LONGWAVE AUSTRALIAN SMALL COMPANIES FUND

A CLASS REPORT ARSN 630 979 449

LONGWAVE CAPITAL

MONTHLY REPORT MARCH 2021

FUND PERFORMANCE TO 31 MAR 2021

	1M	3M	6M	1yr	3yr p.a.	5yr p.a.	SI³p.a.
Net Fund Performance[1]	2.2%	0.4%	12.8%	53.2%			8.5%
Benchmark Performance[2]	0.8%	2.1%	16.2%	52.1%			8.9%
Excess Return	1.5%	-1.7%	-3.4%	1.0%			-0.5%

1. Return net of 0.89% p.a. management fee. **2.** S&P/ASX Small Ordinaries Accumulation Index. **3.** Inception date: 31 Oct, 2019. Past performance is not a reliable indicator of future performance.

The Longwave Australian Small Companies Fund increased by 2.2% during March 2021, outperforming the 0.8% increase in the S&P/ASX Small Ordinaries Accumulation Index benchmark by 1.5% over the month.

IF

We spent some time in March trying to understand the investment case for some of our biggest market disagreements. Stocks where we struggle to understand the investment merit – to the extent we see the stock trading at multiples of fair value based upon what we think are reasonable expectations.

Having talked with management, other investors and sell side analysts during March our observation is that our difference in view comes down to one critical word.

If

> If current industry growth rates can continue for the next five years or more.
> If the company can hold onto or increase market share.
> If new competitors can be prevented from entering the market.
> If new products and services can be sold to existing customers.
> If customers seamlessly transition from a one-off payment to subscriptions.
> If churn can stay low as high customer acquisition costs are reduced.
> If significantly higher revenues can be sustained from the current cost base.
> If capital markets can keep funding near term negative cash flows.

Put all these "ifs" into your excel model, and you may (*may*) get a valuation close to the current share price. For our largest disagreements, almost all of these "ifs" need to happen as the value priced into these companies resides in the distant future.

INVESTING WITH REASONABLE AND RATIONAL EXPECTATIONS

We try and consistently model across our opportunity set based upon what we think are reasonable and rational expectations. We are not kidding ourselves here – both are guesses at the future – however we need to consider the potential for both good and bad outcomes and give some thought to base rates and truly sustainable advantages in the face of strong competition. "If" statements seen above tend to consider only the most favourable outcomes and ignore the reality that sustaining high levels of profitability in highly competitive markets is far harder and more scarce than is currently assumed.

Two recent examples of what we think are reasonable expectations in forecasting:

Firstly, Brickworks when commenting on their 1H 2021 result said that they expect to put prices up 2-3 times this year. They expect price increases to be in the order of 8-10%. This is not certain but given currently operating plants are running at 100% capacity, given a forward order book where demand has increased sharply and given a monopoly or duopoly structure in brick manufacturing across Australia it is probably reasonable.

Another example comes from Newscorp. They made two small acquisitions during March – Investors Business Daily (IBD, US$275m) and Houghton Mifflin Harcourt Books & Media Segment (HMH Books & Media, US$349m). Financial details for IBD were not disclosed however for HMH Books & Media they are paying 13x F2020 EBITDA. After an expected US$20m of synergies given overlap with their existing HarperCollins publishing business this could be an attractive deal. How much of these savings are in operating costs vs plant and capital efficiency was not detailed.

TOP 10 HOLDINGS

Name (Alphabetical)
Brickworks Ltd
CSR Ltd
Harvey Norman Holdings Ltd
Iluka Resources Ltd
Janus Henderson Group PLC
News Corp
Metcash Ltd
Spark New Zealand Ltd
Technology One Ltd
Viva Energy Group Ltd

FUND AND BENCHMARK SECTOR WEIGHT (%)

	Fund	BM²
Communication Services	8.4	5.7
Consumer Discretionary	19.8	17.3
Consumer Staples	6.5	7.1
Energy	4.3	2.3
Financials	16.2	13.3
Health Care	3.2	6.7
Industrials	6.4	6.4
Information Technology	8.5	7.4
Materials	19.9	21.2
Real Estate	4.2	12.6
Utilities	0	0
Cash	2.7	0.0

STOCK ATTRIBUTION (ALPHABETICAL)

Top 5 - Contributors
Brickworks Ltd
Harvey Norman Holdings Ltd
News Corp
Premier Investments Ltd
Zip Co Ltd

Bottom 5 - Detractors
Cleanspace Holdings Ltd
IGO Ltd
Sims Ltd
Vocus Group Ltd
Western Areas Ltd

CONTINUED

There are no certainties but given 60% of the HMH Books & Media revenues are generated by the backlist (titles such as The Lord of The Rings, Curious George, Animal Farm) and that Newscorp is already in the publishing business these synergies are probably reasonable to expect and could generate well over 10% return on the capital employed in the acquisition.

