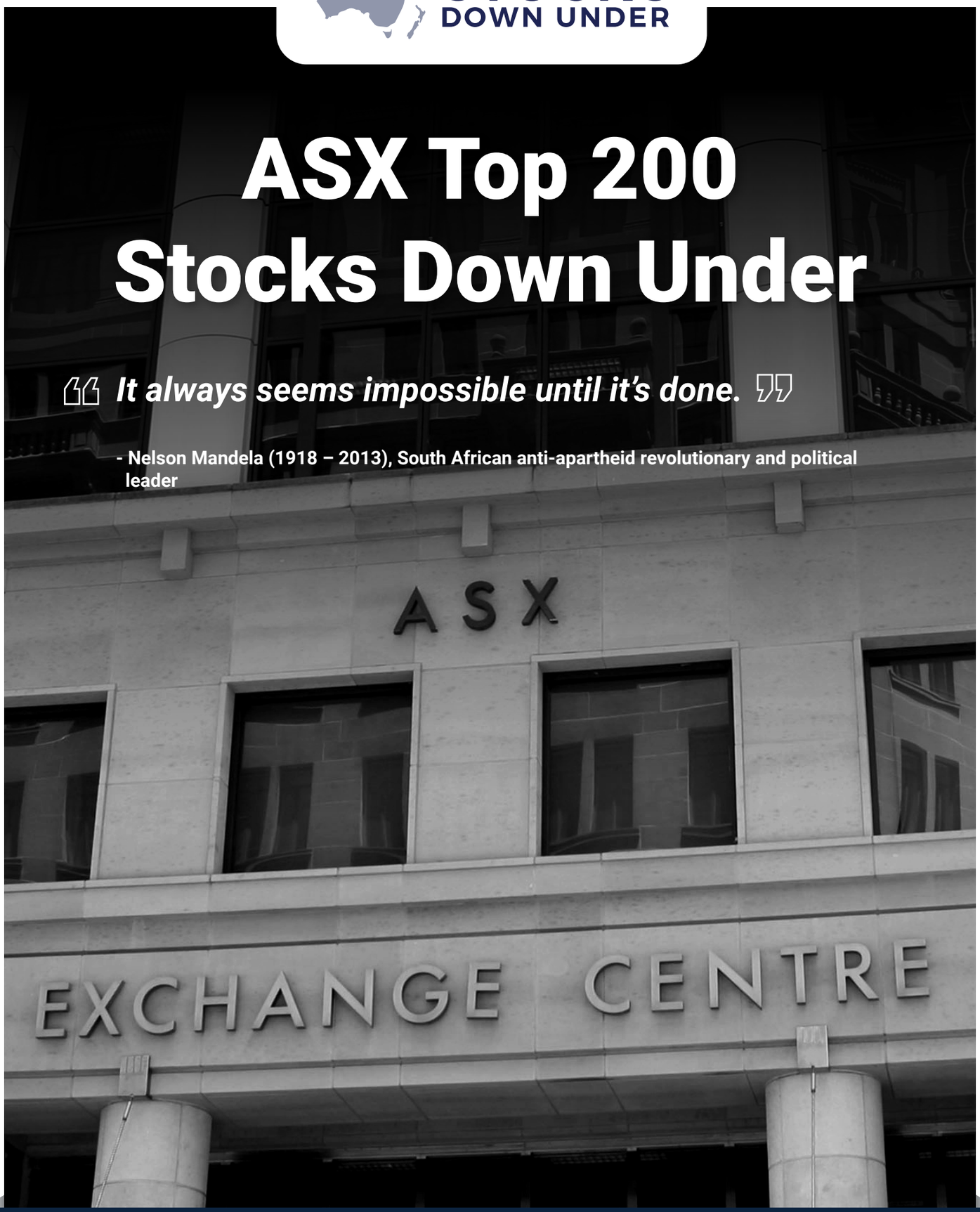
STOCKS DOWN UNDER

8 NOVEMBER 2021

ASX Top 200 Stocks Down Under

> *It always seems impossible until it's done.*
>
> - Nelson Mandela (1918 – 2013), South African anti-apartheid revolutionary and political leader



