

DS Capital Growth Fund

June 2019 Year End Report

The DS Capital Growth Fund ('the Fund') seeks to deliver superior returns through a process designed to minimise the risk of a permanent loss of capital. The Fund comprises a concentrated portfolio of well researched listed businesses. The focus is on companies where we have a deep understanding of their business model and the industries in which they operate. The investment process combines traditional quantitative financial analysis with qualitative tools.

Performance

Top 10 Holdings*

	12 Months	2 Years (pa)	3 Years (pa)	5 Years (pa)	Since Inception (pa)	Since Inception	
DS Capital Growth Fund	11.5%	13.6%	11.8%	16.2%	18.3%	194.3%	CME Group (US)
All Ordinaries Accumulation Index	11.0%	12.4%	12.6%	9.0%	10.4%	89.2%	Collins Foods
Small Ordinaries Accumulation Index	1.9%	12.5%	10.7%	9.3%	6.8%	52.4%	Intercont. Exch. (US)
							Interxion (US)
							Lifestyle Communities
							Resimac
							Rightmove (UK)
							Seven Group Holdings
							Sydney Airport
							Vista Group
							*in alphabetical order

Notes: (1) Data is after management fees and before performance fees. (2) Return after all fees for financial year ended 30 Jun 2019 was 10%. (3) Inception date is 1 January 2013. (4) Return since inception after all fees averaged 15.6% pa assuming reinvestment of net distributions. (5) Data does not include franking credits distributed to Unit Holders.

Portfolio Commentary

We are pleased to report that the Fund returned 11.5% for the financial year. Since inception, investors in our Fund have enjoyed returns, net of all fees, averaging 15.6% per annum assuming reinvestment of net distributions.

The year featured increased stock market volatility driven by changing interest rates and trade negotiations particularly between the US and China.

Sentiment toward interest rates varied wildly over the last twelve months causing periods of stock market weakness. In October, a spike in the key US benchmark rate caused stocks to fall as investors rotated to bank deposits offering improved rates. This led to fears that the pace of increasing rates and resulting inflation would cause an economic slowdown which sent many global indexes down by over 10% by December. Our Portfolio, with several defensive components, behaved as it was designed and, while not immune from the sell-off, fell significantly less than most related indexes. In early 2019, stock markets recovered strongly, buoyed by the return of lower rates and resumed economic stimulus which allowed our Portfolio to recover off a higher base.

During the year, the US continued to negotiate new trading terms, particularly with China. This did not always go smoothly and weighed on the stock market at times.

In most cases, our core Australian investments delivered the earnings growth that we were expecting. As usual over the year, we had many meetings with the senior management of businesses owned or followed by us. This provided further clarity that importantly, in most cases, our businesses were on track to deliver the earnings growth we expect.

The Fund's international investments performed well during the year. New investments, additions to several existing holdings and good share price performance combined to increase the international component of the Portfolio to around 20%. Currency rates had no major effect on the portfolio with the AUD/GBP rate working against the Portfolio and the AUD/USD rate working in favour of the Portfolio. Our US businesses performed very well and most of our UK businesses performed to expectations despite Brexit remaining unresolved. This is discussed in more detail below.

The Fund's cash level ranged between about 15% and 25% over the year and was around 20% of Fund assets at 30 June 2019.

Key Portfolio Holdings

Portfolio Contributors

Lifestyle Communities

The solid operational results of Lifestyle Communities made a material contribution to the Fund's return. Demand for its affordable seniors housing remains robust as demonstrated by strong new home settlements, price increases and upgraded future settlement guidance. Thus far, Lifestyle has not been adversely affected by the housing slowdown with prices actually increasing in major catchment areas. In fact, the broader slowdown, together with an increased debt facility has helped Lifestyle secure new development sites. We remain confident that Lifestyle's excellent leadership team can manage its strong opportunity pipeline, efficiently recycle capital into new developments and continue to grow its recurring rental revenue.

Credit Corp

The last 12 months were productive for Credit Corp and contributed to our returns. The strong share price performance was a product of solid operational results and a \$140m capital raising that enables Credit Corp to accelerate its US debt purchasing business. The market in the US is significantly larger than Australia and we expect that Credit Corp has now laid the foundations to potentially double its US earnings over the next few years. It has announced two US collection sites so far and has other sites and possible acquisitions under consideration. Whilst we continue to like this business and the US opportunity, we have sold our investment on valuation grounds.

