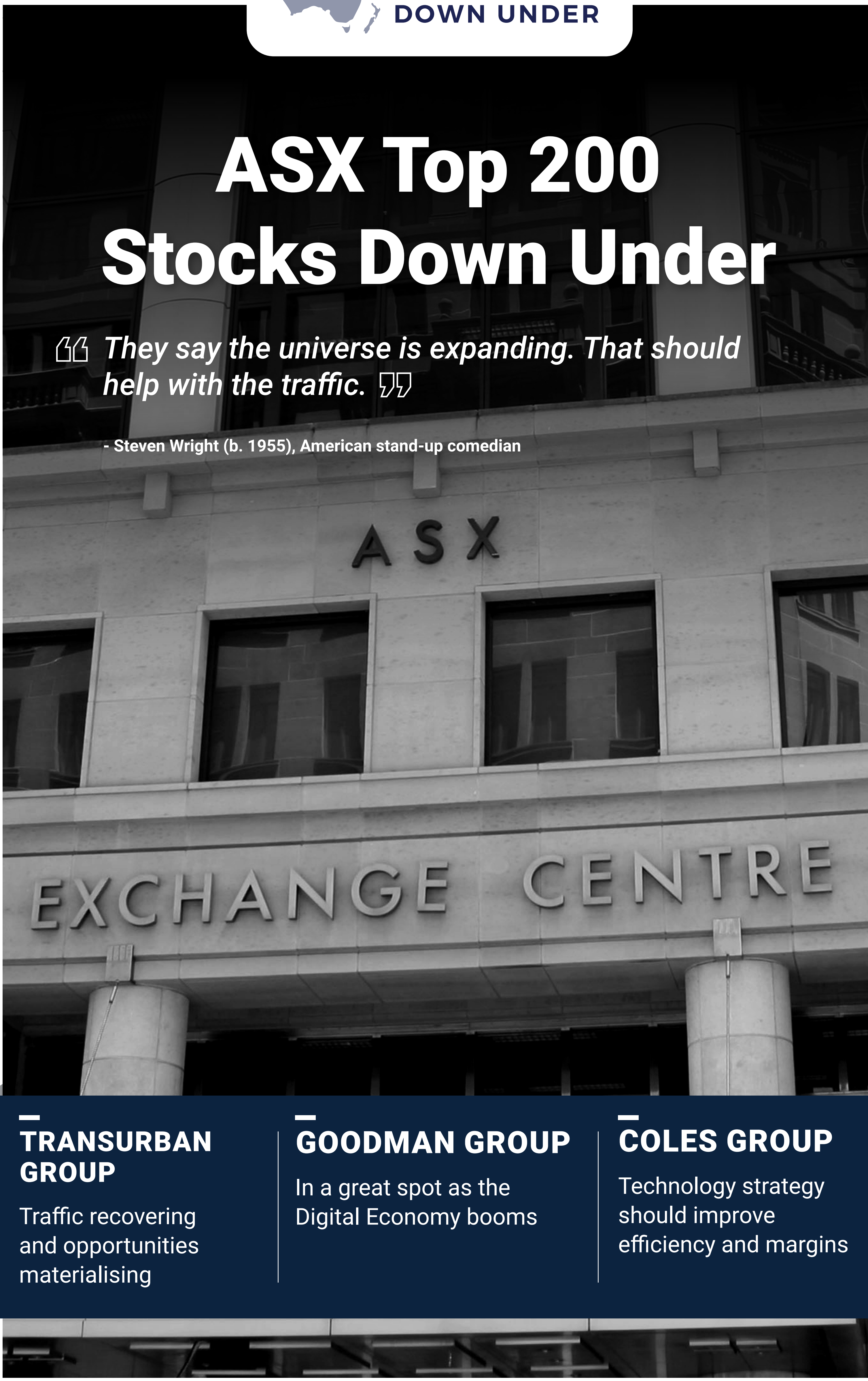
STOCKS DOWN UNDER

3 MAY 2021



ASX Top 200 Stocks Down Under

> *They say the universe is expanding. That should help with the traffic.*
>
> **- Steven Wright (b. 1955), American stand-up comedian**