BHP GROUP

Good times coming…at least in 2027

STOCKLAND

Put this one on your watchlist

TYRO PAYMENTS

All this growth is priced in

BHP GROUP

Good times coming...at least in 2027

Stocks Down Under rating: ★★

ASX: BHP
Market cap: A$106BN
Dividend yield: 11.2% (100% Franked)

52-week range: A$33.88/A$54.55
Share price: A$36.09

When we last wrote about BHP Group on 17 May 2021 the stock was just under $50 and we thought that was too high. We called it two stars. BHP has since trended in the direction we thought it would go. The outlook for most commodities is particularly bright right now, but we're staying at two stars. The trouble with BHP is that it remains too reliant on iron ore.

READ MORE

STOCKLAND

Put this one on your watchlist

Stocks Down Under rating: ★★★

ASX: SGP
Market cap: A$11.1BN
Dividend yield: 5.3% (0% Franked)

52-week range: A$4.07 / A$4.93
Share price: A$4.65

We last reported on Sydney-based diversified property trust Stockland in 24 April 2020's edition of Stocks Down Under. At the time, Stockland was valued at $2.63 per share when we issued our two-star rating. However, Stockland has done well for shareholders since then and saw its Net Tangible Asset value per security increase 5.3% during FY21. The company has a massive development pipeline, but we believe the 14.4% premium to its NTA requires caution.

READ MORE

TYRO PAYMENTS

All this growth is priced in

Stocks Down Under rating: ★★★

ASX: TYR
Market cap: A$1.7BN

52-week range: A$2.31 / A$4.39
Share price: A$3.28

We last wrote about Sydney-based Tyro Payments on 17 April 2020, a time that was far from easy to be in the Point-of-Sales (PoS) business. Unfortunately, we underestimated the how quickly retail would bounce back from COVID. Combined with Tyro's impressive adaptability, the stock rather quickly shoved our two-star rating back in our face. By the beginning of June 2020, Tyro was trading back near its pre-COVID-19 levels at $4.26 per share. However, the market has since turned on the stock due to the operational update at the AGM, but we don't think this makes the stock a steal just yet.

READ MORE

BHP GROUP

Good times coming…at least in 2027

Stocks Down Under rating: ★★

ASX: BHP
Market cap: A$106BN
Dividend yield: 11.2% (100% Franked)

52-week range: A$36.09
Share price: A$33.88 / A$54.55

When we last wrote about BHP Group on 17 May 2021 the stock was just under $50 and we thought that was too high. We called it two stars. BHP has since trended in the direction we thought it would go. The outlook for most commodities is particularly bright right now, but we're staying at two stars. The trouble with BHP is that it remains too reliant on iron ore.

Share price chart

Source: Tradingview

If you look at the consensus numbers, the outlook isn't bright for BHP in terms of earnings growth. For FY22 EBITDA drops 30%. Then in FY23 it drops another 7% and in FY24 by another 6%. Why the big drop this year? Blame iron ore. BHP is the world's lowest cost iron ore producer, with its Western Australian iron ore operations shipping at just around US$15 a tonne. Not bad when 63.5% Fe iron ore was landing in China at US$230 a tonne back in May. On BHP's own FY22 guidance, every US$1 per tonne move in the ore price adds or subtracts in excess of US$200m to the EBITDA line. No other factor has anywhere near that punch in terms of its potential to help or hurt BHP's bottom line. So, until iron ore finds the right level, BHP remains a dangerous stock to hold, in our view.

A cash machine

Now, don't get us wrong. There's a lot to like about BHP. If there's one thing this company has become in recent years, it's a cash machine. In FY21 it generated over US$27bn in operating cash flow, which is about as big as the GDP of Jamaica. Of that US$27bn, it took only US$2.3bn to maintain BHP's disparate collection of mines in good working order. It took another US$5bn in dividends to maintain the minimum 50% payout ratio. From what was left it only needed U$5.3bn to fund all of BHP's major growth projects, so it could use US$9.4bn to pay down debt and then give the shareholders another US$2.9bn in additional dividends. After all that, BHP ended the year with only US$4.1bn in net debt, which could be rubbed out on FY21's numbers in less than eight weeks.

