STOCKS DOWN UNDER

20 SEPTEMBER 2021

ASX Top 200 Stocks Down Under

> *Get busy living or get busy dying.*

- Andy Dufresne, Character in The Shawshank Redemption

ASX

EXCHANGE CENTRE

LENDLEASE GROUP

A strong lease for your portfolio

BANK OF QUEENSLAND

Steady she goes

INCITEC PIVOT

A volatile situation

LENDLEASE GROUP

A strong lease for your portfolio

Stocks Down Under rating: ★★★★

ASX: LLC
Market cap: A$7.7BN
Dividend yield: 2.4% (0% Franked)

52-week range: A$10.37 / A$14.89
Share price: A$11.48

We last reported on the Sydney-based Lendlease Group on 13 March 2020, putting a four-star rating on the stock. Unfortunately, COVID-19 has provided shareholders with effectively flat share price growth over the last year. We do believe the international real estate development industry will continue to face uncertainty well into 2022. However, despite these risks, Lendlease has made a number of significant restructuring and divestment moves that we believe have freed up capital and created a lean and more efficient company. And yet, we believe the shadow of the pandemic has hidden this fact from the market.

READ MORE

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Stocks Down Under rating: ★★★★

ASX: BOQ
Market cap: A$6BN
Dividend yield: 3.1% (100% Franked)

52-week range: A$5.46 / A$9.73
Share price: A$9.46

We last wrote a report on Brisbane-based Bank of Queensland on 12 March 2020. We gave the stock a four-star rating due to our analysis indicating the company's strategy shift and transformation plan would provide one of Australia's oldest financial institutions a much needed jolt. As we explained in our 27 October 2020 Insights article on the bank, the company successfully surprised investors with a 3bps Net Interest Margin (NIM) increase during 2HY20, versus an expected decline. We stated that FY21 would need to provide the proof of the bank's recovery and management has not disappointed. However, even with Stocks Down Under subscribers achieving a 50% return since 12 March 2020, we believe this stock has more juice in it.

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Share price chart

Source: Tradingview

A lean, mean, Lendlease machine

On 21 July 2021, Lendlease announced it had entered into an agreement to sell its Service Stream division for $310m. This divestment is hot on the heels of the company's recent sale of its Engineering and US Telecommunications and Energy businesses. These sales not only are freeing up significant capital, but allow management to narrow their focus to Lendlease's core business, i.e. real estate development. Yes, the industry is going through a lot right now and we don't expect this to change anytime soon. Still, we believe the sharp influx of capital will allow Lendlease to not only better weather business interruptions, but also snap up opportunities that rivals might not be able to due to the current climate. As Baron Rothschild famously said, "buy when there's blood in the streets".

One giant pipeline

For a company like Lendlease, pipeline is key. A robust pipeline of projects gives investors a clear indication as to the company's future plans as well as what important milestones to be on the lookout for. As of 30 June 2021, Lendlease's backlog stands at a whopping $114bn. However, the majority of this backlog is in, what is

called, the conversion and master planned phase. When a project is considered in the conversion part of the pipeline, the project is looking to get master planning approvals, which typically takes between two and three years.

The conversion pipeline currently stands at $59bn. Master planned stands at $40bn and is defined as the stage of having individual building approvals underway, forming investment partnerships and working out pre-sales and pre-leases. Work-in-progress is fairly strategy forward, consisting of $15bn in projects that are in the delivery, marketing, sales and customer experience stage.

Management has been working hard on refocusing on its core business and one of the main metrics has been increasing its annual work in progress to over $20bn on average from FY24 onwards. Between FY17 and FY21, the average annual total work in progress pipeline was $13bn. Management currently predicts the FY22 through FY23 average will reach $20bn. One key part of reaching these goals is to drastically increase the total value of projects in the pipeline's conversion and master planned stage. According to FY21's annual report, FY22 through FY23 will see at least $16bn added to the master planned and conversion stages of the pipeline. The focus will be on the master planned stage, with 14 projects currently being named and five named for the conversion stage. The split between these two stages will be between commercial (38%), residential for sale (36%), communities (14%) and residential for rent (12%). These developments are geographically situated with one in Kuala Lumpur, Singapore and Japan, two in Milan and England, five in the United States and seven in Australia.

In order to meet FY24's production goal of over $8bn, management has singled out five projects that currently are in work-in-progress stage. These are the Barangaroo South Residences One and Two (planned to be sold), Melbourne Quarter Tower (planned to be leased) and, to a lesser extent, Elephant Park (London, England), Southbank (Chicago, USA) and the Exchange TRX (Kuala Lumpur). If any of these five projects hits major delays or are cancelled, this is likely to significantly affect the stock.

