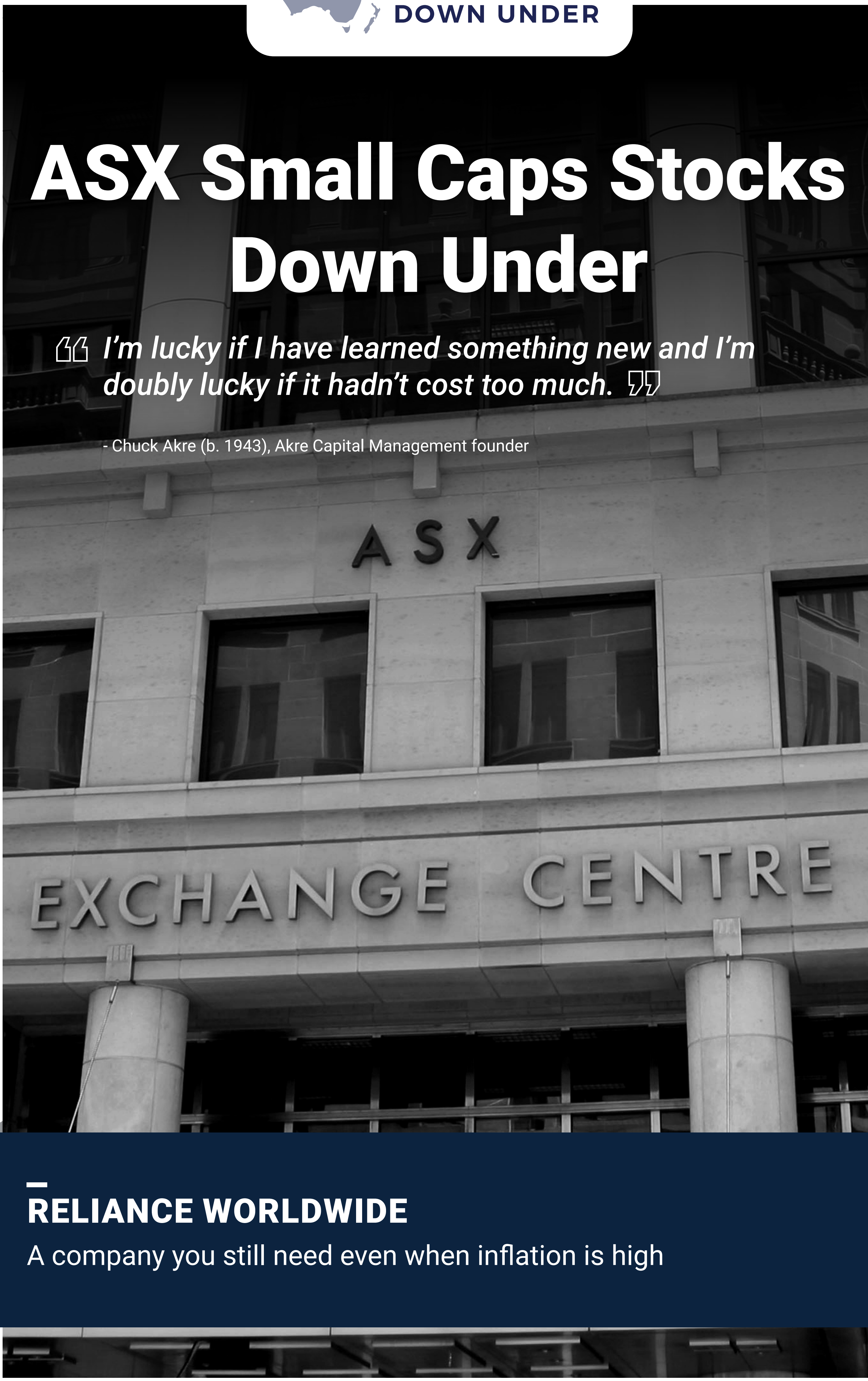
STOCKS DOWN UNDER

30 JAN 2023

ASX Small Caps Stocks Down Under

> *I'm lucky if I have learned something new and I'm doubly lucky if it hadn't cost too much.*
>
> - Chuck Akre (b. 1943), Akre Capital Management founder



RELIANCE WORLDWIDE

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Stocks Down Under rating: ★★★★

ASX: RWC
Market cap: A$2.7BN

52-week range: A$2.80 / A$5.35
Share price: A$3.50

How can companies address inflation? Raise price and cut costs? Perhaps, but this is easier said than done. Plumbing supplies group Reliance Worldwide (ASX:RWC) is a company that is doing just that. And importantly, it can do so because plumbing works are not the kind of service that can be deferred. The company's share price has not been immune to declines, however, as the pandemic-fueled renovation boom ended.

