Fund update

Perpetual Pure Equity Alpha Fund

Fund Commentary

During the month of August 2021, the Perpetual Pure Equity Alpha Fund generated a return of 2.2% (net of fees). The fund benefitted from a strong reporting season, where several of the long positions released positive results. The long book was the primary driver of returns. Our long holding in Flutter was the largest positive contributor to returns, rallying after delivering another excellent operational result. Over the 12 months to September 2021 the fund has returned +15.7% (net of fees).

Historical busts

During every reporting season, we spend our time forensically analysing company accounts and speaking to company management teams. Analysis of earnings quality is one of the most important focal points for us during reporting season as it is often where we find red flags that may need further investigation. Whilst this can often lead to good new short ideas, it is just as important for our existing long positions. A small change in the earnings quality of a company can be a very good lead indicator of a change in underlying business momentum.

At a high level, the relevance of earnings quality analysis over the past 12-18 months has been somewhat diminished by the impact of Covid on business operations and share prices. The market has been, for the most part, looking through short term earnings performance and valuing companies on what it considers to be mid-cycle earnings. We feel that over the last year or so, there are less companies trying to inflate their earnings through accounting tricks for a few reasons. First of all, with the aforementioned distortions from COVID, the market is looking through the short-term earnings. Secondly, thanks to the raging success of Amazon which has generated enormous amount of shareholder value with profitless growth, there is less focus by the market on profit and more focus on revenue growth and total addressable market. This is completely understandable. Re-investing revenue into marketing and new products can generate value through expanding the moat or sowing the seeds of long- term revenue growth. Our concern, however, is that it is easier for companies to fudge revenue than it is to fudge earnings and cashflow. What's more, this focus on revenue growth rather than earnings growth may distort investment decisions by an industry in aggregate which will inevitably result in over-investment and price deflation. While we have identified a number of companies during the 2021 August reporting season which have demonstrated deteriorating earnings quality, we believe the bigger opportunities at the moment are arising from companies chasing growth at any cost and using high P/E paper and cheap debt to fund it.

In this context, we thought it would be worthwhile to reflect on a couple of historical busts and why some of the company attributes in these situations hold relevance to behaviours we are starting to see emerge today.

Babcock & Brown (BNB) and Slater & Gordon (ASX:SGH) are two very interesting case studies. They stand out because, despite being in completely different industries and the catalyst for their busts being quite different, there are quite a few parallels. The first is that they both grew profit aggressively in a short period of time without operating cashflow coming through. They were both over-geared, market darlings with business models of questionable sustainability, culminating in materially overpaying for large and ultimately value-destroying acquisitions at the peak of their respective powers (Alinta and Quindell respectively). The other common feature was that the management and board blamed short sellers for all their issues.

There is some relevance to today. Both companies used cheap debt and big talk to grow rapidly in their respective fields (financial engineering and personal injury). Given how accommodating the equity markets are and how much cheap debt there is about, this is relevant today. When a company's business model requires rising asset prices and loose debt markets (BNB) or are based on optimistic accounting assumptions (SGH), one needs to be careful.

Firstly, Slater & Gordon, the problem was with the accounting where there was a large level of subjectivity when it came to recognition of revenue. Revenue for personal injury was recognised well before the cash was received. The company had to make assumptions about the probability of success of the case, how much the insurers were willing to pay and how aggressively the client would negotiate the fees. This resulted in large accounts receivable and work in progress (WIP) balances. When these sorts of companies grow quickly, cash will lag accounting profit and the market has to assume that the company is accurately predicting the collection of cash. This in isolation is not a problem, if the cash follows the profit recognition in the fullness of time. However, if the cash does not come through to match the assumptions and the balance sheet is geared, then things can get ugly quickly. It is at this point that either the company slows down and adjusts its revenue recognition to be more sustainable or continues to grow through acquisition and aggressive expansion, raising debt and equity, which makes it very difficult for the market to detect any over-optimistic assumptions. It seems that SGH went the latter route, and the rest is history.

Secondly, Babcock & Brown was a very complicated business which evolved over time. It started as an advisory business in asset-backed transactions but evolved to be a principal investor and then a fund manager. The business model, towards the end, involved setting up quite few listed satellite vehicles, which were externally managed by BNB. These satellite vehicles started off as entities which were hard assets generating a yield for its investors. In an environment of low interest rates and rising hard asset prices, these vehicles were sought after. BNB would make money buying, warehousing and then selling for a material profit these assets (power plants, toll roads, wind farms etc.) to the satellite vehicles. Then BNB would collect asset and fund management fees from these vehicles. By and large this can be a good sustainable long-term business. Key to this is making sure the satellite vehicles remain well managed, sustainably geared investment vehicles, which stick to their mandate with any acquisition being priced to create longer term value for the unitholders. However, as the manager, it can be very tempting to maximise short-term profitability by selling assets off your own balance sheet at inflated prices, charging exorbitant fees and over gearing the satellite vehicles. This will maximise short-term profitability in the management company (BNB) but will result in the inevitable demise of the whole platform. The problem for BNB is that it was heavily geared (over 50%) and it became reliant on being able to sell the assets on its balance sheet to either existing or new satellite vehicles. When the satellites collapsed BNB was caught with an over-geared balance sheet and no way of selling its assets. This led to a swift demise soon afterwards.

At its peak almost all of BNB's pre-tax profit of just over $770m came from profit on sale of assets. The buyer of these assets was predominantly one of the satellite vehicles. Working out how much the satellite would pay for this asset was riddled with conflict. The higher price would increase BNB's profit but would be value destructive for the satellite. It seems that over time, BNB may have erred on the side of maximising short-term profitability to the eventual detriment of the satellites (and hence BNB). In periods of falling interest rates and rising asset prices, everyone was happy, but when the GFC hit, things got a little more difficult.

