STOCKS DOWN UNDER

1 MARCH 2021

ASX Top 200 Stocks Down Under

The way we see it, real wealth means having the money and the freedom to live life on your own terms.

- Rich Fettke, Co-Founder and Co-CEO of RealWealth

LIBERTY FINANCIAL GROUP

Liberty achieved

CROMWELL PROPERTY GROUP

A volatile situation

CONTACT ENERGY

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Stocks Down Under rating: ★★★

ASX: LFG
Market cap: A$ 2.5BN

52-week range: A$6.60 / A$8.35
Share price: A$ 8.21

Liberty Financial Group offers home, car, personal, commercial and business loans across Australia and New Zealand. Headquartered in Melbourne, Liberty was one of the many companies that took advantage of the high demand for equities after the Corona Crash and IPO-ed on the ASX on 15 December 2020. With an IPO price of $6, the company has done exceptionally well as it has since rallied 37%. The question is, can the rally continue?

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Market cap: A$ 2.1BN
Dividend yield: 9.3% (0% Franked)

52-week range: A$0.67 / A$1.19
Share price: A$ 0.79

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Market cap: A$ 1.5BN
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52-week range: A$4.32 / A$10.56
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Headquartered in Wellington, New Zealand, Contact Energy is one of New Zealand's largest listed companies. It has achieved this by offering its more than 550,000 customers access to electricity, natural gas and Liquefied Petroleum Gas (LPG) across the country. After dropping around 40% due to the COVID-19 market crash, its share price recovered to its pre-crash level by October. However, the stock has dropped hard since its mid-January high. So, is Contact Energy ready to recover, or will it continue the plunge?

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Share price chart

Source: Tradingview

Debt makes the world go round

When Liberty was established in 1997, it was initially only involved in the Australian residential mortgage sector. Since then, the company has developed a platform that allowed expansion into New Zealand. It expanded its debt services offerings to three main divisions: residential finance, secured finance and financial services. These days, Liberty is a serious player with a loan book worth $11.6bn. In fact, the company has provided $36bn in financing to over 500,000 customers since it was first established.

Residential finance, which is residential mortgages in Australia and New Zealand, is the lion's share of that book. The loan portfolio for this division at the end of FY20 was $8.5bn, a 4% increase year-over-year. However, the growth was mostly in secured finance and financial services.

Secured finance strictly operates in Australia, offering motor financing and commercial financing for Small and Medium Enterprises. This portfolio totalled $2.9bn during FY20, a 31% increase over FY19.

Financial services currently operates across Australia and New Zealand, offering personal loans and cashflow financing, also for Small and Medium Enterprises. This division is comprised of a mortgage broker and advisor network providing investment and deposit services. Financial services saw 80% year-over-year portfolio growth during FY20, the highest growth rate of all of Liberty's divisions. However, its portfolio is also the smallest of the group at only $225m, or 2% of its total portfolio.

You need to dig beneath the surface

FY20 certainly had its challenges for New Zealand and Australian economies, but Liberty Financial still managed to grow the profit generated by all three of its divisions despite these challenges. With its $8.5bn mortgage portfolio, the residential finance division generated a profit of $107.5m during FY20, representing 42% growth year-over-year. Because this profit growth was mainly driven by margin expansion, this growth completely overshadowed the growth in the actual loan book itself, which was only 4%. Importantly, management is currently expecting this margin expansion to continue with FY21 seeing a profit margin of around 31% (26% in FY20). This is important because the residential finance division's revenue is on the decline and management expects this trend to continue with revenues dropping from $417m during FY20 to prospectus guidance of $382m for FY21. While we are impressed that management has been able to increase its margins so significantly, we would like to see a plan to turnaround this division's declining revenue trend.

Fortunately for investors, Liberty Financial's secured finance division and financial services division are both in full growth mode. With its portfolio growing 31% during FY20, secured finance saw revenue growth of 22%, to $244.7m, and profit growth of 49%, to $93.7m, as the company continues to work on its operating margins. Based on FY21's projections, this division's profit margins are expected to grow to 44% from 38% during FY20.

While the financial services division's portfolio only represents 2% of Liberty Financial's total portfolio, it packs a big punch in terms of revenue growth and profit generation. This saw its revenue grow by ($33.1m) 22% and profit grow by ($16.7m) 183% year-over-year, during FY20. Unlike the other divisions, however, margin growth is not expected to drive profits during FY21. Current projections have profit margins only growing from 10.6% during FY20 to 11.6% during FY21.

Normally we would not go into as much detail on the margins of each division. However, in the case of Liberty Financial, we thought it was important to highlight the degree to which future projected profit growth relies on drastic margin increases being achieved in its two largest divisions, i.e. residential finance and secured finance. If management cannot execute on its prospectus guidance, investors will be in for a big disappointment.

