BKI INVESTMENT COMPANY LIMITED

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CONTACT ASSET MANAGEMENT

BKI is managed by Contact Asset Management
AFSL 494045

QUARTERLY REPORT

Consumer Staples in an Inflationary Environment

Welcome to the 34th edition of the BKI Quarterly Report, prepared by Contact Asset Management ("Contact").

Rising global inflation and ongoing supply chain disruptions are just two of the compounding challenges that are testing the resilience of corporations and investors alike. Indeed, inflation has become the dominant topic of our daily news. We believe the main issue for investors as we head into FY2023 is the monetary policy tightening underway by Central Banks. There seems to be a "whatever it takes" attitude to combat inflation. It appears that Central Bankers remain convinced that economies are strong enough to handle the perceived rate increases. The pace of rate hikes remains an overhang as does the level at which interest rates settle. The RBA, which increased rates again in early July to 1.35%, is hoping that it can burst the inflation bubble and settle rates below 3.5% by mid-2023. While this is a significant percentage increase from the pandemic low-rate environment, a rate of 3.5% is still very accommodative in a historical context.

In this Quarterly Report, we consider the likely impact on the Consumer Staples sector, which has historically been a relative safe haven in times of inflation. We revisit our store walk survey from seven years ago and discuss our positive view on Metcash Limited.

The Australian Consumer is Facing Headwinds

In May 2022, the RBA increased the cash rate target by 25 basis points to 35 basis points. It was the start of an RBA strategy to remove the "extraordinary monetary support" that was in place during the pandemic. This was a major U-turn from the rhetoric that rates were unlikely to rise until 2024. The move has caught many Australian households off-guard.

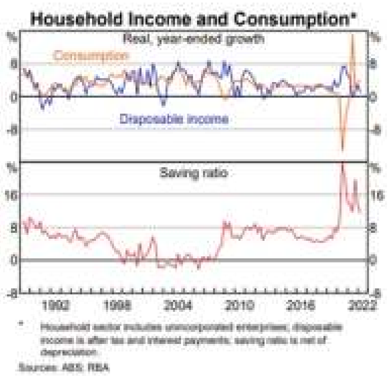
At the time of writing, the cash rate target was 1.35% with bond market expectations that it will settle around 3.5% by the middle of next year. In the RBA's mind, there are two considerations which justify the change in tack on monetary policy:

(i) the economy has been very resilient, unemployment is low and economic growth is expected to be strong this year; and

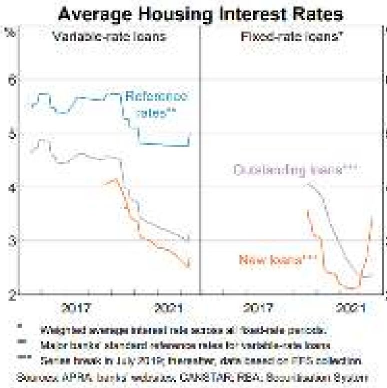
(ii) inflation has picked up more quickly, and to a higher level, than was expected and there is evidence that labour costs are increasing more quickly.

The RBA is of the view that the average household can withstand tighter financial conditions in the battle against inflation. In the July Statement on Monetary Policy, the RBA noted that recent household spending data "have been positive", "the household savings rate remains higher than pre-pandemic" and "many households have built up financial buffers". The following charts illustrate some of the key data points that the RBA Board consider in setting monetary policy.

Charts 1 and 2: Inflation is accelerating quickly however the RBA sees the high Savings ratio as a "buffer".



Charts 3 and 4: Interest rates are low by historical standards and there have been large increases in house prices



The challenge is that most of the data that the RBA considers is backward looking. Primarily, inflation has become the big issue for the RBA, and in turn Australian households and corporates. Until inflation is under control, we can expect a period of rising rates.

