27 MARCH 2020

Stocks Down Under

> *I made my money the old-fashioned way. I was very nice to a wealthy relative right before he died.*
>
> **- Malcolm Forbes (1919-1990) American entrepreneur**

MACMAHON HOLDINGS

Solving miner issues

TASSAL

Bottom fishing

IPH LIMITED

An intangible asset

MACMAHON HOLDINGS

Solving miner issues

Stocks Down Under rating: ★★★★

ASX: MAH
Share price: A$ 0.17
Market cap: A$ 355.6M

While digging up dirt for clients may seem like a scandalous deed, Perth-based Macmahon Holdings is as good as it gets. However, unlike the gossip pages that fill grocery store checkouts, Macmahon Holdings provides surface, underground and engineering services for miners and commodity extractors. Serving some of the world's largest mining companies, Macmahon Holdings has the technology and expertise to provide clients with A-Z service. And with the coronavirus outbreak wiping away five months of hard-earned gains, we believe now is the time for investors to start digging.

READ MORE

TASSAL

Bottom fishing

Stocks Down Under rating: ★★

ASX: TGR
Share price: A$ 3.31
Market cap: A$ 643M

Right after its half-yearly result on 12 February you could have bought stock in Tassal, the seafood company from Tasmania, for $4.61. However, by now you'd be 30% underwater (pardon the pun), having experienced the same kind of drowning as the S&P/ASX200 over the last month or so. Tassal, however, has defensive qualities that make it a good candidate for the turn, not least of which is that people are still buying seafood, and particularly salmon and prawns, through this Coronavirus crisis.

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IPH LIMITED

An intangible asset

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ASX: IPH
Share price: A$ 6.80
Market cap: A$ 1.48BN

With roughly 1,000 employees across Australia, New Zealand and the Asia-Pacific region, Sydney-based IPH Limited protects Fortune Global 500 companies' most important assets – intellectual property (IP). Through its group of subsidiaries, IPH Limited provides filing, prosecution and enforcement of trademarks and patents. But with the stock nosediving over the last month, investors are acting like the company itself is about to expire. Macro headwinds aside, IPH Limited is a leader in legal and IP services. And with the digital economy transforming the future of business, we believe IPH Limited is at the heart of the secular trend.

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Share price chart

Source: Tradingview

Positioned within a growing industry

The Australian mining industry is expected to grow by 6.5% p.a. – to $15bn – over the next five years. With mining companies increasing their capital expenditures and earmarking funds for exploration and expansion, growth remains robust. And with strong global demand for minerals and commodities, Macmahon Holdings has the flexibility to outsource its activity and streamline its cost structure. Specifically, its world class maintenance facilities support frontline contracting services by rapidly deploying supplies to client's developments. And well-positioned within a fragmented market – occupying 6.5% market share – Macmahon Holdings has plenty of avenues for future growth.

Partnering with leading miners, the group secured a large number of long-term contracts with the majority becoming repeat customers. Furthermore, the group is increasing its footprint across Indonesia, while its diversified services allows the company to add value at every stage of the extraction process.

Across commodities, Macmahon Holdings generates 47% of its revenue through its gold operations and 34% through its copper-gold mix. And with the remainder a function of coking coal and other organic materials, Macmahon Holdings has a diversified revenue stream that can weather disruptions from the coronavirus. Moreover, with the price of gold continuing to rise, the group has the expertise to pivot to any areas that lack capacity.

A pipeline of profitable projects

Throughout 2019, Macmahon Holdings' Byerwen coal mine made significant progress. And in H1 FY20, management said that record production led to discussions about expanding the project's capacity. Moreover, the company made provisions to open pit mining services at Mount Morgans gold mine until December 2022, with possible extensions also discussed in H1. Management also extended operations at its Martabe gold mine to March 2023, while its Batu Hijau and Telfer projects are also generating strong demand. On 4 November 2019, Macmahon announced that Telfer would be "cash flow positive" for the remainder of its useful life, while its agreement with Newcrest Mining, a gold-copper miner based in Melbourne, would also increase its compensation rates.

On 18 February 2020, Macmahon's subsidiary GBF also secured a $200m contract with Silver Lake Resources, a gold miner based in Perth. And adding additional revenue, the company's underground division is also delivering positive results, while its civil business continues to participate in infrastructure and rehabilitation projects.

Built for the long haul

In H1 FY20, Macmahon's revenue increased by 27% to $686.7m. EBITDA increased by 28% to $114m and NTA per share increased by 8% to 20.8c. The group also has a $4.5bn order backlog and a $7bn tender pipeline. The strong performance led management to increase their FY20 revenue guidance to $1.3bn - $1.4bn and their EBIT guidance to $85m - $95m. Management also increased their full year capex budget to $155m, as strong consumer demand and investments in automated drilling – which will allow clients to increase safety, productivity and reduce operating costs – has the group extremely optimistic about the future. And as a sign of things to come, BHP, the mining, metals and petroleum giant, said that automated drilling can function for an 11.5-hour to 12-hour shift. Moreover, one person can operate three drills at a time.

So, with investors essentially throwing the baby out with the bathwater, we're bullish on Macmahon Holdings. The four-star rated stock trades at an EV/EBITDA of 1.8x for FY21 (starting in July), with competitor Downer Group trading at an EV/EBITDA of 3.9x. Not only are investors underestimating Macmahon's fundamentals, but the valuation disparity between the company and Downer Group only increases our optimism.

And despite the recent volatility, we believe Macmahon Holdings is built for the long-term. The fragmented mining industry offers plenty of avenues for future growth and we believe Macmahon Holdings is pulling all of the right levers to get there.

