26 MARCH 2020

Stocks Down Under

I hate weekends because there is no stock market

- Rene Rivkin (1944-2005) Chinese-born Australian entrepreneur, investor, investment adviser and stockbroker

IMDEX

Value beneath the surface

VALMEC

Growth fueled by LNG demand, infrastructure activity

THC GLOBAL

Low-cost production at scale means high times ahead

IMDEX

Value beneath the surface

Stocks Down Under rating: ★★★★

ASX: IMD
Share price: A$ 0.80
Market cap: A$ 310.5M

What lies beneath? It's a scary question. Like opening a mystery box, you can be seconds away from treasure or on the cusp of disappointment. But that's why companies turn to Imdex. Through its real-time subsurface technology, the Perth-based developer allows drillers and resource companies to see what's happening beneath the surface. Its intelligence platform enhances profitability by efficiently identifying areas ripe for exploration. And with investors struggling to find direction amid the global volatility, we believe Imdex is exactly what your portfolio needs to get back on track.

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VALMEC

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Stocks Down Under rating: ★★★

ASX: VMX
Share price: A$ 0.20
Market cap: A$ 25.1M

Based in Western Australia, engineering services company Valmec is engineering a comeback bid. The provider of equipment, construction, maintenance and commission services to the energy sector was hit hard by the global equity market downturn. Its shares, which have been largely rangebound for the last six years, look poised for a turnaround. The market underappreciates Valmec's expanding capabilities in the gas, water and renewable energy markets. Given the increasing recurring revenue streams from well diversified sources, this microcap stock is a worth a close inspection.

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Share price chart

Source: Tradingview

A mining-tech powerhouse

Through its core technologies – AMC and REFLEX – Imdex enables miners to obtain accurate subsurface data and achieve real-time results via subsurface visualisation. The technology increases profitability by ensuring faster and more accurate exploration. As the mining sector becomes more tech-savvy, legacy players need integrated solutions, cloud-connected technologies and drilling optimisation solutions. And because Imdex's technology adds value from the exploration stage to the eventual extraction – the mining-tech group is building recurring revenue streams by securing long-term relationships with customers. Furthermore, not resting on its laurels, Imdex acquired Flexidrill – a New Zealand-based provider of drilling technology – on 6 January 2020. The deal added productivity technologies – COREVIBE and MAGHAMMER – to its portfolio, which not only provides cost synergies, but also increases its strategic footprint.

On 1 July 2020, CEO Bernie Ridgeway will also relinquish his post, allowing COO Paul House to take the reins. And with over 26 years' experience across the resources and industrial services market, we like the move. House also has a bevy of international experience – conducting business in the United States, Africa, India, the Middle East and South East Asia.

Diversifying the business model

To avoid the peaks and valleys of the global macroeconomic machine, Imdex is expanding its operations to non-cyclical areas of the mining sector. Launching new technologies like BLAST DOG and COREVIRE – which are expected to generate revenue in FY20 – management is taking proactive steps to shield the company from a potential coronavirus downturn. Moreover, recently acquired drilling productivity products like MAGHAMMER and XTRACT have the company set up for years to come.

Providing guidance for 2020, management said they remain bullish, as miners replacing diminished reserves and higher exploration expenditures continue to support Imdex's growth. Furthermore, with companies ramping-up drilling campaigns to increase safety, productivity and reduce costs, Imdex is poised to capitalize on the secular trend. Imdex's technology also allows drillers to uncover mines that are deep underground. In turn, the discoveries – and the subsequent drilling – requires long-term relationships that support Imdex's service revenues.

In addition, resilient production is likely to support further mining sector investment in 2020. And with a rich pipeline of clinical trials already under way, there are several near-team catalysts that support Imdex's future growth.

Drilling down the fundamentals

In H1 FY20, Imdex's revenue increased 2.3% to $127.9m. EBITDA increased 12% to $28.1m, while the group's EBITDA margin expanded from 20.1% to 24.5%. IMDEXHUB-IQ connected technology sales rose by 52%, while Imdex's rental fleet generated a monthly average rental rate of 12.7%. The Asia-Pacific region was also up by 7.5%, Europe and Africa up by 3.7%, while the U.S. fell by 2.1%.

