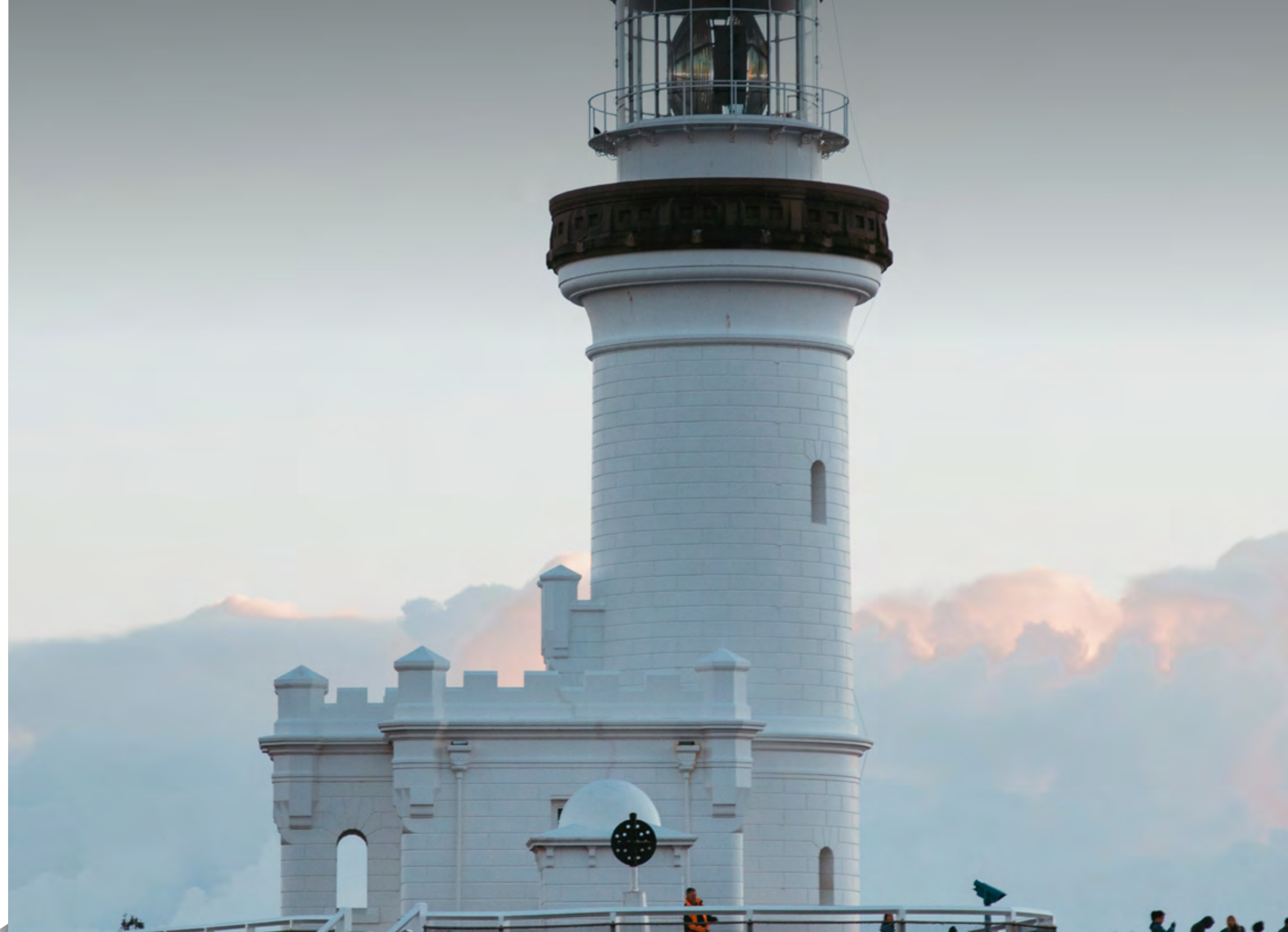
17 JULY 2020

Stocks Down Under

One of the best hearing aids a man can have is an attentive wife.

