

# Intelligent Investor Ethical Share Fund

(Managed Fund) (ASX:INES)

**“The pursuit of excellence is less profitable than the pursuit of bigness, but it can be more satisfying.” — David Ogilvy**

**“When momentum is on your side, people focus on your strengths and forgive your weaknesses. When the momentum stops, they scrutinize the whole thing.” — Packy McCormick**

The fund increased 2.4% in July compared to the market’s 4.2% gain. We sold numerous fairly valued holdings to make room for seven new international names, which we’ll discuss in more detail over time.

The share price of fund manager **Pinnacle Investment Management** continues to rise in a buoyant market after acquiring a highly rated international fund manager and a local stalwart in quick succession.

**CSL** has been a quiet achiever in the fund rising 30% since last year’s lows as confidence increases that the worst is over for the company following a poor acquisition and lingering effects from COVID that impacted profit margins.

Not owning the major iron ore miners is paying off as the iron price falls amidst China’s struggling property market. As we’ve discussed previously, we prefer **Mineral Resources’** higher exposure to iron ore volumes rather than prices, but it continues to suffer as ample lithium supply is pressuring prices.

Performance (after fees)					
	1 mth	1 yr	2 yrs	3 yrs	S.I. (p.a)
II Ethical Share Fund	2.4%	14.8%	6.3%	3.9%	10.0%
S&P ASX 200 Accumulation Index	4.2%	13.5%	12.6%	7.4%	8.2%
Excess to Benchmark	-1.8%	1.2%	-6.3%	-3.6%	1.8%


Inception (S.I.): 11 Jun 2019


RIAA’s RI Certification Symbol signifies that a product or service offers an investment style that takes into account environmental, social, governance or ethical considerations. The Symbol also signifies that Intelligent Investor Australian Ethical Share Fund (ASX: INES) adheres to the strict operational and disclosure practices required under the Responsible Investment Certification Program for the category of Product. The Certification Symbol is a Registered Trademark of the Responsible Investment Association Australasia (RIAA). Detailed information about RIAA, the Symbol and Intelligent Investor Australian Ethical Share Fund (ASX: INES) methodology, performance and stock holdings can be found at [www.responsibleinvestments.com.au](http://www.responsibleinvestments.com.au), together with details about other responsible investment products certified by RIAA.




## Fund overview


The Intelligent Investor Australian Ethical Share Fund is an Active ETF designed for investors seeking a diversified selection of Australian companies that produce growing, sustainable profits at low risk of interruption from the increasing threats associated with Environmental, Social and Governance (ESG) factors.


 **5+ yrs**  
Suggested investment timeframe

 **10 - 35**  
Indicative number of securities

 **Risk profile: High**  
Expected loss in 4 to 6 years out of every 20 years

 **S&P/ASX 200 Accumulation Index**  
Benchmark

 **Investment fee**  
0.97% p.a.

 **Performance fee**  
Nil



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Finally, though, numerous companies are announcing production cuts, with the largest being Albermarle's reduced expansion in Western Australia. We expect many more imminent announcements to bring supply into balance with demand.

**ResMed's** share price has largely recouped its losses as fears that GLP-1 drugs would reduce the need for the company's sleep apnoea treatments have been replaced with suggestions that increased weight loss treatments could increase sleep apnoea diagnosis, which is the main impediment to ResMed's growth.

While Aussie Broadband's share price mostly recovered from an initial 20% fall after it announced a small profit downgrade partly to fund a cheaper service to steal customers from incumbent NBN providers.

Lastly, we added **Eagers Automotive** early in the month following a large fall in its share price as a slowing economy is affecting car sales and prices. Let's take a detailed look.

## Automotive riches

Everyone knows car dealers are rich. In 2019, four economists studied the richest Americans and concluded that car dealers typically generated personal income measured in millions of dollars per year. They were among the most reliably rich in the country.

Families like the Warrens, the Suttons and the Pagents have made generational fortunes from selling cars in Australia.

