Contact Asset Management

INSIGHTS

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Reporting Season Highlights a Few Diamonds in the Rough

August is always a compelling month for the share market as corporate results separate the wheat from the chaff. We consider the August 2021 reporting period to have been generally solid – one that was characterised by more beats than misses and strong dividend or capital management announcements. However, the return of the virus and several State-wide lockdowns meant that many corporates shied away from providing guidance. In this Contact Insights piece, we provide a few high-level comments on the Reporting Season. We also discuss three companies in our Portfolios that, while possibly less well-known, delivered pleasing results and offer exciting prospects.

August Reporting Season Review

The results delivered in August were strong in the main. The solid earnings reported was broad based across a sectors. With massive stimulus, low interest rates and strong asset values, one might argue that there have been far more COVID winners than losers. Balance Sheets are robust. As a result, the share market reacted positively. Small and mid-cap stocks led the market higher in August with the S&P/ASX Small Ordinaries Index increasing by 5.0% and the S&P/ASX Midcap 50 Index increasing by 3.9%. IT, up over 16%, was the standout sector in August. Consumer Staples, Healthcare and Real Estate all increased by more than 6%.

We consider there to be a few consistent themes from Reporting Season

Dividends and Capital Management was a feature: after a dividend drought in the August 2020 reporting period, a highlight for this reporting period has been the bounce-back in dividends. According to Morgans Research, investors received a record $38 billion in dividends – we are back to levels that we became accustomed to pre-pandemic. Of note was $18 billion of new buybacks and special dividends announced. The rise in capital returns is encouraging and suggests companies are increasingly focussing on shareholders' interests. The dividend yield for the ASX 300 is approximately 3.75%, which is attractive by global standards and particularly compelling in a low interest rate environment.

Inflation and Supply Chain: several retailers, manufacturers and developers lamented the pressure on the supply chain. This is an issue that we have discussed in the June *Contact Insights* note. Record freight rates are adding to inflationary pressures for many businesses. For now, robust demand is an offset, however inflation remains a threat., On the supply chain constraints, we note that many retailers are building inventory to meet expected consumer demand when the current lockdown restrictions ease.

Lack of Quantitative Outlook Statements: while the record dividends paid suggests some confidence in the post-lockdown economy, only a limited number of companies (that is, less than 20%) were brave enough to provide quantitative guidance. Consensus estimates have erred on the side of caution and June 2022 profit outlook has been cut slightly. The upcoming AGM season will be an interesting gauge of how companies are faring.

Despite marginal pullbacks to earnings expectations, the market continues to trade on a more reasonable P/E multiple of approximately 18 times. As noted above, the dividend yield for the S&P/ASX 300 index is also now more compelling. We believe that a proportion of these record dividends will be reinvested back into the market in the near term.

As always, there are stark differences in performance during August. In the main, we were satisfied with the results delivered by the majority of our holdings. We were particularly happy with the return to much improved dividend payments. As we continue to learn, reporting season showcases the high-quality businesses and, as we have noted before, we believe that the high-quality businesses continue to surprise on the upside. Below, we provide a few thoughts on three smaller companies that we believe are high quality and offer attractive long-term prospects.

