The Contact Australian Ex-50 Fund

Quarterly Letter – September 2022

Dear Investor,

Ongoing concerns around persistent inflation and hawkish Central Banks drove another round of equity market volatility in the September quarter. This is not new news. The same themes have been plaguing markets since the start of the calendar year. Nevertheless, it seems that investors are now increasingly concerned that ongoing monetary policy tightening will result in a recession in the near term.

The Australian market, as measured by the S&P/ASX 300 Accumulation was one of the few global exchanges to finish the quarter higher, closing up 0.5%. Domestic small and mid-cap stocks were mixed. The S&P/ASX Mid-cap 50 Accumulation Index was up 5.2%, while the S&P/ASX Small Ordinaries Accumulation Index was 0.5% lower for the three months ended 30 September. It is interesting to highlight the poor performance of Small Industrials Index, which has been a feature of calendar 2022. In fact, over the past year, the Small Industrials segment of the market has declined by 27.5%.

The Fund did relatively well in the quarter, closing 3.3% higher. Investments that contributed in a positive way to quarterly performance included OZ Minerals Limited (OZL), Whitehaven Coal Limited (WHC) and Monadelphous Limited (MND). Detractors from performance included Service Stream (SSM), Alliance Aviation Services (AQZ) and Ampol Limited (ALD).

In what has become a more challenging market, we believe that our unwavering focus on quality will put the Fund in good stead. We also think it is crucial to stay the course and remain invested for the long term. I often reflect on the following quote from Francois Rochon of Giverny Partners, who wrote in 2013:

> *I would like to emphasize the most important lesson of the last twenty years: It is futile to try to predict the stock market over the short run. All previous lessons are useless if you try to predict the stock market over the short run. I have heard people say hundreds of times that they were waiting to buy great companies because they had negative views on the short-term direction of the stock market. Owning great businesses, managed by great people and acquired at reasonable prices is the winning recipe. The rest is just noise.*

Thus, our approach to investing remains unchanged. We aim to buy high quality, dividend paying, growth companies and hold onto them. We believe that quality businesses continue to surprise you on the upside. We consider that investing in businesses with identifiable competitive advantages, strong financials, and capable founder-led management teams, is one of the best way to navigate through all market conditions.

Portfolio Developments

We have been reasonably active in the past quarter. After extensive analysis of the Lithium sector, we added IGO Limited (IGO) and Allkem Limited (AKE) to the portfolio. At the time, share price weakness in preceding months piqued our interest, particularly given the industry's sustainable secular tailwinds. Demand from batteries in electric vehicles (EVs) due to lithium's uniquely valuable qualities, is expected to grow at a 15-20% CAGR through to 2030 reaching over 75% of total demand for the commodity. The environmental case provides security around long-term forecasts for consumption. We provide more detail into our thoughts on the Lithium sector below.

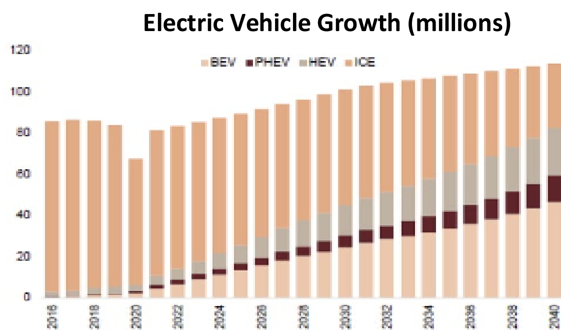
Reliance Worldwide (RWC), a plumbing products supplier, was also added to the portfolio. Its unique branded technology (mainly SharkBite) has allowed it to crack the massive Home Depot and Lowe's US distribution networks. It now boasts market share penetration of 80% in the push-to-connect plumbing niche. We are optimistic on further market growth, expansion into professional trades and leveraging new products.

