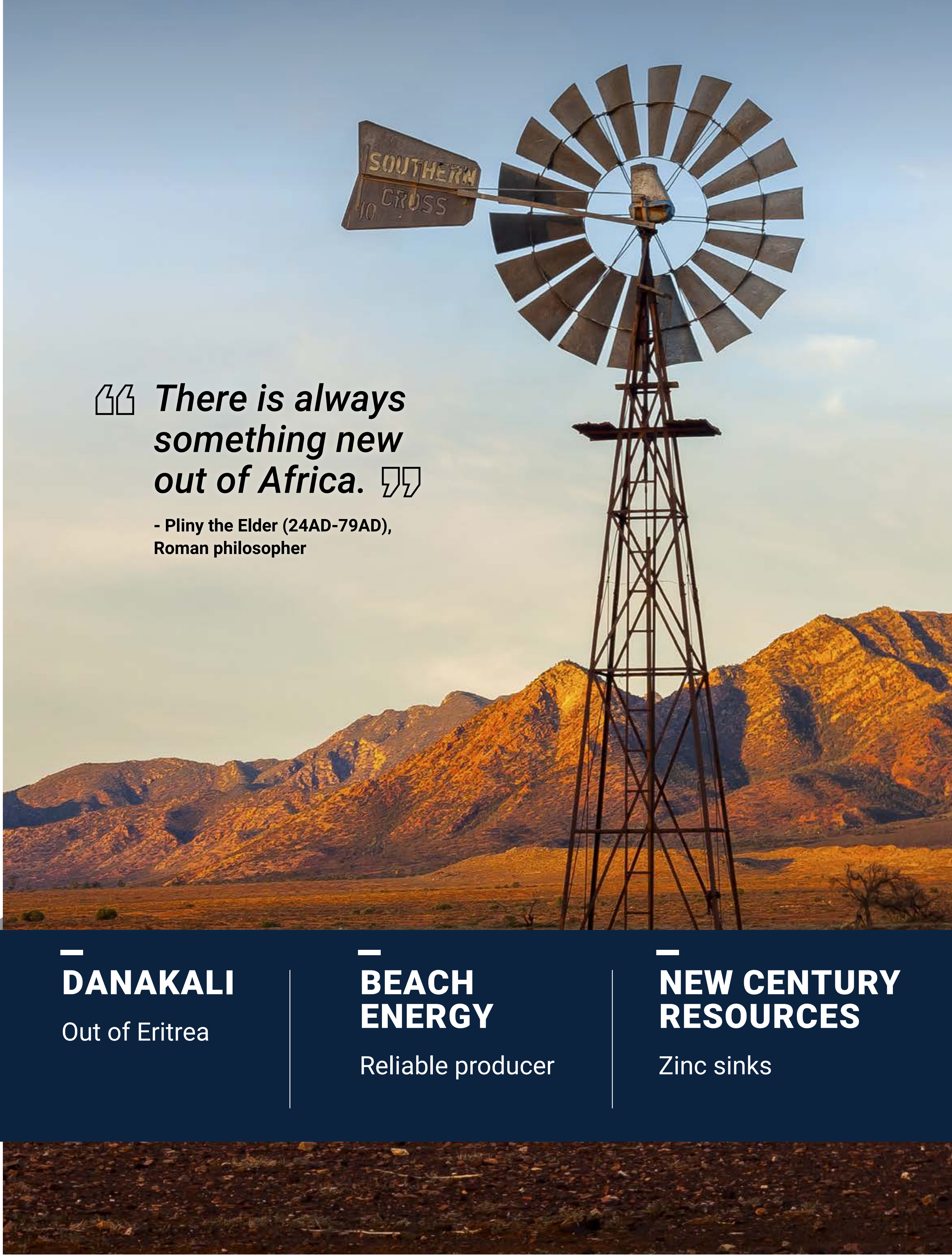
24 FEBRUARY 2020

Stocks Down Under



> *There is always something new out of Africa.*
>
> **- Pliny the Elder (24AD-79AD), Roman philosopher**

DANAKALI
Out of Eritrea

BEACH ENERGY
Reliable producer

NEW CENTURY RESOURCES
Zinc sinks

DANAKALI

Out of Eritrea

Stocks Down Under rating: ★★★★

ASX: DNK
Share price: A$ 0.585
Market cap: A$ 183.4M

The market hasn't been kind lately to Danakali, the Perth-based company which is developing the Colluli Potash Project in Eritrea. On 29 April 2019 you could buy the stock for 81 cents a share. Over the next nine or ten months it declined relentlessly, so that at the 17 February close of 54.5 cents Danakali had lost a third of its value. However, at that level at least one knowledgeable investor thought Danakali was good value – Executive Chairman Seamus Cornelius was an on-market buyer of stock on 19 and 20 February. Should investors be buying too at these levels?

