16 January 2020

Stocks Down Under

'Mount Everest is very easy to climb, only just a little too high'

- André Roch 1906-2002), Swiss mountaineer, skier and expert on avalanches

Speedcast – Now over the speedbump?

Stocks Down Under rating ★★★★

ASX:SDA Share price: A$ 0.95 Market cap: A$ 234M

Today in Stocks Down Under we're going to lead with what many will consider a controversial call. We're going to suggest that Speedcast International, a Sydney-based provider of satellite communications services, is set for a recovery. It's a call that might seem crazy because Speedcast is currently one of the most shorted stocks on ASX, with close to a 13% short position, and the stock was dropped from the S&P ASX200 on 23 December. Balanced against this is the current P/E on consensus numbers of just 4.4x, and the fact that this company has had a long history of organic and acquisition growth led by the highly regarded Pierre-Jean Beylier, who runs the company out of Hong Kong. Speedcast is, in our view, a great company in an industry with decent growth prospects. The more the world globalises, the more it needs efficient satellite communications so that the free flow of data and information isn't hampered by the lack of old-fashioned ground infrastructure. Which is why the number of communications satellites going into space steadily increased from only 55 in 2004 to 114 in 2018. Speedcast doesn't own satellites but it has stitched together one of the world's largest 'network of networks' to service several thousand clients in 140 countries from 70 satellites. Importantly, it doesn't just manage the network for those clients. It has evolved into a Managed Information Service Provider, which is where the good margins will lie. Speedcast did US$623m in revenue in calendar 2018 and US$132m in EBITDA (it reports in US dollars to make it comparable with competitors like Intelsat and Viasat). Speedcast's medium-term ambition, coming off its 2018 acquisition of US competitor Globecomm, is get to US$1bn revenue and US$250m in EBTDA.

Company Share Price Chart

Source: Tradingview

A 'non-structural' profit warning

The stock of Speedcast crashed badly in July, falling from $3.48 on the first of that month to $2.06 the next day as a result of what we consider a mild earnings downgrade. The stock crashed again the following month, from $1.69 on 26 August to 75.5 cents two days later, even though the earnings guidance from July was maintained in the 27 August half-yearly result. An attempted recovery from the 75 cents level fizzled out by Christmas, but that has more or less set the current resistance level. The question is whether or not Speedcast's mild January 2020 rebound puts it out of the danger zone. We think it does. Indeed, so long as Speedcast is able to meet its calendar 2019 EBITDA guidance of US$140-150m, the stock will arguably be in a strong position to re-rate.

The reason we say this is that the July 2019 profit warnings was largely 'non-structural'. Which is to say, it wasn't caused by a worrying downtown in satellite communication services, but by various issues such as 'timing of systems integration revenue' or 'technical difficulties causing further delays in the ramp-up of the Carnival contract'. And the downgrade wasn't heavy – only from US$161-170m in 2019 EBITDA as per the February guidance to US$140-150m in July.

A stretched but not over-stretched balance sheet

Now, the market *was* worried by the Speedcast's balance sheet when it reacted badly to the half yearly result. As at June 2019 the company had US$625m in net debt, up from US$586m six months earlier largely because of short-term working capital movements. Speedcast's net debt to EBITDA ratio at June 2019 was 3.6x. That was consistent with the last several years, but it wasn't going to get in trouble in terms of banking covenants until the ratio hit 4.5. Also, no debt facility matures until 2025. Sure, the longer-term target of 2.5x would be better, but this company still has a margin of safety.

In terms of its business, Speedcast seemed to have been doing better in 2019. Net Promoter Scores were up, a new ERP system was bringing internal efficiencies and new contracts continued to be won across the various divisions at a steady pace. Should Speedcast be able to report that this has contributed to an improvement in the bottom line, we predict the market will sit up and pay attention in February when the 2019 full year numbers hit the streets. Indeed, the reaction could be very favourable given the level of shorts that would then have to be taken off.

