McGrath Limited 16/10/2018 **FAT-AUS-894**

MEA AUD $0.340 Spec. **HIGH** **S**

Time to Move On

Shares of listed real estate agent McGrath (ASX, MEA) have continued to drift down since our last review despite, some favourable developments on the company specific side. We believe the gloomy investor sentiment is being driven by broader sector developments. With many challenges remaining for bricks and mortar agents within the real estate segment we believe it is time to move on, with more compelling opportunities to deploy funds elsewhere.

McGrath Limited - MEA (ASX) - 1 Day CandleStick Chart - AUD

McGrath has had a tumultuous few years since listing in 2015, with a cooling property market and a depressed level of listings having been a key theme. Our view in mid-2016 that an inflection point was at hand has proven wide of the mark, as industry headwinds deepened, and with sentiment disturbed by a string of high profile departures in the agent team, and senior management over that time.

McGrath now appears to have stemmed the tide on the agent side and we are more optimistic given that senior management that have returned to the business this year, including CEO Geoff Lucas. Agent numbers fell in 2018, but as we discuss in more detail in our review of the fiscal 2018 results, they stabilised in the third and fourth quarter of 2018 and company-owned agent numbers ticked up in July.

McGrath continues to have many heavy-hitting agents as well. According to the Real Estate Business publication, 27 of the top 100 agents were within the McGrath network, up from 19 agents in the 2017 ranking.

The balance sheet has been strengthened by property developer Aqualand taking a 15% stake, with approval granted at an Extraordinary General Meeting (EGM) in late July for it to acquire a second tranche of shares to take its total holding to 15%. McGrath has the first right to discuss being agent for Aqualand's new projects in the coming years, or provide property management services. The agreement has an initial 5-year term. Aqualand has a portfolio of 18 sites in Australia with a collective gross development value of about $5 billion.

Consequently, McGrath's cash balance of $10.9 billion at 30 June 2018, with no debt, will be bolstered by the $4.9 million proceeds from the second tranche of the Aqualand placement.

While we are content that McGrath has stabilised and begun strengthening elements of its business, the headwinds from the macro backdrop are not abating, with continued declines in listing and auction activity referred to by many market participants. Updates from Domain and news surrounding industry disrupter Purplebricks do not bode well for a business leveraged to the housing segment such as McGrath in our view. The technical picture also looks glum and therefore we are recommending exiting the stock.

(Members should note we are more optimistic with respect to Domain Holdings Australia, also covered in this week's report, with the company's footprint more digitally based, and greater operating leverage present).

FY18 snapshot

Looking at McGrath's 2018 results and statutory revenue slipped 23% year-on-year to $99.2 million, largely due to commissions falling over 31% to $61.5 million. Property fee income fell almost 5% to $37.6 million. Revenue was impacted by several factors, including challenging market conditions, fewer agents and net decline in offices, especially in the Franchise network, along with a slowing of the company-owned sales and project marketing business.

Group underlying revenue of $96.6 million at the group level was similar to statutory revenue, with the modest $427,000 difference due to a deferred revenue adjustment in the underlying figure.

Cost of sales was well contained, declining 24%, or slightly more than sales. Statutory group gross profit of $61.1 million was down 23%, in line with the revenue decline. Employee benefits and expenses decreased by lesser percentages than revenue, resulting in EBITDA (earnings before interest, tax, depreciation and amortisation) of $1.0 million, marking a collapse from $15.6 million in EBITDA in FY17.

	Statutory			Underlying		
$m	FY18	FY17	% Change	FY18	FY17	% Change
Total revenue	**99.2**	**129.4**	**(23%)**	**99.6**	**129.0**	**(23%)**
Cost of sales	(38.1)	(49.9)	(24%)	(38.1)	(49.9)	(24%)
Gross Profit	**61.1**	**79.4**	**(23%)**	**61.5**	**79.1**	**(22%)**
Employee benefits expenses	(33.8)	(36.9)	(8%)	(31.8)	(36.9)	(14%)
Other expenses	(26.3)	(26.9)	(2%)	(24.7)	(26.9)	(8%)
EBITDA	**1.0**	**15.6**	**(94%)**	**5.0**	**15.3**	**(67%)**
Depreciation and Amortisation	(7.2)	(7.6)	(6%)	(7.2)	(7.6)	(6%)
Impairments	(59.3)	(2.2)	2620%	-	(2.2)	n/a
EBIT	**(65.5)**	**5.8**	**n/a**	**(2.1)**	**5.5**	**(139%)**
Net finance costs	0.0	0.0	(11%)	0.0	0.0	(11%)
Net (loss)/profit before tax	**(65.5)**	**5.9**	**n/a**	**(2.1)**	**5.5**	**(138%)**
Tax expense	2.4	(1.0)	(340%)	0.6	(1.0)	(162%)
Net (loss)/profit after tax	**(63.1)**	**4.9**	**n/a**	**(1.5)**	**4.6**	**(133%)**

