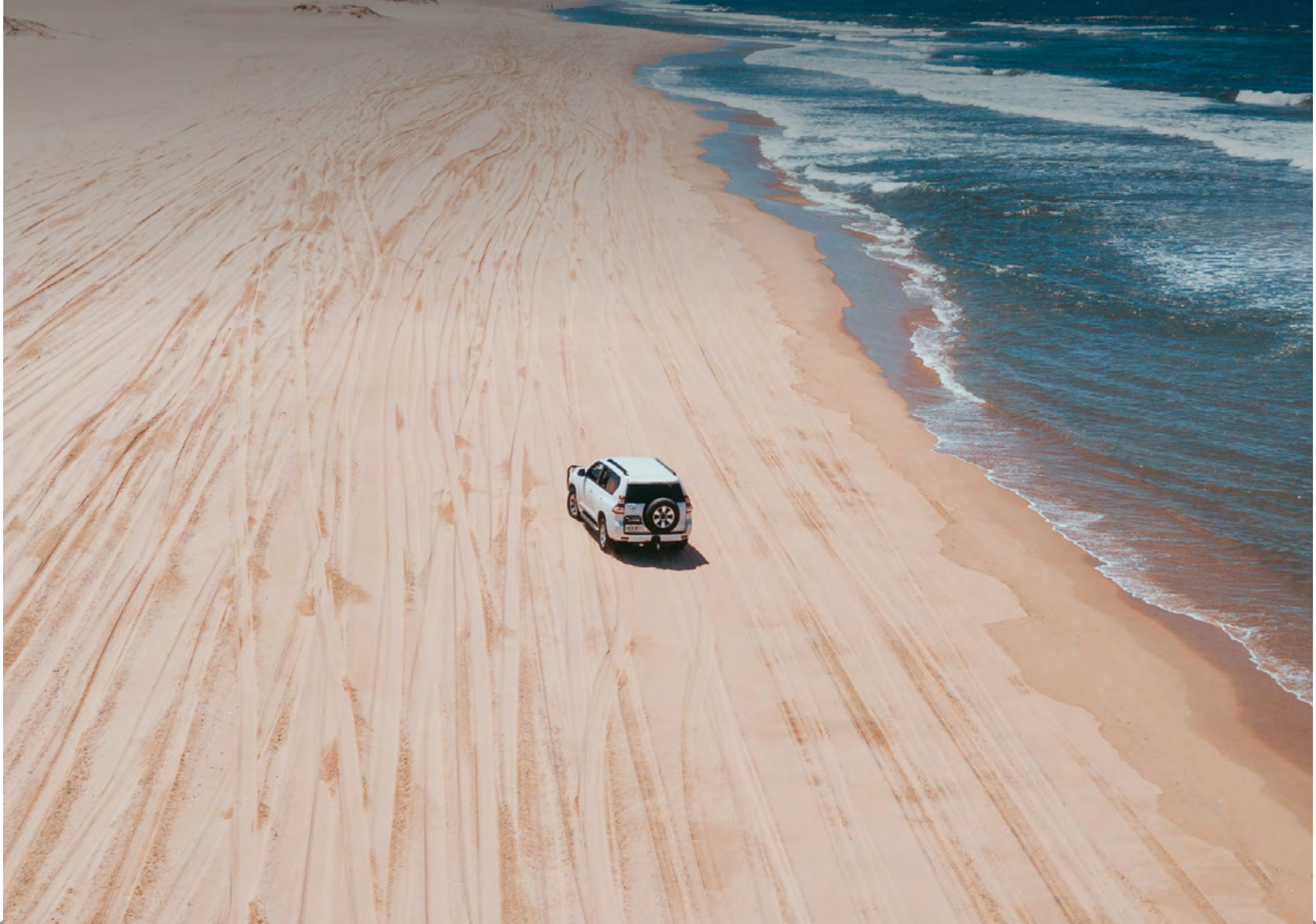
23 JUNE 2020

Stocks Down Under

I didn't want my kids having to pass through an airport named after their father.

- Peter Jackson (b. 1961), New Zealand film director best known for Lord of the Rings and The Hobbit



AUCKLAND INTERNATIONAL AIRPORT

Valuation flying too high

ACCENT GROUP

If the shoe fits

RIDLEY CORPORATION

Feeding off product innovation

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Stocks Down Under rating: ★★

ASX: AIA
Share price: A$ 6.17
Market cap: A$ 9.3BN

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ASX: AX1
Share price: A$ 1.32
Market cap: A$ 732M

Sydney-based Accent Group is a shoe retailer that owns a variety of popular stores across the Australia and New Zealand region, such as Platypus and Hype DC. While the company suffered from store closures during the COVID-19 crisis, surging online sales showed that consumers want their footwear and are willing to get it anyway they can. While traditional traffic will take time to normalise, digital sales will likely continue to cushion any shortfall in store sales. Accent's omni-channel growth strategy puts it on solid footing to capitalise on a sizeable footwear market that is seeing strong demand. The stock has recovered about half its value since the Corona Crash low and appears attractively valued right now.

