BKI INVESTMENT COMPANY LIMITED
ABN: 23 106 719 868

ASX and Media Release

5 January 2022

The Manager
Company Announcements Office
Australian Stock Exchange Limited
Level 6, Exchange Centre
20 Bridge Street
SYDNEY NSW 2000

BKI DECEMBER 2021 QUARTERLY REPORT

Enclosed is the December 2021 Quarterly Report for BKI Investment Company Limited (ASX: BKI).

Jaime Pinto
Company Secretary

Business Overview - BKI Investment Company is a research driven, Listed Investment Company, investing for the long term in profitable, high yielding, well managed companies. Listed on the Australian Stock Exchange (BKI.ASX) with the equity portfolio managed by Contact Asset Management, an investment in BKI gives shareholders access to a diversified Australian equity portfolio.

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ABN: 89 615 320 262

December 2021

CONTACT ASSET MANAGEMENT

BKI is managed by Contact Asset Management AFSL 494045

QUARTERLY REPORT

WHO HAS THE PRICING POWER?

Welcome to the 32nd edition of the BKI Quarterly Report, prepared by Contact Asset Management ("Contact").

2021 has been an extraordinary year. As the calendar year closes, we continue to experience the secondary effects from flooding the world economy with cash through global stimulus packages distributed during 2020 and 2021. We have written about our concerns with production capacity challenges, price rises and a global supply chain bursting at the seams several times in previous Quarterly Reports and *Contact Insights* pieces. We saw how negative operating leverage hampered many businesses in early 2020, followed by a quick recovery in demand of almost every good and service which restored sales numbers to kick these issues down the road. As we enter 2022, we face further issues involving inflation, a lack of service and labour shortages. We monitor these ongoing issues very carefully and focus on which companies have a fixed cost base and those companies that can pass on prices to their customers to ensure continued profitability and earnings growth. With these issues as a backdrop, we seek to identify which companies have pricing power.

Despite product shortages and supply chain issues, the show goes on

Multiple support packages, low rates and a shift of international travel spend over the last two years culminated in a staggering boost in demand for goods and services. This is highlighted by strong retail sales data in almost every sector. This ongoing situation places even further pressure on the supply chain. We wrote about this in the Contact Quarterly Report in September 2020… *"The other issue garnering our attention is the supply chain. Our discussions across various industries increasingly point to bottlenecks in the supply chain – be it mobility of labour, access to inventory or availability of spare parts. Domestically, the lockdowns in Victoria are creating supply chain headaches for many businesses. However, this is also a global issue. We think this issue could be a potential headwind on the earnings recovery story."*

Then, as we wrote in the Contact Insights piece in June 2021… *"A swift change in consumer behaviour from multiple stimulus packages and availability of cash across the globe is causing some damage to economies that may outweigh the positives of inflation. There is such a significant demand for goods and services, that we are now seeing substantial shortages in supply. There are also significant shortages in labour, in manufacturing, in shipping, in containers, in pallets… in almost everything. Our ports are saturated, we do not have enough dockworkers or truck drivers. The system is stretched and is approaching breaking point. This has caused a shortage of product across most parts of the world, and we have all experienced the extensive wait times when purchasing goods. Inventory levels are so low that many stores are holding products that have already been sold. Wait times for cars, industrial machinery, farm machinery, boats, campers, bikes, building products and sporting products have ballooned."*

We have had interest rates at near zero levels and multiple government support packages, such as JobKeeper, JobSeeker, HomeBuilder, early superannuation access and tax concessions handed out over the last two years. We also witnessed the significant impact international holiday travel spending has had on the economy. This created an environment that made it easier than ever for people to buy, invest and to borrow. Second homes, renovations, boats, cars, campers, electrical goods, furniture have all been purchased and, as restrictions eased, we've seen many consumers dining out multiple times per week at restaurants and cafes across Australia. Despite the significant lack of supply, the consumer spending spree continues in full swing.

We now have another major issue… a lack of service

As 2021 rolled on, the product shortages and supply chain issues were joined by another major issue, a lack of service. Put simply, the COVID-19 relief packages appear to have made it far too easy for people to avoid work. The knock-on effect of this is that Australia is now significantly short labour.

