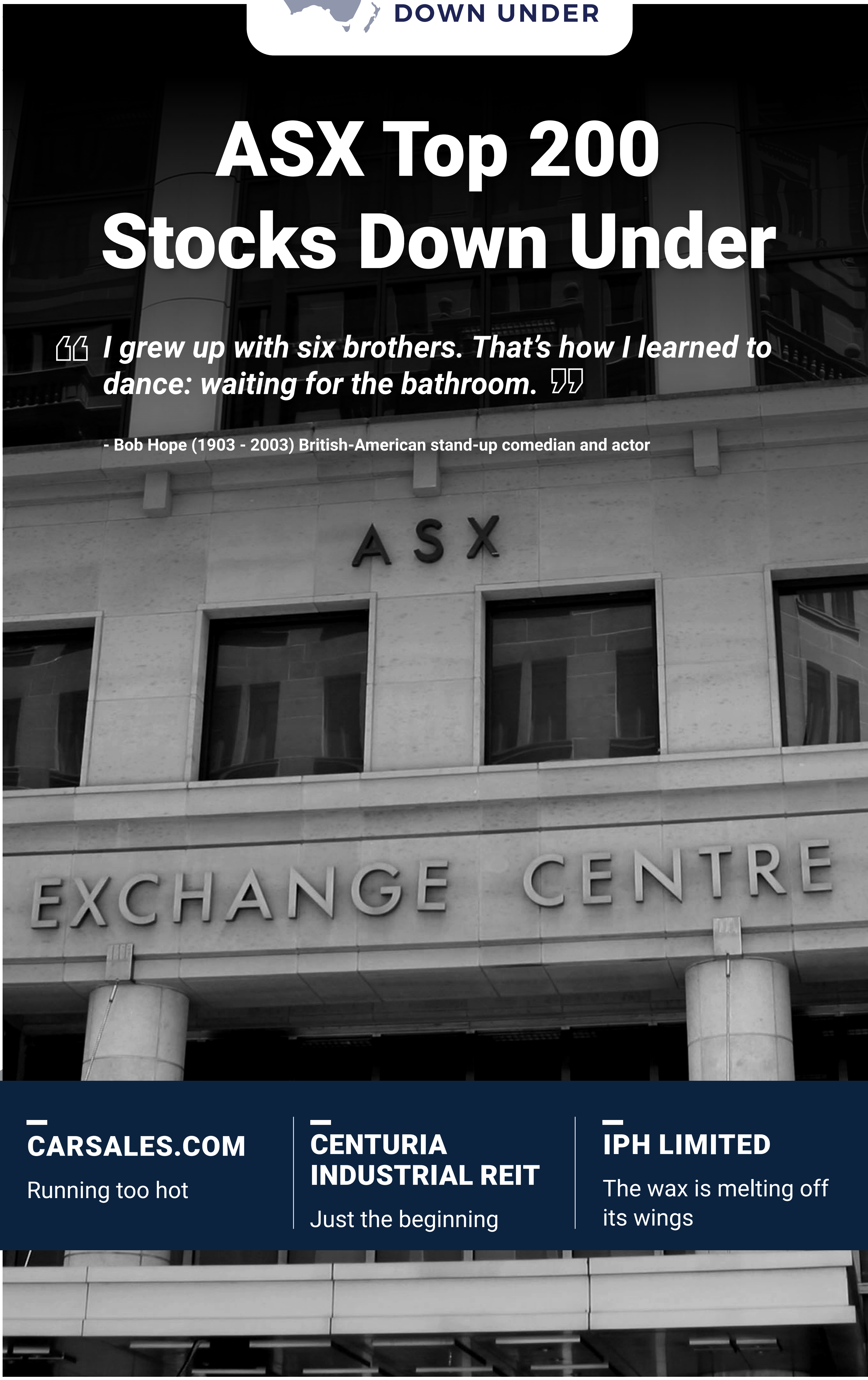
STOCKS DOWN UNDER

11 OCTOBER 2021

ASX Top 200 Stocks Down Under

> *I grew up with six brothers. That's how I learned to dance: waiting for the bathroom.*

