Allan Gray Live - Thursday 17 September 2020

Suhas Nayak, Allan Gray Portfolio Manager & Sid Takla, Asaleo Care CEO

Suhas Nayak: So, welcome everyone to our first Allan Gray live in Australia. I'm Suhas Nayak, portfolio manager at Allan Gray. And with me today is Sid Takla, CEO of Asaleo Care.

So, firstly, let me thank you for joining us. We know time is a precious resource and we appreciate everyone logging in. Secondly, just some housekeeping. Given our limited time and the number of participants online, we've decided to mute and turn off all cameras. Should you have any questions following the webinar, please contact your local relationship manager who will get back to you as soon as they can.

The purpose of this format is to feature a stock in our [Australian equity] portfolio, how we came to buy it and why we hold it, but more importantly, give you the chance to hear from the CEO of the company. I do however want to draw your attention to the disclaimer slide, which should be coming up shortly.

With that out of the way, let me introduce Sid Takla. He's the CEO of Asaleo Care. Sid has been CEO since 2018 and a senior leader at Asaleo Care since 2012. He has over 25 years industry experience gained at Carter Holt Harvey and Amcor Packaging before Asaleo Care. Thank you for joining us.

Sid Takla: Thanks, Suhas, for inviting me.

Suhas Nayak: Perhaps we can start with a brief overview of the company. What does Asaleo Care do, and how does it make money?

Sid Takla: How does it make money? Okay. Well, Asaleo Care is a leader in personal care and hygiene across Australasia. We manufacture and sell key essential everyday products in the feminine care, incontinence management and tissue paper consumable categories. Our brands include brands such as Libra in the feminine care category, TENA in the incontinence space. Tork is our professional hygiene brand that's sold in the B2B channel. And in New Zealand specifically, we have the Purex, Handee and Sorbent brands in the consumer tissue categories there.

Sid Takla: And many of our brands are actually considered heritage brands in the markets that we play in. We've got customers and consumers for over 60 years. So we're a trusted brand. And quite often, Suhas, when I do explain who Asaleo Care is, I go straight to the brands because everybody knows the brands. Obviously, we've had a few name changes along the way, but everybody does recognise the brands, and in one form or another has been a user of those brands.

We are a proud manufacturer, a local manufacturer, and have been for a long period of time. And that's something that's really come to the fore in this current environment, in the COVID environment where we are definitely seeing a shift in sentiment towards local manufacturing, both from our customers and consumers. One, from a surety of supply perspective, but also around the understanding to support local jobs. And we're definitely seeing that. And particularly for brands like Libra, we think it bodes well because Libra is the only Australian manufacturing brand in the feminine care category. So we think that bodes well.

But I think it's also important just to briefly touch on the history of ownership of the business over the last 10 years, because I actually think it's really shaped the organisation during that time. And as you've touched, I've actually been with the business since 2007, so I've been there for 13 years. But I've been through all the ownership structure, so we've gone from being a subsidiary of a large multinational, in Essity, to then being in a 50-50 joint venture with an Australian-based private equity firm, to then being listed on the ASX in 2014.

And what I've found having been through that whole period is that, each of those ownership structures took a different lens on the business. And now, so when I take a step back and have a look at that, my key learning is probably there's not one of those models that's been perfect. There's strengths in each of those models. And definitely, what I've tried to adopt is the strength of each of those, and try and create a fundamental business that we can take forward. And that's really been my focus is... there's been so much destruction over that period... is to really focus the business on the fundamentals as to what makes it a business sustainable longer term.

Suhas Nayak: Okay. We should probably say something about our investment in the company. The price holdings chart that I've put up now shows you the price of Asaleo Care in the red line, and our holdings in the [Allan Gray Australia] Equity Fund in the grey block. You can see, we invested in late 2017. And we really beefed up our exposure after the guidance downgrade that happened in mid-2018, which happened to be just a day or two after, or maybe even on the day of the quarterly report we had for this company.

