Stocks Down Under

"If you must play, decide upon three things at the start: the rules of the game, the stakes and the quitting time."

- Chinese proverb

CROWN RESORTS

Not a gamble worth taking right now

TEMPLE AND WEBSTER

No showroom

SILVER MINES

Golden opportunity

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Stocks Down Under rating: ★★

ASX: CWN
Share price: A$ 9.43
Market cap: A$ 6.7BN

Headquartered in Melbourne, Crown Resorts owns and operates some of Australia's largest gambling and entertainment venues, such as Crown Melbourne, Crown Perth and the new Crown Sydney in Barangaroo. The complexes include a range of hotels, casinos, restaurants, bars and shops. They appeal to both local and overseas customers due to their high-end nature and all-inclusive atmospheres. Crown's other key assets are the Crown London Aspinalls casino and its 50% ownership in online betting exchange Betfair Australasia. While the Barangaroo resort has the potential to drive market share gains over the long-term, a lack of international tourism along with increasing regulatory pressures suggest Crown is not worth the gamble here.

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Market cap: A$ 662M

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Share price chart

Source: Tradingview

Pandemic knocks Crown from the throne

The COVID-19 crisis has impacted the tourism and entertainment space as much as any other industry. As a non-essential business, Crown was forced to close its doors from the start and has been among the slowest operations to reopen. Gaming activities were immediately halted. Food & beverage and conference facilities were also shut down other than for takeaway meals and meal delivery service. Hotels remained open in a reduced capacity, but travel restrictions and consumer safety concerns have resulted in limited demand.

Crown has experienced a significant financial burden burning through cash while it waits in hope of a revival. It provided two-weeks' pay and other one-time payments equalling over $200m to the 95% of its workforce that it had to stand down. It also applied for the government's jobkeeper payment. The company estimated that underlying monthly operating cash costs have decreased by $20m to $30m while it stays closed, but this "savings" pales in comparison to the glaring lack of revenue. What little revenue it has brought in has come from wagering and online social gaming sources.

Crown has obtained funding to get through the COVID-19 crisis securing an additional $1bn in debt over the last few months. It first entered new bilateral facilities with several banks for $560m. In addition, it agreed to terms with three other banks for a $450m project finance facility to support the ongoing construction of Crown Sydney. The company further compromised its financial health by choosing to go forward with its FY20 interim dividend payment on 17 April.

Will Barangaroo be a success or failure?

In early 2021 Crown is expected to unveil its latest resort in Barangaroo. The opening of the much-anticipated Sydney entertainment complex has been complicated by the unlucky timing of the Coronavirus pandemic. With the Australian economy starting to re-open, there is a lot of uncertainty swirling around whether people will embrace the venue as they deal with tighter personal budgets in a recessionary economy. Safety measures around social distancing may also limit customer traffic and unplanned sanitation requirements may lead to higher expenses. The combination of lower revenue and higher expenses will make it hard for the resort to realize its full potential. Given the massive $2.2bn gross project outlay, Crown can ill afford for Barangaroo to be anything less than a major success.

In the near-term Barangaroo will rely heavily on domestic tourism with international travel expected to remain limited for the foreseeable future. Although the property may benefit from a surge in domestic travel, eventually it will need overseas travellers to get in on the action. In fact, having a steady international presence will be a key driver of performance at all of Crown's resorts because adventure-seekers from Asia and elsewhere account for much of its high-roller customer base. A failure to attract overseas patrons to its VIP program would have a profound impact on not just the casino operation but the entire Crown Sydney resort.

Regulatory scrutiny an overhang on reputation

Last year's media reports that called into question Crown's reputation continue to impact operations and share performance. State gaming regulators and government agencies, such as AUSTRAC, have launched inquiries into the company based on a July 2019 '60 Minutes' report called "Crown Unmasked". The report alleged that Crown violated Chinese law by promoting its casinos to mainland China gamblers. It also called into question Crown's relationship with certain middlemen who help recruit VIP gamblers and act as credit agents to get around China's capital controls. The report further revealed an arrangement with Australia's Department of Home Affairs to speed up the processing of Crown VIPs' short-stay visa applications. Crown officials have denied the report's claims calling them part of "a deceitful campaign" against the company.