TRANSURBAN GROUP

Traffic recovering and opportunities materialising

GOODMAN GROUP

In a great spot as the Digital Economy booms

COLES GROUP

Technology strategy should improve efficiency and margins

TRANSURBAN GROUP

Traffic recovering and opportunities materialising

Stocks Down Under rating: ★★★★

ASX: TCL
Market cap: A$ 38BN
Dividend yield: 2.2% (0% Franked)

52-week range: A$12.36 / A$15.63
Share price: A$ 14.14

We last wrote about Melbourne-based Transurban Group on 1 June 2020 when there wasn't much traffic buzzing around Australia's highways. This took an unfortunate toll on the toll-road operator's financial results. But with the economy reopening, traffic improving and development opportunities progressing, the road ahead looks brighter. The Transurban share price rebounded more than 50% from its pandemic low but has since retreated almost 20%. We see this as an opportunity to invest in a defensive business with long-term, income-producing assets.

READ MORE

GOODMAN GROUP

In a great spot as the Digital Economy booms

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ASX: GMG
Market cap: A$ 35BN
Dividend yield: 1.6% (0% Franked)

52-week range: A$12.72 / A$20.07
Share price: A$ 18.91

We last wrote about Sydney-based Goodman Group on 28 February 2020 when the property markets faced the harsh consequences of the pandemic. Although its markets were affected to some degree, Goodman's focus on consumer goods warehouses and the digital economy put it in a better position than most REITs. The share rebounded to a fresh record high in November 2020 but has since pulled back by about 10%. We see this correction as an opportunity to pounce on an attractive e-commerce play with high-quality assets and financials.

READ MORE

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Dividend yield: 3.7% (100% Franked)

52-week range: A$14.95 / A$19.26
Share price: A$ 16.32

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Share price chart

Source: Tradingview

Re-thinking the future of mobility

As one of the world's largest toll-road operators, Transurban Group manages toll roads in Australia and North America. It also researches and develops various tolling, vehicle and road safety technologies that promote the safe and efficient commute of travellers everywhere.

Transurban has done a commendable job of maintaining liquidity during COVID-19 while keeping debt at a manageable level. Granted, the company was in a strong capital position going into the crisis, which helped the group absorb the impact of reduced cash flow. Ultimately, we believe Transurban should have no problem in securing the funding it needs to capitalize on growth opportunities, both inside and outside Australia during the post-pandemic years.

Still, COVID-19 had a significant impact on Transurban's FY20 financial performance. Average daily traffic was down 8.6% across its portfolio and toll revenue fell 3.4% to $2.5bn. Since June 2020, traffic volume has trended higher in Australia, driving increased toll revenue. Commercial traffic volume was quicker to recover thanks to the ongoing need for essential goods distribution and the surge in e-commerce activity. As restrictions have been lifted, work, school and leisure travel have ticked higher.

Despite this improvement, Transurban has had to evaluate the best way to adapt to the post-pandemic world. Will people continue to shun public transportation in favour of driving? Will the accelerating popularity of online shopping equate to fewer cars heading to shopping centres?

We expect some level of permanence to the remote workforce, online shopping and anti-public transportation trends. What is more difficult to predict is the degree to which the unfavourable trends (online shopping, working from home) are offset by the favourable trends (reduced public transportation usage, reluctance to carpool, etc.) We view this uncertainty as the greatest risk to Transurban's future growth, but we are confident that the company has the correct management in place to adapt as necessary.

Pipeline is progressing and the assets are surviving

Perhaps the most attractive aspect of a Transurban investment is the long lifespan of the group's assets. The company doesn't just lay down some asphalt and collect toll money. Transurban designs and constructs well-engineered roads that provide dependable transportation and become an integral component of the local community for many years. Most development projects have at least 30-year expirations, and some, like the 395 Express Lanes in the Washington D.C. area, are locked in for more than 60 years. It's anyone's guess what the next 60 years will bring in terms of global health scares and geopolitical events. Barring a dramatic shift to flying cars, what's more certain is that we will continue to rely on major metropolitan traffic arteries to conduct business, visit family and vacation.

Transurban continues to build out its road network through a combination of its own financial strength and the support of government funding. The Morrison government's October 2020 announcement of a $7.5bn investment in road and transportation projects is just one example of the massive infrastructure spending set to occur in Australia this decade.