Now balance that cash machine against what you currently pay to get hold of BHP. One could argue that the EV/EBITDA multiple of just 3.9x FY22 consensus makes BHP a bargain. That's low for a company that, over the seven-to-ten-year commodity cycle, will continue to grow as it reinvests some of that cash. Basically, BHP is starting to look attractive if you're a bargain hunter with some patience.

Hail to the new Potash Kings

The other thing to like about BHP is its push into commodities that are going to be important in the decarbonised economy we seem to be inexorably moving into. BHP wants to get more nickel and copper mines in its portfolio. It's now laying down its chips on the massive Jansen Potash Project in Saskatchewan. And it's beginning to move towards the exits on coal. This shift not only puts BHP ahead of the curve, it's likely to be beneficial in terms of commodity prices as well.

The shift, however, is going to be gradual. For example, Bloomberg recently reported that BHP may be considering halting its sale of its Mt Arthur Coal Mine near Muswellbrook in the Hunter Valley of NSW. BHP isn't saying one way or the other, but what this illustrates is that BHP isn't necessarily getting out of coal ASAP.

The decision back in August to green-light Stage 1 of Jansen, with its 4.35 million tonnes of potash a year, illustrates the significant upside BHP of the Mike Henry era can achieve without breaking the bank. It's a big-ticket investment of US$5.7bn, which, as we saw above, is easily accommodated by BHP's cash flow. It's a long-life asset that will still likely be producing potash a century from now. It benefits from a rising need for potash in a world that has many new mouths to feed every year. But – and this is a big 'but' – the first ore doesn't get processed at Jansen until 2027. That's right, there's a good six years of construction still to come before the shareholders can think about the beginnings of a return on their investment. And it will take two years after that before Jansen Stage 1 will hit its production targets.

Too much red dust in this one

The other thing that is taking the shine off BHP right now is the fact that it no longer intends to be in oil and gas. The company announced in August that it would vend its oil and gas business into Woodside Petroleum (ASX: WPL) to create what will become a top 10 global energy company. Right at the time when iron ore is cooling off BHP is choosing to get out of a business where oil is headed up, possibly to US$100 a barrel before too much longer. And it's not just the near-term upside that BHP will be missing. The world will still need a heck of a lot of oil over the next couple of decades before the renewables take over and BHP has been in the game since the 1960s, so it knows a thing or two about oil.

But to return to the core problem for BHP investors right now. This stock is still too leveraged to the iron ore price. If iron ore drops back to something like US$60 a tonne by 2023, BHP stock is going to hurt, even if the company is working to create shareholder value across all its current and future assets and even if nickel and copper prices balance things out. We think BHP is starting to drop into the value range once again, but for the time being, it remains two stars.

STOCKLAND

Put this one on your watchlist

Stocks Down Under rating: ★★★

ASX: SGP
Market cap: A$11.1BN
Dividend yield: 5.3% (0% Franked)

52-week range: A$4.07 / A$4.93
Share price: A$4.65

We last reported on Sydney-based diversified property trust Stockland in 24 April 2020's edition of Stocks Down Under. At the time, Stockland was valued at $2.63 per share when we issued our two-star rating. However, Stockland has done well for shareholders since then and saw its Net Tangible Asset value per security increase 5.3% during FY21. The company has a massive development pipeline, but we believe the 14.4% premium to its NTA requires caution.

Share price chart

Source: Tradingview

Come with me for a trip in my time machine

We last reported on Stockland on 24 April 2020, putting a two-star rating on the stock. This turned out to be an incorrect rating, that was spurred by concerns over the retail portion of the portfolio when COVID hit. Yes, Stockland was diversified at the time of the report, but we chose to focus on the retail portfolio as the retail town centres comprised 43% of the portfolio's total value. We believed it was highly likely these centres' fundamentals had fallen off a cliff. Stockland's 3Q20 operational update published 13 May 2020 confirmed this was the case as foot traffic had fallen 40% during April and only 60% (by rental income) of its stores were trading between March and April.

