14 February 2020

Stocks Down Under

'Beauty, to me, is about being comfortable in your own skin. That, or a kick-ass red lipstick.'

- Gwyneth Paltrow (1972), American actress

Galilee Energy: piloting well

Stocks Down Under rating ★★★★

ASX:GLL Share price: A$ 0.68 Market cap: A$ 176M

The market hasn't been kind lately to Galilee Energy, the Brisbane-based gas developer. The stock peaked at $1.31 on 2 September 2019 but by 6 February 2020 it had trended back to 55 cents. Interestingly, the day before that low, Galilee's Chairman, Ray Shorrocks, was in the market buying stock. With the company currently completing a pilot programme at its Glenaras Gas Project in Queensland, Galilee Energy seems headed for a good 2020.

Company Share Price Chart

Source: Tradingview

Now is a good time to be a gas developer with large resources of gas and a reasonable likelihood that this gas can one day be sold into Australia's East Coast gas market. Most observers of Australia's gas industry believe that the 2020s will be characterised by periodic supply shortages in the eastern half of the country. Basically, on the demand side, too much of the available gas will be used to feed three large LNG exports projects in the state of Queensland that started up in 2014 and 2015, while on the supply side the states of New South Wales and Victoria appear likely to maintain 'moratoria' or restrictions of some kind on gas exploration and development due to environmental concerns. The result is likely to be good pricing for anyone permitted to develop their gas fields.

A$29bn worth of gas

Enter Galilee Energy, a coal seam gas developer so called because its 100% owned Glenaras Gas Project, near the town of Longreach in central Queensland, sits in the Galilee Basin where India's Adani Group last year got the green light for their controversial new coal mine. Glenaras is potentially a huge gas field, with an independently certified 3C Contingent Resource of more than 5,300 petajoules. That's a lot of gas. A petajoule is a million gigajoules. The day before yesterday at the Gas Supply Hub at Wallumbilla – a one horse town about 400 km west of Brisbane used as a pricing hub the way Americans use the famous 'Henry Hub' in southern Louisiana – gas traded at an average price of A$5.47 a gigajoule. That would value Galilee Energy's 3C Contingent Resource at a cool A$29bn worth of gas.

Now, in the gas world a 'contingent' resource is just that – contingent. The developer needs to do something to remove the contingency before those resources turn into reserves. The '3C' part refers to the fact that Glenaras' contingent resource is its most optimistic – the 1C (low estimate) resource is about 300 PJ and the 2C (best estimate) is about 2,500 PJ.

Reaching a critical point

Which brings us to what Galilee is doing to make that conversion from resource to reserve. Coal seam gas is simply gas, mostly methane, found in coal deposits, for which the production methods are well known even if this kind of gas is considered 'unconventional'. You obtain coal seam gas by wells drilled into the coal seams, but before you can produce the gas you have to draw down the coal below 'critical desorption'. Coal seams are subject to pressure by water within the seam. The methane won't 'desorb' (that is, be released from the coal) until the water pressure is reduced, so coal seam gas developers need to pump water from their wells before the gas will flow, allowing the correct gas flow rates to be established.

Galilee is now completing a five-well multi-lateral pilot programme at Glenaras to that end. The company believes that a successful conclusion to the pilot will allow it to book 500 PJ of Proved and Probable Reserves at Glenaras. Once those reserves are in place the path to market for Galilee's gas is fairly clear. Under an October 2017 Memorandum of Understanding, the infrastructure company Jemena stands ready to build the pipeline that would plug Glenaras gas into the East Coast gas market. Galilee Energy is already talking to potential customers.

Glenaras isn't Galilee's only gas project. Last August the company was awarded a permit over ground prospective for coal seam gas that straddles the Surat and Bowen Basins. This new gas project, now called Kumbarilla, came with a 3C Contingent Resource of 895 PJ and will see its first well drilled in April 2020. That's nice but we think that in 2020 all eyes will be on Glenaras ahead of the day, probably coming soon, when the critical desorption point is reached and its developer can confirm that it has a real, live, coal seam gas field.

Kogan.com: Trouble at the Almost Everything Store

Stocks Down Under rating

ASX:KGN Share price: A$ 5.14 Market cap: A$ 479M

It wasn't a good start to 2020. Back on 9 January you could get stock in the Melbourne-based online retailer Kogan.com for $7.95 per share. That was more than double the $3.10 of mid-January 2019 and reflected the very strong growth that Kogan.com had been enjoying across multiple verticals. Then came a 20 January 2020 business update which indicated that Kogan.com hadn't been growing as fast as expected. The stock has since been as low as $4.89 last Monday. We think the rout for Kogan.com stock is not quite over yet.

