23 MARCH 2020

Stocks Down Under

> *A pessimist sees the difficulty in every opportunity, an optimist sees the opportunity in every difficulty.*
>
> **- Winston Churchill (1874-1965) British politician, army officer and writer**

CARSALES.COM

In need of repairs

SYDNEY AIRPORT HOLDINGS

Pending global travel freeze, liftoff is ahead

ARIADNE AUSTRALIA

No parking allowed

CARSALES.COM

In need of repairs

Stocks Down Under rating: ★★

ASX: CAR
Share price: A$ 11.80
Market cap: A$ 2.9BN

As Australia's No. 1 Car Website, Carsales.com, an online automotive marketplace based in Melbourne, allows you to browse over 200,000 new and used car listings. What is your car worth? Is there an active market? What are the experts saying? It's all there. But despite the bevy of analytical tools, Carsales.com's dashboard is flashing red. The brakes are squeaking. The engine is leaking oil. And we think it's only a matter of time before the stock's wheels grind to a permanent halt.

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SYDNEY AIRPORT HOLDINGS

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Stocks Down Under rating: ★★★

ASX: SYD
Share price: A$ 4.86
Market cap: A$ 11BN

Sydney Airport Holdings holds a 100% interest in Sydney Airport, which connects to over 90 travel destinations worldwide. A key part of Australia's infrastructure, it generates on average $38bn in economic activity per year, which represents nearly 7% of the New South Wales economy. Its shares have sunk in recent weeks due to the coronavirus epidemic and its impact on global travel. Prior to the current crisis, the stock had been flying high due to strong financial performance. Although much near-term uncertainty remains, we believe Sydney Airport is a high-quality long-term investment.

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Share price: A$ 0.50
Market cap: A$ 98.4M

With global stock markets facing immense selling pressure, is Ariadne Australia, a diversified investment company based in Sydney, a safe place to park your cash? Well, with its wealth of experience in managing property, maritime and car park infrastructure, stable income has its perks. However, when you dig a little deeper, you find an illiquid portfolio that's positioned at the heart of underperforming sectors. And with takeover bids vanishing by the day and regulatory scrutiny leaving investors with more questions than answers – we believe Ariadne Australia is a parking lot you should avoid.

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Share price chart

Source: Tradingview

Fundamentals have peaked

In FY19, Carsales.com's revenue increased by 11% to $417.5m, while EBITDA increased by 7% to $210.1m. The group's Asian revenue also more than doubled during the period. And Carsales.com's stock trades at an EV/EBITDA multiple of 18x and a P/E multiple of 26x (NTM). But given the global disruptions from the coronavirus – and the fact that net-debt also more than doubled to $474.3m – we believe Carsales.com's stock could be on a collision course.

In H1 FY20, Carsales.com reported strong international growth – with Brazil up 29%, Korea up 13% and Mexico showing strong improvement. However, with the global macroeconomic environment becoming cloudier by the day, Carsales.com won't be able to lean on international markets to stimulate growth. Chile and Argentina are already showing signs of slippage – as political unrest, high inflation and anaemic economic growth suppresses consumer confidence.

Across Brazil, Carsales.com's growth was driven by Webmotors integration with Santander Bank – a financial services company based in Spain. However, to maintain the momentum, Carsales.com will need to increase its marketing spending – which is a difficult proposition given the current environment.

Management turnover and business uncertainty

On 2 December 2019, Carsales.com reorganized its executive branch – naming Ajay Bhatia managing director of its consumer, dealer, media and OEM operations in Australia. Similarly, the group created chief product and information officer roles to shore up the company's product, technology and data functions. On 17 January 2020, Carsales.com also named William Elliott as its new CFO – moving him out of his post as head of commercial finance and Carsales.com international CFO.

And with changes in regulatory lending policies and credit tightening causing a cash-crunch at Stratton Finance – one of Australia's largest car and asset finance brokers – Carsales.com wrote down its 50.1% stake in December 2019. However, despite purchasing a controlling stake for $60.1m in 2014, management expects to record a $2.7m gain on the forthcoming divesture, which is expected to close by June 2020.

But after releasing their H1 FY20 results on 12 February 2020, Carsales.com's management was unable to provide any forward financial targets. Management said they expect revenue, EBITDA and NPAT to be solid and that increased marketing and website optimisation should help drive traffic. However, with the coronavirus slowing down the Asian economy and Latin America extremely unstable, we believe a rebound is unlikely in FY20. From our vantage point, strength in one segment is offset by weakness in another. And that trend is unlikely to provide investors with meaningful upside anytime soon.