However, as we now know, that was the worst of the damage as the Australian Government was quick to respond and by the time 3Q20's update was published, 75% (by rental income) of its store were trading again. Yes, we were correct regarding the retail portfolio fundamentals at the time of the report, but we strongly underestimated the impact of government assistance and how quickly the situation would improve.

Stockland was already in the process of slowly reducing its portfolio's exposure to retail properties before COVID-19, announcing that it planned to reduce its weighting to less than 40% over the next five years. As shown in Stockland's FY21 property portfolio report, COVID-19 significantly reduced this timetable. During FY21, Stockland saw a net reduction of five properties in its retail portfolio, bringing its current total to 25, valued at $5.5bn.

By the end of June 2021, foot traffic was just slightly lower than pre-COVID-19. While the Delta lockdowns smashed hopes of a return to pre-COVID-19 numbers in the July-September 2021 timeframe, we don't believe the impact will have been even close to the first lockdown in 2020, although we believe the recovery will probably be very quick.

Management plans to continue selling off properties in its retail portfolio. Still, with 75% of its tenant sales being classified as 'essential goods and services' as of 30 June 2021, occupancy at 99.1%, a Weighted Average Lease Expiry (WALE) of 5.3 years (down from 5.7 years FY20) and tenant retention increasing to 67% during FY21 (61% FY20), we are confident shareholders need not expect any major issues from the retail portfolio.

Buying up stock in Stockland

Recently, two directors have each purchased shares in Stockland: Adam Tindall and Kathryn McKenzie. These on-market purchases occurred on 26 August 2021 (Tindall) and 30 August 2021 (McKenzie), six and ten days after Stockland announced its FY21 results to the market. While two directors making a single block purchase would not normally warrant a mention, we believe the size and price of the transactions is relevant.

Adam Tindall was appointed to the Board on 1 July 2021 with no reported holdings in Stockland. We believe his willingness to put $185,560 of his own money where his seat is at $4.639 per share, is a strong sign of support. Mr. Tindall is not currently on the Board of any other listed company.

Kathryn McKenzie has been a director since 2 December 2019 and on 30 August 2021 doubled her shareholdings in Stockland from 20,000 shares to 40,000 shares. This on-market purchase cost $91,960 ($4.598 per share), bringing her total investment to $183,920. Ms. McKenzie is also on the Board of AMP (ASX: AMP | see 15 February 2021 report) and Healius (ASX: HLS | see 30 November 2020 report). Stockland is her largest investment in any of these three companies.

Put this one on your watchlist!

As of FY21, Stockland's Net Tangible Assets (NTA) per security has increased 5.3% to $3.98. And yet, Stockland is not even close to satisfied looking at the company's rather sizable pipeline of development across the majority of its property types. Logistics, life sciences and technology have a development pipeline worth an estimated $5.5bn, workplace $3.9bn, residential $22bn and land lease $3bn.

We believe this pipeline, coupled with an expected increase in the value of its property during FY22 and its indicative dividend of 5.5%, are why Stockland is currently trading at a 14.4% premium to its NTA.

However, with interest rates beginning to go up for the first time in over a decade, we are less confident about this premium than we normally would be and therefore, are advising caution. Three stars for now.

Having said that, the stock has roughly been trading in a range of $4.30 to $4.85 since early April 2021. With the stock currently heading down towards the lower end of that range, you're probably getting a good deal if you can pick up some shares around the $4.30 level. So, put this one on your watchlist!

TYRO PAYMENTS

All this growth is priced in

Stocks Down Under rating: ★★★

ASX: TYR
Market cap: A$1.7BN

52-week range: A$2.31 / A$4.39
Share price: A$3.28

We last wrote about Sydney-based Tyro Payments on 17 April 2020, a time that was far from easy to be in the Point-of-Sales (PoS) business. Unfortunately, we underestimated the how quickly retail would bounce back from COVID. Combined with Tyro's impressive adaptability, the stock rather quickly shoved our two-star rating back in our face. By the beginning of June 2020, Tyro was trading back near its pre-COVID-19 levels at $4.26 per share. However, the market has since turned on the stock due to the operational update at the AGM, but we don't think this makes the stock a steal just yet.

