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Stocks Down Under

'Old age is no place for sissies'

- Bette Davis (1908-1989), American actress

Estia Health – Contrarians should be bullish on the aged care sector

Stocks Down Under rating ★★★★

ASX:EHE Share price: A$ 2.49 Market cap: A$ 645M

It was always going to be tough keeping investors interested in Estia Health (ASX:EHE), a Sydney based national operator of nursing homes, once the government of Prime Minister Scott Morrison announced the Royal Commission into Aged Care Quality and Safety in September 2018. The automatic assumption at that time was that regulation of the aged care sector in Australia would increase as a result of the Royal Commission's findings of (presumably) poor quality and safety, and that the sector had to suffer financially as a result. Estia stock was $2.95 immediately prior to the announcement. By October 2018 it had dropped to around $2.00. The stock has tried twice to recover, but has been beaten back, in May 2019 and again in November 2019, in each case because of relatively mild profit warnings. The stock had a 2% short interest on 6 January. However, we think Estia's problems are temporary.

Company Share Price Chart

Source: Tradingview

Occupancy rates have declined very slightly

Estia's current share price woes, which has seen it fall from $2.89 in November 2019 to $2.40 now, is a result of a 9 December profit warning. The company's 69 nursing homes around Australia had seen a very slight decline in occupancy and average daily revenue rates were below expectations, so full year EBITDA was now expected to be $78-82m for 'mature homes' (i.e. those that have operated for a while). The previous guidance back in May had been $86-88m. Frankly, we're not greatly concerned because the big picture is that Estia's industry is set for strong growth rather than decline.

Obviously, testimony at the Royal Commission, whose findings will be handed down in November 2020, has led to a lot of talk about care failures that the industry would prefer to keep hidden. But the fact of the matter is that the Australian population continues to age, the need for aged care services continues to grow, and most aged care operators around the country have high quality standards in place. All of which suggests that the leading operators will come out of this period in greater demand than ever, and the government will be obliged to support them financially.

The aged care system in Australia is set up to succeed

The market is likely concerned that more and more people are trying to stay out of aged care, so as to avoid being victim of perceived aged care failure. And it is also concerned that those still in care are increasingly paying for their care via Daily Accommodation Payments rather than lump-sum (and seemingly very expensive) Refundable Accommodation Deposits (RAD) allowed by the 2014 reforms to aged care in Australia.

We think both these issues are temporary because, as we noted above, the population continues to age. Even if occupancy is down now the number of old people who will ultimately need it is going up relentlessly, with the annual increase in Australians over the age of 85 starting to grow strongly from about now and not peaking until the early 2030s. As for Refundable Accommodation Deposits, they are a great funding vehicle for all concerned, even if half a million dollars only gets you a room smaller than your old family home kitchen - for residents, they or their heirs get their money back when they leave while the operators like Estia get interest-free loans they use to fund their growth. We argue Refundable Accommodation Deposits set up the industry for long-term success.

Estia is well placed to benefit once nursing homes come back into favour. The first thing to note about Estia's homes is that they tend to be at the top end of the market, as indicated by the fact that about 90% of their 6,200-or-so beds are in single rooms. Secondly, Estia continues to enjoy net RAD inflow. And, thirdly, Estia has been steadily increasing bed capacity with new homes and refurbishing existing properties, so it has good market standing in the sector. It will therefore benefit when the market starts to trust aged care operators again and will have some choice locations to offer incoming residents. With the market currently valuing Estia at just 5.7x forecast FY20 earnings, this one is looking good for contrarian young, old, and very old investors.

Bathurst Resources – Under 3x EBITDA!

Stocks Down Under rating ★★★★

ASX:BRL Share price: A$ 0.115 Market cap: A$ 196M

We noted previously, in discussing New Hope Group (ASX: NHC) yesterday, that things have been tough in the coal industry for about eighteen months, thanks largely to lower Chinese demand. That doesn't mean that the cycle won't turn. Key parts of the world in 2020, most notably the US, China, India and South Africa, still rely heavily on coal to power their economies and that will change only slowly. As a consequence, global coal demand is expected to at least stay steady for the next few years, with the big theme being declines in Europe and North America offset by strong growth in emerging markets, like India and Southeast Asia. Forecasters are now expecting steady pricing for 2020 and 2021. However, if you look at some publicly traded coal stocks, the market is currently pricing those stocks as though global coal demand was about to end very, very soon.

