Airlie Australian Share Fund Quarterly Update

April 2024

Jack Mann:

Hello and welcome to the Airlie Australian Share Fund quarterly update. My name is Jack Mann, and I'm part of the Magellan distribution team. Today with me, I've got portfolio manager Emma Fisher. Welcome, Emma.

Emma Fisher:

Thank you, Jack.

Jack Mann:

The ASX has another strong quarter up five per cent. What are your company takeaways from the February reporting season?

Emma Fisher:

Yeah, so the ASX has had a really strong quarter, and I think that's really reflecting over February and March, the market digesting the fact that reporting season was no train wreck. So, if I think about the key takeaways, the first is, there's no evidence of the economic Armageddon that the market was pricing in a year ago. If you have a look at it from a granular perspective, over the last four reporting seasons, every single one you've had EBITDA downgrades, and this February reporting season was the first time in a long time that you've actually seen slight upgrades. I think the reason for that is, prices held in there, volumes have held in there. A lot of companies have actually seen raw material price deflation, and that's really supported gross margins. So, all of that has underpinned a very resilient earnings outlook for the ASX.

Now, that's really at odds with the narrative that was being priced into markets this time of year ago, which it feels a world away, but if you remember at the time, it was interest rates to the moon, mortgage cliff coming, economic armageddon for the consumer. If you take a sector like consumer discretionary, for example, in the fund, Premier Investments, Nick Scali, Wesfarmers, you couldn't give these businesses away. In June last year, Nick Scali had gone from $14 to $8. Premier had gone from about $26 to $18, and it was all on these economic cycle fears.

Now, if you have a look at the February results, really, if you take something like Premier, for example, it's not that earnings weren't down. Premier's result earnings had fallen 5% for their retail business. It's that they weren't down anywhere near as much as people were expecting. So, consensus was expecting Premier earnings to fall 20% to 30% this year. So, to come in at minus five, obviously that's driven an incredible rerate in the business. That distance between where earnings were expected to be and where they've come in has driven a lot of performance for those stocks. So Premier, for example, and Nick Scali are both up over 50% over the year.

The other key takeaway that I took away from reporting season was around price. So, meeting with all the companies in Australia really last month, if I compared what they were saying to a year ago, a year ago when we were meeting with companies, they were all talking about price and talking about big price increases like 5, 10, some building materials, companies were talking double-digit price increases. This year, everyone's really returning to that normal cadence of price increases, which is more like 2% to 3%.

Now, I don't know whether we're necessarily going to see that flow through to CPI data and slowing inflation. There're other things in CPI like rent and services, so maybe we're skewing it a bit, just looking through the lens of listed companies on the ASX. But certainly, in that portion of the market, I think price is really cooling as a lever. So those would be my two main takeaways.

Now, what does this mean for the portfolio? I think the main thing is that we're really returning to market fundamentals, to company fundamentals. The last couple of years have been incredibly narrative-driven, and we've seen opportunities in the market where whole sectors have been really cheap because everyone's been really worried about the economic cycle. So, I've talked about the retailers, REITs as well. So, our positions in Charter Hall and Waypoint REIT, as well as building materials, so our position is in Seven Group and in James Hardie. The extraordinary derate that we saw last year and now the extraordinary rerate that we've seen over the last six months has really driven a lot of performance in those names.

You mentioned the market's up 5.3% for the quarter. Allow me a shameless plug for the fund. The fund is up a bit better than that, up closer to 7%. So, it has driven a lot of that performance from these wholesale sector opportunities, and I think that they're probably coming to an end.

Now, does that mean we can all sort of pack up and go home, and there's no ideas in the ASX? The answer to that is no. I just think it's a return to a normalized environment, and where we find undervalued quality these days, it's less-sector specific. It's really just that bottom-up opportunity set.

Jack Mann:

Yeah. So, let's expand on that a little bit. Can you talk us through maybe a new opportunity that you're looking at or even something that maybe the market's been spooked by that you are looking at as a pretty good new opportunity?

Emma Fisher:

Yeah, so one position that we've really recently started to add to the fund is IDP education. Now, IDP education, for those of you who don't know it, so they make money in two ways. Through English language testing. So, if you're an international student and you want to move to an English-speaking country and go to attend a university, you need to prove your English proficiency. 70% of the time, you'll do that with an IELTS test, and they distribute the IELTS test. They're one of two distributors in the world for the IELTS test. The bigger driver of earnings and the bigger driver of their business is student placements. So again, if you're an international student and you want to go to Australia, Canada, the US, or the UK to study, they're going to be the agent that holds your hand through that process. They're going to tell you how to apply, what you need in terms of a visa, what universities you're likely to get into.

Now, it's a bit like a mortgage broker model in the sense that you don't actually pay them for their services. It's free. They get paid by the uni that you end up going to. So that makes pretty good economics for the business because what it means is, there's a really big benefit to being the largest, to being the incumbent. Because the industry can't compete on price, they have to compete on service and offering, and we think IDP has the best offering in the space. They've got 600 unis that they can give you information about where to go to really deep relationships. They've been around for 45 years.

So that's the business. The opportunity, I think, has come really recently because of immigration in all of the home countries of IDP, so the US, the UK, Canada, and Australia. Basically, everyone had this open the floodgates post-COVID. We had a lot of immigration, and now we are getting a political backlash. You always see this, immigration is used as the whipping boy to cover what is probably a bit of policy error, but in terms of housing crises, rental crises, strain on public services and hospitals, and things like that. So, you've seen this political regulatory cycle happen over the years, usually in line with election cycles, where the view is, you've let in too many people. You have to really slam on the brakes, and that's hitting them right now. So, the work that we're doing suggests there's going to be an impact. There's probably going to be an impact for the next 12 months, and that's what's creating the opportunity. We think the stock has halved; the multiple has halved.

