20 JULY 2020

Stocks Down Under

"Strip malls are history."

- Jeff Bezos (b. 1964), American internet entrepreneur

SCENTRE GROUP

New retail dynamic as shoppers slowly return

CENTURIA CAPITAL GROUP

Augusta acquisition strengthens position

FRONTIER DIGITAL VENTURES

Online marketplace royalty

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Stocks Down Under rating: ★★★

ASX: SCG
Market cap: A$ 11.1BN

52-week range: A$1.35 / A$4.14
Share price: A$ 2.14

Headquartered in Sydney, Scentre Group is a real estate investment trust (REIT) focused on shopping centre properties. Under the popular Westfield Living Centres brand it operates 42 retail destinations in Australia and New Zealand that attract over 500 million people annually. The COVID-19 crisis has had a major impact on its retail properties. But with a strengthened balance sheet and innovations built around online shopping, the company is discovering new ways to generate income. With a 5% dividend yield the shares offer investors a bit of an income cushion on top of the upside potential.

READ MORE

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Stocks Down Under rating: ★★★★

ASX: CNI
Market cap: A$ 860M

52-week range: A$1.36 / $2.76
Share price: A$ 1.68

Based in Sydney, Centuria Capital Group is a property funds management company with $7.3bn in assets under management (AUM). The group's growing asset base may get a substantial boost from the pending takeover of Augusta Capital and is further supported by a strong transaction pipeline. Centuria generates high recurring revenues and is in a strong capital position to weather the current financial market volatility and take advantage of property opportunities in the post-pandemic economy. The shares have delivered outstanding returns in recent years and presently offer a 5.5% dividend yield.

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ASX: FDV
Market cap: A$ 294M

52-week range: A$0.55 / A$1.23
Share price: A$ 1.145

In simple terms, Kuala Lumpur-based Frontier Digital Ventures is a Venture Capital (VC) firm specialised in online marketplaces in emerging markets, specifically in South East Asia, Central and South America and Africa. The firm's portfolio companies include online marketplaces for cars and property in particular, most of which are still EBITDA negative but are moving in the right direction. As is typical for VC's, Frontier Digital Ventures not only invests in its portfolio companies, but also provides strategic and operational support. The ASX-listed shares have had a good run recently and are now back to levels seen prior to the Corona Crash. We quite like a VC approach when it comes to investing in Tech and Biotech companies, i.e. spreading your money across a number of bets in a particular (sub)sector. So, an ASX-listed VC specialising in online marketplaces certainly piques our interest.

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Share price chart

Source: Tradingview

Pandemic's impact on retail hits hard

Scentre Group's heavy exposure to the retail industry has been apparent during the COVID-19 crisis. Its retail properties were forced to close due to pandemic restrictions leaving consumers with little physical retail shopping availability. After growing 1.6% in January and February 2020, customer visitation fell as low as 39% of the previous year's level in March and April. This pressured its tenants' ability and willingness to pay rent. While keeping lease obligations in place, Scentre explored ways to assist tenants with cash flow issues. This has ultimately impacted the company's rental income and caused uncertainty around its distributions. As a result, it share price sank to a low of $1.35 in late March 2020.

Scentre's June 2020 update noted that 92% and 94% of its retail stores have opened in Australia and New Zealand respectively. As the stores have reopened customer traffic has improved but remains below last year's levels. Overall customer visitations for the week ended 24 May 2020 were 86% of what they were a year ago. Meanwhile a potential second wave of the virus has undermined consumer confidence and suggests the economic recovery may take longer. The pandemic's impact on retail properties is likely to last longer than other areas of real estate as restrictions and health concerns continue to weigh on shoppers.

Company responds by cutting costs, strengthening liquidity

An otherwise solid start to the year has been set off track by the pandemic. This was reflected in the Scentre's March 2020 quarterly update. Year-to-date through 31 March comparable store sales fell 7.1% in the Specialties category. The Majors category had 0.7% higher sales because Supermarket sales growth of 9% narrowly offset steep declines at department stores and cinemas. Although all 42 of its Westfield Living Centres stayed open throughout the pandemic, retailers remained closed for several weeks. This prompted Scentre to implement a series of initiatives targeting a 25% reduction in centre operating expenses. It also enhanced its financial resolve by increasing its liquidity balance to $3.1bn.

In April 2020 Scentre refinanced bank facilities resulting in an extension of its $1.9bn debt obligation that was set to mature in 2021 through January 2022. This helped strengthen an already healthy balance sheet. As at 31 December 2019, the group had net assets of $23.3bn, interest cover of 3.6x and gearing of 33%, all of which is pretty healthy, in our view. Despite the challenges that have since arisen, Scentre Group has maintained an "A" credit rating by S&P, Fitch and Moody's throughout the crisis.

