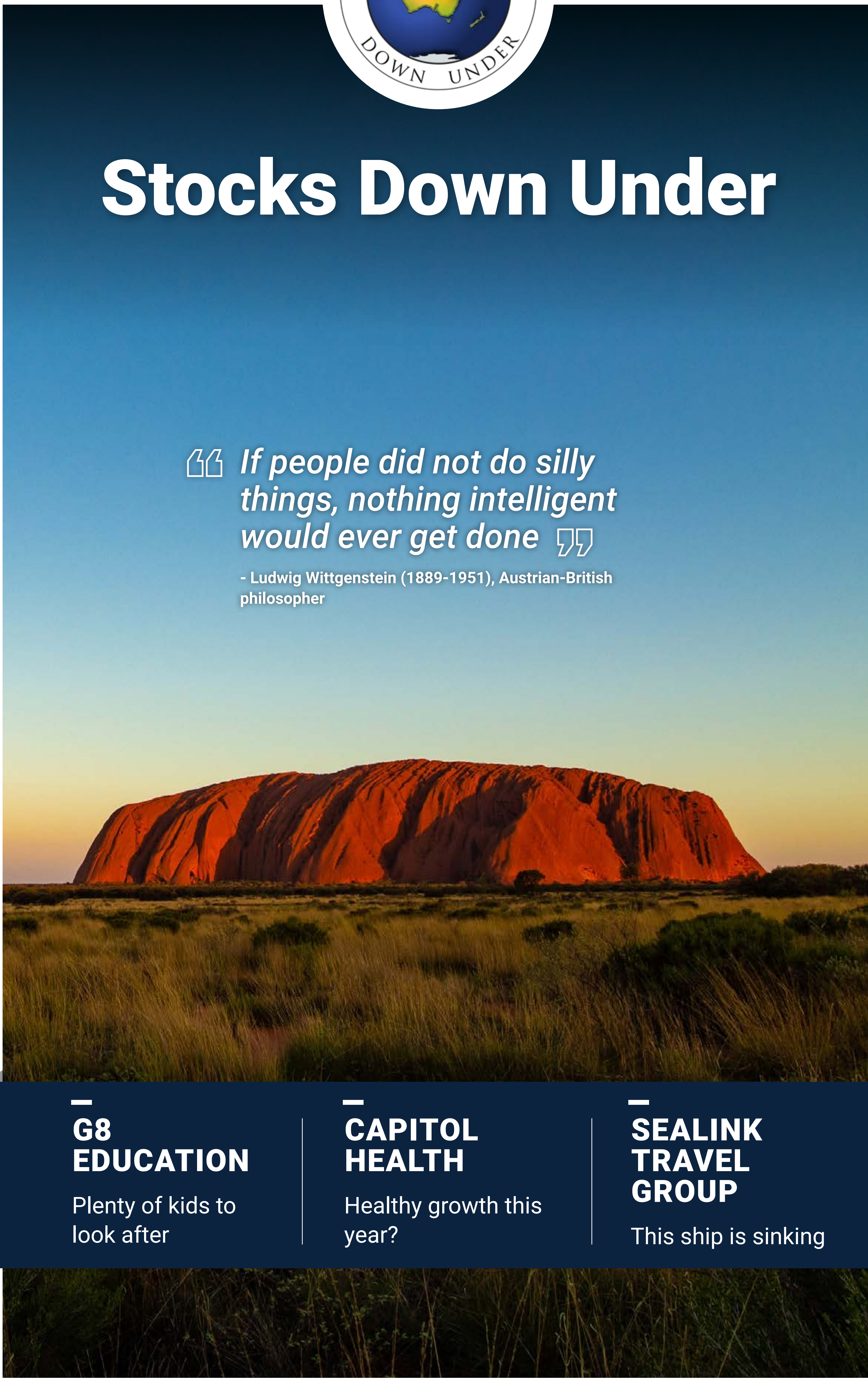
24 JANUARY 2020

Stocks Down Under



> *If people did not do silly things, nothing intelligent would ever get done*
>
> **- Ludwig Wittgenstein (1889-1951), Austrian-British philosopher**

G8 EDUCATION

Plenty of kids to look after

CAPITOL HEALTH

Healthy growth this year?