In July 2020, two more assets came into Transurban's portfolio—the M8 opened to traffic, and the M5 began tolling. Plenty more projects are under development to further diversify the Australian portfolio. The West Gate Tunnel Project timeline was extended to 2023, but this represents a major future revenue source. Transurban has already committed $2.3bn towards the $4.0bn project slated to improve the traffic flow in and around Melbourne significantly. Once completed, the West Gate Tunnel tolls are planned to increase at a quarterly rate of 4.25% per annum through June 2029.

Traffic is improving

The 1HY21 result was highlighted by a positive traffic trend as average daily traffic (ADT) improved to 2.1m compared to 1.8m in July 2020. The North Connex project in northern Sydney opened on 31 October 2020 and is already seeing better than expected traffic and receiving positive community feedback.

As far as the financials, toll revenue was down 16.6% to $1.17bn and Transurban swung to a $448m net loss due to the government restrictions on movement in Australia and North America. Despite this, the effects of the pandemic lessened as the period progressed, which we see as a sign of continued recovery.

The pipeline is also deep in North America. Here, Transurban's partnership with Macquarie was recently selected to develop and deliver the American Legion Bridge I-270 project. The estimated US$3bn to US$4bn project will involve the addition of high occupancy toll (HOT) lanes to Interstate-495 and is part of a broader project valued at more than US$9bn. Transurban is also expected to play a role in Montreal's economic recovery and is in discussions with the Quebec Government regarding potential infrastructure opportunities.

Looking beyond the pandemic, Transurban's toughest task will be balancing the pursuit of growth opportunities with maintaining a strong, investment-grade balance sheet that rewards shareholders with distributions. Given management's track record in this regard, there's no reason to believe it won't be successful. We see Transurban as not only a play on the reopening of the Australian and North American economies, but also as an attractive income share to own for the long-term.

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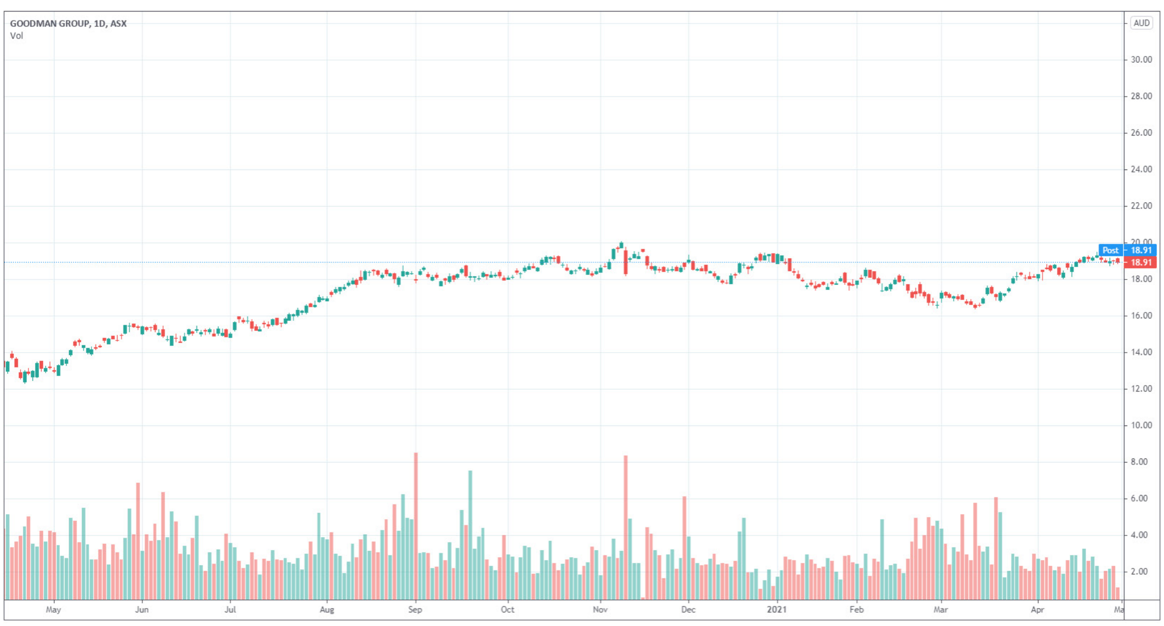

Source: Tradingview

COVID poses limited disruption

Goodman Group owns, develops and manages a diverse portfolio of logistics facilities and located in Australia, New Zealand, Asia, the U.K., Europe and the Americas. The group has $51.6bn of assets under management (AUM) in addition to $8.4bn of development projects, a testament to how much demand is out there for new property. It is important to note that Goodman's work in progress was $6.5bn just six months prior to its most recent report.

