24 JULY 2020

Stocks Down Under

> *Nobody survives open heart surgery better than the guy who didn't need the procedure in the first place.*

- Charlie Munger (b. 1924), legendary American value investor

ORIGIN ENERGY

LNG prospects and Octopus Energy partnership looking good

MACQUARIE TELECOM

We spy some downside

THETA GOLD MINES

A lot of Alpha with this one

ORIGIN ENERGY

LNG prospects and Octopus Energy partnership looking good

Stocks Down Under rating: ★★★★

ASX: ORG
Market cap: A$ 10BN

52-week range: A$3.75 / A$8.89
Share price: A$ 5.71

Origin Energy is a Sydney-based electricity and gas supplier to residential and commercial customers throughout Australia. Origin was formed from the 2000 demerger of Sydney-based conglomerate Boral Limited and has since built a strong track record of gas exploration and production, power generation, energy sales and renewable energy development. The shares offer a 4.8% dividend yield and given the growth opportunities in liquid natural gas (LNG) appear undervalued at present levels. We believe the recently formed partnership with Octopus Energy should further drive its bottom-line performance.

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ASX: MAQ
Market cap: A$ 982M

52-week range: A$19.20 / A$47.75
Share price: A$ 45.44

Sydney-based Macquarie Telecom (MAQ) started life as its name suggests, a Telecom company, but for businesses and government agencies. Like many Telco's globally, it has expanded into adjacent areas over the years and now also offers datacenter capabilities, Cloud services and is a key provider of cyber security and datacenter services to the Federal government. The shares have had an extremely good run and have made up all the ground lost in the Corona Crash, and then some. Talk of cyber security threats emerging out of China, aimed at the Australian government, has pushed investors to drive up the share price 64% higher compared to just before the Corona Crash, to an all-time high. We're starting to wonder if the current valuation isn't a bit too rich right now.

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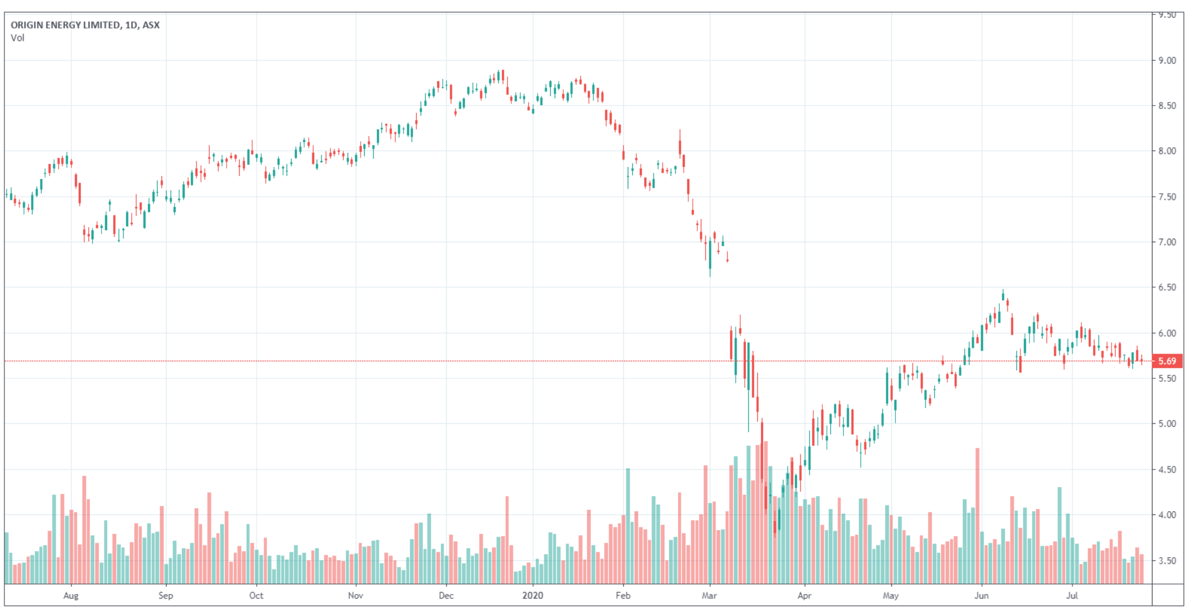
Share price chart



