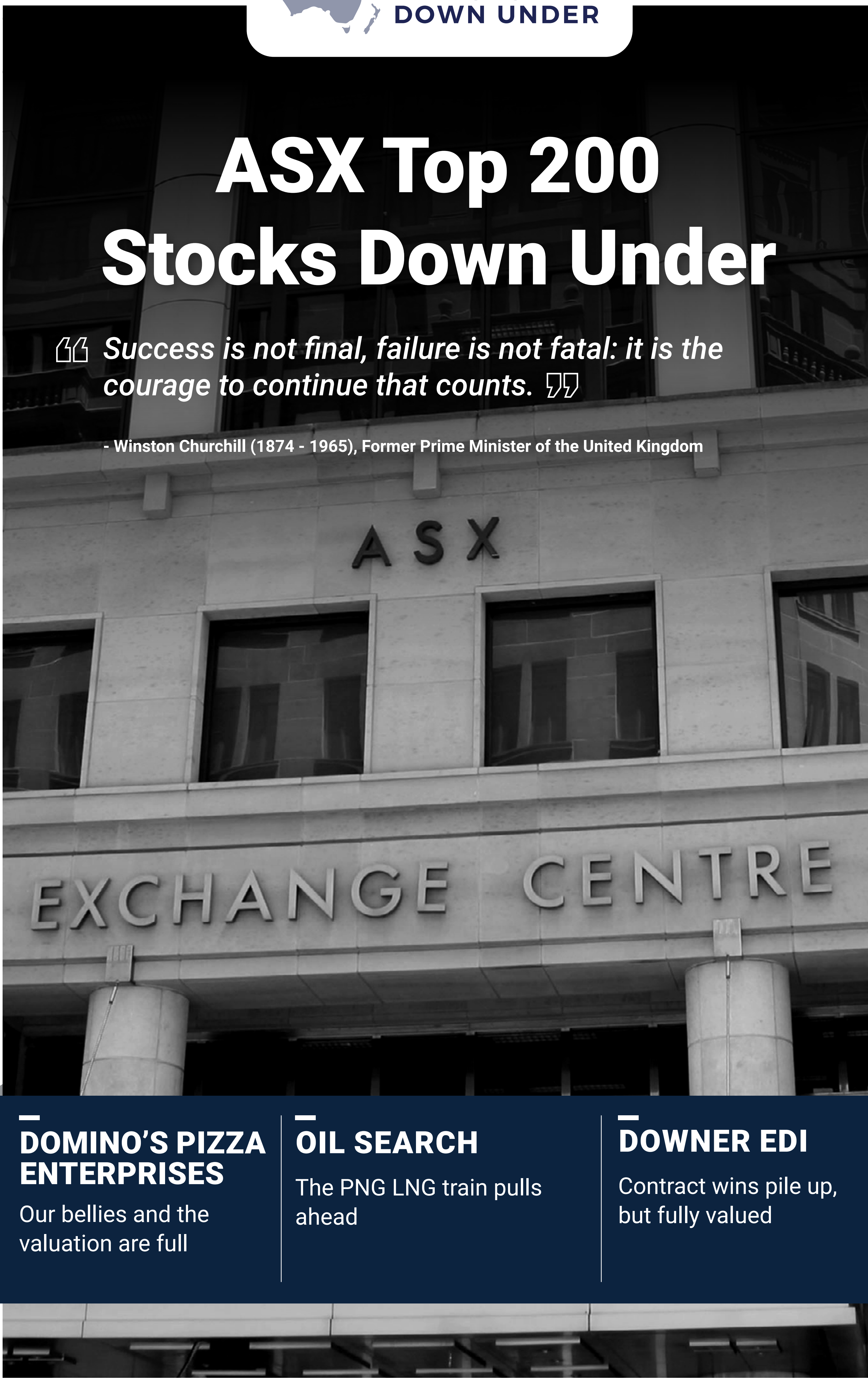
STOCKS DOWN UNDER

26 JULY 2021

ASX Top 200 Stocks Down Under

"Success is not final, failure is not fatal: it is the courage to continue that counts."