DISTRACTION AND OPPORTUNITY

The market is obsessed with speculation. Building wealth deliberately over time is overlooked in the pursuit of getting rich quickly. If you felt like the speculative stocks had a pause in March (we initially thought that, given the performance of our holdings), you were mistaken. In Australia loss makers set another record, with 249 unprofitable companies over A$100m market cap – a total of A$90bn unprofitable market cap outside the ASX100 and up from 77 companies at the height of the COVID panic a year ago. We do not need to draw attention to the names, because they are what most of the market talks about incessantly.

The speculative distraction has created terrific opportunities. Real businesses generating strong returns on capital and increasing opportunities for growth. The examples of Brickworks and Newscorp are among many in which we invest.

Three months ago, we noted that relative to 1% 10 year bond yields, the small cap index and our portfolio both looked reasonably priced. This has changed quickly. 10 year bond yields have jumped to 1.8% but of greater concern the pricing of the small cap index has surged well ahead of earnings. In round terms the index 12 month forward P/E has gone from 20x to 25x and over the same three months our portfolio forward P/E has gone from 18x to 17x. If we express this in pre-tax earnings yield spread terms (relative to the 10 year bond yield) as an approximate Equity Risk Premium (ERP), the index has seen its ERP decline from 6.0% to 4.0% and the Longwave portfolio ERP has gone from 7.2% to 6.6%. For reference to large caps, the ASX 100 ERP has gone from 6.2% to 6.0%.

A small cap index ERP of 4% or less, and a small cap index ERP 200bps lower than the large cap index has each individually been uncommon historically and poor starting points for future small index returns. Seeing both simultaneously suggests investors are entering uncharted waters.

That was a complicated way of saying we remain comfortable with the differences between our portfolio and the index – both in the nature of the businesses we hold, the degree to which we can observe current cash flows and capital returns and the pricing by the market of these stocks – driven largely by the fact they remain ignored.

PORTFOLIO POSITIONING AND PERFORMANCE

For our portfolio, March felt like a brief revenge of the real businesses. The slang 20 years ago was “Smokestack Industries” today they are “Boomer” stocks. Stocks we own like Brickworks, Newscorp, Premier Investments, Harvey Norman and Janus Henderson filled out the contributors, helped by declines in some more speculative names like Zip Co, Piedmont Lithium and PointsBet Holdings. The most notable detractor was CleanSpace – a medical and industrial respiratory device manufacturer that did so well during COVID, the hangover is creating uncertainty about what a more normal revenue base looks like. Falling more than 50% once they announced just how much post COVID sales had slowed shows that even a small position (CleanSpace was less than 40bps in the fund) can hurt when market assumptions shift.

Fund characteristics	
NAV	A$1.081
Redemption unit price	A$1.0778
Inception Date	31 Oct, 2019
Minimum Investment	A$25,000
Management Fee	0.89% p.a.
Performance Fee	-
Buy / Sell Spread	0.30% / 0.30%
Benchmark	S&P/ASX Small Ordinaries Accumulation Index
Distribution frequency	Half-yearly
Portfolio FUM (A$m)	3.8
No. of Holdings:	113
Portfolio Managers	David Wanis & Jai Beathe
Strategy FUM (A$m):	178.8

INVESTMENT OBJECTIVE

The Fund aims to outperform the S&P/ASX Small Ordinaries Accumulation Index over the long term.

The Fund aims to provide long-term capital growth through investment in a diversified portfolio of high-quality Australasian small companies (outside S&P/ASX 100 Index at time of investment or expected to be within six months).

INVESTMENT STYLE

Longwave’s investment philosophy is underpinned by the belief that the stocks of high-quality small companies outperform the benchmark over time, and as such, an active approach to investing in high-quality stocks provides value to investors who might otherwise have invested passively. Longwave believes in the value of a deep and fundamental understanding of the securities in which we invest.

Signatory of:

PRI Principles for Responsible Investment

LONGWAVE CAPITAL

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