Selector High Conviction Equity Fund Quarterly Newsletter No.85
September 2024

In this quarterly, we provide a collection of portfolio company commentaries flowing from the latest reporting season and examine one business more closely.

In our article "Pigeonhole," we discuss the industry's fascination with categorising investment styles and provide insight in how we consider a business opportunity.

We round out the quarterly by discussing the potential pitfalls of private credit in our article "Opaque world of private credit."

Photo. *A pigeonhole is one of the sections in a frame on a wall where letters and messages can be left for someone. To pigeonhole someone or something means to decide that they belong to a particular class or category. Source: Collins dictionary*.

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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 20-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 – September Quarter

Dear investor,

It was only a matter of time. Having exhausted its data dependent approach, the U.S. Federal Reserve led by Chair Jerome Powell, finally cut interest rates in September, citing, "*The time has come for policy to adjust"*.

In less than 16 months the Federal Reserve raised the U.S. fund rate from 0.25% - 0.50% to 5.25% - 5.50% between March 2022 and July 2023. It moved forcefully to control inflation, a direct by-product of COVID supply shocks and labour market shortages.

Powell waited 14 months to cut rates, cognisant of moving too early, due to a fixation with data dependency. Data that in truth, is unreliable as reported in Barron's on 22 August, when the U.S. Bureau of Labor Statistics revised down its previously reported net payroll by 818,000 for the year ending March 2024, a reduction of 0.5%.

With the Fed's preferred measure of inflation, U.S. Core Personal Consumption Expenditure (PCE), which excludes the prices of food and energy, now running at an annual change of 2.6%, there exists significant scope to enact the 'Fed Put' if required, a point highlighted by Powell, *"The current level of our policy rate gives us ample room to respond to any risks we may face, including the unwelcome weakening in labor markets conditions."*

That "*ample room*" was on show in September 2024 with the first rate cut since March 2020 of 0.50%, leaving the U.S. Fed Fund rate at 4.75% - 5.00%. In comparison, Canada sits at 4.25%, Australia 4.35%, The Euro Area 3.65% and New Zealand, in the past a bell weather country, anchored until recently at 5.25%.

But here we look to draw a line. Expending energy on picking the direction of interest rates and macroeconomic outcomes, which so often dominate industry news and investor actions, is unlikely to deliver the superior outcomes that most seek.

The adage of focusing only on what can be controlled rings true. Perhaps even more so for corporate leaders entrusted to control the narrative around a company's products and services, its brand, the balance sheet and the long-term pursuit of delivering a sustainable business.

All these factors matter and remain within the internal control of a business, irrespective of external events. Equally, investors who can separate themselves from the market noise and control their directives are better placed to deal with inevitable setbacks.

During the same period that central banks were raising interest rates, investors in the U.S. and Australia drove their respective share markets higher. The S&P 500, the Dow Jones Industrial Average, the Nasdaq and the All-Ordinaries Accumulation Index posted gains of 21.8%, 18.2%, 20.5% and 15.3%, respectively.

Howard Marks, co-founder of Oaktree Capital Management and reported by Chanticleer in the Australian Financial Review on September 5, said it best:

"*Most people want to know where the market is at a given point in time. Is it rich? Is it cheap? But that leads to too much short-term thinking and hyperactivity for naught. So, forget trying to pinpoint when the Federal Reserve will cut interest rates. Don't worry about trying to predict where US employment data will come in on Friday night. It's the direction of travel that matters, not the details. The world is an uncertain place. One more piece of data is not going to make you smarter. Attaching importance to one report is really just a mistake. The most important thing for most people who have some money to invest is to be in the market on a steady basis – and not screw it up. If you get in, get out; get in, get out; get in, get out – you're unlikely to have a return on all that energy.*"

It is a philosophy that resonates because of its sensibility. In an industry that demands action and constant reaffirmation, it pays to stick with an investment discipline grounded on common sense and time. Not because it guarantees success but because it reduces emotional energy.

Today, a negative by-product of lower inflation and interest rates is slower global growth. With this comes economic pain, particularly exposing companies with inferior business attributes.

One illustration of this is our avoidance of businesses operating with little or no pricing power. The recent rout in iron ore prices impacts all producers, irrespective of individual resource qualities, and highlights the shortcomings of these types of businesses. As does the ongoing need for high levels of capital expenditure and balance sheets that are invariably debt laden.

In our lead article “Pigeonhole”, we discuss the industry’s fascination to label itself, why we avoid such an approach and our long-term pursuit of backing businesses where the combination of superior financial attributes aims to tilt the advantage in our favour.

We discuss the potential pitfalls of private credit in our piece “Opaque world of private credit”, highlighting the 1997 downfall of hedge fund manager Long-Term Capital Management. Lessons that should have been learnt are often forgotten or misplaced, with investors enticed by seemingly attractive high-yielding returns. Importantly, it should underscore the attractiveness of publicly traded, liquid investments compared to private markets that lack transparency and liquidity.

We also provide brief company commentaries on reporting season while examining one business more closely.

For the September 2024 quarter, the Fund delivered a gross positive return of **11.04%** compared to the S&P ASX All Ordinaries Accumulation Index, which recorded a gain of **7.85%**.

We trust you find the quarterly informative.

Regards,

Selector Investment Team

"Technology is the turbocharger of economic growth; it always has been & always will be"

Source: Peter C Farrell, ResMed Origins

Portfolio Overview

Table 1: Performance as at 30 September 2024*

	3 Month	6 Month	1 Year	3 Year	5 Year	10 Year	15 Year	Since Inception
Fund (net of fees)	10.63	9.69	32.78	4.37	7.54	12.41	12.04	10.74
Fund (gross of fees)	11.04	10.50	34.69	5.85	9.29	14.37	14.04	12.78
All Ords. Acc. Index	7.85	6.60	22.15	8.09	8.66	9.17	8.34	8.55
Difference (gross of fees)	3.19	3.90	12.54	(2.24)	0.63	5.20	5.70	4.23

Inception Date: 16/04/2020

**Performance figures are historical percentages and returns are annualised unless otherwise specified. Past performance should not be taken as an indicator of future performance.*

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

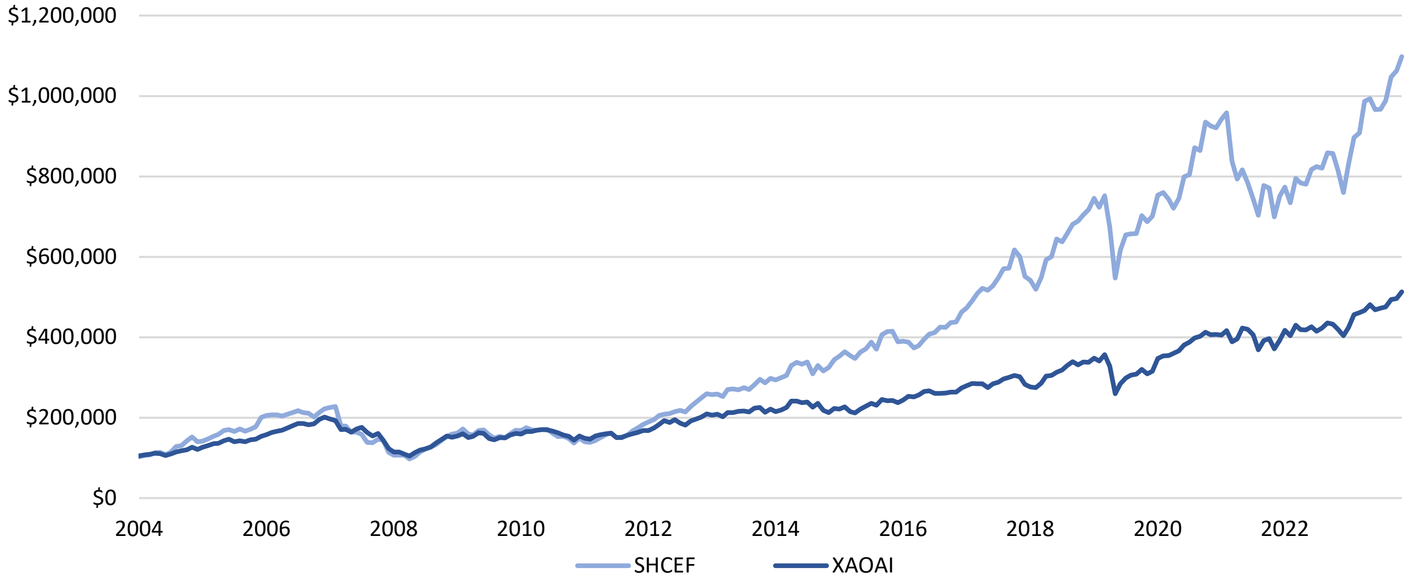


Table 2: Portfolio's Top 10 Holdings

Top 10 September 2024	%	Top 10 June 2024	%
TechnologyOne	7.05	CAR Group	7.93
CAR Group	6.84	TechnologyOne	7.38
WiseTech Global	5.77	Cochlear	6.81
Aristocrat Leisure	5.69	Aristocrat Leisure	5.46
ResMed	5.64	Reece	5.21
James Hardie Industries	5.60	James Hardie Industries	5.20
Reece	5.31	ResMed	4.97
Cochlear	5.20	CSL	4.76
Nanosonics	4.79	WiseTech Global	4.69
CSL	4.15	REA Group	3.23
Total	**56.04**	**Total**	**55.63**

Table 3: Unit prices as at 30 September 2024**

Unit Prices	Entry Price	Mid Price	Exit Price
	3.6998	3.6906	3.6814

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 – September 2024 quarter

S&P ASX Industry Sectors	Quarter Performance (%)
Information Technology	16.06
A-REITS	13.77
Industrials	9.33
Consumer Discretionary	9.32
Materials	8.52
Financials	7.37
Telecommunications	6.11
Consumer Staples	0.70
Healthcare	(0.41)
Utilities	(3.25)
Energy	(9.00)

Table 5: Fund's industry weightings

Industry group	September 2024 (%)	June 2024 (%)
Health Care Equipment & Services	24.41	22.82
Software & Services	19.87	19.65
Media & Entertainment	12.96	13.98
Consumer Services	12.07	12.96
Capital Goods	7.79	7.23
Materials	5.60	5.20
Pharmaceuticals, Biotech & Life Sciences	5.36	4.85
Automobiles & Components	3.33	2.43
Financial Services	2.62	2.83
Consumer Durables & Apparel	2.45	1.87
Commercial & Professional Services	2.14	2.69
Cash & Other	1.06	1.48
Insurance	0.33	2.01

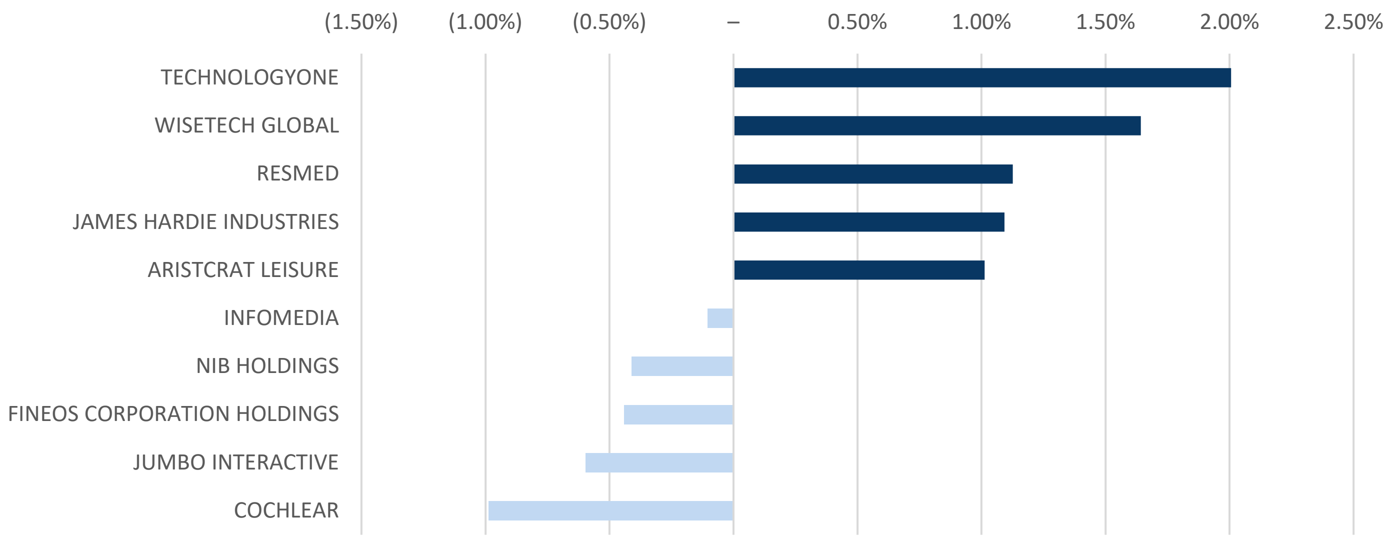
Table 6: Portfolio turnover as at 30 September 2024

Period	**Turnover %**
1 Year	11.40
2 Years	6.62
3 Years	8.00
5 Years	8.21
10 Years	7.20
15 Years	6.89
Since inception	6.30

- Turnover shown as annualised percentages
- Turnover = Lesser of purchases or sales divided by average funds under management for the period
- Turnover calculation excludes cash flows greater than 1% of FUM over any given period

Portfolio Contributors

Graph 2: Contributors and Detractors – September 2024 quarter



Environmental, Social and Corporate Governance (ESG)

ESG 2.0 Roadmap

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

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.

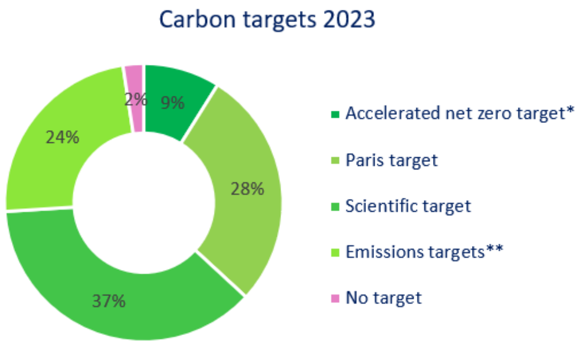
The following is a breakdown of each consideration:

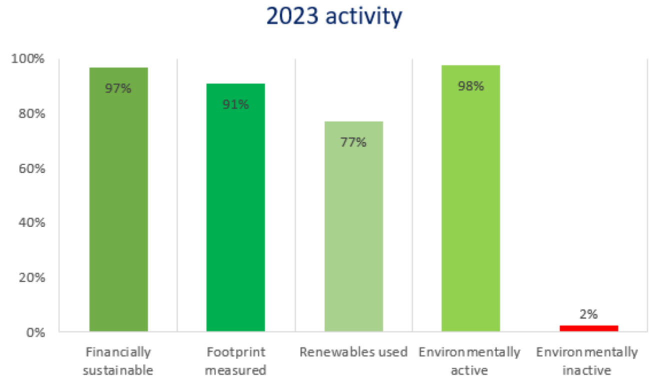
- Human Capital Management – "Is there a history of human rights violations, workplace and IR disputes, discrimination and harassment claims?" Rating of the company's employee engagement, turnover and productivity. Compare the company's work, health, and safety (WHS) standards against peers, including 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.
- Risk, Litigation & Cyber – Rating of the company's internal risk and control framework.
- 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 target – Measuring progress made against announced targets. "0" rating for no effort.

