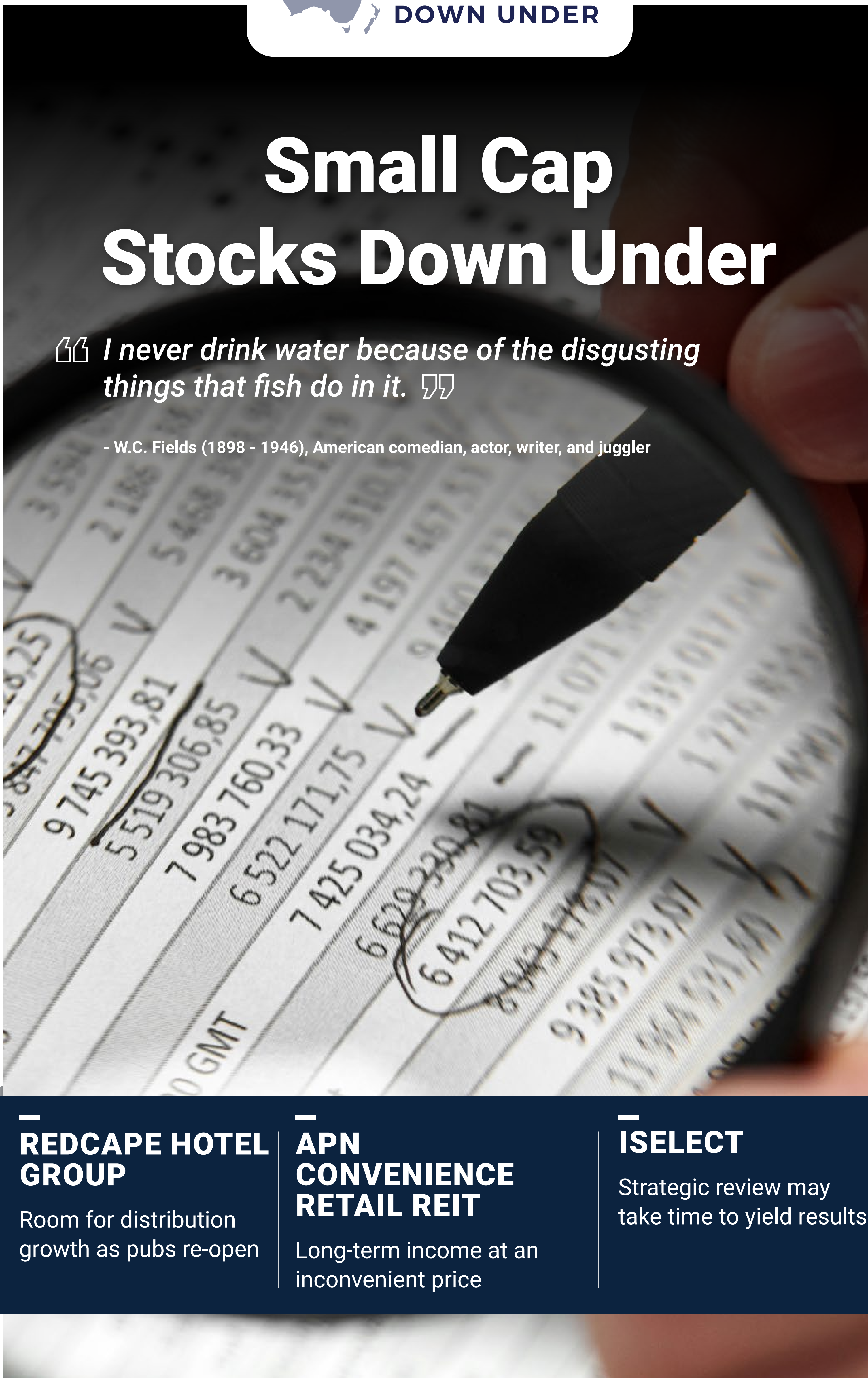
STOCKS DOWN UNDER

4 DECEMBER 2020

Small Cap Stocks Down Under



“I never drink water because of the disgusting things that fish do in it.”

