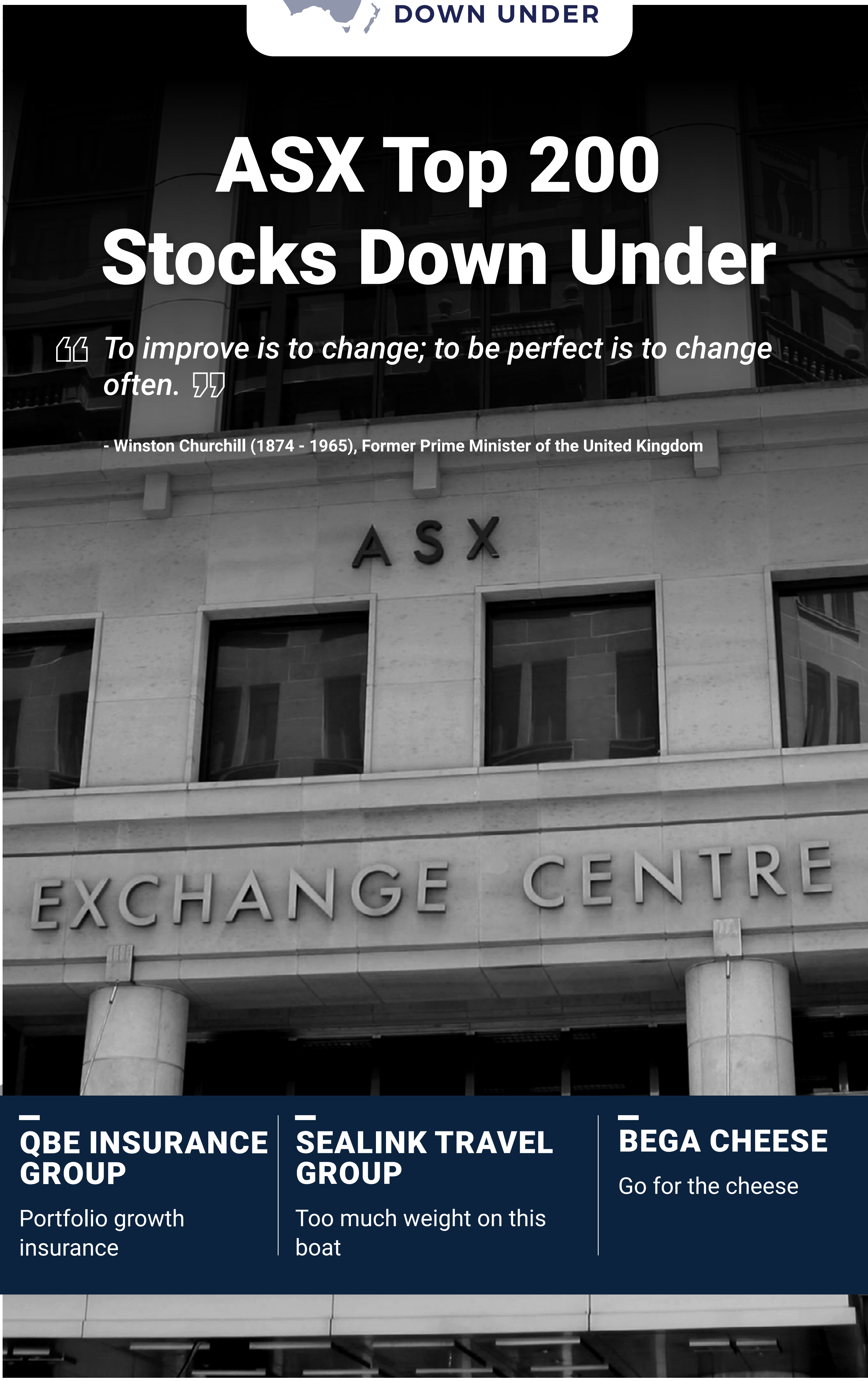
STOCKS DOWN UNDER

12 JULY 2021

ASX Top 200 Stocks Down Under

To improve is to change; to be perfect is to change often.

- Winston Churchill (1874 - 1965), Former Prime Minister of the United Kingdom



QBE INSURANCE GROUP

Portfolio growth insurance

SEALINK TRAVEL GROUP

Too much weight on this boat

BEGA CHEESE

Go for the cheese

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Stocks Down Under rating: ★★★★

ASX: QBE
Market cap: A$16BN
Dividend yield: 0.4% (10% Franked)

52-week range: A$7.88 / A$11.59
Share price: A$10.50

Insurance has gotten a bad wrap during COVID-19 as headlines have been plastered with reports of financial hardships in the insurance industry. However, there are always diamonds in the rough and we believe Sydney-based QBE Insurance Group is one the market has overlooked. While QBE had a large negative result in 2020, we believe there was some positive news too that has set up the company for a strong comeback in the next few years.