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, available at https://selectorfund.com.au/esg

▪ Carbon Risk Analysis

Figure 1: Portfolio Reporting 2023



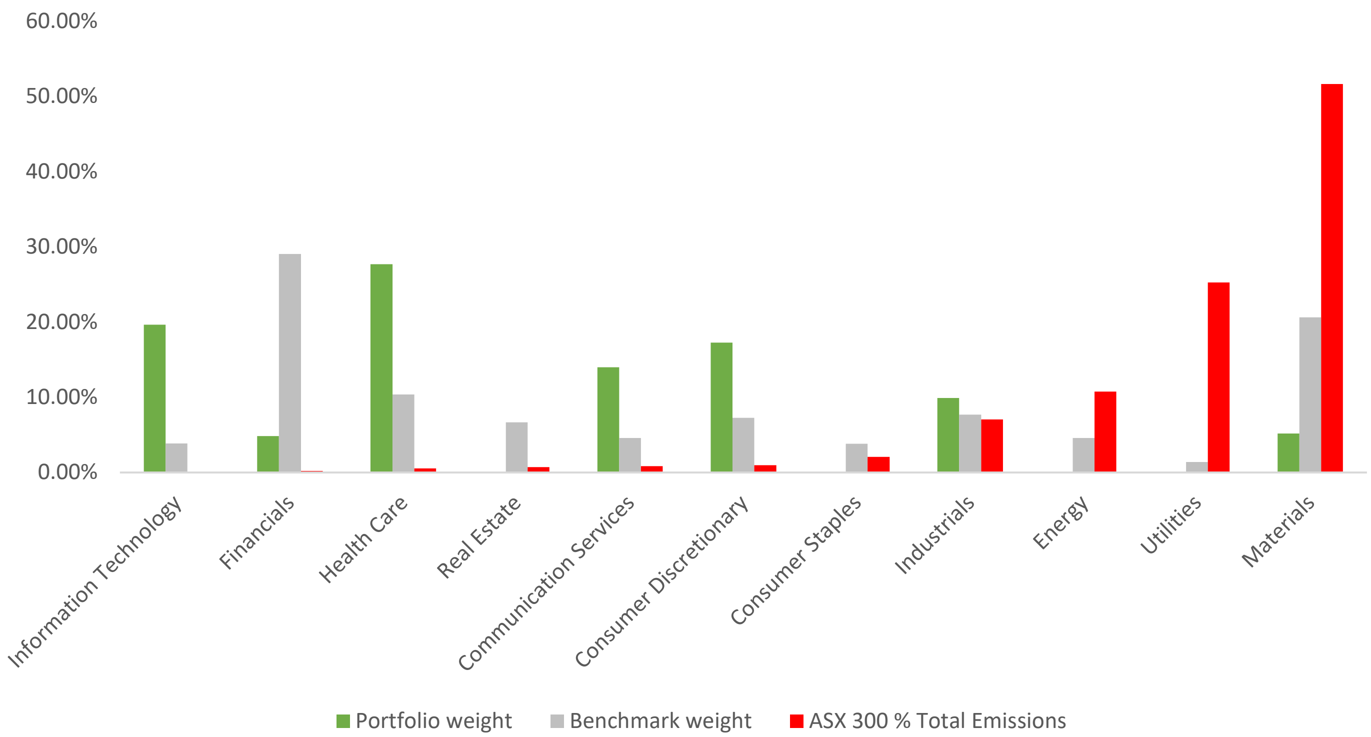


What we are seeking
- Paris targets
- Science based targets
- Emissions targets
- Renewable energy targets

What we are monitoring
- Financial sustainability
- No efforts
- No accountability

**Net zero across all scopes by 2030*
**Has at least measured emissions or energy use or set a target*
Source: SFML Research

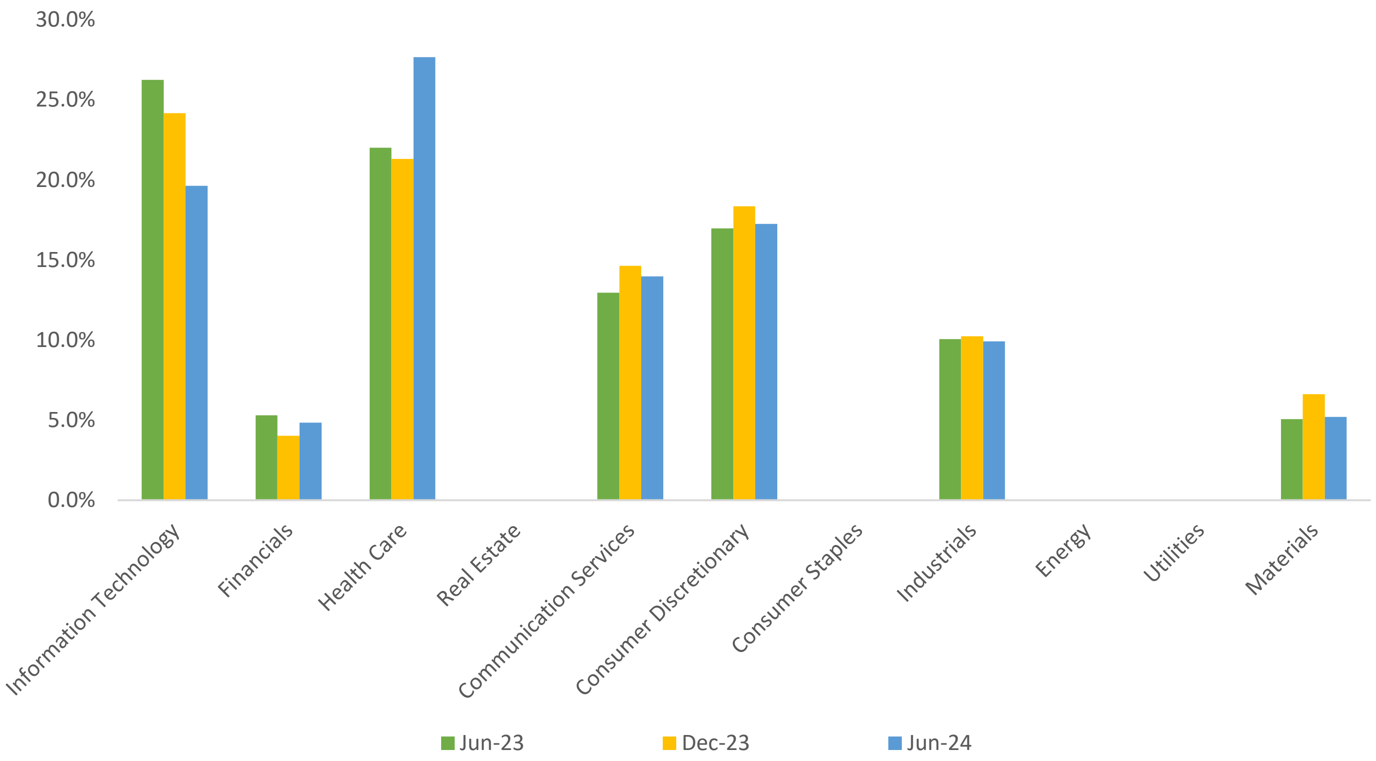
Graph 3: SHCEF vs ASX 300 Carbon Exposure 30 June 2024



**Estimates based on LSEG data*

Source: SFML & LSEG

Graph 4: Portfolio Carbon Exposure Periodic Change



Source: SFML & LSEG

Table 7: SFML Portfolio carbon intensity

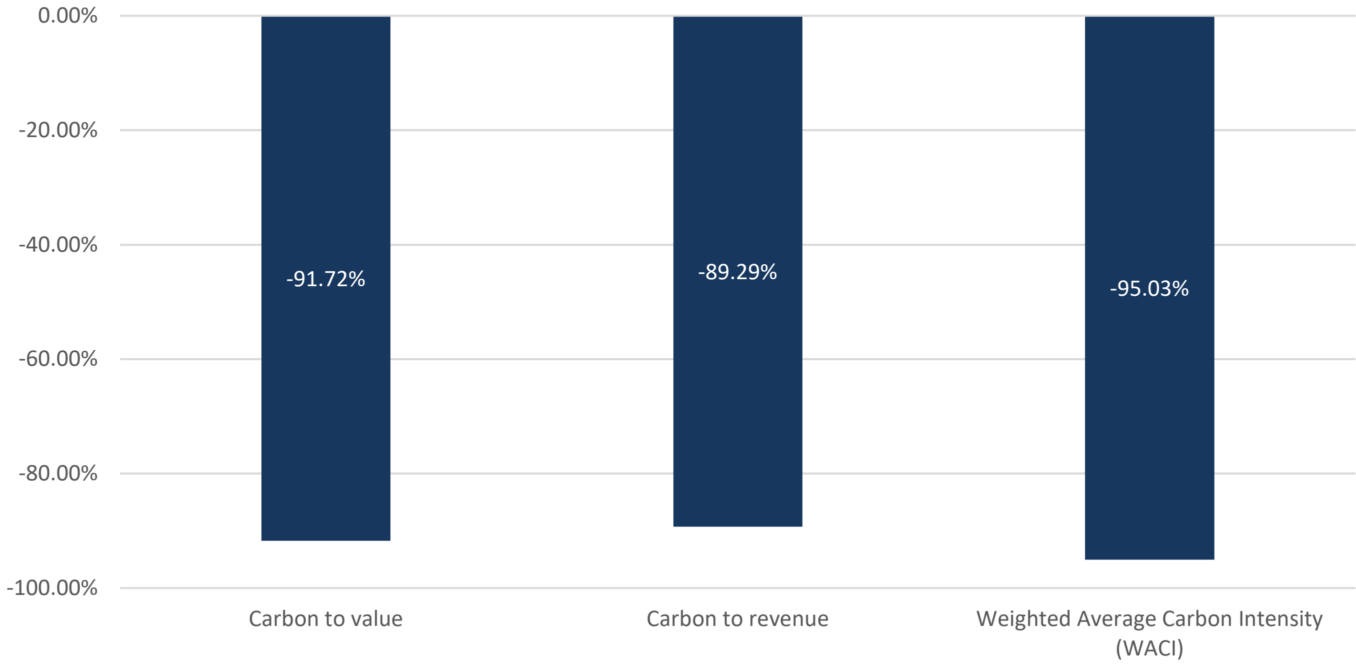
Carbon intensity method[1]	**SFML**	**Benchmark**[2]
Carbon to value invested	3.08	37.17
Carbon to revenue	13.39	125.01
Weighted Average Carbon Intensity (WACI)	6.51	130.96

Source: SFML & LSEG

1. Denominated in tonnes per CO2e/AUD$m
2. Benchmark used is S&P/ASX 300

- ***Carbon to value invested*** – this calculation is the aggregation of estimated owned constituent greenhouse gas emissions per $1m market capitalisation as at 30 June 2024. 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: SFML & LSEG

SFML's carbon to value invested and carbon to revenue are both lower than the S&P ASX 300 index, at 91.72% and 89.29% respectively. SFML's WACI is 95.03% lower than the index, due to no exposure to Energy and Utilities sectors, and low exposure to the Materials sector.

Table 8: SFML Top 10 emitters and total Portfolio Revenue impact of AUD$90 Carbon tax

Portfolio	Revenue ($m)[1]	CO_2 Emissions[2] (Tonnes)	$90 Carbon Tax ($m)	Impact on Revenue (%)
SFML Top 10 Emitters	56,964.38	1,245,252	112.07	(0.20%)
SFML Portfolio – Total	74,746.32	1,262,932	113.66	(0.15%)
ASX300 Top 30 Emitters	630,611.50	195,280,462	17,575.24	(2.79%)
ASX 300 Index – Total	1,276,588.49	208,418,878	18,757.70	(1.47%)

Source: SFML & LSEG CO2 Emission data

1. Last reported financial year revenue as at 30 June 2024
2. Scope 1 and 2 emissions (estimated if not reported).

*Note: ASX 300 index revenue impact from a carbon tax is **9.7x** larger than SFML portfolio*

Table 9: 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	32.51%	98.60%
ASX 300 Top 30 Emitters	29.12%	93.70%

Source: SFML & LSEG CO2 Emission data

*Note: ASX300 Top 30 Emitters revenue impact from a $90 carbon tax is **14x** larger than SFML Top 10 Emitters*

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

Company	CO_2 Emissions (Tonnes)	NPAT[1] (AUD $m)	EPS[1] ($)	Value of Carbon Tax ($)	Cost of Carbon Tax ($m)	Impact on NPAT (%)	EPS Post Carbon Tax ($)
JHX	646,409	1,075.96	2.42	90	58.18	(5.41%)	2.29
CSL	336,000	3,880.65	8.04	90	30.24	(0.78%)	7.98
REH	65,889	387.61	0.60	90	5.93	(1.53%)	0.59
DMP	60,400	122.60	1.37	90	5.44	(4.43%)	1.30
RWC	34,086	207.64	0.26	90	3.07	(1.48%)	0.26
FLT	29,886	47.41	0.23	90	2.69	(5.67%)	0.22
RMD	25,059	1,334.52	9.07	90	2.26	(0.17%)	9.05
ALL	17,258	1,535.60	2.02	90	1.55	(0.10%)	2.02
FPH	16,816	237.96	0.42	90	1.51	(0.64%)	0.41
ARB	13,449	88.46	1.08	90	1.21	(1.37%)	1.06

Source: LSEG CO2 Emission data

1. Last reported financial year values as at 30 June 2024

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.

Further information on how ESG is incorporated into our investment process can be found in the SFML Sustainability report and ESG & Voting policy, available at https://selectorfund.com.au/esg

Reporting Season Snapshot

ARB Corporation (ASX:ARB)

ARB Corporation is a leading manufacturer and distributor of 4x4 accessories in more than 100 countries. The business was founded in 1975 in Melbourne and employs over 2,000 staff across Australia, Europe, North America and Asia.

	FY24 ($m)	FY23 ($m)	Change
Revenue	**693.2**	**671.2**	**3%**
Gross Profit margin	**57.2%**	**53.1%**	
Underlying EBITDA	**169.8**	**147.4**	**15%**
Margin	*24.5%*	*22.0%*	
Underlying EBIT	**141.4**	**121.5**	**16%**
Margin	*20.4%*	*18.1%*	
Underlying Profit after Tax	**103.9**	**88.2**	**18%**
Margin	*15.0%*	*13.1%*	
Net Cash	**56.5**	**44.9**	

In August, ARB delivered a strong result for the full year to 30 June 2024, generating revenue of $693m, up 3.3% on the prior corresponding period (pcp) and profit before tax of $141.4m, up 15.8%. Over the last decade, ARB has delivered a profit before tax compound annual growth rate of 9.2%.

Gross profit margin expansion stemmed from improved pricing and lower freight costs. Cash flow from operations was $125m, up 38.5%. ARB finished the period with $56m cash and no debt.

In the period, ARB acquired a 30% interest in Off Road Warehouse (ORW), a profitable U.S. based 4x4 retailer with 11 stores. Importantly, ORW has 120 experienced staff members and is led by Greg Adler, whose family established 4Wheel Parts (4WP), the largest 4WD accessories specialist in the U.S.

Following the Adler family's exit from 4WP, successive ownership – including Polaris, private equity and The Hoonigan Group damaged the franchise and materially disrupted ARB's U.S. go-to-market strategy and sales in the region.

U.S. expansion

In September, Hoonigan filed for Chapter 11 bankruptcy and within three days, ORW entered a conditional agreement to acquire 4WP's remaining 42 retail outlets across the U.S. for US$30m. As a result of this transaction, ARB's ownership of ORW will increase from 30% to 50%.

The U.S. opportunity has been a compelling proposition for ARB for over a decade. If approved, the acquisition of 4WP will see the combined business operate the largest off-road accessory network in the U.S.

Turning around 4WP is no easy task. However, the opportunity is significant, enabling ARB to control its brand and product representation directly to the end client. ARB has also continued to invest in its local infrastructure to support growth, namely building out its management team, expanding capacity in its distribution centres and announcing a new engineering centre in the U.S. for local product development.

These initiatives support ARB's ability to leverage its unique branded partnerships with Toyota USA and Ford USA.

On the acquisition front, ARB has also acquired a 49% stake in Nacho Lights, a US-based start-up, and Poison Spyder, a US-based Jeep accessories specialist brand from Hoonigan for US$1M, subject to court approval.

ARB Corporation has a market capitalisation of $3.7b.

Flight Centre Travel Group (ASX:FLT)

Flight Centre Travel Group has delivered Total Transaction Value (TTV) growth in 37 of its 42 years of corporate history. Four of its misses occurred during or after COVID, spanning 2020 to 2023. Coming out of COVID, the company committed to building a lower cost and more profitable business by growing its core travel segments: Corporate and Leisure.

To achieve this, management has committed to a 2% plus profit before tax margin target, last achieved in 2015.

The business employs 12,514, down from 13,065 in FY23, operates globally and is ranked within the top five corporate travel operators worldwide.

	FY24 ($m)	FY23 ($m)	Change
TTV	**23,744**	**21,939**	**8%**
Revenue	**2,711**	**2,281**	**19%**
Revenue margin	*11.4%*	*10.4%*	
Underlying EBITDA	**478**	**302**	**58%**
Margin	*17.6%*	*13.2%*	
Underlying Operating Profit before Tax	**320**	**139**	**37%**
Margin[1]	1.3%	*0.6%*	
Underlying Profit after Tax	**230**	**109**	**35%**
Margin	*8.5%*	*4.8%*	
Net Cash | (debt) excluding convertible notes	**604**	**516**	
Net Cash | (debt) including convertible notes	**(16)**	**(172)**	

[1]*Profit before tax margin as a percentage of TTV*

The company delivered a record TTV in 2024, eclipsing its 2019 peak and up 8% on 2023. More importantly, the group reported a material improvement in earnings, with profit before tax rising 37% to $320m, accompanied by a commensurate lift in the profit to TTV margin of 1.3%, compared to 0.6% in 2023.The productivity gains from technology improvements and scale are driving better financial outcomes, with transaction volumes increasing 11% and cost per transaction declining by 2%.

Figure 2: Flight Centre Divisional Results

FY24

Strong divisional results

CORPORATE SEGMENT

- 44% underlying PBT increase to $211m, record Corporate Traveller profit
- 10% TTV growth to record $12.1b (51% of group TTV in FY24 v 38% in FY19)
- Circa 30-40bps YOY improvement in both underlying cost & revenue margins
- Strong & consistent strategic execution – Grow to Win continues, with Productive Operations accelerating
- Compelling customer offerings driving organic TTV growth above market rates & full recovery well ahead of sector overall (FY24 TTV more than 135% of pre-COVID)
- Key performance metrics improving, starting to convert market-share growth to profitability & delivering solid productivity growth ahead of anticipated uplift from Productive Operations initiative

$m	FY24	FY23
TTV	12,105	11,006
Revenue	1,112	978
Underlying PBT	211	146
Underlying EBITDA	**249**	**190**
Margins		
Revenue margin	9.2%	8.9%
Underlying PBT margin	1.7%	1.3%

LEISURE SEGMENT

- Underlying PBT more than doubled to $188m
- 10% TTV growth to $11b (46% of group TTV in FY24)
- Strong ROI on transformation program initiated pre-COVID & fast-tracked during the pandemic
- 110bps revenue margin improvement YOY, 40bps cost margin improvement
- Cost effectively capturing TTV through new growth model built around higher performing shop network & lower cost, highly scalable offerings
- Achieving economies of scale - now significantly more profitable & productive than pre-pandemic

$m	FY24	FY23
TTV	11,031	10,006
Revenue	1,352	1,121
Underlying PBT	188	92
Underlying EBITDA	**281**	**172**
Margins		
Revenue margin	12.3%	11.2%
Underlying PBT margin	1.7%	0.9%

FLT

Business & Geographic segment results are summarised in Appendix 4

FLIGHT CENTRE TRAVEL GROUP

Source: Flight Centre Travel Group FY24 presentation

Both its Corporate and Leisure segments are performing strongly, each achieving a profit before tax (PBT) margin of 1.7%. In 2024, Corporate delivered TTV of $12.1b and a PBT of $211m, while Leisure recorded TTV of $11.0b and a PBT of $188m.

