Antipodes

**Antipodes Global Fund – Long**

APIR WHT0057AU ARSN 118 075 764

**Antipodes Global Fund**

APIR IOF0045AU ARSN 087 719 515

**Antipodes Asia Fund**

APIR IOF0203AU ARSN 096 451 393

# **Quarterly Report** 31 December 2019

# Contents



## Further information


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# Market commentary

**Global equities were strong in the December quarter (+9.0% in USD, +4.5% in AUD), closing the year at all-time highs as further monetary easing, optimism for a US-China trade deal and the UK election result boosted sentiment.**

While the market had a cyclical bias, with Hardware, Materials and Industrials outperforming, profitability and growth remained the winning styles for the quarter as they have been across 2019. Momentum lagged, as previous winners Utilities and Consumer Staples underperformed over the quarter.

Against this backdrop, US equities performed in line (+9.0% in USD). The Federal Reserve cut interest rates by 25bps in both September and October, having also cut in July, and indicated that it expects to leave rates unchanged in 2020. The Fed also began expanding its balance sheet again to address a perceived shortage in system reserves. This led to a much weaker US dollar over the quarter (DXY -3.0%), supporting Emerging Market equities (+11.8% in USD).

Asian equities (+10.1% in USD) outperformed. The US and China agreed to a phase-one trade deal, avoiding the scheduled tariff increase on the 15th December. Trade sensitive markets such as Korea (+13.4% in USD) and China (+13.1% in USD) saw significant relief rallies. India (+5.3% in USD) lagged as Moody's lowered its credit rating outlook to negative citing risks to its growth outlook and government constraints in narrowing the budget deficit and preventing a rise in debt.

European equities were a small underperformer (+8.8% in USD) despite a victory for the Conservative party in the UK general election providing clarity regarding the near-term path of Brexit, with the UK leaving the European Union on the 31st January 2020. New ECB president, Christine Lagarde, reaffirmed the bank's commitment to keep interest rates at very low levels and maintain the pace of quantitative easing until inflation rises.

Elsewhere, Brent Oil (+11.4% in USD) saw a big move higher as OPEC+ agreed to further production cuts with Saudi Arabia shouldering an even greater reduction. Global government bond yields bounced post an aggressive move lower YTD and the Gold rally continued (+2.0% in USD).

**Figure 1: Region-sector valuation heat-map[1] - EV/Sales vs World – Z-score (1995-2019)**

| | Energy | Materials and Industrials | Hardware | Software and Internet | Pharma | Devices/ Life Sciences | Staples | Domestic cyclical | Communi-cations | Property and Infrastruc-ture | Financials |
|---|---|---|---|---|---|---|---|---|---|---|---|
| World | -1.4 | -1.0 | 0.0 | 1.7 | 0.1 | 2.3 | 1.1 | 0.3 | -1.2 | 0.2 | -1.6 |
| North America | -1.2 | -0.8 | 0.7 | 2.0 | -0.1 | 1.6 | 1.4 | 0.6 | -0.4 | 1.2 | -0.2 |
| Western Europe | -1.2 | 0.1 | -0.2 | 0.6 | 0.4 | 2.1 | 1.2 | -1.2 | -1.3 | 0.5 | -1.5 |
| Japan/ Korea/ Taiwan | -1.1 | -1.5 | -0.7 | -0.4 | 0.6 | 2.0 | 0.7 | -1.0 | -0.6 | -1.2 | -1.5 |
| Emerging Markets | -0.7 | -1.8 | 0.1 | -0.2 | 0.6 | -0.1 | 0.1 | -1.0 | -1.2 | -1.2 | -1.1 |

Expensive — Cheap

*Source: Antipodes, FactSet*

**1** The Antipodes Region-Sector Valuation Heat-map provides a more granular illustration of valuation clustering across sectors and regions. Cell colouring indicates the degree to which a sectors' enterprise value to sales multiple (price to book for financial sectors) relative to the world is above or below its 22-year relative trend (expressed as a Z-Score, the number of standard deviations from the mean). The warmer the colour, the greater the relative multiple versus history; vice versa for the cooler blues, with extremes highlighted by the boldest of colours.

# Performance analysis

## Summary

### Performance[2] as at 31 December 2019

| | 3 months | 1 year | 3 years p.a. | Inception[3] p.a. | Inception[3] |
|---|---|---|---|---|---|
| **Antipodes Global Fund – Long** | 4.2% | 17.3% | 11.5% | 11.5% | 63.0% |
| MSCI AC World Net Index | 4.5% | 26.8% | 13.6% | 10.9% | 59.5% |
| Difference | -0.3% | -9.5% | -2.0% | 0.5% | 3.5% |
| **Antipodes Global Fund** | 2.9% | 9.7% | 8.0% | 10.1% | 54.1% |
| MSCI AC World Net Index | 4.5% | 26.8% | 13.6% | 10.9% | 59.5% |
| Difference | -1.6% | -17.1% | -5.6% | -0.8% | -5.4% |
| **Antipodes Asia Fund** | 5.5% | 17.0% | 11.4% | 9.7% | 51.5% |
| MSCI AC Asia ex Japan Net Index | 7.3% | 18.3% | 13.9% | 8.2% | 42.4% |
| Difference | -1.7% | -1.3% | -2.5% | 1.5% | 9.2% |

### Performance & risk summary[4] as at 31 December 2019

| | Antipodes Global Fund – Long | Antipodes Global Fund | Antipodes Asia Fund |
|---|---|---|---|
| Average net exposure | 87.8% | 62.1% | 72.6% |
| Upside capture ratio | 102 | 82 | 72 |
| Downside capture ratio | 85 | 59 | 27 |
| Portfolio standard deviation | 10.3% | 8.5% | 8.6% |
| Benchmark standard deviation | 10.2% | 10.2% | 11.3% |
| Sharpe ratio | 1.11 | 1.16 | 1.13 |

**2** All returns are net of fees and in AUD terms since inception. Calculations are based on exit price with distributions reinvested, after ongoing fees and expenses but excluding taxation. Past performance is not a reliable indicator of future performance.

**3** Inception date is 1 July 2015.

**4** All metrics are based on gross of fee returns in AUD terms since inception. The upside/downside capture ratio is the percentage of benchmark performance captured by the fund during months that the benchmark is up/down. Standard deviation is a measure of risk with a smaller figure indicating lower return volatility. The Sharpe ratio measures returns on a risk adjusted basis with a figure > 1 indicating a higher return than the benchmark for the respective levels of return volatility.

## Global strategies

*Note: The term "cluster" or "exposure" is used herein to reference a collection of positions which exhibit similarities in their risk profile including an irrational extrapolation around change, end-market, style and macro characteristics.*

Key contributors to performance included:

