4 MAY 2020

Stocks Down Under

> *Happiness is your dentist telling you it won't hurt and then having him catch his hand in the drill.*

- Johnny Carson (1925-2005), American television host and comedian

PACIFIC SMILES

Return to the dentist to spark growth

NATIONAL AUSTRALIA BANK

Great opportunity to invest at a 20-year low

THE CITADEL GROUP

Pivot to SaaS model bodes well for long term growth

PACIFIC SMILES

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Stocks Down Under rating: ★★★★

ASX: PSQ
Share price: A$ 1.29
Market cap: A$ 113M

Pacific Smiles Group is a dental practice operator headquartered in the Greenhills area of the Hunter Valley of NSW. As Australia's largest branded dental network, it provides dentists with fully serviced and equipped facilities, including support staff, materials, marketing and administrative services. Its network encompasses more than 569 dentists that conduct approximately 770,000 patient appointments annually. The effects of the coronavirus crisis gave shareholders a cavity cratering the stock from a 2.5-year high. But signs of dental practices re-opening suggest some restorative work can be performed here.

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Stocks Down Under rating: ★★★★

ASX: NAB
Share price: A$ 16.14
Market cap: A$ 50.6BN

Melbourne-based National Australia Bank is one of Australia's largest financial institutions. Founded in 1982, the group offers consumer, business and wholesale banking as well as wealth management and insurance products. It is Australia's top business bank with a 25% share in the small and medium business segment and led by its digital strategy has the potential to grow the personal banking side of the business. NAB has responded well to the COVID-19 crisis offering several forms of support to business and household customers. While moves such as repayment pauses will impact near-term results, they should have a goodwill benefit in the long run from increased customer trust. The stock is trading at a 20-year low and it is hard to imagine further downside from here.

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Share price: A$ 3.47
Market cap: A$ 273M

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Share price chart

Source: Tradingview

Catch-up work can return the company to strong growth

The COVID-19 crisis is having a profound impact on the company's operations. Most of the dental centres have been shut down over the past couple of months. Less than 20% of its footprint has remained open for emergency and other critical work and near-term revenues will most certainly be lower. Given the lack of visibility around the crisis, management has refrained from providing FY20 guidance. Prior to the crisis it had forecast underlying EBITDA growth of 11% to 15%.

As the pandemic subsides, Pacific Smiles should benefit from a wave of Australians returning to their dentists for routine and procedural work. The Australian Health Protection Principal Committee (AHPPC) recently announced the lifting of some restrictions on dental practices that will allow for a wider range of services to be provided. Pacific Smiles began re-opening most dental centres on 27 April. It expects that 70 of its 93 locations will be operating in the short term and the remainder may soon follow pending COVID-19-related developments. As patients return to the dental chair in volume, we believe Pacific Smiles could see a catch-up effect in its financial results rather quickly.

Prior to the coronavirus outbreak, the company was experiencing strong growth that will likely continue once operating conditions normalize. In 1HY20 patient fees were up 14.5% to $105.4m, revenue grew 14.2% to $68.3m, and same centre growth accelerated to 9.4%. This was due to broad-based growth across the network as new surgeries were performed and facility utilisation maximised. Its underlying EBITDA increased 15% to $12.9m and net profit after taxes (NPAT) was up 11.2% to $5m driven by the strong patient fee growth and efficiency initiatives.

These results are consistent with the company's remarkable history of patient fee and EBITDA performance, both of which have increased every fiscal year since FY09. Four new dental centres were added to its footprint in 1HY20.

New centre additions to drive long-term growth

Pacific Smiles has a manageable balance sheet. In FY19 borrowings increased because the company tapped into its debt facilities to fund new centre rollouts. Investment in new centres also caused the property, plant and equipment balance to increase from $50.1m in FY18 to $55.5m in FY19. In 1HY20 alone, the company recorded capital expenditures of $6.9m for the new centres, an automated sterilisation system, the commission of 13 surgeries, the relocation of its Salamander Bay practice, a bulk purchase of dental chairs, equipment replacements and an IT network upgrade.

Its growth model is based on organic growth rather than making acquisitions. The company has established a long-term target of having 250 dental centres, which would equate to approximately 800 dental chairs. It is also projected to give the company a market share of over 5% and represents a significant ramp in its growth from the current 93 locations. The rollout however will be performed gradually to strategically expand its geographic footprint across Australia. Pacific Smiles is still very much in the early stages of its growth with almost one-third of its centres having been in business for less than three years.

Customer satisfaction scores brighten outlook

This organic growth strategy is reasonable and attainable considering the dental network's satisfaction ratings among customers. Granted, not many people enjoy a trip to the dentist, but all things considered, Pacific Smiles has achieved very high net promoter scores. In a recent survey, over 80% of patients scored Pacific Smiles as a 9 or 10, the highest possible customer satisfaction scores.

