18 JUNE 2020

Stocks Down Under

Marriage has no guarantees. If that's what you're looking for, go live with a car battery.

- Erma Bombeck (1927-1996), American humorist

FLETCHER BUILDING

COVID-19 took a wrecking ball to the business

NOVONIX

The emperor's got no clothes...yet

JERVOIS MINING

Its own Private Idaho

FLETCHER BUILDING

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Stocks Down Under rating: ★★

ASX: FBU
Share price: A$ 3.49
Market cap: A$ 2.9BN

Based in Auckland, Fletcher Building constructs homes and supplies building materials under brands like Laminex, iPlex and Tradelink. As one of New Zealand's largest listed companies, it was split from Fletcher Challenge in 2001, which at the time was the country's largest multinational corporation. While it found early success in the years that followed, it has since struggled to deliver consistent profit growth through the ups and downs of the cyclical construction industry. The COVID-19 crisis has presented yet another challenge and may be one that sets the company's growth potential back for at least another year. Expectations of declining residential approvals and a reduced project pipeline suggest it will be a while before Fletcher shares get off the ground.

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Share price: A$ 1.11
Market cap: A$ 333M

Sometimes stocks just take off without warning. That just happened to Novonix, a Brisbane-based company involved in various lithium-ion battery technologies. You could get this one for just 22 cents a share on 23 March at the bottom of the Corona Crash, and for 41 cents on 1 June. However, in just in the last few sessions it's been as high as $1.30. Rechargeable batteries are a pretty important part of the 21st century economy, but let's look at whether the current Novonix spike represents rational or irrational exuberance.

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Share price chart

Source: Tradingview

Weak first half results as steel business weighs

Fletcher is Australasia's largest building materials supplier. It operates under six divisions -- Building Products, Concrete, Construction, Distribution, Residential & Development and Australia. The company delivered weak 1HY20 financial results that included a decline in both the top and bottom lines. Revenue met group expectations but was down 5% to NZ$3.96bn due to worsened market conditions in the Australian market and a slowdown in legacy construction project activity. Operating earnings fell 11.7% to NZ$219m and net profit after tax (NPAT) decreased 7.9% to NZ$82m.

Going forward, the group plans to address the challenged Australian division by implementing cost cutting measures and investing in digital capabilities. The company also expects volumes and margins in the struggling steel division to improve as the fiscal year progresses. Prior to the pandemic, the New Zealand steel business performed poorly and weighed on growth. Steel volumes were down 16% in the six-month period ending December 2019 as trading conditions weakened throughout the year.

The mid-February results came ahead of the COVID-19 crisis and as such management declared an NZ$ 11 cents per share interim dividend that was 3 cents higher than the year prior. We believe the board's likelihood of endorsing this dividend in 2HY20 is low given the current market conditions. Management's full year EBITDA guidance of NZ$515m to NZ$565m includes expectations of second half-weighted earnings, but this may be hard to realise in the current economic backdrop.

Effects of pandemic to be felt for some time

The Coronavirus Crisis has had a meaningful impact on the building materials market. The timing was particularly bad for companies like Fletcher because the outbreak coincided with the company's strong season when it typically books the bulk of its earnings. On 20 May, the group reported that it generated almost no revenue in its domestic operations while New Zealand's level four restrictions were in place. This resulted in an operating loss of NZ$55m for the month of April alone. The Australia division managed to deliver revenue that was around 90% of pre-pandemic expectations.

In anticipation of depressed construction activity, Fletcher also announced plans to lay off approximately 1,000 New Zealand employees representing roughly 10% of its workforce. This followed an April 2020 report that non-working staff would receive a 35% pay cut (that would increase to 70% by June), while senior executives' salaries would be reduced by 30%.

In the aftermath of the COVID-19 crisis the Australian and New Zealand housing markets are likely to continue to feel the effects of soft demand for new construction and home renovation projects. Cautious consumers and hesitant property builders will probably be slow to return to the market until there is stronger confirmation of a normalised economic environment. In May, Fletcher's New Zealand revenues tracked around 80% of forecast, but this does not mean things cannot get worse. CEO Ross Taylor commented that the company expects a "sharp downturn in FY21 and potentially beyond" amid a "shrinking economy, substantially reduced consumer demand…and sustained lower levels of productivity."

Buyback may build a floor for the shares

Fletcher commenced a buyback program on 9 September 2019 that will allow the purchase of up to 70m shares for a maximum aggregate value of NZ$300m. The on-market buyback is expected to run through August 2020 and may help create a floor for Fletcher's share price in the near-term, because the implied buy demand from the company will help prop up the share price as Fletcher periodically makes purchases over the next few months.

Despite its recent challenges, Fletcher's balance sheet is an area of strength. Although net debt increased in 1HY20 due to the share repurchases and weak legacy construction project activity, it has a low 0.8x leverage ratio, undrawn credit of $925m and $570m in cash on hand. It also has a five-year supply of residential lots under its control of which 75% are on the balance sheet.