Company Share Price Chart

Source: Tradingview

Kogan.com has been a storybook Australian online retail success ever since Ruslan Kogan, who came to Australia as child from his native Belarus, started the business in his parent's Melbourne garage back in 2006, when he was about 24 years old. If you look at Kogan.com's story, it very much follows an Amazon-style path. Kogan started with a website offering LCD televisions, constructed to his specifications in Chinese factories. Kogan chose a winning strategy of bypassing wholesalers, distributors and retailers, which resulted in significant cost-efficiency, which allowed Kogan.com to competitively sell products by rated brands like Samsung and Apple. By 2011 company was already shipping products all over the world. By 2016 Kogan.com had grown so much it was able to buy the

‘Dick Smith’ name, after that formerly iconic Australian electronics retailer collapsed, and transitioned the brand online.

Why did Ruslan and Dave sell?

The January 2020 business update shocked many investors who were used to some pretty strong growth numbers. Actually, the numbers weren’t too bad, but Ruslan and his co-founder, CFO David Shafer, had sold $30m worth of stock in August 2019 and had previously sold around $50m in stock during 2018, so maybe the market was expecting something bad and reacted accordingly.

How bad was it? Well, gross sales were actually up more than 16% in the six months to December 2019, as against the FY19 full year when gross sales only grew 12%. Active Customer numbers were up 10% to about 1.7 million. So far, so good. What really disappointed was gross profit. In the December 2019 half this was up more than 9%, but in FY19 the growth had been 12.5%. Basically, margins at Kogan.com are under pressure. In part the margin crunch was because Third Party Brands sales had declined but, more importantly, the company didn’t do so well coming up to Christmas with its own exclusive brands such as Certa (power tools), Komodo (outdoor gear) and Ovela (homewares).

Indeed, sales growth here was only 17% in the December quarter as against 35% in the September quarter. Exclusive Brands make up about half the gross profit mix and Third Party Brands another quarter or so, so the slippage in Exclusive Brands was damaging.

Third Party Brands is problematic

Now, the decline in Third Party Brands in the December 2019 half partly reflects the fact that Kogan recently started up Kogan Marketplace, a platform that allows independent sellers to access buyers using Kogan infrastructure. That business grew 44% in the December 2019 quarter so it’s showing promise. However, part of the decline in Third Party Brands was also, we believe, due to the fact that people pay GST (Australia’s 10% value-added tax) when they buy at Kogan, so more consumers are buying at sites where they don’t have to pay GST. This could be an ongoing problem for Kogan.com in the years ahead.

The other thing to understand about Kogan.com is that it is rapidly becoming the ‘Everything Store’, like Amazon, but it is still in the early stages of that growth with the potential for an occasional slipup. In 2019, as well as Kogan Marketplace, the company also started Kogan Money Home Loans and Kogan Cars. In 2020 it expects to launch more businesses, such as Kogan Money Super, Kogan Money Credit Cards, Kogan Mobile New Zealand and Kogan Energy. Instead of delivering its market leading products, there is a high risk that the company will lose focus on its strongest segments, where Kogan has already established strong market share, like electronics.

While there are many benefits for expanding through verticals, Kogan.com will possibly deliver high first year sales for new verticals due to decent brand recognition in the market, while in the long-term customers may want to return to niche or specialised service providers due to lack of brand loyalty. It’s worth keeping in mind that Kogan.com has had problems in the past with new vertical launches. In 2012 it launched a pre-paid mobile phone business called Kogan Mobile, but shut the business down the following year due to problems with the wholesale telco partner, who suspended customers for overuse even though Kogan.com had promoted unlimited calls on its service.

Too many verticals?

We believe the Kogan.com brand, while strong, needs to be stronger if the company is going to obtain long-term significant market share across these new verticals. Consequently, in our opinion it should first achieve highest quality service with its existing businesses. It’s also worth keeping in mind that, in February 2020, Kogan.com took a hit to its reputation by entering the NSW Fair Trading complaints list yet again, with 25 complaints lodged against it during the month of December 2019 alone. The complaints related to electrical goods, electronics, whitegoods and gas appliances, with the main issues being quality, defective items and longer-than-expected delivery.

