3 JULY 2020

Stocks Down Under

> *We're going to become caretakers for the robots. That's what the next generation of work is going to be.*

- Gray Scott, Futurist and techno-philosopher

BRAMBLES
Defensive, but competitive pressures loom

ARENA REIT
Childcare bringing home the bacon

FBR LTD
The rise of the robot

BRAMBLES

Defensive, but competitive pressures loom

Stocks Down Under rating: ★★★

ASX: BXB
Share price: A$ 10.98
Market cap: $ 16.4BN

Based in Sydney, Brambles is a supply-chain logistics company that manages pallets, containers and reusable plastic crates. The company's roots go back to 1875 when it was founded by Walter Bramble as a Newcastle butchery business and later expanded into transportation and logistics. Today, with operations in over 60 countries, its products help move goods from manufacturers to stores and online businesses in the fresh produce, fast-moving consumer goods (FMCG), beverage, retail and general manufacturing industries. We believe the company faces increasing competition and an ongoing capital expenditure burden.

READ MORE

ARENA REIT

Childcare bringing home the bacon

Stocks Down Under rating: ★★★★

ASX: ARF
Share price: A$ 2.33
Market cap: $ 727M

Melbourne-based Arena REIT is a property investment and management company. The group owns, manages and develops a large portfolio of "social infrastructure" properties across Australia in the childcare, healthcare, education and government sectors. The well-diversified portfolio by sector, location and tenant type is supported by a strong development pipeline. We believe Arena has managed pressures related to the Coronavirus Crisis well and has a long history of delivering reliable earnings growth and shareholder returns. The shares offer a growing quarterly distribution as well as good upside potential from the current depressed valuation.

READ MORE

FBR LTD

The rise of the robot

Stocks Down Under rating: ★★★★

ASX: FBR
Share price: A$ 0.044
Market cap: $ 75M

Sometimes promising technology companies, at the point where the technology has reached an important milestone, are trading way below where they were a couple of years previous, because investors have gotten tired of waiting. We think that's happened with FBR Ltd, the Perth-based company, which has developed automated bricklaying technology. Back in August 2017 FBR stock was changing hands at 28.5 cents. Early last month, when FBR announced that its Hadrian X robot had achieved a 'commercial lay speed', the stock leaped from 2.2 cents to 6.3 cents, but it's since given up some of that gain up as well despite yesterday's 25% upswing. Which is too bad, because we believe FBR's amazing achievement warrants a serious re-rating.

READ MORE

BRAMBLES

Defensive, but competitive pressures loom

Stocks Down Under rating: ★★★

ASX: BXB
Share price: A$ 10.98
Market cap: $ 16.4BN

Based in Sydney, Brambles is a supply-chain logistics company that manages pallets, containers and reusable plastic crates. The company's roots go back to 1875 when it was founded by Walter Bramble as a Newcastle butchery business and later expanded into transportation and logistics. Today, with operations in over 60 countries, its products help move goods from manufacturers to stores and online businesses in the fresh produce, fast-moving consumer goods (FMCG), beverage, retail and general manufacturing industries. We believe the company faces increasing competition and an ongoing capital expenditure burden.

Share price chart

Source: Tradingview

Defensive nature of the business apparent during pandemic

Brambles posted revenue growth of 7% in FY19 because of favourable price realisation and strong volume. Organic growth, however, slowed, particularly in Europe. Underlying profit was up only 2% due to input cost inflation, higher service costs in Latin America and ongoing challenges in the CHEP Americas business. Nevertheless, the group delivered a 19.5% return on capital investment (ROCI), which was well above its cost of capital.

Sales again grew 7% in 1HY20 as the company achieved broad-based top and bottom-line growth. Underlying profit growth accelerated to 5% due to supply chain efficiency gains and moderating transportation and lumber inflation. A highlight of the interim period was the company's 10-year RPC contract win from an undisclosed major Australian retailer. The ROCI slipped to 18.2% mostly due to the adoption of a new accounting standard related to leases.

