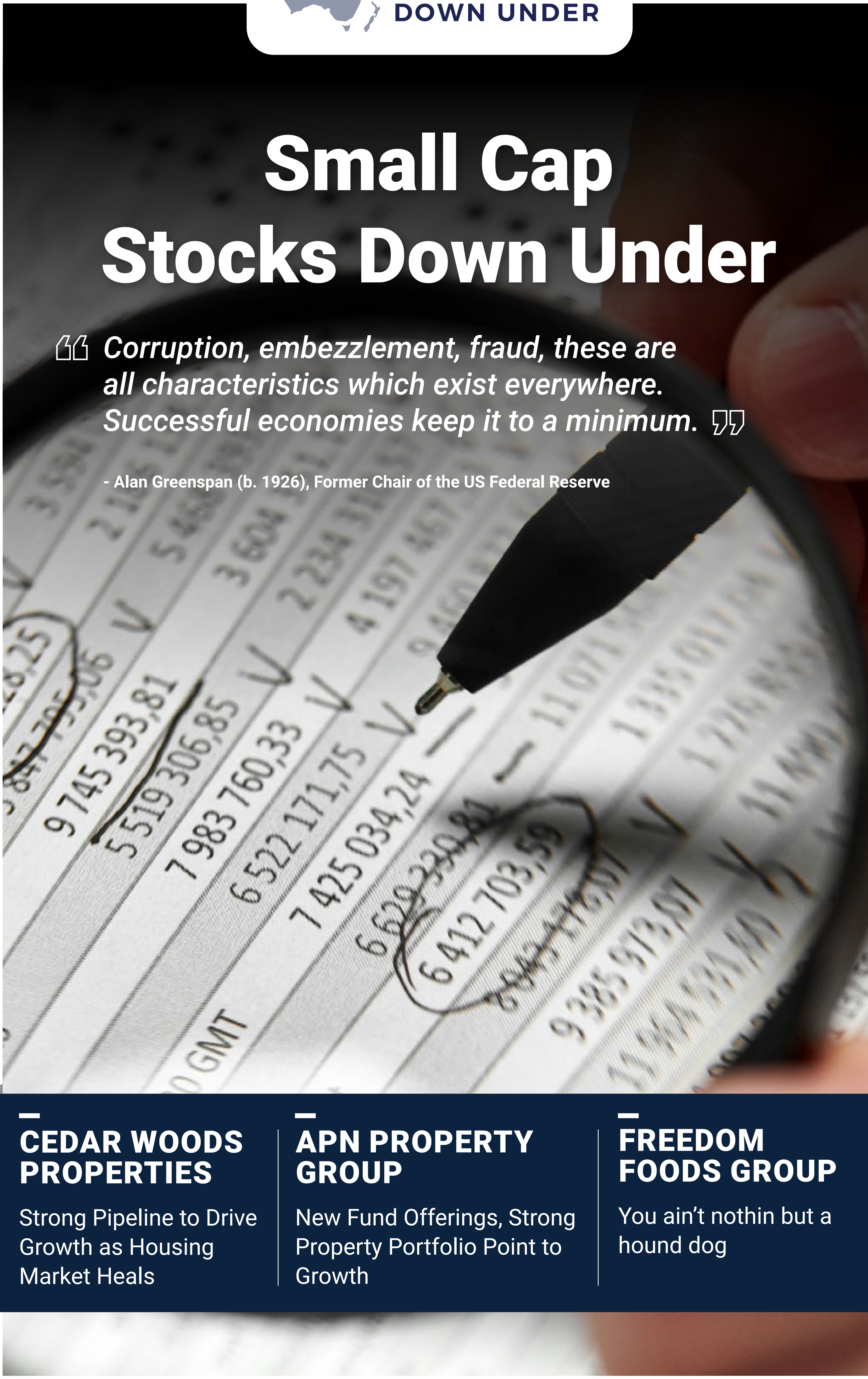
STOCKS DOWN UNDER

11 DECEMBER 2020



Small Cap Stocks Down Under

> *Corruption, embezzlement, fraud, these are all characteristics which exist everywhere. Successful economies keep it to a minimum.*

