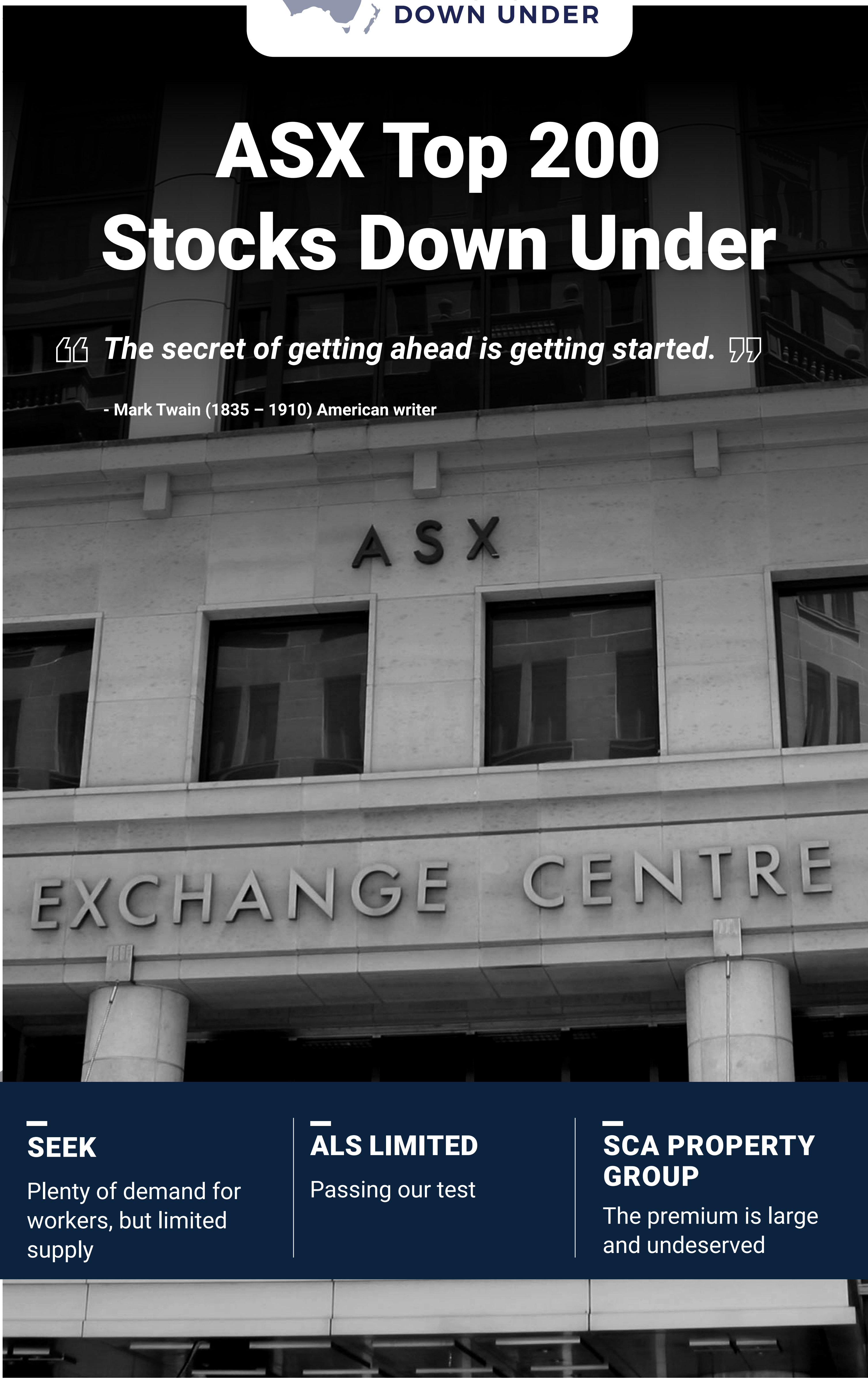
STOCKS DOWN UNDER

25 OCTOBER 2021



ASX Top 200 Stocks Down Under

"The secret of getting ahead is getting started."

