



*Invest with Experience*

Quest Australian  
Equities  
Concentrated  
Portfolio

QUARTERLY REPORT  
JUNE 2023



## Australian Equities Concentrated Portfolio

Mr John Citizen  
123 ABC Street  
Sydney NSW 2000

ACCOUNT NAME: Mr John Citizen

### Portfolio Movement

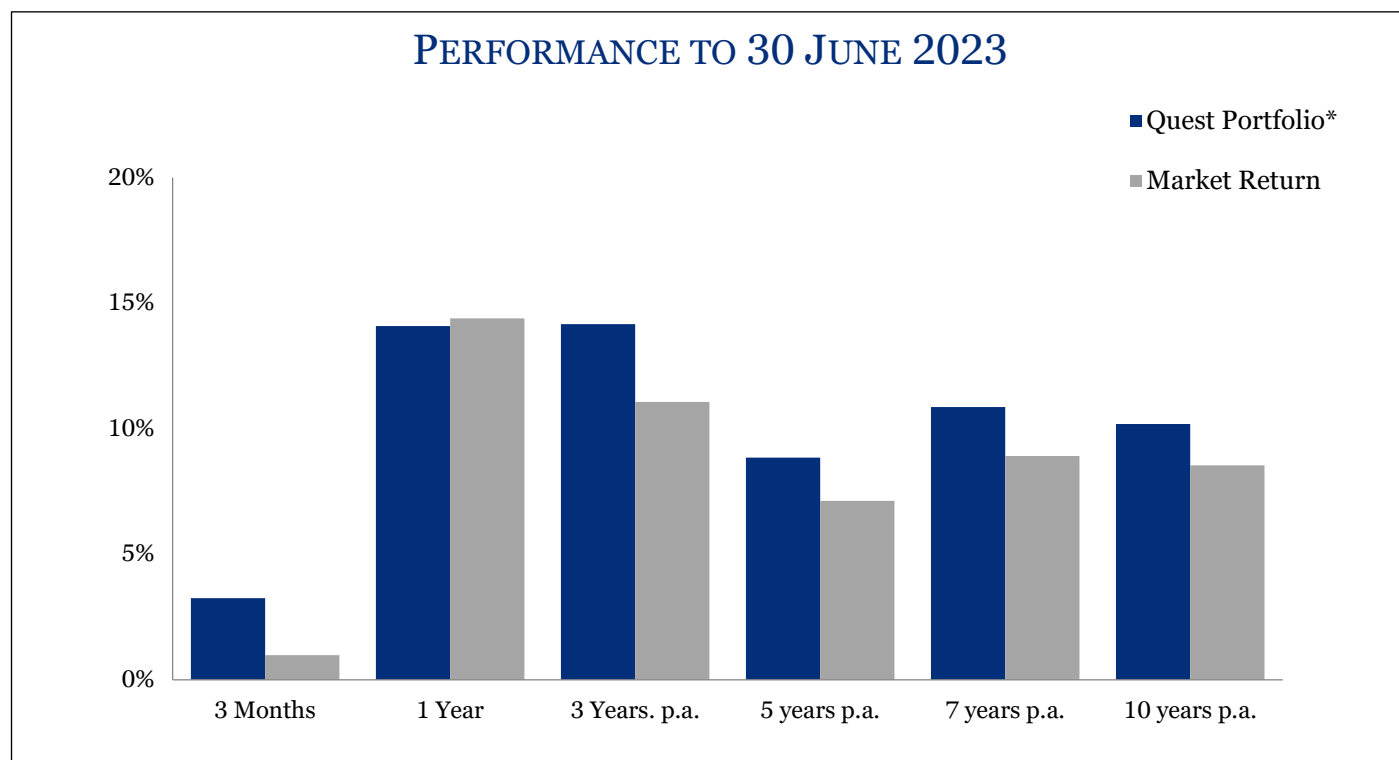
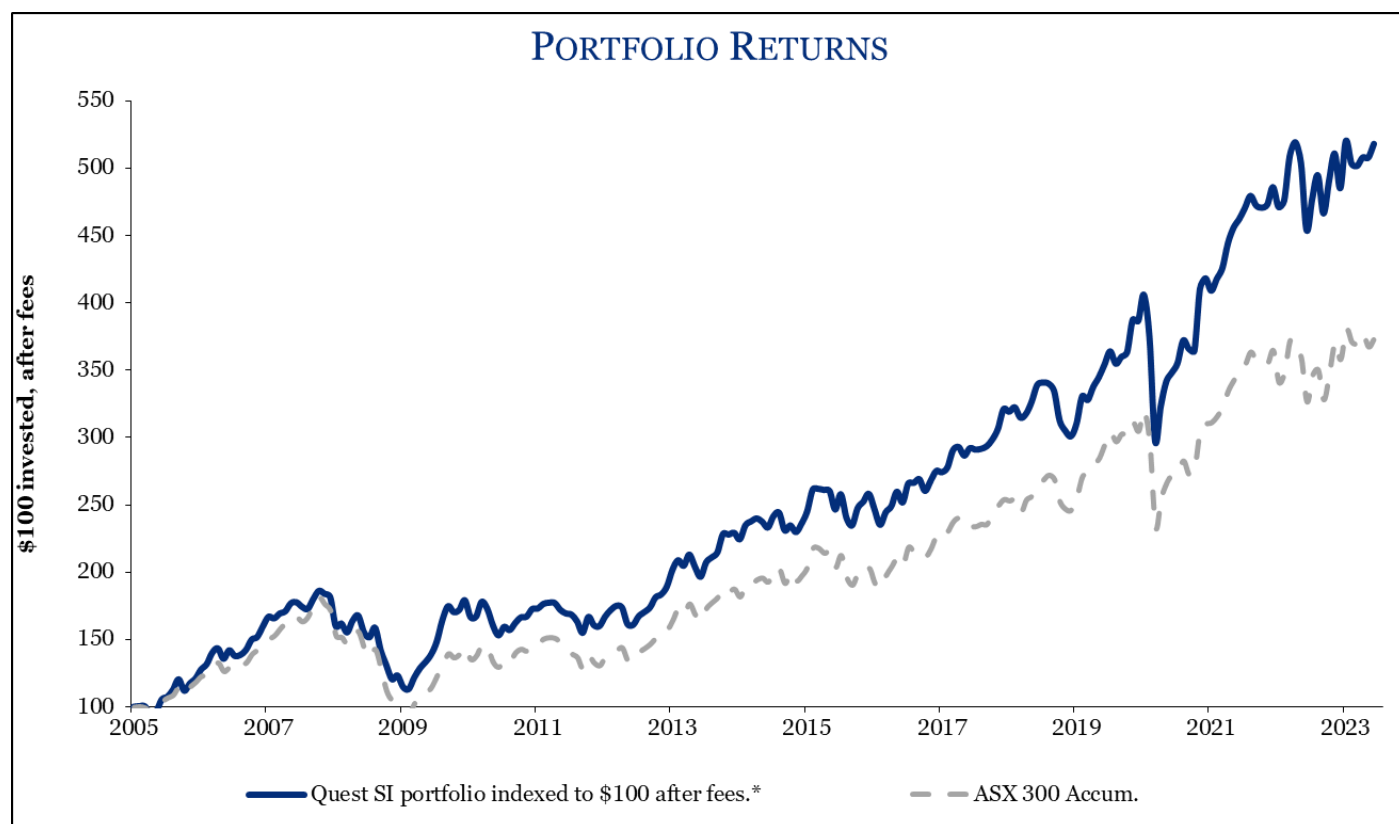
Previous market value 31 March 2023	
Contributions during Quarter	
Portfolio movement*	
<b>Market Value 30 June 2023</b>	

Your portfolio performance for the quarter*	3.23%
Market return (S&P / ASX 300 Accumulation Index)	0.99%
Your portfolio performance for the 12 months*	14.07%
Market return (S&P / ASX 300 Accumulation Index)	14.40%

\* Includes fees for the period.



