27 JULY 2020

Stocks Down Under

"I hate television. I hate it as much as peanuts. But I can't stop eating peanuts."

- Orson Welles (1915-1985), American actor, director and writer

MAGELLAN FINANCIAL GROUP

Playing global investment themes

SANDFIRE RESOURCES

The Next Big Thing is here

SKY NETWORK TELEVISION

Outdated model and small addressable market

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Playing global investment themes

Stocks Down Under rating: ★★★★

ASX: MFG
Market cap: A$ 11BN

52-week range: A$30.10 / A$74.91
Share price: A$ 58.56

Sydney-based Magellan Financial Group is a fund management company that invests globally. Formed in 2006, the company has a solid track record in global equities and global listed infrastructure that has benefitted from key investment themes such as the rise of the emerging consumer, the advent of a cashless society and the arrival of digital consumer platforms. Its investment teams manage over $97bn for clients located around the world. As one of the top-100 ASX shares, Magellan offers investors a 3.5% dividend yield in addition to the opportunity to participate in strong growth in funds under management.

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Sandfire Resources, the Perth-based emerging copper miner, has enjoyed a solid share price recovery since the 23 March low of $2.80. However, we think there's more where that came from. Not only is the price of copper continuing to rally but the company continues to move forward on two valuable copper projects, T3 in Botswana and Black Butte in the US state of Montana. It also helps there's some lucrative silver credits at T3.

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Share price chart

Source: Tradingview

Robust earnings and distributions growth

Magellan's approach to global investing is based on the belief that there are companies outside of Australia that are expected to benefit from the most compelling long-term growth drivers. The group specialises in two strategies -- global equities and global listed infrastructure. Its global equity funds include the Magellan Global Trust, which invests in 15 to 35 global stocks while targeting a 4% distribution yield, an active ETF of 20 to 40 global stocks called the Magellan Global Equities Fund and the Magellan High Conviction Trust, a concentrated fund of 8 to 12 global stocks with a 3% distribution yield target. It manages one listed global infrastructure fund, the Magellan Infrastructure Fund, a currency-hedged active ETF with 20 to 40 holdings. The group also manages unlisted global equity and infrastructure funds.

In FY19 Magellan's net profit after tax (NPAT) increased 78% to $376.9m. Excluding acquisition-related amortisation, Principal Investments portfolio gains and capital raising costs, adjusted profit after tax increased 35% to $364.2m. Management and service fees increased 22% and performance fees were up 110% driving adjusted total revenue higher by 28% to $577.3m. Full year dividend payments increased a whopping 38% to 185.2 cents per share.

The 1HY20 results included a 22% increase in adjusted revenue to $337m that was led by a 26% increase in management and service fees. NPAT rose 23% to $195.7m and adjusted diluted earnings per share (EPS) were up 20% to $1.20. It paid an interim dividend of 92.9 cents per share, which was 26% above the prior half-year distribution.

Australian equities launch supports FUM growth

In 1HY20 funds under management (FUM) were up 29% to $92.8bn as compared to the six-month period ended 31 December 2018. The growth in recent years has been driven by both strong net inflows and investment performance and has been achieved in both the retail and institutional sides of the business. As at 31 December 2019 institutional FUM accounted for 72% of overall FUM. From an investment strategy perspective, global equities comprise the majority of FUM at 74% followed by global listed infrastructure (18%) and Australian equities (8%). Roughly one-third of Magellan's FUM are subject to performance fees. In the six months since the interim report, FUM has grown to approximately $97bn.

Back in 2018, Magellan Asset Management purchased Sydney-based specialist Australian equities fund manager Airlie Funds Management giving retail investors access to Airlie's expertise for the first time. The partnership recently launched the Airlie Australian Share Fund (ASX:AASF), a focused portfolio of around 25 Australian equities. It combines the features of an unlisted fund and an active ETF in one open-ended fund with the goal of delivering long-term growth and income through an active, value-based investment style. Since its 1 June 2018 inception through 30 June 2020, the $27m fund has generated an annualised return of 4.59% compared to its benchmark return of 3.0%. It has diversified its platform and created an opportunity to gain business from both new and existing investors interested in domestic equities.