- Mark Twain (1835 – 1910) American writer

SEEK

Plenty of demand for workers, but limited supply

ALS LIMITED

Passing our test

SCA PROPERTY GROUP

The premium is large and undeserved

SEEK

Plenty of demand for workers, but limited supply

Stocks Down Under rating: ★★

ASX: SEK
Market cap: A$11.6BN
Dividend yield: 0.6% (100% Franked)
52-week range: A$19.78 / A$34.15
Share price: A$33.11

Headquartered in Abbotsford, Victoria, Seek is a name many in Australia know. When looking for a job, many of us have used seek.com.au to find one. And if you run your own business, you will likely use seek.com.au to find the employees that you need. However, despite the extremely tight Australian labour market at the moment, we expect Seek will struggle to capitalise on it because there is simply not enough supply of workers thanks to the government's very strict lockdowns and travel policies in the last eighteen months. This has not only chased away skilled migrants back to their home countries, but it has also scared off potential new migrants. In other words, we believe Seek won't be able to help businesses fill their job openings.

READ MORE

ALS LIMITED

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Stocks Down Under rating: ★★★★

ASX: ALQ
Market cap: A$6.6BN
Dividend yield: 1.7% (70% Franked)
52-week range: A$9.13 / A$13.94
Share price: A$13.71

Brisbane-based ALS Limited has proven that testing is more than just a niche field. This $6.6bn giant provides lab testing, inspection, certification and verification solutions across 65 countries, earning $1.8bn in revenue in FY21. We last covered ALS on 28 August 2020, giving it a two-star rating. We didn't get this one right. The company's stock has had a massive run in the last year, jumping 54.6% from when we last wrote about it to Friday's close of $13.71. However, as the world seems to be finally figuring out how to live with the Delta strain, we believe this share price run was just testing the waters.

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Dividend yield: 4.4% (0% Franked)
52-week range: A$2.19 / A$2.87
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We last wrote about the Sydney-based SCA Property Group on 7 April 2020, when the stock was $2.36 per share, giving it a two star rating. We believed the market would not look kindly on this shopping centre Real Estate Investment Trust (REIT) and we were certainly right. The stock had a small rebound around June 2020, but quickly fell back to around $2.15, only recovering to just below $2.32 by the end of October 2020. We believe the delta variant in 2021 created many of the same risks around SCA Property's portfolio as the original COVID strain did the first time. But this time around the stock is trading at a premium, and therefore deserves two stars.

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Share price chart

Source: Tradingview

One of the few truly essential requirements of industry

No company can run without employees. And since Australia has been sealed off for a long time, the country currently has a massive shortage of workers. According to an AFR article on 6 April 2021, the number of jobs advertised in Australia has hit a 12-year high, 23% higher than before COVID-19. This follows closely with the Australian Bureau of Statistics, who recorded job vacancies at 26.8% higher levels than pre-COVID-19.

Many thought that the end of JobKeeper would force Australians into the workforce and that this would make it easier to find staff. However, despite the end of JobKeeper, employers are still having serious difficulties in finding the right people. For highly skilled industries, like finance, the situation is so bad that the CEO of the Australia & New Zealand Banking Group has requested Australian's email him directly if they are interested in working at the bank and have a financial services background. Unfortunately, even with international travel reopening, it seems this situation will continue to worsen until at least the middle of 2022It may only start to improve around the beginning of 2023, when migration patterns have hopefully started to revert back to normal.

FY21 deserves a second look

FY21's results were, in a word, lacklustre. During FY21, Seek generated revenues of $1.6bn and EBITDA of $473.6m. This represented only 1% revenue growth and 15% EBITDA growth year-on-year. However, we do need to remember that Australian businesses did not restart the hiring process in earnest until September 2020.

