29 MAY 2020

Stocks Down Under

"People always ask me, 'Were you funny as a child?' Well, no, I was an accountant."

- Ellen DeGeneres (b. 1958), American comedian and television host

XERO

Great product, expensive shares

PPK GROUP

Wide range of nanotube applications drives growth potential

BNK BANKING CORPORATION

Focussed on scaling up as lan book grows

XERO

Great product, expensive shares

Stocks Down Under rating: ★★

ASX: XRO
Share price: A$ 85.00
Market cap: A$ 12BN

The internet has made doing business a lot easier over the years. We believe one of the best examples of increased efficiency brought about by the internet is accounting. Back in the day, entrepreneurs and business owners would take a shoebox full of receipts and paperwork over to their accountant once a month or every quarter and let them deal with the mess that is bookkeeping. Not anymore! Companies like Xero, based in Wellington, New Zealand, have taken the entire accounting experience online, thereby substantially reducing a major source of agony for finance people the world over.

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PPK GROUP

Wide range of nanotube applications drives growth potential

Stocks Down Under rating: ★★

ASX: PPK
Share price: A$ 4.03
Market cap: A$ 343M

Based in Brisbane, PPK Group is a developer of innovative materials with an eye on creating the technology of the future for a wide range of industries. It invests in boron nitride nanotubes (BNNTs), high performance batteries and ballistic armour for commercial and military use as well as the mining sector. BNNTs have the potential to dominate the nanotube market as there are dozens of applications under research globally ranging from batteries to 3D printers to targeted drug delivery. PPK is well positioned for growth in the coal mining regions of New South Wales given the adoption of its technology in mining utility vehicles. The shares, however, are not cheap trading around 10x net tangibles assets, but do offer a small (nano) dividend yield of 0.5%.

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BNK Banking Corporation is a Perth-based regional bank focused on banking and mortgage broking aggregation. The group offers savings accounts, term deposits, personal loans, home loans, car financing, business accounts and business loans. It provides the same protection as the big four banks with deposits up to $250k guaranteed by the Australian Government. BNK differentiates itself by offering a unique digital banking experience combined with a strong mortgage brokering business. The newly acquired Finsure provides meaningful scale and earnings upside. The price of the thinly traded stock is moving in the opposite direction of BNK’s loan book growth, which presents an attractive entry opportunity, in our view.

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Share price chart

Source: Tradingview

First class customer experience

Your Stocks Down Under editors use Xero for their accounting and our experience with the software is first class. Unless Xero screws up something in a big way, we won't ever switch providers. That stickiness is one of Xero's key attractions for investors, because it means that customers will be paying their monthly subscriptions with pleasure and probably for as long as they run their business. That's the other aspect we like; Xero's revenues are based on a Software-as-a-Service model, i.e. it generates monthly recurring revenues.

The software integrates neatly with all sorts of other businesses, like banks, payment platforms etc, through easy to install plugins. So most, if not all, financial aspect of a company can be aggregated in Xero. And when it's that time of the year for the tax man to hold up his hand, all reporting can be done in Xero, including all filings to the ATO.

Solid growth year after year

The company's subscriber base has grown to around 2.3m over the years. They generate an average revenue per user (ARPU) of nearly NZD30 per month. Although Australia is by far Xero's largest market, accounting for ~45% of revenues last year, other geographies, including the UK and the US, are showing higher revenue growth. And given that these countries have a substantially larger addressable market than Australia and New Zealand combined, we believe there is plenty of growth ahead for Xero. Revenue forecast for the next several years, through 2024, show Xero growing by more than 23% on average.

According to the estimates of the 12 analysts that cover Xero, the company is expected to generate NZD 848m in revenues in the current financial year, up from NZD 718m last year. That's pretty impressive growth, but it doesn't make Xero the biggest fish in the could-based accounting world. Nasdaq-listed Intuit (NASDAQ:INTU) generated US$7.4bn in revenues last year. Little brother MYOB, which was acquired for $1.6bn by private equity firm KKR last year, generated revenues of $445m in FY18, its last financial year as an independent company.