Fund management business is heavy in human capital

As a fund management business, Magellan's balance sheet is rather capital light albeit strong. It had $890m of net tangible assets as at 31 December 2019. The group does not have any borrowings but maintains a $50m undrawn debt facility for funding flexibility purposes. Although it is not noted in the company's balance sheet, its people are its biggest asset. This is because payments to employees represent about 60% of Magellan's adjusted operating expense base.

The company's balance sheet strength has helped it withstand the challenging market conditions of 2020. Capital market volatility had a significant impact on fund performance in the early part of this year, but as global equities have rebounded over the last few months, fund performance and net inflows have improved. Magellan's global client base and investment approach along with new opportunities in Australian equities should continue to support healthy long-term growth.

Prior to the Corona Crash, Magellan stock was reflecting the company's solid performance over the last few years, having risen from around $25 at the start of 2019 to $73 in early February 2020. After the March lows the stock has rebounded to where we are now, but has struggled to break the $64 barrier. So, we might see a bit of a retracement before the stocks heads up again. We believe it will given that the company's core funds management skills should prevail through the cycle. And although past performance is never a guarantee for future performance, we'll take our chances with Magellan. Four stars from us.

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Share price chart

Source: Tradingview

It's a problem every mining entrepreneur aspires to have to deal with at some point in their corporate career: Your company developed its first mine and is enjoying good cash flow from the operation. Now comes the challenge of doing it again with the second and subsequent mines. Karl Simich and his colleagues at Sandfire Resources had that challenge after their success with their 'company maker', a copper mine called DeGrussa. The Sandfire team had gone public in 2004 to evaluate some ground not far from National Route 95 – the road that takes you from Perth to Port Hedland – about 160 km up the road from Meekatharra. They figured the area had potential to host copper in rocks called 'volcanogenic massive sulphides'. Well, they were right. Five years later they had identified the DeGrussa copper-gold deposit – they named it after a guy called Dave DeGrussa who had helped in the exploration effort but died before the discovery – and three years after that they had their mine.

A disciplined search for the Next Big Thing

Now, the trouble with resource companies at this point in their corporate development is that the next mine tends to take a while, so investors more or less lose interest. We think that's why Sandfire stock has tended to drift sideways ever since early 2013. For a while there in 2018 it looked like the stock was back in vogue, but that was just because copper was recovering after a long bear market. When that rally petered out Sandfire slid back again, with investors increasingly worried that DeGrussa would reach the end of its life around 2022 and Sandfire would have nothing much to show for.

So why look at Sandfire again in July 2020? Because all this time Sandfire has been executing a disciplined plan to find its Next Big Thing. It's done some exploration of its own. It's staked other companies, such as Adriatic Metals (ASX:ADT), the company with the interesting polymetallic project in Bosnia we wrote about on 14 July. It took over a copper project in the US state of Montana called Black Butte, which is now held in a TSX-V company called Sandfire Resources America, with the Perth company holding 85%. And, importantly, last year it took over another ASX-listed company called MOD Resources to get hold of an advanced copper project in Botswana called, simply, 'T3'. We think that T3 is the Next Big Thing Sandfire has been looking for. And, potentially, it isn't far off delivering for the company.

Sandfire has bagged the rhinoceros

Discovered in 2016, T3 is a copper-silver deposit whose current JORC 2012 resource contains 590.4 tonnes of copper and 26.97 million ounces of silver. The MOD takeover valued T3 at $167m but the 2019 Feasibility put a post-tax NPV on it of A$309m. Finding T3 on a map of Botswana is easy – just look for the biggest oasis on planet earth, the Okavango Delta, in the northwest of the country and then edge your eye slightly southwest in the direction of a town called Ghanzi. Why did they name it just plain old 'T3'? Because MOD was too busy proving up its company maker to name it properly. The current owners have settled on 'Tshukudu', which is the Setswana word for rhinoceros, and that project name encompasses not just T3 but also another discovery called A4 and another 11,700 sq km across the Kalahari Copper Belt. Thank heavens for the name change to Tshukudu because a proposed 11 year copper mine that can produce at only US$1.56 a pound or less in All-In Sustaining Costs, if MOD's March 2019 Feasibility Study is accurate, doesn't deserve to have a name that sounds like an industrial robot.

