STOCKS DOWN UNDER

11 AUGUST 2020

Stocks Down Under

"All forms of communications move to IP."

- John Chambers (b. 1949), former Chairman and CEO of Cisco Systems

TPG TELECOM

TPG+Vodafone is not 2+2=5

CENTURIA OFFICE REIT

Great yield, but lockdown uncertainty

MACH7 TECHNOLOGIES

Growing at the speed of sound

TPG TELECOM

TPG+Vodafone is not 2+2=5

Stocks Down Under rating: ★★

ASX: TPG
Market cap: A$ 15.1BN

52-week range: A$7.49 / A$9.70
Share price: A$ 8.15

TPG Telecom completed its merger with Vodafone Hutchison Australia in late June. TPG, as of January 2020, had approx. 17% and 25% of Australia's mobile network and fixed-line broadband market share, respectively. The Vodafone merger was designed to strengthen this, allowing a better response to the behemoth that is Telstra. Also, there were believed to be strong synergies between the two businesses that can be realised over the next couple of years. Given the competitive environment, we're not so sure.

READ MORE

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Stocks Down Under rating: ★★

ASX: COF
Market cap: A$ 996M
Dividend yield: 9.2% (unfranked)

52-week range: A$1.375 / A$3.30
Share price: A$ 1.965

Centuria Office Real Estate Investment Trust (ASX:COF) is a commercial property REIT specialising in quality office space across Australia. COF owns 23 properties across New South Wales, Victoria, Queensland, Australian Capital Territory, Western Australia and South Australia holding 100% ownership of the properties in all states besides NSW. While COF's annualised dividend yield of 9.2% might seem high, it is important to note that it is a 100% unfranked dividend.

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Market cap: A$ 218M

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Share price: A$ 0.965

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Share price chart

Source: Tradingview

TPG brings a diverse, wired, telecommunication portfolio

What we called 'Pre-TPG' was a full-service telecommunications company with consumer, government and corporate customers. Controlling the second largest fixed line broadband network in Australia, right behind Telstra, Pre-TPG supplied nationwide ADSL+, NBN, fibre optic and ethernet broadband access, FTTB, telephone services, IPTV, SIM only mobile plants and other business network services. Pre-TPG's revenue was broken into two categories, consumer and corporate, with the majority of their revenue (70%) and EBITDA (53%), as of 31 January 2020, generated from the consumer businesses. While this may prove to be a boon as COVID-19 forces people to work from home, between FY17 and FY19, the consumer EBITDA margin dropped approximately 3.5%, as against corporate's approximate 6.3% increase in EBITDA margin.

Consumer's EBITDA margin crunch is largely due to the transition to NBN, which has lower margins as well as increased competition. Therefore, Pre-TPG's EBITDA margin has dropped approximately 2.4% between FY17 and FY19. This is exclusive of a one-time, non-cash, impairment charge of $237m due to the company's decision to halt a nationwide 5G mobile network rollout.

During the same period total revenue decreased approximately 2.5%, roughly in-line with the decrease in EBITDA margin.

Vodafone brings the big Gs: 3G, 4G and 5G

Vodafone, which was 50% owned by Vodafone of the UK (LON:VOD) and 50% by Hutchison Telecommunications Australia (ASX:HTA), provided wireless communication services in Australia providing large coverage for both 3G and 4G networks and offers NBN broadband connectivity. As of 31 December 2019, VHA was the 3rd largest mobile network operator in Australia and in March 2020 launched its 5G spectrum offerings with the plan to rollout 650 sites across Sydney, Melbourne, Brisbane, Adelaide, Canberra and Perth. VHA's 5G rollout is expected to expand to a few thousand sites over the next couple of years.

Additionally, VHA has 99 company-owned stores and 226 exclusive dealers in Australia. However, 202 (62%) of those stores are located in New South Wales and Victoria. VHA has also had some problems recently as network customers declined 4.6% from 31 December 2018 through 31 December 2019. The largest drop was in pre-paid customers (8.6%). However, all customer categories saw a decrease during this period. This was largely due to increasing competition in the mobile network space and is likely to continue.

Squeezed EBITDA, falling subscribers, increased competition - all before COVID-19!

