BKI INVESTMENT COMPANY

ABN: 89 615 320 262

September 2024

BKI is managed by Contact Asset Management
AFSL 494045

QUARTERLY REPORT

Did the Recent Reporting Season Meet Expectations?

Welcome to the latest edition of the BKI Quarterly Report, prepared by Contact Asset Management ("Contact").

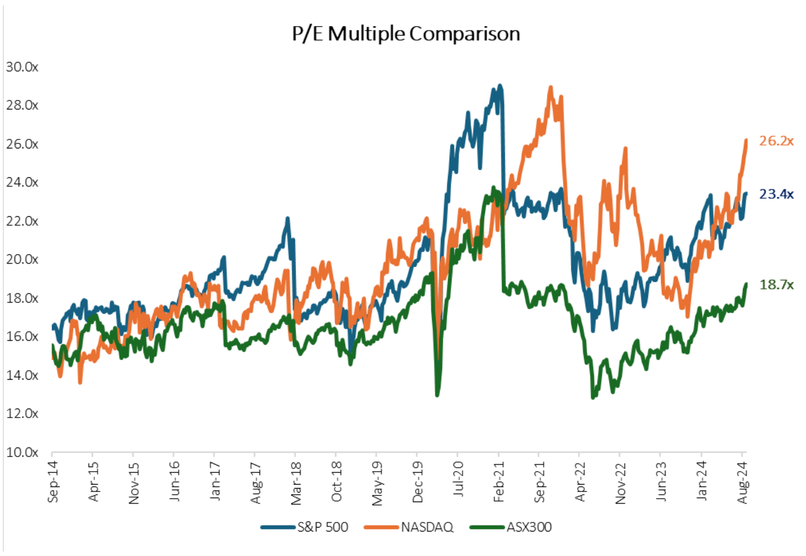
BKI Investment Company released its FY2024 results in mid-July, highlighting four key themes as we approached the broader Australian Reporting Season. These themes included the consumer sector, the resources industry, the escalating costs of debt, and the increasing impact of artificial intelligence. This report evaluates these themes and their relevance to the current economic landscape.

Overall, we rated the Reporting Season as a "Pass," with results characterised by consensus as "better than feared." This reflects a cautious optimism, given the low investor expectations leading into the August reporting period.

Six and twelve months ago, investor sentiment was notably subdued, influenced by the ongoing cost-of-living crisis, rising energy prices, and increased borrowing costs. These factors were anticipated to constrain corporate growth amid persistent inflationary pressures. Despite these challenges, most management teams have effectively managed their cost bases, though the rapid surge in interest expenses surprised some CFOs.

The recent results again underpinned the case for Quality investing. Those businesses with sound growth prospects and strong financials that are run by capable and trustworthy managers did best. It is a reminder to long-term investors on the importance of staying the course.

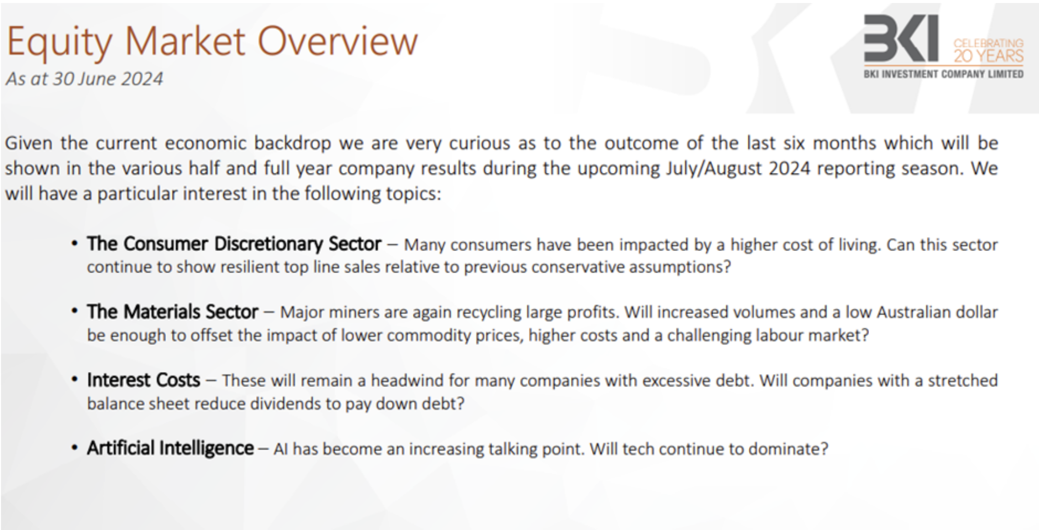
The Australian equities market is currently trading above historical averages in terms of P/E multiples. While there has been a re-rating, the multiple remains less pronounced compared to major US indices. Global equity markets have performed well over the past year, and we believe that earnings expectations are conservative. For instance, Macquarie Equities forecasts less than 1% growth in FY25 earnings. Nonetheless, Australia's resilient economy and several structural tailwinds provide ample reasons for optimism.



