12 MARCH 2020

Stocks Down Under

Wal-mart... do they like make walls there?

- Paris Hilton (b. 1981), American media personality

BANK OF QUEENSLAND

Strategy change as a growth driver

TABCORP

Not Worth the Gamble

INCITEC PIVOT

Fertilisers outcome could pave the way to stronger growth

BANK OF QUEENSLAND

Strategy change as a growth driver

Stocks Down Under rating: ★★★★

ASX: BOQ
Share price: A$ 6.29
Market cap: A$ 2.7BN

As one of Australia's oldest financial institutions, Brisbane-based Bank of Queensland needs little introduction. The retail bank offers traditional banking products to both consumer and commercial customers including savings and checking accounts, mortgages, loans and credit cards. The company's stock price has been halved since its 2015 peak due to weaker credit growth, regulatory changes and questions around the company's culture. More recently, much has been made about the bank's 27 February Strategy Day. Successful steps towards the execution of the transformation plan may put this undervalued stock on the comeback trail.

READ MORE

TABCORP

Not Worth the Gamble

Stocks Down Under rating: ★★

ASX: TAH
Share price: A$ 3.40
Market cap: A$ 8.97BN

Tabcorp, the Melbourne-based operator of gaming, lotteries and wagering services, has struggled to sustain healthy growth since joining forces with Tatts Group in 2017. Due to the impact of the coronavirus on the global travel and entertainment industry, Tabcorp shares have recently sunk to their lowest level since 2014. Further downside looks likely following a weaker than expected first half performance, the threat of new digital gambling competitors and ongoing concerns around the coronavirus.

READ MORE

INCITEC PIVOT

Fertilisers outcome could pave the way to stronger growth

Stocks Down Under rating: ★★★★

ASX: IPL
Share price: A$ 2.16
Market cap: A$ 4.3BN

Melbourne-based Incitec Pivot makes fertilisers, chemicals and explosives, but its stock has been far from explosive. The shares have been largely rangebound between $2 and $4 since the height of the global financial crisis. The company, however, has some interesting growth catalysts in place that can break the stock out of its sideways pattern. Australia's largest fertiliser supplier and the world's second largest explosives supplier has some solid growth ahead if it can navigate weather challenges and competitive pressures.

READ MORE

BANK OF QUEENSLAND

Strategy change as a growth driver

Stocks Down Under rating: ★★★★

ASX: BOQ
Share price: A$ 6.29
Market cap: A$ 2.7BN

As one of Australia's oldest financial institutions, Brisbane-based Bank of Queensland needs little introduction. The retail bank offers traditional banking products to both consumer and commercial customers including savings and checking accounts, mortgages, loans and credit cards. The company's stock price has been halved since its 2015 peak due to weaker credit growth, regulatory changes and questions around the company's culture. More recently, much has been made about the bank's 27 February Strategy Day. Successful steps towards the execution of the transformation plan may put this undervalued stock on the comeback trail.

Share price chart

Source: Tradingview

Challenging industry conditions

Bank of Queensland had a disappointing FY19 recording effective interest income that was 0.7% below the prior year and 14% lower cash earnings. Net profit after taxes (NPAT) fell 11% and EPS declined 16%. The bank's net interest margin (NIM), a key performance metric representing interest earned on loans less interest paid on deposits, slipped from 1.98% in FY18 to 1.93%. This was mainly due to a 36% drop-in lending activity. Macroeconomic challenges in the form of lower interest rates, slow credit demand and regulatory changes that lowered insurance income also weighed on results. The industry-wide overhang from the Royal Commission's investigation into misconduct at financial services companies did not help matters.

The sluggish results caused the company to raise $275m of additional capital in November 2019 which dragged the share price down further because existing shareholders saw their earnings diluted. This infusion of funds was geared towards strengthening the balance sheet and affording the bank greater flexibility to make strategic changes. The added capital is also likely to improve the bank's common equity Tier 1 (CET1) ratio from 9.04% in FY19 to approximately 9.85%, which should appease industry regulators.

The outlook for FY20 in management's view includes lower year-over-year cash earnings, and revenue and impairments that are consistent with FY19. The construction and business lending environment, however, is expected to improve modestly, which may provide a lift to the bank's lending volume. Regional banks in Australia are also hoping for some mortgage risk relief pending clarification from regulators on a revised risk weighting framework due to be implemented in 2022. A favourable outcome on this front may pave the way for a better mortgage portfolio performance.

Banking on Strategy Day initiatives

As a 157-year old institution, Bank of Queensland has been understandably slow to adapt to the technology changes in banking. This is changing though. The company is expanding its offerings of advanced digital products and services to meet changing consumer trends towards mobile banking. Its Virgin Money Australia subsidiary acquired in 2013 is a future earnings growth driver. The Virgin Money digital bank platform is experiencing strong adoption trends. It helped to increase the value of the mortgage business 19% from 1H 2019 to 2H 2019. Around $30m in investments are planned in FY20 for the buildout of the new digital bank, which is expected to launch at the end of this year. These investments should help close the digital banking gap with competitors and help offset the macro effects of the low interest rate environment.

