In The Know: Episode 70



AI, Inflation and a record IPO: Decoding the ASX reporting season

Announcement (00:00):

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Host (00:14):

This is In The Know, a monthly investment podcast brought to you by Magellan Investment Partners.

Ray David (00:20):

Our philosophy is just to own great companies that have got durable assets with great management and great balance sheets, even if they're cyclical. And so we are finding that the market structure change has meant investors are selling down aggressively stocks at missed earnings on short-term noise and providing us opportunities to look at some of these names.

Host (00:39):

That's Ray David, portfolio manager for Airlie Funds Management. Welcome to In The Know. Australia's latest reporting season has offered a revealing snapshot of the ASX with very different forces shaping the outlook across sectors and individual companies. In this episode, Magellan's head of distribution, Mark Burgess, is joined by Ray David, portfolio manager, and David Meehan, investment analyst from Airlie Funds Management. Together they unpack what company results are telling them about the Australian equity market. They break down why Airlie remains cautious on the banks, where reporting season uncovered hidden opportunities, and what a potential record-breaking ASX listing from Firmus Technologies could mean for the AI investment boom. They also weigh in on sticky inflation and higher rates and ask whether the market's reactions signal a genuine turning point or just short-term noise. To kick things off, a welcome from your Host, Mark Burgess.

Mark Burgess (01:48):

Well, hi, I'm Mark Burgess, head of distribution at Magellan Investment Partners. Today we're talking about the Australian equity market, where it stands heading into the second half of 2026, and what the recent reporting season has told us about the outlook for certain companies, the opportunities and of course the challenges ahead. And to help us unpack this, I'm joined today by two members of the early investment team, Ray David and David Meehan. Hi guys. Thanks for joining us today.

Ray David (02:16):

Great to be here.

David Meehan (02:17):

Nice to meet you.

Mark Burgess (02:19):

Okay. Before we get into individual results, Ray, can you set the scene for us? Where do Australian equity stand heading into the second half of 2026 and what are the big themes that you're observing in the markets?

Ray David (02:32):

Yeah, thanks Burjo. The three big themes that we're seeing that's driving equities in global markets, number one, and by far this is the most dominant, it's a strong capital cycle we're seeing. In particular, the AI capital cycle, it's huge. You've got a big uplift in defense spend and infrastructure. And just coming back down to that AI CapEx cycle, this year the numbers are going to be somewhere around a trillion dollars. They're forecast to increase by $1.3 trillion in 2027, and it's driving pretty strong results to companies that are exposed to that thematic. And that thematic seems like it's going to be enduring at least for the next couple of years. The second thematic is inflation and interest rates. Inflation has been higher than what central banks and markets have expected. Interest rates are rising as a result. And the big driver of that has been the Middle East conflict.

(03:28):

Middle East conflict has led to higher oil prices, higher fuel prices, and companies are passing these costs onto their customers. For example, one building materials company we spoke to put up prices by 36% and now that's washing through the system and central banks are becoming much more hawkish. And the last thematic, and this is one which is a big seismic change relative to the last two decades, is the role of big government or an unstable geopolitical environment. And if you sort of think about the US, you've seen a Trump agenda, which is all about onshoring tariffs, increased US supremacy, which has driven that conflict. And back in Australia, it's a bit of the opposite where you're seeing more of a socialist approach to parts of the economy. So you've seen some pretty disadvantages to investors around property investing and also you've seen some large bailout to some unprofitable industries and government programs like NDIS. And so all these confluence of factors is driving different outcomes and outlooks for companies and that really shone through in the last reporting period.

Mark Burgess (04:35):

Thanks Ray. There's certainly three big themes there and we're certainly going to spend a bit of time working through each of those. But maybe Dave, if I can turn to you first and let's follow on the AI capital spend thematic. How is Airlie seeing this thematic and what did we learn from the reporting season?

