INDIAN PACIFIC
FUNDS MANAGEMENT

Monthly Performance Report
June 2019

Performance (net)	Main series
1 Month	-0.2%
3 Month	4.2%
Calendar YTD	12.3%
FYTD	6.8%
Inception (Feb 2018)	10.4%

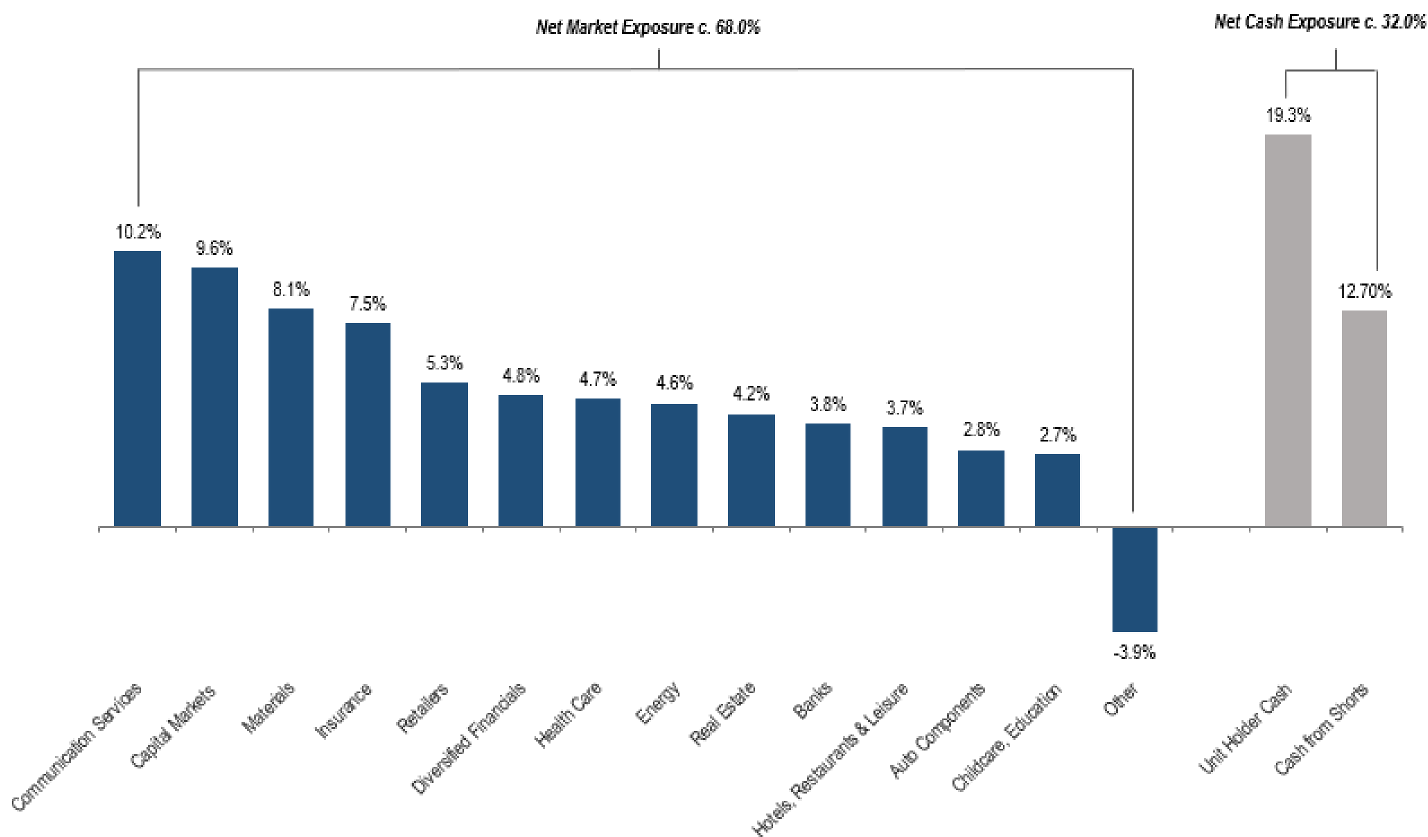
Month end exposure	
Long Exposure	80.7%
Short exposure	-12.7%
Gross exposure	93.3%
Net exposure	68.0%
Cash Weight	32.0%

