# Contact Asset Management

**QUARTERLY REPORT**

SEPTEMBER 2020

## REPORTING SEASON REVIEW

Welcome to the Contact Asset Management Quarterly Report for September 2020.

The August 2020 Reporting Season was as tempestuous as they come from an earnings perspective. Unexpectedly, it was the best August in eleven years from a share market performance perspective. Economic conditions changed drastically in the six months since companies last presented their results. In February, COVID-19 was a potential but oft dismissed threat. With the August results, COVID-19 was omnipresent.

This update provides several insights from the Contact Asset Management team as we reflect on both the year gone and the challenges and opportunities in the periods ahead. We consider companies across several sectors including large, mid and small capitalisation stocks. It is a challenging period for Australian investors – the outlook is uncertain, income is harder to come by and many valuations appear stretched. However, there will be silver linings from the challenges of 2020. As long-term investors, we remain convinced that in the end optimism rules and opportunities never cease.

### (1) Reflections on the August 2020 Reporting Season

**Earnings and Dividends were awful, but it could have been worse**

At a headline level, the comparison to prior corresponding periods (be it FY19 or the six months to June 2019) was dreadful for most ASX listed companies. While this was complicated by “Underlying” and “Statutory” comparisons, the bottom line was that earnings have been decimated by the economic fallout arising from COVID-19.

According to Macquarie Research, Australia’s EPS fell 20% in FY20, with the largest falls in banks (-32%) and only a small fall in resources (-2%). This was better than many feared in March and April and highlights the early success of fiscal stimulus. Consumer stocks did far better than many anticipated as Australians spent the stimulus as we came out of the initial lockdown.

However, a 20% fall in earnings in the context of only four months impact of COVID-19 highlights just how susceptible many businesses are to a change in normal operating conditions. Many management teams crowed about how “resilient” the business was, yet also reported a halving of profits. We continue to think that many business models will suffer when the stimulus runs out – particularly if a vaccine takes longer than expected to develop.

Dividend cuts were also a feature. Corporates put the protection of Balance Sheets ahead of rewarding shareholders.

**Negative operating leverage bites**

Following on from the abovementioned point on resilience, we were surprised at the pace by which negative operating leverage hampered many businesses. Several listed companies have a relatively high fixed cost base – this is a competitive advantage when one has scale and growth. Indeed, many high-quality businesses have this characteristic. However, it can be a significant anchor when sales retreat.

We saw several businesses suffer in recent months due to this factor. Several REITs that experienced slowing sales or rent moratoriums are a good example as are many traditional manufacturing or industrial businesses. The airlines are another obvious example. It has been said that *“Fixed expenses are like the old joke about hell: It’s easy to get into, but very hard to get out.”* Leading into the current recession, Australia had over twenty years of economic growth. Some businesses got fat. As a business grows and its turnover increases, there is always a temptation to increase fixed costs. Then these higher fixed costs commit the business to regular cash outflows, even though the cash inflow may be more erratic, due to fluctuations in trade and delayed payments from clients. Reporting season highlighted that many companies face this dilemma.

One of the challenges facing management teams now is when should they attack the cost base? This is a difficult question given the unique situation we find ourselves in. If there is a vaccine and economies and borders reopen, then the recovery will be swift. Given the lack of certainty around when this will occur, managements and boards are understandably hesitant to cut too early – companies do not want to lose quality people or stall capex on a high value opportunity.

But management teams will have to be cognisant of cash flows as the crisis continues. We are almost three months into FY21 with no noticeable change in economic activity.  In fact, the Victorian situation has made many things worse. Cash flow is the number one culprit in business meltdowns — and nothing causes cash flow problems like inadequate management of fixed costs.

Therefore, we will continue to monitor cash flow as closely as possible. Balance Sheet and Financial Strength is one of the five key fundamentals that Contact Asset Management considers in our investment process.