Source: McGrath

It is around here that the statutory and underlying results begin to differ substantially. Some $3.993 million in total underlying adjustments impacting EBITDA include restructuring costs, change in bad debt estimates and other items that the company says are non-recurring in nature. Adding these back and underlying EBITDA came in at $5.0 million, in line with earlier guidance from the company. The following figures provide the reconciliation of the statutory and underlying results.

Reconciliation of statutory to Underlying amounts

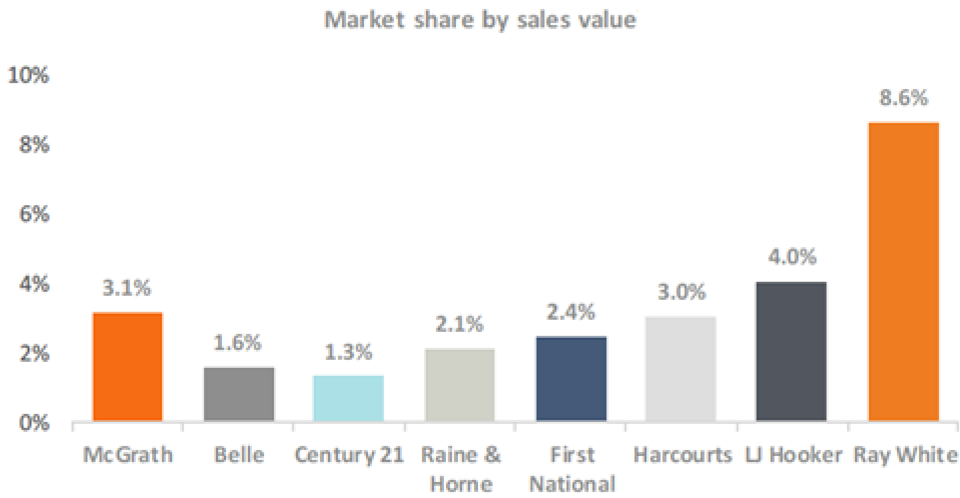
	2018 $'000	2017 $'000
Statutory revenues and other income	**99,176**	**129,363**
Fair value adjustment of deferred consideration		(321)
Deferred revenue adjustment	427	
Underlying revenues and other income	**99,603**	**129,042**
Statutory (Loss)/Profit after income tax expense	**(63,103)**	**4,871**
Fair value adjustment of deferred consideration		(321)
Restructuring costs	1,478	-
Change in bad debt estimates and write off's	951	-
Change in other accounting estimates	809	-
Loss on sale of property, plant and equipment	247	-
Other non-recurring expenses	508	-
Total Underlying adjustments impacting EBITDA	**3,993**	**(321)**
Impairment charges	59,389	-
Tax effect of Underlying adjustments	(1,761)	-
Total Underlying adjustments impacting (loss)/profit after tax	**61,621**	**(321)**
Underlying (loss)/profit after tax	**(1,482)**	**4,550**