- Alan Greenspan (b. 1926), Former Chair of the US Federal Reserve

CEDAR WOODS PROPERTIES

Strong Pipeline to Drive Growth as Housing Market Heals

APN PROPERTY GROUP

New Fund Offerings, Strong Property Portfolio Point to Growth

FREEDOM FOODS GROUP

You ain't nothin but a hound dog

CEDAR WOODS PROPERTIES

Strong Pipeline to Drive Growth as Housing Market Heals

Stocks Down Under rating: ★★★★

ASX: CWP
Market cap: A$ 545M
Dividend yield: 2.8%

52-week range: A$2.87 / A$8.66
Share price: A$ 6.78

Perth-based Cedar Woods Properties is a property developer with assets in Western Australia, Victoria, Queensland and South Australia. In addition to residential communities, it develops commercial properties which are in high amenity locations and often near a train station. We like the geographic and sector diversification, profit history and robust development pipeline of this developer. Following a sharp pandemic-induced downturn that culminated in a share price below $3.00, the company seems to be at least partially out of the woods. Presales are trending above last year's levels as Australia's residential property market continues down recovery road.

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ASX: APD
Market cap: A$ 188M
Dividend yield: 5.5%

52-week range: A$0.35 / A$0.74
Share price: A$ 0.57

Headquartered in Melbourne, APN Property Group is a specialist real estate investment manager with a solid track record of growth. It manages several real estate funds that offer income and capital appreciation potential for both retail and institutional investors. Over the past five years, APN shareholders have been rewarded with a 17.9% per annum total return. APN's business has broadened of late with the addition of newly listed REITs, including the new APN Global REIT Income Fund. We applaud the group's effort to reduce its exposure to economically sensitive retail properties and anticipate steady growth ahead. The long-term nature of the property portfolio and attractive yield make APN a desirable play on a continued recovery in the real estate market.

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FREEDOM FOODS GROUP

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Stocks Down Under rating: ★★

ASX: FNP
Market cap: A$ 834M

52-week range: A$2.75 / A$5.68
Share price: A$ 3.01
(Suspended: 24 June 2020)

Freedom Foods Group seems to have made it its mission in life to prove wrong the saying that there is no such thing as bad press. Since 25 June 2020, Freedom Foods has constantly been in the news as the full details of executives' nearly $600m accounting fraud have come to light. We wrote about the company 2 weeks before all of the facts started to come out. Now that the company has revised its annual reports, we are now setting the record straight and revising our rating.

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Share price chart

Source: Tradingview

Geographic spread reduces risk profile

Don't be fooled by the market cap. Cedar Woods is quickly becoming one of Australia's leading property developers. It is primarily focused on land subdivisions, medium-to-high density apartments and townhouses located in urban neighbourhoods. It offers residences and commercial buildings at several price points that fit a wide range of household and corporate budgets.

Cedar Woods' property portfolio is comprised of 30 projects located across Victoria, South Australia, Western Australia and Queensland. We favour the geographic diversification of the assets because it limits the potential for any one area to have a devastating impact on overall financial performance and reduces the risk of the business. Moreover, the projects are located in the higher growth inner-city areas of the four states, which points to the long-term growth potential.

Balance sheet in good shape

Cedar Woods followed up on record profits in FY19 with a solid FY20 result, all things considered. Revenue decreased year-over-year to $260.7m and net profit after taxes (NPAT) fell to $20.9m. This led to a more modest 5.5% return on equity (ROE) that was below the company's 10% benchmark. We see the potential for ROE and overall performance to improve in FY21 due to pent-up demand, low supply and continued government support.

COVID-19 caused the delay of some settlements that were scheduled for June 2020. Social distancing requirements at construction sites have made it hard for workers to stay on schedule. Fortunately, the company's home base of Perth, where it was founded back in 1987, was virtually unscathed by COVID-19. This is noteworthy because more than half of its portfolio is located in Peth and other parts of Western Australia.

The balance sheet is strong due to its low level of debt and undrawn finance facilities north of $100m. Gearing is 38%, which is near the lower end of management's rather wide 20% to 75% target range. This puts Cedar Woods in a good position to fund operations and organic growth opportunities, make acquisitions and continue to pay dividends. Although the company chose to reduce its dividend from 31.5 cents in 2019 to 19 cents this year to preserve liquidity during the pandemic, the balance sheet is healthy and should support a resumption of annual dividend increases as economic conditions continue to normalise.

Challenging housing market conditions

Market conditions in the Australian residential property sector are mixed. A low level of new housing supply has helped prop up pricing over the last few years. Since the onset of COVID-19, the decline in pricing has been modest and the prevailing limited supply certainly factors in here. Of course, government stimulus has been a tremendous support to the housing sector and is a big reason Cedar Woods has been able to recover fairly quickly.

