8 MAY 2020

Stocks Down Under

Education is the progressive realisation of our ignorance.

- Albert Einstein (1879-1955), German-born American theoretic physicist

RESMED

Too expensive right now

TURNERS AUTOMOTIVE GROUP

Slow momentum, but nice yield

GUD HOLDINGS

Weathering the automotive recession

RESMED

Too expensive right now

Stocks Down Under rating: ★★

ASX: RMD
Share price: A$ 24.95
Market cap: A$ 35.7BN

Headquartered in San Diego, California ResMed is a US company that provides cloud-connected medical devices for people who suffer from sleep apnea, chronic obstructive pulmonary disease (COPD) and other chronic diseases. Its value proposition is based on keeping people out of the hospital by offering products that professionals can apply in a home or care setting thereby reducing costs for both consumers and healthcare systems. The industry leading respiratory care company has generated average annual earnings growth of 9% over the last five years and has plenty of breathing room for more growth.

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TURNERS AUTOMOTIVE GROUP

Slow momentum, but nice yield

Stocks Down Under rating: ★★★

ASX: TRA
Share price: A$ 1.54
Market cap: A$ 132M

Based in Auckland, New Zealand, Turners Automotive Group provides financial services for the automotive industry in New Zealand and Australia. The thinly traded stock has seen its price cut in half since its $3.00 February 2018 ASX debut amid a challenging market for cars. Management resumed a share buyback program in August 2019 because it believed the share price did not accurately reflect the value of the business and it may have been right. However, in 2020 the COVID-19 crisis has had adverse effects on the business and we're not sure Turners can regain the momentum it had before the economic downturn.

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Share price chart

Source: Tradingview

Very large undiagnosed global market

ResMed has experienced reliable growth in the Continuous Positive Airway Pressure (CPAP) market as more and more patients have been diagnosed with obstructive sleep apnea. In fact, sleep apnea, COPD and related chronic conditions are global health epidemics. Over 80% of sleep apnea is undiagnosed. Most people do not even know they have it and it can lead to strokes, diabetes, obesity and heart failure. More than 380m people worldwide have COPD and a large part of the undiagnosed population resides in high-growth markets like China, India, Brazil and Eastern Europe. COPD costs the US healthcare system around $50bn per year.

ResMed has over 90 million patient accounts in its out-of-hospital care network and over 13 million patients are part of its core AirView monitoring ecosystem. Despite its track record of growth, the sleep apnea and COPD markets remain underpenetrated. As health care providers and patients face rising costs, the need for value-based technology solutions has never been greater.

The connected health company has over 11 million cloud-based medical devices being used worldwide and more than 6,000 patents and designs. With approximately 7% of revenue invested in R&D, it has focused on innovation introducing several new award-winning products used to diagnose, treat and manage sleep apnea and COPD. The products have been well received by the global market because they improve patients' quality of life, reduce the impact of chronic disease and lower healthcare costs. Last quarter ResMed launched its first tube-up full-face CPAP mask called AirFit F30i, which makes it easier for people to sleep in any position.

Ventilator production ramps up amid COVID-19

ResMed has become aggressively involved with the production of life support ventilators, non-invasive ventilators and ventilation mask systems to contribute to the dire need for these items amid the Coronavirus pandemic. Increased ventilator production has become the company's focus in recent months as it has set out to help COVID-19 patients breathe easier while their immune system fights the virus.

ResMed's recent quarterly results again demonstrated strong performance due in large part to heightened demand for masks amid the COVID-19 crisis. Third quarter FY20 revenue grew 16% to $769.5m and operating profits were up 31% year-over-year. The gross margin expanded from 58.4% to 60.0% and earnings per share jumped 45% to $1.29. The improved profitability was the result of a more favourable product mix and manufacturing and procurement cost efficiencies. The growth was well diversified across ResMed's product portfolio and software solutions as well as geographically.

The company's SaaS business is an important driver of future growth. ResMed's software solutions are designed to improve patient care in out-of-hospital settings. The sleep and breathing devices can be monitored by healthcare professionals remotely and, therefore, at a much lower cost than in a hospital. The SaaS division represents recurring revenue and is becoming a larger part of the business. In the latest quarter SaaS revenue increased 12% driven by continued growth in its Brightree and MatrixCare service offerings. ResMed has a rich history of making SaaS acquisitions dating back to 2012. Its most recent SaaS buyout was US respiratory care technology provider Snapworx in January of this year.

