Stocks Down Under

> *I thought people would flock to my bank if I offered 0% mortgages. But there was literally no interest.*

- Anonymous non-bank lending humourist

SOUTH32

Three reasons why S32 can turn around

FAR LTD

Less than 2 cents on the dollar

RESIMAC

This is not 2008

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Stocks Down Under rating: ★★★★

ASX: S32
Share price: A$ 1.83
Market cap: A$ 9.1BN

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Share price: A$ 0.014
Market cap: A$ 140M

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Share price chart

Source: Tradingview

It's a lesson great investors like Peter Lynch often impress on us – when a major company is doing a spinout, buy the stock of the spinout because it probably hasn't been allowed to realise its potential within the larger group and new management will find ways to do that. That's basically what happened for South32. They got handed what 171 Collins Street thought was lemons. South32 turned them into lemonade over the next three years or so.

A dumb name but a smart company

Specifically, what foundation CEO Graham Kerr and his team inherited was operations in alumina, aluminium, manganese, silver, zinc, lead, nickel and both thermal and coking coal. BHP had taken a dim view of long-term demand for just about all these metals and didn't like coal's prospects in a world where that commodity looked increasingly dirty. Just to add insult to injury they gave the company a dumb name - South32 was meant to evoke the fact that the 32nd Parallel runs through both Australia and South Africa, but all it did was remind investors that the Beloved Country seemed to be headed south in terms of being mining friendly, to the point where it couldn't be guaranteed to provide enough electricity to run operations like the Hillside aluminium smelter at Richards Bay.

Well, for a long while South32 showed them. They managed the assets better, so they went down the cost curve. Also, the commodities tended to work better than expected. By January 2018 South 32 had doubled and BHP was up only 12%.

However, more recently it has been BHP that has been performing better. Since January 2018 South32 has halved and BHP has risen by around a fifth, mainly because of ongoing weaknesses in coal and nickel, but also because South Africa's recent lockdown for Coronavirus has disrupted operations. With most of its commodities in retreat in the six months to December 2019, revenue for that half was down 16% to US$3.2bn and EBITDA was down 48%, to US$678m. That sounds bad, however, we think South32's two-year bear market is coming to an end, for three main reasons.

Three reasons why South32 can turn around

The first reason relates to portfolio. This company isn't stuck with bad assets any more than BHP was. Late last year it announced it was selling its thermal coal assets in South Africa. We expect that as it shuffles its portfolio over time it will end up with a good portfolio of assets in commodities with a bright future. Also, keep in mind that it has three monster projects in the pipeline that can diversify commodity risk – Amber in Alaska (copper, lead, zinc and gold); Hermosa in Arizona (lead, zinc and silver) and Eagle Downs in Queensland (metallurgical coal).

The second reason relates to capital. South32's existing suite of assets throws off a lot of free cash – like US$284m in the somewhat depressed December 2019 half alone. And this company has a US$277m net cash position. South32 has been buying back stock and only just suspended its buyback when the Coronavirus Crisis got going. On 27 March it announced US$160m in cost cutting to get it through this dark time, but that can easily turn back on again since it relates largely to sustaining capex.

Turning on a nickel

The third reason why we believe South32 can turn around relates to a big change in the commodity world – Electric Vehicles. In 2014 when South32 was being formed people weren't really expecting EVs to be a big deal. Now they are, increasingly turning South32 into a battery minerals play. The Cerro Matoso operation in northern Colombia, which is the world's second-largest producer of ferronickel is going to have a lot more end-users in the energy storage industry in the future than in the steel industry. Same deal with the manganese mines in South Africa's Northern Cape and the manganese mine on Groote Eylandt off the east coast of Arnhem Land in Australia's Northern Territory. All that bodes well for South32 once the Electric Vehicle Revolution gets back its former momentum and soaks up the excess supply that has temporarily depressed the market. Interestingly, nickel has been showing signs of life in recent days.

Currently, South32 is trading at a P/E of just 10.9x forecast FY21 earnings, which starts in July, and this drops to 8.5x for FY22. We think contrarians should take a good look at this one and its significant post-Coronavirus potential.

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Source: Tradingview

Sangomar is a big deal in the energy business. For a long time, people in the industry didn't think much about Senegal at all, even if they liked the fact that it was a democracy, politically stable, resource-sector friendly and all that. Then in 2014 the British independent oil company Cairn Energy (LSE: CNE) discovered Sangomar, containing both oil and gas, in deep water about 100 kilometres south of the Senegalese capital of Dakar. Actually, an initial well called FAN-1 discovered an adjacent field in October 2014, after which the SNE-1 well hit what is now called Sangomar the following month. This whole exercise was Vegas-like in terms of the gamble involved - FAN-1 and SNE-1 were the first exploration wells to be drilled offshore Senegal for over two decades and they were the first ever wells to go down in water deeper than 500 metres. But they paid off in a big way - SNE-1 was the biggest discovery anywhere in the world in 2014.

