

# SGH20 Quarterly Commentary - March 2020

## Quarter in Review

*"In the face of radical uncertainty it is better to be roughly right than precisely wrong"*

*Mervyn King, Former Governor Bank of England*

Radical uncertainty and the fallout from the massive economic shock from the Coronavirus crisis, COVID-19, weighed on markets in the quarter, with the ASX300 Accumulation down 23.41%.

Regrettably, we didn't see the only way to slow the spread of the virus, and give health systems more time to cope, would be for Government's to lock down economic activity. The resulting havoc in stock markets in the quarter was on a scale rarely seen. The market volatility was amongst the highest on record and is likely to continue for some time. The global financial system has taken a big hit, more damaging than the Global Financial Crisis (GFC), as it affects nearly every industry and recessions are unavoidable. The leverage in the financial system and sharp increase in electronic traded funds and risk parity strategy volumes exacerbated the speed and extent of the markets decline, with many investors forced to sell due to financial leverage, margin calls and portfolio redemptions. Further the collapse of the oil price due to a disagreement between OPEC and the major producers added another dimension to the market sell-off.

Polymakers are acting aggressively to limit the economic damage. All Governments and Central Banks of the largest economies are alert and aware as to what they must do to avert a deep, prolonged recession. Central banks, including the RBA, are flooding the system with liquidity and taking extraordinary actions to ensure the financial system continues to function. Meanwhile, fiscal caution has been thrown to the wind with massive government stimulus in many countries, including Australia, with policy initiatives aimed at helping save jobs and businesses and, building a bridge to the other side and road to recovery.

Following nearly three decades of uninterrupted growth in Australia, and given the rise in household debt levels and house prices, the risk of deleveraging and a more austere consumer seems real. This is likely to see tougher times ahead for more consumer facing sectors, and why the key variable to monitor has now become the unemployment rate.

As the virus starts to recede and economy reopens we expect to emerge into a world that will change in many respects. The economic fallout is likely to see unemployment rise, exposing vulnerabilities and imbalances and growing bifurcation in sector and company performance.

From a bigger picture perspective, in thinking through the implications of COVID-19, it's important to recognise the virus has been the catalyst for massive central bank and government intervention and effectively the introduction of radical 'Modern Monetary Theory' (MMT) or 'Helicopter' style policies. The big question for investors is whether this shift in policy is temporary and will be reversed as the crisis recedes, or becomes more permanent and is the beginning of the end of the last three decade long deflationary cycle. To put a not too finer point on it, if it proves more permanent, the implications are likely to be profound and potentially much more dramatic than what happened during the 2008 GFC, which we discuss at further length in this report.

## Portfolio positioning

If the recession is short-lived and economic activity rebounds strongly in two quarters then the current opportunity for buying stocks looks good. But there is currently no way to make a prediction about this with conviction given the uncertainty that still prevails. Being too early can be as bad as being too late, with the risk things can stay volatile and the bottoming drawn-out.

There is a need, however, to have an action plan and ensure we 'never waste a good crisis', and capitalise on being greedy when others are fearful. The sharp sell-off in the market, means almost every company is on sale, and provides the opportunity to upgrade our portfolio into quality companies that have previously screened well, but fallen down on valuation and lacked the required margin of safety.

During the quarter we added Seek on the market sell-off and exited positions in Huon Aquaculture, Virgin Money, Phoslock Environmental Technologies.

In the March quarter the SGH20 portfolio returned -20.76% after fees, outperforming the ASX300 Accumulation Index by 2.65%. The fund held 10.0% cash at end of the quarter.

	3 Month %	6 Month %	1 year %	3 years % p.a	5 years % p.a	7 years % p.a	10 years % p.a	Inception % p.a
SGH20 (after MER)	-20.76	-17.72	-13.13	1.25	3.63	4.90	4.16	8.61
S&P/ASX 300 Accum. Index	-23.41	-22.86	-14.53	-0.59	1.39	4.70	4.80	6.39
Value added (after MER)	2.65	5.14	1.40	1.84	2.24	0.20	-0.64	2.22

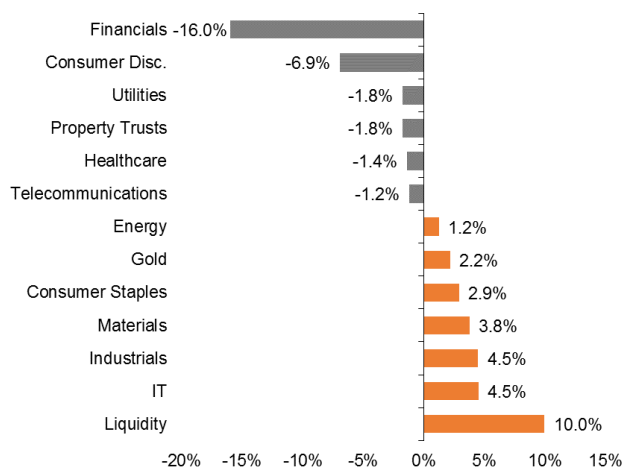
## March 2020 Quarter - Portfolio Performance & Characteristics

