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ISSUE 26: OCTOBER 2019

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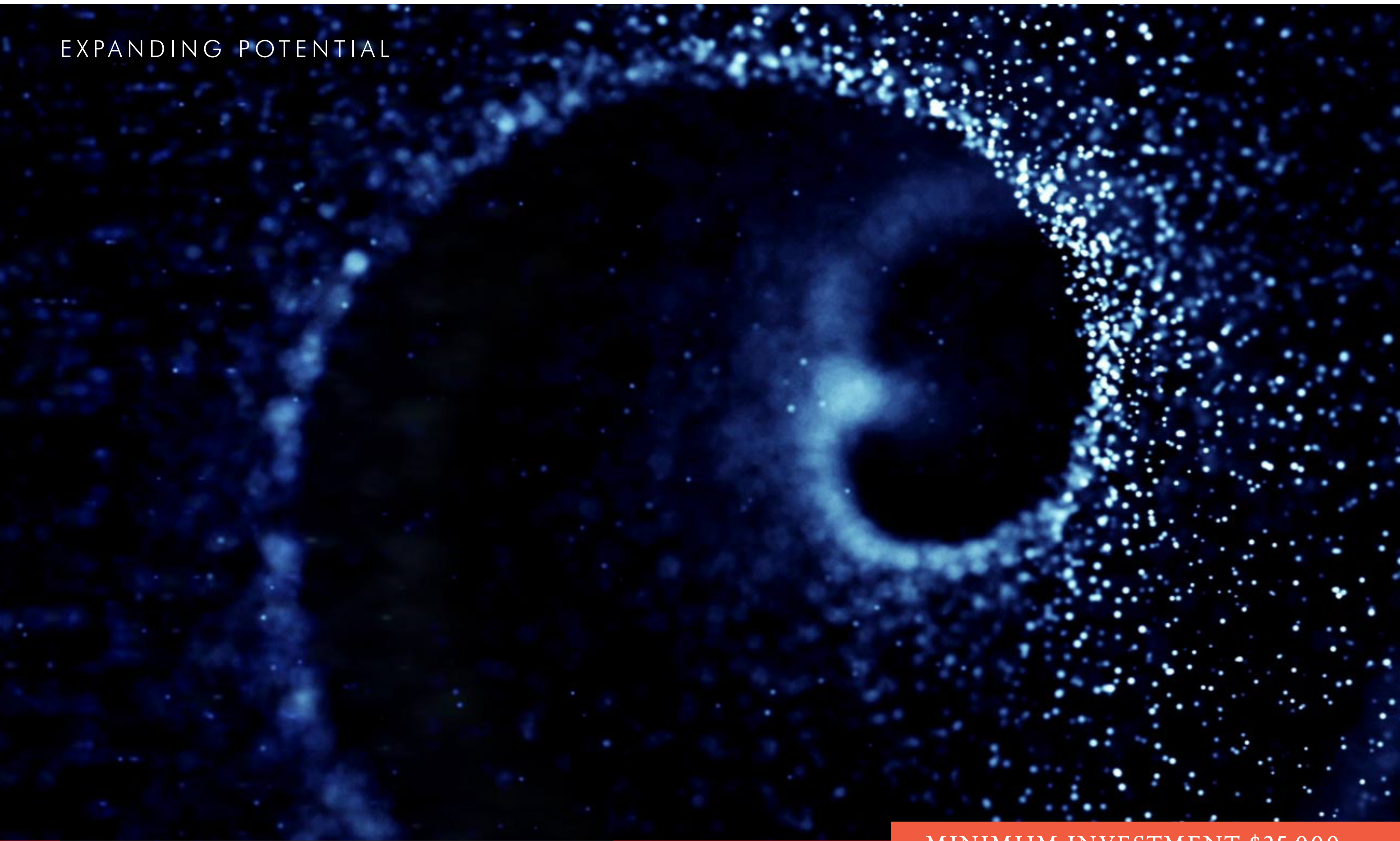


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## FROM THE EDITOR

Welcome to our latest edition of *Best of the Best*. Curious times abound.

With negative rates globally and a slowing economy domestically, it's easy to zip up your wallet and conclude there's nothing to buy. But that's a mistake. In all markets, there can be opportunities to profit with measured risk. In the last nine months, we have profited handsomely from the takeover of two of our domestic holdings, TradeMe and Navitas. We've also done well for clients buying IDP Education in the float and buying Telstra earlier this year, beginning when it dipped below $2.90.

