25 MAY 2020

Stocks Down Under

“Money isn’t everything but it sure keeps you in touch with your children.”

- J. Paul Getty, (1892-1976) oil magnate

WESTPAC BANKING CORPORATION

Attractive risk/reward at these prices

PINNACLE INVESTMENT MANAGEMENT

Strong track record, but not cheap

OFX GROUP

Structural margin decline

WESTPAC BANKING CORPORATION

Attractive risk/reward at these prices

Stocks Down Under rating: ★★★★

ASX: WBC
Share price: A$ 15.01
Market cap: A$ 54.8BN

Based in Sydney, Westpac Banking Corporation is Australia's oldest financial institution and one of the country's "big four" banks. With operations in Australia, New Zealand and the near Pacific region, it provides a full range of financial services including consumer banking, corporate banking, insurance, investment banking, investment management, mortgage lending and credit cards. Since the 20 February peak of $25.69 Westpac shares have dropped 40%. Its big four peers have had a similar demise with National Australia Bank and ANZ shares both down 43%, and Commonwealth Bank shares off 32% over the same period. While pressures related to the AUSTRAC scandal and the COVID-19 crisis remain, the selloff in the stock looks overdone.

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PINNACLE INVESTMENT MANAGEMENT

Strong track record, but not cheap

Stocks Down Under rating: ★★★

ASX: PNI
Share price: A$ 4.04
Market cap: A$ 763M

Sydney-based Pinnacle Investment Management Group is Australia's leading multi-affiliate investment management firm. It offers distribution, infrastructure, and other support to a diverse group of subsidiaries that collectively manage over $61bn in assets. This allows the affiliated investment professionals to focus on what they do best, investments. Pinnacle makes money by earning a share of its affiliates' profits; this amounted to $17.7m, or 38%, of affiliates' profits in 1HY20. With the stock trading at less than half its October 2018 all-time high, we see this a unique opportunity to get in on, what we believe is, the best run investment management firm on the ASX.

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ASX: OFX
Share price: A$ 1.325
Market cap: A$ 316M

Yours truly vividly remembers the fee he had to pay on a money transfer from The Netherlands to Australia when he first moved here. At the time, his new friends at a Big 4 bank, that shall remain nameless, managed to nab a hefty 7% (!) fee on quite a large transfer. With transfer we mean, just receiving Euros from an offshore account, exchanging that into dollars and depositing that money into a local bank account. Not that hard and certainly not worth a 7% fee. Ever since that time, he has been on the lookout for better money transfer options. Ozforex was one of the first ones that offered substantially better service at substantially lower rates.

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Share price chart

Source: Tradingview

AUSTRAC fines weigh on first half results

Westpac's 1HY20 results were rather disappointing. They were the result of the challenging economic environment as well as the company's own internal issues. Profit fell 44% to $2.28bn and cash earnings declined 70% to $993m. Its largest segment, Consumer Banking, suffered a 20% decline in cash earnings, while the Business and Westpac Institutional Bank divisions had 43% and 63% cash earnings declines, respectively. The net interest margin moved slightly higher to 2.13%. Net interest margin is a widely viewed measure of bank performance that reflects the difference between what a bank earns on loans and what it pays on borrowings. Cash earnings were impacted by $127m from additional costs associated with the company's AUSTRAC response plan.

In November 2019, Westpac was found guilty of violating laws pertaining to anti-money laundering, child exploitation and counter-terrorism financing, prompting the resignation of former CEO Brian Hartzer. Australian regulators discovered 23m violations of anti-money laundering laws making it the largest anti-money laundering scandal in Australian history. Regulatory authority AUSTRAC said Westpac failed to abide by money laundering rules and to identify payments which may have been used in child exploitation. The bank recently announced a $1.03bn after tax charge associated with the AUSTRAC proceedings and its response plan. It has provisioned an additional $900m for potential penalties related to the AUSTRAC civil proceedings. This includes remediation costs associated with customer refunds and payments in addition to litigation expenses.

