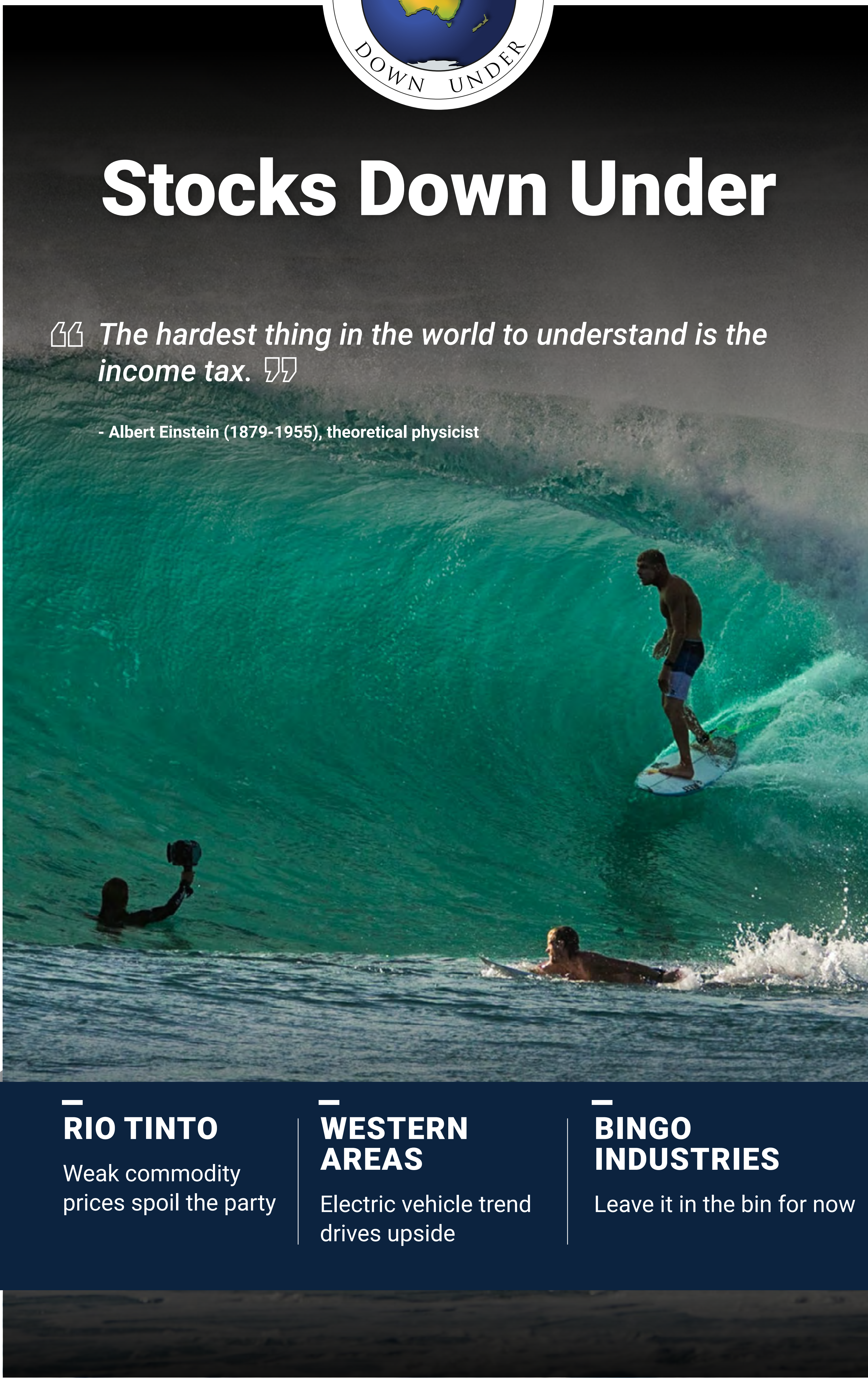
10 APRIL 2020

Stocks Down Under



> *"The hardest thing in the world to understand is the income tax."*
>
> **- Albert Einstein (1879-1955), theoretical physicist**

RIO TINTO
Weak commodity prices spoil the party

WESTERN AREAS
Electric vehicle trend drives upside

BINGO INDUSTRIES
Leave it in the bin for now

RIO TINTO

Weak commodity prices spoil the party

Stocks Down Under rating: ★★

ASX: RIO
Share price: A$ 89.39
Market cap: A$ 33.2BN

Headquartered in Melbourne, global mining company Rio Tinto has interests in many materials. It produces iron ore for steel, aluminium for cars and smartphones, copper for wind turbines, titanium for household products, borates for crops and more. The coronavirus crisis has had a significant impact on operations and will likely weigh on Q1 performance. A recovery will be dependent on government stimulus efforts and how long it takes to return to a normal environment. The company has good long-term growth opportunities, but with the global economy at a virtual standstill, the weak commodity market and near-term operational issues an entry at this point is too early, in our view.