Top 3 Active Holdings	Portfolio Breakdown		Top 3 Portfolio Attribution	Bottom 3 Portfolio Attribution
NextDC	Materials	23.0%*	Next DC	Woodside Petroleum
A2 Milk Company	Industrials	12.9%	A2 Milk Company	Macquarie Bank
Saracen Minerals	Financials	12.4%	CSL	ANZ Bank

\*incl. 5.1% in Gold

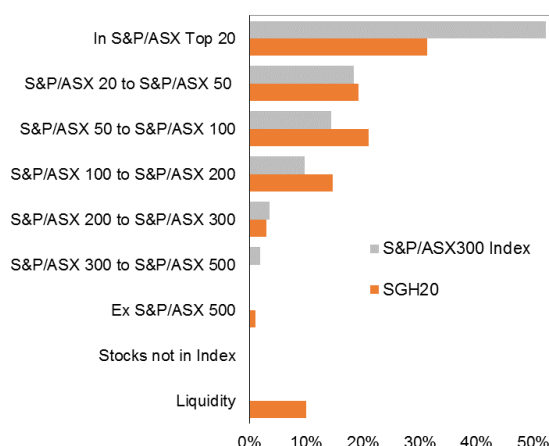
**Figure 1: SGH20 Sector weights relative to ASX300**

Our bottom-up stock analysis and structural views is evidenced in our deviation from the index



**Figure 2: SGH20 Market cap weights relative to ASX300**

Material underweight to the top ASX20, offset by a large overweight to mid-cap stocks



**Figure 3: SGH20 Portfolio Characteristics**

Superior Return on Equity (ROE) to the index with stronger growth (EPS) and trading on a similar valuation multiple

	Sales Growth		EPS Growth		DPS Growth		Yield		PER (x)		ROE	
	FY20/FY19	FY21/FY20	FY20/FY19	FY21/FY20	FY20/FY19	FY21/FY20	FY20	FY21	FY20	FY21	FY20	FY21
SGH20 Portfolio	6.6%	8.1%	0.5%	6.5%	-10.8%	4.9%	2.8%	2.9%	16.7	15.3	14.3%	13.7%
ASX 300 Index	2.8%	5.0%	-7.2%	4.0%	-17.2%	10.2%	3.8%	4.3%	16.4	15.7	10.7%	12.8%

Source: Bloomberg, SG Hiscock

**Figure 4: \$10,000 invested since inception in SGH20**

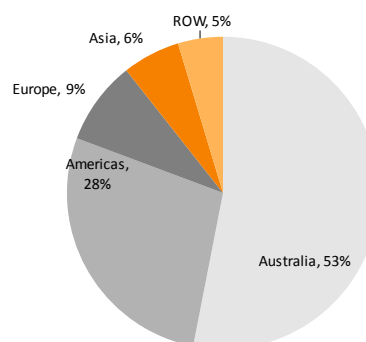
SGH20 has a long track record of adding alpha



Source: SG Hiscock, Bloomberg

**Figure 5: SGH20 Portfolio exposure by revenue**

Portfolio currency exposure



America's includes Canadian and Latin America revenues  
Gold and commodity revenues in USD

## Market Observations

### Managing Radical Uncertainty

***"Uncertainty must be taken in a sense radically distinct from the familiar notion of Risk ... and there are far-reaching and crucial differences in the bearings of the phenomena depending on which of the two is really present and operating"***

*Frank Knight, 'Risk Uncertainty and Profit'*

The extraordinary volatility and dislocation we have seen reflects the 'Black Swan' nature of the COVID crisis, which Nassim Taleb is famous for characterising "as a rare event that cannot be predicted from empirical observation, by virtue of the fact it is rare". The fact that such events cannot be precisely defined and measured, and statistical and probability analysis cannot deal with them, is what leads to 'radical uncertainty', and why equity markets are in their current funk.

Amidst such uncertainty, making predictions about the economic and market outlook becomes extremely difficult, boarding on futile. The unpredictable and unique nature of the shock to the system means there is no data set to draw upon and, nobody really knows how things will play out over the coming months and year ahead.

Mervyn King (the ex Bank of England Governor) and John Kay in their very timely recently released book, *'Radical Uncertainty: Decision making for an unknowable future'*, suggest that in dealing with 'radical uncertainty' it is "better to be roughly right than precisely wrong" and promote using rules of thumb and parables to help organise decision making.

To this end, looking at the history of financial crises provides useful lessons to help in navigating how events could play out and mapping a path forward.

