21 January 2020

Stocks Down Under

'You have to be a romantic to invest yourself, your money, and your time in cheese.'

– Anthony Bourdain (1956-2018). American celebrity chef.

Bega Cheese – It's still dry in the Australian countryside

Stocks Down Under rating

ASX:BGA Share price: A$ 4.53 Market cap: A$ 975M

Conventional wisdom would suggest that right now is not a good time to be involved in Australia's rural economy. Since 2017 the country has been suffering what many now consider to be a 1-in-100-year drought event. And recently it has been ravaged by serious bushfires. Bega Cheese, a food company so-called because it is headquartered in the southern NSW coastal town of Bega, hasn't been impacted by the bushfires, but it has felt the pinch of the drought.

When Bega Cheese came on the boards in 2011 it was a pure-play cheese company just two years beyond its transition from old-fashioned dairy co-operative. While it has spent most of the last several years diversifying its product offering beyond cheese and into higher margin food products, is still a major player in dairy, as you would notice with even a cursory glance at the dairy aisle of your local supermarket.

When there’s a drought on you don’t want to be a dairy processor because there’s less raw milk available and you have to pay supplying farmers more for what you need, while not necessarily being able to raise your own selling prices. That’s why on 29 October Bega Cheese flagged that its EBITDA for FY20 was expected to be A$95-105m, as against $115m in FY19. Bega Cheese stock was $4.53 just prior to this announcement. It quickly dropped 21%, to $3.58 and after a slight bounce, tested that low again on 9 December.

Company Share Price Chart

Source: Tradingview

Vulnerable to wholesale milk prices

Obviously, Bega will remain vulnerable to wholesale milk prices into the foreseeable future, given that around 75% of their products are dairy of some sort. Also, the balance sheet as at 30 June 2019 had a leverage ratio of 2.5 times, which to some seemed stretched. However, that hasn’t stopped Bega Cheese stock from enjoying a partial recovery from the October-December 2019 low. We don’t think that was just because the recent bushfire impact to the company was minimal, as reported on 9 January. We think it is recognition of Bega as an emerging manager of brand equity as well as a company with less reliance on dairy than historically.

Probably the most powerful of Bega’s brands is the Bega name itself. When dressed up in that familiar red logo so recognisable in refrigerators around the

country, the Bega name makes it easy to sell cheddar and mozzarella but has proved strong enough to transition into items like peanut butter. However, without a doubt the most iconic brand owned by Bega is Vegemite.

Growing brand equity

Vegemite, for you non-Australians, is a thick, dark brown food spread, made from brewers' yeast extract. If you're Australian, you are more likely than not to love this product which entered the Bega stable in early 2017 when the company spent A$460m to buy most of the Australasian grocery business of the US food giant Mondelez. Not only is Vegemite not a dairy product, it also has truly enormous brand equity from generations of Australians consuming the product and singing that cute advertising jingle from 1954 about 'happy little Vegemites'.

We argue that Bega's stewardship of the Vegemite brand sets it up for further diversification into other non-dairy food brands as they become available. That Bega is pushing in that direction is suggested by its corporate branding as 'the Great Australian Food Company'.

That doesn't mean Bega stock is without risk right now. Remember, this stock is currently 11% shorted on ASX. Currently the market is only flagging a recovery for Bega's earnings from FY22 onwards, so that the stock looks expensive until you get to FY23 where the P/E on consensus is less than 10x. We think the high FY20 P/E of around 35x is being tolerated by the market on the expectations of growth in brand equity through this drought period. However, that high P/E could evaporate if the nation's milk pool shrinks again in 2020. Investors ought to exercise some caution.

Resolute Mining – Balance sheet improved

Stocks Down Under rating

ASX:RSG **Share price: A$ 1.18** **Market cap: A$ 1.6BN**

Back in August 2019 the stock of Resolute Mining, owner of three gold mines in Africa and one in Australia, was trading above $2.00 a share. The company was on track to produce 400,000 ounces at an All-In Sustaining Cost of US$960 per ounce in calendar 2019. In 2020 the expectation was 490,000 ounces at US$920 an ounce. So, the outlook was bright. Only three months later it was pummelled down to around $1.10 and it has been boxed in to a narrow trading range of $1.10-$1.30 since then. With 11% of the stock shorted, it's fair to say that Resolute has become something of an out-of-favour company in a sector that is otherwise doing well.

Company Share Price Chart

Source: Tradingview

What's gone wrong, and what can now go right?

