Q&A WITH MATT WILLIAMS

Matt Williams, Portfolio Manager of the Airlie Australian Share Fund, discusses the challenges the coronavirus is posing to Australian companies and investors, and how Airlie is positioning the portfolio to ride out a pandemic that could follow one of three scenarios.

Q: Can you sum up your overall view of the crisis so far?

A: 'Unprecedented' is the word of the day and probably the year. Covid-19 has resulted in a near shutdown of economies around the world and that has shattering consequences; hence, the massive monetary and fiscal responses. The rare bright spots right now are that the 'flattening of the curve' in Australia is working and economic activity has restarted in China and South Korea.

"This crisis is a test of their financial strength.."

Q: What is the biggest challenge for companies amid the economic havoc?

A: This crisis is a test of their financial strength, which is a key tenet of our investment process – in fact, our process starts with evaluating companies on this basis. As we entered the crisis, we had confidence in the financial robustness of the stocks in the portfolio. However, not even the best balance sheets can insulate a company from substantially lower, or even no, revenue. So we are reviewing at the solvency of companies in our portfolio and stocks under consideration for investment.

"We are reviewing the solvency of companies in our portfolio..."

Q: Is having ample cash reserves the key for companies?

A: Liquidity doesn't seem to be a problem overall. The global financial crisis taught companies about the importance of having enough cash reserves and central banks have flooded the markets with liquidity so there is ample scope for companies to meet their obligations in the short term. The key issue is how long companies can stay solvent with reduced (or no) revenue.

"The key issue is how long companies can stay solvent with reduced (or no) revenue."

We are studying how companies can cope with three scenarios. Scenario one is that these daily restrictions on economic activity last for fewer than three months; scenario two is that the restrictions persist for three to six months; and scenario three, that doesn't bear thinking about too much, is a situation where the crisis lasts for more than six months. There are some companies that will expand their revenue in even the third scenario. Coles with its supermarkets, and resources companies BHP Billiton, Horizon Gold and Mineral Resources spring to mind, while a small number of our holdings, such as Premier Investments, Nick Scali and Qantas Airways, will obviously experience severe revenue declines even in scenario one.

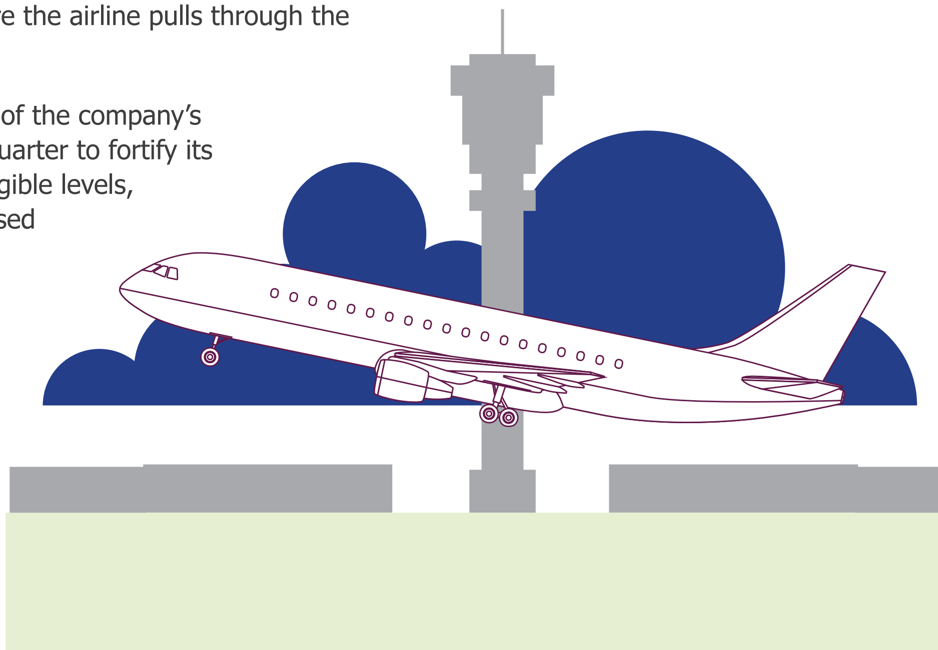
Q: How have management teams responded so far to the crisis?

