



20 MARCH 2020

# Stocks Down Under

“ *The intelligent investor is a realist who sells to optimists and buys from pessimists.* ”

- Benjamin Graham (1894-1976) American investor, economist and professor



**PENGANA  
CAPITAL  
GROUP**

A history of  
underperformance

**FLUENCE  
CORPORATION**

Immune to Corona

**CENTURIA  
INDUSTRIAL REIT**

Stable income production  
with a splash of growth

# PENGANA CAPITAL GROUP

A history of underperformance

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Stocks Down Under rating: ★★

**ASX: PCG**

**Share price: A\$ 0.89**

**Market cap: A\$ 92.2m**

Why invest with Pengana Capital Group? Is it superior risk-adjusted returns? Access to best-of-breed portfolio managers? A window into private equity? Well, for us, the answer is none of the above. Headquartered in Sydney, Pengana Capital Group claims to deliver alpha, while also preserving investor capital. However, if its share price is any indicator, the firm has a ways to go. Down more than 65% over the last two years, before the COVID-19 fallout hit the markets, Pengana Capital Group's performance and liquidity continues to suffer. And with the seas getting rougher by the day, you don't want this asset manager steering your boat.

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# FLUENCE CORPORATION

Immune to Corona

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**ASX: FLC**

**Share price: A\$ 0.31**

**Market cap: A\$ 193.5M**

Fluence Corporation, based in the United States, is in the very noble, yet profit-thirsty business of addressing water scarcity challenges around the world. Its Smart Products Solutions (SPS) and other products and services are designed to meet growing global demand for water consumption that is expected to double by 2050. Fluence is the only global pure play water treatment investment. The stock, which once traded above \$200, has multiple growth drivers ahead and is now dirt cheap, in our view.

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# CENTURIA INDUSTRIAL REIT

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**ASX: CIP**

**Share price: A\$ 2.70**

**Market cap: A\$ 915M**

Headquartered in New South Wales, Centuria Industrial REIT invests in industrial properties throughout Australia. As Australia's largest industrial property real estate investment trust (REIT) it provides investors an opportunity to gain exposure to 48 income-producing industrial assets worth a combined \$1.6bn. The stock is approximately 27% off its all-time high of \$3.79 from late February of this year. We believe the coronavirus-related selloff was unjustified in Centuria's case because it only operates in Australia and resides in the non-cyclical, defensive REIT sector.

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## Share price chart



Source: Tradingview

## A private equity misstep

On 24 April 2019, Pengana Private Equity Trust (PE1) began trading on the ASX. Offering access to a diversified portfolio of private investments, the trust touts superior returns over a long-term time horizon. However, with liquidity evaporating, Pengana Capital Group offered PE1 loyalty units to existing shareholders. And with CEO Russel Pillemer framing the issuance as a unique opportunity for retail investors to gain exposure to private equity, PE1's NAV was trading at an 11.3% premium. Then, on 12 February 2020, the trust announced a secondary offering – aiming to raise another \$473.2m – with current PE1 shareholders getting first dibs on the subscription.

But despite the recent capital build, PE1's liquidity still remains low. And while Pengana Capital Group said PE1 would be accretive to earnings, the trust actually lost money in FY19. And as the share price further deteriorated, management embarked on a stock buy-back program – believing the company was undervalued.

But despite repurchasing 10% of Pengana Capital Group's outstanding shares, the stock only stayed afloat for roughly one month. By the end of September 2019, it was underwater again.

## **A brittle strategy**

Pivoting away from Singapore and increasing its international equity exposure, Pengana Capital Group announced at its AGM – on 23 October 2019 – that it would divest unprofitable divisions and use the cash to secure a broader investor base. Diversification was the goal: By offering a range of funds, the group would shelter investors from poor performance. However, the strategy was counterintuitive. Rather than trying to mask the underperformance by opening new funds, Pengana Capital Group should have shored up its portfolio management team and improved its FUM – which has declined from \$3.27bn on June 2019 to \$3.12bn on January 2020. Driven by significant outflows across domestic equities, underperformance continues to dampen investor sentiment. And while international performance was reasonable, it doesn't fix the structural issues. International strategies account for only \$800m of Pengana Capital Group's FUM – meaning a wave of inflows are needed to have a meaningful impact on the firm's bottom line.

