STOCKS DOWN UNDER

30 NOVEMBER 2020

ASX Top 200 Stocks Down Under

"Exit, pursued by a bear."

- William Shakespeare (1564 - 1616), English playwright

ARB CORPORATION

Unbuckle and exit the vehicle

HEALIUS

Worth a scan

CREDIT CORP GROUP

Boring is sexy

ARB CORPORATION

Unbuckle and exit the vehicle

Stocks Down Under rating: ★★

ASX: ARB
Market cap: A$ 2.3BN
Dividend yield: 1.6% (100% Franked)

52-week range: A$10.40 / A$33.83
Share price: A$ 28.50

Headquartered in Melbourne, ARB Corporation designs and manufactures 4X4 vehicle accessories and light metal engineering work. The company managed to achieve a small growth in revenue during FY20, despite COVID-19, causing profits to remain effectively flat. ARB has a large question hanging over its head; will demand fall once supply satisfies the build-up after worldwide lockdowns? In the medium-term we think the answer is no, but the long run is unclear.

READ MORE

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ASX: HLS
Market cap: A$ 2.3BN
Dividend yield: 1.3% (100% Franked)

52-week range: A$1.92 / A$3.85
Share price: A$ 3.69

Headquartered in North Sydney, Healius provides specialty diagnostics services to healthcare providers and individual clientele across Australia. The company has recently embarked on a strategic streamlining and improvement of its business portfolio with some promising results. With all the changes in the market, the economy and Healius itself, we believe the shares are well worth an investor diagnostic scan.

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Headquartered in Sydney, Credit Corp Group purchases debt, collects that debt, and issues loans. This can often be a highly profitable business but has inherent risks, such as the inability to collect the debt purchased. Due to COVID-19, the company stopped paying a dividend. However, it has stated that it will resume paying during FY21. This is an industry often overlooked by investors but one that, we think, has potential for those savvy enough to look.

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Share price chart

Source: Tradingview

Taking ARB for a test drive

ARB has three main divisions, mainly based on geography: Australia, exports and OEM.

While Australia has historically provided the majority of revenues, reaching 60.9% of total company sales during FY20, this division's growth has levelled off considerably since the beginning of FY18. While not declining, sales to the Australian aftermarket only grew 1.4% during FY20, slightly lower than FY19's growth of 1.6%. This division currently operates 67 stores, split on a 60/40 franchise versus company-owned basis.

In the short-term, management is expecting the Australian market to take advantage of the difficulty in traveling overseas, which is expected to cause a spike in domestic tourism. Additionally, as people get out more, the 4X4 market is expected to see a short-term bump in Australia. The company has changed its domestic marketing strategy to focus heavily on this trend.

The export division includes worldwide sales excluding Australia. This means New Zealand sales are included in this division. If we are going to be honest, we must admit we originally assumed the majority of this division's sales would be to the Asia, New Zealand and Pacific region. However, we were interested to learn that excluding the impact of two acquisitions in New Zealand, this region produced the least amount of

revenue during FY19 and FY20. At $65.1m, the United States generated the largest export revenue, despite the North and South American regions only seeing a 2% increase in revenue during FY20 year-over-year. Overall, exports grew 16.9% year-over-year and its $152.2m in total revenue now represents 33% of total company sales. Once the United States and South America get COVID-19 under control we expect this division to see considerably higher growth. However, we believe it remains extremely uncertain if this will occur during FY22 or FY23, although the vaccine results are encouraging.

OEM (Original Equipment Manufacturers) specifically focuses on the Australian market for new vehicles. Given that COVID-19 hit the Australian market hard, revenue for this division declined 12.9% year-over-year. OEM is a small portion of the company's total revenue with its $29.8m in FY20 only representing 6.4%. This division's decline in growth was likely to occur even without COVID-19 as it is slightly cyclical and FY19 saw 17.1% in year-over-year growth. It is important to note that management stated that 'several new contracts with Original Equipment customers will commence in the next six months.' However, it is unclear how significant these contracts will be.

The update

On 7 October 2020, management released an update stating that ARB had achieved 17.7% revenue growth for 1QY21 and a profit before tax of $29.7m for the quarter. Seeing as how total profit before tax for FY20 was $78.1m, one can fully understand why investors see this as a fantastic sign going forward. Management certainly understood it and that is why they put a cautionary note in this market release stating 'The Board of ARB does not believe that the Company's first quarter performance should be used as an indicator of the likely full year results which remains far too uncertain to predict.' We happen to agree. We believe FY21 will certainly prove to be a strong year for the company and we don't believe long-term growth is going to crash, but we also don't think investors should read too heavily into 1QY21s's results.

