Stocks Down Under

> *I would say that financial markets are very inefficient, and capable of extremes of being completely dysfunctional.*
>
> **- Jeremy Grantham (b. 1938) co-founder and chief investment strategist of Grantham, Mayo, & van Otterloo**

VIVA ENERGY GROUP

An unrefined investment

SMARTGROUP

Automation, Service Expansion Driving Growth

ENGENCO

All aboard the gravy train

VIVA ENERGY GROUP

An unrefined investment

Stocks Down Under rating: ★★

ASX: VEA
Share price: A$ 1.40
Market cap: A$ 2.7BN

With more than 1,250 service stations across the country, Viva Energy Group, a supplier of retail, marine, transport and aviation fuel based in Melbourne, is one of Australia's leading energy companies. But with WTI and Brent prices falling off a cliff and the coronavirus disrupting economic activity across the globe, we believe shares of Viva Energy Group are quickly running out of gas. Making lower-highs and lower-lows, the stock is a nightmare from a technical perspective. And with fundamentals the next to go, we suggest you fuel your portfolio elsewhere.

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Automation, Service Expansion Driving Growth

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ASX: SIQ
Share price: A$ 5.25
Market cap: A$ 697M

Based in New South Wales, Smartgroup has seen its stock tumble from its October 1st peak around $12.50 to a three-year low largely due to the recent departure of long-time CEO Devin Billimoria. It was also announced on 16 December that FY20 insurance product earnings would be negatively impacted by changes in selling terms made by its underwriting partner. While the latter headline may have warranted the market's reaction, the 15% selloff due to the CEO departure was unjustified. With highly capable, former CFO, Tim Looi now at the helm and the global equity market correction beating up fundamentally sound companies, the stock looks well undervalued.

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Servicing companies across the resources, rail, transport, defence, maritime and power generation industries, Melbourne-based Engenco keeps Australia's rolling stock on track. And building momentum in more than just professional recruitment and infrastructure maintenance, Engenco's stock was on a 43% tear before the coronavirus sent shares off the rails. However, we believe the derailment is a short-term blip in the Engenco story. Like placing a penny on the tracks, the four-star rated stock is poised to power through the turbulence and provide investors with a smooth ride to their final destination.

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Share price chart

Source: Tradingview

Refinery division faces internal and external pressures

With consumers becoming more educated about the environmental impact of fossil fuels, hybrid and electric vehicles continue to gain mass popularity. The structural transition has caused a steep decline in fuel per-vehicle demand across Australia. Geelong, the company's refinery division which supplies over 50% of Victoria's fuel, encountered significant cost headwinds in FY19, as restructuring and safety training for its roughly 700 employees weighed on profitability.

And despite the near-term bounce from falling crude prices, we believe refinery margins will follow suit. Subject to an initial lag – where upstream prices fall at a faster pace than downstream prices – the paradigm provides an initial boost to Viva Energy Group's bottom line. However, once the market stabilizes, refined-product prices decline as supply and demand find an equilibrium. On 28 February

2020, the Australian Institute of Petroleum reported that the price of Tapis crude oil was $57.70 – down from a four-week average of $59 and a 12-month average of $63.40. The trend will only worsen over the next 12 months – after OPEC+ failed to reach a supply cut agreement. An all-out price war between Saudi Arabia, Russia and other leading producers is likely to persist for some time.

Also suppressing demand, ethanol-blended fuel (EBF) is growing in popularity – as it substantially reduces volatile organic compounds (VOCs), toxic emissions and carbon dioxide relative to traditional petrol. Recognizing the benefits, the Australian government provides an excise tax discount to producers of the hybrid clean energy.

Retail remans a challenge

Supplying roughly a quarter of Australia's liquid fuel, strong demand for diesel and liquid natural gas (LNG) continues to support Viva Energy Group's bottom line. In H2 FY19, the group renegotiated its contract with Coles, the supermarket, retail and consumer services chain, and acquired Liberty Oil, a supplier of fuel to independent retailers and wholesalers, based in Melbourne. But despite the additions, competition remains fierce in the retail space and pricing pressure is likely to intensify as the dominant players battle for market share.

