Stocks Down Under

“The Second Amendment says we have the right to bear arms, not to bear artillery.”

- Robin Williams (1951-2014), American comedian and actor

QBE INSURANCE

Looks attractive at current, multi-year low

GRAINCORP

Trade the shares, not the grains

SALT LAKE POTASH

Worth its salt (and sulphate)

QBE INSURANCE

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Stocks Down Under rating: ★★★★

ASX: QBE
Market cap: A$ 13.6BN

52-week range: $7.13 / $15.19
Share price: A$ 9.59

Based in Sydney, QBE Insurance Group is Australia's second largest insurance company after Insurance Australia Group. It offers general insurance and reinsurance products and services to customers in Australia, Asia Pacific, Europe and North America, including personal, commercial and specialty products and risk management solutions. The COVID-19 crisis has created unprecedented uncertainty in the global insurance market. However, the impact on QBE's investment and insurance portfolios have thus far been limited. Steps taken to strengthen its capital position bode well for survival and post-pandemic growth opportunities. And come FY21, which starts in January, QBE's dividend yield should go back up to around 5%.

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ASX: GNC
Market cap: A$ 899M

52-week range: $2.79 / $4.52
Share price: A$ 3.93

Sydney-based GrainCorp listed on the ASX in 1998, but it started life all the way back in 1917 as a government-owned company tasked to collect and transport grains from all over New South Wales by rail. In 2000, it merged with its Victorian counterpart and later on expanded into the US and other countries. Today, GrainCorp is one of the world's leading grain traders accounting for more than 50% of export trade. Its shares show a very distinct trading range, between $3 and $4.50, over the last six years. We believe investors can benefit from GrainCorp's grain trading skills, but also from the specific trading history of the company's shares.

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Last October, the Perth-based Salt Lake Potash published a Bankable Feasibility Study (BFS) on its proposed potash mine at Lake Way, near Wiluna, which is 940 km northeast of Perth in Western Australia. Salt Lake Potash's BFS suggested a post-tax NPV for Lake Way of A$479m at an 8% discount rate. However, at the moment Salt Lake Potash is trading at less than half that value. Given the favourable medium-term demand and price outlook for the kind of potash this company wants to produce, that's encouraging.

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Share price chart

Source: Tradingview

Rate increases were accelerating pre-COVID

In FY19, QBE Insurance Group delivered solid results that included underlying gross written premium (GWP) growth of 4% to $13.44bn. The average premium rate increase was 6.3% with increases experienced in all regions. This was led by a strong second half of the fiscal year in which the rate increase was 8.3% after accelerating to 9.2% in 4Q19. The group's investment portfolio recorded a net return of 4.6% and outperformed its benchmark. The group's combined operating ratio, a measure of general insurance underwriting profitability, expanded from 95.7% in FY18 to 97.5%.

QBE's 1Q20 trading update highlighted improving insurance business conditions. Gross written premium increased more than 9% on a constant currency basis to US$4.53bn. This was driven by solid volume growth and improved retention as well as strong premium rate increases. Premium rate increases averaged 8% in the quarter, which slowed sequentially but marked an acceleration from 4% in 1Q19. All divisions achieved premium rate momentum with specific strength in the North America and International divisions.

COVID-19 slows momentum, but strong steps taken

To say the least, the COVID-19 pandemic has been disruptive to QBE's business. Normal business practices were altered as the company was forced to implement its business continuity plans to make sure its services were still available to customers and business partners. This slowed the strong underlying premium growth and pricing momentum that was seen at the start of the year. In addition, sharply declining capital markets pressured the performance of its portfolio. During 1Q20, QBE materially de-risked its investment book by exiting all equities, emerging market debt and high yield debt.

Uncertainty around COVID-19 also caused the company to withdraw its 2020 financial targets. Overall, however, it expects the pandemic to have only a modest impact on 2020 GWP and the low risk, diversified nature of its credit portfolio is expected to help withstand capital market shocks. The fact that QBE exited the travel insurance business in 2019 and does not write material event cancellation or contingency policies have helped limit the impact on its broader insurance portfolio, in our view.