In a recently note titled *'Coming Full Circle'*, by colleague Harry Cator, looking back at history and studying the narrative and parables from prior crisis has identified 4 basic steps that we see as helping navigate through a crisis:

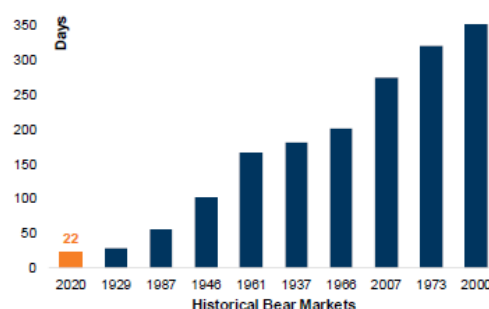
1. Understand the causes and key drivers of the crisis as best you can;
2. Establish triggers and markets to guide you through the fog of fear once drivers have been identified;
3. Communicate these to clients, so that they have an understanding and certainty as to what we will be doing; and
4. Execute on your view and intuition gained from experience.

As a starting point it is important to recognise this is an event driven crisis, triggered by COVID-19, as distinct from a structural correction (e.g. asset bubble busting as in the GFC) or cyclical bear market (e.g. economic cycle rolling over). Event driven corrections tend to be fast and furious. Figure 6 shows this to be the fastest bear market correction on record – even faster than 1929, in terms of days for a 20% decline.

History also shows event driven recoveries tend to be faster and more exuberant than when structural or cyclical change is afoot. Goldman Sachs work looking at US markets over the last 200-years, suggests the average length of an event driven bear market is around 7 months and on average recovered to its former level within 14 months.

**Figure 6: Fast & furious: 2020 correction faster than 1929!**

*Number of days from peak to reach 20% decline*



*Source: Goldman Sachs Research, SG Hiscock*

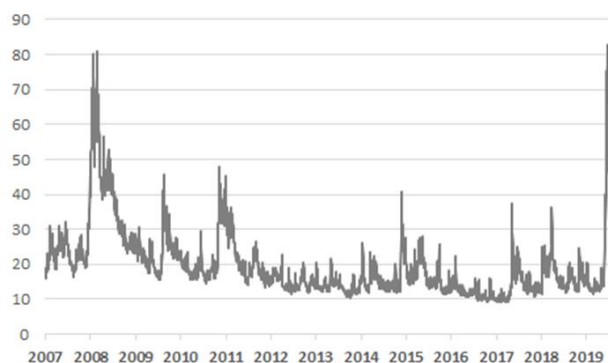
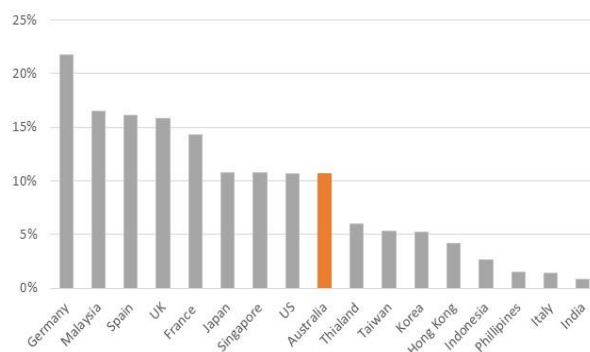
In terms of a checklist of markers to monitor to help navigate out of the current crisis we are looking for evidence that:

1. The infection rate is peaking and declining.
2. Volatility is stabilising and declining.
3. Strong coordinated policy actions at scale.
4. Valuations being more compelling

Much depends on the virus being contained and whether an effective vaccine or treatment becomes available within a reasonable timescale. This remains an open question, but one we are monitoring closely. The key determinants of the success with which different countries are dealing with the virus seems to come down to 1) the extent of lockdown, isolation and social distancing enforcement and compliance 2) border enforcement and travel restrictions; and 3) degree of testing. Australia appears to have been proactive on these issues, and consequently managed the crisis reasonably relatively well.

In March, the Chicago Board of Exchange Volatility Index (VIX) spiked to 83, which as Figure 7 shows is higher than the nadir of the GFC. There is a lot of fear priced into markets. We need to see this stabilise to determine whether we have hit bottom. A period of the VIX travelling around 50 but below its recent highs would start to suggest some bottoming out in markets and return in investor confidence.

With lockdown the only real tool Governments have to manage the virus in the absence of a vaccine, policymakers have had to act aggressively to limit the economic damage. All Governments and Central Banks of the largest economies are alert to the fact they 'must do whatever it takes' to avert a deep, prolonged recession. Central banks, including the RBA, are flooding the system with liquidity and taking extraordinary actions to ensure the financial system continues to function. Meanwhile, fiscal caution has been thrown to the wind with

**Figure 7: VIX index spikes to record high in March. We need to see it stabilise below 50****Figure 8: Fiscal stimulus package announcements as % of 2019 GDP for selected countries**

Source: Bloomberg, Goldman Sachs, Government announcements, SG Hiscock

massive government stimulus in many countries, including Australia where policy initiatives now total greater than 10% of GDP, making it the largest fiscal package in the nation's history. This is aimed at providing relief and helping save jobs and businesses facing a cash flow crunch as the lockdown restrictions bite. While this will not prevent a recession, and there will be failures and fallout, it does help and will minimize the downside risks and support the eventual rebound when the virus does subside.

