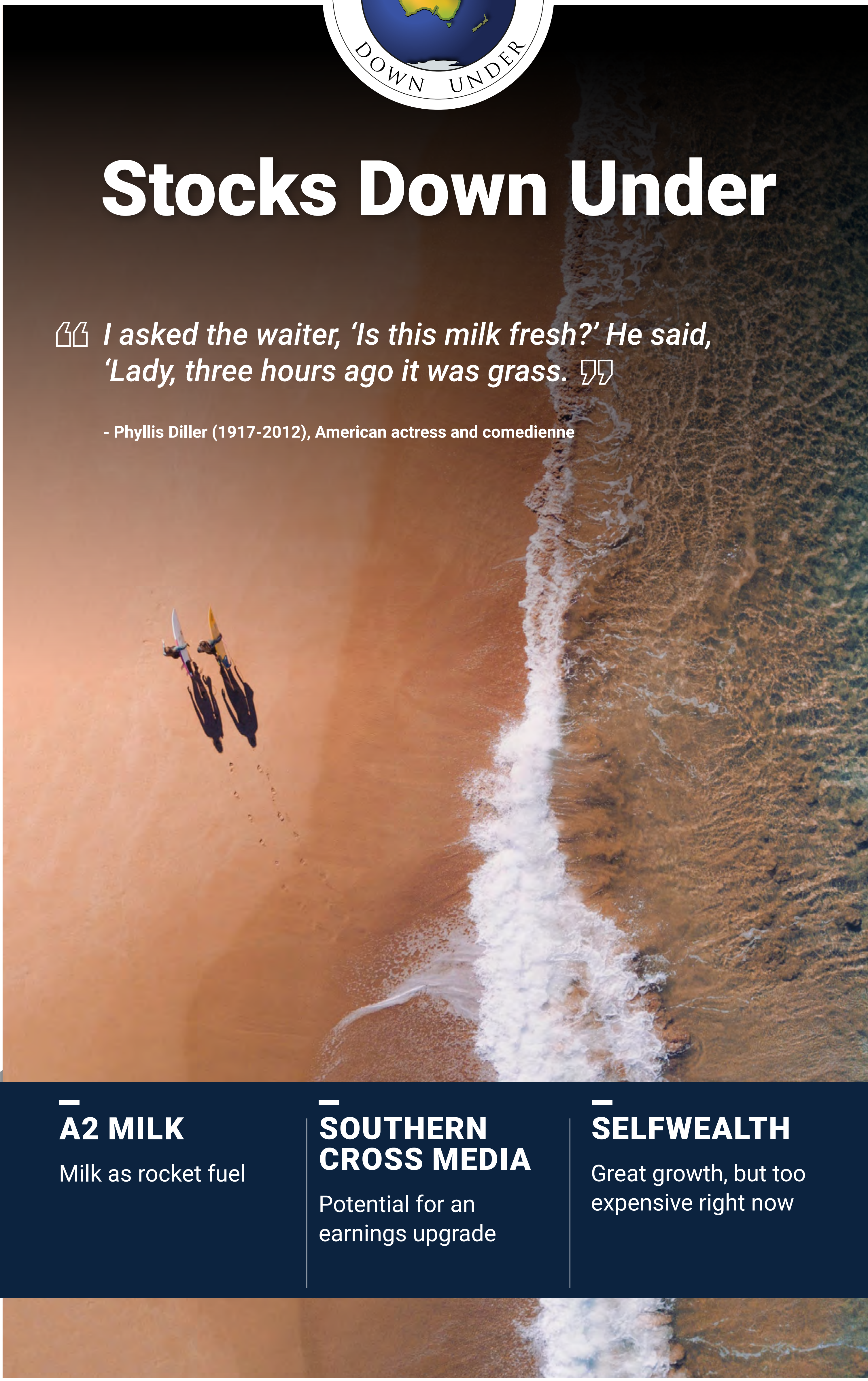
25 JUNE 2020

Stocks Down Under

“I asked the waiter, ‘Is this milk fresh?’ He said, ‘Lady, three hours ago it was grass.”