We have exited some smaller, less liquid positions. In late July and early August, we exited holdings in Adairs Limited (ADH), Cedar Woods Properties (CWP), Orora Limited (ORA) and Readytech Holdings (RDY). Following its result in September, we also exited Tuas Holdings (TUA), which we had inherited from a TPG spin-off and had performed well for us. At quarter end, the Fund held 27 small and mid-cap stocks. We believe this provides a favourable balance of concentration and liquidity.

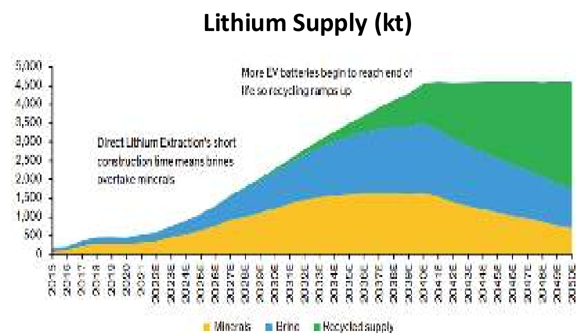
Lithium

A light, soft and silver/white metal, lithium's high heat and electrochemical capacity is uniquely attractive. Non-existent in pure metallic form, it occurs in minerals and salts and is extracted using traditional mining processes and brine pool evaporation ponds respectively. It is then commercialized using chemical methods to produce Carbonate and Hydroxide for batteries. Paradoxically, the brine and refining processes are quite environmentally unfriendly. Most lithium reserves are in South America (~60%) but Australia is the dominant producer (~55%) including the world's best asset Greenbushes (in Western Australia). China does most of the refining.

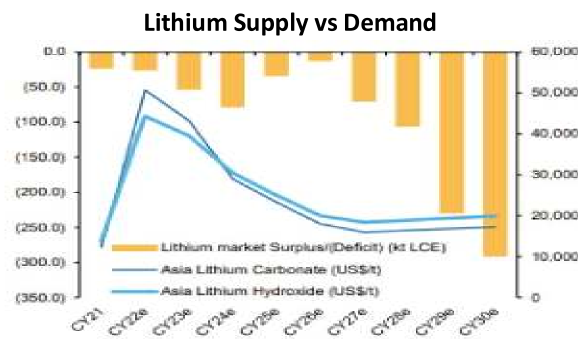
The main source of new demand is Electric Vehicle (EV) batteries, which is forecast to grow at a 15-20% CAGR through to the decade's end and expected to be 75-80% of lithium demand by 2035. While not a scarce commodity, the ability to meet supply is dependent on Probable and Possible projects succeeding, while challenged by environmental (impacts), operational (brine process) and labour scarcity headwinds. The existing deficit, driven by desperate EV manufacturers has driven a sharp rally in prices and boosted margins to iron ore like levels. While this is expected to revert (by as much as 75% by the most conservative), the Free Cash Flow generation by well-placed participants is very substantial.



Source: Barrenjoey (May 2022)



Source: Bernstein (June 2022)



Source: Macquarie (June 2022)

Source: Bernstein (June 2022)

Again, consistent with Contact's quality approach, we shy away from the more leveraged companies. In the Contact Ex-50 Fund, we are positioned in diversified names IGO Limited (IGO) and Allkem (AKE). IGO owns 25% of the world's premier asset (Greenbushes in WA) and 49% of a downstream refinery. While earnings are to become

more lithium dependent (~75%), the company is diversified across other commodities less leveraged to the EV dynamic being nickel and copper. A net cash position and strong cash flows (even if prices come off current levels) ensures growth capex and a dividend yield above 3% can be comfortably funded. AKE is more diversified within the lithium industry, producing multiple products using different extraction methods from locations domestically and in Argentina and Canada. The company also has a net cash balance sheet and is forecast to pay dividends starting in FY23.

Fiscal year 2022 results season

Despite an atmosphere of caution heading into August, we thought the 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. Below, we discuss the results of some of our major holdings. For a more detailed discussion, we circulated a Contact Insights piece *"Reflections on August Reporting Season",* which is available on our website. In it we highlighted a few interesting themes from reporting season, notably:

- 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.

