19 MAY 2020

Stocks Down Under

> *I got the name Slash because I used to work in a grocery store and I was in charge of reducing prices for really big sales.'*

- Slash (b. 1965), Musician and songwriter, lead guitarist for Guns N' Roses

WOOLWORTHS

Pressured by Corona-induced recession

PEET LIMITED

Market attributes zero value to funds management business

ORBITAL CORPORATION

Propelled by superior technology

WOOLWORTHS

Pressured by Corona-induced recession

Stocks Down Under rating: ★★

ASX: WOW
Share price: A$ 35.26
Market cap: $ 44.4BN

Sydney-based Woolworths needs little introduction as one of Australia's leading grocery and retail conglomerates. With an expansive footprint across Australia and New Zealand, the company has been challenged by unusual demand which at the surface appears to be a positive but has led to major and expensive changes to its business model and supply chain. Recent sales trends have been positive, but things like food inflation and higher wages have weighed on profitability. The group is seeing strong growth in the digital part of the business, which combined with prospects for liquor sales growth, should lead to improved financial performance as the worst of the crisis seems to be behind us.

READ MORE

PEET LIMITED

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Stocks Down Under rating: ★★★★

ASX: PPC
Share price: A$ 0.715
Market cap: $ 343M

Peet is a Perth-based property developer specialising in residential communities across Australia. It offers a variety of living choices including townhouses, apartments and retirement homes as well as land. Having been in the business since 1895, Peet has a strong brand, a cost-efficient land bank and a powerful funding model. The shares are trading near a 52-week low and with a 4.9% dividend yield look attractive. We believe the market is not giving enough credit to the group's high margin funds management business. Along with the well diversified growth opportunities ahead, this points to one of the most undervalued property stocks on the exchange, in our view.

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Market cap: A$ 62.1M

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Share price chart

Source: Tradingview

Business mix shifts to lower margin goods

In FY19 Woolworth's sales were up 3.4% to $60bn and earnings per share rose 6.8% led by improved sales and profit momentum in the back half of the fiscal year. Sales increased 6% in 1HY20 to $32.4bn driven by strong Australian Food sales and blossoming online growth. EBITDA was up 55% and earnings per share increased 13% with the improved profitability partly due to better apparel sales at Big W.

Things have changed since the onset of the Coronavirus pandemic. The sudden surge in food demand led to immediate product shortages. The company has increased its network capacity by establishing five third-party distribution sites and repurposing a Big W warehouse to support the supermarkets. Today the supply chain is operating 24 hours a day, product availability has improved and product purchase limits are gradually being removed. Groupwide sales growth continued in April although the growth rate was more muted compared to March when the initial surge of panic buying occurred. Management has said that it will be difficult to gauge sales growth for the remainder of the year given the uncertain consumer environment.

Despite having to restructure its supply chain and shift strategic priorities, sales results in the third quarter were strong. In the thirteen-week period through 5 April, sales increased 10.7% to $16.5bn. The sales growth was particularly strong in March at the start of the crisis as consumers stocked up on food and drinks. However, operating costs were also higher primarily due to wage increases and safety-related costs. Sales growth in the Big W segment have remained strong during the crisis but with consumers buying more everyday items and leisure products, the sales mix has adversely changed, while online fulfilment costs have increased.

The Hotels side of the business, which accounts for less than 3% of revenues, has been closed since 23 March and management estimates that it will incur a $30 to $35 million pre-tax loss per month while closed.

Digital and liquor sales are long-term tailwinds

Growth in the digital part of the business has been strong and will be an increasingly important part of Woolworth's growth strategy. The group's online sales jumped 38% in 1HY20 and 34% in the third quarter amid robust demand for Pick-up services. Digital traffic is growing by more than 50% and with many consumers staying home, order volumes have been even stronger than during the Christmas period.

In the drinks business a new BWS app was recently launched and the On Demand service is now available in over 700 stores. Woolworth's continues to invest in its digital experiences and convenience options such as its Delivery Unlimited subscription, a track my order feature and other website and app improvements. It recently launched a pilot program in 10 stores for a Scan&Go offering that allows customers to avoid long checkout lines.