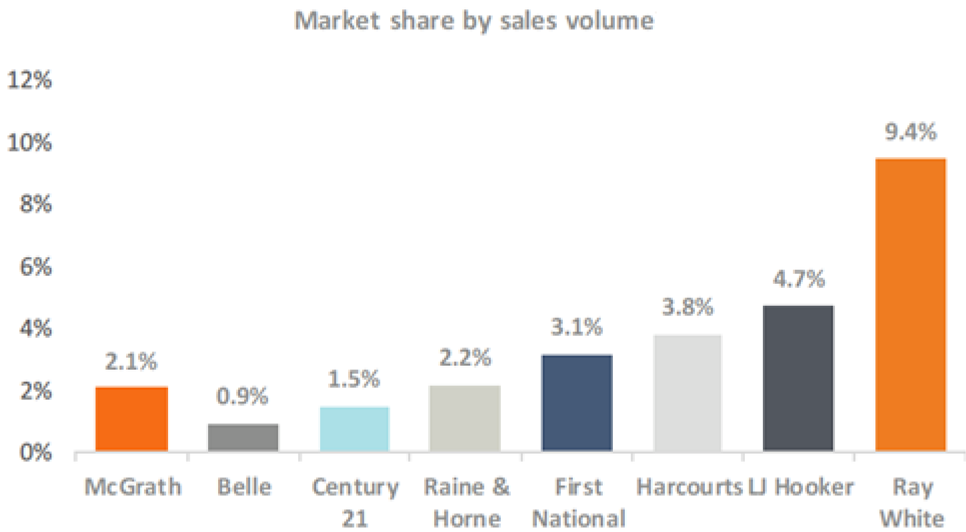
Source: McGrath

A key differentiating factor between the full year statutory and underlying results was the large $59.4 million in impairment charges. The company opted to book a roughly $35 million impairment in the second half against the Company-owned Sales segment, announcing the charge on 31 July 2018. It was in addition to the $21.8 million goodwill impairment against the segment announced in February 2018.

The company therefore reported a statutory loss of approximately $63.1 million in FY18 compared to a profit of $4.9 million the year before. The underlying FY18 net loss was a more modest $1.5 million compared to the underlying profit of $4.6 million in FY17.

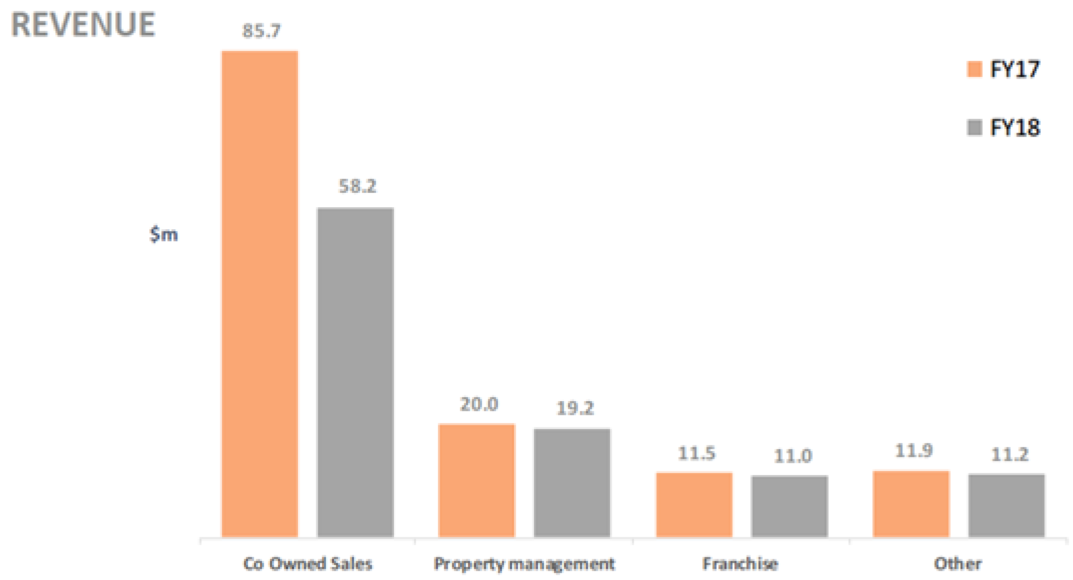
Importantly overall market share was stable between FY17 and FY18 at 3.1% by sales value. That reflects McGrath's strength in the premium side of the market, as its market share by sales volume was just 2.1%. There were market share gains by sales value in three of the four states (NSW, ACT & VIC) McGrath is represented in, with QLD the exception.





Source: McGrath

Looking briefly at segments and company owned-sales was the largest contributor to the decline in sales.



