Stocks Down Under

> *Opportunity is missed by most people because it is dressed in overalls and looks like work.*

- Thomas Edison (1847-1931), American inventor and businessman

MERIDIAN ENERGY

A high price for a Renewables play

OOH!MEDIA

Impacted by COVID-19 but valued attractively now

GALE PACIFIC

Should get its day in the sun

MERIDIAN ENERGY

A high price for a Renewables play

Stocks Down Under rating: ★★

ASX: MEZ
Share price: A$ 4.36
Market cap: A$ 11.9BN

Headquartered in Christchurch, Meridian Energy is New Zealand's largest power generation company focused on solar, hydro and wind power. It sells electricity into the wholesale market and directly to consumers for use in homes, businesses and farms through the Meridian and Powershop brands. The company has delivered six straight years of earnings and dividend growth in addition to double digit shareholder returns since listing. Its solid competitive position in New Zealand was recently strengthened by the country's decision to go carbon neutral. With additional opportunities for growth in the Australian market, the stock has the potential to diversify and energize a long-term investment portfolio.

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OOH!MEDIA

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Stocks Down Under rating: ★★★★

ASX: OML
Share price: A$ 0.985
Market cap: A$ 604M

Based in Sydney, oOh!media is an outdoor advertising and media company. As one of Australia's largest out of home advertising product providers, it is also the parent of digital media company Junkee Media. The company's Unmissable Out of Home advertising solutions encompass 37,000 offline and online locations across Australia and New Zealand. Over half of group revenue is derived from digital assets, which combined with its various online platforms target a unique audience including millennials and youths, CBD enthusiasts and small businesses. It has growth opportunities that are perhaps as interesting as its audience, but coming out of the COVID-19 crisis, management will need to execute for investors to say oOh!

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Share price: A$ 0.145
Market cap: A$ 40M

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Share price chart

Source: Tradingview

Renewables portfolio positioned for growth

Meridian is in a strong competitive position in the well-functioning New Zealand energy market. It is the largest of five major power generators that serve 2.1 million consumers. Around 60% of the nation's electricity is generated by hydro stations. Meridian is 51% owned by the Government, which partially controls the prices it can charge along with regulators and the supply-demand dynamics of the electricity market.

It differentiates itself with its strong brands and through traditional and digital marketing. The Meridian and Powershop brands appeal to customers because they represent a commitment to sustainability. Powershop New Zealand customers also like that they can control their energy usage and cost in a light, engaging way. Meridian's brands have short supply chains because the physical assets used to deliver electricity and meter its use are managed by national and local lines and metering companies. This is another competitive advantage because it creates a lower cost structure.

All the electricity generated by Meridian comes from 100% renewable sources. It has five wind farms, seven hydro stations, and many commercial solar arrays in New Zealand. The company's competitive position was improved after New Zealand made the decision to go carbon neutral. While demand growth in New Zealand has been modest over the last 10 years, decarbonisation is expected to support medium term demand growth. Moving to zero carbon would of course be even better. A Zero Carbon Bill is in the hands of New Zealand's Select Committee and contains the goal of targeting net zero greenhouse gas emissions by 2050.

In FY19 Meridian posted 26% EBITDAF growth and record earnings of NZ$838m driven by strong hydro power conditions, customer growth and higher wholesale market prices. It benefited from some market and weather-related tailwinds in 1HY20, but execution was strong as it delivered record interim earnings and net profit. Group EBITDAF increased 20% to NZ$465m while net profit was up 26% to NZ$191m. The performance was driven by a record level of hydro power generation in New Zealand as well as significant customer and sales volume growth across all segments. Its customer count across New Zealand and Australia grew 8% from June 2019 to December 2019.

Rio Tinto closure to pose near-term risk

The price of electricity is largely dictated by the laws of supply and demand. Oversupply conditions can result in power generation plants being shut down, while rising demand can lead to investment in new power stations. United Kingdom-based mining giant Rio Tinto is the sole industrial electricity user in New Zealand and its Tiwai aluminium smelter accounts for 12% of national electricity demand. Approximately 40% of Meridian's New Zealand power generation is covered by a price guarantee contract with Rio Tinto.

