18 MAY 2020

Stocks Down Under

> *They usually have two tellers in my local bank, except when it's very busy, when they have one.*
>
> **- Rita Rudner (b. 1953), American comedian**

COMMONWEALTH BANK

Asserting market leadership during crisis

SERKO

Too early to get back in

TERRACOM

Swooping on underappreciated coal assets

COMMONWEALTH BANK

Asserting market leadership during crisis

Stocks Down Under rating: ★★★★

ASX: CBA
Share price: A$ 59.60
Market cap: A$ 104.2BN

Sydney-based Commonwealth Bank of Australia is a multinational bank with operations in Australia, New Zealand, Asia, the United Kingdom and the United States. It offers a wide range of financial services including banking, mortgage, insurance and investing to retail, business and institutional customers. The shares have started to pull away from their 52-week low amid strong group performance and improved sentiment around a global economic recovery from the COVID-19 crisis. While challenges related to the pandemic are likely to persist for some time, we believe the bank is in a good position to support the Australian economy and strengthen its leadership among the major banks.

READ MORE

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ASX: SKO
Share price: A$ 2.60
Market cap: A$ 235M

Auckland, New Zealand-based Serko provides travel and expense management solutions for corporations. It listed on the NZX in 2014 and has had a great run from around NZD 0.28 in 2017 to a peak of NZD 5.78 in January this year. Serko has been dual-listed on the ASX since 2018 where it peaked at $5.50, also in January, before crashing to $0.91 late March. The shares have bounced back nicely to around $2.50, but with business travel in the water closet for a while longer the question is what to do with Serko?

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Swooping on underappreciated coal assets

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Share price: A$ 0.15
Market cap: A$ 103M

When we last looked at TerraCom, the company based in Clermont, Qld which owns the nearby Blair Athol Coal Mine, it was 17 February 2020 and the stock was 27.5 cents. At that time the stock was on the slide thanks to weak coal prices and by early April it was below 9 cents, the Coronavirus Crisis having added insult to injury. The stock has since stabilised around the current level. One thing that has gone right for TerraCom since February is completion of the Universal Coal takeover. Coal prices are still lousy, but we believe this company has better days in front of it, so we're maintaining our Four-Star rating.

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Share price chart

Source: Tradingview

Strengthened provisioning and COVID-19 support

The Coronavirus Crisis has had a significant impact on the bank. Individuals and small businesses have turned to CBA in financial distress to request loan payment deferrals and new funding. Since the start of the pandemic the company has provided more than $9bn in support to approximately 100,000 businesses and granted repayment deferrals on around 240,000 loans. It has also reduced borrower interest rates, increased depositor interest rates and waived various fees and charges. The company set aside an additional $1.5bn for loan loss provisions in the third quarter to brace for the potential long-term impact of the crisis on its customers. This brought its total COVID-19 provision to $6.4bn.

Since the start of the crisis on 20 February, Commonwealth has performed well relative to its “big four” peers National Australia Bank, ANZ and Westpac. As of 20 March, CBA’s provision coverage, the ratio of total loss provisions divided by credit risk weighted assets, led the group at 1.65% compared to the peer range of 1.34%

to 1.57%. It also has the strongest deposit profile of the group by virtue of having the highest share of stable household deposits at $269bn out of $533bn in total deposits. Moreover, through 31 March, Commonwealth has an international common equity tier 1 (CET1) ratio of 16.2% that trails only Royal Bank of Scotland and is well ahead of its Australian major bank peers.

Strong capital adequacy

The third quarter FY20 financial results exhibited a strong operating performance and a healthy balance sheet. The group recorded net profit of $1.3bn, which was aided by a 1% decrease in operating expenses due to simplification savings and higher annual leave usage tied to seasonality.

Volume growth in the core Australian market increased in home lending, business lending and household deposits. Operating income was flat compared to the quarterly averages of 1HY20 as the volume growth was offset by a lower net interest margin (NIM). Funding was strong as CBA saw an increase in retail deposits of $10bn in the month of March alone.

We believe CBA has good capital adequacy with a significant level of excess liquidity. It has a robust level 1 common equity tier 1 (CET1) ratio of 11.1% after setting aside the additional $1.5bn COVID-19 provision. This is above the Australian Prudential Regulatory Authority's (APRA) 'unquestionably strong' benchmark of 10.5% and well above the 8% prudential minimum.