TASSAL

Bottom fishing

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Share price chart

Source: Tradingview

From humble beginnings in 1986 Tassal has grown into a force to be reckoned with in the seafood world, best known for the Atlantic salmon that it raises in various seafood farming zones about Tasmania (hence the company name, Tassal being a contraction of Tasmanian Atlantic Salmon). In FY19 the company grew revenue 16%, to $561m, and operating EBITDA 13%, to $112m. Ten years earlier, in FY09, the comparable figures were $358m in revenue and $50m in EBITDA. The secret to Tassal's success has been to adopt best practice when it comes to farming salmon and getting it to market and leveraging that excellence to the growing popularity of salmon both in Australia and around the world.

Look beyond the revenue growth

Not every reporting period, however, works as well as the previous one. In the six months to December 2019 revenue fell by 15% because the company was harvesting less 'biomass' (i.e. the fish when hauled out of the water) in order to increase the EBITDA per kilogram. The fact that EBITDA rose 3.4% in the half suggested that this was a good strategy. However, it may have suggested to some that Tassal had lost its growth mojo. The stock sold off and before investors could blink the current general market rout was on us.

We think this sudden plunge into the deep suggests an opportunity when investors are looking for good names to take into the post-Covid world we are headed towards. Salmon has almost become a staple of dining tables around the world in recent decades and we believe that popularity isn't going away any time soon.

With Tassal now selling larger salmon, the company is well placed to continue growing its foundation business. Meantime the company has been investing heavily in prawns, as evidenced by the $25m acquisition in mid-2019 of Exmoor Station, a North Queensland coastal cattle property on which Tassal is now developing a major prawn operation. Prawns provide Tassal with geographic and species diversification - prawns are very much a product of Australia's northern waters - as well as allowing Tassal to leverage continued domestic demand growth in Australia. Further down the track Tassal expects to be able to tap into superior pricing for prawns in export markets.

Two stars for the market risk, four stars in a recovery

For all this future growth Tassal is currently trading at a P/E of only 8.9x FY21 forecast earnings. The multiple drops to 8x when you look at FY22. Obviously, there is the risk that Tassal makes a mistake in executing its prawns strategy, but a single digit P/E more than balances this off. Looks like one to fish for ahead of the post-Covid recovery. Two Stars for the market risk right now, but Four Stars on the recovery.

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Share price chart

Source: Tradingview

IoT will fuel future demand

As the internet of things (IoT) continues to digitize the global economy, multinational companies, public sector organisations, SMEs and professional services rely on IPH Limited to protect their intellectual property. In 1H FY20 – released on 13 February 2020 – management said that patent filings fell by 3.5%, while the Australian market was down 1.2%. However, there were no major client losses during the period and IPH Limited is still the leader in Australia with 36.9% market share. Moreover, strong demand in Asia is a catalyst for future growth. Patent filings in Indonesia increased by 30% during the period, Malaysia was up by 26.5%, Thailand up by 42.3%, the Philippines up by 27.8% and Vietnam up by 68%. So, despite the underperformance in Australia, Asia is more than capable of stimulating future growth.

Furthermore, with innovation required to maintain a competitive advantage, biotechnology firms, finance companies and software publishers continue to develop new and commercially exploitable products that service Australia's ageing population and disrupt legacy industries. The secular shift requires companies to ramp-up R&D to avoid being left behind. Major legislative changes to IP rights are also a catalyst for future growth. As governments recognize the need to protect intangible assets, the shift in philosophy will be a boon for IPH's future revenue and margins.

Acquisitions are paying off

On 20 November 2019, IPH announced it would merge its Watermark and Griffith Hack subsidiaries in a bid to improve operational efficiency. The consolidation delivered steady results in H1 FY20 and management expects to generate $2m - 2.5m in cost synergies from FY21 onwards. The combined entity is already streamlining its leasing, administrative and operational costs, while consolidating the two groups also diversifies IPH's services and client base. Furthermore, the group has a strong track record of acquiring and integrating portfolio companies. And that's what has enabled IPH to maintain its status as Australia's alpha dog.

In H1 FY20, revenues shot up by 43.9% to $179.8m. NPAT increased by 12.4% to $27.2m, while EBITDA ballooned by 41% to $57.2m. The strong results were driven by IPH's August 2019 acquisition of Xenith IP – which houses Watermark, Griffith Hack, Shelston IP and Glasshouse Advisory. The acquisition generated cost synergies of $1.3m, while management expects to save a total of $3.4m in FY20. And with other acquisitions still in the consolidation process – deferring synergies to future periods – we believe the forthcoming efficiencies will be a significant driver of future EBITDA growth.

Fundamentals remain extremely strong

Across the Asia-Pacific region – which accounts for 28.2% of consolidated revenue – IPH's EBITDA margin increased from 36.6% to 42.8%. Across Australia and New Zealand, at 74.6% of consolidated revenue, EBITDA increased by 55% – though the company's margin fell from 35.6% to 34.8%. However, we believe the spike in agent fees and employee expenses are a short-term blip that will be streamlined in future periods. And while management failed to provide full-year guidance – due to uncertainty from the coronavirus – they're keeping an eye out for potential acquisitions and also prioritizing organic growth. Furthermore, the Trans-Pacific Partnership (TPP) free trade agreement provides IPH with access to overseas markets where IP services are poised to grow in the coming years.

From a valuation perspective, IPH Limited's stock trades at an EV/EBITDA multiple of 11.7x and a P/E multiple of 17.7x for FY21, which starts in July. We believe both metrics underestimate the group's future growth prospects and its ability to acquire value-added businesses.

Furthermore, with the coronavirus stressing balance sheets across the industry, many companies won't survive the pandemic. However, with IPH's track record of strategically adding to its portfolio, the troubling landscape will provide opportunities for the group to scoop-up distressed assets at bargain prices.

Pitt Street Research Pty Ltd

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