- Bob Hope (1903 - 2003) British-American stand-up comedian and actor



CARSALES.COM
Running too hot

CENTURIA INDUSTRIAL REIT
Just the beginning

IPH LIMITED
The wax is melting off its wings

CARSALES.COM

Running too hot

Stocks Down Under rating: ★★

ASX: CAR
Market cap: A$6.9BN
Dividend yield: 1.9% (100% Franked)

52-week range: A$16.72 / A$26.67
Share price: A$24.89

We last wrote about Richmond, Victoria-based Carsales.com on 23 March 2020, right at the bottom of the Corona Crash, rating the stock two stars because we believed the company would not be able to turn itself around. Well, we were wrong with the stock rallying to about $22 in November last year before falling back to $17 in May 2021. More recently, the stock has had a spectacular run, rising to $26 on the back of what has been an equally impressive surge in new and used car sales around the world. That's right, Carsales.com is not only an Australian phenomenon. The company has operations across the Asia pacific region and has investments in other automotive classifieds in Brazil, South Korea, Malaysia, Indonesia, Thailand and Mexico. However, we believe the recent rally has caused this car sales platform to turn from a hot rod to a clunker, based on its current excessive valuation.

READ MORE

CENTURIA INDUSTRIAL REIT

Just the beginning

Stocks Down Under rating: ★★★★

ASX: CIP
Market cap: A$2.3BN
Dividend yield: 4.7% (0% Franked)

52-week range: A$2.91 / A$4.07
Share price: A$3.67

We last wrote about New South Wales-based Centuria Industrial REIT on 20 March 2020 when the stock was at $2.70, rating the company four stars after the COVID-19 market crash caused the stock to drop 27% off its all-time high of $3.79. We believed Australia's largest industrial property Real Estate Investment Trust's (REIT) selloff was completely unjustified due to the sector unlikely to be dealt real damage by COVID-19. And we were certainly right with the stock rallying above $4 last month. So, we do we think of CIP today, with New South Wales opening up and Victoria hopefully following soon?

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ASX: IPH
Market cap: A$1.9BN
Dividend yield: 3.4% (40% Franked)

52-week range: A$5.77 / A$9.50
Share price: A$8.94

When we last wrote about Sydney-based IPH Limited on 27 March 2020, we were extremely bullish on the company, believing the strong balance sheet increased the chances of further acquisitions, while the Trans-Pacific Partnership would allow the company to expand into new markets. It seems that we were right on the money with this one, as the stock has shot-up since the situation became clearer at the start of 2021. However, we believe the stock's rally has pushed the price too far and the current pullback has more to go.

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Share price chart

Source: Tradingview

Car sales and COVID-19, an unlikely pair

One of the big surprises that COVID-19 threw at us was how quickly the car market turned around. People around the world may have been restricted as to where they could drive for a large part of FY21, but that did not stop them from shopping for a car. While Carsales.com reported a 12% year-over-year decrease in the number of cars it has online, the rest of its metrics were way up. For example, the company reported a 17% increase in sessions to 1.1bn worldwide, a 28% improvement in how long it takes a car to sell, a 38% increase in cars inspected (280,000) and perhaps most telling, a tenfold increase in the total time spent on its sites. Clearly, COVID-19 made people long for the open road, or at least a vehicle that could get them there.

Solid growth, but no need for speed

FY21 saw solid growth for Carsales.com across its different divisions. Total adjusted revenue (excluding COVID-19 support rebates) saw growth of 5% year-over-year ($437.8m) at constant currencies and EBITDA growth of 10% ($254.2m). Remember, Carsales.com has operations in Korea, New Zealand, Brazil, Chile, Mexico, Argentina, the United States and Australia, so the company's results can fluctuate widely solely off the performance of certain currencies. Which is why we look at constant currencies when evaluating growth rates.

The largest contributor to EBITDA growth was online advertising, growing 9% to $183.3m in FY21. It is important to note that online advertising does not cover all advertising revenue, just that from Australia and the United States. Latin America and Asia are classified simply as Latin America and Asia, without being broken down further. The vast majority of revenue from the online advertising division is generated through dealers. In fact, if you remove the dealers and just account for the private and media advertising, the division would have seen a decline of 1.6% year-over-year.

