QUARTERLY REPORT #21: PERIOD TO 30 SEPTEMBER 2021[1]

Performance and net asset value[2]

Quarterly gross portfolio return: 2.1%; rolling twelve month gross return +36.7%

Our portfolio continued its recent inverse reaction to short term movements in markets over the quarter; we had a flat July, lower August but stellar September when we returned 7% pre expenses against many global indices which fell 4% or so. Over the quarter we returned 2.1% pre-expenses.

A number of our small-cap Australian exposures performed very well over the three months: Australian Rural Capital rose 111% in the wake of a new funds management initiative, Namoi (featured in Quarterly Report #20) rose nearly 24% in response to upgraded cotton production forecasts for 2022 and a strong cash flow performance from the first half of the current year, whilst Prime Media's excellent results and unexpected dividend facilitated a return of 21%. A number of our short positions did very well – Sezzle (featured in Quarterly Report #20) fell 35% and we have closed our position for the time being, Trupanion declined 33%, ARKK down 15% as the NASDAQ weakened (both were negative contributors in the prior quarter) whilst Freshpet had a volatile quarter in response to results and Adam Neumann-like corporate presentation. Our short in Wisetech (discussed below) was less propitious as the shares rocketed 68%.

These figures suggest the core of the portfolio performed only modestly; our hedging strategy eventually paid dividends late in the quarter, but we have been carefully accumulating a number of new positions or adding to existing ones on weakness.

In this respect, as we discuss below, we have reshaped the portfolio to a small degree being able to acquire some very high quality companies at what we regard as being far more attractive prices, and added to our gold hedges through the two vanEck funds at lower levels.

Portfolio structure

Our top ten long positions in alphabetical order as at 30 September 2021 are:

(The) Agency Group	HAL Trust
Appen Limited	Macerich
Deterra Royalties	Namoi Cotton Limited
E-L Financial Corp	Virtu Financial
Exor NV	Yellow Brick Road Limited

This quarterly focuses on some of the forces giving rise to some new holdings.

1 Readers are referred to footnotes 2 and 20 - 25 explaining the derivation of the numbers. All returns are pre-tax unless stated otherwise. At the current level of net assets, cost imposition is estimated at 0.9% per month over the course of a full year (excluding capital raising related expenses) and is fully accrued monthly according to the best estimates of management. Readers are explicitly referred to the disclaimer on page 15.

2 Month by month tabulation of investment return and exposures is given on page 14, along with exposure metrics.

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An extreme desire for certainty

Given the rolling ravages of the COVID pandemic, whether deep but single cycle (Europe, USA) or shallow but lengthy across two cycles (Australia, Asia) the impact on investors has been surprisingly similar. In a world whether so many more than usual variables in the profit equation are out of kilter, investors seem to have resorted to four types of behavior:

(a) Paying high prices for portfolio protection through options and volatility contracts;
(b) Being willing to buy "blunt" re-opening stocks – airlines, travel – often at capitalisations well above pre-pandemic levels, irrespective of their financial condition;
(c) Divesting securities where profit/profit growth is back-ended to Q4FY21 or H2FY22 one year out; and
(d) Paying extreme valuations for companies which have sailed through COVID and have businesses which are less likely to be affected by current difficulties.

It has been some considerable time that the variables which contribute to profit growth estimation have been so volatile; not just the strictly financial aspects but the impact on timing of pandemic delays, consequent labour shortages, port and shipping delays (and costs) and resultant inefficiencies in the supply chain. Christmas stock arriving in January isn't much use – and for some unlucky folks, that will be the case.

As a good example, FedEx Q1FY22 results reported a $450million increase in "costs due to a constrained labour market which impacted labour availability, resulting in network inefficiencies, higher wage rates, and increased purchased transportation expenses. This was partially offset by higher package and freight yields, increased international export express shipments and a favourable net fuel impact"[3]. If all of the costs were labour related, that would be around a 6% "inefficiency" increase. No inflation, don't forget....

We have often spoken about the VIX index, an index comprised of the 30-day volatility priced into at the market, near term S&P500 option contracts traded on CBOE[4] as a gauge of how fearful or sanguine investors feel at a point in time. VIX is a predictor of volatility, which (of course) may well prove wrong, relative to the actual volatility (or fluctuations) of the S&P500 index day to day. If the VIX overestimates volatility, then since a higher volatility than actually transpires is priced into options, investors using put options[5] to protect their portfolio will be overpaying for protection. By and large, on the S&P500 index, this has been the case for most of this year.

On average, the one-month realised volatility[6] has been 13.6%pa over the past year; the VIX has averaged 21.3%. So portfolio management prophylactics have been very expensive throughout 2021, reflecting the proximity of the March 2020 dislocation, as well as the confusing macro-economic thematics arising from changing consumer and employee behaviour during the different pandemic phases. Let alone fear of removal/reduction of the Federal Reserve Board's money printing and bond buying measures plus recent volatility in ten year yields.

