31 December 2021

Quarterly Report

Intelligent Investor Australian Equity Growth Fund

(Managed Fund) (ASX:IIGF)

Quarter Highlights

- **Resources stocks backpedal but could be at the beginning of long bull market with big dividends**
- **Sold Sydney Airport and Aussie Broadband while adding Karoon Energy, Waypoint REIT and Ansell**
- **Profit taking through 2021 helped minimise the impact of recent falls that were concentrated in highly valued stocks**

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

5 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

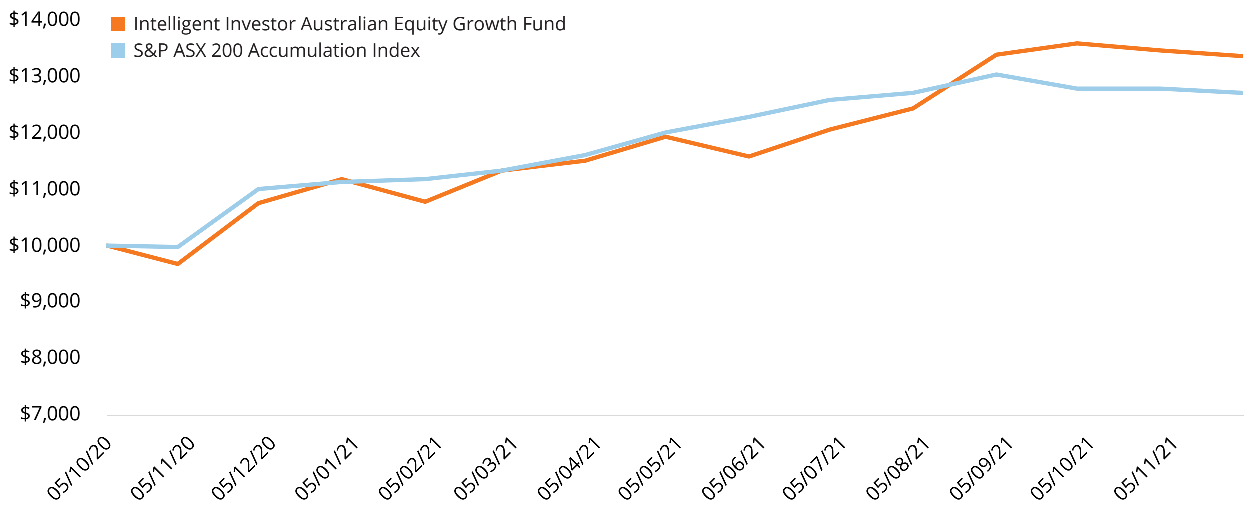
N/A

SUITABILITY

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

As at 31 December 2021

Performance of $10,000 since inception



Fund inception: 5 Oct 2020

Performance (after fees)

	3 mths	6 mths	1 yr	S.I.
II Australian Equity Growth Fund	0.2%	13.0%	21.6%	28.2%
S&P ASX 200 Accumulation Index	2.1%	3.8%	17.2%	24.0%
Excess to Benchmark	–1.9%	9.2%	4.4%	4.2%

Since Inception (S.I.): 5 Oct 2020

Asset allocation

Information Technology	15.9%
Cash	15.3%
Consumer Discretionary	13.5%
Energy	10.1%
Financials	9.8%
Materials	9.5%
Real Estate	7.1%
Communication Services	5.9%
Consumer Staples	4.2%
Industrials	3.7%
Health Care	3.1%
Utilities	1.9%

Top 5 holdings

Frontier Digital Ventures (FDV)	5.9%
Uniti Group (UWL)	5.9%
Star Entertainment Group (SGR)	5.2%
Woodside Petroleum (WPL)	5.1%
United Malt Group (UMG)	4.2%

Intelligent Investor Australian Equity Growth Fund

Quarterly Update

'It isn't the mountains ahead to climb that wear you out; it's the pebble in your shoe.'