If everyone knows car dealers make money, why does Australia's largest car dealership group look like such a lousy business?

Eagers Automotive controls more than 10% of the local market, about five times more than its nearest rival. Last year, one of the best in its history, it generated net profit margins of less than 3%, return on assets of just 7% and held \$2.4bn of net debt against a market capitalisation of \$2.8bn.

With numbers like that, it's no wonder the market isn't interested; Eagers trades on a price-to-earnings ratio (PER) of less than 10 and is viewed as cyclical, capital-intensive and low-quality. But is it?

In this review, we'll argue that Eagers is a better business than it appears and that its worth buying now.

## From start to balance sheet

Eagers is among the oldest businesses listed on the ASX, founded in 1913. From the start, the company has habitually bought rivals and new franchises. It listed on the ASX in 1957 and has paid a dividend every year since.

The consistency and longevity of dividends are one clue that business quality is better than it appears. For others, we need to examine the balance sheet in greater detail.

At first glance, it doesn't look good. Last year, the business generated net profit of about \$300m from \$4.7bn of assets and \$1.8bn of debt. The accusations of being capital-intensive seem to hold up.

Yet several balance sheet items need adjustment: inventories, debt and intangibles.

The easiest to adjust are the intangibles. When Eagers pays for acquisitions, it records goodwill on balance sheet. That goodwill sits like a stone, sinking returns. It isn't amortised and continues to grow with purchases.

Acquisitions are real costs; we aren't trying to argue otherwise. Yet permanently inflating assets will record permanently lower returns.

If Eagers were to write off its goodwill one morning, nothing in the business would change, but asset returns would be dramatically higher. This is a dance of spreadsheets, not a reflection of reality.

The high debt and inventory numbers are intertwined, part of the industry specific floor financing arrangements used by all dealership groups. We need to understand this, too.

## Understanding floor finance

Inventory isn't paid for by Eagers, an external finance business finances it, usually an arm of a car manufacturer. Toyota's finance arm is the largest provider of floor finance, for example.

The finance company charges interest on debt backed by individual vehicles. Eagers pays the interest rate for the vehicle while it sits on the lot. When the car is sold, the receipts pay the finance on the vehicle. Eagers makes its retail margin and makes room for another car.

In this transaction, Eagers has paid only the interest on the loan. The sale of the car has repaid the debt. It earns its margin from a relatively small capital base.

Accounting rules for floor finance (known as bailment finance) force the asset to be recorded as inventory and the debt to be recorded as a liability. However, as we have seen, that doesn't reflect reality.

If we exclude floor financing, net debt moves from \$1.8bn to just \$260m. This isn't a deeply indebted business at all. We should also remove inventory since it is paid for by the finance company rather than the dealer.

From an initial asset base of \$4.7bn, \$3.2bn relates to the business's inventory, goodwill and property.

That means Eagers generates \$300m in profit (a bit less if we add lease expenses to counter owned property) on a much smaller tangible asset base of \$1.5bn. This is a much more profitable business once we adjust the balance sheet for sense.

So here we have a decent quality business with a long history of profits and dividends where insiders own about 35% of the equity. But can it grow?

## How to grow a car yard

We see four sources of future growth. The first is to continue adding dealerships to the network. Eagers currently operates more than 250 dealerships around Australia and New Zealand, but it does add more when operators are prepared to sell. That will continue.

We also note that Eagers tried to acquire novated lease operator **Smartgroup** a few years ago and has taken an equity stake in **Mcmillan Shakespeare**.

Novated leases offer a good deal for customers but suffer from low take-up rates. Eager wants to raise participation. Leases and finance generate high-margin fee income for Eagers and remain an untapped opportunity.

Eagers runs a joint venture with BYD, the largest electric car maker in the world. BYD has been a sales sensation in China. As a vertically integrated car maker, it boasts lower costs than almost anyone and is now aggressively rolling out in Australia. Eagers already generates \$1bn of revenue from the venture and it should contribute profits in future.