- Groucho Marx (1890-1977), American comedian and actor



COCHLEAR
I heard it through the implant

COOPER ENERGY
Sole man

ARDENT LEISURE
Let me entertain you

COCHLEAR

I heard it through the implant

Stocks Down Under rating: ★★★★

ASX: COH
Market cap: A$ 12.5BN

52-week range: A$ 154.60 / A$254.40
Share price: A$ 190.85

Headquartered in Sydney, Cochlear is a global medical device company that supplies hearing implants, acoustics and related accessories to the hearing impaired. With operations in the Americas, EMEA and Asia Pacific, the company holds a leading 60% share in the global hearing device market having sold more than a half million implants. Cochlear invests significantly in R&D, which leads to the development of innovative hearing technology products for healthcare providers and patients. The shares offer a 1.8% dividend yield and significant upside potential, in our view, given the favourable demographics and growth opportunities in both developed and emerging markets.

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Market cap: A$ 643M

52-week range: A$ 0.34 / A$0.685
Share price: A$ 0.42

Like just about every oil and gas producer around the world, the Adelaide-based Cooper Energy suffered badly in the early 2020 crunch that saw an oil price war between Russia and Saudi Arabia merge into the Coronavirus Crash. Cooper Energy stock was at 63 cents on 3 January 2020 but by 23 March it was down to 36 cents. It's tested that level twice more in the three months since and we think it is showing some resilience. At these levels, the market is giving precious little value to Cooper Energy's new Sole Gas Field, let alone the other growth assets that Cooper Energy has been assembling since 2014.

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Share price chart

Source: Tradingview

Services, emerging markets growing well

Cochlear derives approximately 60% of sales from hearing implants that help recipients of all ages hear better and lead more satisfying lifestyles. It offers a range of cochlear implants for people with moderate to profound hearing loss. In addition, it has a line of Acoustics devices under the Baha brand, which serve as bone conduction implants for people with conductive hearing loss, mixed hearing loss and single-sided deafness (SSD). The company's Services division provides accessories, like the Cochlear wireless phone clip, TV Streamer and mini microphone. Finally, it also manufactures bone-anchored facial prosthetics to improve the attachment and cosmetic outcome of facial prostheses.

The FY19 result included a 7% increase in revenue to $1.45bn. This was driven by a 17% jump in upgrade revenue from a strong uptake of the new Nucleus 7 Sound Processor. This along with a growing recipient base helped drive Services revenue 14% higher to reach 30% of overall revenues. FY19 was a slower year for implants sales, which slipped 3% on a constant currency basis but picked up in the fourth quarter after the launch of the Nucleus Profile Plus Series implants. From a geographic perspective, EMEA sales were up 6% while Americas sales lagged down 1%. Underlying net profit advanced 7% to $265.9m aided by lower U.S. tax rates and operational efficiencies.

Cochlear implants growth returned in 1HY20 as unit sales were up 13% due largely to a 20% surge in emerging market units. This helped drive sales higher by 9% to $777.6m. Services revenue was up a modest 5% as penetration rates reached a high level amid a maturation of the upgrade cycle. Acoustics sales declined due to competitor product launches and the market holding off purchases in anticipation of the Cochlear Osia 2 System launch. The group's underlying net profit of $132.7m was in line with 1HY19 because operating profit growth was offset by foreign exchange contract losses.

Opportunity for growth in both adult and children segments

Cochlear's strong free cash flow generation has enabled the company to maintain a strong balance sheet. It has been able to make capital expenditures, acquisitions, invest and pay dividends all while maintaining a conservative gearing level. In FY19 and 1HY20 both capex and dividends increased alongside a small increase in debt. As at 31 December, Cochlear had a low net debt position of $103m and a rising interest cover ratio of 80x. Over the last 5 years net debt has been reduced by about $80m despite more than $400m in capex investments over that time.

Structural growth in the global hearing devices market has been supported by favourable demographics, including an ageing worldwide population. This has led to heavy underlying demand for implants. Moreover, positive clinical results have demonstrated significant quality of life improvements with cochlear implants as compared to hearing aids. Cochlear implants have become the standard of care for hearing impaired adults and seniors. And there is ample opportunity for growth given the company's hearing implant market penetration is only 3% in the adults and seniors developed markets. Cochlear also has room to grow in the children's segment in both developed and emerging markets, in our view.

