Investors' Chronicle | Alpha

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Alpha shares analysis

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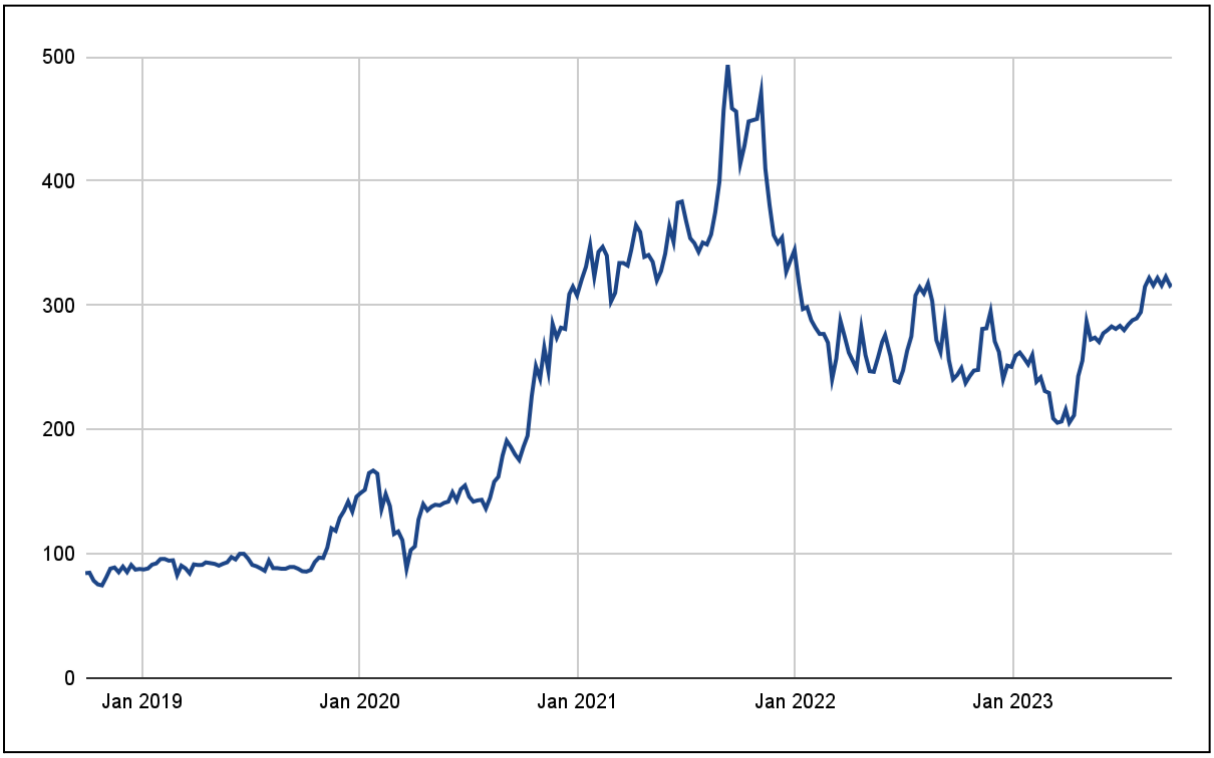
Learn from history but look forward

History can be a friend or a foe to businesses – the market has a long memory and can often take time to forgive. However, where there is too much fear, there can be good value as is the case for one of our selections this week. Our other stock this week is historically very strong but faces risks from competitors, regulators and potential litigation. Although strong businesses like this will often win out.

