Selector High Conviction Equity Fund Quarterly Newsletter No.75

March 2022

In this quarterly edition we review SFML performance, attribution, ESG and company results from reporting season. In our lead article, we provide a view on the macroeconomic backdrop while reiterating our investment philosophy.

We then highlight the importance of maintaining reinvestment consistency and provide examples across the portfolio. Our investment philosophy is fleshed out further across a series of three short articles; "Three buckets - keeping things simple"; "Why point in time investing fails the test of time"; and "Surprises = normal".

We travel for the first time in two years and detail our trip to the U.S. visiting James Hardie Industries. We finish with ESG by reviewing Aristocrat Leisure's 2021 sustainability report.

Photo. Legendary investor Philip Fisher's investment philosophy still resonates today, 50 years on. In a world of unprecedented change and volatility, we prefer to stay the course with quality, long-term compounders.

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Selector is a Sydney based fund manager. Our team combines deep experience in financial markets with diversity of background and thought. We believe in long-term wealth creation and building lasting relationships with our investors.

We focus on stock selection, the funds are high conviction, concentrated and index unaware. As a result, the portfolios have low turnover and produce tax effective returns. Our ongoing focus on culture and financial sustainability lends itself to strong ESG outcomes.

Selector has a 17-year track record of outperformance and we continue to seek businesses with leadership qualities, run by competent management teams, underpinned by strong balance sheets and with a focus on capital management.

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IN BRIEF – MARCH QUARTER

Dear Investor,

Two years ago, the world was grappling with an unknown quantity, COVID-19. Today, it faces an equally unknown quantity in Vladimir Putin and the country that he leads, Russia. It is hard to fathom which is worse, a virus that shuts down the global economy or military aggression that threatens global retaliation.

President Putin wasted no time in upending a return to normality. Entering 2022, the signs pointed to COVID-19 moving from a pandemic to an endemic disease. While global health bodies remain wary of further virus mutations, governments moved to re-open borders and business leaders personally re-engaged with employees and operations.

Central bankers, responding to the threat of a sustained inflationary outlook, considered lifting interest rates. On the one hand you had Reserve Bank of Australia (RBA) Governor Philip Lowe *"prepared to be patient [while] it monitors how the various factors affecting inflation in Australia evolve"*.

On the other hand, the U.S. Federal Reserve, led by Chair Jerome Powell, followed through with its earlier intentions. In March, U.S. cash rates were lifted by 0.25%, the first hike since 2018. Chair Powell also signalled six additional increases for the remainder of calendar year 2022, suggesting cash rates of 1.75%-2.00%. By 2023 calendar year end, median projections point to Fed Fund rates of 2.75%.

Speaking at a press conference announcing the March increase, Chair Powell stressed the need to restore price stability, *"without price stability you really can't have a sustained period of maximum employment...the committee acutely feels its obligation to move to make sure that we restore price stability."*

If the pandemic has taught us anything though, it's the danger of setting in stone circumstances that are fluid. To quote San Francisco Federal Reserve Bank President Mary Daly, in an interview in January, "*we definitely are poised for a March increase ... but after that, I want to see what the data brings us ... let's get through Omicron, let's look at this and let's see."*

Ian Harper, who is a member of the RBA's policymaking board also noted, "*The market is reading a whole lot more of the American situation to being relevant to our situation, than what the bank is doing.*"

His reasoning being, that while full employment is within reach, actual data is not pointing to strong growth in wages as perhaps suggested. Further, the acceleration in inflation reflected a mismatch between supply and demand dynamics during the pandemic.

When Chair Powell spoke of inflation being transitory, he failed to qualify its meaning. In December 2021, he did just that stating, *"We tend to use transitory to mean it won't leave a permanent mark in the form of inflation".* As such *"I think it's probably a good time to retire that word and try to explain more clearly what we mean"* concluding that*, "factors pushing inflation upward will linger well into next year."*

The difficulty is in drawing any concrete conclusions beyond the near term. Recall, COVID, effectively shut down global economic activity for two years and counting, massively disrupting supply logistical capacity, subsequently compounded by surging demand.

This is now followed by a reopening of economies, driving unprecedented demand for employment. Such shocks suggest 'transitory' in nature. How many COVID's, supply and labour squeezes can be endured, in such a concentrated timeframe, without a global economic fallout?

The Russian decision to invade Ukraine has added a further dislocation event. How this plays out is hard to reconcile, although the actions of NATO and Western nations in imposing economic sanctions, alongside a growing list of international company heavyweights hastily retreating from Russia, would have caught many by surprise.

UBS economist Alan Detmeister expanded on this perspective in a Wall Street Journal article, published in March.

"*I'm a macroeconomist by training that believes, yeah, maybe for a month or two, you do disaggregate. But right* *now, is a special time – you have so many of these special stories hitting. Standard models that predict inflation based on unemployment and economic slack would at best explain inflation of as much as 3.5%. These models missed the inflation surge and for the same reason, are likely to miss the reversal*."

Detmeister expects inflation to fall to 2.7% in December 2022, a far cry from the 7.5% level reported during the height of concern in January 2022. It subsequently hit 7.9% during February, the highest level since 1982. In part propelled by sharp rises in oil price impacted by the Ukraine conflict.

Having mentally moved on from COVID, shifting attention to concerns surrounding inflation and the direction of interest rates, only to fall foul of military conflict involving state sovereignty, the resolve of global markets and investors has been tested.

Under such circumstances it would seem almost irrelevant to discuss the latest company reporting season. Our performance numbers would suggest it wasn't well received. However, this belies both the economic handbrake imposed by the COVID-cum-Delta-cum-Omicron variants during the half, as well as the macroeconomic events that have since emerged in 2022.

When viewed in that light, management teams have delivered strong operational performances while maintaining important long-term reinvestment programs. In this edition we discuss company results in our "Reporting Season Snapshot". We then reflect on the current macroeconomic backdrop in our lead article "Macro" and also highlight the importance of maintaining reinvestment consistency in, "COVID-19 – never waste a crisis".

We expand on our investment philosophy across a series of three short articles; "Three buckets - keeping things simple"; "Why point in time investing fails the test of time"; and "Surprises = normal".

This quarter also saw us travel to the U.S. to visit James Hardie Industries' head office in Chicago, before continuing to Orlando, Florida, to attend the NAHB International Builders Show.

To conclude, we profile Aristocrat in our ESG segment.

For the March quarter, the Portfolio recorded a gross negative return of **14.78%** compared to the S&P ASX All Ordinaries Accumulation Index, which posted a gain of **1.62%.**

In particular, the market performance has been driven by the strong surge in commodity prices and the subsequent positive influence on the Energy, Utilities and Materials sectors. These indexes were up **25.1%**, **12.7%**, and **11.9%** respectively over the quarter. The Fund has no exposure to Energy or Utilities.

Over a rolling twelve months the Fund has delivered a positive gross return of **9.54%** compared to the index which recorded a gain of **15.48%**.

We trust you find the report informative.

Regards,

Selector Investment Team

"We do a lot of thinking and not a lot of acting. A lot of investors do a lot of acting, and not a lot of thinking."

Louis Simpson
GEICO Chief Investment Officer
1980-2004

PORTFOLIO OVERVIEW

Table 1: Performance as at 31 March 2022*

	3 Month	6 Month	1 Year	3 Year	5 Year	10 Year	15 Year	Since Inception
Fund (net of fees)	(14.73)	(12.13)	7.84	8.74	13.56	15.78	7.57	10.73
Fund (gross of fees)	(14.78)	(11.78)	9.54	10.77	15.63	17.89	9.54	12.81
All Ords. Acc. Index	1.62	4.14	15.48	11.47	9.82	10.23	6.07	8.63
Difference (gross of fees)	(16.40)	(15.92)	(5.94)	(0.70)	5.81	7.66	3.47	4.18

Inception Date: 30/10/2004

**Performance figures are historical percentages. Returns are annualised and assume the reinvestment of all distributions.*

Graph 1: Gross value of $100,000 invested since inception

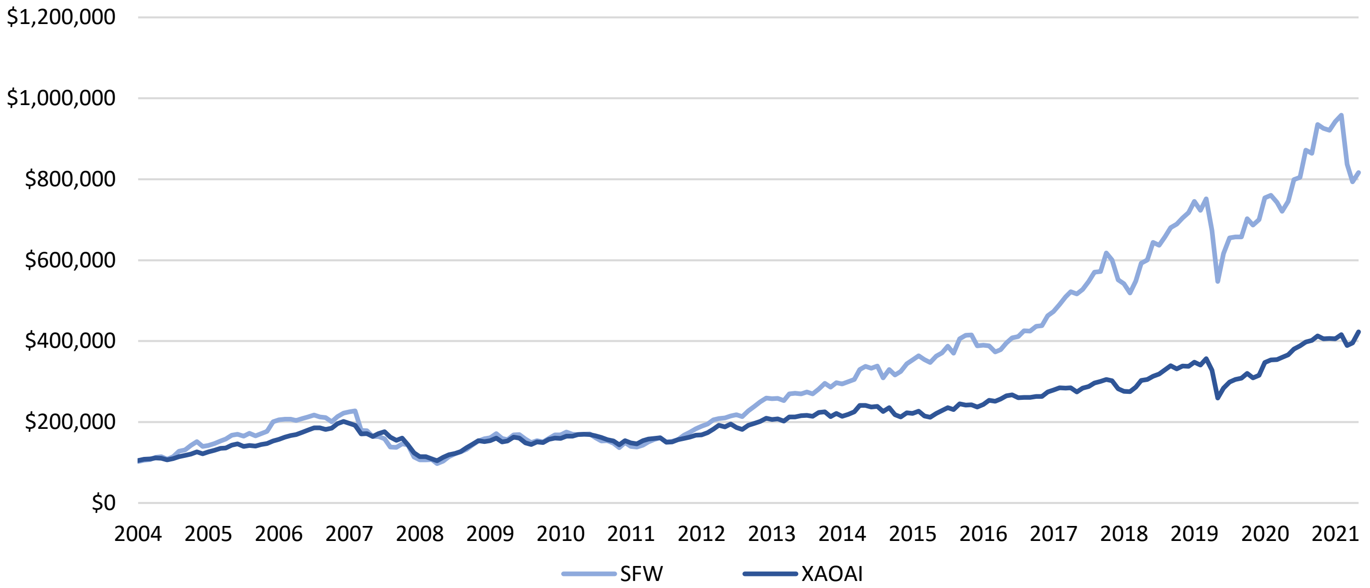


Table 2: Fund's Top 10 Holdings

Top 10 March 2022	%	Top 10 December 2021	%
Altium	5.45	Altium	6.07
James Hardie Industries	4.98	James Hardie Industries	5.83
TechnologyOne	4.98	Reece	5.56
Cochlear	4.93	Domino's Pizza Enterprises	5.18
Aristocrat Leisure	4.92	Aristocrat Leisure	5.02
carsales.com	4.81	carsales.com	4.95
ResMed	4.68	TechnologyOne	4.77
CSL	4.66	ResMed	4.23
Domino's Pizza Enterprises	4.60	CSL	4.00
Reece	4.56	Cochlear	3.74
Total	**48.57**	**Total**	**49.35**

Table 3: Unit prices as at 31 March 2022

Unit Prices	Entry Price	Mid Price	Exit Price
	$3.4055	$ 3.3970	$3.3885

Selector employs a high conviction, index unaware, stock selection investment strategy. The Fund's top 10 positions usually represent a high percentage of its equity exposure. Current and past portfolio composition has historically been very unlike that of your average "*run-of-the-mill index hugging*" fund manager. Our goal remains focused on truly differentiated broad-cap businesses rather than the closet index hugging portfolios offered by most large fund managers.

Table 4: ASX sector performance – March 2022 quarter

S&P ASX Industry Sectors	Quarter Performance (%)
Energy	25.10
Utilities	12.72
Materials	11.87
Financials	3.67
Consumer Staples	(1.42)
Industrials	(3.84)
Telecommunications	(6.92)
A-REITS	(7.70)
Consumer Discretionary	(10.59)
Healthcare	(10.65)
Information Technology	(14.04)

Table 5: Fund's industry weightings

Industry group	March 2022 (%)	December 2021 (%)
Software & Services	27.39	25.93
Consumer Services	15.78	15.41
Health Care Equipment & Services	14.73	14.10
Media & Entertainment	9.84	9.78
Capital Goods	7.05	8.70
Diversified Financials	5.85	4.84
Pharmaceuticals, Biotech & Life Sciences	5.25	4.65
Materials	4.98	5.83
Insurance	2.39	2.27
Automobiles & Components	2.25	2.28
Household & Personal Products	1.93	2.01
Consumer Durables & Apparel	1.46	1.17
Cash & Other	1.10	3.03

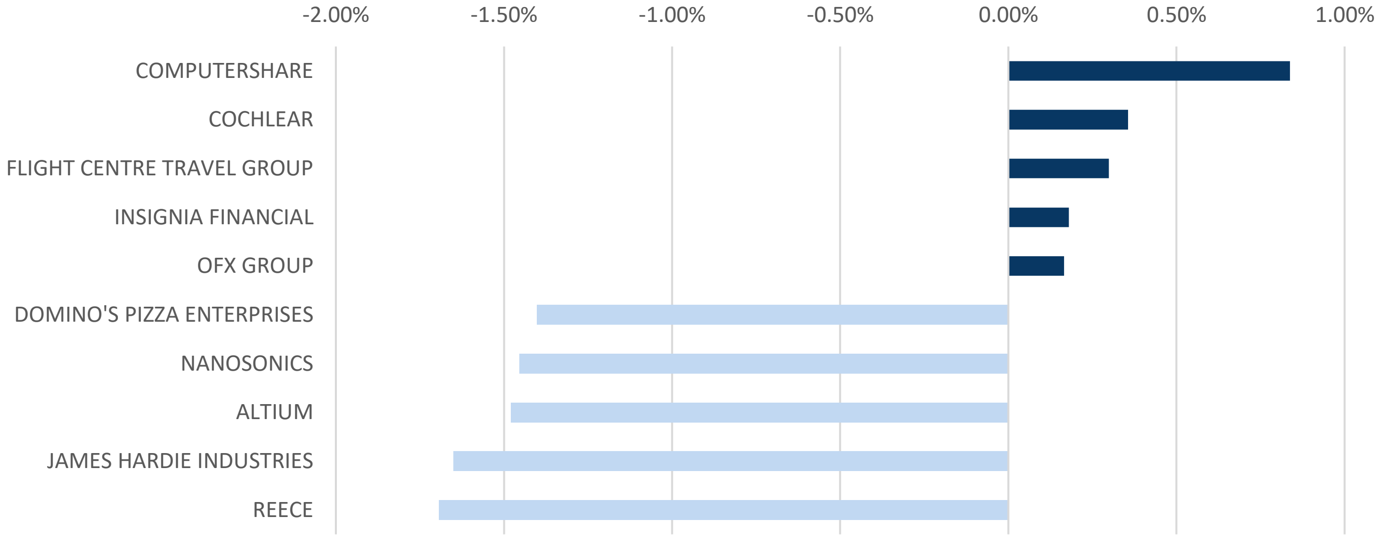
Table 6: Portfolio turnover as at 31 March 2022

Period	Turnover %
1 Year	7.60
2 Years	5.51
3 Years	5.96
5 Years	6.60
10 Years	6.84
Since inception	6.78

- Turnover shown as annualised percentages
- Turnover = Lesser of purchases or sales divided by average funds under management for the period

PORTFOLIO CONTRIBUTORS

Graph 2: Contributors and Detractors – March 2022 quarter



Top quarterly contributors

1. Computershare (ASX:CPU)

Refer to Reporting season snapshot below.

2. Cochlear (ASX:COH)

Refer to Reporting season snapshot below.

3. Flight Centre Travel Group (ASX:FLT)

Refer to Reporting season snapshot below.

4. Insignia Financial (ASX:IFL)

Refer to Reporting season snapshot below.

5. OFX Group (ASX:OFX)

Online foreign exchange and payments company OFX Group provided a trading update at its Investor Day held in March. Operational momentum continued into the fourth quarter, with the company expecting full year turnover to rise more than 30% and net operating income to increase 23%-25% to $145m-$147m. EBITDA is expected to grow 41%-48% to $43m-$45m, reflecting positive operating leverage.

Bottom quarterly contributors

1. Reece (ASX:REH)

Refer to Reporting season snapshot below.

2. James Hardie Industries (ASX:JHX)

Refer to Reporting season snapshot below.

3. Altium (ASX:ALU)

Refer to Reporting season snapshot below.

4. Nanosonics (ASX:NAN)

Refer to Reporting season snapshot below.

5. Domino's Pizza Enterprises (ASX:DMP)

Refer to Reporting season snapshot below.

ENVIRONMENTAL, SOCIAL AND CORPORATE GOVERNANCE (ESG)

- **ESG risk of the portfolio**

Table 7: SFML ESG Scores

Company Name	ESG Roadmap	ESG Score
ARISTOCRAT LEISURE	2.0	8
ALTIUM	2.0	6
APPEN	2.0	8
ARB CORPORATION	2.0	6
BLACKMORES	2.0	6
BREVILLE GROUP	2.0	5
CARSALES.COM	2.0	8
COCHLEAR	2.0	7
COMPUTERSHARE	2.0	8
CSL	2.0	8
DOMINO'S PIZZA ENTERPRISES	2.0	5
FINEOS CORPORATION HOLDINGS	2.0	6
FLIGHT CENTRE TRAVEL GROUP	2.0	8
FISHER & PAYKEL HEALTHCARE CORPORATION	2.0	8
IOOF HOLDINGS	2.0	5
INFOMEDIA	2.0	4
IRESS	2.0	7
JAMES HARDIE INDUSTRIES	2.0	7
JUMBO INTERACTIVE	2.0	6
MEGAPORT	2.0	4
MEDICAL DEVELOPMENTS INTERNATIONAL	2.0	6
NANOSONICS	2.0	8
NEARMAP	2.0	6
NIB HOLDINGS	2.0	9
OFX GROUP	2.0	7
POLYNOVO	2.0	7
REA GROUP	2.0	9
REECE	2.0	9
RESMED	2.0	8
RELIANCE WORLDWIDE CORPORATION	2.0	9
SEEK	2.0	9
TECHNOLOGYONE	2.0	7
WISETECH GLOBAL	2.0	8

ESG 2.0 Roadmap

Consideration			
Environment	Climate Targets	Renewable targets	Progress against target
Social	Human Capital Management	Community (including MS*)	Best Interests
Governance	Board effectiveness	Shareholder interests	Risk & Litigation

Roadmap scorecard
9 filters applied to each portfolio business

*Modern Slavery (MS)

The ESG 1.0 Roadmap, developed in-house in 2019, defines ESG issues that may impact companies and applies a score of 1 or 0 for each of the 12 areas under consideration. The ESG 2.0 Roadmap iteration was created in 2021, with changes integrated into our portfolio models thereafter. The ESG 2.0 Roadmap consists of 9 areas under consideration.

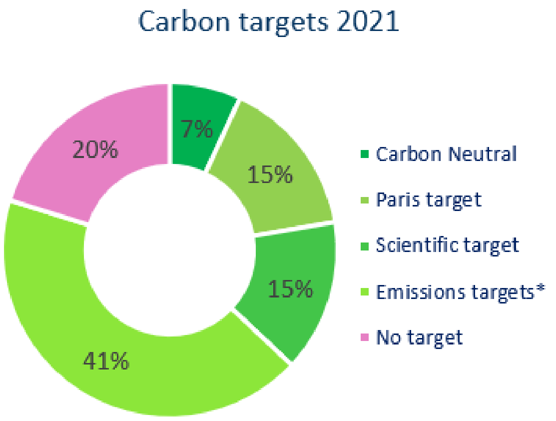
The following is a breakdown of each consideration:

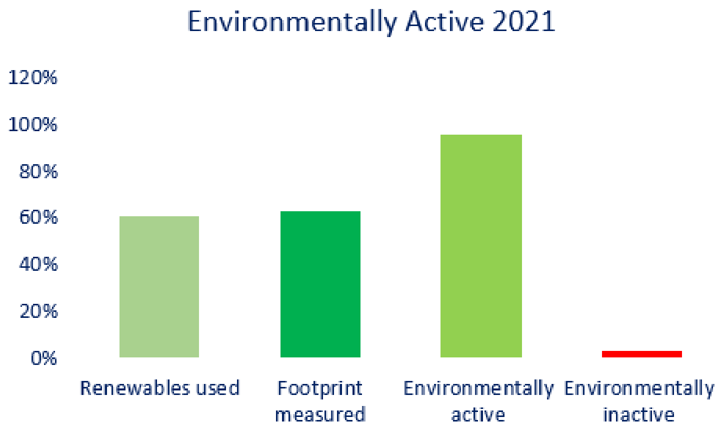
- Climate targets – Assessment of the company's plans relating to carbon neutrality, Paris commitments, scientific targets, or emission targets. "0" rating for no effort.
- Renewable targets – Assessment of the company's documented use of renewables mix or implemented targets for renewable energy.
- Progress against targets – Measuring progress made against announced targets. "0" rating for no effort.
- Human Capital Management – "Is there a history of human rights violations, workplace and IR disputes, discrimination and harassment claims?"
- Rating of the company's employee engagement, turnover and productivity. Compare the company's work, health and safety (WHS) standards against peers, including their recording and track record of incidents.
- Community – Rating of the company's community engagement and social licence to operate. Consider whether the company has a framework on social issues across its supply chain, including labour standards, child labour, health & safety, discrimination, and harassment.
- Best Interests – "Is the company behaving in a manner that is in the best interests of stakeholders."
- Board effectiveness – Assessment of the board including industry experience, independence, age, diversity, tenure, equity ownership and capacity.
- Shareholder interests – Assessment of the remuneration structure, shareholder communication, corporate disclosure, and reliability of financial statements. Test the factors against the company's corporate strategy and whether they are in line with shareholder interests. ssss
- Risk & Litigation – Rating of the company's internal risk and control framework.

The ESG Roadmap is reviewed quarterly with data updated annually by reporting companies. Further detail on our ESG Roadmap can be found in the SFML ESG & Voting Policy 2021, available at https://selectorfund.com.au/esg

- **Carbon Risk Analysis**

Figure 1: Portfolio Reporting 2021



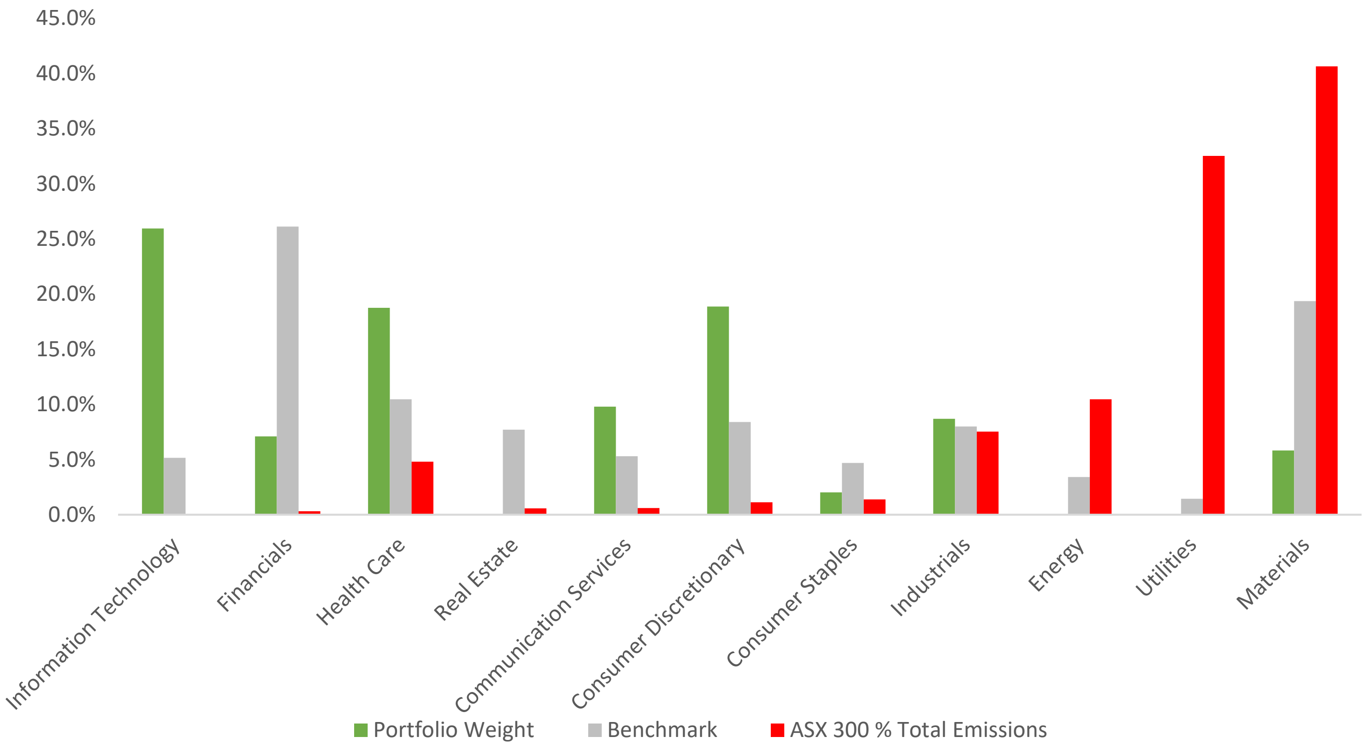


What we are seeking
- Paris targets
- Science based targets
- Emissions targets
- Renewable energy targets

What we are monitoring
- No efforts
- No accountability

Source: SFML Research

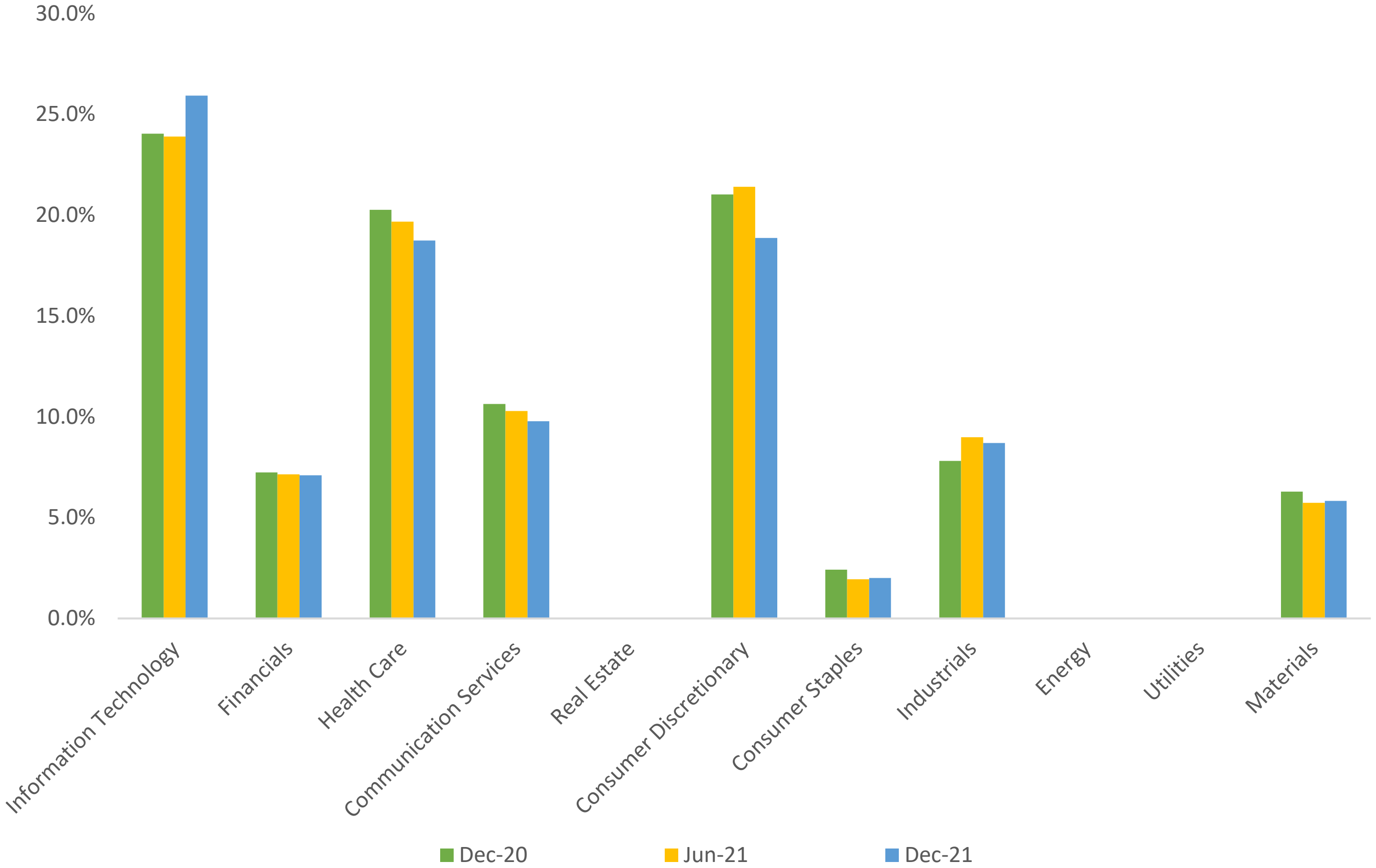
Graph 3: SHCEF vs ASX 300 Carbon Exposure 31 December 2021[1]



Source: Refinitiv

[1] *ASX 300 Index estimated using Vanguard Australian Shares Index ETF*

Graph 4: Portfolio Carbon Exposure Periodic Change



Source: Refinitiv

Table 8: SFML Portfolio carbon intensity

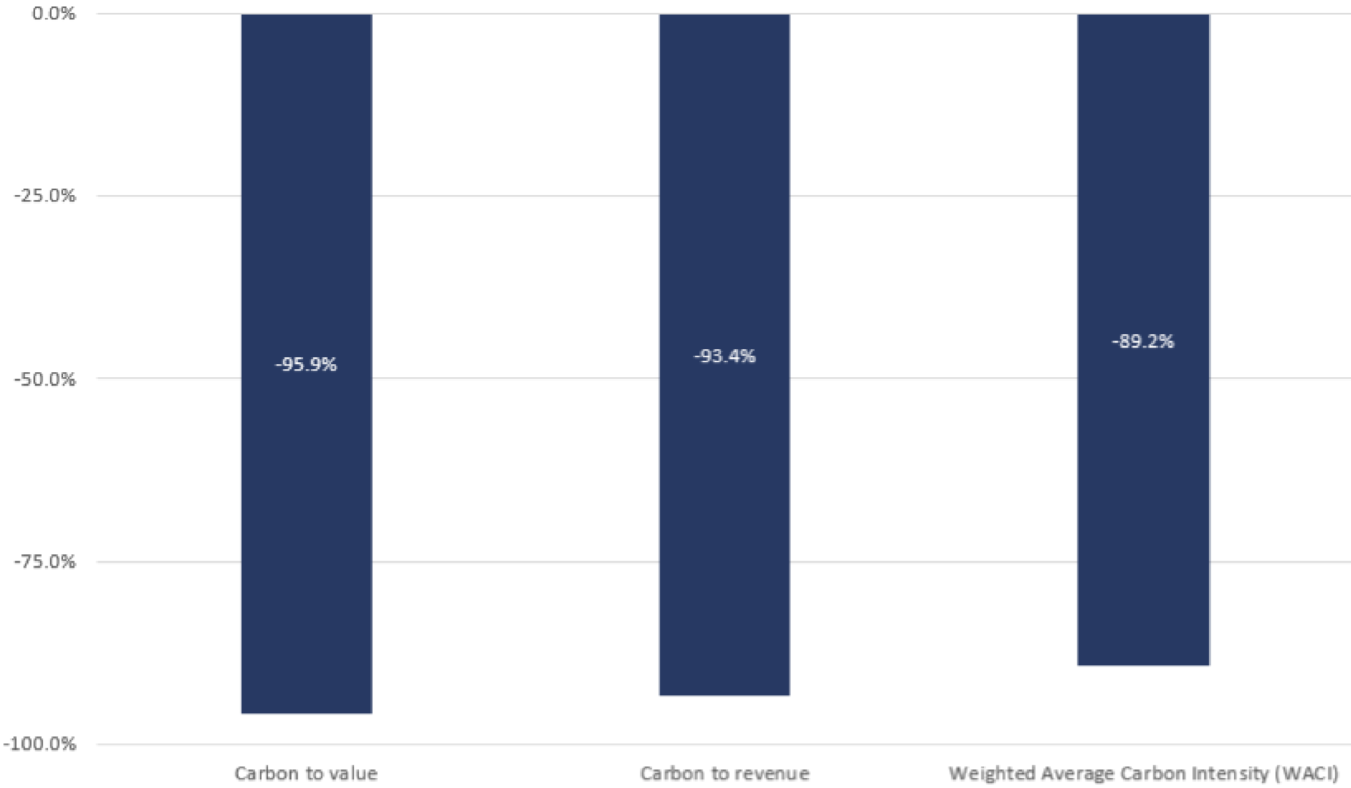
Carbon intensity method[1]	SFML	Benchmark[2]
Carbon to value invested	4.74	116.22
Carbon to revenue	18.62	280.83
Weighted Average Carbon Intensity (WACI)	21.90	202.37

Source: Refinitiv

1. Denominated in tonnes per CO2e/AUD$m
2. Benchmark used is Macquarie True Index-Australian Shares Fund, an approximation of S&P ASX30

- ***Carbon to value invested*** – this calculation is the aggregation of estimated owned constituent greenhouse gas emissions per $1m market capitalisation as at 31 December 2020. It allocates the emissions investors are responsible for based on their level of ownership, enabling them to measure their contribution to climate change.
- ***Carbon to revenue*** – this calculation reflects the aggregation of estimated owned constituent greenhouse gas emissions per $1m generated in apportioned revenues. It allocates the emissions investors are responsible for based on their ownership of company revenues.
- ***Weighted Average Carbon Intensity (WACI)*** is the weighted average of individual company's estimated carbon intensities (emissions over revenues), weighted by the investment proportion of the constituents.

Graph 5: SFML Carbon Intensity Relative to ASX 300



Source: Refinitiv

SFML's carbon to value invested and carbon to revenue are both lower than the S&P ASX 300 index, at 95.9% and 93.4% respectively. SFML's WACI is 89% lower than the index, due to no exposure to Energy and Utilities sectors, and low exposure to the Materials sector.

Table 9: SFML Top 10 emitters and total Portfolio Revenue impact of AUD$90 Carbon tax

Portfolio	LTM Revenue ($m)*	Estimated CO_2 Emissions (Tonnes)	$90 Carbon Tax ($m)	Impact on LTM Revenue (%)
SFML Top 10 Emitters	40,915.18	1,304,349	117.39	(0.29%)
SFML Portfolio – Total	52,335.96	1,371,583	123.44	(0.24%)
ASX300 Top 30 Emitters	458,387.54	216,705,671	19,503.51	(4.25%)
ASX 300 Index – Total	938,332.01	233,754,518	21,037.91	(2.24%)

Source: SFML & Refinitiv Estimated CO2 Emission data

* LTM (Last Twelve Months) revenue as of 31 December 2021

*Note: ASX 300 index revenue impact from a carbon tax is **9.5x** larger than SFML portfolio*

Table 10: Fundamentals behind comparing SFML Top 10 Emitters and ASX300 Top 30 Emitters

Portfolio	Percentage of Total Portfolio	Percentage of Total Portfolio's Emissions
SFML Top 10 Emitters	44.85%	95.10%
ASX 300 Top 30 Emitters	32.33%	92.71%

Source: SFML & Refinitiv Estimated CO2 Emission data

*Note: ASX300 Top 30 Emitters revenue impact from a $90 carbon tax is **14.8x** larger than SFML Top 10 Emitters*

Table 11: SFML Portfolio Top 10 Emitters Carbon Tax Scenario Testing

Company	CO_2 Emissions (Tonnes)	FY21 NPAT (AUD $m)	EPS FY21 ($)	Value of Carbon Tax ($)	Cost of Carbon Tax ($m)	Impact on NPAT (%)	EPS Post Carbon Tax ($)
JHX	603,840	353.83	0.79	90	54.35	(9.78%)	0.72
CSL	344,000	3,197.71	7.03	90	30.96	(0.78%)	6.97
ALL	129,024	820.00	1.29	90	11.61	(1.24%)	1.27
CPU	63,953	254.74	0.45	90	5.76	(1.67%)	0.45
REH	43,835	286.00	0.44	90	3.95	(1.17%)	0.44
FLT	34,328	-433.46	-2.18	90	3.09	(0.71%)	-2.19
DMP	33,539	184.01	2.13	90	3.02	(1.17%)	2.10
RMD	22,171	638.87	4.40	90	2.00	(0.16%)	4.39
ARB	16,405	112.90	1.40	90	1.48	(0.92%)	1.37
FPH	13,253	503.23	0.87	90	1.19	(0.17%)	0.87

Source: SFML & Refinitiv Estimated CO2 Emission data

We provide a more detailed review of the impact of a carbon tax on SFML's portfolio in the article below, *SFML 2022 Climate Commitment*.

