July 2018

BKI INVESTMENT COMPANY

ABN: 89 615 320 262

BKI INVESTMENT COMPANY LIMITED

QUARTERLY REPORT

Technology and Disruption

Exploring some perceived threats in the Australian market

We believe that the best opportunities for investment arise when market perception differs from reality. That belief will form a core part of this Quarterly Report where we explore the perceived impacts of technology and disruption versus what we see as actually playing out in the Australian market. In this note, we pay particular attention to the Australian Supermarket industry and aspects of the Energy market.

CONTACT
ASSET MANAGEMENT

BKI is managed by Contact Asset Management
AFSL 494045

Welcome to the 19th issue of the BKI Quarterly Report, prepared by Contact Asset Management. These reports provide us with an opportunity to communicate with shareholders on high-level topics of interest. The reports are available on the website at www.bkilimited.com.au. We also encourage you to subscribe to the BKI mailing list.

Perception verses Reality

While the content of these reports continues to evolve, we find that our key messages remain quite consistent – think long-term, stay the course, minimise your activity and expenses and try to shut out the short-term noise and volatility. We believe that the best opportunities for investment arise when market perception differs from reality. That belief will form a core part of this Quarterly Report where we explore the perceived impacts of technology and disruption versus what we see as actually playing out in the Australian market. In this note, we pay particular attention to the Australian Supermarket industry and aspects of the Energy market.

Another issue that we discuss in this report is reinvestment. We like companies who reinvest in their business as we believe this gives them the long-term focus needed to ensure the business is here tomorrow, stays relevant and delivers earnings growth and dividends for shareholders. We believe Invocare Limited (IVC) provides a good example of this – we cover IVC later in this report.

A business that can reinvest in itself and generate attractive returns is one that we want to own. On the flipside, companies that constantly engage in aggressive cost cutting programmes often destroy shareholder value. It is hard to shrink to greatness. Warren Buffett made the following comment on this:

> *"Whenever I read about some company undertaking a cost-cutting program, I know it's not a company that really knows what costs are all about. Spurts don't work in this area. The really good manager does not wake up in the morning and say, 'This is the day I'm going to cut costs,' any more than he wakes up and decides to practice breathing."*

Since IPO in 2003, BKI's investment strategy has been, and will continue to be, focused on research driven, active equities management. We invest for the long term, in profitable companies, with a history of paying attractive dividends.

A company's market share, competitive advantage and business model form a vital part of the BKI investment process. We work hard to understand what the company does and how it makes money before we have the confidence to invest.

"Technology" and "Disruption" - not just relevant for start-ups

As noted, BKI seeks well-established companies who continue to reinvest in their business to ensure they stay relevant. As far as many in the market are concerned, this relevance is being tested by the words "technology" and "disruption".

Many investors, analysts and journalists are using these terms, technology and disruption, against established companies who have been around the longest. While getting in first on a stock who has a new idea or technology is in many cases very rewarding, we do find it interesting how the market just assumes that these new companies are the right ones, will be around for the long term and will generate attractive shareholder returns. This is no easy task.

A common theme with the naysayers is that technology and disruption will be the death knell of established companies and will lead to a rapid decline of both competitive advantage and market share. Without taking a deeper dive, many investors also translate this into an assumption of reduced earnings, profitability and, in a worst-case scenario, a broken business model.

In this report, we address a number of questions on the perceived impact of changes in market share:

- Just because a company within an industry has experienced a reduction in overall market share, does this mean it is going to be losing money and report lower earnings?
- What if that company is growing at the same pace as their industry or sector?
- Just because a company now shares its space with other competitors, does this really mean that earnings and profitability will decline?

Companies may very well continue to have a sustainable business model; they may very well remain relevant and continue to generate attractive returns for shareholders. What is often overlooked is what is actually happening to the overall industry growth rate. We believe that you have to put things into the longer-term perspective; otherwise you will end up seeing only the trees and not the forest.

In the following pages, we explore two sectors and one company that have been a focus of ours for some time:

- Retail - The impact of online and discounter supermarket chains.
- Energy - The arrival of alternative energy supplies, in particular solar, wind and batteries.
- Invocare - The changing nature of the funeral industry towards celebrating life rather than just providing a traditional service.

