2 MARCH 2020

Stocks Down Under

> *The art of medicine consists of amusing the patient while nature cures the disease.*
>
> - Voltaire (1694-1778), French writer.

FORTESCUE METALS

On the precipice

ICAR ASIA

The time isn't right

CHARTER HALL RETAIL REIT

More than food for thought

FORTESCUE METALS

On the precipice

Stocks Down Under rating: ★★

ASX: FMG
Share price: A$ 10.21
Market cap: A$ 33.2BN

2019 was a great year to be a shareholder of Fortescue Metals, the iron ore miner. The stock rose a massive 155%, from $4.19 at the start of the year to $10.69 at the end, and it kept running hard into 2020 until it peaked at $12.69 on 22 January. Then market concerns over the price of iron ore kicked in and before you knew it Fortescue was down 15% by 7 February, at $10.85. That sounds bad, but we think there is another de-rating on the way.

ICAR ASIA

The time isn't right

Stocks Down Under rating: ★★

ASX: ICQ
Share price: A$ 0.29
Market cap: A$ 141M

Everything had been going so well for iCarAsia, the Malaysia-based company which sells cars online in that country as well as Indonesia and Thailand. The stock had re-rated from 16.5 cents to reach 43 cents on 21 February 2020 as it became clear that the company was headed towards break-even. Then came the full year numbers for calendar 2019. They were strong, as expected, but investors decided to take profits anyway, reasoning that the middle of a Coronavirus plague was not a good time to be selling anything online, let alone expensive consumer durables. We think iCarAsia stock will be weak for a little while longer.

CHARTER HALL RETAIL REIT

More than food for thought

Stocks Down Under rating: ★★★

ASX: CQR
Share price: A$ 4.93
Market cap: A$ 2.18BN

Unlike the living dead that flood the streets during Halloween, zombie companies trick-or-treat all year round. But while investors are placing their bets on when the retail apocalypse will occur, Charter Hall with its Retail REIT has positioned itself in an area immune to the structural epidemic. Investing in high quality Australian supermarkets and convenience-plus shopping centres, Charter Hall Retail generates stable income while avoiding the cyclical volatility inherent with other retail sub-sectors. And with a business model that's focused on the future, we believe that Charter Hall Retail deserves a spot in your portfolio.

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Share price chart

Source: Tradingview

We'd like to think we saw the 22 January to 7 February downswing coming. On 15 January we published an article on www.stocksdownunder.com headlined 'Market trouble spots to avoid in 2020' where we highlighted some of the stocks with potential to go down during the current year. One of them was Fortescue.

Under the subheading 'Oversupply of iron ore?' we argued as follows: 'The recovery in that commodity last year wasn't because steel makers needed more but because of the Brumadinho disaster of January 2019, when a tailings dam at an iron ore mine in Brazil failed. It's reasonable to expect global supply to outrace demand in 2020 and with it stocks like Fortescue Metals Group (ASX: FMG) may be in trouble'.

Black Swan in Brazil

Take a step back in time. Between 2011 and 2016 the price of iron ore fell like a stone, from over US$180 a tonne to under US$40 a tonne, thanks to progressively weaker demand from steel makers and increased supply from Fortescue and its fellow iron ore miners. A gradual recovery started in 2016 and then came iron ore's 2019 Black Swan - the aforementioned Brumadinho disaster. Brumadinho is owned by Vale (NYSE: VALE), the Rio-based mining major which is the world's largest iron ore miner. That company responded to Brumadinho by taking other dams in Brazil offline, and with it a substantial amount of iron ore output. By mid-2019 iron ore was offloading in Tianjin and Qingdao at over US$100 a tonne, and prices are not far below that level now.

Last month we expected that supply and demand would move more into line over the course of 2020 and weaken iron ore prices. So far in 2020 that's not been happening, but we still think that's a strong possibility later in the year. Indeed, right now iron ore seems a little bit like Wile E. Coyote when that unfortunate cartoon canine has chased his Road Runner prey right off a cliff but isn't falling because he hasn't yet looked down.

Earnings headed backwards

A Chinese economy weakened by Coronavirus will need less steel production for a while, particularly with reports of steel inventories building up. Less steel production will mean less iron ore demand. Recent production and shipping cuts by Vale and Rio Tinto have helped shore up prices in recent days, but that just squeezes the margins of steel makers. Consequently, we're still expecting iron ore prices to go down for a while.

The thing about Fortescue stock right now is that, in a weaker pricing environment for the next few years, earnings should go backwards for the next few years too. Fortescue is currently trading at a P/E of only 5.3x FY20 earnings but that rises to 10.7x FY22 earnings. Still reasonably inexpensive but this leaves Fortescue stock vulnerable to negative sentiment that the story is no longer a 'growth' one. The bulls will note that founder Andrew Forrest has been a recent buyer of stock, and he will probably make money in the medium term. Short term, we believe this stock is headed south.

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Share price chart

Source: Tradingview

It was a great year to be iCarAsia. In 2019 revenue rose 28% to A$14.8m, and the loss at the EBITDA came down by 40%, from $11.3m to $6.7m. Traffic to the various car sale portals owned by iCarAsia was brisk, with 12 million visitors a month being registered, leading to 900,000 sales 'leads' a month, a 'lead' being a unique buyer talking to a unique seller about a transaction. By late 2019 the company had reached a monthly EBITDA breakeven level, and its businesses in Malaysia and Thailand were profitable and cashflow positive.

