Insights from the Macquarie Conference 2023

May 2023

Macquarie Conference 2023

Our Investment Specialist Oliver Stevens recently attended the Macquarie Australia Conference held in Sydney. Opened by Macquarie Group CEO, Shemara Wikramanayake, the conference which is the largest of its kind in Australia, included more than 100 company presentations from senior management across various sectors of the ASX.

Coming less than two months before the end of the 2023 financial year, the conference also unofficially marked the start of ASX "confession season" – the period prior to release of full year results where many companies provide an update (good, bad or otherwise) of trading conditions and how they are tracking compared to their earnings guidance or the market's expectation.

Key investment themes observed

01. Investor focus is on the short-term

The majority of questions to management from the audience were around short-term earnings outlooks, as always seems to be the case.

This highlights to us, the short-term focus of the majority of market participants (including investment professionals), evidenced by the large stock price volatility seen in most stocks. Stock prices of even Australia's largest companies regularly move by 40-50% annually; we see these movements in market valuation as inconsistent with changes in underlying business value.

To avoid this mindset, we seek to focus on share ownership not simply as owning a piece of paper with a stock code on it, but as being a part-owner of the underlying business.

We think this approach affords us an advantage, providing a framework that enables us to focus on the underlying fundamentals of a business and its long-term prospects, while largely avoiding the feeling of the 'need to act' that can come from being exposed to the daily stream of largely irrelevant news and market commentary.

As Warren Buffett says *"time is the friend of the wonderful business".*

02. Megatrends are the new trends

Just as the fashion world no longer simply has models, only super-models, it appears that the corporate world no longer sees *"trends"*, nowadays it's all about *"Mega-trends"*. Some of the mega-trends identified include:

- Healthcare – the shift to prevention and rise of new care settings
- Data analytics, robotics and machine learning
- Environment – caring for the planet

03. Labour issues improving in pockets

With the unemployment rate at ~50-year lows, labour availability has been a key issue across corporate Australia for some time. Interestingly, a number of companies reported that labour constraints were easing somewhat. Some noting that the pace of increases in employee wages seen over the prior 12-18 months is now slowing down. In a similar vein some companies (e.g. Cleanaway Waste Management (CWY) & ALS Limited (ALQ)) noted that employee turnover had dropped materially as vacancy levels declined. Reduced turnover is clearly welcome as this should result in improved productivity over time as less resources (time and money) are needed to be spent on recruitment and training.

Notwithstanding the improvements in certain sectors, those business in, or exposed to, the Resources Sector continue to see tight conditions. Additionally, a number of retail businesses noted that they expect wage inflation to feed through at the start of FY24 given the large portion of retail staff who are on various award agreements.

04. Australia is the place to be

With the continued rise of geopolitical tensions, the attractiveness of Australia as a destination for capital and as a jurisdiction for assets in general was highlighted by several resource companies – not surprisingly, those with assets in Australia or other Tier 1 Western jurisdictions. China is the obvious elephant in the room here, along with the heightened risk in various African countries. It does also extend to other parts of the globe such as Malaysia (Lynas Rare Earths, LYC) and most recently South America, with Chile's recent announcement around Government majority ownership of domestic lithium assets

05. Immigration providing a boost

During Ms Wikramanayake's opening introductory comments she noted immigration as one of the reasons why she sees Australia well placed relative to the likely economic downturn facing many countries. This was a recurring theme as a number of CEO's (including Wesfarmers (WES), Transurban (TCL) & Coles (COL)) highlighted the boost being provided by the strong bounce back in immigration which is expected to continue over the longer term.

Immigration is a double-edged sword in the current fight against inflation. On one hand, immigration is deflationary as it helps to ease some of the labour market tightness and associated wage pressures. On the other hand, inflationary impacts arise from the need to house new arrivals in addition to the increased demand they place on goods and services.

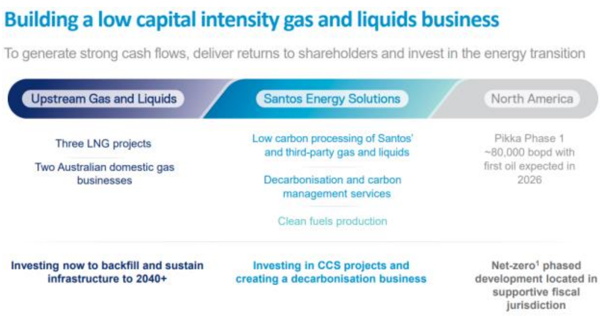
Company Updates

Santos Limited STO:ASX

Santos Managing Director, Kevin Gallagher's presentation focussed around the long-term strategy of the business (Chart 1).

