June 2020

BKI INVESTMENT COMPANY

ABN: 89 615 320 262

BKI INVESTMENT COMPANY LIMITED

Quarterly Report

Getting Out and About

CONTACT ASSET MANAGEMENT

BKI is managed by Contact Asset Management
AFSL 494045

BKI Quarterly Report

Welcome to the 26th edition of the BKI Quarterly report, prepared by Contact Asset Management (Contact).

As the economy reopened and the fastest bear market in history was followed by the fastest bull market, the team at Contact got out and about to try and make sense of the COVID-19 crisis. We consider getting out of the office and visiting companies paramount to our investment process. It allows us to observe the current operating environment and gain a better understanding of the long-term prospects for the companies we invest in. Site tours and company visits included the new airport in Western Sydney, Lindsay Australia's Eastern Creek Facility, Brickworks and Goodman Group's Oakdale Industrial Estate, Sonic Healthcare's Laboratory in Macquarie Park, the store opening of Woolworths in Eastern Creek and several retailers. In this report, we share some of our insights and takeaways.

Infrastructure and Construction

Australia is undergoing its largest ever infrastructure boom with the Government investing a record $100 billion towards transport infrastructure over the next decade. During June, we attended several site tours and company visits around Western Sydney, which is home to some of the country's most significant infrastructure developments. The area is undergoing an enormous transformation from farmland to Greater Sydney's newest economic hub. We continue to be impressed with the ongoing development and investment in the region by both the public and private sector.

One of our tours included the $5.4 billion Western Sydney International (Nancy-Bird Walton) Airport, which is central to the long-term prospects in the region. Situated on 1,780 hectares of land, the initial stage is expected to be complete by 2026, with a single 3.7km runway to facilitate for 10 million passengers per annum. While it may be hard to envisage now, there are future plans to develop a second runway and in 2063, the airport is expected to accommodate approximately 82 million passengers annually, or close to double the passengers at Sydney Airport in 2019[1]. Lendlease and CPB Contractors secured the $644 million contract in 2019 to undertake the major bulk earthworks. On site they have more than 200 scrapers, excavators, graders, dump trucks and dozers working to move 25 million cubic metres of earth or enough to fill about 10,000 Olympic swimming pools; making it one of the largest earthmoving projects in Australia's history[2].

Scrapers working to move 25 million cubic metres of earth at the new airport

State and Federal governments have committed $20 billion to build Western Sydney's new airport and all the associated transport infrastructure[1]. The NSW government estimates that to build out all of the development required in Western Sydney – the airport and aerotropolis, the transport infrastructure, housing, schools, hospitals and so on – will cost more than $100 billion[3]. These investments are expected to have positive implications for population growth and job growth.

Future 3.7km runway at Western Sydney International (Nancy-Bird Walton) Airport

While near term population growth will be negatively impacted by COVID-19, the long-term positive outlook remains intact. Over the past decade, migration has driven 60% of Australia's population growth and as a result, Deloitte estimate that COVID-19 will equate to 480,000 fewer people in Australia by end-2022 than would have been expected had the pandemic not occurred[4]. Despite this, the investment in Western Sydney is still estimated to generate 200,000 jobs, encouraging population growth in the region. Previous long-term population growth forecasts projected Sydney's population would double to 8 million by 2055. 52% of the growth to 2031 was expected to be in Western Sydney equating to one million more residents[5]. We anticipate these forecasts will need to be adjusted for COVID-19 but overall the long-term trajectory remains intact.

After years of housing undersupply, the demand for affordable housing in regions with growing populations has remained strong. Based on our discussions with homebuilders and real estate agents, enquiries rebounded strongly towards the end of the quarter as the economy reopened. This has been coupled with unprecedented fiscal support from the Government. The key pillar is the Homebuilder Grant of $25,000 for renovations or new home builds, for projects between $150,000 to $750,000 or properties below $750,000. Comments by AV Jennings regarding the current operating environment included "we are very pleasantly surprised by the activity level" and "we have definitely seen an increase in activity since it was announced" highlighting the strong turnaround in consumer sentiment. Incentives by the homebuilders themselves is also helping drive demand. There is also consideration being taken to wind back Stamp Duty and replace it with a broad-based land tax in New South Wales and Victoria, which would further help activity.