Share price chart

Source: Tradingview

Dissecting and learning from our mistakes

When we last reported on Tyro Payments, COVID-19 was just starting. We were bullish on the long-term potential of Tyro but concerned that COVID-19 was going to crush its business for the foreseeable future. So, let's review what we liked so much about Tyro.

The Tyro platform has several significant competitive advantages. The company has that all-important first mover advantage as it was the first, original EFTPOS business in Australia, launching in 1996. This allowed Tyro to quickly gain direct access to the Australian financial system. To this day, the company has a plethora of licenses and connections that we believe grant the company greater power in negotiations than many of its competitors.

Through a combination of its technology and negotiating power, Tyro has managed to maintain some of the lowest transaction fees in the business. This helped the company increase its transaction value sharply during FY21, by 26.4% to $25.5bn, despite the problems of COVID-19. It seems merchants were trying to save as much money as possible, with Tyro expanding its client base to 58,186, an 81% increase year-over-year. This is what helped drive revenue growth of 13.7% year-over-year to $230.2m.

In what was likely a logical expansion from process payments, Tyro also offers banking services to its merchant base in the form of bank accounts and business loans. During FY21, the bank had 4,603 active accounts with $72.5m (45.9% increase year-over-year) in deposits on the balance sheet. We believe the growth in deposits was mostly due to Tyro's success at converting its merchant clients, because the average account balance only increased 14.1% to $15,750 during FY21. The one area of Tyro banking that did not see growth was its loan operation. During FY21, loan originations declined 57% to $25.8m. Interestingly though, the average loan size increased 10.2% to $35,500, while the average duration increased 0.9 months to 6.6.

However, we don't believe this is a sign of the loan operation going into structural decline. You see, Tyro suspended auto approval of its loans from 1 July 2020 to 31 January 2021 as a cautionary measure. This was the reason loan originations declined so rapidly during FY21 and we expect a sharp rebound in FY22.

Despite the decline in loan originations, Tyro's banking operation had a strong FY21 thanks to its core banking division, with income increasing 77.2% to $3.2m and gross profit margins increasing 16.6%-points to 88.2%. While this division is still extremely small compared to payments, we believe Tyro's success in cross selling to its merchant clients means the banking division will likely become more financially relevant over the next few years.

Lawsuit adds risk

All of this sounds fantastic, but there is an element of risk facing Tyro right now. Early in 2021, the company experienced a protracted period of downtime where its merchant clients could not use any of its services. This has led to a class action suit being filed and it is unclear as to what level of damages Tyro could be on the hook for. Additionally, the negative press surrounding this class action as it moves forward has the potential to cause increased volatility in Tyro's stock.

However, countering this is the 'great reopening' of most of Australia. New South Wales just moved up the easing of restrictions from 1 December to 8 November 2021 (with some adjustments) and Victoria is re-emerging as well. A payments processor like Tyro should benefit tremendously from the reopening of Australia's two largest states. Still, it is important to note that gross profit only increased 14% year-over-year during the first two months of FY22, this, combined with a lack of FY22 guidance, caused the market to panic and sell down 15% on 3 November 2021.

Following a COVID recovery year in FY22, the market is expecting EBITDA growth of 47.9%, to $38m, in FY23 and 36.8% growth, to $52m, during FY24, which is solid growth. However, Tyro is trading at EV/EBITDA multiples for these two financial years of 45.1x and 32.5x, respectively. So, the market has essentially priced in all this growth already and we think Tyro is fairly valued at this time. So, it's three stars from us.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

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.

You are receiving this email because you subscribed to our Stocks Down Under newsletter.

Stocks Down Under (Pitt Street Research AFSL 1265112) provides actionable investment ideas on ASX-listed stocks. The Content has been prepared for general information purposes only and is not (and cannot be construed or relied upon as) personal advice nor as an offer to buy/sell/subscribe to any of the financial products mentioned herein. No investment objectives, financial circumstances or needs of any individual have been taken into consideration in the preparation of the Content. Financial products are complex, entail risk of loss, may rise and fall, and are impacted by a range of market and economic factors, and you should always obtain professional advice to ensure trading or investing in such products is suitable for your circumstances, and ensure you obtain, read and understand any applicable offer document.