## Portfolio Returns



\* The portfolio returns shown above are for an actual client portfolio on the JBWere Multi Asset Platform. They demonstrate the returns achieved if invested in the Quest portfolio since inception (February 2005). Individual returns will differ for investors that made an initial investment after this inception date or where additional investments, redemptions or any SPP investments have been made. Quest returns are net of fees. Past performance is not a reliable indicator of future performance.

## Market Review

The **2023 fiscal year** proved to be a bumper year for equity investors despite a long worry list of issues. Global returns were above expectations despite relentless interest rate rises and inflationary pressures.

In the June quarter the **MSCI World Index** rose 6.3%. Global markets were led by the US Tech sector. Nvidia was up a stunning 52%, leading interest in the Artificial Intelligence sector. The lowest quarterly return from the **Apple, Alphabet, Amazon, Microsoft, Meta, Nvidia, Tesla** cohort was 16%.

There was a resurgence in the Japanese equity market. After two years of inaction, the Japanese **Nikkei 225** rose 18% with their economy rebounding from COVID. The Tokyo Stock Exchange (TSE) has announced action to tackle poor capital management of their listed companies. Over 50% of companies trading on the TSE have been trading below book value. Actions to address the situation must be implemented or offenders face relegation into secondary indexes.

Global economic activity is currently patchy. The fears of a major US banking crisis have eased despite global bank Credit Suisse folding in a matter of days. US GDP and earnings in Q1 were better than expected but some leading indicators are weakening.

Chinese economic data is poor where the COVID rebound has been modest. In contrast to other regions, Chinese COVID lockdowns have eroded consumers savings. Residential property development has been fundamental to decades of impressive growth but prices are now falling, buyers are nervous and recent government stimulus has been modest.

Inflation remains central to equity returns. During the quarter Australian (see adjacent chart) and US inflation numbers continued to moderate but an alarming 8.7% print for the UK for May showed how inflation can become entrenched.

Quest monthly reports have consistently suggested that inflation will be prolonged and that immediate relief is unlikely. Most of our competitors have no experience of inflation. It does not roll back like a wave. It takes time, maybe years, to abate.

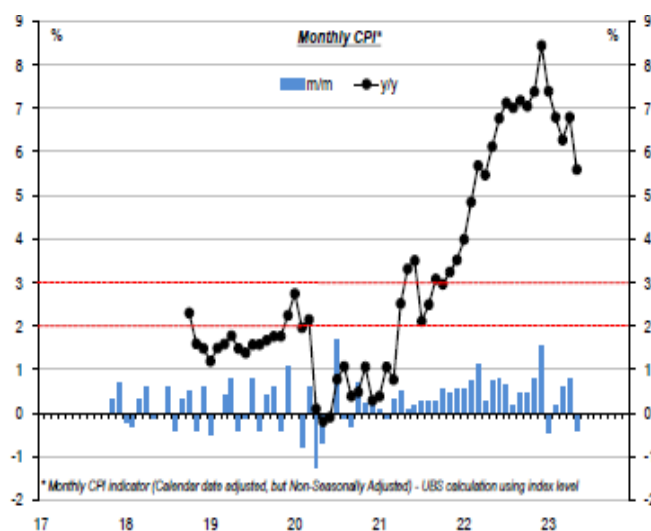
Market expectations have now shifted and reality is setting in. In Australia, a surge in power and insurance costs together with wages will keep pressure on the cost of living.

Central Bank inflation expectations have now been extended in many countries, resulting in higher long bond yields. The Australian government 10 year bond yield, for example, rose from 3.2% at the start of April to 4.0% at the end of June. Equity markets were surprisingly resilient to this sizeable move.

