18 February 2020

Stocks Down Under

'Sometimes your best investments are the ones you don't make.'

- Donald Trump (1946), current US President

Galaxy Resources: Eat my shorts

Stocks Down Under rating ★★★★

ASX:GXY Share price: A$ 1.09 Market cap: A$ 442M

Judging by the 19% short position on the stock, a lot of investors really hate Galaxy Resources, the Perth-based hard rock lithium producer. And, let's face it, the owner of the Mt Cattlin Mine in Western Australia has been a serious underperformer over the last two years, falling from $4.46 per share in January 2018 to only 85 cents on 6 December 2019. We believe, however, that with lithium prices starting to bottom, now can be a good time for the contrarians.

Company Share Price Chart

Source: Tradingview

We've talked previously in Stocks Down Under about the difficult times that lithium producers, such as Pilbara Minerals (ASX: PLS, see our 7 January edition) and Orocobre (ASX: ORE, 17 January), have gone through since mid-2018 as prices for the commodity weakened. None has been hit harder than Galaxy Resources, the owner of the Mt Cattlin Mine near the town of Ravensthorpe, around 540 km southeast of Perth, which produces spodumene, the principal hard rock lithium mineral, as well as tantalum.

Between a rock and a soft space

The reason the shorters have been particularly active in Galaxy is the belief that hard rock lithium mines like Mt Cattlin simply won't have low enough costs to avoid being mothballed during a period of prolonged lithium price weakness. Unlike brine lithium, where costs are low because one is simply pumping up lithium-rich brines out of underground reservoirs and leaving the brines out to dry, with spodumene and other hard rock lithium sources one has to actually mine the stuff, which is costlier. And in Mt Cattlin's case the mine has been on care and maintenance once before, between 2013 and 2016.

We take the view things aren't as bad as the shorters would have you believe. Not just because lithium is probably bottoming right now and headed for better days. And not just because Galaxy had about A$200m in net cash and investments as at September 2019, so it is not in danger of going belly-up any time soon. But because of Mt Cattlin itself as well as the potential upside of a new brine lithium play called Sal de Vida in Argentina.

A low cost-producer

Mt Cattlin this time around (i.e. since the 2016 restart) is one of the lowest cost spodumene producers out there. In calendar 2018 Mt Cattlin produced around 157,000 tonnes of 6% concentrate at around US$411 a tonne. Revenue that year was US$158 and EBITDA US$58m. By the third quarter of calendar 2019 the mine's costs had come down to US$387 a tonne. That was around the time that Galaxy chose to cut Mt Cattlin's output back by around 60% so as to preserve most of the resource for better days. At that level - around 90,000-105,000 tonnes of 6% spodumene concentrate annually - Mt Cattlin is expected to be cash positive even if lithium prices are troughing, because operating costs will come down US$20m or so.

Meanwhile Galaxy is working on Sal de Vida, its Next Big Thing project that it hopes can catch the coming lithium price upswing. Sal de Vida, in Catamarca Province of north-western Argentina, is potentially one of those multi-decade low-cost brine plays that the 2016 Definitive Feasibility Study suggested had a post-tax NPV north of a billion US dollars. Galaxy has been looking for a better 'flowsheet' (i.e. processing recipe) for Sal de Vida so as to have capital and operating costs in the lowest quartile globally and it now thinks it has the right one. The company wants to reach a Final Investment Decision on Sal de Vida later this year and potentially bring it into production in 2022, which isn't far away.

Galaxy stock has stabilised since late 2019, in spite of the high short position, mainly on hopes that the Mt Cattlin production cut will preserve cash in the near term. The stock is now trading at a mere 2.1x calendar 2020 revenue falling to 1.6x calendar 2022 revenue. There's probably nothing in the stock right now for Sal de Vida and certainly nothing for James Bay, a potentially valuable albeit longer-term hard rock mine in the Canadian province of Quebec. We see potential for a strong upside reaction in the share market should the calendar 2019 revenue and earnings numbers, due out this Friday, look okay.

City Chic Collective: High maintenance

Stocks Down Under rating

ASX:CCX **Share price: A$ 3.13** **Market cap: A$ 595M**

Imagine this: A retailer that in FY19 grew same-store sales by 12% and EBITDA by 25%, with underlying EBITDA margins jumping from 15.1% to 16.8%. That amazing growth is the fruits of a good year at City Chic Collective, the Sydney-based company that sells plus-sized ladies clothing. City Chic was formerly the old Specialty Fashion Group where the non-performing brands were sent over to, what is now, Mosaic Brands in mid-2018. The market has liked what it sees in this rejuvenated and spunky company and bid the stock up from around $1.00 a year ago to over $3.00 today. That trouble is … that's probably a little inexpensive for a company that's relatively new as an ASX-listed retailer. Good merchandise but wait till it goes on special.

