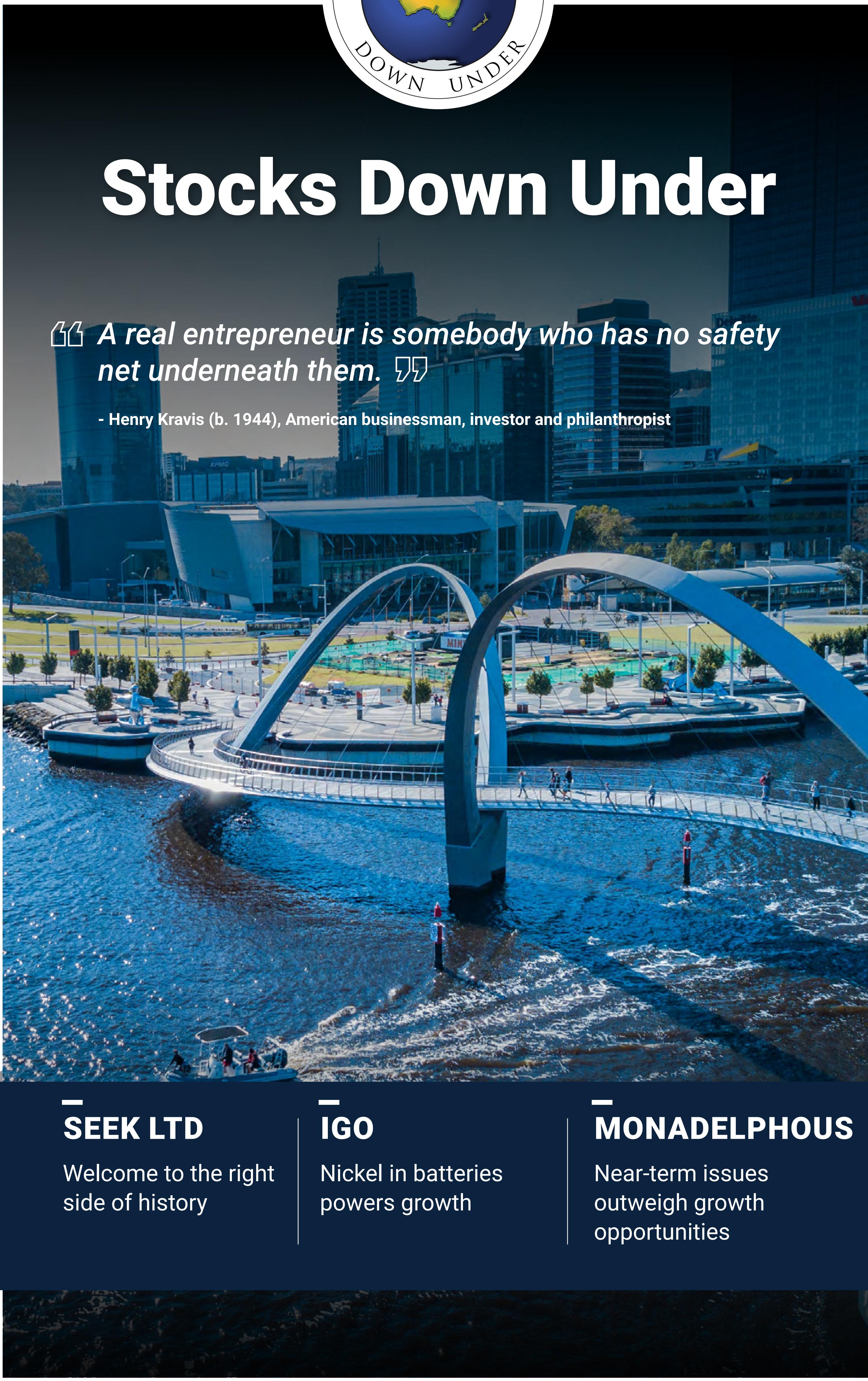
9 APRIL 2020

Stocks Down Under



A real entrepreneur is somebody who has no safety net underneath them.

