7 MAY 2020

Stocks Down Under

Men who have a pierced ear are better prepared for marriage - they've experienced pain and bought jewellery.

- Rita Rudner (b. 1953), American comedian

MICHAEL HILL
The bling is back

PERSEUS MINING
Mine number 3 is coming

ZENITH ENERGY
Barbarians broke down the gate

MICHAEL HILL

The bling is back

Stocks Down Under rating: ★★★★

ASX: MHJ
Share price: A$ 0.325
Market cap: A$ 128M

Between 20 March and 24 March 2020, the Brisbane-based jewellery retailer Michael Hill closed, or in the case of New Zealand was forced to close, its entire store network globally because of the Covid-19 pandemic. The stock had been 58 cents on 26 February, when a good set of half yearly results came out, but by mid-March it was 23.5 cents. However, Michael Hill still knows a thing or two about retail and prior to this crisis its turnaround strategy was working well. With the stock on a single digit P/E, we believe it's now well placed for the post-Covid recovery.

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Market cap: A$ 1.2BN

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Share price: A$ 1.015
Market cap: A$ 150.9M

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Share price chart

Source: Tradingview

On 28 March, Stuart Roberts, one of the editors at Stocks Down Under, got married in Sydney. The event was pretty low key, since only five people were allowed to be present at the ceremony thanks to restrictions on public gatherings. However, this event had been in the planning for some time. Stuart and his fiancée, now wife, had bought their rings the previous December, before all this trouble started, and the store they bought them from was Michael Hill.

From a single store…

Why Michael Hill, and not Goldmark, or Prouds, or Angus & Coote? Maybe because of years of television advertising where Sir Michael Hill himself – who still owns 38% of his company – faced the camera and told us that he was 'Michael Hill, Jeweller' at either end of a pitch where he explained what fine pieces he was peddling at really great prices, many of which the company made and branded itself.

Over the years the Michael Hill name came to exude credibility for people who would have been too intimidated to step into a traditional jewellery store. And it worked like a dream for a long time, from Sir Michael's original store in his hometown of Whangarei on New Zealand's North Island in 1979 to today where there are more than 300 stores all across New Zealand (52 stores as at December 2019), Australia (165 stores) and Canada (87 stores).

Prior to this crisis a lot of people were saying that Michael Hill's glory days were behind it, with customers today wanting more sophistication than the traditional and somewhat unsophisticated Michael Hill customers of 25 years ago. That might explain why, if you'd bought the stock in July 2016, when Michael Hill added an ASX listing to its existing NZX listing, you'd be very much underwater. In FY19, revenue declined 1% and EBIT came down 14%, to $34.6m, off the back of a same-store sales decline of 3.3%.

The mojo is back

FY19 didn't look promising, however you don't build a respected retail house with half a billion in annual turnover without learning a thing or two about trends in consumer taste. Enter current CEO Daniel Bracken, who started at Michael Hill in November 2018 after a stint at Specialty Fashion, the current City Chic (ASX: CCX). The chains Bracken worked on are now at Mosaic Brands (ASX: MOZ).

Under Daniel Bracken , Michael Hill has, we think, got its mojo back. It now crafts up more of its own special and, indeed, unique, products and sells them through multiple channels at full price. In the six months to December 2019 that strategy started to bear fruit – revenue for this period went up by 4.4% and underlying EBIT by 6.9%. And same store sales were up a creditable 6.3%. We think there's more where that came from post-Covid, when those stores are able to re-open. And while Michael Hill is a relative latecomer in terms of online sales, where sales are in single digits of total revenue, it is growing there very quickly – like for like online sales in the December 2019 half were up 44%, albeit from a low base of course.

You can currently get the respected Michael Hill name at a P/E of just 7.7x forecast FY21, dropping to 5.9x for FY22. A valuation discount that seems a little too high to us, given what Michael Hill is selling these days. At least one other really successful retail executive seems to agree with this – Janine Allis, the Melbourne-based founder of the drink retailer Boost Juice, and a non-executive director of Michael Hill, was a recent on-market buyer of stock.

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Share price chart

Source: Tradingview

Develop a good mine at a bad time and the result can be years of heartache for the shareholders. That's what happened to Perseus Mining back in 2011 as it was bringing its foundation Edikan Gold Mine in southwestern Ghana into production. The first gold poured at Edikan in August 2011 and less than two weeks later gold reached US$1,896 an ounce in the London Morning Fix, a peak it has yet to reach again. A bear market for gold ensued that lasted over four years and took the metal down around 45%. In 2015 gold averaged just US$1,160 an ounce, not too far above Edikan's All-In Sustaining Cost (AISC) for that year of US$951 an ounce. The day of the first gold pour Perseus stock changed hands at $3.36 a share. By December 2015 when gold was finally bottoming Perseus was down by 90%, at 33 cents.

Once bitten, twice shy

That disappointment was a one reason why it took so long for Perseus to re-rate when Sissingué made its first gold pour in January 2018. Gold at the time had clawed its way back to around US$1,350 an ounce and Sissingué was expected to produce 70,000 ounces p.a. on average at an All-In Sustaining Cost (AISC) of only US$628 an ounce over a five-year mine life. Okay, that was small in ounce terms – in 2017 Edikan had produced around 208,000 ounces at an AISC of US$1,109 – but there was reasonable potential that a larger mine would evolve at Sissingué as satellite deposits were explored.

