28 January 2020

Stocks Down Under

'I took a speed-reading course and read* War and Peace *in twenty minutes. It's about Russia.'

- Woody Allen (1935), US actor and film maker

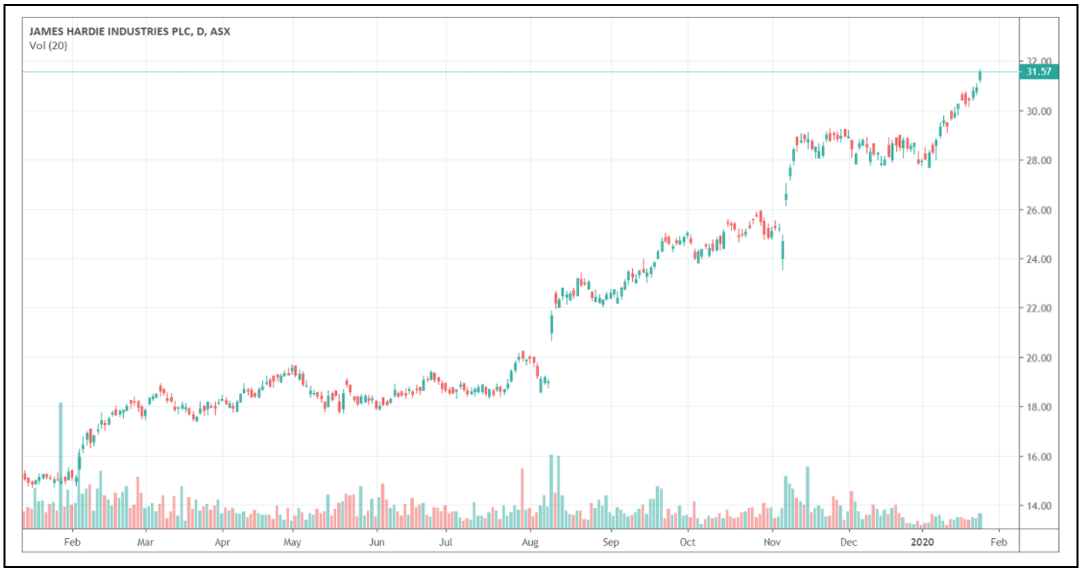
James Hardie: Good times in America

Stocks Down Under rating ★ ★ ★ ★

ASX:JHX Share price: A$ 31.57 Market cap: A$ 13.8BN

The last twelve months have been outstanding ones for the shareholders of James Hardie Industries, the building materials major. On Christmas Eve 2018 the stock closed at $14.54. Last Friday the close was 117% higher, at $31.57, and the stock has barely paused for breath in between. The main reason for this stellar performance has been US housing starts, which in December climbed to their highest level in 13 years. With Hardies having enjoyed a very loyal following among US builders for many years, the market has reasoned that the company can't help but prosper in the current environment.

Company Share Price Chart



Source: Tradingview

Part of the good times at Hardies is the fact that the cost of doing business has come down. In the September 2019 quarter sales only rose 2% year-on-year but gross profit was up 16%. Not only was the price of fibre more reasonable, but also transport costs, gas and electricity. This also bodes well for March 2020 full year numbers. But it's the top line moving into the March 2021 year that interests us more right now.

The house that fibre cement built

You see, James Hardie is still the house that fibre cement built twenty years after the revolution began. Back in the 1970s Hardies was looking for a cement whose reinforcing material would have the strength and fire-retardant properties of asbestos without the health hazards. The company's researchers found the right replacement in cellulose fibres. After a pioneering period in Australia in the 1980s, Hardies then took this product global, most notably to the US, where its first fibre cement plant started up in 1990. By the late 1990s Hardie's fibre cement was taking the market by storm. Without a doubt its greatest achievement in its 131-year history has been teaching the US building industry to use fibre cement and keep coming back to Hardies for more, at progressively higher prices every year. Around a fifth of all new houses in America these days have 'siding', which is simply protective material attached to the exterior side of the walls. When they do get siding, in about 90% of cases its Hardies fibre cement that is being used. So, when houses are going up at an annual rate of around 1.6 million in America, that means good times for shareholders.

