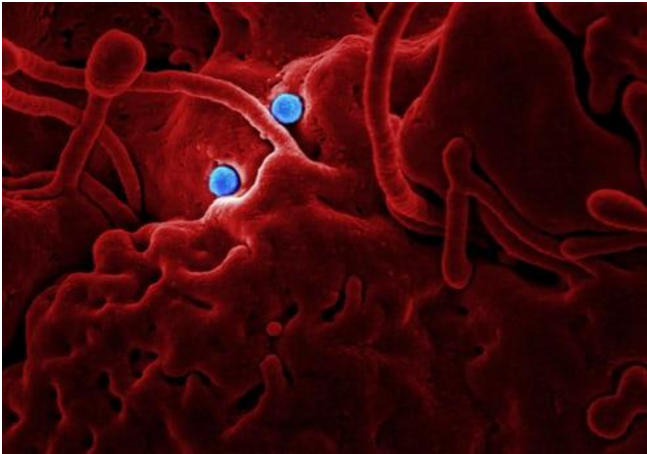
UNCONVENTIONAL WISDOM

Unique investor insights from Wattle Partners

February 2020

The month that was...



- What started off as a somewhat positive month for markets following President Trump's acquittal and generally strong earnings results, end in what can only be described as a disaster. The final week of February saw investors around the world border on hysteria as they sold equities sending most markets down 10% for the week alone. News headlines and inconsistent information flow is turning what may have been a routine virus into a valuation changing event. It's always important to have some perspective however, for instance the ASX 200 is down only 3% for the entire year and many equity funds remain positive for the month.

- The spread of the Coronavirus has led to talk of recessions across Asia (Japan, Hong Kong), Europe (Italy) and even potentially in Australia. Given our substantial reliance on the Chinese economy for not only commodity exports but a substantial amount of our consumer, travel, tourism and retailing businesses, Australia may be particularly hard hit. The table below shows the sectors that have been hardest hit by the outbreak, with the key focus around commodity exports (Energy and Materials) and the somewhat overvalued Australian IT sector.

Sector	Return
A-REIT	-4.86%
Communications	-8.59%
Consumer Discretionary	-8.62%
Consumer Staples	-7.13%
Energy	-17.2%
Financials	-4.89%
Healthcare	-3.72%
Industrials	-8.24%
IT	-17.28%
Materials	-11.74%
Utilities	-3.62%

- As we have stressed on many occasions, portfolios must be built for all conditions, not the continuation of the present Goldilocks' Environment. The biggest mistake the majority of investors made during the GFC was being fully invested in sharemarkets and having few hedges capable of retaining their value in such an environment. Many had continued this strategy into 2020, supported by falling interest rates, however the last week has reiterated their importance. Wattle Partners have traditionally used low volatility, highly diversified strategies within the Targeted Return Bucket, along with traditional long-duration Government Bonds and gold bullion as hedges. Each of these strategies performed well in the final week of February.

- The threat comes at an incredibly difficult time for Australia, as the country struggles to recover from the Bushfire disaster. The unemployment rate unexpectedly spiked in January, increasing to 5.3% from 5.1% and is likely to worsen further depending on how long global travel is put on hold. This came at a time when business investment appeared to be staging a recovery on the back of the improved resources sector, but surprisingly fell another 2.4% in January. The economic impacts are placing additional pressure on global central banks to cut rates further to support markets, with the likelihood of Australia's version of Quantitative Easing likely just around the corner.

- The reaction across Asia has been swift with countries like Hong Kong and China, making cash payments to employees or businesses directly to ensure they continue to spend or keep operations running. It is important to keep this in mind as we have seen in previous periods the combination of global fiscal policy stimulus can result in an incredibly strong and fast recovery, meaning the risks of selling out too soon may be on both the upside and the downside.

- One of the more interesting reactions in markets this week was the sell off of the KKR Credit Income Fund, which holds a diverse portfolio of 'alternative credit' including junk, high yield and private debt to unlisted companies. The share price fell close to 10% during the week as credit spreads on unrated debt spiked heavily in the US and around the world. The key with private credit strategies is ensuring you are not lending to overly indebted businesses or those heavily exposed to an unexpected slowdown in economic advice; unfortunately this doesn't appear to be the case with many of the more recent ASX-listed issues. There may be many disappointed and concerned unit holders who had moved from low risk term deposit to high risk junk debt should this economic weakness continue.

- One of the more interesting announcements during the month was that of Blackrock's Larry Fink, when he announced the company would be putting climate change centre stage for the $7tn asset manager. The statement indicated the company would be using its huge voting power to vote against management who aren't making enough progress in reducing emissions as well as to double down on their investment in ESG focused funds and ETFs. The largest asset managers and pension funds around the world find themselves in a difficult decision in that they are being flooded with such substantial amounts of capital that they have more limited investment opportunities available. Take for instance the growing climate and sustainability options of the likes of Australia's industry funds, but the recent announcement that IFM Investors, which is owned by the same funds, purchased the most expensive oil pipeline in the world in 2019.

- We were interested to learn of the continued cyber-attack on Toll Group, which is now owned by Japan Post. Initial reports indicated that the company had refused to pay the hackers their desired amount and that their systems remained under attack until this day. The integrated and global nature of businesses these days, where outsourcing is involved, means these attacks are becoming more paralysing and effective, likely seeing an extended period of weak sales for the company.

