23 JULY 2020

Stocks Down Under

Marriage is really tough because you have to deal with feelings... and lawyers.

- Richard Pryor (1940-2005), American stand-up comedian and actor

AGL ENERGY

Limited upside, but dividend provides support

CORONADO GLOBAL

Well placed for a metcoal recovery

WISR

We like the model but it's just so darn expensive

AGL ENERGY

Limited upside, but dividend provides support

Stocks Down Under rating: ★★★

ASX: AGL
Market cap: A$ 10.8BN

52-week range: A$15.15 / $21.37
Share price: A$ 17.06

Sydney-based AGL Energy is an electricity and natural gas supplier that generates and sells energy for both residential and commercial use. It generates energy from power stations that use natural gas, coal steam gas, hydroelectricity, wind power and solar power. With more than 3.7m customer accounts it provides approximately 20% of Australia's electricity. AGL's strong financial position allows it to invest in its core electricity and renewable energy portfolio to power future growth. In addition to the growth potential, the defensive shares deliver steady income and currently have a 5.5% dividend yield. However, given the current market condition and looking out 12 months, we believe there is a risk that dividend may be cut. Not by much, but enough to make us a bit cautious.

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ASX: CRN
Market cap: A$ 899M

52-week range: A$0.91 / $3.57
Share price: A$ 0.915

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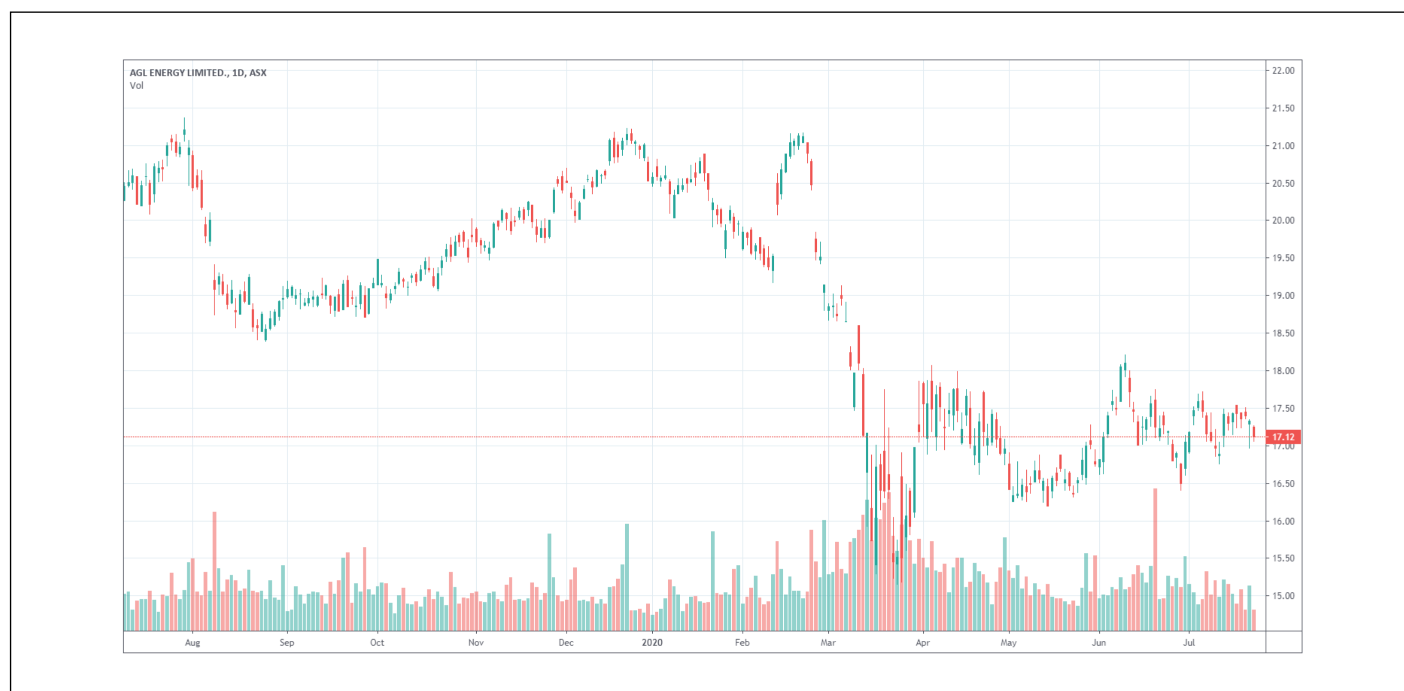
Share price chart



Source: Tradingview

Defensive utility company with high dividend payout policy

A defensive business is one that is well-established and typically generates stable earnings and dividends in all market conditions. The utility business certainly fits this mould because people are always in need of gas and electricity services. Having been in business since 1837 when it was founded as The Australian Gas Light Company, AGL is indeed a well-established defensive share. It has a long history of providing shareholders with steady dividends throughout the ups and downs of the economic cycle. The low volatility stock should benefit from the low interest rate environment and offers modest long-term upside potential.

