

SWAEF Commentary: Commercially reasonable efforts

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Rugged pressures in bond and energy markets weighed on the ASX200 performance during September. In the face of these market pressures and recent tepid performance, for the listing of Firmus to proceed this month, is remarkable. The secondary listing of Sante, in contrast, is likely to engender far less fervour. In valuing each, though, to adopt the Firmus prospectus terminology, we will make commercially reasonable efforts.

Market Review

The world moves as quickly as it does chaotically. On the one hand, over the past year the ASX200 has advanced by 2.7%, with Industrials weakness (down 6%) offset by a strong Resources sector (34%). Outside of Materials (mostly Mining), Energy and Staples, all sectors are down over the past year, and the market in September fell, the first monthly decline since March.

Which sounds gloomy. Yet the ASX is about to welcome Firmus, which in raising \$8b is the second largest IPO in Australian history. The reconciliation of the two – weak broad market performance, against the very strong demand for a large, new entity, reflecting an industry which most investors in Australia would never have invested in before – reflects the collision of some of the biggest forces driving equity markets in Australia.

The broad market performance on the ASX reflects surging bond yields more than any other factor, but also energy prices. We have long suggested that it is difficult to see bond yields reverting to the lower levels that were seen during Covid, and that remains the case so long as the unholy trinity stalk the market. During September, Japan's 10-year bond yield went through 3% for the first time in 30 years. The yen carry trade has financed loose fiscal policy in much of the West for decades. With Australian bonds now yielding 5.4%, the Treasurer has explicitly called out increased borrowing costs as a factor inhibiting further cost of living relief for Australian households and businesses. Given only the Technology sector has performed worse than Discretionary Retail on the ASX through the past year, reflecting weak consumer sentiment (now approaching early 1990s recession levels), higher bond yields are already clearly impacting Australian retailers and households, even though employment levels remain quite strong.

Apart from the Japanese carry trade unwind putting upward pressure on interest rates, RBA Governor Bullock also called out public sector demand and government transfers, further fueling private sector demand, as inflationary forces. Again, this is not an esoteric concept divorced from ASX stock performance; our Ramsay discussion details how government's curtailing of spending is directly impacting upon stocks in the portfolio. A third factor is ongoing energy price pressure, driven partly by the Middle East conflict but also by potential disruption to diesel supply, which, given Australia's land mass, is disproportionately inflationary domestically. Taken together, these factors support our view that a risk-free rate closer to current spot levels, rather than the very low levels seen during the Covid period remains a more likely scenario.

Recent returns came mostly from shares getting more expensive, not from earnings, and with bonds now paying properly, starting valuations matter again

Higher for longer rates means several things for a domestic equity portfolio. Real assets are preferred to financial assets, although in each case the price to book and return profile (position on the cost curve) matters; and gearing against cashflow generation assumes a heightened level of importance. Just as multiple dispersion widened to enormous levels through recent years, as rates continue to be higher than expectations and growth in the market continues to prove elusive, multiple compression should continue to reverse some of the outsized widening that has been experienced. This is especially the case as earnings expectations for higher multiple stocks on the ASX continue to be subject to more downward revisions than those attaching to lower multiples (as detailed in our March monthly commentary).

Multiple gaps are still wide; and higher multiple stocks have earnings risk to the same extent

The dispersion in US style factor returns have been muted over the past year; value, growth and quality have all performed similarly, whereas in Australia the dispersion has been large. We suspect this is more a classification issue than an economic issue; is BHP trading at more than four times book a value stock? Is CBA at a slightly lower book multiple but still as aggressively rated as any bank in the world, likewise a value stock? The market in Australia remains too concentrated in our view for style factors to be instructive in portfolio construction.

Much of our excess return during the past year has come from moving from an underweight to an overweight position in Healthcare, especially during the second quarter of the year. Whilst in the same sector, the companies serve different markets; ResMed, Cochlear and CSL all sell products globally but mostly into the US market, whereas Sonic sells services globally, and Healius sells diagnostic services locally.

The other commonality a few of these stocks had during the past year is that they had a “cleansing” year; misallocation of capital and/or operating expenditure saw privileged assets be taken for granted by the Board and management teams, leaving shareholders to suffer. In each case, the misallocation occurred in prior years; CSL made the ill-fated Vifor acquisition in August 2022, and Ramsay acquired Sante in 2015, yet market recognition of the value destruction was deferred.