We have all seen and heard the stories of businesses unable to reopen post lockdown due to lack of staff. Labour shortages are now as serious a concern as the product shortages and supply chain issues we were introduced to in late 2020. There are many factors that cause shortages in labour across different industries, but at the end of the day, it all stems from COVID-19.

Compounding this is that forced border closures have prevented immigration and migrant workers from entering Australia. As we emerged from lockdown, we also saw a massive rise in resignations in certain industries most affected by COVID-19, tourism and hospitality in particular. Moreover, the spike in COVID-19 cases from the Omicron variant has placed further pressures and labour shortages due to many staff members testing positive to COVID-19 or becoming a close contact, forcing the need to self-isolate.

There are also other sectors that struggle with labour shortages due to their success throughout COVID-19 and resulting from Australia's extremely strong economic recovery. Many businesses simply can't meet demand due to a lack of staff and not being able to provide the appropriate service to their customers.

In November, Australian job advertisement figures from Australia and New Zealand Banking Group Ltd jumped 7.4%. This follows the October monthly increase of 7.5%. The figures now show that Australian job advertisement figures are 52% higher than a year earlier and 44% higher than pre-COVID-19 numbers. Normally these figures would have us all excited about how well the economy is doing; however, due to the lack of desire to work and the lack of immigration and international students, there are simply not enough people to fill these positions. This situation is having the opposite effect on the economy and will cripple growth throughout 2022 unless there is an immediate change.

The other sleeping issue amongst all of this is the "great resignation" of our baby boomers. This issue hasn't eventuated to the scale forecast by many thus far, so this added pressure is still to come in the next few years.

Inflation and the added cost of addressing service and labour issues

There is no question that the supply-chain disruptions discussed above have added to today's concerns around inflation. We believe that the current issues surrounding inflation can be attributed to supply chain issues and the increasing cost of doing business in the current economic environment.

When we wrote about supply and product delay issues in September 2020, we highlighted just how susceptible many businesses are to a change in normal operating conditions. Many management teams over the years have spoken about how resilient their businesses were, but then reported a halving of profits in the depths of COVID-19. Fortunately, many of these businesses recovered quickly thanks to government support packages and a very robust economy experienced throughout much of 2020 and all of 2021.

We remain concerned some business models will suffer when the stimulus runs out and revenues flatten or even fall year on year. We were surprised by the pace at which negative operating leverage hampered many businesses in early 2020 due to revenue declines and high fixed costs. What continues to worry us is that while revenue growth seems reasonable in the current market, the added costs of COVID-19 are now really beginning to crimp margins. The increase in operating costs can be extreme. Many businesses are getting caught out trying to source increased staff to meet demand, and face higher sourcing costs, higher cleaning costs and higher logistics expenses.

We've all seen how the labour shortage has forced many restaurants to close over the Christmas and New Year period, which unfortunately is one of the busiest times for the year. We've seen many businesses simply not reopen post lockdowns because it's all too difficult and we've heard stories of a top end restaurant in Sydney offering to pay their dishwashing staff as much as $90 an hour, but still can't fill the position.

We believe those companies that have scale but don't have pricing power, and there are many, will see their business model come under significant pressure during the next 12-24 months. If that business happens to be in a highly competitive sector and these additional costs aren't able to be passed on quickly to the consumer, that company's competitive advantage is eroded.

On a more positive note, several industries have actually enjoyed strong revenue growth over the last two years and will continue, we believe, to do so over 2022. Many companies within these industries may have a relatively fixed cost base but they also have pricing power, so any additional costs incurred during these COVID-19 times can be passed on. A clear competitive advantage in this environment. It is these quality companies that can pass on additional costs that we intend to invest further in during the year ahead.

Every cloud has a silver lining

Despite times of uncertainty there are always opportunities to invest within equity markets. The Board of BKI and the Portfolio Managers at Contact have seen many difficult investment periods before, and it is in periods like these that it is more important than ever to maintain a robust investment process. The quality assessment of companies that Contact undertakes forms a critical part of the BKI investment process. We've discussed the Contact and BKI six step investment process many times over the years, and as we keep noting, it is robust and repeatable. We look at 1) Principal Activity, 2) Income, 3) Financial Strength, 4) Management, 5) ESG and 6) Valuation. Our goal is always to invest in high quality businesses with a strong balance sheet, a competitive advantage and that are managed by capable and trustworthy people. We seek to invest in businesses that will pay us an attractive and sustainable dividend stream and we look to invest in these businesses at a reasonable price with a view of holding them for the long-term to create long-term capital growth.