FY21 results, poor but expected

Lendlease's FY21 results were less than ideal, but far from unexcepted due to COVID-19 shutdowns and delays. This led revenue to decline 23.3% year-over-year to $10.2bn. However, due to cost savings and the refocusing of the business, management reversed its loss after tax of $310m during FY20, to a profit of $222m during FY21.

The market is currently split, however, on how Lendlease will perform during FY22, FY23 and FY24. FY21 saw a normalised Earnings Per Share (EPS) of $0.55, but the eleven analysts who are currently providing the market with predictions have FY22's EPS between $0.30 per share and $0.75, with the median being $0.43. FY23 estimates range from $0.56 to $0.99 per share (median: $0.70) and FY24's estimates range from $0.78 to $1.40 per share (median: $1.05).

We believe the disagreement among the analysts covering Lendlease here can be easily summarised as follows: Will Lendlease successfully manage its core operational reform and execute on its FY24 goals? While we acknowledge the high level of risk inherent in the global real estate development market due to COVID-19, we believe management has laid out a strong plan of action. As we mentioned above, it has made the right decisions to provide the capital it will need.

Therefore, while FY22, FY23 and FY24's P/E ratios could be considered high at 24.3x, 16x and 10.8x, respectively, we believe the median earnings estimates used are far too low. Therefore, we believe the market is likely improperly valuing Lendlease, leading us to reiterate our four-star rating.

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Share price chart

Source: Tradingview

Opening FY22 with a bang

The Bank of Queensland must have had one crazy new (financial) year party, because it opened FY22 with a bang. On 1 July 2021, the Bank of Queensland announced it completed the acquisition of Members Equity Bank for $1.325bn in cash, or 22.1% of its current market capitalisation. This acquisition was announced a long time ago. If investors missed the first announcement on 22 February 2021, it is unlikely they missed BOQ's subsequent $1.35bn equity raising to fund the purchase. What is unusual about this acquisition, is how management has decided to keep ME Bank as a separate entity from the Bank of Queensland. ME Bank is now fully under the Bank of Queensland's control, but management has decided not to consolidate the banks under one brand and has stated it has no future plans to do so. We believe this is a smart move as it will enable a smoother and less confusing transition for ME Bank's customers. In fact, they might not even notice the change in ownership.

Unfortunately, while we're rather bullish on the acquisition, there is still a few legal issues that seem to be quite serious with ASIC slapping 62 criminal charges on it back in May. Bank of Queensland has stated it was aware

of the issues during due diligence. Last week the bank appeared in court and this matter is yet to be resolved with the next hearing scheduled for 3 November 2021. It is important to note, that ASIC alleges these issues happened due to a failure in ME's systems and processes. We believe the Bank of Queensland has a much better regulatory framework in place and, therefore, we believe this situation is unlikely to repeat itself. The only question is what this matter will cost at its conclusion.

The truth is in the NIM

Unfortunately, the Bank of Queensland has not yet released its full year FY21 results. Therefore, we only have the 1HY21 results, released on 15 April 2021, to go by. However, these results were quite strong, indicating that the bank's turnaround is well and truly underway. The company's Net Interest Margin (NIM) is still low, but steadily increasing. During 1HY21, the NIM stood at 1.95%, an increase of 3bps from 2HY20. Cash earnings after tax increased 9% to $165m. One of the main drivers of the bank's improving NIM was the increase in customer deposits of $1.1bn during 1HY21. Since these deposits heavily favoured savings and investment products, rather than term deposits, funding costs were reduced. Unfortunately, while we expect the Bank of Queensland's NIM to continue to improve longer term, management's latest guidance for FY21 was flat growth compared to 1HY21.

Still a few milestones to go

Clearly the Bank of Queensland's strategy shift and transformation plan have been a massive success so far, no mean feat for a large banking organisation. However, one year of success does not mean the bank is out of the woods just yet. When we compare BOQ's results to that of the big four, the Commonwealth Bank of Australia (ASX: CBA | see 29 March 2021 report), Westpac (ASX: WBC | see 28 June 2021 report), ANZ (ASX: ANZ | see 19 April 2021 report) and NAB (ASX: NAB | see 12 April 2021 report), the company's financials still lag behind. For example, the big four's NIM average is approximately 2% as of the latest reporting season. The Bank of Queensland is catching up, but still has a ways to go.

