STOCKS DOWN UNDER

19 APRIL 2021

ASX Top 200 Stocks Down Under

Keep your friends for friendship, but work with the skilled and competent.

- Robert Greene (b. 1959), American author and scholar

AUSTRALIA & NEW ZEALAND BANKING GROUP

Simpler is better

WOOLWORTHS GROUP

Resilient but expensive

NEWCREST MINING

Share price dip is a Golden opportunity

AUSTRALIA & NEW ZEALAND BANKING GROUP

Simpler is better

Stocks Down Under rating: ★★★★

ASX: ANZ
Market cap: A$ 82.3BN
Dividend yield: 2.1% (100% Franked)

52-week range: A$15.07 / A$29.55
Share price: A$ 28.82

Shares of Melbourne-based Australia and New Zealand Bank (ANZ Bank) have returned to their pre-COVID price level after climbing 55% over the past year. The big 4 bank has proven its resilience and reinforced its balance sheet strength during a tumultuous economic time. We expect this rally to continue as the banking industry benefits from increased business activity and healthier personal loan demand. A simpler, more focused ANZ Bank fits well in the modern banking world.

READ MORE

WOOLWORTHS GROUP

Resilient but expensive

Stocks Down Under rating: ★★

ASX: WOW
Market cap: A$ 53.3BN
2.4% (100% Franked)

52-week range: A$33.82 / A$42.47
Share price: A$ 42.04

We were still in the early stages of the pandemic the last time we wrote about Woolworths Group (19 May 2020) and its stock was at its lowest level since mid 2019. Since then, Australia's beloved retailer has benefited from elevated demand for essential goods like food, toiletries and cleaning supplies, but has been hurt by COVID related expenses and supply chain challenges. The combination of a higher cost profile, limited growth prospects and a premium valuation outweigh the positive developments in our opinion.

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When we last wrote about Melbourne-based Newcrest Mining on 26 May 2020 the company was in capital raising mode and its share was beginning to rally off its pandemic low. However, after climbing into the upper $30's in August, the share price has trended sharply lower on falling gold prices and is almost back where it was in March 2020. We think this presents a golden opportunity to invest in one of the world's top gold miners.

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Share price chart

Source: Tradingview

Out of turbulence comes resilience

As Australia's second largest bank by assets, ANZ Bank serves individual, institutional and small business customers in the Australia, New Zealand, Asia, Pacific, Europe, America and the Middle East markets. The company faced the same COVID-19 pressures that its peers did throughout 2020, including loan payment deferrals and higher provisioning. But the 70-year-old bank has seen its share of financial sector downturns and has not only survived the latest crisis, but emerged stronger.

ANZ Bank's sturdy balance sheet gave it the ability to grant repayment deferral requests and offer other forms of financial support to struggling households and businesses in Australia, New Zealand and beyond. Despite having modest exposure to harder hit industries, like retail, transportation, accommodations and restaurants, capital adequacy remained solid at the end of CY20. Management made the tough, but necessary decisions to see the bank through. Dividend was significantly reduced and non-core businesses were sold to improve liquidity and productivity.

As part of the plan to simplify the business, ANZ completed the sale of its New Zealand-based UDC Finance unit to Tokyo-based Shinsei Bank in September 2020. The move added roughly 10 basis points to the group's common equity tier 1 (CET1) capital and refined its focus in the New Zealand banking market.

Improving economic outlook

As anticipated, the FY20 result was a mixed bag of COVID-19 headwinds and confirmation of underlying business strength. Net profit after tax (NPAT) for continuing operations fell 42% to $3.76bn. The bottom line was dragged down by $2.7bn of credit impairment charges and an additional $815m impairment in the Asian business, both of which were related to the pandemic. One dollar was trimmed from the annual dividend, which was $0.60 per share. On the bright side, the CET1 capital ratio barely budged from FY19 going from 11.4% to 11.3%. And keep in mind, ANZ's fiscal year ends 30 September. So, factoring in the impacts of both the bushfires and COVID, ANZ Bank's 12-month performance wasn't all that bad.

The more recent 1Q21 trading update showed a lessened impact from COVID-19. As at 31 January, 84% of Australian home loan deferrals, 92% of New Zealand home loan deferrals and 88% of Australian business loan deferrals were completed. This marked a major turnaround from just seven months prior. Revenue was up 4% in the quarter with all major businesses doing well including the Australian home loan division, which notched market share gains.

The net interest margin (NIM) increased from 1.57% in 2HY20 to 1.62% thanks to an improved mix, lower funding costs and higher margins in the institutional business. Unaudited NPAT was $1.84bn. Importantly, costs were flat, again suggesting an improved banking backdrop and disciplined cost management.

As at 31 December, the group provision balance was $5.6bn and the total coverage ratio was a healthy 1.6%. Management acknowledged an improvement in the economic outlook, especially in the core Australia and New Zealand markets, but was also quick to note the presence of significant uncertainty and volatility. We favour management's cautious stance and find its current provision levels to be comforting.