The group has also seen strong growth in the newly formed Endeavor Drinks segment. Third quarter Endeavour Drinks revenue increased 9.5% to $2.25bn. While this may be a temporary phenomenon related to more people opting to drink at home with restaurants and bars closed, we believe the prospects in the liquor category are strong. The wine business has an especially promising outlook given consumers increasing taste for localised wine. Dan Murphy's added 350 new wine product lines in 1HY20. Endeavour is already the group's second largest division by revenue. It continues to add stores with nine Dan Murphy's opened in 1HY20 to bring the total number of stores to 239.

Food inflation, volatile consumer create much uncertainty

The competitive environment among Woolworth's, Coles and Aldi diminished towards the end of 2019 prompting the major supermarket chains to hike prices on many items. This has reversed amid the COVID-19 crisis with the companies scrambling to capitalise on hyper demand for food and necessities. Coles had been boosting prices at a faster rate than Woolworth's last year, but with food price inflation now higher for a different reason, the playing field has levelled. Despite the higher prices, however, we believe both groups will continue to be challenged by higher wage costs and higher expenses associated with online order fulfillment and safety measures.

In the near-term Woolworths will be at the mercy of consumer volatility as it pertains to the fallout of the COVID-19 crisis. As such, its business mix is likely to be skewed towards lower margin food sales as necessity shopping takes priority over discretionary spending while the recession lasts. In the key food business, higher inflation and wages will continue to pressure profitability. While the supermarket operator has some compelling growth prospects around e-commerce and liquor, the near-term dynamics are not favourable.

Unappealing, high valuation

At an EV/EBITDA of 10.9x for FY21 and 10.3x for FY22, we can only conclude that Woolies is very expensive at the moment even though it's trading well below its February peak around $43.50. You see, the average EBITDA growth for both years is just 5% on average, so the EV/EBITDA-to-EBITDA-growth ratio is an unappealing 2x. On top of that, we believe that Aldi may crank up the pressure. During times of recession, the German discounter has traditionally done well in Europe, winning market share that it hasn't relinquished when the economic environment improved. Therefore, we'll only go with 2 stars for Woolies.

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Share price chart

Source: Tradingview

Integrated, well diversified by location and price

Peet has a large land bank of over 49,000 lots across 51 projects that is well diversified both geographically and by price point. Combined these lots have an end value of $14.3bn and are strategically located in the growing parts of major cities in every mainland state and territory of Australia. The properties appeal to a wide range of buyers although first time home buyers are the group's core market. Peet's integrated platform includes property development, marketing, acquisitions and sales. We believe it has good operating leverage potential to drive the development of its land bank. Around 80% of the company's land pipeline is forecast to be in production by FY22.

Peet's financial results for FY19 included a 13% decline in revenue to $262.9m and a 2% decrease in earnings per share. The results reflected strict lending conditions across the market, which led to lower sales volumes and fee income. Market conditions improved in 1HY20 leading to a 52% increase in sales compared to 2HY19. Lot sales were up 5% year-on-year.

Group EBITDA remained below 1HY19 figures due to lower settlement volumes, but overall conditions began to improve and performance was in line with expectations. Restrictive lending conditions began to ease and market conditions on the east coast improved to give Peet some momentum heading into 2HY20.

Underappreciated Funds Management platform

Peet's flexible funding model is the engine behind its success. It encompasses over 37,000 lots and is supported by well-established capital partnerships. The company makes efficient capital arrangements with a diverse set of third parties, which gives it a low-cost portfolio of income generating assets. We believe it has executed its capital strategy well with a current gearing of 28.1%, which is well within its target range. Over the last few years, it has quickly built up its funds management portfolio to $1.24bn in assets.

The funds management business is a valuable component of the company that we believe is not fully reflected in the share price. The majority of the company's lots are part of the funds management platform spread across various retail, wholesale and joint venture assets including completed homes, medium density town houses and apartments. Approximately 74% of its $2.1bn in assets under management are in funds management and joint venture investments. Peet's net tangible assets (NTA) per share of $1.18 does not capture the tremendous value in the funds management platform, in our view. The platform generates capital-lite earnings that account for 60% of Group EBITDA. The lowly geared portfolio has a significant lot pipeline that has good, long-term earnings visibility and represents high margin profit sources across multiple projects.

Homebuyers pause amid COVID-19 crisis

The COVID-19 crisis is having a significant impact on the residential property market in Australia. Rising unemployment rates and lower income levels have caused many would-be residential buyers to put their home purchase plans on hold. But when employment levels improve and buyers return to the market, we expect they will find a low interest rate environment to support their purchases. Income tax cuts and government infrastructure investments should also support underlying demand for Peet properties as the economy gets back on its feet.