At last month's much anticipated Strategy Day management outlined an ambitious shift in its strategic direction. The new company strategy is designed to improve productivity and cost efficiency in route to achieving sustainable profit growth. Bank of Queensland has recognized the need to respond to the market conditions and to meet customer demand for better technology.

It is planning to invest heavily in technology and digital platforms. Greater emphasis will also be placed on retail bank performance and lending processes. All the financial resources devoted to these growth plans will likely make for an underwhelming FY20 bottom line but may set the stage for above-industry growth in FY21 and beyond. While the market remains sceptical of the new strategy, management appears laser-focused on delivering stronger performance in the years ahead.

Digital bank being built on a solid foundation

Bank of Queensland is undergoing a significant business transformation. While it is far from a sure success, it makes for a compelling turnaround story. It already has a solid banking platform with strong brands and branches operated by locally integrated small business owners. This platform should be taken to the next level of growth with the investments in the new Virgin Money digital bank.

Shares of Bank of Queensland are trading around 11.4x forward earnings. Banking peers Bendigo & Adelaide Bank, Westpac, NAB, and Suncorp are trading at higher multiples, i.e. in the 13x - 16x range. Much uncertainty remains around the new business strategy, but in our view the stock is an attractive risk-reward proposition, especially since the recent sell-off took the stock down to strong technical support levels dating back to 2009 and 2012.

TABCORP

Not Worth the Gamble

Stocks Down Under rating: ★★

ASX: TAH
Share price: A$ 3.40
Market cap: A$ 8.97BN

Tabcorp, the Melbourne-based operator of gaming, lotteries and wagering services, has struggled to sustain healthy growth since joining forces with Tatts Group in 2017. Due to the impact of the coronavirus on the global travel and entertainment industry, Tabcorp shares have recently sunk to their lowest level since 2014. Further downside looks likely following a weaker than expected first half performance, the threat of new digital gambling competitors and ongoing concerns around the coronavirus.

Share price chart

Source: Tradingview

Tatts very disappointing

Australia's leading gambling entertainment group had a mixed performance in FY19. Revenue surged 45.9% to $5.48bn and EBITDA grew 38.4% to $1.06bn. However, expenses rose 42.9% to a staggering $4.78bn due to expenses related to commissions, fees and government taxes. While the Lotteries & Keno division had strong profitability, Wagering & Media as well as Gaming Services posted EBITDA declines. All three segments had lower profit margins compared to FY18.

What was perhaps of greatest concern to investors was the level of synergies achieved from the integration of the $11bn Tatts Group merger. EBITDA synergies were $64m in FY19, which put Tabcorp well off the pace of reaching its target of $130m to $145m by FY21. Along the way it hopes to realize $90m in EBITDA synergies in FY20, but this may not be attainable. The company is in the final phase of the Tatts implementation and hopes to see an improvement in this area, but much uncertainty remains.

Adding to this concern, during the announcement of its 1H FY20 results, management noted that total implementation costs associated with Tatts are expected to be $135m, far greater than the previous $95m estimate. This is due to increased complexity around the migration of UBET customers onto the UBET platform. The company's leadership appears less confident about the synergies and in turn investors should be less confident as well.

Limited product offerings in the face of rising competition

Overall 1H FY20 revenue increased 4.4% and EBITDA was higher by 2.1%. These growth rates marked a significant slowdown from the FY19 results. The Lotteries & Keno segment performed well adding 300,000 new customers and growing EBITDA by 16% aided by the strong adoption of its digital platform. The core Wagering & Media business, however, had a 7.8% EBITDA decline due to a limited product line-up and the emergence of new competition.

Another discouraging aspect of the 1H FY20 report was that the Gaming Services segment, a pocket of strength in FY19, is now underperforming. Revenue at MAX Venue Services declined 4.9% due to contract expirations, lower rate contract extensions, and a lighter project workload. Following a 14.1% drop in EBITDA, management has decided to perform a review of the struggling Gaming Services business.

Tabcorp's outlook for 2020 was upbeat despite the recent performance. The lotteries business is doing well and has an opportunity to gain market share by continuing to enhance its digital gaming capabilities. Excitement around the growth potential of the wagering business, though, has dulled. In 2019, improved data capabilities were expected to lead to asset monetization and drive geographic expansion. Fast forward to today and management is now expressing concern about the Wagering & Services unit with the prospect of worsening contract losses and renewals.

Distracted and overvalued

The company seems notably distracted by the UBET integration and unlikely to deliver meaningful growth in areas beyond lotteries. Much work lies ahead with not just the Tatts cost savings targets, but in returning the company's other divisions to sustainable growth. Intensified competition for the only outperforming segment, Lottery & Keno, poses a threat. More sophisticated digital gambling platforms are coming to the market and are forecast to capture a growing share of the market.

