Should You Buy SMRT Stocks Now?

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Yesterday, Mothership posted a viral post focusing on SMRT's *huge* gains in profits. At a preliminary glance, I immediately thought, "Wah, if this is true, then I better buy into the stock now!"

But then another voice in my head said, "Don't make the mistake of focusing on the stellar results of one quarter. Check whether such a performance can be sustained before you rush to buy."

SMRT shares climbed almost 3% within a day after the results were released, but I'm laughing at those who jumped to buy so soon after the announcement *instead of doing a further forward analysis to determine whether going in now would be a wise move.*

SMRT has never been (and will never be) on my watchlist of stocks. After reading Mothership's article, I decided to revisit my thesis and investigate if things have indeed turned around for the public transport provider.

TLDR summary: **No, and it will probably get worse from here.**

Running away from SMRT's stock before it falls further in the next few quarters.

Let me first start off by saying that the main reason why I'm not buying in now is because I believe their recent quarter profits growth are only temporary. Upon studying the business in detail and looking at other factors, I realized a key point that may potentially drive their profits (and thus share price) down further in the future:

SMRT's expenses are expected to increase.

Here's why.

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1. Rail operations are still in the red, with million-dollar losses.

Although SMRT's profits from its train segment has increased by 200% compared to the same quarter last year, don't forget the ugly fact that their rail operations are still in the red. Its core business, the MRT, incurred an operating loss of $2.8 million, while the LRT registered a 70% increase in operating losses (close to 500 million extra). You should also note that the LRT business has yet to become profitable for SMRT.

Rail maintenance expenses could reach 50% of rail revenue in 2016: SMRT

Currently, SMRT said its rail maintenance-related expenses was 41 per cent of its rail revenue and formed 23 per cent of its total Group operating expenses in the second quarter.

Credits: Channel News Asia

2. SMRT is grappling with increased costs for maintenance and renewal programmes for its rail network.

With all the highly-publicized train breakdowns, we already know by now that SMRT has a lot of improvement works to do, especially on its third rail system.

The management team has already stated that they anticipate further increases in operating expenses, partly due to maintenance and renewal programmes for the rail network.

3. Higher manpower cost will continue to erode profits.

Singapore's tight labour market also means rising manpower costs for service-oriented businesses like SMRT. In Q1, SMRT registered an increase of $10 million in just staff costs alone.

Basic economics will tell you that when your competitors offer higher wages, you have to either catch up, or offer more intangible benefits in order not to lose your workers. Well, SMRT's incoming bus competitor, Tower Transit, is already offering about 15% more in basic pay for its bus captains. How did SMRT react?

By dangling more carrots in the form of cash incentives – sign-on bonuses of up to $3k, and referral incentives of $1.5k to $3k for existing staff.

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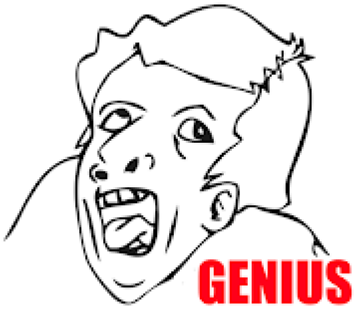
4. SMRT is becoming more and more in debt.

Their net gearing has increased from 0.77 (2014) to 0.79 (Q1) to 0.80 (Q3) in SMRT's latest results. In other words, they have $126 million in cash but $810 million in debt today.

Discounting the nature of debt in their business, will you invest in a company with increasing debt? I certainly wouldn't.

5. Steadily decreasing cash and equivalents.

Everyone likes a cash-rich company, and good free cashflows are one of the primary requirements experienced investors look out for in a company before they put in their money. But in Q1, SMRT registered a sharp drop from $207 million to $131 million in its cash and equivalents, whereas its latest quarter stands at an even lower $126 million.



6. Contrary to popular belief, low fuel prices doesn't automatically translate into more profits.
"But BB, the lower oil / fuel prices today should benefit SMRT in the future!"
While this is indeed true, we have to remember that fuel prices aren't the only expenses SMRT has to take care of. In fact, recently in last quarter, SMRT revealed that its total expenses rose by 7.1%, with cost increases like manpower and depreciation exceeding the savings from lower energy and fuel costs.
7. Neither does higher fares.

In 2013, SMRT appealed to LTA to raise public transport fares in order to cope with its rising operating expenses. But I doubt the rate of increase is enough to keep up, given how costs are steadily increasing and getting worse for SMRT.

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8. SMRT is not the only public transport provider.
SBS Transit has upped its ante from just being a bus service provider to winning the right to operate the North East Line and the Downtown Line, winning both contracts away from SMRT and breaking its monopoly in the train industry.
SMRT has even admitted that they expect the new Downtown Line 2 to reduce their revenue even further. Its CFO estimates this to be a $1 million loss in the fourth quarter, with its impact divided as 80% on MRT revenue and 20% on bus revenue. *I was confused about the bus part, until a taxi driver told me about how folks from Bukit Panjang used to take bus services to get to work in CBD, but are now opting to take the train to Newton and complete the rest of the journey by bus instead.*

Credits: AsiaOne

9. SMRT's 845% increase in bus operating profits is unlikely to sustain.
Although SMRT's bus segment vastly improved and generated huge profits recently for the company,

please do not be fooled into thinking that such a performance will be sustained.
It is almost a joke, looking at how SMRT said with confidence last quarter that they expected their bus business to improve further, as they were "in discussion with the authorities on the contract terms for the remaining bus services beyond the licence expiry in August 2016". They have to eat their own words now.
The outcome of the discussions? SMRT (and SBS) lost the 2 major tenders issued by LTA for the bus services – the contracts were awarded to foreign operators Go-Ahead and Tower Transit instead. Such a loss will make a significant dent on its revenue, so be prepared to see SMRT reporting drops in operating profits after August 2016 when these new competitors take over.
(FYI in case you were wondering – the contract won by Go-Ahead covers operations of 25 bus routes and is expected to generate $497 million, whereas Tower Transit's contract will cover 26 bus routes and earn about $556 million. These figures are for a five-year contract period.)

10. Their 500% increase in taxi profits might drop as well.
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SMRT's CFO has already stated that their taxi business has been adversely affected by ride-hailing apps like Uber and GrabTaxi, as its hired out rate of its taxi fleet has dipped 2% by last December. With GrabCar and Uber Exec, many people who own cars have been signing up as private drivers to earn extra income. One of my friends even does it for a full-time living. There is no need to rent a SMRT or ComfortDelgro taxi anymore.


My main gripe about the Mothership article is that it appears misleading to a novice investor as it presents SMRT in a highly favourable light, especially when one reads sentences like these:

Healthy profits aside, commuters and taxpayers in Singapore will remember the dividend SMRT owes us.

Immediate thought of a novice investor: WOOHOO DIVIDENDS! Time to buy SMRT stocks now so I can benefit from their higher dividends in the future!
Sorry to burst your bubble, but that is unlikely to happen. Also, read this post I recently wrote about the fallacy of making investment decisions based on dividend payouts as a driving factor.

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I wonder if all the retail investors who jumped to buy yesterday considered all of these before buying?

Well, I guess they will realize their mistake when the share price drops further over the next few quarters, especially after August 2016 when the new bus providers enter.

As a BB reader, I hope you're now well aware of the cons you need to factor in before you buy! Still think SMRT is a good stock?

With love,
(a very tired) Budget Babe

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