21 MAY 2020

Stocks Down Under

Courage is being scared to death, but saddling up anyway.

- John Wayne (1907-1979), American actor, director and producer

CHORUS

Very limited EBITDA growth makes for an expensive stock

CLOVER CORPORATION

Regulatory and supply risk spoil the party

PHOSLOCK ENVIRONMENTAL TECHNOLOGIES

Clear water revival

CHORUS

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Stocks Down Under rating: ★★

ASX: CNU
Share price: A$ 7.03
Market cap: A$ 3BN

Based in Wellington, New Zealand Chorus Limited is the leading provider of telecommunication infrastructure across New Zealand as the owner of the most telephone lines and exchange equipment in the country. New CEO J.B. Rousselot came on board on 20 November and has thus far successfully navigated the company through the COVID-19 crisis. The company's initial rollout of the ultra-fast broadband (UFB) network across New Zealand has been highly successful as has its connection performance and cost reduction efforts. The stock is a great defensive play on the ongoing buildout of New Zealand's telecommunications infrastructure including the massive 5G growth opportunity ahead.

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ASX: CLV
Share price: A$ 2.53
Market cap: A$ 373M

Melbourne-based Clover Corporation produces omega-3 oils that are used to make infant formula, baby food and supplements. The company has benefitted from increasing demand for its infant formula ingredients in recent years as formula manufacturers have ramped production in response to solid demand of their own. While regulatory requirements regarding baby formula ingredients may continue to favour Clover, it faces several near-term challenges. With the shares trading at 34x earnings, competition rising, growth slowing and COVID-19 pressures mounting, the stock does not appear to have the formula for near-term success.

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Share price chart

Source: Tradingview

New Zealand stays connected during COVID-19 lockdown

The Chorus network has held up well since the onset of the Coronavirus Crisis. As lockdown conditions across much of New Zealand persisted, the importance of fixed line broadband became apparent. Monthly average data usage was up 18% sequentially in the third quarter to 346GB. The value of unlimited data plans was also confirmed as people used an average of 103GB of data in the last week of March alone. A spike in businesses using video conferencing technology drove an 85% increase in daytime upload usage. Through it all, the network has maintained high levels of performance and investor faith has grown along with the share price.

As an infrastructure company, Chorus is a defensive share market play and among a rare group that have been able to reaffirm FY20 guidance during the COVID-19 crisis. In adherence to the government's plans to eliminate the risks of spreading the virus, Chorus did suspend all non-essential field activity. While it also

deferred capital spending plans and reduced its FY20 capital expenditure guidance to $610m to $650m, it left its FY20 EBITDA guidance unchanged. It is expecting FY20 EBITDA to be in the range of $640m to $655m.

Fibre demand and 5G are growth catalysts

In recent weeks fibre installations have slowed significantly from around 650 to 100 per day with non-essential installs cancelled and the door-to-door fibre migration programme suspended. Going forward, however, Chorus should continue to benefit from high demand for fibre in New Zealand. Compared to copper, the connection is faster and more reliable for customers. Aside from the superior performance, it is also more profitable for Chorus and has grown into its core competency. Fibre already makes up 51% of the company's 1.2 million broadband connections and there is plenty of upside here.

Even though university students largely stayed home and installations were down during the late March lockdown period, fibre demand remained robust as Chorus added 32k connections in the third quarter compared to 36K in Q2 FY20. While the UFB rollout is winding down, the company will continue to push for more fibre uptake. Meanwhile, the dawn of the 5G networking era has ushered in a new and exciting time for Chorus. After receiving a $929m government subsidy back in 2013, it was responsible for constructing approximately 70% of New Zealand's UFB network. It is hoping to win a similar portion of the nation's 5G business. If it does, the long-term growth potential is tremendous.

The group's recent extension of its syndicated bank facility will give it the financial flexibility to deploy capital for 5G and other growth projects. On 17 April it announced that it entered into an agreement to extend its $550m committed bank facility backed by seven Australasian and global banks. Both tranches were extended by 11 months; the $350m tranche was extended through April 2023 while the $200m tranche was extended to April 2025. Chorus has only drawn $35m from the facility and is in a position of high funding certainty.

