STOCKS DOWN UNDER

7 SEPTEMBER 2020

Stocks Down Under

"Investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas'."

- Paul Samuelson (1915-2009), American economist

VICINITY CENTRES

I don't want to be anywhere in this vicinity

OBJECTIVE CORPORATION

Backed by government purchases

NAVIGATOR GLOBAL INVESTMENTS

The price is too right

VICINITY CENTRES

I don't want to be anywhere in this vicinity

Stocks Down Under rating: ★★

ASX: VCX
Market cap: A$ 6.6BN

52-week range: A$ 0.91 / A$2.72
Share price: A$ 1.39

Vicinity Centres is the second largest retail property manager listed on the ASX with approximately $24bn in retail properties under management. The headquarters are in Chadstone in suburban Melbourne. While Vicinity Centres has 64 shopping centres in its portfolio, the company has a direct interest in 60 and manages 32, of which it has an interest in 28. Investors often need reminding that bigger is not always better. That saying is perfectly embodied by Vicinity Centres.

READ MORE

OBJECTIVE CORPORATION

Backed by government purchases

Stocks Down Under rating: ★★★★

ASX: OCL
Market cap: A$ 1.2BN
Dividend yield: 0.6%

52-week range: A$3.80 / A$12.50
Share price: A$ 11.89

Objective Corporation's slogan is 'Great governance - Better business.' The company achieves this by offering nine software products specifically designed for common problems or manually intensive tasks governments and certain businesses undertake on a daily basis. This software increases the ease, security and efficiency with which such tasks can be accomplished. While many companies have needed to preserve capital by cutting their dividends and buybacks, Objective Corporation increased its dividend and has embarked on a massive buyback. While Objective Corporation may seem expensive when you peel back the layers, you find a stock ready to run.

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NAVIGATOR GLOBAL INVESTMENTS

The price is too right

Stocks Down Under rating: ★★★

ASX: NGI
Market cap: A$ 261M
Dividend yield: 12% (Unfranked)

52-week range: A$1.13 / A$3.64
Share price: A$ 1.62

Navigator Global Investments is the ASX-listed parent company of Lighthouse Investment Partners, a United States-based hedge fund solutions manager with a 24-year track record. Since its high of approximately $6 a share in August 2018, the stock has been in an almost constant downward trend, falling around 74% over the last two-years. Despite this, the current average price target as per consensus shows a potential 43% gain over the next 12-months. We are not so sure that seems reasonable as the hedge fund industry continues to go through a major global transformation.

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Share price chart

Source: Tradingview

The tentacles reached across Australia, but the head was in Victoria

As of 30 June 2020, Vicinity Centres had a direct ownership in 60 shopping centres. One of them is the legendary Chadstone Shopping Centre, the super-regional about 18 km from Melbourne’s CBD that Melbournians know as ‘Chaddy’ and is the largest shopping centre in the whole of Australia.

Owning part of a shopping centre in Melbourne is not something to write home about right now, even if it’s Chaddy. Concerningly, Vicinity’s centres are highly localised in Victoria with 54% of the company’s directly owned property value situated in that unhappy state. What’s more, of those 22 retail centres, 20 are located in the Melbourne area, and 10 of those are wholly owned by Vicinity Centres. Clearly, Vicinity Centres has a high exposure rate to the hard, and ongoing, lockdowns in Melbourne and to a lesser extent Victoria. While the number of new cases in Victoria was ‘only’ 70 on 1 September 2020, a significant decline from only a few weeks prior, Victoria is still in the frying pan despite having removed itself from the fire. Therefore, we are concerned that the 30 June 2020 property devaluation from COVID-19 of 11.3% might not be the only significant devaluation in Vicinity Centres’ future.

While there remains concern surrounding the valuation of Vicinity Centres' property portfolio in the short to medium-term, the company's FY20 results had one significant bright spot - the balance sheet. After completing a $1.2bn equity raise in 2HY20, issuing $812m of 10-year term notes, extending its average debt maturity, and maintaining its A/stable and A2/negative ratings from S&P and Moody's respectively, it's fair to say that Vicinity Centres' liquidity is strong. This is why the company's quick ratio is extremely high versus previous years at 0.9x for FY20 while FY19 and FY18 were at 0.1x and 0.2x respectively. Vicinity Centres has been able to maintain a low quick ratio historically due to the fact that it usually maintains a cash from operations to current liabilities of over 1.0x.

