19 December 2020

Stocks Down Under

'Education is what survives when what has been learnt has been forgotten"

- B.F. Skinner (1904-1990), American psychologist

Wesfarmers: Not a Happy Christmas?

Stocks Down Under rating ★★

ASX:WES Share price: A$43.89 Market cap: A$ 48.7BN

If you held Wesfarmers (ASX:WES) a year ago today you'd be getting ready to have a great Christmas. Over the last twelve months the S&P/ASX200 has risen only 22.5%. Nice. But Wesfarmers has done considerably better, up 36.6%. Indeed, the only time Wesfarmers stock has looked in trouble over the last year was when the stock suddenly fell 7.5% between 11 June and 14 June. Since then it's been a powerhouse, particularly since the end of the August market rout.

Company Share Price Chart

Source: Tradingview

Why do people like the Perth-based Wesfarmers so much? Partly because it owns two of the few remaining bricks-and-mortar growth stories you'll find in Australian retail today - the 'big box' hardware retailer Bunnings as well as the office supplies dynamo Officeworks. For another part, because it now doesn't own the supermarket chain Coles and has capital to invest in other things. But people like Wesfarmers chiefly, we think, because it's one of the more successful conglomerates out there. This company owns a lot of different businesses in different kinds of industries, making it less prone to a downturn in any one industry – if department stores are down, as they were in FY19, Chemicals, Energy and Fertilisers will be up.

Well, we wonder if 2020 might be the year when investors get a little disappointed with Wesfarmers. Remember, this is the company that only three months ago laid out A$776m to get into the lithium game with the acquisition of Kidman Resources, at a time when existing lithium producers were getting ready to shut up shop. The Kidman deal will cost Wesfarmers another A$700m in capital to get the Mount Holland mine and its associated lithium hydroxide plant at Kwinana up and running. It could work out well by the time lithium turns in 2021, but Wesfarmers won't be the world's lowest cost producer by any stretch of the imagination.

And don't forget that Wesfarmers still owns those retail time capsules, the discount department stores K-Mart and Target. Those businesses didn't exactly shoot the lights out profit-wise in FY19 and one suspects their structural decline will continue into FY20, with a lousy Christmas in between. Target in particular should have been shut years ago because it sits at a part of the retail market that is rapidly dying where you’re trying to get people to pay up for quality in a business that doesn’t have snob appeal.

Time for a breather?

We reckon that the half yearly result might be the time when investors decide to ease off on their Wesfarmers enthusiasm. Generally, there’s always a business or two in Wesfarmers that should be performing well but isn’t. In FY19 it was Blackwoods, the industrial supplies and safety products business, which was badly in need of a new enterprise resource planning system. For the FY20 first half, the problem child might be Chemicals, Energy and Fertilizers, which had a good FY19 but might not be doing so well pricewise by the time the half yearly numbers roll around. Or it could be Bunnings – same store sales growth halved in FY19 and that slowdown may have continued into FY20, depending on how hardware gets caught up in the general retail downturn.

Priced for perfection

Wesfarmers is currently priced to perfection. At $42 it’s on a P/E of consensus FY20 numbers of around 24 and an EV/EBITDA of over 14. Should the FY19 ordinary dividend of $1.78 be maintained, which is a little more than consensus EPS for FY20, it only yields 4.2%. CEO Rob Scott has had a great time since he got started in November 2017, but his honeymoon may be over in February.

WPP AUNZ: Adapting to the new digital marketing environment

Stocks Down Under rating

ASX:WPP Share price: A$ 0.57 Market cap: A$ 486M

If you’re looking for a midcap stock with plenty of alpha, look no further than WPP AUNZ (ASX:WPP), market cap ~A$440m, the largest advertising and communications agency in Australia and New Zealand, 61.5% owned by the London-based advertising major WPP plc. The ASX-listed stock has traded between 42 cents and 69 cents over the last twelve months, with two big upswings followed by two big downswings. We think that since about late November, when the stock got to about 50 cents, WPP AUNZ has been getting ready for another upswing.

