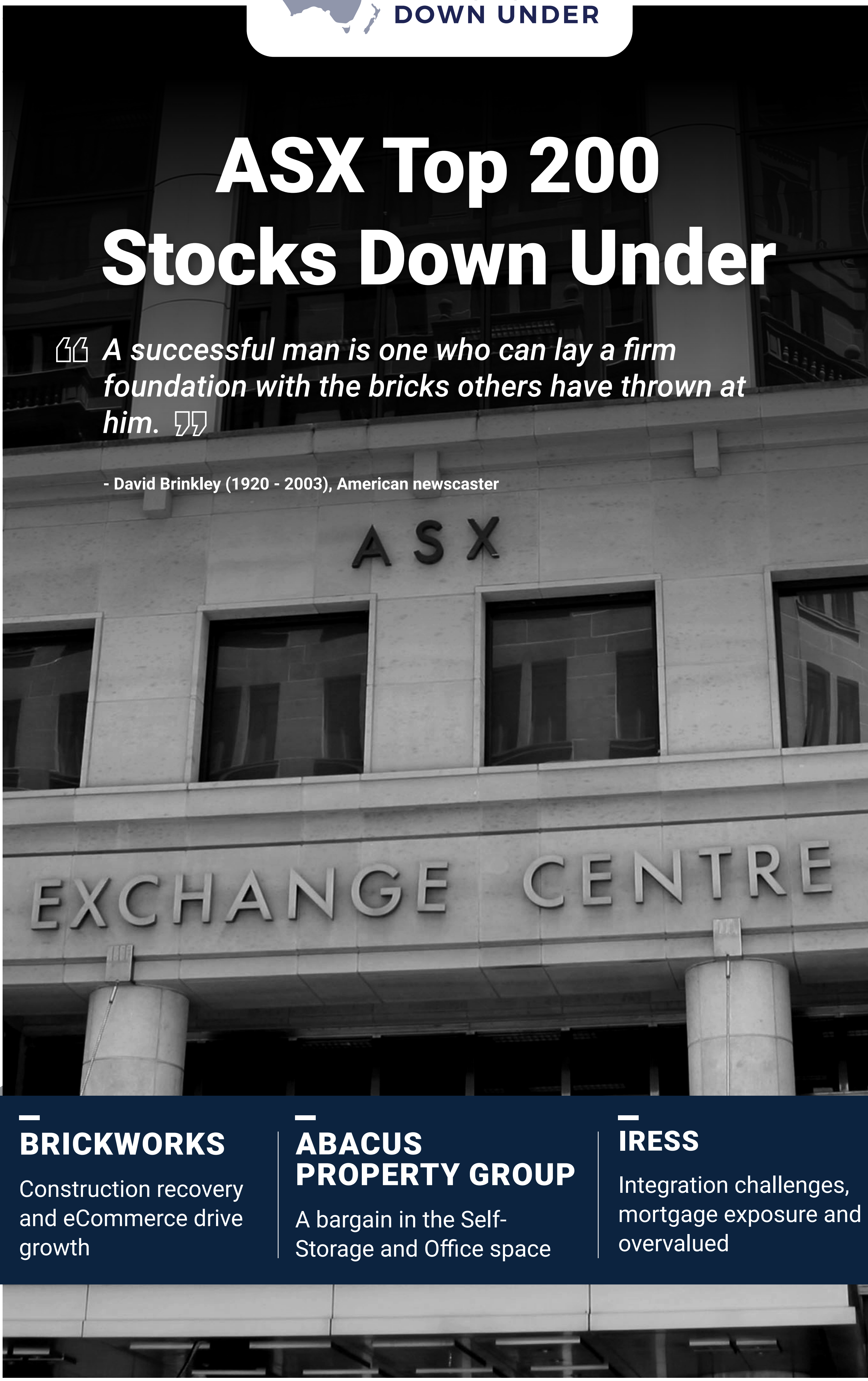
STOCKS DOWN UNDER

21 DECEMBER 2020



ASX Top 200 Stocks Down Under

> *A successful man is one who can lay a firm foundation with the bricks others have thrown at him.*

