23 DECEMBER 2019

Stocks Down Under

> *Come back next Thursday with a specimen of your money*
>
> **- Groucho Marx (1890 -1977), American comedian and actor**

NICK SCALI

Lounge, Dining & Occasional surprising share price increases

COUNTPLUS

Its CUP runneth over

SALMAT

The sad death of the junk mail industry

NICK SCALI

Lounge, Dining & Occasional surprising share price increases

Stocks Down Under rating: ★★★

ASX: NCK
Share price: AA$ 6.83
Market cap: A$ 568M

You wouldn't know it from the share price performance of the last couple of months, but the Sydney-based furniture retailer Nick Scali (ASX:NCK) is supposed to be experiencing 'difficult trading conditions'. It said so in a market announcement on 15 October, where it noted that life-for-like sales were down 8% over then August to October period. At the time Nick Scali stock was trading at around $6.20 per share. It's now just over $7.00. What gives?

COUNTPLUS

Its CUP runneth over

Stocks Down Under rating: ★★★★

ASX: CUP
Share price: A$ 1.11
Market cap: A$ 118.7M

Back in June 2019, Sydney-based CountPlus (ASX:CUP) was the little-known owner of various accounting and financial advice firms around Australia. The company had expanded steadily by acquisition since it went on the boards in 2010, and by FY18 had reached $74m in revenue and $7.8m in EBITA. But the stock wasn't getting anyone too excited. On 6 June you could have bought CountPlus for just 44 cents per share, capitalising the company at a mere $50m.

SALMAT

The sad death of the junk mail industry

Stocks Down Under rating: ★

ASX: SLM
Share price: A$ 0.825
Market cap: A$ 163.7M

Sydney-based Salmat (ASX:SLM) has enjoyed a sharp re-rating over the last couple of months, rising from 46 cents on 11 October to 77 cents. The reason for the buzz has been the company's sale of its foundation Marketing Solutions business to IVE Group (ASX: IVL) for $25m cash, a deal announced on 25 November and it is expected to close next month.

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Share price chart

Source: Tradingview

We think Nick Scali is actually doing better in terms of market standing than current same-store sales would suggest. Nick Scali has positioned itself over the years as an up-scale retailer, and that premium positioning has allowed new stores to open fairly easily, as middle of the road offerings are progressively driven out of the market. High-end furniture is something people prefer to visit a showroom for to see rather than check it out online, and Nick Scali probably has the most recognisable brand in its market segment. That's partly why EBIT margins in FY19 were a healthy 23.5%, as against 22.4% in FY18. Mind you, that doesn't necessarily mean that Nick Scali stock is cheap right now.

New stores are opening at a rapid rate

Nick Scali has been opening new stores at a rapid rate over the last two years – six stores opened in FY18 and another six stores in FY19. We think there's more growth where that came from because the total store count only got to 62 at the end of FY19 – 60 in Australia, two in New Zealand. The long-run plan is 80-85 around the region. Interestingly, five of the 62 stores are 'Nick Scali Clearance'

stores where the outdated stock gets sent to, allowing the other 57 to sell the stuff householders want to buy today. The differentiation between a regular Nick Scali and Nick Scali Clearance means the brand is not tarnished by heavy discounting, as can so easily happen in high-end retailing.

Nick Scali is well placed to expand because, the company has no net debt and cashflow is strong as inventory has been tightly controlled. Throw in the fact that we've had three interest rate cuts in Australia in 2019 – in June, July and October – and there's a lot to like about this company as we move into the second half FY20. We believe the full year FY20 numbers will not be great for Nick Scali but might not be as bad as many people are expecting. Consensus EPS for FY20 is 46 cents per share (6.6% yield) as opposed to 47 cents in FY19 – growing store numbers basically offsets lower same-store-sales.

So will the current share price momentum continue for Nick Scali? We're not so sure about that. You can currently buy Nick Scale at a P/E of 16.6x FY20 consensus, coming down to 14.6 in FY21. Close to 17 times earnings is probably too high, even for a high-quality retail franchise like Nick Scali. However, should there be another sell-off based on the perception that the retail sector in Australia is struggling, this could be one to revisit.