These sectors and company are at the forefront of the disruption and technology debate and will likely be for some time. Simply claiming that a company is going to lose market share and report falling profits because we are seeing "disruption" is premature in our view. Investors need to consider a number of second order effects before they can announce that a company is no longer relevant and that their business model is broken.

Retail

The Companies - In this section, we focus on Woolworths Group (WOW) and Wesfarmers (WES), both important companies in the BKI Portfolio. Of note, we don't own Metcash (MTS), which we believe has been a victim of the changing industry dynamics.

Woolworths continues to lead the Australian supermarket industry as the Fresh Food People. An established company with over ninety years of experience under its belt, Woolworths employs over 110,000 staff and is valued at over $40b. It has 445,000 shareholders with millions more having an indirect shareholding through their superannuation fund.

Wesfarmers Limited is also the owner and operator of supermarket chain Coles. Founded in 1914, Coles today operates over 2,500 retail stores and over 100,000 employees across its network. As an aside, Coles will soon be spun out of its conglomerate parent and trade on the ASX as an independent entity. This is expected to occur in November 2018.

The Disruptors - German discount supermarket chain ALDI, established over a century ago and who now has over 10,000 stores in 20 countries, with an estimated combined turnover of more than €50 billion. Aldi arrived in Australia in 2001 and now has over 500 sites nationally.

New entrant Kaufland is a subsidiary of the Schwarz Group, the world's fourth largest retailer. Their website states that they "operate is more than 1,230 stores in Germany, the Czech Republic, Poland, Bulgaria, Croatia, Romania and Slovakia with more than 150,000 employees across Europe… We are growth-oriented… continually assessing expansion possibilities in new markets… and are currently conducting a feasibility study by analysing the Australian market."

In the medium term, Amazon.com is another potential disruptor. We watch this dynamic play out with interest and believe that the Fresh segment of Supermarkets will be more difficult to disrupt. This was certainly a takeaway from our Amazon.com visits in Seattle in May.

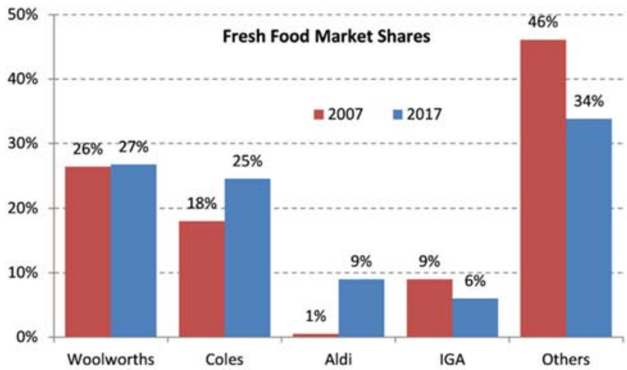
The Technology - Online Shopping: Woolworths Group is staying relevant and defending its market share through technology. Woolworths is reinvesting in their business by targeting operating capital expenditure of $1.8bn in FY2018 to help refresh and refurbish existing stores, and to rollout new stores. They are also using technology to offer customers:

- On-Line Sales with:
  - "Pick Up" to over 1,000 Australian Food sites
  - Over 20 Pick Up sites offering "Drive up/Drive through"
- Woolworths Voice Assistant for Google Home to build shopping lists
- Woolworths Metro for self service and grab n' go

All these initiatives are designed to attack the discounters from "disrupting" their market. It has been implemented by good quality managers who generally want to offer a better product to their customers. They also want to win new customers, stay relevant, protect their business model and ensure Woolworths Group is around for the long-term.

The Result - As published in IBISWorld Industry Report, "Supermarkets and Grocery Stores in Australia", October 2017, Nathan Cloutman stated that "The industry is expected to recover and grow by 1 per cent in 2017-18, to a total of $101.1 billion".