- **Connectivity/Compute** cluster, including Samsung Electronics, Taiwan Semiconductor Manufacturing Co and Qualcomm, as the market increasingly expects a strong uptake in 5G devices in 2020 and inventory has rebalanced. In addition, Qualcomm's latest chip for 5G devices has been well-received by the market, meeting industry-leading standards on performance and speed.
- **Online Services – Asia/Emerging Markets** cluster including Alibaba and LINE. Alibaba reported another strong result with e-commerce sales (+20% p.a.), cloud computing and offline retail all growing strongly, and the company completed its secondary listing in Hong Kong opening up ownership to new investors. Yahoo Japan (now known as Z Holdings) made a takeover offer for LINE at a 17% premium to the pre-offer price and 80% premium to recent lows.
- **Consumer Cyclical - Developed Markets** cluster including UniCredit and ING Groep. UniCredit continues to demonstrate impressive cost control and ongoing balance sheet repair via selling non-core assets, guiding for mid-single-digit earnings growth and a combination of share buybacks and higher dividend payout ratio. ING reported better than expected earnings driven by revenue growth thanks to resilient net interest margins, testament to the consolidated nature of its core markets. ING remains well capitalised with a sustainable dividend yield of 7% and trades at a discount to peers.
- **Consumer Cyclical - Asia/Emerging Markets** cluster including KB Financial and ICICI Bank. KB Financial rebounded from very cheap levels as global economic data stabilised and the company announced the cancellation of bought back shares, a rarity amongst Korean financial holding companies and a positive signpost for future improvements in capital management. ICICI Bank, one of the largest retail banks in India, reported a very strong result with loan growth in excess of 20%. Low levels of retail credit penetration in India, ICICI's investment in technology and its continued expansion into lower tier cities to gather low cost deposits underwrites a high level of sustainable earnings growth.
- **Industrials** cluster, including General Electric and Siemens, as both companies reported solid results that increased confidence in their longer-term transitions. GE reported better than expected earnings and free cash flow, and a strong performance from financial services business GE Capital. Siemens reported a better than expected outlook for Digital Industries (the key structural growth opportunity for the company) driven by growth in software.
- **Software** cluster including Microsoft and SAP. Microsoft's cloud service business continues to grow from strength to strength. Given the company's integrated and bundled offers, Microsoft is well positioned as traditional enterprises increasingly embrace the cloud. SAP reported better than expected earnings due to growth from the new product cycle and cloud business, which had been missing in the company's recent execution efforts.
- **Consumer Defensive - Developed Markets**, notably Tiffany following a takeover offer from LVMH Group, the owner of Louis Vuitton.

Key detractors to performance included:

- **Infrastructure/Property - Asia/Emerging Markets** cluster, notably our exposure to China Telecom and China Unicom as positive news on 5G network cooperation was somewhat offset by competitively priced 5G plans which will likely result in a flat to modest increase in group ARPU.
- **Infrastructure/Property - Developed Markets**, notably SES as the US Federal Communications Commission announced a public rather than private auction of C-Band spectrum. While this creates some uncertainty with regards to how the process will unfold, ultimately the spectrum SES owns will need to be reallocated to US telecom operators in order to move into a 5G world.
- **Online Services - Developed Markets** cluster, notably Expedia as the company indicated it will incur higher advertising expenses as it pays more to Google for search traffic. Expedia, however, continues to take market share and has a large opportunity to grow in Europe, a more fragmented hotel market relative to Expedia's home market in the US.
- **Oil/Natural Gas** cluster, notably Technip which benefited from the rise in oil prices as well as a rebound from

oversold levels. The recent selling in Technip had been somewhat technical nature ahead of the spin-off of the E&C business which will only have a Paris listing.

- **Short positions** detracted from performance. The portfolio is short businesses that we believe are vulnerable to competition and in many cases have highly geared balance sheets. The market, however, is overly optimistic about the near-term growth projections for these businesses and is prepared to pay a significant premium. Short positions protect the portfolio in down markets, but they can act as a headwind in up-markets as experienced in 4Q19.
- **Currency** detracted from performance, notably our position in the US Dollar.

## Antipodes Global Fund

### Top 5 contributors & detractors

| Top 5 contributors | |
|---|---|
| Alibaba | 0.6% |
| Siemens | 0.5% |
| Tiffany & Co | 0.4% |
| UniCredit | 0.4% |
| General Electric | 0.4% |

| Top 5 detractors | |
|---|---|
| Expedia | (0.4%) |
| TechnipFMC | (0.2%) |
| SES | (0.2%) |
| China Unicom | (0.2%) |
| *Short (Online Services cluster)* | (0.2%) |

## Antipodes Global Fund – Long

### Top 5 contributors & detractors

| Top 5 contributors | |
|---|---|
| Alibaba | 0.6% |
| Siemens | 0.4% |
| Tiffany & Co | 0.4% |
| UniCredit | 0.4% |
| General Electric | 0.4% |

| Top 5 detractors | |
|---|---|
| Expedia | (0.3%) |
| TechnipFMC | (0.2%) |
| SES | (0.2%) |
| China Unicom | (0.2%) |
| Cisco | (0.1%) |

## Asia strategy

In addition to the relevant positions discussed above, key contributors over the quarter included:

- **Oil/Natural Gas** cluster including Offshore Oil Engineering and JGC Corp. Offshore Oil Engineering reported a rebound in profitability and robust orders as the company benefits from the next wave of LNG capex. JGC's stock price rebounded as the market's focus shifted from balance sheet concerns to the replenishment of the order book and strong cash generation as working capital begins to normalise.

In addition to the relevant positions discussed above, key detractors over the quarter included:

- **Gold cluster**, notably Newcrest Mining as production fell short of expectations due to maintenance activity and lower grades across operations.
- Grupo Lala in the **Consumer Defensive - Asia/Emerging Markets** cluster as the market reacted to slower than expected sales in its key market of Mexico. The surprising replacement of its CEO who was responsible for initiating operational changes, balance sheet repair and product innovation, also added to uncertainty around the company.
- **Currency** detracted from performance over the quarter.

### Top 5 contributors & detractors

| Top 5 contributors | |
|---|---|
| Alibaba | 0.9% |
| Taiwan Semiconductor | 0.6% |
| KB Financial | 0.6% |
| Offshore Oil Engineering | 0.5% |
| Samsung Electronics | 0.5% |

| Top 5 detractors | |
|---|---|
| Grupo Lala | (0.5%) |
| China Unicom | (0.3%) |
| Newcrest Mining | (0.2%) |
| China Telecom | (0.2%) |
| *Short (Online Services cluster)* | (0.2%) |

# Portfolio positioning

## Global strategies

Key changes over the quarter included:

- Adding to **Oil/Natural Gas** as industry capital discipline improves and financial repression inhibits growth in shale supply. Given the lower cost producers are cheap relative to the commodity price, we added exposures such as Equinor, a European oil and gas major. Equinor will not only benefit from higher gas prices as the world decarbonises, but also increasingly deliver scale wind power thus cementing its relevance in a modern energy era.
- Adding to **Consumer Cyclical - Developed Markets** via broadening exposure to a counter-cyclical US residential opportunity given low housing inventory/aging stock, household balance sheet repair and low mortgage rates. We also broadening our exposure to aspirational and luxury brands via Capri which is trading at a significant discount to peers.
- Rotating exposure in **Connectivity/Compute** as we exited Murata and reduced exposure to Mediatek in favour of semiconductor company Qorvo, a leading specialty radio frequency chip supplier servicing mobile phone, military and telecom infrastructure. We expect radio frequency content to benefit as 5G devices see increased take up from 2020 onwards.
- Rotating exposure in **Software** as we trimmed our position in SAP as our thesis on the strength of its cloud business and the new product cycle has partially played out. We selectively reduced short exposures where the earnings and outlook of certain over-hyped software companies did not meet the market's expectations and their stock prices subsequently declined.
- Rotating exposure in **Industrials** by selectively reducing positions following outperformance on the market's expectation of a trough in manufacturing data. We added Norsk Hydro, a low-cost and low-carbon footprint aluminium producer with integrated hydropower assets. Aluminium demand will benefit from substitution in an increasingly carbon conscious world given its light-weight and recyclable properties.
- Reducing our exposure in **Online Services - Asia/Emerging Markets** as we exited LINE following a takeover offer for the company from Yahoo Japan. We continued to trim Sony as our thesis on the company's superior digital image sensor technology and leading content portfolio across music, gaming and video has partially played out.
- Exposure to **Consumer Defensive - Developed Markets** fell over the quarter as we partially exited Tiffany & Co following the takeover offer from LVMH Group, the owner of Louis Vuitton.

