Airlie Australian Share Fund
- Active ETF

A concentrated, active portfolio of Australian equities.

Airlie Funds Management

Ticker: AASF

Fund Update: 31 March 2025 ARSN: 623 378 487

FUND FEATURES

- Access to an experienced, proven investment team specialising in Australian Equities, with a long track record of prudent common-sense investing.
- A conservative and robust investment process that focuses the team's energies on their 'best ideas'.

FUND FACTS

Investment Objective
To provide long-term capital growth and regular income through investment in Australian equities.

Investment Strategy
- Long only, bottom up specialised and focused Australian equities fund
- Concentrated portfolio of 15-35 stocks (target 25)
- Active, high conviction approach - Airlie's 'best ideas'

Investment Risks
All investments carry risk, returns are not guaranteed and there is a risk that investors may lose money on any investment they make. The Fund's Product Disclosure Statement (**PDS**) sets out the significant risks relevant to the Fund. You can view the PDS at: www.airliefundsmanagement.com.au

Inception Date	1 June 2018
Benchmark	S&P/ASX 200 Accum. Index
Portfolio Size	AUD $852.4 million
Distribution Frequency	Semi-annually
Management Fee^	0.78% p.a. (inclusive of net effect of GST)
Ticker	AASF
APIR	MGE9705AU
Minimum Initial Investment#	AUD$25,000
Buy/Sell Spread#	0.18%/0.18%

^ Transaction costs may also apply – refer to the Product Disclosure Statement. All fees are inclusive of the net effect of GST.
# only applicable to investors who apply for units directly with the fund.

PORTFOLIO MANAGERS

Emma Fisher
Over 13 years investment experience. Formerly an investment analyst within the Australian equities team at Fidelity International and prior to that Nomura Securities.

Matt Williams
Matt has over 25 years industry experience. Matt joined Airlie in July 2016 managing Australian share strategies for institutional clients and is co-portfolio manager for the Airlie Australian Share Fund for retail clients.

DEPUTY PORTFOLIO MANAGER

Joe Wright
Joe has over 10 years experience in the investment industry. Joe joined Airlie in 2021 as an equities analyst and became Deputy Portfolio Manager for the Airlie Australian Share Fund in 2024.

Visit www.airlieaustraliansharefund.com.au for more information, including: fund performance, unit prices and iNAV, investment insights, PDS & forms.

PERFORMANCE*

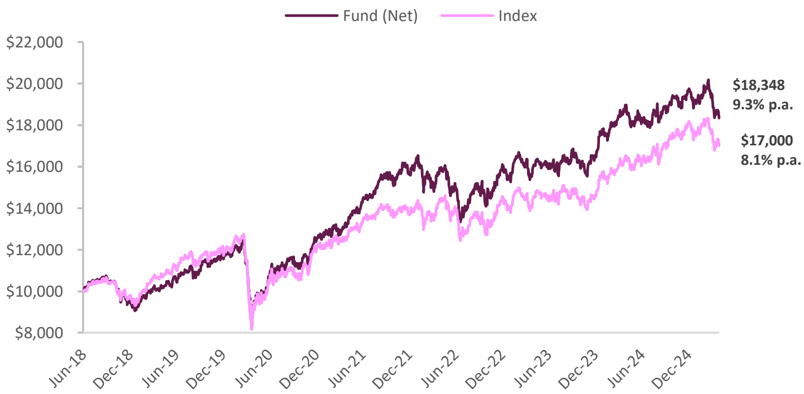
	Fund (%)	Benchmark (%)	Excess (%)
1 Month	-5.1	-3.4	-1.7
3 Months	-3.6	-2.8	-0.8
6 Months	-5.6	-3.6	-2.0
1 Year	-3.3	2.8	-6.1
3 Years (p.a.)	4.9	5.6	-0.7
5 Years (p.a.)	14.8	13.2	1.6
Since Inception (p.a.)	9.3	8.1	1.2

Past performance is not a reliable indicator of future performance.

