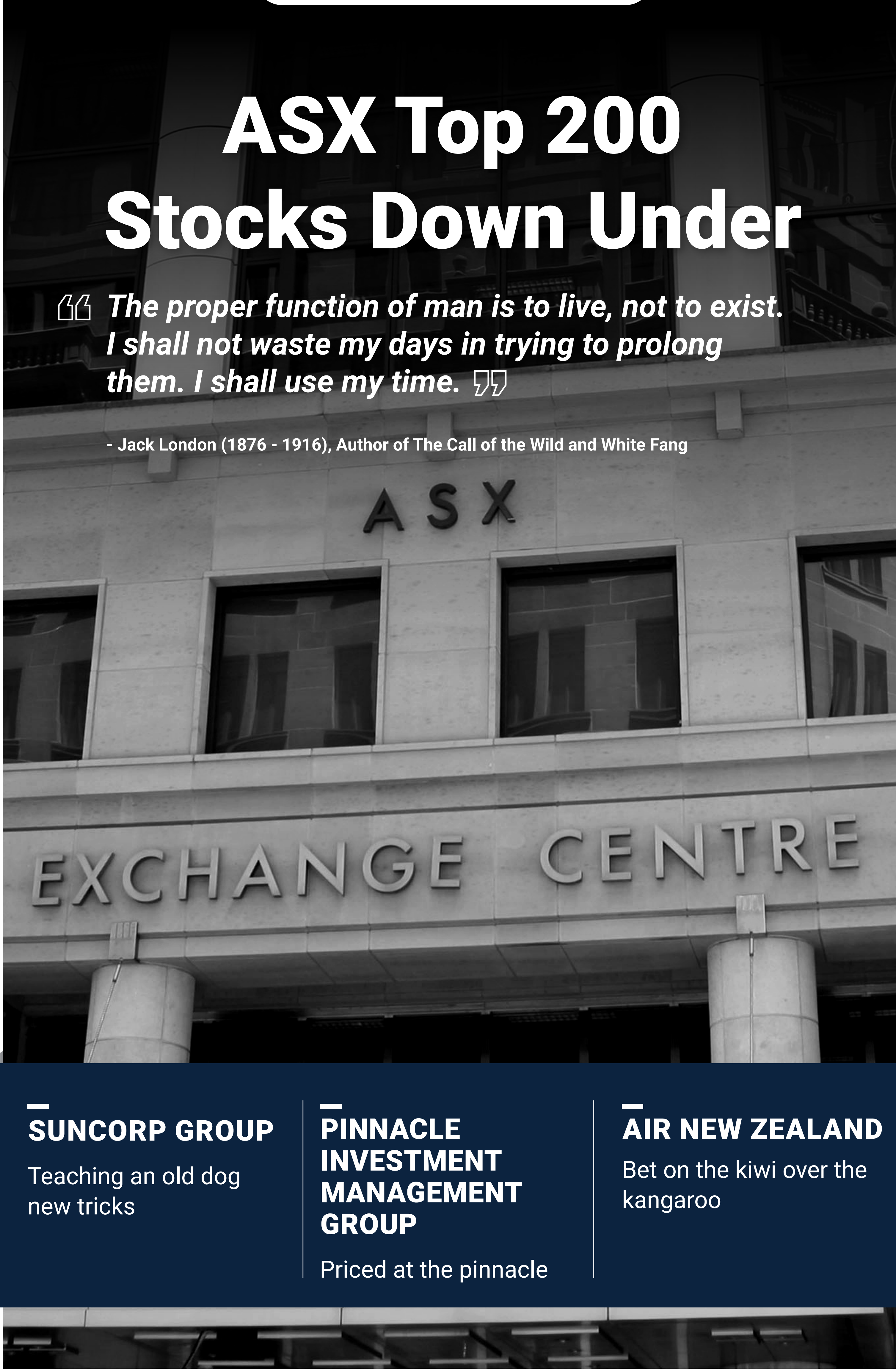
STOCKS DOWN UNDER

10 JANUARY 2022

ASX Top 200 Stocks Down Under

"The proper function of man is to live, not to exist. I shall not waste my days in trying to prolong them. I shall use my time."