AGL reported solid FY19 results as underlying profit was up 2% to $1.04bn. This was primarily driven by electricity portfolio earnings. The company's earnings were supportive of a small full-year dividend increase. It paid a FY19 dividend per share of $1.19 which was 2 cents higher than the prior year. Return on equity for the rolling 12-month period slipped from 13.1% to 12.5% but remained at a good level.

In 1HY20 underlying profit was down 20% to $432m. This was consistent with management's guidance and largely the result of a power outage at Unit 2 at AGL Loy Yang. The Loy Yang Unit 2 station returned to full service on 20 January 2020 following the unplanned outage that began 18 May 2019. Higher depreciation from record levels of investment in recent years, lower wholesale energy prices and reduced gas volumes also weighed on the bottom line. AGL paid an interim dividend of $0.47 per share that was consistent with its generous 75% dividend payout policy. Return on equity declined further in 1HY20, to 11.2%, because of the lower earnings.

Strong balance sheet facilitates share buy backs

AGL has a strong balance sheet that reflects the company's underlying performance and capital discipline. It includes approximately $1bn of cash and undrawn facilities and there is no debt to refinance until FY22. Gearing as at 31 March was 26.5%, which is well below its gearing covenant maximum of 50%. This gives it ample headroom to fund investment in the business. AGL's financial strength is also evidenced by its 41% funds from operations (FFO) to net debt ratio. It has earned a Baa2 rating with a stable outlook from credit rating agency Moody's.

In August 2019 AGL announced a $650m on-market share buyback of up to 32.8m shares, or 5% of its issued share capital. Through 1HY20 it had completed 51% of the buyback program by acquiring 16.8m shares at an average price of $19.72. It had planned to complete the buyback program in the second half of FY20. If it can do so despite the challenging economic backdrop, it may help boost the stock over the next several months.

Solid hedging policies in place

The decline in wholesale energy prices in FY20 was largely offset by the company's hedging mechanisms. These are a series of investment contracts known as forward contracts that the company enters into to protect itself from the potential adverse effects of utility price declines. Lower electricity and gas market pricing during the COVID-19 crisis has similarly been offset by AGL's hedging instruments. The hedges make money when energy prices fall helping to minimize the impact on profit margins.

Ongoing investment in renewables has growth potential

AGL is not only Australia's largest electricity generator, but the nation's largest developer of renewable energy assets. In 2016 it introduced the Powering Australian Renewables Fund (PARF), which was designed to develop over 1,000 megawatts of large renewable energy projects in support of the country's transition to a low-carbon economy. Today it owns nine renewable energy assets across Australia including six wind power farms, two hydroelectricity plants and a solar energy asset in New South Wales. Continued investment in renewable energy is expected to generate not only more megawatts for customers but greater growth potential for investors.

Not a great outlook

AGL's shares have been declining since the 2017 high around $28. The current market conditions are not good, with electricity prices at the lowest level in five years, and a very muted outlook for the next 12 to 18 months. This will likely result in lower revenues and lower EBITDA in the next 2 years, which leads us to believe that there is very limited upside, if any, to AGL's shares at the moment. However, we believe the 5.5% yield may form a bottom for the shares around current levels, that is, if dividend isn't cut further. For these reasons, we take a neutral stance on AGL, so 3 stars from us.

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Share price chart

Source: Tradingview

The June quarter of 2020 was not a good time to be mining metallurgical coal, the coal from which we get the coke that is vital to steel making. Covid-19's impact on demand for steel took metcoal prices down to a low of US$107 a tonne by June whereas in late March they were briefly at US$165 a tonne. However, most forecasters are expecting US$110-120 a tonne for the remainder of 2020, so things probably won't get any worse. And then as global economic recovery starts next year there's the expectation that metcoal will gradually get back to US$150 a tonne by late 2022, or maybe earlier.

When metcoal turns, Coronado Global is well placed to turn with it. This company was put together early last decade by the Houston-based Energy and Minerals Group (EMG), a private investment firm, specifically to buy metallurgical coal mines. Four acquisitions later the company is now the world's largest metcoal 'pure play' and EMG is holding tight to its 80% stake.

Cutting costs

Coronado mines over 20 million tonnes of metcoal annually. And it's good at it. In 2019 Coronado cut its average cost of mining the stuff by 8%, to just US$51.80 a tonne. And it's aiming to push further down the cost curve, from its three mine complexes in the Central Appalachian region in the US states of Virginia and West Virginia, and from the Curragh Mine complex in the Bowen Basin of central Queensland here in Australia.

Coronado became a player on the Australian coal scene when it bought Curragh, an operation located near the town of Blackwater, from Wesfarmers (ASX: WES) for A$700m just before Christmas 2017. At the time Curragh produced 8.5 million tonnes of metcoal a year and another 3.5 million tonnes of steaming coal sold to a local generator. In August 2019, the new owner unveiled plans to spend A$160m expanding Curragh to 15 million tonnes a year by 2023. The move was expected to markedly lower costs as Curragh achieved further economics of scale with its new Coal Handling Preparation Plant capacity. And while the Curragh expansion plans are now on hold, as Coronado rides out the metcoal price downturn, it's reasonable to expect those plans to be reactivated once conditions return to normal.