David Meehan (04:53):

Yeah, so I think the capital being deployed in AI is quite remarkable as Ray said. So you've got about a trillion dollars forecasted this year growing at 30% a year. And so the beneficiaries so far that we've seen to date has been those that manufacture and design compute, but also those that house that compute. And so an example that recently was announced was in Queensland. There's a data center being built up there. It's expected to cost $30 billion and it's being built for Anthropic. That's going to be built over the next four to six years, but I think it's really important to put it in perspective just how big that capital base is. So BHP, one of Australia's largest mining companies in the world, they spend US 10 billion bucks a year in CapEx. So it's three times the size of that obviously getting built out over four to six years, but these are remarkable numbers.

(05:41):

What we're seeing at the moment or how we're playing it is Goodman Group, historically it's been an industrial portfolio business. So it developed industrial properties and then managed them. They a few years ago saw the opportunity to shift into data centers and so they had an agreement with Microsoft, which helped them. And so we think the asset base they have is really important. That first mover advantage has been really important. So when we think about the build out of AI or data centers, there's a couple of bottlenecks we see. So one of those would be land availability in key metro locations, tick for Goodman, they have that land. Access to appropriate power. Goodman were early in the transition and so they were able to secure some power.

(06:23):

And then just planning and development approvals. It's always hard working with councils, but you can imagine now with the rise of how many applications are going through, it's getting harder and harder to get approvals. And so Goodman at the moment, they have around 6.4 gigawatts of power bank, which is one of the largest in the world and $20 billion in project value. And so we see that as a way of playing the thematic in the ASX, but in a way that is reasonable and should benefit from this capital spend.

Ray David (06:51):

Yeah, I'll jump in there on that question as well. So a lot of the economic profits are accruing to the technology vendors, so namely semiconductors, whether it be GPUs, CPUs or RAM or even the hyperscalers. And so on the ASX, you're really playing the build out of that AI infrastructure as opposed to those selling the technology. And so the resources sector has been a bit of an indirect beneficiary as well, but resources to us look pretty expensive on valuations. And so one of the other companies that we own and we think looks pretty good value that's an indirect play on the picks and shovels is SGH Group, which is the old Seven Group Holdings.

(07:31):

Seven Group Holdings has got the master franchise for Caterpillar equipment under the West Track banner. And so as Dave alluded to is BHP's CapEx is starting to increase. There'll be need for more machinery. The fleet age of the machines is increasing as well. And so as a leading supplier of Caterpillar equipment, there's strong demand for that order book and particularly for the parts. So that resources side to us is also a bit of an indirect beneficiary of the capital cycle. So whether it be copper demand, critical minerals, and one of the best value players on ASX is Seven Group.

Mark Burgess (08:08):

I'm going to come back to your views on individual companies, but before I do that, I want to continue on the AI theme if you like. The ASX is gearing up for arguably one of the biggest IPOs in its history and that with the potential listing of the AI data center provider, Firmus Technologies. Can you give us your views on Firmus and maybe tell us a little bit about that company?

Ray David (08:31):

It's probably going to be a record IPO for the ASX. You've got to go back to the privatization of Telstra to look at the size of a company listing on the ASX. And so Firmus is effectively a startup today, but what it is is an AI factory or a token manufacturer. And it's looking to build out data centers that will really service some of the leading AI model owners. So OpenAI is one of the [inaudible 00:09:01] customers. Meta has underwritten a number of their proposed data centers, and then also NVIDIA is a supplier and a customer. In terms of the actual numbers, it's quite mind-boggling. So Firmus is looking to raise US $5 billion of fresh equity. The sort of valuations still yet to communicate to investors, but sort of the [inaudible 00:09:23] valuation is somewhere between an enterprise value of 50 to $65 billion US. And that includes capital obligations, which on our estimates amount to somewhere between 20 and $30 billion of capital to be spent because these data centers are underway in terms of construction.

