Celeste Australian Small Companies Fund

Quarterly stock commentary July 2018

REECE GROUP - Celeste Investment Process at Work

Let us be lovers,
We'll marry our fortunes together
I've got some real estate
Herein my bag
So we bought a pack of cigarettes
And Mrs. Wagner's pies,
And walked off
To look for America

"America" by Simon & Garfunkel   Song Writer: Paul Simon   Greenwood Publishing

At Celeste we are often asked questions about our investment process: "how do we generate returns, why do we feel confident about an investment call, how does an active manager add value". The unfortunate reality is that there is no one single answer as to the source of alpha generation. Investing is a multi-headed hydra that morphs and changes, requiring on-going assessment of the investment case and the regular challenging of our current views and assumptions.

For any investment consideration, a robust analytical process is invaluable. Ideally this is a process that actively considers the nature of the business model, the financial pedigree of the company and, critically, the people involved as stewards of shareholder capital. Once an appropriate handle on these process variables is achieved, what is then required is the discovery of a divergence in opinion - a material difference in the view held by the broader market and yourself. In situations where one holds a view that is not consistent with the market consensus, the potential for alpha generation can be significant, as markets will inevitably move from inefficient to near efficient over time. For an analyst to understand that the market view differs from their own is important. But more critically, they need to be able to validate how their opinion differs from the market. The analyst needs to consider the alternate case with a reasoned argument, based on fact, evidence and assumptions drawn from history.

One stock where we believe that the Celeste view and the market view differs is Reece Group. Current market concerns about Reece Group include the following:

1) EBITDA margins of 13%+ at Reece are unsustainable
2) Competition in plumbing distribution will intensify and returns will be competed away
3) Reece stock is illiquid and not in the Small Ordinaries Index
4) Reece have recently made an acquisition in the USA and Australian corporates have a poor track record in the USA
5) Reece has debt on their balance sheet, inconsistent with their prior history

To sustain our view we need to understand these market concerns and, through the strength of our reasoning, be able to rebut them; or acknowledge them as legitimate risks and incorporate them into our analysis.
In the context of Reece Group concerns we'd make the following comments.

1) EBITDA margins of 13%+ at Reece are unsustainable

It is fact that Reece Group margins have been 'best of breed' for an extended period in both an Australian and global context. Reece Group EBITDA margins at 13%+ are the envy of both their listed and unlisted comparators. To better understand this margin differential one must first understand the Reece offering and see how it differs from their peers. One factor is that, at Reece a significant portion of plumbing product sold is imported directly by the company, under their own portfolio of brands. In addition, Reece also retail plumbing products that are supplied on an exclusive basis by a first tier global plumbing product manufacturers. Whilst it is difficult to quantify categorically, our research of Reece leads us to the conclusion that in a number of core categories some 40% to 70% of the Reece offering are their own branded imports or products where Reece has exclusivity. Exclusivity of product offering is one factor that underpins Reece's margins, so too is the Reece import function that assists the company in garnering a portion of margin that would have historically been accrued by the manufacturer, or distributor.

2) Competition in plumbing distribution will intensify and returns will be competed away

To understand the competitive threat within the plumbing distribution area it is important to first understand the Reece customer base - the plumber. Reece has a focus on the customer, on understanding their needs and how they can best be serviced. From a Reece perspective, their objective is to ensure that the plumber spends as much time as possible in service of *their* end client and as little time as possible worrying about stock availability, access to brands and exclusive offerings, order fulfilment, billing and order system complexity.

The Reece online capability with its click and collect functions, is second to none in the industry. It empowers the plumber, saving precious time and changing the nature of the customer relationship from physical/ analogue to digital/on-line with engagement now possible 7 days per week, 24 hours per day. The Reece 500+ geographic points of presence minimises plumber travel time, whilst further entrenching distribution relationships and the in-house brand offering. No domestic peer can offer comparable access to the Australian market, nor can they derive the scale benefits that accrue to a

$2b+ pa sales platform. The Reece store network is ably assisted by a dedicated property team who have responsibility for the identification and development of new sites, as well as ensuring existing sites offer the appropriate experience to both the trade customer and the end consumer via dedicated showrooms.

Reece Bathroom Life Showroom – 118 Burwood Hwy, Burwood Vic. June 2018

In terms of the less tangible, but equally critical points of competitive differentiation, Reece has the right people in place to service the needs of a trade client base. The Reece employee base is engaged, sticky, have long term career paths, and benefit from Reece training programs.

3) Reece stock is illiquid and not in the Small Ordinaries Index

The spectre of illiquidity must be a consideration in the thinking of any equity investor. Critical to the question of illiquidity is the weighting placed on this factor when one considers the investment case in its totality. Whilst Celeste is aware of the potential pitfalls with illiquidity we believe that it is important to firstly assess the financial pedigree of a company and its return history.