Tabcorp appears to have entered a period of prolonged weak performance and as such we would avoid the stock here. Even after the recent industry-wide downturn, a forward P/E of more than 21x is even more reason to take a pass. The stock does offer a dividend yield of around 6%, but that dividend may not be secure given the financial weakness at the company. We believe the stock is not worth the gamble right now.

INCITEC PIVOT

Fertilisers outcome could pave the way to stronger growth

Stocks Down Under rating: ★★★★

ASX: IPL
Share price: A$ 2.16
Market cap: A$ 4.3BN

Melbourne-based Incitec Pivot makes fertilisers, chemicals and explosives, but its stock has been far from explosive. The shares have been largely rangebound between $2 and $4 since the height of the global financial crisis. The company, however, has some interesting growth catalysts in place that can break the stock out of its sideways pattern. Australia's largest fertiliser supplier and the world's second largest explosives supplier has some solid growth ahead if it can navigate weather challenges and competitive pressures.

Share price chart

Source: Tradingview

Fertilisers decision could unlock value

Top line growth slowed 1.6% to $3.92bn in FY19 (ending 30 September) and EBITDA declined 28.9% to $605.3m. The drop in profitability was driven by higher expenses including a 12% jump in raw materials and consumables inputs. While disappointing, the performance was primarily due to one-off weather events. Flooding in North Queensland prevented third party rail operators from servicing the Phosphate Hill facility and caused a three-month shut-down. In addition, lengthy draughts along Australia's east coast and in the midwestern United States hurt results.

There has also been much uncertainty around the fertiliser business which distributes approximately 2m tonnes annually to Australia's grain, cotton, pasture, dairy, sugar and horticulture industries. The business underperformed in FY19 as revenues fell 3.6% to $1.42bn. It has been speculated that several suitors are interested in the fertiliser asset, but the company is no rush to pursue a potential sale. This may partly be because the business may return to growth once drought conditions break

and global commodity prices rebound. If it is divested or reinvested this could provide a lift to FY20 performance. A demerger may be an even better scenario because this would allow the company to focus on its growing explosives business.

The Dyno Nobel explosives division was an area of relative strength in FY19 with 1.2% revenue growth led by 7.3% growth in the Americas region. It builds detonators, boosters and dynamite used by the mining, quarrying, seismic, and construction industries in the Australian and North American markets.

Management expects earnings growth to persist within the explosives segment in FY20 due to higher demand in both Quarry & Construction and Base & Precious Metals. These units are forecast to grow 5-7% and 3-5% respectively supported by expansion in Chile. Performance should also get a boost from the absence of the third-party gas supply interruption that was experienced in FY19.

Construction activity expected to boost growth

The explosives manufacturing industry is expected to grow at a modest annual rate of 1.5% over the next five years. This is forecast to be driven by stronger growth in mined commodities, a recovery in construction activity, and the development of new civil engineering projects. The fertiliser market, however, is expected to continue to be challenged by adverse weather risks and the entrance of low-priced import producers into the local market.

This may be even more reason for Incitec Pivot to move in a different direction with its fertilisers business. Management is doing a strategic review on the topic and any favourable headlines should breathe some life into the stock.

Aside from this potential catalyst, investors will be looking at Dyno Nobel growth to propel the stock higher. The explosives business saw EBIT rise 13% in FY19 and is well-positioned to deliver even better growth in the current financial year. This is because the U.S. construction industry is showing signs of a resurgence, which should present an opportunity to gain market share. The mining industry in the APAC region is also expected to see healthy activity levels and benefit from recent technological advancements.

Valuation looks dynamite

The near-term investment case on Incitec Pivot rests largely on the outcome of management's strategic review of the fertilisers business. Longer term share appreciation will depend on the success of the explosives business, which should benefit from healthy, diversified demand in both the APAC and Americas regions.

The stock's valuation is undoubtedly cheap, but the investor must be willing to wager that a favourable fertilisers outcome is in the cards or that explosives growth will be even better than forecast. At an EV/EBITDA of 8.4x and a forward P/E of 18x, Incitec Pivot shares seem well worth the gamble.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

Pitt Street Research Pty Ltd provides issuer-sponsored research for Small & Mid Cap companies and is founded on more than 40 years of combined experience researching companies in a range of different sectors.

You are receiving this email because you subscribed to our Stocks Down Under newsletter.

All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without prior written permission from Pitt Street Research Ltd Pty. All intellectual property relating to the Content vests with Pitt Street Research unless otherwise noted.

Stocks Down Under (Pitt Street Research AFSL 1265112) provides actionable investment ideas on ASX-listed stocks. The Content has been prepared for general information purposes only and is not (and cannot be construed or relied upon as) personal advice nor as an offer to buy/sell/subscribe to any of the financial products mentioned herein. No investment objectives, financial circumstances or needs of any individual have been taken into consideration in the preparation of the Content. Financial products are complex, entail risk of loss, may rise and fall, and are impacted by a range of market and economic factors, and you should always obtain professional advice to ensure trading or investing in such products is suitable for your circumstances, and ensure you obtain, read and understand any applicable offer document