Share price chart

Source: Tradingview

Long-term growth

Reliance began with a single tool shop in late 1940s Brisbane. Today, it has 58 facilities (distribution hubs, manufacturing plants and innovation centres) all over the world and employs 2,800 people. Reliance remained Australia-focused up until the mid-1980s when the Munz family took it over and built it up over a 3-decade tenure. The company listed in 2016 and the Munzes gradually cashed out of the business, completing their exit in early 2019. But taking over the top job at IPO was Heath Sharp, who first joined the company in 1990 and worked his way up over time.

Reliance's flagship product is the Sharkbite range of brass push-to-connect fittings. These devices avoid the traditional soldering of parts into place, saving plumbers time. Another example is the Eastman brand of appliance connection products used by plumbers to connect washing machines, dishwashers, water heaters and fridge ice-makers to household water supplies.

Although the company isn't one that is afraid of undertaking M&A, it is selective in what it purchases. In 2018, it spent $1.2bn to acquire the John Guest businesses in the UK. John Guest provides water delivery, control and optimisation products, and the purchase gave Reliance a significant footprint in the UK. In November 2021, Reliance bought American plumbing products maker EZ-FLO for US$325m. EZ-FLO contributed US$70m in sales during the first four months of Reliance's ownership.

Inflation is a tricky beast to tame

As we mentioned in the introduction, Reliance is attempting to overcome inflation by increasing prices – by 10% in FY22. Getting customers to accept price increases isn't troublesome, given that plumbing work is typically urgent. Two other things are cause for concern instead.

Firstly, the company has a lot of prices to monitor, including the materials it uses in product manufacturing (copper, brass, steel and resins). It is also on the hook for higher packaging and freight costs, not to mention higher energy bills, while getting less bang for its buck than before the pandemic. It now takes 12 weeks for goods manufactured in Australia to be shipped to the US, double what it took pre-COVID.

Secondly, it can take RWC several months to negotiate price increases with customers. By the time they agree to them, prices may have increased even further. At its FY22 results last August, CEO Heath Sharp told shareholders it had moved prices on some items in the UK four times in the last 12 months.

Also keep in mind that even if customers can stomach price increases, other factors are impacting demand as well. These include heavy stockpiling of fixtures and fittings to guard against supply chain disruption, and a shortage of professional tradespeople - leaving a large backlog of work that cannot be completed anytime soon.

Results are strong overall, but some warning signs

We think shareholders should be happy with Reliance's results in recent years. In FY22 (the 12 months to 30 June 2022), sales increased 17% to US$1.2bn and EBITDA increased 3% to US$268.7m. However, the company's statutory net profit declined 3% (to US$137.4m) due to amortised goodwill, acquisition costs and asset impairment charges. The company's cash flow from operating activities was down 44% in 12 months due to high working capital requirements, but was still in positive territory, at US$139.6m.

Looking to Reliance's results by geographical region, America has been performing well, while the UK and Europe have lagged with slower sales. During FY22, sales grew 26% in America, 6% in the Asia-Pacific and just 1% in the UK and Europe. However, America would have grown just 6% if not for the contribution of EZ-FLO. And although EZ-FLO inflated Reliance's earnings, it also inflated the company's net debt, from US$420.8m to US$551.1m, as well as the net debt to EBITDA ratio, from 0.5x to 2.1x. Nevertheless, the company remained in a US$1.1bn net asset position. Reliance paid out 9.5c per share as a dividend, which was less than half of the company's adjusted earnings per share.

Turning to FY23, consensus estimates expect US$1.31bn in revenue, US$285.4m in EBITDA and 20c EPS. Revenue and EPS consensus estimates represent 10% growth in FY23, while EBITDA represents 6%. For FY24, consensus estimate call for $1.34bn in revenue, $292.5m in EBITDA and 20c EPS again. Revenue and EBITDA are both up 2% from FY23. The company's FY23 multiples appear reasonable at 9x EV/EBITDA, 12.6x P/E and 1.3x PEG. FY24 multiples are roughly in line with FY23 at 8.9x EV/EBIDA and 12.4x P/E. The mean price target among the 15 analysts covering the company is $3.93, representing 14% growth from Friday's $3.50 closing price, although estimates vary widely from $3 per share to $5.01 per share.

We think it can walk the tight rope

The key investment risks with Reliance Worldwide are inflation, supply chain issues and inventory management. We think the company has proven resilient to these conditions so far since the current inflation spike first emerged, but also throughout the company's entire seven-decade history. We are expecting to see this resilience in the company's 1HY23 results, which are due to be announced on 20 February.

Although some investors may wish to wait until these results, we think Reliance already deserves four stars.

Pitt Street Research Pty Ltd

3 Spring Street, Sydney, NSW 2000, Australia