READ MORE

WESTERN AREAS

Electric vehicle trend drives upside

Stocks Down Under rating: ★★★★

ASX: WSA
Share price: A$ 2.06
Market cap: A$ 559M

Perth-based Western Areas is Australia's largest nickel producer. It owns a portfolio of low-cost nickel mines including two of the world's highest-grade nickel mines. The company has an excellent debt-free balance sheet, multiple upside levers stemming from electric vehicle demand and cost reduction potential. After a strong 1H20 it appears to be on track to meet or exceed its full year guidance. The shares are trading near a 52-week low and at 14.2x earnings present a good entry opportunity, in our view.

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Share price: A$ 2.04
Market cap: A$ 1.3BN

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Share price chart

Source: Tradingview

Winu project upside, Uyo Tolgoi setbacks

Rio Tinto has a disciplined capital allocation strategy focused on sustaining capital expenditures for replacements and growth opportunities and paying dividends. It has successfully reduced its debt level as net debt has declined from $11.3bn in December 2016 to $4.9bn in December 2019. With 63 exploration programs in seven commodities across 17 countries, the company has consistently devoted around $250m annually to capital spending. Some $11.9bn was returned to shareholders in FY19 through ordinary dividends, special dividends and buybacks.

One of the most compelling growth opportunities is the Winu project. Rio Tinto has leveraged its data analysis and technological capabilities to uncover copper and gold resources at Winu in Western Australia. In 2017 the company discovered copper-gold mineralisation and went on to drill 16km in 2018 and 124km in 2019. While the project remains in the early stages, initial results have been encouraging and drilling remains active. The first production is targeted for 2023 and the project has the potential to yield strong cash flows.

Although the mine is one of the world's largest copper and gold deposits, Uyo Tolgoi in Mongolia has experienced some recent setbacks. The open-pit and underground mine is a challenging play given over 80% of its total value lies deep underground. This has required the cost-intensive construction of an underground mine complex from which to extract the ore and transport it to the surface. In July 2019, the company warned that expansion plans would take 16 to 30 month longer than expected and be $1.9bn more costly due to a higher risk of rockfalls. It has also faced a series of legal setbacks over the last couple years. The latest involved a Mongolian administrative court backing a local ecological advocacy organization's claim that the government did not adhere to proper due process regarding the asset's development.

Chinese steel demand holds key to iron ore business

Rio Tinto has modest growth prospects for its core iron ore business. The World Steel Association forecasts that global steel consumption will grow 1-2% per year over the next decade. Iron ore prices were strong in 2019, surging 39% due to Chinese demand for steel and a tight market balance. Continued momentum in iron ore prices and revenue growth will be largely controlled by Chinese demand and the pace of the post-COVID global economic recovery.

Conversely, the company's aluminium business has the potential to weaken growth in shareholder value. Aluminium prices suffered a 15% decline last year due to weak global demand mostly stemming from a slowdown in the transportation sector. This put a $1.3bn dent in FY19 EBITDA and prompted management to conduct a strategic review of its various aluminium operations. The slide in aluminium prices has accelerated in 2020 and there do not appear to be any signs of a near-term turnaround.

Rio Tinto also faces increasing pressure related to higher societal expectations for climate action. This has the potential to increase the company's costs and divert its focus from growth opportunities. Moreover, as investors worldwide increasingly turn to socially responsible investments, Rio Tinto's response to climate change pressures will likely have a material effect on share demand. The company has laid out a 4-part climate change strategy aimed at reducing the carbon footprint, but it remains to be seen if it will appease activists.

Production target shortfalls likely

Rio Tinto has a low-cost portfolio of long duration assets with a leadership position in iron ore and aluminium. In FY19, the company generated strong free cash flow of $14.9bn and $21.2 billion in underlying EBITDA with an underlying EBITDA margin of 47%.

With most commodity prices at depressed levels, we feel the company has limited near-term growth opportunities. Operational issues at Uyo Tolgoi and elsewhere will further weigh on its ability to meet production targets. Urbanisation, electrification and the transition to a low-carbon economy should be favourable trends longer term, but the current mining environment is not in Rio Tinto's favour.

