13 MARCH 2020

Stocks Down Under

I will tell you how to become rich. Close the doors. Be fearful when others are greedy. Be greedy when others are fearful.

- Warren Buffett (b. 1930), American business magnate

AUB GROUP
An acquired taste

LENDLEASE
Strong Urban Project Pipeline

INFRATIL
Powering your portfolio

AUB GROUP

An acquired taste

Stocks Down Under rating: ★★★★

ASX: AUB
Share price: A$ 12.78
Market cap: A$ 942M

Harm. Damage. Financial burden. When an emergency strikes, you need a trusted advisor that can help ease the stress. And since 1985, Sydney-based AUB Group has been doing just that. Through its vast network of brokers, underwriters and risk managers, the firm commits to safeguarding a stronger future. And judging by the recent price movement, investors are buying what AUB Group is selling. Through its market-leading technology, the firm has a clear advantage over legacy insurers. And with no signs of slowing down, we believe the four-star rated shares are a must own.

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LENDLEASE

Strong Urban Project Pipeline

Stocks Down Under rating: ★★★★

ASX: LLC
Share price: A$ 14.41
Market cap: A$ 8.1BN

Sydney-based Lendlease Group is a global construction, infrastructure and real estate powerhouse. The stock has pulled back in recent weeks amid the broad global equity sell-off creating an opportunity to get in on, what we believe is, one of the world's best-run property management companies. A focus on high-growth urban development projects and healthy demand for build-to-rent properties (BTR) bode well for the company's future. As it continues to broaden its geographic reach, a strong brand reputation should drive steady long-term growth.

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INFRATIL

Powering your portfolio

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ASX: IFT
Share price: A$ 5.09
Market cap: A$ 3BN

With a mandate to deliver above average returns over the long-term, New Zealand-based Infratil invests in energy, transport and social infrastructure businesses. And with management striking gold on nearly every acquisition, Infratil's share price has rallied from $1.26 in 2010 to an all-time high of $5.39 on 22 January 2020. But with the coronavirus outbreak causing panic across global markets, the stock fell by 12% last month. Time to sell? Absolutely not. We believe Infratil has significant upside potential, with long-term investments in renewables and infrastructure set to generate huge payoffs over the next year.

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Share price chart

Source: Tradingview

Growth through acquisitions is paying off

Over the last few years, AUB Group has been on a shopping spree. On 11 July 2018, it acquired Adroit, an insurance and risk management specialist based in Geelong. Then, on 23 January 2019, it acquired BrokerWeb Risk Services (BWRS), an insurance broker based in Auckland, New Zealand. The two partnerships have catapulted AUB Group to roughly 20% market share of the small and medium sized enterprises (SMEs) across Australia. Continuing to grow, the firm also has relationships with 61 brokers across the region, which offer a myriad of services from life insurance to premium funding to claims management and legal aid.

On 17 January 2020, AUB Group announced two more strategic acquisitions, buying MGA Whittles Group, a risk advisory firm based in Adelaide. The firm also purchased a 40% equity stake in BizCover, an online insurance provider based in Sydney. Offering economies of scale, the additions allow AUB

Group to leverage its proprietary technology, increase its range of services and target new customers across growing markets.

With BizCover, the company is already a leading InsurTech platform, with services geared toward SMEs. And providing synergies with AUB Group's Austbrokers network, its new Express Cover quote-to-bind platform better enables brokers to find specific products that meet client's needs. With plans to go nationwide in March 2020, the platform is currently being tested across several Austbrokers networks and is already generating positive results. Because of this, management predicts BizCover will be EPS accretive by the end of FY20.

Industry transition is already taking place

As baby boomers transition toward the latter stages of their life, the insurance brokerage industry is expected to benefit from an aging population. Industry revenue is expected to grow by 1.9% p.a. over the next five years, with alternative distribution channels continuing to disrupt legacy players. As more consolidation takes place throughout the industry, M&A activity is necessary to increase efficiency, enhance technology and offer more competitive pricing to consumers. And with AUB Group already well-ahead of the competition, the firm has built a substantial firewall. Furthermore, with robo-advisors becoming increasingly popular, AUB Group's leading technology is also trouncing the competition. With data analytics and artificial intelligence capabilities, AUB Group continues to streamline its pricing mechanisms, while also reducing its labour and marketing expenses.