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Share price: A$ 2.09
Market cap: AA$ 4.88BN

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Share price chart

Source: Tradingview

Danakali is potentially about two years away from being the part-owner of an operating potash mine. Potash, which is any potassium-rich salt, is mined the world over as a key ingredient in fertilizers, of which the planet will need more and more of in the decades ahead to keep the planet's billions fed. Danakali is now sitting on a couple of hundred years' worth of highly valuable potash.

Where in the heck is Eritrea?

Eritrea is a tiny country of 6 million people in the Horn of Africa. It is mostly in the news when it is at loggerheads with its neighbour, Ethiopia, from whom it became independent in 1993. Colluli, which is located around 180 km southeast of the Eritrean capital of Asmara, sits on a potash resource of 1.1 billion tonnes of the stuff, and shipped easily given that a decent port called Massawa is only 180 km away.

That 1.1 billion tonne reserve contains 203 million tonnes of the potash that gets premium pricing, the so-called ‘Sulphate of Potash’ or SoP. The intention is to bring Colluli into production in 2022 selling SoP via a ten-year offtake agreement with a phosphate fertilizer producer called Eurochem. The mine will be 50% owned by the Perth company and 50% by the government of Eritrea.

A mine that is almost funded

Colluli will develop in two stages. Module 1, possibly commencing in 2022, will see annual output of 472,000 tonnes of SoP, with this output going to Eurochem. Module 2 would take production up to 944,000 tonnes. This modularization was designed to lower the necessary capital costs. To bring Module 1 into production requires about US$302m, and most of that has now been raised thanks to US$250m in debt and equity facilities from two multilateral financial institutions, the African Export-Import Bank and the Africa Finance Corporation. All Danakali and its partners have to do now is get the last US$50m and the project is fully funded.

To have gotten this far is quite an achievement. When the Heritage Foundation was preparing its 2019 Index of Economic Freedom, rating 180 countries around the world, it looked at Eritrea and decided that the country ‘…remains one of the world’s most difficult places to do business’ (Eritrea ranked 177th on the list). That’s not to say that miners cannot do business in Eritrea, simply that companies need to persist and have deep pockets if they want to develop mines there. Danakali has been working on Colluli for over ten years now. The payoff for such persistence can be rich - a Canadian company called Nevsun developed a copper mine in Eritrea called Bisha and that asset led to a US$1.4bn buyout in 2018. Danakali wonders of it can’t follow a similar path.

A high NPV once funding is in place

The completion of funding for Module 1 is about the only thing holding Danakali stock back, in our view. The operating costs for this mine are expected to be in the lowest quartile globally at under US$150 per tonne of SoP, and demand for the product in the medium and long term is strong given the world’s need for SoP as a fertilizer. The NPV of Danakali’s share of both modules of Colluli at a 10% discount rate is US$439m, or A$665m. Clearly Chairman Seamus Cornelius is optimistic that the final leg of the funding for Colluli can be secured, unlocking some more of that A$665m.

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Source: Tradingview

Investors have been wary of oil and gas stocks ever since the second half of 2014 and early 2015 when the price of a barrel of oil more or less halved, from over US$100 a barrel to under US$50, in one of the most dramatic declines in the price of oil in recent history. The rout didn't really end until a brief dip below US$30 a barrel in early 2016. The period since then has seen gradual recovery but investors have generally been unwilling to give major players in the sector much love.

A growth company at under 10x P/E!

Take Beach Energy as a great example. In FY19 this company increased its output 55%, from 19 million to 29.4 million barrels. After some accounting adjustments related to the varying level of interests Beach has in its producing assets, that 55% output increase in turn led to an 80% increase in 'underlying' EBITDA, to $1.375bn. Return on Capital Employed was an impressive 27%, and that was for a company sitting on $172m in net cash. And the company completely replenished its 2P

(Proved plus Probable) Reserves so that it still had 326 million barrels of these. For that kind of company, right now, one only pays 8.7x consensus FY20 earnings, dropping to 7.5x FY22. That's pretty inexpensive, in our view.