Top 5 Holdings	% Fund
EQT HOLDINGS LTD	5.5%
INSURANCE AUSTRALIA GROU	5.1%
KINA SECURITIES LTD	4.8%
WESFARMERS LTD	4.8%
INTEGRAL DIAGNOSTICS LTD	4.7%
Top 5 Holdings as % AUM	24.9%

IPFM Portfolio	Factor	Long Portfolio	Short Portfolio	ASX300
Positioning	Weight	81%	-13%	100%
	Number of stocks	25	11	300
Valuation	PER	16.5	23.2	16.6
	EV/EBIT	12.8	15.1	12.7
Yield	Dividend Yield	4.5%	4.4%	4.3%
	Payout ratio	67%	83%	72%
Growth	EBIT growth	14.1%	6.1%	6.6%
	2 Year EPS Growth (	9.1%	2.6%	5.3%
Price to Growth	PEG ratio	2.6	5.9	2.7
Balance Sheet	EBIT interest cover	24.7	17.1	n/a
	Net debt to EBIT	1.2	1.5	n/a

Metrics are average where possible but median where averages are skewed by big outliers
ASX300 estimates sourced from Bloomberg. Valuation metrics are FY20

Portfolio Positioning



Portfolio Summary

The fund was flat in June (-0.2%) which took calendar YTD performance to +12.3% and financial year 2019 performance to +6.8% (after fees). Net exposure for the year averaged 69.9%, meaning that we had an average cash weight of 30.1% in FY19.

Whilst the fund is benchmarked to the RBA cash rate, I understand the importance of comparing performance to the market. In this sense it is also important to include risk in the discussion. Given our cautious positioning throughout the year it was a tale of two halves for the fund, and the market, this year. In the first half of the year the fund outperformed when the All Ords Accumulation index dropped 7.3%, however our high cash levels and our shorts have cost us in a relative sense in the second half as the market rallied 19.7% from the December rout. Given the lower risk attributes of the fund (lower volatility and a portfolio beta of 0.56), I would mark the risk adjusted results as satisfactory however I certainly aim to do better. Versus our Long/Short peer group it would appear as though we had a solid period and you can conduct your own research in that respect.

Turning to individual stock performance in FY19, interestingly the best performing stocks for the fund in FY19 were all S&P/ASX Small Cap companies (ex ASX100) despite the Small Cap index having a tough year (-0.85%) and despite the fund being evenly weighted across Small Cap and Large Cap (ASX100) companies. **Kina Securities**, **EQT Holdings**, **City Chic Collective**, **PWR Holdings**, and **Integral Diagnostics** were the funds top five contributors in FY19 with **Medibank Private** the top large cap contributor. Being under invested in ASX100 Resources (which were +14%) was our most costly decision in the year and in what is symbolic of the unusually long run of value investing underperforming growth investing it was two deep value positions, **Star Entertainment Group** and **Adairs,** who were the funds main detractors late in the year with both companies issuing softer than expected trading updates. Finally, on our short portfolio, whilst it cost us performance in the second half of the year, the short portfolio broke even for the year with an equal amount of positive versus negative months.

To provide some high-level colour on where your funds are invested, I have included a table above with some key valuation metrics for the Long and Short portfolios as well as the market. As you can see the portfolio is still high in cash, the long portfolio is considerably cheaper than short portfolio (particularly on an ungeared basis which is the most important measure), the long portfolio is yielding 4.5% despite its lower payout ratio than the market, it is growing faster than the market and is priced better than the market and short portfolio on a price to growth (or PEG) basis meaning we have not overpaid for growth, and the balance sheets of the quality companies in the portfolio are very strong. For these reasons you should remain very comfortable with the diversified portfolio of stocks held on your behalf in the fund.

By way of an operational update on the business everything is running smoothly with our outsourced service providers all performing their roles well (Morgan Stanley on Prime Brokerage and Custodian, Attentus on back and middle office, Apex on Fund Administration, BDO on tax and audit, and Norton Rose on legal).

