Companies&Markets

www.afr.com | Monday 4 May 2020

Inside

Virgin Bidder groups set to consolidate **p17**

Electric cars Analysts point to battery minerals crunch **p20**

Due Diligence No sure bet playing with Jumbo **p30**

Market snapshot

S&P/ASX 200 Index (points)

S&P/ASX 200 stocks Friday

Best	Close ($)	Change (%)
Janus Henderson	26.60	+8.17
Fisher & Paykel Hlth	26.54	+4.90
ResMed Inc	24.16	+3.25
Blackmores	76.56	+1.06
NEXTDC	8.95	+0.90

Worst		
Austal	2.69	-19.94
Monadelphous Grp	9.65	-14.60
Virgin Money UK	1.455	-12.35
GPT Grp	3.81	-9.93
The Star Entertain	2.73	-9.90

Indices	Close (points)	Change
ASX 200	5245.9	-276.5
Nikkei	19619.35	-574.34
Hang Seng (pm)	24643.59	+67.63
Shanghai A	2997.56	+39.41

Currency		Change
TWI	56.9	-0.9
$A/USc	64.50	-1.01
$A/¥	69.08	-0.75
$A/€	0.5841	-0.0002
$A/£	0.5132	+0.0001

Rates	Close (%)	Change
Cash rate	0.25	steady
180-day bills	0.157	-0.003
10-yr bonds	0.879	-0.014

Commodities	Close ($US)	Change
Gold (spot)	1685.10	-14.02
Iron ore	84.04	steady
Oil WTI	19.78	+0.94

Go to afr.com for live updates

Bad debts hang over Westpac dividend plans

James Frost, Aleks Vickovich and James Eyers

Westpac Banking Corp may be better off delaying its interim dividend or making no distribution when it delivers its first-half results this morning, say investors growing increasingly uneasy about the outlook for bad debts.

Over the last week, bank shareholders have begun to factor in losses from the COVID-19 shutdown on profits. Some estimates suggest they may reach $45 billion over three years. Westpac said last week it would take a $1.6 billion provision in the first-half to cover the mounting cost of the crisis.

With Westpac stock down 49 per cent from its 52-week high, some investors say the last thing shareholders need is a token distribution that weakens the bank and forces it to issue fresh equity soon after its most recent $2.8 billion capital raising in December.

Airlie Funds Management portfolio manager and former head of equities at Perpetual, Matt Williams, said Westpac should take ANZ's lead and not pay a single cent when it announces its results for the half to March 31.

"There's no better time to pay nothing. Investors are now prepared for that outcome: preserve capital as the economic impact of the crisis filters through the system," Mr Williams told *The Australian Financial Review*.

The do-they, don't-they dividend scenario played out last week when ANZ opted to defer a decision on its payout just days after National Australia Bank ambushed the market with a heavily reduced dividend and a $3.5 billion capital raising at the same time.

Banks are being forced to balance the competing agendas of retirees who own big licks of stocks for the income stream, and instructions from the prudential regulator to materially reduce or at the very least defer payments until more certainty around the financial impact of COVID-19.

Argo Investments senior investments officer Andy Forster, who oversees close to a billion dollars invested across the big banks and Macquarie, said over the past week he has been forced to reassess whether Westpac will make a return to shareholders.

"We have been of the view that Westpac would pay a dividend, heavily reduced, but still pay one with an underwritten DRP. ANZ have obviously taken a different path by deferring their decision – which has really opened the door to a range of outcomes," Mr Forster said.

Australian equities manager Dermot Ryan, a portfolio manager at the $192 billion giant AMP Capital, said it would be "prudent" for banks to hold back on dividends in the current climate, given the uncertainty around the impact of the pandemic on credit growth and net interest margins.

AMP – which held 10.7 million ANZ shares as at Wednesday across its various investment management subsidiaries – predicted in early April that bank dividends would halve; a prediction Mr Ryan now says looks relatively "conservative".