And it's fair to say there's not much that can slow down US housing at the moment. According to Freddie Mac, the mortgage securitiser, a typical 30-year fixed rate mortgage is America will settle for a mere 3.6% today. The US unemployment rate of 3.5% is at levels last seen way back in 1969. And US consumers are feeling pretty confident. The well-regarded University of Michigan survey fixed its January 2020 number at 99.1, continuing a high level of confidence that's been noticeable since President Trump took office. The last time Americans felt as good as they do right now (if you take the average of any twelve-month period), it was about May of 2001.

Fibre gypsum is Hardies' next cab off the rank

Wisely, James Hardie isn't just pinning its hopes on fibre cement and America for future growth. Indeed, it believes that it has another product as powerful as fibre cement in the form of fibre gypsum, which is an alternative to plasterboard for interiors but more eco-friendly and with better fire-retardant properties. In late 2017 Hardie announced that it was buying a German company called Fermacell, a leading maker of fibre gypsum, for US$529m. Hardie is now using the Fermacell base to do for fibre gypsum in Europe and then the world what it earlier achieved with fibre cement.

James Hardie stock may look expensive right now – on consensus numbers for the year ending 31 March it's on a P/E of 26.1x. However, the P.E drops to 23.5x for March 2021 and 21.1x for March 2022 because growth expectations in these boom times are pretty strong. This suggests to us a stock that can probably run a little harder between now and late May when the 2020 full year numbers hit the streets.

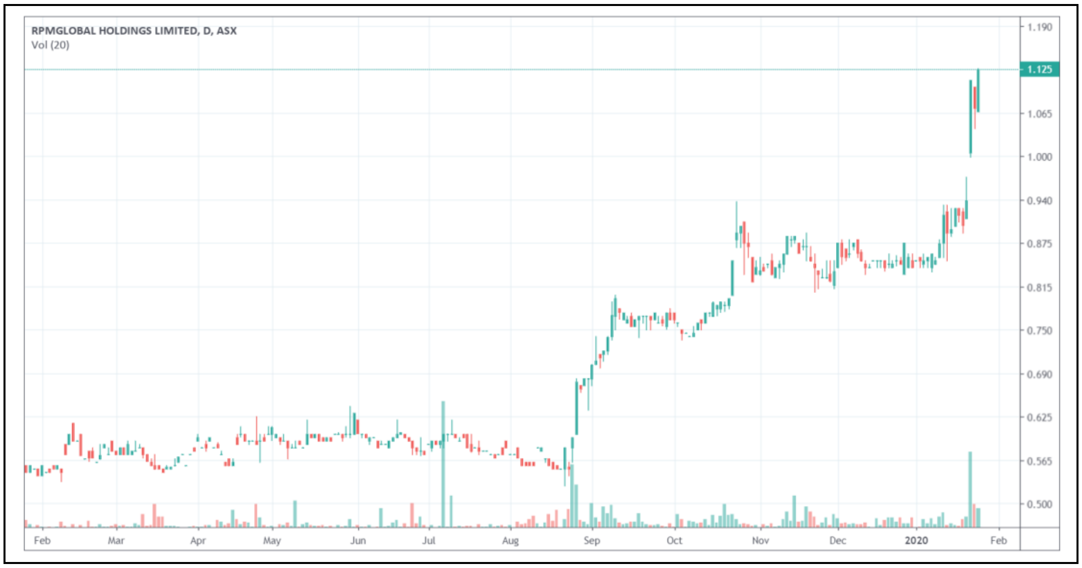
RPMGlobal: Emerging SaaS player

Stocks Down Under rating ★★★

ASX:RUL **Share price: A$ 1.13** **Market cap: A$ 233M**

It was a good year to be invested in RPMGlobal, the Brisbane-based supplier of software, training and advisory services for the global mining industry. The stock had started 2019 at 62 cents and formed a nice base between that level at the 55-cent close of 19 August. Then suddenly it took off. By 25 October it had reached 90 cents and after a brief rest period it took off again to the current level of $1.12. This might be a little too rapid.

