30 MARCH 2020

# Stocks Down Under

> *It is within the power of man to eradicate infection from the earth.*

- Louis Pasteur (1822-1895), French biologist

## A.P. EAGERS

People will one day start buying cars again

## KIRKLAND LAKE GOLD

A buy and improve strategy

## AURIZON

Infrastructure, baby!

## A.P. EAGERS

### People will one day start buying cars again

Stocks Down Under rating: ★★

**ASX: APE**
**Share price: A$ 2.94**
**Market cap: A$ 773M**

The last six months have definitely not been good ones to be a shareholder in A.P. Eagers, the Brisbane automotive dealer. Eagers stock was in the fast line as recently as last September, reaching $14.22 at the end of that month. However, a negative 14 November 2019 trading update caused a sudden pileup and Eagers stock is now back below $4.00, a level last seen in mid-2014. We believe that once consumer confidence returns in Australia and turns around a negative market for new cars, Eagers can turn with it. So, two stars for now.

READ MORE

## KIRKLAND LAKE GOLD

### A buy and improve strategy

Stocks Down Under rating: ★★★★

**ASX: KLA**
**Share price: A$ 54.30**
**Market cap: A$ 15.5BN**

When the Coronavirus crisis started and oil collapsed, gold ran up with all the confusion, reaching US$1,687 on 6 March. Then gold crashed as well, back to US$1,472 an ounce by 17 March. That wasn't great for the major Canadian producer Kirkland Lake Gold, whose stock trades in Toronto and New York as well as Australia. Kirkland Lake Gold stock was over A$76 a share on ASX last September. It's since been as low as $39. However, we think good times for gold will resume shortly, with Kirkland Lake's current suite of mines positioning it to grow with the yellow metal.

READ MORE

## AURIZON

### Infrastructure, baby!

Stocks Down Under rating: ★★★★

**ASX: AZJ**
**Share price: A$ 4.41**
**Market cap: A$ 8.2BN**

Aurizon, the Brisbane-based rail freight operator, started to go out of favour in September 2019 when its stock hit an all-time high of $6.05 per share. It ended 2019 down 14% at $5.23. And thanks to the current market bloodbath the stock has fallen another 26% from there. However, we think Aurizon has strong leverage to the coming post-Covid recovery and in the meantime the 6.7% dividend yield could prove quite attractive, if maintained.

READ MORE

# A.P. EAGERS

## People will one day start buying cars again

**Stocks Down Under rating:** ★★

**ASX: APE**
**Share price: A$ 2.94**
**Market cap: A$ 773M**

The last six months have definitely not been good ones to be a shareholder in A.P. Eagers, the Brisbane automotive dealer. Eagers stock was in the fast line as recently as last September, reaching $14.22 at the end of that month. However, a negative 14 November 2019 trading update caused a sudden pileup and Eagers stock is now back below $4.00, a level last seen in mid-2014. We believe that once consumer confidence returns in Australia and turns around a negative market for new cars, Eagers can turn with it. So, two stars for now.

### Share price chart

*Source: Tradingview*

Back on 25 January, when we profiled the Sydney luxury car dealer Autosports Group (ASX:ASG), we noted that 2019 was not a great year for the automotive trade in Australia. Only 1.06 million new vehicles were sold across the country through the year, 8% fewer than in 2018. Blame it on lending reforms, low wage and house price growth, drought or what you will, it impacted A.P. Eagers in a serious way. Because unlike Autosports, Eagers had much less in the way of luxury to offset the downturn. The result was the November 2019 trading update followed by a calendar 2019 result (Eagers is a December balance date company) showing the company's revenue down 2% and operating EBITDA down 14%, to $122m.

### Merger brings luxury brands

That, however, was the 'old' Eagers. The 'new' Eagers is the company that just merged with its major competitor Automotive Holdings Group where the similarities were such that Australia's competition regulator, the ACCC, had to review the transaction before it could proceed. It said 'yes' in July 2019, two months after the merger was announced, when Eagers agreed to divest new car dealerships in the Newcastle and Hunter Valley region.

This merger places Eagers in an excellent position to recover with the automotive market generally. What Eagers now has is a collection of some of the more prominent dealerships in Australia's big cities so its yards will see some of the early traffic in the recovery. It has the balance sheet to support these dealerships, helped by the fact that the company has always insisted on owning its properties. And we believe it has the operating smarts to be able to realise synergies between Eagers and AHG. What Eagers also has at the senior management level is a strategic concept that in the future there will be fewer dealerships and more auto 'precincts', improving customer access. This company intends to be on the right side of history as the industry transitions.

