30 JUNE 2020

Stocks Down Under

"The Pacific is the best toilet for satellites."

- Neil deGrasse Tyson (b. 1958), American astrophysicist, cosmologist and planetary scientist

SANTOS

Multiple upsides

ELECTRO OPTIC SYSTEMS

Off on a risky space venture

360 CAPITAL GROUP

Bigger and better, but nothing exciting

SANTOS

Multiple upsides

Stocks Down Under rating: ★★★★

ASX: STO
Share price: A$ 5.05
Market cap: A$ 10.9BN

The crash in the oil price that took place earlier this year was not great for the shareholders of Santos, the Adelaide-based oil and gas major, which in calendar 2019 produced 75.5 million barrels of oil equivalent. The oil price dip, however, was temporary. From here we expect Santos will have a lot of free cash. The company believes that it can be cash flow breakeven above US$25 a barrel, meaning that at that price operating cash flows exceeds investing cash flows. Not only that, but we believe there are some attractive core assets that can potentially deliver serious shareholder value in the future.

READ MORE

ELECTRO OPTIC SYSTEMS

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Stocks Down Under rating: ★★★

ASX: EOS
Share price: A$ 4.63
Market cap: A$ 849M

Sydney-based Electro Optic Systems (EOS) is a “traditional” defence company that is pivoting into communications, satellite communications in particular. In addition to sales of defence equipment, like weapons turrets for military vehicles, laser range finders, thermal cameras and fire control software, the company is preparing to leapfrog current satellite communications technologies through two recent acquisitions in the satellite communications space. Such big pivots are usually quite risky from an investment perspective, so let's take a closer look.

READ MORE

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ASX: TGP
Share price: A$ 0.81
Market cap: $ 193M

Based in Sydney, 360 Capital Group is a funds management group focused on both traditional and alternative asset classes. Its strategies are based on themes in the real estate, public equity, private equity and credit sectors. The recent purchase of the Ralton Asset Management platform has transformed the company into a much larger, diversified business. Following the acquisition, funds under management soared 600% to $606m and its investor base went from 3.2k to over 18k. With the shares trading below net tangible assets (NTA), management recently initiated a buyback as part of its strategy to deliver stakeholder value.

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Share price chart

Source: Tradingview

Some companies, when they make good decisions early in their lives, get to dine out on that for a long time afterwards. Santos is a classic case of what we're talking about. Way back in the early 1960s this newly formed company was kicking around in the dusty outback of South Australia about 800 km northeast of Adelaide. On New Years' Eve 1963 it discovered gas in a well called Gidgealpa 2, named after a one-horse town in the neighbourhood. A couple of years later, in March 1966, Santos hit the big time with the discovery of a major gas field nearby called Moomba. The truly magnificent gas riches of the Cooper Basin, which straddles north-eastern South Australia and southwestern Queensland, had been confirmed, and later, in 1970, came the first oil discovery in that Basin. To this day Santos continues to leverage its first-mover advantage in the Cooper as a major producer.

Saving East Coasters from freezing in the dark

A big reason to pay attention to Santos all these decades later is the likely future importance of the Cooper Basin to the economic wellbeing of Australia's populous eastern states. For some years now observers of Australia's energy markets have been worrying that in the near future there won't be enough gas available in that part of the country, thanks mainly to lower production coming out of Bass Strait combined with too much gas feeding into three new LNG plants in central Queensland where that product then leaves our shores. A crisis, maybe, for energy consumers in Sydney and Melbourne, who potentially may freeze in the dark if no-one does anything, but a big opportunity for Santos and its competitors.

The Cooper, however, isn't where the only action will be for Santos in the future. Another important theatre of operations is the Northern Territory where Santos has an LNG Plant at Wickham near Darwin fed by the offshore Bayu-Undan gas field. Late last year Santos agreed to lay out US$1.39bn to buy the stake of American major ConocoPhillips in this operation. There's plenty of known fields nearby that can feed into Wickham once Bayu-Undan is exhausted around 2022, and the location is exquisite, Darwin being only 3,350 km from Singapore. So long as Asian demand for LNG remains robust into the future there's no reason the ConocoPhillips transaction can't pay off in a big way for Santos.