The barriers to entry into the Australian Supermarket industry remain high. Since 2007, Morgan Stanley estimate that Woolworths' market share in fresh food has grown from 26% to 27%, while Coles' has grown from 18% to 25%. This research goes against the perception that Aldi have come in and taken share from the leaders. The real loser here continues to be the independents (including Metcash), with their share having reduced from 46% to 34% since 2007 and IGA falling from 9% to 6%.



Fresh Food Market Shares

Source: Roy Morgan, ABS, Morgan Stanley Research

There is some commentary now that suggest that with the possible arrival of Kaufland there is very little market share left to take from the independents and it will now impact Woolworths and Coles. However, our view is that both Coles and Woolworths have one very clear advantage when it comes to their footprint: Location, Location, Location.

In the first half of FY2018, the Woolworths Australian Food division (Woolworths Supermarkets) grew sales 5% from $18.4m to $19.3m and EBIT by 11% from $811m to $901m, assisting the broader group to deliver Earnings per Share growth of 32.4% and dividend growth of 26.5%.

Coles has also assisted their parent company over the years, with 9.5% EBIT CAGR and a 95% increase in operating cash flows since FY2009.

This is not a new perceived threat. We wrote a BKI Quarterly in June 2015 and compared a basket of goods between Aldi, Coles and Woolworths. The traditional retailers matched up well. The perception of Aldi's threat was overplayed then and we consider it is overplayed now. Woolworths share price bottomed soon thereafter (at $20.50) and we quoted Henry Singleton (as we added to the BKI position in WOW), "It is good to buy a large company with fine businesses when the price is beaten down over worry." WOW has rallied to over $30 and paid an additional $2.76 in fully franked dividends since.

With these industry numbers, and high growth rates in Australia expected from income and population growth, we question the bear case against Woolworths Group of lost market share and deteriorating profits. Disruption and increased competition has forced Woolworths (and Coles) to invest in technology. In our view, the traditional supermarkets have adapted well and are now even stronger businesses. We continue to believe that Woolworths and Coles are well placed to fend off these threats going forward and stay relevant and profitable for investors for the long-term.

Energy

The Company - The New Hope Group (NHC) is an Australian owned and operated diversified energy company. Business interests and operations include coal mining, exploration, port operation, oil, agriculture, innovative technologies and investment. NHC, which listed in 2003, is ranked as one of the 100 largest ASX listed companies by market capitalisation. New Hope is an industry leader in best practice rehabilitation, including the award-winning progressive rehabilitation at New Acland Mine.

NHC is a Top 10 holding for BKI and was the best performing stock in the portfolio in fiscal 2018.

The Disruptor - The world is electrifying, with electricity consumption growing strongly. The mix of fuels used in power generation will change significantly, driven by the emergence of renewable energy, mainly solar and wind. BP Energy Economics forecasts that renewables will account for around 50% of the increase in world power consumption and that the market share of renewables of total power generation will increase from 7% in 2018 to around approximately 25% by 2040.

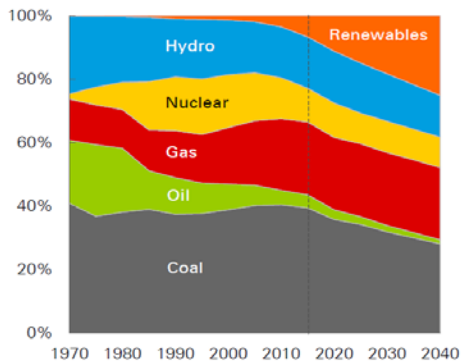
The Technology - Energy efficiency improvements, with the use of the battery one of the main drivers for change. However, despite these increased gains in energy efficiency, the global trend towards increasing urbanisation is set to continue, with approximately 2 billion people forecast to live in urban centres by 2040. As such, energy demand is expected to grow by up to 35% over the next 25 years.

Deploying high efficiency, low emission (HELE) coal-fired power plants is a key first step along a pathway to near-zero emissions from coal with carbon capture, use and storage (CCUS).