Valuations have tended not to be the trigger for a recovery in past corrections, but are a necessary condition. Equity valuations have improved as a result of the collapse in prices, but we are yet to see consensus earnings fully recalibrated. One thing is for certain, with all major economies facing the biggest contraction in economic activity in modern times, the downgrades in company earnings over the coming quarters will be mind-numbingly bad.

Economic estimates for the drop in Australian GDP in the second quarter range as high as 10% quarter-on-quarter, and -40% on pcp, before expectation of some stabilisation in 3Q and recovery in 4Q this calendar year. This is expected to translate to cuts to consensus earnings for the ASX200 in the range of 25% to 30% in FY2020, with cuts as high as 75% in 2Q and 20% in Q3 on pcp.

Large dividend cuts can also be expected given the size of earnings revisions. A number of ASX companies have already deferred and cut dividends to preserve cash and bolster working capital, and it is inevitable there will be more. Risk is some companies who have benefited from regulatory and Government assistance will also be required, or restricted, in how they return capital to shareholders (the price for salvation). In the US we have already seen companies prohibited from paying dividends or undertaking buybacks for 12 months if they have taken Government money. Pay-out ratio limits have also been imposed on UK and European banks, and closer to home New Zealand banks, to ensure they withhold more capital and keep lending happening. APRA's letter of advice to domestic financial institutions to consider voluntarily limiting their dividends is a softer approach, but

may we expect will come with a stick if the banks are not seen to be acting in the spirit of things.

### Exiting from the virus and road ahead

When the virus starts to recede and economy reopens we expect to emerge into a world that will change in many respects. The economic fallout is likely to see unemployment rise, exposing vulnerabilities and imbalances and growing bifurcation in sector and company performance.

In Australia, following nearly three decades of uninterrupted growth, and given the rise in household debt levels and house prices, and muted wage growth, the risk of deleveraging and a more austere consumer seems real. This is likely to see tougher times ahead for more consumer facing sectors, particularly discretionary retail, consumer credit and tourism and leisure, which also remains captive to how quickly travel restrictions and border controls are relaxed. We are avoiding these sectors and currently have no exposure to companies in this space. We also expect the banks and retail landlords to face tougher times and, consequently been reducing holdings in these areas.

With the country in lockdown, most people working from home and education moving on-line, information technology, data and connectivity have never been more important. Data usage activity has spiked as has demand for internet and software as a service solutions. If you hadn't heard of Zoom 6 weeks ago, you almost certainly have now, and most likely been a user with the number of daily active users having jumped from 10m to 200m in the three months. We see datacentres and companies providing fibre connection as big beneficiaries now, but also going forward as businesses reassess their future business continuity plans, and we all have a greater appreciation of the ability and flexibility in working remotely.

Other sectors and businesses which we expect to survive and thrive are those exposed to:

- Infrastructure spending and financing. Initial government fiscal stimulus measures have focused on building a bridge to save jobs and businesses. The next phase is likely to be spending on job creation and private public partnerships.
- Essential goods and services. It goes without saying non-discretionary goods will continue to be in demand. However, we expect market leaders will cement their positions and likely take share from weaker players.
- Health and aged care, which remain supported by strong underlying demographic trends, particularly aging of the population through the burgeoning 'baby boomers'.

From a bigger picture perspective, in thinking through the implications of COVID-19, it's important to recognise the virus has been the catalyst for massive central bank and government intervention and effectively the introduction of radical 'Modern Monetary Theory' (MMT) or 'Helicopter' style policies.

Back in our March 2019 Quarterly Commentary we first discussed the potential for MMT and 'Helicopter money' policies. With traditional monetary policy increasingly looking exhausted as a result of interest rates pushing on their lower zero bounds, central banks reluctant to enter the world of negative rates, and growing political pressure around inequality we asked "Is MMT next?" It seems our question has been answered.

MMT policies, like we have seen announced over recent weeks, effectively result in direct monetisation, where central banks print money and government treasury puts it directly in the hands of consumers and businesses. In effect it is a merging of monetary and fiscal policies with central banks committing to finance government policies.

The big question for investors is whether this shift in policy is temporary and will be reversed as the crisis recedes, or becomes more permanent and is the beginning of the end of the last three decade long deflationary cycle. The introduction of quantitative easing in response to the GFC was initially seen as temporary, but the moral hazard of winding it back saw it become more or less permanent. We suspect a similar risk exists this time. To put a not too finer point on it, if this proves the case, the implications will be profound and much more dramatic than what happened during the 2008 GFC. Whilst the initial impact of the virus will likely be highly deflationary as velocity of money falls with the financial shock, in the longer term it will be reflationary (inflationary) if broad money supply increases on the back of money printing by central banks without the offsetting gain in productivity. This would have major implications for all financial assets and returns, most acutely bonds, but equities as well despite the fact they would be expected to outperform materially in a relative sense.

