Equity Fund

March 2023– Quarterly Report

Wentworth Williamson Management
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Firm belief in the character, ability, strength, or truth of someone or something - Trust

Our performance for the last month, quarter and so far, this fiscal year is -2.3%, 2.9%, and 14.7% respectively.

Our performance in March had little to do with the underlying fundamentals of our investments but more to do with trust, or lack of it, in mid to small US banks with lower regulatory oversight and a complete breakdown in confidence that markets once held in Swiss bastion of strength, Credit Suisse Group. Listed asset prices have mostly been weak across the world. The movement of information and cash moves faster now than ever before. During March, if regulators had not stepped in when they did, contagion and fear may have taken hold. Nobody wins during a credit crunch, however the strong survive and thrive after re-adjustments to normality.

We wanted to write this note on trust because it relates to all of us. The entire wealth effect of capitalism and the availability of credit is built on trust. The simple truth is that all commercial banks around the World lend money long (assets) e.g., mortgages, while mostly funding short (deposits), this model only works if there is trust. Despite the inherent fragility of the model, it has a long history of working out well over time.

From an Australian market perspective on our highly rated banks, the fact that a partly government-supported, highly regulated bank with $1.2 trillion of assets continues to earn an above market Return on Equity (ROE) of ~12.5% should make you go hmmm -Commonwealth Bank of Australia! The road ahead for net interest margins and bad debts is going to get tougher in our opinion.

We are already traveling in a new era

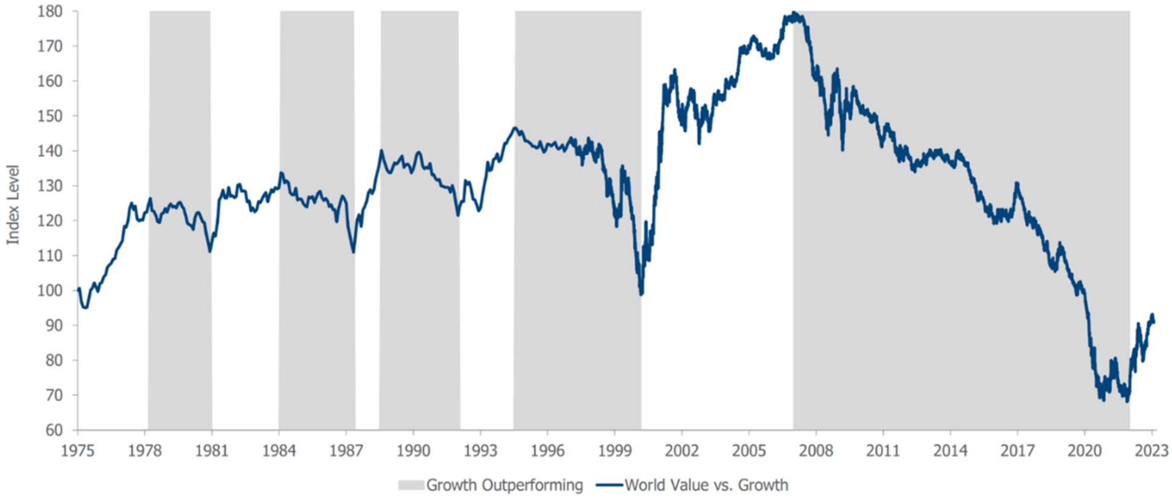
The fact that we narrowly avoided a crisis with the financial plumbing of the global financial system, is a result of us entering a new era with interest rates returning to a level that better reflects normal. With hindsight, it is not a shock that some lessor quality players in the market were caught completely by surprise.

For us, we will continue to adhere to our value-based investment philosophy because that is what we have always promised to do. We look primarily for companies as potential investments that have a long history of making money, and management teams we feel we can trust, often with tangible asset backing and trading at a discount to our assessment of fair value.

We continue to believe our strategy is in the early stage of a revival and we have high conviction it will correct back to normal. The upside potential is likely to be even greater and possibly longer than the post-dot-com bust over 20 years ago. If you trust us to stick to our knitting in the best of times, as we have done in the worst of times for our strategy, then we will be taking full advantage in the years ahead as there is significant upside reversion potential. The chart below represents the MSCI indices relative price performance in local currency of global value versus growth performance since 1975.

