# Stocks Down Under

*"Capital isn't scarce. Vision is."*

**- Sam Walton (1918-1992), founder of Walmart**

## COLES

One for the yield junkies

## AMA GROUP

Smashed up stock but repairable

## MINERAL COMMODITIES

Tier 1 graphite in safe places

## COLES

### One for the yield junkies

Stocks Down Under rating: ★★★

**ASX: COL**
**Share price: A$ 15.51**
**Market cap: A$ 20.7BN**

We'll be completely honest with you...we struggled writing up this article on Coles, specifically the conclusion. You see, if you like yield, Coles is probably a stock you'd want to own. We believe its yield is probably more secure than that of the average bank right now. But it's not a company with an enviable market position, because its being sandwiched by Woolworths from above and Aldi from below. What to do with a stock like that? Let's find out.

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## AMA GROUP

### Smashed up stock but repairable

Stocks Down Under rating: ★★★★

**ASX: AMA**
**Share price: A$ 0.425**
**Market cap: A$ 278M**

We've previously noted in Stocks Down Under, looking at companies involved in the automotive trade, that this sector was in trouble even before the Coronavirus Crisis came along. AMA Group, the Brisbane-based company, which is a big player in auto repairs, saw its stock decline 39% between 12 November 2019 to just before the Coronavirus Crisis on 20 February. Between then and 23 March there was another 81% fall. Now comes the recovery...

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### Tier 1 graphite in safe places

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If there's a group of commodities investors don't have much time for during the Coronavirus Crisis, it's battery minerals like lithium, manganese and graphite, on the general assumption that in the near term most economies won't be able to afford the continued transition to the Electric Vehicle that we have been seeing over the last few years. For contrarians who are bullish on EVs, that makes this a great time to look at the space. We believe the Perth-based Mineral Commodities, with two great graphite projects in Tier 1 jurisdictions, is well worth paying attention to.

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### Share price chart

*Source: Tradingview*

### Market share pressure will remain

As the number 2 player in the market, Coles holds about 30% of the Australian grocery market while Woolworths (ASX:WOW) is sitting on a market share of about 36%.

Challenger Aldi's market share in Australia has been growing for years and is currently around 10%. The European experience has taught us that the German discounters Aldi and Lidl combined can get up to a combined market share between 15% and 20% in developed retail markets. In the absence of a second genuine hard discounter in Australia, we see more market share upside for Aldi, mainly at the expense of Coles and IGA given that they have less wiggle room when it comes to lowering prices compared to Woolies.

By the way, it's a good thing for all parties involved that Kaufland, another German discounter, decided to abandon its Australian expansion plans after having invested more than half a billion dollars in Australia. Kaufland is owned by Schwarz Group, that also owns Lidl, and would have caused some serious pain among Australian incumbent retailers, in our view.

It's bad news for consumers, though, because Australian grocery margins are still structurally higher than overseas where the supermarket landscape typically consists of 3 to 4 mid to large sized food retailers plus 1 or 2 hard discounters.

## Working to bring costs down

Coles' operating margins are structurally lower than Woolworths' margins. In the company's latest full earnings report, for 1HY20, it reported a margin of 3.8% versus 4.9% for Woolies. The company's initiatives to improve its margins resulted in a $95m cut in costs through December. That seems impressive, but there is still a very long way to go to the company's target of taking out $ 1bn in costs by FY23. Also, in the near term COVID-19 has been driving up costs in stores, e.g. for cleaning, security and queuing as well as for additional staff. So, we don't see major steps forward when it comes to costs savings this year.

Longer term, Coles will continue to work on further optimisation of its supermarkets, e.g. through increasing sales density per square meter and supply chain optimisations. Despite these efforts we don't expect Coles will be able to catch up with Woolies, margin wise, simply because the company lacks Woolworths' scale. Unless Coles can somehow bridge the 6%-point market share gap in the next 5 to 10 years, we believe the company will continue to play second fiddle to Woolies when it comes to operating margins.

Looking at the recently concluded March quarter, Coles reported a 13.1% like-for-like sales growth in its supermarkets compared to Q3 last year, probably driven by very solid toilet paper sales. However, the company is already seeing its sales volumes trending back to normal levels in recent weeks. That news triggered a minor selloff on Wednesday.