To mark the start of a new financial year it's a good time to put the spotlight on some of the key positions held on your behalf in the fund. The stock analysis and detail might be a bit much for some investors, so please feel free to skip over this section, however I think many of you will benefit from understanding our investment process and thoughts in each instance. The list of companies below collectively represented 40% of the long portfolio at June 30.

ASX100 Portfolio Positions

At balance date 41% of the portfolio was invested across 12 positions in the ASX100. Here I highlight four of these positions which currently comprise 17% of the portfolio.

IAG Group (IAG.AU, $8.26) **QUALIITY worth holding**

IAG Group has occupied a top 5 position in the fund (or thereabouts) since inception so I thought it was worth explaining our latest thinking here. For those not familiar with it, IAG is the leading personal and commercial insurance operator in Australia and NZ writing around $12bn pa under the commonly known brands NRMA, CGU, SGIO, Swann Insurance, AMI, and Lumley. The group also holds $11bn of investments made up of $4.7bn of shareholder funds, and $6.3bn of technical reserves (policy holder funds with corresponding liabilities) which the company invests for the benefit of shareholders.

If ever you are going to apply a "management premium", this is a sector where it really matters and IAG's management team have consistently demonstrated they are the best risk managers in the Australian and NZ insurance game. Over the last four years they have significantly de-risked their business by entering quota share agreements with global reinsurance giants including Berkshire Hathaway (who also holds an equity stake in IAG). These quota share deals effectively mean that they have removed the downside risk over 32.5% of the policies they write because this is the percentage of claims paid by their quota share partners. This results in reduced earnings volatility and because of this lower risk IAG requires less catastrophe reinsurance and less regulatory capital. It also boosts their underlying insurance margin (a key measure of an insurers profitability) with the most recent 12.5% quota share deal adding 2.5% to their insurance margins. All in all, this helps smooth the cycle for IAG shareholders and results in more predictable earnings.

In addition to the roughly 4-5% (usually fully franked) dividend yield IAG pays each year (60-80% of their cash earnings), shareholders can expect ongoing capital management despite the company already returning $592m in special dividends in 2018. Indeed, near term the company is looking to sell their Malaysian and Indian operations which should return well in excess of their $500m book value to the group, plus there is still a $150m reduction in capital requirements due to flow through from the quota share deals. Given IAG's' capital position (judged by their CET1 ratio) sits at 1.18x, above the top end of its 0.9-1.1x target, we would expect most of this to flow back in to the hands of shareholders mostly in the form of capital efficient buybacks which in turn increases earnings per share. Below are two charts highlighting IAG's strong capital position.

In summary, whilst many in the market comment daily on the elevated short-term PE (price/earnings) multiple IAG trades on versus history, we think this simple analysis ignores the change in capital structure IAG has undergone in recent years. With rate rises driving GWP growth in the medium term, a $250m cost out program currently being implemented, a strong capital position, and best in class ROE and insurance margins we are happy to "stay the course" with our IAG investment.

