20 APRIL 2020

Stocks Down Under

No wealth can ever make a bad man at peace with himself.

- Plato (424-348 BC), Athenian philosopher

TELSTRA

Don't get caught in the value trap

INTEGRATED RESEARCH

The Prognosis is mixed

BORAL

Current valuation strong foundation to build on

TELSTRA

Don't get caught in the value trap

Stocks Down Under rating: ★★

ASX: TLS
Share price: A$ 3.16
Market cap: A$ 37.5BN

Melbourne headquartered Telstra needs no introduction as almost 5 in 10 Australians have a Telstra SIM card in their mobile phones. In 1993, the Australian Telecommunications Commission and the Overseas Telecommunications Commission merged, and the new entity was rebadged Telstra. Privatisation started in 1997 and was completed with Future Fund selling its final stake in 2011. As with many former state-owned Telco operators elsewhere in the world, being exposed to share market forces hasn't been a great experience for Telstra. And we're not sure if it's going to get any better.

READ MORE

INTEGRATED RESEARCH

The Prognosis is mixed

Stocks Down Under rating: ★★★

ASX: IRI
Share price: A$ 2.85
Market cap: A$ 498M

Sydney-based Integrated Research has been selling network monitoring software for more than 30 years. Today, more than 95% of its revenues are generated overseas, especially in the US. And while the product and revenue model look very good on paper, the company's share price development in the last five years seems to indicate something is off. Let's find out what that is.

READ MORE

BORAL

Current valuation strong foundation to build on

Stocks Down Under rating: ★★★★

ASX: BLD
Share price: A$ 2.79
Market cap: A$ 3.2BN

Sydney-based Boral supplies building materials to residential and commercial construction companies. It has been in this business since 1946 when it was founded as Bitumen and Oil Refineries (Australia) Limited. After spinning off its energy business in 2000 it has become Australia's leading building materials supplier. With an increasing presence in 17 countries, the company's growth opportunities are expected to resume once the Coronavirus Crisis subsides. Moreover, leadership change in the aftermath of an accounting scandal is slowly rebuilding investor confidence.

READ MORE

TELSTRA

Don't get caught in the value trap

Stocks Down Under rating: ★★

ASX: TLS
Share price: A$ 3.16
Market cap: A$ 37.5BN

Melbourne headquartered Telstra needs no introduction as almost 5 in 10 Australians have a Telstra SIM card in their mobile phones. In 1993, the Australian Telecommunications Commission and the Overseas Telecommunications Commission merged, and the new entity was rebadged Telstra. Privatisation started in 1997 and was completed with Future Fund selling its final stake in 2011. As with many former state-owned Telco operators elsewhere in the world, being exposed to share market forces hasn't been a great experience for Telstra. And we're not sure if it's going to get any better.

Share price chart

Source: Tradingview

Mobile phone saturation is very high

The key problem for Telco operators the world over is that ever since mobile phone saturation levels hit 75% to 80%, they have been left without significant growth opportunities. As soon as a country hits the approximate 75%-80% threshold, the most obvious way for Telco's to grow their mobile revenues is to lure customers away from the competition. And because mobile telephony and mobile internet products from different providers are highly interchangeable, the best way to attract these customers is by offering a better price. Sure, an operator can offer more data at the same price, but such tactics are easily copied and don't provide a long-term advantage.

Mobile phone saturation in Australia hit 91% in 2019, meaning 91% of Australians own a mobile phone, which puts Australia among the countries with the highest penetration rates worldwide. Good luck selling a new subscription in such an environment.

Cost cutting as a remedy

So, Telcos don't have differentiated products, unlike for instance car and mobile phone manufacturers, and are basically providers of generic network capacity. With limited growth and lack of pricing power, the best way to improve margins is cost cutting, which is what all Telcos have been doing for years, especially the former national carriers that used to have a lot of legacy fat on the bones. However, for Telstra that's not enough as illustrated by its EBITDA development in the last few years.

On 20 March Telstra informed the market that EBITDA for the year will likely come in at the low end of the earlier $7.4-7.9bn guidance range, i.e. substantially down from the FY19 EBITDA of $8bn, which itself was down almost 22% from FY18. The key point to note here is that FY20 EBITDA was already expected to decline this year, even without the impact from COVID-19.

The company is still aiming to reduce costs by $2.5bn by the end of FY22. However, Telstra has paused the reductions in its staff for now, in order to do its bit to support the Australian economic recovery effort post-COVID-19. The company is also hiring 1,000 temporary contractors to support its call centres during this period.

Silver lining for speed freaks

In a further bid to help the post-COVID recovery effort, Telstra will also bring forward $500m in Capex from early 2021 into 2020 to increase network capacity and for the roll out of 5G. The latter is good news for speed freaks, because 5G is a very substantial step up when it comes to data download speeds over mobile networks.

While 4G download speed maxes out at 100 Mbps (Megabits per second), at least theoretically, 5G's theoretical limit is 10 Gbps (Gigabits per second), which is 100x faster, again theoretically. In practice, though, 5G network speeds for everyday use will be substantially lower than that maximum due variables such as number of users on the network, distance to cell towers, type of subscription etc, but the technology will open up new use cases in gaming, remote business applications, video services etc. That in itself will initially present new pricing power opportunities for Telstra if it can get to market fast.