- **Volex (VLX)** – this Aim-traded cabling and sub-assemblies company is a globally dominant business, well-exposed to markets offering very solid, in some cases impressive rates of growth. Despite a good forecast rate of earnings per share (EPS) growth, the shares look cheap on a price-to-earnings ratio (PE) of just 11x in a sector where similar growth can attract a 50-100 per cent premium to this rating. There is more to the story, however. First, in 2016 Volex fell badly due to its over-concentration on a single customer and the market seems unable fully to shrug this off. Second, there is another high concentration to a single customer, less acute than before, but still accounting for over 15 per cent of revenues and more than half of the growth rate. Third, there is some concern about the group's major shareholder and whether his stock is an overhang. All told, concerns look overplayed and while a rating as high as **Halma (HLMA)** or **Spirax-Sarco (SPX)** is hard to support, it certainly merits something closer to, say, **Rotork (ROR)** or **Spectris (SXS)**. Re-rating to align with these stocks could easily add 100p to the 325p share price, leaving this stock looking materially under-valued.
- **VISA (US:V)** – the world's dominant payments processing provider (40 per cent global market share) has enjoyed spectacular growth since its IPO in 2008. Investors have enjoyed an average total shareholder return (TSR) of around 20 per cent. Can this continue in light of rising competition from new generation FinApps plus regulatory threats and potential legal action centred on the group's duopolistic market position? Yes, but maybe not at the same rate. Visa is unlikely to slip very far in its dominant position and growth in the payments processing space looks set to be high and enduring. Some may be concerned that the stock is expensive, but in reality it stands only on a modest premium to the S&P 500, as it should given its wide moat and impressive record. Coming off a strong 12-month rally, now may not be the best time to buy, but investors getting in when the stock is closer to a market average rating could see a double-digit annual TSR.

Analyst: **Robin Hardy**

Volex – power to the people



Source: FactSet

Volex (VLX) is an Aim-traded industrials stock with a market capitalisation of over £800mn, which is large for Aim, but overall it can be considered as a small/mid-cap stock. It's a business with a major industrial footprint, dominant market shares and a global presence. Volex manufactures wiring systems, looms, cradles, sub-assemblies and connectivity modules for a wide range of electrical power and data distribution systems for large original equipment manufacturers (OEMs). It operates across a wide range of industry groups and sub-sectors giving an attractive diversity and some element of counter-cyclicality or cyclical smoothing.

Reporting in US dollars (America is the largest area of operation), Volex last year generated $723mn of revenues (up 11.6 per cent) on which it returned 9.3 per cent earnings before interest and tax (EBIT) margins. The margins are relatively low because Volex owns little of its own IP and is, essentially, a sub-contract manufacturer. This is an acquisitive business having made 11 strategic moves in the last five years, most notably this year when buying Turkey's Murat Ticaret (bring in revenues equivalent to more than 20 per cent of those pre-existing) and weighing in at a €178mn purchase price. As we discuss later, this looks set to be a transformative purchase.

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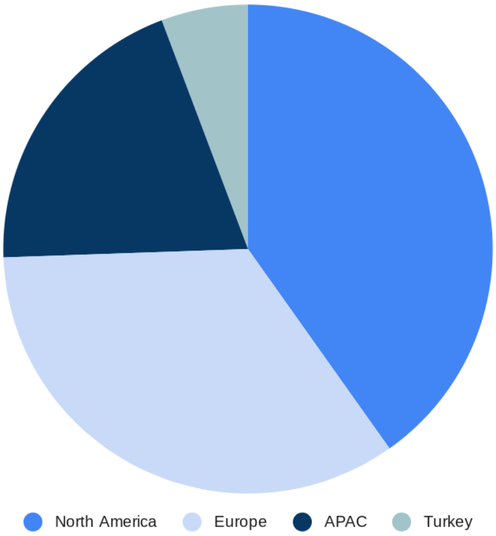
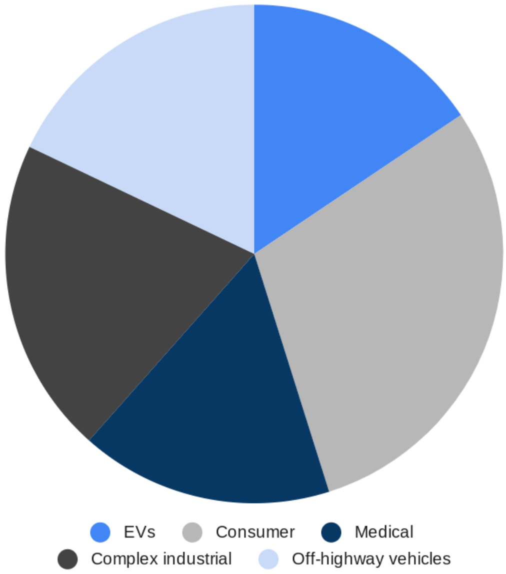
Key business elements and drivers

