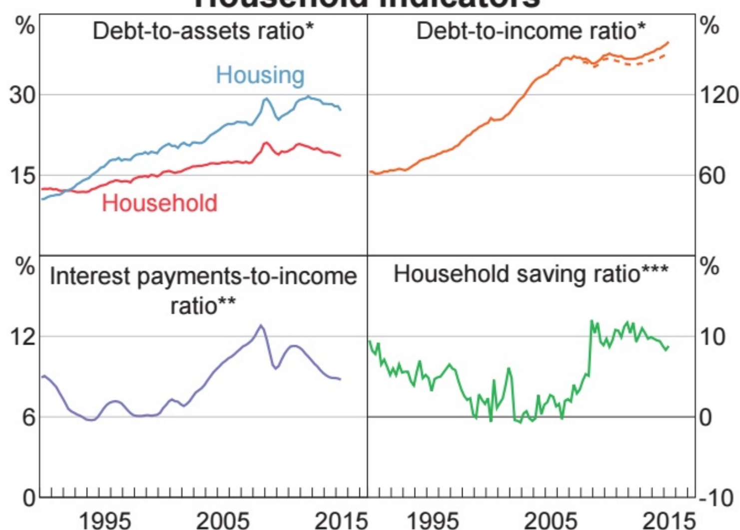
Drowning in a mountain of debt

Dear Investors, 29 Dec 2015

Australian's are the most indebted citizens in the world. The average Australian (according to the RBA) owes about US$56,000. The second most indebted citizens in the world are unsurprisingly, our US friends with US$44,000. In comparing the US and Australia both countries have similar national debt levels as a percentage of GDP but while our Government has less debt than the US government and US corporations run similar levels of leverage to Australian ones, **the Australian consumer is very highly geared both in nominal terms and as a percentage of GDP relative to the USA.**

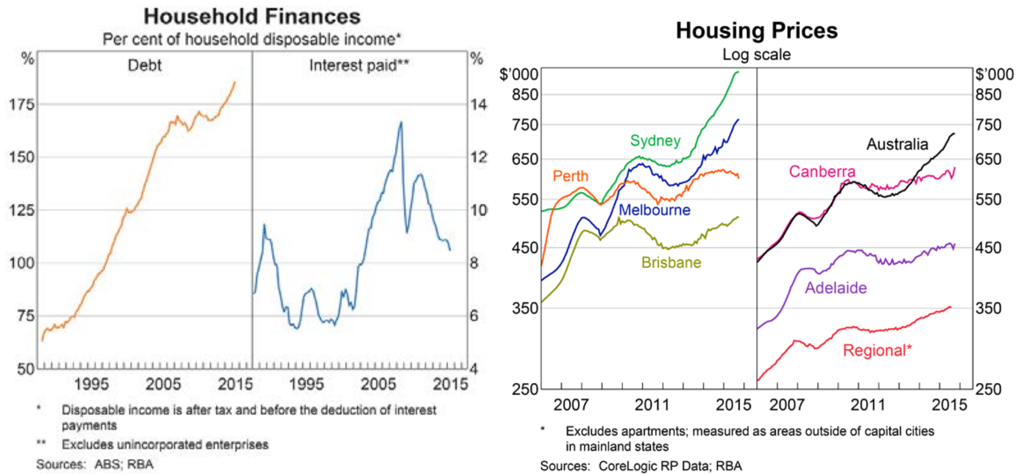
The series of charts below paint a picture of a country of consumers borrowing more money, increasing their gearing during a period of record low interest rates and creating a property bull market that has made our residential property amongst the most un-affordable in the world.