Put into reverse

ARB is a clear 'opening up play.' The company saw a lot of demand emerge once Australia's lockdowns ended and with international borders unlikely to truly open until at last the end of CY21, we think Australian market demand still has some juice left in it. The question really comes down to what will happen after that? The truth is we really don't know. The market is expecting EBITDA growth to decline around 2% between FY21 and FY22, only to rally to $130.6m during FY23. However, as we mentioned above, management is uncertain how demand will develop in the long run. The stock seems to be reflecting this already after its monster run since it hit its 52-week low of $10.40 on 23 March 2020. The stock has lodged a remarkable 225% return between 23 March 2020 and 9 November 2020 before a slight pullback which puts the FY21 EV/EBITDA ratio at 19.4x. Based on the uncertainty surround the company's FY22 and FY23 results we believe this is likely a bridge too far, even after the stock's slight pull back.

Additionally, we believe ARB's 1.3% dividend yield is not high enough to attract yield hunters. We are certainly not bearish about the company and once the United States and South America get COVID-19 under control, we believe long-term growth can be attractive. However, the stock price has rallied far too hard even assuming everything goes well over the next couple of years. Basically, this spells out a two star rating for us at this time.

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Share price chart

Source: Tradingview

Scanning the books

If we were to just look at Healius' FY20 results we would be telling you the company operates four division. As of 23 November 2020, following a divestment, that is no longer the case and we will discuss this in more detail later. Factoring in the sale, Healius operates three main divisions: pathology, imaging and day hospitals.

Pathology benefited heavily from COVID-19 as this division saw a significant rise in business as testing became a priority across Australia. For those who are not familiar with the term, the pathology division examines and tests body tissue and fluid samples to help diagnose a patient. While COVID-19 testing might seem to be significant enough to have more than offset the declines in other, more normal revenue categories for this division, pathology only saw a 3% increase in year-over-year revenue ($1.2bn) and a 5% increase in EBITDA ($142.3m). Healius expects this division to generate an average year-over-year increase in revenues of 4.6% (down from 5.2% FY19) from FY21 through FY25. The reason this past financial year's result was lower than forecasted was the drop off in basically any non-COVID-19 testing demand.

The imaging division saw revenue decline by 4% during FY20 to $376.7m as elective surgery was temporarily halted due to COVID-19. This explains why the EBITDA margin dropped from 14% during FY19 to 8.4% in FY20, resulting in EBITDA of $31.8m. Imaging is forecasted to produce an average revenue growth rate of 6.3% between FY21 and FY25 as the Australian healthcare system returns to normal. One of the drivers of this

growth will be the digitisation of all patient records from referrals, bookings and check-ins from FY22 onwards. We expect this will significantly increase this division's profit margin.

The day hospital division operates 19 locations: 15 Montserrat private hospitals and 4 IVF clinics. The company is currently trying to grow through acquisitions at Montserrat. This is why Healius is expecting Monterrat's revenue to increase 11% on average between FY21 and FY25. Due to COVID-19 restrictions, the company's IVF clinics operated at a loss during FY20. However, the Montserrat private hospitals were resilient enough to see an overall increase in revenue of 40% to $65.4m. Unfortunately, EBITDA declined from a loss of $200,000 in FY19 to a loss of $1.7m during FY20. We believe this is due to the division's revenue growth coming from acquisitions rather than organic growth.

The sale

As of 23 November 2020, Healius sold its entire Medical Centre division (not to be confused with day hospital division) to BGH Capital in exchange for $483m in cash. This was $17m lower than what Healius estimated the enterprise value for this division was. Despite this, we believe it was the right move as it will allow Healius to focus on growing its other businesses. This move was also part of the company's cost cutting initiative with management citing the reduction of its finance support headcount from 192 to 60 as a specific example. This is estimated to result in an annual cost saving of $7.2m. More details on the specifics of the cost cutting and investment strategy following the sale of the Medical Centre division will be provided during an investor update on 9 December 2020.

Slow and steady wins the race

Healius is certainly not a supercharged growth company, but investors can remain confident the essential nature of the company's divisions will provide steady profits and a well-protected dividend over the coming years. According to the 2020 Global Health Care Outlook report by Deloitte, global healthcare expenses are expected to rise by 5% on average between CY19 and CY23, driven heavily by population growth. Australia is in a unique position as it has both a quickly aging and growing population. We believe this will provide stronger demand for the healthcare system than the rest of the globe, especially for essential services like Healius' main division, pathology.