- Phyllis Diller (1917-2012), American actress and comedienne



A2 MILK

Milk as rocket fuel

SOUTHERN CROSS MEDIA

Potential for an earnings upgrade

SELFWEALTH

Great growth, but too expensive right now

A2 MILK

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Stocks Down Under rating: ★★★

ASX: A2M
Share price: A$ 18.11
Market cap: A$ 13.3BN

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READ MORE

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Stocks Down Under rating: ★★★★

ASX: SXL
Share price: A$ 0.195
Market cap: A$ 515M

First there was an October 2019 profit warning, then there was Coronavirus. These two events helped cut the share price of Southern Cross Media by 80% between late July 2019 and early April 2020. However, we believe Southern Cross Media has the potential to recover strongly from this Annus Horribilis. If there's one thing Australian businesses will need as they seek to make it through the crisis, it's low-cost advertising. And Southern Cross Media, with its more than 80 radio stations around the country, has the solution.

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Share price chart

Source: Tradingview

Ever enjoyed A2 milk? Step into the dairy aisle of any supermarket in Australia and you'll find a whole section devoted to the product, easily identifiable by the purple disc in the front of the carton with a white 'A2' inside and the slogan 'The A2 Milk Company – feel the difference' around the side of the disc. One of us at Stocks Down Under only ever buys that milk, and if it's not on the shelves he goes somewhere else to find it or goes home without it. Never mind that 2 litres of A2 full cream milk will cost him A$5 at Woolworths while the same amount of Woolworths 'drought relief' full cream is only A$2.39.

A lot of loyal customers

Clearly, our man is not alone in terms of his love of A2 milk, because in the year to June 2019 its maker grew revenue by 44%, to A$1.3bn, while EBITDA went up 46% to A$414m. Then in the six months to December 2019 A2 revenue grew another 32% and EBITDA 21%. That's a heck of a lot of loyal customers, and growing all the time, as evidenced most recently by the March 2020 announcement about A2's entry into Canada. Why do the drinkers like it so much, other than it tastes good?

Well, if you turn the A2 Milk carton around you'll see there's a diagram with two cows. The one on the right is half purple has the symbols A1 and A2 on it with a label 'Most regular milk'. The one on the left is all purple has just A2, and that's what you're drinking with this product. Way back in the 1990s, a chemical engineer in New Zealand named Dr. Corran McLachlan (1944-2003) figured out that the milk protein beta-casein A1 had a connection with ischaemic heart disease whereas milk with just beta-casein A2 was good for you. Trouble was, most of the milk on the shelves in Western countries in that day came from high-producing Holstein cows and they had a lot of the bad A1 stuff in their genes. A1 was much less prevalent in breeds such as Jersey and Guernsey. That distinction was the basis of the business plan that became the A2 Milk Company – breed herds whose milk output was free of beta-casein A1 casein, and just sell that milk.

This is not your mother's milk

It may sound like a fad. Milk is just milk, right? Well, up until a few years ago most people knowledgeable about the dairy industry believed that too, which is why, as recently as late 2010, you could have bought the entire A2 Milk Company for maybe NZ$40-50m on NZX when it wasn't much more than a start-up. Those naysayers forgot, however, that even with a product as prosaic as milk, tastes change over time.

If you look at the Stocks Down Under edition for 30 January 2020, we talk about the rise of a small company called Australian Dairy Nutritionals (ASX:AHF), whose big thing is 'organic' dairy. That's new and growing fast. Also new is 'permeate-free milk'. It's on the shelf near the A2 goodies. Permeate is lactose, vitamins and minerals added to milk to standardise its nutritional composition and taste. A noticeable number of consumers have decided fairly recently that they don't want that stuff.

However, changing taste in milk isn't a recent thing. Have you noticed that the milk section of the store seems to be equally divided these days between full cream milk and light milk? One could have made a case in the 1980s that light milk would be a fad. Or think about the evolving relationship between Chinese people and milk. Time was when those folks drank hardly any milk, and knowledgeable people would argue that Chinese biology just wasn't set up to cope with it. Well, these days China consumes 30 kilograms of dairy produce per person per year and Chinese consumers are very interested in anything dairy-related that they can be convinced is good for them. Like A2 Milk.

Worried about your health? Drink A2

The reason why A2 Milk is now a multi-billion-dollar company based in Sydney rather than a niche outfit in a relative backwater like Dunedin is because there's a large over-arching concern people have around the world – health. Switch on the news every night before the Coronavirus Crisis and there would generally be a story about how unhealthy we all were, in terms of our diet and exercise. Many of us remain unhealthy, if the statistics on overweight and obesity are any guide, but we're prone to buy anything that can make us feel better about that. The winners are the companies that can then make good health claims in their advertising, which includes A2 where the published literature in peer-reviewed journals is extensive.