Our new Montgomery Small Companies Fund should also benefit from two extremely talented and experienced investors dedicating their considerable skills to uncovering opportunities across the business life-cycle and where stockbroking firms cannot afford to research.

The Montgomery Small Companies Fund is now open and by applying before December 13, investors benefit from a 0.25 per cent discount on the management fee for the first two years. Keeping in mind many, if not most, reputable 'small cap funds' are closed to new investors (small companies' funds must restrict their size and we will too). Please download the PDS and learn more here.

The Australian economy is barely growing, and without immigration it would be going backwards. Term deposit rates of less than 1.75 per cent mean retirees have been enduring an 'income recession' for years. And given the substantial near-halving of residential building approvals (a leading indicator for construction activity), the ranks of those experiencing income reductions will include architects, surveyors, landscape gardeners, brickies, sparkies, plumbers, chippies, tilers, painters and roofers. That's more than 3.5 per cent of the nation's workforce who, by Christmas or early in the new year, will be earning less income even if they keep their jobs or their contracts. In turn, that could have an adverse impact on retailing, which is the country's second largest employer.

It makes perfect sense that our Reserve Bank would cut interest rates. But what's also needed are permanent and enduring tax cuts for those on lower incomes. You will hear a lot more about the need for low-income tax cuts as the economy continues to slow.

Speaking of interest rates, it's also curious that some junk bonds are now trading at negative yields. Yes, you heard that correctly!

A bond buyer who holds the bond to maturity can only ever receive the face value of the bond and the coupon or interest payments. If the premium they pay, in the market, above face value is greater than the sum of the remaining interest payments, they are locking in a loss. They will also lose money if the company defaults. Investors surely cannot be that irrational.

What's going on is unadulterated speculation. The buyer of a negative yielding bond is simply hoping or betting that rates head even more negative. And the only way that can happen is if a bigger 'fool' comes along to pay a higher price for that bond and accept an even greater negative yield. Everyone trading these securities must therefore be expecting to have 'one last dance'.

We're not in the business of 'cigar butt' or one-last-puff investing. Stick instead to quality and value, as we do at Montgomery, and you'll do just fine over the long-term.

Please enjoy this latest selection of articles prepared by our team.

Roger Montgomery

Chief Investment Officer

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# Five key themes for small-cap investors

Dominic Rose, Portfolio Manager

Dominic identifies five themes emerging from the August reporting season, and within these themes are companies you should keep an eye on.

The smaller end of the stock market delivered a mixed bag during the recent reporting season. But if you sift through the company reports, you'll find five themes common to those that provided positive reports and/or outlook statements. These are the companies to put on your watchlist.

Overall, the stats suggest the results were on the soft side with the number of small cap industrial companies seeing downward revisions to their broker forward earnings estimates outweighing those that were upgraded (66 stocks revised down versus 21 revised up).

In aggregate, the index-weighted consensus forward earnings per share (EPS) was reduced by 3.8 per cent, according to JP Morgan Research. The most material projected earnings cuts occurred in the consumer staples, consumer discretionary and healthcare sectors, while only utilities saw net upgrades. However, the share price performances for the month of August indicate that market expectations for consumer related companies was already very low – many of these stocks actually bounced post results despite the forward earnings cuts.

Let's explore five of these growth themes in greater detail.

**Technology**

The small cap technology sector spans software, hardware and IT service providers. Indeed, the ASX has recently become quite an exciting tech hub thanks to relatively cheaper listing costs and growing local investor interest.

IF YOU SIFT THROUGH COMPANY REPORTS, YOU'LL FIND FIVE THEMES COMMON TO THOSE THAT PROVIDED POSITIVE REPORTS AND/OR OUTLOOK STATEMENTS. THESE ARE THE COMPANIES TO PUT ON YOUR WATCHLIST.

Thematically, investors gravitate towards tech stocks for their highly disruptive business models and their relatively long runways for growth (low penetration of large addressable markets).

Driving this structural growth is a number of global mega trends, including large enterprises migrating from on premise servers up into the cloud. This is positive for local data centre operators, such as NextDC, as well as special connection services like those provided by Megaport. Another trend is the evolution of software towards the favoured Software as a Service (SaaS) model – small cap SaaS companies include Technology One, Bravura, Infomedia, Hansen and Nearmap, ecommerce platforms (like Kogan and Temple & Webster) and the emergence of big data and artificial intelligence, Appen is a key small cap player in this space. Additionally, the falling cost of deploying technology has become a key enabler for smaller companies to execute their disruptive business strategies.