## Wesfarmers share overhang nearly gone

Coles was demerged from Wesfarmers (ASX:WES) and separately listed on the ASX in November 2018. Wesfarmers retained a 15% in Coles at the time, but has brought down that stake to 4.9% this March. While we have never seen Wesfarmers' initial 15% post-demerger stake in Coles as a major issue, concerned investors can now rest assured that the overhang is nearly gone. The two previous selldowns have gone without a hitch and if Wesfarmers decides to sell their remaining stake it will be done quickly without much pressure on the share price. Neither do we expect a strong positive response in the share price following a potential final selldown, e.g. on the back of institutional investors coming in following the exit of a relatively large shareholder.

## Fairly secure dividend yield, higher than Woolies'

Coles is trading at an EV/EBITDA of 9.1x for FY21 and a P/E of 21.7x and is clearly the cheaper stock when compared to Woolies, which trades at an EV/EBITDA of 10.6x and a P/E of 24.6x for FY21. We believe this difference is warranted by the EBITDA growth differential between the two retailers, i.e. Woolies is expected to grow its EBITDA by 3.5% in FY21 versus only 2.5% for Coles, according to consensus estimates. However, Coles generates a 3.9% dividend yield, which is higher than Woolies' yield of 3%.

So, the valuation is lower and the dividend yield higher than Woolies. Easy choice, right? Well, we are struggling with this one. You see, while we like the approximate 4% dividend yield, which believe is much more secure than any bank's yield right now, we don't like the market share pressure from Aldi and the margin gap with Woolworths.

So, we're ambiguous on this one. But if you are a yield junkie then Coles could be a four-star investment for you. However, if you like strong, defendable market positions, two stars seems more appropriate. Bottomline? An average of three stars from us.

# AMA GROUP

## Smashed up stock but repairable

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### Share price chart

*Source: Tradingview*

Believe it or not, people are still buying cars in Australia. In the month of March dealers around the country shifted close to 82,000 new vehicles. Sure, that was down 18% on March 2019, but what the data shows is that, even with the dreaded Coronavirus supposedly making people too scared to venture into the showroom, the End is Not Nigh.

### Panel repair shops remain open

The decline in the auto sector in Australia, which has mainly had to do with lower house prices and, therefore, consumer confidence, is now around two years old and has played havoc with stocks covered in these pages, such as Motorcycle Holdings (MTO, 3 April), AP Eagers (APE, 30 March), RPM Automotive (RPM, 10 February) and Autosports (ASX, 25 January).

However, we think that auto stocks probably hit bottom last month. With consumer confidence in Australia rising in April thanks to government economic stimulus measures, it's reasonable to see the trade return to more like normal as the economy re-opens post-Crisis. We expect that AMA Group will be one of the beneficiaries because a major part of its business is auto panel repairs. Indeed, it's the largest auto repair group in the country and the company is pushing towards a billion dollars in annual revenue in FY21 or FY22 mainly from this part of the auto sector.

People may not be buying as many new vehicles right now, but damaged panels, be they on old or relatively new cars, still need to be put back in shape after an accident. In FY19 panel repair was the vast majority AMA Group's $616m in revenue and $50m in EBITDA. AMA Group believes that the panel repair industry is in need of consolidation in Australia and it intends to end up as the dominant player with the best systems and technology. When it acquired Capital SMART from Suncorp late last year, AMA enlarged its national footprint with 188 sites. Capital SMART was a big deal because that business was the Number 2 player in this space with about $340m in 2019 revenues.

### Sell this stock when it's not raining

Did you know that when it's not raining people have fewer car accidents? We learned that during AMA Group's half yearly results briefing in February.

AMA stock was punished after these results because of reduced repair volumes, which the company attributed to 'prolonged dry weather' and 'lower claims frequency'. These were Black Swan-type events in our view and not likely to be repeated in a hurry. Indeed, the company still maintained its full-year guidance at the time of the half-yearly.

AMA only got around to withdrawing its previous guidance on 9 April, on the reasonable assumption that people were using their vehicles less while under partial lockdown during the Coronavirus Crisis and therefore less likely to need panel repairs. The expected drop in work volume had only just started to become noticeable, which suggests to us that it is probably mild. AMA's gearing coming into the Crisis was only 36%, so it can weather the storm and so far, its bankers have been very supportive.