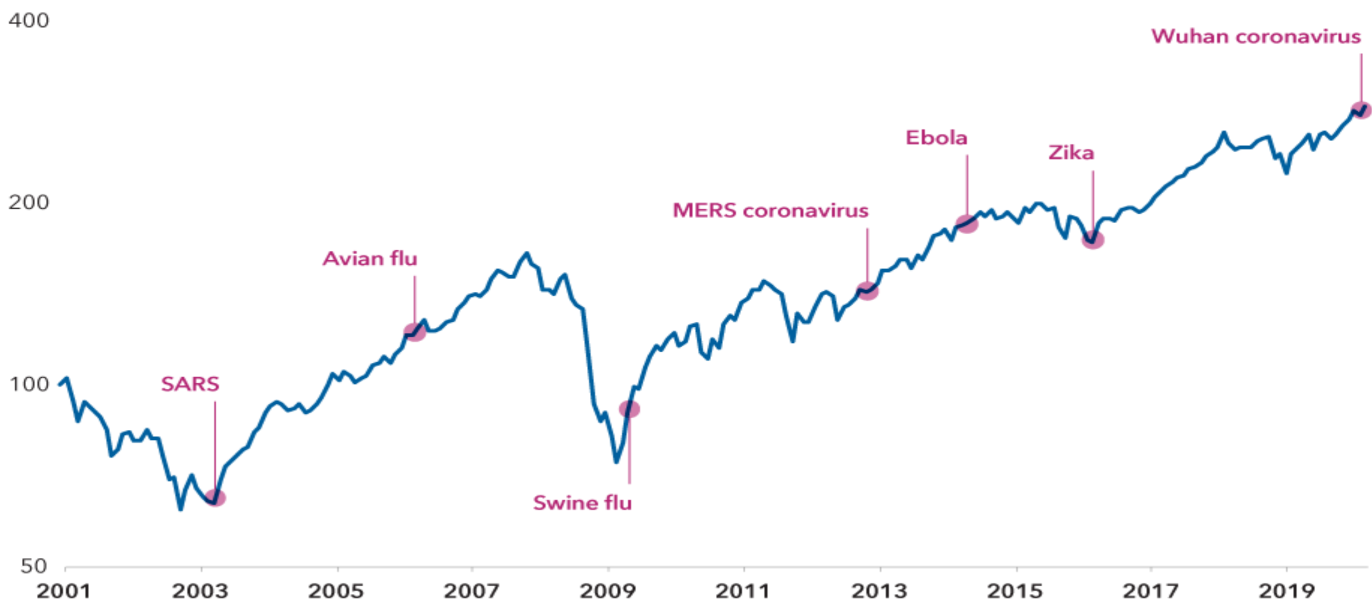
- Shortly after the preparation of this report, the markets have shown signs of turning, with the S&P 500 up close to 5% in a single day. The majority of this support has come from an initial Reserve Bank rate cut and likely support from the US Federal Reserve.

Model Portfolio Update

- Investment Committee –

Index	Index Points - January	Index Points - February	Performance	
			1 Month	1 Year
S&P/ASX 200	7017.22	6441.21	-8.21%	4.41%
All Ordinaries	7121.16	6511.53	-8.56%	4.14%
US Dow Jones	28256.03	25409.36	-10.07%	-1.95%
US S&P 500	3225.52	2954.22	-8.41%	6.10%
Hang Seng (HK)	26312.63	26129.93	-0.69%	-8.74%
FTSE 100 (UK)	7381.96	6580.61	-10.86%	-6.98%
Nikkei 225	23205.18	21142.96	-8.89%	-1.13%

Top 5 Performers	1 Month	Bottom 5 Performers	1 Month
Gold Bullion (Unallocated) - Perth Mint	7.06%	Link Administration Holdings Ltd	-30.98%
Rural Funds Group	4.04%	Santos Ltd	-21.40%
JPMorgan Global Macro Opportunities Fund	1.90%	Orora Limited	-15.22%
Vanguard WS Australian Fixed Interest Index Fund	0.57%	Qube Holdings Ltd	-15.12%
PIMCO ESG Global Bond Fund	0.40%	BHP Group Limited	-14.72%



Sources: Centers for Disease Control and Prevention, RIMES, MSCI. As of 21/2/20. Chart shown on a logarithmic scale. Total return index levels in USD, indexed to 100 on 31/12/2000. Disease labels are estimates of when the outbreak was first reported.

Before the onset of the Coronavirus volatility, investors attention was on Australia's latest reporting season. As we have been stressing in recent years, when market valuations are nearing all-time highs the most important focus for investors needs to be on the underlying strength of the businesses and assets they own. For shareholders, this is reporting seas, which provides both a review of the last 12 months as well as an outlook for the future.

Unfortunately, the reporting season was not a particularly strong one for Australian companies, whether it was the bushfires, drought or floods, a spread of companies delivered weaker than expected returns. In fact, some 30% beat analyst expectations and 26% missed, with the wider issue being a drop in expectations for market wide earnings growth to just 2% for 2020. 2% doesn't

seem sufficient to justify current valuations. According to FN Arena, who's founder offers Investment Committee support to Wattle Partners, the ASX 50 had misses (14) outnumbering beats (11) for the first time in a very long time. Given the number of companies reporting, this issue will be focused around analysing each of these companies in greater detail:

Boral Ltd (BLD): Boral disappointed investors once again, announcing a weaker than expected outlook for the remainder of FY2020. The company highlighted that bushfires, floods and extreme heat had led to major project delays and slowed supply of their core products. They expect earnings to be behind the FY19 as earnings in all three business units, Australia, North America and USG are impacted by specific issues. Management announced the first half result was in line with expectations of a 6% fall on the previous year and subsequently cut the interim dividend from 13 cents to 9 cents. Fortunately, the profit overstatements in the US Window's business were in line with expectations and not the result of theft, meaning the $24.4m profit reduction will be the only lasting impact. CEO Mike Kane also announced his retirement official, leaving after delivery of the FY20 results.

