STOCKS DOWN UNDER

30 JULY 2020

Stocks Down Under

A racing car is an animal with a thousand adjustments.

- Mario Andretti (b. 1940), Italian-born American former racing car driver

MESOBLAST

Breathtakingly good data

CARBON REVOLUTION

The market is asleep at the wheel

BEACON LIGHTING GROUP

Share price rebound petering out

MESOBLAST

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Stocks Down Under rating: ★★★★

ASX: MSB
Market cap: A$ 2.1BN

52-week range: A$1.02 / A$4.45
Share price: A$ 3.65

When the Corona Crash happened back in March the biotechnology sector on the ASX was sold off heavily. A typical example of the declines was Mesoblast, which by 19 March 2020 was down 64% from the $3.07 level registered on 23 January. However, just over a month after the crash, Mesoblast was able to recover all the ground that had been lost and it continues to show form today. The catalyst has been clinical data on the utility of Mesoblast's stem cells in treating Covid-19 infection. However, we believe there's plenty of good news coming for Mesoblast beyond Covid-19 with the potential to propel the stock much higher.

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ASX: CBR
Market cap: A$ 244M

52-week range: A$0.80 / A$4.60
Share price: A$ 1.645

Melbourne-based Carbon Revolution designs and manufactures light-weight carbon fibre wheels for the automotive industry. The company listed on ASX late last year at $2.60 per share and has gained quite a bit of traction with well-known car brands that need ultra-light, but strong wheels for their performance cars, like the Jaguar F-Type R, the Nissan GTR and the Ford Mustang Shelby. Carbon Revolution has felt the impact of COVID-19 as global automotive supply chains were disrupted, which led to delayed revenues in the financial year that just ended. In the near term, more disruptions are anticipated, which we believe has held back the company's share price recovery post the Corona Crash. However, us petrolheads think that there is substantial upside opportunity in the shares given that underlying, longer term, demand is unchanged. Additionally, the company is expected to become EBITDA positive next year with strong EBITDA growth projected in the years thereafter.

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Share price chart

Source: Tradingview

One of Stocks Down Under's editors is widely known in Australia's equity market as 'Mr Biotech' because of the many years he has spent as an analyst covering ASX-listed biotech and medical device companies. Part of his attraction to the biotechnology industry is its demonstrated ability to take mere science and quickly turn that science into medical breakthroughs that the equity market can potentially value in the billions of dollars.

If you want a good example of that, look no further than the Coronavirus Crisis we're in right now. One of the leading competitors in the race to create a Covid-19 vaccine is Moderna, now capitalised on Nasdaq at a cool US$32bn or so. That Boston-based company had a vaccine candidate manufactured and ready for the clinic just four weeks after the genetic sequence of the virus was shared by the Chinese authorities. However, if you want an example closer to home of how the biotech industry can step up in a crisis, look no further than Mesoblast, a stem cell company which hails from Melbourne.

Some good news from New York

On 24 April 2020 Mesoblast reported a remarkable piece of clinical data from a product it is developing called Remestemcel-L. Mesoblast's stem cells have long been known to be able to blunt strong inflammation in the body, which made them potentially useful in Covid-19 because in some patients the virus causes Acute Respiratory Distress Syndrome (ARDS). The poor folks you see on TV in the Intensive Care Unit with ventilators over their mouths are the ones with ARDS. What's happening is that there's a sudden and widespread inflammation in the lungs as the infected patient's immune system reacts to the virus, resulting in shortness of breath and blueish skin. That's potentially, fatal, but possibly less so with Mesoblast's help.

You see, shortly after the pandemic reached New York, Mesoblast took 12 Covid-related ARDS patients at Mt Sinai Hospital in that city and gave them Remestemcel-L. Nine of those patients, or 75%, were able to come off ventilator support within a median ten days, as against maybe 9-12% on standard-of-care. Small patient numbers, obviously, but that proof-of-concept was good enough for Mesoblast to start a 300-patient Phase 2/3 trial in COVID-19 ARDS just a week or so later. And it was good enough to take Mesoblast stock above $3.00 again, on the expectation that thousands of future Covid-19 patients could benefit.

