



Market Review

Global markets shrugged off the September weakness to post significant gains for the December quarter and the year. The US S&P 500 surged 10.6% in the quarter led by Real Estate, Info Technology and the Materials sectors which rose 17%, 16% and 15% respectively. Major European markets rallied more than 4%. The Japanese market was a rare exception, falling 2.2% for the quarter and finishing 2021 with a lackluster return of 4.9%.

Locally, the S&P/ASX300 Accumulation Index rose 2.2%. Materials +13%, Utilities +11% and REIT's +10% were the strongest local sectors, inclusive of distributions. Info Technology was the weakest local sector falling 6%, in contrast to the performance of the US Tech sector, as **Square's** equity bid for **Afterpay** (APT -31%) weighed on the local sector. Square (SQ) has subsequently renamed as **Block** and will join the ASX if the merger clears all approvals. Smaller Industrials had their first negative quarter since March 2020.

Total equity market returns for CY2021 were again strong with the S&P 500 +26.9% and +17.5% for the Australian market. The chart below reveals the Australian market finished 2021 11.6% above the pre Covid highs in early 2020. Client portfolios are around 20% higher since January 2020.

In November the RBA 'discontinued the target of 10 basis points for the April 2024 Australian Government bond'. The reality was that investor selling had overwhelmed the RBA's buying of this bond. The rising three bond yields (+0.58% in the

quarter) forced local banks to increase fixed rate mortgage offers as funding costs increased. Inflation continues to be a concern but a flattening yield curve provided some relief.

Electric vehicle raw material supplies continue to be in demand. Chinese battery grade lithium carbonate price rose more than five-fold in 2021. ASX listed suppliers continued to rally in the quarter, with **Pilbara Minerals** (PLS) +56%, **29Metals** (29M) +34% and **IGO** +29%. Iron Ore bottomed in November as Chinese economic policy pivoted to be more stimulatory. **Fortescue Metals** (FMG) rallied 28%. Many other economies are now withdrawing Covid based economic stimulus.

In a record year for M & A, IFM's consortium bid for **Sydney Airport** (SYD) satisfied the major regulatory conditions including ACCC and FIRB. Quest subsequently sold what has been a core holding at a price we consider to be excellent.

Late in the quarter **CSL** made a \$US11.7bn tender offer for Switzerland based **Vifor Pharma**, partially funded by a \$6bn placement at \$273 per share. CSL describe Vifor as a leader in nephrology, dialysis and iron deficiency with a strong pipeline of product innovation.

Link Administration (LNK), provider of back-office services, was the subject of three alternative offers. The third resulted in Link agreeing to be acquired by Dye and Durham at \$5.50 per share via a Scheme of Arrangement. Queensland gas producer **Senex Energy** (SXY) agreed to a \$852m bid from Korean oil & gas company **Posco International**.





Portfolio Review & Outlook

The Quest portfolio provided a return above the index for the quarter. Lithium holdings were the major positive contributors as shown in the table below whilst some smaller company holdings performed poorly.

Largest Quest moves for the quarter			
Best		Worst	
Core Lithium	+39%	Keypath	-27%
29Metals	+34%	Ai-Media	-24%
IGO	+29%	Kazia	-20%
Fortescue	+28%	Catapult	-20%
Mineral Resources	+25%	Carbon Rev	-16%

Four new holdings were added in the quarter.

Ventia Services (VNT) is a services business specialising in the management of social infrastructure such as roads, hospitals and telecommunications as well as defence and transport maintenance. Ventia was listed at \$1.75 per share and closed the year at \$2.00.

Ventia screens well in our Q Stocks process with a B rating. The float was conservatively priced and we see an opportunity for steady earnings growth and a PE re-rating during the coming year. It is rare to find a “Value” stock with above average business quality. Ventia trades at a substantial discount to the market and will deliver a 5.5% yield.

Siteminder (SDR) is a software company for hotels and accommodation providers that manages room bookings sourced from a wide range of on-line booking search engines. They are the leader for the mid-market, with a global presence and a number of new products designed to expand their influence and grow revenues. Our Quest Q Stocks score is a high B grade. Siteminder debuted in November up 26% to \$6.38 and closed the year at \$6.76.

Qualitas (QAL) is a real estate investor that provides credit to property investors. Qualitas has been operating prior to listing for 15 years and is 54% owned by the executives and early investors. There was no vendor sell down in this pre-Christmas IPO.

Funds under management has grown from \$79m in 2009 to \$4.2bn across 13 funds, one of which is the listed Qualitas Real Estate Income Fund (QRI). We see the business as another disruptor to the banks who have pulled back from many areas of property lending. Qualitas is a niche provider with an established client base. We expect the credit book to tilt toward build to rent development over the next year where the company has been an early adopter. Property credit funds are common overseas but new to our local market. Qualitas is Australia’s only listed commercial real estate credit provider. The company is rated B in our Q Stocks filter.

