Perpetual

Q&A with Alex Patten

17 February 2023



The Perpetual Smaller Companies Fund was named Best Australian Small Companies Manager at the Australian Fund Manager Awards late last year. We asked the Fund's Deputy Portfolio Manager, Alex Patten, to take us through the stock selection process that underpinned this success.

Calendar year 2022 was generally a tough year for markets and especially for smaller listed companies. And yet the Perpetual Smaller Companies Fund delivered performance well ahead of its benchmark. What factors underpinned this success?

The outperformance of the fund in 2022, relative to the benchmark, was pleasing and a vindication of our process which centres on owning profitable businesses, with strong balance sheets and competent management but always with a strong focus on valuation. Late 2021 marked a significant shift in global markets as central banks started to acknowledge that elevated inflation was an issue and wasn't going to quickly come

down on its own. Through 2022 we saw a rapid tightening in financial conditions as central banks sharply raised interest rates and started withdrawing liquidity from the market as QE came to an end. As a result, pockets of excess and speculation in the market that had gained momentum through 2020/2021 quickly unwound. Within the Australian small cap market this included areas like Buy Now / Pay Later, unprofitable Technology and Ecommerce.

These stocks had been some of the best performers over the preceding years. Despite the popularity and strong momentum of many of these stocks through 2020/2021, we remained focussed on owning businesses that were generating good cash flows and with business models that were proven through cycles. We also remained focussed on what an appropriate valuation was relative to the quality and growth prospects of the business and resisted getting sucked into blue sky thinking and optimistic narratives. In Small Cap investing, our view is that it's often about what you don't own and focussing on downside protection. That was certainly the case in 2022.

Net fund performance as at 31 December 2022

	Perpetual Smaller Companies Fund	S&P/ASX Small Ordinaries	Excess Return
1 mth %	**-1.88**	-3.73	1.85
3 mths %	6.69	7.54	-0.85
Financial YTD %	16.88	7.03	9.85
1 yr %	-0.14	-18.38	18.25
2 yrs % pa	12.42	-2.32	14.75
3 yrs % pa	14.05	1.38	12.67
4 yrs % pa	14.91	6.04	8.86
5 yrs % pa	9.64	2.92	6.72
7 yrs % pa	10.77	6.64	4.13
10 yrs % pa	11.37	5.13	6.24
Since inception % pa	12.37	5.22	7.15
Financial YTD %	16.88	7.03	9.85

Source: Perpetual. Past performance is not indicative of future performance.

How do Perpetual Asset Management Australia's four quality filters apply to the Small Cap Fund?

Our process starts with the same four quality filters that are central to how we invest at PAMA across all our funds. These filters are: Business Quality (analysis of industry structure, competitive position, pricing power, return metrics etc); Recurring Earnings (proven business models with a demonstrable track record of positive earnings); Conservative Debt (EBIT interest cover > 3x); and Strong Management (a qualitative assessment but often with a focus on operational and capital allocation track record and incentives). If anything, we feel these filters are even more critical when it comes to investing in smaller companies. In our experience, management typically has an outsized impact on the performance and prospects of a business in its earlier stages. The level to which a CEO can influence the performance and strategy of business as it grows and becomes more bureaucratic arguably diminishes.

Assessing management can be a bit of a dark art but some of things we focus on and look for in managers include their track record in prior roles, their mindset and competence in relation to capital allocation, honesty and willingness to admit to mistakes and be open about what's not going well. We also spend considerable time analysing the structure and nature of management incentives. Further, we prioritise businesses with low debt levels and strong balance sheets. This is critical in small cap investing given the elevated volatility inherent in many of these businesses relative to big caps. Whilst a conservative balance sheet provides obvious benefits in terms of minimising downside risks, in our experience it can also provide significant opportunities to create value through counter cyclical M&A.

What are your expectations for the upcoming February reporting season and what key themes do you think will be most relevant?

Whilst we are optimistic that our portfolio of companies will deliver solid results in aggregate, we think the upcoming reporting season will reflect the current unusual and uncertain economic environment. As demonstrated by recent trading updates from a number of consumer-facing stocks, the decline in consumer confidence reported through the back half of 2022 has not yet manifested itself in an obvious slowdown in consumer spending. We will be watching closely for how businesses have managed their costs in particular. Inflationary pressures around input costs, supply chain and wages have been well publicised in recent times and this environment marks a big change compared to the low inflation environment that existed for many years prior. We expect to see some margin pressure as a result and are of the view that the better management teams will distinguish themselves through active management of their cost bases.

We are also thinking about the impact of recent sharp increases in interest rates on businesses debt costs, which will also be influenced by how aggressive or conservative management have been in structuring their debt and hedging. We expect improvement in cash flows in aggregate this reporting season following the easing of some supply chain pressures over the last six months which should flow through to some normalisation in working capital balances. Finally, we think investors looking for clear outlook commentary and guidance will be disappointed. Management will likely be reluctant to make big commitments given the extremely uncertain macro environment we find ourselves in and we don't blame them. In this volatile environment, we are keeping an open mind and focusing on our bottom up, fundamental research.