The two top charts below show that **gearing measured by debt to assets and debt to income keeps increasing**. This has been supported by unusually low interest rates. In the chart at bottom left, **interest funding costs as a percentage of income has dropped due to lower interest rates but is still historically high.** The final chart below right shows that **Australians have started to save more post the GFC but despite this, debt levels keep increasing.**



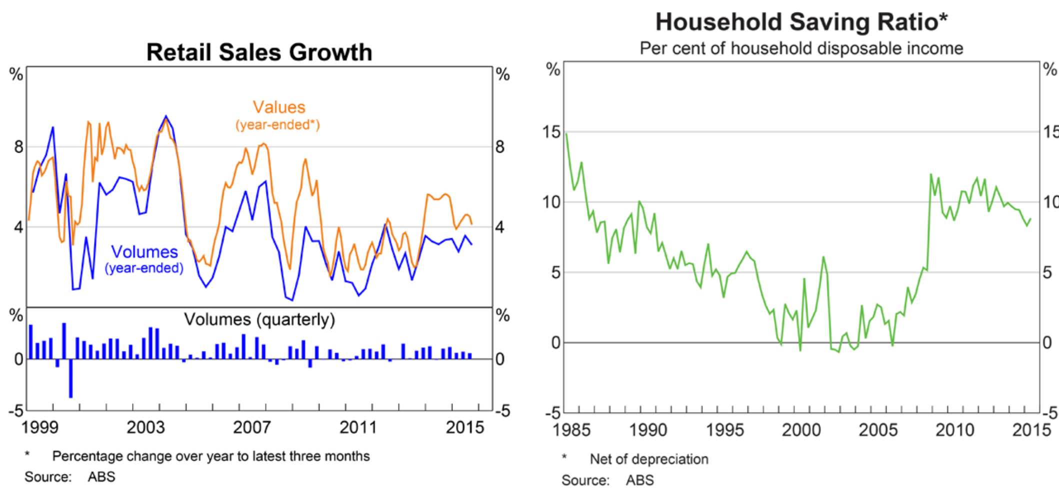
The chart below on the left shows household debt as a percentage of Australia's GDP climbing consistently and has been supported by lower interest rates which, as shown in the chart to the right, allowed interest as a percentage of household income to drop from pre GFC highs as interest rates have been cut. **What happens when (not if) interest rates start to rise?**

The chart on the right shows the key driver of higher debt. The residential property boom has helped create amongst the most unaffordable housing on Earth.

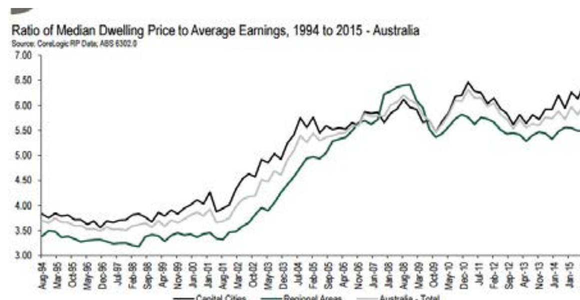


As you can see in the chart below on left, despite population growth and increases in debt, **retail sales growth continues to decline reflecting consumer's inability to keep increasing consumption.**

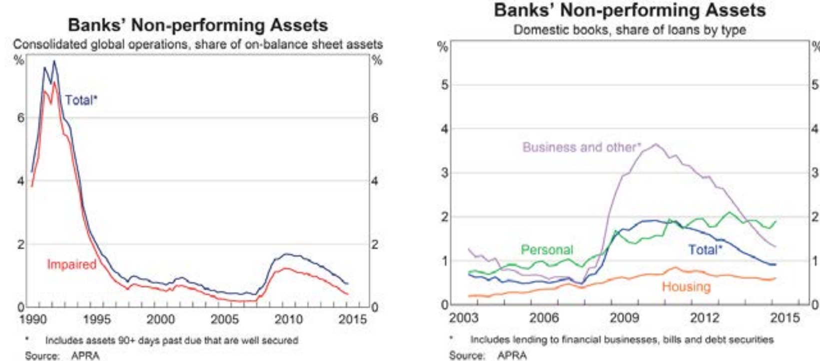
The chart below on right shows that since the GFC Australians are saving more of their income yet debt continues to climb.



The chart below shows how residential property continues to become more expensive relative to income.