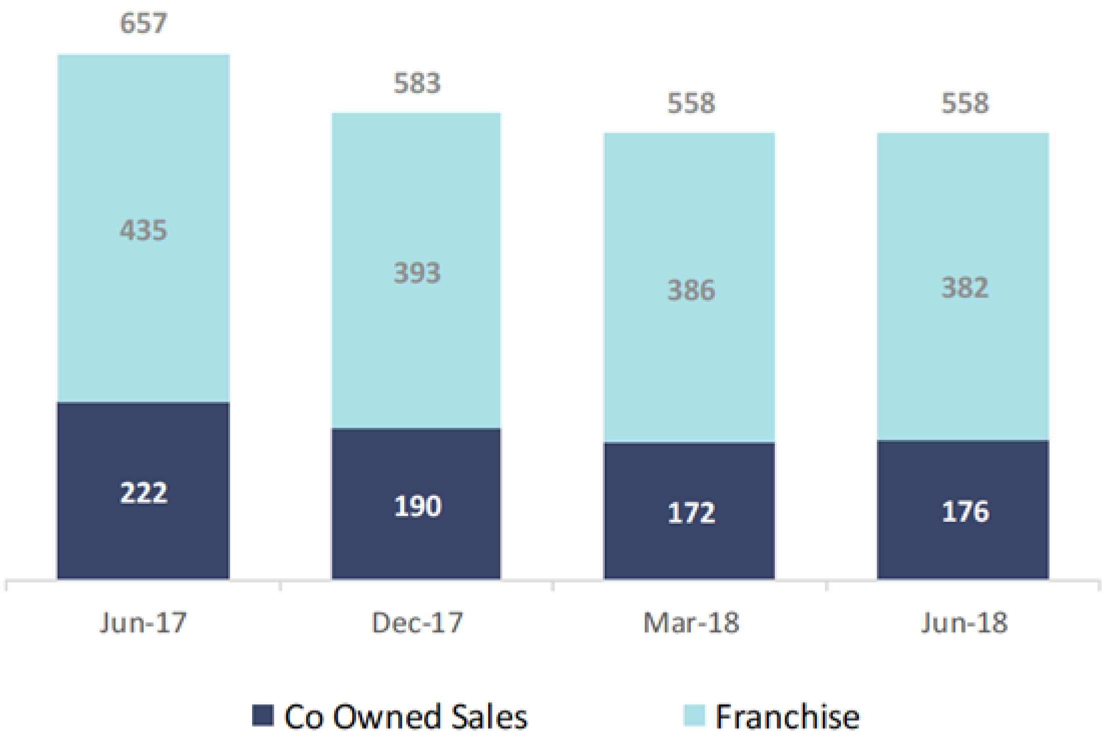
Source: McGrath

Revenue from the Company-owned Sales segment of $58.2 million reflected a 32% drop year-on-year. Some $4.6 billion in sales value during FY18 from 3,002 sales compared negatively to $6.4 billion in sales value from 4,504 sales in FY17.

In FY18 there was a net decrease in offices of two in the company-owned network, with the closure of Seaforth and the transfer of the Avalon office to the Franchise segment. There were 26 company-owned offices at the end of the fiscal year (30 June 2018), with 21 of those in NSW and the other 5 in QLD.

There was a decline in agent numbers over the course of the year, both in terms of total agents and in each of the company-owned and franchise networks. The company-owned network agent numbers fell from 222 at 30 June 2017 to 176 as at 30 June 2018. We note though that these numbers stabilised around the third after management changes and in the fourth quarter the number of agents in this area crept up from 172 in 3Q18 to 167 in 4Q18. The company reported in August that the company-owned network in July increased by 8 to 184.

<u>Agent Numbers:</u>



Source: McGrath

Lower listings volumes, lower agent numbers and lower commission rates combined to result in the underlying EBIDTA for the Company-owned Sales segment tumbling 73% year-on-year to $4.2 million.