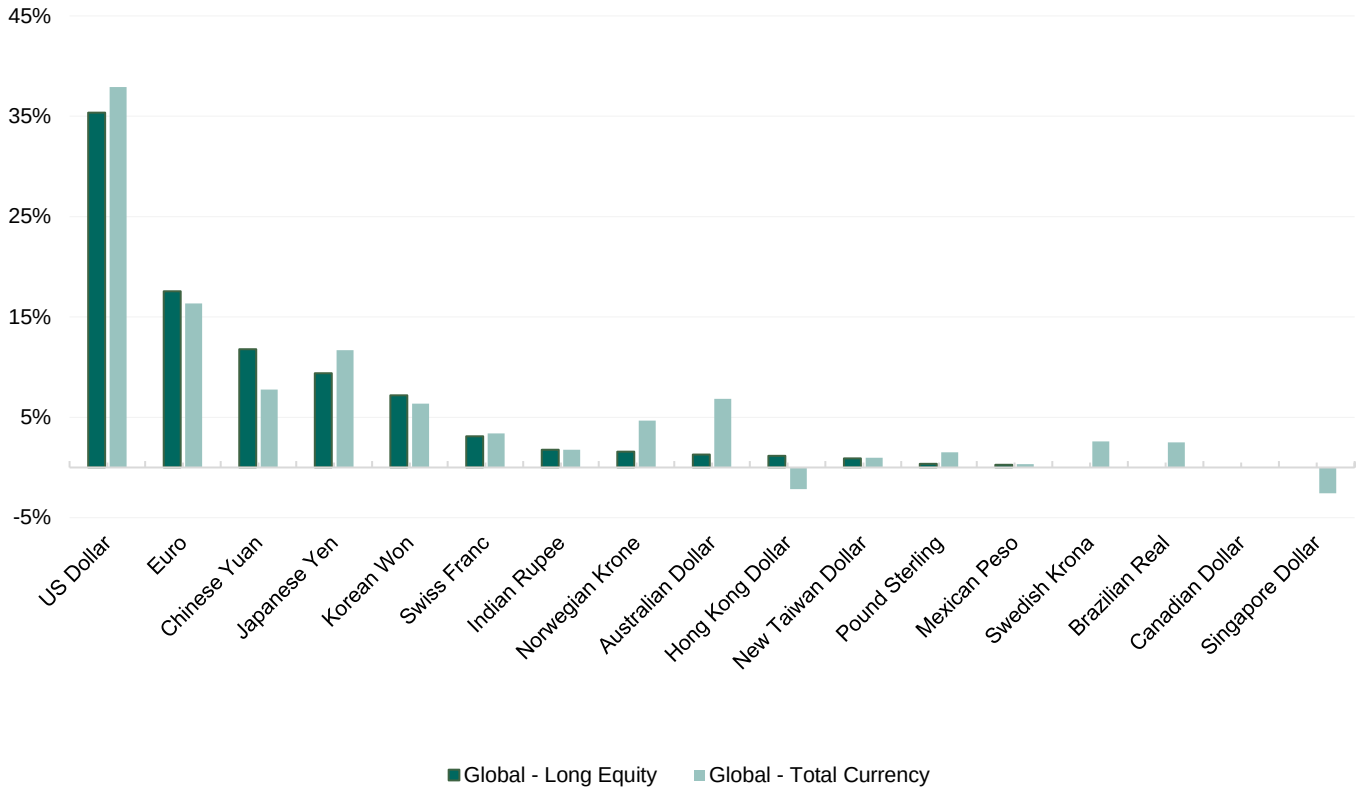
## Antipodes Global Fund

### Cluster exposure & quarterly charge

| Sector/cluster | Long | Short | Net | Quarterly net change | Long cluster examples | Short cluster examples |
|---|---|---|---|---|---|---|
| **Global** | 45.6% | (10.4%) | 35.3% | 2.1% | | |
| Industrials | 12.7% | (4.2%) | 8.5% | 1.2% | GE, Siemens, Continental, Honda | Aerospace & automation roll-ups |
| Oil/Natural gas | 8.3% | (0.6%) | 7.7% | 1.1% | ENI, Inpex, TechnipFMC | Expensive oil |
| Healthcare | 9.1% | (2.4%) | 6.7% | 0.2% | Merck, Roche, Gilead | Weaker competitors |
| Connectivity/Compute | 10.7% | (1.9%) | 8.8% | 0.3% | Qualcomm, Samsung Electronics, Cisco | Weaker competitors |
| Software | 4.9% | (1.3%) | 3.6% | (0.7%) | Microsoft, SAP | Narrow feature-sets vulnerable to platform competition |
| **NA/Europe domestic** | 23.9% | (6.9%) | 17.0% | 2.8% | | |
| Online services | 6.2% | (2.5%) | 3.7% | 1.0% | Facebook, Expedia | Narrow feature sets vulnerable to increasing competition |
| Consumer defensive | 3.3% | (0.6%) | 2.7% | (0.3%) | Tapestry, Equifax | Under investing brands |
| Consumer cyclical | 11.4% | (2.2%) | 9.2% | 2.4% | ING, UniCredit, Capital One | US domestic exposures vulnerable to disruption |
| Telco/infrastructure | 2.9% | (1.6%) | 1.4% | (0.4%) | EDF | Infrastructure assets under competitive pressure |
| **Asia/EM domestic** | 20.6% | (2.3%) | 18.3% | 0.4% | | |
| Online services | 4.4% | (0.4%) | 4.0% | (0.7%) | Alibaba, Sony | Narrow feature-sets vulnerable to platform competition |
| Consumer defensive | 7.3% | (0.3%) | 7.0% | 0.4% | Ping An, Yum China | Under investing brands |
| Consumer cyclical | 5.4% | (0.3%) | 5.0% | 1.1% | KB Financial, ICICI Bank | Chinese property developers with weak balance sheets |
| Infrastructure/Property | 3.4% | (1.2%) | 2.2% | (0.4%) | KT, China Unicom, China Telecom | Gas utilities facing competitive and/or regulatory headwinds |
| **Tail risk hedge** | **2.4%** | **(4.5%)** | **(2.1%)** | **(0.0%)** | Barrick Gold, Newcrest | Indices |
| **Total** | 92.5% | (24.0%) | 68.5% | 5.2% | | |