In the recent Metcash Limited FY2022 result briefing, the word “inflation” was mentioned 26 times. At the FY2020 briefing, “inflation” was mentioned 5 times. On a positive note, “Covid” was only mentioned eight times at the FY2022 briefing versus 40 times in FY2020! The Managing Director noted *“Of course, inflation is here and has accelerated. Getting into a little detail, you'll have seen that H1 and H2 numbers for inflation have changed from the first half to the second half. If you exclude – if you look at inflation on an excluding tobacco and produce basis, wholesale inflation in the fourth quarter was 3.4%, in April it was 5.3% and in May 4.5%. And as we pointed out, an increasing number of suppliers are asking for price increases.”* And *“It's also worth noting, we will continue to invest in inventory while supply of product remains uncertain and whilst inflation remains high. This approach has served our retail members well as well as our investors.”* Simply put, the inflation being felt by the supermarkets will be passed on to households. As depicted below, a lot of the inflation is in non-discretionary items.

Chart 5: Components of inflation outlining non-discretionary and discretionary factors (Source: ABS)

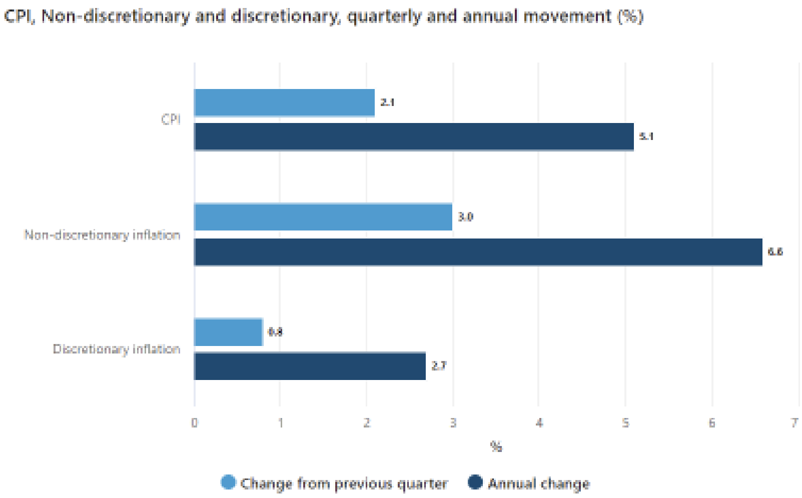


Chart 6: Petrol prices have also increased materially over the past year

The good news is that Household Net Wealth is robust, and unemployment is at multi-decade lows. Thus, there is some credence to the RBA argument that Australia has buffers. Nevertheless, households are facing an increased impost on monthly cash flows and expenses. Many will need to change spending habits as a result.

In an attempt to quantify the headwinds being faced by Australian Households, we have looked through ABS and recent Census data to establish a hypothetical scenario to illustrate the hit to budgets. In it, we assume a $500k mortgage (which is less than ABS data suggests new average mortgages are currently), a tank of petrol per week for a mid-size vehicle (60L tank) and then we have increased an average weekly household grocery bill and other eating out expenses (sourced from Canstar Blue). The scenario does not cover every household expense but is illustrative nonetheless.

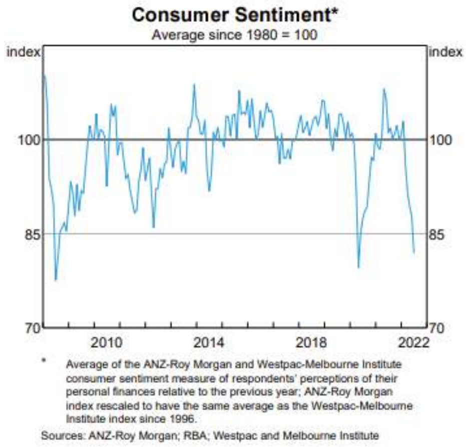
Table 1: Scenario to highlight the hit to Monthly Household Budgets from recent inflationary impacts
Comparing June 2021 to June 2022

Category	Jun-21	Jun-22	Increase ($)	Inflation (%)	Comments
Fuel	$346	$504	$158	*45.8%*	Assumes one tank per week. Camry 60L. Petrol price from $1.44/L to $2.10/L
Mortgage	$2,041	$2,370	$329	*16.1%*	Assumes average $500k mortgage with recent rate increases
Groceries	$612	$652	$40	*6.6%*	ABS Non-discretionary inflation / Canstar ($153/week)
Eating out / other	$440	$452	$12	*2.7%*	ABS Discretionary inflation / Canstar ($110 / week)
Total	$3,439	$3,978	$540	*15.7%*	The $540/mth is an annual impost of c.$6,500 to the Household

Source: RBA, ABS, Census bureau, Canstar Blue, Contact Asset Management assumptions

The median monthly household income in Australia is $7,391 before tax and other deductions. One can understand why the latest Consumer Sentiment data has turned down sharply.