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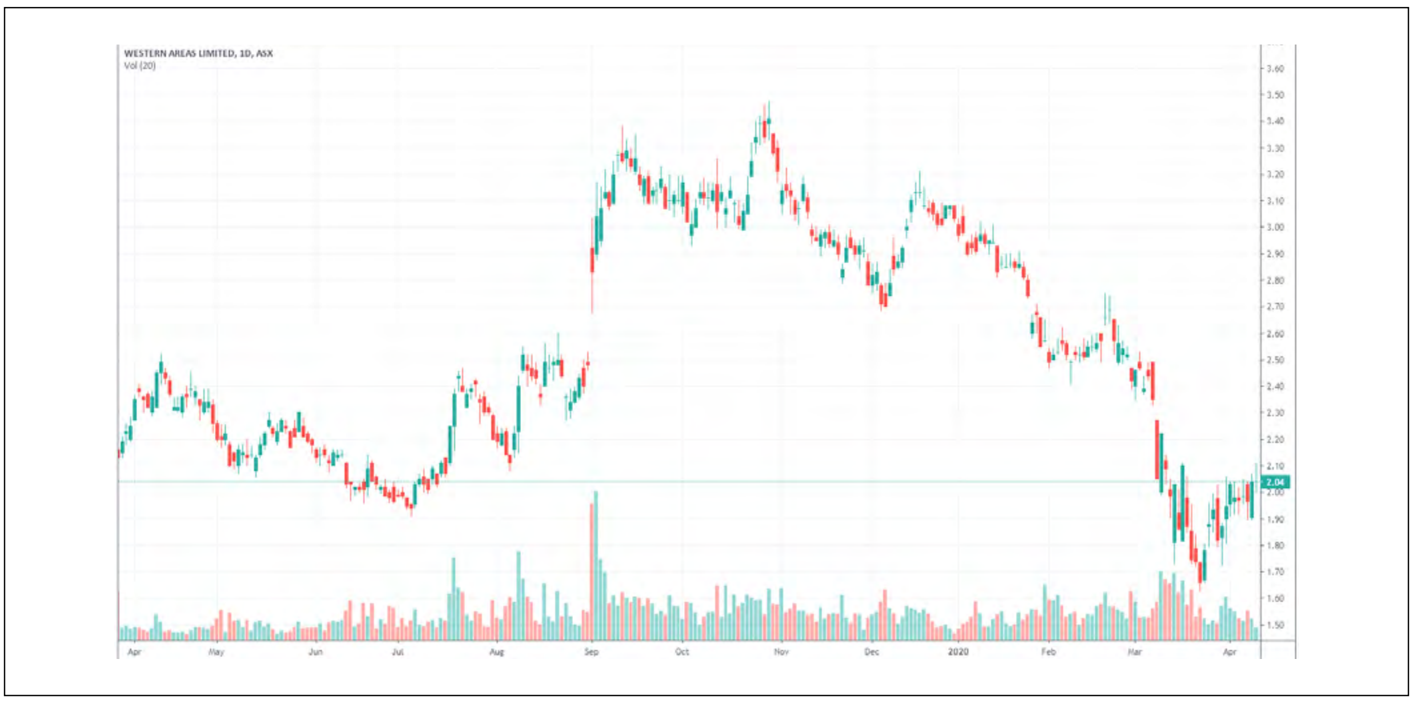

Source: Tradingview

Supplier of rising demand for EV batteries

As the world becomes more mobile, electric vehicles (EV) are forecast to be a key mode of transportation going forward. This will come with strong demand for EV batteries which are made with nickel. China is expected to be a major consumer as evidenced by United States electric vehicle maker Tesla's recent Shanghai factory opening. According to broker Bernstein, global demand for electric vehicle nickel is expected to rise exponentially over the next 10 years reaching 2,000 kilo tons (kt) by 2030.

The company's low-cost Odysseus development is expected to supply much of this demand. Odysseus has consistent annual ore production of around 900kt and with the first nickel concentrate projected for late 2022, there is significant upside here. It has key partnerships with Melbourne-based miner BHP Billiton and China's largest nickel cathode producer Jinchuan that give it direct access to the all-important Chinese nickel sulphate market.

At Western Areas' second mine, Spotted Quoll, there is the potential for costs to move lower in 2H20. The mine has a six-year life expectancy and uses a cost-effective 'top-down' mining method along with an efficient narrow vein technique in shallow areas. Mining and administrative costs have decreased since last year while reduced costs in hauling and milling would further help the company's bottom line. Cost reduction is also possible at the Flying Fox mine, the company's original mine that is still one of the world's highest-grade nickel mines. It now operates more than 1km underground and the total cash cost has trended lower from $2.12 in the December quarter to $2.11 year-to-date with more room for improvement.

