Celeste Australian Small Companies Fund

March 2018

Analysing market forecasts to find opportunities

Reporting periods are a time to reassess positions and compare expectations of company performance with reality. Part of our process involves analysing our future expectations versus market expectations. In searching for potential investment opportunities, an area that can be fruitful is where the market adopts a view that does not represent what we consider to be the best estimate of future outcomes.

We have owned GUD in the portfolio for the past two years. Our original thesis was predicated on the rationalisation of two underperforming divisions: Sunbeam, a maker of small appliances (sold for >$60m), and Dexion, a warehouse racking solutions business (sold for $7.5m). These divestments occurred in line with our thesis and resulted in a significant re-rate in the share price.

So why do we continue to own GUD when it delivered what we had initially thought? We remain attracted to the high-quality earnings growth profile of the automotive aftermarket division, which now contributes ~90% of group Earnings Before Interest and Tax (EBIT). We regularly read research citing concerns over the sustainability of the 28% EBIT margins within this division. GUD's 1H18 result revealed the auto aftermarket division grew sales at 14% (8% organic) with margins drifting slightly from 29% to 28%, due to initially lower margins of acquired businesses. While EBIT margins in the organic business were stable, we again noted market consensus estimates forecasting declines into the future. This is the opportunity…compounding medium-term forecasts of mid-single digit revenue growth with declining margins versus compounding double-digit revenue growth and stable margins produces a meaningful difference in valuation.

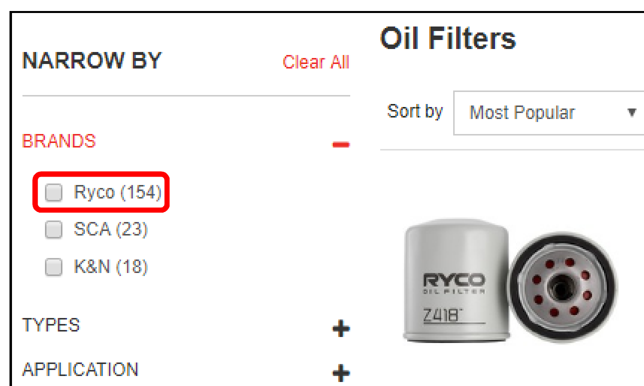
While it is impossible to say with certainty that margins may not decline at some point in the future (as is possible for most businesses) we have tried to understand what would be the catalysts for this to occur in the near term, namely: i) elevated customer power allowing for the re-distribution of economic returns from GUD to its trade supplier customers; and ii) new and existing competitors entering or expanding into the space.

We see the characteristics of the auto aftermarket industry acting as a check on elevated retail power because consumers know and like GUD products (Ryco filters, Narva LED products). While some customers are very loyal to their retailer of choice, the same appears true for strong aftermarket brands. Consumer demand has historically been such that the GUD stable of retail branded product has been a staple in almost every auto retailer's inventory. This creates some level of 'protection' in a consolidating auto parts retail market. In a competitive environment, retailers who act to limit the range of key branded products risk losing sales to rivals. Unlike domestic supermarkets, which have successfully pressured suppliers of many product categories to reduce prices, there is a higher risk in the automotive industry from substituting for generic brands.

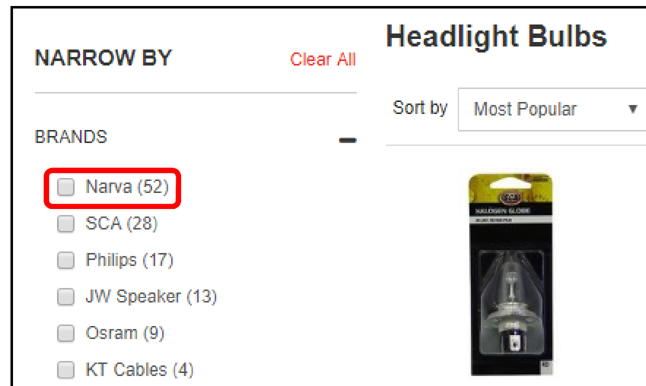
History has shown us that customers of supermarkets were not as brand-loyal as many originally thought. Customers could afford to be more adventurous when buying supermarket goods and try new, often significantly cheaper private label brands. If a shopper were to try private label biscuits and find it was of lower quality, they could buy their old brand next week and forget about it with little inconvenience or financial repercussion. Mechanics that charge hundreds of dollars for servicing and repairing cars do not have the same luxury. They do not wish to have the car returned due to faulty parts. Saving several dollars from the total bill, by using a cheaper, generic brand is not worth the financial consequences.

The risk of private label entrants into GUD's core product segments is real – most retailers already have a private label offering in these categories. The impact so far on sales and earnings has been modest, in part, as private label is most effective in taking market share in high volume, commoditised product categories. In other categories, private label typically fits into a "good, better, best" strategy where pricing is a discount in both price & range to the more popular branded products.

We can see this from the Super Cheap Auto website brand summary for oil filters. Ryco and K&N are the branded providers with SCA the Super Cheap branded generic.



When conducting similar searches on the other key brands/product categories in the GUD portfolio, a familiar pattern emerges. With years of built up credibility and trust, the GUD brands are present in almost all auto retailers and as such any marketing spend by GUD covers the entire auto consumer base and does not end up being retail distributor specific.



The second risk catalyst is the entry of a new competitor. We generally view the capacity for competitors to steal share or lower the pricing dynamic as more a question of their anticipated Return on Invested Capital (ROIC), rather than the EBIT/sales margins that are currently being achieved. A high EBIT/sales margin reflects a company's business model, invested capital and competitive position in the industry in which it operates. Just because a company has a relatively high margin doesn't mean a competitor can set up and achieve the same.

For example, a new competitor in a GUD product category would be required to invest R&D in building a catalogue of products that would suit all the variations of cars, both model & year, that currently exist in the Australian car parc. They would then need to invest in sufficient inventory to ensure they can rapidly supply these parts to retailers. Add to this the marketing spend to build the brand & the likely discounted selling price to encourage consumers to "take the risk". Only then, after all this, and assuming some margin for error could they estimate if their likely returns exceeded the desired hurdle rate, justifying an investment decision.

We know that companies often do get this market assessment wrong, resulting in poor returns to all competitors. Sometimes these decisions are not necessarily made from a purely rational financial perspective. As such, it's not possible to be absolute certain as to what future outcomes will eventually transpire. However, we simply make the point that high margins are just high margins unless someone has the willingness AND capacity to appropriate those returns in some way. In the context of a rational industry, it's likely that GUD is able to sustain strong margins for some time yet to come.