So, it's fair to say that A2 Milk's business can enjoy rocket-emoji-style growth into the foreseeable future. Indeed, in the company's April 2020 Trading Update it reported that business was better than expected. However, sometimes the market pays too much for growth, and we think that's what happening to A2 stock now. Currently, the stock is on an EV/EBITDA multiple for FY21 forecast earnings of about 21x, and 18x for FY22. However, EBITDA for FY21 is only expected to grow about 15%-16% for the next two years as A2 moves further up the adoption curve. In other words, there is a bit of a discrepancy here.

Okay, A2's share price isn't so overstretched that it's pricing the hereafter as well as the future. It is, however, still looking stretched, and that means at some stage the rocket emojis might run out of juice. We expect a consolidation phase for A2's shares in the near to medium term, allowing EBITDA to catch up with the valuation. Which is why we rate this great company three stars rather than four at the moment.

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Share price chart

Source: Tradingview

Way back in 1982 the British punk rock band The Members had a big hit called 'Radio' whose chorus contains the catchy line 'We listen to the radio'. Who would have thought close to 30 years later, after just about every other aspect of life has been digitally transformed, we're still doing what The Members said back then?

Plus ça change, plus c'est la même chose

When it comes to radio in 2020, people who weren't born in 1982 behave just like their parents and grandparents, with the medium on in the background whether they're in the car, the shop or the garage. And more than three-quarters of the time it's commercial radio that's switched on. The difference is that today's listeners are happy to tune in digitally if there's not a conventional AM or FM receiver nearby, as evidenced by the rise of DAB+, which is the digital radio standard that routinely ships in new cars.

How sticky is radio? In the five years to 2019 Australia grew its population by 8% but the audience for commercial radio across the five metropolitan capital cities grew by 10%. And just that big city audience is now close to 11 million people, which in turn is more than 40% of Australia's total population. The typical listener is tuned in two or three hours a day and during the lockdown phase of the current crisis that typical daily listen went up by about a quarter of an hour.

Cost-effective advertising

Now couple that huge audience with the known power of radio advertising, something we touched on in our 11 June article about GTN Ltd (ASX:GTN), the company that supplies traffic information reports to radio stations. There's a large body of research in the marketing world showing that brands spring to mind more easily if they're promoted on radio. Our favourite example of that is a professional services firm in Sydney whose pitch is 'Paul Denny Conveyancing. When all you do is conveyancing, you get very good at it'. This writer last heard that slogan perhaps 15 years ago, but he'd heard it on radio enough to have it permanently seared into his subconscious.

Not only is radio the best kind of propaganda, but the radio station formats allow for a certain amount of segmentation in terms of gender and age range. And, most importantly, the slots are pretty inexpensive, so just about any small business looking to grow can access them right alongside the global brands – and during the day too, not just in the dead of night.

That's why we believe Southern Cross Media has a good shot at recovering some of the lost shareholder value over the next couple of years. In addition to its regional television network around Australia that mostly repackages content from the Seven, Nine and Ten Networks, it also owns the Hit Network and the iconic Triple M Network, where in excess of 80 radio stations convince something like 7 million Australians to lend them their ears every week.

A bad September quarter

Now, we know what you're thinking: If radio is so good and Southern Cross Media has such a great radio network, why has it been such a bad year for the stock? Well, the thing about advertising is that it doesn't always grow in a straight line. Some years will be slower than others. Election years, for example, tend to be slower, as businesses spend less just in case there's an adverse change of government. Last year there was a Banking Royal Commission, so financial service providers were lying low and not advertising. And the housing and automotive markets were in trouble, so they were spending less as well.

It was a perfect storm for Southern Cross Media, which found itself in the invidious position of reporting an 8.5% downswing in revenue for the September 2019 quarter compared to the previous corresponding period. The stock was sent to the dungeons. Interestingly, when we got to February 2020 the revenue number for the whole half was down by only 8% so it looks like the September quarter downswing was an anomaly.

However, before the market could absorb this we had the Coronavirus Crisis and with it a temporary drying up of advertising. Southern Cross Media didn't come into this crisis with a badly overstretched balance sheet – in June 2019 there was $293m in net debt but interest cover during that year had been a very comfortable 13x. However, it could ill afford a prolonged advertising downturn and therefore chose to raise $169m in a deeply discounted capital raising at 9 cents to ensure its survival.

Potential for an earnings upgrade

Which brings us to the present time. We think there's strong potential for Southern Cross Media to reboot its businesses as we come out of this crisis. Remember, in FY19 Southern Cross Media's revenue was more or less flat at $661m but it still eked out a 0.9% improvement in underlying EBITDA to $160m, and both radio and television grew earnings. We think FY19 proves that radio, and even regional television, are viable and growing industries and can continue to grow in the right hands. With the worst of the crisis now behind us, businesses, and particularly smaller businesses, will be looking to grow again and advertising will be a key part of that. Particularly on the radio given post-crisis budget constraints.

