



ASX Top 200 Stocks Down Under

🗉 *I trust bitcoin more than I trust my bank.* 🗉

- Adam Draper, American business man

ASX

EXCHANGE CENTRE

— COMMONWEALTH BANK OF AUSTRALIA

Leading the pack in
several ways

— WESFARMERS

Limited earnings growth in
the medium term

— SPARK NEW ZEALAND

The bill remains high for
investors

COMMONWEALTH BANK OF AUSTRALIA

Leading the pack in several ways

Stocks Down Under rating: ★★★★★

ASX: CBA
Market cap: A\$ 154BN
Dividend yield: 3.6% (100% Franked)

52-week range: A\$57.00 / A\$89.20
Share price: A\$ 86.00

Headquartered in Sydney, Commonwealth Bank of Australia (CBA) remains one of our favourite bank shares. Amid prospects for a strong global economic recovery, the stock has participated in the recent banking sector rally to the tune of 40% over the last 12 months. We see further upside from here on account of CBA's stellar financial position and growth opportunities in retail, business and digital banking.

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WESFARMERS

Limited earnings growth in the medium term

Stocks Down Under rating: ★★★

ASX: WES
Market cap: A\$ 58BN
Dividend yield: 3.2% (100% Franked)

52-week range: A\$32.18 / A\$56.40
Share price: A\$ 52.84

When we last wrote about Perth-based Wesfarmers on 19 December 2019, the world was yet to realize the extent of the COVID-19 breakout. Even a diversified retailer the size of Wesfarmers couldn't avoid the crippling effects on the Australian economy. The stock gave back all its 2019 and 2020 gains in a matter of weeks during the 1Q21 market crash. Since then, however, the recovery in the share price has been nothing short of remarkable...but the valuation doesn't compel us to put Wesfarmers in the shopping cart.

[READ MORE](#)

SPARK NEW ZEALAND

The bill remains high for investors

Stocks Down Under rating: ★★

ASX: SPK
Market cap: A\$ 7.7BN
Dividend yield: 5.7% (0% Franked)

52-week range: A\$3.91 / A\$4.68
Share price: A\$ 4.05

Spark New Zealand, one of New Zealand's two major telecom companies, is still not a name we'd dial up for our portfolio. The business' defensive nature offers downside protection during times of market turbulence, but that's one of few positives for the stock. Like most telecom peers, Spark New Zealand pays a good-sized dividend, but that alone isn't reason to like the share. The price tag remains the main deterrent here. With growth expected to be in the low single digits for the second straight year, the stock's valuation doesn't spark us to give it more than the two-star rating we gave the company when we wrote about it back in August when it traded at \$4.49.

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Share price chart



Source: Tradingview

Australia's banking BFF

Commonwealth Bank of Australia offers banking, mortgage, investment and insurance services to retail and business customers in Australia, New Zealand, the United States, the UK, South Africa and several Asian countries. The group boasts solid fundamentals and market positions that are in many cases superior to those of its big four banking peers.

More than 34% of Australians consider CBA to be their main financial institution (MFI). This metric is the banking sector's equivalent of a BFF (Best Friend Forever) and is more than twice its nearest competitor's share. This is a particularly relevant statistic among younger generations who have increasing purchasing power and represent the next wave of growth. It is no wonder then that CBA's mobile app rating of 28.3 leads its big four peers by a wide margin. CBA also sits atop its peer group based on provision coverage, capital strength and return on equity (ROE).

In a year that COVID-19 heavily impacted, CBA's FY20 performance exhibited its core banking business strength. While statutory profit increased 12%, net profit after tax (NPAT) fell 11.3% to \$7.3bn due to COVID-19 provisioning on a continuing operations basis. We are less concerned about this result, given the unprecedented challenges at the end of the fiscal year and give more value to the bank's ability to strengthen

its capital position. The common tier equity 1 (CET1) improved nearly 1% to 11.6% in FY20. Also encouraging was that business lending, home lending and household deposit volumes all grew significantly despite the pandemic headwinds.

Digital leader

In a banking industry that is quickly moving into the digital realm, we laud CBA's focus on technology. It has spent mightily to build out its digital capabilities (\$1.4bn in FY20), but it will be money well spent, in our view. More than 6m customers use the CommBank App driving daily transactions worth \$1.2bn. This, along with the company's online bank, NetBank, has not only thrived during the pandemic but stands to be a big part of its future growth. Customers are looking for convenient ways to do banking these days and CBA's technology leadership should continue to make it a go-to bank for both individuals and businesses.

