STOCKS DOWN UNDER

6 SEPTEMBER 2021

ASX Top 200 Stocks Down Under

"If you want to beat the system, you do it in a sensible, quiet way."

- Neville Bonner (1922 - 1999), The first Aboriginal Australian MP

JANUS HENDERSON GROUP PLC

Strong fund manager except when it comes to stocks

BENDIGO AND ADELAIDE BANK

Connecting with Millennials

CHARTER HALL RETAIL REIT

Growth moves are a good sign for distributions

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Stocks Down Under rating: ★★★

ASX: JHG
Market cap: A$ 12BN
Dividend yield: 3.3% (0% Franked)

52-week range: A$26.19 / A$60.97
Share price: A$ 58.78

When we last wrote about London-based Janus Henderson on 28 February 2020, the share was being dragged down by the Corona Crash. As the capital markets recovered, so too did the global asset manager, which has seen its stock blast past the $50 level for the first time since early 2018. Fund performance has been mostly solid, but fund outflows and an ailing equity business remain concerns. Given the 104% advance over the last 12 months and a stretched valuation, we think a neutral stance is most appropriate here.

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Market cap: A$ 6BN
Dividend yield: 5.4% (100% Franked)

52-week range: A$5.80 / A$11.68
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Share price chart

Source: Tradingview

Active asset manager

Janus Henderson offers a range of financial products to individual, intermediary and institutional investors. Its portfolio teams manage mutual funds across the fixed income, equity, quantitative equity, alternative and multi-asset classes. Superior security selection is the name of the game in this business and the company leans on its global presence and research resources to help it beat its benchmarks and peers. It has a particularly strong footprint in the United States, Europe, Asia and Australia with the US generating approximately 60% of revenue.

The group no longer has "bond king" Bill Gross among its leadership ranks following his retirement, but Dr. Myron Scholes, co-author of the famous Black-Scholes options pricing model (and 1997 Nobel Prize winner) is still the Chief Investment Strategist. Well regarded CEO (and former colleague of Bill Gross at US bond manager PIMCO) Dick Weil leads a strong executive team.

Active asset management is Janus Henderson's specialty. This means that it seeks to achieve better risk-adjusted returns for its clients compared to the returns of passively managed portfolios like ETFs. The fixed income, alternative and multi-asset products are considered Janus Henderson's strengths. The poor relative performance of its quantitative equity offerings and mediocre equity returns are a glaring weakness, though. Unfortunately, 65% of assets reside on the equity side of the business. So, the path of the global equity markets and the firm's relative performance should largely dictate where Janus Henderson's stock goes.

A pattern of outflows

COVID-19 certainly dictated where Janus Henderson went in 2020. Amid extreme volatility in the financial markets and temporary business closures, the group saw its assets under management (AUM) plunge in the early part of the year. By the end of 1Q20 AUM was down more than 21% from 4Q19. Things got better as the year progressed and capital market conditions improved.

AUM was up 7% for FY20 as a whole, to US$401.6bn, due to the sharp market recovery in the back half of the year. The AUM gains were limited by net outflows of US$24.4 billion, though most of this happened in the first half of the year when panicked investors pulled money out of mutual funds. It was good to see net flows improve sequentially during the year. But it is concerning that flows were negative in every quarter even as the pandemic outlook improved and the markets rebounded. Moreover, it marked another year of net outflows following the US$27.4bn outflow of FY19.

On the bright side, FY20 adjusted EPS increased 22% over FY19 because of the higher AUM and related management and performance fees. Also in the plus column was overall fund outperformance. As at 30 June 2021, 63% of group AUM outperformed their respective benchmarks on a five-year basis and 66% of AUM outperformed on a one-year basis. As usual, the fixed income and multi-asset capabilities shined in FY20. We were also encouraged by the launch of new products that are on point with investment industry trends. New fund offerings in the global sustainability/ESG space show that management is in tune with investor demand.

Equity plays second fiddle

Thus far in 2021, Janus Henderson is off to a decent, but not great start. Looking at the share's year-to-date return of 38.9% makes us wonder if the market has given the firm too much credit. After all, net outflows worsened in 1Q21, and AUM increased a meagre 1% from 4Q20. Fixed income, alternative and multi-asset performance was predictably stellar, but the equity performance remained underwhelming. We wonder how much longer the market will keep overlooking the weak equity business. If it continues to be an eye sore, we expect that either heads will roll or at least part of the business will be sold.

To give Janus Henderson a break, the balance sheet looks strong. The cash position has strengthened and a modest amount of debt maturing in 2025 remains. Management also deserves credit for maintaining generous dividend payments and repurchasing US$131 million of stock last year.

In terms of valuation, the FY21 P/E of 19.8x and EV/EBITDA of 6.7x are rich for our liking and add credence to the notion that the market has granted an unwarranted multiple.

With this said, there is still much to like about Janus Henderson. It operates world class fixed income and alternatives platforms and the 3.9% dividend yield is substantial. But with the share at its highest level since the 2017 merger and equity flows still a drag, we think there are better ways to gain exposure to global equities. It's three stars from us.