CME Group and Intercontinental Exchange

During the year we added CME Group (CME) to our core holdings. Like Intercontinental (ICE), CME is US listed and offers exposure to global financial exchange platforms and data services. Both CME and ICE, performed well during the year. ICE is roughly 50% trading and clearing (mostly energy, commodity and interest rate futures) and 50% data (mostly security pricing). CME is roughly 90% trading and clearing across a range of derivatives and 10% data services. We expect that both CME and ICE will benefit from market volatility that will generate higher volumes, cost cutting initiatives and further developing their data content businesses. We remain attracted to these businesses for their very high margins and market positions as critical financial infrastructure.

AMA

AMA is a leading automotive aftercare and accessories provider. The main business of panel repair is offered through 118 sites. AMA has proven itself adept at making and integrating acquisitions as well as conducting Greenfields developments. During the year, the underlying operations progressed well, and we expect the business is capable of delivering double digit earnings growth for the next few years. In addition, AMA still has a relatively small market share in a fragmented industry and a long list of acquisition targets including some very large 'game changing' opportunities that could meaningfully increase earnings.

Interxion

Interxion is a US listed, data center operator with 52 data centers in 11 countries across Europe and the UK. Like other data center operators, Interxion will be a beneficiary of the continuing move to cloud based computing and data consumption, a structural tailwind that we favour. Operationally, the company is performing well, and market conditions remain accommodating. We expect Interxion can accelerate revenue growth as it maintains focus on higher margin retail customers and leverages its European footprint. We expect low to mid teens top line growth and earnings leverage over the next few years.

Zip Co

We had been following the progress of consumer fintech leader, Zip, for several years and were able to build a position as part of a capital raising supported by Westpac Bank, one of its major shareholders. Being relatively new, the sector has attracted regulatory attention. Zip maintains that its compliance practices are consistent with the recommendations of the recent Senate Inquiry into the 'buy now pay later' sector. Zip has a strong brand and continues to add to its impressive list of large merchants. The business enjoys the structural tailwinds of consumer adoption allowing it to grow strongly in a large market. This has enabled it to deliver impressive lending growth while maintaining good credit quality. Maintaining this will deliver substantial earnings leverage over the next few years.

Vista Group

The share price of New Zealand based Vista was up over 60% during the year. Vista offers software and data services to the film industry. 75% of earnings are from software that provides management tools to cinema exhibitors incorporating point of sale, operations and loyalty modules. This software has 25% global market share, is found in 94 countries and in 8 of the 10 largest global cinema groups. Vista's smaller data division is growing revenue at 15% pa. This division offers studios and exhibitors tools to analyse customer behavior and manage marketing campaigns. Overall, we expect continued earnings improvement driven by strong market share, recurring revenues and growth opportunities in the data business.

MYOB

The takeover of MYOB concluded in May with the Board succumbing to KKR's bid. This was a disappointing outcome for us as the takeover was pitched opportunistically at a time of severe market uncertainty. The shareholder vote forced us to sell our shares preventing us from continuing to participate in the transition of MYOB to a cloud based 'Software-as-a-Service' business.

Collins Foods

Collins Foods made a strong contribution to the Fund's return during the year with the share price up almost 50%. The core Australian business reported strong sales growth and margin expansion driven by the addition of new stores, new delivery options and store refurbishments. The European operations remain challenging but are showing some slight improvement and are a small part of the overall portfolio. The new Taco Bell format is performing in line with expectations and could meaningfully add to group earnings over the next few years with 50 new Taco Bell sites planned by 2021.

Rightmove

The share price of Rightmove finished the year at an all-time high notwithstanding being on the front line of the Brexit affected UK property market. This reflects a dominant market position, delivery of customer efficiencies and pricing power that combine to allow Rightmove to increase yield from its customers. Rightmove's ability to continue to deliver increases in average revenue per agent and double digit earnings growth will be impacted by the health of its customer real estate agents. We continue to monitor this situation.

Over the Wire

Over the Wire made a good contribution to the Fund's return for the year. The business aggregates telco and IT services for small and medium sized businesses with a focus on wresting customers away from the large incumbents by delivering better service. The company has made several acquisitions and has the balance sheet capacity to make more. Management are significant shareholders (about 50%) which we view favorably and remain focused on delivering mid to high teens organic growth next year which should drive strong earnings growth.

Uniti Wireless

The share price of telco service provider, Uniti, has tripled since we first invested and made a good contribution to the Portfolio's return. Our initial investment was small and was made after Vaughan Bowen became involved not long after the company listed in early 2019. We have known and enjoyed success with the highly regarded Vaughan over a long period and saw his involvement in Uniti as a game changer. Uniti offers an NBN alternative and has already made several acquisitions as part of its plan to add businesses with strong cashflow. We continue to closely monitor the progress given the strong share price performance.

