10 MARCH 2020

# Stocks Down Under

*"Truth comes out in wine."*

**- Pliny the Elder (AD 25-79), Roman natural philosopher**

## BLACKMORES

Near-term challenges, long-term opportunities

## TREASURY WINE ESTATES

Growth profile has legs

## ALTIUM

At the heart of PCB design

# BLACKMORES

## Near-term challenges, long-term opportunities

Stocks Down Under rating: ★★

**ASX: BKL**
**Share price: A$ 66.84**
**Market cap: A$ 1.2BN**

We know vitamins are good for your health, but is Blackmores good for your investment portfolio? Blackmores, based in Sydney, is Australia's leading maker of vitamins and supplements, but its financial health has been a source of concern for investors. Strong Chinese demand propelled the stock above the $200 mark in December 2015 but that was a long time ago and hard times have ensued since then due to intensifying competition, key ingredient shortages, and repeated profit shortfalls. Viewed with a medium-term perspective, with a sound strategic pivot in place, Blackmores may be in the bargain aisle. For now, there's the Coronavirus crises to deal with.

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# TREASURY WINE ESTATES

## Growth profile has legs

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**ASX: TWE**
**Share price: A$ 9.27**
**Market cap: A$ 6.7BN**

Treasury Wine Estates is a Melbourne-based winemaker and the former division of Australian brewer Foster's Group. It owns a variety of major wine brands including Penfolds and Wolf Blass in Australia and Beringer, the home of Napa Valley's oldest winery in the United States. The stock has twice flirted with the $20 mark only to suffer its worst ever drop in early 2020 amid a short selling attack, weak U.S. performance and the Coronavirus-linked global equity selloff. While not a screaming buy here, shares of Treasury appear oversold given the company's steady historical growth and prospects in Asia and Australia.

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# ALTIUM

## At the heart of PCB design

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**Share price: A$ 27.84**
**Market cap: A$ 3.8BN**

Altium, a software company based in the salubrious southern California town of La Jolla, has enjoyed a great run the last few years, with its shares peaking at an all-time high of $42.62 last month. Then came the half-yearly result when the company disclosed that it had grappled with customers' excess inventory due to Trade War fears, which slowed the launch of its promising Octopart business. The broad-based market selloff tied to the Coronavirus has taken things down further. Medium term shares in this rapidly growing maker of design software for electronics are on our shopping list. Given China's importance to the company we'd be cautious in the short term.

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### Share price chart

*Source: Tradingview*

### Coronavirus, transition costs to weigh on near-term results

Blackmores recently reported a H1 FY20 revenue decline of 5% to $303m. Net profit after tax (NPAT) of $18m was down 48%. Management acknowledged that much work remains to restore investor confidence.

In connection with the announcement of its half-year results and outlook, Blackmores submitted a request for a trading halt. This is because it lowered its full-year profit forecast due to some adverse manufacturing costs and the impact of the Coronavirus epidemic. It now expects FY20 NPAT of $17m to $21m, which means second half NPAT could be somewhere between a loss of $1m and a profit of $3m. Management is anticipating at least two to three months of sales and supply chain challenges in China. And outbreak-related disruptions will heighten costs involved with new product launches.

In addition to the Coronavirus effects, materials and packaging costs associated with the company's manufacturing transition are expected to put a $13m dent in NPAT. The Board also chose to refrain from paying a first half dividend in the interest of conserving cash for operations.

### Pet industry, China are key growth engines

Blackmores offers a wide range of vitamins, minerals and herbal supplements that improve the health of people across 17 Asian-Pacific markets. But it's the company's Pure Animal Wellbeing (PAW) line of pet supplements that is becoming an increasingly important part of the business.

It just announced a new strategic direction that will target sustainable profit growth. This will include strengthening its domestic business with a focus on better profitability. The key aspects of the strategy are improving the customer experience through education, getting more out of marketing expenditures, and expanding its customer base through digital tool enhancements.

A major component of the plan to revitalize its home market is the PAW business. The Australian pet care industry is a $3.9bn market that is expected to grow 9% annually through 2024. The market size in China is forecast to be ten times that figure by the same year. While PAW is the leading pet supplement brand in Australia, investments in the business have been lacking and Blackmores plans to roll out a series of new products over the next year.