New products help Cochlear maintain market leadership

Cochlear invests heavily in research and development, which leads to the launch of innovative hearing technology solutions that are backed by a broad patent portfolio. On 8 April, the company received expediated FDA approval for its Remote Check solution for cochlear implants. It is the first telehealth patient assessment tool that provides performance data to clinicians. The product will allow hearing healthcare providers and hospitals to remotely identify people that need audiological care during the COVID-19 pandemic and beyond. Remote Check not only offers convenience to patients but also reduces the cost of care.

More recently the U.S. Food and Drug Administration (FDA) approved four new Cochlear products that are expected to soon be available in the US and Western Europe. This includes the Nucleus 7 Sound Processor for the Nucleus 22 implant, Cochlear's first commercial implant released in 1982. This means Nucleus 22 recipients will have smartphone connectivity for the first time. The other new products are the Nucleus Kanso 2 Sound Processor, the first and only off-the-ear cochlear implant sound processor to offer direct streaming from compatible Apple or Android devices. Other future releases include the Custom Sound Pro fitting software and the Nucleus SmartNav system, the latter of which will help surgeons optimise electrode placement during cochlear implant surgery thereby improving surgical outcomes.

In addition to its product development pipeline, Cochlear has a tremendous growth opportunity in the Asia-Pacific region. Asia Pacific sales have increased in each of the last 4 years and were up 13% in 1HY20 compared to 3% in the Americas and EMEA. Although Asia Pacific is the company's smallest geographic segment at 17% of sales right now, we believe it represents its largest growth opportunity because countries like Japan, Korea, and China are experiencing strong growth. After deferring non-critical surgeries during the peak of the pandemic, robust demand for cochlear implant surgery is expected to resume in the region.

Attractively priced for the post-COVID era

At 44x EV/EBITDA for FY21 (July to June), Cochlear seems quite expensive given that FY21 EBITDA is only expected to grow by 13%. However, we think investors need to keep in mind that the disruption from COVID-19 will last for a little while longer in the current financial year. We think FY22 is what you need to look at as that's when we should see more normal trading conditions throughout the financial year.

FY22 EBITDA growth is expected to amount to more than 66% while Cochlear's current EV/EBITDA multiple is "only" 26.2x for that year, implying a very healthy EV/EBITDA-to-EBITDA-growth ratio of 0.4. Granted, that is 12 months away, but we don't see Cochlear shares dip much further than where they are now, unless the whole market tanks. So, four stars from us.

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Share price chart

Source: Tradingview

If you want to know an emerging Australian oil and gas player with a good strategic sense of where the future is headed, take a look at Cooper Energy. Back in October 2016 that company shelled out A$62m cash to acquire Santos's Victorian gas assets at a time when the oil and gas sector was still massively out of favour after the bone-crunching two-year decline of mid-2014 to early-2016.

The main assets that were picked up in the Santos deal were 50% (and operatorship) of the producing Casino and Henry offshore gas fields in the Otway basin and the stake Cooper Energy didn't own in an undeveloped offshore gas field in the Gippsland Basin called Sole. The Otway Basin sits offshore southern Victoria while the Gippsland Basin is offshore eastern Victoria inside Bass Strait. What's the potential prize for Cooper Energy for its 2016 plunge into these two basins? One of these days the whole Australian East Coast is expected to run seriously short of gas thanks to rising demand and a paucity of new discoveries and Cooper Energy wants to be there early to make sure it reaps the rewards.

A better Casino than the one in Melbourne

Now fast forward to 2019/20, and Cooper Energy was, until a few months ago, riding high as a bone fide member of the S&P/ASX 200. In FY19 the company had enjoyed $75.5m in revenue and $32.9m in underlying EBITDA mainly from Casino-Henry as well as a few fields in the Cooper Basin in north-eastern South Australia. In November 2019, the company discovered a new gas field called Annie, not far from the Henry gas field in acreage gained in the 2016 Santos deal. The following month the Casino-Henry partners took control of the Minerva Gas Plant near the western Victorian town of Port Campbell. And then in February 2020 the first gas from Cooper Energy's new Sole field went through the gas processing plant at Orbost in eastern Victoria that APA Group (ASX:APA) operates. This last milestone represented a step change because Casino-Henry only brought in around 6 petajoules of gas for Cooper Energy, whereas Sole was intended to be a 24 petajoule per annum field.