The second reason relates to the fact that Seek underwent a massive change during FY21 that saw its investments reduced and shifted. Therefore, the portion of revenue generated from these considerable investments was reduced. The end objective of this shift was to create a fund called the SEEK Growth Fund that would house and manage Seek's investments. As of the last update on 18 October 2021, the fund has raised $260m from investors on top of Seek's $200m capital injection. At the end of the deal, Seek expects to own 84.5% of the fund and we can expect a more comprehensive update on 17 November 2021 at the Annual General Meeting (AGM). It is important to note however, that this has been a highly publicised move that the market has been able to digest. We don't believe the AGM announcement will do anything to the stock price.

Plenty of demand, but limited supply

In the next twelve months we expect to see continued strong demand for additional workers in many industries. However, migration patterns have been in reverse in the last eighteen months, in large part due to Australia's very strict lockdown and travel policies. Many skilled migrants have left the country, or should we say fled? When it comes to travel and migration, we believe countries like Canada and the US have handled the pandemic much better than Australia, which now has a pretty bad reputation with potential skilled migrants looking to relocate from their home countries. We expect this will hinder Australia in bringing in the required numbers of workers in at least the next twelve months.

In other words, there is plenty of demand for skilled, and even unskilled workers, but Seek won't be able to capitalise on it because these workers are just not around in Australia at the moment. And people with a job are reluctant to move in the current environment as many suffer from so-called change fatigue.

So, despite the extremely tight labour market in Australia, consensus estimates see Seek's EBITDA decline 7.7% in FY22, followed by an EBITDA increase of only 14.4%, to $500m, in FY23. Looking at the FY22 and FY23 EV/EBITDA multiples of 28.6x and 25x, it seems Seek is pretty overvalued. So, two stars from us.

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Testing is for more than just STDs and COVID-19

If there is one thing that becomes blatantly obvious after a short look at ALS Limited, it's that testing is far more than just testing for STDs and COVID-19. ALS' offerings are massive and can be summed up into three main divisions, life sciences, commodities and industrials.

The life sciences division is responsible for providing testing products and analysing services, as well as remote monitoring for companies in the environmental, food, pharmaceutical and consumer product markets. Yes, this is the division responsible for COVID-19 testing, including the manufacturing of kits developed by the company through its team in Portugal. Even before the pandemic, life sciences was the largest driver of future earnings before interest taxes depreciation and amortisation (EBITDA) growth. We highlighted this division's growth as unlikely in our last report. Life sciences' saw a decline in revenue of 3.2% to $930m during FY21, generating $222.4m in EBITDA (0.2% decline). The discrepancy between EBITDA and revenue declines was due to cost saving measures put in place during FY21 as well as the company adjusting to COVID-19's circumstances. For those expecting COVID-19 testing to make up for any lost revenue, we highlighted in our last report this division was unlikely to be able to replace the lost revenue as companies contract their operations, due to the size of ALS' other operations. Additionally, we highlighted that this division was extremely susceptible to fluctuations in the Australian Dollar and we believed it was likely to suffer from this during FY21. It turned out this played a large part in the life sciences division's revenue and EBITDA decline. Fortunately, we don't foresee it playing as large a roll in FY22.

The commodities division provides full-service testing for the global mining industry with a focus on geochemistry, metallurgy, inspection and coal quality. As many of our avid Stocks Down Under readers will know, we are bullish on commodities, outside of iron ore. While we did not see any impact during 1Q21 when we first covered ALS, the rest of the year showed a significant impact. During FY21, the commodities division saw revenue decline 2.7% to $624.8m, but saw EBITDA increase 4.4% to $210.4m. The discrepancy here is due almost entirely to the company's continued cost cutting, as well as a strong recovery in 2H21. In fact, if FY21 had just included the second half, this division would have seen revenue growth as commodities activity sharply increased. However, this division is exposed to Australia-China coal and we believe that will likely put a slight damper on FY22's growth.

