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 December 2021 | 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 $288.6 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 9 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

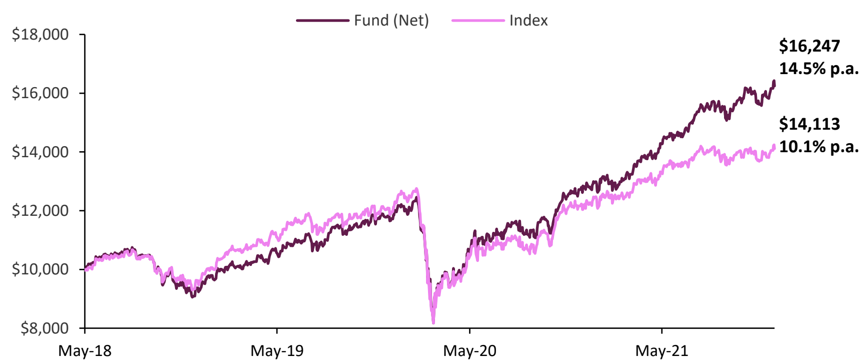
PERFORMANCE*

	Fund (%)	Benchmark (%)	Excess (%)
1 Month	3.2	2.7	0.5
3 Months	5.7	2.1	3.6
6 Months	10.7	3.8	6.9
1 Year	28.8	17.2	11.6
3 Years (p.a.)	20.1	13.6	6.5
Since Inception (p.a.)	14.5	10.1	4.4

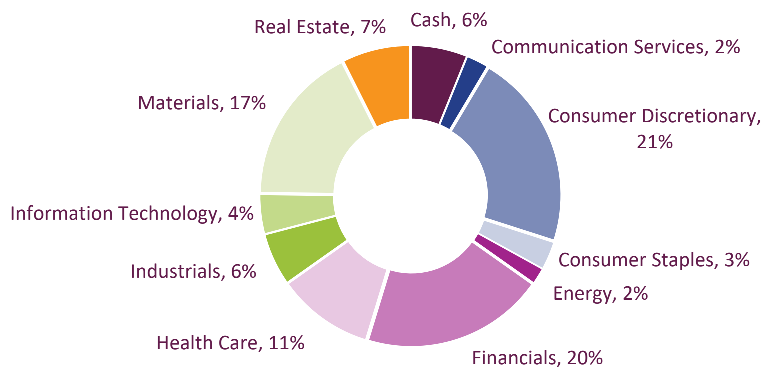
TOP 10 POSITIONS (BY WEIGHT)

Company	Sector**
Commonwealth Bank of Australia	Financials
Mineral Resources Ltd	Materials
BHP Group Ltd	Materials
CSL Ltd	Health Care
PWR Holdings Ltd	Consumer Discretionary
Macquarie Group Ltd	Financials
Wesfarmers Ltd	Consumer Discretionary
National Australia Bank Ltd	Financials
Aristocrat Leisure Ltd	Consumer Discretionary
Dicker Data Limited	Information Technology

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.

FUND COMMENTARY

The Airlie Australian Share Fund rose 5.7% over the December quarter while the benchmark (the S&P/ ASX 200 Accumulation Index) was up 2.1%. For the calendar year, the fund returned +28.8% (after fees) vs the benchmark +17.2%. The best-performing stocks in the fund over the December quarter included:

• Mineral Resources (+25%) – Due to very strong demand globally for lithium miners and producers.

• Nick Scali (+48%) – Purchased competitor, Plush Sofas, for an attractive price and strong synergies are expected.

• Macquarie Group (+13%) – Strong profit result announced during the quarter.

• Dicker Data (+18%) – Major acquisition in New Zealand.

For the 12 months, Mineral Resources (+50%) and Macquarie Group (+48%) featured again as strong performers, while PWR Holdings (+90%), ARB Corporation (+70%), and Commonwealth Bank (+23%) were other major contributors.

For the quarter the portfolio holdings that detracted were:

• Smartgroup (-18%) – Private equity takeover approach fell over.

• Commonwealth Bank of Australia (-3%) – Margin pressures evident due to a competitive mortgage market.

• Pendal (-15%) – Poor second-half fiscal 2022 profit result.

• Aristocrat Leisure (-7%) – Acquisition announced.