In July 2020, it announced partnerships with Square Peg and Zetta Venture Partners to advance the company's ambitions in artificial intelligence and data analytics. CBA committed US\$10m to both venture capital funds. It also launched its own venture called Backr, an app that helps small business owners launch digital businesses.

In yet another step in its digital strategy, in December 2020, CBA announced the merger of its Aussie Home Loans business with Lendi, a Sydney-based online home loan company. The move will jettison Aussie Home Loans' nearly 1,000 brokers and \$70BN home loan book into the 21st century by joining forces with the Lendi platform. Like other areas of personal banking, the home loan market is increasingly moving online, so we like this idea as well.

Strong balance sheets packs on more muscle

CBA's half-year result confirmed that the bank is indeed alive and well. Volume growth was above the industry average, including 7.4% business lending growth that was more than three times the market average.

Once again, NPAT was down 10.8% to \$3.9bn owing to ongoing COVID-19 expenses and low-interest rates. However, profitability did show a significant improvement of 32% from 2HY20, giving us comfort that the worst is likely behind us.

The strong balance sheet continues to be a primary investment attribute here. The CET1 ratio moved another 1% higher to 12.6% and, factoring in recent divestments, is forecast to reach 13% soon. Provision coverage ratios are trending higher, as is deposit funding, which accounts for three-fourths of total funding.

As of 31 January 2021, active repayment deferrals were down to 8% and 4% of overall deferrals in home and business lending, respectively, meaning most loans had returned to repayment or pre-deferral terms. CBA also put up some industry-leading net promoter scores (NPS), achieving the top rankings in the business banking, institutional banking and mobile app categories.

Aside from its capital prowess, we like the group's leadership position in the Australian economic recovery. As business activity continues to improve and new growth markets, like renewable energy emerge, the bank should benefit from increased demand for loans and banking services. The broader economic rebound in CBA's international markets should also support better results and a swift return to pre-pandemic profits.

So, while plenty of COVID-19 uncertainty remains and low-interest rates will pressure net interest margins, CBA is a stock we would bank on delivering solid 2HY21 and FY22 performances. We first wrote about CBA back in May 2020 when the share price was at \$59.60 and gave the stock four stars. It is still four stars from us.

WESFARMERS

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Share price chart



Source: Tradingview

Retail rollercoaster

In the early stages of the pandemic, Wesfarmers stores were allowed to stay open but were impacted by supply chain constraints. The owner of 'big box' hardware retailer Bunnings and office supplies leader Officeworks saw sales slow initially. Construction companies put building projects on hold and with non-essential workplaces closed, there was little need to reorder staplers and Post-it Notes.

Wesfarmers was quick to recover though. By 20 March 2020, over 90% of its suppliers had returned to being fully operational. Bunnings, Officeworks, and Kmart become popular destinations to buy cleaning and hygiene products. Then, as Australians began spending more time at home, home improvement projects became a more popular activity. The market soon realized that Wesfarmers may actually benefit from elevated demand for things like flooring and lawn care equipment. And with many employees having to cobble together a home office, buying desks and filing cabinets was suddenly the thing to do. Students also had to rethink their school supply needs with more classes being held virtually.

Ironically, Wesfarmers may have wished it had a larger stake in Coles Group in the early part of the pandemic when essential grocery stores were one of the few retail businesses making money. But after agreeing to sell another 4.9% of its Coles interest on 18 February 2020, Wesfarmers was down to owning 10.1% of a business it had been slowly exiting since November 2018 when the pair demerged. This was trimmed to a 4.9% stake

when Wesfarmers divested another 5.2% of Coles on 30 March 2020.

The New Zealand business, on the other hand, faced greater challenges. For a four-week period starting 25 March 2020, Wesfarmers' 25 Kmart stores in New Zealand were forced to close. The 53 Bunnings' stores were closed to the public, but remained open for essential trade customers.

Then in August 2020, Victorian Government restrictions tied to COVID-19 meant Kmart and Target stores in metropolitan Melbourne had to close. This was a significant event because these stores accounted for 17% of group revenue in FY20. Bunnings' locations were allowed to stay open and Officeworks was only able to serve business customers in-store.

Online sales shine

The FY20 and 1HY21 results were a mixed bag of groceries that reflected the up and down trading conditions of the 18-month period that also included the impact of the bushfires. FY20 revenue from continuing operations was up 10.5% to \$30.8bn and net profit after tax (NPAT) increased 8.2% to \$2.1bn. Within retail, online sales grew 60% and helped offset periods of weakness.

The FY21 interim report showed a 16.6% jump in revenue to \$17.8bn led by a 24% revenue increases at both Bunnings and Officeworks. Sales were up a more modest 9% at Kmart while the Chemical, Energy and Fertilisers business saw 7% higher revenue. The smaller Industrial and Safety business also had an improved performance.