### Resilient top line growth often undermined by margin compression

Several industries have actually enjoyed good revenue growth in recent months. The sectors grabbing headlines on this front are the supermarket retailers, online retailers and businesses that benefit from the “stay at home” trend.

However, for many, while revenue growth has been robust, the unexpected costs of COVID-19 have crimped margins. For the supermarkets, this has been the result of increased staff to meet demand, higher cleaning costs and increase logistics expense. Management teams told us that the panic buying in March was “like dealing with Christmas every day, yet we didn’t have three months to prepare for the spike in demand.”

Sonic Healthcare demonstrated its resilience in recent months as it managed to pivot away from pathology collection and testing to become an important player in COVID-19 testing. As economies locked down and people stayed away from GP visits, the rates of pathology collection collapsed. Sonic is now well placed as pathology testing returns to normal rates and it has the additional COVID-19 testing revenue stream. However, for FY20 earnings purposes, the cost of investing in new testing technology and processing equipment crimped margins.

### Investors are seemingly looking through near-term earnings in an unusual display of patience

For now, investors seem prepared to look through the near-term earnings trough. According to Goldman Sachs, despite a relatively low bar, 40% of firms missed consensus estimates (above the typical level of 30%). GS wrote “this rarely seemed to matter to stock prices however, with weak results not being met by a typical sell-off. While beats were rewarded by the market, firms that missed were broadly flat on average.”

Looking ahead, earnings visibility remains low. The August reporting season saw a more than 50% decline in companies providing guidance. We remain focused on stock specific opportunities and will watch closely for any signs of fragility as Government stimulus starts to wind down. There has been a significant amount of liquidity pumped into markets in the last six months – it will be interesting to see if the economy can recover at the rate that markets are seemingly pricing in.

The other issue garnering our attention is the supply chain. Our discussions across various industries increasingly point to bottlenecks in the supply chain – be it mobility of labour, access to inventory or availability of spare parts. Domestically, the lockdowns in Victoria are creating supply chain headaches for many businesses. However, this is also a global issue. We think this issue could be a potential headwind on the earnings recovery story.

## (2) Stock specific Reporting Season Highlights

Commonwealth Bank (CBA). We considered the CBA result to be impressive on several fronts. CBA remains well capitalised and its final dividend of 98 cps (fully franked), while significantly down on last year, was better than we expected. Had it not been for tight APRA guidelines, the income from CBA would have been better. CBA remains cautious on the economic outlook but surprised to the upside with collective provisions better than the market expected at 1.70% or $6.4 billion. The coming months are expected to be particularly interesting for the major banks as they start difficult discussions with borrowers who chose to defer payments. CBA remains our preferred Big 4 bank given its fortress like capital position, technology advantage and focus on dividends payments to their shareholders.

ASX Limited (ASX). ASX reported a typically solid result with good revenue growth across all business lines. The company is benefiting from healthy trading volumes and a lack of IPO activity was more than offset by secondary raisings activity. Operating revenue was up 8.6% driven by growth in all four businesses 1) Listings up 7.3%, 2) Derivatives and OTC up 4.5%, 3) Trading up 11.5% and 4) Equity post trade up 17%. Expenses rose 9.0%, 1% above guidance as a result of heightened costs associated with COVID-19.

Capex was $80.4m reflecting the ongoing investment in the contemporisation of ASX's technology infrastructure. They also announced a further $90m tech cap-ex program for FY21. The final dividend of $1.225 per share was 7% higher than the prior corresponding period and ahead of our expectations. The stock appears to be expensive on a P/E multiple basis, but this reflects the resilient earnings stream. ASX is a high-quality business.

BHP Group (BHP). The BHP result was slightly below our lofty expectations. However, we remain optimistic on the outlook for the company given buoyant commodity prices – particularly iron ore. Iron ore now accounts for over 60% of earnings. BHP is generating solid returns; it boasts a strong Balance Sheet and cash flow generation is robust. Future projects are progressing with the first production from Atlantis Phase 3 achieved in July 2020 and Spence Growth Option (Copper) and South Flank (to be one of the world's largest Iron Ore operations integrating the latest advances in autonomous-ready fleets, digital connectivity and modular design) to deliver first production within the next year.