- Jack London (1876 - 1916), Author of The Call of the Wild and White Fang



SUNCORP GROUP

Teaching an old dog new tricks

PINNACLE INVESTMENT MANAGEMENT GROUP

Priced at the pinnacle

AIR NEW ZEALAND

Bet on the kiwi over the kangaroo

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Stocks Down Under rating: ★★★★

ASX: SUN
Market cap: A$14.3BN
Dividend yield: 6.5% (100% Franked)

52-week range: A$9.67 / A$13.25
Share price: A$11.60

When we last covered Brisbane-based Suncorp Group on 16 April 2020, the company was valued at just shy of $12bn after a massive decline in the stock price. However, we believed management's digital strategy and renewed focus on its roots would lead to a strong reversal to the upside, forming the basis of our four-star rating. Suncorp is now valued at over $14bn, and we still believe this company has a few tricks left up its sleeve that deserves a continuation of our four-star rating.

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ASX: PNI
Market cap: A$2.7BN
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52-week range: A$6.80 / A$19.29
Share price: A$13.52

When we last covered the Sydney-based Pinnacle Investment Management Group on 25 May 2020, we rated it as the best-run financial management firm on the ASX. However, with a market cap of over $750m at the time, we thought the firm was a bit too pricey for its financial performance. Management is still as capable now as they were back then, and the firm's track record has only gotten better. However, the company now has a market cap of almost $3bn, and no matter how strong the management team is, we can't recommend Pinnacle at this price.

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Share price chart

Source: Tradingview

What's past is prologue

Slightly over 400 years ago, William Shakespeare wrote down the now-famous words, "What's past is prologue". Like so many of Shakespeare's quotes, it applies to much more than the Tempest for which the words were written. When we last wrote about Suncorp, the company was moving full steam ahead on a massive overhaul of its operations. Management took a look at the entire business and focused on its corporate oversight and core operations.

It might seem like ancient history, but the findings from the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services industry's final report were only released two years ago, in February 2019. Due to the massive amount of corruption, incompetence and just plain old fashioned bad faith uncovered by the Royal Commission, real changes in the industry only began to roll out towards the end of 2019. While some organisations continue to have trouble with the regulators (e.g. Westpac, ASX: WBC | see 28 June 2021 report), we believe Suncorp has taken real steps to improve, and we are still mostly positive on the company's operations. Still, there are some warning flags we will be going over in more detail later in this article.

Rewinding the tape to when we published on Suncorp in April 2020, we believed it was likely that the company would exit the wealth management business due to Suncorp's renewed focus on insurance. Well, it took just slightly over a year, but as of 28 April 2021, Suncorp announced it had agreed with LGIAsuper to sell its Australia Wealth division (Suncorp Portfolio Services) for $45m. Yes, LGIAsuper is the correct spelling. Suncorp management expects approximately $14m in annualised stranded costs from wealth management will be on the books until the end of FY23. However, due to LGIAsuper agreeing to distribute Suncorp superannuation products to Suncorp customers for 18-months after the sale, these stranded costs are expected to be offset in FY22 and FY23. It is important to note, that the transition has not yet received regulatory approval and isn't expected to be completed in FY22. However, we don't expect any regulatory pushback as the government has looked fondly on this type of consolidation in the past.

The great digital expansion

In FY21, Suncorp generated $1bn in Net Profit After Tax (NPAT), a 13% increase year-over-year that allowed the company to announced a $250m on-market buyback plan. The largest source of profit in FY21 came from the company's Australian insurance division at 47%, primarily due to the company simplifying the business and cutting expenses. For example, in February 2019, the company sold the life insurance part of the division. Additionally, as of 1 December 2021, the company sold its 50% interest in its joint venture with the Royal Automobile Club of Tasmania to provide home and motor insurance in the state for $83.8m. The refocus on core offerings, combined with a much more stable operating environment than FY20, allowed this division to increase its NPAT 42.4% year-over-year. We expect this division to continue to be both the largest source of growth and profit in the future, especially when we consider that part of the turnaround process involves some temporary spending increases.

Generating 36% of FY21's NPAT, the banking and wealth division is also undergoing significant changes, as we briefly mentioned above. This division did increase its Net Interest Margin by 13 basis points in FY21, to 2.07%, but the vast majority of the 69% increase in divisional NPAT was due to a reduction in impairments. We believe the home loan portion of this division will remain important going forward, but Suncorp is well and truly shifting towards the insurance divisions, not banking.

The Suncorp New Zealand division generated 17% of Suncorp's NPAT in FY21, as the division's NPAT declined 18.4% due to increased natural hazard costs and lower investment income. Unfortunately, we believe management's focus is mainly on the Australian side of the business and feel a degree of caution is warranted for this division's FY22 performance.

Yellow card play is under review

Before we dive into Suncorp's valuation, we do need to highlight a paragraph in the company's FY21 report which suggested that, *"the administration by ASIC of the newly commenced unfair contract terms legislation which extends the application to insurance contracts"* was an issue that "may impact Suncorp Group". In plain English, Suncorp needs to watch out that it hasn't written insurance contracts whose provisions would look bad if those contracts made the front page of the newspapers. We assume its compliance people are on the case.