The balance sheet is no longer held together by duct tape

When we last wrote about Carsales.com, the company's balance sheet was a mess on the back of declining sales and profitability. However, as of FY21, things have gotten a whole lot better. The company is currently fielding a total debt/EBITDA ratio of just 0.5x and has $102.2 in cash as of FY21. When you compare the total debt/EBITDA ratio to what it was during FY20 and FY19, 3.3x and 2.8x respectively, you can see what we mean by 'held together by duct tape'. However, we are happy to report that investors need no longer be concerned by CAR's solvency.

The car is fixed, but its value won't hold up

Yes, things are back on track and the new and used car market has some legs in it, but the company's EV/EBITDA valuation has shot up to 24.9x and 22.5x for FY22 and FY23, respectively. However, EBITDA growth is only expected to amount to 8.2% in FY22 and 11% in FY23. So, our beloved EV/EBITDA-to-EBITDA-growth metric is flashing dark red at respectively 3x and 2x for FY22 and FY23.

We are also concerned about some of Carsales.com's overseas investments, especially in Brazil. Many of the countries the company is active in are in COVID disaster mode with the longer-term damage to their economies yet to be determined. We believe this is likely to put a damper on car sales as their economies take a hit. While this doesn't mean we are bearish on the company's growth prospects, we believe the likelihood of positive earnings surprises is low, making the valuation seem even more stretched.

Management has done a fantastic job keeping this car on the road during COVID, but the market has stepped on the gas too hard for our liking. For now, this is a two-star stock in our blue book.

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Share price chart

Source: Tradingview

Industrial properties, well sung heroes of COVID-19

One of the major winners to come out of the economic challenges and drastic changes forced upon the world by COVID-19 was clearly the industrial property sector. According to a report released by the Reserve Bank of Australia entitled: Box B COVID-19 and Commercial Property in Australia, the pandemic was responsible for a shift towards online retailing, leading to significant demand for industrial properties, such as logistics and warehouse space. Many, including us at Stocks Down Under, consider this shift to be a permanent one. While this doesn't mean that brick-and-mortar retail is dead, far from it, we expect the demand for industrial properties to not only last beyond the pandemic, but we expect it will continue to expand.

Yep, it's all industrial

Centuria Industrial REIT is Australia's largest industrial property REIT, with a book value of $3bn as of FY21, across 62 properties. However, if you are thinking warehouses, that would be far too great a simplification. As of FY21, Centuria's properties include manufacturing (29%), distribution (29%), data centres (17%), transport logistics (16%) and cold storage (9%).

The REIT's total book value increased a whopping 83.8% to $3bn during FY21 on the back of the acquisition of 12 properties. Breaking down this significant jump in valuation we can see that it mostly followed from the net acquisition of 12 properties, valued at $966m, supplemented by a valuation increase of $587m. With an occupancy rate of 96.9% and a Weighted Average Lease Expiry (WALE) of 9.6 years, Centuria Industrial is in very good shape.

However, that was FY21. So far in FY22, management has moved to acquire eight additional assets as announced on 23 September 2021. The total cost of these acquisitions will be $351.3m, providing an estimated initial yield of 4.1% annually. The properties are currently at full occupancy and have a WALE of 3.8-years. This certainly a lot lower than Centuria's average WALE, but still respectable. However, the market reacted negatively to the news of the acquisition, because it was set to be funded by a $325m share issue. This caused the stock to drop from just over $4 per unit to its current price of $3.67 per share.

NTA is just part of the story

Centuria Industrial's Net Tangible Asset (NTA) value per unit currently comes out to $3.77. Based on the current share price of $3.67, this represents a discount of 2.7%. However, the stock usually trades at a premium for three main reasons. Firstly, its dividend. Centuria Industrial paid out $0.172 per unit during FY21, representing an indicative yield of 4.7%. While this is certainly not a top-of-the-line result, we would point out that the September 2021 distribution, the trust paid out $0.04325 per share. With operations in FY21 showing that things are looking up again for the trust, we believe FY22 will likely see an increase in dividend.

Based on an analysis of its WALE, occupancy rate, portfolio distribution, balance sheet and client base, Centuria Industrial is a high-quality REIT, in our view, fully deserving of a premium. While most REITs should be valued at or below their NTA, REITs with fundamentals similar to Centuria Industrial's typically trade at slight premiums of between 5% and 10%, without being considered overvalued.

