9 JUNE 2020

Stocks Down Under

If your ship doesn't come in, swim out to meet it!

- Jonathan Winters (1925-2013), American comedian

HARVEY NORMAN

It's not McDonalds

GENETIC SIGNATURES

COVID FOMO has driven the stock price too high

SOUTHERN CROSS ELECTRICAL ENGINEERING

Will work dry up post-COVID-19?

HARVEY NORMAN

It's not McDonalds

Stocks Down Under rating: ★★

ASX: HVN
Share price: A$ 3.59
Market cap: A$ 4.6BN

During the Coronavirus Crisis the stock of the Sydney-based Harvey Norman crashed harder than the general market and in the recovery it has lagged. We believe that Harvey Norman's better days as retailer of furniture, beds, lounges, TVs and computers are behind it. The format still has some life in it, but over time we believe more nimble competitors will overtake it. This crisis may be their gain and Harvey Norman's loss.

READ MORE

GENETIC SIGNATURES

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ASX: GSS
Share price: A$ 2.21
Market cap: A$ 322M

Sydney-based micro-cap Genetic Signatures is a molecular diagnostic (MDx) company that develops diagnostics for various infectious diseases. It makes its testing kits available to hospitals and private pathology laboratories, so they are equipped with the necessary molecular tools to screen for a broad range of infectious pathogens with a high degree of specificity. With the company turning its attention towards COVID-19 testing, the shares have become a pandemic play and are trading around an all-time high. While the group's advantageous technology and market opportunities in all disease categories are major positives, we prefer a lower entry point.

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Share price: A$ 0.46
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Southern Cross Electrical Engineering is a Perth-based electrical services company that has historically served Australia's mining industry. Over the past few years, it has become a more diversified national group operating in a range of sectors, including Resources, Commercial, Public infrastructure, Defence, Telecommunications, Industrial, Energy and Utilities. The shares are down around 18.5% year-to-date and may continue to struggle as the Australian economy regains its footing and construction projects slowly come back online. The longer-term outlook is also uncertain amid questions around government infrastructure and capital spending.

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Share price chart

Source: Tradingview

If there's one businessman that Australians genuinely love, its Gerry Harvey. Together with the late Ian Norman (1939-2014) he first wowed us in the 1960s with a discount home electronics and appliance retailer called Norman Ross. We love Gerry's history of thumbing his nose at convention and rules, most notably in 1978 when Norman Ross defied NSW government regulations and opened on Saturday afternoon and Sunday, forcing a change in the law.

And we love the story of how Norman Ross was sold in 1982 and subsequently died, while Harvey and Norman simply started up again with the current incarnation of their approach to retailing. However, that was then and this is now. In mid-2020 the outspoken and racehorse-owning billionaire is 80 years old and you no longer need superstores and prime-time TV ads to move vacuum cleaners and refrigerators.

Why we didn't go to Gerry

In the six months to December 2019 Harvey Norman's revenue from both its own operations and franchises grew only 1.9%, to $4.1bn, while underlying NPAT only went up 3% to $203m. Part of that quietness at the stores had to do with the bushfires Australia was being ravaged by in late 2019; the good old days when that was all the country had to worry about. However, we also think it's because history is beginning to pass Harvey Norman by. Let us give you a good example. Just before the crisis, one of our editors moved into his new apartment. He didn't have a refrigerator or a washing machine for the property. Back in the day, he would have headed down to Harvey Norman to check out what was on offer. This time he simply went to appliancesonline.com.au and placed the order. The products arrived the next day.

The reason Harvey Norman still gets traffic these days is the years of relentless ad campaigns telling you about how long the products are interest free if you buy now, after which some high-pitched female singers deliver the meaningless jingle 'Go Harvey Norman, Go'. We suspect the size of the ad campaigns has had to increase over time from this statement in the December 2019 results presentation: 'Revenue from franchisees decreased…due to a reduction in franchise fees received from franchisees, coupled with a rise in tactical support to promote and protect the brand'. The tactical support wouldn't be necessary if the brand was strong. In other words, the traffic isn't quality traffic. Interestingly, the presentation doesn't mention the word 'online' once! That should be very alarming to investors, in our view.

Would you like fries with that Coronavirus-free mattress, Sir?

Which brings us to another weakness in the Harvey Norman story – that it relies on franchisees for its growth. A lot of what you buy at Harvey Norman isn't bought from Gerry & Co., it's bought from an independent businessman who bought the franchise rights from Gerry. As at December 2019 there were 544 franchisees within Harvey Norman, meaning independent businesses operating within Harvey Norman stores. Like the franchisee in Albury, NSW who put that controversial sign out the front of the store in February that read 'No Coronavirus in our mattresses, as ours are Australian made'.