The right people are still talking about P'nyang

Then there's Papua New Guinea (PNG). On 7 February 2020, when looking at Oil Search (ASX:OSH), we wrote about the potential of the PNG-LNG Project in that country to double in size once the PNG government agrees to decent fiscal terms on the P'nyang gas field. Santos is a 13.5% stakeholder in PNG-LNG as it now stands and in May of last year it paid US$270m to up its stake in the P'nyang field itself. Apparently, the relevant parties to the P'nyang discussions are still talking to each other even though formal talks were broken off in February. So, upside may be coming here for Santos as well.

Santos was well placed coming into the Annus Horribilis that has been 2020 so far. Most of its production had fixed sales prices. Its gearing was only 29% as at December 2019 and the company cut its capex budget by $550m and cut $50m in operating costs just to make sure it was okay. It still expects to be able to close the ConocoPhillips deal this year once all third party consents and regulatory approvals come through, although it may take longer than expected to get the Barossa gas field connected to Wickham because a Final Investment Decision on this field was deferred due to the Crisis.

Santos stock has been recovering with the oil price, but we think that with potential expansions on multiple fronts, there's more upside to the share price. Santos is currently trading at an EV/EBITDA multiple of 5.8x for the current financial year, which ends in December, and just 4.8x for FY21. However, EBITDA is expected to grow by 19% next year. So, on our preferred EV/EBITDA-to-EBITDA growth valuation metric, Santos looks very inexpensive to us, hence our 4-star rating.

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Share price chart

Source: Tradingview

It looks, walks and talks like a duck

Up until last October, if investors took a look at EOS, they would see a "typical" defence company, selling products and systems such as the ones we mentioned above. And with activities in Australia, Singapore, the US, Germany and the United Arab Emirates (UAE), EOS is present in all the geographies a Western defence company needs to be present in. The company generated A$166m in revenues in FY19 (through December), 95% of which was generated by the Defence segment.

Establishing itself as a space cowboy

However, in October last year, EOS acquired Brisbane-based EM Solutions, a provider of on-the-move satellite tracking terminals for wide band communications, used, amongst others, by the Australian Defence Force (ADF). The microwave communications technology used by EM Solutions is proven and widely established.

Then in January of this year, EOS announced the acquisition of Audacity Corporation, which was finalised in May. Audacity is a satellite communications company, based in the US, that owns a space station spectrum license for use of specific microwave spectrum bands for communications between satellites and ground stations.

Now, EOS has developed proprietary microwave communications technology that is actually better than the technology it acquired with EM Solutions. The company also owns an optical communications technology that uses laser light to transmit. Optical communication is seen as the next major step in space communications. So why would EOS buy two companies that use older technology? The answer is rather simple: to establish itself as a player in the traditional satellite communications space, i.e. generating profitable revenue from an established client base, and use the acquired platform to as the launch pad for its own new technology.

From Radio Frequency to optical communications in space

As mentioned above, microwaves are suitable for communications with satellites, specifically geostationary satellites, as they pass straight through the atmosphere. Microwaves are part of the radio frequency (RF) spectrum. However, the use of light waves, laser light in particular, has a number of big advantages, including a higher data rate, lower latency, higher reliability and less power consumption. Laser light can be used to communicate with satellites from earth and for intersatellite communications.

The satellite industry expects this form of optical communication to make up the vast majority of satellite communications 10 to 15 years from now. The market for satellite communications is currently worth A$100BN and is expected to grow rapidly, although existing microwave-based networks are already struggling to keep up with demand.

This is the market EOS wants to play in, but with superior technology, which should offset the immense price pressure in the industry. Because similar to the semiconductor industry, performance of satellite communications networks needs to double every 2 to 3 years, while pricing basically need to stay the same. And like the semiconductor industry, this can only be done through massive capital expenditures, in this case by establishing a constellation of satellites in Low Earth Orbit (LEO) to relay signals to and from satellites.

Betting the farm?

And this is where the risks lie. EOS estimates it will need about A$1.2BN to establish this constellation; A$300m in the next few years and A$900m from 2024 onwards. Raising this will be no mean feat for a company with a market capitalisation of about $850m. In addition to the A$128m net capital raised in April, EOS will likely need to raise additional equity as well as debt to realise its dream. The company is in discussions with industry partners for co-funding and to find ways to reduce this immense capital outlay.

