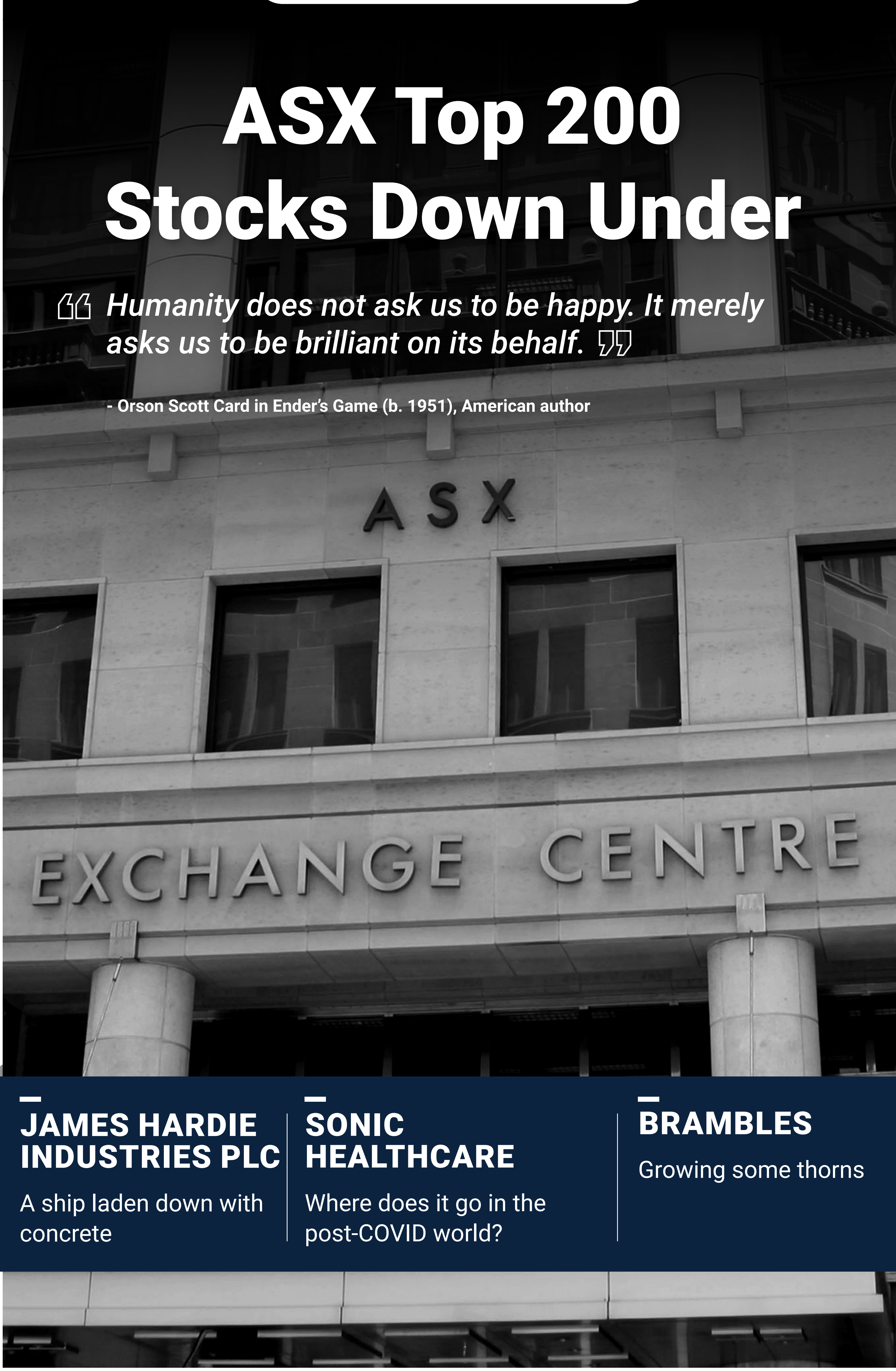
STOCKS DOWN UNDER

31 MAY 2021

ASX Top 200 Stocks Down Under

“Humanity does not ask us to be happy. It merely asks us to be brilliant on its behalf.”

- Orson Scott Card in Ender’s Game (b. 1951), American author



JAMES HARDIE INDUSTRIES PLC

A ship laden down with concrete

SONIC HEALTHCARE

Where does it go in the post-COVID world?