A stem cell revolutionary

Mesoblast is a global pioneer in the field of stem cell therapy, often known as 'regenerative medicine'. Doubtless you've heard of stem cells, if only because around the turn of the 21st century the mainstream media was abuzz with the potential of these cells to cure multiple conditions, such as Parkinson's Disease, heart failure or stroke. Stem cells are basically the body's cell-creating factories. As a particular organ or tissue loses cells through normal day-to-day living or injury, stem cells move to the site and differentiate into the more specialised cells that are needed.

Around 2001, stem cells were controversial because the assumption was that the best kind of stem cells for use as regenerative therapies were embryonic, meaning harvested from human embryos. Then companies like Mesoblast emerged with data showing that adult stem cells could serve just as well and the field moved out of the public consciousness for a while as the key players got on with the job of running clinical studies and working towards regulatory approval for their products.

Fast forward to 2020, stem cells are back in the spotlight thanks to Mesoblast and its Mesenchymal Stem Cells, or MSCs for short, which are the basis for Remestemcel-L. Mesoblast's MSCs originate from human bone marrow, although you can also find such cells in fat tissue or in dental pulp. From around 2009 Mesoblast was able to show clinically that its MSCs are therapeutically useful in things like Crohn's disease and heart failure and that they work in part by damping down excessive inflammation in the body. Over the years, the company has raised a lot of capital, but that capital had enabled it to get all the way through Phase 3 with Remestemcel-L prior to the Covid-19 data.

First US approval potentially two months from now

The lead indication for Remestemcel-L is a condition called Graft-Versus-Host-Disease, where a bone marrow transplant causes a potentially life-threatening immune reaction in the recipient. The favourable data on Remestemcel-L in paediatric patients suffering severe GvHD, where steroids hadn't tackled the inflammation, has now been filed with the FDA. That Agency will give its response by 30 September. Acute steroid-refractory paediatric GvHD may be an Orphan indication (i.e. relatively few patients) but FDA approval would be a significant validation of the science behind Mesoblast.

The reason we think Mesoblast can go higher from here is that after the GvHD indication, in only two months' time, there's potentially good news coming in the Covid-19 Phase 2/3. Behind that, a related MSC product called Rexlemestrocel-L is in Phase 3 studies in heart failure and back pain, both multi-billion-dollar market opportunities. And don't forget, in the background to all this, biotech stocks generally have had a shot in the arm from Covid-19 to the point where the Nasdaq Biotechnology Index is above its pre-Corona Crash levels.

We think this investor enthusiasm will likely keep up until the Coronavirus Crisis is over. Obviously, biotech is risky. In this game even mildly unfavourable clinical data can wipe out a lot of shareholder value in one fell swoop. However, with Mesoblast having progressively developed its science for the best part of two decades we think its risks have been well managed. This one gets four stars from us as the potential commercial upside is breathtaking.

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Share price chart

Source: Tradingview

The less it weighs, the more you pay

Carbon fibre products are typically manufactured through injection moulding whereby a resin is injected into a mould under high pressure. In the most recent quarter, Carbon Revolution moulded nearly 7,500 wheels, which is about 30,000 on an annual run rate. The benefit of using carbon fibre in wheels is that these wheels can be up to 40% lighter than cast aluminium wheels. Such weight savings will benefit the car's performance assuming the handling of the car doesn't deteriorate. The downside is that carbon fibre wheels are more expensive than aluminium wheels, but hey, if you're dropping more than 200k on a car you might as well spend a bit more for fancy wheels, right? In FY19 the company generated $15.1m in revenues and $20m just in 1HY20 alone, which was a 243% increase year-on-year.

The competitive environment for carbon fibre wheels is quite straightforward, with only two serious, albeit big, competitors. Thyssenkrupp has developed carbon fibre wheels for Porsche while Carbo Tech has developed hybrid aluminium-carbon wheels for BMW. Then there's Swedish supercar manufacturer Koenigsegg who has developed carbon fibre wheels, but only for its own cars, which are made in very small volumes. So, we'd say Carbon Revolution won't be feeling any serious competitive pressures for a while.