- **How ESG factors are incorporated into research and decision-making processes**

We believe ESG is incorporated into our investment process and our research efforts. We make this distinction to provide further insight.

ESG incorporation into investment process

ESG consideration is integrated into the three core areas of our investment process:

1. Corporate engagement program
2. Quantitative modelling program
3. Voting program.

The three programs of work listed above are applied consistently to each business that we research. Ultimately, we are seeking businesses with leadership qualities, run by competent management teams, underpinned by a strong balance sheet and with a focus on capital management. Each of these four elements has its roots in culture and ESG.

We believe Culture and ESG are intertwined. We consider them both integral to our assessment of a business. Voting is the other half of ESG, all resolutions are documented, researched and voted inhouse.

Our ongoing focus on the individual culture and financial sustainability of a business lends itself to strong ESG outcomes at a business and portfolio level. This is evidenced by portfolio emissions significantly lower than index emissions, coupled with outperformance since inception.

ESG incorporation into research

All research is undertaken in-house by the Portfolio Managers and investment team. This is an intensive, granular and in-depth approach to continuous learning. We seek businesses with leadership qualities, run by competent management teams, underpinned by strong balance sheets and with a focus on capital management. This approach lends itself to strong ESG outcomes. Our approach is to fully integrate ESG into each of these four areas.

This is a risk out process. We are trying to take as much risk off the table as possible before we invest. The key areas of risk we focus on are board and management competency and the culture they are responsible for, business qualities, balance sheet and capital management. We believe a common-sense approach holds that a net cash balance sheet carries lower risk and more optionality than an optimised or extended balance sheet. We ultimately compare equity risk to a risk-free rate.

Before we invest, we seek to understand which risks a business can control verse those outside its control. For this to be possible, risk must be reported in a consistent and transparent fashion, to avoid any surprises. Here we are considering the possibility of assets becoming stranded (environment) or compromised (Social, Governance, legal, IP, cybersecurity as examples).

Risk sits in each bucket of E, S and G. Our program of corporate engagement has aided our understanding of risk in the S and G buckets since inception. In more recent years we have taken progressive steps to better understand Environmental risk and today, we are actively seeking better financial disclosure from the companies we invest in.

Our conviction in this process generates a concentrated portfolio of our best ideas, or our highest quality stock picks. The aim is to capture as much real earnings per share growth as possible over the long-term.

Our approach has been consistent since inception. It is framed by our Roadmap. This template is both qualitative and quantitative in nature, it focuses our research efforts on the aspects of ESG that we hold important in assessing the risk associated with a long-term investment. This internal scoring system is integrated into our financial model.

Our Roadmap provides a repeatable framework that drives our corporate engagement program, our quantitative program of financial modelling including our stock universe data screen, and our structured voting program. It also holds a strong relevance to our portfolio construction.

Our Roadmap has a material bearing on our investment process from screening ideas to portfolio construction. As an example, we highlight the top left-hand corner of the Roadmap, "Individuals we can trust". If we are unable to establish confidence in management, board and the culture that they are responsible for, we will not invest in a business. We are index unaware and have the luxury of sitting on the sideline or saying no to an investment.

We believe culture and ESG are intertwined, with the former driving the later. We have focused on the culture that drives the social attributes and governance process within a business since inception.

In 2019 we developed our ESG Roadmap which provides an additional framework for integrating ESG into our research. It is also incorporated into our financial models. This is an iterative approach whereby we are building upon successful initiatives and discarding those that do not add value to our process.

We have taken progressive steps to better understand environmental risk. We measure emissions targets and renewables use across the portfolio. We also measure portfolio emissions against index emissions.

We have long had confidence that our process drives strong ESG outcomes in relation to social and governance issues. We believe our long-term outperformance and low turnover is evidence of this. It is now also apparent, from the portfolio reporting discussed above, that we are driving equally strong ESG outcomes in relation to environmental issues.

In addition, we use our templates and framework to actively seek better transparency and financial disclosure from the companies we invest in.

- **Examples of where ESG issues have been integrated into investment analysis and decision-making processes including company engagement and voting**

As part of our corporate engagement program, in March 2021 we met with incoming IRESS Chairman Roger Sharpe. In April 2021, we met with the Investor Relation representative at Jumbo Interactive. In both meetings we presented a case for technology companies with relatively small carbon footprints, to pursue carbon neutrality based on clear financial outcomes. We used Technology One as a case study.

- Technology One (TNE) is carbon neutral via purchased certified credits.
- Carbon neutrality has driven financial and marketing benefits for TNE, above the cost of offset and the positive contribution to society.
- Two key area of benefits are seen in:
    1) New logo wins for the TNE SaaS engine; and
    2) Staff retention and new hires.

Details of any ESG research sources (internal and external) used during the reporting period.

We endeavour to read widely. This includes publicly disclosed documents, such as annual reports, sustainability statements, company and board charters and broker research. We subscribe to news services, various publications and a global business transcript service that also collates broker research and financial data.

SFML also recently integrated a new financial platform, Refinitiv, which provides extensive ESG coverage and data insights across ASX All Ordinaries securities. Refinitiv's reported and estimated emissions data has been used to generate the detailed analysis of SFML's portfolio emissions as seen above. Refinitiv will also enable data to be refreshed more frequently.

All research is undertaken in house by the Portfolio Managers and investment team. This is an intensive, granular and in-depth approach to continuous learning. We believe this is a differentiated approach that generates strong ESG outcomes.

REPORTING SEASON SNAPSHOT

We have included a review of the five top and bottom portfolio contributors, and other selected results from the reporting season.

- Altium (ASX:ALU)

In February, electronic Printed Circuit Board (PCB) designer Altium, released its first half 2022 results. After navigating a hard pivot to the cloud and organisational changes over FY21, the company commented they are *"back to winning form"*. In the period, revenue grew by 28% to US$102m while operating profits (EBITDA) lifted 29% to US$34.8m.

Strategy

At its core, Altium's software and cloud services provide a unique offering that connects product and electronic design to the electronic supply chain and manufacturing, as shown in Figure 2.

To achieve market dominance, Altium are targeting 100,000 active seats and US$500m revenue by 2025-26. With clear industry leadership, transformation can take shape. For Altium, this means disrupting the status quo of the broader PCB industry.

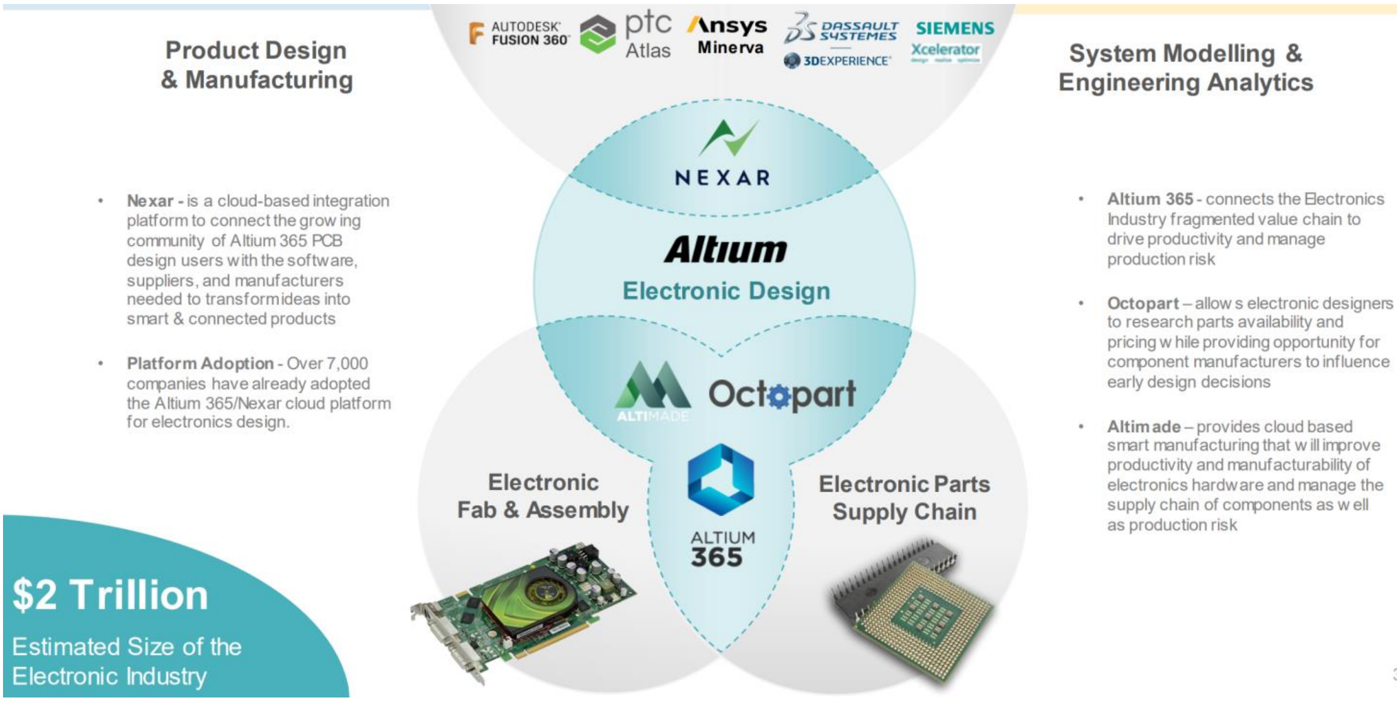
Altium 365

Altium 365 is the pivot point. This cloud-based collaboration model offers an end-to-end solution, which integrates both electronic and mechanical design elements. The result is a more seamless and connected experience across the design, development, and manufacturing process. Released in May 2020, adoption has exceeded expectation; 9,918 Altium 365 seats have been sold to date, up 40% from the prior period and maintaining a 97% renewal rate.

These seats are being used by 19,743 active users and 7,734 active accounts; an active user to account multiple of over 2.5x. In time, this multiple is expected to grow to 4x as the ecosystem continues to widen.

Importantly, 365 is driving material workflow efficiencies, which become immediately apparent to engineers when they make the switch. The switch is not instantaneous; it is a process or transition. Given time, a network effect will become apparent.

Figure 2: Altium's Product Positioning



Source: Altium 1H FY22 Investor Presentation

Manufacturing and Parts

While 365 itself has yet to be monetised, its integration into manufacturing and parts presents a significant opportunity. Altimade, the company's foray into manufacturing, operates as a clearing house aimed at improving productivity and manufacturability of electronic hardware, while managing production risk and the supply chain. Altimade means customers can request instant quotes and place orders to produce their PCB assembly without leaving the design environment. While this is a significant piece in the journey towards industry transformation, it is pioneering work and will take considerable time before its full commercial impact will be felt.

In terms of the electronic parts supply chain, Octopart performed well over the period with revenue up 105% to US$22m. While this growth is expected to temper, the company believes the scarcity and supply chain instability resulting from the pandemic will continue over the next few years, buoying demand for Octopart's services. Here, Altium is remunerated by electronic part distributors for driving traffic. In total, Octopart saw 15m clicks in the half, an increase of 148%.

Altium Designer

Core to this ecosystem is Altium Designer 20. Worth noting here that older versions of Altium Designer do not work with 365. This is a type of soft compliance; the inherent benefits of the platform are expected to drive recurring revenue from 74% today to 95% by 2026 (excluding China and developing markets).

At present, Altium has 55,978 seats on subscription and is used by over 30,000 companies. While there is still a considerable gap between the current seats and the company's target, CEO and Executive Director Aram Mirkazemi commented, *"we are a lot further along in our pursuit of the underlying objectives behind the 100,000 subscribers than the raw number [of seats] may suggest"*. This is particularly due to the increased focus on bringing the Chinese market onto the cloud.

China

Turning to China, Altium have built a standalone version of this platform model, which will sync with AliCloud and WeChat. Designed purely for the local market, this model differs in that it operates via a major Chinese manufacturer rather than a clearing house owned by Altium.

China underperformed for the half with 6% revenue growth, impacted by the temporary effects of COVID-19 lockdowns. This performance reflects a measured approach to license compliance, as the in-person visits required to complete the process were restricted in Beijing.

Strategic Partnerships

The final key tenant to Altium's industry domination and transformation is penetration of the enterprise market. To do so requires maintaining strong and stable relationships with strategic partners, the alignment of product and go-to-market teams and scaling the enterprise sales workforce.

Altium has positioned its Nexus enterprise platform as the PCB industry's version of an iPhone, *"in the same way that an iPhone connects an individual to a variety of applications and services, Nexus will connect electronics within modern enterprises to other engineering disciplines with an ease and efficiency that is unprecedented in this industry".*

Core to this will be Altium's ability to execute strategic partnerships with key industry players to build and maintain digital bridges, which connect electronics to adjacent engineering specialties, such as mechanical computer-aided design (MCAD) simulation and silicon design. In this way, the company is attempting to deliver best-of-grade engineering tools across its cloud platform to customers.

Success here will be measured by enterprise sales growth in the coming years. In the half, enterprise sales contributed revenue of US$7m.

Guidance

Altium has upgraded its FY22 revenue guidance to be at the high-end of the range of US$213m–US$217m. Underlying operating profit (EBITDA) margins are expected to be at the lower end of the 34%-36% guidance considering the company's focus on scaling its leadership recruitment, including new cloud and enterprise sales roles in an increasingly competitive market.

Altium has a market capitalisation of $4.4b, net cash of US$195m and no debt.

- ## ARB Corporation (ASX:ARB)

Four-wheel drive equipment manufacturer ARB reported a strong half year 2022 result. At a group level, sales increased 26.5% to $359.2m, while profit before tax grew 27.6% to $92.0m.

Category performance

- Australian Aftermarket (53.1% of Group Revenue)

In the Australian aftermarket business, strong demand from all customer segments led to revenue growth of 15.6% to $190.7m. The company remains a beneficiary of the structural shift towards Sport Utility Vehicles (SUV) and four-wheel drive (4WD) vehicles, which now represents 50.6% of new vehicles sold.

Over the half, ARB added two new stores, bringing its total retail locations to 72. Noting the success of its updated flagship store layout in improving sales, ARB remains focused on upgrading its existing aftermarket retail network. At period end, ARB had 31 flagship stores nationwide.

- Exports (38.4% of Group Revenue)

ARB's export market, which includes global aftermarket and Original Equipment Manufacturer (OEM) sales, continues to build on its positive momentum. Sales for the half rose 39.9% to $137.9m.

The group benefited from the contribution of Truckman Group, a U.K.-based Auto Styling business acquired in March 2021. Adding scale to ARB’s global business, this saw Europe, Middle East, U.K. and Africa sales increasing 68.7%. Excluding Truckman Group, Exports grew 22% on the prior corresponding period (pcp).

- OEM (8.5% of Group Revenue)

Sales to OEMs increased 50.6% over the half to $30.5m. Management attributed the significant growth to the timing of new vehicle launches. Due to the lumpiness of OEM orders and current supply issues, the company expects sales to decline in the second half, with full year sales remaining relatively flat against FY21 revenue of $51.7m.

Ford Agreement

Commenced in October 2021, the Ford Licence Agreement (FLA) for the Australian market allows Ford to directly promote and sell an extensive range of ARB branded products for the Everest and Ranger models.

All ARB products sold within the Ford network will come with a 5-year warranty, in contrast to ARB’s own 3-year warranty, reflecting Ford’s trust in the quality of the range. Early sales are in line with the company's expectations and are steadily increasing. The group is also looking to expand the licence agreement to New Zealand later this year.

In the U.S., Ford Motor company has entered a strategic partnership with ARB for the new Bronco and Ranger models. Ford are currently undergoing final engineering approvals for ARB's products before its offering across Ford's accessory dealership network is available. The agreement is non-exclusive, and ARB maintains the ability to sell these products via its distribution network. Importantly, under this agreement the accessories will be branded ARB.

The agreement is expected to significantly enhance ARB's presence in the U.S. market. Management noted there is scope to further expand its product offering for the Bronco and Ranger models, as well as potential options to expand outside the small truck market.

Investing for Growth

To manage the next phase of growth, ARB has ramped up its investment to expand manufacturing and research and development (R&D) capabilities in Australia and Thailand.

In Australia, the company is undertaking a four-stage redevelopment of its Victorian head office. Expected to cost $20m, it includes:

- Extending the front carpark to facilitate further headcount expansion – completed
- A new 1,000 sqm Engineering and R&D facility – expected completion in early 2022
- A new 3,600 sqm Corporate head office – expected completion at end 2022/early 2023
- A new 500 sqm Flagship store – expected to open in 2023

In Thailand, the new Ora 4 factory build is progressing well and expected to be complete by the end of the calendar year. This new 36,000 sqm facility is in the same business park as ARB's existing facilities and doubles the group's manufacturing capabilities, supporting its long-term growth ambitions and new product launches. The development cost of Ora 4 is $27m.

Thailand remains a key manufacturing hub for the Exports division. It is expected to generate strong manufacturing efficiency gains over the long run by streamlining the process and consolidating finished good warehousing.

Outlook

Notwithstanding constraints relating to staff shortages for skilled labour, raw material prices and vehicle supply complexities, ARB continues to execute and pursue long-term growth opportunities across all business segments.

Management maintains a positive outlook based on a strong order book, improved inventory levels, increased manufacturing capacity and a dedicated R&D team of 70 engineers.

Post period end, ARB agreed to purchase the manufacturing site of recently acquired NZ Canopy business, PRO-FORM for $14m. The company expected a further $5m investment to enhance the site, with the goal of creating sufficient capacity to facilitate a potential expansion of the canopy offering globally.

Despite significant investment within manufacturing capacity of $27m for the half, the balance sheet remains strong. At the end of the period, the company reported cash of $58.3m and no debt. Operating cash flows remain robust at $28.6m, a decrease of $29.5m due to inventory levels increasing by $40.5m. This was a targeted investment aimed at mitigating long supply lead times.

ARB has a market capitalisation of $3.3b and declared a dividend of 39 cents per share.

- ## carsales.com (ASX:CAR)

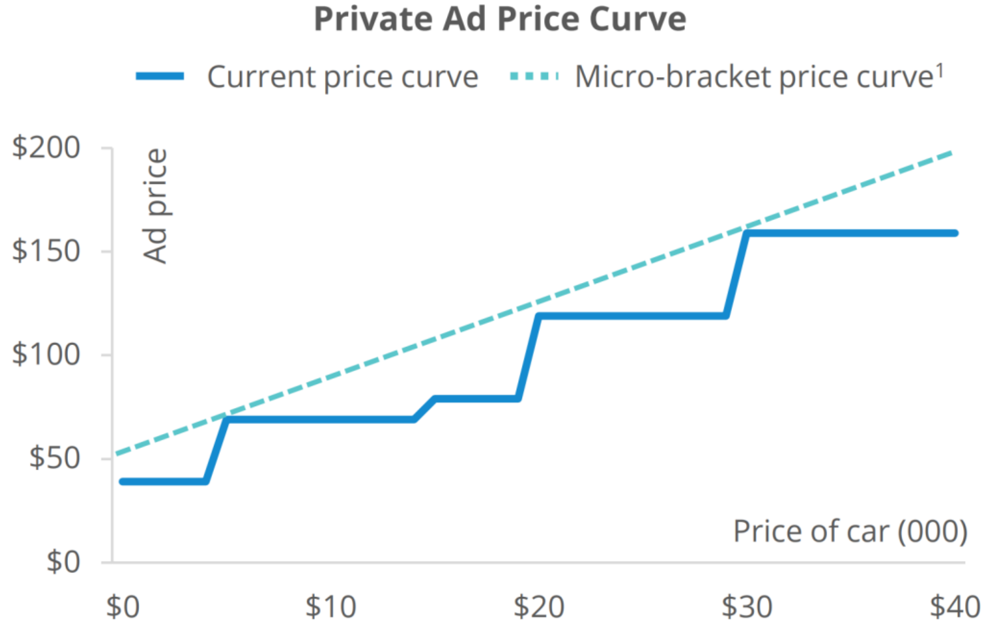
In February, leading online automotive listings business carsales.com reported its half year 2022 results. Revenue and operating profits (EBITDA) increased by 16% and 10% to $242m and $125m respectively. Excluding the impact of government wage subsidies received in first half 2021, adjusted EBITDA grew 7%.

Australia (67.3% of Look-Through Revenue)

Despite supply shortages and lockdowns impacting dealer activity, the used automotive market remained strong. With elevated vehicle prices, strong consumer demand and a new dynamic pricing model, private revenue grew 38% to $31.5m. More than half of that growth came from dynamic pricing, and the rest of the growth was split between Instant Offer and volume.

Since introducing Phase 1 of dynamic pricing last year, the company has grown yield (average ad price) by 20% to $125. The next phase of dynamic pricing known as micro-bracket pricing, aims to better align the value of the car with the price of the ad. The use of algorithms will determine price and allow carsales to transition from the old price brackets and improve yield, as seen in Figure 3.

Figure 3: Private Ad Price Curve



Source: Company HY2022 presentation.

1. Hypothetical model, does not reflect actual ad prices

Longer term, the company believes the pricing model can be even more sophisticated based on the type of vehicle, the season in which the vehicle is being sold and current levels of demand. Management expects this will create yield and volume improvements, by removing pricing inefficiencies.

Uptake of Instant Offer also continued to ramp up and is expected to grow faster in the second half. The first half was impeded by lockdowns.

"When dealerships are not operating, it's hard for them to buy cars. And those conditions have significantly improved, and we're seeing that run rate".

Management will continue investing in growing Instant Offer customer awareness and the conversion rates from quote to sale.

Carsales Select

Launched in August 2021, carsales' online car purchasing platform is seeing good momentum. More than 400 cars have been sold and high vehicle page views have enabled Select to generate 63% more leads for Dealers than standard listings.

Early sales momentum is positive, with one third of all cars selling within the first week of publishing. Improving time to sell by 1.5-2x compared to standard listings, incentives for dealers to adopt the transaction-based solution remains compelling.

While making solid progress in the half, the focus remains on building out inventory and consumer awareness. Management announced plans for Phase 2 of Select, which will integrate Digital Trade-Ins and Dealer Finance features.

Overall, the opportunity remains attractive given the ability for carsales to leverage its partnered dealer network and market leading platform. As of 12 February 2022, carsales Select had published inventory of 1,000 vehicles.

International (32.7% of Look-Through Revenue)

Despite difficult trading conditions, South Korea and Brazil posted solid growth. The Group's wholly owned South Korean business Encar reported constant currency (cc) revenue and EBITDA growth of 19% and 7% to $44.9m and $21.5m respectively.

With a long-term strategy of transforming Encar from a classifieds model to an online car transaction platform, Encar continued to invest in its core products of Dealer Direct, Guarantee and Encar Home.

Over the period, Dealer Direct grew online trade-in and transaction volumes. Further investments within the platform and dealer networks continue to drive adoption, with revenue more than doubling compared to the prior corresponding period (pcp).

Additionally, the Group deepened its Guarantee offering with inspected cars representing 37% of total inventory. This product remains a key differentiator for customers, and the group is targeting Guarantee inspection penetration of over 40% in the second half of the financial year.

For Encar Home, changes were made to the consumer application process to reduce friction during the digital car buying service. Eligible cars for the offering increased to more than 12,000 vehicles over the period.

In Brazil, the 30% owned Webmotors business benefited from improved inventory levels and higher dealer yields through increased penetration of premium products. As a result, revenue and EBITDA grew 20% and 19% in constant currency to $38.5m and $18.1m respectively.

The regional expansion strategy also recommenced during the half, driving dealer subscription volumes up 14% against the pcp.

Across the Latin America regions of Chile, Argentina and Mexico, challenging economic conditions constrained growth with management maintaining strong operational cost controls.

Whilst inventory levels improved in Latin America, they remain 66% below pre-pandemic levels. Nevertheless, the Americas operation remains well placed as inventory and supply constraints improve.

Trader Interactive

The group's recently acquired 49% interest in U.S. based online non-automotive listing provider, Trader Interactive, reported strong revenue and EBITDA growth, underpinned by improving inventory volumes. For the half, revenue and EBITDA increased 12% and 19% in cc to $95.1m and $54.3m respectively.

The opportunity to monetise carsales local knowledge to help drive higher dealer-led productivity in the U.S. operations remains a compelling proposition.

Against 2019 levels, leads per dealer per month has nearly doubled. Likewise, cost per lead has more than halved in the same period, reflecting Trader Interactive's strong value proposition. As a result, Dealer Net Promoter Score (NPS) increased 36% from 2019 levels to +38.

The team remains focused on investing in the solution offering, having recently launched a new leads management system for dealers to improve lead conversions and market insights.

Management remains confident on the opportunities to leverage its proprietary technology and product offerings to further grow Trader Interactive's gross margins on a per product basis. Early momentum has been promising, with Trader Interactive's EBITDA margins expanding from 53.7% to 57.1% in the last twelve months.

Outlook

While no formal financial guidance was provided, business conditions remain favourable, with management expecting to deliver strong growth across the key metrics of revenue, EBITDA, and net profit.

Carsales has a market capitalisation of $5.7b and net debt of $554m.

Cochlear (ASX:COH)

In February, leading global bionic ear manufacturer Cochlear delivered a strong first half 2022 result with revenue rising 12% to $815.3m in constant currency (cc), driven by increased demand for sound processor upgrades and new acoustic implants. Underlying net profit lifted 20% to $157.5m, primarily driven by sales growth and improved margins.

Sales performance varied across geographic regions, due to intermittent COVID-related restrictions and reduced operating theatre capacity.

Segment Performance

- Cochlear Implants (56% of Sales)

Cochlear implants reported unit growth of 7% to 18,598 units and revenues up 2% to $457.9m. Performance across markets varied, with an unexpected shift to emerging markets.

In developed markets, unit volumes declined 2%, but are still tracking above pre-COVID levels. The most notable volume decline was in the U.S., where hospital staffing shortages and restrictions on operating theatre capacity negatively impacted procedure volumes. Sales in Western Europe recovered solidly, with results varying by country depending on COVID-related restrictions and theatre capacity.

In emerging markets, overall unit volumes increased 30%, underpinned by a strong recovery in China and improvements in Eastern Europe and the Middle East. Management noted operating conditions in Brazil and India are recovering but remain materially below pre-COVID levels.

Along with the U.S., the Chinese market opportunity continues to be a key priority. The market dynamics remain supportive of strong ongoing demand, driven by a large private consumer market.

- Services (32% of Sales)

Cochlear Services reported a strong result with revenues rising 21% in cc to $256.5m. This accelerated growth was underpinned by COVID-related theatre capacity constraints, with clinics allocating greater resources to sound processor upgrades.

The Services division represents an important long run opportunity for the company, with ongoing upgrade demand underpinned by a growing installed base of implant recipients.

- Acoustics (12% of Sales)

Acoustics revenue was up an impressive 40% to $100.9m in cc, representing strong popularity for new products and a recovery from COVID-related surgery delays. Strong demand in the U.S. for the Osia 2 System, was augmented by the rollout of the product in Western Europe following CE Mark accreditation in FY21.

The Acoustics division also benefited from positive uptake for sound processor upgrades across all regions, on the back of the product rollout of the new Baha 6 Max Sound Processor.

Strategic Priorities

In the earnings update, CEO Dig Howitt reinforced the company’s three strategic priorities. They are:

1. Retaining market leadership
2. Growing the implant market

3. Delivering consistent revenue and earnings growth

Cochlear is delivering on all fronts.

- Retaining Market Leadership

Amidst the pandemic, Cochlear maintained its focus on research and development (R&D) with 12% of revenue or $98.6m of fully expensed investments during the half. Despite the impacts of COVID, the company chose to maintain its employee count, ensuring ongoing product development and the provision of superior customer service and support.

Cochlear's recipient engagement program, Cochlear Family, grew its membership by 20% to circa 240,000 members by half year end. The opportunity to connect directly with an implant recipient remains a key competitive advantage.

The launch of nine new products and services over the past two years has strengthened the group's competitive position. Amongst these are the off-the-ear Kanso 2 and the Baha 6 Max sound processors, further differentiating the company's product portfolio.

In October, Cochlear achieved FDA approval for Remote Assist for the Nucleus and Baha systems. Remote Assist, part of Cochlear's Connect Care technology, enables live interaction and remote programming between clinicians and patients via a Smart App.

Overall, these initiatives have led to market share gains, cementing Cochlear's leadership position in the profound hearing loss market.

- Growing the Implant Market

The group's market leading position and differentiated product portfolio demonstrates the company's commitment to invest and engage directly with the hearing community, including audiologists, ENT (ear, nose and throat) specialists and consumers in general.

Following the publication of the World Health Organisation's first (WHO) World Report on Hearing in FY21, WHO has given guidance for countries to establish screening programs at key life stages, to drive early intervention for hearing loss. This initiative, alongside the first global consensus on minimum standard of care for adult hearing loss published in JAMA Otolaryngology, is aimed at improving both the identification and treatment of adult hearing loss.

To grow its participation in the hearing market, Cochlear has undertaken product indication expansion initiatives across all markets. Over the half, Cochlear received FDA approval for the treatment of unilateral hearing loss and single-sided deafness (SSD) in people five years of age and older with the Nucleus implant. This provides a significant market opportunity, with the U.S. annual addressable market estimated at 60,000 recipients per annum.

- Delivering Consistent Revenue and Earnings Growth

The company ended the half in a strong financial position, driven by positive sales growth and improved gross margins. When combined with lower than anticipated operating expenses, the group delivered an underlying net profit margin of 19%, ahead of the company's longer-term stated target of 18%.

An interim dividend of $1.55 per share was announced, representing a 65% payout ratio, an increase of 35% over the prior year.

Guidance

Capital expenditure is now expected to be $70m, with $18m to $20m of previously forecasted cloud investment reclassified as operating expenses. This is due to the change in interpretation by the International Financial Reporting Standards (IFRS) for the accounting treatment of cloud computing arrangements.

For the second half, management is guiding to ongoing market growth and a recovery in surgeries across all regions. Net profit guidance for FY22 has been maintained in the range of $265m to $285m, an increase of 13% - 22% on FY21, despite expensing significant cloud costs. Cochlear has a market capitalisation of $14.8b and net cash of $506m.

- Computershare (ASX:CPU)

Global registry service provider Computershare released its first half 2022 result in February. The company reported revenue growth for the period (excluding Margin Income (MI)) of 4.5% to US$1.1b, of which 76% is recurring. As a result, EBIT ex. MI, which reflects operating performance, increased 16.7% to US$157.8m. This result highlights outperformance in the recently acquired Computershare Corporate Trust business in the U.S., careful cost controls driving margin expansion, and the resilience of the business's countercyclical segments.

CEO Stuart Irving commented, *"I am pleased to report that the momentum we enjoyed in the second half of last year has continued, with Computershare delivering a positive set of results for the first six months of FY22… The investments we have been making to strengthen and scale our global growth businesses are delivering the anticipated returns, underpinning the strong operating performance in the first half*."

Business Segments

1. Issuer Services (39.6% of Revenue)

Issuer Services were constrained, as broader economic uncertainty put a dampener on the event-driven Corporate Actions and Stakeholder Relationships Management segments. This was mostly offset by the largest segment contributor, Registry Maintenance, improving revenues by 3.6% over the period. Governance Services increased 29.2%, demonstrating improving traction within this large and complementary market. In total, Issuer Services delivered revenues of US$456.4m, down 1.8%, and EBIT ex. MI of US$97.5m, down 6.3%.

2. Employee Share Plans (13.9% of Revenue)

Employee Share Plans saw revenue increasing 13.2% to $154.8m resulting in stellar profit growth as EBIT ex MI increased 122% to $31.8m. This result was driven by increased recurring client paid fees, higher transaction volumes and cost synergies.

While this business has sensitivities to equity markets in terms of both share prices and transaction fees, management has observed a countercyclicality to operations; when equity markets are weak, employers typically overissue new equity to compensate.

The rollout of the Equate+ platform has been stalled in some jurisdictions due to ongoing travel restrictions. This has resulted in a longer period of operating dual systems and an increased cost to achieve expected synergies.

3. Mortgage Services (25.2% of Revenue)

U.S. Mortgage Services remained subdued, but industry fundamentals are showing signs of improvement. In this market, Computershare has grown the Mortgage Services business by purchasing Mortgage Servicing Rights (MSR) to facilitate groups of loans, in return for an annual fee over the lifetime of the loan. In general, rising rates increase the value of owned MSRs, resulting in improved returns on invested capital and reduced portfolio runoff. The company continues to reduce the capital employed, whilst focusing on initiatives that improve servicing and fulfilment efficiency and reduce costs.

The U.K. Mortgage Services business has returned to profitability, despite revenue contracting in the period. As previously flagged, management has completed a strategic review of the U.K. operations and a sale process is underway with the view that "*the business would be better served by an owner willing to deploy more capital via originating or acquiring assets book to scale*."

In total, Mortgage Services contributed revenue of US$269.2m, down 5.2%, and a Management EBIT ex. MI loss of US$2.5m.

4. Business Services (7.2% of Revenue)

Business Services were significantly impacted by the reduction in Bankruptcy claims, as companies navigated refinancing options and avoided the Chapter 11 process. Class Actions continue to be lumpy with management focusing on global scale opportunities in this vertical. Canadian Corporate Trust delivered a consistent result, with new mandates won and debt under administration continuing to grow in the period. In aggregate, Business Services saw revenue declined 27.8% to $82.6m with Management EBIT ex. MI down 51.2% to $6.3m.

5. Computershare Corporate Trust (6.6% of Revenue)

Computershare Corporate Trust (CCT), the business acquired from Wells Fargo in November 2021, is already exceeding expectations in terms of fee income. The acquisition brought in tow the combination of growing, long-duration recurring fee revenues and increased leverage to rising rates. While management has acknowledged the considerable work left to do in terms of key system migration and client engagement, they are confident in the upside CCT can deliver.

Management continues to work towards the synergy target of $80m in the first five years of the acquisition. CCT delivered revenue of US$76.7m and a Management EBIT margin ex. MI of US$1.7m. Including MI, the CCT business delivered a two-month EBIT contribution of US$9.1m.

Margin Income

MI performed broadly in line with management expectations, delivering income of US$62.1m on average balances of US$27.9b. This includes a US$7.5m contribution from CCT as discussed above.

As this segment generates income from the interest earned on client balances held, the improved rates outlook and additional balances held post the CCT acquisition, provide significant earnings latency within the business. CEO Stuart Irving explained, *"as expectations have also firmed for more interest rate rises this year and beyond, Computershare is well placed to benefit. A 100bps increase in interest rates on the exposed average balances we currently manage would generate an annualised EPS increase of 26 cents per share (cps)."* Noting Management EPS was 22.76 cps in the half, this alone would equate to additional net profits of circa US$157m.

Factoring in the 25bps increase in the U.S. Federal Reserve, as announced in March, Computershare is forecasting MI of US$152.2 for FY22. Of this, the CCT business is expected to contribute MI of US$41.3m.

Cost Out Program

Management remains focused on improving the underlying, recurring revenue of the business and delivering long-term value for shareholders. To that effect, in the period cost savings of US$23m were realised, more than offsetting the impact of underlying inflation. Computershare is targeting further cumulative cost savings totaling US$274.5m through to FY24, up from the 2021 level of US$194.7m.

Guidance

For FY22, Computershare has upgraded its Management EBIT ex MI guidance to US$383.4, an increase of 9%, and its MI guidance to $152.2m, an increase of 5%.

With a net debt of US$1.3b, the company's leverage ratio as measured by net debt to EBITDA sits in the middle of the company's targeted range of 1.75%-2.25%. An interim dividend 24 cps was declared, an increase of 4.3%.

Computershare has a market capitalisation of $15.5b.

▪ CSL (ASX:CSL)

Leading global biotechnology company CSL reported a resilient first half 2022 result. Total revenue rose 4% in constant currency (cc) to US$6b, while net profit after tax (NPAT) fell 5% in cc to US$1.7b. Gross margins decreased by 3.4% to 57.1%, due to increased collection costs and lower volumes through its fixed fractionation base. These headwinds will continue into the second half and ease into FY22.

