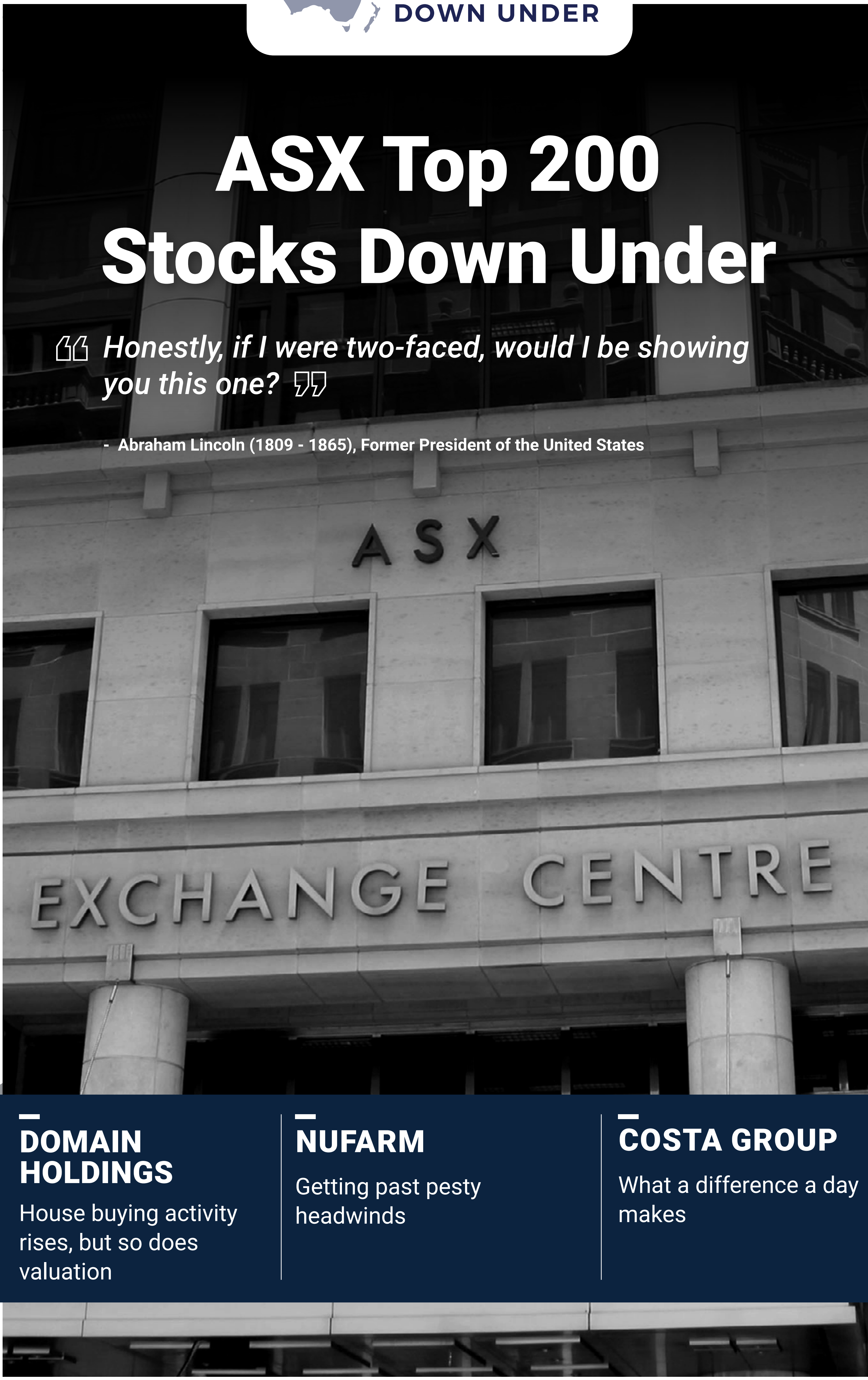
STOCKS DOWN UNDER

2 AUGUST 2021

ASX Top 200 Stocks Down Under

"Honestly, if I were two-faced, would I be showing you this one?"

- **Abraham Lincoln (1809 - 1865), Former President of the United States**



DOMAIN HOLDINGS

House buying activity rises, but so does valuation

NUFARM

Getting past pesty headwinds

COSTA GROUP

What a difference a day makes

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Stocks Down Under rating: ★★★

ASX: DHG
Market cap: A$3BN
Dividend yield: 0.4% (100% Franked)
52-week range: A$3.24 / A$5.61
Share price: A$4.86

When we last wrote about Sydney-based Domain Holdings on 11 February 2020, Australia's residential property market was healthy and the share was trading near a record high. Then COVID-19 hit and within weeks Domain was at an all-time low. The real estate technology and services company has since rallied above $5.00 for the first time. We expect home buying to stay strong as the economic recovery progresses, but Domain's valuation is now through the roof.

