McGrath Limited 05/07/2016 **FAT-AUS-780**

MEA AUD $0.960 Spec. **HIGH** **B**

After the dust settles

Investor perceptions of IPOs can be fickle at the best of times, with the high profile failure of Dick Smith, which was laden with debt and spun out of private equity, sparking further cause for caution. The case for a Caveat Emptor approach to new listings has also been strengthened by companies which have revised their original prospectus forecasts within a short time of listing. Not surprisingly the market response in such instances is unforgiving.

The latter is also a sure fire way to erode investor trust, and will usually mean a lot of time will be needed for this to be won back. This though can also create opportunities for those prepared to back the company's efforts to steady the ship and put matters right in the eyes of the market.

And such faith can be rewarded if management is successful in their endeavors. A good example of where this has worked out very well for Fat Prophets was KFC operator Collins Foods, which has continued to make strong operational progress in recent years, despite a disastrous IPO and overly optimistic prospectus forecasts.

McGrath Limited is certainly a more recent example of what can go wrong with an IPO, and fairly quickly. The real estate company raised $129.6 million at an offer price of $2.10, and listed in early December. Within four months management issued an earnings downgrade, with the shares losing more than 30 percent in a single session. Investor sentiment has stabilised somewhat since, but the shares remain around 55 percent lower than their listing price.

Whilst McGrath has many of the ingredients of a botched (from the market's perspective) IPO, we believe there are also many reasons why the shares can win back favour and make amends with investors. A primary source of the earnings downgrade was a lower level of listings, and even with 'certain uncertainty' following the Federal election these should pick up. The company also is well placed to continue growing, albeit more selectively, with a robust balance sheet and no debt.

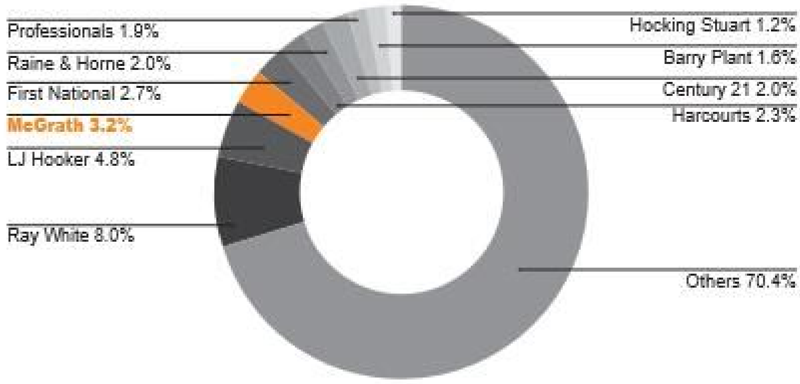
From a valuation perspective McGrath is also appealing, which is not surprising given the trust discount. The shares trade on an earnings multiple of around 7 times, and offer a 3.5 percent yield.

We are therefore recommending McGrath as a High Risk buy to all Members.

Company Background

McGrath was founded in 1988 by John McGrath (recently famed for Shark Tank) who has retained a 27 percent shareholding, and the company has grown to become one of the leading residential real estate service providers in Australia. The company has 87 offices (25 company owned/62 franchised) located throughout the east Coast of Australia. According to the company's prospectus, McGrath had 3.2 percent of the Australian residential real estate market by sales volume in the 12 months to 31 March 2015.

Chart 2.1 Australian residential real estate service market share data by sales value, 12 months to 31 March 2015



Source: McGrath management estimates based on published sales where an agent was recorded derived by McGrath management. Total market value of residential property sales over time based on CoreLogic Data.

Note: Where an agent was not recorded, it is included in 'Other'.

Source: Company Prospectus

The company has a particularly strong presence in the NSW and the ACT, with market shares of 7.2 percent and 5.4 percent respectively according to the prospectus. McGrath has a growing presence in Queensland and also entered the Victorian market at the end of 2015.

