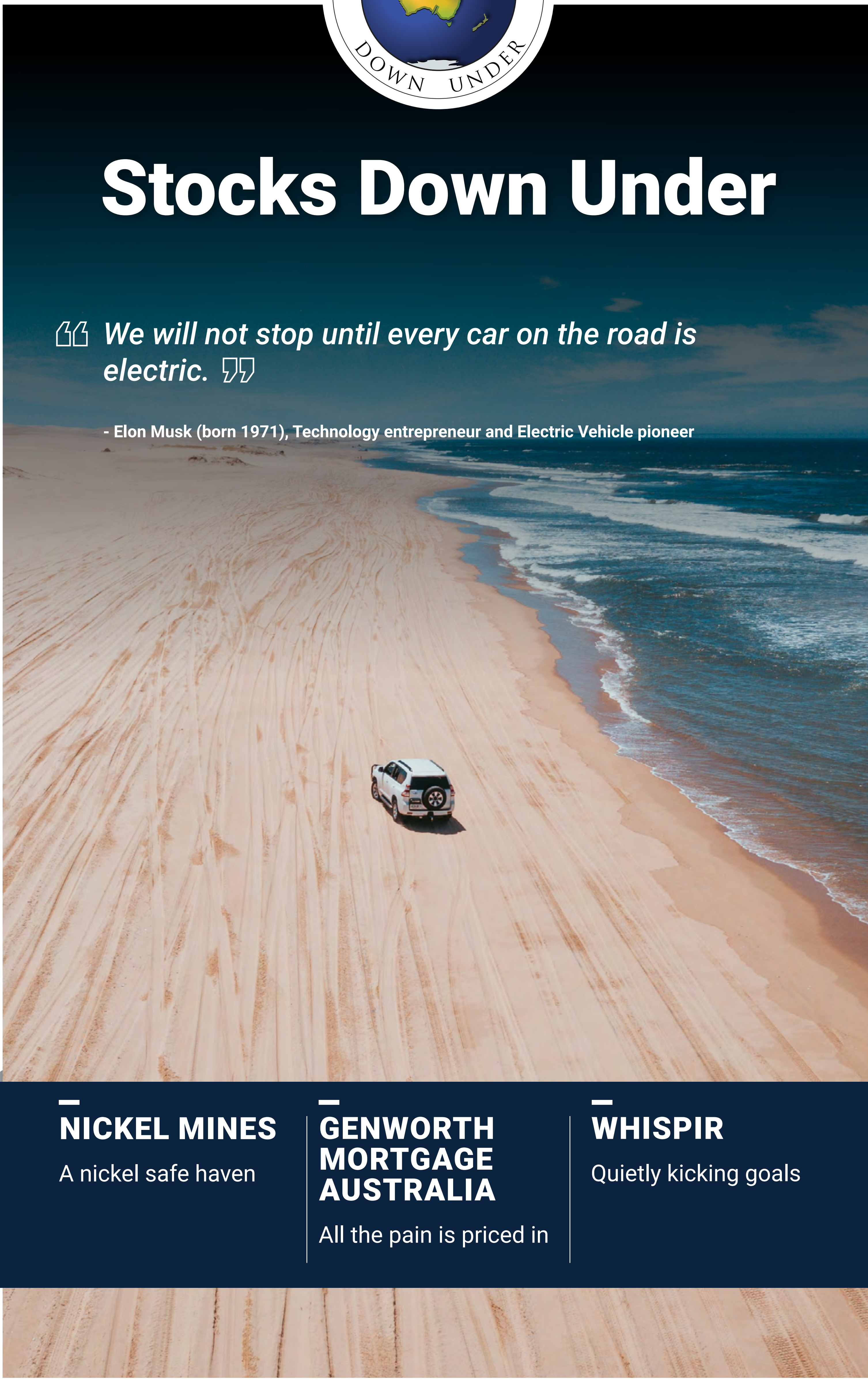
13 JULY 2020

Stocks Down Under



> *We will not stop until every car on the road is electric.*

- Elon Musk (born 1971), Technology entrepreneur and Electric Vehicle pioneer

NICKEL MINES

A nickel safe haven

GENWORTH MORTGAGE AUSTRALIA

All the pain is priced in

WHISPIR

Quietly kicking goals

NICKEL MINES

A nickel safe haven

Stocks Down Under rating: ★ ★ ★ ★

ASX: NIC
Market cap: A$ 1.1BN

52-week range: $0.29 / $0.73
Share price: A$ 0.60

The Sydney-based company that is the subject of this article is called Nickel Mines, but that's something of a misnomer. The company does own part of a nickel mine in Indonesia but the real value driver for Nickel Mines is its ability to produce a value-added product, called nickel pig iron, at the lower end of the global cost curve. That was valuable at the 2018 IPO of Nickel Mines, but as nickel returns to favour post-Coronavirus, we think it'll be even more valuable.