Balance sheet

Not one to *"waste a crisis"*, the company finds itself in a materially stronger position post-COVID, operating with net cash of $60m, excluding outstanding convertible notes. Even when factoring in all outstanding convertible notes, the company's net debt position would be largely neutral. The group is committed to further restoring the strength of the balance sheet, maintaining the ongoing payment of dividends, which represented a second-half payout of 38%, and continuing the buyback of convertible notes.

Guidance

CEO, co-founder and the company's largest individual shareholder Graham Turner remarked, *"Looking ahead, we continue to focus on profitable growth and our target of returning to a 2% underlying profit margin for the first time since 2015. We see a clear path to 2% and aspire to achieve it during FY25 although it remains a stretch target within this time frame."*

The business is on much firmer ground following the halting of operations during COVID. Internally, there is now a clear sense of individual accountability across all operating segments, instilling financial discipline and a relentless focus on delivering profitable growth while maintaining a conservative balance sheet.

Flight Centre Travel Group has a market capitalisation of $4.8b.

Reece (ASX:REH)

Reece is a leading supplier of plumbing, bathroom, waterworks and heating, ventilation, air-conditioning, and refrigeration (HVAC-R) products. The company was founded in 1920 and employs approximately 9,000 people across more than 900 branches in Australia, New Zealand and the United States.

	FY24 ($m)	FY23 ($m)	Change
Revenue	**$9,104**	**$8,840**	**3.0%**
ANZ Revenue	*$3,846*	*$3,853*	*1%*
*U.S. Revenue**	*$5,259*	*$4,987*	*5%*
Adjusted EBITDA	**$1,007**	**$958**	**5.1%**
Margin	*11.1%*	*10.8%*	
Adjusted EBIT	**$681**	**$668**	**2.0%**
Margin	*7.5%*	*7.6%*	
Underlying Profit after Tax	**$415**	**$405**	**2.8%**
Margin	*4.6%*	*4.6%*	
Net debt	**$518**	**$725**	
Leverage	*0.6x*	*0.9x*	

**U.S. sales up 3% in USD*

In August, Reece reported a solid FY24 result in a challenging environment. Group revenues increased 3% to $9.1b and normalised operating earnings (EBITDA) were up 5% to $1.0b on a constant currency (cc) basis.

In the ANZ region, sales revenue was steady at $3.8b and EBITDA was up 1% to $560m, reflective of a softer housing market and disciplined cost control. Reece continues to forge ahead with its growth strategy, adding six branches and completing fifteen refurbishments, bringing the total number in the ANZ network to 661 at period end.

The U.S. saw revenues lift 3% to US$3.5b, while operating profits were up 9% to US$293m, providing an EBITDA margin of 8.5%, an improvement of 0.44% on the prior year. The group continues to scale, adding twelve new stores and completing four refurbishments during the year. To facilitate the growing network, Reece opened a new distribution centre in DeSoto, Texas in January 2024.

Balance sheet

The group has implemented a sensible capital management strategy to achieve sustainable long-term growth in the business, as shown in Figure 3. Management continues to prioritise investing in growth with capital expenditure of $258m in FY24, up 45% on the prior year. Despite the additional capital spend, the group reduced debt by $207m, finishing the year with net debt of $518m.

Figure 3: Capital Management Priorities

Source: Reece FY24 Results Presentation

Leadership

In May, Reece announced a series of leadership changes to bolster long-term success and facilitate the smooth transition of Group CEO Peter Wilson into the expanded role of Chair and CEO. This change follows the retirement of current Chair and Director Tim Poole on 1 November 2024.

To support the shift, Sasha Nikolic, CEO of Reece USA, transitioned to the newly created position of Group President and Managing Director. Meanwhile, James Healy, the former President of Plumbing at Reece USA, took over as CEO of Reece USA.

Nikolic has held leadership roles since joining Reece in 2009 in the finance team and played a significant role in the transformative acquisition of MORSCO in 2018.

Healy is a shining example of the company's willingness to develop and promote talent from within. Starting on the trade counter in 1996, Healy has progressed to hold senior roles across the ANZ and U.S. businesses.

During the quarter, Reece announced the appointment of two new independent directors, Ross McEwan and Angela Mentis, alongside the resignation of Karen Penrose. Both McEwan and Mentis have over 30 years of experience in the financial services industry, with McEwan most recently serving as the CEO of National Australia Bank.

Following the appointment of McEwan, Group CEO Peter Wilson commented, *"We are looking forward to welcoming Ross McEwan to the Board. Ross' global perspective, practical approach, and deep experience running large, complex businesses will be essential for us as we look ahead to our next stage of growth, and as I transition into the role of Chair and Chief Executive Officer in November."*

Outlook

The group remains firmly focused on executing its key strategic priorities – Operational Excellence, Accelerating Innovation, and Investing for Profitable Growth as it strives to achieve its 2030 vision of becoming the trades' most valuable partner.

While not providing guidance, Reece believes it is well placed to navigate the current macro complexity with a strong brand and a diversified business model focused on the less cyclical R&R market.

Reece has a market capitalisation of $18.2b.

ResMed (ASX:RMD)

ResMed is a global leader in sleep health and respiratory technology, with 10,000 employees in over 140 countries. Founded in 1989, the company has become the dominant provider of CPAP devices for sleep apnea. Over the last 12 months, ResMed has helped change more than 178 million lives through its digital health products in sleep, respiratory care and out-of-hospital software solutions.

	FY24 ($m)	FY23 ($m)	Change
Revenue	**4,685**	**4,223**	**11%**
Devices	2,440	2,271	8%
Masks & Other	1,657	1,454	14%
Software as a Service (SaaS)	584	498	17%
Underlying Gross Profit Margin	**57.7%**	**56.5%**	
R&D expense	**308**	**288**	**7%**
% revenue	*6.6%*	*6.8%*	
Underlying EBIT	**1,478**	**1,224**	**21%**
Margin	*31.5%*	*29.0%*	
Underlying Net Profit After Tax*	**1,139**	**950**	***20%***
Margin	*24.3%*	*22.4%*	
Operating Cash Flow	**1,401**	**693**	
Capital Expenditure (CAPEX)	(115)	(134)	
Net Cash	**1,286**	**253**	

** Underlying figures exclude amortisation from acquired intangibles, restructuring costs and one-off recall expenses*

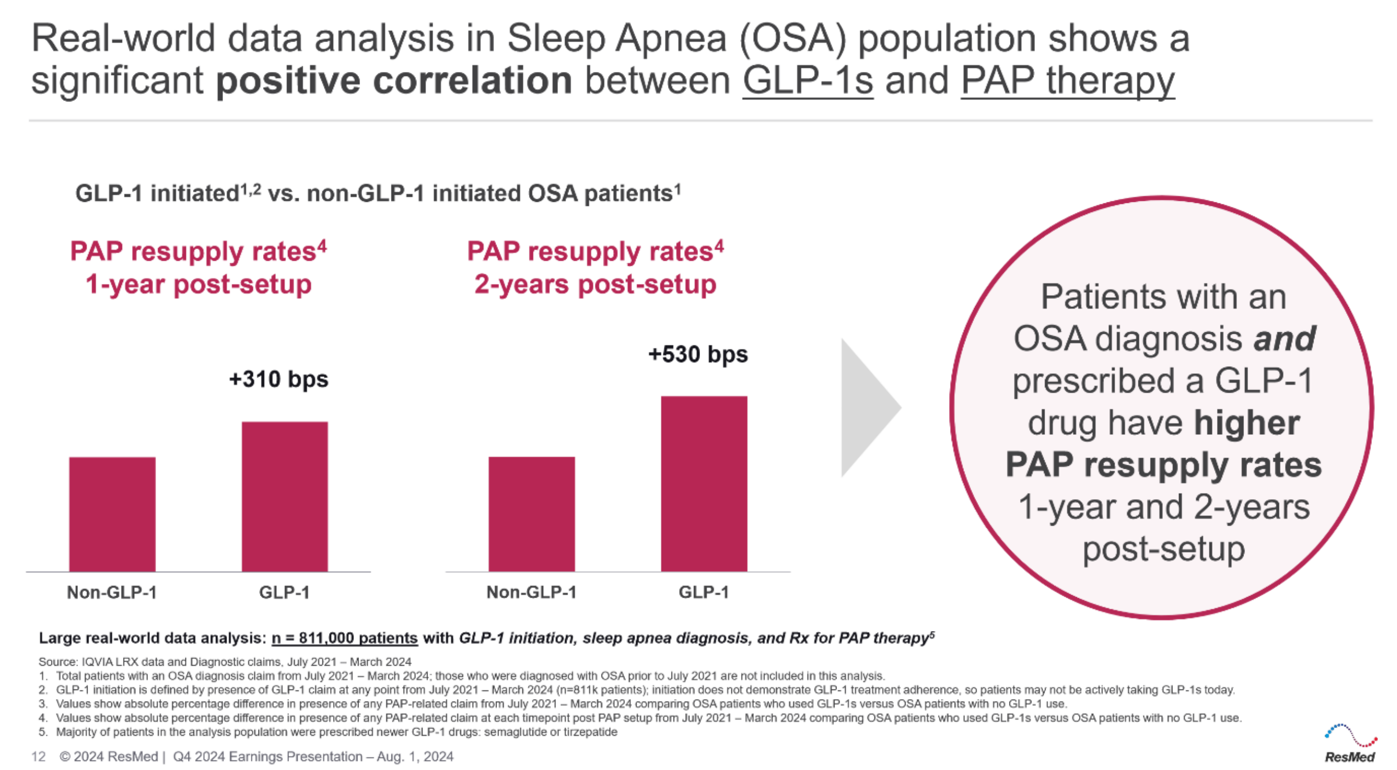
In August, ResMed delivered a strong result with revenue increasing 11% to US$4.7b and operating profits (EBIT) up 21% to US$1.5b. Underlying gross profit margins expanded 120 basis points to 57.7%, driven by lower freight costs and manufacturing improvements. Management continues to see further opportunities to improve gross margins to between 59% and 60% over FY25.

Sleep awareness

Sleep apnea is estimated to impact more than one billion people globally. ResMed sees this as a significant opportunity to grow the market through investment in consumer awareness initiatives and improving the pathway to diagnosis and treatment. Two megatrends in the industry are driving these initiatives: pharmaceutical and technology innovation.

On pharmaceuticals, ongoing evidence of GLP-1 weight loss drugs and market activities by its manufacturers have led to more aware and compliant patients entering CPAP therapy, as reflected in ResMed's data of 811,00 patients.

Figure 4: ResMed GLP-1 Patient Population - Therapy Compliance Insights



Source: ResMed 4Q24 results presentation

The second trend relates to technological innovation in sleep tracking wearables designed to detect moderate to severe cases of sleep apnea.

Samsung was the first company to announce a detection feature on its smartwatch, enabling users over the age of 22 to detect signs of moderate to severe obstructive sleep apnea. The company received U.S. regulatory approval in February and expects the feature to launch this quarter in the U.S.

Apple's announcement followed in September, unveiling its sleep apnea features in its recent showcase of its new series 10 release. U.S. regulatory approval was granted a week later for individuals aged 18 and older who have not previously been diagnosed with sleep apnea.

While the devices are not intended to diagnose, they represent important milestones in helping raise awareness of sleep apnea and prompting users to seek treatment options.

ResMed remains well positioned to benefit, holding the two leading CPAP devices in the market and the only player with meaningful scale, with 26 million connected devices globally.

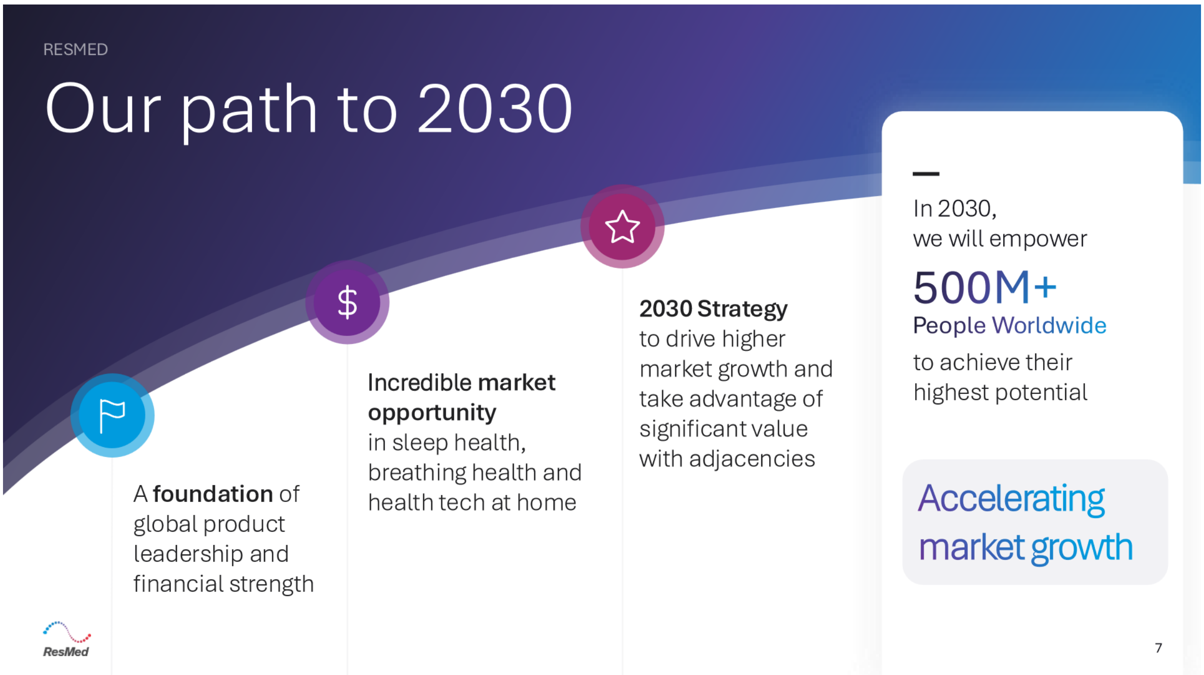
Investor Day

On 30 September, ResMed hosted an Investor Day in New York, marking 25 years since listing in the U.S. and 35 years as a company.

Management highlighted three takeaways from the event:

1. Its leadership position in sleep apnea with clear market opportunities.
2. Its sustainable competitive advantage in sleep and breathing health.
3. A five-year strategy aimed at driving market growth with a target to improve 500 million lives by 2030, up from the current mission of 250 million lives by 2025.

Figure 5: ResMed path to 2030



Source: ResMed 2024 Investor Day presentation

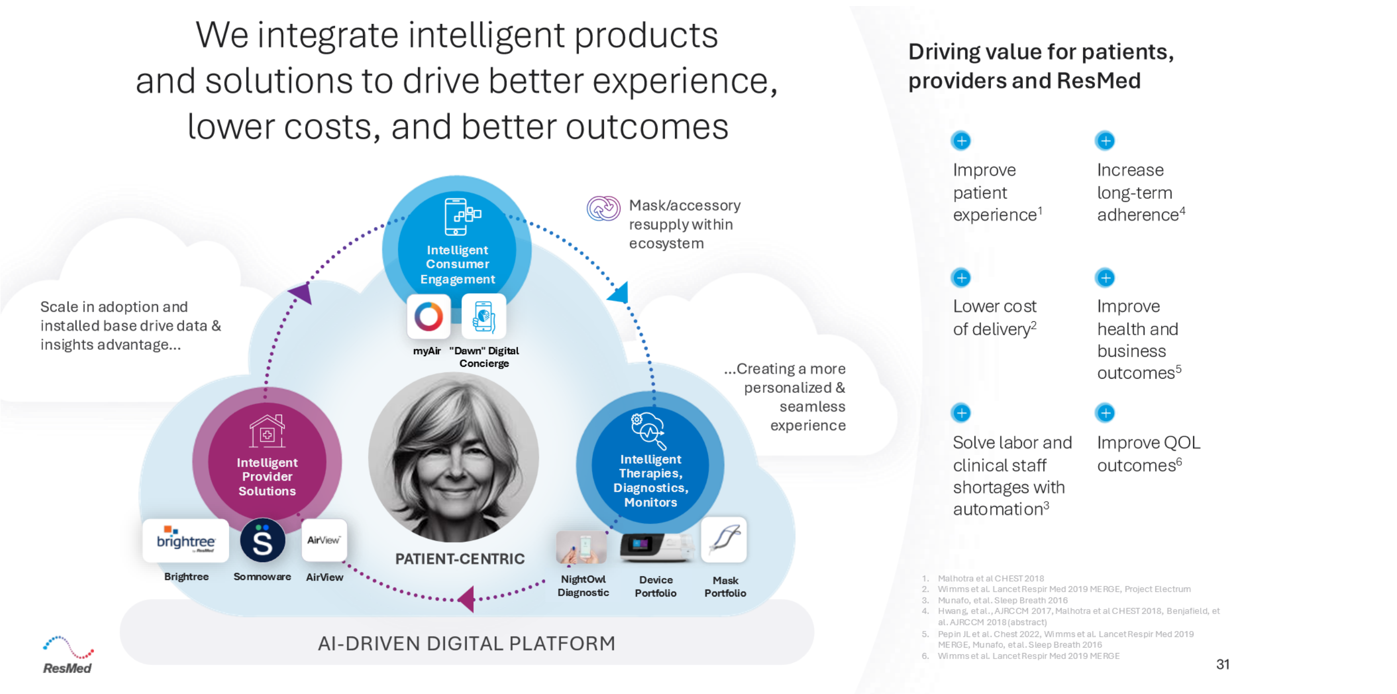
Financially, the five-year target represents high single-digit revenue growth and profit before tax growing faster than revenue.

