Contact Asset Management

INSIGHTS

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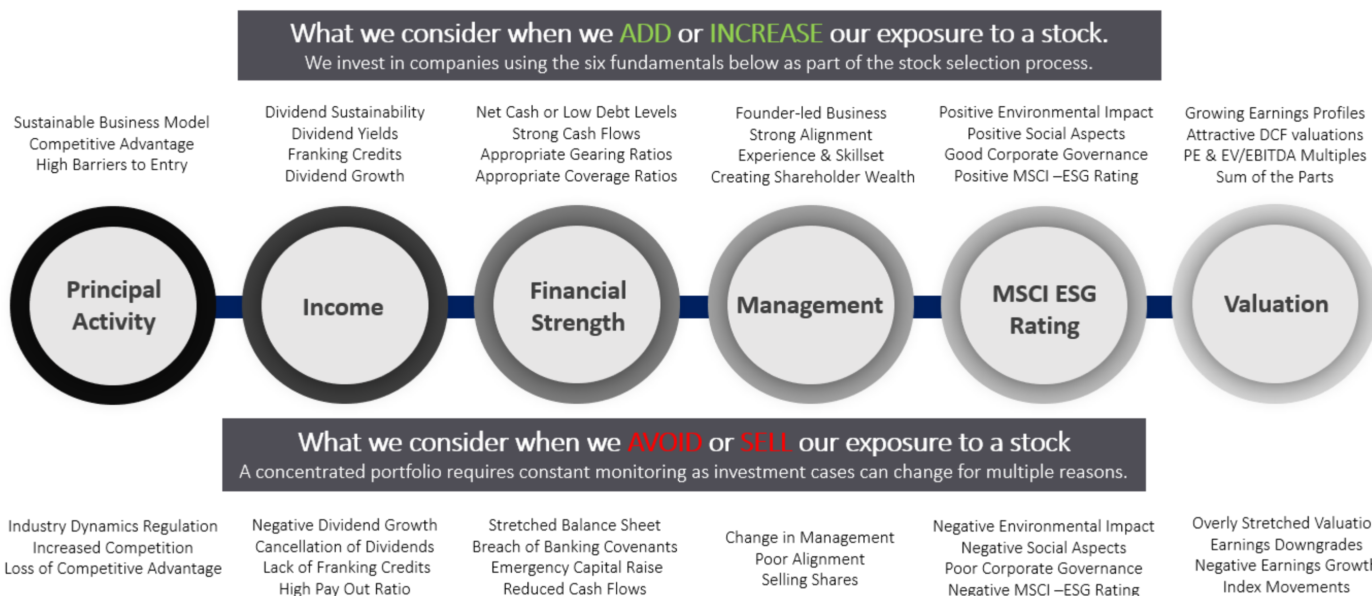
CONTACT
ASSET MANAGEMENT

Bang for your buck!

The quality of a business is often a reflection of the quality of its earnings profile. There are three metrics we consider useful in assessing quality of earnings; ROE (Return on Equity i.e., profit as a percentage of total ownership), ROIC (Return on Invested Capital i.e., operating profit after tax as a percentage of debt & equity less cash) and ROCE (Return on Capital Employed i.e., Earnings before interest & tax as a percentage of total assets less liabilities). When a business generates returns well above its cost of capital, this illustrates to Contact Asset Management that the operating model has favourable and efficient characteristics. Sustainably high returns often demonstrates that management is deploying the resultant cashflows effectively to grow shareholder value through the cycle.

Capital light business models that do not require additional capital to fund continued growth are incredibly attractive investments, but this alone is not enough. It is the efficiency of capital deployment within the business that is important. The following graphic provides an overview of Contact's Investment Process. The Quantitative and Qualitative metrics we value are a favourable Principal Activity relating to how the business makes money and the variable mechanics of these core business drivers; a reliable and growing dividend stream, Financial Strength underpinned by robust Balance Sheet, a Management team with demonstrated track record of performance that is financially aligned with shareholders, appropriate ESG metrics and Valuation support that provides opportunity for outsized returns. As we work through our bottom-up analysis, we find that the analysis of the returns being generated manifests through so many other investment characteristics. Businesses that generate attractive returns often have a competitive advantage, a sustainable dividend profile, strong financials, and capable management teams.



