Contact Asset Management

INSIGHTS

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Reflections on Reporting Season

The team at Contact Asset Management 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 find it intriguing that market commentators continue to place a heavy emphasis on macroeconomic factors, especially considering the track record of significant forecasting inaccuracies. We think that the best way to handle the macro is to handle the micro. This is where we believe the key lies: identifying and maintaining positions in high-quality companies.

In light of the prevailing negative sentiment heading in August 2023, we found the results to be generally favourable. Over an extended period, we have observed a pervasive sense of pessimism within the investment landscape. This sentiment has served as a strategic opportunity for us to increase our exposure toward high-calibre enterprises. Indeed, over the past six months, Quality has outperformed, as investors have gravitated towards companies possessing attributes such as pricing power, growth potential, robust balance sheets, and astute management teams. These attributes have been prevalent among the top-performing equities in the month of August.

Within this *Contact Insights* note, we explore prevailing themes derived from Company Results. Our enduring confidence in the positive long-term outlook for Australian Equities remains steadfast, and we shall expound upon critical factors that underpin this optimism.

Reporting season: FY23 Results Satisfactory, Confidence in Guidance Elusive

Two years ago, we wrote: *"The results delivered in August 2021 were strong in the main. The solid earnings reported was broad based across all sectors. With massive stimulus, low interest rates and strong asset values, one might argue that there have been far more COVID winners than losers. Balance Sheets are robust. As a result, the share market reacted positively."*

August 2023 provided clear evidence of our entry into a more challenging phase of the economic cycle. While revenues generally exhibited strength, the driving force behind this upturn often stemmed from price escalations rather than volume expansion. Concurrently, profit margins came under strain, frequently attributed to rising labour costs, albeit alleviated by factors like declining freight rates and energy expenses. A significant development is the escalating cost of debt, with interest payments emerging as a formidable challenge for companies grappling with stretched Balance Sheets.

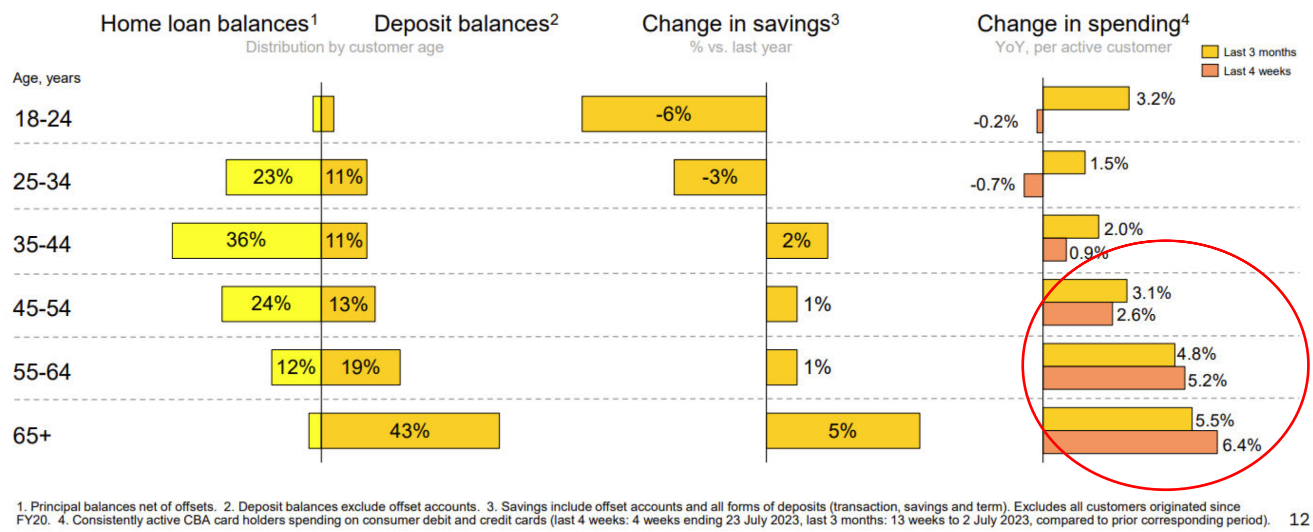
Cash flow generation was generally robust, as companies placed growing emphasis on efficient working capital management. As conditions tighten, cash is king! Despite a retreat in commodity prices from their remarkable peaks in recent years, the Resources sector continues to amass substantial cash reserves. Yet during August, the sector underperformed the broader market, registering a 2.0% decline. This decline was attributed to investor concerns regarding the absence of Chinese stimulus and escalating capital expenditure costs.

