SANDON CAPITAL

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ASX Announcement

Sandon Capital Investments Ltd
Shareholder update

Dear fellow Shareholders,

Last time we wrote to you like this was on 26 March 2020, as markets began considering what the then-new COVID-19 virus might mean. Now more than 2 years later, most of the world is well and truly living with COVID-19. We've all learned a lot since then. Human ingenuity (and necessity) came to the rescue with several vaccines developed. In 2020, many thought there could be no such thing. As vaccines tempered the impact of the virus (except perhaps in China), other problems emerged. Global supply chains, lauded in the last 20 years for becoming hyper-efficient, have shown themselves to be far more fragile than anyone realised. As a result of the pandemic, supply chains have gone from "*just in time*" to "*just in case*." These supply chain challenges led to what was thought by central banks to be only "*transitory*" inflation. Today, most have recanted and are aggressively raising interest rates.

Applying Murphy's Law, a global pandemic was not enough; there have been extreme weather events – drought, floods and fires – and now there is a war between Ukraine and Russia. This conflict has added to tensions and affected energy and food prices, further exacerbating supply issues. Together, these countries grow about a quarter of the world's wheat and Russia is one of the largest producers and exporters of energy. In Australia, these issues have combined with the consequences of pandemic-related border closures. We face a skills shortage or perhaps more generally a "*people*" shortage. According to the latest OECD economic outlook, Australia is experiencing the second largest skills shortage among developed countries.

This preamble leads to the reason for this update. Human nature is such that we all tend to extrapolate the present into the future. Good news today portends good news tomorrow. Conversely, bad news today portends bad, if not worse news tomorrow. Given the news we are all reading and listening to presently, the future must be indeed dire.

We disagree. We accept there are challenges facing Australia and the global economy. Despite this, we remind ourselves that such challenges will also present opportunities.

The spectre of excessive inflation has spooked investors around the world. In the past, there have been instances of over-prescribing the cure by raising interest rates too far. Excessive inflation can have wide-ranging effects on business and the economy, including on profit margins. Equity markets are down, as are fixed income markets. Rising interest rates have a mathematical impact on the value of an investment. All other things being equal, a higher discount rate leads to a lower present value for a particular stream of future cash flows. This effect was most pronounced in the high-growth companies. At near zero interest rates, many of these companies, particularly in the technology sector, were bought by many irrespective of price. These companies were changing hands at prices equivalent to 10, 20 and even 100 times revenue. Profits would come later – how could they not with such incredible growth prospects? Many of these companies exhibited exponential share price growth as their revenues grew as a result of COVID-induced impacts on consumer behaviour. As we wrote above, such effects were extrapolated *ad infinitum*. We assiduously avoided such investments. The euphoria was so widespread and long-lived we dared not even take the contrary view by short-selling such companies. J.M. Keynes's quip, "*markets can stay irrational longer than you can stay solvent*" was again proved true.

Now these same profitless growth companies have suffered terrifying share price declines. Unfortunately, so too have many profitable companies with sound long term prospects, particularly those in the smaller- and mid-sized space. Like so often in the past, when the music seems like slowing, market reactions are indiscriminate.

The effects on our portfolio

So far, the effect on our portfolio and its constituent companies has been on market prices, rather than on business operations and the intrinsic value of our investments. From a peak in Oct 2021, the market price of our portfolio has fallen by 18.8% to the end of May 2022. In spite of this decline, the portfolio was 22.6% above the level at 31 Jan 2020 (prior to the impact on markets from the global pandemic). The table below shows this data compared to broader market indices.

	SNC	Small Ordinaries Accum.	S&P/ASX200 Accum.	All Ordinaries Accum.
31 Jan 20 to 31 May 22 return	**22.6%**	**8.4%**	**11.8%**	**13.8%**
31 Oct 21 to 31 May 22 return	-18.8%	-11.3%	0.9%	-0.1%

Source: Bloomberg, Sandon Capital analysis
Notes: SNC returns are net of investment management fees but before performance fees, corporate expenses and tax. All performance data is as at months' end.

In early 2020, we did not attempt to "predict" the gravity of COVID.[1] How could we? In fact, such predictions were really nothing more than a wager – the virus was either going to be serious or not.

We focused on what we could reasonably know and observe. Our response was to test our companies for their ability to survive. Not knowing what the future would hold, we decided that determining survivability was crucial. Little did we know then that Australia and the world would endure lockdowns of varying durations. What we could, and did, reasonably expect was that if economic activity had to be curtailed, governments would step in to assist, which they did. In some respects, economic activity in some sectors was at times in a state of suspended animation. Despite all this, our portfolio companies survived and most emerged from COVID-19 in better shape than before.

Even with recent events (and since the end of May), we consider our approach has paid off. Our portfolios remain above their pre-COVID peaks, and importantly, ahead of Australian market indices. We are applying the same approach to the situation we face today.

The corporate performance reported in the half-year to 31 December 2021 was largely positive for most of our companies. Their outlooks provided at the time and those that have since provided further updates were also mainly positive. Yet almost all have seen significant share price declines as investors flee equity markets more generally. While we are frustrated by this, we remain very comfortable with the medium and long-term prospects for our core portfolio holdings.

Our investment decisions are not based on trying to accurately predict global macro factors, however we are not ignorant of what happens in our world. Here are some of the facts we are focused on in the current environment:

- Despite recent increases, nominal interest rates remain historically low (very, very low). Furthermore, real interest rates (that is nominal rates less the inflation rate) remain largely negative, which is highly accommodative for economic activity.