In a bold, contrarian move amid the Coronavirus epidemic, it also announced plans to increase its investments in China and Indonesia. Blackmores additionally plans to break into the highly competitive, but potentially lucrative India market within the next 12 months.

### Building off a loyal customer base

The recent headlines have been a tough pill to swallow for shareholders of Blackmores. Much of the stock's more recent decline has been linked to the Coronavirus outbreak given the company's significant footprint in China and South Korea. Heightened expenses tied to the manufacturing transition will also be a near-term drag on performance but should be transitory.

These near-term challenges may ultimately present an entry opportunity for the long-term investor. Blackmores has strong brand recognition and a loyal customer base that can serve as a launching pad for return to growth. It already enjoys the number one market share in Australia, Malaysia, Singapore and Thailand. Plans for a renaissance in the Australian market look promising and the growth potential in China over the next 5 years is strong especially in pet supplements.

### The patient remains weak and tired

Weighing the near-term challenges with the longer-term opportunity, we take a bullish but cautious stance on shares of Blackmores. Increasing global health consciousness and a burgeoning Asian middle class represent encouraging long-term growth catalysts. However, the forward 12 months P/E of 61x is a stretch, which, with the Coronavirus crisis, is the reason we rate Blackmores as only two stars at the moment. Medium term the growth profile of this company moving into FY21 could allow us to revise our view.

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### U.S. challenges spark analyst fireworks

Treasury had an outstanding FY19 with EPS growth of 17% driven by 27% growth in luxury and masstige brands. The winemaker's interim net profits after tax (NPAT) increased 5% to $229m and EPS also advanced 5% despite a 17% profit decline in the Americas. An encouraging aspect of the report was that the overall operating margin expanded to 23.9% moving the company closer to its goal of achieving at least a 25% margin.

The company lowered its profit outlook sending the shares tumbling 26% in one day. Citing underperformance in its U.S. business, it slashed its previous earnings before interest, tax and SGARA (EBITS) growth for FY20 from 15% to 20% to 5% to 10%. SGARA refers to an agricultural accounting standard and is short for Self-Generating and Regenerating Assets. The U.S. market has

experienced a sudden shift towards low-priced private label wines stemming from U.S. suppliers moving surplus wine across the market for less. This meant Treasury could not recover its costs of goods sold (COGS) in the U.S. luxury space.

Following the surprise profit reduction, a Merrill Lynch analyst berated CEO Michael Clarke regarding its U.S. expansion strategy accusing the company of “destroying value”. Clarke defended the U.S. presence citing outperformance of luxury and masstige wines in the country despite the oversupply conditions. At the same time, he explained the cause of the U.S. underperformance as deep pricing concessions by competitors and the rising popularity of less expensive private label wine amongst other factors. The analyst’s disdain was well placed though as Treasury has always struggled to establish a clear competitive edge in the U.S.

**China, premium brands to drive long-term growth**

The woes in the U.S., however, contrast with Treasury’s success in Australia and Asia where it has achieved solid growth and profit margins are higher. The current Coronavirus epidemic aside, the Chinese market represents a massive growth opportunity for Treasury. In China, westernizing consumers are increasingly turning to wine as their preferred alcoholic beverage. Online shopping for wine is also prevalent and prestige wines such as Penfolds are popular.

Much of the success outside the U.S. can be attributed to consumers’ increasing taste for premium label wines. The company’s 5-year old strategy of showcasing premium brands is finally bearing fruit. Luxury and masstige wine accounts for 69% of Treasury’s sales. Marketing dollars have been increasingly allocated to the company’s most profitable brands including in aggressive campaigns in China.

The global wine market is expected to grow 5.8% annually through 2024 due to more advanced global distribution chains and product innovation including flavoured wines. Treasury is well positioned to benefit from these trends given its expanding global presence, distribution capabilities and strong brand portfolio.

**Great business model**

Going forward Treasury’s performance will be dictated by growth in the ANZ, Asia and EMEA markets and strong global demand for luxury and masstige wine. Challenges in the U.S market will likely persist due to surplus conditions, the emergence of cheaper private label wines and Treasury’s leadership changes. Strength in the business’s other regions, however, should more than offset the U.S. troubles.