However, the weakness Stateside was a result of consolidation in the mining sector and industrial unrest in South America. Management – and we – believe these headwinds will subside in 2020. Adding to our optimism, Imdex's revenue is now split between sales and rental – which provides more stable cash flows during periods of uncertainty. Furthermore, with miners ramping up their exploration activities, management's strategic pivot toward exploration and development positions Imdex at the heart of a flourishing sub-sector of the industry.

With plenty to like, we're bullish on Imdex. The four-star rated shares trade at an EV/EBITDA multiple of 4.8x and a P/E multiple of 9.7x for FY21 starting in July – offering tremendous value in an increasingly uncertain environment.

Moreover, the stock was on a steep uptrend before the coronavirus cut the rally off at the knees. And because the recent plunge was macro driven and not fundamental – we believe Imdex's stock remains ripe for exploration.

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Source: Tradingview

Improving gas industry trends

Valmec had a solid FY19. Revenue grew 6.7% to $110.2m, EBITDA rose 64% to $8.06m and EPS increased from $0.012 in FY18 to $0.028. While construction activity stalled, demand for oil & gas services remained robust. Energy construction services, which comprised 58% of the oil and gas business, had a 14.1% decline in sales. Conversely, oil and gas Services revenue soared 61.3%.

The strong Service sector result was driven by continued growth in infrastructure. Valmec secured additional contracts with new and existing customers, which displayed both its customer retention strength and recurring revenue structure. The recurring service component of the sector achieved 68% revenue growth. A key accomplishment was its selection by the Australian Gas Infrastructure Group (AGIG) to participate in South Australia's largest renewable gas project. Helping to develop the region's first hydrogen production facility enhanced the company's capabilities and further diversified its recurring revenue sources. In response to the government's 2030 carbon emission targets, Hydrogen is increasingly being looked at as an alternative energy storage solution for both Australian energy producers and users.

Valmec extended its operational footprint by adding new, Queensland-based, facilities in Roma and Brisbane. This gave it increased capacity to service East Coast gas customers, which underwent a transition in 2019. Low liquid natural gas (LNG) prices spurred increased export demand and Federal Government measures were put in place to make more supply available. This should lead to increased domestic infrastructure production and demand for Valmec services.

Another positive development was the expansion of its $80m order book and $595m pipeline tender opportunity for FY20/21. The company capitalised on an improved gas industry trend amid lower gas production in Southern Australia and limited pipeline capacity among Queensland suppliers. Ongoing tight supply-demand conditions are likely to create a favourable headwind for Valmec.

Strong order book, project pipeline

Valmec's 1H FY20 results showed a 47% revenue increase to $70.1m, a 65% jump in EBITDA to $5.4m, and 66% EPS growth to $1.81. The revenue growth marked the strongest top line performance for a six-month period in the company's history. Revenue in its key energy construction segment improved dramatically rising 107.2% to $47.8m because of a stronger order book and new projects with the Jemena Atlas Pipeline, Water Corporation and Newmont Gold.

Second half FY20 performance is again expected to get a boost from a sizeable order book, strong tendering activity across its service segments and good growth prospects in the energy and infrastructure segments. Valmec should also benefit from the continued implementation of its Asset Service strategy, which is geared towards attaining larger service contracts and generating greater recurring service revenue.

For the full year, Valmec anticipates 20% growth in both revenue and earnings, which looks quite attainable given the strong 1H performance. Expectations are also likely to be met because of the company's construction project pipeline and continued execution of the Asset Services strategy. A shift from offering one-off services to fully integrated service packages will reduce its exposure to cyclical revenue sources and allow it to secure more stable, higher value contracts.

LNG export demand, infrastructure activity boost outlook

East Coast gas producers are responding to higher overseas LNG demand and the Federal Government has stepped in to facilitate the necessary infrastructure development. This should lead to increased spending on inspection, testing, industrial and maintenance services, such as those offered by Valmec. Increased activity in the water and renewable energy industries also bodes well for the company's future.