This is a diverse business both geographically and operationally, as summarised in the pie charts below. Here we have adjusted the FY2023 reported figures as pro forma to include the post year-end purchase of Murat Ticaret.

Volex business split FY 2023 pro-forma

Geography	End markets
	

Source: FactSet, Volex

Consumer – this is the largest segment (30 per cent of revenues) and arguably is the lowest quality part of the group. Over half of the revenue is from 'white goods' which is highly commoditised, cyclical and, right now, is facing a consumer down cycle. That said, Volex is looking to push higher up the value chain across all end markets via a greater focus on premium brands, harnessing the increase in smart internal technology (more functions means more wiring) and OEMs making their products 'feature rich', again raising complexity. As OEMs do not want to lose pricing gains to cost, Volex's unique selling point of simplifying OEMs' workloads by pre-sizing and pre-assembling wiring structures could boost market share. Overall, the macro outlook is weak (down near-term and long-term growth 2-4 per cent) but Volex is well-positioned to fare better overall than market demand: but this may only mean flat near-term revenues at best.

Complex industrial – at around a quarter of sales, this business is largely about manufacturing automation and ever faster data transmission & handling capabilities. The primary areas of operations are aerospace / defence / space, data centres, industrial manufacturing and robotics & automation. While working on many large-scale, high volume projects, the highest value part of this division's work is lower volume and 'awkward niches' where much more value can be added. Growth is likely to be well above global GDP (led by automation) and one of the fastest in the group, most likely capable of 7-10 per cent revenue growth.

Medical – this is an area where products must be more reliable and robust than in other sectors, so OEMs are more exacting and this plays to the group's strengths. This is a decent market as populations age in larger economies but the current strength of the market is still largely a post-Covid catch-up plus an apparent under-investment in recent years by many healthcare providers. What has been comfortably double digit growth is likely to drop back to a lower, sustainable (but still respectable) 5 per cent.

Off-highway – this is, essentially, all from Murat Ticaret so a new market for Volex. The end market base is highly diverse embracing agriculture (the largest and close to half of sales), commercial (bus, coach, train, rubbish trucks), construction (cherry pickers, diggers, dumpers) and industrial (fork lifts, rising platforms). The business is largely focused on small batch production, thus avoiding aggressive pricing / renewals and frequent sourcing changes prevalent in high volume production. Overall growth is healthy (7 per cent) and margins are a little above the group average in the low double digits. The still highly fragmented US off-highway market is a major opportunity, with only 9 per cent of sales there against c.40 per cent in the rest of the group: this should allow for numerous cross- and up-selling opportunities.

Electric vehicles (EVs) – leaving the best until last, this is the smallest division today, but by far the fastest growing (revenue almost doubled in FY 2023). This is a high growth sector (setting aside the most recent UK policy shift) but in this sector Volex is highly skewed towards just one manufacturer – **Tesla (US:TSLA)**. Out of $138mn revenue last year, Tesla accounted for around $90mn, which could easily set investors on edge, both for over-reliance *per se* and reliance on this particular customer. The recent decision by US EV manufacturers to standardise on the Tesla plug and wiring configuration should, however, allow Volex to broaden its base and consider the after sales market. Growth is very attractive with almost 20 per cent compound annual growth rate (CAGR) expected in the next five years but Volex has been expanding this business line materially faster than the underlying market for some time.