A market leader in a large emerging market

Investors have seen the way in which online automotive sales in Australia turned the Melbourne-based Carsales.com.au (ASX: CAR) into a A$4bn company, and they wondered if similar riches were headed iCarAsia's way once the business was fully developed. The company has a large market opportunity, with Malaysia's 32 million, Thailand's 69 million and Indonesia's 264 million strong markets for car ownership with more to come as incomes rise. In Malaysia there are about 440 cars on the road for every thousand people while in Singapore the number is 230. Indonesia is a laggard at 90 but that's balanced by it being one of the most populous nations on the planet.

Malaysia has already proved a 'company maker' for iCarAsia. In 2019 the company enjoyed a $1.9m EBITDA from its Malaysian sites on $7.5m in revenue, and no wonder, since the company is about four times bigger in terms of audience than its nearest competitor. And there is likely to be more where that came from because the rate of car ownership in Malaysia is very high – that 440 per 1000 ratio we noted above means that in excess of 90% of households in Malaysia have at least one car. Thailand wasn't break-even in 2019 but it was close, losing only $0.8m at the EBITDA line.

Coronavirus plagues tend to be bad for business

The main reason iCarAsia hasn't reached overall break even yet is because the company is investing heavily in the Indonesian opportunity. It doesn't have as strong a lead over its competitors as it does in Malaysia and Thailand, but the business still grew revenue by 70% and halved its EBITDA loss in 2019.

With everything tracking to plan at iCarAsia, why would we be negative om the story? Well, in the medium term we're bullish. But in the short term we think the Coronavirus can hamper this business in a serious way. New car sales are plummeting right now in China and it's a reasonable bet that elsewhere in Asia people are being cautious. Malaysia and Thailand both have Coronavirus cases, and while Indonesia strangely has none at the moment it's a reasonable bet one will show up in the near future.

Currently, iCarAsia is trading at 6.1x forecast 2020 revenue and 4.8x 2021 revenue. The company expects to increase revenues by 50% in 2020, but the multiple is still high given the challenges this company will face over the next few months. That said, in 'normal' times such a multiple is not excessive given the fact that this is an online story. We think iCarAsia will be worth revisiting once the crisis is over.

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Share price chart

Source: Tradingview

The attractiveness of convenience retail

While many areas of retail remain under water, prioritizing food and beverage (F&B) and non-discretionary items enables Charter Hall Retail to take advantage of shifting consumer trends. As the wealth gap continues to accelerate across developed markets, consumer's wallets are becoming lighter than ever. The structural change has forced traditional retailers to offer heavy discounts in a bid to move product.

However, with supermarkets generating stable and reliable income, Charter Hall Retail is poised to benefit from the shifting landscape. Colliers International, a Canadian real estate services provider, reported that since July, the convenience retail sector has grown by 3.7% over the last year – outperforming traditional retail by 50bps. The shift is also spreading across Asia, with demand increasing for supermarket assets, as commercial investment shifts into residential areas.

And with Charter Hall Retail CEO Greg Chubb saying that $3.5bn of the trust's $5bn investment portfolio is leveraged toward grocery tenants, the strategy allows Charter Hall Retail to maintain its competitive advantage, while still generating stable income in a defensive area of the market.

Sustainability is crucial

Aiming to secure a better future for all, Charter Hall Retail places a lot of emphasis on ESG and corporate ethics. And while tackling climate change is important to all stakeholders, management also has a diligent plan to ensure investor's financial success. Not long ago, Charter Hall Retail moved away from discretionary retail – areas like department stores and fashion retailers – to focus on non-discretionary grocery and discount department stores. The pivot led Charter Hall Retail's stock to surpass the $5.00 mark for the first time earlier this week.

With close to 60 properties in its portfolio, Charter Hall Retail's high-quality units are spread across large metropolitan areas with dense population. Its largest tenant is Woolworths Group followed by other high-quality retailers Coles and Wesfarmers. And in FY19, the trust divested its 'small-mall' operations so it could increase its exposure across larger and more affluent neighbourhoods. Three properties have already been contracted for sale – and are expected to close in FY20 – while another $100m in non-core assets are also expected to be divested in FY20. Conversely, the trust acquired two new convenience-plus retail centres in Sydney, which only increases Charter Hall Retail's future upside potential.

Fundamentals remain strong

Despite Charter Hall Retail's FY19 revenue declining by 8.7% to $201.7m, its operating income increased by 3.9% to $128m and its occupancy rate remained extremely strong at 98.1%. The increased efficiency led management to raise their FY20 guidance, saying they expect operating earnings per-security (OEPS) growth of 2.2% (versus FY19) compared to their previous estimate of 1.7% to 2%.

Similarly, Charter Hall Retail trades at a P/E of 15.4x, while Charter Hall's Social Infrastructure REIT (ASX: CQE) trades at a P/E of 20.7x, its Charter Hall Long WALE (weighted average lease expiry) REIT (ASX: CLW) trades at a P/E of 19.2x and Charter Hall Group as a whole trades (ASX: CHC) at a P/E of 19.3x. If Charter Hall Retail's multiple can converge to its sister funds, e.g. by continued strong operating income growth, there could be roughly 19% to 25% upside in the stock.

Furthermore, via an institutional placement, Charter Hall Retail recently raised $100m in new equity at $4.81 per unit. This raising demonstrates there is ample demand from institutional investors. So, despite Charter Hall Retail's strong run since the beginning of 2020, we believe there is still upside in the name. And with a dividend yield of 5.88%, it also makes a great addition for income investors.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

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