We believe Peet is well positioned to leverage its unique business model when the market starts to recover. Volumes and prices are expected to improve through the course of FY21. Lower interest rates, a reduction in income tax rates and an easing of credit availability make for a positive medium-term outlook for Australia's largest pure play residential developer that is currently trading at a P/E of 9.3x for FY21.

With an anticipated EBITDA growth of 20% in FY21, Peet's EV/EBITDA multiple of 9.2x looks quite attractive. Four stars from us.

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Share price chart

Source: Tradingview

Orbital's raison d'etre

Tactical UAV's are high end drones that are used by the military and coast guards around the world for various purposes, including reconnaissance, surveillance and intelligence gathering. They are not to be confused with military UAV's that have attack capabilities, i.e. rocket launchers and such.

Tactical UAV's are often required to stay in the air for up to 24 hours at a time, which puts stringent requirements on engine specifications. For instance, fuel efficiency needs to be very high to minimise the weight of the on-board fuel.

Furthermore, exhaust and heat profiles need to be optimised to minimise the chance of detection. The total price for a single UAV system can run up to $6m, so it is easy to see why so much attention is given to fuel efficiency and stealth aspects.

Innovative and patented technologies

Orbital's secret sauce is the way its engines inject fuel into the cylinders. Orbital's FlexID technology produces much smaller fuel droplets than conventional engines, which leads to improved vaporisation of the fuel and better combustion properties for various fuel types, including gasoline, JP5 (used on aircraft carriers), JP8 (fuel for turbine powered aircraft) and Jet A, a US-specific jet fuel. FlexECU is Orbital's Engine Control Unit, that works together with FlexID, and manages the combustion process. Both technologies have been patented by Orbital. The net effect of using FlexID and FlexECU in UAV's is a 40% more efficient combustion process compared to the more traditional port injection system.

Playing with the big boys

The global tactical UAV market is about US$22BN in size, with Insitu (owned by Boeing), Lockheed Martin, Elbit Systems, Textron Systems, L3Harris and Northrup Grumman being the key players. Orbital has been supplying engine modules to Textron Systems for a while with total sales to-date of $22m. The company also closed a long-term supply agreement in October 2018 with Insitu worth up to a maximum of $350m through 2023. And in April 2020 Orbital announced a development agreement with Northrop Grumman for the development of two hybrid propulsion systems for UAV's that need vertical take-off and landing (VTOL) capabilities.

Delivery of the prototypes for Northrop Grumman is expected in 2021 and could lead to a new customer for Orbital. More importantly, successful conclusion of this development project could provide Orbital with a strategic advantage in the area of hybrid propulsion for UAV's. This is the next big thing in tactical UAV's, given that hybrid propulsion may lead to a combination of higher payloads and longer flight times. In March Orbital signed an MOU with an unnamed defence company in Singapore for a long-term development program for a multi-fuel UAV engine.

Not impacted by Coronavirus

Following $15.3m in revenue in FY19, Orbital guided to revenues between $25m and $35m for FY20. This guidance was reiterated as recently as 23 April. It's fair to say that the company's revenues don't seem to be affected too much by the Coronavirus Crisis, although a range of $25-35m is very wide and leaves a substantial margin for adjustment. In 1HY20, which ended 31 December, Orbital generated $11.4m in revenues, up from $2.2m in 1HY19 and $13.1m in 2HY19.

The consensus estimate for FY20 revenues is $29.8m, which would imply $17.4m in revenues in the second half of FY20. Given that Orbital's revenues are a bit lumpy and dependent on development and delivery milestones, its hard to say if that $18.4m is a reasonably number. However, given that guidance was reiterated late April, we believe the lower end of the range, i.e. $25m in revenues, is probably already in the bag.

Orbital is also expected to generate its maiden EBITDA profit this financial year, to the tune of $4.8m. While we believe this may be on the high side, given everything that's happened in the world in recent months, the key thing is to focus on the fact that the company is likely to turn EBITDA positive in the first place.

The valuation for FY21 is an EV/EBITDA of 11x and a P/E of 20x. Given that the company is really only in the early stages of its revenue ramp up stage and is able to get in bed with the largest players in its addressable market, we believe this valuation looks quite attractive, hence we give Orbital a four star rating.

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