[3] FedEx Corp (NYSE: FDX) "FedEx reports First Quarter Results" 21 September 2021
[4] Chicago Board Options Exchange
[5] The right but not obligation to sell securities at a fixed price up to a predetermined time in the future
[6] Measured by S&P Dow Jones indices

In addition, we are starting to see a plateauing of earnings forecasts for S&P500 for the current and 2022 year. That's hardly surprising given the broad supply chain issues -timing, labour, shipping costs – which may not have been adequately built in to what have been (to date) euphoric analyst forecasts for the just completed Q3CY2021. Consensus forecasts for S&P500 EPS for CY2022 still reside at a high 219, leaving the wider index (4307 at end September) at 19.7x these estimates. Not cheap, still, and providing the backdrop for a further correction.

What is clear is that even in a market which still looks very elevated, there are significant dichotomies between "cheap" and "expensive" which in our view is not a straight comparison of perceived "moderate" versus "good" businesses. That is why the current period has been a more active one for us, picking up securities where a desire for extreme certainty of earnings has led to divestment by others, at <u>prices we regard as been very attractive for the nature of the businesses</u>.

In Australia we have acquired larger positions through the quarter in two businesses who are US$ earners and account in that currency: Ansell (gloves and protective equipment manufacturer) and Appen (development of annotated datasets for AI/ML). What is discouraging (in some ways) about the overall investment environment is that these are two high class companies who exhibit clear transparency about the impacts of key themes – supply chain disruption, input price increases (Ansell) impacts of timing in dealing with major digital advertisers (Appen) – but are seemingly penalised for the same aspects that other companies (attempt to) sweep under the carpet. Ansell shares are down 15% since the day prior to the FY21 results and Appen a staggering 35% since the day prior to their interim results for CY21.

FULL YEAR RESULTS FY21

Over The Past Decade, We Have Transformed Ansell

KPI	FY10	FY21	Comments
Sales	$1.1bn	$2.0bn	Expect to leverage expanded capacity further in FY22
Driver 1 *- Core Brand sales*	*$400m*	*$1,650m*	*4X – From 37% to 81% of total sales, from 250 to 13 key brands*
Driver 2 *- EM sales ($M)*	*$140m**	*$421m*	*3X – From 13% to 21% of sales*
Driver 3 *- NPS ($M)*	*$102m*	*$292m*	*3X – From 9% to 14% of total sales*
SG&A %	25%	19%	Efficiency and scale steadily improving
EBIT	$127m	$338m	Strong growth
Quality CPM (quality issues/sales)	4.48	0.2-1.3	CPM quality significantly improved
# new products launched p.a.	8	25	5 additional research centers, 3X the number of patents
% of global sales on modern ERP (SAP, Oracle, 365)	0%	85%	Focus now on all mfg. systems merging to selected ERP
Manufacturing capex	$12m	$76m	6X, reduced machine age and capacity up more than 3X
ROCE	21%	20%	After years of higher investment, ROCE high again
EPS	79.7¢	192.2¢	Steady growth

* Adjusted for Sexual Wellness exit

Ansell HyFlex GAMMEX AlphaTec MICROFLEX 7

Ansell was an obvious winner in the pandemic through heightened demand for its single use gloves, but the remainder of the business in mechanical and life sciences picked up nicely in H2FY21. The company's mid-point guidance for FY22 based on sensible assumptions leaves the shares on a P/E of only 13.5x, earning returns on employed capital of over 19%, and which – as illustrated in its FY21 results presentation (above) has transformed over the past decade.

Whilst the retirement of MD Nicolin is a shame, the internal promotion should continue the same cultural drive, with earnings at a far higher plateau.

Appen shares have been dismembered since reaching their crazy peak in August 2020 of $43.66 and are down close to 80% from that peak. In broad terms, this reflects a de-rating from the flattening of the company's 50%pa EBITDA growth rate; EV/EBITDA has collapsed from around 48x at its peak to a prevailing level of 9.2x CY21 EBITDA of **US$**81m – which many investors feel is still on the high side.

We don't look at Appen this way from a valuation standpoint, as the company capitalises and amortises software development over different periods, giving a (positive) skew to earnings not prevalent in US software companies. Bear with us in dealing with some accounting issues, which are stretching many valuations to an insane level, before we return to Appen's metrics.

Accounting standards now infecting valuation metrics

On 6 September, *Wall Street Journal* interviewed the newly appointed Chair of the International Accounting Standards Board, based in London. Andreas Barckow is a Deloitte partner in Germany, 55 years old, gray-haired and bespectacled and lectured at Germany's top business school. Sorry for the stereo-typing but you can **tell** he's an accountant a mile away. His key priorities are accounting for intangibles and ESG climate change accounting issues. For securities analysts, Herr Barckow is of limited value, unless he changes priorities, I'm afraid.