The Fund's backing of the Financials ex Property Trusts and Resources sectors in 2022 was a key overweight relative to the index. Talk us through some stocks that contributed to performance?

Pacific Current (PAC) and Helia (HLI) were both in the top 10 contributors for the Fund over 2022. PAC has been a core position for a number of years. It owns minority stakes in a range of fund managers globally and receives either a share of revenues or profits depending on the individual agreements. The underlying fund managers operate across a wide array of asset classes, many in the 'Alternatives' space. Many of the funds operated within these managers are closed ended, which means that the funds are sticky and stable even through periods of market volatility. These dynamics mean that the portfolio typically exhibits relatively low beta. This benefitted the

stock in 2022 but beyond this many of the underlying boutiques saw strong net inflows, which contributed to PAC's earnings growth. Helia, formerly Genworth, provides Lenders Mortgage Insurance to borrowers of a number of Australian banks, including CBA, Bank of Queensland and ING. Whilst the business is influenced by lending volumes as well as the trajectory of house prices, HLI has an extremely strong capital position built off conservative assumptions in our view. The Board has stated its intention to return capital to the target range within two years, which should translate into significant capital return in the form of dividends and share buybacks, which is why we continue to hold a position.

We bought an initial position in Whitehaven Coal (WHC) in early 2021. The thesis was relatively straightforward as WHC's balance sheet had improved materially in the preceding 12 months and was likely to be in a net cash position by Q2 2022. And with the Thermal Coal price up around US$200/t the fundamentals were extremely compelling. Investor sentiment towards the coal sector was also extremely negative, which is typically a good starting point for prospective returns. We trimmed our position in WHC through 2022 as the stock traded higher in order the manage the position size, but it remains one of the larger holdings currently. Whilst the sector is no longer shunned by investors, the lack of new supply in recent years and resilient demand for WHC's high energy content coal should support strong cash flows over the coming years. WHC recently reported $2.5bn EBITDA for the recent half year ended December 2022, as compared against its current Enterprise Value of $6.2bn. More broadly, we think the set up for most commodities remains positive given the capital discipline shown by management teams during this cycle has resulted in less new supply, with more of the cash flows returned to shareholders rather than invested in M&A or expansion.

Can you also give us a sense of what didn't work out over 2022?

The two largest detractors to performance over the year were media and entertainment company HT&E Ltd (HT1) and real estate funds management company Centuria Capital Group (CNI). HT1 owns and operates the Australian Radio Network, which includes the KIIS and WSFM stations. In November 2021, HT1 acquired Grant Broadcasters, a group of 46 radio stations across Regional Australia, for $307m. In our view, the acquisition makes strategic sense and allows HT1 to provide advertisers with a more complete and valuable offering. However, the purchase price was full in our view, particularly with reference to where the market was pricing HT1's existing business. HT1 traded poorly over CY22 as the broader market became more focussed on a potential economic slowdown domestically and therefore de-rated economically sensitive sectors including traditional media. Given Radio's resilience in prior downturns and HT1's strong cash flow profile and balance sheet we feel the stock has been oversold at current levels.

Centuria Capital Group is a property fund manager with $20.6bn of group AUM across both listed and unlisted vehicles. Whilst CNI had a successful year in FY22, with AUM growing 18% and EPS up 21%, the sharp rise in interest rates through the year had a negative impact on valuations across the listed REIT sector. Higher interest rates typically have a more significant impact on REIT fund managers than passive REITs. Not only are balance sheet investments pressured due to higher discount rates, but funds management earnings are also impacted through slowing transaction volumes and reduced potential for performance fees.

Looking forward, can you take us through your investment thesis on McMillan Shakespeare?

McMillan Shakespeare (MMS) is a salary packaging and novated leasing provider, with strong market share in the Health and Education sectors. It also has a small but rapidly growing plan management business which helps NDIS participants manage and efficiently utilise their funding budgets. MMS has a strong track record of steady organic growth within its core salary packaging and novated leasing business and operates within a relatively consolidated industry with only one major competitor. Despite announcing some significant capital management initiatives at the most recent result – including an increase in the dividend payout policy and a 10% off market share buyback – the balance sheet remains in a strong net cash position. We think the market may be

overlooking the value inherent in the plan management business which has strong market position and momentum. Further, novated lease settlements have been adversely impacted by new car supply shortages, which we expect to ease progressively through 2023. Whilst we recognise that MMS will always carry some regulatory risk given the importance of its core novated leasing business, we think valuation is attractive with the stock trading on FY23 13x consensus EPS.

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