Then came the dark times for the energy sector, which hammered the Cooper Energy share price even though, for the company itself, the times weren't so dark. Cooper Energy had taken on some debt to get Sole into production, but its bankers were highly supportive as the crisis deepened, in no small measure because all the gas from Sole was going to be sold under take-or-pay contracts out to 2025 once the commissioning phase had been completed. Consequently, the $73m in net debt as at December 2019 was not regarded as a serious roadblock for the company. In July 2020 that commissioning is still ongoing, but we see its completion as potentially allowing Cooper Energy stock to re-rate from the 36-cent support level we noted above.

Mrs. Minerva and a girl called Annie

Beyond Sole, Cooper Energy has a number of growth projects it is working on. The most immediate one to take notice of relates to the Minerva Gas Plant. It's called Minerva because it was originally built by BHP to process gas from a field of the same name, which has now ceased production. Control of Minerva makes Cooper Energy a key player in the East Coast gas scene because there's only two other plants that process offshore Otway Basin gas.

Currently, gas from Casino-Henry flows to another gas plant near Port Campbell called Iona, which is owned by a private company called Lochard Energy. Cooper Energy is nearing a Final Investment Decision on switching Casino-Henry output to the Minerva Gas Plant instead. That decision alone could add a lot of value to Cooper Energy. After the Minerva Decision, we'll be very interested to see what happens with the Annie Field, which could easily add a lot of value to the Casino-Henry complex.

One to get your gums into

And then there's Basker Manta Gummy. Gummy what?, we hear you ask. Yeah, sounds dumb, doesn't it, but, you see, all the gas fields in the Gippsland Basin from the mid-1960s on were named after sea creatures. Sole, named after the fish people like to eat at restaurants, was just one of more than a dozen fields like that. The gummy's real name is Mustelus antarcticus and it's a shark often found in Australian waters, so in 1990, when they discovered a gas field next to the Basker and Manta gas fields, they just had to name it Gummy…but we digress. Basker, Manta and Gummy produced only briefly between 2006 and 2010 and proved more challenging than expected. Cooper Energy bought in to these now idle fields in 2014 and is currently re- evaluating the gas and liquids potential of Manta, which is potentially ample.

We think none of this potential upside – Minerva, Annie or Manta – is even close to being discounted into the Cooper Energy share price right now. At the moment you can get the stock for an EV/EBITDA multiple of just 4.2x forecast FY22 earnings even though that forecast EBITDA is set to grow 112% per annum over the next two years because of Sole.

One of the reasons that Cooper Energy is that inexpensive today is that gas prices have taken a dive, from over A$8/GJ last Victoria to perhaps $4/GJ now. However, it's a fair bet that East Coast gas can recover as the Australian economy comes back to life in the second half of this year. We believe Cooper Energy represents a great way to play that recovery.

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Share price chart

Source: Tradingview

Ordinarily Ardent Leisure is a great business to be invested in, primarily because of Dreamworld and its next-door sister park, WhiteWater World. Dreamworld is a theme park with over 40 fun rides, and is the largest theme park in Australia, while WhiteWater World, opened in 2006, is a 'water park', that is, an amusement park that features multiple water play areas. And, no, WhiteWater wasn't named after the American political controversy of the 1990s that so badly impacted the Clinton Administration.

A tourist attraction like no other in Australia

But seriously, the reason these key Ardent Leisure assets are very valuable is because, just as every kid in America wants to go to Disney World, every kid in Australia wants to go to Dreamworld. And every Generation X parent who never got to go as a kid after Dreamworld opened in the southern summer of 1981/82, but now has the money to do it, wants to take their kids today.