- Henry Kravis (b. 1944), American businessman, investor and philanthropist

SEEK LTD

Welcome to the right side of history

IGO

Nickel in batteries powers growth

MONADELPHOUS

Near-term issues outweigh growth opportunities

SEEK LTD

Welcome to the right side of history

Stocks Down Under rating: ★★★★

ASX: SEK
Share price: A$ 15.80
Market cap: A$ 5.3BN

In the current economic crisis triggered by the Coronavirus, a lot of people are losing their jobs. Which is why the stock of Seek Ltd, the Melbourne-based online job advertising company, has seen its share price fall 40% from the all-time high it reached on 24 January 2020. However, if this crisis is temporary, as we think it will be, then Seek may be trading at a fraction of the potential post-Coronavirus upside.

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IGO

Nickel in batteries powers growth

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ASX: IGO
Share price: A$ 4.81
Market cap: A$ 2.7BN

Headquartered in Perth, IGO Limited is an exploration and mining company focused on nickel, gold, copper and cobalt mining in Australia. The company's stock has started to bounce off its recent low and may be poised for a sustained recovery due to a favourable nickel market and the growth potential of its various exploration projects. Although much of its fortunes will be tied to future demand for nickel for electric vehicle batteries, it should also benefit from stable stainless-steel demand, rising gold prices and other metal expansion opportunities.

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MONADELPHOUS

Near-term issues outweigh growth opportunities

Stocks Down Under rating: ★★

ASX: MND
Share price: A$ 10.04
Market cap: A$ 963M

Monadelphous Group is a Perth-based provider of construction, maintenance, and engineering services to a wide range of energy and materials markets. Shares of the company have faltered in recent weeks due to the impact of COVID-19 on the global economy and in particular the company's exposure to the energy sector. The company has also been challenged by increasing competitive pressures and customers' focus on cost containment, which has weighed on profit margins. The long-term forecasts for end market demand are encouraging but are overshadowed by the near-term uncertainty.

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Share price chart

Source: Tradingview

Historically if you were looking for a job in Australia you turned to the employment classified section of the newspaper. Then from 1998, after the brothers Paul and Andrew Bassat had worked their magic with their friend Matt Rockman, you turned to seek.com.au. There was no comparison between the old and new ways of job search because of the ease with which employers could now source candidates and candidates could look for positions.

The start-up vibe remains

Paul Bassat and Matt Rockman have moved on from Seek and into technology investing with Square Peg Capital, but Andrew Bassat is still around as the CEO, so Seek still has a bit of a start-up vibe about it. And it shows. The world is a much different place in 2020, technologically speaking, but the Seek brand continues to do well because it has invested in itself and therefore adapted to each new change in the technology ecosystem.

When we at Pitt Street Research, the Sydney-based creators of Stocks Down Under, were making our first hire in mid-2019 we turned to seek.com.au and not to a competitor like the local arm of LinkedIn, and were very satisfied with the price and the outcome. So, it didn't surprise us to learn than in FY19 Seek grew revenue 16% in constant currency terms. In the six months to December 2019 the comparable figure was 13%.

A culture of reinvestment

EBITDA, mind you, only grew 3% in constant currency terms in FY19, to A$455m while in the first half of FY20 EBITDA growth was only 1%. The market has hated that. What the market is choosing to forget, though, is that low growth at the EBITDA line for companies like Seek represents strong reinvestment. The reason Seek will live long and prosperous post this current Coronavirus Crisis is that it has been paying its dues now. And investing (and reinvesting) in the right geographies. Unless you're from China you have probably have never heard of Zhaopin. That's Seek for the Chinese market. Seek first invested in this business way back in 2006 in order to position itself to one day be the site of choice when a billion people of working age were looking for a job. 13 years later, in FY19, Zhaopin generated $648m in revenue for Seek, 38% more than in FY19. Zhaopin now accounts for over 40% of Seek's total revenue. Talk about foresight…

One reason to back Seek right now is that this crisis is temporary, in China and around the world. Of course, earnings will take a hit because hiring activity in geographies where Seek operates has been slack in the last few months. However, that will change. China is now going back to work two months after the Hubei lockdowns of 23 January. The rest of the world is likely to follow two or three months from now, in our view. And that will likely require a lot of ads on Seek, Zhaopin et. al.