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ASX: SLK
Market cap: A$2BN
Dividend yield: 1.3% (100% Franked)

52-week range: A$3.98 / A$10.64
Share price: A$9.16

Headquartered in Adelaide, Sealink Travel Group is Australia's largest land and marine transport service provider, with international operations in London and Singapore. The company currently operates approximately 3,500 buses and 116 ferries, moving more than 206 million customers per year. Interestingly, the budget's notice that the country won't open up until at least mid-2022 has had no real impact on the share price. When we look at year-to-date results, the stock is up 35.4%. Unfortunately, we think this makes it somewhat overvalued.

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Headquartered in Bega, New South Wales, is a company named after its location: Bega Cheese. This massive Australian agricultural products conglomerate produces many of the quintessential classic Australian staples. The second half of 2HY21 has been rather brutal for shareholders, with the shares dropping 15.5% from the beginning of May. The market has been selling off rather strongly overall during this period, and we think Bega shares are finally becoming something to put on your plate.

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Share price chart

Source: Tradingview

What does QBE insure?

QBE is what is known as a general insurance and reinsurance company. Basically, this means the company provides standard insurance, like property and indemnity insurance etc. But the company also insures other insurance companies' claims. This practice, known as reinsurance, helps spread the risk on higher value policies around the financial system.

The company has ten different categories of insurance, spread across North America (USA mostly), Australia and other counties. The top three account for 56.6% of total gross written premiums by value. During 2020, QBE's gross written premiums totalled US$14.6bn, a 10% increase year-over-year. Commercial and domestic property insurance accounts for 30.4% of the total during 2020, representing an increase of 120bps. While this does make up a significant portion of all three geographical categories, most of this insurance category resides in Australia.

The second-largest insurance category is agriculture, a division that operates almost exclusively in the United States. According to the United States National Drought Mitigation Centre, run by the University of Nebraska-Lincoln, as of 20 May 2021, most of the United States' agricultural production capacity by geography is in

D3 (extreme) and D4 (exceptional) levels of drought. Making matters worse, most of the affected area faces a combination of long and short-term impacts, making water supply severely stressed with no end in sight. Since agriculture derives 14.1% (13.7% in 2019) of QBE's gross written premiums, we are concerned that the company is overexposed to this aspect of climate risk.

Motor and motor casualty insurance generated 12.1% of gross written premiums in 2020, with the largest exposure in Australia. According to Budget Direct's annual report, Australia is the third-largest country in the world by deaths per 100,000 people from annual road fatalities. Unfortunately, the Australian roads have not been getting safer. Looking at New South Wales specifically, during 2020, 10,029 serious injuries were recorded, compared to 11,221 during 2019 and 11,350 during 2018. While this seems to be an improvement, if we look a little further back, to 2010 (8,993), the number of serious injuries increased every year with the exception of 2015 and the last three years. However, we believe that 2020's improvement had more to do with lockdowns and limited traffic than anything else.

FY20, the year of loss

Like most, if not all, insurance companies, 2020 was a year of massive write-offs and losses. This is old news and well-priced into the stock at this point. However, we believe 2020 wasn't all bad for QBE.

QBE's gross written premiums increased across the board, with the international division experiencing the largest growth at 12.6%, bringing the total to US$5.9bn for the year. The North American and Australian divisions saw premium growth of 9.5% and 4.1%, respectively. Combine this with the average premium retention rate increasing from 78% during 2019 to 82% in 2020, and we find solid portfolio growth for such a challenging year.

The second aspect we want to highlight is the company's net earned premium. While the North American division underperformed mainly due to a terrible year for crops, net earned premiums grew 10.9% for the international division and 1.6% in Australia. Overall, this resulted in the total net earned premium, including COVID-19's impact, to increase 0.8% year-over-year. Unfortunately, we expect the crop issue to continue in North America. However, QBE has been increasing premiums accordingly, with the average renewal premium rate jumping from 6.3% in 2019 to 9.8% in 2020. Crop insurance is a must-have for farmers, now more than ever. Therefore, we don't believe QBE is at risk of pricing itself out of the market, despite its 10.2% average renewal rate hike in North America. However, crop insurance will likely remain a trouble spot for QBE over the next few years.

