Contact Asset Management

INSIGHTS

SEPTEMBER 2022

Reflections on the August Reporting Season

We thought the August Reporting Season was robust in the main, particularly given several COVID-induced headwinds that plagued fiscal year 2022. The outlook for Earnings per Share and Dividends remains buoyant.

The team at Contact welcomes Reporting Season as it allows us to spend more time considering the fundamental qualitative and quantitative characteristics of our investments and hearing from management. We continue to be amazed by the intense focus on the macroeconomic factors by market commentators, particularly given the history of extreme forecasting error. We think that the best way to handle the macro is to handle the micro. That is, we focus on what we have control over: finding and holding high quality companies.

In this latest Contact Insights piece, we reflect on some of the major themes that appeared during reporting season.

Reporting season was generally robust

Despite an atmosphere of caution heading into August, company results were better than expected. According to Barrenjoey Equity Research, the ratio of upside surprises to downside surprises was roughly two-to-one. At a high-level assessment, we witnessed revenues holding up yet some margin pressure as costs increase. With Australia operating near full employment, tightness in labour markets and increasing wage inflation was a common theme. Kees Weel, CEO of PWR Holdings summed it up, when he said *"Staff retention is damn hard, everybody knows that"*.

The best performing sector in August was Resources, and specifically Energy. The Energy sector increased by almost 8%, which is an interesting performance given the decline in oil prices. However, this has been countered by remarkable strength in LNG. Forward LNG prices passed A$70/GJ in August, having traded at $14/GJ twelve months ago and $3/GJ in August 2020. Investors in Energy companies were rewarded with record dividend payments, which underscores the huge amount of cash being generated by major Resources companies currently. We discuss that in more detail later in this report.

Real Estate was the worst performing sector in August, declining 3.3%. Investors have become increasingly concerned about the rising cost of debt and many REITs issued 2023 guidance below expectations, often citing higher expected interest costs. The performance of Consumer stocks was mixed. Several Consumer Discretionary companies delivered resilient results and noted ongoing positive trading updates. Investors paid particularly close attention to inventory levels, as the consensus view is that we may see liquidation risk as demand slows. It appears that the consensus view is that consumer demand is going to fall off a cliff as higher interest rates start to bite. Thus, earnings expectations for most discretionary retailers are very low. We think expectations could be too pessimistic and we outline some reasons for that below.

We will also cover a few interesting themes to emerge from reporting season and discuss a few stock specific points in each. The themes we cover include:

- The enormous cash generation from Resources,
- The mixed signals on consumer behaviour,
- Increasing cost pressures to business, and
- Companies still coping with a COVID-19 hangover.

Finally, we look at the outlook for Earnings per Share growth in the coming years and our view on current valuation metrics in the market.

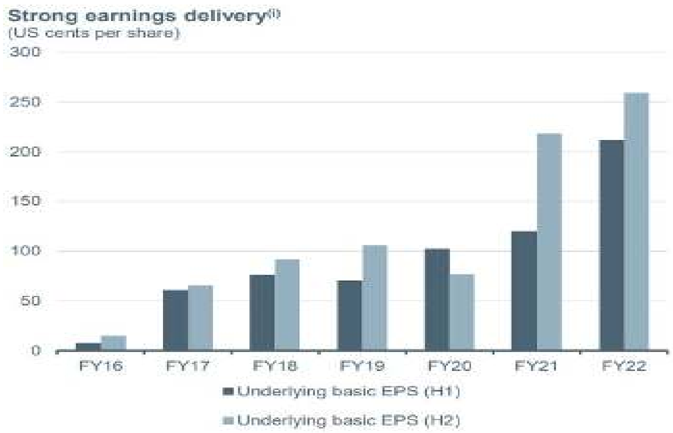
The Resources sector is printing cash

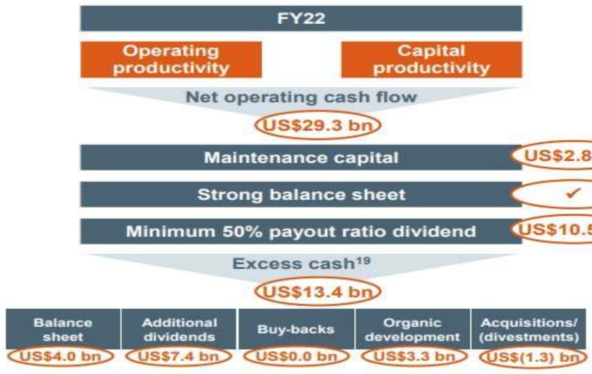
The increased demand for energy across the globe at the end of 2021 through 2022 has been a great sign that the world economy is recovering from COVID-19. However, the surge in coal, oil and gas prices to ensure this energy demand is physically delivered is a reminder of how the energy mix continues to rely heavily on fossil fuels. Since the Russian invasion of Ukraine, the supply shortage of energy has escalated rapidly, pushing the supply demand imbalance even further out of sync and forcing prices to extraordinary levels.