Digital strategy ramping

Although its difficult to say what the "new normal" will look like for most economies, we think ANZ Bank is in a good position to benefit from whatever that is. It is streamlining the business to focus on its core competencies of home loans and business lending. Rather than trying to be everything to everyone, it is simply staying in its lane and trying to win business in areas of strength. Customers are likely to understand and appreciate this model, especially in an age where convenient, easy-to-use digital banking solutions are in demand.

One of the main pillars of ANZ's growth strategy is to invest in its digital platform. In some ways it may be late to the digital game, but it seems to be making up for lost time. After spending a relatively light $95m on digital and data projects in FY19, digital investment more than doubled to $200m in FY20. Once more of a novelty, the Digital Banking Division is becoming a greater focus for ANZ Bank. We think this bodes well for satisfying the accelerating innovation needs of the bank's eight million retail, commercial, and institutional customers.

While there have been early signs of a sustainable economic recovery, we are not out of the woods. With this said, ANZ Bank was operating from a position of strength prior to the pandemic with record levels of capital and liquidity and it continues to do so today. Positive developments around the global economic recovery will be ANZ Bank's (and its shareholders) gain.

At a P/E ratio of 14.4x for FY22 and a dividend yield of 2.1%, we continue to see good value in the stock, including room for both dividend and share price upside. Four stars it is.

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Share price chart

Source: Tradingview

Heavy demand, higher expenses

Best known for its supermarket chain, Woolworths Group's other businesses — liquor, financial services and hotels — give shareholders a little bit of everything with a dash of hospitality. The operator of Big W, BWS and Dan Murphy's has had a bumpy ride since the start of COVID-19 that has ultimately ended with its shares being down 2.5% over the last 12 months.

Resilient has been a common term used to describe many Australian companies during the pandemic and Woolworths is certainly worthy of the moniker. A sudden flood of demand put unprecedented pressure on the company to hold up its end of the bargain. Supply chain constraints were a problem as were increased costs associated with safety and wages. In the end, there were sales gains but profit pains.

The FY20 result showed that group sales were up 8.1% to $63.7bn. The Australia and New Zealand food and drink businesses fared well, but as expected, the Hotels business was heavily impacted by COVID-19 restrictions. Online sales increased 42%, but still only accounted for 5.5% of overall sales. We think Woolworths will need to invest more in WooliesX and its other digital sales channels to capitalize on growing consumer interest in online shopping. Despite the increased sales, net profit after taxes (NPAT) fell 1.2% to $1.6bn with COVID-19 safety expenses (cleaning, PPE, security) the main culprit along with higher supply chain costs. This led to a reduced dividend payout of 94 cents that was 8% below the FY19 dividend.

The distribution dilemma

In some ways there was little the company could do to alleviate its near-term supply challenges, so it turned its attention on preparing for the future. Woolworths is transforming its grocery supply chain by adding a pair of automated regional distribution centres at Moorebank Logistics Park in Sydney. It signed a 20-year lease with Qube Holdings Limited and plans to invest up to $780m over the next four years to develop the automation technology. The step up in logistics capabilities should help lessen the impact of any forthcoming supply snags, improve efficiency and lower costs. The negative part, however, is that investors will have to wait a while to see the potential fruits of this labour. Construction on the centres isn't expected to be completed until the end of CY23 and the financial benefits won't hit Woolworths' books until FY25.

In another attempt to inject some life into the rather stale food business, Woolworths announced a strategic investment in PFD Food Services on 19 August 2020. It took a 65% equity stake in the foodservice supplier and attained full ownership of PFD's 26 distribution centres for a sum of $552m. PFD is the number two player in the out-of-home and non-retail business-to-business (B2B) markets. About a quarter of PFD's revenue comes from restaurants with the remainder from fast food and other businesses. It marked another move to bolster the Woolworths' food distribution ecosystem and highlighted the ripple effects of the pandemic on supply chain vulnerabilities. The deal is expected to be earnings accretive in the first full year of ownership.

Share price not on sale

Turning to the 1HY21 report, sales were up 10.6% to $35.8bn and NPAT increased 15.9% to $1.1bn. Australian food sales accounted for 65% of group sales, but were front-loaded and followed by a more modest 8.3% increase in Q2 sales. If these In New Zealand, Big W delivered a strong performance thanks to the success of key shopping events, like Halloween, Black Friday and Christmas. Meanwhile, Endeavour Drinks continued to bring in good results as homebound Kiwis poured a few more back. E-commerce was once again a star performer with a 78% surge in sales. Results in the Hotels business showed signs of improvement thanks to the reopening of Victorian venues towards the end of the year. Despite these positive notes, there are concerns of a new price war emerging between Coles, Woolworths and Aldi. These have hit hard at margins in the past and pose a risk that any future growth could be hindered as a result.

The higher profitability supported the ability to pay a 15% higher dividend compared to 1HY20, which was a positive development. Overall, the balance sheet is in good shape and pending a continued recovery in the business, dividends should normalise. Net debt as at 3 January 2021 was $447m and below where it was through 1HY20 and FY20 because of the improved cash generation.