Now, franchising is a smart way to grow a business, as McDonald's brain-of-the-operation Ray Kroc taught us long ago. But the difference between McDonalds and Harvey Norman is this – you can only get a Big Mac at McDonalds. You can get a Samsung appliance virtually anywhere. That tactical support the Harvey Norman franchisees need is only likely to become bigger over time.

Now, don't get us wrong – Harvey Norman can still grow. The brand remains viable and the recent arrival of the name in Malaysia shows the Harvey Norman Way can still work in certain markets. And the stores stayed open in Australia through the crisis. We just don't think Harvey Norman will grow as strongly as many expect in the next few reporting seasons.

At the moment Harvey Norman is on a P/E of forecast FY21 earnings of only 12.7x. That comes down to 10.7x by FY23. However, that's with EPS expected to rise from only 24 cents in FY21 to 28 cents by FY23. The suggested jump takes place in FY22. If business is good by that time and the stock is still at a P/E of 13 it might be worth looking at. In the meantime, only Two Stars from us.

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Source: Tradingview

Technology simplifies genomes for microbial detection

Genetic Signatures, founded in 2001 by the late Dr. Geoffrey Grigg, makes pathogen detection kits under the EasyScreen brand. The kits are based on the company's proprietary 3base Multiplex technology, which simplifies genetic code from the traditional, naturally occurring 4base sequence through a chemical conversion process. Microbial DNA is treated with sodium bisulphite to reduce four nucleic bases to three. This 3base process doubles the amount of genetic information that can be obtained from each organism because two strands of nucleic acid are no longer complementary. Importantly, the technology is compatible with non-molecular labs because it uses a universal extraction for all sample types (viral, bacterial or protozoan).

The group offers a suite of real-time data products that enable the routine detection of over 100 pathogens including enteric, respiratory, antimicrobial resistance, sexual health, tropical diseases and viral meningitis. The competitive advantage of the EasyScreen kits is their ability to detect more pathogen targets in less time compared to conventional methods. Its proven technology has been third-party validated and clinical data on its effectiveness in several pathogens sets it apart from competitors.

COVID-19 pandemic leads to global expansion opportunities

The COVID-19 crisis has put a spotlight on the need for fast, effective diagnostic solutions worldwide. As more countries move towards re-opening, demand for reliable testing is sure to soar. Through 24 May, nearly 1 million COVID-19 tests had been conducted in the APAC region almost two-thirds of which were in New South Wales and Victoria. With the firm backing of the Australian government in the form of a Medicare-funded $170m testing program, the tests have only just begun. In the United States, over 1m tests are being delivered weekly and there is a need for this figure to increase dramatically for the safe reopening of the economy.

Genetic Signatures has been the subject of several recent newspaper articles due to the early success of its COVID-19 diagnostic. On 28 April it was highlighted in a Sydney Morning Herald article that focused on the importance of nationwide COVID-19 screening. A few days later, it was back in the same publication for a discussion with CEO Dr. John Melki on how the 3base technology is being used to quickly diagnose COVID-19 patients.

Once the DNA sequence for COVID-19 became available to the medical community in mid-January, Genetic Signatures went to work adapting its technology to diagnose the novel coronavirus. Soon thereafter it announced that the EasyScreen respiratory pathogen targets included an assay for all known coronaviruses including ARS-CoV-2. The kits have been approved for sale in Australia and Europe and clearance for U.S. Food & Drug Administration (FDA) emergency use is expected in the coming weeks. With a COVID-19 vaccine likely to still be some time away, accurate COVID-19 testing tools will remain on the front lines for some time. With the ability to test up to 1,500 samples in 24 hours, Genetic Signatures should play an important role.

Infectious disease threat creates huge global market

As a wide variety of infectious diseases continue to threaten global health, the outlook for growth in the molecular diagnostics market is favourable. Prior to the Coronavirus outbreak, the World Health Organization's 2019 list of the planet's biggest health threats included several infectious diseases -- global influenza, antimicrobial resistance, Ebola, dengue, HIV and vaccine hesitancy. Genetic Signatures' ability to process rapid results in as little as four hours puts in an advantageous position to gain market share.

In combining the various infectious disease categories, the group's addressable market is undeniably large. The global STI/genital market is estimated to be $1.9bn. The respiratory market is $627m and that does not even include COVID-19. The $573m global enteric market represents another large opportunity.

While Genetic Signatures has multiple growth opportunities ahead, the expanding COVID-19 testing market will be the group's near-term performance driver. As other areas that have been put on hold come back under development, well-diversified revenue growth should be sustainable.