## Action plan to navigating COVID-19

***"Slumps are experiences to be lived through and survived with as much equanimity and patience as possible. Advantage can be taken of them more because individual securities fall out of their reasonable parity with other securities on such occasions, than by attempts at wholesale shifts into and out of equities as a whole."***

*John Maynard Keynes*

If the recession is short-lived and economic activity rebounds strongly in two quarters then the current opportunity for buying stocks looks good. But there is currently no way to make a prediction about this with conviction.

The case for a strong recovery is the rate of infection declines, medical advances are made, and the benefits of the stimulus start to kick-in and, pent up demand drives a sharp return in growth. If the virus proves more protracted, the risk is the current cash flow and liquidity crisis turns more into a solvency crisis with stresses in credit markets leading to increased company failures and associated job losses. This would also see consumers and businesses left with greatly weakened balance sheets. It also needs to be considered that consumers may emerge from the crisis more cautious, fearing a return of the virus, with a reluctance to consume and return to pre-existing consumption patterns.

Over the coming months we believe the stock market still has to cross its "valley of death", which includes companies pulling their earnings guidance, a raft of very bad economic numbers, cuts or suspended dividends and emergency capital raisings. To facilitate these emergency capital raisings the ASX has quickly changed its rules to allow companies to issue up to 25% of their share capital without a shareholder vote and conduct very dilutive rights issues, punishing small shareholders. This also means that although the investor panic seems now over, for the short-term the effects of the panic are not.

Faced with such uncertainty, it is hard to make aggressive bets on how things may play out in the economy or markets. No modelling will help provide a definitive answer, because no model can predict human behaviour in a crisis.

Being too early can be as bad as being too late, with the risk things can say volatile and the bottoming drawn-out.

There is a need, however, to have an action plan and ensure we 'never waste a good crisis', and capitalise on being greedy when others are fearful.

The sharp sell-off in the market, means almost every company is on sale, and provides the opportunity to upgrade our portfolio into a number of higher quality companies that have previously screened well, but fallen down on valuation and lacked the required margin of safety.

Because timing the recovery remains uncertain, and with it trying to pick the bottom in markets, we are participating prudently and looking to average in and:



1. Build positions in higher growth companies that are structural leaders and typically trade at significant valuations premiums, but currently discounted.
2. Invest in companies which will emerge stronger from the crisis with a better sustainable market position and competitive advantage.
3. Buy deeply oversold, large, liquid quality cyclical stocks that will benefit as the cycle turns; and
4. Remove companies that will struggle to recover from the COVID-19 crisis without Government intervention, or are likely to suffer longer term structural issues as a result.

## Portfolio Commentary

*"It's the nature of stock markets to go way down from time to time. There's no system to avoid bad markets. You can't do it unless you try to time the market, which is a seriously dumb thing to do."*

Charlie Munger

For the quarter the portfolio was down -20.6%, but outperformed the ASX300 Accumulation benchmark by 2.85%.

In the quarter we added **Seek Limited (SEK)**, which discuss further later in this report, after the company pulled back sharply on the market sell-off. We also exited positions in **Huon Aquaculture (HUO)**, **Virgin Money (VUK)** and **Phoslock Environmental Technologies (PET)**, as we looked to manage risk around liquidity, company balance sheet strength and impending implications from the COVID-19 crisis.

**NextDC (NXT)** (+36%), **The A2 Milk Company (A2M)** (+16%) and **CSL** (+8%) outperformed strongly in the quarter experiencing strong demand for their services/products despite the impact of the Coronavirus.

**NextDC (NXT)** has seen a fivefold increase in data traffic as the country has moved to lockdown and moved to work from home on mass. The company also delivered a very strong interim result in February with revenues up 13% and EBITDA 21%. Its enterprise business continues to perform very well with sales of 1.3MW in the half, and during the quarter announced a material contract win at its M2 facility in Melbourne. Whilst contract wins by their nature can be lumpy, and frustrate the market when they don't materialise as and when they would like, it is pleasing to see the broader thesis around the growth in data and demand for data centres including structural shift to the public cloud continue to play out, and validated through the recent wins.

We were also encouraged to see the recent sale of AirTrunk, a competitor to NextDC in the Australian datacentre market, to Macquarie Infrastructure & Real Assets (MIRA) for \$3bn, an implied EV/EBITDA multiple of at least 30x. We view NXT as a better quality business than AirTrunk with superior sites and more exposure to the enterprise market which has better economics than the more competitive wholesale market. We continue to see a long pathway of growth for NextDC over

multi years, making it in our view one of the clearest long term structural growth stories listed on the ASX.