ANOTHER STRONG FINTECH THEME PLAYING OUT IN THE AUSTRALIAN SMALL CAP ARENA IS THE STRUCTURAL GROWTH OF THE INDEPENDENT WEALTH PLATFORMS.

With market expectations relatively high, stock price moves in the tech sector during results season were more about hitting or missing near-term earnings. Looking further out than the next earnings print, we saw no evidence of any weakening of these global mega trends during results season so expect the medium-term investment thesis for owning tech to largely hold.

**Fintech**

Another interesting structural growth theme available to small cap investors is fintechs. Here, innovative companies, known as fintechs, are using technology to disrupt the traditional financial services industry. Key target areas include payments, wealth platforms, e-wallets, digital currencies, foreign exchange, crowd funding and even traditional banking. Armed with a clean sheet of paper and a better technology stack, many of these fintechs are creating real change. For example, Afterpay's buy now pay later model has materially disrupted the credit card segment, and driven significant online sales growth for many retailers, particularly in the millennial cohort. In the aftermath of the financial services Royal Commission, the major banks have largely pulled back to focus on their 'bread and butter' housing mortgage books, leaving the consumer and small business financing sector wide open for the fintechs – names include: Zip Money, Flexigroup, Money3, Prospa.

Another strong fintech theme playing out in the Australian small cap arena is the structural growth of the independent wealth platforms (Netwealth, HUB 24 and Praemium). Their platform technology is superior to the legacy platforms found within the incumbents, and these fintechs are also rapidly gaining share on the back of the Royal Commission fallout which is driving financial advisers out of the aligned groups and into independent planning networks. Fund flows remain strong, but market focus has been on near-term pricing pressure from increased competition and lower cash profits due to falling interest rates. The longer term structural trends appear intact.

**The Asian consumer**

Rising wealth within the expanding Asian middle classes, particularly in China and India, presents a strong structural growth theme and a significant market opportunity for a number of small cap companies. Premium Australian products and services are highly sought after in Asia, especially infant formula (Bellamys, Bubs and Clover), vitamins (Blackmores), health and beauty products (BWX and McPherson's) and education services (IDP Education).

Indeed, technology is also playing an important role here with the dominant e-commerce platforms such as Alibaba's T-Mall and JD.com (partly owned by Tencent) facilitating strong cross-border transaction growth. Notwithstanding the recent global macro turmoil brought about by unresolved trade wars and disruptions to the grey 'daigou' channel, demand for these premium Australian products and services remains exceptionally strong.

**Mining services**

On the cyclical front, the small cap mining services sector has offered investors exposure to the recovery in global commodity prices and the resurgence in construction activity, particularly in the domestic iron ore and coal industries. All three of the iron ore majors operating in the Pilbara region are embarking upon multi-billion dollar projects to sustain their current rates of production well into the future.

This is underpinning a significant pipeline of work for small cap contractors (such as NRW, Decmil, Monadelphous and Seven Group). The key question for investors here is how long will this current iron ore construction boom last?

Recent commentary from the majors suggests at least two more years of significantly elevated construction activity based on committed projects, with the potential for the cycle to extend further subject to the iron ore price and demand from China. The exceptionally strong rally in the gold price over the last quarter has also increased investor confidence in small cap companies leveraged to gold exploration and production like Perenti, Macmahon, MACA, Imdex and Swick.

**Improving household outlook**

One cycle small cap investors are increasingly considering playing is the potential recovery in domestic household consumption. FY19 was a really tough year for many consumer discretionary companies – retailers traded through a soft demand backdrop with high household indebtedness, low wages growth, falling house prices, Federal election uncertainty etc. while media businesses saw reduced advertising spend, particularly from their banking and finance (Royal Commission) and retail clients.

Looking forward, investors appear to be wondering if we have perhaps seen the bottom of this consumption cycle with a potential turnaround on the horizon driven by improved consumer confidence on the back of the surprise Federal election outcome, ensuing fiscal and monetary stimulus through tax cuts, RBA rate cuts and APRA loosening credit requirements, and early signs of a stabilisation of house prices.