Way overvalued

As will be clear by now, we like Xero, the product, its growth profile and its SaaS-based revenue model. Our main issue with the stock is valuation, though. The company's expected EBITDA growth for the current financial year (ending March 2021) is 35%, while Xero is expected to grow its EBITDA by 32% the year after. Even though an annual EBITDA growth of mid-30% is nothing to sneeze at, it needs to match the company's valuation, which is where things go wrong.

Xero is currently valued at an EV/EBITDA of 68.3x for FY21 and 51.8x for FY22. In other words, the EV/EBITDA-to-EBITDA-growth ratio is 1.93x for FY21 and 1.63x for FY22, which is well above the fair value level of 1x.

Because of this excessive valuation, we remain very cautious with Xero at this time. We'd need to see a major pullback in the share price before there is any long-term value to be had, in our view. So, even though our user experience with Xero is five stars, when it comes to Xero stock two stars is the most we can do right now.

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Share price chart

Source: Tradingview

Superior material properties of BNNTs are an advantage

The group's BNNT Technology division is the world's leading maker of boron nitride nanotubes (BNNTs), the world's strongest and most advanced fibre. Despite being as lightweight as traditional carbon fibres, BNNTs are 100x stronger than steel, 30x stronger than Kevlar and 7.5x more thermal conductive than copper. They are flexible, optically and infrared transparent, electrical insulators and can conduct heat and withstand extreme temperatures. These properties make them valuable for a wide range of applications in aviation, automobiles, space travel, power generation, batteries, electronics and defence. The clear or white BNNTs have commercial advantages over the more widely adopted carbon nanotubes, which are black only.

PPK recently announced a pivotal collaboration with Deakin University, which will open the door to a wide range of opportunities in BNNT production and application. It will construct the world's first commercial scale BNNT manufacturing facility using technology that was developed by the university for manufacturing BNNTs in volume. In the past BNNT production has occurred in small quantities and in temperatures over 5,000 degrees Celsius. Through the joint venture, PPK is expected to be able to produce large volumes of BNNT at temperatures under 1,600 degrees Celsius. This will make the production of BNNTs far less expensive and significantly improve the product's ability to compete commercially.

As BNNTs approach the commercial stage, the research agreement with the university has the potential to lead to broader market access for the use of BNNTs in next generation batteries, thermal conductive materials, metal composites, armours, polymers and ceramics. The JV has sufficient financing in place to fund the R&D for an initial six BNNT application projects. This includes the development of lithium sulphur batteries and other advanced materials for use in items like mobile phones, medical devices, aerospace and industrial safety markets.

CIB acquisition provides access to lucrative military market

On 28 October 2019, PPK announced that it had acquired a 45% interest in Craig International Ballistics (CIB) for $5m. CIB is a body armour supplier to the Australian Defence Force (ADF) and Police Forces. The purchase gave PPK access to the defence sector at a time when Australian defence spending is expected to be $200bn over the next 10 years. It has secured several government and defence contracts to supply aircraft armour panels, armoured vehicles, structural armour and body armour. Most recently, on 18 May, it was awarded a $1 million ADF contract for 750 sets of soft armour inserts to replace existing armour due to its superior protection and lighter weight, which make it more comfortable for the troops. Customer response to CIB's innovative technology has been positive and should continue to lead to more wins in defence and other sectors.

The underground and open cut mining sectors are two other areas that can benefit from CIB's products both in the domestic and international markets. The trade war between the U.S. and China led to a 34% decline in coal prices in 2019. This led PPK's coal mining customers to suspend much of their capital spending plans. Yet as market conditions improve, there is the potential for significant upside from the use of nanotubes in mining equipment.

PPK's mining equipment segment manufactures and services CoalTram Load Haul Dump (LHD) utility vehicles. The flame and explosion proof vehicles are used in mines across Australia by clients such as mining giant BHP, Singapore coal miner Centennial Coal and British mining company Glencore. The division is making progress towards the electrification of underground vehicles. It is planning to retrofit CoalTrams with a battery electric engine by June 2021. It is also evaluating the use of ceramic filters in mining vehicles and testing has thus far demonstrated that the product is significantly cleaner than any other filter on the market.

