STOCKS DOWN UNDER

21 JUNE 2021

# ASX Top 200 Stocks Down Under

*"Those who cannot remember the past are condemned to repeat it."*

**- George Santayana (1886 - 1912), Spanish philosopher**

ASX

EXCHANGE CENTRE

## SANTOS

Better commodity pricing means a strong rebound ahead

## SCENTRE GROUP

From premium to discount

## TPG TELECOM

How low can it go?

## SANTOS

### Better commodity pricing means a strong rebound ahead

Stocks Down Under rating: ★★★★

**ASX: STO**
**Market cap: A$ 16BN**
**Dividend yield: 1.2% (100% Franked)**

**52-week range: A$4.64 / A$7.84**
**Share price: A$ 7.34**

When we last wrote about Adelaide-based Santos, on 30 June 2020, the stock was trading at $5.30. It has since climbed as high as $7.76 before retreating in recent weeks. With shares of the oil and gas major now up 28% over the last 12 months, higher commodity prices point to strong profits ahead for this low-cost producer. The company's recently announced clean energy targets also bode well for generating investor interest for this still undervalued share.

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## SCENTRE GROUP

### From premium to discount

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**ASX: SCG**
**Market cap: A$ 15BN**
**Dividend yield: 6.5% (0% Franked)**

**52-week range: A$1.88 / A$3.13**
**Share price: A$ 2.86**

Headquartered in Sydney, Scentre Group owns and operates 42 Westfield Living Centres across Australia and New Zealand. We last wrote about the company on 20 July 2020. Despite the constant negative press surrounding retail property during the pandemic, Scentre Group presented a declining, but overly strong earnings result for 2020. With the company trading at a large discount to its Net Tangilbele Assets (NTA), we think this is one centre we find worth a shot.

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### Share price chart

*Source: Tradingview*

### Record volumes, but low pricing

Santos, which has traded on the ASX for over 50 years, is one of the top natural gas suppliers to households and businesses in Australia and Asia. The company supplies more gas in Australia than anyone and has its sights set on being a leading liquid natural gas (LNG) supplier to the Asia-Pacific region.

The 2020 full year results had a little bit of everything. It was somewhat a tale of two halves as COVID-19 impacts in the early part of the fiscal year made way to an improving economic backdrop as the year progressed. When it was all said and done, Santos recorded record production and sales volumes albeit in a lower commodity price environment. Due to the weaker oil and gas pricing, FY20 revenue fell 16% to US$3.39bn and the company swung to a net loss of US$357m. It did, however, maintain its dividend, which isn't large but nevertheless reinforces management's commitment to shareholders. For the year, Santos produced 89 million barrels of oil equivalent (mmboe) and sold 107 mmboe. Despite these records, the pandemic's effect on global energy demand sapped what would've otherwise been an outstanding report.

There is a silver lining. The underlying strength in the business points to a convincing return to profitability in FY21 and beyond as oil and LNG prices continue to recover. Since the start of CY21, Brent crude oil is up almost 30% and natural gas prices are up about 15% thanks to improving demand. We think demand will only

get stronger as the global economic rebound gains momentum. Firmer commodity pricing along with Santos' strong operating performance should lead to some dramatically better results over the next couple of years. In FY20, Santos' averaged realised oil price was US$47. As of 30 April 2021, Brent crude oil was trading US$20 above that—and as a low-cost producer, Santos should see some healthy margins.

### Getting cleaner

We got a glimpse of the better results to come in Santos' first quarter FY21 report, which started on 1 January. Production in the period increased 39% year-over-year, although most of this was due to the company's recent acquisition of Conoco Philips' assets in Western Australia. Lower domestic gas demand in Western Australia, however, contributed to lower overall sales volumes, but the better commodity pricing led to higher first quarter revenue and strong free cash flow. The balance sheet is also getting healthier, with net debt down to US$3.6bn and gearing at 33.6%.

With energy prices moving higher, Santos has been moving forward with its project pipeline (no pun intended) to capitalise on the more favourable environment. On 30 September 2020, Santos received approval from the New South Wales Independent Planning Commission (IPC) to move forward with its Narrabri Gas Project, which is expected to provide NSW customers with the lowest cost source of gas. Further approvals are required and a 12 to 18-month drilling program will precede development, but once the project gets off the ground it should be a nice complementary source of natural gas revenue. Narrabri has the potential to meet as much as half of NSW's gas demand, much of which comes from the commercial and industrial sectors.

The progress with the Narrabri Project bodes well for Santos' broader ambition to become one of the world's leading suppliers of clean energy. In December 2020, the company announced a plan to reach net-zero emissions by 2040. A couple of months prior to the announcement, Santos successfully injected approximately 100 tonnes of carbon dioxide into depleted gas reservoirs deep underground in the Copper Basin as part of its Moomba Carbon Capture and Storage (CCS) Project. It is targeting the injection of 1.7m tonnes per annum, which would make it the second-largest such project in the world and go a long way in reducing Australia's carbon emissions.