At Reece 'Return on Equity' over the last decade have tracked at 20%+ and 'Return on Capital Employed' have been 30%+ all with minimal debt used and land and buildings generally owned freehold. Reece has achieved significant growth in earnings and dividends by re-investing in the business, all without recourse to shareholders. In the last decade (FY '08 – FY '17) Reece sales have moved from $1.438b to $2.429b. EBITDA over the same period has increased from $184.8m to $358.9m and Net Profit has risen from $113.6m to $211.8m. In FY '08 Reece paid shareholders a total dividend amounting to $55.1m, which by FY '17 had increased to $99.6m.

In assessing the liquidity issue at Reece we are mindful that the company currently has 560.8m shares on issue (as at 4/7/2018) and with a last sale price of $12.60, Reece has a market capitalisation of $7.066b. If one excludes the 73.6% of Reece owned by the Wilson family interests, then the free float of the company is $1.865b. Notably, if just the free float at Reece were a listed company it would be the 20th largest stock in the Small Ordinaries Index, with an index weight of around 1.1%. Whilst sensitivity to liquidity and index weighting are important, investors should not lose sight of financial pedigree as it is the critical arbiter that will lead to alpha generation and growing levels of stock turnover.

Reece Bathroom Life Showroom – 118 Burwood Hwy, Burwood Vic. June 2018

4) Reece has recently made an acquisition in the USA and Australian corporates have a poor track record in the USA

On May 7th Reece Group spent $1.9b on the acquisition of US based plumbing products distributor Morsco Inc. To do this Reece raised $560m in equity and took on some $1.5b in debt. For a company that has never once raised equity since listing in 1953, the May 7th event was quite a momentous day. Further evidence of their respect for equity capital can be seen from an examination of their FY 2017 balance sheet which shows that 98.8% of shareholders' funds is made up of retained profits.
There is little debate that acquisitions often do not deliver anticipated benefits. We believe however that the critical risk variables with the Morsco acquisition have been appropriately identified, dimensioned, ring fenced and understood. Morsco is an established business, with a long operating history and a management team that has over 130 years of collective experience in dealing with trade based distribution businesses. It has a diverse, granular customer base, with a geographic focus on the high growth US 'sun belt states'.

Morsco and Reece fundamentally deal with the same customer, a licensed plumber, who services a comparable end customer. As Morsco is an American company there are few cultural differences, no language impediments, and a familiarity with the legal backdrop. Finally Morsco is being acquired from Advent International, a global private equity group. In recent years Reece has acquired 2 businesses from private equity firms, Actrol in 2014 and Viadux in 2018, and so have an understanding of the risks and challenges in buying businesses from private equity.

Whilst no acquisition is without risk, Reece appear to have an excellent understanding of Morsco, both as it is now and how it can grow in the medium to longer term. Importantly, Reece have noted that Morsco is part of a longer term strategy, consistent with their history. When Reece Executive Chairman, Alan Wilson, gained control of H J Reece in 1969 it had 2 stores. It took almost 10 years before Reece opened its first site in Albury NSW in 1978, as Alan Wilson wanted to make sure that the model worked, after testing it in Victoria for a decade. In 1988 Reece expanded into Queensland, with South Australia and Western Australia following in 1997. We believe that in the US Reece will adopt a similar template to their history in Australia, grow within clearly defined geographic areas, build to a critical mass position and then consider expansion into contiguous geographies.

5) **Reece have debt on balance sheet, inconsistent with their prior history**

Post the acquisition of Morsco Reece will have Net Debt of $1.458b, and Shareholders Equity of $1.693b. This is a level of borrowings unprecedented in the history of Reece. This shareholders equity figure includes a material level of intangibles, some $1.7b, and $543m in fixed assets. On 30th June 2016 Reece noted Land and Buildings with a written down book value of $236.4m and a market value of $371.2m.

It is our belief that the appropriate sensitivities with respect to debt should be around its ability to be serviced, its potential to be paid back, and its term/structure. Reece interest coverage at the EBITDA level is over 6 times, post the Morsco acquisition, a level we feel extremely comfortable with given cashflow durability. In addition we believe that unencumbered cashflows will allow Reece to repay all borrowings by 2023, while still allowing for dividend growth and for Morsco to expand by both organic and ‘bolt-on’ means. In the context of the Reece debt structure, it needs to be understood that the debt has a 7 year term and that it has no financial covenants. Whilst the debt structure terms and conditions are not public, it is often the case with debt structures of this type that the amortisation schedule is modest in the initial years, with a balloon payment at maturity. We believe that any debt concerns with Reece are misplaced, do not pay appropriate attention to the company’s historic cashflow generation, and lack understanding of the inherent flexibility within the terms and conditions of the Morsco loan facility.

Whilst we acknowledge equity market concerns about Reece Group our analysis leads us to believe that these concerns are misplaced. Reece Group ticks the boxes of the Celeste investment process and is a compelling investment opportunity. Reece Group has a definable, visible growth trajectory for 20+ years with minimal potential for strategy drift. Celeste anticipates that Reece Group will continue to be an attractive investment for our investors into the future, as has been the case in the past.

Frank Villante
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4th July 2018

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