A rising interest rate environment leads to a rising Cost of Capital for businesses to fund their operations. As a result, the hurdle for an adequate return also increases, as it is a requirement that returns be above funding costs otherwise the business is effectively destroying shareholder value. Further, from a valuation perspective, an increase in the Cost of Capital reduces the present value of future cash flows which reduces the value per share that the business is fundamentally worth. The last fifteen years has seen enormous tailwinds for valuations in a falling interest rate environment. As depicted on the following page, the RBA's target overnight cash rate was 7.25% in March 2008, and reduced significantly in the disinflationary period to February 2020, when rates stood at 0.75%. The COVID-19 pandemic witnessed further emergency interest rate cuts. By November 2020 Australia's official overnight cash rate stood at 0.10%.

Source: RBA

Equity markets were subsequently engulfed by the "TINA" trade (There is No Alternative) in an environment of unprecedented liquidity. As Central Banks cut interest rates to near zero, there was little to no return for cash in bank deposits, which fuelled capital flows into risk assets. When cash is cheap, funding costs are cheap, as is the ability to boost valuations. Investors need a hurdle rate to value investments otherwise speculative behaviours that stem from a zero cost of capital take charge. This dynamic supported the hyper-growth segment of the market and re-rated even the loss-making businesses that had no cashflows to value. Much of 2020 and 2021 was dominated by a "Greater Fool Theory", which refers to a belief that 'someone else will pay me more for the stock than I paid for it'. This works when a rising tide (of dovish monetary policy and unprecedented fiscal support) is floating all boats. However, when the tide starts to go out, as we are now witnessing with policymakers dialling up the cost of cash to cool inflation pressures, then quality of earnings becomes a focus again. With a period of Quantitative Tightening (QT) looming ahead it is the Quality businesses that will deliver.

Quality Investing

Quality investing looks beyond the bottom line and compares a company's earnings to its invested capital and revenue. The following example from Long Equity Fund (USA) provides an interesting comparison between two businesses, both of which make $1 billion in earnings. The comparison notes that comparing a company's earnings to its invested capital, revenue, historic earnings, and market capitalisation reveals four important investing ratios.

	Company A	**Company B**
Return on capital (Quality) *How efficient is the company at investing its capital at high returns*	Earnings = $1bn Invested capital = $4bn ROC = $1bn / $4bn = **25%**	Earnings = $1bn Invested capital = $20bn ROC = $1bn / $20bn = **5%**
Profit Margin (Quality) *How efficient is the company at adding value to the supply chain*	Earnings = $1bn Revenue = $2bn Margin = $1bn / $2bn = **50%**	Earnings = $1bn Revenue = $10bn Margin = $1bn / $10bn = **10%**
Earnings Growth Rate (Growth) *How efficient is the company at growing its earnings over time*	Earnings = $1bn Earnings 5 years ago = $0.25bn Growth rate = $1bn / $0.25bn = **4x**	Earnings = $1bn Earnings 5 years ago = $0.5bn Growth rate = $1bn / $0.5bn = **2x**
Earnings Yield (Valuation) *How attractively does the market value the company's earnings*	Earnings = $1bn Market capitalisation = $20bn Earnings Yield = $1bn / $20bn = **5%**	Earnings = $1bn Market capitalisation = $50bn Earnings Yield = $1bn / $50bn = **2%**

Source: Long Equity Fund (June 2022)

The ratios highlight that, despite earning the same, Company A is a more efficient capital allocator (ROC), has more negotiating and pricing power (margins), has faster growth (growth rate) and is more attractively valued (earnings yield) than Company B. It is precisely this favourable business model that has a high return on capital that can thrive in most market conditions over the long-term.