Perhaps the most promising growth path is the creation of a new car retailing concept, the Automall.

Eagers has been the first dealership in the world to introduce the idea. It consolidates seven or eight brands onto one property to lower costs and raise productivity. Eagers currently runs two Automalls and has planned an additional seven.

They typically sit on lot sizes of 21,000 square meters, larger than the typical 6,000sqm car yard but smaller than the land needed across seven. Service and parts are shared across all brands, and, so far, lower property costs, higher inventory turn, and more sales per worker have almost doubled margins at Automalls compared to traditional yards.

## Intelligent investing

Eagers won't be a fast-growing business, but we think it can generate 7-9% earnings growth for decades. It's worth noting that a decade ago, Eagers made just \$63m in net profit; last year, it made \$300m. The business has been growing consistently for years.

Today, Eagers can be bought on a PER of less than 10 times and a fully franked yield of 7%. That cheapness is, in our view, because the business is misunderstood as poor quality and cyclical. We have argued that it isn't poor quality, but it does remain cyclical.

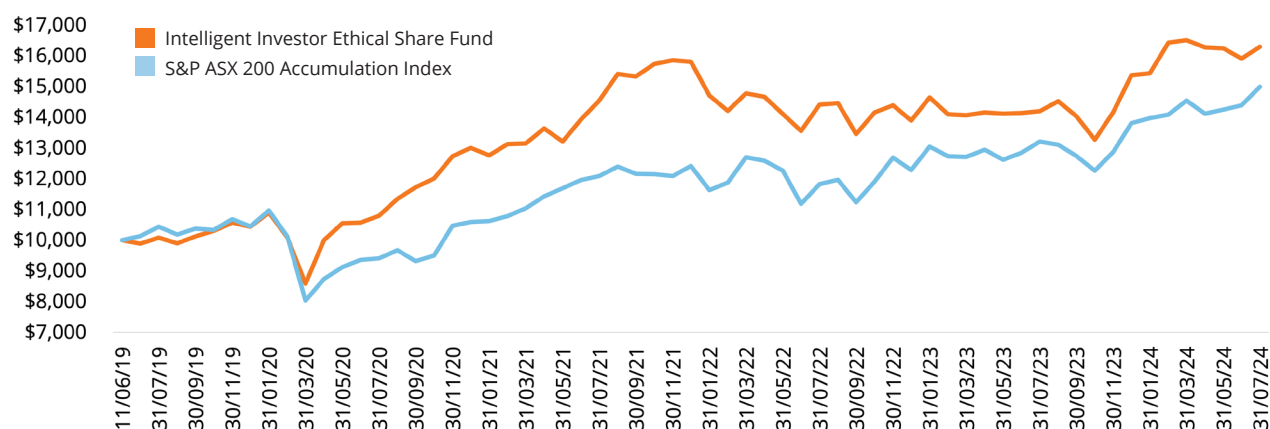
The market is expecting a slowdown - Eagers has already warned of one - and has priced low expectations into the stock. Yet past slowdowns have recovered swiftly, and the structural growth from more dealerships and higher margins will continue, and will be sold in due course.

*Please get in touch if you have any questions*

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## Performance since inception



Inception (S.I.): 11 Jun 2019

### Asset allocation

Financials	26.6%
Health Care	17.1%
Information Technology	17.0%
Communication Services	14.3%
Materials	7.5%
Consumer Discretionary	7.1%
Cash	6.8%
Industrials	3.6%

### Top 5 holdings

RPMGlobal Holdings (RUL)	10.0%
CSL (CSL)	7.0%
Mineral Resources (MIN)	5.5%
Fairfax Financial (FFH.TSX)	5.0%
Pinnacle Investment (PNI)	5.0%

### Fund Stats

Distribution yield	4.7%
Net asset value	\$3.34

### Important information

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All tables and chart data is correct as at 31 July 2024