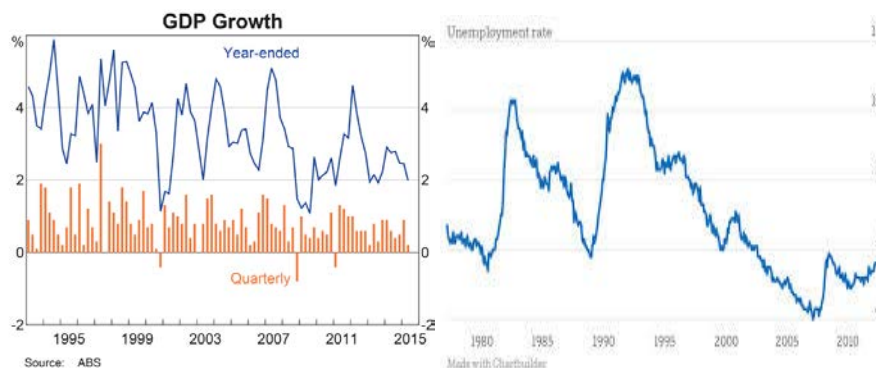
These charts below show the trend in non-performing assets has been recovering since the GFC highs except in the case for *personal* (chart on right) which suggests the number of people failing to service their personal debt (becoming impaired) has been gradually increasing since 2003.



Reflecting the lack of productivity improvement and very high cost of doing business in Australia (amongst other factors), Australia's GDP continues to trend lower albeit with high volatility. With Government spending constrained due to the Federal and state governments trying to get budgets under control, consumers tapped out, and unemployment trending higher, low growth rates are the likely outcome.

Based on data from the bureau of statistics, the average Australian's household debt to annual income at around 180% exceeds that of Canada, France, Italy, USA, Japan and Germany.

Anyone under the age of about 50 has never worked in a high unemployment era. How will people react if/when it is no longer *easy* to get a job?



What does it all mean?

We believe this trend is creating an enormous probability that the number of people struggling to service their debts will continue to increase. The number of people becoming financially distressed will increase and those people will require help.

Who do the financially distressed turn to?

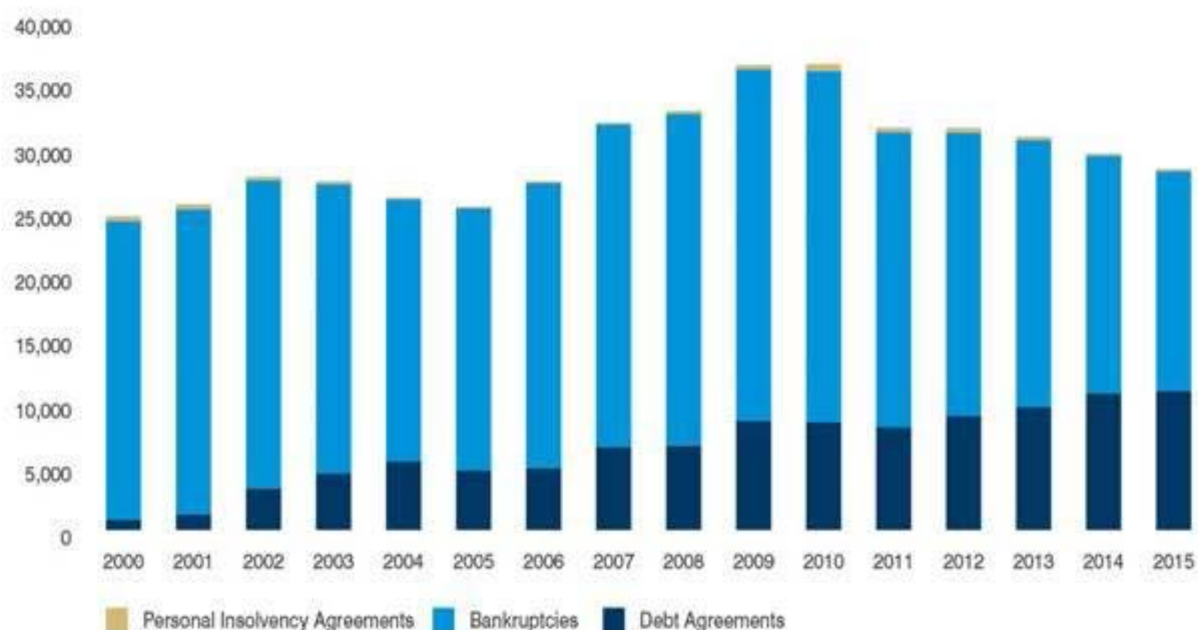
There are of course a number of options for people in financial trouble, perhaps friends and family come first but after that, options dry up quickly.

