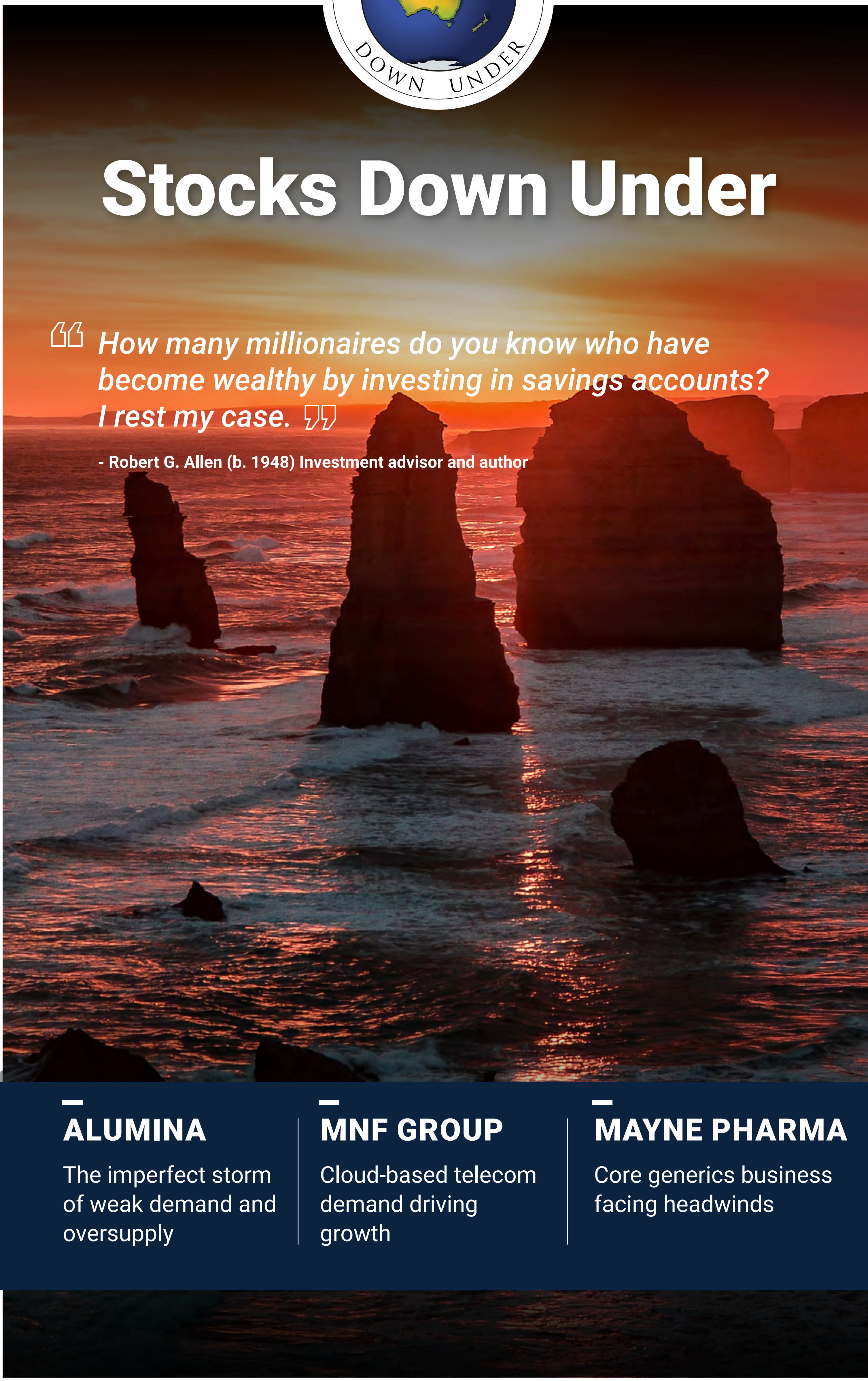
24 MARCH 2020

Stocks Down Under



How many millionaires do you know who have become wealthy by investing in savings accounts? I rest my case.

