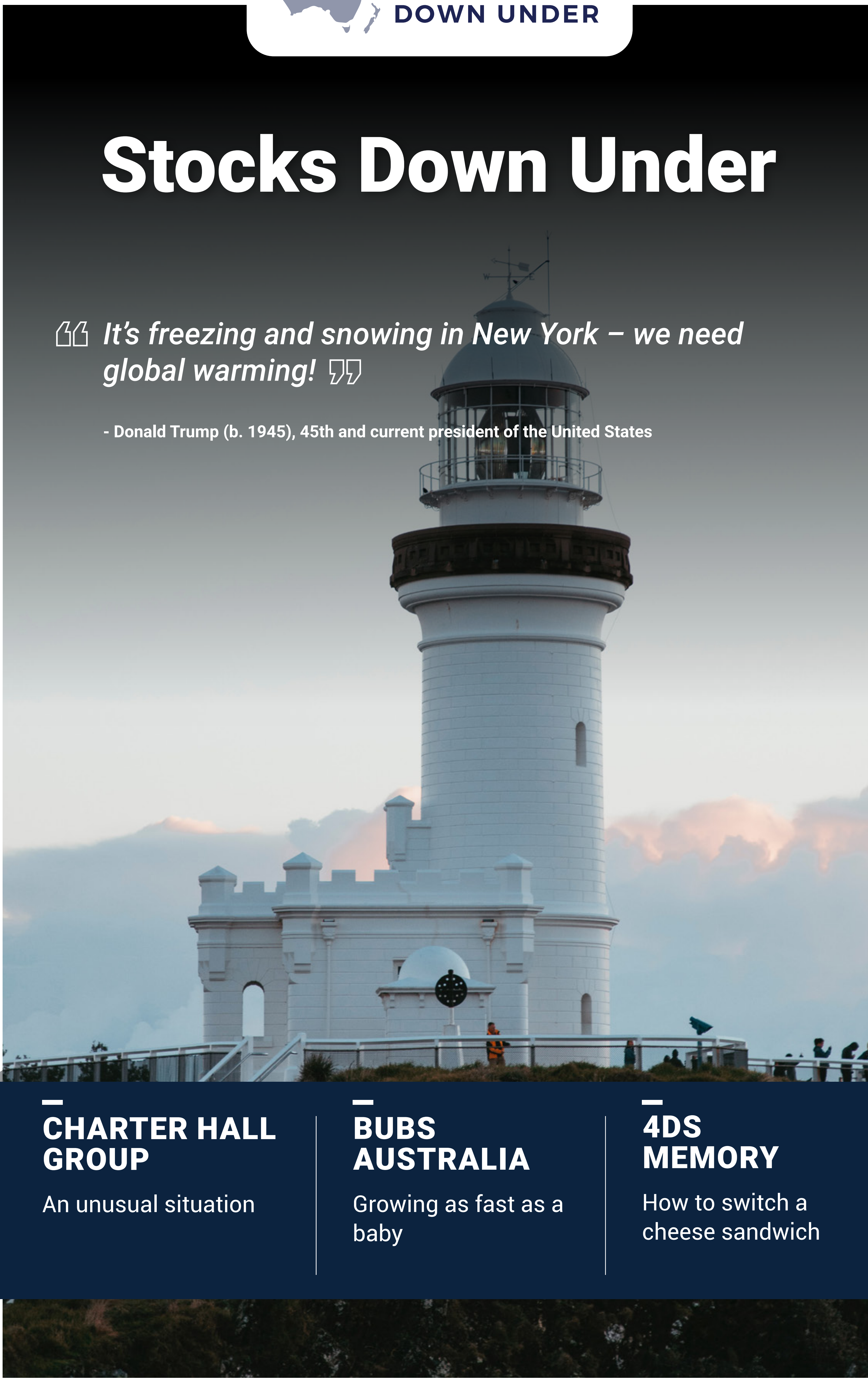
STOCKS DOWN UNDER
15 SEPTEMBER 2020

Stocks Down Under



It's freezing and snowing in New York – we need global warming!