Sector and stock examples

Taking a Sector view, those that need substantial capital invested like resources, energy and utilities require high profit margins to make acceptable levels of Return on Capital Employed (ROCE). For the cyclical names, margins are the interplay between pricing dynamics and the controllable operational efficiencies. It is the latter that should be of greatest concern in that space, operating in the lowest cost quartile solves for through-the-cycle earnings without the need for dilutive capital raisings. The charts below demonstrate that even sectors that typically exude capital light characteristics like technology does not equate to arbitrary high returns on equity or invested capital, largely due to lack of profits. This demonstrates the requirement for deep dive analysis in the fundamentals of the business to determine whether true quality characteristics are present. Jeff Mueller from Polen Capital stresses "All compounders tend to have high returns on capital but not all companies with high returns on capital are compounders. That's important because it means you can't just run a screen and buy. There is real critical thought and judgement required."

ROE		FY7	FY8	FY9	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21
XAO-ASX	ASX All Ordinaries	21.75	18.04	12.50	13.23	15.80	13.66	11.86	12.64	10.80	9.10	11.76	11.14	11.87	8.70	11.98
XDJ-ASX	S&P ASX 200 / Consumer Discretionary -SEC	28.22	7.94	7.83	9.75	10.81	10.65	9.79	10.23	11.13	12.15	16.40	9.66	14.88	11.68	11.82
XEJ-ASX	S&P ASX 200 / Energy -SEC	20.20	19.02	22.11	11.83	11.80	9.69	10.31	9.65	8.73	2.81	7.31	9.02	9.81	5.50	4.68
XFJ-ASX	S&P ASX 200 / Financials -SEC	18.12	15.97	10.17	13.48	13.95	12.30	13.20	13.81	13.80	12.41	12.35	12.17	10.90	7.16	10.43
XHJ-ASX	S&P ASX 200 / Health Care -SEC	17.06	14.63	15.89	16.17	15.92	16.41	18.83	20.31	23.41	22.51	20.97	21.39	21.49	18.72	19.34
XIJ-ASX	S&P ASX 200 / Information Technology -SEC	-	-	-	-	-	15.33	15.96	14.44	15.16	9.23	15.17	12.42	13.39	6.20	5.15
XJO-ASX	S&P ASX 200	22.26	18.45	12.27	13.58	16.20	13.90	12.46	13.53	11.39	9.39	12.09	11.63	12.30	9.10	13.14
XKO-ASX	S&P ASX 300	22.18	18.33	12.56	13.37	16.09	13.93	12.39	13.03	11.26	9.36	11.97	11.26	11.98	8.84	12.30
XMJ-ASX	S&P ASX 200 / Materials -SEC	37.28	32.49	15.58	17.55	27.87	21.28	13.36	15.93	7.64	2.42	12.47	10.92	17.21	16.42	26.88
XNJ-ASX	S&P ASX 200 / Industrials -SEC	19.28	14.84	3.02	6.13	7.23	7.31	7.16	8.53	9.13	10.37	9.22	10.54	8.64	3.32	3.04
XPJ-ASX	S&P ASX 200 / A-REIT -SEC	14.16	2.77	- 16.65	2.16	6.56	5.65	5.18	7.62	8.48	9.75	9.61	9.56	7.31	4.05	8.01
XSJ-ASX	S&P ASX 200 / Consumer Staples -SEC	-	-	-	-	16.55	15.59	15.54	18.02	15.48	1.33	14.80	19.23	19.18	14.88	25.64
XSO-ASX	S&P ASX Small Ordinaries	18.83	10.41	7.23	6.16	8.48	9.84	7.51	4.66	8.10	8.70	9.00	8.76	8.68	4.12	5.20
XTJ-ASX	S&P ASX 200 / Communication Services -SEC	-	-	30.83	30.75	27.77	28.80	27.27	23.88	21.01	20.09	19.09	16.10	14.70	7.61	10.27
XUJ-ASX	S&P ASX 200 / Utilities -SEC	5.59	12.61	49.83	7.04	5.94	7.36	6.71	7.72	4.31	3.13	2.23	9.78	9.63	7.76	- 8.02
XXJ-ASX	S&P ASX 200 / Financial Ex A-REIT	18.12	15.97	10.17	13.48	13.95	12.30	13.20	13.81	13.80	12.41	12.35	12.17	10.90	7.16	10.43

