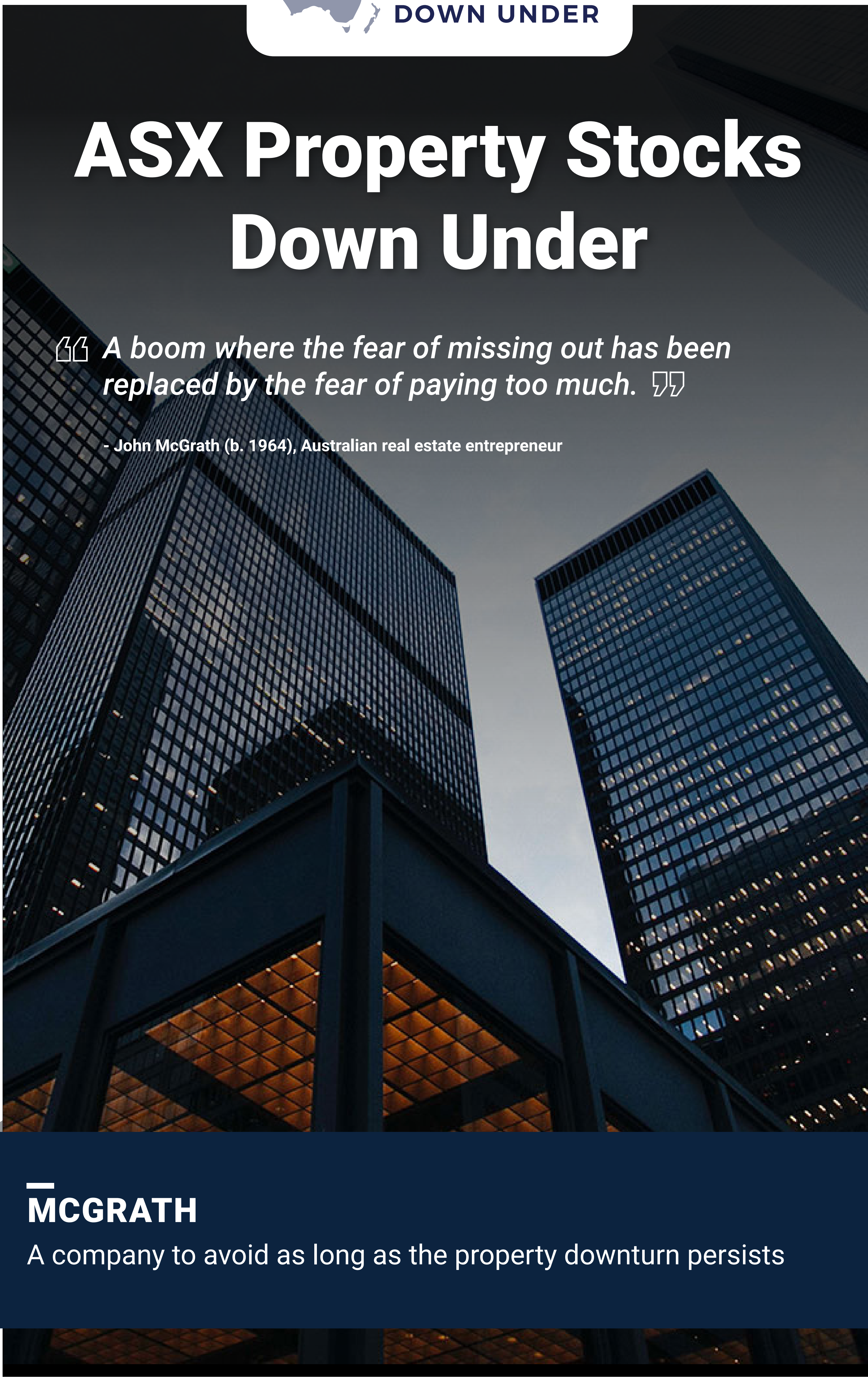
STOCKS DOWN UNDER

25 JAN 2023



ASX Property Stocks Down Under

A boom where the fear of missing out has been replaced by the fear of paying too much.