Chart 3.17 NSW market share data in the 12 months to 31 March 2015

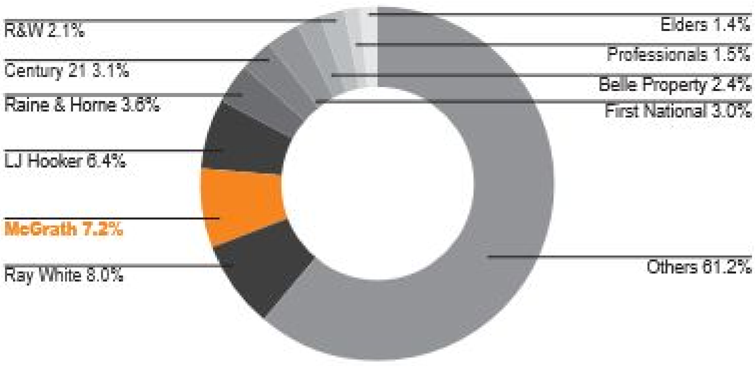
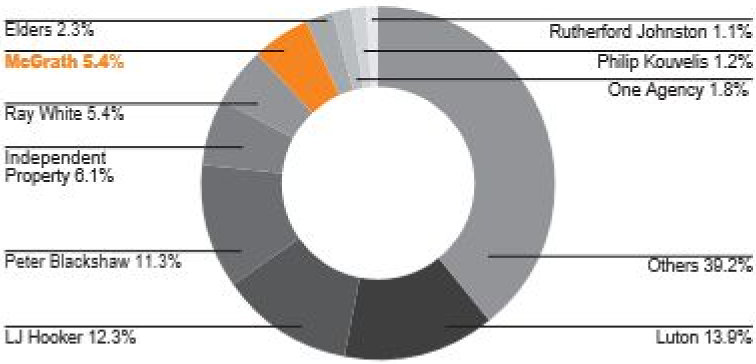


Chart 3.18 ACT market share data in the 12 months to 31 March 2015



Source: McGrath management estimates derived from published sales in data available to McGrath management where an agent was recorded in that data.Total market value of residential property sales over time based on CoreLogic Data.Note: Total market share is based on the total value of properties sold in the 12 months to 31 March 2015. Where an agent is not recorded, it is included in 'Other'

Source: Company Prospectus

A key point about the above market share figures is that McGrath offices have a less concentrated, but arguably more efficient, structure to peers. At the national level for instance, the company's 3.2 percent market share is achieved on 87 offices which compares well to LJ Hooker (4.8 percent share) and Ray White (8 percent) who have over 750 and 1000 offices respectively.

By implication, McGrath also has a significantly smaller concentration of 'shops' with 30-50,000 residences per territory. The company's offices are also 6-7 times 'more productive' earning on average $3.3-3.25 million GCI (gross commission income) annually per office compared to the industry average of $400-600,000 pa.

This also clearly is attractive to franchisees, giving them a larger territory from which to make an economic return. This is evidenced by the fact that franchisees (on a 5+5 year basis) pay a grant fee of $50,000 for each 5 year term. Many competitors meanwhile pay their franchisees to come on board.

And with a very manageable number of 62 franchise offices (and an average of 2 franchises per owner), McGrath is a very 'high touch' business, and management can be intensely across all aspects of the franchise operations.

Business Units

McGrath operates five business units that provide a range of services including residential property sales, property management, mortgage broking, auction services and real estate training.

The lion's share of earnings (around 70 percent) emanate from the group's company owned stores, which charge a commission on property sales, which are shared with agents in an agreed proportion. Profitability in recent years has been underpinned by consistent growth in sales volumes along with agent numbers in recent years as shown below.

Chart 3.4 Company Owned Office property sales volumes from FY2009 to FY2015

Source: McGrath

Chart 3.5 Company Owned Office Agent numbers from FY2009 to FY2015

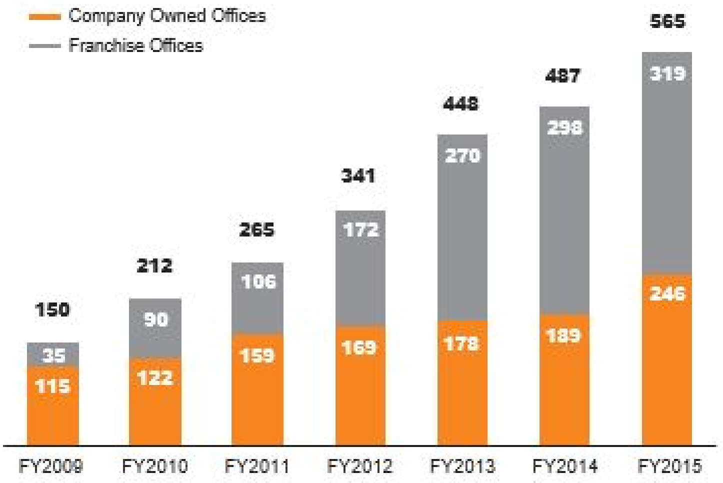
Source: McGrath

The company owned property management operations generate around 11 percent of earnings, and derive commissions for managing properties, and are also paid a letting fee on successful lettings.