A solid company for a light risk focused portfolio

It is true that Healius is undergoing a transition which adds some risk to the company. However, we believe the consolidation and additional capital leave the company well-placed, especially as the Australian healthcare system gets back to 'normal.' Healius is currently trading at an estimated FY21 EV/EBITDA ratio of 8.8x. The market is expecting EBITDA to remain effectively flat across FY21, FY22 and FY23. We believe the market is slightly pessimistic with this forecast as we believe the company's margins should start to see improvements through its continued cost cutting and establishment of more efficient systems across divisions. The main wildcard here is what management plans to do with the new influx of cash and how much exactly it expects to save in the years to come.

We believe Healius' 8.8x FY21 EV/EBITDA multiple and 1.2x price-to-book ratio offer risk-adverse investors an interesting company in a growing industry, which is currently taking steps to drive margin improvement over the next couple of years. So it's four stars from us. Having said that, on 9 December we're expecting a solid plan from the company on how to drive margins going forward.

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Share price chart

Source: Tradingview

The big three

Credit Corp has three main revenue sources: Australia and New Zealand debt buying, United States debt buying and consumer lending. In a nutshell, the company's business is the collection of consumer debt in the United States, Australia and New Zealand.

The Australian and New Zealand debt division produces the majority of the company's revenues and profits. Out of the company's total revenue of $313.4m, $183.4m was generated by this division during FY20. The Australia and New Zealand division also has the highest margin at $269 per hour of productivity, up 6% versus FY19 despite COVID-19. That's one of the strongest aspects of this division, i.e. its ability to work without a designated office space without significant damage to margins. Hence, the Australian and New Zealand debt division managed to produce $18.8m in Net Profit After Tax during FY20.

The United States buying division has historically provided the smallest margin of the company's three main divisions. During FY20, the company's productivity per hour was $220, the same as it was during FY19. However, this division saw a sharp decline in revenue to $30.6m from $40.8m during FY19, due to issues with debt collections during COVID-19. The United States has seen significantly more economic damage from the pandemic than either Australia or New Zealand so it was not a surprise when this division posted a Net Profit

After Tax loss of $18.3m. As this division has historically seen better growth than the other debt division, the poor performance is certainly a concern.

The consumer lending division operates across Australia and New Zealand and specialises in lending to consumers with credit issues. This division saw no COVID-19-related decline during FY20 and it managed to post the only revenue increase across the company during FY20. Consumer lending posted 5.7% year-over-year growth with $99.4m in revenues during FY20 and is expected to produce higher than historical growth going forward as government support programs expire across Australia and New Zealand.

The FY20 COVID-19 issues

The debt purchasing and collections side of Credit Corp were the two divisions negatively affected by COVID-19 as the company was forced to increase its total loan loss provision from 18.7% to 24.1% during FY20. Additionally, the company was forced to take a $68.6m impairment charge as management expects the company to see a reduction in collections for the next two years as the world recovers from COVID-19. We believe this impairment charge and the two-year time line are certainly on the conservative side. However, for a company that deals in high-risk debt, we believe that a conservative approach is the only appropriate way to operate.

1Q21 defused COVID-19 concerns

After Credit Corp released its FY20 results we were certainly concerned about the United States debt buying division. Seeing this division's 1Q21 results, however, certainly eased a lot of our concerns. Productivity jumped to $247 per hour while total collections increased 34% year-over-year to $36m. Additionally, now that the US election is over, we believe the chances of some form of stimulus in the United States are quite strong, which will certainly help the company recover the money it is owed.

A risky play for sure

The market currently expects FY21 will see a decline in EBITDA of 2.5% compared to FY20, at $109.8m. However, in our view that is not the most likely outcome based on 1Q21's results as well as Australia's and New Zealand's economic outlook. We agree with Credit Corp that the expiring of stimulus is likely to drive up demand for the company's lending in Australia and New Zealand and we think it is unlikely the company will have to take another big impairment charge like it did in FY20.

Credit Corp is trading at a Price-to-Tangible-Book ratio of 2.8x after having reduced its debt to zero and having increased its cash and credit lines to $400m. The company's strong liquidity position is why we believe a 2.8x P/B ratio is appropriate at this time. Additionally, management has stated that all three of the company's divisions are slated to produce 'solid profits in 2021.' This compares to the $18.3m loss the US division produced during FY20.

We think the market is underestimating Credit Corp's FY21 earnings potential and with the company still trading below its pre-COVID-19 high of $3.04, we are rating it four 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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