Quarterly Report

Antares Ex-20 Australian Equities Model Portfolio (Model Portfolio) – March 2020

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Highlights for the quarter

Performance: The Model Portfolio returned -26.5% (gross of fees) for the March quarter, outperforming its Benchmark by 0.8%.*

Contributors to performance: Positive contributors – Metcash, Northern Star, Goodman Group, Oil Search (underweight) ; Negative contributors – Star Entertainment, Qantas, Worley, Coles (underweight).

Stock activity: Buys/additions – IDP Education, Lend Lease; Sales/reductions – Atlas Arteria, Electro Optic, Incitec Pivot, Iluka Resources, Worley.

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 31 March 2020

Period	3 months	1 year	3 years pa	5 years pa	7 years pa	Since inception pa
Gross return %	**-26.5**	**-12.9**	**1.8**	**-**	**-**	**6.8**
Benchmark return %	-27.3	-17.9	-0.6	-	-	3.5
Gross excess return %	**0.8**	**5.0**	**2.4**	**-**	**-**	**2.5**

*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 market update

The portfolio weathered some of the worst volatility seen in markets as the world struggled to come to terms with the impact of COVID-19 and the associated damage being done to businesses and economies, let alone people's health. Over the quarter, the portfolio fell in value by 26.4%, which was ahead of the declines in our benchmark which fell 27.3%. Pleasingly, having delivered very good absolute returns in the peak of last year's bull market, the portfolio was able to retain and even extend those relative gains in a period where sentiment was the complete opposite. We have aimed to diversify the portfolio and feel our returns are indicative of some success in this regard.

Outlook and Positioning

It is normally our preference to provide some commentary around the major macro drivers for markets and relate these to our portfolio – both to explain how these things have impacted performance and how they are affecting our positioning. With the onset of the CoVid 19 pandemic, much of that analysis seems rather pointless at present. Near term historical economic data is meaningless, as most developed economies have been effectively shut down with a view to riding out the pandemic so that it can be managed in an orderly fashion in healthcare systems globally. As free, liberal states, the option of a draconian shut-in, as implemented by China for the source of the virus around Wuhan, is not feasible.

Instead we have opted to discuss our strategy for navigating the impact of the virus and how we have gone about executing it

We have a clear strategy in mind. We are thinking about our investable universe in four ways:

1. Structural beneficiaries
2. Tactical beneficiaries
3. Leveraged business models with competitive advantage that we are prepared to support in the event of balance sheet repair
4. Others (or the remainder) which lack these attributes.

We have looked to use the volatility in both the market and at an individual stock level to allocate capital in line with this strategic overlay, with a clear focus on increasing exposure to the first three categories above. While this has resulted in some changes to holdings in the portfolio, it has also led to a re-allocation of funds within the portfolio, away from defensive stocks as they have rallied, and towards those we see with most value emerging on a multi-year view. The broadly diversified nature of the portfolio has given us the benefit of doing this as events began to unfold.

Structural Beneficiaries

We are looking to deploy our capital into companies that we believe will enjoy an enhanced competitive position from the economic impact of the virus over the following years. Obviously, we need to be sure these companies' capital structures are robust enough to survive, given the possibility of an extended lock down and delayed recovery that would accompany that. However, once we are confident about this, our attention turns to the impact of the virus on the industry in which a company is involved, and the impact on the competitive landscape created by the virus' repercussions. Particularly attractive are businesses where the market has sold-off the shares on near term earnings issues which we think are transient.

There are a number of businesses that we have identified which will likely benefit in the long term from the impacts of the virus on both the local and global economies. This can occur in a number of ways – but the end result is that competitors may emerge in a worse position in a relative sense than was the case beforehand. Companies in our portfolio that are in this basket include A2 Milk, Aristocrat Leisure, IDP Education (a new addition), Nine Entertainment, Qantas and Seek. We provide a brief discussion of our thinking on these stocks in the following section.

A2 Milk (A2M)

We expect demand for A2M's principle product, A2 branded infant milk formula, to increase, particularly in key offshore markets in China. We believe that A2 has the best brand name for product integrity and health in the industry, and the company remains focused on building on its strong brand. History suggests that Chinese consumers turn to foreign premium brands such as A2 as they have more confidence in its integrity relative to other products.