In the Quest September 2022 quarterly, we detailed how fixed rate mortgages would delay the impact of the RBA's twelve interest rate increases to tighten financial conditions. The impact peaked in the June quarter when the largest number of mortgages rolled from fixed to variable. Despite wage growth and full employment, mortgage arrears are rising and discretionary retailers are cutting forecasts. Economists expect further rate rises will disrupt discretionary consumption and unemployment will rise.

The highest returning sectors of the ASX in the quarter were Information Technology (+21%) and

### Australian monthly CPI and RBA targets



Source: ABS, UBS

Utilities (+4%) whilst CSL's downgrade dropped Healthcare 3%. Materials also dropped 3% with China's weak economy weighing on commodities.

In corporate news, lithium producers **Allkem/Livent** announced a merger which is discussed later. **Invocare** announced they will recommend a revised \$1.8bn bid from TPG for the funeral business and **Blackmores** recommended a \$1.8bn bid from Kirin. **BHP** completed its acquisition of **OZ Minerals**.



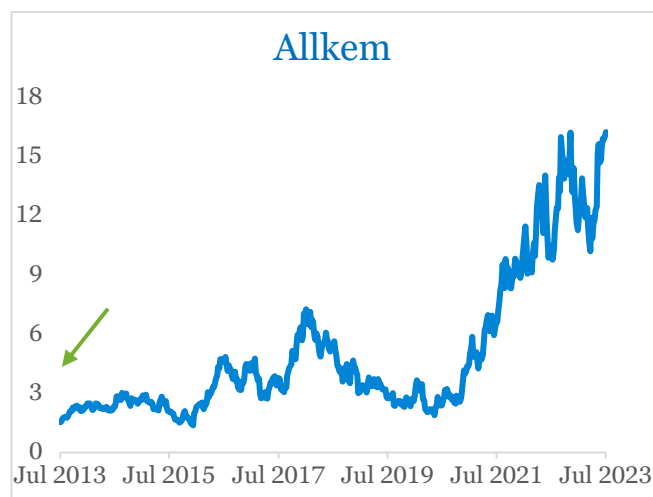
## Portfolio Review & Outlook

The Quest portfolio sprang to life during the quarter, delivering a return well above benchmark. The table reveals the holdings that were material contributors to the performance.

Best for Quest was lithium carbonate producer **Allkem**. Allkem has announced a “merger of equals” with **Livent Corporation**. Livent is a lithium technology company listed on the NYSE. The company sold the first lithium batteries to Sony in 1991 for use in cameras. Livent has a brine operation in Argentina not far from the Olaroz facility owned by Allkem. Livent also has manufacturing facilities for lithium products and an emerging spodumene operation in Quebec in the same region as Allkem. There is a planned hydroxide plant nearby which will save Allkem building a similar facility. The deal provides bulk to the merged business which could become the third largest global producer behind **Albemarle** and **SQM**.

There is however discussion about the proposed merge ratio which is seen by some Allkem shareholders as not reflective of relative value. We expect Livent to release merger documents to Allkem shareholders in September. This document will be interesting as Livent disclosure, by Australian standards, has been limited. All will be revealed but we are favourably disposed to the deal at this time.

Allkem, or **Orocobre** as it was known when it entered the portfolio a decade ago (see arrow), has been a stellar but volatile performer. On a number of occasions Quest has documented our optimism about lithium being a critical mineral in any energy transition. This transition will take decades.



Source: Iress

Also contributing were uranium miner **Boss Energy** and building products leader **James Hardie**. A Uranium update is provided latter in this report.