Figure 1: IAG's CET1 Ratio versus target range

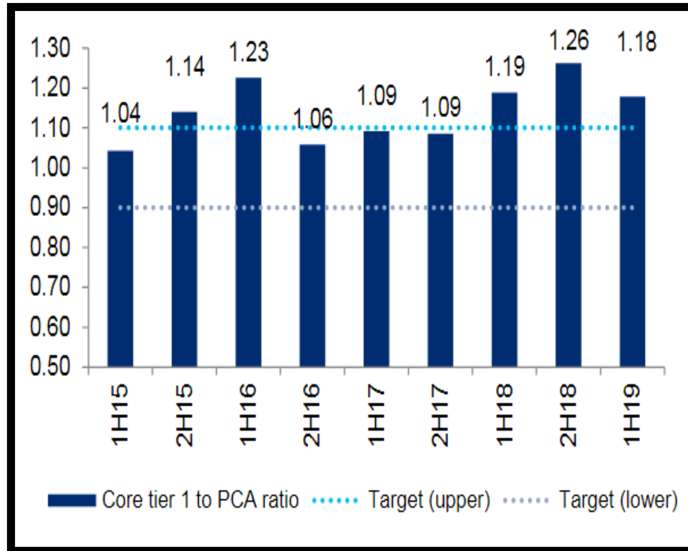
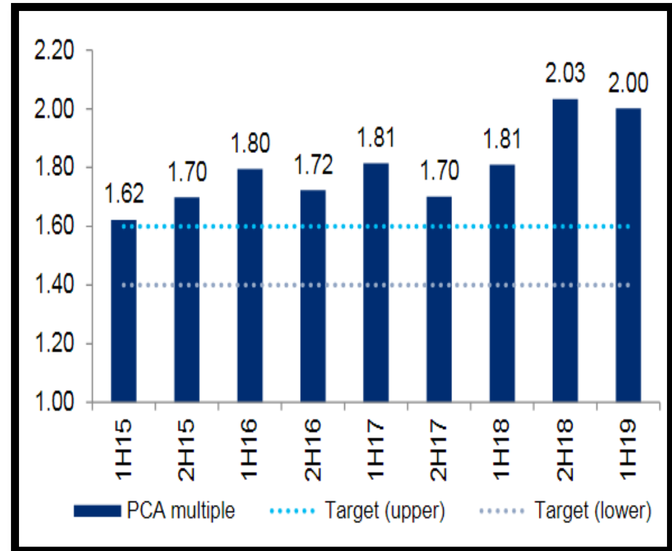


Figure 2: IAG's total capital-PCA ratio



<u>Origin Energy</u> <u>(ORG.AU, $7.31)</u> **<u>VALUE investing is lonely, but is this the cheapest stock in the ASX50?</u>**

Origin Energy has been a new addition to the portfolio in recent months with the company's share price languishing some 53% below the level British Gas (BG Group) bid for them way back in 2008 (a $15.50 cash bid that the ORG board in their wisdom decided NOT to put to shareholders). In a decision which has had long lasting disastrous consequences, Grant King (then CEO of ORG) and his board (which current Chairman, Gordon Cairns, had just joined as director) instead decided to "bet the house" and partner with US giant ConocoPhillips and China's Sinopec to build the $25bn Australia Pacific LNG (APLNG) project, Queensland's largest LNG export project, with ORG to become a 37.5% shareholder in APLNG. That decision transformed ORG from a defensive, conservatively run business which was almost debt free to a highly geared company with an eye watering $12bn of debt by 2015 when their annual interest bill reached $500m and net debt to EBITDA reached almost 6x (excluding their share of APLNG debt!). This all culminated in a $6.85bn package of rescue measures in September 2015 as the company tried to save its credit rating from falling to junk status. Value destruction was the order of the day and investment banks had a field day - capex was slashed by $1.1bn, operating costs were slashed by $435m, dividends were cut, $800m of infrastructure assets were hocked off, they sold their A$1.6bn stake in NZ's Contact Energy at multi year lows (40% below today's price), and shares on issue increased by 70% over the period with $2.5bn in equity finally issued in a "gun to the head" 4 for 7 entitlement offer at just $4 a share (-38% from the prior days close). Make no mistake, when management let bond holders and banks take the reins equity holders rank last and, in this instance, they paid a hefty price.

Fast forward four years and whilst conditions in the Australian retail energy markets have become more competitive (or should I say regulated), cash dividends from APLNG are now pouring in the door to the tune of $850m in FY19 with a refinancing of an APLNG debt facility likely to increase ORG's cash distribution from APLNG by A$100m pa FY20-25 as the distribution breakeven (the price above which ORG receives dividends) drops by US$3.50/boe from the current US$39-42/boe breakeven levels (boe refers to barrels of oil equivalent). ORG itself is very much in de-gearing mode with net debt dropping well below $7bn at December 2018 (refer Figure 4 below) and the redemption of a €1bn hybrid in September 2019 is set to save them $50m pa in interest. ORG is on track to achieve its 2.5-3.0x ND/EBITDA gearing target by the end of FY19 and in recognition of this both S&P and Moody's recently upgraded ORG's credit rating.

