7 APRIL 2020

Stocks Down Under

> *The function of economic forecasting is to make astrology look respectable.*
>
> **- John Kenneth Galbraith (1908-2006), Canadian economist, public official and diplomat**

CLASS

The jury is still out

SHOPPING CENTRES AUSTRALASIA

Challenges abound

FREELANCER

Blessing in disguise?

CLASS

The jury is still out

Stocks Down Under rating: ★★★

ASX: CL1
Share price: A$ 1.24
Market cap: A$ 141M

After peaking around $4 in 2016, shares in Sydney-based Class limited have been on a downward slope, reaching an all-time low of 90 cents in late March. Although the Corona Crisis pushed Class' shares over the edge, the trend had been negative for a long time. The question now is whether Class can get its act together and start performing for shareholders.

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Stocks Down Under rating: ★★

ASX: SCP
Share price: A$ 2.36
Market cap: A$ 2.1BN

Shopping Centres Australasia Property Group is a Sydney-based REIT specializing in both discretionary and non-discretionary retailers. In an era of online shopping, the company's portfolio of shopping centres is increasingly targeting convenience shoppers across all of Australia. The stock has dived with the rest of the market, falling from its February record high of $3.13 amid the coronavirus pandemic selloff. The near-term effects of the virus on Australia's economy combined with a challenging overall retail environment are reason to expect further downside in the shares.

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Share price chart

Source: Tradingview

Hits and misses

Class Limited is Australia's largest provider of cloud based SMSF accounting software, used by accountants, administrators and advisers. Dating back to 2009 the company's main product, Class Super, has a 28.4% market share in Australia and generates essentially all of the company's revenues right now, specifically revenues from software licenses. The company's other product, Class Portfolio, was launched in 2015 and generated only 3% of revenues in the first half of FY20. A third, new, product is Class Trust which the company says will be launched in FY21, although it recorded a tiny bit of pilot revenue ($31k) in 1HY20 already.

In January, Class announced the acquisition of NowInfinity, a company that produces legally backed documentation for the financial services industry. NowInfinity is expected to generate $7m in revenues in FY20 and to be earnings accretive in FY21. The acquisition is aimed at expanding Class' product offering to existing clients and provides an excellent cross-sell opportunity for the company, in our view.

While Class Portfolio has never really delivered on its promises over the last few years, it has resulted in the development of Class Trust. You see, trusts are more flexible than super funds and facilitate the intergenerational transfer of wealth. So, while Class Portfolio never really took off as a product, it turned out that many client portfolios being managed through Class Portfolio were actually trusts, around 45% in fact.

Many trusts are still being managed the old-fashioned way, through spreadsheets. Many accountants still perform basic functions, like investment performance and capital gains calculations, manually, which is time-consuming and prone to errors. This is where Class Trust comes in as it automates these functions. And the market for trusts is comparable in size to SMSF's. The number of SMSF's in Australia totals about 700,000, while the number of trusts amounted to 530,000 back in 2017. So clearly an attractive addressable market. And best of all, through Class Super, the company already knows many of the accountants, advisers and administrators managing these trusts.

We're big fans of recurring revenues

Class' products are super sticky, i.e. once customers come on board and integrate Class Super into their workflows, they hardly ever leave. Whether that is because Class Super is such a great product or because it is too much of a hassle to change over to another provider is unknown. Fact is, Class' customer retention rate was close to 99% last year.

We see this sort of stickiness with other types of products too, like bank accounts and corporate accounting software. This very high level of recurring revenues is one of the key things we like about Class. What we don't like about Class is its cost base.

Cost blow-out

In the last few years, Class has been on a steep revenue growth trajectory, with revenues growing from $29.2m in FY17 to an estimated $44m in the current financial year, ending in June. This is a compounded annual growth rate of nearly 15%, which isn't too shabby. However, Class' net income has basically flatlined during that same period, which explains the company's poor share price performance over the last four years. It turns out, the company's employee costs are quite high, in part related to the company's strong product development efforts. Just for FY20, Class earmarked $12m for core product development.