### Material Stock Contributions

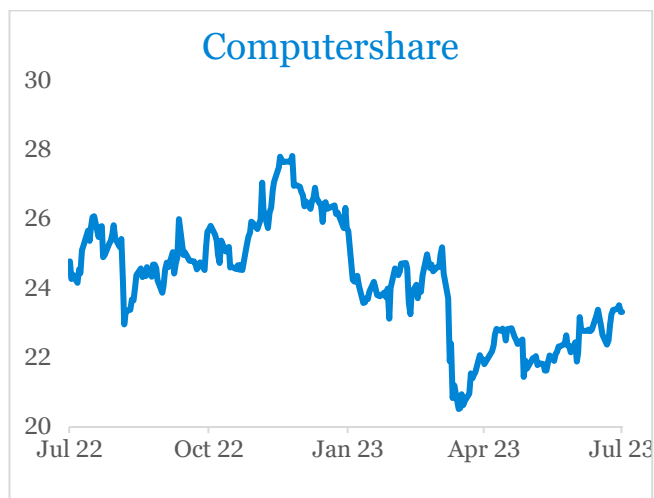
#### June Quarter 2023

<u>Best</u>		<u>Worst</u>	
Allkem	+1.14%	Stanmore	-0.84%
Xero	+0.85%	Ramsay Health	-0.61%
Ventia	+0.61%		
James Hardie	+0.60%		
Boss Energy	+0.52%		
Santos	+0.50%		
IGO	+0.49%		
Catapult	+0.35%		

In April we added **Computershare** to the Quest portfolio with an initial holding that was increased into May.

Computershare is a financial services company providing share registry, share plans and stakeholder communication services as well as mortgage services. The company is a global leader with a history of growth by acquisition and is based in Victoria. The stock hit all-time highs late last year with a peak of nearly \$28 driven by higher interest rates but has now settled around \$22. Computershare is now below our valuation.

Our quality rating has risen with sector consolidation as well as a company commitment to simplify activities into three quality divisions. The recent labelling of a “Managed” or non-core division suggests asset disposals are likely. The balance sheet is under geared indicating capital management is possible, particularly if the asset sales do occur. There is also potential for acquisitions in areas more aligned with the now defined core operations of the company.

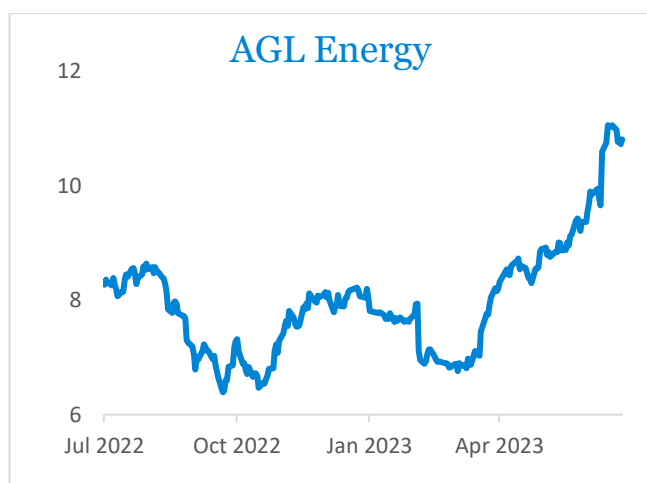


Source: Iress

**AGL Energy** has returned to the portfolio after a few tumultuous years. Quest last owned this stock in 2015 and made an excellent return through to 2017. AGL has been best avoided since then. Our recent purchase in May at \$9.80 is well below our entry price back in 2015.

The rationale for AGL is provided on the following pages. We also outline our thoughts on **Xero** which is one of our best performers this year.

**Ramsay Health Care** has been a frustrating holding. They were unable to consummate an indicative proposal from KKR and the recovery in surgery volumes has been slow. Margins have also been disappointing. The company recently indicated productivity was finally improving. We regard the recent change in Chair to David Thodey as a positive step.



Source: Iress

We have taken the profit on **Bellevue Gold** which has performed ahead of our expectations. We have banked a gain of about 30%. Bellevue is still under construction and will become Australia's newest gold mine with commissioning planned for December.

