DSCAPITAL

DS Capital Growth Fund

June 2024 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 as at 30 June 2024	
Financial YTD	17.9%
2 Years (pa)	13.4%
3 Years (pa)	2.9%
5 Years (pa)	9.2%
7 Years (pa)	9.9%
10 Years (pa)	11.5%
Since inception (pa)	12.6%

Notes: (1) Inception date is 1 January 2013.(2) Returns are after all fees and assumes reinvestment of net distributions.(3) Data does not include franking credits distributed to unitholders.

Top 10 Holdings (alphabetical order)
Breville
Dalrymple Bay
HUB24
Macquarie Technology
Netwealth
NEXTDC
Pacific Current Group
REA Group
Rightmove (UK)
Seven Group

Key Fund Information	
Manager	DS Capital
Strategy	Long only
Liquidity	Monthly
APIR Code	DSC001
Investors	Wholesale
Distribution	Annually
Inception	1 January 2013
Minimum	$250,000
AFSL	427283
Contact	dscapital.com.au

Portfolio Commentary

We are pleased to report that the Fund delivered a return for the financial year of 17.9% net of all fees. This compared favourably to the broader indexes of 12.5% for the All Ordinaries Accumulation Index and 9.3% for the Small Ordinaries Accumulation Index.

Over the year, equity markets closely tracked investor sentiment toward interest rates. Early on, economic data showing cooling inflation drove markets higher as investors factored in the lower inflation and multiple rate cuts. As the financial year progressed, economic conditions continued to be resilient to higher interest rates, and inflation proved stickier than anticipated, albeit well off its highs. The recalibration of the timing and magnitude of expected rate cuts weighed on stock markets. As we have consistently stated, the benefits of moderating inflation in parts of the economy were countered by a stubbornly tight labour market that entrenches an element of inflation that will be hard to reverse.

Domestically, the Australian consumer is being pressured by cost of living pressure and the prospect that interest rates will be higher for longer. The impact of this is increasingly showing up in weak discretionary spending data. Fortunately, late last year, we substantially reduced the Fund’s exposure to discretionary retail, being concerned that the combination of challenging top line growth and cost inflation will continue to impact the bottom line.

Mergers and acquisitions were a feature of the year with a significant number of companies across a broad range of sectors receiving takeover bids. Amongst those, fund holdings Thorn Group, MMA Offshore, Pacific Current Group and PSC Insurance, all attracted corporate interest.

Most pleasingly, almost all key businesses in the portfolio delivered operational results consistent with our expectations and are navigating the current conditions well. Consequently, we made no major changes to our key holdings as the portfolio benefited from investments made eighteen months earlier at a time when investors feared sharply higher inflation and stock prices were significantly lower.

The Fund finished the year being 88% invested with 12% cash.

Key Portfolio Holdings

Macquarie Technology and NEXTDC

Our holdings in data centre businesses, **Macquarie Technology** and **NEXTDC**, performed strongly over the year providing good exposure to leading global megatrends. Macquarie increased 38% over the year and NEXTDC finished 42% higher. Our investment thesis for the sector has always been driven by the digitisation of the world, and momentum related to cloud computing applications only accelerated further over the last twelve months. In addition to this strong tailwind, the sector benefited from an increasing focus on the significant lift in demand for data centre space related to high performance computing and Artificial Intelligence.

Macquarie delivered impressive operational results featuring better than expected earnings growth and cash generation as well as returns on capital of over 20%, despite not yet billing at full capacity. Macquarie occupies an important position in the domestic market where data sovereignty is important. It has the highest level of government security certification available which is a competitive advantage allowing it to service around 42% of government departments. NEXTDC also delivered strong operational progress as evidenced by winning new contracts, building new capacity, and converting constructed capacity to billable capacity. Management commentary delighted investors mapping out the sizable opportunity and the need to accelerate the rollout to meet customer demand. With demand from multiple drivers, we expect both Macquarie and NEXTDC are strategically well positioned to take advantage of the current evolution in technology.

Both Macquarie and NEXTDC have the advantage of access to land and power that can take years to accumulate. This is a competitive advantage that can be monetised, become very cash generative and deliver strong returns over the medium term. While this sector is currently enjoying significant investor attention, we understand that this level of adulation can ebb and flow, but we remain committed to the long-term structural opportunity that this sector offers.

