STOCKS DOWN UNDER

4 OCTOBER 2021

ASX Top 200 Stocks Down Under

“Live each day as if it’s the first day of your life.”

- Donald Duck

HARVEY NORMAN

Different situation, same ratingc

FLETCHER BUILDING

Building past COVID

AUB GROUP

A little too hot in the valuation

HARVEY NORMAN

Different situation, same rating

Stocks Down Under rating: ★★

ASX: HVN
Market cap: A$6.3BN
Dividend yield: 7% (100% Franked)

52-week range: A$4.33 / A$6.09
Share price: A$4.90

We last covered Sydney-based on 9 June 2020, rating the company two stars based on a combination of Australian growth concerns, COVID-19 and what we considered to be an inflated valuation. Unfortunately, we seem to have called the bottom of the stock as it went up in an almost straight line until early 2021, driven by COVID-induced online spending. Let's take a dive into this franchise-based general retailer and see where we went wrong and where this company is likely moving in the future.

READ MORE

FLETCHER BUILDING

Building past COVID

Stocks Down Under rating: ★★★

ASX: FBU
Market cap: A$5.6BN
Dividend yield: 3.5% (0% Franked)

52-week range: A$3.55 / A$7.64
Share price: A$6.72

We last wrote about Auckland-based Fletcher Building on 18 June 2020, rating the stock two stars. This building giant currently employees over 14,500 people in New Zealand, Australia and the South Pacific throughout its manufacturing, distribution and retail, and residential and infrastructure construction operations. We believe the company is well positioned to take advantage of New Zealand and Australia's construction boom, but we think the stock still has a bit left to go on its current pull back before it returns to four star territory.

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Share price: A$23.52

AUB Group represents over one million client insurance policies through its 75 partner businesses across over 500 locations throughout Australia and New Zealand. These policies represent over $4bn in insurance premiums placed with its local and foreign insurers. The company had an extremely strong FY21, fuelled by the Australian division. This led the stock to rally 47% year-to-date, although it has pulled back slightly from its end of August high of $25.58. The question now is, will the stock fall some more or is it time to get back in?

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Share price chart

Source: Tradingview

Pobody's Nerfect

As the saying first popularised by Cracked magazine in the 1970s and more recently by the American TV show The Good Place goes, 'Pobody's Nerfect'. While we believe our track record is quite strong, and we strive for strong transparency on this issue, like all investors we are sadly not Nerfect. Our two-star rating of Harvey Norman on 9 June 2020 unfortunately followed about 10 weeks after the bottom of the stock's COVID Crash low in March.

Before we continue, we believe it is important to examine exactly where we went wrong in our analysis. The crux of our two-star view was a combination of three factors: COVID-19 and concerns we had about the company's growth protentional. We noted that the main threat to our thesis was the company's international expansion plans, specifically its launch into Malaysia.

So, where did we go wrong? Much like Maccas, the company runs most of its business through a franchise model. In exchange for setting up the franchisee with products, suppliers, a business plan and a highly recognisable brand, the parent company charges a fee and rent (when it owns the property). It all came down to the area we were least bullish on, Australian domestic growth, due to a combination of increased franchise margins (3.68%-points versus FY19) and directly related pandemic buying, leading to a $100.2m (40.3% year-over-year) increase in franchise profit during FY20. This increase in franchise profit margin as well

as overall profits not only surprised us, but the market as well. This resulted in an Earnings Per Share (EPS) surprise of 11.8% ($0.04 per share) at $0.38 per share. Management's bullish sentiment about the company's international expansion plans combined with the strong and surprising result is what spurred on the rally last year.

However, the delta variant has changed things and the chances of an earnings surprise from the Australian franchise division are small, in our view. But hey, recent history has shown you never know.

A disappointing FY21

The last three months have been tough for Harvey Norman's shareholders with the stock declining 12%. The company reported rather disappointed FY21 results. There was nothing wrong with them on the face of it with a 54.4% year-over-year increase in EBITDA to $1.1bn, except that the market was expecting EBITDA of $1.3bn. On the bright side, this was an issue of margins, not sales. In fact, Harvey Norman beat the market's revenue estimate by approximately 10%, coming in at $4.4bn. This was split between $2.8bn in sales to customers, $1.3bn in revenue from its franchisees and $0.3bn in other income items. But the market's disappointment over the EBITDA miss dominated investor sentiment.

Adding fuel to the market's disappointment over FY21's results is the current consensus expectation that Harvey Norman will see a decline in EBITDA of 11.9% in FY22 and 1% in FY23. Revenue is also expected to decline, to $4bn in FY22, before slightly recovering to $4.2bn in FY23.