So in the research for this investment, we thought that while there were a number of challenges in front of the company, including some underspending on brand and marketing, we thought the long term earnings [potential] of the company more than justified the price we were paying for the stock, which was why we bought when we did and why we've increased our exposure since. We thought there were some good brands there, as Sid has already touched on. And there were some distractions in the business that prevented getting full value for the company at the time.

Sid, you came into the role at a difficult time. Can you talk about the challenges you faced when you first became CEO in 2018, and what you did to work through them? And what were you surprised by?

Sid Takla: Okay. Well, I might start off with the last part of that question, what I was surprised by. And to be fair, I mean, I was part of the executive team prior to moving into the CEO role. I was heading up the B2B business at the time. So it wouldn't be right for me to say that I was completely surprised with where the business was at. In the whole, I pretty much knew what I was coming into. And I think that's one of the benefits, I think, of having an internal successor in the CEO role, is I had a bit of time to actually think about what I would do differently if I was in that role.

But you're right, it was a difficult period coming in. Primarily around where we had found ourselves with a debt position. I would probably say that's the first thing that I stepped into, a high debt position, and particularly around a time where EBITDA was in decline. I literally stepped into the role and pulp hit an all-time record high. And at that time, 70% of our business was exposed to pulp, and so it had a significant impact on our profitability. And in fact, you'll see that big drop that you had previously on that graph, was literally the first six months into the role was a profit downgrade on the back of that … pulp price increase.

And so ultimately what that meant is there was a lot of strain on covenants straight away moving into that role. So high debt position, declining profits, and we really had to navigate our way through that. So that was a very stressful process up front.

The other thing that I got a taste of straight away, and talking to the likes of Allan Gray, is that we had lost a lot of credibility in the market. We were coming off two to three years of profit downgrades. And not just disappointing the market from an investor perspective, but also from a customer and consumer perspective. You touched on it. We hadn't invested in the brands for a long period of time, and that was really reflected in our sales performance. Since listing, when I moved in, we hadn't grown the top line. In fact, every one of our major brands had been in decline since listing. So I'm talking four or five years by the time I got into the role. So I knew coming in that that was going to be one of my biggest challenges, that when you've had that length of period of brands in decline, you can't turn them around overnight. It was always going to take time to do that and, importantly, it was going to take investment into the brands to do that. So that was the other one, was just around where the sales position was at.

And the third one that I'll touch on is just around the morale within the team. So morale was quite low. When you have a stable of brands, and you've touched on this, one of the reasons why you bought into the business is that you could see that they were high quality brands and had been number one or number two for many, many years in their categories. And so when you have a stable of brands like that that just haven't been winning for the last four or five years, it is really demoralising. And it makes it difficult just to retain talent and attract talent into the business because everybody wants to be part of a winning brand or a winning team. And so that was one of the things that we had to address early on.

So essentially what we then did, Suhas, to correct those is, the first thing I did is to come up with, you know, what was the plan to get out of this? Because that was one of the things you said, "What were you surprised with?" is there wasn't really a plan in place of how are we going to get the business through this. So we did an in depth strategic review of the whole business, looked at every element. What was the return on invested capital for each business unit? How are we going to get through our debt position? And one of the first things we did was really around our brands and to come up with detailed brand plans, customer plans. And what came out of those... And this

importantly was backed by research, not just having our people come up with what we think the plans are. We spent a lot of time talking to consumers and customers around what we needed to fix.

So what really came out of that was the need to invest heavily in our brand. So the first opportunity really, I had to talk to the market and probably ever since, I've really been communicating heavily is the need to reinvest back in the brands. And it was material. That first year, last year, we're talking over $10 million reinvestment back into the brands, and we've continued that this year with a further 10% increase. And what's been really pleasing with that is, for the first time in six years, we've taken market share across all our key brands, and that's really the ultimate metric for us. Categories can grow when your sales can grow, but taking share was a really important driver for us.

