4 February 2020

Stocks Down Under

'Happiness is not in money, but in shopping'.

- Marilyn Monroe (1926-1962), American actress.

Adairs: The power of design

Stocks Down Under rating ★★★★

ASX:ADH   Share price: A$ 2.18   Market cap: A$ 388M

It was a great way to end 2019. On 4 December Adairs, the Melbourne-based homewares retailer, announced that it was acquiring Mocka, a profitable New Zealand-based furniture company that has its origins in baby, kids and nursery products and that had more recently moved into general home furnishings. The Mocka acquisition was expected to be earnings accretive in FY20 and to markedly increase the revenue which Adairs received from online channels. The market really liked both these prospects. Within a week Adairs stock was up 38%, from $1.78 to $2.44. While the share price has since eased back, we see potential for further upside from Mocka as well as the foundation Adairs business.

Company Share Price Chart

Source: Tradingview

Visit any major shopping centre around Australia and you're likely to find an Adairs store – there were 165 open as at June 2019 and maybe 5 or 6 will open in FY20. Adairs sells a wide range of tastefully designed homewares from quilts to towels to sofas to wall art. The company more or less divides up the 'middle' market for homewares in Australia with Myer, Country Road and Bed Bath and Table, where 'middle' means not as pricy as David Jones or Sheridan but not 'low rent' like Kmart or Target.

7% Like-for-like growth!

Adairs has proven that even in these tough times for old-fashioned bricks and mortar retail, there's room for its middle-market brand to grow. In FY19 revenue grew 10% to $344m. Like-for-like sales growth was a massive 7%. That's right, 7%. But there was a catch – EBITDA of $51m was flat. That was partly a function of a lower Australian dollar increasing the price of imported material and partly an increase in distribution costs through its network as that network expanded. However, the lion's share of Adair's cost increases related to costs associated with growing its online business. In other words, not too much to worry about since the more the brand takes off online, the better and more profitable Adairs will be in the medium term.

The secret to Adairs's success is that it designs its own products, which is the best way to create a loyal following because it helps shape consumer taste to its advantage and justifies the premium pricing. A second growth factor is that the stores are getting bigger, improving the customer experience. And, thirdly, the Adairs brand has managed to succeed online. In FY19 17% of all sales came this way.

A fourth secret of Adairs success is the fact that the only serious competitor in mid-market is Bed Bath and Table. The Melbourne-based Dempsey family have built their business from the ground up in the mid-1970s and know the space back to front. Myer (ASX: MYR) and Country Road (owned by Woolworths South Africa, JSE: WHL) may compete but their core business isn't homewares. By contrast this is all Bed Bath and Table's and Adairs' bread and butter.

30% of revenue now online

Which brings us back to the Mocka acquisition. Mocka, like Adairs, is a design-led business. Where Mocka is ahead of the game is in online retailing. Adairs estimates that online sales from the combined businesses will be about 30%, so basically Mocka takes Adairs further in the direction it wants to go and, possibly, a step ahead of Bed Bath and Table. We'll be very surprised if Adairs doesn't enjoy substantial synergies from this acquisition.

Adairs got a good price for Mocka. It paid NZ$80m, around 9x expected FY20 EBIT pre-synergies. The acquisition will be earnings accretive because Adairs paid only NZ$46m cash at settlement alongside NZ$6m in shares, with the remainder to be paid based on Mocka EBIT in FY21 and FY22. We think if Mocka works out there are more acquisitions for Adairs where that one came from.

At the moment the market isn't expecting much from Adairs – the stock is currently on a P/E of 11.3x expected FY20 earnings dropping to 9.7x FY21. We think the half-yearly numbers in February might reveal a retail brand in surprisingly good health.

Downer EDI: An unusual downgrade

Stocks Down Under rating ★★★★

ASX:DOW Share price: A$ 7.27 Market cap: A$ 4.41BN

Shareholders of the Sydney-based engineering company Downer EDI didn't have a good start to 2020 – on 23 January a profit warning took Downer stock down 18% to $7.17. Interestingly, the stock stabilised around this level fairly quickly. We think that Downer's transition to a focus on services and its large pipeline of new work can overcome what appears to be a short-term issue.

Company Share Price Chart

Source: Tradingview

Downer EDI is one of those engineering companies that rarely have profit warnings. Between 2015 and 2019 the company's management would set earnings guidance at the start of the financial year and then be able to say at the end of the year that it had met that guidance. In August 2019 the company had confidently declared that NPATA would be $365m in FY20, as against $340m in FY19. The 23 January downgrade took FY20's guidance down to $300m. We think the reason why Downer stock has stabilised since 23 January is the market's willingness to trust that this is a one-off. Downer came into FY20 with net debt / EBITDA in FY19 of only 1.2x, so the market doesn't have to worry about the balance sheet here.

Urban services is where the game is at

The blame for the profit warning lies mainly with Downer's Engineering, Construction and Maintenance (EC&M) business, which builds equipment and infrastructure for the resources sector. That division was only 8% of EBITA in the first half of FY19, but in 2019 it yielded a number of projects that required more costs to complete than Downer had initially thought.