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Chasing the Big Four...

Together, Australia's Big Four banks control 75% of the banking market. Then there is Bendigo and Adelaide (B&A) Bank, Australia's fifth largest bank, which has a small, but increasing 2.3% market share. Although its stature in the industry isn't that large, it sits in a bit of a sweet spot — on the heels of the Big Four, but ahead of the rest of the pack. Remember, bigger isn't always better when it comes to banking. Smaller banks like B&A are often nimbler and have more room for growth.

B&A Bank's roots date back to 1858 when the Bendigo Mutual Permanent Land & Building Society was founded on the goldfields of Bendigo. Nearly 15 years ago, it came to be B&A Bank following the merger of Bendigo Bank and Adelaide Bank. Today it serves almost 2 million retail, small-to-medium sized businesses and agribusiness customers through its 700-plus physical locations across Australia. Its various brands offer a range of products and services, including personal banking, business banking, commercial mortgages, residential mortgages, financial planning, investments and insurance.

COVID-19 had an extensive impact on the Australian banking sector. As an essential service, B&A Bank's branch network remained open, while corporate employees worked remotely. Like its peers, B&A Bank offered a variety of support packages to customers including loan repayment deferrals and interest rate cuts and faced higher credit provisions. In total the bank's COVID-19 collective provision was $127.7m which, on top of safety-related operating expenses and fee concessions, put a major dent in FY20 profits.

We all need to find our niche

FY20 cash earnings fell 27% to $307.1m, although cash earnings were only down 2.8% when we exclude the impacts of COVID-19. Operating expenses rose 7% due in part to higher staff-related expenses and ongoing technology spending. We of course give B&A a pass on the COVID-19 expenses and feel the investments in technology will pay off in the long run. Given the higher expense profile, cost to income in FY20 went in the opposite direction of management's 50% target, up to 62.7%. The Net Interest Margin (NIM) slipped from 2.36% in FY19 to 2.33%.

The pandemic-related pressures eased in the back half of CY21. COVID-19 deferrals were down 90.5% from peak levels and represented less than 1% of gross loans as at 31 December 2020. However, due to the current Delta strain outbreak, support packages were reinstated during June 2021 for residential, consumer and commercial customers. As of 31 July 2021, B&A Bank had provided 274 accounts with a total of $87m in deferrals. While we anticipate this will increase, it is important to remember the context. We don't believe provisions will come close to reaching the $6.9bn and 21,621 accounts we saw last year.

FY21 lending growth amounted to 10.6%, which reflected an uptick in economic activity and consumer confidence. This growth was particularly impressive compared to system growth of just 2.8%. Again, smaller banks are typically more flexible, higher growth banks. The 12.5% deposit growth in FY21 was also strong and substantially outpaced the overall market growth.

B&A's cost transformation program helped reduce operating expenses by 2.5% when we remove one-time growth and transformation costs. This, combined with strong deposit growth, led the cost-to-income ratio to fall to 60.3%. The NIM was down to 2.26% and continues to be an industrywide challenge. We expect FY22's NIM to decline further due mainly to the bank's continued shift towards fixed loans. It is important to note that during FY22, B&A Bank's NIM could drop a whole 0.1%- points. During 2HY21, the average NIM was 2.23% and, as of June 2021, the NIM was already 2.19%. For comparison's sake, the Commonwealth Bank of Australia's (ASX: CBA | see 29 March 2021 report) NIM was 2.03% during FY21.

In the current low-rate environment, Australian banks are looking for new ways to deliver growth. B&A has been among the best in this department. What separates the bank from its peers is its industry-leading technology platform. Up Bank, Australia's first and largest mobile only digital bank, has amassed over 400k customers and is the country's highest ranked banking app. Most importantly, the e-bank is resonating with convenience-minded Millennials. This is a key target market for B&A, because the younger generations will drive future growth. It's fitting then that half of Up customers are age 16 to 25. Up's mission to take the stress out of money management and take people to a "happier place where they feel empowered and in control of their money" seems to be working like a charm. Up customer numbers more than doubled in FY21 thanks to continued product enhancements, like streamlined payments between users and COVID-19 budgeting tools.

In total B&A boasts 860k e-banking users. It also owns the popular Connect app, which along with Up is among the top four banking apps in Australia. Then there is tic:toc home loans in which the bank has a 28.6% stake. It is Australia's only end-to-end digital home loan fulfilment platform. B&A's investments in digital services, open banking and automation (such as digital signatures) are not only providing a better customer banking experience, but are improving its cost structure. Over time we expect the focus on technology to drive greater operational efficiencies and profitability.

Still undervalued

B&A's strong balance sheet and capital position helped it get through the recent crisis and has it in a good position for growth. In October 2020, it raised $350m of capital notes to support balance sheet growth and fund the redemption of convertible preferred shares. The CET1 capital ratio has steadily increased to 9.57%. This bank measure of solvency is comfortably above APRA's 'unquestionably strong' benchmark target.