## Antipodes Global Fund

### Currency Exposure



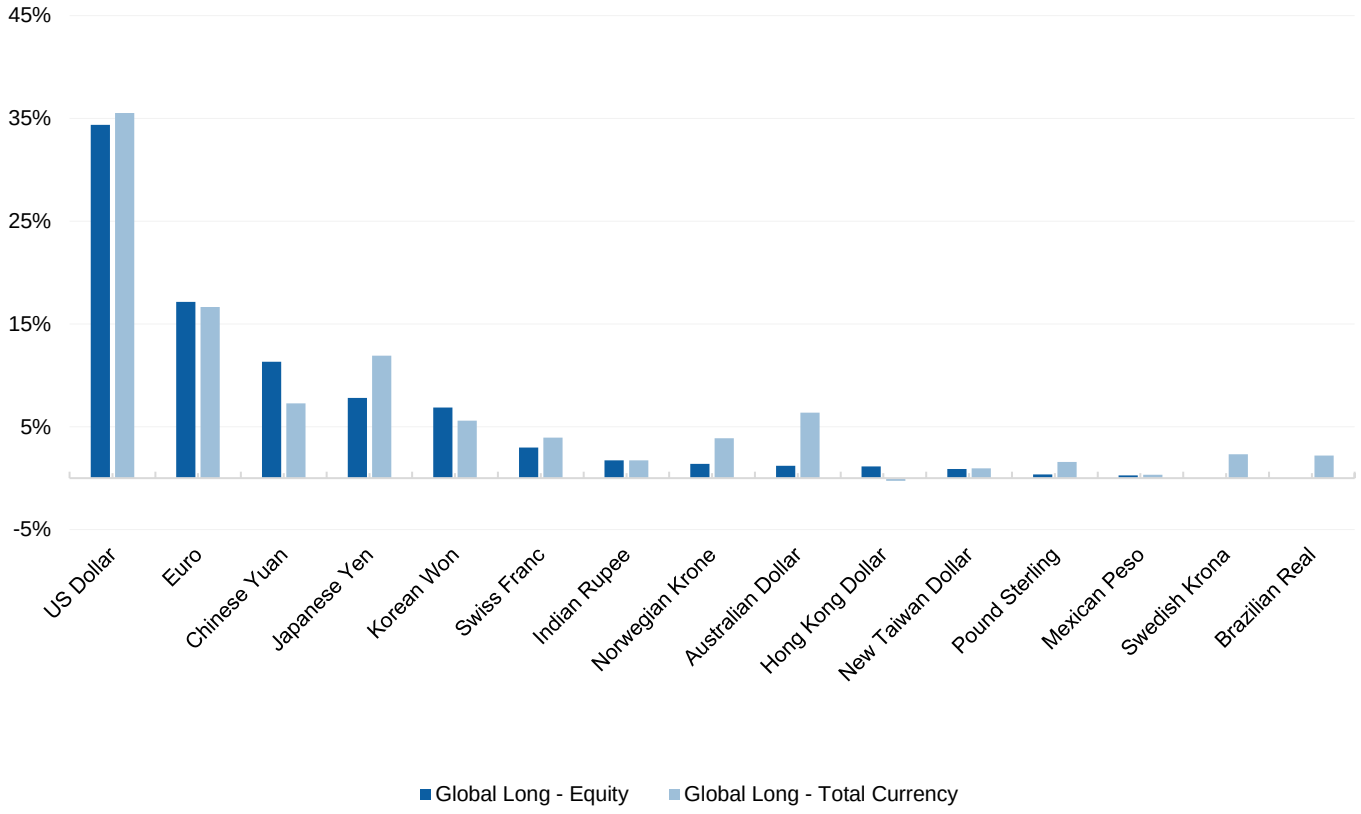
## Antipodes Global Fund – Long

### Cluster exposure & quarterly charge

| Sector/cluster | Long | Quarterly change | Long examples |
|---|---|---|---|
| **Global** | 41.2% | 0.2% | |
| Industrials | 11.2% | 0.3% | GE, Siemens, Continental, Honda |
| Oil/Natural gas | 6.9% | 0.8% | ENI, Inpex, Technip |
| Healthcare | 8.8% | (0.2%) | Merck, Roche, Gilead |
| Connectivity/Compute | 9.7% | (0.3%) | Qualcomm, Samsung Electronics, Cisco |
| Software | 4.7% | (0.3%) | Microsoft, SAP |
| **NA/Europe domestic** | **23.5%** | **1.0%** | |
| Online services | 6.0% | 0.5% | Facebook, Expedia |
| Consumer defensive | 3.7% | (0.7%) | Tapestry, Equifax |
| Consumer cyclical | 10.9% | 1.4% | ING, UniCredit, Capital One |
| Telco/Infrastructure | 2.9% | (0.1%) | EDF |
| **Asia/EM domestic** | **19.8%** | **(0.3%)** | |
| Online services | 4.3% | (0.7%) | Alibaba, Sony |
| Consumer defensive | 7.1% | 0.2% | Ping An, Yum China |
| Consumer cyclical | 5.2% | 0.9% | KB Financial, ICICI Bank |
| Infrastructure/Property | 3.2% | (0.7%) | KT, China Unicom, China Telecom |
| **Tail risk hedge** | **2.9%** | **(0.4%)** | Barrick Gold, Newcrest |
| **Total** | **87.4%** | **0.6%** | |

## Antipodes Global Fund – Long

### Currency exposure



## Asia strategy

Key changes over the quarter included:

- Adding to the **Consumer Cyclical - Asia/Emerging Markets** cluster including via China Construction Bank, a leading retail bank in China trading on attractive valuations relative to its growth profile, and China Overseas Land & Investment where we see evidence of accelerating contract sales and the potential of a relaxation of property policies from the People's Bank of China. We also added Banco do Brasil as the country passed the pension reform bill - a significant milestone - as Brazil moves to gain control over its finances, and the bank itself is trading on an attractive multiple relative to peers.
- Adding to **Oil/Natural Gas** as industry capital discipline improves and financial repression inhibits growth in shale supply. Given the lower cost producers are cheap relative to the commodity price, we added to our CNOOC holding.
- Re-ordering exposure in **Online Services - Asia/Emerging Markets** as we exited LINE post the takeover from Yahoo Japan but added to leading Chinese e-commerce and social media platforms including Alibaba and JD.com.