EOS is not widely covered by brokers, so any data around future revenues and valuation needs to be taken with a grain of salt. Based on the little data that is available, EOS is trading on an EV/EBITDA of more than 25x for FY20 (ending in six months) and 15.7x for FY21. It drops sharply to 8.8x for FY22, because the single analyst that covers EOS expects EBITDA to jump to A$89m in that year.

From where we're sitting the risks for EOS are too high to put a 4-star rating on the company. Not only is there significant execution risk associated with the new space venture, there's a risk that the existing business may get neglected in the next few years as senior management is too busy putting satellites in orbit. And then there's the funding risk as EOS will likely need to raise more equity and a big pile of debt.

We're not saying that there is huge downside either following the big drop from $10 per share back in February. But with the high share price volatility recently and the risks we see, this stock is probably a good one for trading-oriented investors for a little while. So, 3 stars from us.

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Source: Tradingview

Versatile investment strategy

360 Capital is primarily involved in the active management of alternative investments but also manages traditional asset class funds. Its overall goal is to maximise shareholder returns by uncovering hidden opportunities across the capital markets. The group presents itself as a 'high conviction investor' who invests alongside its stakeholders and partners. Through a joint venture with Dennison Hambling it has established a series of funds and direct investment opportunities in both public and private equity.

It has investment strategies in real estate assets, public equity, private equity and credit. When it comes to real estate, it invests in both bricks and mortar as well as digital infrastructure assets. Its real estate holdings typically include apartment complexes, townhouses and childcare facilities. Since it takes both debt and equity positions it has the flexibility to capitalise on the different phases of the real estate cycle by investing in direct, indirect, debt and non-performing debt assets. It also seeks to take advantage of growth opportunities in technology infrastructure by investing in areas that support cloud computing, the Internet of Things and global connectivity. These assets include data centres, fibre optic cables and multi-tenant 5G networking poles.

The group also holds minority or controlling stakes in listed Australian shares across a range of sectors. It manages a series of funds and direct opportunities focused on small and mid-cap public companies. The 360 Capital Active Value Equity Fund emphasizes both income and growth in a value investing style. In the private equity space, the new 360 Capital Equity Fund will also focus on smaller domestic companies across different economic sectors.

Capitalising on alternative credit market growth

The alternative credit market in Australia and New Zealand is experiencing growth due to the regulatory changes and compliance remediation taking place in the traditional lending market. In response, the group will soon launch the 360 Capital Credit Income Fund designed to offer investors access to mid-market senior and junior corporate direct lending opportunities. It is a sector that has historically been serviced by traditional lenders and had limited opportunity for investor participation.

360 Capital's fixed income strategy supports companies in their growth aspirations. It seeks to preserve investor capital and deliver consistent, monthly distributions. The Credit Income Fund will be diversified by geography, maturity, industry and loan term with a focus on the lower end of the private credit risk spectrum. It is targeting a 4% annual return above the RBA cash rate and has committed to a $10m long-term co-investment.

The asset management industry is experiencing increasing demand from financial advisors for managed accounts. 360 Capital's recent purchase of Ralton Asset Management's fund management platform significantly enhanced the company's public equity and managed account capabilities. Ralton is an equity managed account specialist that offers separately managed accounts (SMAs) and individually managed accounts (IMAs) for both individual and institutional investors. The platform gives 360 Capital a more personalized, complementary offering to its public equity fund. It will enable it to build tax-effective, low-turnover portfolios for a diverse client base. Ralton's portfolios have a strong track record of outperformance and cover large and small companies as well as growth and value shares.

Increasing cash balance, new share buyback

We believe 360 Capital has a strong balance sheet that features an increasing cash balance and contains no debt. As of 31 December 2019, it had a cash balance of $96.7m representing $0.44 cash per security, which is expected to increase following the loan repayments from a childcare business.

With the shares trading at a 31% discount to net tangible assets (NTA) on 24 March, the company initiated a 20% stock buyback program. As staff and directors plan to refrain from the buyback, the insider ownership of the group is expected to increase to approximately 43% upon completion of the program.

As of 31 December 2019, 360 Capital had NTA per security of $0.90, so at the current share price the shares are trading at about a 10% discount, which is nothing to write home about. Therefore, we're neutral on the stock and give it a 3-star rating.

Pitt Street Research Pty Ltd

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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.