- Donald Trump (b. 1945), 45th and current president of the United States

CHARTER HALL GROUP

An unusual situation

BUBS AUSTRALIA

Growing as fast as a baby

4DS MEMORY

How to switch a cheese sandwich

CHARTER HALL GROUP

An unusual situation

Stocks Down Under rating: ★★

ASX: CHC
Market cap: A$5.8BN
Dividend yield: 2.9%

52-week range: A$4.93 / A$14.40
Share price: A$ 12.32

The Charter Hall Group can be described as two separate, but related businesses. The first is the property investment division, which currently owns 1,027 properties across Australia and New Zealand. The second is the property funds management division, which manages properties both for the Charter Hall Group and other entities. As most of the Charter Hall Group's properties are in NSW, it makes sense that its head office would be in Sydney. The Charter Hall Group is a well-run company with solid, long-term rental properties and we believe the market has priced it accordingly.

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BUBS AUSTRALIA

Growing as fast as a baby

Stocks Down Under rating: ★★★

ASX: BUB
Market cap: A$ 480M

52-week range: A$0.40 / A$1.38
Share price: A$ 0.79

Bubs Australia is a pre-profit, Australian producer of infant formula, organic baby food, children's vitamins and goat dairy products. The vast majority of both Bubs Australia's sales and growth is derived from infant formula. Despite being headquartered in Melbourne, and the vast majority of revenue being derived from Australia, China remains the largest platform for growth as continual food quality scandals in China have fed the demand for 'Australian premium' baby formula. However, we believe there is too much uncertainty around the geopolitical situation with China and Australia right now.

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How to switch a cheese sandwich

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Semiconductor technology company 4DS Memory (ASX:4DS) is officially based in Perth, WA, but most of the company's development work is done out of Fremont, California, right in the heart of Silicon Valley. The company backdoor listed on ASX in 2015 and is developing a new way to store digital information using a technology called Interface Switching ReRAM. While shares of sector peers BrainChip (ASX:BRN) and Weebit Nano (ASX:WBT) have had a good run recently, 4DS' shares have been lagging. Is 4DS ripe for a re-rate?

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Solid company but overpriced

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Share price chart

Source: Tradingview

Owning land is one of the oldest forms of wealth

Charter Hall Group's property investments span across Australia and New Zealand consisting of 1,027 individual properties as of 30 June 2020. Approximately 81% of the group's properties are based on the east coast of Australia with 42% of those located in New South Wales. While Charter Hall Group's property portfolio does have exposure to Victoria, the vast majority (77%) of the portfolio is based outside of Victoria and, therefore, outside of Australia's major COVID-19 hotspots.

As of 30 June 2020, the estimated value of the Charter Hall Group's property portfolio is approximately $2bn. This is further split into five distinct categories, SC retail (11.2%), long Weighted Average Lease Expiry retail (19%), office (42.6%), industrial and logistics (16%) and social infrastructure (11.1%). Despite the negative press surrounding 'the demise of offices,' the property portfolio's average occupancy between the end of FY19 and FY20 declined only around 0.1% to 97.6%. While at first glance, this could be attributed to the long weighted average lease expiry of the Charter Hall Group's property portfolio, we believe this would be an incorrect assumption.

The company's property portfolio's Weighted Average Lease Expiry (WALE) increased from 7.6 years at the end of FY19 to 8.7 years at the end of FY20. Combined with the high average yield of 6.2%, we feel confident in stating that the Charter Hall Group's property portfolio is significantly stronger than many of its other large-cap Real Estate Investment Trust peers, such as Vicinity Centres (ASX:VCX), which we rated two out of five stars on 7 September 2020.