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RIDLEY CORPORATION

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Stocks Down Under rating: ★★★★

ASX: RIC
Share price: A$ 0.725
Market cap: A$ 227M

Melbourne-based Ridley Corporation is an animal nutrition company that provides food for a wide range of species and customers. With 20 facilities across Australia, it produces approximately 2m tonnes of finished feeds and feed ingredients annually based on home-grown cereal grains. Despite the defensive nature of the business, Ridley has struggled to generate consistent growth. As Australia's rural sector continues to feel the effects of the drought and bushfires, the company has turned to product innovation and international expansion as potential roads to growth. With the shares approaching their 2000 all-time low, success in commercialising the new Novacq prawn feed ingredient will be a key determinant of its ability to deliver growth.

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Share price chart

Source: Tradingview

The thing about airports as businesses is that ordinarily their earnings are highly defensive. All around the world people tend to fly more from year to year, and every time they fly they usually buy some overpriced merchandise or food when they're at the airport. Think of airports as the busiest shopping centres in the world, where those malls also do flight services.

An expensive airport

That innate defensiveness of airport businesses, however, can sometimes sucker investors into paying too much, particularly if the location is attractive to the people who usually fly there. We think that's what's happened with Auckland International Airport, dual-listed on ASX and NZX and one of New Zealand's largest listed companies.

At the moment it's trading at an EV/EDITDA multiple of 59.2x forecast FY21 earnings, which comes down to 30.3x for FY22 and 19.8x for FY23. That's high when you can currently buy Aeroports de Paris SA (ENXTPA:ADP, owner of Paris Charles de Gaulle) and Aena S.M.E., S.A. (BME:AENA, owner of Madrid Barajas) at only around 11.7x FY21 and around 9x EV/EBITDA for FY23. Indeed, even Sydney Airport (ASX:SYD) is cheaper at 22.5x for FY21 and 14.4x FY23.

It's also high because Auckland International Airport, IATA Code AKL, isn't exactly one of the world's busiest airports in terms of passenger numbers. In 2019 it handled only 21.1 million of them. That was about a third of what you need to make it into the elite Big 20 list that starts with Hartsfield-Jackson in Atlanta and its 110.5 million passengers in 2019. That list also includes icons of international travel such as LAX, Charles de Gaulle in Paris, Schiphol Amsterdam and Changi in Singapore before you get to JFK in New York at No. 20 with its 62.5 million passengers. That's why international fund managers are more likely to pass over Auckland's rather small airport at the far end of the earth if they're making a global call on which airports to buy.

A beautiful country, but only a 'nice' gateway to it

Auckland, admittedly, does have one big competitive advantage over the Top 20 – it's in New Zealand, a country that gets a lot of international tourists and has a robust domestic aviation scene. That's why Auckland Airport grew passenger numbers by an average 5% p.a. in the ten years to 2019, which was slightly faster than 4.6% p.a. average for the Big 20.

There's no doubt that Auckland Airport will do well in the post-Coronavirus recovery. Eventually. The tourists will be keen to come back to New Zealand because, let's face it, it's a beautiful, friendly country and it's considered a safe place to visit in a world that currently looks a little dangerous. When VRBO, an American vacation rental company, surveyed Americans last year about their preferred international travel destination, New Zealand ranked fifth on the list when it was the Baby Boomers responding. No wonder, then, that after Australian and Chinese people, Americans were third on the list of countries represented by the 3.89 international visitors who came in 2019.

And those tourists were reasonably well looked after when they got to New Zealand. In the World Economic Forum's Travel & Tourism Competitiveness Index for 2019, Australia came in at No. 7 out of the 140 countries ranked, and New Zealand wasn't far behind at No. 18. Indeed, New Zealand led the ranking in international openness', largely because of the openness of its bilateral air service agreements.

Now, international travellers might come to the country, but if the airport is lousy, they won't spend as much money there. In that respect Auckland Airport probably still has some work to do. The Travel & Tourism Competitiveness Index rates New Zealand's ground and port infrastructure at only No. 50 out of 140. Interestingly, travellers in 2019 ranked Auckland only the world's 29th best airport in Skytrax's Annual Survey. Paris Charles de Gaulle was 20th, Sydney 26th and Madrid Barajas 27th.