We were looking specifically for commentary on the divestment of their Mt Arthur Asset in The Hunter, but BHP have also now taken the view of divesting BMC, Mt Artur and Cerrejon. BHP will continue to hold tier 1 Met Coal assets in Qld, under the BMA portfolio. These thermal coal assets will take a significant amount of time to divest but will be welcomed by many groups. BHP's forecast yield is 5.5% grossed up to 7.5% and we have this growing to 8.6% in FY22. This yield is very attractive and represents a very good opportunity for investors. BHP has returned over $40 billion to shareholders in the last three years and we believe this strong return of capital to shareholders will continue.

ResMed (RMD). RMD delivered a solid result driven by higher ventilator sales more than offsetting the decline in CPAP (continuous positive airway pressure) sales. COVID-19 has highlighted the importance of digital health and accelerating home testing and patient's engagement with the cloud network as well as the value of out of hospital healthcare and respiratory medicine. The Company's progress in the SaaS component of the business bodes well for future growth, particularly in a post COVID-19 world. With 900 million people globally suffering from sleep apnea and only 20% diagnosed the long-term thesis remains intact. Furthermore, free cash flow generation is impressive, the Balance Sheet is in good shape and the Company is run by an experienced and aligned management team.

Goodman Group (GMG). GMG has benefited from the changes to behaviour in the COVID-19 world with the trends driving the demand for high quality, well located logistics assets accelerated because of the pandemic. CEO Greg Goodman noted "Goodman has seen increased demand for both temporary and permanent space from customers in the food, consumer goods and logistics sectors, particularly related to e-commerce operators and those transitioning to online."

GMG achieved EPS growth of 11.4% in line with the Company's guidance. Management is guiding to 9% EPS growth in FY21 which exceeded our expectations. The increased demand for space in the undersupplied geographies GMG operates in has led to work in progress increasing 59% to $6.5 billion and expected to exceed $7.0 billion in 1H21. This bodes well for earnings visibility and we expect strong earnings growth from developments in the near term and funds management income growth thereafter.

Woolworths Limited (WOW). WOW announced a strong result at the revenue line yet flat profit growth as the cost of doing business in this new COVID world crimped margins. The Supermarkets division was required to hire an additional 17,500 employees to help deal with demand. Endeavour Drinks also reported strong top line growth – this division is still expected to be spun off in 2021. The turnaround in Big W was also a highlight. Woolworths is expected to continue to generate good returns and the Balance Sheet is in good shape. However, the business will cycle some tough comps in FY21 given the massive panic buying seen in the early parts of this year. Woolworths offers a grossed-up yield of approximately 3.5%.

Harvey Norman (HVN). HVN delivered one of the best results of the period. The rebound in activity from the depths of the March lockdown has been quite remarkable and this has been mirrored in its stores internationally. The free cash flow generation was a highlight – up almost 200% on FY19. The business is now net cash and has a significant property portfolio that underpins the valuation. This founder-led business continues to be well managed and continues to have compelling growth options offshore. HVN boasts a very attractive dividend yield and has a strong balance sheet.

ARB Limited (ARB). The FY20 result emphasised the strength of ARB's brand and business. The Company managed to deliver positive earnings growth which was better than the withdrawn guidance of NPAT down by a similar amount to the first half (1H20 -7.4%). Despite COVID-19 the outlook for the business has improved with Government stimulus and border closures driving an increase in domestic travel. The Company noted that July was its highest ever sales month and the current order book is at record levels.

Furthermore, the strengthening of the Australian Dollar, particularly against the Thai Baht, will lead to an improvement in margins. ARB is net cash, which has allowed the Company to pay its deferred interim dividend and a final dividend highlighting the benefit of a strong Balance Sheet and an aligned management team.