Which brings us to what Suncorp is worth. The current market consensus has Suncorp generating GAAP Earnings Per Share (EPS) growth at 23.9% in FY23, resulting in an FY23 P/E multiple of 13.6x, with an indicative (fully franked) dividend yield of 6.5%. There may be upside risk to the consensus because, on 15 December 2021, S&P Global Ratings announced it was updating the credit rating of Suncorp's operating entities to AA- with a stable outlook from A+. This might seem like a small move, but it can impact Suncorp's future funding costs in a positive way.

Okay, there is certainly regulatory risk in the insurance sector going forward, but as far as we can tell Suncorp has, over the last few years, been (relatively speaking), one of the good apples. Therefore, we believe the discount in valuation and sizable dividend more than make up for any additional risk, four stars.

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Share price chart

Source: Tradingview

Fund of funds

Pinnacle's business model is simplicity itself: all it does is invest in a wide range of investment management firms and takes a share of those firm's profits. All in all, the company has a stake in over 40 funds that are well-diversified across various asset classes.

While the number of funds may seem too high, the number of fund managers that the company is affiliated with is only 17. For example, six of those funds are managed by Resolution Capital, all differing in the investment strategies used. This way, the company can achieve diversification without investing in a proportional number of fund managers.

When we last covered Pinnacle in May 2020, we claimed that Pinnacle was the best investment management company currently on the ASX. Considering the company's share performance since then, it seems that we were right.

Despite the equities market downturn that resulted from COVID-19, the company managed to declare a net profit of over $32m in FY20, up from $30.5m the year prior. In FY21, the ASX 200 rose by over 21%, and the company capitalised on it to report a profit of $67m.

On the back of improving market conditions, the company announced a share buyback plan for 300,000 of its employee-owned shares in December 2020. As for the portfolio of funds, it is still largely the same, with Pinnacle not making any major acquisitions since December 2019 when it acquired the Sydney-based investment management firm Coolabah. It has, however, made some smaller investments, such as $65m in private equity firm Five V Capital. The 25% investment included an additional $10m contingent on a successful second fund raising.

Capitalising on the boom

Pinnacle's amazing performance in FY21 cannot be entirely attributed to shrewd decisions made during the year, as the results largely came about from stock market performance after COVID-19. Over 60% of the fund's assets are invested in equities, with Australian equities forming over two-thirds of that figure.

However, it is important to remember that the positive results came about due to investment decisions made in the past. With almost all of the company's affiliates performing exceptionally well during the year, the total Funds Under Management (FUM) at the end of August 2021 was over $91bn, compared to $61bn when we last covered the company. By 31 October 2021, FUM had declined to $90.9bn due to the outflow of Omega passive 'Smart Beta Plus' investments.

Omega what? No, Omega is not a new COVID strain you haven't heard about yet. Smart Beta investing is basically where you do passive investing via an index, but you construct your own index. Omega Global Investors was one of Pinnacle's funds and one of its specialties was Smart Beta.

Excluding that Omega outflow, Pinnacle actually had $2.6bn in net inflows, of which $2bn was retail, between August and October. And the Omega outflow was far from a surprise, as management had disclosed in the FY21 annual report that Omega was being integrated into another Pinnacle affiliate called Plato.

As of August, none of Pinnacle's affiliates form more than 20% of the company's total FUM, reducing the company's exposure to the performance of a single manager. At the end of August, the company's assets were largely the same as when we previously covered the company. 46% of the total FUM comprised Australian equities, 14% of global equities, 19% of real assets in public markets, and 9% of private real estate.

To put it simply, Pinnacle's management is just as competitive as it was back in December 2019. It believes that its current mix of assets should yield positive returns for the foreseeable future. The price, however, is another matter.

Just over the line

As 2019 rolled into 2020 the Pinnacle share price was just over $4. Now, a single share of the company is trading at $13.52. Sure, the company does have a portfolio that allows it to divest quickly out of any failing funds (due to most investments being extremely liquid). However, that is not our problem with the company. The consensus estimates show that Pinnacle is expected to generate a net profit of $93.6m in FY23 (21.5% growth). That is amazing growth considering current financial performance, but the company is still trading at almost 27x its FY23 earnings.

The P/E multiple, estimated to be 31.8x at the end of FY22, is expected to drop down to 19.2x by FY25. As we said, not a bad performance, but we believe the multiples are slightly past what we would consider the high end of fair value. Pinnacle does have a distribution-focused policy, and the total dividend for FY21 was $0.29 per share, the current indicative dividend yield is 2.1%.