REA Group

The share price of leading property portal, REA increased by 37% over the last 12 months. During the year, trading conditions improved allowing REA to capitalise on a better listings environment and new price increases. More recently, REA has lifted new listings guidance which we still expect is conservative. REA has demonstrated the quality of its business through its ability to navigate a challenging environment and position itself for the inevitable recovery. Year to date, REA has delivered 23% growth in earnings from a 20% increase in revenue. We expect future growth will come from a combination of an improvement in listings, price increases and new products. Whilst growth may not be linear, the business enjoys very high earnings margins (circa 65%), very high returns on capital (circa 50%) and can grow profits without needing additional capital. REA is one of the best real estate portals in the world and is a very attractive business to own.

Dalrymple Bay Infrastructure

The share price of Dalrymple Bay Infrastructure was 12% higher over the year in addition to paying attractive distributions. Dalrymple provides terminal infrastructure and services to the global steelmaking supply chain with capacity fully contracted on a 'take or pay' basis. The favourable customer arrangements incorporate CPI inflation adjustments providing an attractive hedge in the current environment. Distribution guidance from its AGM implies that at current share price, DBI still trades at an attractive 9% grossed up yield (including franking). While currently a single asset entity that is operating at 100% capacity, growth options include capacity expansion or new acquisitions. We continue to view this holding attractively on a risk/reward basis.

Seven Group

The share price of Seven Group finished the year 53% higher tracking strong earnings results. Seven offers diverse exposure to mining, infrastructure and construction, key growth sectors of the Australian economy. Strong operational performance was driven by mining equipment business WesTrac, and equipment hire business Coates, which reported first half earnings growth of 31% and 10% respectively and each lifted margin. Coates, Australia's largest equipment hire business, is benefiting from growing end markets due to huge projected infrastructure spending. WesTrac offers exposure to new equipment sales and product support and featured first half growth in equipment sales and product support of 23% and 30% respectively. WesTrac has 50% market share, a strong forward order book and is positioned to benefit from the long term shift in the decarbonisation of mining fleet. Boral's first half result showed margins have almost doubled due to optimising pricing and the cost base. The investment in Boral is progressing well and Seven has moved to 100% ownership of the business which it first invested in at attractive levels. Whilst the share price of Seven has more than doubled over the last two years, we continue to expect attractive returns due to management's strong track record of capital allocation.

Lifestyle Communities

Lifestyle Communities had its most challenging year since we first invested almost 10 years ago, finishing the year 20% lower and falling out of our top 10 largest holdings. At that time, we were attracted to the model of building housing communities where profits from building and selling homes covered the costs of building the homes and the communal and club-house facilities. The homes were attractively priced as Lifestyle built efficiently and retained ownership of the land, collecting lease payments for the land from the homeowner. The growing real estate portfolio generated a growing stream of annuity income. Conditions were more challenging this year and earnings were impacted by slower sales of new homes. Lifestyle explained that this was due to (a) higher interest rates and (b) customer fears of builder completion risk that necessitated a substantially completed home before customers marketed their existing home. Lifestyle also announced a capital raising – its first since listing, that weighed on the share price given its historic ability to fund all expansion plans with existing cashflows. Lifestyle is expected to continue to grow and announced plans to acquire several new sites that will add more new home sites. Whilst the current trading environment is unpleasant, we expect that management can navigate the tougher conditions that are evident across the Victorian property market.

Pacific Current Group

The share price of Pacific Current finished the year up almost 50%. Since first investing 6 years ago, our investment thesis was based on the view that PAC's portfolio of holdings in boutique managers was trading at a significant discount to our valuation and that this discount would close over time. While taking longer than we anticipated, this happened rapidly over the last twelve months. The catalyst for this change was several takeover proposals and a strategic sales process. Although these initiatives did not result in a transaction for the whole company, value was realised through the sale of several of PAC's investments and the associated reset of the cost base. This included the sale of its highly successful investment in GQG Partners and stakes in three other boutiques for almost $370m.

With a market cap of around $530m, PAC is now planning a large share buyback. Ex the cash, our estimation is that the value of PAC's remaining investments are still trading at an almost 15% discount to our valuation that should be realised over time.

Breville

Breville's share price was 36% higher during the year as the business continued to deliver organic growth, new products and progress in new markets. Whilst first half revenue was only marginally higher, both gross margins and earnings margins were higher at 36.7% and 14.5% respectively. Working capital improved significantly with inventory well managed and debt reduced to negligible levels. Although the consumer outlook remains unclear, Breville has maintained earnings guidance of 5-7.5% earnings growth for the full year. We are attracted to the continuing evolution of Breville as a global brand driven by its expansion into new markets, increasing direct distribution arrangements and new product launches. We are confident the company's exposure to the continuing structural tailwind of a shift to premium coffee consumption is a competitive advantage.