TOP 10 POSITIONS (BY WEIGHT)

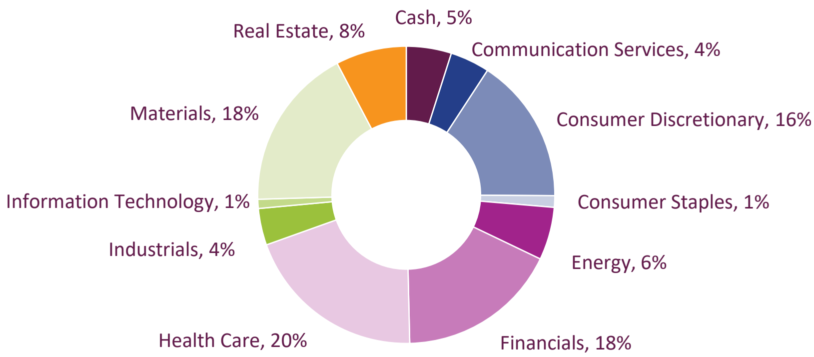
Company	Sector**
BHP Group Ltd	Materials
CSL Ltd	Health Care
Commonwealth Bank of Australia	Financials
ResMed Inc	Health Care
Aristocrat Leisure Ltd	Consumer Discretionary
Macquarie Group Ltd	Financials
News Corp	Communication Services
Medibank Pvt Ltd	Financials
SGH Limited	Industrials
BlueScope Steel Ltd	Materials

PERFORMANCE CHART GROWTH OF AUD $10,000*



Past performance is not a reliable indicator of future performance.

PORTFOLIO POSITIONING**



* Calculations are based on exit price with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). Returns denoted in AUD.
** Based on GICS Sector classification, may not sum to 100% due to rounding.

FUND COMMENTARY

The Airlie Australian Share Fund portfolio returned -3.6% net of fees for the March quarter, underperforming the S&P/ASX 200 index return of -2.8% by 80 basis points. This was a disappointing outcome given the outperformance in January/ February as the hyper-rally in the big four banks started to reverse. Unfortunately, we were swept up in the market volatility in March, with several of our top 10 holdings (CSL, ALL, RMD, NWS, BSL) having large exposures to the US where newsflow regarding impending tariffs led to increased fears of a recession. We explore our views on this below, as we believe the subsequent move down in April to date is offering some excellent long-term opportunities.

Contributors during the quarter include:

- **Medibank Private (+19%):** A solid 1H25 result from Medibank came at the same time as the long-awaited announcement of next year's premium rate rises. With Medibank granted a rate rise of 3.99%, well ahead of market expectations in the low-3s, some of the "regulatory risk" discount came out of the stock.
- **BlueScope Steel (+15%):** A rare direct beneficiary of tariffs, US steel spreads have increased dramatically since Trump came into office. BlueScope is also focusing on self-help, which should improve through-the-cycle returns, with a further $200m cost out on track for end FY26, as well as a $200-300m working capital release on the same time frame.
- **Charter Hall (+13%):** One of the best results of reporting season in our view, Charter Hall have done a great job at permanently reducing their cost base during this property downturn, pulling c20% out of their operating expenses on an ongoing basis. This sets them up well for operating leverage to return, as we now reach a more benign point in the property cycle. Transaction activity should pick up from here, and with devaluations ceasing to be a headwind to FUM, we think the business looks well placed, particularly as interest rates come down.

Detractors during the quarter include:

- **James Hardie (-23%):** We saw a mind-boggling move from James Hardie to acquire outdoor-decking company Azek, in a half-scrip, half debt-funded deal that originally valued Azek at US$8.75bn. (Note the valuation has fallen with the fall in scrip value of JHX shares.) We outline our thoughts on the deal below but suffice to say we are no fans. The challenge is that the share market spotted the value destruction immediately and has repriced the shares. As such we have not bought or sold any shares, and are focusing our work on channel checks as to the logic of bringing these two companies together.
- **IDP Education (-25%):** A poor result from IDP left us with more questions than answers in relation to working capital and cash flow, and we have since exited our position. While we acknowledge we could be selling the stock somewhere near the bottom of the regulatory cycle, we have a growing unease with the combination of a deteriorating balance sheet and a growing divergence between EBITDA and cash flow that to us suggests further downside is possible.