(09:41):

For us, when we looked at it, the key debate as always is what's the valuation? But this is a new type of business listing on ASX. The technical term is near cloud. And so when we look at valuing a business like this, the challenge I think investors will have, and certainly what we've faced is once the contracts basically come to an end, so the average contract life is 5.5 years, you've got to make some pretty heroic assumptions around the economic use for life of the assets. And so the key inputs into putting a valuation on that residual value is what do you think is going to be the residual value of the GPUs? What do you think is going to be the price of tokens? What do you think the demand curve will look like beyond the initial contract phase? And so that's quite important because when you've signed a contract with one of these large AI model providers, effectively you're getting a payback of around somewhere between three, three and a half years.

(10:37):

So your first couple of years look good, then you've got two year surplus cash flows. But beyond five and a half years, there's a lot of moving variables. And so when you ask to pay a multiple of 10 to 12 times earnings, effectively most of that value sits in that terminal value. So for us, it looks capital intensive. It does look like a commodity producer. There's a lot of execution risk given it's a startup essentially, and we're likely to sit on the sidelines, but we're watching with interest because this sort of whole landscape is evolving pretty quickly. And to management's credit, I mean, they've positioned themselves at a time when the world is short to compute. They're long GPUs through this preferred partnership with NVIDIA. And so in the sort of short run, if they can hit those numbers, then the short run returns look okay. But beyond that, the valuation's really uncertain.

Mark Burgess (11:28):

Thanks, Ray. And I think message for me out of that is as part of the yearly suite, it's good to have some stability and the depth of experience across the team to look at potentially new IPOs of this scale. You want to have the experience behind you in valuing something like this that's ever-changing. So that'll be an interesting one to watch Airlie's position on that. Maybe Ray, continuing with you, you've talked about the three big themes that you came out of reporting season. Let's look at the banks. The banks are always interesting and always indicators for direction of the market. How did you see them play out given the reporting season?

Ray David (12:03):

Look, from the Australian bank's perspective, they do really fall into that second category where they are being squeezed by higher rates and also the consumers are being squeezed by inflation. And the big impact to banks has been so far the change around tax advantage for investment properties. So one of the biggest topics of discussion coming out of the bank's results was what's happened to mortgage applications since the May budget. And it's really, really unprecedented. You probably got to go back to the GFC or COVID to see that sort of fall in mortgage applications. And so it did vary by bank, but on average investor loan applications are down 18%. So it's quite a big sharp drop off and you're seeing it in the residential property market. So clearance rates are sitting at the low 40s. House prices are down somewhere between 8% and 10% since that announcement.

(12:55):

And so why it's important for the banks is a bank's business model is pretty simple. It's your credit growth or the volume of loans that you're writing. The second element is the margin you're making on those loans. So typically the spread between your deposits and your borrow rates. And then the third line is your cost growth. And lastly, it's your provision for bad debts. And coming out of COVID, there's been a tailwind for all four of those line items on the bank's profit and loss, particularly with house price growth being north of 40% since COVID. But we are seeing a bit of a change in the winds now. And so we're quite cautious coming out of reporting season with the banks because again, credit growth is slowing and if those applications stay down 20%, we think we'll knock off about 200 points of credit growth.

(13:40):

And then competition is increasing. And we've had some pretty direct feedback from the channel that the banks are struggling for growth because of this investor issue. And if I was a betting man, I'd say cashbacks are going to come back to the market and it's going to be led by one of the major four banks and that's going to put immense pressure on margin. And then the second element is the bad debts are creeping up. And so it's a pretty somber outlook for banks. Valuations are pretty elevated. And for the first time in a while, we're pretty confident that earnings growth is going to slow and potentially even go backwards if these conditions continue.

Mark Burgess (14:15):

Okay. Well, I want to turn now to some individual companies. Maybe let's start with the standout winners during the reporting season, and maybe if you can touch on a couple of winners, what drove them, outlook for those sort of companies?

