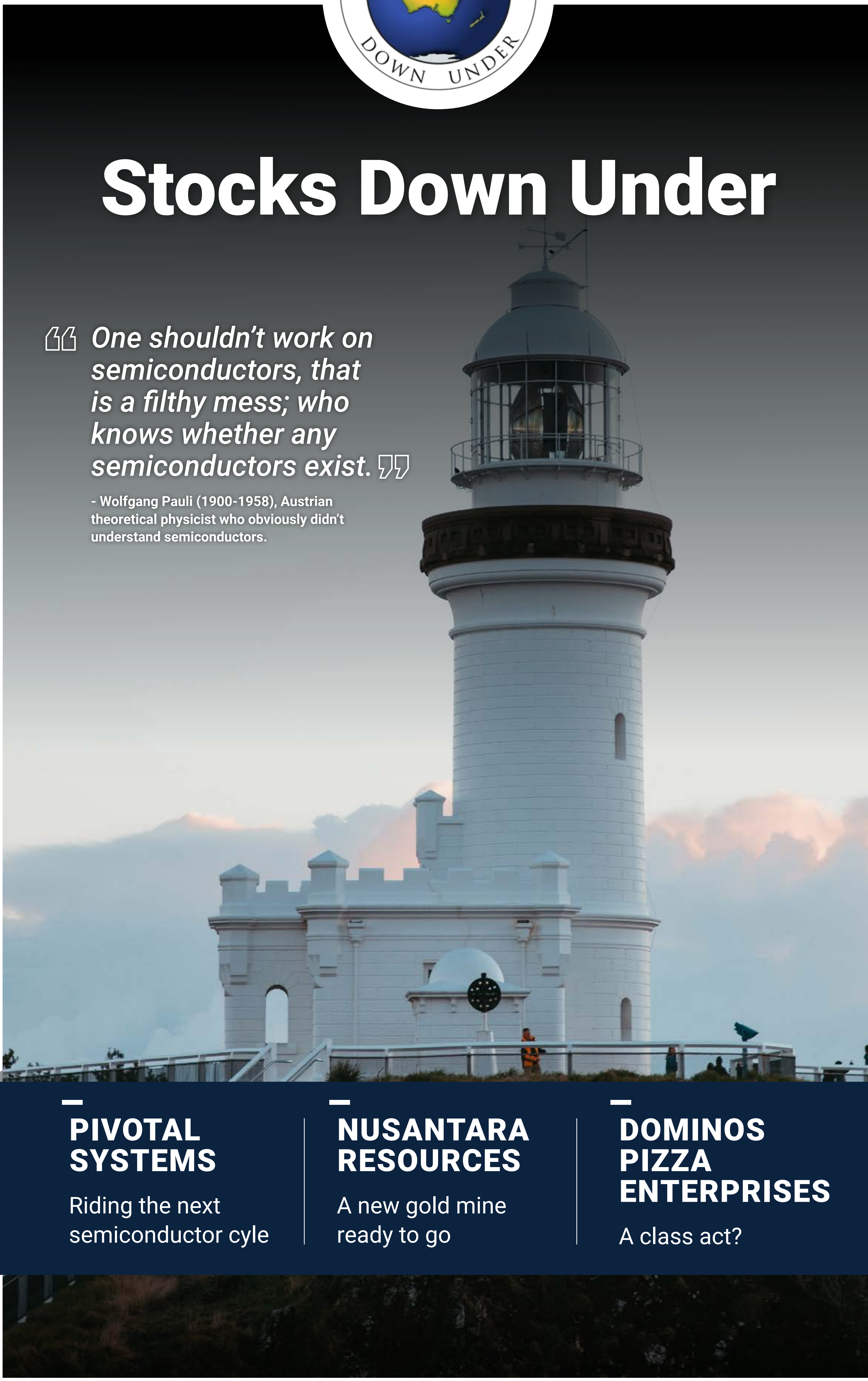
3 FEBRUARY 2020

Stocks Down Under



> *One shouldn't work on semiconductors, that is a filthy mess; who knows whether any semiconductors exist.*
>
> - Wolfgang Pauli (1900-1958), Austrian theoretical physicist who obviously didn't understand semiconductors.

PIVOTAL SYSTEMS

Riding the next semiconductor cyle

NUSANTARA RESOURCES

A new gold mine ready to go

DOMINOS PIZZA ENTERPRISES

A class act?

PIVOTAL SYSTEMS

Riding the next semiconductor cyle

Stocks Down Under rating: ★★★★

ASX: PVS
Share price: A$ 1.60
Market cap: A$ 181.6M

Pivotal Systems is a California-based manufacturer of Gas Flow Controllers (GFC) that are used in machines that manufacture computer chips. Like the rest of the industry, PVS suffered from a cyclical downturn in the semiconductor industry in 2019 as the market was working through an oversupply of DRAM and Flash memory. However, the first green shoots started to appear in the fourth quarter and PVS now sees the market picking up again in a strong way.