"With a new CEO, we think that Westpac may opt for a low dividend or even a deferral as well," he said. "We think that is part of the broader capital squeeze going on in the economy."

The decision on dividends will have been made on Friday after the market closed. and will be reviewed once more early today before the earnings release.

The announcement will be part of a much bigger set of numbers from Westpac chairman John MacFarlane's and CEO Peter King's first set of results which will be carefully scrutinised by investors, regulators and analysts.

Westpac has already softened

Continued p19

Andrew Maple-Brown says Australian infrastructure stocks don't offer the same value opportunities as global stocks. PHOTO: PETER BRAIG

Infrastructure on fast track in low-rate world

Monday fundie Long-term ownership has paid off for listed fund.

Robert Guy

"You're spot on," says Andrew Maple-Brown with a laugh when it is suggested Royal Vopak is one of the best infrastructure stocks to own right now.

As the global glut of oil swelled and producers grew more desperate to find a home for their unwanted supplies, shares in the world's largest independent owner of storage tanks soared to a five-year high in April as the scramble for every spare cubic metre of space became ever more frenzied.

"We've been a long-term owner and that has been a favourable benefit for us this year. The oil storage is extremely valuable," he says.

The Dutch stock's 20 per cent rally from its April lows is testament to the rarity value of its assets, a common theme that Maple-Brown and his fellow managers of the $5.2 billion Maple-Brown Abbott global listed infrastructure fund look for in the 25 to 35 stocks that make the cut in the portfolio.

"We very much focus on assets with the strongest combinations of low cash flow volatility and natural inflation linkage. There's about 110 companies globally which we believe will exhibit those characteristics," says Maple-Brown, who is also the firm's managing director of global listed infrastructure.

Continued p23

Afterpay to use Tencent as springboard to Asian expansion

James Eyers

Afterpay's co-founders say the Chinese technology giant Tencent, which appeared as a substantial shareholder in the buy now, pay later pacesetter on Friday, will help it expand in Asia, as the two companies consider integrating aspects of their payment platforms.

Afterpay shares are expected to open higher this morning on the back of the announcement on Friday evening, as analysts suggest Afterpay could become a payment option in Tencent's WeChat Pay mobile wallet, which has 1.2 billion users.

The deal comes amid a spat between the Australian and Chinese governments after Australia called for an investigation into the origins of the coronavirus, which Beijing's ambassador to Canberra warned could spark a Chinese student and tourist boycott of Australia.

But two of the biggest fintech players in each country are forging a partnership despite the political fracas, with Afterpay co-founder Anthony Eisen describing a "shared understanding" of the benefits alternatives to traditional credit can provide retailers and customers transacting on internet platforms.

"It is our business proposition that translates, and it's our business model that's at the core of this relationship, and the relationship we have with our growing domestic and international investor base more broadly," Mr Eisen told *The Australian Financial Review*.

"The discussions we have had [with Tencent] relate to global expansion. Being a retail-led company, they see the value proposition we are delivering to retailers and how that can be expanded in more countries."

Nick Molnar says Tencent "brings a new level of experience" to his company, Afterpay. PHOTO: LOUIE DOUVIS

The $300 million investment, built up over the past five weeks through on-market purchases after the Afterpay share price was felled when the coronavirus struck, will be followed by collaboration on technology, both companies said in the announcement on Friday.

Tencent processes a billion transactions each day and has a 39 per cent market share of third-party mobile payment volumes in China. which are linked to a wide array of its technology investments including retail platforms, music streaming and video gaming services, auction sites and the retailer JD.com.

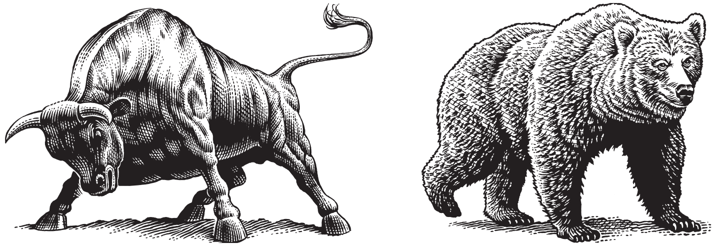
Earlier this year, its key competitor in China, Ant Financial, took a minority stake in European buy now, pay later leader Klarna, in which Commonwealth Bank is also an investor.

