30 APRIL 2020

Stocks Down Under

"The trouble with having an open mind, of course, is that people will insist on coming along and trying to put things in it."

- Sir Terry Pratchett (1948-2015), English writer

AUDINATE

Growth at An Unreasonable Price

MOELIS AUSTRALIA

Corona Crisis weighs on performance

IRONBARK ZINC

Hot on a cold climate mine

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Growth at An Unreasonable Price

Stocks Down Under rating: ★★

ASX: AD8
Share price: A$ 5.23
Market cap: A$ 355M

If you're a musician and you've played live gigs, you will be very familiar with the massive amount of cabling that is required to make you sound good on stage. The technology that Sydney-based Audinate developed eliminates the need for this spaghetti of cables by using ethernet cables to connect all devices in a network, both audio and video, in a range of Audio/Visual (AV) settings, like concerts, airports, churches, schools, music studios, shopping malls etc. Changing a network configuration can now be done using only software. Life has never been easier for AV specialists, but whether investors can make some money off this one is what we want to know.

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ASX: MOE
Share price: A$ 2.29
Market cap: A$ 351M

Sydney-based Moelis Australia is an integrated financial services provider focused on asset management and corporate advisory services. It has approximately $5bn in assets under management (AUM) that are well diversified among institutional, high-net worth and retail clients in Australia and China. It has advised on about $110bn of corporate advisory transactions and raised around $10bn in the equity capital markets. The shares are now trading below their 2017 IPO level. Further near-term pressure looks likely amid the recent downturn in the financial markets.

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Share price: A$ 0.007
Market cap: A$ 6.4M

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Share price chart

Source: Tradingview

Audinate's foundations were laid back in 2003 when Motorola shuttered its Australian research labs. A few engineers stuck together and with the help of NICTA (National Information and Communications Technology of Australia) started working on what would later be known as Dante, which ultimately evolved into a software and hardware platform that could replace all connections in traditional AV setups with a computer network.

With Dante, all microphones, speakers, amplifiers, cameras, monitors etc are connected in one network, which makes it very easy to set up and to make changes to configurations. Instead of having to plug in a new cable between two points that need to be connected, an operator can simply make that connection in the Dante software program if both nodes are already in the network.

When sent over the network, all digital audio and video signals are broken up into small packets and are reassembled at their destination with extremely low latency and without loss of quality. The latter is an issue with analogue signals that deteriorate as the distance travelled increases.

Dante inside

Audinate doesn't sell its equipment and software directly to end customers, but rather sells its products in an OEM model, i.e. Original Equipment Manufacturers, like AKG, Sony, Sennheiser, Shure, Yamaha, Bose and Bosch. These OEMs each develop their own products, incorporating Dante, and market them in their respective markets. In other words, it's a model similar to the one that chip maker Intel has been employing for decades for its computer processors.

Audinate currently has almost 300 OEMs with products in the market and another 179 OEMs are developing their first Dante-enabled products.

The benefit of this model is that the company can still command high gross margins, i.e. in excess of 75% and growing, but is not required to market its products to many hundreds of thousands of end users, like concert halls, churches, transportation hubs, schools and studios. Instead, Audinate can focus on a relatively small group of OEMs and let them do their own product marketing.

Over the last 5 years, Dante has basically grown into the de facto industry standard for real-time digital audio/visual networking. Compared to the nearest competitor, Dante is used in about seven times as many products, i.e. about 2,500 versus 340 for the number 2 player in this industry. That is an enviable market position, which should enable the company to grow very profitably going forward.

Priced for perfection

Revenues have grown very nicely in the last several years, from US$ 3.8m in 1HY16 to US$ 11.1m (A$ 16.1m) in the most recent half year through December. The market is projecting revenues of A$ 32m for the whole of FY20, which ends in June, aided by favourable currency translation effects with the Aussie dollar being where it is today. EBITDA is expected to amount to A$ 2.9m this year.

Looking forward, the market is quite bullish on Audinate's prospects, with revenues projected to grow to about A$ 72m in FY23, or a compounded annual revenue growth rate of 30.6%, with EBITDA margins in excess of 30%. During that same period, EBITDA is expected to grow to A$ 21.6m.

Now, all that growth comes at a price. Audinate's EV/EBITDA multiples of 144.5x and 33.7x for FY21 and FY22 respectively seem very rich to us. The market has pencilled in some Corona headwind in FY21, but its still early days when it comes to assessing the financial impact from Corona on Audinate's OEM customers. In other words, there is a risk that today's estimates for FY21 are too optimistic. But even looking beyond that, Audinate is also expensive based on FY22 estimates.