OUR THOUGHTS ON THIS MARKET MELTDOWN

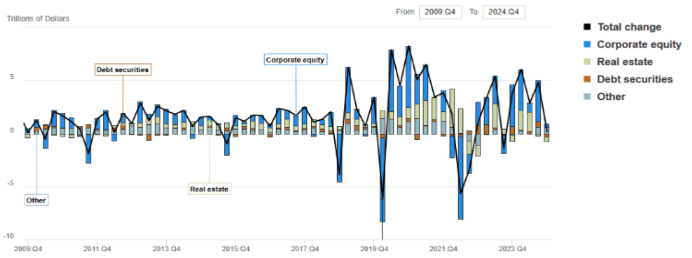
As we share our views on the macro backdrop, we are mindful of the apocryphal saying, "In bull markets, everyone is a long-term investor, in bear markets everyone is a macroeconomist". We do not profess to be experts on tariffs nor do we wish to become experts, given the policy appears to be changing day by day. Instead, our macro research has focused mainly on the relative strength of the US and Australian consumers, given our portfolio is chiefly exposed to those two markets, and given the market is increasingly pricing in a US recession.

US consumer – in rude health but prone to sentiment shocks

The first thing to note is that the US consumer is the economy, far more than is the case for other countries such as Australia. As the below Bloomberg chart shows, US household consumption accounts for nearly 70% of US GDP – vs c.50% for Australia.

Further, annual trips to the US over the years have taught us that the US consumer is a lot more responsive to media headlines and stock market movements than the Australian consumer, where consumption and consumer confidence tend to be driven by the changing outlook for variable interest rates. This makes sense given the nature of US mortgages where most people are on 30-year fixed mortgage rates. The US also has higher stock ownership levels, with c.62% of Americans owning stocks directly vs c.50% for Australia (outside superannuation).

That's contributed to a very positive backdrop for consumer confidence in the US over the last few years. The chart below shows the change in the components that drive American net worth over the years. As you can see, the last two years have had strong positive contributions from rising share markets and house prices.

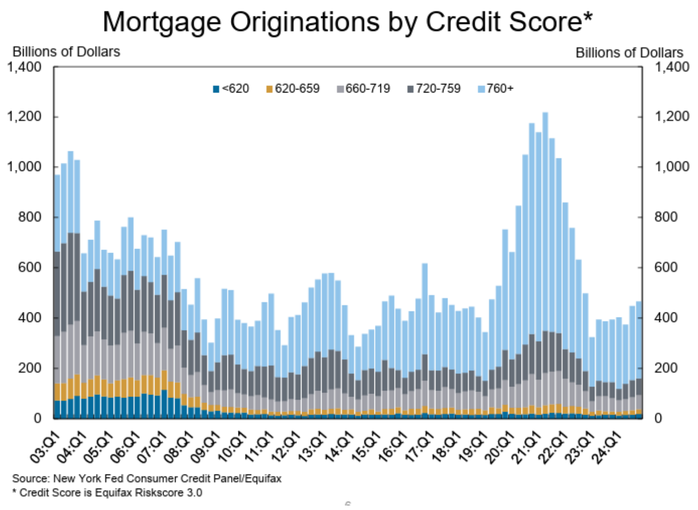


Source: St Louis Fed.

