July 2023

Warakirri ASSET MANAGEMENT

Australian Equities – Investment Themes Observed in 2023

Our specialist Australian Equities investment partner, Northcape Capital, observed a number of themes across the market in the last financial year. Below they outline the themes that were most prominent, the opportunities they are seeing and how they are positioning the portfolio.

This information has been prepared by Northcape Capital, the underlying investment manager for Warakirri's Australian Equities funds.

The Return of Profitable Tech

During an extended period of declining and low interest rates, investors were willing to pay up for growth at any cost. This led to a boom in valuations for all types of tech companies, regardless of their business model or profitability. As a result, it was less important for investors to differentiate between tech business models during this time.

As interest rates have begun to rise, investors have needed to adapt. The opportunity cost of holding profitless investments is now significantly higher, and investors' tolerance for sponsoring new ideas with merely vague aspirations for earnings in the distant future is far lower. This has been a painful transition for investors in the sector, as many technology shares fell heavily and somewhat indiscriminately during 2022.

The silver lining for investors from these events is threefold.

1. Firstly, valuations in general became far more attractive than they had been, creating a better risk vs. reward opportunity than had existed during 2020 and 2021.
2. Secondly, barriers to entry increased as access to funding dried up for hopeful new entrants. Markets that were crowded with well-funded competitors have begun to consolidate. Higher barriers to entry will help tech players who are already established to consolidate their market shares.
3. Finally, the incentives for established tech businesses are shifting in a way that is favourable for shareholders. Where previously companies had an incentive to demonstrate the highest growth in user numbers or revenue, they now face demands for operating discipline and cash flow generation. Announcements of layoffs at tech companies both locally and in the US are a sign of this shift in priorities and typically follow years of unrestrained spending.

We saw something similar play out for the Australian mining sector in the aftermath of the Global Financial Crisis. Chinese stimulus caused commodity prices, particularly iron ore, to enter the stratosphere in the early 2010s. Faced with far higher operating cash flows, the major mining companies committed to grandiose expansion plans that absorbed much of these windfall gains. As commodity prices contracted around the middle of that decade, the miners' cash flow positions were crunched.

This was a painful experience for investors at the time. However, this proved a blessing in disguise for astute investors as management and board renewal led to a heightened focus on operating efficiency, investment discipline and capital returns to shareholders. When commodity prices recovered toward the end of that decade, shareholders were rewarded with far higher profits and dividends than they had in the earlier boom.

The potential for a similar renaissance in shareholder value for tech investors exists today. However, there is an important caveat. The advantages of the changing investment landscape will only accrue to the highest quality, most resilient tech businesses. The rest of the sector will find the environment far more challenging. This is a favourable development for investors like us who are more focused on business model strength than growth in user metrics.

Xero is a good case study for the opportunity that exists today. They are a leading provider of cloud-based accounting software to small businesses. For 15 years the business has generated strong growth in customer numbers and revenue but had never earned material profits. We think Xero is a highly resilient business that is well placed to benefit from the changing tech landscape.

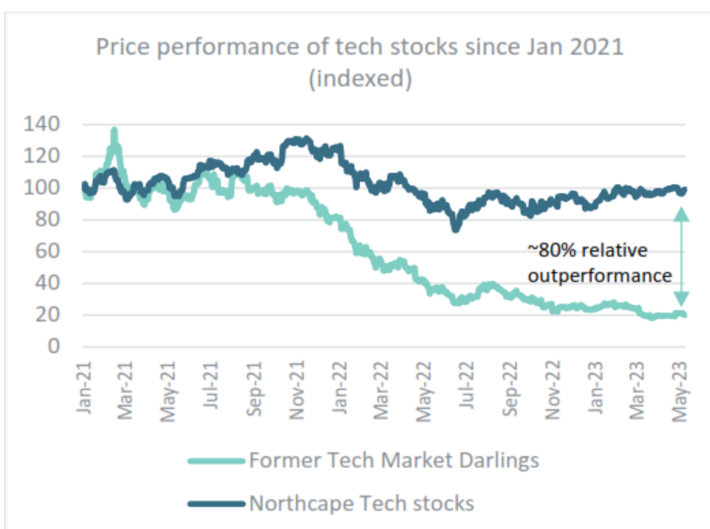
In March, new management announced they would be cutting up 15% of its workforce (after years of rapid growth in staff numbers) and targeting a lower operating expense to revenue ratio compared to recent years. This decision signalled to the market an inflection point in strategy where strong growth would now also be balanced with profit-generation and the stock has now almost doubled since their 1H23 result last November.

