5 JUNE 2020

Stocks Down Under

> *Not all readers are leaders, but all leaders are readers.*
>
> - Harry S. Truman (1884-1972), 33rd US President

JB HI-FI

Too much growth now means less later on

AFT PHARMACEUTICALS

The house of pain relief

GEOPACIFIC RESOURCES

1.6 million ounces of gold just waiting to be produced

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Stocks Down Under rating: ★★

ASX: JBH
Share price: A$ 40.29
Market cap: A$ 4.6BN

The Coronavirus Crisis was hard on the shareholders of the Melbourne-based retailer JB Hi-Fi. The stock crashed 47%, from $44.71 per share on 10 February to only $23.50 on 25 March. And then, just as suddenly, came the rebound, to the point where we think JB Hi Fi is overvalued. JB Hi Fi has traded well through this crisis, but we believe there's not likely to be enough earnings growth for the next two years to justify the current valuation.

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Stocks Down Under rating: ★★★★

ASX: AFP
Share price: A$ 4.40
Market cap: A$ 462M

AFT Pharmaceuticals is the Auckland-based company that brought you Maxigesic, an over-the-counter painkiller, which is a combination paracetamol and ibuprofen. AFT's stock went sideways from its March 2016 listing on both ASX and NZX until April 2019. Since then it's re-rated quite nicely, to the point where the Coronavirus Crisis hardly mattered. We think there's more upside to come.

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Share price chart

Source: Tradingview

In February 2020 JB Hi-Fi surprised the market with another good result. The owner of the iconic home entertainment retailer JB Hi-Fi and the electrical and home appliances retailer The Good Guys, grew revenue in the six months to December 2019 by 4% and EBIT by 8%. There were only another three JB Hi-Fi stores in the chain compared to the December 2018 half and exactly the same number of stores in The Good Guys chain, so the growth was almost purely organic. The reason the growth caught most investors by surprise was the widespread assumption, among observers of the Australian retail landscape, that chains like JB Hi-Fi and The Good Guys can't compete in the 2020 online world. Well, it turns out they can.

Good vibrations

Why in 2020 do people still shop for home entertainment products at JB Hi-Fi when they easily can get them online? Well, the JB Hi-Fi stores are always at the best, easy-to-get-to locations. They stock the best brands at the lowest prices. And when you need customer service you get friendly help from a knowledgeable team member who can often do you a better deal than the sticker price. For many that beats online any time. Plus – and we think this is important - the place looks and feels low-rent, but in a neat and orderly way, so you aren't overpowered by the sense that you're paying for snooty store ambiance.

The Good Guys succeeds for similar reasons. Prior to JB Hi-Fi's A$870m acquisition in 2016, this business spent years promoting the sense that it is a friendly and approachable place to look for competitively priced electrical appliances. Even as we write these words the now redundant jingle of 'Come in and see the Good Good Good Guys / Pay cash and we'll slash the prices', sung to the tune of the Beach Boys' 1966 hit Good Vibrations, comes into the head of this writer, pounded in there by years of highly effective television and radio propaganda.

Great business but a little expensive

The naysayers think this highly effective market positioning doesn't count in an era of online selling. We think it does. The Coronavirus Crisis proved it. Indeed, the company didn't need its healthy balance sheet (gearing at only 0.7% at December 2019) to survive the crisis because, as people rushed the stores looking for products that would help them both work at home and relax at home during the lockdown, they drove same-store sales growth in the March quarter to a massive 11.3%.

So why be negative on JB Hi-Fi now? Well, for a start, the stock is looking expensive after the sharp post-March re-rating. EV/EBITDA is now 9.2x forecast FY21 EBITDA, which is high when EBITDA growth is expected to decline by 6% in that year, according to average analyst estimates.

One can make the case that the company's growth was crammed into the Coronavirus Crisis months and an easing off will inevitably follow. Also, the consensus estimates suggest that in FY22 EBITDA may recover by about 5%, but that's more than 12 months away. So it's worthwhile being cautious, in our view. After all, unemployment right now is at levels not seen since the call to action at the Good Guys was to pay cash.

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Source: Tradingview

AFT Pharmaceuticals has gone from strength to strength business-wise over the last four years. When the company went public, revenue from Maxigesic and other products was NZ$64m and the company's loss in the year to March 2016 was NZ$9m. Four years later, in 2019/20, revenue has grown to NZ$106m and the company is NZ$12m in the black at the NPAT line.

Doing what GSK and Reckitt couldn't

For observers of the OTC medicine space, that growth by a relatively unknown company from New Zealand has probably come as something of a surprise, with the general consensus being that two giants - GlaxoSmithKline with Panadol (paracetamol) and Reckitt Benckiser with Nurofen (ibuprofen) - had the global market more or less sewn up. Well, little AFT has shown them. Maxigesic now has distributors and is selling in dozens of countries around the world. The product is getting decent shelf space in pharmacies wherever it goes because the Kiwi company was the first to put the two raw ingredients together and show that it could engineer fast and rapid pain relief.

What we like about AFT is that this company was built from scratch by the pharmacologist Dr. Hartley Atkinson and his wife Maree, who retain 70% of the stock and remain actively involved in the business. Back in 1997 Hartley was let go from his job at the New Zealand subsidiary of the Swiss pharmaceutical company Roche. Instead of panicking, Hartley went into his garage in the northern Auckland suburb of Takapuna and drew up a business plan in which the company would import and distribute medicines on the New Zealand market, and then develop its own products. The first product that it developed and patented was Maxigesic. Hartley figured the OTC pain medicine market was due for disruption and reckoned his was the product to do it. Two decades later that dream has been achieved.