The modest earnings growth in FY20 is expected to be followed by stronger growth in FY21 when EBITS growth is forecast to be in the range of 10% to 15%. Treasury’s ability to meet this target will depend on how long tough U.S. market conditions persist, but the target seems reasonable if not conservative, in our view.

Treasury has a differentiated business model focused on global wine sourcing and self-distribution through its network of locally owned teams. While U.S. risks remain, at its current level and a forward EV/EBITDA of 10.6x the stock has a favourable risk-reward profile for those with a medium-term view. However, for now, with U.S. drinkers not helping Treasury, we’re neutral on the stock.

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### Strong Sales Growth, Expanding Margins

Altium makes software used by electronics engineers around the world to design printed circuit boards (PCB). PCB design software is used to make devices like pagers, radios as well as sophisticated radar and computer systems. It is the engine behind the design of next-generation electronic products.

Its FY19 performance included revenue growth of 23% and EPS growth of 41% owing to the success of its "Line and Length" strategy geared towards delivering double-digit sales growth alongside expanding EBITDA margins. Growth was solid across all regions especially in China (37%) where the company recently opened a new Beijing location. Investments in its sales capabilities for the Nexus product line also drove strong Altium Designer sales.

Altium's 1H FY20 results showed a slight slowdown in the business with 19% revenue growth and 1.5% lower net profit after taxes (NPAT) primarily due to a tax expense rate that tripled from 9% to 27%. In the prior period, the company was relocating some of its core assets to the U.S. which led to a more favourable tax situation. The core Altium Designer software had 14% growth and its subscriber base increased 7% to 46,693, approaching Altium's goal of 50,000 subscribers by the end of FY20. A massive 195% jump in Altium Nexus sales also drove results and helped offset the 1% growth in the Octopart business, which is a search engine for electronic components and industrial products. Octopart underperformed because fear of higher prices due to the Trade War which led to an inventory build-up on the part customers, lowering demand for a product like Octopart. The 1H EBITDA margin continued to expand to 39.7%.

### Innovation, Internet of Things Drive Growth

The global PCB design software market is projected to grow at an annual rate of 4.3% and reach US$1.1bn by 2026. The market is expected to experience higher demand across several end-markets for more innovative products that offer new features and have shorter life cycles, all of which are catalysts for Altium. The emergence of the Internet of Things (IoT) and the miniaturization of electronics devices should also be supportive of long-term demand.

Altium's FY20 guidance is for revenue of US$205m to US$215m and an EBITDA margin of 37% to 38%. The guidance may be appropriately conservative given the uncertainty around the Coronavirus and underperformance in the Octopart division. While these macro events are risks to near-term results, importantly, what has not changed amidst the recent stock price downturn is demand for Altium's products and its strong financial position.

The company has established a strong global presence by acquiring 16 businesses since 1998 and inorganic growth will likely continue to be a part of its growth strategy. In April 2019 it acquired Canadian hardware manufacturer Gumstrix to enhance its expertise in embedded hardware development. Gumstrix will be an important driver of a potentially ground-breaking technology that can make electronics design accessible to non-electronic engineers.

### Seeking Market Leadership by 2025

At its December 2019 AGM, Altium's management reiterated its plan to become the market leader in PCB design software by 2025. It is aiming for 100,000 subscribers and US$500m in revenue. It expects this to be accomplished by expanding its geographic reach, scaling its sales capacity, and driving strong demand for its new Altium 365 cloud platform designed to expedite electronics innovation. The new Altium Designer 20 is also expected to see increased adoption with advanced capabilities, like interactive routing, that no competitor offers.

Altium exhibits many of the fundamental strengths that the growth investor finds attractive. It is achieving its revenue growth targets, is experiencing increasing profitability, is debt-free and has a strong cash flow. A 59% recurring revenue structure further supports the investment case. The forward P/E of 51x is far from cheap, but Altium looks well-positioned to meet or exceed the high growth expectations in the medium term. The reason we have two stars on the stock right now is the potential of Coronavirus to make havoc with the stock and the business in the near term.

**Pitt Street Research Pty Ltd**

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