What went wrong, we think, was the company's debt position and a minor problem at the Syama Gold Mine in Mali. In June 2019 Resolute had $142m in net debt. In August the company announced it was acquiring the privately-owned Toro Gold for $US274m, which owned the Mako Gold Mine in Senegal. Resolute paid US$130m cash and the rest in shares at A$1.45 each and funded it through a bridging finance facility provided by Taurus Funds Management. The market became concerned that Resolute was over-borrowed, particularly when a debt facility to replace the bridge wasn't announced quickly. Combine that with the roaster at Syama, having to go offline for a while for cracks to be repaired in its external shell, which raised the expected AISC for 2019 to US$1,020 an ounce, and Resolute was out of favour.

Debt to be paid down

We argue that Resolute can come back into to favour now that it is raising up to A$196m in equity to pay off the bridge at $1.10 per share. This would take away

the main reason for the 11% short position we noted above. Also, the company has chosen to sell the Ravenswood Gold Mine in Queensland to private equity for long-run total proceeds of up to A$300m, more than the pro-forma net debt post the equity raising of A$191m. Ravenswood was the highest cost of Resolute's mines and while it had a bright future as it transitioned to open-pit mining, from a previous underground operation, the company can rightly argue that it enjoys more opportunity in two lower-cost African mines - Syama, which is believed to be one of the most automated mines in the world, and Mako.

Currently Resolute is trading at a P/E of only 5 times calendar 2020 consensus. That seems low given how gold is holding about US$1,500 an ounce this year and Resolute is guiding to 500,000 ounces of production at an AISC of US$980 pre the Ravenswood sale. With a large resource base of 19 million ounces, there's plenty of room to grow improve these numbers over time.

St Barbara – Moving beyond Gwalia's problems

Stocks Down Under rating

ASX:SBM   Share price: A$ 2.99   Market cap: A$ 2.1BN

On 22 March 2019 St Barbara, the major Australian gold miner, made a somewhat technical market release where it reported that it had completed the so-called 'Gwalia Mass Extraction Feasibility Study'. With this study St Barbara's engineers had looked into the best way to extend the orebody of the Gwalia Gold Mine near Leonora in Western Australia, a mine with a history stretching back to the 19th Century. Up until 2019 St Barbara had trucked out of the Gwalia mine. St Barbara's engineers had evaluated the economics of hydraulic hoisting and decided trucking was still the better option.

Sounds pretty ordinary, doesn't it? That announcement, however, was the start of a bad time for St Barbara shareholders because on page 2 there was guidance that Gwalia would only produce 235,000-240,000 ounces of gold in FY19 at an All-In Sustaining Cost (AISC) of A$980-1000 per ounce. Previously the guidance had been 245,000-255,000 ounces of gold at A$930-970 per ounce. The reason

for the change was the timing of when a 'paste aggregate fill' circuit would be brought into operation at Gwalia. Paste aggregate fill is simply rock and paste mixed together to fill up mined-out stopes. The market didn't care that paste aggregate fill was a normal part of a life in a mine that would produce 200,000-230,000 ounces p.a. until 2031. And it was particularly testy to learn in late May, not long after an equity raising of A$355m at $2.89 per share, that Gwalia production in FY19 would be only 220,000 tonnes because of a problem with the machinery that sent the paste down the stopes being filled. By June 2019 St Barbara stock was down 35% on the levels of three months previous, to around $2.50.

Company Share Price Chart

Source: Tradingview

Another Gwalia downgrade

St Barbara stock did recover between June and August but then crashed again. This time the issue was an October 2019 downgrade at Gwalia, which is now only expected to product 175,000- 190,000 ounces in FY20 because of the way in which the Gwalia extension will temporarily constrain capacity down the mine. The bottom here was once again around $2.50 per share.

Interestingly, St Barbara stock is now levitating off this well-tested $2.50 resistance level, maybe because, as they say in the markets, downgrades always come in threes, and St Barbara has now had its three.

Leaving aside Gwalia, the company is set for a good year at the Simberi Gold Mine in PNG (110,125,000 ounces in FY20) and at the Atlantic Gold Mine in the Canadian province of Nova Scotia (95,000-105,000 ounces), which have proved fairly problem-free for St Barbara in the current year. We suspect that St Barbara management have been conservative in its estimate of Gwalia production. Any

number closer to 190,000 ounces when the full year results hit the streets in August is likely to be well received.

Gold is in favour right now at over US$1,500 an ounce so the market seems to be in a forgiving mood for St Barbara. We think the risk of another Gwalia downgrade is already factored in to the current P/E on consensus numbers of around 10x.

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