Contact Asset Management

INSIGHTS

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ASSET MANAGEMENT

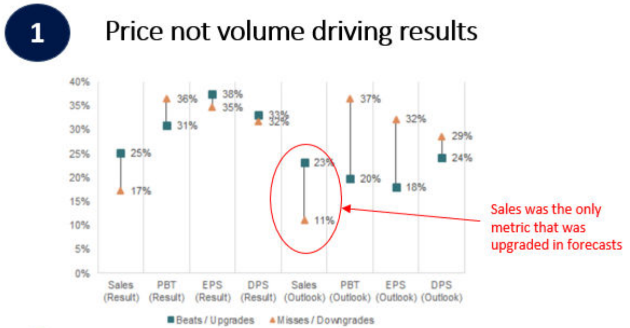
Quality Prevails – Reflections on February Reporting Season

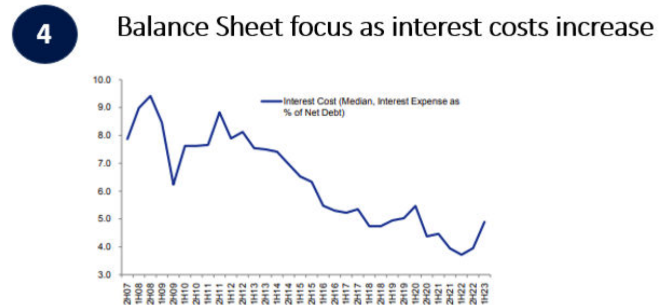
Reporting Season is always an interesting time for bottom-up stock pickers such as Contact Asset Management. Our investment approach involves a robust process whereby we analyse the individual qualitative and quantitative characteristics of companies. We discuss some notable results below. At a high level, we noted consistent themes from company results: tight labour supply, rising interest expense, a cautious consumer and ongoing inflation. Top line momentum was strong; however, this was primarily driven by pricing increases rather than volume growth. Companies with limited pricing power were treated harshly by the market. Despite the cautious tone that has set into market sentiment, there were several pleasing results that give us cause for optimism.

Reporting Season Review

As is often the case, the February Reporting Season can be summarised as "mixed". Top line momentum was strong as many businesses are managing to pass on cost inflation through higher prices. While there is a degree of caution in outlook statements, earnings have proved to be relatively resilient as we adjust to a post-Covid world. We are less concerned with near term "beats" and "misses" compared to much of the market. Rather, we view Reporting Season as an appropriate time to take a health check of our portfolios and ensure that the long-term investment case of our investment companies remains intact.

The following graphic encapsulates some of the key high-level themes from the February Reporting Season.





Source: Factset, Contact Asset Management, Barrenjoey, CBA, Goldman Sachs

We suggest that one overarching theme of the results period was the resilience of Revenues. However, this was primarily driven by price increases rather than volumes. As we have been saying for some time, pricing power is incredibly important in an inflationary environment. As Warren Buffett noted in 2013, *"The single most important decision in evaluating a business is pricing power... If you've got the power to raise prices without losing business to a competitor, you've got a very good business. And if you have to have a prayer session before raising the price by 10 percent, then you've got a terrible business."* As

highlighted in Chart 1 on the previous page, “Sales” was the only metric that saw more upgrades than downgrades in consensus forecasts.

As depicted in Chart 2, wage inflation is topical. Yet again, the impact has been mixed. The following comments on wage inflation highlights that it is top of mind for most corporates:

- ARB Limited (owned by BKI and Ex-50): *“We note that employee expenses grew by only 1.1%, i.e. less than current inflation levels, as the company tightly manages its head count and wage increases.”*
- Best & Less (not owned): *“Inflation is high, cost of wages are increasing.”*
- Brambles (not owned): *“Importantly, while we expect transport and fuel cost to continue moderating, labor costs are expected to remain elevated with wage inflation in many regions, reflecting increasing cost of living pressures.”*
- Estia Health (not owned): *“However, inflationary wage pressures in other sectors of the economy means increases in excess of 15% are likely to be required to attract and sustain the workforce required in the future.”*
- Reece Limited (owned by BKI and Ex-50): *“Effectively, the uplift has really been driven by wage inflation. So, there's wage inflation across our existing staff in order to try and prevent turnover. And then when we're replacing staff, those staff continue to cost more than the personnel replacing.”*

Despite the apparent margin pressure, consensus market EPS did not change much (Chart 3). In fact, consensus forward EPS for Australian stocks has been largely flat for almost a year. Since the start of 2023, there has been minor 0.5% fall in forward EPS for the ASX 300 (source: Macquarie). However, it is worth noting that Energy was perhaps the most disappointing sector in reporting season, with the most negative EPS surprise and the most downgrades. Again, according to Macquarie, of the 8 Energy stocks they cover, all 8 had EPS downgrades of at least 5%.

Dividends have also been resilient as Australian investors continue to benefit from the healthy profits from many of our Resources companies. We often comment that *“Dividends don’t lie”*. A company needs to be of a certain quality to be able to pay a dividend in the first place, giving consideration to the Balance Sheet, profitability, cash flow and confidence in the outlook. As noted by Morgans Research, dividends declared among the large caps was strong, with 81% of ASX 50 Industrial companies growing their dividends. This comes in a period whereby many companies are continuing with previously announced buy-backs. We continue to believe that the outlook for dividend income from the quality companies will be resilient.