Aristocrat Leisure (ALL)

ALL faces severe near-term headwinds with 70% of its casino customer base effectively shut due to social distancing protocols. That said, ALL enjoys a materially stronger balance sheet than its peers. ALL has already established a significant lead in the quality of its games content in the market relative to its competitors because of its ability to invest in content while its peers were focused on servicing large debt positions. With earnings collapsing for now, ALL's peers will struggle even more. We expect this to result in ALL's strategic advantage in games' content extending further, thus boosting market share and consequently earnings in time, relative to pre pandemic levels. In short, while the near term is difficult for ALL, it will make it even more difficult for its rivals to compete with ALL's premium game content.

IDP Education (IEL)

We recently added IEL back to the portfolio given the substantial share price fall. IEL relies on students travelling for education, particularly to Australia, Canada and the UK. It is the clear market leader in a fragmented industry and enjoys strong relationships with partner universities. With travel restrictions now in place, IEL can no longer place those students into foreign universities, although it can continue with its IELTS English Language testing. As market leader, with a strengthened balance

sheet, IEL will be well-placed to further consolidate the student placement industry once this business resumes. The disruption to universities from travel bans and delayed enrolments may also provide additional opportunities for IEL to source quality students for universities once they are lifted. Migration through education is a structural growth story which we believe will continue once movement is allowed.

Nine Entertainment (NEC)

The market has also sold down NEC shares on near term earnings issues as the advertising markets have fallen materially. To us, however, NEC is a business in transition – from free-to-air TV to a more even mix of recurring revenue digital and subscription businesses, such as Domain, Stan and Nine Now. Further, it too enjoys a very strong balance sheet, while its rivals Seven and Ten are both struggling with their capital positions; Seven, in particular, may be in a precarious position. Nine will have the pick of the content going forward given its financial strength and the price of this content will fall, especially sports rights as there will be limited funds to compete for these: rival networks will be more focused on survival.

Qantas (QAN)

Another business where shares have fallen materially on near term virus-related concerns is QAN. It is clear to us, however, that while this a problem for QAN, it is a far larger problem for most other airlines globally, especially its local competitor Virgin. QAN has already shown that it is well-prepared for the crisis as it could quickly raise liquidity via a secured loan on certain aircraft – QAN owns most of its aircraft outright. As a result, when other airlines will need to raise air fares to restore balance sheets via higher earnings, QAN will be able to enjoy that benefit too, or could take market share by holding prices lower, should it wish to do so.

Seek (SEK)

In the short term, SEK's job listings revenues will fall materially. But as the recovery takes hold in both Australia and abroad, SEK will benefit from a surge in hiring. Further, the fall in valuations will allow SEK to accelerate its strategy of investment into education-linked businesses and so build out that portfolio, which is highly complementary to its position as a leader in all things to do with getting a new job.

Tactical Beneficiaries

We have also taken a slight tactical tilt towards Chinese end demand – be it consumer goods or raw materials. Not only was China the first country to experience the virus impact, and so we expect its economy to normalise faster, we also expect it to commit substantial stimulus to its economy. This stimulus should help it recover, and replace lost exports as its major markets continue to shutter their economies to deal with the virus. Chinese stimulus tends to drive demand for raw materials.

With this in mind, we have added investments into companies like Fortescue Metals, and added to Mineral Resources and Treasury Wine Estates. We also note that SEK has a substantial business in China, and that A2M's biggest end market for infant milk formula is also China.

These are tactical positions generally, which have been beneficial for now.

Leveraged Models

There are two types of leverage: operating leverage and financial leverage. In a situation such as that presented by the pandemic, a combination of both these factors in a business can prove to be an existential risk. We have avoided these businesses. Even where the company can raise funds from the equity market to repair the financial leverage problem, the duration of this event remains unknown and the fixed cost base remains hard to mitigate without a return of demand.

There are some exceptions: Qantas, for instance, has financial and operating leverage. We balance this risk against its industry position, which we see improving through this event as discussed earlier. This has led us to persevere with our investment in QAN. Other companies like this in our portfolio include AfterPay (APT), Lend Lease (LLC), Qube Logistics (QUB) and Star Entertainment (SGR).

APT has been a controversial inclusion in the portfolio since its addition in 2017. The question is: why are we persevering now, rather than exiting with our solid gains?

We had moderated our position in APT last year which de-risked the portfolio to a degree. That said, we have also ridden out other perceived issues in the APT model over the last two years, most notably the push by some vested interests to regulate APT's model out of existence. In each case we have analysed the arguments of those that think APT will fail and found them wanting. So too, here, we have done the same.

