PENDAL

Factsheet

Pendal MidCap Fund

Equity Strategies

ARSN: 130 466 581

August 2019

About the Fund

The Pendal MidCap Fund (**Fund**) is an actively managed portfolio of Australian mid cap shares.

Investment Return Objective

The Fund aims to provide a return (before fees, costs and taxes) that exceeds the Pendal MidCap Custom Index over the medium to long term. The suggested investment timeframe is five years or more.

Description of Fund

This Fund is designed for investors who want the potential for long term capital growth and tax effective income from a portfolio of primarily 40-60 Australian mid cap shares and are prepared to accept higher variability of returns. Pendal defines the mid cap universe to include companies ranked between 51 and 150 of the S&P/ASX 200 Index. The Fund may also invest in equivalent companies listed on the New Zealand Stock Exchange, hold cash and may use derivatives.

Pendal's investment process for Australian shares is based on our core investment style and aims to add value through active stock selection and fundamental company research. Pendal's core investment style is to select stocks based on our assessment of their long term worth and ability to outperform the market, without being restricted by a growth or value bias. Our fundamental company research focuses on valuation, franchise, management quality and risk factors (both financial and non-financial risk).

The Fund may have assets denominated in foreign currencies. This means that changes in the value of the Australian dollar relative to foreign currencies may affect the value of the assets of the Fund. The Fund's foreign currency exposure may be hedged from time to time, in whole or part.

Derivatives may be used to reduce risk and can act as a hedge against adverse movements in a particular market and/or in the underlying assets. Derivatives can also be used to gain exposure to assets and markets.

Investment Team

Pendal's Equity team is headed up by Crispin Murray who has extensive experience and a strong record in equities research. Andrew Waddington is the portfolio manager for the Fund.

A combination of the Australian equities large cap and small cap teams' research is used to construct the Pendal MidCap Fund.

Investment Guidelines

Investable universe	ASX and NZX listed and soon to be listed companies, generally with a market capitalisation of A$0.5 billion to A$5 billion; derivatives; cash
Investment ranges	Australian shares 80 - 100% New Zealand shares 0 - 10% Cash 0 - 20%
Ex-ante tracking error	3 – 8%
Number of stocks	Typically 40 – 60
Absolute stock position	15%
Maximum active stock position	+/- 5%[1]
Maximum active sector position relative to index	+/- 10%[1]

[1] compared to benchmark.

Performance

(%)	Total Returns (post-fee)	Total Returns (pre-fee)	Benchmark Return
1 month	-1.70	-1.63	-3.68
3 months	2.86	3.09	3.15
6 months	6.87	7.35	5.00
1 year (pa)	-0.38	0.52	0.33
3 years (pa)	9.96	11.23	9.40
5 years (pa)	11.84	13.20	10.95
7 years (pa)	14.28	15.85	12.76
10 years (pa)	11.35	13.13	8.73
Since Inception (pa)	10.03	12.14	5.95

Sector Allocation (as at 31 August 2019)

Energy	4.3%
Materials	17.1%
Industrials	14.4%
Consumer Discretionary	11.1%
Consumer Staples	7.8%
Health Care	6.4%
Information Technology	7.2%
Telecommunication Services	10.5%
Utilities	0.0%
Financials ex Property Trusts	3.1%
Property Trusts	2.8%
Cash & other	15.3%

Top 10 Holdings (as at 31 August 2019)

Nine Entertainment Co Ltd	5.5%
Xero Limited	5.4%
JB Hi-Fi Limited	4.8%
Metcash Trading Limited	4.5%
Resmed Inc	4.1%
Seven Group Holdings Ltd	3.5%
Tabcorp Holdings Limited	3.2%
Bendigo & Adelaide Bank Limited	3.1%
Atlas Arteria	2.9%
Northern Star Resources	2.9%

Other Information

Fund size (as at 31 Aug 2019)	$501 million
Date of inception	June 2008
Minimum investment	$25,000
Buy-sell spread[2]	0.50% (0.25%/0.25%)
Distribution frequency	Quarterly
APIR code	BTA0313AU

[2] The buy-sell spread represents transaction costs incurred whenever you invest or withdraw funds, and may vary from time to time without notice.

Management Costs[3]

Issuer fee[4]	0.90% p.a.
Performance fee[5]	20% x the Fund's performance (before fees) in excess of the performance hurdle

[3] You should refer to the latest Product Disclosure Statement for full details of fees and other costs you may be charged.

[4] This is the fee we charge for overseeing the operations of the Fund and managing the assets of the Fund. The Issuer fee is paid from the assets of the Fund and is reflected in the unit price of your investment.

