Contact Asset Management

INSIGHTS

MAY 2024

CONTACT ASSET MANAGEMENT

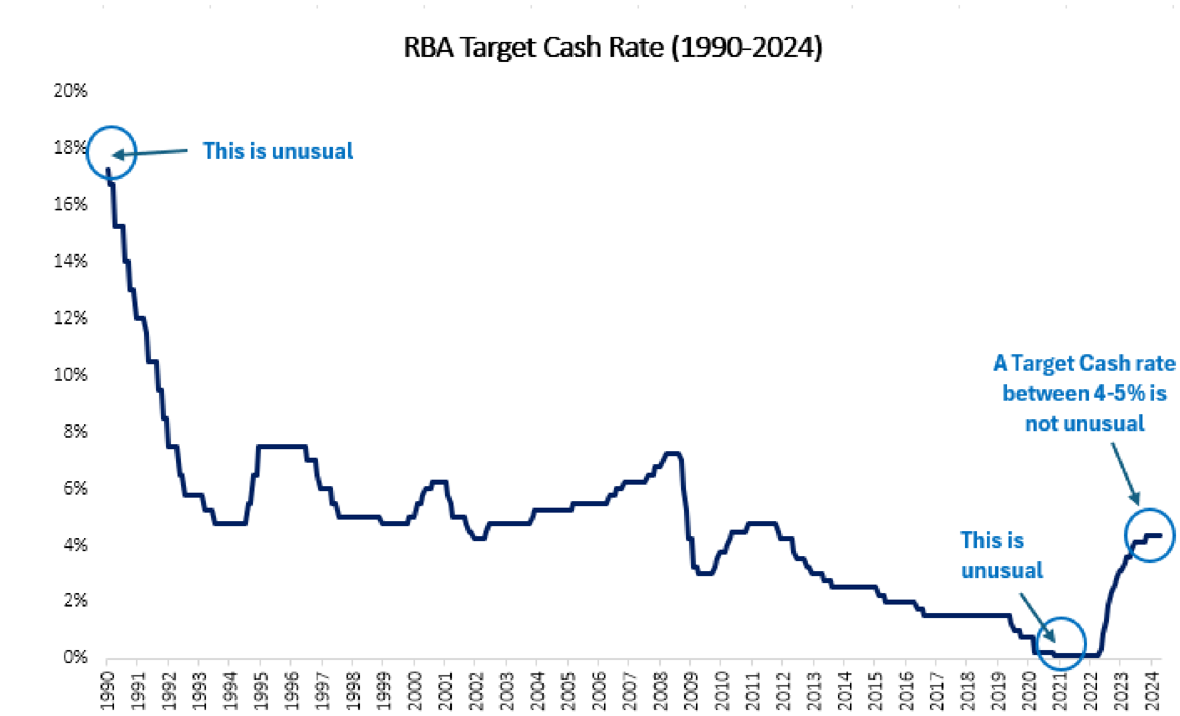
Underlying Business Fundamentals are more useful than Macro Forecasts

At Contact Asset Management, we aim to invest in quality businesses for the long-term. Macroeconomics are important but not the overarching consideration of our investment process. We are operating in a world where there is a seemingly unprecedented focus on the short-term direction of interest rates. We are not in the business of crystal balling macro calls. In fact, we think this is a strategy fraught with danger. In this note, we consider recent consensus estimates for interest rates and how wildly they have differed from reality. Forecasting is hard and macroeconomic forecasting is even harder. We prefer to view interest rates from a cost of capital perspective. We believe that risk assets need a hurdle rate for the efficiency of capital markets to function appropriately.

With this in mind, we discuss three stocks that we believe are well placed regardless of whether we get a short-term interest rate cut or not. These are solid, dare we say "old school", industrial companies generating free cash flow that display attractive growth prospects.

The Interest Rate Environment

The current interest rate environment is not an aberration and not unusually high despite what the echo chamber tells us. What was uncommon was the period of unusually low interest rates during the Covid years. In fact, this new normal is the old normal.