As business conditions normalize, we believe Pacific Smiles can regain the momentum it had in 1HY20. The stock market will likely reacquaint itself with the company's long-term growth record soon and bring smiles to the face of its investors. The shares are not cheap at an EV/EBITDA of 39.9x for FY21, although we believe this multiple is distorted due to the Coronavirus Crisis. It normalises for FY22 at 10.5x. Pacific Smiles offers a 3% dividend yield and has solid prospects for continued long-term growth, in our view.

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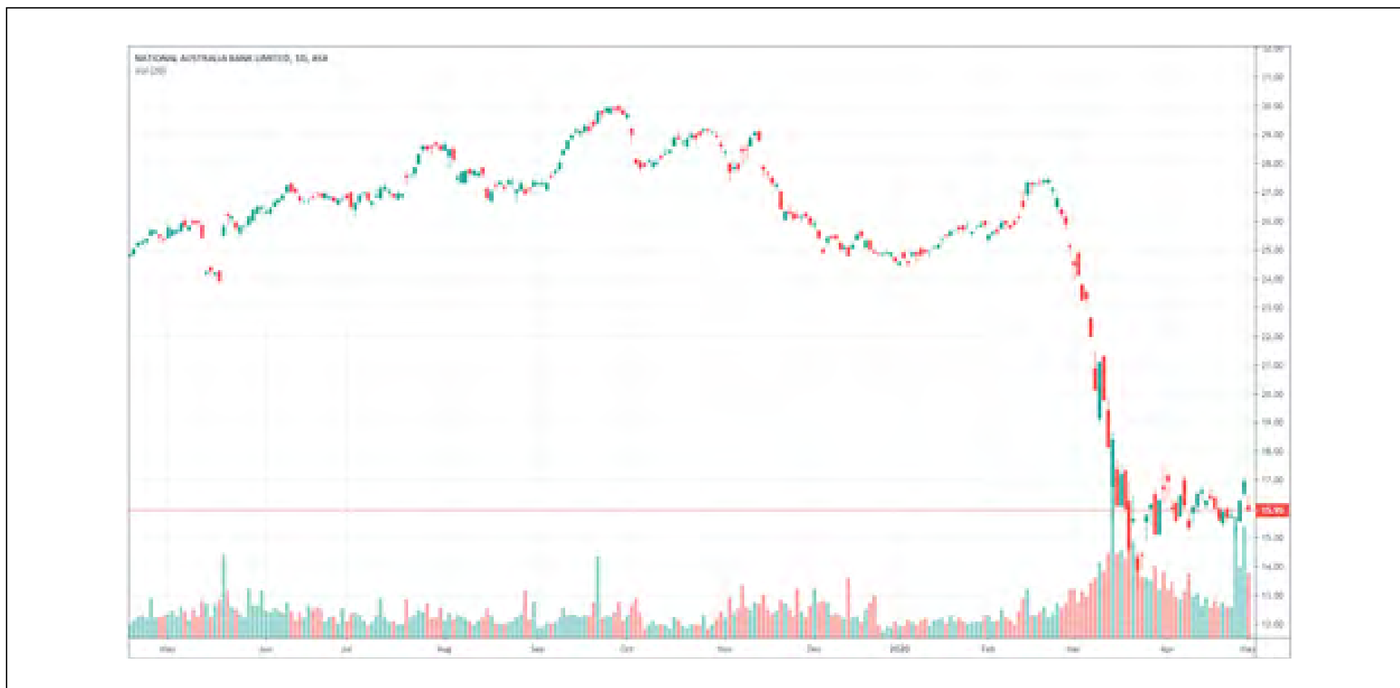

Source: Tradingview

Recent results suggest strong 'return to normal'

The COVID-19 crisis has certainly weighed on NAB's business and caused the company to have a cautious near-term outlook. Underlying profit fell 8.1% in 1HY20 from $5.1bn to $4.7bn. This was largely attributed to lower earnings in the corporate and institutional banking division. Moreover, its provision for expected credit losses (ECL) was $4.8bn as of 1HY20, which is $807m above the September 2019 figure. This includes a combination of business loan and mortgage customer losses with the retail, travel, hospitality and commercial real estate sectors expected to account for the bulk of repayment slowdowns.

In the long run, however, we believe the bank will not be excessively hurt by the current repayments pause. There is good potential for its business lending franchise to benefit from a better market standing following the current crisis. Strong results in FY19 bode well for a 'return to normal'. Australia's GDP is expected to rebound in the fourth quarter. By this time, NAB should have already begun to see more normalized business conditions and a financial performance that looks like it did in FY19.

NAB has received strong support from the Reserve Bank of Australia (RBA) throughout the crisis. This has strengthened its leadership position in the small, medium and agribusiness lending markets. In March, the RBA took an accommodative stance in cutting the official cash rate to support the ability of Australia's big banks to lend to struggling businesses and consumers. Soon thereafter NAB announced a series of initiatives to improve the cash flow of Australian businesses and households. This included the option to pause home loan repayments for six months, a 0.60% reduction in 1 to 3 year fixed home loan rates, a 1% reduction in small business loan rates and an option to defer business credit card payments and loan repayments.