McGrath has a sizeable rent roll, and one of the largest in the industry, with over 7500 properties under management. This equates to an intrinsic 'asset' value of around $50 million presently. With a 'churn' rate of 10-15 percent a year this also underpins real estate listing activity. And with properties under management growing at the rate of 1,000 properties a year, this will provide a tailwind to earnings on a number of fronts.

The company's franchise operations are expected to account for around 14 percent of full year 2016 earnings. McGrath receives a grant fee on the issue or renewal of a franchise as well as a fixed percentage fee of total commission received. The 'scarcity' value of McGrath's offices and relatively larger territories (versus competitors) has also been a key attraction for franchisees as mentioned. This has also bolstered the ability of McGrath to attract high quality sales people and also retain them - the company's top performing 50 sales agents in 2015 had an average tenure of 9 years.

Chart 3.25 Number of McGrath Network Agents from FY2009 to FY2015



Source: McGrath

Financials

Looking at the company's financials, and with the above attributes, and buoyant property market, it is not surprising that McGrath has delivered a strong earnings performance in recent years. Revenue has grown from $77.3 million in FY13 to $122.3 million in FY15. Over the same period EDITDA (earnings before interest tax and depreciation) has risen from $10 million to $27.2 million.

Table 4.3 Pro forma historical and forecast segment revenue and EBITDA

YEAR END 30 JUNE	PRO FORMA HISTORICAL			PRO FORMA FORECAST	STATUTORY FORECAST
$ IN MILLIONS	**FY2013**	**FY2014**	**FY2015**	**FY2016**	**FY2016**
REVENUE					
Company owned sales	54.4	72.5	87.1	98.8	83.2
Company owned property management	11.0	12.9	15.6	19.6	17.3
Franchise services	5.1	7.2	9.4	10.7	12.1
Other operating segments	6.8	8.6	10.2	11.9	12.6
Total revenue	**77.3**	**101.2**	**122.3**	**141.0**	**125.2**
EBITDA					
Company owned sales	12.9	22.4	27.6	31.6	24.7
Company owned property management	2.8	3.1	4.0	5.1	4.6
Franchise services	3.3	5.1	5.8	6.3	7.7
Other operating segments	1.1	1.1	1.0	1.6	1.6
Corporate	(10.1)	(10.4)	(11.3)	(13.6)	(19.0)
Total EBITDA	**10.0**	**21.3**	**27.2**	**31.0**	**19.6**

Source: Company Prospectus

A robust bottom line performance has been underpinned by a consistent rise in the network footprint, number of property sales, and average selling prices.

Table 4.2 Key operating metrics

YEAR END 30 JUNE		PRO FORMA HISTORICAL			PRO FORMA FORECAST
	NOTES	FY2013	FY2014	FY2015	FY2016
COMPANY OWNED SALES					
Number of offices at year end		18	18	22	26
Number of Agents at year end		178	189	246	306
Average number of Agents	1	179	189	224	274
Number of property sales		3,618	4,650	4,954	5,733
Value of property sales ($ billion)		3.65	5.17	6.33	7.33
Average selling price ($ thousand)		1,008	1,111	1,277	1,278

Source: Company Prospectus

Looking at the balance sheet, we notice an important difference versus other miscued IPO's. McGrath has no debt, and expects to have cash in the bank of around $10 million at 30 June.

Table 4.6 Pro forma indebtedness as at 30 June 2015

AS AT 30 JUNE 2015 $ IN MILLIONS	STATUTORY 30 JUNE 2015 (AUDITED)	PRO FORMA 30 JUNE 2015
Cash and cash equivalents	2.8	9.7
Current interest bearing loans and borrowings	(0.6)	-
Non-current interest bearing loans and borrowings	(6.4)	-
Net total (indebtedness) / working capital	**(4.1)**	**9.7**

On Completion of the Offer, McGrath will repay existing debt from proceeds of the Offer and McGrath will have a New Debt Facility of $11.5 million which will be undrawn.