Company Share Price Chart



Source: Tradingview

The main driver of the 2019 re-rating was RPM's move to a subscription-based model for its software. On 5 August the company told the market that annual recurring revenue from software subscriptions was running at a $5m annual rate. Suddenly, on 12 August, it was $6m and on 23 August it was $7m. The market was now convinced that RPM was a genuine Software-as-a-Service (Saas) success story and began to re-rate it accordingly. On 19 November the annual recurring revenue figure was just over $8m. We suspect there's more growth where that came from but would wait for the half yearly numbers to see what the company has to say.

RPM still has a big advisory business

RPMGlobal did just over $80m in revenue in FY19, up 9%, and enjoyed EBITDA of $7.7m. The boring part of the $80m revenue base is the 40%, or so, that comes from advisory-type services to the mining industry, including a gas consulting business called GeoGAS. The Advisory business is boring because it's slow growth - excluding GeoGAS, RPM's advisory business only grew its earnings contribution by 3% in FY19. Software is really where the action is.

In software RPMGlobal had a great FY19, growing net revenues by 11%. The company's suite of software products, taken together, allow a mine to more efficiently manage its inputs and outputs. RPM's recent move to make its software subscription-based bodes well given that SaaS-type products scale so elegantly and allow a different, generally smaller, kind of customer to be able to access them. We argue that the future is bright for RPM on two fronts. Firstly, commodity prices stayed off their 2016 lows, so the company's customer base is still spending. Secondly, mining is rapidly moving towards greater levels of automation and RPM can sit near the forefront of that trend.

Where in the heck is Barranquilla?

The thing about RPMGlobal that has us a little worried is that the 'global' in its name isn't just hype. RPM announced on 5 March 2019 that it was opening an office in Barranquilla, a port town in northern Colombia, to support its business serving miners in that resource-rich country. The same announcement flagged upcoming offices in Russia and Kazakhstan. When a company with just $80m in annual revenue plants its flag, it's a sign that the company intends to establish a serious niche that competitors can't easily displace. On the other hand, such expansion can also be a little unnecessary, since SaaS by its very nature isn't geography dependent.

Which brings us to our note of caution on RPMGlobal – this company has yet to be become noticeably profitable at the NPAT line given the hefty amortisation charges common to the P&L of software developers. This means it doesn't effectively have a P/E right now, which might make some investors nervous. Also, those same investors may not like the fact that the company's annual software R&D is around a quarter of revenues, making it a relatively expensive story from a cash-flow point of view. Consequently, the recent run-up above $1.00 may prove short-lived unless there is further progress on growing subscription revenues.

Tigers Realm Coal: From Russia, with love

Stocks Down Under rating ★★★★

ASX:TIG   Share price: A$ 0.01   Market cap: A$ 69M

If you're in the mood for a serious punt, do your homework on Tigers Realm Coal, which owns a producing coal mine in Russia. At the moment, Tigers Realm Coal labours under two negative sentiment issues. The first is that it is a coal play, at a time when coal is out of favour. Second, it is a Russian play, at a time when Russia makes people frown. We believe, both sentiment issues have the potential to be overcome in the medium term though.

Company Share Price Chart

Source: Tradingview

At first glance Tigers Realm's Amaam Coking Coal Project looks like it is located in the middle of nowhere. If you go to Google Earth and plug in 64.7 degrees North, 171.5 degrees East, it'll land you not far from a town called Anadyr, population ~14,000, which is the capital of Russia's remote Chukotka Autonomous Region. It's around 5,900 km from St Petersburg and about as far east in Russia you can go because further east is the Bering Sea, which divides Russia from Alaska. Go a mere 240 km south of Anadyr and you've reached Amaam.