- W.C. Fields (1898 - 1946), American comedian, actor, writer, and juggler

REDCAPE HOTEL GROUP

Room for distribution growth as pubs re-open

APN CONVENIENCE RETAIL REIT

Long-term income at an inconvenient price

ISELECT

Strategic review may take time to yield results

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Room for distribution growth as pubs re-open

Stocks Down Under rating: ★★★★

ASX: RDC
Market cap: A$ 516M
Dividend yield: 4.6% (0% Franked)

52-week range: A$0.42 / A$1.14
Share price: A$ 0.94

Redcape Hotel Group is a Sydney-based operator of pub properties. After a rough few months following the onset of the Coronavirus Pandemic, the company is now reaping the benefits of pub reopenings across Australia. It still managed to produce a strong FY20 result despite the challenging circumstances and its customer reviews have been positive. However, even with the improving economic backdrop and recent performance, Redcape shares continue to trade below net asset value at less than $1.00. That's attractive to us now that Australia is more or less back to 'normal'.

READ MORE

APN CONVENIENCE RETAIL REIT

Long-term income at an inconvenient price

Stocks Down Under rating: ★★

ASX: AQR
Market cap: A$ 418M
Dividend yield: 6% (0% Franked)

52-week range: A$2.39 / A$4.10
Share price: A$ 3.63

APN Convenience Retail REIT has a $455m portfolio of 80 service station and convenience retail assets that are mostly located in the eastern seaboard states where more than three-fourths of Australia's population resides. The major tenants (Chevron, EG Group and 7-Eleven) provide a defensive income stream due to the essential nature of their businesses. Although the long-term nature of the portfolio is appealing as is the steady nature of its shareholder distributions, the stock trades at an unattractive valuation.

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52-week range: A$0.18 / A$0.56
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Share price chart

Source: Tradingview

A focus on the fast-growing greater Sydney area

As one of Australia's top pub and hotel operators, Redcape now holds 32 quality hotels in its property portfolio. They are located in attractive, higher growth areas across New South Wales and Queensland with 21 situated in the sought- after Greater Sydney area. All but two are freehold going concerns. This is important because the freehold ownership structure is more conducive to fast refurbishments and asset optimisation.

Redcape has returned to business-as-usual after months long closures crippled the hotel, restaurant and entertainment industries. Since its popular pubs have re-opened, customers have anxiously returned for a good meal out and a pint (or two). Despite the strong pent-up demand, Redcape's stock still trades below Net Asset Value (NAV). As at 30 June, NAV per share was a sturdy $1.09, which we consider remarkable since that is only $0.05 below where it was 12 months before.

Prudent portfolio management

Now fully operational, the company has its sights set on optimising its portfolio through new service offerings and by staying active on the acquisition front. In November 2020 Redcape bolstered its property portfolio by acquiring the Gladstone Hotel at Dulwich Hill in Sydney's inner west for $38m. The Gladstone fits nicely with the existing mix of surburban community hotels, which are mostly located in western Sydney. We like that this addition will be immediately accretive to distributable earnings. The deal is expected to settle prior to March 2021.

We also favor Redcape's recent divestments which amounted to $98.1m in FY20 and included the sale of the St. George Hotel in Belmore and the Royal Hotel in Granville, both in Sydney. Both were sold at a premium to book value. These sales combined were more than double what the group spent on acquisitions during the year, which included the Eden Brewhouse in the Brisbane suburb of Redbank Plains and the Kings Head Tavern in South Hurstvillle in Sydney.

Since trade resumed on June 1st, thirsty customers have picked up where they left off by frequenting Redcape's high-touch venues. Meanwhile, Redcape management has treated staff well during the pandemic through various support initiatives. This has translated into favorable customer and staff Net Promoter Scores (NPS). The Customer NPS through 30 September was +48, a tad below Redcape's +50 target, but still good and above the previous quarter's +32. The most recent staff satisfaction score of 4.5 out of 5 also improved quite a bit from 30 June. These are some of the stronger scores in the industry.

Strong FY20 points to a resilient business

Considering the challenging circumstances, Redcape managed to generate a strong financial performance in FY20. The result included a palatable 14.8% dip in operating EBITDA and a 20% decline in distributable earnings. Net profit after taxes (NPAT) was $11.2m versus a $4.9m net loss in FY19. Comparing the first eight months of the year to those of the prior year, total revenue was up 11.2% and distributable earnings grew 22.1%. Overall, we are impressed with the FY20 figures given the unprecedented operating environment during much of the year.

