STOCKS DOWN UNDER

20 AUGUST 2020

Stocks Down Under

> *Whenever I see a stock market explode, six to twelve months later you are in a full blown recovery.*

- Stanley Druckenmiller (b. 1953), American investor and hedge fund manager

COMPUTERSHARE LIMITED

A premium not worth paying

HEARTLAND GROUP HOLDINGS

A bank you can take to the bank

OM HOLDINGS

Recovery story, but wait a while

COMPUTERSHARE LIMITED

A premium not worth paying

Stocks Down Under rating: ★★

ASX: CPU
Market cap: A$ 7.3BN
Dividend yield: 3.3%

52-week range: A$8.27 / A$18.39
Share price: A$ 13.54

Computershare is a global financial administration company featuring 12,000 employees and over 25,000 clients across 21 different countries. With approximately 40% of their $2.31bn of annual revenue derived from issuer services, they are one of Australia's largest share registries. Despite COVID-19 pressuring its revenue, Computershare is still a cash generating machine and, therefore, has been able to maintain its FY20 dividend without sacrifice. While there are growth opportunities for Computershare, we believe the overall growth of the company will be hard pressed to pass five percent in the coming years. Therefore, the company does not warrant the current valuation, in our view.

READ MORE

HEARTLAND GROUP HOLDINGS

A bank you can take to the bank

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ASX: HGH
Market cap: A$ 639M

52-week range: A$0.90 / A$1.64
Share price: A$ 1.10

Heartland Group Holdings is an ASX and NZX dual listed New Zealand based financial services group with operations primarily in New Zealand, but also in Australia. Focusing on niche markets, like rural, households and business financing, Heartland Group is consistently more profitable than its peers in the New Zealand market. While it is unclear if investors should expect a dividend to be paid out for 2HY20, as well as in FY21, Heartland Group's current valuation, as well as growth and profitability profile make it an interesting stock for most portfolios, in our view.

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Share price chart

Source: Tradingview

COVID-19 has slowed the world down

Like most companies, Computershare has seen its fair share of earnings damage during COVID-19. Total revenue fell 1.9% on a year-over-year basis for FY20, driven largely by declines in corporate action revenue and margin income. Despite the unusually large number of capital raisings and other corporate actions on the ASX during 2HY20, corporate action revenue still fell approximately 13.8% on a year-over-year basis.

Unlike most companies, however, Computershare has a unique, adverse exposure to the economic cure offered by most countries. At approximately 10% of its annual revenue, margin income suffers when interest rates are low and, therefore, dropped around 18% on a year-over-year basis during FY20. With global interest rates generally predicted to stay low, or negative, until at least 2023, the chances of growth or recovery in this business segment are not high in the foreseeable future, baring any acquisition.

On the bright side, Computershare has rather successfully adapted its business to COVID-19 conditions. Despite over 90% of its workforce operating from home, there were no significant delays or cancelations of the initiatives started or announced prior to COVID-19. One important example is Computershare's long-term cost saving program, saving $50.2m during FY20 for a total of $130.3m since FY17. Additionally, the Equatex acquisition in 2018 has continued to be absorbed by Computershare successfully generating $7.2m in synergies during FY20 while its UK mortgage services business managed to cut $16.6m during FY20. Computershare also identified a further $15.5m stage three savings during 2HY20 to be realised by the end of the estimated $235.9m long-term cost savings program in FY23.

Organic growth is here to stay

Organic growth is an important measurement of the success a company is having in growing and competing against its rivals and competitors. Since organic growth excludes all increases due to acquisitions during the previous period, it allows investors to determine the extent a company is relying on acquiring companies to fuel its growth. In the case of Computershare, excluding margin income, solid organic growth is a staple across all revenue segments.

FY21 guidance released on 11 August 2020, expects full year revenue to increase between 2-5% organically with employee share plans, mortgage services and business services driving the growth. However, Computershare is facing significant headwinds going into FY21 from margin income, transaction activity and government action in the mortgage space.

