PENDAL

Factsheet

Equity Strategies

February 2020

Pendal MidCap Fund

ARSN: 130 466 581

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	-7.65	-7.59	-8.97
3 months	-5.04	-4.83	-6.15
6 months	-1.91	-1.47	-1.16
1 year (pa)	4.83	5.77	3.78
3 years (pa)	8.96	10.23	8.84
5 years (pa)	8.87	10.15	8.71
7 years (pa)	10.93	12.46	9.54
10 years (pa)	10.45	12.11	8.36
Since Inception (pa)	9.40	11.45	5.58

Sector Allocation (as at 29 February 2020)

Energy	3.2%
Materials	20.3%
Industrials	16.3%
Consumer Discretionary	8.9%
Consumer Staples	9.5%
Health Care	7.2%
Information Technology	8.4%
Telecommunication Services	8.8%
Utilities	0.0%
Financials ex Property Trusts	2.7%
Property Trusts	3.8%
Cash & other	10.9%

Top 10 Holdings (as at 29 February 2020)

Xero Limited	5.6%
Metcash Trading Limited	4.7%
Resmed Inc	4.6%
JB Hi-Fi Limited	4.5%
Seven Group Holdings Ltd	4.5%
Nine Entertainment Co Ltd	4.2%
The A2 Milk Company Limited	4.2%
Atlas Arteria	3.9%
Northern Star Resources	3.6%
Cleanaway Waste Management Ltd	3.0%

Other Information

Fund size (as at 29 Feb 2020)	$453 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

Australian equities alongside the global market sold off during February, amid growing concerns of Covid-19 becoming a pandemic. The S&P/ASX 51-150 Accumulation index lost -9.0% against this backdrop, with Resources (-8.5%) faring marginally better than Industrials (-9.1%). US 10 year bond yields dropped from 1.52% to 1.14% while Australian 10 year government bonds fell from 0.95% to 0.82% as investors turned risk-averse.

The rally in bond yields first appeared as a result of fears of the virus' effect on global growth led to a significant rotation out of value (particularly cyclicals) into bond sensitives and growth stocks, up until 20 Feb. Those stocks and sectors exposed directly to Chinese demand and travel restrictions – such as resources, tourism, education, and those stocks with significant direct sales to Asia were hardest hit. From 20 Feb onwards, almost the entire market came under selling pressure as an increasing number of cases were confirmed outside of China. The growing realisation of the impact on global supply chains of the Chinese shutdowns has also played a role. The Covid-19 situation remains fluid. The degree to which the virus can be contained, the effect of warmer weather, the availability of a vaccine are all important factors in determining the ultimate outcome.

In terms of sector performance, Energy (-18.3%), Information Technology (-17.8%), Financials (-10.8%) and Industrials (-10.7%) were hit the hardest with double-digit losses. Underperformance from the energy was largely thematic in February as concerns over the demand effect of Chinese shutdowns has weighed on the oil price; Brent crude has fallen from US$68bbl to US$56bbl (-17.8%) over the year to date, dragging down the oil/LNG producers, such as Beach Petroleum (BPT, -33.9%). Also weighing on the sector, Whitehaven Coal (WHC, -19.7%) released a disappointing set of earnings, with EBITDA down by 68% versus the prior corresponding period (pcp). This was mainly due to lower revenues, as a glut in LNG following a mild Northern Hemisphere winter weighed on the coal price. However WHC's Maules Creek mine also suffered disrupted production due to labour shortages and dust storms. Viva Energy (VEA, +2.3%) was the only standout to buck the trend inside Energy. Management announced the unlocking of value via the sale of its stake in Viva Energy REIT, with the proceeds used to fund a sizeable buy-back of the stock and was well received by the market.

Turning to the WAAAX cohort, Afterpay (APT) gave up -14.0%, Xero (XRO) -13.9% and Wisetech (WTC) -21.7%. WTC is now down -60.4% from its high point in September 2019. APT's result delivered strong gains in terms of revenue – up over 100% - and customer additions – up over 134%. However it also demonstrated the amount that the company has to spend in order to drive business growth, with earnings growth going backwards.

Elsewhere, within Industrials plumbing supplies manufacturer Reliance Worldwide (RWC, -24.9%) came under pressure as profits fell 20% for the half, even as revenue remains flat. It is facing stiff competition in the US as retailers have begun to offer their own private label versions of RWC products, putting pressure on pricing and margins. Offsetting this loss, Cleanaway Waste management (CWY, +11.3%) defied market concerns to post a 6.8% increase in underlying EBIT and 15.2% gain in underlying NPAT. It has been an eventful year for CWY as it digests several recent acquisitions and flagged further capex, however it delivered an increased dividend and increased its guidance for the second half of FY20.

Lastly, Healthcare (-1.0%) and Consumer Staples (+1.3%) were the two best performing sectors. Within the former, Healius (HLS, +2.7%) delivered an uninspiring result. Performance of its GP clinics was disappointing, although there was some offset from better margins in its pathology division. Here, though, the focus remains on the takeover offer from private equity. Fisher & Paykel (FPH, +10.1%) on the other hand upgraded their guidance for FY20, helped in part by an uptick in Chinese demand in its Homecare division in the wake of the Covid-19 outbreak.

Fund performance

The Fund outperformed the benchmark over the month of February.

Contributors

Not owning Wisetech

Wisetech (WTC) delivered another half of profit growth, but slashed its full year earnings guidance as the effect of Chinese production closures feeds through into global supply chains and logistics. The scale of the stock price reaction demonstrates our primary concern with several of the market's high-flying growth names – that while they are, for the most part, good businesses, valuations leave little room for any disappointment. We do not own WTC and it helped on relative performance.