As the owner of over 330m pallets and crates under the well-known CHEP brand, Brambles has been a beneficiary of COVID-19 panic buying. Amid a scramble to snatch up toilet paper, food, cleaning supplies and other household essentials, Brambles' pallets and crates have become a hot commodity. The group has placed record volumes of pallets in supermarkets and other consumer goods channels. Revenue grew 6% in the March quarter supported by the surge in essential, and not so essential, goods demand at the onset of the pandemic. Although the heavy volume of pallets and containers also led to higher repair and collection costs, this was more than offset by the strong top line growth.

Limited US growth prospects, ongoing capex burden

While Brambles may find long-term growth in emerging markets, we believe its growth prospects in the US market do not look as promising. This is a concern because U.S. and Canadian customers together accounted for 45% of revenues in 1HY20. The company has faced network capacity constraints in the US, which along with evolving retailer and customer behaviours has led to higher costs and soft demand. Rising US labour and property inflation are also limiting the near-term growth prospects in the US, in our view.

But Brambles is not waving the white flag just yet. It invested $73m in US automation and lumber procurement initiatives in FY19 to improve its competitive position in the core market and continues to pour money in its US operations. The recent resurgence of the US - China trade war, however, does not bode well for the company because a slowdown in global trade means less need for supply-chain logistics.

To combat retailer driven cost increases and improve supply chain efficiencies, Brambles has accelerated its investments in areas such as automation. Capital expenditures on property, plant and equipment (PPE) increased significantly in FY18 and again in FY19 to $1.06bn. Capex for asset efficiency projects, such as those in the Latin America pallets business, topped US$500m in 1HY20. Although capital spending was lower than in 1HY19 and helped drive improved cash flow generation, the company's large US supply chain investment is weighted towards the second half of FY20. This suggests little reprieve is in sight for the group's capex burden.

Intensified competition another hurdle

Meanwhile, we believe intensifying competition in the global supply chain industry is a significant threat to Brambles. It is especially concerning that the increased competition is taking place in the group's key markets. As an example, an important US customer recently engaged Brambles along with all its major US competitors in plastic pallet trials designed to test the functionality, asset management, pricing and overall economics of the wood alternative. The retailer accounts for only 3.5% of Brambles global pallet flows, but if competitors' offerings prove superior, we believe this could lead to a broader shift of business towards its peers.

Brambles had a strong balance sheet going into the COVID-19 crisis with a comfortable cash balance of $1.1bn. It also had $1.3bn of undrawn debt facilities and an increased committed facilities term of 4.5 years. This has provided the company with sufficient liquidity to manage the uncertain economic environment. The conservative, flexible balance sheet and defensive business model should continue to drive modest growth in the post-pandemic world.

However, we believe Brambles is currently fully valued. With limited EBITDA growth in FY21 of 4.6% and an EV/EBITDA valuation of 8.1x, we don't see much upside in the shares right now. The picture is slightly more positive for FY22 with an EV/ABITDA multiple of 7.5x and projected EBITDA growth of 7.7% versus FY21. However, that still doesn't leave share price upside and it's still 12 months away.

The 3.9% dividend yield is not bad, but if yield is your thing you're probably better off looking at some of the banks, or Arena REIT below. Long story short, we're neutral on Brambles and give it 3 stars.