Reece Limited (REH) REH reported a record result that was ahead of expectations. REH is a well-run, high quality business with a market leading position in Australia and decent growth prospects in the US. The near-term outlook has improved, largely driven by Government stimulus with fourth quarter sales ahead of the prior year and economic forecasts suggesting 9% growth in the alterations and additions market in 2021. With a focus on innovation and technology we expect REH to maintain its market leading position. We are positive on the long-term growth prospects in the US where the Company currently has 184 branches servicing a population of over 300 million compared with Australia with over 600 branches servicing a population of only 25 million. Management's long-term approach and alignment provides us with comfort in their ability to execute the US strategy. The recent capital raising has strengthened the Balance Sheet providing financial flexibility to pursue growth opportunities.

## (3) This is a stock pickers market. At a headline level, there is a disconnect between earnings expectations and valuations

We remain cautious on many segments of the Australian market. Given what is transpiring in economies across the world and particularly at home, we find it remarkable that the S&P/ASX 300 Accumulation Index is only 6% lower than it was at the start of the calendar year.

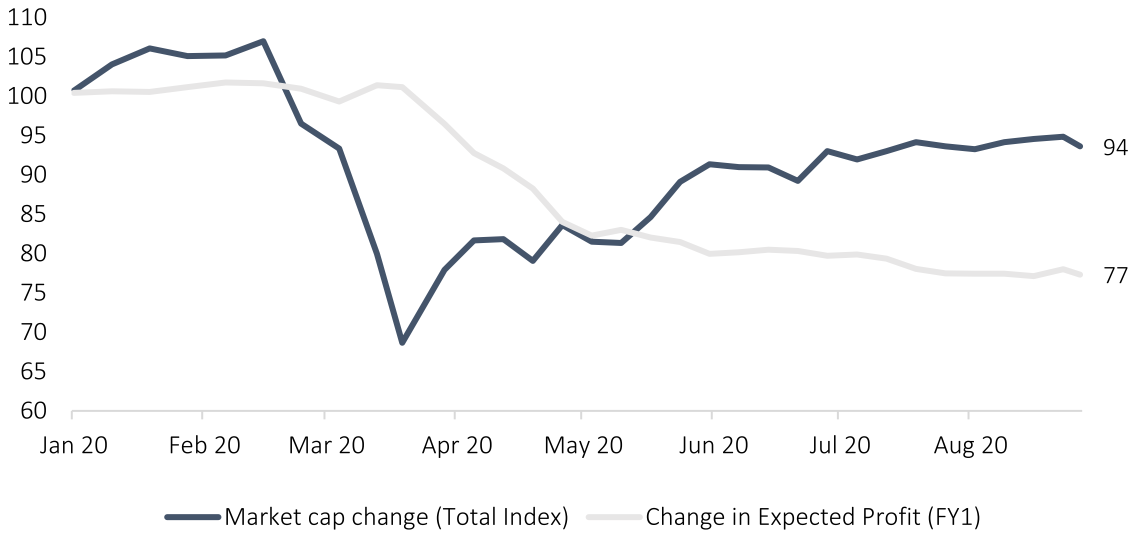
This is not a "buy the market" scenario and not every business will necessarily survive. To highlight how quickly things can change, consider:

- At the start of the year, Flight Centre was forecast to generate profits of $236 million in FY20. The company reported losses of $510 million,
- Combined, the WAAAX (WiseTech, Afterpay, Altium, Appen and Xero) stocks are expected to generate profits of $280 million. For context, this is a similar level of profit that a BlueScope Steel, a TPG Telecom or Crown Limited typically produces on their own. The combined market capitalisation of the WAAAX stocks moved from $34 billion on 1 January to $24 billion in mid-March to $58 billion at end August. The WAAAX stocks are currently trading on a combined PE multiple of 280 times!

In the following charts, we illustrate some interesting dynamics – particularly the disconnect between earnings expectations and market valuations.

