IML INVESTORS MUTUAL LTD

Quality Is Always Important… Now It's Critical

by Daniel Moore
6 July 2020

It's safe to say the Australian economy is currently experiencing a recovery as businesses continue to re-open following the worst of the COVID crisis. Despite this, there remains a significant amount of uncertainty in the world and as long-term investors, it's difficult to determine what the sustainable level of demand looks like.

The recurring theme that we're hearing from the companies we speak to as part of our in-depth research process is uncertainty. The IML research team have spoken to management teams from over a hundred companies over the past few months to get a feel for the impact on their business of this current situation, and what their companies' prospects are for the future. Nearly every company is looking to manage costs via reducing the number of employees, limiting marketing spend and cutting back on capex.

So given this uncertainty, we do see risks in the outlook for the future. We obviously do not know for sure what the future holds but if these risks eventuate, we believe investing in good quality companies is going to be absolutely critical.

Defining Quality

Quality means different things to different people. At IML we have defined quality in the same way since the company was founded by our Investment Director Anton Tagliaferro in 1998. Firstly we look for companies with a strong ***competitive advantage***, which means they are industry leaders and they are number one or two in their category for some special reason. We invest in companies with **recurring, predictable earnings**, run by ***capable and experienced management*** teams and we obviously want to invest in companies that can ***grow their earnings*** over the next three to five years. Of course, we want to be able to buy those companies at a ***reasonable price***. These are the attributes we look for when we invest in companies for the long term.

Quality in the COVID Environment

There's no doubt our focus on quality is heightened when looking for opportunities in the current environment. With so much uncertainty around the economic outlook, we are also looking at IML's long-standing quality attributes through the lens of the COVID crisis.

We want to invest in industry leaders, and this is really important on a number of fronts. If the demand environment is weaker, or competition becomes more intense, is it likely to lead to price falls in industries. Industry leaders are usually able to withstand the short-term impacts of lower demand, or potentially lower prices due to their scale and higher margins, giving them more flexibility to hold onto customers. Industry leaders also have the capability to withstand the storm whereas the smaller players with less scale and with lower margins, are unlikely to have the capacity to lower prices for an extended period of time in order to retain customers.

Over the past few months, another thing we are seeing across many industries and sectors is a significant drop in customer churn rates meaning customers are less likely to switch to new products or services. The telecommunications industry's churn rate is at a record low, and churn rates across electricity and insurance are also at very low levels. One of our conclusions from this is that customers are quite loyal at the moment and businesses that require new customers each year to make profits are more at risk. Whereas businesses with predictable, recurring earning streams from existing customers are a much lower risk prospect in quite an uncertain world. We're really looking for those companies that don't need to win new customers, as it is quite a difficult period to build trust.

Another insight we have gained is that almost all consumers and companies are going over their budgets forensically to see which expenses are justified. Therefore, the greatest risk lies with companies providing a good or a service that is non-essential or something that could be substituted for a cheaper option. So IML's focus is on companies that provide an essential product or service – such as telecommunications, supermarkets selling food and liquor or companies that provide critical infrastructure. These are the companies which are a much lower risk if the demand environment gets weaker in the future.

We are also looking for companies that can grow earnings because of their own specific initiatives, irrespective of the headwinds weighing on a business from the current economy. We like to invest in companies that have strong cost out or restructuring programs, companies we feel confident that can gain market share over time, or companies where they have some contracted growth. These companies potentially will have quite a different earnings profile from others that are very reliant on the economy to grow their earnings.

These growth initiatives usually are put in place by experienced management teams with a good track record of navigating previous cycles. We want to see invest in companies with management teams that can refer back to past experiences and hopefully call upon some corporate memory of how to deal with recessionary periods. We spend a huge amount of time talking to companies and what we really want to see is management that are preparing the company for a number of different environments or scenarios… whether the economy recovers completely back to where it was before, or whether the demand outlook is going to be lower. Companies that are forward looking and on the ball tend to pick up market share, and they are more likely to come out of the crisis in better shape. Unfortunately, those that are on the back foot and reactionary are more likely to lose market share, which is very hard to get back in the longer term. This how we are assessing management teams in the current environment.

Quality Companies Shine Through in a Weaker Economic Environment

Coles

As the second largest supermarket player in Australia, Coles is quite a simple business with its earnings made up 90% from its supermarkets and 10% from liquor sales. It's a business with a very strong balance sheet with very little debt and fantastic cash flows. Coles also has negative working capital, which means its customers pay upfront for goods and services, and the company can pay its suppliers a bit later. The benefit of this – especially in the current economy – is that Coles has no risk of bad debts. The management team are relatively new, but very experienced, and they're making some real good, positive changes to the business, which we think can deliver growth over the next three to five years.