Source: Factset, Contact Asset Management

Reporting Season Review

BKI Investment Company delivered its FY2024 result in mid-July 2024. As we met with investors, we highlighted four key themes that we deemed topical as we headed into the broader Australian Reporting Season. These topics are summarised in the following slide:

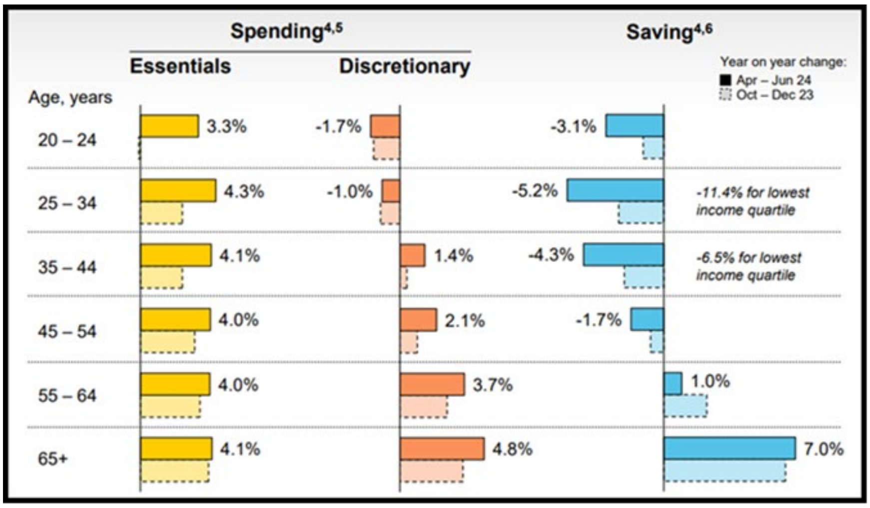


Source: BKI Investment Company FY24 Result Presentation, 23 July 2024

Consumer Discretionary Sector

Over the past year, the Consumer Discretionary sector has arguably endured more negative headlines than any other, reflecting the broader challenges facing the Australian economy and households. Despite this, many listed retailers have managed to navigate these obstacles and achieve solid financial results. While it's true that households are grappling with rising borrowing costs, food inflation, higher power prices, and increased insurance premiums, the broader economic landscape remains robust. With low unemployment rates and rising wages, we believe that the Australian economy continues to demonstrate resilience.

Recent data further illustrates the two-speed economy affecting different demographics. An updated slide from Commonwealth Bank offers a clear snapshot of current consumer behaviour. The graphic reveals that younger households are bearing the brunt of inflation, drawing on their savings to cope with high accommodation costs—whether from rent or mortgage payments—and rising food and transport expenses. This financial strain is leading to a reduction in discretionary spending. In contrast, the older generation is experiencing a period of prosperity. Many in this group are debt-free and have benefited from strong returns on investments in equities, property and term deposits, leading to increased spending, particularly on travel. In its result, Flight Centre management said: "In terms of market conditions, cost of living pressures have curbed discretionary spending, but travel has generally out-performed other sectors – again underlining its resilience."