Company Share Price Chart

Source: Tradingview

If there's one sector of the ladies' fashion market that everyone agrees has traditionally been overlooked, it's 'plus-sized' fashion, where 'plus' in Australia generally means dress sizes over 16. For the gentlemen reading this publication who may be unfamiliar with the intricacies of womenswear, permit us to explain: In Australia, as in the UK, a woman who wears size 16 clothing has bust size of 101 cm, waist of 83 cm and hips of 108.5 cm. This is basically the low-end clothing for 'larger' women, if you're not quibbling about who's really large. However, if you look at the fashion magazines or even the mannequins in the store windows you might agree with this assessment from Julie Power, writing in the Sydney Morning Herald in November 2014: *'…for most retailers and designers, "plus size" is anything above a size eight, while the average woman is size 14 to 16'*. We checked with the statistics and, sure enough, 30% of Australian women in 2018 were overweight, as per the Body Mass Index, and another 30% were obese. That's a large market opportunity, excuse the pun.

Made to flaunt

That tendency of most retailers to overlook (or, indeed, look down on) a natural constituency has been gold for City Chic, whose lowest size in Australia is 14. This company not only sells fashionable plus-size clothing, footwear and accessories from in excess of 100 outlets in Australia and New Zealand, but actually designs the products (often in conjunction with big-name designers), exhibits them at major fashion shows, gets photos of attractive plus-sized models wearing the gear into glossy magazines, and has concessions in the major stores like Macys and Nordstrom. The company's motto: 'Designed to fit. Made to flaunt'.

Importantly, in a market where the customers are often afraid to buy online in case the garments don't fit or don't look so good once you actually get them on, City Chic's kind of clothing sells online like hotcakes. In FY19 online sales represented 44% of the total (38% from its websites 6% from online marketplaces), with the online category having grown 36% year-on-year. And there's more where that came from – in October 2019 it spent US$16.5m buying the online business of Avenue Stores, an American plus-size retailer than went into Chapter 11 in August 2019. Avenue added another brand to City Chic's growing presence in the US, where, in April 2019, the company bought Hips and Curves, an American plus-sized lingerie business.

Near term earnings are expensive

The trouble for investors looking at this story right now is that this kind of opportunity currently comes at too high a price on ASX – the stock is currently on a P/E of 29x FY20 earnings. That's a high-maintenance stock.

Admittedly that drops to 19x by FY22, but it still means that the stock is priced to perfection. Any curves that get thrown at this stock – such as, for example, weaker sales in the Australian and New Zealand stores during the December 2019 half – could see it badly impacted. Should the stock find its way back towards $2.00 it would look very attractive. In the meantime, we'd be cautious.

Service Stream: Why three directors just bought on market

Stocks Down Under rating

ASX:SSM   Share price: A$ 2.30   Market cap: A$ 962M

The market didn't like the half-yearly result for Service Stream, the Melbourne-based company that provides specialist services for Australia's telecommunications, energy and water networks. The stock was $2.75 on 5 February, just before the announcement. It's since dropped to $2.32, merely because the $58m in EBITDA from $498m in revenue for the six months to December came in slightly below consensus. The fact that three directors have bought stock on-market is telling us something.

Company Share Price Chart

Source: Tradingview

If there's one thing any economy can't do without, it's telecommunications, gas, water and electricity. If any one of these goes down, even for a short period, the results can be disruptive, so operators are very careful to make sure that their networks are well designed and maintained. Traditionally a lot of this work was done in-house, but in the last twenty years or so operators have realised they can outsource it – for telecommunications the maintenance outsource rate is around 85% in Australia while for utilities it's 60%. But the outsource partners have to be trusted and generally price contracts well, where those contracts are with companies considerably larger than the provider.

Growth by acquisition

Enter Service Stream, which is very good at what it does. Service Stream was founded in 1996 and listed on the ASX in 2004 as a telecommunications service provider. Since listing it has barely made a misstep in terms of executing on its contracts and acquiring other providers at favourable prices. The result has been strong growth over time.

In 2005 Service Stream was a $61m revenue company with around $3m in EBITDA. By 2010 it had grown to A$520m in revenue and EBITDA of $27m. A decade on, in FY20, the consensus is for Service Stream to have more or less doubled revenue to just under a billion dollars and to have enlarged EBITDA close to four-fold, to $115m. And the acquisitions are getting bigger as well. When Service Stream bought Comdain Infrastructure in late 2018 the price was $161.7m, $93.7m in cash and the rest in scrip. Comdain, a gas and water services company, brought $320m in revenue and $22m in EBITDA.

The NBN will be good for Service Stream going forward

Critics of Service Stream will argue that with Australia's National Broadband Network nearing completion, company revenue from that major project will impact earnings going forward. The NBN is a high-speed broadband network that's been rolled out across Australia by the Federal government since 2010. Rollout is expected to be done and dusted around June 2020. Service Stream has provided a lot of network constructions services for NBN. However, it's reasonable to expect Service Stream to remain a serious maintenance provider for many years to come, so we're not concerned. It's also reasonable to say that the Comdain acquisition was well-timed because it reduced Service Stream's reliance on the telecommunications sector.

The market may have been disappointed after the half yearly results since analyst numbers weren't met, but that hasn't fazed Chairman Brett Gallagher, and directors Deboard Page and Peter Dempsey, all of whom have been on-market buyers of stock post the result. And no wonder. Service Stream earned 5.8 cents per share in FY10 and consensus is for 16 cents in FY20. That would represent about 11% p.a. compound growth over a long period of time, but currently you can get the stock for only 14.7x FY20 earnings. Not bad for a story as dependable as this one.

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