Contact Asset Management

INSIGHTS

MARCH 2022

A Take on the February Reporting Season

While reporting season was relatively solid with net positive revisions, this is as unusual as the current macro environment which includes: emergence from COVID-19, impacts from massive stimulus, tight supply chains, roaring commodity prices and now a major European conflict. Key Contact holdings that saw consensus FY22 upgrades of over 10% included Nine Entertainment (~20%), Monadelphous (~10%), Harvey Norman (10%) and Kelsian Group (~10%).

More Beats than Misses

The outbreak of war in the Ukraine dominated headlines in February as investors looked to reduce risk. The increased uncertainty came at a time when several macroeconomic indicators were already slowing, combined with concerns around inflation and tighter monetary policy already weighing on sentiment. Most global markets finished the month lower. By comparison, the Australian Equities market increased by 2.1% in February. The relative strength was partly attributable to a higher proportion of resources and commodities companies in our index and less technology stocks relative to offshore peers. In addition, the February reporting season was characterised by generally robust results with more beats than misses. The EPS outlook for the Australian market was upgraded (Chart 1) and valuation and yield metrics now appear more attractive.

However, margins fell slightly with negative operating leverage (Chart 2). This is some concern given sales growth was so strong and the economy is in the relatively benign early stages (compared to the US) of the inflation cycle.

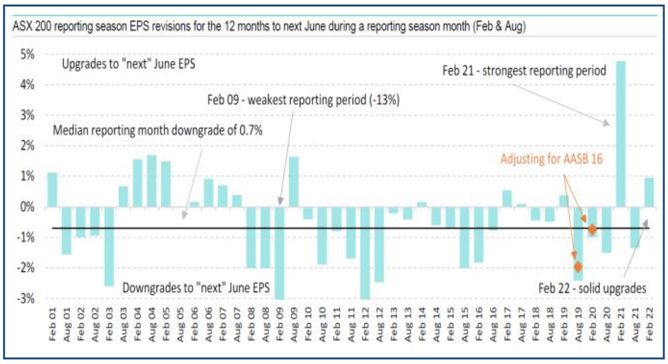

Chart 1 - Source: MST Marquee

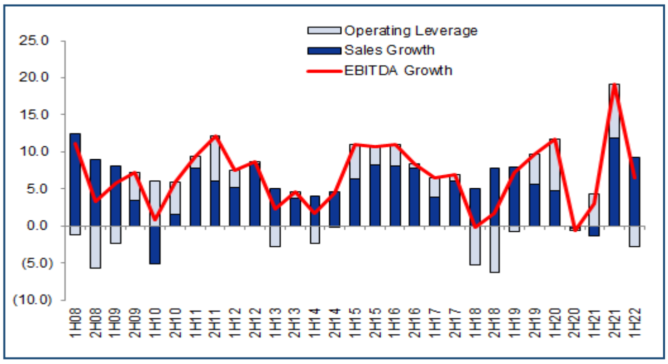

Chart 2 - Source: Goldman Sachs

Another interesting observation out of reporting season, is the operating outperformance relative to expectations (profit upgrades) of Value names compared to high multiple stocks (Chart 3). While the sharp bounce in cyclicals contributed to this outcome, the result is still unusual relative to recent history but also considering the volatile environment, when investors might expect highly rated "quality" to prove more sustainable. While this has been partially rewarded, valuation dispersion remains material (Chart 4). We have been patiently waiting for this outcome to emerge and Contact portfolios are well positioned for momentum in this trend.

