STOCKS DOWN UNDER

28 JULY 2020

Stocks Down Under

A baby is God's opinion that the world should go on.

- Carl Sandburg (1878-1967), American writer

CHAMPION IRON

From the people who bought you Riversdale

INVESTEC AUSTRALIA PROPERTY FUND

Nice yield and take-over potential

VIRTUS HEALTH

You can't get a little bit pregnant

CHAMPION IRON

From the people who bought you Riversdale

Stocks Down Under rating: ★★★

ASX: CIA
Market cap: A$ 1.3BN

52-week range: A$1.36 / A$3.23
Share price: A$ 2.75

The snap-back in the fortunes of Champion Iron, owner of the Bloom Lake Iron Ore Mine in Canada, has been nothing less than spectacular. The stock halved between early January and the bottom of the Corona Crash in late March. However, from that low it proceeded to more than double by mid-July. The catalyst has been improved iron ore prices and we believe there can be more where that came from if Champion moves ahead with plans to double Bloom Lake's capacity. Until that move happens, though, we'd be a little cautious.

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ASX: IAP
Market cap: A$ 863M

52-week range: A$0.90 / A$1.64
Share price: A$ 1.225

Based in Sydney, Investec Australia Property Fund is a real estate investment trust (REIT) that has been around since 2006, but debuted on the ASX a little over a year ago. It operates a fund management platform and invests in direct property for the parent Investec Property group and third-party investors. Asset growth has been steady and the portfolio of office and industrial properties is backed by government, listed and multinational tenants. Investec's strong balance sheet puts it in a good position to take advantage of acquisition opportunities in the post-pandemic economy. The stock has a 6.5% dividend yield and is trading below its IPO price.

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Share price chart

Source: Tradingview

In December 2015 Champion Iron, a small company based in Montreal, but dual-listed on ASX and TSX, announced that it had acquired an idle iron ore mine in Quebec called Bloom Lake. The price was C$10.5m, which was A$10.7m at the time, and no one paid much attention. Champion Iron's market capitalisation was only A$26m or so, and no wonder, since it was merely a potential developer of iron ore mines in Canada at a time when iron ore was a miserable US$40 a tonne. And the mine was in the most God-forsaken part of Canada imaginable – near a town called Fermont, 1,200 km northwest of Montreal and close to the border with Labrador where the top temperature in January is minus 17 degrees Centigrade. Be that as it may, the Bloom Lake transaction of 2015 may just turn out to be the Deal of the Century in the iron ore world.

Go with the Smart Money

You see, the seller was Cleveland-Cliffs, a US iron ore major (NYSE: CLF). That venerable institution, with a history running back to the 19th Century, had paid a cool C$4.9bn in early 2011 for a company called Consolidated Thompson, just to get hold of Bloom Lake. That's right, billions of dollars. The mine was in a noted ore iron region of long standing that included ArcelorMittal's Mont Wright Mine, in operation since 1973.

It was producing premium 66% iron fines. And it had only recently been commissioned at a cost of US$1.2bn. This mine was going to be huge. It was ramping up to be an 8 million tonne a year operation, with a second phase planned to double that to 16 million tonnes. So, at US$180 a tonne for iron ore the sky was the limit. However, at US$70 a tonne in late 2014, Bloom Lake wasn't going to make money, leading Cleveland-Cliffs to put the operation on care-and-maintenance and sell to whoever was crazy enough to take it off their hands.

The Australian leading the team that took on that Mission Impossible turns out to be not so crazy and a candidate for inclusion in that elite club called the Smart Money. Michael O'Keeffe, Executive Chairman of Champion Iron, is the man who brought you Riversdale. Not the 2017 American TV series (that's Riverdale without the 's'), but a company called Riversdale Mining, which went all the way from A$7m to A$3.9bn on the back of coal assets in Mozambique which Rio Tinto were happy to grab in 2011. If you read our 4 June story on Atrum Coal (ASX:ATU) you would have encountered another transaction of O'Keeffe & Co's – last year a second Riversdale, this one called Riversdale Resources, was bought by the Perth mining entrepreneur Gina Rinehart for a metcoal property in Alberta called Grassy Mountain. The price tag here was a still-cool A$744m.

