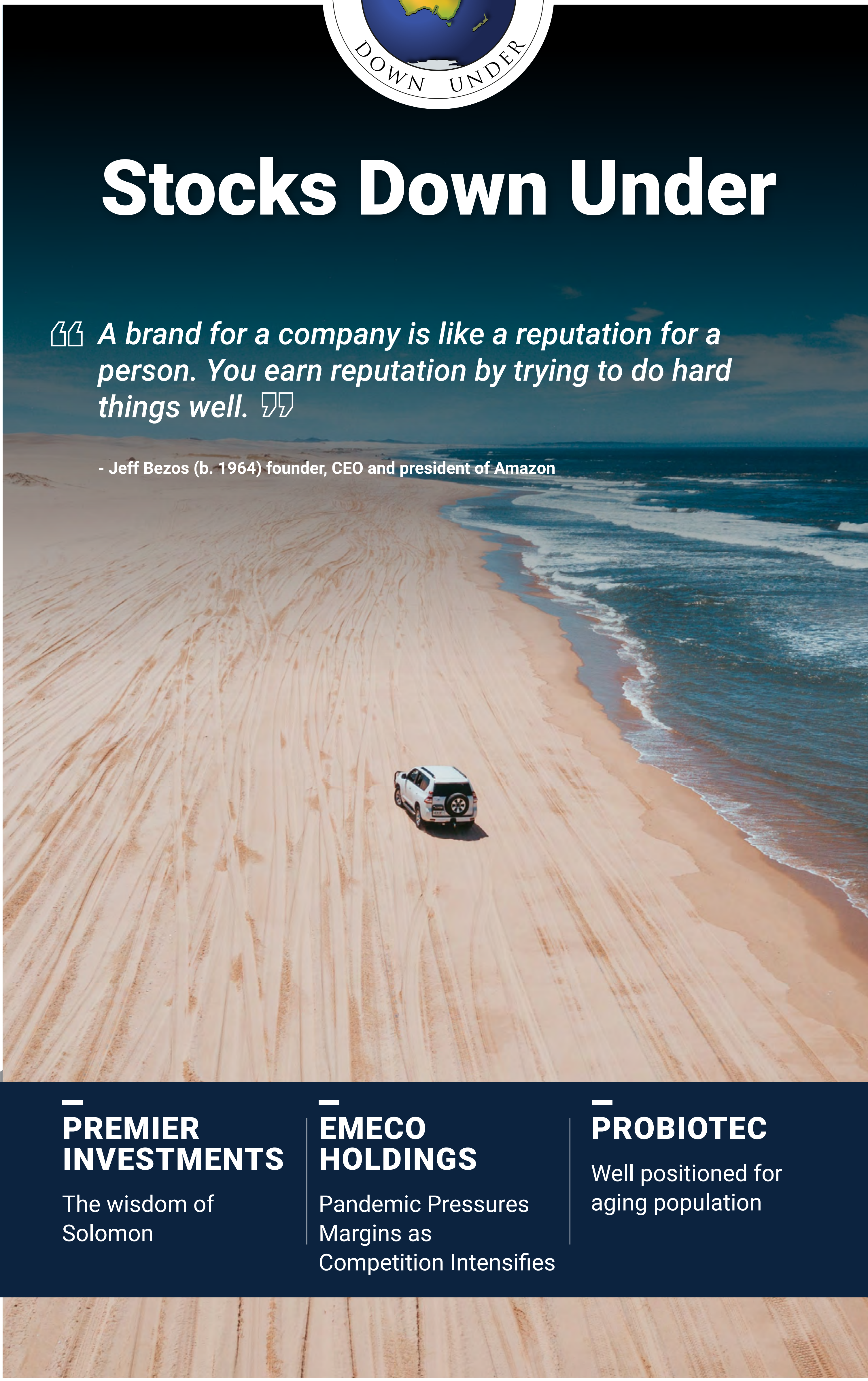
Stocks Down Under



A brand for a company is like a reputation for a person. You earn reputation by trying to do hard things well.

