1 JUNE 2020

Stocks Down Under

There is no reason and no way that a human mind can keep up with an artificial intelligence machine by 2035.

- Gray Scott, Futurist and Techno philosopher

TRANSURBAN GROUP

Up to the challenge the post-COVID world

THE REJECT SHOP

Crash-prone

BRAINCHIP

Computer chips that learn like humans do

TRANSURBAN GROUP

Up to the challenge the post-COVID world

Stocks Down Under rating: ★★★★

ASX: TCL
Share price: A$ 14.29
Market cap: A$ 39.9BN

Melbourne-based Transurban Group is one of the largest toll-road operators in the world. It develops and manages 14 toll road networks in Australia, three in the greater Washington D.C. area of the United States and one in Canada. More than 1.7 million trips are made across its roads daily. The group's secondary business involves the research and development of tolling and transport technology. The shares have recovered much of their sharp losses in recent weeks as travel and other restrictions have been lifted. As the group ponders the traffic patterns of the post-COVID-19 world, an investment in Transurban remains a source of defensive income due to the long lives of its assets. The shares presently offer a 3.2% dividend yield and with several long-run opportunities under development, look to be worth the trip.

READ MORE

THE REJECT SHOP

Crash-prone

Stocks Down Under rating: ★★

ASX: TRS
Share price: A$ 5.59
Market cap: A$ 210M

The Reject Shop, a Melbourne-based 'two dollar store' operator, is looking hot right now as far as investors are concerned. The stock may have crashed from $4.71 on 31 January to only $2.40 on 27 March but it's since recovered almost all of that. And no wonder. With the Australian economy now supposedly in Depression-mode, the conventional wisdom is asking where else are people going to have money to shop. However, we would caution against taking this view too readily. The Reject Shop has a habit of disappointing.

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ASX: BRN
Share price: A$ 0.071
Market cap: A$ 103M

Imagine a computer chip that can genuinely learn all by itself in a way that is similar to how you and I learn, i.e. by processing sound, vision, touch etc. not as digital ones and zeros, but through neuromorphic processing of these so-called spikes. BrainChip has developed technology that puts the "art" in Artificial Intelligence. It's key product, Akida, is a Neuromorphic System on a Chip (NSoC) and has turned quite a few heads in various industries, including the Automotive industry. Let's have a closer look.

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Share price chart

Source: Tradingview

Traffic on the other side of COVID-19 an unknown

The Coronavirus Crisis resulted in a steep drop in traffic on Transurban's roads as well as a steep drop in its share price. In Australia, traffic deteriorated sharply beginning in early March before improving in the second half of April. Traffic was trending upward in the company's latest weekly reading but was still down 44% across the network for the week of 26 April. Through it all, commercial traffic has proven more resilient with grocery trucks moving through the tolls while most workers stay home. Transurban has responded to customers in need by providing financial support in the form of toll credit to healthcare workers, emergency services personnel, caretakers and the unemployed. Although traffic appears to be improving, we believe it will remain sensitive to any future government responses to the COVID-19 pandemic, i.e. the timing of easing of lockdown restrictions.

The company's 1HY20 results were likely a sign of things to come as the global economy starts to recover and braces for a 'new normal'. In 1HY20 average daily traffic increased 2.3% across its portfolio leading to a 9.5% increase in EBITDA to $1.09bn. As more businesses, schools and social activities reopen, this will lead to increased traffic patterns around major Australian and North American cities.

However, there will still likely be a large part of the population that continues to work from home or transitions to working from home on a more permanent basis. Transurban faces a new reality that a good part of its workweek commuters may never return. And those that do hit the roads may opt to take non-toll roads due to a newly strained budget. But a large number will return to the toll roads and this should eventually lead to traffic volume that is comparable to what was experienced in the months leading up to the pandemic.

Regardless of how the new normal unfolds, Transurban will still represent a relatively safe way to accumulate long-term portfolio income. The profits generated by the group and the distributions that flow through to shareholders are defensive in nature because the group's assets have long lives. Roads are designed for the long-term to make sure they deliver lasting benefits to their communities. Transurban's projects typically have concession expirations that are 30, 40, 50 or more years down the road. Some North American assets have even longer lives such as the recently opened 395 Express Lanes, which expires in 2087. This business model is rather unique and one that income-oriented investors can depend on. No matter how our lives change post-COVID-19, there will be always be a need to travel in and around our favourite urban venues for work and pleasure.

