Contact Asset Management

INSIGHTS

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CONTACT ASSET MANAGEMENT

Three's a Crowd? . . . The benefits of investing in oligopolies

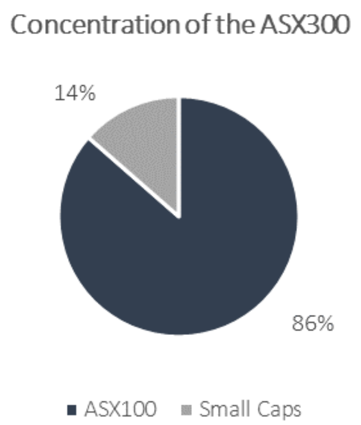
Oligopoly: a state of limited competition, in which a market is shared by a small number of producers or sellers.

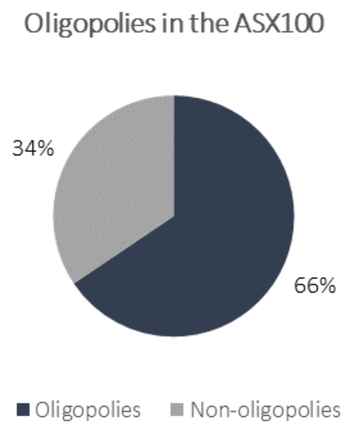
Australian equities are structurally well positioned to deliver sustainable and highly franked dividend yields over the long term. This is due to the market's concentration in large, mature, financially stable, and strong cash flow generating companies.

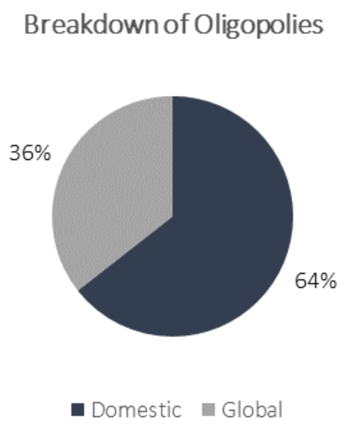
Oligopolies dominate many Australian industries

Oligopolies and monopolies, like those that dominate many Australian industries, behave differently to the way economists assume firms behave in most economic models. Rather than facing stiff competition for every dollar of profit they earn, they face only a few competitors. As a result, much of their activity is directed at getting a strategic advantage over their rivals and maintaining the high barriers to entry that give them extensive market power. This market power with minimal competition makes these firms highly profitable.[1]

The Australian Equities market is dominated by oligopolies, and many of them are large, powerful and very profitable. The largest 100 listed Australian stocks account for over 85% of the entire market's capitalisation. Of this, we consider 66% to be companies operating as oligopolies. Of this amount, over 60% (over 40% of the total) relates to domestic oligopolies with almost 40% (almost 25% of the total) enjoying the same position in global markets (as well as in the local market in most cases).







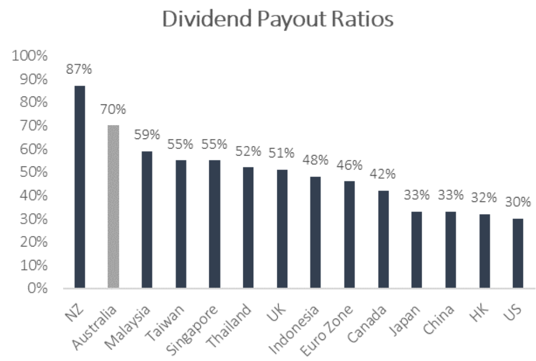
Source: FactSet, Contact Asset Management. Note that we do not include Wesfarmers, Macquarie Bank, Goodman Group or Amcor as oligopolies even though they do possess near-oligopolistic characteristics.

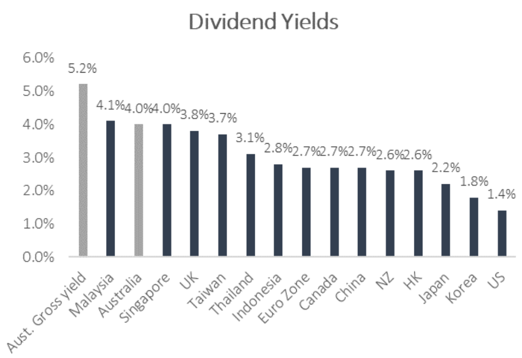
The highly profitable oligopolies often reward shareholders through dividends

Oligopolistic environments generally deliver stable volumes and pricing, ensuring more predictable operating cash flows. These market structures also mean substantial industry moats, which limit competition and therefore require relatively less operating and capital expenditure. These market leaders have historically invested significantly to gain strong positions within their sector and are now in a potion to produce healthy and reliable free cash flows, available for dividends and other capital management initiatives.

This enables Australian companies to pay out the second highest ratio of earnings at approximately 70%. While we trail New Zealand from a payout ratio, the dividend yield is more compelling in Australia as New Zealand has higher earnings multiples. As depicted in the charts below, the benefits of franking credits in Australia provide investors with a substantially greater gross yield.

[1] The Australian Institute, Oligopoly Money, Grundoff & Richardson, February 2016





Source: FactSet, Contact Asset Management

Some examples in the Australian market

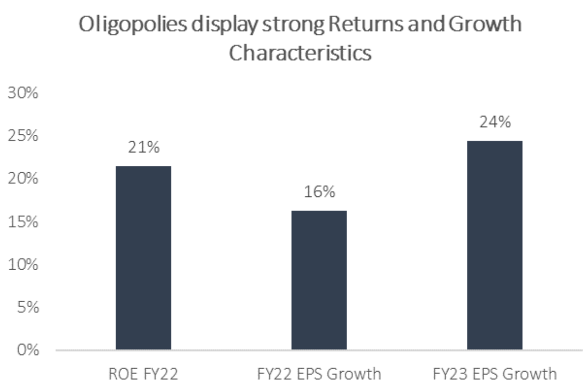
This doesn't imply that investors can simply buy and forget the list of stocks exposed to oligopolies. The very characteristics that make them so attractive, can also encourage competition particularly from disruptors. For example, the recent involvement of Apple and AfterPay in the traditional banks space of payments.