Now, this is a business that, I guess, when you think of the Airlie style, we've admired it from afar. We've known that it's very high quality. It generates return on investor capital in the '50s, but we haven't been able to own it because that valuation piece has been very uncompelling. The PE multiple has been in the '40s for most of the time that it's been listed over the last decade. Now the P/E multiple has halved, so it's now trading on 26 times, which is actually only a slight premium to the BOG average stock in the market. Yet this is a business that has generated returns in the 50%s. It's grown, its eave at 10x over the last decade, and it's trading on just a slight premium to a market multiple because everyone's so worried about the regulatory cycle.

So, we're not saying the market's wrong. We're not saying that immigration isn't going to be a headwind immigration policy. We're saying that if not for that, this business will probably be on 40 times again. So, one day, it goes from a headwind to a tailwind. We believe that structurally, we're not having enough babies in this country and in many other western countries to grow our populations. So, we are going to have to rely on immigration. When we do again and those headwinds turn to tailwinds, we believe the business will rerate.

Jack Mann:

Yeah, okay. So, I want to pick up there a little bit, is that headwinds and tailwinds, I'd say like ResMed has had a bit of a headwind off the back of this kind of GOP one play at the moment. So, if you think about ResMed and CSL, they've obviously performed really well in the portfolio over the last six months or so. Can you talk us through healthcare as a sector? How do you guys actually assess that sector?

Emma Fisher:

Yeah, it's interesting that you put it that way because ResMed's definitely had a headwind, but it's been a very sentiment-driven headwind. It actually hasn't been an earnings headwind. If you look at the ResMed story from an earnings perspective, everything's gone brilliantly. From an industry perspective, their number one competitor, Philips, is basically under a consent decree from the FDA. So cannot sell CPAP machines, and that's going to last for years, we think. So, everything ResMed-related has gone really, really well. The headwind has been sentiment. There was a point last year in September where the market was basically saying, "Obesity's been cured by GLP-1 drugs." And that's going to be a real problem for ResMed's addressable market.

Now, I guess a bit more sanity is now being priced into the stock. We've always said all along, we think it can grow alongside, and I think the share price has gone from 21 bucks up to 29. As you said, that's been a big driver of performance for the fund that, but we still think it looks great relative value here, and CSL, I guess, is a similar story. But when we look at the healthcare sector as a whole, it's a funny sector because people always think people are attracted to healthcare businesses because they think they're defensive. They think they've got this aging population dynamic, so there's going to be growth for a long time. But I think you've actually got to be very cautious when you're investing in healthcare because

there's very big disparities in the quality of these businesses. The two things that we think really set them apart, the first question is, "What's the capital intensity of the business?" And the second question is, who's paying?

So, on the first question, what's the capital intensity of the business at one end? You've got the private hospitals. They are very capital-intensive businesses. They're almost like a hotel, really. So very capital-intensive, and you have to keep investing in the business in order to grow. The dynamic that's now hitting them, and we think it's a structural headwind, is the fact that surgeries are getting better, faster, recovery times are lower. It's a very expensive setting for you to be treated in a private hospital. You're actually better off. It's quicker to be treated with most things in day surgery and convalesce at home. So, you are happy with that. Who doesn't want to spend a night in their own bed, not hospital? The insurers are happy with that because it's a cheaper setting for them, and the government's happy with that because if you're in the public sector, again, it's a cheaper setting for them. So that's a win-win, lose for hospitals in a very capital-intensive business. Again, the pathology players, the diagnostic imaging players, they're capital-intensive businesses.

If you look at ResMed, ResMed's barely any capital in the business. I think it's Capex is about 2% of sales each year. So, it throws off an enormous amount of free cash. That's always been one of the attractions to us for the business. CSL is actually a pretty capital-intensive business, but actually, part of the thesis is they're coming off a big wave of Capex, so their returns should increase as the capital intensity dies down.

So that's the first thing I look at to sort the wheat from the chaff. The second thing I look at is, who's paying? You get these amazing demand projections, but if you've got demand running at five to 6% per annum for your services because of an aging population, that's a problem for the government. If they're paying for that, tax take is not growing at 5% to 6% per annum. So, like clockwork, if the government's paying, you're going to get price cuts. If you think about it ideologically, why should the government be funding a high return to the private sector? They Shouldn't. These assets shouldn't really make much more than their cost of capital. That's what we see.

So, we are pretty wary from that perspective of the pathology players, the diagnostic imaging players, aged care. They've all got single government payers. The private hospitals, they're more argy-bargy against the insurers. But then, within Ramsay, which is the only listed private hospital group, their offshore operations in the UK and France, that is directly the government that's paying. In fact, a couple of weeks ago, the French government came out and said, "Basically, we're not going to fund the private sector. We're not giving them a fee increase. They can just eat the inflation in their own cost base, and we're going to prioritize the public sector."

So that's the risk that you always run. You just bring it back to the government's not in the business of caring about listed shareholders. So why would you want to be one? Effectively, at the other end of the spectrum, you've got the consumer pays models. So Cochlear consumer pays a lot of the time. ResMed consumer pays. CSL is a little bit of a hybrid, but I guess with CSL, the thing that attracts us there is the fact that these are rare diseases that they're treating. So even if you've got an environment where the government's paying for some of these treatments, we're not talking big numbers. These aren't hundreds of thousands of people with these diseases. They're usually in the thousands, so they aren't big-ticket expense items for them.

So yeah, those are the two things that we look at that really determine the returns that these businesses make. That's why we tread carefully in the healthcare sector because, over the years, it seemed quite glamorous and defensive, but you get very different outcomes over time investing across it.

Jack Mann:

Thanks for that, Emma, and thanks very much for listening today. Please feel free to share this with your clients as well.

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