The key argument against APT at present is that it is exposed to low-quality consumer financing which will default in sufficient scale in the unfolding unemployment crisis so as to wipe out APT's equity. We disagree. APT's model ensures a very rapid

turnover of its debtors, with an average cycle of less than 30 days outstanding. Its high volume, frequency of use and customer numbers give it an advantage in terms of data collection and ability to respond.

That makes it quite different to the old consumer finance models of days gone by when advances were for much longer duration and for larger sums. This is important because it gives APT a great deal of control over its outstanding exposures as well as diversification in its base of users. It also has the deepest learning of the sector for its algorithms which should allow it to adapt the fastest of its buy-now-pay-later peers and reduce losses from bad debtors.

Qube is especially interesting to us at present. The business is carrying larger than normal debt levels as it builds the Moorebank Industrial Park in south-western Sydney. This is a high-quality logistics development, connected to the port of Sydney by rail and set up for modern distribution networks, especially e-commerce. One impact of the pandemic has been a focus on supply chains. Any business that can improve the efficiency of a supply chain has increased strategic value. We believe this applies to Moorebank, and while it is uncomfortable for Qube at present with the higher debt levels, the end result will be something of greater value than beforehand.

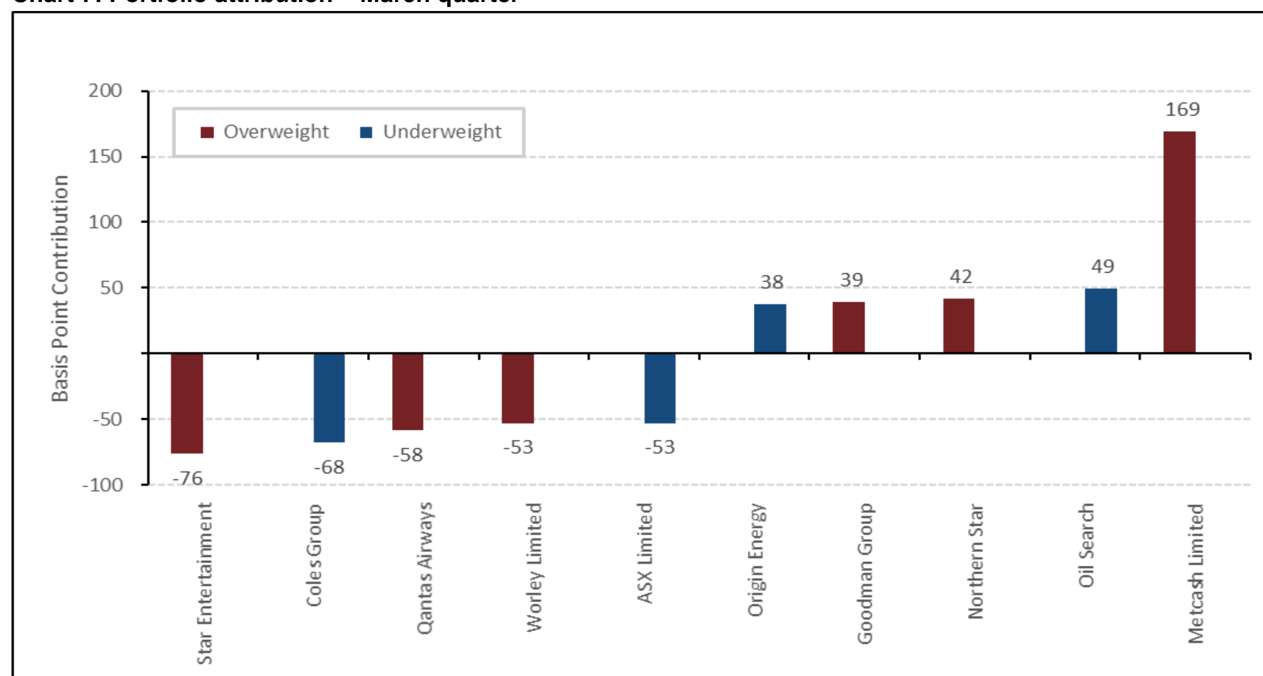
Lend Lease is a recent addition and we were attracted by the quality of the urban regeneration projects it is undertaking in cities like London, as well as the campus developments for Google in the Bay Area of San Francisco. The work is on LLC's balance sheet as it progresses, but we are confident that third-party investor demand for such high quality sources of yield, especially in a low interest rate environment which will persist now for longer than people may have previously thought, will be strong.

