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Investor Series: Is the Sharemarket Correctly Pricing in Fundamentals?

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*When **Afterpay**'s share price rose above A$100, its market-cap surpassed some of Australia's most successful global companies, such as **Amcor, Brambles** and **Orica**. Afterpay has become a poster child for the momentum-type growth-obsessed phenomena currently driving sharemarkets. In this article, we analyse these companies' fundamentals to provide insight into the 'blue sky' being factored into Afterpay's share price.*

Sharemarkets have experienced very strong rallies thanks mainly to interest rate cuts to record lows and quantitative easing from central banks. This flood of cheap money has led many speculative growth stocks to trade well above their fundamental value. Sectors such as online shopping, online conferencing, and streaming services have also boomed during COVID-19 virus lockdowns, leading to a significant rise in almost any technology-related stock. This has also driven the divergence between 'value' and 'growth' stocks to expand to levels surpassing the 1999-2000 'tech boom'. Many investors appear less concerned about the underlying fundamentals or valuations of many companies, instead focusing on anything with 'blue sky' potential, particularly in the technology sector.

Afterpay

Afterpay is a 'buy now pay later' (BNPL) service which allows consumers to pay for goods and services over four instalments. The base service is offered to customers free, with retailers paying a percentage of the purchase price to Afterpay. Customers face financial penalties if instalment payments are late or not made.

Afterpay is focused on its rollout, in particular in the northern hemisphere. As with any landgrab, however, there is a constant need to reinvest in growth. In the meantime, the BNPL space is becoming increasingly competitive, in particular from the entry of established financial players whose huge balance sheets enable them to compete effectively. **PayPal**, for example, is a very well-capitalised and profitable business in a very strong position to achieve market share. Despite Afterpay's first mover advantage and early success, competition is picking up quickly, which suggests that margins will come under pressure.

Afterpay's focus on reinvestment means that it is not yet profitable. The business is estimated to deliver a $25 million profit in FY 2021, although any decision to accelerate its rollout may push profitability further out. Afterpay's current market capitalisation of around $29 billion implies net profits after tax of $1 billion (as compared to zero profit currently). For Afterpay to earn $1 billion, the company would need to have 40-50 million customers, or 30-35% market share. This is a big leap of faith, given the credit, competition, and regulatory risks involved in getting to that scale.

It's worth comparing this with three other companies which are core holdings in IML's portfolios, and which have lagged Afterpay's meteoric rise.

Amcor is a global leader in consumer packaging products, whose customers include some of the world's largest consumer product companies such as **PepsiCo**, **Nestlé**, **Unilever**, **Johnson & Johnson**, and **Kraft Heinz**. Amcor's strategy is to develop scale in its key focus areas of flexibles packaging, rigid packaging, specialty cartons and closures. This has been achieved through a combination of organic growth and bolt-on acquisitions, which has enabled Amcor to develop leading regional market positions across each business segment. Amcor generated US$12.5 billion in sales and US$1.03 billion underlying profit after tax in FY 2020. Amcor's revenues are highly recurring and predictable and underpinned by long-term contracts.

Brambles, through its subsidiary CHEP, is the global leader in pallet pooling solutions. Brambles' CHEP wooden pallets are used by companies such as **Proctor & Gamble**, **Unilever**, **PepsiCo**, and many others to deliver their products to retailers such as **Walmart, Costco, Amazon.com, Tesco, Carrefour** and **Woolworths**. CHEP holds the clear number one market share position in about 60 countries worldwide, including about 70 - 80% market share across the largest pallet markets in the US, UK, Europe, Latin America and the Asia-Pacific.

Brambles earnt global revenues of US$4.7 billion and made an underlying profit after tax of US$504 million in financial year 2020. Over time, Brambles' revenue and earnings should continue to grow at mid-single digit rates. Importantly, because CHEP pallets are used for everyday consumer items, Brambles should deliver this growth in a relatively consistent and low-risk manner. While wooden pallets may not be an exciting new industry, owning a global leader with a hard to replicate business model and strong fundamentals certainly looks a reasonable proposition at its current valuation.

Orica is the global leader in explosives and innovative blasting systems to the mining, quarrying and construction industries. The company services customers across more than 100 countries, including **BHP Billiton, Rio Tinto** and **Newcrest Mining**. Orica is the scale player in many of the major mining countries in the world. Its key competitive advantages are the location of its ammonia nitrate plants and the firm's significant scale of investment in research and development and technology, which enables Orica to lead the market with innovative products and services and grow its market share globally.

Orica is expected to earn global revenues of $5.6 billion in financial year 2020, and to make an underlying profit after tax of $320 million. The company's revenue and earnings should grow around mid-single-digit rates, driven by growth in mining volumes, incremental market share gains and growth in new products and services, in particular from Orica's new wireless blasting initiating systems. The firm is trading at an attractive valuation, given that Orica is a global leader with strong competitive advantages and possesses a positive long-term growth outlook.

Conclusion

We began this article by noting the extraordinary valuation that the sharemarket is assigning to Afterpay compared to well-established, profitable companies like Amcor, Brambles, and Orica. Given the global scale and profitability of these businesses, this valuation indicates that investors are taking an enormous leap of faith in Afterpay's ability to reach sufficient scale and profitability to justify its near $29 billion market valuation.

We prefer to back the proven fundamentals, management and track records and steadily growing profitability of well-established companies like Amcor, Brambles and Orica than to use what looks like excessively optimistic forecasts to try and justify Afterpay's current valuation and share price.

Our discipline back in 1999/2000 rewarded our investors with substantial subsequent outperformance, and the conditions we see today seem to echo the hype of that period. Our approach remains that of anchoring our portfolios with high-quality companies with strongly defensive characteristics using a low portfolio turnover approach and seeking to produce tax-effective income streams for our investors. We continue to believe that investing in well-established, profitable companies with sound fundamentals will ultimately prove much more successful than chasing the latest exciting sector or fad.