Management aims to achieve these targets by accelerating product innovation across devices, masks and software within its core sleep apnea market, transferring existing capabilities into adjacent sleep categories, such as Insomnia and Chronic Obstructive Pulmonary Disease (COPD), and improving the patient pathway to diagnosis and treatment in sleep apnea.

The ability to integrate ResMed's digital ecosystem and hardware across the patient, physician and provider remains core to delivering on its 2030 strategy, as summarised in Figure 6.

ResMed has a market capitalisation of US$36b.

Figure 6: ResMed Digital Ecosystem Vision



Source: ResMed 2024 Investor Day presentation

SEEK (ASX:SEK)

SEEK is a leader in online employment marketplaces with a global presence across eight markets. The Asia Pacific (APAC) platform hosts over 30m monthly unique visitors with 97k monthly unique hirers. In Australia, the marketplace holds 32.8% market share by placements, a 3.6x lead against its nearest competitor. SEEK was founded in 1997 and currently employs over 3,300 people across Australia and New Zealand (ANZ), Asia and Latin America

	FY24 ($m)	FY23 ($m)	Change
Revenue	**1,084**	**1,158**	**(6%)**
Operating expenses (OPEX)	(615)	(612)	(1%)
Underlying EBITDA	**469**	**546**	**(14%)**
Margin	*43%*	*47%*	
Underlying Operating Profit before Tax	**318**	**431**	**(26%)**
Margin	29%	*37%*	
Adjusted Profit after Tax	**177**	**265**	**(33%)**
Margin	*16.3%*	*22.9%*	
Net debt	**1,032**	**1,064**	
Leverage	*2.4x*	*2.0*	

SEEK delivered a full year result that was considered weak, although this belies the significant progress made in reshaping the business over recent years.

The strategic company review undertaken in February 2021, which led to Ian Narev's appointment as CEO, was only three years ago. Since that time, SEEK has become a simpler and more focused business.

This reset has led to the separation and establishment of the SEEK Growth Fund, housing the company's early-stage investments, the successful completion of the $175m three-year platform unification investment, delivered ahead of schedule and under budget, as well as the sale of non-core assets, specifically the group's Latin American investments in Mexico and Brazil.

FY24

The ongoing employment ad yield transition to variable pricing helped to offset general volume weakness. During FY24, employment paid ad volumes reduced 20% in ANZ and 21% in Asia, partly offset by the paid ad yield up 13% and 24% respectively.

At a group level, this resulted in revenues down just 6% to $1,084m, while costs rose 1%, illustrating the early benefits of unification. Operating profits (EBITDA) lowered 14% to $469m, with margins at 43%, down from 47%.

Looking beyond 2024

Platform unification provides the foundational framework to offer differentiated products by leveraging improved technology capabilities across a single source of online user and corporate data. If successfully deployed, it should allow SEEK to move faster, delivering both scale and leverage across the local markets of Australia, New Zealand and the six countries within Asia.

Figure 7: Platform unification benefits

Unification to support placements, yield and leverage

Unified platform providing additional early benefits in FY24

Growing Placements

- Consolidated to best customer experience on the unified platform → improved user engagement contributed to 15% uplift in candidate applications and increased SEO share across APAC
- Commenced freemium pilot in Asia → increased total directly posted ads in the Philippines by 10% in May and June 24 vs pcp

Growing Yield

- Launched variable pricing capability across Asia which was adopted from ANZ → better aligned price to value with a weighted average 80% differential between highest and lowest cost ads[1]
- Released free-to-premium upgrade capability which is adaptable by customer type and location → provided hirers additional choice

Operating leverage and scale

- Accelerated speed and breadth of product releases → increased from 10 material releases[2] available to select markets, to over 25 releases available to all 8 markets each month
- Strengthened protection of customer information through decommissioning of 34 legacy systems → reduced software applications and susceptibility to operating system vulnerabilities
- Moved to a single source of online user and corporate data → reduced duplicate data stores, improved governance controls and enabled faster insights

Source: based on internal analytics and management estimates.
1. Price differential represents a weighted average across Asia based on ad volumes.
2. Material releases excludes continuous deployment and optimisation experiments.

seek

Source: SEEK FY24 presentation

Balance sheet

The company maintains a net debt position higher than what we would prefer. With the SEEK Growth Fund reflecting an equity interest valued at $1.8b and the remaining 23.5% holding in China's online employment group Zhaopin still on the books, the company has clear options to deleverage.

With an ongoing capital investment profile of $150m-$170m per annum and a dividend payout ratio of 70%, a broader rethink of capital management may be warranted.

Figure 8: Aspirational target FY28

Source: SEEK FY24 presentation

Guidance

Management is pointing to unchanged revenue of $1,080m for FY25, with net profits equally flat or down at $130m-$180m. Despite the economic slowdown that has impacted employment volumes, management continues to point to aspirational revenue and margin targets for 2028, as illustrated by Figure 8**.** This period may indeed be different, but to assume a myriad of investors will act rationally during times of heightened risk is irrational. History would suggest otherwise.

SEEK has a market capitalisation of $8.9b. ***SFM***

The Breville Project

Figure 9: Breville appliance

A 12-year-old Breville smart toaster has two important numbers

While on a recent business trip to the U.S., a text message from my daughter stated, *"Lights on - no toast :("*.

The "Breville text" rapidly escalated to the "Breville project".

It was an opportunity to learn about the Breville after-sales service in Australia and, hopefully, gain some insights into the Breville Platform.

Ease of enquiry

The first great reveal was when you turn the toaster over. This decade-old appliance contains important information, namely a phone number, in plain sight. If you go to Breville.com.au, the same number can be easily found. This offers instant relief for a consumer, as the first critical hurdle has been overcome.

Monday 22 July, 11am

The first wall goes up when you call the number and learn there's a 16-minute wait time. A call back option is offered. We waited a few more minutes and were informed the new wait time had increased to 18 minutes, and so we succumbed to the Breville service call back.

The call back

11.20am

The call back came 14 minutes later; first impressions are important. Breville's representative, Aidan, was pleasant and clear enough, and obviously based in Australia. Later, after some prompting, Aidan disclosed he works for both the call centre and Breville.

Magic code

The second great reveal was the four-digit code visible on the bottom of the machine. This code, requested by Aidan, identified that the "Breville 2 Slice Smart Toaster" was *"twelve years old, uneconomical to repair and that parts for this appliance are not maintained."*

Most consumers aware of planned obsolescence would consider twelve years of service a reasonable lifespan for a $149 appliance (using today's price for a 2-slice smart toaster). If we inflation-adjusted this amount, it equates to about $11.17 per year to toast bread.

Breville's representative made the following offer: they could send a link with all the available Breville toasters and offer a 40% discount off the advertised retail price on any item of choice. This is a decisive and attractive offer for consumers who are influenced by the retail price.

In making this offer, Breville is achieving three things:

1. The full wholesale price
2. Retains a repeat customer
3. Gains or updates a full customer information dataset at no customer acquisition cost.

All while potentially delighting a customer.

To access the offer, the customer must provide an email and physical address for delivery, as well as a phone number for follow-up purposes.

In this instance, the Breville representative could see all the previous purchases our family had made, which were registered under the warranty program.

We accepted the replacement offer on the same day, just after midday, and then waited. Unbeknownst to us, this was now an automated transaction.

Figure 10: Breville Smart Toast 4 Slice

Coincidently the new Smart Toaster 4 Slice at 40% discount is priced at $149. Source: Breville website

48 hours later

Day 3, Wednesday

Having proclaimed to our family the "Breville problem" was solved on the Monday night, I was asked twice on Tuesday morning "Where is our new toaster?"

The two days waiting for Breville to email a purchase order so we could finalise the transaction was frustrating.

Thankfully, the credit card payment process was simple and there were no "hi-jack fees" for using the payment system, which integrates into Breville's CRM and accounting system. Pleasingly, there was also no delivery fee.

Another day, no toast

Day 4, Thursday

No receipt or confirmation email received and our junk mail has also been checked and is clear. This is a slightly disappointing outcome.

Thursday 5.25pm

We somewhat underestimated the Breville process and may have jumped the gun. The fact that an email from Breville arrived at 5.25pm was a win in our book. It restored some faith and showed not everyone exercises the "right to disconnect" after 4.55pm.

The email from our customer service representative stated, *"The invoice is sent along with the tracking details once the unit has **been shipped**. I can see the shipment details being updated currently so you should receive the invoice with the tracking number soon, if not already."*

Australia Post notification

Thursday 8.20pm

Late Thursday evening, we received a notification from Australia Post, who was also working after 5pm, informing us that we could now track our appliance. It's a tantalising prospect that it could arrive on Friday, ready for the weekend…

Friday morning arrives!

Figure 11: New Breville Smart Toaster

Our service representative has nailed it. The “Breville problem” is solved within the week via an automated transaction, and our household productivity has just climbed with the upgrade from two toaster slots to four.

After several weeks of use, we can confirm the smart toaster is pretty good – maybe a 4.5 out of 5-star rating. However, the reality is, toasters are a sideshow.

New Product Development (NPD) at Breville is firmly focused on coffee machines and smart ovens. Of Breville’s 17 highest revenue products, 13 are espresso machines and four are ovens. On a combined basis, they represented 62.5% of FY24 sales.

A flimsy “project” or platform insight

CEO Jim Clayton, like the customer service team, may disappoint you before he delights you. Of course, this depends on how you invest. Breville is a company being built for the long term at the expense of the short term.

EBIT margins, for instance, could be pushed higher in the short term. Instead, the additional EBIT dollars are redeployed to grow the business. This EBIT “guardrail approach” ensures that forward investment befits the significant global business opportunity at hand. As a result, the quantum of investment in R&D has increased.

Under Clayton’s leadership, Breville has delivered sustained, sector-leading performance. Revenue, Gross Profit and EBIT have grown every year since FY15.

Since July 2015, Breville has increased revenue by 12.6% CAGR per year and EBIT by 11.5% CAGR per year. Investment in R&D, marketing, technology and solutions (R&DMTS) has lifted from 9.3% of sales in FY15 to 14.0% in FY24, amounting to $214m. As a result, $3.1b has been added to the group’s market capitalisation with a greater than 4x increase in share price.

Success has seen the board hand the reins to management. We expect to see Clayton’s R&DMTS investment increase in the future, in both absolute and percentage terms. Effectively, Breville would be diverting more of today’s profits into productive investments in its core operations to drive a significantly larger business in the future.

This fits with SFML’s view. A quality business will continuously reinvest back into one or more of the four key areas driving sustainable cash flow. These include:

1. Brand
2. Leadership
3. IP
4. Recurring revenue

The most successful businesses invest in all four of these opportunities simultaneously.

Investment also drives platform development. This is equally important but harder for an outsider to identify. If Breville is to scale across new and existing geographies, processes must be systematised and automated. Our “Breville project” is an example of customer service automation across the platform.

The platform approach enables the business to scale through:

- Organic expansion – R&D and NPD
- Geographic expansion – into white space
- Inorganically – via acquisitions
- Horizon 4 – Solutions

R&D and NPD

Breville R&D, the NPD component of R&DMTS, sits under Greg Nash, Head of Global Product. Nash was an internal promotion, succeeding the recently retired Scott Brady, who was in the role for five years.

NPD is a multi-year process that spans from the initial R&D funnel to sitting on the shelf. It starts with a "skunk works" approach, using small agile teams. At Breville, they are referred to as the "Rapid innovation" and "Deep dive" teams.

Project Forever is an example of a "Deep dive" R&D project. It identified a variety of opportunities for Breville to participate more fully in the circular economy. The findings, which resulted in a detailed paper, will increasingly be used to inform the NPD funnel and ESG priorities. The discovery phase of Project Forever aimed to identify the most impactful design changes Breville could undertake to materially reduce the per-unit carbon impact (Scope 3 emissions) of its products, while also ensuring a strong customer experience.

Project Forever has progressed to the next phase of the innovation funnel, the Exploration phase, beginning in FY25.

The development of new products and solutions is a key element of the group's growth strategy and reflected in the balance sheet as "Capitalised Development Costs and Computer Software". As more products are developed and launched, capitalisation increases, and with a lag, so does amortisation, driven by the length of the development cycle.

In FY24, Breville capitalised Development Costs and Computer Software of $37.2m (pcp: $32.8m) and recognised an amortisation expense of $22.4m (pcp: $16.5m). This increased the capitalised development to $86.3m.

White space

New geographies can be opened with a full range of skews and a full-service offering. If an "on continent" Distribution Centre (DC) is accessible, new geographies become routine execution for this high performing management team. This includes the customer service piece, which we recently tested and experienced in Australia.

Importantly, Breville can deliver NPD, enter new countries and assimilate acquisitions simultaneously, without slowing down. The componentisation of web infrastructure enables Breville to set up new sites quickly with a proven underlying code. Entering a new market or acquiring a company doesn't directly require the addition of new people in Tech services. Rather, an extension of the existing system automates the new transactions.

In 2016, circa 30% of group transactions were automated and 70% manual. By FY23, 85% of transactions were automated, while 15% remained manual. In that period, the overall transaction count increased 3x. Breville is focusing on eliminating the remaining manual transactions.

Acquisitions

When the opportunity arises for inorganic expansion, the global platform provides Breville with a competitive advantage in M&A. Integration is the key to success in any acquisition. For Breville, the platform is a true enabler. Acquisitions to date include Chef Steps, Joule, Baratza and the largest to date, Lelit.

At the time of acquisition, Lelit was a boutique premium coffee machine manufacturer based in Italy. Price points range from AU$1,000 to $5,000. This single warehouse business was essentially lifted onto the Breville platform, gaining substantial operational efficiencies across design (ECAD + MCAD), procurement, supply chain, accounts and marketing, including Ecommerce and social content or "go to market".

Old world functions, such as manual transactions, associated cost bases and distributors were jettisoned. In their place, the Breville platform delivers automated direct B2B and B2C solutions, offering greater brand and product control across a growing multi-geography opportunity.

Lelit began transacting on the global platform four months after the transaction closed. Within 15 months, Lelit was trading direct in Europe, the U.S. and Australia, operating from four warehouse locations, extended into the premium mass channel and launched a new multi-geography transacting website.

The platform delivers scale, efficiency, profitable growth and margin expansion.

Figure 12: Lelit Bianca V3 Black with Maple Handles US$2,999 (AU$4,999)

Source: Lelit website

The platform makes Breville more competitive in M&A. In a contested bidding process, the Breville platform delivers a better cost base and a global opportunity set. A replatformed business is simply worth more in Breville's hands. Importantly, integration, a post-acquisition minefield, is dealt with upfront rather than becoming a problem for tomorrow's CEO and shareholders.

Solutions

In the 1990's book *The Alchemy of Growth,* McKinsey developed the Three Horizons Framework. Over time, strategists expanded the framework to a fourth horizon, encompassing visionary blue-sky thinking. Solutions represent horizon 4 for Breville. Here, CEO Jim Clayton will lead the company in pivoting from a hardware-only company that relies on one-off sales to a subscription model with recurring revenues. This is rarely achieved. Think Microsoft, Apple, Samsung and LG.

At Breville, Solutions sits under the leadership of Chief Technology Officer Tal Ball. Ball has been with Breville for over six years and is based in Vancouver, Canada. Ball is a globally recognised CTO, Advisor (SingularityNET) and a former CEO.

In the global product segment, coffee, which we estimate brings in over 50% of group revenue, delivered strong double-digit growth in FY24, driven by an innovative range of coffee machines and the new Oracle Jet. Breville's most promising solution and new B2B portal, *"powered by Beanz",* sits in this coffee vertical.

"Powered by Beanz" opens an important branding opportunity for Breville products in specialty coffee retailers by facilitating automated transactions and product dropship for these smaller businesses. This solution also allows all three brands – Lelit, Breville and Baratza – to be sold side-by-side in all direct countries.

Typically, specialty coffee retailers, cafés and/or boutique roasters have a small Ecommerce offering. They often have strong, cult-like social media credibility, but may lack access to funding and the working capital capacity to hold stock and offer a streamlined supply solution. A platform providing a dropship solution is often the missing piece. For Breville, this opens a growing white space.

The Beanz platform is live in Australia, the U.S., UK and Germany, with further countries to follow. According to Trustpilot, the jury is out on the original cashback offer and service. Users typically like the product, especially access to local boutique coffee roasters. However, customers criticised the first iteration of the Breville $200 cashback offer, a subscription model combining fresh coffee beans with a newly purchased and registered machine. This service was subsequently closed. Breville believes that by bringing the cashback piece in-house, this financial hygiene factor can be quickly solved.

In September, the "Fast-Track Barista Pack" was launched in Australia. This offer *"bundles an espresso or coffee machine with fresh beans from the country's leading roasters, provides step-by-step expert guidance and offers up to $800 cashback".* It also launched in Germany with a value of up to €600. In the UK, a cashback of £600 is on offer.

