McMillan Shakespeare: our half-year assumptions

by Roger Montgomery

With reporting season gathering pace over the next fortnight, this is the time we get to revisit the assumptions behind many of our current portfolio holdings. Through large amounts of data crunching, we are also able to compare and contrast management teams and businesses we hold against others that we do not and potentially identify opportunities.

One of the holdings we will be testing our assumptions against – albeit a smaller holding in terms of relative portfolio size – is McMillan Shakespeare Limited (MMS).

McMillan Shakespeare is a business that has been busy trying to reduce reliance on its core remuneration services division through the acquisition of Presidian, United Financial Services and expansion into the UK market.

The key things we will be looking for in their upcoming half-year result follow.

Division one: remuneration services – 78% of FY15 pre-tax profits

Anyone that has modelled McMillan Shakespeare will quickly conclude that the majority of its valuation is derived from its remuneration services division. So a good showing here is important.

This is the core business and since it was founded many years ago, has grown into a large, highly profitable and cash generative area servicing more than one million employees across Australia.

This division provides outsourced administration services for salary packaging, including the provision of motor vehicle novated leases.

Just prior to Christmas, McMillan Shakespeare's largest competitor Smartgroup (SIQ) had a material upgrade, citing excellent growth, leading to a 30 to 40% lift in profitability.

Even though SIQ is a smaller business and growing from a smaller base, at MMS's full year result in 2015, they pointed to improving momentum with a recovery in volumes, particularly in the second half of 2015.

If SIQ's update is anything to go, the momentum MMS experienced should continue into the current half as a result of new contracts awarded in April 2015. We hope to see the momentum supported by a strong pipeline of new business.

Division two: asset management – 16% of FY 15 pre-tax profits

The asset management division finances and provides fleet management services for motor vehicles, commercial vehicles and equipment.

This is a highly competitive market, with pressure on net interest margins and management fees, it provides a relatively a small amount to our overall valuation for MMS, with more weight placed on the higher margin remuneration services division.

The business unit drives cross-sell opportunities and we note that 2015 was apparently a record-breaking year for the Australian new vehicle market, with the industry database **VFACTS** recording total registrations of 1,155,408 cars, SUVs and commercials. We suspect this is a tailwind for transaction volumes.

In their 2015 results, MMS's UK asset management business turned profitable late in the period. This is an immature business with good prospects, and has the potential to be further boosted given:

1. MMS now have scale in these operations;
2. Financed Assets grew from just £7m to £55m in the 2015 year so a further profit contribution is likely to come as these assets mature and continue; and
3. MMS acquired Anglo Scottish Asset Finance in November 2015 for £7.7m, which will contribute two months to the half-year result and also into the balance of FY16.

We are anticipating growth from this division.

Division three: retail financial services (RFS) – 6% of FY15 pre-tax profits (and growing quickly)

This is the newest division within MMS and we are watching closely to see what management can achieve here.

The division provides consumer finance brokerage services, aggregation of finance origination and provision of extended warranty cover including insurance predominantly for used cars.

It is early days for RFS but the cross sell opportunity is large. Effectively MMS can now capture all vehicles rolling off novated leases in asset management, refinance them and up-sell warranties and insurance.

Previously, as a client rolled off a novated lease, MMS had no way to capture this business, which we estimate could be a double-digit percentage churn. This gives MMS the ability to capture repeat business.

Presidian, acquired in February 2015, only made a small pre-tax contribution in FY15. Now the acquired business has been owned for a full six months, its contribution will be much higher and should add to growth.

To give some insight into the cross-sell opportunity, we understand the integration is proceeding faster than anticipated and consumer loan originations of $500m were some 10% higher than forecast at the time of acquisition.

In addition to Presidian, the purchase of United Financial Services (UFS) was acquired in August 2015.

It is also an originator of finance and insurance of around $370m in vehicle and personal loans and $14m in insurance premiums each year. UFS will add to the scale and synergy benefits of Presidian and strengthen MMS's new Retail Financial Services division.

With this scale, MMS' loan book should now be in excess of $1.5 billion allowing MMS to extract better broker funding commissions and potentially secure improved funding arrangements.

The upside and downside

The combination of the growth drivers outlined should see MMS report a strong first half-year result. We will be looking for signposts that point towards a good full year in FY16.

MMS carries a valuation that is undemanding in the context of its growth profile and with approximately $60m of available debt capacity, there is also the chance for more acquisitions.

However, it's not a business for everyone given its exposure to regulatory and government risk.

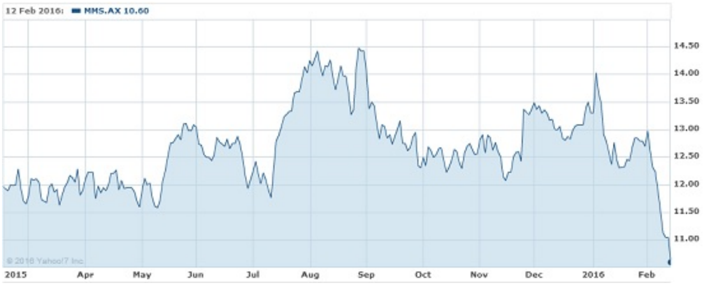
Even though MMS has reduced its reliance on the remuneration services division (and FBT concessions) via the acquisition of Presidian, United Financial Services and the expansion into the UK market more recently, remuneration services still remains the largest profit contributor to the group.

The majority of any valuation for the business relies on the performance of remuneration services, which could be potentially impacted, and materially so, if there were any changes to the regulations.

Our research indicates that changes are not currently on the government's agenda with no mention in the latest government review of taxation.

We await an update on how the business is progressing and how the integration of the recent strategic acquisitions is progressing.

McMillan Shakespeare Limited (MMS)



***Source**: Yahoo!7 Finance, 15 February 2016*

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