Fund update

Perpetual Share-Plus Long-Short Fund

During the month of March 2022, the Perpetual SHARE-PLUS Long-Short fund generated a return of 5.2% (net of fees). This underperformed the benchmark (S&P/ASX 300 Accumulation Index) by 1.7%. The short book had another pleasing month with a positive alpha contribution offset by the long book which failed to keep up with the market. The largest detractor to returns during the month was Flutter Entertainment which fell after delivering a result and outlook that slightly missed expectations. The core US division continued to perform very strongly. Whilst the result and share price reaction was disappointing in the short term, our long-term view is unchanged, and we see material upside from current levels. Long positions in WHC and IPL were the key positive contributors to performance.

Over the 12 months to March 2022, the fund has generated a return of 18.6% (net of fees), outperforming the benchmark (S&P/ASX 300 Accumulation Index) by 3.4%.

Fund Commentary

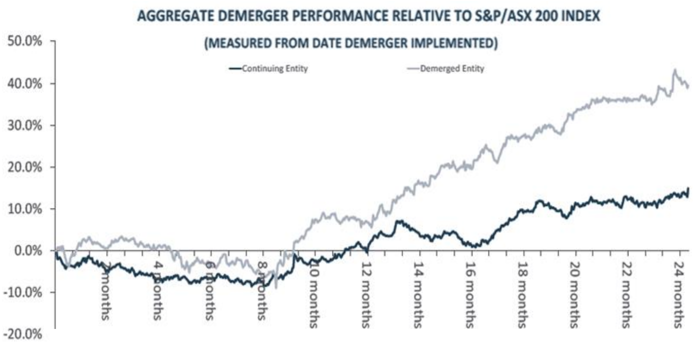
Demergers

We published a piece in January 2020 (which seems like a lifetime ago) where we wrote about the benefits of demergers. We had gathered a lot of information about 28 previous demergers in Australia to see if there was some significant trend. Our research indicated that the continuing entity outperformed the market in the following couple of years, but not significantly. However, the demerged entity outperformed by an average of 35% in the following two years.

Some of the examples we gave of demerged entities which have performed very well over a longer period were Dulux (spun out of Orica), Treasury Wine (spun out of Foster's), Henderson (spun out of AMP) and Orora (spun out of Amcor).

More recently, an independent expert report by Grant Samuel assessing the benefits of the TABCORP demerger presented a similar calculation. They found that the outperformance of the demerged entity was 40% and that the outperformance of the continuing entity was 15% in the ensuing two years. These numbers are greater even than our numbers. The best explanation of the difference is a slightly different sample set.

Below is a chart which came from the Grant Samuel Independent valuation analysis for TABCORP's demerger of The Lottery Company:



Source: Grant Samuels Independent Expert Report – Tabcorp demerger

Why are demergers successful?

At the time we published our first demerger note, we put it down to two fundamental reasons:

1. Splitting the company into two bite-sized pieces increases the chances that one of the two companies will get acquired. Of the 28 demergers we analysed, 18 of one of the two parts had been taken over (most within a couple of years).

2. The demerged entity received more love once it had been demerged. We think this is worth expanding on below.

In the January 2020 piece we said this when describing why Orica's demerger of Dulux had been so successful:

"*…Capital allocation, human resources, marketing etc. would be completely different between these two businesses (paint & explosives). Once demerged, attracting and retaining top quality management is made easier as employees of the demerged entity can be incentivised with equity in an entity in which you can make a difference rather than being part of a larger conglomerate.*"

When asking a parent of multiple children if they have a favourite child, they will typically say that they are all equal and they have no favourite. However, more often than not, they are lying. The same could be said for companies. Whenever we ask a CEO or chairman which of his/her divisions he/she is most excited about, they always answer that they are equally excited about all divisions. Again, I believe that this is a lie. Every CEO/board has a favourite division. Capital is a scarce asset and, when push comes to shove, that capital will tend to gravitate to the favourite child. When there are extra corporate costs, they will tend to be shoved more to the less loved children, which has the impact of understating the earnings of the ugly duckling.

What is interesting in demergers is that the CEO and chairman are forced to make a choice about which division is their favourite child as they must make the decision about where they are going to remain. In the recent demergers, Woolworths/Endeavour, Graincorp/United Malt and Iluka/Deterra the CEO and chairman both decided to go to Woolworths, United Malt and Iluka respectively. In the TABCORP/The Lottery Company demerger the chairman went with The Lottery Company despite having a self-professed great relationship with the racing industry.