- Robert G. Allen (b. 1948) Investment advisor and author

ALUMINA

The imperfect storm of weak demand and oversupply

MNF GROUP

Cloud-based telecom demand driving growth

MAYNE PHARMA

Core generics business facing headwinds

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The imperfect storm of weak demand and oversupply

Stocks Down Under rating: ★★

ASX: AWC
Share price: A$ 1.45
Market cap: A$ 4.1BN

Shares of Melbourne-based Alumina haven't made much headway since the market bottom more than a decade ago. The stock has moved in a mostly sideways pattern largely due to general weakness in the materials sector and lower global demand for aluminium oxide, or alumina. A by-product of the deconsolidation of Western Mining Corporation in 2003, today Alumina's sole business is its 40% stake in Alcoa World Alumina & Chemicals (AWAC), a joint venture with US aluminium producer Alcoa (NYSE: AA). Currently trading just above its 52-week low, further downside is plausible amid ongoing price pressures.

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MNF GROUP

Cloud-based telecom demand driving growth

Stocks Down Under rating: ★★★★

ASX: MNF
Share price: A$ 3.82
Market cap: A$ 321M

MNF Group, based in Sydney, is the power behind our smartphone apps and laptop collaboration tools. The former MyNetPhone encompasses eight major brands that serve customers in Australia, New Zealand and Singapore. The stock has held up relatively well in the face of the coronavirus pandemic and as an Internet provider, MNF's revenues should be resilient to the current crisis, especially with some many people working from home now. Within increasing recurring revenue streams and opportunities for both organic and inorganic growth, investors may want to call MNF's number.

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Based in Adelaide, the pharmaceutical company Mayne Pharma specializes in oral drug delivery systems to be sold globally. It has a branded and generic drug portfolio that covers several areas including cariology, dermatology, oncology and women's health. Mayne's drug delivery systems have failed to deliver shareholder value with the stock now back down to levels not seen since 2012. With pricing pressures and competitive threats weighing on the key generics business, the present outlook is not compelling.

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Share price chart

Source: Tradingview

Declining prices to lead to underperformance

AWC is involved in bauxite mining, alumina extraction and pure aluminium smelting. The joint venture owns two bauxite mines, three refineries and controls two smelters in Australia. As Alcoa has a 60% stake in the business, Alumina's assets are effectively managed by Alcoa entities. From a corporate governance standpoint alone, this makes Alumina an unappealing investment because of the complex board structure and lack of control.

Aside from its much-maligned governance structure, Alumina is expected to be hurt by surplus conditions in the alumina market. This is forecast to drive the commodity's price down to US$312 per tonne over the next couple years, if forecasts from Australia's Office of the Chief Economist prove accurate. After sinking in 2019, declining alumina prices are expected to persist in 2020 as aluminium companies diversify along the supply chain amid a global manufacturing slowdown that is decreasing the need for primary aluminium. As such, Australian aluminium, alumina and bauxite producers are likely to underperform in 2020 as both prices and export levels drop.

A bright spot for alumina prices in 2019 was strong demand from China, which imported Australian alumina to complement their own production. But with a significant slowdown in Chinese demand in the aftermath of the coronavirus outbreak, this catalyst won't be able to prop up Alumina's pricing power. Slow demand from downstream consumers and rising inventories should negatively impact the company's 2020 financial results.

Cost pressures add to negative market dynamics

As if the supply-demand forces impacting prices aren't bad enough, Alumina is also expected to be negatively affected by rising prices of caustic soda (sodium hydroxide), an input used to dissolve aluminium-bearing materials. This cost was a tailwind for Alumina in 2019 as slower growth in the EU and China pushed caustic soda prices lower. Things are set to reverse in 2020 after some of the world's largest chlor-alkali producers recently announced price hikes. Although regulators did not accept the higher pricing, if demand for aluminium improves, caustic soda prices will likely move higher as well. This means that even increasing demand may come with a negative side of higher expenses.

The outlook is not much brighter for Alumina's bauxite business. While production increased 3.8% last year to 40.7m BDT (bone dry tonnes) and cash costs fell to $10.2 per BDT, the outlook for global bauxite demand is weak. Moreover, the decrease in costs was not due to improved operating efficiency but rather the stronger U.S. dollar. Oversupply conditions are also present in the global bauxite market. After an export surge last year at Queensland Bauxite, which has since re-emerged on the ASX as a cannabis company, a bauxite surplus is anticipated in 2020. This has led to big commodity players like Rio Tinto divesting their bauxite businesses to third parties.