HELE technologies are commercially available now and, as stated by the World Coal Association, if deployed, *"can reduce greenhouse gas emissions from the entire power sector by around 20%."*

The Result - What seems to be forgotten when talking about energy is that a majority of the growth in energy consumption is from fast-growing, developing countries. It is estimated that China and India could account for half of the growth in global energy demand. Coal continues to provide the main source of energy supporting India's economy, accounting for 45% of the increase in energy demand. Over 70% of the increase in coal consumption feeds the power sector as India seeks to provide access to electricity to its entire population.

So, while on a headline number, the perceived loser in the arrival of renewables is coal, BP Energy Economics is forecasting that coal will still account for 13% of the increase in power over the next 20 years. Coal remains the most affordable and thus the largest source of energy used for power. By 2040, forecasts suggest that the market share of coal will still be significant at 30%.



Market shares of Total Global Power Generation
Source: BP Energy Economics, BP Energy Outlook 2018 Edition

It is this 30% market share that will continue to see coal producing companies deliver increased earnings and dividends to their shareholders for many years to come.

Industry analysts, Commodity Insights, recently prepared a paper for the Minerals Council of Australia and found that despite the perceived loss in market share, *"Asia's thermal coal import demand is expected to* **grow** *by more than 400 million tonnes (Mt), from 740Mt in 2017 to 1147Mt by the year 2030."*

Utilisation of HELE technologies has resulted in material efficiency increases, and a dramatic improvement in the amount of energy that can be extracted from a single unit of coal. By using this technology, the World Coal Association studies show that moving the current average global efficiency rate of coal-fired power plants from 33% to 40% could: *"cut two gigatonnes of CO2 emissions now, while allowing affordable energy for economic development and poverty reduction."*

To put this into perspective; Two gigatonnes of CO2 is equivalent to:

- India's annual CO2 emissions
- Running the European Union's Emissions Trading Scheme for 53 years at its current rate, or
- Running the Kyoto Protocol three times over.

Worldwide it is expected that there are 1,600 new coal-fired power plants planned and under construction in 62 countries. Many of these power plants are utilising HELE technology.

Invocare Limited

The Company - Invocare Limited (IVC) owns and operates funeral homes, cemeteries and crematoriums in Australia and NZ. It is the clear market leader in its field. IVC's activities include the provision of funerals, burials and cremations through its funeral home brands including Blackwell, Guardian, George Hartnett, Le Pine, Purslowe, Simplicity Funerals and White Lady Funerals.

The Disruptor - Disruption is coming from changing customer needs rather than a new entrant. Invocare's reported market share has been depleting in the "traditional sector" for the last 5 years. This is the old style of funeral with a funeral director creating the plan and informing families how the ceremony will proceed. Invocare is changing the offering and as the largest operator in our market is becoming the disruptor.

The Technology - Audio visual and communications. Invocare are investing heavily (c. $200 million) over the next few years as part of their "Protect and Grow 2020" plan to meet the changing demands of the industry driven predominantly by baby boomers. These individuals want more from their funeral services than has been offered traditionally; they want a celebration and they want that to be captured through audio-visual technology.

The Result - Invocare management are wide-awake to the changing customer needs and is focused on **growing** its market leading position. No one can match the investment that IVC is making which we believe will see it in an enviable position for many years to come.

IVC is adapting their strategy to allow for this customisation across their premium, standard and budget segments.

As part of Invocare's Network and Brand Optimisation programme in the Protect and Grow plan, refurbishments have created open, inviting facilities that will meet the contemporary needs of the customer. At its 2018 Annual General Meeting Invocare stated that "overall market share, in the markets that IVC operates, is modelled to increase from 33% to circa 40% over a ten year period."

Funeral Homes of the Future
Source: Invocare 2018 AGM presentation

In investing, we believe that the wonderful opportunities are when the perception of a company changes. That is a chance for outsized returns.

At BKI, we will continue to think longer term. When we think about appropriate valuations, it is the price we pay for earnings five years out that interests us rather than the short term. We think it is dangerous for investors to get too caught up in the next big thing. We believe that the tried and tested companies that continue to reinvest in their businesses will do well. Disruption should not be ignored; however, we think it inappropriate to get overly spooked on "what ifs?". The negative argument is always easier to believe – it is important to stay the course.

Tom Millner
Contact Asset Management