In our opinion, it would be far better for Herr Barckow to revisit the 2020 implementation of IAS16, which amongst other things deals with lease accounting such as your simple two year office lease; even a minnow like East 72 has to apply an imputed interest rate to the monthly lease payments and also a depreciation schedule. Over the (say) two years, the profit impact and cash outflow on rent coalesce, but the negative profit impact is front-end loaded arising from the unwinding of the imputed discount rate.

Worse still, rental payments are counted as a financing cash flow item, when they are patently an operating cash flow item. In addition, since they are a depreciation and financing item, they don't count in EBITDA either! So virtually every business quoting EBITDA as guidance does so excluding the rental payments on their shops, offices and warehouses.

In Australia, things are worse still. In our opinion, large accounting forms are slapdash in the extreme allowing companies to capitalise software expenditure, and call it an "investment" so that doesn't count against operating cash flow either. Australia's Big Four banks have been particularly devious in this area, then writing off hundreds of millions of dollars below the line every five years or so. Analysts just ignore it, which is, of course, why the banks do it.

The cash flow table below is that of Wisetech Limited (ASX: WTC), a software solutions developer for the logistics industry, mainly via its key CargoWise product. The table shows Wisetech spends over $70million a year in software development on its products not expensed through the profit and loss account ("payments for intangible assets") and pays ~$9million a year in rent – which is now styled "repayment of lease liabilities".

Consolidated statement of cash flows

For the year ended 30 June 2021

	Notes	2021 $M	2020 $M
Operating activities			
Receipts from customers		535.6	456.4
Payments to suppliers and employees[1]		(305.6)	(310.0)
Income tax paid		(18.4)	(16.5)
Net cash flows from operating activities	22	**211.6**	**129.9**
Investing activities			
Acquisition of businesses, net of cash acquired	18	(5.8)	(57.0)
Payments for intangible assets		(74.5)	(70.4)
Purchase of property, plant and equipment (net of disposal proceeds)		(16.3)	(20.1)
Interest received		1.3	3.1
Net cash flows used in investing activities		**(95.2)**	**(144.4)**
Financing activities			
Proceeds from issue of shares		35.8	24.8
Transaction costs on issue of shares		(0.1)	(0.4)
Treasury shares acquired		(35.8)	(24.8)
Repayment of borrowings		-	(0.8)
Repayment of lease liabilities		(8.7)	(5.9)
Interest paid		(2.4)	(2.4)
Dividends paid	6	(13.2)	(11.1)
Net cash flows used in financing activities		**(24.4)**	**(20.6)**
Net increase/(decrease) in cash and cash equivalents		**91.9**	**(35.2)**
Cash and cash equivalents at 1 July	9	223.7	260.1
Effect of exchange differences on cash balances		(0.6)	(1.3)
Net cash and cash equivalents at 30 June	9	**315.0**	**223.7**

[1]For the year ended 30 June 2021, $8.6m of payments related to restructuring programs are included in payments to suppliers and employees (2020: nil).

These Consolidated financial statements should be read in conjunction with accompanying notes.

Wisetech quotes only "underlying EBITDA" (and revenue) in its robust guidance, which shows EBITDA up from $126.7million in FY20, through $206.7million in FY21 to a forecast midpoint of $273m in FY22. But the "real" EBITDA[7] in FY20 was only $70million, and $147million in FY21.

At 30 September 2021, Wisetech has an equity market value of $17.4BILLION; deducting its balance sheet cash leaves an enterprise value (EV) of $17.1billion, equivalent to 63x expected EBITDA in FY22. However, if we assess EV against the real cash flow before interest and tax, the multiple blows out to 117x. Moreover, Wisetech spends ~$20million a year on capital expenditure (excluding acquisitions); hence its free cash flow before dividends in FY21 was around $130million. This should increase to some $175million in FY22. So if you owned the whole business - including the cash - the free cash flow yield to you (before finance) would equate to $175million on $17.1billion: around 1%.

Wisetech may be a growing business, exhibiting an extreme degree of earnings certainty, but the price demanded is now absurd. We have a short position, which hurt in the September quarter.

Appen (ASX: APX) also benefits from the ability to capitalise software costs which equate to around US$25million a year; in addition, rentals are some US$4.5m per annum and there is a further US$1.0million of capex. Based on low-end company guidance of US$81m of EBITDA for CY21, Appen should mint free cash flow of over US$50million this year.

[7] Derived from the net receipts of $230m in FY21 ($146.4 in FY 20) less payments for intangible assets less repayment of lease liabilities

The current enterprise value for the business is US$733million giving us a free cash flow yield of ~6.9% for a strategically positioned business in the rapidly growing AI space. More than 3x that of Sydney eastern Suburbs residential property.......

In our view, recent gains in equity markets have given rise to lazy analysis, unquestioning acceptance of company appointed "underlying EBITDA", accounting and company presentations that seem more promiscuous than De Wellen[8] in its heyday.

Property exposures

We currently have four property exposures, which reflect valuation, positioning and our view of how the "Great Reopening" might pan out across the world, and what future trends in the sector will be.

