Quarterly Update

30 September 2023

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Intelligent Investor Australian Equity Income Fund (Managed Fund) (ASX:INIF)

"What the pupil must learn, if he learns anything, is that the world will do most of the work for you, provided you cooperate with it by identifying how it really works and aligning with those realities."

— Joseph Tussman

"You never know what the American public is going to do, but you know that they will do it all at once."

— Bill Seidman, the former head of the FDIC

The Fund fell 3.4% during the quarter compared to the market's 0.8% fall, and we made a few changes.

While Mike Brady was singing 'One Day in September' outside the MCG in the lead up to the AFL grand final, CEO of **Star Entertainment** Robbie Cooke was sinking the boots into shareholders again with a highly dilutionary capital raising barely six months after the previous $800m raising that was supposed to put the company on solid ground.

The second raising eliminates the company's financial problems, but it's also destroyed the company's value, so there was no point increasing our small holding with Cooke issuing shares like confetti despite not buying one himself. We sold.

Fearing that governments around the world are looking for more punching bags like Star to raise taxes we also sold **Tabcorp**. Its recent performance has underwhelmed, margins continue to be pressured across the industry due to intense competition

Performance (after fees)

	3 mth	1 yr	2 yrs p.a	3 yrs p.a	4 yrs p.a	S.I. p.a
II Australian Equity Income Fund	−3.4%	0.7%	1.3%	13.7%	7.3%	6.0%
S&P ASX 200 Accumulation Index	−0.8%	13.5%	2.3%	11.0%	5.3%	6.9%
Excess to Benchmark	−2.6%	−12.8%	−1.0%	2.7%	2.0%	−0.9%

Inception (S.I.): 18 Jun 2018

Fund overview

The Intelligent Investor Australian Equity Income Fund (ASX:INIF) is a concentrated portfolio of 10-35 Australian listed stocks. The Fund focuses on large, mature businesses with entrenched competitive advantages, and dominant smaller companies we believe will produce strong cash flows to support dividends in the future.

5+ yrs
Suggested investment timeframe

10 - 35
Indicative number of securities

Risk profile: High
Expected loss in 4 to 6 years out of every 20 years

S&P/ASX 200 Accumulation Index
Benchmark

Investment fee
0.97% p.a.

Performance fee
Nil

and increasing regulation, and the potential rewards from the equalisation of state taxes aren't enough compensation for the growing risks.

A familiar name returns

We also swapped **Woodside Energy** which is trading at fair value for **Brickworks**, which has been in and out of our portfolios over the years. Its valuation fell to attractive levels after the market overreacted to its recent result.

While the building products division is struggling, about 70% of profits come from turning exhausted quarries into industrial property and leasing them in a joint venture with **Goodman Group**. Brickworks' share of the trust's net assets is $2.2bn compared to the company's $3.9bn market value.

The property business's current rental agreements average $148 per metre, well below the current market rate of $225/m which would increase rental income by almost 50% as leases are renewed.

Over the next two years, the venture will release another 140,000m of space and twice as much again in five years. Growth from both higher rents and more space should lift cash flows materially.

Much of this growth is driven by explosive demand for industrial property that is strategically located near key roads and customers. Brickworks is also working on replicating its success in NSW – more than 90% of its industrial property assets are in Western Sydney – across Victoria. There is potentially decades of growth to come as a proven formula is repeated by one of Australia's best and most trusted managers.

Sleeping soundly?

We also added the world's leading sleep apnoea company **ResMed**. Its share price has fallen over 40% on fears new obesity drugs will drastically reduce the number of sleep apnoea patients and rival Phillips will further pressure margins by discounting its products following an expensive recall.

We believe the fears are overdone, as the drugs have numerous side effects, are expensive and need to be taken forever, and being overweight is only one cause of sleep apnoea. Any discounting should also prove temporary, as it has in the past.

Assuming we're right, ResMed's growth will help balance our much larger positions in slower growing but higher yielding stocks like **BHP** and **New Hope Corporation**, while helping fight inflation. We also increased our positions in **CSL**, **Sonic Healthcare** and **Lovisa** as their valuations became more attractive.