The recent decision by General Motors to kill off the iconic 'Holden' brand in Australia was a blow to Eagers, which has six Holden dealerships in Queensland and another four in Tasmania. The US company will have to compensate Eagers for this move, so we don't see it having a long-run impact as far as shareholders go.

### Consumer confidence will be key

Obviously, the big question for investors looking at Eagers in the near term is when consumer confidence comes back post the current crisis. It might take a while, or it might not. We argue that if the virus is controlled quickly (i.e. over the next two or three months) the world can start getting back to 'normal', which for Australia would likely mean a catch-up in terms of the nation maintaining its car fleet after the difficult 2019. We expect that 2020 can see the beginnings of that recovery and 2021 can be the year that brings home the bacon.

Currently ahead of that recovery Eagers is trading at a P/E of 6.8x calendar 2020 earnings and 5.6x 2022 earnings. When people start buying cars again this stock is well placed to re-rate and we can call it Four Stars. In the meantime, we see Eagers as Two Stars because of the current weak economic circumstances.

# KIRKLAND LAKE GOLD

## A buy and improve strategy

**Stocks Down Under rating:** ★★★★

**ASX: KLA**
**Share price: A$ 54.30**
**Market cap: A$ 15.5BN**

When the Coronavirus crisis started and oil collapsed, gold ran up with all the confusion, reaching US$1,687 on 6 March. Then gold crashed as well, back to US$1,472 an ounce by 17 March. That wasn't great for the major Canadian producer Kirkland Lake Gold, whose stock trades in Toronto and New York as well as Australia. Kirkland Lake Gold stock was over A$76 a share on ASX last September. It's since been as low as $39. However, we think good times for gold will resume shortly, with Kirkland Lake's current suite of mines positioning it to grow with the yellow metal.

### Share price chart

*Source: Tradingview*

### Acquire and improve

Kirkland Lake Gold is one of those rare gold miners that always seem to buy good assets at the right time. Its history starts in late 2001 when gold was a mere US$270-280/oz and a junior explorer called Foxpoint Resources had just convinced an established miner, Kinross Gold (TSX: K), to sell to it a number of former gold mines in the neighbourhood of Kirkland Lake, Ontario, a town around eight hours drive north of Toronto nicknamed 'the Mile of Gold' because of the productivity of its gold mines back in the day. The cost was C$5m.

One of the idle properties Kinross offloaded was an underground mine called Macassa. Kirkland Lake Gold, which is what Foxpoint Resources renamed itself, dewatered Macassa and started exploring, finding a major new gold resource, which Kirkland Lake Gold has since profitably exploited. It took a while to develop Macassa into a substantial mine but by 2012 it was a 100,000-ounce producer at a cash cost of about US$800 an ounce. In calendar 2019 the comparable figures were 241,000 ounces at US$414 an ounce.

Kirkland Lake Gold's next big move after Macassa was a late 2015 merger with fellow Canadian producer St Andrew Goldfields in an all-scrip deal worth C$178m. The timing was exquisite – gold was at a major low of US$1,100 an ounce. This merger brought three mines together called the 'Holt Complex' at Matheson, Ontario, around 70 km north of Kirkland Lake. These days the Holt Complex assets are non-core for Kirkland Lake Gold but in 2011 they started the company on a path to becoming a gold major by adding 140,000 ounces of output.

## Into the big league

After St Andrew came the pivotal Newmarket Gold merger of September 2016. That C$1bn transaction brought Kirkland Lake Gold into the big time because it added the Fosterville Gold Mine in central Victoria. In 2015 Fosterville, which is 20 km from the gold town of Bendigo, had delivered some of the highest-grade gold discoveries in Australia in recent decades in exploration drilling. Therefore, it could reasonably expect to be a strong producer for the new Kirkland Gold. That, indeed, proved to be the case.

At the start of 2016, Newmarket Gold had been expecting 110,000-120,000 ounces from Fosterville that year at an operating cash cost of US$500-575 an ounce. In 2019 Kirkland Lake Gold got 619,000 ounces from the mine at a cash cost of US$119 an ounce. It was Fosterville that prompted Kirkland Lake Gold to add an ASX listing because of strong local interest in gold miners in the Fosterville area.

## A 4-star strategy

Notice a pattern here? Kirkland Lake Gold buys an asset and then transforms it via smart exploration or mine engineering, so that costs go down and production goes up. The company is expecting its acquisition, the Detour Lake Gold Mine in northern Ontario, to follow this same path. Detour Lake is Canada's second largest gold mine and currently a 600,000 ounce-a-year producer at an AISC of US$1,100 an ounce. Kirkland Lake Gold paid C$4.9bn in scrip for its owner, Detour Gold, late last year and expects to realise a strong return on that investment over time.