Nonetheless, a significant portion of the challenges mentioned above had already been anticipated. Consequently, the reporting period exceeded pessimistic expectations. Surprisingly, even the mere notion that earnings might not plummet triggered a substantial upward revision of share prices in several cyclical industries. Contrary to the reservations of many, it's evident that consumer demand is not completely dead. In fact, the Consumer Discretionary sector outperformed in August, with a notable 5.8% increase. Households have amassed a substantial savings buffer of over $300 billion since March 2020, although this reserve is gradually diminishing as, on average, households are now saving less compared to the pre-COVID era.

The savings buffer has seemingly been an important counterweight to the much feared "Mortgage Cliff". Strong underlying unemployment has also been important. The results from the major Banks were devoid of any major bad debt problems. While there is an air of caution with the outlook comments from the big Banks, there is certainly no panic. The update from National

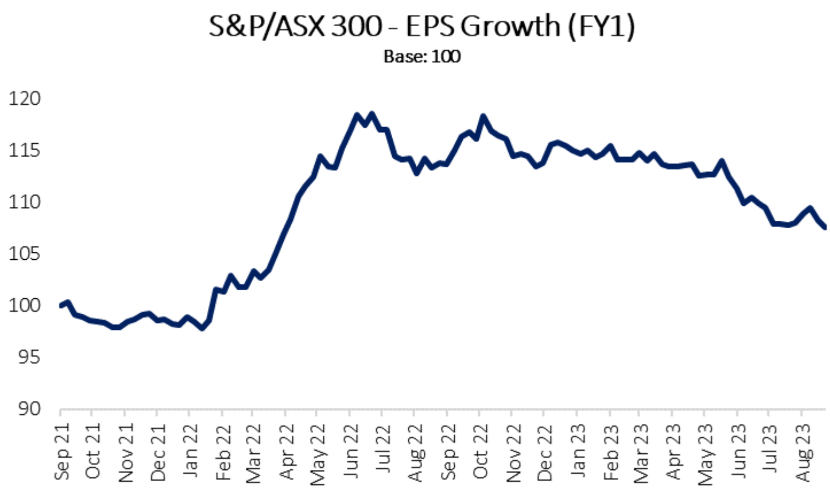
Australia Bank (NAB.ASX) highlighted that while economic uncertainty is still high, the risk of a hard landing has decreased and the likelihood of significant losses within small-to-medium enterprises (SMEs) is reducing.

The other factor to be conscious of is that not every Australian household has a mortgage. There is a large segment of Australians that are debt free – these people have had a pay rise with appealing Term Deposit rates and robust equity markets. This cohort is still spending. Commonwealth Bank of Australia (CBA.ASX) shared the following slide in their Results Presentation. CBA customers over the age of 65 received approximately $2 billion in additional interest income last year. For other company results, this was reflected in the strength of spend on Travel, highlighted through the Fight Centre (FLT.ASX) and HelloWorld (HLO.ASX) results and Luxury goods with Vicinity Centres (VCX.ASX) results. We are not belittling the fact that there is stress among many Australian households, we make this point to suggest that it's not all doom and gloom.



Source: Commonwealth Bank of Australia Result Presentation (August 2023)

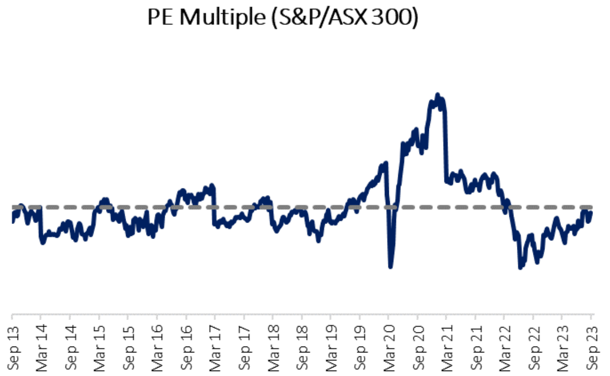
Result Presentations frequently featured conservative outlook statements. Often, there was no guidance at all. Barrenjoey Equities estimates suggest that Consensus EPS forecasts for FY24 generally fell, noting that that there were 17% upgrades and 41% downgrades. The following chart illustrates that consensus FY24 EPS growth forecasts have moderated. What is hidden in this chart is the volatility of EPS expectations from the Energy sector over the past two years, which has possibly exaggerated this chart. From September 2021 to September 2022, EPS forecasts for Energy stocks increased by 143%. Since then, Energy sector earnings expectations have been cut by 36%. In all, consensus expects a more challenging period in the coming 12 months, with negative EPS growth for the market now anticipated.