**Domino's Pizza** was sold at a loss this quarter. Updates from the company have been disappointing particularly the lack of ability to pass on inflationary pressure through pricing.

Holdings in **Steadfast** and **Transurban** have been reduced into strong bidding during the quarter.

## Uranium Market Update

Update by Chris Cahill

Quest has a positive view on uranium for the balance of the decade. Our portfolios have built a holding in emerging producer **Boss Energy**. The strategy is similar to our early moves into lithium production some years ago. The pricing outlook for both commodities is positive with supply unlikely to meet looming demand.

Boss Energy raised funds to restart the Honeymoon Mine in South Australia in March 2022. A two tranche placement raised \$120m to rebuild the existing plant over 18 months. Mine life is 11 years with possible extension from satellite deposits. Infill drilling has recently started on these resources. The share price for the raising was \$2.15. The raising resulted in funds for capital expenditure and working capital with a target completion in 2024. The current price is now \$3.05. Plant refurbishment continues. Boss is a C grade stock under our process.

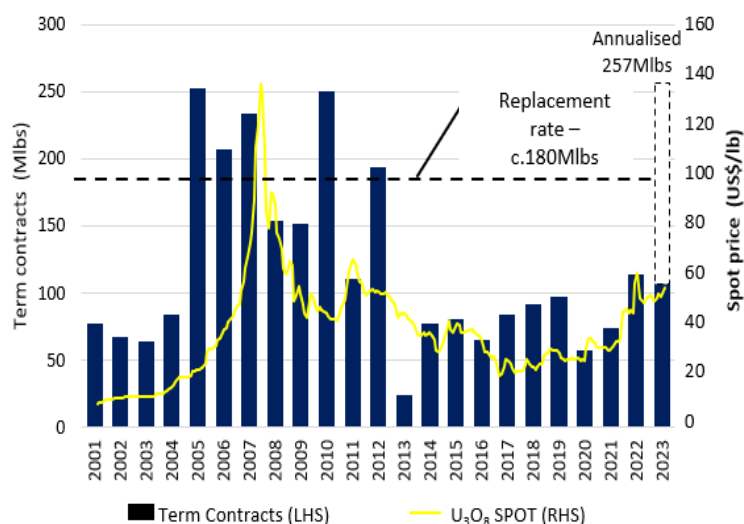
Australia has four existing uranium export licenses. Three mines are in South Australia and include U308 from BHP's Olympic Dam copper mine while one is the closed Ranger mine in Northern Territory. Honeymoon is NNE of Adelaide and it is literally in the middle of nowhere. The site does have grid power, rail access and an airport. We visited in November 2022.



Uranium has a controversial history in Australia with some seeing the commodity as the root of all evil while others see uranium power as the ultimate zero emission solution. Uranium was named in 1789 by German chemist Martin Klaproth shortly after the discovery of Uranus. Klaproth was thrilled to discover “U” which became the 92nd element of the periodic table.

Last time we counted there were 436 reactors in 32 countries with more than 50 being built, over 100 planned and dozens on the drawing board. Modular reactors are increasingly favoured. They are expensive but long lasting, provide base power while emissions are immaterial.

### Contract volumes and spot uranium price



Source: Petra Capital

Boss Energy suggested mine gate costs of approximately US\$26 per pound at the time of raising. The market price for U<sub>3</sub>O<sub>8</sub> at that time was US\$40 but prices have moved beyond US\$55 presently (yellow line in chart above). A broad summation of profitability is that total cost could reach US\$35 per pound with a potential sale price of US\$55 per pound giving a solid US\$20 per pound margin. Contracts tend to be long term, off market, not widely reported and infrequently written.

Boss has a strategic stockpile of U<sub>3</sub>O<sub>8</sub> held on balance sheet which has now delivered an unrealised gain in value. There are active ETF funds now investing in uranium stock baskets. The Sprott Physical Uranium Trust holds physical U<sub>3</sub>O<sub>8</sub> and is listed on the Toronto exchange.