Infrastructure investment, jobs growth and population growth bode well for the future value of the Brickworks (BKW) and Goodman Group (GMG) Oakdale Industrial Estate. The Estate is located within close proximity to the new airport, has direct access to the M4 and M7 Motorways and will benefit from further planned road upgrades, some of which have now been fast tracked. The Estate is split into five stages with Stage 1, Oakdale Central and Stage 2, Oakdale South complete. We toured Stage 3, Oakdale West which received development approval late last year after years of planning. As the image below suggests, construction is well and truly underway. Once complete, this will be the largest parcel of industrial-approved land in Western Sydney.


Construction at Oakdale West

The site highlights the competitive advantage of having such a significant parcel of land in a supply constrained market, the development expertise required to complete a large and complex greenfield development and the importance of strong, longstanding relationships with tenants. While there are development risks associated with greenfield projects of this scale, longstanding relationships with tenants has benefited the development. Pre-commitments with Coles and Amazon for a large portion of the site helps de-risk the project, and both tenants have locked in long leases given the significant investments they are making. Amazon will be investing more than $500 million into the 200 square metre distribution centre (a site the equivalent of 22 rugby fields)[6]. By securing two high quality, long term tenants, GMG and BKW have de-risked the development and enhanced the end value of the project.


Future Amazon and Coles Distribution Facilities

Bridge construction over Water NSW pipelines at Oakdale

We also toured Lindsay Australia's (LAU) recently completed facility in Erskine Park, just 16kms from the new airport. Driven by strong consumer demand, the site replaced the Arndell Park depot where LAU had been for over 25 years. On a massive 5-hectare concrete slab, the site includes 15 loading docks, 3,426 sqm refrigerated warehouse, 2,590 sqm ambient warehouse, fuel stations, driver accommodation, truck maintenance, 36,800 sqm hardstand and docking space and has the capacity to house over 100 vehicles. The new site has led to improved operating efficiency, better services for drivers, decreased safety related reports, improved staff morale and presented synergies across the business allowing for shared resourcing across Lindsay Transport, Lindsay Rural and Lindsay Fresh. The investment has set LAU up to cater for future demand across the business.

Western Sydney has emerged as a major driver of Australia's medium to long term economic growth. Our site tours highlighted that with a growing population, infrastructure boom, thriving key industries and large tracts of undeveloped land, the long-term prospects for the region, and thus many of the companies we invest in, remains intact.

Retail

As COVID-19 lockdown restrictions eased and stimulus cash flowed into bank accounts, we have witnessed some very strong retail sales data over the June quarter. The ABS reported retail sales up 16.3% in May, the largest seasonally adjusted rise ever published in the 38 years of the Retail Trade survey, following the largest ever seasonally adjusted fall of 17.7% in April 2020[7]. Trading updates by retailers have seen double digit sales growth with a significant amount driven by online sales. Company specific sales updates by retailers for the second half (unless otherwise state) included:

- Wesfarmers: Bunnings +19.2%; Officeworks +27.8%; K-Mart +4.1%; Catch +68.7%.
- Harvey Norman: Australia +17.5%
- Nick Scali (4Q): +20.4%
- Adairs: +27.4%
- Beacon Lighting: +15.5%
- Super Retail Group (May): +26.5%
- Woolworths (4Q): Food +8.6%; Liquor +21.4%; Big W +27.8%; NZ +15.1%

Over the last three months we have spent time actively “walking the floors” of the various retailers to get a deeper understanding of COVID-19 impacts. Consistent with the strong sales numbers reported by retailers, our shop floor experience revealed that trading conditions had rebounded strongly and as restrictions eased, people were keen to get back to spending. Comments by retail floor assistants comments included “I could not even take lunch, we were that busy”, “we have 400 orders on back order, and customers are switching up the price curve” and “we simply can’t get enough stock in to meet demand,” putting to bed weakness in consumer sentiment.