ARENA REIT

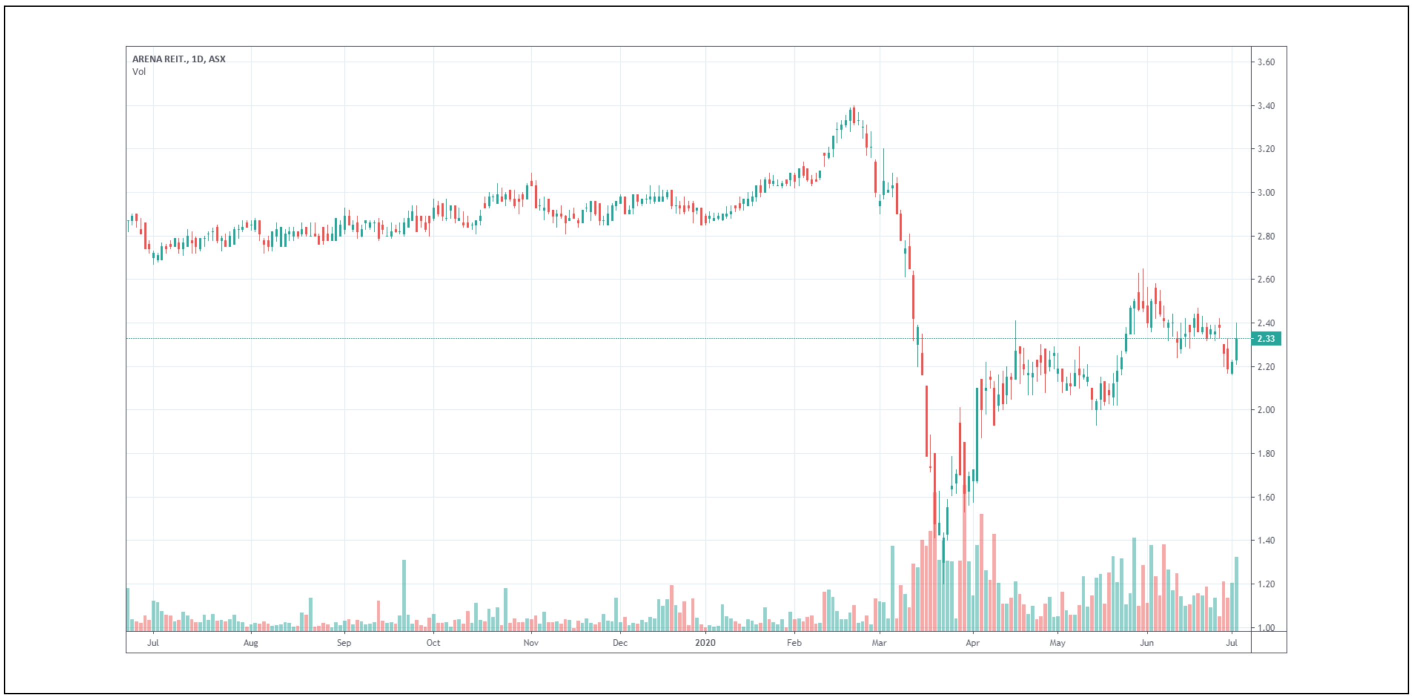
Childcare bringing home the bacon

Stocks Down Under rating: ★★★★

ASX: ARF
Share price: A$ 2.33
Market cap: $ 727M

Melbourne-based Arena REIT is a property investment and management company. The group owns, manages and develops a large portfolio of "social infrastructure" properties across Australia in the childcare, healthcare, education and government sectors. The well-diversified portfolio by sector, location and tenant type is supported by a strong development pipeline. We believe Arena has managed pressures related to the Coronavirus Crisis well and has a long history of delivering reliable earnings growth and shareholder returns. The shares offer a growing quarterly distribution as well as good upside potential from the current depressed valuation.

Share price chart



Source: Tradingview

Attractive property mix with built-in rent increases

Arena REIT's portfolio includes 233 social infrastructure properties valued at $853.3m. Its investment strategy is focused on childcare, healthcare, education and government tenanted facilities. The facilities are leased on a long-term basis, which locks in rental income for shareholders. The company often negotiates rent increases and has increases built into a significant percentage of contracts. Arena also makes value added acquisitions and divests certain properties at a premium enabling it to lock in increases valuation and enhance its overall profits.

Around 85% of the portfolio value is in early learning centres (ELC) properties that generate consistent rental income. Some of its largest tenants include childcare providers such as Goodstart Early Learning and Green Leaves, which account for 31% and 14% of portfolio income respectively. Prior to the pandemic, the ELC sector was seeing strong underlying demand with record levels of children attending day long care. According to the ABS population projections, the 0 to 4 age group is forecast to grow 17% from 2019 to 2030. A rising female workforce participation rate has also been a main driver of the growth and rising childcare costs have been made more affordable by the childcare subsidy (CCS).