Not really in the middle of nowhere

We say 'at first glance it's the middle of nowhere' because the location couldn't be better if you want to sell coal to the all-important customers in North Asia. You only need to truck coal 37 km from the Amaam North mine to a coal terminal and port which Tigers Realm owns in a town called Beringovsky, and you're landing coal in Northern Asia in about eight days from the time it is first dug up. It's more like 13-14 days if you're mining in the Elk Valley in the Canadian province of British Columbia, or in Queensland's Bowen Basin. The use of trucks is important because that means Tigers Realm isn't reliant on creaky Russian railroads.

Tigers Realm brought Amaam North, an open cut mine, into production in 2016. The mine produced 750,000 tonnes in calendar 2019, up from 576,000 tonnes in 2018 when revenue was A$52m and EBITDA A$15m. Amaam North can produce for a long time – the resource is estimated at 110 million tonnes, while the nearby and hitherto undeveloped Amaam deposit, 80% owned by Tigers Realm, has another 521 million tonne coking coal resource.

Performance issues are being fixed

It's fair to say that Tigers Realm has underperformed until recently in part because of two issues – coal quality and port inefficiencies. At the moment the output is a mixed 30% coking and 70% thermal product that doesn't attract premium pricing, but once a coal handling and preparation plant goes into operation from 2022 the ratio will flip because the ash content in the coal will be stabilised. As for the port, Tigers Realm has already fixed that issue by taking over its management and using its own barges.

The main trouble for Tigers Realm is that coal prices came down in 2019, which is why the share price declined from 4.5 cents on 31 May to 1.1 cents on 3 December. This decline in coal prices was not helpful given that the company had around A$41m in debt and was being kept alive with a US$15m shareholder loan announced in late October. On 18 December Tigers Realm announced a 13:4 rights issue that would raise up to A$58m at 1 cent per share in order to pay down debt, although some will go into the mine and port. What's encouraging about this exercise was that director and major shareholder Bruce Gray, who owns around 23% of the company, committed ~A$13m in the rights issue. Bruce Gray was the Perth interventional radiologist who founded Sirtex Medical, ultimately a highly successful medical device company. The institutional part of the rights issue raised $39.7m and the retail part is still ongoing but expected to close on 5 February.

Coal is coming back in 2020

The timing of the rights issue is good because coal is looking better as 2020 gets started. In last week's Production and Activities Report for the December 2019 quarter Tigers Realm noted that '*As expected, the resetting of import quotas in China has led to a rebound in demand. This has pushed up thermal coal and coking coal prices. A shortage of low ash South African thermal coal has also helped to support prices in India and the Asia Pacific region (where Tigers Realm sells its coal).'*

The sentiment issue of Amaam being in Russia might take a little longer to overcome since whenever Russia is in the news it seems to be for the wrong reasons, like raising hell in Ukraine in 2014 or interfering in US elections in 2016.

That doesn't mean Tigers Realm has sovereign risk issues. Indeed, quite the contrary. When the Fraser Institute, a Vancouver-based free-market think tank, did its 2018 Annual Survey of Mining Companies, Russia scored an impressive 74.2 points in the 'Investment Attractiveness Index'. That was only slightly less than Australia's 75.5 points. Not only is Tigers Realm not impacted by any kind of sanctions, it doesn't see any political or Russia-specific risks that would affect its business.

Tigers Realm is currently trading at the 1 cent rights issue price. Investors ought to watch this price carefully, and if 1 cent forms a support level, there is the potential to re-rate on better coal prices and the strategy that will move Amaam over to being primarily a coking coal producer in a couple of years' time when coal could be in much better shape price-wise.

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