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52-week range: A$3.37 / A$5.60
Share price: A$4.31

The last time we wrote about Melbourne-based Nufarm (17 February 2020) it was facing pressures related to drought conditions, a profit warning and potential herbicide lawsuits. As if this wasn't enough, COVID-19 soon followed, presenting a new set of challenges to Australia's agriculture sector. Nufarm's business has recovered well over the past year and has opportunities to expand into new markets. Farmers are always looking for ways to improve crop yields especially when commodity prices are rising, so we see good growth potential ahead.

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Share price: A$3.20

When we last wrote about -based Costa Group on 7 February 2020, its share price was depressed due to the drought conditions in Australia. Then Mother Nature began cooperating and the horticulture specialist went on a nice run. Unfortunately, the rally came to a screeching halt on 27 May after the company's Annual General Meeting (AGM). We think the market overreacted in sending the stock to a 24% one-day decline. As the agriculture sector rebounds, we have seen steady improvements ahead in crop production and Costa's financials.

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Share price chart

Source: Tradingview

Its all about the digital

Domain Holdings operates Australia's second largest online property advertising business under the Domain, Allhomes and Commercial Real Estate brands. It provides residential and commercial property listings through its websites, mobile platform, social media and print magazines and newspapers. The company also offers the complimentary Domain Loan Finder for mortgages, Domain Insure for house insurance and Domain Connections for utility services. In recent years it has closed the gap with the market leader, Richmond-based REA Group, which owns the more popular realestate.com.au site.

Historically dominant in the premium end of the market, Domain is learning that you can teach an old dog new tricks. In addition to making inroads in other parts of the market, it has expanded its content and services offerings to attract website traffic and influential real estate agents. Going forward, a big part of the company's strategy will be to build its digital audience, an area where it lags REA Group. Having Sydney-based Nine Entertainment as its largest shareholder (and former parent company) should certainly help in this regard.

From open homes to sheltered homes

Just as things were looking up for the country's property market, COVID-19 turned things upside down. Needless to say, the number of real estate transactions collapsed during the early months of the pandemic. Domain nobly offered agents free refreshes of sales and rental listings and the ability to relist without charge. It also went to work on new digital features, like virtual tours that allowed business to proceed as normal as possible in a socially distanced world.

On the financial end of things, Domain had a healthy balance sheet going into the pandemic, giving it the flexibility to secure funding. In late April 2020 it took on an $80 million, 18-month debt facility to strengthen its liquidity position. It also adopted a series of cost-cutting initiatives. Since nearly half of the company's expenses go towards staffing, this was target number one. It offered employees reduced hours or a program whereby they could receive a portion of their salary in share rights. Most opted for the latter, which helped drive some significant cost reductions. Domain also halted print publications until demand improved.

The COVID-related disruptions clearly weighed on the FY20 result as revenue decreased 9% to $261.6m. The cost-cutting measures helped drive expenses lower by 5%, but EBITDA still fell 17% to $84.4m. In fairness, considering the market conditions, the result was respectable. There were also some silver linings, like a 23% year-over-year increase in audience traffic and a 24% reduction in marketing cost per lead.

An interest in PEXA

The half-year result reflected the ongoing impact of COVID-19, but things started to look a little better. On a like-for-like basis, the revenue decline was a more modest 5.5% to $137m and EBITDA increased 3.6% to $54.5m. Residential revenue growth was strong at 8.5%, but we found the digital revenue growth of 3.4% to be underwhelming. Growth in the core digital business will need to accelerate for Domain to gain market share—and justify its valuation.

Trading conditions have improved dramatically since the early days of COVID. In 2021, Australia's property market is healthy again thanks to low interest rates and high levels of demand. This is driving a strong rebound in residential listings, open home attendance, website search volumes and interest in Domain Home Loans. That said, revenue growth was only 2% in the March quarter. We would have hoped for better considering the easy comparison to the COVID-impacted March quarter of 2020. Still, the progress gave management the confidence to cancel the $80m debt facility on 9 March 2021 although it held onto the $225m it borrowed in November 2019.

With a stronger balance sheet, Domain will be better equipped to pursue growth developments in digital and explore potential acquisitions. It recently disclosed its participation in a consortium that is considering taking a 10% stake in Torrens Group Holdings. This is the company that owns online property exchange PEXA, which recently launched its $910m IPO, Australia's biggest yet in 2021. The IPO coincided with an offer from United States investment company KKR to buy PEXA for $3bn excluding cash, a bid that Domain is looking to join. We think gaining an interest in PEXA would be a nice addition to Domain's asset base, but the $3bn-plus valuation is a steep price to pay.