An important step taken by management during the COVID-19 crisis was the preservation of liquidity. Redcape has a significantly increased cash position of more than $100 million as well as $10m of undrawn loan facilities. It exited FY20 with a manageable 36.3% gearing ratio, which checks-in at the low end of its target range. The healthy balance sheet supported a 22 September decision to reinstate dividend distributions. The distribution for the first quarter of FY21 was a generous 1.83 cents per share and came on the heels of a record Q1 performance that saw further trade momentum. Over time, management's main goal is to increase shareholder distributions. It appears to be heading in the right direction.

Redcape stock has rebounded sharply off its March 2020 bottom, but in our view has more room to run. The pub operator has a strong portfolio and customer base, an effective capital management strategy and trades well below NAV. We expect that Redcape shares will continue to get scooped up by income investors—and that soon there may be limited vacancy for buyers.

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Strategically located assets with long leases

The goal of the APN Convenience Retail REIT is to provide investors with a stable income stream by investing in service station and convenience store properties across Australia. It does so by investing in assets that are in high customer traffic areas and that have long leases to stable tenants. The REIT also aims to generate income growth and capital appreciation by identifying assets with rental increase potential. The portfolio's average annual rent increase is favourable at 2.8%.

On 19 October 2020, the REIT agreed to purchase Chevron Balcatta in suburban Perth for $7m. The three-year old retail property is anchored by a 15-year lease to Chevron, which operates under the well-known Puma Energy brand. It is also supported by a new 10-year lease to automotive services company UltraTune.

In our view the investment will have a positive impact on the portfolio because it has a weighted average lease expiry (WALE) of 11.7 years—and it provides for annual rental increases of 3% to 4%. It will also significantly diversify the income profile of the portfolio with the addition of five new tenants.

Strong balance sheet, emerging pipeline

The FY20 results were largely positive. Distribution per share increased 4.3% to 21.8 cents while funds from operations (FFO) per share inched just 0.4% higher to 21.6 cents because of an increase in security issuance. While many REITs have struggled due to COVID-19, the APN Convenience Retail REIT has been one of the more resilient businesses. Rental relief was provided on a mere 1.2% of the portfolio in FY20 and no relief is currently being provided to tenants. Meanwhile, the value of the property portfolio was uplifted by $31.9m, which helped raise the management fee.

The REIT has a strong balance sheet that affords it the room to make value-added acquisitions. And management has certainly been active on the acquisitions front, committing to properties worth more than $90m in FY20. In the process it added five new quality tenants to the portfolio including BP, Coles Express, Liberty, Ampol and Mobil/X-convenience. Gearing is a healthy 18.6%, which we find to be among the more conservative capital management positions in the REIT space. The REIT used some of the proceeds from equity raising to reduce interest bearing debt to $75.8 million from $115.4m as at FY19.

It has an interesting pipeline of new opportunitie as its development project portfolio encompasses ten assets all but one of which are located in South Australia. Six of the properties have been recently completed while four are nearing completion. The remaining properties have commitments totalling $22.4m including sites in Grand Junction, Taperoo, Sheidow Park and Hillcrest. APN Property Group has also noted more development opportunities are coming down the pipeline. It probably won't be long before the portfolio welcomes its 100th property.

Stock's expensive price tag overshadows a nice portfolio

We like the long-term nature of the APN Convenience Retail REIT portfolio. The current WALE is 10.7 years, which represents consistent income for investors stretched over an extended period of time. Conversely, a portfolio of shorter leases would be less compelling because it carries greater risk that leases aren't renewed and, therefore, income streams are less reliable.

Since gas stations, service stations and convenience stores have relatively steady consumer demand, this REIT can be considered a defensive income investment. With Australian travellers returning to the highways, business at these convenient pitstops is picking up. But while the counter-cyclical nature and dependability of the portfolio's yield are attractive, the stock's price tag is not. This outweighs the attractive nature of the portfolio in our opinion.