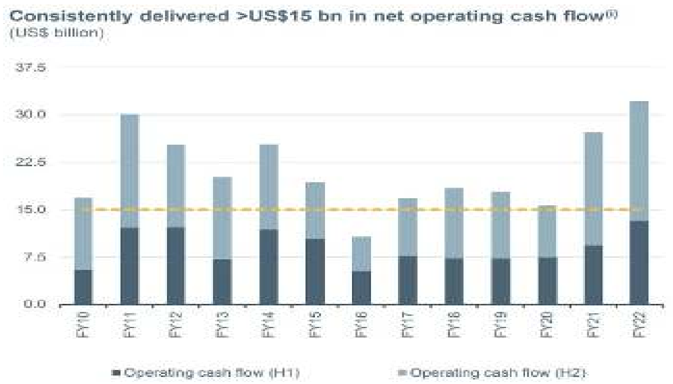
Strength in global energy prices was reflected in several record results for many Australian Resources companies. For example, Woodside Energy Group (WDS) produced an exceptional first half result, reflecting strong operational performance and realised benefits of the merger with BHP's petroleum business. Net profit after tax was US$1,640 million (+up 417%), Underlying net profit after tax was US$1,819 million (+414%) and WDS produced positive free cash flow of US$2,568 million (+89%).

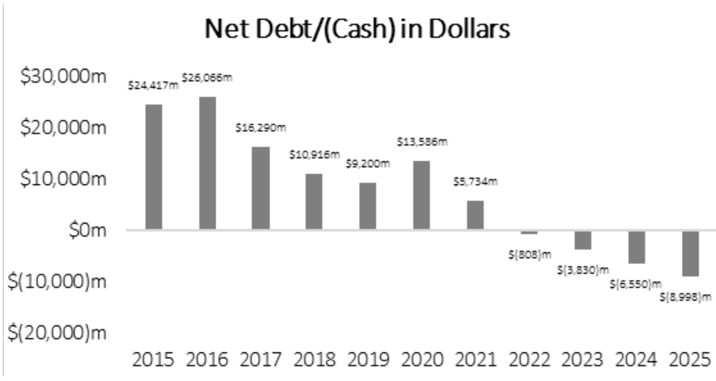
BHP delivered a very solid result for the year ended 30 June 2022 with a record EBITDA of US$34.1b, up 34%, at a record margin of 65%. Record free cash flow of US$24.3b reflects higher coal and copper prices and good cost control.

The BHP result provides a good proxy into the overall strength of the Australian Resources sector









Source: Company reports, Contact Asset Management

Global energy consumption continues to rely heavily on oil, coal and natural gas accounting for 31%, 27% and 25% respectively of the total, adding up to more than 80% of the total energy used. Over the last few years most of the global energy produced has been 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, and India 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. In the months and years ahead, the requirement for coal, oil and gas to generate power in Europe will also be significant.

Thermal coal prices have increased from US$50/t in September 2020 to over US$450/t in September 2022. The earnings and share price growth from the listed Australian coal companies in 2022 has been quite monumental. The following graphic from the Whitehaven Coal FY22 Result Presentation highlights the turnaround in earnings. Of note is the enormous amount of Free Cash Flow being generated, with the company going from Net debt of $800 million to Net cash of over $1 billion in twelve months.

Source: FY22 Whitehaven Coal Results Presentation

The strength of earnings in the Resources sector has second order effects for many of the companies that provide maintenance and other services to the industry. One such result was from Monadelphous Limited (MND). Management noted that its strong result was "reflects strong demand for maintenance services across the resources and energy sectors as customers maintained high levels of production, capitalising on favourable commodity prices".

Both BKI Investment Company and the Contact Ex-50 Fund have significant exposure to the Resources/Energy sector. BKI has a higher weighting given that there are more high-quality Resources companies in the investable universe. Contact is confident that this cycle could be longer than a typical commodities cycle. Australia’s strength in commodities and the 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 Resources/Energy companies has been a clear positive and Contact forecast this to continue.

Mixed signals on consumer behaviour

In our June Quarterly Report, we discussed some of the mixed signals coming through the consumer sector. Consumer confidence numbers continue to paint a bleak picture, however this is yet to be reflected in Retail Trade and corporate results. Despite rising rates, consumers continue to spend. In our June quarterly, we noted that “the good news is that Household Net Wealth is robust, and unemployment is at multi-decade lows. Thus, there is some credence to the RBA argument that Australia has buffers. Nevertheless, households are facing an increased impost on monthly cash flows and expenses. Many will need to change spending habits as a result.”