CSL Behring (72.1% of Revenue)

Global therapeutics business CSL Behring delivered steady revenue down 2% at cc to US$4.2b, while operating profits fell 22% at cc to US$1.3b. During the half, the segment experienced the impact of lower plasma supply in FY21 due to the 9-12-month lag from collection to sale. Immunoglobulins (Ig) as a result, which represents 45% of Behring revenues, recorded a reduction in volumes sold with sales falling 9% to US$2b. With industry supply constrained, CEO Paul Perreault notes *"the demand for Ig is still there. People are waiting for Ig."*

Plasma collections did recover in the first half with volumes rising 15% against the prior corresponding period. However, the cost to collect plasma continues to increase as staff labour, donor payments and personal protective equipment (PPE) expenses, are expected to remain elevated.

To offset this, CSL is targeting investments within its collection centres to drive greater efficiencies. Technology enhancements through new self-service kiosks and a new donor app reduces donor time in centres. The company also expects to begin rolling out Terumo's new plasma collection platform, Rika, which will bring increased operator productivity and greater yield efficiencies during the plasma collection process. FDA approved Rika in March.

In time, these initiatives should differentiate CSL's collection centres. For plasma donors, this should drive retention through a more seamless experience. For operators, the process is expected to be more efficient and reduce errors. CSL continues to see opportunity, adding 18 collection centres during the period.

Albumin recorded stable growth of 1%. Similar to Ig, supply has been constrained by lower plasma volumes. The transition to a direct distribution model in China is complete and has allowed CSL to engage directly with health care practitioners, driving greater transparency and improved effectiveness in its efforts. CSL expects market volumes in China to grow in the mid to high single digits.

Haemophilia sales rose 5%. Largely a result of its market leading Haemophilia B product, Idelvion, which was up 17%. Less differentiated products, such as Afstyla and Beriate, have continued to face competitive pressures.

Speciality revenue growth was driven by the differentiated products in Haegarda and Kcentra, up 7% and 15% respectively. Overall, the segment rose by 2%.

Seqirus (27.9% of Revenue)

The company's vaccine business continues to go from strength to strength. Product differentiation has been the key driver, with CSL's higher value product portfolio of cell based (Flucelvac) and adjuvanted egg based (FLUAD) seasonal influenza vaccines rising by 11% and 48% respectively.

COVID has brought vaccine effectiveness to the forefront of the decision-making process. The past decade has seen efficacy in the U.S. ranging from 19% to 60% due to a lack of innovation. With the transition to new and more effective vaccine technology overdue, CSL has innovated here through its cell-based vaccines and more recently in its MF59 adjuvanted egg-based vaccine, FLUAD, which provides a stronger immune response.

In the U.K., FLUAD has become the standard of care for people aged 50 and over. Remarkably, the National Health Service (NHS) purchased enough doses to cover the entire cohort for the most recent flu season.

The research and development (R&D) pipeline is also robust. Management are developing an adjuvanted quadrivalent cell vaccine as the next standard of care, with self-amplifying mRNA a potential offering further down the road. To support this, construction has commenced on a world-class cell culture influenza vaccine facility in Melbourne and a mRNA facility in Holly Springs, North Carolina.

Seqirus revenue rose 17% to US$1.7b, while operating earnings increased 24% to US$884m. Seasonal influenza vaccines rose 20% and represents 90% of Seqirus revenue.

Vifor Pharma Acquisition

In December, CSL announced its intention to acquire Vifor Pharma, a Swiss specialty pharmaceuticals company which develops, manufactures and markets leading products in iron deficiency, renal and cardio-renal therapies. Strategically, the acquisition augments CSL's business with adjacent products and an extended high-value R&D pipeline, including four potential new product launches by 2023. CSL can also leverage its global infrastructure to grow Vifor's renal and iron franchises.

Key to the acquisition is Vifor's partnership with Fresenius Medical Care, the global leader in dialysis. This partnership positions CSL for global leadership in nephrology and provides access to 350,000 kidney disease patients, over 54m dialysis treatments and 4,000 dialysis clinics.

The all-cash public tender offer values Vifor at $16.4b and will be funded through a $6.3b institutional placement, along with existing cash and new debt facilities. With unanimous approval from Vifor's board and 74% of shares tendered following the provisional interim vote in March, CSL plans to waive the 80% acceptance rate condition and declare the offer successful. The acquisition is expected to be earnings accretive, with Vifor delivering approximately US$2b of revenue and US$0.4b of free cash flow in FY21.

2030 Strategy

CSL's 2030 vision reflects the ongoing targets and decisions to drive the next decade of growth. The five pillars to support this are focus, innovation, efficiency and reliable supply, sustainable growth and digital transformation.

The Vifor transaction accelerates the 2030 strategy by enhancing CSL's leadership across areas of innovation and sustainable growth into the latter part of the decade. R&D at 10-11% of revenue, capital expenditure across manufacturing and collection centres, as well as strategic acquisitions, will also help deliver this.

Outlook

CSL reaffirmed its FY22 NPAT guidance of between US$2.15b and US$2.25b in cc. This includes US$90m-US$110m of Vifor transaction costs.

CSL has a market capitalisation of $126b and expects net debt to EBITDA to be approximately 2.65x following the Vifor acquisition. The company also declared an interim dividend of US1.04 cents per share.

▪ Domino's Pizza Enterprises (ASX:DMP)

In February, Domino's Pizza Enterprises reported its half year 2022 result. The group navigated full and partial temporary store closures brought on by COVID-19, to deliver increased network sales of 11% to $2b and operating earnings (EBIT) of $145m down 6%. Over two years, network sales and operating earnings have risen by 29.5% and 25.2% respectively.

Network expansion also continued. 156 Taiwan stores were acquired and 129 net new organic stores added during the period. Domino’s expects to deliver 500 new stores, including the Taiwan acquisition by the end of the financial year, reflecting an acceleration in new organic stores.

Operating margins reduced from 14% to 12%, due to upfront investments in Project Ignite in Australia and a re-basing of sales following the lifting of the State of Emergency in Japan, explained below.

Australia & New Zealand (ANZ) – 863 Stores (+3 New Stores)

Under the leadership of new CEO David Burness, ANZ delivered a solid result with network sales up 6.4% to $689.6m and EBIT down 6.1% to $60.3m. A $6m investment in Project Ignite and a $1.8m impact from store closures in New Zealand reduced operating margins to 15%.

Within the ANZ market, management has prioritised the optimisation of its franchisee base and continuation of its “fortressing” strategy. This follows an initial program dubbed Operations 360, which has led to 37 of the lowest performing franchisees being exited from the system.

Project Ignite is the next phase. Here, Domino's incentivises franchisees through subsidies to enhance the economics of purchasing or opening new stores. During the period, the store network saw considerable optimisation with 19 corporate stores re-franchised and another 58 franchisees choosing to expand their network. These transactions were predominantly completed by franchisees who are internally rated either an A or B.

While three new stores were opened during the half, the cadence for new store openings is expected to increase, with Project Ignite set to drive a record CY22 and further growth beyond this.

Asia – 1,043 Stores (+87 New Stores)

Asia, which consists of Japan and Taiwan, recorded network sales of $562.1m, up 16.4%, while EBIT fell 17.3% to $45.7m. Japan experienced a re-basing of sales in the second quarter, as COVID restrictions were lifted with same store sales (SSS) down 12.4%, alongside lower earnings from newer corporate stores. On a two-year basis, Japan SSS are up 27.9%, while total Asia network sales and EBIT are 61.4% and 70% higher.

Franchisee appetite in Japan remains strong. Its large owners are looking to pursue new store openings, rather than take the traditional, risk averse route of purchasing corporate stores. The average number of stores per franchisee has grown from 2.3 in 2019 to 3.5 in 1H22. This translated to a record 82 new stores opened in 1H22.

As the franchised store mix continues to grow, less profitable corporate stores will be removed, leading to margin expansion in the region. The long-term strategy remains in-tact, with management committed to its target of 2,000 stores by 2033.

Taiwan performed above expectations, with the refreshed ownership reinvigorating the local franchisee base and the opening of five new stores. Like previous acquisitions, Domino's will invest to fortress the market. Early progress is positive with CEO Don Meij noting *“it really gets us excited when we can see that we can add a new market like Taiwan and immediately apply our experience in this business and get such extraordinary traction.”*

Europe – 1,321 Stores (+114 New Stores)

Europe delivered the standout result with network sales and operating earnings up 12%, while SSS rose 3.6%. As restrictions ease, delivery has remained the pillar for growth with online sales up 16.5%, while carry out has returned. Germany and Benelux recorded growth, despite cycling a strong comparative period.

Store expansion has had a slower start to the year. However, a full pipeline across all markets and high franchisee appetite is expected to deliver a record finish.

Age of Delivery

COVID-19 has delivered a shift in consumer behaviour as people become more accustomed to the ease of online ordering. For years, Domino's has invested in delivery. Its fortressing strategy of being closer to the customer, combined with lower aged labour and electric scooters, are driving efficiencies.

Germany CEO Stoffel Thijs reiterates this view, *"the future of our whole category is delivery. If you look in the streets today in bigger cities in Europe, you'll see the number of delivery drivers out, not just for QSRs but for restaurants and also for grocery deliveries. And with that, obviously, the operators will have some challenges. And us having delivery in our DNA from day 1 over 60 years ago. We understand the importance of delivery and how to run operations. . . through these difficult times where, as Misja said, we're facing some headwinds with the availability of labor, we are still be able to reduce our delivery times to customers. And Mr. Monaghan's vision 60-plus years ago was that if we deliver quickly to customers, we'll grow cohorts of frequent customers of which we're also seeing in these current times."*

Efficiency is key. To achieve this, Domino's is driving continuous improvement and operational supremacy through its culture of high-volume mentality, Project 3TEN initiative and investments in technology. The company has a clear competitive advantage and a proven track record of doing more deliveries per hour due to small delivery zones and better processes.

The addition of a new website and native mobile app should drive further online ordering, as it improves the user experience by making the process faster and easier. ANZ CEO David Burness provides his take on how he sees this playing out over time, *"as people start to get in the habit of ordering delivery, they'll recognise that Domino's are the more reliable delivery. It's faster than what most of the aggregators are and also Pizza delivers better than a lot of those other food."*

Domino's online sales are a barometer for deliver orders. Looking over a two-year period, online sales are up 41.3% and now represents 78% of the company's network sales.

M&A

With a proven strategy and track record of successfully operating across multiple markets, Domino's is positioned to enter new regions through acquisitions.

Domino's has a market capitalisation of $7.0b and net debt of $491m.

▪ FINEOS Corporation Holdings (ASX:FCL)

In February, Life, Accident and Health (LA&H) insurance software vendor FINEOS provided a strong half year result. For the period, the company reported revenue of €65.4m, an increase of 24.4%, and operating profit (EBITDA) of €6.5m, more than doubling from €3.2m in the prior period.

With over 60 customers globally, FINEOS has been focused on cross-selling and upselling products to existing clients, culminating in a 35.2% increase in annual recurring revenue (ARR), now at €51.8m.

Strategy

Following the successful capital raise in September and with current cash holdings of €48.6 million, FINEOS is well-funded to pursue its growth strategy, as defined by the following four pillars:

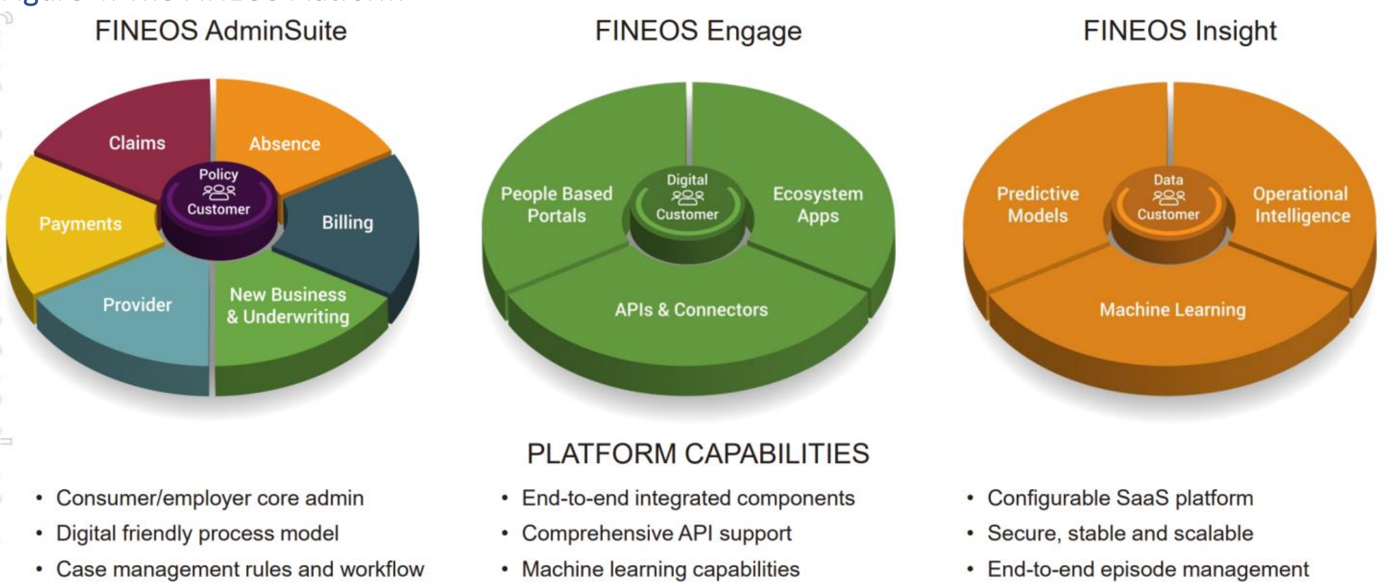
1. Grow and upsell with existing clients
2. Win new clients
3. Expand sales and enter new markets
4. Make FINEOS the L,A&H industry leading platform for Group, Voluntary and Absence Management

With headcount growing 5.3% to 1,098 and staff retention over 90%, FINEOS is well placed to continue to execute on these objectives.

Platform

FINEOS has been quick to integrate Limelight Health and Spraoi, acquired in the first and second half of FY21 respectively. Described as the missing link in creating the first end-to-end Software-as-a-Service (SaaS) insurance suite, Limelight offers a highly configurable cloud-based platform that provides quoting, underwriting and rating modules, which are highly complementary to FINEOS' existing back-office solutions.

Figure 4: The FINEOS Platform



Source: FINEOS 1H FY22 Investor Presentation

Spraoi's product capabilities enhance FINEOS Engage and FINEOS Insight. Notably it provides additional digital smart-portal options, industry specific operational and analytical models, as well as machine learning capabilities across the FINEOS Platform. Figure 4 provides an overview of the complete FINEOS platform.

Clients can cherry pick the solutions they require by opting to adopt only part of the platform. For instance, paid leave has become a key employee benefit in the U.S. market driving continued adoption of FINEOS Absence. In time, FINEOS expects to attract further business from clients who have adopted limited services as they show the value of their integrated, cloud platform solution.

Research & Development (R&D)

FINEOS continues to dedicate significant resources to develop its software platform. In the period, 31.7% of revenue was invested in R&D, equating to €20.7m. Since FY15, over €170m has been invested in the FINEOS platform. While this is important in capitalising on the current market opportunity, it also serves as a significant competitive moat.

Outlook

Total FY22 revenue is expected to be at the lower end of the guidance range previously provided; €125-130m.

FINEOS has a current market capitalisation of $728m.

- ## Flight Centre Travel Group (ASX:FLT)

Flight Centre Travel Group is targeting a near-term return to profitability as global borders reopen. Co-founder and CEO, Graham Turner summarised the current travel landscape, *"after two years of lockdowns and heavy restrictions, we are now seeing the strongest indicators of a return to normalcy. Borders are now generally open and some governments, particularly in Europe, are starting to treat the virus as endemic. Changes are happening at pace – we are seeing positive new developments relating to travel every day."*

For first half 2022, the company reported total transaction values (TTV) of $3.3b, an increase of 113% on the prior period. The recent sales ramp up has been solid with the Corporate and Leisure businesses tracking at 57% and 30% respectively of pre-COVID TTV at period end.

Despite the substantive reset of the cost base, an underlying loss before tax of $270.2m was recorded. Management noted the improved underlying operating performance was masked by a $65m reduction in net government subsidies over the period.

Investing to Win

Having weathered the initial impacts of COVID, Flight Centre maintained its investment spend to deliver further platform enhancement, while building technology leadership capabilities that extends to the use of Artificial Intelligence (AI) and Machine Learning (ML). These advancements are set to deliver meaningful benefits to customers and likely to further disrupt legacy travel management companies.

While the company hasn't provided specific profit guidance, the Corporate division is targeting breakeven in March-April 2022, with the Leisure division following shortly thereafter. Importantly, profitability is expected for Corporate and Leisure at only 55% and 45% of pre-COVID TTV levels. This speaks to the significantly reduced operating cost base and importantly, a commensurately higher group pre-tax profit margin.

Overall costs in the period tracked at circa 40% of pre-COVID levels, as the group maintains tight controls despite continuing to invest in key growth drivers including people, systems and technology. Flight Centre is well placed to benefit in this recovery phase, operating as a leaner and more efficient organisation.

Corporate (62.5% of Group TTV)

Flight Centre has continued to invest in digital technology and driving efficiencies from its two category-leading brands of FCM (for large clients) and Corporate Traveller (for small to medium enterprises). These businesses are positioned to present a highly differentiated product offering; an end-to-end technology solution, which delivers improved customer experience and greater operational synergies across countries.

Despite travel restrictions, Corporate continued to execute its Grow to Win strategy, coupling large volumes of new account wins and high customer retention rates to deliver market share gains across key regions.

While average client spend remains well below pre-COVID levels and will likely remain suppressed in the short-term, Corporate TTV is expected to surpass its peak FY19 levels during FY23. Due to the significant client wins over the past two years, this would only require average client spend to return to 60-75% of pre-COVID levels.

Twelve of the company's 20 largest clients globally were contractually secured for periods of three to five years during the pandemic, with total new client wins in the last two years representing an expected annual recurring TTV spend of $4.5b.

In the period, Corporate generated $2.0b of TTV, an increase of 148%, and an underlying loss before tax of $30.0m, which is a reduction from the $46.0m loss in the prior period.

Japan

In September 2021, Flight Centre announced its continued strategic expansion within the Asian corporate travel sector with the launch of its leading FCM travel management business in Japan. This will be undertaken via a joint venture (JV) with Tokyo-based NSF Engagement Corporation.

As the fourth largest corporate travel market, access to Japan will significantly enhance Flight Centre's ability to win new local and multi-national accounts and provide existing customers with an improved offering.

This business started to trade in January 2022.

Leisure (29% of Group TTV)

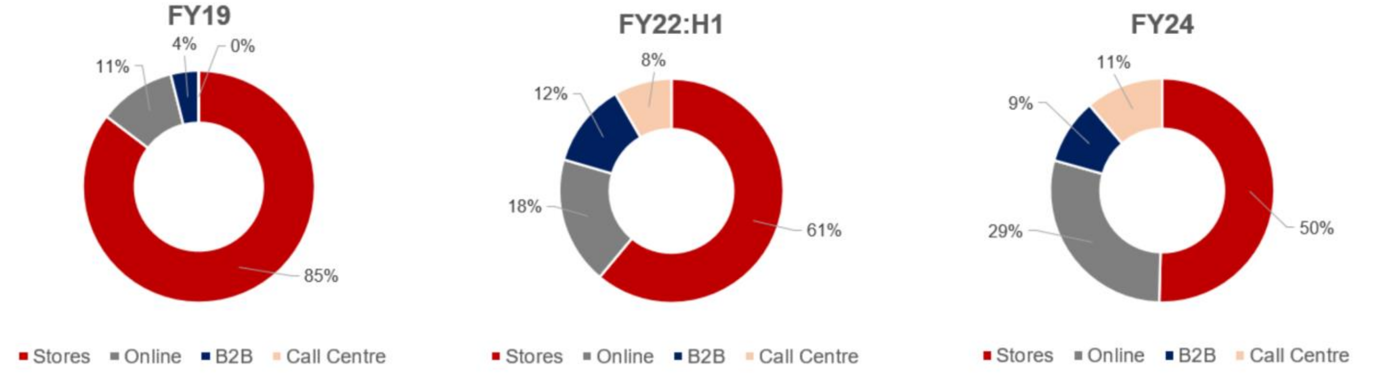
In Leisure, the company has accelerated its plans to increase online sales, complemented by a smaller and more profitable retail store base. Store rationalisation has reduced the density of locations, while maintaining easy access for customers.

Under the revised go-to-market strategy, the company is expecting a significant channel shift as shown in Figure 5. With a reduced cost base and the introduction of value-added services due to the increased complexity of current travel, the company is working to achieve a higher net profit margin from these transactions. Online, business to business and call centre businesses now collectively capture circa 40% of gross core leisure TTV and complement the rationalised store network.

The Leisure business is well placed to capitalise on the significant pent-up demand for travel. Case in point is news of the impending West Australian border reopening, which led to a circa 200% increase in searches for flights on each of the first three days after the announcement (Feb 18-20).

For the half, Leisure TTV reached $950.5m, an increase of 90%, resulting in the division generating a $119.4m underlying loss for the year.

Figure 5: Global Leisure Model TTV Shift - FY19 to FY24



Source: Flight Centre Travel Group 1H FY22 Investor Presentation

Looking Forward

At period end, Flight Centre held a net cash position of $495m, which excludes client cash of $414m and outstanding bank debt of $$564m. With a monthly cash burn at circa $20m, the company is confident its liquidity runway is sufficient.

Flight Centre has a current market capitalisation of $4.3b.

- ### Insignia Financial (ASX:IFL)

In February, financial services company Insignia Financial reported its first half 2022 result. Including MLC results in the prior comparative period on a pro-forma basis, gross margins (GM) rose 5% to $778.4m, while underlying profit after tax (UNPAT) increased 21.4% to $118m.

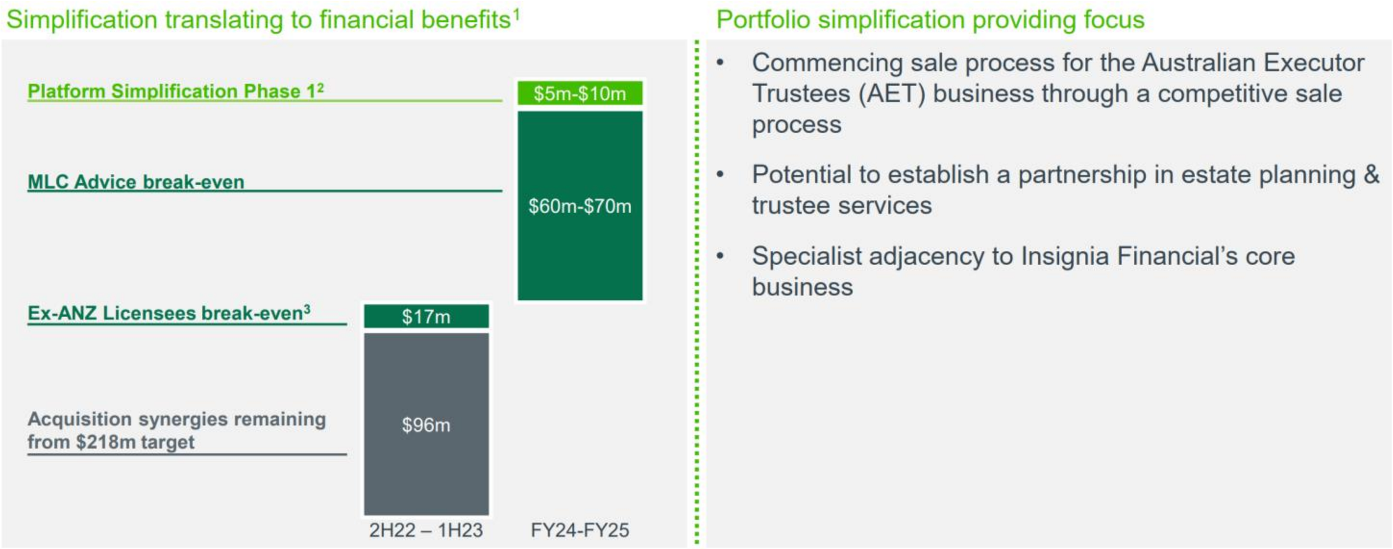
Underlying operating costs fell 3%, largely as a result of in-period synergy and simplification benefits of $22m. The lift in gross margins along with cost efficiencies, led to net operating margins rising 2 basis points (bps) to 17bps.

Business Simplification

Insignia is moving towards simplification following the transformational acquisitions of the ANZ Pensions & Investments (P&I) and MLC Wealth businesses.

Non-core assets that no longer strategically fit, such as Perennial, Ord Minnett and IOOF New Zealand have been divested, while a competitive sale process has started for Australian Executor Trustees (AET). Insignia is creating a unified model across its Advice and Platforms segments, which will see reduced complexity over time. As seen in Figure 6, a simpler business is expected to drive savings and in turn operating margins.

Figure 6: Simplification



Source: Insignia Half Year 2022 results presentation

The company has consolidated reporting into four independent segments across Financial Advice, Platforms, Asset Management and Corporate to simplify the message.

Acquisition Synergies

During the period, Insignia delivered $66m in annualised synergies, and upgraded its full year target from $80m-$100m to $100m-$120m. To date, cumulative run rate synergies of $122m have been achieved, with the company maintaining its $218m target set in FY21. The synergy program is now expected to be completed by calendar year 2022, 18 months earlier than originally forecast.

To date, most synergies have been delivered through cost reductions. However, there is scope to target additional revenue related savings through the simplification program.

Segment Performance

1. Platforms (69.5% of Group GM)

The Platforms segment is the dominant business driver, representing 125% of Group UNPAT. The segment delivered gross margins up 7% to $540.7m and UNPAT of $147.3m, rising 19% with a central focus centred on platform consolidation.

The Evolve21 project was finalised during the period, consolidating IOOF branded platforms and increasing funds under administration to $42b. CEO Renato Mota highlights the importance that *"the size and scale of this transition really gives us confidence in our ability to successfully manage large-scale transitions and deliver these transitions alongside continuing to deliver better outcomes for our advisers and investors."*

As a result, Evolve23 has been brought forward, which will decommission an additional platform, lower the cost to serve and provide clients with a simpler fee structure and enhanced functionality. The $40m-$50m investment is expected to deliver $5m-$10m of net operating margin benefit. Further consolidation is expected as the group moves towards operating one or two platforms, compared to the six today.

While Insignia experienced net outflows of $0.9b in the half, positive progress was seen across each platform. Notably, IOOF products experienced net inflows of $1.2b, while MLC related outflows have reduced. In addition, the second quarter saw an improvement in P&I flows, following the repricing of the OnePath platform. Re-pricing initiatives across MLC and P&I are expected to help reduce outflows, while platform consolidation should be a key lever in driving net inflows on the consolidated Evolve platform.

While re-pricing initiatives will pressure gross margins, the operational benefits of simplification are expected to deliver overall improving net operating margins.

2. Advice (14.7% of Group GM)

Management continues to reshape its financial advice business by implementing sustainable economic models, which will enable standalone profitability. The segment delivered gross margins of $114m down 9.3%, while UNPAT losses grew modestly to $28.3m. Excluding the $15m impact of the BT contract termination, gross margins were positive.

Advice includes losses from ex-ANZ aligned licensees and MLC Advice of $5.9m and $31.3m respectively. The self-employed channel, where advisers operate their own advice businesses using an Insignia licence, is contributing the bulk of these losses, with a new fee and cost structure expected to reverse this trend. During the period, adviser exits were predominantly experienced in the self-employed channel, while total advisers were down 183 to 1,765.

Insignia is on track to reach breakeven for ex-ANZ licensees by the end of the financial year, while the MLC advice segment is expected to achieve this target by FY24.

3. Asset Management (15.8% of Group GM)

Asset management delivered growth off the back of strong investment performance. Gross margins rose 14.2% to $123m, compared to the $30.8m recorded in the prior first half before the MLC acquisition. The benefits of scale are beginning to flow through, with UNPAT lifting 67% to $38.2m.

Group Execution

The core priorities remain unchanged; reach breakeven in Advice, stabilise fund flows in Platforms, and sustain the operational performance in Asset Management, while delivering on the stated synergy targets.

The group appears well on track to achieve its $500m operating profit (EBITDA) 2024 target, set at the time of the MLC acquisition in 2020.

Insignia Financial has a market capitalisation of $2.4b and net cash of $17m. The company declared an interim dividend of 11.8 cents per share, representing a 65% payout ratio.

- ## James Hardie Industries (ASX:JHX)

Leading fibre cement producer James Hardie recorded a strong third quarter performance. At the group level, total sales lifted 22% to US$900m, while adjusted net income excluding asbestos payments increased 25% to US$154.1m.

Operating margins held constant at 27.3%, despite inflationary cost pressures and increased investments in growth initiatives.

Strategy

James Hardie's critical initiatives are unchanged, with the global management team committed to executing on the following:

1. Marketing directly to homeowners to accelerate demand creation;
2. Penetrating and driving profitable growth in existing and new segments, especially within the Repair and Remodel (R&R) market; and
3. Commercialising global innovations by expanding into new categories.

1. Direct Marketing

Through direct engagement with the ultimate decision maker, the homeowner, James Hardie is driving true demand for its solutions. These efforts are particularly focused on selling higher value products. As part of this strategy, the company has recently partnered with Magnolia, the popular home and lifestyle brand founded by Chip and Joanna Gaines. Magnolia provides omnichannel exposure with a presence across their own television network and the like, a magazine and social media.

2. R&R Market Focus

The strategic focus on the R&R market, particularly in North America, presents a significant opportunity for growth. While the R&R market already accounts for approximately 65% to 70% of current sales in the region, the opportunity set is large. Currently, more than 44m homes in North America are over 40 years old, while homeowner's equity is at an all-time high. Growth in R&R is expected to be driven by the company's differentiated products, which offer modern and contemporary design aesthetics, as well durability, low maintenance and non-combustibility.

3. Innovation

As part of the global innovation strategic initiative, James Hardie announced the release of two new products in Hardie Architectural Collection: Sculpted Clay and Sea Grass textured panels. Along with three other designs released in May, this collection represents a platform that will continue to grow. It broadens the addressable market beyond wood-look design and importantly shifts the consumer focus from panel to product. Interim CEO Harold Wiens commented *"these products will help to change how the world builds by reimagining what is possible for the exterior of the home as well as aiding the speed of construction."* These innovations will drive further competitive differentiation and price mix improvement.

During the quarter, research and development expenses rose 8% to US$8.5m.

Regional Performance

- #### North America (71.7% of Sales)

In the group's largest market, North America, James Hardie continues to deliver record results. Volume and price both grew 12% respectively, resulting in net sales of US$644.9m, an increase of 24%. Operating profits (adjusted EBIT) increased 18% to US$183.3m, while margins declined 1.6% to 28.4%. Margins were impacted by the current inflationary environment as well as significant investments in marketing, innovation and talent. The momentum in the region is strong, as management executes well across LEAN manufacturing, marketing to the homeowner and driving higher value products.

- #### Europe (15.9% of Sales)

Europe grew volume and price by 1% and 13% respectively, resulting in net sales of €97.6m up 14%. While operating margins rose by 0.5% to 10.7%, they were significantly impaired by hyperinflation of key energy prices. The notable uplift in price mix was driven by continued execution in driving high value product penetration, particularly through strong fibre cement growth, which increased 22% in the period.

- #### Asia Pacific (12.4% of Sales)

In the Asia Pacific market, sales increased 20% to A$196.6m, consisting of a 9% increase in volume and price mix expansion of 11%. Operating margins declined modestly by 0.8% to 27.3%, again due to continued investment and the current inflationary environment.

All three regions are executing on the global strategy with continued execution of LEAN manufacturing and driving deeper penetration of high value products.

Global Capacity Expansion

To keep up with future demand, James Hardie is adding new manufacturing. Over the next four years, the company expects to invest between US$1.6b and US$1.8b on expansion projects across all regions. Senior Vice President of Global Operations, Ryan Kilcullen notes, "*as we drive profitable growth into new and existing segments, it is imperative that we regularly add capacity to ensure that supply has kept ahead of demand. The[se] short and long-term initiatives ... will accomplish just that.*"

Asbestos Injuries Compensation Fund (AICF) Update

James Hardie is required to make an annual contribution to the AICF. The amount is determined using the lower of two calculations: 35% of free cash flow or a Top Up payment, which ensures the Fund has three years of liquidity available. As current forecasts indicate decreasing claims, the company expects the Top Up calculation will be used going forward. This will reduce the required FY23 contribution by between 15%-20% of FY22 operating cash flows. Since inception, James Hardie has contributed over $1.8b to the Fund and remains committed to its ongoing operation.

Management

In early February, we met with staff, management and the board in the U.S. at the new Chicago Head Office and at the International Business Show in Florida. We conducted a series of interviews relating to the termination of CEO Dr Jack Truong, culture, succession and future business planning. We also gained first-hand experience of the innovation platform released to the market in Florida.

Guidance

James Hardie increased its guidance for FY22, now expecting adjusted net operating profit to be within the range of US$620m-US$630m, revised up from US$605m-US$625m. In addition, the company expects adjusted net operating profit for FY23 within the range of US$740m-US$820m.

James Hardie has a current market capitalisation of A$18.2b.

▪ Jumbo Interactive (ASX:JIN)

The strong growth of online lottery play continues to present a significant long-term market opportunity for internet lottery reseller and platform provider, Jumbo Interactive. With 36.7% of Australian ticket sales now processed online, up from last year's 32.1%, the value of Jumbo's product offering is becoming increasingly evident. For the half, the company successfully grew the total transaction value (TTV) of ticket sales facilitated through its digital platform by 41% to $327.9m. This saw a revenue increase of 35% to $52.8m and underlying net profit after tax lifting 27% to $16.5m.

Jumbo Interactive operates across three segments; Lottery Retailing, its Software-as-a-Service (SaaS) "Powered by Jumbo" platform, and Managed Services.

Lottery Retailing (72% of Group TTV)

Buoyed by a strong lottery jackpot environment with larger average pools, Jumbo delivered an 11% lift in average spend per active customer to $465 for the year. The company's active customer base grew 15% to 836,582. While jackpots will continue to fluctuate as a reflection of the unpredictability of lottery games, expected game changes and odds lengthening for Oz Lotto should lead to higher jackpot activity.

While Jumbo has historically refrained from marketing heavily in a low jackpot environment, the company reassessed this approach last year, determining that customers who join when prize pools are low show greater propensity to maintain transactional spending. This was reflected in higher customer acquisition costs per lead of $20.02, up from last year's $16.21. Importantly, this is driving a more diverse customer base and a higher quality recurring revenue base. Early signs are promising, as depicted in Figure 7; for jackpots below $15m (shown in light blue), Jumbo has continued to successfully increase transaction volumes.

In total, Lottery Retailing contributed underlying TTV of $234.7m, an increase of 38.3%, and underlying revenue of $46.7m, an increase of 34.9%. With Tabcorp's service fee increase to 2.5%, set to incrementally rise to 4.65% by FY24, alongside additional marketing and acquisition costs, Jumbo's underlying operating profit margin

(EBITDA) declined from 39.7% to 33.9%, resulting in earnings (EBITDA) of $15.8m.

Powered by Jumbo (25% of Group TTV)

Moving beyond its traditional ticket reselling business, Jumbo's SaaS platform "Powered by Jumbo" (PBJ), enables the company to licence its software platform offering to external lottery operators globally. At present, Jumbo services four charity lottery operators: St Helena Hospice in the U.K., Mater Foundation, Endeavour Foundation, and Deaf Services.

In addition to its charity partners, PBJ also services Western Australia's LotteryWest. Jumbo continues to work closely with LotteryWest and after some encouraging early results from a recent marketing trial, both parties have agreed to progress a jointly funded advertising program focused on bringing new customers onto the platform.

Software license fees range between 3.0% to 9.5% of ticket sales (TTV) processed on the PBJ platform. For the half, PBJ contributed TTV of $81.5m, up from $55.9m and external revenue of $4m up from $3.1m.

The pace of digital adoption in the U.S. lotteries remains slow with only 11 out of 48 U.S. jurisdictions having an established iLottery channel. Despite this, North America presents a significant opportunity and focus for the company. The recent appointment of a General Manager for the region reflects this focus.

The total addressable market opportunity for PBJ across the U.S., the U.K. and Canada is estimated at $25b TTV.

