STOCKS DOWN UNDER

28 JUNE 2021

ASX Top 200 Stocks Down Under

I refuse to join any club that would have me as a member.

- Groucho Marx (1890 - 1977), American comedian

ASX

EXCHANGE CENTRE

WESTPAC BANKING CORPORATION

Not yet bankable

MAGELLAN GLOBAL FUND

Blue Chip stocks at a discount

LATITUDE GROUP

No latitude to give

WESTPAC BANKING CORPORATION

Not yet bankable

Stocks Down Under rating: ★★★

ASX: WBC
Market cap: A$ 95BN
Dividend yield: 3.4% (100% Franked)
52-week range: A$16 / A$27.12
Share price: A$ 25.89

Westpac Banking Corporation, headquartered in Sydney, is one of the four pillars of Australian banking. This bank has had its fair share of scandals, which we covered the last time we wrote about WBC on 25 May 2020. We had hoped all the skeletons were out of the closet, but it seems that is not yet the case. Unfortunately, when we look at the value and risk of continued regulatory trouble, as investors this is not a company we would bank on.

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MAGELLAN GLOBAL FUND

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Stocks Down Under rating: ★★★★

ASX: MGF
Market cap: A$ 3BN
52-week range: A$1.56 / A$2.04
Share price: A$ 1.80

This is the first time we've written about the Magellan Global Fund, a closed-end investment fund managed by Sydney-based Magellan Asset Management. It is a by-product of the group's recent move to amalgamate some of its listed and unlisted funds as separate entities. The flagship Global Fund made its ASX debut on 30 November 2020 and after a strong start is trading below its initial offering price and NAV due to near term underperformance. Given the long-term track record of the fund's fearless leader, Hamish Douglass, we think the dip is transitory and a good opportunity to gain broad equity exposure on sale.

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Stocks Down Under rating: ★★

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Market cap: A$ 2BN
52-week range: A$2.25 / A$2.99
Share price: A$ 2.26

Headquartered in Docklands, Victoria, the Latitude Group offers clients general lending options. As one of the ASX's newer listings (22 April 2021), initial shareholders have been rewarded with a sharp, continual fall in the stock since its first trading day. Overall, this is not really all that surprising as the company booked a loss for FY20 after declining year-over-year during FY19 as well. To put it plainly, as the company received no capital from the IPO, this was a liquidity event for its legacy shareholders and we don't see a lot of value in the current climate.

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Share price chart

Source: Tradingview

What makes up Westpac?

Before we dive into the current issues surrounding Westpac, we need to answer one vital question: what exactly is Westpac? The Westpac Banking Corporation was established in 1817 as the Bank of New South Wales, granting it the claim to the title of Australia's first and oldest bank. Back then, the company's first employee was Joseph Hyde Potts who received a payment in the form of a weekly ration and 25 pounds a year. Following its acquisition of the Commercial Bank of Australia in October 1982, Westpac adopted the name we are all familiar with today.

Fast forward to today and Westpac continues to be a major player in both Australian and New Zealand banking and finance. Making up the giant that is Westpac are its five major divisions: consumer, business, institutional, New Zealand and specialist businesses. In total, these divisions generated a net profit of $3.4bn in 1HY21 (financial year ends 30 September). The largest contributor to this result by far was the consumer division, generating cash earnings of $1.6bn and core earnings of $2.2bn during 1HY21. Compared to 1HY20, these results were mostly flat with the largest change being an increase in the Net Interest Margin (NIM) of 6bps year-over-year to 2.39%. However, it is important to note that the NIM declined sequentially compared to 2HY20 (2.41%).

The business division on the other hand, saw a strong recovery as COVID-19 continued to dissipate from the equation in Australia generating $920m in cash earnings and $1.2bn in core earnings during 1HY21. NIM improved 12bps compared to 1HY20 and 24bps when compared to 2HY20, resulting in a NIM of 3.17% for the period. Additionally, total customers increased 4.1% year-over-year to nearly 1.1m. All-in-all, it seems the business division has seen significant improvements during 1HY21 and we expect this trend to continue during 2HY21 and into FY22.