Regulatory uncertainty around revenue caps

The revenue cap beginning in 2022, which will cap fibre pricing and subsequently adjust for inflation, is likely to have a significant impact on how the company operates. Management has noted that the Commission responsible for this regulation may review its current revenue cap framework, so the final version of the regulation remains unknown. What is known is that exercising cost discipline amid a rapid growth environment will become a major challenge for Chorus and its peers. Those that can execute and gain market share without damaging profitability will emerge as sector winners.

On the heels of the UFB1 rollout and with the UFB2 rollout already 37% finished, Chorus continues to execute on its plans well within financial and scheduling guidance. The telecom operator also recently launched the new Hyperfibre 2 and 4 gigabyte per second offering. We believe the arrival of 5G will create a good growth opportunity nationwide as businesses and consumers upgrade to this ultra-fast, modern communications technology.

Too expensive given its limited EBITDA growth

Chorus shares come with a 3.4% dividend yield, which is nice to have. However, the shares are currently valued at an EV/EBITDA multiple of 9.6x for FY21, yet only offer 1.8% EBITDA growth in FY21, which starts in July, and 1.1% the year after. In our book, that is very expensive, which is why we'll sit this one put for now, waiting for a better entry moment.

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Source: Tradingview

Inventory build-up amid slower growth

After experiencing solid growth over the last few years, growth slowed considerably in 1HY20. Although revenue increased 9.8% to $37.6m, net profit after tax (NPAT) was up just 3.4% to $4.6m compared to 1HY19. The performance fell short of analysts' expectations and was primarily due to weakness in the Asian market. Asia sales declined 17% as some customers began moving production from Asia to facilities in Australia and New Zealand amid restrictive Chinese policies. Overall operating expenses increased 20% to $5.5m due to higher marketing, sales personnel and administrative costs as well as increased R&D activity.

Management chose not to declare an interim dividend following the soft results and the onset of the Coronavirus outbreak. In the first half, the company also strategically increased its inventory to $36.6m to give it improved flexibility to fulfill future demand. The build-up of raw materials at a time of waning demand and high economic uncertainty looks to have been poorly timed. Unless there is a significant uplift in near-term demand, Clover's high inventory level may amount to spoiled milk and weigh on second half financial results.

COVID-19 impact, China legislation cause high uncertainty

The COVID-19 pandemic has been disruptive for infant formula manufacturing. Heightened safety concerns and supply chain disruptions have caused manufacturers to pause and re-evaluate their costs and raw materials requirements. Clover has witnessed this firsthand with forward orders for its products slowing in recent months. A return to normal demand patterns in the second half appears unlikely.

China represents a key market for the group. Infant formula manufacturers there have taken an especially cautious stance due to the new operating environment caused by the COVID-19 crisis and an uncertain regulatory backdrop. The country is in the process of reviewing draft legislation that would potentially require infant formula to have a minimum DHA (docosahexaenoic acid) loading of 15mg per 100Kcal. Chinese manufacturers naturally do not want to build inventory levels until they know for certain the outcome of the potential legislation.

Meanwhile the approval of licenses to non-Chinese manufacturers have slowed amid a push to promote local brands. This has added to the very uncertain environment for Clover regarding the all-important China market. Fortunately for the company, China has forged ahead with the opening of more cross border warehouses that give Clover indirect access to the Chinese market without the need for a retail license. Nevertheless, the current COVID-19 crisis will undoubtedly hamper Clover's ability to sell into the Chinese market as consumers and manufacturers alike remain hyper-sensitive about all food-related sourcing. Even though this is a defensive business because babies need healthy nutrition, we believe the demand patterns will be unknown for the foreseeable future.

Market growth opportunity attracts new players

Since Clover's Nu-Mega products provide the nutritional input that is critical for a baby's first 1,000 days of life, securing a healthy source of raw materials is paramount to its business. Its omega-3 DHA tuna oil products are derived from wild caught tuna as a by-product of the tuna canning process. The safety and sustainability of its sourcing are ongoing inherent risks. But as its supply chain faces risks related to fewer workers and lower production, the potential for disruption in ingredient sourcing has never been a more serious issue for the company. With a rather limited base of fish oil supply partnerships, Clover has recognized the need to expand its raw material sources.