Overweight Cleanaway

Cleanaway Waste management (CWY, +11.3%) defied market concerns to post a 6.8% increase in underlying EBIT and 15.2% gain in underlying NPAT. It has been an eventful year for CWY as it digests several recent acquisitions and flagged further capex, however it delivered an increased dividend and increased its guidance for the second half of FY20.

Detractors

Overweight Beach Petroleum

Underperformance from the energy was largely thematic in February as concerns over the demand effect of Chinese shutdowns has weighed on the oil price; Brent crude has fallen from US$68bbl to US$56bbl (-17.8%) over the year to date, dragging down the oil/LNG producers, such as Beach Petroleum (BPT, -33.9%). BPT has been in something of a sweet spot for a couple of years, with low capex requirements and high free cash flow as a result of its acquisition of Lattice Energy in 2017. However it is now needing to dial up the capex on some long-dated projects.

Overweight Nine Entertainment

Nine Entertainment (NEC) released 1H20 results in February. The biggest news is that management will be taking cost out of the TV business over the next 3 years, mainly from sport cost and international content. Stan also beat market expectation, growing EBITDA for the half by $35m, for a total of $14m. The business also continued to grow subscribers despite competition.

Market outlook

We are now seeing the market pricing in the economic disruption born of government efforts to contain the coronavirus spread and "flatten the curve." We have seen from the Chinese, South Korean and Singaporean experience that economic lockdowns can be successful in limiting the increase in infection rates. This reduces mortality rates as healthcare systems are not overwhelmed. All three countries appear to have brought the virus spread under control. The question remains: at what economic cost? There are two parts to this question; how long does the economic disruption last for – and how successfully can monetary and fiscal measures compensate? Ultimately, at stake is how much structural damage is done to the economy as a result of measures to prioritise the health outcome. This is the uncertainty reflected in the extreme volatility of equity markets in recent weeks.

It is important to acknowledge that we do not know the outcome. We are experts in analysing companies – not in virology. Hence we have no special insight here that gives us an edge in determining the likely outcome for the spread of Covid-19 and social distancing measures to combat it. We are mindful that governments and authorities have pledged to do whatever it takes to limit the economic fallout. In this regard it is important that the crisis is not the "fault" of any particular sector or of widespread misallocated capital. Hence there is little degree of moral hazard in governments providing support. Any number of unusual options for government support remain on the table.

While the outcomes are uncertain, we remain focused on what we can control. What we do is provide a framework in how to think about probabilities, position the portfolio to perform in the most likely outcome, but also make sure we are hedged against the less likely but still possible scenarios.

We can look at the way forward in terms of four broad scenarios.

1) **Worst case is a widespread global pandemic**, provoking a sustained global recession, zero rates, unconventional policy responses and further material falls (>20%) in the equity market. We think this is a low probability outcome.
2) **Rolling outbreaks globally**, prompting short-term economic downturns of 2-4% followed by quick recovery. Policy responses could include zero rates and targeted fiscal stimulus. This scenario could see further markets falls – potentially of up to ~10% - but a bounce back by the year's end.
3) **A milder outbreak** – with containment measures and the Northern hemisphere Spring curtailing the spread. This could see a short-term slowdown, with rate cuts and limited fiscal stimulus. The market may already have seen its lows if this is the case, with a good chance of a 10-20% bounce.
4) **A quick resolution** driven by a medical breakthrough. This could see economic acceleration, a reversal in rate cuts, bonds falling sharply and a 20%+ rally in equities. Like the negative extreme, we see this as a low probability outcome.

It is in uncertain situations such as this – with a degree of binary outcomes – that portfolio construction becomes critical. We are positioning the portfolio to weather the more likely outcomes – scenarios (2) and (3) - and to take advantage of the buying opportunities that have emerged. However we also need to be mindful of protecting it in the case of one of the more extreme scenarios – positive or negative - playing out. In this context, the portfolio's key positions can be considered in the following framework. In each instance, we are looking for the best stocks to populate each part of the portfolio. A key part of this – and our focus in recent weeks, is analysing debt levels and stress testing cash flows under various scenarios to gain comfort around company liquidity and capital.

1) **Recession insurance.** We want stocks with the potential to hold up well if economic conditions deteriorate. We have some gold exposure via Saracen Minerals, infrastructure in Atlas Arteria, consumer staples in Metcash and a strong asset-backed REIT with low gearing in Viva Energy REIT,
2) **Quality defensives.** These are companies which combine strong balance sheets, good management and low sensitivity to the near-term economic dislocation, with relatively limited impacts on revenue. Examples include Xero, A2 Milk and ResMed.
3) **Beneficiaries of fiscal stimulus.** While central banks have already moved to cut rates, governments are also increasingly expected to inject stimulus to help companies and the economy bridge the expected slowdown. We see Seven Group and Cleanaway as two companies set to benefit from likely stimulus actions.
4) **Franchise winners.** These are good businesses which may see a near-term hit but which are well positioned in terms of balance sheets and competitive position to withstand a slowdown and which look attractively valued on a two to three year view. Examples here include Monadalphous, JB Hi-Fi and Nine Entertainment.
5) **Resolution insurance.** There are several stocks which have been exposed to the first-order effects of this disruption, but which we would expect to surge quickly on any sign of slowing infection rates or a medical breakthrough. Again, in each case we are focused on the capital position and the company's ability to survive a sustained period of depressed cash flow. Examples in the portfolio include Altium – and we are also looking at several other opportunities.

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

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