9 MARCH 2020

Stocks Down Under

Computers are useless – they can only give you answers.

- Pablo Picasso (1881-1973), Spanish artist

MYER

Uncharted territory

FLIGHT CENTRE

Rising to the challenge

CORPORATE TRAVEL MANAGEMENT

Contrarians take note

MYER

Uncharted territory

Stocks Down Under rating: ★★

ASX: MYR
Share price: A$ 0.275
Market cap: A$ 248M

Home to iconic brands like Calvin Klein, Yves Saint Laurent and Apple, Myer, a retail chain based in Melbourne, wants to be Australia's favourite department store. And with its exclusive line of "only at Myer" brands, CEO John King remains confident in the company's ability to navigate a tough retail environment. But the share price, at an all-time low, is telling a different story. Looked at with a medium-term view, the share price move is overdone, but in the short term times are tough.

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Rising to the challenge

Stocks Down Under rating: ★★

ASX: FLT
Share price: A$ 26.50
Market cap: A$ 2.88B

Based in Brisbane, Australia's largest retail travel agency Flight Centre Travel Group has been grounded in recent weeks as travel related companies reel from the effects of the Coronavirus outbreak. The stock was flying high a couple years ago reaching a peak of around $68 in August 2018 on improved trading conditions and higher airfares. It has since been more than cut in half amid a client price gouging scandal and more recently fears that the Coronavirus epidemic will hurt performance. The market's overreaction may prove a chance to get on board with an industry leader with a runway for growth, should $26 per share prove a good support level. If it breaks that level the next one isn't until about $16 though.

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Share price: A$ 10.80
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Brisbane-based Corporate Travel Management (CTM) is a global travel service provider that has experienced its share of ups and downs since listing on the ASX in 2010. The company's stock price has been more than halved since climbing to its August 2018 peak of $32.68. The initial descent was triggered by a short sale attack from hedge fund VGI Partners which claimed the presence of aggressive accounting practices. While CTM defended a profit level that was twice its competitors', the stock continued to fall. More recently, the impact of the Coronavirus on travel demand has pushed the stock to a four-year low. Is it oversold? Maybe, but at the moment there's no resistance forming.

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Share price chart

Source: Tradingview

Management is diligently and continuously restructuring

Anchored by a competent team of deputies, John King implemented significant cost-cutting measures at Myer in FY19 to shore up the business. By reducing occupancy of real estate, increasing efficiency and implementing strategic marketing, the company eliminated $33m in excess waste in FY19. Capital expenditures were reduced to $45m, net debt reduced to $39m and a 5.4% reduction in inventory helped increase operating cash flow by 6.2%. Management also continues to close underperforming stores, reducing the company's gross lettable area by 29,000 square meters. And through diligent workface management, the company continues to optimize staff during non-peak periods, further aligning labour costs with customer activity.

Also, in FY19 management strategically pivoted toward online sales, expanding its online range by over 100 brands and growing digital sales by 26%. And with digital sales generation close to 10% of Myer' total sales in FY19, that was significant. The company continues to expand its digital fulfilment capabilities and continues to optimize its direct-to-consumer (DTC) channel. The bottom line? Management understands the evolving nature of retail and is taking proactive steps to address the issues.

“Only at Myer”

Expanding its exclusive line of products – which also include Karl Lagerfeld Paris, Oasis and Vero Moda – Myer added 50 new brands in August and is “well progressed” in its initiative to add 90+ new brands as of Christmas FY19. Key additions include Polo Ralph Lauren, Tommy Hilfiger and Levi’s. The exclusive offerings are also lifting the company’s gross margin, as it swaps unprofitable lines for high-demand items.

In FY19, the company also opened its Myer Beauty Emporium in Melbourne, Sydney and Chadstone – which offers a carefully curated collection of innovative skincare and makeup brands. A destination for the country’s favourite A-brands, Myer Beauty offers locally sourced products that are made with simple and organic ingredients. Also capitalizing on the popularity of Korean skincare, its K-beauty line consists of handpicked brands that are developed through sophisticated formulas.

The advancements led to 2.2% NPAT growth in FY19 – Myer’ first expansion since 2010. EBITDA also increased by 7.2% to $160.1m, while the cost of doing business (COBD) decreased by 3.1% to $1bn. The company’s operating gross margin also increased by 65bps to 38.85%, while fulfilment costs at myer.com.au fell by 13.5%.