In April 2020, QBE announce a US$825m capital raising that was comprised of a US$750m fully underwritten institutional placement and a US$75m share purchase plan (SPP) that was offered to existing eligible shareholders. The rationale of the equity raising was to strengthen the company's capital position in preparation for potential severe downside economic scenarios. The offer price was $8.25 per share, which represented a 9% discount to the 9 April 2020 closing price of $9.11. The placement resulted in approximately 145.5m new shares being issued, which equalled about 11% of QBE's existing issued capital at the time. It helped lift QBE's regulatory capital from 1.6x PCA (Prescribed Capital Amount) to 1.9x, placing it at the top end of its target range and above Standard and Poor's 'AA' rating level. Aside from bolstering its capital position, the issuance reduced gearing and improved earnings resilience. The stronger capital base also positioned QBE to capitalise on future organic growth opportunities.

Reinsurance limits QBE's risks

QBE's broader insurance policy that covers property damage typically includes business interruption insurance. Business interruption insurance, however, generally excludes pandemics and requires the presence of physical damage. On 24 May the group addressed queries regarding the potential receipt of business interruption insurance claims from UK-based policy holders. Although QBE's policies do not generally cover claims related to COVID-19, it noted that reinsurance cover would limit its UK business interruption costs exposure to $75m.

QBE's purchase of reinsurance coverage is designed to protect the company from large, unexpected claims and losses. Under the risk-limiting agreements, reinsurers assume a portion of the claims and related expenses in connection with QBE's written insurance policies. Today, the group's reinsurance cover is adequate, in our view, and more sustainable following a program restructuring in December 2018. It includes greater protection against catastrophe claims and lower large individual risk retention compared to the previous program.

We believe the company's management has thus far weathered the COVID-19 crisis rather well. QBE has a strong capital position that should protect it from the ups and downs of the economic recovery. As the pandemic subsides it will also be in a good position to pursue growth opportunities across its global platform. And with dividend yield expected to return to 5% in FY21 and 6% in FY22, we believe now may be a good time to build a position in QBE. Since the stock is at a 5-year low, it seems most, if not all, of the recent bad news is priced in.

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Share price chart

Source: Tradingview

Not all grains are created equal

Grains, also known as cereals, are the edible seeds of various sorts of grasses belonging to the Poaceae family. The grains that GrainCorp mostly trades, wheat, barley and canola, are just some of the different types of grains. Others are rice, corn and oats, for example.

While not the largest of the grains in terms of volumes grown globally, barley is certainly one of the more interesting grains. While it's mostly used in animal feed and as a source of malt for beer in particular, it is also used to make bread, soups and stews. And it is also increasingly used in health foods.

Wheat is by far the largest grain in terms of volumes globally and is the biggest source of vegetable protein in human food consumption, specifically in the form of flour for bread, pasta, breakfast cereals and noodles.

Severe impact from drought last year

GrainCorp provides a range of services, including collection, transportation and storage of grains as well as marketing (trading) of grains. This is the Agribusiness side of GrainCorp, which generated almost $2bn in revenues in 1HY20 (ended 31 March). The Agribusiness achieved an EBITDA margin of 4.1% during this period compared to an EBITDA loss the year before. This side of the business has been particularly hard hit by the drought that plagued large parts of Australia last year. Grain volumes were depressed and well below the long-term averages.

Apart from the Agribusiness, GrainCorp also generates revenues from processing, i.e. crushing grains to generate oils. This is a small part of the business with revenues in 1HY20 of $306m, although the EBITDA margins of 7.5% are substantially better than the margins at the Agribusiness.

In March GrainCorp divested its malts business by listing United Malt Group on the ASX (ASX:UMG). Prior to the divestment, this malts business generated $78m in EBITDA in 1HY20. We wrote about UMG in Stocks Down Under on 11 June 2020. GrainCorp retains a 10% interest in UMG.

The likes and dislikes

There is one aspect of GrainCorp that we really like, which is the defensive aspect of an investment in the company. People will always need to eat, recession or not. However, certain things are outside the company's control, such as the weather. Periods of drought or excessive rain affect grain harvests and hence transportation and storage volumes, which affects GrainCorp's revenues and ultimately the bottom line. And the unpredictability of such climate change effects increases the company's risk profile, in our view.

Put this one on your watchlist

In the last six years, GrainCorp has basically been trading sideways in a range from $3 to $4.50 per share. At the current share price, the shares are still trading in the upper half of this range. However, the trading pattern is very specific, with the shares trading up to the upper end of the range and staying there for a couple of months only to fall back towards $3, spending most of their time below $3.50 before moving up again. This pattern can be seen on the chart for the last six years.

So, having peaked at $4.50 last month, we wouldn't be surprised to see GrainCorp trade back down below $3.30 or $3.40 over the next six months, at which point the share will become interesting again, in our view. Especially since EBITDA is expected to show a jump in FY21 (starting in October) to $181m from $122m in the current financial year.

