BKI INVESTMENT COMPANY LIMITED

BKI INVESTMENT COMPANY

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BKI is managed by Contact Asset Management
AFSL 494045

QUARTERLY REPORT

An Exposure to Energy and Resources Was Worth the Wait

Welcome to the 33rd edition of the BKI Quarterly Report, prepared by Contact Asset Management ("Contact"). There has been an unusually high level of attention on macroeconomic news in recent months. This has been dominated by uncertainty in bond markets and the ongoing geopolitical tension in the Ukraine. The impact of inflation on the direction of interest rates is a hot topic. For Australia, the strength of commodity prices has had an outsized impact on our equities market, given the proportionately high exposure to Resource and Energy companies in our indices. Having an exposure to energy and materials companies has been well worth the wait.

Long-Term Focus and Being Patient

As managers of long-term portfolios, we have been patiently waiting for the tide to change. The domination in recent times of exponential growth assumptions has been substantial. Many investors have been caught focusing on companies selling hope and have bought into large revenue multiples and unbelievable and unreliable investment returns. The first quarter of 2022 has witnessed many high growth companies with no earnings or dividend prospects come back down to earth. The value versus growth debate is always an interesting one. We look for quality first.

For equity managers who have been in the game long enough, we know that these markets and these high growth expectations don't constantly deliver over the long term. We're happy to be told we're "Old fashioned", or that "value is dead" or "dividends don't matter, it's all about growth". But, at the end of the day, stocks that benefit from momentum shifts and trends come and go. It's the high quality, profitable, well-run companies that will always stand the test of time, and most of the time you just need to be patient and let the market work it out.

This has been the case with one sector in particular, Energy. Many individuals and investors have been unable to understand the energy mix situation clearly and many have lost the scope of the big picture of energy itself. As the world scrambles to gain access to energy, mainly through, oil, gas and coal, or through the growth of electrification through copper, steel, nickel, aluminium, uranium, zinc, silicon and lithium, it is the companies that directly produce these resources that are being recognised once again for what they are actually offering.

Falling Energy Demand and Carbon Emissions

According to BP's "Statistical Review of World Energy 2021" in 2020 *"carbon emissions from energy use fell by 6.3%, to their lowest level since 2011"*. Chart 1. The report states that "*Primary energy consumption fell by 4.5%, the largest decline since 1945. The drop in energy consumption was driven mainly by oil, which contributed almost three-quarters of the net decline, although natural gas and coal also saw significant declines. Wind, solar and hydroelectricity all grew despite the fall in overall energy demand.*"

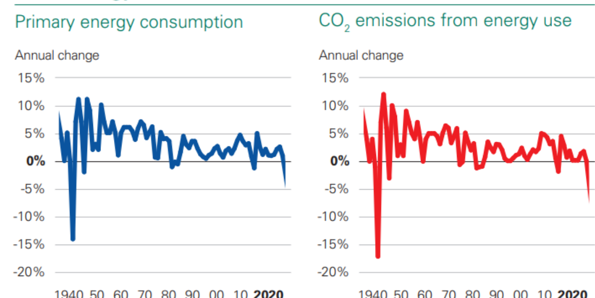


Chart 1; Global Energy Demand and Carbon Emissions

The report showed that coal consumption fell by "*6.2 exajoules (EJ), or 4.2%, with OECD coal consumption falling to its lowest level in our data series back to 1965*" and that natural gas consumption "*fell by 2.3%*" and oil consumption *"fell by a record 9.3%, to its lowest level since 2011."*

While BP's Statistical Review of World Energy, 2021, stated that coal, oil and gas consumption fell in 2020, the world continues to require these commodities to produce the energy demand needed in today's economy, Chart 2. Pleasingly, the share of renewables in total global power generation continues to increase, with wind and solar power more than doubling over the last 5 years, Chart 3. Germany's coal generation has now been equalled by wind. In the UK, coal is now only used as a backup baseload power source. Even traditional users of coal, Japan and South Korea, are significantly growing gas fired plants, investing further into nuclear and renewables all in an effort to reduce the carbon impact of electricity generation.

However, from a global point of view, removing coal in totality from the energy mix is currently impossible. The developed world has pushed heavy manufacturing to China. China has responded by building out an enormous energy base using coal-fired power plants. These are long-term investments with up to a 50-year lifecycle, with many only 40% of the way through operation.

