Quarterly Update

30 September 2023

# Intelligent Investor Ethical Share Fund (Managed Fund) (ASX:INES)

**Issued by**
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ASX Code: INES

**"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 0.7% during the quarter matching the market's 0.8% fall, and we made a few changes.

We sold **Ansell** and increased our positions in **CSL**, **ResMed** and **Sonic Healthcare**, which are far better businesses and potentially offer much higher returns.

Sonic has turned its one-off COVID profits into intelligent tuck-in acquisitions in Europe that we believe are being underestimated, while the share price of sleep apnoea company **ResMed** 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.

## Performance (after fees)

| | 3 mth | 1 yr | 2 yrs | 3 yrs | S.I. (p.a) |
|---|---|---|---|---|---|
| **II Ethical Share Fund** | –0.7% | 4.3% | –4.3% | 6.2% | 8.2% |
| **S&P ASX 200 Accumulation Index** | –0.8% | 13.5% | 2.3% | 11.0% | 5.8% |
| **Excess to Benchmark** | 0.1% | –9.2% | –6.6% | –4.8% | 2.4% |

**Inception (S.I.): 11 Jun 2019**

RIAA's RI Certification Symbol signifies that a product or service offers an investment style that takes into account environmental, social, governance or ethical considerations. The Symbol also signifies that Intelligent Investor Australian Ethical Share Fund (ASX: INES) adheres to the strict operational and disclosure practices required under the Responsible Investment Certification Program for the category of Product. The Certification Symbol is a Registered Trademark of the Responsible Investment Association Australasia (RIAA). Detailed information about RIAA, the Symbol and Intelligent Investor Australian Ethical Share Fund (ASX: INES) methodology, performance and stock holdings can be found at www.responsiblereturns.com.au, together with details about other responsible investment products certified by RIAA.

### Fund overview

The Intelligent Investor Australian Ethical Share Fund is an Active ETF designed for investors seeking a diversified selection of Australian companies that produce growing, sustainable profits at low risk of interruption from the increasing threats associated with Environmental, Social and Governance (ESG) factors.

**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

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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.

Lastly, we added another founder-led business, insurance broker **PSC Insurance**. Like better known rivals **Austbrokers** and **Steadfast**, it finds the best insurance deals for its 80,000 clients without taking insurance risk.

PSC Insurance also has a well-established business overseas with plenty of growth ahead as it buys more local franchises as their owners retire from the industry.

## Reporting season

**Aussie Broadband**'s share price jumped over 30% after announcing another increase in market share as Australians continue to pay up for faster internet speeds. But the big potential now lies in corporate offerings. **Carsales**' share price also increased 20% as it continues its recovery post Covid.

The hero of the quarter was **Audinate**, whose share price jumped nearly 50% after delivering its maiden profit, albeit with help from some one-offs. The company's $1bn market value will attract a new group of passive and active investors and the increased liquidity frees up space in the fund for the next hidden gem.

Audinate has been shunned partly as it hasn't been profitable despite dominating its fledgling industry, but getting in early and backing an owner-led management with a potentially highly profitable niche is a classic example of our process. Management and staff also deserve credit for managing such a young business through Covid.

**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.

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%.

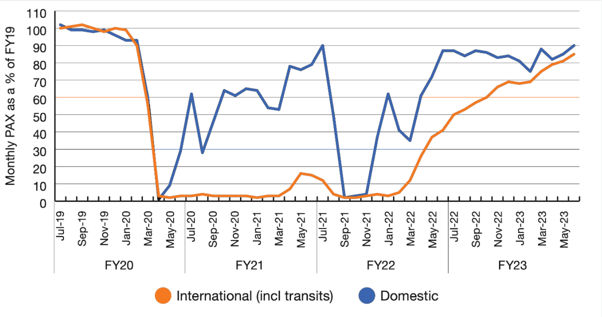
## Today, tomorrow

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.

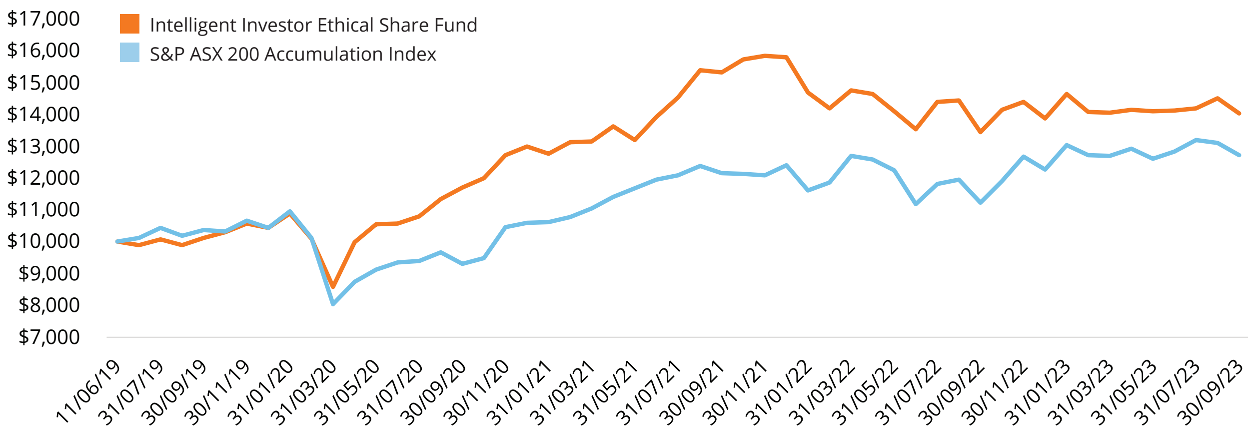
Net debt of NZ$1.6bn is manageable given operating profits are likely to pass NZ$600m in the year ahead and, as mentioned earlier, the airport is a long way from breaching its covenants again. That said, management expects capital expenditure of between NZ$1.0bn–1.4bn in 2024 as work starts on a new 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.): 11 Jun 2019**

## Asset allocation

| | |
|---|---|
| **Information Technology** | 19.7% |
| **Health Care** | 18.0% |
| **Communication Services** | 17.4% |
| **Financials** | 11.0% |
| **Cash** | 10.4% |
| **Materials** | 7.2% |
| **Industrials** | 7.2% |
| **Consumer Discretionary** | 6.8% |
| **Real Estate** | 2.4% |

## Top 5 holdings

| | |
|---|---|
| **Auckland Internationaal Airport (AIA)** | 7.2% |
| **Audinate (AD8)** | 6.7% |
| **CSL (CSL)** | 5.9% |
| **RPMGlobal Holdings (RUL)** | 5.9% |
| **Telstra Corporation (TLS)** | 4.5% |

## Fund Stats

| | |
|---|---|
| **Distribution yield** | 0.92% |
| **Net asset value** | $3.01 |



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