10 JULY 2020

Stocks Down Under

You make more making computer chips than potato chips.

- Ross Perot (1930-2019), American business magnate, billionaire and philanthropist

INSURANCE AUSTRALIA GROUP

Bushfires and COVID-19 have adverse impact

MUSGRAVE MINERALS

Cue the coming gold mine…

PIVOTAL SYSTEMS

Riding the semiconductor equipment rebound

INSURANCE AUSTRALIA GROUP

Bushfires and COVID-19 have adverse impact

Stocks Down Under rating: ★★★

ASX: IAG
Market cap: A$ 13.2BN

52-week range: $5.00 / $8.74
Share price: A$ 5.59

Sydney-based Insurance Australia Group (IAG) is an insurance company that serves customers in Australia and New Zealand. As the ANZ region's largest general insurance company, it offers a range of personal and commercial insurance products including home, vehicle and contents insurance. IAG underwrites around $12bn of premium per annum and operates under several brands such as NRMA, SGIO, CGU, Swann and WFI. It is a leading insurance player with a scale advantage that offers a high cash earnings payout to shareholders during normal times. While a series of natural disasters and the COVID-19 crisis have had adverse effects, its recession-proof nature and growth opportunities in digital remain attractive qualities. As the world hopefully returns to (the new) normal, the dividend yield can potentially get back up to round 4.5%.

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Stocks Down Under rating: ★★★

ASX: MGV
Market cap: A$ 267M

52-week range: $0.06 / $0.62
Share price: A$ 0.585

Back near the bottom of the Corona Crash you could buy the stock of Musgrave Minerals, a Perth-based gold explorer, for 7.4 cents, capitalising the company at around $30m. Suddenly, in early June, the stock took off and by late June the market cap was more than $200m. The catalyst for this was some spectacular drill result at a new discovery in Western Australia called Starlight. However, we think the edge might come off this stock in the near term.

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Share price chart

Source: Tradingview

Mixed results reflect higher premiums, lower interest rates

Prior to the COVID-19 pandemic, IAG's underlying business performance was rather mixed. Gross written premiums (GWP) were up 3.1% to $12bn in FY19 due to higher rates. Like for like premium growth was approximately 4%. Insurance profit was down 13% to $1.22bn, but net profit after tax (NPAT) was up 16.6% to $1.08bn as the underlying insurance margin improved. Shareholders' funds income was up 37.6% to $227m.

The 1HY20 result showed a 1.4% increase in GWP and GWP growth of around 2.5% on a like-for-like basis. After strong 4.1% growth in 1HY19, insurance profit increased just 1% to $501m, however, NPAT fell 43.4% to $283m. The mixed results were driven by a lack of growth in the company's Australian operations that was contrasted by 6.3% growth in New Zealand. The interim performance was adversely impacted by lower interest rates on investment income.

IAG has a moderately strong capital position. It exited FY19 with a common tier equity 1 (CET1) ratio of 1.15 times compared to 1.31 on 30 June 2019. Its regulatory capital position recently improved by around $450m due to the completion of the sale of its 26% stake in SBI General in India, but is not that far above the CET1 benchmark. A 70% franked interim dividend of 10 cents per share was paid in 1HY20, which represented 61% of IAG's cash earnings.

Bushfires, COVID-19 a tough 1-2 punch

Management has acknowledged the negative impact of the 2019/2020 bushfires on the group's recent trading performance. Natural hazard losses for 1HY20 were $80m above allowances primarily due to bushfire related claims. This led to a lower reported margin of 13.5%. In addition to the bushfires, hailstorms and heavy rain events have also contributed to greater losses. The company is now forecasting FY20 total net losses from natural perils to be $850m. Following a high incidence of naturals disaster events during the first two months of CY20, IGA's common equity tier 1 (CET1) had been reduced to 1.09.

On the heels of these natural perils, the COVID-19 crisis has applied further pressure to the group's financials. Although premiums are likely to offset claims inflation, IAG has noted that a final dividend will be unlikely in FY20 because of sharp losses in investment income over last few months. In the 12 months through 30 April, investment income on shareholders' funds amounted to a loss of about $280m. This was due to the severe corrections in both the stock and bond markets witnessed earlier this year that lowered IAG's growth assets weighting from 49% to 30% in just four months.

