Quarterly Report

Antares Ex-20 Australian Equities Model Portfolio – September 2020

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Highlights for the quarter

Performance: The Model Portfolio returned 4.7% (gross of fees) for the September quarter, outperforming its Benchmark by 3.1%.*

Contributors to performance: Positive contributors – Nine Entertainment, Aristocrat Leisure, Afterpay; Negative contributors – Fortescue Metals, a2 Milk, Qube Holdings.

Stock activity: Buys/additions – Lynas Corporation, Worley, Wisetech; Sales/reductions – Lend Lease, Ampol.

Portfolio snapshot

Inception date	27 May 2015
Benchmark	S&P/ASX 200 Total Return Index excluding the S&P/ASX 20 Total Return Index
Investment objective	The Model Portfolio's objective is to outperform the Benchmark over rolling 5 year periods.

Investment returns* as at 30 September 2020

Period	3 months	1 year	3 years pa	5 years pa	7 years pa	Since inception pa
Gross return %	**4.7**	**1.2**	**10.9**	**13.8**	**-**	**11.4**
Benchmark return %	1.6	-7.7	5.7	10.1	-	7.5
Gross excess return %	**3.1**	**9.0**	**5.2**	**3.7**	**-**	**3.9**

**Past performance is not a reliable indicator of future performance. Returns are not guaranteed and actual returns may vary from any target returns described in this document. The value of an investment may rise or fall with the changes in the market.
Investment returns for the Model Portfolio are based on a notional model portfolio constructed by Antares and are gross of administration (platform) and investment management fees, net of estimated transaction costs, and assume all dividends remain in the Model Portfolio.
*Performance is based on the income and market value of the notional model portfolio.

Performance and Portfolio Positioning

The portfolio delivered a return of 4.7% (gross of fees) for the September quarter, compared to our benchmark return of 1.6%. While the returns look benign, they mask another unsettled period where markets wrestled with a re-emergence of COVID in Victoria as well as the northern hemisphere and the uncertainty created by the looming US Presidential elections.

We have continued to focus on our strategy of identifying longer term beneficiaries from COVID-induced disruption. This includes the likes of IDP Education (IEL), Nine Entertainment (NEC) and Qantas (QAN). In all instances, these businesses have faced significant near term disruption but this has also impacted their competitors. Given the relative strength of their industry positions, they stand to emerge better and stronger companies with more market power than was previously the case.

Rather than focusing on the macroeconomic backdrop in this quarterly, as we often do, we felt that it might be illuminating to our readers to understand the drivers of some of these positions and discuss our investment in NEC. Why do we invest into it? And why do we think it is a beneficiary?

Nine Entertainment - an example of our investment approach

We believe the market has long misunderstood NEC and its strategy. As a smaller company, many investors do not feel the need to pay too much attention to it as it is not large enough to affect their relative performance. As a mid-cap oriented fund, it is this sort of opportunity we seek out.

We note that this is our opinion. It is not a prediction or an endorsement.

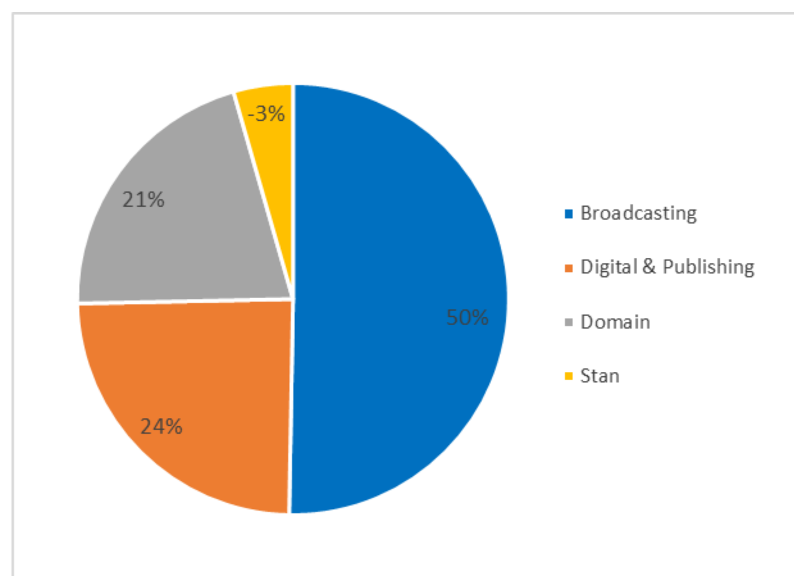
Investment Thesis

We see NEC as a company in transition. We believe it is successfully shifting its business from an old world media business based on highly cyclical advertising revenues to one deriving its revenues from higher quality digital and subscription streams. It is moving from a business model that was "ex-growth" to one that taps into contemporary products with their growing demand streams. We believe the market is slow to recognise the transformation hence is undervaluing the NEC earnings streams.