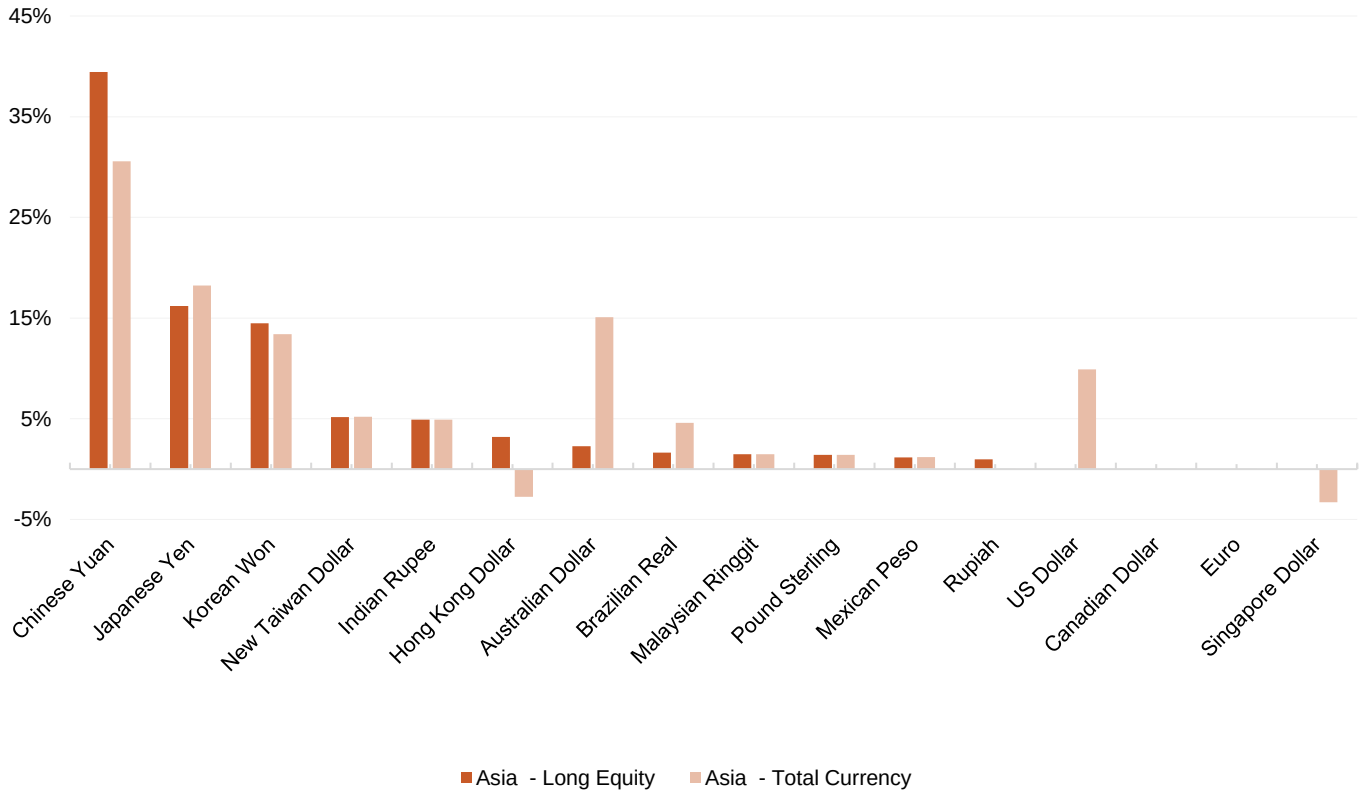
## Antipodes Asia Fund

### Cluster exposure & quarterly change

| Sector/cluster | Long | Short | Net | Quarterly net change | Long cluster examples | Short cluster examples |
|---|---|---|---|---|---|---|
| **Global** | **32.7%** | **(2.6%)** | **30.1%** | **4.7%** | | |
| Industrials | 9.5% | (2.6%) | 6.9% | (0.1%) | Honda, Komatsu | Automation |
| Oil/Natural gas | 8.6% | - | 8.6% | 2.8% | CNOOC, Inpex, JGC | |
| Healthcare | 1.3% | - | 1.3% | 1.2% | | |
| Connectivity/Compute | 13.3% | - | 13.3% | (0.5%) | Samsung Electronics, TSMC, ASM Pacific | |
| Software | - | - | - | 1.2% | | |
| **Asia/EM domestic** | **57.0%** | **(5.5%)** | **51.5%** | **5.9%** | | |
| Online services | 11.6% | (0.7%) | 10.9% | 0.0% | Alibaba, Sony | Narrow feature-sets vulnerable to platform competition |
| Consumer defensive | 17.1% | (1.4%) | 15.7% | (0.8%) | Ping An, Yum China | Under investing brands |
| Consumer cyclical | 21.6% | (0.5%) | 21.1% | 7.6% | KB Financial, ICICI Bank | Chinese property developers with weak balance sheets |
| Infrastructure/Property | 6.8% | (3.0%) | 3.8% | (0.9%) | KT, China Telecom, China Unicom | Gas utilities facing competitive and/or regulatory headwinds |
| **Tail risk hedge** | **2.7%** | **(4.9%)** | **(2.2%)** | **(2.6%)** | Newcrest | Indices |
| Total | **92.4%** | **(13.1%)** | **79.3%** | **7.9%** | | |

## Antipodes Asia Fund

### Currency exposure



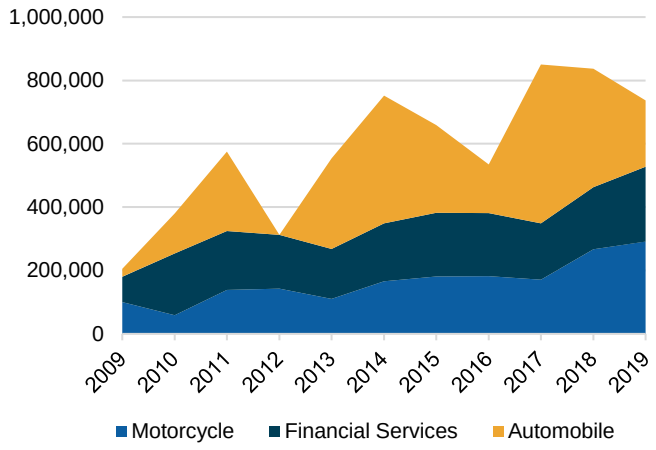
# Feature: Honda Motor

**When looking for less obvious pockets of growth across the globe, we frequently delve into the operations of companies buried within unloved sectors. The automotive sector and its supply chain is one area in which we're finding an increasing number of value opportunities. The auto sector frequently graces the headlines for all the wrong reasons – cyclical demand, emissions scandals, the disruptive rise of electric and autonomous vehicles, factory closures and product recalls. It is therefore unsurprising that the sector is extremely cheap relative to both the broader market and its own history.**

Look at the valuations of some of the major players in the automotive sector: Honda trades on 7x forward earnings, Volkswagen trades on 6x earnings, Toyota on 9x, GM on 6x and BMW on 8x. Our challenge as investors is to decide whether these low multiples are an accurate reflection of the sector's prospects or if there are companies within the sector that offer exceptional value.

One company that we believe provides a compelling investment opportunity is Honda. Honda's current multiple implies that it is a lower tier automaker with limited prospects. In fact, Honda is a company in robust health with a globally dominant motorcycle franchise, and for whom making cars is only its third most lucrative business. The growing earnings from Honda's motorcycle and financial services businesses have acted as an offset to the volatility of the automotive profit stream.

**Figure 2: Honda operating profit by division (JPY, M)**



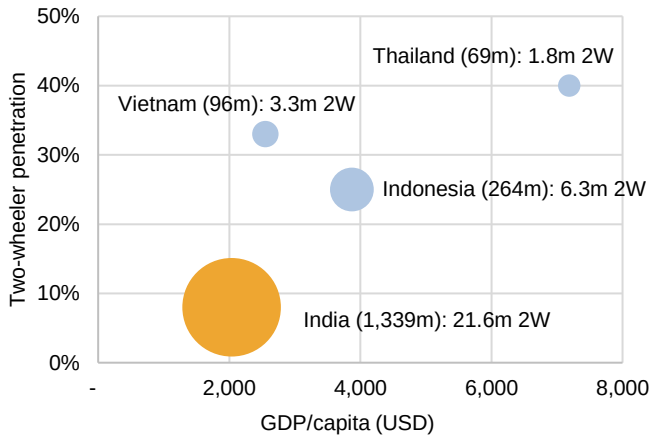

*Source: FactSet*

## Irrational extrapolation

The best asset within Honda is its motorcycle business, with two-wheelers increasingly the mobility choice of consumers in emerging markets. In the post crisis period Honda's motorcycle business has grown revenues at a compound rate of 7% and now controls around 25% of the global motorcycle market. The biggest opportunity for the motorcycle business is India.

Our proprietary research of the global motorcycle market shows a positive correlation between the size of an emerging nation's two-wheeler market and all of GDP per capita, urbanisation rate and population age. Forecasts of all these variables point to higher rates of Indian motorcycle ownership in the coming years. In fact, we believe that the Indian motorcycle market, which is already the largest in the world, has the potential to roughly double in unit terms over the coming decade driven by a growing, aging and increasingly affluent population. The example of other emerging markets is supportive of that thesis.

**Figure 3: Two-wheeler volume and penetration relative to GDP/capita (USD) and population**




*Source: Antipodes, FactSet*

In addition to the growth in the overall Indian motorcycle market, we expect Honda to further increase its market share which has already nearly doubled from 14% in 2010 to 27% in 2018. Honda has become dominant in some of the world's most important motorcycle markets (Vietnam, Indonesia and Thailand) with between 70-82% share. Learnings from these markets will be supportive of gradual share gain in India facilitated by Honda's control of the supply chain for key emissions control components, which we discuss further below.

Honda's global motorcycle business has posted six consecutive years of double-digit operating margins, making it comfortably Honda's most profitable manufacturing

business. A counterweight to that strong performance has been the underwhelming performance of the automotive business. Honda's issues in the automotive business are margin related as opposed to technology, demand or brand equity – all of which they have in abundance. Honda today is delivering operating margins in the low single digit range, global peers achieve margins in the mid to high single digit range.

The automotive margin has been sliding since 2002 due to poor execution. The business has had the wrong products, with too many small cars and sedans and not enough SUVs, and a growth obsession within a multi-regional structure. This has led to much of the growth being unfocused, with too much capacity producing too many models with too many variants. The prior "Vision 2020" strategy sought six global regions which were largely self-reliant, increasing complexity and significantly impairing the synergies that the company's scale could deliver.

The goal of the new automotive strategy is to heal these self-inflicted wounds and improve profitability through three main actions – lowering costs whilst increasing capacity utilization and increasing the commonality of production by moving to a new platform.

It's also worth mentioning Honda's evolving partnership with GM, which has some interesting facets. Honda will invest just under $3 billion over the next 12 years in GM's Cruise, providing Honda with access to GM's autonomous technology. The companies have a joint fuel cell manufacturing plant and are working together on "next generation" batteries. This is a sensible industrial tie up, defraying the cost of development over more vehicles than each would have alone.

The third pillar of Honda's business, and the second most important in terms of earnings after the motorcycle business, is the financial services company which finances customers to buy vehicles, largely in the US. It's a compelling business which has an option of first refusal to finance the customers they wish to adopt given the proximity at the point of sale. The scaled dealership network offers Honda lower costs of servicing than third party finance providers. Charge offs peaked at just 55 basis points during the Global Financial Crisis which is testament to the underwriting quality of the customer base.