Management justifiably has an energetic outlook for the remainder of FY20 and FY21. It is well positioned to keep winning large scale service contracts and grow its diversified recurring revenue base of operators, drilling contractors, plants, and asset owners. Despite its microcap status, we believe Valmec shares are presently undervalued and perhaps misunderstood at 5.4x forward earnings.

THC GLOBAL

Low-cost production at scale means high times ahead

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Share price chart

Source: Tradingview

Access to the high growth European market

THC Global's 'Farm to Pharma' business model encompasses the full medical cannabis process from cultivation to pharmaceutical development. After receiving its manufacturing license on 13 June 2019, THC held the coveted license trifecta for cannabis research, medical cannabis development and manufacturing. Since then, it has attained significant farming scale through its two Australian grow sites and develops pharmaceuticals at its $35m biomanufacturing facility. The Queensland-based Southport facility is the largest bio-floral extraction facility in the southern hemisphere. It produces 120k of cannabis biomass annually for 250k patients in Australia. It does so at a much lower cost than import producers, which is a major competitive advantage. Since the Southport facility has European design and equipment, it meets the requirements for entering the rapidly growing European market. THC is also exploring the possibility of using some of its land for hemp cultivation, which would open it up to new markets in the nutraceutical, cosmeceutical and food industries.

The fast-growing Australian cannabis market is expected to reach 100k patients by 2021 compared to around 10k patients in 2019. THC has the capacity to meet this demand in its entirety and still be a major global exporter. The domestic market has significant regulatory barriers regarding patient access and competitor entry, which give THC a significant advantage. Current demand for medical cannabis products is mostly being met by higher cost imports. THC expects that it will soon be able to sell its products to Australian patients at half the cost of imports and still be profitable.

THC recently launched two varieties of CBD oil under the Canndeo brand. THC oil and THC/CBD oil hybrid products are targeted for mid-2020 availability. By June 2020 it plans to ramp production to begin supplying the global export market. It also plans to launch an extended line-up of medicines over the next couple years for both the domestic and export markets including dried flower, gel capsules, gel-tabs and topicals.

Oh Canada

THC also generates revenue from its Canada-based Crystal Mountain subsidiary, which is focused on supplying hydroponics equipment, materials and nutrients to the North American and European markets. With over 600 products to supply small-scale cannabis producers, there is plenty of room for revenue upside from this expanding division. THC expects Crystal Mountain to deliver over $7m in revenue in 2020, which is likely a conservative estimate given the market size.

Further penetration of the Canadian market is represented by its pending license to supply Canndeo products under the Canndeo Canada name. THC has already received pre-orders from licensed producers in Canada and the first shipments are expected in 2H 2020. The target market in Canada is 369k patients and THC forecasts that demand for medical cannabis prescriptions will be over 100k annually.

The New Zealand market is another area of future growth. THC currently sells Endoca CBD products there through its exclusive distribution agreement with Endoca. This is a favourable market because New Zealand regulations make for a relatively easy prescription process. Patients there can seek a medical cannabis product subscription without obtaining government approval, which gives THC access to a broader patient population compared to its home market. The company's partnership with DATAPHARM, which operates the CBDinfo.co.nz informational website further strengthens its presence in the neighbouring region. Sales of its own Australian-manufactured products are expected to begin by the middle part of this year.

A high-quality global player

As a leader in low-cost, high quality cannabis, THC's growth opportunities stretch well beyond the medical field and the Australian border. Its scalable, low-cost production and compliance with European standards put it in a position to compete on a global level. Global demand for medical cannabis products is on the rise and yet there aren't many GMP (Good Manufacturing Practices) certified producers to meet the demand.

The stock is well undervalued, in our view, given its growth prospects. Its biopharmaceutical manufacturing facility alone has a $35m replacement value, yet the market value of THC's equity is around $25m. We see limited downside and tremendous upside potential from here and as such view THC Global as a fairly pain-free investment.

Pitt Street Research Pty Ltd

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