Seven Group Holdings

The half year result of Seven Group Holdings was one of the best of the recent reporting season. Seven Group Holdings is the Stokes family investment vehicle. They own 66% and actively manage Seven Group that holds a portfolio of investments. The three key businesses, Coates Hire, WesTrac and Beach Energy performed well during the year and offer exposure to growing infrastructure activity (Coates), increasing Australian mining capital expenditure (WesTrac) and Australian East Coast energy demand (Beach).

Portfolio Detractors

Challenger

Challenger had a difficult year. The main issue is the low interest rate environment that reduces the returns Challenger earns on its investment portfolio. Also of impact was the disruption to the advisor distribution channel caused by the Royal Commission that hampered annuity product sales. Challenger's new CEO has reset the return on equity target and earnings guidance for next year which we expect to be conservative. We misread the impact of the low interest rate environment but, at current levels, Challenger is trading almost at net assets and, on 11x next year's earnings, is priced for no growth. Notwithstanding this, it remains the dominant manufacturer of annuity products with international growth options. We feel that patience will be rewarded.

Experience Co

Adventure tourism group, Experience Co, was one of the Fund's weakest performer for the year as its share price fell 60%. An accident, bad weather, the integration of acquisitions and soft tourism numbers to far north Queensland all took their toll and we underestimated the combined severity and the time it would take to rectify issues challenging the business. A new Chairman, CEO and CFO are at the helm and although the repair will take time, the core sky diving business (55% of revenue) has shown improvement. Experience Co is a 'work in progress' but we expect the new leadership team to refocus and reinvigorate the business.

Premier Asset Management

The 30% fall in the share price of Premier detracted from the Fund's returns. Premier is a UK based asset manager that distributes funds management solutions for the retail market through independent financial advisors. The focus is on multi asset and income products, areas that Premier has identified are in strong demand. Up until very recently, Premier enjoyed over 5 years of consistent growth in Assets Under Management (AUM). While the underlying investment performance of most of its products has been competitive, Brexit related fatigue appears to be weighing on investors who are less inclined to make investments until Brexit is clarified. Premier has about £6.8b of AUM and we expect that once Brexit is resolved, inflows will resume and provide material earnings upside.

Axesstoday

Axesstoday was our worst performer of the year. Since its successful IPO in 2016, the business had consistently delivered strong growth in its lending, profitability and share price. Despite strong representations from the CEO that credit quality was being maintained amidst the strong lending growth, the full year result showed a rapid arrears build indicating that loan book growth was being seriously mismanaged. This was a shock to investors and the CEO left the company within weeks, in questionable circumstances, leaving us to conclude that our trust in the CEO was a clear mistake. We began selling our position but regrettably were not able to complete our exit before the business was suspended to undertake a capital raising that was ultimately unsuccessful leaving the business in administration.

Outlook

Long term interest rates of most major economies are at multi year lows reflecting expectations for low economic growth in the medium term. Although low rates favour equities as investors chase higher returns than bank deposits, this can result in investors mispricing the risks of higher returns by paying too much for listed businesses. Another risk is the challenge facing businesses trying to grow in a low growth environment.

While interest rates do not appear likely to rise significantly in the short term, we know that stock markets are very sensitive to increases in interest rates that will cause a rotation from equities back to bank deposits. We are conscious of these issues and the Portfolio is positioned for a transition to a more normal interest rate environment. We are disciplined on valuation and focused on buying businesses that can grow earnings under various conditions and, over the longer term, will be worth more in the future. As always, we maintain a close watch on any material shift in sentiment toward interest rates and the effect on our portfolio.

We expect the market to remain susceptible to macro-economic issues and particularly to developments in relation to the trade relationship between the US and China. We continue to view this dynamic as a complex negotiation that will take time to play out and cause bouts of stock market volatility.

Domestically, economic growth has slowed and, although the housing market has seemingly stabilised for now, consumer confidence is soft and the Reserve Bank has been sufficiently concerned to cut official interest rates. This has left the Australian dollar at close to a 3 year low. We foresee these conditions continuing for some time and expect that the tug of war between any uptick in economic growth and the 'sugar hit' of economic stimulus will add volatility to stock markets. As always, the short-term prices will be based on investor psychology while long term prices are driven by business fundamentals. We remain focused on the long term and our fundamentals-based valuation approach to investing.

We continue to see and assess several new potential investments. We remain flexible and nimble and our opportunity set remains wide. In addition, the portfolio holds several investments where, although the underlying businesses have progressed well over the last year, this is not yet reflected in the company's share price. These investments, along with investments in several new businesses, mean that our portfolio is well placed for growth over the next few years.

Thank you to all our unitholders for investing alongside us over the last twelve months. Our team looks forward to the year ahead and will continue our search for high quality businesses led by talented managers capable of delivering earnings growth over the next few years.

As always, feel free to contact us if we can be of any assistance or if you would like more information about your investment with us.

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