In all of its end markets Volex looks to be extremely well-embedded with its customers. Its products are seen as being not only highly quality but vital to ensuring lowest product costs thanks to the precise pre-finishing, cutting/sizing, loom assembly, terminations, connectivity and Volex's high levels of vertical integration (it is the world's largest producer of co-extruded coated wiring) which helps mitigate supply chain issues. So, this does look to be a very stable and well-positioned business across a range of diverse and robust end markets which leads to a well-above average quality of earnings.

Valuation and conclusions

Overall, Volex presents investors with a business in solid growth markets, a little extra spice via the EV sector, potentially high marriage value in the US via the Murat acquisition, a strong balance sheet - debt is less than 1x Ebitda (earnings before interest, tax, depreciation and amortisation) - and low capex/R&D requirements. This leaves it with high cash conversion which is typically cycled into acquisitions rather than shareholder returns as there are myriad add-on businesses than can be acquired, typically for very attractive valuations. This is a very sensible capital allocation policy for this company. Also the business seems to enjoy a wide moat with a high quality perception and being well integrated into often complex, manual and low-batch production cycles it does not appear likely that its customers will easily drop Volex and shift to a cheaper, most likely Chinese-sourced, alternative.

Add to this a well-defined growth strategy aiming to deliver $1.2bn of revenues by 2027 (13 per cent CAGR including Murat and further acquisitions) with modest margin expansion giving potentially a slightly higher EPS growth rate. So why are the shares so cheap? The PE is just 11x on year two estimates and that after approximately a 25 per cent rally year-to-date and a near 60 per cent rally since the recent low in April.

Actually there are plenty of reasons that could justify a modest rating in spite of growth that's likely to comfortably exceed the wider market.

> **Its own history** – in 2016 Volex was very heavily reliant on a single customer, **Apple (US:AAPL)**, who overnight announced that it would no longer have Volex as sole supplier for its cabling needs. The shares lost nearly 80 per cent of their value in the following year. The business has substantially moved on from there, and while the market should forgive and forget, all too often it does not.
>
> **Nat Rothschild** – this high profile entrepreneur and financier is the group's Executive Chair and largest shareholder with a near 25 per cent stake. Although Rothschild is seen as having been instrumental in rebuilding since the Apple affair (and to be fair the share price is four times higher than even the high point before that fallout), there is always some reticence about large, individual investors in highly successful companies. Will they jump ship (looking for the next big fish), will they dump their shares or will they scale back their input with unknown impact? While those close to the company see his position as very stable, this is a risk factor.

Tesla – a two-strand issue here: 1) worry that Volex has allowed itself to become overly concentrated again, although the reliance on this single customer is far lower than it was with Apple; 2) that it is Tesla and Elon Musk with whom they are aligned. Musk is not to everyone's taste and is known for rash decisions and flights of fancy with insufficient regards to the fall out.

Consumer exposure – this remains the largest end market space for Volex and although being made relatively smaller with each acquisition (especially Murat), there will be concerns that in a tougher consumer environment this could become the tail that wags the dog. While desertion to China for cheap sourcing feels unlikely in other divisions, the quality thresholds feel lower here and one would have to consider seriously the risk of volume and/or pricing pressures.

Margins – the margins are moderate meaning that there is less headroom to absorb potential problems with labour, materials, contract pricing or volume losses. The better-rated favourites in the sector (Spirax-Sarco and Halma) each have EBIT margins of around 21 per cent against Volex's 9 per cent. That said, these others have a lot of IP to maintain and far heavier R&D requirements.

How should Volex be rated taking into account the generally favourable operating climate and these understandable (but not necessarily likely to materialise) counterpoints? There is a very well established ratings hierarchy in the industrials sector with Halma and Spirax as the premium plays (25x PE), this is followed by Spectris, **Weir (WEIR)** or Rotork as companies going positively through change (high teens PE). Then in the next tier solid less attractive players like **IMI (IMI)** or **Bodycote (BOY)**, low double-digit PEs, and cyclicals such as **Vesuvius (VSVS)**, single digit PE across the cycle, at the bottom in terms of rating.

