Three resilient stocks with pricing power

By Perpetual Asset Management

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Perpetual Asset Management Australia's team of analysts have spent much of 2022 running the rule over those ASX-listed companies that are likely to outperform in a higher inflation and interest rate environment. However, with volatility set to continue, we asked them to name

three resilient stocks they think will likely withstand changes in the market environment such as recession or prolonged inflation.

Broadly, the past 12 months has been about moving away from those stocks that were “Covid winners” and positioning for a more inflationary environment. In doing so, we’ve very consciously been focused on companies that have options at their disposal – often through strong balance sheets – to manage their own outcomes. In other words, these companies are less worried about what the market or the economy does because they can control their own destiny better than their competitors. Three examples are:

Bapcor

Australia’s new and used car market has experienced unprecedented demand over 2022, and we expect this growth to continue in the medium term. Some Perpetual funds are long-term investors in Bapcor, a leading auto parts company in Australia and New Zealand, which operates businesses like Burson Auto Parts, BNT and Autobarn. The company has been operating in the automotive aftermarket segment since the early 1970s and listed on the ASX in 2014. In simple terms, Bapcor has a large network of stores throughout Australia and New Zealand, from which it supplies mechanics with a range of automotive replacement parts and consumables – think things like brake pads and oil filters. This trade business remains the largest and most important segment for Bapcor but, since the IPO, management have expanded into other automotive aftermarket segments, most notably the Autobarn retail store network, which is a combination of company-owned and franchise stores.

The attraction of the business centres on the strength of their competitive position within the automotive aftermarket industry, the nature of that industry, as well as Bapcor’s proven strategy. The industry structure of the core trade business is highly concentrated with Bapcor and Repco both roughly the same size and together they have about two-thirds of the market in terms of market share. Scale matters in this sector and we think that they’ll both continue to take share off the independents over the coming years. The nature of the industry is very attractive for us as well as both the number of cars on our roads is growing consistently, while the complexity of new cars is also increasing, which flows through in terms of their repair and maintenance requirements. Bapcor’s value to the mechanic stems from its large physical store network and extensive range of parts. Their customers are essentially the mechanics, and the mechanics are much more focused on getting the right part quickly, than on price. Ultimately, that means Bapcor has a high degree of pricing power, an attribute that is increasingly important in the current inflationary environment we find ourselves in.

Brambles

Several Perpetual funds have built significant, long-standing positions in the ASX-listed Brambles, which operates in 60 countries with its pallets and containers used to transport groceries, beverages and other consumer staples to retailers and e-commerce operators. The

transport and logistics company has been able to use its considerable pricing power and clout in the market as insulation from inflationary costs, while also being disciplined in recovering costs. To date, Brambles has kept revenues strong over 2022 through its ability to pass on in full the rising costs of timber, fuel, labour and transport to customers using its pool of 360 million pallets, crates and containers. An example of this is that Brambles produced 14 per cent annual profit growth in 2021-22 despite having to absorb $US470 million in timber price inflation. While there has been some minor softening in demand in the North American market – Brambles biggest division – in the September quarter, the company expects overall growth to remain solid in the December quarter.

We were also pleased to note the company's decision earlier this year not to pursue a $1 billion-plus investment in plastic pallets to be used in the supply chain for US retailing customer Costco. Our analyst team has long expressed concerns that the extra investment required for Brambles to shift to a full-scale plastic pallet operation at Costco could be a drag on returns because of the high up-front costs. We expect Brambles to win new customers in the US, management to extract better operating performance from the existing network and to continue to push prices to reflect the higher inflation in the business. Brambles recently reaffirmed its full-year guidance for 2022-23 of revenue growth at between 7 per cent and 10 per cent on a constant currency basis, and underlying profit growth of 8 per cent to 11 per cent using the same measure.

Telstra

One stock held by some Perpetual funds is Telstra. We are attracted to Telstra's market leading mobile position. Competitors Optus and TPG are dealing data privacy and integration challenges, which ought to provide Telstra an opportunity to capitalise on their already strong subscriber momentum. Telstra also offers an infrastructure-like exposure through the Infraco assets, in particular inflation-linked receipts from the National Broadband Network for use of Telstra's network assets.

Telecommunications infrastructure assets have been sold on very large multiples in recent years. And while there is some risk of valuation pressure given the rise in interest rates, the quality, scale and defensive revenue attributes of Telstra's network assets make them an appealing proposition. We believe the stock hasn't fully captured the upside in value for the Infraco assets, and as such we see some downside protection. Further, Telstra carries far less debt relative to earnings than many other infrastructure-like exposures. As such a partial (or even full) selldown of Infraco assets would see significant sums returned to shareholders through capital management.

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