1. What lessons can investors take away from these examples?

You always need to be careful over-simplifying lessons from historical busts. A lot of great Australian companies have been formed through entrepreneurs aggressively growing their businesses through organic and acquisitive means. Macquarie Bank and Westfield are two examples of this. A lot of money can be made by backing smart and aggressive entrepreneurs early and growing with them over time. However, for us, the two most important lessons to glean from these episodes are to keep an open mind when it comes to your investments and to heed red flags when they present themselves. Having a true understanding of the business model and working out the weaknesses while understanding what lead indicators might forewarn that the business model is under pressure is very important.

The most important thing as an investor is to wake up each day with an open mind. With SGH and BNB, the early backers had made a lot of money. Selling is an extremely difficult discipline. This discipline is sometimes made harder when you have backed a management team early and this has resulted in you making a lot of money from that investment. You build up a sort of loyalty to that management team and company, which is understandable. However, if the investment thesis changes, and the company exhibits some big red flags (as BNB and SGH did), then you need to have a serious think about whether you should sell.

2. Red flags identified:

We are of the view that management teams, either consciously or sub-consciously, know the problems in a business before the rest of the market does. Therefore, analysing their behaviour can give you a lead indicator of problems ahead. The six red flags we look for are:

- Insider selling
- Sudden management departure – especially the CFO
- Strange Acquisition
- Over Promotional Management
- Management which berates Short Sellers
- Optimistic Accounting/Cashless Profit

In the two collapses mentioned above there are a few red flags which were common.

- Cashless Profit/Optimistic Accounting: This was common across both BNB and SGH. For SGH, recognition of revenue for personal injury is extremely subjective and relies on assumptions around case wins, what the insurer is willing to pay and how aggressively the client will negotiate the fees. In hindsight, SGH was a little optimistic. For BNB, it was more that an extremely large portion of its earnings were generated from revaluations and recycling assets from the BNB to its satellite vehicles at what, in hindsight, turned out to be pretty inflated prices.
- Strange Acquisitions: Both companies had business models which needed to continue to grow aggressively due to the poor operating cashflow generation. Acquisitions can hide a lot of sins. For BNB, the $8bn acquisition (along with its satellites) of Alinta was the beginning of the end for the company. In the case of Slater & Gordon, the $1.2bn acquisition of Quindell was definitely a strange acquisition and ended disastrously for shareholders. While the market cheered the acquisition due to its massive EPS accretion (a terrible reason for an acquisition), they were buying a company which was a roll up of various legal services companies with similar inflated work in progress (WIP) issues as Slater & Gordon, such as accounts which hadn't been audited for over 15 months. Following the acquisition, SGH had a 40% gearing level which was on the high side for a company with very low tangible assets and poor operating cashflow. It may be an understatement to suggest that the acquisition did not go to plan but, as it unravelled, it showed that some of the previous revenue recognition for Slater & Gordon may have been on the optimistic side.

- Blaming Short Sellers: The other red flag and a thread common among corporate collapses is to blame short sellers for all the sins of the world. Short sellers are market participants who are taking a view on the direction of the stock. While the quality of some of the more recent short reports has been quite poor − some have been riddled with mistakes and seem designed to use innuendo to have maximum short-term impact on share prices− the same could be said about a lot of long reports. Having said that, short sellers cannot be blamed for the unsustainable business models of these fallen companies. Short sellers cannot be blamed for the high levels of leverage. Short sellers cannot be blamed for boards and management materially overpaying for acquisitions. However, even in liquidation, there are countless examples of non-executive board members using short sellers as a reason for companies failing.

3. Current opportunities

While there have recently been some large accounting shenanigans overseas (like Wirecard), we are not seeing as many here in Australia. We believe it is because, thanks to Amazon's enormous success, investors by and large don't care as much about accounting profits anymore. Therefore, there is less incentive for companies to artificially inflate their profit. Currently the market seems to be more focussed on narratives like the size of the total addressable market and revenue growth than how much profit a company generates. This may change over time. Having said that, we feel the future collapses will come from three sources:

- Old school businesses with new disruptive competitors taking market share or facing other structural headwinds. If combined with a stubborn board and an over-geared balance sheet, then danger lies ahead.
- Companies in hot sectors who underestimate the competitive response from existing or new market participants. We are starting to see signs of companies investing significant amounts of money in marketing and capex with the sole purpose of generating revenue growth, given that is how these companies are getting valued. There does not seem to be any focus on sustainable cashflow or profits. If the market environment were to change (either through increased competition or change in consumer preferences) this could end badly for more than a few of these profitless companies.
- Companies who rely on cheap funding for their entire business model and will struggle when interest rates inevitably normalise.

Conclusion

We have not turned over our portfolio much over the last month or so. During August we did trim some of our Woolworths, which has been a stellar performer, to fund some buying of QANTAS and A2 Milk, which have had weak share prices of late. We are more optimistic about companies which are in the "opening up" or "COVID losers" bucket than the "COVID winners". While there have been some false starts, we feel the political narrative in NSW has become a little more realistic and we expect that as we enter 2022, by and large life will return to normal in NSW and probably Victoria. Unlike other jurisdictions trying to live with an eradication strategy, NSW and Victoria will be able to be connected to the rest of the world. We believe that when constituents from jurisdictions such as Western Australia or New Zealand see their NSW friends taking pictures of wing tips on Instagram while heading to exotic locations, they may start pressuring their leaders to go down the same path. We believe that this change will probably coincide with demand for experiences and services rebounding hard at the expense of purchasing objects. We will keep an open mind but that is how we see the next few months. We are not thematic traders, however, when looking at a company like QANTAS, we see it trading at a big discount to mid cycle valuation and the industry structure being materially improved on the other side of COVID.

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