Where should Volex sit? Arguably with Rotork and Weir, although there is a good case for something of a discount, but that would still indicate fair value would be around a PE of 14-15x rather than 11x. If that was right, Volex should trade nearer 425p and with scope to step the rating a little higher if it can prove to the doubters it can avoid those issues still seen as hanging around its neck.

This has been something of a roller-coaster for investors with negative TSR over two years, a halved share price in that time and a strong rebound and that can all too easily appear off-putting. This sector can, however, be volatile and global, with big-picture issues able to easily overwhelm even strong specific fundamentals. But this is a stock that seems to be forced by the market to carry an excessive amount of baggage and that has been allowed to drag on the rating. Volex looks pretty decent value and could easily deliver a high TSR still, but buyers do need to be sensible of the risks.

VISA – past its prime or storms in a teacup?

Source: FactSet

Visa (US:V) is not a credit card company – credit is the business of local banks – it is a global payment processing company that manages card payment transactions on behalf of the credit issuing banks and their merchant customers. Larger than **Mastercard (US:MA)** and China's UnionPay (which is mainly in APAC, Middle East and Africa), Visa has a 40 per cent global market share (the other two majors hold 66 per cent), leaving just 4 per cent of this $75bn-$90bn market (estimates vary considerably) to the rest of the pack. The 'others' for scale include the likes of Amex, Discover and JCB. Forecasts suggest that by 2030 the market will have grown to nearer $200bn, with a CAGR of more than 10 per cent.

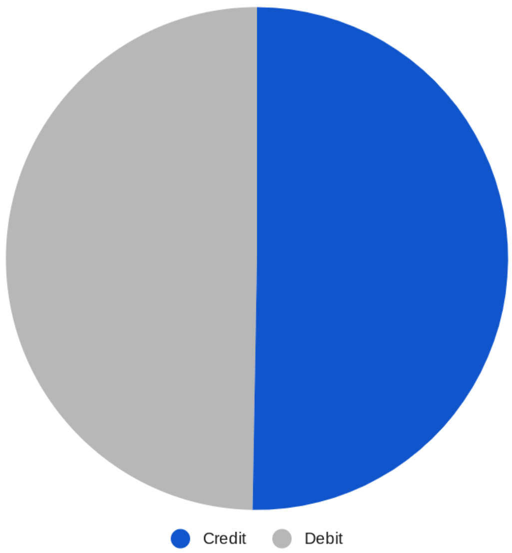
Visa has a market cap of almost $75bn-$80bn, revenues of around $30bn on which it makes an impressive EBIT margin of about 66 per cent. It has grown its revenue for each of the last 15 years, shrugging off the global financial crisis (GFC) since when it has grown its revenues almost five-fold and its profits almost seven-fold.

Key business elements and drivers

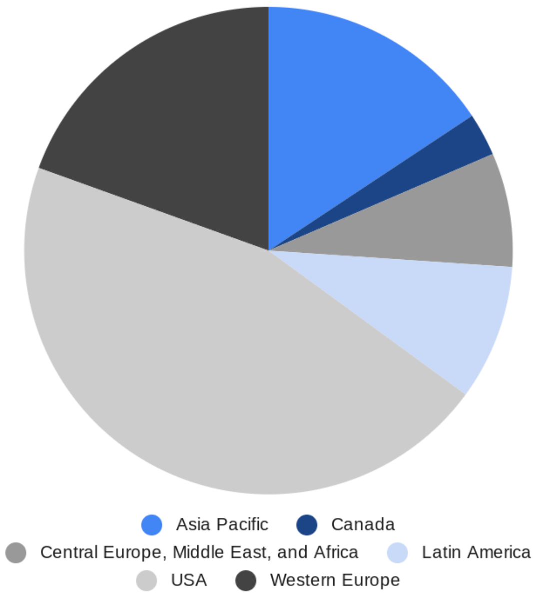
Visa essentially operates a single business line – processing physical and virtual credit and debit card transactions on behalf of partner banks and other card issuers. It is globally diverse but centred on the USA and its business is split evening between debit and credit payments.