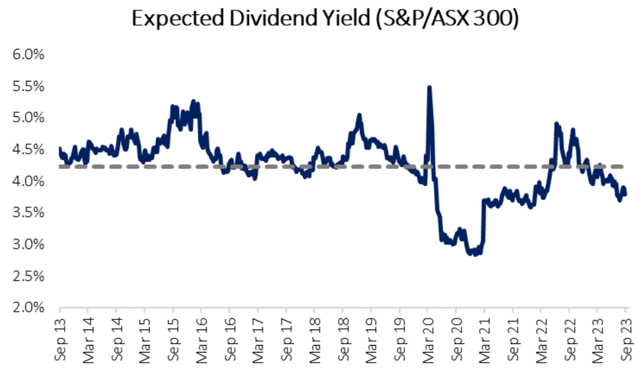


Source: Factset, Contact Asset Management

What does this mean for valuations?

The retracement in EPS expectations and a relatively resilient market has mean that high level market metrics are now trading reasonably close to historical levels. We think this is appropriate for this point in the cycle. We continue to believe that we are in a stock pickers market and that a focus on quality companies remains the most sensible strategy.





Source: Factset, Contact Asset Management

What impressed us during Reporting Season?

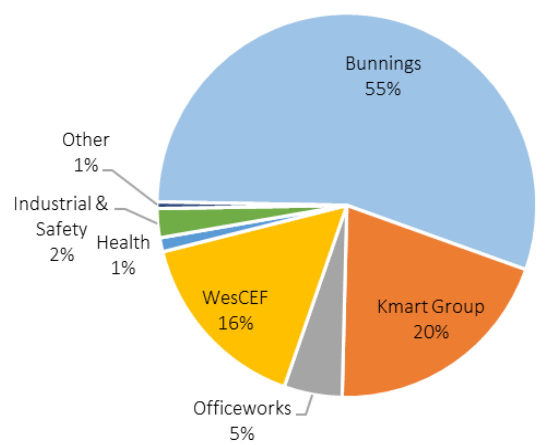
Below we comment on a couple of mid-and-small cap results. These companies are held by both BKI and the Contact Australian Ex-50 Fund. But first, at the big end of the market, we thought Wesfarmers Limited (WES.ASX) is worth highlighting.

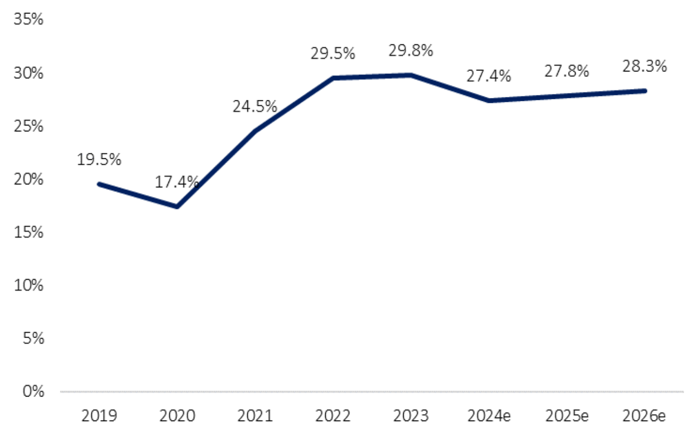
WES delivered a strong result in a challenging market. The business remains well diversified with a robust Balance Sheet and solid dividend yield (c.5% on a grossed-up basis). The business boasts almost 1,800 retail locations across Australia with excellent customer loyalty built through its strong value proposition, convenience and omni-channel offering. Bunnings remains the core foundation of the business, however WES has several growth options, especially through their Chemicals, Energy and Fertilisers business WesCEF.

In FY23, revenue increased by 18%, aided by the Wesfarmers Health acquisition. Earnings per share increased by 5% and the final dividend was 3% higher. The impressive part of this was that WES delivered continued growth despite headwinds including increasing costs, a more cautious consumer and higher import costs.