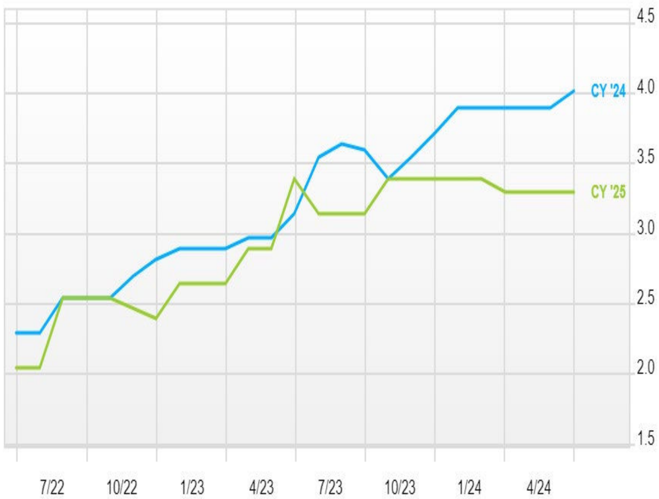


Source: Factset, Contact Asset Management

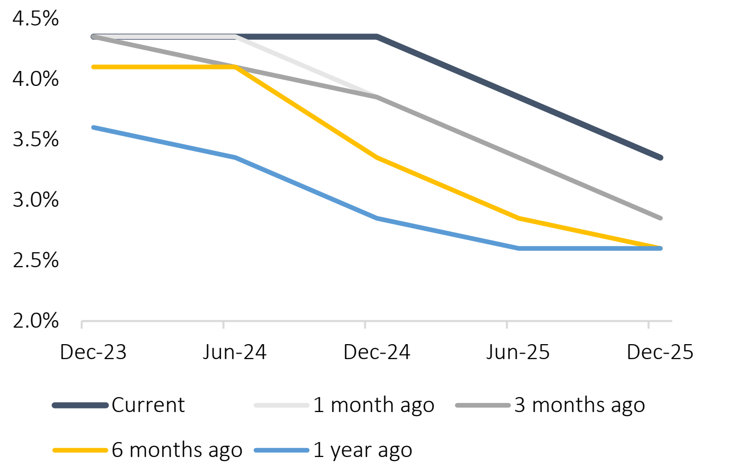
Investing in today's equity market is layered and nuanced. We firmly believe discerning and disciplined work must be applied, as a market with an actual hurdle rate demands actual returns. Even though we now have a nominal cash rate that is attempting to provide gravity to risk assets, we are back nudging all-time highs. The forward-looking nature of markets has already jumped ahead to a world where Central Banks have done just enough to curb inflation and begun the loosening cycle. However, as this can is kicked further down the road as shown in the below figure (LHS), this free kick to the present value of future cashflows is further pushed out.

Our point here is simple: who knows where interest rates will land? It wasn't that long ago that the RBA Chief Philip Lowe was telling Australians that the RBA Target rate would stay at 0.10% *"until at least 2024"*. In reality, interest rates started rising in May 2022 and we entered 2024 at 4.35%. As depicted in the chart below (RHS), economists have been far too optimistic on the prosect of interest rate cuts. The consensus view was that the RBA rate would be 3.35% by now and that caution should prevail in asset allocations. As it turned out, rates remain at 4.35% and the ASX300 Accumulation Index hit all time highs recently.

Target Cash Rate Forecasts- Calendar Year Trend



Consensus Estimates for RBA Target rate has moved drastically



Source: Factset, Contact Asset Management

Forecasting macroeconomic indicators is hard. Unfortunately for many market economists, the phrase ""Frequently wrong, but never in doubt" is all too common. The enormous challenge in estimating the macro reinforces our belief that a more sensible approach is to assess the individual characteristics of companies rather than ride a wave of momentum or high level thematics.

To be clear, we do believe the RBA will trim rates at some point but when and by how much we don't know. We are not in the business of crystal balling macro calls. But we do believe risk assets need a hurdle rate for the efficiency of capital markets to function appropriately. This is a very different proposition than deploying capital in a zero-interest rate world. This period where free and easy money lifted all boats was a force multiplier for long duration stocks that extrapolated the promise of attractive future cashflows to inflate the present value of those cashflows.

Prominent U.S. investor Stanley Druckenmiller commented, *"It's very clear to me - but not the Fed, and they've got the PHD's and not me - that you need a hurdle rate for investment. And if you don't have a hurdle rate for investment, bad things happen."* He was of course referring to the uneconomical allocation of capital, often to trivial and frothy momentum pursuits. In recent times these have manifested in things like NFT's (non-fungible tokens), many and various coins, and the meme stock of the day. We agree with the sentiment of another U.S. investor, Howard Marks of Oaktree Capital Management that *"risk control is invisible in good times but still essential, since good times can so easily turn onto bad times".*

Three interesting "Old School" companies with solid business fundamentals

The only way that one can maintain conviction long-term is if the underlying business fundamentals are strong. We believe that eventually the share price follows earnings. That's why we deploy our resources towards understanding real businesses generating attractive free cashflow. We consider the following three Industrial businesses to be interesting at current prices.

Redox Limited (RDX.ASX): We invested in RDX at the IPO in July 2023. We were attracted to the company as it was still managed by the founding family (established 1965), who own 46% of the shares on issue. Redox is a leading supplier and distributor of chemicals, ingredients and raw materials. This is an old school industrial company. RDX has a diversified offering of almost 5k SKUs from 950 suppliers. In our analysis Redox is the market leader, yet only has 3% market share in Australia, which presents share gains and consolidation opportunities.