### An important earnings driver…literally

We think it's reasonable that the lifting of Coronavirus travel restrictions in the near future will allow AMA Group to snap back smartly. Currently, you can get this well-managed company for 11.5x forecast FY21 earnings, starting in July, but that drops to only 6.6x on FY22 numbers. Looks inexpensive to us and a great way to play, not just the coming Coronavirus recovery, but also the automotive recovery in Australia. One director seems to share our view – Simon Moore of the Sydney private equity house Colinton Capital Partners has been a recent on-market buyer of stock.

# MINERAL COMMODITIES

## Tier 1 graphite in safe places

Stocks Down Under rating: ★★★★

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### Share price chart

*Source: Tradingview*

Back in January, Mineral Commodities was riding high. The stock made it to 30 cents when the company announced the favourable results of a Definitive Feasibility Study on its Munglinup Graphite Project in Western Australia. However, by 8 March, when the company announced a maiden JORC 2012 resource at the newly acquired Skaland Graphite operation in Norway, Mineral Commodities was down 40% to 17.5 cents. There's been a couple of other pieces of good news since then, but the stock has yet to regain the January high.

### The key to success in graphite…location, location, location

The thing to like about Mineral Commodities is that when graphite comes back in favour, this company will be a serious player because it has acquired very high-grade projects in the right places. Mineral Commodities picked Western Australia in 2017 when it could have gone to Tanzania. WA is now is the most mining-friendly jurisdiction in the world in the view of the Fraser Institute in this year's Survey of Mining Companies, with an 'Investment Attractiveness' score of 92.35. That will help Mineral Commodities come out ahead of all those ASX-listed companies went after large graphite deposits in Tanzania and then found that the government of

President John Magufuli had taken their country's Investment Attractiveness for miners down to 32.82, the lowest ranked country for which the Fraser Institute actually gave a score.

Munglinup, however, didn't just have the right address. It had everything else a would-be graphite producer would want. A high grade - the graphite reserve of 4.4 million tonnes at 12.8% Total Graphitic Content (TGC) is one of the highest in the graphite world – and a plurality of flake sizes, which allowed the majority of the output to be suitable for lithium-ion battery anodes. And it's not in the middle of nowhere, either, being only 105 km west of the southern WA port town of Esperance. Mineral Commodities' DFS gave the project a post-tax NPV of US$111m.

### The Ska(land) beat goes on

Munglinup, however, may not be where the early graphite action is for this company. What's even more exciting is Skaland, an operating graphite mine in northern Norway (a cool 69 degrees north, to be exact), which was acquired last year. Skaland produces around 10,000 tonnes of graphite concentrate per year, sold to various industrial users in Europe for traditional applications, such as in refractories. The amazing thing about this mine is the truly high grades of the graphite, with typical output being around 28% carbon.

Mineral Commodities bought Skaland at a very low price of only US$9.2m, of which only US$4.8m was payable upfront and the remainder over the next five years. The big upside for the company is not so much the fact that Norway is a Tier 1 mining country, with a Fraser Institute Investment Attractiveness score of 70.26 (and a large early adopter of Electric Vehicles), but the potential to move the mine up the value chain. Mineral Commodities is now working on upgrading Skaland so as to improve the quality of its concentrate, increase plant utilisation from the low 60% level on acquisition and, ultimately, supply spherical graphite into the battery space. The mine isn't making money yet, but it's early days on this turnaround.

### Like Tormin sands through the hourglass…

The trouble with Mineral Commodities right now is that most investors only know this company for its original 'company maker', which was the 50%-owned Tormin Mineral Sands Mine in South Africa. That mine has been producing since 2013 and in 2019 enjoyed around US$60m in revenue and US$16m in EBITDA.

However, the asset has been troublesome in recent days, and not just because it was suspended for 18 days until 13 April by South Africa's Coronavirus lockdown. More importantly, the mine is nearing the end of its life unless an expansion, based on adjacent sand resources, goes ahead. That expansion had received its key Environmental approval for expansion, but this was held up by a legal appeal for a long time. Thankfully for Mineral Commodities' shareholders, the appeal was dismissed last month.

We think Tormin and its expansion issues has detracted from the quality story emerging in graphite for Mineral Commodities at Skaland and, ultimately, at Munglinup. That said, we believe the stock may have near-term upside as it becomes clear that mineral sands prices are recovering post-Coronavirus.

We see the big upside coming from any developments that move Skaland not just towards profitability, but into a quality supplier of battery-grade graphite. Interestingly, in its recent quarterly the company noted strong sales from Skaland due to supply constraints from other Coronavirus-impacted mines. Four stars from us.

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