What typically happens is the ugly duckling company will typically get a new CEO, a new board and generally a new culture. Often you get divisional management promoted to CEO. There emerges an almost underdog status within the new company. We articulated in our first demerger note that some of the outperformance can be explained by the extra attention a demerged entity gets. However, we think it runs deeper. The new team running the demerged business are unshackled from corporate overheads frustrating constraints. This can give way to a new culture which is hungrier, leaner and more agile. This demerged business can make the right investments and seize on market opportunities without having to prepare a pitch book for head office. We have observed from the performance of recent ugly ducklings (Endeavour, Graincorp and Deterra) how a new culture and lease of life can be injected post demerger.

The role of lifecycle in company demergers

Some companies are great companies with great culture forever and some companies are badly run companies and have poor culture forever. Most companies are somewhere in the middle. They go through periods of good decision making and periods of poor decision making. Generally speaking, the poor decision making usually occurs at points in time when things are going well. Either the cycle is in the company's favour, or the management team are basking in the glory of previously astute decision making. **The point here is that the worst decisions are generally made when times are good.** We believe the contra is also true. When people/companies have their backs against the wall, the survival instinct hones one's decision-making ability, and people tend to make their best decisions. As mentioned above, we have observed most companies drift between arrogance and humility.

One example is the supermarket sector in Australia. While there are smaller competitors, it is essentially an oligopoly with two major players, Coles and Woolworths. Over the last couple of decades, the ascendancy in terms of market share, profitability and share price has swung between Coles and Woolworths. What we have observed is that there is an almost seven-year cycle as one of these companies moves from outhouse to penthouse and vice versa. For Woolworths, we see that when things were supposedly at their best in the mid to late noughties, they started to get arrogant. They focussed on rolling out new stores, maximising short term profitability through price increases and thought it was a good idea to start a new hardware business, Masters, from scratch.

To cut to the chase, this ended in a lot of pain for shareholders as the company stretched its balance sheet and got distracted away from their core business – selling groceries. At this point in time, they were well and truly in the outhouse. This is when we observed the board and new management start to make smart investment decisions. These included shutting down Masters, taking the short-term profit hit by improving service and dropping prices, investing in the store network, investing in automating their supply chain, developing best of breed online offering and data analytics, and demerging its bottle shop and pubs business Endeavour.

The point of the above is that most listed companies go through periods of good and bad decision making. Our observation is that, generally speaking, the good decisions are made during periods of humility and bad decisions are made during periods of arrogance.

We believe that this could be one of the reasons that demergers tend to work. Demergers tend to occur in businesses when the company is going through that part of the lifecycle where they have worked out that they cannot be all things to all people. They tend to be decisions made by a humble CEO and board who are focussed on shareholder value maximisation and an understanding what that company's core skillset is.

I believe that this is another subtle reason why demergers tend to work. When a board and management are arrogant, they prioritise getting bigger over maximising shareholder value. Therefore, a demerger would not rank highly as an option as it would signal that they are not masters of the universe. Therefore, the culture of a company leading into a demerger tends to be a little humbler, at which point there is generally better decision making.

Markets Prefer Pure Plays

This last reason is probably the most basic, but still a good reason why demergers tend to work. That is, markets generally tend to prefer pure play companies over conglomerates. We believe that market participants are pretty simple creatures. With the onset of retail punters chasing "meme" stocks and passive money and ETFs pursuing the popular "theme of the day", we feel that this is the case even more today than ever before.

With this in mind, we believe the market is more likely to ascribe a higher value for a pure play company than it would for a division within a conglomerate. This sounds asinine. Surely market participants would be clever enough to assign the same valuation to the same business within a corporate structure as it would if it were to be stand alone? Sadly this is not the case. When market participants want to get exposure to a theme, they will pay a material premium for that pure play company rather than a division of a conglomerate in the sum of the parts.

One example is comparing Iluka to Lynas. Iluka has a market cap of $5.3bn. It has a mineral sands business which will generate EBITDA of $700m and we think is worth around $3.5bn and it also owns a $500m stake in Deterra. Therefore, one can imply a value of around $1.3bn for its rare earths deposit and refinery. By our calculation, the volume and earnings from Iluka's rare earths business in a few years' time will generate EBITDA, revenue and volume from its rare earths business just over 50% of Lynas. Lynas has a market cap of $9bn. By these measures, the market should be valuing ILU's rare earths business of at least $4.5bn as a stand-alone business rather than $1.3bn attributed to it by the share price. We suspect one reason for this is the conglomerate discount.

