BKI INVESTMENT COMPANY LIMITED

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ABN: 89 615 320 262

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CONTACT ASSET MANAGEMENT

BKI is managed by Contact Asset Management
AFSL 494045

QUARTERLY REPORT

LOOKING BEYOND A REMARKABLE YEAR . . . AND A FEW STOCKING FILLERS FOR CHRISTMAS!

Welcome to the 28th edition of the BKI Quarterly Report, prepared by Contact Asset Management (Contact).

It has been quite the year – an understatement to say the least! In mid-December 2019, the S&P/ASX 300 Accumulation Index was 73,188 points. In mid-December 2020, the S&P/ASX 300 Accumulation Index was 73,336 points. A mere 0.2% change. This seemingly benign move gives little insight into a period which witnessed:

- A 36% drop in the Australian Equities market from 20 February to 23 March;
- A 51% recovery in the Australian Equities market from 23 March to 9 December;
- An unprecedented Australian Government stimulus and support program totalling $507 billion (source: KPMG Australia) to cushion the blow from the COVID-19 pandemic and strengthen the economy;.
- Widespread lockdowns across the country;
- The lowest Australian influenza rates in recorded history (according to Doherty Institute deputy director Ian Barr) due to social distancing, mask wearing, hygiene practices and school and international border closures;
- A moratorium on people paying mortgages or rents;
- An oil price that traded at *negative* US$37.63 in April;
- Home loan rates below 2.0%; and
- Term Deposit rates below 0.50%

However, the volatility does provide a key lesson for investors – stay the course and invest for the long term. In mid-April 2020, Contact Asset Management was featured in the Australian Financial Review under the article "*This bear market will be a generational wealth opportunity*". We confess that we were cautious leading into April 2020 and were holding a higher proportion of cash than usual. However, we were quoted as saying, *"These [bear] markets happen. Its important not to get caught up in the headlights and the noise. Often the best thing to do is nothing – just stick with your winners . . . the high-quality companies. It all comes back to don't panic, be patient, stick to the long term."*

We expect there to be a plethora of 2020 year end market commentaries that provide a blow-by-blow of several remarkable events. There are many others that will do a far better job at this than we can lay claim to.

Rather, we take this Christmas missive as an opportunity to discuss a few stocks that are owned by BKI and other portfolios managed by Contact Asset Management. We believe that too many investor reports dwell on macroeconomics, interest rates, asset allocation, currencies or growth versus value. We believe that our co-investors are better served by Contact discussing the characteristics of quality companies that we seek to own for the long-term.

We are optimistic that the recovery from COVID-19 will continue and we are seeing increasing numbers of management teams convey more positive operating environments. Last week, Jamie Dimon, CEO, JP Morgan Chase & Co noted, "There's no question that things are better than people thought a few months ago".

Four potential stocking fillers for 2021

Contact Asset Management invests on behalf of BKI using a set of principles that have been honed for generations. We seek to invest in quality companies that offer income and growth. We adopt five fundamental tenets in our investment process and assess opportunities across Principal Activity, Income, Financial Position, Management and Valuation. It is a process that has served us well for many years.

Contact Asset Management is the investment manager for BKI Investment Company, the Washington H Soul Pattinson Large Caps Portfolio, the Contact High Conviction Fund and the Contact Australian Ex-50 Fund. We manage $1.5 billion across these strategies. In this report, we highlight four stocks (two Large Cap and two Ex-50 companies) that we believe are well positioned heading into 2021 – Transurban Group, BHP Group, Harvey Norman Holdings and Inghams Group.

Transurban Limited (TCL)

Transurban operates 19 roads in Victoria, NSW, Queensland and North America. Toll road usage was hit hard during the COVID-imposed lockdowns in late March and early April. In Melbourne, use of Transurban roads was down 65% at its lowest level in April compared with the same time in 2019. Sydney and Brisbane bottomed at 51% declines.

However, the recovery is well underway, and we believe traffic volumes will continue to rebound to historical levels. Many commuters are still shunning public transport. With restrictions being lifted on Australians returning to the office, the percentage of employees working from home will reduce and trips on TCL operated roads will increase. The Northconnex tunnel in Sydney has also opened. It is an impressive infrastructure project and will take 5,000 trucks off Pennant Hills Road each day. Many investors underappreciate the importance of the Truck toll multiplier. For example, a car travelling on Northconnex pays $7.99 per trip, a truck (or Class B vehicle) pays $23.97, three times as much. This multiplier effect is common across most of TCL's assets.

The NorthConnex Tunnel under construction (left) and completed (right) opening on 31st October 2020

Over its network, TCL's Average Concession Expiry is 37 years and has an Annual Average Toll Escalation Growth rate of 3.0%. TCL's ability to increase tolls above inflation is impressive. In a low interest rate environment, TCL is actively refinancing debt at attractive rates. The company offers a compelling distribution yield in excess of 4%. Importantly, there are plenty of growth opportunities for this well-managed business. Future growth opportunities exist with WestConnex in Sydney and the West Gate Tunnel in Melbourne to be delivered over the next 2-5 years. These projects will also now be fast tracked due to infrastructure stimulus announced by State and Federal governments. Future projects that TCL is likely to play a vital role in design, construction and management include the Beaches Link, Western Harbour Tunnel, Sydney Gateway and M6 in Sydney.