Over the 12 months, the stocks that detracted included gold miner Northern Star (-25%), Coles (-1%), and mining service company MLG (-12%).

After being the largest detractor in the previous quarter, Mineral Resources was the biggest contributor in the December quarter due to a re-appraisal of its lithium business. The pursuit of 'green' metals (nickel, cobalt, and lithium) was a continuing theme over the period. (Please see our report on the lithium market below.)

The other major theme over the quarter was the increase in merger and acquisition activity. Portfolio holdings CSL, Aristocrat, Ebos, Wesfarmers, Healius, Aurizon, Nick Scali and Life360 announced acquisitions. CSL, Aristocrat, Life360 and Ebos tapped the equity market for funding. At this point in the cycle, we are generally sceptical about large M&A. On a case-by-case basis, we can see the strategic benefit in most; however, we think Aurizon management has miscalculated and overpaid. We immediately reduced our position. Furniture retailer Nick Scali's purchase of sofa competitor Plush has the most potential to add value. Nick Scali management has been preparing the company for an acquisition for a few years. Excess capacity in warehouses and logistics operations mean the synergies should be significant. Ebos paid a full multiple for medical device, consumable distributor, Life Healthcare. However, management has a strong track record of execution and have added significant value through acquisitions over the past decade.

The fund benefited from having little exposure to the information technology sector (-6%). Surprisingly this sector was the worst-performing sector over the calendar year (-3%) although admittedly its first negative year since 2011. Despite being a recipient of a takeover bid, the AfterPay juggernaut finished the year down 30%. Wisetech was a strong performer (+90%) after a very impressive second-half result.

Australian equities outlook 2022: Looking back to the future

The month of January takes its name from Janus, the ancient Roman god of beginnings and endings. He is usually depicted with two faces, one looking forward and one looking back. Similarly, as the year draws to a close, we always find ourselves looking forward with anticipation to a new year, which for financial markets typically means thought pieces on what to expect in 2022, with many putting out year-end S&P/ASX 200 Index targets (although very few mark their homework 12 months later!), and various articles highlighting the key risks or themes to watch out for in 2022.

However, after a period of bushfires, a pandemic, closed borders, and months of lockdown that has coincided with one of the fastest periods of house and share price growth in history, I've been left with a healthy dose of scepticism in the value of my crystal ball. So just like Janus, perhaps at this time of year we should dedicate at least as much time looking back as forward, asking ourselves the question: what have we learnt from 2021 that might be relevant for 2022?

If the word of the year (roughly defined as a word you never want to hear again by year end) for 2020 was 'unprecedented', I would argue 2021's word has been 'inflation'. The US consumer price index print of 7% for 2021 was the highest reading since 1982, and the eighth consecutive month that CPI growth over a 12-month period had exceeded 5%. On 1 January 2021, the US 10-year government bond was yielding 0.93%. As at mid-January 2022, it is currently yielding 1.75%, nearly double. Similarly, the Australian 10-year yield has leapt from 0.97% to 1.84%. Company after company globally has painted a picture of supply-chain disruption, product shortages, soaring input costs and tight labour markets. Over this period, the dominant debate raging in financial markets has been whether this inflation is transitory, as supply chains normalise post-pandemic, or whether it is structural.

Lesson #1: Beware the dominant market narrative

While time will clearly settle this debate once and for all, I think the lesson from 2021 (and the past few years) is to beware the dominant market narrative. Despite markets correctly anticipating rising inflation that indeed occurred over 2021, the S&P/ASX 200 Accumulation Index rose against this backdrop by 17%. Does this mean inflation doesn't matter for equities? No. To me, it means that trying to pick the eyes out of where these big macro drivers (e.g., inflation and interest rates) are headed is a fool's errand: you're as likely to be wrong as right, and then just as likely to be wrong about what it means for markets.

Every year a dominant market narrative will emerge. Some seem quaint in hindsight: remember in 2012 when we were all suddenly existentially worried about the level of Greek government debt? Other narratives can have an enormous and rapid impact on markets: The March 2020 global drawdown reflected a market that took 23 days to price in the narrative that the coronavirus pandemic would cause a global solvency crisis, with the S&P/ASX200 falling 35% off its highs, before another narrative quickly emerged: central banks will save us.