Active allocation opportunity emerging in Healthcare

In Ramsay’s case, it announced six months ago that it would demerge and spin off its 52% stake in Ramsay Sante, which owns assets in France and the Nordics, via an in-specie distribution to Ramsay shareholders which will see the Sante shares listed on the ASX in December.

The website banner headline for Sante is “Health matters much more than numbers”, and the financial history of the group suggests that maxim has been lived to the fullest. Having said that, Ramsay Santé doesn’t lack scale. There are plenty of raw operating metrics which underscore the scale of the business as Europe’s leading private hospital network: 40,000 employees, 10,000 practitioners, 492 facilities, five countries (France, Sweden, Norway, Denmark and Italy), and 13 million patients each year. As an investor, we haven’t yet got to the most important metrics, though; no real revenue growth and a sub economic return.

As a heavily indebted business with the French government being both master of revenues (through setting price) and costs (through setting wages), and no history of making an economic return, we have valued the Sante equity at zero for many years. Our concern was that Ramsay would invest further into

Sante, thereby creating a contingent liability for us as shareholders. Thankfully, that risk has passed and come December we will hold Ramsay itself with a significantly lower debt load (given the large Sante debt was consolidated onto the Ramsay balance sheet), and a pro rata holding of shares in Sante. For ourselves and no doubt many Ramsay shareholders, a feeling reflecting the French aphorism “Mieux vaut être seul que mal accompagné” – in a corporate, not a personal sense - accompanies the end of what has been a painful excursion into the ownership of European assets.

It doesn't look like it is getting easier for Sante. The 2027 French budget released the week after the visit by Sante management proposed €43b in budgetary cuts, including €7.1b in healthcare savings. Given the price for Sante's services in France is set by the French Government, this is not great news. Dr Sally Warneford, our analyst, described the French management of Sante as earnest in their intent to improve margins and returns. We wish them every success but a high debt load in the company and country makes for an unpleasant cocktail. We mentioned earlier how rising bond yields can directly impact upon company performance; Sante is a classic example, given the increasing pressures it is now assuming in an operational, as well financial, context.

If the initial issue of Sante on the ASX will be metaphorically 'boo-hissed', there are nothing but cheers for Firmus. We would make the following five observations which have assisted in forming our view of value, whilst equally admitting that we have read the prospectus more agog than Chris Fagan at full time. We have tried to give detail for our reasoning, and readily concede we have had a lot of information to discern (and value) in a short amount of time. Whilst we will have made some errors in this judgement, the wide spectrum of possible outcomes is exactly how Firmus has gained such an incredible amount of value so quickly, and will likely be very volatile through the next 18 months as it seeks to complete its ambitious plans.

Twelve months ago, the issued capital of Firmus was circa \$150m. The company has grown swiftly, and in that time arranged agreements of sorts for the supply of GPUs, the development of sites and offtake of compute with the likes of Nvidia (through Supply Micro), Gunvor Group and Meta. Upon completion of the offer, Firmus will be raising \$7.2b (with an option of a further \$700m). Call it an \$8b raise, for a market capitalisation of \$45b. The growth in value in such short order means that valuation ranges will, by definition, be very wide. A good analogy used by our analyst, James Bandara, was that Firmus has some of the characteristics of a short life miner in a strong price environment, where the temptation is there to now also value reserves based on spot prices. Typically, such assets trade on low multiples, but only because the cynical have seen price cycles and expect any short-term increases to revert. With GPUs, such price cycles are still yet to be seen; as Jensen Huang said in the most recent NVIDIA earnings call “... our revenue opportunity has recently grown from roughly \$18b per GW to \$25b with Blackwell, to \$40b with Vera Rubin ...”. Time for Wharfie Time with GPUs!

Secondly, that price point as reference is critical because the total developed cost of a facility is now circa \$55m per MW, with payments to the distributor and the acquisition of land and buildings on top of the GPU cost. Firmus is projecting a development cost closer to \$40m than \$55m per MW. It is possible that Firmus have an advantaged supply contract through SMCI (the distributor), but we are not privy to that, and by definition do not know how long that agreement might last for. That might be one reason why there are no forecasts in the prospectus, only targets.