Global value versus growth performance

MSCI indices relative price performance in local currency



Note: Monthly Frequency until 1996. Daily Frequency from 1997 onwards.
Source: Datastream, Goldman Sachs Global Investment Research

During the quarter we took advantage of market volatility to invest in two new investments for the Fund, Aurizon Holdings (AZJ: ASX) and Alumina (AWC: ASX). Both companies are linked to Australian commodities transported to the East. See below for a comprehensive update on the investments in the Fund. As discussed earlier, we experienced a strong reporting period over February, and we expect this momentum to continue for the remainder of the year.

Update on February 2023 Results and Outlook for our Assets

SRG Global (SRG: ASX): We have maintained a meaningful position in SRG Global for several years, including through some troubling times in the past. Our confidence in the management team, which is also heavily invested in the company for the long term, by owning a substantial portion of the company themselves, has been handsomely validated. The mostly annuity earnings profile of this engineering-led global specialist company remains in a sweet spot and is well-positioned to perform well in the years ahead. We believe the exceptional earnings and free cash flow growth of over 30% for the half-year to December 2022 will be replicated with a similar growth profile for the remainder of the financial year. Additionally, the landscape over the medium term for the company remains attractive with a strong pipeline of opportunities on the horizon. Today the ~$400m market capitalisation company still only trades on a ~10x price-to-earnings multiple with a healthy net cash balance sheet. Future earnings growth and some earnings multiple expansion will continue to drive the share price of this well-managed business. The current dividend yield is ~5.5% fully franked.

Servcorp (SRV: ASX): The Group posted another excellent result for the six months to December with underlying free cash flow up ~13% and reaffirmed double-digit earnings growth guidance for the full year. The financial performance numbers of Servcorp speak for themselves, this business is in our opinion the best-run international serviced office operator in the World. With a market capitalisation today of a little over $300m, unencumbered cash of $115.6m on the Balance Sheet, and the business generating easily over $30m of free cash flow per annum, the company continues to trade on a big discount to our assessment of fair value. We believe the CEO and major shareholder, Alf Moufarrige, who is nearing retirement age, will crystalise an exit plan at a price for the company he feels better reflects fair value. In the interim we expect him to continue to buy shares cheaply on the market as he has demonstrated in recent times and we will get paid along the way with reliable dividends, and this dividend stream remained unbroken even during the worst of COVID lockdowns. The current dividend yield is ~6.4%.

Fleetwood (FWD: ASX): The FWD result in February was not good and the share price has responded accordingly. The poor result was flagged to the market late last year, so it was not unexpected, but the market has punished the share price anyway. Despite the setback, our investment thesis remains intact. The substantial net cash and property-rich conglomerate own three distinct businesses, all of which should be profitable going forward. The value proposition is as follows:

1. Break-up value: The Enterprise Value of the company today is approximately only $80m, this includes net cash on the balance sheet of approximately $40m but excludes the estimated value of the property they own adjacent to the airport in Perth, estimated by management to be worth in the vicinity of $20m. Historically, collectively the three divisions generated earnings before interest and tax (EBIT) and before corporate costs of approximately $25m. The Recreational Division should maintain earnings at ~ $7m of EBIT per annum but in our opinion, there is substantial upside potential for the earnings of the Community Solutions and Building Solutions Divisions. The break-up value looks obvious to us.
2. Community Solutions: If you go back to the financial accounts of FWD in 2011 / 2012 you will get an idea of the earnings capability of the FWD fly-in-fly-out hotel in Karratha running at full capacity. Should the Perdaman Urea plant in the region finally be given Final Investment Decision (FID) it is likely that the new contractor on the project, WeBuild Group, will sign a long-term contract with FWD for beds. Karratha is short of beds if the project goes ahead. Despite the numerous delays, we remain optimistic the case for fertilisers will prevail. If you refer to the geographic regions that produce the most fertilisers around the World, one would assume there is the political will for this project to go ahead, but you never know. Should the Perdaman Urea plant never see the light of day, the accommodation division will generate $8-$10m of EBIT each year depending on the activity levels of existing clients. Should the project get the green light, earnings for the division may go up at least three times (quite possibly four times). Current occupancy rates are at around 30%.
3. Building Solutions: We like the Modular Building division. We believe all major players in Australia have a role to play. Australia is way behind the US and Europe when it comes to Modular construction in terms of penetration rates in the building industry, and unfortunately also in terms of best practice manufacturing (and this especially applies to FWD). The current CEO, Bruce Nicholson was brought in by the major shareholders to execute a turnaround in mid-2021. It has been much harder than expected and COVID lockdowns were unhelpful to the cause! Thankfully, the company has worked through all problem contracts left by the previous regime and the senior management team has been largely refreshed with every manufacturing site in the Group now integrated using a standardised manufacturing approach. EBIT should return to ~$10m per annum, run well profitability should at least double from this level over time by achieving adequate operating margins of ~8%. Earnings visibility should also improve with a focus on standardised smaller jobs – think schools, social housing, aged care, etc.