As we have said before, we believe Pinnacle is the best investment manager listed on the ASX, but we believe the correction that started in November 2021 still has a ways to go before Pinnacle's valuation makes sense. This stock certainly deserves a premium, but it's too far over the line right now. Two stars.

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Share price chart

Source: Tradingview

A look at the past

Prior to COVID-19 (FY19), the New Zealand flagship airline offered 32 international and 20 domestic destinations, focusing on the Pacific Rim. The company generated $5.8bn in revenue, resulting in $270m in Net Profit After Tax (NPAT). The vast majority of the company's annual revenue was generated through travel resulting from New Zealand (43.7% in FY19). The United States generated the second-largest geographical segment (15.1% in FY19), then Australia and the Pacific Islands (12% in FY19), followed by Asia (8.9% in FY19), with the smallest being the United Kingdom and Europe (4.9% in FY19) before COVID-19. As with most airlines pre-COVID, the company lived and died by passenger revenue, accounting for 86.2% and 85.5% of FY19 and FY18's total revenue respectively.

A look at the present

Now that we have the pre-COVID-19 baseline let's take a quick look at Air New Zealand's most current data, November 2021 (released 22 December 2021). In November, Air New Zealand carried 345,000 passengers 198,000 km, representing a decline of 50% and 43.7% year-over-year, respectively. This decline was felt across almost all divisions, with the exception of the Americas, which saw passengers decline 3.9% year-over-year in November. We believe this is a direct result of the spread of Delta and Omicron through Australia and New Zealand.

Unfortunately, we believe this poor result is unlikely to improve in early 2022. On 21 December 2021, Air New Zealand announced it was cancelling all existing quarantine-free flights from Australia to New Zealand between 17 January and 28 February 2022. This cancellation applies to 120 flights, impacting 27,000 customers who have "limited" quarantine replacement flights available. It is unclear if this impacted December 2021's results, but there was a slightly positive sign in the announcement. The company decided not to extend its 'international flexibility policy' for flights departing before 30 June 2022. The policy allows customers to change flights with fees waived. We view this as optimism that the cancellations are a short-term measure.

The market's looking to FY24

Before we dive into the valuation, it's important to mention that Air New Zealand's ASX listing is secondary, and most shares listed on the ASX are held outside of Australia. According to the ASX's November 2021 Foreign Entity Report, out of the 1.1bn shares quoted on the ASX at the end of November, 124m were held in Australia (these figures are rounded up and should not be used to calculate market capitalisation). That's still plenty of liquidity in Australia, but clearly, most shares are traded on the New Zealand Exchange (NZX).

When it comes to the airlines, we believe the market is valuing companies based on earnings growth in FY24, post COVID-19 and after the 'return to normal' growth expected in FY23. Therefore, we believe it is best to ignore FY22 and FY23's market consensus estimates and skip straight to FY24 and FY25, where the market is currently expecting EBITDA at NZ$1.2bn (26.1% growth year-over-year) and NZ$1.7bn (43%), respectively.

It is worth noting that FY24's EBITDA estimates have a standard deviation of NZ$198m across the five analysts, with the high estimate at NZ$1.5bn (57.8%) and the low at NZ$984.1m (3.5%). In our view, the consensus estimate has a solid enough risk buffer, but investing in airlines right now is especially risky since your investment thesis will take at least two years to prove. So, let's take a look at the current valuation across the three scenarios in what we will call worst (low), base (consensus) and best-case (high). These EV/EBITDA multiples come out to 4.8x (3.5%), 4x (26.1%) and 3.2x (57.8%), respectively. Before we render a verdict on these valuations, let's take a quick look at the other major airline option on the ASX, Qantas (ASX: QAN | see 11 November 2021 report). Using the same worst, base and best-case analysis that we did with Air New Zealand gives us FY24 EV/EBITDA multiples of 4.3x (12.5%), 3.9x (24.2%) and 3.6x (36%).

All-in-all, we don't see significant downside if the worst-case scenario comes to pass for Air New Zealand, but it does seem like there is certainly some downside, unlike Qantas (where we have a four-star rating). Four stars, but we would note that there is likely to be some volatility towards the end of January when Air New Zealand releases its December 2021 monthly update. Still, Air New Zealand has much greater upside potential than Qantas does, and we believe based on the company's pre-COVID-19 track record, the base-case is far more plausible than the worst-case. So, if you are willing to risk your money in a two-year hold, then we believe Air New Zealand currently offers a more attractive risk-return analysis than Qantas at this time.

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