A diamond in the rough

QBE is currently trading far below what we would consider fair value, especially once we factor in its historical dividend yield. We strongly believe that 2020 was an abnormal year and the current market consensus seems to agree. The market is currently forecasting an EBITDA growth of nearly 35% for FY22 and 17.5% for FY23's, bringing EBITDA back up to $2.8bn in 2023. These consensus estimates result in EV/EBITDA ratios of 8.2x and 6.9x for FY22 and FY23 respectively.

We also believe it is highly likely that dividend repayments will resume during 1HY22 at the latest. Assuming a minimum payment of half of 2019's dividend payout of $0.52 per share, this implies an indicative dividend yield of at least 2.4%.

Looking at QBE as a whole, we certainly see some underlying risks to its largest insurance categories. However, the company is well capitalised so we don't believe investors are exposing themselves to any serious level of default risk. The market hates insurance right now, but we believe that will change as improving results start to come in. We believe QBE is one of those boats likely to benefit from the rising tide, so it's four stars.

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Share price chart

Source: Tradingview

Reopening was the play

If you look back to the beginning of the COVID-19 market crash, Sealink has been one of the top performers in the ASX Top 200. Since 1 April 2020, the stock has maintained a mostly upward trajectory, rising a total of 204% as of Friday's close. What's so unusual about this stock's price rise is that, prior to the post-crash period, Sealink's stock price had only barely touched above $5 a share. Meanwhile, after the crash, the stock had already broken $5 a share by the end of August 2020 and it has been an a very steep upward trajectory ever since.

The reasoning for this is rather simple, in hindsight that is. While not on the list of obvious reopening plays, Sealink is a clear beneficiary of COVID-19 lockdowns ending and people moving out and about. But why is the stock is currently valued at almost twice it's pre-COVID level, with tourism unlikely to return until mid-2022?

Directors booking some major profits

We want to answer one major question right now. No, Sealink is not heavily overvalued. Over the last year, the company has shot up in price for mostly fundamental reasons, namely the surprisingly successful integration of the Transit System Group acquisition during FY20. Despite the challenges of COVID-19, management somehow combined these two large companies seamlessly, causing EBITDA to increase by 49.6% year-over-year to $71.7m and revenue by 157.2% to $646.5m with only 5.5 months of contribution from the newly acquired company. If the acquisition had been completed on 30 June 2019 instead of 16 January 2020, revenue would have skyrocketed by 335.2% while EBITDA would have risen 128.6% in FY20. To drive the point home even further, 1HY21 EBITDA increased 319.7% to $96.2m, keeping in mind that 1HY20 does not include the contribution from the acquisition.

However, a few directors had shares locked up for a period of time in voluntary escrow due to this acquisition, and as soon as they were released, these directors took a rather considerable amount of profits. As announced on 11 May 2021, four directors sold slightly over 6.2m shares at $9.80 for a total of $61m. When we compare this to those directors' new total holdings of Sealink, this represented an average sell down across the four of 18.1% of their total shares, a considerable number. While we can't say we blame them after such an incredible run-up in the share price, this is still a good sign of just how strong the recent rally has been.

Unfortunately, there might be more selling on the horizon. Another block of shares currently in voluntary escrow is slated to be released on 15 January 2022, which may very well come to the market soon after.

Not all clear just yet

We believe there are two main risks in Sealink's future. The first is the lack of workers returning to offices across Australia. According to the Property Council of Australia, as of 30 March 2021, the office occupancy rate is still far from its pre-COVID-19 average of approximately 90%. The council's media release on 30 March 2021 found Melbourne's CDB occupancy rate at 35%, Sydney's at 50%, Brisbane's at 63%, Canberra's at 65% and Perth's at 71%. Even though things are improving, we are concerned that the recovery may prove to be fragile and that a new outbreak could cause these numbers to drop rather quickly. If this happens, the number of commuters will drop, and since the Australian bus division generated 60% of total revenue during 1HY21 (total revenue $571m), this division's future growth could be at risk in the short term.

Our second concern is its international bus division, specifically the UK operations. This division is responsible for public bus transport in London and Singapore under contract with the government, generating $130.3m in revenue during 1HY21. With the increasing number of COVID-19 strains attacking Europe at the moment, we are concerned that there is a risk of additional lockdowns and continued increased operating expense due to safety and sanitation precautions. Overall, we are not that bullish on Europe at the moment.

Stretching too far

Sealinks has had an impressive run recently, but unfortunately, we think it has run too far for now. The market is currently expecting EBITDA to grow 17% during FY22 and 8.4% during FY23. Using these market forecasts, the company is valued at FY22 and FY23 EV/EBITDA ratios of 11.5x and 10.6x, respectively.

