Quarterly Investment Insight January 2021

Thank you Mr Scali

The 2020 year will forever be inextricably linked to Covid-19. The pandemic caused severe dislocation in societal norms and lifestyles which, when supported by various fiscal stimulus measures, resulted in an accompanying shift in consumer spending habits. Excluding the panic buying and hoarding seen in late March 2020, the restrictive nature of Government-mandated lockdowns both accelerated the shift to online consumption and drove consumers towards at-home spending. Grocery sales flourished as home cooking became the fashion of the day, with struggling restaurants and pubs forced to offer takeaway and delivery alternatives. Online retail blossomed, with shopping centers, and their bricks and mortar tenants, becoming moribund wastelands. People rushed to ensure their home office set-ups would see them through until the end of the year, or in some cases, longer.

Since the easing of restrictions, many of these changed consumption patterns have become seemingly entrenched, with continued at-home spending driving sales growth in home improvement and DIY activities, kitchen appliance purchases, online gaming, furniture and home office equipment. Similarly, whilst international travel remains unlikely in the near future (other than 'travel bubbles' with neighbouring countries), there has been a surge in domestic tourism and 'stay-cations'. Nevertheless, there has been some return to old habits as restrictions eased with pubs, restaurants, gyms and even shopping centres bouncing back as consumers shook off their cabin fever.

The question remains around whether these changes in consumption patterns will be sustained once lockdowns are lifted globally and the world returns to a more unrestricted state. Significant assumptions need to be made around long-term work-from-home trends as well as general lifestyle trends. Will we continue to see a higher level of savings or will international travel claw back the portion of wallet it once had? Will consumption be impacted by any upcoming ‘fiscal cliff’ or further economic shock? One must also keep in mind that consensus macroeconomic opinions are regularly wrong, constantly changing, and never more so than in the past year.

At Celeste, we believe that the best way to generate alpha for our unitholders is to be mindful of the macroeconomic environment but seek to invest in strong, durable and robust businesses, like Nick Scali Limited (ASX: NCK). Nick Scali is an established retailer of quality furniture. With an operating history spanning nearly six decades, there is ample evidence to support the fact that Nick Scali is a company that has refined and honed its business over numerous economic cycles and delivered strong performance. One unique feature of the Nick Scali business model is its minimal working capital requirement which in turn, allows the company to grow without capital calls on shareholders. Since raising $40m at their IPO in 2004 to the last reporting date (30 June 2020), Nick Scali has not needed further capital from shareholders. Over this time sales have grown from $44m to $262m, the store network from 10 to 58, and net profits from $7m to $42m. All growth at Nick Scali has been funded by internally generated cash flows. Investors at the company’s listing have also received some $3 in fully franked dividends, compared to a Nick Scali listing price of $1. Since IPO, total shareholder returns for a Nick Scali investor have been almost 1,200%.

The Nick Scali 58-store network are essentially showrooms which carry no inventory given that the majority of their offering is made-to-order. Products are mainly sourced overseas from suppliers with whom Nick Scali have long-standing trade relationships.

Customers pay an upfront deposit upon purchase, followed by the remainder once the product is manufactured and shipped to them. The 'deferred revenues' at Nick Scali provide visibility over near-term sales. Combined with the customer profile the business enjoys, there is modest scope for bad debts, minimal inventory obsolescence and shrinkage. This results in a business well equipped to weather economic downturns.

As discussed in our September 2020 Quarterly Investment Insight, having hard assets on the balance sheet can provide confidence in valuations during times of uncertainty. In Nick Scali's most recent financial report, NCK had no net debt, and net cash on hand of some $30m, equivalent to 35% of shareholders' funds. Additionally, the business owns freehold land and buildings, across 6 states, valued at $80m. Combining the cash balance and property owned, Nick Scali is in the enviable position of being a retailer with $1.30 per share of hard assets on its balance sheet, some 14% of the market capitalisation.

Regardless of short term furniture spending patterns, Nick Scali offers a multi-year growth opportunity as the company grows the total network in Australia and New Zealand to 85 stores from the current 58. The business also continues to expand their offer, recently adding bedding via a Nick Scali-branded mattresses. In April NCK launched their online store and this has driven significant revenue growth. All of these initiatives are logical, earnings accretive steps, for a business with strong brand equity and a healthy balance sheet.

When assessing a company's strategy, one of the aspects investors must evaluate is the Board and Management teams. These individuals are the stewards of capital that execute the strategy and create wealth. Nick Scali's Managing Director, Anthony Scali (son of Nick) is aligned with shareholders' interests holding almost 14% of the company. He has significant corporate memory gained from over 30 years' experience in the business across multiple economic cycles. The Board has extensive retail and listed company experience. At Celeste, although we don't specifically target highly yielding companies, we believe that Nick Scali's track record of consistently paying healthy dividends speaks to a Board that understands the balance between growth and tax effective returns to shareholders.

Celeste believes that a good business model, appropriate financial disciplines, and the right people, can generate attractive returns to shareholders over time. Nick Scali is one business that has these attributes and as such we believe will create long term tax effective wealth for our unitholders for years to come.

Thank you Mr Scali.

Cameron Jackson
Analyst – Celeste Funds Management
5th January 2021

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