Afterpay's other co-founder, Nick Molnar, said Tencent "brings a new level of experience on how to scale a payment infrastructure globally, and as we improve our relationships with retailers, it provides immense opportunity in other markets where they are prevalent".

Tencent could provide Afterpay, which offers instalment payments, with a new funding source if that was needed, and help the Australian

Continued p19

▶ **Street Talk** Tencent taps Goldies **p16**
▶ Crunch time for Sezzle **p23**
▶ **James Thomson** Five ways Afterpay wins from Tencent **p30**



Crunch time for Sezzle in US buy now, pay later

Bulls & Bears

Tom Richardson

For investors, the growth in the United States buy now, pay later (BNPL) sector makes Australia look small beer.

Around $1 billion of Afterpay's $2.6 billion in total sales came from the US in the March quarter, with rivals like US-centric Sezzle also growing strongly.

Over the year to March 31, Sezzle more than quadrupled North American merchants and consumers using its services to 12,715 and 1.15 million respectively. Afterpay has 4.4 million active customers in the US, more than the 3.2 million in its maturer Australian market.

Overall, it's a market that is between 10 to 20 times bigger than Australia.

Yet Minneapolis-based Sezzle chief executive Charlie Youakim says the US BNPL sector is still three years behind Australia. "We're at the early adopter phase in the US, but it's definitely picking up. Retailers are taking notice. They're starting to realise they need a solution," says Youakim.

The key to profitability will be how the fintechs manage costs fixed to every transaction. If transaction costs are managed, then BNPL could profitably scale as other non-transaction-facing costs such as staff and marketing can be kept relatively fixed versus headline growth.

"When we launched in the US we looked at what happened in Australia and noticed the biggest difference in the unit economics between the two countries was card processing rates," Youakim says.

BNPL players charge consumers' cards themselves, rather than the retailer, and pass on the cost as part of a bundled fee to retailers for different services provided.

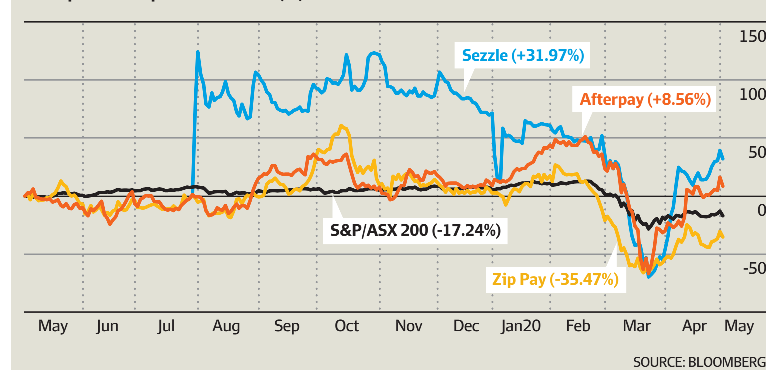
In the US, the fee charged by card issuers to process a transaction is far higher than in Australia.

"In Australia, it's regulated by the government. [The fee] runs at 0.6-0.7 per cent. In the US it's unregulated, so the oligopoly have their run at it," Youakim explains.

A typical Visa processing fee in the US is 3 per cent. Sezzle charges retailers fees around 6 per cent plus 30 cents per transaction, with the pitch that this includes the 3 per cent card fee. Afterpay typically charges retailers 4.5 per cent in the US, including the card fee.

Sezzle' Charlie Youakim and chief revenue officer Paul Paradis believe the US BNPL market can profitably support multiple players. PHOTO: WAYNE TAYLOR

Land grab



Bulls argue the source of income BNPL players provide Visa and Mastercard explains why they have little incentive to compete with or disintermediate the sector.