Now you might be saying, "wait a moment what do all of these ratios mean?" We understand these terms can be confusing, so we are going to take a moment to explain. The quick ratio is rather simple, you just take cash and short-term investments, add accounts receivable and other receivables, and divide the sum by total current liabilities. Basically, it tells an investor how much the company needs to rely on operating cash flow, debt, or equity dilution to pay off the liabilities that are due within the next 12-months. Meanwhile, the cash from operations to current liabilities ratio simply divides the total cash from operations found in the statement of cash flows by the liabilities due within the next 12-months. If the ratio is greater than 1.0x, that means the company can pay off its short-term liabilities with cash generated during that period.

No, the sky is not falling. It's just dropping a little at a time…

As many investors know, brick and mortar retail has been struggling to adapt to online retailers like Kogan.com (ASX:KGN). This has led to a slow, but steady, decline in the revenue of certain retailers and therefore, has bled into the rents traditional shopping landlords have been able to collect. As the second-largest listed retail property manager in Australia, Vicinity Centres has certainly not been immune. Excluding the devaluation the company had to take on 30 June 2020 - as this was mostly due to the effects of COVID-19 - Vicinity Centres' net portfolio valuation has been consistently in decline. For example, for the 6-months ending 30 June 2019, the company reported a decline in net portfolio valuation of 1.3%. While it is important to note there are a number of standout properties not in decline, like Chadstone and Vicinity's Melbourne and Sydney CBD assets, many of Vicinity Centres' retail centres (say that ten times fast) have suffered from the steady decline in physical space retail. This was an ongoing concern prior to COVID-19 and will remain for investors after COVID-19.

A bruised apple at a discount is not always good to eat

Vicinity Centres is currently trading at an approximate 39% discount to its net tangible asset value as of 30 June 2020 and while that may seem like a wonderful price we disagree. Between 30 June 2017 through 30 June 2020 the net tangible asset value per security has declined 19% while the devaluation from COVID-19 was only 11.3%. We are concerned that a decent portion of Vicinity Centres' properties have larger issues outside of COVID-19 and with the situation in Victoria still concerning, we believe another significant devaluation is likely at the six-month asset valuation due on 31 December 2020. Therefore, we are forced to rate Vicinity Centres two out of five stars.

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Share price chart

Source: Tradingview

Let's break this company down

Objective Corporation's software portfolio consists of nine products: Objective ECM, Objective Trapeze, Objective OpenGov, Objective Ministerial, Objective KeyStone, Objective Inform, Objective Perform, Objective Connect, and Objective Redact. The majority of these software products are specifically designed for government use; however, there are uses for big corporations that require similar security, collaboration, and disclosures as government agencies. The success of these products is evident by the significant growth in recurring revenue between FY16 (62% of revenue) and FY20 (75% of revenue) featuring a Compound Annual Growth Rate (CAGR) of 11.3%. Recurring revenue growth is a large part of Objective Corporation's rapid expansion as it allows the company to plan better and focus on additional growth markets. While the CAGR of recurring revenue over the last five years was over 11%, FY20 saw the growth rate double that, at 22%. Not only is Objective Corporation's organic growth plan working successfully, but the company's suite of products are keeping its customers coming back for more on a regular and predictable basis.

It’s all about the two Bs: Balance sheet and Buybacks

Objective Corporation had a pristine balance sheet as of 30 June 2020 - with the exception of lease liabilities, Objective Corporation has no long-term debt. In fact, cash and cash equivalents alone could pay off 80% of the company’s total liabilities and including trade and other receivables the percentage increases to 97%. This high liquidity is not due to equity dilution or debt that has been paid off but rather the high rate of net cash from operating activities which Objective Corporation reports on an annual basis. During FY20 and FY19, net cash from operating activities was approximately 46% and 50% respectively. The company’s high reliance on government agencies for revenue has allowed a high resistance to the effects of COVID-19.

While many companies have revoked dividends and buybacks due to the consequences of COVID-19, Objective Corporation actually increased its annual dividend from $0.06 in FY19 to $0.07 during FY20. As well, it instituted a buyback program starting on 25 August 2020 and ending on 24 August 2021 that is slated to purchase approximately 10% of the company’s outstanding shares. This massive buyback can potentially support the stock price and also enhance the effects of any good news the company releases in the coming year. When an investor sells Objective Corporation stock at this time, they are effectively selling it back to Objective Corporation. Buybacks of this magnitude are rare, and due to Objective Corporation’s highly liquid balance sheet and operating cash flow, unlikely to be cancelled during FY21.

