STOCKS DOWN UNDER

6 AUGUST 2021

Small Cap Stocks Down Under

"The world is neither unipolar, multipolar, nor chaotic - it is all three at the same time."

- Joseph S. Nye Jr. (b. 1937), Former Dean of the Harvard's Kennedy School of Government

AUSTRALIAN UNITY OFFICE FUND

Suffering from poor timing

GENERATION DEVELOPMENT GROUP

The greatest generation

BEYOND INTERNATIONAL

Beyond expectations

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Stocks Down Under rating: ★★★

ASX: AOF
Market cap: A$393M
Dividend yield: 6.3% (0% Franked)

52-week range: A$1.99 / A$2.85
Share price: A$2.39

Headquartered in Melbourne, the Australian Unity Office Fund is an office REIT focused on the Central Business Districts (CBDs) of Australia's capital cities. Unfortunately, CBD office space has been the main exception to Australia's current post-COVID-19 property recovery and shareholders are still well below Unity's pre-Corona crash share price of $3 per share. However, with a 6% indicative annual dividend we think this REIT deserves a second look.

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GENERATION DEVELOPMENT GROUP

The greatest generation

Stocks Down Under rating: ★★★

ASX: GDG
Market cap: A$190M
Dividend yield: 1.9% (0% Franked)

52-week range: A$0.61 / A$1.10
Share price: A$1.08

Headquartered in Melbourne, the Generation Development Group is a truly diversified financial operation. The company has three main divisions providing exposure to fund administration services, investment bonds and minority holdings in two other Australian firms. Generation has succeeded in consistently attracting fund inflows, while limiting its fund outflows, no mean feat during COVID-19. Despite fund-inflows accelerating during the third quarter of FY21, we believe the market has already valued Generation Development fairly, in our view.

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Beyond expectations

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ASX: BYI
Market cap: A$43.5M

52-week range: A$0.50 / A$0.71
Share price: A$0.71

Entertainment, such as TV shows and movies, has been one of our few comforts during lockdown. While COVID-19 was certainly a boon for streamers, it posed a significant challenge for those tasked with the creation of content. Despite the challenges COVID-19 posed, Artarmon, New South Wales-based Beyond International rose to the challenge like the quintessential action hero and smashed its way to a highly respectable result. However, the stock has not yet returned to its December 2019 level, but we believe that is just a matter of time.

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Share price chart

Source: Tradingview

REIT my lips…bumpy ride ahead

Australia's property market is soaring and ASX-listed Real Estate Investment Trusts (REITs) have been providing investors strong returns over the last year. In fact, between 1 March 2020 and 31 March 2021, Vanguard's Property Securities Index ETF (ASX 300 A-REIT) saw its Net Asset Value grow 45.3% compared to Vanguard's Shares Index ETF's (ASX 300) 38.5%. Unfortunately, there has been one glaring exception to this rally, Australia's office properties.

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 found Melbourne's CDB occupancy rate at 35%, Sydney's at 50%, Brisbane's at 63%, Canberra's at 65%, Perth's at 71% and Adelaide's at a relatively strong 71%.

Despite Australia's overall success at stamping out COVID-19 cases outside of quarantine, approximately 70% of respondents to the Council's survey said they don't expect to see a material increase in the occupancy levels of their CBD office buildings for another three months or longer. Office property in Australia's major CBDs continue experience extremely slow recoveries on every metric and there's no light at the end of the tunnel yet. It's going to be a bumpy ride for the rest of 2021.

That’s no great white whale

As of 31 December 2020, Australian Unity Office Fund owned nine office buildings split between New South Wales (four), Queensland (two), South Australia (one), Victoria (one) and the Australian Capital Territory (one). Combined, these properties have an estimated market value of $681m, 100% of which is attributable to shareholders of Unity for a Net Tangible Asset (NTA) value per unit of $2.77. Unsurprisingly, Unity’s NTA as of 31 December 2020 represents a decline of 3% year-over-year, but an increase of 1.8% compared to 30 June 2020. And yet, when we compare this to the trust’s unit price performance, unit holders have suffered a 17.7% loss since 31 December 2019.