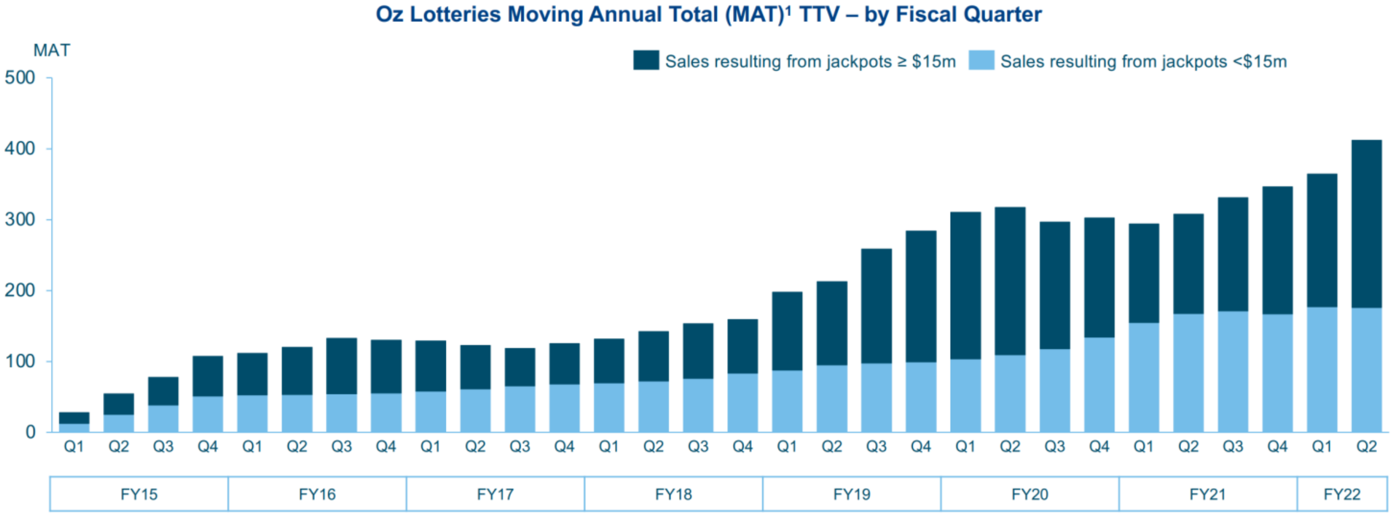
Managed Services (4% of Group TTV)

While PBJ is an appropriate offering for mid-to-large lottery operators, it is not well suited for smaller organisations. Jumbo's Managed Services segment provides more comprehensive lottery management services, including prize procurement, lottery game design, campaign marketing, customer relationship and draw management; effectively a "lottery-in-a-box" solution.

Following the strategic acquisition of Gatherwell in 2019 providing the foundation for the Managed Services segment in the U.K., this business has grown to support 108 charities, up from 86 last year. As a result, TTV has increased 56.1% to £6.2m, while revenue has risen 30% to £1.1m.

In August 2021, Jumbo announced the acquisition of Stride Management, a Canadian based lottery Managed Services group. Stride is a full-service lottery management solution, serving over 750,000 active lottery players in the Alberta and Saskatchewan provinces. In the year to September 2021, Stride generated an estimated TTV of A$122m (C$115m), revenue of A$6.5m and profit before tax of A$2.5m. The acquisition has an upfront cost component of C$7.7m (~A$8.2m), with earn outs totaling C$1.65m (~A$1.76m) to be funded entirely from available cash.

Figure 7: Lottery Average Moving Annual Total Transaction Value (TTV) by Quarter



Source: Jumbo 1H22 Financial Results Investor Presentation

Following this, in January 2022 Jumbo announced it entered into an agreement to acquire U.K. lottery manager StarVale Group for up to £21.5m (~A$40.6m). The Lancaster-based operator provides services to over 850,000 active lottery players across 45-plus charities and not-for-profit organisations. During 2021, StarVale processed ~A$119m in ticket sales, generating revenue of ~A$9.8m and net profit before tax of ~A$3.8m. StarVale also comprises of DDPay Ltd, a wholly owned subsidiary and digital payments company, which facilitates Direct Debit payments and is expected to provide cost efficiencies for U.K. operations.

The acquisition of StarVale consists of two components; an upfront cash payment of £17.0m (~A$32.1m) and up to £4.5m (~A$8.5m) of deferred consideration pending FY23 earning hurdles being met. To fund the acquisition, Jumbo has secured a new A$50m senior debt facility for up to five years, of which an initial tranche of A$30m will be used for StarVale, leaving additional headroom for future acquisitions and growth initiatives.

The acquisitions of both Stride and StarVale are subject to regulatory approval, which is anticipated to be received by the end of the financial year.

For the Managed Services segment, the total addressable market opportunity, including the markets of Australia, the U.K. and Canada, is estimated at $42b TTV.

Jumbo has a market capitalisation of $1.1b and net cash of $69.6m as at the end of December.

Nanosonics (ASX:NAN)

Global leader in infection control solutions Nanosonics reported a strong first half 2022 result. Despite the Delta and Omicron variants impacting hospital access and activity, the business maintained positive sales momentum.

During the half, Nanosonics reported total revenues of $60.6m, up 41% on the prior corresponding period (pcp) or one percent on the second half of FY21. Earnings Before Interest and Tax (EBIT) was $3.4m, a positive outcome despite increased spend to support future growth.

At a group level, Nanosonics recorded solid growth in Trophon upgrades and new installed unit sales, leading to capital revenue doubling to $19m. Consumable revenues rose 23% to $41m for the half, despite a tougher finish to the period as COVID disruptions led to lower hospital procedural volumes.

Regional performance

- North America (90% of Revenue)

In North America, total revenue increased by 47% to $54.4m. This was underpinned by 380 Trophon unit upgrades, which was more than double the prior half. Management highlighted the growing opportunity for upgrades, with approximately 7,000 units or 25% of the total installed base being at least seven years old, of which most are in North America.

The North America installed base grew by 12% to 24,680 units. While Nanosonics are clear market leaders, there remains significant opportunity to grow, with Trophon penetration at 41% of the estimated 60,000-unit total addressable market.

- Europe and Middle East (EMEA)

In EMEA, total revenue was $3.5m, down 6% on the pcp. This was mainly driven by a 47% decrease in capital revenue to $0.8m. Management remains optimistic as the market recovers from COVID headwinds, with 80% of the new installed base coming in the second quarter of the half. At period end, the Trophon installed base grew by 10% to 1,650 units.

- Asia Pacific (APAC)

In APAC, the total installed base grew by 10% to 1,840 units and Capital revenue increased 8% to $2.9m. Nanosonics continues to invest in infrastructure and people to position for growth as the market returns.

GE Healthcare Agreement Update

Prior to reporting its half year result, Nanosonics announced a revision to the GE Healthcare (GE) agreement to a “pass-through” model from effect on 8 February 2022, until expiration of the current deal in June 2022.

This new arrangement will complete Nanosonics’ transition from an indirect to direct U.S. and Canadian sales model. GE will no longer purchase and hold capital units or consumables. Instead Nanosonics will manage all inventory, ship, install and train all new customers, and service all consumable requirements.

The company expects a one-off revenue impact of $13-$16m in FY22 as GE transitions to this new "pass-through" model.

Importantly, GE's Trophon customers will transition to Nanosonics, enabling direct engagement with customers. Nanosonics can now optimise value within its Trophon base by driving greater use and upgrades from customers, with the latter expected to become a more important driver of the business going forward.

Nanosonics aims to have a new reseller capital agreement in place on 1 July 2022. If both parties agree, GE is expected to have the same financial incentives to continue selling new Trophon devices without the overhead requirements. Importantly, this new arrangement has no impact on Nanosonics' recurring revenue. GE has not received any margin from managing the distribution of consumables since 2019.

The company is expanding its U.S. full time equivalents (FTE) from 85 to 100, with an additional 12 sales and clinical staff expected to be onboarded. Nanosonics intends to begin transitioning existing GE Trophon customer details over the coming month, with the view to have this completed by June.

Direct distribution in its major U.S. market reflects a maturing of the business. Following a similar path taken by ResMed and Cochlear, Nanosonics will emerge a stronger business as a result. Like many forms of future investment, this is not well understood by the market.

Investing for the next phase of growth

During the half, Nanosonics continued to invest in product development. R&D investment rose by 41% to $10.7m, representing 17.7% of total revenue. This investment was fully expensed.

The group also signed the lease for its new corporate headquarters in Macquarie Park. This will provide a three-fold increase in capacity across its R&D activities and manufacturing in particular.

Management expects to begin transitioning people to the new facility in the fourth quarter of this financial year.

Outlook

While no formal guidance was provided, management expects to achieve full year revenue growth and has targeted gross margins of 75% and operating expenses of approximately $93m. These investments in sales, marketing and R&D, are positioning Nanosonics for growth over the medium term.

Nanosonics has a market capitalisation of $1.2b. The company remains well funded with $92m of cash and no debt.

- ## Nearmap (ASX:NEA)

In February, aerial imagery leader Nearmap released its first half 2022 results. The company's leading growth metric Annualised Contract Value (ACV) grew by 28% to $143.3m at constant currency (cc). Group revenue rose 24% to $67.9m at cc, while net loss after tax was $11.9m, reflecting the ongoing commitment to investments in scaling and expanding its product offering.

Commenting on the period, CEO and Managing Director, Dr Rob Newman noted *"Nearmap has delivered yet another exceptional result on the back of continued record performance in North America and an extension of our market leadership in Australia & New Zealand. This has been enabled by our ongoing commitment to invest in our leading Research & Development initiatives, which are delivering strong returns and will continue driving our future growth. Refinements to our go-to-market strategy in North America are continuing to deliver outstanding results for our customers."*

Nearmap's first half result points to improved execution, as the company saw increased take-up of premium content product sets, higher average revenue per user and lower churn metrics.

Regional Performance

- #### North America (NA, 48% of Revenue)

NA now represents half of the company's total ACV. The refined go-to-market strategy focusing on the Insurance, Government and Roofing industry verticals is proving successful, with total ACV in the region increasing 57% to US$55m.

Importantly, the NA segment recorded a significant milestone during the period, generating positive cash flow for the first time. This development underpins management's confidence in maintaining strong internal investment.

For the half, NA delivered record net upsell of US$7.6m, an increase of 39% on the prior comparative period (pcp), with over 25 enterprise transactions in the period (individually exceeding $50,000). All key verticals showed success in expanding the existing customer base and delivering enhanced value to customers through continued product innovation and value-added premium content.

Focusing on the primary verticals, Roofing saw ACV growth of 76% as Nearmap continues to partner with market leaders to provide a differentiated roof geometry technology solution.

The Insurance vertical also grew ACV by 76%, through deeper integration with leading insurance carriers; four of the top six Property and Casualty carriers are Nearmap subscribers. Roofing and Insurance now represent around 11% and 40% of the NA ACV portfolio respectively.

The Government vertical saw 38% ACV growth. 40 of 50 states in the U.S. now use Nearmap content for a host of reasons including: asset tracking, COVID-19 planning, managing disasters, city planning, and responding to emergency situations.

- Australia & New Zealand (ANZ, 52% of Revenue)

The more mature ANZ market saw ACV growth of 8% to $71.9m. The sales team contribution ratio of 55% and subscription retention of 93.1% both reflect half on half improvements. The company remains focused on continuing to optimise sales and marketing efforts to increase growth opportunities in the region.

Balance Sheet and Research & Development (R&D)

From a balance sheet perspective, the company finished the period with cash of $110m and is well-funded for continued investment. Nearmap expects cash to decline through FY22 and FY23, before turning cash flow positive in FY24.

Ongoing investment in R&D saw Nearmap complete the design and commence testing of the next generation camera system, the HyperCamera3. This latest iteration offers unparalleled capture efficiency and improved image resolution. In short, more expanded coverage at a lower overall cost.

HyperCamera3 is designed from the ground up, using almost completely custom component parts and delivers superior productivity and wide operational flexibility. The new camera system is on track for manufacturing this financial year, with prototype testing already underway.

Despite being in its infancy in terms of commercial availability, the demand for Nearmap artificial intelligence (AI) is proving to be a key differentiator across target industry verticals. The investment in AI has continued, expanding the use cases and attributes available for customers.

In total, customers representing $103m of ACV (70%) have access to premium content types including AI, wide-scale 3D, oblique imagery and roof geometry which competitors, particularly in Australia, do not offer.

Patent Litigation

In relation to the complaint of patent infringement made by EagleView Technologies and Pictometry International, Nearmap has engaged globally recognised patent litigators to lead its defence, maintaining the allegations are *"fundamentally meritless"*.

The growth in the North American market indicates the proceedings are not impacting sell-through. During the half, the company spent $3.6m in litigation fees.

Guidance

The company expects to finish FY22 at the upper end of its $150m-$160m ACV guidance range and continues to target 20-40% annual ACV growth in the medium to long term.

Nearmap has a current market capitalisation of $694m.

- PolyNovo (ASX:PNV)

PolyNovo, a leader in synthetic bioabsorbable polymer solutions, reported a strong half year 2022 result. Total revenue from BTM sales increased 44.6% to $16.3m, while operating losses were contained at $1.5m. Group gross margins remained robust at 95%, up from 93.5%, driven by BTM manufacturing efficiencies and market leading efficacy.

Regional Performance

- U.S. (89% of Revenue)

The U.S. market remains the core growth driver for PolyNovo. Despite COVID-19 related hospital restrictions, BTM sales grew 57.9% to $14.2m. Client acquisition remains strong, with 35 new accounts added over the half, bringing the total to 154.

While continuing to target new clients, PolyNovo is deepening its relations in each account, enabling sales to expand across multiple hospital wards. These decisions are being driven directly by surgeons who gain exposure to BTM in burn cases.

To maintain the current growth trajectory, 12 sales staff were onboarded in the period, increasing the U.S. sales team to 40 employees. Additional recruitment is underway, with the aim to increase this team to 53 heads by the end of the current financial year.

Presenting significant opportunity to scale, PolyNovo is taking a sensible approach in building out the sales team by focusing on getting the right people in the right places. Management is also adding to the clinical and technical team to shorten the time to become effective for each new hire.

In the long run, PolyNovo's ambition is to have every territory manager capable of handling a minimum of ten accounts and generating at least $1m a year in revenue. Currently, territory managers are averaging four accounts.

The U.S. market remains profitable on a standalone basis and is looking to expand into Canada by the end of the calendar year.

- Australia and New Zealand (ANZ, 6.8% of Revenue)

In ANZ, prolonged lockdowns negatively impacted sales, with revenue decreasing 33.8% to $1.2m against the prior corresponding period (pcp). Post December end, the company is experiencing a strong recovery with January sales up 72% on the pcp.

Having established longer-term relations with its customers, the group benefits from high recurring orders across multiple hospital wards. Further, the sale of smaller BTM sizes outside the traditional burn market now represents over 50% of the total units sold, reiterating the opportunity in the global alternate care market.

- Other Markets (4.7% of Revenue)

In the U.K. & Ireland, PolyNovo added 12 accounts, bringing the total to 38. Management is targeting 150 accounts within these regions.

In Europe, distribution sales were flat compared to the pcp. Focus remains on improving the effectiveness of the distribution model, with lower than expected conversion rates from hospital sales to theatre use.

With long-term account dynamics remaining positive, supported by strengthening recurring sales, PolyNovo is scaling out its educational efforts globally to improve surgeon awareness and depth of sales across new and existing accounts. To date, the company has not lost an account.

Product Pipeline and Research & Development (R&D) activities

With growing penetration in the burns market, PolyNovo is leveraging its BTM infrastructure to expand its product usability in the alternate care and chronic conditions market.

- Matrix

Closest to market launch is Matrix, which is expecting to file with the FDA in calendar year 2022. Matrix comprises of the BTM foam without the top layer of film. PolyNovo expects the Matrix platform will broaden applicability for single-stage grafting in burns, chronic, surgical and deep tunnelling wounds. Management believes the Total Addressable Market (TAM) in the U.S. is around US$750m and plans to rollout Matrix globally.

- SynPath

For the U.S. Outpatient Alternate Care Market, PolyNovo is seeking to widen BTM's usability in the Diabetic Foot Ulcer and Venus Leg Ulcer market. If successful, management expects a market launch in late 2023 and a TAM of US$400m.

Initial reimbursement trials of ten patients with Diabetic Foot Ulcers showed positive underlying data; 70% completed wound closure at 12 weeks, whilst the remaining patients showed significant reductions in wound size. The next trial phase, comparing SynPath against the current standard of care, will commence in April. PolyNovo is targeting a trial patient population of 138.

Approximately 30% of all Diabetic Foot and Venous Leg Ulcer patients require an amputation. With COVID-19 impacting the level of patient care, amputation rates lifted to 50%, reiterating the market's need for a more effective treatment option and the opportunity present for the company.

- SynTrel

PolyNovo's entry into the Hernia market through SynTrel remains on track for calendar year 2024. Following the completion of the manufacturing facility last half, the company is now in the process of validating four design options. The intent is that two products will be successful. Management is taking a flexible approach in the design process with possibilities to leverage the product in adjacent markets.

- BARDA trial

The BARDA trial for full thickness burn reimbursement in the U.S. remains on track and patient recruitment is currently in process. The group has enrolled 25 sites in the U.S. and five in Canada. For the half, five patients were enrolled and now sits at 10, as of mid-February. The company expects total patient enrolment of 120 and three years to complete the study.

BARDA remains a close partner of PolyNovo and has committed US$15m towards the trial, of which $1.8m was received in the period.

Outlook

Whilst no formal guidance was provided, Interim CEO Max Johnston pointed towards five focus points for the next 18 months. These include:

1. Increasing the sales team to intensify efforts in direct markets.
2. Optimising the distributor and emerging market model.
3. Expanding the geographic footprint.
4. Expanding the Key Opinion Leader Program.
5. Focusing on product development and faster commercialisation.

With the new manufacturing plant commissioned in Australia and majority of capital infrastructure completed, the company has positioned its operational cost base for the next phase of growth. Management is doubling down on its sales growth efforts across all regions and accelerating R&D activities. This is reflected in R&D expenses rising 86.3% in the period to $2.4m and employee expenses increasing 45.3% to $11.4m.

Cash position

Despite reporting a net underlying loss after tax of $1.7m, the group ended the half with a cash position of $3.3m. Following the sale and lease back of its Port Melbourne facility, the company is expected to end the year with a higher cash balance, reflective of its expected positive cash flow position.

PolyNovo has a market capitalisation of $734m.

- Reece (ASX:REH)

Reece, a leading supplier of plumbing, bathroom, heating, ventilation, air-conditioning, waterworks, and refrigeration, delivered a record half year result. Group revenues increased 17% to $3.6b and normalised operating earnings (EBITDA) were up 14% to $397m. The impressive results were driven by strong demand, the ability to pass on costs and excellent execution. All this despite navigating competing pressures of ongoing COVID-19 lockdowns, constricted global supply chains and capacity constraints.

CEO Peter Wilson noted, *"Our network and our customers remain busier than ever. In this context, the strong execution from the team across the group stood out. Our people were stretched to the limit but demonstrated what we were able to achieve when we all pull together."*

Group Vision and Strategy

CEO Wilson used the earnings update to reiterate the key strategic priorities driving the business' 2030 vision of "*being the trade's most valuable partner, helping them to success in a digital world*". The three key priorities are:

1. Being brilliant at the fundamentals of the business with an intentional focus on the foundations of the Reece model.
2. Creating opportunities for growth through reinvestment in stores and systems in addition to expansions into new markets and adjacencies where appropriate.
3. Delivering innovation to stay ahead of their customer's needs.

Whilst Australia and New Zealand (ANZ) continues to deliver on all three priorities, the U.S. is currently primarily focused on the first two, drawing learnings from the more developed ANZ market where appropriate.

Australia and New Zealand (ANZ, 48% of Revenue)

ANZ sales were strong, up 11% to $1.7b, driving normalised operating profits up 6% to $249m. ANZ continues to deliver standout EBITDA margins of 14.4%, albeit 0.60% lower than the prior comparable period (pcp). This was primarily due to demand, driving higher employee numbers and wage inflation. The business remains a clear market leader across many real-world metrics.

In December, following an extensive global search, Marius Vermeulen was appointed to the role of CEO of the ANZ business. Marius was internally promoted from his role as Chief Supply Chain Officer, a position held since joining Reece in September 2020, and is seen as the right leader to drive the business toward its 2030 vision. In time, Marius may well have a bigger role to play in the group, as supply chain and distribution is reimagined domestically and internationally.

Despite the disruptions in the market, Reece continued to forge ahead with its growth strategy. During the half, two new branches were added to the ANZ network bringing the total number to 644 at calendar year end. In addition, the business continued to upgrade the network, with 17 refurbishments completed.

Online sales increased 25% on the back of the strong growth trajectory in FY21, as Reece continued to invest in its digital ecosystem. Digital improvements made in the half include: enhancements to the customer facing maX platform; expansion of the ReeceConnect ecosystem; and a further rollout of a new mobile-enabled point-of-sale system, now set up in 100 branches.

U.S. (52% of Revenue)

The U.S. performance delivered impressed results. Revenue was up 24% and operating profits up 30%, to $1.9b and $148m respectively. The EBITDA margin of 7.9% was up 0.3% on the pcp. The U.S. generates around half the EBITDA margins of ANZ due to structural differences.

While margins represent a long-term opportunity, and remains the preoccupation of the market, this is not the focus of management today. Clearly telegraphed by the store rollout and refurbishment program, which requires investment. Margin improvement will come with scale, operational excellence, distribution and buying power, which will not emerge until the later part of the decade. Supply chain and distribution, for instance, will require additional significant investment and will not be addressed inside five years.

The U.S. opportunity is large, and the market is fragmented. Reece global management are first to acknowledge the gaps remain wide. They describe this as the ongoing 20-mile march, with local management needing to focus on incremental gains and the global team addressing the gaps. Along this journey, Reece USA is making a determined pivot to the R&R market that few big players have interest in.

Despite the challenging macro environment, the Reece U.S. strategy is on track. At the time of the MORSCO acquisition, CEO Peter Wilson made it very clear the U.S. opportunity was for the long-term; measured in decades not years.

"What we have here is a 100-year-old place that needs a refurbishment while you're living in it. So, we have started by re-stumping the place. Then there needs to be a new roof and walls. The biggest thing will be when we rewire the company, which is the technology part. The opportunity for MORSCO is even bigger than I thought but there is still foundational risk. We need to get it right because it is a 10-year journey."

During the half, five new stores were rolled out and five completed refurbishments. On an annual basis, the company believes they can roll out between 10 and 20 stores in the U.S. market. The acquisition of Schumacher & Seiler Inc was undertaken, which added a further seven stores to the network. The small bolt on adds further scale north of the Sunbelt area and is expected to be earnings accretive in H2 FY22. At 31 December 2021, the U.S. store count stands at 201.

In what is seen as a symbolic, nonetheless important, milestone for the company, the Reece corporate brand was launched for the first time in the U.S. Whilst new stores continue to be rolled out in locally branded names, the aim is to progressively rebrand the network at an initial rate of 15 refurbishments per year.

Finally, the digital platform maX was launched for the U.S. market. Locally built, maX is tailored to the needs of the U.S. and is a forward step in Reece's commitment to solving customer's needs.

Supply Chain

Reece's local distribution model has held them in good stead during a period of immense supply chain disruption. Taking advantage of long-standing supplier relationships, Reece purposely held higher inventory levels, actively purchasing where available. Inventory is seen as a strategic asset and being "in stock" has enabled

Reece to manage customer expectations and improve market share.

Interest Bill

A successful refinancing of the existing US$ Term B debt facilities in December 2021 and the gross repayment of $344m of borrowings, saw Reece end the half with net debt of $898m. Importantly, the new facility offers improved drawdown flexibility and a lower overall borrowing cost of circa 2.4%.

In the second half, the company provided an illustration that based on $1.0b of net debt the company would incur an interest bill of $10m-$12m, compared to the $42m incurred in the first half of 2022. Applying this over a full year, the company's interest bill would come in at $24m, a significant reduction to the $71m incurred during 2021.

The company declared an interim dividend of 7.5 cents per share.

Reece has a current market capitalisation of $11.1b.

- ## Reliance Worldwide Corporation (ASX:RWC)

Specialist plumbing fittings manufacturer Reliance reported a positive first half result, with sales increasing 12% to US$521.8m and operating earnings (EBITDA) up 5% to US$125.5m. The half was characterised by continued strength in underlying demand for Reliance products, supported by price increases introduced to offset rising costs.

CEO Heath Sharp commented, *"We continued to experience robust market conditions and demand for our products. The trend of increased spending on home remodelling activity, coupled with strong new residential construction markets, has underpinned record levels of demand. We were able to consolidate our volumes following a period of exceptional growth in 2021. Importantly, we were able to meet our customer's service and delivery expectations despite the increased incidence of COVID and supply chain challenges."*

Segment Performance

1. Americas (64% of Sales)

The Americas performed well in the half, buoyed by price increases and new product sales driving revenue growth. Underlying volumes were stable, assisted by a robust repair and remodel (R&R) market, despite supply chain restrictions. On an underlying basis, the Americas delivered revenue of US$323.2m, an increase of 12% and adjusted operating profits of US$47.5m, up 2%.

Operating margins of 14.6%, down from 16%, were impacted by higher commodity prices and increased costs. While Reliance lifted prices to protect margins, further price increases, agreed with channel partners, are expected to have a positive influence in the second half.

The first half included a contribution from EZ-FLO, acquired in November 2021, which reported sales of US$22.5m for the 6-week period post-acquisition. CEO Sharp commented, "*It's very early days for us with EZ-FLO but we remain excited about the prospects that the business offers. We have made very good progress integrating EZ-FLO's operations and are now starting to focus on pursuing the growth opportunities that attracted us to the business."*

2. Asia Pacific (21% of Sales)

Sales in Asia Pacific increased 10% to A$151.4m, alongside operating profits of $18.7m, up 11%. Operating profit margins were stable at 16.8%. The result reflected strong domestic demand in Australia, driven by new residential construction and growth in remodeling activity.

In July, Reliance acquired the business assets of LCL, one of Australia's largest producers of high-quality copper-based and brass copper alloys. To date, there has been no contribution from this business as Reliance works through its existing brass inventory. Beyond this, LCL is expected to contribute operating profits of A$7m per annum.

3. EMEA (26% of Sales)

EMEA, which includes the U.K. and Continental Europe, recorded flat sales of £105.9m and operating profits of £41m, up 9%. Operating margins rose to 28.3%, compared to 27.7% on the prior period.

Sales in the U.K. were 8% lower. as a result of supply chain impacts adversely affecting residential construction, with reduced volumes partially offset by price increases. Continental Europe saw sales increase 23%, driven by strength in the water filtration and drinks dispense market.

Balance Sheet

Due to planned investments in inventories to ensure customer service levels are maintained, Reliance saw net operating cash flow of US$60m, down from US$112.4m. Net debt increased by US$371.1m to US$545.3m, following completion of the LCL and EZ-FLO acquisitions during the period. With net debt to EBITDA of 1.97x, current leverage is comfortably within the company's target range of 1.5x – 2.5x.

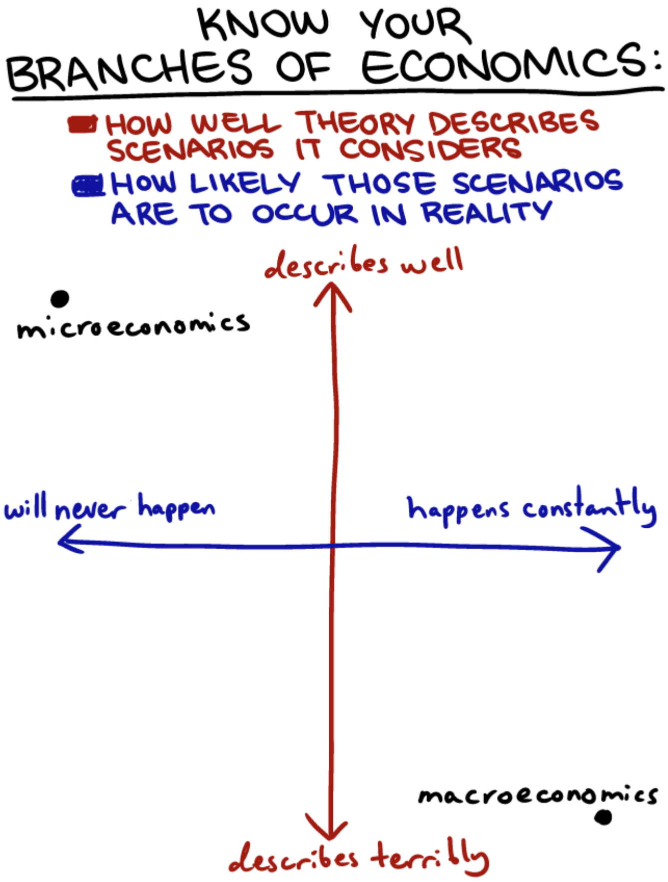
For the period, Reliance announced a US4.5 cents per share interim dividend.

While no specific guidance was provided, management did note recent trading was broadly consistent with the trends observed over the half.

Reliance has a market capitalisation of $3.0b.

MACRO

Figure 8: Macroeconomics verse Microeconomics



Source: Economic Sociology and Political Economy Community

A morbid macro fascination

In the second edition of *Common Stocks and Uncommon Profits*, Philip A Fisher noted that after 50 years of having his investments buffeted by great waves of optimism and pessimism, "*plus ca change, plus c'est la meme chose*". This translates to, "the more things change, the more they stay the same". We think this remains applicable today.

But let us be brutally frank, performance this quarter in isolation is not good optically. There is however a bigger picture, and it is longer-term performance. Make no mistake this is no mea culpa. We base this comment on the following facts:

1. We do not manage to a quarter or a month, we manage in years and decades.
2. We have an industrial focus, and this was the best quarter recorded by resources in more than three decades.
3. We focus on quality long-term investments that produce compound returns.
4. We have the right businesses in the portfolio to deliver long-term real earnings per share growth.

The downdraft this quarter has seen the overall cost of these earnings fall. The portfolio has become cheaper as a result. At the same time, we see no quality degradation or structural change occurring that would have us replace capital light recurring earnings, with capital intensive price takers that have run hard because of global shocks.

We operate a simple repeatable process that provides a frame of reference for all our ideas. It is based on people, business, balance sheet and real earnings per share growth. This risk out upfront approach we employ lends itself to quality businesses that can compound into the future. If we select correctly, the hardest part is having the discipline to ignore the ever-changing noise and hold onto the compounders.

Fisher noted his stocks were buffeted by waves of optimism over the decades. We wonder if it was the periods of optimism he found the hardest to deal with?

In his book, Fisher devotes pages to the folly of being shaken out of great investments under the guise of profit taking or timing. The primary reasons supporting this view is that good businesses go on to make new highs, as earnings grow during and following periods of market weakness.

Unwavering in his long-term approach, Fisher was not engulfed by the periods of pessimism. A participant who is subject to bouts of pessimism during market weakness should not have held equities in the first place.

Risk

The two recent macro shocks include:

- Pandemic: Government intervention that closed borders, countries and business, followed by multiple types of stimuli, resulted in supply chain distortion, inflation, and policy shift on interest rates, including quantitative easing to tightening.
- War: Commodity shocks, additional supply disruption and more inflation.

We did not guess either of these events. Not knowing, in its simplest form is risk. To cope with this, our process is risk out up front. We manage risk by choosing to invest alongside competent people, with unique businesses, that have strong balance sheets and real earnings per share growth. We believe the long-term compounders we favour are durable enough to overcome risk.

It is important to understand that periods of weakness are normal for a consistent strategy. Neither business nor markets move in linear fashion. If you believe a strategy is wrong, that is a different story.

The debate

This is not about seeking growth or value. It is about owning quality that compounds into the future. The immediate debate today is about multiple compression verse earnings growth.

Rising bond yields have pushed up the risk-free rates used in discounted cash flow models. The question is, can compounding earnings growth overcome this compression effect in the medium and longer term.

The simple answer is that this depends on the period of your investment horizon. The evidence, our track record for instance, suggests that compound earnings win out eventually.

Consensus

Looking forward, macro consensus seems to have been:

- 1970’s style entrenched inflation
- Significantly higher interest rates and quantitative tightening
- Ongoing robust growth as evidenced by the strength of commodities

While we do not have the answer to this, the outlook may well be complicated by slower growth, or even recession. China’s growth has stumbled, and Europe is also challenged. Both pose risk to this consensus that is currently driving record returns in the capital-intensive price-taking sectors of energy, materials, and utilities.

As we write in late March, part of the yield curve temporarily inverted, with five-year US Treasury yields climbing above 30-year yields for the first time since 2006. Yield curve inversion suggests that rates rise in the short term, before a slowdown or fall in economic growth leads rates to fall. This has been an indicator of a coming recession in past cycles.

So far, the spreads between 20-year and 30-year yields, and between five-year and 30-year yields, have experienced inversions, while the closely watched spread between two-year and 10-year yields has closed to within about twelve basis points. We note the more important three month and 10-year relationship still shows a premium.

These are just observations. We have never attempted to position the portfolio for shifts in the macro-outlook. Our bottom-up approach is consistent.

We entrust high quality management teams operating high quality businesses to both plan for, and deal with externalities, shocks, or black swans as they unfold.

Importantly, they need to screen out short-term noise and continue to plan and invest consistently for the future, regardless of the macro events outside their immediate control.

Modelling & Macro forces

The macro environment consists of six forces: Demographic, Economic, Political, Ecological, Socio-Cultural, and Technological.

This set is broad enough to capture all external variabilities, policy instruments and induced variables. The black swans should be captured within. This does not mean they are accounted for though, as that is not possible according to Professor Taleb, a finance professor, who invented the term.

Professor Taleb argues black swan events are so rare, often +/-3 standard deviations or more, and forecasting techniques are useless because the data does not exist to create a normal distribution curve that can be analysed using statistics. He goes on to warn that modelling an extrapolation may make us more susceptible to black swan events.

Modelling human, global or financial systems, while useful, is of course fraught with dangers. Yet it remains the key decision-making process of the world's central banks and global financial markets alike.

When it comes to macroeconomic policy all eyes are on the U.S. Federal Reserve, so it is worth considering how they operate. When you dig in you find that they may only be seeing part of the picture.

The U.S. Federal Reserve has a Congressional mandate to set monetary policy consistent with achieving maximum employment and price stability. Members of the Federal Open Market Committee (FOMC) are mostly Ph.D. economists with dissertations in macroeconomics. They take for granted that the right way to make sense of the economy is through the lens and models provided by macroeconomics, one of the six forces listed above.

Critics note the FOMC uses sense-making and market devices to guide its decision making.

Weick's (1995) theory of sense-making in organisations is that market operators act in highly structured ways, drawing from pre-existing frameworks shaped by *"institutional constraints, organizational premises, plans, expectations, acceptable justifications, and traditions inherited from predecessors"*.

A tool is created to evaluate, facilitate, or calculate what market actors are doing. This is called a market device (Espeland and Stephens, 2001; Carruthers and Kim, 2011). Market devices aid sense-making (Karpik, 2010). They formalise how one calculates features of the world. Examples include credit scores, bond ratings, discounted cash flow, and models of option pricing. Each of these enables a decision-making process by market participants. Buying and selling decisions for assets and securities are often based on the logic of using market devices to facilitate transacting.

The primary sense-making framework at the Federal Reserve is macroeconomic theory. This focuses on aggregate-level economic indicators such as GDP, unemployment and inflation. Macroeconomists' models explain the relationships among these and related factors like savings, investment and consumption.

The concept of sense-making suggests that for people to make decisions and act, they must continuously construct an interpretation of the signals sent to them by the exterior world. This interpretive work necessarily relies on pre-existing categories of perception. Remember Taleb, he believes it is impossible to account for unknowns.

The FOMC view the economy as a collection of distinct industrial sectors, each making an independent contribution to GDP and impinging upon one another only as far as the inputs and outputs of different sectors are directly connected to one another. They are using Macroeconomic Theory as a framework for the construction and interpretation of relevant facts, thereby enabling prediction of future economic trends.

Critics claim this is a flawed approach. As a most recent example, at the start of the Global Financial Crisis the FOMC failed to see the depth of the problem because of its overreliance on macroeconomics as a framework for making sense of the economy.

As a result, Committee members couldn't apprehend the deeper connections between housing and finance. Specifically, the degree to which the fortunes of the entire financial sector were tied to the housing market via the securitisation of mortgages and the use of related financial instruments. They significantly underestimated the degree to which the economy was in danger of collapse.