We all want to strive towards reducing global warming, however, the path of how we get there isn't as simple as switching off all oil, gas and coal generated power. The total percentage of coal used in this energy mix has reduced over the last 6 years, however it still accounts for approximately 35% of world energy consumption, Chart 4, and that total consumption requirement is growing significantly.

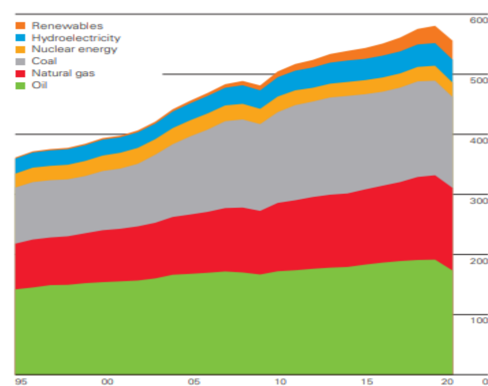


Chart 2: World Energy Consumption*

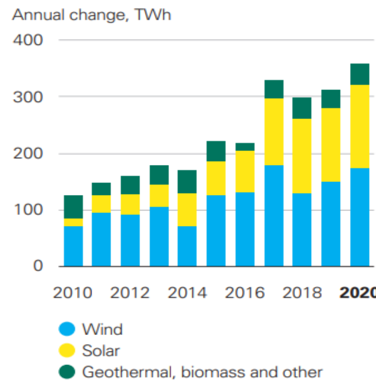


Chart 3: Renewable Power Generation*

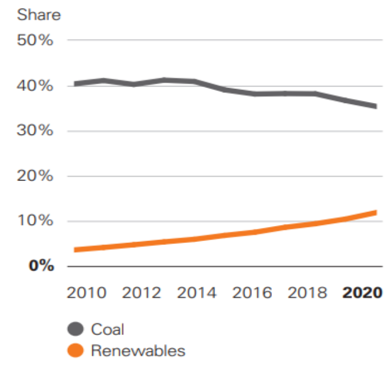


Chart 4: Share of renewables and coal in global power generation*

It is also important to point out that the outcome of falling carbon emissions in 2020 was assisted in a pullback in total energy consumption brought about by a slowdown of economic activity across the world during COVID-19. BP's Statistical Review of World Energy, 2021, states *"The two elements combining to produce the near-record decline in carbon emissions – the falls in energy demand and in the carbon intensity of the energy mix – can be largely traced back to the unprecedented decline in oil demand triggered by the lockdowns. This suggests that as lockdowns around the world are eased and economic activity begins to recover, there is a significant risk that last year's fall in carbon emissions will be reversed. Indeed, the IEA recently estimated that the level of carbon emissions last December was already back above pre-crisis levels."*

Oil, gas and coal markets were challenged in 2020 by an immediate global lockdown. This caused many in the market to believe it was caused by the energy transition gathering pace. However, as we've seen the world reopen and demand return, prices have exploded as power generators globally needed to react to the significant lift once again in world energy consumption.

A Commodity Supply/Demand Imbalance

We are seeing a commodity supply/demand imbalance like never before. On the supply side, in addition to global lockdowns and reduced energy and manufacturing requirements, there were other short-term issues at play such as China being unable to acquire coal from Australia due to an import ban. Other disruptions included the reduced export quantities of major coal producers in Indonesia, South Africa and Russia, all impacted pricing.

However, as the world economy was recovering from COVID-19, the supply/demand imbalance in commodities flipped and flipped quickly. In the last quarter of 2020 and into 2021, many parts of the world began to figure out that energy and metals demand was far outstripping that of supply and prices began to move. As can be seen in Table 1 from 1st September 2020 to

* Source: BP Statistical Review of World Energy, 2021

31st December 2021, Crude Oil (Brent) increased 67%, Thermal Coal (Newcastle) increased 236% and LNG (Japan/Korea Marker) increased 374%.

Commodity	1 September 2020	31 December 2021
Crude Oil (Brent)	$46/bbl	$77/bbl
Thermal Coal (Newcastle)	$50.6/t	$170/t
LNG (Japan/Korea Marker)	$4.30/mmbtu	$20.40/mmbtu

Table 1; Source: Factset

Since the Russian invasion of Ukraine, this imbalance has escalated rapidly. Russian commodities that would have typically been exported across the world are now being put on hold with some product being diverted to India and China, but most being unsold on the global market without an end user in sight.

