IML INVESTORS MUTUAL LTD

Why Holding Good Quality Stocks Matters

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Quality is one of the key aspects in Investors Mutual's investment decision-making process. In this article, we discuss why we focus on quality, the factors we consider, and provide examples of well-established quality companies with attractive fundamentals which are cornerstone holdings in our investment portfolios which will over time enable us to deliver sustainable capital growth and tax-effective income.

Why Focus on Quality?

At Investors Mutual (IML), we have defined quality in the same way since our foundation in 1998. We look for companies that have a strong competitive advantage, generally the number one or two in their industry; that have recurring, predictable earnings; that are run by experienced and capable management teams; that can grow their earnings over the next three to five years; and that based on our research are trading at a reasonable valuation.

Why focus on 'quality'? We believe that quality companies are most likely to produce sustainable cashflows over the long term for the owners of the business. These cashflows will be returned to shareholders either through dividends or buybacks, or retained for reinvestment to increase the value of the enterprise. Sustainable, reliable cashflows that can grow over time underpin valuations in both times of market volatility and relative stability. They tend not to inspire speculators chasing momentum and 'blue sky' during rapidly appreciating late phase bull markets but are key fundamentals that ultimately underpin every asset's valuation.

While good quality companies are expected to deliver steady and sustainable cashflows, these companies are also more defensive in times of market stress, as their reliable businesses and cashflows underpin their valuations, as was demonstrated in the March 2020 downturn and previous downturns.

Many quantitative metrics are available when assessing companies. These include valuation ratios such as price/earnings and enterprise value/earnings before interest, taxes, depreciation and amortisation (EV/EBITDA), and performance metrics such as return on equity, asset turnover, and operating margins. Although quantitative metrics are useful lenses for understanding the fundamentals of a company, we believe that identifying quality is more often reliant on judgement, and that many aspects of quality are not easily captured numerically. At IML we use a scoring system based on a range of factors that we believe delivers a deeper and more holistic view of a company's quality, which can at times be at odds with a purely quantitative view.

Quality includes several factors which we group under franchise, management and financial strength. Of these factors, competitive position, management quality, accounting transparency, and environmental, social and governance (ESG) issues are poorly captured by a quantitative approach. While some other factors such as balance sheet strength and capital intensity can be assessed quantitatively, these are some of the key factors that require experienced and considered judgement.

Competitive Position

While competitive position may appear to be captured by metrics such as return on equity (ROE) or margins, this is not necessarily the case. Commodity producers such as mining companies will earn high ROE and strong margins in commodity price booms or during periodic shortages, but fundamentally have limited pricing power. For example, for several years the oil price hovered around $US100, and oil and liquefied natural gas producers generated strong margins and returns, whereas more recently many of these companies are not much above breakeven.

By contrast, **CSL** produces a commodity product, intravenous immunoglobin (IVIG) from blood plasma, and enjoys a very high margin on this product. However, CSL's competitive position is very strong because the company has invested well ahead of competitors in plasma collection centres and has worked hard to enhance collection efficiency, with CSL enjoying the lowest cost position in its industry. New competition is highly unlikely because of the regulatory hurdles in place involved in production of safe blood products, and price pressure is limited by the lack of new competition and the relative inefficiency of competitors.

A strong competitive position such as a monopoly with long licences may not make high returns, but the returns produced will be much more sustainable than the average business. **Crown Resorts**, for example, has a substantial asset base and owns significant property assets, and so makes unexceptional returns when looked at from an ROE point of view. However, the cashflows the firm generates are very durable because of the firm's long monopoly-type licenses. Similarly, **Tabcorp**'s long duration lotteries and wagering licences are very valuable, but are not reflected in high returns. We believe Tabcorp can be better managed to take advantage of the amazing franchise that its licences represent, and we are encouraged by recent developments on this front.

Management Quality

Experienced management teams with good track records are generally well-equipped to deal with cyclical shifts in demand and changing economic conditions. While management quality is often assessed by growth in earnings and share price performance, a deeper assessment is required to understand the sustainability of the business. Earnings may increase if management pushes prices hard, but this may be at the expense of future returns. Reducing expenses in research and development, information technology, safety, sales, and marketing and advertising are frequent tricks employed by private equity to dress up a business' earnings before a public offering, but cost-cutting measures like these can hurt a business' longer-term returns through lack of investment for the future.