The challenges faced by residential and office property managers didn't apply to Goodman, although some of its customers were impacted by COVID-19 disruptions. Overall, though, it largely found itself in the right sectors at the right time — food distribution, logistics and e-commerce. Goodman's warehouse properties had few instances of closure as businesses like supermarkets and online retailers were thrust onto the front lines. This allowed its occupancy rate to remain stable at 97.5% and its cash flow to be steady throughout the pandemic.

Meanwhile, demand picked up for temporary and permanent space from essential businesses and others pivoting to online models. As companies continue to consolidate supply chains and expand their e-commerce capabilities, we see Goodman's development pipeline getting bigger, faster.

The developments are focused on logistic properties in urban areas where land is hard to come by. Much of the development work is taking place across Asia where demand for logistics space is strong, particularly in China and Japan. We like the geographic and property type diversification within the development workbook, because it gives us a good sense of future AUM growth. The 15-year weighted average lease expiry (WALE) is also attractive, because it means new tenants are being locked in for long lease periods.

Pandemic spurs logistic property demand

The FY20 results confirmed that Goodman was in a good competitive position due to its exposures to essential infrastructure and capital strength. FY20 operating profit increased 12.5% to $1.06bn. Asia accounted for 36% of the earnings and the ANZ region 32%. During the fiscal year, its portfolio recorded $2.9bn in revaluation gains, which contributed to the 9.4% increase in net tangible assets (NTA) per security to $5.84. As of 31 December 2020, NTA per security rose to $6.03.

Digital commerce stole the show in last month's interim report. Operating profit was up 16% to $614.9m. Asset pricing was once again strong, driving another $1.5bn revaluation uplift. The relatively small, but mighty development business made a strong contribution to the result, reflecting the elevated customer appetite for warehouse space to keep up with demand from the digital economy. In the existing portfolio, the occupancy rate ticked higher to 97.9% as like-for-like property income grew 3%. Interestingly, Europe and the U.K. were the biggest contributors to 1HY21 profits, while operating earnings in Asia were the third largest contributor, further highlighting the value of Goodman's geographic diversification. It seems that in any given period, one of the three main regions can drive a better-than-expected performance.

Goodman's most attractive long-term growth catalyst stems from the surging demand for logistics properties to support e-commerce growth. In the wake of COVID-19, consumers worldwide are spending more money than ever on digital platforms. E-commerce companies, old and new, are scrambling to keep up with this demand by running effective and efficient supply chains — and many are reaching out to Goodman because of its strong logistics property portfolio.

Many tenants are looking for facilities with automated capabilities to reduce costs and gain an edge on the competition. Goodman's technology-oriented buildings meet this requirement and are a big reason why blue-chip names like Amazon, Wesfarmers and Japan Post have become key tenants. The rise of e-commerce and demand for related properties should stay robust, in our view, especially in developing nations where middle-class consumers with purchasing power are on the rise.

Gearing on the decline

The balance sheet is in good shape with a very low level of gearing (4.8%) that has come down significantly in recent periods. This gives the group some added flexibility to pursue growth funding as opportunities arise. The low global interest rate environment should certainly help in this regard. Despite the COVID challenges, Goodman Group paid out the same dividend in 2020 as it did the year prior. And with an increasing cash position of $1.8bn, we see upside to the dividend especially given the strong demand backdrop.

We expect Goodman to benefit from the favourable dynamics of strong property demand and limited property supply. Its exposure to some of the world's fastest-growing metropolitan areas should drive an uplift in its property valuations, further strengthening its asset base. The valuation is compelling at 3x NTA per security, so it's four digital stars from us.

