11 JUNE 2020

Stocks Down Under

Milk is for babies. When you grow up you have to drink beer.

- Arnold Schwarzenegger (b. 1947) Austrian-American actor and former politician

UNITED MALT

Crafting a growth strategy

GTN LTD

Extremely cheap for the growth you're getting

SCIDEV

Contract wins flowing in

UNITED MALT

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Stocks Down Under rating: ★★★★

ASX: UMG
Share price: A$ 4.63
Market cap: A$ 1.4BN

The timing couldn't have been worse, but that just meant more upside for new investors. Back in April 2019, GrainCorp (ASX: GNC), the grain trading company, had announced that it was spinning out its malt business, but the demerger wasn't completed until March 2020 at the bottom of the Corona Crash. No sooner was it listed but United Malt had to do an equity raising in order to strengthen its balance sheet. From there, however, we believe there's a lot of upside. You see, the world is unlikely to stop drinking beer any time soon, so now is a great time to be a major supplier of beer's principal ingredient, malt.

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ASX: GTN
Share price: A$ 0.56
Market cap: A$ 114M

When GTN Ltd, a supplier of traffic information reports, went public on the ASX in mid-2016, the offer price for the stock was $1.90 per share. Just under four years later, on 18 May 2020, the stock was changing hands at just 35 cents. Investors seem to have taken the view that this business has exhausted its growth potential. We take a different view.

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Share price chart

Source: Tradingview

When you brew beer, you are basically just mixing malt, hops, yeast and water. Many beer aficionados, including your editors here at Stocks Down Under, reckon that what makes beer taste good is hops and that malt is irrelevant. We tend to forget, though, that without malt you wouldn't have beer at all. That makes Sydney-based United Malt an important company for people like us to get to know because, after three gigantic European companies – Boortmalt (Belgium), Malteries Soufflet (France) and Malteurop (France) – United Malt is the world's fourth biggest 'maltster'.

Maltster's ball

Malt is simply a cereal grain where that grain has been partly germinated and then dried. The malting process makes available certain sugars, principally maltose, that can then be fermented into beer. As the term 'single malt' will have suggested, whisky also relies heavily on malt. Most brewers and distillers aren't vertically integrated on the supply side and therefore buy their malt from the maltsters. For beer, it's generally the barley plant, scientific name Hordeum vulgare that is the starter material for malt, and since GrainCorp is a major trader in barley, it made sense for that company to grow in the malt business as well. The result was United Malt, with a production capacity of 1.25 million tonnes spread over 13 plants in the US, Canada, the UK and Australia. In the year to September 2019 revenue was $1.3bn and EBITDA $160m.

The thing about malting – and part of the appeal to GrainCorp – is that it's a dependable trade. The brewing and distilling industries – and the former takes well over 90% of the world's malt – generally manage to grow modestly or at least stay stable from year to year, regardless of the economic climate. United Malt is therefore a good company for the temporarily hard economic times that COVID-19 has brought with it. The birth pangs experienced by United Malt revolved around concerns that, with the places where people usually drink being closed, beer would suffer a rare downturn. United Malt had spun out of GrainCorp with $503m in net debt as at 31 March, so the $140m raised at $3.80 per share in mid-May was necessary to alleviate concerns about that downturn.

Craft is where the action is

We believe United Malt will do well post COVID-19. Typically, in many countries today beer consumption is rising at slightly higher than population growth, but craft beer consumption is running at high double digits. And no wonder, the stuff actually tastes good. GrainCorp's malts business made the strategic decision some years ago to focus on the needs of craft brewers, a decision that made sense because it's not uncommon for craft brewers to use three times as much malt in their beers as conventional brewers. In the March 2020 half, it was craft brewing customers that drove a 7% EBITDA increase in United Malt's Processing business, although the COVID-19 impact on the Warehousing and Distribution business meant that overall EBITDA was down 2%.

Currently investors can get United Malt for an EV/EBITDA multiple on September 2021 forecast earnings of 11.6x, dropping to 9.7x in FY22, a year when EBITDA is expected to grow by about 15%. Looks inexpensive to us. As it likely did to United Malt's American CEO, Mark Palmquist, and its Chairman Graham Bradley. They were both on-market buyers of stock above $4.00 in early June.