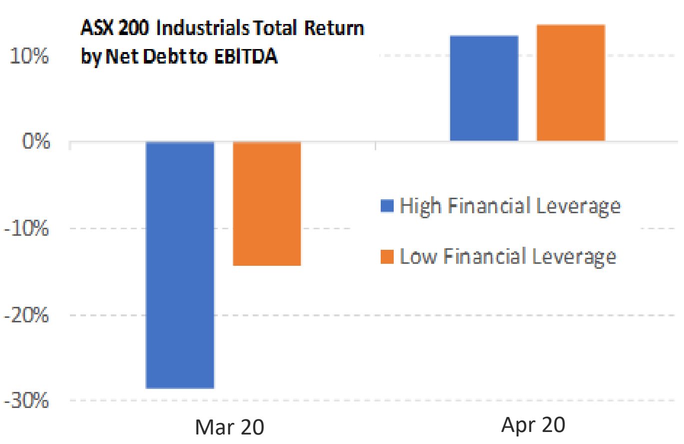
The reason I suggest being wary of the dominant market narrative is simply because it rarely matters in the long run; however, it can be distracting or scare you out of owning good, solid businesses. If you'd simply fallen asleep on 1 Jan 2020 and woken up on New Year's Eve 2021 with your money invested in the S&P/ASX 200 over that time, your holding would be worth 17% more including dividends, translating to roughly 8% p.a. (which is interestingly around the long-term average return of Australian equities over many decades). You might conclude that you'd missed very little in your slumber!

In the long run, only one thing drives the value of a company, and that is the returns it generates on the capital invested in the business.

Lesson #2: Own businesses with good balance sheets

Every year we would advocate for owning businesses with solid balance sheets. For one thing, it provides downside protection in a sharp market drawdown, as seen in March 2020 (and highlighted in the chart below), those businesses with lower levels of gearing fared much better through the March drawdown.

Figure 1: ASX 200 Industrials total shareholder return

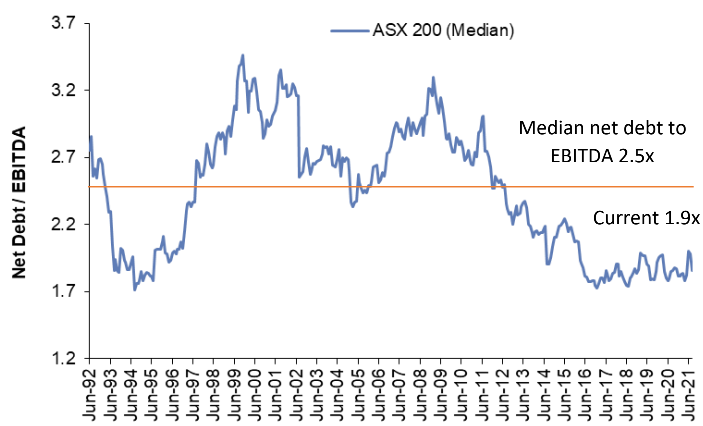


Source: MST Marquee, Airlie Research

The other reason we like a strong balance sheet is that optionality is a source of value upside, something we saw repeatedly over 2021. In our view, the market is typically terrible at putting a value on the optionality that a solid balance sheet provides, unless it is forced to through some sort of capital management event. This may occur through the announcement of a surprise special dividend (à la Wesfarmers with a $2 per share capital return announced in August), significant buybacks such as those undertaken by the big four banks this year (partly underpinning a 25% average total shareholder return for the big four over 2021) or a cash- or debt-funded acquisition (e.g., Nick Scali has rallied 35% since it announced the acquisition of Plush Sofas, largely funded through its considerable cash balance).

The good news for 2022 is that the past two years has strengthened a lot of balance sheets, with strong demand and capex cuts driving lower levels of gearing. As per the chart below, corporate gearing for the S&P/ASX 200 is well below its long-term median of 2.5x net debt to EBITDA. We expect this latent optionality to fuel further capital returns to shareholders over 2022.