At first glance, this discrepancy between NTA and unit performance does not make a lot of sense. Despite owning office properties in Australia’s major cities, Unity managed to increase its occupancy rate to 95.3% on 31 December 2020, from 95.2% the year before. However, when we look closer, we can see that unit holders’ losses are due to two factors: a historical premium and dangerously short WALE (Weighted Average Lease Expiry). Looking at Unity’s historical unit price between 1 June 2016 and 31 December 2019, it quickly becomes apparent that the trust was trading at a premium to its NTA most of the time. The size of the premium fluctuated, but shares were trading at a 7.9% premium to NTA on 31 December 2019 and 5.3% right before the Corona Crash in March 2020.

The second issue is Unity’s dangerously short WALE. The trust’s WALE was 2.6 years as of 31 December 2020. To give you a better idea of the issue, when we combine FY21, FY22 and FY23, the percentage of net lettable area up for lease renewal is 61.3%. We are not really concerned that Unity’s tenants won’t renew their leases, but rather that they will be able to lock-in significantly reduced rental rates. Additionally, we also need to point out that there is risk of downsizing tenants. According to the Property Council of Australia’s March 2021 CBD survey, approximately 50% of respondents said “preferences for greater flexibility including working from home” was a main influencing factor for their level of occupancy, an increase of approximately 17-% points compared to February 2021.

Being early is the same as being wrong

There’s a common saying in finance, “being early is the same as being wrong.” Unfortunately, we are concerned that many of Unity’s upcoming lease negotiations will take place during a particularly soft and uncertain time for the office property market. Therefore, there is a risk that many of these new lease agreements will lock in unfavourable rental rates for at least a few years. Combine this with the much lower risk of some clients downsizing, and we find the trust’s 95.3% occupancy rate to be a rather irrelevant figure at the moment.

Yes, Unity is trading at a discount to NTA per unit of 13.7% while offering an indicative dividend of 6.3% annually (non-franked). However, we believe investors looking to take advantage of the discount office REITs are trading at would be better served finding one whose WALE is at least three years. Three stars.

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Share price chart

Source: Tradingview

What makes a generation?

The Generation Development Group is best known for its main product, i.e. investment bonds. For our readers outside of Australia, the term investment bond is likely to be confusing. The term is not referring to investment grade bonds, but rather a type of investment portfolio also known as an insurance bond. Basically, an insurance bond is a combination of an investment portfolio and a life insurance policy. The benefit of this structure in Australia is that this investment bond becomes what is known as a 'tax paid' investment. Basically, the portfolio is taxed at the company rate (currently 30%) for the first ten-years, assuming the funds are not removed. After ten-years, the portfolio does not require any additional tax to be paid on gains or removals. This type of investment is typically used as a means of transferring funds to a child or grandchild at a set future date, or as a way of paying future funeral costs. Generation is well regarded in the Australian investment bond market, because as of 25 February 2021, it was the only provider to hold Highly Recommended ratings with both Zenith and Lonsec. However, Lonsec is owned partially by Generation, so we think that rating might be a bit tainted.

Generation is currently working hard at producing another category of investment product, annuities. While

the company still has some way to go, in its third quarter FY21 results announcement on 13 April 2021, management stated it had entered into a "non-binding term sheet with one of the world's top five reinsurers." If finalised, this would serve as the basis for safeguarding Generation's annuities against longevity risk, thereby reducing the regulatory capital requirements to launch this product. While this is certainly an important milestone, the company still has a large number of regulatory and operational hoops to jump through before it can launch any kind of annuity product.

A one-way spigot

During the third quarter of FY21, fund inflows were not completely one-way. Funds under management (FUM) grew 40% to $1.6bn due to inflows of $104.9m and investment growth of $34.2m. Withdrawals and maturities saw an increase of 7% year-over-year, but remained extremely low when compared to the 52.2% growth of inflows. Unfortunately, management does not provide revenue and profit numbers on a quarterly basis. However, we do know that guidance has been posted with revenue expected to increase year-over-year during FY21, an obvious statement after the third quarter's FUM number.

Therefore, to get a sense of how the company is performing financially we are forced to resort to 1HY21's results. For this period, revenue increased 26% to $12.3m on the back of 15% increase in FUM year-over-year. Net Profit After Tax increased 52.6% to $2.2m, mostly due to a slight increase in margins as total expenses only increased 22.2%. Therefore, we believe it would be unreasonable to assume Net Profit After Tax will increase in such a disproportional way to revenue growth going forward. However, we do expect margins to continue to increase as FUM growth continued at such a rapid pace in Q3.