- Jeff Bezos (b. 1964) founder, CEO and president of Amazon

PREMIER INVESTMENTS

The wisdom of Solomon

EMECO HOLDINGS

Pandemic Pressures Margins as Competition Intensifies

PROBIOTEC

Well positioned for aging population

PREMIER INVESTMENTS

The wisdom of Solomon

Stocks Down Under rating: ★★★★

ASX: PMV
Share price: A$ 16.40
Market cap: A$ 2.6BN

Whenever the media talks about Premier Investments, the Melbourne-based owner of a number of successful retail brands, they tend to say 'Billionaire Solomon Lew's Premier Investments, reflecting the fact that the Premier Investments Chairman owns 42% of the stock. There's a reason the 75-year-old Solomon Lew is a billionaire – he has a sixth sense of what can work in retail. We think that sixth sense will stand Premier Investments in good stead as it trades out of the current Coronavirus Crisis.

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Stocks Down Under rating: ★★

ASX: EHL
Share price: A$ 1.085
Market cap: A$ 405M

Emeco Holdings is a Perth-based provider of trucks, excavators, dozers, loaders and other heavy earthmoving equipment to the domestic mining industry. The equipment is powered by big data analytics and is therefore designed to increase mine productivity and performance. The group's proprietary fleet management and mining technology platform, EOS, measures and streams real-time fleet payload performance, dig rates, operational efficiency and time utilisation data. In addition to Emeco Performance Rental, the Emeco Flexible Rental division allows companies to rent a complete fleet or just a few machines and choose between long- and short-term agreements. We chose to stay on the sidelines on this one given the impact of the COVID-19 crisis and threat of new market entrants.

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Share price chart

Source: Tradingview

One of the best ways to evaluate trends in retail is to take your family to the local shopping mall and just follow them around. If there's a particular store that a family member is beginning to favour and the store is owned by a public company, take a look at the stock. You might be on to a huge winner.

The shopping mall test, circa 2013

Yours truly should have paid attention to the shopping mall test when his daughters were aged about 6 to 8 years old, because if he had, the upside could have been huge. It was around 2013 and the girls just loved Smiggle. Yeah, we know, dumb-sounding name (as far as the grown-ups were concerned). But this small-format retailer of colourful stationery, bags, lunchboxes and drink bottles was always chock full of infant school and primary school kids, mostly squealing and female. They couldn't get enough of the stuff and their parents were happy to oblige. Smiggle was a Premier Investments chain and if you bought that stock in mid-2013 you only paid about $6.00 a share.

Smiggle came into Solomon Lew's empire right before the worst of the Global Financial Crisis in 2008, when

Premier Investments laid out a cool $800m in cash and scrip to get hold of Just Group. It took about five months of negotiation before a deal could be reached that would give Premier control of Just Jeans. Solomon Lew et. al. now also owned Jay Jays (grungy teenage 'fashion' for both sexes), Peter Alexander (trendy pyjamas – yes, that's a real business) and Portmans, Jacqui E and Dotti (ladies' fashion). However, at the time no one who claimed to know retail cared all that much that they now owned Smiggle.

Who was smart and who was dumb in 2008?

At its 2004 re-listing Just Group had been valued at A$573m, making a fortune for the private equity group Catalyst Investment Managers, who had paid just $125m back in 2001. For a while Premier Investments and Solomon Lew at their $800m valuation must have looked a little silly to the uninitiated, as the chains struggled through the GFC and into the uncertain environment which has been Australia retail since that time. But not for long. By 2012 the Just Group was starting to yield the kind of promise Solomon Lew had foreseen. For the next seven and a half years, right up to the current crisis, its stock returned 23% p.a. excluding dividends while the S&P/ASX200 managed just 8%.

Well, all the chains have adapted to contemporary retail trends and done well, particularly Peter Alexander, probably the only name in sleepwear in Australia and New Zealand. But most of the wealth Premier has created since 2012 can be chalked up to Smiggle. Back in 2008 Smiggle was only about five years old and Just Group had bought it for $29m the previous year on the promise of roughly 30 stores doing $11m in turnover annually. The chain of only 30 stores enjoyed sales of $11m but it was growing strongly, for reasons your editor's daughters could explain a few years later even if they didn't have MBAs.

Smiggling around the world

Now fast forward to the present. In the year to July 2019 Smiggle did $307m in revenue (around a quarter of Premier Investment's total) from 352 stores globally. And with Premier stepping on the growth accelerator from September 2018, it was expected that it could to get $450m sometime in 2022, that is until COVID-19 hit. The brand had been doing nicely and it has transitioned seamlessly into the online space. Which makes sense since you may have noticed how comfortable kids are with the Internet these days.