The global infant formula market is expected to enjoy structural growth in the years ahead. Unfortunately for Clover, this means many new players have come on board in recent years and made it an increasingly crowded space. As economic conditions improve over time, Clover will ultimately have to convince the market that its premium products are worth the price for it to emerge as a winner.

We believe Clover is not expensive at 18x EV/EBITDA for FY21, given its projected 27% EBITDA growth next financial year. However, we see multiple downside risks to the Clover story, which is why we err on the side of caution with this one.

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Share price chart

Source: Tradingview

Three revenues streams

In a nutshell, PET provides chemical and engineering solutions that can remove excess nutrients, like phosphates and nitrogen, from water and water bodies. Excess nutrients can result in excessive growth of algae and can cause odour problems as well as issues with low oxygen levels. The latter can adversely affect fish stock.

PET not only provides the chemicals that lock in pollutants, but can also provide customised design and engineering work, tailored to a specific situation. For example, the company has three active projects in China that are essentially turn-key solutions to specific issues with water pollution.

While this design work generates one-off revenues for PET, Phoslock, the product that actually captures the excess nutrients and pollutants, is a consumable in these water management facilities and generates recurring revenues for PET. Phoslock was developed by CSIRO and brought to market by PET. It permanently binds pollutants and then settles as a sediment at the bottom of the water body.

When a project is up and running, PET can also provide maintenance services in multi-year contracts. For instance, the ongoing Shilongba project in China's Yunnan province has a $25m project value and an approximate $5m in annual maintenance services attached to it post-completion.

Revenue guidance reaffirmed

Even though PET's Phoslock factory is based in Changxing, China, the company's manufacturing operation has seen little impact from COVID-19. Production of Phoslock came back online after Chinese New Year and peaked at 60 tons per day in April. Similarly, the company's three Chinese projects, all in Yunnan province, have been unaffected.

Unlike in China, projects in Europe and North America have been delayed by three to six months due to COVID-19. However, this has not resulted in a change in revenue guidance by PET. On 30 April, the company reaffirmed its previous $50m to $70m revenue guidance for FY20 (Jan-Dec), which would be up significantly from FY19 revenues of $24.5m. The company achieved an operating profit of $3.75m in FY19, or an operating margin of 15.3%.

With $380m in the project pipeline, of which $250m in China, we believe PET has very solid prospects, i.e. this pipeline should allow for strong year-on-year revenue growth for the foreseeable future. Additionally, we believe the problem that PET is addressing is so big globally that this project pipeline is likely to grow strongly in existing and new geographies.

The company recently did a $20m capital raise and has around $50m in net assets. With no debt on the balance sheet, we believe the company is well positioned to capture the growth opportunity ahead.

A favourable long-term revenue outlook

Having established that PET's market opportunity is large and very attractive, we'll turn our eyes to the company's valuation. PET's share price peaked around $1.50 mid-2019 and has come down to $0.29 at the bottom of the Corona Crash on 23 March. Before the crash, PET had already given up a lot of ground, in part due to the fact that the company did not achieve the revenue level it had been guiding towards for FY19, i.e. $27m to $30m in guidance versus actual FY19 revenues of $24.5m. That did not go down well with investors.

The midpoint of the company's FY20 guidance is $60m. At that level, PET is trading at a revenue multiple of 5.8x. While that may seem high, we believe the company's long-term revenue outlook is very favourable, given the $380m project pipeline. So that multiple should come down strongly in the next few years. Furthermore, the company is profitable and should see strong expansion of operating margins as its Phoslock production capacity increases and attractive maintenance contracts become a larger part of revenues.

In our view PET is a four-star company at current levels. We believe it may pop back up on radar screens of institutional investors if and when the market cap rises back above $500m. In turn, that should drive further share price appreciation.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

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