Chart 7: ANZ-Roy Morgan and Westpac-Melbourne Institute Consumer Sentiment Survey



Revisiting our store walk from seven years ago to test inflation

In June 2015, we walked the floors of several Sydney supermarkets. At the time, Coles was still embedded within the Wesfarmers (WES) conglomerate and Aldi was rapidly taking share with many calling the death of the big Supermarkets. Our thesis was to test the perception that the Aldi offering was significantly cheaper than Woolworths (WOW, Woolies) and Coles (COL). In the report, we noted the Japanese proverb that "One look is worth 100 reports".

It wasn't. Our conclusion (based on us buying three identical baskets of goods) was that Woolies was not broken but it has a distracted Management team (recall the Masters Hardware fiasco) and was mispricing its Woolworths Select (home brand) offering. It was failing to compete with Aldi for the low value customer. Following an assessment of WOW across our fundamental factors, including Principal Activity, Income, Balance Sheet and Valuation, we started buying WOW for the BKI Portfolio below $20. While it took a few quarters to turn around, the investment in price and customer experience finally reversed the customer perception. WOW has since outperformed the broader market by 25%.

Table 2: A revisit of our 2015 store walk "basket of goods" and a comparison to 2022 prices

Product	Aldi June 2015	Woolies June 2015	Coles June 2015	Woolworths Online (Today)	Inflation per annum
Organic Milk (1L)	$1.99	$1.25	$2.18	$2.20	*8.4%*
Bread (Standard Multigrain)	$1.99	$2.00	$1.90	$2.70	*4.4%*
Foil (30m)	$2.79	$4.19	$2.79	$4.90	*2.3%*
Cling Wrap (60m)	$1.39	$1.39	$1.39	$3.50	*14.1%*
Kleenex Toilet Paper	$11.99	$13.20	$12.00	$11.60	*-1.8%*
Uncle Toby's Oats	$5.87	$3.59	$3.55	$3.60	*0.0%*
Self Raising Flour	$0.75	$0.75	$0.75	$2.00	*15.0%*
Vegemite	$5.50	$5.51	$5.00	$7.00	*3.5%*
Rexona Deodorant	$5.24	$4.62	$5.00	$8.50	*9.1%*
Bananas (1kg)	$2.69	$1.88	$1.85	$6.25	*18.7%*
Butter (500g)	$2.59	$2.59	$2.70	$4.00	*6.4%*
Sandwich Bags	$1.79	$2.00	$2.00	$2.85	*5.2%*
Dishwashing Tablets (40 pack)	$7.99	$10.00	$12.49	$18.00	*8.8%*
Cost of the Basket of Goods	**$52.56**	**$52.97**	**$53.60**	**$77.10**	***5.5%***

The table above is also interesting to highlight the pace of inflation over the past seven years. While there are some outliers, it is clear that the cost of living has been running above the RBA's 2-3% inflation target for some time.

Recent store walk anecdotes

Two weeks ago, the Contact Asset Management investment team headed out to visit several Consumer Discretionary stores and sellers of Household Goods. We visited Artarmon, Macquarie Centre and the Northwest of Sydney. Our last day trip of this nature was in June 2020 as we emerged from the initial Covid-induced lockdown. Australian households had just been handed stimulus cheques. We were blown away by the level of activity in stores such as Harvey Norman, Beacon Lighting, Nick Scali, ARB and Super Cheap Auto. Of note, was our visit to Nick Scali Penrith where the Store Manager noted that she hadn't had a lunch break for weeks because the store had been so busy. It was a revealing insight and the subsequent increase in earnings and share prices in the second half of 2020 and into 2021 was testament to the strength of the Consumer Discretionary sector.