## Multiple ways of winning

### Competitive dynamics & product cycle

Honda has a strong brand in the automotive sector, and the internally focused restructuring will be aided by a major model cycle with roughly 50% of the line-up refreshing over the coming two years or so, including the hugely important Civic and CR-V, with that new volume coming against a restructured cost base.

New model launches will also increasingly be on the company's new automotive platform, known as Honda Architecture. This follows the well-trodden path of many global automakers in increasing the commonality of processes and parts used on different models to bring procurement scale, manufacturing flexibility and efficiency. The full benefit of this new platform will not be felt until 2027 but begins with the high volume Civic next year.

### Regulatory

The Indian Government is progressively rolling out new vehicle emission standards. From April 2020, all new motorcycles sold in India will be required to have BS6 emissions standard compliant engines. This should allow Honda to take market share because subsidiary supplier, Keihin, controls 70-80% of the market for fuel injection systems – the key item for BS6 compliance. In addition, anti-lock braking systems are becoming mandatory on all bikes with engines over 125cc. This will provide another competitive advantage as Honda subsidiary, Nissin Kogyo, a brake manufacturer, controls 60-70% of the Indian market.

This captive supply chain represents a major competitive advantage. The company has indicated it will use any related manufacturing cost advantage to add features to bikes, such as LED lights or a smart key, in order to make models more attractive rather than just offer a lower price.

Honda ranks second with 27% share in the Indian market behind Hero but, post the introduction of the BS6 standards, aims to get to first with around 30% share. It should be mentioned that in the near-term the Indian automotive market is going through a rocky patch with weaker economic growth, limited credit availability and volatility around emissions standards. These factors, however, don't alter the fundamentally strong long-term adoption opportunity.

### Management and financial

Honda has a fortress balance sheet and is in excellent financial health. The structural growth in the motorcycle business and targeted margin improvement in the automotive business should yield materially higher earnings over time, for which investors are paying a low multiple today.

Honda has undergone significant management change in the past four years, with all the top roles transitioning in that

period and culminating with the change of Chairman in April of this year. The Motorcycle business has performed exceptionally well during that period, whilst the process of rectifying the underperforming Automotive business has been slower than we would have hoped. The new plan, which was only communicated this year, is the right solution to the challenges of the business. We expect increased front-footedness from management in the coming quarters, along with improving financial delivery.

### Style and macro

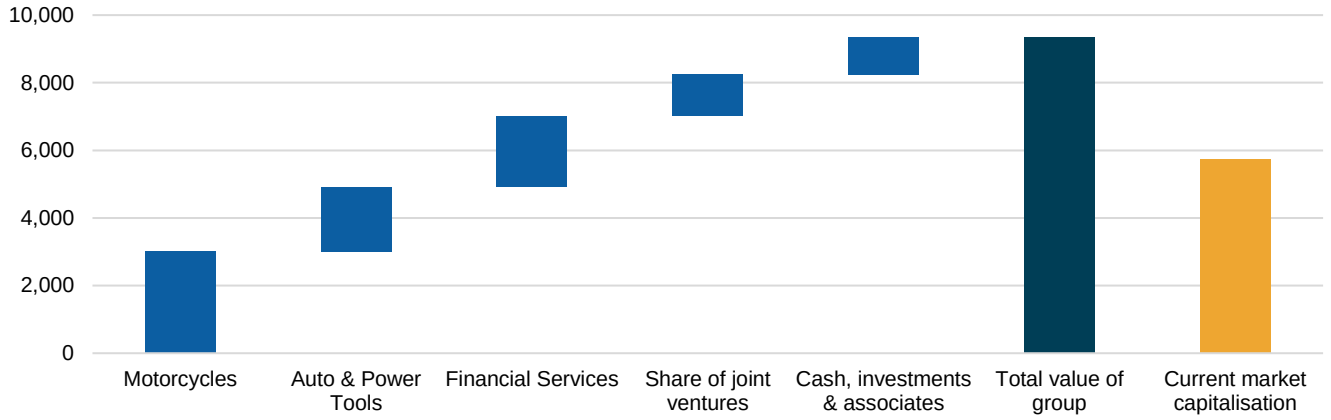
Throughout the current protracted period of low rates and concerns over global growth, investors have been paying increasingly high multiples for businesses with defensive and structural growth qualities. Honda represents an attractive way for investors to gain such style exposure, that is, adding a cheaper expression of quality growth to portfolios.

## Margin of safety

Honda's valuation is incredibly attractive with ¥2.57 trillion of cash on the balance sheet against a market cap of ¥4.5 trillion. The industrial business alone, excluding the Honda Finance Company, has nearly ¥2 trillion of cash. It trades on an ex-cash 2021 PE of a little over 2x. A sum of the parts implies the shares are materially undervalued.

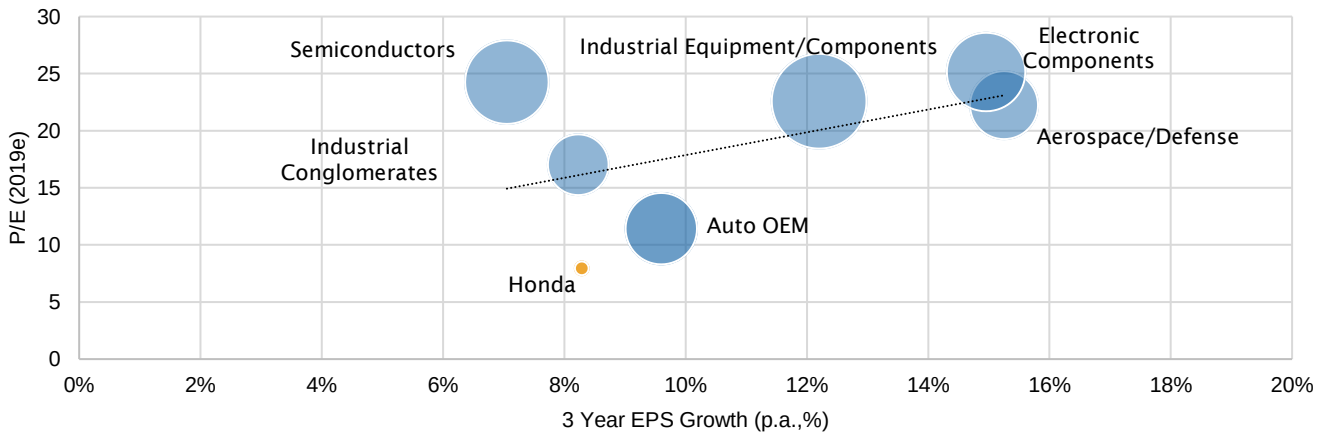
In fact, the hardest question to answer when considering an investment in Honda Motor is "which bit do you want for free?" As we demonstrate in the following chart, at the current market valuation you would be getting at least one of the major divisions of the business, all of which we consider attractive, for nothing.

**Figure 4: Honda value by division (JPY, B)**




*Source: FactSet*

**Figure 5: Honda valuation multiples v peer groups**




*Source: Antipodes, FactSet*

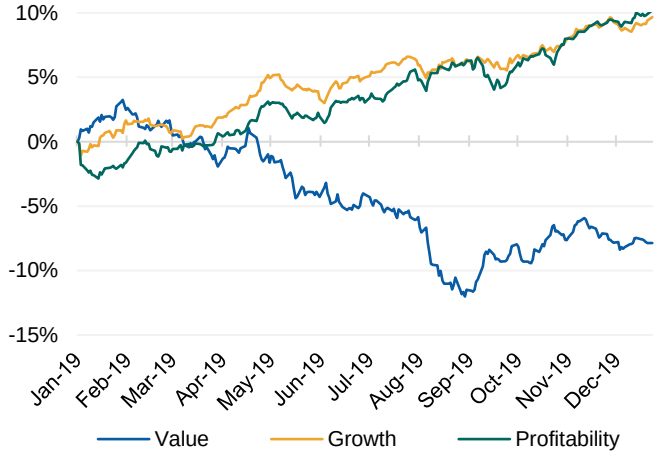
# Outlook

**The final quarter of 2019 was characterised by a third rate cut by the US Federal Reserve (Fed), a step forward in US-China trade relations and a convincing win by the Conservative Party in the UK election which raises the probability of an orderly exit from the European Union.**

US and Eurozone (ex Germany) reported tepid signs of a trough in manufacturing data and Chinese private sector growth stabilised. Despite the improving shorter term economic outlook, besides a brief period in September and October we have not seen a sustained rotation into lower multiple or "value" stocks.