Telstra Corporation Ltd (TLS): Telstra delivered another solid result amid its continuing restructure, with the company actually increasing earnings (excluding NBN impacts) by $90m for the first half, the first such growth since 2016. Importantly all the key figures were in line with expectations, with revenue down 2.8% to $13.4bn, earnings don 6.6% to $4.8bn and net profit -6.4% to $1.2bn. The biggest news for Telstra was the final approval of the Vodafone-TPG merger, which will see another 5G player enter the market that they are currently dominating. However, it is increasingly looking like Telstra's head-start will see outsized returns and a more stable network before the others becoming real competitors. Andy Penn's cost cutting strategy continued, with costs of $422m or 12.1% reduced already and more to come before 2022 as forecast, allowing the outlook for FY20 to be reiterated and the interim dividend on hold. Telstra's PR remains important, delivering 34,000 disaster packages and 8,200 free telephone bills for those impacted by the bushfires. Importantly, the company continues to win new customers in both its low cost Belong brand, 91k of 137k new post-paid subscribers, and its Telstra Plus loyalty business hit 1.2m members.

BHP Group Ltd (BHP): BHP delivered a result broadly in line with expectations, with the continued strength in the iron ore price and the falling AUD a key driver of earnings growth. Underlying profit, which is an estimate of true profit excluding one-off events like write-downs, grew 15% to $12.1bn for the first half, with attributable profit up a further 29% to $5.2bn. The management level focus on cost control, including reducing exploration capex, has paid off substantially in the last 6 months, with each business unit benefitting. The breakdown of profit remains focused around iron ore, which represents 60%, and has a cost per tonne of just $13 close to the lowest in the world. Copper continues to grow in importance for BHP, 20% of profit, due to its role in the new world of battery power and storage, BHP's cost base is just $1.1 per pound meaning it is well protected from short-term demand shock. The profit is rounded out through coal, 9%, which continues to be demerged, and petroleum 13%, where the cost is just $9.56 per barrel. The companies focus on cost and only retaining the highest quality mines means their profit margins are incredible, at 56%. Analysts were slightly disappointed by the free cash flow production, falling to $3.6bn, whilst the dividend was increased by 18% to 65 US cents per share. Management did highlight some pressure coming from the unknown impact of the Coronavirus on the Chinese and Asian economies, which contributed to the slightly lower than expected dividend.

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Commonwealth Bank of Australia (CBA): CBA managed to meet expectations as they continue to move on from the disastrous foray into wealth management and financial advice. In fact, the share price is once again nearing all-time highs even as competition, margins and earnings remain under pressure. The bank delivered a 34% increase in net profit to $6.16bn for the half, with the sale of Colonial First State Global Asset Management contributing $1.69bn to the total. Cash profit was down a more reasonable 4.3% to $4.4bn on the back of flat revenue growth compared to 2019. The bank delivered just a single basis point increase in its NIM to 2.11%, however, given the nature of the market the fact that it remained stable must be respected. The business remains well capitalised, with 11.7% the strongest of the major banks, driven by a 2% improvement in direct deposit funding to 71% of its loan book. Compliance, IT and wage inflation remain key pressures as they bank navigates its way out of its regulatory troubles, contributing to a 2.6% increase in costs. In a sign that the major banks are getting back to business as usual, the CBA deliver home loan growth of 4%, 1.5 times faster than the system, and business lending growth of 3%. They also announced a venture alongside Klarna, investing $100m, as they take Afterpay and Zip Pay on head to head in the buy now pay later sector.

CSL Limited (CSL): Once again, CSL was the highlight of the first week of reporting season, delivering another double digit increase in profit, up 11% to $1.25bn for the first half of FY20. The core immunoglobulin business, which many expected to see weakening demand, bucked the trend and saw buyers once again outstrip supply. The decision to switch to a direct distribution model in China is the only strategy holding back the business, with a 33% decline in volume, but this will be offset in the coming years. The core treatments in Privigen and Hizentra are delivering technology like growth levels, +28% and +37%, stunning first half figures. The strong result saw earnings per share increase 11% and contributed to an 18% boost to the interim dividend to USD$0.95. Unfortunately, the third string of HAEGARDA, was hit by an unexpected increase in demand following broader approvals, of which CSL manufacturing capability could not keep up. The Seqirus influenza business kept its recent recovery going, growing 16% in the first half on the back of a 9% increase in revenue to $1.02bn. It remains the product leader in the EU, Australia and the UK. The result saw management upgrade the outlook for FY20, which is now expected to see a profit of $2.11bn to $2.17bn, representing growth of 10-13%.

National Australia Bank Ltd (NAB): The NAB provided a quarterly trading update, rather than a formal financial report. The first half of 2020 would best be described as sound; particularly given the difficult and competitive environment the banking sector finds itself in. NAB bucked the trend of recent quarters, announcing an improvement in their Net Interest Margin (NIM), which drove the $1.7bn statutory profit for the quarter. The NIM is

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key to every financial institutions profitability as it represents the difference between the cost of capital and the interest rate they charge, whilst the bank didn't release the exact figure, the trend is highly positive. NAB continues along their simplification strategy, in a similar vein to Telstra, removing 32 different fees in recent months as they attempt to reduce the cost of doing business. Revenue improved 1%, however costs also increased 3% as management under the new CEO invest heavily in new technology, resulting in redundancies and write-downs. The bank remains well capitalised, with Tier 1 Capital of 10.6%, improving from 10.4%, with a 21% fall in credit impairment (arrears) charges to $185m a positive surprise for investors. The dividend remains on hold, however, institutional investors are eagerly awaiting the announcement of Ross McEwan strategy and whether this is likely to involve a capital raising. Finally, the board provided an update on the sale of the MLC Wealth Management business, noting that it will occur via a demerger or IPO but that this has been pushed beyond FY20 as they continue to remediate customers and become more competitive with their fee scales.