Our store walks in late June 2022 highlighted conditions were more benign. While End of Financial Year promotional activity was significant, foot traffic is certainly down. We find this type of scuttlebutt useful. While our financial models are a critical part of our Investment Process, we know that there is more to investing than simply what lies in a spreadsheet. Some high-level discussions and observations included:

- A coffee shop owner in the only café in a homemaker centre on Sydney's North Shore: "Foot traffic has dropped a lot in the last couple of weeks. The customer has become a lot more price conscious."
- <u>Adairs</u>: seemingly had a lot of inventory and heavy promotions underway.
- <u>Plush Furniture</u>: an employee commented that business is "only OK". The wait time on a new sofa has reduced from the supply chain induced delays of six months ago. A couch ordered in late June, would be delivered in late October.
- <u>Freedom</u>: it seemed that almost everything was on sale. There were only two staff that we could see in the store. Perhaps that is a way to reduce costs.

- Good Guys: noted that they were still tight on a lot of items (notably Miele and Asko). Activity was expected to be strong with the promotions underway.
- Harvey Norman: conditions in the electrical department were strong. Like the Good Guys, HVN was expecting a big weekend given the EOFY promotions. There is a long lead time on BBQs. The furniture department seemed quiet.
- Nick Scali: activity had slowed with the employee stating that he believed that the reopening of international travel had meant that many consumers were prioritising travel over spending on household goods
- Total Tools: was a well-presented store. Activity remained strong (again EOFY a factor) yet very little was on sale.

In early July, we are starting to see many sell-side analysts aggressively cut their earnings estimates for a lot of Consumer Discretionary stocks. Many of these cuts seem reactionary and have followed material falls in share prices. The table below outlines the price movements of several Consumer Discretionary names. With several companies trading on single digit P/E multiples and compelling dividend yields, a lot of negativity is already priced in. Harvey Norman is the only company that BKI owns in the list below. Our investment case is tied to its Property Portfolio as much as the retail business. With Property assets conservatively valued at over $3 billion, we believe that the market is only valuing Harvey Norman's vast international retail business on a low single digit P/E multiple.

Table 3: Summary of share price declines and valuation metrics of Consumer Discretionary stocks

Code	Company Name	Price	52 week high	Change from High	Current P/E Multiple (FY22e)	Current Dividend Yield (FY22e)
AX1-AU	Accent Group Ltd	$1.33	$2.85	(53)%	17.9x	4.3%
ADH-AU	Adairs Ltd.	$2.08	$4.35	(52)%	7.2x	9.1%
UNI-AU	Universal Store Holdings Ltd.	$4.16	$8.56	(51)%	14.9x	4.2%
NCK-AU	Nick Scali Limited	$8.59	$16.30	(47)%	8.9x	7.9%
BLX-AU	Beacon Lighting Group Ltd	$1.94	$3.39	(43)%	11.0x	4.8%
PMV-AU	Premier Investments Limited	$20.15	$32.62	(38)%	12.8x	5.0%
HVN-AU	Harvey Norman Holdings Ltd	$3.84	$5.93	(35)%	7.5x	9.5%
SUL-AU	Super Retail Group Limited	$8.90	$13.73	(35)%	8.9x	7.4%
LOV-AU	Lovisa Holdings Ltd.	$15.46	$23.07	(33)%	32.2x	3.1%
JBH-AU	JB Hi-Fi Limited	$39.04	$56.85	(31)%	9.1x	7.2%
XKO-ASX	**S&P ASX 300**	**6575.6**	**7628.2**	**(14)%**	**13.0x**	**4.9%**

Source: Factset, Contact Asset Management

Back to the Consumer Staples sector

By comparison, the Consumer Staples sector has fared far better than the Discretionary names discussed above. History has shown that non-discretionary companies generally perform better in uncertain environments. These companies normally pass on cost increases to consumers to maintain profit margin. With Consumer Staples being a non-cyclical sector, the sheer necessities of staples can't even deter consumers from buying those goods. Hence, the sector should hold up well in an inflationary environment. Data from NASDAQ.com shows that Consumer Staples outperformed inflation about 55% of the time during 1973-2020 with an average real return of about 2.3%.