What does NEC do?

NEC is comprised of a Broadcasting Division, including its free to air (FTA) television business in Channel 9 and its ownership of the Macquarie Radio network, the broadcast video on demand (BVOD) streaming service Stan, a majority stake in real-estate classifieds company Domain, and the Digital and Publishing division consisting of the newspaper mastheads The Age, Sydney Morning Herald and Australian Financial Review (AFR). This structure was the result of the merger between Channel Nine and Fairfax Media in 2019. Its historical earnings composition was as follows:

Chart 1: NEC FY19 Proforma EBITDA composition



Source: NEC Company Reports & Antares; September 2020

NEC's origins are those of a typical media company. Historically these provide content to their customers and readers which is paid for via advertising. It is called a reach model as the company sought to "reach" as many readers as possible. The more readers, the higher the potential audience hence the more for advertising a company could charge, regardless of what that audience actually liked.

This model has been totally disrupted by the advent of on-line media. Companies such as Google and Facebook know the content their audiences look at and so can better target advertising to those with similar interests. The reach model was one size fits all and so a very expensive way to reach your customers. If you were advertising you were paying for that "reach", regardless of the viewers' interests.

The market has historically thought of NEC as this type of business but, in our opinion, the market has misunderstood.

Take FTA as an example. While the old model is still popular and reaches a large audience, it is now possible, via subscriber (or catch-up) TV, to collect information on individual viewers and their preferences. How? By obliging viewers to create a unique identity and log in every time they wish to watch something. This allows advertising to be curated to the interests consistent with

the viewing history of a particular subscriber. For example, if you watch programs on travel, companies in travel related industries will pay more to target you with their advertising knowing that you are interested in travel. NEC is the market leader in this subscription model with Nine Now. Essentially the content is leveraged from the FTA channels of NEC (Nine, Nine Gem etc) and the advertising is sold at a higher rate. This is a genuine digital business but the market has long ignored it.

Subscription Models

Stan is a clear second in the market to Netflix; it works on the same principles. It is now profitable and has nearly 2.5m active subscribers. Despite new offerings from Disney, Foxtel and others, it continues to grow handsomely and like Netflix, it has begun to make some of its own content. It is worth noting that Netflix trades on over 50 times next year's forecast Earnings before Interest Tax and Depreciation and is a tech market darling. The market here struggles to value Stan, and ignores the Netflix comparisons.

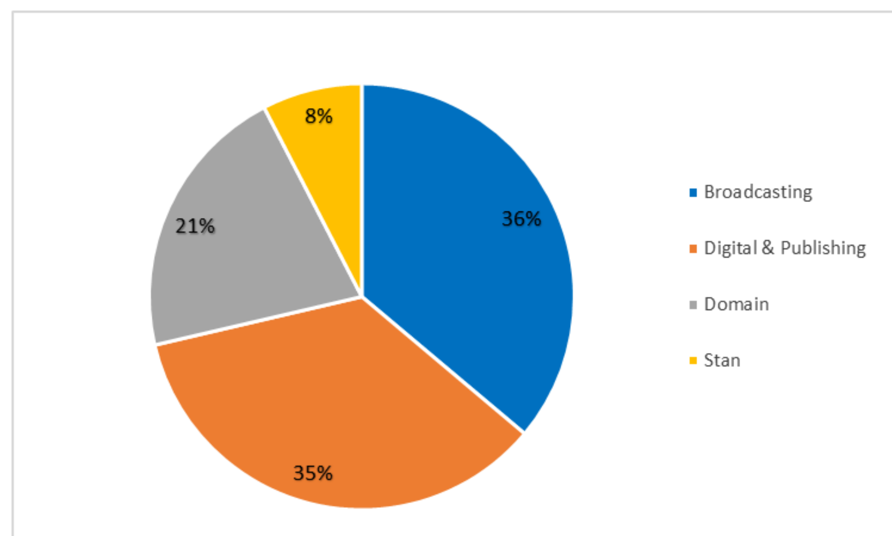
Likewise within NEC's Publishing division, readership is moving to a subscription model. These subscription services offer insight into preference and tastes of readers that are valuable to companies looking to advertise their goods and services to a receptive audience. When people think newspapers are dead, think about the value the market ascribes to trusted sources such as The New York Times and The Wall Street Journal. These are market leading mastheads that have adapted to subscription models – just like the SMH and AFR are currently doing.