- David Brinkley (1920 - 2003), American newscaster

BRICKWORKS

Construction recovery and eCommerce drive growth

ABACUS PROPERTY GROUP

A bargain in the Self-Storage and Office space

IRESS

Integration challenges, mortgage exposure and overvalued

BRICKWORKS

Construction recovery and eCommerce drive growth

Stocks Down Under rating: ★★★★

ASX: BKW
Market cap: A$ 3BN
Dividend yield: 2.9%

52-week range: A$11.76 / A$20.75
Share price: A$ 19.45

Sydney-based Brickworks is a building products supplier with roots dating back to 1934. As Australia's largest brick manufacturer, the company is benefitting from the recovery in the domestic construction market after a sharp downturn caused by COVID-19. Brickworks' share price has nearly returned to its pre-pandemic peak and looks ready to build off the recent momentum. We favour the company's position in the Australian construction market and its expanding presence in the United States. A lesser-known, but more compelling exposure to the global e-commerce boom through a stake in an industrial property trust as well as the company's 44-year history of stable or increased dividends are further reason to construct a position in Brickworks.

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ABACUS PROPERTY GROUP

A bargain in the Self-Storage and Office space

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ASX: ABP
Market cap: A$ 2.0B
Dividend yield: 5.9%

52-week range: A$1.96 / A$4.03
Share price: A$ 2.93

Abacus Property Group is a Sydney-based commercial property investor. The group is focused on the office and self-storage sectors and primarily invests in properties located in the central business districts of Sydney, Brisbane and Melbourne. Abacus is in the process of shifting away from non-core assets towards the growing office and self-storage sectors. The recent takeover of Storage King should help the company build on its increasing clout in the self-storage industry. Abacus shares offer an attractive 5.9% dividend yield and significant upside potential. So, as long-term investors, we'd store some money in this stock.

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ASX: IRE
Market cap: A$ 2.1B
Dividend yield: 4%

52-week range: A$8.29 / A$14.36
Share price: A$ 10.82

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Share price chart

Source: Tradingview

Soul Pattison relationship is special

Brickworks is a major supplier of building products to the Australian residential and commercial markets. As you probably guessed, its main Building Products division makes and sells a variety of bricks and masonry products under the Austral, Glen-Gery and UrbanStone brands. This includes paving, roofing and precast supplies. Brickworks is in the midst of constructing a new $125m brick plant at Horsley Park that, once completed, is expected to be the world's most sophisticated brick plant. Although the name suggests bricks are the main part of the business, this segment represents only one-quarter of the group's assets.

It also has an Investments segment, which accounts for more than half of the group's assets. It holds a 39% interest in Sydney-based investment firm Washington H. Soul Pattinson & Company. Brickworks' relationship with Soul Pattinson goes back decades. So too does Soul Pattison's track record of strong, diversified investment returns.

We believe the feelings are certainly mutual in this relationship. Soul Pattinson also holds a significant number of Brickworks shares. In fact, with a 42% ownership of Brickworks' equity capital, Soul Pattison is by far the largest shareholder. Nearly one-fourth of Soul Pattison's asset exposure is in the building products space.

Unique exposure to the online shopping boom

Brickworks is additionally involved in the property market. It holds a 50% stake in an industrial property trust joint venture with Sydney-based commercial property company Goodman Group. Through this interest, Brickworks builds and operates properties for a range of industrial businesses.

The industrial sector has been one of the hottest areas of real estate due to rising demand for e-commerce and logistics properties. We really like the exposure to this growth market. The trust is in the process of building distribution warehouses for both Australian retailer Coles Group and United States eCommerce giant Amazon. The Coles Group warehouse is set to break ground early next year while the sprawling Amazon facility at Oakdale West is expected to be finished by September 2021. These properties combined are expected to increase the trust's gross asset value to more than $3bn and increase rental distributions by at least 25%. Looking further down the road, Brickworks sees five more years' worth of development left in its land pipeline.

Back to the construction side of the business, Brickworks has been aggressively expanding into the United States market through a series of acquisitions, including Glen-Gery. It has become the top brickmaker in the north-eastern United States. Recent progress has been slow in the US because COVID-19 forced the deferral of many non-residential construction projects. Nevertheless, Brickworks' US business has made good inroads over the last couple of years. With net tangible assets of $225m in a large, growing US market, we see room for growth as the North American construction market rebounds.