Source: Company Prospectus

So what went wrong?

A poor start to the year by the stock market generally, and concerns over the property sector took its toll on McGrath earlier in the year, but the company specific blow to sentiment came on the 18th April. The company noted continued pressure on listings and sales volumes, and downgraded FY16 revenue expectations to $136 to $140 million (versus $141 million in the prospectus) and pro-forma EBTIDA of $26 to $27 million (versus $31 million in the prospectus)

Management specifically highlighted listing pressures in the company owned offices acquired from Smollen Group (for $52 million last year), with these expected to be 25-30 percent lower in the final quarter of FY16 than was anticipated when prospectus forecasts were made. This also compares to pre-existing company owned offices where listings are expected to be flat to slightly lower over the same quarter.

The company noted a continued reduction in Chinese buyer activity in North and North West Sydney where the 11 Smollen offices (now fully integrated) are based. Management also commented that performance related deferred consideration of $2.625 million in relation to the acquisition of Smollen was unlikely to be paid as a result.

The weakness seen in the Smollen areas was likely to impact earnings in the order of $3 million to $4 million, while delays in the launch of several marketing development projects and implementing new IT software would further pare earnings by another $1 million.

As a result, the company said that the final dividend would be 3 to 3.5 cents (on a 75 percent pay-out ratio), down from 4.5 cents in the prospectus.

The market was clearly in no mood for such a re-calibration within a short period of listing, with the shares marked down more than 30 percent on the day of the earnings downgrade.

The Lessons and Outlook

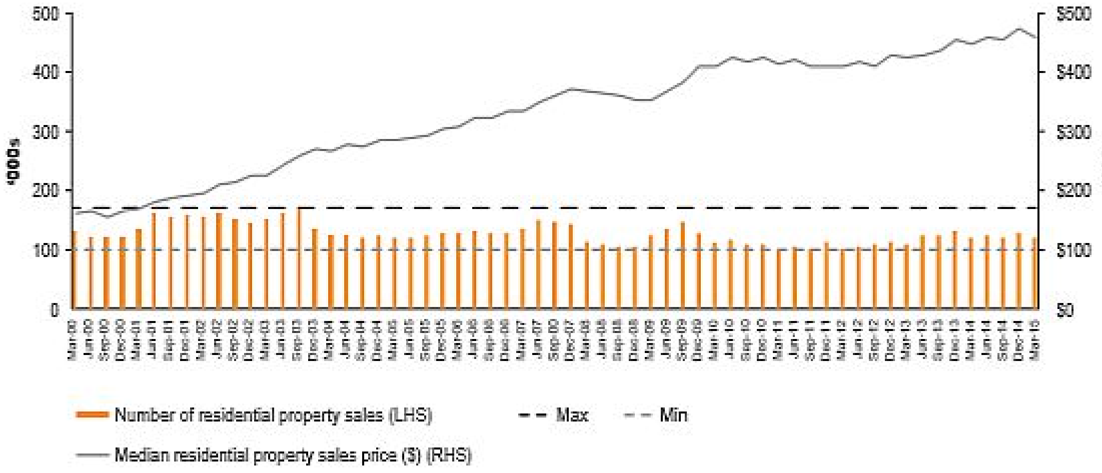
McGrath has paved the way as the first listed real estate agent in Australia, and to date there has been some pain that experience for investors. We do however believe there are a number of reasons to be upbeat about the shares, both from a company specific and thematic perspective.

Firstly, the company has learnt the hard way with its acquisition of Smollen, but we believe management will learn from this experience, applying an even sharper eye and pencil to further deals. Certainly with a highly fragmented industry and strong balance sheet there is plenty of scope for the company to grow. McGrath has set out a five year plan of increasing the number of offices to 175 and over time plans to expand into South Australia, WA, and New Zealand.

In terms of the outlook for listings we believe, this is set to improve, and despite any concerns that the Australian property market has had its day. The company reports anecdotally that although there have been strong volumes of appraisal activity, these have not yet converted into listings; but will. It is therefore quite possible that a cyclical uptick in activity in the Spring will come early.