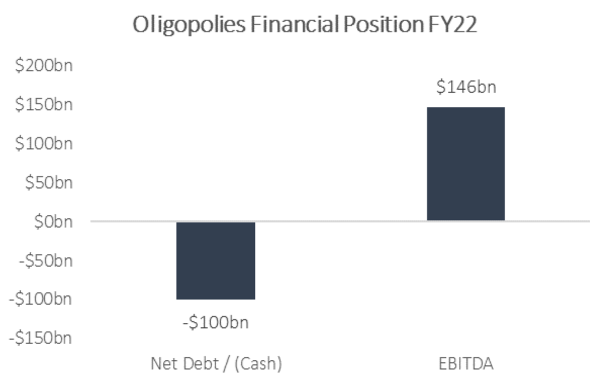
Dominant positions can also be threatened by government policy, technology and environmental issues. Energy generation and retailing is exposed to all three with environmental concerns leading to communities, shareholders and governments to push for renewables with solar and battery technology allowing consumers to embrace self-sufficiency.

However, the graveyard of efforts to break up Australian oligopoly industries is substantial:

- The Commonwealth Bank, National Australia Bank, ANZ Bank and Westpac Banking Corporation continue to dominate the banking sphere, having consolidated some small competitors around the GFC. There have been recent "neo bank" failures and the main players have actually increased their exposure to their core by divesting other businesses (e.g. wealth/asset management and insurance).
- Despite producing a "commodity" while prices are at all-time highs, BHP Group and Rio Tinto still aim at selling every ounce of iron ore they can mine and the industry seamlessly absorbed Fortescue Metals growth over time. Efforts to break this Australian dominance (particularly given the proximity to China) through Vale, China internally or from reserves in Africa, remain illusionary.
- Similarly, Woolworths and Coles have barely been impacted by Aldi, with the brunt mainly absorbed by the independents. Significantly, Aldi's German peer Lidl recently abandoned efforts to enter the market.
- Telstra Corporation is arguably in its strongest position since the Government-initiated disruption of the NBN with two competitors merging, concentrating power further and already delivering more rational price outcomes.
- Having now seen off multiple encroachments, Qantas Airways has something closer to a monopoly in many routes and business segments.

The underlying quality of companies in oligopolies is highlighted by the weighted average Return of Equity (ROE) of 21% and Earnings per Share (EPS) growth expectations of over 24% and 16% in FY22 and FY23 respectively (weighed down by an assumed iron ore correction). Excluding financials their total net debt is only \$100b relative to the over \$146b in EBITDA they'll deliver in FY22.



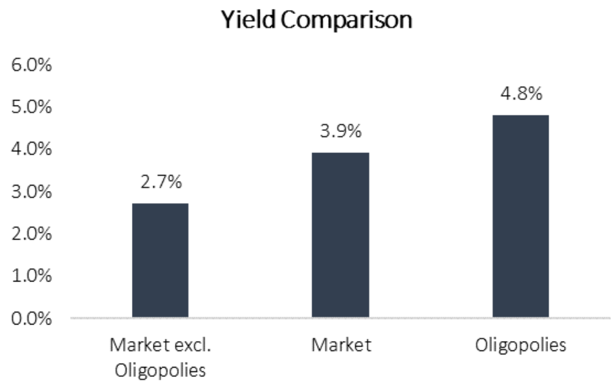


Source: FactSet, Contact Asset Management

Dividends from the Oligopolies are also compelling

These ASX listed stocks with strong oligopolistic exposures are forecast to deliver a FY2022 dividend yield of 4.8%, with those locally focused offering 3.9% and the global subgroup offering 6.4% (driven by the iron ore miners). These dividends will be highly franked given most are produced by domestic tax paying businesses - even the global miners' dividend distributions are typically 100% franked. This produces a gross yield of over 6.0%.

This 4.8% yield before franking from the oligopolies, compares to just 3.9% for the Australian market (which includes the oligopolies themselves). This implies a yield of just 2.7% for the non-oligopolistic stocks, which are producing their operating cash flows and profits in a much more challenging environment, creating risk around this figure.



Source: FactSet, Contact Asset Management. The numbers above do not include franking credits

Conclusion

At Contact Asset Management, we spend a significant proportion of our research efforts on what we call Principal Activity. This is complemented by other tenets of our Investment Process being Income, Financial Strength, Management, ESG and Valuation. In our Principal Activity analysis, we question: How does the business make money? What is the competitive advantage? What is the industry structure? In doing so, often those businesses operating in oligopolistic industries offer more attractive investment attributes.

BKI Investment Company invests in several large oligopolies. As it stands, almost 60% of the portfolio is currently invested in such companies. If we include the abovementioned four stocks (Amcor, Goodman Group, Macquarie Group, and Wesfarmers) with similarly strong characteristics, this lifts this allocation to almost 75%. The fund's current dividend yield is 4.3% and 5.7% on a grossed-up basis.

In the Contact Australian Ex-50 Fund, Contact aims at investing in tomorrow's leaders, many displaying oligopolistic characteristics and who have a significant competitive advantage. Some examples include Resmed Inc, ARB Corporation, REA Group, Link Administration Holdings, Nine Entertainment Company, Reece Limited, Iress Limited and IPH Limited.

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