SEALINK TRAVEL GROUP

This ship is sinking

G8 EDUCATION

Plenty of kids to look after

Stocks Down Under rating: ★★★ ★

ASX: GEM
Share price: A$ 1.92
Market cap: A$ 902M

It wasn't a great Christmas for the shareholders of G8 Education, the operator of childcare centres headquartered at Varsity Lakes on the Queensland Gold Coast. The previous August the company had flagged that its calendar 2019 EBIT was expected to be in the range of $140-145m. Then on 14 November, at the company's 'Investor Day' (the day where management fronts the investor community, presents at length on its businesses, and takes questions), G8 indicated that the EBIT number would be more like $131-$134m.

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CAPITOL HEALTH

Healthy growth this year?

Stocks Down Under rating: ★★★★

ASX: CAJ
Share price: A$ 0.25
Market cap: A$ 184M

Now is not the greatest time to be a provider of healthcare services in Australia. The levels of private health insurance coverage in Australia have been declining for several years now, so that it's now down to around 44% of the population. And meantime the Federal and state governments are always looking at ways to cut back the costs of the system. So, companies like Capitol Health, a Melbourne-based provider of diagnostic imaging services in Victoria, Tasmania and Western Australia, are always in danger of having their fees cut.

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SEALINK TRAVEL GROUP

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Stocks Down Under rating: ★★

ASX: SLK
Share price: A$ 4.34
Market cap: A$ 948M

The bushfires burning around Australia over the last couple of months have been bad for a whole range of businesses. We noted yesterday, for example, that Mosaic Brands' suite of fashion retailers saw an 8% drop in same store sales in November and December due to a fifth of its stores being in bushfire-affected areas. Another stock that has been under pressure lately for bushfire-related reasons is Sealink Travel Group, a 'multi-modal' transport and tourism operator that operates bus and ferry services around Australia as well as in the UK and Singapore.

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Share price chart

Source: Tradingview

The twin issues for G8 are occupancy at its centres and labour costs. We think G8 is managing both issues well.

G8's centres are still growth occupancy

Typically, G8's centres start the year about two thirds full in terms of the number of children that can be looked after and end the year at closer to 80%. The aim of the game is to increase the percentage average through the year. In August G8 reckoned that its occupancy growth could be 'in the mid 1% pts'. In November it admitted that occupancy growth was only 'circa 1%', which meant $7m less revenue. For a company that did $858m in revenue in calendar 2018, $7m doesn't seem like much of a shortfall. It's also worth noting that G8 still enjoyed occupancy growth in 2019 against a backdrop of continued increases in supply of new childcare centres nationwide by competing operators.

Then there's labour costs. By November these were $3m above G8's earlier forecast, however there was a good reason for it - from the start of this year there were new rules in place around Australia obliging childcare centres to have a second 'early childhood teacher' on-site where there were 60 or more children being cared for at the centre. These teachers are, more often than not, university trained and therefore don't come cheap. Again, we think an extra $3m to the wage bill isn't much of an imposition given that this staff is likely to improve quality at the centres in the medium term, and therefore contribute to the growth of the centres over time. It's worth noting that G8 actually has a track record of turning underperforming centres around, and a lot of that has to do with the people and the programmes in the centres. For G8, childcare is not just a property play.

G8 actively manages its portfolio

The third thing to note about G8 is that its growth isn't completely dependent on the 500-or-so centres it is holding in Australia (it also has 17 in Singapore) at any one time. The company actively manages its portfolio, as evidenced by a recent sale of 25 centres in Australia, and also continues to build greenfield sites. This also bodes well for better long-run growth than the kind that had the market panicking last November.

G8 Education is currently on a P/E of only around 12x. For a leading company in a growth industry like childcare in Australia that's modest. This industry is growing at high single digits around the country as more and more parents opt for childcare rather than leaving kids with grandma. Any casual scan of Australian media will show continued increases in the prices parents are paying for healthcare for years now. We believe that if G8's occupancy growth rates are better than 1% by the half-yearly numbers in August, and it can continue to raise its fees as per the sector average, then this stock could smartly re-rate.