Ray David (14:26):

Yep. I'll go first. I mean, ResMed was by far one of the best results we saw during reporting season. And for the listeners that don't know, ResMed's the leading manufacturer of devices that treat sleep apnea. So they delivered a great result. They had top line sales growth of 10%. They had margin improvement in an environment that was challenged by supply chain challenges, so particularly around freight. And then the second big takeaway is that the company's producing a lot of cash flow to the point where there's no more debt on the balance sheet and they are buying back stock. And so what stuck out to us was ResMed, the stock's down by about 35 to 40% over a rolling 18 month period because the market's really concerned that the uptake of weight loss drugs like GLPs will effectively disrupt the demand for CPAP devices. But we haven't seen that and all the feedback from the channel we get is GLPs are complimenting CPAP.

(15:23):

And so that was to us one of the good results. I'll talk to the other result, which we thought was quite good, which was BHP. So BHP, the biggest stock on the ASX, delivered a 30% increase in earnings. That was buoyed by very strong copper prices. So we've seen copper hit around sort of $6.60 a pound levels. Copper is now 54% of EBITDA and BHP does have some of the most privileged assets in the world. So Escondida, which is their flagship copper mine, they own two thirds of that business. They delivered a 70% EBITDA margin. Their cost per pound came in pretty low at around a $1, $1.50 per pound in an inflationary environment. And so that's allowing cash flows to increase significantly from those copper assets. And I think BHP did a really good job of communicating to the market three things.

(16:14):

So number one is production stability. They've never really missed production, which is quite a good outcome for a mining company. The second thing they communicated was there's a very strong copper growth profile. So copper tons will go from about 1.4 million tons per annum to about two million tons per annum. And then thirdly, they just continue to demonstrate great capital allocation and a returns focus. So that was a good result for us. And then some of the other results we thought were quite strong were in the tech and online classified space. A lot of these companies are still delivering top line growth, particularly the car groups and the REA. And again, that's in an environment or narrative where these businesses are going to be disrupted by AI, but we're just not seeing any evidence of that to date.

Mark Burgess (16:59):

Maybe on the flip side, and David, maybe I'll turn to you on this one, companies are disappointed. Where do you think there might've been either a disappointment or an overreaction from the market?

David Meehan (17:08):

Yeah, so I think one that's really interesting is Ridley Corporation. So I'll give you the ticker, it's RIC. It's not really a household name, but it does have a major role in Australian agriculture. And so the business, you've got to think about it in three separate parts, so it is quite diversified. So the first is their bulk stock feeds business. And so this is where they run Australia's largest network of feed mills. And so a feed mill essentially takes grain and other raw materials and outputs animal feed that's used for primarily chickens and cattle. The second part of their business is the package feed and rendering side of the business. So again, this takes raw materials into their rendering facility and this produces ingredients which are then used in both Ridley's own branded products for dog feed and other feed and also Nestle and Mars, which use the more premium dog food.

(18:00):

And then finally, what's been really interesting for us is they recently acquired East Coast of Australia's largest fertilizer distribution business, that's around 50% market share. And so that's sort of the third arm of their business. And so look, the result was a touch soft. They had some disruptions within two of their rendering facilities, so there were two separate incidences. And then also when you do a large acquisition like the IPF acquisition they did, typically the accounts can get quite messy. And so there was a little bit of a miss to earnings

than what the market was expecting, but we really like Ridley and we like for three key reasons. The first is the scale. So in agriculture where you have big assets, being a market leader gives you a big cost advantage compared to your competitors. And so for example, Ridley procure the most amount of grain in Australia domestically than anyone else.

(18:50):

And so they get the cheapest price, which is a key input into their feed. And so they share these benefits with their customers. And so this means that other competitors can't compete because they just don't have the same scale. And so we see that as a key competitive advantage and a barriers to entry from competition. The second part is management. So the business is run by Quentin Heidelbrand. He's been the CEO since 2019, and he has shown a great ability to not only allocate capital to high returning parts of the business, but also divest away from low returning parts of the business. And so over his tenure, which has been about seven years now, he's doubled the returns of the group. And so we think with this recent acquisition of the fertilizer business, that capital allocation's been on display and yet you haven't fully realized all the benefits through the earnings line.

