12 OCTOBER 2020

ASX Top 200 Stocks Down Under

Never attribute to malevolence what is merely due to incompetence.

- Arthur Clarke, 1917-2008, British Sci-Fi writer

ASX

EXCHANGE CENTRE

NETWEALTH GROUP

One of the few lanterns in a fog of failure and incompetence

RELIANCE WORLDWIDE CORPORATION

Returning to normal after a waterfall event

METCASH

Breaking out of the dividend valuation shell

NETWEALTH GROUP

One of the few lanterns in a fog of failure and incompetence

Stocks Down Under rating: ★★★

ASX: NWL
Market cap: A$ 4.1BN
Dividend yield: 1%

52-week range: A$4.80 / A$18.17
Share price: A$ 17.95

Headquartered in Melbourne, the Netwealth Group provides superannuation and non-superannuation financial platform products to Australian investors and financial planning advisors. The financial platform industry has seen massive upheaval over the last couple of years as consolidation, scandals and giants falling from grace in this industry has been a constant splashed across the headlines. Few companies have stayed above the fray of this industry turmoil, but Netwealth is one of them. This has not escaped the market, however, and the company's share price reflects this special status.

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RELIANCE WORLDWIDE CORPORATION

Returning to normal after a waterfall event

Stocks Down Under rating: ★★★★

ASX: RWC
Market cap: A$ 3.4BN
Dividend yield: 1.6% (20% Franked)

52-week range: A$1.63 / A$4.76
Share price: A$ 4.32

Headquartered in the eastern Brisbane suburb of Eagle Farm, Reliance Worldwide designs, manufactures and sells water flow and water control products designed with the plumbing industry in mind. The COVID-19 equities rout hit Reliance Worldwide particularly hard with the stock falling almost directly from its 52-week high of $4.76 to its 52-week low of $1.63. While the company's share price has almost entirely recovered, and the stock is closer to fair value than it was in March, there might be a little more to go on this one.

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METCASH

Breaking out of the dividend valuation shell

Stocks Down Under rating: ★★

ASX: MTS
Market cap: A$ 2.9BN
Dividend yield: 4.4%

52-week range: A$2.17 / A$3.47
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Headquartered in Macquarie Park, Sydney, Metcash is a wholesaler of food, grocery items, liquor, hardware and automotive products to independent retailers. FY20 was a challenging time for Metcash as the company was first hit by the bushfires and then the COVID-19 pandemic. The company still managed to beat EBITDA consensus in FY20 and the Total Tools acquisition may provide additional growth going forward. Metcash remains, however, a slow-growth company.

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Share price chart

Source: Tradingview

I live under a rock, what's been going on?

Netwealth taps into two different major ongoing developments: the continued drastic expansion of Australia's financial resources due to Superannuation and the reckoning Netwealth's industry is experiencing.

Australia is home to the fourth-largest pension pool of capital in the world due to our Superannuation system. Over the last 10 years our total pension assets have seen a CAGR of 10.2%, one of the fastest growth rates in the world. When taking into account Australia's ranking as the 55th largest nation by population size (according to the United Nations), Superannuation has truly allowed Australia to punch well above its weight. This capital pool is predicted to grow from the current $1.9tn to $7tn by 2035 and a significant portion of these assets are invested in the Australian capital markets. Netwealth's platforms fall squarely within the main benefactors of this economic might: Superannuation funds and Australian financial products.

The meek shall inherit Australia's fund inflows

At the end of FY20, the top ten platform providers by market share of Funds Under Administration comprised of Westpac (18.4%), AMP (16%), CBA (15.2%), NAB (13.4%), Macquarie (10.4%), IOOF Group (8.8%), Netwealth (3.8%), Mercer (3%), HUB24 (2.1%) and Xplore Wealth (1.8%).

Behold, the invisible hand of the market said the meek shall inherit Australia's fund inflows and it was so. FY20 saw a continuation of an apocalyptic financial industry trend - of the top ten platform providers listed above, only Netwealth ($9.1bn), HUB24 ($4.9bn), Macquarie ($3.2bn) and Xplore Wealth ($0.7bn) saw positive net fund flows. In fact, the smallest loss of net funds of those top ten platform providers was CBA losing $1.2bn. This trend started with the Royal Commission and we believe this will likely continue over the next couple of years.

Netwealth has proven that it is able to grab the largest portion of the funds up for grabs and with AMP (ASX:AMP) most likely to be sold for parts in FY21 (see our AMP update published in our 11 September 2020 edition) we believe Netwealth will be in a strong position to take advantage of the continuing industry Armageddon.