The de-gearing impact of the APLNG dividends flowing through to ORG have been a catalyst for the company to reinstate dividend payments with a modest 10c interim dividend at the 1H19 result (having last paid one in 2016) and **we believe ORG is now poised to return to a more generous payout ratio having flagged to the market it will announce its new dividend policy at the FY2019 result.** My guess is this will be staged increase given the tough conditions in Energy Markets and their reasonable debt position, however a 65% payout ratio by FY21 would see the company paying around 42cps in dividends (a 5.6% yield at today's share price).

From a valuation perspective, however you cut it, ORG looks cheap. If we assume spot oil prices for APLNG (a reasonable assumption given the recent weakness) this implies ORG's Energy Markets business is trading on around 9x FY20 EBIT, a 5-10% discount to its close comp AGL, which in our view is unjustified. Book value for ORG is $19bn versus the current enterprise value $20bn ($13.5bn market cap plus $6.5bn debt) hence the stock is trading just above book value currently. On a PE basis, the stock trades on just 12.0x FY20, a 25% discount to the market. I personally think if ORG's stake in APLNG was put up for sale currently in this low interest rate environment it would sell for 20-30% above book value (assuming a very bankable $700-800m of dividends pa using US$64 oil and AUDUSD 70c currency). From a blended NPV and SOTP valuation perspective we see fair value for ORG being just over $9.00/share +23% from last close.

In summary whilst the ghosts of the past decade are etched in many investors' minds (including ours), we are enthused by the opportunity of accessing the generous cash flows APLNG should provide ORG shareholders for the next 20-30 years. Whilst debt levels are still a bit higher than we'd like to see them they are de-gearing fast. The caveat short term is the impact of retail price regulation which will likely impact FY20 earnings in the order of $100m, and this may keep a lid on the share price around the FY19 result. However, with a more regular dividend policy about to be reinstated we think the coming years will be a rewarding time to own the stock.

Figure 3: ORG's FCF as APLNG dividends rise

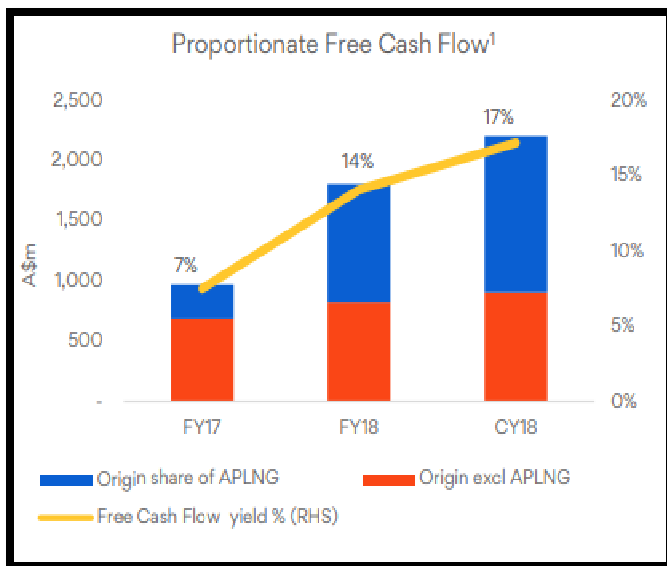
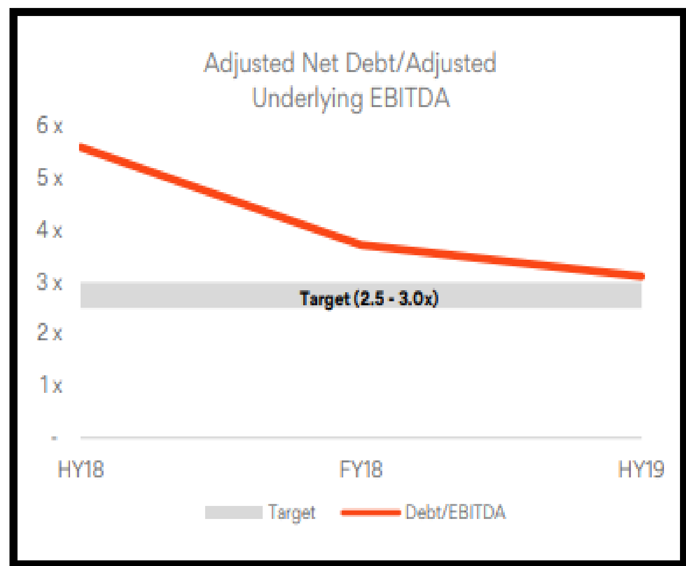


