25 FEBRUARY 2020

Stocks Down Under

If you are not measuring it, how can you manage it?

- Peter Drucker (1909-2005), American management consultant

GWA Group

Likely to take a bath amid weak housing, competition

VGI Partners

Growing with you

Super Retail Group

Wavering amongst competition

GWA GROUP

Likely to take a bath amid weak housing market, competition

Stocks Down Under rating: ★★

ASX: GWA
Share price: A$ 3.67
Market cap: A$ 965.7M

GWA Group, a Brisbane-based maker of bathroom and kitchen products has had its share of ups and downs since going public back in 1993. In 2017, the company made the bold move of closing its last active factory to adopt a 100% import-focused business model. While the strategy has had modest success, fundamental weaknesses remain. With the stock having risen roughly 30% in the last three months we think a downturn is imminent.

VGI PARTNERS

Growing with you

Stocks Down Under rating: ★★★★

ASX:VGI
Share price: A$ 12.15
Market cap: A$ 847m

Navigating financial markets can be treacherous and unpredictable. Rogue waves can strike at any time, leaving your portfolio under water. But what if you had an experienced captain steering you in the right direction? Well, Sydney-based funds management company VGI Partners claims it can do just that. With an investment philosophy structured around capital preservation, long-term growth and high-conviction asset allocation, VGI offers a competitive advantage through superior knowledge and analysis. And with shares down by more than 12% over the last three months, we believe these wealth managers deserve a second look.

SUPER RETAIL GROUP

Wavering amogst competition and scandal

Stocks Down Under rating: ★★

ASX:SUL
Share price: A$ 9.37
Market cap: A$ 1.85bn

Super Retail Group, the Brisbane-based retail network focused mainly on camping and sporting goods, has over 670 retail stores and 12,000 staff across Australia, China, and New Zealand. In retail, however, and particularly in bricks and mortar retailing, size isn't everything. In the six months to December 2019 Super Retail grew sales only 2.9% but EBITDA declined 3.9%, to $160m. We predict further tough times ahead.

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Company Share Price Chart

Source: Tradingviewt

Jack of all trades, master of none

There are plenty of well-run consumer product conglomerates out there, but GWA is not one of them. GWA has some well-known brands, but the company seems to lack a cohesive strategic direction. Its Caroma brand makes commercial sanitaryware and bathroom products, Dorf Clark makes stainless steel sinks and laundry tubs and Gainsborough specializes in door hardware and fittings. The recently acquired Methven manufactures shower and tapware. Then there is EcoSmart which makes solar water heaters and power equipment.

Historically, the company's main growth driver was its Door & Access System business which made household and industrial garage doors, motors, and security products. This business was sold in mid-2018, leaving commercial & household bathrooms, kitchens and water solutions as its niche market. While this helped narrow the company's focus, the size and growth potential of this market is underwhelming.

The six months to December 2019 saw GWA's revenue decline 11.5% and EBIT 12.1% if you don't include the Methven, the New Zealand maker of taps and showers, which GWA bought for A$112m in December 2018. And no wonder. The market for bath and kitchen products has been declining for some time now due to a slowdown in residential construction and renovation, which basically constitutes more than half of GWA's revenues. Detached house completions, which accounts for around a third of GWA's sales, has also been declining. In FY19 the only area of growth for GWA was its commercial division, but that's also its smallest at less than 20% of revenue.

Rising costs threaten market share

At the same time that GWA's key markets are stagnant at best, costs are on the rise. Despite moving to an import-based model and having a workforce that is less than half what it was five years ago, expenses remain high. In a battle to maintain its 20% to 25% market share GWA has spent mightily on marketing. This, along with acquisition and integration-related expenses, has created an elevated cost structure. Moreover, its recent broad-based 2.5% price hike to offset cost inflation may ultimately erode market share.

Fundamental weakness can also be seen in GWA's debt level. Net debt has increased from $98m in December 2018 to $157m in December 2019, which has afforded the company less flexibility to secure financing for future expansion.

It also does not instil confidence in management that Methven has underperformed until recently. EBIT fell from $9.8m in FY18 to $6.6m in FY19. The cost of the Methven buyout caused other growth projects to be put on the back burner. While Methven turned around in the December 2019 half, and GWA estimates that $5m in cost synergies will result from the Methven integration by FY21, this segment has the potential to be a cold shower on the company's overall performance.

Lack of near-term catalysts

The outlook for 2020 doesn't appear all that bright. The company is directly exposed to a volatile retail sector that is showing signs of continued struggles. GWA has forecast a soft housing market characterized by falling prices and further tightening. A tougher housing environment combined with increased competition from lower cost international and private-label brands is also likely to weigh on GWA's performance.

Until its end-markets begin to grow and the fundamentals of the business improve, these factors are likely to put downward pressure on GWA's share price. The stock's valuation is also uninteresting. The price-to-earnings (PE) ratio is around 18x and the enterprise value (EV) to EBITDA is 12x. At the very least the GWA shares are fairly valued, but more than likely overvalued given the lack of a compelling growth narrative.

