Stocks Down Under

“I believe that economists put decimal points in their forecasts to show that they have a sense of humour.”

- William Gillmore Simms (1806-1870), American writer and politician

FISHER & PAYKEL

Growth in ventilation market more than priced in

AUSTRALIAN ETHICAL INVESTMENT

Invest in the funds, not the manager

IVE GROUP

Attractive yield to tie us over

FISHER & PAYKEL

Growth in ventilation market more than priced in

Stocks Down Under rating: ★★

ASX: FPH
Share price: A$ 32.90
Market cap: A$ 18.9BN

Headquartered in Auckland, New Zealand, Fisher & Paykel Healthcare makes equipment for respiratory care, acute care and the treatment of obstructive sleep apnea (OSA). Its products are designed to improve outcomes both for adults and infants and are primarily sold internationally with only a small portion of revenue derived from the New Zealand market. Due in large part to a spike in ventilator demand during the coronavirus pandemic, the shares have more than doubled over the last 12 months and are trading at an all-time high. We believe Fisher & Paykel's innovative product pipeline places it in a good position to capitalise on the favourable demographics behind a rapidly growing global respiratory care market.

READ MORE

AUSTRALIAN ETHICAL INVESTMENT

Invest in the funds, not the manager

Stocks Down Under rating: ★★

ASX: AEF
Share price: A$ 6.35
Market cap: A$ 738M

Based in Sydney, Australian Ethical Investment is a wealth management company focused on ethical investments. With funds under management of $3.42bn, the group has grown to more than 43,000 members to which it offers a range of ethically based superannuation and managed funds. It invests in areas that seek positive change for society and the environment such as renewable energy, medical breakthrough technology and efficient transport. It avoids areas that harm people, animals or the environment like tobacco, uranium and coal mining. After soaring 279% over the past year, we believe the shares are far from cheap at 100x earnings. Although this is a quality company that has a strong performance track record and an opportunity to capitalise on the increasing popularity of ethical investments, we believe investors would be better off putting their money in Aussie Ethical's funds and not the funds' manager.

READ MORE

IVE GROUP

Attractive yield to tie us over

Stocks Down Under rating: ★★★★

ASX: IGL
Share price: A$ 0.915
Market cap: A$ 130M

Sydney-based IVE Group is a marketing company that delivers a range of print, mobile and interactive media products and services. As the company has significant exposure to the retail sector, it has felt the ripple effects of reduced consumer and advertising activity on its performance. Management has embarked on a strategy designed to unify its diversified business lines into a singular IVE brand and has thus far executed well in a challenging environment. The stock remains well off its all-time high set in January 2020 and we believe the selloff has created an opportunity to invest in a stock that trades at 5.8x EV/EBITDA, has a leadership position in the marketing space and good upside potential.

READ MORE

FISHER & PAYKEL

Growth in ventilation market more than priced in

Stocks Down Under rating: ★★

ASX: FPH
Share price: A$ 32.90
Market cap: A$ 18.9BN

Headquartered in Auckland, New Zealand, Fisher & Paykel Healthcare makes equipment for respiratory care, acute care and the treatment of obstructive sleep apnea (OSA). Its products are designed to improve outcomes both for adults and infants and are primarily sold internationally with only a small portion of revenue derived from the New Zealand market. Due in large part to a spike in ventilator demand during the coronavirus pandemic, the shares have more than doubled over the last 12 months and are trading at an all-time high. We believe Fisher & Paykel's innovative product pipeline places it in a good position to capitalise on the favourable demographics behind a rapidly growing global respiratory care market.

Share price chart

Source: Tradingview

Broad product portfolio, global distribution footprint

Fisher & Paykel's products are used in hospital and homecare settings. The hospital segment has historically accounted for approximately 60% of revenue. Over 100m people worldwide are affected by obstructive sleep apnea (OSA). OSA is most commonly treated with continuous positive airway pressure (CPAP) machines, however these products face stringent compliance hurdles especially with regards to mask specifications.

F&P's products are differentiated by their use of humidification, which increases the water vapour content of air and gas flow without increasing temperature. This leads to compliance improvements and greater market acceptance. Its respiratory humidifiers, chambers and breathing circuits are designed to humidify and deliver gases to patients during ventilation, oxygen therapy and laparoscopic surgery. The products help prevent the airways from closing during sleep. They are sold directly to hospital and homecare dealers as well as through over 100 medical equipment distributors globally.