A: This situation is as unprecedented for company management as it is for investors. But we have seen good reactions from most of the companies that we follow.

Qantas is being hit by the travel restrictions yet management quickly formed and enacted a plan to reduce flying capacity and furloughed many of their employees; actions that, while tough for staff, should ensure the airline pulls through the crisis.

Wesfarmers management has sold nearly 10% of the company's stake in Coles at a decent price over the past quarter to fortify its balance sheet. Having reduced its debt to negligible levels, Wesfarmers is well placed to pounce on distressed assets for a great price.

Reece management made a sound decision to conduct a pre-emptive balance sheet fortification in April when it raised capital in case conditions in its new market of the US proved tough should scenario three eventuate.



"Another move has been to add to resources stocks…"

Q: Looking at the portfolio, what's your cash position and has it changed much over the crisis?

A: Cash is about 7% as at early April, not far from our 10% limit. We are not trying to play the market in terms of shifting our cash holding. We are more focused on using stock selection to brace the portfolio for the tough economic conditions ahead.

One way we have done that is to reduce our financial holdings. We've cut positions in Commonwealth Bank of Australia, Macquarie Group, Suncorp and Westpac Banking on a view that most economic downturns prove tough for financial stocks.

Another move has been to add to resources stocks because we think they are positioned to weather the worst of the scenarios discussed. We have added to existing positions in BHP Billiton, Horizon Gold and Mineral Resources. In other moves, we repurchased ASX, paying in the 60s (in terms of dollars) after having sold in the 80s, and we have invested in some real estate investment trusts; namely, GPT and Viva Energy.

We are watching some other stocks that we'd like to own at the right price. These include Xero, the accounting software business, and REA, the owner of realestate.com and other property websites.

> ***"We are watching some other stocks that we'd like to own at the right price."***

Q: There's talk that banks will need to cut or suspend dividends. Is this one reason why you have reduced your exposure to financials?

A: It seems likely, given the request from the Australian Prudential Regulatory Authority in April and Westpac's following announcement that, at the very least, there will be substantial cuts in dividends when the major banks report their results in May. We are underweight the major banks but their sell-offs have boosted our interest in them. We own CBA and Westpac and we do not own ANZ Banking Group and National Australia Bank. But any move would depend on which of our three scenarios we think will unfold. At this point, given the uncertainty, we think being underweight the banks is a good spot to be in.

> ***"We are underweight the major banks but their sell-offs have boosted our interest in them."***

Q: Several companies have conducted capital raisings. Have you participated?

A: The nature of this crisis makes these decisions tricky in the short term. How do you price a travel company that might have reduced or zero revenue for an extended period under scenario two or three? When we think more long term, however, we can see opportunities. That's why we participated in the Flight Centre capital raising. This stock was not in the portfolio but we felt the price of $7.20 a share was attractive on a medium-term view. We took part in Reece's capital raising. It has been the only company in the portfolio to raise capital to date.

We feel we have a handle on which of our portfolio companies need to raise capital under all the scenarios. The unsurprising news is that the majority of companies under scenario three will have to raise capital. Under scenarios one or two, we think that most of our companies have the financial strength to cope without raising capital. But the caveat here is that management teams and boards might decide, à la Reece, to prepare for scenario three by raising capital.

> ***"...we think that most of our companies have the financial strength to cope without raising capital."***

Q: One of the stocks you have been purchasing of late is Medibank Private. Can you explain the rationale?

A: Medibank Private, according to our process (especially when judged on financial strength), is a strong company. Australia's second-largest insurer has net cash, is well managed and has invested wisely in recent times after a period when it had underinvested in technology.

We have a view that people will want to pay for health insurance, even if some no longer can, and the regulatory situation was starting to tick the way of the health insurance industry.

While there are always negative issues surrounding the health system, the fact is that spending on health will grow over the medium to long term. Medibank Private is a great way to play that increased spending. The federal government was looking to bolster the industry with some carrot and some sticks to get insurance levels growing again, which would be helpful for Medibank Private. The crisis might reinforce the government's intentions.

> ***"We have a view that people will want to pay for health insurance, even if some no longer can..."***

Airlie
Funds Management