We view Woolworths as a reliable defensive share that comes with some growth upside on account of the hotel exposure. The stock has rallied modestly from its pandemic low, but still trades about 12% below its pre-COVID (and all-time) high. The 2.4% dividend yield and sturdy business model are attractive, but the low growth nature of groceries and 10.6x EV/EBITDA valuation for FY22 are not. EBITDA is only expected to grow by 4.2% next financial year. Woolworths is just not worth the investment, in our view, so it's two stars from us.

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Share price chart

Source: Tradingview

Cadia produces world-class profits

Newcrest is the world's sixth largest gold mining company having produced 2.2m ounces of the yellow metal in FY20. Its portfolio includes assets in Australia, Asia and Africa. The key asset is the Cadia gold and copper mine, which dates back to 1992 and is located in the city of Orange in central NSW. Cadia produced 843k ounces of gold in FY20 which accounted for 38% of Newcrest's total gold production. The All-In Sustaining Cost (AISC) of the Cadia mine was US$160 an ounce in FY20. Gold prices averaged US$1,530 per ounce for the year so it doesn't take math wizard to see there were some serious profit margins.

One of the most appealing aspects of Newcrest is the long-lived nature of its assets. The Cadia mine alone is estimated to have another 37m ounces of gold left to go. Based on last year's production, the mine still has another 15-plus years of strong production. Then there is the Lihir mine, which operates at a much higher AISC of US$1,206 an ounce, but still contributes significantly to production and profits. Lihir's AISC increased 36% in FY20 amid lower recovery rates. Still, the shelf life of the Lihir mine is even longer than Cadia given the 49m ounces of gold resources. Newcrest is expanding at Cadia and investing in recovery improvement initiatives at Lihir. Both projects were approved by the Board on 9 October and hold the potential to increase gold and copper recoveries. The Cadia expansion is projected to result in a $22 per ounce reduction in AISC.

So, now that we have Newcrest's mining landscape, let's get into the all-important discussion of gold prices. Gold reached a record high of US$2,056 on 6 August 2020 fuelled by high demand in an uncertain economic time. It has since trended lower. Due to increasing U.S. Treasury yields and expectations of a strong recovery in the global economy, gold now sits more than US$300 from its peak. Where does it go from here?

Gold rally part 2

Most economists see gold continuing to trend lower this year. The Economy Forecast Agency sees gold reaching US$1,563 by December, but staging a strong rebound in 2022 and into 2023 as interest rates begin to rise and loose monetary policies continue. This suggests that gold's current downturn will be short-lived and that gold miners like Newcrest may be in for better times ahead.

This means that Newcrest shareholders may be in for strong results, like what the company produced in FY20 and 1H21. The FY20 result showed a 34% increase in underlying profit to US$750m as the AISC came in at US$862 an ounce. The surge in gold was evident in the 1HY21 result. Newcrest's AISC margin jumped 48% to US$842 as underlying profit nearly doubled to US$553m. The strength in the business gave management the confidence to set a new dividend payout policy of 30% to 60% of full year free cash flow.

It's always good to see a successful company sharing the wealth with loyal shareholders. Another positive development in the period was improvement at the Lihir mine. A Lihir mine optimisation study identified the potential to mine an additional 1.4m ounces of gold across FY22 to FY34.

Low gearing, valuation

What about the exploration projects? Last year Newcrest issued new shares at a price of $27.54 to raise approximately $1bn in capital. This was not to survive the pandemic, but to pursue growth opportunities in a favourable gold price environment. Some funds went to the Fruta Del Norte mine in south-eastern Ecuador, which is forecast to produce gold at roughly US$600 an ounce AISC over the next 13 years. Newcrest is an indirect owner of the asset by virtue of its 32% stake in Canada-based Lundin Gold, the mine's owner.

Another portion of the capital went to Red Chris, a copper-gold mine in a remote area north of Vancouver. Newcrest operates Red Chris under a joint venture with Canada's Imperial Metals. The resource contains some 20m ounces of gold and 5.9m tonnes of copper. On 31 March 2021, Newcrest released an initial mineral resource estimate for the mine of 14.9m ounces of gold and 4.3m ounces of copper. Red Chris produced just 39k ounces of gold in FY20, so the runway for growth is substantial.

Newcrest operates from a position of financial strength which helps it capitalize on strong gold markets and organic and inorganic growth opportunities. The balance sheet is in great shape with a rising cash balance and a very low, 3.3% gearing ratio that sits well below its 25% maximum.

In August 2020, Newcrest shares came close, but failed to eclipse their August 2019 peak. Since then, the stock has declined more than 30% making for a more attractive valuation. At an EV/EBITDA of 7.5x for FY22 we believe Newcrest is a bargain for long-term investors that value its long-life assets, expanding gold and copper portfolio, and exploration opportunities. Four gold stars from us.

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