One other important point relating to Charter Hall Group's property portfolio is its stated goal of achieving 0% net emissions by 2030. Now, we do understand that some investors might view this as a purely political move. However, our response to this view is a reminder of the significant shift among the global passive investment and superannuation funds into Environmental Social and Governance focused investments (more commonly known as ESG Investments). We believe large companies adapting to this trend early on will help stave off potential activist attacks.

To own or to manage Charter Hall answers the question: the answer is both.

Funds Under Management grew approximately 33% from the end of FY19 through the end of FY20, to around $40.5bn. The majority of this growth came from new business, approximately 50% of which was from office buildings coming under the management of the Charter Hall Group. Due to the magnitude of Funds under Management it should come as no surprise that the vast majority of the company's consolidated EBITDA is derived from the property management division.

The property management division derives most of its revenue from two main sources, investment management revenue and property services revenue, with the vast majority coming from the investment management side. This division also saw an incredible FY20 as revenue from investment management fees increased by 69.8% year-over-year. While Funds under Management provided a significant increase to Charter Hall's management fee revenue, an approximate 112% increase in transaction and performance fees was due almost entirely to the acquisitions that led to the sharp increase in Funds under Management. This is why management issued a FY21 post-tax operating earnings per security guidance of a decline from $0.693 for FY20 to around $0.51.

An interesting valuation conundrum

The Charter Hall Group requires an interesting valuation approach, unlike many other property investment companies, the Charter Hall Group requires splitting its two revenue divisions. The reason for this is since the Charter Hall Group has both an asset driven property investment portfolio, which can be properly valued through its Net Tangible Asset value per share, and a EBITDA driven property management division, we need to split the EBITDA earnings from the tangible assets. As of 30 June 2020, the property investment division had a net tangible asset value of $4.28 per share, or approximately $2bn. Therefore, in order to accurately calculate the estimated FY21 EV/EBITDA of the Charter Hall Group, we have subtracted $2bn from the current Enterprise Value. This gives us an estimated FY21 adjusted EV/EBITDA ratio of 12.6x. We believe this valuation overestimates the earnings potential of the Charter Hall Group for the next couple of years. Therefore, we give the shares two stars out of five.

However, there is a caveat to our two star rating. Due to the upheaval in the Australian property market caused by COVID-19, the next couple of years are uncertain and could easily see a significant increase in purchases and sales providing a boost to Charter Hall's transaction and performance fees. As shown during FY20, a sharp rise in revenue from this segment does not cause a comparable boost to expenses, and therefore, this would cause a sharp increase in EBITDA. For now, however, we believe two stars is appropriate.

BUBS AUSTRALIA

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Share price chart

Source: Tradingview

Many products, one revenue driver

Bubs Australia has six major products lines, infant formula (55% of revenues), adult goat milk powder (26%), fresh goat dairy (6%), organic baby food (5%), raw materials (4%) and canning services (4%). Infant formula is the key driver behind Bubs Australia's revenue growth and drive towards profitability in FY21. This has also helped the company make significant progress towards its goal of a gross margin of at least 40% by 2025 as infant formula's margin is one of the company's strongest. During FY20, Bubs Australia achieved a 3%-points increase in its group gross margin to 24%, despite the supply chain disruption from COVID-19 and the company's expansion in domestic retailers.

The company's three main markets are Australia (67%), China (23%) and other international (10%). While Australia has seen continual sales growth, the main star over the last couple of years has been China. During FY20 Australia, China, and other international saw a year-over-year increase in revenue of 9%, 32% and 501% respectively. China is an especially interesting case as 'Australian premium' baby formula, and related food products are highly sought after following a series of domestic food quality scandals over the last five-years. This trend is unlikely to abate unless the central government itself gets involved for geopolitical reasons, a situation that recently has entered the realm of possibility.