A future, fully-integrated pharma company

By March 2020 Maxigesic was selling in 28 countries with more to come as distributors add the product to their shelves. How many more? There are out-licensing agreements in 125 countries across the globe that are expected to execute between now and this time in 2022.

A lot of AFT revenue still comes from distributing other company's drugs, mainly in Australia and New Zealand, but increasingly globally, and Maxigesic is becoming more important to the bottom line. Down the track we expect that AFT will ultimately evolve into a fully-integrated pharmaceutical and medical device company, taking advantage of the fact that all the talent you need to build a company like that is available in New Zealand. And the company increasingly has product development smarts in-house.

One issue many investors have had with AFT is the fact that the company is carrying about NZ$41m in debt, which was assumed several years ago in order to fund the global roll-out of Maxigesic. Since the 2016 IPO, investors thought that was risky given the relatively untried nature of the product. In 2020, we believe that debt looks very manageable.

The Next Big Things are in the hopper

Coming down the pike are two potential Next Big Things for AFT. The first is Pascomer, a topical treatment for two rare skin conditions, which is based on the antibiotic rapamycin. As an Orphan Drug we expect big things from Pascomer but the product's commercialisation has been delayed by Covid-19, which temporarily disrupted the clinical trials, which can lead to its first approval.

The second Next Big Thing is NasoSURF, a hand-held nebuliser for the intranasal delivery of medication, which represents a big leap over what's currently available. AFT has told the market that it expects to have its first product available for clinical testing in a few months' time.

If you look at AFT on expected earnings for the current March 2021 year it's not cheap, with an EV/EBITDA multiple of 23.6x. However, as Maxigesic delivers in the 2021/22 year that multiple drops to 17.2x. We believe this is very cheap given the projected EBITDA growth of 74% and 38% for both years.

And after that Pascomer and NasoSURF could deliver considerable shareholder value depending on how well AFT executes the needed clinical work. On the strength of this one we think there's upside in this innovative Kiwi company. Indeed, we think that before Hartley and his team are done, AFT may have grown into a billion dollar company. Four Stars from us.

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Share price chart

Source: Tradingview

The trouble with investors is that they tend to get impatient. In July 2016 Geopacific announced the acquisition of the project that will likely become its 'company maker', a gold deposit on an island belonging to Papua New Guinea (PNG) called Woodlark. About $150m had been spent on this project up to that time, a lot of that by the vendor, another ASX-listed company called Kula Gold. The yellow metal was weak at the time, so Geopacific got to farm in for 75% of the 2.1 million ounces that had been identified for just $19m or so, in three easy tranches. That was $19m in exploration expenditure, not payments to Kula. At the time you could buy Geopacific for $1.02 a share.

Now fast forward to November 2018. The Woodlark resource was slightly lower, at 1.57 million ounces, thanks to a conversion from JORC 2004 to 2012, but Geopacific now owned 93% of it thanks to an almost-completed merger with Kula Gold, ahead of the remainder being acquired early last year. In November 2018 a Definitive Feasibility Study had shown that A$202m would bring into production a mine with a post-tax NPV, at an 8% discount rate, of $197m. With a low waste-to-ore ratio and near surface mineralisation, the first five years of that mine would be particularly good years, averaging 100,000 ounces p.a. at an All-In Sustaining Cost of only about A$866 per ounce. Life of mine AISC for all 967,000 ounces to be produced would be A$1033. The market, however, wasn't as impressed as it was two years previous. Now Geopacific stock was only worth 60 cents.

Gold just keeps getting better

The reason Geopacific stock was so weak in the second half of 2019 was that the company chose to raise $40m in order to fund the early development work at Woodlark ahead of the main project financing. That deal got done at 62.5 cents and the market had only just finished absorbing the new stock when the Corona Crash set in. The fact that gold is now a lot higher than the US$1,235 per ounce level of November 2018 has since prompted a post-Crash re-rating. The DFS was done at A$1,650 an ounce. Pre-tax that made Woodlark worth A$251m. At A$2,000 for gold that pre-tax value expands to A$474m. Gold is now A$2,550.

Woodlark Island, population 6,000, is a long way from the Big Smoke. The island, part of PNG's Milne Bay Province, is about 600 kilometres east of Port Moresby, so it's fair to say that it is a little challenging in a logistics sense to get this mine up and running. That said, the proposed flow sheet for Woodlark involves just a conventional carbon-in-leach plant and the ore is free milling, meaning you don't have to use lots of chemicals to process it. And Woodlark won't be the first time a gold mine started up on a remote island – just think of the Lihir mine of Newcrest (ASX: NCM) and the Simberi mine of St Barbara (ASX: SBM), both around 900 km from Port Moresby.

Risk? Nothing Geopacific can't handle

Another issue investors may have with Geopacific is sovereign risk. The inability of the PNG-LNG owners to reach fiscal terms with the government of Prime Minister James Marape regarding the inclusion of the P'nyang gas field this year has people worried about how mining friendly PNG really is. It's true that PNG is slipping in terms of attractiveness to mining companies, as the Fraser Institute's 2019 survey makes clear. However, the rules for gold miners, including the 2.25% royalty, are still fairly straightforward. So we're not greatly concerned about that either.

Geopacific is now seeking project financing for Woodlark while it completes the early work on mine site preparation, some of which has been delayed due to COVID-19. Currently gold is around US$1,700 an ounce which, as we noted above, translates to A$2,550, so the margins for this mine are now looking pretty good. But the equity market is pricing Geopacific stock as if this mine will never get up, with the enterprise value (EV) of the company being only $48m – i.e. the market capitalisation of $83m less $35m in cash as at March 2020. That's an EV per resource ounce of only $30, which we believe is a small price to pay for a mine this close to payday.

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.