At **James Hardie Industries**, for example, Louis Gries (chief executive from 2012 – 19) pushed hard to increase earnings, but the company experienced safety incidents and production inefficiencies which hurt earnings for several years, as expenditure on maintenance and safety had to catch up. By contrast, CSL's management plans 10 years ahead, expenses items that could be capitalised, and does not chase short-term profits.

One of the key functions of a company's management (and board) is capital deployment. Poor deployment of owners' assets is often clear in hindsight, but it is more useful to be able to make the assessment before the sorry results are obvious to all. **Fosters**' purchase of **Beringer Vineyards** and then **Southcorp Wines** diluted a very strong beer franchise in pursuit of building "a global alcoholic beverage giant". The wine business was later spun off after years of poor returns for the entire business. Similarly, **Boral**'s acquisition in 2016 of US fly-cash company **Headwaters** – on the grand vision of transforming Boral into a global construction materials and building products firm – seemed to us a poor decision at the time, which has been vindicated by the subsequent impairment of the value of those assets as it never earnt a reasonable return.

Accounting Transparency

Accounting transparency is something that is often hard to quantify, but it is a very important factor when analysing companies. There are many tricks that management can use to inflate short-term profits, including

the use of provisions, the reclassification of maintenance costs as capital investment, the regular reliance on significant items, and the writing down of fixed assets which lowers future depreciation (since many analysts focus more on earnings before interest and taxes than the balance sheet). **Boral**, for example, impaired assets in its Australian construction division and claimed to have increased profits the following year when profits moved up much less than the decline in depreciation and as stated returns rose because the asset base after the writedowns was lower. Simply looking at operating cashflow relative to EBITDA will not capture all the nuances of conservative or aggressive accounting.

Environmental, Social and Governance Factors

Environmental, social and governance (ESG) issues are also often key influences on a company's value. As an active value manager with a long-term time horizon, our investment philosophy is based on the premise that a company's share price will eventually reflect its underlying value. This leads us to focus primarily on the longer-term underlying valuations of companies. We recognise that companies with good ESG records are likely to be beneficial for underpinning investment returns. Our analysts and portfolio managers rank their level of confidence in a company's current and future earnings. The earnings of companies with a good ESG record are likely to be less volatile and therefore more predictable in nature. The confidence ranking is considered in conjunction with valuation for the purposes of portfolio construction.

A formulaic assessment of ESG falls short of delivering a comprehensive view on the sustainability of the business and the durability of its social licence. Boards might tick the box on governance – perhaps gaining extra credit for having several women on their board, or a female chair – while presiding over a company culture and structure facilitating customer overcharging and being economical with the truth when dealing with regulators, as was the case with **AMP**.

Fletcher Building has been a comparatively poor investment for us because of mistakes made by past company management. However, for several years the company has been lowering the carbon intensity of its cement facility so that its cement now generates significantly lower carbon emissions than competitors, and carries an environmental product declaration (EPD) label. Construction materials is a high carbon emission industry, but Fletcher already has nine EPD labels with five pending. This focus will stand the firm in good stead when bidding for work from government and other customers, as well as helping the cause of global sustainability.

Further Examples of Quality Companies in IML's Portfolios

Amcor

Amcor is one of the largest global suppliers of flexible and rigid packaging to customers predominantly in the defensive food, beverage, and healthcare sectors. The firm's operations are highly cash-generative and have produced steady earnings and dividend growth over time thanks to organic growth as well as bolt-on acquisitions. Amcor's scale and customer and geographical diversification reduce earnings risk through the cycle and generate significant free cashflow for shareholders. Amcor's ongoing organic growth should drive mid-single-digit earnings growth over the next few years, and the firm deploys excess free cashflow after dividend payments for bolt-on acquisitions to supplement growth. Amcor is also at the forefront of using recycling plastics as an input for its products. Our outlook is for reasonable total returns factoring in both earnings and dividend growth, although what is most attractive is the resilience of the earnings profile.