But it still faces challenges related to the lingering effects of the pandemic. While economic conditions are improving, homebuyers still lack confidence because they are uncertain of the stability of the recovery. A weak jobs market has much to do with this. Buyer demand is also being impacted by social distancing in that some Australians are seeking an alternative to higher density urban living in the form of suburban residences. Fortunately, however, demand should be supported by historically low-interest rates for the foreseeable future. As major infrastructure projects, such as new train stations and transportation hubs, resume, buyers are likely to be more attracted to Cedar Woods' conveniently located city abodes.

There is a strong pipeline of new properties at Cedar Woods—more than 8,600 lots stand ready to be developed. As of 30 September 2020, the developer had approximately $454m in presales, which marked an increase of 11% over presales from the 12 months prior. This was largely the result of the Federal Government's HomeBuilder package as well as incentives offered by the Western Australian state government. The company expects that about 60% of presales will settle in FY21. The remainder will count towards earnings in FY22 or FY23.

Meanwhile, the acquisitions environment is positive since many projects are being reassessed in the wake of the pandemic. Cedar Woods recently agreed to acquire 28.55 hectares of land in the high growth Moreton Bay part of Burpengary, Queensland.

Overall, we like the diversification and strength of Cedar Woods' current projects and are encouraged by the deep development pipeline. As Australia's housing market continues to recover, expect this company to be a major beneficiary of residential and commercial property growth. Four stars from us.

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Share price chart

Source: Tradingview

Expanding fund suite, acquisitions drive FUM growth

APN Property Group's fund offerings include real estate securities, direct real estate, industrial real estate and convenience retail property funds. Its business has become more diverse in recent years as it has branched out into different sectors in Australia and stretched beyond the country's borders. As of 30 June 2020, it managed 12 funds, which together hold $2.7bn in commercial property investments. The APN AREIT Fund, the group's biggest fund, has provided consistent distributions to long-term investors and anchors a strong line-up of income-generating investment products.

The direct property funds are well positioned for both shareholder returns and growth. This is because of the management team's focus on industrial, convenience retail and non-CBD office properties that are leased to stable corporate and government tenants. The funds have conservative gearing levels around 30%, which we like because it leaves room to fund acquisitions that can increase group profitability.

Over time APN has witnessed solid growth in funds under management (FUM) that has coincided with rising income levels and distributions. FUM grew at an annual rate of 7.9% from FY15 through FY20 and we see this trend continuing on account of the group's financial strength. Year-to-date through 30 June, FUM has grown by more than $150m as a result of favourable market movements and direct property acquisitions.

Strong FY20 result as APN shifts away from retail

Within the real estate securities portfolio, APN has been gradually reducing exposure to retail property. In FY20 it lowered its retail exposure by 20% with some funds shifting to the non-discretionary and convenience segments of the retail industry. The group is making this shift because of lower tenant demand and increased risk associated with most retail properties in a post-pandemic economy that has become increasingly e-commerce centric. We give this move two thumbs up as it puts the portfolio in a better position to achieve reliable income growth.

We are impressed by the group's ability to navigate the challenges presented by COVID-19 to both its business and tenants. APN delivered a strong FY20 result that included a 12% increase in operating earnings to $10.4m. Dividend distributions rose 15% year-over-year to 3.15 cents per share. Although market movements had a negative impact on the securities funds, underlying FUM growth was approximately $170m due to asset acquisitions. The group exited the quarter with a strong balance sheet that contains $16.3m of cash. APN also holds co-investments worth $115m to round out the non-funds side of the business.

Global REIT offering has significant growth potential

The group recently launched the APN Global REIT Income Fund, which is focused on various income-producing properties around the world. Backed by real assets, it gives investors diversification and exposure to the international real estate market by investing in quality commercial properties with growing income streams. The Global REIT's holdings include the Crown Castle Mobile Phone Tower, the Digital Realty Trust Data Centre and the Prologis Industrial Centre located in the United States as well as the Gecina multi-family and office property in Europe. Several key distribution platforms have embraced the fund, and we see that as a significant contributor to APN's future earnings. We also like the defensive nature of the fund's assets because it serves as a protection against inflation.

