Two Stocks for a Low Interest Rate World

Reserve Bank of Australia (RBA) Governor Phillip Lowe told a recent lunch gathering that "it's a strange world" where equity markets rise on the back of interest rate cuts. It may be strange. But it's the world the rest of us have been living in for the past decade.

To give Lowe some credit, his comments were directed at those assuming that interest rates fall dramatically and corporate profits don't fall. Surely interest rates will only be cut to near zero *if* the economy is facing a recession? And that cannot be good for the earnings part of the equation.

On behalf of Australia's savers, we're hopeful to be wrong on this, but the Forager view is that low rates are here to stay. We have one of the highest debt to income ratios in the world, mountains of mortgage debt and a dearth of fundamental reform in the past two decades. It is hard to imagine a scenario where rates go back up without cratering the economy.

Interest rates on deposits, already woefully low, are likely to be at or near zero within a few years.

Lowe can be perplexed all he wants. The case for investing in strong businesses with reasonable dividend yields and the ability to withstand an economic downturn remains compelling. Two that fit the mould are **Smartgroup** (SIQ) and **SG Fleet** (SGF).

Making a smart choice

Smartgroup administers salary packages for Australian charities and public sector clients. Certain charitable entities are provided an effective subsidy for salary costs through exemptions or concessions under legislation from 1986. This means eligible employees can claim expenses — the cost of a car on a novated lease for example — as a tax deduction.

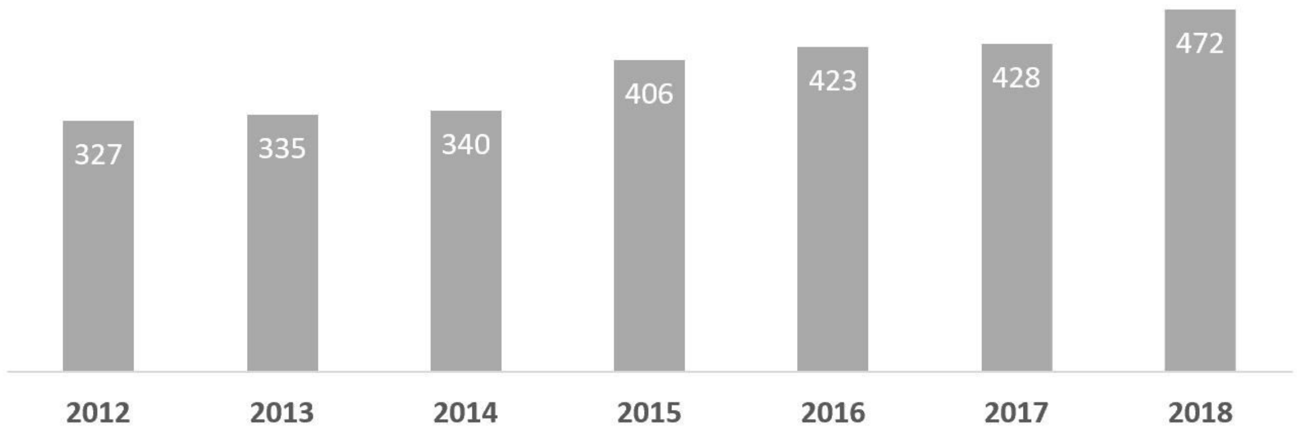
Complex administration (who can claim what?) is the reason for Smartgroup's existence. In addition to a relatively low fee paid by the employee, the company earns additional fees from arranging finance, cars, insurance and other services. In fact, that's how Smartgroup earns its profit — commissions, mostly from novated leases, accounted for 61% of Smartgroup's revenues in 2018.

Smartgroup has a stable client base owing to the difficulty of switching administrators. Transitioning is a big project and requires changing systems and processes across HR, IT, finance, compliance, audit and the employees. According to Smartgroup's prospectus, 45% of the company's largest clients have been with the company for more than ten years.

Salary packaging uptake and employee numbers will increase naturally and the runway should be decent given rising employment in the health and charity sectors. The number of novated leases will likely follow. Growth can occur without retaining any capital.

Margins for earnings before interest, taxes, depreciation and amortisation should also continue to expand with volume growth. Efficiency will improve as unnecessary platforms are consolidated and enhancements continue in online processing and automation. Over the past three years, margins increased from 40% to 46%.

Smartgroup – Average Salary Packages per FTE



Source: Smartgroup, Forager analysis

Focus and skin in the game are hallmarks of great capital allocators. In the past four years, Smartgroup tripled the salary packages it managed. Through well priced acquisitions the company is now on an even footing with incumbent McMillan Shakespeare. Those acquisitions required capital - the shareholder equity in the business quadrupled over the four years - but the return on equity has been outstanding. In the most recent financial year it was 27%. Earnings per share grew by three and a half times.