Domain is trading at an EV/EBITDA multiple of 24.4x for FY22, which we feel is justified given the expected 26% EBITDA growth rate this year. Its rival REA Group is trading at 32.4x EV/EBITDA for FY22. But consensus EBITDA growth estimates for REA only amount to 21%. So, REA is overvalued in our book.

We like the direction Domain is going and the valuation is fair, but with the current lockdowns in Sydney we believe there may be some near-term downside to the shares. So only three stars from us.

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Share price chart

Source: Tradingview

Growing by helping farmers grow

Nufarm is Australia's leading supplier of crop protection solutions and seeds, and is among the top 10 crop protection companies in the world. The company was founded in 1956 in Melbourne where it is still headquartered. Its founder Max Fremder sold herbicides to professional spray applicators across Victoria. Thirty years later Nufarm became a subsidiary of New Zealand's Fernz Corporation whose roots go back to 1916 when it was founded as The New Zealand Farmers' Fertilizer Co. In 2000, the group's incorporation was changed to Australia and was renamed Nufarm Limited.

The 1990's marked the beginning of a major overseas expansion period that stretched well into the beginning of the 21st century. Today Nufarm is still very much a global company with operations in Australia, New Zealand, Europe, Asia, Africa and the United States. Its core herbicide, insecticide and fungicide products account for roughly 80% of revenue. They are designed to improve farmers' output by protecting crops from diseases, pests and weeds. It also has a seeds business called Nuseed that sells canola, sorghum and sunflower seeds to customers in more than 30 countries. The United States is Nufarm's key market accounting for more than one-fourth of overall sales.

No joke, on 1 April 2020, Nufarm completed the sale of its crop protection and seed treatment businesses in Brazil, Argentina, Colombia and Chile to Japan's Sumitomo Chemical Company for $1.2bn in cash. Sumitomo is Nufarm's second largest shareholder with a 16% stake. We found this to be a good move because it eliminated an underperforming segment and allowed the company to pay down debt.

Nufarm certainly needed a stronger balance sheet to get through the COVID-19 challenges. Since agriculture was deemed an essential service, the global agriculture markets were little impacted by the pandemic. Likewise, Nufarm's manufacturing wasn't disrupted and, like everyone else, it sped up its digital marketing efforts. It did, however, face increased supply chain costs and foreign exchange losses as some currencies fell fast, an omnipresent risk of a global business. Still, the balance sheet and improved cash flow helped it drive a decent FY20 result. Revenue was up 7% to $2.8bn, underlying EBITDA was down 21% to $236m and NPAT swung to a -$81m.

Salmon swim upstream

On 30 June 2020, Nufarm took more steps towards improving its financial performance by closing its insecticides and fungicides manufacturing facilities at Raymond Road in Laverton, Australia. It also chose to curtail herbicide manufacturing in Linz, Austria. Once finalized, the two moves are expected to deliver a combined $15m EBITDA improvement per annum.

Just as FY20 closed, Nufarm took a different kind of step in expanding into Canada. It received regulatory approval for Nuseed omega-3 canola for use in aquafeed and livestock feed as well as human consumption. Omega-3 canola is a major growth opportunity for the company given its increasing use around the world. It wisely chose to start in Canada, the world's largest canola cultivation market and third largest farmed salmon producer.

Speaking of salmon, on the bearish side of things, the European business has been a drag on performance. Increased competition and higher manufacturing costs have weighed on earnings and caused the company to recognise a $215m impairment charge in FY20. Nufarm does, however, expect profitability to improve in FY21 as raw material cost pressures ease and weather conditions improve.

FY21 is indeed off to a solid start. The COVID-related headwinds of higher supply chain and logistics costs persisted in 1HY21, but these were offset by cutbacks in discretionary expenses, like travel and promotions. Meanwhile, improved global demand, especially in the key United States market helped drive better results. 1HY21 revenue increased 20% to $1.65bn, underlying EBITDA grew 118% to $234m and NPAT amounted to $58.9m. The European business is showing signs of a turnaround after underlying EBITDA increased 135% in 1HY21.

Insiders planting the seed

There has been some bullish on-market trading since late September 2020. This is when newly elected Chairman of the Board John Gilliam wasted no time in buying nearly $750k worth of Nufarm stock over a two-day period. More recently, Director Peter Margin made a purchase of almost $50k on 21 May 2021. A trading day later, Nufarm CEO Gregory Hunt executed his second buy order in eight months, the latest valued at approximately $97k. It is always encouraging to see management and board members showing faith in the company they know so well.

The stock is trading at an EV/EBITDA of 6.3x for FY22, which is in line with the consensus EBITDA growth forecasts of 7% for FY22. And looking out to FY23 with a valuation of 5.9x and projected EBITDA growth of 6% we consider Nufarm fairly valued at the moment.