Speaking of strong properties, APN's direct property portfolio is a collection of defensive assets, which are mostly located in Australia's East Coast capital cities. It generates strong income returns because of its long leases and affordable rents. The $1.4 billion direct property portfolio has a compelling 7.3 years Weighted Average Lease Expiry (WALE) and a 95% occupancy rate.

Overall, we like APN's long-term growth prospects due to its exposure to attractive, but defensive sectors and the income and growth potential of the assets held across its fund suite. Four stars.

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Share price chart

Source: Tradingview

The fraud

So, what's the situation? On 30 November 2020, Freedom Foods finally released its FY20 full-year results while also restating the accounts for FY19 and FY18. The total damage done was $591.5m in monetary restatements. To give this some context, FY20's total revenue was $580.2m. This means that the restatements were 102% of last year's total revenue.

The main hits came from write-downs of $60.1m in out-of-date inventory, $372.8m in asset value, $75.9m in goodwill and brand value, and $38.9m in impairments for underperforming products. Additionally, FY19's profit of $11.6m was restated to a $145.8m loss and FY20 saw a loss of $175m.

Unfortunately, shareholders might be in for a more significant walk back than even this. On 8 December 2020, Slater and Gordon (ASX: SGH) filed a class-action lawsuit on behalf of shareholders between 7 December 2014 and 24 June 2020. The law firm is alleging that instead of the issues going back to only 2017, material information was actually withheld starting in 2014. We believe a class action like this, although not unexpected, may bring out more bad news.

What's left?

That's not as easy a question to answer as it sounds. Freedom Foods has been in a trading suspension since 24 June 2020 and it is unclear as to when the company will return to active trading. Using the last traded price of $3.01, the company has a market capitalisation of around $834m. However, this was before the $591.5m write down and well before the market had any real time to grasp the situation. If Freedom Foods' stock does resume trading, we fear it could end the day well below $1 per share.

Why below $1 per share? The company's restated filings have shown that the only division that has any chance of a profitable future is the plant-based beverages division. This is the only significant division operated by Freedom Foods that is currently profitable with an EBITDA margin of 12.9% and revenue of $132.3m, resulting in $17m in EBITDA. This division saw a 30% increase in revenue year-over-year and EBITDA returning to profitability after a $6.5m loss during FY19. The specialty seafoods division is also profitable. However, it only generated $15m in revenue and $200,000 in EBITDA. This represents 4% year-over-year revenue growth and an EBITDA margin of 1.3%.

Even at $1 a share, Freedom Foods would still have a market capitalisation of around $277m. While the company has assets totalling $682m as of FY20, the company also has total liabilities of $621m. When adding in the $280m in additional debt management is attempting to raise to pay its current obligations, this provides net assets of negative $219m. This is before any fines, lawsuit costs and judgements with lossmaking operations.

No crisis is complete without some China risk

One of the very few bright spots left on Freedom Foods balance sheet is its 10% stake in Australian-based dairy processor, Australian Fresh Milk Holdings. Australian Fresh is also jointly owned by China-based New Hope Group and saw its UHT milk product sales to China rise by 7.7% to $60m during FY20. This represents 56% of the company's $107.4m in FY20 total revenue. Both Australian Fresh and Freedom Foods have gone on record stating they are confident that the company has a strong relationship with China and won't be hit by any stray bullets from the Australia-China fight. However, we tend to opt for the Jim Chanos approach to China in that it is "a pig on LSD, you don't know which way it's going to run." Seeing as the 10% stake is one of the few positive standouts left on Freedom Foods' balance sheet, we don't believe China is a minor risk.

Well that was just a lie

Some of our subscribers will remember we rated Freedom Foods four stars at the worst possible time, 12 June 2020. Also known as 13-days before the first major ASX announcement bomb was dropped. With all we know now about this company we feel the need to quote the great Elvis Presley who once said, "They said you was high-classed. Well, that was just a lie… You ain't never caught a rabbit and you ain't no friend of mine."

Despite all of this we are revising our rating to three stars from four. The truth is it's not at all clear that Freedom Foods will receive the funds necessary to recapitalise and resume trading. Even if Freedom Foods does recapitalise and resumes trading, the price the company will receive for its sale of assets as it pivots to focus on plant milk is also unclear, and we believe that will be the lynchpin that determines how the market will treat the stock going forward.

Lastly, if the stock does come out of suspension, is it unclear at what price it will resume trading. Taking all of this uncertainty into account, we feel a two star rating is the only appropriate course of action at this time.

Pitt Street Research Pty Ltd

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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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