30 June 2021

Quarterly Report

Intelligent Investor Australian Equity Growth Fund

(Managed Fund) (ASX:IIGF)

Quarter Highlights

- **Fund up 20.4% since listing last year**
- **Minimal portfolio activity for the quarter**
- **M&A activity indicative of value in the portfolio**

About Us

With a 20-year track record of beating the market, clear and straightforward language, and an 'open book' approach to stock research and analysis, *Intelligent Investor* offers actionable, reliable recommendations on ASX-listed stocks.

In 2014, *Intelligent Investor* became a part of the InvestSMART family, extending our expertise to even more Australian investors seeking quality analysis and advice.

Portfolio overview

The Intelligent Investor Equity Growth Portfolio is a concentrated portfolio of 10 - 35 Australian-listed stocks. The Portfolio invests in a mix of large, mid and small cap stocks, focusing on highly profitable industry leaders that have long-term opportunities to reinvest profits at high rates of return.

As contrarian value investors, producing safe and attractive returns in the stock market means sticking to a disciplined and repeatable process. We do this by patiently waiting for overreactions in share prices, so we can buy at a large discount to our estimate of intrinsic value.

Investment objective

The portfolio aims to achieve a return of 2% above the S&P/ASX 200 Accumulation Index p.a. over five year rolling periods with minimal turnover to allow returns to compound in a favourable tax environment.

Who manages the investment?

Nathan Bell, has over 20 years of experience in portfolio management and research and is supported by our Investment Committee, chaired by Paul Clitheroe. Nathan returned to *Intelligent Investor* in 2018 as Portfolio Manager, having previously been with *Intelligent Investor* for nine years, spending five of those as Research Director. Nathan has a Bachelor of Economics and subsequently completed a Graduate Diploma of Applied Investment and Management. Nathan is a CFA Charterholder.

Key Fund Details

INVESTMENT CATEGORY

A portfolio of individually-selected Australian Equities

INVESTMENT STYLE

Active Stock Selection, Value Investing Approach

BENCHMARK

S&P/ASX 200 Accumulation Index

INCEPTION DATE

6 October 2020

SUGGESTED INVESTMENT TIMEFRAME

5+ years

NUMBER OF STOCKS

10 - 35

INVESTMENT FEE

0.97% p.a.