Lastly, the industrials division provides diagnostic testing and engineering solutions for the energy, resources, transportation and infrastructure sectors. The company has warned that this division has relevant exposure to the United States oil and natural gas exploration industry, which continues to be under significant pressure as the price of oil continues to remain volatile. We are bullish about this division, however, for the exact same reason we were bearish last time. As COVID-19 affected the global economy, companies deferred business with ALS' asset care department, the largest driver of organic revenue growth in the industrial division. We believe this division will experience ongoing order growth, regardless of the Delta strain.

You can pick up ALS at a discount

We got this one wrong last year by underestimating how strong the future recovery would likely be. Yes, we got a lot right about FY21's performance, but the market was already looking well past that, to FY22. The market is expecting 21% EBITDA growth during FY22 and we believe this is a reasonable expectation and yet, the stock is currently only trading at an FY22 EV/EBITDA ratio of 14.4x. While not a screaming buy, it still means an investor can pick up ALS at, what we consider, a discount. Additionally, just recently the stock broke out of a 4-month trading range of $12 to $13. So, four stars from us.

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Share price chart

Source: Tradingview

Shop and don't worry about the risk of a drop

The delta variant of COVID-19 completely changed the game for Australia's COVID-19 strategy. It smashed the government's early success at achieving zero cases. The incredibly virulent Delta strain has led to lengthy lockdowns in 2021 and strictness surpassing the original lockdown of early 2020. While this may be par for the course for the rest of the world, Australian businesses have certainly not adapted to harsh COVID-19 restrictions and lockdowns, with the arguable exception of Melbourne-based ones.

However, the fight for vaccine adoption has fortunately been successful with the country passing 70% of the population having received both doses of the vaccine as of 21 October 2021. Australia finally seems to once again have COVID under control. With reopening underway across the country, we at Stocks Down Under believe all kinds of traffic will increase sharply, and retail will finally get the break is has needed for so long.

Portfolio occupancy fighting WALE for the spotlight

The SCA Property Group owns 80 neighbourhood, 11 sub-regional and one freestanding shopping centres. Your first thought on this might be that SCA's occupancy rate must have taken a hit, but the truth is, when you compare it to the previous four years, FY21's occupancy rate is only approximately 1%-point lower than it was in June 2020, 2019, 2018 and 2017. Making matters more impressive, 60.2% of the Real Estate Investment Trust (REIT) leases by gross rent expire after FY25.

So, how did SCA manage to maintain such impressive statistics? Clearly the REIT has premium locations, the focus on neighbourhood shopping centres likely helped maintain traffic where lockdowns would have otherwise hurt. The other thing is the trust's diversification. New South Wales accounts for the largest percentage of properties, but it's still only 31% of the total. Queensland has 24%, Victoria 17%, Western Australia 12%, Tasmania 10%, South Australia 5% and the Northern Territory has 1% of the portfolio's value.

We believe the combination of geographic diversification and focus on neighbourhood shopping is what allowed the trust's occupancy rate to remain so high. Sure, there was certainly a drop in cash collection as a percentage of gross invoiced rent, but it really is no cause for concern when you factor in collections relating to previous months. Over the last six months, the average collected for the current month was 87%, but if you include collections from previous months, that average increases to slightly over 100% of rent due for that month. It seems SCA's properties are mostly back on track.

An undeserved premium

SCA's Net Tangible Assets per unit was $2.52 per unit per the end of FY21. This implies the trust is currently trading at a premium of 12.7% and even when we factor in the strong recovery of SCA's properties as well as management's announcement that the dividend will likely be $0.075 per unit for FY22, we don't believe this premium is deserved.

SCA is still heavily exposed to retail, and it's unclear how strongly retail in general will come back. Remember, as the country reopens, whatever government support is currently left will go away. We don't think this means SCA is at risk of any major issues with its portfolio, but we do believe it means the trust does not deserve to trade at such a significant premium. Two stars.

Pitt Street Research Pty Ltd

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Pitt Street Research Pty Ltd provides issuer-sponsored research for Small & Mid Cap companies and is founded on more than 40 years of combined experience researching companies in a range of different sectors.

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