



ASX Top 200 Stocks Down Under

📖 *As I grow older, I pay less attention to what men say. I just watch what they do.* 📖

- Andrew Carnegie (1835 - 1919), American steel tycoon

ASX

EXCHANGE CENTRE

MACQUARIE GROUP

Waddell & Reed
acquisition scales Wealth
Management

TELSTRA CORPORATION

Faster networks, but slower
growth

ARISTOCRAT LEISURE

Digital gaming blasts off

MACQUARIE GROUP

Waddell & Reed acquisition scales Wealth Management

Stocks Down Under rating: ★★☆☆

ASX: MQG
Market cap: A\$ 56.6BN
Dividend yield: 2.0% (40% Franked)

52-week range: A\$93.62 / A\$158.50
Share price: A\$ 158.45

Last time we wrote about Sydney-based Macquarie Group (2 July 2020), it was in the thick of the pandemic. Ten months later, the share has more than doubled off its March 2020 low and is trading near an all-time high. We think the rally can go on as the group asserts its financial strength in an improving global banking environment. This is a company that has delivered profits for 51 consecutive years. Not even the unprecedented challenges of COVID-19 could bring this streak to an end—and it wouldn't be surprising to see it continue for another 50 years.

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TELSTRA CORPORATION

Faster networks, but slower growth

Stocks Down Under rating: ★★☆☆

ASX: TLS
Market cap: A\$ 40.4BN
Dividend yield: 4.7% (100% Franked)

52-week range: A\$2.66 / A\$3.54
Share price: A\$ 3.40

We last wrote about Melbourne-based Telstra on 20 April 2020 and we referred to the stock as a value trap. Fast forward 12 months and it is trading around the same level at just over \$3 per share. The former state-owned Telco operator has had some ups and downs, but has ultimately mirrored the poor share market performances of its predecessors. Absent any major differentiator or growth catalyst, we continue to see little reason to dial up a position in Telstra.

[READ MORE](#)

ARISTOCRAT LEISURE

Digital gaming blasts off

Stocks Down Under rating: ★★☆☆

ASX: ALL
Market cap: A\$ 23.5BN
Dividend yield: 0.3% (100% Franked)

52-week range: A\$21.33 / A\$37.51
Share price: A\$ 36.71

The last time we wrote about Sydney-based Aristocrat Leisure (11 February 2020), the world was not quite in the playing mood at the brink of the COVID-19 outbreak. The gaming machine maker faced the grim impact of closed casinos and its share price quickly plunged by more than half. Since then, the stock has more than doubled on some better-than-expected results and a brighter outlook for the casino industry. Aristocrat's move into digital gaming has accelerated during the pandemic and we see these investments leading to a bigger payoff for shareholders.

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Share price chart



Source: Tradingview

Annuity-style businesses = consistent profits

Macquarie Group is a well-diversified investment bank in several ways. It offers advisory, banking, investment and asset management services to an increasingly global customer base. Way back in FY98, international income accounted for 22% of total income; in FY20 it was two-thirds of total income.

The group's strength lies in providing commercial banking services to the agriculture, commodity, energy, infrastructure and resource sectors and supporting the M&A needs of large institutions. A big part of why Macquarie was able to extend its profitability streak in FY20 is that more than 60% of net profits were derived from annuity-style activities. The rest of the profits come from market-facing activities. It's hard not to like a business model like this and easy to see why the bottom-line performance has been so consistent.

Global asset management, although a smaller part of the mix, has quickly joined the ranks of the 50 largest such businesses in the world with \$556bn in funds under management (FUM). Also a small slice of the Macquarie revenue pie is the retail banking business. Even though is a relatively minor part of the business, Macquarie's retail bank is still on the heels of Australia's big four banks in fifth position. We like the diversification that the funds management and retail businesses bring to the firm and see room for growth in both.

Waddell & Reed buyout

The 1HY21 result reflected mixed trading conditions in Macquarie's operating groups, particularly in 1Q21. The Macquarie Capital business suffered an 8% net loss as infrastructure and energy project construction activity slowed due to COVID-19 restrictions. All other businesses made positive contributions to net profits. Overall, however, profit fell 32% to \$985m. The result was dragged down by subdued commercial client activity, reduced M&A activity and higher credit impairment charges. Profits were also lower compared to 1HY20 in banking because of COVID-19 costs to support clients and margin compression, but this was partially offset by strong home loan and deposits growth. Overall, it was a decent start to FY21 considering all but one business unit were profitable, and the balance sheet strength was maintained.

The bigger news in CY20 came on 3 December 2020 when Macquarie Group announced the acquisition of U.S. asset management firm Waddell & Reed Financial for \$2.3bn. Waddell & Reed has assets under management (AUM) of approximately US\$131bn between its asset management and wealth management businesses combined. There won't be a need to spend much time on the welcome party though, because Macquarie plans to turn around and sell the wealth management portion of Waddell & Reed to US-based LPL Financial Holdings for US\$300m. Why not just buy the asset management business? Well, Macquarie will still be partnering with LPL Financial (the largest independent broker-dealer in the U.S.) to provide continuity for existing wealth management clients and open doors to new growth opportunities longer term. The deal, which is expected to close later this year, is a good one in our view as it will enhance Macquarie's wealth and asset management platforms and further diversify the market-facing side of the business.