One particular store visit for us during COVID-19 was telling. The new $72 million Woolworths store complex at Eastern Creek Quarter opened on 10th June. The centre has 50 specialty stores and a 3,800 sqm Woolworths store with a catchment of 330,000 people. Woolworths has introduced a tailored range alongside innovation in fresh produce, deli, and produce. Our store walk highlighted the many possible improvements to the operating model for Woolworths and the opportunities for cost outs including shelf friendly packaging, D pallet optimisation, gondola ends, promotion frequency, presentation, management structures, mainlane v ACO optimization, stock loss gates being brought back and range optimisation for grocery fill. The store car park was packed for a mid-week morning, indicating the offer is being well received by customers. Woolworths continues to be a strong long term holding in the BKI portfolio and we remain optimistic that it can continue to pay a growing dividend to its shareholders in the future.

Moving to shelf friendly packaging is a cost out opportunity

Smaller footprint Bakery with less SKUs helps sales and stock loss

Healthcare

While COVID-19 has had implications across all sectors, demand across the healthcare sector has rebounded strongly. One example of this was across Sonic Healthcare's (SHL) global business as the pandemic and associated lockdowns precipitated dramatic falls in volumes and revenues. With pathology testing an integral part of clinical practice, for screening, diagnosing and monitoring disease, the reopening of economies has seen demand rebound as the majority of Sonic's divisions returned to pre-COVID levels in recent weeks.

In early March, we toured Sonic Healthcare's laboratory in Macquarie Park, Sydney. At the time, COVID-19 was more of a topic of interest rather than a global threat, therefore the focus was on normal business operations rather than the impact of the pandemic. The facility is an impressive one – it runs 24 hours a day, it is large scale and highly automated. It has a similar sized facility in Melbourne and a slightly smaller lab in Brisbane. SHL has invested in technology which has the dual benefit of reducing testing times and also reducing staff numbers. SHL has also invested in artificial intelligence (AI) and voice recognition to streamline the process.

The key earnings driver (from a macro perspective) is population growth and the aging population. The use of pathology services is higher for older age groups, with those aged 55 years and over accounting for over 50% of Medicare funded services[8]. SHL does not have pricing power, however it continues to win work through strong relationships with GPs and collection centres on site.

M&A will continue to be a feature - mergers enable SHL to view how other pathologist methods are used around the world. Adopting the best pathology method or introducing new testing opportunities (such as cardiology testing) throughout the SHL business will enhance further synergy gains on top of just the procurement strategy commonly used.

Finally, we believe there is a long-term monetisation opportunity in the data that SHL captures from its testing. This is some way off and will be subject to strict privacy laws but may help longer term in early detection of disease. This not only has the potential to improve the quality of life for patients, but early detection also helps improve the productivity of the economy and the value of expenditure across the healthcare system.

TPG Telecom and Vodafone Hutchinson Australia Merger

During the quarter, we welcomed the final court approval for the TPG Telecom (TPG) merger with Vodafone Hutchinson Australia (VHA). The Merged Company will create Australia's third largest telecommunications company bringing together two highly complementary businesses and creating economies of scale to compete with Telstra and Optus. The Merged Company will have an enhanced network which leverages quality backhaul infrastructure and opportunities to capitalise on the 5G market opportunity without the issues of a legacy mobile network.

As part of the merger, TPG spun-off Tuas Limited (TUA), who will now be the owner of the TPG Singapore business. As an existing shareholder of TPG, BKI received one share in Tuas Limited via an In-Specie Dividend of TUA's shares for every two TPG shares. This has been realised by BKI as a fully franked special dividend in FY2020.