Figure 2: Median net debt to EBITDA of ASX200



Lesson #3: Management matters

This past year gave us more evidence that management matters, not only for creating value for shareholders, but by giving us further examples of how a poor management team can seriously destroy value. Sadly, every year we seem to get a scandal that reminds us of this: from AMP charging fees to dead customers to the destruction of culturally significant sites at Rio Tinto, it seems the title of 2021's most egregious example of value destruction from a management team must surely go to the former executives and board of Crown Resorts. Regulatory reviews in NSW and Victoria found a lack of oversight from the board and senior management. A singular focus on the bottom line led to serious operational and governance issues. This culminated in the NSW and Victorian regulators finding Crown unsuitable to hold its casino licences, leading to a clean sweep of management and the board. It serves as another reminder that backing businesses that are run by talented and ethical people is an important consideration in investing. Although it now appears shareholders will be able to exit via a takeover, the round trip has been painful, and the stock has meaningfully underperformed over the medium term.

In conclusion, in anticipating the outlook for Aussie equities next year, we advise looking back to look forward. 2021 was another year that reinforced the value of looking through the short-term noise, instead focusing on investing in well-run companies with solid balance sheets.

Lithium - Where to from here?

Following on from our report on Mineral Resources and, in particular, its lithium business, we thought our background work on the lithium industry and supply-demand fundamentals might be of interest:

Over the past 12 months, the share price movements for ASX-listed lithium producers and developers have been eye-watering. Pure-play producer Pilbara Minerals (PLS) is up 280%. Nickel and lithium producer IGO is up 80%, having completely reshaped its business through a procession of transactions to become an integrated 'battery metals' business. Iron ore, lithium and mining-services company Mineral Resources (MIN), an Airlie favourite, is up 50%, despite a 27% decline in the iron ore price over the same time. Listed developers and explorers Liontown Resources (LTR), Firefinch (FFX) and Core Lithium (CXO) are up 318%, 380% and 270% respectively. The sceptic is wary of being the greater fool in the lithium sector, but pragmatically the equation is simple – even the most conservative estimates see the lithium market entering a material deficit at some point over the next 10 years as the electrification of transport takes place globally.

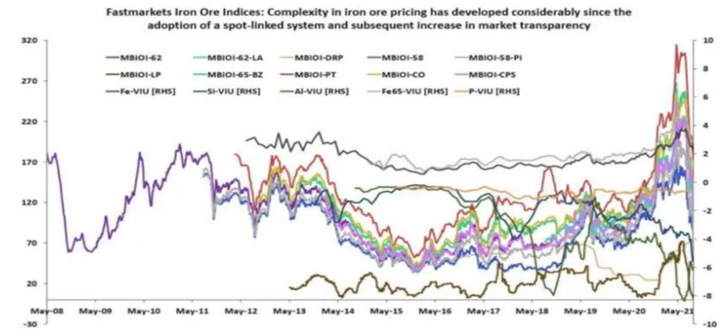
Figure 1 – Airlie Funds Management

The potential for a material lithium supply deficit means prices for lithium raw materials and chemical products could continue to rise. As more lithium extraction volumes and processing capacity comes online, the cost curve for lithium will potentially result in a range of economic outcomes for companies depending on their cost position and capital invested. Herein lies the opportunity and uncertainty for investing in lithium extractors and processors going forward.

Demand

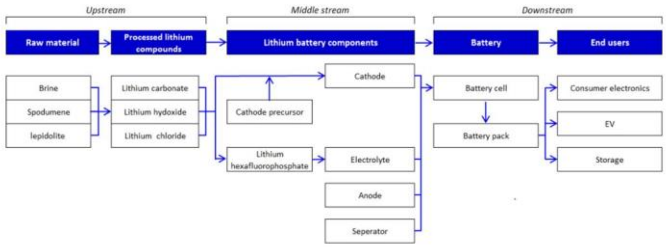
Lithium mining and processing aren't new industries, but they are experiencing a structural change in their demand profile. Lithium is a chemical element that doesn't occur freely in nature, but only in compounds, and is generally extracted from hard-rock deposits or brines and then processed into a useable chemical product. Historically, demand for lithium chemical products has come from applications in glass and ceramics, as well as additives in steel and aluminium production. Today, due to the superior energy-to-weight characteristics of lithium, lithium chemical products have become an important component of the rechargeable battery cells that can be found in most modern electric vehicles. As the world looks to transition away from fossil fuels, the demand for electric vehicles, and subsequently lithium chemical products, is robust.

