Celeste Australian Small Companies Fund

Quarterly stock commentary November 2018

Netwealth

Growth or Value? It doesn't matter, capturing alpha is the objective

Celeste's investment style is often described as value investing. We however tend to think that our investment process leads us to be style agnostic. We look for opportunities where we can capture alpha[1], as we believe this is the best way for us to deliver on our investment objective of achieving 5% outperformance after fees on a 3 year rolling basis. Celeste's investment process is centered on the analysis of a company's cash flows. We wish to understand and assess the quality, predictability and certainty of a company's cash flows by examining the business model, accounting, board & management. We then value the company using what we believe is the most appropriate methodology for that particular stock and its cash flows. Some examples of the different methodologies we use include: Enterprise Value to Earnings before Interest, Tax & Depreciation (EV/EBITDA); Price Earnings (P/E), Price to Book, or Discounted Cash Flow. It is then a question of whether there is an opportunity to capture alpha between today's share price and our valuation.

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1 Alpha definition - Alpha, used in finance as a measure of performance, is the excess return of an investment relative to the return of a benchmark index.

In looking at different valuation methodologies, an interesting stock position that is held in our portfolio is Netwealth. The stock listed in November 2017 and with the share price doubling since then, it is often described as an expensive market darling. This is understandable given the stock is trading on an FY19 EV/EBITDA multiple of 33x and a P/E of 49x. Despite these headline multiples, we believe that Netwealth will generate significant alpha for our investors.

Founded by joint Managing Director, Michael Heine, in 1999, Netwealth is a 'Technology Platform' that allows individuals and their financial advisors to organise and transact their investments. Netwealth has grown Funds Under Administration (FUA) to over $19b, which represents 2.1% market share of the Australian Platform industry. It is currently taking more than 20% of net new flows into the industry.

We value Netwealth using an EV/EBITDA methodology, applying a 15x multiple to our earnings estimates 5 years forward. In our opinion, this methodology best captures the business drivers and the company's ability to scale. We discuss this in more detail below.

As a technology company, Netwealth spends a significant amount of money developing its platform. Importantly with respect to accounting quality, Netwealth expenses all of it's spend on technology development through the income statement. As a consequence, EBITDA is a good proxy for the free cash flow the company generates.

In recent years Netwealth has delivered considerable earnings growth. This is driven by three critical factors: first, the level of Funds Under Administration (FUA); second, the average fee charged on those Funds; and third, the operating margin or EBITDA margin achieved.

With respect to the revenue drivers, FUA and fees, we observe two divergent forces. FUA has grown to $19.3b at September 2018 from $6.8b three years prior. This growth, 41% compounding annually, is largely attributable to financial advisors moving to specialty platforms, such as Netwealth, which offer a superior technology solution to the legacy platforms of major financial institutions. In the wake of the Royal Commission into the Financial Services Sector, we expect this trend to accelerate as Financial Advisors look to provide greater independence and transparency to their clients. In our view this trend is a multi-year event that is likely to gain increasing traction over the next three to four years as many financial advisors work through issues associated with their back-books, such as grandfathered commissions.

On the other hand, the average fee Netwealth and its competitors can effectively charge across these funds is in decline. Over the past two years, the effective average fee Netwealth has charged investors has declined at around 10% annually. In part this is due an increase in average account balances. It is also due to competitive responses from major institutions attempting to protect market share. Going forward, we expect further price erosion will occur in the industry. Combining the growth in FUA with the decline in fees, the underlying trend is best assessed over a longer period than just the next 12 months.

For example, market consensus is for Netwealth to achieve revenues of $103m in FY19. Looking out over the next five years or to FY23, we estimate Netwealth can achieve revenues of greater than $300m or approximately triple FY19 estimates. This implies a compound annual growth rate of 31%. When you then combine this with the third factor, operating (EBITDA) margin, the power of Netwealth's potential earnings growth becomes more apparent.

Netwealth is already a highly profitable business, with operating margins of around 50%. While further investment in the technology platform is required each and every year, only incremental investment in sales and administration staff is required. As such, Netwealth is well positioned to scale its margin to more than 60% over time. Assuming Netwealth achieves such a margin, it implies that at the current share price Netwealth is trading on a FY23 EV/EBITDA multiple of 8.5x and a P/E of 13.2x.

While Netwealth's growth characteristics are clearly attractive, what is of more importance is the quality and predictability of the resultant cash flows. Over the next five years the movement in FUA and fees charged will not be linear. However, given the nature of the industry within which Netwealth operates and management's attention to efficiently delivering a superior technology solution, we believe we have a high degree of certainty over the level of cash flow Netwealth will sustainably deliver to shareholders. In our view, these cash flows therefore deserve to be rated highly, in line with companies that display similar characteristics in our investment universe.

Combining this all together, we envisage a Netwealth share price of greater than $12, some 60% above today's share price, representing a significant alpha capture opportunity.

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2 November 2018