Contact Asset Management

INSIGHTS

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Margin of Safety is in the Eye of the Beholder

Like many borrowed terms that become overused marketing cliches, Margin of Safety (made popular by Ben Graham in his almost 100-year-old book Security Analysis*) has many interpretations. These include low valuation multiples, discount to intrinsic value, or an assessment of likelihood to lose money. Contact owns some low multiple stocks, but only after the businesses have passed our 6-step process, of which valuation is one. This means our team believes the stock represents a quality investment because we understand how the business makes money, that it will generate attractive levels of income, has a strong financial position, an aligned management team, acceptable ESG credentials, as well as an attractive valuation.*

Value Investing in Quality Companies is a successful combination

Companies trading on low valuation multiples are often dismissed (now more so than ever given the decade long outperformance by growth indices over the value style) as reflecting business weakness either due to industry or stock specific factors.

Obviously, a naïve investment process of simply buying low P/E stocks is weak, as would blindly buying growth stocks because they have momentum or are, by definition, popular. History has taught us that “Value” investing fails when business earnings are actually even weaker than what is factored into the relatively low valuation multiple.

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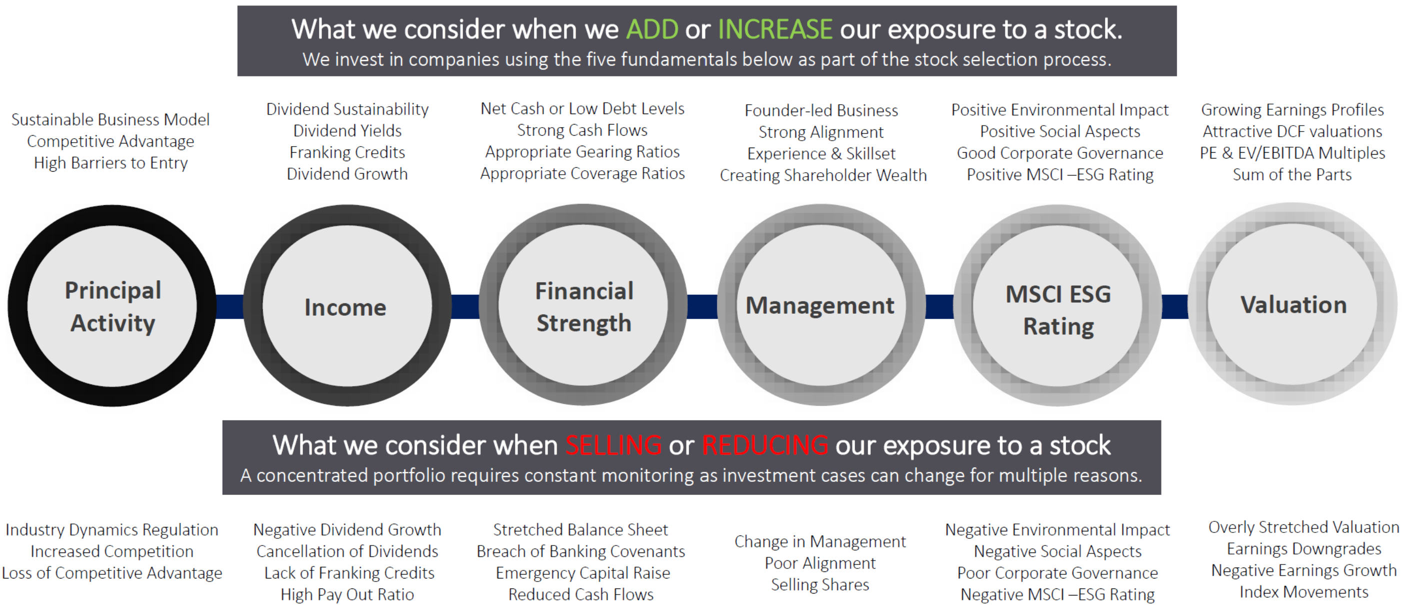
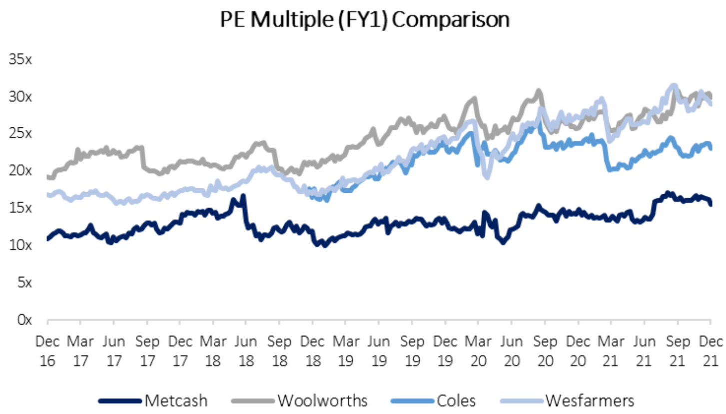
Contact Asset Management’s Stock Selection and Investment Process



Generally and broadly, this means Contact believes these stocks are trading on even lower multiple levels relative to a range of risk adjusted future cash flows. Examples of headline low multiple stocks owned by Contact that have been assessed to not be value traps include the relatively well positioned Metcash Limited (MTS) and Adairs Limited (ADH). Investors would recognise these businesses as having stable or secular underlying demand (being groceries, household goods and hardware) and net cash balance sheets. These factors provide us confidence that their apparent low multiple margin of safety is real.

