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Stocks Down Under

'Everything has its limit - iron ore cannot be educated into gold'

- Mark Twain (1835-1910), American writer

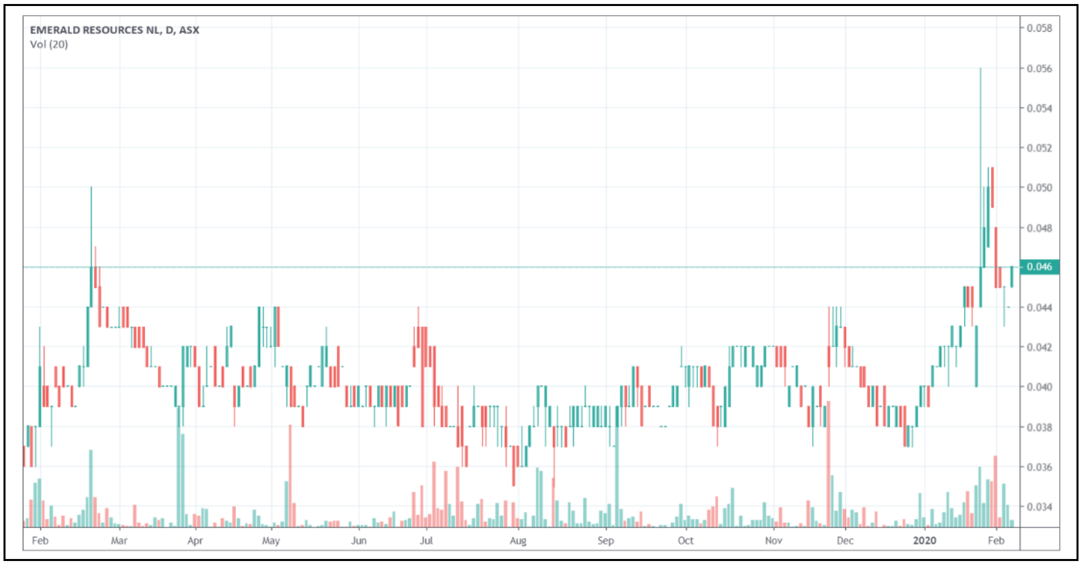
Emerald Resources: Another wonder from the land that gave us Angkor Wat

Stocks Down Under rating ★★★★

ASX:EMR Share price: A$ 0.046 Market cap: A$ 167M

The timing couldn't be better for Emerald Resources, the Perth-based company that owns 100% of the Okvau Gold Project in Cambodia. Gold's recent move above US$1,500 an ounce, and favourable fiscal terms in Cambodia, has made Okvau's transition to a producing mine relatively easy. With the project now funded, Emerald is on track to be a 100,000+ ounce p.a. gold miner from the middle of next year at an All-In Sustaining Cost (AISC) of just US$754 an ounce.

Company Share Price Chart



Source: Tradingview

When investors in Perth or Vancouver or Denver think 'mining' they don't generally think 'Cambodia'. Indeed, this small southeast Asian nation – population 16 million, capital Phnom Penh – didn't even get rated as to its attractiveness to mining companies when Canada's Fraser Institute conducted its most recent Annual Survey, because there weren't enough responses from those surveyed. That, however, may be about to change given the favourable terms on which Emerald Resources will be developing its 'company maker' at Okvau, a gold deposit with a 1.1-million-ounce resource in Cambodia's eastern province of Mondulkiri.

Great fiscal terms

Cambodia, which has a long history of 'artisanal' mining (that is, small-scale, subsistence-style informal mining conducted by individuals or small groups on mineral-rich fields), began to mainstream its mining industry in 2016, offering terms Western miners would find attractive. Under Emerald's Mineral Investment Agreement with the government, the company gets to own 100% of Okvau rather than having to take in a local partner, as is commonplace elsewhere in the region. The company will pay a 3% royalty on gold sales to the Cambodian government, and its tax rate will be 25% for the first five years and 30% thereafter. There's also an exemption from import duties for the first three years.