How does this help NEC?

Alone amongst the traditional media companies in Australia, NEC has realised the benefits of these new digital tools and invested heavily to transform its business. This has been enhanced by COVID which has seen traditional advertising fall away sharply as companies seek to better target their audiences.

While NEC suffered a fall in its overall profitability of approximately $70m when it reported its FY20 results, driven by the old FTA reach model, whose revenues fell over $130m. This is a cyclical business. But the move online and to subscription- based offerings protected the earnings base. Hence the business now has an earnings base that is approximately 60% digital and subscription.

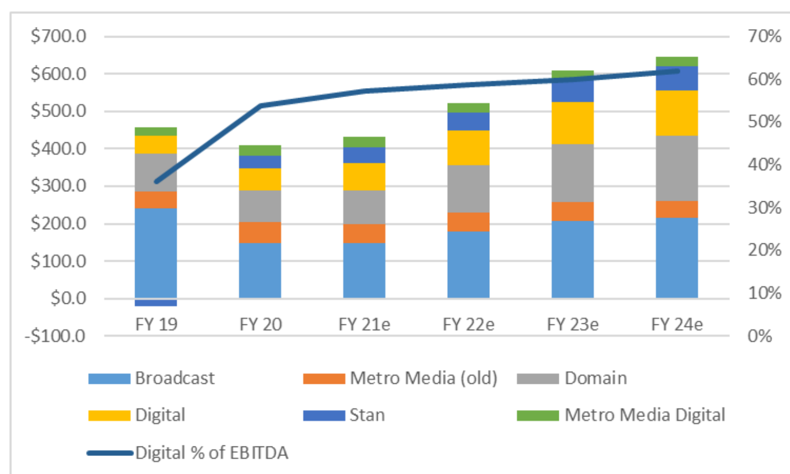
Chart 2: NEC FY20 EBITDA Composition



Source: NEC Company Reports & Antares; September 2020

We expect this to be maintained even as the more cyclical elements of earnings recover, which accords with the guidance provided by NEC in its FY20 earnings commentary. As the chart shows, while the earnings recover from other units, especially FTA, the digital and subscriptions business should grow organically at the same pace.

Chart 3: Forecast EBITDA by division ($m)

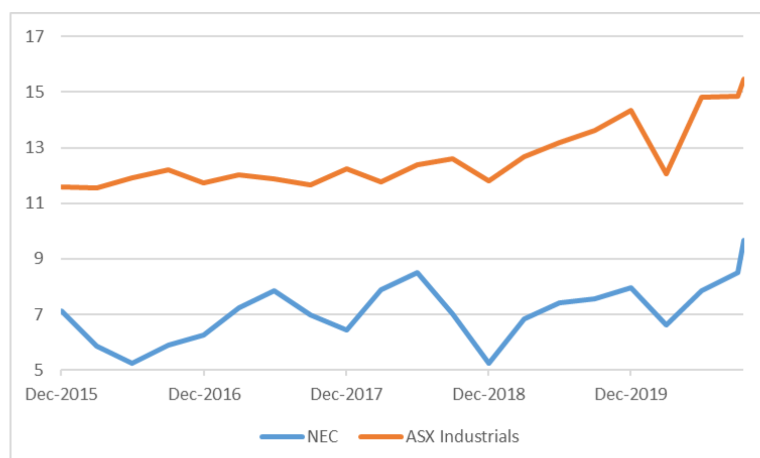


Source: NEC Company Reports & Antares Equities Forecasts; September 2020

What does this mean?

We believe the market is not yet realising the value of the NEC earnings given their improved quality in terms of stability and contemporary nature. As the following chart shows, the market still prices NEC at a material discount to the S&P/ASX 200 Industrials Index on a whole of company (or enterprise value) to future operating earnings basis:

Chart 4: NEC Enterprise value / Earnings (x)



Source: Bloomberg & Antares; September 2020

Given NEC offers both a recovery and base in contemporary and growing offerings, we think the stock is mispriced - the gap between the blue and the orange lines is too great.

How did COVID help NEC?

While NEC took a hit to its cyclical advertising businesses, the company had a very strong balance sheet and was well advanced in moving its audience onto digital and subscription platforms which benefitted during the COVID restrictions, thus mitigating the cyclical weakness apparent in FTA markets. Its main competitor, Channel 7, was hamstrung by a weak balance sheet and over commitment to sport that could not be played given COVID, eg the 2020 Tokyo Olympics. This led to large gaps in its programming schedule which further hurt its earnings.