The 23 January downgrade doesn't worry us too much because Downer is moving as quickly as it can towards what it calls 'urban services', where 80% of its revenue and earnings currently comes from. 'Urban services' encompasses things like road network management, or facilities management, or asset management for the utilities industry. This kind of business is characterised by predictable and long-term revenue streams and dependable margins, albeit not as big as what you can get in EC&M.

The other reason we're not too worried about the 23 January downgrade is the strong pipeline of work in hand, currently sitting at US$46bn versus the

US$44.3bn level of June 2019. This suggests a company that continues to attract business from a loyal customer case.

Look through to FY21's earnings

The big picture for Downer is that owners of transport and utility infrastructure, as well as facilities such as jails or stadia— are increasingly disinclined to keep the management of such assets in house and prefer reliable partners like Downer to do it. It doesn't take Downer much capital to grow in this space and the long-term returns are sizeable. Downer could conceivably exit its Mining Services business as well as EC&M, having put both these businesses under review in 2019. A decent exit would probably prompt a re-rating in the share price.

Downer is currently on a P/E of 17.4x FY20 earnings, but that drops to 13.9x FY21. This could be a good one for the contrarians willing to look through to next year's rebound in earnings. An upper, not a downer.

Dacian Gold: Mt Morgans appears to be fixed

Stocks Down Under rating ★★★

ASX:DCN   Share price: A$ 1.40   Market cap: A$ 320M

Every now and then stocks of resources companies with producing mines crash because of temporary production issues of one sort or the other. That happened to the Perth-based Dacian Gold, owner of the Mt Morgans Gold Mine in Western Australia, in June 2019. One bad quarter at that mine and suddenly Dacian stock was down 80% on the level of late February. Dacian stock has since partly recovered, however, we think a stronger gold price can further assist that recovery in 2020.

Company Share Price Chart

Source: Tradingview

Dacian Gold is one of those relatively new gold miners on ASX, having got its start with the recent reboot of the old Mt Morgans Gold Mine in Western Australia. Don't confuse this Mt Morgans with the famous Mt Morgan copper-gold mine near Rockhampton in central Qld. Dacian's Mt Morgans (note the 's' at the end) sits in that gold rich Kalgoorlie-Laverton-Leonora region of Western Australia, around 20km west of Laverton. The Western Australian Mt Morgans was first mined in the 1890s and, after a mid-20th century closure, was revived intermittently in the second half of the century. It came into Dacian's hands in 2012 and, after around $200m in capital costs, poured its first gold in March 2018.

Mt Morgans 1.0 was a disappointment

Dacian's intention at the commencement of Mt Morgans was to produce 180,000-210,000 ounces in FY19 from two mining centres 15 km apart – underground at Westralia, open cut at Jupiter – with ore being processed at a 2.5 million tonnes p.a. plant in between. Under the original mine plan, Mt Morgans would produce 200,000 ounces or more over the following ten years at an All-in Sustaining Cost of around A$1,000 an ounce. That looked conservative because Mt Morgans was backed by a resource of 3.5 million ounces. A slow March 2019 quarter due to equipment availability issues cut the FY19 forecast to 150,000-160,000 ounces, but then, on 5 June 2019, came a revelation that took Dacian's share price down by 68% in a day.

Dacian indicated that the June quarter would only bring the total output for FY19 to around 140,000 ounces. Worse still, the grades at both Westralia and Jupiter weren't coming in as expected. The expectation, therefore, was that FY20 would only see 150,000-170,000 ounces produced at an AISC of A$1,350-1,450 and production for the next five years would be in the order of 160,000-180,000 ounces.

Mt Morgans 2.0 looks better

Dacian was only able to come back from this downgrade after its engineers went back over what they knew, particularly with regard to grade, and the company reported back to the market on 10 July what seemed credible numbers on production and costs at Mt Morgans. The current guidance, which is reasonably close to the 10 July estimates, is 150,000-170,000 ounces at A$1,400-1,500 an ounce in FY20 and 150,000-170,000 ounces over eight years at A$1,340-1,440 over an eight-year mine life.

The current resource at Mt Morgans is 3.65 million ounces, higher than at the time of the first gold pour. Interestingly, Mt Morgans stock is currently in voluntary suspension on ASX while the company prepares to disclose what it thinks the correct resource and reserve should be. A resource/reserve downgrade probably doesn't change the current mine life by much, and it comes at a time of rising gold prices that could offset this. Moreover, we think the Dacian board, which includes the noted Perth mining entrepreneur Barry Patterson, has been conservative on its production outlook since mid-2019.

So, there is potential for this company's share price to go forward after the resource announcement, helped by the fact that as of 6 January it has a new CEO, Leigh Junk, who succeeded the founding CEO, Rohan Williams. Junk's previous port-of-call was Doray Minerals, which merged last year with Silver Lake Resources (ASX: SLR) and whose company-maker was the successful Deflector Gold-Copper Mine in the southern Murchison region of Western Australia.

People who like gold stocks right now need to watch this one carefully post the recommencement of trading. Should Dacian stock be weak, this could be a great opportunity given what the yellow metal has been doing lately.

Pitt Street Research Pty Ltd

95 Pitt Street

Sydney NSW 2000

Australia

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