One of the more egregious examples of this mispricing is Bathurst Resources (ASX:BRL), which, while publicly traded on the Australian Securities Exchange, owns a number of coal mines in New Zealand and is headquartered in the New Zealand capital of Wellington. Currently you can buy this established coal producer at just 2.6x forecast 2020 EBITDA. That's right. An established producer at under 3x EBITDA.

Company Share Price Chart

Source: Tradingview

Great coal mines, but the country probably doesn't appreciate them

Admittedly, this is New Zealand, a country that has long marketed itself globally as clean and green, which is currently governed by the green-friendly Labour Party and whose Parliament voted, in November 2019, for the country to go carbon neutral by the year 2050. That said, governments can change, Labour has been polling behind the opposition Nationals, and New Zealand's next election has to happen by November of this year. Bathurst Resources's coal mines are going to be around for a long time so one suspects that an EBITDA under 3x is a little extreme.

Bathurst Resources operates four relatively small coal mines in New Zealand for domestic consumption but makes most of its money from an export mine, the Stockton metallurgical coal mine, 35 km north of Westport on the West Coast of New Zealand's South Island. This mine, 65% owned by Bathurst Resources, produced 1.1 million tonnes in FY19 but has a resource of 68 million tonnes so it could be mined even beyond 2050 if New Zealand chooses to dispense with the carbon neutral goal. The mine does well price-wise because its coal has a low ash content – ash being the material which doesn't burn and therefore presents a disposal problem. Bathurst is currently working on expansion plans for Stockton and the greater Buller Coalfield around it.

A Canadian escape plan?

Beyond New Zealand, Bathurst Resources is collaborating with another ASX-listed company, Jameson Resources (ASX: JAL) on development of Crown Mountain, a metallurgical coal project in the Canadian province of British Columbia. The intention is to eventually own 50% of this mine, in the prolific Elk Valley Coal Field, after investment on its part of C$121.5m. Elk Valley, in south-eastern BC, is where the Canadian major Teck (TSX: TECK.A) owns a number of successful metallurgical coal mines. The Crown Mountain project currently has a pre-tax NPV in excess of US$400m on Jameson's numbers at a 10% discount rate. Jameson may provide a way for Bathurst Resources to use its Kiwi cash flows to easily transition into a more coal-friendly jurisdiction. A Bankable Feasibility Study is underway. Bathurst Resource has the financial firepower to make this transition happen – its balance sheet is currently clean and, with net cash on hand (NZ$50m cash including restricted deposits out of $159m in total assets and only NZ$14m in borrowings), it is currently buying back stock.

With solid cashflows from New Zealand and the beginnings of a strategy to realise value outside it, contrarians could do nicely out of this one should metallurgical coal enjoy even a slight re-rating.

Inghams Group – This chicken tastes good

Stocks Down Under rating

ASX:ING Share price: A$ 3.53 Market cap: A$ 1.3BN

It looks like the worst is over for Inghams Group (ASX:ING), the Sydney-based poultry producer. After a hair-raising decline between late August and mid October 2019 that took the stock down from over $4 to under $3, sentiment and the share price has since partly recovered. We think there's further rallies to come beyond the one that The stock is still heavily shorted, mind you – there was a 12.7% short position as at 6 January.

The issue for Inghams back in August was an increase in feed costs. In FY19 the company actually shifted around 4% more chicken through its network and NPAT rose 10%, to A$126m, but costs were higher than expected because the drought in Australia had lifted feed costs, Inghams's single largest input cost. As a consequence, Inghams flagged a drop in EBITDA in FY20 before a recovery in FY21. The market hated to hear that, and one suspects that the share price reaction had a lot to do with the sense that Inghams had been priced too highly when it listed in 2016 (out of private equity).

Company Share Price Chart

Source: Tradingview

Eat more chicken

The market rout ended after an investor day on 22 October where Inghams' management talked a lot about the strong underlying demand for poultry and elaborated in detail on their plans to improve efficiencies and lower costs. If you scrutinise the PowerPoint from this meeting there's a lot to be excited about, but you can still buy Inghams for just 8.7x FY20 EBITDA. Not bad given the fact that Inghams is dominant market player in a growth industry. And its chicken tastes good too!

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