Apis Global Long/Short Fund

OBJECTIVE

The Fund's investment objective is to provide investors with risk adjusted, absolute returns through diversified exposure to global equities over 3 to 5 years.

APIR	HFL0108AU	**MANAGER APPOINTED**	1 October 2020
ARSN	093 497 600	**FUND SIZE**	$68.4m
INCEPTION DATE	31 March 2001	**EXIT PRICE**	$2.8313

Net performance (%)

	1 month	3 months	1 year	3 years p.a.	5 years p.a.	7 Years p.a.	10 Years p.a.	Since inception p.a.
Fund[1]	**0.22**	**2.43**	**10.05**	**14.33**	**9.56**	**8.01**	**7.59**	**7.11**
Apis Composite[2]	--	--	--	--	**11.77**	**12.62**	**13.43**	**10.86**

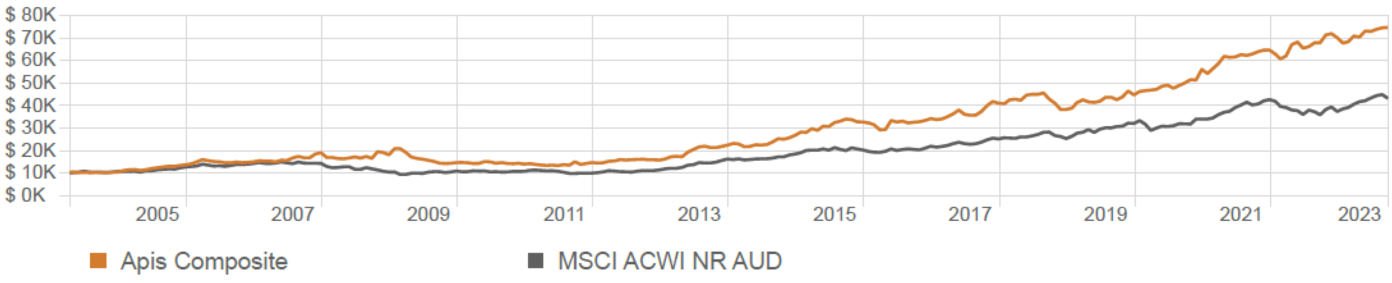
[1]Fund performance prior to 1 October 2020 is not attributable to the current investment manager, but the previous investment manager. The Apis composite is presented below to provide a longer-term view of the Fund's current investment strategy.

Apis Composite 1 month rolling returns[3]

CY	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	CYTD
2023	-3.51	0.88	3.76	-0.71	3.88	-0.25	1.30	0.90	0.22				**6.42**
2022	-2.77	-3.46	2.27	8.00	1.78	-4.05	1.11	2.55	0.02	5.17	0.77	-2.42	**8.58**
2021	-3.25	3.90	4.19	5.44	-0.74	0.34	1.62	-0.58	1.09	1.59	1.07	0.07	**15.42**
2020	3.31	0.82	0.50	0.73	2.98	0.96	-2.80	2.55	2.30	2.90	-0.23	9.15	**25.27**
2019	1.60	6.42	2.93	-2.19	-0.56	1.24	4.15	0.10	-2.51	3.07	5.84	-3.61	**17.11**
2018	-0.67	4.26	0.76	-1.09	5.36	0.87	-0.10	1.37	-5.93	-4.37	-6.67	-0.13	**-6.86**
2017	-1.31	0.81	3.06	3.55	4.73	-4.93	-1.32	0.32	4.48	7.13	4.44	-1.77	**20.17**

Investment growth of $10,000 since inception[3]

