

Fat Prophets take a loss

Integrated pet care player, **Greencross** (ASX.GXL) has had quite a tough year having reported a substantial drop in profits as the vet business saw lower visitation and higher costs. We also expect pressure from lower consumer spending down the road. The final nail in the proverbial coffin is that the company will be removed from the **ASX 200** index which weighed on the shares in the near-term, recognising this, **we take the opportunity to cut our losses and SELL the stock.**

What's New?

In our last coverage of the stock back in May (FAT-AUS-873) we covered a Trading Update where management provided a heads-up that profits will take a hit due to an expected \$16 to \$20 million non-cash impairment from a mix of project costs, redundancies and other one-offs.

Following that, the shares continued to come under pressure with the FY18 results out and indeed showing pressure on the bottomline. Another clincher was that the S&P Dow Jones Indices changes announced at the close of last week showed that Greencross will be removed from the S&P/ASX 200 index by 24 September 2018. This will likely weigh heavily on the shares as institutional funds trim the company out of their respective portfolios. Unsurprisingly, the shares are now trading at 5-year lows

S&P/ASX 200 Index – Effective at the Open on September 24, 2018		
Action	Code	Company
Addition	BIN	Bingo Industries Limited
Addition	ELD	Elders Limited
Removal	GMA	Genworth Mortgage Insurance Australia Limited
<u>Removal</u> →	GXL	Greencross Limited

Source: 07 September 2018 S&P Dow Jones Indices Filing

Before moving on, we'll take a brief look at results for the FY18:

FY18 Results Review

At first glance, with the company reporting a statutory profit of \$20.7 million which is a substantial 50.9% year-on-year drop, would indicate that the results were significantly disappointing. However, it's not as straightforward, in fact the company's results are more aptly described as "mixed" instead of purely bad.

Revenues across the board were up with some units reporting double-digit growth leading to group level revenues expanding 7.5% year-on-year to \$878.7 million. Moreover, the increased focus on higher margin private label brands (for retail) and increased demand for specialist medical petcare have pushed gross margins up 90 basis points to 56.3% and up 9.2% year-on-year to \$494.75 million.

FY18 financial overview

\$ million	FY18 52 weeks	FY17 53 weeks	Change
Sales revenue	878.7	817.5	7%
LFL sales growth (52 v 52-week basis)	4.9%	4.5%	40 bps
<i>Before exceptional items</i>			
Gross margin	56.3%	55.4%	90bps
Underlying EBITDA	97.6	104.2	(6%)
Underlying NPAT attributable to GXL shareholders	37.2	43.0	(14%)
Underlying EPS	31.5	37.0	(15%)
Dividends per share	15.5	19.0	(18%)
<i>Exceptional items</i>			
Recognised in EBITDA	22.8	4.5	n.c.
Recognised in depreciation	1.4	-	-
<i>After exceptional items</i>			
EBITDA	74.8	99.8	(25%)
Statutory NPAT attributable to GXL shareholders	20.7	42.1	(51%)
Statutory EPS	17.5	36.2	(52%)

Source: 20 August 2018

On the other hand, the company's "integrated petcare model" featuring in-store clinics proved to be its undoing, as these seemingly cannibalised sales from their standalone clinics which reported substantial drops in visitations. As such, the **Vet segment** saw underlying EBITDA fall by 17% year-on-year to \$24.6 million.

Other factors that weighed heavily on the result were 'immature' in-store clinics which, according to management, have a "short-term" negative impact. Others include losses from higher labour costs of \$1.3 million in the Animal Referral Hospital joint venture and a \$1.8 million impact from start-up losses in new emergency clinics.

Operating Expenses also surged higher at group level, up 18.6% or by \$65.6 million to \$418.8 million due to the "immature" clinic rollouts, the Joint Venture and a one-off \$19.8 million from IT projects and other impairment costs.

Upon closer inspection though, we believe that it is likely that the New CEO, Simon Hickey coming onboard has used this opportunity to write down asset values early in his tenure and to start FY19 on a clean slate. In

fact, underlying NPAT is only down 14% year-on-year to \$37.19 million versus Statutory NPAT which was down a substantial 50.9% to \$20.66 million.