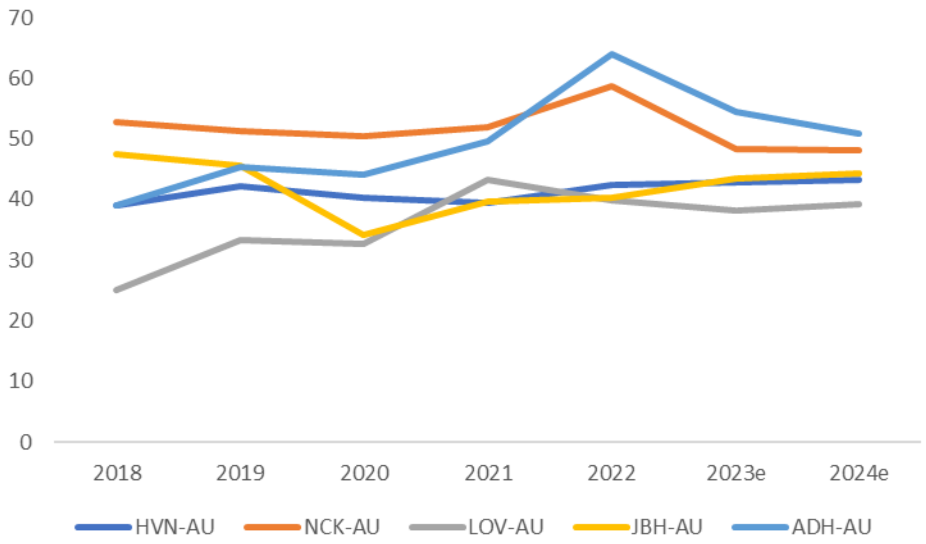
The results delivered during reporting season continues to paint a mixed picture. Indeed, it appeared that the market was surprised that the Trading Updates from several Consumer Discretionary companies was so upbeat. Anthony Scali (MD of Nick Scali) commented that *“Look, it's certainly very difficult to understand why the consumer confidence is at such low levels...So there is a disconnect [between our sales and consumer confidence]”*. The market statement of Lovisa Holdings Limited was similar, *“Trading for the first 7 weeks of FY23 has seen a continuation of the strong performance of FY22”*. Harvey Norman noted that *“the start of FY23 has seen solid sales results, Low unemployment and high net deposit rates continue to underpin results”*. HVN reported comparable sales increases of 10.3% in the first eight weeks of FY23.

However, it was some of the Consumer Staples names that disappointed the market. Leading into reporting season, Coles and Woolworths were trading on high PE multiples. While both delivered pleasing results, cost inflation was a factor in margin compression. On consumer behaviour, Woolworths MD Brad Banducci said that *“We’re starting to see instances of customers trading down. For example, from beef to more affordable sources of protein, and trading across categories for example, from fresh vegetables into more affordable frozen or canned offerings”.*

Back to the Consumer Discretionary space, where sentiment is very negative. Investors paid particularly close attention to inventory levels, as the consensus view is that we may see liquidation risk as demand slows. It appears that the consensus view is that consumer demand is going to fall off a cliff as higher interest rates start to bite. We think that some of the forecasts are too pessimistic. For example, the market has Harvey Norman earnings falling almost 25% next year to basically pre-COVID levels.

In addition, we don't see a major inventory problem ahead. The following chart shows the historical Days Inventory from a select group of Australian listed retailers. We believe that the Retailers are holding more inventory to combat supply chain delays rather than investing in what will be obsolete stock.

An analysis of Days Inventory (historical and forecast) does not suggest an Inventory issue



Source: Factset, Contact Asset Management

Lingering COVID-19 hangovers and cost pressures

Supply chain challenges and staff absenteeism continue to plague several companies even as it seems that the worst of COVID-19 has passed. Several companies that we invest in lamented that this was the case and, despite posting solid results, were cautious on guidance.

ARB Limited, the 4x4 accessories business, is a prime example of lingering challenges. ARB's financial results were in line with expectations as the company provided an update in May. ARB noted again that the key challenge continues to be new vehicle availability across the globe. The company's sales back orders remain at record levels. With uncertainty prevalent, management was hesitant to provide guidance. The Balance Sheet is pristine with net cash of $50m despite $60m in PP&E investments vs sustainable capex of $20m. Despite the short-term challenges with labour and supply chain delays, we remain optimistic on ARB. We consider there to be a delay of revenue rather than a loss of revenue.