Source: Tradingview

Pandemic impacts electricity demand

As a utility company Origin Energy is considered a defensive business. This is because energy demand from homes and businesses is relatively constant as an essential need for our daily personal and working lives. Although energy volumes can fluctuate in the short-term, over time utility businesses are able to generate steady earnings streams from customer energy usage and contracts. Therefore, many investors choose to "pad" their portfolios with utility shares. In times of economic downturn these stocks tend to maintain their earnings, outperform other sectors and in turn help investors outperform.

Although utilities tend to be defensive businesses, the COVID-19 crisis nevertheless has had a material impact on energy pricing. Most businesses were closed for an extended period this year, which translated to lower energy demand. Origin's electricity and gas volumes were down 7% and 1% respectively in the March 2020 quarter due in part to the early stages of the pandemic. The lower volumes and ample supply of 2020 have put downward pressure on energy prices and impacted utility company profits, including Origin. The uncertain economic environment caused the company to temporarily suspend exploration activity as of March 2020.

Despite the challenging environment Origin has committed to support its customers by pausing late fees and foregoing service disconnections for residential and small business customers in financial distress at least through the end of July 2020.

Outages detract from strong performance

In FY19 Origin recorded a 42% jump in underlying profit to $1.03bn. The strong earnings were driven by the Integrated Gas division, which benefited from a higher effective oil price, cost efficiencies and stable production at Australia Pacific LNG, which delivered net cash flow of $943m. In the Energy Markets division, earnings in electricity decreased because of price relief measures provided to customers, intensified retail competition and lower customer numbers and energy usage.

Profits were lower in 1HY20 as underlying profit declined 11% to $528m. This was due to the impact of price re-regulation, one-off generation outages at the Eraring and Mortlake Power Stations as well as lower electricity volumes in the Energy Markets division. Cash generation remained strong, however, as free cash flow increased 22% to $680m. The Australia Pacific LNG segment once again delivered a strong performance that included record production and higher revenue. This allowed the company to increase its dividend by 50% to $0.15 per share.

Origin has worked hard to strengthen its balance sheet in recent periods. It paid down over $1bn in debt in CY19 to bring its adjusted net debt balance to a more manageable $5.1bn. Meanwhile, after a period where the company paused dividend payments, the strong free cash flow generation supported a substantial dividend increase in the interim period. Having a more resilient and lower risk balance sheet has provided Origin with more options for capital allocation, in our view.

Well positioned for growth through energy of the future

In May 2020, Origin established a strategic partnership with United Kingdom energy retailer and energy technology company Octopus Energy. Origin took a 20% equity interest in Octopus Energy, which owns a market leading operating model and customer platform called Kraken. Joining forces with this fast-growing company is likely to rapidly transform Origin's retail business by delivering an improved customer experience, lowering costs and creating opportunities for future growth. On the back of this deal, Origin is targeting pre-tax cash savings of $70m to $80m in FY22 followed by accelerated savings of $100m to $150m per annum starting in FY24.

Within its Integrated Gas segment, the company is also pursuing opportunities in hydrogen and LNG for transport. This is driven by the fact that the average realised gas price is higher for LNG compared to domestic gas. This creates opportunities for margin expansion and growth through LNG transport to overseas markets. This, along with unique opportunities in the Energy Markets segment around digital Internet of Things (IoT) capabilities, solar, storage and broadband, means Origin will have multiple revenue drivers to support future earnings growth and deliver increasing income to investors.

At the current share price level, i.e. still 35% below where it was before the Corona Crash, we believe Origin provides good long-term opportunities for capital gains and dividend streams, hence 4 stars from us.