Sealinks is still in acquisition mode, having just announced a new acquisition on 5 May 2021 for $84.7m, so we must assume that the market forecasts will be going up. However, even after granting future growth a little wiggle room, once we factor in the risks we mentioned above, the price just seems too high at this moment. Additionally, the number of shares those four directors offloaded and the potential for more to be offloaded in approximately six months concerns us. Overall, fantastic story, great company, but the valuation is just too high, so two stars for now.

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Share price chart

Source: Tradingview

Australian staples

Bega Cheese is a massive brand that is part of Australian culture. Bega's most 'Australian' product is Vegemite, the spread foreigners hate and Australian's love. The company also produces peanut butter and different types of cheese as well as spreads, dips, sauces and lactoferrin supplements. These products are combined into cheese, dairy, spreads, grocery, bionutrients and contract manufacturing categories.

Bega is in an unusual situation when it comes to analysing its recent results. Due to the pandemic, Bega Cheese was a beneficiary of the panic buying that engulfed most of the country during the initial stages of COVID-19's lockdown, making 1HY21's results far from normal. Therefore, when discussing how the business is broken down, we will be using FY20's results. During FY20, Bega generated $1.5bn in revenue and $87.8m in EBITDA.

The branded division generated slightly under 50% of Bega's total revenue in FY20 ($878.6m) and it produces all non-dairy products under the Bega brand name, other brands internally controlled by the company and contract manufacturing. Some examples of internally controlled brands are ZoOSh (dips, mayonnaise and dressings) and B honey. In the manufacturing and retail industry, the most profitable product lines usually involve exclusive and branded products, and we believe this likely holds true for Bega as well. However, since management has decided not to separate out its contract manufacturing, it is unclear what portion of this division's revenue is generated from this source. Due to management making the decision to shift away from contract manufacturing over the last few years, we can infer that it is not a large portion anymore. Overall, the branded division generated $76.1m in EBITDA, or 64% of operating EBITDA ($118.4m) in FY20.

Milking the milk offerings

The bulk division produces Bega's dairy-based brands and dairy-based contract manufacturing. A few examples include HAPPi (lactoferrin supplement), Bega Cheese, and Lion Diary (milk and other milk-based products). Historically, this division has generated the majority of revenue, but not EBITDA. During FY20, the bulk division generated $977.4m in revenue and only $42.3m in EBITDA. This is far from surprising, as, over the last few years, the dairy business has been hit hard by margin squeezes as prices have been slashed and demand has softened. However, Bega is a major brand and we remain confident that the company will be more than able to weather the dairy storm.

The 25 January 2021 acquisition of Lion Diary was a major one for Bega, costing $534m. This was a large, further step into the dairy business for Bega, specifically because it's the hard-hit liquid dairy market. We believe this acquisition will likely prove to be a wise move by Bega in the long run, though. However, in the short term, we believe the Australian dairy industry is in for additional pain as COVID-19 supply issues and Chinese political drama are expected to continue for the foreseeable future. By purchasing Lion now, Bega is able to gain a solid asset at a depressed price, but it's a long-term play with limited short-term upside, in our view.

Margin expansion and panic buying hangover

During 1HY21, revenue declined 4.5% year-over-year to $707.7m on the back of lower contract manufacturing volumes and a tough global dairy price market. However, the company's non-dairy brands saw considerable growth with spreads growing 9.4%, Bega Simply Nuts 100% and B honey 11.4%. However, due to a sharp decrease in cost of sales (7.8% year-over-year) as a result of lower dairy prices and lower marketing spend, Bega was able to expand its EBITDA by 68% to $65.8m during 1HY21.

The market is expecting this margin growth to continue during FY22 as milk prices continue to be depressed and demand likely improves. However, it is important to note that a major contract manufacturing contract of Bega's was cancelled on 21 April 2021. This will likely depress revenue growth slightly.

FY22 is expected to see EBITDA growth of 68%, but we believe between 8% and 15% is likely to be a more sustainable growth number going forward. FY23 is expected to generate 7.2% EBITDA growth with 16% projected for FY24.

Based on market consensus, Bega is currently valued at FY22, FY23 and FY24 EV/EBITDA ratios of 6.5x, 6x and 5.2x, respectively. While we are not optimistic about milk's short-term prospects, the current prices cannot last forever and we believe Bega is positioning itself well for when things turn around.

Additionally, the company has a diverse group of products outside of the dairy business that we believe will keep the company's earnings afloat in the meantime. Therefore, we believe the company's current valuation is far too low. Four stars from us.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

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