Encouragingly, outlook commentary from leading retailers, JB HiFi and Super Retail Group, noted 'green shoots' in activity. If household consumption improves, this could ultimately drive improved auto sales (A.P. Eagers, ARB Corporation, G.U.D. Holdings, Bapcor and Autosports Group) and residential construction (Adelaide Brighton, CSR, Fletcher Building, GWA and Bingo). It's very early days but worth watching considering the consensus trade here looks to be underweight.

Many small cap retailers have the benefit of store roll-out programs (like Adairs, Baby Bunting, Lovisa, Nick Scali, Noni B and City Chic Collective), which help drive earnings growth even when underlying conditions are tough. Another key driver for small cap retailers has been strong double-digit online sales growth, partly propelled by the growth in by now pay later offerings and partly attributable to significant investment in technology to support e-commerce transactions. Amazon threat was likely a key catalyst here.

For the ground-floor opportunity to invest in tomorrow's leaders today, download the Product Disclosure Statement for the Montgomery Small Companies Fund, please click here.

This article was written on 11 September 2019. All share and other prices and movements in prices are on this date.


# Roger that – Flight Centre delivers again!

Roger Montgomery, Chief Investment Officer

Roger takes a closer look into Flight Centre's annual 2019 full year result, which highlights the emergence of the company's overseas businesses generating the majority of the company's profit.

Many have doubted Flight Centre's ability to thrive in an online world. But its clicks-and-bricks strategy looks to be succeeding, as does the goal of expanding its global footprint.

Flight Centre's (ASX:FLT) 2019 operating cash flow followed its normal seasonal pattern with the company recording a modest cash outflow during the first half, followed by a larger inflow during the second half of the year.

For the full year, operating cash inflow was $278.9 million, compared to $314.3 million in FY2018. An additional week of salaries due to some businesses moving to weekly pay cycles explains the difference which, if adjusted for, was flat.

The company's statutory FY2019 profit before tax (PBT), which is not adjusted to exclude non-recurring losses and gains, was slightly higher than the underlying result at $343.5 million (FY2018: $364.3 million). As an aside, underlying is an indication of what businesses may do year after year if all other parameters remain the same, while the statutory profit is calculated by adding one-off gains (or losses) to underlying profit.

Adjustments to statutory PBT during FY2019 included a $29.8 impairment loss relating to the Olympus destination management company (DMC) in Mexico; which was offset by $30.1 million in non-recurring gains. The adjustments translated to a $266.6 million underlying net profit after tax (NPAT) or a $264.2 million actual or statutory NPAT (FY18: $283 million and $264.8 million respectively).

**A growing overseas business**

The announcement of FLT's annual 2019 full year result was used to highlight the emergence of the company's overseas businesses as generating the majority of the company's profit and 52 per cent of total transaction volume (TTV). With a winning formula, and relatively small existing market share in several much larger overseas geographies, the trend is expected to continue.

The 2020 forecast is partly dependent on an improvement in the domestic tourism market. However, a growing corporate and overseas business should become a focus for investors. Indeed, in TTV terms, the Americas business is growing strongly, consistently and has just overtaken its counterpart in Australia and New Zealand to become FLT's largest corporate business globally. The Americas businesses delivered an underlying PBT in excess of $100 million, having increased almost five-fold since FY2016. It is now entrenched as a key earnings driver for the group.

Record profit contributions were also recorded in New Zealand and from the Asia businesses (India, China, Singapore and Malaysia).

FLT's company-owned corporate businesses grew TTV at 15.2 per cent and generated $8.9 billion in TTV during FY2019.

Despite rapid growth overseas, the Australian business is still large and investors are concerned with possible maturity locally. 'Softness' in domestic leisure reflected a challenging macroeconomic picture and disruptive changes including brand consolidation, a new wage model ($14 million), an EBA, and the deployment of a new sales system (GDS), which temporarily impacted TTV growth, sales staff numbers, margins and in-store productivity. The company is also reviewing its domestic leisure network. 20 new stores will be opened while up to 30 Flight Centre shops will be closed. An additional 30 are expected to be converted to either Travel Associates or the new youth-focused Universal Traveller brand. An additional 30-40 leisure shops are expected to be relocated to superior sites and roughly 200 sales consultants will be added to ensure optimum staffing levels.