While that may seem counterproductive to some, we remind investors that China has a strong, and recent, history of lashing out at individual companies and industries instead of more conventional geopolitical tactics. One of the more recent examples of this is China's investigations into Australia's wine industry, block of most coal imports, 80% tariff on barley, and banning of beef exports from Australia's four largest exporters. As Trade Minister Simon Birmingham warned on 23 August 2020, "Some of the regulatory decisions that China has made this year will obviously increase the risk profile that businesses would see when it comes to trading with Chinese counterparts. To what extent that necessitates a change in business behaviour is a matter for each individual business." The Australia-China geopolitical tiff does not seem to be abating, and companies with extensive reliance on exporting into China require investors to be more on guard.

Better positioned in China than most

However, Bubs Australia does have more protection than most Australian exporters to China due to the Memorandum of Understanding it signed with Beingmate to expand the their partnership with a joint venture to acquire exclusive use of a China domestic State Administration for Market Regulation brand slot. Part of the joint venture includes an ownership stake in one of Beingmate's CNCA registered manufacturing facilities in China. Since Beingmate is one of China's largest domestic sellers of infant formula and other children's food products, this joint venture could save Bubs Australia from being another casualty in the escalating Australia-China geopolitical battle.

Bubs Australia is well aware of the dangers surrounding its reliance on China for growth and therefore launched in Vietnam and Hong Kong during FY20, providing the 501% year-over-year increase in Other International revenue. As announced on 31 August 2020, Bubs Australia plans on launching into the Middle East and Malaysia during 2Q21 to mitigate its dependency on China for growth.

There is a growing demand for quality guaranteed infant and child-focused food products in these regions that leads us to be optimistic around Bubs Australia's global expansion plans. Our chief concern is COVID-19's potential to cause continued disruptions to the global supply chain network. However, Bubs Australia has seemed to find ways to mitigate these concerns for now.

Yes, another company issuing equity

On 3 September 2020, Bubs Australia announced that it was looking to issue, at most, an additional 2.4% of shares outstanding with the goal of using the funds to fund its joint venture with Beingmate, working capital needs and its international expansion plans. While Bubs Australia has a strong financial position with approximately $26m in cash and cash equivalents compared to around $5m in debt (as of 30 June 2020), Bubs Australia is still not profitable and therefore requires more capital to fulfil its FY21 goals. Consensus estimates place FY21 as the first year Bubs Australia achieves a positive EBITDA result, even with COVID-19. We believe this is likely, assuming the central Chinese government does not step in the way of Bubs Australia's joint venture with Beingmate.

Strong prospects but a lot riding on FY21 profitability

There is a solid four star argument to be made for Bubs Australia with an estimated $10m increase in EBITDA during FY21, to become EBITDA positive this year, and a further increase to $16.1m and $43.7m in FY22 and FY23 respectively. And if Bubs Australia's joint venture and international expansion plans go smoothly, EBITDA growth to around $77m by FY25 may be a very reasonable assumption.

Therefore, the current EV/EBITDA valuations of 28x for FY22 and 10.5x for FY23 seem highly attractive. However, COVID-19's continual disruption of supply chains and the current, accelerating tensions between China and Australia have thrown a significant shadow of risk across Bubs Australia's FY21 plans, in our view. The market is expecting positive EBITDA during FY21, and we believe a disappointment in this regard would be hard on the stock. Therefore, until at least the extent of the Chinese-Australia diplomatic and economic conflict becomes clearer, we believe the risk dictates a three star rating.

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Share price chart

Source: Tradingview

On 3 August we wrote about Weebit Nano (ASX:WBT) in Stocks Down Under and it would be good for readers to have another look at that article, because 4DS and WBT are trying to achieve the same thing, but in different ways. Both companies are developing a new type of new computer memory, called Resistive Random Access Memory (ReRAM). Our article on WBT explained why there is a need for new technologies to store digital 1's and 0's and what the potential market opportunity is. And our friends at Pitt Street Research have been covering both companies for many years, so you may want to check out the freely available research on 4DS and WBT at www.pittstreetresearch.com.