The shares traded below IPO price for almost eighteen months. However, the market has become more confident in the resilient revenue stream and return on invested capital exceeding 20%. This is one example of a company far surpassing a hurdle rate from a cost of capital perspective. RDX shares dipped below $2.20 in January 2024. It hit a high of $3.31 in May. RDX is debt-free, it has an attractive dividend yield (>5% grossed-up) and is reasonably priced. The company is being managed for the long-term. We expect it to continue to deliver solid earnings growth.

LGI Limited (LGI.ASX): is a relatively new position for our Contact Australian Ex-50 Fund. LGI is an established green energy producer that converts methane from landfill into energy and/or less harmful greenhouse gases. Landfills contain a variety of waste which will include an amount of organic material. As that material breaks down it will give off methane, and other gases, over decades. If enough gas can be gathered, then it can support the installation of gas engines that can also produce useful energy (often with the upside of battery storage). LGI generates revenue in two main ways. Firstly, its generators in Queensland, New South Wales and the ACT supply energy to the National Electricity Market (NEM). Secondly, it sells ACCUs (Australian Carbon Credit Units) to companies or Funds seeking offsets.

LGI is another business that is founder-led. It has a conservative Balance Sheet and it is investing in growth across more than 30 sites. We visited LGI's facilities in April and we walked away impressed with both the calibre of its management and the strategy to significantly boost earnings. Many in the market would consider this another "boring Old School" business. We see opportunity. LGI is a high margin business generating sustainable, quality earnings. It has a sound history of FCF generation. In a world where a lot of "green" credentialled companies fail to clear the hurdle of a reasonable return, LGI stands out as a viable option in our opinion.

Service Stream Limited (SSM.ASX) is an infrastructure services provider of design and construction (D&C), and operation and maintenance (O&M) for telecommunications (fixed and wireless), utility (water, power, gas), and transport (roads) sectors. Customer contracts vary between multi-year to demand driven agreements. Management has decidedly lowered the group risk profile by exiting large Design & Construction projects leading to greater confidence in the business stability of earnings and ensuing ability to pay dividends. This high volume, low margin business achieves high ROIC >20% (ex-Goodwill) due to low capital intensity. Again, we value businesses generating attractive returns above hurdle rates.

The SSM Balance Sheet is net cash. It has achieved this less than two years after a transformative acquisition (of Lendlease Services), which demonstrates its cash generation abilities. The end markets are strong. SSM continues to benefit from infrastructure investments across core verticals driven by increased digitisation, ageing infrastructure, population growth and the national energy transition. The positive outlook and good visibility of earnings has driven the stock over the last 12 months.

Conclusion

Contact Asset Management aims to invest in quality businesses for the long-term. We seek investments that inherently possess a sustainable business model and that maximise competitive advantages in their industry. Incumbents that operate in industries with high barriers to entry are structurally advantaged and welcomed, as are challengers that possess the ability to grow in attractive industries. Solid financial foundations are critical for long-term stock selection in Contact portfolios. These include appropriate Balance Sheets that are supported by robust cash flows and appropriate gearing and coverage ratios. Management teams that are consistent in messaging and action and that are financially aligned with shareholder interests provides us with a level of surety irrespective of any given macro environment.

Rob Horne (May 2024)

CONTACT
ASSET MANAGEMENT

The material contained within this note has been prepared by Contact Asset Management (AFSL 494045)(Contact). It is issued by the Responsible Entity of the Fund, Evolution Trustees Limited (AFSL 486217)(Evolution). Figures referred to are unaudited. The Insights piece is not intended to provide advice to investors or take into account an individual's financial circumstances or investment objectives. The NAV Unit Price has been used for performance reporting, however if an investor is to come out of the fund that would be done at the exit price. This is general investment advice only and does not constitute advice to any person. Neither Evolution nor Contact guarantee repayment of capital or any particular rate of return from the Fund. Neither Evolution nor Contact gives any representation or warranty as to the reliability, completeness or accuracy of the information contained in this Presentation. To the maximum extent permitted by law, Contact and Evolution disclaims all and any responsibility or liability for any loss or damage which may be suffered by any person relying upon any information contained in or omission from this communication. All opinions and estimates included in this communication constitute judgments of Contact as at the date of this communication and are subject to change without notice. Investors should consult their financial adviser in relation to any material within this document. Past performance is not a reliable indicator of future performance. Target returns are targets only and may not be achieved. Investors should consider the PDS, TMD and Reference Guide and any other material published by Contact or Evolution in deciding whether to acquire units in the Fund. This information is available at www.contactam.com.au The Contact Australian Ex-50 Fund Product Disclosure Statement (PDS), Reference Guide, Investor Handbook and Target Market Determination (TMD) is available at https://contactam.com.au/ex-50-fund-overview/