The chart below focuses on the S&P/ASX 100. Since the start of the year, consensus earnings expectations have been cut by 23%. The market has rallied from its March lows notwithstanding a lack of any clear recovery in profits.

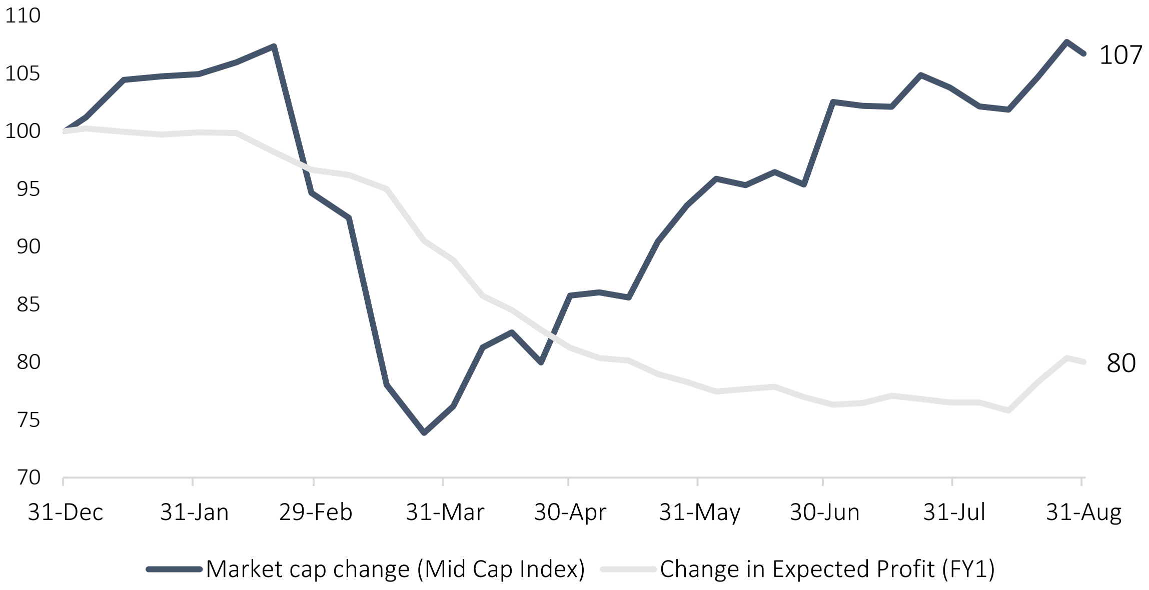
ASX 100: Change in Market Cap vs Change in Expected Profits



*Source: Factset, Contact Asset Management*

It is a similar story in the S&P/ASX Mid-Cap 50 Index. However, the rally is more pronounced given a higher proportion of Tech-related stocks in this index.