**A2 Milk (A2M)** was one of the best performing stocks during the February reporting season delivering an impressive 31% revenue growth and 21% net profit growth. Management guidance remained positive "anticipating strong revenue growth" in FY20 across all key regions and, they highlighted revenue growth has been above expectations at the start of 2H20 despite the impact of coronavirus in China and the disruption to local supply chains.

The strength of the China segment which reported revenue growth up +77% and EBITDA +60% in the half was particularly impressive, and supports the view we formed on the back of our China visit last October, that A2's position in the Mother & Baby store channel and CBEC (China's official online) channel is strong and improving as they win share and are relying less on the Daigou (unofficial online) channel. Overall, we see the business continuing to have strong momentum and the shift in strategy in China appears to be paying dividends.

**CSL** continued to perform strongly, and finished the quarter as the largest company on the ASX by market capitalisation. A combination of the scarcity of large cap growth stocks, strong underlying company fundamentals, positive earnings revisions and track record of execution are providing positive tailwinds in the current low growth environment.

In its core IVIG business **CSL** is the lowest cost producer in a global oligopoly, where underlying demand over the last three decades has been growing on average at around 8% p.a. It is hard to think of another market that has grown at this pace so consistently for so long. Normally one would expect competition and supply side response to erode returns, but it remains a feature of the industry that inventory levels are low as **CSL's** competitors have failed to invest or misexecuted over many years, resulting in the IVIG market remaining tight. In contrast **CSL** has been very focused, executed superbly and invested ahead of the curve to capitalise on the growth opportunities.

To justify the current share price requires ascribing around 30-40% of the valuation we have on the R&D portfolio and growth options including **CSL112** (its acute coronary syndrome, heart attack drug candidate in Phase 3 trials), transplant and growth in HAE franchise and recombinant haemophilia sales. The confidence one can have in these earnings is implicitly lower given the nature of risk that they may not materialise, hence we discount the value based on a probability of success. We should have some catalysts over the next 12 to 18 months which will help provide some better colour on whether these growth options will or will not be more likely. Success, particularly in **CSL112**, would help underpin the current valuation premium, but any disappointment is not priced.

Given the strong share price run and multiple expansion the margin of safety has fallen. We continue to believe **CSL** is one of the best positioned businesses in Australian market for long term growth, and in the time we have been following the company its core IVIG business has never been better positioned and optionality in the R&D portfolio never been

better, but we have used recent price strength as an opportunity to take some profits.

**Saracen Minerals (SAR)** also continued to perform strongly during the quarter on the back of the rising gold price and improving underlying company fundamentals as it continues to grow production at its existing assets and through the recent acquisition of 50% of the Superpit. During the quarter Saracen released its 2Q production results which reaffirmed it is on track to deliver production in excess of 500koz in FY20 and +600koz in FY21. We believe there is potential for Saracen to further revise up its FY21 production guidance as they work through the details and production plans for the Superpit with Northern Star, who purchased the other 50% that Saracen didn't own in December. We view the coming together of two likeminded owners with underground mining expertise and track of growing production and mine life at their respective operations as very positive. It should provide the opportunity to significantly lower the hurdles to invest and grow the Superpit asset, overcoming many of legacy ownership issues which have prevented the full value of this asset being developed.

**Treasury Wine Estates (TWE)** was a major detractor from portfolio performance during the quarter, following a disappointingly surprise trading update and pre-release of its interim results, and then subsequently withdrawing its guidance given uncertainty around how COVID-19 will impact its China business. The downgrade was primarily driven by the US business and the commercial wine (\$5 to \$10 category) portfolio where earnings are expected to decline ~25% due to execution and market issues relating to oversupply and heavy industry discounting to clear stock following the strong US 2019 vintage, and drop in export demand on the back of US-China tariff increases.

TWE has been a long standing portfolio position, which has added significant value through the shift to a more premium brand strategy and focus on growth in China. The downgrade is particularly disappointing given its surprise nature and fact it reflects in part internal issues around management changes and an emergence of legacy issues in the US commercial wine business which had supposedly been addressed. We do think the changes TWE has made in its US distribution model will in time add value, and some of the issues were outside the company's control and one off in nature. But the supply side shock is a reminder of the underlying agricultural risk in business, and raises some questions around the improved predictability in earnings management have emphasised under the change in strategy.

**Reliance Worldwide (RWC)** reported a disappointing result with revenues slightly softer but costs significantly higher than we anticipated. The softer revenue performance was largely expected given the Americas was cycling a tough comp in the prior period, Asia Pacific was impacted by the residential downturn in Australia and EMEA suffered from Brexit and broader macro softness in continental Europe. However, the step-up in cost suggests the investment in new products is higher than we had previously assumed, and it begs the question whether Reliance can now generate the sales required to support the additional investment.