It is noticeably clear that macroeconomics alone is a weak proxy for real world interactions and outcomes, yet this becomes gospel in financial markets. The Fed output, the risk-free rate, becomes the key ingredient for the next layer of modelling.

Hindsight will judge the Fed's response to the current set of human and economic developments currently unfolding. We suspect the institutional constraints of the Fed's approach will continue to deliver results that are wide of the mark at best.

DCF and CAPM

The sense-making approach combined with market device also dominates equity markets. When modelling a business, most sell-side financial analysts use a discounted cash flow model driven by the capital asset pricing model (CAPM). Like macroeconomic modelling the relationship to the real world is limited.

DCF stands for Discounted Cash Flow, so a DCF model is simply a forecast of a company's unlevered free cash flow discounted back to today's value, which is the Net Present Value (NPV).

The DCF is overly sensitive to moves in the discount rate or risk-free rate, commonly determined by the capital asset pricing model, which was developed in the 1960s. The problem is the approach is at best limited and at worst flawed.

The formula assumes expected return, and risk profile is reflected in share prices. It also assumes relative stock performance is predictable from their histories and that one hundred per cent of investors act in a rational fashion with identical time horizons.

The CAPM is effectively defining risk as historic share price volatility when these just measures of sentiment, which in turn can be truly short-term in nature.

Two key weaknesses include:

1. It does not capture change or adaptation in the real world. Namely innovation and research and development (R&D), two key components of latency within a business.
2. As a tool it works against the notion of compounding, which is a multi-decade endeavor.

In the short run the value of a listed company has only a loose relationship with the progress of the business. The real progress of a business is its ability to solve the problems of an end user. This will drive earnings and share price.

As we reflect on this quarter it is evident the change in valuations was big, driven by moves in bond and commodity prices (down and up respectively) rather than solving future problems and compounding.

We have discussed two layers of modelling driving equity valuation, both flawed due to notable limitations. This presents a real opportunity for those who are prepared to think independently.

Point in time accounting

Equally flawed, in our humble opinion, is the obsession with point in time accounting. Point in time accounting (PITA) is the institutionalised focus on quarterly and half year accounting periods, and the subsequent performance appraisals derived from these periods.

At each PITA, a series of short-term beats, misses and DCF changes are delivered by sell-side analysts looking to drive transaction volumes. No company worth owning manages its business this way.

The bulk of broker analysis is geared towards PITA, which assists in driving higher turnover. The transaction-based broker model has helped to perpetuate this thinking, and few brokers are interested in servicing a client who has low turnover, as they are simply not economic.

When the swathes of daily research are too great for a busy trader with 60+ investment positions, PITA manifests in the worship of the current price-to-earnings multiple, or similar metrics. This is a work-shy way to review the future earnings potential of a business.

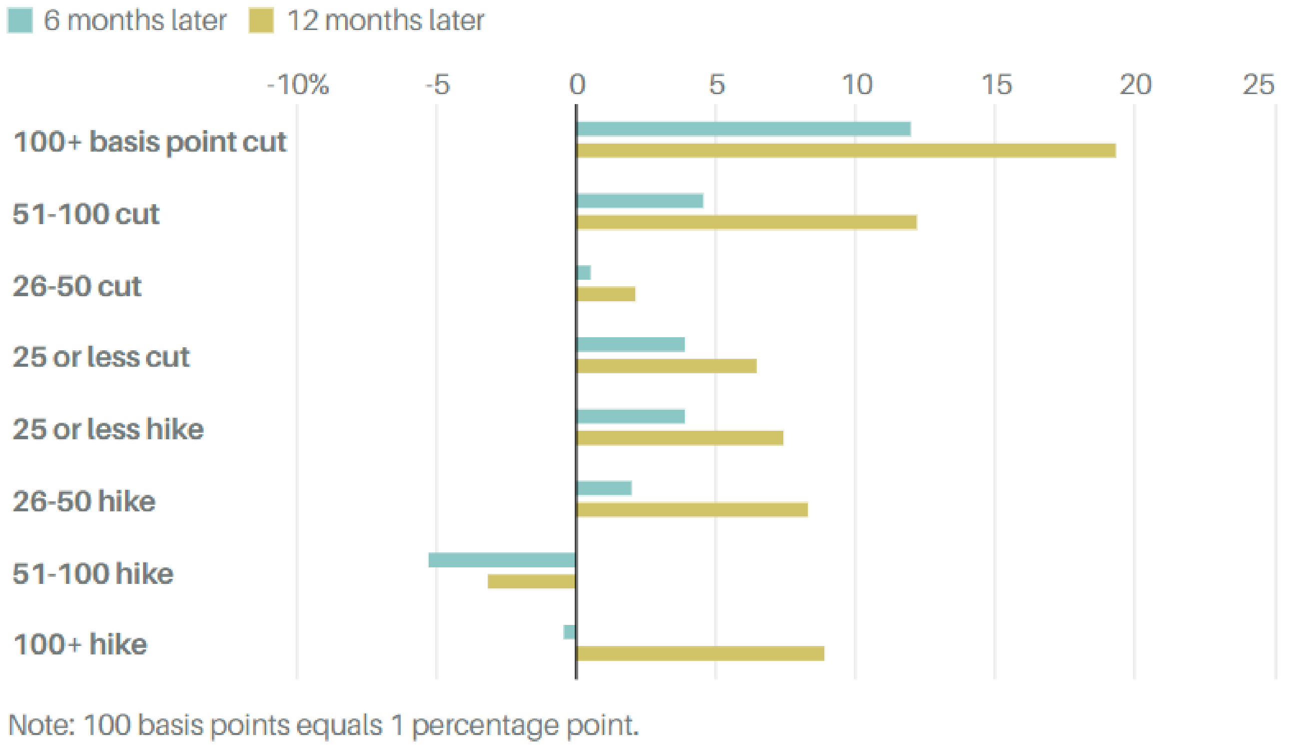
The absolute focus on PITA provides a significant opportunity for an industrious longer-term perspective to exploit.

Could the multiple compression be wrong?

Many investors believe higher interest rates might lead to lower stock prices because they discount the future cash flows of companies, making them worth less today. As bond yields rise, investors also tend to sell their equity holdings and move to the more attractive fixed-income investments instead.

But the relationship between rates and stocks is more complicated than textbooks suggest, says Russ Koesterich, portfolio manager for BlackRock's Global Allocation Fund. "*It very much depends on where the rates are starting from and how fast they are moving it up*."

Figure 9: S&P 500's average return after Fed rate changes



Source: Federal Open Market Committee

In the '70s and early '80s, higher rates often coincided with poor stock returns. But when rates are rising from low levels like today, stock valuations have been more likely to rise than fall, according to Koesterich.

Barron's analyse the S&P 500's average performance six and 12 months after the Fed adjusts its interest rate. Whether it is a cut or hike and regardless of the size of the rate moves, in every case the stock market is higher one year after the change.

When the central bank raised or cut rates by a quarter-point or less, the S&P 500 returned an average of about 4% six months later and around 7% a year later.

Returns also tend to be good one year after big moves of more than one percentage point, with the S&P 500 advancing 9% for hikes and 19% for cuts of that magnitude, on average.

One exception was when the Fed raised rates between half of a percentage point and one full point. Stocks performed poorly, on average, both six months and a year after the change.

Koesterich notes higher rates often come during times of faster economic and earnings growth, which can make up for companies' discounted future cash flows and support their stock prices.

Stocks are also less likely to collapse because investors do not have many reasons to move their money into bonds and cash when rates are as low as they are today — even when they are rising. The Fed-funds' nominal rate has remained effectively zero since March 2020, and the mounting inflation means the real rate has long fallen into the negative territory.

At this time, there is scant evidence that the current inflation is wage-expectation driven. That means it would need quite a fall in output, than if it were wage expectation-driven, to get current inflation down.

In other words, it would be a much deeper recession than those who keep saying the Fed is behind the curve to bring down the current inflation. They will get what they ask for, but they will not like it.

Quality

Venture capitalist Chamath Palihapitiya is an outspoken voice in Silicon Valley. The voices that are worth listening to seem to cut to the chase with simple language. In his words aligning quality to sustainable profits seems so simple and so logical.

*"I think unfortunately in this gold rush mentality that we've been in for the last five years there has been not enough focus on **business model quality**. So, when push comes to shove, there actually aren't that many great businesses that can go public. Because I think if you're going to thrive as a public company, it presupposes that you make more money than you spend.*

And it's weird but I think people in Silicon Valley are almost like "Why is that important?". They don't appreciate the fact that you must be self-sufficient and self-sustaining."

We believe quality is defined by owning long-term durable franchises that in five to 10 or 15 years out will be stronger businesses because the moat or IP is improving. This is often a function of managements' discipline around continuous reinvestment back into the business so that leadership is maintained. It's notable that this latency is not measured by a DCF.

Culture including all aspects of governance, market penetration runway, leadership, scale, margins, and balance sheet optionality, are equally important quality proxies that we seek and are not measured by a DCF.

Cashflow is also of critical importance, and a DCF does measure this. However, it is unrealistic to believe cashflow will not decline in any given year in the forecastable future. Yet this is the modelling outcome of all DCF's until radical cuts are made when things change.

Durable compounders can navigate macro headwinds over time. They have the following attributes:

- Culture
- Uniqueness
- Price power verse price taker
- Recurring earnings verse contractual
- Attractive margins that improve with scale
- Capital light verse capital intensive
- Debt light verse debt heavy

While our 17-year track record is testament to this, they cannot do this in a straight line as a DCF may have you believe.

Why is valuation last

A long-term strategy requires fewer decisions on a daily, weekly and quarterly basis. Rigor is higher as a greater level of internal research is conducted on each idea. In fact, the research never stops, it's continuous.

This is a crucial factor in a risk out process if you are trying to take as much risk off the table as possible before you invest.

Investment requires reading, engagement, listening and learning. The real learning only starts after you become an owner. We do not gain this type of understanding from a PITA number. In other words, there are other things more important than valuation that we need to understand first.

Our roadmap covers the soft and hard business factors we seek to understand before we invest. This is followed by ownership and ongoing corporate engagement, which is the only way to truly understand a business.

Unfortunately, a valuation, like a DCF model, does not capture all the qualitative and quantitative elements we favour. We list examples below that are not captured adequately.

Soft or qualitative:

- Culture
- Founder mentality
- Leadership
- Governance

Hard or quantitative:

- R&D expensed verse capitalised
- Latency from real innovation and R&D
- Pricing power verse price taker
- Recurring earnings verse contract
- Market share and penetration lifecycle
- Organic verse acquired growth
- Margin expansion opportunity
- Scale benefits

We would argue a PITA valuation is a work-shy approach to understanding a quality business that is investing on five and 10-year horizons, and in some cases longer.

As Philip Fisher noted 50 years ago, exiting a high-quality franchisee based on valuation, that can compound earnings, may look smart at a point in time. But in our experience, it can be very costly over the long run, particularly if a business accelerates or benefits from increased scale.

Our findings are that this type of mistake, which we have made, can have a greater impact than losing 50% of your capital on a stock selection that was wrong.

Furthermore, if the alternative stock entered is a lower quality franchise, the problem is compounded.

The rise of the intangible asset

Warehouses and factories as a proxy for the key balance sheet item, Property Plant and Equipment, are increasingly being replaced by digital solutions, as companies rapidly advance in technological capability.

Innovation ideas, intellectual property and R&D investment are a growing source of income for companies worldwide.

The race for ideas and the pursuit of knowledge for creativity are emphasising the increasing role of intangible assets and the need to quantify them.

Some intangible assets are protected legally where they meet the criteria for intellectual property protection and rights. Intellectual property rights are often granted for innovative products and processes through patents or copyrights.

Other intangibles will never sit on a balance sheet. Consequently, they are not captured by a valuation or multiple.

True to label active

We made a conscious choice to manage equities with a bottom-up approach at inception. The other side is we do not manage equities based on foretelling the wide-ranging macro forces discussed in this article. Nor are we dabbling with timing the market, other than to take advantage of periods of weakness. After all our target is long-term real earnings growth.

While we define ourselves as active, this term is misrepresented as being different from an index. This is wrong. It has been hijacked by managers who think "active" is being +/- a certain amount of basis points from the index. This type of behavior is trying to outsmart other investors, rather than doing the fundamental job of investing.

In our active approach, we attempt to remove the noise of the 24-hour consensus and the institutional imperative of monthly and quarterly performance.

This promotes independent long-term qualitative thinking, while ownership encourages rigour. We are active in imagining how leadership and scale interact, how the combination of core execution, R&D and real innovation can deliver into the future. This is the bumpy road of compounding.

Our risk out approach is based on extensive corporate engagement, an unashamedly qualitative approach, combined with thorough quantitative modelling based on a system developed in house.

While our buyout ratio is articulated, up to 50 financial ratios are calculated. The key difference here is we focus on trends over a long period rather than a single point in time. This is how a long-term business owner thinks and at the end of the day that is exactly what we are.

As a quick recap on how we manage equities.

We are:

- Index unaware
- Long only
- Low turnover

We undertake:

- Bottom-up stock selection
- Rely on internal research, and have an industrial focus

Our process seeks to identify the long-term compounders with the following attributes:

- Capable people we can trust
- Businesses with global leadership
- Balance sheet optionality
- Capital management that promotes real earnings per share growth

We are looking for long-term structural changes that impact what we own today and into the future. Structural changes can be both headwinds and tailwinds, which impact investment and divestment decisions.

Our consistency comes from the fact we seek to own the highest quality businesses in a concentrated portfolio, with no padding back to the index. High quality refers to the ability to compound into the future. Combined with our low turnover, we believe this enables us to capture as much real earnings per share growth as possible.

Compounders

So, what do the compounders look like?

Table 12: SFML Top 10 Holding Analysis

Top 10	Global Leader	Compounder	Recurring or Better Model	Penetration	Scale	Margin Opportunity	R&D Annual	IP Moat	Cash (DEBT x)
RMD	Yes	Yes	55%	Low	Yes	Yes	$250M	Strong	(US$468M) 0.4x
COH	Yes	Yes	32%	Low	Yes	High	$200M	Strong	$500M
ALU	Yes	Yes	74%	Early	Yes	Yes	US$40M	Strong	$200M
JHX	Yes	Yes	Better Model	Low	Yes	Yes	US$34m	Yes	0.9x
ALL	Yes	Yes	80%	Strong core	Yes	Yes	$500M +	Strong	$500M
TNE	Leader	Yes	90%	Low	Yes	Yes	$77M	Strong	$140M
CAR	Yes	Yes	Recurring	Early	Yes	Yes	Not provided	Yes	2.2x
REH	Yes	Yes	Better model	Early	Yes	Yes	$210M Capex	Yes	1.4x
DMP	Yes	Yes	Better model	Early	Yes	Yes	Not provided	Strong	1.0x
CSL	Yes	Yes	Recurring	Early	Yes	Yes	$1B	Strong	2.5x

Source: SFML Research

Everything has changed

Pre global pandemic, the macro backdrop was high indebtedness, low growth, and low interest rates.

Since then, everything has changed, including:

- Black swans / Pandemic / War
- Supply chain disruption / Inflation
- Central bank policy / Risk free rates / Quantitative tightening
- More indebtedness (Govt)

An argument can be made however, that we may well face an environment not dissimilar to pre-pandemic, in years to come.

One certainty today is that global central banks are communicating they will aggressively fight inflation. If they fulfil this rhetoric, this will throttle growth. A breaking point of one or the other (inflation or growth), may well see a continuation of pre-pandemic conditions of low growth and low interest rates. It strikes us that the bigger the near-term inflation problem, the higher the likelihood of low growth.

Looking out, our views remain unchanged despite the noise. We see low interest rates continuing; this does not mean zero or near zero rates. Much higher than a 2-3% band will drive a contraction that is unpalatable to central banks as indebtedness remains high. In Australia this includes household indebtedness.

On 30 March Robert Gottliebsen, economics writer at The Australian, commented on yield curves indicating interest rates at 3% in 18 months, *"I would put it more bluntly. Such an interest rate rise would trigger a deep recession and a huge fall in dwelling and share prices."*

He notes *"the CBA forecasts that RBA's interest rates will top out in the 1.25% to 1.5% vicinity – levels that are manageable."*

A final word on recession

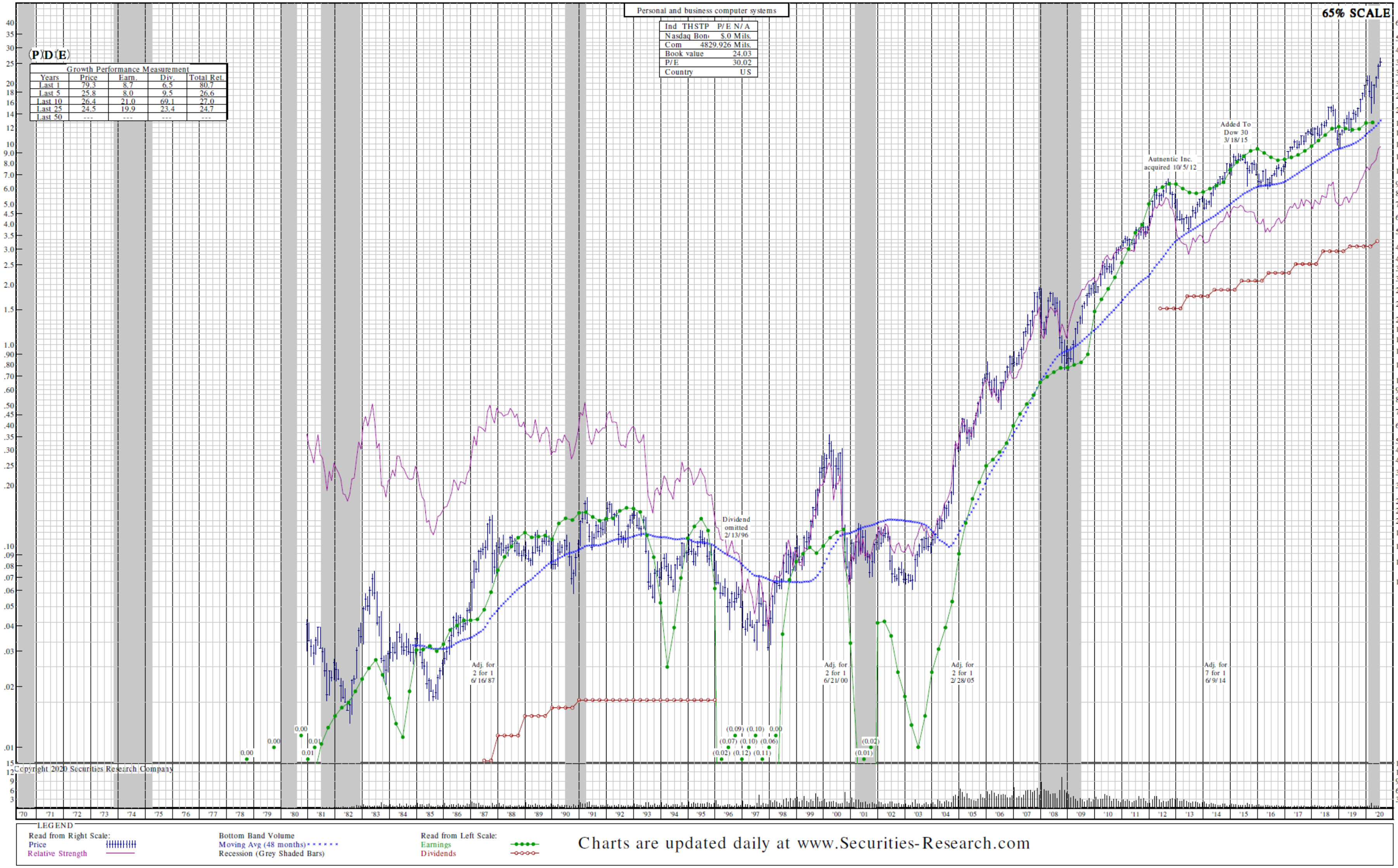
The word recession is used nine times in this article (inclusive of the heading above). The portfolio is not recession proof, no long-only equities portfolio is. However, the greatest single risk of business failure stems from the balance sheet. We believe we have always managed for this risk.

Recessions are notoriously hard to predict in terms of timing, depth and duration. The following long-term view across a variety of sectors we participate in, suggests that compounders will overcome these shocks also.

The charts below go hand in hand with the teaching of Philip A Fisher, and his poetic reference "*plus ca change, plus c'est la meme chose"*.

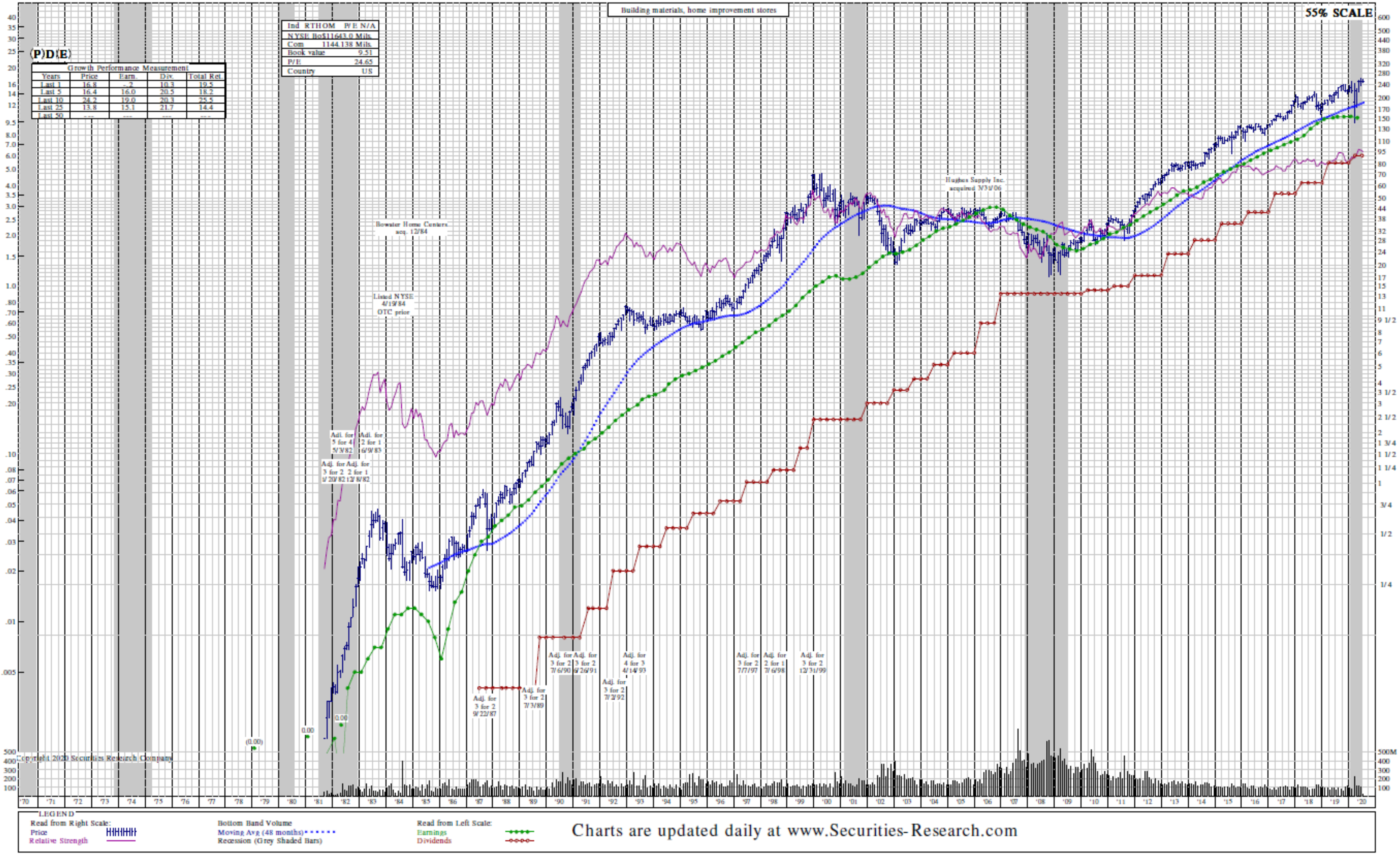
While everything may have changed, compounders will continue to deliver if the investor does not pick a point in time that does not allow for this outcome. ***SFM***

Chart 1: Apple Inc 50 year chart (Technology comparison)



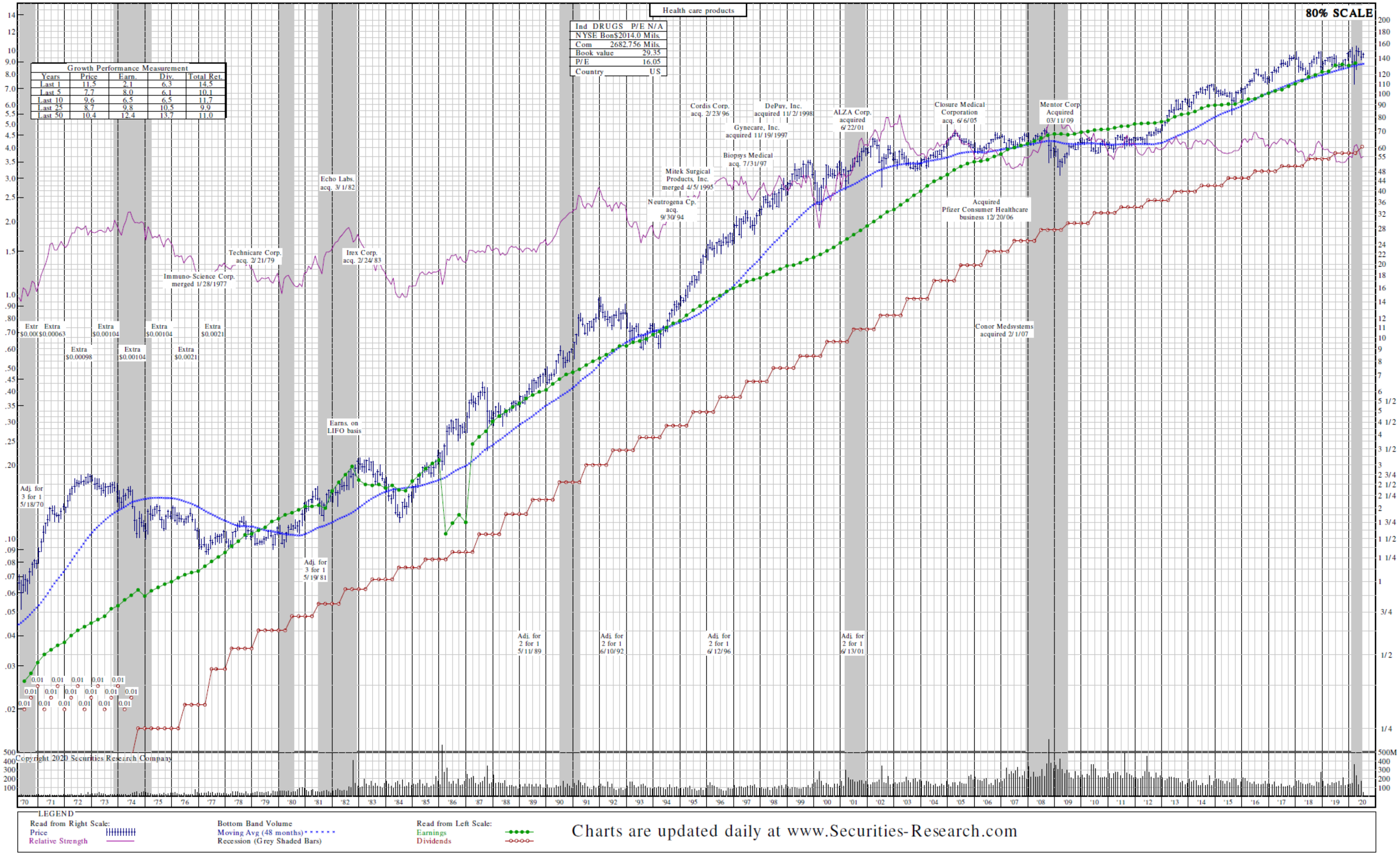
Source: Securities Research Company Dow Jones Industrial Average

Chart 2: Home Depot 50 year chart (James Hardie Industries comparison)



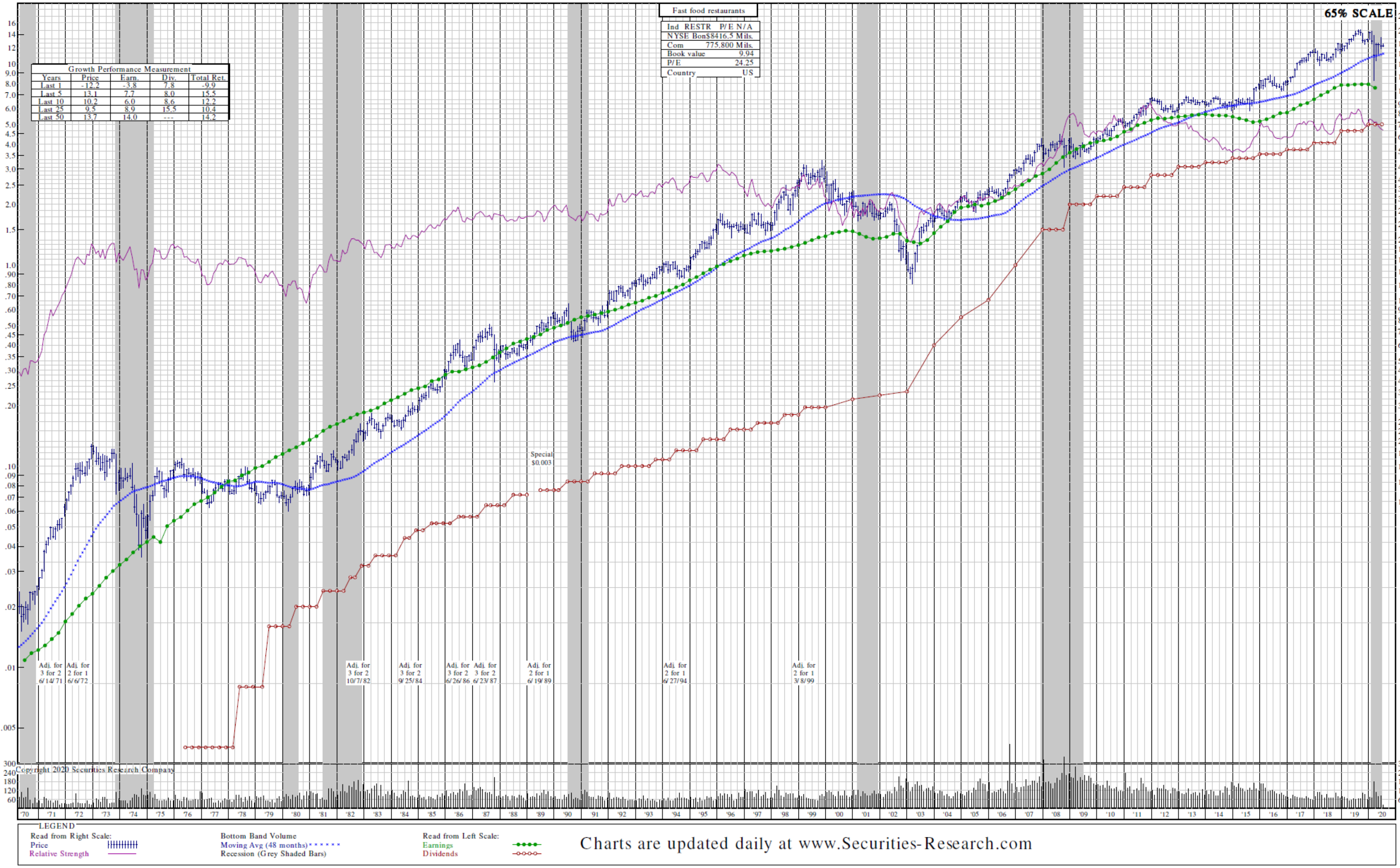
Source: Securities Research Company Dow Jones Industrial Average

Chart 3: Johnson & Johnson 50 year chart (Health care comparison)



Source: Securities Research Company Dow Jones Industrial Average

Chart 4: McDonald’s 50 year chart (Domino’s Pizza Enterprises comparison)



Source: Securities Research Company Dow Jones Industrial Average

COVID-19 – 'NEVER WASTE A CRISIS'

The health impacts from COVID-19 cannot be overstated. Similarly, the economic bill is unquantifiable. In the fullness of time, we believe this period will be defined with an asterisk. One that made little sense going in and even less going out. In short, any outcomes are difficult to reconcile.

Business leaders have been tasked with traversing a landscape that is both difficult to read and unpredictable at the extreme.

There is no doubt COVID has ushered in structural change. Work from home is seen as the most tangible outcome. Into the mix we can add the shift to all things digital, from home delivery to cloud computing and the technological migration from offline to online. Consumers have got a taste of things and permanent changes are afoot.

'Never waste a crisis'

Some suggest this quote was made famous by Winston Churchill. Irrespective, the message here is in taking action that one wouldn't consider under normal circumstances. COVID is one such crisis ushering in a multitude of responses.

But even as we enter the second year of "living with COVID", what is clear are the business leaders with the foresight and preparedness to exit this period with 'velocity'. The term 'velocity' is illustrative of a business that exits the mayhem of COVID with greater market relevance, earnings power, and operational momentum.

Global product manufacturer Breville CEO Jim Clayton, coined this term when discussing the company's own transition and the necessary investments being made now to propel the business in the outer years.

In his assessment there are three possible outcomes when considering the COVID period. There are those who will not survive, having invested heavily into fixed cost structures that are no longer appropriate.

The second group will have used up enormous energy to get to the end and collapse in exhaustion. Their business model is under threat as the economic inputs that underpin it alters negatively.

The third is where you want to be. Taking decisive action now, as unpleasant, or unprofitable as it may be, with the intention of emerging with strength and purpose.

Intel CEO Pat Gelsinger

Understanding the importance of change and being decisive about it requires two actions, vision, and courage. U.S. Intel CEO Patrick Gelsinger has strong views on how the world, spurred on by the pandemic, needs to adapt.

He calls out to all governments with a warning; more investment is required in manufacturing, supply chains must diversify, and damaging chip supply shortages are here to stay.

We are novices when it comes to understanding Intel. Although in his book, *Only the Paranoid Survive,* founder and former CEO Andy Groves provides a historic and compelling insight into the company's strategic pivot in the 1980s to ensure survival.

Today, CEO Gelsinger echoes similar views. Investors may not like what he is saying and doing, but he has conviction and clarity of thought. In a recent exclusive interview with the Australian Financial Review, Gelsinger's reasoning and operational direction was made clear as outlined further below.

At its core, Gelsinger is highlighting the role of semiconductor technology and the manufacturing of chip sets. The world is dependent on chips. Nearly every digital electronic device today is powered by semiconductors, which contain silicon and are critical for creating integrated circuits, also referred to as microchips.

The looming issues surrounding chip shortages has Gelsinger taking a leading role, "*I love technology and building products, and making customers successful with those products ... but the [politics] is important right now too, so I can get myself motivated to go do that and do it well, but it isn't my life calling.*"

The problem stems from years of underinvestment and shift in manufacturing power to Asia. As the AFR article notes in its discussion with Gelsinger, on the growing manufacturing gulf between regions, *"He observes that in 1990, the U.S. made 37 per cent of global semiconductors, and Europe made 44 per cent. This has now dwindled to 12 per cent and 9 per cent, respectively, with the bulk of the world's supply coming from Asia.*

Believing a more balanced supply chain to be necessary from an economic and national security perspective, and in terms of the world's ability to deal with unexpected situations such as pandemics, Gelsinger says those manufacturing market shares need to evolve to become 30 per cent for the U.S., 20 per cent for Europe and 50 per cent for Asia by the end of the decade."

Gelsinger highlights the importance of getting this right, "*We can't have individual narrow locations that the entire world depends on. We've become too focused on cost, and we need to be more focused on resilience for our supply chains going forward. Obviously, I'm not going to build a fab in every country. My Australian customers can't say 'Pat build a $20 billion fab here' ... These are large at-scale investments, but we can do a lot better than we have. Every aspect of human existence is becoming more digital, and everything digital runs on semiconductors, so as a result of that, I would say it is more important where we build the fabs and the supply chains, than where oil reserves are. It's that important.*"

It appears the urgency to act is resonating. The European Union recently launched the European Chips Act, which has committed €43 billion to build a domestic semiconductor manufacturing base, while the U.S. Chips for America Act is slated to provide US$52 billion to encourage more private sector investment in production.

So, what is Gelsinger doing over at Intel?