These demographic trends have helped Arena increase rental rates and drive strong underlying earnings growth. The resilient nature of Arena's tenant base is also evident in the healthcare portion of the portfolio. Regardless of the economic environment, there is always a need for healthcare, which makes the REIT a rather conservative, defensive play. It owns 10 healthcare buildings most of which are leased to Healius Ltd. which represents 12% of income. There are also three specialist disability accommodation facilities in the healthcare portfolio.

Government relief package supports ELC tenants

The onset of the COVID-19 crisis sent REIT shares crashing due to concerns of a global recession, the potential for tenant departures and lower income. Fortunately for Arena REIT, the government's response has been quick and effective. The Early Childhood Education and Care Relief Package (ECECRP) was created to provide ELCs weekly payments equal to 50% of gross revenue to keep centres open and employees in their jobs. The term of the package was from February 2020 through 28 June during which time families were also not charged fees. All of Arena's ELC tenants qualified for the ECECRP as well as the JobKeeper programme.

As the Australian economy reopens, the availability of childcare is a critical element of getting people back to work. Under the Commercial Code, Arena was required to provide tenant rental relief in proportion to its reduction in trade. It reached rental relief agreements with all customers and the level of rent abatement has been immaterial. Approximately 90% of tenant rental payments were received from March through May 2020. More recently, however, profits at ELC tenants have been constrained as attendance has increased. This is because costs are increasing while fixed government funding remains in place and fees are not able to be charged to families. Although what happens regarding the ECECRP beyond 30 June is uncertain, this will likely be a transient headwind for Arena.

Arena's overall portfolio strength can be seen from several angles. Its 100% occupancy rate means every property has rent-paying tenants. With 70% of leases expiring in FY32 and beyond, the weighted average lease expiry (WALE) of 14.1 years is among the highest in its peer group. The group recorded an average like-for-like rent increase of 3.6% in FY19 and 3.1% in 1HY20 driving strong operating earnings and distribution growth.

Solid development pipeline, improving balance sheet

Arena REIT's development pipeline consist of high, quality purpose-built properties that represent the next phase of growth. It acquired 11 new projects in 1HY20 to bring its development pipeline to 16 projects that are forecast to have a total cost of $86m. Three development projects are forecast to be complete in 2HY20 and the remainder of the current projects are targeting FY21 completions.

In early June, the group raised $60m of additional equity through an institutional placement and a share purchase plan (SPP) to help pursue other social infrastructure property investments. This strengthened its already well-capitalised balance sheet by reducing gearing to 17.6%. Prior to the equity raise, as of 31 December 2019, Arena REIT had $11.7m in cash, $890m in assets, borrowings of $207m and a low weighted average cost of debt of 3.55%. It also had an undrawn debt capacity of $123m to fund its development pipeline and future growth opportunities.

Arena's dividend yield is a very attractive 6.4%. It's not only attractive, but also fairly safe, in our view, given the solid and stable tenant base. Four stars from us.

FBR LTD

The rise of the robot

Stocks Down Under rating: ★★★★

ASX: FBR
Share price: A$ 0.044
Market cap: $ 75M

Sometimes promising technology companies, at the point where the technology has reached an important milestone, are trading way below where they were a couple of years previous, because investors have gotten tired of waiting. We think that's happened with FBR Ltd, the Perth-based company, which has developed automated bricklaying technology. Back in August 2017 FBR stock was changing hands at 28.5 cents. Early last month, when FBR announced that its Hadrian X robot had achieved a 'commercial lay speed', the stock leaped from 2.2 cents to 6.3 cents, but it's since given up some of that gain up as well despite yesterday's 25% upswing. Which is too bad, because we believe FBR's amazing achievement warrants a serious re-rating.

