3 APRIL 2020

Stocks Down Under

Losers make the best historians.

- Eric Hobsbawm (1917-2012), British historian.

WAGNERS

A concrete investment case

MOTORCYCLE HOLDINGS

Born to be wild (when the market improves)

SERVCORP

Ain't nothing going on but the rent

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Stocks Down Under rating: ★★★

ASX: WGN
Share price: A$ 0.97
Market cap: A$ 177.8M

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Share price chart

Source: Tradingview

Some of the best public companies to back in a crisis are the ones where the family that founded the company from scratch and then built it are still partly in charge, where the family are well known in their small town, and where their name is still written on the shingle out the front. All of which are good reasons to back Wagners at current prices.

A Toowoomba success story

Wagners is based in Toowoomba, a small town in southern Queensland 126 km west of Brisbane with a population of around 120,000. If you're from that part of Australia you'll doubtless know about the Wagner family, not just because their antecedents arrived in Toowoomba in the 1850s, but because they were the people that created Toowoomba Wellcamp Airport. When that piece of infrastructure opened in 2014 it was the first greenfield, privately funded public airport to be built in Australia in almost half a century. The Wagners were able to build Toowoomba Wellcamp because of the wealth they created with the construction materials company over the previous 25 years.

The Wagner brothers - Denis, John, Joe and Neill - started their company with a single small concreting plant in the Toowoomba suburb of Harristown in 1989. But they didn't stay small. By 2017, when the company did the ASX IPO, Wagners had grown into the largest independently owned cement manufacturer in southeast Queensland with one of the largest precast concrete manufacturing facilities in the state. They'd also developed, in the early 2000s, a composite fibre material for use in construction with better properties than traditional steel or concrete, and they'd invented 'Earth Friendly Concrete' that didn't use the usual Portland cement as a feedstock, but instead used a more carbon-neutral 'geopolymer' made out of blast furnace slag and fly ash.

Both innovations have done well commercially. By FY17 Wagners was doing close to $200m in revenue and $40m in EBITDA, and the IPO, which raised $197m - $100m for the company, $97m for the family to partly sell down - valued the company at $437m.

Dust-up with Boral

In March 2019 Wagners stock dropped heavily, from $3.18 on 18 March to $1.94 on 27 March, after the company announced that it had temporarily stopped supplying cement to its biggest customer, the building materials giant Boral (ASX: BLD), due to a dispute over pricing. In 2011 Wagners had sold its concrete business to Boral and that company was contractually obliged to buy cement from Wagners until December 2021. Only Boral wanted the price to go down and Wagners had vehemently disagreed. Wagners stock kept going down until October 2019, shortly before it was announced that the Boral matter was still going to court, but that Wagners had agreed to resume the supply to Boral of cement products from its massive grinding plant in the Brisbane suburb of Pinkenba.

Just after Wagners and Boral agreed to kiss and partly make up, Wagners announced a rights issue at $1.55 per share to raise $40m. The company wanted to pay down debt in order to better pursue growth initiatives with the composite fibre and with Earth Friendly Concrete. The Wagner brothers, who own 55% of the company, took up their full entitlement, investing a cool $22m. However, they quickly lost money on that investment because the Boral matter was nowhere near being resolved and it had made the last couple of earnings releases look bad.

A low valuation, but uncertainty looms

In the six months to December 2019 revenue was down only 1.2% but EBIT crashed by 84%, to just $2.1m. While sales volumes from Boral were lower during the period, Wagners' high fixed cost base to keep the plant open ate into the company's margins. Also, the Boral matter had bunched up against a concrete market in southern Queensland that generally was under pressure already from an easing off of new building work in the region.

The financial market hated to hear this news. The day of the release Wagners stock dropped 17%, to $1.47. Then came the Coronavirus Crisis of 2020 and Wagners stock was slaughtered without hesitation.

Which brings us back to the point we made above: The Wagner family, still represented on the Wagners board by Chairman Denis and Non-Executive Director John, built this company from scratch and set it up for long-term growth. And they have backed this company at prices much higher than the current share price. We think contrarian investors, beginning with locals who know the story, will take note against a backdrop of a crisis that can end sooner rather than later, thanks to heavy government intervention to prevent the worst of the fallout from the virus.

Currently you can buy Wagners on a P/E of 40.5x for FY20 (ending June 2020), which is optically high due to a very bad 1HY20 (through December). This multiple drops to only 13.4x FY21 earnings and 12.1x FY22. The latter two multiples look inexpensive to us given Wagners' growth potential as well as the potential for a favourable court outcome from the Boral matter. But we won't go higher than three stars on this one given the COVID-19 uncertainty for the construction industry in the next 12 months.

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Share price chart

Source: Tradingview

For the last couple of years now Motorcycle Holdings has seemed to struggle, with unfavourable trading updates in June 2018 and again in May 2019. In October 2017 the company had acquired Cassons, a Sydney-based wholesaler and retailer of motorcycle parts and accessories, and that had led to the expectation that the combined group could reach revenue of $310m and EBITDA of $30m. However, by FY19 the business was at $330m revenue but underlying EBITDA was only $18m.

Can for afford this company's products?

The trouble is that the Australian motorcycle market has been in double-digit annual declines through that time. And while Motorcycle Holdings, which roughly has a 10% share of the market, has done better it is still feeling the competitive pinch. The dynamics of motorcycle sales in Australia has been similar to those for car retailing, which we've seen impacting companies like Autosports (ASX: ASG – see Stocks Down Under for 25 January) and A.P. Eagers (ASX: APE – see Stocks Down Under 30 March). Additionally, tighter lending practices, a stagnant housing market, droughts and bushfire catastrophes have all taken their toll.