- STO has five core Upstream Gas and Liquids assets. STO expects relatively high capital expenditure for these assets over the next 2-3 years following which a decade plus of low-capital requirements is expected to see the generation of very strong cash flows.
- STO's Energy Solutions division is focussed on developing its large-scale decarbonisation projects. These carbon capture projects will essentially take STO and third-party CO2 and inject these into STO reservoirs. STO forecasts that market opportunities from third-parties by 2030 will be greater than 40mtpa of CO2 providing significant potential for STO.
- The "Net Zero" Pikka project in Alaska is in development, with first oil expected in 2026

Chart 1 – Santos energy



Source: Santos (Macquarie Conference 2023)

On the back of very strong free cash flows delivered in recent years (US$5.1bn over the prior two years), STO has a strong balance sheet, with gearing of 19% (as at December 2022) well within the target range of 15-25%.

STO provides material leverage to the oil price, with breakeven cash flow estimated to be achieved at US$34 / bbl with every US$10 / bbl above this price generating additional cash flow of ~US$400m annually.

In general, our view has been that energy stocks are not compelling long-term investments due to their commodity price exposure and relatively high through-the-cycle capex requirements.

In the current environment with energy security front of mind, we believe that exposure to a well-managed, cash generative energy business has a place in client portfolios.

Wesfarmers WES:ASX

Rob Scott, Managing Director of WES, provided a high-level presentation around the WES strategy and its approach to capital allocation, including the following key points:

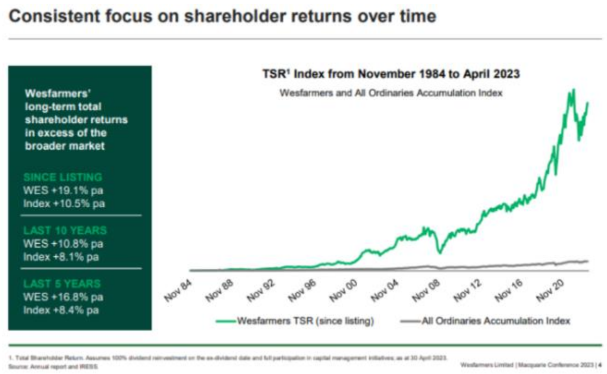
- WES primary objective remains; “to deliver a satisfactory return to shareholders” (Chart 2).

- WES seeks to direct incremental capital toward its higher returning businesses. In this vein, the Bunnings offer continues to evolve, with its recent entry into the $6bn Pets segment being their largest category expansion undertaken in ~20 years.

- Investment decisions are made with a long-term view with WES approach to active portfolio management allowing management to deploy and reallocate capital between existing businesses and into new opportunities.

- In assessing new opportunities, management favours investments that provide opportunities to deploy incremental capital over time such that the business would be materially more valuable in five to ten years’ time. WES investments into its Lithium business and more recently the establishment of a Health division (via the acquisition of API) are examples.

Chart 2 – Delivering a ‘satisfactory return to shareholders’



Note: Total shareholder Return. Assumes 100% dividend reinvestment on the ex-dividend date and full participation in capital management initiatives as at 30 April 2023.

Source: Wesfarmers (Macquarie Conference 2023)

In regard to current trading conditions, WES is confident in its position given:

- The majority of WES businesses provide essential and everyday products, providing a level of resilience when household or business budgets come under pressure.

- WES retail businesses are known for their strong value credentials and everyday low prices. As inflation and cost of living pressures increase, WES expects value to become even more important to customers.

> As expected, there have been no changes to WES well-established, sensible strategy which should continue to see WES well placed over the long-term.

In the shorter-term, WES value focused and resilient retail businesses are relatively well-positioned in the current uncertain economic climate.

While most businesses talk about prudent capital allocation, we believe that WES actions and results are consistent with this approach. As an entrepreneurial business we expect WES to make some errors over time (e.g. the entry of Bunnings into the UK), however, on balance we think the probability is skewed positively toward WES current (and future) portfolio of businesses continuing to provide a satisfactory return to shareholders.

Pilbara Minerals PLS:ASX

Lithium was a key theme throughout the Conference, with presentations from eight companies that have significant exposure to lithium assets across both production and development.

Not surprisingly the presentations we attended all pointed to the massive lithium demand expected into the future as part of the global energy transition.

PLS Managing Director, Dale Henderson provided a clear, simple to understand presentation, reflecting the simplicity of the PLS business.

Some points of interest:

- PLS strong cash generating ability continued in the most recent quarter; the cash balance at end of March increasing to $2.7bn (Chart 3), with net cash (i.e. cash less debt) sitting at $2.4bn.

- With a growing cash balance, a key question becomes what to do with it all?