HUB24 and Netwealth

The share prices of wealth management platforms, **HUB24** and **Netwealth** finished the year up around 83% and 60% respectively and delivered strong operating results. Recovering markets and good inflows drove growth in Funds Under Advice (FUA) of almost 30% for both HUB and Netwealth that now have FUA of $100b and $85b respectively. Early in the financial year we added to both holdings taking advantage of a period of weak investor sentiment that depressed both inflows (the operating environment) and share prices (the multiple that the business traded on). Such periods are often attractive entry points when investors that are focused on short-term issues are distracted from the long-term opportunity of investing in a sector with strong structural growth. Subsequently both HUB and Netwealth benefited from improving operating conditions and strong earnings results with high margins, double digit profit growth and attractive return on capital metrics. We remain excited about the outlook for this sector and expect both businesses will take further market share from older legacy solutions.

Rightmove

Closing modestly higher for the year, Rightmove is the UK's biggest and incumbent property portal accounting for over 80% of time spent on property portals. Unlike its Australian peer (REA) which primarily derives revenue from vendors paying to list homes for sale, Rightmove's revenue is mostly from real estate agents paying a subscription fee to upload inventory and access productivity tools. Rightmove has a long track record of growing its average revenue per agent, which we expect will be driven by an improving property market and product innovation. Early in the year, one of Rightmove's smaller peers was acquired by a large US player causing some investors to fear an impact on Rightmove's strong incumbency. In the subsequent share price weakness, we added to our holding having witnessed several previous failed attempts to disrupt its strong market position. Each failure was evidence of the value of incumbency where the newcomer offers no major change to the customer offering. Operationally, Rightmove continued to deliver, showing that it remains at the forefront of the digitisation of the UK Property market. We expect a continuation of increasing average revenue per agent (over half to come from product innovation), high margins, earnings leverage and, all without the need to raise additional capital to grow.

Outlook

Key stock market drivers will continue to be economic growth, inflation and interest rates. Recent global economic data has been stronger than expected and inflation is still above central bank target levels particularly in Australia. This has caused central bank interest rate settings to stay elevated and has caused a reset in the timing of rate cut expectations. Broadly speaking, we expect these conditions to continue in the short term.

Geopolitical instability is regrettably unlikely to improve in the medium term and the effect of elections in France, the UK and the United States of America may give investors cause for consideration. These events generally add volatility to the stock market, but that volatility tends to pass in the absence of major new government policy pivots.

Domestically, we expect that economic growth will be modest and supported by tax cuts, commodity prices and immigration. Headwinds will be cost of living pressures, soft housing investment and weaker business investment. Our working case continues to be that inflation will take longer to return to central bank target levels particularly in Australia. Inflation will be exacerbated by strong labour markets with new Enterprise Bargaining Agreements embedding further inflation into our economy. This will increase the likelihood that inflation remains elevated, reducing the chances of rate cuts and meaning rates will be higher for longer.

The Fund is currently holding around 12% cash which provides flexibility to add new or to increase existing holdings that we expect can deliver strong returns over the next few years. While we expect rates will trend lower over the medium term, this is not the driver of our investment strategy. Our strategy remains focused on identifying and investing in well managed businesses that can grow earnings over the medium term in a variety of economic conditions.

Stock market volatility – which quickly changes the prices of listed businesses – will continue to present occasional opportunities to invest at attractive prices. Not lost on us is that volatility can be unsettling compared to unlisted assets that are not priced as often. This can sometimes leave investors ***feeling*** that they carry more risk due to the short term price moves. This is not our view and we have never viewed volatility as ‘risk’. To us, ‘risk’ is getting our analysis wrong. We believe that in the short term, stock prices will be driven by the news cycle (noise), which is less important, and in the long term prices will catch up to fundamentals (business quality), which is most important. The latter is our focus and is a more robust and repeatable investment process.

The volatility of listed markets can present opportunities that other asset classes struggle to match during periods of fear and pessimism. For example, the dramatic change in consensus expectations as to the timing and magnitude of rate cuts created stock market weakness that provided excellent entry points for nimble investors who could see through that period.

We have just ruled off our 12th end of financial year and, since inception, have delivered our first investors a compound return of 12.6% per annum net of all fees. Thank you to all our unitholders for investing alongside us over the last twelve months. We remain focused on our objective of protecting and growing our unitholders’ capital and look forward to continuing to deliver acceptable returns. We welcome any feedback or questions that you may have. Please feel free to contact us personally if you want to discuss the portfolio, the current conditions, or any aspect of your investment with us.

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