Orora Ltd (ORA): Of the companies to report in the first week, ORA was the only one to underperform. Management reiterated the difficulties experienced thus far in consolidated the recent US purchases, with overall revenue growth of 13.3% to $1.835bn and a 10.6% increase in EBITDA to $194.8m, not enough to slow weakness in earnings per share, which fell 11.1%. Cash conversion, representing sales to actual money deposited fell from 75% to 72%, and the dividend remained on hold at 6.5 cents per share. The company's domestic business delivered a mature growth rate of 1.8%, for earnings of $82.6m, with can volumes improving but glass stagnating as consumers remain concerned about the outlook for the economy. The rebuild of the Gawler glass furnace remains on track for April completion, but the $50m cost has been draining short term cash flow and profits, but will be offset by gains in FY21. Concern remains around the US business, as earnings fell 17.2% to $34.6m (higher than 2019) on the back of weaker promotional campaigns during summer, however, management have announced a focus on extracting the flagged synergies during the remainder of FY20 and FY21. We remain confident on the outlook in the US, which represents substantially more revenue, but substantially less share of profits due to thinner margins, however, the fragmented nature of the retail point of purchase advertising sectors means it is ripe for a consolidator like Orora to deliver outsized returns. Management confirmed that the end of FY20 will be much like the beginning, however, investors can still expect the return of some $1.2bn in proceeds from the sale of the energy intensive Fibre business in 2019. Orora continues to innovate within this mature sector, commissioning a digital proofing printer in Dandenong, that will reduce the time taken to produce short run promotion products, protypes and the like, streamlining the sales process and boosting margins.

AMP Limited (AMP): Whilst the sentiment towards AMP remains as negative as ever, change is happening quickly within the company. The sale of AMP Life will be completed before 30 June, some 440 financial advisers have left the business and client remediation has already reached $264m. Where the likes of the Commonwealth Bank are employing hundreds of compliance managers to review every client file, AMP is taking a more proactive approach, effectively paying out anyone potentially impacted by poor advice or the Fee for No Service scandal. AMP delivered 585,000 fee reductions across their collection of superannuation and investment products as they seek to deliver market leading solutions: with a further 110,000 fee reductions for AMP Bank customers. On an underlying basis, i.e. before write-downs, the companies remains profitable, delivering $464m, down just 3% from the previous year, as AMP Capital's growth of 18.6% to $198m, offset the 49.9% reduction to $182m in Wealth Management, driven by one-time fee reductions. At its core, AMP is a diversified financial services business and the new CEO has expressed a clear vision to deliver market-leading products that remove the conflict of interest faced by vertically integrated businesses. We see this as an intelligent strategy and one that has the potential to deliver advice to the masses in a cost effective manner, something the industry super fund sector is loath to provide given it would increase their 'low fees' and make them vertically integrated themselves. The bank wrote down the value of its wealth management business and superannuation platforms by around $2.0bn, which naturally attracted all the headlines, but wasn't reflective of the improving conditions for the company as the

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Simplify, Reinvent and Reduce strategy gains traction. For those able to see the positives, there are many on the outlook for long suffering shareholders. In wealth, most major banks ae exiting the sector offering great opportunities for those able to survive, but importantly cost structures must first be reset. AMP Bank has grown its loan book to $20bn, supported by $14bn in retail deposits, suggesting the brand isn't broken, and management sees potential in integrating their banking and wealth management products under the same roof. AMP Capital remains the highlight, hitting $198bn in assets under management, supported by growth in their offshore businesses, China Life +19% in assets, and China Life Pension +49% in assets under management. The dividend remains cancelled following the recent capital raising.

QUB Holdings Ltd (QUB): QUB's earnings report couldn't come at a worse time, as global sharemarkets were hit by the escalating impacts of the Coronavirus. Despite the negative market sentiment the business continued its strong recent growth, with statutory revenue increasing 14.4% to $957.3m, supported 9.8% growth in earnings to $102.8m and underlying profit growth of 5.3% to $68m. The introduction of the AASB 16 accounting principles in 2020 which requires companies to account for leases differently means comparable figures are more difficult to measure. Management noted that QUB's vertical integration was an important benefit to their customers with the ability to support all aspects of the supply chain and save them time and money. They noted that container trade growth had slowed around 4% due to the trade war and continuing weakness into 2020, whilst slowing vehicle sales, down 7.2%, have been hit by consumer sentiment. Across the divisions, Logistics was the standout growing revenue 19.9%, benefitting from a combination of organic growth, market share and cost synergies from recent acquisitions. Ports and Bulk commodities were similarly strong as oil and gas improved, along with mineral sands exports, but were offset by a decline in scrap metal. The Patrick Terminal's business saw continued strength, growing market share by 2% to 47% and management confirmed the Fremantle lease had been renewed. Market volumes declined 4.4%, however, price improvements meant revenue grew 11.8% to $350.8m making the division a growth highlight. 2020 saw management announce they were seeking partners for the Moorebank operations, where Target's warehouse is now fully operational and another tenant under offer. Revenue declined 5.2% to $49.4m but on the positive side the rail construction is now complete and operational. The strong performance across the business increasing headwinds meant the dividend was increased 3.6% to 2.9 cents per share. QUB's outlook statement was decidedly weak, but not necessarily an outright downgrade. They expect growth in their operation division, a decline in infrastructure and property as capex continues to ramp up and a flat result from Patrick. Importantly, they noted that Coronavirus will have an impact, but that this was difficult to measure at the current time. The opening of offers for the Infrastructure and Property division offers a potential upside catalyst for the stock in the near term.

Woolworths Group Ltd (WOW): Woolworths continues to shoot the lights out, delivering solid sales and revenue growth across the board in the first half. Signs of weakness amid the bushfire season appear to have subsided with the company announcing 6% sales growth for the half to $32bn.