(19:36):

And so they've paid four and a half times EBIT, which is a pretty low multiple for a market leading fertilizer distribution business. And so we think they're going to grow through both increasing market share, being more efficient in how they operate. So that could be making the network a little bit smaller and more efficient. And then thirdly, there's a Eurea plant, which is a key fertilizer opening up in WA in 2027. And we think that will lower the procurement costs of some of their urea plants where they currently source it from the Middle East. And so when we step back, often when you're talking about a market leading business with a good management team and improving returns, you're having to pay up on the multiple front, except Ridley's trading at only 13 times PE, which is a very low multiple in this market and a 5% dividend yield, which is fully franked. And so yes, the result was a touch soft, but we think there's significant growth to come over the next few years and it's backed by a good management team at a cheap price, which gives us confidence in the outlook.

Mark Burgess (20:32):

Great. Ray, have you got a similar one that you can offer up to listeners?

Ray David (20:37):

Yeah. I think one of the results that caught our eye was SEEK. The stock was down 14% on the day and it's fallen by another sort of 15% since the announcement. And what the market got wrong on SEEK was the softer outlook for employment ads in 2027, which led to a negative revision to earnings. But beyond that cyclical weakness, we did see some things in that result which we though were really interesting and highlighting an inflection point to the market. The first one was around the liquidity or sale of their growth ventures portfolio. Now this has been a bit of a sore point for investors. The company has seeded assets and invested in a number of startup software HR businesses, and the portfolio is sitting at a valuation around 1.6 billion at the moment. It's just hit its liquidity window. So it's now in the sort of five-year window where investors have the option to look to redeem some of their capital.

(21:37):

And what SEEK did communicate to the market was there's a process underway to realize up to about a billion dollars of those assets. And so why we think that's important is because the markets effectively value that portfolio. Some analysts in the market value it at three to $400 million, and so it's a real discount. So you've got that side of the business, which we think potentially looks interesting, particularly if that capital comes back to shareholders. But within the core business, we think it's a pretty strong franchise. It's the leading job portals provider in Australia. They've got about a sort of 35% placement share against some tough competitors such as Indeed and LinkedIn, but also they've just completed a multi-year reinvestment tech re-platforming period where basically their cost base is north of now $800 million, which is very high compared to sort of an REA or CAR.

(22:27):

And what they're communicating to investors is, look, we threw the big cost out, cost growth will slow going forward, and if revenue growth slows, then our cost base will be adjusted. And that's a bit of an inflection point. And so when we look at where the company's trading at today, the market cap is somewhere around sort of $4 billion. The growth funds is potentially worth 1.6 billion and the debt's about a billion. And so your enterprise value for the company is sitting north around sort of 3.6 bill effectively, which puts it on a very low multiple, roughly around 12 times EBIT. And look, the stock has never been as cheap, but there's a lot of skepticism in the market that they'll realize this growth fund and there's a lot of skepticism that they'll control costs. But when we look at management and their incentives, they are extremely aligned with shareholders.

(23:11):

The STIs and LTIs are all equity based. Andrew Bassett, who's one of the co-founders and a director, he's got three and a half percent of the company that's worth around $200 million, but he's personally invested almost $80 million into the growth fund. So he's highly incentivized to actually realize value for shareholders. So to us, we think that's a stock that's looking pretty interesting and there's an inflection point potentially there.

Mark Burgess (23:34):

Okay. So let's now think about the opportunities coming out of the reporting season. So you've talked about the AI spend, interest rate inflationary pressures, the government policy and geopolitical environment. What are the challenges investors still need to be mindful of?

Ray David (23:49):

Yeah, I think there's no doubt the environment for the domestic economy is going to be challenging and conditions are slowing. You've just got to look to the housing market, to the rate cycle. Australian households are highly indebted compared to most OCD countries.

Mark Burgess (24:04):

Fuel prices.