More recently, Macquarie's Commodities and Global Markets (CGM) business was thrust into the world spotlight following the extreme winter weather events in Texas and other parts of the United States. The deep freeze conditions led to hyper demand for Macquarie's services to maintain gas and power supplies. The CGM unit ships gas on most of the major US pipelines and since it has built up capacity over time, was leaned on heavily to fulfill the unexpected customer demand. This windfall should provide a nice boost to the tail end of the FY21 period which ends 31 March 2021. Last month management said it expects the FY21 group result to be up 5% to 10%.

Premium price is right

Macquarie has historically been in good financial health and that hasn't changed throughout the pandemic. It has a common equity tier 1 (CET1) ratio of 13.5% that is well above the 7% minimum regulatory requirement and the 5.9% leverage ratio is almost twice the Basel III minimum. The group's strong capital position along with robust demand for commercial and investment banking should support its ability to deliver growth, especially in the key Asia-Pacific market. In the meantime, the near-term performance will continue to be impacted by the ongoing pandemic uncertainty, government economic support and the speed at which the group can complete its transactions.

At a P/E of 19.1x for FY22, Macquarie's stock isn't the bargain it was a year ago and it trades at a premium to peers. But we believe the group has certainly earned the premium valuation. Since listing on the ASX in 2007, Macquarie's earnings have grown at an 11% rate on average as have dividends per share. No other diversified financial company has had a better track record in that period. So, we don't mind paying up a bit for Macquarie, nor do we mind giving it four stars.

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Share price chart



Source: Tradingview

Few growth levers to call on

Telstra is Australia's largest telecommunications services provider offering fixed, mobile and Internet service to retail and business customers. Unfortunately for Telstra and its peers, a saturated mobile market has created a tug-of-war atmosphere in which companies compete for the same customers. Without any groundbreaking product or service launches, promotions designed to simply wrestle away business have little potential to deliver sustainable growth. As a player in this zero-sum game, Telstra may win out on price in the short-term, but faces an omnipresent risk that a competitor will swoop in and undercut it.

Without much ammunition in its growth arsenal, it's hard to get excited about investing in Telstra. The vast majority of Australians now own mobile phones so there would appear to be a large market for a large telco like this. However, at the end of the day, the participants are all selling network capacity and data, commodities that come with limited pricing power. This means that a company like Telstra has to revert to cost cutting as a way to make its anaemic revenue growth look shinier.

Shrinking profits

As the company warned investors, FY20 underlying EBITDA came in at the low end of its guidance range at \$7.4bn. This was 10% lower than the \$8 billion generated in FY19 and confirmed that the company unfortunately may be dying a slow death. NPAT fell 14% to \$1.8bn. Despite the pandemic challenges and included incurred costs, the FY20 dividend was maintained at 16 cents. Management also noted that is on track to reach \$2.5bn in cost reductions in FY22. We consider this a mild positive but are mindful that this is one of its only profitability levers.

To be fair, COVID-19 had a material impact on 2HY20 performance. All things considered, it could be argued that the FY20 result was quite decent. First half growth was mostly washed away by the second half setback. In fact, Telstra played a key role in making sure Australians had good phone and Internet service during a critical time in part by using 2021 capex to increase network capacity. Unfortunately, this goodwill likely won't translate into any sort of economic benefit for the company.

A major development towards the end of 2020 was the divestiture of the Telstra Velocity business. Telstra sold the division's fibre-to-the-premise (FTTP) assets to Uniti Group for an upfront consideration of \$85m. As part of the deal Telstra will have to pay a \$21.6m per annum license fee to Uniti and will become a retail service provider (RSP) on Uniti's fibre networks.

The 1HY21 result included a 14.2% decline in underlying EBITDA to \$3.3bn and NPAT was down 2.2% to \$1.1bn. The FY22 cost reduction target was raised to \$2.7bn, but this was one of few positives in the half year report. The interim dividend was maintained at 8 cents and management said it expects to pay another 16 cents for the year. We wonder, however, when this story changes given the weakening financial position and fundamentals.

5G won't likely help

The most exciting development in the telco space may be the launch of 5G networking. Telstra will play an important role in the rollout, but again, so too will everyone else. Faster data downloads are good news for gamers, video viewers and businesses, but whether it amounts to improved financial performance for Telstra and others remains to be seen. Speed to market is the critical factor when it comes to 5G deployment and the potential for pricing power. Telstra seems to be somewhere in the middle of the pack in this regard, neither a leader nor a laggard.

Telstra's overall strategy does make sense to us, though. Its so called T22 plan revolves around simplifying the business and moving from legacy telco service into the digital world. This includes the buildout of the My Telstra app along with some related digital bells and whistles. Its ability to differentiate itself from the competition and bring in meaningful levels of new business are what's less certain especially given the history of uninspiring execution.