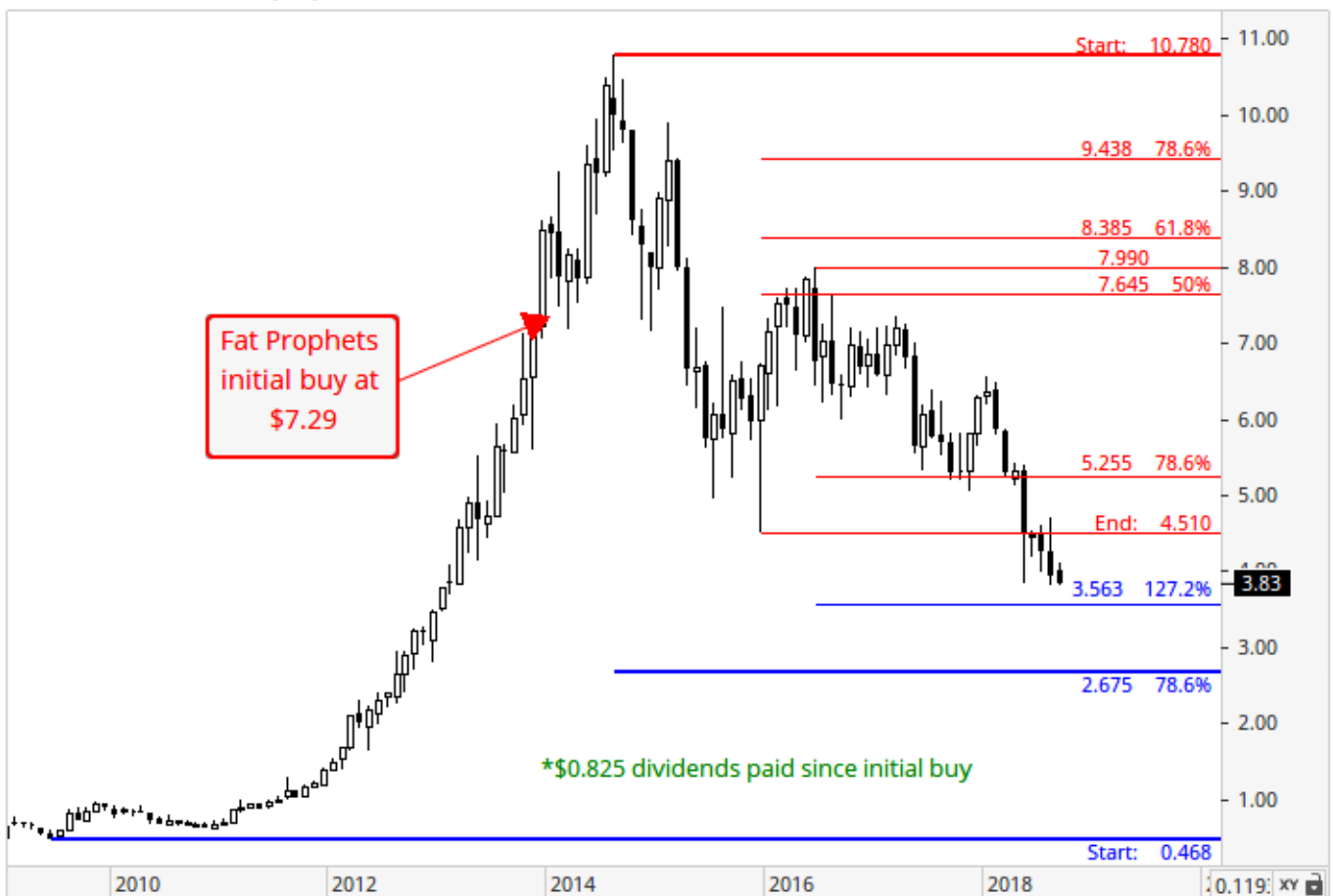
Going forward though, management has provided a positive outlook for FY19 with an expected 8% growth in group revenue and targeting cost savings of between \$10 and \$13 million, with \$5.8 million having already been realised as at 20 August 2018.

However, we believe that headwinds are likely to come around from depressed consumer spending. The ongoing falls in Sydney and Melbourne home prices have reversed the wealth effect from years of price increases, while snail-paced wage growth also weighs down on consumer confidence.

We're already seeing initial signs that consumers have started to tighten their belts, with data from the Australian Bureau of Statistics showing that retail sales in July were flat at 0.3% – its weakest results since March – dragged down by lower sales in apparel (-2%), department store goods (-1.9%) and household goods (-1.2%).

We believe that with the company's execution being lacklustre, makes it incredibly difficult to "fight the tide" and despite that many see their pets as part of the family; that doesn't mean that luxuries for pets is immune to budget cuts.

Greencross Limited - GXL (ASX) - 1 Month CandleStick Chart - AUD



Summary

Looking closely at Greencross's FY18 results, these were mixed with some areas doing well (private label & specialist petcare) while others (vet services) were weak. With external headwinds coming in from reduced consumer confidence and spending, and expected further downward pressure on the shares from index rebalancing, we believe it's time to move on.

Greencross Limited - GXL (ASX) - 1 Day CandleStick Chart - AUD



We recommend that Members SELL their holdings in Greencross (ASX.GXL). Fat Prophets will cease coverage of Greencross immediately.

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Snapshot GXL

Greencross

Latest Closing Price: \$3.80

Greencross (GXL) is a veterinary service provider which has grown impressively through acquisition in recent years, delivering compound annual growth rates in revenues and earnings of 29 percent. Meanwhile the company's successful roll up model of vet clinics has plenty of room to expand, with less than 6 percent of the available revenue market share in Australia.

The creation of Greencross was enabled by deregulation of veterinary industry which removed the limitation of business ownership to veterinary professionals. This, combined with a growing willingness by people to spend more on vet procedures to prolong the life of their pets, has underpinned the company's growth over the past five years.

The company's growth profile could also be turbo-charged further by a proposed tie up with Petbarn, the largest wholesaler of pet products in Australia. Petbarn also boasts a robust revenue and earnings profile, and the merger will create strong synergies between the two businesses.

Market Capitalisation: \$456.5m

	FY1	FY2
Price to Earnings	25.7	12.6
Dividend Yield (%)	3.5	3.7
Price to Book	1.10	0.94
Return on Equity (%)	4.3	7.3
EV/EBITDA	7.9	7.6