

Lazard Australia Equity

Quarterly Investment Option Update

31 March 2021

Aim and Strategy

To achieve total returns (including income and capital appreciation but before the deduction of fees and taxes) that exceed those of the S&P/ASX 200 Accumulation Index by 3% per annum over an investment cycle. The Lazard Australian Equity option takes large active positions, holding generally 25 to 45 securities chosen for their potential to deliver absolute returns over the long term. It is a high-conviction portfolio but key benchmark risks are also taken into consideration when constructing the portfolio.

Investment Option Performance

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Investment Option Overview

Investment Category	Australian Share
Suggested Investment timeframe	5 years
Relative risk rating	7 / Very High
Investment style	Specialist
Manager style	Single Manager

Asset Allocation	Benchmark (%)	Actual (%)
Australian Shares	100%	99.1
Cash	0%	0.9

Sector Allocation	%
Communication Services	1.0
Consumer Discretionary	5.7
Consumer Staples	9.5
Energy	12.5
Financials	34.5
Health Care	3.1
Industrials	7.0
Information Technology	2.5
Materials	19.6
Real Estate	3.7
Utilities	0.0
Cash	0.9

Top Holdings	%
BHP Group	8.6
Rio Tinto Limited	5.1
Westpac Banking Corporation	5.0
Commonwealth Bank of Australia	4.8
National Australia Bank Limited	4.5

Investment Option Commentary

Contributors

- South 32 (S32) is a stock Lazard added during Q4 2021 and has outperformed the market with a gain of 13% in Q4 2021, underpinned primarily by strong commodity prices. S32 is a mining conglomerate with more than 95% of its portfolio leveraged to the green energy transition, including more than 50% exposure to aluminum and alumina (2nd tier producers on the global cost curve), 25% exposure to manganese (a key ingredient in steel making process and they are one of the lowest cost producers in the world), and the rest of the business exposures are in nickel, zinc and met coal (less than 5%). During Q4 2021, they announced an acquisition of 45% interest in Sierra Gorda Copper mine in Chile for US\$1.5bn, with 20 years reserve life and annual production rate of 210kt. This transaction adds another future demanding commodity in its portfolio and copper is estimated to account for 20% of its underlying earnings if it contributed for the full FY21. The deal is attractively priced at 3.3x EV/EBITDA or around 2x EV/EBITDA at spot copper price. Lazard have a relatively conservative copper price long-term on the basis that they seem to have paid for the full value for the operating asset, but it doesn't include the option value for both mine life extension and a phase 2 concentrator expansion. In addition, S32 bought another 25% interest in Mozal aluminum smelter (backed by hydro power) at an attractive acquisition multiple of 3.6x, which will increase its ownership in this smelter to 72%, adding another 145kt pa of green aluminum production. Overall, Lazard continue to see S32 as attractively priced currently on a long-term basis, with many of their mid to long-term commodity price assumptions are still significantly below the current spot prices. At the current spot prices, the business is enjoying a strong free cash flow yield well over 20%.
- On 6th December 2021, Metcash (MTS) reported its 2022 half year results. In summary, the profits were very strong across all three segments; total EBIT was up 14% on the back of only 1.5% top line revenue growth. Importantly, EPS improve by 15% to 14.6cps for the half year. Both the Food and Liquor segments performed well while maintaining margins vs last year. The Food segment results were better than expectations as the business managed to absorb the loss of the 7-Eleven distribution contract (impact of A\$8m vs the 2H21) and with no Fedur tobacco tax excise increase profits from tobacco distribution fell (impact A\$6m vs the 2H21). Hardware was the best performing segment on the back of the Total Tools acquisition. Revenue grew by 42% and EBIT by 53% making Hardware the biggest contributor to MTS earnings. The market likes the growth of its Hardware segment, due to long term questions on the sustainability of the Food distribution business. The overall result was around 16% ahead of market expectations, hence the strong relative share price performance. Lazard's forecasts have also increased on the back of these results.

Detractors

- Whitehaven Coal's (WHC) share price underperformed in Q4 2021 as thermal coal prices retreated from record levels. Newcastle (NEWC) (NAR 6,000 kcal/kg) coal prices appear to have stabilized at around US\$150/t-US\$160/t during Q4 2021 and looking to be well supported through the coming winter with continued tightness in supply and demand. In addition, Lazard saw a temporary coal export ban by the Indonesian government to alleviate coal shortage for its domestic power sector at the beginning of 2022, which has fueled a spike in seaborne coal price in the recent week to close at US\$190/t. Indonesia is the largest coal exporter which accounts for 40% of global seaborne supply. Lazard expect the ban will probably be short lived once their domestic restocking is finished, but nevertheless this further tightens the supply and demand balance in the market. In early December 2021, the Chinese government announced domestic coal price guidance for next year at between RMB 550-850 per ton with the seaborne equivalent price being RMB700/t or US\$110/t for benchmark 5,500 kcal/kg coal. The new price guidance is a 30% increase from previously guided price range and is significantly higher than Lazard's long-term coal price assumption of US\$70/t for NAR 6,000kcal/kg which is the key input for their WHC valuation. NAR 6,000kcal/kg also has a higher energy content compared to the Chinese benchmark coal and hence typically commands a premium. Overall, Lazard continue to see WHC as attractively priced currently on a long-term basis with current profitability implying a FCF yield well over 40%.