Let's get a bit technical: a cheese sandwich

ReRAM is based on the resistive characteristics of certain materials in order to store data. Specifically, ReRAM uses an electric current to change the resistance level of the materials inside a memory cell, with a low resistance level associated with a value of 1 and a high resistance level associated with the value of 0.

Think of a ReRAM cell as a cheese sandwich, with the bread being the two metal electrodes and the cheese in the middle being the reactive materials of which the conductive properties can be manipulated.

In a ReRAM cell, a non-conductive material is sandwiched between two metals. When a positive or negative voltage is applied to one of the electrodes (the bread), the electrical resistance level of the sandwiched material in the middle (the cheese) changes to high or low, depending on the polarity of the voltage.

So, rather than using an electrical charge to store information, as is done in today's main types of memory, like Flash memory and DRAM, ReRAM uses a material's electrical resistance level to store information, resulting in much lower power consumption and higher read/write speeds.

Different approaches to switching a ReRAM cell

There are different ways to alter resistance levels in ReRAM cells. One way is to create a conductive filament, or conductive channel, from one electrode to the other. This is the basis of Weebit Nano's (ASX:WBT) technology, Silicon Oxide ReRAM. When a voltage is applied to the top electrode, typically made of copper, positively charged copper ions travel through the non-conductive material in the middle towards the bottom electrode. The copper ions start to form atoms at the bottom electrode and eventually form a conductive filament connecting the top and bottom electrodes. In this state the cell exhibits a low electric resistance level representing a value of 1. Applying a reversed voltage, the filament is destroyed, changing the material's resistance back to high, representing a value of 0.

In our cheese sandwich analogy, in filamentary ReRAM a connection between the two slices of bread is formed straight through the cheese layer.

Interface Switching ReRAM

Another way to manipulate the resistance level of the sandwiched switching material is based on Interface Switching, which is how 4DS does it. Rather than using materials that stimulate the forming of a filament between the two electrodes, in Interface Switching ReRAM the resistivity level of the entire middle layer is manipulated.

4DS uses a material called Praseodymium Calcium Manganese Oxide (PCMO) as the middle layer (cheese) together with an ion-conducting insulator (let's call that the ham). When a positive voltage is applied to one electrode, oxygen ions move from the PCMO layer, across the ion conducting insulator to the reactive metal at the other side. This substantially increases the resistance level of the entire PCMO layer to which a value of 0 can then be attributed.

With Interface Switching ReRAM there is no single connection being formed, but rather the resistance level of the entire ham/cheese layer is manipulated. The benefit of this approach is that there is no repetitive cycle of creation and destruction of the filament, as is the case with filamentary ReRAM. This should theoretically improve the endurance of the memory cell. A potential downside of Interface Switching ReRAM longer term is that it may not scale down (get smaller) easily due to the minimum required dimensions of the supporting electrical circuitry around the memory cells.

4DS is currently working on multiple batches of test wafers together with its development partners IMEC and HGST, the latter being part of storage giant Western Digital (NASDAQ:WDC). By early 2021, 4DS hopes to have the technology developed to the point where it will have a working megabit array, the very minimum requirement for addressesing the Storage Class Memory (SCM) market, i.e. datacenters, mobile phones and computers. SCM is 4DS' main target market.

Undervalued versus peers

While BRN and WBT have seen their respective share prices increase very substantially in recent weeks, 4DS has been lagging. Even though there was a brief spike in 4DS' share price last week, its current $83m market capitalisation is still well below WBT's of $133m, let alone BRN's of $988m. And although BRN's share price may have gotten ahead of itself, we believe 4DS is substantially undervalued.

Next year, the company may look to do a strategic deal with a semiconductor manufacturer or design house that is looking for a viable ReRAM technology to take forward. If and when that happens, we believe a transaction value should be at least $200m to $250m, but potentially substantially higher, depending on valuations throughout the semiconductor industry at that point. So, right now we comfortably put a four star rating on 4DS Memory.

Full disclosure: Stocks Down Under editor(s) own shares in 4DS Memory.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

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