20 February 2020

Stocks Down Under

'It's nice to finally get scripts offered to me that aren't the ones Tom Hanks wipes his butt with."

- Jim Carrey (1962-   ) Canadian-American actor

Nanosonics: Thriving Infection Prevention Technology

Stocks Down Under rating

ASX:NAN   Share price: A$ 7.32   Market cap: A$ 2.25BN

Last year saw Sydney-based Nanosonics become one of the top growth stocks, with share prices increasing by 123% across 2019. Sales increased by 39% to $84.3m, and EBITDA increased by 201% to $17.6m. The global leader in ultrasound probe disinfection technology managed to keep their costs in line with previous years. However, there was a slight (15.5%) increase in operating expenses due to prior investment commitments.

Company Share Price Chart

Source: Tradingview

2020 – A Year of Increased Global Expansion

Over 90% of Nanosonics revenue is generated outside of the Asia Pacific region, giving the company substantial geographic diversification. They currently distribute products in 21 countries via distributor partners or direct operations. With 40% of the US market under their belt, NAN has already installed 17,000 of its Trophon and Trophon 2 devices out of a potential US market of 40,000. In 2020, the company expects further growth as they implement a comprehensive expansion plan and release a new product to target unmet needs in the infection prevention industry. Additionally, their distribution agreement with GE Healthcare in the US has changed to a Capital Reseller model, with increased sales and margins expected for H2 FY20.

Asian Demand up in the Face of Covid-19 (Coronavirus)

With the global pandemic of Covid-19 (what the rest of us call the Wuhan Coronavirus) currently on the increase, China is taking all necessary measures to decrease contamination in medical facilities and amongst the Chinese population. For NAN, expansion into China represents a considerable market opportunity. The Chinese Centre for Disease control and Chinese regulatory authorities are currently driving demand for NAN's Trophon products. So-called Healthcare Acquired Infections (HAIs) are currently in the spotlight as the increased global focus is honed on decreasing and containing the spread of infections. Additionally, the need for more efficient health standards in hospitals has been emphasized due to the continuing spread of the coronavirus.

As a result of the coronavirus outbreak, healthcare providers are becoming more cautious regarding sterilization procedures. This increases the demand for

infection control specialists like Trophon. Trophon offers a modern solution to the archaic method of probe sterilization in healthcare facilities, which is using a chemical wipe and cleaning equipment by hand. This is not a requirement limited to hospitals, but is also in demand across dental care, elder care and other medical service providers.

Innovative products and a great business model

Initial sales of Nanosonics' Trophon machines turn little profit. However, after completing the preliminary purchase, customers are locked into contracts for servicing and patented consumable products, exclusively supplied by Nanosonics. The initial attraction of the Trophon machines is fantastic for healthcare providers that don't want to commit to high upfront costs. Throughout their product lifetime, consumables account for over 70% of the total revenue. This gives Nanosonics a lucrative profit margin that is currently higher than 75%.

The company currently has a market penetration of 17%, with huge potential for growth and new product launches in the pipeline for FY21. The FY20 outlook remains positive due to the rollout of marketing activities and distribution partnerships in Qatar, Kuwait, Israel, Saudi Arabia, Mexico, South Korea, Hong Kong, and more. Last year, NAN expanded distribution agreements with GE Healthcare and signed new contracts to increase its presence in Switzerland, Israel, and Kuwait.

A promising future for NAN, but very expensive

There is enormous growth potential for NAN if we consider its marketing and distribution strategy and the fact that many countries are stepping up the disinfection requirements for their healthcare providers in the wake of the coronavirus outbreak. Combine this with their impressive growth last year, the upcoming release of their new product and their estimated investment of $15m in research and development planned this year, and you're looking at a great long-term investment.

However, NAN currently boasts a P/E of 182x, an EV/Revenue of 20.5x and an EV/EBITDA of 120.8x, which we believe is extremely rich. Although these multiples drop to 91x, 16.2x and 59x respectively for the upcoming FY21, we believe once the Corona virus burns itself out the heat will come out of NAN for a while. Hence, our two-star rating at the moment. We believe investors will get a better chance to get in on this story.