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Company Share Price Chart

Source: Tradingview

A true partnership

Key members of VGI's management team own 80% of the company and its portfolio managers have a large portion of their net worth invested in the company's funds. VGI's staff is also prohibited from investing in securities outside of the partnerships' funds. The investment structure aligns managers' interests with investors, ensuring their success is tied to your success.

When the company had its IPO in September of 2019, no one on their investing team divested their shares and the majority of the teams' managers offered to leave their shares in escrow for the next five years. Moreover, the company's founders are also committed to reinvesting their after-tax performance fees back into the funds.

VGI's commitment to ethics and culture also allowed the company to increase its Funds Under Management (FUM) to $2.6bn during the first-half of FY19. But with assets remaining flat at the end of September 2019, the stock sold off as investors questioned VGI's growth prospects. But FUM snapped back in the December 2019 quarter with the company strategically targeting more retail and high-net-worth investors. The strategy will allow VGI to scale its business and increase operating leverage. And with that, future profits will grow at a faster pace than revenues.

A winning strategy

Instead of trying to 'time the market', VGI targets high-quality businesses and invests with a five to seven-year time horizon. The partnership constructs high-concentration portfolios, where a large amount of capital is allocated to a small number of positions. By doing so, managers end up with high quality stocks that have significant upside potential. Remember, diversification preserves wealth, while concentration builds wealth.

The partnership has a target return of 10% to 15% per year and mitigates risk by capping leverage and maintaining a diligent cash balance. This allows managers to take advantage of price dislocations when opportunities arise. Its VG1 portfolio – which is up 8% over the last 12 months – has large positions in Amazon, Colgate and General Electric. And currently, its top five holdings make up 42% of the portfolio.

Since its inception, VG1 has outperformed during periods of market stress. In months when the ASX has declined an average of 2.3%, VG1 has only declined 0.7%. The low beta strategy delivers superior risk-adjusted returns – which are essential for growing and preserving capital. During the Great Recession in 2008, the partners sensed something was amiss in the markets. Following their instincts, they reduced their equity exposure and increased their cash balance. The reset protected investors from one of the worst stock market collapses in history.

Demand for VGI's products remains strong

With the launch of VGI's new ASX-listed Asian investment strategy fund (VG8), the partnership increased its global footprint. Following the same strategy and investment principles, VG8's portfolio managers target companies in Japan, South Korea, Singapore, Hong Kong, Taiwan – and of course – Australia. Portfolio managers are also monitoring India, Mainland China, Thailand and the Philippines, however, they don't plan to allocate capital to these regions in the near future. Strong demand for the fund allowed VGI to raise $557m and increase its FUM to $3.1bn at the end of December FY19. And following its recent period of strong performance, total FUM sits at $3.2bn.

But even as the tide starts to turn in VGI's favour, the broader market remains unconvinced. We believe VGI is poised to recapture its early 2019 glory – when the stock price was at $17.80 – because VGI's performance fees are typically highest in June of each year. Moreover, with second-half results set to hit the wire on 27 February 2020, we see potential for an earnings surprise that the market isn't anticipating.

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Company Share Price Chart

Source: Tradingview

The December 2019 half was a reversal on the experience of the June 2019 year when, with just a 5.4% increase in revenue, EBITDA grew of 7.3%, to $335m. Up until recently most of Super Retail's lifestyle brands were strong – in the June 2019 year the auto parts group Supercheap Auto achieved sales growth of 3.4%, while Rebel with its sporting goods offering grew 3.8% and the outdoor recreational group BCF achieved 3.3%.

Performance up in smoke

With national bush fires across Australia affecting the demand for outdoor activity throughout the last six months, nationwide car and auto sales have declined. This could explain the recent decline in sales for Super Retail's Supercheap Auto brand throughout Australia. However, online sales are another area that needs to improve, as Super Retail faces increased competition from rival brands and online-only players.

Super Retail's primary focus is the organic growth of their existing brands, and without improving their online sales, they could face significant difficulty unless their online sales grow in FY2020. Online sales efforts still need a good sales environment to succeed. People don't buy camping goods online or offline when there are bush fires on.

Recent underpayment scandal

Perhaps more worrying than online competitors and national bush fires is the fact that Super Retail recently admitted to underpaying their staff by $61.2m. On 20 February 2020, while announcing their half-year results, Super Retail told investors that they had identified additional expenses concerning their underpayment remediation. This announcement mirrors similar problems faced by Super Retail in FY2018, failing to pay staff allowances and overtime on multiple occasions.

Super Retail's CEO, Anthony Heraghty, has blamed these excessive underpayments on the company's failure to implement appropriate systems to deal with the complexity of Australian wages, which could be believable … the first-time round. However, after happening two years in a row, many investors and staff are losing faith in the transparency of this retail giant.

What next for Super Retail?

The bush fires are under control and the underpayment problem is being fixed but it may take some time for the company's sales to recover. We believe most brands will remain under pressure for another six-to-twelve months, especially Supercheap Auto and BCF. Super Retail's previous track record of positive growth and profitability shows that they can outperform year-on-year across several different retail segments. However, the problems that they have faced both internally and externally over the last six months has damaged their bottom line, reputation with investors, and their brand. The FY20 P/E multiple of 14.3x still looks too high given the growth challenges. There are plenty of other stocks available that provide better prospects with proven track records

Pitt Street Research Pty Ltd

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