Margin income is expected to be approximately $100m, a rather significant decrease from FY20 and this will be one of the main drivers in EPS dropping 11% to approximately $0.50 a share. However, excluding margin income, currency consistent EBIT is expected to increase approximately 10% year-over-year.

Generating cash like Scrooge McDuck

With an EBITDA cash conversion rate of approximately 91% during FY20, this last financial year has continued to show the cash generating power of Computershare. This was one of the main reasons Computershare made it clear during their FY20 conference call that a cut to the dividend was not anticipated in the foreseeable future.

However, despite its cash generation, the company still has significant debt holdings with total liabilities to total assets of 68.1% at 30 June 2020 and a drawn debt average maturity of 3.8 years. While Computershare's debt is still clearly manageable for the company, during COVID-19, as with any economic downturn, investors should continually be aware of a company's debt load compared to its assets. Computershare certainly has room to take on more debt and there is no cause for alarm, but Computershare's debt load has reached the point where we believe it needs to be monitored more actively going forward.

Valuation too high given the growth outlook

Over the last five years Computershare's compounded annual EBITDA growth rate has been 5.4% while its revenue has increased 2.9%. The difference being primarily driven by successful cost cutting and realised synergies in Computershare's businesses. Currently valued at an EV/EBITDA ratio of 11.8x, we expect Computershare's future growth will be lower as COVID-19 and continuing pressure on margin income take its toll. Consensus estimates indicate that EBITDA in both FY21 and FY22 will be below the FY20 level. Therefore, the we believe current valuation too high and it must be two-stars for Computershare from us.

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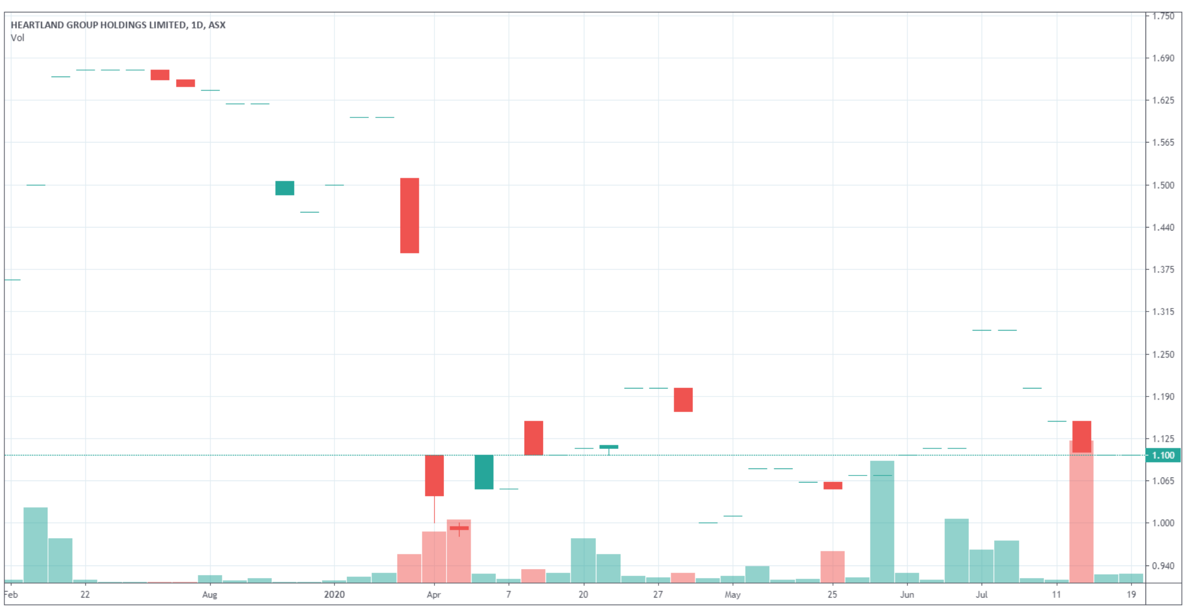

Source: Tradingview

Stable never sounded so good

The rating agency Fitch has recently reviewed a number of New Zealand banks and saw fit to downgrade a number of them to outlook negative. However, on 19 May 2020 Heartland Group received their review and Fitch decided to keep their rating, and outlook, unchanged. This was due in large part to their solid balance sheet and stronger profitability than its peers. In the era of COVID-19 and uncertain economic conditions, this was welcome news.