Flight Centre is working towards a 2025 vision in addition to a transformation program with targets in place through to the end of FY2022. These include 7 per cent compounding annual TTV growth, a 10 per cent underlying cost margin (excluding touring cost of sales) and a return to a 2 per cent net profit margin which is defined as profit before tax as a percentage).

The company's 8.8 per cent year-on-year TTV growth was achieved with fewer sales staff –14,622 at June 30 2018 to 14,346 at June 30, 2019.

Revenue growth was more subdued (up 4.5 per cent globally), which meant that its revenue margin – revenue as a percentage of TTV – decreased during the year to 12.9 per cent (FY2018: 13.4 per cent). While this was expected, as a result of its changing business mix (lower margin corporate business and fast growing online sales), the actual movement was larger than anticipated and was a key reason for FY2019 PBT being 10.8 per cent below the record underlying FY2018 result of $384.7million.

**Other highlights include:**

- Lower growth in expenses (in constant currency) during both FY2018 and FY2019 and improved cost margins.
- Record sales, with total transaction value (TTV) for the 12 months to June 30 2019 topping the record FY18 result by almost $2 billion or 8.8 per cent.
- TTV has now eclipsed the prior year's result in 23 of FLT's 24 years as a listed entity.

Importantly, solid TTV growth did not translate to the record profit. While international and corporate delivered solid profit growth, it was more than offset by soft Australian results in a fairly subdued trading cycle and during a period of significant disruption for the leisure business in particular.

Europe, the Middle East and Africa (EMEA) held up well despite ongoing Brexit uncertainty in the UK, which is the company's largest business within this region.

Asia delivered strong profit and TTV growth, making record contributions in both measures.

A strong balance sheet, and probably a founder who isn't getting any younger, saw record dividends through the year including a special dividend of $1.49.

While Flight Centre describes a focus on organic growth, each year is marked with acquisitions. The company notes "major focus has always been on organic growth, we will continue to acquire businesses – when appropriate opportunities arise – to complement this growth."

In FY2019, the company bolstered its technology platforms and offerings with the acquisitions of Upside, Umapped, Claire & Sam, expanded its corporate travel footprint through Casto, and 3mundi, and accelerated growth in emerging businesses with the purchase of the Bali Camakila resort.

Since June 30, FLT also acquired the remaining 25 per cent interest in Les Voyages Laurier Du Vallon (LDV) in Canada to take 100 per cent ownership of an established corporate travel and premium leisure business.

**Outlook**

External challenges have continued in early FY2020. A weaker Australian consumer is having a negative impact on leisure travel demand, while uncertainty relating to Brexit in the UK and the recent unrest in Hong Kong is also impacting travel plans.

As the company expands its overseas footprint, however, geographic and brand diversity will help shield the company from the impacts of individual macroeconomic or geopolitical events. If the company continues on its current path, with the inevitable bumps along the way, investors will see it much as they see Resmed, CSL or Cochlear – an Australian export success with domestic performances becoming a footnote.

Significant ongoing spend in systems and technology is tantamount to investment in future growth at the expense only of short-term performance.

Any stabilisation or improvement of the Australian leisure results will be a bonus but the long-term story is global.

This article was written on 28 August 2019. All share and other prices and movements in prices are on this date.

# Five global themes we think will deliver strong returns

Andrew Macken, Portfolio Manager

Andrew shares an update on five global themes he believes will deliver strong future returns. Featuring a range of companies held by our funds exposed to these growing industries.

Amid all the noise and volatility in global equity markets are some powerful structural shifts that should provide solid investment returns for many years to come. Here, I'd like to present five of them, and some strong businesses that are riding these industry tailwinds.

Notwithstanding the return of volatility in global equity markets, our global strategies seek to provide investors with exposures to a set of undervalued, high-quality global businesses which are experiencing industry tailwinds which are structural in nature.

**Digital music streaming**

For example, consider Vivendi (Euronext: VIV), owner of the world's largest record label, Universal Music Group (UMG). As consumer behaviour continues to evolve from purchasing individual music tracks to subscription-based digital streaming, UMG's revenue growth continues to accelerate at a significantly higher incremental profit margin. And this dynamic is structural with a long runway still ahead. Consider that only around 13 per cent of adults in the US subscribe to a paid digital streaming service. In countries like France, Germany and the UK today, this penetration rate is less than 10 per cent. And in China today it's around 1 per cent. This will underwrite structural growth in global digital streaming revenues of around 20 per cent per annum, well into the next decade.