So, what went wrong in the latest half?

In the six months to 25 January, Myer’s sales fell 3.8% but EBITDA only came down 0.4%, to $113m. The market didn’t like that result at all, even though it showed that the business had been strengthened by King and his team so that margins didn’t collapse. The market didn’t like the reminder that Apple and Country Road had exited Myer stores, and it didn’t like the underperformance in Womenswear, where Myers needs to be strong to be competitive. The market therefore ignored another impressive half from the online platform, which grew sales by 25% and increased the sales percentage represented by online to 10.5%.

With Myer’s share price down by around 90% since the April 2013 high, investors believe the company’s only lever is to cut its way to profitability. Essentially, the stock is priced for zero sales growth. However, despite rumours of an impending retail apocalypse, the industry continues to grow at a CAGR of 2.5% and the popularity of “buy now pay later” Fintech services are leading to increased consumer demand. Furthermore, with interest rates at or near their historic lows, consumer spending continues to be the main driver of GDP growth across developed markets.

Low valuation, but it might stay low for a while

From a valuation perspective, Myer is also trading like it’s going out of business. With a P/E of 10x and an EV/EBITDA of 7x, the company’s multiples are low – even by value investor standards. Moreover, the company has a strong corporate balance sheet, generates stable cash flows and “all banking covenants have substantial headroom.” As well, with the company’s share price continuing to decline, Myer remains a possible buyout candidate. With private equity having more dry paper than ever, the company can add value to their portfolio by providing stable returns within a mature industry. Myer has already done well under private equity once before, prior to 2009.

For the medium term we’re bullish on Myer, if only because stocks rarely stay at ten-year lows for long and the general equity market will prove more congenial once the Coronavirus scare is out of the wat. For the short term we think the market is going to ignore the achievements of the present management team and fixate on the low growth of the bricks and mortar side of the business. So, two stars from us for now. We think a good catalyst for a switch in our view would be a full year result that sees online sales shifting to more like 15% of the total at the next result in September.

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Great 1H results, overblown 2H concerns

In FY19 revenue grew 4.5% to $3.06bn and total transaction volume (TTV) accelerated to 8.8%, but net profit after tax (NPAT) was only 0.1% higher at $264m. However, things are looking up at Flight Centre following a solid 1H FY20 report. Underlying PBT was a tad ahead of the company's $100m forecast at $102.7m led by record profit in the EMEA region despite Brexit-related challenges in the U.K. It reported record 1H sales of$12.4bn with total transaction volume (TTV) growth of around 11% as a result of market share gains. This was well above the targeted growth of 7% and marked the company's strongest 1H growth trajectory since FY16.

Last month, Flight Centre issued a statement saying that it was performing in line with expectations but was monitoring the impact of the Coronavirus outbreak on second half results. The company has acknowledged disruptions in its small corporate travel operations in China, Malaysia and Singapore. The market, though, has taken it upon itself to decide that near term financial results will be far worse than FY20 guidance. However, when you consider these countries combined accounted for only $625m of TTV in FY19, the impact may not be as bad as the stock price indicates.

Growing at home and abroad

While Flight Centre can't do much to combat the effects of the Coronavirus on travel demand, it can move forward with its revamped strategy geared towards international expansion and inorganic growth. The international side of the business has recently grown to represent the majority of overall TTV and profits. It is these higher volume, higher margin markets that will drive future growth.

But that's not to say the Australian market won't be able to deliver growth of its own. The ANZ region still comprises the lion's share of Flight Centre's revenues at 51.3%. The domestic online leisure business is a pocket of strength and investments made in this area should drive continued momentum. Over the next few years Australia's travel agency business is forecast to grow at a 4% annual rate to $10.1bn. This will be driven by an increase in both domestic and foreign tourism and industry-wide integration of physical and online businesses. Flight Centre's expertise in airlines, accommodations and transport will save customers time and money by giving them the flexibility to book at retail outlets and from home.

