28 MAY 2020

Stocks Down Under

The quickest way to double your money is to fold it in half and put it in your back pocket.

- Will Rogers (1879-1935), American newspapers commentator

AFTERPAY

Reached our $50 target. Where to from here?

BELLEVUE GOLD

Bellevue 2.0 is going well

HOTEL PROPERTY INVESTMENTS

A toast to lease extensions and acquisitions

AFTERPAY

Reached our $50 target. Where to from here?

Stocks Down Under rating: ★★★★

ASX: APT
Share price: A$ 45.25
Market cap: A$ 13.1BN

As our readers will know, we at Stocks Down Under are very bullish on the Buy Now, Pay Later (BNPL) space. Last year we called a share price target for AfterPay of $50. On 26 May, the shares finally hit that target after COVID-19 temporarily spoiled the party. Following the low point of the Corona Crash on 23 March, when AfterPay bottomed around $8.30, the shares have bounced back remarkably, to the point where they are now trading at a level that could be interpreted as a psychological hurdle for many investors. The question is: What to do with AfterPay shares at these levels?

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BELLEVUE GOLD

Bellevue 2.0 is going well

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ASX: BGL
Share price: A$ 0.72
Market cap: A$ 508M

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Stocks Down Under rating: ★★★★

ASX: HPI
Share price: A$ 2.80
Market cap: A$ 444M

Melbourne-based Hotel Property Investments is a real estate investment trust (REIT) that owns a diverse $774m portfolio of 45 properties comprised of pubs and specialty stores across Queensland, South Australia and New South Wales. It has a history of generating strong cash flow and delivering reliable returns to shareholders. As economic conditions improve, its properties should continue to produce earnings that can translate to steadily increased distributions over time. The shares have recovered nearly half their value since plunging to an all-time low in the early stages of the Coronavirus pandemic. Yet they are still trading at a discount to net asset value and offer a 6.8% distribution yield to which we say cheers!

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Share price chart

Source: Tradingview

Very resilient business model

When COVID-19 hit and many people lost their jobs, investors' knee-jerk reaction was to sell anything retail related, including AfterPay. The thought was that consumer spending would take a big and lasting hit as the global economy tumbled into the abyss of depression, seriously disrupting bricks and mortar retailing. But if there's one thing that the COVID-19 crisis has highlighted, it's the resilience of AfterPay's business model. Online retailing was already the main driver for the company, but driven by COVID-19 it saw consumers, who couldn't leave the house anymore, flock to online retailers. Once the initial lockdown shock was over in late March, AfterPay experienced resumption of growth, driven by online retailing. We wrote about this in the Stocks Down Under Buy Now, Pay Later Special on 23 April.

Surfing USA....and China?

Another thing that has become very clear in the last few months is that the United States is indeed the Promised Land for AfterPay. In the last two years, since entry into the US market, AfterPay signed up 9 million customers, of which 5 million active ones, defined as consumers who have transacted using AfterPay in the last 12 months.

However, just in the period from 1 March to May 15, so basically right through the COVID-19 lockdown period, AfterPay has been able to add 1 million new US customers to its platform. With the US being the Mecca of retailing, we believe there is substantially more growth where that came from.

And China could potentially be the next big market. Chinese internet giant Tencent recently showed up on AfterPay's register as a substantial shareholder. While Tencent may be interested in AfterPay as an investment, we believe it's more likely that Tencent is keen to take the AfterPay model and payment technology into China. While that will not happen overnight, it certainly provides a long-term view of what AfterPay's expansion strategy could look like.

Institutional investors forced to buy

The other big thing, in the very near term, is AfterPay's inclusion into the MSCI Australia index at the end of trading on Friday, 29 May. The various MSCI indices are used by many institutional investors around the world as benchmarks for their own performance, i.e. they are measured by how well their funds perform compared to an index. They typically buy all the stocks that are included in the index that is relevant for their fund and then make only make small deviations in weightings of individual shares in their portfolio, so their performance doesn't stray too much from the index performance.

If a stock gets included in the MSCI Australia index, by default these types of institutional investors need to buy that stock so that their portfolios keep resembling the index they follow. Inclusion into the MSCI Australia will in part have been the reason for AfterPay's strong performance in the last few days and weeks. And it will likely continue to influence trading today and tomorrow.