Viva Energy Group's retail business has also been a causality of volatile oil prices. Gasoline and diesel prices continue to decline, while freight and supply chain costs are pressuring margins within its commercial business. And despite Viva Energy Group's history of scaling its operations and improving profitability, the coronavirus outbreak and the challenging macroeconomic environment make 2020 even more difficult.

Furthermore, on 20 February 2020, the group sold 35.5% of its Viva Energy REIT for $734.3m, while also announcing a $680m off-market share buy-back. And while the move is positive for investors, we believe the decision is more of a band aid – one that will provide relief in the short-term, but won't protect investors from the emerging economic challenges.

Fundamentals are headed for disaster

Releasing its FY19 results on 24 February 2020, Viva Energy Group's revenue increased by 0.9% to $16.5bn. However, NPAT fell by 41.3% to $135.8m and came in at the low-end of the group's $135m to $165m guidance. COGS increased by 1.9%, while the company's EBITDA margin fell from 4.7% to 3.9%. Declines were seen across all segments – with retail, commercial and refinery all reporting a 6% to 10% decline in profitability.

With an abundance of downside catalysts, we're bearish on Viva Energy Group. The two-star rated shares trade at a P/E of 20x (NTM) and management is already behind on the majority of its FY20 strategic initiatives. And with a flood of new oil set to hit the market – and refining margins to decline in the process – we believe Viva Energy Group won't hit any of its financial targets until at least 2021, hence only two stars for VEA.

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Share price chart

Source: Tradingview

Automation shift, acquisitions driving smart growth

Smartgroup had modest growth in FY19. Revenue was up 3.3% to $249.8m and EPS rose 3.5% to $0.615. Outsourced Administration (OA), the company's biggest segment offering salary packaging, novated leasing and payroll services, grew revenue by 3.9%, although profitability was flat compared to FY18. The next largest division, Software, Distribution & Group Services (SDGS), whose products include salary packaging software and debit card marketing, delivered 4.3% top line growth and a higher EBITDA margin of 50.5%. Vehicle Services, which provides end-to-end fleet management services had revenue growth of 10.5% and significant EBITDA margin expansion of 52.7% to 60.8%.

Overall expense growth of 3.6% was slightly ahead of revenue growth and was largely attributed to administrative costs. These costs, however, should decline over time as Smartgroup shifts towards more automated processes. The company's focus on achieving greater automation is designed to enhance its service offerings through both acquisitions and partnerships. Last year these efforts were impacted by decreasing new vehicle sales and the Hayne Royal Commission's regulatory review of add-on insurance solutions, which hurt demand for Smartgroup's products.

Multiple acquisitions were made in 2019 in conjunction with the automation transition. In April, Smartgroup added the novated leasing assets of iNovation, also known as Mylease, to its Autopia car salary packaging subsidiary. Then in June, it acquired the salary packaging business from South Perth-based SET Leasing as well as Pay-Plan's novated leasing business. The inorganic growth spree continued in October when Smartgroup bought Lease & Asset Finance's novated leasing assets. In 2020, the company plans to consolidate its blossoming salary packaging and novated leasing business into four distinct units with centralised administration. This should drive operating efficiency gains.

Diverse, growing customer base

The company met the challenges faced in 2019 by maintaining a focus on customer service. This led an increase of at least 5% in its customer count across all divisions including the key salary packaging business, which grew its number of customers to 358,500. We believe the enhanced customer base has given Smartgroup a solid foundation from which to expand organic growth. Another attractive aspect of the growing customer base is its diverse composition. For instance, the salary packaging division's revenue base is comprised of 52% public and private non-profit hospitals, 22% government and 19% education customers.

The favourable organic growth trend is expected to continue across all segments in FY2020. Smartgroup has recently formed strong partnerships that should give it broader access to more customers in both the private and public sectors. The partnership pipeline is also encouraging especially its union with Sydney-based online mortgage health checker Loandolphin.

