BKI INVESTMENT COMPANY LIMITED

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BKI Quarterly Report

Out On The Road

Welcome to the second issue of the BKI Quarterly Report. We hope you enjoyed our first edition where we focused on the value of franking credits and dividends.

The March quarter was an eventful one. In January BKI's Half Year Result to 31 December 2013 was released. The Net Operating Result* increased 16.8% to $18.0m, while Earnings per Share* increased 4.5% to 3.72cps. A fully franked Interim Ordinary Dividend of 3.45cps was declared, up 6.2% from 3.25cps paid in 1H2013. We conducted a successful post-result road show across the country, lifting awareness of BKI amongst Advisors and Brokers.

We then rolled into a very interesting reporting season with many companies reporting revenue growth slightly below forecasts. However, on a profit basis, most companies released numbers ahead or in line with our expectations highlighting the ongoing "cost-out" story. As we expected, those companies exposed to offshore markets and foreign exchange movements were a standout. Outlook commentary was cautious. EPS growth for our equity market is now forecast at 8% for FY14. March provided a great opportunity to spend some time out on the road analysing companies at the coal face; visiting manufacturing facilities, mines, ports, retail outlets, distribution centres and head offices of many of the companies within the BKI portfolio.

Who said Australian Manufacturing is finished?

There has been significant media hype recently calling the death of Australian manufacturing. The argument is fuelled by comments from companies such as Ford Australia that the unit cost of production for Australian-made car models is four times that of Asia and double that of Europe. If this is the case, it is difficult to criticize the decision to close local facilities. However, we think it short-sighted to throw all manufacturing in one basket and claim that the end is nigh. Manufacturing remains a significant part of the Australian economy – the industry employs 8% of our workforce and accounts for a similar level of GDP. Despite all the hype, the ABS reported that Australia actually added manufacturing jobs in the year to February 2014.

While the high Australian dollar and labour costs are obvious headwinds, we believe there are opportunities for Australian manufacturing where there is a clear niche or innovation. Two companies in the BKI portfolio that we believe fit that criteria are ARB Corporation and Maxitrans. We travelled to Victoria and visited both facilities at the end of March. Both companies fit the BKI investment criteria of offering an attractive income stream, possess a competitive advantage, boast strong financials, are well managed (by people with skin in the game) and are nimble and able to keep up with the times. Both firms invest for the future, spend money on their businesses ensuring their facilities are state of the art. This enables them to stay competitive and continue to manufacture product right here in Australia, employ Australians and deliver profits and dividends for their shareholders, not just now but for many years to come.

ARB Corporation is a global leader in four-wheel drive vehicle accessories. They are Australia's largest manufacturer and distributor with facilities in Victoria and Thailand. Product is distributed in over 100 countries, employing thousands of individuals. ARB's success has been built by a highly skilled workforce who design, produce and distribute quality, reliable product for their customers adhering to their 40 year old philosophy "quality, reliability and practicality above all else". Despite import pressure, exchange rate movements, labour costs, skill shortages and steel price fluctuations, ARB has maintained its competitive advantage by balancing manufacturing capacity locally and offshore. This gives management the ability to monitor quality control and flexibility of distribution, product cost and innovation. Competitors and Original Equipment Manufacturers haven't been able to match ARB in quality and brand awareness.

Maxitrans designs, manufactures, sells and services road transport equipment for the general freight, temperature controlled and bulk transport sectors. They are the largest manufacturer of these products in Australia, with main brands including Freighter, Maxi-CUBE and Hamelex White. We visited their largest manufacturing facility in Ballarat, which employs approximately 450 staff. The expertise of these employees is critical to the Maxitrans business model. Maxitrans dedicates resources and capital to training, skills development and R&D. This is where we define their competitive advantage - the delivery of high quality products, product innovation, service and solutions to their customers. Importers cannot match this, as quality of imported trailer products is substandard, innovation is poor and aftermarket service is nonexistent.