We have purchased from the "one-off" coffee beans offered via Beanz.com and it was a seamless experience if you are happy to disregard the excessive packaging required to deliver. We found the $8 delivery fee for 500grams of beans to be on the aggressive side. This fee is absorbed when 1kg is purchased and is actually lower than the $9.08 fee charged by the same local roaster not using the B2B platform offered by Breville.

Overall, the Beanz.com transaction is a very satisfying experience. We received an email invoice immediately after our purchase. A day later, we received confirmation from Beanz.com that our chosen boutique roaster, Rogue in Victoria, had freshly roasted our order. On the third day, it was delivered. If you are a coffee buff, the smell of freshly roasted beans through the packaging is absolutely palpable. By contrast, the equivalent beans (St Ali) purchased from Coles on the same day have no smell emanating from the package.

The Breville+ solution in the U.S. now includes over 1,200 recipes sourced from ChefSteps, the Breville Test Kitchen, the New York Times, Serious Eats, Americas' Test Kitchen, Williams Sonoma and individual chefs. It includes cooking guides to help consumers achieve great results with their own recipes aided by live and on-demand cooking classes. All Breville+ content is optimised for the individual Breville products supported by the service, which now encompasses food processors, ovens and sous vide.

It remains early days for Breville solutions with Breville+, Beanz.com, B2B dropship and fast-track barista pack all in test-learn-iterate cycles. **SFM**

13SICK

Structural Change

Delivery models in healthcare are changing as we speak. General Practice, Medical Centres and Hospitals are all undergoing structural change. Some models will survive, others will not.

13SICK

One Sunday morning in late July, at 9.30am, it was blowing a gale on Sydney's Northern beaches. It was cold outside and felt like it would be snowing further south in our Alpine regions.

One teenager in our household was sick after the first week of school term, so it was ominous that we had not seen the eldest. He emerged from his room around 9.35am with a sore throat, despite having had his tonsils previously removed.

What are our options?

The non-digital option is to hop in the car and visit a General Practitioner (GP) at Warringah Medical Centre. This medical centre is a division of Limestone Bidco Pty Limited (trading as ForHealth Medical & Dental Centres), and to sit in the waiting room of a "Private Equity (PE) firm".

It's good to understand who is behind the delivery of your local services and their motivation. In this case, it's a PE firm and they are a known seller.

ForHealth arose from the medical centres division that BGH Capital purchased from Healius in 2020 for about $500m. Healius was previously Primary Healthcare, founded by Northern Beaches GP Dr Ed Bateman.

When BGH bought Healius, it had been generating $30m of annual earnings before interest, tax, depreciation and amortisation (EBITDA). According to The Australian on 28 April "BGH preparing for $1bn ForHealth medical centre sell-off", that figure may now be $100m annually.

Figure 13: Private equity investment in healthcare delivery

ASIDE: Medical Journey of Australia

A total of 75 private equity acquisitions of health care delivery assets in Australia during 2008–2022 were identified; the annual number rose from three acquisitions in 2008 to eighteen in 2022. During 2008–2010, five of seven acquisitions were of in vitro fertilisation providers; during 2020–2022, 22 of 39 acquisitions were of clinics or clinic groups, including eleven of eighteen in 2022. The total value of the 39 acquisitions for which purchase price could be ascertained (52%) was $24.1 billion. During 2017–2022, the clinic specialty with the greatest number of private equity acquisitions was general practice (256 of 446 clinics purchased within acquisitions). Seven companies owning ophthalmology clinics (24 clinics) were acquired by private equity. Four private equity acquisitions during 2017–2022 included 60 oncology clinics, all related to a single clinic group.

Source: V. Berquist: Private equity investment in health care delivery, Australia, 2008-2022 (15 April 2024)

BGH is considering a $1b trade sale to a large global private equity healthcare industry investor like Sweden's EQT. An IPO is the back-up plan.

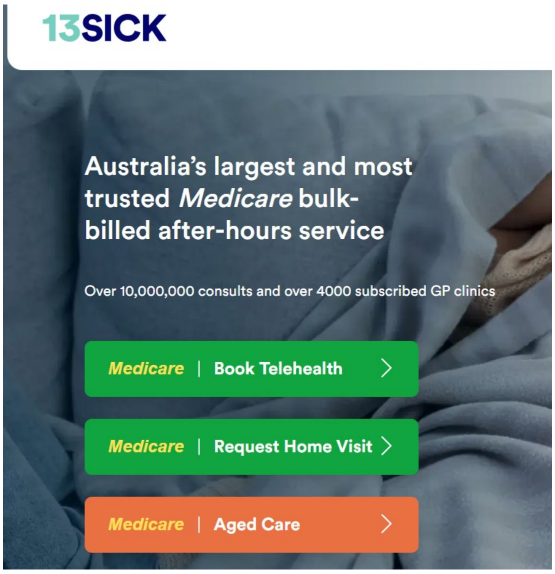
Digital alternative

One of the digital alternatives is 13SICK, accessible via its website or app. You can request a home visit or book the telehealth service with Australian licenced doctors.

13SICK claims to be Australia's largest and most trusted Medicare bulk-billed after-hours service, operating on Sundays, 6pm-8am on weekdays, and before 8am and after 12pm (noon) on Saturdays.

To date, 10 million GP consultations have been delivered by 4,000 subscribed GP practices.

Figure 14: 13SICK Landing Page



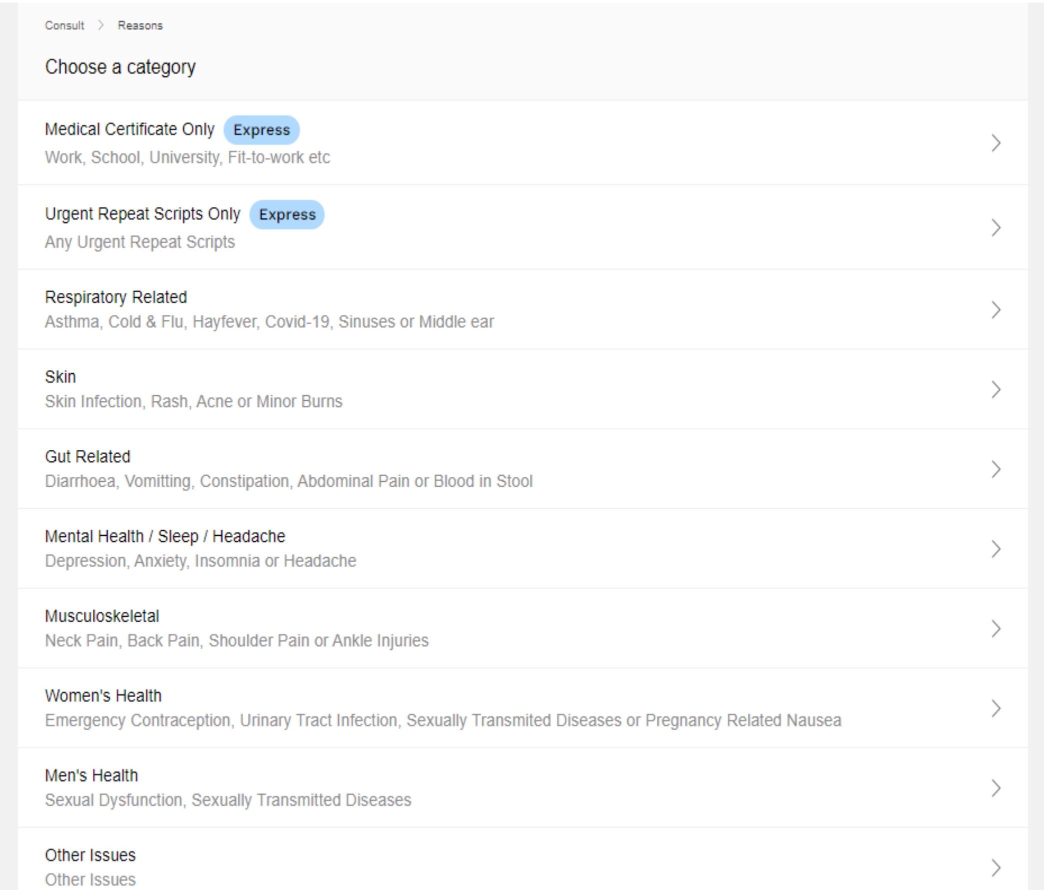
Source: 13SICK website

Executive decision

Having made the executive decision to engage the app, at around 9.40am our teenager was clearing his throat to consult with the General Practitioner over speaker on his mobile phone in our kitchen.

He was required to confirm his name and date of birth. The GP already knew he had a recurring sore throat. This was a brief, clear, no-nonsense consultation.

Figure 15: 13SICK Patient Consult Options



Source: 13SICK website

A text message with a digital script was instantaneous and by 9:45am, a parent was heading to Chemist Warehouse down the road to have the prescription filled.

This digital experience was even more satisfying than solving the Breville Problem.

13SICK's Terms and Conditions are clearly listed, which state you must be 16 and over and an Australian Medicare cardholder to create an account and use the services.

Additionally, to receive a bulk billed telehealth consultation with a Medical Practitioner on the platform, you need to have attended one of the 4,000 subscribed GP practices in the last 12 months. This is determined automatically when you plug in your Medicare number. **SFM**

Pigeonhole

According to the Collins dictionary, *"A pigeonhole is one of the sections in a frame on a wall where letters and messages can be left for someone. To pigeonhole someone or something means to decide that they belong to a particular class or category*."

The funds management industry is a "*pigeonhole*" market. The industry's fascination with fitting within a box leads to a myriad of investment styles intended to help investors understand what they are hopefully buying.

Photo: Pigeons looking for a home

The most popular 'boxes' operate at opposite ends of the investment spectrum, represented by a Value or Growth approach. Sitting somewhere in the middle is GARP – or Growth at a Reasonable Price – which combines aspects of both approaches as a great each-way bet. At the very extreme is Deep Value. On the surface, this approach sounds like an utterly sensible way of investing, except for the very reasons these investments trade at such deep value in the first place.

None of these styles sit comfortably with our thinking. It is not the way we consider a business opportunity. Over the years, our approach has evolved in part due to improvements in business models.

Historically, companies operated within a certain earnings environment and were exposed to cyclical economic swings, which led to revenue models that were more contractual and lumpier in nature. While these conditions still exist for many companies today, there are exceptions.

Over recent decades, the economic business model has moved in lockstep with technology. How we consume products and services is no longer a one-off lump sum transaction. While that may be the case for purchasing an expensive item, subscription services have become the norm for most people.

Our consumption of phones, music and computer services all add to a long list of daily, monthly and yearly subscriptions, often running on a 'set and forget' basis. In other cases, they are deemed mission-critical 'must have' services that are difficult to forgo, resulting in incredible user loyalty and generating consistent recurring revenue streams for their providers.

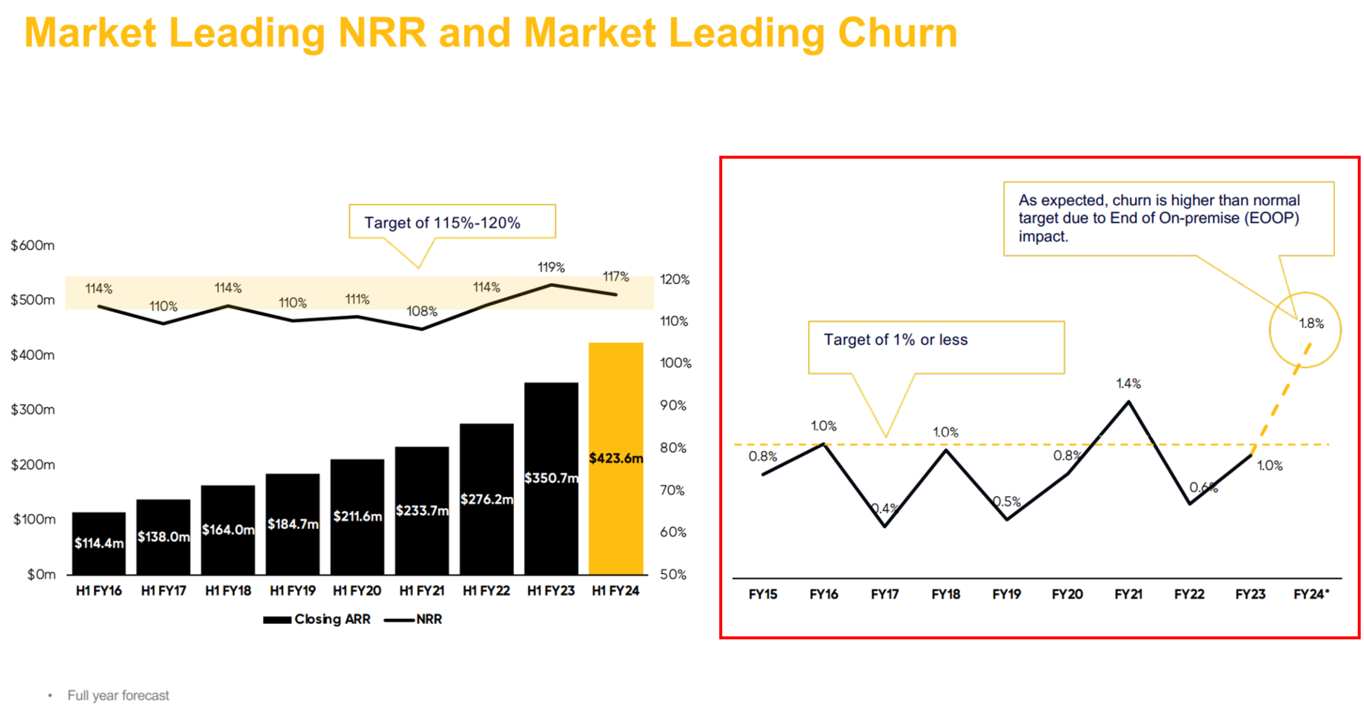
Not all businesses benefit from such revenue streams, but those that do have a huge advantage over others.

Firstly, they often command a leadership position in their respective field or market with a brand that resonates strongly. Online real estate operator REA Group quickly comes to mind.

Secondly, they deliver consistent and predictable operating cash flows, the lifeblood of any business. Business owners who can forecast their revenue with greater predictability can also control their expenses with more confidence. Software as a Service and Cloud provider TechnologyOne has built a formidable business spanning 37 years, by providing essential enterprise software services to over 1,200 clients, predominantly across Government departments and the University education sector.

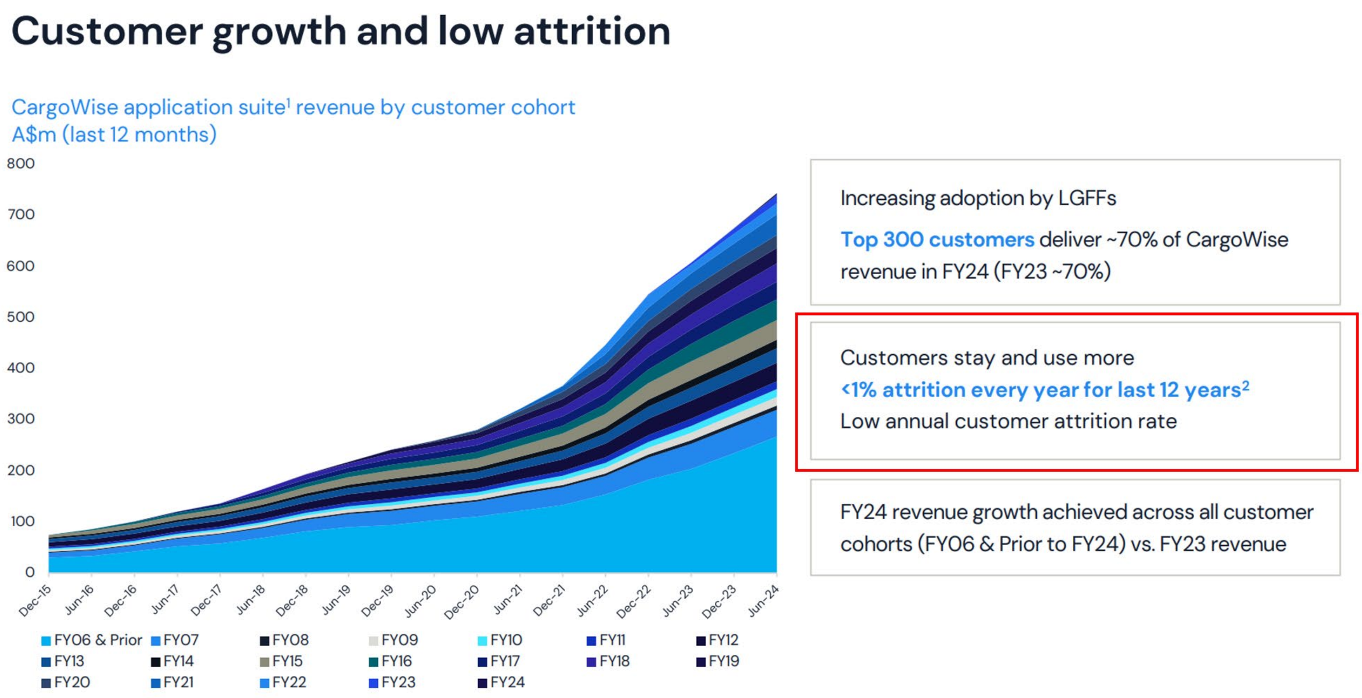
Thirdly, the business owner shifts focus from pursuing new customers to prioritising the satisfaction of existing users. While the former will always be sought after, a company that retains a high percentage of its existing customers over the long term is a highly prized business. The focus here is on the level of customer churn. Software companies like TechnologyOne and WiseTech enjoy annual churn rates of less than one percent. As such, they start the new financial year with 99% of their customer base still intact.