Pandemic provides an unexpected tailwind

The company has a history of doubling its revenue every 5 to 6 years. The group's full year results were highlighted by an 18% increase in revenue to NZ$1.26bn. This was driven by a 25% increase in hospital revenue while homecare sales were up 9%. The vast majority of hospital revenue comes from consumables, such as ventilation tubing and accessories. This is a positive investment aspect of the company because it represents known, recurring revenue.

The gross margin decreased by 73 basis points to a still very solid 66.1% as the company expedited shipping to certain customers ahead of the financial year-end and additional start up costs for the Mexico facility. On balance, after tax profits increased 37% to NZ$287.3m.

Gearing, as measured by net interest bearing debt as a percentage of capital, was a negative 4.3%, which is very positive from a balance sheet strength point of view. However, one could argue that the company should put its strong balance sheet to work by taking on more debt to improve Return on Equity.

Fisher & Paykel's products were thrust onto the frontlines of the COVID-19 crisis because of the global need for respirators. Many hospitalized COVID-19 patients have been supported by F&P products. To keep up with the pressing demand the company hired over 1,000 additional direct manufacturing staff for its New Zealand and Mexico facilities to be able to ramp its production. It also moved capital spending plans forward to enhance manufacturing capacity and new product tooling. Over the course of a few months it doubled or tripled the output of some of its hospital hardware products in response to COVID-19. This led to hospital hardware growth of more than 300% in the first three months of FY21.

Deep product pipeline supports future growth

A high level of investments in R&D has driven an expansion of the company's product portfolio. It recently launched the F&P Evora, a compact nasal mask for OSA in New Zealand, Australia, Europe and Canada. It also recently expanded the release of the F&P 950 heated humidification system in Europe and the F&P Vitera mask in the U.S. The company has several new products in its pipeline including masks, humidifier controllers, flow generators, respiratory consumables and compliance monitoring solutions, which will continue to support growth.

Fisher & Paykel competes with other global players like Resmed and Phillips for a share of the US$16bn respiratory care market. Its competitive position has strengthened in recent years because of its expanding line of comfortable and effective CPAP masks and other products, which have received high customer satisfaction ratings.

The COVID-19 crisis put a spotlight on the importance of respirators. This along with the huge global respiratory care market opportunity should lead to market share gains and continued earnings growth.

Future growth more than priced in

Following an expected 25% surge in EBITDA in the current financial year, driven by strong COVID-19 related demand, next year is expected to see a slowdown to just 6% EBITDA growth. After that, the company is expected to resume its more normal EBITDA growth rate in the mid-teens in FY23.

When we relate this growth to Fisher & Paykel's EV/EBITDA valuation for FY21 through FY23 of 37x, 35x and 30x respectively, we can only conclude that all this EBITDA growth is already discounted into the company's share price…and then some. As a consequence, we'll stay away from this one for now. Only two stars from us.

AUSTRALIAN ETHICAL INVESTMENT

Invest in the funds, not the manager

Stocks Down Under rating: ★★

ASX: AEF
Share price: A$ 6.35
Market cap: A$ 738M

Based in Sydney, Australian Ethical Investment is a wealth management company focused on ethical investments. With funds under management of $3.42bn, the group has grown to more than 43,000 members to which it offers a range of ethically based superannuation and managed funds. It invests in areas that seek positive change for society and the environment such as renewable energy, medical breakthrough technology and efficient transport. It avoids areas that harm people, animals or the environment like tobacco, uranium and coal mining. After soaring 279% over the past year, we believe the shares are far from cheap at 100x earnings. Although this is a quality company that has a strong performance track record and an opportunity to capitalise on the increasing popularity of ethical investments, we believe investors would be better off putting their money in Aussie Ethical's funds and not the funds' manager.

Share price chart

Source: Tradingview

Investors looking to invest with a social purpose

The recent ascent in Australian Ethical Investment (AEF) shares has coincided with the rising popularity of ethical investing. People have taken a liking to the concept of avoiding companies that have a negative impact on the world in favour of those that do the world good. They have recognized that AEF's funds not only offer excellent performance but the opportunity to be a part of social goodness.