Time Period: 16/04/2004 to 30/09/2023



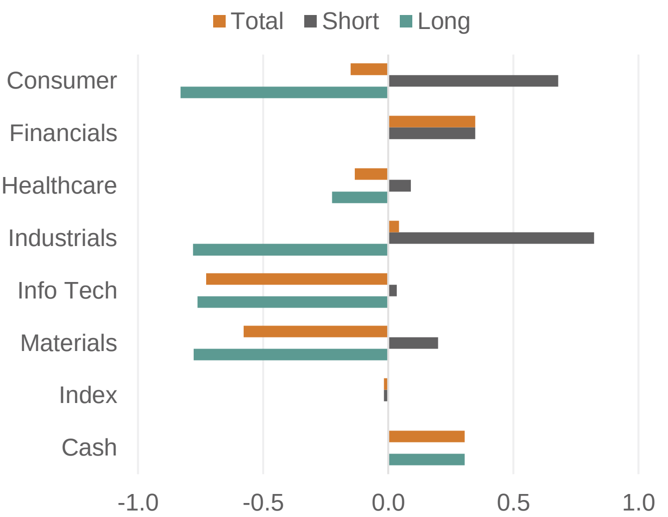
Past performance is not indicative of future performance. Net performance figures are calculated using exit prices, net of fees and reflect the annual reinvestment of distributions.

[2]The inception date of the Apis Composite is 16 April 2004. Performance periods from 16 April 2004 to 30 September 2020 for the Apis Composite represent the Apis Offshore Capital Ltd USD track record converted to AUD terms, net of management fees and an annual performance allocation. Performance periods for the Apis Composite from 1 October 2020 to month-to-date reflect the net returns of the Apis Global Long/Short Fund. Source: Apis Capital Advisors, State Street Australia Ltd and Morningstar Direct.

Sector exposure (%)[1,2]

	Long	Short	Gross	Net
Consumer	9.53	-8.17	17.70	1.36
Financials	0.00	-5.55	5.55	-5.55
Healthcare	3.19	-4.00	7.19	-0.82
Industrials	33.71	-11.19	44.89	22.52
Info Tech	22.27	-1.09	23.36	21.19
Materials	8.39	-1.69	10.08	6.70
Other	0.00	-0.22	0.22	-0.22
Total	**77.09**	**-31.90**	**108.99**	**45.18**

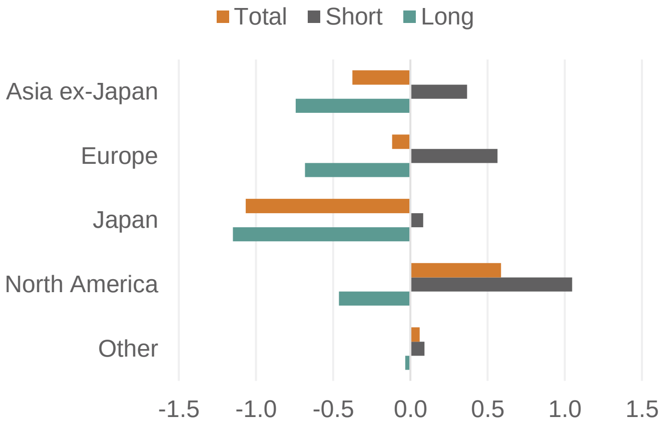
Monthly sector contribution (%)[1]



Regional exposure (%)[1,3]

	Long	Short	Gross	Net
Asia ex-Japan	24.73	-7.84	32.57	16.89
Europe	25.09	-7.52	32.62	17.57
Japan	12.23	-3.39	15.63	8.84
North America	13.82	-12.78	26.60	1.04
Other	1.21	-0.37	1.58	0.84
Total	**77.09**	**-31.90**	**108.99**	**45.18**

Monthly regional contribution (%)[1,3]



[1]Data is stated in USD terms and reflects the underlying fund. Totals may not equal due to rounding.
[2]'Other' includes exposures from Index and Cash.
[3]'Other' includes countries outside the regions stated above.

All currency references in the commentary below are in US dollar terms unless stated otherwise.

Performance review

The Apis Global Long/Short Fund (the 'Fund') returned 2.43% (net) for the quarter (in Australian dollar terms).

Regionally, North America was exceptionally good on both longs and shorts in the quarter, offset by Asia and Europe, where losses on the long-side curtailed returns. From a sector perspective, technology contributed positively to the quarter, with other sectors flat or down; the biggest declines were in the consumer (-0.9%) and industrials & materials (-0.7%) areas.