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Share price chart

Source: Tradingview

Room for improvement

MAQ's Telecom arm provides all the usual services you expect from a Telco provider, like Voice, Mobile, NBN and data services. But unlike its competitors, such as Telstra, Optus and TPG, MAQ only provides those services to business and government customers. The Telecom arm generates 54% of revenues and 31% of EBITDA. MAQ's EBITDA margins were just 14.1% in FY19, which to us signals lack of scale. Ideally, Telco EBITDA margins should be in excess of 30%. As an example, some of Europe's leanest operators achieve EBITDA margins in the high 30's and low 40's.

MAQ's other revenue generating unit is Macquarie Government, which accounts for 46% of revenues and 69% of EBITDA. This unit provides cyber security, cloud and colocation services to the Australian government at a more attractive margin of 29.1%, up from 28% in FY18. Given the specific nature of MAQ's services to the government, i.e. securing some of the country's most classified data, we expect MAQ to be able to command higher margins from this government business going forward.

Underpinning these two units are Macquarie Cloud Services and Data Centres, with the latter developing and operating MAQ's proprietary datacenters, three in Sydney and two in Canberra. In this space it competes with the likes of NEXTDC (ASX:NXT) and global datacenter giant Equinix. MAQ will start to report the results for Data Centres as a separate segment in the new financial year. In Cloud Services, MAQ runs into competition from the number 1 global player Amazon Web Services (AWS), Rackspace and also NEXTDC.

Overall, revenues totalled $246.6m in FY19, up 5.5% from the year before. In 1HY20, revenues grew by 9% year-on-year, to $131.9m. EBITDA grew by 24% to $31.6m. However, this included a $4m accounting windfall from the implementation of AASB16, a complicated new accounting rule around how leases are treated in the company's books.

The $300m announcement

Back to the reason for MAQ's phenomenal share price run since mid-June. On June 16, with the shares having closed at $31.70 the previous day, the company announced it will start construction of a new Canberra datacenter, its third one in the capital. MAQ cited increased demand for its cloud and cyber security services from the government, which we believe loosely translates into "The Chinese government is hacking the Australian government and Canberra needs our help".

Since then the shares have rallied 46%, adding more than $308m to MAQ's market capitalisation. Now, we're no rocket scientists, but on the company's current P/Revenue multiple of 3.4x, that added $308m in market value would imply $90m in additional revenues from the Australian government. That is about 80% of what MAQ generated from Canberra in FY19. We're sure MAQ will be able to double the revenues it derives from the government at some point. But it's not going to happen anytime soon. Remember, construction has only just started this month and the initial 1.5MW of capacity is expected to come online in December. We reckon by the time it's at full capacity, we're looking at 2023. So, to summarise, we think the market's become a bit overexcited when it comes to MAQ.

Investors have gotten ahead of themselves

MAQ is currently trading at an EV/EBITDA of 15.3x for FY21 and 13.6x for FY22. We always like to relate these numbers to a company's EBITDA growth in those years. In the case of MAQ, EBITDA growth is expected to amount to 7.9% and 12.7% for FY21 and FY22 respectively. Based on these numbers, our beloved EV/EBITDA-to-EBITDA-growth valuation metric for these years yields values of 1.94 and 1.07 respectively. The 1.94 for FY21 confirms our view that the stock is quite overvalued at the moment. The 1.07 for FY22 is more in line with what you'd expect for a Telecom company generating modestly growing revenues. Clearly, the market has gotten ahead of itself in the last six weeks and is looking beyond the current financial year.

However, we believe that the cyber security hype in MAQ share price is likely to subside. Remember, cyber terrorism is not a new phenomenon, it's just been in the press more lately. We expect that when MAQ reports its results throughout FY21, the company will show steady EBITDA growth, i.e. nothing out of the ordinary. When this reality kicks in, we expect to see the stock come off its highs. So, 2 stars from us.