Solid top line growth, higher margin revenue opportunities

The most recent interim results showed revenue grew 11% in 1HY20 to $22.1m although the group incurred a loss for the period of $0.23m. While the bottom-line performance was disappointing, it reflected the costs involved with diversifying the business, acquiring CIB and commercializing BNNTs. All three should provide higher margin revenue streams over time.

PPK has a cash balance of approximately $4.4m, access to additional funding through bank facilities and carries no debt. While its ability to generate sustainable profit growth is far from bulletproof, it has well diversified growth opportunities in the form of the broad applications of BNNT technology.

However, we believe the shares are a bit expensive at the moment, hence a 2-star rating for now.

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Share price chart

Source: Tradingview

Healthy loan book growth as Aggregation division shines

The group had a strong 1HY20 result. Net Income was up 57% to $17.9m and statutory NPAT was up 348% to $3m. Aside from the high growth rate, the result is compelling because most of the revenue is recurring in nature. Group wide loans under management were up 17% to $44.5bn.

BNK has enjoyed healthy loan book growth over the past few years. This has been supported by the September 2018 acquisition of Finsure, which has been able to help absorb the increasing loan volume on the group's balance sheet. Loan growth has been broad based across its bank, wholesale and aggregation loan books all of which increased in FY19 and are off to strong starts in FY20. In the third quarter, the Bank's on balance sheet lending book swelled to a record $285.4m and was up 48% year-on-year while Wholesale loans remained relatively flat at $2.3bn. Balance sheet loan settlements have accelerated due to the group's broader distribution capabilities following the combination with Finsure.

The Finsure Aggregation division has one of Australia's largest distribution networks. It serves 1,686 mortgage brokers and manages a loan book valued at more than $43bn. The rapidly growing Finsure loan book represents 94% of the group's overall loan book. The reach of this network along with its region-specific market insights allows BNK to develop competitive products using its low-cost, technology driven platform. The Aggregation business is averaging an impressive $1.2bn in home loan settlements per month.

Maintaining credit quality amid push to grow

In what is traditionally a soft third quarter, settlements were up 40% bringing the total aggregation loan book to $43.4bn. This was an outstanding performance given the subdued lending environment that slowed even more so in March as the COVID-19 crisis began. The aggregation unit has added 56 brokers to its network since last year. What is most compelling from an investor's standpoint is the fact that Finsure is diversifying its revenue base away from commission splits to focus on generating recurring revenue from fees, subscriptions, training and compliance.

The strong loan growth has coincided with the maintenance of a strong level of credit quality in the loan portfolio. Much of this stems from Finsure's ability to attract high quality loan writers that target a financially sound customer base. Of course, with BNK's lending growth aspirations comes the risk that the group may sacrifice quality to achieve its volume targets. This is especially a risk in the current, low rate, economic environment where loan applications are likely to rise. BNK saw its loan loss rate decrease to 0.12% in 1HY20. It must continue to avoid going down the path of approving lower quality loans.

Outside of the core mortgage business, BNK offers simple deposit accounts and personal loans under the Goldfields Money brand in the Goldfields region of Western Australia. This is an area that, putting the recent impact of the COVID-19 crisis aside, has experienced increased business activity. Increased investments around gold and nickel production has spurred a greater need for business loans and banking services creating a golden opportunity for BNK. While this is a rather small part of the bank, the favourable demographics in Western Australia's largest region should be supportive of growth in the years ahead.

Solid balance sheet aids growth strategy

BNK's balance sheet will serve as the foundation for growth. It has a capital adequacy ratio of 22% which is a testament to its portfolio strength as well as a healthy minimum liquidity holdings (MLH) ratio of 16.8%. Management is targeting balance sheet loan growth of 40% to 50% over the next few years with the goal of reaching $599m to $723m by FY22. This will need to be supported by continued growth in the group's deposit book along with additional capital sources. On 1 April, BNK announced an increase to its off-balance sheet lending capability after Bendigo & Adelaide Bank extended the term of its agreement to February 2021 and increased the limit to $90m. This served the dual purpose of increasing lending origination flexibility and the ability to conserve capital.

As the domestic economy recovers from the Coronavirus pandemic and home loan demand normalizes, BNK is in a strong position to resume progress with its growth strategy. It has a robust, modern digital bank offering and a fast-growing aggregation business that give it the potential for significant earnings upside over the next several years.

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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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