Ray David (24:05):

Fuel prices. And then also the big thing is you've got really sticky inflation that's embedded in these labor cost agreements. And so the way we're thinking about the portfolio and positioning is we are underweight the domestic economy, so underweight the banks, underweight consumer discretionary. On the other hand, we're a lot more comfortable with that exposure to the US economy. Given that capital cycle, you've just got a much more mobile labor base there as well. And so Emma Fisher, who is a portfolio manager of the Airlie Australian Share Fund, ticker code AASF, has just come back from her trip to the US and she's confirmed that the economy is running very strong, these capital cycles are well underway. And even with rates rising in the US, some of these industrial companies such as Blue Scope are really well positioned in the backdrop of this capital cycle. So broadly we're positioning ourselves to companies with more exposure to the US.

(25:03):

But at the same time, we're looking at some of these domestic companies that have been hit really hard. And we talked earlier about SEEK, SGH. These companies are now looking extremely good value. And the advantage that we have of Airlie is we're not chasing short-term performance. We've got great clients that are backing us long-term. So we can start buying these companies and look through the cycle because eventually inflation will pass, rates will fall. And the way the market works, it's so short-term at the moment that as soon as there's any positive news, the market will pivot aggressively and suddenly it's beating up darlings and there's just not enough liquidity in the market. So you've got to position yourself early before those inflection points start to arise.

Mark Burgess (25:46):

And so thinking about what you've said today and looking forward, what are you going to be watching most closely in the next few months? And do you think what we've seen in this reporting season, does that signal to you a deeper shift in the market or is this more short-term noise? And I'm just conscious you've just talked about the fact that the market's really on a short-term lens.

Ray David (26:06):

Yeah. The three things that I guess we started out with this conversation was the AI capital cycle, that's having a huge effect. And so we're watching announcements, we're looking at budgets, and the big driver of those AI budgets will be funding around Anthropic and OpenAI. So if there's any challenge around those models of attractive funding, then that will impact the capital cycle. And the second and the bigger issue for markets is inflation and rates. And so any change around the inflation outlook and the big sort of potential change that could happen there is a resolution on the Middle East conflict. So if the Strait of Hormuz opened up and there was free flowing oil and refined fuel through the strait, then that would be quite disinflationary, which could see a bit of a change in inflation expectations. And government policy is what it is. We're just sort of taking the government policy and we're trying to find stocks that are well positioned and avoiding companies that aren't.

(27:00):

But that's sort of the macro. And I guess if we sort of put aside the macro, our philosophy is just to own great companies that have got durable assets with great management and great balance sheets, even if they're cyclical. And so we are finding that the market structure change has meant investors are selling down aggressively stocks that missed earnings on short-term noise and providing us opportunities to look at some of these names. So we're not shy to sort of back into some of these names and we've been doing that with the course of reporting period and we've given some examples. But we think as long as you can look long-term and you're right on the company's earnings, you're right on the [inaudible 00:27:38] that surround these companies and the discount rates are attractive, you'll make money long term and you just can't afford to be sort of short term.

David Meehan (27:44):

And I think from my end, I completely agree with everything Ray said. The key things I'll be watching, the IPO firms, I think that's going to be really topical in the short term. You've got Anthropic supposedly later this year. So I think those two will be really interesting to see how they trade post IPO. And then the other thing would just be the private credit market in Australia. I think you've got this increasing inflation in construction costs while you have increasing rates. It could really put a bit of a dent in new build and new supply of homes in Australia. And so I think that will also be one where ASIC is definitely cracking down on. And so it'd be interesting to see how that plays out over the next six to 12 months.

Mark Burgess (28:23):

Well, thanks Ray. Thanks David. It's been a fantastic conversation. I really appreciate you both sharing your perspectives. Reporting season always throws up plenty to unpack and it's great to hear directly from the team who's genuinely on the tools every day. So thanks for joining us.

David Meehan (28:37):

Thank you.

Ray David (28:37):

Thank you.

Host (28:38):

That was Magellan's head of distribution, Mark Burgess, in conversation with Ray David, portfolio manager, and David Meehan, investment analyst from Airlie Funds Management. We trust you've enjoyed this episode. For more information on previous episodes, visit magellaninvestmentpartners.com/podcast where you can also sign up to receive our regular investment insights program. Thanks for listening.

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