Figure 16: TechnologyOne churn history



Source: TechnologyOne half year 2024 presentation

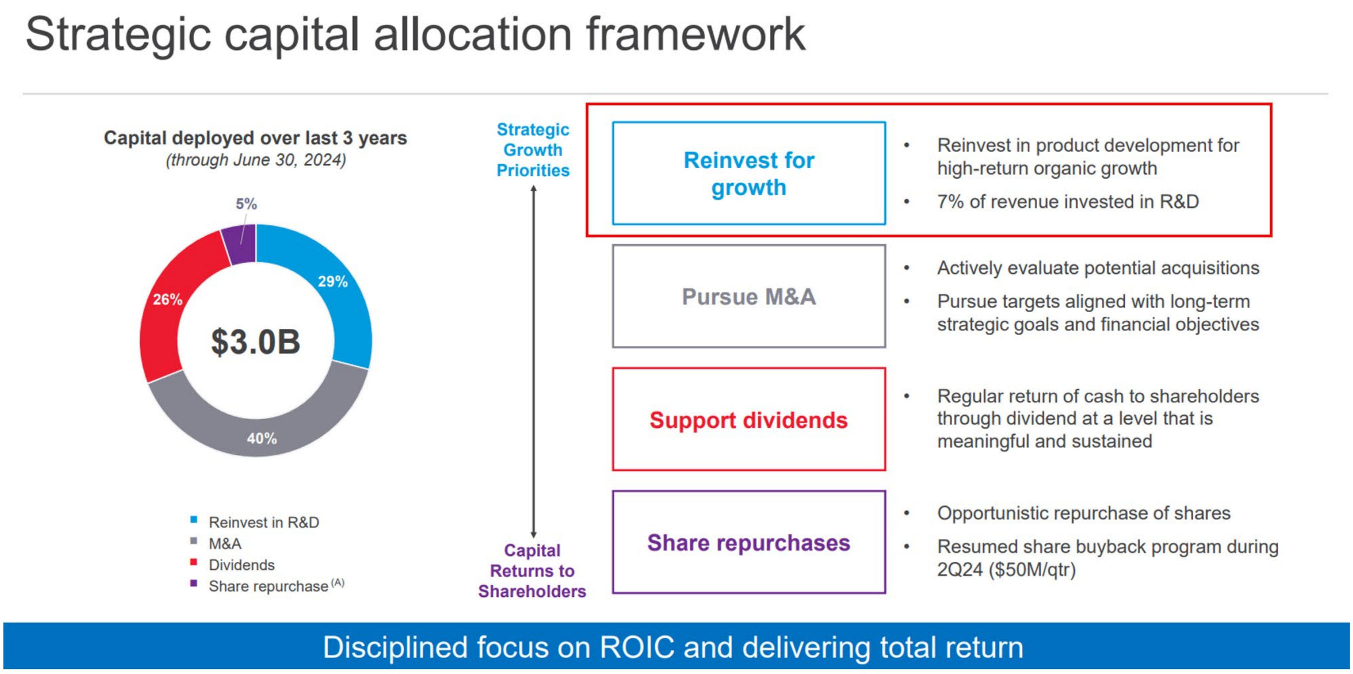
Figure 17: WiseTech churn history



Source: WiseTech full year 2024 presentation

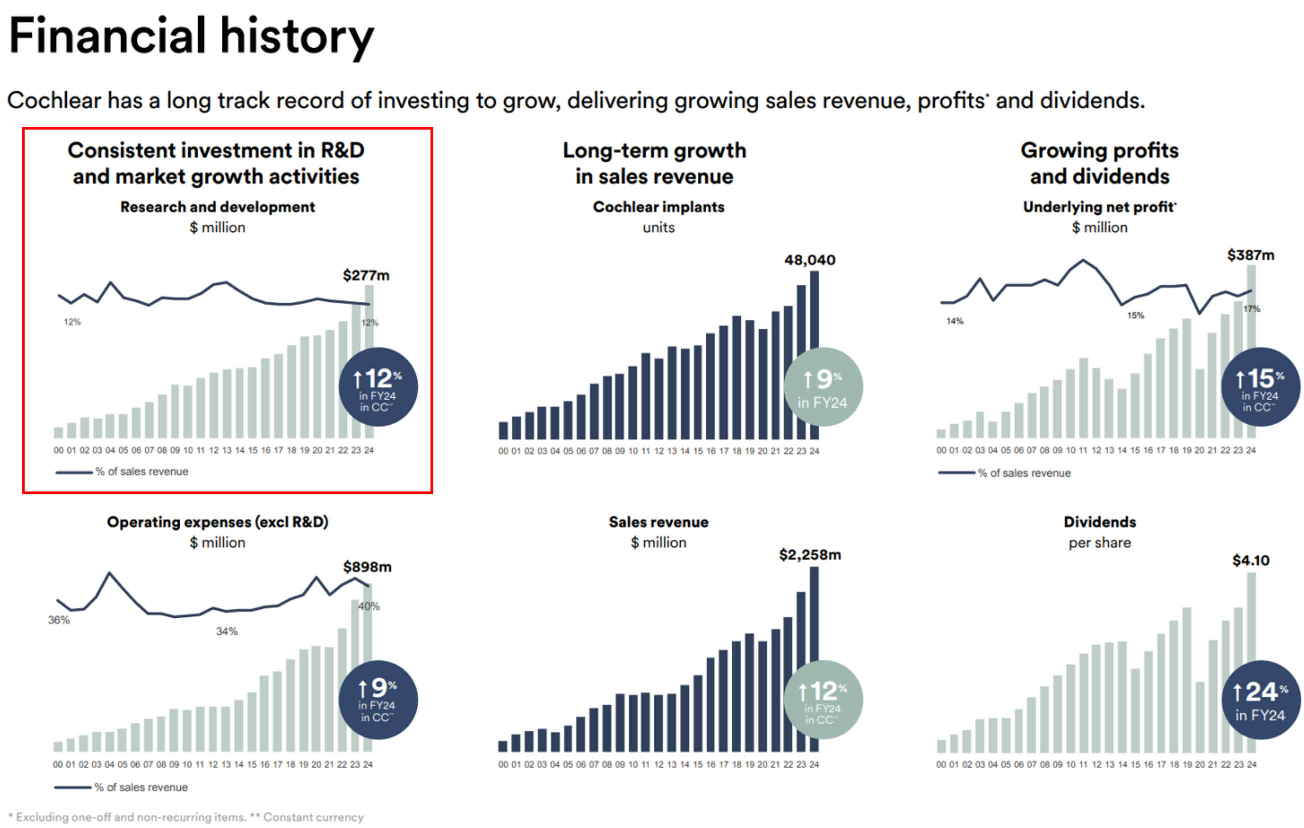
Fourthly, a business with a high degree of sustainable cash flow will look to enhance it with a forward-looking mindset, often reinvesting significant amounts of its annual revenue to sustain its competitive advantage. Consider the likes of ResMed, Cochlear and Aristocrat Leisure, which are all investing within the range of 7% to 13% of annual revenues in this pursuit. In dollar terms, the amounts are significant. ResMed committed over US$300m in the past twelve months, while Cochlear and Aristocrat Leisure allocated $277m and $873m, respectively, in the same period. In all three examples, these investments were fully expensed, lowering the current year profits but providing a base for future profitable product streams and services.

Figure 18: ResMed reinvestment focus



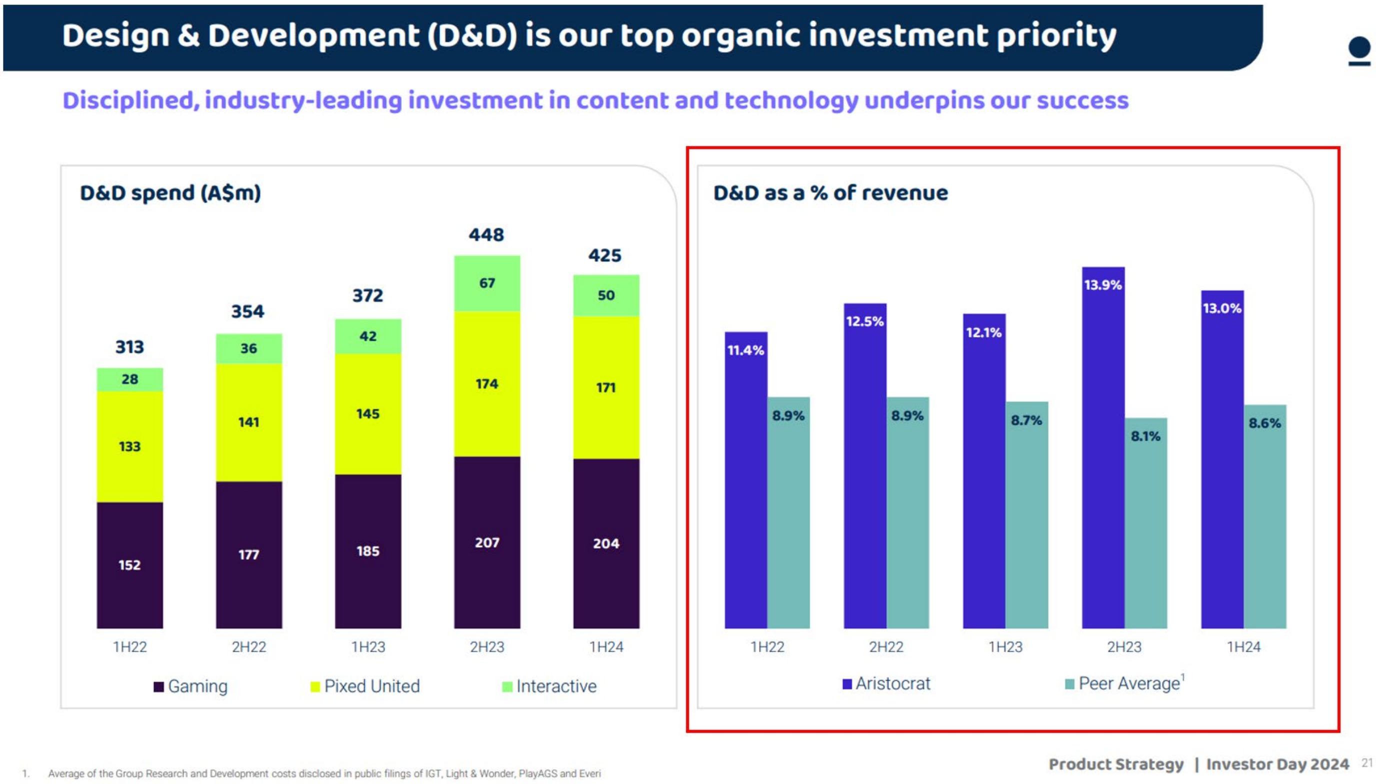
Source: ResMed 2024 full year presentation

Figure 19: Cochlear reinvestment focus



Source: Cochlear full year 2024 Annual Report

Figure 20: Aristocrat Leisure reinvestment focus



Source: Aristocrat Leisure 2024 Investor Day

These businesses also possess other powerful financial attributes that drive the ‘flywheel’. It starts at the top (as we noted) with a very high percentage of recurring revenues, which leads to high gross profit margins, allowing for ongoing daily investment and, importantly, future reinvestment. They enjoy strong cash flows and choose to remain conservatively geared.

By way of example, medical software provider Pro Medicus ended the year with gross margins of 99%, having retained all existing clients, while adding a further nine contract wins in North America. The group invested 7% of revenues in research and development, allocating 50% of staff to this function, and reported net profit margins of 50%, resulting in a bottom-line profit of $83m. The firm paid a dividend equal to half of the profits generated and lifted net cash on the balance sheet to $155m.

Equally, appliance group Breville maintained its impressive global rollout performance. As a wholesaler, the company operates a capital light business model, with gross margins of 36%, driving operating profit margins of 12%. The company’s top line has more than doubled over the past five years to $1.5b, while the balance sheet remains pristine, with net cash of $53m and a prudent dividend payout ratio of 40%.

Similar comments can be applied to many other businesses held, including CAR Group, ARB, Reece Group and James Hardie. In circumstances where recurring revenues are less prominent, brand recognition and customer engagement play an increasingly important role.

It is worth noting these companies are not immune to the economic challenges that beset businesses. Rather, their ability to navigate the ups and downs of corporate life stems from having more options available to them.

This is an important point when considering a business with a singular advantage operating in a market competitive field. With little discernible difference from its competitors, this advantage can diminish over time. The banking sector and supermarket industry highlight sectors vulnerable to new well-funded operators.

However, a business possessing multiple advantages is incredibly powerful. Consider a market-leading business with few competitors, enjoying low customer churn, earning strong margins, benefiting from highly recurring revenue streams and prepared to sustain high levels of reinvestment, while carrying low debt or net cash. When all these attributes are harnessed in a coordinated fashion, they can offset many of the prevailing negatives.

Importantly, it can lead to a level of financial sustainability that smooths out the extreme highs and protects against the very lows. Since we began, we have seen the evolution of better business models. Their success is leading to dominant market positions and an owner's mindset that considers today's needs but not at the expense of tomorrow. Rather than a pigeonhole approach, we will go where the business case is strongest and where the combination of superior attributes tilts the advantage in our favour. ***SFM***

Opaque World of Private Credit

In February 1994, a new fund manager opened for business. Long-Term Capital Management (LTCM) raised $1.25 billion from investors and set about exploiting the trading opportunities in the bond market. This was their area of expertise, built on mathematical models developed by the LTCM team.

Led by John Meriwether, LTCM trading relied on buying and selling bonds based on the respective relative value on offer, as dictated by the models. This would entail taking on thousands of trades since the spread (profit) between the bonds bought and sold was often minuscule. To make a decent profit on these tiny spreads, Meriwether added one significant factor to the offering, lots of leverage.

We refer to LTCM as a hedge fund. LTCM did not see itself as a hedge fund but rather as a state-of-the-art financial intermediary providing capital to markets, like the banks. For the privilege, LTCM charged its investors a yearly fee of 2% on assets and 25% of the profits delivered.

The term “hedge fund” is derived from the expression ‘*to hedge one’s bets*,’ meaning to limit the possibility of loss on speculation by betting on the other side.

In securities law, this term does not exist. As Roger Lowenstein explains in his acclaimed book *When Genius Failed*, which chronicles the rise and fall of LTCM, it is more accurately described as a limited partnership. These partnerships operate as private, unregulated investment pools for the rich. They keep their portfolio contents hidden, can borrow as much as they choose and are free to concentrate their bets. This lack of transparency, and one most guarded by the hedge fund industry, is a significant drawback for outside investors and financial regulators alike. Among the most celebrated hedge fund managers is George Soros’s Quantum Fund.

In marketing its fund, LTCM compared the tiny spreads (profits) earned on the thousands of trades entered to vacuuming up nickels others in the market couldn’t see.

To capture these nickels, LTCM leveraged its capital upwards of twenty to thirty times, or even more.

Not everyone was convinced that Meriwether and his talented hedge fund operators fully comprehended the risks involved.

As Lowenstein explains, “*At least one observer had grave doubts about the fund’s seemingly cavalier approach to debt. Seth Klarman, the general partner of Baupost Group, a collection of smallish hedge funds based in Cambridge, Massachusetts, wrote to his investors that he had been offered a stake in a new fund run by former Salomon bond traders – obviously Long Term – and had declined. Klarman was perturbed by a seemingly reckless trend on Wall Stree*t. *Investment banks possessed of the equivalent of financial Veg-O-Matics were slicing and dicing financial assets into potent, newfangled securities – IOs and POs – that investors were scooping up with reckless elan (enthusiasm).*

What was worse, investors had rediscovered their thirst for leverage. With double-digit bond yields a thing of the past, investors – particularly the new hedge funds that were “popping up all over” – were resorting to borrowing to inflate their returns.

How could investors be so certain that markets would always be liquid? Klarman wondered. He feared that investors were running a blind eye to the consequences of outlier events such as the sudden disturbances and occasional crashes that, historically, have always upset the best-laid plans of investors.

In general, Klarman warned, ‘Successful investors have positioned themselves to avoid the 100-year flood. Increasingly, that way of thinking has become passé. Turning to the former Salomon traders’ fund – that is, to Long Term – Klarman noted that, given its projected leverage, even a single serious mistake would put a “major dent” in the fund’s capital. Two major errors at the same time, of course, would be catastrophic.”

Why LTCM?

LTCM is a wonderful example of what you see is *not* what you get. The period in which LTCM operated, 1994-1998 should remain fresh in our minds. However, like the Global Financial Crisis (GFC) of 2007-2008 and even more recently COVID-19, investors are prone to forget.

Those fortunate to have operated in markets during these periods should have learned some valuable lessons. Importantly, authors like Lowenstein have also done their part in bringing to light past events.

LTCM ultimately failed because its models, which were supposed to protect them on the downside, didn't.

The partners' view of the world was that "*Risk is a function of volatility. These things are quantifiable.*" As such, they were blinded by the power of their models, seeing volatility rather than leverage as the best proxy for risk.

At its peak in 1996, LTCM managed assets worth $140 billion with just $4.7 billion of capital, a leverage of 30 times.

It was this leverage and an inability to model all possible events which led to its downfall. LTCM had Nobel Prize winners Robert C. Merton and Myron S. Scholes in their corner, who, alongside Fischer Black, developed a new method in 1973 for determining the value of an option, known as the Black-Scholes-Merton option pricing formula.