However, we believe the share price has gotten way ahead of itself in recent months, driven by COVID-19 FOMO (Fear Of Missing Out). At an EV/Revenue multiple of 11.4x for FY21, which starts next month, we have no choice but to put a 2-star rating on Genetic Signatures while we wait for a better entry point.

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Share price chart

Source: Tradingview

Cautious stance reflects post-COVID-19 uncertainty

Southern Cross supplies electrical, communication, instrumentation and maintenance services for major resource, infrastructure, commercial and other projects. Its capabilities are categorised into three segments -- E&I Construction, E&I Services and Maintenance and Communications. E&I Construction designs and delivers medium to high voltage electrical systems while E&I Services and Maintenance offers multi-disciplined support for its clients' operating assets. The Communications division, a capability enhanced after the 2016 acquisition of Datatel, provides electrical data and communication solutions, while the 2017 combination with Heyday5 has given it access to the growing East Coast commercial market. Southern Cross provides support throughout the lives of its customers assets from design and construction to production and decommissioning. It works alongside some of the country's largest contractors on a variety of public and privately funded infrastructure projects.

In FY19, revenue advanced 11% to a record $386m, EBITDA increased 13% to $23.6m and NPAT was up 51% to $12.7m. The full year revenue result fell short of management's forecast of over $400m due to the earlier than expected demobilisation of the Westconnex M4 project. Nevertheless, gross margins expanded from

11.9% to 12.3%. Aside from the top line performance, profitability was aided by lower amortisation of acquired customer contract intangibles. It recently recorded record half year revenue of $230.3m which was up 27% over the interim period last year. EBITDA increased 21% to $10.9m and NPAT was 24% higher to $5.5m led by continued growth in infrastructure and commercial.

Despite the pressures caused by the COVID-19 crisis, management has noted that it is on track to exceed its FY20 revenue forecast of at least $420m as it expects stronger 2H profitability. Construction work was designated an essential service from the start and the group's operations have largely moved forward as planned. While some projects have been delayed, none have been cancelled. A variety of safety measures have been put in place including social distancing and screening procedures and while management has acknowledged some loss of productivity the net impact is expected to be immaterial. Despite early concerns over supply chain disruption, Southern Cross has been able to procure materials as needed. Travel restrictions did have some initial impact on access to remote projects but have been managed by roster changes. While the company expects the pandemic to have little financial impact, it has implemented cost control measures and delayed some investment spending to preserve cash.

Can the new contract wins continue?

Southern Cross has been active on the new business front. In February 2020, it was awarded a contract valued at more than $18m for relocation works at the refinery site of Rio Tinto's Gove Peninsula in North East Arnhem Land in the Northern Territory. The project will involve the isolation and re-routing of electrical and hydraulic services to the refinery and is scheduled to be completed by March 2021. The following month it was awarded a $40m contract to provide electrical services at Sydney Metro's Pitt Street Station marking the company's first award on Australia's largest public transport project.

The Heyday5 subsidiary has secured a series of new contracts in recent months. This has included an agreement with Buildcorp Group for the electrical services at the 44 Martin Place redevelopment project, a contract with Richard Crookes Constructions at the 6 Hassall Street business and education hub, a deal with J. Hutchinson at the Whitton Lane development and a contract with Scentre Design and Construction for the Myer backfill project. The contract wins continued 20 May when the group announced a five-year $40m services deal with Energy Queensland for asset inspection and maintenance services on their network in the Northern Region of Queensland.

While the company has a healthy order book of $440m and an opportunity pipeline of more than $2.7bn, the big unknown is whether the well will soon run dry. Work may indeed be hard to come by in the challenging post-COVID-19 environment. While Southern Cross has yet to see any major changes to its business development pipeline, the company does foresee an impact to construction activity in the sectors that have been hit hardest. The ability of stimulus programs and private infrastructure investment to offset a potential decline in business activity will be paramount to the group's near-term performance.

Strong balance sheet a foundation for diversified growth

Southern Cross has a maintained high-quality balance sheet that includes a $53.3m cash balance and no debt. Capital expenditures totalled $2.1m in FY19 and are expected to stay at a low level in FY20.

It has been focused on diversifying its business and has found success the last couple years. The Public infrastructure and defence sectors now comprise the largest portion of revenue, while the legacy Resources business has experienced revenue declines and became the third largest revenue contributor. The strong order book and financial health put the company in a favourable position to execute on its diversified growth strategy.

While much uncertainty remains in the post-COVID-19 period, at an EV/Revenue of 0.13x, a P/E of 7.2x and an EV/EBITDA of 2.2x for FY21, we believe Southern Cross' is a company for value investors. So, 4 stars from us based on valuation.

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.