Premium product addition, exploration support future growth

It also has significant upside from the Mill Recovery Enhancement Project (MREP) at the Cosmic Boy Concentrator (CBC). High-grade raw nickel ore mined at Forrestania is converted to a nickel concentrate product at the CBC and then sold to Tsingshan Group, China's largest stainless-steel producer. The recently commissioned MREP employs the company's BioHeap technology to recover nickel from the tailing waste stream, which is made into a nickel-sulphide product. This can be added to the CBC concentrate or sold as a separate premium product that can be processed in a refinery. This project will increase concentrate volume and add a high-margin product offering that is desirable to smelters and roasters.

The company's balanced exploration program seeks to replace existing resources and discover resources in existing and new terrains. Aside from the Odysseus mine there is significant exploration upside at the Cosmos Nickel Operation, which has several highly prospective mines for nickel sulphide mineralisation. This includes the Neptune prospect and Prospero, which have both seen encouraging exploration results since their inceptions.

Management's update last month showed that FY20 production and unit cash cost guidance was on pace to be reached and unchanged. The company's target for nickel tonnes in concentrate production is 21k to 22k and it is about halfway there after generating 10,658 tonnes in 1H20. It is projecting mine development of $33m to $38m and recorded $17m in 1H20. It is also well on its way to meeting its exploration value guidance of $14m to $17m with $11m already achieved as of 1H20. There is still some work to be done at the Odysseus development to reach the $75m to $85m guidance after recording $29m in 1H20.

Strong balance sheet

Western Areas has a high-quality balance sheet that is free of debt and includes $184.9m in cash. It has positive free cash flow of $40.6m owing to its industry leading cash cost of $3.07/lb that produced an increased EBITDA margin in 1H20.

The company should benefit from several long-term trends that are expected to be supportive of nickel consumption growth. This includes demand for electric vehicle batteries, urbanization and growth in renewable energy. We believe it has a portfolio of enviable high-grade nickel assets and a sound growth strategy in place to capitalize on these trends and as such we 'dig' this stock, especially at the current depressed level.

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Source: Tradingview

Bingo started life in 2005 as a small waste collection services business in western Sydney. It floated on the ASX in 2017 with an IPO price of $1.85. Since then, Bingo has been working hard on its growth initiatives. In addition to collecting waste from the Building and Demolition (B&D) market, Bingo has expanded its collection services to the Commercial and Industrial (C&I) market where it collects waste from commercial, education and government buildings. Along the journey, it has also been acquiring businesses that are complementary to its operating model.

Bingo proved its success in its recent 1H FY20 result, where its underlying revenue grew by 38% to $249m while NPAT was up 32% to $28m. Its margin at the EBITDA level has expanded from 26% to 33%, underpinned by cost synergies from its Dial A Dump Industries acquisition (March 2019) and the NSW price rise (July 2019). Its EPS of 5.8 cents also doubled over 1H FY19.

Coronavirus means less waste volumes to collect

However, shortly after announcing the interim results, the impact of COVID-19 rapidly aggravated throughout Australia, which led to the Federal Government implementing extreme measures that involve non-essential service closures. As a result, foot traffic in shopping centres and commercial districts have dramatically reduced, causing a direct impact on Bingo's C&I waste volumes. Management has thus pulled its profit guidance.

More on the negative front, headwinds in residential construction and delays in the start of infrastructure projects may substantially inhibit Bingo's near-term revenue growth. Since B&D waste constitutes more than 50% of Bingo's total waste volumes, an expected decline in construction activity can be seen as a material downside risk to group revenue and earnings. The Australian Bureau of Statistics has shown that building approvals in NSW have continuously declined in the months of January and February 2020. Given that building approvals are a leading indicator for residential construction activity and that it is trending downward, we believe the short-term outlook isn't great for Bingo's B&D business.

Tough times to come

The lack of wages growth in Australia coupled with the current economic downturn will likely translate to lower retail activity, which will in turn impact Bingo's emerging C&I business. Even if COVID-19 subsides in the next 3 months, the Australian economy will need an extended period of time to recover. And as Bingo has a high operating leverage model due to its high fixed asset base, a material decline in both its C&I and B&D waste revenues will be detrimental to the bottom line, in our view.

Bingo is currently trading at a P/E multiple of 18.7x for FY21, which is almost half of what it was trading at on 20 February 2020. Now, this may represent a good buying opportunity if you assume that the long-term growth of the business remains intact and that the near-term impact of COVID-19 has been priced in. In the short to medium term however, given the headwinds that the construction sector is facing, we find it difficult to see growth in Bingo's underlying revenue and earnings. Consequently, we would caution investors not to rush into this stock despite the current COVID crater in the company's share price chart.

Pitt Street Research Pty Ltd

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