In March 2021, he laid out his turnaround strategy for the company. This was headlined with a US$20 billion pledge to build two new labs in Arizona. In January 2022, this was followed up with the announcement of a US$20 billion plan to construct two new chip factories in Ohio.

Not everyone is on board with Gelsinger, noting the share price (Chart 5) has headed south over the past year. While accepting that his strategy comes with pain, it speaks more to a market that "*values short-term cost management over long-term vision."*

To his executive team and board who may quiver at the sight of share price volatility, he is quick to remind them they are at the start of a five-year journey. His conviction of doing what is right and what is painfully hard is worthy of repeating here.

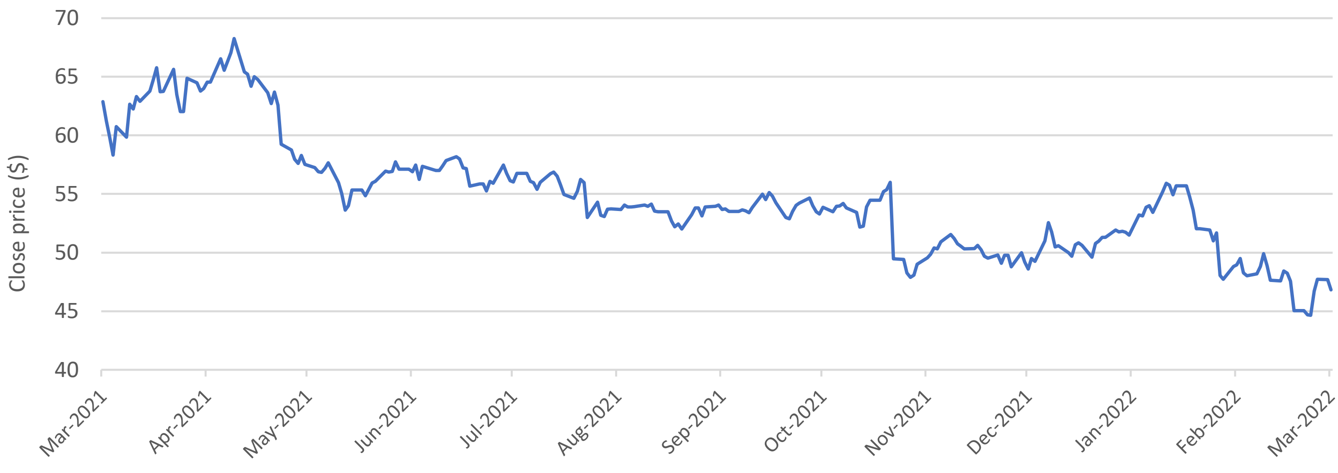
"I'm here to 'double double' ... I'm going to double the size of the company and double the multiple of the company, if we're at $50 or $60 I don't care because we're making the investments to do that.

Wall Street will say to raise margins and not worry about the future, but I'm saying the exact opposite.

We are going to invest in manufacturing, and we're going to lower margins because we're going to go faster, and those are the right decisions today to create a great company for the middle and second half of this decade.

We can't be worried about some of the near-term financial performance as a result because you can't do both, so we are picking to invest for the long-term."

Chart 5: Intel Corporation Share Price, 2021-2022



Source: Iress

Beyond Intel – looking up

The message Gelsinger is sending is very much about looking up rather than down. Executives do the heavy lifting. They set an agenda and work to make it happen.

While the share market may have marked down many of our investment holdings during reporting season, we took a different view.

We are quite unsure why our take on things differs so markedly to many broker analysts, but if we were to sum it up in one word it would be common-sense.

Common-sense in the same vein Gelsinger had when describing the task at Intel. That to cross a river, you first must build a bridge. There is no reward in the construction phase, but plenty when the task is done.

Many of our holdings are doing just that. Whether the market agrees with us or not, the COVID period, stretching from 2019-2024, will require greater investment across supply chains, employees, research and development investment, and business platforms.

The fact they are doing that while delivering outstanding results not only highlights the quality of these performances, but also the management mindset to exit COVID with a better business model.

SEEK

CEO Ian Narev said it best in his opening comments when delivering a strong set of first half numbers. "*We are a bit less concerned about results every six months and much more concerned about what happens over two, three and four years.*"

Under the platform unification program SEEK have set an ambitious target. To scale the business and take advantage of its leading online employment position, both in Australia and in many parts of Asia, management is investing to consolidate its operations into one scalable platform, enabling efficiency, rapid innovation, and improved reliability.

They refer to this investment as Platform Unification, a task that CEO Narev calls out as being "*incredibly tough*." The reality though is that this is the perfect time for such an undertaking. The business is performing strongly and now singularly focused on online employment, post the establishment of the separately managed Growth Fund.

Management have outlined the task timeframe and prize, reflected in Figure 10 and Figure 11 below.

Figure 10: Platform Unification

Source: SEEK 2022 first half presentation

Figure 11: SEEK's Strategic Outlook – 2026

Source: SEEK 2022 first half presentation

CSL

CEO Paul Perreault in answering an analyst question surrounding lower group margins responded appropriately, *"If you all want better margins then I can stop spending money, right, well that's fine, it's simple. But that's not want we do at CSL for growth, right. We believe that the underlying business is quite strong, the demand is there. We are going to continue to invest, I'm going to open new centres, we are building the capacity that we need as we see the demand coming. We are still spending US$1.2 billion or so on capital and probably a similar number next year because these projects are not an annual project cost…..the investment in the business is the key."*

"We understand the margin piece, we are going to get it back, it will take some time, it's a big business, it's complex but we understand it well and we will make sure that our shareholders are happy."

One of the key strengths of the CSL group is its consistency. CEO Perreault's message reaffirms the importance of maintaining absolute clarity and focus.

Cochlear

In 2021 analysts were asking comparable questions over at hearing implant manufacturer Cochlear. Net profit margins had slipped to 16%, below the company's historical long-term target of 18%.

At the time, the focus on why and when margins would be restored dominated the results call. It was the classic approach of looking down and not out.

The company delivered a strong first half 2022 performance, despite the COVID handbrake to business. Net profit margins came in at 19% as reflected in

Figure 12, with little questioning from the audience. The caravan had moved on to other matters.

The share market response was very positive, but management continues to point out that required investment in cloud infrastructure (fully expensed) will hamper margins over the short run.

But over the long-term, the company is making the appropriate investments to ensure it can support a business double its current size of $1.5b in revenues.

Figure 12: Cochlear 1H22 Financial Summary

Profit & loss

$m	HY22	HY21**	Change % (reported)	Change % (CC)
Sales revenue	**815.3**	**742.8**	**10%**	**12%**
Cost of sales	**207.7**	**209.2**	**(1%)**	**0%**
% gross margin	*75%*	*72%*	*3 pts*	*3 pts*
Selling, marketing and general expenses	231.6	209.8	10%	12%
Research and development expenses	98.6	88.4	12%	12%
% of sales revenue	*12%*	*12%*	*0 pts*	*0 pts*
Administration expenses (excluding cloud investment)	65.1	54.2	20%	18%
Administration expenses (cloud investment)	5.2	0.7	643%	643%
Operating expenses	**400.5**	**353.1**	**13%**	**14%**
Other income / (expenses)	5.1	(6.0)		
FX contract gains / (losses)	5.4	0.4		
EBIT (underlying)*	**217.6**	**174.9**	**24%**	**20%**
*% EBIT margin**	*27%*	*24%*		
Net finance expense	3.5	4.5	(22%)	
Income tax expense*	56.6	45.6	24%	
% effective tax rate	*26%*	*27%*		
Underlying net profit*	**157.5**	**124.8**	**26%**	**20%**
*% underlying net profit margin**	*19%*	*17%*		
One-off and non-recurring items (after-tax):				
Innovation fund gains	11.8	34.7		
Patent litigation-related tax & other	-	59.0		
COVID government assistance	-	17.2		
Statutory net profit	**169.3**	**235.7**	**(28%)**	**(30%)**

* Excluding one-off and non-recurring items (refer p10). ** HY21 net profit has been restated to reflect the reclassification of cloud-related investment from capex to opex.

Source: Cochlear first half presentation document

Flight Centre Travel Group

Without question the travel industry has copped the brunt of COVID. Flight Centre Travel Group is still losing money monthly, but management has completely transformed its operations, removing legacy cost structures, investing heavily into digital platforms, while remaining a top four global operator.

With some clear skies emerging, what should we expect on the critical metric of net margin (defined as profit before tax compared to total transaction values, expressed as TTV)?

In recent years this has slipped from circa 2% into the low 1% range. COVID forced the hand of management. Years of restructuring happened in months, with an accelerated shift in the business model and significant ongoing digital investment.

During the first half 2022 results call, CFO Adam Campbell in directly answering the question on whether margins could recover responded, "*yes most definitely, there are some moving parts that you highlighted but look we certainly feel that if we don't come out with a 2% plus PBT margin then we'll have wasted what was an* *opportunity that we never wanted to receive but were given."*

It is an incredibly important point. Having endured a crisis, the restructured cost base, alongside a digitally enabled platform will propel the business well beyond pre-pandemic levels.

The 2024 numbers, should they transpire as currently expected, would see the business requiring no further capital, generating TTV at pre-pandemic levels of $24b, while delivering pre-tax profits of circa $480m (2% PBT margins).

Altium

Electronic printed board designer Altium confirmed a strong return to organic growth following an organisation and commercial reset in 2021. The company has set aggressive targets, openly discussing its pursuit to digitally connect electronic design and manufacturing to the broader electronic ecosystem.

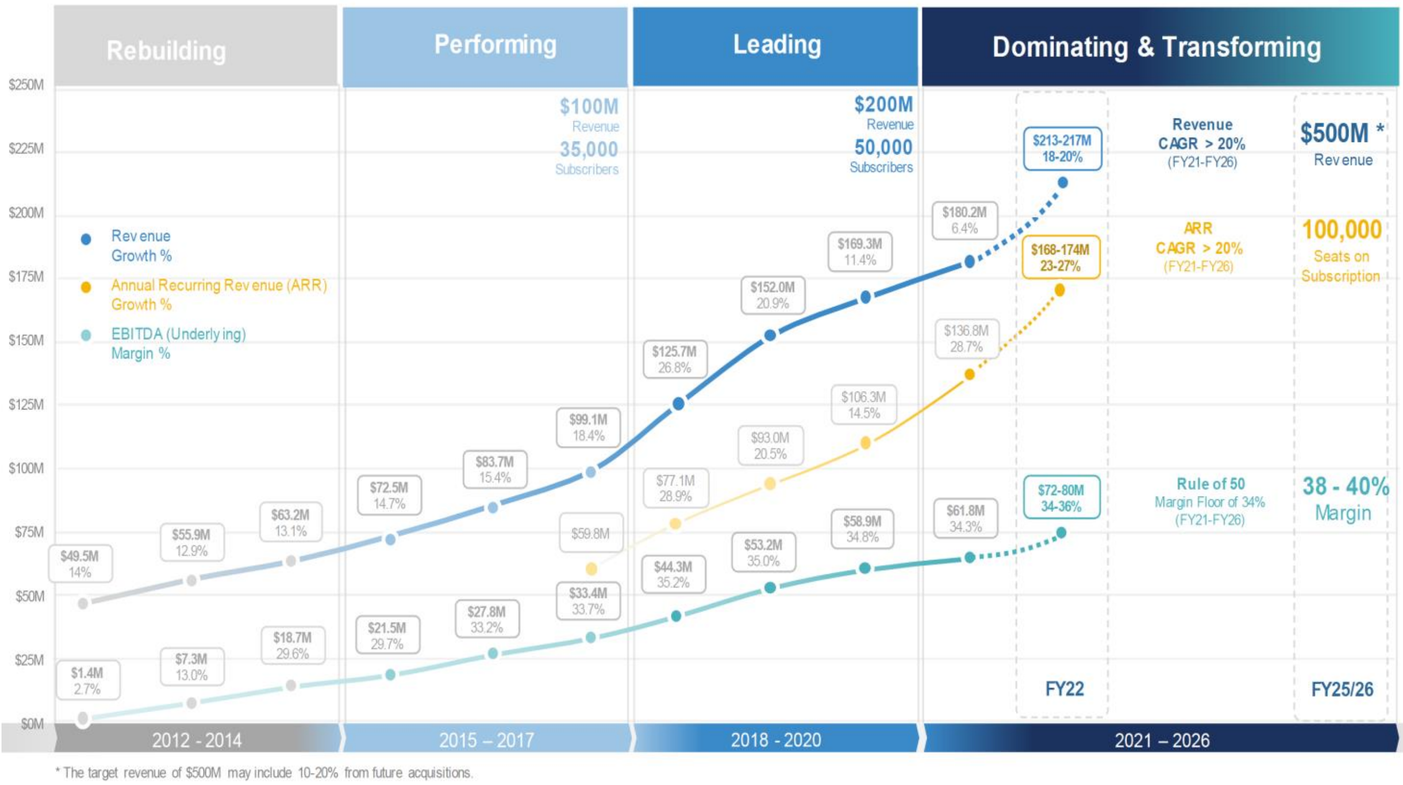
This has involved upfront investment and a deliberate shift to a highly recurring cloud enabled business model. The rewards are significant and already on show. Apart from the obvious benefit to customers, who enjoy improved efficiency, flexibility, and up-to-date product functionally, it also meaningfully improves the company's economic metrics.

This is most evident in the reduced level of customer churn, meaning they stay connected for longer, driving long-term sustainable revenues. In the first half, recurring revenues as a percentage of total sales lifted to 74%, compared to 60% two years earlier. This compares to a 2025 target of 80% excluding China.

The result was also accompanied by confirmation that full year revenue guidance would be met on operating margins of 34%, with this figure coming in at the lower end of the provided range. The market's fixation with 'point in time' percentages is illustrative of the difficulty of satisfying the crowd.

A closer read of the accounts would show that Altium is one of the very few that fully expense their investment spend, compared to accounting standards that allow for capitalisation, thereby depressing reported operating profits. This approach is conservative and consistent with a management team and board prepared to invest, while openly communicating the path taken to its owners. Figure 13 charts their course out to 2025-26, one that is bold, well thought out and hitting critical milestones.

Figure 13: Altium Flight Path



Source: Altium first half presentation document

Appen

The company's 2021 full year result should not have surprised investors, but it did. Crucially, management dropped historical precedence and gave no forward earnings guidance. For analysts this was akin to removing the training wheels, leading to all manner of concerns regarding future revenue demand and profitability.

As such the share price reaction on the day, down 29%, can be sheeted home to general misinformation, rather than what the price action may have implied.

CEO Mark Brayan said as much but was drowned out by the market's determination to get to the bottom of something. In reality, the company was moving on from the circus that is profit guidance. Once a company provides a number it is bound to deliver it or face the wrath of investors and analysts. It matters nought that a 'miss' or even a 'beat' comes down to external events or deliberate efforts by management to invest.

For this reason, Appen has given investors a different perspective, one that looks out five years, with the twin aims of doubling company revenues from the current base of US$447m, while driving operating margins of 20%. Management have set targets, which are considered realistic and well researched. More importantly, it removes the shackles of short-term shocks affecting guidance, while opening the flexibility to pounce, should opportunities arise.

A case in point is the company's New Markets division, which has grown to US$102m in revenues, yet due to ongoing investment recorded operating losses of US$11.5m for the year. The opportunity to capture a larger piece of business in multiple segments, including Government work, Enterprise and China warrants further investment at this juncture. Management is prepared to do just that, but it comes at a short-term cost to profits. In five years' time, the belief is that this business segment would have grown into a US$300m revenue base, with operating margins likely to approach the stated minimum 20% level.

Stepping back and allowing a business to flourish makes far more sense than to pick a number each year and hope you hit it. On most scenarios this sounds more like luck than good management.

Blackmores

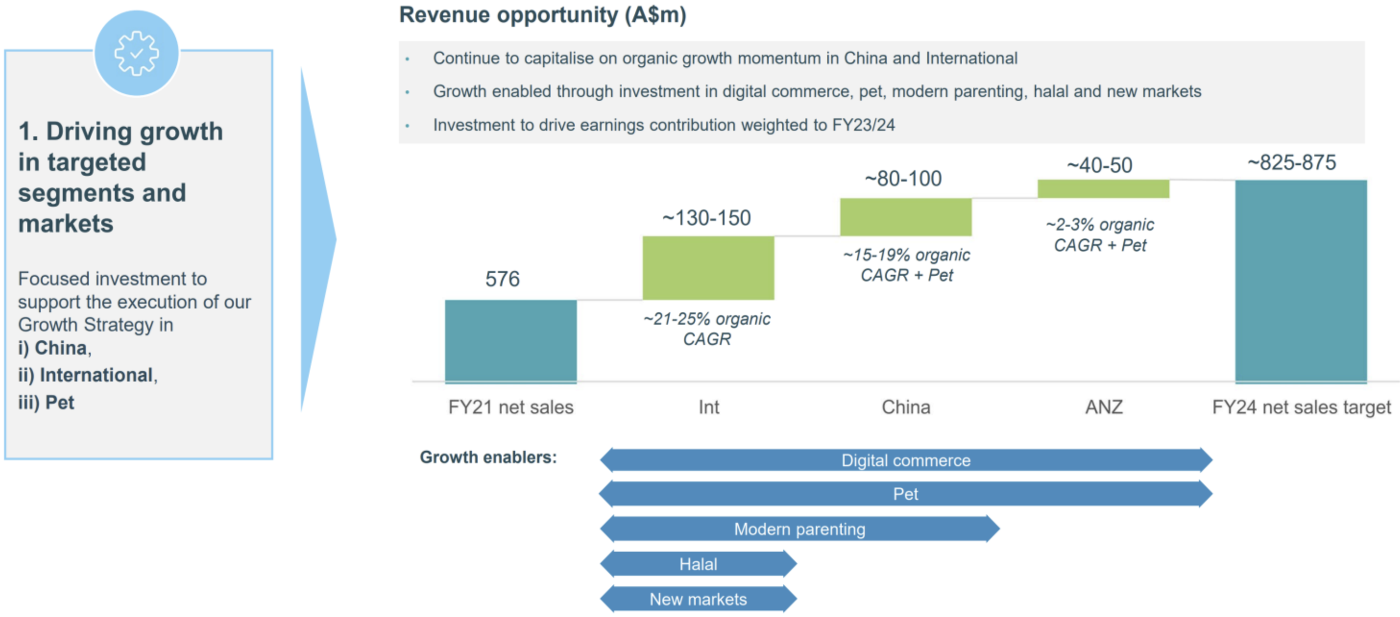
The company has made significant positive progress since the appointment of CEO Alastair Symington in 2019. Prior to this, the company had been in a world of pain. A dysfunctional board, a new manufacturing plant to bed down, an Australian business under operating pressure and general restructuring underway.

Since then, aided by new capital, the business is on the mend. Management is now focused on growing the business and investing to drive sustainable long-term growth across domestic and international markets. The recent departure of CFO Gunther Burghardt is a loss, but his replacement, Patrick Gibson offers considerable industry experience.

The trajectory of the business is the most pleasing development. CEO Symington didn't have to put forward numbers but chose to back his confidence with transparency. As Figure 14 highlights, the company, despite all its recent issues, is aiming to deliver some impressive top and bottom-line growth out to 2024. While many associate the Blackmores brand as a local leader, its growing reputation offshore should not be discounted.

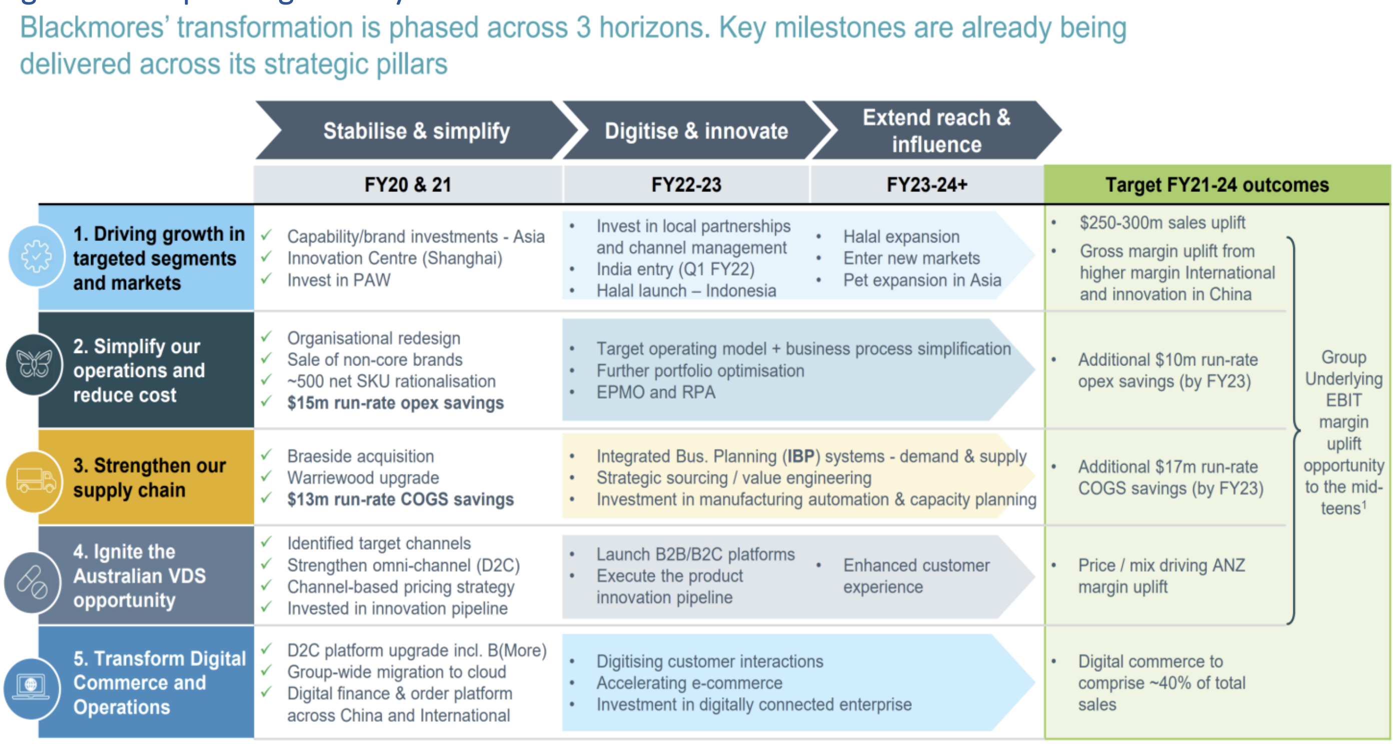
This is clearly reflected in the numbers, with International, inclusive of Indonesia, Thailand, and a host of existing and newer territories, expected to deliver the biggest gains. Figure 15 articulates further the steps required in meeting these targets.

Figure 14: Looking out to 2024



Source: Blackmores FY21 results presentation

Figure 15: Steps along the way



Source: Blackmores FY21 results presentation

Iress

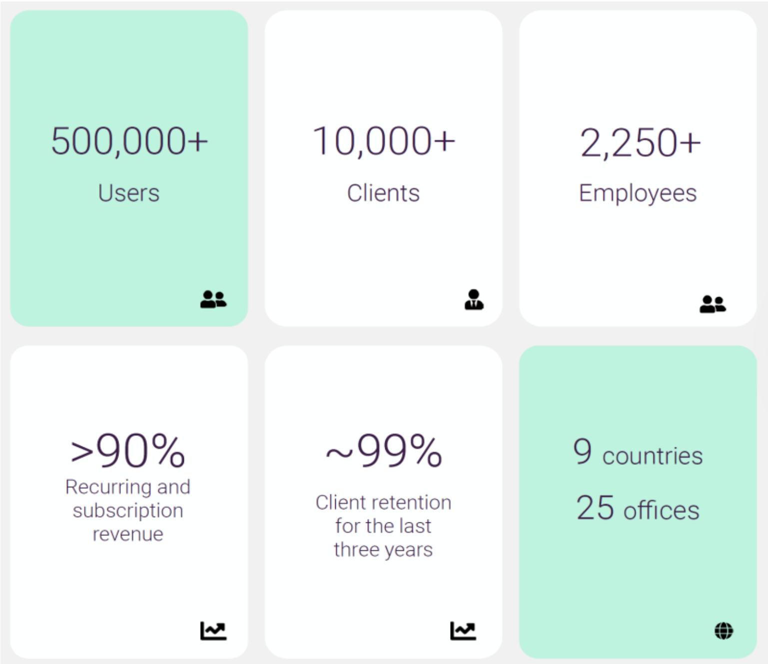
Financial services group Iress operate a highly profitable business model. In 2021 the group received a $15.91 per share cash takeover offer from Private Equity firm EQT. Ultimately, EQT walked away leaving Iress management, led by longstanding CEO Andrew Walsh, with some unfinished business.

This was unveiled at the company's July 2021 Investor Strategy Day. At its core Iress is aiming to simplify processes while generating higher returns. To do so it is undertaking a significant piece of work and the intention to end with a single technology platform. This would allow the business to move faster, and service customers more efficiently and with higher numbers of products and services.

Make no mistake management is being bold and has set high targets. The market, judging by the muted response since its update is not convinced. Figure 16 provides a high-level business snapshot, showcasing the company's global depth and highly recurring earnings profile. Figure 17 is what CEO Walsh wants to achieve. It is not without risk and while the $30m cost to deliver these returns appears acceptable, it will require business disruption and the market's acceptance of new industry offerings across financial markets and superannuation.

Management is prepared to sacrifice short-term discomfort to deliver long-term returns. They are aiming high and if they fall short, the prize is still worth the time, money, and effort.

Figure 16: Iress key statistics



Source: Iress strategy day 2021 presentation

Figure 17: Iress 2025 path

	FY20 Actuals	FY25 base case targets	**Target growth v FY20**	FY25 potential upside growth	**Potential upside growth v FY20**
Revenue (A$m)	$542.6m	$766m - $806m	**7-8% pa**	$870m - $910m	**~10%-11% pa**
Segment Profit in constant currency (A$m)	$152.9m	$240m - $250m	**9-10% pa**	$320m - $330m	**16%-17% pa**
NPAT (A$m)	$59.1m	~$120m	**15% pa**	~$180m	**~25% pa**
EPS (cents)	32.3 cents	~67 cents	**~+35 cents**	~99 cents	**~+67 cents**
ROIC (%)	9%	~18%	**+900bps**	~27%	**+1800bps**

Source: Iress strategy day 2021 presentation

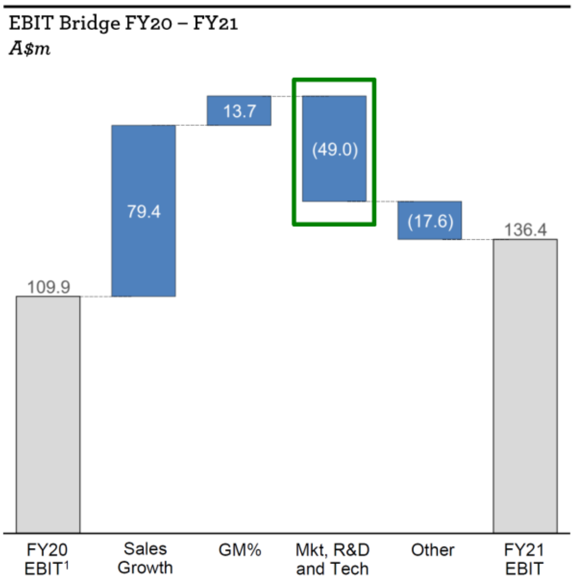
Breville Group

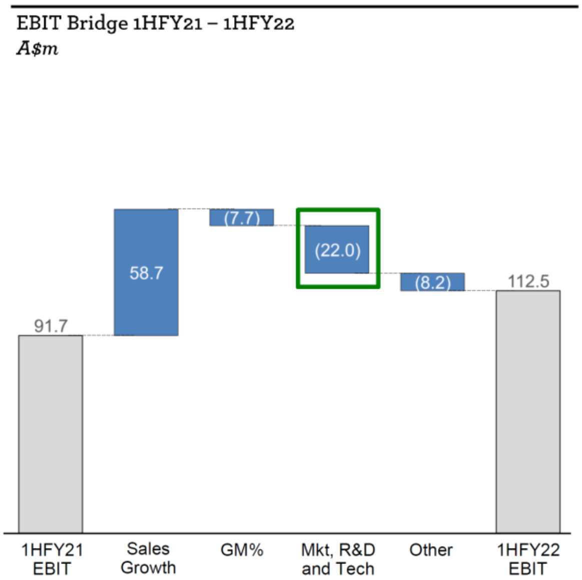
There are few CEOs that have transitioned from Private Equity and made a success of running a long established, somewhat sleepy local business. To be fair, the company was having some success offshore, but not until Jim Clayton joined as CEO in 2015 was the true potential of this manufacturer unleashed.

In the period since, CEO Clayton and his team have fundamentally transformed this business. On almost any metric it is hard to fault what has been achieved. Along the way CEO Clayton set the narrative of what was needed to be done and the investment required.

At the group's interim result in 2022, CEO Clayton further outlined the actions taken. COVID has been a positive for companies like Breville. The structural shift to a work from home environment has necessitated lifestyle changes and driven strong demand for home appliance products. As such, the company didn't need to spend money to market itself, as demand easily outstripped supply. But here it is important to appreciate what the company did do. It invested internally as Figure 18 and Figure 19 demonstrates.

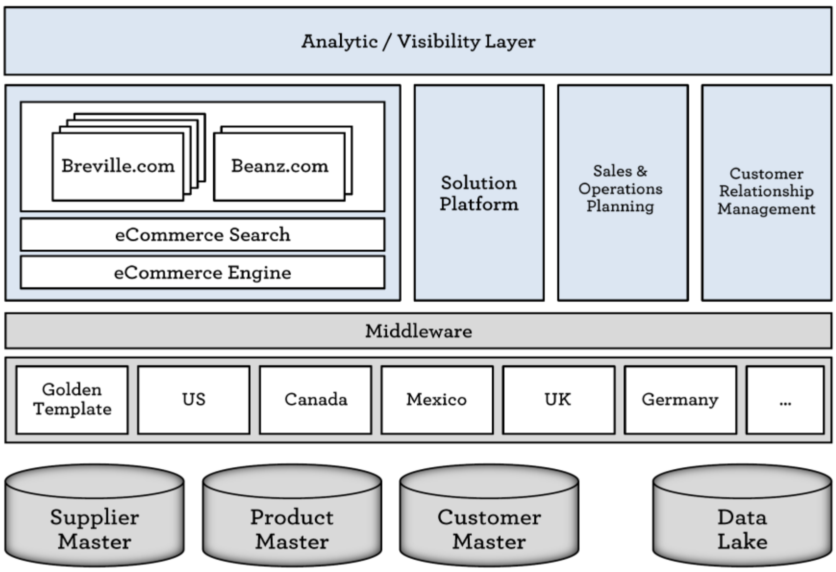
Figure 18: Breville investment





Source: Breville first half presentation

Figure 19: Breville - Building a scalable global platform



Source: Breville first half presentation

The company invested $49m and $22m in both 2021 and in the first half of 2022 to accelerate the group's global platform completion. Normally, this would have occurred over several years, but COVID provided an opportunity the company was not prepared to waste. It now has a global infrastructure platform that will allow new products to be added and scaled across the company’s worldwide operations. In essence, it has taken a short-term profit hit to build a stronger long-term business.

Final point

All this takes us back to our opening comments. The best businesses, the ones with genuine shareholder alignment, are those who continue to invest year in, year out. Some have called this the '20-mile march', maintaining the consistency of improving the business.

In Breville’s case and in most of our business holdings, some of which have been mentioned here, the overriding message is simple. To succeed, you need to plan, and you need to invest. This is not something you turn up and turn down. The key is in its consistency, rinse, and repeat.

Come 2024 when we finally have clear air from COVID, we believe it is the third group of businesses that will exit this period with ‘velocity’, having taken the necessary actions to not ‘waste a crisis’. ***SFM***

THREE BUCKETS – KEEPING THINGS SIMPLE

There are multiple ways to invest. And the truth is, there is no perfect approach. If we were to strip things back though, we would argue long-term success can only follow businesses that are themselves succeeding.

In our experience every business has a vision, and a purpose, reflected in its own corporate life. They are founded (born), nurtured (capital) and set free (floated) to either fail or succeed.

If we were to be crude, businesses can be lumped into one of three buckets. The first are today's domestic businesses, think banks, commodity type retailers and general insurers. They remain incredibly profitable but are slow and structurally constrained or limited in their outlook. So, it's no surprise that they ultimately ebb and flow with economic conditions.

They have largely outgrown their corporate life, which is not to suggest that they've run their course, but more that their best days are behind them.

The second bucket are for the aspirational players that fall short. Be it because they lack the scale, the capital and quite frankly, the business acumen to reach such heights. These organisations struggle to get past go, earning too few dollars and consuming far too much capital.

The Stock Exchange is littered with "gunna" companies, although there is acknowledgment that even successful companies struggle in the formative years. Too often though we throw away our winners to catch the next intended one. In doing so, investors make the cardinal mistake of "*cutting their flowers and watering their weeds.*"

The last bucket contains those that have made the transition, no longer fighting for survival instead striving to lead. They operate in that sweet spot of corporate life, enjoying economic clout, business scale and improving market power, unhindered by lack of opportunity. These organisations are early in their business pursuit; success is not guaranteed and setbacks part of the course, but the opportunity for long-term outperformance is real.

Measuring investment success or failure comes in many shades. All three of our investing buckets can lay claim to both. But in truth, timing is more critical in the first two. Stick around for too long in a business that is in decline and no amount of time will help. The adage if you are not growing you are dying is most appropriate.

Businesses that fall into the second bucket rely on a good dose of time and luck. They will not succeed to the extent that investors think, but that is not to suggest good returns can't be delivered. Too few businesses achieve an economic return that justifies the risk pursued. The luck side plays its part invariably early on, when investor enthusiasm is high and a track record yet in place.

The third bucket is where we aim to invest. We want time to work for us, for compounding to do the heavy lifting. In the process, we want to remove obstacles that hinder long-term success.

Human nature that continually seeks outperformance is one such impedance. This powerful impulse prompts the need for constant action, when what is really required is time and a common-sense perspective. Counter intuitively, the real skill is to maintain investment discipline, often reflected in doing less.

Different approaches

Professional investors come in all shapes and sizes. Some keep a low profile while others seek attention. We prefer the former, sticking to a bottom-up investment approach that works to identify businesses to add to our preferred third bucket. This is not without its challenges, helped enormously by keeping emotions in check and learning from others.

Louis Simpson

On 8 January, at the age of eighty-five, Louis Simpson passed away. Not many are familiar with his investing background, but for Warren Buffett and Berkshire Hathaway, Simpson played an important, yet unassuming role.

In 1979, Simpson was hired by then GEICO CEO Jack Byrne as the company's new chief investment officer. Having originally invested in the business in 1951, Berkshire Hathaway acquired the balance of shares outstanding in 1996, making Government Employees Insurance Company (or GEICO Insurance for short) a fully owned subsidiary of the business.

Arguably core to the business success is this idea of an insurance float. An insurance company will receive premiums upfront and then pay out claims as needed at a future date. This leaves an insurer holding large sums of money – otherwise known as float – which can then be invested.

As the GEICO business has grown, so too the level of insurance premiums collected and the size of the investing float. It remains one of the most important and successful investment decisions ever undertaken by Buffett.

The 'float' was managed by Simpson from 1980 to 2004, a period of 25 years, before he stepped down from GEICO in 2010. Interesting to note that in 2000, under an emergency succession plan, Simpson would have become the investment director of Berkshire Hathaway if Buffett had died while holding the reins. History shows this was not the case and Buffett continues in his role at age 91.

As for Simpson, his performance history at GEICO speaks for itself and is outlined below in Table 13.

Over the 25 years, the GEICO equity portfolio delivered average gains of 20.3%, compared to the U.S. S&P returns of 13.5%, delivering outperformance of 6.8%.

Equally impressive was Simpson's approach, "*The essence of my investment philosophy is simplicity. What we do is run a long-time horizon portfolio comprised of ten to fifteen stocks. Most of them are U.S. based, and they all have similar characteristics. Basically, they're good businesses. They have a high return on capital, consistently good returns, and they're run by leaders who want to create long-term value for shareholders, while also treating their shareholders right*."

He kept a low profile, undertaking only two on the record interviews over a 14-year timeframe.