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ASX:NUS
Share price: A$ 0.32
Market cap: A$ 60M

The good times have continued for gold in 2020, with the yellow metal reaching US$1,580 an ounce on 30 January, as against close to US$1,520 at the start of the year. Now is, in our view, a good time to be looking at companies with new gold projects, and one of the best available on ASX belongs to the Perth-based Nusantara Resources. This company's Awak Mas Gold Project in Indonesia can potentially be producing by late 2022 at an All-In Sustaining Cost (AISC) of US$758 an ounce. All it will take is US$110-120m in bank debt, which is now being sought. We predict the search will be completed successfully before too much of 2020 has passed.

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A class act?

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Share price: A$ 54.93
Market cap: A$ 4.74BN

Domino's Pizza Enterprises, the Brisbane-based company which operates the largest pizza chain in Australia, saw its stock enjoy a nice recovery in 2019, from $40.81 on 10 July to $54.10 on Christmas Eve. However, there's still a little way to go before the previous resistance level of around $58 from August 2018 gets broken, which would push Domino's stock into fresh growth territory. With that stock still 9% shorted on ASX, we're not sure it will get there in the near term. There's too much that's risky about this company right now.

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Share price chart

Source: Tradingview

Computer chips, or semiconductors, are built one layer at a time and can consist of dozens of layers. These layers are essentially "grown" using a range of different gasses that react chemically to each other and to the material on which they are deposited. Pivotal's GFC's control the flow of these gasses. And because the mix of gasses and the flow rates of gasses are critical in growing uniform layers, Pivotal's products are crucial components in various semiconductor manufacturing tools, such as machines for Chemical Vapor Deposition (CVD) and Atomic Layer Deposition (ALD).

Catering to all relevant OEMs

Pivotal has several channels through which it sells its products. The company sells its GFC's directly to chip manufacturers in Asia, Europe and the US. It also sells to Original Equipment Manufacturers (OEM's) that build the production tools that they then sell on to the chip manufacturers. Then there's the foundries, mostly in Asia. These companies run chip manufacturing plants (fabs) and produce chips for third parties that don't have their own production facilities.

Pivotal supplies to all three groups, but importantly, we believe the company sells to the top 3 OEMs for deposition and etch tools, Applied Materials, Tokyo Electron and Lam Research. Through these key OEMs, Pivotal can basically address the entire market.

At the start of the next semiconductor upcycle

We would argue that the semiconductor industry is one of the most cyclical industries we have covered in the last twenty years. Because the financial returns are so high during the good times, especially in DRAM and Flash memory, the two dominant technologies for computer storage and memory, the industry tends to overinvest during these good times. This typically results in oversupply, driving down chip prices as well as share prices. We saw this happen in late 2018 and into 2019, with share prices typically preceding the industry fundamentals by about 6 to 9 months, as illustrated by the renowned Philadelphia Semiconductor Index (SOX).

During the fourth quarter of 2019 we already noticed certain indicators turning positive again, like the North American semiconductor equipment billings numbers. And more recently Samsung, Micron Technology and several other chip manufacturers reported stabilising prices for DRAM and Flash memory products with a positive outlook for 2020. And SEMI, an industry organisation, expects sales of semiconductor manufacturing equipment to grow by 5.5% in 2020 to US$60.8BN and another 10% in 2021.

As companies become more positive, they are likely to revise existing Capex plans upwards, both to expand existing fabs and to start up new ones. In 2020 Pivotal should see these Capex revisions reflected into its order book with a delay of several months or quarters, either through direct orders from chip manufacturers and foundries, or through the OEMs.

Get set, ready, go….!

In its 4C announcement and conference call on 31 January for the fourth quarter 2019 results, the company struck a positive tone regarding its revenues, its order book and industry developments in general. Combine this with the positive comments from other industry players, and it appears the semiconductor industry is on the cusp of a solid expansion phase. Yet, Pivotal's share price has been trotting along the bottom for a while now.

Given the company's strong positioning with its customers and the fact that we're only at the very start of the next industry upcycle, Pivotal is worth 4 stars in our book at the moment.

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A new gold mine ready to go

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Share price chart

Source: Tradingview

Nusantara is so-called because that's the Indonesian word for 'archipelago'. Indonesia has traditionally been a strong gold producer, and in 2018 was the world's seventh largest, with output of around 137 tonnes. Awak Mas is expected to be the country's next gold mine. The project is located on Sulawesi, that funny-looking island with four long peninsulas that lies to the east of Borneo and the northeast of the main Indonesian island of Java. The project covers a 2-million-ounce resource in the province of South Sulawesi that, under the current mine plan as per the October 2018 Definitive Feasibility Study, will yield 100,000 ounces a year over 11 years from an open pit. The capex bill to get this operation started is only US$146m after pre-production mining costs of USD$16m.