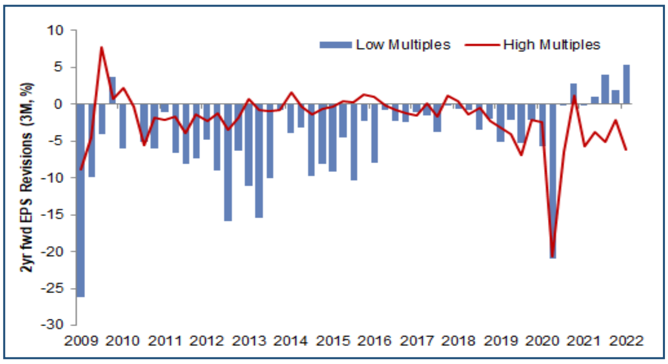

Chart 3 - Source: Goldman Sachs

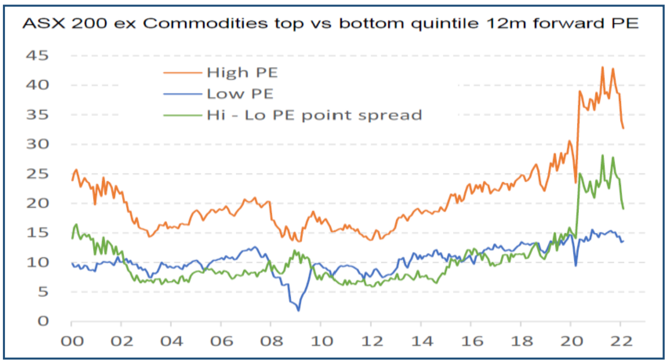

Chart 4 - Source: MST Marquee

Margin Expansion

Contact seeks to invest in businesses with idiosyncratic drivers (often founder led), that are relatively less leveraged to the broader conditions. Portfolio holdings that managed to expand margins include Nine Entertainment (through Domain's Marketplace strategy), Orora Limited (by executing pricing discipline and power), EQT Holdings (as scale benefits of funds growth were realised) and Lindsay Australia (as recent rail investments generated returns).

In large caps this thematic was led by Coles Group (as eCommerce initiatives continue to be rolled out), BHP Group (through a strong cost out program and higher realised prices across their commodities portfolio). Woodside Petroleum (higher realised prices across their oil and gas portfolio), Sonic Healthcare (through providing higher COVID-19 testing) and Goodman Group (as the shift to eCommerce, distribution and logistics gains significant momentum). Further to this, Coles Group has demonstrated with their most recent result that the better-quality retailers can produce significant growth in the area of eCommerce. Coles saw Supermarkets eCommerce sales grow 46% and Liquor eCommerce sales grow 60%.

Cost Pressures

Of the cost impost, labour pressures have now caught up to raw materials as areas of concern (Chart 5). Reece Group mentioned staff turnover and recruitment challenges which resulted in expense increases of 20-30%. EQT Holdings management mentioned staff turnover of 20%, Netwealth Group commented on salary pressures as did Bravura Solutions specifically in the technology space. At the larger end of the market, Woolworths Limited saw direct COVID-19 costs reach $150m, Coles estimated that they also suffered $150m of higher COVID-19 disruption costs and BHP Group reported that the total impact from COVID-19 was US$223m due mainly to staff shortages and lockdowns. BHP also saw an unfavourable working capital movement of US$2.2bn largely related to inventory builds, net price impacts on receivables and royalties.

Still the focus on inflation is much lower than in the US. While the tightness of the US labour market is greater, with the so-called "Great Resignation", other drivers are common to all economies and sustainable, dissuading most central bankers from their previous denial. This includes supply chain stress and the move to resilience rather than efficiency, away from globalisation, underinvestment, which is partly driving elevated commodity costs, including in agriculture/food, demographic changes and substantial policy support, shifting from monetary to fiscal. Transcript mentions (Chart 6) of inflation during the last 10 reporting seasons were elevated in both Australia and in the US. Somewhat surprisingly given the uncertainty, items reported as "unusual" (one-off) are at decade lows. It wouldn't surprise Contact to see this increase as companies take more significant action to address the abovementioned secular challenges.

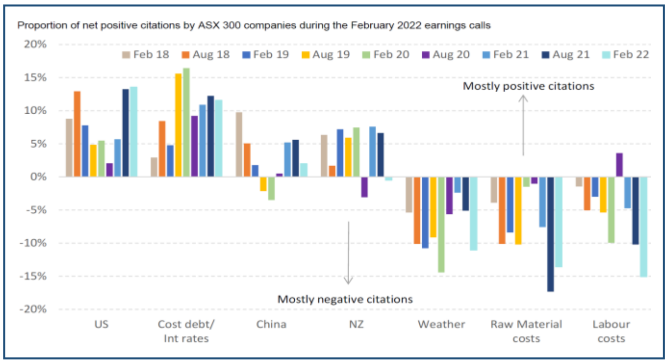

Chart 5 - Source: MST Marquee

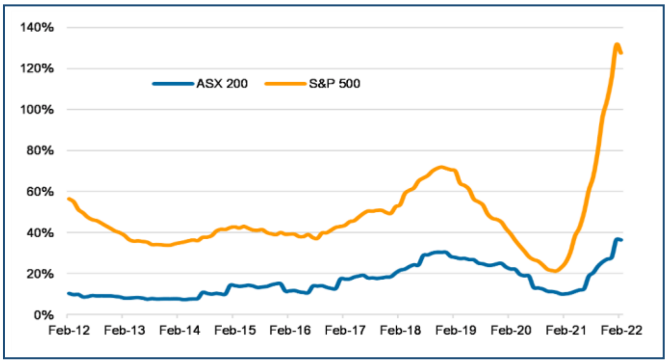

Chart 6 - Source: JP Morgan

Balance Sheets

While balance sheets in general are relatively strong, rising interest rates will have sharp incremental effects given the decade low starting base (Chart 7). Contact can't help but be more concerned about the impacts of yield increases on investor positioning, where leverage is greater and given the correlation with share prices (Chart 8).