While above we are talking about pure play thematic investing, we also believe that this conglomerate discount is applicable even when there is no "hot theme" involved, given how market participants like to think about their investment portfolio. Investors like to pigeonhole their investments. Some investments they want to put in the bucket of companies with steady and predictable (at least perceived) earnings growth, which they can model out for many years (low growth compounder). Other investments are a bit more speculative where there are very little earnings now, but the growth potential is massive (high growth speculative). Then there are deep cyclical companies. These companies struggle at the bottom of the cycle but can generate a remarkable amount of cash at the top of the cycle (deep cyclicals). The attraction for investors in these sorts of businesses is if you get the cycle right and are counter cyclical, you can make a lot of money. The three examples above are by no means exhaustive but are illustrative of how investors have a tendency to pigeonhole.

The problem comes when there are companies which have two material divisions with materially different investment traits. Take Graincorp pre-demerger as an example. The malt business (subsequently called United Malt) was perceived to be a low growth compounder. The rest of Graincorp would be put into the deep cyclical camp. The "low growth compounder" investors didn't like the volatility associated with the cyclical part of the business and the deep cyclical investors didn't like the boring United Malt business as it diluted the cyclical leverage. They would look to get their exposure elsewhere, in say, Elders.

When you separate these different businesses, you get a completely different shareholder base for the two companies over time. Management can run capital management and make investments based on its specific earnings stream and shareholders preference rather than a hybrid of the two.

This is another reason why we feel the right demergers can work. Generally speaking (and there are some very obvious exceptions) the market prefers pure play businesses where they can pigeonhole the investment characteristics rather than having to analyse two completely different sets of cashflow streams. While this in itself is a weak reason for a demerger in isolation, it is an explanation as to why the right demergers tend to work.

As value investors, we like finding companies like these hidden gems within larger conglomerate companies where the market is unwilling to ascribe a proper value. We believe that, one way or another, this value will get realised over time to the benefit of our unitholders.

So how have the recent demergers performed?

Company	Demerger Date	Total Return Since Demerger	S&P 200 Accumulation Index Return	Outperformance
Iluka/Deterra	23/10/2020	80%	28%	52%
Graincorp/United Malt	24/03/2020	101%	76%	26%
Woolworths/Endeavour	24/06/2021	11%	6%	5%

Source: Perpetual Research, IRESS

As a major shareholder in both Iluka and Graincorp pre-demerger we pushed the respective boards for these demergers and we believe that we were instrumental in getting them done. We are happy to say that as you can see from the table above, they have materially outperformed the market since the demerger.

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There can be the argument that for both Iluka and Graincorp their respective markets have turned more favourable since the demerger and that they would have performed as strongly whether or not they had demerged.

However, this is not completely fair. United Malt has had a pretty torrid time since the start of COVID and has underperformed the index by over 75% since listing so that has evened things up. We believe that had United Malt still been part of Graincorp, the market would have not been able to focus on the strong cycle and cash generation of the core Graincorp business. It is our judgement that the demerger has helped the combined returns here.

Iluka has outperformed by 52% since the demerger. While market conditions have improved and Iluka has executed well on progressing Stage 3 Eneabba rare earths project, again we feel that the market's ability to focus on the demerged companies respective attributes has contributed to this outperformance.

Other Potential Demergers

The corporate history of Incitec Pivot is quite interesting. It started life inside Orica. Orica merged its fertiliser distribution business with a co-op called Pivot Limited, which was a fully integrated fertiliser company with manufacturing of urea at Gibson Island. This merged entity listed in 2003 with Orica maintaining a 70% stake. In 2006, Orica sold out of Incitec Pivot. In the same year, Incitec Pivot bought Southern Cross Fertilisers from BHP. The main asset here was DAP manufacturing facilities at Phosphate Hill. Two years later, IPL bought Dyno Nobel which was a global explosives manufacturer. The interesting aspect here is that the child (IPL was born out of Orica) became Orica's largest competitor. In 2016, Incitec commissioned an ammonia plant in Louisiana.

As you can see, IPL has had an interesting corporate history with a conglomerate of different assets. We believe that the fertiliser business is quite a different investment proposition to the Dyno Nobel business, an explosives business which supplies Ammonium Nitrate (AN) to mining and aggregates companies to blow up rocks. This is a pretty steady business with long term contracts and a strong market position both in Australia and the US. In the above analogy you would call this a "low growth compounder".