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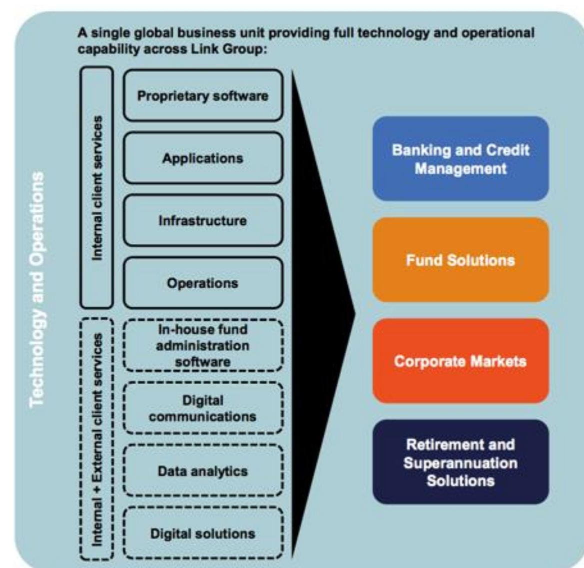
Importantly, earnings improved 33% to $1.89bn and profit 9% to $979m on the back of tighter cost controls and recent store refurbishments. Management once again announced an increase in the dividend by 2.2% to 46 cents per share. The biggest highlight was no doubt the turnaround in BIG W, with earnings increasing 155% in the half as the companies rationalisation and simplification strategy paid dividends. The Endeavour Drinks business has been successfully separated and ownership delivered at 85%, with earnings growth of 6.7% likely to support a strong valuation upon its eventual demerger later in 2020. The core groceries business is lengths ahead of Coles growing same store sales 3.8% year on year as their remarkable turnaround from the lazy, wide margin business of the 2010's moves completed into the rear vision mirror. Gross margin, represent the profit on operational sales, improved 38 basis points to 29.1%, still well below the heady years but more reflective of the competitive market environment. Woolies rolled out 14 new stores in the first half, and refreshed 36, which is ensuring they remain ahead of the dated Coles Group sites in terms of customer experience. The company's expansion into online sales remains its highest growth but smallest division, seeing a 28% increase in sales and 12 million members joining their rewards program. Management continue to deal with the impacts of the underpayment scandal, which has seen potential costs increase to $400m.

Link Administration Holdings Ltd (LNK): After a strong rally to begin 2020, LNK's earnings announcement disappointed the market sending the price down 13% and wiping out most gains for the year. Management highlighted that it was a year of transition for the company, as it continued its global expansion, moved on from previous investments and was hit several client losses in their superannuation and retirement administration division. On the positive side some 80% of revenue is recurring and the net reduction in the first half was a measured 4% to $624m. The Retirement Solutions division remains the key plank of the business, delivering outsourced administration to pension funds, and represents 32% of total revenue. Corporate market activity including employee share schemes and registry services represent 23% and the burgeoning Technology and Data division 24%. Operating profit was hit to the tune of 11% falling to $81m and net profit a much weaker $29m down 84%. The company has continued to diversify its businesses with 41% of income now sourced from European markets following the acquisition of the Pepper Loan Servicing business and the UK Smart Pension venture. After a difficult 2019 for the Retirement division the first half saw the business supported by 5.2% growth in its customers membership base (including the likes of Australian Super) and its stands to benefit from continued outsourcing by the remaining 48% of pension funds still undertaking the task in house. The company's outlook disappointed, forecasting operation profit of just $160m, down 10% on the previous year, and cutting the dividend to 6.5 cents per share. The highlight however has been the strong growth in the PEXA platform, 44% owned by LNK, which saw its loss of $6m turned into a $26m profit increasing the likelihood of dividends in 2020. LNK's real growth opportunity comes from its expansion and harnessing of the important data it collects, which has seen the establishment of a new business unit and cross selling across it's many customers.



Ramsay Health Care Ltd (RHC): As highlighted early, the introduction of AASB 16 and Ramsay's acquisition of Capio has made direct comparisons of performance more difficult. For the purposes of this report we will compare without the Capio acquisition. The second half of 2020 continued as expected, with volume growth in Australia offset by a much improved outlook for the UK and Europe. Revenue improved 4.8% to $6.3bn in total supported a 5.4% increase in EBITDAR to $1.1bn. The Australian business grew at a more mature 3.9% and still represents the core source of profit, European revenue grew 2.4% with the UK the

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highlight, up 8.7% as NHS and Patient-Pay volumes continued to recover. The performance saw net profit and earnings per share grow 3.4% and 3.7% respectively. Whilst these sounds like lower than expected growth rates, in an increasingly volatile environment any positive earnings growth is well received by investors. The strength of the Australian business supported a 4.2% increase in the dividend to 62.5 cents per share. Looking closely, an announcement by the French Government that they would be providing multi-year transparency into tariffs with a minimum increase of 0.2% each year, was a positive for the group, and the Capio acquisition is performing well with expected synergies being delivered. The UK saw an 8.7% increase in revenue before currency impacts and Australian admissions were above the previous period but remain quite weak. On the other hand, waiting lists in public hospitals continue to grow meaning we continue to believe the weakness is cyclical rather than structural. Management provided no specific guidance on the impact of the Coronavirus but noted they expect earnings growth of between 2 to 4% as previously noted.

Around the markets

- Jamie Nemtsas -

Cleanaway Waste Management Lts (CWY): Acquisitive recycling and waste management business Cleanaway surprised the market with a better than expected earnings result, profit lifting 13.7% to $76.2m for the first half of 2020. The results came from improving margins with revenue growing just 0.5% from the business in general. Margins have benefitted from substantial investment in recycling and management centres and the many acquisitions including Toxfree Solutions and the bankrupt SKM. The integration of these businesses is allowing management to reduce overhead costs and increase recycling volumes. Free cash flow was weaker than expected due to these acquisitions, however stronger cash conversion was a highlight and supported a 21.2% increase in the dividend to $2.00. Business growth remains mixed with the core Solid Waste business growing revenue 2.4%, when excluding the falling commodity prices of products resold growth was closer to 5.4%. The business won the City of Casey contract but has been impacted by Queensland's new landfill levy. The Industrial Waste business remains under pressure, revenue falling 6.4% to $165.7m, however the medical and liquid waste business has begun to turnaround, adding 3.0% to $258.6m and delivering company leading earnings growth of 15%. The strength of the result saw management upgrade guidance for the second half, with earnings between $515 and $525m forecast, growth ahead of the previous two halves as they seek to drive Australia towards a more sustainable waste management production cycle.