When the merger of Pre-TPG and VHA was proposed, the Independent Expert's report estimated annual synergies, on an EBITDA basis, of $200m to be fully realised in FY2023 or FY2024. Based on the combined EBITDA from the latest reporting from Pre-TPG and VHA, $200m represented approximately 10% of the total. This estimate was due to the compatibility of VHA and Pre-TPG's businesses allowing for cost cutting and cross selling. However, the last Pre-TPG guidance update was provided in March and it is uncertain how COVID-19 has impacted the success of the merger and if there will be issues or delays going forward.

While the company has now merged, both business segments (Pre-TPG and VHA) have issues with increasing competition and EBITDA margin pressure that will continue after COVID-19 has passed. Until the situation is clearer, we believe there are better companies to invest in at this time.

Currently, TPG is trading on an EV/EBITDA multiple of 11x forecast FY21 earnings. However, consensus is suggesting EBITA growth through the year of only 7%. We think that suggest strong potential for disappointment as the current year progresses. So only 2 stars from us right now.

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In 2020, its location, location and interest rates

Compared to FY19, the balance sheet improved in many ways during FY20, even despite COVID-19's first wave. Total occupancy by area has averaged at 97.8% between FY15 – FY20. It is still high at 98.1% and 79% of COF's rental income comes from multinational, ASX-listed and both state and federal government (25% government) tenants. While total occupancy did decrease by 0.3% from FY19, weighted average lease expiry (WALE) by gross income increased from 3.9 years in FY19 to an attractive 4.7 years in FY20. To drill down a little more into the WALE, 58.4% will expire in 2024 and beyond, up from 38.2% in FY19, and only 22.2% will expire through to FY22 versus 27.9% in FY19. So, we believe the WALE has clearly improved year-on-year.

Despite write-downs of approximately 1.1% from the last reported book value of 1.1%, there was positive news in the balance sheet. The interest coverage ratio covenant, as of FY20, is 2.0x. This basically means COF's loans have a condition in their contract that their interest coverage ratio (EBIT/Interest Cost) cannot be lower than 2.0x. During FY20 COF's interest coverage ratio increased from 4.1x in FY19 to 6.2x, due in part to COF decreasing their all-in interest costs from 3.2% in FY19 to 2.2% in FY20. Another important step COF took was to increase the hedge on their debt from 58% in FY19 to 75% in FY20. With interest rates at all-time lows and

COVID-19 bringing a high level of uncertainty, we believe it is smart for COF to take advantage and hedge their rates.

During FY20 COF's portfolio value increased from $1.4bn to $2.1bn. Included in FY20's portfolio increase were three acquisitions totalling $625m, leaving $61m of the increase due to organic growth. The three acquisitions were 100% ownership of an office building in Northbridge, WA and in Canberra, ACT, while the third was a 50% ownership purchase of an office building in South Eveleigh, NSW. The average annual yield on the three buildings is 5.6%, but more importantly, they have 100% occupancy by area and an 8-year WALE by gross income.

Heavy weighs the COVID-19 mask

COVID-19 has had its effect on COF, though management has declined to put forward guidance on FY21 funds from operations and has estimated that FY21's annual dividend, paid out quarterly, would be approximately $0.165 per unit, up from FY20's $0.178. While management did decline to lower the net tangible asset value of COF from FY19's $2.49, it is unclear how COVID-19 will affect the real estate market in the near to medium term. The company has already stated that valuations are hard to measure as the number of comparable data points has decreased.

Additionally, with Victoria entering a stage 4 lockdown again it is unclear how harsh that will affect the valuations and lease agreements in the state. By portfolio weighting Victoria is third highest at 17.2% and features a lower than average WALE of 3.3 years. One of the three buildings in Victoria is 100% leased by Target and according to the AFR on 4 August 2020, Target is forced to stand-down its non-online staff and is not eligible for the extended JobKeeper subsidy. Its hard to imagine this not having an effect on valuations and lease agreements in the near term.

So, what do we do now?

Currently, COF is trading at an approximate 21% discount to its NTA per unit of $2.49. However, the dividend is not franked, guidance has it decreasing and there is strong uncertainty surrounding the near to medium term stability of the NTA, as well as the funds from operations. The dividend might seem tempting during this time of exceptionally low-interest rates, but based on the current uncertainty, we believe the market's discount to NTA seems prudent. More clarity is needed, and for now, investors should remember that this too shall pass. Two stars from us.