Reporting Season Highlights from some of our Small and Mid-cap Holdings

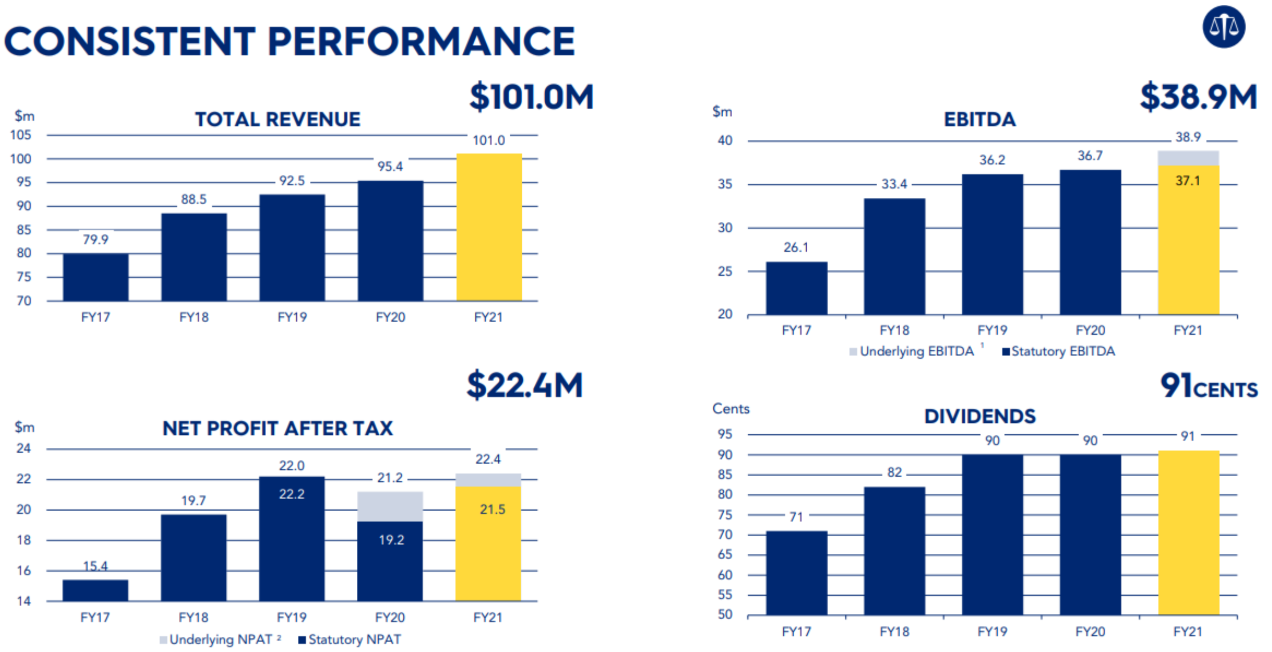
EQT Holdings Limited (EQT)

EQT, which is more commonly known as Equity Trustees, was established in 1888 and has become one of Australia's largest specialist trustee companies. A trustee company is a legal entity that manages and invests funds on behalf of a beneficiary for their benefit. In doing so, EQT offers a range of financial and fiduciary services. EQT's market capitalisation is approximately $650 million. The company has Funds Under Management and Supervision (FUMAS) of $144 billion.

Our investment case for EQT is supported by a highly resilient and long-term revenue stream. In the fiscal year 2021 result, we were pleased to see another year of solid revenue growth to $101 million. We are optimistic on the growth prospects for EQT via both organic growth and corporate activity. FUMAS has doubled in the past five years. EQT has invested in technology and compliance in recent years and we are hopeful that as FUMAS continues to grow, the economies of scale will start to be reflected in robust growth in earnings per share.

On the result itself, the business continued to demonstrate its resilience. Underlying NPAT grew by 5.5% to $22.4 million. Underlying EPS increased by 4.4% to 107.2cps and EQT increased the full year dividend by 1 cent to 91cps. The Balance Sheet is very strong, even after considering the regulatory capital that EQT is required to hold. Return on Equity continues to expand and the dividend has been resilient, even through the market shocks associated with COVID-19.

We are optimistic that EQT's top line momentum, combined with investment in the business, will flow through to future growth in earnings and dividends



Source: EQT FY21 Result Presentation

We consider EQT to be a well-managed, trusted and high-quality business that offers investors a combination of growth and yield. The current dividend yield is 5.5% on a grossed-up basis. The volume traded in the stock is quite low and thus, very few brokers cover the stock. Therein lies an opportunity. We believe that there are several reasons to be positive EQT, including (1) Limited number of players in the space; (2) Strong tailwinds due to continual growth within the funds management and superannuation environment; (3) High customer retention rates over 93%; and (4) Good growth prospects in the UK and Ireland. At current prices, we consider EQT to be an attractive value proposition.

On the back of a solid result, the EQT share price increased by 11% in August.

IPH Limited (IPH)

IPH Limited is another company that traces its roots back to the 1880s. It is a leading Intellectual Property (IP) services group in the Asia-Pacific region, employing over 900 people. Its core operation is patent and trademarks filing. The company's value proposition is based on offering its global clients a single point of market access across eight IP jurisdictions covering more than 25 countries. IPH's market capitalisation is approximately $2 billion.

IPH offers many compelling investment attributes. It is the market leader in Australia, New Zealand and Singapore. The business is capital light and cash generative on the back of an annuity like revenue stream. This flows into very attractive returns on invested capital. The management team have demonstrated an ability to complement solid organic growth with M&A – since listing in 2014, IPH has integrated ten acquisitions and delivered margin accretion and earnings growth.