Deven Billimoria, Smartgroup's founder and CEO, has $29m of his own wealth tied up in shares. Chairman and former Macquarie Banker Michael Carapiet owns $19m worth of shares too. The largest shareholder, a subsidiary of a Malaysian private investment holding company led by billionaire Ananda Krishnan, keeps a close eye on its 25% holding through its associate Andrew Bolam, a non-executive director on the board.

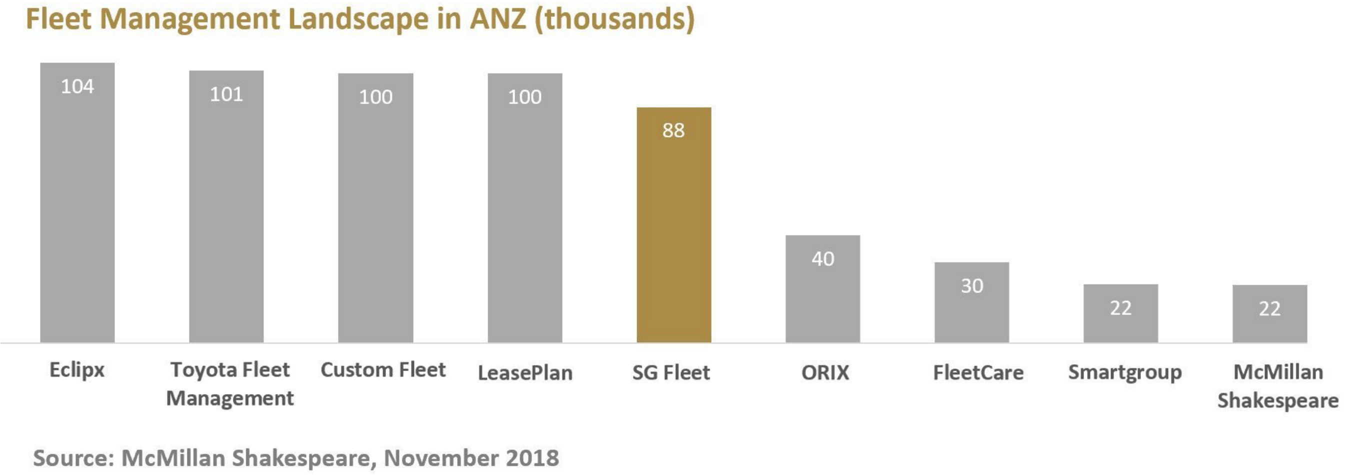
There are some cyclical concerns however. Demand for new novated lease vehicles has been weak for some time. More customers are refinancing their cars rather than trading in for a new one, which means lower profits per vehicle for Smartgroup.

We are happy to let the board and management team worry about this, though. The company distributed 70% of its profits as fully franked dividends in 2018, equating to a 5% yield at the current price. We expect that to prove resilient and rise over time, either through sensible investment of the retained 30% of profits or an increase in the payout ratios if opportunities are hard to come by.

Surprising quality at an attractive price

The investment proposition at fleet management company **SG Fleet** (SGF) is not dissimilar. SG Fleet manages fleets of vehicles on behalf of government and corporate clients. For a large client that can mean thousands of cars. Fleet management systems need to integrate with procurement, finance and compliance. Drivers need to be in the loop too.

Five main players account for about two thirds of the industry. There doesn't seem to be dramatic differences between the product offerings and competition for new clients is fierce.



Once again, though, large industry participants earn very healthy returns on shareholders' capital. There are efficiency benefits to size. And, once a customer has chosen their fleet management provider and integrated the service into their operations, moving to a competitor can be costly, time consuming and risky.

This means for a new competitor, simply replicating SG Fleet's assets is not nearly enough to assure a return on investment. There has been no new competition of scale in the past four decades. All of the five largest fleet managers have been around since the 1980s.

The average customer life for SG Fleet's largest clients was 11 years according to the company's 2014 prospectus.

A recession in Australia wouldn't be helpful. Corporate clients might reduce demand for new vehicles but even if growth slows, the total fleet size should be stable given the mostly non-cyclical customer base. And about one third of SG Fleet's business is with retail leasing clients, where demand is already diminished. The balance sheet is strong and the long-term structural tailwinds to fleet outsourcing are helpful. There is also the possibility of further accretive acquisitions.

South African fleet management business Super Group owns 59% of the company and the capital allocation track record under its watch has been sound. Robbie Blau, the CEO, personally owns $20m in shares.

The business is attractively priced at an 11 times price-to-earnings ratio and pays a 6% fully-franked dividend yield. At the very least, we think that is sustainable.

Both SG Fleet and Smartgroup have been added to the Forager Australian Shares Fund portfolio in recent months. Healthy yields, robust businesses and strong shareholder alignment are just what the doctor ordered in a world of zero interest rates.