Although management had an upbeat tone during the soft 1HY20 report, at this time, we would not recommend building a position in Fletcher. Unfavourable market dynamics in both New Zealand and Australia in the form of reduced residential and commercial construction activity and a slow return to infrastructure project development suggest the builder will be in the basement for some time. And despite the crash in March, Fletcher is still not cheap at a P/E of 18.5x for FY21.

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Share price chart

Source: Tradingview

Back when dot.com was hot the finance professor who told the world that the Emperor had no clothes was Robert Shiller. His book Irrational Exuberance explained that basically there was a bubble going on. The exuberance had no rational basis and the bubble was going to burst. It did, right about the time the book came out in March 2000.

Elon's given us all something to be exuberant about

The thing about bubbles is that they start with something to be rationally excited about. In Novonix's case it was lithium-ion batteries, where strong demand growth is a fact, as the rise of Tesla (Nasdaq: TSLA), the pioneering maker of Electric Vehicles (EVs), has shown. Back in October 2019 Tesla announced that it had just enjoyed its first profitable quarter. Partly driving that important milestone was rapid growth in the demand for EVs. It's estimated that some 2.2 million plug-in cars – both EVs and hybrids – were sold around the world in 2019, and most of them were EVs from Tesla. Back in 2016 the comparable figure was only 0.8 million. Obviously, 2020 has been a bad year to be selling any new car, but most observers of the EV space are expecting the EV sector to go mainstream during the current decade, to the point where perhaps a fifth of all cars sold will be EVs by 2030. And driving that will be lower and lower costs for battery cells, a trend which has gone on for some years now.

Novonix, with revenue of A$1.8m in FY19, is a little smaller than Tesla, which in the same period clocked up US$24.9bn in revenue. However, the Brisbane company argues that it is leveraged to the same growth wave. The world's battery

makers need testing equipment to develop better batteries over time, and that's Novonix's core business. Those battery makers also need tonnes and tonnes of graphite for the anode part of their batteries, that is, the positively charged end. Since last year Novonix has been marketing its low-cost high-purity graphite material, which it calls PUREgraphite. And more recently the company has been talking about commercialising a new way of manufacturing both battery anode and cathode materials that involves DPMG, that is, dry particle micro granulation.

The house that Dalhousie built

The battery testing part of Novonix originated from work at Dalhousie University in Canada related to high precision coulometry. Dalhousie is located in the Nova Scotia capital of Halifax, so it's fair to say that it's a little off the beaten track. What is not off the beaten track is the university's brains when it comes to lithium-ion batteries, as evidenced by the initial technology they supplied to Novonix.

Readers who paid attention in high school chemistry will recall that a 'coulomb' is the SI unit of electric charge. Coulometry is therefore simply a tool to measure how much charge is being generated in a battery. Believe it or not, before 2010 there was no easy way to do coulometry that was appropriate to the kinds of batteries needed for EVs. The Dalhousie laboratory of Professor Jeff Dahn, a world leader in lithium-ion battery development, changed all that. In 2013 Dalhousie formed a spin-out company called Novonix around the relevant intellectual property, and that company was acquired in mid-2017 by an ASX-listed company called Graphitecorp, which subsequently changed its name to Novonix. By that time Novonix's customer base was a who's who of the battery world, including Apple, Bosch, Dyson and Panasonic.

The technology that caused the bubble

The PUREgraphite part of Novonix was the result of a 2017 joint venture with a Dalhousie alumnus named Dr. Edward Buiel, who had developed anode-manufacturing methods that were lower-cost. By 2019 Novonix had material that was suitable for use in batteries and it was having commercial discussions with battery makers. That yielded an important announcement in December 2019 related to an agreement with Samsung where that company will take a small amount of PUREgraphite product beginning around October 2020.

Then there's dry particle micro granulation or DPMG, which comes out of another lab at Dalhousie, that of Professor Mark Obrovac. Development of this technology was partly funded by Novonix and, we admit, the technology is potentially revolutionary. Granulation is where you take small particles and stick them together to form large particles. Granulation for making battery grade anode and cathode material would be great if you could guarantee uniform particle size, because then the processing costs would be low. Professor Obrovac, with DPMG, reckons he's cracked that puzzle, and he published his work back on 13 May in an open-access journal called Cell Reports Physical Science. Novonix has the commercial rights. And they're being patented.

Why Novonix rocketed

Which brings us to why Novonix stock suddenly took off this month. There's no reason, really, except that, in the aftermath of the Cell Reports Physical Science paper, Novonix stock ticked up and the company announced a $58m capital raising at 29 cents per share in a placement and rights issue. After that transaction the market suddenly decided that Novonix is the Next Big Thing in lithium-ion batteries and re-rated the stock accordingly. We noticed a lot of people talking about Novonix in investor chat rooms. Most are probably not chemists by training but seem sure this one is headed to the moon. Is their exuberance rational or irrational? We think the latter. Not that the DPMG isn't potentially ground-breaking. It may be. It's just that it's too early to tell. For one thing, Novonix first needs to make battery-grade material using the DPMG process. For another, the potential customers will have to test and re-test that material. And that will likely take years. That's right, years, not months.

