SECTOR FINTECH

New breed in the lead

Allure of specialty products proves a winner for fintech companies

Among the very best performing shares since July, and indeed through reporting season, were financial technology companies such as IRESS, Praemium and Bravura Solutions. Other companies in this space include HUB24, Netwealth and GBST.

These companies offer financial platforms for investors and advisers to access and tailor portfolios comprising a range of investments and securities including managed funds, individual stocks and exchange traded funds (ETFs). Platforms also allow users to administer those investments through separately managed accounts, superannuation and pension structures, by providing consolidated reporting (for taxation, performance and asset allocation), discount brokerage and portfolio management tools. In essence, a platform is simply a convenient way to buy and then hold and administer investments.

Demand by investors for individually managed accounts, disaffection with managed fund performances, the rising popularity and convenience of listed investment companies (LICs), the increasing vertical integration of adviser groups and, most recently, the royal commission's dim view of platforms owned by fund manufacturers, have all resulted in funds flowing away from the legacy wrap platforms owned by the largest financial institutions and into products offered by the new breed of fintech companies.

With an 80% share, incumbents still dominate the market: BT has $150 billion under administration, AMP has $143 billion and CBA about $120 billion, but their higher costs and limited product range has seen fund flows to the new breed accelerate. By way of example, Netwealth has $16 billion growing at 48% versus growth of low single digits for the incumbents. Meanwhile, the big banks and AMP are looking to offload their wealth arms.

A structural shift to specialty platform providers is clearly underway with HUB24, Netwealth and Praemium attracting funds under management (FUM) at an impressive rate. The only question is what is the right price to pay for these companies?

All of the above listed companies are trading on very high earnings multiples and such high multiples are usually the result of strong growth and strong profit margin expectations. It is unusual, though, to find any industry where a company manages to dominate both growth and margins. More typical is that one characteristic – growth or margins – is sacrificed for the other. Either the company cuts prices to gain share or it maintains prices but grows more slowly than its peers. And technology is not free. Across the globe, tech companies have to re-invest large portions of their revenues into upgrading platforms constantly to remain attractive and competitive. This has been especially true in financial services where index fund managers now offer funds with zero fees.

> A structural shift to specialty platform providers is under way

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Prices as at close of business, 12-Oct-18.

Netwealth share price

Praemium share price

IRESS share price

1 Netwealth

ASX code NWL
Price $7.84
52wk ▲ $9.93
52wk ▼ $4.84
Mkt cap $1.86bn
Dividend 10.56¢
Dividend yield –
PE ratio 87
HOLD/ LIGHTEN

Netwealth reported an almost 75% jump in full-year profits on the back of revenue growth of 36% – highlighting the massive operating leverage of fintech platforms.

The company also noted that Netwealth reported growth in funds under advice of 41% to $18 billion or about 2% of the market.

Profits rose to $29 million and revenue jumped to $83 million, and while the strong growth is impressive and there appears to be a long runway of growth ahead, Netwealth trades on a market capitalisation just shy of $2 billion. In other words, it trades on more than 80 times historical earnings and, based on consensus analyst estimates, the shares are trading at 42 times estimated FY20 earnings.

Somewhat unsurprisingly, while Netwealth has grown FUM strongly, margins were 0.1% lower in the second half of the 2018 financial year and growth in lower fee-paying new accounts, albeit larger accounts, dominated the company's growth.

It is also worth noting that Netwealth may not be able to sustain the returns it generates from fees charged against cash balances, which might account for a quarter of revenue.

Discounts for family pooling or accounts and lower cash balances could be where fee and margin compression begin. And keep in mind the recent class actions against bank-owned super funds such as AMP Super and CommBank-owned Colonial First State, for low returns on cash balances and fee gouging, could put further pressure on Netwealth's fees from cash balances.

2 Praemium

ASX code PPS
Price 96¢
52wk ▲ $1.19
52wk ▼ 40¢
Mkt cap $387m
Dividend –
Dividend yield –
PE ratio 274
HOLD

Praemium's $387 million market cap may be more appealing but before you get too excited the shares for this platform-providing fintech are expensive too. Praemium's domestic funds under advice grew 45% with funds in SMAs rising almost 70% to over $2 billion. Revenue in FY18 grew 22% to $43 million, and EBITDA rising 40% to just under $9 million. That puts the shares on 52 times pre-tax, pre-interest, pre-amortisation and pre-depreciation earnings.

Comparing the market capitalisation to net profit after tax (NPAT) puts PPS on over 270 times historical earnings. On consensus analyst estimates, it is trading at 37 times estimated FY20 earnings, so there are some very ambitious growth expectations baked into the price. In fact, consensus estimates suggest EBITDA could double in 2019 and then double again in 2020. Praemium also runs a business in the UK and in Asia and it was the overseas operations that held the group's earnings back. But UK funds under advice grew by 13% year-on-year so while overseas expansion can prove to be a stick in the mud, it can also offer investors optionality and diversification. The UK business is expected to break even in the foreseeable future.

Praemium has enjoyed strong group funds under advice growth of 35% year-on-year to $8.3 billion currently with domestic inflows up 45% and self-managed account inflows rising 69% to $2.2 billion. Unlike some of its peers, such as NWL and HUB24, however, PPS's gross margins expanded by 2% to over 80%.

Praemium is regarded as offering the market's superior platform. The SMA market is growing quickly.

3 IRESS

ASX code IRE
Price $11.43
52wk ▲ $14.20
52wk ▼ $9.17
Mkt cap $1.98bn
Dividend 44¢
Dividend yield 3.85%
PE ratio 31
HOLD

IRESS sits in a different subsector. It offers a financial markets portal in Australia, the UK, Canada and South Africa, and while it is significantly smaller than Reuters and Bloomberg, it has grown strongly via reinvestment in its technology and through acquisition. As with Netwealth, HUB and Praemium, IRESS's revenues are primarily subscription based and 90% are recurring.

In August, IRESS reported its first half 2018 results with revenue growing 8.4% above the corresponding half a year earlier, and profit before tax up 12.4% to $41.8 million, maintaining its prior guidance for the full-year 2018 results, with an EBITDA range of $131 million to $136 million. Analysts expect the company's UK wealth management division to accelerate margin growth next year after a period of heavy investment.

Encouragingly, the company is focused on sustaining growth and margins with the charging of implantation fees recovering costs. A major project with advisory group Tilney in the UK is expected to become operational in calendar year 2019, which should be reflected in better margins in subsequent periods.

Praemium has indicated unspectacular full-year profit growth (the company has a December year end) but an acceleration of earnings (notwithstanding a market correction – the company is leveraged to market cycles) is expected in 2019 and 2020.

This growth currently appears to be priced in. Even stronger growth than current estimates is required to drive the share higher and with a market capitalisation of almost $2 billion, the company's PE ratio of about 30 may not expand much further.