The portfolio growth is real

The main story for Liberty is specifically the loan and asset portfolio growth the company has historically experienced and is expected to generate during FY21. According to its prospectus, management expects its portfolio to reach $12bn in size during FY21, an increase of 3.5%. Despite this low expected portfolio growth, the prospectus talked about a profit before tax increase of 18.2% to $174.9m and a revenue decline of 2%.

Unfortunately, we do not have more current information to go on as Liberty just listed. However, the current valuation based on a Price/Earnings ratio is 12.6x for FY21. We believe Liberty's stock certainly has room to move upwards. However, we also think the expected decline in revenue and low growth in its portfolio is a significant risk factor. On top of that, the company is currently only generating an approximate 1% return on assets, a very low rate for a company in this industry.

All in all, we believe Liberty is currently within the range of what we would consider fair-value based on its expected FY21 results. Three stars from us.

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Share price chart

Source: Tradingview

ARA Group who?

If the name Cromwell Property Group rings a bell for you, it might be because the trust is involved in a hostile and bloody takeover battle with its largest shareholder. The crux of the issue is the ARA Group does not believe Cromwell's management has overseen the trust in a way that has provided shareholders with the most bang for their buck. It seems that the ARA Group is well on its way to win after it forced out the CEO, Chairman and two other directors in November and December 2020. With all this negative press, Cromwell is unsurprisingly trading at an 18% discount to its Net Tangible Asset Value per share of $0.99. Now, we want to answer the question, does this takeover affect the value, or is it all just a sideshow?

We all love property

Cromwell has never been an obscure REIT. With total assets under management as of 30 June 2020 of $11.5bn across Australia, New Zealand and Europe, this trust has well earned its place in the S&P/ASX 200 index. Unlike many of its REIT peers, Cromwell's portfolio of around $11.5bn in assets is split between directly owned properties (25%), indirect property investments (10%) and its fund portfolio (65%).

The vast majority of Cromwell's FY20 profit of $268.9m was generated by the directly owned property division ($172.2m). This division is exclusively invested in Australian real estate, split mostly between NSW (41.5%), Queensland (32%) and the Australian Capital Territory (14%). With 95.9% of its portfolio by gross income consisting of office properties, we believe it is fair to say that Cromwell's largest exposure is to office properties. Yes, the directly owned property division is the second-largest division in terms of total assets under management, but it generates around 64% of the trust's divisional annual profit. Now that we know this trust's primary profit exposure is in office properties, how stable are those office fundamentals?

While office REITs have copped considerable flak over the last year as COVID-19 forced employees to work from home, we believe Cromwell's properties are well insulated. Not only are its properties 98.8% leased as of FY20, but by gross income, 45.3% is leased by a Government Authority, while the Federal Government accounts for 22.1%. If this was not stable enough for you, over 67.5% of its lease expiry profile occurs during or after 2025. When it comes to office properties, we believe Cromwell knows how to pick a solid portfolio.

Indirect ownership around the world

As we mentioned above, Cromwell is more than just its directly owned Australian property. The trust's other main business interests include partial ownership of two separate property funds, CEREIT and CPRF, as well as a fund and asset management division. Cromwell's stake in CEREIT is 30.7%, representing a fair value of €394m ($605m). This fund is mainly invested in office properties (63% by gross income), but in this case across Europe. With a Weighted Average Lease Expiry (WALE) of 4.6 years and a high occupancy rate of 94.8%, we are not concerned about this fund's stability.

Representing a fair value of €452m ($694m), the CPRF investment consists of six shopping centres in Poland. Unlike many retail properties in Poland, this investment has held up under COVID-19 due to these centres being anchored by a major grocery store or hypermarket. We believe this is the weakest of Cromwell's current investments due to Poland's continued economic hardship. However, we also believe its WALE of 4.7 years, an occupancy rate of 94.8% and anchorage by essential shopping provides a degree of stability that helps alleviate our concerns.

Representing the most considerable portion of its total assets under management, at $8.2bn, the funds and asset management division is split between Australian ($2.2bn) and international investments ($6bn). This division's FY20 profit of $40.8m was generated through the management of its funds and the properties they control. The Australian investments are broken down into two funds comprised of logistical centres and office buildings. The international investments are based in Europe (€3.5bn) and New Zealand (NZ$2bn) through a combination of different funds with investments in data centres, logistics, and office buildings. All in all, we believe Cromwell is very well diversified.

A bloody distraction

While the level of executive turnover we have seen at Cromwell is never a good thing for any company, we believe the takeover battle with ARA Group has been a big distraction. We believe Cromwell should be considered a high-quality office property trust with a solid level of diversification. The diversification into a fund and asset management business is certainly an unusual for a REIT. However, we think it is mostly a value add in terms of another source of revenue in an area that is well within management's area of expertise, property investment and management.