Figure 2 – Albemarle Investor Day September 2021; Roskill



The trouble is, while lithium is not exactly scarce, the supply chain from raw material to useable chemical product is still developing as demand grows rapidly.

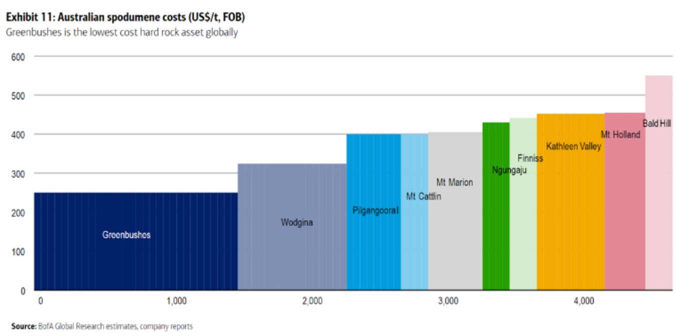
Figure 3 – Lithium Battery Supply Chain, Deutsche Bank Lithium 101 May 2016



Extraction

As mentioned earlier, lithium must be extracted (via hard-rock mines or brine lakes) and then processed into a useable chemical product. The Australian lithium extraction industry is dominated by hard-rock assets (mines) that produce an ore that contains the lithium-bearing mineral spodumene. Like all ore bodies, hard-rock spodumene deposits can vary in size and grade, which ultimately affects the quantity, quality and cost of the product produced (see Australian spodumene cost curve below). Spodumene must be processed into a concentrate of a suitable grade before it can be processed into a chemical product. Thus, higher-grade ore bodies can have significantly less costly pathways to final product. Brine assets (most found in South America) take saline brines with high lithium content and pump them from below the earth's surface into a series of evaporation ponds from which a more concentrated lithium-brine is produced.

Figure 4 – BofA Global Research, January 2022

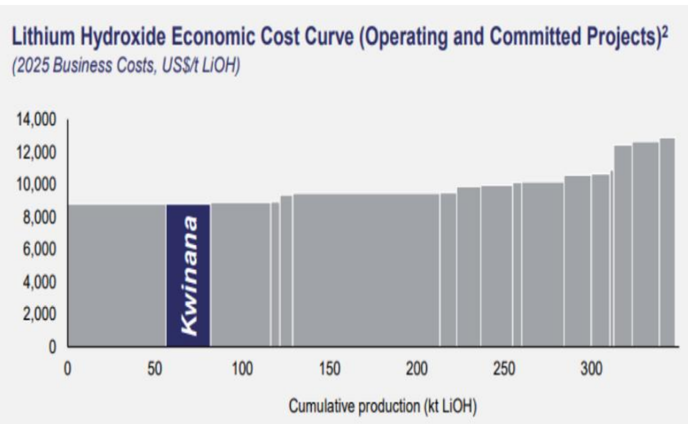


Processing

Spodumene concentrate can be converted directly to lithium hydroxide, while brine assets ultimately produce a lithium carbonate, which can then be further treated to create a hydroxide product if necessary. To further complicate things, not all processing assets are integrated with upstream raw material extraction assets, meaning they must procure raw materials (i.e., spodumene or lithium carbonate) from producers. Currently China has the dominant share of downstream lithium conversion capacity, a function of a historical cost advantage and proximity to customers. Australia's share of global downstream conversion is significantly smaller than its extracted share and will remain so even as assets currently under construction come online. Increasingly, Australian spodumene producers are looking to capitalise on the opportunity for margin expansion via vertical integration into downstream conversion, largely because of the price strength in lithium chemical products and the view that customers will want an ex-China supply chain. Given Australia is long spodumene (and China is short) it makes sense to develop optionality around spodumene concentrate offtake and create a lever around which the 'seaborne' lithium products markets can be kept tight.

Like extraction assets, processing assets will have different capital requirements and cost positions depending on their location, scale, and access to raw materials. The cost curve for integrated processing assets remains in its infancy, given many projects that make up industry cost estimates are either still under construction or ramping up.