[1] This is not to say we did not think it could be serious, but rather the world only knew it was serious once it became so.

- In Australia, demand for labour is high. We have skilled and unskilled labour shortages, largely the result of COVID-era restrictions on migration. This can be fixed.
- Commodity prices remain elevated, which has overall net benefits to the Australian economy. Those sectors augur well for Australia even as spot prices eventually revert to more reasonable levels.
- Many supply chain issues are slowly ironing themselves out, which in time, should flow through to more stable prices.

Having regard to these issues, our focus remains on the prospects for the companies we invest in (and those we seek to invest in).

The 2022 financial year reporting season, like an outgoing tide, will show those wearing bathers and standing on solid ground. We expect most of our portfolio companies will report sound results. That said, we cannot say what this will mean for share prices in the short term. What we can say, is that if companies continue to execute on their plans, in time, their value will continue to grow. As business owners, this is what we want.

The Sandon Capital portfolio is the cheapest it has ever been, with solid growth prospects

Most of our companies today are in better shape than they were when we first became shareholders. Our core holdings have gone through significant changes to become better. There have been board changes, management changes, strategic reviews and demergers, for example. Some are now more focused and others have improved their capital allocation and operational strategies. All of these changes have contributed to the betterment of those companies.

Yet, despite these improvements, the Sandon Capital portfolio is in the bargain bin of the market. We estimate the weighted average price earnings (PE) ratio for the portfolio today stands at approximately 6 times, for a group of companies that on average is growing net profits at 10-15%[2]. This compares to 13 times for the Small Cap Index, with lower profit growth. Despite the shortcomings of the PE ratio, it provides a useful shorthand for illustrating the value that resides in the portfolio.

Outlook

While we cannot predict the direction of financial markets in the short term[3], we remain confident in the medium-and longer-term prospects for the companies in our portfolio. Eight out of our top ten investments hold net cash (or will soon do so when announced asset sales complete). This removes one of the critical pressures companies face when interest rates rise. Many have significant levels of land, property and non-core assets, which should also help underpin their ability to navigate the near future.

In the past two months, we've spoken with the management teams of most of our companies. We have questioned them on demand, labour and wages pressures, raw materials prices and their ability to pass through price increases. Some companies have also provided market updates. Those have been positive. Where updates have not be provided, given the continuous disclosure obligations, we expect any previous comments remain valid. In those instances, those comments too have been positive.

The noise that surrounds us would suggest that a retreat beneath a rock is the most prudent course of action. Rather than do what might feel comfortable and easy, we are aiming to stay focused on our medium to long term outlook. We firmly believe that the businesses we own today will be better and more valuable in the future. Most will be able to take advantage of the current conditions to grow, both organically and via acquisitions. We will support these businesses as we can. Others may need to consider radical change, for example by selling themselves. We will look to influence these decisions where we can.

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[2] This figure is calculated for the top 10 holdings, which account for approximately 80% of the value of the portfolio, adjusted for cash and excess non-core assets such as property.

[3] Except perhaps, that it will be volatile for some time!

In the short term, share prices will be influenced by what other investors think, though in the medium and long term, share prices will be influenced by a company's capacity to deliver growing profits. Where they cannot grow, we expect those companies will either return cash to their shareholders or they may sell themselves or their assets. Either way, we expect most of our companies to deliver satisfactory returns in time. The potential disparity between short-term and long-term performance epitomises Benjamin Graham's adage of the share market being a voting machine in the short term and a weighing machine in the long term. We remain focused on growing the weight of the portfolio even if we lose the odd daily election.

We will continue to focus on what is within our control and our influence. We continue to apply our investment approach and will continue to seek out opportunities to influence outcomes that should improve or enhance the value of our portfolio companies.

By virtue of our structures and importantly our investors, Sandon Capital has a significant advantage over other investors. Our committed, long-term investors allow us to act rationally, when many others are forced to act irrationally. When others have been forced to sell into falling markets, we have been able to take advantage of the volatility. So far, this advantage has played in our investors' favour each and every time there has been market turmoil.

Given the rapidly approaching financial year end, we expect there may be further volatility as some investors engage in tax-loss selling. Such selling may provide us with some attractive buying opportunities. Although never enough at times like these, our cash levels will grow naturally in coming weeks as we receive dividends, returns of capital and takeover consideration. We will likely deploy this cash into some existing positions as well as some new investments. We don't know today how quickly we will do this, but we will look to take advantage of opportunities

Campbell and I have both increased our investments in funds managed by Sandon Capital in recent weeks.[4] Our timing may prove prescient, or premature. On this measure, we are unconcerned and are confident that our existing and additional investments are likely to be worth significantly more in the future than they are today.

Worth noting is that, since SNC is below its high-water mark, any returns that might take the portfolio back to its high water mark will be performance fee-free.

We are grateful for your continued support, confidence and patience during these tumultuous times.

If you have questions or would like to discuss the portfolio, please do not hesitate to contact me at 0408 936 357.

Yours sincerely,

Gabriel Radzyminski
Chief Investment Officer
Sandon Capital Pty Ltd

Campbell Morgan
Portfolio Manager
Sandon Capital Pty Ltd

This release of this announcement has been approved by the Directors of Sandon Capital Investments Limited (ASX:SNC)

[4] As of the date of this letter, Sandon Capital Pty Ltd, your investment management team and their families have approximately $6 million invested in Sandon Capital funds, so we too have endured this decline.

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