This event has forced developed nations to scramble to access traditional energy inputs, oil, gas and coal. From the period 1st January 2022 to 31st March 2022, as seen in Table 2, we have seen a further jump in prices with Crude Oil (Brent) increasing a further 40%, Thermal Coal (Newcastle) increasing a further 52% and LNG (Japan/Korea Marker) increasing a further 67%.

Commodity	1 September 2020	31 December 2021	31 March 2022
Crude Oil (Brent)	$46/bbl	$77/bbl	$108/bbl
Thermal Coal (Newcastle)	$50.6/t	$170/t	$259/t
LNG (Japan/Korea Marker)	$4.30/mmbtu	$20.40/mmbtu	$34.10/mmbtu

Table 2; Source: Factset

In soft commodities, the war has created the same scenario. Russia and Ukraine are net exporters of agricultural products. They rank amongst the top global exporters of wheat, maize, canola and sunflower seeds & oil. In 2021 Russia also ranked as the world's number one exporter of nitrogen fertilizers and the second in supply of potassic and phosphorous fertilizers.

This places both countries among the most important producers of agricultural commodities in the world. The war has disrupted Russia's and Ukraine's planting and harvest seasons, destroyed fields, infrastructure and has seen significant shipping disruptions from the Black Sea. This has resulted in the wheat price over the last 3 months jump 29%, Chart 5, and the Canola price jump 18%, Chart 6.

Chart 5: Wheat Market Delivered Price (3 months)*

Chart 6: Canola Market Delivered Price (3 months)#

*Delivered Wheat bid prices, all grades, Adelaide; Cargill Australia. # Delivered Canola bid prices, all grades, Geelong; Cargill Australia.

Energy Mix – Balancing Energy Transition and Global Consumption

The increased demand of energy across the globe at the end of 2021 and now into 2022 has been a great sign that the world economy is recovering from COVID-19. However, the surge in coal, oil and gas prices to ensure this energy demand was physically delivered is a reminder of how the energy mix continues to rely heavily on fossil fuels. Global energy consumption totalled 556 exajoules in 2020, and oil, coal and natural gas accounted for 31%, 27% and 25% of the total respectively, adding up to more than 80% of the total energy used.

Most of this energy produced is required for China and India. The significant economic growth in China over the last 20 years, and the continual expansion of electrification in India have been based on energy produced from coal fired power plants. Due to this significant demand in China, Chart 7, and India, Chart 8, the globe has more than doubled its coal-fired capacity since the year 2000. In 2020 alone, coal generated over 60% of electricity in China and over 70% in India.

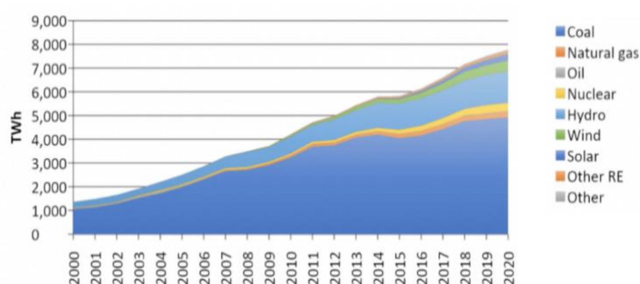


Chart 7: Electricity Generation in China**

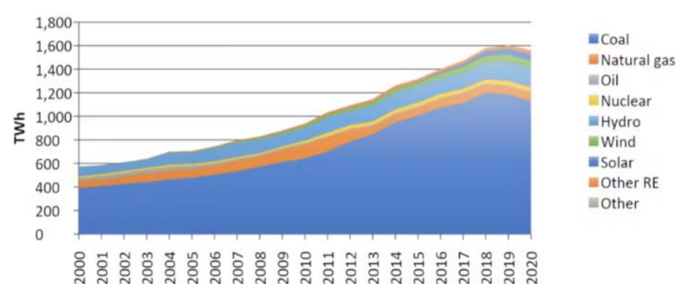


Chart 8: Electricity Generation in India**

In addition to the high demands of oil, gas and coal to continue its delivery of affordable baseload power used in a world where we now require more electrification than ever before, we must also accept that there are many metals and minerals that are also essential inputs for the hardware being used in the process of energy transition and decarbonisation. As BHP's Dr Huw McKay, Vice President, Market Analysis & Economics wrote about in the recent publication Pathways to decarbonisation: episode 5: the energy transition dilemma. *"Rising standards of living and population growth point to increasing resource consumption based on traditional drivers. Modern life is fundamentally dependent on the metals, energy and chemicals that the natural resources sector provides, which need to be supplied sustainably, affordably and at scale."*