Source: Commonwealth Bank FY24 Result Presentation

Management commentary has underscored a growing consumer emphasis on value. During its August results briefing, Coles' management mentioned the term "value" 27 times—up significantly from just three mentions in FY21. This shift was echoed by

Coles' competitors. Endeavour Group Ltd, which owns Dan Murphy's, noted that while spending levels remain stable, consumers are increasingly demanding greater value for their money. Similarly, Woolworths Group acknowledged that although they aim to expand customers' shopping baskets, ongoing cost-of-living pressures are likely to lead to continued cross-shopping and trading down. This trend was also evidenced by the strength of Kmart in the Wesfarmers portfolio.

Investors were heartened by the fact that many retailers pointed to a stronger start to FY25. JB Hi-Fi CEO said, "It is pleasing to see sales momentum in Australia continue into July." Carsales said: "So despite some concerns about the broader macro environment here, the automated industry in Australia has continued to be robust"

In short, contrary to earlier predictions of a sustained economic downturn, Australian consumers are not on strike; rather, they are increasingly focused on value. Early trading data for FY25 is promising, and management outlooks indicate that activity levels may have already reached their lowest point. With the possibility of interest rate cuts over the next 12 months, there is optimism that these factors could drive further market gains.

Result summary of key Consumer Discretionary stocks in the BKI portfolio:

Company	Portfolio weight	Thoughts on Result
Wesfarmers (WES)	6.0%	WES delivered a solid result that met expectations. Kmart emerged as a standout, with revenue up 6% and earnings rising 25%, reflecting its strong value proposition and success in capturing consumers who are trading down. Bunnings reported top-line growth despite a sluggish building market, though it was one of the few retailers to highlight a challenging start to FY25. While interest expenses were higher than anticipated, cash flow generation remained robust. Overall, the results underscore the quality of the Wesfarmers businesses, with the increased dividend reflecting management's confidence in the company's ongoing performance.
ARB Limited (ARB)	2.8%	ARB reported another strong performance, with sales growth of 3% and a notable 18% increase in net profit after tax. Total new vehicle sales in Australia rose by 12.6% over the year, and current customer orders remain robust. ARB, which remains debt-free, also boosted its dividend by 11%. The company demonstrated solid cash flow generation, further highlighting its financial health and operational strength. Management said: *"The Company's outlook remains positive with ongoing healthy demand for ARB's products, a consistently strong order book, retail store development and expansion, stabilised new vehicle supply around the world, healthy gross profits despite high inflation and new products recently and soon to be released to market."*
Harvey Norman (HVN)	2.6%	HVN delivered a reasonable result. Earnings were weaker than FY23 but this was expected. Importantly, profitability improved in the second half. The property portfolio, now valued at $3.65 billion remains a key competitive advantage and underpins a strong Balance Sheet. HVN provided a reasonable trading update which highlights continued growth in Australia, although New Zealand continues to bevery challenging. Management noted that "We are strategically positioned to capitalise on improvements in retail trading conditions and the expected growth from the home renovation cycle, new home construction and increases in net migration."

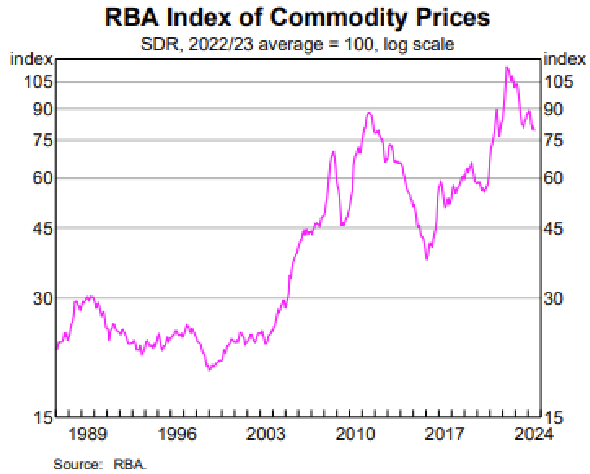
Source: Contact Asset Management. Portfolio weight is as at 31 August 2024.