In the 2019 calendar year global equities delivered the second-best performance since the Global Financial Crisis (GFC), rising 26.8% in AUD and 26.6% in USD terms, a surprising result given we're in the eleventh year of a bull market, the longest bull market in history. Stocks that exhibit high growth or high profitability characteristics outperformed value stocks by more than 15% over the year (Figure 6). In addition, the US market was the best performing market as trade tensions escalated.

**Figure 6: Factor Performance (2019)**




*Source: Antipodes, FactSet*

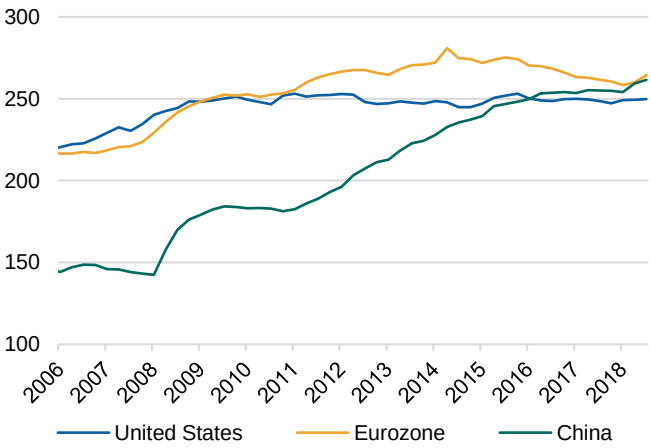
Reflecting on our stark underperformance for the year, we anchored too much to owning lower multiple, more economically sensitive exposures and did not pay enough attention to the collapse in bond yields. In terms of lessons learnt, we should have lifted net exposure by reducing shorts in some of the more egregiously overvalued stocks as momentum in growth stocks continued to be strong. In a word, we needed to be even more "pragmatic" while staying true to our value principles.

In terms of process evolution, we continue to invest in sector/regional focused research resources and our quant/macro process, and specifically in our ability to measure style tilts within the portfolio to ensure we are adequately compensated for the active risk we are taking.

Buoyant equity and credit markets have interpreted the Fed's actions as mid-cycle insurance cuts. In stark contrast, the fixed income market continues to price in a much lower growth/later cycle/recessionary environment with very little change in record low real yields across the curve. This means the duration bubble continues to inflate. How the apparent inconsistency between equity and bond markets is resolved has broad implications for both equity sector and style outcomes.

It will pay to keep a close eye on the performance of corporate credit in divining the answer to the mid versus late cycle conundrum. Since the GFC we have seen a steady increase in debt in the US and Europe, but rapid expansion in China. Debt now stands at around 250% of GDP for all three major economic blocs. Households in the US and Europe have de-levered and accordingly, in a weaker growth and lower rate environment, new housing demand may act as a counter-cyclical stabiliser. The same cannot be said of the corporate sector or the US government.

**Figure 7: US, China & Eurozone Total Debt to GDP (%)**

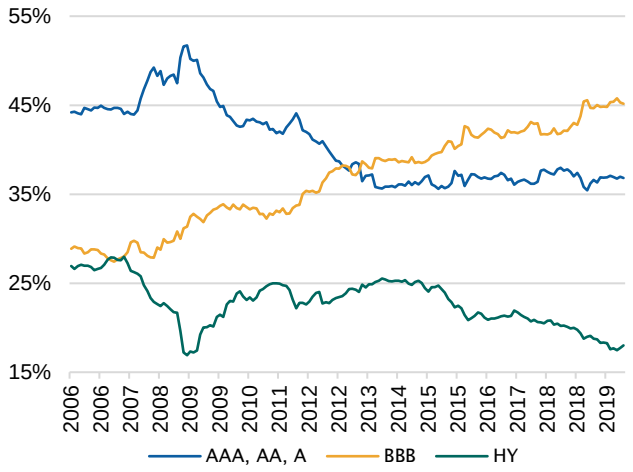



*Source: Bank for International Settlements*

Since the GFC, the proportion of debt rated BBB (the lowest tranche of investment grade) and below has risen from around 50% of the total US corporate bond market to more than 60% (Figure 8). About one-quarter of this lower rated credit is high yield, otherwise known as junk. In addition, the leveraged loan market – loans that have been extended to companies that already have considerable leverage and/or

poor credit history i.e. even higher on the risk scale – has substantially expanded over this period from around $400b to $1.2 trillion today. The leveraged loan market is now the same size as the US High Yield bond market. Companies are increasingly preferring to borrow money in the leveraged loan market because there are fewer restrictions on the borrower (covenant light).

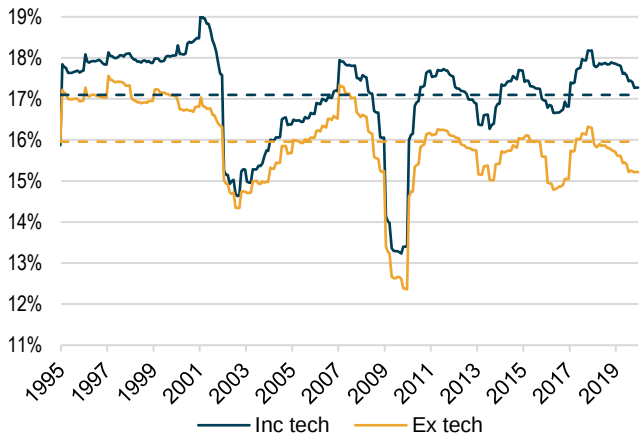
**Figure 8: Credit rating as % of US bond market**




*Source: Bloomberg, Barclays*

This stock of debt is high and average leverage ratios have risen against a backdrop of what has been a "goldilocks" scenario of low policy rates, historically tight credit spreads and, in the case of the US, robust economic activity. Yet outside of the large software-internet stocks, sometimes referred to as “Platform Companies”, US corporates (and we believe the same holds true globally) have struggled to lift profit margins in the current cycle (Figure 9). Almost all improvement in return on equity since 2009 has resulted from lower interest rates, higher leverage and lower tax rates - all of which have arguably reached their structural limit.

**Figure 9: US non-financials EBITDA margin**

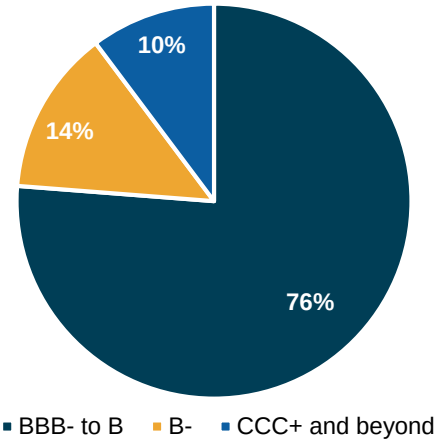



*Source: Refinitiv, Credit Suisse research*

Private equity (PE) firms have enjoyed buoyant capital inflows since the GFC, becoming the dominant issuer in high yield markets with the bulk of this in covenant light loans. Whilst leveraged loans are performing poorly (ratio of downgrades to upgrades are at GFC levels), defaults have remained in check largely thanks to this covenant light phenomenon. It’s not surprising that PE investee companies are under pressure as they are facing the disruptive pressure that the Platform Companies are applying to all parts of the economy.