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Share price chart

Source: Tradingview

Capitol Health didn't have a good start to 2019. In February the stock dropped from 27.5 cents to 18 cents off the back of an earnings downgrade that was primarily due to 'subdued demand' in its network of clinics. Believe it or not, it happens every now and then - sometimes people are just not going to the doctor at the rates they are expected to, given the likely rates of illness in the community. As a consequence, there are less referrals from X-rays and MRI scans. The six months to December 2019 in Australia seems to be one of those times, and Capitol Health blamed it on low consumer confidence. When people are scared of medical bills, they just ignore their health problems unless it's an emergency.

People went back to their doctors in 2019

The good thing about healthcare is that, eventually, most people come to their senses and stop putting off their medical consultations. That seems to have happened for Capitol after the start of 2019 because the company got to August and didn't have to make another downgrade, reported FY19 revenue of $149m and EBITDA of $26m. Capitol is merely flagging 'modest growth in underlying EBITDA' for FY20.

One suspects that Capitol could do a little better than 'modest growth' this year. As well as the usual organic increases in patient flow there's also the chance of a few acquisitions given that the balance sheet doesn't carry much debt – net debt at June 2019 of $35m was only 1.3 times EBITDA – and Capitol brings new practice groups into its network fairly regularly. For instance, just yesterday Capitol announced that it was buying an Adelaide provider called Fowler Simmons. Also, Medicare in Australia will index its rebates on diagnostic imaging from July 2020, as per the 2019 Budget announcement, so there's a government-mandated price rise coming for Capitol and its competitors.

Diagnostic imaging gets a lower multiple than pathology

Diagnostic imaging tends to trade on a lower multiple than pathology because the former is harder to scale – reading images has historically been a labour-intensive business. We think Moore's law is gradually changing this, allowing greater productivity with imaging software tools than had previously been possible. We think that will allow radiology providers to re-rate over time. As things stand, Capitol Health is trading at just 16x forecast FY20 earnings, much lower than Sonic's (ASX:SHL) 25x. Both stocks are doing well at the moment ahead of a May 2020 budget which may provide some further sectoral growth. So long as people keep going to the doctor like they supposed to, it could be a good year for Capitol shareholders.

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Share price chart

Source: Tradingview

We think there's a bigger issue at work in Sealink stock, however, which has been dropping since 9 December when it was about $5.20. The trouble was the sudden jump in the share price from October 2019, which started when it was only $3.50. That was when Sealink announced the acquisition of Transit Systems Group, a major metropolitan bus operator in Australia, the UK and Singapore. Transit Systems was a step-change acquisition for Sealink, a company which in the year to June 2019 had done revenue of $251m and EBITDA of $48m. The company Sealink was acquiring had $895m in revenue and EBITDA of $78m. Often when these kinds of deals happen the market initially thinks that 'bigger is better'. We're not so sure.

Lower margins are coming

Remember, the margins are much lower at the company being acquired. And no wonder. The 'old' Sealink earned its keep from recreational spending related to fun stuff like cruises on Sydney Harbour, and the ferry ride to various tourist destinations. By contrast Transit Systems runs the boring old buses that people uncomfortably endure on their way to work every day. Pricing of these kinds of services are much more tightly regulated, and any operational mis-step can draw the ire of politicians as well as passengers. Sure, tenders when they are won tend to be dependable and long-term, but costs have to be managed tightly in these situations or shareholder value can be destroyed. We think the Transit Systems has rendered Sealink a riskier proposition. Risk related to government tenders isn't something one can tolerate at a P/E of 18x. And let's not forget that with this deal debt levels go up from 1.7x EBITDA to 2.2x. Not too bad, but, still, a step up the risk curve.

Profit taking continues apace

An additional factor at play in Sealink's share price is that the Transit Systems acquisition was funded in part through a $154m rights issue at $3.50 a share. The easy money for the pre-October 2019 shareholders from the run-up to $5.20 will see a lot of profit-taking before Sealink stock finds its proper level.

All up, it's better, in our view, to let this bus drive on and wait at the bus stop for the next one.

Pitt Street Research Pty Ltd

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Pitt Street Research Pty Ltd provides issuer-sponsored research for Small & Mid Cap companies and is founded on more than 40 years of combined experience researching companies in a range of different sectors.