Reporting season

The September quarter included reporting season in August, along with some more recent operational updates.

The worst result belonged to **Alumina**, whose share price has fallen two thirds from its high five years ago. It's only redeeming feature is that its competitors are faring even worse, and it trades at one third of replacement value.

The company is doing what it can to preserve cash and, as the lowest cost producer, it will be the last man standing if industry conditions deteriorate further. In that case, industry supply will fall and Alumina's profitability should be restored, though not to the extent of our coal miners.

Last year, New Hope Corporation produced 7.2m tonnes of high-quality thermal coal. It cost about $70 a tonne to dig the coal up and get it on a ship; including royalties and blending costs, the total cost came to $113 a tonne. This is slightly lower than last year but higher than average, mostly because of wet weather and more staff working on an upcoming production upgrade.

Each tonne of production was sold for $346, with New Hope capturing a margin of $233 a tonne. Net profit came to just over $1bn with operating cash flows of

$1.5bn, supporting an interim dividend of 30cps, fully franked. For the full year, New Hope has paid out 70cps in dividends, bought back $190m of stock and $367m of dilutive convertible notes. Incredible.

Stronger for longer

It was possible because thermal coal prices continue to boom. Newcastle thermal coal prices are less than half of their peaks, but New Hope confirmed it was selling coal cargos this month for $250 a tonne. That's twice historic averages at a time when weather is benign and global inventories well stocked.

We believe the world is short on energy and limited new supply of thermal coal means prices remain higher for longer. This appears to be playing out. New Hope noted that futures prices are rising again, and it expects higher prices as global inventories are drawn down.

Higher prices are needed to offset higher costs across the industry. Fuel and labour costs remain high, and management noted the higher risk of royalties, taxes and other government intervention. The NSW state government has already confirmed higher royalties for local mines. The latest increase probably won't be the last.

Bigger, and soon

Over the next three years, the miner could double output making it one of the fastest growing coal miners on the bourse. We don't think New Hope's imminent expansion is well understood.

From Bengalla, efficiency gains and plant upgrades should grow output from 11.8mtpa (million tonnes per annum, New Hope has an 80% stake in the asset) to 13.4mtpa by this time next year. New Acland, in Queensland, is now fully approved and is now producing coal again.

Over the next three years, output from New Acland will rise to 5mtpa. New Hope will fund both the New Acland and the Bengalla expansion from operating cash flows. New Hope also owns a 15% stake in Malabar Resources, which runs the Maxwell metallurgical coal mine, a fantastic asset that should add 1mtpa to New Hope's account.

That means about 7mtpa of new capacity, all of it high quality and low cost, will hit the books in the next three years or so. Not bad for a stock trading on five times earnings.

Wesfarmers' result was better than expected with its discount brands such as K Mart benefitting from more price conscious shoppers. This trend is likely to continue but it's the potential of its lithium business that's underappreciated.

Telstra's mobile business continues to shine but investors hoping to reap a cash windfall from the previously mooted sale of its remaining infrastructure assets were disappointed when new CEO Vicki Brady changed course.

The adoption of cloud computing and AI is making these assets more useful but large investors aren't likely to pay extreme prices for predictable infrastructure assets anymore now interest rates are much higher.

Domino's share price bounced as CEO and major shareholder Don Meij suggested the company's performance was stabilising after implementing a raft of changes including cutting costs, closing stores and offering better promotions after withdrawing delivery fees.

Lastly, **MA Financial** reported a decent result. Corporate activity has slowed, but its attracting new fund investors which is where the long-term value of the business lies.

In the Appendix we'll take a detailed look at core holding **Auckland Airport**.

Please get in touch if you have any questions on **1300 880 160** or at **info@intelligentinvestor.com.au**

Auckland Airport: with planes come profits

As capacity hits a milestone, profitability returns – along with the dividend.