The large refinancing spike that potentially crystalises losses in PE portfolios does not begin in earnest until 2022, but analysis suggests the bulk of B- rated debt is already on negative watch. Indeed, the majority of downgrades that did occur over 2019 were PE covenant light B+ to B- rated credit. Worryingly, B- credit represents 14% of high yield debt, material in size relative to the next rung down, CCC+ and below (Figure 10). Any downgrade of the B- tranche to CCC+ would be significant as the natural buyer (CLO manager) is already very close to their maximum holding limit of 10% in CCC+ and below loans. If downgrades occur, who will buy this debt and at what price?

**Figure 10: Breakdown of high yield credit**




*Source: S&P LCD database*

Finally, it’s worth noting the mark to market equity value on a typical 2016 vintage PE fund is not looking great as almost a third of these deals have missed their EBITDA forecasts by at least 50%. EBITDA leverage ratios could be as high as 10x, meaning the original deal equity has been substantially impaired. PE returns will likely mean-revert rapidly around the same time as debt refinancing requirements spike.

As stated earlier, it’s worth understanding these linkages as it’s important for corporate credit to remain well behaved for the US cycle to extend.

Let's now turn to monetary and fiscal policy. The US banking system in aggregate has excess reserves, however weaker banks have a much tighter reserve position which is leading to periodic bouts of distress in shorter-term funding markets. This issue has been serious enough to force the Fed into a form of stealth Quantitative Easing (QE), buying $60b of Treasury Bills a month until mid-2020 for a total liquidity injection in excess of $500b to help ease this funding pressure. This is not immaterial, equivalent to almost 20% of total QE undertaken between 2008-2014. But will this be enough?

As we enter an election year in the US, there is a real possibility of Trump or his opponent announcing middle class tax cuts to gain support. With a fiscal deficit already at ~4% of GDP, a level typically associated with times of war or recession and not full employment, and a current account deficit of more than 2% of GDP[5], any additional tax cuts would take the US further into unchartered territory in terms of *extreme* fiscal stimulus.

The US government's rapidly expanding funding requirement has the real risk of forcing up longer term interest rates. We appreciate that many believe this won't ever happen, though it's notable that the Fed has already embarked on a form of stealth QE to ameliorate shorter-term funding stress. It's only a very small step for the Fed to be bullied by politicians and/or the market into active monetisation of these aggressive US government deficits.

In the past QE has stoked duration sensitive asset prices as it was ultimately interpreted by markets to be deflationary, i.e. a blunt tool for stimulating economic activity but very effective at stimulating excess liquidity/asset price inflation.

In contrast to QE, the implications of active monetisation of fiscal deficits by the Fed include the potential crowding out of private sector investment, a weaker US dollar and inflation. If QE has failed to generate CPI inflation so far, why would it be different this time? The US government is running large and expanding deficits at a time when the labour market is tight (there are currently 1.4m more job openings than job seekers) and there is pent up demand in the real economy (the average house in the US is now more than 30 years old, a level last seen in the late 40s[6]).

Debt to GDP in Europe is comparable to that of the US but unlike the US, Europe is running a current account surplus and has followed a pathway of fiscal repair since the GFC. In the case of Germany, the fiscal surplus has expanded to almost 2% of GDP and for the rest of Europe the deficit has fallen to less than 2% of GDP[7]. As we discussed in the September quarterly, Europe has greater fiscal flexibility, where stimulus will likely take the form of a green new deal.

In the case of China, the level of debt alone is reason enough to pause but it's the pace at which it has accumulated that's worth highlighting. Whilst there has been some policy stimulus in 2019, China remains committed to keeping housing affordable and working off excesses in the system. To the extent that the consumer/services economy has held up well even as manufacturing has weakened, households are increasingly dependent on credit to fund consumption.

In summary, our base case is that the major structural change in the macro backdrop in recent times has been a move towards populism in response to extreme wealth disparity. This will take many different forms but will ultimately result in much larger fiscal deficits and a less certain regulatory environment. The US is well down this path.

Whilst US and Chinese geopolitical competition will likely intensify, steps towards a near-term trade resolution would reduce some of the uncertainty impacting business investment decisions. Hence, as trade uncertainty falls away, fiscal stimulus gains traction and interest rates remain accommodative, we see an ongoing path towards a cyclical rebound, especially ex-US where valuations of domestic/cyclical equities remain attractive.

This acceleration in global economic growth would likely result in a slight steepening of the yield curve and outperformance of lower multiple stocks (commodities, financials, domestic ex-US). Conversely, the rise in the discount rate would represent a headwind for some of the more expensive growth and bond proxy stocks that have been played as the equity beneficiaries of the duration bubble.

The current cyclical rebound will face headwinds into 2022-23 as a serious corporate debt refinancing cycle exposes the underlying deterioration in credit quality. At this point, governments will go all in on fiscal stimulus/debt monetisation. Gold anyone?

**5** Source: FactSet, Bloomberg
**6** Source: Bureau of Economic Analysis
**7** Source: Bloomberg, Morgan Stanley Research

# Appendix

## Market returns to 31 December 2019 (USD, p.a.)

| Absolute performance (%) | 3m | 1y | 3y | 5y | 10y |
|---|---|---|---|---|---|
| **Regional equities (MSCI)** | | | | | |
| AC World | 9.0% | 26.6% | 12.4% | 8.4% | 8.8% |
| USA | 9.0% | 30.9% | 14.6% | 11.0% | 12.9% |
| Europe | 8.8% | 23.8% | 9.8% | 5.1% | 5.2% |
| Japan | 7.6% | 19.6% | 8.9% | 7.7% | 6.6% |
| Korea | 13.4% | 12.5% | 9.4% | 5.9% | 5.2% |
| AC Asia ex Japan | 11.8% | 18.2% | 12.8% | 6.6% | 6.0% |
| All China | 13.1% | 27.6% | 11.4% | 4.3% | 4.1% |
| EM ex Asia | 10.1% | 16.3% | 8.3% | 3.4% | 0.0% |
| **Global sectors (MSCI)** | | | | | |
| Consumer Discretionary | 8.2% | 27.7% | 13.6% | 9.4% | 12.5% |
| Consumer Staples | 2.6% | 21.6% | 8.6% | 6.4% | 9.3% |
| Energy | 5.8% | 12.8% | 1.5% | 0.7% | 1.2% |
| Financials | 9.0% | 23.2% | 8.9% | 6.5% | 6.7% |
| Health Care | 13.7% | 22.7% | 14.4% | 8.2% | 12.1% |
| Industrials | 7.4% | 26.4% | 10.7% | 8.0% | 9.4% |
| Information Technology | 14.5% | 46.9% | 25.2% | 17.8% | 15.0% |
| Materials | 9.3% | 20.1% | 9.4% | 6.3% | 2.8% |
| Communication Services | 8.2% | 24.6% | 6.1% | 4.2% | 6.0% |
| Utilities | 2.3% | 21.1% | 11.8% | 6.3% | 5.2% |
| **Commodities** | | | | | |
| Crude Oil Brent | 11.4% | 22.7% | 5.1% | 2.9% | (1.6%) |
| Gold | 2.0% | 18.4% | 9.7% | 4.7% | 3.4% |
| Bloomberg Commodity Index | 4.0% | 5.4% | (2.6%) | (5.0%) | (5.3%) |
| **Bonds (BAML)** | | | | | |
| Global Government | (0.6%) | 5.5% | 3.9% | 2.1% | 2.0% |
| Global Large Cap Corporate | 1.9% | 11.5% | 5.5% | 3.3% | 4.1% |
| Global High Yield | 3.4% | 13.7% | 6.6% | 5.9% | 7.2% |
| **Currency** | | | | | |
| AUD | 4.2% | (0.1%) | (1.0%) | (3.0%) | (2.4%) |
| EUR | 3.0% | (1.8%) | 2.1% | (1.5%) | (2.4%) |
| JPY | (0.6%) | 1.0% | 2.4% | 2.0% | (1.5%) |
| CNY | 2.5% | (1.4%) | (0.1%) | (2.3%) | (0.2%) |

*Source: MSCI, BAML, Bloomberg, FactSet*

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