We added to the **Santos** (STO) holding during the quarter. In December **Oil Search** (OSH) shareholders voted to accept Santos’ merger proposal and as a result Santos has an expanded presence in PNG LNG. Already a diversified, low cost energy producer, the merger lifts PNG to 30% of combined gas reserves. The next largest Santos operation is in Northern Australia and includes the Bayu-Undan and Barossa/Caldita field and the Darwin LNG plant.

Any investment in energy needs to be carefully considered given Quest’s focus on sustainable returns. As the world moves to lower greenhouse gas emissions, we see LNG as a transitional fuel. Solar, wind and nuclear are the current long term sustainable fuel alternatives but due to intermittency with wind and solar, a backup fuel is required to power lights, heating and industry. Globally there is a significant focus on developing hydrogen as a backup fuel. Supply is likely to be a decade away and is not yet a cheap alternative.

This is an immense global transition. It is estimated that 1.2bn people rely on fossil fuel for winter heating. A number of large Asian LNG buyers have already declared long term commitments to LNG in order to reduce coal consumption and therefore the production of CO². LNG has approximately half the emissions of



thermal coal. In our “More Upside for Lithium” article below, lithium batteries are one solution.

Regarding this climate challenge, Santos have committed to net zero emissions by 2040¹. In November they committed to a 1.7mt pa Carbon Capture and Storage (CCS) project in Moomba. The project will inject CO₂ into depleted reservoirs to offset plant emissions. The project can also be used to extract CO₂ from the atmosphere. Santos believe CCS will have application at other operations.

Holdings in **Transurban** (TCL) and **BHP** were increased. **Woolworths** (WOW) is rated A under our process and has rejoined the portfolio after a disappointing trading update provided an attractive entry. Banks were a source funding as detailed below. **James Hardie** (JHX) has been exited after a very strong run. The company is performing very well but a lot of positives are now in the price.

The surprise at Woolworths was additional Covid related supply costs. Whilst Woolworths is well positioned to recoup these costs, we believe cost escalation will be an important issue for markets in 2022.

Currently shipping related costs are an issue but staffing shortages are anticipated to create wage pressure.

Some businesses will be unable to pass higher costs on to customers. Also segments of both local and global markets trade with very high valuations. We are mindful that that these groups are unlikely to navigate inflationary surprises well.

For decades, Australian banks have been the largest component of the ASX. Banks have been core holdings in most portfolios, benefitting from a regulatory environment supportive of a concentrated sector, a tight oligopoly, franked dividends and growth built on perpetually escalating house prices. CBA has been a core Quest holding since 2010.

We have more than halved our bank holdings, with CBA sold and a portion of the profits harvested from **NAB**. We are concerned about the

sustainability of returns in banking, especially from mortgages. Competitors continue to emerge, with better technology, more diverse funding options and highly efficient, monoline based operating costs. These include Athena, Nano, **AFG**, **Liberty** (LFG), TicToc, **Peppermoney** (PPM), Firstmac and **Resimac** (RMC). **Macquarie's** (MQG) share has also grown substantially. Our investment in **Lendi Group** is part of a thesis that digital offers will materially disrupt mortgage profitability. At Quest, this return headwind is expressed in falling bank quality scores (Q Stocks) as well as falling target prices. In the years before the GFC, the major banks were highly rated but gradually these scores have eroded. Most are now rated as C grades.

The Quest portfolio holding of only one major bank worked well as global markets collapsed in early 2020 with the emergence of Covid. Concerted policy support to stimulate economic activity via a resurgent housing sector provided a brief respite from this headwind. Major banks were suddenly very cheap, over-provisioned, well-capitalised and with unique low cost term funding from the RBA. In May 2020, Quest made a significant investment in NAB, backing the new Chair and CEO as they recapitalised and rebuilt NAB. This proved to be a well-timed and very profitable investment.

That remarkable opportunity for investment in the sector has run its course and the headwinds have re-emerged.

The NAB holding has been reduced but it is the best placed of the big four with a lower mortgage weight and material exposure to the SME sector that is anticipated to grow as Australia recovers from Covid.

The latest CBA quarterly update shows that even CBA is not immune from margin pressure. The factors that provided the temporary relief have now peaked. The RBA's supportive settings are fading, removing the remarkable policy support for house prices. This fade is also likely to impact mortgage application volumes, loan sizes and potentially equity buffers. The cheap RBA funding has also expired. **ANZ** and **Westpac** (WBC) have lost share to emerging competitors but are

¹ Scope 1 & 2 emissions



responding with lower prices in an effort to regain share.

