14 JULY 2020

Stocks Down Under

> *Going to war without France is like hunting without an accordion.*

- Norman Schwarzkopf (1934-2012), United States Army general

APA GROUP

Expensive stock, but energising dividend yield

CHARTER HALL SOCIAL INFRASTRUCTURE REIT

Attractive yield with room for capital gains

ADRIATIC METALS

Polymetallic riches from Bosnia

APA GROUP

Expensive stock, but energising dividend yield

Stocks Down Under rating: ★★★

ASX: APA
Market cap: A$ 12.8BN

52-week range: $8.06 / $11.85
Share price: A$ 11.14

Sydney-based APA Group is an owner of natural gas and electricity assets. As the operator of Australia's largest natural gas transmission business, it has provided energy to households and businesses for over 20 years. With additional assets in power stations as well as wind and solar farms, the company has a well-diversified revenue profile that generates reliable earnings and increasing dividends. The shares presently offer a 4.6% dividend yield along with the potential for capital appreciation largely due to growth opportunities in renewable energy.

READ MORE

CHARTER HALL SOCIAL INFRASTRUCTURE REIT

Attractive yield with room for capital gains

Stocks Down Under rating: ★★★★

ASX: CQE
Market cap: A$ 819M

52-week range: $1.49 / $3.96
Share price: A$ 2.29

Based in Melbourne, Charter Hall Social Infrastructure REIT owns social infrastructure properties that serve the changing needs of communities in Australia and New Zealand. The portfolio of approximately 400 properties is valued around $1.08bn and is primarily invested in education-related facilities, such as university buildings and early learning centres. Charter Hall boasts a 99.8% occupancy rate and has a long weighted average lease expiry (WALE) of 11.7 years. The REIT has a 6.6% dividend yield and, after plunging 39% year-to-date, appears to be an attractive investment opportunity.

READ MORE

ADRIATIC METALS

Polymetallic riches from Bosnia

Stocks Down Under rating: ★★★★

ASX: ADT
Market cap: A$ 321M

52-week range: $1.49 / $3.96
Share price: A$1.84

One of the things that has made the Australian Securities Exchange a world leader when it comes to mining stocks is how truly global that quarter of the market has become. These days on ASX you can find companies with resources projects in every corner of the earth, from Greenland to Madagascar to, believe it or not, Bosnia. The London-based Adriatic Metals believes it has found its company-maker in that under-rated Eastern European country and is currently in the process of acquiring another interesting project in its neighbour, Serbia.

READ MORE

APA GROUP

Expensive stock, but energising dividend yield

Stocks Down Under rating: ★★★

ASX: APA
Market cap: A$ 12.8BN

52-week range: $8.06 / $11.85
Share price: A$ 11.14

Sydney-based APA Group is an owner of natural gas and electricity assets. As the operator of Australia's largest natural gas transmission business, it has provided energy to households and businesses for over 20 years. With additional assets in power stations as well as wind and solar farms, the company has a well-diversified revenue profile that generates reliable earnings and increasing dividends. The shares presently offer a 4.6% dividend yield along with the potential for capital appreciation largely due to growth opportunities in renewable energy.

Share price chart

Source: Tradingview

Defensive nature delivers reliable earnings

Nature Formerly Australian Pipeline Trust, APA Group's natural gas infrastructure spans the entire country helping to deliver energy to Australian homes and businesses. Its natural gas assets include the SEAGas Pipeline, Riverland Pipeline and QSN Link. Together the pipelines deliver roughly half of the country's natural gas usage. It also owns electricity transmission assets including the Murraylink electricity interconnector and the Terranora interconnector. APA also owns gas-fired power station, wind farms, solar farms as well as gas storage facilities.

The company has a history of delivering not just energy, but reliable profit growth and dividends to shareholders. It has been able to produce steady cash flow throughout the ups and downs of the economic cycle. It is the defensive nature of its earnings that appeal to many investors. In today's uncertain economic environment, we believe APA shares provide a relatively comfortable means of generating portfolio income.