S&P/ASX Mid Cap 50 Index: Change in Market Cap vs Change in Profits

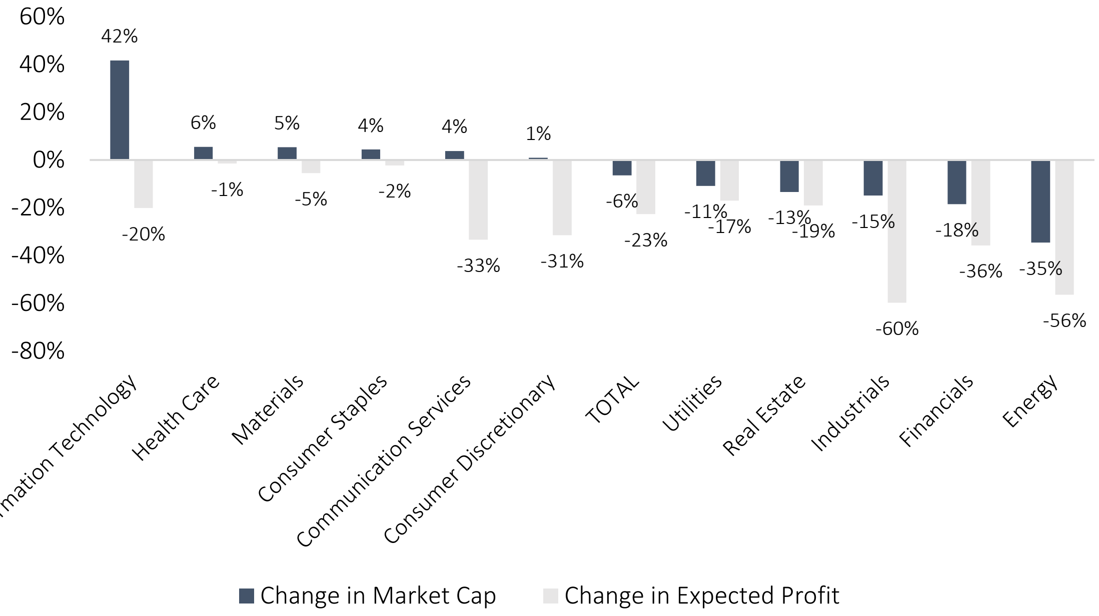


*Source: Factset, Contact Asset Management*

If we dive deeper, we find that there are a few themes playing out.

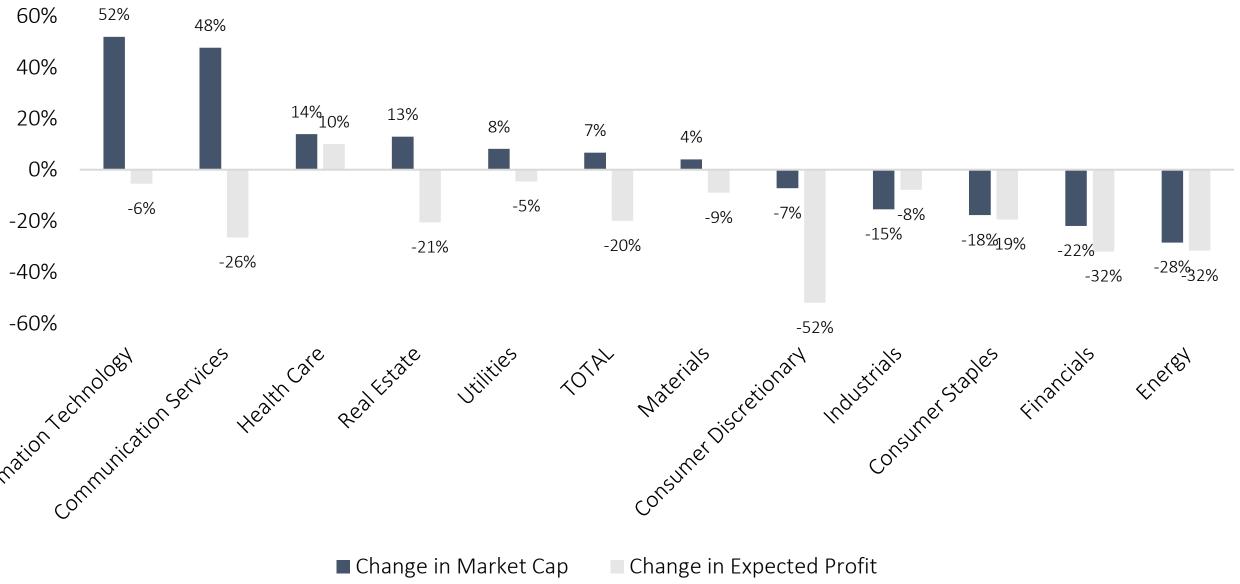
- As is widely known, Tech stocks are leading the market higher notwithstanding no increase in earnings expectations.
- The Consumer Discretionary sector is a tale of extremes. Many businesses are thriving under COVID-19 conditions (e.g. Harvey Norman, JB Hi-Fi and Dominos Pizza) yet others are struggling (especially the casinos and travel related stocks).
- Financials continue to face many headwinds – we worry that the Banks will be forced to carry the weight of a lot of consumer hardship under "Team Australia".