Awak Mas's time has finally arrived

Awak Mas was first discovered in 1991 and was owned by a string of companies before it was finally placed into Nusantara and listed on the ASX in 2017, under the aegis of the well-regarded mining investment house Lion Selection, which owns 23%. The reason it's taken so long for Awak Mas to get going is that either low gold prices or political risk in Indonesia or both have tended to conspire against the project. Gold is obviously doing well right now, and Indonesia under President Joko Widodo, re-elected last year, is proving to be attractive to foreign miners moving into the country. In Awak Mas's case all the infrastructure is in place, including good roads, a nearby port, and grid power, and there are no forestry issues that would hinder the completion of permitting.

In a place like Indonesia, an Australian company needs to have a local partner, and under an agreement struck in December last year Nusantara will own Awak Mas 60/40 with Indika Energy, one of Indonesia's largest integrated resources companies. That bodes well for the current discussions around bank debt, as does the decision by Petrosea, an Indika subsidiary that among other things provides mining engineering and construction services, to defer around US$40m in costs to lower Awak Mas's overall up-front capital costs.

A decision to mine in late 2020

Currently, Nusantara and Indika are getting ready for early works at Awak Mas like road construction and land clearance at the site. Nusantara is funding its share from an $11m share placement done at 34 cents in December 2019. The decision to mine is expected to take place late this year once the bank debt has been negotiated. Nusantara has plenty of upside to enjoy from Awak Mas once it gets going. There's room to expand the resource with new exploration drilling and Nusantara is already working on project optimisation that would increase production beyond 100,000 ounces annually.

Nusantara stock has run hard since the May 2014 low of 14 cents, buoyed by Indika's entry into Awak Mas and the bullish environment for gold in 2019. While the stock has eased back since the placement, there's room for it to continue rising given the quality economics of the project as per the October 2018 DFS and the imminence of a decision to mine. Not bad when at the moment you can buy Nusantara for an Enterprise Value to Resource ounce of only a little over A$40. That low figure leaves a fair bit up upside. No wonder a couple of Nusantara's directors have bought stock on-market recently.

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Share price chart

Source: Tradingview

The main risk relates to the take-up of new franchises. Domino's, the ASX-listed company, has grown into a Top 200 stock in Australia through its deft management of the master franchise rights for the Domino's brand, as granted by Domino's the US company, NYSE Code DPZ. These master rights don't just pertain to Australia and New Zealand but also Japan and six Western European countries. The store network for Domino's Pizza Enterprises now runs to more than 2,500. That's a lot of franchisees to keep happy, not to mention a lot of workers, and Domino's is going to have to get this right if it is to double to 5,000 stores this decade, as is its ambition. In several of its territories Domino's is relatively new, so there may be teething problems.

Unhappy franchisees?

The trouble is, Domino’s Pizza Enterprises might not have been keeping its franchisees happy in recent years. There’s an action now afoot in Australia’s Federal Court relating to a Perth franchisee complaining among other things about the low price he was forced to sell pizza at and the high price at which he is forced to buy ingredients. Domino’s Pizza Enterprises argued in a 6 January ASX announcement that it’s done nothing wrong except try to improve its franchise network and that it had told the market a while ago to expect some franchisees to leave the network and, maybe, sue. He said, she said…

Interestingly, there’s also a class action out there against Domino’s Pizza Enterprises which started in June 2019 related to alleged underpayment of delivery drivers and in-store workers in Australia. You can read all about that by visiting dominosclassaction.com.

The customers seem to be happy…for now

All of which doesn’t mean that Domino’s Pizza Enterprises hasn’t done a great job of serving the customers better and better over time. This is a company where you can order very low cost but still tasty pizzas (like A$5 for a normal size) via your mobile device, and one of the most efficient IT backbones known to man will help get it to the sofa in front of your television in a heartbeat. However, the customers might feel a little less comfortable about buying from Dominos if word gets out that the workers getting it to you were underpaid.

And, let’s face it, the company’s ultimate growth depends on the franchisees putting up the capital to build out the store network that supports that. If Domino’s Pizza Enterprises gets a reputation for not doing the right thing by its franchisees, that reputation, deserved or not, might also be bad for business.

We’re hearing that the flow of new franchisees in the core Australian business has been slow in FY20. In FY19 Domino’s reported revenue growth of 24% to $1.44bn but EBITDA only went up 9% to $282m because of lower than expected margins as Domino’s had to take more stores onto its own books.

In our view Domino’s looks expensive on 30x FY20 earnings and the half-yearly result in late February might see something of a reaction if the organic growth rate or EBITDA isn’t as strong as expected. This pizza might not be as tasty as usual for a while.

Pitt Street Research Pty Ltd

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