Metcash Limited (MTS) is trading at a significant P/E discount to its larger listed peers yet all boast solid Balance Sheets, reasonable yield, defensive earnings and capable Management teams

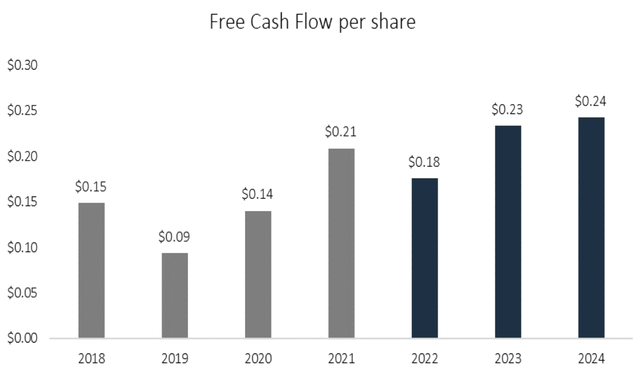


Source: Factset, Contact Asset Management

However, multiples are not Contact's main valuation metric. Discounted Cash Flow (DCF) valuation is an alternative measure of intrinsic value. While DCF is sometimes criticised for being sensitive to inputs, every quantified forecast used in security analysis is dependent on assumptions. By capturing the profile of future earnings, DCFs dilute short term profits that may overstate the strength of the business with cash flows that better reflect underlying sustainability.

In the Contact Australian Ex-50 Fund, two stocks that are owned that we believe are trading at significant discounts to our DCF valuation include Alliance Aviation Limited (AQZ) and Nine Entertainment Company Limited (NEC). In these instances, Contact has assessed that the margin of safety is greater than consensus expects because future normalised earnings are superior in quantity and quality than priced by the market. In the case of AQZ we expect profitability from its aviation services to be materially higher in a normal post CV19 environment, while NEC continues to morph from an old media institution into an increasingly digital driven multi-brand offering.

NEC is generating attractive levels of Free Cash Flow as it grows through its Digital offering



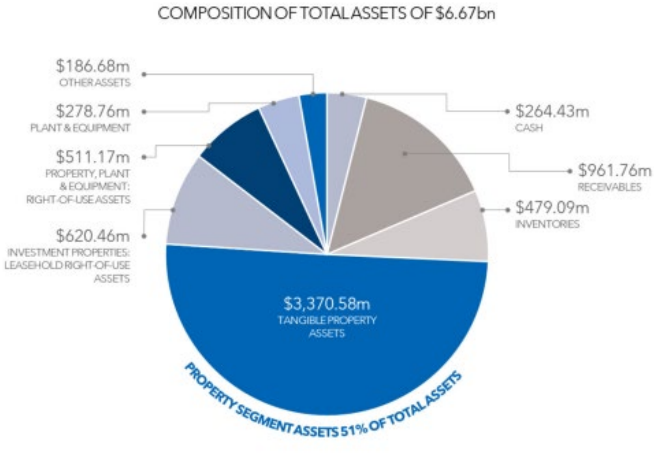
Source: Factset, Contact Asset Management Estimates

Source: NEC Investor Reports

A low probability of losing money is another type of margin of safety and can be due to cash flow and/or asset strength, that is by operating performance or financial position. Harvey Norman Holdings Limited (HVN) and Smartgroup Corporation Limited (SIQ) qualify on both counts. HVN is net cash, and the investment case is underpinned by a large property portfolio (i.e. $3 billion) valued at conservative cap rates.

SIQ provides employment management services such as novated leasing, salary packaging and fleet management. It is a capital light model with long-term client relationships. SIQ offers a strong dividend yield sustained by high cash conversion and a low but relatively stable growth business. The business is net cash and the normalisation in new vehicle supply should provide an additional tailwind.

Harvey Norman's Property Portfolio underpins a Margin of Safety



Source: Harvey Norman 2021 Annual Report

It's unrealistic to expect every portfolio holding to display outstanding evidence of massive margins of safety. Investment history is full of examples of stocks that traded on seemingly stretched valuations (and therefore narrow margins of safety) only to grow into global oligopolistic leaders and generate cash flows with utility-like security. While not Apple or Google, Contact's positions in ARB Limited (ARB) and Reece Limited (REH) look through sharper short-term margins of safety metrics and are based on product competitive advantage and achievable shares in huge global markets. The fact that both these businesses continue to be Founder led, which is key characteristic of over 70% of companies in the Fund, adds to our conviction.

Overall, based on our analysis, the Ex-50 Fund is packed with stocks with comfortable margins of safety derived from several stock specific factors. We believe that all our investment positions pass our 6-step process to find high quality businesses, and we also note that the Fund itself does not borrow. This has resulted in the Fund owning a portfolio with similar P/E valuation multiple metrics to the market, higher yield, greater cash flow generation and stronger balance sheets.

Portfolio Characteristics of the Contact Australian Ex-50 Fund

	Contact Ex-50 Fund	S&P/ASX Midcap 50 Index	S&P/ASX Small Ordinaries Index
Return on Capital Employed	28.4%	10.3%	8.4%
Operating Margin	24.3%	21.4%	17.0%
Gearing (Net debt / Equity)	31.1%	38.8%	53.8%
P/E Ratio (FY1)	18.8x	17.9x	19.1x
Yield (FY1)	3.7%	2.7%	2.3%

Source: Factset, Contact Asset Management. Note that the Gearing refers to the weighted average gearing of companies within the Portfolio. The Fund itself does not borrow.

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