It is through uncertain periods such as we're in now that we home in on step one of our process, Principal Activity. Questions we ask ourselves here include; Do we understand the business and how it makes money? Does this business have a sustainable business model? Does the product they produce or service they provide give them a clear competitive advantage? Are there high barriers to entry, making it difficult for other competitors to enter their space or take market share? What are the industry dynamics and are there any regulatory threats?

As long-term investors we are confident that a company with a clear and simple business model, and one which has sustainable pricing power will be able to protect their profit margins, competitive advantage and be successful in most cycles. Further, with slowing top line growth, rising inflation and other COVID-19 related uncertainties on the horizon for 2022, we will focus on companies that don't just have nominal pricing power but real pricing power. Real pricing power is more of a focus for us as it refers to a company's ability to raise prices above inflation.

On this topic, Warren Buffet has been quoted saying *"If you've got the power to raise prices without losing business to a competitor, you've got a very good business. And if you need a prayer session before raising the price by a tenth of a cent, you've got a terrible business."*

Taking a closer look – Who has the pricing power?

Several companies have enjoyed solid revenue growth for the first quarter of FY2022. It's not whole sectors grabbing headlines but rather specific stocks. Indeed, there has been a clear divide within sectors of the supermarket retailers, online retailers, healthcare and resources.

We have begun to see that while revenue growth has been robust for the supermarket retailers, the unexpected costs of COVID-19 have crimped margins of some of the major players. While online sales have increased significantly, not all online retailers can pass the additional costs on to their customers. Despite still being in the middle of a pandemic, not all healthcare companies have performed equally well. Whilst lacking pricing power on commodities produced, the high-quality resource companies continue to drive their cost of production to historically low levels, enabling them to protect and grow earnings despite fluctuations in commodity prices.

Woolworths Limited (WOW). WOW despite having significant market share and a clear competitive advantage in the retail space, has proven with their latest announcement to the market that they cannot pass on all additional COVID-19 costs to

the consumer through price increases. Woolworths has had to deal with these pressures for the best part of two years now, and recently announced a profit downgrade on its FY 2022 first half trading performance.

Woolworths Group CEO, Brad Banducci, said: *"The first half of FY22 has been one of the most challenging halves we have experienced in recent memory due to the far-reaching impacts of the COVID Delta strain and its impact on our end-to-end stock flow and operating rhythm. We have continued to put the health, safety and wellbeing of our customers and team first in the context of this challenging and volatile operating environment."*

"Sales growth in Australian Food is positive on a one-year basis and strong on a two-year basis but moderated in Q2 following the easing of restrictions in NSW and Victoria. We are pleased with our sales growth compared to the overall market."

"However, the ongoing material costs of operating in a COVID environment has impacted our expected earnings in H1. COVID has had a significant impact on costs, even more so than last year due to the combination of both direct COVID-related costs, together with the indirect impacts from disruption caused by COVID. This includes the significant disruptions we have seen across the end-to-end supply chain, and the material inefficiency this causes in our stores, distribution centres and transportation."

Woolworths noted in their announcement that for *"H1, direct COVID costs in Australian Food are expected to be approximately $150m, with the costs split between supply chain and stores, to ensure the safety of customers and team. In addition, the indirect disruption to stores and distribution centres from operating in a COVID environment has led to elevated operating costs of approximately $60m to $70m in the half."*

What this announcement highlights to us is that Woolworths and many of their competitors, despite having real pricing power, are overly focused on market share and revenue growth, not profits. If competition within this space wasn't so fierce, then we would expect to see continual price inflation and profit margins being maintained. Woolworths is able to lift prices, if only a fraction, to offset these additional COVID-19 related costs and maintain profits for its shareholders, but they appear to have chosen not to.