In early April, Rio Tinto suspended the fourth potline at the Tiwai Point aluminium smelter for up to six months in response to a slowdown in business activity amid the COVID-19 crisis. Given the importance of this operation, if Rio Tinto were to decide to permanently close this Tiwai Point plant, overall demand would be significantly reduced. The company has noted that a closure of the Tiwai smelter would likely trigger further investment in the company's South Island grid. As Rio Tinto is Meridian's largest customer, the company will need to continue to negotiate contract changes even if it means offering lower transmission rates to maintain this key relationship.

Changed stance in the Australian market

Meridian also has an emerging presence in Australia where new power generation plant construction is being dominated by renewables. It has two wind farms and three hydro power stations. There is significant growth upside in Australia where the customer base is predominantly retail. As a result, electricity sales have increased during recent months with people spending more time at home.

However, the surprising Federal election result in 2019 is likely to produce more cautious policy settings that favour traditional energy sources over renewable sources, like the ones Meridian operates.

Valuation is stretched

The power generator has low operating costs and modest capital needs. It has a strong balance sheet that gives it the ability to act at will on its capital management priorities. As the only New Zealand electricity company with an asset and customer base diversified across different countries, it has unique access to growth opportunities at home and overseas.

However, we believe the company's valuation of 17.7x EV/EBITDA and its P/E of 37.5x for FY21 is stretched with falling EBITDA in FY21 and very limited EBITDA growth the year after. We'll stay away from this one for a while.

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Source: Tradingview

Lack of consumers causes pullback in ad spending

The COVID-19 pandemic has had a negative impact on trading conditions at oOh!media. In fact, the entire media industry has been hit hard by the sudden absence of consumers to market to. oOh!media's target audience has largely gone away in response to government policies around business closures and stay-at-home orders. Many clients have pushed back their bookings from 2Q20 to later in 2020. On 5 May, management noted, however, that over the previous two weeks its audience has shown signs of returning to growth.

With much uncertainty remaining around advertising demand, near-term visibility into oOh!Media's bookings is limited. In the meantime, the company has adopted several measures to strengthen its balance sheet. It successfully raised $167m in equity capital to secure funding that can help it get through the current environment. In addition, it has increased its debt covenant head room from its banking syndicate to a 4x net debt-to-EBITDA ratio. At least $20m in fixed rent savings and operating expense savings of $10m to $15m derived from a suspension of all discretionary spending and reductions in staff pay are expected to help keep the company afloat. Capital expenditure targets have also been reduced by $25m to $35m.

oOh!Media recently sold its Health network to Perth-based advertising company XTD for $300k in cash to further improve its financial position. The national network operated in 58 large medical and dental facilities and included 77 digital displays across Australia. Although this was a small part of its business, it allows the company to better focus on its core markets and growth opportunities in the Commute, Road and Retail segments.

Growth opportunities are there, but execution is key

There are growth opportunities to be had in the out-of-home (OOH) advertising business. After growing an at annualized rate of 9% per annum from 2014-2019, the sector is expected to continue a stretch of long-term structural growth. By FY23, the OOH media market is forecast to grow 8% per annum to $1.24bn compared to $936m in FY19.

Major advertising agencies spent an increasing portion of their budgets on OOH advertising from 2014 to 2019 and this trend is likely to continue. This is because the OOH audience is growing faster than the general population and data analytics is increasingly being employed to better understand demographics and consumer preferences. Furthermore, new advertisers, especially young technology companies like United States ride-hailing company Uber, tend to be attracted to the OOH sector for targeting millennials.

oOh!media's revenue sources have become more diverse and less dependent on discretionary spending in recent years with more business coming from the financial, food, communications and government sectors. There appears to be room for additional upside in these noncyclical sectors. With that said though, the management team will need to capitalise on the potential market growth by exercising better financial discipline and focusing on its core strengths.