Westpac incurs $1.6bn COVID-19 charge

The COVID-19 crisis has had a meaningful impact on the bank. As one of Australia's largest lenders to homeowners and businesses, it has felt the effects of the hard-hit Australian economy. With unemployment forecast to reach 8.8% in the third quarter, home prices declining and consumer confidence falling, Westpac has offered relief packages and continued to lend. It has deferred mortgage balances, offered special rates and kept most branches open for consumers. Businesses have seen loan balance deferrals, lower lending rates, merchant terminal fee relief and bridge financing.

The company has recently taken significant provisioning related to possible bad loans. Provisioning refers to when a commercial bank sets aside funds in anticipation of potential loss from non-performing loans. Ahead of its half year report, Westpac announced that it took a $1.6bn impairment charge due to the COVID-19 crisis as part of a total impairment charge of $2.2bn. The purpose of the charge was to brace for the potentially longer than expected impacts of the Coronavirus pandemic. While $1.6bn was certainly a large amount, it only represented a 0.1% hit on its common equity tier one (CET1) capital ratio which improved to 10.81% as of 31 March. Regardless, management noted that the virus may still be in the early stages and that the impact on customers and the banking sector remains uncertain.

Westpac has also become more cautious about lending to people that are self-employed. This is because the income generated by this part of the working population tends to me more uncertain and variable in nature compared to those employed by stable corporations backed by a lot of financial resources. This has put an added strain on the self-employed and resulted in Westpac alienating this segment of its customer base somewhat.

Strong capital position, attractive valuation

With Westpac feeling the effects of the AUSTRAC costs and COVID-19 provisioning and relief, speculation is building around the possibility for capital raising and a dividend cut. But despite the challenging environment, the company appears to be well capitalised to continue offering customer support and survive the crisis.

The bank has a tough road ahead to restore healthy growth and investor faith, but we believe the negative headlines are fully priced into the stock. Not even halfway through the year, Westpac shares are down 46%. At 11x FY21 earnings and an expected dividend yield of 6.2% for that year, the shares are worth the risk for the patient, long-term investor, in our view.

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Strong platform puts it at the pinnacle

Pinnacle's strength is its robust underlying platform. It contains a diverse set of 16 specialised investment managers that have a track record of delivering sustained, long-term outperformance relative to their respective benchmarks. The funds managed by the affiliates are invested in Australian equities (45%), global equities (20%), liquid and private real estate assets (20%), liquid and private credit (12%) and liquid alternatives (3%). No single fund manager accounts for more than 15% of Pinnacle's aggregate funds under management (FUM). Combined, we believe these investment vehicles have the potential to deliver strong long-term upside.

Pinnacle is no slouch either. It has highly regarded distribution teams with expertise in the Australian retail, Australian institutional and the increasingly important offshore institutional and wholesale markets. The group was named the Zenith Distributor of the year in 2019, the same year its stock was added to the S&P/ASX 200 index.

The strength of Pinnacle's platform was on full display in the company's first half report. 1HY20 net profit after taxes (NPAT) of $13.8m was 37% higher than the same period a year ago. Basic earnings per share from continuing operations were up 33% to 8.1 cents. The strong results allowed Pinnacle's board to declare a fully franked interim dividend of 6.9 cents representing 90% of diluted earnings per share. The company is reaping the rewards of its Horizon initiatives designed to drive long-term revenue growth. This includes an expansion of its offshore distribution channel, a focus on the popular ETF space, and providing services directly to retail customers. It has also begun to place a greater emphasis on servicing new affiliates that have yet to reach profitability to accelerate their collective growth potential.

Coronavirus pandemic slows growth

Pinnacle had been experiencing strong growth before the onset of the COVID-19 crisis. Funds under management were growing nicely, supported by increasing net inflows. Funds under management increased 13% from the second half of FY19 to $61.6bn. Aggregate Retail funds under management were a standout performer in 1HY20 surging 28% from 2HY19 to $11.6bn.

The economic slowdown that has resulted from the COVID-19 pandemic, however, has caused problems for some of the managers under its umbrella. Amid the sharp market downturn, falling asset prices have led to lower portfolio values and asset management fees. As of 31 March 2020, FUM slipped 15% from 31 December 2019 to $52.6bn. This has put in jeopardy the firm's streak of annual FUM growth that dates back to FY13. The retail segment has especially been under pressure although net outflows have thus far been modest. Historically Pinnacle's profit has been back-half loaded, but it is unlikely to experience the usual strong second half due to the expected effects of the Coronavirus Crisis. After recording $13.8m in NPAT in 1HY20, second half NPAT is forecast to be a muted $11.5m.

