Hold the phone – a telecommunications retail stock

by Roger Montgomery

It is said that investing in 'growth' companies can be riskier than large 'blue chips' companies. However many large blue chip companies are mature and don't grow. What then could be riskier than being assured of zero growth? How would one maintain their purchasing power?

The key to successfully staying ahead of the rising cost of living is to invest in businesses that grow. Whether the company is small or large, new or established, is less important than whether it's future earnings are ahead of the past. And this will be a function of how well it conducts its business in the future– after all.

To determine whether the prospects for a firm are bright or not, we rely on evidence and remove the labels of 'growth' and 'blue chip', instead evaluating all companies in an unbiased way. In using this approach at Montgomery, we've found some fantastic opportunities and one worth sharing with you for your review is Vita Group Limited (ASX: VTG).

VTG is an Australian electronics and telecommunications reseller comprised of six brands; One Zero, Fone Zone, iConcierge, Next Byte, Vita Networks and Sprout Accessories. In addition, it operates 100 Telstra retail stores and 17 Telstra Business Centers (TBC's) from which virtually all of the company's earnings are generated.

Vita Group-run Telstra stores are operated under a Master Agreement between Telstra Corporation Limited (ASX: TLS) and VTG. The agreement limits VTG to 100 retail outlets and provides terms around their relationship but before you believe this limits the growth we described as important earlier, read on.

VTG historically operated a large network of FoneZone stores, which was an early beneficiary of increasing mobile penetration in Australia. As smartphones began to dominate in 2007/2008, FoneZone was unable to obtain stock from major brands and quickly lost market share.

The franchise has struggled ever since and now contributes virtually no profit to Vita Group.

Having understood the weakness of Fone Zone, management moved to develop the network of TLS retail stores. These stores notably had a much easier time securing stock, particularly iPhones, since the relationship with Apple Inc. (NASDAQ: AAPL) was managed by Telstra itself.

The company's competitive advantage can attributed to two sources; First, the brand name of Telstra affords VTG a range of benefits. Telstra is a widely recognized brand in Australia and carries a perception of quality in telecommunications, particularly in terms of mobile reception coverage and connection reliability.

The Telstra network in Australia is widely regarded as superior to that of its competitors and VTG benefits from this advantage via the large customer base attracted to this offering. TLS also has a substantial marketing budget ($421m in FY15) of which VTG also implicitly benefits from at no additional cost.

The firm's second competitive advantage is its sales culture. The firm places a high emphasis on employee's abilities in achieving sales targets (as a function of attachment rates, sales dollars volumes and number of transactions over certain time intervals).

We expect that many would disregard culture as being a true competitive advantage but this approach has proven to be effective. Not many firms in retail can sustain like-for-like EBITDA growth of >20% for many years.

This will likely plateau in future, however, even less aggressive rates of growth are value accretive.

Originally, management expected that at maturity, the Telstra retail stores would generate EBITDA of $250k p.a. This was soon exceeded, is now over $500k per store, and management expects further growth, boosted by product launches that have a positive impact on profitability.

The upcoming opportunity for commissions earned by VTG-operated stores will be driven by the migration from the copper network to the NBN network. In a market of circa 10 million households, hundreds of millions in potential commissions are available to operators facilitating the switch and it will arguably have the largest impact on the smaller operators.

Consumers are also downloading more data than ever on smartphones, and while the cost per gigabyte of data has fallen, commissions have not been negatively impacted – in fact, commissions and hence earnings per store are rising as VTG cross sells data plans, warranties and accessories.

VTG is also pursuing growth in the small & medium enterprise market. Telstra has divided Australia into 78 ‘zones’ and VTG is seeking to be in twenty or twenty-two of these with circa 30 Telstra Business Centres.

Implementing many of the same tactics that generated superior profitability in its retail stores, VTG expects to be successful in the commercial space.

Whilst VTG may not be considered a true ‘blue chip’, it has the required qualities to grow its earnings at a decent clip, and little exposure to the boom and bust cycles of commodity markets or increasing regulatory burdens that many much larger companies are currently facing.

We were fortunate at Montgomery to acquire our shareholding in VTG at prices well below its $3.40 price today.

In our view however there still appears to be value and upside based on even a conservative estimate of future earnings.

Vita Group Limited (VTG)

Source: Yahoo!7 Finance, 16 May 2016.

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