The largest stock contributor was Alchip Technologies in Taiwan which added about 1.4% to returns. Alchip continues to report excellent results on legacy designs, while additional wins with aspiring AI chip developers such as AWS (Amazon) provide future optimism. The next three long contributors (together adding 1.4%) came in the offshore oil services area. Higher energy prices and strong pricing of multi-year contracts support visibility. On the other hand, AMG (Netherlands) detracted 1.0% as earnings forecasts fell on weakening lithium prices. As mentioned, consumer names also underperformed, as Evolution Gaming and Square Enix detracted about 0.50% each. The hangover from COVID continues to weigh on online gaming.

Performance review (continued)

Outside a couple of detractors in healthcare, short performance was strong. Four of the top five shorts were in the solar energy sector, where a bubble of excess capacity is driving product prices down. The investment manager also saw some retracement in the speculative “concept” stocks which were resurgent earlier in the year. Detractors were limited with Intercept Pharma which lost 0.2% on a takeover by a private Italian firm.

Portfolio outlook and positioning

Small-capitalisation stocks continue to be in a funk relative to large-capitalisation stocks, with valuations that began the year historically wide blowing out significantly more this year.

Even within the investment manager’s definition of “small-cap,” when they break down the strategy’s year-to-date performance by very small (sub-$1 billion) versus $1- 5 billion or $5+ billion, the investment manager sees that the sub-$1 billion names have detracted 5.0% while the “mid-cap” $1-5 billion companies added 3.6% and “large” $5+ billion names contributed 2.6%. The smallest of the strategy’s small-cap names have so far kept the investment manager from what might have been a decent year. In keeping with the investment managers general approach to risk management, they have fortified what has been ‘working’ and starved what has not. Net exposure in the sub-$1 billion category have dropped from the low twenties to 13% currently, while “mid-cap” has remained in the twenties, and larger cap net exposure is up from low single-digits to about 10%.

The investment manager does not intend to belabour the point, but it must be noted that this market is extremely narrow. A few stocks are driving performance, and they are the usual suspects – mega-cap technology companies. The investment manager is not sure why this is happening, but the effect is to drive a wedge between market cap-weighted indices such as the S&P, which is up 12% year-to-date, and smaller cap indices such as the equal-weighted S&P, which is flat year-to-date. This spread of 12% points is the widest since the 1980s, barring just 1998.

Valuation is not the only reason the investment manager believes this reverts; the rally in mega-cap is premised on a fragile assumption about rising sales and earnings. Amazon is a case in point. It is no secret that sales estimates rose sharply during the COVID pandemic lockdowns. Sales estimates (by year/vintage) increased 20-30% through mid-2021 only to reverse course through the end of 2022, ratcheting back down each quarter. The stock soared over 100% and then collapsed during this time. However, at the stroke of midnight on December 31, 2022, the stock began climbing again, sharply. This time there was just one, small upward revision to sales estimates in the second quarter of 2023. The trend is essentially the same for all the FAANG+ companies. This mega-cap market rally has been fragile and premised on a very small positive signal; many more positive revisions are already priced into these stocks. At 39x 2023 earnings and staring into the teeth of a possible consumer recession, the investment manager struggles to explain why speculators have bid up Amazon (and others) and the market along with them.

The investment manager was asked many times in 2021, after a multiyear bull market and period of wild speculation, “why even short at all?” only to see a reversion to the mean in 2022. The reversal occurred and the investment manager’s discipline paid off. Today, a common question they hear is, “why small caps?”. The investment manager believes the bottom-up investment case has never been more stark – small companies are cheaper, and they believe (at least the portfolio’s holdings) have superior growth. While the investment manager has managed to navigate the last 20 years despite these headwinds (small versus large, US versus. ex-US), ultimately, the investment manager expects these trends will unwind in their favour.

Investment highlights

Solar

China is trying to corner the energy transition market.