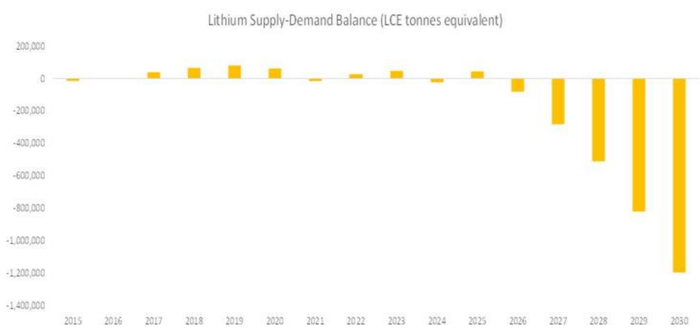
Figure 5 – IGO Corporate Presentation, 9 December 2020



Supply

Ultimately to meet demand raw material supply will have to come from both hard-rock and brine assets. Battery chemistry will vary depending on the availability of supply as well as the manufacturers' preference, meaning supply of lithium hydroxide and carbonate will be necessary. The main takeaway here is simply that the lithium battery supply chain is complex, and that given this it should be expected that theoretical supply will undoubtedly differ from realised supply. Below is a consensus estimate of the future supply-demand balance for lithium (as measured in Lithium Carbonate Equivalent tonnes) out to 2030. While obviously these estimates are rubbery, it gives a feel for the extent to which an imbalance may eventuate.

Figure 6 – Airlie Funds Management



Price

Of course, the reason cost curves and supply-demand paradigms are pored over by investors is to take a view on future prices. Often with resources stocks, get the commodity price right and you'll give yourself a fighting chance investing in the right companies. Over the past 12 months, prices for lithium products have exploded.

Figure 7 – BofA Global Research, January 2022.

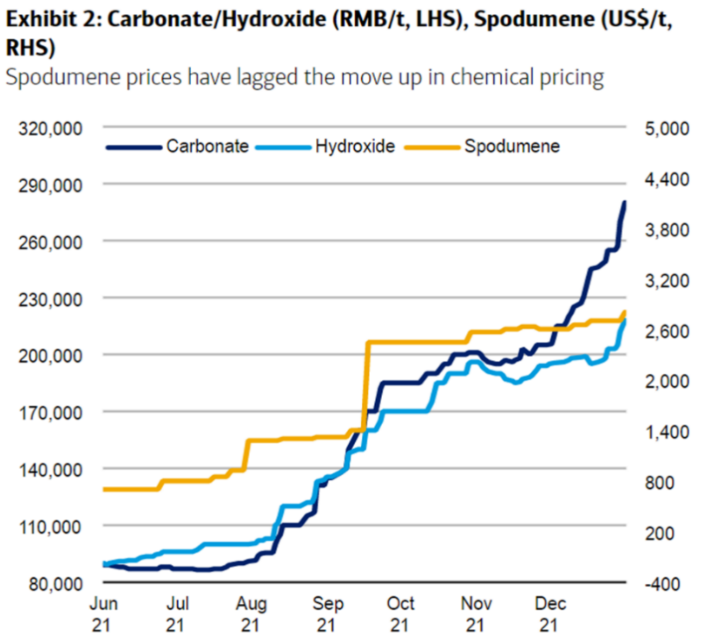
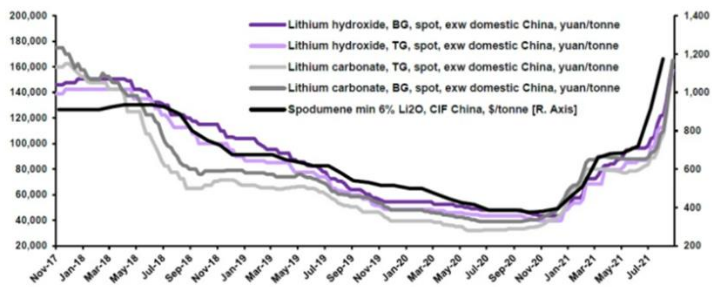


