STOCKS DOWN UNDER

27 SEPTEMBER 2021

ASX Top 200 Stocks Down Under

Never do anything out of hunger. Not even eating.

- Frank Semyon (Vince Vaughn), True Detective

ENDEAVOUR GROUP

Raise your glass

INFRATIL

Sitting on some exciting assets

VIVA ENERGY GROUP

Petering out

ENDEAVOUR GROUP

Raise your glass

Stocks Down Under rating: ★★★★

ASX: EDV
Market cap: A$12.3BN
Dividend yield: 0.1% (100% Franked)
52-week range: A$5.77 / A$7.50
Share price: A$6.87

Based in Sydney, the Endeavour group primarily operates in the hospitality sector in Australia. The company owns numerous drinks brands that it distributes through its retail network of stores and distributors. It also operates a chain of hotels with over 300 venues in Australia. All the company's brands were originally part of the Woolworths group. They were recently spun off to form the Endeavour group, creating a separate entity that can exclusively focus on its niche.

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INFRATIL

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Stocks Down Under rating: ★★★★

ASX: IFT
Market cap: A$5.6BN
Dividend yield: 2.1% (0% Franked)
52-week range: A$4.51 / A$7.89
Share price: A$7.89

We last wrote about New Zealand-based energy, transport and social infrastructure investor Infratil on 13 March 2020. Subscribers who invested at the time of our four-star rating have done fairly well for themselves as the stock has rallied 40%, due in large part to the substantial profit the company made on the sale of one of its investments, Tilt Renewables. Infratil has since continued to make acquisitions, the latest being New Zealand-based Pacific Radiology for approximately NZ$350m. We believe management has a proven track record and with the latest IPCC climate report, its renewable holdings are likely to become a lot more valuable.

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VIVA ENERGY GROUP

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Stocks Down Under rating: ★★

ASX: VEA
Market cap: A$3.6BN
Dividend yield: 0.1% (100% Franked)
52-week range: A$1.44 / A$2.35
Share price: A$2.28

We last wrote about Victoria-based Viva Energy Group on 17 March 2020, back when the stock was $1.40 per share. We put a two-star rating on it and when we factor in the 21:25 stock consolidation on 8 October 2020, we seem to have called the bottom, not a good thing for a two-star rating. Two things mitigated our rating, the sudden and sharp rebound in the price of oil and the Australian government announcing it was effectively propping up the country's failing refineries. However, all things considered, we still believe the company is in a tailspin that even the Federal Government can only forestall, not prevent.

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Share price chart

Source: Tradingview

Not your average retailer

With a market cap of around $12.5bn, the Endeavour Group is not a small company by any means and has eight major brands under its wings. It owns Dan Murphy, which retails liquor through its chain of almost 250 stores. It also owns Langdon's, an online wine retailer and brokerage house, along with Cellarmasters, Shorty's Liquor, Pinnacle Drinks and Jimmy Brings. However, the company's primary business is not drinks, but hospitality. To that end the company operates ALH hotels, a segment that encompasses two different hotel chains (ALH and Nightcap), an event planning company (Live at Your Local) and a rewards program (Monty's rewards). Lastly, another source of revenue for the company is BWS, a retail drinks network that has over 1400 stores across Australia.

Endeavour aims to synergise as many of its brands as possible to complement the strengths of each brand and maximize profits. For example, Pinnacle Drinks manufactures various wines through its extensive network of vineyards and wineries. It can then tap into Endeavour's vast distribution network to stock its drinks in Dan Murphy's, BWS, ALH Hotels and Jimmy Brings.

The demerger from Woolworths

The Endeavour Group was originally a part of the Woolworths group, the Sydney-based supermarket giant with a market cap of over $49.5bn. Management recently spun off Endeavour and shareholders received one share of Endeavour for each share of Woolworths they held.

Endeavour officially listed on the ASX on June 24, 2021. Woolworths still owns slightly over 14% of the Endeavour group. The company also announced that it had access to $2.5bn in debt facilities to make sure it could move through the demerger process without any hiccups. Considering the company already had a large amount of debt, this new facility was necessary for working capital requirements. The company debuted on the ASX at $6.60 and it crossed the $7 mark within two months of trading.

