STOCKS DOWN UNDER

5 FEBRUARY 2021

Small Cap Stocks Down Under

"If you are going to be a great investor, you have to fit the style to who you are."

- Michael Burry (b. 1971), American hedge fund manager and main protagonist of the Big Short

IRONGATE GROUP

Don't open the gate

PTB GROUP

The wind is beneath its wings

METRO PERFORMANCE GLASS

A shatterproof stock

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Don't open the gate

Stocks Down Under rating: ★★★

ASX: IAP
Market cap: A$ 761M
Dividend yield: 6.6% (0% Franked)

52-week range: A$0.90 / A$1.58
Share price: A$ 1.24

Headquartered in Sydney, the Irongate Group is a REIT dual-listed on the ASX and the Johannesburg Stock Exchange (JSE). With an investment fund of over $1.1bn across Australia and New Zealand, Irongate recently changed its name from Investec Australia Property Fund (ASX: IAP) after the group decided to reform into a stapled entity on both exchanges. Irongate is currently trading at its Net Tangible Asset value after underperforming the November REIT rally. The question must be asked, does this company have room to run or has it reached its limit?

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Market cap: A$ 88.2M
Dividend yield: 3% (100% Franked)

52-week range: A$0.27 / A$0.95
Share price: A$ 0.67

Headquartered in Brisbane, PTB Group is a maintenance, repair, overhaul, leasing and spare parts operation focusing on aircraft and, specifically, aircraft engines. In what has proven to be important during the turbulence of COVID-19, this company's revenue divisions are fairly diversified when it comes to industries serviced and geographical location. PTB's global customers are based mainly in Australia, the Americas, Asia and the Pacific Islands. The stock has yet to return to its pre-COVID-19 levels ($0.80), but we think this is one company whose stock has not caught up to the wind beneath its wings.

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Share price chart

Source: Tradingview

Is this a cast iron company?

No, Irongate does not produce cast-iron gates. The company is a Johannesburg Stock Exchange and Australian Securities Exchange dual-listed REIT owning office and industrial properties throughout Australia and New Zealand.

The trust has 30 properties in total, with 12 offices and 18 industrial properties. However, this split is slightly misleading from a valuation perspective, because Irongate is basically an office REIT with supplemental industrial holdings. As of 26 October 2020, the trust’s total property valuation was $1.1bn split between its office (70%, $771m) and industrial properties (30%, $329m), respectively.

When analysing any REIT, one of the most important figures is the Weighted Average Lease Expiry (WALE) of its property portfolio. While not always the case, long-term WALEs over seven years are generally considered to be more stable. Irongate is not a long-term REIT as its WALE by gross property income is currently 4.8 years for its total property portfolio; 4.4 years for its office properties and 5.7 years for its industrial properties. With office properties currently at 96.5% occupancy and industrial properties at 100%, we believe this places Irongate towards the lower end of the range when it comes to stable, medium-term REITs.

We believe it is important to note that the Weighted Average Rate of Return (WARR) by gross property income is 3.4% for office properties and 3.2% for industrial properties. Approximately 53% of the trust's total property portfolio is in NSW and VIC where property prices and rents are still recovering from COVID-19. The trust's total portfolio WARR of 3.4%, which we believe is an acceptable rate of return during these times of effectively 0% interest rates. However, should the interest rate environment change, which we believe will likely take a couple of years, 3.4% will likely trend towards the lower end of acceptable returns. This is why we believe it is positive that the WALE is currently at 4.8 years with occupancy of 97.5%. We view this situation as not locking the trust into historically low rates of return for too long, while at the same time providing stability as the property market recovers.

What happened to November?

REITs took a serious beating during COVID-19 as many temporarily suspended dividends. Our long-term subscribers will remember that during this period we were very bullish on REITs, and that bullishness was rewarded in November when the ASX/S&P 200 A-REIT (ASX: XPJ) rallied 12.8%. Despite this sector-wide rally, Irongate significantly underperformed, rising only 7.3% to merely reach its net tangible asset value.

So, what happened here? We believe this is a simple case of Irongate not being undervalued like many of its peers when the rally started. After management created the new stapled version of Irongate, the Net Tangible Asset Value per unit was reduced from $1.32 to $1.24 due to an intangible asset adjustment. This arrangement was made public on 20 October 2020, when the stock was already trading at its Net Tangible Asset Value of $1.32 per share. This prompted a rapid decline in the share price over the next few days until it was on par with the new, stapled security.