The Materials & Energy Sectors

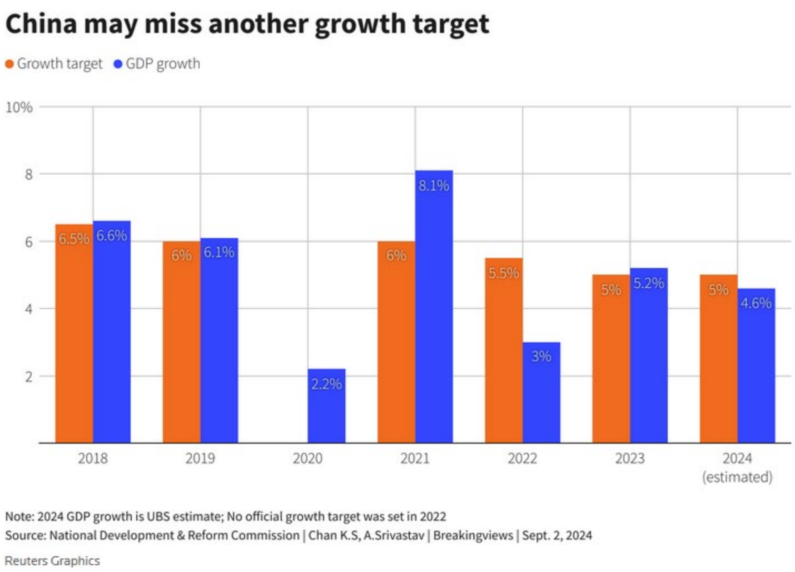
Commodity price weakness was a headwind as uncertainty around the prospects for Chinese economic growth continues. This was a known known. Nevertheless, the major Australian miners are still enjoying significant margins and cash flow generation, which helped to underpin results. For example, BHP is producing iron ore for less than $20/t and selling it for $100/t.

As always, investors were keenly focused on comments around capital investment plans. Production performance was mixed. Wet weather played a role in curtailing production for some companies.

As depicted in the following chart from the RBA, commodity prices have retreated from the generational highs hit in recent years. Some of this relative year-on-year softness was evidenced in results of Resources and Materials companies.