Compared to the consumer and business divisions, the remaining three operations are as important, generating a total of $1bn in cash earnings and $1.5bn in core earnings overall during 1HY21, representing 29% and 30% of the total, respectively.

A new scandal

If you thought all of Westpac's skeletons were out of the closet and already dealt with by regulators, ASIC's 5 May 2021 announcement of legal action was a rude awakening. Making matters worse, the charge is far from small. ASIC is currently accusing Westpac of using insider information during a $12bn interest rate swap deal linked to the privatisation of New South Wales' electricity distribution network, Ausgrid, back in 2016. Even worse, it seems the Ausgrid insider trading scandal has some specific victims, specifically investors who bought into Ausgrid at the time, including AustralianSuper. Therefore, not only is Westpac open to regulatory punishment, but there is the strong possibility of a class action in the future.

We are not going to go into the specific details of the allegation, but what it shows is that investors still risk being punished for Westpac's historically poor and illegal conduct. Unless Westpac is trading at a significant discount to fair value, this risk places the stock on our "avoid" list until further notice.

Forecasted results do not impress

The market is not expecting impressive results from Westpac going forward. The most recent consensus estimates have revenue falling 1% to $20.9bn in FY22 and Earnings Per Share (EPS) remaining stable at $1.76 per share. From a valuation perspective, Westpac is certainly no bargain based on these projections, trading at a Price/Tangible Book Value of 1.6x and FY22 Price/Earnings ratio of 14.4x. When we factor in the dividend yield of 4.4%, we don't see any reason why Westpac would be a steal right now, especially considering the risk. It's certainly not a two-star stock, but at Stocks Down Under we think there are more attractive banks out there. So, this one is just three stars from us.

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The Douglass effect

The Magellan Global Fund is a portfolio of collective assets known as a closed class fund. Like other companies that debut on the ASX, it raised capital through an initial public offering (IPO) and became listed on the exchange. In contrast to the Magellan Global Fund Open Class (MGOC), which is also directly available from Magellan and whose shares trade near the prevailing net asset value (NAV), the closed fund is only available via the ASX and can trade at a discount or premium to NAV. Also, the closed class fund's targeted 4% per annum distribution (paid semi-annually) can be reinvested at a 7.5% discount to NAV.

Magellan Financial co-founder and CIO Hamish Douglass is the fund's lead investor which in itself is the main selling point to many investors. Aside from being a billionaire, Mr. Douglass is widely considered one of Australia's top fund managers based on his stellar track record of fund performance. Over the last 10 years, the Magellan Global Fund has returned 15.9% per annum on average (as at 31 March 2021) and outperformed its benchmark by roughly 3% per annum.

In broad terms, the Magellan Global Fund's objective is to achieve attractive risk-adjusted returns over the medium to long-term by deploying a rigorous investment research strategy. It aims to invest in a portfolio of

20 to 40 high quality companies although the current portfolio is rather concentrated at 23 names. In terms of investment style, Mr. Douglass along with co-manager Arvid Streimann, focuses on companies' fundamental value, but they aren't your typical value managers. Rather than limiting the fund to low price-to-earnings (P/E) or low price-to-book (P/B) stocks, they invest in companies with fairly high P/E ratios if their businesses are of high quality and look undervalued. That said, the fund is significantly weighted towards the technology related stocks with IT, Internet, e-Commerce and payment processing companies comprising nearly 50% of the fund.

Read the fine (fee-related) print

The fund's first interim report since trading on its own showed that net assets increased 40% to $15.6bn, which includes the much larger MGOC open-ended fund. The NAV attributable to the MGF units was $1.76 as at 31 December 2020 and has since climbed to $1.88 as at 28 April 2021, which we note is well above where the share is currently trading.

The actively managed Magellan Global Fund represents a unique way to invest in US shares in that it doesn't require buying individual companies or exchange traded funds (ETFs) that have no hope of outperforming their respective indices. That's because many of the positions are popular US companies. In fact, seven of the top 10 holdings are US-domiciled, i.e. Microsoft, Alphabet, Starbucks, Facebook, Visa, Netflix and Pepsico, although these are very much global companies. China's Tencent and Alibaba as well as Europe's Reckitt Benckiser round out the current top 10. Together, US and China-based companies make up 60% of the fund. It is also important to note that the fund is unhedged meaning investors are exposed to currency risk.