Long-term, we expect that things will change. These days motorcycles are no longer a 'low-rent' form of motor transport for kids who can't afford a car, or for disreputable 'bikie' types. By contrast, the customer base tends to older, more financially stable people, often in their 50s, who can afford a quality product like a Harley Davidson. Motorcycle Holdings has spent more than 30 years developing to the point where it can lead this market and it currently sells 8 of the top 10 selling motorcycle brands in Australia.

From humble beginnings

There are three things to really like about Motorcycle Holdings as a business. The first is that CEO David Ahmet, who is the company's largest shareholder with 18% of the stock, really loves motorcycles and has spent his life around them, so he knows the business back-to-front. Motorcycle Holdings effectively started when this former motorcycle mechanic became a partner in the Yahama dealership he worked at in Moorooka in southern Brisbane. It has since grown to encompass around 40 locations.

The second thing to like is that the long-term direction of the business makes sense. Unlike the usual distribution channels for cars, the motorcycle trade in Australia tends to be dominated by small 'mum-and-dad' operations. Motorcycle Holdings has grown largely by bringing the discipline of car dealerships to motorcycles.

Lastly, there's the fact that Motorcycle Holdings spent close to five years in private equity hands before going public, which brought strong financial disciplines into the group. We predict that these qualities will eventually lead to strong growth in EBITDA for Motorcycle Holdings once the usual customers return to the market.

Obviously it's anyone's guess how the market for motorcycles plays itself out during the current Coronavirus Crisis but David Ahmet and Rob Cassen, one of the two Cassen brothers who vended Cassons into Motorcycle Holdings (yes, the surname is spelled differently to the business he helped build), both feel optimistic about the long-run direction of their company after this mess is over. With the shares near an all-time low they've both been recent on-market buyers of the stock, the last a transaction by Rob Cassen on 30 March.

With an EV/EBITDA of 6.6x for FY21 (starting in July) and a P/E of 3.4x, we're with them.

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Share price chart

Source: Tradingview

Servcorp, founded by Alf Moufarrige way back in 1978, has been an early pioneer of what we're going to see a lot more of in advanced industrial countries in the years ahead – office space where there are multiple tenants sharing the same facility. Tenants take small rooms, or even sit in in open plan area shared between various tenants, and with those tenants often having very short rental periods. This sector of the commercial real estate market has been growing rapidly in recent years because of the changing nature of the workforce, where teams come together, disband quickly and where start-ups and small & medium-sized enterprises are a more noticeable part of the economic landscape.

Servcorp is everywhere (and so is the competition)

Servcorp has had a long head start in this sector, so that its 150-160 locations can now be found in 52 cities across 22 countries around the world. Servcorp offices have a classy look and feel to them that almost markets itself. This, plus the fact that the company has been publicly traded on ASX since 1999, should stand it in good stead as the flexible office concept matures. The brand is well known and therefore more likely to be top-of-mind for prospective tenants. And they seem to be everywhere you want to be. Go to New York, for example, and just in Manhattan you'll find a Servcorp at Battery Park and at One World Trade Center, a couple in Midtown and one on the Upper East Side.

The trouble for Servcorp is that it now has serious competition, and not just from IWG plc (LSE: IWG), owner of Regus, or the upstart but still privately held WeWork that Softbank recently bailed out. Other, lesser known players less classy than Servcorp are now getting in on the act, eroding Servcorp's lead. Some are looking to use former retail space that's becoming redundant in a world where people shop less in brick-and-mortar locations, so they may be able to move quickly.

A brand with staying power but a big problem today

This competition explains why in FY20 Servcorp's underlying NPAT rose only 1%, to $29m, even though revenue rose 8% to $337m. The company was basically doing well in regions where there's less competition such as North Asia and the Middle East, but not so well in places like Hong Kong or New York. During the year the company had to close some locations and occupancy only averaged 73%. However, one shouldn't write off Servcorp too quickly as 'so 2015'. In the six months to December 2019 Servcorp increased revenue 9% and as a result saw NPAT snap back 46%, to $17m. And occupancy improved to 76%, although that was partly because of capacity decreases during the half.

Long-run, we think Servcorp will continue to do well and Alf Moufarrige is right to be optimistic about his company. Financially Servcorp is in a good spot, with a $76m cash balance and no external debt as at December 2019.

However, there's a big problem right now. Servcorp's tenants can't occupy their space because they are generally being forced to stay home due to COVID-19. Some of them are hibernating their businesses for a while. And just about all of them don't want to pay rent for space they can't use. Moreover, governments like Australia's are, in effect, backing those tenants. That's got to hit Servcorp's bottom line hard in FY20 and into FY21.

We think Servcorp stock has further to fall due to this Coronavirus-induced disaster. On 18 March the company did announce a 3 million share buyback to kick off on 2 April and we noted above that the stock is below NTA, but neither counts for much until we know when the tenants will come back and work in their Servcorp office as before.

Also, there's still plenty of uncertainty about how lease agreements can be enforced. And how many tenants will still be in business after the crisis passes. For all these reasons Servcorp is Two Stars right now. When the Coronavirus goes back to the bats where it belongs, we'll come back and take another look at Servcorp. Because at the current ten-year low around $2.00 and a FY21 EV/EBITDA of 2.6x this could be a bargain.

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