While TUA is only a small part of the overall portfolio, we are optimistic on the growth prospects for this business. TUA is the fourth largest and newest mobile network operator in Singapore, having secured 4G spectrum a few years ago. On 25 June 2020, TUA was also allocated 800 MHz of mmWave spectrum by the Singapore Infocomm Media Development Authority (IMDA). This will allow the roll out of next generation 5G services in support of new consumer and enterprise use cases. While still in start-up phase, TUA will have no debt and circa $130 million of cash which they anticipate will be sufficient to get to EBITDA breakeven.

TPG Shareholders were also rewarded with a $0.49 fully franked special dividend following the implementation of the Scheme. This will be recognised in FY2021.

What happens next?

In our last quarterly, we noted that we had seen the fastest fall in market history, at 38% for the ASX200 that took 21 days compared to the average 250 days for 1929, 1987, 2000, and 2007 bear markets. Since our last quarterly, we have now experienced the fastest rise in market history in just 62 days, given the S&P/ASX200 Index has increased 36% from a 4,403 low reached on 23rd March to 6,006 points, reached on 19th June[9].

Since the low, an unprecedented amount of liquidity has been pumped into the global economy. Globally, $9 trillion has been injected into world economies or 18% of GDP. The Federal Reserve has printed over US$3 trillion and commenced buying Bond ETF's pushing Mutual Funds into Equities. Perversely the saving rate is climbing in the USA, having grown 33% month on month with USA Banks now sitting on excess reserves of $3.1 trillion. In Australia, the government continues to cap the 3-year term funding facility at 25 basis points for the Australian Banks. This has led to robust lending growth over the last 3 months at +4.5% year-on-year against +1.5% on a 12 month basis, whilst deposit growth has followed similar trends to the US growing at 19% year-on-year against 7% year-on-year on a 12 months basis[10].

The Banks and the Government continue to provide support to the country. Team Australia (Banks, APRA and Government), have committed to continue to help the 485,003 customers on mortgage deferrals worth $175 billion, once the debt moratoriums roll off in 3 months[11]. APRA are now talking about providing CET1 capital relief for the risk weighted assets of the Banks' portfolios, which would help support the $4 trillion loan book of the major Banks.

While it is unclear what happens when the $60 billion Australian Job Keeper program rolls off in September, we counsel caution. Valuations are not compelling. The S&P/ASX300 today is trading on a Price to Earnings ("PE") multiple of 19.6x for FY20, 19.2x for FY21 and 17.2x for FY22. The market is therefore implying Earnings per share ("EPS") in FY21 will be only down 0.2% year-on-year with a strong rebound of 8.6% in FY22.

Despite some strong updates reported in recent weeks, companies have also noted that the outlook is uncertain, and it is unclear whether the current environment will continue. In Australia we have close to one million people unemployed with underutilisation of labour at 20.2%[12]. Going into reporting season, we remain cautious on the FY21 outlook given the artificially inflated environment we are in.

Conclusion

Despite the uncertainty, at BKI we continue to follow our five-step investment process. We focus on investing in the highest quality companies in Australia that can deliver a sustainable dividend over the medium-to-long term for shareholders. While we expect the market volatility we have seen over the past few months to continue, our company visits and site tours highlighted the importance of our process. The knowledge we gain is two-fold – it provides us with insights regarding the current operating environment and also allows us to better grasp the magnitude of the long-term opportunities. Our site tours and company visits have confirmed that with a growing population, infrastructure boom, thriving key industries and large tracts of undeveloped land, the long-term prospects for the companies we invest in remains intact.

Sources

(1) Aerotropolis Investor Guide
(2) Major works begin on mammoth Western Sydney Airport project, March 2020
(3) Investor opportunities abound in Western Sydney Aerotropolis: Westpac, February 2020
(4) Australia Market Snapshot - How Will Population Growth Impact Property Markets, CBRE
(5) Shaping Future Cities Designing Western Sydney, December 2015
(6) Amazon launches giant robot-filled centre in Sydney
(7) ABS Retail Trade
(8) The economic value of pathology: achieving better health, and better use of health resources, April 2016
(9) Factset
(10) Macquarie Bank Research, May 2020
(11) Australian Banking Association
(12) ABS Labour Statistics 6202.0

Disclaimer and Important Information