7 DECEMBER 2020

ASX Top 200 Stocks Down Under

> *I fear all we have done is to awaken a sleeping giant and fill him with a terrible resolve.*
>
> **- Isoroku Yamamoto (1884 - 1943), Imperial Japanese Admiral**

ASX

EXCHANGE CENTRE

INGENIA COMMUNITIES GROUP

Build, rent, cash

NATIONAL STORAGE REIT

It's not buy high sell low

Z ENERGY

Pin the tail on the donkey

INGENIA COMMUNITIES GROUP

Build, rent, cash

Stocks Down Under rating: ★★★★

ASX: INA
Market cap: A$ 1.6BN
Dividend yield: 2.1% (0% Franked)

52-week range: A$2.67 / A$5.28
Share price: A$ 4.79

Headquartered in Sydney, Ingenia Communities Group is a diversified property developer focusing on four main areas: age-appropriate housing, housing development, tourism accommodation and aged care communities. The company's stock was hit hard by COVID-19, dropping about 42% from its pre-COVID-19 height down to $3.05, yet sharply recovered to $4.79 on Friday's close. Despite the hit to operations of many of Ingenia's peers, the company presented a strong FY20 result. This company still has plenty of opportunity to build on.

READ MORE

NATIONAL STORAGE REIT

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Stocks Down Under rating: ★★★

ASX: NSR
Market cap: A$ 1.9BN
Dividend yield: 4.3% (0% Franked)

52-week range: A$1.20 / A$2.43
Share price: A$ 1.91

If there was one thing COVID-19 proved to us all it was that things can change in an instant. National Storage REIT is in the business of fulfilling one of humanity's primary needs: security and the peace of mind that comes with it. National Storage owns and operates 194 storage centres across Australia and New Zealand providing a range of services from conventional storage to wine and vehicle storage. This company has a specific niche that has some value, but just how much?

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ASX: ZEL
Market cap: A$ 1.5BN
Dividend yield: 5.2% (0% Franked)

52-week range: A$2.41 / A$4.84
Share price: A$ 3.05

Headquartered in Wellington, Z Energy truly is New Zealand's one stop shop for all things motor vehicle fuelling related. The company owns stakes in New Zealand's only oil refiner, Refining NZ, as well as Loyalty New Zealand (runs Flybuys) pipelines, terminals and bulk terminal storage infrastructure. On top of which there's around 368 service stations and truck stops. COVID-19 saw a triple threat hit the company's stock as the market crashed, worldwide economic outlooks became bearish and the price of oil fell off a cliff. With those issues receding, this is a four star opportunity, in our view.

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Share price chart

Source: Tradingview

Diversity is king

Ingenia is far from your classic property developer. The company's operations are more like a mashup of property developer AVJennings (ASX: AVJ), aged care community developer Lifestyle Communities (ASX: LIC) and a resort operator. We wrote about AVJ on 28 August 2020 and about LIC on 13 November 2020. Ingenia has three main sources of income: rental, home sales and other.

The rental revenue operations are rather simple. The company owns a number of communities that either consist of one and two bedroom properties, holiday communities or retirement community land leases. Rental revenue provides the second greatest source of annual revenue at $94.5m during FY20, accounting for 38.7% of Ingenia's total revenue. The rental revenues saw 5.3% year-over-year growth, a significant achievement compared to FY19's 3.7% annual growth, especially considering COVID-19.

Ingenia's main source of income, though, is derived from the sale the residential properties developed by Ingenia, either as part of its retirement communities, where the land is leased and community and care services are provided, or in more standard land and home purchases. Home sales produced $126.8m in revenue during FY20, an impressive 6.5% year-over-year growth during COVID-19. Compared to FY19's year-

over-year growth of 38.6%, 6.5% is not impressive. Although, when taking into account that the majority of the company's operations are on the East Coast of Australia, we believe 6.5% growth is pretty impressive compared to the company's peers.

Other revenue makes up the remaining 9.4% of the company's total FY20 revenue at $22.9m. Basically, other revenue is a category we created by combining the company's supplementary revenue. Some examples of this are food and beverage sales at the company's tourism facilities and revenue from the company's owned and operated service stations that are located near and within its communities. While 9.4% of revenue is nothing to sneeze at, this category will likely remain a small part of the company's overall operations.

You only have so many fingers for so many pies

We do realise that it can seem like Ingenia has its fingers in a lot of different pies, but we in essence we think it mostly comes down to property and facility management. We believe the company's rental, aged care and tourism segments are more or less vertical additions to Ingenia's main property development division rather than completely unrelated industries.