Noteworthy again were the company's online sales, which more than doubled in the half. Group NPAT advanced 25.5% to \$1.4bn. Management refrained from providing 2HY21 guidance citing ongoing pandemic uncertainty, but did strike a more upbeat tone on the outlook for the business and noted strong retail sales in January and February of this year.

To address the underperforming Target business, management commenced a strategic review in April 2020. It ultimately decided to close some Target stores and convert others to Kmart. Nineteen Target stores were converted to Kmart during 1HY21 and the remainder of the changes are expected to be implemented this year. We like this move given how much Target has lagged amid the structural shift towards online shopping.

Batteries are included

We'd be amiss to leave out an update on Wesfarmers rather peculiar foray into the lithium business. Our readers will recall that the company dished out \$776m to acquire Kidman Resources in 2019. An additional \$700m would later be needed to launch the Mount Holland lithium mine and the nearby Kwinana lithium hydroxide plant.

On 17 February, following COVID delays, Wesfarmers announced the commitment of initial funding of the lithium project with plans to commit to full funding once the Kwinana refinery receives environmental approvals (which is expected to occur in early FY22). So, this venture is still alive and well and while the opportunity to capitalise on growing global demand for electric vehicle (EV) battery components is huge, we remain unsure of Wesfarmers' ability to grab market share without being a low-cost producer.

Wesfarmers is one of the most financially fit Australian conglomerates. It is one of the few companies that can say it owns growing brick-and-mortar stores in an increasingly e-commerce driven economy. But while we like the diversification and financial strength, we don't like the price tag.

At an EV/EBITDA of 13x for FY22, which starts in about 3 months, we think the stock is pretty expensive given that the market expects EBITDA to be essentially flat for that year at around \$5.1BN. And FY23 is only expected to show 3.8% EBITDA growth. And the modest dividend yield of 3.3% is nothing to write home about.

However, we believe there's strong support for the shares at around the \$50 level and we don't see Wesfarmers going down much from here. So overall, we think investors will find better value while shopping for other shares and reiterate our 3-star rating for Wesfarmers.

SPARK NEW ZEALAND

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Stocks Down Under rating: ★★

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Market cap: A\$ 7.7BN

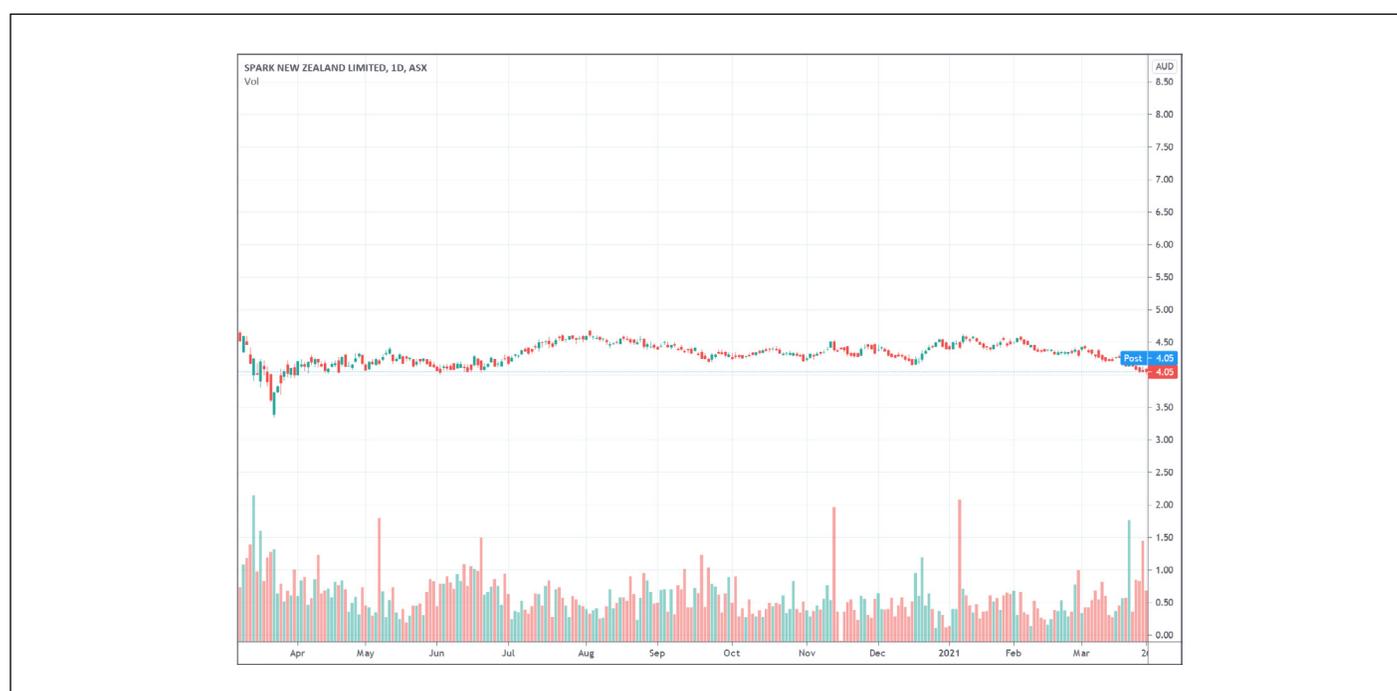
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Share price chart