We have tried to apply a degree of "second level thinking[9]" to such trends. We know people will want to travel again with a consequent benefit for the airlines, but that's already factored in. We've tried to think of lifestyle changes arising from behaviour during the pandemic – not just Work From Home but also decentralisation: tree change and sea change as the advent of Zoom and Teams has made relocation feasible. A higher level of WFH than pre-pandemic is inevitable, but continuation of the "decentralisation" trend - which has seen properties of all types in regional areas across the globe appreciate in value – is not. We believe this trend will moderate and that there will be a shift back towards larger cities, as prevailed prior to the pandemic. People demand culture, even in Australia.....same old, same old sea front walk is boring when you are young and free.

We hold four property exposures which are diverse but reflect this "urban" thesis:

- **BOWX** – the SPAC[10] acquiring **WeWork**, reflecting a more flexible workplace use and move away from long lease gargantuan CBD floor plates;
- **FRP Holdings** (FRPH) – a US based mixed use developer with an emphasis on build-to-rent in Washington, DC and its environs, buttressed by a multi-year royalty stream from owning aggregates quarries;
- **Macerich** (MAC) – one of the top five shopping mall owners in the USA, focused in affluent areas and using the pandemic to transition to wider-use entertainment area, but still relatively indebted which is reflected in the very low pricing of its equity; and
- **Lend Lease Corporation** (ASX: LLC) – an Australian company now refocusing to its leading expertise and experience in urban renewal, with strong "green" credentials.

However, we view this re-centralisation trend – because it will be culture driven - as likely to exclude mainstream office properties, where demand will potentially be constrained by "hybrid" work models, reducing the requirement for space. However, we do see increasing demand for serviced office type accommodation where companies hire space for employees to preserve flexible work patterns.

[8] The red light district of Amsterdam, which also includes "coffee houses"
[9] See Chapter 1 of Howard Marks' book "The Most Important Thing" (Columbia Business School Printing, 2013)
[10] Special Purpose Acquisition Corporation or "blank cheque" company – a shell company with only cash seeking to acquire a business.

In this respect, we have a small position in **BOWX Acqusition Corp**, the SPAC[11] which is acquiring **WeWork** at an implied enterprise valuation of US$8.6billion ($6.55bn equity; $2.07bn debt[12]); this compares to the postulated IPO in Q3 2019 of US$47 billion. Whilst the delta variant has pushed back earnings forecasts in the current and 2022 year, on a pro-forma basis, we are paying a 6.25x EV/EBITDA multiple of current CY2023 estimates and around 4.4x for CY2024 for a pre-eminent franchise in the sector. <u>These numbers will likely be adjusted downwards, the day after this quarterly is released given WeWork is holding an investor presentation on 7th October US time</u>. We may take a larger position once the de-SPAC[13]is complete after 19th October.

I have had the benefit in historic visits to the US of visiting assets owned by both MAC and FRPH – respectively the Scottsdale Fashion Mall in Scottsdale, AZ (February 2019) and the residential "Dock 79" development at the Navy Yards on the Anacostia River in Washington, DC (April 2016).

FRPH (all figures in US$) is an unusual $526million equity capitalised company, in which we have previously invested. FRPH stands for Florida Rock Properties Holdings and was a spin off from Florida Rock Industries (FRK), an aggregates business in 1986. If you think about Boral or Brickworks with their "mined out" land, selected quarries or other surplus property, FRPH was akin to placing that into a separately floated vehicle[14]. The largest shareholders in FRPH are the Baker family who are descendants of the original founder of FRK, Thompson Baker, in 1929.

FRK itself was acquired by Vulcan Materials in 2007 for $4.7billion. The quarry retention in FRPH provides an annuity revenue stream, mainly from Vulcan and Martin Marietta, on a minimum royalty and per ton basis across 14 properties, which averages out at just over $1.00 per ton of aggregate. The royalty yielded $9.5million over the past twelve months to June 2021, and is immensely valuable whilst producing a virtually risk free, stable growing cash flow, as well as two specific sites which are being prepared for a "second life" as development properties.

FRPH has four segments:

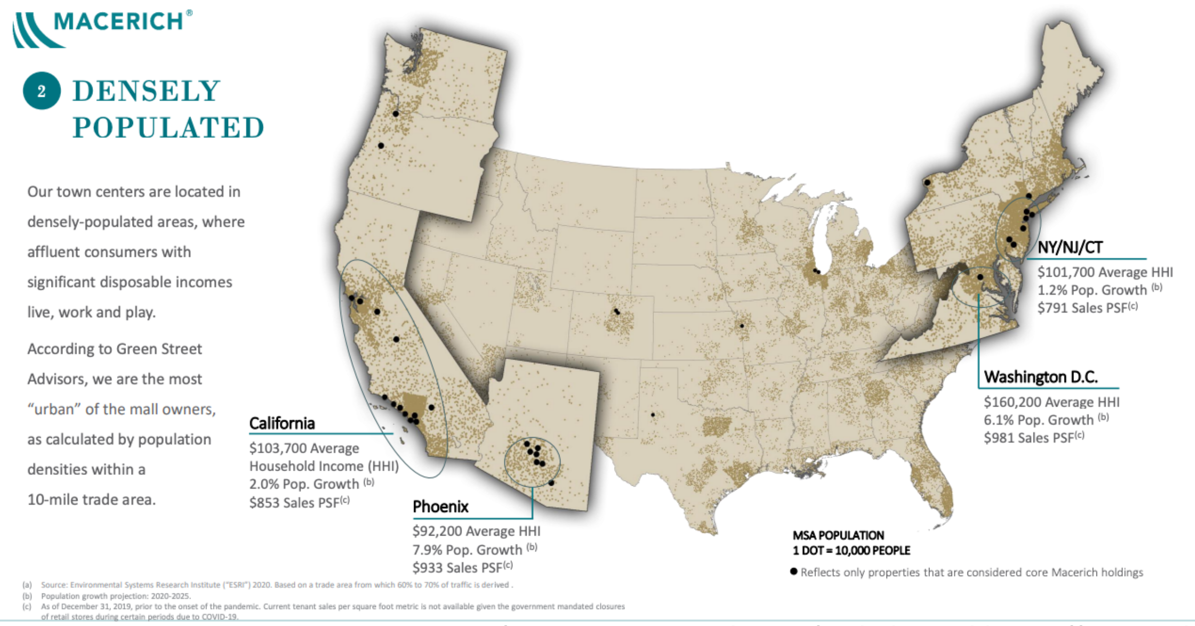
- the Mining royalty lands noted above, which based on comparable multiples of aggregates companies potentially has a value of ~$140million, excluding "second life";
- Asset management which owns three commercial properties (2 in Maryland, one in Duval County, FL);
- Stabilized JV's which own 66% and 70% of two waterfront apartment buildings totaling 569 apartments at Dock 79 and Maven on the Anacostia waterfront ("Navy Yards") in Washington DC plus 27% of a smaller complex in Maryland;
- Development which is a mix of 11 JV's across business parks, residential, and mixed-use projects, with a carrying value of ~$145million

FRPH has a narrow equity base of only 9.4million shares (priced at just over US$500million) has attached all debt ($178m) on a non-recourse basis to the waterfront apartments, has $138million of cash at the head corporate level and has demonstrated a past track record of strong capital management and recycling of assets on an opportune basis. Most notably, FRPH sold its 41 property industrial portfolio to Blackstone in May 2018 for US$359million.

[11] ibid
[12] See pages 187 – 195 of BOWX S4 lodged with US SEC on 16 September 2021
[13] De-SPAC is where the new business acquisition is completed.
[14] The assets formerly included a transport business, Patriot Transport, spun out in 2015

We believe the assets are underappreciated at the current stock price given the value of the existing residential buildings in Washington DC, to be supplemented by further development along the riverfront in a high value precinct adjacent to Nationals Park[15], in a city with an extremely stable workforce. Additionally, there is protection form the mining royalty and on-balance sheet cash.

Macerich (all figures in US$) is a major US mall owner, with an interest in 51 regional centres, mainly in California, Arizona, DC, and the New York Tri-state area. As a consequence, its 4.7million sq.m of lettable space attracts well above average spend from concentrated urban population[16]. The REIT has a market capitalisation of ~$3.5billion (221m shares at $16.70) and $4.7billion of net on balance sheet debt with a further $6billion debt in unconsolidated JV's where it holds an overall 54% share of assets carried at $9billion. Hence, attributable net debt is around $7.5billion.



MAC's current position is galaxies away from early 2015 when it fielded – and beat off - a stock and cash offer from Simon Property Group (US #1 mall owner) of $95.50 a share, implying a capitalization rate on rentals of about 4.8%. By early 2018, the shares were down to around $65 a share, and were $27 a share in late 2019 immediately prior to the impacts of COVID.

In common with other mall REIT's around the globe (see QR#17 on Unibail Rodamco Westfield) , MAC's debt saw their equity value crushed once the pandemic took hold; MAC's equity price cratered out in early April 2020 at ~$5/share. Our average entry price is around $13.40.

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[15] Home field of the Washington Nationals Major League Baseball franchise and World Series champions in 2019, the last season they got more than 22 innings from the league's most expensive pitcher, Stephen Strasburg. (Yes, I saw him live in 2016 and he is quite brilliant. Not sure the Miami Marlins batters agreed)

[16] As a rough comparison, Scentre Group (ASX: SCG) has 3.9million sq. metres across its 42 centres and an enterprise value of US$21.6billion, reflecting its management fee income

So what's the attraction? With the exception of some injudicious at-the-market stock issuance[17] in October 2020 and March 2021, MAC management has done a good job of divesting non-core assets and focusing on the core properties whilst reducing debt.