As is well known the Australian residential property market has been very strong over the past 5 to 6 years, as evidenced in the graph below. We agree that we have seen values peak, at least in the rate of growth. However it is this very tapering of price growth expectations that should reinvigorate listings, even though the Federal election has not given the most conclusive of outcomes. This is as sellers decide that there is nothing wrong with banking some gains, and sitting on the side-lines for a time.

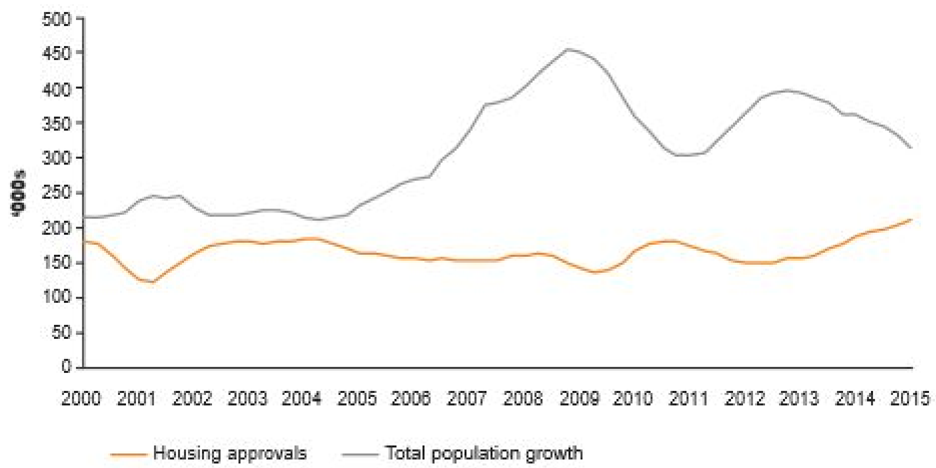
Chart 2.3 Australian quarterly residential property sales volumes and median sale prices from 2000 to 2015



Source: CoreLogic Data

Whilst a sharp correction is possible we also do not see a full scale crash on the horizon with the supply of housing relatively constrained when put against the backdrop of a growing population. We also see the low cost of money remaining in place for some time, which should also ensure that clearance rates remain healthy.

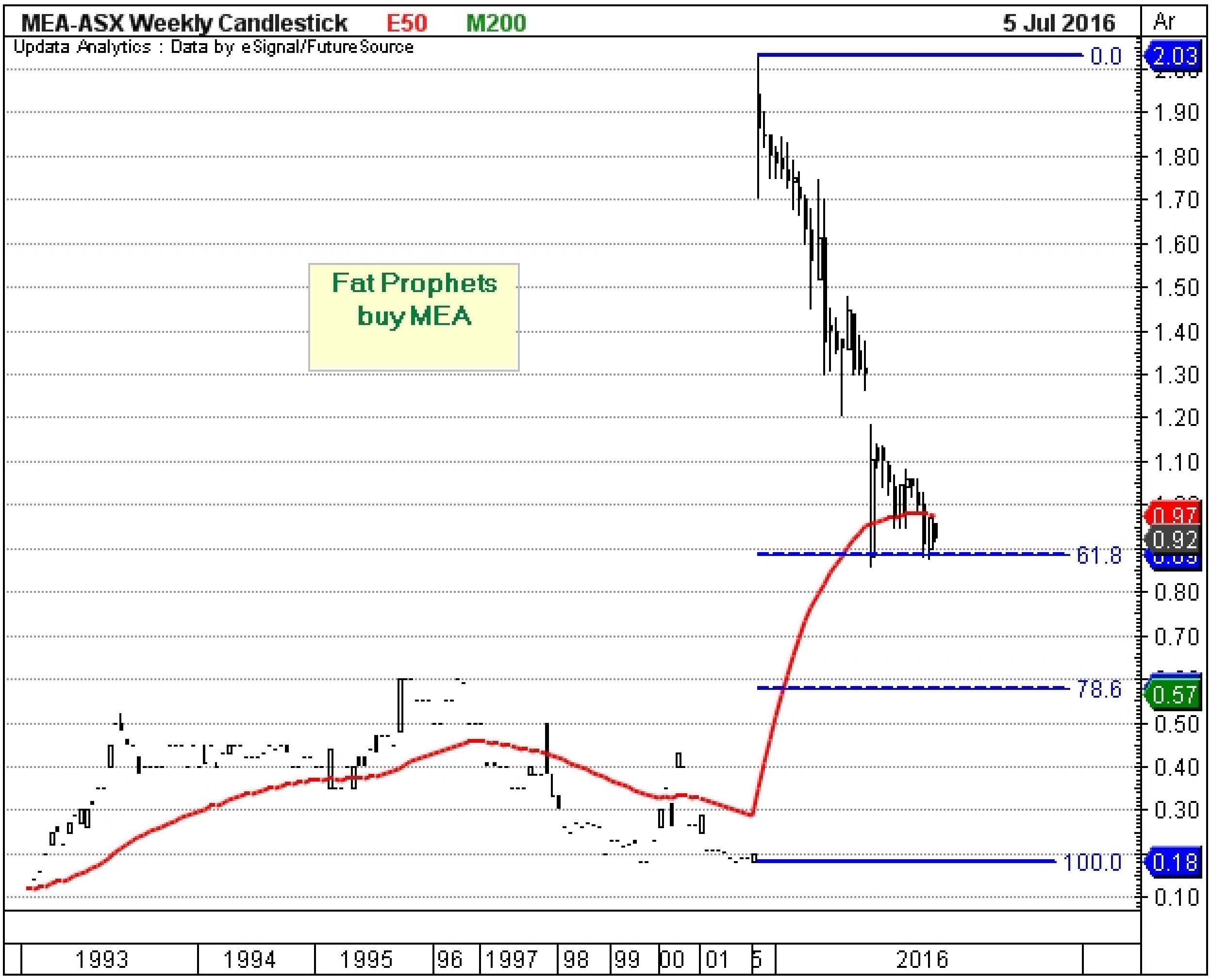
Chart 2.7 Australian annual population growth versus housing approvals from 2000 to 2015