Disconnect between Market Valuations and Earnings
S&P/ASX 100 Index



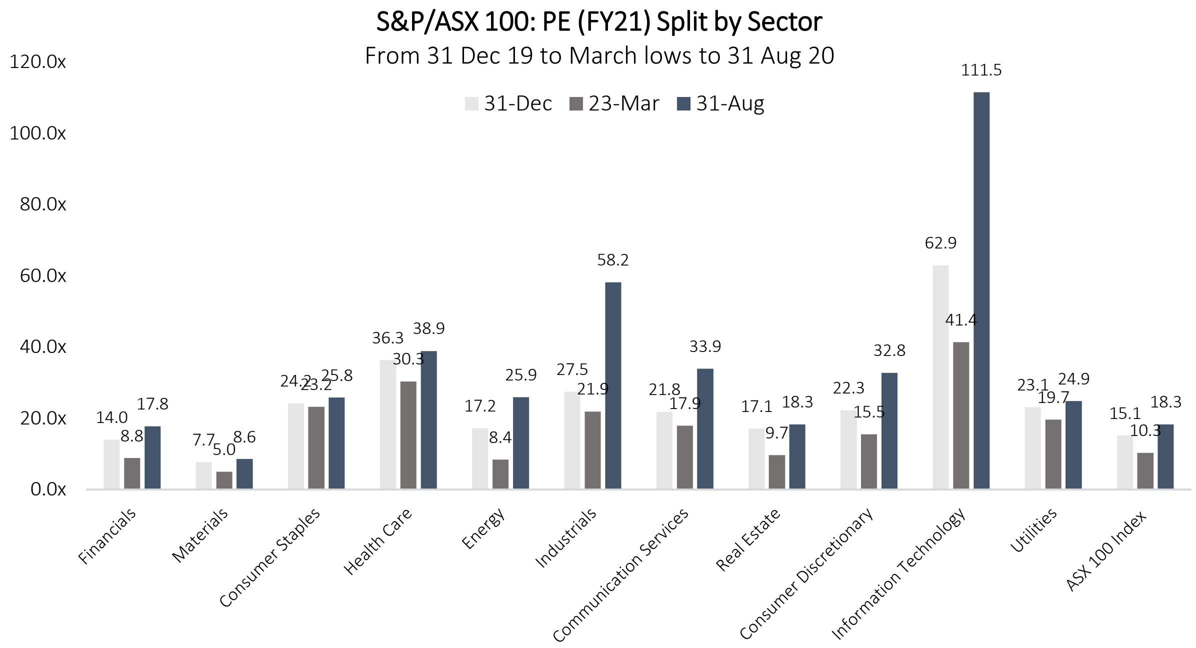
*Source: Factset, Contact Asset Management*

Disconnect between Market Valuations and Earnings
S&P/ASX Mid Cap 50 Index



*Source: Factset, Contact Asset Management*

Finally, the following P/E multiple analysis provides a quick snapshot of the volatility that we have seen in recent months.



S&P/ASX 100: PE (FY21) Split by Sector

From 31 Dec 19 to March lows to 31 Aug 20

*Source: Factset, Contact Asset Management*

## Our approach amidst uncertainty

We continue to advocate that the only way to maintain conviction long term is if the underlying business fundamentals are strong. We do not look at the share price for confirmation of the investment thesis – rather we look to the underlying earnings growth and the quality of the people running the business. Experience has taught us that if the business does well, the share price will catch up. We also know that the opposite is the case. Sooner or later, valuations matter and share prices often run ahead of valuations.

We build portfolios that consist of high quality, income producing companies managed by capable people that are financially strong. We do not invest in companies that do not generate profits nor do we invest in companies that have weak Balance Sheets. We expect volatility in the coming months, but we are also excited about the opportunities that will arise. We remain convinced that in the end optimism rules and opportunities never cease.

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