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ASX: GMA
Market cap: A$ 811M

52-week range: $1.22 / $4.37
Share price: A$ 1.97

Sydney-based Genworth Mortgage Insurance Australia is a provider of lenders mortgage insurance (LMI). Following a 71% surge in 2019, the shares are down 32% in 2020 due to pressures on insurance companies in the aftermath of the bushfires, hailstorms and the COVID-19 crisis. With those concerns largely allayed and a newly appointed CEO in charge, the company is looking to deliver underwriting efficiencies and revenue growth by enhancing the customer experience, supporting borrowers and leveraging its technology platform. The shares look attractively valued at present levels.

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Share price chart

Source: Tradingview

Ever since the nickel boom of the late 1960s, Australians have been used to thinking of their country as a major player in nickel, but, let's face it, Australia with its 150,000-200,000 tonnes of nickel output per annum has nothing on Indonesia. That country, producing well north of 500,000 tonnes each year, accounts for about a quarter of the world's supply, much of it coming from mines on Sulawesi, the island to the right of Borneo. One recent entrant to the ASX that participates in the nickel industry on Sulawesi is Nickel Mines, which owns a new mine called Hengjaya in Central Sulawesi province and a processing complex about 15 km to the north, in the region of Central Sulawesi called Morowali.

A value-added product

Nickel Mines was able to go public in 2018 at a high initial market capitalisation of $486m, in part because founder Norm Seckold has had a pretty strong investor following ever since he helped sell Bolnisi Gold to Coeur Mining in 2007 for US$930m. However, Nickel Mines' processing complex in Morowali Regency was an even more compelling reason to look at this company.

You see, in January 2014 the Indonesian government banned the export of raw nickel ores, but Nickel Mines had worked with a major Chinese producer of stainless steel, called Tsingshan, to develop a local operation that would take nickel ore from Hengjaya and turn it into NPI, that is, nickel pig iron.

'Nickel what?', we hear you ask. Yeah, sounds strange, doesn't it? In the iron and steel game 'pig iron' is simply the crude iron obtained by smelting iron ore in a blast furnace. Nickel pig iron is a similar product. Lateritic nickel ore of the kind mined at Hengjaya is rich in iron as well as nickel (that is, it's 'ferronickel') and if you smelt it in a similar way to the way you create conventional pig iron you get a product that can easily go into the world's nickel refineries and from there into stainless steel. Indeed, nickel pig iron can sell for almost the same price as the regular nickel that gets traded every business day on the London Metals Exchange (LME). Nickel Mines and Tsingshan's first nickel pig iron from Morowali was poured in January 2019.

A nickel bear market? What nickel bear market?

That timing was exquisite because in mid-to-late 2019 nickel went for a tearing run. In June the metal was changing hands on the LME at between US$11,000 and US$12,000 a tonne. However, by late August it had rallied to over US$15,000 a tonne. Then in early September nickel briefly spiked above US$18,000 a tonne, a level it hadn't seen since 2014. The reason for this relates to the Indonesian export ban we referred to previously. The original 2014 ban had been designed to encourage smelting and refining within Indonesia and thereby add value to an important export earner. This policy was reversed in 2017, but with the Indonesian government indicating that a new ban would come in to play in 2022.

In August 2019 Jakarta changed its mind, announcing that the ban would now be effected two years earlier, in January 2020. That prompted the spike to US$18,000 a tonne but most nickel buyers had seen it coming and consequently had excess inventories on hand. By 20 February 2020 nickel was down by 30%, at around US$12,500 a tonne. That was a disaster for the shareholders of most nickel producers around the world, but through that period Nickel Mines' stock had held more or less steady at just above 60 cents per share.

And no wonder. Nickel Mines, with its Rotary Kiln Electric Furnaces at Morowali, has one of the lowest nickel costs of production in the world, helped by the fact that power is cheap in Indonesia and the export ban locks in high grade nickel ore at a very reasonable price compared to what's available from producers in other parts of the world. All of which means that Nickel Mines is something of a safe haven for nickel investors who can see the upside for this metal.