The severe reaction in the share price seems a reflection of another earnings miss and the fact the market is still trying to understand the underlying sales growth rate in the business. In the initial public offering in April-2016 it was sold as a mid-to-high teen's growth story. It is clear this was too optimistic, the subsequent correction provided an opportunity for us to enter the stock. Further earnings disappointment has seen the company priced as a low single digit growth business. We think the truth lies somewhere in between and the company can continue to grow through penetration in its core push-to-connect fittings market, albeit below the rates it was when it rolled out to Home Depot and Lowes in the US. In addition, there are also opportunities for the company to broaden its supply of Holdrite and John Guest products within its existing distribution network, in addition to exploring new opportunities in the repair & remodel, commercial, and remodelling segments.

Late in the quarter the collapse in the oil price also saw portfolio stocks in the energy sector (**Woodside Petroleum (WPL)**, and **Cooper Energy (COE)**) materially underperform the broader markets.

Overall, despite the big falls in prices, we think our portfolio is in good shape. At present, we have a well-diversified portfolio, and the balance sheets of our companies we hold are in sound shape. Although, this didn't stop Carbon Revolution, one of our portfolio investments, which had over \$20m of cash on its balance sheet and undrawn credit facilities, doing an emergency capital raising in the height of the panic during the quarter. We are expecting more companies will look to fireproof their balance sheets. As a result, we have been contacting company management to assess their ability to "ride-out" the turmoil and evaluate the effects of the economic shut-down on their business. Further, we hold no portfolio exposure to many of the industries that we think will suffer long-term effects or headwinds from COVID-19 including, discretionary retail, travel, consumer finance, education, hotels, media, private equity and venture-capital.

Finally, many company share prices have fallen more than 40% over the last six weeks, we believe that some outstanding investment opportunities have appeared. We also think there will be many opportunities to participate in company recapitalisations. We are not in a hurry, but opportunistically we will look to take advantage of these and re-balance and selectively upgrade the portfolio to where we can make money.

## Portfolio - Process & Structure

### Strategy

- Benchmark unaware and high active share
- Allocate capital to best large, mid-cap and small company opportunities using our proprietary 'quality' framework
- Portfolio of uncorrelated stock specific stories
- Disciplined repeatable process to stock selection and portfolio construction
- Limited capacity

### Process

**SGH20 aims to provide long-term returns above the ASX300 Accumulation Index through:**

- Long only, concentrated portfolio (15-25 stocks)
- Focus on capital preservation and absolute returns
- No leverage, derivatives or shorting
- Small team leveraging SGH's well-resourced research platform

We invest in quality businesses that are able to sustainably grow earnings and free cash flow at a sensible price. We look for companies that have:

- A competitive advantage and are well positioned in large growing end markets with tailwinds
- Engaged, focused, and innovative management
- An acceptable margin of safety to intrinsic value

### Structure

The Fund portfolio is structured around sector diversification and company lifecycle groups which includes:

#### 1. **Structural compounding** (37% of the portfolio)

- Have a competitive advantage through a unique product or service, or brand which gives them a dominant position and/or ability to take market share in large attractive end markets
- Superior growth and their earnings power persistence tends to be underestimated, providing the potential for excess returns.
- Currently, companies we focused on and exposed to include:
  - Health & wellness (CSL)
  - Big data and on-line platforms (NextDC, Carsales, Seek)
  - Changing consumption & rising emerging market incomes (Treasury Wine Estates)
  - Urbanisation & innovative building solutions (James Hardie, Reliance Worldwide)

#### 2. **Stalwarts** (29% of the portfolio)

- Well positioned in attractive end markets with high barriers to entry which are hard to disrupt and replicate, and often exhibit strong pricing power providing strong free cash flow and dividends.
- Currently, we are focused on:
  - Stalwart industrials (Ampcor, Orora)
  - Bond proxies (GPT Group, Unibail-Rodimac-Westfield)

#### 3. **Quality cyclicals** (20% of the portfolio)

- Looking for a step change in growth through leverage to a cyclical upswing with multi year earnings momentum.
- Important to align with experienced management and companies with a strong balance sheet which sit low on the cost curve and have operating leverage to the cycle
- Cyclical themes and stocks we are focused on:
  - Urbanisation & critical infrastructure (Seven Group Holdings, Lendlease, Macquarie Bank, Rio Tinto)
  - War on pollution & LNG (Woodside Petroleum)

#### 4. **Emerging companies** (4% of the portfolio)

- Entrepreneurial or emerging businesses growing and benefiting from developing strategic assets in new markets, innovative business models or disrupting incumbents.
- Typically smaller investments and based around an 'up or out' view where we increase position sizing as our conviction builds or exit.
- Currently, we are focused on:
  - East coast gas and energy crisis (Cooper Energy)
  - Innovative Technologies (Carbon Revolution)

At the end of the period, the portfolio held 10% cash.



