

Advtech

Another bite at the cherry

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The small cap space is littered with poor quality companies that tend to flourish under favourable economic conditions and struggle, or cease to exist, when the economy tightens up. Typically, companies such as these exhibit a combination of the following characteristics: lack of scale, price takers, inexperienced management teams, weak balance sheets and lack of product diversification. Consequently, the market generally punishes the small cap sector by awarding a discount to its rating relative to the market. So, when we find a small cap that generally displays the opposite characteristics at an attractive price, we get very excited.

Our long-term focus tends to lead us to these well priced little gems at a time when the market is fixated with short-term challenges. Advtech, in our opinion, is one such little gem. While we have been holders of Advtech stock for the past three years, its recent bout of underperformance has given us the opportunity to have yet another bite at the cherry.

Advtech derives the bulk of its earnings from private education and training. While it also has a small well-run recruitment business, we believe its prospects are greatest in the education business. We like the fundamentals of the local private education market. The poor state of public schooling has driven demand for private education by those who can afford it. The problems faced by the country's public schooling system are structural in nature and will therefore take a long time to fix. Hence we believe that demand for private education and training is on a long-term growth trend.

Over the years the sector has recorded impressive growth, with enrolments growing at a compound rate above 20% p.a. since 2002. However, at still only 4% of the total education market in South Africa, it has a long way to go by global standards, which average 13%.

Capitalising on this demand wave, Advtech has strong brands in both the schooling and tertiary sectors of the market. The capital outlay required to build a school is extremely high and it can take a considerable length of time before it operates at optimal capacity utilisation levels. This makes schools as an investment very risky in the early stages. It also creates a significant barrier to entry for new competitors. Once a school is up and running however, the annuity stream derived from fees is fairly predictable and stable. Parents are also very reluctant to move their kids to a different school in tough times, opting first to cut on other discretionary spending. Coupled with the fact that the bulk of income is derived from returning students, schools are in reality very defensive businesses.

Private tertiary institutions on the other hand do not have the same 'certainty' of returning students and spend is more discretionary. This renders them less defensive than schools. That said, their low capital intensity means that they can generate a good return on capital through the cycle. Local players are protected by the regulatory environment which makes it quite onerous to be accredited as a private tertiary institution. Advtech has balanced exposure between the two sectors of the private education

market.

The strong demand in the private education market coupled with little supply response has given the private education providers pricing power. Fee increases tend to more than offset inflation in teacher salaries (largest cost). In addition, fees are usually collected upfront while teacher salaries are paid in arrears; giving the education business a negative working capital cycle. This has helped to fully fund the highly capital intensive expansion programme using only internal cash resources. What is even more impressive is that after funding all capital expenditure, Advtech still managed to convert most of its accounting earnings to cash at a 10-year average of 82%.

Growth is predominantly volume driven through increasing capacity in existing campuses or by building new ones. However achieving this balance is not as easy as one might think - too much capacity growth impacts profitability negatively, while too little impacts enrolment growth negatively. Excellent planning systems are essential due to the need to fill capacity immediately, which can take up to three years before coming online. For the best part of the last decade, Advtech's management team has achieved this balancing act very well. However, sometimes even the best planning systems can be slightly off the mark. This was the case in 2010 when additional capacity, which was planned a couple of years prior, was not immediately filled on completion. As such, profit growth was impacted negatively and the share price fell.

Investing with a long-term focus allows us to look through the short term and assess the business based on its normalised earnings. We believe excess capacity will be filled over time which should result in the business returning to normal profitability levels. Our assessment of normal earnings of 60 cents per share is higher than recently reported earnings of 37 cents per share. At current prices the share is trading at a multiple of 9.5 times normal earnings which for a business of such good quality is attractive.