FWD is a meaningful and attractive asset in the Fund, and we expect a substantial improvement in earnings and the share price in the months and years ahead. The Board approved dividend policy is to pay out 100% of earnings as dividends going forward. The company presently has 20 cps in franking credits available to support up to 46 cps of fully franked dividends.

AMA Group (AMA: ASX): AMA Group, Australia's largest smash repairer, has been through a torrid time over the past 3 years. Until recently all key drivers of the business were going backward. Before COVID-19 and our time as a shareholder, the board approved a debt and equity-funded 'strategic' acquisition at an exorbitant price gearing up the business at exactly the wrong time. When the pandemic hit, volumes went into reverse, the availability of labour became a problem, and then to top it all off, it became apparent the board also negotiated a price standstill agreement with their largest customer for three years. We first moved into AMA after the share price had halved but we were still too early. The next year will be crucial.

All the previously mentioned key drivers are slowly turning in AMA's favour. The company has been corporatised with an experienced management team and the board has been strengthened with some fresh experience, volumes have returned to such a level there is now a shortage of capacity in the market (my wife 'kissed' our car against another vehicle recently, so I am fully aware of the waiting time), prices on most customers have been adjusted to reflect current market circumstances and the agreement with the major customer Suncorp expires in June 2023, the labour issue is slowly rectifying itself and smash repair shops in the Group have been consolidated to ensure the Group footprint is running closer to capacity.

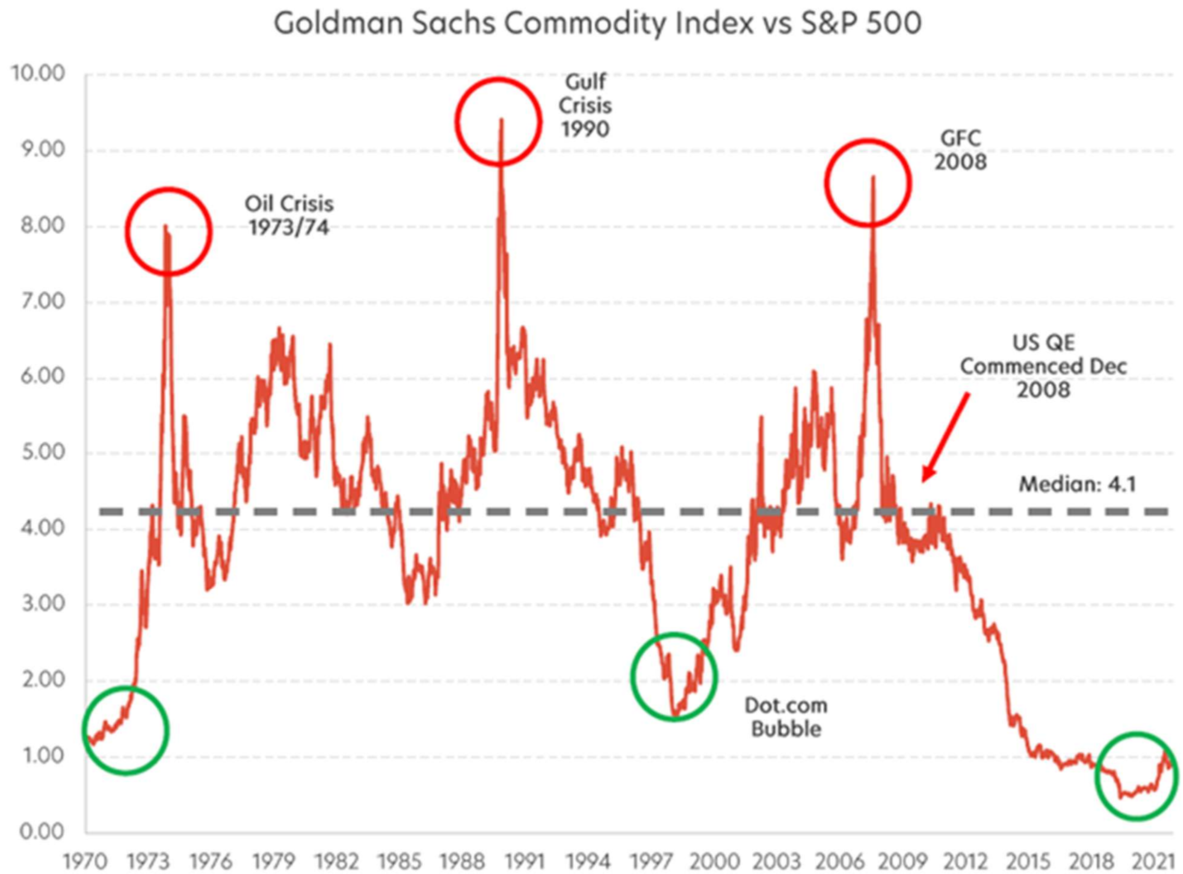
By May or June 2023 price hikes with the major customer Suncorp should be finalised and announced to the market. This represents approximately half the Group's turnover. This should be the catalyst for refinancing the company's covenant-heavy bank debt as the company-run rate for FY24 should be in significant free cash flow territory. On our estimates, the company is trading on an FY24 free cash flow to equity multiple <10x.