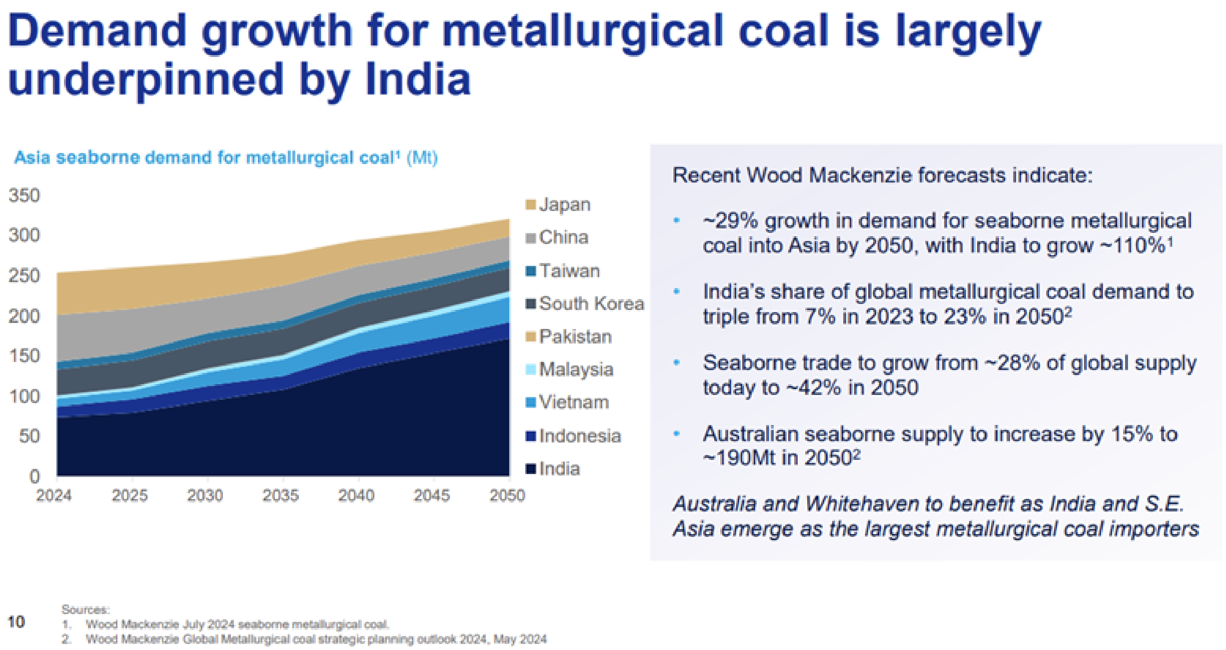


In the near-to-medium term, all eyes are on China. The much hoped for stimulus measures are yet to materialise. BHP's CEO made the following comment: "In the near term, we expect volatility in global commodity markets, with China experiencing an uneven recovery among its end-use sectors... India is set to continue as the world's fastest growing major economy." Continuing our analysis of China's economic landscape, the country's GDP growth is showing signs of slowing down. This year's target of "around 5%" has become more of a strategic guideline rather than a strict objective, reflecting a shift in Beijing's approach. Despite this recalibration, a slowdown could still prompt significant policy adjustments to ensure alignment with longer-term goals, such as doubling per capita GDP by 2035.



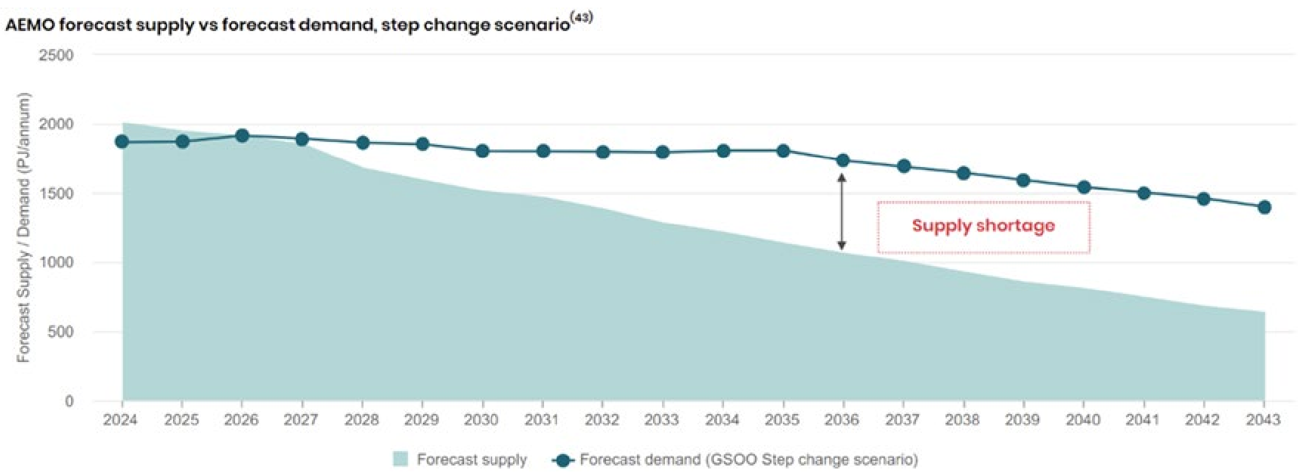
Source: Reuters

The good news is India. Out to 2035, India's increasing urbanisation, rising household incomes and industrial activity will drive demand for greater volumes of key Australian resource commodities. Australian resource exports to India, particularly metallurgical coal, but also copper and gold, will continue to make up the bulk of our merchandise trade. The slide on the following page from the Whitehaven Coal FY2024 Result Presentation, shows Australian metallurgical exports to India increasing significantly.