Wesfarmers Ltd (WES): Wesfarmer's conglomerate strategy has placed increasing pressure on earnings, with the company disappointing the market after announcing a 0.5% fall in earnings to $1.73bn for the first half. This came despite a 6.0% increase in revenue to $15.25bn. Net profit was slightly better at $1.13bn growing 5.7% however the combination of a weaker than expected performance from Target and the companies Industrial investments meant the dividend was cut by 25% to $0.75 per share. It is apparent that the strength in Bunnings is becoming more reliant on investment in price (read discounting) and the need for more and more staff to be employed. The division grew revenue at 5.3% thanks to strong like-for-like sales growth with earnings up a further 3.1% to $938m. Management continue to direct capex of $455m towards Bunnings digital strategy and store refurbishments. Officeworks continues to grow strong thanks to its diverse product base, with earnings up 3.1% on to $1.23bn albeit with lighter margins than the other business units. Kmart has once again hit some difficulty with earnings falling 9.9% to $343m despite revenue growth of 7.6%, which is of growing concern to analysts. Target has also suffered from the retail weakness, with a $67m decline in sales as Woolworth's BIG continues to improve its offering. Whilst a number of WES core businesses remain strong, they are heavily exposed to the cyclical headwinds facing both the Chinese manufacturing and Australian retailing sector, suggesting growth levels are likely to remain muted. The sale of Coles has however opened up the potential for further acquisitions with an apparent preference for assets in the mining sector with a focus on battery and power storage commodities.

Apple Inc (AAPL): After delivering record results in January (quarterly revenue of $91.7bn), Apple Inc. warned investors that is 3rd quarter profits were likely

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to take a substantial hit from impact of the Coronavirus. The company relies heavily on Chinese manufacturers for many parts of its ubiquitous smart phones, ipads and notebook computers. Whilst work is beginning to resume it remains well below capacity meaning supply bottle necks will impact on the products they can deliver. The company also noted that whilst the global demand for iPhone's remains strong, the virus has had a substantial albeit temporary impact on Chinese demand with many partner stores closed or operating on reduced hours.

Star Entertainment Group Ltd (SGR): Whilst not a part of our core portfolio for obvious reasons, Star Entertainment Group which owns various casinos and gaming venues on the Eastern Seaboard reported during the week. The result was in line with expectations, in fact it was at the upper range of guidance at around $307m, growth of 8.5%. Importantly the domestic business which represents 92% of earnings saw improving margins as $20m in cost cutting and a rationalisation of 20% of the workforce supported the growing business. The Gold Coast star stunned investors with 16.8% growth in revenue, contributing to earnings growth of 18.2%, and offsetting weakness in Sydney, where revenue fell 4.3%. Interestingly the level of VIP spending remained in line with previous quarters, even as the impacts of the bushfire, trade war and Coronavirus had an impact. The outlook, or lack thereof, may just be a sign of a struggling business. Whilst management noted the virus may have some impact, they were not willing to quantify the impacts. Our investment team happened to be staying at the Star Gold Coast during the week whilst attending the Self-Managed Superannuation Fund Association conference and were somewhat shocked by the lack of customers, store and table closures throughout the premises. In our view, the company is ripe for a turnover as the all-important Chinese tourist dollar takes some time to recover.

Never sell stocks...

- Drew Meredith -

This month we continue our coverage of 'never sell stocks'. The purpose of this column is to put forward companies that we have confidence will be equally or more dominant in 20 years as they are today. This month, we take a look at LVMH, or Louis Vuitton Moet-Hennessy, the company which briefly made it's CEO and largest shareholder Bernard Arnault the richest man in the world in December 2019.

The company made news recently after successfully acquiring the well-known jewellery brand, Tiffany and Co for US$16bn, but the company is much more than that. In 2020 the group houses some 75 individual luxury brands and is the only global consumer company with operations across all five sectors of the market:

- Wines and spirits;
- Fashion and leather;
- Perfumes and cosmetics;
- Watches and jewellery; and
- Selective retailing.

For some background, the company effectively began as Christian Dior, which remains the holding company owning some 60% of the headline stock. Christian Dior was purchased by Bernard Arnault along with the well-known supermarket chain Le Bon Marche in 1984. Over many years he was behind the merger of LV and MH and acquisition of any number of additional brand names.

Today's LVMH looks very different to that of 1987 when it was first traded. The company now has a market cap of close to $50bn, employs 156,000

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people and is the clear global leader in luxury, high quality products. For some background, here are just a few of the 'houses' that form the group in 2020:

- **Wines and spirits:** Moet, Hennessy, Ruinart, Veuve, Krug, Cape Mentelle, Belvedere Vodka
- **Fashion and leather:** Louis Vuitton, Fendi, Marc Jacobs
- **Perfumes and cosmetics:** Christian Dior, Guerlain
- **Watches and jewellery:** Tag Heuer, Hublot
- **Selective retailing:** Sephora, DFS, Starboard Cruises

Clearly, the brand names are impressive, but more importantly are the financials and outlook for the business. In the final quarter of 2019, the company reported strong revenue growth of 8%, to EUR$15.27bn, and $53.67bn for the year, for a total increase of 10%. This supported a c10% increase in profit from $6.35bn to $7.17bn for the full year and a 10% increase in the dividend. In just two years the company has grown revenue from $42bn to $53bn with operating leverage and margins meaning profit has increased by over 20% in the same period.