In one of those rare times in the spotlight, Simpson reminded everyone of his personal qualities, "*I have always felt I could do a better job in adding value by being somewhat removed from the circus and pari-mutuel atmosphere of the market. So many people broadcast what they buy or sell, and it works against them. I'm in favour of people not knowing what we're doing until the last possible time*."

Table 13: Louis Simpson GEICO 1980-2004

Year	*Return from GEICO Equities*	*S&P Return*	*Relative Results*
1980	23.7%	32.3%	(8.6%)
1981	5.4%	(5.0%)	10.4%
1982	45.8%	21.4%	24.4%
1983	36.0%	22.4%	13.6%
1984	21.8%	6.1%	15.7%
1985	45.8%	31.6%	14.2%
1986	38.7%	18.6%	20.1%
1987	(10.0%)	5.1%	(15.1%)
1988	30.0%	16.6%	13.4%
1989	36.1%	31.7%	4.4%
1990	(9.9%)	(3.1%)	(6.8%)
1991	56.5%	30.5%	26.0%
1992	10.8%	7.6%	3.2%
1993	4.6%	10.1%	(5.5%)
1994	13.4%	1.3%	12.1%
1995	39.8%	37.6%	2.2%
1996	29.2%	23.0%	6.2%
1997	24.6%	33.4%	(8.8%)
1998	18.6%	28.6%	(10.0%)
1999	7.2%	21.0%	(13.8%)
2000	20.9%	(9.1%)	30.0%
2001	5.2%	(11.9%)	17.1%
2002	(8.1%)	(22.1%)	14.0%
2003	38.3%	28.7%	9.6%
2004	16.9%	10.9%	6.0%
Average Annual Gain 1980-2004	20.3%	13.5%	6.8%

Source: GEICO

Controlling emotions were equally important for Simpson, *"If I have the Bloomberg on, I find I am looking at what the market is doing. I am looking at every news story. I really like to be the one who is parsing the information rather than having a lot of irrelevant information thrown at me."*

All of which was reflected in his decision making, "*We do a lot of thinking and not a lot of acting. A lot of investors do a lot of acting, and not a lot of thinking.*"

Simpson's track record illustrates his approach was quite distinct from the market's performance; a combination of periods of underperformance, well and truly offset by significant outperformance.

He has spoken of the big wins. Most notably his investment in Nike Inc, going against market research that pointed to Reebok as being the "*cat's meow*", "*The more we got into it, the more I saw the really quality company with the franchise and sport brand was Nike*." In contrast his investment in furniture retailer Pier I Imports was a value trap, describing it as "*a horrible mistake, it was our doing. They were totally out of touch fashion wise, and it was a disaster*."

Throughout, Simpson remained focused on a philosophy and strategy that measured the progress of the company based on its financial outcomes, rather than the ups and downs of the stock market.

There is much to learn and admire from Simpson's investment approach. Here are eight quotes that show just a glimpse of this:

1. "*I think you need a combination of quantitative and qualitative skills. Most people now have the quantitative skills. The qualitative skills develop over time."*
2. *"Everyone talks about modelling – and it's probably helpful to do modelling — but if you can be approximately right, you will do well."*
3. *"One thing you need to determine is: Are the company's leaders honest? Do they have integrity? Do they have huge turnover? Do they treat their people poorly? Does the CEO believe in running the business for the long-term, or is he or she focused on the next quarter's consensus earnings?"*
4. *"There are a few factors that we look at. First, is this the business we thought it was? If you figure out that a business is not what you thought it was, that's a bad sign."*
5. *"The second factor is the management, which can also differ from what you thought. Unfortunately, a lot of managements are very short-term oriented, and that can be another reason to sell. This goes back to the basic integrity and the focus of people in charge."*
6. *"The third factor is an overly high valuation, and this is often the most difficult, because you're investing in something you wouldn't buy at current prices, but you don't want to sell because it's a really good business and you think it's ahead of itself on a price basis. It might be worth holding on to it for a while.*"
7. *"…be very careful with each decision you make. The more decisions you make, the higher the chances are that you will make a poor decision."*
8. *"If I've made one mistake in the course of managing investments it was selling really good companies too soon. Because generally, if you've made good investments, they will last for a long time."*

Jeremy Grantham

Whilst Louis Simpson rarely spoke to the press, Jeremy Grantham thrives on it. He is the co-founder of Grantham, Mayo & van Otterloo (GMO), a Boston based asset management firm established in 1977.

Grantham is a member of GMO's Asset Allocation team and the firm's Long-Term Investment Strategist. GMO currently manages US$65b, in comparison to its peak of US$120b.

GMO's investment approach is from a macroeconomic perspective, with Grantham's philosophy underpinned by the commonly used phrase "*reversion to the mean.*" Essentially this represents the belief that all asset classes and markets will revert to mean (average) historical levels.

In expressing such views, Grantham is prepared to make market predictions well out into the future. He has been described as both a contrarian investor and a permabear, a term that we had to look up to find its meaning, and which the Collins dictionary notes as, "*an investor who consistently acts in the expectation that the value of stocks and shares will fall.*"

This approach may not please everyone, but Grantham has never wanted to win friends. He has built a reputation on thinking independently and making big calls. GMO's quarterly newsletters are usually the frontline of expressing these views, although his alarmist style no doubt aims to grab attention.

An illustration of which is reproduced below.

"For the record, I wrote an article for Fortune published in September 2007 that referred to three "near certainties": profit margins would come down, the housing market would break, and the risk-premium all over the world would widen, each with severe consequences. You can perhaps only have that degree of confidence if you have been to the history books as much as we have and looked at every bubble and every bust. We have found that there are no exceptions. We are up to 34 completed bubbles. Every single one of them has broken all the way back to the trend that existed prior to the bubble forming, which is a very tough standard. So, it's simply illogical to give up the really high probabilities involved at the asset class level. All the data errors that frighten us all at the individual stock level are washed away at these great aggregations. It's simply more reliable, higher-quality data."

However, it is also fair to say that everyone suffers from one's own bias, Grantham included. Post the Global Financial Crisis (GFC), Grantham warned of an imminent U.S. share market collapse every year, centrally related to over-extended valuations and the market's reliance on central bank support.

In a Barron's interview given in 2015, Grantham conceded that while he has made a career out of identifying share market bubbles, "*for bubble historians … it is tempting to see them too often*".

This is perhaps where making constant predictions and timing deviate. In both the Japanese experience of the late 1980s and the GFC of 2008, he admits an early exit cost investors about 60% each time. Equally, timing a re-entry based on determining mean reversion carries its own risk.

As a fund manager, GMO's or Grantham's strategic investment views may not always align with the management of the firm's own portfolios.

Take the GMO's Quality Trust as an example, which was published in September 2020, so is relatively new in the scheme of things.

The website's product description of the Trust states, "*The GMO Quality Trust seeks to generate total return by investing primarily in equities the Focused Equity team believes to be of high quality. The team believes that companies with established track records of historical profitability and strong fundamentals – high quality companies – are able to outgrow the average company over time and are therefore worth a premium price. The Trust's disciplined approach uses both quantitative and fundamental techniques to assess the relative quality and valuation of global companies and aims to exploit a long-term investment horizon while withstanding short-term volatility.*"

Over this relatively short period, the Portfolio has performed solidly, outperforming the MSCI World Index. The top 10 holdings comprise leading technology companies Microsoft Corp, Apple and Alphabet, alongside more traditional names US Bancorp, Coca-Cola and Wells Fargo. In aggregate, Information Technology is the biggest weighting at 39.5%, followed by Health care at 23.7% and Financials at 8.5%.

Similar comments can be made regarding GMO's other equity managed portfolios, illustrating the disconnect between the group's strategic intent and its application across mandates.

Comment

Louis Simpson and Jeremy Grantham illustrate fundamentally different approaches to investing. Others, including the likes of Ray Dalio and Warren Buffett, have also featured heavily over the years, each with their own insights and investment methodologies.

No approach should be regarded as either right or wrong. Our preference for a bottom-up, stock specific backing of long duration companies, aims to concentrate our focus on individual business outcomes, rather than a top-down market centric approach.

We profess to have no knowledge of a market's future direction. Irrespective, when you find something that works, applying it consistently does have its rewards. ***SFM***

WHY 'POINT IN TIME' INVESTING FAILS THE TEST OF TIME

Former Canadian ice hockey star player Wayne Gretzky, regarded as the greatest to have ever played the game is also famous for his quote "*I skate to where the puck is going to be, not where it has been*." Sporting people will describe this in one word, anticipation.

The business world is far removed from the sporting field, yet competition can be just as fierce and Gretzky's quote just as relevant.

On 4 February Chanticleer columnist Tony Boyd from the Australian Financial Review penned an article titled, "*Westpac's lost decade*". It was pertinent and reinforced a view we hold dearly, that the likely success of any business goes way beyond a valuation metric taken at a point in time.

We discuss Boyd's comments in more detail below. His opening question being an apt place to start.

"*It's the big question on the minds of those who have followed the Australian banking industry for the past 30 years – how did Westpac go from being bigger than Commonwealth Bank to less than half its size in just over a decade*?"

According to Boyd, "*The answer is complex because apart from exploring all of Westpac's strategic, operational and governance mistakes, the response must examine why CBA is such a high performing outlier.*

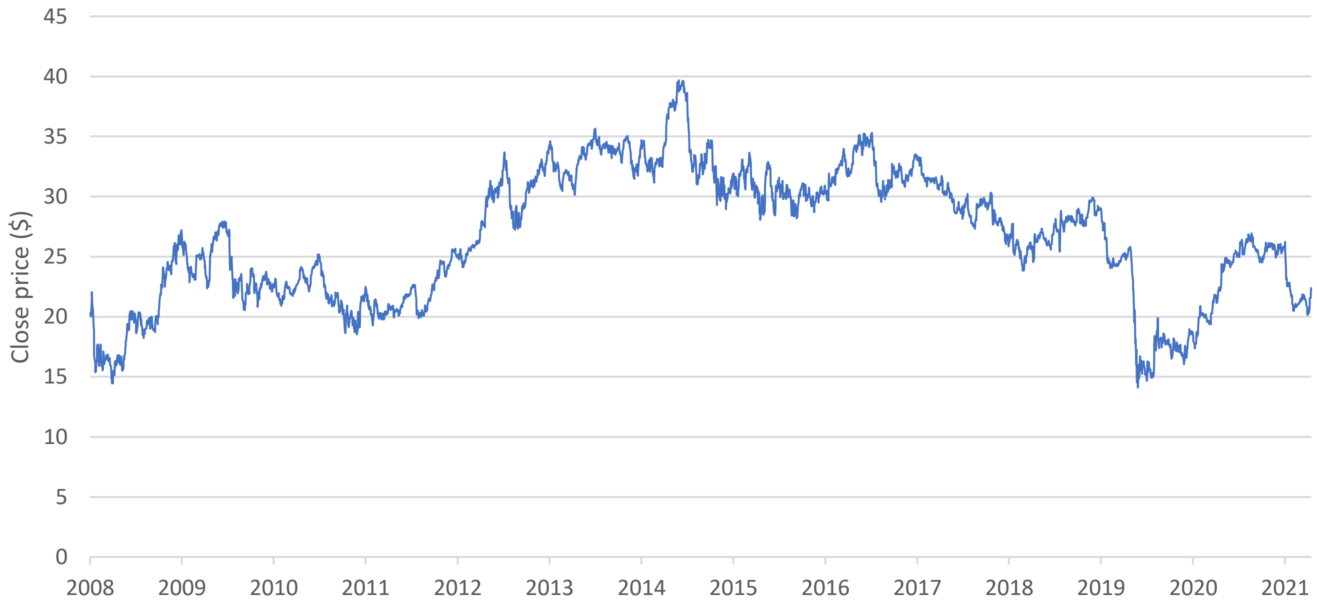
Westpac surpassed the CBA in market value terms in 2008 after it bought St George Bank in a scrip merger deal worth $12 billion. It had a market cap of $42 billion, about $2 billion more than CBA.

The two banks had fairly similar franchises and almost the same key financial ratios. Westpac and CBA controlled about half the residential mortgage market with $265 billion each of mortgages. Both banks traded at twice their book value, had cost-to-income ratios – measure of efficiency – of 46 per cent and total capital ratios of about 10.5 per cent.

Westpac's return on equity at 22 per cent in 2008 was superior to CBA's 19 per cent and the market was willing to pay more for Westpac's management expertise – shown by the fact Westpac had a higher market value even though its assets of $590 billion were less than the $620 billion at CBA.

Today, the gap between the two banks is $86 billion, with Westpac's market cap at $75.6 billion and CBA's at $162 billion. The market's poor assessment of Westpac's prospects is summed up in its share price being equal to book value while CBA trades at twice its book value."

Chart 6: Westpac 2008-2022



Source: Iress

Chart 7: Commonwealth Bank 2008-2022

Source: Iress

We can now consider where Westpac went wrong or where in fact CBA got it right. To be fair though, this is after the matter. The aim here is not to suggest we have the answers when the outcomes are already known. Rather, that investors appreciate the value created or frankly destroyed if things are left undone for a period.

Point in time comparison

In the short run financial comparisons can be very deceiving. Westpac's starting position, as Boyd pointed out, was almost equal to CBA on most fronts. Banks are complex businesses, and we avoid this sector for that very reason. They are also highly leveraged businesses, relying on debt rather than equity when lending to mortgage and commercial borrowers. When things get tough, as they sometimes do, there is little in capital protection, other than the bad-debt provisioning taken along the way.

So, while our major bank shares are prized by investors, attracted by the high dividends and historically strong returns on capital, they are incredibly intricate businesses. To that end, knowing how things work is half the battle. It is for this reason that founder-led businesses have such appeal. Not only is there genuine shareholder alignment, but their oversight and propensity to consider what is best for the business is incredibly important.

As Boyd observes, some consider Gail Kelly's elevation to the Westpac top job in 2008, from her former role at St George Bank, as a critical error in judgement.

The smart money suggested that this appointment should have gone to the bank's existing numbers man, its Chief Financial Officer Phil Chronicon.

According to close observers Chronicon was regarded as a details man, something the current CEO Peter King rightly acknowledges as a must have requirement, "*But as you go to the new world, where you've got to get your processes clearly mapped and digitised, you have got to look at things end-to-end. I've got to have business people running businesses that care about details. I think former CEO David Morgan used to say to me, that retail is detail and that is in the back of my mind*."

Reinvestment

So having picked the wrong CEO, a lack of reinvestment compounded the situation further. Boyd's article speaks to this exact point. The easy decision for any executive is to take a pass on investment.

The tough and correct call is to sustain reinvestment, in its people, systems and infrastructure, even when it comes at the expense of short-term profitability.

Boyd explains, "*During Kelly's tenure, Westpac made the strategic mistake of not investing in an upgrade to its core systems. Someone who worked in IT under Kelly said* *there were plenty of IT outages, but no desire to spend the money to rebuild the entire system. Her rival at the CBA, Ralph Norris, took on the risks associated with large IT projects and gave CBA a technology leadership that continues today.*"

Anointing the wrong person is unfortunate and happens, but business underinvestment is inexcusable. Further, the revolving CEO door that is part of banking in this country, is also at fault.

Since 1999 Westpac has witnessed the appointments of four CEOs. The longest involving David Morgan from 1999 to 2008, followed by Gail Kelly in 2008 to 2015. Since then, CEO tenure has shortened. Case in point is Brian Hartzer who stepped down in 2019, following claims made by AUSTRAC of alleged money laundering by the bank. Current CEO Peter King stepped in as his replacement in 2020.

A non-founder-led mentality

Replacing CEOs every five years or so is disruptive and counterproductive. Consider the move into wealth management by CEO David Morgan. At the time this was lauded as a natural extension of servicing customers from early in life through savings plans, followed by mortgages and ultimately investment solutions into retirement.

The Haynes Royal Commission into Misconduct in the Banking, Superannuation and Financial Services industry undertaken in 2017, put paid to that.

Westpac and all the other major banks have since exited or reduced their involvement in this segment. In Westpac's case, remediation payments totalling $1.5 billion have left a bitter taste.

In comparison, businesses like four-wheel drive manufacturer ARB, software developer TechnologyOne, medical group ResMed or even travel operator Flight Centre Travel Group, have seen leadership and ownership consistency for well over two decades and counting.

Even big organisations that are not founder-led, including the likes of blood plasma manufacturer CSL, respiratory healthcare provider Fisher & Paykel Healthcare and cochlear implant global leader Cochlear, have retained continuity of leadership stretching over long durations.

Westpac's shortcomings are of their own making and should not surprise anyone.

Culture

Lacking focus, direction and investment commitment is why companies go backwards. Where this is most apparent is the people that make up the business. Today we call it culture.

Boyd's article homed in on this issue. Several industry participants cited the primary difference between the performance of Westpac and CBA over the past decade is the quality of management, "*I was always overawed by the difference in the calibre of the second tier of executives at those levels. That's about recruiting discipline, and also about the calibre of the CEO and who they choose to surround themselves with.*"

CEO Peter King agrees, "*I need better operating performance. The culture reports in the last couple of years said we tended to value intellect over performance execution.*"

Strategy?

Having centralised banking functions at head office, CEO King's intent is to now decentralise operations.

Boyd's article draws on comments from an industry consultant, *"The other thing that Westpac screwed up on, and this is part of their current cost issue, is the pendulum. It's a bit like changing governments, right?*

Whenever we change governments, it's like a lost year and a half, while all the public servants go from the left-hand side to the right-hand side.

If you look at Westpac's latest cost-reduction approach, they're going to take costs out of head office and then put them back into the business.

Hello, only four or five years ago, they took them out of the business to centralise them in head office, so we have less of them.

I think you're better off sticking to an approach and being more of a zealot around that approach and staying the course."

Technology

Some investors struggle to appreciate the technology era we now operate in. The rise of cloud computing and move to subscription-based revenue models, makes the suppliers of these services far more valuable, rendering traditional price to earnings ratio (PER) comparisons to lower quality businesses less meaningful.

Even for the likes of Westpac, the technology transition is underway as CEO King points out, *"The concept of going out and buying one computer system that does everything is gone in my mind.*

What you're doing now is you're building the infrastructure and it's often provided by cloud providers such as Amazon and Microsoft.

You're effectively pulling together a lot of digital process capabilities from different suppliers. If you look at what we've done with the 10x system, it's cloud based, the change is quick, and it is in real time – you're buying components and putting them together."

Work to do

Restructuring the bank is now in train, a fact not lost on CEO King who admits there is no quick fix to entrenching a better performing bank, "*There is still a few years to go in this to get us out of businesses we want to get out of and to really get the operational discipline back into the company at the level we need."*

Lessons

When you consider Westpac's cumulative series of missteps, repercussions follow. Not necessarily in the short run, but unquestionably over a longer timeframe. And importantly, the more entrenched the situation, the harder the path back.

Competitors do not stand still, and the internal changes required involve a strategic reset and buy-in from the board, executives, and staff.

CEO King is now embarking on that journey, announcing deep cost cuts, retrenchments at head office and asset sales. Staff morale is unlikely to be positive, while the legacy of years of underinvestment problematic.

To that end, the error that investors make is to focus on point in time valuations as a true comparator of businesses and competitors. Such an approach ignores the elephant in the room – is the business remaining relevant?

Relevancy is not easy to deduce, but as we have tried to highlight in this and previous articles on the subject, investor and shareholders alike need to consider a business across multiple disciplines and not just profitability.

If the focus is purely on the bottom line, it will come at the expense of reinvestment, considered risk taking and the cultural fabric of an organisation. Such an approach, as Boyd has clearly articulated, will undoubtedly lead to disappointment. ***SFM***

SURPRISES? – NORMAL

Anyone who has been involved in stock markets will appreciate the one thing investors do not like are "negative" surprises. Ironically, business is full of surprises – good and bad.

Publicly listed companies operate in a difficult space. Maintaining ongoing communication with external owners, while meeting all regulatory requirements, is a high wire act.

At the first sign of a surprise, sentiment can turn. Questions asked of management teams are clinically efficient, requiring black or white responses, and set against expected timeframes. Industry analysts aim to draw out answers that at the time, are frankly unknown or unreasonable.

This lack of real-world understanding, reflected in the complexities of running a business, hiring staff, or recovering from setbacks, is lost on those in the investment community who are solely focused on financial modeling.

The problem? Thinking it's as simple as black and white. In reality, business can be consumed with long periods of grey – not what analysts want to endure.

We do not think we are out of school in saying that most management teams genuinely aim to deliver a better outcome, for the business and for shareholders.

The challenge for investors is the path. Don't expect smooth sailing. Buckle yourself into an all-terrain 4WD-vehicle and you may have a chance.

The unexpected event then, while unpleasant, is normal. So, how do you communicate that to an audience only receiving snippets of information?

Like Chinese whispers, delivering a message to a wider group often leads to varying interpretations, uncertainty, confusion, and requests for further clarity.

During the quarter, a case in point involved global disinfection manufacturer Nanosonics, a business we have followed for well over a decade and which we profiled in our June 2018 Selector Quarterly Newsletter.

In this instance, the surprise to market watchers came when CEO Kavanagh informed investors that the company's long-standing arrangement with leading distributor GE Healthcare would be revised, effective immediately from 8 February 2022 until the end of the current three-year deal in June 2022. Thereafter, should both parties agree, a new reseller agreement would flow.

Despite the company's stock exchange release outlining the new reseller model and CEO Kavanagh's subsequent investor call, many interpreted this as a negative development.

It appears no one likes grey. What appeared rushed, brought into question the GE Healthcare relationship, while the estimated $13m-$16m deferral in unit sales resulting from the new arrangement only increased market uncertainty.

We believe the public release and investor call addressed the circumstances and decision points surrounding the revised deal and future business path. Not surprising though, when snippets of information are provided to shareholders that lack the historical context, more questions flow. On occasions, enough is never enough.

Like a freeze frame, things can be taken out of context. Buckling in from the start, however, provides the necessary threads and appreciation of what is underway. With this in mind, we roll back the years and join the dots on the evolution of Nanosonics and GE Healthcare's relationship.

Nanosonics - joining the dots

Trophon

On 28 February 2011, the company received its initial 510(k) approval from the U.S. Food and Drug Administration (FDA) for its Trophon product. This would mark a new standard in the disinfection of ultrasound devices.

From a standing start, the global rollout of Trophon, superseded in 2018 by the latest generation Trophon 2 device, now totals an installed base of 28,160 units. In the key market of the U.S., the company has 24,680 devices operating across a hospital network of 5,000.

Leadership

On August 2013, the company appointed Michael Kavanagh as CEO, President, and Managing Director, having originally joined as a Non-Executive Director in

2012. The transition of its former CEO Dr. Ron Weinberger to a newly created Technology Development / Commercialisation position, opened the doors for Kavanagh to apply for the top role.

GE Healthcare timeline 2011-2022

Nanosonics has had a long and successful business relationship with GE Healthcare. Stretching well over a decade, below is an illustration of its evolution:

1. **June 2010** – GE Healthcare (GEHC) and Nanosonics announce a distribution agreement. GEHC has exclusive rights to market the Trophon EPR ultrasound probe, disinfector and consumables in the U.S. and Canadian markets.
2. **June 2012** – GEHC extends relationship with Nanosonics, agreeing to invest $7.5m of equity into the company to drive ultrasound disinfection innovation and product development.
3. **August 2013** – As outlined, Nanosonics appoints Michael Kavanagh as CEO, President, and Managing Director, underscoring the transition to a direct business model under his watch.
4. **February 2015** – Nanosonics announces an expansion to its North American presence, introducing a direct sales operation. This paves the way for the company to work alongside GEHC to drive and support broader and deeper penetration across the total market of both the U.S. and Canada.

Consequently, the GEHC arrangement shifted from an exclusive to non-exclusive reseller of Trophon and consumables in these two important markets. For context, the installed base in 2015 stood at 4,000 devices.

5. **August 2017** – Nanosonics announces the establishment of a new three-year Capital Reseller agreement with GEHC, effective at the conclusion of the current deal on 1 July 2019. GEHC will retain the non-exclusive right to sell Trophon capital equipment in the U.S. and Canada, but all consumable revenues and margins will be retained by Nanosonics.

The new agreement also creates opportunities for further geographic expansion into new international markets. Importantly, Nanosonics' full retention of its high margin consumables offering illustrates the evolution of the business and ongoing product investment.

6. **February 2022** – Company announces the revision of the GEHC agreement to a "pass-through" model, effective from 8 February 2022 until the expiry of the current deal in June 2022. Discussions for a new reseller capital agreement are underway to come into effect on 1 July 2022, if both parties agree.

The new arrangement will see Nanosonics transition to a direct to market model in the U.S. and Canada. It's a move reflective of CEO Kavanagh's desire to control its own destiny, creating a deeper on the ground presence to better serve the needs of all its customers.

The company will expand its U.S. personnel footprint from 85 to 100 roughly and transition existing GEHC Trophon customers to Nanosonics.

Under the new "pass-through" agreement with GEHC, Nanosonics will manage all inventory, ship, install and train all new customers, and continue to service all their consumable requirements. From GEHC's perspective, the financial incentives remain in place to continue to sell new Trophon devices, without the requirement of overheads.

Comment

When viewed with a long-term lens the company's recent announcement should not come as a surprise. It has been in train for over a decade and is a logical next step for a business that is a global leader in ultrasound disinfection.

The timing may not please everyone, nor the revenue deferral, but that is reality. Business leaders make decisions, both pleasant and unpleasant, but hopefully always heading in the right direction.

There is no doubt this new revised deal with GEHC will create short term challenges, change always does. There is also the possibility GEHC may not renew or agree to new terms, but that is a bridge to cross in the future.

Either way, Nanosonics is a better business, in far greater control of its own business pursuits, whilst navigating an investment community that often hops on and hops off, but rarely buckles in for the whole ride. ***SFM***

JAMES HARDIE TRIP

First in two years

In early February we left the shores of Australia for the first time since late 2019. This was a welcome return to our global corporate engagement program, an important part of our process that we hope to normalise over 2022. While we were travelling, Australia announced it was reopening its borders. We see this as a critical step in repairing damage done during isolation.

Why Travel?

Travel always opens your eyes, forcing you to learn and adapt as you step outside regular routine and your comfort zone. These simple social behaviours of engagement are vastly more valuable to a long-term investor than the daily noise of market movements. In fact, travel even assists in driving irrelevant noise into the background. In essence travel and sitting next to humans helps you find the truth.

Our trip, at the height of the Omicron paranoia in Sydney, and the start of reporting season, was deliberately short. First stop being the Head Office of James Hardie (JHX) in Chicago Illinois and then onto the National Association of Home Builders (NAHB) International Builders Show (IBS) in Orlando Florida, billed as the national platform for launching new product and innovation.

It was a chance to learn about James Hardie's new architectural platform. A portfolio of five unique fibre cement products, two of which were launched at the show. It was also an opportunity to meet customers, builders, and competitors in the siding and wider housing construction space and better understand the departure of an outwardly successful CEO.

Observations

Coming from one of the world's most locked down nations, what became immediately apparent was the U.S. was anything but. From crowded airports and overloaded airplanes to booked out three and four-star hotels, capacity indoor basketball stadiums, and streams of cheerleaders (school sport) heading to theme parks. It was all happening and while masks prevailed mostly, this was not the case at the IBS.

"Burn the house down mentality"

No doubt a powerful business transformation has been underway at James Hardie over the last three years. Whether it was the start of a "good to great" transition remains to be seen. In any case, it has been interrupted in the short-term by a Board who believe it was moving off the rails.

All parties we interviewed, including the Chairman, acknowledged CEO Jack Truong was the right man for the job during that window of his tenure. According to Corporate Insight's surveys, Truong was the best performing CEO in the S&P ASX 50. This is a survey SFML participates in. He had received two years of perfect scores from the board across all KPIs.

Truong came to James Hardie with a mandate for change, and the board was clearly aware of his background.

Jack resigned from Electrolux in 2015 amidst an earnings hole, according to the press.

"What we can say is today's announcement is around restoring business results and accelerating our plans to ensure the business results are in line with expectations," McLoughlin told the Observer. *"It's obviously about making sure we have skills and capabilities in place to close the GE transaction,"* he said in reference to the company's plans to acquire General Electric's Louisville, Ky-based home appliance business, a \$3.3b deal announced last year.

An unnamed executive who has worked with Jack at multiple locations gave the following opinion. *"If you leave him too long, he will burn the house down as he did at Electrolux."* The board's main reason for exiting Truong was survey-based risk assessment of multiple departures in the upper management ranks. Post Truong's departure, this particular executive and the chair agreed the risk of further management departures had been mitigated.

Truong came to James Hardie with an imposing track record. He has graced the cover of a U.S. business magazine as one of the top three performing U.S. Executives, in company with Amazon's Jeff Bezos and Best Buys CEO Hubert Jolly. At Electrolux he was recognised as the public face of the company. Truong was clearly the opposite to the media shy outgoing CEO Louis Gries.

Gries knew, possibly better than any other, what made a fibre cement plant tick. As CEO he was an operator who could call the shots. Truong's strengths were perhaps his ability to find a solution when handed an incomplete puzzle. He could see what was needed and what was missing to solve for a complex set of outcomes.

From our early meetings with Truong, before he became CEO, he understood culture was important to SFML. Early on Truong told us that not all the key players were on the bus; he believed at the time that a cultural change was needed, which would be a challenge, so he introduced former colleagues into the management team and directors onto the board.

Vision and Execution

From the outset Truong was responsible for two things at James Hardie: vision and execution.

When Truong arrived at the helm, plants operated on a standalone basis. No *"rule book to play"* existed for operations, start-up plants or new lines. The captains' call had consistently failed, and it was time for change.

The vision was to embark on a three-part transformative journey to become a customer-led product business.

The execution, which culminated in a share price rise from $15 to $58 on the day Truong was terminated, is best depicted by three layers of transformation:

1. Transformation 1 - Plant
2. Transformation 2 - Selling
3. Transformation 3 - End User Demand

Transformation 1 - Plant

This involved the introduction of:

- Hardie Manufacturing Operating System (HMOS)
- Lean (Continuous Improvement)
- Cultural change across manufacturing including 4,000 FTEs

James Hardie required a world class manufacturing system across all 17 plants. The HMOS program, which predated Truong's tenure, was designed to systematise manufacturing. To achieve this, James Hardie needed to transition from a silo model to a fully integrated operation. A lean approach to manufacturing was also adopted for ongoing improvement of the system. Lean fails in up to 90% of implementation, with execution being the key to success. Sometimes you need to go close to burning the house down to get to a new starting point.

The HMOS and Lean programs needed to be designed for the plant operator, not for senior executives. These programs explicitly targeted the daily struggles of the operator. Previously, operators would dial the plant each day or period, based on issues they encountered at that plant. This occurred without management's knowledge.

Immediate improvements included reduced turnover in manufacturing teams. Plants across the group achieved gains from greater consistency of production run rates. This enabled resources to be optimised, which in turn reduced waste and delivered cost savings. The biggest win was from reduced variability in output.

Remove the variability

When Truong took the reins from Gries, direct reports provided up to 50 different manufacturing metrics. These metrics represented levers and were often adjusted daily across 10 domestic manufacturing plants, by operational managers dealing with local issues. The variability of outcomes translated to higher waste, increased downtime, and volatility in volumes.

Today, 17 plants across the globe are working from a consistent Lean and HMOS flow plan. This encompasses global best practice in safety and manufacturing, alongside continuous improvement. Individual plant operators are no longer pulling on these levers. The reduced variability has extended through the business. It enables management to focus on two key manufacturing metrics: square feet produced and yield.

The most significant change is the reduced variability and volatility of production outcomes, which has driven better forecasting.

Forecasting failed

In the period preceding Truong's tenure, James Hardie struggled to forecast. The variability in production was simply too high. Plant consistency is the bedrock for being able to forecast and deliver with confidence. James Hardie had upwards of 12 reporting quarters under CEO Louis Gries, where it missed guidance when Primary Demand Growth Primary Demand Growth (PDG) had flat lined or fallen.

In 2018 Gries, who loved being forthright with the market, acknowledged that he didn't know what the root cause of variability was.

Transformation 2 - Selling

A change to the traditional James Hardie selling (Push Pull) method required material culture change at both board and management levels. One former insider described this as a cultural struggle.

"Across the entire organisation customers were considered as rats and bottom feeders." They were seen as order takers adding no value to James Hardie. This was apparently also a view held by the board.

The fallout from this was that the company had *"limited vision of the end demand of its product. It was 1-week full stop."*

Attitudinal change for culture change

In the U.S., the top 20 builders want *"all of house from the same supplier"*. Consequently, James Hardie was a substitute supplier. However, this top 20 group only delivered 12% of James Hardie sales, so it was the wrong target to be focusing on.

With 80% of sales coming from its top 20 customers, not the U.S. top 20 builders, James Hardie simply needed to focus on making these customers more profitable, so they would sell more. As it turned out, James Hardie would achieve far greater market insight if they established partnerships with these builders, lumber yards, and wholesalers.

The key to increasing profitability for these customers was reducing their working capital, by delivering the right product from machine to customer on time. Management noted this in turn *"Spins up order insight"*. The success found here was responsible for driving the vision of the forward book demand from one week to eight weeks.

Better Forecasting

Forecasting had now taken its second leap forward. It could combine plant consistency and stability of volume, with eight weeks of vision of volume demand in the marketplace. This was the driver of business confidence, which has enabled the capital expenditure commitments that will drive future market share gains. The next element was direct demand.

Transformation 3 - End User Demand

It's not well understood if the journey to become a customer-led product business was originally driven by management or the board.

What is certain is the creation of direct end user demand (Christine – essentially a consumer brand building exercise that enables marketing direct to the homeowner) required both a marketing and a cultural change.

Direct to end consumer needs a *"home is my Castle or sanctuary attitude"* held by every female home maker. Christine knows the type of house she wants. Her key focus is the platform of products she can choose from to achieve the look she wants. A panel does not resonate with Christine, where a product platform is attractive. It assists visualisation of a look.

Galvanising this demand is the driver that will deliver scale and leverage for the next three years. Significant capital expenditure is required for execution of the vision.

A higher value product mix is key here, hence the focus on these type of products rather than a panel. James Hardie can overcome the cyclical nature of the building industry if it can achieve consumer demand pull that drives product demand.

According to the company the big picture opportunity, which enables them to rise above the cycle, is the Repair & Remodel (R&R) market of 44m homes that are currently more than 40 years old. Taking a conservative view, if each year 5% of these homes undertook a repair and remodel, 2m homes would require products, double the U.S. annual new build opportunity.

End user demand is critical to the next phase of the journey, being the execution of the large capital expenditure program outlined.

Cookie Cutter Capital

Manufacturing rollouts are to follow a *"Cookie Cutter"* approach. This is critical to the future success of capital deployment. The confidence to deliver this larger capital program is derived from plant volume consistency achieved by HMOS and Lean. It's all about the ability to confidently forecast.

Plant layout, sheet lines and delivery bays can now be standardised to the cookie cutter or modular approach similar to that undertaken by CSL, whose plants can look identical on opposite sides of the globe.

Consistent production volumes, combined with an 8-week order book vision is powerful. The outcome is that James Hardie can fulfil larger volumes of higher value product to a partner’s market, without the customer tying up working capital. In turn, the customer becomes more profitable, taking margin on the higher value and higher volume, with a lower invested capital base.

At scale, this is leveraging higher margin and delivering greater price power.

The Chairman

Chairman Michael Hammes sees himself as the long-term custodian of James Hardie. He also declares his time is coming to an end. He was elected to a three-year term, but says he won’t stay around for the full duration. Initially planned to leave by August 2022, Hammes is now likely to stay on as Executive Chair for an additional three months, until sometime in November 2022. Clearly Chairperson succession will follow hot on the heels of the appointment of a new CEO.

The Board

In early February, Hammes did not anticipate any further resignations from the board. This was proved wrong however, with the unexpected and early departure of Dean Seavers. When we met Hammes he could see the need to add three new directors, which we can now safely assume has increased to four. This includes the clear need for a director who resides in Australia. Post his retirement, Hammes believes a board of nine to 10 would be a reasonable outcome.

At the time Hammes was very confident he could appoint a capable Chairperson from the current board. One year ago he did not believe this was the case. That would suggest the new Chairperson would come from the recent appointments of Susan B Rowland, Dean Seavers (now resigned) and Nigel Stein. With the latter two being more qualified for the role.

Mr Seavers, who departed in March, had some experience as Chairperson and Director of Pacific Gas & Electric Utility since 2020. Mr Stein has extensive experience in the global automotive and manufacturing sectors. He currently serves as Chairperson of Inchcape PLC, an automotive distribution, retail and financing company, a position he has held since May 2018. Ms Rowland does not have experience in the role of Chairperson, making her the less likely appointment. Obviously Seavers is now out of the running.