Table 4 shows that Australian investors are putting a high relative price on the resilience of earnings. The BKI Portfolio owns Coles, Metcash, Treasury Wines and Woolworths. We have been adding to Metcash in the past twelve months and we believe that the stock is a compelling opportunity (more below). We remain very comfortable holding COL, TWE and WOW.

Table 4: Summary of share price movements and valuation metrics of Consumer Staples stocks

Code	Company Name	Price	52 week high	Change from High	Current P/E Multiple (FY22e)	Current Dividend Yield (FY22e)
TWE-AU	Treasury Wine Estates Limited	$11.30	$13.34	(15)%	25.4x	2.5%
WOW-AU	Woolworths Group Ltd	$36.80	$42.66	(14)%	30.6x	2.4%
MTS-AU	Metcash Limited	$4.28	$4.90	(13)%	14.4x	5.0%
COL-AU	Coles Group Ltd.	$18.29	$18.94	(3)%	24.4x	3.3%
EDV-AU	Endeavour Group Ltd	$7.88	$7.92	(1)%	28.4x	2.6%
XKO-ASX	**S&P ASX 300**	**6575.6**	**7628.2**	**(14)%**	**13.0x**	**4.9%**

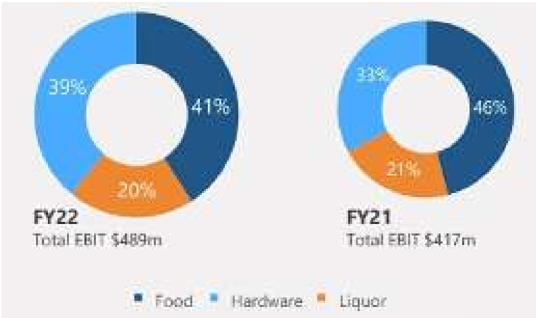
Source: Factset, Contact Asset Management

Taking a Closer Look – we believe that Metcash is a compelling opportunity

While we remain comfortable with our positions in COL, WOW and WES, BKI has been adding to Metcash (MTS) in the past twelve months. We continue to be positive on the stock.

Metcash is Australia's leading wholesaler and distributor, supplying and supporting Independent Retailers across the food, liquor and hardware sectors. The company is well balanced across the three divisions and has a wide distribution network boasting 1,612 supermarket retail stores, 2,790 liquor retail outlets and 730 hardware retail stores. Brands include IGA, Foodland, Celebrations, the Bottle-O, Mitre 10, Home Timber and Hardware and Total Tools.

Chart 8: MTS has a diversified earnings base across Food, Liquor and Hardware



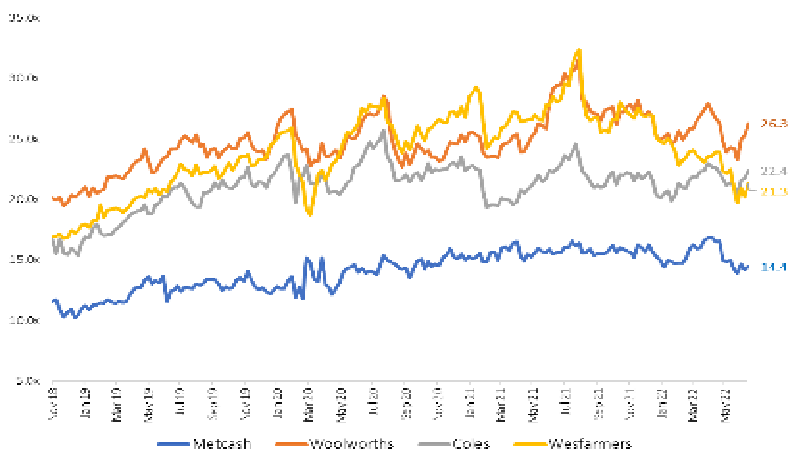
Source: MTS FY22 Result Presentation

MTS recent FY22 result was ahead of expectations and early trading conditions for FY23 are strong. The business is being well managed. Food inflation is aiding the top line and costs are being contained.