We were pleased to see this outcome as we had been agitating for this change with management.

Seek is another example of a high quality business that got caught up in the general sell-off of the tech sector, but had potential to adapt its strategy. In this case, excessive focus on the short term outlook for the economy also placed pressure on the share price. The company has responded by simplifying its business mix and implementing cost initiatives and price increases that should lead to both revenue growth and strong margin expansion in time.

Overall, we have been pleased with the outperformance and resilience of the tech names in our portfolio, which has avoided much of the carnage that has befallen former market darlings. In many cases these companies had weak business models with questionable network effects, high competition, and lower barriers to entry and switching, and this has been exposed by the tougher economic environment and less forgiving financial conditions. Formerly loved tech names like Bravura, Appen and Zip Co (all not owned nor on our approved list), are all down by more than 80% from their peaks given emergency capital raises and / or concerns around the viability of their business models.

Even more extreme examples can be found in the unlisted market where some of the start-ups that attracted venture capital funding never looked like they had a chance of making money. This includes businesses that offered to deliver groceries in 15 minutes at virtually no extra cost to the customer. The demise of these services is a loss for the consumer but a more painful blow for their investors.



Notes: *Former tech market darlings are Afterpay / Block, Appen, Bravura, Megaport and Zip. Northcape Tech Stocks are HUB24, Netwealth, REA, Seek and Xero. Price performance assumes continued holding of all basket stocks and doesn't reflect actual Northcape trading of these stocks during the period.*

A disciplined process has allowed us to not only protect investors' capital during times of market turmoil but to also generate strong overall performance in our portfolio even after the market peaked in late-2021.

Going forward, we believe increasing bouts of market volatility will continue to favour careful active managers and a focus on quality names, and believe our investment process will continue to generate value for investors through the market cycle.

Lithium Frenzy

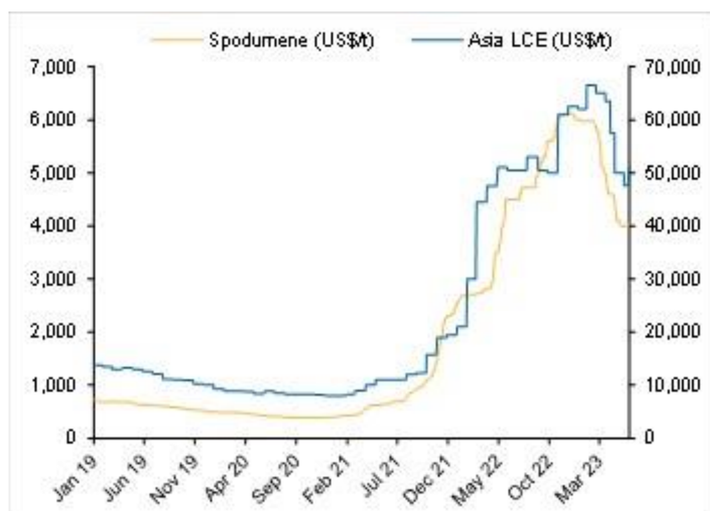
The past financial year has seen an explosion of growth in the local lithium mining sector as lithium commodity prices shot up to 8x higher than historical averages. Market caps in the sector have doubled over the year and now comprise ~2.5% of the market index.

The rapid increase in demand for EVs and renewable energy sources as part of the global energy transition is spurring demand for key battery commodities such as Lithium at a faster rate than supply can currently support and this demand-supply imbalance is proving to be very lucrative for those miners with low-cost assets that are already producing, including many of the Australian spodumene producers.