MAC is benefitting in very short order from post-COVID reopenings of malls, as well as the global trend of diversifying these centres from straight retain into multi-asset use, wider entertainment/dining options which are attractive magnets for customers. MAC tenant sales in May and June 2021 were 15% ahead of their 2019 equivalents; traffic was 90% of pre-COVID levels. Leasing activity is robust – volumes are ahead of the equivalent periods in 2019 – with 27% of 2022 expiries now let and letters of intent for a further 64% of expiring leases. As a consequence, MAC has issued guidance for funds from operations (the REIT equivalent of net profit, ignoring revaluations and asset sales) mid-pointing at $1.90/share for 2021, leaving them on a P/E equivalent below 9x.

The attraction of MAC is not just the more rapid retail recovery than seen in the exit from the GFC, but MAC's reshaping of its finances and potential attraction to another retail investor. MAC has repaid $1.3billion of debt so far this year and has realised a further $200m in property sales since June 2021.

In CY2019, the properties themselves, including the unconsolidated JV's, earned operating income (so excluding management fee income) after direct mall expenses of $897million. In 2020, this fell to around $770million, and in the current year is on track for ~ $800million. A full recovery to 2019 levels, and placing the remaining properties on an approximate 6% gross 2023 yield (Scentre Group valuations – not stock price implied pricing - equates to 5.63% as a guide) would imply a gross asset value of $15billion, NAV of $7.5billion or $33.90/share. This is around double the prevailing price, which in our view more than compensates for the obvious risks.

[17] An at the market deal is a deal whereby a company issues stock over a period of time directly to an investment bank, who then sells it off its own book into the secondary market.

Lend Lease Corporation: A reincarnated Dusseldorp shows the way forward

We are attracted to one of Australia's most venerable property businesses, LendLease (LLC) on a number of fronts. (All figures A$) The company is clearly at a watershed having just changed CEO with a share price now less than half where it was in 2000, despite massive tail-winds in most of its businesses. To be blunt, it is a story of board failure, with strategic fuzziness, and executive enrichment resulting in a lack of shareholder reward. The past two years have obviously been uncontrollably more difficult with its core global inner city renewals being out of vogue due to pandemic.

However, that is what the company are very, very good at – which they now seem to have realised – and seem to be losing the "diworsification" tag and getting back to basics. It's been a more expensive extraction than from a Harley St. dentist; for example, LendLease eventually divested their ill-fated engineering business, announced nearly two years ago, but at significant cost. Reaping $180m of proceeds but having to book $725million in two-stage profit charges doesn't endear the company to potential investors.

LendLease has always been a tricky business for investors to evaluate due to the multiplicity of income streams which roll through the accounts – development and construction profits, funds management fees from managed assets and managed fund vehicles, and dividend income and capital gains from principal investments in funds and project sales. A quick recap of the company's history shows how opaque (but legal) accounts and profit smoothing combined to give the shares an outrageous rating in the late 1990's, which was eroded as the company provided far greater disclosure to investors.

LendLease's real origins are in the early 1950's with the contracting company Civil & Civic (C&C) established in Australia by the legendary Dick Dusseldorp, sent to Australia by his Dutch building company, Bredero's. C&C built the tallest skyscraper in Sydney (Caltex House, now Stamford on Kent) in 1957, but with the Dutch parent needing to find larger sources of funding, Dusseldorp established Lend Lease to fulfill this role as a public company in 1958. Lend Lease found its own sites and projects, with C&C as the builder, leading to the merger of the two in 1961.

In 1971, LendLease formed General Property Trust, the first REIT in Australia, for the public to invest in certain of the projects, producing a management fee stream from the external management function. So even fifty years ago, LendLease's raison d'etre was effectively the harvesting of funding for property projects which it proceeded to build and either progressively on-sell or place into managed vehicles. The gradual acquisition of the publicly listed MLC Life in 1982 and 1985 accentuated this role, as well as complicating the valuation of the company to an even greater extent.

To create a positive thesis for LendLease means that we need to counter the argument that the company peaked out at the time of its most visible global achievement: having changed the face of Sydney's CBD with two iconic Seidler designed office buildings ten years apart – Australia Square in 1967 and MLC Centre in 1977 - Lend Lease built the Sydney Olympic village concluding in 1999. In 2000, when the share price peaked out, LendLease sold MLC Life to NAB for a thumping $4.65billion or ~1.8x – 2.5x embedded value depending on how certain companies within MLC Group were treated[18]; NAB sold the business at below embedded value last year.