Dr Huw McKay went on to say, *"There will be no energy transition without a very large increase in the production of critical minerals". "The resources industry must not only continue to service demand based on traditional drivers in order to support sustainable development goals: it must also provide the material building blocks of the hardware required to radically reconstitute how we produce energy and use land. Whether the nickel used in electric batteries; the uranium needed to power zero operational carbon emissions nuclear reactors; the steel used in wind turbines; the potash required to boost agricultural yield for biofuels and conserve land for afforestation; the silver and silicon used in solar panels; or the copper that will enable the electrification megatrend at large, the products produced by this industry will only grow in importance to the world."*

With this background, over the last 6 months we've seen significant growth in global energy consumption and electrification, coupled with limited supply of oil, gas, coal, copper, steel, nickel, aluminium, uranium, zinc, silicon and lithium we have a situation where many investment opportunities have presented themselves. These opportunities have created and will continue to create long-term wealth for the patient investor.

Taking a Closer Look - Exposure to Energy and Resources

BKI has been a beneficiary of the recent strength in commodity prices, and we are in the "stronger for longer" camp regarding the outlook. Collectively BKI has a 25.9% weighting towards the energy and materials sectors, including:

Portfolio Weighting	Company	Commodity Exposure
10.2%	BHP Group	Oil, Gas, Coal, Copper, Iron Ore, Nickel
7.0%	APA Group	Gas, Solar, Wind
3.3%	New Hope Corporation	Coal, Oil, Gas
2.8%	Woodside Petroleum	Oil, Gas
2.6%	Rio Tinto	Iron Ore, Aluminium, Copper, Borates, Lithium

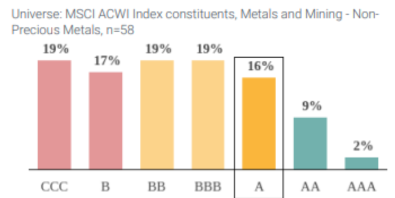
BHP Group (BHP)

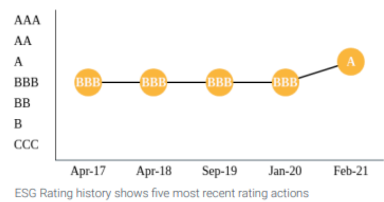
Company Statement - *"Our products help build a better, clearer future. What we produce is essential for the world to continue to grow and many of our products will help make the transition to cleaner energy possible."*

Business Description - BHP Group was founded in 1851 and operates as a resources company in Australia and across the globe. It operates through Petroleum, Copper, Iron Ore, and Coal segments. The company engages in the exploration, development, and production of oil and gas properties, and mining of copper, silver, zinc, molybdenum, uranium, gold, iron

** Source: BP Statistical Review of World Energy

ore, and metallurgical and energy coal. It is also involved in mining, smelting, and refining of nickel; and potash development activities.





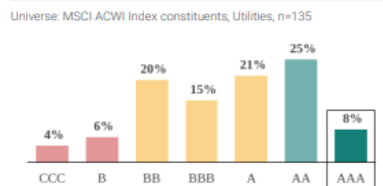
MSCI ESG Ratings - BHP has been recently upgraded to 'A' from 'BBB'. The latest MSCI ESG Ratings report states that BHP has strong governance, labour management and business ethics practices. BHP also continues to lead peers in its safety management programs and performance.

Contact View - Contact continues to rate BHP highly as a world class, diversified resource company. We have continued to add to the position over the last year as operating cost forecasts have stabilised and BHP continues to benefit from scale and diversification into Potash and Nickel. Asset sales are being completed with the Petroleum demerger and Thermal Coal divestment. With BHP increasing guidance on their debt target range to between US$5b and US$15b at their half year result in February, they will continue to have a very strong balance sheet with average gearing over the next 3 years of 16%. Contact forecasts a grossed-up yield of between 8% and 12% p.a. over the next 3 years for BHP.