Source: Whitehaven Coal FY24 Result Presentation

The other interesting debate in Australia is the outlook for gas. APA Group again spoke to the (now shorter-term) supply/demand of gas. The gas supply source is shifting from southern to northern markets and ongoing investment by APA in gas infrastructure will be required to enhance system capacity, reliability and security. APA again made the point that new gas supply is required to support demand and Australia's renewables ambition.



Source: APA Group Result Presentation (August 2024)

We are increasingly concerned about Australia's future energy policy, particularly regarding the impact of overregulation, stringent compliance requirements, and ambitious renewable targets. These issues were notably highlighted by APA Management during their recent annual result presentation. APA cautioned that prioritizing LNG import terminals over investment in domestic gas supply could lead to a substantial increase in energy prices and emissions. The company projects that industrial gas prices along the East Coast might surge from $15/GJ to $24/GJ, a stark contrast to the $4-$5/GJ rates seen just 5-7 years ago. This is potentially a topic for another BKI Quarterly Report! Nevertheless, for the purpose of the recent Reporting Season, the uncertainty is creating headwinds and negative sentiment for many Energy companies.

Result summary of key Materials and Energy stocks in the BKI portfolio:

Company	Portfolio weight	Thoughts on Result
BHP Group (BHP)	7.9%	BHP delivered a good FY24 result driven by solid operating production. Record volumes were achieved at Western Australia Iron Ore (WAIO) and they again claimed the position as world's lowest cost iron ore producer at US$18/t. This is important and BHP is well-placed given cost advantage has widened vs. peers. BHP is well placed to benefit from favourable supply / demand dynamics in Copper and Iron ore in the near to medium term. Its Balance Sheet is robust and the dividend yield is reasonable. We expect BHP to maintain a disciplined approach to capital allocation.
APA Group (APA)	4.9%	APA delivered a good result with FY24 EBITDA up 10% to $1.89 billion and was in-line with consensus forecast and guidance. Growth was driven by a solid performance from the east coast gas expansion and an 8-month contribution from Pilbara Energy and Bass Link acquisitions. Corporate cost growth was below guidance which was a big assist to profits. APA is a high-quality business with an excellent market share position in Australia. Distributions are paid out of Free Cash Flow rather than statutory EPS and is well covered. FY25 Distribution forecast is for 57cps, up from 56cps in FY24.
Woodside Energy Group (WDS)	4.0%	WDS produced a solid but complex result with Operating Revenues 19% lower than pcp. The result was complicated by the sell-down of the Scarborough Joint Venture during the period (which we consider a positive development). Importantly, WDS declared a fully franked interim dividend of US$0.69 (AUD$1.045) per share and was at the top end of the payout range and represented an annualised dividend yield of 7.3%.

Source: Contact Asset Management. Portfolio weight is as at 31 August 2024.

Interest Costs

One of the notable challenges from the recent reporting season was higher-than-expected interest costs, a concern we had anticipated as companies adjusted from the artificially low rates of the COVID-19 era. The impact of rate hikes over the past two years has become increasingly evident.

Despite our preference for companies with strong balance sheets, the BKI portfolio has not been immune to these pressures. While none of our holdings are excessively leveraged to the point of requiring recapitalisation, elevated debt levels have affected results. Notable examples include APA Group, Ampol, IPH, Ramsay Healthcare, and Woodside.