PERFORMANCE FEE

N/A

MINIMUM INITIAL INVESTMENT

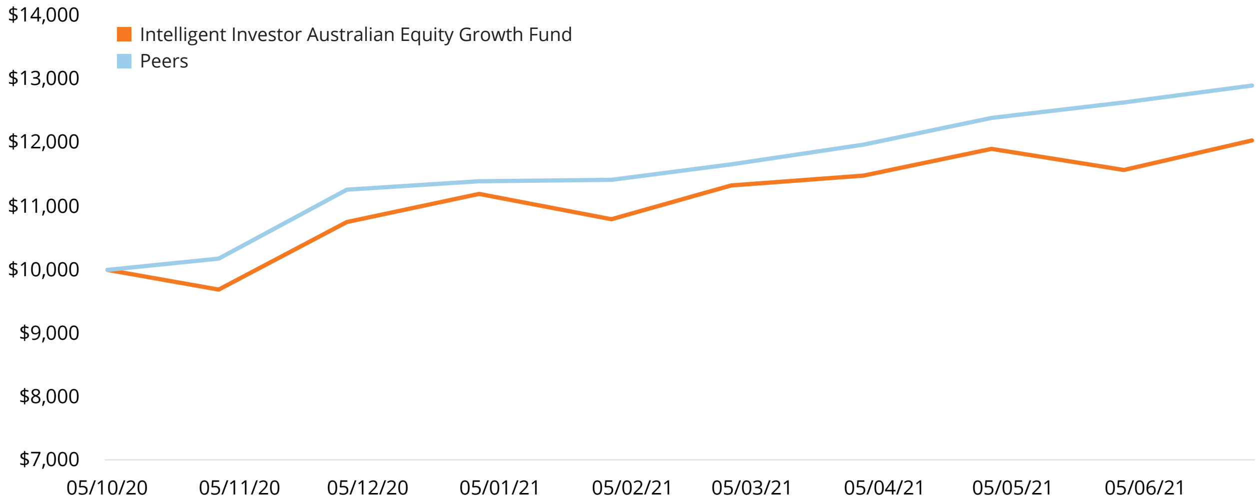
N/A

SUITABILITY

Suitable for investors who are seeking domestic equity exposure with a growing stream of dividends to offset inflation

As at 30 June 2021

Performance of $10,000 since inception



Performance (after fees)

	1 mth	3 mths	6 mths	1 yr	S.I. (p.a)
II Australian Equity Growth Fund	4.0%	4.8%	7.6%	N/A	20.4%
S&P ASX 200 Accumulation Index	2.3%	8.3%	12.9%	N/A	25.6%
Excess to Benchmark	1.7%	–3.5%	–5.3%	N/A	–5.2%

Asset allocation

Information Technology	28.3%
Consumer Discretionary	17.2%
Cash	16.9%
Financials	14.3%
Materials	5.8%
Communication Services	5.4%
Energy	5.2%
Industrials	4.2%
Utilities	2.7%

Top 5 holdings

Star Entertainment Group (SGR)	6.6%
Frontier Digital Ventures (FDV)	6.5%
Pinnacle Investment Mgmt Group (PNI)	6.2%
RPMGlobal Holdings (RUL)	5.9%
Uniti Group (UWL)	5.4%

Intelligent Investor Australian Equity Growth Fund

Quarterly Update

'It was thoroughly exciting. I have no doubt that I cannot persuade anybody not to speculate, it is far too gripping, thrilling, and everyone in it together. It's irresistible. All I can do it point out, like a historian really, this is what it feels like, it feels wonderful, they go up like this, they deviate at the end, then they crash, and they go all the way back to what is a fair price. That's what will happen this time.'

–Jeremy Grantham

'As I grow older, I pay less attention to what men say. I just watch what they do.'

–Andrew Carnegie

'Many people believe that investors must make the macro decision to be either bullish or bearish. Our preference is to be agnostic, objectively finding absolute bargains, and in their absence, holding cash. In short, we are neither bullish nor bearish. We are value-ish.

–Seth Klarman

It's been a strong start for the fund, up 20.4% since listing last year compared to the market's 25.6% return.

The fund also had a good final quarter, increasing 4.8%, but it paled next to the market's huge 8.6% return, helped by strong performances from the big banks.

For the record, economic factors like inflation don't change our investment process, as we're focused on companies armed with plenty of pricing power. It's also unlikely interest rates will rise much anyway, as small increases will have a larger impact than usual given the world's gargantuan amount of debt.

No country has successfully lifted interest rates from zero, so hopefully any future attempts will provide plenty of 'taper tantrums' along the way so we can add to our collection of high-quality stocks at great prices.

So far at least, we've avoided disasters in the technology space like **Nuix** and **Appen**. But as we're focused on finding the next generation of big technology winners, volatility like that experienced in May is the price we must pay for superior long-term returns. Nor does it mean the volatility is over, as high growth stocks are still very expensive overall.

It doesn't take much selling to knock the share prices of stocks like **Frontier Digital Ventures** around given the absence of a long history of profitability, small market valuations and tightly held stock in a concentrated share registry of investors like ourselves.

We updated the investment case for Frontier in April's report, and have included it as an Appendix below. The next quarterly report is due at the end of July, though it will be a year or two before we start to see whether recent acquisitions will pay off.

Unfortunately, the material cash holding in the fund didn't help cushion the falls during May, and the selling was compounded by reducing our positions in two of our best ideas, Frontier Digital and **RPM Global**.