Net tangible assets (NTA) have increased in every interim period since the REITs IPO. As at 30 June 2020 NTA was $3.27 compared to $3.13 six months prior. With the stock trading approximately 12% above NTA per share, we'd prefer to fill up our income tank with a more attractively valued REIT. For now this is a two star story for us.

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Weak full year results

The iSelect portfolio of comparison-shopping tools for insurance, finance and utilities products includes the iselect.com.au and energywatch.com.au websites. The technology allows consumers to compare features and rates for health, life, auto and even pet insurance in addition to home loans and income protection. Customers can tap into iSelect's utilities tools to "Compare. Select.Save." on their electricity, gas, phone and internet bills.

The group's FY20 result is best characterised as weak. It booked 23% lower sales due to a 43% decline in the energy business and a rough fourth quarter for the health insurance business due to the onset of COVID-19. Leads were also down significantly and the key customer conversion metric slipped to 8.9%. This ultimately led to a decrease in iSelect's gross margin and a 40% drop in underlying EBITDA to $13.7m. Although we acknowledge iSelect faced unprecedented external market forces, it has also been slow to adapt to the changing trade environment.

COVID-19 and energy reforms produce a one-two punch

COVID-19 has had a major impact on iSelect's trading conditions. For starters, the pandemic began at a time when health insurance sign-ups are usually in their peak period. Late March has historically been the group's busiest time of the year. The annual rate increase was deferred, elective surgeries were suspended and the shutdown of certain health facilities amounted to a 50% drop in health insurance demand in the months of March and April. Since then, demand has improved but it has been a slow rebound.

On top of the pandemic-related challenges, iSelect was severely impacted by regulatory changes in the energy sector. The Default Market Offer (DMO) and Victorian Default Offer (VDO) prompted a 'price ceiling' which hurt electricity retailers' profit margins. In response, the electricity retailers raised the pricing on their more competitive offers. This translated into sharply lower conversion levels for iSelect starting in July 2019. While its conversion has since recovered, more than a year later, it is still below historical levels. Today, the energy reform pressures continue to weigh on iSelect's revenue and profitability.

The COVID-19 and energy reform challenges along with uncertainty around the timing of a full recovery caused a downward revision in the value of iSelect's iMoney business. The group eventually had to dispose of the iMoney platform for a nominal value. Meanwhile, the value of the Energy Watch business became impaired.

ACCC investigation casts an unfavourable light

The COVID-19 outbreak also spurred a change in consumer behaviour. Many consumers delayed making purchase decisions amid the uncertain economic backdrop while others chose to forego previously planned spending. This pushed management to conduct a strategic review of its operating model. Some changes have been implemented and are showing early signs of success, while others may take quite a bit more time to bear fruit.

For instance, iSelect chose to stay in the life insurance and home loan comparison businesses, but has opted to outsource order fulfillment. New service models, vertical integration, and partnerships in the B2B space will also take time to evolve. We also expect performance-focused changes to develop slowly. This includes a plan to reduce the cost base and an increased focus on profitability and cash flow. Part of this involves new investments in technology, which will undoubtedly happen over time.

Switching gears, last month the Australian Competition and Consumer Commission (ACCC) put iSelect in the crosshairs by announcing an investigation of recent stock purchases in the company. The ACCC cited competition concerns after discovering business services group Innovation Holdings Australia had been gradually building a position in iSelect—and doing so to the tune of a 29% stake over the last two years without reporting the transactions to the ACCC. Innovation Holdings Australia are the people who own 'Compare the Market' – you know, the folks that have the meerkats pitching the service in Russian accents in those great TV ads.

You guessed it: Since Innovation Holdings' subsidiaries offer online tools for insurance, energy and financial product comparison, it fishes in the same pond as iSelect. With Innovation Holdings seeking to tack on another 6% to its iSelect stake, the ACCC has finally caught wind of the situation. While the investigation is ongoing, the fact that a competitor was investing in iSelect in itself isn't a bad thing. However, the fact that no one bothered to report the build-up of Innovation Holdings' stake in iSelect is not a good look. We see this issue dampening investor confidence in the stock and being an overhang for some time.

So, at this point there are still far more questions than answers when it comes to iSelect's outlook for growth. For that reason, we prefer to select stocks that have better visibility into their strategic direction. Two stars.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

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