One of the more attractive features of the business, however, has been their ability to pivot, diversify and enter new markets successfully. Such has been the success that the likes of the US and Europe represent around 24-30% of revenue respectively with the fast growing Chinese and Indian markets hitting 30% in 2019. Diversification across business lines is similarly strong, with fashion and leather goods the primary source of revenue (41%) but selective retailing (28%), perfumes (13%) and wines and spirits (10%) all material contributors. Further evidence of the strength of their business model is the fact that some 1,453 of their 4,915 stores, being 30%, are located in the faster growing Asian region.

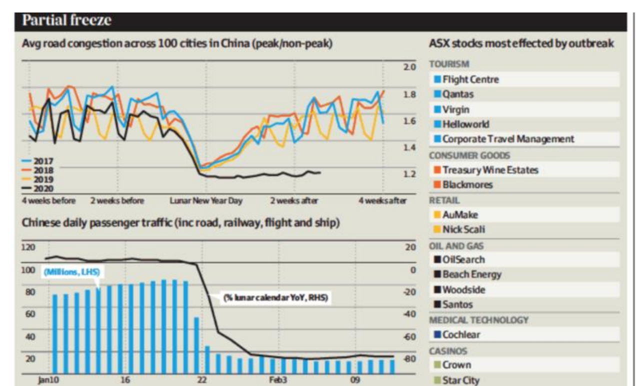
The companies continued success has been driven by their simultaneously autonomous and vertically integrated business lines. They allow each of the major brands to act on their own and react to market changes, but also ensure that the experience of other houses can be leveraged to the benefit of every other business. Easier said than done for most companies. Management highlighted a few key details in their latest report, which was released in early February:

- All geographic regions saw revenue growth;
- Wines and spirits, which is 35% owned by Diageo, recovered after a weak 2018;
- Louis Vuitton and Christian Dior delivered exceptional growth and continue to exhibit substantial profit margins;
- Duty free business DFS showed some resilience in the face of the Hong Kong protests;
- Operating free cash flow increased 13% to EUR$6.2bn;
- Gearing fell to just 16.2% to finish the year.

Whilst the coronavirus is likely to have a short-term impact on sales around the world as more populations are quarantined or travelling less, this will be just a blip on the company's long-term growth. With its oldest business established in 1593, we would be surprised to see the company still delivering products in 2100; as they say, champagne never goes out of favour.

Interesting Charts

It's been a difficult month for Australian investors, first trying to grasp the implications of the bushfires on the retail, tourism and travel sector and then that of the Coronavirus outbreak. Obviously, neither compare to those impacted, but we thought it worth putting forward some interesting charts highlighting those likely to be most impacted; both are sourced from the Australian Financial Review.



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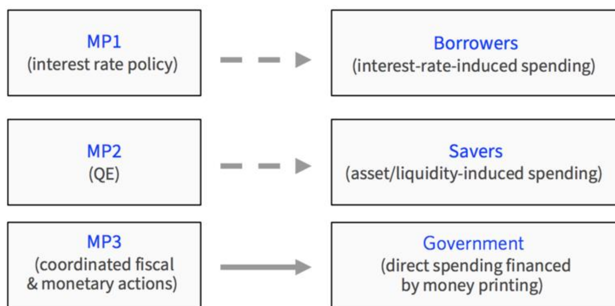
Bushfire implications

SECTORS		
Food & bev / Agriculture	Mixed	Potential impact to crops / supply chain disruptions. Food price inflation from bushfires may offset.
Transport	Downside	Potential flight cancellations affecting ~20% of passenger movements. Airlines may cut capacity.
Infrastructure / Utilities	Downside	Damage to powerlines in regional areas.
Insurance	Downside	Insurance losses may reach $2b. Higher premium inflation likely, which could help insurance brokers.
Retail	Downside	Potential disruption to stores and delayed consumption.
Resources	Downside	Some unscheduled production stoppages due to visibility issues.
Building materials	Downside	Potential reductions in production / margin from staff on extended leave and supply disruptions.
STOCKS		
Treasury Wine Estates	Cons staples	Potential damage to 2020 vintage, albeit impact unlikely until at least FY21.
Premier Investments	Disc retail	Core Apparel brands potentially impacted given higher regional skew.
Flight Centre	Disc retail	Weaker domestic travel intentions could be offset by Australians travelling offshore.
Webjet	Disc retail	Weaker domestic travel intentions could be offset by Australians travelling offshore
Caltex	Energy	Potential disruption to regional locations and demand for commercial fuel (travel / transport).
Viva Energy	Energy	Potential disruption to regional locations and demand for commercial fuel (travel / transport).
Crown Resorts	Gaming	Less inbound tourism.
Star Entertainment	Gaming	Less inbound tourism.
SKYCITY	Gaming	Less inbound tourism.
Virgin Australia	Industrials	Weaker travel intentions may be offset by reducing capacity.
Qantas Airways	Industrials	Weaker travel intentions may be offset by reducing capacity.
AusNet Services	Infrastructure	Victorian poles and wires incurred some damage but costs likely to be passed through.
Sydney Airport	Infrastructure	A fall in international tourists (~20% of passenger volumes) could be negative.
IAG	Insurance	30% share of industry loss, well protected from 1H aggregate cover. $80m above budget in 1H20e.
Suncorp	Insurance	Well protected in 2H from aggregate cover & FY20 stop loss. $109m above budget in 1H20e.
QBE	Insurance	$US1.4b global catastrophe budget for FY19.