- John McGrath (b. 1964), Australian real estate entrepreneur

MCGRATH

A company to avoid as long as the property downturn persists

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Stocks Down Under rating: ★ ★

ASX: MEA
Market cap: A$63.3M

52-week range: A$0.30 / A$0.66
Share price: A$0.39

It has been a while since we looked at McGrath (ASX:MEA). This company is best known for being a real estate agent, although it also runs other real estate services, including property management, auction services and even in-house mortgage broking services. The parent company has three sources of revenue: from fixed percentages of total commissions, an ongoing marketing fund contribution (again based on total commissions) and a fixed percentage of the franchisees' property management fees.

Share price chart

Source: Tradingview

A $641.3bn decline in 9 months

McGrath was founded in 1988, named after the surname of co-founder John – who remains at the helm today and holds a 22% stake. The company has endured a turbulent history, especially since it went public at $2.10 a share in 2015, primarily because the housing market has been turbulent, but it has also had significant board turnover. The boom in the housing market during the pandemic helped the company, as we observed when we last covered McGrath in November 2021. It made underlying profits of $13.5m in FY21 and $11.5m in FY22.

However, house prices have fallen as interest rates have risen. Since house prices peaked in April 2022, the last month with record low interest rates, home values nationwide have declined 7%. This represents a $641.3bn decline in just 9 months. New listings during November 2022 on a national basis were 26% lower than 12 months prior and were down by 12% compared to the five-year average. In the month of December, new listings fell by 44% in Brisbane and by 22% in Sydney, Melbourne and Perth.

Where's the bottom?

Where will prices go from here? It is anyone's guess, but most experts suggest it is unlikely prices will rise until interest rates stop rising. Even then, some areas will perform better than others. For McGrath, this will mean subdued new business and lower commissions.

We acknowledge that some investors may be encouraged by the tight rental market, which may bring in new business for the company's property management services. But given that this segment generated just $16m of McGrath's $112m FY22 revenue, we think this would not be enough to cancel out declining revenue from commissions (which were $68.7m in FY22).

So where does McGrath go from here?

It is not all doom and gloom, however. In the longer term, land values only go up. And as migrants gradually return to Australia, new listings continue to dry out and central banks hit the pause button on interest rate hikes, the market could turn sooner than everyone thinks. SQM predicts that a pause on interest rates would be enough to fuel a lift in house prices by as much as 7% nationwide. This increase could be even higher if the RBA began to reduce rates.

Current housing inventory levels are 1.8 months' worth of supply – in other words, it would take 1.8 months for the market to absorb the advertised supply of houses on the market if no more new listings were added. The current housing inventory level is less than half of the 3.7 months recorded during the last national housing downturn between 2017 and 2019. And consider that the average peak to trough decline has been 9 and a half months since records began and no decline has lasted longer than 11 months (at least on a nationwide basis).

There are no consensus estimates for McGrath because there are no analysts covering the stock. It is trading at 5.3x trailing P/E and just 1.7x EV/EBITDA (with a $43.6m Enterprise Value and $25.4m in EBITDA in FY22). We cannot expect McGrath to pay a dividend next year – even though it has for the last two years running, this was the exception rather than the rule. It did not pay a dividend at all between FY17 and FY20.

The housing market alone is enough to give McGrath 2 stars

Beyond the property market, there are regulatory and competitive risks too. Regulations are a particularly noteworthy risk because they vary between different states and can often change. Competitive risk is not just a risk in respect of would-be customers, but even in respect of its own agents – agents can easily switch between firms that may offer a more competitive commission and incentive program.

Ultimately, the biggest influence on McGrath's performance will be the property market and it will be difficult to see the market improve in the short term. Even if that is not the case, the company is in a highly competitive industry and has a record of share price underperformance even during property booms. Even if the recovery in the housing market started sooner and faster than experts are anticipating, we think it would be difficult to see investors deriving a substantial return on this company. Two stars from us.

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