As a 1.5-million-ounce producer Kirkland Lake Gold is now a prime target for any institution that needs easy exposure to gold and a management team with a track record of adding value. At a P/E of around 11.9x forecast 2020 earnings, those institutions don't have to pay much to get that exposure right now. But even if they're not buying, the company itself is. On 18 March Kirkland Lake Gold announced it had bought in one fell swoop some 10.1 million shares of its scheduled 20 million share buyback. This stock is Four Stars in our book.

# AURIZON

## Infrastructure, baby!

**Stocks Down Under rating:** ★★★★

**ASX: AZJ**
**Share price: A$ 4.41**
**Market cap: A$ 8.2BN**

Aurizon, the Brisbane-based rail freight operator, started to go out of favour in September 2019 when its stock hit an all-time high of $6.05 per share. It ended 2019 down 14% at $5.23. And thanks to the current market bloodbath the stock has fallen another 26% from there. However, we think Aurizon has strong leverage to the coming post-Covid recovery and in the meantime the 6.7% dividend yield could prove quite attractive, if maintained.

### Share price chart

*Source: Tradingview*

### Australia’s largest rail freight operator

If there’s one place equity investors need to be right now (other than cash), it’s infrastructure. The assets in this sector are generally monopolies or semi-monopolies, customers need to use them every day and they will be around long after the Coronavirus crisis of 2020 has been consigned to the history books.

Aurizon represents a great play on that theme because its Australia’s largest rail freight operator. The company is perhaps best known as the operator and manager of the Central Queensland Coal Network, a 2,670 km collection of railways across four corridors that collects coal from more than 50 coal mines in Queensland’s Bowen Basin. It takes it to five major export ports as well as other places where domestic coal users can collect it.

In addition to that Aurizon also runs rail networks around Australia handling bulk commodities as well as coal. When Aurizon talks about its ‘Network’ business they are simply referring to the Central Queensland Coal Network. When it talks about ‘Coal’ or ‘Bulk’ it means everything else. The Network part of Aurizon has caused some problems for the company in recent years because the rate of return Aurizon is allowed to earn from

the rails is regulated by the Queensland Competition Authority. But late last year the company persuaded the Authority that its view of the appropriate cost of capital to apply to the Network was the right one.

### A coal junkie

The reason Aurizon went out of favour last September is because of its leverage to coal. There were concerns that China was taking less of the product being shipped out of central Queensland. And for those with a long-term view there was concern that the world's use of coal would gradually taper off over time. Since the Coronavirus crisis started these fears have morphed into a general concern about a slowdown in coal and bulk trade generally.

### Plenty of capital to distribute

We take the view that Infrastructure play Aurizon will come out of this crisis in reasonable shape. Consider that in February, when the company reported its results for the six months to December 2019, it could point to a 5% revenue lift and a 12% increase in EBIT. Moreover, the company affirmed previous guidance of $880-930m EBIT for the full year and increased the amount of stock it was buying back by $100m to $400m. This is a company with plenty of capital to hand back to shareholders after it's done maintaining the rail network and the rolling stock.

### Four stars in the recovery

What this tells you is that in normal times Aurizon is a well-managed company.  At the moment times aren't so normal but we take the view that the end of the crisis will see a general re-stocking of global supply chains, of which Aurizon's rail networks are an integral part. Aurizon, as a Top 100 company on the ASX, has falling about as fast as the S&P/ASX200, but bounced back somewhat in the last few trading sessions.

In our view, the stock is now on an attractive 6.7% dividend yield and a 7.7x EV/EBITDA for the 2021 financial year, starting in July. Although the ugly market mood right now would suggest only a two-star rating for Aurizon, we believe the dividend yield will attract ready buyers once the market turn is more convincing. Hence our four-Star rating for this Infrastructure company.

**Pitt Street Research Pty Ltd**

95 Pitt Street, Sydney, NSW 2000, Australia

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.

You are receiving this email because you subscribed to our Stocks Down Under newsletter.

All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without prior written permission from Pitt Street Research Ltd Pty. All intellectual property relating to the Content vests with Pitt Street Research unless otherwise noted.

Stocks Down Under (Pitt Street Research AFSL 1265112) provides actionable investment ideas on ASX-listed stocks. The Content has been prepared for general information purposes only and is not (and cannot be construed or relied upon as) personal advice nor as an offer to buy/sell/subscribe to any of the financial products mentioned herein. No investment objectives, financial circumstances or needs of any individual have been taken into consideration in the preparation of the Content. Financial products are complex, entail risk of loss, may rise and fall, and are impacted by a range of market and economic factors, and you should always obtain professional advice to ensure trading or investing in such products is suitable for your circumstances, and ensure you obtain, read and understand any applicable offer document