Australian Vintage (AVG: ASX): The AVG leadership headed by Craig Garvin is outstanding. Despite a substantial increase in costs outside their control, many of them such as freight costs now abating, the company continues to invest money in its premium brands. The company is benefitting from a positive brand mix effect and continues to gain market share overall in its key geographies both in Australia and in the UK. The first mover advantage of moving the company brands into no-and-low alcoholic wine categories along with the premiumisation strategy will most likely serve the company well in terms of sales growth and gross margin improvements in FY24 and beyond. On our estimates, the stock is trading on an FY24 price to free cash flow multiple of 8x with modest gearing of only ~17%. With the Group's NTA of ~$1, the stock is trading on a significant discount with the current trading price of only 52cps.

Aurizon Holdings (AZJ: ASX): We have been waiting for a favourable time to build a position in an inflation-protected monopoly-like asset for the Fund. The recent decline in the AZJ share price presented us with such an opportunity and we have quickly built a meaningful position in the fund. Approximately half of the Group's earnings are generated from the operation of the Central Queensland Coal Network (2,670km) of critical infrastructure which supports 90% of Australian metallurgical coal export volume. The earnings are regulated and therefore predictable and calculated using a weighted average cost of capital (WACC) on a regulated asset base (RAB). The RAB escalates by CPI and the new increased WACC of 8.18% applies from 1 July 2023. The other half of earnings include the above rail freight transport business transporting coal (coking and thermal) and other commodities (bulk) in Queensland and increasingly in other states. The above rail contracts with customers are protected with CPI-linked rate escalations. We estimate the FY24 dividend yield to be in the high single digits fully franked and we expect earnings to grow over the medium term.

Woodside Energy (WDS: ASX): Commodity cycles, both up and down, tend to last much longer than most expect. The Goldman Sachs Commodity Index vs S&P 500 adequately illustrates below that we are still most likely bumping along the bottom of the cycle for resources somewhere. This analysis is also backed up by the fact that ExxonMobil (XOM) alone generates similar free cash flow to Microsoft, even though the latter has a market capitalisation larger than the entire S&P US Energy sector of 23 constituents.

Maintaining hydrocarbon exposure to our portfolio makes sense to us at this time as we believe it will take many years (and even arguably decades) for the World to meaningfully transition to new energy sources. Additionally, as we have recently witnessed in our local politics, it is getting increasingly difficult to sanction new sources of hydrocarbon supply. Similar collective action from western nations could lead to supply constraints in years to come leading to upward pressure on prices - https://wentworthwilliamson.com.au/insights/hydrocarbons-the-new-tobacco/.



Locally we remain comfortable with our hydrocarbon exposure via Australia's premier oil and gas producer. Following the acquisition of BHP Petroleum, the company is now substantially larger, more globally relevant, and has greater diversification in its product and asset base. Additionally, the cash profiles of the two businesses are complementary.

We anticipate resilient hydrocarbon demand over the medium term, particularly as Asian economies continue to grow. We forecast the Group to generate strong cash flow over the medium term, and we expect to bank meaningful dividends on the investment journey.

MMA Offshore (MRM: ASX): In early November 2020 we received a call from a stockbroker to gauge our interest in potentially participating in a substantial recapitalisation of MMA Offshore. For the previous years, the company was a graveyard for value investors. As mentioned earlier in this report, resource cycles tend to be very long! However, this time the proposal was for a substantial equity raise along with meaningful bank debt haircuts, effectively shifting the power back to equity holders. We had been following the company for many years, so we understood the assets and we were one of the few deep-value investors remaining to take the call, it was time to move. The entry price was 30cps. https://wentworthwilliamson.com.au/insights/talk-ya-book-with-chris-judd/

Over the years leading up to November 2020, it had become clear that the industry was on life support due to many years of low new investment in offshore hydrocarbons. As a result, utilisation rates for ships designed to service the industry were at all-time lows and most of the companies were getting slowly strangled to death with crippling levels of debt. Not only were no new ships entering the industry but much of the existing fleet was stacked, many of them unlikely to enter service again. We were heading for a classic bottom-of-the-cycle turnaround with demand set to increase from a low base, coupled with a constrained supply of available surviving ships remaining in the industry.