Channel Ten's American owner, CBS, was going through a merger with Viacom (which would have occupied a significant proportion of management time) and also faced many of the same issues as Channel 7, albeit in the United States where it hosts much of the major sport on FTA. Hence it was not likely to commit capital to a market such as Australia. Neither 7 nor 10 had invested in a suite of contemporary products as NEC had and their balance sheets further prevented them playing "catch up". For them, it was about survival.

The weakness in the advertising industry helped the strongest player with the best balance sheet and a far-sighted strategy. It sped up the transition to online and leaves NEC is a very strong industry position in a recovering advertising market.

The case study highlights how the broader market can be slow to recognise significant changes in smaller to mid-size businesses. Most managers focus on the risk of their portfolios relative to their benchmarks in how they conduct stock selection and portfolio construction. Likewise, the large investment banks focus on those larger companies too as that's what their clients generally want.

Our process is a little different in that we focus only on these smaller and mid-sized companies. Further, our portfolio construction process does not base its decisions on the benchmark. We either own a company or we do not, regardless of what the benchmark says. Hence this is a live example of how our analysis of broader trends can be paired with our bottom up research to find potentially profitable ideas.

Outlook

We are maintaining our focus on COVID winners, hence our discussion of NEC. We are, however, pivoting this somewhat to the domestic economy as we exit lock downs and begin to rebuild the lost economic output. Hence we have added to positions in Qantas (QAN) and Star Entertainment (SGR) and have added BlueScope (BSL) for exposure to building and steel consumption both here and in the United States.

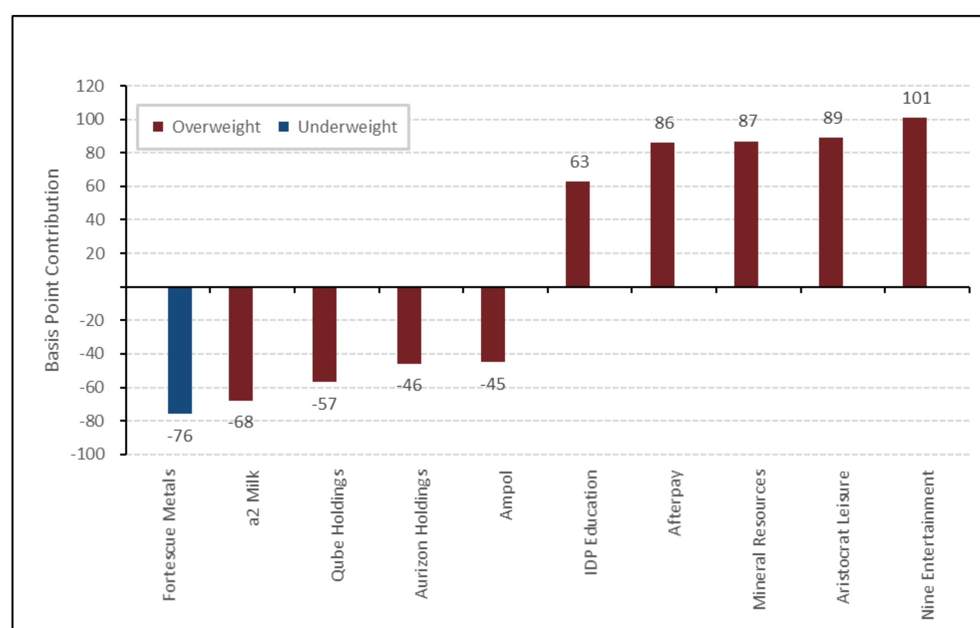
We have also moved away from the China focused tilt we put into the portfolio in the March quarter given its position as the first major economy to encounter the COVID pandemic. In its place we have begun to invest into businesses associated with the upcoming decarbonisation of western economies. This led to the sale of Fortescue Metals (FMG) and the addition of Lynas (LYC) and Oz Minerals (OZL).

It is clear from the various announcements of governments globally that energy policy is a focus. Governments see the conversion of their power supply systems from hydrocarbons to renewables as a way of stimulating economies damaged by COVID and aligning to stated targets of greenhouse emissions. To that end we expect significant government stimulated investment and have aligned with companies involved in the supply chain for this investment. We began to implement these changes towards the end of the June quarter but only set our positions in full in the early part of July.

We are unsure of the exact path to normality with COVID. We take a longer term view that this is a pandemic, and one that seems, thus far, mild by the standards of things like Asian and Hong Kong flu of the 1950's and 1960's. Policy, however, is far more exaggerated in its response and the changes it will create longer term are the key to assessing the investable universe in future years. It seems to us that the recession of the mid 2000's encouraged governments to increasingly interfere with market mechanisms and this has been sped up by the response to COVID.