Shares trading below inferred asset backing

In FY20 underlying NPAT fell 38% to $146m due to the effects of the bushfires and droughts in Australia as well as the impact of COVID-19 on the construction industry worldwide. But investors need not fret for two reasons 1) the decline was off a record year of profitability in FY19 when economic conditions were normal and 2) the prospects for FY21 are bright.

In its first quarter update, management noted a strong start to FY21 for the Building Products division and continued strength in the industrial property trust. First quarter earnings were up significantly over last year. With the support of government stimulus home builders are expected to stay busy for the rest of FY21, which is a big positive for Brickworks.

Brickworks' underlying asset value is mostly comprised of assets that aren't related to bricks and construction products. The company's current inferred asset backing is $3.79bn, or $25.24 per share. The growing investment in Soul Pattinson alone accounts for almost 70% of asset backing. The $25.24 figure is important because it represents a support level for Brickworks' share price. And with the current share price well below the asset backing, we see good value here. Brickworks' unique exposure to the recovering building products business and the fast-growing industrial property market as well as its investment in Soul Pattison make its stock a great building block for an investment portfolio. Four stars.

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Shift to office and self-storage is accelerated by acquisition

Abacus Property Group's office portfolio accounts for roughly half of total assets. It mostly consists of properties in central business districts that have good growth potential. Amid challenging trading conditions, the performance of the office assets has been resilient. Through 1Q21, Abacus had completed over 28,000 sqm of leasing with positive spreads, had 91.4% occupancy and collected 91% of rents.

The self-storage side of the business stems from the group's relationship with Australia's biggest self-storage company, Storage King based in Crows Nest. Through this partnership, Abacus became one of the country's largest self-storage property owners with more than 80 locations. Occupancy rates in the self-storage business have rebounded after COVID-19 lockdowns and reached 89.7% as at September end. Rental yields have fully recovered generating revenue of $251 per available square metre and rent collection is an impressive 99%.

Abacus also has non-core interests in the retail, industrial and residential sectors. Combined, these assets account for approximately 11% of the REIT's asset base. We aren't too concerned about the retail exposure because this portfolio represents less than 6% of assets and mostly consists of convenience retail centres.

Strong pipeline of acquisitions and developments

We favour Abacus's strong track record of enhancing the long-term value of its investments through acquisition, development and expansion. The company's strategy is largely built on acquisitions. It has put $926m of capital towards acquisitions in the office and self-storage sectors including $205m already in FY21. With additional acquisition capacity, the REIT is well-positioned to capitalise on further growth opportunities in its key markets.

Last month, the company agreed to acquire the three-fourths of Storage King that it didn't already own for $50m. Abacus tapped into existing debt facilities to fund the buyout and give it access to all of Storage King's 170 locations and over 50,000 customers. The purchase should make self-storage a more integrated management business and drive higher asset returns as Abacus asserts its scale on the competition.

Abacus further strengthened its self-storage portfolio further by acquiring four self-storage assets for $45.1m, including urban facilities in Sydney, Melbourne and Wollongong. With the company's pace of acquisitions ramping, we expect more will soon follow.

On 8 December, Abacus announced a $402m equity raising at a discounted $2.90 per share. The purpose is to use the funds to repay debt and enhance its acquisition capacity. Management noted an ambitious acquisition pipeline of $160m in assets most of which are in advanced negotiations. The financing will reduce gearing to 17.5% and provide an extra $911m of acquisition capacity, which we expect the company to put to good use. Abacus additionally has a strong development pipeline that it expects to spend $80m on in the medium term while targeting an 8% return on invested capital (ROIC).

Share price is below Net Tangible Assets

Looking back on the FY20 result, things were mixed. But considering the impact of the pandemic late in the fiscal year, we found it to be positive. The asset base grew by more than 18% to $3.3bn, funds from operations fell 3.6% to $124.6m and statutory profit was down 58% to $84.7m. More importantly, we were encouraged by the company's capital deployments in the growing office and self-storage sectors and divestments of slow or no growth, non-core assets. We also applaud the group's active asset management prowess, which led to 12.5% higher net property rental income in FY20.

The impacts of COVID-19 have highlighted the risks that small and medium sized enterprise (SME) tenants pose to real estate investors like Abacus. With many of Australia's smaller businesses struggling to get back on their feet, SMEs are at higher risk of not being able to pay rent. As a proportion of income, Abacus' exposure to SMEs in the office and retail portfolios is 28% and 49%, respectively. This isn't overly concerning, but certain warrants monitoring in our view.