Japara Healthcare: Transitioning to a higher standard of Aged Care

Stocks Down Under rating

ASX:JHC **Share price: A$ 0.95** **Market cap: A$ 253.7M**

Sometimes a stock reaches a new low for good reason. But sometimes it gets there simply because it has fallen out of favor with investors despite decent long-term growth prospects. Melbourne-based Japara Healthcare falls into this second category of under loved, undervalued stocks. It is trading around an all-time low following a series of events that have put the aged care industry in an unfavorable light.

Company Share Price Chart

Source: Tradingview

An October 2018 Royal Commission interim report asserted that Australia's entire aged care system needed a major overhaul. This meant it was time for new regulations and better funding. Cutbacks in government funding and a lack of ACFI indexation added to the woes of the aged care companies. Japara and its peers found themselves in the crosshairs for failing to provide adequate care for the nation's burgeoning elderly population.

Meanwhile Japara's occupancy rates were on the decline falling 2.2% in 2018 and 1.7% in 2019. This prompted downward earnings revisions and an overall pessimistic view from analysts. However, despite all this negativity there appears to be a light at the end of the hallway. Let's explore a few reasons why Japara is an attractive investment opportunity here.

Responding to the need for change

The industry is moving to a new standard of care. New regulations have forced Japara to do a comprehensive review of its policies and procedures and bring them up to the new standards. Part of this effort is the launch of an educational program about the new standards which will be rolled out to about 5,000 staff members.

In response to criticism towards care inadequacies and new regulations, Japara has embarked on a course of change. It invested $108m to improve existing aged care homes. Much of these improvements are centered around technology. Resident management systems and business information are being updated to improve Japara's ability to analyze data and customize its services to residents. Every room is being upgraded with WiFI internet in support of clinical care and visiting practitioners. The company has also made a commitment to promote connectivity with families and the community. Residents will have greater access to movies, games, and electronic books.

Last February, the Federal government announced a $320m subsidy increase designed to benefit Australia's seniors that receive residential aged care services from providers like Japara. In addition, the government's 2020 budget includes increased funding for hospitals, pharmaceuticals, and aged care. While most of this funding will be directed towards primary and home care, these recent measures highlight a greater government focus on elderly care. Monetary benefits aside, these steps have placed companies like Japara in a better light and put them in a better position to succeed.

Aging population demographic supportive of long-term demand

In the next decade, the ranks of people above age 70 is forecast to swell by 1.1 million. The current target provision ratio stipulates that 78 facilities are necessary for every 1,000 members of this population segment. This means that over 85,000 new residences will need to be supplied to meet this requirement. Looking further down the road, Australia's 70-plus population is expected to increase to 8.8 million by 2057. It all adds up to tremendous future demand for aged care facilities and a significant growth opportunity for Japara.

Japara is also investing in land to develop new facilities. By the end of fiscal 2022 over 1,200 new homes are expected to be developed. The company has ambitiously set out to deliver 300 new facilities annually. This development is expected to be the driving force behind earnings growth over the next few years.

Compelling valuation means investors should Care

It is no secret that the market opportunity for Australia's aged care providers is massive. What makes Japara stand out from the crowd has been its nimble, dedicated response to the evolving industry standards. What also differentiates Japara is its specialization in the care for dementia, which is becoming a more prominent diagnosis globally. Other major aged care providers like Regis and Estia lack this advanced capability.

Like Regis and Estia, however, Japara is trading at low multiples. The P/E ratio for Japara is around 20x, on par with Estia but well below that of Regis (25x). Japara also has a modest 9.5 EV/EBITDA multiple, which further suggests the stock is undervalued. As industry standards and funding improve, expect Japara to be a major beneficiary of the increasing demand for high-quality aged care.

Pact Group Holdings: Plastic makes perfect?