VISA business breakdown

Revenue by mechanism



Revenue by acquirer geography



Source: VISA

Only around one-third of Visa's revenues come from the direct fees levied on each transaction ('service revenue') with the remainder arising from allied services, as described below.

Service revenue – the direct fees collected per transaction from merchants (the retailer) plus device/terminal rentals.

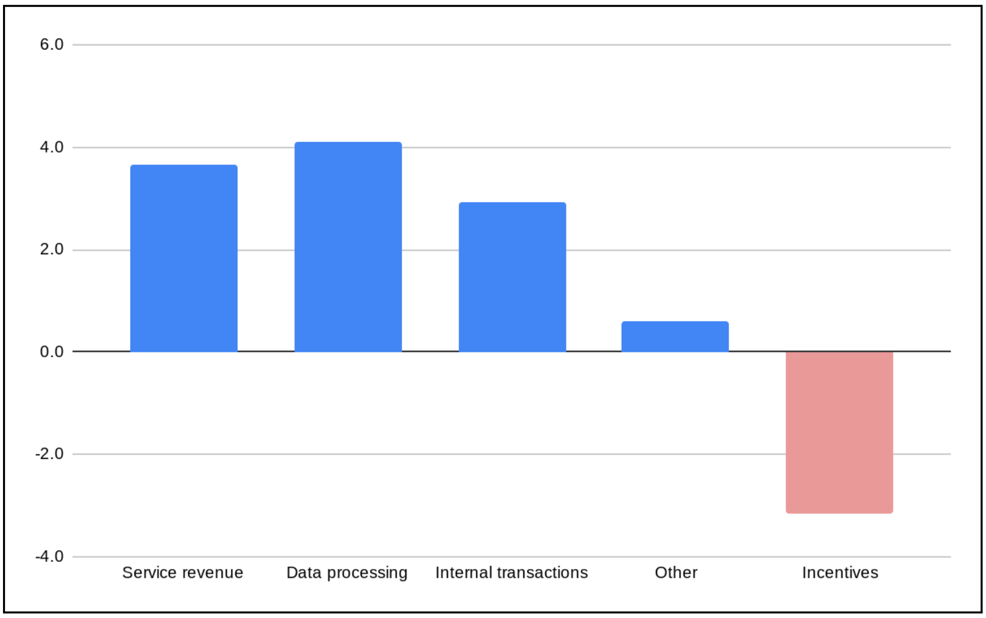
Data processing – clearing, settlement, authorization and network access for acquirers (the card issuer).

Internal transactions – primarily cross-border transaction processing and currency conversion.

Other – licence fees, value-added services, account holder services, certification.

Incentives – not a revenue source but a cost comprising reward schemes, offers, discounts etc at both the merchant and acquirer level to drive new/expanded business.

Visa's total revenue profile – Q3 2023 – $bn



Source VISA

There are numerous positive market drivers for payment processing, although not all will accrue for Visa.

The death of cash – a global phenomenon accelerated by apps and phone payments.

Straight to app banking – explosive growth especially in India and Africa. The number of traditional and pseudo banks is expanding very rapidly and all will need payment services. While newer and smaller banks are more risky, they pay higher fees. Finnaps and new banking services are forecast to grow at well above 20 per cent CAGR and fastest in less developed economies.

Online shopping – growth is killing in person shopping where electronic payment is the only option. Online retail is forecast to grow at 8-10 per cent versus 3-4 per cent for retailing overall.

Identity and security – the need for assurance for merchants and acquirers is growing rapidly and generates new revenue streams. Here the use of tokenization and blockchain technology play to the strength of the larger operators such as Visa due to the investment and high levels of trust required.

Ticket to card transition – airline, bus and rail tickets are increasingly moving to app format but must still be processed. Metro transport systems are growing especially fast and replacing local, direct systems such as London's Oyster. Growth is estimated to be running at 10 per cent CAGR.

Prepaids – this is fast replacing cash for both travel and gifting/rewards and is forecast to grow at almost 20 per cent CAGR for the rest of this decade.