The earnings recovery is coming

Coronado was well placed when Covid-19 hit. The balance sheet was holding only US$303m in net debt, which represented something like half a normal year's EBITDA. In late March the company temporarily idled its US mines but by late May it was bringing two of them – Buchanan in Virginia and Logan in West Virginia – back on stream. A third mine, called Greenbrier, also in West Virginia, remains shut but can come back as demand returns. We predict it will be up and running by next year.

Obviously, calendar 2020 is not going to look great earnings-wise for Coronado. Forecast EBITDA is expected to slump by close to 60% this year to under US$400m before recovering to over US$500m in 2021 and then over US$600m by 2022. The 27% per annum the EBITDA growth profile for the two years to 2022 looks very attractive when the EV/EBITDA multiple is just 3.4x for FY21 and 2.8x for FY22.

Metcoal may be out of favour right now, but we believe an investment at these levels will pay for itself pretty quickly. And, who knows, Coronado may just take advantage of the temporarily depressed metcoal market and make another inexpensive mine acquisition or two over the next couple of years. So, 4 stars.

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Building from scratch has its advantages

One of the great things about Neobanks is that they're not dragged down by legacy IT. Believe it or not, for certain applications some banks and insurance companies still run software developed back in the 80s and 90s, simply because they never took the time to switch over to newer applications, or because it was just too complicated. As a result of these outdated systems, many new applications need to be able to deal with these older IT systems. Good luck trying to innovate in such an environment. Enter Neobanks.

Neobanks have the same advantage as many payment providers in Africa twenty years ago. The latter completely skipped traditional banking services and moved straight to offering mobile payments solutions in many African countries. By the way, the same was true for Telecoms operators active in Africa, who didn't bother rolling out fixed lines for Voice or Internet, but simply went straight to offering mobile services only, enabling mobile-only payments for the aforementioned payment providers.

Back to Neobanks. If you don't have to take an existing financial services infrastructure into account, you can develop your new system exactly as you want it, no compromises and no backward compatibility necessary. As a consequence, Neobanks can conduct most processes, including credit checks and loan approvals, much faster than traditional banks. And because of their lower cost base, they can offer very attractive terms to their clients. Additionally, everything clients need to bank with a Neobank can be done on a mobile phone, Millennials' bodily extension of choice.

Fast growing loan book

Wisr's revenue generating product offering currently consists of personal loans on which it generates on interest margin. The company has seen its loan book grow strongly over the last few years, from $39.3m at the end of 2018 to $225.8m per the end of May. This loan book generated about two-thirds of Wisr's revenue in FY19 and about 50% in 1HY20. The average client credit score of 712 is well above the Australian average of 600, which should have beneficial effects on its loan default rate over the longer term.

Funding of the loan book is done through a warehouse facility, which is now up to $200m in size. Just recently, the Australian Office of Financial Management invested $30.8m into the Wisr warehouse under the Coronavirus Economic Response Package.

Wisr also generates management fees by deploying third-party capital into the consumer lending market in a funds management model. In FY19 this accounted for nearly 27% of the company's revenues. However, in 1HY20 this percentage had grown to 43%, which is a good thing in our view as it provides stability to the company's revenue stream.

Nifty little hooks

Apart from consumer lending, Wisr offers free use of its credit score tool to anyone who wants. It's a great way for the company to generate leads. Another way Wisr is generating leads is through WisrCredit Bootcamp, which is basically a simple online course in money management, aimed at helping clients and prospects stay out of financial trouble or help them if they're already in it.

Lastly, the Wisr App is a clever way for people to speed up repayment of loans. The App connects to the mobile wallet on your phone and will ask you if you would like to round up a mobile payment for, say, a coffee of $3.50 to $4.00. The 50-cent difference will go towards repayment of a loan. App users doing this for multiple purchases a day, that they pay for with their digital wallet, should see the additional repayments add up pretty quickly over time, which in turn contributes to a better credit profile.

We like the scalability of the business model

Revenues grew a very solid 83% in 1HY20. While 83% year-on-year revenue growth is nothing to sneeze at, the expectation is that the company will even see its growth rate increase to well over 150% annually in the next 2 years, to reach revenues of more than $43m by the end of FY22. That is also the year in which Wisr is expected to become cashflow positive as measured by EBITDA. The scalability of the company's business model should become apparent in the following year, FY23, with its operating result expected to jump to more than $20m on revenues of $62m … nice margins indeed.

At the current share price, the market values Wisr at approximately $260m, which is arguably pretty rich for a company that is expected to have generated about $7m in revenues in FY20. Even looking out three years, to FY23, the company is still trading at a P/Revenue of 4.2x. And on a P/E basis it's valued at 17x for that same year. But that is still three years out! A lot can go wrong in the meantime.

So, while we like the scalability of the business model and the agility of Neobanks, we think the medium-term share price upside from current levels is limited, perhaps up to the previous high of 31 cents. Even though that implies an upside of 26%, we believe the risks of operational disappointments are just too high. In our view, Wisr is already priced for perfection so we'll go with a 2-star rating for now.

Pitt Street Research Pty Ltd

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

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