How did Premier Investments know this gold mine was about to get discovered? Well, Solomon Lew, current net worth US$1.5bn according to Forbes, is hands down the smartest name in retailing in Australia. He tends to know what can work before the rest of us figure that out. Attribute that skill not just to the smart and talented people he has around him, most notably Executive Director Mark McInnes, but also to the fact that he didn't get into bricks and mortar retailing until the late 1970s. For a decade and a half before that with his original business, Voyager Solo, he was a supplier of fashion garments to the stores where the difference between success and failure was understanding changes in consumer taste.

This stock remains 'on sale'

In FY19 Premier's retail revenue was $1.27bn and EBIT $167m. That'll be a lot less in FY20 because of Premier's decision to temporarily shutter its stores in late March as a result of Covid-19 and then not pay rent at all, or pay a lot less. The company was only carrying $101.6m in debt going into this crisis so it'll be fine financially. However, some think the 'nuclear option' on rent might have longer-term repercussions in terms of site availability in the future, which may be why Premier Investments stock has regained only about half of what it lost after the February sell-off. However, we believe the size of the chain and the appeal of the brands can mitigate this risk, at least partially.

Currently you can get Premier Investments for an EV/EBITDA multiple of 8.2x forecast FY21 earnings and 7.5x FY22 earnings. Given the projected EBITDA growth in both years of ~10% and given how Smiggle is taking the world by storm, that looks inexpensive in our book. But if you're disinclined to believed us, just ask your seven-year-old daughter what she thinks.

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Share price chart

Source: Tradingview

Lower fleet utilisation weighs on performance

As Australia's largest pure play mining equipment rental and service provider, Emeco has felt the effects of the COVID-19 crisis. With operations in all the country's key mining regions and exposure to several commodities including coal, gold and iron ore, the broad slowdown in mining activity has led to reduced near-term demand for equipment rental and maintenance.

As the mining industry experiences a cautious return to normalcy, lower fleet utilisation rates have impacted near-term profitability. In 1HY20, the gross fleet utilization was 91% compared to an industry-wide equipment utilisation rate of 95% for all of calendar 2019. While fleet utilisation has remained stable since FY18 when it was 90%, it has declined in recent months with many mining companies suspending or limited operations. EBITDA margins improved to 48.3% in 1HY20. The return on capital (ROC) was at record interim high of 20.6%, but slipped from 21% in FY19. Both key performance metrics have since been hurting with fleet utilisation down.

Pit N Portal acquisition brings diversification, integration risk

Emeco's total fleet was boosted by 123 pieces of equipment following the acquisition of Pit N Portal announced on 29 January 2020. It bought the underground rental company to enhance its fleet and diversify revenues away from the open cut rental business, which now represents around 70% of revenue. The group's exposure to gold mining instantly more than doubled to 27%. The addition marks the company's first entry into the hard-rock underground equipment and mining services market. Aside from a significantly altered commodity profile (at a time when gold prices are at multiyear highs), Emeco faces the challenge of integrating the unique Pit N Portal business. For instance, Pit N Portal's tele-remote controlled and auto-guidance equipment is similar to that of Emeco but uses its own technology. Integrating this technology into Emeco's own platform may prove more time consuming and costly than expected.

Meanwhile the group faces another challenge in the form of potential new entrants in the heavy equipment hire market. With the mining market expected to experience robust growth as economic conditions normalize, the rental business has piqued the interest of some new players. Aside from having to compete with a couple of larger players, Emeco will also have to deal with emergence of new market entrants over the next couple years. This means is may need to compete on price to further differentiate itself from the upstarts putting added pressure on margins. It also has the potential to cause a repeat of the 2010 to 2013 period when mining companies invested large amounts of capital and a large influx of equipment caused oversupply conditions. Today's environment is far closer to a shortage than an excess of equipment. However, the ability of the market to absorb the potential extra supply is unknown. And while Emeco has done its part to consolidate the mining equipment industry with five recent acquisitions, it remains a fragmented and competitive market with a relatively low barriers to entry.