Like other banks, the dividend is a ghost of its former self. The final FY21 dividend was $0.545 per share. We see the dividend increasing over time as banking activity continues to improve.

B&A is trading on a P/E of 12.7x for FY22, based on consensus estimates. Not as cheap as it was year ago, but still relatively inexpensive, in our view. Australia's other 'tech-forward' banks, Macquarie (ASX: MQG | see 26 April 2021 report) and Commonwealth Bank, both go for approximately 19x FY22 earnings.

We see costs coming down and technological investments bearing fruit over the next few years at B&A Bank. The share has long been considered a simple income share, but we think may also have a decent amount of growth up its sleeve. It's four stars from us.

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Share price chart

Source: Tradingview

The safe retail real estate share

Charter Hall Retail REIT is Australia's leading owner and manager of convenience-based retail centres. The REIT is managed by Charter Hall Group (ASX: CHC | see 15 September 2020 report) which operates several other listed REITs. The group is led by CEO David Harrison who has the longest tenure of any manager or director—and at a young 54 years of age, we expect he will continue to do a solid job navigating the Australian retail landscape for many more years to come.

The company's focus on food, beverage and other non-discretionary shopping outlets makes it a defensive investment that can persevere throughout the ups and downs of the economic cycle. When other retail REITs falter during downturns, Charter Hall Retail continues to generate reliable cash flows. That's easy to understand considering its biggest tenants are shopping mainstays, like Woolworths, Coles, Wesfarmers and Aldi.

In recent years, Charter Hall has shifted away from department stores, clothing retailers, and 'small-mall' settings in favour of grocery stores, discount stores and regional/sub-regional areas. After a series of divestures and acquisitions, the portfolio has evolved into a mix of about 60 high-quality properties centred around large metropolitan areas. Charter Hall Retail centres get approximately 150 million visitors per year.

Growth rather than survival

Charter Hall Retail's stunning plunge from an all-time-high above $5.00 to a record low under $3.00 was an emotionally driven 1-month ride that, in hindsight, created a glorious buying opportunity. On one hand, it stood to reason that the share got dragged down with the rest of the retail sector. At the time, it was unknown when shopping centres would reopen. On the other hand, Charter Hall Retail's exposure to essential retail and stockpiling consumers were clues that it would get through the recession just fine. About $1 has been added to the oversold share since that doomsday drop.

Rent deferrals were less of an issue compared to shopping centres that didn't have a strong anchor, like a Woolworths or Coles, that continued to meet Australians' demand for essential goods and services. Operating earnings increased 9.5% in FY21 to $156.2m. As the situation continued to improve for Charter Hall Retail during 2HY21, the trust managed to end the year increasing its NTA to $4.02, from $3.77 during December 2020.

Shortly after FY20, Charter Hall Retail took a 52% stake in a distribution facility that was leased to Coles for 14 years. This reassured the market that the company was in growth mode despite the pandemic and added another source of long-term income for shareholders. This purchase, along with the addition of the BP convenience petrol stations, helped boost the Weighted Average Lease Expiry (WALE) of the portfolio above seven years. We like the increased earnings visibility that this provides.

The company's 16 June 2021 update then showed just how far the REIT has come in the turbulent past year. Following a reassessment of 64% of its portfolio, a $143m, or 4.1%, positive revaluation to $3.65bn confirmed that Charter Hall's convenience retail properties are valued in the market. In a retail environment where reliable rent collection, high occupancy rates and sales growth are hard to come by, we believe this REIT stands out from the crowd.

Charter Hall Retail also announced the acquisition of the Butler Central Shopping Centre in Western Australia. It bought the property from Woolworths for $51.2m using existing debt facilities. In our view, it was another positive step towards strengthening the portfolio.

A resilient income play

At the early stages of COVID-19, the balance sheet was strengthened by a $304.2m equity raise that was completed in April 2020. This helped improve liquidity, reduce gearing and put the company in a good position to grow as Australia's economy recovered. The September 2020 institutional placement of $60m to fund the purchase of BP petrol stations in New Zealand further demonstrated a healthy investor appetite for the shares.

Charter Hall Retail has a FY22 P/E of 14.6x that goes down to 13.9x for FY23. Compare this to the broader Charter Hall Group, which trades around 23x and 22x for FY22 and FY23, respectively. If the retail REIT can continue to deliver strong operating income growth, its valuation could gravitate towards that of Charter Hall Group, which would imply significant upside.

Following the recent portfolio uplift, Net Tangible Asset (NTA) per share rose to $4.02. This means that the share is currently trading at a 7% discount to NTA, another reason we find the share to offer good value.

As a REIT, the main appeal of Charter Hall REIT is the unfranked distributions, which shareholders have consistently received twice per annum since 1996. Given the resilient nature of the portfolio we expect the dividend to increase over time (as it will in 2HY21) and therefore see Charter Hall REIT as a nice addition to the income investor's shopping cart. We give it four stars.

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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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