Is the market’s recession conviction warranted?

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They say the market is forward looking. I’ve never seen it quite this forward looking. Investors are absolutely convinced that Australia is going to have a recession. And that it’s going to be a humdinger.

Look no further than Seven West Media for your poster child. Back on the 10th of February, its share price hit $0.80. Today, the owner of Channel 7 and The West Australian is trading at $0.39 a share, down some 51% in four months.

In the interim, it announced an excellent half-year result and, just a month ago, upgraded its expectations for the full year thanks to “strength of advertising markets”. It now expects to generate earnings before interest, tax, depreciation and amortisation (EBITDA) of between $335m and $340m. That will translate to approximately $180m of profit after tax for shareholders.

After the share price fall, Seven West’s market value is just $603m, or roughly four times its likely profit for the year.

An advertising recession?

An explanation for such a lowly valuation is not difficult to find. The stock has been downgraded by two well-regarded brokers over the past month, with Morgan Stanley laying out the bear case best: “Advertising is cyclical and the economic outlook is softening … we believe it is entirely possible that a 6-12 month period of negative TV advertising growth lies ahead, with the magnitude of the declines more likely to be in the range of -10% to -20%.”

Due to its high fixed costs, Seven West’s earnings could halve on a 10% decline in revenue.

Is it going to be that bad?

There are three important factors in answering that question.

Firstly, are we about to have a recession? Wide swathes of the market are trading at heavily discounted prices on the assumption that it’s coming soon. The ASX Small Industrials Index - a good barometer of the most economically sensitive companies - is now trading below where it was in 2018.

It can’t be ruled out. Interest rate rises are clearly going to bite. The Government’s stimulus needs to be unwound. But mining and agriculture are important contributors to the Australian economy and conditions have never been better. Other important sectors - tourism and hospitality in particular - are only just beginning their recoveries. There are going to be dramatic shifts in spending patterns, but it’s not clear to me that the aggregate translates to a certain decline.

Second, assuming we do enter a technical recession, will it impact advertising budgets the same way previous recessions did?

A jumbled up economy

When Covid lockdowns first hit back in 2020, Forager’s recession playbook was immediately dusted off. Sell everything with high debt burdens. Avoid stocks exposed to discretionary spending - that’s the first thing people will cut when faced with the risk of losing their job.

The playbook was useless. Hardly anyone lost their job. Many of those who did ended up getting paid more by the government than they received when employed. Discretionary consumer stocks like Temple and Webster and Nick Scali made more profits than ever before.

If there is another recession coming, it’s going to be another weird one. Some sectors are clearly still humming. In two important sectors for the TV advertising industry - automobiles and tourism - the recovery is only just getting started. Spending levels in those sectors are nowhere near their pre-Covid levels of spending. Harvey Norman will be selling less, but does that mean the total pie needs to shrink?

Third is the assumption that an advertising downturn hits Seven West proportionately. This, I will admit, is likely. As Morgan Stanley points out, this is still a television company. As eyeballs shift online and to streaming services, traditional television is losing market share in the battle for advertising dollars. You won’t win analyst of the year for predicting that trend will continue.

But I am having a long-priced wager that the nadir is behind us.

The value in connected television

There is a chance (it is just a chance) that internet-connected TVs change the game for traditional television companies. Traditional media companies' own streaming services are mitigating the loss of eyeballs. That is widely understood. But few are thinking about the value of the eyeballs that remain.

A colleague of mine was watching TV via 10Play app recently when an advertisement popped up for a new Bunnings at Pymble in Sydney's north. He lives just around the corner and it is highly likely that the ad was only served to people in that area.

Traditional TV's one big downfall was that it only worked for brands with mass appeal. You had to show the same ad to every single person watching. That's why cars, beer and supermarkets dominate the ad breaks. They still wasted a lot of money on people who don't drive, drink or buy groceries.

The big benefit with connected TVs is that they can serve different ads to different people. Unlike the days of linear television, Channel 7 knows where its streaming viewers live and what programs they like watching. They know their email addresses and, with that, can buy plenty more information about them. Each 30-second advertising slot can then be carved up into different segments and sold to the most relevant advertisers.

We are still in the early stages of this technology's evolution but it is growing fast and, in my opinion, is going to be an incredibly powerful advertising medium. There might be less eyeballs in aggregate, but each could be worth many multiples of its traditional value.

While all of that is specific to Seven West, the expected recession's impact on its share price is not. Retailers like Accent and Adairs are trading at 5-8 times earnings. Small lenders like Plenti and Wisr have suffered share price falls of 45%-70% this calendar year.

I wouldn't bet my life on a recession not happening. But I'm happy to own a few very cheap options on a scenario that isn't as bad as everyone the market currently thinks.