With all this in mind, we have been remodeling the portfolio over the last quarter. It has a low exposure to the high PE tech names and a much-reduced bank weight. We have increased defensive holdings and retained select small cap's where expectations are low but the businesses are improving. As stated above, some current valuations are hard to justify, especially with inflation emerging. We believe our holdings have justifiable valuations and we are well placed to capitalise on any market pull back.

More Upside This Year For Lithium

Quest have been early investors in lithium. The Quest December 2016 quarterly highlighted the emergence of electric vehicles (EVs), the difficulties in bringing new lithium projects to market and the outlook for the lithium battery industry. Our best performing stock in 2016 was Orocobre, an Argentinian lithium producer that extract salts from brine pumped from below the salt flat. In 2021, Orocobre is again a top performer with a 132% return this year. The company merged this year with Galaxy Resources and has been renamed **Allkem** (AKE).

It has not been an easy five years however, as the lithium price soared in 2017 before collapsing from oversupply in 2018 and 2019. Our portfolio has also owned **Mineral Resources** (MIN) since 2015. **IGO Limited** (IGO) was added in 2020 and **Core Lithium** (CXO) in 2021.

A lot has changed since 2016. The drive toward EVs and away from the Internal Combustion Engine (ICE) appears unstoppable, even fanatical.

We expect 2022 to again be a big year for the lithium producers. Demand will exceed supply lifting the price to new records. Corporate activity will increase as the number of producers consolidate and new players expand into battery materials.

The lithium producers

Lithium can be extracted from brine in a process involving bores and evaporation followed by a complex processing operation. Allkem is a lithium from brine producer. Alternatively, lithium can be extracted from hard rock through conventional open cut mining and crushing with a separation process. Mineral Resources, Pilbara Minerals and Core Lithium are hard rock miners.

The budget for planned lithium development projects are unlikely to be met. History shows that new projects are complicated and experience delays. The stock market continues to underestimate the risks around regulation and permitting of developments. The main sources of lithium are Chile, Australia, China and Argentina.

We expect any stock associated with lithium to get caught up in the excitement during 2022. New hopefuls with early stage prospects, a drilling program and some handy grades will be raising funds from a willing marketplace. We are wary of these long tail development projects, many of which will not produce any cash flow for years.

We prefer companies that have existing permitting and approvals, have commenced or completed project build, have funding and offtake agreements. They are benefitting from strong pricing today.

Global mining majors may attempt to move into the lithium market which is dominated by Ganfeng, Albemarle, Tianqi and SQM. The world's largest miners are conspicuously absent from the lithium market.

The Auto Companies

The world's largest car manufacturers by volume are Volkswagen and Toyota followed by the Renault/Nissan/ Mitsubishi alliance. Volkswagen brands include Audi, Seat, Skoda, Bentley, Porsche and Volkswagen of course, plus a few others. Toyota also own Daihatsu, Hino and Lexus.

The Renault/Nissan/Mitsubishi alliance is the third largest, a multi nation collaboration that has proved resilient and provides technology synergies between the member groups. The next largest by unit sales are General Motors, Hyundai (includes KIA), Ford and Honda.

In 2021, VW had a 3% share of EV sales which are currently dominated by Chinese manufacture. VW have committed to EVs achieving 50% of auto sales. The intended trajectory is 20% EV share by 2025 with 50% penetration by 2030. Toyota was a very early mover, kicking off with the hugely successful hybrid Prius in 2000. They and BMW continue with hybrid offering in contrast to others.

The lofty ambitions of car makers will add pressure to the battery supply chain which must cater for storage batteries as well. There is now an arms race to partner, build factories and secure battery componentry.

Battery Production

Battery factories for EV and storage are popping up all over the globe. There are currently 122 operational, none of them in Europe. There are estimates that in 2030, more than 200 mega factories will be producing EV batteries. Total capacity was estimated to be 750GWh in 2020 with the pipeline suggesting around 3,500GWh in 2030. That is an expansion of 5 times in a decade, as seen in the chart below.

Of the 200+ factories expected by 2030, 148 are anticipated to be located in China. Europe and North America will have 21 and 11 mega factories in the pipeline. A further 20 will be in other regions. Factories are getting larger. Capacity used to be 10 GWH to 20 GWH but now plans for 40 to 50 GWH factories are common.

The puzzling piece is how the suppliers to battery manufacturers will maintain the feedstock of cathodes, anodes, separator and electrolyte to ravenous factories. Factories will be pumping out storage batteries as well as EV batteries.

It appears inevitable that the price of components will rise as volumes lift and competition builds. There is a disconnect between ambition and the ability to supply feedstock.

This sets the scene for a good year for pricing particularly for lithium which is critical in cathode manufacture. Depending on battery type, the cathode can be more than half the cost of a battery.