5G is not a structural differentiator for Telstra

However, as we have seen with previous technology upgrades, the Telco's will likely struggle to really move beyond just being a provider of 5G pipeline capacity. It's typically third-party service providers, who can make optimal use of new technologies, that capture the monetary upside from these new technologies.

For instance, substantially higher 5G network speeds and extremely low latency will be a major boost to autonomous driving as future autonomous vehicles will be able to communicate with servers and cars nearby much faster and more accurately than they currently can with "slow" 4G networks. So, the Tesla's of this world will benefit much more from 5G than the Telstra's of this world, in our view.

The same for Gaming companies that will be able to offer data-heavier online gaming experiences, including Virtual Reality gaming, through 5G networks.

Value trap ahoy

As you may have guessed, we're not big fans of Telco operators, including Telstra, because their business models lack uniqueness. Not just in the mobile market, but also in fixed line internet. The NBN isn't going to save the day for Telstra, in our view. In fact, we believe 5G can make fixed line internet networks largely obsolete in the next five years, depending on 5G pricing to the market.

We believe the one thing that is supporting Telstra's shares right now, i.e. a dividend yield of just over 5%, is likely to further erode in the next few years. Dividend has already come down from 31 cents in 2017 to 16 cents in the current financial year and we believe there's a high likelihood of further reductions in the next few years.

The current 6.7x EV/EBITDA multiple for FY21 is not expensive, but we believe Telstra is a potential value trap….it's cheap for a reason and we're steering clear. Two stars.

INTEGRATED RESEARCH

The Prognosis is mixed

Stocks Down Under rating: ★★★

ASX: IRI
Share price: A$ 2.85
Market cap: A$ 498M

Sydney-based Integrated Research has been selling network monitoring software for more than 30 years. Today, more than 95% of its revenues are generated overseas, especially in the US. And while the product and revenue model look very good on paper, the company's share price development in the last five years seems to indicate something is off. Let's find out what that is.

Share price chart

Source: Tradingview

It's all about Prognosis

Integrated Research's key product is called Prognosis. In a nutshell, Prognosis is a software platform that can monitor and assess computer and communications networks from end to end, for instance to pick up any current issues in a network. But it can also predict potential network issues before they occur through predictive analytics. The key application areas for Prognosis are payments transaction monitoring, and monitoring of networks used in Unified Communications (UC). Consequently, Payments/Financial Services and Telecom/IT are important verticals for Integrated Research.

Prognosis for UC improves quality of communications

UC entail the integration of enterprise communication services, such as instant messaging, voice and VoIP (Voice over Internet Protocol), audio, video conferencing, desktop sharing, data sharing etc. The goal is to provide users with a smooth experience and a comparable interface across all these different technologies.

There is a lot of scope for performance issues in UC due to problems in the network given that a lot of these networks have been stitched together over the years and have been supplied by different vendors. Therefore, a tool that provides an end-to-end overview of a network, and its potential performance issues, is highly valuable.

Consequently, Telco's such as British Telecom, Optus and T-Mobile are an important target market for Prognosis for UC and this vertical accounts for around 55% of total revenues. Prognosis for UC is also widely used by IT and Telco service providers, like Cap Gemini, Intel, Cisco, HPE and Avaya, broadening the company's addressable market quite substantially.

Prognosis for payments improves platform stability

Prognosis for payments provides real-time insights into the entire payments chain, from point-of-sale through to the retailer's bank and on to the retailer's customers' banks. One of the very useful, and, dare we say, cool, features of Prognosis is that even if it's used by one bank (bank A) but not another (bank B), it can still predict future performance issues at bank B, even though they are not a Prognosis customer. This gives bank A the opportunity to prevent these potential issues at a partner bank before they even materialise. In other words, Prognosis helps improve stability across payments platforms.

The recent contract renewal by JP Morgan Chase, worth US$10m over a 5-year contract, is testament to Prognosis' value add to financial institutions. This renewal also underlines another important aspect of Prognosis: it's highly sticky. JP Morgan Chase has been a customer of Integrated Research for 25 years now and this sort of customer retention is what we like about the company. One of the company's key Australian Payment customers is ANZ while Citibank, ING, VISA and HSBC are well-known customers internationally.

Flattening the curve

After a number of years of strong revenue growth, i.e. a near-doubling of first half revenues from ~$6m in 1HY16 to nearly $12m in 1HY19, the growth rate of 6% in 1HY20 was a bit disappointing. Even more disappointing was the EBITDA-margin decline to 39%, from 41% in 1HY19, driven by higher sales and marketing expenses. The after-tax profit margin fell from 23% to 22%. It seems Integrated Research is flattening the curve, albeit the wrong one.

A dominant shareholder with a lot of sway

Despite some peaks and troughs, Integrated Research's share price is back to where it started in 2015, around $3, which we think is unusual for a software company that provides very sticky, mission-critical software in a recurring revenue model. In our view, the large 39.7% stake that founder Steve Killelea still holds in the company is a big reason for the mediocre share price performance.