CBA also has a Net Stable Funding Ratio (NSFR) and a Liquidity Coverage Ratio (LCR) that are well above regulatory requirements. The strong capital position allowed the company to deliver $3.5bn in 1HY20 dividend payments as an additional boost to the economy.

The group just announced that it entered into an agreement to sell a 55% majority stake in the Colonial First State (CFS) investment business, which implied a robust valuation of CFS of $3.3bn. The move was a step towards the company's strategy to create a simplified structure and focus on its core banking business. Commonwealth will receive cash proceeds of approximately $1.7bn from US investment firm KKR, which represents a 15.5x multiple of CFS's net profit after taxes of $200m. Upon completion of the transaction, the bank has estimated that it will book a $1.5bn after-tax gain on the sale and see an increase in its level 2 CET1 of $1.4bn to $1.9bn.

Progress with simplification cost savings

Prior to the Coronavirus pandemic, Commonwealth made good strides with its cost management initiatives. Although operating expenses were up 2.6% in 1HY20 due to wage inflation and compliance costs, significant cost reduction has been achieved in recent periods through business simplification initiatives. The last three halves have seen increasing business simplification cost savings of $80m (1HY19), $110m (2HY19), and $222m (1HY20). Customer remediation costs have also trended lower, falling by $249m in 1HY20.

CBA trades at P/E of 14.3x FY21 earnings, which makes it the most expensive bank of the Big 4. The other three big banks are trading at a P/E between 9x and 10. However, we believe this premium is justified given CBA's market position and balance sheet.

The dividend yield is about 5%, not too shabby with the RBA cash rate at 0.25%. CBA has a strong capital position and favourable business mix that we believe will enable it to endure the challenging times ahead. Four stars from us.

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Share price chart

Source: Tradingview

Fully integrated corporate travel management platform

The origin of Serko dates back to 1994 with the establishment of ITL, a mid and back office solution for travel agents. Six years later Serko pivoted to online business travel booking for corporates and later on sold the original ITL business.

Today, Serko's main revenue contributor is the company's travel platform, which accounts for about 60% of revenues. The platform removes the friction from booking corporate travel arrangements, adhering to company travel policy and travel expense management.

This platform, called Zeno, is linked up to distribution systems for air travel, hotels, rental cars, rail and transfer providers, i.e. Serko has partnered with groups such as Booking.com, Expedia, Amadeus, Hertz, Avis and several airlines. An entire trip can be booked on the same platform, following corporate travel policies and maintaining travel cost controls.

More than 70% of Serko's revenues are generated in Australia although the US is growing fast. Last year Serko acquired InterplX in the US to strengthen its position in the North American market.

Major validation from Booking.com deal

In October 2019, Serko announced that Booking.com, part of Nasdaq-listed Booking Holdings, was to invest NZ$ 17.5m in the company as part of a larger, NZ$ 45m capital raise. Additionally, both companies expanded their existing agreement, allowing Booking.com to start marketing Zeno to its corporate customers. That deal provided major validation for Serko's technology and was the starting point for an accelerated share price rally towards the peak in January. In our view, COVID-19 hasn't changed that validation one bit. Once corporate travel gets back on its feet, we believe the Booking.com relationship will prove to be very beneficial for Serko.

Strong growth stopped in its tracks

In FY19, which ended on 31 March 2019, Serko generated operating revenues of $23.4m and a profit before tax of $1.5m. And before the Coronavirus spoiled everyone's party, Serko was on track to achieve a 20% to 40% revenue growth in FY20. However, like many companies, Serko recently abandoned its formal revenue guidance for FY20 as corporate transactions on Serko's platforms came to a grinding hold in February and March. And we don't expect those transactions to pick up anytime soon given that a lot of corporate travel will likely be deemed non-essential for the rest of this calendar year, and maybe longer.

On the back of the poor prospects for corporate travel, the company has implemented strict cost control measures, including lowering data hosting costs and shedding external IT developers. The aim is to limit cash burn to a maximum of $2m per month on average through March 2021. With $42m in cash per the end of March, which the company largely raised late last year when Bookings Holdings came on board as a shareholder, Serko will be able to ride out this storm, in our view.

Too much uncertainty around corporate travel

As a result of the COVID-19 fallout, Serko's EBITDA is expected to drop off a cliff in FY21, which just started in April. The consensus puts EBITDA at a negative $11.3m, so an EV/EBITDA multiple is not available for valuation purposes. Instead, when we look at EV/Revenue, we can see Serko is currently trading at a multiple of 8.2x for FY21. We believe this is extremely high given the massive amount of uncertainty surrounding any resumption of corporate travel, and hence Serko's revenue.