Quest monitors African miner **Paladin Energy** as well. Paladin is rebuilding the old Langer Heinrich mine in Namibia which has given us the

chance to watch progress in Africa at the same time. Paladin also raised funds in March 2022.

Fuel buyers are power utilities who are juggling the needs of government and the consumer to deliver sustainable power into the future. There are many buyers but only a few producers. The disruption in Russia and Ukraine has driven the need for improved self-sufficiency in enriched fuel supply (same as lithium and rare earths).

Uranium provides 10% of world power. Sweden and France both derive 70% of power from nuclear reactors. Sweden's new government has recently suggested a move towards more reactors and away from wind and solar due to constraints on base load reliability.

Australia has the largest reserves of uranium in the world followed by Kazakhstan and Canada. Kazakhstan however produces 3 times the output of Australia with Namibia third. Customers are hungry for feedstock enriched supply but constraints exist at mine and enrichment levels.

Our thesis is simple. The world is committed to emissions reduction and is employing a combination of technologies to power the globe. Options are coal, gas, wind, solar, hydro, hydrogen, uranium and some more esoteric technologies. Most countries are adopting a combination of solutions.

The latest contracting figures show that in 2022, volumes contracted were the highest since 2012. In 2023, similar quantities have been achieved in only 5 months. The current demand explains a 15% increase in U<sub>3</sub>O<sub>8</sub> pricing this calendar year. Stock performance however continues to lag commodity price.

**We believe demand will continue to strengthen and that the uranium sector will deliver growth for many years.**



## AGL Energy update

Update by Michael Evans

**AGL** is one of Australia's oldest companies having started in 1837 selling gas to power street lamps in Sydney which were lit by hand. Today AGL is one of the country's largest energy retailers, generating energy from power stations fueled by coal, natural gas, wind, hydroelectricity and solar. AGL also owns gas storage facilities and an almost depleted gas field near Camden.

A lot has changed in recent years. Firstly, Australian climate policy is now more defined after the previous federal government failed to deliver a plan for voters that want action on climate change. Importantly state and federal plans have much commonality.

AGL has been through its own gyrations. Prior to their Loy Yang A acquisition in 2012, the company was committed to zero coal based generation. Only two years later, they became Australia's largest emitter with the acquisitions of Loy Yang A and the NSW government owned Bayswater and Liddell power stations.

AGL is now making a push to decarbonise, having closed the Liddell power station and brought forward the closure dates for Bayswater in NSW and Loy Yang A in Victoria. Both will be closed by June 2035. They have outlined a fundable plan to transition the generation fleet and undertake land remediation. The recent \$18bn bid for **Origin Energy** (ORG) by Brookfield Renewable Partners has revealed the scale of partner funding available for global power transition.

The cost of the transition is becoming clear. Our Quest March 2023 quarterly referred to a \$US4 trillion per annum global power transition estimate. Whilst solar and wind are low-cost replacement generators, 'firming' (providing power when the sun and wind is unavailable) is expensive. Power prices have risen more than 15% since the closing of Liddell in April. AGL's retail margin will likely narrow but with AGL's coal cost being fixed, we think power generation EBIT will rise dramatically. This is despite operating fewer power stations.

The scale of the required power transition for Australian and elsewhere is colossal. In Australia, network upgrading is complex, invasive and expensive while Snowy 2.0 has blown out the budget and is now due in 2029. AGL is largely a beneficiary of delays with the big proviso being their existing fleet remains operable. AGL are

committed to net zero and will play a critical role in this transition.

Internally AGL has been working hard to streamline and improve customer relationships. It is unusual for a large energy retailer to have a positive NPS score.

AGL has lifted a few points in our Q Stocks rating system to a high C grade. Valuation over 3 - 5 years is compelling given the low double-digit PE. Over the years we have found improving business quality to be a major driver of share price returns. We have invested in AGL and anticipate the changes to our power use and distribution in future years to be earnings accretive to the company.