APA Group (APA)

Company Statement - *"We are a leading energy infrastructure business. Our purpose is to strengthen communities through responsible energy. We are listed on the Australian Securities Exchange (ASX) and own and/or operate a $21 billion portfolio of gas, electricity, solar and wind assets around Australia. With a vision to be world class in energy solutions, at APA we are Always Powering Ahead."*

Business Description - APA develops, owns, and operates natural gas transportation and energy infrastructure in Australia through three segments: Energy Infrastructure, Asset Management, and Energy Investments. It operates natural gas pipelines, gas storage, gas processing, gas compression, electricity transmission, electricity interconnectors, and renewable and gas fired power generation assets; and operates solar farms and wind farms. APA has interests in 15,000km's of gas transmission pipelines; 25,700km's of gas mains and pipelines; and 1.4m gas consumer connections.



MSCI ESG Ratings - APA has had an unchanged 'AAA' rating for the past 5 years. The highest possible rating. The latest MSCI ESG Ratings Report states that APA continues to display strong ethics, governance and health and safety. APA also scores very well in biodiversity and land use.

Contact View - Contact considers APA to be a high-quality business with an excellent market share position in Australia with scope to grow domestically and abroad. The business is well managed. Contact expects APA to offer a growing distribution stream and offers an attractive total return profile with valuation upside. APA is expected to continue to deliver between 3% and 5% Revenue growth in future years maintaining a 78% EBITDA margin. Distributions are paid out of Free Cash Flow with forecasts linked to the long run growth trend.

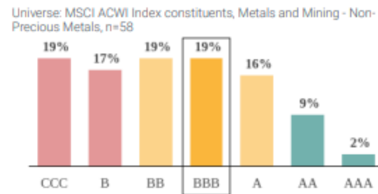
New Hope Corporation (NHC)

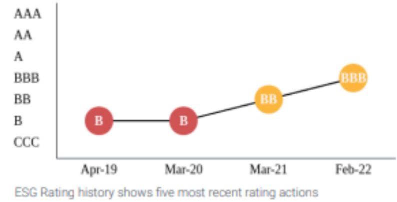
Company Statement - *"An Australian owned and operated company, supporting local communities for almost 60 years. Our continued growth is founded on a long-term commitment to our employees and disciplined management, alongside a proactive approach to the environment, community and social responsibility."*

Business Description - Founded in the 1960's, NHC explores, develops, produces, and processes coal, and oil and gas properties. The company holds interests in two open-cut coal mines that produce thermal coal, which include the New Acland project located in Queensland; and the Bengalla mine situated in the Hunter Valley region of New South Wales. It also holds

oil-producing acreage in the Cooper-Eromanga Basin. In addition, the company engages in farming, grazing, and land management activities; port operations; and logistics and marketing.

MSCI ESG Ratings - NHC has been recently upgraded to 'BBB' from 'BB'. The latest MSCI ESG Ratings report states that NHC has displayed strong governance and labour management. MSCI's updated assessment indicates improvements in NHC's community engagement programs and policies.





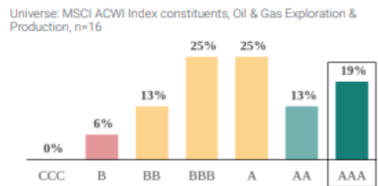
Contact View – The market has recently upgraded valuations to NHC based on thermal coal price assumptions both on a short-term and longer-term basis. These upgrades have seen a significant lift to EPS and dividend assumptions. NHC is in a strong financial position with the market expecting net cash to be approximately $700m by FY23. Consensus forecasts are now showing a grossed-up dividend yield, including special dividends, of between 9% and 20% through to FY24.