Stocks Down Under rating

ASX:PGH Share price: A$ 2.49 Market cap: A$ 849.6M

Provider of specialty packaging solutions Pact Group Holdings, based in Melbourne, closed out a mixed FY19 with its top line increasing 9.6% to $1.834 million and EBITDA falling 2.8%, to $230.7 million. The Four Horsemen of plastics – polyethylene, polypropylene, polystyrene and polyvinyl chloride (PVC) – also saw a drop in volume, as declines in feedstocks and weaker PET and nylon prices led to operational and share price deterioration. However, Gotham's White Knight once said, *the night is darkest just before the dawn*. And we believe that dawn is just around the corner. PGH's 12-month chart tells the story.

Company Share Price Chart

Source: Tradingview

Show me the catalysts

Diversified across food, dairy, beverage, chemical, agricultural and industrial sectors, PGH is the largest rigid plastics manufacturer in Australia and New Zealand – controlling 30% of the overall market. And after conducting a strategic review of PGH's portfolio, new CEO Sanjay Dayal's first order of business was to divest the company's contract manufacturing business, which was announced this January. Poorly aligned with the rest of the group, offloading the division will allow PGH to improve shareholder returns and strengthen its balance sheet as it focuses solely on its core business.

Management also unveiled their "Packaging Network Redesign" program – which is expected to improve margins, increase automation, streamline the supply-chain and reduce the number of packaging plants from 28 to 18. The strategy is expected to reduce overhead costs by $50 million.

Zeroing in on organic growth, PGH is also pivoting toward handling and sustainability. And while the market remains in prove-it-mode, we believe the company is in a great position to deliver. Take resin prices. As one of PGH's main inputs of production, a decline in resin prices provides a tailwind for future profitability. What should also lift margins isfalling steel prices, with exports to China expected to drop by 4% in 2020. If the trend continues, PGH will be a significant beneficiary of slowing steel demand.

Undervalued versus peers

Over the long-term, population and income trends remain in PGH's favour. With demographics and wealth across Australia and Asia stimulating inflation, the

benefits should pass-through to PGH's top line. And while the company's commodity exposure hits both sides of the coin, the trade-off should increase revenues to a greater degree than it increases costs.

From a valuation perspective, the market is also mispricing the company's future growth prospects. Currently trading at a P/E of 11.2x, PGH's earnings multiple is well below that of its competitors, Amcor (AMC) and Orora (ORA) – at 17x and 17.7x respectively. Furthermore, management told investors at the company's annual general meeting (AGM) that 1HY20 trading conditions were in-line with expectations and that first-half EBITDA is expected to improve. And with earnings poised to move higher under Dayal's leadership, we believe PGH is ready to turn the corner in 2020.

It's the Climate, stupid!

With environmental, social and governance (ESG) standards a renewed priority within the C-Suite, PGH hit the ground running in 2020, launching its 2025 Sustainability Promise. In the battle against climate change, PGH renewed its commitment by becoming the largest processor and consumer of post-industrial recycled resin in Australia and New Zealand. And after increasing capacity in its recycling business and partnering with governments on several initiatives, PGH was able to land new contracts within its pooling and re-use segments, with operations set to expand throughout fiscal 2020. Notable partnerships include providing returnable-produce crate pooling services to Aldi – a German supermarket chain – and earning a recycling services contract with another U.S. retailer. Increasingly these days companies are punished by investors if they are perceived to have poor ESG standards. That's not likely to be Pact's problem going forward.

Avoiding mistakes of the past

As profit downgrades and deterioration of PGH's balance sheet led to significant share price pressure in August of 2018, management reorganized the company's capital structure to help stop the bleeding. And in response to a bloated cost structure – which included labour, raw materials and occupancy costs that outpaced competitors' – management cleaned up the company's balance sheet in 2019, reducing its leverage ratio to 3x. Though net-debt has risen 9.9% – to $733.5 million – $380 million of it was refinanced and extended until January of 2022. Moreover, the aforementioned divesture of PGH's contract manufacturing business will improve the company's working capital position and ensure that any short-term obligations are met. So, from where we're sitting, PGH looks in pretty good shape for a rerate, especially given the undervaluation compared to its peer group. Four stars for this one!

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