The company's inorganic growth strategy is in synch with its desire to expand its international footprint. Last year the company took over European corporate travel business 3Mundi as well as Canadian premium travel service Voyages Laurier du Vallon. The previous year it acquired United States travel management company Casto Travel to enhance its presence in the U.S. corporate travel market. These and other future acquisitions should be supportive of overseas growth.

Navigating turbulent travel industry conditions

Not only did Flight Centre's 1H results set company records, but TTV records were additionally made in all geographic segments in both the corporate and leisure travel businesses. This speaks to Flight Centre's ability to deliver broad-based growth and grab market share especially in the North American business where TTV jumped 24%. Considering the pressures surrounding Brexit, political unrest in Hong Kong and global trade wars, the results showed that management can steer the company through tough industry conditions.

Looking further down the road, the travel service giant's "Destination 2035" strategy, if executed well, should strengthen its global leadership position. Flight Centre is aiming to become the world's biggest corporate travel company with operations in more than 50 countries. This will include exposure to a wide range of specialties including travel, fitness, bikes, education, finance and foreign exchange.

At the moment we rate this quality company only two stars because of the punishment being handed out to anyone involved in travel during the current Coronavirus crisis. What would shift our view on Flight Centre? If the stock could hold the current $26 support level. At the moment Flight Centre is on an FY20 P/E of 15.9x dropping to 12.3x for FY21. That's low by recent history but not drastically inexpensive. Should the $26 level be broking the next support isn't until 16. That level would represent much better buying.

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Source: Tradingview

Investments in technology bearing fruit

CTM reported strong results in FY19 with revenue growth of 21%, underlying EBITDA growth of 20%, and earnings growth of 10%. This was driven by the acquisition of new clients, effective cost management and the successful integration of automation. Together these factors led to an increased market share as total transaction value (TTV) swelled 30% to $6.45bn.

On 19 February, it posted 1H FY20 results that included a 12% increase in TTV, 6% revenue growth and an 8% decline in profits. The disappointing performance was attributed to above average technology project costs in North America and customer onboarding delays. These headwinds, however, should turn into tailwinds in the back half of FY20. Client migration to an online model is expected to result in a return to growth and the onboarding delays should flow into 2H results as new client wins appear back on track.

Citing the impact of the Coronavirus, management recently lowered its EBITDA guidance for FY20 from a range of $165m-$175m to $125m-$150m, which would represent a decline from the $151m in EBITDA recorded in FY19. It did, however, express confidence about growth returning in FY21 on account of its geographically diverse business model, integration of new technology and value-added acquisitions.

Geographically diverse with an eye toward M&A activity

Favourable industry fundamentals are expected to provide CTM with significant growth opportunities over the next few years with the travel agency business forecast to grow at an annual rate of 2.7%. Agencies that cater to corporate and government travellers are expected to benefit from a rise in business sentiment and travel demand as global economic growth accelerates. The exact timeline of this is of course dependent on the uncertainty around the ongoing Coronavirus crisis, but one would certainly hope a near-term resolution is plausible.

On its own merits, CTM has an attractive business model that is well-diversified both in terms of its services and geography. It is not overly dependent on one region with ANZ, North America, Europe and Asia accounting for 32%, 27%, 26% and 15% of EBITDA respectively.

In addition to CTM's organic growth drivers, the company is active on the acquisition front. Its January takeover of U.S. travel service provider Corporate Travel Planners for $26.5m gives CTM access to a valuable United States education niche market and expands its U.S. scale. The acquisition is also expected to be accretive to earnings and give a much needed $2.2bn boost to North American TTV.

China exposure overblown, opportunity knocks

While there has been some turbulence for CTM there is also a lot to like in the medium term. The company does have exposure to China and the surrounding region, but Asia accounts for only about 15% of profitability and the region's contribution to TTV is even lower. Eventually the Chinese workforce will return and their demand for travel service will pick back up. Meanwhile, CTM's value-added technology and inorganic growth strategy put the company in the driver seat for a recovery when the Coronavirus burns itself out. So, we see the potential for us to shift our star rating upwards.

The trouble for watchers of CTM right now is that if the stock breaks the support level of around $9, a subsequent down draft might take it all the way down to $6 or even $3. CTM's stock is currently valued at roughly 15x forward earnings and an EV/EBITDA of less than 10x. That might have been reasonable in 2018 but not so much now in these uncertain times we're in.

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