The company conducts positive and negative screens of prospective investments to determine if they meet the criteria of its Australian Ethical Charter. The Charter includes a list of 23 guiding principles around the business activities it aims to avoid and seek. What also sits well with many investors is that 10% of AEF's profits go towards its Community Grants program whereby members of the community vote on which projects to fund, such as those related to the victims of the bushfires.

As ethical investment has moved into the mainstream, clients have increasingly come on board with Australian Ethical. This has led to strong growth in membership and funds under management (FUM). After growing 10% to $2.85bn in 2018, FUM growth accelerated to 36% in 2019. This was the result of growth in all three of the company's divisions - superannuation, managed funds and institutional. Superannuation, which comprises approximately two-thirds of FUM, recorded a net flow increase of 82% in CY19.

Stellar risk-adjusted performance

The group has a strong balance sheet that is free of debt and has ample liquidity. The cash position of $17.7m has increased over the last three years and net assets have grown in each of the last five years at an annualized rate of 10%. Its parent company holds a regulatory capital surplus of $5.7m.

Another appealing aspect of AEF from an investor's standpoint is its decorated track record of fund outperformance. The company's flagship Australian Shares Fund has generated outstanding risk-adjusted returns and is the best performing Australian Shares super option. Through 31 May 2020, its 10-year annualised return of 9.3% has topped its benchmark and the S&P/ASX 300 while taking on less risk than both.

Meanwhile, the Balanced MySuper Fund is the fastest growing super fund in the country. It has consistently outperformed its peer-based benchmark and has delivered a 10-year annualised return of 6.9% through 31 May 2020. The Emerging Companies Fund has also been a standout due to its strong outperformance.

Decreasing fees improves competitiveness

As AEF has grown its member numbers and FUM, it has passed on scale benefits to its customers through fee reductions. This not only improves investor returns but increases the competitive position of its products. It has also led to a steady decline in the company's average revenue margin. This margin has gradually decreased from around 1.6% in CY15 to 1.16% in CY19. Fee reductions have primarily occurred in the Super products segment, mostly recently on 1 December 2019 when AEF implemented fee reductions on three options. It has capped super fees at 3% in compliance with Protecting Your Super (PYS) legislation and has removed exit fees on certain funds.

The group's most recent monthly trading update provided FY20 guidance for underlying profit after tax (UPAT) of $6.8m and $7.5m before performance fees. At the midpoint this represents an increase of 10% over the prior fiscal year. Following interim half UPAT of $4.4m, profitability has slowed due to the COVID-19 crisis. The downturn in the capital markets and the early release of superannuation conditions have weighed on AEF's investment performance and FUM balance in the second half.

However, as market conditions normalize, the company is in a good position to leverage its outstanding performance record and capitalize on increasing demand for ethical investment.

Better off investing in the funds than in the stock

The midpoint profit after tax of $7.2m for the last financial year implies a trailing P/E of roughly 100x. In our book that's a high valuation to pay for an asset manager. Looking at the performance of AEF's funds, investors are probably better of investing in the funds rather than in the manager. So, its two stars from us.

IVE GROUP

Attractive yield to tie us over

Stocks Down Under rating: ★★★★

ASX: IGL
Share price: A$ 0.915
Market cap: A$ 130M

Sydney-based IVE Group is a marketing company that delivers a range of print, mobile and interactive media products and services. As the company has significant exposure to the retail sector, it has felt the ripple effects of reduced consumer and advertising activity on its performance. Management has embarked on a strategy designed to unify its diversified business lines into a singular IVE brand and has thus far executed well in a challenging environment. The stock remains well off its all-time high set in January 2020 and we believe the selloff has created an opportunity to invest in a stock that trades at 5.8x EV/EBITDA, has a leadership position in the marketing space and good upside potential.

Share price chart

Source: Tradingview

Traditional marketing is alive and well

Some say that traditional marketing methods are dead. Do not tell this to IVE Group. It has an expanding client base to which it offers a variety of print media products like catalogues, billboards and other attention-grabbing displays. That is not to say, however, that it is not changing with an evolving marketing landscape that is increasingly focused on digital media platforms. Mobile advertising for mediums like websites and mobile applications will continue to serve as a higher growth complement to its legacy marketing offerings.