All this makes for somewhat of a self-fulfilling prophecy: if the stock market is falling and media headlines are overwhelmingly negative, the US consumers (who ARE the economy) will put away their wallets and we will likely see a recession in the US. What really matters for equity markets, however, is how protracted such behaviour is. The GFC, for instance, was devastating to equity markets, and US economic activity took nearly a decade to recover because the US consumer was ground zero for the crisis. Unemployment shot through the roof and unsavoury lending practices prior to the GFC meant a whopping 23% of US mortgage owners were underwater on their mortgages in 2008.

This time around we feel things would be different. While we can't rule out a short, sharp recession based on collapsing consumer confidence, the underlying balance sheet of the US consumer is in rude health. US consumers are sitting on a mountain of home equity, with the average loan-to-value ratio for US mortgages at 46%. This figure was 85% at the height of the GFC in 2008. In Australia, the average LVR is more like 65%.

Lending practices have also improved markedly since the GFC, with good credit-score loans making up the bulk of mortgages today (vs the lead-up to the GFC). So while the consumer might be likely to put away their wallets for a time as uncertainty reigns, it's a matter of choosing not to buy, rather than not being able to, which are fundamentally different propositions.



Australian consumer – coming out of a dark, dark place

The Australian consumer is a different story. While US consumers are rolling off high consumer sentiment and confidence, Australian consumer sentiment is at a three-year high following the first RBA rate cut in February, and expectations of a further two cuts this year, highlighting the extent to which confidence is driven by the perceived direction of variable mortgage rates. On a per capita basis, real disposable income and consumption are both down significantly due to inflation, interest rates and taxes. We expect both to trend up as mortgage rates fall.

Source: Goldman Sachs.

Finally, the Australian consumer is not overly exposed to direct tariffs. Only 4% of our exports go to the US, so we shouldn't see much flow-on impact on businesses and consumers.

Pulling it together, while the average American has a much better balance sheet than the average Australian, consumer sentiment and disposable income is likely to improve from here in Australia, following three years of falling disposable income and consumption per capita, while the US is likely to go the other way, as consumers put away their wallets at a time of heightened uncertainty.

This leaves us with a few baskets of ideas to add to during this sharp market sell-off.

1. US-exposed businesses with great balance sheets: Portfolio holdings Resmed, Aristocrat, News Corp and BlueScope fit this bill. Markets are repricing down to accommodate a heightened likelihood of a US recession. However, the underlying health of the US consumer, and the rude health of these companies' balance sheets, allow us to take advantage of the indiscriminate sell-off.

2. Domestic companies exposed to improving Australian household income and falling interest rates: These include businesses such as Nick Scali, JB Hi-Fi (a new addition to the portfolio this quarter), Charter Hall and The Lottery Corporation.

We are also watching the sell-off in a number of high-quality businesses that we don't own, hoping we may get an attractive entry point.

FIRST DO NO HARM

An alternative working title for this note was "management teams behaving badly", but we felt it more apt to invoke the Hippocratic oath, the cornerstone of medicine that emphasises the importance of avoiding harm to patients above all else. If we consider the 'patients' in this context as public companies, management teams across Australia would do well to consider their own Hippocratic oath to shareholders: first, don't do anything dumb. This should go without saying, and yet these past 12 months feel littered with the fallout of dumb decisions from management teams, primarily regarding the pursuit of large-scale M&A.

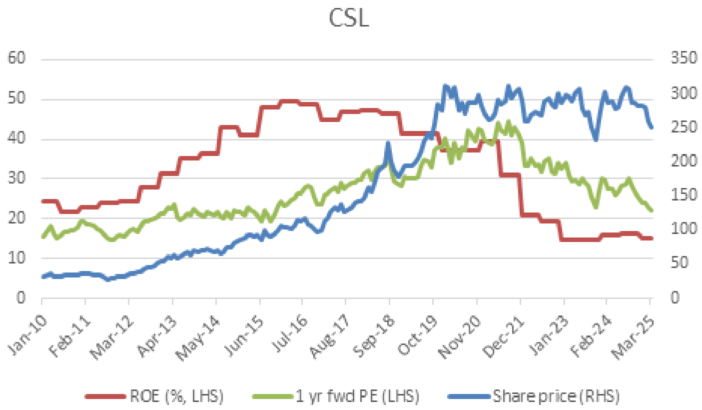
Is this a bit too harsh? Let's examine the evidence.