[5] The Fund's performance fee is 20% of the Fund's performance in excess of the performance hurdle. The performance hurdle is the performance of the benchmark (Pendal MidCap Custom Index) plus the issuer fee of 0.90% pa. If a performance fee is payable, it is charged in addition to the issuer fee. The fee is calculated each Business Day based on the investment performance and value of the Fund on that day. If we are entitled to a performance fee, it is paid to us as at 30 June each year.

Risks

An investment in the Fund involves risk, including:

- **Market risk**: The risk that factors affecting one or more countries that can influence the direction and volatility of an overall market, as opposed to security-specific risks.
- **Security specific risk**: The risks associated with an individual security.

Please read the Fund's Product Disclosure Statement (**PDS**) for a detailed explanation of each of these risks.

Market review

The S&P/ASX 51-100 Accumulation Index fell 3.7% over August, underperforming its larger cap ASX 100 counterpart (-2.1%). 6 out of the 11 GICS sector finished the month in the red, with Consumer Staples (-11.6%) experiencing the largest loss. Within the sector, A2 Milk (A2M, -20.9%) retreated the most. The price drop was mainly due to subdued revenue growth in the Australian markets and an underwhelming FY19 EBITDA margin (28.2%) that was 12% below market consensus. Blackmores (BKL, -18.8%) also reported weak FY19 growth (1.4% revenue growth and -24% NPAT growth) that showed persisting signs of margin degradation – despite management's attempts to adjust the cost base. Sales in the Chinese market declined 15% on the prior year, as the export business had been impacted by regulatory change as well as management's decision to reduce excess stock on e-commerce platforms. Elsewhere, reporting season sent Costa Group's (CGC, -20.7%) share price plummeting down for the third time this year. EBITDA dropped 8.4% although management has mentioned that the general figures were still "broadly in line" with the lower end of their guidance range. Adverse growing and market conditions such as the low mushroom demand, softer blueberry prices and inconsistent raspberry quality were all factors that affected profitability. Offsetting some of the sector losses, Coca-Cola Amatil (CCL, +4.7%) saw some share price growth. Despite reporting an 8.3% slide in Australian EBIT, non-cola drinks yielded strong double digit (12.5%) growth and Coca-Cola has spent $10 million on its "Feet on the Street Campaign" to continuing boosting volumes by rebuilding relationships with customers.

Materials also faced a large decline (-8.2%) in August. Amongst them, packaging company Orora's (ORA, -17.5%) price fell due to weak performance in the US (EBIT fell 3.6%). Management stated that certain factors in the US economy such as the government shut down and over-stocking during the 2018 Christmas period had led to a dramatic oversupply in capacity. Meanwhile, construction related stocks, such as Adelaide Brighton (ABC, -12.7%) and Boral (BLD, -15%), have felt the pinch of the recent weak housing market. Although the cash rate cut to 1% has helped the market rebound, it will still take a while for construction companies to pick up volumes due to the nature of the cycle. In particular, Adelaide Brighton's lack of an integrated market position in some geographic locations heightened its exposure to input cost increases. Subsequently, Adelaide Brighton downgraded its profit guidance for the second time this year and scrapped its interim dividend, but management has stated that there won't likely be any further deterioration. Within Metals and Mining, Iluka (ILU, -25.7%) reported a 10.1% drop in mineral sands revenue and a negative $65 million FCF in 1H19. Management has commented that ongoing trade tensions and political instability affected consumer sentiment and reduced buying activity in the zircon market.

On the other side of the tally board, Healthcare (+5%) was the best performing GICS sector. Amongst them, Helius (HLS, +10.7%) increased underlying profits by 5.9% on the prior corresponding period. All divisions have seen increasingly positive momentum with double digit growth in their medical and imaging centres (respective EBIT growths of 19% and 14.5%). FY19's EBIT ($167.3 million underlying) included the $12.5 million investment in greenfield sites, and management stated that strong profitability improvements will continue as these sites become fully contributing. Meanwhile, ResMed (RMD, +8.7%) finished FY19 with double-digit growth as net revenue grew by 11.4%. Performance was largely driven by successful sales and market-share gains in America – growth of 11% in last quarter as compared to the year prior. Management has also commented that ResMed is currently well positioned for FY2020.

Lastly, Real Estate (+4.5%) was the second best performing GICS sector. Bond proxy stocks, such as REITs, were the largest contributor to a positive sector performance amidst the global environment of decreasing bond yields. Charter Hall (CLW, +11.8%) led the sector, after recently acquiring Telstra's Melbourne Headquarters for $830 million. On top of Woolworth's renewed 5 year lease, Charter hall has a wide and long-term portfolio that provides investors with steady earnings. SCA Property Group (SCP, +7.8%) also rallied, after the company reported 25.3% growth in revenue. Additionally, SCA's value of investment properties increased by 28.3% as it continues expanding its portfolio via acquisitions and developments. On the other hand, Abacus Property Group (ABP, -4.3%) retreated in price as FY19 revenue decreased by 15%. Abacus is currently in the midst of strategically shifting to a more annuity-style business, by increasing its Storage and Office weighting and decreasing exposure to residential and retail. Abacus raised $275 million equity through an institutional placement and a share repurchase plan to fund these investments.