BRAMBLES

Growing some thorns

JAMES HARDIE INDUSTRIES PLC

A ship laden down with concrete

Stocks Down Under rating: ★★★

ASX: JHX
Market cap: A$ 19BN
Dividend yield: 0.1% (0% Franked)

52-week range: A$25.19 / A$44.57
Share price: A$ 42.50

When we last wrote about James Hardie Industries (28 January 2020), it was Australia's largest manufacturer of fibre cement and backerboard. This Sydney-based company has been a shareholder's best mate over the last year, rising 57% during FY21 to date. The market is expecting strong earnings growth on the back of the COVID-19 construction boom. But maybe the shareholder return ship has already sailed.

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Where does it go in the post-COVID world?

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ASX: SHL
Market cap: A$ 16BN
Dividend yield: 2.5% (30% Franked)

52-week range: A$27.22 / A$38.00
Share price: A$ 34.82

We last wrote about Sydney-based Sonic Healthcare on 21 September 2020. At the time we noted the favourable impact of COVID-19 on demand for pathology services, but also noted that it was not likely sustainable. Even as non-COVID laboratory services normalise and imaging appointments are rescheduled, profits are expected to decline considerably in FY22. Therefore, with the stock up 43% over the past year and trading near an all-time high, our diagnosis is that Sonic Healthcare is probably at peak valuation.

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Headquartered in Sydney is a company looking to take the thorns out of the world's logistics waste problem. Brambles offers companies the ability to transition from single-use pallets, crates and containers to the company's reusable products. The company currently operates in approximately 60 countries, employs 12,000 people within its network of 750 service centres handling the 330m pallets, crates and containers Brambles owns.

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Share price chart

Source: Tradingview

Since when is cement made of fibre?

James Hardie is the world's largest producer of high-performance fibre cement and fibre gypsum building options. Fibre cement is not actually made of fibre, but rather reinforced by it. The material is made with sand, water, cement and cellulose fibres. The cellulose fibres drastically increase the durability and strength of the material and this is why it is often used to cover the exterior of houses and other building projects.

The North American Fibre Cement division had two things going for it over the last nine months: price and volume. The average net sales price per unit over the last nine months was US$739, a 2% increase year-over-year. During 3QY21, the price increased by US$1 to US$740. Volume saw strong growth during the period, with demand increasing due to the world's infrastructure-focused COVID-19 recovery. During the first nine months of FY21, volumes rose 9% to 1.9bn square feet, driven mostly by the 17% year-over-year increase during 3QY21 to 693.8m square feet.

The Asia Pacific Fibre Cement division has unfortunately not been as strong as the North American segment. Over the last nine months, the price increased 7% year-over-year to US$753, but square foot volume declined 3% to 397m. Fortunately, the last financial quarter (3QY21) saw much stronger results, with volume increasing 9% to 141.8m square feet at US$760 per unit. Going forward, we expect Asia Pacific to continue to post strong growth results, i.e. more in line with 3QY21 than the previous 1HY21-period.

The European division also happens to be the company's most diverse. In Europe, James Hardie sells both its fibre cement and fibre gypsum, with over 85% of its annual sales coming from fibre gypsum sales. Over the last nine months of FY21, this division's volume increased 5% to 623.4m square feet on a 2% price increase, resulting in an average price of US$354 per unit during the period. From a volume perspective, 3QY21 saw the largest growth of all of James Hardie's divisions after a 17% increase during the period to 221.3m square feet, mostly driven by fibre gypsum sales. Prices grew a lot less, only 4% during 3QY21 to US$355.

If you have the cash, you don't need the debt

James Hardie's balance sheet is currently particularly well-positioned for future growth. Before the COVID-19 infrastructure spending boom, management has seen fit to deploy its increasing cash pile to pay off its higher yield, long-term debt. On 15 January 2021, the company announced it was spending US$410m in cash to pay out the principle of its 4.75% 2025 notes, reducing long-term debt to US$900m. By paying off this chunk of its long-term debt, the company estimated it will save US$20m in interest payments on an annual basis. In other words, James Hardie's US$410m debt reduction is saving shareholders a substantial amount of money.

Too much concrete on this valuation

According to the latest market estimates, James Hardie is set for FY22 EBITDA growth of 16.5%, resulting in $1.15bn for the period. Based on these estimates, the shares are currently trading at an FY22 EV/EBITDA multiple of 17.1x. We believe James Hardie's stock is one that has gotten a lot of attention around the infrastructure boom excitement, driving the valuation to a point where we don't see much upside in the medium term. The company's liquidity is something we do need to consider, however, as the number of large mergers and acquisitions worldwide has seen strong growth during FY21 and we believe James Hardie could play a part in that.