Online education's Day in the Sun is here

Another good reason to look at Seek right now is the fact that this company is a leader in online education, through platforms like OES, FutureLearn and coursera. With the Coronavirus showing decisively, and for the first time for many, that education can be delivered online without students having to show up to a physical classroom, Seek is well placed to accelerate its businesses as the online learning trend gains momentum.

Okay, Seek has not gone to a single-digit P/E yet. The multiple for FY21 (starting in July) is 42x. However, that drops to 28x by FY22. That's low given the prospects for this company that has a habit of being on the right side of history in very big market opportunities. Seek directors Vanessa Wallace, Graham Goldsmith and Leigh Jasper all agree with us that this Crisis represents a buying opportunity and they've been topping up in recent days with on-market purchases. With the market expected to start recovering from May onwards, we suspect Seek shares will not stay around $15 for long.

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Nickel in batteries powers growth

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Share price chart

Source: Tradingview

Undersupply, strong battery demand to drive nickel prices

IGO reported record half-year profits in 1H20. NPAT swelled to $100.1m from just $0.9m in 1H19. Revenue grew 33% to $474.7m and underlying EBITDA more than doubled to $270.7m. Underlying free cash flow increased for the fifth straight interim period due to improved production and higher commodity prices at both the Nova and Tropicana mines. Management noted that metal production was on track to meet its FY20 production guidance.

The current dynamics in the global nickel market are very much in IGO's favour. The company already has well-established demand from stainless steel manufacturers. In addition, nickel is emerging as a critical lithium-ion battery metal. Lithium batteries are using an increasing nickel intensity to provide a reliable charge range for electric vehicles. The company's copper concentrates are also in demand for traditional electricity purposes as well as for electric motors.

IGO's business strategy is evolving to match the structural shift to clean energy storage. It has a vertically integrated structure that enables it to produce high- demand battery grade chemicals and cathode precursors. IGO is expected to benefit from a nickel market that is forecast to see declining stockpiles and a market deficit over the next five years. Nickel prices are expected to be in the range of US$14,000 to $19,000 per ton by 2025. This would be a major positive for IGO because it would be able to command a higher price for its nickel concentrate.

Expansion projects in Australia, Greenland

IGO's wholly owned Nova mine has operations around nickel, copper and cobalt although nickel mining is the main business accounting for over 80% of revenue. As nickel revenue increased 31% from FY18 to FY19, cash costs at the Nova mine have gradually decreased over time and are currently almost half of what they were at the beginning of 2018. Mining costs per pound fell from $2.40 in FY18 to $2.21 in FY19. Processing costs and development costs also declined during this period. This has produced increasing EBITDA and Free Cash Flow margins that are among the best in the mining sector.

IGO has adopted an aggressive growth strategy by building a portfolio of exploration projects. It is moving toward unlocking 'the mines of the future' and in doing so increased its exploration budget to $66m in FY20 to accelerate its organic growth opportunity. There is potential for exploration upside from many areas including Northern Territory greenfield opportunities at the 70%-owned Lake Mackay Project and the Raptor Project. Outside of Australia, the Frontier Project in Eastern Greenland is also a promising growth opportunity.

IGO also holds a 30% non-operating interest in the Tropicana gold mine through its joint venture with South African mining company AngloGold Ashanti. Tropicana posted strong performance in 1H20 as gold production was 257koz and the All-In Sustaining Costs (AISC) were $1,007/oz. This equates to strong profitability given rising gold prices that recently hit 7-year highs. The new Boston Shaker underground mine is making strong progress. The development is on schedule for its first gold extraction in 1Q21. Studies on additional underground gold mining opportunities are underway and the Tropicana's 7-year life expectancy affords it ample expansion opportunity.

Disciplined, shareholder-friendly capital management

The company's disciplined capital management has resulted in a strengthening balance sheet. In FY19 it allocated 60% of capital towards enhancing its balance sheet strength, 20% towards exploration growth projects, and the remaining 20% for shareholder returns in the form of dividends and share buybacks. It has an increasing cash balance that was $453m as of 31 December and a low debt level.