On 2 April 2020 the Reserve Bank of New Zealand ordered all registered New Zealand banks to refrain from paying out dividends for the foreseeable future in order to ensure banks are well capitalised and are able to support lending. However, due to the corporate structure of Heartland Group's listed entity it is not prohibited from issuing a dividend under the Reserve Bank of New Zealand's 2 April 2020 order, as laid out in their 11 August 2020 filling. Therefore, Heartland Group has stated, with no guarantees, that they are considering if a dividend is within shareholder's best interests for 2HY20.

Unfortunately, we will not find this out for some time as the 11 August 2020 filling's main function was to inform investors that, subject to an NZX class waiver due to COVID-19 complications, Heartland Group will not be releasing its FY20 results until 17 September 2020. There was no indication of significant concerns surrounding FY20's results and we believe it is not worth reading too heavily into the delay.

Happy balance sheet means happy life

As we mentioned above, Heartland Group's balance sheet is strong and has been strong historically as well. Nonperforming loans as a percentage of total loans over the last twelve months ending 31 December 2019 was only 0.6%. However, it has been higher at 1.5% during both FY18 and FY19. As of 31 December 2019, Heartland Group's coverage ratio was a strong 212.8%. The coverage ratio is used to determine a bank's ability to absorb losses from nonperforming loans and with low historical nonperforming loans as well as a high coverage ratio, investors can be confident in Heartland Group's ability to weather a loan crisis.

Heartland Group's gross finance receivables of approximately NZ$4.4bn are fairly evenly split between reverse mortgages (approximately 30%), business finance (approximately 25%), motor vehicle finance (approximately 25%) and rural finance (approximately 15%). Harmoney and other consumer lending is a small part at approximately 5% and is made possible through Heartland Group's partnership with Harmoney, an online-only personal loan platform servicing up to around $50,000.

Solid metrics for the new economy

As COVID-19 continues to envelope the world economy in a cloak of uncertainty, investors need to operate with an air of caution when it comes to banks, often referred to as the backbone of the economy. Fortunately for Heartland Group's shareholders the company boasts some impressive earnings power.

Because the Heartland Group has deferred FY20 earnings till September we currently can't discuss the company's earnings ratios. However, for the last twelve months ending on 31 December 2019, the Heartland Group provided a return on assets of 1.4% and a return on equity of 10.3%. When it comes to return on assets for a bank, investors should like to see at least 1%. For example, the Commonwealth Bank of Australia's return on assets for FY20 and FY19 was 0.7% and 0.8% respectively, while its return on equity was 10.5% and 11.8% respectively.

Even though the Heartland Group's return on equity is currently lower, it has seen a continual uptrend with FY18 and FY19 providing a return on equity of 8.3% and 9.8% respectively. Return on assets has stayed relatively stable at approximately 1.4% during FY19 and 1.2% during FY18. We realise all of these numbers can be mind numbing at times but unfortunately, when it comes to a bank, understanding these figures is crucial.

The last, we promise, important statistic to look at when evaluating a bank is its price to tangible book value ratio. Since tangible book value removes all intangible assets from the equation, this metric gives a powerful understanding of the premium a bank is currently trading at.

Trading at a discount, but deserves a premium

The Heartland Group is currently, as of the closing price of 19 August 2020, trading at a price to tangible book value ratio of 1.1x. For comparison purposes, the Commonwealth Bank of Australia is currently trading at a ratio of 1.9x. In other words, The Heartland Group is substantially cheaper.