In line with what we wrote about 3P Learning yesterday, investing in product is fine, but there comes a time when you need to recoup those investments through structurally higher sales. That time for Class is now, in our view. With Class Portfolio never having taken off, we remain on the fence when it comes to Class Trust.

Not very ambitious

Another thing we don't like about Class is the company's ambition level. Class' long term EBITDA margin target is 40%, which doesn't seem very ambitious for a software company, especially since the EBTDA margin in 1HY20 was 42% already, excluding one-off costs related to the NowInfinity acquisition. We believe businesses like Class should be able to achieve operating margins well in excess of 50%.

Even after the recent Corona-led share price decline, Class' shares are still not extremely cheap at an EV/Revenue of 2.4x, and EV/EBITDA of 6.2x and a P/E of 18.8x, all for FY21 that starts in July.

While we do believe the company has a solid market position in the SMSF market and Class Trust has got potential, the jury (i.e. us) is still out on Class' ability to improve the bottom line. We'd want to see evidence of commercial success with Trust before we move to a four-star rating, hence only three stars for now.

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Coronavirus pressures weigh on REITs

Management withdrew its FY20 earnings and distribution guidance on 25 March due to the unknown effects of the COVID-19 pandemic. Its 84 supermarket centres are an essential component of Australia's supply chain for food, medicine and other basic needs. And while these centres are seeing increased customer traffic amid stockpiling spending at Woolworths and Coles, this volume hasn't come without costs. Heightened expenses related to cleaning and security for its properties are weighing on Shopping Centres. Similar pressures to ensure the safety of its tenants and their customers are mounting at non-anchor retailers like pharmacies, medical centres and discount stores.

Aside from these challenges, the recent government closure of gyms, cinemas, beauty salons and other non-vital businesses along with limiting restaurants to take-out only services is impacting the Group. These types of businesses combined represent 7% of annual gross property income. Revenue losses from these tenants can be offset by raising anchor-tenant rent and lower interest expenses, but only partially. Moreover, anchor tenants, like Woolworths, will push back on rent increases.

The REIT's debt level was $1.22bn as of the end of last year, 7% more than on 30 June 2019. Gearing increased 1.4%-point to 34.2% during the six-month period ending 31 December 2019. This was within the company's target range of 30% to 40%, however, a declining figure closer to the low end of the target range would be better at this stage of the economic cycle. The company's cash and undrawn loan facility balance is $176m. Its next debt expiration is April 2021 at which time $225m will be needed. Management expects to meet this need by generating positive cash flows and tapping into undrawn facilities. Given the uncertain nature of cash flows over the next twelve months, we believe this cash balance relative to the debt maturity is too close for comfort from an investment perspective.

Shifting to non-discretionary tenants

Prior to the coronavirus outbreak Shopping Centres was already dealing with headwinds related to the online shopping revolution. Australian consumers are increasingly shunning traditional retail outlets and turning to their computers and smartphones to buy anything from clothing to electronics to personal care products. This represents an ongoing challenge for shopping centre REITs and especially those exposed to discretionary retail tenants.

Shopping Centres is addressing this challenge by shifting its tenant mix towards non-discretionary categories. Nearly half of its gross rent is derived from supermarket anchors and major retailers like Woolworths, Coles, Big W, Wesfarmers, Aldi and Farmer Jacks. Speciality retailers make up the remaining 52% of income sources. In recognition of the online consumer trends, the company is scrambling to make higher-risk speciality tenants a smaller part of its business. Other industry players are doing the same, but there is only so much grocery tenant space requirement to go around.

Consistent with this industry-wide shift, Shopping Centres has also altered its acquisition strategy. It is buying properties that fit the non-discretionary mould to create a more defensive property portfolio. In December 2019 it acquired Warner Marketplace, a Brisbane-based convenience centre anchored by Woolworths and Aldi, for $78.4m.