Hammes states his role as an Executive Chairman has changed so much so that half his working hours are devoted to James Hardie. He is in daily contact with multiple members of the management team; the current custodians of the business.

Board-led Strategy

During our discussion, Hammes clearly stated that James Hardie’s three-part transition is a board-led strategy executed by Jack Truong, rather than a strategy created by Truong. This is at odds with our previous discussions with Truong, but was confirmed by management.

In Hammes words, the former CEO Gries took James Hardie from nothing, under the right strategy of engaging the dealers and developers. Gries knew how to run a plant, but when he had multiple pots, he had boil overs. There was nothing visionary required. The board determined the need to go after the R&R, and it knew Gries was not capable of delivering on this.

At that time, the board believed they had the global best fibre cement product offering, but also understood James Hardie did not operate at a world class manufacturing standard. Hammes credits Danaher Corporation, former Executive Vice President, and James Hardie Director Steve Simms for making this well-known at the board level.

Gries didn’t know how to deliver Lean. There was a need for silos to be broken down so all pieces could work together. Hammes is unapologetic in stating that the strategy to get there was created by the board and delivered by Jack Truong.

Jack Truong was the right person to deliver the strategy, but he did not invent it. The Hardie Advantage predated HMOS, Lean was not created by Truong nor is he the only person who could deliver it.

Today, the strategy titled “Christine” which is essentially a consumer brand building exercise that enables marketing direct to the homeowner, is a board strategy embedded in the business, rather than being the brainchild of a former CEO.

New CEO

Hammes hopes to have the CEO role filled by August 2022. This will be the fourth CEO appointment of Hammes' career. He believes he is well placed to complete the task successfully. He was somewhat dismissive of SFML's view that you don't know if you have the right CEO until 12-18 months into the role.

In discussing the custodians of business today, the Chair referred to Sean Gadd as the custodian of North America, an important role. While Ryan Kilcullen is seen as the custodian of LEAN and Global Operations. CFO Jason Miele is a strong communicator who could well lead this business if he had a stronger support structure, possibly including a Chief Operating Officer.

Collectively these three mangers present a formidable team, with three important elements covered. Each has a clear passion for James Hardie; they believe they can run the world's best fibre cement business and they are driving strong and improving financial metrics. Jointly they represent over 40 years of company experience.

We believe an internal appointment remains a live option, but little was given away by Hammes here. We note that companies that make the "good to great" transition more often appoint management from within.

Hammes believes an external candidate can be introduced, and that this individual would see very good opportunities as an incoming CEO. Hammes sees scope for a new CEO to be creative and improve on a strategy which can be evolved, particularly in *"getting after Christine"*, the direct to customer opportunity.

According to Hammes an external appointment who is more mature, will work. Interestingly, the Chair argues Jack Truong was an external appointment who worked.

"For a bad situation (forced CEO loss) this is good timing, we don't need anything transformational, we don't need a new strategy and we have a talented low ego management team in place."

Threat of Leavers

According to the Chair the potential leavers were widespread, and this was the last straw for the board. Electrolux people wanted to leave, and Hardies people wanted to leave.

Personal discussions with Truong in relation to his behaviour were undertaken by Harold Wiens, Human Resources, and the chair himself *"including having him over to dinner for Uncle type chats"*.

According to Hammes, communication with Truong did not break down, *"there was simply no reaction and no response"*.

During the termination process undertaken by the board, James Hardie Director Dr Mo Nozari was not consulted. This decision was based on legal advice taken by the board.

We assume this was due to his relationship with Truong and the fact that Dr Nozari was planning to resign in February 2022. We understand Nozari departed on good terms.

Hammes believes the significant risk of leavers has been averted by the actions of the board. This was verified by former Electrolux and longer serving James Hardie managers we interviewed.

Further to this, the feedback we received was that the management team will likely remain in place, regardless of an internal or external appointment of a new CEO.

6 months before The Departure – a view from Management.

The Top 50 executives had had enough, and potential leavers were growing. General turnover increased from 12% to 17%. In short, *"culture had got notably worse."*

Jack Truong displayed a *"God complex"*. The more success the business units generated, the more he dispelled the views of the leadership team.

"The problem was worse the closer you got to the direct report level. And the direct reports got badly singed as they were closer to the Sun. At this point Jack Truong could not be challenged or questioned by senior management. Several breaches of the James Hardie code of conduct were referred to the board."

"The board acted at the right time and just in nick of time."

"Culture is way better than 6 months ago."

Culture

Culture is important. Essentially it is about the people who control, govern, and direct the pursuit of profits. It is the principles that they adopt in life and business and the way they treat the various stakeholders involved.

Things go wrong in business with good culture as they do in business with poor culture. However, over the longer term the former is more sustainable than the latter.

The culture of a business is made up of many individuals, each with their own interpretation or set of behaviours. In the best companies in the world there are common attributes embedded in the business, rather than the trait of a leader or manager. This includes: passion, discipline, focus, the freedom to innovate, iterate, test and fail, and have the resilience to keep going.

These companies become great by consistently applying these qualities in the pursuit of attaining global leadership based on sustainable economics.

In the case of James Hardie, and in particular the termination of CEO Jack Truong, we initially conceded to clients that we got this wrong.

We had been backers of Truong and the cultural shift he brought to the high performing team within.

After a flurry of one-on-one interviews across the board and management in Chicago, and staff and customers in Orlando, one thing became clear; we were not wrong in backing Truong.

He was the right man at the right time to lead change at James Hardie. Driven and focused, and with a track record in consumer electronics at 3M and Electrolux, he ushered in a more disciplined culture. The roots were in place for HMOS, Lean, Push Pull and direct selling to thrive. Perhaps the resilience was already in place when you consider the company's exceptional financial performance was built with only 65% of free cash flow, due to the asbestos liability it carries.

In three years, the management team led by this former CEO achieved a multi-faceted transformation. Truong's legacy is not three lost years. It is three years of incremental gain that has the business positioned to benefit from scale in manufacturing and on a path to achieving scale in marketing as they pursue a consumer-led strategy.

The future will also see James Hardie benefit from innovation in the form of a significantly differentiated and award-winning product platform that is only set to expand.

This platform is the foundation of a price / mix strategy, where lower value production is substituted for higher value colour and architectural panels. The platform has substantially increased the total addressable market. Fibre cement in the form of board, plank, panel, and trim historically competed against wood, wood look and vinyl products. Today, the market includes stucco, stone, and in time will include a brick look and corrugated iron type product. Both can be viewed, by invite only, at James Hardie's new Downtown Chicago headquarters.

Culture today

Manufacturing today is better than three years ago, culture on the manufacturing floor has improved. Safety, turnover, fibre cement square feet produced, and yield are the best proxies here.

Cross functional connection exists across the business and has replaced the old silos. Teams work together more closely. A proxy here is the rate of continuous improvement.

CFO Jason Miele now works in a closer relationship with President of North America Sean Gadd, and Senior Vice President of Global Operations Ryan Kilcullen. They describe themselves as a humble team working globally with an entrepreneurial mindset.

Consensus is that this team will remain if an external CEO is appointed. SFML notes that each of these managers have been recently promoted, noting the CFO has been in this role for two years. Any lift out from this team creates a senior role that needs to be filled.

The culture today is hard driving, with a *"Do the impossible"* mindset. The target is to deliver strong results each quarter with pride.

Business

The business is a clear leader in fibre cement, the best indicator here are:

- Is growth above market
- The ability to take price
- The success of the price / mix strategy
- The deepened relations with top 20 customers
- Platform innovation
- Cookie cutter approach to US$1.6b–$1.8b capacity expansion
- Direct fibre cement competitors, Allura and Nichiha, are not growing capacity
- LP has supply chain issues

Balance sheet

The James Hardie balance sheet is in good health thanks to five periods of strengthening cash flows.

When a balance sheet is in rude health a business has optionality. James Hardie is in this position with net debt trending below 1.0x net debt to EBITDA and cash flow trending up because of scale. It's an enviable position.

James Hardie offers an additional unique upside from the declining cashflow commitments to the Asbestos Injuries Compensation Fund Limited (AICF) funding commitments, identified by the company via an actuarial process.

This quarter they announced that contributions to the AICF will fall materially, from 35% of free cash flow to 15%-20% of cash flow in 2023 and 2024. This is set to reduce further as cash flow increases and the AICF actuarial forecasts are set to fall even more.

A morbid take is that as sufferers of mesothelioma pass, the compensation required falls. But the reality is that as James Hardie cash flow swells, the proportional contribution to the AICF falls and at a point, determined by the actuarial curve, the pipeline of liability is funded.

Successors

The question that remains is, who is best placed to run this business for the next three to five years? It's a hard question to answer, but we are now convinced an external candidate would be well accepted by the current management team.

There are three key internal leaders each with more than 14 years' experience at James Hardie. Jason Miele was appointed CFO by outgoing CEO Truong. Sean Gadd was promoted to President of North America in January; from all accounts a very popular promotion.

Ryan Kilcullen was also promoted in January to Vice President of Global Operations, including supply chain procurement manufacturing and Lean. Kilcullen, an Australian, is quietly spoken and has the details at hand. He will be responsible for leading the $1.6b to $1.8b capital expenditure program out to 2026. While extremely capable, we expect the internal candidates under consideration would be either Gadd or Miele.

We put the question to both and the answers were humble. Gadd was touted as CEO in 2018 before Truong took the reins. Back then (Texas visit 2018) he candidly told us he was probably not ready. Today, while more experienced he would lean heavily on Miele's financial skill sets and his confidence in communicating with financial markets. Likewise, Miele's appointment to CEO would require some structural change, including the likes of an experienced Chief Operating Officer and of course an experienced CFO. Jointly they could manage, but this is probably not optimal as new hires or internal promotions to the key roles of President of U.S. and CFO would be required.

So, we circle back to our observation that this deeply experienced team is humble. We believe these executives are in the right roles to execute a strategy they have jointly created and believe in, not to mention that any promotion to CEO from this group of three creates another hole, which may be even more disruptive to the execution needed. We expect that these three executives will remain in place if an external CEO is appointed.

Remuneration of these executives is competitive against the peer group, and the STI and LTI are well received. This is a key point, as we don't believe any of the key executives are looking over their shoulders at better offers.

Interestingly, key management introduced by Truong remain in place and they are energised. Again, these individuals communicate that Truong, a key architect of the three-year transformation, was the right man at the right time, while a new leader will be well placed to continue to drive execution of the future strategies.

New appointments in addition to January promotions

Recent appointments include:

- Chief Technology Officer Dr Joe Liu
    - 26 years with 3M Company
- Global Chief Information Officer Mr James Johnson
    - Carpenter Technology
    - 25 years IT experience
- Head of ESG Jill Kolling
    - Former Cargill Head of ESG
    - Significant appointment with experience

In the quarter the stock has been sold down, in line with U.S. home builders. If the market is overlooking anything it might be that the following bar chart, Figure 20 is not resonating.

A 30%-33% EBIT margin is being delivered with 1% contribution from the innovation platform. At the same time, record high prices in pulp and freight are being absorbed. The future state where innovation has meaningful contribution will see margin improvement.

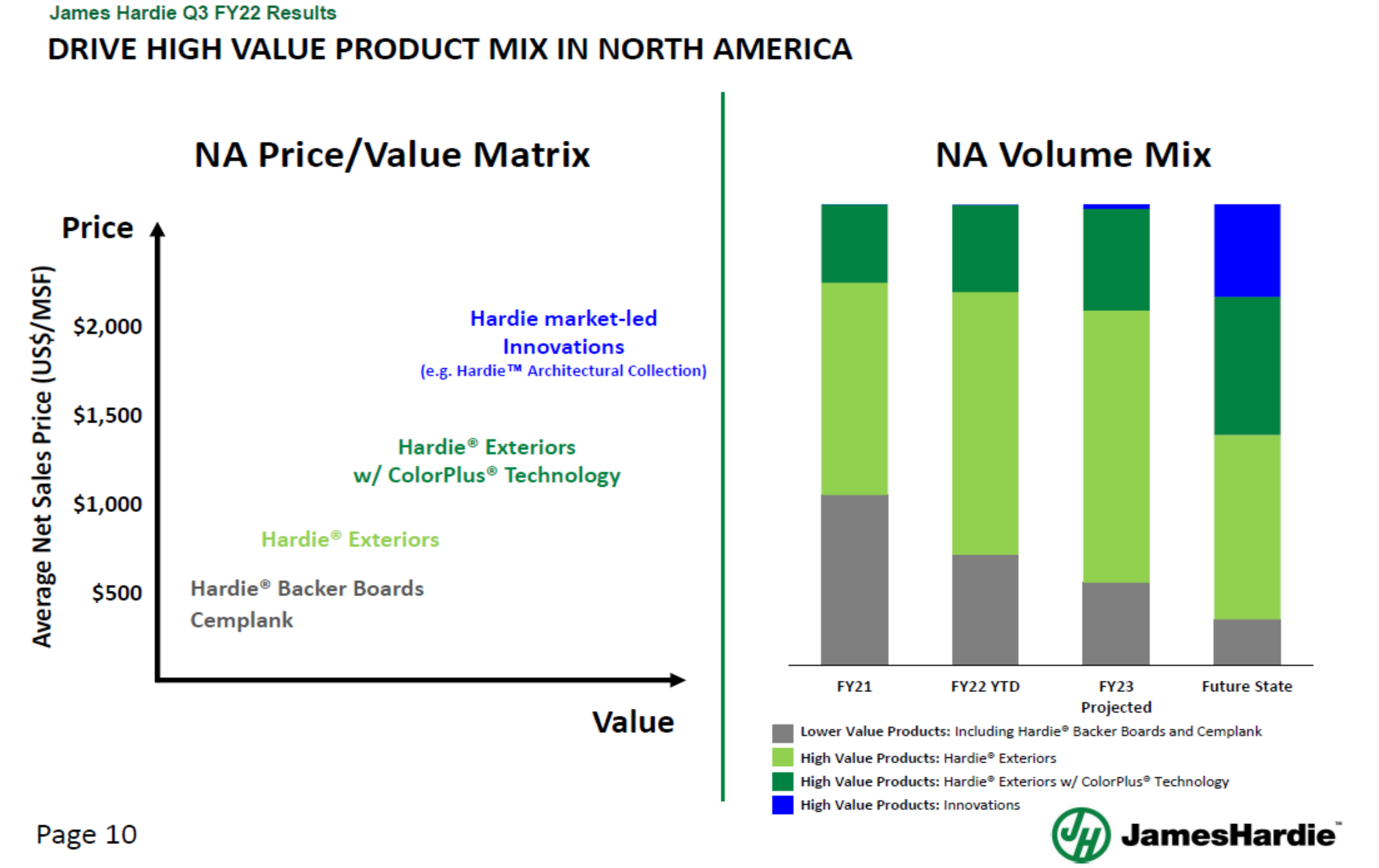
International Builder Show (IBS), Orlando February 2022

So, what does innovation look like?

In Orlando we were able to see first hand James Hardie's new architectural platform against the competitor set. It is differentiated and we believe a superior offer. The pictures below tell some of the story.

The release for the show, while impressive, was only an early glimpse. In the days before the IBS show, we visited James Hardie's new headquarters in downtown Chicago. The offices here, and in particular the bathrooms, display unique products that we have not seen before in any competitor set. On display, if you look carefully, is a fibre cement take on an old local favourite in corrugated iron, and another brick look, that actually looked like bricks. No photos permitted. ***SFM***

Figure 20: What is the market missing?



Source: James Hardie Q3 FY22 Management Presentation

Gallery

Figure 21: James Hardie Booth

Source: SFML U.S. Trip

Figure 23: New - Sea Grass Horizontal

Source: SFML U.S. Trip

Figure 22: New – Textured Clay

Source: SFML U.S. Trip

Figure 24: New – Smooth Sand

Source: SFML U.S. Trip

Figure 25: New – Smooth Sand Grooved

Source: SFML U.S. Trip

Figure 26: Alternative – Vinyl product

Source: SFML U.S. Trip

Figure 27: Alternative – Vinyl product

Source: SFML U.S. Trip

Figure 28: Wood look competitor

Source: SFML U.S. Trip

ARISTOCRAT – SUSTAINABILITY DISCLOSURES 2021

Overview

Leading global gaming content and technology company, Aristocrat Leisure published its 2021 Sustainability Disclosures in November. At an impressive 91 pages, up from 35 in the prior year, the report showcases the sustainability achievements and efforts during the year along with key areas for future focus.

For business, sustainability is not static. It is a process of continual learning and development, which progresses with changing society and stakeholder expectations. CEO Trevor Croker states *"We acknowledge that we're on a journey, and have plenty of scope to grow, and do more over time."*

Materiality Assessment

During 2021, Aristocrat conducted a comprehensive review of key Environmental, Social and Governance (ESG) issues to gain a better understanding of the impact on the business and the importance to stakeholders.

The review sought feedback from internal and external stakeholders including customers, suppliers, investors, regulators and senior management. Inputs were also drawn from external sustainability frameworks, such as the Sustainability Accounting Standards Board (SASB) and the United Nations' Sustainable Development Goals (SDGs).

SASB Standards provides industry-specific guidance that helps businesses in disclosing financially material sustainability information. For the Casino and Gaming industry, SASB identifies the following four issues as being materially important: Energy Management, Customer Welfare (Responsible Gaming), Employee Health and Safety, and Business Ethics.

The SDGs, on the other hand, are a collection of 17 interlinked global sustainability goals set by the United Nations in 2015, with the aim to be achieved by 2030. Aristocrat have aligned themselves with 11 of the goals including Gender Equality, Reduced Inequalities and Climate Action.

Off the back of the materiality assessment, Aristocrat has set out 10 key priorities, as shown in Figure 29. They can be categorised under three core pillars: Business Operations, Product Responsibility, and People & Community.

We provide further detail on each below.

Figure 29: Aristocrat Materiality Matrix

Source: Aristocrat Sustainability Disclosures 2021

Business Operations

Governance

"Strong governance is one of Aristocrat's most important commitments."

Corporate Governance is a key area of focus and ranked as the most important issue for stakeholders. Aristocrat are set on being a clear leader amongst its peers in this space. The Aristocrat board is strong. Made up of seven directors, six of whom are independent, there is a breadth of skills and diversity, as noted in the company's 2021 Corporate Governance Statement.

Further adding to the breadth and depth, in March 2021 the board appointed A.G. Burnett as an independent member of the Board Regulatory and Compliance Committee (RCC). Mr. Burnett is highly regarded in the gaming industry, having served as Chair of the Nevada Gaming Control Board from 2012 to 2017 and provides significant strength to the RCC.

Compliance training is an important tool in the group's overall corporate governance function. During the year, 94% of all employees completed mandatory training with the remaining 6% attributed to headcount changes. New training modules introduced in 2021 include: Data Security and Privacy, Social Media, Code of Conduct and Insider Trading.

Climate

"As a global organisation, we're taking responsibility to help address climate change through initiatives that support the transition to a low carbon and climate resilient economy."

Pleasingly in 2021, Aristocrat formally signed a commitment with the Science Based Target Initiative (SBTi) to set goals to reduce greenhouse gas emissions across the business. This is an important step forward for the company, with the reduction targets to be developed within 24 months.

The SBTi is a global collaboration between the Carbon Disclosure Project (CDP), the United Nations Global Compact (UNGC), World Resources Institute (WRI) and the Worldwide Fund for Nature (WWF). The group supports businesses to set emissions reduction targets in line with climate science. Currently, there are over 2,860 companies globally committed to taking action, 1,300 of those with approved targets.

Figure 30: Three-year approach to Climate Disclosures

Source: Aristocrat Sustainability Disclosures 2021

During 2022, Aristocrat will introduce an Environmental Management System (EMS) platform to significantly enhance the company's ability to capture and report emissions. The initial focus in 2022 will be on scope 1 and 2 baseline emissions data across all global assets, with the intention to expand to other areas in the future, including water use, recycling and responsible sourcing.

Aristocrat has adopted a three-year phased approach to expand climate-related disclosures, in line with recommendations by the Taskforce on Climate-Related Financial Disclosures (TCFD), as shown in Figure 30. In 2021, the business completed an assessment of climate risks and opportunities concluding that residual risks from the impact of climate change are currently not at a level that would significantly impact the business.

Circular Economy

A circular economy model aims to eliminate waste and pollution, keep products and materials in use, and regenerate natural systems by reusing, repurposing, remanufacturing and recycling goods as they reach their end of life. For Aristocrat, this means taking into account what their products are made of, where they are made, as well as the expected lifespan, to pursue sustainability and efficiency wherever possible.

Key focus areas in this space comprise of innovative sustainable product design, waste management and reuse or recycling of materials. During the year, the company achieved a 97% recycling performance at their Australian Integration Centre in Sydney. This was a substantial improvement from 50% in 2016.

Product Responsibility

Responsible Gameplay

Along with governance, responsible gameplay (RG) is a key priority for the business. As stated in the SASB Materiality Index, *"the gaming industry faces a negative perception that is often related to pathological gambling."* This demonstrates the importance for participants to put in place industry best practices to reduce the impacts of problem gambling and overcome the social stigma.

Aristocrat are committed to being a responsible gameplay leader. We believe they are achieving this. One notable example during the period is the launch of new self-help materials and self-ban policies for free-to-play social casino games across Pixel United, the group's mobile-first games division. This saw an uplift in click-through rates to RG information pages on the Big Fish and Product Madness games, increasing 10-fold and 2-fold respectively.

In addition, the following initiatives and achievements were made in the year:

1. **RG Governance** – New requirements for the Board to complete RG training; the formation of a Gaming RG Working Group; and a refresh of the Responsible Gameplay Policy.
2. **RG Player Education, Information and Tools** – Expansion of player information videos, which are designed to educate players on how gaming (slot) machines work.
3. **RG Employee Awareness and Training** – Mandatory RG training for employees every two years; development of an employee portal containing updated RG information and resources; and ongoing support of the American Gaming Association's Responsible Gaming Education Week.
4. **Pixel United** – Launch of a number of RG initiatives. This includes the creation of a RG Resource Centre; proactive communication to players to build awareness; and pop up messaging within games promoting RG resources.
5. **Aristocrat Gaming** – Development and testing of Flexiplay, which allows gaming players to manage their gameplay responsibly; voluntary pre-commitment functionality in gaming machines currently installed in over 400 venues in New South Wales (NSW) and the Australian Capital Territory (ACT); and Aristocrat's PRIME Mobile gaming digital wallet, set to be trialed in NSW.

Data Security and Privacy

With a growing digital gaming business, cyber security and data privacy are critical and pose a significant business risk if not adequately executed. To bolster data security and privacy, the group adopted Global Privacy Principles (GPPs) designed to provide an environment where personal data is processed in a fair, lawful and responsible manner.

Additionally, as part of Aristocrat's extensive ongoing education program, all employees are required to undertake monthly cybersecurity training.

Responsible Sourcing

Responsible sourcing or supply chain management is a commitment to take into account environment, ethical and social considerations, including modern slavery, in dealings with suppliers and customers.

During 2021, Aristocrat was awarded Made in Macau certification in recognition of the significant value their manufacturing facility added in Macau. Additionally, the group undertook a comprehensive Supplier Sustainability Assessment with their top 93 suppliers, which covered a range of sustainability areas and identified suppliers who are meeting best practice. Figure 31 below presents a summary of the results.

Further, key suppliers were required to complete a Modern Slavery Survey in which no material concerns were identified. To further improve awareness internally, both the Board and employees participated in Modern Slavery training in 2021.

Figure 31: Supplier Sustainability Assessment results

Source: Aristocrat Sustainability Disclosures 2021

Figure 32: Gender Diversity Targets

Source: Aristocrat Sustainability Disclosures 2021

People & Community

Aristocrat appreciates the importance of attracting and retaining talent as a key enabler of business success. In recognition of their efforts, the group was certified as a Great Place to Work (GPTW) for the first time in Australia and North America, and for the sixth time in India. We believe this speaks volumes of the culture within the organisation.

Talent

We believe culture and ESG are intertwined. We consider them both integral to our assessment of a business. Companies with superior cultural behaviours are better disposed to responsible management of ESG issues.

During the year, Aristocrat sought feedback from employees through frequent Power Pulse surveys. Participation sat at an impressive 91%, 6% higher than industry average. The results are just as positive, with an overall aggregate engagement score of 8.4 out of 10, 0.3 higher than the benchmark.

A key contributor to retaining and attracting talent is the group's training and development programs. Building on from their existing leadership program, a Global Women's Leadership Development program will be launched in 2022.

Inclusion

Diversity is another key priority for the business. The main focus areas are increasing the representation of women, creating an inclusive culture, and extending their diversity focus beyond gender. To bring further alignment across the group, diversity and inclusion performance objectives have been introduced for executive leaders in 2022.

There are currently 12 employee-led impact groups (EIGs) globally, which enable employees to participate and collaborate to drive change on issues they are passionate about. As an example, GAMER is an EIG dedicated to support employees who identify as Black / African American / BIPOC (Black, Indigenous, People of Colour), which along with the launch of GAMER magazine, aims to enhance the culture of inclusion.

In 2021, the group met their 30% gender diversity targets, as shown in Figure 32, with 42.8% female representation at the board level and 32% overall within the Aristocrat group. In 2022, the targets have been lifted to 40% board representation and 35% group wide.

Wellbeing

The COVID-19 pandemic has brought to the fore the importance of fostering a supportive work environment, which enhances employee wellbeing and provides strategies to minimise stress and manage mental health. Key wellbeing actions taken during 2021 include providing remote working assistance, forming local Crisis Management Teams, launch of a mental health support learning module, and implementation of a new incident management process.

Aristocrat's dedication to employee welfare was also on display with their recent update on the situation in Ukraine. With over 1,000 employees normally located in Ukraine, the company made the following comment in its 9 March 2022 update to the ASX, "*To date, Aristocrat has assisted over two-thirds of our Ukraine based employees and their families to voluntarily relocate, either internationally or to safer locations within the country. A special task force has been set up in Poland to assist staff and families on the ground. Aristocrat is providing transport, visas and legal help, housing and settling-in assistance for relocated staff.*"

Community

During 2021, 350 employees participated in volunteering activities. This included, but is not limited to, Martin Luther King Jr Day in North America, Cerebral Palsy Alliance in Australia and Kupyansk Specialized School in Ukraine. In addition, over $1m in donations were granted to 65 charities.

Summary

We recognise the journey Aristocrat is undertaking and we look forward to seeing how future initiatives play out. In particular, the group's undertaking to set science-based targets and efforts to build on their leadership positions in Governance and Responsible Gaming. Aristocrat's endeavors in 2021 highlight the company's strong commitment to sustainability and a close alignment with their four core values: It's All About the Player, Talent Unleashed, Collective Brilliance, and Good Business, Good Citizen. ***SFM***

COMPANY ENGAGEMENTS – MARCH 2022 QUARTER

Date	Company	Description
7-Jan	RMD	ResMed GS U.S. Annual Healthcare Conference
7-Jan	MP1	Megaport Citi AppsEconomy Conference
11-Jan	RMD	ResMed JPM Healthcare Conference
14-Jan	JHX	James Hardie Industries Management Meeting
20-Jan	EVRI.NYSE	Everi Holdings JPM Management Meeting
27-Jan	JIN	Jumbo Interactive StarVale Acquisition Conference Call
28-Jan	RMD	ResMed 2Q22 Results Conference Call
28-Jan	MP1	Megaport UBS Industry Insight Call
28-Jan	MP1	Megaport Extraordinary General Meeting
28-Jan	RMD	ResMed Barrenjoey Management Meeting
3-Feb	ALL	Aristocrat Leisure Investor Update Conference Call
3-Feb	NEA	Nearmap Investor Product Demonstration
4-Feb	REA	REA Group HY22 Results Conference Call
7-Feb	JHX	James Hardie Industries 3Q22 Results Conference Call
7-Feb	JHX	James Hardie Industries Barrenjoey Management Meeting
7-Feb	JHX	James Hardie Industries Management Meeting
7-Feb	REA	REA Group GS Management Meeting
8-Feb	NAN	Nanosonics Investor Update Conference Call
8-Feb	TNE	TechnologyOne Morgans Management Meeting
9-Feb	CPU	Computershare HY22 Results Conference Call
9-Feb	MP1	Megaport HY22 Results Conference Call
9-Feb	CPU	Computershare Citi Management Meeting
9-Feb	MP1	Megaport Morgans Management Meeting
9-Feb	MP1	Megaport UBS Management Meeting
10-Feb	CPU	Computershare JPM Management Meeting
10-Feb	NAN	Nanosonics Barrenjoey Management Meeting
10-Feb	MP1	Megaport Citi Management Meeting
10-Feb	CPU	Computershare Management Meeting
11-Feb	MP1	Megaport GS Management Meeting
11-Feb	MP1	Megaport Barrenjoey Management Meeting
11-Feb	CPU	Computershare UBS Management Meeting
14-Feb	MP1	Megaport Macquarie Management Meeting
14-Feb	CAR	carsales.com HY22 Results Conference Call
14-Feb	CAR	carsales.com Barrenjoey Management Meeting
15-Feb	CAR	carsales.com GS Management Meeting
15-Feb	SEK	SEEK 1H22 Results Conference Call
15-Feb	MP1	Megaport JPM Management Meeting
15-Feb	SEK	SEEK Barrenjoey Management Meeting
15-Feb	CAR	carsales.com UBS Management Meeting
15-Feb	CAR	carsales.com Management Meeting

Date	Company	Description
15-Feb	CAR	carsales.com Macquarie Management Meeting
16-Feb	BRG	Breville HY22 Results Conference Call
16-Feb	NEA	Nearmap HY22 Results Conference Call
16-Feb	CSL	CSL HY22 Results Conference Call
16-Feb	BRG	Breville UBS Management Meeting
16-Feb	BRG	Breville Macquarie Management Meeting
16-Feb	NEA	Nearmap Citi Management Meeting
17-Feb	PME	Pro Medicus Barrenjoey Management Meeting
17-Feb	IRE	Iress FY21 Results Conference Call
17-Feb	CSL	CSL Jarden Management Meeting
17-Feb	BRG	Breville JPM Management Meeting
17-Feb	NEA	Nearmap Macquarie Management Meeting
17-Feb	NEA	Nearmap Management Meeting
17-Feb	BRG	Breville Barrenjoey Management Meeting
18-Feb	SEK	SEEK Management Meeting
18-Feb	IRE	Iress Management Meeting
21-Feb	RWC	Reliance Worldwide HY22 Results Conference Call
21-Feb	ALU	Altium HY22 Results Conference Call
21-Feb	NHF	NIB Holdings HY22 Results Conference Call
21-Feb	IRE	Iress JPM Management Meeting
22-Feb	ALU	Altium Management Meeting
22-Feb	CSL	CSL Management Meeting
22-Feb	ALU	Altium Barrenjoey Management Meeting
22-Feb	JIN	Jumbo Interactive HY22 Results Conference Call
22-Feb	COH	Cochlear HY22 Results Conference Call
22-Feb	ARB	ARB Corporation HY22 Results Conference Call
22-Feb	NAN	Nanosonics HY22 Results Conference Call
22-Feb	IRE	Iress Barrenjoey Management Meeting
22-Feb	NAN	Nanosonics Barrenjoey Management Meeting
22-Feb	BRG	Breville HY22 Results Conference Call
23-Feb	DMP	Domino's Pizza Enterprises HY22 Results Conference Call
23-Feb	COH	Cochlear Barrenjoey Management Meeting
23-Feb	WTC	Wisetech Global HY22 Results Conference Call
23-Feb	TNE	TechnologyOne Annual General Meeting
23-Feb	NAN	Nanosonics Management Meeting
23-Feb	DMP	Domino's Pizza Enterprises Citi Management Meeting
23-Feb	JIN	Jumbo Interactive Barrenjoey Management Meeting
23-Feb	COH	Cochlear Management Meeting
23-Feb	IRE	Iress UBS Management Meeting
23-Feb	ARB	ARB Corporation UBS Management Meeting
24-Feb	RMD	ResMed Citi Healthcare Conference
24-Feb	JIN	Jumbo Interactive GS Management Meeting
24-Feb	IFL	IOOF Holdings HY22 Results Conference Call
24-Feb	BKL	Blackmores HY22 Results Conference Call

Date	Company	Description
24-Feb	FLT	Flight Centre Travel Group HY22 Results Conference Call
24-Feb	ALL	Aristocrat Leisure Annual General Meeting
24-Feb	APX	Appen FY21 Results Conference Call
24-Feb	FLT	Flight Centre Travel Group UBS Management Meeting
24-Feb	DMP	Domino's Pizza Enterprises Management Meeting
24-Feb	FCL	FINEOS Corporation Holdings HY22 Results Conference Call
25-Feb	FLT	Flight Centre Travel Group Barrenjoey Management Meeting
25-Feb	IFM	Infomedia HY22 Results Conference Call
25-Feb	REH	Reece HY22 Results Conference Call
25-Feb	MVP	Medical Developments International HY22 Results Conference Call
25-Feb	BKL	Blackmores UBS Management Meeting
25-Feb	JIN	Jumbo Interactive Management Meeting
25-Feb	WTC	Wisetech Global Citi Management Meeting
25-Feb	PNV	PolyNovo HY22 Results Conference Call
25-Feb	NAN	Nanosonics UBS Management Meeting
25-Feb	BKL	Blackmores Management Meeting
28-Feb	REH	Reece Management Meeting
28-Feb	PNV	PolyNovo UBS Management Meeting
28-Feb	APX	Appen Barrenjoey Management Meeting
28-Feb	IFM	Infomedia Management Meeting
28-Feb	IFL	IOOF Holdings Barrenjoey Management Meeting
28-Feb	ARB	ARB Corporation Management Meeting
28-Feb	APX	Appen Citi Management Meeting
28-Feb	FCL	FINEOS Corporation Holdings Macquarie Management Meeting
28-Feb	FCL	FINEOS Corporation Holdings Management Meeting
1-Mar	RWC	Reliance Worldwide Management Meeting
1-Mar	APX	Appen Management Meeting
1-Mar	REA	REA Group Management Meeting
1-Mar	FLT	Flight Centre Travel Group Management Meeting
2-Mar	WTC	Wisetech Global Management Meeting
2-Mar	APX	Appen Barrenjoey Management Meeting
2-Mar	FCL	FINEOS Corporation Holdings Citi Management Meeting
3-Mar	MVP	Medical Developments International U.S. FDA Clinical Hold Lifted Investor Call
3-Mar	DMP	Domino's Pizza Enterprises Barrenjoey Management Meeting
3-Mar	MP1	Megaport Management Meeting
3-Mar	IFL	IOOF Holdings Management Meeting
3-Mar	NHF	NIB Holdings Barrenjoey Management Meeting
4-Mar	NHF	NIB Holdings Management Meeting
4-Mar	IFM	Infomedia Management Meeting
7-Mar	MVP	Medical Developments International Taylor Collison Management Meeting
7-Mar	IFM	Infomedia UBS Management Meeting
7-Mar	MVP	Medical Developments International Management Meeting

Date	Company	Description
7-Mar	PNV	PolyNovo Management Meeting
8-Mar	FPH	Fisher & Paykel Healthcare JPM Management Meeting
8-Mar	VHT	Volpara Health Technologies GS Healthcare IT Series
9-Mar	ALL	Aristocrat Leisure Virtual Investor Roundtable
10-Mar	RMD	ResMed UBS Industry Insight Call
11-Mar	BRG	Breville Management Meeting
14-Mar	ALL	Aristocrat Leisure Management Meeting
14-Mar	APX	Appen Management Meeting
15-Mar	JHX	James Hardie Industries Management Meeting
15-Mar	DMP	Domino's Pizza Enterprises UBS Industry Insight Call
16-Mar	RMD	ResMed Oppenheimer Annual Healthcare Conference
16-Mar	OFX	OFX Group Investor Day
16-Mar	FLT	Flight Centre Travel Group Management Meeting
18-Mar	ARB	ARB Corporation Taylor Collison Industry Insight Call
21-Mar	BKL	Blackmores Macquarie Management Meeting
23-Mar	RMD	ResMed KeyBanc Capital Markets' Life Sciences & MedTech Investor Forum
24-Mar	RMD	ResMed UBS Industry Insight Call
25-Mar	CSL	CSL Citi Industry Insight Call
28-Mar	JIN	Jumbo Interactive Taylor Collison Management Meeting
28-Mar	FPH	Fisher & Paykel Healthcare JPM Industry Insight Call
29-Mar	REA	REA Group Citi Industry Insight Call
30-Mar	360	Life360 Management Meeting