Key Points

- **Capacity almost at pre-pandemic high**
- **Dividend reinstated**
- **Capex and debt to grow**

With a near-total shutdown of international flights during the pandemic, Auckland Airport was one of the hardest-hit businesses on the ASX. The company quickly swung to operating losses, was forced to raise capital, and stopped paying a dividend.

This dark chapter in an otherwise brilliant company's history has come to an end. The board has reinstated its dividend – the first since 2019 – with a final dividend of 4.0 NZ cents per share. This follows the removal of payment-restricting covenants imposed by the airport's lenders during the pandemic and a dramatic recovery in passenger numbers.

Auckland Airport's new dividend policy is to pay 70–90% of underlying net profit after tax, excluding property revaluations. Management expects underlying net profit of NZ$260m–280m for the full year, which at the midpoint suggests around 15 NZ cents of dividends for a yield of 1.9%.

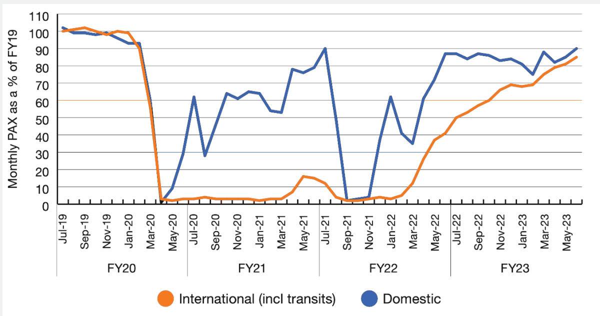
Today, tomorrow

This brings us to one of the drawbacks of focusing too much on yield: it's a 'point-in-time' measure and doesn't tell you about a company's ability to grow.

When Sydney Airport was a public company, it paid 100% of profits as dividends. Against that yardstick, Auckland Airport's payout ratio of 70–90% looks weak, but it is actually a good thing – it reflects management's ability and willingness to allocate more capital to growth projects and paying off debt.

Auckland Airport is well-positioned to grow the dividend from here. Firstly, in February last year, the airport renegotiated the interest coverage covenants on its bank facilities to allow a transitionary period between now and December 2024; the interest coverage threshold (EBITDA/ interest expense) is set to rise from 2.0 times today to 3.0 times by late 2024.

Monthly passenger volumes



Source: Company reports

That's a stricter covenant than was permitted during the pandemic but the airport has plenty of breathing room: its interest coverage ratio for the 12 months to June was 6.5, and that's despite some lingering pandemic effects. We see no reason why the airport should breach its covenants in the foreseeable future and risk another capital freeze. Management is now free to invest in growth projects as it pleases.

Almost there

What's more, domestic and international travel rebounded strongly in 2023. By year-end, international seat capacity had recovered to 90% of pre-pandemic levels, while domestic capacity was at 89% and international freight capacity at 95%.

North American services were the big draw, with many airlines expanding their routes to the continent. Capacity between Auckland and North America is expected to soon exceed 2019 levels, with a forecast 29% increase between November 2023 and March 2024 compared to the same period before COVID-19.

Asian markets were also on the ascent. Capacity between China and New Zealand had recovered to 78% of 2019 levels by the end of the year, and it's expected to reach 93% this month. Auckland's largest international market, Australia, has just about fully recovered, reaching 96% of pre-pandemic capacity. The total number of passengers tripled to 15.9 million.

As you would expect, the passenger rebound had a dramatic effect on Auckland Airport's income statement: revenue was up 108% to NZ$625.9m while underlying net profit came in at NZ$148m against last year's loss of NZ$12m.

Capex rising

An important pillar of our investment case in recent years has been that Auckland Airport owns the freehold over its 1,500 hectares of waterfront land, which adds considerable value in development potential. It's a contender for the best bit of undeveloped real estate in all of New Zealand.

This year, the book value of the company's property grew 8% to NZ$10.8bn, though that isn't as great as it seems: most of the increase was due to NZ$647m of capital expenditure on construction projects and a revaluation of certain asset classes, partially offset by a NZ$140m decline in the value of investment properties, such as hotels and commercial space, due to rising capitalisation rates.