Industrial REITs are hot, but Irongate is still an office REIT

An important trend to have emerged during the pandemic is the vital nature of industrial properties to our modern economy. For this reason, demand from renters and investors for industrial property is currently hotter than it has been in a very long time. It may be tempting to look at Irongate as an industrial play, but we believe it is predominantly an office REIT with supplemental industrial properties. Despite 18 out of its 30 total properties being industrial properties, 70% of its current property valuation is based around its 12 office properties.

For investors looking for a stable, solid income REIT, we believe Irongate may be a good choice. However, we also believe a 1x to Net Tangible Asset valuation is fair value for an office REIT. Therefore, it's a three-star stock in our view.

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Share price chart

Source: Tradingview

It's all about geography, geography, and geography

PTB provides support, equipment and services for the entire lifecycle of the PT6 series, TPE331 and Rolls Royce Turboprop planes. The lifecycle is based around five main parts: leasing the aircraft, financing the planes, leasing the engines, selling parts, supplies, equipment and repair services, and lastly tearing apart the aircraft and engines for spare parts. Turboprop planes are a highly specialised product whose repair requires an unusual amount of training and certification. This makes PTB's business model somewhat protected against new entrants. At the same time, the engines themselves are so valuable that it is not unusual for customers to buy a plane and to lease the engine. Turboprops are a big deal in modern aviation. Indeed, more than one-third of the world's commercial airports rely exclusively on planes with a turboprop engine, especially isolated and remote locations.

To give a quick overview of PTB's geographical reach, it's focused heavily on the United States, but don't take this to mean the rest of the world is ignored. The United States does make up the majority of the Americas revenue, which in turn is 40% of total revenue, but the rest of FY20's $78.1m total revenue was generated in Asia (30%), Australia, Papua New Guinea, and New Zealand (17%), the Pacific Region (7%), Europe (5%) and Africa (1%).

Regarding the United States, management believes this is where their focus should be. This all began when PTB acquired Prime Turbines for US$21m in FY20. Management has since used this acquisition to launch its expansion plans. One of the main thrusts of this plan is PTB's 'power by the hour' plan that allows operators to pay for maintenance as they fly, instead of a lump sum whenever there is a problem. As we mentioned before, these engines require highly specialised skill to repair and maintain and are by far the most expensive part of the plane. This 'power by the hour' payment schedule allows for a spreading of client costs and we believe is a strong selling point for PTB.

Who's the end clientele?

We believe that one of the key advantages PTB has over others in its industry is its client base. While not accounting for all of its clientele, 55% of revenue is split between essential services and freight (20%), government (15%), medical (10%) and agriculture (10%). The remainder is split between tourism (20%), corporate (15%) and other (10%). We believe this revenue majority of 55% is stable and allows PTB to have a baseline revenue on which to expand its operations. For example, part of PTB's essential services and freight division involves the transfer of supplies, equipment and food between Pacific Island communities where there are often no other options.

Using this revenue base, PTB is focusing on expanding its operation in the United States. Management believes that the majority of future growth will come from that country through its three main facilities there, in Dallas, Tx, Mesa, Az, (near Phoenix) and Butler, Pa. (near Pittsburgh) as well as the aircraft dismantling facility in Miami, Fl.

PTB used FY20 to hire additional staff in order to expand operations with an eye on FY21 and FY22's economic recovery.

Its Scrooge McDuck time!

PTB's FY20 balance sheet make us want to fill a room full of gold coins and see if we can swim in them like Scrooge McDuck. Here at Stocks Down Under we offer our readers a primer on a company and we have to prioritise what we want to mention. We don't usually even mention the balance sheet unless there is an issue. PTB is an exception to this rule as the company is currently carrying so much cash that we believe it has become an essential part of the valuation.

As of FY20, PTB had a total of $15.5m in cash and $20.2m in receivables. This is an unusually high level for receivables to be at, 50% larger than FY19's $13.4m. While we believe it warrants mention, we are unconcerned with PTB's clientele being unable to pay their receivables.

As of 15 December 2020, management announced it had sold its Warriewood properties in Sydney for $9.5m. We believe this was the right move as the properties were on the books with a carrying value of $3.5m offering a pre-tax profit of $5.8m. While the unconditional sale is expected to be finalised on 30 April 2021, we believe it makes sense to add the cash value to PTB's FY20 cash for valuation purposes. This leaves us with a current cash basis of $25m, compared to a current market cap of $88.2m (28%).

One not to miss

Over the next three years, between FY21 through FY23, the market is expecting PTB to grow at an average annual rate of 14.9%. Despite this, the company's shares are only valued at an EV/EBITDA of 7.3x, 7x, and 6.8x FY21, FY22, and FY23, respectively.