Although Mr. Killelea is not on the board of Integrated Research, rumour has it he still holds quite a bit of sway over the board and has been at least partly responsible for the early departure of one CEO. Apart from this, we believe the share overhang is inhibitive to institutional investors coming on the register.

At an EV/EBITDA of 10.5x and a P/E of 19.7x for FY21, which starts in 10 weeks, we believe Integrated Research is not a bargain, given the current market environment. Although we like the company's product and revenue model a lot, at this stage, a 3-star rating is the maximum for us.

BORAL

Current valuation strong foundation to build on

Stocks Down Under rating: ★★★★

ASX: BLD
Share price: A$ 2.79
Market cap: A$ 3.2BN

Sydney-based Boral supplies building materials to residential and commercial construction companies. It has been in this business since 1946 when it was founded as Bitumen and Oil Refineries (Australia) Limited. After spinning off its energy business in 2000 it has become Australia's leading building materials supplier. With an increasing presence in 17 countries, the company's growth opportunities are expected to resume once the Coronavirus Crisis subsides. Moreover, leadership change in the aftermath of an accounting scandal is slowly rebuilding investor confidence.

Share price chart

Source: Tradingview

Full control of USG Boral should pave the way for growth

The company operates in three divisions -- Boral Australia, Boral North America, and USG Boral. The USG Boral division is the leading supplier of plasterboard, ceiling lining systems and related accessories in Australasia. In August 2019, the division acquired Knauf Asia Plasterboard and sold the Middle East business to Knauf. The company now plans to acquire Knauf's 50% stake in USG Boral Australia and New Zealand. Given the current economic environment it will likely be able to do so at a lower price.

Regaining full ownership in USG Boral will allow it to maximize growth opportunities in this division. The expanded joint venture should improve asset utilisation and distribution and derive value from the low capital intensity of USG Boral's businesses. The transaction with Knauf is subject to regulatory approval and is expected to be completed in 2HY20. Management expects US$30m in synergies in year four.

Post-Windows scandal, leadership change bode well

The North American Windows business has been a black eye for the company. In December 2019, Boral announced the finding of financial irregularities in the U.S. Windows business related to the misreporting of inventory levels and various expenses. The company's internal investigation confirmed that personnel artificially inflated the profitability and health of the Windows business. Pre-tax earnings were overstated by US$24.4m in the 20-month period through October 2019 and this caused the company to restate results. More importantly, the accounting scandal shook investor confidence and drove the share price lower.

The financial misreporting, while damaging to the company's reputation, was confined to the Windows business and all things considered managed well by the company. Management has implemented a Windows improvement program to drive profitability and restore shareholder confidence. Prior to the COVID-19 crisis, the company's U.S. business was healthy. Housing starts were up 13% in December 2019 and demand for ready mix was up 3% due to ongoing infrastructure activity. We believe, Boral has a strong national network of 223 operating sites in the US business that is well diversified, both geographically and by business line.

Boral recently announced the retirement of CEO Mike Kane at the conclusion of the full-year FY20 results in June. Kane has been much maligned by investors after a series of profit downgrades. The change of leadership should bode well for the company and generate interest from new investors.

Moderate debt level

The company's balance sheet is healthy. Gearing decreased from 30% in FY18 to 27% in FY19 and remains well below its threshold of 60%. In the near-term, however, gearing is expected to increase in line with the USG Boral investment. The net debt level was a moderate $2.32bn as of 31 December 2019 which was 6% higher than six months prior. Its net interest coverage of 4.7x decreased from 6.1x on 30 June 2019 but still indicates sufficient liquidity. It also has over $1bn in undrawn syndicated facilities available through FY22.

Boral has adjusted well to the current COVID-19 crisis. It no longer requires delivery signatures and has launched a digital 'docketless' delivery platform. The Boral Connects online portal also allows customers to manage their concrete orders online. The near-term impact on global construction from Covid-19 crisis is likely to be meaningful but temporary.

Boral is involved with several lucrative projects including the redevelopment of Scarborough Foreshore, the resurfacing of the Bolte Bridge, the Punchbowl Mosque, and has several infrastructure projects in the pipeline. Its medium-term project pipeline includes an increasing shift towards asphalt projects in conjunction with higher demand from major transportation construction initiatives in Australia.

Well diversified revenue, low multiple

Boral's scale and experience give it a competitive advantage in the global construction market. The building materials supplier has solid upside potential especially in Boral North America and USG Boral, which have grown to comprise approximately 50% of the business combined. Revenue is also well diversified across construction materials with concrete, asphalt and quarries representing 81% of total revenue followed by cement and other building products.

The stock is trading near a 10-year low at a FY21 EV/EBITDA multiple of 6.6x and a P/E of 11.3x. We believe the market sell off related to the accounting scandal was overdone and opened the door for an entry in the shares. Under normal circumstances the shareholder friendly company distributes around 70% of its earnings as dividends and the stock currently offers a dividend yield in excess of 5%. Although the near-term outlook is uncertain due to the Coronavirus Crisis, at the current valuation we believe Boral certainly looks attractive.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

Pitt Street Research Pty Ltd 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