New opportunities ahead bolster domestic portfolio

With major infrastructure projects underway or planned in Australia, Transurban has the potential to acquire new assets. The 17km West Gate Tunnel project will connect the western parts of Melbourne with the central city serving as a much-needed alternative to the congested West Gate Bridge. The $6.7bn project will be funded through new toll collection, changes to the CityLink concession and a contribution from the Victorian government. NorthConnex will be a 9km dual-lane tunnel that links Sydney's M1 Pacific Motorway with the Hills M2 and will be designed to accommodate for future expansion to three lanes. The 50% owned, $2.9bn project began in 2015 and is expected to open in Q1 FY21. Finally, the new M5 is also on track to open in Q1 FY21 with more than 60% of the tunnel lining complete. Transurban now owns 100% of M5 West after recently acquiring the remaining minority interest.

It also has some brand-new market opportunities such as the Western Harbour Tunnel (WHT) in Sydney. The WHT environmental impact statement is currently on public exhibition and given the many popular destinations in the region this project has the potential to make a significant contribution to Transurban's portfolio. With government budgets stretched from addressing the COVID-19 crisis, this and similar opportunities will largely depend on private sector investment to drive growth on the other side of the pandemic.

Favourable capital position supports future growth

We believe Transurban has managed its liquidity position well throughout the COVID-19 crisis and has ample headroom against its debt facilities. It has a manageable $20.7bn of debt, a healthy funds from operations (FFO) to debt ratio of 8.5% and gearing of around 33%. A favourable capital position has earned the company strong investment grade credit ratings and enhanced its ability to secure additional funding. While much is unknown as to how soon regular traffic patterns will resume, the group's diverse portfolio, long-term concessions, and new market opportunities are worth the toll, in our view.

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Source: Tradingview

The technical term for category in which The Reject Shop competes is 'discount variety store'. The common name for the category is the 'two dollar store'. You go into the shop and there's aisle after very thin aisle of low priced merchandise – in The Reject Shop's case, about 7,000 items. The average selling price is actually $3, not $2. Amazingly, there's even inflation in the $2 stores in Australia!.

The appeal to the customer is that not everything in there is junk. Indeed, most of it has utility, such as storage boxes, potato chips and tools you might only need to use once or twice. Moreover, the convenience factor is high. And if you overspend on stuff you later decide was junk, then you only lost three dollars, or thereabouts. This kind of format is almost impossible to disrupt digitally, and if the middle class in Australia is gradually dying it will likely take Myer and David Jones to their graves as well. So the next port of retail call is something like this.

Can this one turn around?

The Reject Shop is the apparent leader in the discount variety store category in Australia. There are 356 Reject Shops around the country and they all stayed open during the Coronavirus Crisis. Indeed, it did quite well through the crisis, enjoying robust sales of cleaning products and household goods as shoppers panic-bought in the early days of the pandemic. That panic buying allowed The Reject Shop to raise another $25m at $3.12 per share even though the company already had a $52m net cash position. And it put the new CEO, Andre Reich in a good position. He joined in January from K-Mart, where he helped that discounter turn around.

Fresh from a disappointing result for the six months to December 2019 where revenue only rose 0.7% and NPAT fell 10%, Reich and his team are now working on cutting back stock levels within the business and rationalising the product range as part of a revamp of The Reject Shop's merchandising strategy.

The trouble with The Reject Shop as a business is that when everything in the store is $3 and you're competing against other two dollar shops we call the 'Hot Crowd' (because they inevitably have names like 'Hot Bargain' and 'Hot Dollar'), the razor-thin margins can mean profits turn on a dime if you've got the wrong stuff cramming the shelves. It's not so much the gross margins, which are still north of 40%, which is the problem, as the overhead of having to put stores in Tier 1 shopping malls and running an expensive logistics network. If you look back at The Reject Shop's history it runs into profit warnings with amazing regularity – in December 2010, January 2014, April 2017, October 2018 and May 2019. That last one cost Andre Reich's predecessor, Ross Sudano, his job after five years in the corner office.

Saturation point

It's worth remembering two other factors about The Reject Shop which suggests its day in the sun may not have arrived yet. Firstly, at 356 stores, as against only 100 when it went public in 2004, this outfit has probably saturated its market opportunity. When we plugged in our Sydney postcode to the store finder function at rejectshop.com.au, 11 stores came up within a 20 km radius.

Secondly, these days The Reject Shop isn't just competing against the Hot Crowd, it's competing against K-Mart and Big W as they go down-market. And let's not forget that powerhouse of modern grocery retailing, the Germans from Aldi, who haves general merchandise in the centre aisles of its more than 400 stores around Australia which the customers just love.

So how will Andre Reich et. al. succeed where others haven't? Well, we're not sure they can, although they seem to have some good ideas on 'evolving' the merchandise, picking better store locations and business simplification to get costs down. However, the market is pricing this stock like a turnaround is in the bag. The current P/E on forecast FY21 earnings is a very high 36.6x. That drops to 24x for FY22 on the expectation that EPS can jump from 15 cents to 23 cents. But given the crash-prone nature of this company we remain very cautious. At the moment, two stars from us.