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Share price chart

Source: Tradingview

End-to-end platform

Mach7 Technology is a provider of what's known as image management systems. The company sells a vendor neutral platform for archiving, communication and consolidation of unstructured data, i.e. medical images. The term vendor neutral is very important because there are at least a dozen large to very large suppliers of imaging equipment in the world, like Philips and GE, and a typical hospital will have imaging equipment from multiple suppliers on the workfloor. So radiologists need tools that help them work with all of the different data types and procedures.

Mach7's platform manages the data that is produced by a clinic's medical imaging equipment and serves it up to the right person at the right time. It also makes the data available to the wider network of all medical professionals that are dealing with a specific patient.

Integrating vertically

In addition to the imaging equipment companies and the providers of enterprise image management systems,

there is a third type of company active in the medical imaging market. And that's the PACS companies, PACS standing for Picture Archiving and Communication System. PACS companies are the viewing specialists that provide the tools to actually view and diagnose the medical imagery, e.g. on large screens or on handheld devices. Canada-based Client Outlook is one of only a very few of these independent viewing specialists. In July, Mach7 acquired Client Outlook for A$40.9m. Combining this company's eUnity diagnostic and enterprise viewer with Mach7's back end technology should make for a very attractive proposition for hospitals, clinics and universities that need a vendor neutral solution that can cope with different imaging brands. The acquisition should more than triple Mach7's addressable market.

Post-merger integration should be fairly smooth, especially on the technology side, given both companies have been working together for years and a number of platform integrations are already in place. Mach7 has retained outside help to assist with the overall integration of the systems and processes as well as to help both companies' align their respective cultures. The company expects to achieve at least A$2m in costs savings.

Solid fourth quarter

Mach7 had a pretty good fourth quarter, achieving $9.2m in new sales orders, helped by several big purchase orders, and $3.6m in free cash flow. The company received a purchase order from Hong Kong's Hospital Authority worth $4.8m, and a $4.2m order from Qatar's Hamad Medical Centre, spread out over 5 years. On top of that, the company also won some smaller contracts, including from the University of Michigan, worth $175,000 annually.

For FY20 as a whole, Mach7 expects to have achieved more than $18m in revenues. The company also announced that it was free cashflow positive in FY20 to the tune of $4.5m, its first-ever cashflow positive financial year.

Mach7 raised $22.9m (after costs) in Q4, largely to fund the Client Outlook acquisition, so the company's financial position per the end of Q4 was $48.9m. However, given the completion of the Client Outlook acquisition on 14 July, that cash position fell to approximately $19m in the middle of July. We believe this is more than sufficient for the time being, given that the company has become free cashflow positive. And although there maybe some quarters with a net cash outflow, e.g. due to fulfilment of certain orders or investments, we think Mach7 is in pretty good shape financially, especially since the company doesn't have any debt.

Growing fast

Since there are no reliable earnings forecasts available for Mach7, we'll have to make due with a rearview mirror approach and some back of the envelop calculations for FY21. Although not ideal, this will give us some sense of the company's valuation.

Based on FY20 revenues of "more than $18m", the company is currently trading at a trailing 12-month EV/Revenue of 11.1x. Year-on-year, Mach7 has roughly doubled its revenues in FY20. Let's assume that in FY21 the company can increase its revenues by "only" 50% autonomously, to around $27m. We need to add to that the revenue contribution from newly acquired Client Outlook, which Mach7 indicated achieved $8.8m in revenues in its own FY20 that ended in January. Client Outlook grew its revenues 48% on average in the last few years. So let's assume Client Outlook's revenues grew to $10.9m by the start of Mach7's new financial year and is able to grow that by 48% in FY21 to about $16m. That brings the company's pro forma revenue estimate for FY21 to around $43m. On that basis, Mach7's shares would currently be trading at an EV/Revenue multiple of 4.7x for FY21. Mind you, we have made a few assumptions around revenue growth in FY21. Hopefully Mach7 will provide some forward-looking guidance when it presents the full set of FY20 results on 27 August.

We believe 4.7x is very reasonable for a fast-growing, EBITDA positive technology company that has a substantially larger addressable market following the Client Outlook acquisition. So four stars from us.

Pitt Street Research Pty Ltd

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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.

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