Great timing

But to return to Bloom Lake. The timing for Champion Iron and its 0.2 cents on the dollar speculation four years ago was exquisite because the iron ore recovery started around the time the company was taking control of the asset. That helped Champion get the necessary funding for the restart, upgrade and optimise the Bloom Lake plant and equipment and get the necessary offtakes in place. It only took a little over two years and C$327m in capex before Bloom Lake was shipping its first ore down to Sept-Iles, Canada's answer to Port Hedland on the north shore of the St. Lawrence. Iron ore had made it above US$75 a tonne by then. By early 2019 it was clear that things had gone very right for Champion Iron. In the December 2018 quarter Bloom Lake was operating about 90% of capacity, its selling price was US$86 a tonne and its All-In Sustaining Cost was US$55 a tonne. It's no surprise then, that 2019 saw a strong re-rating in the share price which turned Champion into a billion-dollar company.

Champion's February 2017 initial Feasibility Study on Bloom Lake, which was broadly based on what Cleveland-Cliffs had been going after, shows the upside has now been partly realised. It put an after-tax NPV or C$984m on Phase I of the project, which was a 7.4 million tonne p.a. operation over a couple of decades. A second Feasibility study in June 2019 covered Phase II, which is where Bloom Lake goes to 15 million tonnes p.a. Phase I and Phase II together had an NPV of C$2.38bn. At today's exchange rate that's A$1.04bn for Phase I and A$2.5bn for Phase I+II.

Will Phase II bloom at Bloom Lake?

The market is now starting to bet that Phase II is coming for Bloom Lake, pricing the company at A$1.3bn on ASX. That bet may seem like a reasonable given that iron ore at US$110 a tonne is currently above the price levels required in the June 2019 Phase II Feasibility, due to a combination of high demand from Chinese steel mills and serious supply constraints in Brazil. However, as much as we like the operational smarts of this company, we would still be cautious. Phase II is going to require C$590m in capital costs so it's a big decision for the Champion Iron board, especially since the Phase I debt hasn't been paid down yet. And the board may take the view that a resumption of Brazilian production could limit the upside for such a long-term asset.

At the moment Champion Iron is trading at an EV/EBITDA multiple of 3.6x for FY21, which end in March, and the forecast earnings are assuming no Phase II so earnings don't really grow much for the next couple of years. That's why we're calling this a Three Star story right now. An announcement on Phase II with an offtake agreement would change this picture. So, watch this space carefully, just like savvy investors watch anything Michael O'Keeffe gets involved in.

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Share price chart

Source: Tradingview

Defensive portfolio of office and industrial properties

The Investec Australia Property Fund invests in a diverse portfolio of office and industrial properties located in major metropolitan areas or established commercial precincts in Australia and New Zealand. It's well spread out geographically with the largest exposure being 37% in New South Wales. The fund seeks to deliver both capital and income to shareholders through active management. There are 30 properties (12 office and 18 industrial) in the portfolio valued at $1.09bn. The occupancy rate is excellent at 99% and backed by a high proportion of government, listed and multinational tenants. We also like the WALE of 4.5 years.

The fund had a strong performance in FY20 ended 31 March 2020. Adjusted funds from operations (AFFO) surpassed guidance at 9.17 cents per unit (cpu). It had an 8.88 cpu distribution and the net asset value (NAV) ended the fiscal year up 1.5% to $1.32. The total portfolio value increased 2.74% year-over year based on a combination of external and directors' valuation of all 30 properties.

Opportunistic balance sheet management

Investec's ability to provide growth and income to investors is supported by a strong, efficiently managed balance sheet. It contains $17m in cash and $67m of undrawn debt. Gearing has decreased meaningfully since FY19 to 22.2% which is below the target range of 30% to 40%. It recently restructured its debt, resulting in a lower funding cost of 3.05% and higher weighted average debt expiry (WADE) of 7.4 years. Investec has a hedging strategy to mitigate downside portfolio risk and 95.8% of debt is fixed or hedged.

The COVID-19 crisis has prompted the company to re-evaluate and stress test its portfolio based on the uncertain market conditions. Its recent risk assessment incorporated tenant covenant strength, WALE and the possibility of rental reversion and support. Since the end of the reporting period it adjusted the fair market value of the portfolio. Some of the fund's tenants have been significantly impacted by the COVID-19 crisis. Management has received requests for rental support, which it assessed on a case by case basis.

Fortunately, rental support arrangements have been made with only a small number of tenants. While the full impact of COVID-19 on its tenant base remains unknown, we believe the absence of retail properties in the portfolio has been a positive. The company will have to understand new work practices and space utilisation in the post-pandemic economy as it continues to value and protect its assets.

Internalisation discussions underway

In November 2019, the Investec Fund sold its 757 Ann Street property in Fortitude Valley QLD to Trosa AusProp Pty Ltd for $94m. This price tag was 11% above the property's book value of $85m. The proceeds were used to repay debt and help bring down gearing. The fund managers created good value for the portfolio by capitalising on the strong demand for high quality office properties in the Brisbane fringe office market.