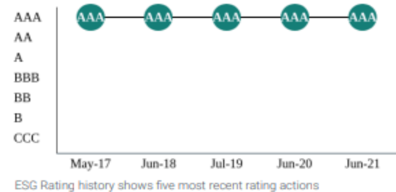
Woodside Petroleum (WPL)

Company Statement - *"A better tomorrow needs action today so we're delivering energy that's cleaner, cheaper and reliable. Woodside led the development of the LNG industry in Australia and is applying this same pioneering spirit to solving future energy challenges. Our operations are focused on safety, reliability, efficiency and environmental performance."*

Business Description - Founded in 1954 and headquartered in Perth, Australia, WPL engages in exploration evaluation development, production, marketing, and the sale of hydrocarbons into the international market. The company produces liquefied natural gas, pipeline natural gas, condensate, liquefied petroleum gas, and crude oil. It holds interests in the Greater Browse, Greater Sunrise, Greater Pluto, Greater Exmouth, North-West Shelf, Wheatstone, Julimar-Brunello, Canada, Senegal, Greater Scarborough, and Myanmar projects.

MSCI ESG Ratings - WPL has maintained a 'AAA' rating. MSCI states that WPL's policies and practices for managing ESG risks appear to be stronger than those of peers, as evidenced by strong performance on all ESG parameters assessed for the oil and gas exploration and production industry.





Contact View – Contact has recently upgraded WPL's share price valuations and earnings forecasts, reflecting the current project profile and steadier commodity prices. Contact is also positive on the upcoming merger between WPL and BHP Petroleum, expected to deliver an estimated $400m in annual synergies, and strengthen WPL's balance sheet, enabling them to progress future growth options. WPL's dividend yield trajectory and large franking balance are also very attractive.

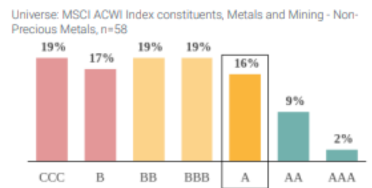
With the all-stock merger of WPL and BHP Petroleum, WPL will seek shareholder approval for the transaction on 19 May 2022. The target implementation date is now set for 1 June 2022 for the distribution of new WPL shares to BHP shareholders.

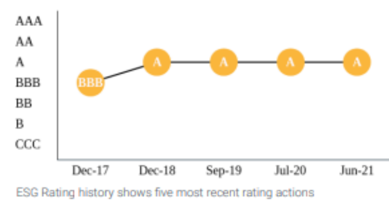
Rio Tinto (RIO)

Company Statement - *"We produce materials essential to human progress. Our materials are essential for the low-carbon transition. We are putting the low carbon transition at the heart of our business strategy."*

Business Description - RIO was founded in 1873 and engages in exploring and processing mineral resources worldwide. The company offers aluminium, copper, diamonds, gold, borates, titanium dioxide, salt, iron ore, and lithium. It also owns and operates open pit and underground mines, mills, refineries, smelters, power stations, and research and service facilities.

MSCI ESG Ratings - RIO has maintained its 'A' rating. The latest MSCI ESG Ratings report shows positive scores in governance, health and safety, carbon emissions, and waste. However, RIO's alleged involvement in the destruction of the rock shelters at Juukan Gorge in 2020 led to several leadership changes and at the 2021 AGM, shareholders indicated their dissent through 60% negative votes on the remuneration report.





Contact View – RIO has benefited recently by the strong lift in spot Iron Ore Pricing. RIO is a highly cash generative business with a progressive dividend policy targeting between 40% and 60% through the cycle. RIO is providing shareholders a very attractive dividend yield and is experiencing solid capital growth in the current strong spot environment. RIO is a direct beneficiary of strong iron ore prices as they supply 28% of iron ore into the total global supply system.

Conclusion

As managers of long-term portfolios, we always have capital preservation in mind. We will always focus on the high quality, profitable, well-run companies that will stand the test of time. In this current market, the companies focused on energy will do well. As the energy mix situation continues to take time to develop and transition, the BKI portfolio will continue to benefit from those companies who produce oil, gas and coal, as well as those who will benefit through the growth of electrification by producing copper, steel, nickel, aluminium, uranium, zinc, silicon and lithium.

With an exposure to energy and metals, BKI's short-term performance has been solid, especially through these recent periods of volatility and drawdown. BKI is into its 19th year of operation and has been tracking well, with the most recent half yearly result in January being a record for the company. Annual total shareholder returns for BKI including franking credits was 23.5% as at 31 March 2022. We have achieved this through a consistent and disciplined approach to buying quality stocks with above average rates of return, strong financials and who are managed by outstanding teams.

As at 31 March 2022, BKI was holding 5.2% of the portfolio in cash, so we are well positioned to act if the current volatility continues and produces some additional buying opportunities.

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