In a deal that closed on 1 January 2020, Pengana Capital Group also acquired a significant stake in Lizard Investors LLC, an American asset manager based in Chicago, Illinois. Specializing in small and mid-cap equities, the firm believes the partnership will expand Pengana Capital Group's footprint in the U.S., while also increasing its small-cap offerings in Australia. However, we don't expect the acquisition to have a material impact. Lizard Investors LLC is already well-positioned in Europe and its outperformance across U.S. small-caps was more of an outlier than a recurring trend. And given the recent market turmoil in recent weeks, we wouldn't be surprised if Lizard Investors LLC has experienced significant outflows.

## **Fundamentals remain weak**

In FY19, Pengana Capital Group's revenue fell 18.3% to \$44.3m, while NPAT fell 30% to \$8.7m. Underperformance across small and global credit investments also led to a \$239k loss within its JV and associate divisions. In addition, Pengana Capital Group's rotation into low-risk stocks weighed on FY19 performance, and if you include the \$16.6m spent on the PE1 launch, the firm actually lost money in FY19.

We believe investors should steer clear of Pengana Capital Group. Performance fees continue to decline, while a dislocated strategy and crumbling liquidity continues to suppress demand for the stock. The firm also trades at a P/E of 13x (NTM), which isn't too expensive, but not cheap either – even considering the aforementioned two-year decline. Furthermore, with volatility increasing across global markets, the wind isn't at Pengana Capital Group's back. We believe the two-star rated shares are poised for further declines, with no signs of upside catalysts present in the near-term.

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## Share price chart



Source: Tradingview

## Turnaround expected in FY20

Traditional approaches to wastewater treatment involve the construction of large, capital intensive treatment plants that are usually unaffordable. Today, the industry is shifting towards modular, decentralised systems for which current global demand is estimated to be US\$13 bn. Fluence differentiates itself by offering pre-engineered, low cost solutions that can be deployed quickly, even in rural areas, using multiple, smaller treatment plants. About the size of a tractor trailer bed, its products take weeks to install compared to years for traditional plant development. This is because of the company's proprietary membrane technology called MABR, which improves the quality and capacity of the water treatment process.

Revenue declined 40% in FY19 to US\$60.9m. This was due a steep revenue decline in the legacy Custom Engineered Solutions (CES) business which involves larger, longer-term projects. EBITDA decreased 41% to -US\$24.2. As Fluence gets paid according to various project milestones, it faced a sizeable order backlog, especially related to its new deployment in Ivory Coast. A dramatic reversal of these results is expected in FY20. The company forecasts revenue to top US\$161m due to revenue recognition from the Ivory Coast project and continued growth in the SPS business.

## **Two-headed growth monster**

Fluence's business model is changing fast and for the better. It has become less reliant on its traditional CES segment and is now focused on more profitable areas. Management expects to become EBITDA positive in FY20 and to be able to maintain this trait going forward. This assertion is based on it hitting an inflection point in higher margin SPS sales. SPS sales grew 20% in FY19 and are expected to increase another 20% to US\$32m in FY20, driving margin expansion. Improved profitability will also be driven by lower fixed costs, which decreased 30% in FY18 and 12% in FY19. SPS sales made up 43% of total sales in FY19 and this segment is targeted to comprise 65% of future sales. The CES business, which accounted for 82% of sales just a few years ago, is expected to become just 10% of the business.

Another part of what makes Fluence an appealing investment is its recurring revenue stream, which has increased over time. Its pre-engineered products used in Build Own Operate & Transfer (BOOT) projects generate predictable, long-term revenue. This is because customers pay for the water over the life of a contract instead of paying for a system upfront. Following 11% growth in FY19, growth in the Recurring Revenue (RR) segment is expected to accelerate to 30% in FY20.

## **China market expected to deliver growth**

The SPS business is largely dependent on China which made up nearly half of SPS sales in FY19. The Chinese government's current Five-Year Plan includes a US\$15bn commitment to providing rural wastewater treatment for 440 million people. Fluence's Aspiral and SUBRE solutions are expected to meet much of this demand. The company ramped its number of MABR manufacturing plants in China from 7 in 2018 to over 100 in 2019. Fluence has established key partnerships with three bulk order customers in China that are expected to drive long-term growth in the region and negotiations with additional partners are ongoing. The three existing partnerships are expected to be worth more than US\$100m in revenue over the next three years. Approximately 100k people in China across 13 provinces have already been served by Fluence solutions.