The current Net Tangible Asset Value per share for Cromwell is $0.99 which leaves 20% upside from the current share price. Although it must be mentioned that 29% of outstanding share proportional offer was for $0.90 per share. We believe investors will have to wait for the takeover to be completed, but all indications are that this unfortunate episode is in the process of being wrapped up. All-in-all with a its four stars from us.

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Share price chart

Source: Tradingview

We need more power

Contact Energy was founded in 1996 and quickly became one of New Zealand's largest hydroelectric, thermal, geothermal and Liquefied Petroleum Gas (LPG) power generators through its 11 plants. The company is a leader in New Zealand's sustainable electricity generation. Contact Energy's prime geothermal assets provide a strong hedge against droughts that have caused significant problems with New Zealand's hydroelectric power generation in recent years. Approximately 57% of New Zealand's power generation comes from hydroelectric generation. This means there is a strong demand for renewable, but non-hydroelectric, power as droughts are expected to become more frequent events due to climate change.

Contact Energy generated NZ$2.1bn in revenue during FY20 resulting in NZ$451m in EBITDA. The company sells the power from its plants at both retail and wholesale rates. During 1HY21, Contact Energy generated 4,615GWh of electricity, making it a a 'back to normal' half - 1HY20 saw electricity production of 4,617GWh. During 1HY21, 21% of the power was generated by thermal, 44% by hydro and 35% by geothermal plants. We believe this greater diversification will help maintain profits during times of drought in New Zealand.

Not the fun kind of plunge

Contact Energy finished 2020 strong at $8.60, providing shareholders with a 24% capital gain (excluding dividends). The trouble began after the stock reached its 52-week high of $10.56 on 7 January 2021. It is currently sitting at $6.41 per share, a 26% drop in less than two months. So what happened?

Our analysis indicates that a significant amount of the initial runup in January 2021 was due to substantial buying from BlackRock's various subsidiaries and trusts. On 5 January and 6 January, BlackRock's consolidated share purchases were 795,772 and 442,689, respectively. For those not familure with BlackRock, it is one of the world's largest investment management companies in the world with US$8.7t under management as of 2020. Total shares traded during these days was unusually high at 2.6m and 2m, respectively. This means that BlackRock's consolidated share purchases represented 31% of total shares traded on 5 January and 22% on 6 January 2021. This is all according to the disclosure Contact Energy published on the New Zealand Stock Exchange on 11 January 2021. We believe that BlackRock's purchases strongly supported the share price in January and that when this support fell away, other investors used the high share price level to take profits.

Another reason for the sell-off is the drastic increase in the New Zealand 10-Year Government Bond. Since 7 January 2021, the yield rate has increased from 1% to 1.7%, an increase of 70%. The rising bond yields globally have impacted not just Contact Energy, though, but the broader market.

A new power plant, but a capital raise

Compounding the downward pressure on the share price, on 15 February 2021 Contact Energy announced that it was planning on raising NZ$400m in fresh equity to build a new geothermal power station in Tauhara, near Taupo on New Zealand's North Island. The new plant has been in the planning phase for over a decade while management has waited for the market conditions to become viable. Management believes the market conditions are finally right and the plant is expected to have construction completed by mid-2023.

Still some downside left

We believe Contact Energy has two main issues facing its stock price right now, i.e. the recent capital raise putting downward pressure on the stock and the continuing uptrend of the 10-Year New Zealand Government bond yield. Contact Energy is a stable utility with strong assets, but this means that there is not much to look forward to in terms of above-market-average EBITDA growth.

The main reason to invest in a utility like Contact Energy is stable dividend yield, in the case of Contact Energy a substantial 5.3% dividend yield. This has been enough for investors to ignore the fact that the company is expected to produce EBITDA growth of only 7% and 2% during FY21 and FY22. Yet, the stock is currently trading at FY21 and FY22 EV/EBITDA ratios of 13.2x and 12.9x, respectively. When bond yields were below 1%, this was fine, but with yields edging closer to 2%, we believe investors are unlikely to continue to ignore the valuation in favour of the dividend.

Before we get to our rating of the company, there is one, potentially major, wrench that management threw in the works during its 15 February 2021 release of the 1HY21 results. The company has, what we consider to be, strong thermal assets and because of this, management is currently reviewing its geothermal assets. We believe the New Zealand energy sector would put a solid premium on these assets if they were to be spun-off or sold. While management said this review could take several months, we believe the most appropriate rating right now would be three stars given that it is not clear if this potential spin off will be a good or a bad thing for Contact Energy.

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