How we arrived at our $50 price target

Last year when we published our $50 price target for AfterPay, we based it on our favourite valuation metric, EV/EBITDA-to-EBITDA growth, where a ratio of 1 signals a fair valuation, i.e. at that ratio you're paying for the growth you're getting. If the ratio gets above 1 a stock gets progressively expensive as the EV/EBITDA multiple is becoming too high for the growth you're getting as an investor. Alternatively, a stock is cheap when the ratio is lower than 1 and gets cheaper the lower the ratio becomes.

Looking ahead, based on the average estimates of the 13 broker analysts that cover AfterPay, as calculated by S&P Capital IQ, the stock's EV/EBITDA-to-EBITDA growth ratio for FY21 is currently 0.27x. In other words, we believe AfterPay's valuation is very low compared to the EBITDA growth investors are expected to get in FY21.

AfterPay shares can double from here

If AfterPay were to re-rate to a ratio of 1x for FY21, i.e. what we would consider to be a fair valuation, you're looking at more than a tripling of the current share price, i.e. more than $150 per share. However, while we at Stocks Down Under never shy away from bold predictions, the share market has its own way of processing information and expectations. Simply put, we believe the average Australian investor, retail or institutional, first needs to get his or her head around these sorts of valuations and this way of thinking.

In other words, we don't expect a re-rating of AfterPay to levels we consider fair simply because the market isn't ready to pay that number…yet.

However, based on our calculations for FY22 and FY23, we see AfterPay going to $100 per share in the next 12 to 18 months, just by using the same EV/EBITDA-to-EBITDA growth ratio the stock is trading at now, but applying it to future years.

Now, no stock has ever gone up in a straight line and AfterPay won't be the exception to that rule. Given the strong share price run since March and the fact that $50 may be considered a psychological barrier, we do expect choppiness along the way. In the very near term, we would expect some consolidation in the share price and potentially a bit of a retracement as the share price takes a breather. However, we believe the scalability of AfterPay's model and the size of its global addressable market are simply too attractive to hold a good stock back for long.

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Share price chart

Source: Tradingview

If you've ever done the 800 km drive up the Goldfields Highway in Western Australia from Kalgoorlie to Meekatharra, you will have passed through the old gold mining towns of Menzies at 132 km north and Leonora at 235 km before getting to Leinster at about the 370 km mark. Leinster, which in 2016 had a population of 582, is a major nickel mining centre for BHP while the 250,000-ounce per annum Agnew Gold Mine owned by the South African company Gold Fields (JSE: GFI) is in the immediate neighbourhood. Further afield, but within a 100 km radius of Leinster, are the Darlot (Red 5, ASX: RED), Bronzewing (Echo Resources, ASX: EAR) and Thunderbox (Saracen, ASX: SAR) gold mines. Bellevue Gold reckons it will be next with its resurrection of the Bellevue Gold Mine, around 30 km north of town.

Bellevue was a high grade mine last time around

In Western Australia a lot of the gold is hosted in long belts of very old rocks from the Archaean era called greenstone. Bellevue, known since the 1890s, was historically one of the star gold attractions of the Wiluna-Norseman Greenstone Belt. It was a very high grade mine last time around, producing 800,000 ounces at a massive 15 g/t gold from the early 1980s until its closure in 1997, across a number of open pits as well as an underground mine. The listed company that became Bellevue Gold started working on Bellevue 2.0 in mid-2016. The attraction was that virtually no exploration work had been done since 1997 so modern exploration techniques would likely yield millions of ounces at high grade.

The last four years delivered on that promise and made money for savvy players, like the Melbourne-based investor Tolga Kumova, who backed this story at 5 cents a share in an August 2017 placement and still holds 6% of the stock. By February of this year, Bellevue's JORC 2012 resource had increased to 2.2 million ounces. The maiden resource from just August 2018 was only half a million ounces at 8.2 g/t 2018, but work on multiple high grade lodes, such as Viago, Deacon and Tribune has taken the grade of the result up to a very high 11.3 g/t gold over the last four resource upgrades. And the drill rigs will be kept busy for a while yet addressing new targets, which could yield announcements like that of late November 2017 when one 5 metre drill intersection came back at 37.5 g/t gold and first caused this story to gain investor traction.