High capital adequacy, transformation progress

A big part of why NAB may emerge stronger from the COVID-19 crisis it its high degree of capital adequacy. It has recently engaged in a series of capital raising activities to solidify its already strong capital position. It has underwritten a $3bn institutional placement and a share purchase plan that is targeting to raise approximately $500m. As a result of these and other moves, its common equity tier 1 (CET1) has become a healthy 11.2%, strengthening from 10.4% in September 2019. This has provided a buffer to help with credit losses and has given the company to ability to offer continued lending support to customers.

Despite the challenging economic environment NAB has made solid progress with its business transformation plans. It achieved its target for 'broadly flat' expenses in FY19, has generated $934m in cost savings year-to-date and is well on its way to reaching its FY20 cost saving target of more than $1bn.

It has also made strides on the technology front by asserting its cloud first agenda. One-third of its IT applications have been migrated to the cloud, which has increased app reliability and led to lower costs. NAB is becoming a slimmed-down version of its former self in terms of product offerings and fees. More than 60% of basic consumer product sales are now done through its digital channels. It offered 412 products as of 1HY20 compared to roughly 600 in FY17 and over 250 bank fees have been removed since September 2018.

Attractive dividend yield and valuation

Like most major banks, NAB has faced the difficult decision between maintaining its strong balance sheet and returning cash to shareholders. Despite the recent 60% cut in dividend to $0.30 for the interim period, the current yield is more than 5% for FY21 on today's "new normal" share price. The dividend payout ratio of only 35% suggest there is plenty of room for potential dividend increases as the economic environment improves. At 11.2x FY21 earnings NAB shares are trading at a 20-year low and it is hard to see them going much lower.

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Share price chart

Source: Tradingview

IT support for Government, Education and Healthcare

Citadel is one of Australia's leading software and technology companies specialising in secure information management services for enterprises that operate in complex environments. Its solutions provide real-time data and information to support the business decisions made by companies in the healthcare, education, national security and defence sectors. Citadel's healthcare solutions hold more than 28 years of data and support 50,000 daily transactions. Some of Australia's leading education providers depend on the company to manage its IT content and collaboration services. It is also moving into the financial services sector to capitalize on rising demand for IT solutions.

The company reported strong 1HY20 results that included a 24% increase in revenue to $61.1m driven by a 19% increase in software revenue and a 25% increase in services revenue. Citadel has historically generated industry leading profit margins, but its gross margins decreased to 41.2% and gross profit grew only 8.2% to $25.2m. This, however, was due to the company's move towards a recurring software revenue model that has lower margins but a longer contract length. This led to a 5.3% decline in EBITDA to $12.5m, but a closer look at the transition underway shows the softer profitability to be transitory.

Citadel 2.0 strategy drives growth opportunities

Citadel has developed into a pure play software and technology company through the transformation of its Citadel 2.0 strategy. The growth-focused strategy emphasises cross-selling initiatives, strengthening distribution channels, moving into new markets and the development of software-as-a-service (SaaS) solutions. The SaaS initiative is particularly interesting because it will create an annuity style revenue model, shorten its sales cycle and diversify its client base. Since the Citadel 2.0 pivot, SaaS contract revenue has grown considerably. Business significant contracts, i.e. those that have a large lifetime value, increased from 14 in FY18 to 25 in FY19 leading to strong SaaS revenue growth. SaaS revenue now represents more than 30% of overall revenue and the company estimates that its subscription-based business will become 60% to 70% of the company over the next 2 years.

Citadel's background in secure IT solutions should continue to serve as a foundation to achieve global scale and growth. The timing of its entry into the SaaS business is good given that the global cloud service market is expected to reach US$278bn by next year and continue to see strong growth throughout the decade. Growth in financial services cloud spending is expected to be especially strong at 23% annually through 2022.

Wellbeing acquisition expands global footprint

Citadel has successfully undertaken several acquisitions since becoming a public company in 2014. The recent $200m acquisition of United Kingdom healthcare software company Wellbeing has the potential to deliver meaningful upside. Wellbeing has grown nicely over the last 25 years and its digital solutions for health care providers are a strong complementary fit with Citadel's healthcare platform. Wellbeing generates 70% of revenue from recurring software sources and delivered an impressive 39% EBITDA margin in CY19.

Citadel has a strong balance sheet that supports its various organic and inorganic growth initiatives. Since branching out into the private sector, it has delivered solid organic growth by diversifying its solutions and software offerings. We believe it has large opportunities ahead in government, education and healthcare and the build-out of its SaaS platform should drive long-term sustainable growth. The market's recent reaction to the 1HY20 results reflects a misunderstanding of the long-term opportunity, in our view. Citadel shares are trading at a P/E multiple of 15x and an EV/EBITDA of 6.3x, both for FY21, which starts in July. This is not expensive in our view. On top of that Citadel offers a dividend yield of more than 3%.

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Pitt Street Research Pty Ltd is founded on more than 40 years of combined experience researching companies in a range of different sectors.

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