That kind of fiscal regime adds to the attractive economics of Okvau itself. The May 2017 Definitive Feasibility Study, which proposed processing 2.0 million tonnes or ore p.a. to produce 106,000 ounces a year over seven years, suggested a post-tax NPV of A$213m on a 5% discount rate at a mere US$1,250 an ounce gold price. The capital cost for the operation was envisaged at US$98m. Okvau is relatively straightforward from a processing point of view, with the single stage crushing circuit and SAG mill, sulphide flotation, regrind mill and cyanide leaching all par for the course in the gold industry. When Emerald updated the DFS in late 2019 to assume US$1,450 an ounce gold, and bumped AISC from US$731 to US$754, the post-tax NPV came out a lucrative A$345m.

Funded and ready to go

Some investors may worry that in a 'frontier' mining country like Cambodia, Emerald's project is too remote. We don't think so - Okvau is only 90 km from Kratie, a Mekong River port town about five hour's drive north of Phnom Penh. Interestingly, Okvau has access to grid power at under 12 US cents per kilowatt hour in a country where the grid is only available for around 72% of the population. Sometimes the new frontiers aren't as 'frontier' as you think.

Emerald Resources found the debt funding for its project in mid-2019 via a US$60m term sheet with the Toronto-based Sprott Inc. (TSX:SII), an asset management firm that often does precious metal financing and is associated with billionaire and noted 'precious metal fanatic' Eric Sprott. The equity component of the Okvau financing has, in effect, just kicked in via a A$75m placement at 4 cents per share that Sprott assisted with. With funding now more or less in place and Okvau's Mining Licence, Environmental Approval and Mineral Investment Agreement all nailed down, Emerald is on track for its first gold pour in the second quarter of 2021.

Room to expand

Beyond Okvau, Emerald is sitting on 1,400 sq km of exploration territory in the neighbourhood that could considerably expand the upside of Emerald from the original project. The geologists reckon the region looks ripe for 'intrusive-related' gold structures like those which created the Pogo Gold Mine of Northern Star (ASX:NST) in Alaska. The folks at Sprott like what they see in Cambodia – alongside the US$60m project finance facility they have also extended to Emerald a US$100m 'acquisition and development facility' to help the company find other gold opportunities in Cambodia. So how do you say 'large upside' in Khmer?

RPM Automotive: Performance vehicle

Stocks Down Under rating

ASX:RPM   Share price: A$ 0.18   Market cap: A$ 16.2M

Often when companies ‘backdoor list’ on the ASX, backing the company into a defunct but still-listed ‘shell’, the stock can languish for a while as shareholders of the shell take the opportunity to sell without waiting to see if the newly backdoored company can rescue shareholder value. We wonder if that’s what happened to the Melbourne-based automotive aftermarket supplier RPM Automotive Group, which completed its backdoor listing in August 2019. The fact that the CEO recently bought stock on market might be telling us something.

Company Share Price Chart

Source: Tradingview

Let’s face it: 2019 wasn’t the best year to be listing a company involved in the automotive trade. Only 1.06 million new cars were sold around the country, down 8% on 2018, as drought impacted sales in rural Australia, while declining property prices hampered the confidence of consumers in urban areas. And when people aren’t buying new cars, they may be less inclined to participate in the aftermarket as well.

Trading below issue price

That’s probably been the concern of investors looking at the newly public RPM Automotive. That company raised $2.6m in a placement at 20 cents per share prior to the completion of the backdoor. On the first day of trading the stock closed at 16.5 cents and the highest close it's been to since then is 19.5 cents.

The assumption would be that in a time when automotive expenditure is being pared back in Australia, the company's Genie Headers business would be in trouble, since the exhaust manifolds from this business are used in performance vehicles. The same assumption would apply to Revolution Racegear, which sells race safety gear and performance accessories to the motorsports industry and includes the RPM brand in its brand stable. Possibly the franchised Carline Automotive chain, which sells and services automotive exhaust systems, and Fix My Truck, which provides 24/7 nationwide breakdown service for vehicles 3-tonnes and above, would be holding their own, alongside RW Tyres. The latter, as the names suggest, imports and wholesales tyres. But the general assumption would be that 2019 was not RPM's year.

A good year for tyres

We think RPM's trading update from late November shows that possibly 2020 might be its year. What it showed was that all the company's divisions were trading profitably, and that Tyres and Wheels, its biggest division, was doing particularly well, with turnover up 11% year-on-year. Interestingly, RPM has recently made some acquisitions in the tyre space. Tyre distribution is an area ripe for growth in Australia because, unlike a decade ago, consumers are coming to trust Chinese brands in the automotive space, and that opens up opportunities for tyre importers like RPM with good relationships in China. Long March, an important Chinese tyre brand, is an RPM staple.