Revenue delays from supply chain issues was a common Reporting Season theme. Jim Clayton, CEO of Breville Group said, *"First and foremost [a macro headwind] is the supply chain. We are not done with this one, it's just morphing, though as a general rule, improving".*

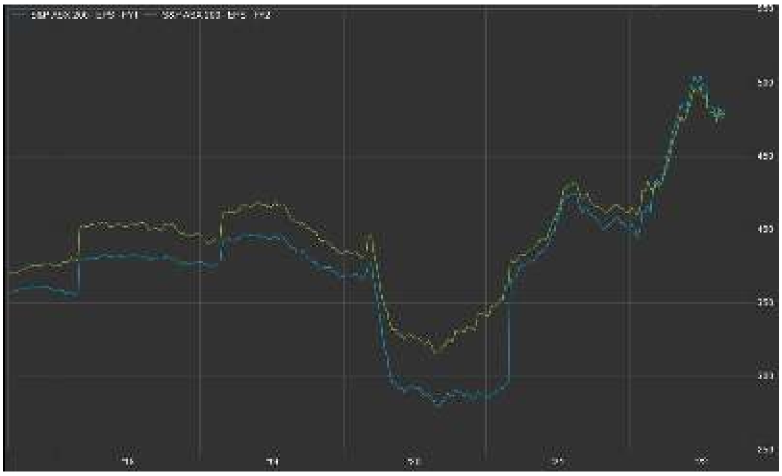
Leasing company Smartgroup (SIQ) faces similar challenges. The order book continues to grow, with excess orders now reaching $14m – however, SIQ have experienced a reduction in sales conversions, as consumers defer purchasing decisions. SIQ noted that order times for vehicles had blown out from <20 days pre Covid to almost 90 days in the Jun-22 half. The market reacted harshly to the uncertainty on the outlook from SIQ with the stock dropping sharply on result day. We think the company looks interesting given its strong cash conversion, increasing market share and attractive valuation.

The ability to attract and retain people was a common theme. This is starting to impact margins as companies are forced to incentivise staff to stay. The strong employment market should continue to underpin Australian economic strength. Indeed, the lack of staff may underpin a recovery as the economy catches up to demand. BlueScope management noted this: "Whilst rising rates have seen some curtailment of demand, ongoing labour and supply chain constraints may provide a buffer as they elongate the pipeline of work."

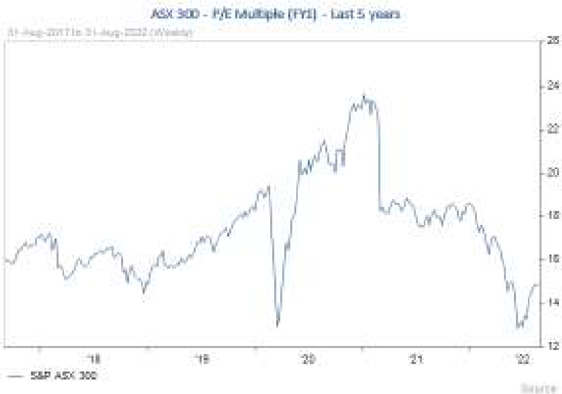
Conclusion – Earnings estimates and Valuation metrics continue to look reasonable

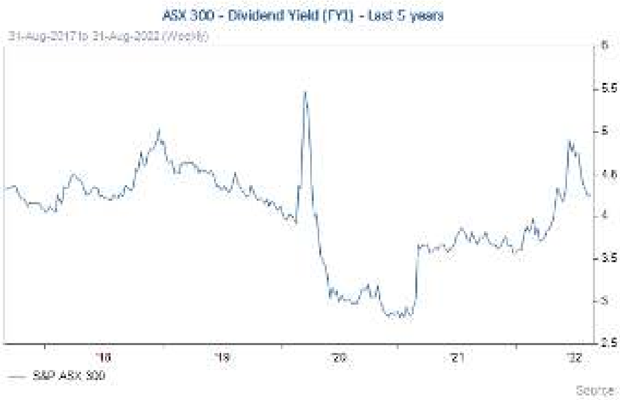
Conservative guidance forecasts has led to slight downgrades in EPS forecasts for the coming years. According to Morgans Research, only 16% of companies provided quantitative guidance in the latest reporting season. This compares to 23% this time last year and over 30% in a normal year (i.e. pre-Covid). As depicted in the following chart, EPS growth expectations have only been pared marginally. Consensus expectations for FY23 EPS growth is c. 3%. The big swing factor is the outlook for Resources companies' earnings. As it stands, EPS growth for Resources is expected to decline by almost 10% in FY23. Time will tell but given that commodity prices remain robust and the dollar is providing a tailwind, the expected decline in earnings from the miners may be pessimistic. The P/E of the market seems reasonable at 14.5 times. The current dividend yield for the market is just under 4.5%.

Earnings per Share (EPS) forecasts for S&P/ASX 200 Index (Rolling one year and two year forward estimates)



Source: Factset





Source: Factset

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