Small Talk
Coming, going and throwing

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After peaking in late 2010 the Small Resources Index has suffered an unimaginable multi-year retracement. It fell 32% in the year ending December 2011, 19% in 2012, 43% in 2013, 29% in 2014 and has fallen 15% calendar year to date. In total the index has fallen over 80% from its peak in 2011, and now represents only 14% of the Small Ordinaries Index (from a peak of over 45%). In the last month it fell 8% versus the Small Industrials Index which was down a less pronounced 4.5%. The collapse in small resources is in contrast to the Small Industrials Index which has ground upwards since 2011 despite the commodity headwinds evident in the economy. It's difficult to envisage this trend continuing given at some point you must expect weakness in the resource sector to translate to industrials given the economy's reliance on the export of its natural resources. Perhaps there is an inflexion point nigh?

Reporting season was kind to us for the most part. A wise friend once told me that value managers tend to make their money at results. Well in this case he was right as we were stretching the limit on several significant positions on the view that the undervaluation would eventually unwind. Little did we know it would happen so quickly with results validating our view on three core holdings. In each case we backed relatively new CEOs at businesses that were perceived broken by the broader market. In each case the CEO articulated a sensible strategy to turnaround underperformance and moved with alacrity on execution. One that we discussed in previous commentaries was Pacific Brands (PBG) – the owner of the Bonds and Sheridan brands. In this case it was addition by subtraction with divestment of several divisions leaving it devoid of debt and with a much cleaner business that is demonstrably growing and becoming less reliant on third party distribution. The steep valuation discount has now unwound with further delivery of earnings growth and cash flow required to drive it to the next level. The first 8 weeks of the fiscal year 2016 have kicked off well for PBG with sales up over 8%.

There was significant volatility in share prices during reporting season with massive short covering rallies and fast money seemingly coming, going and throwing. As described in past monthly commentaries, before reporting season we noted that cheap companies were becoming even cheaper whilst expensive companies (some loss making) were becoming even pricier. Clearly, in some cases this nexus was broken with PBG being the obvious example. What we have yet to see is a breakdown in the multiples paid for expensive companies despite several warning shots over the bow in recent months. It will be interesting to see what it takes for these companies to unravel; generally there is blanket denial on the first downgrade or profit miss, with ensuing downgrades delivering significant destruction to market valuations. Downgrades always come in threes is the old adage in small cap investing.

One of my great annoyances is the market's obsessive desire for earnings guidance from companies. Why participants rely on guesstimates baffles me. How many times during reporting season do we see an email from an analyst finding greater conviction in their buy call because of "strong guidance" from the company? I much prefer a management team that under promises and over delivers. Buying a company on a high multiple that over promises and invariably under delivers seems a recipe for disaster. I would love to see the statistics on how many of these companies with aggressive guidance actually meet their targets. Most, when push comes to shove, simply game the system by acquiring growth to cloud the fact that guidance was unachievable. Seriously, I suspect that many of these companies have as much visibility on their earnings for the next year as I have on how many points I am going to score in my next basketball game. Why anyone thinks management have perfect foresight when businesses are inherently volatile is beyond me. I suppose it's easier blaming managements' crystal ball than applying rigour and valuation discipline in the analysis and ultimate investment decision.

One recent IPO that is well owned and well loved, is a stark illustration of a lack of rigour after a multi-year bull market. If you go back to 2006 accounts when it last reported as a listed entity and you reconcile with recent results you quickly surmise that the core business has exhibited very little organic growth despite it being valued and labelled a growth company. Back then it produced EBIT of $48m, it has since acquired EBITDA of $32m and capex has risen from $12m to $46m. Its EBIT in FY14 (before re-listing) was $106m which is not far different to the $48m when you adjust for the incremental capex ($34m) and acquired EBITDA ($32m). Quite conveniently for the vendors the market wants to value this company on a multiple of EBITDA when clearly it and others need to be valued after capital expenditure that is on a cash EBIT basis. At the end of the day the value of a company is the amount free cash flow it produces into perpetuity, after ALL expenditures. How anyone looks at EBITDA multiples particularly when they are engineered beggars' belief. Bradken (BKN) stands out as company that was much loved and for whatever reason valued on an EBITDA basis by its fair weather shareholders. For many years its capital expenditures greatly exceeded its depreciation. It justified this excessive capex by conveniently labelling a large component as “growth” capex. In a meeting with BKN last year the CFO admitted in hindsight the “growth capex was actually stay in business capex”. I suspect with the advance of time we will find that many of the companies with excessive capex today are following a similar path. Interestingly, the previously described IPO provided guidance at its recent result that has underwhelmed its shareholders, whilst EBITDA growth is in line with expectations; the drag from excessive growth capex is leading to increased depreciation and amortisation expense resulting in EBIT and NPAT lagging market forecasts.

While we are on the topic of valuation and companies being worth the discounted value of their free cash flow. It's interesting to note the rash of IPO'd companies with grandiose expectations and little in the way of earnings that have been ascribed valuations not seen since the peak of the Dot Com Boom in 2000/01. You are expecting a lot to go right, perhaps even perfection, to validate their existing valuations. From my experience in business, and in life, things rarely go to plan. Any loss of faith will severely test the resolve of shareholders. In one example the company has a market cap just over $600m but in the past financial year generated an EBIT loss of $1m. Just as Bradken was in a growth phase several years ago, this company is expanding overseas which apparently is consuming the profits emanating from its home base. Without it entering other markets it would not get the blue sky valuation. In the meantime the company is buying capability and insiders are apparently selling stock ($30m recently).

Outlook

We are finding opportunities in sectors and companies that have been left behind because they are unpopular due to share price under performance or simply because they are unfashionable – objectivity is one of our key competitive advantages. We think the low valuation multiples provide protection as does the cash generative nature of many of these businesses. We have no inkling which direction the market is headed in the short to medium term although we remain concerned with systemic overvaluation in many sectors and the fact that generous liquidity underpinning many of these sectors might be tightening. We have seen a glimpse of this with Westpac withdrawing funding from the pay day lending sector and banks reducing lending to the investor housing market. This in addition to headwinds in the resources sector may have a run on impact on the broader economy and present challenges for earnings in the industrial sectors, albeit it is early days.