## Xero

Update by Swapan Pandya

Accounting software provider **Xero** has been a strong contributor to the portfolio this year with the share price up around 70%. We have successfully traded Xero in recent years having initially purchased in January 2019 at \$42 and sold in November 2020 at \$137. We re-established a position in May 2022 at an average entry price of \$79. Currently Xero trades at \$116.

Xero rates as an A grade under our Q Stocks process. The shift from desktop to cloud based accounting software created an opening for Xero as a cloud native software solution that was competing against legacy desktop based software providers. Xero has focused on creating a simple user experience for its SME customer base. Cloud-based accounting allows users to work from anywhere and automates tasks that were previously manual and time consuming (e.g. reconciling bank account data). It also provides better data security and ensures compliance through automatic software updates.

Although some of the legacy desktop competitors now have competent cloud offerings, they were lagging in functionality in the early years and generally do not have the same focus on user experience as Xero. This allowed Xero to build a global footprint, invest heavily in research and development and establish a strong sales channel by partnering with accountancy firms. Xero dominates local markets in Australia & New Zealand, has a leadership position in the UK and is building its presence in the US, Canada, South Africa and elsewhere.



The product is loved by customers and the passionate userbase is clearly observable at their annual “Xerocon” conferences. There are limited competitors that have the same global scale as Xero aside from US-based Intuit. Xero has successfully competed head-to-head with Intuit in the key battleground of the UK despite Intuit being so much larger.



We believe Xero has significant untapped pricing power which it is now starting to demonstrate. It recently announced price increases of around 10% in ANZ. Users are unlikely to change accounting software providers for the sake of a few dollars per month, particularly when the overall cost (around \$35 per month) is relatively small compared with the software’s importance in running a business.

New CEO Sukhinder Singh Cassidy has arrived with a clear focus on profitability rather than growth at any cost. Technology companies around the world are adapting to the higher interest rate environment by focusing more on their cost bases. Shareholders want to see profits and cash generation now, not at some point in the future. Not all tech companies will be able to successfully make this pivot without materially impacting revenue growth. We believe Xero is well positioned given its revenue is subscription based with relatively low customer attrition.

We had a window into Xero’s margin potential during COVID where lockdowns and economic uncertainty enforced cost discipline. The result was a sharp increase in margins while revenue remained resilient. We now get to see what cost discipline over a longer period looks like.

**There is no doubt about the quality of this business, the critical issue for the investment case is determining a reasonable valuation.**

Our previous sale in November 20 at \$137 was based on the valuation being full rather than specific concerns around the business. Rising interest rates resulted in valuations of Tech/growth stocks coming down and this provide an opportunity to re-establish the investment.

The recent strength in the share price has moved the stock closer to our ‘base case’ valuation but we continue to see upside potential in a couple of areas. The first is the US business where Xero has historically underwhelmed relative to its performance in other markets. There have been notable product gaps in the US which are gradually being addressed.

The new (US-based) CEO will provide more detail on the US strategy in the coming months. The North American market (which includes Canada) is around 10x the size of Australia/New Zealand so winning even a small slice of this could be material. Canada is roughly equivalent in size to Australia/New Zealand and Intuit does not have a strong presence there like it does in the US.

The second area of upside is platform revenue. Xero has a thriving ecosystem of external apps. Xero provide the integrations to help SME’s run their business. These apps include functions like payments, payroll, rostering and inventory management. Historically Xero has not been generating revenue from these external app providers but around two years ago it started charging commissions for new users acquired via the app store. It has also acquired some app providers where it sees potential and launched a payment solution through partnering with Stripe. Platform revenue is only around 11% of total revenue today. A customer who successfully adopts a few platform functions would likely pay over \$100 per month vs. the current average of \$35 so there is a significant opportunity here.

## Performance Fees

A few clients will pay a small performance fee for the June 2023 quarter returns depending on your High Water Mark established in March 2022.