Meanwhile, Crown's balance sheet has weakened since the start of the pandemic after using its cash balance to pay employees and dividends to shareholders. As of 31 December 2019, it had $500.6m of cash and a net debt position of $371.2m. It has taken on additional debt since then to help it manage the pandemic, making it a significantly levered company in the process. Most of the debt is long term debt that matures in FY25 or beyond. With a BBB credit rating from debt rating agency S&P, it is barely of investment grade quality. There are too many regulatory and post-pandemic hurdles for us to feel comfortable placing a bet on Crown shares at the moment.

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Share price chart

Source: Tradingview

If you live near trendy St Peters in inner Sydney and you're in the market for upmarket furniture for your apartment or townhouse, don't think of wandering into the offices of Temple and Webster on Unwins Bridge Road to take a look at what's on offer in the showroom. There is none. They may be one of Australia's leading furniture retailers, but it's all 100% at templeandwebster.com.au. Now, if you've never heard of Temple and Webster, that's understandable. The business only started in 2011, but by FY19 a loyal customer base had generated $102m in revenue, allowing the company its first year in the black at the EBITDA line.

Great design. Great price.

While that FY19 EBITDA was only $1.8m, it allowed the stock, ASX listed since late 2015, to re-rate from around 80 cents in August 2018 to the $4.18 all-time high of last February. About that time Temple and Webster handed in a half-yearly result that saw revenue up another 50% and EBITDA at $2.3m. And that EBITDA was just for a six month period.

There are various secrets to Temple and Webster's success. Firstly, the products have excellent design. As yours truly writes this article he's tempted to buy some of the merchandise, it looks so classy. Secondly, the prices don't look outrageous. For example, if this writer was in the market for a Queen-sized wooden bedbase, then the one called 'Natural Beldevere' on the company's website would set him back only A$249. That seems like pocket change if you've bought one of these offline, but the price reflects the fact that showrooms are expensive things to run while websites and third party logistics operations are not. Gross margins for this company were 44% in the most recent half, unchanged on the previous corresponding period.

Smart people

Then there's the really smart digital marketing targeted to the kind of audience that would buy bedbases online when most of us would still need to look at it and touch it before we buy. These guys are so advanced there's even an app!

The digital smarts came with the founders. CEO Mark Coulter, CXO Adam McWhinney (CXO is Customer Experience Officer – yeah, we didn't know that either) and Conrad Yiu, currently a non-executive director, were all previously employed at News Ltd in the digital division, so they know a thing or two about e-commerce.

Which brings us to a fourth reason why Temple and Webster has done so well –customer loyalty. This company is now getting Net Promoter Scores in the high 50s, which means a lot of people really like the way Adam McWhinney and his colleagues have looked after them.

The Coronavirus Crisis was a godsend for Temple and Webster. There was no shops to shut nor shop workers to stand down, and people newly working from home suddenly needed to tool up their houses with new desks and chairs which they discovered could come to them quickly and inexpensively from Temple and Webster. If revenue had fallen during the crisis, the company had $13.5m in cash to support itself, but it's revenue was up 74% year-on-year for the period from 1 January to 24 April. And Temple and Webster had been smart on its supply chain, so it wasn't excessively dependent on China or any other country for stock.

Four reasons not to buy the stock…just yet

So, what's not to like about this Australian success story? Well, we're concerned that the growth to-date has more or less been early adopters at the bottom end of the standard z-shaped customer adoption curve. Reaching and converting the more mainstream customers may be more difficult so the growth rates may slow. Secondly, Coulter and Yiu recently sold some of their stock. Thirdly, you'd want to be worried about other competitors, like Bed Bath N' Table, Adairs (see Stocks Down Under from 4 February 2020) and Sheridan, stealing a march on Temple and Webster's constituency as they go harder online.

Fourthly, and most importantly, the current valuation is now looking stretched. Currently, Temple and Webster is trading at an EV/EBITDA multiple on forecast FY21 earnings of 57x, while FY21 EBITDA growth is only expected to be around 40%. And remember, the Australian economy has taken something of a hit with this crisis we're in, so a slowdown in sales isn't off the table later in 2020 as the world returns to normal. If such a slowdown does happen, investors might be tempted to return Temple and Webster stock to the levels of mid-2018, even if the customers don't return that fancy bedbase they just bought.