15% of a really big oil field

Fast forward five years from SNE-1 and a few wells later, Sangomar has turned into a huge project – 231 million barrels for Stage 1 and 255 million for Stage 2, with another 160 million barrels of oil equivalent gas to follow. And FAR is up for 15% of that, having first bought in to the relevant exploration blocks in January 2006, when the company was still called First Australian Resources. FAR stayed through the whole journey.

One player that only got involved just recently is the current field operator, the Perth-based oil and gas major Woodside Petroleum (ASX: WPL). In October 2016 it bought the 35% stake in the project held by ConocoPhillips (NYSE: COP) for US$440m. Woodside then transitioned to be the project operator. The ConocoPhillips/Woodside transaction annoyed FAR, with the Melbourne company arguing at the time that its pre-emption rights over the ConocoPhillips stake had been incorrectly overridden. Woodside disagreed. The parties eventually went to arbitration over the matter and Woodside won, in an award that came down on 14 February 2020. It was one more reason even before the oil price crash as to why investors haven't wanted to own FAR stock.

Longing for US$65 a barrel Brent

Which brings us to the present, apparently perilous, state of Sangomar. Brent crude at US$20 a barrel doesn't really cut it for this field, whose breakeven production cost is US$22 a barrel. For the life of the field Brent crude has to be US$33 a barrel.

Now, at US$65 a barrel, which is where Brent was late last year, everyone makes out like bandits and FAR has made the case that at that price its share of Sangomar would have an NPV of US$630m at a 10% discount rate, not including any gas production. But US$65 is a way away. Woodside is now working on options to reduce total project cost in order to keep this project from falling apart.

Less than 2 cents on the dollar

As far as FAR is concerned, the company disclosed on 30 March that it hasn't been able to raise the debt it needs for its share of the project. Which has led to speculation that it might sell out.

So why look at FAR now? Well, as at 31 March this company had US$80m in cash and term deposits, which translates to A$126m cash at the current exchange rate. And no debt. A lot of that cash was raised late last year at 4.25 cents in anticipation of Sangomar progressing smoothly. The market capitalisation at the 4 May market close was only A$140m. $140m minus $126m equals $14m. In other words, you currently get 15% of a major oil field offshore Senegal with favourable fiscal terms from the Senegalese government, where a 'normal' oil price (i.e. Brent at US$65) would create a notional A$987m in value for FAR shareholders for only $14m. Mr. Market is giving it to you for almost nothing, or, to be more precise, roughly 1.4 cents on the dollar (i.e. $14 million divided by $987m).

Throw in stakes in other projects in The Gambia and Guinea-Bissau for free. Ok, it's Vegas-style risky, but followers of the Sangomar story are used to that. It's a risk that might be worth taking given the potential for sanity to return to oil markets as soon as the Coronavirus Crisis ends, which we argue is coming sooner rather than later.

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One of the more amazing aspects of Australia's mortgage market is the fact that the banks don't get all the business. Consistently non-bank lenders like Resimac write 7% to 9% of all mortgages in Australia and their market share has been gradually increasing for several years now.

There are various reasons for this. An important one has been the 'investor loan growth benchmark' which the Australian Prudential Regulation Authority (APRA), watchdog for the financial services industry, introduced in December 2014. Back then, worried that there would be too many bad loans to property investors unless they acted, APRA told the banks that they basically weren't allowed to grow their loan books for investment properties by more than 10% a year. That gave the non-bank lenders a clear competitive advantage. Another important reason for the growth in non-bank lending is the fact that banks started making it harder for customers to qualify for loans and those customers ultimately ended up going with the non-bank lenders.

Rapid expansion pre-Crisis

Resimac has been one of the leaders in the non-bank lending space. And it's been growing fast. Five years ago, when Resimac was called Homeloans, there was just $7.6bn in assets under management. Now it's $14.2bn, driven in part by the activity of thousands of mortgage brokers around the country that continue to send business Resimac's way.

With the housing market in recovery mode during the six months to December 2019, Resimac was able to grow its loan book by 20%, to $11.3bn, and total assets under management by 11% to the aforementioned $14.2bn. Net interest income was up 53% to $84m. And, importantly, the cost-to-income ratio came down to just 42%, from 57% previously, showing just how scalable the Resimac model is and how the company's investment in fintech to make the platform more efficient is paying off.

Warehouse to the rescue

The fear among investors was that Coronavirus would bring this all unstuck. The company wouldn't be able to write mortgages for a long while and while the banks could handle a pause in their mortgage repayments by customers whose income had been temporarily impacted by the Virus, maybe Resimac couldn't.

On 17 March the company was able to dispel those concerns, noting that it had multiple warehouse lines (i.e. lines of credit given to loan originators) that it could draw on in a rainy day like this, i.e. in the event that it was unable to securitise, which is what it normally does. It was even able to argue that its loans were defaulting at a lower level than its competitors because it had been conservative on lending risk.

Since that announcement two non-executive directors of Resimac have been buying heavily on market - Susan Hansen and Duncan Saville. And no guesses why – you can currently buy Resimac stock for a P/E on forecast FY21 earnings of just 5.8x. Seems inexpensive to us given our view that the Coronavirus problem has potential to be over sooner rather than later.

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