New Century Resources – Good times coming for zinc

Stocks Down Under rating ★★★★

ASX:NCZ Share price: A$ 0.27 Market cap: A$ 137M

2019 was not kind to the shareholders of New Century Resources, the Perth-based company which owns the Century Zinc Mine near the Gulf of Carpentaria in northwest Queensland. Back in mid-April New Century was trading around 90 cents. Over the next six months it steadily declined until it had reached 23.5 cents by 4 October. Since then, the stock has been more or less base building. That bodes well for investors looking at New Century now, given that zinc seems to be headed for better times.

The Century Mine, located at Lawn Hill, 250 km north-west of Mount Isa, was a major zinc mine brought into production by the major lead-zinc house Pasminco in 1999. It produced continually until it was shut down by MMG, the mid-tier global resources company, in early 2016. Century ore would be mined at Lawn Hill and then sent through a 300mm pipeline to the port town of Karumba, 304 km away, where zinc concentrate was processed and shipped.

Company Share Price Chart

Source: Tradingview

Sale of the Century

After the closure a new investor group bought Century from MMG and then back-door listed it in mid-2017 with the intention of rehabilitating the mine site and the preparing to bring the mine back into production. What New Century inherited was over 2.2 million tonnes of JORC-compliant zinc metal equivalent resources in the tailings and another million or so tonnes, again JORC compliant, in several previously unmined deposits. There might also be an economic phosphate resource in the neighbourhood as well. The Century Mine re-entered production in August 2018. It is expected to be in production until 2026, mining both tailings as well as the ‘in situ’ deposits, that is, the deposits that have been identified but not yet mined. Since mid-2018 New Century has been steadily ramping up to a production rate of 250,000 tonnes of zinc-equivalent in concentrate, expected to be achieved in FY20. At this size, Century will be one of the ten biggest zinc mines in the world. The company is also driving hard on zinc recovery rates and on costs and making some progress.

Zinc has recovered from its 2016 nadir

New Century management reckons now is a good time to be bringing an old zinc mine from Australia back on to the market because global zinc demand, not just for galvanising but also for things like die-cast alloys and for brass and bronze casting, is gradually closing up on zinc supply. As a consequence, zinc has been doing well since the lows of early 2016 when it was about US$1,500 a tonne. Trouble is, after a peak in early 2018 at US$3,600 a tonne it has since eased back to more like US$2,300 a tonne. That downward move took the price of New Century with it and is the big reason New Century is heavily shorted right now – there's currently an 8% short position.

What could turn this around?

2020 might just be a good year for zinc as the supply/demand gap closes further and as inventories continue to get drawn down, which they have been since April 2019. Indeed, one could argue that the only reason zinc has been weak since stocks started to come down was concerns about the Trade War and global growth generally. Once the zinc market figures out there is not much stock available and that the Trade War is coming to an end, we could see a sharp rebound in the commodity. Remember, back around 2014 there was more than a million tonnes of zinc crammed into warehouses around the world. Now there's less than 60,000 tonnes.

Not much new zinc supply is coming after Century

As for zinc supply, the next big zinc mine to open up globally might be Kipushi, which would represent a restart by the Canadian major Ivanhoe of a zinc-copper mine in Copperbelt of Central Africa. Kipushi sits near Lubumbashi in the south-eastern part of that paragon of law and order called the Democratic Republic of the Congo. If it's not Kipushi that gets up it might be Mehdiabad, located in the central part of another troubled country, albeit troubled in a different way, called Iran.

What could go wrong with New Century?

We'd be worried about a slowing of the ramp-up, although mitigating against that is the fact that the management team under Patrick Walta have executed very well since 2018. We'd also be worried about continued weakness in spot zinc. If neither of those things emerge, New Century Resources may be in a position to revisit the levels around $1.00 per share that it saw shortly after the 2017 backdoor listing.

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