Stock attribution

Chart 5: Portfolio attribution – September quarter



Source: Antares, September 2020

Positive contributors

Nine Entertainment Co Holdings (NEC) - NEC was our top contributor for the quarter. We have spent considerable time discussing NEC in this quarterly hence only make a further brief comment. The market seems to be recognising now some of the structural changes in the business. It may also have been encouraged by signs that the advertising market has turned positive for the latter part of the year, which is acting as a catalyst.

Aristocrat Leisure (ALL) - ALL enjoyed a strong quarter as the market gained confidence that the recovery in US casino trading post COVID was real and that casinos were not likely to shut again despite rising COVID numbers in some states in the US. ALL's strategy of supporting casinos, at ALL's cost, also bore fruit as the company took market share in both the for-sale market and the participation market based on games being switched back on and the value of play in those games.

Afterpay (APT) - We have discussed APT numerous times and its strength continues. The reason being that it is at the heart of the retail shift from physical stores to online, which COVID has accelerated. It has built a global processing platform which creates substantial optionality around things like cross-border payments and leads for smaller retailers. We do not see competition as a major issue given the early stage of the market and the latency of the opportunity, coupled with APT's alignment to both sides of a retail transaction. We think its continuing good performance is indicative of these things, although we are wary that short term expectations are very high.

Negative contributors

Fortescue Metals Group (FMG) - FMG continued to rally as the iron ore price continued to climb. We sold FMG last quarter and it looks as if this was a little early. Nevertheless, we see increasing supply of iron ore towards the back end of this year as Brazil recovers and demand decreases as stimulus in China begins to wane.

a2 Milk Company (A2M) - A2M delivered a very solid FY 20 result during the quarter but the market was expecting a stronger number and sold the stock down. Further, the company flagged some inventory build-up associated with weakness in its daigou delivery channel. This was ultimately caused by the severe lockdowns in Victoria which is the home of A2M's largest corporate daigou suppliers. We believe the brand remains strong and see this as a temporary blip in a story of robust demand growth.

Qube (QUB) detracted from performance as its FY 20 results were a little below expectations and the outlook statement was also downbeat. The market was especially concerned with the loss of market share of its Patrick's stevedoring joint venture in the latter part of the year. Further, the company provided little update on the potential for a "monetisation" of its key Moorebank asset. Finally, associated with the loss of share at Patricks, the dispute with the Maritime Union intensified over the period, adding to concerns that the market share losses may prove longer lasting. We believe these issues will be resolved, as management has a strong track record with such disputes, while Moorebank is a timing issue.

Stock activity

Additions

We added **Lynas Corporation** (LYC) to the portfolio in August. LYC is a producer of "rare-earth" minerals. These are essential ingredients in the production of renewable energy generation and battery developments. They are also important in production of night vision goggles and related products. China dominates the ownership of rare earths and given their structural importance in the emerging decarbonised economy, LYC is a unique asset in having one of the world's major deposits in Western Australia, and one that is not under Chinese control. We see this as a very long term and strategic asset. The recent capital raising has removed the capital risk.

We also added **Worley** (WOR) to our portfolio. WOR historically provides engineering consulting to the upstream oil and gas industry and while this remains important, it has diversified downstream via its acquisition of Jacobs chemical business. More importantly, WOR's engineering capabilities are increasingly important in energy transformation – pivoting towards more integration of renewables away from traditional hydrocarbons. This offers a long term growth option in the business. We intend to replace our other hydrocarbon related investments with WOR as price allows.

We added (back) **Wisetech Global** (WTC) to the portfolio in September. The company's results in August were well ahead of market expectations, and we see very significant headroom for the company to grow in its existing and potential verticals. This should support strong growth rates over the medium term. Demand for Wisetech's solutions are underpinned by a backdrop of increasing supply chain complexities and cyber risks. In addition, we see WTC as a beneficiary of a recovery in global trade volumes and commerce.

Removals

We sold **Lend Lease** (LLC) from the portfolio. While we remain attracted to the longer term thematic of urban renewal and community development in the LLC business pipeline, we think the metrics of these may have changed to some extent given the move to work from home driven by the virus. Hence we prefer to re-assess likely demand for these assets in the future.

The portfolio exited the position in **Ampol** (ALD) during the quarter. Whilst we believe there continues to be long term strategic value in the assets, we have lost conviction in the position due to management's lack of proactivity in ensuring the value of those assets is realised or understood by the market. As a result we see limited near term catalysts and exited our position, preferring to deploy the capital elsewhere.

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