**Digital advertising**

Or the structural migration of advertising spend onto digital platforms that offer highly-targeted forms of advertising – thereby driving the highest rates of ad spend ROI for the digital marketer. The world has really divided into two distinct digital advertising markets: (i) the world, ex-China, which is dominated by Google, owned by Alphabet (NASDAQ: GOOGL), and Facebook (NASDAQ: FB); and (ii) China, which is dominated by Alibaba (NYSE: BABA) and Tencent (HKEx: 700). In studying the quarterly disclosures of numerous consumer facing businesses, including nearly all the major CPG companies, it is clear that marketing budgets are being significantly re-weighted towards higher-returning digital channels all around the world. Here is what Kimberly-Clark (NYSE: KMB) CEO, Michael Hsu, had to say earlier this year: "Today, digital is approximately half of our working media mix – and that percentage is growing… the ROIs are a multiple of what our traditional ROIs are…"

**Cloud IT spend**

And this is not the only technological transformation taking place inside the enterprise. Readers will know that substantially all businesses today – both large and small – are moving at least some of their technology infrastructure to the cloud. You can think of the cloud as an external source of storage, compute, services and applications. There are enormous cost, efficiency and security advantages in outsourcing this technology infrastructure. Today, Bernstein estimates the total addressable market for cloud services to be approximately US$1.9 trillion. And yet, aggregate cloud spend is less than 10 per cent of this total addressable market, meaning there is a very long runway ahead for growth in cloud related revenues. Microsoft (NASDAQ: MSFT) is arguably the most well-positioned business to take advantage of this structural growth in cloud related spend. Its offering spans the cloud-based compute/storage infrastructure as well as the enterprise applications that sit on top of this infrastructure. Indeed, Microsoft is in a particularly well-suited position given that Windows is installed on around 90 per cent of the world's PCs and Office is used by around 85 per cent of enterprises. This creates a high degree of customer captivity that Microsoft is in the very early stages of monetising.

**Demographics**

Demographic changes are structural trends to which we seek to be positively exposed. In the US, for example, the ageing population sees 10,000 Americans turn 65 years old every day. This is creating enormous demand for healthcare services. UnitedHealth (NYSE: UNH), the largest health insurer in the US, is particularly well positioned to grow its insurance business – particularly its highly-popular Medicare Advantage offering which is available to Medicare recipients aged over 65 years old. But it is actually UnitedHealth's underappreciated healthcare delivery platform, Optum, which has the greatest opportunity of profitable, structural growth. Optum is a technology and data-enabled healthcare delivery platform, not only for UnitedHealth's own insurance business, but for more than 80 third-party payers. Optum is seeking to use data and technology to deliver healthcare more efficiently and effectively to drive better outcomes for patients and at lower costs, creating value in which Optum will share.

At the other end of the demographic spectrum in the US, readers may be interested to know that the children of the baby boomers – known as the "echo-boomers" – are around 28 years old today. Over the next 10 years, population growth in the all-important 35-44 year old cohort in the US will be around six million. By comparison, growth in this cohort was negative over the last 10 years. This favours demand for housing and those businesses exposed to demand for home renovations. We own Floor & Décor (NYSE: FND), a specialty retailer of surface flooring – the preferred supplier of flooring products to professional customers and known for its 1,500 SKU in-stock, job-ready inventories.

**Asian middle-class**

Finally, Asian demographics represent another structural trend that is providing great opportunities to the disciplined investor. Over the next 15 years, more than 80 per cent of the growth in middle-class spend will stem from the Asian-Pacific region. And private financial wealth levels in Asia will continue to grow at around 10 per cent per annum for many years to come. In China, Ping An (HKEx: 2318) is an industry leader in life insurance and wealth management offerings. It is a leader in technology and data-enabled design and distribution of insurance and wealth products. And given that its average customer age is only around 38 years old, it is set to grow structurally with the wealth of its customer base.

Outside of China, Prudential (LSE: PRU) is a clear leader in Asian life insurance with a top-two market position in Indonesia, Singapore, Hong Kong, Malaysia, Vietnam, India and elsewhere. Asian insurance markets are around half the size, on average, of western insurance markets as a percentage of GDP, suggesting there is substantial penetration ahead. And Prudential's Asian business has delivered circa 20 per cent post-tax economic returns consistently for years – and we expect this performance to continue for many years to come. The growth in the wealth levels of the Asian middle-class will also drive structural demand growth for services like travel.

