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Stocks Down Under

'There are two times in a man's life when he should not speculate: when he can't afford it and when he can'.

- Mark Twain (1835-1910), American writer.

Syrah Resources: Is graphite back?

Stocks Down Under rating ★★★★

ASX:SYR **Share price: A$ 0.535** **Market cap: A$ 199M**

How the mighty have fallen! Back in June 2016 stock of the Melbourne-based graphite miner Syrah Resources – yes, they named it after the dark-skinned grape variety used primarily to produce red wine – was changing hands at $6.27 per share. By late November 2019, in the wake of a long hangover, you could get it for only 35 cents, in spite of the fact that Syrah's massive Balama graphite mine in Mozambique had come into production in 2018. Syrah is still 17% shorted on ASX but we see potential for the stock to turn around in 2020 based on better pricing for Syrah's product.

Company Share Price Chart

Source: Tradingview

Syrah's three-year decline was the fruits of two major concerns – one that the market for graphite had become oversupplied as a result of Balama, and the other that Syrah's graphite was not a premium product.

A huge graphite mine

Graphite, as we all learned at school when handling pencils made of the material, is simply crystalline carbon. The reason the world will need markedly more graphite in the future isn't because we'll be using more pencils, but because the lithium-ion batteries in Electric Vehicles use graphite in the battery anode. Syrah aims to be a major supplier of that graphite.

Balama, which lies around 200km west of the northern Mozambican port town of Pemba, is potentially a huge graphite mine. The mine's reserve is 113 million tonnes at 16% TGC (Total Graphitic Content) which, with a processing plant capacity of 2 million tonnes p.a., means that Balama can operate for more than 50 years pumping out 350,000 tonnes of graphite concentrate every year.

Syrah turned the tap off last September

The price of all battery minerals came down in 2018 and 2019 on concerns about oversupply. Most analysts predict a bottoming in prices this year and a return to good times in 2021 as demand catches up with supply. Syrah had the misfortune to be bringing Balama onstream at a time when its output would exacerbate a growing surplus of material. Interestingly, Syrah stock has recovered so far in 2020 after the December 2019 quarter indicated that the company was getting better pricing. That better pricing may have been partly because Syrah reduced production at Balama by 66% in September 2019.

A bit flaky

A second issue that investors have grappled with regarding Syrah is flake size. ‘Flake’ graphite is simply natural graphite and is so called because flakes are what you get when you take a lump of such graphite and break it up. There are five kinds of flake graphite – ‘fine’ (i.e. very small), ‘small’, ‘medium’, ‘large’ and ‘jumbo’. The larger flake sizes are in demand for ‘expandable’ graphite used in fire retardants and in making graphite foils for electrical and computer applications. The smaller graphite flake sizes are what is used for lithium-ion batteries. The larger the flake size, the better the pricing. Balama’s output in 2019 tended to be towards the smaller flake size.

One for the speculators

We think flake size is not really relevant to Syrah’s long-run performance with Balama. So long as the company can balance its output against marginal demand in the near term, and steadily bring its costs down – which, so far, it has been successful in doing – then in the medium and long-run flake size does not matter so much. We believe demand for graphite of all flakes is likely to rise strongly in the years ahead.

Now, don’t get us wrong. Syrah is still risky because the company is loss-making – the forecast cash outflow in the March 2020 quarter is US$16m, which would bring the cash balance to US$65m. However, the December quarter indicated that the company seems to be moving in the right direction in terms of ‘right-sizing’ Balama. So, this one is Four Stars but one for the speculators.

Australian Agriculture: Looking up for the first time in a while

Stocks Down Under rating ★★★★

ASX:AAC Share price: A$ 1.14 Market cap: A$ 672M

As with Syrah Resources, the last three years have not been kind to Australian Agricultural Company, commonly known as AACo. The stock of this Brisbane-based cattle producer was $2.12 in July 2016 but by February 2019 it was just 90 cents. Most of the downswing has been due to a pretty severe drought afflicting Australia, and often cattle prices haven't helped either. We see better times ahead in 2020.

Company Share Price Chart

Source: Tradingview

AACo's 24 cattle stations and feedlots cover something like 1% of Australia's land mass, spread over 6.4 million hectares in the state of Queensland and the Northern Territory and holding more than half a million cattle. AACo is one of Australia's oldest companies, having been continuously in business since 1824, however, this is not just any cattle producer. AACo's strategy for some time now has been is to go after the premium pricing that cattle producers can get for grain-fed beef, and in particular for a Japanese breed called Wagyu. That breed naturally obtains uber-premium pricing due to the 'marbling' in its meat where white flecks of intramuscular fat add a lot of flavour.