Sandfire has the means to develop T3 with its proposed US$182m in capital costs because DeGrussa has been throwing off A$200-300m a year in operating cash flow and Sandfire as at March 2020 had $242m cash and no debt. And T3 is a great replacement for DeGrussa, because Botswana is one of the most mining-friendly emerging countries in the world that is also democratic and politically stable. It's also worth keeping in mind that this project may not end up costing US$182m to develop, because Sandfire is currently optimising the MOD study. We believe that this mine can potentially be up and running in 2023/24 depending on how the optimisation work goes.

Sandfire's silver lining

One of the early warning signs that the Coronavirus was going to cause big trouble for the world economy was when the price of copper started to slide. On 14 January the metal was about US$2.86 a pound on COMEX but by 3 February it was about US$2.50. Then came the February and March meltdown so that by 23 March it was just US$2.10. Now it's up close to US$3.00 a pound, which is about the level used in the MOD study, and this rally shows no sign of slowing down as China works hard to reboot its economy post-COVID.

An additional fillip for Sandfire has been silver, which as we noted above is a valuable credit at T3. That precious metal has been rallying strongly in recent days – something we foreshadowed in our 26 June piece on Silver Mines (ASX:SVL). Given these favourable commodity moves and the potential of a better NPV for T3 coming soon, we think there's more upside yet in Sandfire's current return to form. Four stars from us.

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Share price chart

Source: Tradingview

It's all about Sports

Sky generated NZ$795m in revenues in FY19 and NZ$385 in 1HY20, which was down 4.5% year-on-year. Around 75% of Sky's revenues come from residential satellite subscriptions with 13% of revenues generated from commercial customers, like pubs, clubs and hotels. Advertising only accounts for about 6% of revenues. Sky's sports offering is probably the biggest attraction for most subscribers.

Per the end of April Sky had 1m subscribers, up from the 779,000 subs it had per 30 June 2019. The 1m number includes the 130,000 that came in with the Lightbox acquisition that was completed in February 2020. Sky acquired Lightbox, a streaming video on demand (SVOD) service from Spark New Zealand and merged it with its own NEON SVOD service.

Prior to COVID-19, Sky was already witnessing net subscriber outflows. But during the height of the COVID-19 lockdowns in New Zealand, Sky saw new inflows slow down to a trickle, while outflows were still around 1,000 per week. These net outflows lasted into May, the last period for which Sky released these numbers.

COVID-19 impacts every aspect of the business

Given the importance of live sports for Sky's subscriber base, the pause in live sports globally has driven up the number paused subscriptions and cancellations, while many people downgraded their sports packages. This resulted in a 1% decline in ARPU to $82 per month. At the same time, commercial venues have had to close and are now only gradually opening up again. This too has had a big impact on Sky's subscription revenues, with venues cancelling or pausing subscriptions. Additionally, Sky has seen a reduction in ad spending across its network as advertisers have been reluctant to spend money in an environment where the effectiveness of ad spend is highly uncertain. One bright spot in all this is the take up of higher value movie packages by subscribers looking to replace their lost sports content.

In decline well before COVID

While Sky said that it expects EBITDA to amount to $155-175m in FY20, which just ended, with NPAT of $20-25m, the guidance for the new financial year is substantially more sober. Given the uncertainty around the timing of live sports resuming, Sky's best guess for FY21 is substantially lower EBITDA of $100-130m and NPAT of $5-15m. The company will be taking $80-95m of costs out of the business and has identified another $135-155m in potential cost and Capex savings that can be implemented should the resumption of live sports take longer than anticipated.

Apart from the current uncertainty around COVID-19, Sky's revenues have been in decline for many years. The rise of streaming video, e.g. through Netflix, and younger generations getting their video fix through YouTube rather than TV, will likely continue to put pressure on companies like Sky. So, even as the impact of COVID-19 will pass, as we're sure it will, we are not bullish on Sky. Like Foxtel's, we believe Sky's business model is antiquated and we expect the company will continue to struggle given limited growth opportunities in New Zealand.

The sky is getting darker

While Sky's EV/EBITDA valuation of 4.2x for FY21 may seem low, it's arguably still high for a company that is expected to see its EBITDA decline from $152m in the past financial year to $121m this year and $109m the year after. Sky's subscriber base would potentially be valuable to a strategic player in some sort of consolidation scenario. However, in the absence of any M&A rumours, we'd steer clear of this one. Two stars from us.

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