HUB24 is Netwealth's most relevant competitor and peer

HUB24 is the most relevant peer and competitor to Netwealth due to the comparable commitment to technological advances and success in attracting high levels of net fund flows. From a Funds Under Administration growth perspective, Netwealth is growing faster than HUB24 with an increase of around 48.1% during FY20 compared to HUB24's 27.9%.

However, HUB24's EBITDA growth is significantly higher than Netwealth's, with consensus FY21 estimates putting HUB24's EBITDA growth at around 30.2% and Netwealth's at 17%. However, it should be noted that part of the reason HUB24 is able to grow its EBITDA faster than Netwealth is that HUB24's margins are significantly lower than Netwealth and, therefore, margin expansion is partially fuelling growth. Netwealth, on the other hand, has a stable EBITDA margin, an efficient 52% compared to HUB24's 22.4% during FY20.

Netwealth is the place to be, but is not cheap

For investors looking for exposure to Australia's growing financial platform industry, it is hard to find a better company than Netwealth. While HUB24 is held in high regard in the equity market, Netwealth is more established, has a larger portion of the market and is likely to remain in a leading position compared to HUB24 as Netwealth has been able to capture more of the funds being withdrawn from its larger competitors.

While Australian's Superannuation system will continue to provide significant growth to the financial product platform industry for years to come, we believe the capital flight from the more established companies won't last forever. Therefore, if Netwealth can continue to grab the largest portion of these newly available funds, we think it will provide the company with an invaluable competitive edge over the competition.

Netwealth definitely deserves a premium to its competitors and comparing it to HUB24 presents as expected. From a consensus FY21 P/E perspective, HUB24 is currently trading at 75.4x compared to Netwealth's 82x. From a Price to Tangible Book persepctive, as of FY20 HUB24 is trading at 36.3x compared to Netwealth's 54.2x.

Taking all of this into account, we believe Netwealth shares are certainly very interesting for the long term. However, we also believe the market has realised this and the current share price already reflects a large portion of the company's potential. Therefore, we would advise investors to place Netwealth on their watchlist and wait for the stock to pull back somewhat. Consequently, we are issuing a three star rating at this time.

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Share price chart

Source: Tradingview

Never underestimate the value of unassuming essentials

There are few parts of your house or apartment that, if they break, could cause the whole building to collapse. Pipes and other water and plumbing fixtures, such as valves, are at the top of that very short list. Every building, with very few exceptions, requires some form of pluming and water connection. Therefore, Reliance is an interesting example of both a global housing boom play while also encompassing the main aspects of a consumer staple product.

Reliance's products include water and pipe fittings, valves integrated installation solution, FluidTech (a proprietary product) and piping. All of these products are a main staple in nondiscretionary building maintenance spending and often one of the least likely areas to be deferred due to financial issues. Therefore, Reliance's global leadership position, as the top five producer of a large portion of its products in its supported markets, means sales are relatively "recession proof" due to their nondiscretionary nature.

However, Reliance's consensus EBITDA average growth rate of 6.8% in the next five years, will be largely dependent on new building construction and discretionary property improvement rather than normal maintenance, replacements and upgrades.

After looking across the United States from 1995 through 2019, the company has found a strong correlation between home values, home sales and corresponding increases in home improvement expenditure. More importantly to Reliance's product line, existing home sales as well as bath and kitchen remodels were also found to have a very high correlation across the same time frame in the United States. So, Reliance can expect sales to be boosted by a booming housing market, while still expecting a bottom in demand if the housing bubbles eventually bursts.

The first quarter of FY21 presented a solid flow

On 1 October 2020, Reliance Worldwide provided the market with an update for the first quarter of FY21.

On a constant currency basis, sales in the experienced strong growth during July, August and September at 22%, 15% and 29% respectively. However, a large portion of this can be directly attributed to the outsized performance of the United States division.But due to a lack of additional stimulus packages, management does not expect to see FY21 results continue in this fashion.

Sales in the AsiaPac division were among the most disappointing as Australia continues to see significantly lower housing and dwelling construction approvals. Australia is Reliance's main market in AsiaPac and any infrastructure focused recovery, like in the recent budget proposal, will certainly be a significant boon for the company. Sales in July, August and September saw year-over-year increases of 5%, -2%, and 4% respectively.