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Share price chart

Source: Tradingview

If you listen to the radio on your morning commute in a big Australian city you will likely encounter GTN every day of the week in the brief segment where the announcer says something like ‘And now here’s Bill Smith with the traffic report’. On comes the familiar and trusted voice of Bill quickly describing that morning’s litany of traffic problems in your metro area. When Bill is done with the traffic, he adds a short piece of advertising. If he were pitching Stocks Down Under on a radio station called 2SD he might conclude his bulletin with these words ‘Stocks Down Under is rapidly becoming Australia’s leading source of new investment ideas. Do yourself a favour. More importantly, do your portfolio a favour, and subscribe to Stocks Down Under. I’m Bill Smith for 2SD traffic’.

Digital didn't kill the radio star

That slick 30-second sound grab, when replicated around Australia and in radio markets globally, generated a cool A$185m in revenue and $37.5m in adjusted EBITDA for GTN in FY19. GTN, which stands for 'Global Traffic Network', records the traffic reports and gives them to the radio stations for free, in return for advertising spots strategically placed around the reports. It's a win-win – the stations don't have to invest in content generation and GTN gets valuable advertising real estate where the listener is all ears because managing the daily commute is important to him or her. The trick is that the stations have to be in cities noted for their traffic problems. That's why GTN's founder, an American named Bill Yde (pronounced 'EE-dee'), moved to Australia in the 1990s to start the Australian Traffic Network. He'd figured out that there were five cities in this country that fitted the criteria. Canada came later, in 2005, then the UK in 2007 and Brazil in 2011.

The thing about radio is that it is perceived to be in structural decline, but it's not…really. Talk to anyone in media today and they'll tell you that radio advertising is one of the most cost effective and immediate forms of marketing there is, with a high level of cut-through. Which explains why, in FY19, Southern Cross Media (ASX: SXL), which owns more than 80 stations, grew at both the revenue and EBITDA line in FY19. You see, video may have killed the radio star, as The Buggles famously sang in 1979, but it didn't kill that propensity for so many of us to have the radio itself on in the background of whatever it is we're doing. Consequently, when the Internet came along, radio was more or less immune and even benefited from the rise of digital offerings. Sure, radio is not a boomtown, but it still grows in most years.

A smooth Brazilian opportunity

Which brings us to why GTN could be worth taking a look at now. For about a year, until late 2019, this company appeared to have lost its growth mojo. The FY19 result were flat at the revenue line, but down 22% at the EBITDA line. Then in the six months to December 2019 revenue declined 1.4% and EBITDA fell 20%. However, the problem was limited to Australia, where GTN's business has more or less reached the saturation point. Elsewhere in the world the company is still growing. Indeed, in Brazil GTN grew 26% at the revenue line in the most recent half.

Brazil is potentially a very rich opportunity. Remember, that giant of a country has more than 200 million people and the most recent market GTN entered in Brazil, the city of Curitiba in the southern state of Paraná, has a population of 1.9 million. Brazil may have yet to overcome Coronavirus, but it does have a very business-friendly government led by President Jair Bolsonaro. Not to mention 40 million cars on the road and serious traffic problems in the big cities.

Riding a radio wave out of the crisis

The Coronavirus Crisis temporarily caused a drying up of advertising revenue across most media formats globally, which obviously had a knock-on effect on GTN. However, we believe radio can recover quickly due to the cost effectiveness of radio advertising we were talking about before. GTN went into the crisis carrying net debt of only $14m but was recently able to refinance its main debt facility on favourable terms. So, we believe it is well placed to recover, particular since the company was actually growing at the EBITDA line before the crisis, accordingly to the company's 22 May update.

Currently, you can buy this proven radio advertising platform at an EV/EBITDA multiple of just 2.9x forecast FY21 earnings, dropping to 2.2x by FY23. That looks very inexpensive to us given the potential for solid average expected EBITDA growth of 29% over the next three years. Indeed, the only major risk we can see about this one right now is if commuters in the big cities stop getting stressed about traffic, which, as economies unlock from the crisis, is not likely to happen.