As our funds are listed on the ASX, they are subject to ASX liquidity rules. One of which is having no more than 25% of the fund invested in stocks with a market capitalisation of less than $500m. With RPM Global's share price increasing, and Frontier's market value falling below $500m, we were forced to reduce our holdings in both.

We've now banked more in profit from Frontier than we have invested in the fund, which is something we wish we could say about every stock. It also highlights the value of discovering potentially great businesses as early as possible in their lifecycle.

While selling your best ideas is not the way to investing heaven, risk management is paramount, and it won't dent your returns much in the long run if both stocks live up to their potential.

The main drawback is that we've got no room to add any more small-caps despite having some good ideas, so the sooner our small caps grow into mid-caps the better.

Given their recent share price performances at the time of writing, they're both very close.

Portfolio transactions

This quarter's only portfolio change was selling smash repairer **AMA Group** where we accepted a small loss. The impact of labour shortages is compounding the loss of key management personnel following the departure of former CEO Anthony Hopkins.

While the share price rallied after new chief Carl Bizon recently announced that the company is currently trading within its bank covenants, the absence of a profit forecast so close to the end of the financial year suggests the result will be lousy and is increasing the chances of another potentially dilutive capital raising.

The share price of **EML Payments** initially fell nearly 50% after its recent purchase and European payments company Prepaid Financial Services (PFS) became the subject of a regulatory investigation in Ireland.

It's unclear how deep the problems run and how easily they can be fixed, but the share price has recovered somewhat as the initial fall suggested PFS was worth nothing, which is highly unlikely.

While **Qantas** boss Alan Joyce tried to get the Morrison government to commit to opening our international borders by October, Australia's botched vaccine roll out has condemned the reopening until 2021.

While that's kept the pressure on the share prices of **Sydney Airport** and **Auckland Airport**, we expect international travel will ramp up quickly as vaccination programs mature around the world. It will take time for earnings and dividends to recover, but at current prices we believe we're being compensated to wait.

Note: Sydney Airport has since received a takeover offer pitched at $8.25, but it's worth more than that to a serious infrastructure buyer.

The merger and acquisition activity around **Crown Resorts** continues to dominate the news. Crown rightly rejected the bid from US private equity firm Blackstone, which undervalued the business while weakened by COVID restrictions at its world class facilities.

While Star Entertainment's share price jumped in response to its bid for Crown Resorts, the share price has sagged following an investigation by Austrac into potential breaches of the Australian Anti-Money Laundering and Counter-Terrorism Financing Act 2006.

If the investigation shows deliberate negligence on a major scale, it could sink CEO Matt Bekier's chances of acquiring Crown Resorts to create a national casino and hotel business that Bekkier estimates will save the combined entity $150-$200m per year. It would also mean the Sydney casinos would complement each other rather than compete head on.

If a deal isn't consummated, we think the current price will still look attractive once the new $2bn Brisbane Casino opens next year and life gets back to normal post-covid.

Tabcorp also received an audacious $4bn bid for its wagering business from minnow **Betmakers**, which will be ignored due to price and most of the payment coming in newly issued Betmakers shares. A split of its wagering and lotteries business remains our preferred option without a materially higher bid, and an announcement at the time of writing has confirmed that's happening.

RPM Global's share price has been increasing recently, after announcing its annual recurring revenue has now increased from just a couple of million dollars two years ago to $20m. CEO Richard Matthews believes that could easily increase to $30m based on its current offering.

The stock has been one of the cheapest software companies on the market by a large margin. As its fundamentals improve, we expect it will eventually draw more attention from investors and is a likely takeover target.

Pinnacle's share price has continued to rise with the market, now almost up five-fold from its lows last year. We expect a very strong result when it reports its year end numbers in August and it remains a key holding.

We believe it can manage well over $100bn and its dividends can continue to increase. Although Ian Macoun has cashed in a large component of his shareholding this year, it's a sensible personal decision and he still owns a large chunk of the company.