In 2019, Afterpay announced a partnership with Visa given their mutually beneficial interests. Visa or Mastercard also cannot acquire customers at online checkouts like BNPL players, because they don't face the consumer, but the consumer's bank or card issuer.

Despite this niche, bears such as broker UBS argue the BNPL sector has little moat as there's little to stop new competitors offering retailers lower fees to win market share.

Another significant transaction cost for BNPL is the interest on the warehouse funding required to manage receivables.

Receivables balances are the vast sums a BNPL provider borrows from a bank to pay a merchant upfront, while waiting six weeks for the consumer to pay it back with no interest charged.

The interest on warehouse funding a BNPL provider must pay for a credit line is based on periodical LIBOR interbank lending rates. Three-month (US dollar) LIBOR is now 76 basis points and a typical 30-day LIBOR rate 50 basis points.

The BNPL players have benefited from interest savings on warehouse balances as LIBOR tumbled in line with global rates. If LIBOR rose with rates it would hurt transaction margins.

In turn, if BNPL players had to extend consumers' credit periods under the COVID-19 "Team Australia" principle of debt leniency, costs to fund receivables increase via higher interest and longer durations. This reduces return on invested capital as a measure of profitability.

In its March quarter update, Afterpay controversially revealed it shortened credit duration for consumers by making the first instalment payments upfront for most Australian customers.

The third key variable transaction cost driving how profitable the BNPL business model is at scale is bad debts as a percentage of sales.

In a bear scenario it's possible US margins turn negative on merchant fee pressure, increased bad debts, funding costs, or payment-processing charges.

Broker UBS says sell Afterpay because margin pressure will hurt it in FY21. It has a lowly $14 price target.

Youakim dismisses fee pressure as a risk, given the business model increases sales and basket sizes for retailers, while giving consumers a superior alternative to interest-bearing credit cards.

"There's much more room to grow," he says. "This payment by instalment trend is a mega trend. Customers love it. It's going to continue to take hold. It's still early days."

Broker Ord Minnett says "the growth rates Sezzle is experiencing cannot be ignored and the company represents the best opportunity in the BNPL segment".

It has a $3.40 valuation, more than double Friday's $1.61 closing price.

From page 15

Infrastructure on fast track in low-rate world

A career in funds management was never a certainty for Maple-Brown despite the family's pedigree within the industry.

As a scion of the late Robert Maple-Brown, one of Australia's most storied investors, he came to funds management later in his career after working at Lendlease and then Macquarie on project finance for property and infrastructure transactions.

"Dad always encouraged us to have our own careers. He was very cautious around encouraging us into the sector and certainly cautious around encouraging us into the family firm."

"I learnt from dad the importance of discipline within an investment process and the importance of being cautious or conservative."

The break into funds management came in 2007 when at Macquarie he decided he wanted to make the switch from structuring debt to buying equities. After spending time managing money in Sydney and New York, Maple-Brown and three colleagues decided to hang up their own shingle in 2012.

"We very much believed in the asset class and wanted to tie ourselves to it over the long term," he says.

"But it is very difficult to start a firm totally from scratch, particularly a globally focused one. So we needed a partner."

While approached by other backers of boutiques, the team eventually found its home at Maple-Brown Abbott. The four founders own 54 per cent of the fund.

Maple-Brown sees ongoing demand from sovereign wealth funds, pension funds and retirees for the asset class given its higher dividend yield relative to global equities, and longer-dated and lower volatility cash flows.

Opportunity is also seen in the gap between valuations for listed infrastructure assets and direct – or unlisted – infrastructure assets.

He cites media reports that a stake in TransGrid, which operates electricity transmission networks in NSW, could be sold at 1.6 times its regulated asset base. That compares with listed Spark Infrastructure, which has a stake in TransGrid, that the fund calculates is trading at 1.25 times its regulated asset base.

"That's a massive differential between where the assets trade in the listed market versus where they trade when direct infrastructure investors buy them."