Metcash Limited (MTS). Metcash, on the other hand, have been a beneficiary of the recent COVID-19 situation. As the company wrote on the 6th December 2021 in their Half Year 2022 ASX Announcement, *"The preference for local neighbourhood shopping and shift from cities to regional areas helped our independent retail networks all deliver 'like for like' sales growth in the half. Compared with 1H20, substantial growth was delivered with IGA Supermarkets up 18.8%, Liquor up 27.0%, Independent Hardware Group stores up 17.7% and Total Tools stores up 51.0%. This is a significant achievement given the many challenges in the half including staff isolations, labour shortages, supply chain issues, continuously changing health regulations and other lockdown-related impacts."*

Along with strong revenue growth from all their pillars, Supermarkets, Liquor, Hardware and Total Tools, Metcash's Group underlying EBIT and underlying profit was also higher, up 13.9% and 13.1% respectively. Metcash's earnings per share grew 15.0% to 14.6 cents per share, enabling Directors to lift their interim dividend by 31.0% to 10.5 cents per share. A great result for shareholders and a display of real pricing power.

Metcash went on to say in their outlook that *"strong sales have continued in the first five weeks of 2H22 buoyed by the shift in consumer behaviour and improved competitiveness of our retailer networks. The Food and Liquor pillars are expecting to benefit from a strong Christmas/New Year trading period and the extensive regional presence in our retail networks. We expect supply chain disruption, and increased COVID-related and labour costs, particularly in distribution centres, to continue to be a risk for all Pillars in 2H22."* Despite these risks we are confident Metcash is focused on the shareholder and will execute real pricing power to ensure continued profit and dividend growth for shareholders into the future.

Transurban Group (TCL) – Transurban, as one of the world's largest builder and operators of toll roads, has pricing power. Toll collections for TCL's network of roads across Melbourne, Sydney, Brisbane and North America are growing annually as price increases are either linked to CPI or to a greater mandated amount, providing large pricing powers for the group. The annual price rises aren't just a one off either - Transurban's assets are long life with the average concession being over 30 years. Across the network there is approximately 1.7 million trips per day, with this expected to grow through the group's multiple projects currently under construction. Since the reopening post COVID-19, traffic volumes have improved

significantly across all markets, with the recovery trend particularly evident in Sydney and Melbourne following lifting of restrictions late in 2021.

Sonic Healthcare (SHL) – As a medical diagnostics company with operations in pathology, Digital Imaging and medical centres across Australia, New Zealand, the USA, Germany, Belgium, Switzerland and the UK, SHL has significant pricing power. Sonic Healthcare has been in Australian clinical labs and pathology for many years and has more recently seen an increasing contribution from offshore markets due to its organic growth and acquisition strategy. Since the commencement of the pandemic, SHL has been able to diversify its business model further from pathology collection and testing to include COVID-19 testing.

Today, Sonic is performing crucial laboratory testing on tens of thousands of people every day for COVID-19. The company estimates that to date they have conducted approximately 40 million COVID-19 PCR tests. They also perform whole genome sequencing to aid identification of COVID-19 variants. In Australia Sonic has also provided more than 1 million COVID-19 vaccinations to the public.

For these services, in this environment, SHL has real pricing power as shown in their recent release to the market. SHL's headline financial results for the four months to 31 October 2021 showed Revenue growth of 5%. Pleasingly SHL has been able to pass on all additional costs and charge for their services appropriately, as evidenced by their EBITDA growing 16%.

Amcor Inc (AMC) – AMC generates annual revenues of approximately USD$13 billion by supplying flexible plastics and rigid plastics across a wide range of products including food, beverage, pharmaceutical, medical, home and personal care. As a global leader in packaging and production of flexible and rigids, Amcor Inc, has pricing power. This was proven once again recently when Amcor confirmed that it had passed on price increases of up to 15% for products across its global businesses effective from the 1st January 2022. These pass throughs are part of the company's ongoing response to supply constraints and higher input costs across multiple categories including raw materials, transport and energy. Peter Konieczny, Amcor's Chief Commercial Officer, was quoted saying *"Amcor is working closely with customers and supply chain partners to keep servicing elevated demand for high performance packaging. These price increases are necessary to ensure we continue to minimize the effects of challenges in global supply chains."*