Blame the weather

With AACo anything that *can* happen, will happen when it comes to weather. For example, in early 2019 there was record flooding on several of AACo's stations in the Gulf of Carpentaria, and this event brought the stock down to its 90-cent low. The result was the loss of around 40,000 head of cattle. One station, called Wondoola, lost as much as 90% of its cattle in the flooding. In addition to the cattle losses AACo had to spend millions on repairing fences and water infrastructure.

However, drought has been worse for AACo than floods, and the drought which hit eastern Australia at the start of 2017 has been one of the worst in living memory. When it's dry on cattle properties you've got to spend a lot more on feed and cattle prices can become depressed. In the six months to September 2019 AACo's operating profit was slashed by 75% to just $6m because of this drought. That took the shine off the fact that AACo sold 9.5% more of its branded Wagyu meat than the previous corresponding period.

Bullish on Wagyu

We think the Wagyu story is the reason to back AACo for the long haul. For decades now Wagyu has been a high-priced dining experience and that demand shows no sign of slacking off in the foreseeable future. If a 16 January 2020 story in the San Francisco Chronicle is any guide *(‘The cult of Wagyu hits San Francisco’* by Justin Phillips), the Wagyu boom will be with us for a while yet, carrying AACo with it.

Over the cycle we expect that AACo can create considerable shareholder value from Wagyu and the only thing that can hold this back is a sudden change in consumer tastes. Of course, it helps to buy when the country is at its driest, as it was late last year. Another buying opportunity now might be Coronavirus fears, in the light of the fact that China recently became Australia’s largest beef export market in 2019 after the US and Japan.

The good news for AACo today is that this wretched drought might be breaking. There’s been a lot of rain in eastern Australia since the start of the year and while the weathermen aren’t calling the end of the dry spell yet, the commentary appears to be hopeful. Throw that in with continued strong export demand for Australian beef, and a lower pool of cattle to satisfy that demand, and AACo may have a pretty good year ahead of it, from paddock to plate. Not bad when you can get AACo stock at a discount to its $1.37 per share Net Tangible Asset Backing.

Fonterra Shareholders Fund: China doesn’t want any more milk for a while

Stocks Down Under rating ★★

ASX:FSF   Share price: A$ 3.78   Market cap: A$ 382M

The Fonterra Shareholders Fund is the vehicle that allows people who aren’t dairy farmers to own a piece of Fonterra Co-operative Group, a New Zealand based dairy co-operative. After a long slide between January 2018 and August

2019 that saw the share price of the Fund halve in value – from $6.10 to $2.94 – the Fund rebounded 36% in September and October before stabilising. We think it is headed for another tough period.

Company Share Price Chart

Source: Tradingview

The issue is milk prices and how they are driven by Chinese consumption. Fonterra started the FY20 year with a bright outlook – hence the Fund price rebound. Also, investors had regarded positive Fonterra's indication that it would get out of old-fashioned milk pools outside New Zealand and focus more on being a new generation dairy company making value-added products around the world. Fonterra, however, still sells a great deal of raw milk and milk products on wholesale markets and the price of such products selling into China is likely to be weak in the near term.

China doesn't want as much milk as they did last year

Global Dairy Trade, the online market for dairy that conducts regular auctions and whose system acts as a price reference point for producers globally, saw a 4.7% drop in average prices in its February 4th auctions. That's basically Chinese buyers withdrawing from the market for a while. The resulting price weakness is likely to continue until the Wuhan Coronavirus burns itself out, probably in the middle of 2020 if the SARS experience of 2002/2003 is any guide.

China has become a major dairy consumer as the country moves into the middle class, economically speaking. Per capita milk consumption in China was only 18 kilograms in 2007 but it increased to 36 kilos in 2018 and there's more where that came from because the world average is about three times as high. Even at 36 kilos any disruption to China's economic life becomes bad for dairy producers globally and particularly so for Fonterra, since China is now the world's leading dairy importer. Ominously for Fonterra, it accounts for around 11% of all dairy consumption in China, with the country taking around a quarter of Fonterra's milk exports and the long-standing Fonterra brand Anchor having become a major milk brand in China over the last five years or so.

Fonterra has various challenges

So, Fonterra has some difficult times ahead in the near term. But even after the Coronavirus has been consigned to the epidemiological history books Fonterra will still have challenges. The drought in Australia might be breaking as we speak but it will still have an impact on the next financial result. There's also been issues with DPA Brazil, a dairy products business that has suffered as a result of a weak Brazilian economy, and Fonterra's New Zealand consumer business, where brands such as Mainland and Anchor have been underperforming. And let's not forget the big issue for Fonterra, which is debt. Gearing as measured by net debt to EBITDA was 4.3x as at July 2019 and the company needs to get it down to more like 3.75x.

Fonterra Shareholders Fund is currently on a P/E of 17x FY20 earnings, where FY20 refers to the year ended 31 July. For FY21 the P/E falls to 12.5x but we think the market will have difficulty seeing through that in the near term.

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