Quality mid and small cap companies produce positive results despite COVID-19

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In a reporting season where most small and mid-cap companies reporting were materially impacted by the disruption caused by COVID-19 and a change in consumer patterns – some positively and some negatively – it was reassuring to see the vast majority of the core holdings in IML's mid-/small-cap Funds report positive results for the first half of the 2021 financial year. This once again reinforced our belief in the benefits of owning good-quality, well-established businesses that generate real cashflows, real earnings, and real income from dividends, and which trade on reasonable valuations.

Bega Cheese

Bega Cheese recently completed the acquisition of Lion Dairy & Drinks, continuing its transformation into a diversified branded food company owning a portfolio of successful, well-known brands such as Vegemite, Dairy Farmers, and Yoplait yoghurt. Bega's result for the first half of the 2021 financial year was very positive, with net profit after tax (NPAT) (A$29.7 million) and earnings before interest, taxes, depreciation and amortisation (EBITDA) both growing strongly. The result highlighted Bega's growing skillset at managing its portfolio of consumer brands, as well as the company's ability to extract greater value from its milk supply network. Export branded sales also increased strongly, despite the impact of the rising A$.

Bega's capable management team continues to grow the business successfully by buying assets at good prices and through the extraction of synergies. The recent acquisition of Lion Dairy & Drinks provides cost and revenue synergy opportunities which will underwrite earnings growth over the medium term.

Integral Diagnostics

Integral Diagnostics is a leading provider of diagnostic imaging in Australia. Integral's result for the six months to 31 December 2020 was very positive, with NPAT of A$23.2 million and A$52.0 million in EBITDA, on the back of solid volume growth and strong increases in the average fee per test. The result demonstrated the benefits of the company's geographical diversification across Australia and New Zealand, as well as the move towards increased specialisation, a focus on higher end scans sustaining demand for radiology services during the COVID-19 environment and generating higher fees.

Integral should continue to benefit from the long-term growth drivers of Australia's ageing population and from advances in technology enabling earlier screening, diagnosis, and treatment of cancers and other medical issues. The company's management team continues to grow its business' margins effectively by optimising staff to patient demand, using technology to improve the patient and referrer experience, as well as through greater use of scanning technology. We also expect Integral Diagnostics to maintain its effective track record of acquisitions which are strategically aligned and earnings-accretive.

MNF Group

MNF Group is a leader in cloud-based communications in Australia and New Zealand. MNF produced an excellent result for the six months to 31 December 2020, with A$8.4 million in net profit after tax, up 30% on the first half of the 2020 financial year. The company produced record growth in addition of numbers to its network in calendar year 2020, its 5.1 million number network up 24% on the first half of the 2020 financial year.

MNF's highly competent management team has built a blue chip business-to-business customer base, which includes virtual number hosting for Uber and Carsales.com and operating as an audio provider for Zoom and Teams. A growing proportion of MNF's revenue is high margin recurring software-as-a-service (SAAS)-type revenue. The company has promising growth prospects in an Asia-Pacific region with little direct competition, and is trading on a very reasonable 19 times earnings. MNF is a major beneficiary of the acceleration in network complexity and virtual networking, and we expect this to be increasingly reflected over time in the company's share price.

Nine Entertainment

Nine Entertainment is the largest media company in Australia spanning the television, streaming video, online real estate, newspaper publishing, radio and digital media sectors. Nine grew its net profit after tax by 79% to A$181.9 million for the first half of the 2021 financial year, an extremely commendable result given the challenging conditions for advertising in the COVID-19 environment. While a sharp rebound in television advertising has driven near-term earnings growth, long-term value creation is being driven by the continued strong growth of the company's digital assets. Digital earnings grew 53% year-on-year and now account for 41% of earnings, which we expect to rise to around 60% over the next three years.

The Stan streaming business' subscriber growth accelerated in 2020, with 2.3 million subscribers now signed on, making Stan the clear number two to Netflix in Australia. The long-term deal with NBC Universal also secures premium content for many years. Between Stan and digital subscriptions at the mastheads, Nine has an increasing proportion of high-quality recurring digital revenue. Domain's ongoing listings recovery and the expectation of carriage fee agreements with Facebook and Google should also provide earnings tailwinds. Nine has a solid balance sheet, low debt, and is trading at around 15 times earnings, with an increased payout ratio or share buyback a possibility.

Pact Group

Pact Group is a leading manufacturer and supplier of rigid plastic and metal packaging in Australia, New Zealand, and increasingly internationally. Pact reported a very strong result for the first half of the 2021 financial year, reporting an A$52.0 million net profit after tax, up 59% on the first half of the 2020 financial year. This was largely the outcome of strong volume growth, in particular from the materials handling and contract manufacturing businesses, as well as strong cost management and lower interest expense. The strong cashflow generated over the previous 12 months helped Pact's balance sheet improve markedly, and enabled the company to return to paying dividends to shareholders.

Pact has increasing earnings exposure to the growing plastics re-use and circular economy (such as returnable plastic crates and garment hangars), which creates a genuine competitive advantage for the firm's core packaging business. The reorganisation of the packaging segment should produce continued efficiency improvements and the opportunity to improve margins in the years ahead. The refreshed and excellent management team at Pact is bringing improved capital allocation discipline, while the focus on sustainable solutions will provide a source of sustainable competitive advantage. Pact remains an attractive business with predictable recurring cashflows and a very reasonable valuation.

Pro-Pac Packaging

Pro-Pac Packaging is the number two player in the flexibles packaging sector in Australia behind Amcor. Pro-Pac produced a very positive result for the first half of the 2021 financial year, reporting a net profit after tax of A$6.2 million off the back of robust operating performances from all the company's divisions.

Pro-Pac has strong recurring earnings from its packaging operations, a much improved balance sheet, and a focused, highly-motivated and very capable management team. The company is also proceeding with substantial cost savings from factory site consolidations and is deploying a new information technology system which will benefit the company greatly in the years ahead. Pro-Pac recently completed the acquisition of Melbourne flexibles manufacturer Supreme Packaging, and will continue to use its healthy balance sheet for further accretive acquisitions.

Conclusion

The positive results from core shareholdings in IML's mid-/small-cap Funds for the first half of the 2021 financial year reiterate the rationale for continuing to invest in good quality, well-established businesses which produce real cashflows, earnings, and dividends. We continue to stay disciplined, looking to select the right companies at attractive prices to enable us to deliver very positive long-term outcomes for our investors.