Figure 4: ORG is now in de-gearing mode



Source: Company data. (1) FCF Yield assumes current price $7.31

Carsales.com (CAR.AU, $13.53) **GROWTH at a reasonable price**

For anyone who genuinely does detailed valuations as part of their investment process, the online and technology space is a difficult area to invest in Australia due to very stretched current valuations. CAR however offers the most attractive growth prospects within the online classifieds space in Australia relative to what you pay (for equity) with the stock trading at roughly a 35% discount to their peer group. With a dominant position domestically, CAR has replicated its business model in several offshore markets throughout Asia and LATAM. Their "jewel in the crown", SK Encar (in South Korea), has achieved 20% EBITDA CAGR on 20% revenue CAGR in the 3 years to FY18 and comprises almost 17% of our CAR valuation. Webmotors (in Brazil) has also achieved 65% EBITDA CAGR on 25% revenue CAGR. As demonstrated in the charts below, International look through revenue and EBITDA grew at 79% and 83% respectively in the H1 FY19 and their international businesses now contribute more than 20% of look through revenue and 15% of look through EBITDA. We expect this trend to continue in the years ahead.

Whilst CAR's domestic business has been experiencing tough market conditions recently, they have a dominant market position and we believe there remains significant upside opportunity for their onshore and offshore businesses via monetisation (price) and new product initiatives. CAR has been a good contributor for the fund in the last six months (+30%) and with it trading at 1.2x the ASX Industrial average PE this continues to be one of the few large cap online growth stories in Australia where the valuation still looks reasonable to us.

Figure 5: CAR Look Through Revenue ($m)

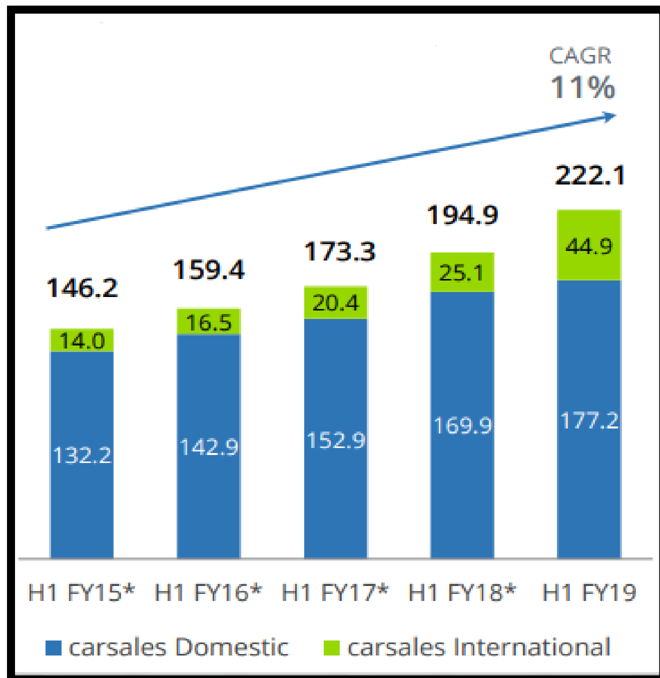
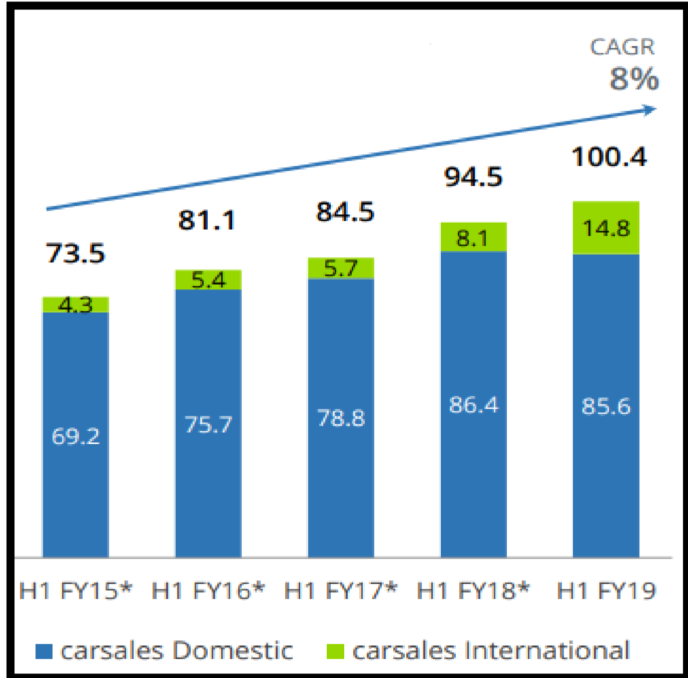