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Share price chart

Source: Tradingview

Locked in at number two

As Australia's second-largest grocery retailer, Coles sits in a fairly comfortable position. It's unlikely to experience a big wave of new customers and overtake Woolies, nor is it likely to see a mass customer exodus. People tend to have their regular local spot for groceries and generally stick with it often out of familiarity or convenience. Companies try to compete on price, quality, selection and promotions, which can sway some shoppers, but generally speaking, it is difficult to steal customers. Therefore, absent any major competitive advantage, Coles seems likely to stay in the number two position for a while.

We don't consider this to be a bad spot for the company to be in, but it's not that spectacular either. The group will be hard-pressed to dethrone Woolies, not only in terms of market share, but financial performance as well. The main reason for this is because there is quite a gap between the operating margins of the two retailers. Coles 1HY21 EBIT margin of 5.0% showed significant improvement (from 3.7% in FY20), but still compared unfavourably to Woolies' 5.8% EBIT margin. The improvement was primarily related to the greater proportion of higher-margin online sales, the same as Woolies.

Coles FY20 result included a 6.9% increase in revenue to $37.4bn. Supermarket comparable sales rose 5.9%, stretching that growth streak to 51 quarters. Operating earnings were up 4.7% to $1.38bn and net profit after tax (NPAT) was up 7.1% to $951m. Not surprisingly, the liquor business experienced the highest sales growth (8%) thanks to pandemic-driven at-home consumption and 40% online liquor sales growth.

Tech and e-commerce are reshaping the industry

The 1HY21 result reflected Coles increasing focus on the e-commerce side of the business. Revenue was up 8.1% to $20.4bn, EBIT jumped 12.1% to $1.0bn, and NPAT increased 14.5% to $560m. The acceleration in top-line growth was mainly due to 61% e-commerce growth as more people became comfortable ordering online. Coles is trying to capitalize on the increased demand for online ordering by investing in its Ocado and Witron automation projects, which are intended to speed up the order fulfilment and distribution processes. Construction of the technology-forward facilities is underway and should be money well spent given where the grocery business is headed. Management noted that it was on track to exceed its $250m cost savings goal in FY21, a positive development for shareholders. Another bright spot was that the net debt position was actually cash positive by $38m.

Coles doesn't have the luxury of being able to drastically slash prices to fend off competition from the Aldi's of the world as Woolies can — and that's an important weapon in the grocery game. We believe this not only makes it vulnerable to market share losses, but leaves it with fewer ways to attract customers and improve its financials. This means cost-cutting is the next logical step to turn to and Coles is in the early stages of this battle. COVID-19 protocols have forced Coles to spend more on cleaning and security, not to mention employee costs. Much work remains to reach the group's target of $1 billion in cost reductions by FY23. We see Coles continuing to chase Woolies in a game of margin improvement for the foreseeable future.

The group's cost-saving strategy is connected to its plan to use more technology to become a more efficient business. It has implemented technologies, like Deli easy ordering and bakery production tools, into some stores. It is also developing artificial intelligence (AI) tools to improve its forecasting and decision making on dynamic price markdowns. Even the lights in the stores are being targeted to maximize energy and reduce costs through the use of LED lighting. These are all valid steps towards improving margins and enhancing competitiveness, but it's still too early to call the strategy a success.

Cheaper is not always better

We see Coles as a share that will make the investor neither rich nor poor. The defensive nature of the grocery business drives steady revenue growth, but the group's relatively low margin equates to little capital appreciation potential. Coles 3.7% dividend yield is significantly larger than that of Woolies (2.4%), but that and the cheaper valuation (8.8x versus 10.2x EV/EBITDA for FY22) are the only places where it seems to have an advantage. Plus, Woolies' market leadership, higher margins and better growth forecast justifies its higher checkout price, in our view.

Coles is, however, showing early signs of progress with its cost savings initiatives despite the ongoing COVID-19 expenses. As these expenses dissipate, the group's technology and efficiency efforts could start to bear more product. How much this closes the margin gap with Woolies remains to be seen. So, Coles is still a middle of the aisle yield investment that's not much different than purchasing a bond. Three stars from us.

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.