Source: Factset

ROIC		FY7	FY8	FY9	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21
XAO-ASX	ASX All Ordinaries	7.59	6.44	5.07	5.69	6.95	6.10	5.47	5.85	4.95	4.12	5.31	5.20	5.40	3.94	5.72
XDJ-ASX	S&P ASX 200 / Consumer Discretionary -SEC	22.58	5.47	6.18	7.89	8.69	8.53	7.73	8.36	8.66	9.34	13.06	7.50	10.83	7.07	7.60
XEJ-ASX	S&P ASX 200 / Energy -SEC	16.02	14.96	16.26	10.02	9.03	7.56	7.96	7.37	6.28	2.00	5.37	7.10	7.00	3.70	3.12
XFJ-ASX	S&P ASX 200 / Financials -SEC	3.54	3.26	2.55	3.48	3.73	3.46	3.98	4.12	4.15	3.77	3.64	3.60	3.12	2.21	3.50
XHJ-ASX	S&P ASX 200 / Health Care -SEC	12.12	10.67	12.46	12.12	11.84	11.83	12.89	13.48	13.88	12.70	11.82	12.33	12.58	10.01	11.40
XIJ-ASX	S&P ASX 200 / Information Technology -SEC	-	-	-	-	-	7.60	7.86	8.10	8.41	5.26	9.24	8.33	8.01	4.03	3.49
XJO-ASX	S&P ASX 200	7.57	6.41	4.86	5.70	6.94	6.06	5.66	6.13	5.14	4.20	5.38	5.31	5.46	4.09	6.29
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XMJ-ASX	S&P ASX 200 / Materials -SEC	27.26	21.92	10.89	13.75	22.23	15.52	9.04	11.18	5.34	1.63	8.85	8.07	12.49	11.76	20.64
XNJ-ASX	S&P ASX 200 / Industrials -SEC	11.48	8.78	1.82	3.65	4.43	4.36	4.44	5.27	4.95	5.69	5.01	5.79	4.73	1.60	1.62
XPJ-ASX	S&P ASX 200 / A-REIT -SEC	9.34	1.71	- 10.67	1.48	4.52	3.79	3.64	5.42	5.84	6.83	6.78	6.83	5.21	2.79	5.65
XSJ-ASX	S&P ASX 200 / Consumer Staples -SEC	-	-	-	-	12.09	11.13	11.17	13.26	12.02	0.97	11.60	15.74	13.99	6.24	9.49
XSO-ASX	S&P ASX Small Ordinaries	13.21	7.34	5.41	4.70	6.40	7.08	5.34	3.43	5.81	6.18	6.68	5.77	5.64	2.65	3.21
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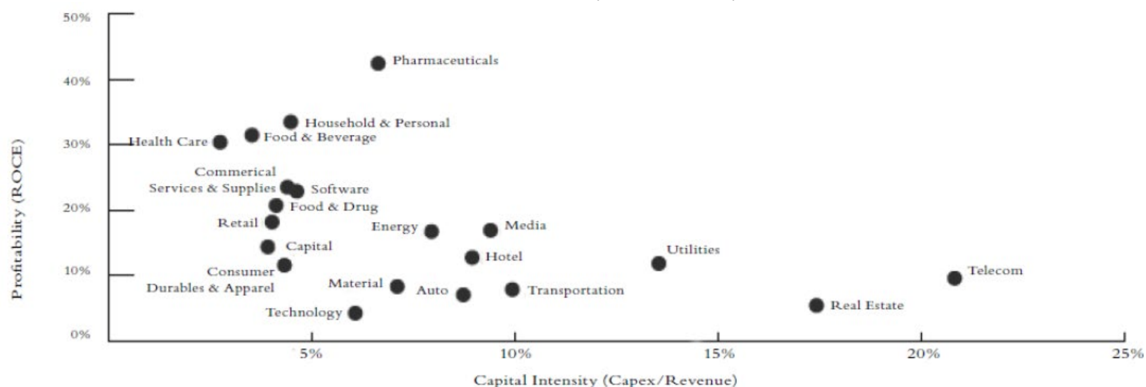
XXJ-ASX	S&P ASX 200 / Financial Ex A-REIT	3.54	3.26	2.55	3.48	3.73	3.46	3.98	4.12	4.15	3.77	3.64	3.60	3.12	2.21	3.50