The other element really around that was the divestment of the Australian consumer tissue business. And the proceeds of that, $180 million, went a long way to really correcting our debt position. And it was probably the catalyst or the reset for the business. It was the one big transaction that we needed to really reset the business, not just from a debt perspective, Suhas, but also, as I touched on earlier, the portfolio needed correcting because we were 70% exposed to pulp. So I felt we were always going to be subject to the fluctuation in pulp prices when you have so much of your portfolio exposed to that. So divesting that consumer tissue business in Australia was a big part of also correcting that portfolio.

And then, I've touched on morale that the big thing really we did there was actually put a plan in place, a tangible plan that the team could see we had our way through this. And once the team started to see that we were serious about it... By serious, I mean that the significant investment in the brands, the $23 million investment in the new asset in New Zealand last year as well. And then they can see the results that we're getting from that. That's had a significant boost to morale because the teams could now see, they can join those dots of the investments and the outcomes of that. So that's had a real big impact on morale for the business.

Suhas Nayak: You mentioned the divestment of the tissue business. And I know we had a lot of conversations around that time about selling businesses at the bottom of the cycle. And you managed to get a very good price. How did you find interactions with Allan Gray and also more generally, how do you find managing the desires of shareholders through reporting periods, et cetera?

Sid Takla: Yeah, I mean, to be really frank, being the new CEO, it's something that I've had to learn along the way. I mean, in regards to Allan Gray specifically, Suhas, I definitely wouldn't classify you as a passive investor. Right from the beginning, yourself and Simon were very clear on your thoughts on where the business was at, as you touched on you were particularly very clear around selling assets at the bottom end of a cycle.

But I think you would agree that the result that we achieved on the divestment of the consumer tissue asset was outstanding. I mean, to achieve a greater than 11 times multiple on a proforma P&L for a business that was loss making in the year that we sold it was a fantastic result. And the transaction, I really felt, added a lot of value to shareholders.

And as I said, it wasn't just the $180 million sale proceeds, it was a trigger for many other changes within our organisation. So I think what that helped do, something like that that when a shareholder shares with you a very clear thought, and definitely I took that on board, but we're still able to transact something even at that bottom end of the cycle that was value-adding, I think you start to build trust with your shareholders. I think again, it was an important transaction for me personally in that context to make sure we delivered a good result and so that we can start to rebuild the credibility of the business, as I said, coming off three years of profit downgrades. So building the credibility of the business and building the credibility of the new management team, it was, in a transaction, it was really important for me and the team and obviously the business.

In terms of shareholders, generally, I'm a strong believer that focus is a big ingredient in success in business, because there are so many distractions. And for me, there's a real discipline around maintaining focus. And that's not to say that you don't listen to shareholders. It's more the discipline around taking that feedback on board and trying to decipher what's the key message, or what's the key insight that's coming out of that. And if it makes sense, how do I incorporate that into our strategic thinking and strategic planning?

And I have to say, I actually... It might sound a bit funny, but I actually really enjoy the investor roadshow process because it's a couple of times in the year that really forces you to take a step back from the day-to-day running of the business and look at the business from a different lens, the investor lens, or the analyst lens.

And quite often, it's different, or you pick up some insights around perhaps something that we haven't communicated well or an idea or an insight that we need to incorporate into our planning. So I think if you incorporate that in your mindset that, hang on, I can actually get something out of the dialogue with the investor as opposed to being defensive, I think you can get something out of it. And something that I've tried pretty hard to work on as well is just the communication, to try and have a plan that we can articulate clearly to our shareholders, having a strong communication plan around that, and as much as possible, try and provide transparency around how the business is performing and where we're going.

And obviously, being in a listed environment, there is a fine line that you tread there around sharing too much commercially sensitive information versus providing your shareholders with as much information so that they can make solid decisions and judgements around that. So it's something, again, the team and I have worked really hard at, and sometimes I've probably felt we've disclosed too much. But based on where we were coming from as a business, I felt it was important that we probably erred on that side more, that we were being as transparent as possible around what we were doing and how we were going about that.