Moreover, as natural disasters occur with more frequency, we believe AUB Group can increase its insurance premiums by more than the 5% to 6% that management currently anticipates.

Management is firing on all cylinders

AUB Group released its H1 FY20 earnings on 25 January 2020. Revenue increased by 12% to $162.9m, while adjusted NPAT increased by 25.3% to $21.3m. Commercial insurance premiums were up 6.2% – outperforming the 5% expected – while the BWRS acquisition helped fuel a 24.1% rise in brokerage commissions. The previously underperforming health and rehabilitation (H&R) segment also showed improvement – with revenue increasing by 5.2% and the segment's EBIT margin expanding from 6.5% to 12.2%. The outperformance led management to increase their full-year FY20 adjusted NPAT growth forecast to 16% - 18%. With the MGA Whittles Group and BizCover acquisitions starting to bear fruit and the H&R segment beginning to stabilize, management remains optimistic.

And by combining effective management with a well-thought out strategy, we believe AUB Group is poised to outperform in the coming quarters. Organic growth remains strong, while management has not only shown the ability to select appropriate M&A targets, but also integrate them within the firm's existing portfolio. Furthermore, Steadfast, Australia's largest general insurance broker, trades at a P/E of 23x, while AUB Group trades at a P/E (NTM) of 20x. And given the higher growth potential of AUB Group, we believe the 15% premium is unwarranted. With upward earnings revisions becoming the norm for AUB Group, we believe the stock's streak of new highs won't be letting up any time soon.

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Source: Tradingview

New investments drive recurring revenue

In FY19, Lendlease had a 1% increase in revenue to $13.4bn but EBITDA declined 9% to $1.33bn while NPAT fell 19% to $804m. Slow 0.2% revenue growth in Construction, the company's largest division, offset 4.7% growth in the Development segment and 11.7% growth in the Investment segment. Revenue growth was 10.7% in Australia, but a robust 25.2% in the United States, its second largest market. Importantly, in December 2019, Lendlease was finally able to offload the Engineering & Services division, which was operating at a net loss. Although it will take a substantial loss on the sale, a headache will be removed allowing the company to focus on other core businesses.

The recently reported 1H FY20 results included a 4.6% revenue decline to $7.4bn and a return on invested capital (ROIC) that slipped from 7.55% to 7.30% due to the recognition of partial results from FY19 construction activity. An increase in the company's overall projects portfolio helped boost the return on equity (ROE) to 9.8%. A highlight of the report was management's upbeat tone around its capital investments. Going forward it expects to have a solid $4bn base from which to generate a recurring revenue stream that may double over time. In the second half of FY20, both commercial and residential projects are forecast to contribute to improved earnings. Lendlease has also shown it is not afraid to part ways with properties when the price is right as evidenced by the recent sale of its 25% stake in the Victoria Cross metro station tower in North Sydney.

Strong urban development pipeline

A strong development pipeline valued at $112bn bodes well for Lendlease's outlook. This includes 21 projects across nine cities, most of which will be deployed for urbanization purposes. We believe the higher growth urbanization projects will be the company's main catalyst for the next few years. Many of these projects are in the U.S. and Europe, which is a positive because it further diversifies Lendlease's well-recognized brand name. It also improves the company's position to attract additional joint venture partners and its ability to secure large-scale projects. The Thamesmead Waterfront in London and the company's potentially lucrative partnership with Google in the San Francisco Bay area are examples of some of the major growth projects ahead.

Another attractive growth opportunity is in the build-to-rent space. In this model, the developer builds a property and then holds the equity for the purpose of generating long-term income. The model has had proven success globally including in the U.S. where the BTR sector has become the second largest asset class contributing US$3.4tn to the U.S. economy per year. Similar growth has been witnessed in the U.K. Lendlease stands to benefit from this growth given its 1,700 BTR apartment complexes in the U.S. and many development projects in Europe. Popularity for these dwellings in Europe is growing with the line between owning and renting blurring and many families staying in the same place for multiple generations.