On top of the market-related pressures, IAG's financials were further impacted by its trading decisions related to the COVID-19 crisis. Amid growing demand for insurance products, it employed more staff in the customer-facing parts of the business leading to higher expenses. It also provided support to small business owners in the form of deferred premium payments for up to 6 months and full refunds for cancelled policies. Travellers received refunds for travel insurance. So, all in all, it hasn't been a great time for IAG.

Reinsurance renewal provides much needed support

Fortunately for IAG given all the challenges it has faced in 2020, it completed the annual renewal of its reinsurance catastrophe cover on 1 January. The gross protection of its main catastrophe cover was increased to $10bn and was structured similarly to prior years. The maximum event retention (MER) was set at $250m and the second event MER was reduced to $200m by a $50m drop-down cover.

As IAG looks to rebound from this environment and move forward with growth initiatives, much of its focus will be on digital projects. In 2HY20 it plans to expand its Carbar digital car-trading and subscription platform in response to an increasing customer appetite for alternative forms of vehicle ownership. It is also planning to extend the geographic reach of Repairhub, its vehicle repair joint venture. IAG's ability to leverage its scale with data-driven technology will be a key determinant of its upside potential in the Australian and New Zealand markets.

Following the share price declines from more than $8 in the middle of 2019 to where we are today, we're not too bearish on IAG. We think the bush fires and COVID-19 have essentially been discounted into the share price. However, a P/E of 15.7x FY21, the shares aren't cheap either, in our view. So, for now we'll just let this one pass us by: 3 stars from us.

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One of the things we love about the Australian Securities Exchange is the way a mineral explorer's fortunes can change in a 'New York minute' (i.e. really quickly). All it takes is one hot announcement like the one Musgrave Minerals filed on 3 June. The headline simply read '12 m @ 112.9 g/t gold intersected near surface at Starlight'. That jumped Musgrave from 15 cents to 26 cents. Then came 'Bonanza near surface hit of 18m @ 179.4 g/t Au at Starlight' on 9 June, and that was good for another jump, not just to 31 cents on the day, but to above 50 cents by 26 June. We wondered what all the excitement was about.

Oh little town of Cue

The Musgrave mineral exploration project responsible for the sudden re-rating is called Cue. If you know something of the history of mining in the Golden State, you've doubtless come across that name before today. Drive up National Highway 95 from Perth in the direction of Port Hedland and at about the 640 km mark, not long after you've passed through Mt Magnet, you get to the little town of Cue, 2016 population 328, in a Shire of the same name. Cue's nickname is 'Queen of the Murchison', which comes from the fact that the vast mineral-rich Murchison region, in the midwestern part of Western Australia, first came to the attention of miners because of a major gold discovery at Cue in 1892. So plentiful was that discovery that the gold in Cue was still being worked up until the First World War, after which came another major gold mine in the 1930s called Big Bell. Naturally when the Western Australian gold industry revived in the 1980s, Cue was one of the areas that prospectors routinely picked over. Today, the major gold miner Westgold Resources (ASX:WGR) has a major gold mining operation at Cue based on Big Bell and another major, Ramelius Resources (ASX:RMS), has its Mt Magnet Gold Mine not far away either.

Musgrave's adventures in the Cue area started in November 2015 when the company farmed in to the Cue Project of Silver Lake Resources (ASX:SLR), now a big shot gold player thanks to its Mt Monger Gold Mine near Kalgoorlie. Musgrave later acquired the Silver Lake project outright and added to it. These days Musgrave's project covers two large areas to the east of the town. So far there's about 613,000 in JORC 2012 resource ounces over six deposits. The southernmost of two blocks are where the action is right now. Musgrave already had a couple of deposits there called Break of Day and Lena with 520,000 ounces in place, and Break of Day looked particularly promising at a high grade of 7.2 g/t gold. The shear zones in the neighbourhood were interesting enough to the gold major Evolution Mining (ASX:EVN) that in September 2019 that company farmed in to earn up to 75% of any new gold and may spend $18m on this project. However, this year Musgrave has shot to prominence without Evolution's help. The current fun at Musgrave relates to a discovery which isn't part of the Evolution joint venture, at the Break of Day deposit.