Company Share Price Chart

Source: Tradingview

Is it an old media or new media company?

The trouble with WPP AUNZ is that investors don't know what to make of it, even if they know WPP as one of the largest ad agencies in the world. There's around 70 different marketing services businesses contained within the AUNZ unit, serving all sorts of customers through all sorts of media, but the basic assumption of many market observers is that too much of the company is still tied up with declining old-line media and not enough in the newer agencies that are set up to flourish in the new era.

Consequently, every time WPP ANZ reports a decline in earnings, like it did in August, where NPAT came down 15% for the six months to June (it's a December balance date company) the stock tends to go down heavily before investors give it another chance. We argue that the time for another chance is about now.

A new boss and lower debt

For one thing, the company has some new leadership. Jens Monsees arrived at 1 Kent Street in Sydney as the new CEO at the beginning of October, although his appointment had been announced in late May. Monsees, a German, led digital strategy for the car company BMW before joining WPP AUNZ so he's been at the cutting edge of the new styles of marketing for some time now. Monsees will focus on bringing new creative talent into the company as well as breaking down the solos within the WPP AUNZ group.

For another, the company has now sold all of its Kantar market research business, so debt levels will likely come down to a reasonable level – e.g. Net Debt / EBITDA of 1.5 to 2.0 rather than the 2.5 of the half yearly result. WPP AUNZ got a net $150m or thereabouts from selling Kantar, and it got a good price for it too, at 8.2 times EBITDA, not bad in an environment where market research is getting easier to do in this digital era and, as a consequence, where the competitive environment is getting tougher.

Attractively priced

2019 has been the transition year for advertising globally, where digital ad spending is surpassing traditionally spending in most advanced industrial countries for the first time. Consequently, we think WPP AUNZ is well placed. It's very focused on growing in digital, has the capacity to keep expanding in this space, and has leadership with the skills to grow there. WPP AUNZ has flagged that calendar 2019 earnings could come down 5-10% on 2018. EPS in 2018 was 8.4 cents. On a 10% EPS reduction that means the stock is currently trading on a 2020 P/E of only 6.5. Not bad for a major advertising and communications franchise with strong digital capability in an economy that's still doing pretty well as we speak.

Fleetwood – It takes a company to build a village

Stocks Down Under rating

ASX:FWD **Share price: A$ 2.07** **Market cap: A$ 192M**

So what the heck happened to Fleetwood (ASX:FWD), the Perth-based modular construction company, market cap ~$180m? This stock was $2.30 at the start of last month. Suddenly without warning it's back at $1.95. Has the market for temporary buildings like the demountables we sometimes had to suffer in at school suddenly collapsed? We don't think so.

Company Share Price Chart

Source: Tradingview

The trouble with Fleetwood is that every now and then it is obliged by the ASX's Continuing Disclosure rules to announce individual contracts. On 24 October the company announced that it had been selected by Rio Tinto to build the accommodation village at Koodaideri, a new iron ore mine in the Pilbara region of Western Australia. Koodaideri was worth A$17m in revenue to Fleetwood and it was the reason for the spike from $1.95 to $2.30. Interestingly, on 22 November Fleetwood won another contract, this one for modular accommodation needed by the NSW government and worth $35m, but by then the market had tired of the Fleetwood story for a while and many investors had moved on to other stories. Small caps tend to be like that. People with longer attention spans can make good money.

Plenty of growth ahead

Fleetwood is flagging similar FY20 earnings to FY19, which is about $25m at the EBITA line, but we'd be bullish on this one longer term. Fleetwood has evolved from a somewhat checkered past into a respected go-to firm for modular accommodation in Australia.

With the resources sector off its 2016 lows, and growing again, there's plenty of work likely to emerge for this company in Western Australia, while in the Eastern States the big spend from governments for jails, schools and the like will continue. At the moment you can get this quality franchise for only 4.5 times FY20 EBITDA or a P/E of 9. Sounds good to us!

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