Figure 6: CAR Look Through EBITDA ($m)



Source: Company data

Wesfarmers (WES.AU, $36.16) **QUALITY, but a tougher year ahead**

Given my concerns on the housing market in Australia, and the fact that Bunnings is ~55% of WES group EBIT (and a higher percentage of the valuation) I mentioned in my March report (stock price $34.65) that I was tussling with whether to ride out the cycle and maintain our position here or sell this position. The conclusion I came to was that whilst the soft housing market will undoubtedly negatively impact parts of Bunnings, the long-term runway for growth is still very large and one I want to be on as a shareholder. Bunnings expansions into several new categories along with ongoing store rollout (+3-4% pa to the network), plus their push to grow their commercial business (30% of sales currently) to a similar market share to their DIY business means there are decades of opportunities ahead. Most importantly in my interactions with management I feel an underlying level of confidence that they have a "play book" on how to run Bunnings in a very weak housing market having done so in WA where house prices fell 20-30% but comp store sales (I believe) held positive. I also believe management of Bunnings have several cost-out opportunities up their sleeve to hold or grow profits in the event of further deterioration.

Since March there have been two important bits of news that have impacted WES. Firstly, the surprise result in the Federal election saw a relief rally in consumer and housing related stocks (this saw WES reach $38.56 on the 11th June). Secondly, the company reduced their EBIT guidance for Kmart Group at their strategy day on the 12th June as they (like many) observed that the Australian consumer is doing it tough. Whilst Kmart Group is less than 15% of our forecast FY20 group EBIT, clearly most of WES earnings do face the consumer. Also, whilst I support management's efforts to diversify their earnings stream in non-consumer facing areas, it will take time (beyond FY20) to extract a return on the circa $10bn war chest they have to deploy. With the stock having performed well and with it now trading in line with my SOTP valuation, there is a risk WES becomes "dead money" in the next 6-12 months hence you should expect the fund to reduce its large exposure into any periods of strength.

Small Cap Portfolio Positions

At balance date 38% of the portfolio was invested in 14 positions in the ex-ASX100 space. Below I highlight the largest three of these positions which comprise around 15% of the portfolio.

EQT Holdings (EQT.AU, $29.60) **QUALITY worth holding**

Equity Trustees was established as an independent Trustee and Executor company in way back in 1888 and is now Australia's largest independent provider of specialist trustee services. I underline the word independent, because post the Hayne Royal Commission this has become a significant competitive advantage for EQT versus their peers, many of whom are being forced to outsource their corporate trustee services (to the likes of EQT).

EQT operate two core divisions. Firstly, their **Trustee and Wealth Services** (TWS) businesses which are around half their earnings. 97% of revenues in the division are 10 year+ opportunities (think charitable trusts, estate management, not for profit mandates, indigenous trusts). The division has many growth opportunities, not the least a list of 55,000 clients who have wills held with EQT. This "will bank" has recently been digitised which will allow EQT to become more active in offering valued services (such as estate planning) to these clients who currently generate a very modest amount of revenue for the group.

Their second division, **Corporate Trustee Services** (CTS), provides a range of Responsible Entity (RE) and trustee services for managed investment trusts on behalf of fund managers, as well as corporate and structured multi party transactions. As I mentioned above, this business has big structural tailwinds flowing from increasing regulation of the clients they service.