A metal for the long haul

And remember: Nickel is one of those metals you want to stay with for the long haul because it's not just used in stainless steel these days but also in lithium-ion batteries. We think that's why, after nickel bottomed in a Coronavirus-induced panic in March 2020 at around US$11,000 a tonne, a recovery got going. We believe that this rally will continue the generally upward trend for nickel that started in 2016 and will continue, with fluctuations around the trend, for a couple of decades more while the Electric Car revolution proceeds apace. Nickel Mines recently showed its confidence in this thesis by paying Tsingshan US$120m for an additional 20% of the Morowali venture, to 80%. It funded this with a rights issue at 50 cents per share, which leaves the company with virtually no net debt.

Currently, Nickel Mines is trading not far above the recent capital raisng price at an EV/EBITDA multiple of only 3.7x forecast FY22 earnings. Not bad for a company expected to grow EBITDA by 27% annually between now and 2022. The naysayers will argue that forecast earnings growth slows in 2022. However, we think that increases in nickel prices over the next few years might give voice to a different story. Also, there's plenty of room to expand both Hengjaya as well as the processing complex at not much capital cost. Ahead of these potential good times, and ahead of a nickel bull market that may get a full head of steam as we move into 2021, this stock gets Four Stars from us.

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Share price chart

Source: Tradingview

Playing an important role in Australian home ownership

Genworth's core business is lenders mortgage insurance (LMI) but it also offers risk and capital management solutions for customers in the Australian residential mortgage market. LMI's role in the mortgage lending process is to transfer risk from lenders to LMI providers. The insurance product is mostly used for residential mortgages with high loan-to-value ratios. This helps the accessibility of residential mortgage loans for Australian homebuyers. Genworth has well-established relationships with more than 100 lenders including three of the five major banks.

The COVID-19 crisis had a significant impact on Genworth's operations and performance. As markets dived, investment income moved lower and the company's claims experience worsened. Fortunately, the worst of the pandemic appears to be over and the mortgage market looks to be on the road to recovery. And this means Genworth can re-focus on its growth strategy, which is largely based on improving the customer lending experience and leveraging its data and technology capabilities.

Low rates, housing market recovery support Q1 results

In FY19, new insurance written (NIW) was up 20.3% to $26.7bn and gross written premium (GWP) fell 5.9% to $433.2m. Excluding a bespoke transaction written through the company's Bermuda insurance division, GWP actually increased 17.1%. Net earned premium (NEP) increased 6% to $298.2m, which slightly surpassed Genworth's guidance. This was driven by the continued seasoning of the FY17 and FY18 book years as well as policy cancellation initiatives that were implemented in FY19. Net profit after tax (NPAT) surged 58.7%. This was partially due to a $24.6m unrealised gain in the company's investment portfolio, which contrasted with the $18.3m unrealised loss in FY18. Underlying net profit after tax (NPAT) was up 3.3% to $97m, which included a $20.1m realised gain. Genworth's loss ratio matched its guidance at 50.6%.

The company's 1Q20 results were driven by strong volume growth and improved claims data prior to COVID-19. This was the result of a healthy housing market recovery and low interest rates. GWP increased 32.2% to $114.1m and net earned premium advanced 3.4% to $75.4m due to the continued seasoning of prior books years and a strong NIW performance. New insurance written increased $1bn to $6.4bn. As a result of the economic impact of COVID-19, Genworth reported a statutory net loss of $125.6m and an underlying net loss of $103.2m. Excluding a $127.3 deferred acquisition cost (DAC) write-down, underlying NPAT increased 8.1% to $24.1m. A favourable ageing of delinquencies helped the loss ratio decline to 47.1%.

Strong capital position and reinsurance coverage

Genworth's capital adequacy is good given a prescribed capital amount (PCA) of $786.5m and a PCA coverage ratio of 1.78x as at 31 March. This was well above the high end of the Board's target capital range of 1.32x to 1.44x. In 1Q19 the PCA coverage ratio was 2.10x. As of 31 March it had $71m of cash, net assets of $1.37bn and net tangible assets (NTA) per share of $3.28, i.e. well above the current share price.

The company's reinsurance coverage is also good with $800m of excess of loss cover with varying durations. The cover is well-diversified with more than 20 different reinsurers in the program all of which have a credit rating of at least A-.

Speaking of ratings, credit rating agency Fitch moved to downgrade Genworth in May 2020. Citing the impact of COVID-19, it was a one-notch downgrade from 'A+' to 'A' with a 'negative' rating outlook. The 'A' rating is still in the 'Strong' category and this is likely to be transitory with Australia's unemployment data and housing market both improving.