The MGF share has slumped in recent weeks largely because of some near-term underperformance that we think can be rectified. As at 31 March 2021, the Magellan Global Fund returned 4.5% over the past 12 months compared to 23.8% for the fund's benchmark, the MSCI World Net Total Return Index in AUD. This deeply negative alpha along with the fund's lofty 1.35% management fee and 10% performance fee have been tough to swallow for shareholders. As stated in the fine print of the fund's literature, even if the fund underperforms the MSCI benchmark, the 10% performance fee could still apply if the fund outpaces the yield of the 10-year Australian Government Bond. Ouch!

An expedition worth taking

Although ongoing underperformance could further dent the fund's more important, longer term return figures, we expect Mr. Douglass et al will soon right the ship through shrewd portfolio management moves and/or an uplift in the unperforming holdings. We note the 5% cash balance gives the fund a bit of wiggle room with further potential to raise cash.

We also find it comforting that Magellan Global Fund Directors have been active in purchasing shares. On 1 March 2021, seven buy orders were placed by Directors on top of what they were issued for their participation on the board. This shows they believe in the management team and long-term growth prospects of the fund.

So, while the near-term underperformance should be monitored, overall, we consider the Magellan Global Fund to be an attractive alternative to buying individual US and international shares or ETFs given its decorated history of delivering above benchmark returns over the long haul. With the newly listed shares now trading at a significant discount to NAV, this Magellan fund is well worth exploring. We give it four stars.

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Share price chart

Source: Tradingview

The Latitude Group first started trading on the market 22 April 2021, after offering shares at its IPO price of $2.60, raising $200m. However, unlike most IPOs, this was purely an opportunity for the existing shareholder, KVD Singapore, to offload a portion of its shares as 100% of the $200m raised will go to KVD. Latitude will receive no capital from this IPO. While KVD retained 67% of outstanding shares, we believe the fact that none of the capital raised went to the company is a red flag.

Declining operations grant no latitude

Latitude has not had a fun time over the last two years. According to the prospectus, the company's operations declined during 2019, followed by an across-the-board decline during 2020 as well. The only exception to this is the company's coverage ratio and cost of funding, but we will get back to that shortly.

Latitude operates through two main division across Australia and New Zealand: L-Pay and L-Money. Combined, these divisions offer customers a range of personal financing options. They generated a loss of $32.6m in 2020 on $1.1bn in interest income and $823m in total operating income.

L-Pay is the company's Buy Now Pay Later business, operating through five products allowing for a combination of either ten-week repayment plans or long-term plans with repayment periods of up to 60 months. L-Money, on the other hand, operates a credit card business (28o Global) and provides personal and motor vehicle loans.

Unsurprisingly, Australia offers the largest portion of Latitude's annual income. During 2020, interest income declined 14% to $815m. This division saw an expense ratio of 16.3% during 2020, a decline of 4.5%-points year-over-year.

The New Zealand division fared mostly the same as the Australian division, generating $202.7m in net interest income with an expense ratio of 16.8%. Compared to 2019, this implied a decline of 0.5% and 4.5%-points, respectively. However, we are concerned that 2021's New Zealand results will only be a slight improvement compared to 2020's, and still a decline compared to 2019.

A poor market environment

Like many companies, Latitude had a tough time due to COVID-19, but as we discussed, it would be a mistake to think that's where the company's problems stem from. Yes, the company has managed to lower its expenses considerably, but it has yet to exhibit the ability to return to loan volume growth in any meaningful way. So, it comes as no surprise that the current market estimate (off one analyst's estimates) places 2022's EPS growth as flat, remaining at 2021's estimated $0.23.

Management has not offered any numerical guidance, other than stating that 2021 will likely mirror 2HY20's results. Unfortunately, management does not go into detail as to what the results will be.

Therefore, we are left with a declining operating situation where the only real hope is that Latitude's expense ratio will decline in 2021, as it did in 2020. We believe there are better businesses out there. Two stars.

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.

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