Having grown revenue comfortably in the 5-10% range in recent years, their bottom line (NPAT) has grown at a higher rate with fixed cost leverage benefits flowing through to many of their divisions. Future revenue tailwinds include an aging population supporting record levels of wealth transfer in Australia, existing clients taking them to new geographies, and lots of governance driven divestitures by their competitors. EQT's acquisition of Zurich's Australian superannuation trustee business which has $1bn of funds and 18k members, for a nominal sum, is a good example of such opportunities.

Our position size in EQT has grown with share price strength recently (with the stock +38% from our entry level), and we believe there are numerous revenue upside risks embedded in EQT's businesses so we plan to "stay onboard" and watching as some of them are monetised in the years ahead.

Integral Diagnostics (IDX.AU, $3.16) **VALUE, DEFENSIVE and GROWTH**

IDX are an Australian and NZ radiology and diagnostics imaging company who provide MRI and CT scans for patients referred to their licenced operations both inside hospitals, and at stand-alone clinics via their "hub and spoke" model. The industry is supported by the favourable dynamics of ongoing population growth, an aging population, and increased demand (for images from doctors) which has seen industry revenues generally grow by 5-7% pa for the last two decades. Unlike the pathology industry where the top two players in Australia have roughly 80% of the market between them, the top four MRI operators in Australia have around 40-45% share between them leaving lots of room for consolidation. On this front IDX plan on being one of the key consolidators with acquisitions typically transacting in the 4-8x EBITDA range. IDX have a strong management team, have best in class margins, and we see the market supporting them for any additional equity requirements as they emerge as one of the key industry consolidators in the years ahead. This, along with strong organic growth, should result in ongoing double-digit earnings growth for many years to come. Despite these attributes the stock trades at a 15% discount to the market (ex-resources/banks) and on a blended DCF and multiple based analysis we still see 20% upside to fair value in the next twelve months.

Kina Securities (KSL.AU; $1.30) **VALUE and GROWTH**

KSL was the funds best contributor in FY19 and continues to occupy a top five position in the portfolio. As most of our investors would know, we have been a big fan of this PNG based financial services company for over a year now and with their acquisition of ANZ PNG due to close in the third quarter, and organic growth alone running at 15-20% pa, we forecast a 2 year EPS CAGR of 35% pa for KSL. Whilst recognizing the market cap is small and there will always be a "sovereign discount" in the stock, we think investors are being more than compensated for these risks with KSL trading on just 5.9x our estimated FY20 earnings with a forecast yield of 11%.

I look forward to working hard for us again in FY 2020.

Regards,

Preston Hamersley

Portfolio Manager

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FUNDS MANAGEMENT

About the fund

The Indian Pacific Fund is an Australian Equity long/short fund founded in February 2018. The fund has an absolute return focus (with long bias), has no cash limit, and can invest in both large and small cap companies. The investment process is a fundamental bottom up investment process with a focus on balance sheet risks and identifying companies with strong cash flows, in good industries, with strong management teams. The fund was founded with the view that whilst markets rise in the long term it is always prudent to maintain the flexibility to hold more cash when markets are overly optimistic, and selectively short stocks if opportunities arise.

Fund Holdings	Typically, 15 to 25 long positions plus selective short positions
Investment Horizon	Medium to long term.
Investor Eligibility	Wholesale Clients, as defined in the Corporations Act 2001.
Minimum Investment	$250,000[1]
Management Fee	1.0% of the GAV of the Fund, plus GST
Performance Fee	20% of Outperformance subject to a Hurdle rate (RBA Cash Rate), plus GST. Calculated and accrued monthly and payable quarterly. High water mark applicable.
Distributions	Annually, with the discretion of the Trustee to make interim distributions.
Applications processed	Monthly
Prime Broker (and Custodian)	Morgan Stanley
Legal Advisers	Norton Rose Fulbright Australia
Fund Administrator	Apex Fund Services Ltd
Fund Auditor	BDO Audit (WA) Pty Ltd

1 The Trustee may, in its sole discretion, vary the minimum investment and minimum additional investment amounts.

Contact:

General enquiries
E admin@indianpacificfm.com.au
W www.indianpacificfm.com.au

Contact the Fund Manager
E preston@indianpacificfm.com.au
P +61 8 6280 0129
M +61 403535820

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