Share price chart

Source: Tradingview

A little known fact about the legendary British statesman Winston Churchill is that, among his numerous talents, he was a skilled bricklayer, a trade he learned on building projects around his country house, Chartwell. One day in 1928 Churchill, then Chancellor of the Exchequer, wrote to Prime Minister Stanley Baldwin, 'I have had a delightful month building a cottage and dictating a book: 200 bricks and 2000 words a day'. History does not record how long it took bricklayer Churchill to lay his 200 bricks. However it's a fair bet that an Australian-developed robot named after another statesman, one of Rome's Five Good Emperors, could do it faster today. Much faster.

Meet Hadrian from Perth, our best worker

On 3 June 2020, FBR announced that its Hadrian X robot had laid 200 concrete blocks in an hour on a test building site. This particular robot, called H02, ran 300% faster than its processor H01 did in February last year. If you're a bricklayer in an advanced industrial country, now is the time to start planning for a change of occupation because at Hadrian's current speed, he (we'll call the robot a 'he' because his namesake who died in 138 AD was male) is already more cost effective as a builder than you are.

Indeed, if you want to know where all this is heading, check out a seminal 2015 book by the American futurist Martin Ford called Rise of the Robots. Technology, says Ford, used to displace just the unskilled workers. Now, it's coming after the skilled. Like bricklayers. FBR is working on optimising the technology behind Hadrian X so there's further improvements to come. FBR reckons Hadrian X can eventually get to 1,000 blocks an hour, which would make him slightly faster than the world's fastest human. And, remember, this guy with the Latin name can work around the clock. Even Winston Churchill had to sleep a few hours every now and then.

Everyone talks about the weather

The good news for Altura is that the debt that was taken on to finance the Altura Mine was refinanced in March 2020 and there's also $50m in standby equity funding available, so the company isn't in danger of being killed by low lithium prices any time soon. Also, Altura is continuously driving down costs at the mine and has an immediate target of getting them below US$300 a tonne. And, we argue, it's a fair bet that 2020 will be the nadir for lithium before a 2021 recovery.

For one small piece of evidence that global lithium demand is set to escalate sooner rather than later, consider a landmark event that took place on 26 June 2020 in Zwickau, a town in eastern Germany about 85 km south of Leipzig. The car factory in Zwickau is one of only 16 that Volkswagen operates around the world, VW having inherited the old monster that made the world's worst car, the Trabant. Since 1990 VW has produced Polos, Golfs and Passats at Zwickau, but on 26 June the factory produced its last car with a conventional International Combustion Engine. From now on Zwickau will only make electric cars. And you know what electric cars have a lot of in their battery packs? You guessed it, lithium. As other factories for other companies go the way of Zwickau over the next few years, expect Altura to enjoy better times.

Continuous progress

What impresses us about FBR today is the progress that has been made in more recent years. When FBR did its backdoor listing on ASX in 2015, it had shown with the Hadrian 105 prototype that its approach could build a wall using ground-mounted robots and mortar. By 2016 Hadrian 105 could build a multi-room block structure from a CAD model, without human intervention. By late 2018, after the company had changed its name from Fastbrick Robotics to FBR, the new Hadrian X machine, which was truck-mounted, could build a whole house with three bedrooms and two bathrooms in under three days. And in February of last year Hadrian X built its first outdoor home structure. It's this continuous improvement which tells us that more good stuff is coming for Hadrian X in the months and years ahead.

Obviously the building industry has been impacted by Covid-19 all around the world, but we think the industry will look through this downturn and see the obvious economic benefits of Hadrian X. Remember, construction is a US$1.3 trillion global industry, but possibly US$120bn represents the labour and other inefficiencies that the industry currently has to absorb, which robots could help recoup. That opportunity represents considerable upside for a company currently capitalised at $75m, of which $7m or so was cash as at March 2020. So while FBR is still pre-revenue and burns through approximately $0.7m a month, we expect that a lot of important companies will be looking closely at hiring Hadrian from Perth sooner rather than later. Particularly if his next reported lay speed is better than 200 bricks an hour.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

Pitt Street Research Pty Ltd is founded on more than 40 years of combined experience researching companies in a range of different sectors.