Don't forget the properties

Ingenia has provided investors with steady revenue and EBITDA growth, but the company also has a significant amount of property ownership. We believe this property portfolio lends to a minimum level of value to be conferred onto the stock. As of 30 June 2020, the Net Tangible Asset Value per share rose from $2.65 as of FY19 to $2.90. We believe a conservative approach to using the Net Tangible Asset Value as the base valuation for the stock would be at a discount of around 30%, or $2.03 per share.

Why 30% you may ask? We have chosen 30% based on two main characteristics, the first is the low dividend paid by Ingenia. Basing the valuation on the company's Net Tangible Asset value puts it in the Real Estate Investment Trusts (REIT) bucket. REIT's are often invested in for the dividend yield. As we saw during COVID-19, when REITs stop paying a dividend, their valuations typically plummet, with the ASX 200 A-REIT index still down 6.6% year-to-date after rallying around 12% during November.

The second reason is that we believe the quality of the properties owned by Ingenia is not the same as, say, a Blackwall Property Trust (ASX: BWR) or Growthpoint Properties Australia (ASX: GOZ). We are not saying that the properties are junk, but if this was a standalone REIT, we would value the company at a discount to its Net Tangible Asset value per share.

A profitable community is a strong community

Ingenia is estimated to provide investors with solid EBITDA growth over the coming years with a consensus growth number of 15% on average over the next three years. As we explained above, we have calculated the adjusted FY21 EV/EBITDA ratio at 10.7x. To clarify, adjusted means we removed the discounted valuation of the company's properties. Additionally, we believe the company's tourism communities are likely to benefit strongly from the rise in domestic tourism during CY21 as it is still unlikely Australia's international borders will be fully open during this period. Altogether, four stars.

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Share price chart

Source: Tradingview

Unlocking the storage vault

National Storage has two main portfolios: Australia and New Zealand. One term that we use is REVPAM, which stands for Revenue Per Available Square Meter. This metric is a simple way to view the historical performance of the company's properties while removing the added effect of new properties.

The Australia portfolio makes up the majority of National Storage's properties with 168 out of 194 of the total centres controlled by this division. The occupancy rate of the Australian properties has surpassed the pre-COVID-19 occupancy rate. As of 25 October 2020, the occupancy rate was 84.2%, 3% higher than at 30 June 2019. The REVPAM for Australia's division is around $223.

It is important to note that Victoria and Tasmania are the only two States (out of all seven) in this division whose occupancy rates were lower than on 30 June 2019 at 0.4% and 6.1%, respectively. Based on management's current analysis and the current trajectory of growth, we believe Victoria will end FY21 with a higher occupancy rate than it did at the end of FY19.

The New Zealand division consists of 26 properties spread across the country boasting a strong occupancy rate of 86% as of 25 October 2020. In fact, this division saw a very small decline in its occupancy rate of 1% on 30 June 2020 compared to FY19. The New Zealand portfolio is the only division where the REVPAM is broken out with the latest statistics being as of 30 June 2020. Despite the impact of COVID-19 on occupancy, the New Zealand REVPAM rose 6.9% to $175/sqm. Unfortunately, this is still well below the total company's REVPAM of $195, although the company as a whole did see a 4% year-over-year decline.

Nothing to do about nothing

National Storage had a Net Tangible Asset value of $1.65 per share per 30 June 2020. Taking a look at the last three years worth of trading data, the average share price premium to the company's Net Tangible Asset value was 16%.

No two market situations are ever exactly alike. The biggest difference in the market right now, aside from COVID-19, is the Reserve Bank of Australia. The RBA followed the rest of the world during its 3 November 2020 meeting by lowering official interest rates to 0.10%. Since then, the ASX 200 A-REIT index has rallied 18.5%, although National Storage has only rallied 3%.

We believe the main reason National Storage only rallied 3% since the rate cut was due to the lower than average dividend yield the company was already paying. As we have discussed in previous publications, this REIT rally was mainly due to the steep discount to NTA and high dividend payment by REITs in general. National Storage did not fall into this category. On 2 November 2020, the stock's closing price implied a 4.4% dividend yield.

It's just too expensive right now

National Storage is currently trading at a considerable 17.5% premium to its Net Tangible Asset value per share of $1.65. As we mentioned above, this level of premium is not unusual for the company as the stock has traded on average at a 16% premium over the last three years. What is unusual is the company's dividend yield. Over the last three years the company provided an annual dividend yield between 4% and 8%, with an average of 5.3%. The company's 17.5% premium currently offers a relatively low 4.2% dividend yield, indicating to us that the stock is currently moving towards the high end of both its fair value. We would recommend investors keep a close eye on this company and revisit it when the share price aligns more closely to a 10% premium. Until that time, National Storage is a three star stock for us.