Doing a lot right

We have been bullish on the Bank of Queensland's turnaround for some time now and despite the regulatory issues, we still believe ME's acquisition will turn out to be a net positive for growth. Full-year FY21 normalised Earnings Per Share (EPS) is expected to reach $0.68 and stay flat during FY22, before jumping to $0.73 in FY23. Unfortunately, this market assumption for FY22 seems to be based on falling profitability although the top line is expected to reach $1.2bn during FY21 and then jump to $1.7bn during FY22.

We believe management has done an impressive job increasing the bank's profitability so far and there is still more upside to the NIM if we look at the peer group, although 2% may be a bridge too far for a small bank. However, we believe the current market consensus, that says margins will erode in FY22, may be incorrect. Management is expecting a flat NIM during 2HY21 and a strong decline in FY22 seems unlikely given the path the bank is on.

The stock trading is trading at a FY22 P/E multiple of 13.8x, which implies a P/E-to-growth (PEG) ratio of 0.45x. This is well below the 0.6x for NAB and ANZ. CBA's and Macquarie's PEG ratios are in a different category at 2.6x.

Summarising, we think BOQ is still a four-star stock.

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Share price chart

Source: Tradingview

Praise the mining gods

The Australian Bureau of Statistics regularly releases a slew of data about the mineral exploration industry in Australia. We took the time to analyse its June 2021 release on expenditure and metres drilled. We found that during 2HY21, the total metres drilled in Australia totalled 6.8m, resulting in the largest half (1H and 2H) since the ABS began releasing data in 2003. When we combine this with the fact that 2HY21 saw the largest total metres drilled in new deposits on record (beating the previous record of 1HY21) and combine this with the fundamentally backed raw materials boom, we believe drilling is likely to continue to produce record-breaking figures during FY22.

Consistently explosive results out of mining

Why did we discuss the mining boom above? Well, Incitec Pivot is not involved in mining or drilling itself, but rather something with a little more oomph. Incitec manufactures the industrial explosives and blasting equipment necessary to make your mining profits go boom. It is important to note that while this is not an open playing field devoid of competition, this industry's regulatory barriers to entry are understandably high.

Unfortunately, the explosive's division faced a few challenges during the first half of 2021, driving EBIT down 21.4% to $44m. The main challenge here was through the Americas division, where its Waggaman ammonia plant in Louisiana, USA suffered a number of unplanned outages at the beginning of the year. Unfortunately, this has happened again during the second half of 2021 as the plant was brought offline on 28 August 2021 in anticipation of Hurricane Ida. The outage is expected to last for a total of four weeks, generating a loss of EBIT of US$28m for the second half of 2021.

Therefore, it should come as no surprise that the Americas division was what brought down the explosive division's half-year result. This division saw a decline in EBIT of 29% to $60m, although the sale of premium emulsion and electronic detonators increased on a year-over-year basis. The Asian Pacific region saw a decline in EBIT of 1% to $70m, due to a decline in the sales of premium emulsion. However, we believe this is likely due to a delay in demand from mining, as electronic detonators systems saw a sharp rise.

While this division has experienced trouble in past, and we expect the second half of FY21 will be less than ideal due to the additional outage at the Waggaman plant, we believe the mining boom will drive a rebound during 2022.

Agriculture growth

While we believe the explosive division will likely lead Incitec's long-term growth, the company has one other division we need to cover. Incitec also produces fertiliser for the agricultural sector, with operations in the Asia Pacific region. This division saw an increase in EBIT of $30m year-over-year during the first half of 2021, leading to a profit of $20m. Agriculture in the Asia Pacific region has been tough recently due to multiple droughts, wildfires and lower product prices. However, the sector has recently begun to recover and management expects a rebound, leading to the beginning of a demand cycle for fertiliser. While we believe management is correct about agriculture's growth potential, we believe there is still significant risks from an increasingly volatile regional climate. Since the sector is still recovering from the recent drought period, we are concerned the recovery could easily be reversed.

A volatile situation

The market is currently expecting full year EBITDA for FY21 (which ends in 2 weeks) of $853.9m, representing 16.8% year-over-year growth. By 2022, the market is expecting the growth in EBITDA to drop slightly to 15.5%. Unfortunately, there are considerable risks across both the fertiliser and explosives division that have a clear path to derail Incitec's earnings growth potential, in our view.

It seems the market agrees with us here, as the company is currently valued at a FY22 EV/EBITDA ratio of 7.4x, a significant discount to expected growth of 15.5%. While we view this discount as slightly excessive, we still think the risks justify it at this time. Additionally, EBITDA growth for the subsequent year, FY23, is expected to be slightly negative year-on-year. Therefore, we believe Incitec is a three-star stock at this time. Better to put your money to work elsewhere.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

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