It's all about the annuities

Generation Development has certainly generated admirable results in the first 9 months of FY21, but from a valuation perspective we believe this company is right where it should be. During FY22, the market consensus has EPS rising from $0.01 to $0.02 per share, and $0.03 during FY23. Based on these projected growth rates, FY22 and FY23 Price/Earnings ratios are 47x and 31.3x, respectively.

While these valuations might seem on the high side, we believe the market is adjusting for the future contribution of the annuity division once it finally launches its new products. However, there is currently no expected date of launch and, therefore, we believe investors should hold off until the future of the annuity business becomes clearer.

Generation has done an excellent job in establishing itself as a force to be reckoned with in the Australian investment bond industry with a strong FUM growth trajectory. However, we believe the current valuation is on the high side, so three stars for now.

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Share price chart

Source: Tradingview

Do you mean space?

Beyond International is involved in the production and distribution of TV and film entertainment. The company is responsible for shows like My Lottery Dream Home on HGTV, Pooch Perfect USA and UK, How to Spot a Killer, among others. Through its four main divisions, TV Productions and copyright, Distribution TV, BHE, and BeyondD, the company generated $54.7m in revenue and $3.8m in EBITDA during 1HY21.

In order to gain a better understanding of what exactly Beyond does to generate its income, we are going to briefly go over its four main divisions. The largest division by revenue is TV production and copyright, generating $28.9m during 1HY21. Simply put, this division is responsible for the creation of both Beyond's intellectual property and the production of the actual shows. Despite the major challenges COVID-19 initially presented, Beyond managed to mostly overcome these challenges rather quickly.

Distribution TV was the second largest division as measured by revenue ($25.5m) during 1HY21. As the name suggests, this division is responsible for international distribution of the company's IP, created through TV Production and Copyright. While Beyond International has not yet released its FY21 results, we believe the 2HY21 acquisition of TCB Media Right, its main international competitor, will significantly drive results and

FY22 forecasts. We believe the acquisition will provide a strengthened international distribution pipeline over the next couple years, while reducing direct competition.

BHE, also known as the home entertainment division, is a small subsidiary for Beyond, only generating $256,000 in revenue during 1HY21. BeyondD is also small compared to the main two divisions, generating only $2.2m during the same period. It is important to note that Beyond wrote down this division's remaining goodwill to $0 in FY20 due to a softening market, despite the division continuing to operate.

A Borglund buying spree

Mikael Borglund is the CEO and Managing Director of Beyond International and has been on an on-market buying spree of Beyond International shares since 9 September 2020. Through a combination of direct and indirect portfolios, he has bought 84,127 shares at an average price of $0.57 per share in 11 different transactions. The latest transaction was on 7 June 2021, for 14,141 shares at an average price of $0.68 per share.

Non-Executive Chairman, Ian Ingram purchased 12,941 shares on 7 September 2020 at an average price of $0.55 per share. While he certainly has purchased less than CEO Borglund, with a current total of 19.5m shares compared to the CEO's 3.2m, he clearly has plenty of skin in the game.

Despite the share price rebounding well above the average cost of $0.56, we believe the CEO's continued on-market buying, even as the share price rose 36% from when he first started, substantiates our thesis that the market has priced in far too much COVID-19 damage for Beyond's shares.

Beyond market expectations

Beyond International is a standout in a sea of terrible troubles and production halts in the entertainment production industry. In a 1 July 2021 trading update, management stated it is expecting EBITDA to be between $5.8m and $6m, compared to $1.2m during FY20. Sure, things have not been smooth sailing for Beyond International, considering the company was forced to take advantage of Job Keeper and has suffered from production delays. Despite these troubles, however, FY21's results guidance is hardly surprising. We believe management has shown its incredible competence during this challenging period and there should be no doubt that this company knows its industry and has a solid IP portfolio that remains in demand.

Using the high end of FY21's profit guidance, FY21's EV/EBITDA ratio is only 5.5x. While the recent Delta strain is likely to add additional costs through production delays and safety protocols, we believe management's track record so far alleviates a portion of this risk. In our view, the largest risk for investors is Beyond International's lack of liquidity. Over the last three months, the company only averaged 490 shares traded daily. Investors would be wise to realise that this leads to significantly increased volatility and if things go wrong, it will likely be hard to get out of the stock. Still, for investors willing to take that risk, this is clearly a four-star stock.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

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