### Well-positioned for the recovery

A big part of why Santos shares have trended lower since 8 March 2021 is because Chinese energy company ENN Group trimmed its Santos stake from approximately 15% to 10% at that time. Despite dumping some 107.1m shares at $7.33, ENN is still Santos' largest shareholder and expressed support for the company's strategy and outlook. Due to an agreement between the companies, the director that ENN nominated to the Santos board has to step down. So, with ENN now having less of a stake and less of a voice in Santos' operations, it wouldn't be surprising to see its stake further reduced over time. We therefore see this as an overhang that could exert near-term pressure on the stock with no notice.

Despite this risk, we believe the overall risk-reward profile is considerably skewed to the positive given the combination of better oil prices and low-cost production. In terms of valuation, Santos shares are not as cheap as they were 10 months ago but are still priced attractively. The EV/EBITDA for FY21 is 5.7x and the stock gets less expensive looking out to FY22 with an EV/EBITDA of 5.4x. EBITDA growth in both years is expected to amount to 48% (due to the Conoco Philips' assets) and 5% respectively. So an EV/EBITDA of 5.4x for FY22 is more than reasonable.

With Santos now riding the upswing in the energy cycle, investors should strap in for an enjoyable ride ahead. It's four energetic stars from us.

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### Share price chart

*Source: Tradingview*

### It's Westfield. Need we say more?

Scentre Group owns and operates 42 Westfield Living Centres across Australia, Auckland and Christchurch, New Zealand. These centres house over 12,000 outlets and are in the vicinity of over 20m people, an extraordinary amount when you consider Australia and New Zealand are only 30.3m people combined. All-in-all, Scentre's net operating income did not decline as much as you might expect during COVID-19. During 2020, income declined 8.1% to $1.8bn resulting in EBIT of $1.4bn (a 26% decline year-over-year), which we consider a fairly strong result, all things considered. Combine this result with enough funding to pay off debts through 2024, and management was able to maintain a 6.7% indicative, annual dividend yield, last paid on 26 February 2021.

### The bells and whistles mitigating COVID-19

While Scentre certainly has mostly Real Estate Investment Trust (REIT) attributes through its ownership of the Westfield Living Centres, the Westfield brand has some customer perks that we believe helped reduce COVID-19's overall impact. Two customer-facing initiatives were enacted during 2020, Westfield Plus and Westfield

Direct. Westfield Plus is a membership program based around an easy-to-use application that was expanded into Australia in 2020. The application offers members a number of features, like extended free parking, booking tables at restaurants and activating and managing the centre's retailer gift cards. By the end of 2020, the application had generated 1.2m signups.

Westfield Direct was shut down on 22 June 2020. However, we believe it likely helped drive customer visits during the period March through May 2020. Customer visits during this period obviously collapsed as people avoided shopping centres either by their own choice or due to lockdowns. However, during those three months, visitor numbers still amounted to 34m in March, 16m during April and 26m in May. When you compare this with 2020's average of 37m per month and 2019's of 46m, we believe that this was an overall impressive result when you factor in lockdowns and restrictions.Without Westfield Direct, we believe these numbers would have been a lot lower. Quick thinking and action on the part of management gives us confidence that if another wave of lockdowns were to envelope Australia, management would be able to mitigate these as much as possible.

### Like many of its lessee's, discounted

Compared to other REIT's, Scentre Group might have some extra bells and whistles, but its still basically a REIT. Therefore, we have to spend some time reviewing its NTA per share and occupancy rates.

As of 31 December 2020, Scentre's NTA per security was $3.63, a decline of 18.6% compared to 31 December 2019. The drop compared to 2019is not surprising. Despite what you might have heard, Australia's post-COVID-19 real estate boom is extremely niched, with the largest beneficiaries being logistics and residential buildings. While we believe the value of Scentre's retail properties will recover, we also note that this will likely take at least a year.

Unlike many other retail properties, Scentre's occupancy rate has managed to stay surprisingly high during 2020. As of 31 December 2020, 98.5% of its portfolio was fully leased after the company papered 2,625 new deals, including 848 new merchants. Management has indicated that collections are stable and demand for new leases has continued to rise. Clearly, as Mark Twain is often misquoted as saying, "the reports of my (retail's) death are greatly exaggerated." We remain confident in Scentre's ability to maintain and maybe even increase its annual dividend back to around $0.11 per share with the shape of its operations and holdings.

Despite the design and other work that Scentre does, we believe the company is best valued using NTA per share as a yardstick. Currently, Scentre is trading at a discount of 21% with an indicative, annual dividend of 6.7%. There is a risk, though, that further lockdowns could hinder the retail recovery and we believe this would drag down the entire industry.