Figure 8 – Fastmarkets 2021

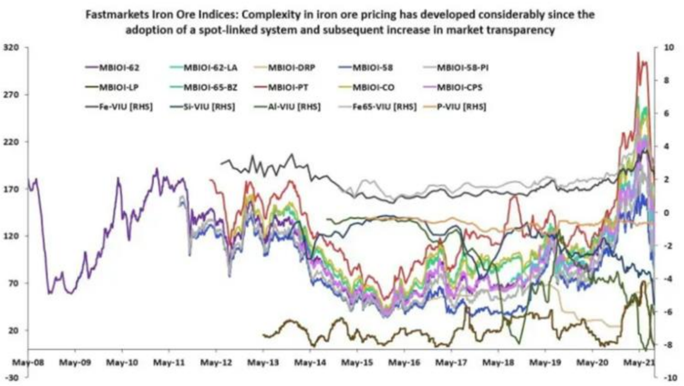


But how should we interpret spot prices given the structure of the lithium industry? Are spot prices an accurate reflection of what producers are receiving?

At present, spot transactions only account for a small portion of supply of lithium raw materials and chemical product producers, with most volumes traded in fixed price or index-linked contracts (for set periods). For spodumene spot pricing, many market participants have begun relying on Pilbara Minerals (PLS) BMX Platform results, in which the company auctions off small parcels of spodumene to prospective customers. If these 'spot' prices reflect what is being paid for the marginal tonne of product, then they still give great insight into the market balance.

Without wanting to oversimplify things or draw flawed comparisons, we can look at the development of the iron ore price (and value-in-use price variation) as a guide to how the lithium pricing system could mature. The iron ore market moved to a spot-linked pricing system in 2008, despite considerable variation in product quality and specific end-use. The result has ultimately been a significant increase in market transparency which we believe should be expected for lithium over the next decade.

Figure 9 – Fastmarkets 2021



With greater transparency over market pricing should come greater ability for market participants to allocate capital, and ideally create a smoother transition to electric vehicle use. Yet, as investors we still must take a view on future prices even as pricing systems develop. For mature commodities, long-term price forecasts typically reflect a marginal cost of production, where prices are set by cash operating cost levels that ultimately mean those at the top of the cost curve are not profitable, so as not to induce oversupply. The general rule of thumb most people use here is equivalent to about 90% of the cost curve. An obvious example where this logic is applied to a mature commodity is again iron ore, where long run prices are usually US$60 to US$80 a tonne, with 90% of the cost curve effectively profitable at about US$70 a tonne.

Using this approach for, say, spodumene would yield a long run price of US$450 a tonne versus a spot of more than US$3,000 a tonne. Given the lithium market is not 'mature' in the sense that pricing is underdeveloped, and the future supply-demand equation remains so unbalanced, a marginal cost of production method for forecasting future price is perhaps unreasonable. Instead, to address the future supply-demand imbalance predicted, new production needs to be incentivised, i.e., long-term pricing must be bid up to encourage investment in new supply, and so it's not out of the realm of possibility that current spot prices can hold for longer than people expect, or for long run prices to settle above the current cost curve (especially given this cost curve will have to change over the next decade).

All in all, without a crystal ball and given the plethora of unknowns, we remain open to the possibility that spot prices can hold or go higher despite their impressive run. Even modest changes to the supply-demand equation can see hefty price responses, and it would be foolish to assume the future will not be volatile in both directions.

How are we navigating the lithium sector at Airlie?

Given the industry dynamics discussed above, we believe it is prudent to have some form of lithium exposure in our portfolio. The uncertainty that features in all aspects of the lithium paradigm means each opportunity warrants a degree of conservatism, and valuation is still important, despite rubbery supply, demand, and price forecasts. Undoubtedly, we will see an endless stream of new explorers-cum-developers front the market over the next decade, some of which will be fantastic investment opportunities and some of which will be looking to take advantage of investor optimism.

We have previously highlighted Mineral Resources as our preferred lithium exposure. Mineral Resources represents a compelling investment both in isolation, and when considering its relative valuation versus other ASX-listed producers. For the company, earnings growth will be driven by the organic expansion of spodumene and iron ore production volumes, as well as the development of a lithium hydroxide conversion plant via a venture with global producer Jiangxi Gangfeng. Supporting this growth is the Mineral Resources robust mining services business and exceptional management, and it remains a key holding in our portfolios.