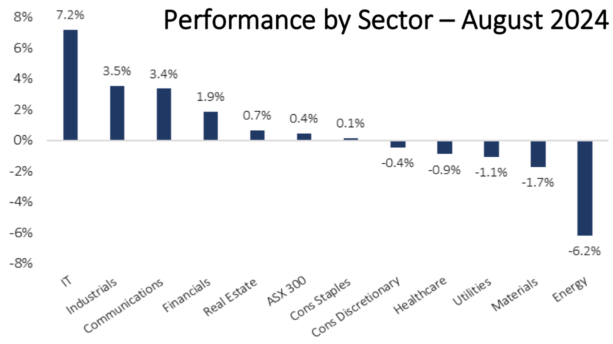
Looking ahead, the peak of these interest cost headwinds is likely to pass within the next twelve months. Forecasts suggest that the Reserve Bank of Australia may begin cutting rates by early 2025, while the US Federal Reserve is anticipated to reduce rates four times before the end of 2024 calendar year.

Generally speaking, corporate Balance Sheets are in good shape. While reporting season was characterised by cautious outlook statements, several of our portfolio holdings used a solid financial position to underpin reasonable dividends. According to UBS: "dividend surprises were stronger than earnings beats, running at a ratio of three beats to every two misses. This tells us that companies have used their balance sheets to pay out money to shareholders."

Artificial Intelligence

In our BKI Presentation, we asked, AI has become an increasing talking point: will tech continue to dominate? While it is difficult to invest directly into AI on the ASX, there is little doubt that tech will continue to dominate. The IT sector was the best performing sector in August and had the most positive earnings surprise.

Despite the challenge in getting direct exposure to the AI theme, several ASX listed companies referred to Artificial Intelligence in Result Presentations:



Source: Factset, Contact Asset Management

- "As AI and cloud technologies increasingly drive global enterprise, the demand for speed, scalability, and reliability in digital infrastructure will continue to surge." NEXTDC Ltd
- "Jumbo got to where it is today by being an early adopter of Technology. AI is an area that we have considerable experience in dating back many years. A dedicated AI team is using multiple large language models to enhance our products and services, pushing us further ahead of the competition." Jumbo Interactive
- "We are excited about the recent Gen-AI product cycle and are committed to further investing in digital initiatives to assist both out franchisees and company-operated stores in promoting Gen-AI-enabled products to mainstream consumers." Harvey Norman

Goodman Group (GMG) is a key holding for BKI Investment Company, and recent developments in its data centre sector have captured our attention. Data centre projects now constitute 40% of GMG's work-in-progress (WIP) and are poised for significant expansion. The company's global power portfolio has grown to a notable 5GW across 13 major cities, with 2.5GW of secured power and an additional 2.5GW in advanced stages. GMG has initiated further projects, infrastructure developments, and secured planning approvals to ensure reliable project milestones for clients. Additionally, the company is enhancing its team of over 1,000 professionals by integrating data centre specialists, crucial for advancing their global infrastructure projects. Each data centre is projected to involve a $1.0 billion investment.

Conclusion

The August 2024 Reporting Season revealed several complexities. Technology sectors showed strong performance, consumer resilience exceeded expectations, while the outlook for resources and energy remained mixed, with more short-term challenges than opportunities.

Inflation remains a concern, though it has moderated. Management teams have generally done well in controlling costs, but rising borrowing expenses have impacted some businesses. While management guidance was largely conservative and limited, it was encouraging to see many consumer-facing companies report a solid start to FY25.

At BKI, with over 20 years of long-term investing experience, each reporting season reinforces the value of a Quality-first investment approach. Historically, companies that excel are those with robust financials, pricing power, and agile, well-aligned management teams that effectively balance growth investments with cost control.

Despite prevalent negative investor sentiment and concerns leading into the reporting season, the local share market has continued to climb. Companies that have successfully protected their margins have been rewarded. This reporting season underscores the importance of maintaining a long-term investment perspective. Australia's resilient economy and often-overlooked structural tailwinds offer ample reasons for continued optimism.