Suhas Nayak: Changing tack a little, many people talk about the difficulty suppliers have negotiating with our supermarket duopoly. How do you manage those relationships and how do you think Asaleo Care is placed?

Sid Takla: Okay. Look, I've been dealing with customers long enough now, Suhas, to have a view that that's business. You can waste so much energy and time whinging about it. And I can't recall or think about an example where an actual supplier has been able to change the strategy or the direction or negotiation in a major way with those retailers.

So I think you're better off putting your energies towards, well, what is the strategy and plan that I can come up with that can actually win with the retailer? And I think importantly for us, what we have done, to your question around what our relationship is like with the retailers at the moment, if you were to ask me that question two years ago, I would say there's been a significant shift between then and now in terms of the improvement in our relationship with the retailers.

And it's not down to one individual. That's down to having clear brand plans, clear customer plans. And most importantly, it's actually been the investment in the brands. If you want to engage in the retailers and they see that you're investing into the brands, you're more than halfway there because ultimately that's what they want. They want to see what you are doing to grow the category. If they see that you're investing into the brands, it makes doing business with them so much easier. And I've definitely seen that. That major investment we have made and continue to make, it's just opened up dialogue, and it's really positioning our brands again.

As the category captains, we're coming up with innovation and new ideas and that's the position you want to be in. You want to be the category captain, where the retailers are coming to you and say, "Hey, what do you think about what's next for this category?" And we've set that as the personal target for ourselves, that we want to be the category captain in these. For some, we are, and in others, we need to regain that position.

The other key message around that in dealing with the retailers and something that I talk to my team about all the time is that I feel that the best way to actually win with, whether it's the retailers or even our large B2B distributor partners, is to actually win with the end consumer. If you can get the end consumer to say, "I want the Libra brand, or I want the TENA brand or the Tork brand, then that puts you in a really strong position with the retailer or the distributor, because you know that that end consumer wants your product.

And that's why, again, that investment in the brand has been so important because it's about regaining that trust with our consumers, about being top of mind for them, all our brands back on air for the first time in a long time in both countries. And that's all around that brand health and brand awareness to make sure that we are top of mind and that we are winning with consumers, which then puts you in a great position with your retailers and distributor partners.

Suhas Nayak: And moving to the current health crisis, what challenges and opportunities are you seeing now?

Sid Takla: Well, other than not being able to get a haircut for the last two months, Suhas, and I think I have to wait another six weeks before that happens, the way we've been looking at it is essentially if there's a short term view and a longer term view for us, because the short term view, and we've sort of discussed this over the course of the half year results, has really been around the challenges of trying to continue to run a business whilst implementing a COVID-safe plan, keeping your team safe, and trying to keep the business running whilst you're having these peaks and troughs in demand.

So obviously during the March and April period, we had panic buying and the peaks that we had in demand during that period, we've seen nothing like it. And then in the subsequent months, you enter into a trough period as consumers start to use that product.

And so trying to manage that in a cost effective way has been quite a challenge for us. But I've been really proud with how the team has addressed that. Management of the supply chain has been a challenge. Generally from a revenue perspective, revenue has been strong, but we've definitely seen a shift towards in-home activity. It's a brand such as Libra, TENA and our consumer tissue brands in New Zealand. They're performing well because of that stronger in-home activity, whereas our away from home activities, so brands such as Tork in particular, our professional hygiene brand, that's directly impacted by the lockdown measures because that part of the business needs people to be away from home. We want people in offices. We want us in offices. We want kids at school. We want people traveling. We want them in hotels and eating out at restaurants, et cetera. That's what drives that professional hygiene part of the business. So that's definitely been impacted.

