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Stocks Down Under

'You've got to take the bitter with the sour'.

- Samuel Goldwyn (1879-1974), American movie mogul

Costa Group: Making a comeback

Stocks Down Under rating ★★★★

ASX:CGC Share price: A$ 3.17 Market cap: A$ 1.21BN

Not too long ago – in June 2018 – you had to pay over $8.00 per share to get a piece of Costa Group, Australia's biggest fruit and vegetable producer. Just before Christmas 2019 the stock was very much 'on special', changing hands at just $2.37. However, we predict a recovery for Costa in 2020 as the drought breaks in Australia, leading to better growing conditions for avocados, blueberries and late-season citrus crops.

Company Share Price Chart

Source: Tradingview

If you look at the chart for Costa Group since the company went public on ASX it forms an almost perfect inverted ‘V’. Costa did its IPO at $2.25 per share in mid-2015 and the stock performed strongly for the next three years. In part we think that was because investors like a story they can relate to in their daily life, and what’s more everyday than buying fruit and vegetables? Costa also had that ‘humble beginnings’ story investors tend to favour – this company started out as a single fruit shop in the western Victorian town of Warrnambool, which the original Costa opened sometime around 1928 after he emigrated from Italy.

2019 – Costa’s Year of Living Dangerously

Folksy stories about fruit shops in Warrnambool, however, weren’t enough to prevent investors coming unstuck between mid-2018 and late 2019. Disaster struck in the form of drought in Australia, although there was also oversupply in some of Costa’s key products. By late 2019 there was an additional problem because Costa’s balance sheet was looking stretched - a lot of capital expenditure had been debt funded, and at the lower level of earnings for 2019 Costa was now in danger of breaching banking covenants. That danger was only averted with a deeply discounted one-for-four rights issue that raised $176m at $2.20 per share. Interestingly, Costa stock has consistently remained above $2.20 since this transaction was conducted in October and November 2019, even when bushfires impacted Costa’s berry farm at Tumbarumba in southern New South Wales as 2020 started.

It’s fair to say that Costa Group remains deeply out of favour with most investors. Indeed, if you speak favourably of it at a barbeque this weekend you are likely to hear howls of derision from those who remember the halcyon days of 2018.

But at Stocks Down Under we would regard those howls as the sign of a great contrarian play. We like Costa Group a lot right now.

2020 could be a good year

What's to like about Costa? Well, for a start, the company is still profitable – in calendar 2019 it expects to enjoy EBITDA of $98m, with a snap-back in 2020 to $150m so long as growing conditions are favourable. With indications in early 2020 that the drought seems to be breaking, that guidance has a good chance of being met.

The next thing to like about this company is that, most of the time, its portfolio of fruit and vegetable properties allows Costa's earnings to grow. Which is to say, if berries are having a bad year, then tomatoes will be good, or if Australia isn't doing well then Morocco or China, where Costa also has blueberry and raspberry properties, can take up some of the slack. 2019 was a rare Black Swan year for Costa where just about every property was impacted in some way.

Australians are eating more blueberries

Then there's the underlying market. Australia's population is growing and its people tend to eat more fruit and vegetables. When they do buy, they prefer to buy Australian-made produce, even at a higher price point, on the assumption that our production standards are higher than the countries that ship their lower-quality produce Down Under.

Currently you can get Costa for a P/E of around 24x forecast calendar 2020 earnings. That may look expensive, but we believe that the forecasts may be revised upwards as 2020 progresses and Costa executes well in a better growing and selling environment. It will be interesting to see how the market likes the full year 2019 numbers, due out 27 February. The rebound could be strong if the 11% short position in the stock has to be bought back.

Oil Search: The patient oil company

Stocks Down Under rating

ASX:OSH Share price: A$ 6.55 Market cap: A$ 9.85BN

The last month or so hasn't been kind to shareholders of Sydney-based oil and gas major Oil Search. In addition to falling oil prices as a result of the Wuhan Coronavirus outbreak, the market had to swallow the news on Monday 3 February that a major expansion of the PNG LNG Project, of which Oil Search is a co-venturer, would not be taking place in the near term. That was unexpected. Oil Search fell 7% on the news that day. We think Oil Search stock has now dropped into interesting territory for the contrarians.

Company Share Price Chart

Source: Tradingview

To understand why Oil Search is looking good right now, let's revisit a bit of history. Oil Search, founded way back in 1929, was one of the luckiest or unluckiest companies publicly traded in Australia for many decades, depending on your point of view. Unlucky because for over 50 years it kicked around what is now Papua New Guinea (PNG) looking for oil and gas and didn't make a major discovery. Lucky in that it managed to stay alive all through that time until the drought finally broke in 1986. That was when a Chevron-led joint venture, with Oil Search as a partner, discovered the Iagifu/Hedinia field, with in excess of 200 million barrels of oil in place, in PNG's South Highlands Province. This field, plus the later Usano and Agogo discoveries, became the foundation of the Kutubu Oil Project, PNG's first commercial oil development, which came on stream in 1992. By that time English dictionaries in Australia were, we like to joke, considering adding another definition for the word ‘patient’ when used as an adjective: ‘*Characteristic of a long-term Oil Search shareholder’*.

PNG LNG has been a roaring success for Oil Search

After Kutubu, Oil Search started going after the massive gas riches of PNG based on a field discovered in 1987 called Hides, located not far from Kutubu in neighbouring Hela Province and known to contain trillions of cubic feet of the stuff. The original idea was to take Hides gas and pipe it 3000 km down to Queensland. That idea was finally dropped in 2007 due to an apparent lack of Australian customers, but in 2008 ExxonMobil began to steer the project in the direction of Liquified Natural Gas (LNG). The pivot to LNG was genius, because global LNG demand was booming by 2009, and no wonder, since that kind of gas frees customers from the need to have pipelines coming from not-so-nice countries, like Russia.