There's likely more resource where that came from

Bellevue Gold is still some way away from conducting a scoping study or a Feasibility Study on what the company hopes is its new mine, but the company is optimistic about its prospects because there's already 28,000 metres of mine development to access their resource, which just needs to be dewatered, and the metallurgical test work has shown that gold recoveries in the order of 98.8% are easily achievable from Bellevue ore with a conventional flowsheet or gravity separation and cyanide leaching.

The reason to look at this stock now is the fact that there is likely to be a lot more resource upgrades, given that exploration has still only reached the 500 metre mark whereas other gold mines in Western Australia in similar geological settings are known to yield economic resources down to 1,500 metres. Throw in the fact that there's plenty of infrastructure in the neighbourhood and investors are likely to stay interested. Particularly if gold keeps behaving the way it has in recent months.

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Share price chart

Source: Tradingview

Coles extensions, hotel acquisitions good for long-run growth

Of HPI's 45 properties, 41 are leased to Queensland Venue Company (QVC). QVC is a recently formed joint venture between Melbourne-based supermarket operator Coles and Australian Venue Company (AVC), an experienced pub and hospitality operator of over 150 venues. AVC manages the pub and hotel businesses while Coles manages the packaged liquor business.

The tenancies of HPI's leases are long term and include contracted rental increases both of which are attractive attributes of the investment. All hotel leases that were expiring in CY21 have recently been extended. This increased the weighted average lease expiry (WALE) of the group's investment portfolio from 3.8 years to 11.8 years. The extension of leases demonstrates the importance and strength of the HPI-Coles relationship.

Most of HPI's properties are leased to a high-quality tenant in Coles. This is something that investors should find much comfort in. Through agreements with QVC, this encompasses 28 pubs that represent 57% of HPI's income. We believe the likelihood that Coles does not renew its leases upon expiration is very low given the tenure and strength of the relationship. This bodes well for HPI's future earnings stream and ability to increase distributions.

Pub closure opens door to a great buying opportunity

Pandemic-related government restrictions on gatherings and travel that closed hotels and bars across Australia crippled HPI's tenants. On 1 May, HPI announced an agreement with QVC to defer a portion of rent through September 2020 representing a total value of around $7.5m. The arrangement, however, is not expected to have a significant impact on HPI's financial performance over the next few fiscal years. The silver lining here is that the pub closures have devalued HPI shares and created a great opportunity to invest. As pubs and hotels begin to reopen, even under new restrictions and potentially higher costs, traffic is expected to return and with it the continuation of reliable rental income for HPI and its shareholders.

HPI actively seeks pubs that fit its detailed investment criteria. This includes properties in high growth and metropolitan areas that are often supported by nearby infrastructure investments. It looks for properties that have operators with proven track records, long lease terms with options to extend, and diversified income sources like food and beverage, bars, gaming and accommodations. The group's most recent acquisitions fit this mould and exemplify the growth opportunity that lies ahead.

The REIT purchased the Gregory Hills Hotel for $40m marking its first entry into the burgeoning metropolitan Sydney market. The venue is a single level structure that contains a bistro bar, sports bar, 30 electronic gaming machines (EGMs) and a walk-in bottle shop. It also bought Acacia Ridge Hotel for $20m to add a large format suburban hotel in metropolitan Brisbane. Acacia Ridge has a main bar, a bistro bar, a drive through and walk in bottle shop, TAB and a gaming lounge with 45 EGMs, along with 42 motel rooms. Both properties are leased to experienced pub operators with strong track records and carry 12-year terms.

Solid first half results, healthy balance sheet

HPI reported solid 1HY20 results that included a 2.3% year-over-year increase in rental revenue and a 5.1% increase in distributions per security. Net asset value (NAV) was up 1% to $2.96 driven by cap rate compression in 28 properties that was partially offset by valuation declines in properties that experienced rent resets. The investment portfolio's weighted average capital rate was reduced from 6.4% in June 2019 to 6.1% in December 2019.

The hotel property investor has a strong, well-managed balance sheet that gives it the flexibility to pursue growth investments and return value to shareholders. It recently added debt capacity to its funding lines, which affords the company plenty of headroom for additional capital. Gearing is approximately 38% and there is no debt maturing over the next 12 months.

HPI's investment portfolio generates a secure income stream that is underpinned by long term lease agreements. Although management withdrew distribution guidance due to the near-term uncertainty around the COVID-19 crisis, the Coles relationship and potential to acquire more growth properties make for a favourable long-term outlook.

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