Brambles

Brambles, through its subsidiary CHEP, is the global leader in pallet pooling solutions, which are used by companies such as **Proctor & Gamble**, **Unilever**, **PepsiCo**, and many others to deliver their products to retailers such as **Walmart, Costco, Amazon.com, Tesco, Carrefour** and **Woolworths**. CHEP holds the clear number one market share position in about 60 countries including about 70 - 80% market share across the largest pallet

markets in the US, UK, Europe, Latin America and the Asia-Pacific. Consumer staples account for approximately 80% of Brambles' revenues and underpin the resilience and defensive qualities of the business.

Over time, Brambles' revenues and earnings should continue to grow at mid-single digit rates, driven by growth in emerging markets where pallet use is still developing; by converting customers in mature markets from single use, disposable pallets to pooled pallets; and through modest price inflation. Because CHEP pallets are used for everyday consumer items, Brambles should deliver this growth in a relatively consistent and low-risk manner.

Brambles is very well run by its management team. Investments in automation and supply chain efficiencies across the US are driving margin improvement there, while the Latin American business has been restructured to have a greater focus on pallet retrievals, making this activity a cash contributor to the group rather than consuming cash. Management is also actively investing for the future, with research and development projects focused on tracking technology and data solutions that will add value for the business and its customers.

Metcash

Grocery and liquor wholesaler **Metcash** has invested heavily in recent years in efficiency programmes to ensure that its independent retailer network can compete effectively with the other larger supermarket chains. Metcash received an unexpected boost during the COVID-19 lockdown as more shoppers switched to the convenience of neighbourhood stores. Feedback from new and returning customers to IGA stores has been positive, and we expect Metcash to retain a portion of these customers going forward, which should help Metcash's food business return to growth for the first time in many years.

Liquor trends continue to favour retail liquor stores, with Metcash's network – which is the clear number two behind Woolworths – expected to continue to do well.

Hardware trends have also been positive, with Metcash represented by brands Mitre 10 and Home Timber & Hardware. While sales in this division are cyclical and reliant on activity in the building and renovations sector, Metcash's Hardware division remains the clear number two player in Australia behind Bunnings, and still has scope to make bolt-on acquisitions to grow its scale and footprint in this segment.

Metcash's food, liquor, and hardware divisions should all benefit from improved independent retailer profitability. We expect this – plus the recent tax incentive schemes announced in the latest Federal Budget – will encourage store owners to reinvest in the customer proposition, further strengthening the independent retailer offer that Metcash's wholesale division supplies.

Telstra

Telstra has about 50% market share of both the Australian mobile and fixed line markets. The mobile industry has been highly competitive in recent years, as Optus has been aggressive with pricing in a bid to gain market share. This strategy by Optus has dramatically reduced profits across the telecommunications industry. Telstra's economies of scale and network quality advantages mean that it is currently the only player able to earn meaningful sustainable margins, and despite increased recent competition, Telstra has still been able to grow its market share to a record high of 55% of industry revenue.

Optus' recent results have indicated that the company is losing customers and it is now loss-making at the underlying net profit level. In order to achieve an economic return on invested capital on future network investments, such as the 5G rollout, we believe it is only a matter of time before Optus returns to a more rational pricing strategy which should benefit the mobile industry's profitability.

Telstra is also extending its network advantage with the rollout of 5G to cover 75% of the population by the end of financial year 2021. This differentiated offering will enable Telstra to win high value customers, increase prices, and grow its earnings despite the competitiveness in the mobile sector.

In addition to this, at its recent strategy day Telstra signalled its intention to monetise some of its very valuable infrastructure assets, including its towers division and some of its other physical infrastructure assets such as its data centres and subsea cables. Given the high prices being paid for these assets, we believe that any such monetisation of these assets by Telstra would be very value-accretive for shareholders.

Telstra is a well-managed company which generates strong cashflows and has a sound balance sheet and will continue to generate a very attractive and sustainable dividend yield.

Conclusion

In these fairly uncertain times, in our view a focus on owning good quality companies remains more important than ever. Many investors own or are chasing high-profile 'high growth' companies such as those in the currently popular technology and medical technology sectors. This skew towards growth and momentum has left many good quality companies looking very attractively priced.

A portfolio of these high-quality, well-established companies with sound fundamentals and strongly defensive characteristics, selected judiciously on the basis of quality and value criteria, will prove to be very effective in delivering long-term capital growth and tax-effective income in the years to come.

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