Solid recent performance

In FY19 the company had revenue growth of 4.6% to $2.03bn. Net profit after tax (NPAT) increased 8.8% to $288m. The solid results were driven by the performance of new energy infrastructure assets, tariff escalation, and a favorable foreign exchange impact. It paid out a 47 cents per share dividend which was 4% above the prior year distribution and represented 55% out its earnings.

The 1HY20 result was similarly solid. Revenue was up 6.4% to $1.08bn and NPAT jumped 11.2% to $175m. New growth assets continued to drive performance as they accounted for $38.3m of EBITDA. EBITDA growth was posted in all three segments - Energy Infrastructure, Asset Management and Energy Investments. APA Group paid a 7% higher dividend of 23 cents per share and was also active in responding to the bushfires through financial and in-kind assistance, including a fire truck donation to the Shire of Dandaragan.

Following the interim result, APA Group's business became an even more important service during the COVID-19 crisis. Its critical facilities and essential field sites remained in operation to ensure customers continued to receive services. This was especially critical for healthcare facilities and emergency services customers. However, with most businesses shut down, the group experienced lower volumes. Fortunately, its defensive nature helped mitigate near-term volume risk. This is because capacity contracts and regulated revenues helped lessen the volume impact.

Opportunities in renewables to drive upside potential

We believe APA Group's balance sheet is of moderate quality. In 1HY20 the group refinanced $389m in higher cost debt to lower its borrowing costs. However, as at 31 December it had drawn $9.1bn of its $10.4bn of total debt facilities. The balance sheet appears to be able to support organic growth and sustainable distribution growth, but a reduction in the debt balance would improve the company's financial position.

With the future of energy likely to involve a shift towards lower carbon and zero carbon energy sources, the development of renewables infrastructure will be paramount. APA Group completed several major projects in FY19 in the renewable energy space, including the Badgingarra Wind and Solar Farms and the Darling Downs Solar Farm.

With customers demanding renewables in their energy portfolio mix, we believe the company has the potential to generate growth from additional renewables investments. This would further diversify its power generation portfolio and expose it to some of the higher growth areas of the energy sector. APA Group also has growth opportunities in the North American market where the market dynamics and regulatory environment are favourable.

APA Group's projected EBITDA growth for FY21 and FY22 is a modest 4.5% and 3.1% respectively. So, at an EV/EBITDA multiple of 13.1x and 12.9x for both financial years respectively, we believe APA is not a cheap stock. But it's reliable dividend payout make this an interesting one for the yield junkies among us. So, on that basis APA Group gets 3 stars from us.

CHARTER HALL SOCIAL INFRASTRUCTURE REIT

Attractive yield with room for capital gains

Stocks Down Under rating: ★★★★

ASX: CQE
Market cap: A$ 819M

52-week range: $1.49 / $3.96
Share price: A$ 2.29

Based in Melbourne, Charter Hall Social Infrastructure REIT owns social infrastructure properties that serve the changing needs of communities in Australia and New Zealand. The portfolio of approximately 400 properties is valued around $1.08bn and is primarily invested in education-related facilities, such as university buildings and early learning centres. Charter Hall boasts a 99.8% occupancy rate and has a long weighted average lease expiry (WALE) of 11.7 years. The REIT has a 6.6% dividend yield and, after plunging 39% year-to-date, appears to be an attractive investment opportunity.

Share price chart

Source: Tradingview

What is 'social infrastructure'?

Social infrastructure refers to property that enables social and community services. It is property that serves the needs of society and enriches living standards. Charter Hall's social infrastructure portfolio consists of early learning centres, university buildings, police stations and court houses. It is Australia's largest early learning centre owner and as such its focus is education. It has partnerships with more than 30 childcare operators, such as Goodstart Early Learning and Only About Children, which combined account for about 60% of portfolio rental income.