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



DOMINO'S PIZZA ENTERPRISES

Our bellies and the valuation are full

OIL SEARCH

The PNG LNG train pulls ahead

DOWNER EDI

Contract wins pile up, but fully valued

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Stocks Down Under rating: ★★

ASX: DMP
Market cap: A$10BN
Dividend yield: 1.2% (50% Franked)

52-week range: A$72.70 / A$122.65
Share price: A$119

The last time we wrote about Brisbane-based Domino's Pizza Enterprises on 3 February 2020, we were weary of the company's plan to take-up new franchises. As it turned out, it could've probably benefitted from having even more locations to meet the increased consumer appetite for take-out and delivery food during the pandemic. The stock has climbed to record high levels above $100 bringing along with it a much higher valuation. With growth expected to slow as people return to in-person dining, we believe investors are likely to reconsider Domino's bloated valuation and make share reservations elsewhere.

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ASX: OSH
Market cap: A$8BN
Dividend yield: 0.2% (0% Franked)

52-week range: A$2.50 / A$4.62
Share price: A$3.99

When we last checked in on Sydney-based Oil Search on 7 February 2020, we found a company in a depressed state. Oil prices were plunging amid the coronavirus outbreak and the expansion of the Papua New Guinea (PNG) LNG co-venture had just hit a brick wall. While oil has bounced back sharply, Oil Search shares have lagged. Over the last 12 months, Brent crude has doubled and Oil Search is up 10%. There have, however, been some positive developments in PNG and Alaska that have put the company in a more favourable light.

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ASX: DOW
Market cap: A$4BN
Dividend yield: 1.7% (0% Franked)

52-week range: A$4.01 / A$5.99
Share price: A$5.38

The last time we wrote about Sydney-based Downer EDI on 4 February 2020, the company started a plunge that stemmed from an atypical profit warning, which accelerated by the onset of COVID-19. It mercifully ended around $2.72 in late March 2020. Shares of the engineering company have since doubled but remain well off their pre-pandemic peak. We think the rally will continue as Downer benefits from a renewed focus on its core business surge in infrastructure activity across Australia and New Zealand.

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Share price chart

Source: Tradingview

Carry-out carries the load

Domino's Pizza Enterprises (DPE) operates Australia's largest pizza chain both in terms of locations and sales. It has dished out pizza, bread, chicken wings, desserts and Pepsi products since 1983. It holds the master franchise rights to the brand through an agreement with US-listed Domino's Pizza, America's largest pizza chain. As the world's largest Domino's franchisee, the rights allow DPE to operate locations in Australia/New Zealand, Japan and six European countries (Belgium, Denmark, France, Germany Luxembourg and the Netherlands). There are now more than 2,800 restaurants in the network and revenues are roughly balanced between the three regions.

COVID-19 has had an unusual impact on the global restaurant industry. Closures and restrictions on dining room capacity hurt businesses large and small, forcing many to pivot to take-out and delivery-only models. Restaurants that already depended on these services, like Domino's, flourished in an environment where safety, convenience and a good bargain mattered most. For a while, carry-out and delivery were the only games in town, which meant people turned to Domino's digital platforms like never before to satisfy their cravings.

Like other restaurant chains, Domino's had to spend on higher wages to adhere to COVID-safe protocols and have a workforce that could keep up with demand. Yet, the steady flow of orders more than offset these costs. The company was also fortunate that none of its franchisees exited the business due to the pandemic.

After record profit delivery, more pizza coming

In FY20, network sales were up 13% to $3.27bn. Online sales increased 21% and accounted for more than 70% of sales. Pizza ordering was particularly rampant in Japan where EBITDA grew 44%. It was a different story for the ANZ region where additional store support and temporary closures led to a 6% EBITDA decline. Overall EBITDA was up 7.3% to $303m. COVID-19 was estimated to reduce FY20 EBITDA by $8.2m, which wasn't too bad all things considered.

The 1HY21 result reflected a full six months of COVID-driven ordering patterns. Network sales climbed 16.5% to $1.84bn led by 25% online sales growth. EBITDA was up 24% to $218.7m. Including same store sales growth of 8.5%, the interim period was undeniably strong, but not sustainable. This is a business that under normal trading conditions delivers low to mid-single digit sales growth. Eventually we believe Domino's will face some tough year-over-year comparisons that the market could find unappetising.

Domino's five-year plan is targeting same store sales growth of 3% to 6%. It is also aiming to increase its store count by 7% to 9% per annum, which we see as an overly ambitious goal. Adding 200+ locations annually over the next five years would bring its pizza empire close to 4,000 stores. Looking out over the next 10 years, the group sees the store count rising to 5,550 including 1,200 stores in ANZ.

How much pizza do we really need? As the classic economics "law of diminishing returns" goes, at a certain point, our stomachs will be bloated and Domino's market presence saturated. We question the strategy of growing store count at a faster pace than sales especially in the ultra-competitive, low margin fast food industry.

