies. A lot of people focus on the raw materials (lithium, rare earths, cobalt, nickel, copper etc.), which is a bottleneck in itself but the other bottleneck is the refining of such materials. In most cases this is completely dominated by China. The area we think is interesting is ex-China refining of some of these important materials. On this front we own some Iluka, which is building one of the largest rare earths refining facilities outside of China, and Jervois, which owns cobalt refining facilities in Finland and is building nickel and cobalt refining in Brazil.

There is a lot to play out in the decarbonising thematic. We believe that the cost of carbon is likely to head upwards in the short term in Australia given the demand/supply dynamics at play and the fact that the Australian carbon price is a fraction of the European price. Understanding winners and losers from a spike in carbon price is going to yield some good ideas. Finally, we think that there is a bottleneck in the feedstock for biodiesel (whether that be used in the sustainable aviation fuel industry or the biodiesel industry) and again we have identified some winners from that thematic as our government is likely to use both carrots and sticks to motivate transport companies to increase the amount of renewable fuel sources they use.

How did the year go?

The fund had a solid year during CY22, delivering a 7.5% return net of fees. Both the long and short books contributed positively to fund returns during the year however the short book was the standout.

On the long side, as mentioned above, we did well to identify New Hope as an early winner as high-quality thermal coal prices spiked. Another long position which generated a good return was Oz Minerals, which rallied strongly after the Board recommended a takeover proposal from BHP.

On the short side, we generated fantastic returns from our high conviction shorts in the first half of the year, predominantly in the profitless technology sector where we deemed business models to be unsustainable. We bought back most of these shorts in the middle of the year and have transitioned our short book to overpriced defensive companies where we think the market is overly complacent. We also have a heap of stock specific ideas where there are red flags being exhibited, such as overly geared balance sheets, which has been an outcome of ultra-low interest rates and the market underestimating cost pressures.

Positioning Going into 2023

On the long side, we have taken profits in a lot of our winners over 2022. For instance, we thought that conditions in the agricultural side of the market in Australia are as good as they will get with three years of rain in Australia combined with three years of drought in the northern hemisphere a scenario unlikely to be repeat. Hence, we sold our position in Incitec Pivot. There is a lot to like about IPL, however, we cannot ignore the fact that it is cyclical and sometimes with cyclical you need to sell when things seem to be looking fantastic as the share price tends to fall ahead of the actual cycle turning.

One of the big furphies of value investing is that being a fundamental value investor must mean looking to buy lower quality companies just because they are out of favour or have a low P/E. It may come as a surprise but as a value investor we prefer high quality, growth companies over low growth, old school businesses. The issue for us has been that the value the market has been willing to pay for these growth companies has been ludicrous over the last few years.

However, the way the market is set up currently, due to the sell-off in all long duration stocks (read high P/E), which has become a little non-discriminatory, we are seeing some good opportunities in what we would classify as higher quality companies which have de-rated massively over the last twelve months. Two of these higher quality names, which we talk about below, is one new position in Goodman Group (GMG) and one existing core position in Flutter Entertainment (FLTR).

Goodman Group

At the outset, GMG ticks a lot of boxes. It is founder-led which is something to which we are always attracted. It is the best in the world at its specific niche, which is unusual for an Australian company. It has a very strong balance sheet and has stuck to its knitting rather than be all things to all people. While the property sector generally is experiencing decent-sized headwinds, one thing we have learnt is that well run companies with aligned management and a strong balance sheet tend to come out the other side of these sorts of cycles in a significantly stronger position.

But what is GMG about? Goodman Group is a property fund manager that develops, owns, and manages warehouse and logistics assets located in a select number of urban in-fill markets globally. The underlying fundamentals of industrial property remain strong with vacancy in GMG's key markets sub-1% driving strong rental growth due to: (1) the on-going shift to e-commerce (requiring up to 3x the warehouse space used by "traditional" retail), (2) customer demand for same or next day delivery, (3) onshoring of supply chains and (4) competition for urban land by other property asset classes. The fund manager structure allows GMG to move investment and development risk off its balance sheet and generate management fees and development income (two-thirds of total income).

During CY22, GMG fell materially along with other property fund managers and REITs as the market priced in higher interest rates and the impact these will have on valuations, access to capital, FUM growth and ultimately earnings growth. For GMG, we believe that the recent rise in interest rates will have only a marginal impact on EPS growth over the next few years and that the drivers of earnings growth for GMG are largely resilient. Due to the location of GMG's assets and strong rental rate growth over the past 18 months, GMG's platform is 20-25% under-rented across Australia, the US and Europe.

As such, it is likely in our view that any cap rate expansion on industrial assets is largely offset by rental growth. The \$13.8bn development book has an average yield on cost of 6.4%, attractive versus industrial cap rates currently around 4.5% and providing a sizeable buffer to rising rates. Further, due to the structure of its platform and low balance sheet gearing, GMG has the ability to hold more of the development work on balance sheet to capture more of the margin. As such, we believe GMG has the ability to offset any dev margin compression through a reallocation of development work between its balance sheet and its funds. We see a long runway for continued development through redevelopment of older sites held by GMG and through new land/site acquisitions as rising rates has reduced competition for new sites. Further, due to the strong performance of its assets and development work over the past few years, GMG also has significant performance fees embedded in its funds that will likely support earnings over the next few years. As such, whilst no doubt the rise in interest rates will see cap rates expand and slow down fund raising, we continue to believe that GMG will generate EPS of >\$1 in FY24 and earnings growth from this level.