Right strategic direction, wrong time to buy

At the end of the day, a REIT is only as successful as its tenants. This means it is directly affected by what dictates spending patterns at its shopping centres. Personal income levels are a key driver of consumer spending and especially discretionary spending. With many Australians out of work at least temporarily due to the coronavirus, people are looking for ways to reduce expenses and discretionary spending is a natural place to start.

Shopping Centres has a solid 98.3% occupancy rate and is making the right moves in shifting towards more resilient non-discretionary properties and tenants. But with more than half of its gross rent still coming from speciality retailers, the category mix remains unfavourable given the soft retail market and the shift to online shopping. The added near-term pressures from the coronavirus outbreak are further reason to stay away from this stock.

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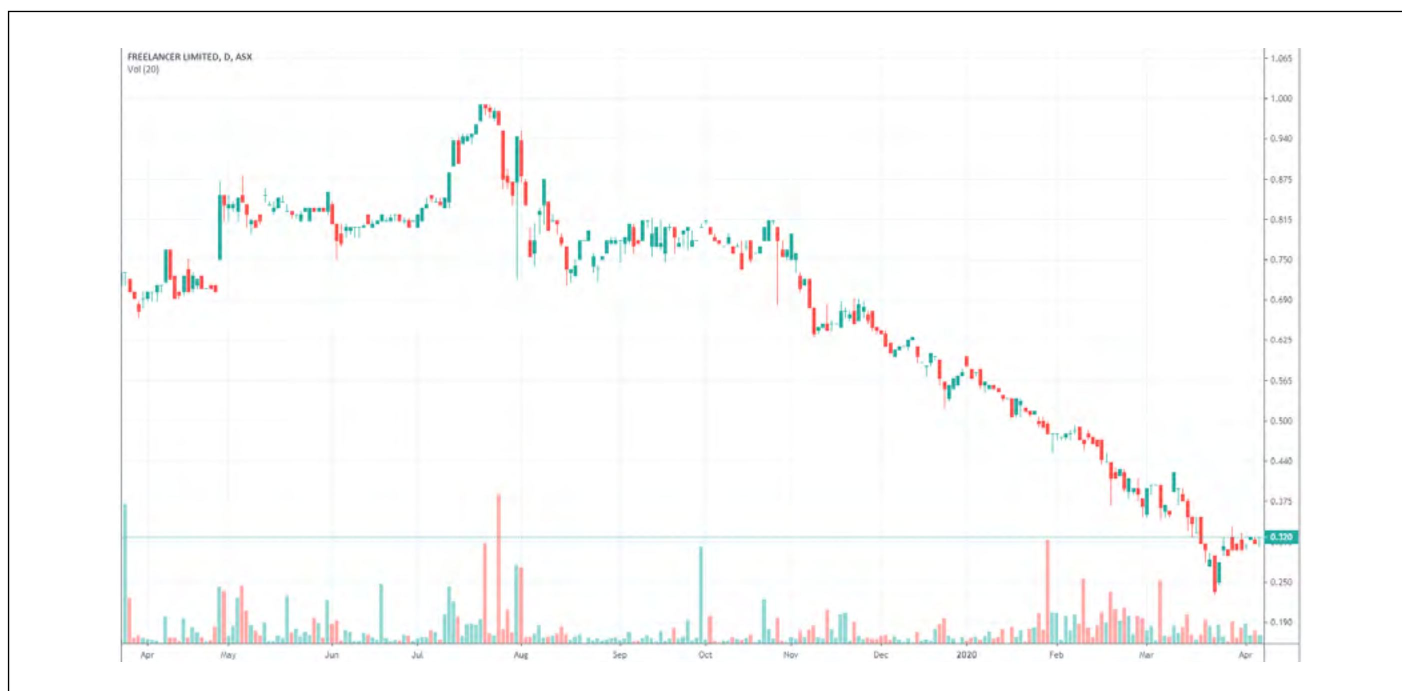

Source: Tradingview

Silver lining playbook

As evidenced by the 2019 annual results, released on 17 February 2020, the total number of new job postings on Freelancer's website declined 13% over 2018. Since then, the stock was heavily sold by the market, hitting an all-time low of $0.23 before bouncing back to the current level. Although the market may be less hopeful on the prospect of this business, we believe it stands to make good money for the contrarians among us given the current market circumstances.