The strategic shift to automated services has made good progress. Smartgroup is already seeing increasing adoption trends in its online distribution channels as it migrates its packaging and leasing solutions onto core platforms. It recently took on 49 robots, which are estimated to be equal to 55 digital full-time equivalents (FTEs). This should help reduce the company's labour costs over time and drive improved profitability.

Execution improving, yet shares are getting cheaper

Smartgroup's value proposition is the time it frees up for its customers to focus on their respective businesses. It offers cost-effective solutions that service some of Australia's largest employee benefits programs. Smartgroup has shown improved execution of its service expansion and automation strategy which should drive further customer acquisition and future growth.

In our view, the downturn in Smartgroup shares presents a great opportunity for investors to get in on the growing provider of the popular SmartSalary and AccessPay solutions. In addition to the growth potential, the stock offers a nice dividend, which just had its largest-ever year-end payout of 21.5 cents. Given the momentum in the business, at 12.6x forward earnings, we believe Smartgroup is attractive at current levels.

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Source: Tradingview

A business model that's built to last

With zero debt on its balance sheet, Engenco is operating from a position of strength. And with its stable operating cash flow, the company can withstand nearly any economic downturn. Throughout 2019, Engenco delivered strong organic growth by diversifying its services and developing long-term relationships with clients. Following the principles of health, safety, environmental sustainability and quality, Engenco has built a loyal customer base that provides a recurring revenue stream. And by prioritizing vertical markets – including mining, rail, heavy industrial and infrastructure – Engenco is poised to grow its top line, while also keeping costs in check.

In FY19, Engenco's consolidated revenue increased by 11.1% to $174.9m. Gemco Rail, which manufactures and services products for Australia's national rail operators, generated 25.5% revenue growth – with regional expansion and investments in heavy maintenance lifting full-year volume. The positive sales momentum led management to construct a wheel bearing and wagon maintenance facility in Central Queensland. The workshop services the bulk of the rail market across the region and also supports Engenco's expansion along Australia's east cost – which should be a significant driver of future growth. And despite a revenue decline of 9.5% in Engenco's second largest division – Drivetrain Power and Propulsion (DTPP) – the group is restructuring the division by expanding its technical services, expanding its mining sector products and providing new specialist services across the gas compression market.

A solid multi-year strategy

With a long-term focus, Engenco continues to invest for the future. The company made strategic investments in inventory and product innovation in FY19, and Engenco is well-diversified with its finger on the vertical market's pulse. In FY19, the company also completed a major rail upgrade project in South Australia. And through its reputation as a highly skilled operator, Engenco is poised to land more nation-building contracts in the future. The group's CERT division, which provides innovative training, assessment and recertification services to the Australian rail industry, also rolled out a new technology that tracks its "Paperless RTO" strategy. And awaiting the greenlight from government funded programs, Engenco plans to expand its CERT training operations – which is another catalyst for future growth.

Management also launched new products and technical services across the mining sector. They introduced a mining utility vehicle in FY19 and management believes the sector will offer profitable opportunities going forward. Furthermore, with the Australian government earmarking $100bn for infrastructure projects over the next 10 years, Engenco's maintenance and service revenues are poised to balloon in the coming years.

Macroeconomic headwinds are weighing on the stock

In H1 FY20, Engenco's revenue inched up 1.1% to $89m, while NPAT fell by 46% to $3.5m. However, we believe the weakness was a result of macro uncertainty and not company fundamentals. Gemco Rail was a standout during the period – with revenue up 39% – while Engenco declared its first dividend in 10 years. Management made the decision because they believe the business is in a safe place. If they were worried about the future, they would not be returning capital to shareholders. Furthermore, management increased their capex budget for FY20, another signal that the business is in good shape.

And with the company's strong pipeline of rail infrastructure projects and robust demand for its rail training and certification services, we believe Engenco's stock is poised to revisit its January highs. The company's EPS has grown by an average of 25% p.a. over the last three years and we believe the trend is likely to continue. Furthermore, DTPP is poised to rebound in the near-term, which will also lift margins. And once this perfect storm occurs, we believe investors should be ready to board Engenco's gravy train once again.

Pitt Street Research Pty Ltd

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