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Share price chart

Source: Tradingview

CountPlus bought Count Financial for just about zero

Count Financial was a CBA financial planning business, which the bank chose to sell because of the various scandals that had been uncovered in wealth management by the Banking Royal Commission. The reason everyone got excited about this transaction as far as CountPlus was concerned was that the purchase price was only $2.5m, which looked very inexpensive given that the net revenue of the business in FY18 was $25m. Importantly, the bank indemnified CountPlus for up to $200m arising from any 'past regulatory and advice failure liabilities'. Basically, in its haste to get out of the scandal-plagued wealth management sector, CBA handed Count Financial to CountPlus for just about zero. The transaction was completed in October.

CountPlus was widely regarded as the right fit for Count Financial because, after the Royal Commission, if you asked a typical high net worth individual who they trusted to give them financial advice, around 80% would say an accountant and only 40% a financial adviser. When your whole franchise in financial advice is accounting-led, as CountPlus's is, you're in a strong position to grow given that in any one year 2 million Australians will need to seek financial advice and there's a $5bn market up for grabs.

CountPlus now has the right strategy for growth

The other thing the market could now better appreciate, after the Count Financial acquisition, was the way in which CEO Matthew Rowe had changed the strategy. Previously, CountPlus had just bought accounting and financial advice practices and made the previous owners employees. That, Rowe and his colleagues decided in July 2017, just wasn't working. They argued it would be better to give the practitioners some direct equity so they still had skin in the game. This new strategy has helped lift the performance of the group over the past two years and the Count Financial acquisition takes it to the next level. It has also helped to attract new members - CountPlus has executed two more member acquisitions since the Count Financial transaction closed. The company is well placed to grow because it has no debt and around $14m in cash post Count Financial.

Good company but a little expensive right now

So CountPlus would appear to be sitting pretty right now. We would, however, be a little concerned at the current share price. The FY20 P/E is now 16.5 times, high for a company that only recently got its strategy right. There is potential for Count Financial to have restructuring costs associated with it in FY20 even if the regulatory and advice failure liabilities are on CBA's tab. And CBA still owns 35.85% of the stock which it intends to sell, which seems like a large overhang to us. For all of these reasons we'd be a little cautious and fear the stock may run out of steam, especially since the re-rating has been driven by just one major transaction. That said, another year or so of growth may establish the market standing of CountPlus more firmly in investor's minds.

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Share price chart

Source: Tradingview

Salmat's Marketing Solutions business is the outfit that distributes all those catalogues you find crowding your letter box every week of the year. The company in effect created the industry around four decades ago. Believe it or not, unsolicited catalogue delivery to your letter box is still a preferred marketing option for many businesses in 2019, and Salmat's junk mail goes into something like 7 million letter boxes around Australia, covering just over two-thirds of the population. Marketing Solutions also does online catalogues, and that business is growing. However, the old-style junk mail business is in long-term structural decline, wedged between rising prices and declining demand.

Salmat is turning itself into a cash box

Another Salmat business, called MicroSourcing, helps Australian businesses outsource business processes to the Philippines, and there's been recent media speculation that Salmat will sell MicroSourcing as well. In effect, Salmat is turning itself into a cash box.

Salmat closed FY19 with $58.6m in net cash ahead of a $10m special dividend. Marketing Solutions adds another $25m or so. Basically, the market is now punting that MicroSourcing will sell for a good

price. That business did $13.4m EBITDA in FY19. It would need to sell for around 8x EBITDA to justify the current market capitalisation. Now, MicroSourcing did grow EBITDA 28% in FY19, so a better number than 8x EBITDA is possible, but we think investors' outcomes should always be determined by business performance, not by the negotiating skills of M&A teams.

Being a cash box can go two ways. On the downside we argue that management may choose to invest in risky acquisitions to rebuild shareholder value. On the upside, if you're invested in this company now, the special dividends to be paid may represent a good dividend yield for a relatively short holding period.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

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