Fund performance

The Fund outperformed the index over August. There were good gains from the positions in JB Hi-Fi (JBH, +11.1%), Healius (HLS, +10.7%) and ResMed (RMD, +8.7%). Metcash (MTS, +2.8%) also held up well in a falling market.

At the same time underweight positions in A2 Milk (A2M, -20.9%), Magellan (MFG, -16.2%) and Worley Parsons (WOR, -23.0%) also helped drive relative performance.

Contributors

Underweight a2 Milk

Market growth darling a2 Milk (A2M,-20.9%) was down during the month. Market expectation was high in the run-up to the results, and management's relatively cautious tone around outlook weighed on sentiment. Investors are wary about the costs associated with the company's future growth. A2M has been heavily relying on the Daigou channel for its top line expansion over the past few years, and this channel is slowing down. To replace it with alternative channels, the company would need to spend more in marketing and sales, which will negatively affect the margins. In addition, A2M has been spending a significant amount of money for their North American expansion, the payback of which has been unclear to some investors, including ourselves.

Overweight JB Hi-Fi

JB Hi-Fi (JBH, +11.1%) impressed the market with its FY19 earnings in August. The underlying net profits of A$249.8m exceeded both management guidance and market consensus by 2% and 3% respectively. Good Cost-Of-Doing-Business (CODB) control helped to offset gross margin pressure in general; whereas the gross margin for The Good Guys also improved in 2H19. The strong result helped confirm our view that not all retailers are equally bad, and the well-executed ones in the right category can do really well. July was quite strong for JBH itself, which was another potential indicator that the domestic economy may not be as bad as many had thought.

Detractors

Overweight Monadelphous

Monadelphous (MND, -16.0%) retreated in August after releasing its FY19 results. Revenues declined by 10% for the period, which was in line with guidance as the company rolled off peak LNG construction volumes. Nevertheless, management's cautious outlook for FY20 weighed on investor sentiment, The company highlighted that high levels of competition and customer price sensitivity will continue to challenge margins going forward; despite a solid pipeline of resources projects. We believe the statement from management is conservative, and continue to hold conviction in the company.

Does not hold Afterpay Touch

Market growth darling Afterpay Touch (APT, +15.9%) soared to record highs in August, after delivering strong customer additions over FY19. Nevertheless, Management indicated their intention to invest more over the next two years in people, infrastructure, technology and innovation. We do not hold APT and Xero (XRO) is our preferred name in the growth space, as we continue to see the company as the best medium-term opportunity in this cohort.

Strategy and outlook

Reporting season broadly reflected the effect of a weaker domestic demand environment. The number of companies which downgraded earnings was roughly double the amount that upgraded. However it was interesting to note that in many instances there was a muted price reaction to downgrades, suggesting that the market had already priced in a weaker environment.

In this vein, there were several examples of market segments where trends were actually not as poor as many had feared. Some larger retailers such as Super Retail (SUL) and Harvey Norman (HVN) saw relief rallies post reporting. Several management teams called out signs of improving trends in discretionary spending, helped by the Reserve Bank cutting rates, tax cuts and signs of stabilisation in property prices. Nevertheless, domestic economic growth remains very patchy and our retail exposure tends to be more defensive areas or with global opportunities.

High growth technology stocks continued to surge through reporting season. We do not own Afterpay Touch (APT, +15.9%) or Wisetech Global (WTC, +15.6%) and this dragged on performance. We do own Xero (XRO), which outperformed the market but was still down -2.2% for the month despite a strong set of results.

We continue to see Xero as the best medium-term opportunity in this cohort and the only one that we own in our large cap portfolios. It continues to gain traction and subscribers with its cloud accounting software in the US and in the UK – both of which have far lower levels of penetration in small business online accounting than Australia and New Zealand. At the same time, Xero has a second string to its bow in its platform which hosts third party apps designed to help businesses with a range of administrative functions such as payroll, payment automation and cash flow management. This offers an additional avenue of growth.

We are also mindful that both growth and defensive yield stocks have had a strong twelve month run on the back of falling bond yields. Yields are likely to remain depressed for a period - now is not the time to go aggressively underweight. However these stocks are unlikely to replicate the same degree of outperformance over the coming year unless Australian bond yields fall to near zero.

For more information please call **1800 813 886**,
contact your key account manager or visit **pendalgroup.com**

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