Thirdly, timelines for development during this year are very tight, development experience is limited, and penalties for non-performance could be material. Firmus has genuinely built and operated capacity at Singapore (5MW) and now Melbourne (42MW), the latter completed barely weeks ago. Everything else, which is 865MW or 95% of the contracted footprint, is either still under construction on sites Firmus

owns itself (107MW) or entirely dependent on a co-location partner executing on sites it does not (758MW). A sub 50MW live base is a thin foundation for underwriting a 912MW+, multi-country, multi-billion dollar build, all scheduled to be completed between mid and late 2027. As James puts it, NVIDIA and Supermicro (NVIDIA's distributor to Firmus) need only make "commercially reasonable efforts" to deliver against their commitments to supply GPUs. In contrast, Firmus has hard, penalty-backed delivery obligations, on defined delivery dates, to Meta and OpenAI. It may be that "we are all in this together" and penalties will not be enforced should Firmus not meet its demanding delivery timetable. Nonetheless, the black letter law basis risk embedded in the seemingly back-to-back contracts is real and a material risk, on our preliminary analysis.

Fourthly, the South Australian sites require enormous amounts of energy. The entire state currently consumes 1.4GW of energy. Firmus' disclosed pipeline in South Australia will require 2GW of energy; even with efficiency measures this adds 100% to the energy demands of the state. Another Neocloud, Iren, is proposing centres with similar energy demands. Whilst the proposed interconnect may offset some of this strain, it is difficult to see additions in demand of this magnitude not impacting upon energy prices. Equally, we presume Firmus are confident there will be no regulatory or community pushback with these developments, although note that community opposition to data centre developments are a significant political issue in many US states currently in the context of the mid-term elections.

Free cash flow, profit less investment, determines long-term shareholder value. Assuming a company can finance its operations, negative FCF is not only fine, but desirable, if returns on investment exceed the cost of capital.

Indeed, that's the entire judgement that needs to be made with investment into AI-related companies currently. As Andy Jassy, Amazon CEO wrote, "... The FCF and ROIC for these investments [land, power, buildings, chips, servers, and networking gear] are cumulatively quite attractive a couple years after being in service; however, in times of very high growth (like now), where the capex growth meaningfully outpaces the revenue growth, the early-years FCF is challenged until these initial tranches of capacity are being monetized and revenue growth outpaces capex growth ..." The fact that Firmus is investing material amounts in the next couple of years deters us no more than would be the case if it was doing so while building a new toll road, or developing a new mine.

This is the dilemma in valuing all the DC developers that are listed on the ASX, whether that be Goodman Group or, more directly, NextDC. Will the demand be there to provide an economic return for the development once the initial lease expires; and if so, for how long? When GMG was trading at close to \$40 and 4 times book a year ago it was assuming a long duration of excess return; at almost half that share price and book multiple now, the equation is far more palatable. It's fair to say Firmus' book value multiple at the IPO price leaves GMG looking positively old world. Even with our best "commercially reasonable efforts" we can't get a valuation for Firmus approaching the issue price.

The above is a significant amount of detail for a stock we don't own (and probably won't, at least for a while). But the size of Firmus, and the potential for large gains (as has been experienced) but also now potentially losses means it would be remiss of us to simply brush it aside and not treat the potential investment on its merits. We would like to think we do that for all sectors; our exposure to IT continues to be sparse, but as with Healthcare earlier this year we continue to be vigilant with valuing the companies in this sector such that we are well positioned should attractive investment opportunities emerge. We aren't there yet for IT, but for some companies in that sector we are far closer than we are with Firmus.

Market Outlook

Assets continue to trade at a higher multiple relative to their underlying earnings and cashflows than the risk-free rate and an appropriate risk premium would suggest they should, even after the market moderation of recent months. Given this backdrop, any assumption that equity returns in future years can continue to be driven by re-rating, in the face of increasing inflationary pressures and these high starting multiples, seems courageous.

For higher multiple stocks in the market, it is true that the easier unwind of multiple excess has now been banked; but the harder element of earnings and cashflows now being produced to meet expectations which have hitherto regularly been unmet, is still in front of us. That edict applies to commodity stocks as well, where price to book multiples have in recent months run well ahead of even currently high commodity prices. Aggressive portfolio rotation, however, is not a given, because the characteristics we are looking for in those positions we are adding weight to – predictable operating leverage, moderate financial leverage and a justifiable multiple on sustainable earnings and cashflows – continue to be a scarce resource. Notwithstanding, as Firmus' suppliers note, we will continue to make commercially reasonable efforts.

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