Based on recently disclosed company discussions, there is the potential for Investec Property to internalise the external fund management team by acquiring its investment manager. Internalisation may provide several benefits like securing the management team for the longer term and broadening the universe of potential investors to the group. It would also simplify the management structure and decision-making processes and improve transparency.

Unit holders should benefit from this move as the stock is trading below NAV ($1.32 per the end of March) and we'd expect to receive at least NAV plus the accumulated dividend since 1 April. If the proposed internalisation doesn't happen, you still get dividend yield of more than 6% at the current price level. That is, if dividend isn't cut due to the current market circumstances. So overall, we see limited downside risk with the potential for a nice short-term gain. Hence, four stars for IAP.

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Source: Tradingview

It's a rule of thumb a lot of investors like to follow: If private equity is selling, don't buy. Not because private equity funds are somehow crooked – quite the contrary – but because the investment professionals at those funds have likely done more homework on their portfolio companies than you and I can do as investors. So, if they are selling, they think they've grown as much value as they can from their investment and it's time to move on. Ask investors for two examples and they'll generally say Myer in 2009 and Dick Smith in 2012. Some might also say Virtus Health, which in June 2013 became the world's first publicly owned IVF provider.

Investors paid A$5.68. Private equity sold.

Virtus Health had been put together by Sydney-based Quadrant Private Equity over the previous five years as that firm acquired various providers of IVF services. IVF is 'in vitro fertilisation', which is the fancy name for the science behind 'test tube babies'. If your memory stretches back thirty years or so you'll recall that Australia was a world leader in the development of IVF technology, with the first test tube baby to be born here making her debut less than two years after the miraculous science first became a reality in the UK in 1978. IVF has come a long way since then. These days it's called 'assisted reproductive services' and, while not commonplace, it's not rare either. In 2017 there were around 309,000 babies born in Australia and 13,500 of them were IVF babies. That's about 1 in 23. When you add it all up, each one of those babies, priceless as they are, would have cost on average A$30,000 to $40,000 to bring into the world, making for a half billion-dollar market.

When Quadrant started buying IVF service providers its thinking was that demand for IVF just simply had to grow in a country where the age at which women attempted their first pregnancy was rising and where Medicare and private health insurers would usually pick up about half the tab. By the time Quadrant was done, one in every three IVF babies born in the country owed their existence to Virtus Health. At Virtus' 2013 IPO, investors paid $5.68 to buy in to this apparent growth story, which represented an EV/EBITDA multiple of 9.4x forecast earnings. Quadrant sold out completely.

Who's left holding the baby?

The stock has been declining about 10% per annum on average since 2013, with a November 2016 profit warning only part of the decline. Why hasn't Virtus worked out? Well, every now and then the field seems to come to a complete standstill, most recently when Covid-19 more or less shoved inessential health services, like IVF, to one side, although that was only for a month or so. At other times the slowdown has come when the government reduced financial support to the sector. But, looking more broadly, we believe there are two main reasons for Virtus' decline. The first has been the rise of lower-cost IVF providers who have sought to broaden the market beyond the upper and upper-middle classes. That has eroded margins and caused revenue growth to slow. The second has been a general weakening of the spending power of would-be Virtus Health clients, who have been less eager to go down the expensive and uncertain IVF pathway ever since Australia's housing market went off the boil in 2017.

In FY19 Virtus grew revenue 6% to $280m but EBITDA declined 2.3%, to $63.5m. Virtus today is slightly different to its 2013 counterpart, with about a fifth of revenue coming from clinics in Asia and Europe, but the trend is the same in the rest of the world – more competition and less spending power on the part of clients, leading to a decline in margins. In 1HY20 the picture got poorer as revenue only grew 1% and margins came down another 0.5%.

Now is not a good time to get pregnant

We think Virtus will continue to struggle as a company coming out of this crisis. The balance sheet is okay, with leverage of 2.8x EBITDA, which is why Virtus was able to announce on 7 May that it had the support of its bankers to slightly change its debt covenants. However, we believe it will take a while before people will start to feel financially secure enough to look at IVF again, given the economic impact of what we're going through, and that will undoubtedly slow demand growth. We think that's why the rebound from the Corona Crash had petered out by 26 May, after which the stock has trended down again.

Currently, EBITDA is only expected to grow in the order of 3-4% per annum over the next couple of years. So, on an EV/EBITDA multiple of 6.9x forecast FY21 we think Virtus is looking overvalued. The end-product of what Virtus does is cute and desirable, but that doesn't mean you have to own the stock. Only two stars from us.

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