- Orora's value-destructive $2.2bn acquisition of Saverglass, which managed the cardinal sin and hat trick of gearing up the balance sheet to purchase a business off private equity in a new jurisdiction (France – not renowned for its business-friendly labour laws). Orora's share price touched $3.75 in the week before the deal announcement, and today languishes below $2;
- Viva's $1.15bn acquisition of On The Run, which was touted to add $165m in EBITDA post synergies, for an acquisition multiple of 7x EV/EBITDA, yet contributed $45m in FY24 – a true price of 26x EV/EBITDA. The deal also allowed the founders to strip out the property, saddling Viva with an $80m a year lease cost;
- CSL's acquisition of Vifor, which has so far proven a dud, torching the group's historically high ROIC >20% down to a paltry 12%;
- Healius's $300m acquisition of Agilex Biolabs, promising EBITDA of $16m and delivering a paltry $4m in its first year of ownership, prompting Healius to achieve the impressive feat of exiting the covid-era pathology funding avalanche with a balance sheet issue requiring an emergency capital raise;
- Perpetual's disastrous $2bn acquisition of Pendal;
- Ramsay's $1.4bn acquisition of Elysium in 2022, which they funded entirely through debt. To date, the business generates barely any profit.

The most topical current example of a management team violating the Hippocratic oath to shareholders has to be James Hardie's proposed $8.75bn[1] acquisition of Azek, which we will return to later on in this piece.

All of this begs the question as to why. Why does large-scale M&A typically destroy value? The answer is because of its deleterious impact on the returns of the acquirer's business. Over the long term, a company's share price will follow the return on capital it generates. The issue with large-scale M&A is that it typically enshrines a low return on capital from day one, as the acquirer must pay a takeover premium to "win" the target.

Picking on CSL as an example, much has been made of the extraordinary de-rate in CSL shares over the last five years as the share price has gone nowhere. However, when viewed through the lens of the returns the company generates, the de-rate makes a lot more sense.



Source: FactSet, Airlie Research

CSL enjoyed a phenomenal run-up in its share price over the decade 2010-2020, as improving return on equity (from 24% in 2010 to a peak of 47% in 2018) drove a PE re-rate from 15x to a peak of 45x earnings. ROE has since declined to 15%, primarily due to the combination of covid-era donor fee inflation shredding CSL's plasma business gross margin, and the acquisition of Vifor, which we estimate generates a ROIC of c3% on the initial A$17.2bn invested. Hence, the de-rate CSL has experienced makes sense in the context of some external misfortune and some capital allocation own goals. The good news, and why we own CSL in the fund today, is that we believe incremental returns should improve from here, as gross margins improve in Behring and the company shows more discipline on capex. The value destruction from the acquisition of Vifor is a one-and-done phenomenon, which is why we are so focused on avoiding harm (dumb acquisitions) in the first place, as we believe the CSL share price would be much higher today if they had not done this deal.

Applying this framework to the Hardie acquisition of Azek highlights the likely immediate value destruction of the deal, one that tarnishes Hardie's reputation as one of the cleanest, high-returning organic growth stories listed on the ASX. Consensus estimates have James Hardie generating EBIT of $865m for FY25, from an invested capital base of just $2.8bn, for a pre-tax return on invested capital of 32%. This is an extraordinarily high return for a manufacturing business. The $2.8bn of invested capital mostly represents the sum of the capital invested over several decades in building up the

1 US$8.75bn refers to the value of the deal on the day of announcement. James Hardie's share price has since fallen, hence the scrip component and overall deal value will be lower.

company's largest division, North American Fibre Cement, comprising 19 manufacturing plants globally, three R&D centres, the working capital tied up in the channel, and the historic goodwill associated with the acquisition of Fermacell. With the proposed US$8.75bn acquisition of Azek, a new(ish) management team (CEO Aaron Erter was appointed only two-and-a-half years ago) has seen fit to add an extraordinary $8.75bn to the existing capital base of Hardie' - a 312% increase in the company's invested capital base overnight.