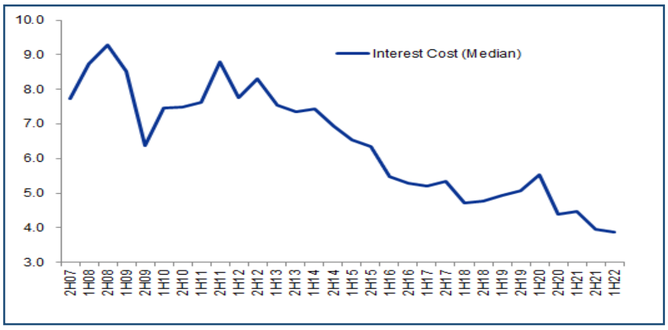

Chart 7 - Source: Goldman Sachs

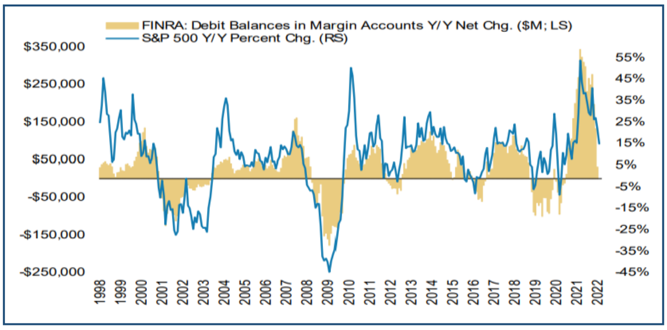

Chart 8 - Source: Morgan Stanley

Commodity Price Environment – EPS and Cash Flow

BKI Investment Company has Approx. 18% exposure to the Resource sector. The exposure of Contact's Ex-50 Fund to resources is relatively low at Approx. 10%. Despite the current buoyant commodity price environment, producers in the small cap universe are not comparable to their larger peers in terms of asset quality, operating costs, returns, balance sheets or cash flow generation.

The most recent reporting season highlighted that even across the broader small cap universe and despite the favourable conditions, resources stocks were much more binary bets yet again relative to industrials. A research report from Macquarie showed that within the resource sector there were 38% beats in EPS, 9% inline and 53% misses (Chart 9).

When looking at free cash flow, the analysis is slightly less favourable for industrials relative to resources (Chart 10). This was due to many industrials being manufacturers who need to have raw material inputs to produce the products they sell. As supply chains have continued to be challenged, companies have brought forward purchases and payments which has inflated inventories relative to payables, expanding working capital and depressing cash flow.

Retailers who on-sell the completed products weren't immune with Harvey Norman noting it built up "ample inventory reserves in light of anticipated supply chain disruptions due to COVID-19". Harvey Norman have been in retailing for decades and the fact they were so focused on mitigating any ongoing global supply chain constraints is a credit to the management team. These actions highlight the founder led approach by this business. They think long term. Adairs Limited also took this approach and disclosed they decided to "land stock earlier" to ensure customer demand can be met. Its rather simple… you can't make a sale if you don't have the product.

This dynamic was even more apparent among global industrial businesses which have the additional challenge of distance when managing their companies. Stocks where Contact observed this trend include Amcor Inc (who require raw materials for their flexible and rigid packages), ARB Corporation (where demand has exploded in recent times, driven both by direct demand from the aftermarket enthusiast, and big manufacturer contracts wins like Ford). James Hardie (who require pulp to produce its fibre cement products, and who also spoke to hyperinflation in Europe) and Reece Group (who are busy rolling out in their US expansion requiring additional product to fill the shelves).