New transactions forms – there has been substantial growth in new ways of interaction in payments between parties especially in peer-to-peer (P2P), such as 'texting money' which is very common in Europe, and government-to-citizen (G2C) interactions replacing cash or bank payments and instead using global payment systems.

PaaS – payment-as-a-service is similar to Finapps but allows very small businesses and nonprofits to take card payments and significantly expands the potential customer pool for payment processing.

Subscription services – increasingly individuals and businesses are swapping periodic (say annual) one-off payments for services and software products for monthly recurring payments. Typically these services cost more over time and generate, say, 12 times as many transactions to process.

Valuation and conclusion

Visa has been a spectacular performer both financially and in terms of TSR since its 2008 IPO. Investors buying in on the initial float would have made 20 per cent annual TSR, although over the last five years this has dropped to nearer 10 per cent, still a very attractive return. However, can this momentum be sustained? There are numerous macro positives but there must be a concern that while the market may continue to expand rapidly, Visa could be at risk of losing market share.

While Visa is a global business it remains heavily skewed to the USA and western Europe and this is not where the highest rates of growth will be. That is coming from Africa, India, China, the Middle East and southeast Asia and in these locations the dominant player is China's UnionPay. Around the world, smaller local disruptors are also taking market share rapidly with the likes of Mercado Pago, Ant Group, Tencent and Grab gaining a lot of traction in key, high population nations such as Brazil and Indonesia. In China, WeChat and Alipay are building market share rapidly but are using unsustainably rock-bottom fees. As a left of field long shot, there could even be a threat to some payment processing systems from crypto.

There is also evidence of push back in some countries against Visa in favour of Mastercard, as we saw recently in the UK with several banks moving their debit card processing away from Visa. This was more due to the push by Mastercard to grow its market share using price but this could mean that there is a risk of some form of price war looming.

There is also concern in the US about the power of the duopoly between VISA and Mastercard, to the extent that bills have been put forward in the senate, e.g the Credit Card Competition Act ("CCCA"), which seeks to force banks to have minimum two processing services of which only one can be from the duopoly players. This could be something of a politically motivated 'trust buster' rather than something positive for consumers as the most likely beneficiaries in the USA, Amex and Discover, actually have higher fees than Visa and Mastercard. However, with greater throughput that need not remain so. Americans are arguably being materially overcharged, according to ValuePenguin, with average fees there of about 1.75 per cent against a global average of just under 1 per cent.

Not only are the fees high, but they are set/dictated by Mastercard and VISA rather than by the acquiring bank and this gives a lot of power to these giants – in regulators' minds this begins to look like market abuse. Regulation has to be taken seriously and in the EU for example, a cap of just 0.3 per cent was recently imposed on credit card payments.

There is also a risk of growing resistance by Visa's customers – the merchants and the acquirers – who are left to pass through Visa's dictated fee structure. There is a high profile court case in the US from Block (owner of Finapp 'Square') which alleges that Visa and Mastercard are engaged in "horizontal price fixing" and "vertical price restraints", i.e. abusing their market share. More litigation could follow, but realistically we are not looking at another Standard Oil or AT&T enforced break-up.