Tough competitive environment

The company competes in a tough competitive industry with several large and small players jockeying for advertising dollars in a relatively low growth environment. The Australian out of home market saw just 1% revenue growth last year as did oOh!Media. It was encouraging, however, that the OOH channel continued to gain ground on traditional media, which experienced a 5% decline in revenue. Competition has been especially fierce in the company's Road segment as many big automakers and banks have pared advertising spending in recent quarters even before the pandemic.

oOh!media should be able to survive the COVID-19 crisis due to its improved financial health and early signs of recovery. Its ability to grow and take share in the crowded OOH advertising space remains to be seen, though.

The shares traded at a 55-cent all-time-low late March and have rebounded to above a dollar since then. However, they're nowhere near the pre-COVID high of 3.25 in late December. Although we believe the advertising industry will have a tough 6 months ahead, we believe there is value to be found in oOh!media. With an EV/EBITDA of 5.6x and a P/E of 10.9x, both for FY21, the valuation seems quite modest given the project 13.8% EBITDA growth in FY21.

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Source: Tradingview

Fabrics technology a competitive advantage

At the core of Gale Pacific's competencies is its unique fabrics technology. As the inventor of knitted shadecloth, it is the one of the largest global producers of technical fabrics with several leading brands such as Commercial 95, Canvacon and Landmark. It uses a proprietary coating process that uses the only three-layer, single pass process in the southern hemisphere giving it a distinct competitive advantage. The company supplies its high-performance fabrics to a diverse set of commercial customers in the agricultural, architectural, industrial, horticultural and mining sectors. Its fabrics are especially popular in agriculture because they help farmers improve crop protection, water conservation and plant yield.

The results in 1HY20 were challenged by tough business conditions. Revenue decreased 8.1% to $62.3m due to some mixed results across its geographic segments. The domestic business saw a 5.9% increase in revenue driven by retail growth and Eurasia revenue was up 10.6% due to new large-scale commercial projects and expansion into new markets.

However, revenue was down 27.4% in the Americas due to an unfavourable comparison to a major program the year before and MENA region revenue fell 17% due to project spending shifts and tightened credit policies. After posting a net profit after tax (NPAT) of $1.5m in 1HY19, it recorded a net loss after tax of $2.6m. Performance was also impacted by an unexpected provision for a major customer incentive program in the ANZ business.

New leadership focused on profitable growth

Late last year Gale Pacific underwent a major leadership change. John Paul Marcantonio became the company's new CEO effective 29 November and other executive changes created a brand-new leadership team. The group has acknowledged the disappointing first half results and moved forward with a focus on achieving its profit growth objectives for 2020 and beyond. Marcantonio recently assured investors that the balance sheet is in good shape and going forward cash generation is expected to be strong.

There has also been a significant amount of insider share purchases by Gale Pacific Directors. This is often a bullish signal because it demonstrates that management has skin in the game and confidence in the growth prospects of the company. Based on management's guidance, and consistent with previous seasonal patterns, fiscal 2020 performance is expected to be backloaded with three-fourths of profits occurring in the second half of the financial year.

Despite the sluggish start to FY20, Gale Pacific has growth opportunities ahead in areas outside of Australia, including the Americas. It has constructed a higher capacity warehouse in California to be able to support demand for exterior blinds, shade sails, shade cloth and umbrellas during the warm weather months. As the U.S.-China trade war improves, doors should begin to open for the company to continue to make inroads in the Americas because many products are manufactured in China and face cost-prohibitive tariffs. The company's ability to have success growing in the Americas will be critical to overall growth and investor sentiment.

Multiple long-term growth catalysts

Gale Pacific has been challenged by a series of unfortunate circumstances, which has setback its timetable for growth. This has included bad weather conditions in ANZ, changes in government spending and tightening credit policy in MENA, and U.S. tariffs on Chinese goods in the Americas. Despite these roadblocks, the company is seeing strong sell-through rates in its core categories, new retail placements, is entering new markets and developing new products to fuel the next wave of growth.

Unfortunately, there is no broker coverage of Gale Pacific, but the shares are trading at less than 5x last year's earning! We believe Gale Pacific's business is healthy with solid underlying demand and declining debt. With multiple growth levers ahead, Gale Pacific might just get its day in the sun.

Pitt Street Research Pty Ltd

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