Dividend yield not worth the risk

Weak global demand, poor aluminium prices and excess alumina supply are a dreadful combination for Alumina. Putting the potential impact from the coronavirus aside, the market dynamics are not favourable for its key materials, alumina and bauxite. This is cause for a gloomy outlook for at least the rest of this year and probably into next year.

Recent demand for Alumina's stock has largely come from dividend hunters that have been willing to take a chance on its 6.5% yield. This is not reason enough to buy into a company with deteriorating fundamentals stemming from weak demand for its only products not to mention rising input, labour, and maintenance costs. Although the forward P/E ratio of 11.8x is reasonable, valuation from an EV/EBITDA perspective of around 10.8x, which is more than threefold joint venture partner Alcoa's valuation, points to an overvalued stock.

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Source: Tradingview

Growing customer base, increasing profitability

MNF had mixed performance in FY19. While revenue slipped 2.3% to $215m, EBITDA increased 11% to $27.2m. Like its EBITDA margin, the company's network size expanded significantly adding 18% more phone numbers to bring its total to 3.8m. The company benefitted from both consumer and enterprise customers migrating their communication services to cloud computing environments. This drove an 86% jump in recurring revenue as MNF saw a rapid uptake in its wholesale UCaas (Unified Communications as a Service) and CCaaS (Contact Center as a Service) offerings.

Towards the end of FY19, MNF divested its DSL/NBN (National Broadband Network) business, which was being pressured by shrinking retail margins. The move has resulted in a simpler business structure allowing the company to focus on faster growing segments like small to medium sized business (SMB), enterprise and government customers. The relaunch of the Connexus brand expanded MNF's portfolio in the SMB space and should lead to market share gains.

Results were noticeably strong in 1H FY20 as revenue grew 14% to $112m, EBITDA increased 52% to $16.9m and EPS rose 16% to 4.83cps. The performance was driven by solid strategic execution and effective cost management. Robust demand for phone numbers and number portability in both the domestic and international markets increased MNF's customer base by 16% to 4.1m numbers.

In November 2019, the company raised $52.1m in capital to pay down bank debt and attain a positive cash balance. Then, in December 2019 MNF offloaded telecom service provider Symmetry Network to Sydney-based United Networks to further bolster its cash position. As of the end of 1H FY20 MNF was sitting on $38.6m in cash and had $30m of untapped debt facilities with which to fund growth opportunities.

Soaring global demand for cloud-based telecom service

Over the next four years, global demand for UCaaS, CCaaS and related software services is forecast to reach $46bn driven by increased business spending on cloud-based communications solutions. MNF is already seeing increased customer adoption of its offerings through Applications Programming Interfaces (API) platforms, which has led it to roll out its own API developer zone. Local telecom companies crippled by aging infrastructure are replacing VoIP-based copper networks with UCaaS cloud offerings. We believe this market shift bodes very well for MNF's future.

For the remainder of FY20, MNF plans to enhance its presence in existing markets in addition to expanding elsewhere in the APAC region. The expansion efforts will be aided by its integration with Singapore-based Super Internet, which it acquired in June 2018. Singapore is an area that is experiencing strong demand for specialised voice networks and MNF is bringing the nation its first fully interconnected carrier network since 2000. Trial-based customers are expected to be on board by the end of this month. The country is expected to be a steppingstone towards further expansion across Southeast Asia.

For FY20 management is forecasting EBITDA of $36m to $39m and NPAT of $10m to $12m as it continues to focus on growing its sticky, high-margin monthly recurring revenue (MRR) streams. Much of this growth is expected to come from Australia's leading wholesale telecom aggregator Telco-In-A-Box (TIAB), which MNF acquired in December 2018. Integration of TIAB's core voice network is underway and a full year benefit for MNF is expected to be realized in FY21.

Focused on core network and software solutions

After shedding its challenged DSL/NBN business, MNF has become a lean, extremely focused business. The well diversified communication network provider has all three of its divisions operating within its core area of expertise. This should drive sustainable recurring revenue growth for the next several years supported by strong global demand for cloud-based solutions.

