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Stocks Down Under

“Banking is necessary. Banks are not.”

- Wells Fargo 2004 annual report

ANZ BANK

Solid balance sheet to weather the COVID-19 storm

BRISCOE GROUP

The Duke will be back

OPENPAY GROUP

Can it follow in the footsteps of its larger rivals?

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Stocks Down Under rating: ★★★★

ASX: ANZ
Share price: A$ 18.41
Market cap: A$ 53.7BN

Melbourne-based Australia and New Zealand Banking Group, commonly referred to as ANZ Bank, is one of Australia's four major banks. The multinational financial institution offers a full range of banking products to individual, small business, corporate and institutional customers. As the country's second largest bank by assets it has felt the impact of the COVID-19 crisis through loan repayment deferrals, the need for increased provisioning and uncertainty around its dividend. Although the bank appears to be on a long road to recovery, it is well positioned to weather the storm and capitalise on growth opportunities at home, in Asia and in other international markets. The shares have shed approximately one-third of their value in the past year and we believe they are attractively valued for the long-term investor at 11.8x FY21 earnings.

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Share price: A$ 2.85
Market cap: A$ 600M

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Share price chart

Source: Tradingview

Provisioning rises while loan repayment deferrals soar

With consumers and businesses alike struggling to survive during the COVID-19 crisis, ANZ Bank has turned to capital buffers to cushion the blow from the potential of higher loan defaults. From 2HY19 to 1HY20 provisions soared 319% to $1.27bn and had a major impact on interim half profitability. As of 31 March, the group's collective provision balance was $4.5bn. Its collective provision coverage ratio increased 23bps to 1.17% as it continued to brace for the likelihood of increasing bad loans.

The pandemic has also led to a sharp rise in ANZ customers requesting repayment deferral on their loans. From a baseline of close to zero on 31 March 2020, the bank received 105k repayment deferral requests on some $36bn worth of Australian home loans through 24 April 2020. This accounted for 14% of the total domestic home loan balance. Nearly 20,000 New Zealand home loan accounts also requested deferral in this brief period representing 5% of the group's New Zealand home loan balances.

In addition, ANZ launched a series of packages to help Australian and New Zealand retail and commercial customers with loan payment deferrals in anticipation of repayment deferrals. It granted about $7.5bn of repayments deferrals for Australian commercial lending customers in the first half of FY20 comprising 15% of its customer base. It also provided financial support to over 30,000 New Zealand customers through roughly $12bn of deferrals or adjustments on personal, home and business loans.

Modest exposure to high impact industries

The group's half year financial results revealed the early effects of the COVID-19 crisis. Statutory profit dropped 51% to $1.55bn and cash profit fell 60% to $1.41bn. Return on equity dropped from nearly 12% in the first half of FY19 to 4.7%. The group took a huge $1.67bn credit impairment charge compared to a $0.37bn charge recorded a year ago. And while ANZ's customer base is extremely well diversified by industry, its institutional and commercial portfolio does have exposure to some of the industries that have been more immediately impacted by the pandemic. This includes areas such as retail trade, accommodation, restaurants, transportation and recreational services. Approximately $41bn, or 6% of the portfolio is comprised of businesses that are in these high impact industries.

While the domestic retail and commercial operations are the largest component of the business, ANZ's Asia market represents an important region for growth. ANZ has a growing presence in the emerging markets of China, Indonesia and Vietnam where the commercial property sector was on the rise prior to the pandemic. With these economies slowing along with the rest of the world, ANZ is likely to see a slowdown in new loan demand and higher potential for loan defaults and deferrals among existing customers in these markets.

Capital adequacy remains solid

The early effects of the COVID-19 crisis have certainly weighed on ANZ's near-term performance. Ongoing uncertainty around the global economic outlook prompted the bank to suspend its decision about its latest interim dividend. It deferred the distribution discussion to August 2020 when the company plans to provide a comprehensive trading update. Decisions around the group's Dividend Reinvestment Plan and Bonus Option Plan have also been put on hold until the outlook becomes clearer.