Additionally, the company's cash hoard is currently sitting at 28% of its total market capitalisation. Management has already stated that it plans to use a portion of this cash to fund its US expansion plans. We believe this is likely to include acquisitions that would push PTB's EBITDA growth higher. Combine all of this with a 3% indicated annual dividend and we believe the broader market has so far missed PTB. Its four stars from us.

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Share price chart

Source: Tradingview

What makes up this glass?

Metro Performance Glass provides high-performance glass and installation services to New Zealand and Australian residential and commercial construction markets. The company operates this business through seven processing plants and twelve distribution and retail sites across New Zealand and Australia. The types of glass products produced by Metro include windows, mirrors, shower doors, kitchen splashbacks and commercial facades. Stop for one moment and take a look around your office, apartment or house. How many things do you see made out of glass? While we were researching this company, we took a second and looked around and in the modern world a truly shocking amount of things are made from glass. In fact, until 1835, mirrors were made of mostly highly polished metal. In 1835, the first glass mirror was invented by German chemist Justus von Liebig. Something so essential and common in modern life, the glass mirror turns out to be less than 200 years old.

Now that you realise just how common glass is in our modern life and infrastructure, let's take a look at Metro's corporate breakdown. The company is divided into two large divisions and three smaller ones. The two overarching divisions are designated by countries: Australia and New Zealand.

The New Zealand division generated NZ$89.2m in revenue during 1HY21 through its residential (66.3%), commercial glazing (20.2%) and retrofit (13.6%) businesses. Due to the Australian division's smaller nature, generating only NZ$27.8m during 1HY21, it is simply designated the 'Australian Glass Group.'

We have mentioned 1HY21 instead of FY20's results. We believe FY21 is more important in terms of analysis since, as we will discuss later on, this year's results will likely determine if the company will finally reach profitability. Additionally, with COVID-19 causing disruptions and a highly unusual economic situation, we don't think FY20's results are especially indicative of Metro's normal performance.

It's all about that boom

As we saw above, Metro is more or less a New Zealand company by revenue. The New Zealand business saw a 19% revenue decline in 1HY21 compared to 1HY20. This is important to remember as we believe the company is more likely to benefit from New Zealand's infrastructure recovery plan than Australia's. Sure, Metro will generate a significant portion of its future growth in Australia, but we believe the company's emerging business in Australia is not yet entrenched enough to outshine the New Zealand division.

New Zealand has devoted a significant amount of funding towards an infrastructure based COVID-19 recovery, much like Australia. On 30 June 2020, the Government of New Zealand announced it was allocating NZ$3bn towards infrastructure projects with slightly over NZ$1.1bn being earmarked for housing, urban development, and community and social development projects. As the largest manufacturer and installer of double-glazed windows in New Zealand, we believe Metro, as a New Zealand based company, will likely benefit significantly from this recovery plan.

Profits! When do we want them? Now!

The market expects FY21 to see the company's first net profit, despite an expected decline in EBITDA of 5%. This expected decline in EBITDA and net profit emergence is due to the management's turnaround plan's continued success. An essential part of it was the decline in interest payments through debt reduction. The turnaround plan will be continued over the coming years as the company is focused on improving its financial health.

Part of this process was the recently announced refinancing of its banking facilities. This saw the total facility size reduced to NZ$85m from NZ$120m as of 14 October 2020. Additionally, the facility was also extended from August 2021 to October 2023.

In addition to this debt restructuring, the company has also used its increasingly positive financial performance to pay down its net debt from NZ$66.9m as of 31 March 2020 to a much more manageable NZ$47.7m at 30 September 2020. This decrease in debt is an important step towards the company's turnaround as financing expenses were a significant expense eating away at the company's profitability.

Risky, but the turnaround is real

The market is currently valuing Metro at an FY21 EV/EBITDA of 4.5x. In fact, the market is expecting Metro's EBITDA profit margin to continue to decline from 18.4% during FY21 to 14.7% during FY23. This decline is why we believe the market is currently valuing Metro below 1x EV/Revenue and only at 4.5x EV/EBITDA.

The company is undoubtedly still fixing itself and we believe management's turnaround efforts will need to continue for the next few years. However, we disagree with the market's assertion that the company will decline over the next three years. Debt and interest payments have continued to decline and we believe management has proven that it is able to cut costs without sacrificing its business.

Additionally, we believe the infrastructure recovery is perfectly timed with Metro's turnaround to provide it with the boost it needs. There is certainly risk as with any company in the middle of a turnaround, but everything weighed up, we see this as a four-star stock.

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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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