Source: Tradingview

Low growth mode

Spark New Zealand provides fixed-line and mobile telephone services as well as internet service exclusively in its home market. It caters to both residential and corporate customers in addition to being a player in the wholesale market. This makes the business model rather easy to understand, but the stock difficult to get excited about.

The company's annual result as of 30 June 2020 came in largely as expected. Revenues advanced a modest 2.5% to NZ\$3.6bn with a strong interim period setting the stage for a performance that delivered to guidance. Mobile network revenue grew 3.9%, while the cloud, security and service management segment had 10.8% higher sales.

COVID-19 of course had an impact on operations in the latter part of the fiscal year, but the company reacted effectively to ensure its essential communication services were up and running. It also kept expenses under control to help offset its limited ability to grow the business. EBITDAI (earnings before interest, tax, depreciation, amortisation and investment income) increased 2.1% to NZ\$1.1bn, which was in-line with earnings guidance. A decreased tax bill helped net profit after tax (NPAT) grow 4.4% to NZ\$427m.

It's all about the digital services

Soon after the FY20 result, management shared its three-year strategy through FY23. In recognition that landlines are going the way of the dinosaurs, the company wants to keep moving towards a predominantly mobile business model. These days retail customers (both individuals and corporations) are seeking ways to make their lives simpler, more convenient and more efficient. Digital technology accomplishes all of this and then some. Spark New Zealand wants 80% of its customer relationships to be centred around wireless technology. It also wants to become New Zealand's top cloud custodian offering both public and private cloud computing services. As part of the strategy, Spark is aiming to fully build out its 5G networking and Internet of Things (IoT) platforms over the next couple of years.

We like that the company is getting up to speed with modern technology and focused on the higher growth areas of telecom and the internet. The pace at which it can deploy its 5G and IoT capabilities will likely coincide with the speed of New Zealand's economic recovery from the pandemic. We believe moving beyond traditional telecom services and into smart business solutions is the major growth pathway for Spark New Zealand.

The recently announced 1HY21 performance was also okay, but not inspiring. Revenue slipped 1.5% to NZ\$1.8bn, EBITDAI was up 0.4% to NZ\$502m and NPAT decreased 11.4% to NZ\$148m. Spark New Zealand's share of the mobile service market increased a tad to 40.4%, even though revenue in the business declined 1.2%.

The cloud, security and service management division remained a bright spot. Revenues were up 4.6% there, thanks to a higher demand for flexible work environments for its collaboration products. We like that approximately 84% of cloud revenues are recurring.

Although New Zealand's economy is recovering sooner than expected, Auckland's recent lockdown was a reminder that we are not yet out of the woods. The impact of border closures and lower roaming revenue will likely carry over to the second half. The company noted an apparent improvement in billing and collection risk, but this is hard to gauge because government stimulus may be artificially propping up these measures.

Solid balance sheet, unwarranted valuation

Overall, Spark New Zealand's financial health is good. It has ample solvency to weather the ongoing economic uncertainty, a sizeable cash balance, and a manageable level of debt. In November 2020, the company's financing arm, Spark Finance Limited extended the term of its NZ\$200m revolving credit facility with Westpac New Zealand Limited by three years. The funds are not intended for debt repayment or growth purposes but for general corporate needs.

So, we like Spark New Zealand's direction in driving the country's digital transformation. New Zealand's workers' habits across all sectors are changing, emphasising remote productivity and security, so there will be plenty of need for Spark's services.

What we don't like is the stock's valuation around 9x EV/EBITDA for FY22. With FY21 earnings growth forecast to be similar to that of FY20 and hardly any EBITDA growth in the next few years, investors would be paying too much of a premium. So, we'll stick with our 2-star rating for Spark New Zealand's shares. But if you like the 5.7% dividend yield, go for it.

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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