Finally, as depicted in chart 4, an emerging trend, albeit one not getting a huge amount of airtime, is the increase in interest costs starting to hit corporates. Just as the mainstream media is warning of the pitfalls of the coming “mortgage cliff” for homeowners, there will be a similar day of reckoning for highly geared companies. This theme was at the periphery in the February reporting season, but is worth watching following the release of the June 2023 results. Yet again, we believe that the high-quality companies will emerge best placed. Investment fundamentals matter again – those companies that were beneficiaries of overly geared Balance Sheets in the low-rate environment of 2020-2022 could face significant headwinds.

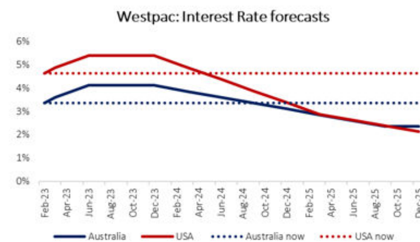
Sentiment is very negative. But there is a Bull case.

We think that investor sentiment is too negative and has been for some time. Economic uncertainty is not new; indeed, there is always something to worry about and the bear case is often easier to believe. While we concede that a rising interest rate environment creates headwinds for valuations and consumer sentiment, there are several positive signals. Unemployment is at record lows. This is a critically important metric. Further, expectations have moderated in certain sectors, notably in consumer facing industries where consensus forecasts now anticipate a significant reduction in year-on-year growth. Cash positions remain above average for a lot of Australian institutional and retail investors, which would likely to be put to work in a drawdown.

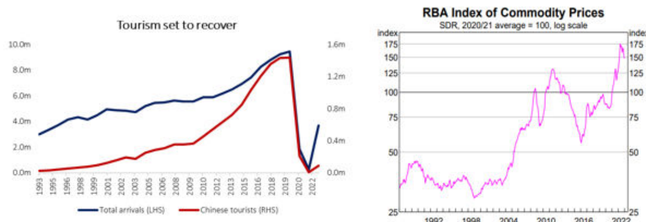
As depicted on the following page, there are additional reasons for optimism. We expect interest rates will soon peak. While we are less convinced on the subsequent cut in interest rates (as forecast by Westpac), we think that a RBA rate of close to 4% should not be overly restrictive. We expect the Australian economy to continue to be supported by a strong commodities market and a recovering tourism industry.

1 Unemployment near record lows

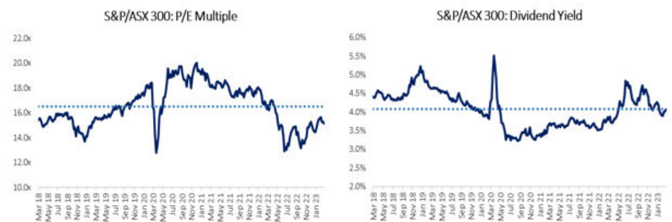
2 Rates are close to peaking and may soon fall



3 Australia well placed – Tourism & Resources



4 Valuations & Dividend Yields are Reasonable



Source: Factset, Contact Asset Management, RBA, Westpac

Contact Asset Management's Approach – focusing on the bottom-up fundamentals

At Contact, we are conscious of the macroeconomic environment, but see greater relevance in the investment fundamentals of individual companies. We prefer to focus on the bottom-up rather than top-down metrics. In a busy period of results, we thought it worth highlighting a few portfolio holdings (that are owned by *both* BKI and the Contact Ex-50 Fund) where aspects of the results were particularly interesting:

After enduring challenging operating conditions over the past two years, Smartgroup Corporation's (SIQ) operating momentum is improving. Novated leasing leads have been buoyant while supply chain pressures on vehicle availability are only just beginning to abate. As the environment normalises, we expect sales to improve (as orders are converted) and costs to drop (as redundant service expenses are removed) at a better-than-expected trajectory. Growth in EVs is an unappreciated additional boost to activity as are benefits from the recent investment in digital platforms. SIQ has a strong Balance Sheet with near zero debt forecast even as 90% of earnings are paid out. The better-than-expected dividend highlights management's confidence in the outlook. A forward-looking P/E of 11-12 times suggests excellent value in Contact's opinion.

TPG Telecom (TPG) delivered a solid result that was broadly in line with expectations. This was the first time since the Vodafone/TPG merger that positive earnings momentum is obvious across the group. Mobile subscribers and ARPU lifted as international travel returned. TPG/Vodafone grew their post-paid customer base as well which is critical and suggests they have returned to growth in the domestic market. The market appeared pleased to see earnings momentum return to the business. This combined with tight cost control saw EBITDA lift year on year. The momentum appears sustainable and management guided to an FY23 Underlying EBITDA number which is up 6% YoY and slightly better than expected.

Ampol Limited's (ALD) result was solid and buoyed by very strong capital returns to shareholders. Fuel volumes continue to recover but it is the strength of refining margins that are driving earnings growth. If these margins are maintained, Ampol's earnings growth will exceed market expectations by some margin. The convenience retail business continues to perform well and has managed cost of doing business admirably in a difficult environment. These factors are expected to support a consistent dividend payout and ongoing growth.

In conclusion, we continue to advocate the importance of investing with a "Quality first" mindset with a long-term horizon. Reporting season is often a timely reminder that good investment fundamentals matter. The macroeconomic environment always offers something for the bulls and something for the bears. However, at the end of the day, attractive long-term returns are often best achieved by investing in a portfolio of quality businesses, led by capable people with strong Balance Sheets and excellent earnings prospects. And then, staying the course to let compounding work its magic.

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