The largest provider of solutions and advice for people in financially distressed situations is FSA Group (ASX:FSA). FSA receives around 5000 phone calls a month from people in trouble. FSA puts the people through a thorough screening process and then works out the best way forward for them. The options are as follows:

1) A debt agreement with the person's creditors.
2) Bankruptcy that FSA may (or may not) administer
3) Personal insolvency agreement
4) Refinance into affordable debt package.
5) Provide a free budget and recommended to adhere to a more financially disciplined life style.

In 2015 about 30,000 people sought either: bankruptcy, personal insolvency agreement or a debt agreement. This has been trending down (with interest rates) since peaking back in 2010 at about 36,000 but is higher than 15 years ago at 25,000. During the last 15 years the number of debt agreements relative to bankruptcies has steadily climbed as people have preferred to pay back some of what they owe (via debt agreements) to creditors and avoid bankruptcy.

The chart below provides a picture of the services market that FSA is the dominant player in. **While it shows benign growth, the ever growing levels of household debt during a period of record low interest rates is creating a large group of potential victims of financial distress for FSA to help in years to come.** The graph below has the potential to move back into a growth phase.



FSA is the biggest player in this debt solutions space. While medical services stocks are well understood by the market, FSA is a financial health services stock and a one of a kind so not so well understood.

FSA was founded by its current senior executive team and is effectively owner operated which on balance we like as their interests are aligned with those of shareholders. Management own around 46% of the company.

The company deploys capital judiciously and generates over 20% return on equity. Its balance sheet is not heavily geared with most of the balance sheet debt non-recourse to FSA (a little confusing).

The stock is trading on a trailing p/e of less than 10x and fully franked yield of 6%.

The stock has recently been sold off providing some frustration for shareholders perhaps but also an opportunity for those who want to buy more. The reasons as best we can interpret for the sell off are below with our response:

1) Comments by the prime minister about changes to bankruptcy laws have caused uncertainty about the outlook for FSA's services business. *Our view is that this has been misunderstood and Govt is proposing changes that will have no impact on the FSA business.*
2) Management commentary at the AGM suggested revenue for the first quarter was weaker than expected. *For short term investors this may be a concern although the executive director in charge of*

services confirmed business had picked up post the end of the first quarter. We are not anticipating strong growth at this time….but neither are we having to pay for it.

3) There may be concerns that Westpac withdraws its support of FSA's lending books due to changes in capital requirements. *Westpac makes good margins out of its FSA lending, the relationship remained solid through the GFC, we see it as very unlikely this will change in the near term. Other banks would likely step into such a profitable business if Westpac withdrew*.

So we have several reasons above that may explain the recent 20% sell off, none of which impact our long term view that FSA is attractive value, very well run, a sound business with very good return on equity and is the future beneficiary in the event that interest rates or some other catalyst start creating a higher level of distressed borrowers in our economy. Given the trends we have provided above we believe it is highly likely that at some point, FSA will be receiving more phone calls each month.

FSA remains our biggest single investment and while the pullback is somewhat frustrating, equity investing is like that. Markets go up and markets go down but ultimately, share prices reflect the underlying value of the businesses they represent. The chart below provides a picture of a change in sentiment that we believe in the long term will represent an attractive risk/reward opportunity for investors.

Chart data from Big Charts

Good investing,

Nigel Littlewood

Note: Harness Asset Management Small Companies Value Fund (the Fund) and the author own shares in FSA as at the date of publishing. **The above is in no way intended as financial advice**, nor any recommendation by the manager of the fund. This report has been prepared by Harness Asset Management Pty Ltd (ABN 61 158 314 982 AFSL 469551) and any views or commentary expressed herein are those of that party. This report contains general information only and has been prepared without taking into account your particular objectives, financial circumstances or needs. Before making any decision based on this report you should assess your own circumstances or consult a financial advisor. You should consider the Information Memorandum (IM) before deciding to acquire units in this fund. The IM is available at www.harnessam.com.au or contact us at admin@harnessam.com.au. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this report. Neither Theta Asset Management Limited (ABN 37 071 807 684 ASFL 230920), the trustee of the fund, nor Harness Asset Management guarantees the performance of the fund or the return of any investor's capital. Past performance is not an indication of future performance.