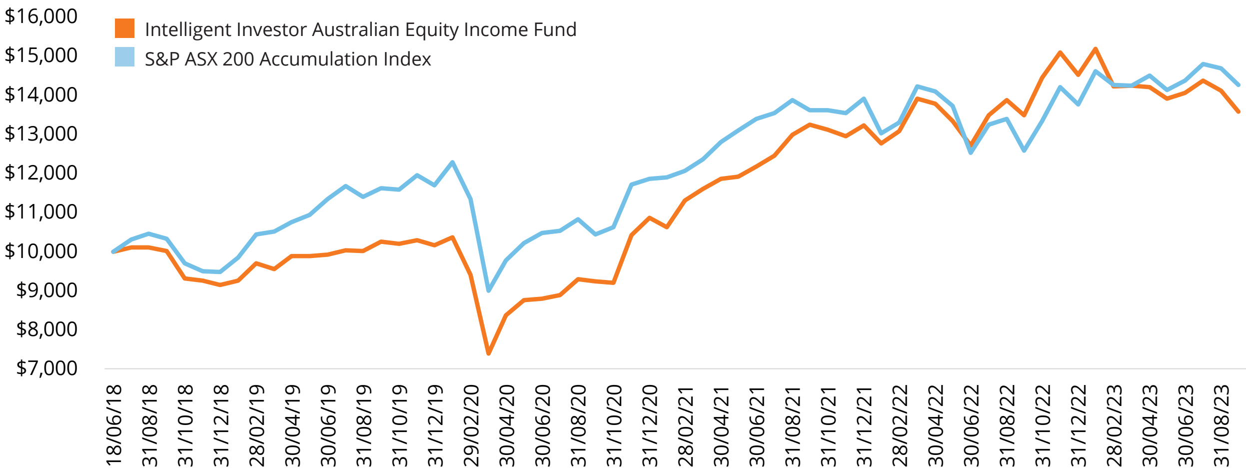
Net debt of NZ$1.6bn is manageable given operating profits are likely to pass NZ$600m in the year ahead and, as mentioned earlier, the airport is a long way from breaching its covenants again. That said, management expects capital expenditure of between NZ$1.0bn–1.4bn in 2024 as work starts on a new domestic terminal costing NZ$2.2bn and due to open in 2028 – in addition to the largest expansion of the airfield in the airport's history.

Throw in new landing stands, fuel infrastructure, a refreshed baggage system, a new transport hub, and road upgrades, and the total bill over the next decade will top NZ$5bn. Though some of that will be funded by internal cash flow, net debt will almost certainly surpass NZ$4.0–5.0bn a decade from now.

Still, as international traffic continues to rebound and aeronautical price increases kick in next year, long-term earnings growth should be capable of reaching 5–7% a year. The airport's infrastructure upgrades will accommodate 40m passengers and 260,000 flights by 2040, which will roughly triple aeronautical and retail revenue, and is expected to deliver returns on capital around the 9% mark.

We expect the current dividend of 15 NZ cents or so to reach 20 NZ cents or more within five years; total returns might come in at around 8–10% a year over the long term, which isn't bad for a business of Auckland Airport's quality and a real estate gem.

Performance since inception



Inception (S.I.): 18 Jun 2018

Asset allocation

Materials	27.2%
Health Care	12.8%
Consumer Discretionary	12.4%
Financials	9.9%
Cash	9.4%
Industrials	6.4%
Energy	6.1%
Information Technology	5.7%
Real Estate	4.2%
Utilities	3.0%
Communication Services	2.9%

Top 5 holdings

BHP Group (BHP)	11.6%
Auckland International Airport (AIA)	6.4%
New Hope Corporation (NHC)	6.1%
CSL (CSL)	6.0%
RPMGlobal Holdings (RUL)	4.6%

Fund Stats

Distribution yield	8.92%
Net asset value	$2.58

All tables and chart data is correct as at 30 September 2023