It is worth highlighting the turnaround at Kmart in recent years. A decade ago, Kmart was turning over $4 billion in sales yet making zero profit. The business was poorly maintained and the pricing strategy was confused. In FY23, Kmart Group generated almost $11 billion in sales and $850 million in EBIT. Kmart itself generated total sales growth of 22%. Margins have improved and Return on Capital, which has long been a focus for Wesfarmers management, is a superb 47%. While the jury is still out on the long-term viability of both Kmart and Target brands, the turnaround is well entrenched. Customers have reacted positively to Kmart's lowest price positioning.

WES: Diversified business delivering excellent returns





Source: Company results, Contact Asset Management. Note the pie chart excluded Catch Group (which is loss making). The pie chart highlights EBIT contribution. The line chart is Return on Equity and includes Contact Asset Management forecasts.

We remain positive on the WES investment case. WES has an exceptional portfolio of growth businesses and a significant retail footprint. The business is well-managed, it is focused on long-term investment and has an impressive history of rewarding shareholders through capital management.

Interesting results in the Small and Mid-cap space

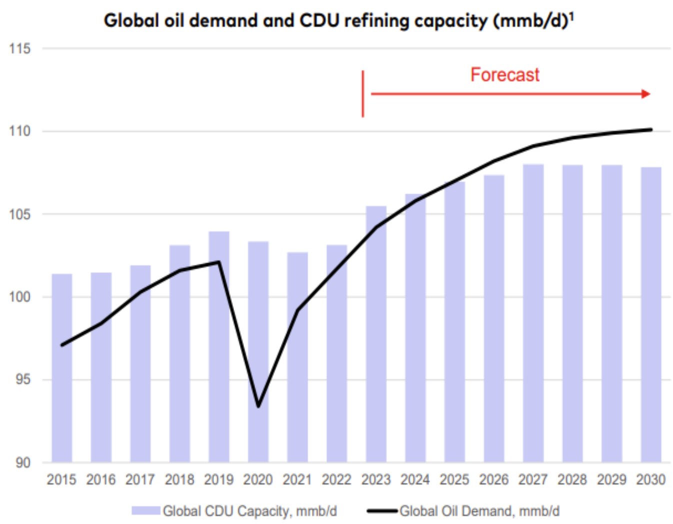
Ampol Limited (ALD.ASX) reported a strong interim result, signalling ongoing underlying business momentum. In the last eighteen months, we believe that ALD has become a higher quality and more diversified business generating far more resilient earnings. We think this transformation remains underappreciated by the broader market.

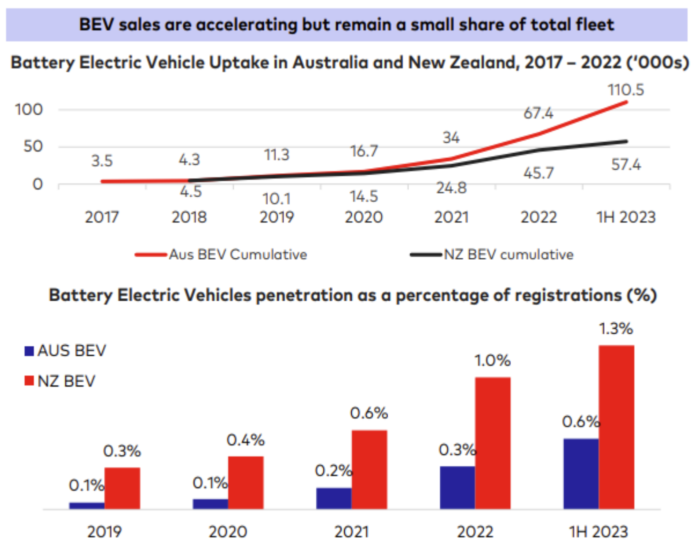
ALD's interim result was characterised by a positive outlook for the refining business and a higher-than-expected dividend that was at the top end of the target range. ALD now generates far more resilient refining margins and the average for the half was c.$10.30/bbl but has traded up towards $20/bbl in recent months. The barriers to entry in the underlying refinery business are often underappreciated. There are now only two refineries left in Australia (Ampol's Lytton and VEA's Geelong) and both now are underpinned by support from the Australin Government. This has removed a lot of earnings volatility for ALD. As depicted below, the lack of investment in new refinery capacity globally paints a compelling demand / supply picture.