In FY19 the REIT reported a 5.5% increase in operating earnings to $44.2m. Net tangible assets (NTA) per unit increased 6.5% to $2.96. For the third straight year it delivered 6% distribution growth as higher lease income outweighed development and finance activity costs. Like-for-like rental growth was up 2.3% and the company achieved a 5.2% average rent increase on 10 property market reviews. Seven properties were disposed of in the fiscal year for a total of $9.2m.

Operating earnings jumped 20.3% in 1HY20 to $25.5m and net property income increased 8.8% to $2.6m. Gross assets grew 7.3% to $1.3bn supported by $97m of acquisitions. The WALE of the property portfolio increased to 11.7 years driven by 40 new, 20-year lease agreements with Goodstart Early Learning. The interim distribution increased 4.4% and NTA per unit advanced to $3.05 due to a $21.3m increase in property valuations.

Capital raising improves liquidity and flexibility

On 30 April, Charter Hall announced the sale and settlement of 26 chilldcare properties located in New Zealand for NZ$36.9m. The purpose of the sale was to reduce the company's portfolio exposure in New Zealand amid challenging market dynamics. These buildings were among the smallest of the group's New Zealand properties and had a WALE of 5.7 years. The properties were sold at a selling yield of 6.6% and an 8.7% discount to book value. Charter Hall still owns 20 childcare properties in the country all of which are leased to BestStart, New Zealand's largest provider of early childhood education. These properties have a longer WALE of 7.4 years.

About a week later, the company announced a capital raising. The equity raise comprised of a $100m institutional placement as well as a Unit Purchase Plan (UPP) of up to $15m for eligible Australian and New Zealand unitholders. The rationale for the issuance was to strengthen the balance sheet to protect against the COVID-19 crisis. It was also meant to provide Charter Hall with the flexibility to purchase attractive social infrastructure properties in the aftermath of the pandemic. The institutional placement was issued at a price of $2.20 per unit, which represented a 7.6% discount to the 1 May closing price. This gave the company $292m in liquidity and substantially reduced gearing to 16.7%.

Robust development pipeline to support further growth

The COVID-19 crisis resulted in the closure of early learning centres across the ANZ region. As with other non-essential services, health and safety concerns took priority. The centres could no longer operate and children had to be educated from home. Fortunately for Charter Hall, the childcare sector received significant support from the government. This, along with its long WALE and low exposure to smaller tenants, have helped it weather the storm. The uncertainty around the pandemic, however, did cause it to withdraw its FY20 guidance on 23 March.

We believe Charter Hall has a robust pipeline of development projects than span the office, industrial, retail and social infrastructure sectors. In total it has 80 projects that together represent a $7.1bn completion value. This year, 14 of the developments are expected to be completed. Like the current portfolio its development pipeline is well diversified by geography and sector. The REIT should continue to benefit from strong demand for childcare as well as growth in other property markets.

Apart from an attractive dividend yield, the company's share price is at a five-year low. We're not saying it will recover to pre-COVID levels, but we may see yield chasers drive the share price up in the medium term. So apart from yield, we think there's potential for capital gains with this one as well. Four stars from us.

ADRIATIC METALS

Polymetallic riches from Bosnia

Stocks Down Under rating: ★★★★

ASX: ADT
Market cap: A$ 321M

52-week range: $1.49 / $3.96
Share price: A$1.84

One of the things that has made the Australian Securities Exchange a world leader when it comes to mining stocks is how truly global that quarter of the market has become. These days on ASX you can find companies with resources projects in every corner of the earth, from Greenland to Madagascar to, believe it or not, Bosnia. The London-based Adriatic Metals believes it has found its company-maker in that under-rated Eastern European country and is currently in the process of acquiring another interesting project in its neighbour, Serbia.