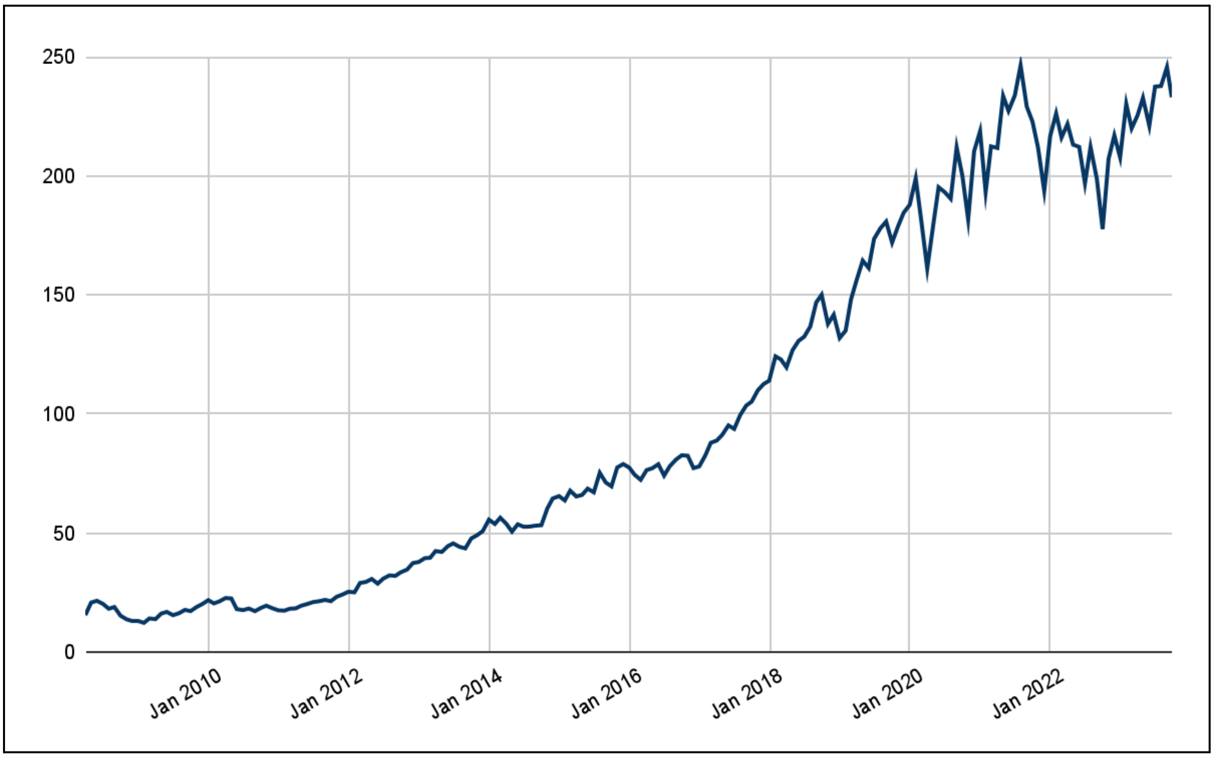
There are a few more clouds on the horizon for Visa and some opportunities it might historically have expected to pick up could drain away to newcomers. However, there is still a lot of organic growth in established fields and a share of new generation business that can continue to push Visa ahead at a steady rate. Growth may not be above 20 per cent like over the last 15 years, but the brokers' consensus suggests a CAGR in EPS from 2022 to 2025 of 13-16 per cent: down but far from out.

A key negative argument is that the growth available is expensive for investors, but that is not really the case. The average for the S&P 500 index is a year 1 PE of approximately 20x, while Visa trades on 23x. Given the record and exceptionally wide moat this business has, that does not look expensive, especially with Mastercard trading at 28x. There have been no upgrades or positive surprises in the forecasts for more than two years, but this too should not be seen as a negative – steady often wins the race.

Analysts are almost uniformly positive with just three hold recommendations of the 26 brokers expressing a view. Target prices feel a little bullish (some as high as $325 versus today's $230), but with EPS growth in the teens, only a moderate(ish) premium to the S&P, annual buy-backs averaging 2.3 per cent of the issued equity over the last five years and a cash dividend of just under 1 per cent, there still looks to be a good chance of seeing a double digit TSR. But it is probably best not to buy in today.

The US stock market is coming off a 30 per cent rally over the last 12 months and there is some concern about consumers' spending habits and resilience (Black Friday and Christmas will tell us a great deal), but the share price may, for now, test some resistance levels. A lower bound could be the stock dropping towards a market average rating (that would be around $198 against today's $231), but that could easily prove to be a solid buying level from which to see double-digit TSR.

Almost straight line since 2008 IPO



Source: FactSet

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