Overall, we believe James Hardie is a strong company with shrewd management, especially after the recent debt paydown. However, investors have been excited about the infrastructure boom and we believe this has led to a fully valued stock. Therefore, we would advise our readers to keep an eye out for a more attractive entry point. Until then, it's three stars from us.

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Source: Tradingview

Lab services

Sonic Healthcare's network of approximately 900 specialist pathologists and 200 radiologists provides diagnostic services to medical practitioners in Australia, New Zealand, the US, the UK and four European nations. In FY20, sales growth in the US market was robust at 29%, but in the single digits in Sonic's other three geographic segments, including less than 4% in Australia. This reflected the elevated demand for COVID-19 testing, but little demand for, or availability of, the rest of Sonic's offerings.

The laboratory side of the business, which provides services related to the study of infectious diseases, received a major boost from COVID-19. To say the least, Sonic's laboratories have been busy keeping up with demand for coronavirus test results, which led to the lab segment accounting for 85% of revenue in FY20. Unfortunately, this has shifted the company's focus away from its other testing areas. In effect, resources have simply been re-allocated. The 11% revenue growth posted in FY20 was good, but not great, especially considering the market's inflated expectations for a more significant COVID effect.

The imaging side of the business, which is exclusively based in Australia, had been performing well prior to the pandemic. But the cancellation and postponement of non-critical appointments hit the pause button on growth. As rescheduled appointments have occurred, results have improved though.

Sonic's third, 'Other', segment includes medical centre operations, occupational health services and remote healthcare. Unfortunately, remote healthcare is a tiny part of the business, so heightened demand for virtual care during the pandemic has had little impact on overall performance.

COVID testing driving the business … for now

The 1HY21 result was much stronger as it reflected the full benefit of six months' worth of COVID testing. More than 18 million COVID PCR tests (that's 'polymerase chain reaction' for the science nerds among us) were performed across 60 Sonic labs per31 December. The company effectively leveraged its scale and global footprint in generating 33% revenue growth to $4.4bn, 89% EBITDA growth to $1.3bn and 166% net profit growth to $678m. But to show just how COVID-centric the business has become, excluding COVID testing, 1HY21 revenue was down 1%.

The US segment continued to show strength in the interim period as organic revenue grew 39%. COVID and serology (i.e. immunity) test volumes were high across Sonic's 13 US labs. With almost $1.2bn in revenue, it accounted for 27% of total revenue while Germany and Australia accounted for 23% and 22%, respectively. In Australia, pathology revenue was up 26% and, unlike in the US and Germany, revenue in the base business (non-COVID) grew to the tune of 5%. This bodes well for a recovery in the underlying pathology business in Australia and potentially other geographies.

We haven't forgotten about the imaging business. This too showed signs of a rebound as revenue increased 14%, EBITDA increased 19% and the business gained market share. Workflow has improved in this segment as Australians have resumed showing up for MRI and X-ray procedures. This business should also get a boost in 2HY21 when Sonic becomes the majority owner of Epworth Medical Imaging in Victoria. Epworth generates around $35m in revenue per annum while Sonic's imaging business had revenue of $520m in FY20. The clinical services business continued to be impacted by the COVID in 1HY21, but maintained 1HY20 profit levels.

Stronger balance sheet

Sonic's balance sheet became healthier in 1HY21. Gearing is now the lowest it has ever been at 21.6% and the EBITDA-to-interest-expense ratio improved to 20.5x. There is approximately $1.3bn in available liquidity, which gives it plenty of room to meet its near-term obligations. Cash generation has been good as one would expect, but with COVID-related debtors up $195m and COVID-related inventory up $90m in 1HY21, it still fell short of $1bn despite the $4bn-plus revenue figure.

Management sees a strong 2HY21 result ahead, as do we, but where things go from there is less certain. With plenty of pandemic uncertainty still present, COVID-19 testing volumes will remain a wild card heading into FY22. We are optimistic the state of the world's health will improve as vaccinations progress, but with cases now picking back up in many parts of the world, it's hard to know how the virus-vaccine tug-of-war will play out. Therefore, it's also hard to gauge how much of Sonic's business will be dictated by COVID-19 testing as we enter the new fiscal year.

When we get to the valuation, the party gets rained on a bit. EV/EBITDA for FY22 is around 11.6x, which at first glance is attractive, but a closer look at the x-ray says otherwise. Absent high COVID volumes, EBITDA is forecast to decline significantly in FY22 and slip further in subsequent years. By FY23, we expect the operating margin to revert to pre-pandemic levels around 13%, which is uninspiring for a company participating in a growth market, like lab diagnostics. Even with the 2.5% dividend yield, we feel the stock offers little upside from here, so it's two stars from us.