Battle of the Retailers

We recently completed a series of site visits to companies within the consumer sector. We covered a wide cross section of retailers and suppliers including Woolworths, Coles, Aldi, IGA, Costco, Bunnings, Masters, Harvey Norman, JB Hi-Fi, ARB and Coca-Cola. We believe that it is invaluable, and indeed critical, to get out of the office and discover what might be happening on the ground. We see two key takeaways from our visits:

1) The Consumer is Cautious

2) Brand loyalty versus value: value is winning

"The Fresh Food People"

"Sign up Today"

"Prices You'll Love Talking About"

"Australia's Fastest Growing Hardware Store"

"Down, Down Prices Are Down"

"How The Locals Like It"

"Where Lowest Prices Are Just The Beginning"

"Always Cheap Prices"

Source: Company Data April 2014

1) The Consumer is Cautious

The retail environment is still tough. Concerns over job security is having a noticeable impact on the consumer. Retailers need to be savvy to claim a share of wallet. It is imperative that retail managers invest in brands, locations, store refurbishment and a solid online offering. Consumers want the best but are hesitant to pay a premium. Old, tired stores and clumsy websites don't satisfy the shopping experience or quality expectation.

The international players are disruptive but are here to stay – Costco and Aldi are beneficiaries of the value conscious consumer. There are five Costco stores in Australia and we are told there could be another three within 18 months. Aldi now has over 350 sites and a 10% market share in the grocery market (we've also been told they "want to get to 600 sites Australia-wide"). Woolworths opened 26 new stores in the last six months and BWS/Dan Murphy's has opened 22. Coles have been aggressive for five years now through their accelerated renewal program with 382 stores in renewal format.

However, Metcash/IGA seem to have missed the boat here, with management recently declaring that their Food & Grocery division will have to spend $100m-$125m per annum to fund store refurbishments, new stores and store buy-backs just to stay in the race.

Source: Company Data April 2014

2) Brand Loyalty versus Value: Value is winning

Consumers are spoilt for choice. They are more informed and increasingly playing products, venues and internet offerings off each other. The consumer of today seems far more willing to switch between retailers. One only needs to visit a Costco mid-week or an Aldi on its "Special Buy Wednesday" to witness this behavior in full swing. Both these retailers are running loss leading promotions to drive heavy foot traffic.

It has become a very competitive and convoluted landscape and thus difficult to see who is competing with whom – there is crossover of product between almost all retailers that we visited, so seeing the consumer switching outright from one venue to the next is difficult to monitor. Does a camping promotion from Aldi or Costco dent the sales figures of BCF, Rays Outdoors or Katmandu? Is Appliances Online the new price setter for the likes of Harvey Norman, Masters and JB Hi-Fi? Is Coca-Cola once again driving promotional traffic through Woolworths, Coles, Aldi, Costco and even IGA?

Answering these questions is difficult. The next step of analysing stocks down to their product offering near impossible. However if we take the Costco and Aldi model, these players are generally taking market share from the traditional space by offering something different to the consumer. Aldi, whilst being predominantly a home brand offering, has lower priced products across the board than Woolies, Coles and IGA. Costco is competitive on pricing, has a genuine buzz and hype with their larger trolleys, packaging and warehouse store format. However, an in store price check on dozens of household items revealed that on a per 100 gram basis, Woolies and Coles were in-line or offered lower prices. The $60 Costco membership fee is in addition to this. Nevertheless, perception is reality and Costco customers believe they are getting a good deal driving a consumer switch.

Product innovation remains critical in satisfying consumer demand without sacrificing margins. One of the best examples of this working in today's market is through Coca-Cola. The company has reduced pack size and introduced "mini cans" (200mL) in a quest to satisfy the demand of individuals who would like to monitor their intake of carbonated drinks and sugars. Sales of mini-cans have surpassed all expectations. However, if one analyses the price points, it works out to be $5.42/L, a huge premium to a traditional 2 litre bottle at $1.50/L. Same product, different packaging and driven by consumer demand.

The Bunnings versus Masters hardware battle is an interesting one. The Woolworths-backed Masters continues to roll-out new stores at a rapid pace, but with 17 stores is still a minnow against the 237-store Bunnings. While we were impressed with the aesthetics of the Masters store (it is targets the female shopper), our visits indicate Bunnings has a significant price advantage. In fact, with the exception of both stores being in big box warehouses, the two hardware retailers seem to target slightly different markets. The Masters offering is less reliant on Trade (~10-15% of sales), has a significant white goods offering, is brightly lit with polished concrete and seems to offer more after sales care (e.g. installation). While it is more discreet, Masters has a similar 10% discount to Bunnings (under "Best Price Guarantee"). Hardware remains a highly fragmented market and we believe both have the potential to be successful. Yet again, the small operator is likely to suffer.

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10 YEARS

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