Consensus forecasts have Azek earning US$270m EBIT in FY25. This would imply a day one pre-tax return on invested capital of 3% for James Hardie shareholders. For Azek to generate an acceptable return for shareholders of, say, 10-12% pre-tax, you would have to believe Azek can earn a sustainable EBIT of US$875m-1bn; that is, a trebling of the current forecast EBIT. This seems highly unlikely. If we take the earnings base of US$270m and give management the benefit of the doubt on all outlined cost synergies of US$125m, this is a $395m EBIT base. For the business to generate an acceptable return of 10-12% pre-tax, Hardie's would have had to have paid US$3.3bn-$4bn for Azek; that is, the deal looks immediately value destructive to the tune of US$4.5-5bn. Now obviously if management can achieve the outlined $500m in revenue synergies from the deal, this will offset some or all of this value destruction. However, that will be proven out over the medium to long term. Incidentally, two weeks before the deal was announced James Hardie had a market cap of US$14bn, which has fallen to cUS$10bn today – indicating the market has been quick to price in this value destruction.

Now the bigger question is where to from here – the value destruction of this deal has been spotted by an efficient market very quickly. The extent to which James Hardie "makes good" on this deal (from the new, lower share price starting point) will come down to execution. Azek is by no means a bad business, and there appears to be logic to putting these products together under one manufacturer when selling into the same US R&R channel. As with any acquisition, the long-term success will be a function of the extent to which one plus one equals something more than two. However, when you pay up to begin with, one plus one must equal something more than three for value to eventually accrue to James Hardie shareholders.

Markets are efficient, no doubt, which is why we ask (beg?) Australian management teams to adhere to the Hippocratic oath when considering M&A: first, don't do anything dumb. And we'd take it so far to suggest that most large deals, no matter what the bankers cook up regarding synergies, EPS accretion, multiple re-rates, etc., are simply dumb deals for acquirers – an immediate value transfer to target shareholders that will sit on returns and immediately torch value.

UK AND IRELAND TRIP OBSERVATIONS

During the period we visited the UK and Ireland to see a few of our portfolio holdings with offshore operations.

Nick Scali – UK expansion

Nick Scali has been a long-term holding in the Fund. The business demonstrates all the characteristics we look for in an investment: net cash balance sheet, market-leading position in the sofa category domestically with best-in-class operating margins, a founder-led management team with Anthony Scali at the helm for the past 20 years, and an attractive valuation. In April 2024, after many years of market diligence, the company made the decision to enter the UK via the acquisition of furniture retailer Fabb Furniture ('Fabb'), gaining access to an initial store network of 21 stores. While the loss-making Fabb was acquired for just £2, the company raised A$50m to fund store refurbishments and working capital. We consider this a relatively low-risk entry to a new geography.

We met with Rodd Orrock (Head of Nick Scali UK) at one of Nick Scali's recently converted stores in Thurrock (just outside of London) to get an update on the progress of converting stores to Nick Scali branding and product as well as the initial customer response. We walked away positively disposed towards the transaction and made the following key observations:

- Nick Scali's product range is unique relative to local competitors, with a more modern look and brighter colour palettes. Some adjustments need to be made to dining and coffee table sizes to account for smaller houses in the UK. Nevertheless, Anthony on the most recent results call noted the best-selling sofa in the UK is the same as the best seller in Australia.
- To date, six stores have been converted to Nick Scali format in the UK and these stores are all located in retail parks outside the major city centres. Anecdotally, foot traffic at these retail parks is high and indeed the Lakeside Retail Park we visited rivals some of Sydney's busiest centres such as the Moore Park Supa Centa.
- There are ~30m dwellings in the UK vs ~11m in Australia so the market opportunity is significant. Given population density is higher as well, management expect the UK stores to generate higher sales per square metre than Australia.
- Conversion rates to date have been solid at ~75% on customer quotes, but store traffic remains below Australian levels, indicating the brand is still building awareness among customers.
- Interest-free promotions are highly advertised in store. Unlike Australia, ~40% of transactions in the UK are done using interest-free credit for terms of between 6 and 48 months.
- Some operating cost synergies have already been realised with the Fabb headcount reduced from 270 people to 120 by leveraging the Australian operations for key functions such as buying and marketing.