Solid balance sheet for difficult times

ResMed is producing best-in-class medical devices and software globally. It has established itself as a leading provider of ventilators and other COVID-19 support for governments, health authorities, hospitals, physicians and patients. Beyond the current COVID-19 demand boost, we believe it has solid growth prospects in the respiratory medicine field with opportunities for further geographic and digital health product expansion.

The company's balance sheet is in good shape with a large cash balance of $352.9m and $900m in unused borrowing capacity that should enable it to remain resilient in the current economic environment. From that perspective, ResMed is a stock that can help investors sleep better at night.

Too expensive right now

Our problem with ResMed right now is valuation. The stock is trading at an EV/EBITDA multiple of 25.6x for FY21 (starting in July) and 23.5x for FY22. We never have issues with valuations like this if companies are expected to demonstrate EBITDA growth in the same proportions, i.e. in this case a year-on-year EBITDA growth of at least 25%. However, after a projected EBITDA jump in the current financial year, in part due to COVID-19, EBITDA growth for FY21 and FY22 is only expected to amount to 3% and 8% respectively.

In other words, there is a clear disconnect between valuation and growth at ResMed right now to the point that we believe a correction may be in order. So, we'll put this one to bed for now. Two stars.

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Share price chart

Source: Tradingview

Growing share as market consolidates

Over time Turners has been able to grow its market share in the used car industry that continues to see consolidation. Turners had strong FY19 and 1HY20 financial results. In 1HY20 underlying net profit before taxes (NPBT) increased 11% to $14.8m on a 1% increase in revenue to $171m. Earnings per share, however, declined 18% due to a one-time $3.5m gain on a property sale that was recorded in the first half of FY19.

The COVID-19 pandemic has had a profound impact on New Zealand's automotive market. Turners has seen its business "heavily disrupted" in recent months as consumers have stayed home and away from auto dealerships. Nevertheless, it expects its FY20 NPBT to be within its original guidance range of $28m to $30m and has noted that it was on track to reach the high end of this range prior to the COVID-19 outbreak. Before the pandemic, the used car market was robust. It has historically been resilient during down cycles in the economy because consumers tend to favour used vehicles over new. Going forward, the low interest rate environment and general need for older cars to be replaced should be supportive of demand.

Braced for an economic downturn, Turners is in good financial standing and operating well within its bank covenants. It has a strong balance sheet that includes over $20m in cash, which allows it to continue to invest in growth opportunities and conduct further share buybacks when appropriate. Its financial position was recently solidified with the extension of its BNZ loan facility from $200m to $250m. Management's interests are well aligned with the success of the company because 28% of issued shares are controlled by the Board and other executives.

Improving loan quality, property investment

Over the last few years, Turners finance business has emphasized higher-quality lending and become a stronger part of the company. Through its Oxford unit, Turners has improved its use of technology and credit data to better manage credit risk and approve higher quality loans. In the 11-month period ending 20 February, the average credit score for new consumer loans was 568 compared to a 534 average in FY19.

Moreover, like what it experienced during the global financial crisis of 2008-09, Turners is likely to see an uptick in business at EC Credit Control as corporate customers take on a higher debt load. Commission income surged 90% in the two years following the global financial crisis.

Investing in property has also become a key part of Turners growth strategy. In 1HY20 it delivered the new North Shore cars site and three more retail branches are under development and scheduled for a 2020 opening. It also has five additional branches that are being planned for 2021 and beyond. On the leased property side, Tuners has been negotiating lower rent payments with property owners during the lockdown period and has also been aided by government stimulus programs.

Well-positioned to shift gears back to growth

Improving retail sales have earned Turners an increasing share of New Zealand's used car market, which is currently around 7%. This business has stalled during the COVID-19 crisis as low auto retail and credit management activity has hurt.

But this should be somewhat buffered by the company's diverse business model, which includes the annuity style revenue it receives from the finance and insurance segments. Three of its four business units have been designated as "essential services" within the government's financial institutional guidelines.