[18] NAB 2000 Annual report page 19

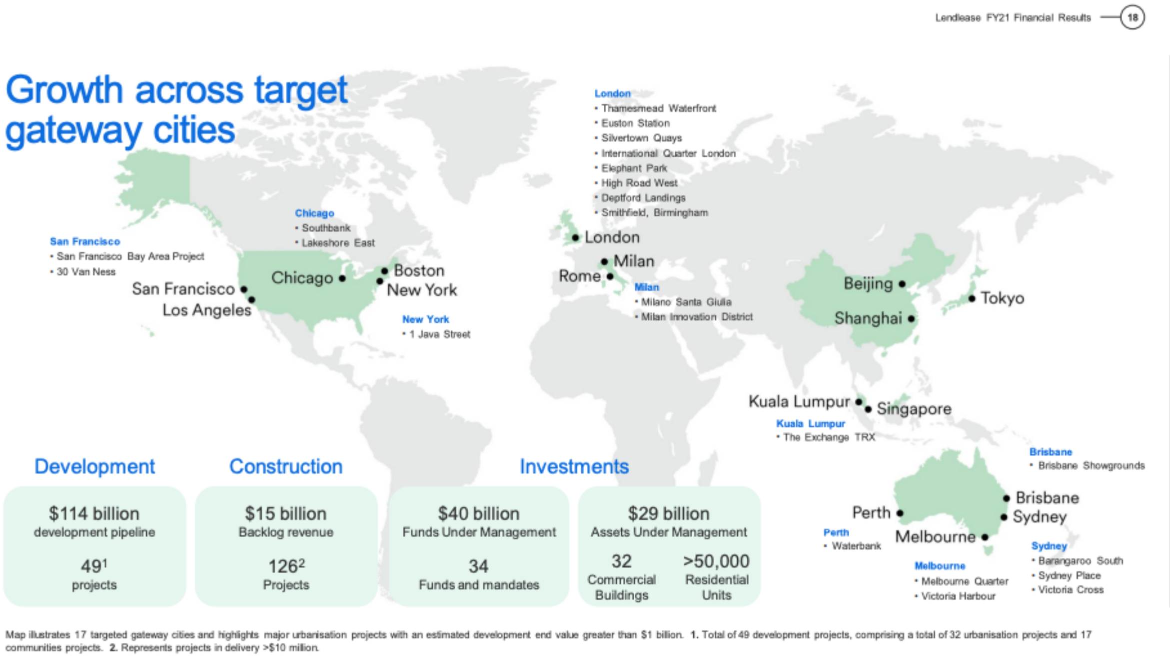
The year 2000 also co-incided with the retirement of its Chair Stuart Hornery, who was CEO from 1978 – 1994; Hornery was always keen to find "profit smoothing" businesses to offset the inevitable volatility within property, but also ensured gradual profit releases from major developments at the time, notably the Bluewater Shopping Centre in the UK.

The post-Hornery period was a nightmare for LendLease, eventually losing the management rights to GPT in a highly contested battle in 2005, but struggling to put the proceeds of MLC to work.

In search of the holy grail, Lendlease has been guilty for many years of trying to find adjacencies that fit against the core business – see below for my definition – and generally succeeding in investing in sub-scale enterprises, black holes where it had little competitive advantage (engineering most obviously) and finding activities to keep the core business platform fully occupied.

The past two years have seen a divestment of a slew of non-core businesses and a recognition by the recently appointed CEO Tony Lombardo that the "platform" is too bloated and costly and into which insufficient core construction and project business is actually flowing. It's a simple signal that LendLease is returning to basics.

The recent strategy presentation[19] lays LendLease's problems out starkly – the "platform" is too costly and the conversions of pipeline developments into actual projects ("production" in LLC terminology) is too slow. LLC have been running at production levels just above $4billion in the key division for the past few years but in new management's eyes, need to double this. It can't be done straight away due to the impacts of COVID and the inevitable time-lags between a development idea/proposition and commencement.



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[19] LendLease strategy briefing 30 August 2021 (ASX Release)

The company has a genuine competitive advantage. The pipeline is spectacular, $114billion of developments across a number of Tier 1 global cities, and one aspect which has not gone missing in recent times has been the development of LLC's "green" credentials.

But in effect, even reverting back to Dusseldorp's model doesn't mean evaluating the company is easy. LendLease earnings cannot be capitalised to obtain a valuation for the company. They are a mixture of:

- Development and construction earnings, which deviate from cash flow and are generally not valued highly by the equity market unless there is consistency; as we see below, in our opinion, "not highly valued" is an understatement;
- Earnings derived from dividends and distribution from LLC's holdings in its own managed funds;
- More highly rated earnings derived from the management of these funds and other vehicles where external investors have bought into a specific LLC developed project; and
- Capital gains from the divestment of projects or equity in managed vehicles.

The integrated model is important. As we know with Macquarie Group, investors value annuity streams from infrastructure and property assets extremely highly; indeed so do corporates themselves, as the rush to dismember AMP Capital's key fund mandates illustrates very clearly. LendLease's development backlog is a massive potential supplier to attractive new funds and vehicles, which together with its commitment to ESG, has the potential to fuel strong growth – valued at high multiples – into the funds management area. But it's too slow at developing these opportunities, and is being hampered by COVID (in all respects) such that it will be another two years before production can realistically attain the desired $8bn a year level.

That's why cost reductions are vital, because otherwise LendLease is a lowly valued corporate "sitting duck".