Unappetising valuation

While the growth in sales, profits and store count is a good thing, it means even more franchisees, employees and customers to keep happy. This is no small order. Domino's has faced lawsuits in recent years stemming from anything from franchisee costs to pricing controls to worker wages. These matters have largely quieted down, but are nevertheless a constant overhang in the industry. They involve not only hefty legal expenses, but run the risk of reputational damage. No single competitor faces this challenge to the magnitude that Domino's does. Bigger isn't always better.

Unlike some of those supreme pizzas and desserts, the balance sheet is healthy. In 1HY21 debt was lowered by $70.6m and there was $407.2 in net assets on the books. The leverage ratio of 1.1x also goes in the plus column.

But after the stock's big pandemic rally, the valuation is a big minus. Domino's is trading at EV/EBITDA multiples of 23.5x for FY22 and 20.6x for FY23. That's a lot of dough for a company entering a slower growth phase, i.e. consensus estimates put FY22 and FY23 EBITDA growth between 12% and 14%.

We think consumers will start to lose their taste for pizza as other venues open and travel restrictions are lifted. At this point, we believe it's too late to grab a slice of the action. Two stars from us.

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Share price chart

Source: Tradingview

Next stop: FEED

Oil Search is an oil and gas explorer and producer that has had its share of ups and downs. The soon to be 100-year-old company got off to a slow start making only a handful of gas discoveries in the first half of its existence. Advancements in transport and infrastructure eventually led to more oil discovery opportunities in the remote areas of PNG. Now the sole operator of the country's oil fields (and the largest overall company in PNG), Oil Search is starting to remind us that its better late than never.

Its most significant opportunity is the PNG LNG Project, a liquid natural gas venture that is now run by French oil and gas supermajor Total. In conjunction with United States energy giant Exxon Mobil, the PNG venture is an estimated 6.9m tonnes per annum integrated LNG project. After Prime Minister James Marape opposed the expansion of the project to three trains (i.e. processing units), we felt an agreement could eventually be reached with the government. Indeed, progress has been made on this front.

In February 2021, the co-venturers signed a Fiscal Stability Agreement (FSA) with PNG, which provides reassurance as to government backing. This came a few months after the PNG Parliament passed legislation that allowed the venture to move forward as a two-train project independent of the P'nyang Project. With the PNG Government now showing more support, the project is derisking—and the production train is heading in the right direction. Total is now aiming to enter the FEED (Front End Engineering & Development) phase of the project in 2022.

Eskimos, salmon, and oil

Oil Search also owns a portfolio of oil leases in the cold weather US state of Alaska, where its Nanushuk play is the key asset in the portfolio. In March 2020, it completed well testing of the Nanushuk reservoirs that showed good flow rates. However, the coronavirus outbreak followed by the rough winter season caused the drilling program to be put on the back burner.

The Alaskan exploration program came back to life later in the year. In November 2020, Oil Search announced a 33% increase in oil resources to 968mmbbl. This was almost twice the original resource estimate and marked a positive development for the Alaskan North Slope asset. With a projected breakeven cost of less than US$40 per barrel, we see good upside from phase one of the Pikka Project. The project is expected to produce up to 80k barrels of oil per day and should be ready for a final investment decision (FID) by the end of this year.

The 2020 result wasn't pretty as anticipated due to the collapse in demand, resulting in lower realised oil and gas prices. Revenue was down 32% to US$1.1bn and the company swung to a net loss of US$320.7m. On the bright side, core net profit after tax (NPAT), excluding impairment and non-recurring items was on the plus side at US$22m. Another positive was that the PNG LNG project had a record production of 8.8 MTPA (million tonnes per annum). It's hard to criticise Oil Search for the FY20 result given the trading conditions and steps it took to limit discretionary spending and reduce operating costs. Also, the $260m impairment charge accounted for much of the net loss related to the company's strategic review and portfolio streamlining towards low carbon initiatives. In the end, we believe these steps made it a leaner organisation better positioned to leverage the oil recovery and future low carbon opportunities.

In search of balance sheet strength

Oil Search turned to the equity markets at the start of COVID-19 to raise US$700m to strengthen the balance sheet and improve liquidity. This measure along with cost reductions, capex deferrals and debt maturity extensions helped Oil Search withstand the prolonged low-price environment. It took oil prices a full 12 months to return to pre-pandemic levels.