The near-term risks are significant but given its leadership position in the used vehicle industry, Turners is in a good position for a turnaround when the economic environment begins to normalize.

Dividend yield of more than 10%

At today's "new normal" share price around $1.50, Turners is trading at a P/E of just 6.3x and EV/EBITDA of 9.4x, both for FY21, which we believe is reasonable. What's more interesting, though, is the company's dividend yield of more than 10%. If the company can maintain dividend going forward this could be very interesting for the yield junkies.

We'll give Turners just 2 stars for the weak near-term outlook for the automotive market and 4 stars for its valuation and dividend yield, so 3 stars on average. If you like dividends, this may be a stock for you.

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Share price chart

Source: Tradingview

If you want to understand why a lot of investors hate GUD's guts right now, you need to know a bit of history. It starts with a failed attempt to build a successful manufacturing conglomerate between 1992 and 1998, followed by 20 remarkable years of building shareholder value largely from what was put into that conglomerate.

The house that Ryco built

Once upon a time very few investors in Australia had ever heard of GUD, even though the stock had been publicly traded since 1959. They probably did know GUD's only business, which was automotive oil, air and fuel filters sold under the highly recognisable 'Ryco' brand. By 1992 that was a $70m a year operation, but under CEO Ian Beynon the company started acquiring underperforming manufacturing businesses in order to grow, not necessarily in automotive. A typical example was Davey Pumps that GUD bought in March 1995. Davey was owned by McPhersons, a metal products and printing group that was in decline. McPhersons was keen to sell to lower a crushing debt burden, so GUD got a $40m per year market-leading business for just $29m.

For a while that strategy seemed to work but the turnarounds proved harder than expected, leading to the crisis of 1998 when the ex-Pacific Dunlop executive Ian Campbell was brought in as the new CEO. Under Campbell, who was in charge for the next 14 years, GUD started to realise its potential, thanks largely to more talented management who brought better capital and cost disciplines.

The stock rose 8.5% p.a. while the S&P/ASX200 only did 4.8% p.a. Then between 2013 and 2018 Campbell's successor, Jonathan Ling, whose previous port of call had been Fletcher Building in New Zealand, began to slim GUD back to focus mainly on automotive, although Davey was so good that GUD couldn't bear to part with it. Ling's tenure yielded results as well, with GUD rising another 13.9% p.a. as against only 4.4% for the S&P/ASX200.

The mildest of recessions

Which brings us to the current buying opportunity in GUD. The current CEO, Graeme Whickman, inherited a pretty solid suite of mostly automotive aftermarket businesses in 2018 that were impacted by the recession in the Australian automotive trade. The stock fell from close to $14 in mid-2018 to a Coronavirus Crisis low of $7.63 on 23 March. Many investors who discovered GUD during the 1998-2018 glory days are saying this is a Yesterday Company.

We're not so sure. For one thing, the 'recession' as far as GUD is concerned has been very mild indeed. In FY19 the automotive businesses still enjoyed 1% organic revenue growth and underlying EBIT for GUD still rose 6%. As for the December 2019 half when things were supposed to be really bad, revenue was up 3% and underlying EBIT was flat.

Cars in Australia are getting older

Why so mild? Well, mainly because right now the Australian 'car parc' (yes, it's a real word – the industry term for the number of cars on the road in a particular jurisdiction) is aging and features a lot of the characteristics that favour GUD, such as more diesel vehicles on the road and more OEM warranties and service plans. When that has happened elsewhere in the world the aftermarket for cars becomes a lot more important and the nation's leading aftermarket player is – you guessed it – GUD.

Not only does this company have Ryco, it also has Narva (lighting), Projecta (battery management), AA Gaskets (gaskets) and dba (disc brakes) among other names every motor mechanic works with daily.

Currently you can get all this for a P/E of just 13.7x forecast FY21 earnings and just 12.4x FY22. The latter P/E is low given the long-run potential of these brands and the fact that net debt was only 1.6 times EBITDA in December 2019, so GUD has plenty of firepower to still expand by acquisition if it finds the right opportunity.

At least one director thinks that GUD looks inexpensive right now– non-executive director Anne Templeman-Jones was an on-market buyer of shares on 1 May.

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