Kogan.com is currently trading on a P/E of 21x forecast FY20 earnings. We think that’s a high multiple considering the challenges within the consumer discretionary retail sector in Australia at the moment and Kogan.com’s own issues. The stock may have stabilised a little bit in the last week or so, but we’d be cautious.

BWX Ltd: Recovery from the 2018 debacle

Stocks Down Under rating

ASX:BWX Share price: A$ 4.32 Market cap: A$ 534M

2018 was *Annus Horribilis* for BWX, the Melbourne-based supplier of cosmetics. The share price dropped from $8.08 on 10 January 2018 to $1.35 on 11 January 2019, a slide of more than 80%, because of a string of issues. Since January 2019 the stock has recovered and been as high as $4.63 on 15 January 2020. We believe that, with BWX's issues now more or less fixed and a new management team in place, that the stock can continue to re-rate in 2020.

Company Share Price Chart

Source: Tradingview

BWX has been built on a portfolio of 'natural' beauty skincare and cosmetics brands like Sukin, Andalou, USPA, Mineral Fusion and Nourished Life. Going forward, the company intends to move into the 'organic' beauty products category as well. 'Natural' beauty products are simply products whose raw ingredients come from nature, as opposed to something artificial. 'Organic' products are those where the ingredients are organically farmed, meaning no use of Genetically Modified Organisms (GMO), herbicides, synthetic fertilisers and more.

People want to go natural

The natural beauty market is huge globally, projected to reach >US$600m by 2022 and growing 6% p.a. due to rising consumer consciousness that demands organic and natural products, and in particular transparency of product ingredients, combined with the ease with which consumers can source products online. Basically, it's the same mindset that allowed Dame Anita Roddick to start The Body Shop in the mid-1970s but working at a much larger scale. In Australia natural cosmetics is expected to grow by 9% over the next 5 years, mainly due to use of Social Media by key players and increasing numbers of beauty blogs dedicated to the benefits of organic products.

In mid-2018 BWX was riding high on the growth of the natural beauty products space and the success of its own products. In FY18 revenue had doubled to $149m and EBITDA had risen 52% to $40.3m. In May 2018 the company had received a tentative offer of $6.60 per share from a consortium led by the Boston-based Bain Capital that included BWX's top executives, CEO John Humble and Executive Director Aaron Finlay. Then on 17 September 2018 the BWX board announced that there was no deal. The stock was about $3.90 at the time and this rejection was, we think, the main reason for the rapid slide down to $1.35 by January 2019.

Annus Horribilis

The trouble with the discussions around the Bain transaction was that it distracted management from implementing its strategy, resulting in loss of domestic sales, higher operational costs, and a slippage in momentum for the brands which BWX was pushing in the key US market. In October 2018 BWX had given guidance on EBITDA for FY19 of $40.3m, which subsequently had to lower three times to $21-23m in May 2019. In the end BWX met this guidance in a year when revenue only grew a measly 0.5%.

Thankfully for BWX shareholders the May 2019 downgrade proved to be the worst of it. BWX has since gone about rebuilding its business under new leadership - Dave Fenlon was named the new CEO at that time and he started in July 2019. In the second half of FY19 revenue stabilised due to US retail market momentum coming back and gross margins improving to 52.7% (120bps higher than in the first half).

And now for the recovery

Which brings us to the currently financial year. For FY20 BWX is flagging revenue growth of 20-25% and EBITDA growth of 25-35%. Can they do it? We don't see why not.

The thing about BWX is that the key brands remain powerful even after the distractions of 2018. Sukin is the No. 1 natural skincare brand in Australia right now. Andalou is the No. 1 facial skincare brand in the US natural channel and Mineral Fusion is the No. 1 cosmetics brands in that channel. BWX is now ‘mainstreaming’ these brands in North America key so that they are available in outlets that are less niche and more mass market. Meanwhile in China, BWX has been engaging heavily with key influencers and it’s reasonable to expect that effort to bear fruit given the strong Chinese liking for natural and organic health and beauty products from places with high quality standards like Australia.

Currently BWX is trading on a P/E of 34x FY20 forecast earnings, but that P/E drops to a mere 13 times by FY23. We think the $6.60 figure that was talked about in 2018 is still realistic given what has happened in the past to well-executed health and beauty stories on ASX such as Blackmores and A2 Milk. The key is execution.

With BWX about to unveil half yearly numbers for FY20, we think it’s a reasonable bet that the company is still on track to meet the aggressive FY20 EBITDA growth targets set last August.

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