In the first quarter commentary, the investment manager wrote about the various pieces of legislation supporting green energy adoption and their impact on demand in both the US and Europe. In the months since then, it became clear that a much bigger force was at work on the supply side in China. Worldwide, electric power production is about 26,000 Terawatt hours (TWh) and this figure grows each year at just over 2%, or around 600 TWh. The percentage of this 600 TWh attributable to renewables has risen to over 50% with solar accounting for about 20% of the total and most of the renewables balance coming from wind. Starting from 2023, the growth in solar production from China is set to explode higher with capacity sufficient to add as much as 750-1,000 TWh annually from solar alone, far more than the total electric power capacity installed worldwide annually. The capacity has been added by several different large companies listed in Shanghai and Hong Kong. The investment manager suspects there are a few reasons for this seemingly irrational behaviour. First, these companies made a windfall during COVID lockdowns when product prices shot upwards. They have money burning a hole in their pockets and have decided the best way to use it is to build more capacity. Second, the companies each claim to be the lowest-cost producer. Solar has a history of unstable cost leadership as technology shifts rapidly and companies constantly leapfrog each other. The investment manager sees zero credibility in this reasoning. Lastly, a more conspiratorial rationale is that the Chinese government wants to dominate this industry and bury foreign competition. Manufacturing subsidies, forced labour, IP theft, and various other malpractices all lend some credence to this theory.

From the viewpoint of grid stability, adding nothing but solar power could be a disaster. Something else is needed to provide power during the nighttime, when clouds pass by, or the occasional solar eclipse. Germany offers an interesting illustration as solar currently accounts for about 10% of their power production (measured by actual watt hours of production, not theoretical capacity.)

Investment highlights (continued)

The Germans have used gas-fired turbines to ramp up power production in the morning and evening while relying on less flexible coal to provide most baseload power. Naturally, this raises the question, where will all that extra Chinese production go.

As discussed in the first quarter commentary, both the US and Europe are trying to build a domestic manufacturing base for solar and have thrown bundles of cash around to incentivise this production. While the US has been strict about preventing dumping by the Chinese, the Europeans have not and now face domestic backlash from companies that, just six months ago, were planning to make major investments.

The investment manager does not think this is sustainable, and the most likely outcome is further protectionist barriers erected by the Europeans, along with a painful multi-year competitive fight among Chinese producers for sales to the rest of the world. Prices will most likely remain low for a long time to come. Given this situation, the investment manager is short a handful of producers up and down the supply chain in China where they think profits are headed lower and will stay low for the foreseeable future.

China Autos

A similar dynamic is taking place within the Chinese automotive industry. China has incentivised its domestic production and consumption of electric vehicles, kickstarting the industry far more effectively than anywhere else in the world. Last month, over 36% of vehicles sold in China were “New Energy Vehicles” (NEVs) containing some kind of battery – e.g., hybrid, fully electric, plug-in hybrid, etc. This figure compares to 20-25% in Europe and 10-15% in the US While the mix is impressive, the actual unit volume is even more so. China produces about 26 million passenger vehicles per year, compared to approximately 17 million in the US and around 15 million in Europe. This means that of the roughly 15 million NEVs produced worldwide, China is nearly two-thirds of all the units. US investors laud Tesla as the epitome of success in the EV market, but China has BYD. Tesla’s nearly 1 million units is impressive on its own but pales in comparison to BYD’s forecasted volume for 2023 of 3 million units. BYD is by far the worldwide leader in NEVs. The company’s sales are growing double-digits while Tesla’s have stalled, and they spend more than twice as much as Tesla on CapEx for growth while generating significantly more free cash flow. A recent tear-down of BYD’s newest model shows that it can be made in China for 25% less than a comparable vehicle in Europe or the US In a market where operating margins of 5% are considered good, this cost advantage would be disastrous for the high-cost, unionized producers in the West. Tesla is no stranger to this and has benefited from producing cars in Shanghai for export out of the country.

The Chinese understand this cost advantage and have begun exporting NEVs aggressively. Like the Koreans and the Japanese before them, Chinese brands are quickly finding acceptance in the marketplace as well-made, inexpensive alternatives to more familiar Western brands. Reviews are favourable and sales are growing quickly. Europeans can see the writing on the wall and they have already begun investigating the Chinese for dumping, as highlighted last month when the President of the European Commission said, "global markets are now flooded with cheaper electric cars. And their price is kept artificially low by huge state subsidies.” The Chinese exported approximately 1 million vehicles globally last year and 2023 sees at least a doubling of that number.

Against the backdrop of a looming trade war in NEVs, China continues to ramp production aggressively. The effect has been to squeeze out foreign manufacturers within China who benefited tremendously under JVs for decades. Local companies like SAIC and Dongfeng are now seeing their traditional JV business shrivel as they fail to adapt to competition from BYD. SAIC is the largest producer in China, controlling JVs with GM and VW, and has seen its market share drop from 19% to 11% in just four years.