We think LendLease's past history of profit smoothing is farcical and that the company should do more to provide a view on how it is <u>adding total value year to year</u>. Disclosure is not the issue – this is an incredibly transparent company but one which doesn't help the investor. Effectively they give you ALL the jigsaw pieces, but leave you to put them together. And too many pieces look like green tree background, so you need help!

Once LLC is dismembered analytically it becomes clear that the development and construction business is hopelessly undervalued, at below 3x EV/EBITDA (which does include some capital gains) and even at a discount to the JV assets which it carries on-balance sheet as the starting point (or seed money) for new projects.

LendLease's loss of credibility is our gain. We know these types of principal capital seeding of real assets businesses are extraordinarily highly valued elsewhere if they garner a track record – think Brookfield, KKR, Blackstone, Macquarie. LendLease's off-reservation moves to complex adjacencies have cost shareholders billions in direct losses but more so in what might have been via a far higher equity market rating.

To show this, we have valued LLC on a sum-of-the-parts basis to evaluate the implied price of the development and construction business, whilst fully aware that the company must operate an integrated model. As we have noted, a simple bottom line number for LLC in one year is meaningless, despite the historic best efforts at profit smoothing.

The company should be evaluated on how it grows shareholder value from a sum-of-the parts calculation. It's a damn low base at present:

		$million	comments
Equity Capitalisation	689m shares @ $10.92	7,522	
Debt at 30 Jun 21		2,357	
Cash at 30 Jun 21 adjusted		(1,903)	Includes services sale
ENTERPRISE VALUE		7,976	
Balance sheet investments at carrying value 30 June 21		(3,550)	Properties, equity accounted, Retirement Living Trust, APPF, US Military Housing
BUSINESS VALUATION		4,426	
Asset Management	18x EBITDA		Funds ($40bn) & asset ($29bn) management ($69bn)
	5% fum	(3,185)	
IMPLIED PRICE OF DEV. CONSTRUCTION & HQ		1,241	2021 EBITDA: $481million 5 year average EBITDA: $602million

Based on our analysis, LendLease is dramatically underearning relative to the past few years, but is absurdly priced at below 3x EV/EBITDA for the "core" development/construction business, having regard to central costs. The derivation of this number (above) of $1.24billion becomes even more absurd when it is considered that LLC carries $1.78billion of joint venture development assets on balance sheet.

Outlook

Like many other "value" investors, we are now finding large numbers of opportunities, even in markets where index levels are still expensive despite a little retracement. This is leading us to be use more aggressive hedging of indices, to reduce the leveraged exposure we are carrying. In August that hampered us; in September, it worked well, although stock performance was the larger contributor.

We will be holding a virtual AGM scheduled for Tuesday 23rd November 2021 prior to the next quarterly report.

For further information:

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STATISTICAL APPENDIX: QUARTER & FYTD TO 30 SEPTEMBER 2021

1. Monthly performance, exposure and NAV

	Investment return[20]	Cost imposition[21]	Net Return[22]	R12 Return	NAV/share pre tax (c)	Gross Exposure[23]	Net Exposure[24]
30 Jun 17				46.6%	35.5	276%	-6%
30 Jun 18				-18.8%	29.0	278%	81%
30 Jun 19				-25.8%	21.6	395%	0%
30 Jun 20				-68.0%	7.0	185%	122%
30 Jun 21				+20.3%	7.3	297%	67%
				R12 return			
30 Apr 21	(6.3%)	(0.7%)	(7.0%)	20.6%	7.4	343%	(17%)
31 May 21	5.0%	(1.0%)	4.0%	20.9%	7.7	294%	79%
30 Jun 21	(4.6%)	(0.5%)	(5.1%)	20.3%	7.3	309%	84%
31 Jul 21	(0.5%)	(0.7%)	(1.2%)	25.0%	7.2	356%	74%
31 Aug 21	(4.1%)	(0.7%)	(4.8%)	29.5%	6.9	341%	122%
30 Sep 21	7.0%	(0.8%)	6.2%	24.2%	7.3	339%	125%

2. Equity exposure as at 30 September2021[25]
(as % month end pre-tax shareholders funds):

	percent	exposures
LONG	232.2%	31
SHORT	(24.5%)	5
FUTURES/INDEX DERIVATIVES	(82.6%)	
TOTAL	339.4%	36
NET	125.0%	

[20] Change in market value of all investments – cash and derivatives – after interest charges, dividends receivable, dividends and fees paid away divided by opening period net asset value and time weighted for equity raisings

[21] All accrued expenses for company administration (eg. listing fees, audit, registry) divided by opening period net asset value and time weighted for equity raisings

[22] Calculated as 2 (above) minus 3 (above)

[23] Calculated as total gross exposures being nominal exposure of all long and short positions (cash and derivative) divided by end month pre tax net asset value – assumes index ∂ of 1

[24] Calculated as total net exposures being nominal exposure of all long minus short positions (cash and derivative) divided by end month pre tax net asset value – assumes index ∂ of 1

[25] Figures may not sum due to rounding

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