So, we give GrainCorp 2 stars at the moment, not because we don't like the company, but in anticipation of lower potential entry points, in line with the last six years of its share trading history.

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Share price chart

Source: Tradingview

If you're into gardening, you may have encountered a version of the product that Salt Lake Potash intends to be selling on world markets from next year. Just look at the bag of fertiliser you recently bought at Bunnings and you'll notice it lists three main ingredients: There'll be an 'N' for nitrogen, a 'P' for phosphorous and then there's that mysterious letter 'K'. That stands for 'kalium', which is the Latin word for potassium. That element is ultimately obtained from deposits of potash, which is simply potassium-rich salt.

The world simply needs more food

The thing about fertiliser, and therefore potash, is that the world is needing more and more of it to keep everyone fed. In 2010 there were perhaps 6.9 billion people on the planet. Today, there's about 7.7 billion and unless Covid-19 proves to be a lot more virulent than it's been so far, there's expected to be something like 8.6 billion people alive in 2030. And growing all the time is the world's Middle-Class population that likes to eat well.

So, all up, Salt Lake Potash, with its expected 245,000 tonnes of Sulphate of Potash (SoP) from Lake Way per annum believes that its prospects are good. The naysayers will point to a chart of the SoP price and ask why it has been going down since 2014. We would simply reply that the 2010's generally were not great times for most commodities and yet the annual average variance in SoP price has only been 4% or so. Basically, the current potash producers have managed to keep up with demand for SoP, but only just.

Farmers want the good stuff

There's an additional factor at work in the potash industry that will also work in Salt Lake Potash's favour. Most of the world's potash today is of a kind called Muriate of Potash (MoP), which is potassium chloride (muriate being just a fancy word for chloride). MoP is what BHP will be producing if it ever gets its gigantic Jansen Potash Project up and running in the Canadian Province of Saskatchewan. That's the project most of the media commentary suggests is going to be put on the shelf sometime soon. And no wonder, because increasingly what farmers are looking for is fertiliser for growing chloride-sensitive crops such as fruits, vegetables, coffee, tea and nuts. Sulphate of Potash, which, as its name suggests, contains both potassium and sulphur, is that premium product.

Even if the price of SoP continues to go down, Salt Lake Potash reckons it is well placed to succeed as a low-cost producer. Lake Way is a dry saline lake of the kind you find a lot of in the Western Australian outback. Salt Lake Potash will simply take the brines from that lake and process them into Sulphate of Potash. That's a lot less expensive than underground bulk mining of potash, the making of MoP from that, and then the converting of that muriate into Sulphate of Potash using the expensive Mannheim Process.

All up, Salt Lake Potash reckons Lake Way will be bottom quartile producer of SoP globally with cash costs of only about US$200 a tonne, way below the US$450-600 a tonne that the commodity has traded for in recent years.

Funding shouldn't be an issue

It's a reasonable bet that Lake Way will be up and running by early 2021. There are already substantial offtake agreements for most of the Lake Way SoP, the most recent being secured with the Japanese trading house Mitsui in February of this year. And the funding for the project, whose capital cost with contingencies as per the BFS is A$254m, is more or less in place thanks to a financing facility from the Sydney-based Taurus Funds Management, which was announced in August 2019, prior to the completion of the BFS. We say 'more or less' because the business end of that facility has yet to kick in almost a year later, which may be why the Salt Lake Potash stock is still trading at a discount to the valuation suggested by the BFS.

You see, that financing from Taurus came in two parts. An initial US$30m 'Stage 1' facility from Taurus, extended to US$45m in December 2019, allowed the BFS to complete and has assisted with early construction work at Lake Way. However, the main US$150m Project Development Facility has yet to close. There could be any number of reasons for that, but Salt Lake Potash isn't the first company and won't be the last where the negotiations around project financing have taken a while. The fact that Salt Lake Potash raised equity at 70 cents in December (A$23.5m) and again at 34 cents in April (A$20m), and early this month took out at $10m convertible note facility (which converts at the lower of 45 cents or 5% discount to the next equity raising price), suggests that this company won't die before Lake Way starts to deliver on its potential.

Salt Lake Potash stock has rallied strongly since the Corona Crash low of 30 cents on 19 March and the stock is still pointing north. We think that closure on the main Taurus facility can provide the catalyst for considerable additional upside. Remember, the stock was north of 80 cents when the BFS came out last October. With the funding risk in mind, we're still giving this one Four Stars.

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