The other part of the business is the fully integrated fertiliser business. Its earnings are extremely volatile and leveraged to global fertiliser prices (specifically DAP and urea prices). It would be best described as a "deep cyclical" business. We believe that the investors of each division are likely quite different and that, as it currently stands, the company is neither here nor there. Its earnings are too volatile to attract the "low growth compounder" mob and its fertiliser business is too small a part of the valuation to attract investors interested in that part of the business.

We believe that the management and board would be in favour of a demerger. They tried to sell the fertiliser business a few years ago, but to their credit decided to hold onto the fertiliser business when bids were not high enough. There is a lot going on in the world of agriculture and fertiliser at the moment. Following Russia's invasion of Ukraine, food and energy prices (which were already on an upward trajectory) went vertical. Given Ukraine is the world's food bowl and Russia was the largest exporter of fertiliser, the impact of the war and the ensuing sanctions will have a long-lasting impact on the agricultural supply chain. Fertiliser is very energy intensive and hence is also leveraged to skyrocketing energy prices. The point here is that fertiliser stocks in the US have rallied strongly over the last year, with Mosaic, CF Industries and Nutrien up anywhere from 100-140%. Incitec over the same period is only up 44% (even less in USD terms). We are sympathetic to the view that there could be a "stronger for longer" cycle for fertilisers. With 20% of the world's traded fertiliser likely to be sanctioned for the foreseeable future, underinvestment in fertiliser plants in the western world due to ESG concerns, high agriculture prices and the difficulty in increasing capacity, we think that existing fertiliser manufacturing companies have a decent outlook for the medium term.

While at this stage Gibson Island urea plant is scheduled to shut in December this year, we believe that circumstances have changed. Not only does Gibson Island manufacture agricultural grade urea but it is the only manufacturer of Adblue in Australia. With a global shortage of Adblue made worse by conflict in Ukraine and China stopping urea exports, imports of Adblue have almost completely dried up. IPL's Gibson Island plant currently supplies 95% of Australia's Adblue without which our whole supply chain would likely come to a grinding halt. It could be argued that there is national interest for the government to assist IPL in keeping Gibson Island open for a few years. The point here is that while the fertiliser business is at an earnings high point, we feel the assets are quite strategic given the current geopolitical climate. We think the cashflow generation of the fertiliser division will be very strong in the short to medium term as we have difficulty seeing supply side response in the fertiliser market and farmers can only hold off application for so long. The point here is that we think that the time is perfect for IPL to demerge its fertiliser business. We think that, over time, IPL could work with the government to become the national champion in fertiliser and Adblue manufacturing to leverage off its expertise, Australia's competitive advantage in agriculture and the medium to longer term desire for the country to sure up the supply chain in strategic industries like fertiliser. This may require some capital spend which investors in the current IPL may feel dilutes the company away from the high returning and steady explosives business.

We suspect, in the event of a demerger, the CEO and chairman will stick with the explosives business as it is the "favourite child" and that the "ugly duckling" fertiliser business will get a new management team, new board, new culture a strong balance sheet, great cashflow and a new lease of life. We think as a stand-alone entity it will be a cyclical but unique business with several growth opportunities.

Conclusion

As an active value manager, we like investing in companies where there are hidden assets not being properly valued by the market. If we believe that there is material value accretion by demerging the undervalued division on a long term basis, we will push the board to consider such a demerger. We believe that we have been instrumental in the demerging of Iluka & Deterra, Graincorp & United Malt as well as the upcoming demerger of TABCORP and The Lottery Corporation. Since demerger the combined businesses have outperformed materially. While early days we are seeing quite a few benefits from breaking these businesses up.

We wrote about the benefits of demergers in our January 2020 report where we outlined ensuing M&A as well as more love for the demerged entity as reasons for successful historic demergers, we also think that demergers tend to happen at a time in a company's life cycle when they are less arrogant and tend to make better decisions. We also think that investors' ability to pigeonhole the separate companies is also a reason why the two separate companies tend to trade better than if they were still together.

With this in mind, we feel strongly that IPL should look to demerge its fertiliser business. We think that it dilutes the strong outlook for its explosives business through its volatile earnings stream. As a demerged entity, the fertiliser business would be able to get more attention. We believe it may be able to work with the government to keep Gibson Island open and potentially invest in other fertiliser manufacturing facilities, so Australia becomes more self-sufficient in such a strategic commodity. We feel that, as a standalone fertiliser company, global investors with the view of a super cycle in fertilisers would be more likely to invest in the company whereas right now it is diluted by the explosives business.

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