So, what is driving these lacklustre market expectations? While Harvey Norman's overseas operations in New Zealand, Ireland, Northern Ireland, Singapore, Malaysia, Slovenia and Croatia are likely to see continued growth, the overseas division only accounted for 23.1% of Profit Before Tax (PBT) in FY21. It seems that expectations around the revenue decline are centred around Australia and are mainly due to the risk posed by increasing online competition. Harvey Norman has made great strides in opening an online marketplace, but it still cannot completely compete with the likes of Kogan.com (ASX: KGN | see 8 March 2021 report). COVID-19 has made clear just how important a company's online footprint is and we believe this forms the crux of the market's pessimistic view on FY22 and FY23.

Stay away for now

Harvey Norman has seen a pull-back since it announced its FY21 results on 31 August 2021, declining 16.4%. Yes, the market is expecting EBITDA to decline during FY22 and FY23, but the stock is still trading over 20% higher than it was at the start of 2020. At its current price the stock is valued at FY22 and FY23 EV/EBITDA ratios of 7.5x and 7.6x, respectively. While we would be surprised if Harvey Norman posted another major EBITDA miss in FY22, we believe the chances of an upside surprise are low. Therefore, we believe the pull-back has a ways to go, two stars.

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Source: Tradingview

Check one for the win column

We covered Fletcher Building on 18 June 2020, rating the stock two stars. Over the next month, our rating was confirmed as the stock dropped 14%. The crux of our thesis was simple, COVID-19 was causing a significant decline in both residential and commercial construction activity. However, we also noted that the company had an extremely strong balance sheet going into the crisis and a rather robust buyback scheme.

Starting in October 2020, the construction industry in both Australia and New Zealand reopened with a vengeance as the market experienced a combination of pent-up demand and a post-lockdown refurbishment boom. In fact, management resumed dividends, currently offering an indicative yield of 3.5%, as the share price quickly rocketed 68% to its current price of $6.72 per share. However, the stock has recently pulled back from its highs as the Delta variant has taken its toll on the construction industry in Australia that has been plagued by shutdowns and restrictions in its two largest markets, New South Wales and Victoria. And yet, we can now clearly see the light at the end of the tunnel.

New Zealand still reigns over Fletcher

Fletcher splits its operations into three main categories: New Zealand, construction and Australia. Over the last three years, New Zealand has remained the company's largest source of revenue (NZ$3.8bn FY19, NZ$3.3bn FY20, NZ$4.1bn FY21). New Zealand has not been immune to the Delta variant. In fact, the country's largest city Auckland is has been in lockdown for over a month now. Despite this, the economic forecast for the construction industry is widely seen as positive. The Organisation for Economic Cooperation and Development (OECD) predicts GDP growth will return to 3.1% for 2021 and rise to 3.8% during 2022. One of the main sectors the OECD believes will drive this growth is residential construction. In fact, the OECD states that one of the top structural reform priorities for New Zealand during 2021 should be to increase the supply of affordable housing as supply remains tight and prices high.

However, this report was last updated in May 2021 and there has been a number of structural changes since then. A more up-to-date report was published 10 June 2021 by GlobalData that found that the fundamentals behind the construction boom will likely remain strong between 2022 and 2025, with average annual growth expected at 3.5%. The segments most likely to benefit from this boom are quoted as being residential and infrastructure. At the time of the report's publication, New Zealand already had NZ$1.2bn of projects announced for community development, NZ$1.1bn in transport infrastructure projects and NZ$974.6m in housing projects. As one of the largest providers of building products, concrete, distribution and construction services in New Zealand, we expect Fletcher to be one of the largest winners of this macro investment trend.

During FY21, Fletcher's Australian division generated NZ$2.7bn in revenue, the same as it generated during FY20. However, while revenue remained the same, the company managed to drastically increase its EBIT margin from 2.5% during FY19 to 3.7% during FY21. This increase in margin was a result of a multi-year efficiency program management started in FY18. Fortunately for shareholders, it seems this division has plenty of margin growth left as the core New Zealand division's EBIT margin currently stands at 11% (FY19: 10%). Therefore, through a combination of a return to some form of 'COVID-19 normalcy' and the efforts of management to increase this division's margins, EBIT jumped 212% year-over-year to NZ$103m during FY21.

Buy-back potential make this a three-star company

During FY21 Fletcher's management ran a fierce buy-back program that helped drive the share price rally all the way to $7.64 per share. The last time Fletcher purchased shares on-market was 21 June 2021 at an average price of $6.996 per share for the shares purchased on the ASX and NZ$7.555 for the shares acquired on the NZX. The fact that management has not purchased any shares since the end of FY21 should not be taken as an end to the buyback program. In fact, in its FY21 report management confirmed that it's NZ$300m buyback program will continue through June 2022.

There is large disagreement between the ten analysts who cover Fletcher over what level of growth to expect during FY22 and FY23. Currently, the low estimate for FY22 has EBITDA declining 1% and the high estimate has EBITDA growing 21.1% year-over-year. FY23 has the same discrepancy with the low estimate seeing EBITDA decline 7% and the high expecting EBITDA to grow 13.7% year-over-year compared to FY22's median estimate.