Starlight Express

Break of Day and its high-grade resource was based on two quartz vein lodes called Twilight and Velvet. By early this year Musgrave's geologists were convinced that they'd found another lode in the middle that would link the two and that's what the recent drilling has been all about. The results, as we noted above, have been spectacular. Ask any follower of the gold space and they'll likely say it's been a while since they got intersections as juicy as the ones that have been reported by Musgrave lately, and so close to the surface as well. Remember, you only need about 31 g/t gold for the yellow metal to be visible to the naked eye right there in the drill core.

So the market has been betting that Musgrave has found its 'company maker' at Cue – a new mine that would be easy to bring into production because the ore could simply be trucked the short distance to either Westgold's or Ramelius' mill. We're excited too, but we're also cautious. There's a bit more drilling to do before Musgrave can upgrade the resource at Cue, and intersections this high are going to make the geologists extra careful to make sure that they haven't drilled into their lodes the wrong way and therefore overestimated the overall resource. In the meantime, the market might get bored with the Musgrave story and a rise this sharp can often lead to profit-taking. So, we'd be cautious for now. So, three stars from us at this point.

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Source: Tradingview

Gas Flow Controllers of the highest quality

Semiconductors are manufactured on so-called silicon wafers in large quantities at a time. Depending on the kind of chip being made, the number of chips per wafer can be several thousands if it's a small type of device, like a sensor. Other chips, like Central Processing Units (CPU's) for laptops and desktop computers that Intel and AMD manufacture, are much larger so a lot fewer chips will fit onto one single wafer. However, whatever the chip is that's being built, the manufacturing processes are largely similar.

Semiconductor devices are built one layer at a time by depositing gasses onto the wafer. These gasses react with the top layer of the wafer and form a new layer on top. These layers can either be conductive or insulating layers, meaning they will either let an electric current pass through or block it.

While the exact manufacturing process is too complex to explain here in too much detail, when it comes to Pivotal the important thing to remember is that the flow of the gasses used in the process needs to be precisely monitored. That means control over how much gas is used, the location where gasses enter the reaction chamber, the speed at which gasses enter the chamber and the mix ratio of gasses in case a mix is used. As an example of the precision required, opening and closing of valves is measured in milliseconds. Similarly, the settling of gas pressures after opening or closing a valve is measured in milliseconds. The faster this response time, the better the production process can be controlled, which will lead to higher yields (good chips per wafer).

In bed with the largest global equipment companies

Pivotal is well ahead of the competition when it comes to these sorts of metrics and has developed some of the most advanced Gas Flow Controllers (GFC) in the industry. With production largely outsourced, it sells these GFC's as components to semiconductor equipment companies (Original Equipment Manufacturer or OEM's) and directly to chip manufacturers around the world. While Pivotal never mentions customer names, the biggest companies for deposition and etching tools are Tokyo Electron, Lam Research and Applied Materials, which we believe are all on Pivotal's customer or prospect list.

This time last year, yours truly visited Pivotal during Semicon West in San Francisco (a key industry trade show) and got an up-close demonstration of the various GFC's. At the time, Pivotal was working hard to get its latest products qualified by existing and potential customers. Some of these companies were already purchasing older models from Pivotal. However, each new product generation requires it own qualification by customers. Since that time, Pivotal has expanded its marketing efforts to include Chinese and Korean OEM's as well.

Prolonged underinvestment in industrywide production capacity

While COVID-19 has nibbed the recovery of the global semiconductor sector in the bud earlier this year, we believe the underlying trends are intact, i.e. demand for computer chips on all shapes and forms has been on a steady rise, basically ever since the semiconductor started to be mass produced about 65 years ago.

The proliferation of computer chips will not stop because of a virus and we expect end demand will catch up sooner rather than later, simply driven by productivity requirements by end users of chips. Therefore, we expect to see a catch-up effect in terms of Capex in the next 12 months as the industry has now been underinvesting in manufacturing capacity for at least four to five months after a period in 2019 where expansion Capex was very low to begin with.

In other words, we believe Pivotal is in a very good position to benefit from pent up demand for chip production capacity, especially in the so-called logic segment. With the share price where it is today, we see quite some upside on a 12-month horizon given that EBITDA projections call for a jump to A$11.8m in FY21 (starting in January) and A$26.7m in FY22, from EBITDA break even in the current financial year. So, four stars from us.

Pitt Street Research Pty Ltd

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