New Zealand is in recovery mode, but only domestically

Which brings us to Auckland Airport's current situation. When New Zealand lowered its Covid-19 measures from Alert Level 3 to Level 2 on 13 May, Air New Zealand (ASX: AIZ) started flying to most of the domestic destinations it serviced before the crisis. The airline is starting small and building up, expecting to run at roughly half its usual capacity through July and August. So, for Auckland Airport it's fair to say that the recovery is underway given that around 45% of Auckland Airport's passengers in a typical year are domestic. The big question is when New Zealand opens its borders to foreign visitors. And that's where we think Auckland Airport investors might run into trouble. The talk is that Trans-Tasman flights will restart in September and that possibly various small Pacific Island nations that didn't get hit hard by Covid-19 will also be included in that 'travel bubble'. However, the jury is out as to when citizens of major countries further afield would be allowed to come in, most notably China, which, as we noted above, is usually the biggest supplier of tourists to New Zealand after Australia.

Before this crisis Auckland Airport was temporarily booming in a financial terms. In FY19 it enjoyed NZ$743m in revenue, up 9%, and EBITDA up 10% to NZ$555m. However, that was mainly because the retail precinct had just enjoyed a major expansion. Obviously FY20 and FY21 will be lousy for Auckland Airport and while there's potential for FY22 to see the airport getting back to where it was before the lights went out, it won't be until FY23 when the bacon comes home.
We think that's probably too long to wait given the currently stretched multiple. This one gets Two Stars from us. Not because it's not a good company, but because we believe the stock has run too hard, too fast.

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Share price chart

Source: Tradingview

Strong shoe portfolio and vertical offerings

Accent Group is the largest retailer and wholesaler of premium lifestyle footwear in Australia and New Zealand. After opening 54 new stores in FY19 and 51 in 1HY20, it now has more than 500 stores located in both metropolitan and regional areas. It has 10 retail banners under which it sells a wide range of lifestyle and performance shoe brands including Sketchers, Merrell, CAT, Dr. Martens, Timberland and Saucony. In addition to being the exclusive distributor of global brands like Sperry and Vans, it sells popular third-party brands like Nike and Adidas. It also franchises The Athlete's Foot corporate stores, which continue to be added to its footprint with 66 stores through 1HY20.

As the group has positioned itself to offer something for everyone, its portfolio has grown to 18 popular footwear brands. Although many brands cater to the athletes and style-conscious among us, it also sells work-related shoes. Since the start of the COVID-19 crisis, it has seen increased demand for active footwear and apparel from essential workforces. Accent's vertical product strategy is designed to generate incremental revenue from complimentary products like socks, shoe care, laces and other accessories. In 1HY20 it launched several vertical products like Shubar in Hype stores, The Trybe accessories, The Athlete's Foot performance socks and Alpha school shoes. The expansion of its vertical program should continue to drive top line growth and margin improvement.

Record profits in both FY19 and 1HY20

Accent Group posted a record profit in FY19 as net profit after tax (NPAT) increased a very solid 22.5% to $53.9m. Total sales (including The Athlete's Foot franchise stores) grew 8.7% to $935.3m in the last financial year. The gross margin expanded 130 bps to 56.1% due to the success of vertical products. Digital sales were up 93% and accounted for 15% of overall sales. The group is aiming for digital sales to comprise 20% of sales over the next three years.

The strong growth continued into 1HY20 when record profits were once again achieved. NPAT was up 9.7% to $35.3m on $507.9m in total sales, which increased 10.9%. The gross margin declined 60 bps largely due to cyber sales events and a competitive holiday shopping environment. Digital sales were up 33% in 1HY20.

The company has a healthy balance sheet that includes a manageable net debt position of $47m. Both inventory and plant, property & equipment (PPE) increased in 1HY20, but this was mostly due to investments in new stores and digital infrastructure as well as acquisitions of The Athlete's Foot corporate stores. Over the last few months, the company has secured additional banking facilities to bring its total facilities to $207 million. This will provide added protection for the uncertain economic environment and should support the company's growth investments.

Online sales growth is the key strategic focus

With stores closed during the pandemic and trading conditions poor, the group's digital platform rose to the occasion. Digital sales skyrocketed nearly 350% during the last two weeks of April from $250k per day to $800k to $1.1m per day. The pandemic appears to have accelerated the consumer shift from physical retail to online retail. Footwear shoppers have been no exception as they have discovered a love for the ease, efficiency and safety of the online shopping process.