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Share price chart

Source: Tradingview

If it packs, it posts

We all love flat rate posting, but we often don't think about the logistics that go into this Australian Post offer. For one thing, shipping objects can be quite wasteful as we send and receive our things in disposable packages. Now imagine the waste generated through commercial shipping, and the scale of the environmental damage is staggering. Brambles generated US$3.8bn in revenues during the first nine months of FY21, representing 8.5% year-over-year growth. Unfortunately, approximately 2.5%-points of this growth was due to changes in foreign exchange movements, bringing revenue growth down to 6% year-over-year on a constant currency basis.

The Americas division generated the majority of Brambles' revenue at US$1.9bn during the first nine months of FY21, implying a 7% year-over-year constant currency growth rate. Unsurprisingly, the vast majority of demand came from North America as companies began stocking up on inventory as businesses attempted to resume normal operations. Due to the explosion of Brazil's COVID-19 mutation in South America, we believe it is unlikely South America will see any real growth in the near future. However, we remain cautiously optimistic that the North American market will continue to see strong demand for logistics services through the remainder of FY21 and during FY22.

The Europe, Middle East and Africa division generated US$1.5bn during the first nine months of FY21, implying

4% year-over-year growth on a constant currency basis. The European business saw increased demand due to the acquisition of new customers, but mostly from continual inventory stockpiling due to BREXIT and COVID-19 impeding logistics. Unfortunately, the Middle East and Africa are seeing significantly higher levels of instability, especially in the southern parts of Africa where Brambles operates. We believe this division's future is far more uncertain due to the instability in the African regions and the continued ravaging of Europe by COVID-19 mutations. However, we are cautiously optimistic that Brambles will continue to win clients throughout Europe as its product plays directly into the environmentally friendly focus of the EU's recovery package.

The Asia-Pacific region generated the largest year-over-year growth at 8% year-over-year, resulting in $383m in revenues during the first nine months of FY21. The main reason for this strong growth was a large contract that was won in Australia and continued demand from the Australian and New Zealand regions.

Sharing is caring

On 10 February 2021, Brambles management announced a merger between its Kegstar rental business and its US-based keg solutions provider MicroStar. The merger reduces Brambles' ownership of the new entity to 15%, with MicroStar's current shareholders owning the remaining 85% . We believe this merger has the potential to be significant going forward since, as of 30 June 2020, the Kegstar division only accounted for 1% of Brambles' total revenue. We believe management giving up control of this subsidiary in this merger with a company with a broader spread of offerings and focus in the beer industry is significantly more likely to increase shareholder value. In this case, we certainly think that for Brambles' Kegstar division, sharing is caring. The merger was completed on 16 April 2021.

Who doesn't love a good buy-back?

Management is not happy with the company's current share price and they are not afraid to act on that. As of 1HY21, Brambles was sitting on US$ 560.8m in cash and US$115.1m in term deposits. The company has decided to use part of these funds to repurchase its ASX-listed shares. Between 9 December 2020 and 22 March 2021, Brambles purchased 40.5m shares for a total of $423.9m at a price per share between $9.78 and $11.28, representing a 2.7% buy-back of outstanding shares. Management has made it clear that it plans on continuing the buy-back program for at least the remainder of FY21. We believe this will continue to provide a solid floor under the company's share price.

Steady growth and decent dividend

Brambles offers the market something the vast majority of companies have shied away from, i.e. forward-looking guidance. Unfortunately, this guidance only goes as far out as FY21's full-year results, but it's better than nothing. Management expects revenue growth between 4-6% on a constant currency basis and net profit growth between 5% and 7% during FY21. The market is slightly more bullish than the company, expecting revenue growth of 8.2% for FY21.

Moving towards FY22, the market is currently expecting revenue growth of only 3.9% and EBITDA growth of 3.3%. Since management has issued FY21 revenue and profit guidance (not EBITDA), we are comfortable with these FY22 consensus numbers. Using the consensus FY22 EBITDA estimate, Brambles is trading at an EV/EBITDA multiple of 8.3x, which we believe is on the high side given the expected 3.3% EBITDA growth rate.

It is important to remember, though, that Brambles is not just a normal logistics story. Since the company's entire business plan revolves around introducing reusable packaging and storage options to the world's supply chains, there is the environmental angle to consider. We believe this will strongly benefit the company over the next few years as North American and European governments start hitting companies over their waste.

While we believe the Brambles valuation is slightly high for its expected growth, we believe the price becomes more reasonable when we factor in the share buy-back program and the 2.4% indicative dividend. Unfortunately, it is still far from a steal, so its three stars for now.

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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.