Strong track record of value-added acquisitions

Pinnacle's acquisitions have largely turned out quite well. This is because it has a knack for identifying strong performing investment managers many of whom have performance fees which align their interests with those of their shareholders. In December 2019, it fully drew down its CBA debt facility to purchase a 25% stake in Coolabah Capital Investments (CCI) for $29.1m. CCI is a leading long-only and long-short active investment grade credit manager that manages $3bn of institutional and retail money. It is also responsible for the Smarter Money Investments product suite and the BetaShares Active Australian Hybrid ETF (ASX:HBRD).

Pinnacle has a strong balance sheet that includes cash of $7.9m. It distinguishes itself from competitors by gathering some of the highest quality investment managers in Australia with a focus on performance and that have skin in the game through equity ownership. Through 30 April 2020, 94% of Pinnacle's investment managers have outperformed their benchmarks over a 5-year period. In our book, that is an exceptional performance.

However, our concern with Pinnacle is valuation. The shares are trading around 27x FY21 earnings and even though Pinnacle has a strong track record, a lot of things can go wrong in the current economic climate. So even though we like the company, we have a neutral view on the shares right now.

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Straightforward business model

Ozforex, later on renamed OFX, got started in Sydney's Northern Beaches in 1998 and has grown strongly since then with the ability to send money to more than 190 countries in 55 different currencies. Today, key growth areas are North America, the UK and Asia, in particular for corporates and online retailers.

The company's business model is quite simple: a client in country A wanting to transfer money to country B can transfer the amount to OFX's bank account in country A in the local currency. Using the current exchange rate, OFX will calculate the amount to be transferred to the account designated by the client in country B, minus its own fee of course. OFX's branch in country B will then transfer that money to the designated account in country B. No money actually moves between countries A and B. OFX simply receives money into its account in country A and sends money out of its account in country B, clipping the ticket in the process. Its fee is around 0.5% on average.

Fees are under structural competitive pressure

OFX reported full year numbers for FY20 last week. Turnover, i.e. the total dollar amount of transactions executed for clients, amounted to $24.7bn, up 4.1% versus FY19. Revenues, consisting of fees and trading income, rose by 6.6% to $137.2m in FY20, while EBITDA grew 6.4% to $38.2m. Judging by the trading patterns on the day of the results announcement, i.e. a clearly higher opening, but a lower close, the market didn't really know what to make of it. However, we think we have a good sense of what's going on at OFX.

When we look at the long-term turnover numbers, we can see an annual average growth of 10.5% in the money value of client transactions from 2014 through FY20, which we think is quite attractive. However, OFX's EBITDA margin has been coming down steadily; from 39% in 2014 to 30.5% in FY20. We believe this is largely attributable to OFX's deteriorating pricing power, i.e. the fees it can charge are coming down.

OFX's so-called Net Operating Income (NOI) as a percentage of turnover has come down from 0.534% in 2014 to 0.507% in FY20. This may not seem like a big drop, but when you apply those percentages to the company's turnover of $24.7bn in FY20 it adds up to a substantial number and accounts for most of the decline in EBITDA margin.

We believe the heart of OFX's problem is competition. While OFX was one of the pioneers in alternative money transfer options, its business model has never been unique, nor has its technology. Over the last six to eight years, other companies with similar models and technologies have emerged, including our favourite TransferWise. These competitors have eroded OFX's margins by offering a superior user experience at lower fees.

No relief expected

We believe it will be very hard, if not impossible, for OFX to increase its margins in this competitive environment. Additionally, we believe the Coronavirus Crisis will continue to pressure transaction volumes for a while as global economic activity has taken a big hit. At an EV/EBITDA of 8.8x and a P/E of 16.6x for the current financial year, we believe there's better value to be had elsewhere. Two stars from us.

Pitt Street Research Pty Ltd

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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.