Lastly, the share price of **Uniti Wireless** has continued to soar as the market better understands the value of its recently acquired fibre telecommunications assets.

Even if Uniti avoided new projects, a further 200,000 dwellings will be connected over the next few years, doubling the current connection pool. Each new dwelling represents decades of high margin, recurring cash flow that's extremely predictable and therefore valuable.

For a more detailed update on the stock, we've included a recent update from analyst Gaurav Sodhi in the appendix below.

While the fund is not currently keeping up with the market, that's common for a value portfolio in the late stages of a bull market. That's ok in the long term as long as we're paying the right prices for the right businesses, and the flurry of M&A activity impacting our businesses justifies our stock picks and suggests our patience will eventually be rewarded.

The news overall from our holdings continues to be good to excellent. And with many of them trading materially below their highs, it augurs well for our future returns compared to the major components of the index that look increasingly expensive.

If you have any questions, as always, please call us on ***1300 880 160*** *or email us at* ***info@intelligentinvestor.com.au***.

Appendix

Uniti Group: You've got fibre

Uniti boasts high quality revenues and a clear path for growth. Is that enough to justify the higher share price?

Our tryst with Uniti Group reads like a Nora Ephron script. When we first met the business, we didn't like it.

The base operation – wireless broadband – wasn't promising and management had made a flurry of wild acquisitions including a telco services business, an internet services provider, and a fibre infrastructure business. As we got to know Uniti, however, initial hostility began to thaw.

Accidently in love

Among the acquisition spree, Uniti had consolidated four NBN competitors into one, creating a business capable of building fibre networks direct to homes. It is now the only competitor to the NBN for new fibre builds and commands about 20% of the new estate market.

Uniti's customers are typically developers who fund the initial construction of fibre into new estates. Uniti earns a profit on the construction of the network and retains ownership of the completed network.

Any resident wanting to access fibre broadband must use its network. Uniti leases capacity to internet service providers (ISPs) who then sell access to customers. They can also bundle services like TV, content, and smart products.

Once fibre is in the ground, there is little additional expenditure and vast capacity for new customers.

Uniti can potentially collect rental fees on its fibre for decades and, as new estates are added to its portfolio, those residents will be rolled into Uniti's monopoly. This is a high-quality business generating growing recurring revenue that is gently contested.

It's also the movie equivalent of us chasing Uniti to the airport. It's finally love.

It helps, of course, that the share price has flown. The stock is up 86% since our initial recommendation a mere five months ago, but the business has improved.

All about fibre

Judge Uniti on its historic numbers and it looks absurd. Last year it generated revenue of $59m, operating profit of $26m, and net profit of $15m. Those are handy numbers at decent margins but hardly justification for a market capitalisation of $2.3bn.

Totting up the acquired businesses, however, improves matters. By 2022, with acquired businesses integrated and counted, Uniti should be generating revenue of about $240m a year and 60% EBITDA (earnings before interest tax, depreciation and amortisation) margins.

That means EBITDA should rocket from $26m last year to over $140m by 2022. Once we include net debt of $300m, Uniti trades on a future EV/EBITDA multiple of about 18 times. That might not sound cheap but consider what that sum gets you.

Uniti's revenues are 70% recurring and monopolistic. No matter which broadband provider is chosen by the household, if fibre is used, Uniti will get its cut of revenue. With developers contracting new builds years in advance, growth is also baked in and likely to accelerate with the construction market.

If Uniti did nothing else to pursue new projects, a further 200,000 dwellings will be connected over the next few years, doubling the current connection pool. Each new dwelling represents decades of high margin, recurring cash flow so high multiples are warranted.

Uniti has transformed its business swiftly and we suspect many still see this as a traditional telecom business and not as an infrastructure business. As more builds are completed and as recurring revenue swells, that notion will change.

Bumps on the road

The early acquisition binge had us questioning the capital allocation credentials of management, but it has confirmed that the buying spree is over. Concerns about capital allocation have been soothed.

