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Stocks Down Under

'The gambling known as business looks with austere disfavour upon the business known as gambling'.

- Ambrose Bierce ((1842-1914), American writer

Domain Holdings: A strong No.2 can be too strong

Stocks Down Under rating

ASX:DHG Share price: A$ 3.80 Market cap: A$ 2.23BN

If there was a Top 200 stock on ASX that made a massive comeback in 2019 it was Domain Holdings, the Sydney-based online property advertising business. Domain's stock went from $2.07 on 8 February to $3.70 at the end of the year. In early 2019 just about everyone thought that residential property in Australia was entering a bear market, and that would be bad for Domain. A year later the picture has changed, with property rising again, but possibly the market has gotten a little overexcited about Domain.

Company Share Price Chart

Source: Tradingview

The thing investors like about Domain is that this is not the old real estate classified operation of Fairfax, which made that dinosaur tonnes of money but also made it fat and happy because the money would just roll in without Fairfax having to try too hard. Sure, Fairfax started the Domain brand for its real estate pages in 1996 and created domain.com.au in 1999 when it realised that the Internet was real and not a fad. But a couple of decades later, and a couple of years after Domain was spun out of Fairfax as a listed company in its own right, Domain is now a highly innovative online player with multiple growth engines that isn't wholly reliant on whether or not people are buying or selling houses or apartments right now. And it has a new 60% shareholder in Nine Entertainment (ASX: NEC) after the 2018 merger with Fairfax.

Domain tries harder

What investors have recognised about Domain is that there is an 'Avis effect' at work. Back in the early 1960s Avis, the No. 2 player in the US rental car market, set out to close the gap with the No. 1 player, Hertz. The campaign they came up with to do this had the genius slogan 'We're Number 2 – We Try Harder'. It worked like a treat.

Domain has had to try harder because in property advertising in Australia it is No. 2 to No. 1's realestate.com.au, owned by REA Group (ASX:REA). We argue that the gap between 1 and 2 is closing. Traditionally REA Group has been strong across the board, whereas Domain has traditionally only dominated at the high end of the market. In recent years Domain has come to better understand where it is an established player, where it is 'expanding', and where it is 'emerging'. Better service of the latter two markets could allow Domain to not just catch up but actually overtake its larger and better-resourced competitor in the long haul.

Content is king in property advertising

The big innovation that has worked for Domain in 2019 has been content. Domain is getting smarter at creating content which will draw eyeballs to its various websites. And it's getting better at gauging the audience for that content so that richer amounts of data and other premium services can be sold to the agents who act as the gateway for most property transactions in Australia. The result has been that while Domain only has around 70% of the digital audience of REA Group, it now gets around the same number of listings. As of 2019 Domain is effectively better at leveraging its content than REA Group. And with Nine Group now the major shareholder of Domain, there is significant potential to close the digital audience gap further, particularly in the 'emerging' segment.

Cross sell galore

The other big Domain innovation of recent days has been consumer solutions. Domain Loan Finder tapped into a market opportunity where the traditional broker model had cut the cost of mortgages compared to their historical average, but not made the process of finding and signing up for a mortgage convenient for the end-users. The success of this business made it relatively easy to sell insurance via Domain Insure and utilities via Domain Connections.

Now, just because it's a great company doesn't mean it's a great stock right now. Indeed, the increasing strength of Domain versus its main competitor doesn't mean that Domain stock doesn't have downside. A poor half-yearly result in terms of margins could wreck Domain's 2019 bull market in a serious way, so investors need to be careful. At the moment Domain gets a tech-style P/E multiple of 55x FY20 earnings, dropping to 29x by FY23. The comparable numbers for REA Group are 49x and 28x respectively. That makes Domain stock particularly vulnerable. Like Sydney or Melbourne property prices around 2017, this one may have run too hard, too fast.

Zenith Energy: Blue sky

Stocks Down Under rating ★★★★

ASX:ZEN **Share price: A$ 0.70** **Market cap: A$ 105M**

The Perth-based independent power producer Zenith Energy has performed well since a mid-2019 placement at 58 cents per share. And no wonder…in FY19 this company earned $20.7m in EBITDA from $55m in revenue and for FY20 is flagging $26-27m EBITDA on $62-64m in revenue. With Australia's resources sector in reasonably good shape, Zenith's pipeline of new build-own-operate power projects continues to expand apace.

Company Share Price Chart

Source: Tradingview

Once upon a time companies tried do everything in-house, on the assumption that it would lead to better control over their cost base. The classic case of this was the Ford Motor Company, which in Henry Ford's day used to run timberlands and rubber plantations because Ford's car factories were heavy users of wood and rubber. And old Henry wondered why he hadn't made a real profit in twenty years. These days most companies have come to the realisation that Henry got it wrong – that, by contrast, it is usually better to outsource non-core functions to other companies with better skills and knowledge, and only keep the core function in-house.

Build, Own, Operate, Profit

Zenith Energy is a recent beneficiary of this outsourcing trend in the resources sector. Traditionally, if a mine was being developed in a remote location, the mine developer would work out its own power solution, more often than not putting in diesel generators and trucking in its own diesel. These days, the miners can turn to Zenith Energy and that company will do it for them on the traditional 'BOO' model used by other infrastructure providers the world over – Build, Own, Operate.