- Suncorp's (SUN) share price performed strongly over the first nine months of the 2021, ending September at A\$12.50, but fell to A\$11.00 by the end of the last quarter of 2021. This was mostly driven by the multi-state weather events of 3 November 2021, which SUN estimated to have cost A\$225-\$250m. Accordingly, the company increased its expected natural hazards costs for the f22 financial year to the range of A\$1.05bn to A\$1.13bn, or about A\$125-\$150m above the budgeted allowance. This would lower f22 EPS by up 10% at the top of the range, but the annual tally is the sum of a random series of events and can thus rise or fall as the year progresses. In this case, the remainder of November and December 2021 recorded no major loss events. There was little other news, apart from Suncorp bank's APS330 disclosures, which showed modest mortgage growth and no credit loss for Q3 2021. SUN traded at a 29% FY 3-year P/E discount on consensus earnings that Lazard see as broadly reasonable. At A\$11, Lazard continue to see SUN as being at a modest discount to its fair value relative to the market overall. SUN is a beneficiary of rising interest rates, as long as rising rates do not reflect permanently higher inflation.

Market Commentary

The ASX 200 rose 2.7% in December 2021 and ended the calendar year 2021 with a gain of 17.5%.

Materials, Communication Services and Consumer Staples outperformed in Australia during December 2021 and the sectors which underperformed the most were the Energy, Financials and Information Technology. Another year has passed in which COVID-19 has monopolised headlines, with the new 'Omicron' variant spreading across the world since early December 2021. Despite the new highs in Australia's COVID-19 case count, the prevalence of the less severe 'Omicron' variant compared to previous strains, is so far proving to be smaller economic drag. Markets, however, displayed persistent immunity to rising case rates, lockdowns, gummed up supply chains, inflation surprises and hawkish pivots from multiple central banks. Despite recent signs of a decline in consumer spending and activity data due to 'Omicron', global growth is expected to remain resilient and above potential.

Outlook

Looking back over the 18 months since the COVID-19 crisis hit, two major events of consequence have occurred that Lazard believe will impact economies and financial markets in the coming years.

The first of these was the announcement of efficacious COVID-19 vaccines in November 2020. This, together with improved treatment options, should allow the eventual return of close-to 'normal' life and economic activity. While re-openings will occur intermittently as additional COVID-19 waves, new virus mutations and vaccination programs individually wax and wane, the end result seems clear, with timing being the variable up for debate. Even in this respect, locally, the 'Omicron' strain out-breaks and consequent abandonment of suppression strategies and the rapid Australian vaccination roll-out over Q3 21 have reduced the timing uncertainties.

Before COVID-19, equity markets were generally expensive with valuations dispersions between stocks and sectors at levels not seen since the TMT boom in 1999/2000. This bifurcation was pushed to record breaking levels during 2020 due to the peculiar dynamics of lockdowns. Stock market leadership and the portfolio relative performance changed from November 2020, however, coinciding with the vaccine announcements. Although there are only limited precedents, turns in market performance of the speed and size witnessed have typically continued for extended multi-year periods. While definitive market turning points are only clear in hindsight and never linear, gains for value strategies have now accumulated to significant levels and given the still prevailing distortions, Lazard's confidence has increased that the ultimately inevitable unravelling of the excess returns has commenced.

The second key development is the fully monetized fiscal stimulus undertaken by governments globally of a scale not seen since World War II. Positively, this has led to significant upgrades to economic growth forecasts and earnings expectations for stocks owned in the portfolio. What is less clear, and continues to be debated, is the potential for stimulus of this size and nature to cause inflationary pressures. While Lazard continue to keep an open mind and assess the incoming evidence on inflation risks, given many asset prices seemingly require 'lower forever' rate expectations, any change could be a major event. To be clear, the emergence of inflation is not a forecast Lazard make, nor that they depend on. However, they do believe that this is an increasing risk, and one that investors should be mindful of when considering broader portfolio positioning. Recent inflation outcomes across the Western nations from New Zealand to the UK, labour market indicators, commodity prices and particularly energy prices have increased the risks of an inflationary dynamic developing.

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Product Name	APIR Code
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