Growth at An Unreasonable Price

The EV/EBITDA multiple only becomes more reasonable when we look at FY23, but that's two years away! A lot of things can go wrong during that time, when Audinate is trading at highly elevated multiples. The company is basically priced for perfection right now. Should anything go wrong, Audinate shareholders might be sent to Dante's Inferno. And, unfortunately, the economic circumstances are far from perfect right now. So, even though we like Audinate's market position and business model, we prefer GARP (Growth at A Reasonable Price). We consider Audinate's valuation unreasonable right now, so we'll sit this one out. Two stars.

MOELIS AUSTRALIA

Corona Crisis weighs on performance

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Compensation expenses impact profitability

The company's fiscal 2019 results included underlying revenue growth of 16.2%. This was led by a 19.8% increase in Corporate Advisory & Equities revenue. Underlying EBITDA was up a more modest 6.1%, NPAT increased 2.2% and EPS was higher by 3.1%. The EBITDA margin decreased from 43.9% in FY18 to 40.1% in FY19. The weak earnings growth was primarily due to higher operating expenses related to new staff investment as compensation expenses rose 3.1%. Moelis increased its full-time employee count (FTE) from 180 to 204 in FY19 to build out its capabilities in Australia and China.

Within the Asset Management unit, real estate and credit are the company's main areas of focus. Asset Management revenue grew 14% in FY19 as assets under management increased 32% to $4.9bn. Despite the solid growth in assets under management, the division's EBITDA only grew a modest 4.2% to $55.7m, again, owing to new staff additions. Although its managed funds have performed relatively well, investments in the aged care and childcare sectors have hurt. For example, an investment in Southbank-based residential care company Japara Healthcare has negatively affected performance.

Crisis equals opportunity

Moelis's Corporate Advisory and Equities divisions have been impacted by the more volatile and weaker equity markets seen thus far in 2020. Although this business has had consistent revenue productivity over the last 10 years, momentum had already slowed entering 2020. Revenue per executive has averaged $1.4m in the past decade but has been below average in the last couple years. This figure was $1.5m in FY17 but has slipped to $1.2m in each of the last two fiscal years.

Management had targeted a revenue productivity range of $1.1m to $1.3m per head for FY20, but recently said it is too early to tell if this can be achieved. The advisory business remained highly productive during the 2008-2009 global financial crisis due to some restructuring manoeuvres and it may need to produce similar magic to navigate the current market crisis. Going by the sheer number of live capital raises right now, forced by the Coronavirus Crisis, we believe the company may actually pull that off.

Property strength challenged by uncertain retail environment

Although Moelis had taken a cautious stance on market conditions before the onset of the Coronavirus Crisis, its operations will still be materially impacted. The recent downturn in the global capital markets has resulted in reduced asset management fees amid declining portfolio market values. Management did note, however, that its year-to-date contracted asset management fees and expected equity commissions combined exceed its fixed operating costs. This should give the company sustainable cash flow in the near-term. Moelis has also undertaken some cost management initiatives to improve this operating cash flow surplus mostly in the form of voluntary reductions in executive compensation. Board members and the company's joint CEOs recently took a temporary 25% cut in their fixed compensation.

Gross outflows across managed funds have been relatively small and less than inflows since 1 January. This is mainly because Moelis sources much of its investment funds from China where clients continue to view Australia as an attractive investment opportunity. Moelis is considered one of Australia's largest fund managers to be servicing high-net worth Chinese clients.

Property has historically been a pocket of strength for Moelis; however, this will be put to the test in the aftermath of the current crisis. Will consumers return to retail environments? Will leisure seekers and foreign travellers come back to its hotel properties? Moelis has retail real estate assets of $1.8bn which account for 53% of the overall real estate portfolio. This includes eight shopping centres in NWS, Victoria, SA and Canberra. Management has said it expects a retail shopping recovery to be "difficult and protracted" due to the combination of lower tenant demand and a weaker Australian consumer. It also has significant exposure to the hotel industry, which has been halted by the government mandated closure of Australian hotels. This includes the Redcape Hotel Group, which manages a portfolio of pubs in NSW and Queensland, and the recently completed MAHM Beach Hotel Fund located in Byron Bay, NWS both of which will likely struggle to generate business as the economy recovers.