Currently Southern Cross Media is trading on a P/E of only 6.9x forecast FY21 earnings, a multiple which drops to 5.8x in FY22. We see potential for an upgrade to the FY22 forecasts, which may prove too conservative as the advertising markets come back to life. The economy may be not so great, but those extra 15 minutes of listening gained during lockdown made the slots on Hit and Triple M just a bit more valuable.

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Share price chart

Source: Tradingview

"Power of the Crowd" concept breeds investor community

SelfWealth markets itself as Australia's cheapest online broker. It currently offers $9.50 trades and does not charge account fees. Aside from being the least expensive, it is also the country's fastest growing flat-fee trading platform for retail investors. Compared to January 2019, the platform saw a 140% increase in active traders and a 185% jump in trade volume in January 2020. This drove a 150% increase in funds under administration (FUA) to $1.86bn and a 107% advance in monthly operating revenue to $480k. The company projects that it will acquire more than 15,000 new active traders in CY20 representing 25% of all new and switching investors.

For $20 a month, SelfWealth also offers access to the "power of the crowd" phenomenon. The concept is based on the notion that subscribers can receive unique, actionable insight from real investor portfolios owned by members of the community. Through a partnership with BGL, the world's leading developer of self-managed super funds (SMSF) administration, SelfWealth receives trading and portfolio data for over 80,000 SMSFs. This enables investors to mimic and follow the top performing funds. With access to a growing social media-influenced investor community, traders can use a variety of benchmarking tools focused on performance and a SafetyRating. The 80,000+ investors are ranked based on performance, diversity and portfolio valuation using the company's WealthCheck score. This creates an atmosphere of belonging and competition that has been become popular with do-it-yourself investors.

The company took things a step further by introducing the SelfWealth SMSF Leaders Fund. Launched in November 2019 with $100m in seed funding, it is the world's first ETF driven exclusively by investor community data. The fund uses the platform's top-performing equity portfolios to construct the ETF comprised of no more than 75 Aussie equities.

Mobile transition targets younger investors

Looking down the road, the company plans to keep the innovations coming so it can stay fresh and relevant to new and existing customers. First, it will be allowing existing clients to add additional accounts, which should lead to more trading per user and more revenue for SelfWealth. It is also in the process of transitioning to a mobile-first mindset. Its mobile app is undergoing a refresh designed to capture younger investors like millennials. Lastly, the group is setting out to harness the high volume of international trades that investors are presently placing elsewhere. This enhancement is expected to go live in December 2020 and 5,000 domestic clients are forecast to be trading U.S. equities by June 2021.

The company is also transitioning to new leadership with Rob Edgley now holding the top post. Edgley, who had been the company's acting CEO since November 2019, was appointed the company's new Managing Director on 17 April replacing company founder Andrew Ward who last year took an extended leave of absence for personal reasons. Edgley gained his experience in international finance and investment banking in Australia, the UK and Asia.

Share price has gotten ahead of itself

SelfWealth's number of active traders has increased every month since January 2018. With this and other monthly metrics exceeding expectations, the group is quickly moving closer to profitability. After peaking around $1.75m in the June quarter of FY18, cash burn was down to around $500k in the December quarter of FY20. Meanwhile, the company's cost per new active trader has come down dramatically over the last two years. In June 2018, this figure was over $700, but today it is well under $100 amid a rapid decline in marketing spend per trader. With the platform is attracting over 1,300 new active traders monthly and marketing efficiencies are driving customer acquisition costs lower, the breakeven point appears to be on the horizon.

The company has a strong balance sheet that includes approximately $1.5m in cash and no long-term debt. However, even though low interest rates and rising equity markets continue to fuel demand for online trading, we believe the SelfWealth share price has gotten ahead of itself, following the surge since early April from around 10 cents per share to 51 cents now.

There are no consensus analyst forecasts available, but looking at the last 12 months through December 2019, the company's Price-to-Book ratio (P/B), often used to value Financials, and Semiconductor companies by the way, was a staggering 73.3x. Meanwhile, EV-to-revenue stood at 25.9x. Granted, these multiples look backwards a year, but even though they will likely be better looking forward to FY21, we suspect they will still be way too high to comfortably invest in SelfWealth.

That's why we think SelfWealth is a 2-star company right now. We need a lower share price before we can become excited again.

Pitt Street Research Pty Ltd

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