The EMEA division saw recovery in volumes as the UK and Continental Europe saw declines in COVID-19 cases and relaxed some restrictions.However, more recently there has been another uptick in cases. Therefore, we are cautious about the full year FY21 performance of this division. Additionally, the September uptick in sales was mostly due to partners restocking inventory rather than drastic increases in end demand. July, August and September sales growth in EMEA were -4%, 5% and 24%, respectively.

A solid company which never should have gone so low

If you need any more proof that markets are not perfectly efficient than take a look at Reliance Worldwide's share performance during the COVID-19 crash. In around a month the stock declined around 63% after hitting its 52-week high. However, the company has since rallied to right below its 52-week high or an estimated FY21 EV/EBITDA of 13.6x.

Is 13.6x too high? Probably not just yet, because EBITDA is also expected to grow at a low double digit level. Sure, in the September quarter US growth may be outsized, but just a return to 'normal growth' there bodes well for overall earnings at Reliance given how well the company has executed here. That's not to say this stock is without risks, and the key risk, in our view, is that growth expectations in a fiscally-constrained post-Covid world may become unrealistic. However, as the latest Australian government budget proposals will have illustrated, governments everywhere are tending to err towards over-stimulus. So investors should watch Reliance carefully. However, for now we're giving it four stars.

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Share price chart

Source: Tradingview

With a dividend strategy, boring is good

All in all, Metcash's operations have consistently provided solid but rather boring results. Between FY16 and FY20, sales revenue grew only 2.1% on average, while EBIT grew 2.5% annually across the same period.It is impressive, though, that throughout the bush fires and COVID-19, EBIT only declined 1.8% while revenue saw an increase of around 1.8%. Overall, FY20 presented a solid performance in the face of major business interruptions.

Moving forward, consensus estimates have Metcash's business growing at around the same rate as seen in the last few years, i.e. around 2%. This means that Metcash will continue to operate as a solid, fully franked, dividend play as it has been over the last three years providing $0.13 a share in FY18, $0.135 a share in FY19 and $0.125 for FY20. However, if the company can bring its Hardware division strategy to its new Total Tools acquisition, it would go a long way to shedding the its historical, dividend based, valuation in favour of a higher, growth based, valuation.

Total Tools acquisition a total success

On 1 September 2020 Metcash announced the successful completion of the 70% acquisition of Total Tools for $57m. The acquisition price also included a number of put and call options allowing/forcing the purchase of the remaining 30% of Total Tools. It is unclear as to what portion of the remaining 30% Metcash could purchase in early 2024. Management expects Total Tools to generate an annual EBITDA of $12.6m, which, at 70% ownership, means an increase in Metcash's annual EBITDA from the acquisition of around $8.8m.

Overall, we believe the Total Tools acquisition will provide a strategic addition to Metcash's portfolio of companies and a strong next step after the success of its Independent Hardware Group. We should expect more moves from Metcash in the next couple of years as management continues to pursue a strategy of independently-owned and joint venture retail stores as the company looks to replicate its success in hardware. Lastly, it is important to note that Mark Laidlaw has been appointed Chairman of the Total Tools board.

Mark Laidlaw is the former Metcash CEO who shaped the strategy and success of the Hardware division Metcash is attempting to replicate here. He is coming out of retirement for this position.

Metcash a solid company with a solid plan

We believe Metcash is a solid company with a solid plan. The Total Tools acquisition, and Mark Laidlaw's willingness to come out of retirement, are a sign that this company is moving away from being just a dividend play and intends to get back to solid growth. However, Total Tools is currently only estimated to contribute around 2% of FY21's consensus EBITDA and Metcash has not announced any additional ventures just yet. The company is definitely one to watch going forward as we are optimistic about its ability to replicate the Hardware division's success with Total Tools and then expand the strategy to other, industry related companies. However, until this new initiative begins to present a potential timeline as to when it will generate a sizable enough chunk of annual EBITDA to fuel growth, we have to rate the company based on its current form.

If Metcash is valuable for anything right now it is dividends. The company's cash flow is consistently high enough to have an operating cash flow payout ratio of between 40-50%, excluding FY20 due to the bush fires and COVID-19. Right now the dividend yield is 4.4%.

What Metcash is not good for right now is growth. The company has a relatively low consensus FY21 EV/EBITDA ratio at 7.2x. However, its estimated EBITDA growth is only 2.3%. That's a little too slow, in our view.

We will repeat, however, that the Total Tools acquisition and the strong indication from management that this is only the beginning of a new strategy are highly favourable indicators. At this time though, we do require more information and execution before changing our view that this is still a two star stock.

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