Source: Factset

The following chart shows that as Capital Expenditure-to-Sales falls, the subsequent ROCE rises. Interestingly, low profit margins are also acceptable, provided they have high and increasing frequency of sales. An example of this is Wesfarmers Limited (WES-ASX), which has demonstrated disciplined allocation of capital to become one of the dominant oligopoly conglomerates in our market. Note that we have discussed the power of oligopolies in an earlier Contact Insights piece (Contact Insights – August 2021 – Three's a Crowd? (contactam.com.au). Companies that focus on returns thrive in most markets, but they especially outperform in down markets. During the GFC, which was a far more drawn-out bear market than the V-shape experienced during the COVID-19 selloff, S&P 500 companies that earned consistently high Return on Capital Employed were the only stocks to go up 10% or more in 2008.

Sector ROCE/Capital Intensity



Source: FactSet, MSCI, Worldscope, Morgan Stanley Investment Management. Past performance is no guarantee of future results

An incredibly profitable business model and outlier from ROE/ROIC/ROCE perspective is Deterra Royalties Limited (DRR-ASX). Deterra operates as a royalty company focused primarily on bulk commodities with its cornerstone asset being BHP's Mining Area C (MAC), located in the Pilbara. DRR receives 1.232% of the Free on Board (FOB) revenue that BHP collects from the MAC site. DRR also receive an additional capacity payment of $1m per 1mtpa of new capacity added year on year. The MAC Iron Ore Cash Costs Curve is 1st/2nd quartile. The business model is effectively a letterbox with no operating risk and that simply incurs corporate costs resulting in operating margins of 96% and net profit margins 67%. Our forecasts imply that the ROE/ROIC/ROCE increase to 258%, 259% & 369% respectively.

Metcash Limited (MTS-ASX) operates in Food wholesaling (40% contribution through IGA/Foodland), Hardware DIY & trade retailing (40% contribution through Mitre 10/Home Timber & Hardware/Total Tools) and Liquor retailing (20% contribution through Cellarbrations/Bottle-O/Duncans/Thirsty Camel/Porters). The business has successfully reinvested at high rates of return in store network creating more conducive shopping environments for customers aided by shop local behaviours driven by COVID-19. This along with astute corporate activity purchasing Total Tools has been transformative for Metcash. The historical ROE 6%, ROIC -1% & ROCE 24% will improve materially with Contact's forward estimates implying that the metrics increase to ROE 24%, ROIC 13% & ROCE 46%. We expect that a sustained improvement in the returns being generated will result in an upward re-rating of the stock.

When assessing management incentives, it's important that they align with shareholders. The percentage of companies that tied executive pay to capital allocation measures, according to a Harvard Law study (2017) pleasingly showed a rise from 21% in 2014 to 30% in 2016, with the bulk of over 50% tied to EPS. While in a survey conducted by Rivel Research Group (2016) of buy-side investors, 77% favour ROIC as a performance metric while only 30% approve of EPS. This disconnect between what investors value and how corporates link management incentives are trending in the right direction. It is appropriate to be thoughtful when assessing ROE/ROIC/ROCE. Yes, ROE can be distorted by debt, ROIC can be impacted by D&A, payout ratios and tax rates but when assessed not in isolation and looked at in conjunction with ROCE, the advantage is that it provides a consistent form of evaluation for a business to use when measuring performance. Warren Buffet concurs "the primary test of managerial economic performance is the achievement of a high earnings rate on equity capital employed (without undue leverage, accounting gimmickry, etc.) and not the achievement of consistent gains in earnings per share".

The challenge with high ROE/ROIC/ROCE is that it is hard to sustain over the long-term. High returns attract competition both from new entrants that come with new capital and existing competitors that try to compete away the advantage. The new capital and competitive tension often succeed in driving down the superior returns. The ability of the incumbent to maintain and extend the competitive moat is imperative to compounding shareholders capital.

At Contact, we continually strive to find the high-quality businesses. We consider that an understanding of the factors driving returns is important. We believe that if we can invest in businesses with attractive returns, earnings growth and a sustainable dividend that are managed by capable and aligned management teams, then our portfolios will perform well over the long term.

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