However, the Heartland Group's portfolio is riskier than those at banks like the Commonwealth Bank of Australia. But with additional risk should come additional reward and we believe the Heartland Group is healthy and well capitalised.

While investors should not count on a dividend for 2HY20, there is a slight possibility management will decide to issue one. With its high return on assets, solid balance sheet and growing return on equity, the Heartland Group deserves a premium, in our view, which it is not currently trading at and therefore, we feel a four-star rating is in order.

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Share price chart

Source: Tradingview

OM Holdings is a vertically integrated maganese and silicon specialist, and is involved in mining, smelting and trading. It has mining operations in Australia and South Africa. And it has smelter operations in Quingdau in eastern China and its flagship smelter in the Malaysian state of Sarawak. OM produces sinter ores, manganese alloys and ferrosilican and the company has a significant trading operation based in Singapore. It has been listed on ASX since 1998 and for the past two years has produced revenues in excess of A$1bn.

Deferred capital expenditure

OM's main products are ferro-manganese, silica-manganese and ferro-silicon. All these products are for steel mill customers. They are used in crude and stainless steels as well as the kind of specialty steels used in car bodies, transformers and cast products, such as machinery parts and engine blocks. The company has many blue chip steel mills with customers such as POSCO, Hyundai Steel, JFE Steel and Nippon Steel.

OM has plans to expand in this 'metallic-silicon' space over the next two years. However, this will require capital expenditure of A$100m and because of the current market conditions, it has decided to delay this expansion for now.

A vertically integrated model

This company operates a vertically integrated model. That is, it sources its manganese from mines that it owns and operates in Australia and South Africa, which it then ships to smelters that it owns and operates in China and Sarawak. During boom times, this is a great model because miners can not hold you to ransom with supply and as a company you are able to control your production costs.

Unfortunately, when metal prices fall, the costs of mining and shipping ore can be more expensive than if you are buying the raw ore from another miner. Likewise, when you own your smelter, costs of production as well as running the smelter can exceed the cost of buying the finished product from a third party. OM has tried to mitigate this with a trading division, but there has been such a significant investment made in the mines and smelters that the company feels it has no choice but to continue operating under this model.

A weak pricing environment

Calendar 2019 was not kind to OM with EBITDA halving to $154.5m. The principal villain here was lower manganese prices. At the end of 2018 the manganese 'index price' (i.e. the benchmark as set by Metal Bulletin in London) was about US$7 per dry metric tonne ('dmt') whereas at the end of 2019 it was US$4.20 per dmt, which is roughly where it still is now. Mind you, OM sells a 28% manganese, while the index is 44% manganese. But you get the point. The same negative pricing dynamics were at work in ferro-silicon, which traded at US$1,250 – US$1,500 in 2018 and US$1,000 – USD$1,250 per metric tonne in 2019.

The good news is that OM's balance sheet can stand the strain. As at December 2019, OM had net debt of A$410m ($474m debt, $64m cash), which is a lot higher than the current market capitalisation of about A$252m. OM has actually been paying down debt and as 2019 ended, the debt/equity ratio was only 1.1.

COVID and managing the downturn

OM has done a tremendous job in controlling cashflows since COVID has begun and in the general environment of metal prices decreasing. In March 2020, the company shut down two of the furnaces at its Sarawak smelter and has deferred all non-essential capital expenditures. The board took the hard decision to defer half of the final dividend and will make a decision shortly on when this will be paid.

Over the past twenty years the company has built a solid reputation for mining, smelting and producing ferro-manganese and ferro-silican products for steel mills and associated markets. It has invested a considerable amount in the process, including its mines and especially in the Sarawak smelter in Malyasia.

Unfortunately, we believe the recent global events and prices of metal have put a burden on the company going forward. The company has solid cash reserves and should be able to weather the storm, though. Once the markets return to normal, so should the share price of this company. So, three Stars from us for now.

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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