But the reason I say it's a short term and long term view because particularly for professional hygiene, I see that as a short term impact. There are more longer term benefits, I think, of COVID on specifically the professional hygiene business. In fact, net net for the business, we definitely see this pandemic is a benefit to Asaleo Care. And specifically for professional hygiene, we're seeing that trend now already, even though activity is down, we're seeing an increase in consumption of paper towel, because there has been a lot of education, a lot of rhetoric around the best way or the most hygienic way to dry your hands is through the use of a paper towel. And so we're seeing paper towel consumption go up considerably, and we expect that to continue.

Again, there's been a lot of research to say that warm air dryers or air dryers generally are less hygienic relative to that. It's about 10% of the market, is the dryer market. So again, we're starting to see a shift in consumption around paper towel.

The other obvious one is around soaps and sanitisers. We've seen significant increase in those. But again, our long-term solution is a dispenser-based one. So there's a lot of competitors have come out with pump packs that you can put on a desk, et cetera, but we know that people take them. It's not a long-term solution, whereas ours is a dispenser based one. It's lockable, it's bolted to a wall, that's the right long-term solution.

So when we're thinking about what does the office of the future look like, it's those dispenser solutions that we think about, which is leading into sort of the next point I was going to make around we're definitely seeing a trend towards non-touch dispensers. So we have the broadest range of sensor-based dispensers, and we're seeing a significant increase in requests for those.

Because, again, if you think about washrooms of the future, you don't really want to touch anything in that public environment. If you can use a sensor-based one, where you can just swipe your hand in front of a sensor and the towel comes out, or the paper comes out, et cetera, we definitely see that as a longer term trend in this category.

So they're the three big ones around consumption. And the other one I've touched on just finally, Suhas, is around the shift that we are seeing towards Australian-made or locally-made. So whether it's our customer base around shoring up supply and they experienced difficulties, or those that didn't have relationships with local suppliers who experienced supply difficulties, but also the consumers. Consumers are saying to us, and even our retailers, one of the major retailers shared

with me recently, some research that they have done where consumers are telling them, "Make it easier for us to shop locally-made."

So that's something that we're working with the major retailers on, is how do we call that out better on shelf. I mean, our latest packaging on Libra now, we've made that loud and proud the Australian-made front of packaging. And I'm not sure if you've seen our latest Libra commercial, but also right at the last image on the latest Libra commercial, calls out that we've been a proud manufacturer for more than 30 years of feminine care products in Australia. And we're the only ones.

So we feel that changing sentiment will also be a longer term trend towards our business. So there's some short term challenges around the current health environment, but we definitely feel net net going forward it'll be a positive trend for Asaleo Care.

Suhas Nayak: We talked about the balance sheet and the divestment improving the balance sheet metrics, and it's improved a lot over the last few years and without an equity raise, so well done. Cash is starting to come into the business. Are dividends a possibility in the future again?

Sid Takla: Look, definitely. I mean, cash flow in the last two halves has been really strong and we paid a full-year dividend for 2019, which we paid in April. And even though cash was strong in the first half, we made a conscious decision not to pay an interim dividend in calendar year 2020, just really around the uncertainty with the current COVID environment. We wanted to see how the second half panned out, as I touched on a bit earlier. We were not really sure how things were going to pan out for professional hygiene. So we just thought it was prudent that we will be conservative around cash management and just wait to see what happens into the second half.

As I said, the last two halves have seen very strong cash flow. Our forecasts indicate that that will continue going forward. So we have a stated mandate around getting back to regular payment of dividends. So obviously, it's a decision for the board at the end of the day, but definitely when we look at sort of the stated objective that we have put in place, it is around getting back to a regular payment of dividends. And our cash flow indicates that that definitely should be the case.

As you touched on, we're getting debt levels down to a very manageable level. We don't have any major capex planned in the next couple of years. So really, we definitely should be in a position where that is the case, we are returning to a regular stream of dividends.

Suhas Nayak: And you know that we're long-term investors. And so I'm curious about what your priorities are for the future of the business in the next three to five years, and also what worries you over that timeframe.