- Pre-acquisition, Fabb was generating gross margins of just 41% vs 65% for Nick Scali in ANZ. Nick Scali has made changes to the way sales staff operate, removing on-floor discounting and customer returns, which lifted gross margins immediately. As they start to sell more Nick Scali product that is sourced from low-cost Asian factories, gross margins are expected to move into the high 50s.

While it remains early days, we are optimistic the brand will gain traction in the UK market.

Nick Scali Thurrock showroom with Rod Orrock (Head of Nick Scali UK)

Chemist Warehouse – Ireland

Another portfolio company we visited was Chemist Warehouse in Ireland where we met with local CEO and joint venture partner Colin Galligan. Chemist Warehouse has been operating in Ireland for five years now and our key observation was that the discount pharmacy model is gaining traction. Anecdotally, Aldi and Lidl entered the Irish market 20 years ago and from a standing start have been able to capture a combined 26% market share, completely disrupting the local grocery industry. We believe Chemist Warehouse is on a similar trajectory.

We visited three stores in Dublin (Blanchardstown, Henry St and Talbot St) and store traffic was elevated at each for Tuesday morning trade. Store layouts are similar to Australia with shelves stacked above eye-level with pink and yellow price stickers creating what management describe as 'theatre' in the stores. Most pharmacies in Ireland have a dispensing counter near the front of the store and are focused on prescription medicines. Chemist Warehouse flips this model by placing the dispensary at the back of the store and typically sells more 'front of shop' items; e.g., vitamins, fragrances, skincare. The average pharmacy in Ireland is generating a healthy gross margin of 40%, which allows Chemist Warehouse to undercut prices by 20-30%. These discounts drive a disproportionate increase in sales volumes, which allow Chemist Warehouse to generate significant operating leverage on its fixed costs (labour and rent) and effectively earn a similar profit before tax margin of ~10%.

Some other observations we made:

- Relaxed pharmacy ownership rules have allowed Chemist Warehouse to acquire larger sites in Ireland with the Blanchardstown store we visited occupying ~1,000 sqm vs the ~500 sqm average in Australia.
- Sales mix is over 90% skewed to 'front of shop' items, indicating the local consumer still doesn't view them as a traditional pharmacy. Management have adapted the range to stock more Irish brands but have also kept Australian brands where it makes sense (e.g., Bondi Sands in sunscreen).
- Chemist Warehouse is yet to introduce higher-margin private label products as they are looking to build trust with the consumer by stocking big-name brands such as L'Oréal. They are also in the process of building their own warehouse; this should allow for better inventory management and lays the foundation for launching an e-commerce offering.
- There are ~2,000 pharmacies in Ireland and the market remains highly fragmented with ~60% of the market comprising operators with only one or two pharmacies.
- Boots, a key competitor in Ireland with 92 stores, has been aggressive in securing exclusive leases with shopping centres to limit these precincts to one pharmacy. This has made it difficult to secure new sites and Chemist Warehouse have adapted by taking on bulky goods centres and high street locations.

Left: Aisle in Blanchardstown store and Right: Henry St shop front

Chemist Warehouse currently has 12 stores in Ireland and is aiming for 15 stores by the end of June. We think 40-50 stores is a realistic long-term target. If they are successful in capturing market share in Ireland, we expect Chemist Warehouse to enter the UK where Boots is also the major competitor.