Apart from the fact that we believe Centuria Industrial deserves a premium, we think this trust has something extra that must be considered. We believe the trust will likely continue to see significant increases in its NTA over FY22 through a combination of acquisitions and property valuation increases. And while certain areas of property have done poorly with the resurgence of COVID-19 in Australia, we believe industrial properties like the ones owned by Centuria Industrial are likely to see a renewed fire under the already red-hot rally. And no, we don't believe these properties are in bubble territory as there are significant long-term, non-COVID-19 related macro trends that will drive demand long after the virus is gone.

Therefore, we believe that the discount Centuria Industrial shares are currently offering is a rare opportunity. So, it's four stars from us … again.

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Share price chart

Source: Tradingview

Innovation runs on patents

Patents … we hear about them a lot. But what exactly is a patent? According to the Australian Federal Government, "a patent is a right that is granted for any device, substance, method or process that is new, inventive and useful". Additionally, "a patent is a legally enforceable right to commercially exploit the invention for the life of the patent".

In order to fully understand how important these 'rights' are too society, lets take a little step back in time to 1416's Venice. This is when the University of Southern California's Gould School of Law reports the first technological invention patent was granted to Ser Franciscus Petri of Rhodes. However, the first modern version of patent law is widely considered to be the Statute of Monopolies passed by the English Parliament in 1623. Monopoly is often considered a dirty word these days, but that is what a patent truly is when it comes down to it, i.e. a monopoly on who has the right of use for the patent's target for a set period of time. This right can be transferred, loaned, or even parcelled out.

For example, if Stocks Down Under were to invent a new form of report delivery and patented it in Australia, we would have the right to licence the use of the patent to Joe Smith's Analysis of Locksmithing periodical, but restrict the licence to use only in Queensland. That is the true value of patents. Not only do they allow for exclusive rights, but the ability to licence and loan some or all of those rights as the owner sees fit.   dependant

Heavily currency dependant

IPH operates in a staggering eight different Intellectual Property (IP) jurisdictions, covering over 25 countries through its seven brands. But what exactly does IPH do? Organisations and individuals hire IPH to ensure that the IP they create is granted adequate protections under the relevant country's law and jurisdictions. The two main ways to do this are through filing for trade markets and patents. And it just so happens that IPH is the largest patent group in Australia, New Zealand and Singapore, as well as the largest trade mark group in Australia and New Zealand. However, despite the company's large footprint in those countries, IPH's main focus during FY21 was growing its Chinese patent business (12.4% growth year-over-year).

While China carries a lot of risk right now, the government is pushing hard on technological innovation and we don't expect patent filing to face the wrath of President Xi Jinping, even if IPH is an Australian company. This is important, because the Asian division is far less mature than the Australasian one and it is where we expect management to focus its growth efforts going forward.

FY21's results were a lot more complicated than we had anticipated. Revenue declined across the board, declining 1% to $275.7m in Australasia and 6.4% to $96.1m in Asia. Like revenue, EBITDA also fell across both divisions, 2.4% in Australasia and 5.8% in Asia. This brought IPH's total revenue decline to 2% ($363.5m). However, due to significantly less overhead during FY21, EBITDA was flat at $113.3m.

Here is where the complications start: the decline in revenue and divisional EBITDA was mostly due to negative currency movements in FY21. If we were to look at EBITDA on a like-for-like basis, EBITDA would have increased 10% year-over-year on the back of increases in Australasian margins and organic growth in Asia. In our view, that makes FY21 a success. For a company like IPH, investors need to be aware that currency movements can ruin a reporting period's results. However, if we are looking long-term, we want to see through the currency movements and focus on underlying results.

Valuation got ahead of itself

IPH is clearly a monster when it comes to protecting organisations intellectual property in the Asia Pacific region. However, the market is expecting EBITDA growth to slow to 6.2% in FY22 and 5.1% in FY23. During 2021, the stock had a massive run and while it is currently slightly off its high, we believe IPH's valuation is far too high at 15.5x EV/EBITDA for FY22 and 14.7x for FY23.

Although IPH may make further acquisitions this year, judging by the company's autonomous growth rate, it's a two-star stock, in our view.

Pitt Street Research Pty Ltd

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