Regarding the impact of the coronavirus pandemic, Fluence management has noted that purchase orders in China are still being signed through electronic means as its staff works remotely. As the virus is known to be partially transmitted through contaminated sewage, it has also stated that it is prepared to supply wastewater treatment plants to its local partners on short notice. Although the company has said it does not anticipate disruptions to have a material impact on FY20 results, it seems likely that some revenue will shift from 1H to 2H pending further developments in the coronavirus outbreak.

## **Long-term vision on water demand**

In the years ahead, Fluence should continue to benefit from its strategic shift towards the more profitable SPS segment, which historically earns repeat business from customers. A normalization of the China market and solid growth in global BOOT projects would provide a powerful one-two growth punch into FY21 and beyond.

Near term, the company has a healthy balance sheet that includes cash of \$26.9m, while COVID-19 is driving demand for clean water. Given the forecasted demand for water consumption globally over the next 30 years and an EV/EBITDA of 20x for FY21, we would take a drink of Fluence shares at the current, multi-year, low levels.

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## High quality industrial properties

Centuria's industrial properties are strategically located in some of Australia's fastest growing metropolitan areas. Its portfolio encompasses nearly 1m square meters of industrial space ranging from a roughly 4,000 square meter building in Melbourne North to the sprawling 54,000 square meter Woolworths Way complex in New South Wales. It is a very well diversified fund with assets in Queensland, New South Wales and Victoria accounting for 84% of portfolio value.

The properties' tenants are also well diversified in terms of industry representation. Transport Logistics companies comprise 29% of all tenants, 20% are consumer staples businesses, 20% are in manufacturing while various other industries make up the remainder. This is an attractive feature of the fund because it does not depend too much on any one sector. The largest tenants by income are Woolworth and AWH, which each generate 7.3% of total income followed by Green's General Foods (6%) and Visy Board (5.6%).

Based on income, the Centuria REIT boasts an industry leading occupancy rate of 95.8%. Another key performance metric in this business is the weighted average lease expiry (WALE), which measures the average period in which all leases will expire. It is used by Centuria's management team to forecast vacancy risk, and generally speaking the higher this value is, the better. Centuria's current WALE is a very good 7.1 years. It attracts large corporate tenants who commit to longer leases and also investors that are willing to pay a premium for properties filled with tenants that are in for the long haul. Only 6.6% of the fund's leases will expire over the next two years, which puts it in a strong position to generate stable, longer term income.

## **Australia's largest pure-play industrial REIT**

Centuria's recent 1H FY20 report included revenue growth of 20.3% to \$53m. Although net profit after taxes declined 31.7% to \$31.5m, funds from operations (FFO), an important measure of cash flow for REITs, increased 25.3% to \$30m. The company's cost management improved as expenses fell 10.1% to \$26m. The balance sheet also became healthier as gearing decreased from 37.4% to 35.5% giving Centuria greater flexibility to pursue growth opportunities. The property occupancy rate slipped from 97.1% to 95.8%, but this is in-line with FY19 results and still a very respectable figure.

The company saw its portfolio value rise 34.4% from \$1.15bn to \$1.55bn primarily due to acquisitions. The acquisition spree, which boosted its WALE from 4.3 years to 7.1 years, included 3-54 Kaurana Avenue at Edinburgh Park, a sale-leaseback agreement with Arnott's involving two properties and the fully occupied 24 West Link Place in Queensland. These buyouts further strengthened Centuria's future income streams and made it Australia's largest pure-play industrial REIT.

Management also announced the expansion of its relationship with Woolworth, which will be increasing the footprint (by 5,500 square meters) of its regional distribution centre in Townsville. Upon the completion of the project in the middle part of this year, a new 12-year lease will begin on the entire property.

## **Focus on metropolitan growth, income stability**

As the year progresses look for Centuria to identify additional acquisition targets located in growing metropolitan regions that offer good access to important infrastructure. Management's FY20 full-year outlook includes FFO growth of 2% to 3% and distributions of \$0.187 per unit. The company is well positioned for multi-year growth and should resume its uptrend once the coronavirus pandemic improves if not sooner.

Centuria's real estate fund owns a collection of high-quality industrial properties that generate predictable, stable income. This is because it invests in properties that have strong occupancy rates and a well-structured lease expiration schedule. Opportunistic asset management of the portfolio also creates room for the fund's value to grow over time.

The fund distributes income to shareholders on a quarterly basis and currently offers a dividend yield around 7%. Its shares are trading around 13.7x forward earnings and an EV/EBITDA of 16.8x. We believe Centuria's increasing scale and well-diversified asset base make it a compelling long-term investment.

## **Pitt Street Research Pty Ltd**

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