The median EBITDA growth estimates for FY22 and FY23 currently stand at 5.2% and 3%, respectively. To be blunt, we believe the low estimate will likely turn out to be way too low. However, we believe the high estimates don't adequately take into account the current lockdowns and restrictions. All-in-all, we believe the median growth estimate for FY22 is at least in the right ball-park. This gives us FY22 and FY23 EV/EBITDA multiples of 7.1x and 6.9x, respectively.

Fletcher stock is still coming down from what was a monster rally and we believe it still has a bit to go. Under those circumstances we would normally give the company a two-star rating. However, management showed just how powerful its buyback program can be during FY21 and with a NZ$300m buyback program in place, we believe the resumption of buybacks would turn this pullback around. Therefore, we feel a three-star rating is probably more reasonable.

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Share price chart

Source: Tradingview

Yes, we will take a bow

When we first reported on the AUB Group, on 13 March 2020, the stock was trading at $12.78 per share with a market capitalisation of just under $1bn. We stated "by combining effective management with a well-thought-out strategy, we believe AUB Group is poised to outperform in the coming quarters. Organic growth remains strong, while management has not only shown the ability to select appropriate M&A targets, but also integrate them within the firm's existing portfolio".

Today, the stock is trading at $23.52 with a market capitalisation of $1.8bn, graduating it from Small Cap Stocks Down Under to today's edition of ASX Top 200 Stocks Down Under. The company was already experiencing improving momentum towards the end of 1HY21 and on 10 November 2020 management upgraded its FY21 Net Profit After Tax (NPAT) guidance to between $60m and $62m. However, in the full spirit of outperformance, AUB decided that was not good enough and smashed management's upgraded guidance with FY21's NPAT coming in at $65.3m (22.9% year-over-year growth).

A year of change and transformation

To generate its outstanding FY21 result, the AUB Group went through a lot, all of it positive and mostly focused on its Australian operations. The company continued on its strategic acquisition streak, purchasing Experien, QRM and YDR, but the star of FY21's acquisitions was 360 Underwriting Solutions. 360 Underwriting Solutions is a group of ten underwriting agencies with a combined gross written premium of $170m and was already an established partner of Austbrokers (one of AUB's divisions). Following the acquisition, AUB announced a major restructuring and expansion of its underwriting division. With the restructuring complete, the underwriting division will now be split into three sub-divisions: general commercial underwriting, SURA specialty (focusing on speciality risk classes and industries) and strata agencies.

The general commercial underwriting sub-division was the main focus of the restructuring with combined gross written premiums of $270m, $170m of which came from the acquisition of the 360 Underwriting Solutions group. According to management, AUB's focus on its agencies and subsequent restructuring delivered a 13.9% increase in pre-tax profit (FY21: $14.8m) as well as an increase in EBIT margins of 1%-point to 31.9%.

Australia really was the place to be for AUB during FY21 as operations in the country saw improvements across the board. The Australian broking division saw pre-tax profit climb 21.8% to $72m. This growth was driven by an increase of 6.2% in commercial lines insurance premiums and cost reductions. Combined, this drove EBIT margins up by 3.6%-points to 31.9% for FY21.

Just starting AUB's New Zealand journey

New Zealand was another story during FY21 with pre-tax profit increasing only 3.6% to $12.5m during FY21. This was mostly driven by negligible premium growth and a lack of major efficiency improvements. However, don't be fooled into thinking management is ignoring its New Zealand operations. In fact, New Zealand is squarely in management's focus for the next few years. You see, during FY21 the company began to focus on New Zealand by making major investments in its technological offerings to its NZbroker members, helping to facilitate the transition and adoption of a new regulatory regime.

Management has also stated that it has a "good pipeline of new clients and acquisition opportunities" in the country. Now that the Australian operations are running smoothly, the restructuring of its New Zealand operations is underway. And we are confident that a number of highly strategic acquisitions will be announced during FY22 and FY23 in New Zealand. If management's success in transforming its Australian operations is any indicator, we should expect significant margin growth in New Zealand over the next two years with growth supercharged by some significant acquisitions.

Guidance has FY22 looking strong

As announced with its FY21 earnings release on 26 August 2021, AUB's guidance for FY22 is NPAT growth between 15.7% ($70m) and 20.7% ($73m). We tend to believe AUB will repeat FY21's result and outperform managements guidance for one main reason, acquisitions. AUB is certainly not a growth through acquisition story, but as we have repeatedly said, it has a strong track record of using acquisitions to expand its expertise and footprint in a market and we expect this to be a key part of its FY22 New Zealand strategy. When the FY22 guidance was issued, the company specifically said "from continuing operations" and, therefore, we expect FY22's guidance to be upgraded at least once during the year.

However, while we are rather bullish on AUB's growth prospects for FY22, we believe the recent pullback still has some way to go. The stock is currently trading at a FY22 P/E multiple of 24.7x, significantly more than the 20x it was trading at when we reported on the stock back in March 2020. Therefore, while AUB is clearly one to keep an eye on, we think it's a two-star stock for now.

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