Strong balance sheet will be put to the test

Moelis is a profitable small cap financial services company with a strong balance sheet. It has $129m in available cash and roughly $227m in net assets. It is also a positive that company staff owns approximately 30% of the company's shares. While its robust financial position should help it manage the current downturn in the financial markets, it faces formidable challenges on multiple fronts. Weakened profitability, reduced corporate advisory activity and pressure in the property portfolio are too much to get past from an investment standpoint, so just two stars from us.

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Hot on a cold climate mine

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Share price chart

Source: Tradingview

We've previous argued in the pages of Stocks Down Under that zinc is a metal worth being bullish about for the long haul. Its cousin lead (the two metals often occur together) is a health hazard and has lost most of its major applications except lead acid batteries. By contrast, zinc has stayed in vogue over the years thanks to its utility in galvanising, die-casting of alloys and bronze and brass casting. You can't really grow your status as an industrial power without your economy consuming a lot of zinc, and so, unsurprisingly, China takes about half the world's output.

China is buying zinc again

Now, that fundamental need for zinc hasn't made the metal immune to major price swings. Early 2016, for example, saw it plumbing the depths at about US$1,500 a tonne as against the July 2015 level of US$2,300 a tonne. Right now, it's about US$1,900 a tonne as against U$3,600 of February 2018.

What's interesting to us is the trend in zinc stockpiles. In 2014 there was more than a million tonnes of zinc in LME warehouses, but by November 2019 there was only about 50,000 tonnes. The current figure is 97,000 tonnes as stockpiles having jumped suddenly when Coronavirus stalled the Chinese economy earlier this year. However, as China's factories have re-opened they aren't going any higher.

When Ironbark Zinc did its 2017 Feasibility Study update it used a zinc price of US$3,044 a tonne. That looks a little bullish on today's numbers, but what's instructive to us is that the Life of Mine cost estimated at that time was US$1,411 a tonne, which included smelter fees. That's profitable at the zinc price today.

A safe place to mine zinc

Which brings us to the reason to pay attention to Ironbark Zinc with Citronen. It's zinc supply that is relatively chancy. The re-start of the Century Zinc Mine in Queensland by New Century Resources (ASX: NCZ) two years ago gave the market enough product for a while – hence the price weakness of 2018 and 2019 – but the next mine might have to be in the Congo or Iran unless the world can come up with a safer source. Like Greenland.

This 2.17 million sq km island – the largest in the world – is a territory of Denmark, one of the world's more civilised countries. Greenland is so good that US President Trump wanted to buy it in August 2019 for strategic reasons. But seriously, folks, since 2009 Greenland has been more or less independent of the mother country in all but foreign policy and the voters regularly elect governments that are very pro-mining. In 2016 Greenland granted Ironbark a 30-year lease over Citronen.

Citronen represents one of the ten largest undeveloped zinc projects in the world. When it gets going it can potentially supply up to 200,000 tonnes of zinc annually, not much less than New Century. However, the capital cost of getting the project up and running is US$514m on the 2017 numbers. The last couple of years have not been conducive to raising that kind of capital. However, that can change once the market is getting ready for its next source of new zinc. Importantly, the current Ironbark management team are working to optimise the capital costs and believe they can bring it down.

It's interesting to us that Glencore, the commodity trading major, and Nyrstar, a big publicly traded European player in zinc, thanks to smelters, own 15% of Ironbark's stock. Both companies already have offtake agreements in place for future Citronen product. Ironbark believes it can have serious discussions with project financiers based on revised mine plans and the offtake agreements from early next year.

A slow boat to Citronen Fjord

If you're an investor who likes the ASX resources sector it probably won't be hard to find people who would be dismissive of Citronen as a potential Next Big Thing in the zinc world. They'll note that Ironbark Zinc first acquired this project in 2007 and the deposit itself was discovered way back in 1993. The naysayers forget that many great mines have a long lead time. Or those naysayers will note with contempt the location within Greenland at a fjord in the north of the country of the same name about 83 degrees north of the equator. That's so far north that the Greenlandic capital of Nuuk is about 2,100 km south and boats can only get there in the summer. It's really a dumb argument given that mines that far north are commonplace but, let's face it, the capital costs are partly a factor of the cold climate.

We argue that location, the long lead time and the recent weakness in zinc, are all in the price, and then some, making this stock a great option on zinc upside right now when you need a magnifying glass to see the market capitalisation. Maybe that's why Danny Segman, an Ironbark non-executive director, has been a continual buyer of stock all through March and April.

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