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Share price chart

Source: Tradingview

Many benefits to BrainChip's Akida chip

While a full description of Artificial Intelligence (AI), neuromorphic processing, spiking neural networks and unsupervised learning goes beyond the scope of this article, the key thing to remember is that BrainChip has developed a computer chip technology that doesn't use elaborate software programs and doesn't consume enormous amounts of electrical power. Its chip, called Akida, which is Greek for spike, processes incoming information like the biological brain does, i.e. through neurons and synapses. That approach has a number of advantages compared to traditional, software-based, convolutional neural networks, including faster processing at much lower power consumption. Additionally, there is no need for any connection to a Cloud-based data center for data processing. Everything can be done on-chip. Most importantly, Akida can learn by itself, so-called unsupervised learning in AI lingo.

Readers who are interested in a more in-depth explanation of neuromorphic processing and Spiking Neural Networks may want to read the report Pitt Street Research published on BrainChip last year. It's available for download at www.pittstreetresearch.com.

Active conversations in various industries

Unsupervised learning at the Edge of the Internet has near-infinite applications. Basically, any sensor at the edge needs on-board decision-making capabilities, be it in your mobile phone, in your car, in smart watches, in industrial robots, digital assistants, cameras etc. You see, not all data that a sensor collects necessarily needs to be sent to the Cloud for processing.

Firstly, a lot of collected data is useless and needs no processing. Secondly, relevant data that does need to be classified and acted upon often needs to be processed instantaneously. For instance, a car sensor in a car with Advanced Driver Assistance (ADAS) that notices a pedestrian crossing the road, will need to send a response to the car's brakes if the driver is not stopping for this pedestrian. There is simply no time to send that sort of data to the Cloud for processing and then back to the car to be acted upon. This sort of data needs to be processed in the car in real-time.

There is a very large market for this so-called Edge Computing that requires computer chips with on-board processing power and memory that use very little power. This is where Akida shines, i.e. combining ultra-low power usage, on-chip learning and processing as well as high performance in one chip.

While BrainChip is in active discussions with various types of prospective customers for the technology, including tier 1 Automotive suppliers and manufacturers, smart home OEMs as well as other chip companies, the recent announcement of an evaluation deal with Ford is the most concrete example of what future applications and deals could look like, i.e. supplying neuromorphic computing technology to car manufacturers for us in ADAS and fully autonomous vehicles.

How to value a pre-revenue neuromorphic chip company?

Valuing chip development companies is hard. Yes, you can make assumptions around future revenue models and the potential number of customers. But predicting the future number of customers is crystal ball stuff and not something that we'd like to engage in. However, there is another way to value BrainChip and that is simply looking at what Mr. Market has paid, or is currently paying, for similar companies.

In 2016, semiconductor giant Intel acquired two companies in the neuromorphic chip space, Nervana Systems and Movidius. Nervana was only two years old at the time of acquisition while Movidius had been around for eight years. We believe neither company generated meaningful revenues, if any. At the time, Intel paid approximately US$400m for each company, which is around A$600m at today's exchange rate.

Looking at other chip development companies listed on the ASX, we can see that companies like Weebit Nano (ASX:WBT) and 4DS Memory (ASX:4DS), who are both developing ReRAM technology, are capped at A$27.3m and A$58m respectively. Of the three companies, though, we believe BrainChip is the closest to doing a commercial deal. In other words, it should have the highest valuation of the three, which is indeed the case at A$103m.

However, there is another chip development company listed on the ASX; AudioPixels (ASX:AKP). This company has been developing digital speaker technology that should ultimately facilitate generating sound directly from a digital audio stream using microdevices called Micro Electromechanical Systems, or MEMS. AudioPixels is currently capped around A$603m on the ASX. In other words, its worth around the same amount that Intel paid for its two acquisitions in BrainChip's space four years ago.

Now, we're not saying that BrainChip will rerate to that valuation level just like that. The company will need to close commercial deals, comprising of outright sales of its Akida chips, license income, royalties or a combination thereof. We believe the evaluation deal with Ford is a big step in the right direction, but until a truly commercial deal is signed, the market will likely maintain its wait-and-see approach. We could see the shares starting to creep up, though, in anticipation of additional evaluation deals or a genuine commercial deal. But until the latter actually happens, many investors will keep BrainChip in the "Speculative" bucket.

However, based on the company's announcements around discussions it's having with prospective customers in various industries, we believe BrainChip is definitely on the right track, which is why we at Stocks Down Under are happy holders of the stock.

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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.