Back on 10 March, the company decided to suspend its share buy-back program because of the volatile capital markets conditions. Prior to this it had purchased $479 million in shares under its $800 million buyback program. This left $321 million, which it chose to use to pay down debt and enhance capital. As the economic recovery unfolds and Scentre's financial outlook improves, however, we believe there is a good possibility that the share buybacks will resume given how inexpensive the stock is at the moment.

eCommerce is a growing threat to Scentre

As COVID-19 restrictions have eased, Scentre Group has seen a concurrent shift in spending at its retail properties. Although some purchases that were being made online may be transitioning to stores, there is still an overbearing move to online shopping underway in the ANZ region. This presents a challenge to a retail REIT such as Scentre. Although its tenants still make money from their website businesses, they may see less of a need for a physical retail presence if orders increasingly get shipped directly from warehouses to customers' doors. While the retailers will undoubtedly still need some combination of a storefront in addition to their e-commerce presence, they may begin to close underperforming stores to reduce expenses. This may pressure Scentre's occupancy rates and rental income.

In response to the evolving retail landscape, in April 2020, the company launched a new drive-through, contactless click-and-collect service called Westfield Direct. The rollout of the service has since been accelerated and is now available across all Westfield shopping centres. Customers have thus far welcomed the service as a safe and convenient way to purchase products online from Westfield retailers. Through 11 May 2020, the Westfield Direct platform connected customers to over 500 retailers offering a range of food, essentials and lifestyle goods.

Aside from Westfield Direct, Scentre's development pipeline includes a new Kmart store at Westfield Carindale which is scheduled to open later this year. New entertainment, leisure and dining projects have resumed at Westfield Doncaster, while similar development activity at Westfield Mt. Druitt has been placed on hold.

Dividend yield is good, but limited share price upside

Optically, when looking at the chart, Scentre looks cheap at the current share price, still down close to 50% compared to pre-COVID levels. However, from a valuation point of view, things look less rosy. The shares are trading at an EV/EBITDA of 16.5x for FY20 (ends December) and 15.3x for FY21. Yet EBITDA growth is only expected to amount to 8% next year, in a post-COVID rebound sort of move. The year after, EBITDA growth is only expected to be 2.5%. In our view, that sort of growth doesn't justify the valuation, even at this optically low share price level.

We get it if you're in it for the dividend, which is about 5% for FY20 and around 7.6% for FY21. But we wouldn't rush in to Scentre if you're looking for strong upside. So, we can't go higher than 3 stars right now.

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Share price chart

Source: Tradingview

Strong AUM growth drives shareholder returns

Centuria Capital helps investors grow their wealth through investment in property. Its property platform includes both listed and unlisted property funds. The company specializes in office, industrial and healthcare properties located in Australia and New Zealand. It purchases, leases and manages these properties. Fund investors receive a portion of the group's operating earnings as income in addition to upside potential derived from the value of the properties. Its stable of property funds include Australia's largest pure play office REIT as well as the largest domestic pure play industrial REIT.

The group has a strong track record of assets under management (AUM) growth that has coincided with outstanding securityholder returns over the last few years. AUM increased from $3.8bn in FY17 to $4.9bn in FY18 and to $6.2bn in FY19. Including the pro forma 1HY20 results with the addition of Augusta Capital, AUM has grown at an annualised rate of 42.4% since FY17. This has translated to robust shareholder returns. From 9 January 2017 to 28 January 2020 Centuria delivered a very solid 178% total return to shareholders.

Augusta Capital takeover provides significant scale

On 30 January Centuria made a $174m takeover offer for Auckland-based property manager Augusta Capital. As one of New Zealand's largest listed real estate funds management platforms, Augusta Capital manages a variety of listed, unlisted and private funds with an expertise in industrial and office properties. It also owns some retail and tourism assets that will bring new sector exposure to Centuria's portfolio mix. The complementary acquisition of the $1.9bn property group provides Centuria with valuable scale in the New Zealand market and strengthens its competitive position in Australasia. If the transaction is finalized group AUM would increase 26% to $9.2bn. It would also enhance the potential for Centuria Capital shares to be included in the S&P/ASX 200 index. There is the potential for revenue and cost synergies as well through the deployment of Centuria's balance sheet and systems rationalisation. The completion of the takeover appears likely following the unanimous recommendation of Augusta's Directors on 14 July 2020.