In our view, Coles can achieve growth in the next few years as it is coming off quite a low base in regard to its margins and its operating potential. Under previous management the company's margins had been going backwards and as of last year were at almost a 10-year low. That margin is 150 basis points below Woolworth's margin, which - given the sales productivity of Coles and Woolworths are almost identical – means that margin gap is largely due to Coles' operational inefficiencies. So we see significant potential to improve that margin over the next few years, if management executes their strategy well.

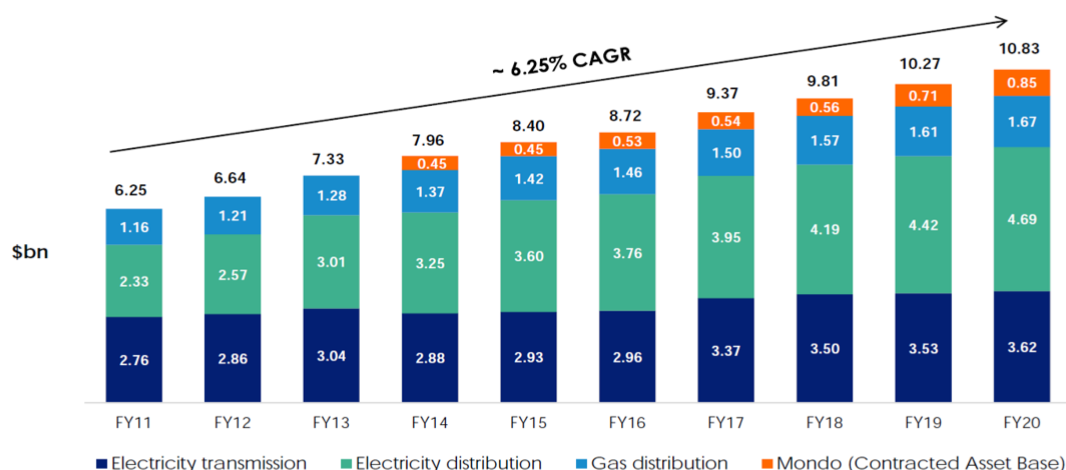
Another aspect that we believe will deliver growth is an ambitious cost out program of over a billion dollars, which involves several elements. One of the key elements to that plan is to redesign, consolidate and automate their supply chain. At the moment Coles has five Distribution Centres (DCses), in both New South Wales and

Queensland which are sub scale and in particular Queensland is at capacity. These DC's are very expensive to run as they are not automated so they require a lot of staff. So over the next five years, Coles plans to consolidate a number of those sites into fewer highly automated warehouses. This will remove significant costs from the business over the next three to five years. As one of the non-discretionary sectors, as mentioned above, our view is that demand for supermarkets will remain quite solid no matter what the economy does. So Coles offers good demand growth despite the potential weak economy, as well as company specific growth drivers. On top of that, the company is paying a 4% fully franked dividend, which we think will also grow over time.

AusNet

AusNet is a regulated utility which owns electricity and gas distribution as well as transmission networks in Victoria and South Australia. These are regulated monopoly assets, so AusNet's earnings are highly predictable. In addition the demand outlook for these assets is quite strong, as Chart 1 shows AusNet's asset base has been growing at about 6% per annum.

- FY11-FY20 asset base growth of ~6.25% p.a. CAGR



Source: IML & AusNet FY 2020 Results presentation; As at 12 May 2020

This growth is driven by a number of factors, including population growth and the investment in renewable energy that's being made by governments and private companies. Those renewables need to be connected to the grid through AusNet and that grows their regulated asset base. So in the current environment, demand for electricity will continue. Although demand is strong, Ausnet actually has no demand risk as its earnings actually aren't reliant on demand. The government guarantees a level of earnings based on the investment AusNet already have making it one of the safest earning streams in the Australian sharemarket. AusNet also have a quality management team and a strong balance sheet making it, in our view, a very attractive investment. The company is now paying a yield of 5.5%, 50% franked, and we see that yield growing about 2-3% per annum over the next three to five years.

Conclusion

Stockpicking is really going to be key in the current environment where demand could be weaker. We think it's a time to invest cautiously to protect the capital of our clients because that future environment is quite uncertain. IML portfolios are invested in a number of quality companies, such as Coles and AusNet as well as companies such as Telstra, Amcor, Brambles and Orica. These companies have been around for a long time proving their businesses can deliver recurring earnings through the economic cycle and which we believe can do well even if the environment does get tougher. We think that these businesses will weather economic down periods quite well and will merge stronger out the other side.

While the information contained in this article has been prepared with all reasonable care, Investors Mutual Limited (AFSL 229988) accepts no responsibility or liability for any errors, omissions or misstatements however caused. This information is not personal advice. This advice is general in nature and has been prepared without taking account of your objectives, financial situation or needs. The fact that shares in a particular company may have been mentioned should not be interpreted as a recommendation to buy, sell or hold that stock.