Endeavour recorded revenues of almost $11.6bn in FY21, up from $10.6bn in the pandemic-stricken year before. This led to a profit of $445m compared to a loss of $64m in FY20. We believe these results show that the company has left the pandemic behind. Within the drinks retailing space, we believe Endeavour is quite innovative. For instance, BWS is the first Australian retailer to offer a one-hour delivery guarantee, promising to deliver the next order for free if the delivery is late. Drive-thru facilities are also being added to stores rapidly to facilitate contactless shopping. The 220 stores offering drive-thru are currently performing better than their counterparts.

The lessons learned during the pandemic should allow the company to increase its business by placing a greater focus on convenience. Over the long term, this should secure the company's position as a leader in Australian drinks retailing.

What kind of company is Endeavour going to be?

Although Endeavour is a newly-listed company, it is best to think of it as a mature business that should achieve slow, but steady growth. Most of the company's brands have been around for some time and it will be interesting to see what acquisitions the company can make to expand its portfolio further.

At the end of FY21, the company announced a dividend of $0.07 per share. We expect this dividend to continue to grow by a small percentage every year. As per consensus estimates, net income is expected to rise from $445m to $464m in FY22 and $540m in FY23. This means that Endeavour is currently trading at EV/EBITDA ratios of 12.3x for FY22 and 11.4x for FY23, which we believe is a pretty good valuation given the consistent, but gradual growth rate.

The only thing to be slightly worried about is the company's debt. Currently, it has a net debt position of around $5bn and a net debt / equity ratio of 1.49x, which we think is quite high. However, unless another act of God, like the pandemic occurs, we are confident that the company should be able to slowly deleverage. As such, we think Endeavour Group is a four-star company ideal for investors looking for stability and a solid dividend.

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Share price chart

Source: Tradingview

Doubling down on renewable energy

Infratil is clearly diversified with holdings across a number of sectors, from telecommunications to radiology. However, even after the sale of its stake in Tilt Renewables, renewable energy production remains a large part of its holdings. These types of assets have seen significant growth in both investor interest and price over the last few years, despite many not yet being profitable. While many observers have called this a bubble, which might turn out to be true, we don't believe it is likely to burst anytime soon, especially not after the United Nations released its most damning climate report yet on 10 August 2021.

We won't go into all the details here, but the nutshell version is this; the massive report produced the most rigorous and in-depth research into climate change yet and the conclusion was significantly worse than before. Instead of still having some time left to avert climate catastrophe, it seems we are already too late, with once in a hundred year storms already becoming the new norm. The immediate reaction to this report has been some form of panic among leftish world leaders and with countries and organisations like the EU planning or already having announced additional taxes on imports from countries that fail to match its strong

climate policies, we believe one of the results from this report will be a renewed interest in renewable energy assets.

One of the key examples of how Infratil is moving to take advantage of this macro trend is the 10 September 2021 announcement on its new Asian-focused fund. Per the announcement, we now know that Infratil has committed US$233m in order to create Gurin Energy. This 'renewable energy development platform' will be headquartered in Singapore and will partake in developing renewable energy projects across Australia. The committed capital will be in the form of US$133m in equity and US$100m in letters of credit from 3rd party banks. Infratil is funding this from the proceeds of the Tilt Renewables sale that generated gross proceeds of NZ$2bn. Based on the 10 September 2021 announcement, we know that this fund plans on focusing on Vietnam, the Philippines and Japan for its first round of investments.

An outline of the all-important assets

For those who are not totally sold on renewable energy investments, it is important to note that while it is a focus of Infratil's future allocation, it currently only makes up 20% of the company's investment portfolio. As of 31 March 2021 (end of FY21 for Infratil), the company reported a total portfolio value of NZ$6.1bn (excluding Tilt), or NZ$11.06 per share. This portfolio is currently broken down into the following sectors: digital infrastructure (53%), renewable energy (20%), social infrastructure (13%), airports (12%) and other (2%). The main investments can be broken out into CDC Data Centres with installed capacity of 133MW and a further 77MW under construction (33% of the portfolio), Vodafone New Zealand across 5G and regional networks, fixed wireless, which is currently undergoing a digital transformation programme (20% of portfolio). Additionally, the company's Wellington Airport accounts for 12% of the portfolio value at 31 March 2021.

Heavy on assets, low on earnings growth

Infratil is an investment that is not only based on earnings growth. While FY22's EBITDA growth estimates are strong at 22.1%, the actual value of the assets owned by Infratil are arguably just as important to the company's overall valuation. The last few years have seen a significant uptick in both the prices of renewable energy assets and the amount of investment flowing into these assets. According to research conducted by BloomberNEF, US$174bn was invested globally into clean energy projects and companies during the first half of 2021, the highest level ever recorded for the first half of any year. Refinancing mergers, acquisitions and buyouts accounted for US$68.3bn, up 18% year-over-year. With governments around the world fully invested in this trend, we believe this is a long-term trend. Therefore, it is reasonable to assume that while Infratil continues to experience earnings growth, the underlying value of its assets will also continue to grow.