The balance sheet has since become even stronger. Net debt was down 20% in FY20. Management also entered oil price hedges to reduce the company's downside exposure to oil prices over the remainder of 2021. It locked in a floor price of US$55 covering 9m barrels of oil production. Although we don't see oil prices taking another dive, we like that this makes for a more resilient balance sheet.

Oil Search is going for roughly 8.7x EV/EBITDA for FY21 (which ends in December) and 6.8x FY22. We think this is a Goldilocks-type valuation—not too hot, not too cold. Although there has been some good momentum in the business and FY22 EBITDA is expected to grow by 28%, FY23 should already see the earnings momentum reverse if consensus estimates for that year are anything to go by. So, overall the risk-reward is balanced, in our view. When it comes to compelling energy plays, we'd keep Oil Search on the watch list while searching elsewhere. Three stars it is.

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Share price chart

Source: Tradingview

Chiselling down to the core

Downer EDI designs, builds and maintains a wide range of building and infrastructure assets. Its business is limited to Australia and New Zealand, but it serves a very diverse group of customers across the construction, engineering, mining, transport and utilities sectors. Downer's largest segment, Transport, which includes road, rail and other infrastructure services, accounted for almost one-third of FY20 revenue.

Most of Downer's work falls under its self-titled "Urban Services" category. This covers assets, facilities and road network management for the utilities sector. These services generate steady, long-term revenue for the company and are considered the backbone of the business. In contrast, project-based work in other areas tends to be less predictable.

Speaking of unpredictable, Downer's mining division has been all over the place. First, The Australian Financial Review speculated that Perth-based mining services company Perenti was interested in purchasing the business. Soon thereafter, Perenti stepped back from the table citing the uncertain market conditions. This coincided with Downer suspending its mining review for the same reason.

Then the mining business made a media comeback in late CY20. Rather than sell the mining business in its entirety, Downer had started to chip away at it by selling certain parts. On 15 December, it sold the Western

Australian open-cut mining business to mining group MACA Limited for $205m. A month later, it exited underground mining services at OZ Minerals' Carrapateena mine by transitioning the business to Byrnecut, Australia.

Six major awards in less than a year

The mining business selloffs are just one step in management's broader plan to exit non-core businesses and right-size the cost base. Another step took place on 18 November 2020, when Downer sold its Blasting Services business for $62m to Enaex S.A., a subsidiary of Chilean explosives producer Sigdo Koppers Group. The yard sale continued on 27 April 2021 when the company sold its Otraco tyre management business to Bridgestone for $79m.

Since economic activity has improved, Downer has been picking up some significant business wins. On 26 May 2020, it reached a new five-year, $450m deal with Perth-based iron ore producer Fortescue Metals Group to continue providing early mining and maintenance services at the Eliwana mine. Then on 7 July 2020, it was awarded road maintenance contracts worth $420m over a 13-year maximum period from the South Australian Government to maintain 8,500 km of roads. On 29 July 2020, the Asset Services business reeled in $324m in contract wins and extensions from the industrial, oil and gas, and power generation sectors.

The wins kept coming on 31 August 2020, when Downer was awarded a new network contract from NBN Co Limited, the publicly owned broadband network, valued at $320m over a maximum of eight years. On 20 October, Downer was awarded two new contracts worth NZ$825m for the City Rail Link through its affiliation with the Link Alliance, a consortium that includes five other companies working on Auckland's major rail project. Most recently, Telstra awarded Downer a $330m field services contract for various construction and facilities works to support its 5G mobile rollout.

Undervalued

Like many ASX-listed companies, Downer withdrew its guidance and deferred its dividend in the early days of COVID-19. Yet it had plenty of cash and bank covenant headroom to weather the storm. A new $500 million bank facility secured in April 2020 further strengthened its liquidity position. It was also fortunate that most of its work comes from government and critical infrastructure projects that have been strong sources of demand.

The balance sheet is strong, with a growing cash balance and a low 1.7x leverage ratio. A $400m equity raise not only funded the Spotless acquisition, but gave it more wiggle room to invest in its core business.

We think Downer is potentially an attractive play on the rebound in construction and engineering activity in Australia and New Zealand. It has a solid base of repeat customers and the flow of new contract wins has been impressive. However, the share is trading at 6.6x FY22 and 6.3x FY23 EV/EBITDA. Given zero expected EBITDA growth in FY22, based on consensus estimates, and just 4% EBITDA growth in FY23, we believe Downder EDI is fully valued right now. So, only three stars from us.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

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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