Sid Takla: It might not be the most sexiest of answers, Suhas, but my primary objective at the moment is to continue to get the base business fit. And that's the terminology we use in-house, is that we're really focused on getting the base business fit. And what I mean by that is focusing on those elements that I think will create a genuine rerate of the stock. And so I'm talking about continuous profitable sales growth, and that's why there's been so much rhetoric for me around investment in the brands and getting the business back into sales growth, because as I said, we're coming off five years of decline since we listed. And the brands just weren't going to survive that.

So sales growth is the big focus for us as an organisation. And that's through ongoing investment, bringing new innovation to market and expansion of categories as well. So you'll hear me continually talk about organic profitable sales growth is our primary objective.

The other one is around disciplined capital management. So we will focus to continue to pay down debt. We'll be very targeted in any capex over the sort of the horizon. And as we just touched on, the dividend piece, we do want to return to a sustainable dividend stream, and so being really disciplined around that.

And the third element that I talk to mainly internally with my team is around just really focusing on building credibility and confidence again in the market. When I think about sort of where we're currently at and where the share price is at, I definitely feel, and again, talking to investors and analysts, there is definitely an element of hesitance around the business' performance and can it be sustained. I understand that because coming off three years of profit downgrades, I can understand why that sentiment is there.

So a big focus for me and something that I'm driving within the culture of the organisation, and these are words that we use internally, is that results are binary. Now, there are lots of reasons why you could miss a number, but at the end of the day, we've promised a number and that number is binary. And so that's something that I'm trying to build as a culture of the organisation, and to build that credibility and confidence back into the market. So they're my primary objectives at the moment, is to continue to get base business fit.

In terms of what worries me, it's not so much that it worries me, but it's probably more a frustration, to be honest. And that's just really where the current valuation multiple is of the business. I think we're better than that. We're worth a lot more than that, but I understand the reasonings as to why, but it's a frustration for me.

And so that's, again, back to the point that I made a bit earlier, that we need to be patient and I keep talking to the team about that. We need to keep delivering on what we promise. We need to keep focusing on those fundamentals that will drive a genuine rerate. When I look at the share price on a daily basis, it'll drive you crazy. So I don't do that anymore. I learnt that pretty quickly actually, not to monitor the share price. It's just a focus on what are those long-term objectives, but that will generate a genuine rerate of the stock. And it's those elements that I've spoken about, that we will continue to focus on and continue to be patient.

And the reason I say that, Suhas, is because post the divestments, the business has a lot of capacity in terms of its overhead, it's overhead that we could leverage. But, we need to be patient. We need to get the multiple valuation up so that we do put the business in a position that if it wanted to entertain some inorganic growth, that we were in a position that we can afford something quite good. And clearly, we're not in a position to do that at the moment.

So I know it's probably not the most sexiest of answers in terms of just focusing on the fundamentals, but that's definitely my primary objective at the moment.

Suhas Nayak: Thanks, Sid. I see we've just ticked on 12:30. So we may draw the interview to a close. But thank you, Sid, for being so generous with your time during what would be a very busy period for you and for the company. And thanks for your thoughts. But let me finish this interview with why the company is still in the [Australian equity] portfolio for us.

As you saw, [the Allan Gray Australia Equity Fund's] holdings haven't really changed that much since we raised our holdings after that downgrade [in 2018]. We take company guidance for the year, which is around the $90 million mark, once you adjust for businesses that have been exited, that's at an EBITDA level. Capex and leases amount to about $30 million. So that puts the company on about 12 times free cash flow before interest and tax, which we think is reasonable value in this market, as long as those earnings are sustainable.

And so, we do hope that you manage to deliver on those numbers year in, year out, and then that valuation multiple should come through. So thank you, everyone, for joining in our first interview. Please send your BDMs any comments or questions you have in relation to the interview, and we'll try and get back to you. Thanks again for joining. And thanks, Sid.

Sid Takla: Thanks, Suhas. Thanks for your interest. Thank you.