Make no mistake, however, that many industries will undoubtedly benefit from the lightning speed of 5G networks. Video game companies will be able to spread their wings further into the world of virtual reality (VR) and augmented reality (AR). Self-driving car manufacturers will see their vision advanced by faster communication speeds and ultra-low latency. But as unfair as it may seem, telcos like Telstra aren't expected to be among the big monetizing winners.

So, we continue to dislike Telstra and the telco operator group as a whole given the mundane, undifferentiated nature of the business model. The main attraction of Telstra shares is the dividend, but even this is not what it used to be. Last time around, the yield was above 5% and is currently clinging to the 3% level. We see further downside to the dividend payout as Telstra is forced to explore all avenues to keep cash in its pocket. A dwindling dividend stands to exert further downward pressure on the share.

And don't be fooled by the low valuation of just 8x EV/EBITDA for FY22. It reflects Telstra's limited growth prospects, which are a major 'hang up' for us. It's two dim stars from Stocks Down Under.

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Share price chart



Source: Tradingview

Casinos close, but digital grows

Aristocrat Leisure is one of the world's top gaming technology companies with a presence in 84 countries and 328 licensed jurisdictions. Its offerings include pokie machines, casino management software and an increasing line-up of interactive digital games. Aristocrat's Big Fish Games division has reeled in a massive global audience to become the world's largest free-to-play game producer. Aside from the geographic diversification, we like the business mix with about 60% of revenue historically coming from land-based operations and outright sales with the remainder from digital games.

COVID-19 had a profound impact on the gaming industry in Australia and beyond. Aristocrat's land-based markets saw widespread closures. Virtually all of its land-based customers suspended operations for at least several weeks as of mid-March 2020. Since then, re-openings and customer traffic have been gradually increasing. In its February 2021 trading update, management said it maintained or enhanced its market leadership in the Gaming Operations business and expects to see "sustainable growth" in floor share across its most important Outright Sales markets.

Fortunately, the digital business has gone largely unscathed during COVID-19 and, if anything, may have gained momentum. Homebound folks all over the world have been quick to embrace the digital gaming concept as a much-needed source of entertainment. This has widened Aristocrat's customer base to include people that previously hadn't considered online gaming and increased engagement with existing users.

While there will likely be some attrition as people leave the home to visit other entertainment venues, there will probably also be some level of permanence to the newfound online gaming behaviours. This may especially be the case with mobile phone gaming as people will still be able to enjoy their favourite games while relaxing on the beach or waiting in the doctor's office.

The social gaming world is worth discussing

The FY20 result showed that the negative impact of casino closures was partly offset by the impressive strength in the digital business. Revenue decreased 5.9% to \$4.1bn with digital sales accounting for 57% of overall revenue compared to 28% in FY19. Net profit after tax (NPAT) fell 52.6% to \$357.1m as profitability was hurt by COVID-19 expenses and the lack of revenue.

Aside from an improving economic backdrop, the most exciting aspect of Aristocrat's business is its bold move into digital gaming. This is clearly where the industry is headed and where Aristocrat has been putting a lot of its investment chips. This is not only leading to an increasing daily active user (DAU) base, but higher bookings per user. In FY20, average bookings per DAU increased 34% to US\$0.59.

Today's online gaming realm goes beyond gambling on slots, table games and sports. People, and especially the younger generations, are more than content paying to participate in certain online games purely for the entertainment and social value rather than to try to make a few dollars. Newly launched social casual games like Undersea Solitaire Tripeaks and Evermerge have been solid contributors as have role playing games like RAID: Shadow Legends. Aristocrat holds the #2 position in the global social casino market thanks to the popularity of games like Lightning Link and Cashman Casino.

So, together with the online gaming enthusiasts, Aristocrat is tapping into a whole new gaming market full of people that may never step foot into a casino, instead choosing to play from the comfort of their own sofas. This could be bad news for casino operators that don't have a digital presence, but suits Aristocrat just fine given the increasing strength of its digital portfolio.

Valuation is a steal

Like many companies, Aristocrat suspended its interim FY20 dividend. Prior to COVID-19, Aristocrat's dividend had been growing nicely and we see a return to this pattern as trading conditions and its financials continue to improve. We favour the conservative nature of the balance sheet including the low level of gearing (net debt/EBITDA of 2.2x). Its term loan facility won't mature for another 3.5 years affording ample financial flexibility. Aristocrat had approximately \$2bn in available liquidity as at 30 September 2020, which should continue to see it through the ongoing pandemic uncertainty.

Even with a healthier global economic outlook though, an Aristocrat Leisure investment comes with plenty of risk. However, given the potential rebound in the key North American land-based gaming market and the strong growth prospects in digital gaming, we believe the risk-reward is very much skewed to the positive side. And at an EV/EBITDA multiple for FY22 of 14.7x and EBITDA growth of almost 28% for that year, we consider Aristocrat shares to be well worth the gamble.



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