There are a number of reasons why elevated commodity pricing may persist for longer, including the long lead times to bring new supply online, approval risks for new mines (especially for Chilean brine and Chinese lepidolite), cost overruns and potential project delays, as well as continued demand stimulus from various tax credits and government incentives.

However, we remain cautious around imputing current favourable conditions into perpetuity, with current commodity prices still well above incentive prices, and a wide range of outcomes in the long run around new sources of supply, technological innovation, changes in battery chemistry, and alternate energy storage solutions.

We continue to monitor the rapidly changing developments in the space but believe sticking to our disciplined approach that has proven itself over many cycles and across sectors (as seen in the technology section above) will again pay dividends.



Cyber attacks

Last year saw a number of high-profile corporates fall victim to a barrage of cyber-attacks. Medibank, Optus, Australian Clinical Labs, and Woolworths' MyDeal business were just some examples where millions of customers had their identification, financial or health data stolen and used as ransom.

In the case of Medibank, this led to a savage reaction to their share price, falling ~20% as details of the breach were revealed. We took the opportunity to add to our position and the shares have since rebounded. Whilst the ultimate outcome of Medibank's cyber incident is still yet to fully play out, Medibank's experience shows that the market can over-emphasise short term noise and misprice the likely impact on fundamental value.

For Medibank, an assessment of their strong underlying franchise, supportive industry conditions, management capability, customer centricity, risk management structure, and a more considered view of the likely customer impact allowed us to take advantage of this dislocation and trade around the volatility. Given significant volatility in market reactions to such company developments, we reiterate the importance of carefully considering these implications rather than simply reacting to sentiment.

More broadly we see higher investment in cyber security and broader compliance and resilience as necessary across all companies, particularly in sectors where potentially sensitive customer data is being stored. Companies in the financial sector are obvious targets but increasingly companies in other sectors like retail are becoming more exposed as they digitise and try to harvest customer data to drive sales and efficiencies.

This trend will likely see continued pressure on cost outlooks. In this context it is interesting to contrast companies such as Westpac where more aggressive cost targets appear out of step and potentially inadequate relative to peers like ANZ and Macquarie which are responding to not only inflationary pressures but also reinvestment requirements.

We see opportunities for companies which are proactively investing for more sustainable long-term profits rather than managing the business to more short term and potentially unrealistic market expectations. Companies with scale and the ability to fund these increasing compliance requirements are also potentially advantaged.

ESG - Divest or engage?

We saw an ongoing increase in ESG activity from companies over the year including widespread commitments to net zero emissions. Unfortunately, the heightened focus on emissions played out against the backdrop of energy shortages and high prices in Australia and overseas, which has forced investors to consider their approach to investing in fossil fuels.

For investors who have a strong ESG focus and who want to see decisive action on climate change, the easy answer is to simply divest of any fossil fuel exposure. While many super funds have encountered pressure from activists to divest, we see three main drawbacks to this approach.

First, divestment doesn't directly reduce fossil fuel production. Whether investors divest their shares or companies divest reserves, activity simply shifts from the seller to the buyer, who is more likely to operate in private markets or jurisdictions with less oversight. Divestment can drive up the cost of capital, but this simply leads to higher profits for the new owners.

Second, if investor pressure were to be successful in driving lower production, the result would be high prices and shortages in energy markets with serious consequences for household and business customers. As we saw in Europe last year, existing energy sources can't be shut off until a replacement is ready. The energy transition needs to involve lower demand for fossil fuels, not just lower supply.

Finally, divestment can lead to the risk of lower returns for investors at a time when super funds are under increased pressure to prioritise financial outcomes for members.

We are acutely conscious of the ESG risks associated with fossil fuels including the potential for lower demand and stranded assets. In our view, the key factors are the resilience of a company to a range of transition scenarios, and its ability to participate in the transition by phasing out its scope 1, 2 and 3 emissions over time. We see value in engaging with companies on their transition plans and capital allocation, and we are encouraged by the progress made by Woodside and Santos to date.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au

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