Thus was born the PNG LNG Project. All the co-venturers signed off on this project in 2009 and the first LNG shipped from a facility near the PNG capital of Port Moresby in mid-2014. The project has since been a roaring success for all concerned, producing way above the original design specification of 6.9 million tonnes of LNG a year. Now ExxonMobil and Oil Search, who own 33% and 29% respectively of PNG LNG, as well as their other co-venturers, want to double the size of the project.

PNG LNG can potentially double in size

Which brings us to this week’s news. To increase the size of PNG LNG from two ‘trains’ to three (in the energy industry each LNG processing unit is called a train) another gas field needs to be added to the project. The field in question is called ‘P'nyang’ (yes, there’s an apostrophe between the P and the first n) and it was discovered in 1990 about 130 km northwest of Hides. Before it can be developed as part of PNG LNG, the relevant fiscal terms need to be decided between the owners of the project, led by ExxonMobil, and the PNG government. The news this week was that the government, under Prime Minister James Marape, who took office last May, didn’t like whatever terms were on offer from ExxonMobil, so there was no deal. Hence the crash in Oil Search stock.

The reason we think Oil Search is interesting for the contrarians right now is that it’s a reasonable bet that eventually a deal will be struck with the PNG government that works for all concerned. For PNG the opportunity is for this relatively poor country to become an LNG powerhouse alongside Qatar, Australia, Mozambique and other countries emerging in this rapidly growing part of the energy market. For the co-venturers including Oil Search there’s obvious upside in terms of shareholder value.

Right now, you can buy Oil Search for a P/E of 19.6x expected FY20 earnings. Not cheap, but not expensive either. We suspect Oil Search stock might be weak for a while until oil prices find a new post-Coronavirus level and the market forgets about P'nyang for a while. In the meantime, this is one for the contrarians to watch closely.

Medical Developments: Huffing and puffing

Stocks Down Under rating ★★

ASX:MVP Share price: A$ 10.50 Market cap: A$ 700M

It's been a great Australian success story: the Melbourne-based drug development company Medical Developments has taken Penthrox, a hand-held, inhaled, non-opioid analgesic product that was once used only in Australia, and gained approval for it in many jurisdictions around the world. The stock has responded nicely, to the point where Medical Developments is now a $700m company. However, we feel that the stock is ready for a breather.

Company Share Price Chart

Source: Tradingview

Medical Developments is a one-hit wonder company. But what a hit! The company came to the ASX way back in 2003 to take to a global market the so-called 'Green Whistle', which was simply a green-coloured inhaler for the delivery of an analgesic called methoxyflurane. For a long time, Australia was one of the few places in the world where methoxyflurane was an approved drug. You'd have an accident, the ambulance would arrive and the medics would give you the Green Whistle. A few puffs of methoxyflurane and the pain relief would kick in on the way to the hospital. The reason this wonder drug wasn't available in most other markets was because of concerns that this 'halogenated ether' would cause kidney damage at high doses. Medical Developments did the work to show that its formulation of methoxyflurane, brand name Penthrox, was safe for acute pain and could bring about clinically significant reductions in the level of pain. It has subsequently reaped the upside of this knowledge.

An established business

Medical Developments' stock first started to take off around 2012 when revenue was \$11m. The initial re-rating took the stock to \$2.15 when the results of a 300-patient Phase 3 study showed that Penthrox worked as expected and paved the way for European approval. A second re-rating started in late 2014 and was driven by the gradual globalisation of the product and took it from \$1.00 to more like \$8.00 by early 2018. A third re-rating started last September and has seen the stock go from \$4.40 up to the current level above \$10.00.

Medical Developments is now an established and rapidly growing business. Revenue in FY19 was \$21m, up 20%, and EBITDA was \$3.4m, up 55% on the previous year. We're confident the company has a bright future because of the high utility of Penthrox. However, we wonder if the easy share price increases are over.

US approval is a long way away

Consider, for example, the fact that Medical Developments won't be filing for FDA approval until next year and might not get approval until late 2022 or maybe even early 2023. Medical Developments reckons Penthrox is a \$2bn global opportunity, but half of that is the US market, which the company won't be able to access for another two or three years. In August 2018 the FDA sent Medical Developments a long letter outlining its safety concerns and why it was putting the Penthrox programme on 'Clinical Hold' (i.e. not approved for clinical work in the US). While these issues can be overcome with data the company will generate, getting this data will take time. The Clinical Hold remains in place for now.

Meanwhile for China, the so called 'IND' (Investigational New Drug) that would allow the drug to be tested there only just got cleared last November. It will likely be years before Penthrox is approved in that market after the relevant clinical studies asked for by China's regulators have been performed.

The Russians are going to love Penthrox

Another factor to keep in mind with Medical Developments is that not all approvals are the same, and most of the low-hanging fruit has already been plucked in this regard. In December 2019 Penthrox filed for Marketing Authorisation of Penthrox in Russia. Approval there will be nice, but no self-respecting pharma company regards Russia in the same way as it regards Germany, France, or Japan, or even Brazil.

Given these factors – the lack of US and Chinese approvals and the fact that the 'easy' approvals have already all been gained – Medical Developments looks expensive right now. The stock is currently trading at 27.5x FY20 forecast revenue and 21x expected FY21 revenue. We'd be cautious. The potential share price pain, once the current bull market eases off, will not be treatable with a few quick puffs from the Green Whistle.

Pitt Street Research Pty Ltd

95 Pitt Street

Sydney NSW 2000

Australia

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