Management's astute capital management has resulted in a strong balance sheet. The focused deployment of capital into the office and self-storage sectors has created a high-quality portfolio of real estate assets that generate steady income. The balance sheet has a high level of liquidity thanks to an increased bank facility that has favourable terms.

Following the completion of the equity raise, net tangible assets (NTA) per security are expected to be $3.15. The announcement pushed the share price below $3.00, but we don't expect it to stay there for too long. With the stock down 15% this year and trading at a discount to NTA, we believe Abacus is a bargain. Real estate investors can count on steady growth and income in the years ahead. Four stars from us.

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Share price chart

Source: Tradingview

First half performance just okay

Iress develops software that is used by companies in the financial services industry including banks, brokers, insurers, financial advisors, traders and superannuation companies. Its software helps customers manage investments, navigate the financial markets, compare insurance, simplify mortgage applications, administer super funds and deliver financial advice. The Xplan, Super, QuantHouse and O&M software solutions are among the company's most popular offerings and are experiencing decent client demand, particularly in the APAC region.

The company's half year results contained some positives, but were largely uninspiring. For the six months ended 30 June 2020, revenue was up 12% to $270.7m. However, net profit after tax (NPAT) fell 14% to $26.3m. The decline in profitability was due to losses in its acquired businesses (including QuantHouse and O&M) as well as higher annual leave expenses. Although we favour the recurring revenue stream that is generated by Iress software subscriptions, we have overriding concerns in other areas.

COVID-19 continues to impact Iress's sales figures in the U.K. Mortgage segment. Project delays amid a cautious level of spending and slow business activity have weighed on the mortgage business. In the interim period, mortgage revenue fell 19%, which, along with sales in the South Africa segment, dragged down overall results. We see the challenging macroeconomic environment continuing to impact Iress' near-term results and regard its mortgage exposure as a significant investment risk.

With a broad customer base of tier one, two and three U.K. lenders, the Iress mortgage business accounts for approximately 6% of revenue. Management noted that all key Mortgage projects have resumed, two of the company's mortgage clients went live in August 2020 and two more are expected to go live in 1HY21. This is encouraging, but there's another reason to be cautious about the Mortgage segment — more than half of the business still operates on a non-subscription model. The company is gradually moving towards a subscription model, but this is historically a lower margin business whose margins have contracted in each of the last two interim periods.

OneVue integration will take time

Iress has taken on several of acquisitions to spur inorganic growth. Last month it acquired Sydney-based financial technology company OneVue Holdings. Iress had to sweeten its offer for OneVue, but ultimately succeeded in buying the firm for 43 cents per share in cash, which represented a generous 79% premium. OneVue offers a range of services, including its main managed funds administration business in addition to various platform and superannuation services.

We think OneView complements the Iress business rather well. However, the new company will need to be integrated with the Iress technology and culture. Given the tedious, time-consuming nature of software integrations, investors should anticipate this to take a considerable amount of time and financial resources. There is potential for efficiency gains here, but these types of integrations can be extensive. For instance, OneView has 61 fund manager clients that will need to be integrated with each one being a largely customised process.

Similar to the half yearly results, the Iress balance sheet is okay, but not spectacular. Gearing is conservative at 0.3x segment profit. Net debt has come down since December 2019, but still stands at $48.7m. The company's financial position is conducive to pursuing future growth opportunities although we'd prefer a stronger cash position. With that said, while much of the money from its recently completed $170m capital raise went towards the purchase of OneVue, remaining funds do give Iress increased balance sheet flexibility.

Price tag too rich for investors to subscribe

While pandemic restrictions have been lifted in some of the software developer's markets, some of its customer base are in lockdown. New waves of the coronavirus threaten to impact the pace of software implementations, revenue recognition and Iress's ability to win new business. This heightened level of uncertainty caused management to refrain from offering earnings guidance, so its hard to assess valuation from a forward earnings perspective.

But what we do know is that, based on the last 12 months of earnings, the valuation is stretched. Iress shares are trading at 29x earnings and aren't worthy of such a premium valuation, in our view, given the mortgage exposure and OneVue integration risks. The stock does offer a nice yield, but we believe there are better options for income and growth in the technology sector. So, only three stars from us.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

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