Sure, in the November 2019 Trading Update, Roadside and Repairs were down 9%, as was Motorsports, but the September quarter is generally the slow time for the automotive sector in Australia, since there's no major holiday period in the offing at that time of the year. RPM commented that it had seen a 'strong recovery in October-November'. We suspect that the half-yearly numbers, when they come out, will show a business in reasonably good shape. Last week RPM CEO Clive Finkelstein bought some RPM stock on market. Clearly, he's confident that his company is a performance vehicle and not just any old passenger car.

Australian Pharmaceutical Industries: Not yet in the clear

Stocks Down Under rating ★★

ASX:API **Share price: A$ 1.30** **Market cap: A$ 638M**

Australian Pharmaceutical Industries, the Melbourne-based pharmaceutical wholesaler, doesn't own the world's most attractive business. Getting medicines to 3,500 pharmacists around Australia requires a huge and costly network of 15 distribution centres where the growth and margins of the network are, in effect, capped by the government. API showcased its various businesses last week in an Investor Briefing, the same day Chairman Mark Smith disclosed that he'd bought stock on the market. There could be upside for shareholders yet. But we'd be cautious right now.

Company Share Price Chart

Source: Tradingview

For years now the board and management of API have been working on a difficult problem – how to grow shareholder value when a significant amount of its assets are trapped inside the infrastructure required to do pharmacy wholesaling in Australia?

Pharmacy wholesaling is a tough business because no-one really wants to pay for that infrastructure, even though without it people couldn't get their prescriptions filled, and that could be life threatening. In the year to August API gained 71% of its revenue from pharmacy wholesaling but the gross profit was only 7.5%. That's gross profit. EBITDA is anyone's guess because API doesn't disclose that at a divisional level. In 2018 and 2019 API tried to merge with its competitor Sigma as a path to realising shareholder value from this difficult space but that effort was called off late last year when API sold its 13% of Sigma.

Priceline just can't move that damn lipstick!

Prior to the Sigma merger effort, API's answer to the problem of wholesale was to use the cash flow from the business to diversify out of it. Priceline, the franchised health and beauty retail chain, which doubles as Priceline Pharmacy when there is a licensed pharmacy attached to the store, was one answer to that problem. API's supporters will argue that API has built Priceline from only 156 stores at the time of acquisition in 2004 to 488 in August 2019. However, everyone can see now that Priceline has not been an overwhelming success for API. In the year to August like-for-like sales only grew 0.7%, and store numbers only grew by 13. We argue that's pretty woeful when you're supposed to be a prime beneficiary in a slow retail market of the so-called 'lipstick factor' (i.e. the female preference for certain consumer items to be 'non-discretionary' in the household budget during a downturn in consumer spending). It also suggests that Priceline hasn't made the most of the 8 or 9 million mostly female names it has in its marketing database.

API's most recent diversification effort has been Clear Skincare Clinics, acquired for $127m in mid-2018. Clear Skincare is one of these places folks (again, mostly female) go for laser hair removal, or acne treatment or other non-invasive aesthetic services to make their skin look younger an healthier. At the time of acquisition there were 44 clinics in Australia. API had grown that to 52 by August 2019, in a year that saw 20% top line growth. This time API may have picked the right growth segment to go after in the health and beauty space. But we'd want to see a second year of growth before being sure of that.

Return on Capital is all right for API

Priceline and Clear Skincare are the main reasons why Return on Capital Employed (ROCE) was a reasonable 16.3% in the year to 31 August – basically these businesses don't require much capital and offset the large amounts required by wholesale. However, we think it will take a few more years and a few more Clear Skincares before investors can see this business has outgrown wholesale to the point where it can be jettisoned. Meanwhile there's a near-term problem coming and it could be serious.

The 7th Community Pharmacy Agreement needs to be worked out in the first half of this year. Community Pharmacy Agreements represent the government's pact with the pharmacy industry about how much the government will spend on getting drugs to patients and how much of that gets taken by wholesalers and retailers. If the government is in a non-generous mood, API shareholders will suffer.

API is currently trading on a P/E for the August 2020 year of 13x. A little too high for a company most of which doesn't shoot the lights out on growth. We'd be cautious on API until we saw how the 7th Community Pharmacy Agreement works out, and whether Clear Skincare can have another good period of growth.

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