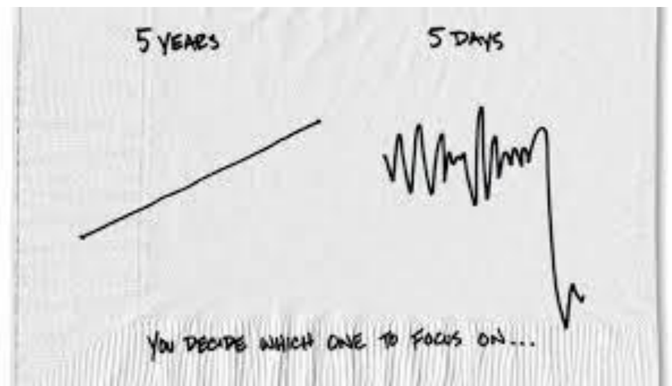
SOURCE: UBS

The second chart is somewhat more straightforward, it shows the differing reasons and purposes of the monetary policy we have seen thus far around the world. Put simply, monetary policy 1 (MP1) which involves rate cuts, aims to stimulate borrowers to spend; MP2 aims to stimulate savers to spend by forcing rates further down or buying back bonds from the market; and MP3 aims to stimulate the Government to spend through coordinated and fiscal actions.



The final chart, as referenced in the introduction to this month's newsletter, shows the real concerns that investors should have with high yield credit and many of the listed investment companies offered in recent months. The chart shows the 'spread' or premium paid on unrated debt versus rated debt, and as you can see, after trading near all-time lows for an extended period, it spiked quickly in February, resulting in some products falling as much as 10% in just a few days.

Carl Richard's notes are as relevant as ever in this environment:



Wattle Watch

This month we were invited by Artesian, a specialist alternative asset management firm. The group is probably best known for their high quality Australian Corporate Bond Fund, which was one of the first in the market before the recent flood of high yield and junk listed investment companies. The strategy involves purchasing AA or A rated bonds on behalf of investors across all sectors of the Australian economy and has delivered an annualised return of 5.68% since inception in 2017.

However, this session was on another topic, Artesian's venture capital strategy. For some background the group has been operating in venture capital since 2004 and were among the first to open offices in China in 2008. They have around $800m in assets under management and are one of the most active early stage venture capital investors in Asia. Importantly, the group has a focus, albeit not the sole purpose, of generating positive impacts for the community as well as investors, as seen through their green bond, sustainability bond and clean energy funds.

Whilst venture capital and private equity have become incredibly popular with pension funds who are able to allocate the many billions in contributions, they receive each month to these less liquid investments, they have not taken off particularly strong for retirees and advisers. Yet it is

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clear there are great opportunities for patient investors, that may in fact share the same 20-30 year time frames as the large institutions. The presentation started with some background on the sector, highlighting the incredible disruption coming from the tech sector, but which permeates every business model from agriculture to transport and consumption today.

They noted some important trends including the reducing cost of starting a company, which has seen a 5x increase in start ups over the last 20 years. This has also lead to many companies, like Telstra, becoming so-called Corporate VC's as they seek to invest into the new companies that are disrupting their current way of doing business. Most importantly, they highlighted the opportunity in Asia, as the US' monopoly has declined to just 50% of the market.

So what's the strategy?

We will try to keep this short, but effectively Artesian don't want to become a mega venture capital company like Square Peg or Blackbird with multi-billion dollar funds, as this vastly reduces the potential returns and increases competition. They are seeking to partner with Capital Lite start ups and seeking as little as $200m for each of their funds. There strategy is quite straightforward, they will allocate the capital raised in the following proportions:

1. 15% of the fund or $150,000 to 150 seed or angel investments – A seed investment is one that basically funds the short-term operations for an entrepreneur who has an incredible idea, but needs to confirm the addressable market and bring it to life. Many companies never leave the seed stage. At this stage it is traditionally family, friends and incubators that are the primary investors.

2. 35% of the fund or $1.25m in 70 Pre-Series A investments – Series A investments typically occur once a business is generating consistent revenues, has identified and signed on a user base but requires funding to continue to improve its business model and prepare to scale up. Pre-Series A investments occur as a business starts to generate revenue and are typically not open to a broad range of investors.

3. 50% of the fund or 25 $5m Series A investments – As noted, Series A is when the model is proven, is ready for scaling but the founders now require external capital and business advice.

One of the unique differences of the strategy is their ability to open up opportunities for investors and clients to co-invest as the portfolio companies grow, outside of the fund itself. The strategy seeks to invest in around 500 individual companies and targets a return of 20% per annum over its lifetime. Importantly, it is a 10 year strategy, with no reinvestment period but with any monetisations or listing being paid out as they are exited. Some interesting portfolio companies include: Liven, a Crypto Commerce platform, Shareablee, a social media monitoring system for businesses and 24-7 Tickets, one of China's most popular travel sites.

What are we reading this month?

We were reading a lot this month as we attempted to obtain enough knowledge to understand the implications of the Coronavirus around the world, but rather than add more noise, we are linking to three longer term pieces.

The first is the famous Bridgewater Associates hedge fund manager, who provided an update on their strategic outlook for the global economy. A highlight is in their introduction:

'As we enter the 2020s, the forces that drove the recent paradigm are nearing their limits. Forces such as falling interest rates and corporate taxes, increased globalisation and deregulation, and the shrinking power of labor, which have supported profit margins and growth for decades are unlikely to be further supports in the future and, in many cases, are more likely to reverse.

World class global bond manager also put forward 7 key macro themes for 2020 and their implications

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for investors. Again, the interesting quote relates to the private credit market:

'if growth slows further in 2020 rather than picking up during the year, the riskier segments of the credit market would seem vulnerable. Private credit, leveraged lending and high yield debt have been concentrated in businesses that are highly cyclical and have riskier credit profiles. With speculative grade credit lending around 35% of GDP, stress across these sectors would be more than enough to contribute to a recession.

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