Despite the uncertain environment, ANZ has a strong level of capital adequacy. Its balance sheet has grown and the company has parted ways with some non-core businesses amid a focus on improved productivity. ANZ's common equity tier one (CET1) capital ratio declined from 11.5% in the interim period of FY19 to 10.8% in 1HY20, largely due to credit impacts, but it remains at a healthy level. It also has a comfortable liquidity position with a net stable funding ratio (NSFR) of 118%, that increased from 116% six months prior, and a liquidity coverage ratio (LCR) of 139% that is slightly higher than a year ago. Both liquidity measures are well above the 100% regulatory minimums.

While it is difficult to predict the depth of the economic impact and how long it will take the economy to recover from the pandemic, what is certain is that ANZ entered the crisis in a strong financial position. While difficult times lie ahead, it remains on solid financial footing and should emerge from the pandemic as a leaner, stronger bank. The stock is trading at a P/E of 11.8x for FY21 with the dividend yield for the next financial year expected to be around 4.6%.

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Up until the present Coronavirus Crisis, Briscoe had been one of the more dependable retail stocks one could buy on either the NZX (since 2001) or the ASX (since 2017). If you bought it at the bottom of the Global Financial Crisis in March 2009 and held until about April 2017 you would have made over seven times your money.

Good old-fashioned merchandising

The secret to Briscoe's success was old fashioned merchandising - selling products that the customer is looking for at reasonable prices in easily accessible locations. That, and gradually selling more premium-priced products as the Kiwi consumer evolved from the 'cheap and cheerful' days of the 1980s when the country had less money to spend than it does now. It's fair to say that, today, Briscoes more or less owns the homewares category in New Zealand and will continue to do so for the foreseeable future.

The evolution of Briscoes over time has made the Australian-born Rod Duke one of New Zealand's richest men, off the back of his 77%-or-so of the company. It was Duke, now aged about 69, who bought and turned around the original Briscoes business back in 1989, and then added the New Zealand incarnation of Rebel Sport in the mid-1990s when he found it was difficult to buy the sporting goods he was looking for. The Australian Rebel Sport today is part of Super Retail, (ASX:SUL). Today, there are around 87 Briscoes and Rebel Sports stores up and down New Zealand. Living and Giving, a gift ideas and home furnishing concept that hasn't worked so well, is a single physical store in Auckland.

Adapting to the online world

That Briscoe and Duke know a thing or two about value in bricks and mortar retail is suggested by the fact that in 2015 the company attempted to buy Kathmandu (ASX:KMD) for A$324m in cash and scrip at a low point in that company's listed life. But the 2017 sell off of Briscoe stock, which took it down from NZ$4.50 TO NZ$3.20 between April and October of that year, was almost solely related to concerns by investors that Briscoes would be eclipsed as companies like Amazon set up shop in New Zealand. The share price recovery back up to NZ$4.50 at the start of this year reflects the fact that Briscoe has, contrary to those concerns, adapted well to the online world. In the year to 26 January 2020 Briscoe grew revenue 3%, to NZ$653m while NPAT edged up 2.5% to NZ$63.5m. Online sales grew a solid 16% and now constitutes 11% of the total.

You can't keep a good homewares retailer locked down

We think the Coronavirus Crisis represents a rare buying opportunity for Briscoe stock. The lockdown in New Zealand was so strict between 25 March and 27 April, that most physical stores were shut across the retail landscape unless they were deemed 'essential', and even online shopping and delivery was banned if they were 'non-essential'. Thankfully that level of restrictions has now been lifted but it meant that in the three months to 26 April Briscoe sales were down 36%.

Briscoe had a robust debt-free balance sheet coming into this crisis and it is notoriously tight on costs, so making it through the present trouble is a given. On the other side of Covid-19, as the New Zealand economy recovers, Briscoe will still be the only name in homewares in New Zealand and an important name in sporting goods. For all that one can currently buy Briscoe at an EV/EBITDA multiple on the year to January 2021 of 12.3x, dropping to 7.7x in the 2022 year. Seems inexpensive to us, given the sales recovery we expect during the remainder of the year.