The COVID-19 outbreak is causing global chaos that is significantly impacting most if not all industries. Confronted by falling business activity, employers across the globe have been restructuring businesses and shedding staff in order to achieve an appropriate cost base. For most companies, the COVID-19 crisis is a significant hindrance to their performance, but for others, such as Freelancer, COVID-19 may instead be fuelling growth.

COVID-19 forces a lot of businesses to re-assess their cost structure. When facing growing economic uncertainty, businesses tend to tilt their cost base towards more variable components. One way to achieve this is by shedding in-house employees and outsourcing work to freelancers. This strategy is not only cost-effective for business owners, but also particularly useful when dealing with a volatile workflow.

Given most businesses will be impacted by COVID-19, it is likely that they will explore outsourcing options to preserve cash. As Freelancer runs one of the world's largest freelancing platforms, employers are likely to turn to its online marketplace when posting jobs and searching for talent. Effectively, this should drive Freelancer's user base and the number of new jobs posted. Additionally, the fact that many skilled workers have lost their jobs means that they too will likely turn to Freelancer and similar platforms, such as UpWork, to look for work.

Consequently, we believe COVID-19 may cause a significant scale up in terms of new users and jobs posted for Freelancer, which in turn is expected to drive a material uplift in revenues and margins.

Wide range of job categories, but not a great UX

Competition-wise, Freelancer has a diverse job category offering. Unlike its direct competitor Fiverr (NSDQ:FVRR), that only offers limited job categories, Freelancer has over 1,600 job categories as diverse as aerospace, engineering, biotechnology, sales and manufacturing. We believe, this versatility provides both employers and freelancers the option to best match jobs with specific talents. It therefore strengthens Freelancer's competitive position in the market.

UpWork (NSDQ:UPWK), the product of the 2013 merger between Elance and Odesk, is another player in this space, and is a formidable competitor, in our view. When it comes to the user experience, or UX in developer speak, UpWork is the benchmark and Freelancer can learn a thing or two from UpWork. So, there's work to be done in that area.

Targeting the Enterprise market

In addition to its core marketplace offering, where Freelancer generates the majority of its revenues, its new enterprise revenue stream grew exponentially in 2019, reaching $5.2M (2018: $580K). Enterprise revenue is derived from the provision of services to enterprise customers including a number of Fortune 500 companies.

In 2019, the company also inked commercial agreements with major brands in the technology, professional services and healthcare industries. The ongoing deployment of projects with signed enterprise customers should ensure continuing growth in near-term enterprise revenue. Given the rapidly growing enterprise adoption of cloud-based labour, we expect the uptake by enterprise customers to increase significantly over the short to medium term.

One for the contrarians?

If you are a contrarian, here is something to think about. Currently, Freelancer is trading near its all-time low of $0.23. This implies that future growth for the business has been priced at a very low level by the market. The market also seems to believe that COVID-19 will be a major detractor to Freelancer's future performance, as reflected by the fall in the stock price in March 2020. However, if the company does thrive in the COVID-19 crisis on the back of more work moving online, we expect there will be a major uptick in Freelancer's user base and in new job postings. This should drive a significant re-rate of the stock.

At an approximate EV/Revenue of 1.6x for FY20, Freelancer is valued roughly in line with UpWork, which is about 6x larger though, but well below Fiverr at 4.4x. When it comes to slapping a star rating on Freelancer, we definitely see opportunities for the company, but we are hesitant to give it four stars given its market position compared to UpWork. After all, cloud-based job platforms compete globally. Hence, three stars for now.

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Pitt Street Research Pty Ltd is founded on more than 40 years of combined experience researching companies in a range of different sectors.

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