Whilst this earnings resilience is important in the short term, what we are most excited about for GMG is the potential for them to invest heavily in land and future development opportunities at a time when competition for assets is materially reduced. We believe there has already been a significant reduction in competition for assets with competitors facing liquidity issues. GMG has a strong balance sheet with only 8% gearing of the head company and sub 20% on a look through basis providing significant debt capacity to invest even if equity flows slow. Given the duration of these assets, if GMG can put the balance sheet to work over the next 18 months, we believe it could set the company up for the remainder of the decade. We also rate management highly with significant alignment between staff and long-term shareholder returns.

GMG shares have de-rated from 35x forward earnings in mid-2021 to 20x currently, attractive in our opinion versus history and given the strong earnings outlook.

Flutter Entertainment

We have written extensively about FLTR over the last few years and worked through some of the reasons why we think that it is an exciting opportunity. Over the last few months, the FLTR share price has started to rebound strongly with the main reason being that the company is a step closer to a resolution with FOX over the value of FOX's option in Fanduel. The arbitration deemed the value of Fanduel to be \$US22bn (currently). During the period, arbitration found that FOX has the right but not the obligation (if it is willing and able to attain a licence – a big if), to purchase 18.5% of Fanduel at any time before 2030. This has provided a level of certainty and at the very least took off the table the downside risk of arbitration finding that FOX could exercise the option at a lowball valuation. Operationally, Fanduel has continued to dominate the market with monthly state data suggesting Fanduel will hold >40% of the sports betting market in 2H22. Fanduel has also reiterated that it expects to be EBITDA positive, including share-based payments, for the entirety for 2023. Finally, FLTR got sold off as the market put it in the “long duration” bucket – given its most valuable asset (Fanduel) was still loss making. We believe that the benefit of the market becoming more discerning of loss-making businesses with questionable business models has resulted in a substantially better competitive

environment for Fanduel. We have believed that Fanduel has competitive advantages relative to its competitors in the online sports betting business in the US and that the last twelve months continues to prove it. What's interesting is that despite increasing market share, Fanduel will be in a profitable position at the EBITDA line (even after equity-based compensation). Its biggest competitor Draftkings, however, will lose \$US475m to \$US575m in CY23 (EXCLUDING equity-based compensation).

During November, Flutter held an investor day focussed on the Fanduel asset, which provided the market with the reasons why Fanduel is dominating competitors and in our view why that dominance will be sustainable and only strengthen as the US market continues to develop. Fanduel is acquiring customers more efficiently than its competitors and is monetising them at a materially higher rate due to product superiority and generosity to the customer. We believe the market is starting to understand the highly strategic and sustainable position Fanduel holds in structurally growing market. There will no doubt be volatile periods ahead for Flutter, however, we believe this will be a significantly larger company in the years ahead and do not believe that is reflected in the current share price.

Shorting

On the short side, we think the style of shorts will begin to change over 2023. To be clear, what we mean by that is over the last five or so years, earnings and earnings quality have not really mattered in markets. Narratives ruled the roost over fundamentals. Now with higher interest rates and less liquidity in the system, the market is demanding companies produce strong sustainable cash-backed earnings. With this in mind, CEOs are going to start trumping up their accounts again to make them seem to look better than they actually are. This was unnecessary in a narrative-driven environment. These sorts of aggressive accounting tricks are right in our wheelhouse, and we are beginning to see this play out. It is especially dangerous in companies with stretched balance sheets and poor business models.

Conclusion

We think that there are a few themes which are likely to play their part in generating returns in 2023. The first is trying to get ahead of the curve in the decarbonisation trend and trying to work out how to make money from the likely progress and policy missteps along the way. The second is that we believe there has been an enormous amount of competition coming from unsustainable, unprofitable businesses. As these companies withdraw due to lack of funding, there are going to be some incumbents which will exit the year in a better competitive environment. Finally, we think we are in for a year where fundamentals will actually matter. Strong balance sheets, management teams and business models will get rewarded over a well-articulated narrative.

Remaining active, keeping an open mind and being wary of getting caught in crowded trades is going to be extremely important. We continue to believe that we are going to be caught in a pretty choppy market for the next few years which will make life difficult for passive and momentum strategies. We look forward to the year ahead and hope to be able to generate good returns for our unit holders.

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The product disclosure statement (PDS) for the Perpetual Pure Equity Alpha Fund, issued by PIML, should be considered before deciding whether to acquire or hold units in the fund. The PDS and Target Market Determination can be obtained by calling 1800 022 033 or visiting our website www.perpetual.com.au.

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Total returns shown for the Perpetual Pure Equity Alpha Fund have been calculated using exit prices after taking into account all of Perpetual's ongoing fees and assuming reinvestment of distributions. No allowance has been made for taxation. Past performance is not indicative of future performance.

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