

Beyond COVID: investing in realigned companies

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In an interview with the Australian Financial Review, Vince Pezzullo, Deputy Head of Equities, praised businesses like Qantas, Flight Centre and Boral for their willingness to reinvent themselves in response to the global pandemic.

COVID and associated market disruption rocked global markets in March last year but the rebound was just as sudden. Those who had some spare cash rushed in to capitalise and Vince Pezzullo took the opportunity to buy Qantas shares, which he continues to hold.

"You need to be focusing on the businesses where it's not just about the cyclical recovery," he told the AFR in early February. "Look for the second leg, which is, 'how has management taken advantage of a pretty quick and material slowdown to rationalise the business?'. Qantas is one of them, they've basically realigned the entire business very quickly."

Pezzullo and his team of equities analysts felt the stock was a buy when it fell to nearly \$3. It was trading at around \$4.80 in mid-February 2021. Qantas pays an annual dividend yield of 2.8%, fully franked. However, Pezzullo concedes there were times in 2020 when it was tough to find value anywhere in the market.

"That (Qantas) was one of the stocks we haven't owned for a long time. We were a bit nervous about the balance sheet but once they did the raising that, for us, was a good enough reason," he explained. "You really have to be on your toes now, so to speak, to ensure that you can take advantage of what may occur due to some of the actions in the last 12 months ... doing the same thing as last year will not work for the next 18 months to two years."

Here Pezzullo is referring to not only the trillions of dollars of monetary stimulus investors have come to rely on, but the fiscal interventions, suspension of bankruptcy protocols, and the pressure on companies to prevent job losses.

"We work in a market where government and central bank authorities in general would like to see some risk-taking behaviour," Pezzullo told the AFR. "GameStop is part of that, right? Bitcoin is part of that. I'm not saying those assets are right or wrong, I'm just saying that's a consequence of the environment we're living through now, where there's significant liquidity and a bolstering fiscally of the economy to hold it up."

We also bought Boral significantly below book value while participating in the recapitalisations of both Oil Search and Flight Centre. Regarding Flight Centre Pezzullo told the AFR: "We thought there was a few things that needed to be done, pre-corona, regarding restructuring the business on the bricks and mortar side. The management really took a pretty aggressive attitude, and it was the right thing to do to restructure the business almost overnight rather than do it over a few years."

We also bought Aristocrat below \$20 (now \$33.55) on the expectation that this business will be back operating normally within two to three years. This timing brings its own challenges.

"You're always trying to balance out what price for just a return to normalisation of activity, and that will get you so far in owning the stock," Pezzullo told the AFR. "You need something more – what's the management actually doing to improve the business that the market's not pricing in today? There's a few stocks like that."

Pezzullo cites BlueScope Steel and Iluka Resources as examples and is also keeping a close eye on insurers, Suncorp and IAG.

“They’re both pretty determined I’d expect to improve the business, whether it’s cost-out or a hardening cycle in rates and they’ve both been forgotten a bit. There’s actually a bit of value in those names.”

Dexus Property is another company of interest as it continues to trade below net tangible asset value but manages to sell assets close to book value. And as has often been the case, when we believe the market is not appropriately ascribing value, we will get involved with an activist approach.

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