  There have been plenty of businesses that have squandered excess cash on poor acquisitions (particularly in the Resources sector) in years past.

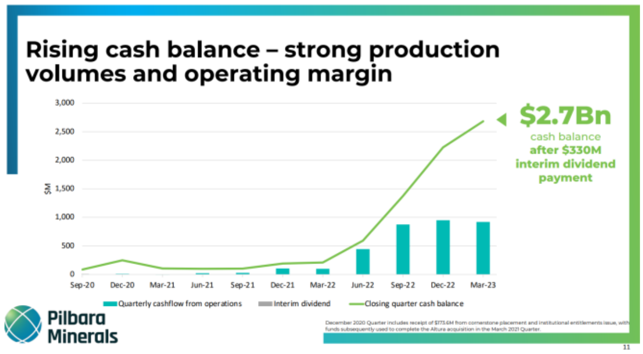
  In this respect, Mr Henderson commented that PLS will likely re-visit its capital management framework later in the year.

- The large and growing cash balance is clearly a benefit. However, sometimes when companies have significant cash backing, inefficiencies can creep in. As best as possible we will be keeping an eye on things to ensure that PLS remains disciplined in managing its expenditures, both from an operational and capital perspective.

- Mr Henderson noted that investor feedback made it clear that the clean, simple, direct lithium exposure that PLS provides is appealing to investors.

- In relation to recent lithium market softness Mr Henderson was of the view that short-term prices had either bottomed or were near a bottom.

Chart 3 – Producing cash



Note: December 2020 Quarter includes receipt of $173.6M from cornerstoe placement and institutional entitlements issue, with fund subsequently used to complete the Altura acquisition in the March 2021 Quarter.

Source: Pilbara Minerals (Macquarie Conference 2023)

> We recently added a position in PLS to portfolios on the back of the solid long-term outlook for lithium and the direct exposure to this thematic that PLS provides.

While obviously subject to prevailing lithium prices, which we expect will continue to display volatility, we think there is a reasonably high probability that PLS will continue to generate strong cash flow for many years. In addition, we see potential for PLS to become an acquisition target.

JB Hi-Fi Limited JBH:ASX

We attended the JBH presentation given by CFO Nick Wells.

We think that JBH is an excellent business:

- As Australia's largest retailer of consumer electronics (JB Hi-Fi) and home appliances (The Good Guys) the business enjoys the benefits this scale brings.

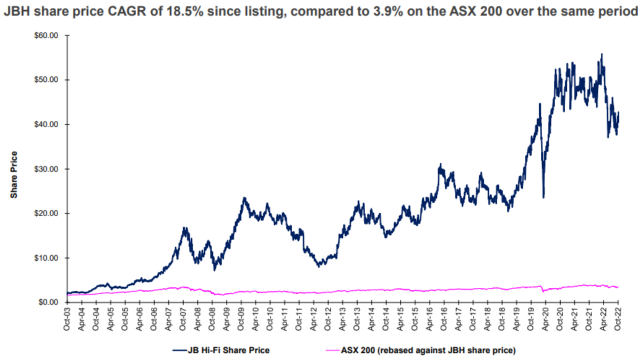
- We see JBH as one of the few Australian businesses that employs a business model, coined by renowned investor Nick Sleep, as "Scale economies shared": *a model whereby a company that benefits from 'economies of scale' shares those benefits with its customers, typically by offering lower prices, to gain long-term market share and thus creating a virtuous circle, benefiting both the customer, the business (and shareholders)*, Chart 4. As an aside, we think another exceptional Australian retail business in Bunnings enjoys the same benefits.

- JBH has cost of doing business (CODB) well below that of its peers, providing it a very strong base from which to consistently maintain its low cost offering to customers.

- JBH has over many years been an excellent generator of cash, thus enabling all growth initiatives to be funded from internal cash flows whilst also maintaining payment of a strong dividend stream to shareholders.

- JBH has a strong balance sheet and a shareholder friendly approach to capital management, having completed a $250m off-market share buyback in FY22 and previously a $170m buyback in FY11.

Chart 4 – Scale economies shared, good for customers, the company and shareholders



Source: JB Hi-Fi (October 2022)

There has been much commentary over many months around the impending slowdown in consumer spending as interest rate rises feed through to the consumer. JBH noted that while sales growth has started to moderate as anticipated, it remains at levels almost 40% above the pre-Covid period.

As a consumer-focused business JBH will always be subject to a certain degree to the short-term retail environment. Over the longer-term and through numerous cycles, JBH has a proven the resilience of its business model, delivering exceptional returns to shareholders. We are keen to add JBH to portfolios should the opportunity present.

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