China’s willingness to flood the market with NEVs also extends to the supply chain and batteries, where – similar to the renewable energy market – they have constructed far more capacity than is likely needed given the trend to localise this production worldwide. The portfolio is short a number of companies on the back of this theme in NEVs as the investment manager expects the recent price cuts to continue due to excess production capacity.

Transformers & Electrical Infrastructure

Lately the investment manager has been probing for opportunities relating to the anticipated upgrade of the US electrical grid, which they view as a long-term secular trend. Legislation out of Washington, D.C. has designated generous funding toward updating the grid, as well as green energy in general: the Infrastructure Investment and Jobs Act earmarked $73 billion toward grid updates, and the Inflation Reduction Act is contributing $369 billion toward the green transition (which in turn will create new grid demand). The US opportunity is huge, but there is international demand too: Europe’s green transition is creating abnormal demand for grid products, and gigantic infrastructure projects in the Middle East are compounding the issue.

With this theme in mind, the investment manager’s attention has turned to high-voltage transformer manufacturers. Most of the US grid was built in the 1960s and 1970s, so the average age of large power transformers in the US (which handle 90% of electricity flow) is over 40 years old. That is exactly the age when malfunctions start to escalate, and as a result, there has been near double the power outage time in the US in the last few years.

While some of the low/mid-voltage distribution products are relatively commoditised with numerous competitors, high-voltage transformers are difficult to do. It is an oligopolistic market that is not generally subject to Chinese competition and carries healthy margins – these are mission-critical products that need to meet stringent qualification standards by utilities.

Transformers & Electrical Infrastructure (continued)

These stocks are typically cheap given their cyclical history, but are starting to see sustained double-digit growth, backlogs extending from 1 year to 3 years, climbing ASPs, and higher margins.

One of the investment manager's favourite names in the space is HD Hyundai Electric, a Korean company that was historically more domestically-focused but has seen a surge in demand from US utilities as US transformer manufacturers have run out of capacity. HD also has easy access to electrical steel in Korea, a unique raw material its US counterparts struggle to get. HD is now working on a US capacity expansion and they think profit margins can hit historic highs as US sales carry higher pricing/margins. Expectations are for 20% growth next year with expanding margins, yet the stock trades on less than 10x PE with a 7.5% FCF yield. Its order backlog is an impressive 4.7 trillion (in KRW terms) (2-3 years' worth of sales), up 60% compared to a year ago and up 147% compared to December 2021.

LS Electric is another name in Korea that is poised to benefit, but for additional reasons. While LS also makes transformers, it mainly focuses on hardware & installation services to connect new factories to the grid (e.g., switchgear, switchboards, controls, etc.). With the CHIPS Act ($280 billion designated for tech onshoring), Korean car, battery, and semiconductor companies are building facilities in the US and taking LS along for the ride. LS has long-standing relationships with these Korean customers and is winning business as a turnkey electrical solution provider for their new US factories. The company's backlog now stands at 2.5 trillion (in KRW terms) (nearly a year of sales), up 43% vs. a year ago and up 133% vs. December 2021. At a very reasonable 9x PE, the investment manager thinks LS is far from peak earnings – especially if they achieve margins equivalent to the last cycle (8-9% net income margins vs. 4-5% currently).

Material matters

There have been no material changes to the Fund in terms of key service providers, the risk profile, investment strategy or changes to individuals in the investment team who play a key role in the investment decisions of the Fund.

The Fund is classified as a hedge fund in accordance with the Australian Securities and Investments Commission, Regulatory Guide 240 'Hedge funds: Improving disclosure'. This classification is based on the fact that the Fund currently exhibits two or more characteristics of a hedge fund, being:

- complexity of investment strategy or structure;
- use of leverage;
- use of derivatives;
- use of short selling;
- charges a performance fee.

This information contains general information only and is not intended to represent specific investment or professional advice. The information does not take into account an individual's personal financial circumstances, objectives or needs. Before making an investment decision, you should consider obtaining professional investment advice that takes into account your personal circumstances and should read the current target market determination and offer document before making an investment decision to acquire or to continue to hold units in the Fund.

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