Today, the investment backdrop has changed completely, utilisation rates have jumped up very quickly and we are witnessing boom time day rates already. This time, in addition to increased investment in new hydrocarbon supply, we are also seen increased work for offshore hydrocarbon decommissioning, offshore Australian defence contracts, and an enormous pipeline of work for offshore wind projects in the Asia region. Although we are conscious it will take time for an increased supply of ships, we have cut our exposure to MRM by more than half due to the increase in the share price, crystalising substantial profits. The current price is ~$1.10.

SkyCity Entertainment (SKC: ASX): SKC reported a strong result in February with Group normalised EBITDA already back in line with pre-COVID levels. However, the stock price remains depressed due to negative sentiment towards the sector following Star Entertainment Group's repeated breaches of the law. SKC's Adelaide Casino is also under Scrutiny by the regulators but it only represents 15% of Group earnings and any potential fines are likely to be relatively immaterial to the overall valuation. This asset-rich company with monopoly-like assets, particularly the casino in Auckland which generates the bulk of profits for the Group, remains significantly undervalued in our opinion.

Alumina (AWC: ASX): With increased market volatility we initiated our second new investment position this quarter. We like the demand profile for Aluminium over the medium term. This includes traditional sectors like construction and packaging but also new areas of growth such as electric vehicles and ongoing strong demand for power lines, especially from Asia. AWC is a passive 40% shareholder in Alcoa World Alumina & Chemicals (AWAC), one of the world's lowest-cost producers of alumina, which is the refined form of bauxite. As a rule of thumb, it takes 4 tonnes of bauxite to make 1 tonne of alumina and 2 tonnes of Alumina to make 1 tonne of Aluminium. AWAC with its low on the cost curve and long-life assets is well-positioned for the industry tailwinds over the medium term.

BSA Limited (BSA: ASX): BSA remains a small position in the Fund and the commentary remains similar to our last quarterly update. The company is tightly held between two fund managers and a major investor. Most of the loss-making enterprises have been sold off already. We believe, the company will soon be in a position to sell off its highly prized (by trade buyers) communication business which holds the NBN long-term contracts to the highest bidder. In our view, a sale of the communication business could double the current market valuation of the company given the attractiveness of the NBN service contracts to a trade buyer.

Looking forward

We are confident.

What is becoming more evident is that for the first time in over a decade, small-cap value companies in the western world are emerging from a decade of neglect. One could say the last decade has 'coiled the spring' for many traditional cyclical businesses as demand re-emerges and supply remains challenged from years of neglect – the MMA Offshore (ASX:MRM) story all over again in a broader context – see above. It is highly unlikely the stars will align again over the next decade for mega-cap technology and growth companies. The biggest beneficiaries will be local, and they will be small companies that stand to benefit, directly or indirectly, from investments in hard assets. Our new investments in Aurizon (ASX:AZJ)and Alumina (ASX:AWC) fit into this theme.

Another reason why small-cap value should win over the next decade is that their valuations are inexpensive. Global data points suggest as cheap as they were since the dotcom bust. When you refer to our largest holdings such as SRG Global (ASX:SRG), Servcorp (ASX:SRV), Fleetwood (ASX:FWD) it's hard to argue with this statement. All investors are greedy, as soon as there is a sniff of a resurgence in earnings growth they will be back, seemingly out of nowhere driving up share prices.

Additionally, where is the supply of fresh eager young future value investors for the future? There are very few. In fact, I only know of one, Martin Marais, and he has worked with me for 8 years. Typical of the end of an era, most promising young investors of today only have memories of the tech and venture capital boom of the last several years, and few of them aspire to be value investors. It's a good sign! The competition will remain low for an extended time in our field. Every day in the trenches we have been practicing our strategy.

Finally, on our local level, we know our companies and management teams well and they have just reported strong half-year results and the outlook for earnings growth is equally solid. We are preparing for tailwinds and we plan to take full advantage.

Thank you for your trust in us.

Yours sincerely,

James Williamson
Portfolio Manager

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