No rush to get in, but yield should return to normal by FY22

Overall, Genworth appears undervalued given its strong lender network, capital strength and leading position in the LMI market. The P/E ratio for FY21, which starts in January, is 15x. However, we would consider FY21 a transitionary year following a recovery from COVID-19, which we expect to start in 2HY20. So realistically, FY22 would be the first "normalised" year to look at when it comes to Genworth's valuation. At a P/E for FY22 of 9.4x we believe Genworth is priced very reasonable. Granted, FY22 is 18 months away, so there's no rush to get into the shares.

From a yield perspective, FY21 is also likely to be a transition year with dividend gradually expected to get back up to pre-COVID-19 levels. So, while the dividend yield for FY21 is only expected to be around 3.6% at the current share price, FY22 should see the yield returning closer to 7%.

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Share price chart

Source: Tradingview

Versatile communications platform

Whispir's platform can be used for anything that involves communication with stakeholders, including from one to many and one-on-one communications. Use cases include Qantas notifying all passengers on a particular flight that the flight is delayed or the Victorian health authorities communicating with people in self-isolation and with people who have been in recent contact with someone who contracted COVID. But as we at Stocks Down Under will attest, Whispir is also very well suited to the SME segment of the market. You are receiving your edition of Stocks Down Under through Whispir's platform every morning, both the emails and the text messages.

The boost in business activity that Whispir experienced on its platform at the start of the COVID-19 crisis was triggered by customers activating and coordinating their business continuity plans, in other words, companies needed to figure out how to cope with the crisis and needed to communicate their strategies with employees, customers and suppliers.

Strong tailwind from COVID-19

Whispir's revenue model is very straightforward. In addition to a monthly fee for use of the platform, the company charges a small fee per message and per recipient. For instance, a text message may cost just a few cents per recipient, but if a company is sending that message out to 10,000 people at once, the numbers do add up quickly. And the great thing about this revenue model is that more than 95% of Whispir's revenue is recurring.

This model generated $18.2m in revenues in 1HY20 (ended December), which was a 20% increase year-on-year. The gross margin amounted to 62% while EBITDA amounted to negative $4.8m, which was 26% ahead of its own prospectus forecast. Another metric that Whispir reports is its annualised recurring revenue (ARR), which amounted to $36.7m per the end of 1HY20.

In its 3Q20 trading update, Whispir indicated that this ARR grew by more than 29% y-o-y, to $40.5m. The growth was especially driven by new Federal and State government customers, including police, health and transport authorities, that needed quick ramp up of communications protocols as the COVID-19 crisis unfolded. Together with its Telco partners, Whispir started to provide a range of communications templates for customers so they could be up and running in a matter of days.

The COVID tailwind has been so material for Whispir that it recently informed the market that it is now well ahead of its own EBITDA forecast for FY20 of a $9.4m EBITDA loss. The company now expects an EBITDA loss between $7.4m and $7.9m for the year.

Ample room for margin expansion

Whispir is one of those company's that should be able to demonstrate strong revenue growth rates for long periods of time given that it's business model makes it very easy for customers to increase the number of use cases on the platform. In doing so, average revenue per customer goes up over time and the lifetime value for each customer increases. The average revenue per user across more than 500 customers amounted to more than $72k during 1HY20, up 17% y-o-y.

Another one of Whispir's strong suits is its high gross margin of more than 60%. The cost of service of an SMS is basically fixed, but we'd expect Whispir to be able to drive its gross margin up as the volumes of messages increase over time enabling the company to negotiate better bulk terms with Telco's. At the same time it can essentially mark up these prices when reselling SMS volume to individual customers. In other words, we believe there is room for gross margin expansion as Whispir grows its customer and revenue base over time.

Room for more earnings upgrades

Whispir is expected to see its revenues grow from $31.2m in FY19 to $112m in FY24, which implies a 29% compounded annual growth rate (CAGR). During that same period, EBITDA is expected to grow from negative $11.3m to $15m, according to average analyst estimates. However, we believe that $15m EBITDA estimate for 2024 will prove to be too conservative. Once Whispir reaches break even, which we expect will be achievable on a revenue base between $55m and $60m, its gross margin can potentially drop straight to the bottom line. Yes, the company will want to expand internationally and launch new products going forward, but we believe the investments in staff and facilities required to do all this will be lower than what the market is projecting. So, we see potential for more earnings upgrades going forward.

On an EV/Revenue basis, Whispir is trading at 6x FY21 and 4.7x FY22, which we believe is very reasonable for a high-growth company with a proven product line and business model that is on track to become EBITDA positive within 18 to 24 months. So, despite the company's strong share price run since March, we believe there is more upside to the shares. Four stars from us.

Pitt Street Research Pty Ltd

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