It is important to observe that each of our theses not only identifies the sources of business quality and structural growth opportunities; but also makes the important assessment as to whether (or not) the business in question remains undervalued today. After all, not even the greatest growth story in the world can stop you from losing money if you overpay for an asset.

*The Montgomery Global Funds and Montaka own shares in Google, Facebook, Alibaba, Tencent, Microsoft, United Health and Floor & Décor. This article was prepared 1 August with the information we have today, and our view may change. It does not constitute formal advice or professional investment advice. If you wish to trade any of these you should seek financial advice.*

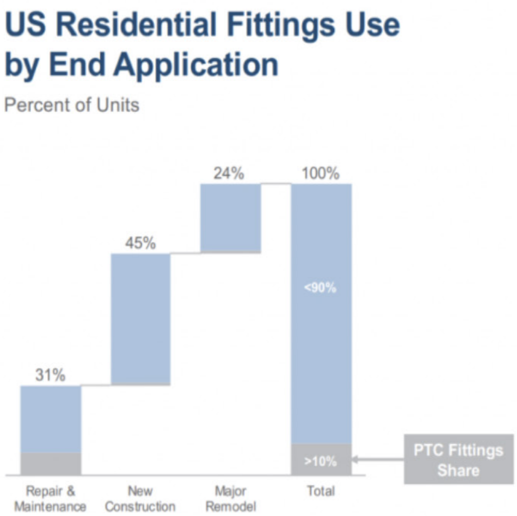
This article was written on 1 August 2019. All share and other prices and movements in prices are on this date.

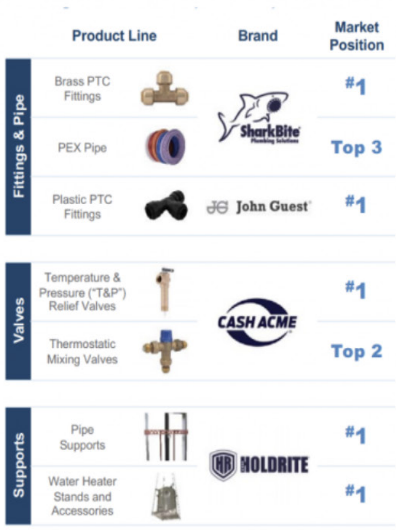
# Three reasons why we have held Reliance through recent price volatility

Joseph Kim, Senior Analyst

Joseph shares why we view Reliance Worldwide as a quality company with a strong management team and solid medium-term growth prospects on a genuinely global platform.

Reliance Worldwide (ASX:RWC) has been a recent introduction to the portfolio. The company sells innovative and simple plumbing fixtures to enhance productivity and efficiency for end users. Reliance's core product is the "Push-to-Connect" (PTC) fitting to connect two ends of a pipe, marketed under the Sharkbite brand. The "PTC" story is one of market penetration given the time efficiency benefits and versatility of the product for end-users vs other methods such as crimp, press and solder. Reliance is also looking to leverage its suite of products for an entire plumbing solution for both residential and commercial buildings.




*Source: Reliance*

We view Reliance as a quality company with a strong management team and solid medium-term growth prospects on a genuinely global platform. However, the share price has gone through some turbulence over the past few months – exacerbated by a significant sell down of shares by the previous owner / Chairman, a lack of a "winter freeze" event that impacted sales by approximately $12-15 million, concerns around the impact of Brexit and sales dis-synergies on its recent John Guest acquisition.

## New competitive threat

While those factors were largely known by the market and quantified via an earnings downgrade in mid-May, we became aware of a new threat potentially emerging over the past few weeks – namely the launch of a competing private-label push-to-connect product by one of Reliance's distribution partners – Ferguson.

With over 1400 locations across the US, Ferguson represents a significant customer for RWC's push-to-connect products. While our estimated sales impact to RWC was small (maximum of US$20 million, or around 2 per cent of group sales) our view was the market's reaction to this news when more widely disseminated would be greater than the estimated impact on revenue and profitability.

Despite anticipating a potentially negative share price over-reaction to this development, the Montgomery portfolios elected to keep a sizeable shareholding in the company. In making this decision, we took into account several factors:

- **Reliance is a high-quality business going through cyclical challenges**

One may argue the company is exposed to cyclical forces implies it is lower quality, the truth is there are very few businesses globally that are not exposed to some cycle or another.