## Company & Industry Insights

*Research insight is critical to our investment decision making process. As part of this we undertake an extensive company visitation program and reading to develop our thinking and highest conviction idea. Here we provide some of our recent insights*

### Seek (SEK): Buying into a quality franchise on sale

**"A great company is not a great investment if you pay too much for the stock"**

*Benjamin Graham*

Since listing in 2005 as an Australia & New Zealand (ANZ) online classified job advertising board, Seek has significantly expanded its geographic markets and product depth. Seek operates online employment websites in many countries the key regions being ANZ, Asia (Hong Kong, Malaysia & Singapore the key countries) and China. It has also broadened its service offering from online job boards to include talent sourcing/placement, online education and a portfolio of start-up investments in employment related fields.

The Seek business generates ~50% of earnings from the ANZ business, ~17% from Asia, ~27% from China and the balance across a combination of other businesses.

Domestically, Seek enjoys the benefits of a network effect, which provides a strong competitive advantage and leading market position. The network effect is a result of the more employment ad listings on the Seek's website driving more eyeballs (audience), which attracts more employment ad listings and more eyeballs. The virtuous circle of listings driving more inventory and in turn more eyeballs (as detailed in Figure 9) is what gives Seek its competitive advantage.

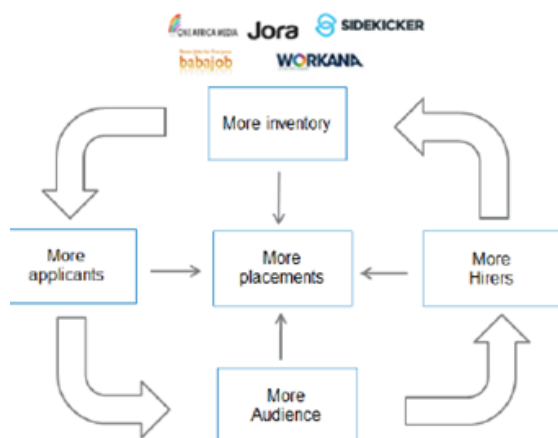
In Australia, Seek has ~300K listings close to 3 times (indeed) and 6 times (Linked in) its nearest competitors. In addition, it has ~14m candidate profiles covering 85% of the labour market with a strong leadership position over competitors in both hirer and candidate numbers. This makes its website attractive to both parties, and explains why it can charge a material price premium for employment listings.

The ANZ business charges clients on a minimum spend per month basis with rolling 12-month contracts and revenue is approximately split across Small to Medium Enterprise (SME, 40%), Corporates (35%) and Recruiters (25%). While the Asian countries operate a similar business model to ANZ, Seek China (Zhaopin) is differentiated by the fact it has moved from a pay per ad model to a 'freemium' model in the last three years, as Seek has looked to accelerate its network effect and entrench its competitive advantage. Under the 'freemium' model Seek provides 10 free listings and only charges for ads in excess of this, or where clients refresh listings or purchase the premium service.

Seek's nearest competitor 51job has taken a different strategic direction and decided to aggressively monetarise job ads. This has seen 51job grow revenues quickly, but volumes and the number of candidates and hirers decline relative to Seek. While on the face of it, this seems counter intuitive as it appears to compromise 51job's longer term growth prospects, it seems a deliberate strategy to try and focus on the large multinational company market.

Importantly for Seek, the divergent strategic approaches has provided the opportunity for it to cement its competitive position in China. With a ~2 times lead in hirers (SMEs) and ~1.5 times lead in candidates to its nearest competitors, Seek is now approaching a position where it will be able to increase prices. This should help drive an uplift in revenue and margins, whilst continuing to grow volumes. There are approximately 80m businesses in China, of which ~8m are online, and Seek has ~800,000 hirers providing a large opportunity to continue to penetrate the market and grow share.

**Figure 9: Seek's 'network effect' drives a sustainable competitive advantage**



Source: Company presentations, SG Hiscock

**Figure 10: Seek's market opportunity pipeline is large**



Domestically, Seek is also looking to better align its price to value with clients. Given the significant investment in technology Seek has made, it believes it has the capability to migrate from a minimum monthly spend model to a more dynamic model charging based on supply and demand. This has the benefit of reducing recruiter discounts and improving yields, even after adjusting for some expected decline in volumes.

Seek's investment in technology has also allowed it to create a suite of new depth/premium ad services which yield higher prices (and margins), and there is the potential to leverage this across geographies, specifically Asia, as these markets develop.

In addition to the growth opportunities mentioned, Seek has a number of investments in start-up companies which

management term Early Stage Ventures (ESV). These are based around a number of key themes and large market opportunities including online education, human resources software as a service (SaaS), and contingent labour, which have an estimated total market revenue opportunity in excess of \$50bn (see Figure 10).

Seek's business will not be immune from the impact of COVID-19 and expected decline in job listings from economies being locked down and rise in unemployment. However, we believe these cyclical headwinds only defer the longer term growth opportunities and, do not impair them. We therefore see the recent price correction as an opportunity to buy a high quality company with very strong competitive advantage, significant domestic/international growth opportunities and high quality management team at an attractive margin of safety and significant discount to our assessed intrinsic value.

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