However, given that the ASX is Briscoe's secondary listing and that The Duke's stake in the company is very substantial, trading in Briscoe shares on the ASX is very thin. That's the downside to owning Briscoe…you could get stuck owning the shares due to a lack of liquidity. Maybe look at the NZX if you want to buy some.

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Source: Tradingview

Often when a new sub-sector of the equity market opens up, analysts and market commentators will talk about the field as being 'crowded', largely because it takes a while to get one's head around the different companies in the field, and who's got the time? When in the near future you hear people start to talk about the Buy Now, Pay Later space as 'crowded', that will probably be a buying opportunity, because some companies will have had less chance to get their story out there and may therefore be underappreciated, even as their businesses continue to improve.

OpenPay is different…really

We think one of the less understood stories at that time will be OpenPay Group. Here's a challenge for you: Take a look at OpenPay's 31 January 2020 investor presentation and see how long it takes you to figure out how OpenPay is different from its competitors in the Buy Now, Pay Later space. For us it took a while. Like those competitors, OpenPay collects fees from merchants and consumers, it can split up a payment into smaller chunks and it eschews the idea of interest payments on the part of customers. So frankly, at first glance this company seemed like a me-too. It's not, really.

The key point of differentiation for OpenPay relates to the flexibility of the offering. With this company the repayment terms can differ from between two and 24 months and the purchases can range from $50 up to $20,000. And importantly, there's no interest, ever, unlike other offerings where the interest kicks in if you're late for a payment. For these reasons OpenPay believes that its version of Buy Now, Pay Later can work for more sectors than its competitors. The company is targeting healthcare, automotive and home improvement as well as the conventional retailers.

Boom, boom, shake the room. Or at least the dental surgery

Will OpenPay work out? Well, like its competitors it's growing strongly right now. Very strongly. Active customer plans doubled between FY17 and FY19 but in the March 2020 quarter active plans were up 203% on the previous corresponding period. Also, in that quarter active customers were up 113% (a customer can have more than one plan) and the number of merchants using OpenPay was up 63%. All those customers, plans and merchants helped facilitate $45.8m in total transaction value, yielding $5.3m in revenue to OpenPay, up 71%. That success can be chalked up to its use in transactions that have a higher ticket value than buying a pair of jeans or a new handbag, such as a trip to the dentist, or car repairs at Ultratune. It's fair to say that OpenPay is scratching where the market is itching and has a niche where people will get to know it. And the business model is going global, starting with the UK.

It was the March quarter result that propelled OpenPay's share price up from 32 cents on 23 March to a heady $3.51 on 4 June. However, the company then took advantage of all this exuberance to raise another $33.8m in post-IPO capital at $2.40. Sure, there's now enough cash to keep the doors open for maybe another two or three years – we estimate there'll be $90m or so in the till when the June quarter numbers come out.

How to value OpenPay?

When it comes to valuation, there's not much to go on with OpenPay as it is expected to be EBITDA negative until FY23. However, we can look at EV/Revenue and compare that to OpenPay's big brother AfterPay and big sister Zip.

Based on that multiple, OpenPay is trading at around 5.5x FY21 revenues and 3.4x FY22 revenues. For those same years, Zip (market cap of $2.25BN) is trading at 8.9x and 5.8x, i.e. about 60% to 70% higher. Mind you, Zip has got a substantially larger revenue base and a wider analyst following, so it's much more established. And it is projected to become EBITDA positive in FY22, so a full year earlier than OpenPay.

On the same EV/Revenue valuation metric, industry leader AfterPay (market cap of $13.7BN) is trading at 18.2x for FY21 and 12.1x FY22, so more than 3x OpenPay's relative valuation. Again, compared to OpenPay, AfterPay is the much more established company.

Given that OpenPay has traded back down to the price of the capital raise, and then some, we believe most of the pain from the capital raise is in the market now. Additionally, we are big believers in the Buy Now, Pay Later space and see room for multiple players in this market long term.

Going forward, OpenPay should be able to substantially grow its revenue base, supported by the cash on its balance sheet. Additionally, as the company grows, we believe it's very feasible that the shares will see a partial rerate towards the valuation levels of its larger peers. In other words, we see more upside to the shares from where we are today, hence our 4-star rating for OpenPay.

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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.