This mathematical equation, regarded as one of the most important concepts in modern financial theory, estimates the theoretical value of derivatives based on other investment instruments, by considering the impact of time and other risk factors.

Merton took these workings a step further. As Lowenstein writes, "*He assumed that volatility was so constant that prices would trade in continuous time – in other words without any jumps… In short Merton assumed a perfect, risk-free arbitrage that was an essential building block in Long-Term's hedging strategies…This gave them tremendous confidence. Their trades usually were sensible, meaning that they were aligned with the odds. Nevertheless, the fact that the group's ship hadn't capsized in the past didn't guarantee that the group had properly calculated the odds of a tidal wave – just that such waves were relatively infrequent.*"

Black-Scholes-Merton team

From right to left | Fischer Black | Myron S. Scholes |Robert C. Merton

Formula: Black-Scholes-Merton model

$$C = N(d_1)S_t - N(d_2)Ke^{-rt}$$

$$\text{where } d_1 = \frac{\ln\frac{S_t}{K} + (r + \frac{\sigma^2}{2})t}{\sigma\sqrt{t}}$$

$$\text{and } d_2 = d_1 - \sigma\sqrt{t}$$

C = call option price

N = CDF of the normal distribution

S_t = spot price of an asset

K = strike price

r = risk-free interest rate

t = time to maturity

σ = volatility of the asset

28 September 1998

On 28 September 1998, LTCM collapsed and was bailed out by fourteen investment banks that collectively invested US$3.65 billion to take ownership.

The irony of LTCM was evident in its name, given how inappropriate it was for a hedge fund operating with such outsized leverage.

In 1998, amidst market turmoil and Russia defaulting on its debt, a series of outlier events unfolded. While the impacts on spreads that followed might seem absurd when modelled and would have likely rectified itself in the long run, highly leveraged firms like LTCM could not afford the luxury of long-term thinking. As a result, LTCM's hand was forced at the worst possible time.

This was LTCM's undoing: too much leverage and a failure to model for unforeseen events. Lowenstein again, "*Even when these models are applied by government regulators their application is flawed, because they look to past market history as received truth.*

But markets, we must emphasise, are imperfect. They are the agglomeration of myriad investors, most of whom usually act rationally, usually, as history has shown, but not always.

Even perfectly logical investors will panic, as will theatregoers at the mere possibility of fire, so as not to be last to the exit; this threat of contagion renders financial markets inherently unstable. The susceptibility to panic is especially troublesome when they manifest in credit markets.

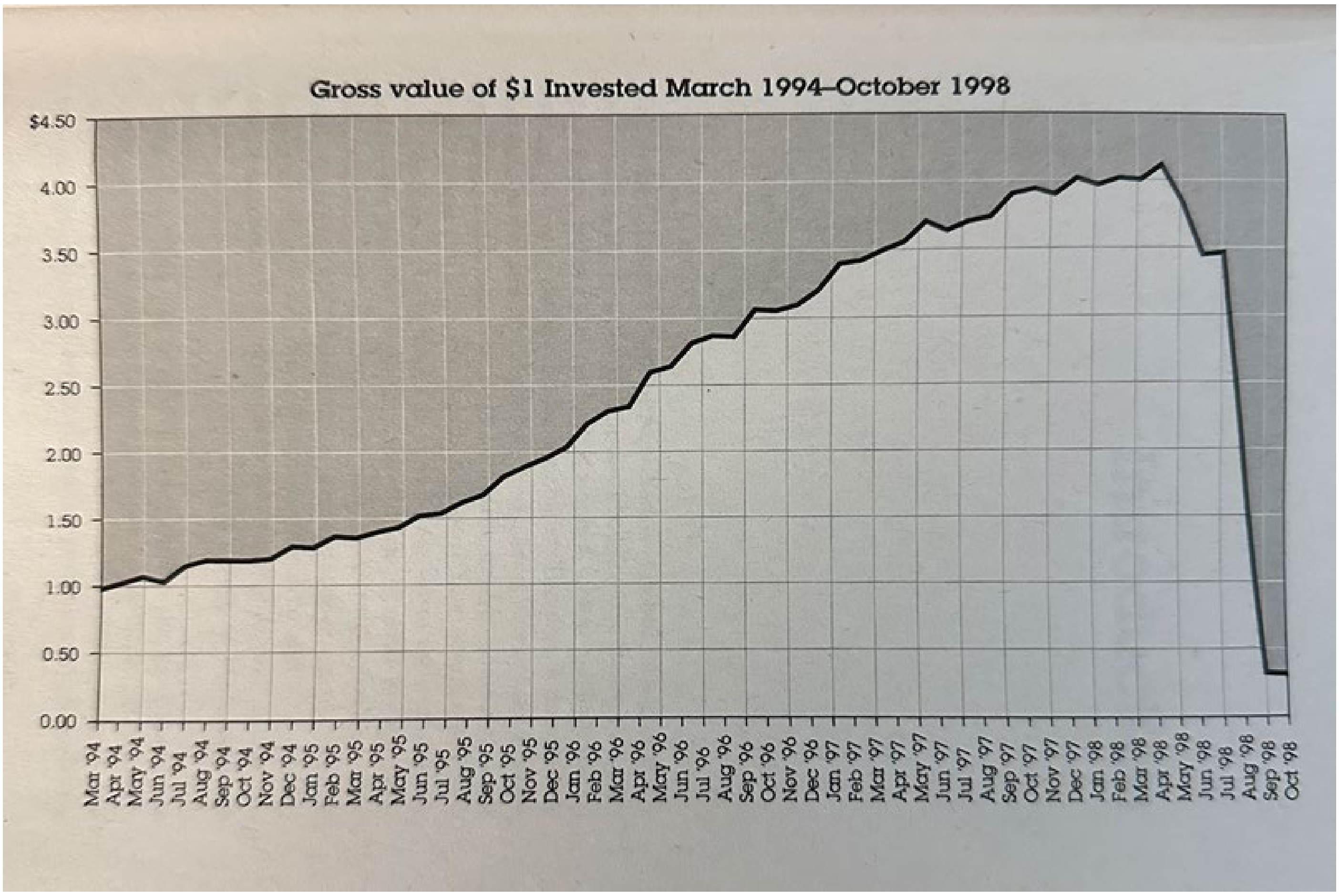
Credit is a wager that the lender makes with respect to the borrower; every loan is a gamble on repayment. When the market's calculation is off, too many people are either offered credit or denied it.

This is the fear of systemic failure and why both LTCM and the collapse of the mortgage bubble were so destabilizing. Each was caused by a condition of over-indebtedness."

At its conclusion, LTCM's cumulative loss was staggering, best summed up by Lowenstein, "*Through April 1998, the value of a dollar invested in Long-Term quadrupled to $4.11. By the time of the bailout, only five months later, precisely 33 cents of the total remained.*

After deducting the partners' fees, the results were even sorrier: each invested dollar, having grown to $2.85, shrank to a meagre 23 cents. In net terms, the greatest fund ever – surely the one with the highest IQ's – had lost 77 percent of its capital while the ordinary stock market investor had more than doubled his money."

Figure 21: LTCM gross value invested 1994-1998



Source: Roger Lowenstein, When Genius Failed: The rise and fall of Long-Term Capital Management

Florida, 15 October 1998

In a lecture to MBA students at Florida University in October 1998, Warren Buffett, CEO of Berkshire Hathaway, was asked the following question and provided this response:

Question: "*You were rumoured to be one of the rescue buyers of Long-Term Capital, what was the play there, what did you see*?"

Buffett: "*The Fortune Magazine that has Rupert Murdoch on the cover. It tells the whole story of our involvement; it is kind of an interesting story. I got the really serious call about LTCM on a Friday afternoon that things were getting serious. I know those people most of them pretty well--most of them at Salomon when I was there. And the place was imploding and the Fed was sending people up that weekend.*

Between that Friday and the following Wed. when the NY Fed, in effect, orchestrated a rescue effort but without any Federal money involved. I was quite active, but I was having a terrible time reaching anybody.

We put in a bid on Wednesday morning. I talked to Bill McDonough at the NY Fed. We made a bid for 250 million for the net assets, but we would have put in 3 and 3/4 billion on top of that. $3 billion from Berkshire, $700 mil. from AIG and $300 million. from Goldman Sachs.

And we submitted that, but we put a very short time limit on that because when you are bidding on $100 billion worth of securities that are moving around, you don't want to leave a fixed buy and sell price bid out there for very long.

In the end the bankers made the deal, but it was an interesting period. The whole LTCM is really fascinating because if you take Larry Hillenbrand, Eric Rosenfeld, John Meriwether and the two Nobel prize winners. If you take the 16 of them, they have about as high an IQ as any 16 people working together in one business in the country, including Microsoft.

An incredible amount of intellect in one room. Now you combine that with the fact that those people had extensive experience in the field they were operating in. These were not a bunch of guys who had made their money selling men's clothing and all of a sudden went into the securities business.

They had in aggregate, the 16, had 300 or 400 years of experience doing exactly what they were doing and then you throw in the third factor that most of them had most of their very substantial net worth's in the businesses.

Hundreds and hundreds of millions of their own money up (at risk), super high intellect and working in a field that they knew. Essentially, they went broke. That to me is absolutely fascinating.

If I ever write a book, it will be called, Why Smart People Do Dumb Things. My partner says it should be autobiographical. But this might be an interesting illustration. They are perfectly decent guys. I respect them and they helped me out when I had problems at Salomon. They are not bad people at all.

But to make money they didn't have and didn't need, they risked what they did have and what they did need. That is just plain foolish; it doesn't matter what your IQ is. If you risk something that is important to you for something that is unimportant to you it just doesn't make sense. I don't care if the odds you succeed are 99 to 1 or 1000 to 1 that you succeed.

If you hand me a gun with a million chambers with one bullet in a chamber and put it up to your temple and I am paid to pull the trigger, it doesn't matter how much I would be paid. I would not pull the trigger. You can name any sum you want, but it doesn't do anything for me on the upside and I think the downside is fairly clear. Yet people do it financially very much without thinking.

There was a lousy book with a great title written by Walter Gutman—You Only Have to Get Rich Once. Now that seems pretty fundamental.

If you have $100 million at the beginning of the year and you will make 10% if you are unleveraged and 20% if you are leveraged 99 times out of a 100, what difference if at the end of the year, you have $110 million or $120 million? It makes no difference.

If you die at the end of the year, the guy who makes up the story may make a typo, he may have said 110 even though you had a 120. You have gained nothing at all. It makes absolutely no difference. It makes no difference to your family or anybody else.

The downside, especially if you are managing other people's money, is not only losing all your money, but it is disgrace, humiliation and facing friends whose money you have lost. Yet 16 guys with very high IQs entered into that game. I think it is madness. It is produced by an over reliance to some extent on things.

Those guys would tell me back at Salomon; a six Sigma event wouldn't touch us. But they were wrong. History does not tell you of future things happening. They had a great reliance on mathematics. They thought that the Beta of the stock told you something about the risk of the stock. It doesn't tell you a damn thing about the risk of the stock in my view.

Sigma's do not tell you about the risk of going broke in my view and maybe now in their view too. But I don't like to use them as an example. The same thing in a different way could happen to any of us, where we really have a blind spot about something that is crucial, because we know a whole lot of something else. It is like Henry Kauffman said, "The ones who are going broke in this situation are of two types, the ones who know nothing and the ones who know everything." It is sad in a way.

I urge you. We basically never borrow money. I never borrowed money even when I had $10,000 basically, what difference did it make. I was having fun as I went along it didn't matter whether I had $10,000 or $100,000 or $1,000,000 unless I had a medical emergency come along."

July 2024

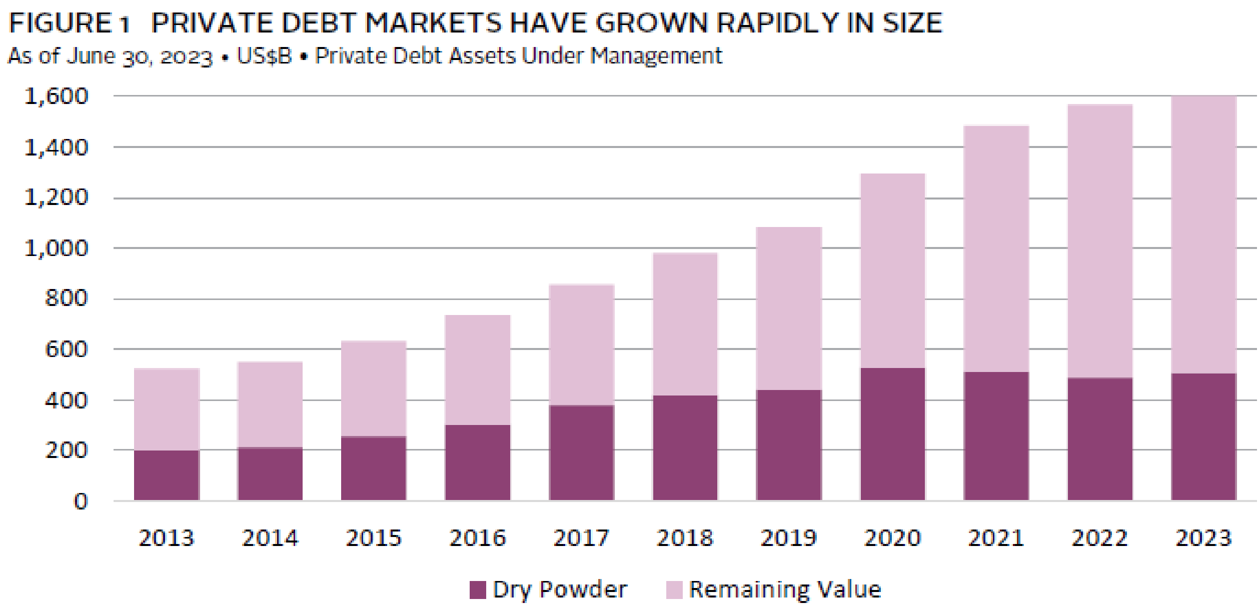
A lot of water has passed under the bridge since LTCM or the GFC. However, as is often the way, investors are good at forgetting. Today, concerns surrounding the valuations of technology businesses are grabbing the headlines, perhaps understandably considering their increased market prominence.

However, one area of potential concern is the growth in private credit.

The private credit markets are non-publicly traded instruments, provided by non-bank entities to fund private businesses. They have gained prominence due to a confluence of events, including an elevated interest rate environment and tighter lending standards, making capital harder to obtain than traditional debt markets. This situation provides a solution for borrowers and an opportunity for investors seeking higher returns.

The size of the private credit market at the start of 2024 was approximately US$1.5 trillion, compared to approximately US$1 trillion in 2020, as Graph 6 highlights. It is estimated to grow to US$2.8 trillion by 2028.

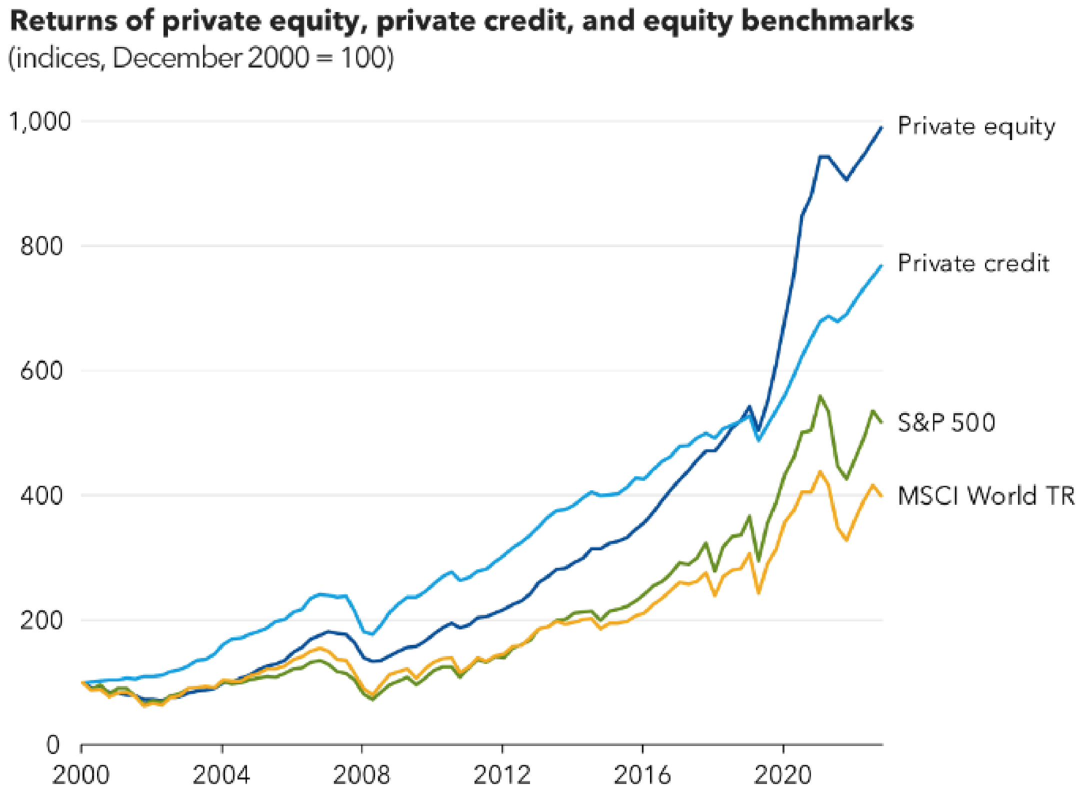
Graph 6: Private credit market



Source: Pitchbook

Private credit has also been a strong returns generator, illustrated in Graph 7, although the lack of transparency and use of leverage makes direct comparisons to other asset classes more difficult.