BHP Group Limited (BHP)

BHP is Australia's largest resources company – its major divisions are Iron Ore, Copper, Petroleum, and Coal with work spread across 18 projects globally. The recent strength in iron ore and copper prices is a boon for BHP. At the time of writing, iron ore was trading at more than a seven year high, driven by robust global demand and reduced global supply due to persistent operational issues at Brazilian miner Vale. The spot price for iron ore has exploded since the start of November and is currently above US$150/tonne – BHP's cost per tonne is less than US$15. At its last result, iron ore accounted for approximately 60% of BHP earnings and we are forecasting iron ore to contribute over 67% of BHP earnings in FY2021.

Images from the BHP 2020 Annual Report

The recent strength in the copper price is hugely beneficial also. Copper accounts for approximately 20% of BHP earnings. Copper is also trading at seven-year highs and has surpassed $3.50/lb. The rebound of activity in China has been a driver. In addition, a deficit in the copper market is set to deepen over the next several years as supply of the widely used metal struggles to keep up with strong demand from the power and construction sectors, compounded by the proliferation of electric vehicles, mobile phones, televisions and computers.

The free cash flow that is expected to be generated by BHP based on current commodity prices is significant. Contact forecasts that free cash flow in FY2021 is likely to exceed US$15 billion. It is not inconceivable that BHP could soon be debt free. Contact's forecasts imply a dividend yield in the next twelve months of close to 5% (grossed up) and a P/E multiple of approximately 15 times.

Harvey Norman Holdings (HVN)

Harvey Norman was founded in 1982 and today has over 850 stores under a company owned and franchisee model. The business has become one of Australia's great retailing success stories, that has compounded capital at 14.4% since IPO. Not only does Harvey Norman have a successful retail store offer, but it also has a property book that often gets overlooked. The property segment is valued at approximately $3 billion and contributes 30% of group profits. We consider this valuation to be conservative. The HVN Annual Report discloses capitalisation rates of the properties to be between 6.0% and 10.5% - yet many listed peers are trading on 4.5% to 5.5% capitalisation rates.

Harvey Norman also boasts a strong overseas presence, contributing over 30% of group revenue through 95 stores across New Zealand, Singapore, Malaysia, Slovenia, Ireland, and Croatia. The potential to enter new geographies through its scale, combined with allowing its geographic franchises to own the P&L bodes well for retailing success. The success of the business overseas, which is growing profits double digit, all comes down to Harvey Normans strong culture and ability to successfully recruit and maintain talent. When we talk to Management, they tell us "Our success is all about our people".

Older Harvey Norman format (left) and a new Flagship Store layout (right).

As a founder-led business, and with sales still strong growing double-digit post COVID at +28% year on year, we expect Harvey Norman to produce a strong result in the coming year. At the recent HVN AGM, Chairman Gerry Harvey noted, “It doesn’t look like the economy is going to be anything other than very strong in the immediate future”.

Harvey Norman has emerged as a winner from COVID-19 and its Balance Sheet is now very strong. Based on our sensitivity analysis, even if sales are low single digit per annum and the space roll out plan is achieved, Harvey Norman could be net cash over $900m within three years. For FY21, if Harvey Norman pays out dividends at the lower end of its target range at 65% and achieves EPS growth at 11%, half the rate of current sales growth, Harvey Norman is still on a potential grossed up Dividend Yield of 8.2%. We believe Harvey Norman has shown itself as a compounding machine - BKI are happy long-term owners.

Inghams Group (ING)

Ingham’s was founded in 1918 and was managed by members of the Ingham family from its establishment until 2014 when it was acquired by Private Equity and subsequently listed in 2016. ING is a vertically integrated poultry producer with 40% market share in Australia and 35% in New Zealand. Chicken consumption has proven to grow as a category year on year, having compounded at an average 4.0% for over 30 years. It is the most consumed source of animal protein in both Australia and New Zealand (at 40% of all consumption) yet importantly is far cheaper per kilogram than Beef and Lamb.

We believe that ING boasts a solid balance sheet, an experienced international Management team, and latent pricing power. Importantly, ING is set to benefit from significant tailwinds in 2021 on the back of a bumper wheat season (as forecast by the Australian Bureau of Agricultural and Resource Economics (ABARE)). This will drive feed costs lower.

Ingham’s cold store facility (right)

As we know, Australia has experienced significant drought for many years – and last year Australia was forced to finally import wheat. This is the first time that has happened in twelve years. 2021 is set to be very different – ABARE projects Australian wheat production to double to around 31 million tons, with a potential over supply of domestic grain. This bodes well for Ingham's margins and Net Profit, with wheat accounting for over 60% of the cost of doing business for Ingham's. The sensitivity to profit is meaningful – every 5% move in the wheat price has a 6% impact on Net Profit. The price of wheat has dropped significantly from ~$450/tonne out of Port Kembla in March 2019 to now ~$250/tonne. Volumes remain robust and Ingham's recently reported 6% growth in volumes at its latest trading update. With costs coming down, we anticipate positive operating leverage. In the meantime, we are being rewarded by the likelihood of a compelling dividend yield of over 8% (on a grossed-up basis).

ARB Corporation (ARB)

Finally, we believe that a fundamental responsibility of the Equity Analyst role is to visit our investments where possible and meet management. In November, Contact shared an Insights note on ARB Limited (ARB) following a tour of several key ARB stores in Sydney. The note is available on our website at https://contactam.com.au/insights/

It has been quite the year. 2020 reinforces an important lesson – stay the course and invest for the long term. We are optimistic that the recovery from COVID-19 will continue. We remain convinced that in the end optimism rules and opportunities never cease.

Tom Millner and Will Culbert