Share price chart

Source: Tradingview

If you are looking for a low-cost place in which to develop some new world-class mines, look no further than the Balkan Peninsula in southeastern Europe. All the countries in that region have left their Communist past behind them and are open to foreign investors. A gigantic geological feature called the Tethyan Mineral Belt, which runs through the neighbourhood, means there's notionally plenty of gold, copper, lead and zinc to be found. But because people outside the Balkans remember the chaos that followed the breakup of Yugoslavia, some of these mineral riches are going for a relatively low price. Their loss is Adriatic Metals' gain. This company intends to become a serious miner in this part of the world alongside the big guys, like Rio Tinto.

Bosnia: That was then, this is now

Adriatic Metals reckons it has found its company maker in Bosnia and Herzegovina, one of the six former Yugoslav republics and probably the one rated least likely to succeed by many commentators. If your memory stretches back to the period 1992-1995 you will remember when Bosnia was in the news most nights of the week, because there was a terrible war going on there. However, that was then and this is now. These days Bosnia, population 3.5 million, has an economy that is gradually liberalising, routinely grows 3% per annum and features public finances in such excellent shape the government routinely runs budget surpluses. And that's with a 10% corporate tax rate!

Adriatic Metals owns two high-grade polymetallic deposits in Bosnia not far from the town of Vareš, which in turn is about 50 km north of the Bosnian capital of Sarajevo – that's right, the place where the First World War started a century ago. When Adriatic Metals listed on ASX in 2018, the Vareš Project was primarily thought of as a zinc play, although there's also plenty of lead, silver, copper, gold and barite in situ. One of the deposits, called Veovača, was actually worked as an open cut mine in the 1980s, so the deposit is well understood. We think the metallic diversity is the reason why Adriatic Metals stock has performed so well since 2018 - Vareš makes out nicely so long as one or two of the commodities are in reasonably good shape price-wise, with everything else counting as credits.

How valuable is this project, potentially? In November 2019 Adriatic reported the results of a Scoping Study where Veovača as an open pit would be combined with the other deposit, called Rupice, as a new underground mine. Adriatic Metals found that only US$178m in capex at Vareš would yield an NPV of US$917m at an 8% discount rate. Obviously, a Feasibility Study will be needed to firm these numbers up, but the market has liked what it heard.

Another would-be mine available at low cost

The Serbian opportunity at Adriatic Metals comes from a merger announced in May 2020 with a small Vancouver-based company, called Tethyan Resources. That company owns a couple of old silver-zinc-lead mines called Kizevak and Sastavci, near the town of Raška in southwestern Serbia, about 260 km south of Belgrade. The Kizevak mine looks like a lucrative opportunity, with a resource of 6.2 million tonnes at 5.3% zinc, 3.2% lead and 48 g/t silver, all close to surface.

The Kizevak and Sastavci resource estimates convert to the JORC 2012 standard later this year, so we'll find out how valuable it is pretty soon. But we suspect they are probably more than the US$10.6m in Adriatic scrip being paid under this deal. And, as with Bosnia, the address is favourable. The corporate tax rate in Serbia is only 15% and for mines there's only another 5% Net Smelter Royalty payable to Belgrade.

Adriatic Metals still has some way to go before it is producing at either Vareš or Kizevak, but with most commodities rallying after the Corona Crash earlier this year the time seems right for this one. Zinc in particularly has risen from US$1,800 a tonne on LME in late March to over US$2,000 a tonne now. A Pre-Feasibility study for Vareš is now ongoing with completion expected shortly and that will provide some confirmatory data on the US$917m NPV we noted above. US$917m at the current exchange rate is A$1.32bn. Adriatic obviously has some development capital to raise if Vareš is to become a reality, but A$1.32bn is worth over A$7 per share at the current number of shares on issue. Adriatic may have risen by a third during FY20, but we think there's probably more where that came from.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

Pitt Street Research Pty Ltd is founded on more than 40 years of combined experience researching companies in a range of different sectors.