Growth is trending lower

When Carsales.com released its H1 FY20 results, revenue growth slowed from 17% in H1 FY19 to 5% in H1 FY20. EBITDA growth also fell from 8% to 6%, while management allocated capital to early-stage businesses that generate little profitability. The company also conceded that the Australian market remains out of favour, with international markets doing much of the heavy lifting. But in reality, only 23% of Carsales.com's revenue comes from international markets – which isn't enough to offset core declines in the Australian market.

Furthermore, new car sales – which generate higher margins – have essentially flat-lined. The result has forced Carsales.com to prioritize used car sales – which generate much lower profitability.

The group's domestic dealer revenue also slowed from 6.9% to 6% in H1 FY20, while data, research and services revenue were essentially flat. The challenges across the new cars market also caused display revenue to decline by 5% – with economic uncertainty, tightening credit and difficulties sourcing new cars from Europe unlikely to abate in 2020.

Piecing the story together, we're bearish on Carsales.com. Despite the recent, Corono-induced share price crash, the two-star rated stock is still trading at multiples that, we believe, don't represent the company's future growth trajectory. Furthermore, doubling its debt in this macro environment is a recipe for disaster. So, take the bus. Or walk. But whatever you do, don't catch a ride with Carsales.com.

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Share price chart

Source: Tradingview

Top line growth, cost savings drive increasing profitability

Sydney Airport operates as a monopoly, which gives it significant pricing power. It has a very diverse revenue base given its exposure to a wide range of passenger geographies. Within the property itself there are also varied revenue sources including from airliner leases, parking, ground transportation, retail, hotels and office space.

The company reported full year 2019 results on 20 February that were highlighted by a 3.5% increase in revenue to $1.64bn, a 1.6% decline in operating expenses to $205m, and a 4% rise in EBITDA to $1.33bn. Shareholder distributions increased from $0.375 in FY18 to $0.39. Cost savings of $15.9m were achieved by simplifying the organisation, reducing energy expenses, renegotiating contracts and other efficiency gains.

Aeronautical revenue, the largest segment comprising 45% of the business, increased 2.4%. Retail revenue was up 5% and Property revenue jumped 5.5%. Parking & Ground Transport revenue was relatively flat. Sydney Airport served 44.4m passengers last year, 0.1% more than 2018, driven by a 1.1% increase in international travellers, which represented 38% of total passengers.

Demographic trends underpin new growth markets

Sydney Airport's highest growth priorities include reinvestment in customer service, aviation business development, employee training and technology. It invested $301m in 2019 towards things like layover bays, security, retail expansion, advertising assets, storage and bathroom upgrades. Funds also went towards hotel construction and upgraded WiFi access across the company's hotel portfolio.

Capital expenditures are forecast to be $600m to $800 in 2020 to 2021 for other growth projects. These investments will include enhancements to the airfield, terminal, parking and ground transportation. Technology will be used to more effectively manage costs, increase revenue per passenger and expand services beyond the core offerings. Terminal improvements will also be driven by technology including the installation of automated bad drops, CT scanners and bag stores.

However, with the COVID-19 crisis putting passenger volumes out of its control, management has not offered any 2020 guidance beyond its outlook for capital expenditures of $350m to $450m.

Targeting emerging markets

Future growth will also come outside the airport terminal confines. It is looking to expand into several new geographic areas by targeting underserved markets. Much of the expansion will be in South Asia where urbanisation is on the rise. Indian and Nepalese passengers are the airport's fastest growing passenger segments. In Southeast Asia low cost airlines are significantly increasing seat capacity creating opportunity for more profitable travel routes. South America is experiencing increased travel demand for educational purposes and Brazilians are among the fastest growing nationalities traveling to Sydney. New bilateral trade and air service agreements and extended range aircraft technology are opening the skies to emerging African nations. International travellers are an attractive group to the company because they drive 70% of passenger generated revenue despite international aircraft occupying only 25% of terminal slots.

Prior to the coronavirus outbreak, international visitor arrivals to Australia were expected to increase 9.7% over the next two years reaching 10.3m by 2021. Overseas travel by Australians was forecasted to increase 10.5% to 1.33m departures in 2020, however the timeline of a coronavirus resolution will undoubtedly dictate near term growth.