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Share price chart

Source: Tradingview

Ordinarily when investors think of gold mining in South Africa they only think of Johannesburg, not a sleep little town 100 km north of Nelspruit in Mpumalanga Province called Pilgrim's Rest. And that's fair enough. Johannesburg, or more specifically the Witwatersrand, that prolific arc of gold-bearing reefs around Johannesburg, has, since the first discoveries in 1886, yielded 1.5 billion ounces of gold. That's something like half of all the gold mined in the entire world for the last 130 years. However, drive four or five hours northeast of Jozi and you'll find two other fields, which by most standards were pretty rich. One is Barberton, which was rushed in 1883 and is still producing, having been good for about 11 million ounces so far. The other is Pilgrim's Rest, first rushed in 1873. That field wasn't so prolific and had petered out by the early 1970s but still did something like 6 or 7 million ounces. Theta Gold Mines, which is in the process of bringing Pilgrim's Rest back to life, as well as a neighbouring field called Sabie, reckons there's at least another 6 million ounces where that came from.

6 million ounces and control of a whole field

Theta Gold Mines' efforts to revive Sabie-Pilgrim's Rest have been ongoing as an ASX-listed public company since early 2012. The Pilgrim's Rest part of the project is called TGME because Transvaal Gold Mining Estates was the company which in the 1890s was put together to develop the longer-term potential of Pilgrims Rest after the initial rush. Theta Gold Mines owns 74% of TGME, the other 26% sitting with Black Economic Empowerment interests, as per the requirement of South Africa's Mining Charter. A similar arrangement is in place for Sabie.

The ASX-listed company may only have 74% of the TGME upside, but's it a big upside nonetheless. In May 2019 Theta Gold Mines upgraded its JORC 2012 resource from 3 million ounces to 6 million, the latter figure being 44.8 million tonnes at a very high 4.2 g/t gold. A lot of the old mines at Pilgrim's Rest were underground, but in recent years management at Theta Gold Mines had figured out that there was still plenty of shallow and flat-lying reefs which the old-timers hadn't properly tapped. When the 2019 resource upgrade was announced, 1.3 million of it was an open pit resource. Part of that resource now becomes the basis of a proposed 'starter' pit which is called Theta because the last gold mine at Pilgrim's Rest before mining ceased in the 1970s was called Beta. It's beyond us why they didn't call it Gamma, because Theta sounds like the name of a sorority.

Start small and grow

The philosophy of Theta Gold Mines around Sabie-Pilgrim's Rest is to start small and grow from there. On the latest plans, announced in April, only around 260,000 ounces will be produced from the starter pit over 6.5 years. However, that initial project will only require US$31m in capital costs and will operate at a very modest All-In Sustaining Cost of just US$855 an ounce, helped by a conventional flowsheet featuring Carbon-in-Leach processing. Theta Gold Mines put a post-tax NPV on this project of US$85m, but that analysis assumed gold at US$1,500 an ounce. After the Theta starter pit there's more than 40 historic mines and prospects that could keep Theta Gold Mines going for a very long time.

Theta Gold Mines recently raised $4m in new equity at 24 cents per share but still has to raise the requisite project finance for the starter pit. However, with economics this good, we don't think that will be too hard. Remember, those economics get better all the time, not just from the gold price but from the fact that the ZAR has dropped a lot against the US dollar in recent days, which has the effect of lowering Theta's production costs. Sure, power reliability is an issue in contemporary South Africa, but that's nothing a good back-up generator can't deal with.

The South Africa discount

And as for everyday operations, Pilgrim's Rest is not Johannesburg, so it will likely be easier for Theta Gold Mines to get things done than it would be in that somewhat chaotic megalopolis. One potential issue for Theta Gold Mines is the need for approval of the Environmental Impact Assessment. However, a decision on this issue from the South African Department of Mineral Resources and Energy is expected soon. Should all go to plan there's potential for the Theta starter pit to be producing from next year.

The trouble with ASX, when it comes to South African resource projects, is that a lot of people from South Africa live in Australia, and in our experience they tend to be unenthusiastic about the economic prospects of their former country. That thought leadership results in what we call a 'South Africa discount'. For Theta Gold Mines the discount is noticeable, with those 6 million ounces now being valued by the market at about A$30 per resource ounce, which is tiny. However, we think that once project finance is in place for the Theta starter pit, that discount can gradually close. The fact that Theta Gold Mines' share price has been re-rating since Christmas 2019 suggests that the discount can be closed sooner rather than later. Ahead of that move, this stock is four stars from us.

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