Reece Limited (REH) - Supplier of plumbing and bathroom products Reece Limited, announced in their Q1 FY2022 sales update that they had achieved *"sales revenue of A$1,771m for the first quarter, up 13.2% on the same period last year. In ANZ, sales revenue was up 9.0%. In the US sales revenue grew 18.6% on a USD basis."* Peter Wilson, REH's CEO and Managing Director said in the announcement that, *"Sales revenue for the first quarter has been positive, reflecting momentum from FY21. We have continued to see growth in both regions which has exceeded our expectations. However, the future continues to be unpredictable with inflation dynamics, supply chain disruptions together with tight labour markets and wage inflation we are expecting to accelerate in Q2 and persist for the balance of FY22. As an essential service we will rely on our adaptive and resilient business model to protect and preserve our business today, whilst creating a position of strength to accelerate our long-term strategy".*

Despite the caution, and the issues we've spoken about in this quarterly report, the company did also flag that their EBITDA for the first half of FY2022 would grow between 8%-11% on last years figures. At 11% EBITDA growth, we are again confident REH has pricing power and will be able to pass on additional costs to their customer without the fear that they will be losing business to a competitor.

ARB Corporation (ARB) - ARB Corporation has been designing, manufacturing, distributing and selling 4WD vehicle accessories and light metal engineering works since the 1970's. They boast a globally recognised brand and focus on innovation and R&D as a core part of the Company's strategy. They have significant pricing power and have displayed this multiple times over the years. More recently ARB's export segment has produced double digit sales growth and remains a key growth area for the business. ARBs domestic and international order book remains very strong.

The company recently stated in a presentation to shareholders that they are, *"continuing with its product development work, store development program in Australia and the expansion of its manufacturing capability. The Board is pleased to report*

that, in the absence of unforeseen circumstances, sales and profit growth is expected to continue for the first half. The Board believes that the Company is well positioned to achieve long term success with strong brands around the world, increasing manufacturing and distribution capacity, capable senior management to meet any challenges and a strong balance sheet to take advantage of opportunities as they arise."

BHP Group (BHP) – It has been a great time for Australian resources as we have seen a soaring demand for major commodities being met with limited supply. However, within these periods we often see big business get fat. As the business grows and their revenues increase to levels never seen before there is always that temptation for management teams to increase fixed costs. Add additional staff, appoint additional contractors, spend surplus capital on unnecessary equipment. If a management team isn't disciplined on their costs throughout the cycle the company can very quickly see their higher fixed costs stick despite the issues of potential commodity price corrections in the future. To the credit of BHP management, despite seeing record commodity prices for much of 2021, their cost discipline is excellent.

Despite not having pricing power, BHP continue to be one of the lowest-cost iron ore majors globally, with Iron Ore unit costs of US$14.82 per tonne, which is remarkable. BHP's copper unit costs at Escondida are US$1.00 per pound and Petroleum unit costs are only US$10.83 per barrel of oil equivalent. Queensland Coal unit costs are US$82 per tonne and NSW Energy Coal unit costs US$64 per tonne which are also very favourable and competitive. Despite these low costs, we are confident they will continue to improve on this in years to come. BHP has announced in the 1st Quarter Report in October that *"all production and unit cost guidance remains unchanged for the 2022 financial year."*

Fortescue Metals (FMG) – Fortescue has announced a strong start to FY2022 with their latest quarterly report stating that *"mining, processing, rail and shipping combined for record first quarter shipments of 45.6mt, 3% higher than the prior comparable period. Ore processed and railed also achieved record first quarter volumes, reflecting strong operational performance across the supply chain and expanded system capacity following the ramp up of Eliwana."*

It is also a similar story with Fortescue and their focus on costs. FMG's cost of production for the first quarter of FY2022 was US$15.25/wmt. Again, a remarkable achievement.

Despite what 2022 brings and the ongoing concerns with production, price rises, supply chains, inflation, serviceability and labour availability we will continue to focus on investing in quality companies. We will target those quality companies with the ability to pass on prices to their customers to ensure continued profitability, earnings growth and dividend growth for their shareholders. It will be these businesses that will prove to be the standout investments during this period of uncertainty.

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