— Muhammad Ali

'You never know what the American public is going to do, but you know that they will do it all at once.'

— Bill Seidman

'I always come out with my best when my back's against the wall. It's always when the luxury and financial rewards come piling in that I begin to lose it.'

— Ozzie Osbourne

The Fund was essentially flat for the quarter, while the market increased 2.1%. Let's look at the changes in the portfolio before updating some existing holdings.

The biggest change was selling **Sydney Airport**. It's sad to see such a great business leave the ASX, but a higher takeover bid is unlikely and the return from holding on assuming it's taken over is miniscule. We'd rather have the cash now and wait for new opportunities, as QE is ending early in the US and interest rates are starting to increase around the world.

That won't be good for highly priced infrastructure stocks, though there should still be decent upside in COVID casualties like **Auckland Airport** as international travel, profits and dividends recover.

We also sold **Aussie Broadband** after excellent results led to a record share price and valuation. We only wished we'd made it a larger position, but it's produced incredible returns in a short period despite not catching it at the IPO.

This is an area where we can do much better. While most IPOs are rubbish, all great businesses start life as an IPO and we're not catching our fair share of good ones early enough.

This is a cultural hangover from the past when Warren Buffett's warning that the best ideas don't usually show up in your letterbox was taken so literally that IPOs were mostly ignored. This is slowly changing.

New additions

On the flipside, **Karoon Energy** was added to the portfolio. Under renewed leadership, Karoon beefs up our oil and gas exposure that includes a larger investment in **Woodside Petroleum**. The entire oil and gas sector looks cheap around the world right now.

Oil's ubiquitous usage across the economy will continue for decades to come. The switch away from burning fossil fuels is a worthy one but given dwindling investment in new oil projects there could be many oil price spikes along the way.

These stocks also provide some protection against inflation, particularly as th e tidal wave of ESG and ethical investing is temporarily undermining their valuations.

On a related theme, **Waypoint REIT** was a slightly controversial addition as it owns petrol stations that many worry will be far less valuable as we eventually switch to electric cars. In short, we believe you're being compensated for those risks at the current price and expect the properties to remain valuable despite the remediation costs for potential land contamination if they're redeveloped.

Lastly, **Ansell**'s share price has fallen further than we believe it deserves. Its push toward more specialised and higher margin gloves have been very successful, and we expect margins to hold up better than the market expects as demand for cheaper protective gloves fades post COVID.

Resources slow down

The enthusiasm for resources stocks earlier in the year petered out, though we could be at the beginning of a long period of substantial gains given the underinvestment in oil projects, for example, and low starting valuations.

Our pair of coal stocks **Newhope Coal** and **Whitehaven Coal** lost some of their strong recent gains, as the Chinese government tries any way it can to reduce coal prices. You know its worried when it starts accepting Australian coal despite its current hostile attitude to Australia.

We don't expect coal prices to stay as strong as they have been recently, but there's still plenty of potential for capital gains and big dividends next year from Newhope and Whitehaven, which remarkably should be debt free early next year.

The share price of **Pinnacle Investment Management** slipped below its recent capital raising price of $16.50 to raise around $100m for a cornerstone shareholding in alternative asset manager Five V Capital.

It's small beer next to Pinnacle's $3.5bn market value, but the stock remains a core holding despite taking profits as its share price exploded out of last year's bear market.

RPM Global's latest update reaffirmed sales are recovering post-COVID when it was all but impossible for sales staff to meet clients in person. It also recently swapped its coal consulting business for an ESG one, which should make it much more appealing to ethical funds. Either through increasing earnings or a takeover, there's more value to come in our view.

Woodside announced and confirmed several deals, including the massive purchase of **BHP**'s oil business. The upshot is a pristine balance sheet and plenty of ways to increase sales for decades to come.

We believe the share price should be above $30 at current oil and gas prices but given the huge number of shares its issuing to fund the BHP deal it will take time before the share price begins marching up.