Source: ABS

Turning to the charts, on the daily chart, support was respected at the $0.86 region being the April low. Resistance is located at the $1.05 mark over the near-term. This is made up of both the 50 and 200-day moving averages. A sustained break above this level would swing medium term momentum upwards. Coupled with the RSI moving out from oversold territory this is suggestive of an exhaustion of short-term selling pressure.

With reference to the weekly chart, support was respected at the 61.8% Fibonacci retracement of $0.89, which is bullish. A definitive break above a zone of resistance expected between $0.97 (the 50-week moving average) and $1.00 (a psychological round number), would result in a strong boost of upward momentum. Should this scenario unfold, then further gains would likely follow over the broader term.



Summary

McGrath has not had the easiest of starts to its life in the stock market, and an adverse reaction to 'revised' prospectus forecasts within a few months of listing was understandable. The reaction however had left the shares trading on a compelling multiple of around 7 times earnings, with a 3.5 percent yield also on offer.

It may take some time for the 'trust discount' being applied to the share to narrow, however there are a number of company specific and big picture factors which warrant faith being placed in the shares.

First and foremost, we are heartened by a strong balance sheet, which distinguishes McGrath from some other troubled high profile IPOs. We are also encouraged by the company's degree of operating efficiency, and earnings, given a small relative footprint. This bodes well for strong earnings gains as the company expands its network within and into other states. The company's ability to attract high quality sales people is also underpinned by the larger size of its territories.

While we believe that property price gains have peaked, we also see listing activity being supported by a low interest rate environment, population growth, and housing supply constraints.

We are therefore recommending McGrath as a High Risk buy to all Members.

Disclosure: McGrath is held in the Fat Prophets Concentrated Australian Share, and Small/Mid-Cap Models. The proprietors of Fat Prophets own a stake in McGrath.

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Snapshot MEA

McGrath Limited

Latest Closing Price: $0.96

McGrath was floated on the ASX in December 2015. The company was founded in 1988 by John McGrath (recently famed for Shark Tank) who has retained a 27 percent shareholding, and the company has grown to become one of the leading residential real estate service providers in Australia. According to the company’s prospectus, McGrath had 3.2 percent of the Australian residential real estate market by sales volume in the 12 months to 31 March 2015.

Market Capitalisation:$129M

	FY1	FY2
Price to Earnings	7.0	7.0
Dividend Yield (%)	3.3	7.4
Price to Book	1.3	1.22
Return on Equity (%)	17.46	16.09

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