The expected growth of Infratil's assets is one of the reasons we believe the stock is not currently trading at fair value, despite having a FY22 EV/EBITDA ratio of 22.1x on expected 22.1% EBITDA growth. Renewable energy investment has its long-distance running shoes on making Infratil a four-star stock, in our view.

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Share price chart

Source: Tradingview

Refining is in for a long-term decline

On 23 June 2021, Parliament approved plans to pay Viva Energy and Ampol (ASX: ALD | see 21 August 2020 report) up to $2.3bn to keep the company's Australian refineries open. Under the plan, the companies will receive payments when margins are weak through 2027, with an option to extend this to 2030. Part of the payments will include $125m each to upgrade the refineries to produce ultra-low sulphur petrol by the end of 2024. On the face of it, this sounds fantastic for Viva and Ampol, and in part it is. However, we don't believe this will make much of a difference in the long-run and the government subsidies are likely to be the only reason these refineries remain open. The hard truth is this, the reason Australia has lost its refineries is simple economics, Asia can produce larger quantities, more efficiently and cheaper. This is due to a number of factors including more advanced and larger plants, cheaper workforces and governments who are willing to subsidies significantly more than Australia ever will or can.

While we believe there certainly will be short-term swings, we are looking at a company dependent on long-term government subsidies to move forward. But political capital is a fickle thing and if the Labor party has it's say, those subsidies will be a thing of the past. The long and short of it is that it does not look good for the future of diesel production, especially in Australia.

Retail and commercial sales are normalising

Viva Energy is a lot more than its refineries, although it still makes up a chunk of the company's earnings. Comparing Viva Energy's first half of 2021 results to 2020's, in our view, is not a like-for-like analysis due to the extreme impact of COVID-19 on all three divisions: refinery, retail and commercial. Despite our pessimism about the refinery division, we believe the retail and commercial divisions alone are set to drive FY22's results and, therefore, these divisions will be our focus.

During the first half of 2019, Viva Energy generated $7.9bn in revenue and $297.4m in underlying EBITDA. The majority of EBITDA came from the retail division ($116.7m), which consists of fuel product sales through its Australian network of Shell, Liberty and Westside branded service stations. The division also supplies Coles Express sites and other, smaller retail operators and wholesalers. During the first half of 2021, this division generated $373.7m in EBITDA on 2.2bl retail fuel volumes. While Viva Energy did not release divisional fuel sale volume numbers during the first half of 2019, we do know that full year 2019 retail sales were 3.7bl. It seems to indicate a strong recovery, past 2019's more 'normalised' results. With most of the country expected to finally be free of lockdowns and allowed to travel for most of 2022, we expect full year 2021's outlook to be rather strong for this division.

The commercial division generated $105.9m in 1HY21 EBITDA from the sale of fuel products to industry. This includes sectors such as aviation and maritime, but it also includes the resources, transport, specialty, agriculture and wholesale sectors. These sectors have seen a strong recovery during 2021, especially the domestic resource sector as regular readers of Stocks Down Under know. Additionally, management had taken steps to control costs specific to this division that helped offset the anticipated decline in fuel volume sales, i.e. 1HY21 volumes amounted to 4.5bl compared to FY19's 11bl. It is important to note, that despite the decline it is still an impressive result as 3.5bl of the FY19 volume was specifically jet fuel products, compared to 1HY21's 0.7bl.

During 1HY21 this division still managed $105.9m in EBITDA, which is 66.9% of 1HY19's $158.3m. For the same reasons we listed for the retail division, we believe the commercial division will likely return to 2019's 'normalised' results during 2022.

With nine analysts covering Viva Energy, the median EBITDA growth forecast for FY22 is 13.7%, resulting in an EBITDA estimate of $745.4m. On that basis, Viva Energy is currently trading at a FY22 EV/EBITDA ratio of 8.2x. However, EBITDA growth in FY23 is expected to be just 2%. So, while Viva's near-term prospects are not too shabby, we believe the longer-term outlook is very mediocre, which makes this a two-star stock for us, especially since the stock has already been on a pretty solid run since March this year.

Pitt Street Research Pty Ltd

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