Also, on 30 January Centuria announced the completion of an $80m fully underwritten institutional placement that was first introduced the day prior. Strong demand for the company's equity from existing and new institutions increased the placement from its initial amount of $60m to $80m. A total of 34.2m shares were issued at a price of $2.34 per security. The equity raising made Centuria's balance sheet stronger and gave it the flexibility to pursue unlisted and listed business growth. It also put it in a favourable position to pursue the Augusta takeover.

Minimal balance sheet debt

Centuria has a strong balance sheet that included $135m of free cash and operating gearing of just 0.4% as at 30 April 2020. The minimal debt balance is comprised of two corporate bonds that total $170m and the earliest maturity is $90m in April 2021.

Prior to the COVID-19 crisis Australia's property market had been experiencing solid growth due to strong demand and limited supply conditions. As the pandemic subsides and the economy recovers, property values are expected to gradually rebound towards pre-crisis levels. Some areas of the market may recover faster than others depending on subsector dynamics and the respective demand for office, industrial and healthcare leases.

We believe Centuria, with its recently increased scale and market relevance, is well positioned to capitalise on market opportunities as they arise and to continue to deliver excellent long-term securityholder returns. Throw in the nice 5% yield and its 4 stars from us.

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Share price chart

Source: Tradingview

These guys know their sh*t

Frontier Digital Ventures (FDV) was founded by two Internet rock stars, Shaun Di Gregorio and Patrick Grove. The former spent 8 years as General Manager at Realestate.com.au (ASX:REA), driving the business to $150m in revenues. He subsequently spent 5 years at iProperty Group (formerly ASX:IPP) prior to the take-over by REA at a $750m valuation.

Co-founder Patrick Grove is a serial entrepreneur who started and listed several Internet-related businesses. Not all of them were successful, just ask shareholders of Ensogo (formerly ASX:E88). However, he also founded the aforementioned iProperty Group and made a killing from the sale to REA. So, in an industry where failure is not uncommon, we believe it's fair to say two of FDV's founders have been around the block a few times and have established their bona fides in online marketplaces.

Nicely spread emerging market portfolio

FDV currently has interests in 12 companies, 7 of which are active in property. This segment accounted for 76% of revenues in FY19 (ended December). The 4 automotive-related portals, similar to Carsales.com.au, generated 10% of revenues. The only general marketplace in the portfolio, Central America-focused Encuentra24.com, which does everything from cars, property, electronics, jobs and other classifieds, generated 14% of revenues in FY19.

Mind you, when we say revenues, we mean revenues generated by FDV's portfolio companies attributed to FDV based on its interest in each individual company. To give you an idea, FDV's stakes range from 20% in Propzy in Vietnam to as high as 65% in CarsDB in Myanmar. So, while all portfolio companies combined generated A$72.5m in revenues in FY19, FDV's economic interest in those revenues was A$23.6m.

Revenues through the respective online marketplaces are mostly generated from ads and classifieds around the actual products. For instance, someone wanting to sell their car online may be able to do that for free, but may be asked to spend some money to make the ad stand out, or be placed at the top of search results. Additionally, all sorts of companies can advertise on these marketplaces, like car insurance companies, real estate agents etc.

FDV recently did a small institutional placement of A$6.5m, which will enable to company to make further investments in new portfolio companies.

Valuation is steep, but revenue growth supports it

When it comes to valuation, we don't have much to go by, other than EV/Revenues. You see, FDV's collective of companies as a group is not expected to turn EBITDA break even until FY21, which starts next January, and only just. For the following year, the company is expected to generate EBITDA of about $4.6m, which would imply an EV/EBITDA of more than 57x.

However, on an EV/Revenue basis, the shares are trading at 11.5x for the current financial year and 9.2x for FY21. In our book that is pretty rich. However, revenues from its portfolio companies attributable to FDV have grown by 57.9% on average in the last four financial years. And the EBITDA margins have been improving substantially over the same period.

Now that several portfolio companies have started to write black numbers at the EBITDA level, while most of the others are moving towards EBITDA break even, we expect to see further strong improvements in the financial metrics of FDV's portfolio companies. For instance, when high-growth companies turn EBITDA-positive, and stop bleeding money, investments in growth can be increased without the need for additional funding. It may mean EBITDA may not grow as much in the near term, but revenues should accelerate even more on the back of these extra investments.

So, despite the company's current valuation, we believe many of its portfolio companies are demonstrating that they're on the right track. And the pedigree of the founders provides us with quite a bit of comfort around future performance. Keep in mind, though, that an investment in FDV can be volatile given the geographies the portfolio companies are active in. Overall, 4 stars from us, though.

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.

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