Lytton is an important factor in underpinning earnings in the near term, however ALD continues to evolve its business mix. ALD acquired New Zealand's largest fuel retailer (Z-Energy) in March 2022 and has driven margin improvement. Its Australian convenience stores have c.4 million visitors per week. Convenience stores continue to grow earnings and management is expected to leverage greater benefits of scale going forward. Underpinning all this is a significant property portfolio.

While ALD (and Contact) are cognisant of the increasing demand for Electric Vehicles, it appears that widespread adoption is some way off. As depicted below, less than 1% of vehicles in Australia are currently EVs. In a 2021 release, ALD noted that by 2030, EV penetration was expected to be somewhere between 10-20%, as price parity made EVs more affordable. ALD management expanded that to achieve 15% EV fleet penetration by 2030, EV sales are required to reach ~70% of new vehicles sold. In 2021, 1.1 million new cars were sold in Australia; 2% were EVs. Despite the longer than expected ramp up, ALD is rolling out fast charging stations at some of its retail sites and will look to monetise the investment. In the meantime, those investors that are avoiding ALD due to the imminent threat of EVs are likely to be waiting some time for that thesis to play out.

Ampol is expected benefit from attractive demand for refining alongside slower than expected EV penetration





Source: ALD 1H2023 Result Presentation.

The short-term share price reaction to ARB Limited's (ARB.ASX) result was one of the more unusual events during reporting season. Upon the release of the FY23 result on 22 August, ARB shares dropped close to 15% in early trading to $28.55/share. As investors focused on the positive outlook rather than the result headlines, confidence returned. By 24 August, ARB was back at $34.35/share, a 52-week high. Sometimes Mr Market has a bad day.

For those less familiar with the company, ARB is a designer, manufacturer and retailer of branded 4x4 accessories. It sells a range of Fabricated Metal, Mechanical, Suspension, Canopies and Traded products, primarily under the well-renowned ARB brand which commands a premium price to competitors. ARB has a proud history approaching 50 years with a brand that represents quality and reliability.

The 2023 Financial Year certainly presented challenges for ARB. Profits suffered as price increases failed to keep pace with cost pressures and a falling Australian Dollar. The company also battled headwinds from labour and manufacturing. However, much of the challenges were caused by external factors, notably bottlenecks in the network, primarily around new car sales and the ability to fit and deliver product. These headwinds have now exacerbated.

Importantly, the outlook from management was optimistic. A welcome development during a reporting season thick with cautious guidance statements. ARB management maintains a positive outlook with strong ongoing demand, improving new vehicle supply, stronger gross profits (back to historical levels) and benefits from new products released.

We also remain encouraged by the long-term opportunity into the United States. ARB continues to grow revenue from its partnership with Ford USA and should benefit from Ford Ranger accessory parts in FY24. This will be enhanced by new Ford Bronco accessories which unlocks a huge market opportunity.

We have been long-term investors in ARB Limited. We expect the business to continue to generate excellent returns on capital and a growing dividend stream. The company boasts excellent alignment amongst its management team and has no debt. We remain optimistic on the future.

Final thoughts

Reporting season is a useful time to assess company financial metrics and reevaluate the investment case. Its also a period whereby many investors get caught up in the short-term noise. We remain focused on the long-term and we remain optimistic on Australia.

We continue to believe that Australian investors remain overly cautious on the likelihood of a significant economic downturn. Our brief assessment of the macroeconomic picture is that inflation has peaked, interest rates should stabilise and the employment market is robust. Consumers may be more cautious, which should not be a surprise after an ebullient period of cheap money and Government handouts. Of note, we think that the expected high population growth (driven by immigration) should not be overlooked. This is a major economic tailwind for Australia in the coming years. As an additional tailwind for Australian equities, our superannuation system is fortress-like and there will continue to be a wave of employee contributions looking for a home as total superannuation balances triple to $10 trillion in the next 15-20 years.

We believe that the current economic conditions suit high-quality businesses. That is those businesses that that have pricing power, those with experienced and capable management teams, those that control costs and those that have strong Balance Sheets. These are the businesses that we seek to invest in. Over the long-term, an unwavering focus on quality is the formula that we believe will put our Portfolios in the strongest position.

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