However, we also think Nufarm could be an attractive takeover candidate given the potential to provide product and geographic diversification to a larger industry player. Simply put, the world's population is growing and people need to eat. That means the agriculture sector will be called upon to produce safe, quality crops in higher volume. And therein lies the need for Nufarm's herbicides and seeds. It's four stars from us.

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Share price chart

Source: Tradingview

Weather supports growth until…

Costa Group is Australia's leading fruit and vegetable producer. Here at home, it grows and packs berries, citrus fruits, tomatoes, avocados and other high-quality produce that is sold to a range of domestic supermarket chains and independent grocers as well as the Asian, European and North American export markets. Most of the produce is grown on traditional farmland, but Costa is also known for its glasshouse grown tomatoes and mushroom growing facilities.

The group also provides chilled logistics warehousing and related services within Australia, which accounted for 12.5% of revenue in FY20. In addition to its core Australian farms, Costa has berry farming operations in China and Morocco and earns royalty income from the licensing of blueberry varieties, such as the premium Arana blueberry in Australia, the Americas, China and Africa.

After years of drought and poor weather conditions, better growing conditions have led to better financial results. Revenues ended up 5.8% in 2019 and by the first quarter of 2020, crop pricing had improved significantly, especially in berries and mushrooms. Then COVID-19 hit and threw another curveball at the embattled company.

An essential part of the food supply chain, Costa Group had to plough ahead while adhering to extra hygiene and social distancing protocols. As you can imagine, this presented challenges to the farming process and created added costs and operational inefficiencies. Despite these challenges, we think the group did a fine job of maintaining crop yields and managing tough labour supply conditions. It did not claim any JobKeeper funds.

All things considered, the CY20 result was quite good and fuelled a recovery in the stock as we anticipated. Revenue was up 11.2% to $1.16bn and net profit after tax (NPAT) more than doubled to $59.4m. The resilient performance reflected a strong recovery from the drought and a solid contribution from the international side of the business. Demand and pricing improved as the year progressed especially in the berry, citrus and avocado categories, which sounds to us like the makings of a tasty salad.

AGM spoils the recovery

In last year's AGM, the highlight was the announcement of then CEO Harry Debney's retirement within the next nine months. This rattled the market a bit due to the leadership uncertainty and the stock went on a bit of a slide. In November 2020 we learned that Sean Hallahan would be the successor starting 31 March 2021, which sparked a bit of a relief rally. These market reactions were nothing like what we saw after the most recent AGM.

The 27 March AGM included a revised outlook for CY21 that left a sour taste in investors' mouths. It fell well short of the consensus expectation. It also implied that the 1HY21 result would only be slightly ahead of the prior-year period. Management cited weakness in the domestic operations and unfavourable foreign currency translation. The issues seem to be confined to mushrooms, citrus fruits and tomatoes as berries and avocado sales are doing well. Yours truly at Stocks Down Under will be requesting extra mushrooms and tomatoes in his salads.

By the end of the trading day, Costa shares were down 24%. We think some sort of correction was warranted. But peeling off a quarter of the company's market value for soft interim period guidance? Talk about not seeing the forest through the trees, or the farm from the blueberry bushes.

The mushroom issues relate to temporary labour constraints rather than demand so that's unlikely to mushroom into a bigger issue. Citrus is dealing with hail damage to the table grape crop and fruit fly restrictions in the South Australia Riverland, both temporary matters. It's unclear what's going on with the tomatoes, but we'd imagine improvements can be made and the strength of the international business can be leaned on. Moreover, it's a reminder of the importance of having a diversified fruit and vegetable portfolio. And some growth is better than no growth.

Easy pickings

We've always liked Costa's balance sheet and even with the pandemic challenges, it got stronger in 2020. Leverage is a low 0.99x and ahead of management's plan. The net debt position is a manageable $143.9m, which should continue to support the company's ability to pursue growth opportunities and new funding, and pay a fully franked dividend.

Based on the latest consensus estimates, Costa Group is trading at an EV/EBITDA multiple of 8.9x for FY21 (ending in December) and 7.3x for FY22. Given the expected EBITDA growth rates of 51% and 22% for these years, we believe Costa Group is dirt cheap.

Additionally, we like that underlying demand and pricing is healthy and we like the strategic direction of the group. It is investing in ways to improve yields, cut costs and address climate risks. It also recently announced a plan to expand its citrus footprint to at least 700 hectares in CY21 in anticipation of greater demand.

When life gives you lemons, you make lemonade. We think the recent selloff has created a ripe contrarian buy opportunity. Costa Group is low hanging fruit at these levels, so it's four stars from us.

Pitt Street Research Pty Ltd

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