Admittedly the company reduced its FY20 guidance slightly when it brought out its half yearly result on 11 February. Previously Beach had flagged that it would do 27-29 million barrels in FY20. It now says 27-28 million. That, however, really didn't change the outlook much, which is for EBITDA to be in the vicinity of $1.3bn. And that was even after Beach increased its likely capex number by $125-150m, roughly a 14-16% change on previous guidance.

Dependable production

So, Beach is set up for a pretty good FY20. The question is what will change the miserably low multiple, which that quality company is currently afforded on ASX at the moment?

We think a major issue for Beach Energy is that to the unpractised eye it looks too 'safe'. A big slab of production from the Cooper Basin in northern South Australia – both on its western Flank and in the Basin proper – and another significant slab from the Otway Basin in Victoria, represents dependable earnings but not the 'shoot the lights out' growth in reserves and production from a new part of the world where Beach can now afford to explore.

That's not to say there's not some risk-taking on the exploration front. Beach will participate in drilling a gas prospect in the Carnarvon Basin in Western Australia called Ironbark, and another gas prospect in the Canterbury Basin offshore New Zealand's South Island called Wherry. In Ironbark there could be 15 trillion cubic feet of gas in place. That excitement, however, isn't until the second half of the current calendar year at the earliest.

Oil will see better days

That leaves Beach shareholders hoping that the oil price will improve as 2020 progresses, and we think that in this respect they will be rewarded. A lot of the recent weakness has had to do with the Corona virus temporarily stalling the Chinese economy that should have kicked into gear right after the Chinese New Year celebrations were done. Epidemics like Coronavirus tend to burn themselves out quickly. We note with interest that oil was back above US$53 a barrel during the week ended 21 February on hopes of a swift end to the Coronavirus crisis. There are other things that can lift the oil market as well. For example, the US just sanctioned a subsidiary of the major Russian energy company Rosneft for dealing in Venezuelan crude. Stuff like that suggests that oil won't be this cheap at the end of 2020, and neither will Beach Energy.

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Share price chart

Source: Tradingview

Back in mid-January you could get zinc on the London Metals Exchange (LME) for somewhere between US$2,300 and US$2,400 a tonne. Not long after we wrote about New Century Resources, the minor rally that zinc had been enjoying since November petered out, and the long-term downtrend from early 2018, from about US$3,600 a tonne, reasserted itself. Zinc is now about US$2,100 a tonne. The early 2016 nadir was closer to US$1,500 a tonne.

Zinc is a medium-term story

Back on 16 January we argued that things were looking up for zinc, whose main use is to galvanise iron or steel to prevent rusting, although there's also significant use in the zinc alloys used in cars, electrical components and household fixtures. On the demand side an end to the US-China trade war was expected to be good for the metal, at a time when levels of zinc stockpiles were pretty low by the standards of recent years. On the supply side, there wasn't much in the way of new mines coming on for a while yet, and the new mines were in risky places like the Democratic Republic of the Congo and Iran.

We still think that zinc will do well in the medium term. Why is zinc in such bad shape at the moment? The main culprit seems to be the Coronavirus crisis, which has been impacting a range of commodities where the concern is that the Chinese economy will suddenly slow down and not need as much raw materials to feed its manufacturing base in the near term. For zinc, that has meant an increase in zinc stocks held in LME warehouses around the world, rising from about 50,000 tonnes in early February to more like 75,000 tonnes now. Keep in mind, however, that in 2014 there was more than a million tonnes of zinc in stockpiles.

This stock has been roughed up

Production-wise New Century is moving ahead nicely. On 21 February the company announced that the upgrade of the 'rougher circuit' at the Century Mine had been completed. New Century processes zinc ore using the standard 'froth flotation' process where crushed ore is put into a chemical bath, causing bubbles coated with zinc ore particles to float to the top and form a froth that can be skimmed off. 'Roughing' is the first stage of froth flotation where the coarser-grained zinc particles are recovered. With Century's rougher circuit now upgraded – ahead of schedule and under budget – the mine can now go from 9 million tonnes of ore p.a. to 12 million, raising zinc production to over 200,000 tonnes of zinc in concentrate.

We think New Century has executed very well on the re-start of the Century Zinc Mine and the company is well placed to benefit from the day when zinc ends its current bear phase. However, given the supreme importance of the zinc share price right now, we're switching to two stars. This one bears watching carefully against the day when things change for the better on the LME.

Pitt Street Research Pty Ltd

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