Another concern is operating risk. Uniti has, through luck or skill, assembled a fine business but it has yet to prove it can build anything.

The founders of **Opticomm**, which was taken over by Uniti, built that business over decades but have now left. Telstra's Velocity business is Uniti's alone now.

The NBN may not be nimble and innovative but it has been assembled for the single purpose of building fibre networks and has proved it can do so. Uniti still has to build its operating credibility.

Those shouldn't be insurmountable hurdles. The balance sheet carries debt but the business should comfortably fund its growth with cash flows.

Having invested in **Chorus**, **Aussie Broadband** and **Telstra** a cross our various funds, it's fair to say we are fond of fibre. Huge capacity with low maintenance costs means fibre is scalable, reliable, and hard to replicate. It is also vital. We're unlikely to consider selling Uniti below $4.

Appendix

Frontier Digital

Frontier Digital's quarterly results are always messy due to varying levels of ownership and the associated accounting. But recent acquisitions muddied the Q1 results even further.

A strong performance from key business Zameen was largely offset by a 20% fall in the Pakistan rupee versus the Australian dollar. This trend was consistent across the portfolio and is masking positive business trends as the world emerges from COVID shutdowns.

While there's not much we can do about currency risk (Zameen enjoys somewhat of a natural hedge as expats buy more Pakistani property when the rupee is weak), eventually the rapid profit growth we expect across Frontier's portfolio in the decade ahead should outweigh unfavourable currency impacts.

Importantly, there has been a step change in Frontier Digital's profitability. Profit at the EBITDA level would've continued its upward trend to 8% after the company reached breakeven last quarter, however recent acquisitions have brought Frontier back to break even.

With $30m in the bank, founder and CEO Shaun Di Gregorio plans to make more acquisitions like recent ones that have either strengthened or handed the company market leadership. This is absolutely vital in online real estate classifieds markets, as you can see in the contrasting values of REA Group and Domain Holdings, for example.

iMyanmarhouse and CarsDB, which supply less than 5% of FDV's revenue, have essentially stopped trading due to the political turmoil. While they're expected to reopen when things settle, they hardly matter to Frontier's potential longer-term value.

Skin in the game

Operating in frontier markets is difficult at the best of times, but Di Gregorio's management over the past year has been exceptional, seizing on opportunities that could deliver multiples of their purchase price over time from larger companies focused on other things.

I recently had the opportunity to send a few questions Di Gregorio's way in a short interview he did with our Investsmart colleague Evan Lucas.

The key takeaway is that Di Gregorio's ambition is 'to have a seat at the table' with regional heavyweights Adaventa and fellow investor and partner Naspers/OLX whose current market values tower over Frontier's i.e. he's not going anywhere soon.

Our concern has always been that Di Gregorio would be a keen seller at a price of $4-5. While making three times our money from here would be nice, as we've seen with REA Group, for example, the monster returns in these businesses come further down the track.

REA Group is up around 40 times since I stupidly put a Hold on it in our subscription service during the GFC thinking that the business was mature having signed up virtually every property agent. But that's only the beginning.

Early on many agents aren't paying anything, which soon changes once competition to distinguish properties on the market's leading property portal takes off. And there are even more opportunities in frontier markets to clip the ticket on property purchases and other transactions, as the leading classifieds businesses are considered one of the few trusted networks to transact on.

While Frontier's Q1 result offers nothing for momentum traders, there is a load of progress being made across Frontier's portfolio and we're still only in the first or second innings for this business.

Frontier is a much less risky business than when we initially bought it. And if Infocasas or another business within Frontier's stable can fulfill its potential, then Frontier will become more diversified, more valuable and less risky again.

Our view is firmly fixed at least a few years out when COVID becomes a distant memory (apart perhaps from our annual jab), recent acquisitions start showing their potential with key staff currently being appropriately incentivised, and profits taking off as key businesses like Zameen mature and maximise their market leadership.

INTELLIGENT INVESTOR

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