More importantly, the Yaouré mine was on its way by January 2018. That project, in central Côte d'Ivoire, not far from the capital Yamoussoukro, had been the subject of a Definitive Feasibility Study in November 2017. That DFS described a mine producing 215,000 ounces per annum at an AISC of US$734 per ounce over the first five years of what was expected to be an 8.5-year mine life.

So where exactly is Côte d'Ivoire anyway?

Basically, the market waited another 18 months or so after Sissingué's first pour before deciding that the 'new Perseus' was real. By then, investors had had time to figure out exactly where Côte d'Ivoire is (right next door to Ghana) and to appreciate that Côte d'Ivoire under President Alassane Ouattara, in office since 2010, is strongly pro-mining, with outstanding infrastructure, political stability and a modernised mining code.

Also, by the June 2019 quarter Perseus was operationally in good shape, with Edikan at an AISC of US$1,090 an ounce and Sissingué at US$791, but tracking for lower costs ahead. And by that quarter Yaouré financing had been secured, putting this mine on track for a late 2020 launch. Throw in gold above US$1,400 an ounce and the potential upside was getting serious. Perseus stock took off. However, we think there's further upside to come.

Consider that, by FY22, Perseus expects to be producing 500,000 ounces a year across its three mines. At the moment its total hedge position is only 317,000 ounces at US$1,393, so this company can continue to enjoy a lot of the upside from the currently strong gold price, given that Edikan still has seven years to go, Sissingué four years and Yaouré 8.5 years. However, for Yaouré, that's just on the open pit, there's potentially strong upside here from an underground mine in the years ahead.

For all this, you can currently get Perseus for a P/E of 16.4x on FY21 numbers. That drops to 6.1x for FY22. Looks inexpensive given the current bullish environment for gold and the fact that the market likes West Africa where all the lowest cost deposits seem to lie.

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Share price chart

Source: Tradingview

What attracted Pacific Equity Partners to Zenith? Well, for one thing, it was growing quickly. In FY19 this company earned $20.7m in EBITDA from $55m in revenue and for FY20 it was flagging $26-27m EBITDA on $62-64m in revenues. Obviously, Covid-19 is disrupting a whole bunch of industries globally, but Pacific Equity Partners is taking the view that Zenith's pipeline of new build-own-operate power projects can continue to expand over time. Additionally, Zenith was collecting annuity-style revenue streams from its projects as it completed them, underwriting future expansion.

Build, Own, Operate, Sell to private equity

Zenith Energy is a recent beneficiary of the outsourcing trend in the resources sector. Traditionally, if a mine was being developed in a remote location, the mine developer would work out its own power solution, more often than not putting in diesel generators and trucking in its own diesel. These days, miners can turn to Zenith Energy and that company will do it for them on the traditional 'BOO' model for other infrastructure providers – Build, Own, Operate.

A good recent example of Zenith's model is the Hybrid Solar PV-Diesel Facility, which it built to serve a relatively new nickel mine in Western Australia called Nova, located in the Fraser Range 360km southeast of Kalgoorlie. Nova is the flagship of IGO Ltd (ASX: IGO), an emerging Perth-based miner. In FY20 the Nova operation had been expected to produce somewhere north of 27,000 tonnes of nickel, 11,000 tonnes of copper and 850 tonnes of cobalt. When Nova came into production in 2017 it got its power from a diesel station which Zenith built.

However, in October 2018 Zenith announced that it was adding a solar farm to the diesel generator to sell to Nova on a revised Power Purchase Agreement. The result was lower average power costs for Nova and an expansion of the annuity-style income for Zenith from a 25 MW operation. Interestingly, solar is only a fraction of the company's BOO assets at the moment, even though outback Western Australia is awash with Direct Solar Irradiance (what you and I call sunlight). We think that if the Nova Hybrid facility works out as expected, solar could prove a big growth factor for Zenith given the obvious cost advantage as well as the fact that renewable energy is more desirable from a 'social responsibility' point of view.

Repeat customers, annuity-style income

As at December 2019 Zenith had around 384 MW in operating projects under its control, mostly in Australia. The portfolio was expanding rapidly, with 450 MW in future project in the pipeline and the opportunity to take its Australian-developed model overseas was strong. The intention of Zenith going forward is to only do BOO projects where the big money sits because these projects are so long-term in nature. The clients are, more often than not, big names in the mining industry like Newmont, Northern Star and Silver Lake Resources, capitalised at more than $1bn. They come to Zenith because of the company's track record and because the outsourced power model makes sense to the project economics of the miners. And often they're repeat customers – witness the expansion to Northern Star's Jundee Power Station in November 2019, and to Superior Gold's Plutonic Power Station in March 2020.

Shareholders will likely vote on the proposal from Pacific Equity Partners in June and we expect the deal will be approved. The take-home lesson for investors looking for the next Zenith is this: Look for companies that don't just provide miners with what they need but help take miners' costs down, as Zenith did, and where there's annuity-style income for the company concerned. Replicate that business model, and private equity might just come knocking.

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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.