Finally, a brief comment on why we have maintained our position in Star Entertainment (SGR). With casinos closed nationally, all three of SGR's facilities are closed. While the Job Keeper package from the federal government will help SGR retain key staff, the business has no revenue until these are re-opened. Compounding this is the fact that SGR has just finished a substantial program of capital investment at its Gold Coast casino, leaving debt levels higher than might be preferred. On the flip side, SGR has indeed finished that program of investment and going forward will have depreciation higher than capital investment, which helps cashflow materially. Further, history has shown that demand for casinos rebounds strongly from interruptions such as this and we expect SGR to recover quickly. Its assets are unique, underpinned by licenses and exclusivity. As such they enjoy a competitive advantage that is difficult to replicate.

In summary, we have focused our capital on those businesses where our analysis shows that the business will actually strengthen its competitive position or will be viewed as more valuable by the market, given the nature of the underlying assets. The caveat is our analysis of liquidity, cash spend and balance sheet positions.

Stock attribution

Chart 7: Portfolio attribution – March quarter



Source: Antares, March 2020

Positive contributors

Our best performer for the quarter was **Metcash** (MTS). Demand for groceries in the past quarter has been artificially higher than normal given stockpiling behaviour from a population facing lock-down scenarios. Further, the closure of cafes and

restaurants is seeing more food being consumed at home. While some of these trends will persist for the short to medium term, we think that MTS (and other staples retailers) are facing a hole in demand in coming months as these stockpiles are run down. As a result, we have been reducing our position.

Northern Star Resources (NST) also contributed positively in the quarter. As a gold miner, NST benefited from a flight to safety given the onset of the pandemic.

Finally, **Goodman Group** (GMG) also enjoyed a strong quarter. GMG has been prudently reducing debt over recent years and so its balance sheet is very strong. This was well-received as debt markets struggled due to the uncertainty created by CoVid 19. With its specialised niche in business to consumer logistics, GMG is developing properties for investors that are enjoying a boost in demand as a result of the bricks and mortar retail shut downs. Further, lower interest rates globally mean its properties will be highly sought after going forward. This will support future earnings.

Negative contributors

Star Entertainment Group (SGR) was our worst contributor for the quarter. There is a greater discussion of SGR in our strategy piece earlier.

Qantas Airways (QAN) also detracted from the portfolio in March. Like SGR, we have already discussed our position in detail.

Finally, **Worley** (WOR) also detracted from our performance. WOR suffered from a confluence of two significant negative factors which combined to drive down the oil price materially in the period. The economic impact of the virus and associated shut downs drove the demand for oil down materially, taking the price down. Compounding the problem was the standoff between two of the world's largest suppliers, Saudi Arabia and Russia over production levels. This led to substantial cuts to the future value of capital investment in the industry, which is a key component of WOR's business mix. We exited WOR as we have no insight into when this situation is likely to normalise and we have concerns about WOR'S near term refinancing risks.

Stock activity

We have focused our discussion predominantly on where we have directed our capital spend. In other words, where we have increased investment. We have had to fund those investments and will now discuss how we have done that.

Atlas Arteria (ALX) - We chose to exit ALX given its substantial debt burden. Most of ALX's roads are in France and that nation has implemented one of the strictest lockdown scenarios thus far in response to the pandemic. As such, traffic on its roads has plummeted, creating possible debt covenant breaches for ALX, which would need equity funding to repair. Given that we also expect a very slow recovery in Europe (its structure makes fiscal stimulus more difficult than in fully sovereign nations), we felt it best to exit and devote resources to businesses with better prospects.

Electro Optic Systems (EOS) - We exited EOS because our research into the governance structures of the company led us to have reduced conviction in the investment. Given the volatility that was emerging at the time, it is our experience that poor governance can lead to material losses for investors. As a result we exited before that could occur.

Incitec Pivot (IPL) - We exited IPL as it had large levels of debt, which is something we have been conscious of in the current environment. Further, with demand for the chemicals it produces in the US likely to be subdued, and the market volatility delaying any possible demerger of its fertiliser business, we could not see an investment case given the value that was becoming available in other businesses.

Iluka Resources (ILU) - We sold our exposure in ILU to make way for FMG, as discussed earlier. ILU's major products are zircon and titanium dioxide. These are commodities which are "late cycle" (think tiles and paint) and we felt that its iron ore royalty was reflected fully in its share price when we sold it so the business faced near term earnings risk.

Worley (WOR) - We have already discussed our rationale for exiting WOR.

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