United Malt announced another set of lousy results. Although revenue has held up, margins have been crushed like an empty tinnie as higher margin on-premises sales were replaced by pre-packaged sales during lockdowns.

Throw in a full year of corporate costs for the first time (United Malt previously shared corporate costs with **Graincorp**), currency movements, accounting changes, and subsidy impacts, and you can see why this was a messy result with more adjustments, one-offs and significant items than we are very uncomfortable with.

Management is desperately trying to flatter the company's results with things not going to plan since being spun out of Graincorp with high expectations. A full recovery post COVID puts the stock on price-to-earnings ratio of 12 with some growth, which is why, for now at least, we're being patient.

The share price of **EML Payments** increased 30% after Ireland's financial regulator permitted its recently acquired business PFS to get back to business within prescribed limits. Management's long track record has been deeply tarnished by this highly problematic acquisition, but the share price was reflecting no value for it after earlier falls. Things should be much quieter and more profitable for the company in the year ahead.

Our small holding in **Crown Resorts** benefited from a favourable regulatory decision in Victoria. It has two years under the watchful eye of Stephen O'Bryan, QC, to clean up its act and keep its casino license.

Blackstone also made a third tilt for Crown Resorts, increasing its offer to $12.50. We're not getting too excited, though, as any takeover for such a politically and regulatory sensitive business will be drawn out.

Though the regulatory news was also good for our larger holding in **Star Entertainment**, the share price still fell 18% during the quarter following a *60 Minutes* investigation into a host of alleged regulatory and governance failures.

The company is facing regulatory investigations in New South Wales and Queensland, but we don't expect the company to lose its licenses. Even if it did, you're not paying much for the casino licenses at the current price given the company's valuable properties in Sydney and Brisbane and on the Gold Coast.

It's a classic case of heads we win, as profits recover at Star Sydney following COVID lockdowns and the company keeps its licenses, or we don't lose much if the regulatory outcomes don't follow the precedent at Crown.

Once the new $2bn Brisbane casino opens next year, the company should be producing plenty of cash as we move on from COVID to pay high dividends.

Frontier Digital Ventures

Frontier Digital Ventures' share price eventually drifted lower after a strong start to the quarter despite announcing that its acquisitions made a year ago are performing at or above expectations.

Frontier also raised money to acquire the remaining 73.7% of Encuentra that it doesn't already own. Founder Shaun Di Gregorio clearly believes he can add more value with full control of the business.

Given he knows the business inside out and has paid four times revenue, there's a lot of potential given similar mature businesses trade for four to five times as much. They key is profit margins, but it will take time to get there even if Di Gregorio is successful.

Singapore's ProperyGuru, backed by fabled VC investor Peter Thiel and **REA Group**, plans to list in the US soon. It's the closest comparable to Frontier Digital and is expected to list at around 18x revenue. If FDV traded at the same value, the stock price would be at least $4 compared to its current price of around $1.50.

It's made enormous progress over the past 18 months with the company virtually breaking even on a cashflow basis. The importance of this achievement cannot be overstated.

As we've seen with similar businesses such as REA Group, once they become profitable they're a license to print money if you're the market leader, as Frontier's investments typically are.

Despite the good news, Frontier still trades at around eight times next year's revenue, while **iCar Asia** – essentially the Indonesian version of **Carsales** and a deeply inferior business to Frontier – has just accepted a takeover offer priced at 15x revenue. REA Group currently trades at 22x revenue.

While Frontier is far riskier than REA Group due to the countries in which it operates, it might deserve a higher multiple given the company's higher growth prospects and numerous deals to sell parts of its business in a couple of years – not to mention the potential for further acquisitions that could materially boost profits.

Frontier is currently valued at $570m, but Zameen (the Pakistan version of REA Group of which Frontier owns 30% with internet giant Naspers owning the remainder) alone could eventually be worth billions. The country has 225m people with Karachi and Lahore both boasting populations of more than 10m, and a large pool of expats in places like the UK that regularly buy property at home.