We believe IGO's portfolio of low-cost, high quality metals make it an attractive investment given the market's shift to energy storage and renewable energy products, like electric vehicles. Its diverse pipeline of metal exploration projects gives it considerable upside potential over the next several years. IGO shares pay a 3.2% dividend yield and trade around 13.2x FY21 earnings. Given the strong free cash flow generation and growth opportunities we believe the stock looks golden here.

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Share price chart

Source: Tradingview

Dependence on oil & gas, iron ore markets

The company breaks its operations into two divisions -- Engineering Construction and Maintenance & Industrial services. Its services include major construction projects, long term maintenance, electrical and instrumentation services as well as aviation industry support. Roughly 68% of its $852m 1H FY20 revenue came from the Maintenance and Industrial Services segment, which posted 16% growth and record performance. This was largely offset by an 18% decline in Engineering Construction revenue due to project delays.

The coal, power, water and mineral processing markets are among its core markets, but it has a heavy reliance on the currently depressed oil & gas and iron ore sectors. Oil & gas and iron ore customers account for 30% and 27% of revenue respectively. Combined, we believe this exposure represents a significant risk, especially given the cyclical nature of these sectors. Both have been impacted greatly by the global economic slowdown and have seen business activity grind to a near-halt amid the coronavirus pandemic.

The company is already feeling the effects of COVID-19 on its operations. Management has stated that FY20 financial performance will be significantly impacted. It had previously forecast FY20 revenue growth of around 10%, but this target will likely be revised downward. Prior to COVID-19, project development activity in the iron ore market had been a bright spot and key relationships with BHP Billiton and Rio Tinto drove repeat business. While this activity is likely to support future construction projects, it is unknown at this point just how far into the future they will be pushed back.

Capex forecasts, LNG development support long-term growth

Looking beyond the near-term environment, Monadelphous should benefit from strong spending on capital projects in Australia. Capital expenditures on resource development grew in 2018 and 2019 and a pattern of increased spending is expected to continue for the next four years. Resources capex is forecast to reach nearly $30b in 2020 and stay above the $30b level through 2024. By comparison, Australian resources capex was around $15b in 2017. Similar patterns of increased spending are expected in energy, infrastructure, and maintenance over the next few years.

When the liquid natural gas (LNG) sector recovers, there is strong potential for new projects in this space. Management expects renewed development in the LNG business in the years ahead. This should lead to demand for onshore construction, commission and start-up services for LNG plants. A pickup in offshore activity would spur demand for the company's hook-up and commissioning services. Prior to the slowdown, the company was seeing strong demand for maintenance services in the energy sector as offshore oil and gas activity increased in 1H FY20. Monadelphous has formed solid relationships with some of the leading oil and gas producers during its 35 years in the business, so once a recovery unfolds this stability should be a good foundation for growth.

Monadelphous has 29 locations in eight countries. It has an established infrastructure business in New Zealand focused on irrigation and water solutions. Last year it expanded into Chile by acquiring construction and maintenance services contractor Buildtek as well as plant and equipment hire company Maqrent. The growing Chilean mining and construction sectors are attractive areas for the company. We believe continued expansion outside of Australia represents an important long-term growth opportunity.

Near-term uncertainty overshadows momentum

Monadelphous had good momentum heading into 2020 due to favourable conditions in the resources and energy markets. Unfortunately, the impact of the Corona virus outbreak and the ongoing oil price war on the global economy put an abrupt end to this and have pressured shares of companies with high exposure to the energy sector.

The company's balance sheet is conservative and includes a steady cash balance of $163.3m. The stock offers a 4.7% dividend yield (for now) and trades at 13.6x FY21 earnings. From a long-term perspective, Monadelphous has the wind at its back with strong expected demand for maintenance services and increasing resources capex. However, we feel the uncertain duration of the COVID-19 crisis and the impact from the oil price war make it too early to construct a position in this stock. Hence, only two stars for now.

Pitt Street Research Pty Ltd

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Pitt Street Research Pty Ltd is founded on more than 40 years of combined experience researching companies in a range of different sectors.