Source: IPH FY21 Result Presentation

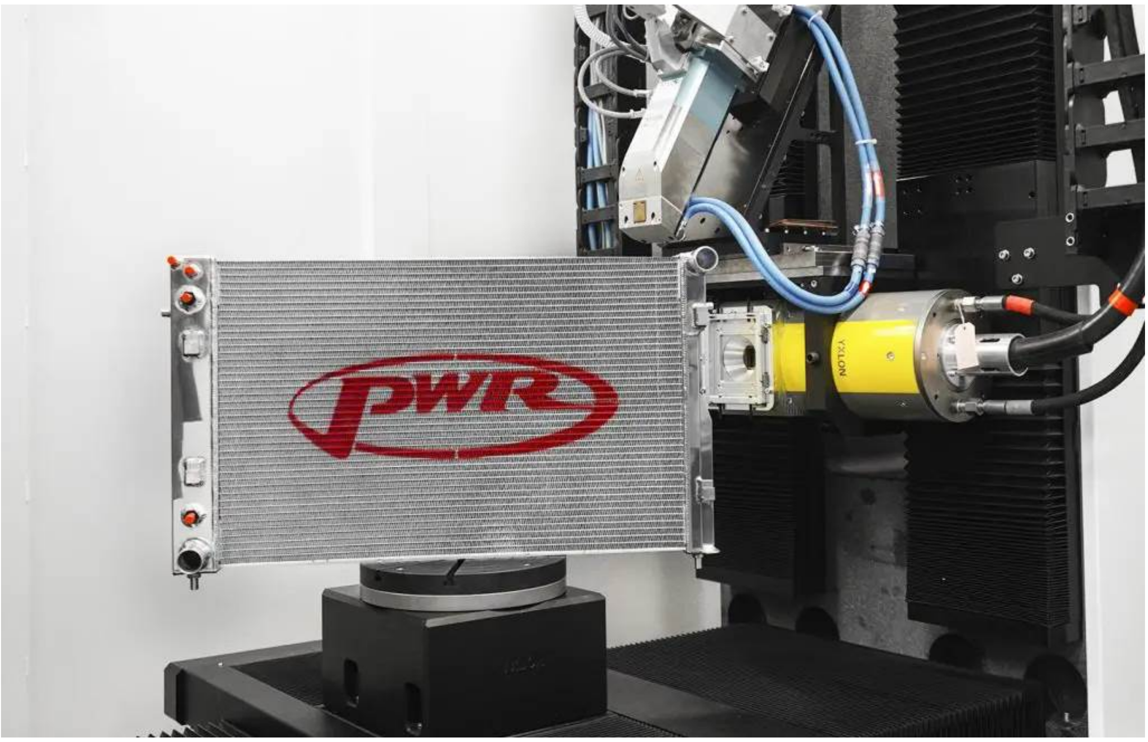
While some of the headline numbers were mixed in the IPH FY21 result, the constant currency growth was solid. Patent filings continue to grow at a reasonable rate and growth from the Singapore division was a standout. The company is demonstrating operating leverage on the back of cost out/synergies and strong underlying momentum in the Asia business. IPH has a solid Balance Sheet, which leaves it well positioned to continue accretive M&A transactions.

IPH was one of the best performing stocks of August, increasing by almost 20%.

PWR Holdings (PWH)

PWR Holdings (PWH) is a market leading automotive cooling system designer and manufacturer. PWH offers a unique combination of collaborative design, testing and manufacture of high-end cooling systems. Such is the quality of its products, PWH provides cooling systems to V8 Supercars, nine out of 10 Formula One teams and it works with leading Nascar and Indycar teams, touring cars and rally teams all over the world. The products are also sold to original equipment manufacturers (OEM's) building high performance motor vehicles. PWH's market capitalisation is approximately $880 million.

PWH was established by Kees Weel in 1987, manufacturing automotive radiators in a small factory on the Gold Coast. Weel continues to lead the business today and, when family interests are included, he accounts for more than 20% ownership in the business. At Contact, we like founder-led businesses. Businesses that are founder or family led tend to think longer-term. The Board and Management at PWH have consistently reinvested in the business for growth, they pay a reasonable dividend and yet manage the business in a conservative manner. PWH has no debt and the business generates solid cash flow and high returns on equity. In some ways, the business reminds us of an ARB of yesteryear.



Above: An example of a PWR radiator. Source: PWH Annual Report 2021

PWH announced a strong result in August with EPS up almost 30% and the dividend almost 50% higher than the prior year. The result was characterised by solid revenue growth across all segments, including Motorsports (+13%), Automotive Aftermarket (+29%), OEM (+18%) and Emerging Tech (+113%). PWH is well positioned with the revenue diversification strategy starting to flow through. FY21 EBITDA margin expansion to 36.6% (+100bps) was also pleasing as increased manufacturing throughput lifted scale benefits. Unsurprisingly, the stock reacted well with PWH's share price increasing by 16% in August.

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