Healthy demand for traditional marketing was on full display in FY19 as revenue was up 4% to $724.2m. The top line result was driven by some meaningful new client wins, key customer contract extensions and an effective cross-selling strategy. EBITDA jumped 9.8% to $80.4m and net profit after taxes and the amortisation of customer contracts (NPATA) increased 4.4% to $37.5m. This was driven by top line growth and efficiency gains. An expanding EBITDA margin of 11.1% helped the company deliver a robust 17% return on funds employed (ROFE).

In 1HY20 revenue slipped 4.1% to $360.2m and net profit after taxes (NPAT) decreased 7.3% to $17.6m as elevated paper and energy expenses continued to weigh on the bottom line as did general economic weakness. The continued stabilisation of the global pulp and paper markets should improve near-term profitability. While the interim results were somewhat soft, the group's gross profit and EBITDA margins were consistent with FY19. More importantly, it renewed several key customer contracts during the six-month period.

Acquisition strengthens retail platform

IVE Group has been active on the M&A front in recent years. On 2 January 2020 it announced the completion of its $25.4m takeover of Salmat Marketing Solutions and Reach Media New Zealand. While some have scoffed at the valuation, we believe the price tag was reasonable considering the potential of the assets to lead to higher profits. The purchase was made to strengthen the group's competitive position in the retail space through the addition of Australia's largest letterbox distribution business. It is expected to have been earnings accretive in 2HY20. The addition appears to be a good fit with IVE's existing retail platform and the company recently noted that Salmat and Reach customers have expressed early positive sentiments around the combination.

The company's balance sheet is in good order and absent an overwhelming amount of debt or other obligations. Despite recent issues around a high level of bad debts in the Kalido Asia business, which have resulted in write-offs, the group has maintained good financial health. The cash balance stood at $29m per the end of February and net debt amounted to $174m. The debt load, however, remains manageable, supported by the recent extension of its senior loan facilities. In FY19 it refinanced its senior debt facilities by extending the term by four years and attaining improved pricing.

Recent insider buying a bullish signal

The bullish case for IVE Group has been bolstered by a string of recent insider buying activity in the stock. Insider buying is often considered by investors to be a signal that management has confidence in the medium-term growth prospects of the company. On 8 May, Directors Paul and Geoff Selig each acquired 1.15m shares worth over $815k. This followed a wave of insider buying activity in March 2020 that saw four different IVE Group directors make purchases as the share price tumbled in the Corona Crash.

Like other marketing companies, IVE Group has witnessed a slowdown in advertising demand amid the COVID-19 crisis. Clients in certain sectors, like retail, have reduced their marketing budgets and engagements with IVE Group. Complicating matters, supply chain challenges in Asia have hindered the group's ability to deliver to some customers. While this has certainly weighed on near-term performance, we believe the group should be able to manage the situation. The diversification of its customer base should help lessen the potential damage from any one customer or group of customers.

As economic conditions improve, its expanding portfolio and strong reputation in retail marketing should enable it to return to the level of financial performance that occurred it FY19.

Very reasonable valuation and attractive dividend to tie us over

Due to the COVID-19 fallout, the company passed on its 8.6 cent interim dividend recently and has put certain capital expenditures on hold. In terms of EBITDA growth, FY21 will most likely be a lost year with EBITDA expected to be flat versus the $71m that is expected for FY20. FY22 should see strong EBITDA growth, however, of around 26% if and when the advertising market normalises in the next 12 months.

Seen in that light, we feel the company's 5.8x EV/EBITDA for FY21 and 4.5x for FY22 is more than reasonable. Additionally, if the company goes back to paying even half the dividend that was paid in FY18 and FY19 (16 cents in each year), we're looking at a yield of almost 9%. That should be enough to tie cautious investors over to a time when things start to normalise. Four stars from us.

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.

Stocks Down Under (Pitt Street Research AFSL 1265112) provides actionable investment ideas on ASX-listed stocks. The Content has been prepared for general information purposes only and is not (and cannot be construed or relied upon as) personal advice nor as an offer to buy/sell/subscribe to any of the financial products mentioned herein. No investment objectives, financial circumstances or needs of any individual have been taken into consideration in the preparation of the Content. Financial products are complex, entail risk of loss, may rise and fall, and are impacted by a range of market and economic factors, and you should always obtain professional advice to ensure trading or investing in such products is suitable for your circumstances, and ensure you obtain, read and understand any applicable offer document