We expect Serko's results announcement for FY20 to be very ugly. Publication of these results has been delayed due to COVID-19, but make sure you're strapped in when the company finally announces them. Any comments the company may make around current trading conditions will likely be even uglier, in our view.

All in all, we believe it is simply too early to get back into Serko right now. We'll wait this one out for now. Two stars.

TERRACOM

Swooping on underappreciated coal assets

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Share price chart

Source: Tradingview

On 5 May TerraCom gave the usual Covid-19-related market update that every company has been making lately, but this one was encouraging. The company indicated that it had scaled down the production profile at Blair Athol, which in FY19 had produced 2.65 million tonnes. It would do about the same in FY20, said TerraCom, and cut that just a little, to 2.0 million tonnes, in FY21. TerraCom still though it could generate A$58-60m in attributable EBITDA in FY20.

Debt not a problem

In the past TerraCom has had a high debt burden associated mainly with getting Blair Athol back up and running in mid-2017. However, that debt has been paid down fast and we don't think it's a problem now. Universal Coal came with virtually no debt. TerraCom's net debt as at December 2019 was A$179m. We think the debt burden is manageable. Remember, Universal Coal did A$52.5m in attributable normalised EBITDA in the year to June 2019, while guidance for full year FY20 EBITDA was A$43m.

It's also worth noting that TerraCom just agreed with Bridge Resources for that company to take Baruun Noyon Uul off TerraCom's hands. Bridge Resources is a Singapore-based coal trader. Baruun Noyon Uul is a small coking coal operation in Mongolia's South Gobi Desert, which TerraCom brought into production in 2014. But at the moment it's costing TerraCom money. Bridge Resources will buy it for just two US dollars but assume US$15m in TerraCom debt.

Four coal mines for just 4x EBITDA

In our opinion TerraCom has made a very smart acquisition in Universal Coal. The company offered 10 cents cash plus 0.6026 TerraCom shares, which at the time valued Universal at 33.5 cents. At that price the acquisition was about 4 times attributable FY20 EBITDA. That was low for a company which had started in 2013 with just a single colliery, called Kangala, about 65km east of Johannesburg. By 2020 Universal Coal had expanded to four South African thermal coal mines.

Universal Coal sells most of its coal on the South African domestic market. The thing about the Beloved Country is that it routinely suffers power shortages because of a lack of adequate generating capacity, something that the local state-owned power utility Eskom has been working to correct. In that sense the nationwide lockdown in South Africa has been a blessing because it temporarily lowered power demand, allowing needed maintenance to be completed.

South Africa needs more coal

In the medium term many in South African policy-making circles hope that coal can be replaced by renewable energy sources. This is, after all, the Rainbow Nation. However, in the near term the country has to make the most of the creaking coal-fired power stations that it has. In turn that means sourcing the best quality coal for those stations at the lowest price. We believe the four collieries inherited with Universal Coal, which in FY20 were slated to produce around 8.4 million tonnes, are therefore well placed.

Beyond 2020, it's not clear that coal won't be part of the future of energy in South Africa, in which case Universal Coal will have new domestic power stations to sell to. As things stand there's plans for two new 750MW coal plants, with the first up and running in 2023. With 147 million tonnes in Reserves and 676 million tonnes in measured Resources, TerraCom can be a player in South Africa for a long time. Universal Coal had collieries five and six on the drawing board at the time of the merger with TerraCom.

Directors are buying

Okay, TerraCom is a coal company, and coal is not exactly the most popular commodity out there in certain circles right now. And there have been allegations raised in court documents concerning coal sample certificates allegedly altered to fraudulently improve coal quality, a charge TerraCom has investigated and vehemently denies (see the company's 3 April announcement). That said, we're hearing that coal demand is ratcheting up in northern Asia as economies up there restart post-Covid, which has got to be good for Blair Athol. An end to South Africa's lockdown, which we suspect is coming soon, will also be helpful for the Universal Coal assets.

And there's also the intriguing announcement from February where TerraCom optioned a large bauxite project in the West Africa nation of Guinea, which if it exercises could diversify the commodity risk. In short, we believe there's a lot to like about this one at the moment. Maybe that's why Chairman Wal King and non-executive directors Glen Lewis and Paul Anderson have been recent on-market buyers of TerraCom stock.

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