Overall, we believe Scentre currently offers investors the opportunity to own some valuable, financially sound retail real estate at a steep discount. And you should consider the 6.7% indicative dividend as well. We do not believe the market is going to become bullish on this sector anytime soon, so share price recovery may take a while. But for patient investors, it's four stars from us.

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### Share price chart

*Source: Tradingview*

### COVID demand helps, but pressures remain

TPG Telecom is a full-service telecom company and the second-largest player in Australia's fixed-line broadband market. Its 3G, 4G and now 5G cellular networks offer services like video calling, texting and data through a range of prepaid and post-paid mobile plans. TPG caters to consumer and corporate customers, although most of its revenue comes from the consumer side of the business. The company plays second fiddle to industry giant Telstra and while being second in any space is still good, lately TPG's financial performance has been out of tune.

With so much weight on the consumer business, you'd think the prevalence of people working and playing at home during the pandemic would've provided a big lift to TPG's results. Consumer sales more than doubled in FY20, but a decline in the corporate business and weak operating margins weighed on profits. Overall sales were up 24% to $4.35bn, but down 6% compared to the 2019 pro forma. Service revenue was up 45%, but with retail locations closed for much of the year, handset revenue fell 21%.

The story was the same in the EBITDA department where reported EBITDA was up 18% to $1.39bn, but 10% below the 2019 pro forma numbers. The pro forma EBITDA shortfall was due to a decline in mobile subscribers, a lower average revenue per user (ARPU) and margin erosion from the NBN business. Both

prepaid and post-paid mobile subscribers fell in FY20 as consumers jumped ship to other promotions or simply eliminated the expense in the pandemic economy.

So, while there was some benefit, even abnormal COVID-19 demand couldn't overcome the pre-existing issue of shrinking subscribers and profitability. TPG already faces an uphill battle as a consumer-centric business. Consumer margins are lower because of intense competition and the country's transition to the national broadband network (NBN). In FY20, TPG suffered a loss of approximately $60m due to the migration from DSL to NBN service.

### Vodafone synergy targets tamed

The acquisition of Vodafone was touted as a means to improve TPG's wireless communication capabilities, particularly in 5G, which Vodafone launched early last year. Yet TPG inherited a business that, prior to its 5G launch, was dealing with customer losses of its own amid heightened competition in the mobile networking market. Therefore, it is hard to imagine that the combination of two companies facing similar challenges will magically turn into a strong entity. That said, it's too soon to give up on TPG given its scale and competitive positioning in Australia's telecom market. With the rollout of its 5G offering in progress and the company on pace to cover 85% of the country's population by the end of CY21, we still see a major growth opportunity.

It is still early in the marriage, but TPG has much to prove to convince investors that it can achieve its target of $125m to $150m of cost synergies by FY23. This is expected to be derived from cost-cutting and cross-selling, but the pandemic has brought its own version of cost challenges and limited sales opportunities that could continue to push out the timetable. Moreover, these targets are a far cry from the Independent Expert's initial estimate of $200m in annual synergies by FY23.

Another area of concern is the recent wave of departures at the company. On 25 March 2021, billionaire founder David Teoh resigned as Chairman of the Board citing a desire to "pursue other interests". So too did director, and David's son, Shane Teoh who was convicted of assaulting an Uber driver in September 2019. The timing of the exits was unusual considering the recently completed merger. Although it could relate more so to the reputational damage from Shane's Uber incident, it also makes you wonder if the media-shy David Teoh saw more integration challenges than prospects ahead. On the same day, Antony Moffatt resigned from the Company Secretary role, a post he just took over on 17 August 2020 when the previous Secretary resigned. A board and executive team that appears to be in a state of flux is never a comforting thing for investors and could be an overhang on the stock, especially if more changes occur.

### Valuation is reasonable

Although COVID-19 pressures have lessened, TPG and its new Vodafone business are still facing competitive threats as telecom challengers big and small clamour to get in front of prospective customers in the post-pandemic economy. We think the competitive landscape will limit TPG's pricing power and suppress its already low EBITDA margin.

TPG's valuation is more tempting than it was in August 2020, but has the makings of a value trap. The EV/EBITDA based on the consensus forecast for FY21, which ends in December, is 9x. For FY22, the first full year after the merger, it's 8.3x, but when you consider that EBITDA is expected to grow only 7.8% that year, we don't see much to get excited about.

So, the low share price may appear tempting, but TPG is trading where it is for good reason. We believe the company has a difficult road ahead gaining market share and will likely be a 'show-me' story for some time. We see a low likelihood of management executing its strategy and think growth will be more of the 2G variety. It's two stars from us.

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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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