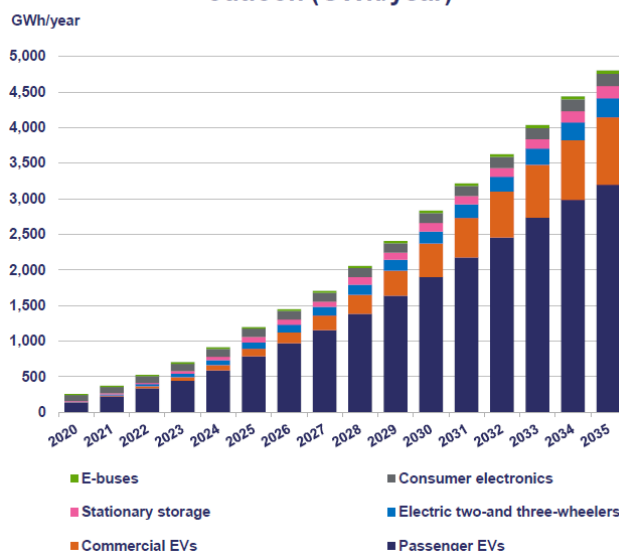
Benchmark Intelligence believe that 77% of global lithium-ion production capacity was located in

China at the end of 2021. Based on current plans in the pipeline, China will still hold 67% of global lithium-ion cell capacity in 2030. This capacity includes both EV and storage batteries.

China remains by far the most aggressive in building lithium cell production but the USA and Europe are starting to move. Tesla has led the charge in the USA.

Volkswagen have moved to a vertical integration strategy with partnerships in six 40 GWh cell plants in Europe alone and are developing bespoke battery cell formats. Previously Volkswagen, like most auto makers, bought batteries from a handful of suppliers with no interest in owning the technology.

Lithium-ion battery demand outlook (GWh/year)¹



Source: IGO, Bloomberg NEF

The big miners

We are interested in the approach of the major mining companies in 2022 including BHP and RIO who have interests in copper and nickel but no existing lithium production. Will they develop projects or attempt to buy existing production?

RIO have committed to the Jadah Project in Serbia but local protests against the mine have delayed progress. Rio have also bought the Rincon lithium development project in Argentina.

BHP have no lithium production or projects. Sources close to BHP have said the industry is too small.



The lithium price

This time last year the price of 6% spodumene (lithium content in host rock) was US\$400. Today it is US\$2,360. Nearly a six fold increase in 1 year!

Last year the lithium carbonate price was \$7,400/t. It is now \$40,000/t for 99.5% grade. Lithium hydroxide was US\$8,200 and is now \$31,000/t.

These price moves suggest a shortage of supply which will continue in the medium term. New supply will arrive slowly. In the meantime, we see the year ahead being dominated by auto makers securing battery supply, battery makers securing feedstock supply and a consolidation of producers. The major lithium producers, Ganfeng, Albemarle, Tianqi and SQM will be keen to maintain their strong market positions and are likely to buy further assets and participate in more equity and offtake deals.

Our Quest lithium holdings

We hold IGO, Mineral Resources, Allkem (previously Orocobre) and Core Lithium. All but Core Lithium are developing conversion processing into lithium carbonate and lithium hydroxide to add further value.

IGO Limited: IGO have shaped themselves for the EV market with interests in copper, nickel and lithium. The historic gold assets have been sold to fund the move to “Future Facing Metals”. The Lithium investment is a 49% interest in Tianqi Australia, giving it 25% of the Greenbushes spodumene mine east of Perth and 49% of the Kwinana lithium hydroxide plant south of Perth.

Mineral Resources: MIN are a leading service provider to mining companies and specialises in crushing and processing of iron ore. They built the Wodgina spodumene plant near Port Headland in Western Australia and sold 60% of that operation to Albemarle while also earning a 40% interest in the Kemerton hydroxide plant south of Perth. MIN is therefore in partnership with Albemarle. The Wodgina plant was placed under care and maintenance when prices tumbled but is now being dusted off to produce spodumene from lithium bearing rock later in 2022.

Allkem: Formerly Orocobre, the core asset is the Argentinian brine operation known as Olaroz. A recent merger with Galaxy Resources we think will

prove to be one of the deals of 2021. The merger diversifies the company and delivers further development projects in addition to the Argentinian Olaroz project. The September quarter at Olaroz produced 2,800 T of lithium carbonate (LiC) which was sold at US\$9,341 T. Production cost is approximately US\$4,700 T. We anticipate higher prices at lower cost in 2022 which will expand the margin which is already at 100%.

Core Lithium: located less than 30km from Darwin this is a developing spodumene hard rock miner with full approvals and offtake agreements located close to services. Plant construction has commenced. CXO is likely to ride the lithium wave despite being in construction mode.

Lithium producers accounted for 5.8% of the Quest portfolio at the beginning of the year and made up 10.5% at the end of 2021.

Performance Fees

A small performance fee is payable for the performance of the December quarter.