The location makes it easy for the parents to deliver. Since the 1960s the Gold Coast in south-eastern Queensland has been the Florida of Australia in terms of where people of all ages like to go on vacation. And the two theme parks, at a town called Coomera, are only 28 km north of Surfers Paradise, the Miami of this tourist wonderland. Such is the pulling power of Dreamworld that even after the tragic accident in October 2016, where four people were killed on a ride called Thunder River Rapids, the park was able to re-open less than two months later and attendance quickly rebounded to a level equivalent to well over a million a year.

Unlockdown is happening

Now, to state the bleeding obvious, 2020 is not going to be an ordinary year for Dreamworld. Ardent Leisure closed Dreamworld and WhiteWater World on 23 March 2020 because of Coronavirus and they have yet to re-open. That now puts them at something of a competitive disadvantage with Village Roadshow (ASX:VRL), whose Gold Coast theme parks have now all re-opened. But it doesn't mean that Dreamworld has lost its mojo because the brand equity here has been building up for close to 30 years now and Ardent Leisure continues to invest in new rides and attractions. The same brand equity argument is true to a lesser extent of SkyPoint, which is an observation deck with a bistro and bar at the top of Q1, a skyscraper in Surfer's Paradise, and SkyPoint Climb, which lets you climb up the side of that building. Let us tell you folks, the views are spectacular. SkyPoint is closed right now, but it will be back, as will Dreamworld. At this stage, the plan is to open in time for the September school holidays.

And these attractions will probably be back sooner rather than later. Australia may currently be cut off from the rest of the world, but the Gold Coast is the place to go for Australians when the rest of the world is too scary to visit. We saw that after 11 September 2001 and we think we'll see it again. The state of Queensland just re-opened its borders to the rest of Australia on 10 July. Sure, it is excluding travellers from known Coronavirus hotspots to the south and just getting over the border from New South Wales is reportedly taking a while. But the tourists just out of lockdown and looking for a good time are coming back.

The Main Event

One thing that is delivering right now for Ardent elsewhere in the world is Main Event. This outfit is a suite of 44 bowling alleys with associated dining and entertainment venues all around the United States. There's a reason why Main Event has been a part of Ardent Leisure and its predecessor, the Macquarie Leisure Trust of Macquarie Bank, since the business was acquired in 2006. Americans love bowling, but they also want to move up the experience curve from the scuffed old bowling alleys of the early 1960s. Main Event is the main gig in this market dynamic and Ardent has been growing the business steadily.

Ardent Leisure now believes that, coming out of Covid-19, it can step up the pace for Main Event, which is why it recently sold 24% of Main Event to an investment group called RedBird Capital Partners. Importantly, in terms of the current situation for Ardent, 28 of the 44 Main Event sites are currently operating, and more will likely emerge from lockdown soon.

Look through the near-term haze

All up, we are confident that Ardent Leisure can get through the current Coronavirus Crisis in one piece. Gearing as at December 2019 was modest, with net debt of only $133m balanced against $362m in equity. So, is this a stock for your portfolio now?

It's interesting to us that on 18 June a shareholder class action related to the Thunder River Rapids disaster was initiated against Ardent Leisure. We think that's a key reason why the stock has trended down in recent days – no one likes litigation risk, even though these types of matters tend to settle out of court for a fraction of what the plaintiffs are going after. Maybe the current weakness is a buying opportunity given that the NTA backing for this stock at 31 December was 59 cents.

At 50x EV/EBITDA for FY21, Ardent Leisure's valuation looks very distorted, obviously due to the COVID-19 fallout that we're going through right now and a lack of overseas visitors. However, assuming a return to some sort of "new normal" twelve months from now, we believe things are looking substantially better. The shares are currently trading at just 13.4x for FY22 in a year that should bring Ardent's EBITDA level roughly back to FY19 levels (A$54m), from an estimated $13.5m in the current financial year. That seems like an attractive proposition to us. So, despite the risk of Corona infections flaring up, like in Melbourne currently, we believe that Ardent Leisure could prove to be an attractive investment at current levels. That said, we think there's no need to rush in. After all, Dreamworld will still likely be there for the summer of 2021/22, its fortieth anniversary.

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