A good recent example of Zenith's model is the Hybrid Solar PV-Diesel Facility which it has just brought online to serve a relatively new nickel mine in Western Australia called Nova, located in the Fraser Range 360 km southeast of Kalgoorlie. Nova is the flagship of IGO Ltd (ASX:IGO), an emerging Perth-based miner. In FY20 the Nova operation will produce somewhere north of 27,000 tonnes of nickel, 11,000 tonnes of copper and 850 tonnes of cobalt. When Nova came into production in 2017 it got its power from a diesel station which Zenith built. However, in October 2018 Zenith announced that it was adding a solar farm to the diesel generator to sell to Nova on a revised Power Purchase Agreement. The result, from last December, was lower average power costs for Nova and an expansion of the annuity-style income for Zenith from a 25 MW operation. Interestingly, solar is only a fraction of the company's BOO assets at the moment even though outback Western Australia is awash with Direct Solar Irradiance. We think that, if the Nova Hybrid facility works out as expected, solar could prove a big growth factor for Zenith given the obvious cost advantage as well as the fact that renewable energy is more desirable from a 'social responsibility' point of view.

Big, established customers

Zenith now has around 417 MW in operating projects under its control, mostly in Australia. The portfolio is expanding rapidly, with 450 MW in future project now in the pipeline. The intention of Zenith going forward is to only do BOO projects, because these projects are long-term in nature. The clients are, more often than not, established names in the mining industry like Newmont, Northern Star and Silver Lake Resources capitalised at more than $1bn. They come to Zenith because of the company's track record and because the outsourced power model makes sense to the project economics of the miners. And often they're repeat customers – witness the recent expansion to Northern Star's Jundee Power Station in November 2019.

For all this Zenith is currently trading at an EV/EBITDA multiple of only around 7x FY20 earnings. We think, given the growth track record of this company in recent years, this multiple is modest. And if the solar opportunity takes off, let's just say there's plenty of blue sky in this company's story.

Aristocrat Leisure: The Great Gamer

Stocks Down Under rating ★★★★

ASX:ALL **Share price: A$ 36.65** **Market cap: A$ 23.4BN**

2019 was another great year for the shareholders of Aristocrat Leisure, the Sydney-based maker of gaming machines. The stock was $21.84 at the start of calendar 2019 and it was $33.67 at the end, driven by a stellar Full Year result where revenue rose 23% and EBITDA 20%. The global market for gaming continues to grow strongly and Aristocrat, as a leading supplier of the hardware and software, is riding the growth wave smartly.

Company Share Price Chart

Source: Tradingview

In the year to September 2019, Aristocrat Leisure grew revenues by 23% to $4.4bn. If you listened to many commentators on the global casino industry, you'd be thinking that this revenue base is under threat in the medium term. The naysayers argue people will stop going to land-based casinos to play the gaming machines that Aristocrat and its competitors supply. Instead, they'd be looking for a better user experience online, so Aristocrat is going to be in trouble in the long-term.

A growing digital portfolio

The good news for Aristocrat's shareholders, and the reason for the stock's currently strength, is that the company has seen the potential for the move to online gaming to happen and has invested accordingly. $1.2bn of that $4.4bn revenue in the 2019 reporting period came from its digital portfolio. Basically, someone at Aristocrat has gotten hold of Clayton Christensen's seminal book *The Innovator's Dilemma* and helped the company avoid being killed by the 21st Century. Christensen taught that most successful companies are afraid of 'killing the golden goose' by investing in new technologies that could kill their old technology paradigm. That's clearly not Aristocrat's problem.

The thing to understand about Aristocrat is that its investment in digital, and particularly its mid-2017 acquisition of Plarium, the Israeli gaming company, for US$500m, has diversified its business away from gambling and into a world where people pay-to-play all sorts of games where they're not gambling but just having fun. That lowers Aristocrat's regulatory risk should governments ever try to crack down on gambling, and it also introduces a potentially more dependable customer base - people who would never darken the door of a casino from one end of the year to the next but who are keen to sit in their living room and play games like the Plarium-developed *Vikings: War of Clans*.

Investing wisely

In digital gaming Aristocrat has learned the main lesson that newcomers often miss – that content needs to stay fresh because what's 'hot' today can be 'not' tomorrow. Aristocrat regularly releases new games but also puts new features into games that have performed well. And it hasn't stinted on the content development. There are ten studios around the world and the global headcount in digital is 2,400. That Aristocrat is doing well in this space is suggested by the 30% profit margins that the digital segment enjoys. That's after user acquisition costs of 26-28% of revenues where, again, Aristocrat isn't stinting.

Back in the casino world, we would also argue that the rumours of land-based gaming's early death have been greatly exaggerated. Aristocrat believes that this market in North America has been more or less steady over the last six years, but that the company is better placed in terms of addressing a greater slice of that market. In 2019 it was gaining market share. That's the fruits of Aristocrat's decision two decades ago to focus on North America as its most important growth market.

Aristocrat is currently trading on a P/E of 22.8x expected FY20 earnings. That's relatively low for a company increasingly positioned in the digital world where the company is successfully growing. The P/E drops to 19x in FY22. We believe there's potential for investors to keep winning big.

Pitt Street Research Pty Ltd

95 Pitt Street

Sydney NSW 2000

Australia

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