Z ENERGY

Pin the tail on the donkey

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Share price chart

Source: Tradingview

Selling fuel to fuel a company

Z Energy has one main source of revenue and two supplementary ones. We say this because the truth is Z Energy has one true business, the refining and sale of petrol-based fuels. The company's two side revenue streams are the sale of products at its convenience retail locations and 'other revenue.'

Fuel revenue consists of three different categories: petrol, diesel and other. Other is mainly a combination of jet fuel and fuel oil, which is primarily sold to cruise ships. During FY20, the fuel division produced $4.9bn in revenue, 97.7% of total company revenue. In the prior year, this division produced $5.3bn in revenue, or 98% of the total. In terms of volume sold (millions of liters), diesel has consistently been the largest product sold and only dropped 4% to 731ml, petrol fell 23% to 475ml while other fell 68% to 173ml. All-in-all FY20 was a rough year for Z Energy's fuel division and we expect this pain to continue into FY21, albeit to a lesser degree.

Convenience retail is quite literally the sale of products from Z Energy's convenience stores that operate at its fuel pumps. This division's revenue stayed flat at $64m during FY20 and at a mere 1.3% of the company's total revenue of $5bn, convenience retail is inconsequential for Z Energy.

‘Other’ accounts for all other activities, such as electricity generation. Like the convenience division, other is inconsequential at $53m or 1.1% of total FY20 revenue. As with convenience, this won’t change any time soon, in our view.

Declining business still has some juice

We believe Z Energy is a company in decline. There really is no denying it. In its FY20 annual report management made the following statement “we have clearly entered a new phase of the margin cycle in which retail fuel margins have peaked (for Z Energy, profitability peaked at 5.5 cents per litre in 2013.)” Additionally, the New Zealand Parliament unanimously passed a Zero Carbon Bill during FY20. While Z Energy’s management has mentioned this in its risk section of the annual report, we are concerned this will accelerate the company’s decline.

All of this is certainly concerning, but its does not mean the company is going bankrupt anytime soon. The goal of New Zealand’s new legislation is to reduce net carbon emissions to zero by 2050 leaving a small window for companies like Z Energy to squeeze out some final profits. We believe the trick in this situation is buying at a low price and reaping a fat dividend for a number of years, without expecting a significant rise in the stock.

Spin around and pin the tail on the donkey

Z Energy has a rather concerning risk hanging over it, i.e. the price of oil. The year 2020 has been one crazy ride for oil prices as worldwide COVID-19 lockdowns pushed already high crude stockpiles to the breaking point, causing a complete collapse in the oil price. After opening 2020 at US$61.18, WTI Crude has swung from negative US$37.63 (20 April 2020) to its current US$44.58 (2 December 2020). In fact, the price of WTI Crude has rallied 16.6% in the last month alone.

This rally has led both the S&P/ASX 200 Energy index and Z Energy’s stock to rally 28% and 3% respectively in the last month. We found that over the past month (2 November – 2 December) the correlation coefficient between the full day returns of the index and Z Energy has been produced a median correlation of 0.93. For the sake of complete disclosure, we also ran the numbers on Z Energy’s stock versus USD WTI Crude Oil price and despite the correlation not being as strong as the index, the median correlation was still 0.70.

Stocks Down Under’s ‘House View’ is that oil is headed up as the world moves out of the Coronavirus Crisis in 2021. If you look at the ‘Insights’ section of our web site there’s an article from 27 November 2020 headed “Oil is making a comeback’ where we argue that the revival of world economic growth is good for oil. If oil is making a comeback then Z Energy is going up with it. Of course, there will be volatility with that. OPEC may increase production and US oil inventories may go up. During these periods, oil will likely have bad days and so will Z Energy.

Solid and steady

For investors looking for an oil refining play we believe Z Energy certainly fits the bill. The company is currently valued at FY22 and FY23 EV/EBITDA ratios of 8.2x and 7.8x respectively, while paying a 5.2% dividend. We believe the company’s estimated EBITDA growth during these periods, of 26% and 5% respectively, as well as its dividend payments provide for a solid bull case going forward.

While we are currently rating Z Energy four stars, we would caution investors that, unless they are specifically looking to invest in an oil or refining play, we believe other companies are likely to provide better long-term share price appreciation.

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