Graph 7: Returns from asset classes



Source: Preqin and IMF staff calculations

Commenting on the upward trajectory of private credit markets, the International Monetary Fund (IMF) notes, *"Private corporate credit has created significant economic benefits by providing long-term financing to corporate borrowers. However, the migration of this lending from regulated banks and more transparent public markets to the more opaque world of private credit creates potential risks.*

Valuation is infrequent, credit quality isn't always clear or easy to assess, and it's hard to understand how systemic risks may be building given the less than clear interconnections between private credit funds, private equity firms, commercial banks, and investors.

Today, immediate financial stability risks from private credit appear to be limited. However, given that this ecosystem is opaque and highly interconnected, and if fast growth continues with limited oversight, existing vulnerabilities could become a systemic risk for the broader financial system."

A vocal sceptic of this asset class is DoubleLine CEO Jeffrey Gundlach, who referred to private credit as a "bubble" that often enjoys a boom "when public credit is not financeable." Further, as the Financial Advisor reported, *"With so many big institutions and wealthy individuals flocking to private markets, Gundlach raised the issue of a liquidity crunch if there were a financial crisis."*

The largest private credit players are well-known global operators, as set out in Table 12.

Table 11: Largest private credit managers

TOP 10 BIGGEST PRIVATE DEBT FUND MANAGERS

Rank	Firm	HQ	Capital raised ($m)
1	Ares Management	Los Angeles	117,171
2	Goldman Sachs Asset Management	New York	83,421
3	HPS Investment Partners	New York	66,742
4	Blackstone	New York	58,389
5	Apollo Global Management	New York	49,612
6	Intermediate Capital Group	London	49,482
7	Oaktree Capital Management	Los Angeles	46,317
8	BlackRock	New York	45,727
9	AXA IM ALTS	Paris	43,769
10	M&G Investments	London	38,005

source: Private Debt Investor 200

Not to be outdone, Australian asset managers are also jostling for pole position, as reported by the Australian Financial Review (AFR) in its piece, "Marking their own homework: Inside Australia's $200b unregulated private credit boom."

As reporters Aaron Weinman and Jonathan Shapiro noted, "*High returns, high fees – life is good in private credit. A once unloved investment class has turned hot property as cashed up families and asset managers chase yields from floating rate loans that have risen in lockstep with interest rates*."

However, opaqueness remains a key concern and was singled out by Westpac CEO Peter King, *"Ideally, private credit and banks should face the same liquidity requirements"* so as *"to ensure we do not face issues such as liquidity risk due to lower standards of transparency in that sector*."

Unlike banks, private credit funding is sourced from investors enticed by the lure of double-digit returns, without the volatility of equity markets. However, as LTCM investors discovered, focusing on volatility and ignoring leverage and transparency issues can be its undoing.

Private credit managers have far more flexibility to say less to investors since they are loosely regulated, particularly if their target audience are deemed sophisticated investors.

This has seen a wave of private credit acquisitions, including Phil King's Regal Partners acquiring Merricks Capital Partners Fund for $235 million in June. The firm oversees $2.9 billion in private credit loans across agriculture, infrastructure, commercial property and industrial sectors.

Merricks Capital Partners Fund has returned 10.1% since inception in January 2017, compared to the share market All-Ordinaries Accumulation Index return of 10.2% over the same period.

King's move on Merricks was made clear, "*We like it because we are very, very bullish on private credit. The thing about private credit is it is important to have scale. By combining our businesses, we get more critical mass, we see more opportunities to invest.*"

Merricks founder Adrian Redlich was just as enthusiastic when describing King, "*I worked with a couple of the smartest hedge funds in the world in the 2000s, and I think the people involved in Regal remind me of those smarts.*"

The move closely followed David Di Pilla's HMC Capital acquiring Payton Capital for $128 million in May, a manager with $1.5 billion of private credit loans. Di Pilla's experience in complexity makes private credit a worthy pursuit, as he explains, "*Ultimately, this comes down to the ability to do large complex transactions and to have the relationship to be able to get access to those transactions. If you look at the history of HMC, it's been built on doing the largest, most complex transactions in Australia - so this is a natural fit for our skill set.*"

HMC Capital aims to build the private credit loan book to $5 billion.

Further, in July, fund manager Perpetual Trustees set about raising $100 million from investors in its share market traded credit fund. Rather than targeting commercial real estate deals, Perpetual was steering towards investment grade and high-yield bonds, issued by the likes of Santos and other asset backed securities, preferring this over real estate exposure.

Another well-known operator Alceon, which counts ex-Babcock and Brown founders Trevor Loewensohn and Phil Green as principals, is also taking bold steps, hiring former Goldman Sachs banker David Gribble as its newest partner.

With $5.5 billion invested on behalf of clients, mostly funding property developments, Gribble says that private credit is only getting started in Australia, "*Private capital has a lot to play out, particularly in Australia, which is behind the curve. The banks are a much smaller part of the system here than in many parts of the world*."

All these providers have a willing audience, namely, high-net-worth clients and family offices. According to KPMG more than 2000 family offices now operate in Australia, many in need of product specific investments. This has underpinned a surge in demand for private credit investments, which has attracted more capital, largely at the expense of the banks.

JPMorgan CEO Jamie Dimon provided perspective on the matter, as reported by the AFR in April, "*Not all players were necessarily good in private credit and should anything go wrong, investors could be left nursing losses.*

He cautioned private credit had not been stress-tested by a major event like the GFC, which crushed the housing market in the United States in 2008."

Super Fund Industry

Not to be forgotten, the $4 trillion superannuation industry is also sizing up the private credit opportunity. Past reluctance to invest in this asset class is now giving way to fund participation. The ability to earn 8%-12% returns, double the current base interest rates of 4%-5%, at a time of limited investment opportunities, is drawing attention.

The larger players, CBUS, Hostplus and our own Future Fund have upwards of 7%-10% allocated, with intentions to scale further.

The issues that the Super Fund industry needs to consider are liquidity and credit risk. The two go hand in hand. Private credit is an illiquid asset class and terms now being entered into have a locked period of up to three years. This may carry an added risk if super fund members shift from one fund to another, forcing redemptions.

The other more damaging outcome involves credit risk. Investors are attracted to the high yields on offer, seeking stable and reliable returns without the risk of capital loss. While investors have ignored the potential of credit risk in their pursuit of attractive yields, others have highlighted some shortcomings.

In the AFR opinion piece on 22 July 2024, Jonathan Shapiro wrote on one important issue, the valuing of illiquid assets:

"*One of the most contentious issues for regulators of super funds to contend with is the accuracy and frequency with which to value illiquid assets. In a system that allows members to switch options or funds at short notice, a consistently fair and timely valuation is vital for the integrity of the system.*

The issue of liquidity constraints is one that super funds and regulators are all too aware of. But another issue confronted by the chief investment officers of super funds is the value of the liquidity they're giving up when they buy private assets.

That is, what is the extra return they should extract from a private illiquid investment relative to a public market equivalent.

Investors of all sizes, including super funds, have been guilty of under-pricing this premium because of the illusion that the investment is more stable when, in fact, it is simply being valued less frequently.

The sooner investors can recognise the true value of liquidity and price it accordingly, the better it will be for asset classes such as private credit to flourish sustainably."

Perhaps sensing these concerns, Australian Securities and Investment Commission (ASIC) Chair Joe Longo, speaking at a recent Bloomberg conference reported by the AFR, noted, *"We have to come up with actionable policies or ideas as far as regulation is concerned. The very nature of private markets is a lack of transparency … what we are worried about is the protection of investors and integrity of the market."*

In a welcomed sign, increased regulatory scrutiny is likely to follow as a result, "*As we see more activity in the private market, my question is about conflicts of interest and valuations … why is capital flowing more to the private markets and not the public? That is the area we have decided to make a priority in the coming 12 months."*

Comment

Events like LTCM, the GFC and even COVID-19 are reminders that systematic failure in our financial markets happens quite regularly.

The current circumstances propelling private credit markets have all the components of heightened exuberance, smart operators, loose reporting requirements, leverage and investors flocking into opportunities in search of high returns.

These investors are not prepared for capital losses, nor were the investors in LTCM. The LTCM mathematical models, built by the smartest operators around, gave the principals the false hope that markets were perfect, when in fact they were far from it.

This period may indeed be different, but to assume a myriad of investors will act rationally during times of heightened risk is irrational. History would suggest otherwise. **SFM**

What's Next? More Capital

Listed cloud service provider, NEXTDC is a well-oiled machine. The company delivers critical infrastructure to meet the industry's thirst for cloud connectivity via its data centres. It has a stellar track record of lifting revenues, growing earnings before interest, tax, depreciation and amortisation (EBITDA), and raising new capital.

It has never disappointed on this last point. The business model of 'build it and they will come' has typified its approach since listing in December 2010, at the original offer price of $1.00 per share. Like clockwork, the company's shareholders have consistently accommodated management's request for more money. It is quite astonishing that such a capital-intensive business attracts so many loyal shareholders.

On the surface, it makes perfect sense. Data centres are highly specialised IT infrastructure facilities for the storing and processing of data. Clients sign up on long-term lease plans, which support the business case for each new centre. However, such is the demand for cloud storage capacity; additional sites are needed – sites that are larger in size, scale, complexity, and require more capital to build.

NEXTDC now runs 16 centres nationally, with plans to add further sites locally and internationally.

In September, the company raised another $750m of new capital, following $617m of new equity collected in financial year 2023 and $1.3 billion already raised in 2024. In total, shareholders have supplied more than $2.7 billion over the past two years.

At the September raising, new shares were offered at $17.15 each, underscoring the capital gains investors have enjoyed over the years. Since going public, the number of shares on issue has grown from 80 million to 644 million, an eight-fold increase. Everything is up except profits. The company can use EBITDA as its key metric, but you cannot bank EBITDA.

The truth lies in the cash flow statement and on that score, the company rarely gets out of the red. In financial year 2023 and 2024, NEXTDC recorded negative outflows of $584m and $882m respectively, including a two-year capital expenditure program totalling $1.6 billion.

The company advised that total capital spend for FY25 is expected to be $1.3 billion to $1.5 billion, some $400 million higher than previously guided.

The business is ranked within the ASX top 100 listed companies with a market capitalisation of $10.3 billion. Judging by the demand from investors, it matters naught that the company loses money.

Management's remuneration metrics are also tied to growing revenues and EBITDA, not profits. So, the incentive to build more centres and the need for additional capital to fund these sites remains strong.

Investment banks love these types of businesses, a proverbial gift that keeps on giving and guaranteed to deliver attractive fees. Analysts are equally in sync, applying their skills to a discounted cash flow model (DCF) that invariably spits out an even higher business valuation.

NEXTDC operates a business in high demand. Our issue is not demand but turning that into profitable outcomes while avoiding the constant need for new capital. At some point it will matter, unless of course investors are happy to keep tipping in more money. ***SFM***

Company Engagements – September 2024 Quarter

Date	Company	Description
2-Jul	RMD	ResMed UBS Industry Insights Call
15-Jul	NAN	Nanosonics Barrenjoey Management Meeting
18-Jul	DMP	Domino's Pizza Enterprises Management Meeting
22-Jul	PNV	PolyNovo Management Meeting
22-Jul	IRE	Iress Management Meeting
23-Jul	OFX	OFX Group Product Demonstration
24-Jul	JHX	James Hardie Industries Management Meeting
24-Jul	PNV	PolyNovo Macquarie Conference
25-Jul	TNE	TechnologyOne UBS Industry Insights Call
26-Jul	MVP	Medical Developments International Bell Potter Management Meeting
29-Jul	AUTO.LSE	Autotrader Plc Barrenjoey Management Meeting
30-Jul	TNE	TechnologyOne Investor Day
1-Aug	OFX	OFX Group Annual General Meeting
2-Aug	RMD	ResMed FY24 Results Call
2-Aug	RMD	ResMed JPM Management Meeting
2-Aug	CMG.NYS	Chipotle Mexican Grill Macquarie Management Meeting
8-Aug	FPH	Fisher & Paykel Healthcare Management Meeting
9-Aug	JHX	James Hardie Industries Annual General Meeting
9-Aug	REA	REA Group FY24 Results Call
12-Aug	CAR	CAR Group FY24 Results Call
12-Aug	CAR	CAR Group Barrenjoey Management Meeting
12-Aug	REA	REA Group Barrenjoey Management Meeting
12-Aug	REA	REA Group Management Meeting
13-Aug	ALL	Aristocrat Leisure Australian Gaming Expo
13-Aug	JHX	James Hardie Industries 1Q25 Results Call
13-Aug	CSL	CSL FY24 Results Call
13-Aug	JHX	James Hardie Industries Macquarie Management Meeting
13-Aug	SEK	SEEK FY24 Results Call
13-Aug	CAR	CAR Group BoA Management Meeting
13-Aug	CAR	CAR Group Management Meeting
13-Aug	SEK	SEEK Barrenjoey Management Meeting
14-Aug	JHX	James Hardie Industries Management Meeting
14-Aug	CPU	Computershare FY24 Results Call
14-Aug	PME	Pro Medicus FY24 Results Call
15-Aug	COH	Cochlear FY24 Results Call
15-Aug	CSL	CSL MST Management Meeting
15-Aug	CPU	Computershare Management Meeting
16-Aug	COH	Cochlear Management Meeting
16-Aug	COH	Cochlear Macquarie Management Meeting
19-Aug	REH	Reece FY24 Results Call
19-Aug	IRE	Iress FY24 Results Call
19-Aug	RMD	ResMed Management Meeting
20-Aug	RWC	Reliance Worldwide FY24 Results Call

Date	Company	Description
20-Aug	ARB	ARB Corporation FY24 Results Call
20-Aug	CSL	CSL Management Meeting
20-Aug	ARB	ARB Corporation JPM Management Meeting
20-Aug	IRE	Iress Morgans Management Meeting
20-Aug	REH	Reece Management Meeting
20-Aug	ARB	ARB Corporation Macquarie Management Meeting
21-Aug	BRG	Breville FY24 Results Call
21-Aug	DMP	Domino's Pizza Enterprises FY24 Results Call
21-Aug	FCL	FINEOS Corporation Holdings FY24 Results Call
21-Aug	WTC	WiseTech Global FY24 Results Call
21-Aug	ARB	ARB Corporation UBS Management Meeting
21-Aug	BRG	Breville UBS Management Meeting
21-Aug	RWC	Reliance Worldwide GS Management Meeting
21-Aug	ARB	ARB Corporation Management Meeting
21-Aug	ARB	ARB Corporation Macquarie Management Meeting
21-Aug	BRG	Breville Macquarie Management Meeting
22-Aug	BRG	Breville Management Meeting
22-Aug	DMP	Domino's Pizza Enterprises Management Meeting
22-Aug	RWC	Reliance Worldwide Management Meeting
22-Aug	DMP	Domino's Pizza Enterprises Barrenjoey Management Meeting
22-Aug	DMP	Domino's Pizza Enterprises UBS Management Meeting
22-Aug	FCL	FINEOS Corporation Holdings Macquarie Management Meeting
23-Aug	PNV	PolyNovo FY24 Results Call
23-Aug	JIN	Jumbo Interactive FY24 Results Call
23-Aug	BRG	Breville Barrenjoey Management Meeting
23-Aug	WTC	WiseTech Global Barrenjoey Management Meeting
26-Aug	IFM	Infomedia FY24 Results Call
26-Aug	MVP	Medical Developments International FY24 Results Call
26-Aug	NHF	nib holdings FY24 Results Call
26-Aug	JIN	Jumbo Interactive Barrenjoey Management Meeting
26-Aug	PNV	PolyNovo Macquarie Management Meeting
26-Aug	JIN	Jumbo Interactive Management Meeting
26-Aug	WTC	WiseTech Global Management Meeting
27-Aug	NAN	Nanosonics FY24 Results Call
27-Aug	IRE	Iress Management Meeting
27-Aug	IRE	Iress Barrenjoey Management Meeting
27-Aug	NAN	Nanosonics Barrenjoey Management Meeting
27-Aug	FCL	FINEOS Corporation Holdings Management Meeting
27-Aug	PNV	PolyNovo Management Meeting
28-Aug	NAN	Nanosonics Management Meeting
28-Aug	FLT	Flight Centre Travel Group FY24 Results Call
28-Aug	FPH	Fisher & Paykel Healthcare Annual General Meeting
28-Aug	FLT	Flight Centre Travel Group UBS Management Meeting
28-Aug	NHF	nib holdings JPM Management Meeting
28-Aug	NHF	nib holdings Management Meeting
28-Aug	FLT	Flight Centre Travel Group Management Meeting

Date	Company	Description
29-Aug	FCL	FINEOS Corporation Holdings Management Meeting
30-Aug	NAN	Nanosonics Morgans Management Meeting
2-Sep	MVP	Medical Developments International Management Meeting
3-Sep	REH	Reece Management Meeting
3-Sep	IFM	Infomedia Management Meeting
4-Sep	FCL	FINEOS Corporation Holdings Annual General Meeting
10-Sep	CRM.NAS	Salesforce Macquarie Management Meeting
12-Sep	FLT	Flight Centre Travel Group JPM Travel Industry Insight Call
13-Sep	DPZ.NYSE	Domino's Pizza Inc. Barrenjoey Management Meeting