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Source: Tradingview

Sometimes really good ideas get to Stocks Down Under via emails from interested investors. This one came from Brent, who lives in the New Zealand capital of Wellington. He was looking at an ASX-listed company developing an orebody we thought of as being good mainly for lead (i.e. chemical symbol Pb, atomic number 82) and wanted to know what we thought of his analysis. 'Why that company?', one of us asked when we got him on the line. 'Because I really like silver', which in this case was just the by-product.

A 16-to-1 long shot

That call to Brent got us thinking. Historically gold and silver have tended to move in lockstep, in what we call the Special Relationship. If you know your US economic history you'll recall that in the 19th century the magic number for silver was '16', that being the number of ounces of gold for every ounce of silver in the US dollar from 1834 until silver demonetised in 1873. For decades thereafter the clarion call of so-called 'bimetallists' who wanted both gold and silver in the currency, as well as silver industry lobbyists, was '16 to 1'. That led to the Special Relationship, with silver more or less keeping pace with gold after the price of the latter

decontrolled in the mid-1970s. The Special Relationship was one of the reasons why the Hunt brothers tried to corner silver in 1979. It was instrumental in taking silver from US$9 an ounce to US$45 an ounce between 2008 and 2011. And it remains an important consideration today.

Nowadays the magic number for the Special Relationship, we would argue, is '64', that being the average for the 25-year period 1991 to 2016. So when gold is US$1,000 an ounce silver should be US$15.60 an ounce. A high SR Number and silver is headed up. A low SR Number and it's headed down. However, allow a fair degree of latitude because silver, unlike gold, is an industrial metal as well as a 'physical cryptocurrency', with half of global demand related to applications like photography, solar cells and electric vehicles in addition to jewellery and silverware. You could tell that silver was headed for hard times in June 2011 because at that time the SR Number was only 30. The silver bear market ended in 2016 with the ratio back around 64. Now, in mid-2020, we're at the other extreme. On 19 June 2020, when silver closed at US$17.62 an ounce on LME, the SR Number was 98.7, which is extreme. In nearly 30 years it's never been as high as it has in the last three months.

The next Bolnisi?

Which brings us to Silver Mines, whose stock represents a good way to play the coming mean-reversion of the gold-silver ratio. Silver Mines's Executive Chairman is Anthony McClure, who understands the value of silver because he was part of the team that developed the Palmarejo silver-gold deposit in the northern Mexican state of Chihuahua for Bolnisi Gold. That former ASX-listed company got bought by America's Couer Mining (NYSE:CDE) for a cool US$930 million in 2007. Silver Mines's Bowdens Project could be a repeat performance in that Bowdens represents one of the largest undeveloped silver deposits in the world, at a JORC resource of 275 million ounces of silver equivalent. The 'equivalent' refers to the fact that there's also a lot of lead and zinc in the deposit.

Bowdens is located near Mudgee in central NSW, in a region about 270 km northwest of Sydney best known for its red wines. The June 2018 DFS for Bowdens modelled a 16 year mine producing 3.4 million ounces of silver, as well as 6,900 tonnes of zinc and 5,100 tonnes of lead. That study was a little disappointing because it calculated a post-tax NPV of only A$71m, after A$246m in capital costs, but that was done on a 0.75 AUD/USD exchange rate and an All-In Sustaining Cost of US$13 an ounce.

Sensitivity to the silver price

Silver Mines is now working on an optimisation of the DFS and is confident costs can come down significantly. It's feeling confident enough about its prospects to have filed an Environmental Impact Statement for the mine in May 2020 and raised $12m at 10 cents a share to continue development. It also continues to drill around Bowdens so there's potential for new resource development in the neighbourhood.

The thing about Bowdens is that its value on the 2018 DFS is quite sensitive to increases in commodity prices. At that time a 20% lift in silver prices yielded something like a 240% increase in NPV. If the gold-silver ratio goes back to 64 on an unchanged current gold price, silver would rise by 50% to over US$27 an ounce. That would be a golden outcome for Silver Mines shareholders.

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