So how does the valuation make sense?

Now for the bad news: This company is currently trading at an FY21 estimated EV/EBITDA ratio of approximately 48x. Meanwhile, Objective Corporation’s EBITDA growth for FY21 is excepted to be approximately 35% according to consensus estimates. However, in this specific case, we believe this valuation holds up for three main reasons. The first is the excellent state of the balance sheet and cash flows. When a company is fiscal shape this good, you can never discount the possibility of major capital expenditures or acquisitions coming down the pipeline. While you should not assume this will happen, the possibility means the company deserves a premium. The second reason is the massive buyback program as well as the continual increase in its annual distributions. We believe these two things on their own would likely warrant the premium being demanded by the market today. And, of course, the growth in recurring revenue and the strength of its highly government-based clientele is an excellent proof of concept and platform for Objective Corporation to grow both its client base and suite of products. Taking all of this into account, we believe the only possible rating for Objective would be Four Stars.

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Share price chart

Source: Tradingview

What is a hedge fund solution manager anyways?

Navigator Global Investments is the holding company for Lighthouse Investment Partners, whose investment strategy is to run a 'fund of funds'. Which is to say, Lighthouse picks the fund managers it likes, and places between 8% and 25% of its funds with any one of those hand-picked fund managers.

Navigator Global Investment's Assets Under Management peaked in July 2018 at approximately US$16.7bn and has been steadily declining since then to the current US$11.8bn. One of the main macroeconomic factors affecting the global world of fund managers has been the seismic and consistent shift from active managers to passive managers since the Global Financial Crisis. To quickly clarify, active managers are significantly different from passive managers in two main ways, the first being that active managers charge substantially more in fees and the second being that passive managers follow a strict set of guidelines and rarely touch their portfolios. One of the most common examples of a passive management fund are index funds like the BetaShares Australia 200 ETF (ASX:A20) which tracks, within reason, the performance of the 200 largest companies by market capitalisation listed on the ASX. The fees on this fund are 0.07% per annum, significantly

lower than any active fund. For these reasons, as well as the global active management industry performing so poorly during the Global Financial Crisis, many investors have been removing money from active managers. This has been especially true among United States pension funds which is a concern for Navigator Global Investments as its main investor is United States-based pension funds. Looking at Assets Under Management as at 30 June 2020, 67% of Navigator's investors were based in the Americas (mostly the United States), and 58% of its investors were pension funds. During 4QF20, investors in Navigator Global Investments took approximately US$1bn out of the fund as clients sought to reduce their exposure to hedge funds.

It's all about the dollar bills

The revenue split for Navigator Global Investments does not paint a promising picture. Approximately 86% of the company's revenue was derived from management fees during FY20, down from around 92% during FY19. While this might seem like a positive trend, total revenue actually declined approximately 12% during FY20 on a year-over-year basis while operating revenue declined around 21% year-over-year due expenses declining at a substantially reduced rate to revenue. In effect, all of Navigator Global Investments' revenue comes from management fees and therefore, the continued decline in its Assets Under Management is a worrying trend in line with the global fund industry.

One positive note remains the solid financial position Navigator Global Investments finds itself. Featuring cash of approximately US$27m and total liabilities of around US$23m, there is no ongoing concern for the company's financial position. Meanwhile, cash flow remains high, with dividends paid out during FY20 consisting of around 87% net cash from operating activities. Since the company does not partake in any activities that would require significant use of the cash flow on a regular basis, this high rate of distribution makes sense to us and signifies that the dividend is safe for now.

Sometimes the market just knows what's going on

Despite the rosy price targets issued by analysts looking at this stock, we are not convinced. FY21 EBITDA is estimated to continue its decline, and we find it difficult to believe Navigator Global Investments will be able to stifle the decline in Assets Under Management in the mid-term. However, we also believe that the 74% decline since its share price high in 2018 has taken most of the negatives into account. While we don't see much upside, we also don't see much downside. The global hedge fund industry is trending towards lower fees and significantly more competition, as investors demand better results for the disparity in fees they are paying compared to passive managed investments. Taking all of this into account, we believe that the best rating for Navigator Global Investments at this time is Three Stars.

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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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