High replacement cost may lead to hefty capex

Emeco's fleet has a good amount of life remaining with its equipment having logged about half the work hours of the industry average. While the company may not have any large capital expenditures in the near-term, it will at some point face a heavy dose of capital expenditure. The high $2bn replacement value of the group's fleet means a significant capex bill looms large. Just how much growth and profits it can haul in between now and then is uncertain. As such it may not be worth jumping into the stock at this stage knowing a major capex spend is on the horizon.

The balance sheet has shown declining leverage as acquisitions have been equity financed. As of 31 December, leverage was down to 1.8x, but still rather high and well off management's target of 1x. If the mining industry were to experience an unexpected downturn, the group's balance sheet weakness may be exposed. Current debt levels are manageable and liquidity is sufficient, but a cyclical downturn may necessitate tapping into credit facilities and taking on more debt to sustain operations.

At 3.6x and 3.5x EV/EBITDA for FY21 and FY22 respectively, Emeco doesn't look expensive. However, EBITDA-growth is only expected to be 3% in FY21 while FY22 is looking better at 7.5% expected EBITDA-growth. But that's more than a year away. All the more reason not to rush into this stock, in our view.

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Share price chart

Source: Tradingview

Acquisitions complement strong growth history

Over the past four years Probiotec has posted an annualized sales growth rate of 68%. The strong sales and profit growth continued in 1HY20. Revenue was up 34% to $44.1m, EBITDA increased 68% to $6.2m and NPAT was 85% higher to $2.4m. And since the group's performance is seasonally skewed to the second half due to demand for cold and flu products, higher revenue is expected in 2HY20. It recently won a major new packing contract from a leading Australian health company, which is expected to further support increased back half volumes. Management has forecast FY20 revenue growth of 26% to at least $100m and EBITDA of $16m to $17m.

To complement the solid organic growth, the company has made a series of strategic acquisitions in recent years. On 31 July 2019 it completed the acquisition of pharmaceutical and consumer contract packer Australian Blister Sealing (ABS) to strengthen its contract packing portfolio. The deal was funded through a combination of cash and debt and has been earnings accretive from the start. ABS accounted for 27% of 1HY20 earnings and represents a major opportunity for the group to leverage new and existing customer relationships.

In December 2019, it acquired the business assets of high-end pharmaceutical contract packer CPSA for approximately $4.5m. These assets included plant and equipment as well as major customer contracts. They are expected to generate around $2.0 to $2.5m in EBITDA once they are transitioned into Probiotec facilities in FY21. The group has demonstrated an ability to successfully integrate accretive buyouts and this bodes well for potential future acquisitions.

Aging population and local supplier preference support growth

The outlook for the Australian health supplements and pharmaceuticals market is bright. The demographic trends related to an aging population should be supportive of demand for health-related products for many years to come. Probiotec is in a good position to capitalise on this long-term opportunity given its increased capacity stemming from recent investments and acquisitions.

The group is also seeing a growing industry preference for pharmaceutical companies to source domestic requirements from local Australian suppliers. It is constructing a new state-of-the-art warehousing facility to help meet the expected higher demand and to generate improved operational efficiencies and cost savings. The recently completed 85 Cherry Lane Development is also delivering cost savings largely due to its proximity to the company's existing facility. Both this development and the new warehouse should see reduced inventory and lead times and reduced freight and supply chain costs amounting to significant cost savings in the years ahead.

Contract length provides strong revenue visibility

Probiotec 's heavily contracted customer base provides strong revenue visibility. It has a weighted average remaining contract term of over 2.5 years. It also has a strong historical contract roll-over rate and has not suffered any major contract losses over the last five years. The contracts for its key customers range from 3 to 5 years in length and most include exclusivity on the manufactured products. Probiotec also holds the intellectual property (IP) for a significant portion of its overall sales.

The group raised $10m in capital in 1HY20 and although part of this was used to acquire the CPSA assets, it has a strong capital position. This was supported by the company's October 2019 sale of Celebrity Slim to Victoria-based beauty business Global Brands Australia for $6.75m in cash. The weight loss program divesture has allowed the company to focus on its core business and the integration of ABS. Probiotec 's financial health should also be strengthened by a decline in capital expenditures over the next few years with no major growth projects currently planned.

The shares are trading at an EV/EBITDA of 9.4x for FY21 and 7.8x for FY22. We believe this offers great value given Probiotec's projected EBITDA-growth of 14% and 20% in both years.

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.