Near-term uncertainty, long-term optimism

We take a cautiously optimistic stance on Sydney Airport shares given the uncertain global economic environment. Sydney Airport has a strong track record of navigating major global events including 9/11, SARS, swine flu and the Australian bushfires. This resiliency will likely show itself again. This time, we believe the challenging period will likely be looked back on as an opportunity for investors to come on board.

Sydney Airport is one of the world's busiest tourist and business hubs. It has long term contracts with airline companies and tenants and its lease goes through 2097. The company's balance sheet is healthy with strong interest coverage and a declining debt-to-EBITDA ratio.

The balance sheet was further strengthened by a unique multi-tranche, multi-currency February 2020 private placement, which added approximately $600m to the company's cash position. Even after the 48% share price decline in the last three months, at 18x EV/EBITDA (NTM) and a P/E of 42x, the stock is still not very cheap. But at these levels we believe it would make a solid long-term investment, i.e. looking through the Corona tunnel. Further declines would make it a stronger buy, in our view.

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A portfolio under pressure

ClearView holdings, Ariadne Australia's life insurance, wealth management and financial advisory division, saw its value decline by $14.3m in FY19. After the Financial Services Royal Commission cited 300,000 offences in 2018, the negative press led to a 66% decline in the insurer's share price, with the division now trading below its acquisition value. Hillgrove Resources, Ariadne Australia's mining division, is also under fire. Unfavourable market conditions and the termination of a $31m agreement with AGL, a provider of electricity, gas, solar and renewable energy, based in Sydney, has the segment's future outlook in disarray. And while management points to the division's drilling program, mine design, optimisation and feasibility studies – we don't think the projects will add any value in the near-term.

Ariadne Australia's car parking division also saw its profit decline by 75% in FY19, while the segment lost $16k in H1 FY20. And while management invested another $2m in Cover Genius, an up-and-coming Insurtech based in Sydney, we believe weakness across the retail insurance space will weigh on future growth. Currently, management is banking on Cover Genius' full stack platform and large customer base to drive international expansion. The Fintech has partnerships with Netherlands-based Booking.com and U.S-based eBay.com. However, these relationships only go so far. And with the coronavirus outbreak poised to cause a spike in future insurance claims, Cover Genius' profitability remains extremely uncertain.

H1 didn't instil confidence

Unable to stop the bleeding, Ariadne Australia recorded a $5.1m NPAT loss in H1 FY20, with its investments division – which includes ClearView, NatureSeal, Hillgrove Resources and Ardent Leisure – losing $2.7m. The firm also wrote down ClearView by $5.3m, while its property division lost $203k due to poor performance at New Zealand-based Orams Marine Services. And while Orams is ready to proceed with Stage 1B Works – which involves the construction of two large marine sheds, two office buildings as well as commercial and retail tenancies that are likely to derive significant value – we believe the ventures will take a long time to pay off. More importantly, they still won't offset the weakness across Ariadne Australia's other segments.

On the bright side, FreshXtend and NatureSeal outperformed in H1. However, segment patents are approaching expiration, making their future prospects increasingly uncertain. Ariadne Australia's Main Event group also has plans to open five new centres in FY21 – with five to eight new openings per year scheduled thereafter. Riding the momentum, management increased their full-year centre revenue growth guidance from 1% - 2%, to 1.5% - 2%. And while the renewed optimism is positive for shareholders, we don't think the slight uptick in guidance will have a material impact on the stock.

Investors aren't buying the story

On 20 February 2020, Ariadne Australia extended its on-market stock buy-back program for another 12 months. Believing shares are trading below their intrinsic value, management has already repurchased 650,000 shares for a total cost of $402k. But despite their efforts, investors haven't flinched. There hasn't been any new demand for the stock, and to us, the program smells like an attempt to divert investor's attention away from the company's deteriorating fundamentals.

Furthermore, with Ariadne Australia's portfolio spread across so many industries, we question management's expertise within all of these markets. And with the majority of the company's assets held in the private market, illiquidity is a major concern, and not just for the portfolio assets. Illiquidity of the ASX-listed shares is also an issue for investors looking for fast entries and exits. With business on hold due to the coronavirus outbreak, companies continue to drawdown credit lines in an attempt to weather the storm. However, with the duration of the crisis still uncertain, weeks could eventually drag into months. And with Ariadne Australia already reporting a net loss in H1, we believe the downside risks are quickly turning the company's traffic lights from yellow to red.

Pitt Street Research Pty Ltd

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