Considering other investment fundamentals that we look for at BKI, MTS offers a compelling dividend yield of 7.1%, which we believe is sustainable. The Balance Sheet is robust and is essentially net cash once the accounting for Finance Leases is offset. The returns being generated are attractive, with ROCE of c.15%.

Our investment case is also tied to a relative valuation argument. That is, we do not think that MTS should be trading at such a large discount to COL, WOW and WES from a P/E multiple perspective. We believe that MTS is now a far more resilient business than it was five years ago. The various businesses are now leveraging off the superior competitive foundation rebuilt over recent years. The evolution into a solid food, liquor and hardware conglomerate makes comparisons with WOW (26x P/E), COL (22x) and WES (21x) increasingly pertinent.

Chart 9: We consider the PE discount of MTS to peers as unjustified



Source: Factset, Contact Asset Management, P/E multiples are based on FY23 earnings estimates

Retesting our Basket of Goods comparison with IGA

The bears point to MTS, and IGA supermarkets specifically, being a Covid beneficiary as many households shopped locally. The negative argument is that IGA is at too much of a price premium to the major Supermarkets and that in a tight economy, price will prevail over convenience. As we did in 2015, we sought to test the perception that IGA was far more expensive than Coles and Woolies and utilised a basket of goods test (a similar although marginally different basket to above as MTS stocked less home brands). The findings are below. Yes, there is a slight premium, by far less than many would perceive. We believe that IGA has invested in a better customer experience and will maintain market share. The Total Tools acquisition adds more upside to the investment case.

Table 5: The "basket of goods" comparison shows IGA is a 5% premium, which is less than many would perceive

Product	IGA June 2022	Woolies June 2022	Coles June 2022
Organic Milk (1L)	$3.30	$2.20	$2.20
Bread (Helgas Wholemeal)	$4.10	$4.10	$4.10
Foil - Multix (30m)	$5.08	$4.90	$4.90
Cling Wrap (60m)	$5.00	$5.00	$5.00
Quilton Toilet Paper (9)	$4.89	$5.30	$5.80
Uncle Toby's Oats	$3.50	$3.60	$4.50
Self Raising Flour - White Wings	$3.00	$3.00	$2.00
Vegemite	$7.00	$5.50	$7.00
Rexona Deodorant Sport	$6.50	$6.80	$4.25
Bananas (1kg)	$3.99	$3.50	$3.50
Western Star Butter (500g)	$6.50	$6.50	$6.50
Sandwich Bags (30 pack)	$3.89	$3.00	$4.00
Finish Dishwashing Tablets (36 pack)	$20.93	$20.00	$20.00
Cost of the Basket of Goods	**$77.68**	**$73.40**	**$73.75**

Source: Contact Asset Management, Company online shopping websites

This is what we wrote in our June 2015 Quarterly Report: "In all, we consider companies like Woolworths, which are working through some problems, as a great way to engage in value investing. BKI will continue to receive a decent stream of cash that is expected to keep rising each year. It may take a few years for the business to change investor sentiment and drive the valuation upward. However, we believe that we will look back and see that Woolworths was a great opportunity. It remains a long-term profitable company that is still paying good dividends when the stock is cheap and will offer an attractive capital return as we experience the inevitable P/E expansion."

Every now and then in markets, we face a situation which feels like "we've seen this movie before". We think the perception around Metcash linked supermarkets as excessively expensive is incorrect. We believe that Metcash is *a long-term profitable company that is still paying good dividends when the stock is cheap and will offer an attractive capital return as we experience the inevitable P/E expansion.*

Conclusion

We believe the main issue for investors as we head into FY2023 is the monetary policy tightening underway by Central Banks. Investing in a rising interest rate environment carries an added layer of risk. We continue to believe that investing in quality companies for the long-term is a superior strategy in any environment, but particularly one with heightened volatility. We continue to seek companies with pricing power and/or an identifiable competitive advantage in their Principal Activity.

The upcoming August earnings season will be interesting. It is anticipated that earnings will be robust as the recent interest rate increases would not have had a material impact on household budgets as yet. We expect outlook statements to be very cautious. Nevertheless, with the S&P/ASX 300 Accumulation Index already down approximately 14% from recent highs, some of the negativity could be already priced in.