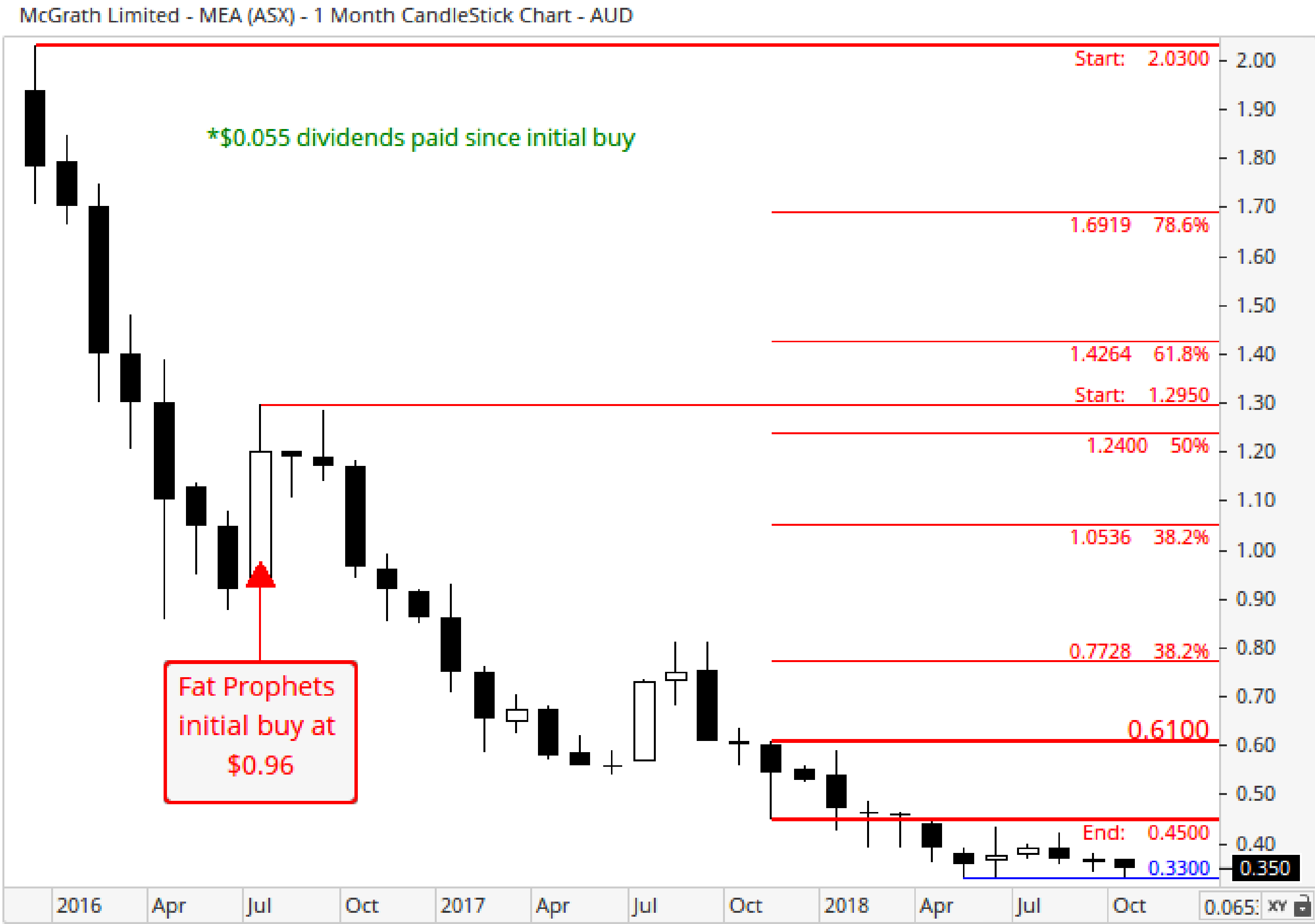
The Company-owned Property Management segment revenue of $19.2 million was down modestly from the $20 million in FY17, as properties under management decreased by 3% to 7,215. The lower number of managed properties and fewer referrals from company-owned sales agents led to underlying EBITDA for the segment to decline 6% to $6.6 million.

The Franchise network revenue declined from $11.5 million in FY17 to $11.0 million in the year to 30 June 2018 on the back of 8,065 property sales. Agent numbers in the franchise channel fell from 435 at the end of FY17 to 382 by the end of FY18 as office numbers decreased. The agent numbers effectively stabilised over the third and fourth quarters. Underlying EBITDA in the segment declined 11% to $6.4 million primarily due to the lower number of agents.

Other operating segments include the mortgage broking (Oxygen), training and auctions services and the 'Other' segment posted an underlying EBITDA loss of $0.5 million, marginally better than the $0.6 million loss a year earlier.

Turning to the charts, and the technical picture has weakened. On the daily chart, prices have entered a corrective phase of the overall technical cycle after printing a high of $6.90 earlier in the year, as marked by the horizontal red line. Support has also given way at the $4.89 region. Dynamic resistance at the 50-day moving average (red line) at $4.98 has also failed to hold. The 2018 low of $4.51 stands as the next buttress.

The technical picture has continued to remain weak with respect to McGrath. Multiple of layers of support have given way over the past few years. That at 33 cents had held through 2018, but any bounce from here will likely be very slow in coming.



Summary

McGrath has had a tumultuous few years since listing in 2015, with a cooling property market and a depressed level of listings having been a key theme. Our view in mid-2016 that an inflection point was at hand has proven wide of the mark, as industry headwinds deepened, and with sentiment disturbed by a string of high profile departures in the agent team, and senior management over that time.

While we are content that McGrath has stabilised and begun strengthening elements of its business, the headwinds from the macro backdrop are not abating, with continued declines in listing and auction activity referred to by many market participants. McGrath also has less operating leverage to an eventual pickup in listings than the likes of the digitally focussed Domain (also covered in this week's report). The technical picture also looks glum and therefore we are recommending exiting the stock, and moving on to other opportunities.

We recommend Members sell McGrath. The stock will be removed from the Fat Prophets portfolio.

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Snapshot MEA

McGrath Limited

Latest Closing Price: $0.34

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:$57.94m

	FY1	FY2
Price to Book	1.38	1.21
EV/EBITDA	9.2	9.0