Accent Group is betting that trend is here to stay by making digital growth its top priority. It operates 19 websites from which people can order from its vast line-up of footwear, apparel and accessories. It is delivering targeted content and sales promotions to drive customer traffic and conversion on its websites. Its recently launched premium online footwear marketplace Cremm should increase social and brand awareness. The recent acquisition of Stylerunner, a premium digital business in the fast-growing women's athleisure segment, instantly added 600,000 Instagram followers.

With stores reopened, the group has also turned its attention back towards the expansion of its retail footprint. Management has noted plans to evaluate the location, size and format of its store network to ensure it maintains an appropriate balance between store and digital sales. It is targeting the opening of at least 70 new stores in FY20 across all banners. An additional 30 to 40 stores are being planned by the end of FY22 across the Platypus, Hype, Skechers, Dr. Martens, CAT, Merrell, TAF and Vans banners. In seeking to optimise its storefront presence and invest in digital growth, Accent Group is taking steps in the right direction.

At an EV/EBITDA of 6.3x and 5.2x for FY21 and FY22 respectively, we believe Accent looks attractive in the medium term in particular, given its expected EBITDA growth of 7.3% in the next financial year and more than 20% EBITDA growth in FY22. On top of that, the dividend yield is a cool 3.8%.

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Share price chart

Source: Tradingview

Steady earnings, but the missing ingredient is growth

Ridley provides high-performance animal nutrition products to Australia's agricultural industry. With major brands like Barastoc, Copper, Rumevite and Primo, it makes complete rations, mineral concentrates, nutritional blocks and supplements for a wide range of species. While it serves a variety of customer types, its ultimate end customers include dairy cows, beef, poultry, pigs, sheep, horses, fish and dogs at all stages of life. Its products are designed to help customers bring animals to market, ensure the maximum performance of working dogs and horses and care for companion animals.

Since food is a necessity for livestock and other animals, much like the human food industry, Ridley's business tends to be rather defensive in nature. This means that regardless of the broader economic environment, demand for its products is pretty steady. But despite being a well-diversified, defensive company, it is simply not growing.

Earnings over the last five years have been remarkably steady staying in a tight range of around $50m to $58m. The group's FY19 EBITDA of $54.3m was 2% lower than its FY18 result. Net profit increased from to $23.6m in FY19 but remained below the NPAT figures from both FY17 and FY16. Although a stronger second quarter helped drive Ridley's 1HY20 EBITDA result to $30.7m, it was essentially flat compared to 1HY19. Expenses associated with the closure and remediation of the Murray Bridge feed mill as well as the Baiada legal claim settlement weighed on the company's bottom-line performance.

Product innovation and international expansion in focus

The devastating impact of the drought and wildfires in the last 12 months has left Australia's rural sector in bad shape. Many farms and businesses were forced to cease operations while those that survived are still struggling to re-establish themselves. This has resulted in only modest demand for Ridley's products. One area that is a bright spot, though, is strong demand for protein products across various species. The company will seek to capitalise on this demand as it expands its customer base into new verticals and geographies.

Another key area of potential upside is the group's Novacq feed ingredient for prawns. It is aiming to sell the value-added aquafeed product globally, building on its position as Australia's leading prawn feed manufacturer. The novel raw material ingredient, which is winding down a five-year commercial development process, is said to help prawns grow 20% to 30% faster on average, putting more profits in prawn farmers' pockets. The product has sparked an entire new industry in Australia -- the production of sustainable prawn feed.

Ridley is also looking to accelerate the commercialisation of the Novacq franchise internationally. Its February 2020 acquisition of assets in Thailand was a big step in that direction. The $8.2m purchase of 50 hectares of land included the previously leased site of its Novacq production ponds as well as the remaining 51% stake in the Pen Ngern feed mill. The acquisition gave Ridley the ability to house the Novacq operation within the Pen Ngern precinct and a base from which to expand its role as a supplier to prawn producers in Asia and the Middle East. The commercialisation of Novacq in Thailand is planned for FY21.

Balance sheet has room for improvement

Ridley's balance sheet is of average quality. It contains a cash balance of $39.8m and a net debt position of $132.7m both of which increased from six months prior. In November 2019, the company extended its banking facilities for 5 years and now has $70m in headroom against its $230m of funding facilities.

Ridley's well-diversified business model includes some interesting opportunities around Novacq and other new product developments. And the company has been restructuring some of its operations.

Its EBITDA growth is expected to amount to 10.4% In FY21 and 8.6% in FY2, which we believe is pretty good for a feed stock company. And at an EV/EBITDA valuation of 7.3x for FY21 and 6.8x for FY22 we certainly think Ridley isn't too expensive. Add to that a 6% dividend yield, and Ridley is OK in our book.

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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.