Infrastructure stocks have not proved immune from the violent selloff in global markets sparked by the COVID-19 pandemic, which has locked down many of the world's largest economies.

Airports and toll roads, which only two months ago were eagerly sought by yield hungry investors, have not been spared by jittery investors.

Despite the battering of stock prices, Maple-Brown is treading carefully.

"Shorter term I am more cautious around markets," he says.

"While in some sectors we see what appear to be attractive valuations at this point in time, we've been pretty cautious in terms of materially adding those stocks just yet."

One sector the fund is watching carefully are transportation infrastructure assets, particularly airports.

The fallout from COVID-19 could have an enduring impact on the airline industry and the infrastructure that serves it.

"There will be an impact on long term traffic, there will be an impact on the airlines which drives seat capacity, there will also likely be an impact on passenger behaviour.

"We still see airports as extremely strategic assets with high barriers to entry, just not as valuable as they previously were. "

> **We still see airports as extremely strategic assets with high entry barriers.**
> Andrew Maple-Brown, Maple-Brown Abbott

While airports may struggle in a post-COVID-19 world, Maple-Brown is upbeat on the prospects for another popular means of transport in Europe: rail.

The fund is an investor in UK-listed Getlink, which owns the tunnel that connects the UK to France.

"That is very much an asset that we think is highly strategic," he says.

While the main route is London-Paris, there is also London-Brussels and London-Amsterdam, while there are also seasonal routes into southern France during summer and into ski areas in the winter.

Every passenger on Eurostar, which is a different company, pays a fee to the tunnel owner. That fee is escalated as a function of inflation.

"The concession goes to 2086, but there's very high barriers to entry," Maple-Brown says.

"It's still trading today around at the price it cost to build 25 years ago. No one is going to build another tunnel."

He adds there is plenty of capacity available on the tunnel so Getlink can continue to increase its revenues with very little in the way of additional costs.

"We think rail travel has some strong tailwinds: it's far more environmentally friendly than flying by plane between these cities. We expect further direct routes to be added into the network."

Around 55 per cent of the portfolio is in regulated infrastructure assets, especially in the US and UK.

These include regulated utilities such as water, gas and electricity, assets that are less economically sensitive and have limited exposure to the current uncertainty caused by COVID-19.

One stock that has caught the fund's attention has been US-listed Duke Energy, which offers defensive earnings and attractive regulated returns in a low-rate environment.

"It's predominantly a regulated electricity business so it will benefit from the move to electrification that we're seeing globally," says Maple-Brown.

"That company sold off quite sharply, At one stage it had sold off 35 per cent from its peak a few weeks earlier which is very unusual from our perspective that such a large-cap, low beta stock was sold so aggressively."

"We took the opportunity to materially increase our exposure into North American regulated utilities including companies like Duke."

He says one question that is often asked is why the fund has low exposure to Australian infrastructure stocks. It currently owns toll road operator Transurban and Spark Infrastructure.

Access to a broader set of infrastructure, such as regulated water assets or telecommunications towers, is one appeal of investing offshore. Another issue is the valuation of Australian infrastructure stocks.

"We have a very high regard for companies like Sydney Airport and Transurban but one of the problems we find is their stories are quite well known in Australia so we tend to see less valuation opportunities to comparable assets in offshore markets."

Maple-Brown argues what is less well known or appreciated is how Australian fund managers have come to dominate the global listed infrastructure industry.

"I can't think of another sector in finance where Australia is effectively the market leader," he says, reeling off names like Macquarie, AMP, Colonial, RARE Infrastructure, Magellan and Lazard as examples of Australian funds that have succeeded as global infrastructure investors.

He calculates that when the fund started in 2012 there was about $US20 billion in listed infrastructure being managed by specialists.

The capital now deployed is closer to $US100 billion, of which Maple-Brown estimates around half is run out of Australia. "Australia does have very high quality infrastructure managers. What is unusual about our sector is if you are a US pension fund looking for an infrastructure manager, then almost certainly on your shortlist will be an Australian manager."