Nine Entertainment Company (NEC) announced a solid result that was ahead of expectations. Buoyancy in the ad market has continued, leading to excellent Free Cash Flow generation. The growth in BVOD (Broadcast Video on Demand) and other digital assets continues to drive high rates of growth. Given its strong result and Balance Sheet position, NEC announced an on-market buyback (up to 10% of shares).

Harvey Norman (HVN) delivered a solid result in what was a year of two halves. After a challenging, COVID impacted first half, HVN delivered steady growth in the second half, which has continued into FY23. The overseas segment now accounts for 25% of earnings. The property segment remains strong with real, tangible property assets exceeding $3.7b. Our investment case is tied to the proposition that HVN is trading on a very attractive valuation for the retail business once the Property assets are stripped out. Whilst we wait for that value to be realised, we are being rewarded by a grossed-up dividend yield of >10%.

Fund Manager **GQG Partners (GQG)** reported a pleasing interim result that was ahead of both consensus and prospectus forecasts. Despite significant market volatility in the first half of 2022, GQG's investment performance has been excellent, which is attracting consistent inflows. The Balance Sheet is net cash. We continue to see material upside in our valuation of GQG, which is founder-led and building its brand.

Another founder-led business, **Netwealth Group (NWL)**, posted a result characterised by excellent top line growth offset by higher expenses. Importantly, NWL continues to generate continued growth in Funds Under Administration (FUA). An underappreciated earnings tailwind is the spread on cash transaction accounts is back to 120bps, from 80bps in the ultra-low interest rate environment. Cash balances on platforms exceeds $4 billion, hence the earnings tailwind is material.

Metcash Limited's (MTS) trading update highlighted that strong growth has continued into 1H23 across all three pillars – Food, Liquor and Hardware. MTS is taking share driven by retailer reinvestment into stores and is likely benefiting from strong regional economies after years of drought. MTS remains well placed to benefit from inflation and the strong trade hardware market. At ~13x FY23 P/E, the stock looks cheap relative to peers and history.

Closing

Macroeconomics continues to dominate the short-term direction of the market. It seems that we wake each day and witness the market whipsaw from optimism to pessimism based on anticipation of how much the Fed might increase rates. Sooner or later, company fundamentals will again prevail. Until then, patience is required.

A patient, long -term approach is where we believe we have an edge as Investment Managers. We are not chasing a short-term performance fee against some arbitrary index. Instead, we target a 10% p.a. total return over a 5-7 year time horizon. We think that this is an admirable return target and one that is likely to outperform the broader equities market in any case. We are not diluting returns through excessive management fees and performance fees, which has sadly become the norm for much of the Financial Services industry. We invest alongside you and seek to grow our wealth through our investment the Fund (and investment in other Listed Investment Companies we manage).

Our approach to investing remains constant. We aim to buy high quality, dividend paying, growth companies and hold onto them. We believe that quality businesses continue to surprise you on the upside. We consider that investing in businesses with identifiable competitive advantages, strong financials, and capable founder-led management teams, is the best way to navigate through all market conditions.

At the end of September, the Portfolio characteristics of the Fund were as compelling as we have seen for some time. From a valuation perspective, the Fund was trading on a P/E of 11.6 times (based on 2023 earnings estimates). This is very cheap by historical standards. We aim to buy businesses at above average rates of return and the ROIC (return on invested capital) of the Portfolio was 25.9%. By comparison, the ROIC on the S&P/ASX Mid-cap 50 index was 15.8%. We believe this is a high-quality portfolio and the companies within it also deliver greater cash flow generation and stronger balance sheets than the broader market.

Please let us know if you have any questions or require additional information. In the meantime, we encourage you to visit the Insights section of our website at https://contactam.com.au/insights/ where we collate interesting thought pieces on a monthly basis.

We appreciate the opportunity to manage your assets and we look forward to reporting to you in the quarters ahead.

Yours sincerely,

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