Solid core growth, compelling valuation

Lendlease has recently seen an acceleration in production rates and is actively deploying third-party capital. It therefore expects to see both assets under management (AUM) and profits grow into FY21. Tenant demand for its three residential towers at One Sydney Harbor in Barangaroo have already reached $1.4bn in pre-sales. Business in the U.K., which represents 30% of the project pipeline, is also expected to pick up absent Brexit-related uncertainty.

Management has a positive tone around its ability to deliver solid medium-term growth in its core segments. More value-added joint venture partnerships and the strong development pipeline should also be supportive of AUM growth. The stock offers a 3.9% dividend yield and at a forward P/E of 13x is an attractive long-term investment for the income-oriented investor, in our view.

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Fine-tuning the portfolio

Knowing when to hold 'em and when to fold 'em, Infratil shed underperforming assets in FY19 and reinvested the proceeds in high-value projects. Management pumped $236.3m into Tilt Renewables, which consists of 322 operating turbines spread across eight wind farms in Australia and New Zealand. The company also allocated another $140.6m to its CDC Data Centres, which provides network and telecommunications infrastructure to governments and commercial entities.

Infratil also divested its New Zealand bus business in September 2019 and cut its Australia National University (ANU) student accommodation as well as its Snapper Services stakes by 50%. Eliminating non-core assets allows the company to streamline its operations and focus on businesses that provide synergies with the rest of the portfolio. Furthermore, the reallocation enables Infratil to reinvest in businesses that offer material scale – like infrastructure, connectivity, long-term data and renewable energy.

To that point, On 31 July 2019, Infratil acquired Vodafone New Zealand, the region's leading mobile telecommunications company, for NZ$3.4bn. The acquisition paid immediate dividends – contributing $39.1m to Infratil's bottom line during the first two months of H1 FY20 – while management has already forecasted higher earnings in H2 FY20. And with 5G rollouts in the works across Queenstown, Christchurch, Wellington and Auckland, Infratil has a clear roadmap to additional mobile and broadband revenue.

Minority stakes continue to perform

Longroad Energy, an American wind and solar developer based in San Francisco, California, partnered with Danish pension funds on 15 July 2019 to construct a 234-megawatt (MW) wind farm in Texas. The project is expected to be revenue-generating in 2020, adding another layer of utility income to Infratil's bottom line. With its 40% stake in Longroad, the addition is part of a stream of projects that have an 800 MW development target. And with the U.S. one of the fastest growing regions in renewable energy, the associate investment places Infratil at the heart of the action.

Also creating a significant gain for shareholders, Infratil's 48.2% minority stake in CDC Data Centres was revalued on 6 January 2020, with the businesses' enterprise value increasing from NZ$1.33bn to NZ$1.67bn. And while the accounting uptick was beneficial, the revaluation also emphasized the strong momentum within the business.

On 5 February 2020, Infratil also partnered with the New Zealand Superannuation Fund to acquire Galileo Green Energy, a developer of wind and solar infrastructure based in Zurich, Switzerland. The consortium paid $NZ150m for a 40% stake, with capital being used to fund wind and solar power projects across Europe and to develop wind infrastructure in Ireland. The benefit is twofold: Not only does the project offer superior risk-adjusted returns, but the investment allows Infratil to diversify its clean energy holdings.

Fundamentals remain strong

Infratil released its H1 FY20 results on 15 November 2019. Operating revenue increased by 9%, EBITDAF was up 1.7%, though NPAT fell by 17% due to the structural reorganizations. Longroad Energy's EBITDAF also declined from $51.2m to $17.8m due to its divestment of El Campo wind farms. However, EBITDAF did not include the realized gain from the sale, but it should provide momentum in the coming quarters. Conversely, Trustpower, Infratil's provider of electricity, natural gas, bottled LNG and telecommunication services, is positioned to capitalize on above-average wholesale prices. Because of this, management confirmed their full-year FY20 EBITDAF guidance of $575m to $615m.

With the portfolio on solid ground and fundamentals trending higher, we believe Infratil is positioned for superior growth. And despite trading at a P/E of 48x (NTM), the stock remains extremely cheap. With so much turnover in the portfolio, investors haven't fully assessed Infratil's renewed growth prospects. And given that the recent pullback has nothing to do with fundamentals, we believe Infratil provides a seamless connection to a more prosperous future.

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