MNF's two-pronged expansion approach puts it in a strong position to achieve stable long-term growth. It has opportunities to expand in current geographic markets and room to grow in other parts of the APAC region. The recent capital raising has provided a cash infusion that has strengthened the balance sheet, potentially creating acquisition opportunities in the currently distressed market. Given the growth expectations, we believe MNF is attractively valued at a forward P/E of 17.5x and an EV/EBITDA of 8.8x.

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Share price chart

Source: Tradingview

Sales declines spurs cost cutting, discontinuations

Mayne has over 100 clients for which it provides contract development and manufacturing services, but the solid customer base has not translated into good financial performance. Following a late-2018 head fake rally, the stock's recent slide began after it reported a 1% slip in FY19 revenue to $525m. EBITDA fell 4% to $112m due to higher spending to support the launches of TOLSURA and LEXETTE which are used to treat fungal infections and psoriasis respectively. The company's biggest segment, Generic Products, had a 16.7% revenue decline, which offset gains in other divisions.

The company's financial performance worsened in 1H FY20 as revenue decreased 17% to $227.2m and EBITDA dropped 42% to $47.4m. The company's bottom line also swung to a loss as EPS went from 0.2c to (1.2c) amid intensifying industry competition. Mayne was also negatively impacted by unfavourable conditions in the U.S. generic drug market as aggressive contract actions drove prices lower. This trend is likely to persist in the near-term.

In response to pricing pressures, management implemented cost cutting, portfolio rationalisation measures and discontinued some of its unprofitable product lines. Product discontinuations caused the company to write down its equity value by $5.5m. The moves, however, did little to appease investors as the coronavirus outbreak picked up steam and drove the shares to a fresh 52-week low.

Focus on commercialization agreements, new products

The sluggish first half results did have some silver linings, though. Performance ticked up during the fourth quarter of 2019, led by a 4% increase in the Specialty Brands segment. Sales in the Metrics Contract Services business were up 13% due to new analytical and formulation development offerings. Mayne signed commercial manufacturing agreements with a pair of global pharmaceutical companies to assist with the product formulation and production of FDA approved oncology medications. The company is aiming to transition from a project-based revenue model to a recurring revenue model in commercial manufacturing and expects to have five commercial clients by the end of FY20. It is also restructuring its global sales team, an initiative that is expected to produce US$6m in annual cost savings.

Despite these bright spots, it was hard for the company to hide from a 29% sales decline in its key Generic Products unit. Industry upstarts launched several new products that weakened demand for liothyronine (thyroid hormone), dofetilide (arrhythmia treatment), and butalbital (headache medicine).

Mayne has been very active rolling out new generic products in the U.S. market. It recently submitted a complete response letter to the U.S. FDA for its generic version of the NuvaRing birth control product, which it expects to launch later this year. It filed applications for three additional generic products bringing its total number of pending FDA products to 12. Going forward the company plans to focus on its more stable products including topicals from Encube Ethicals and Taligent. Establishing stronger positions in the women's health and dermatology businesses are key growth initiatives.

More pain for Mayne

Mayne has an interesting product pipeline notably in women's health, dermatology and infectious disease. Yet these potential growth drivers face ongoing competitive and pricing pressures and as such it isn't enough to get us excited about the stock. Weakness in the company's main Generics Products segment is a tough pill to swallow. Until there is significant improvement in this business, it is hard to get on board.

To the company's credit, it has reduced its dependence on the underperforming generics division and increased its exposure to the more stable dermatology segment. This likely won't be enough to produce strong FY20 results given the overhang of a soft U.S. generics market and Mayne's high number of products still in pending status with the FDA.

Top line growth is likely to remain constrained at least in the near-term and quite possibly longer given the global economic uncertainty around the coronavirus. At a FY21 EV/EBITDA multiple of 5.1x and 23.3x forward P/E this speculative stock is not worth the gamble at this time.

Pitt Street Research Pty Ltd

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Pitt Street Research Pty Ltd provides issuer-sponsored research for Small & Mid Cap companies and is founded on more than 40 years of combined experience researching companies in a range of different sectors.