Reliance is one of the few businesses listed in Australia, with an established global footprint with prospects for sustained medium-term growth. The company has not only spent significant dollars, but also time and years investing in engineering, supply chain, distribution, R&D and marketing to build a formidable position in its major markets.


*Source: Reliance*

While advances in global technology have lowered barriers to entry in many businesses (especially for technology-based capital-light companies), building a vertically integrated industrials business of this scale through a combination of organic growth and complimentary acquisitions (more than A$1 billion of sales) is not readily replicated. For context, as CEO Heath Sharpe has noted, it took 10 years for Sharkbite to get to $100 million of sales.

- **Competitors are common in every industry**

Competitors are a fact of life in almost every industry. It is relatively easy to construct bear arguments for the Reliance business – especially around longer-term gross margins – when viewing RWC's product suite through a commodity-like lens. In fact, RWC's gross profit margins are a major reason why the product attracts competitors in the first place.

Reliance enjoys healthy margins given its focus on customer service and an uncompromising view on brand strength and loyalty. Given the function of (i.e. connecting pipes without leaks, including behind-the-wall) versus relative price point of the core push-to-connect product, it is easier to understand why brand strength provides a competitive advantage given the potential damage and warranty concerns caused by a faulty product.

Core to our central investment thesis for Reliance is brand. Assuming every me-too (or in this case, "Fake-bite") business will be successful understates the years of investment built into marketing – both on a national and grassroots level. Gatorbite and Blue Hawk are two prior examples (not to mention Tectite – sold in select Home Depot stores) that have failed to gain meaningful traction.

It's entirely possible Plumbite – Ferguson's private label brand – is here to stay, but assuming guaranteed overnight success and significant change to the competitive landscape appears pre-emptive. While every example is different, you'd be hard pressed to find someone selling A2 Milk shares just because Bellamy's (or Nestle / Danone for that matter) released a new infant formula.

- **Knowing when to buy back in**

While the share price did sell off in the case of Reliance (to a low of $3.10/sh), it is not always possible to predict when the best time is to buy back in on impending "negative" news. In most examples the share price provides a good guide, but given the potential threat of a new competitor, it is almost always uncertain how other investors would respond.

In this situation, a solid FY19 result versus revised expectations – showing improved cash-flow and working capital management – as well as a top-line that demonstrated a level of resilience and allaying concerns of a new competitor was enough to spark a rally in the shares. A wait-and-see approach before uncertainty fades would have quickly eroded potential gains on re-entry.

**Why the sell-off?**

In this example, how other investors may perceive the risk is important to anticipate and understand. The Plumbite threat had greater credibility for 2 reasons – the new entrant was Private Label with national US distribution in place; and Ferguson has a reputation as a "go-to" destination for plumbing pros.

As earlier noted, there was also uncertainty around the potential quantum of lost sales; given Ferguson's 1400 locations, it's likely that some estimates of lost sales far exceeded our own. The approximate 15-20 per cent fall in the share price from $3.75/share to $3.10/share had implied over US$40 million of lost sales – double our high-end estimate. RWC's own estimated impact is less than 1 per cent of group sales, as other customers stock greater levels of Sharkbite product in anticipation of taking share off Ferguson stores.

**Outlook**

The business clearly has some external challenges – the 2H showed some margin decline, tariffs and Brexit loom as potential earnings impacts and the Plumbite entry may impact sales more than expected. Weather impacts are uncertain. There are also opportunities – cross selling of the expanded product range and its Big Box retailer experimenting with re-organising shelf space. In other words – business as usual for most companies in a dynamic world.

Given the relative maturity of the RWC business and product suite, delivering continuously compounding top-line growth will be more challenging over time – especially for a business without nascent network effects.

However, we remain attracted to RWC's product suite and relative positioning in its end markets – and with an eye on relative valuation – it remains an active position in the Montgomery portfolios.

*The Montgomery Fund and Montgomery [Private] Fund owns shares in Reliance Worldwide. This post was prepared 13 September with the information we have today, and our view may change. It does not constitute formal advice or professional investment advice. If you wish to trade Reliance Worldwide you should seek financial advice.*

This article was written on 13 September 2019. All share and other prices and movements in prices are on this date.

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