At Stocks Down Under we're bullish on lithium-ion batteries as the technology paradigm whose time has come. We're also bullish on the battery minerals space since the prices of these commodities have been depressed for around 18 months now. However, we'd be cautious on Novonix. The thing about Next Big Things is that they can change rapidly, as anyone who backed MySpace over Facebook can tell you. For DPMG, a lot of work has to get done before the big payday.

In the meantime, this technology might get superseded, or ignored in favour of the conventional technologies, and investors might get bored waiting for the future billions in shareholder value to show up. Also, there's bound to be profit-taking by some of those investors who got set at 29 cents. That's why we rate this a 2-star story right now.

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Share price chart

Source: Tradingview

Traditionally, investors in the resources sector didn't care much for cobalt, chemical symbol Co, atomic number 27. If you crack open the Fifth Edition of Alexander and Street's Metals in the Service of Man from 1972 (the book that first popularised metallurgy), and turn to page 243, you'll see that cobalt rates only two paragraphs in the chapter with the unhappy headline 'Some minor metals'. The obscurity of cobalt relates to the fact that, back then, the country formerly known as Zaire (now the Democratic Republic of Congo, or DRC) produced what little of the metal the world needed. All cobalt was good for, and the reason it occasionally became a credit in a new nickel mine, was its use in niche-market heat resistant and corrosion-resistant alloys.

Cobalt's next day in the sun may be coming soon

How times have changed. Since 2010, cobalt has been traded on the London Metals Exchange and these days it's not uncommon to find ASX or TSX-listed developers working on new projects. The reason for cobalt's rise is simple – it's a battery mineral, cobalt being the easiest metal to combine with lithium in the cathode of a lithium-ion battery.

It was demand from battery makers that drove the metal's rise from around US$ 22,000 per tonne in January 2016 to an all-time high of US$ 95,250/t in March 2018. While cobalt is now back under US$ 30,000/t, it's not unreasonable to see better days ahead as the Electric Vehicle revolution goes for its next wave from 2021. Which brings us to Jervois Mining's plans to become a leading cobalt company.

So that's how you pronounce the company's name…

Jervois Mining has been on the ASX in one form or another for about five decades now. It was named 'Jervois' after a little town on the Murray River in South Australia and most people in the know pronounce it 'jerv-waa', the way a Frenchman would.

These days, Jervois is one of the best ways in the world to play the potential recovery in cobalt because it has one of the more significant collections of projects you'll find. There's the original Australian project, called 'Nico', near Young in southern NSW, and another recently acquired cobalt project in Uganda. And then there's the potential 'company-maker' – a major cobalt project in the northern US state of Idaho.

A belt of cobalt deposits in east-central Idaho, near the town of Salmon, has been known about and sporadically mined for more than a century. The latest effort to develop a mine at Salmon has been ongoing since around 2004 and Jervois' Idaho Cobalt Project – acquired when it merged with TSX-listed company eCobalt Solutions last year – benefits from about C$135m in prior substantial exploration and development work.

Its own private Idaho

That C$135m in prior expenditure left behind an existing mine and mill completed in 2013 with all the relevant environmental approvals. The project has a substantial Measured and Indicated NI-43-101 resource (not JORC compliant, but the Canadian equivalent) of 5.24 million tonnes at 0.44% cobalt and 0.69% copper, containing about 23,000 tonnes of cobalt and 36,000 tonnes of copper, as well as some gold. eCobalt completed a Feasibility Study on an enlarged version of the project a few years back and Jervois is currently working that into a Bankable Feasibility Study to publish later this year. At that time, it will be in a good position to discuss financing options.

Now, eCobalt's original Feasibility Study from September 2017 hasn't stood the test of time, but it's not hard to understand why. Back then the idea was to mine the copper-cobalt-gold ore and refine it into cobalt chemicals for batteries, which was really too expensive. It would cost US$187m to build, of which US$124m was the refining part, and only yield an after-tax NPV of US$136m if cobalt stayed at the then prevailing level of around US$ 59,000 a tonne, about double what it is now. Jervois believes an operation that can process 50% more ore but produce only cobalt and copper concentrates can unlock the value here. If all goes well, this operation could be up and running in 2022 or 2023.

A strategic way to play a strategic metal

One reason the Idaho Cobalt Project is likely to attract a lot of attention is cobalt's strategic importance. As we noted on 21 April when looking at Rafaella Resources (ASX: RFR) in Stocks Down Under, there are certain critical minerals the US wants to develop more of domestically and one of them is cobalt. Because at present most of the raw metal comes from the DRC and most of the processed metal comes from…you guessed it, China. Idaho is a great state for Jervois to be working in because it's mining friendly, being rated in the world's 10 most attractive mining destinations in the 2019 Fraser Institute Survey. The only big risk for Jervois is the cobalt price.

Cobalt's retracing of the 2016-2018 spike was over by the middle of last year and we think the market has been going through a 'base building' period since then. As a consequence of cobalt's relative inaction recently, Jervois stock has been weak. Which is why we give it only three stars at the moment. Once cobalt gets moving again, we believe Jervois can be a great way to play it.

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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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