In contrast to REA Group and its ilk that rely purely on advertising, transactional revenue from taking a cut of property sales and other property services across Frontier's portfolio has increased to around 50%. Yet this form of revenue is still near zero for some of the company's recent acquisitions, which shows their potential.

Before the Encuentra deal management had a clear line of sight to $100m of annual revenue (currently $70m) and inclusion in the ASX300, which would force index funds to buy shares. Given how tight the current shareholder registry is with a handful of value investors like ourselves, that should put a rocket under the share price.

Frontier's accounts remain a mess due to a mix of minority shareholdings and recent acquisitions. That, Frontier's small size currently, funds being unable to buy shares in companies that aren't reporting an accounting profit and the fear of investing in frontier markets, likely explains the low share price.

But as profits start flowing through in the years ahead the stock will become impossible to ignore, as founder Shaun De Gregorio aims to build a business worth $3.5bn–5bn dollars.

Audinate

Audio company **Audinate** is struggling to buy enough microchips to fulfil demand for its products. The 9% fall in the share price following the announcement was an overreaction in our view, but neither a surprise nor unwelcome; the market's tendency to put too much emphasis on short-term factors is a large part of the reason that value investing works.

Of course, this assumes that the problems faced by Audinate are short-term in nature and don't affect years 2024 to infinity in our valuation model (and the remaining 99% of the value) – and we think they are.

The problems stem from the well-publicised global chip shortage. Specifically, a Korean semiconductor foundry has been unable to provide silicon chips to a US-based 'Top 30 global semi-conductor manufacturer' which needs said chips to make a component that goes into Audinate's higher-end Brooklyn II, Broadway and Dante video products. To make matters worse, Audinate's OEM customers also use the components themselves in implementations that utilise Audinate's products.

The US-based supplier 'can no longer guarantee delivery' of orders for the part, and in Audinate's case this applies to orders dating back to January of this year. Supply of the part will apparently remain constrained for the foreseeable future.

Audinate has some existing stock, but this is expected to be exhausted in the second half of the current financial year, from which point revenues will be affected. As a result, while management still expects revenue growth for the current year, it will not be in the 25%-plus pre-COVID historical range, which it had previously been guiding towards.

New module

Fortunately, Audinate was already planning to release a new version of its Brooklyn module, which will use a different part from the same US supplier, which is not dependent on the Korean foundry. It will be a drop-in replacement for the old module, so will not require any re-design work by customers.

The company is now rushing to get the new module ready by the June quarter (which could result in costs being brought forward, and therefore margins being reduced alongside the revenue shortfall, although management didn't specifically warn about this). Management is working on ways to mitigate the supply constraints for the Broadway and Dante video products but had nothing further to report on that.

It's important to note that none of this is Audinate's fault, so it doesn't reflect on management and affect our long-term valuation in that sense. Neither has it come out of the blue – management has been warning about the potential impact of the global chip shortage since April, and it continues to warn that there may be further problems, with disruptions to the global chip market expected to linger throughout calendar 2022.

Record demand

Even so, it has no impact on our estimates for Audinate's total addressable market, market share and margins, in five, ten and twenty years' time, which are the key inputs into our valuation. Over the long term, it may even encourage the industry to move more quickly towards software implementations of Audinate's products, which aren't dependent on global supply chains and make higher gross margins.

There were also some more tangible and immediate positives in the announcement. The chip shortage has encouraged customers to place orders further ahead of time, providing better visibility of future demand – even if now it can't all be met. At the end of September, the order backlog stood at US$14.8m, compared to typical pre-COVID levels around US$2.5m.

The company also generated record revenues for the September quarter, with growth of 46% over the same period last year, to US$7.6m (A$10.3m), despite temporary factory closures in Malaysia and China during the period.

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

INTELLIGENT INVESTOR

Important information

Intelligent Investor
invest@intelligentinvestor.com.au
www.intelligentinvestor.com.au
PO Box 744, QVB NSW 1230
1300 880 160