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Share price chart

Source: Tradingview

Chemical solutions for a wide range of industries

SciDev's science-based technologies include MaxiFlox, OptiFlox, DairyFlox and BioFlox. They are mostly used for solids-liquid separation in the mining, resources, water, wastewater treatment and food manufacturing industries. MaxiFlox provides cost-effective chemicals for industrial wastewater treatment. As wastewater from food manufacturing often contains fats, oil and other matter that can create problems when discharged to the sewer, MaxiFlox breaks up these harmful materials most common in meat, snack food, margarine and pet food manufacturing. In January 2020, SciDev received a trial order for MaxiFlox from Peru-based copper mine Las Bambas marking the company's first order in the extensive South American copper industry.

OptiFlox provides specialised chemicals and technology for the mining industry. High performance coagulants and flocculants are used for safe and effective mine water and mineral processing. The DairyFlox technology consists of unique polymers used by dairy processors to treat wastewater from milk and dairy product manufacturing. Similarly, specialised polymers for the sewage treatment industry are offered through the BioFlox solution. These chemicals are specifically designed to treat wastewater and sludge in both sewage and biological applications. SciDev's products service several more industries including power generation, cosmetics manufacturing and paint manufacturing.

The next-generation technologies offer value to customers that face existing and new challenges around water treatment. SciDev's proprietary research and specialised manufacturing capabilities allow it to deliver site-specific products in short order. It spends time researching customer challenges and comes up with solutions quicker than its competitors. Aside from the speed of the service, customers' operating treatment costs are low and the cost savings are not just from the cost of the chemicals themselves. Costs associated with the complete wastewater process like sludge disposal, trade waste charges, pH correction costs and the labour costs of treatment plant operation are eliminated or significantly reduced through SciDev's solutions.

Opportunities in U.S., Canadian oil and gas industries

SciDev has completed its $1.9m buyout of ProSol Australia, a chemistry and service provider for the New South Wales mining and water treatment industries. It also recently acquired privately held United States oil field equipment supplier Highland Fluids Technology for US$6m. The addition will give SciDev access to not only a new geography but to the large U.S. oil and gas sector as well. The specialty and production chemical market within the U.S. oil and gas industry is estimated to be a US$2bn market.

The integration of Highland Fluids Technology and formation of new U.S oil and gas sector relationships will be key strategic priorities for the rest of FY20. Highland delivered around US$7.8m of revenue in CY19. The acquisition is expected to help accelerate SciDev's growth because it will be able to target larger value customers. Margins are also expected to expand through the introduction of SciDev's low cost chemical supply chain into the Highland facilities.

Another potential growth catalyst is the group's newfound exposure to the Canadian oil sands industry. On 3 March, SciDev announced the receipt of a trial purchase order from Syncrude, one of Canada's biggest oil sands operators. The trial will incorporate SciDev's chemistries in Syncrude's CND$1.9bn Tailings Centrifuge Plant. It is expected to generate up to $1m in revenue in just a couple of weeks. Aside from the instant revenue boost, Syncrude represents good upside potential longer term because fluid tailings management within the oil sands extraction process is facing increasing regulation by the Canadian government. SciDev's ability to succeed with its Syncrude relationship could lead to new business not only from Syncrude but other Canadian oil sands players as well.

Strong March quarter result

Following robust Q2 sales growth, SciDev reported strong Q3 numbers on 7 April. Sales were $7.3m including record March sales of $4.8m driven by continued contract wins across the business. Most importantly, it marked the company's first quarter of positive cashflow after nearly 20 years in business as $0.7m of cash inflows were generated. The performance was particularly impressive given the challenging global economic environment due to the COVID-19 crisis.

We believe SciDev is executing on its business development opportunities and is in a strong financial position to grow. Its cost-effective technology is a good value proposition for its expanding scope of customers. As it enters new growth markets in U.S. and Canadian oil and gas, it will likely continue to separate itself from the competition.

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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.

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