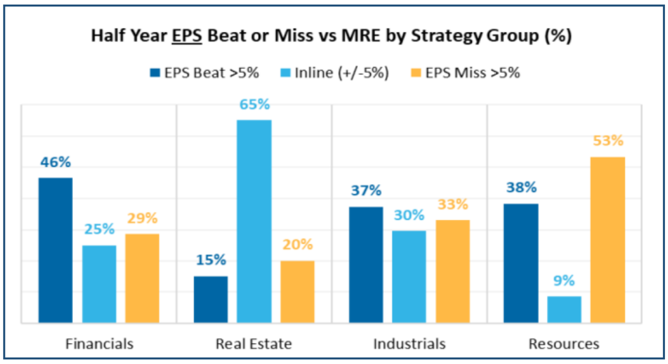

Chart 9 - Source: Macquarie

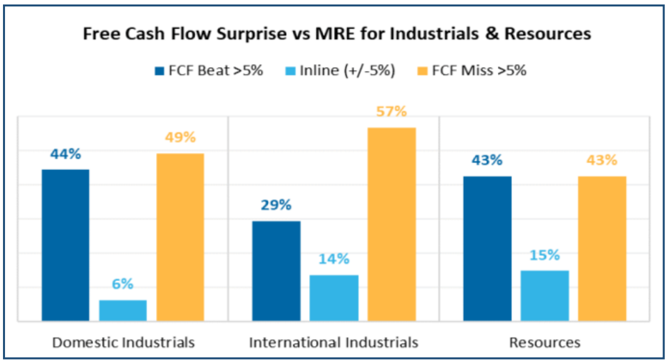

Chart 10 - Source: Macquarie

Resource companies, as the producers of the original raw materials, performed slightly better over the most recent half. Commodities were very strong during February amid geopolitical tensions. Brent oil lifted US$10/bbl to US$100/bbl, continuing its strong upward trend. This trend has continued into early March as markets react to sanctions on Russia. In fact, approx. 70% of all the major commodities are at or are close to new record highs. Iron ore prices closed the month relatively stable around the US$140/t mark but has traded up to US$162/t since. Thermal Coal NEWC (6,000 kcal/kg) is now trading at US$423/t and Hard Coking Coal is trading at US$660/t. Gold has also found support, increasing to US$2,045/oz. These movements will place most resource companies in an even stronger position heading into the last quarter of the 2022 financial year.

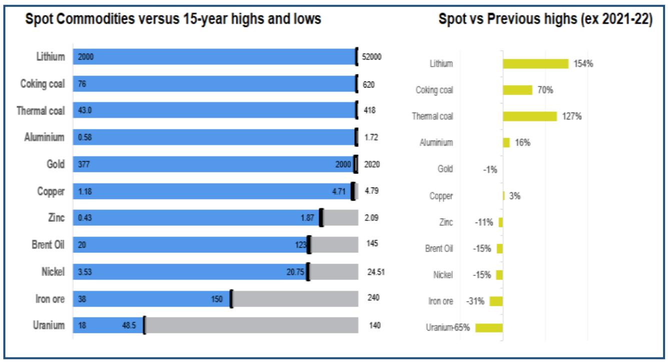

Chart 11 - Source: Morgans Financial

Chart 12 - Source: Morgans Financial

Cash Flows Converted into Stronger Dividends

We saw the use of excess cash skewed towards dividends at the expense of capex, although plenty was still available for buy-backs and M&A. Contact's investment process focuses on free cash flow generation and durable dividend payments. Once again, we saw that founder-led companies, those whose founder holds a position of influence; CEO, Chairman, Board Member, Family Member or a substantial shareholder, and who are highly motivated to think long-term have invested a sizable portion of their life savings into their companies. They are aligned with those of their shareholders and as such we saw a tilt towards higher dividends than other short term capital management incentives during the period.

ARB Corporation lifted their dividend 34%, Lindsay Australia lifted their dividend 17%, Reece Group grew dividends by 25%, TPG Telecom by 13% and Nine Entertainment lifted their dividend payout and indicated further capital management was under consideration. Smartgroup Corporation was able to pay a substantial $0.30 per share fully franked special dividend, on top of the $0.19 per share ordinary dividend declared by Directors.

At the larger end of town and led by the resource majors, Rio Tinto announced an enormous ordinary dividend of $5.7704 per share and an $0.858 per share special dividend both fully franked. BHP Group paid a record interim dividend of US$1.50 per share ($2.08 AUD) and has now paid shareholders over $22 billion in capital returns in only 18 months, with over $65 billion being paid in BHP dividends to shareholders over the last 4 years. Woodside Petroleum paid out US$1.05 per share ($1.46 AUD) with their full year results, a dividend that was up over 8 times on the previous corresponding period.

On buy backs JBHiFi Limited announced a $200m off-market buyback which includes franking credits, and Sonic Healthcare announced they will commence a $500m on-market share buyback.

Overall, Contact viewed the most recent reporting season as supporting undervalued and sustainable stock specific theses that dominate our portfolios. This includes businesses with the management and pricing power to handle inflationary impacts, and models to maintain resilient supply chain strategies. Contact believes companies largely in control of their own destinies, driven by a founder led individual, family or cornerstone investor, are even more attractive given the geopolitical risks added to an already unusual investment environment.

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