Initially targeting the top end of the market

Carbon Revolution sells its wheels to the likes of Ferrari, Ford and Renault that use these wheels in their high-end cars. The company estimates that the addressable market for its high-performance wheels totals more than 50 million units annually. Seen in that light, the current production run rates seem very low still, i.e. we believe there is plenty of room to grow if the company can maintain its high quality standards.

Longer term, Carbon Revolution aims to move into the mass automotive market, i.e. outside of performance and luxury cars. This market was estimated to need around 430 million wheels annually in 2018. In order to make this move into the mass market, the company will need to industrialise its production process so that it can manufacture at large scale, not just 30,000 units a year. This will include further automation and larger production facilities, which in turn will require capital to set up.

The company's proprietary carbon fibre manufacturing technology should also have multiple application areas in other industries, like aerospace. Carbon fibre has been used in airplane manufacturing for years because of its strength and light weight. Last year, Carbon Revolution received a grant to develop carbon fibre wheels for Boeing's Chinook helicopter. But we believe there's plenty more work in the aerospace industry, including in commercial airplanes.

COVID-19 supply chain disruptions

While Carbon Revolution still expects to be able to grow its revenues year-on-year in FY21, the company is seeing an impact from COVID-19 in the current quarter of the new financial year. Demand from one OEM customer in particular will likely impact sales growth in the first half. Additionally, we believe demand in the higher segments of the market may likely be muted for a few quarters longer as the economic fallout from COVID-19 progresses, especially in Europe and the US. Longer term, though, we think demand for Carbon Revolution's products will remain strong, and given the company's very low market share right now, we believe there's plenty of room to grow.

Valuation underestimates growth potential

While the total EBITDA number for the entire financial year 2021 is still expected to be negative at -$4.3m, Carbon Revolution is expected to cross over into EBITDA positive territory sometime this year. And with an expected $15.7m, FY22 should be the first full year of EBITDA positive results. In the following two years, EBITDA is expected to grow to $61m and $74m respectively. In other words, the prospects are pretty good.

However, when we turn our attention to the valuation, we can see that the market hasn't caught on to Carbon Revolution's solid outlook yet. At an EV/EBITDA of 14.8x for FY22 and 3.8x for FY23, we believe the company is clearly undervalued. Granted, the company will first need to become EBITDA positive and FY23 is still a while away, but at the current share price level we believe this is stock is one to buy and hold.

This view is confirmed by the EV/Revenue multiple, which is 4.3x for the current financial year. However, it drops to just 2x for next year even though revenues are expected to more than double in FY22 and then more than double again in FY23. And the multiple for that year is just 0.9x.

In summary, we believe the market has been asleep at the wheel with this one. So, we're quite comfortable putting a 4-star rating on Carbon Revolution.

BEACON LIGHTING GROUP

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More time at home electrifies online sales

Beacon has several components to its growth strategy for FY20 and beyond. It wants to enhance the brand and customer experience to increase differentiation in the market. It is also targeting the optimisation of its store network and the opening of new stores to grow sales and profits. Establishing a bigger online and social media presence as well as growing the emerging businesses are other key parts of its strategy. Lastly, it aims to pursue complementary domestic and international business opportunities as it continues to broaden its global reach.

The June 2020 business update showed year-to-date sales growth of 15.5% and like-for-like sales growth of 16.9%. Keeping stores open throughout the COVID-19 crisis has illuminated Beacon's CY20 sales. The shining star has been online sales, which have soared 77.7%. This is being driven by the fact that customers are spending more time working, educating and completing projects at home during the pandemic and are shifting purchases online. The company estimates that approximately 60% of its customers are "home renovators". It is a good omen for Beacon's online growth strategy (and not simply because of the lucky 7-7-7 result). The permanence of changed shopping habits and Government policy are uncertain, but management expects underlying NPAT to exceed the $16.5m FY19 result.

Record sales across multiple divisions

The FY19 highlights included record sales of $246.3m. Record sales were achieved in the company stores, online sales channels, Beacon International, Beacon Energy Solutions, Light Source Solutions Roadway and Masson For Light. Comparative sales, however, declined 2.3% as the group was challenged in 2HY19 by lower housing prices and churn rates, weak consumer confidence, the federal election and tighter mortgage availability. The NPAT result was $16.0m. The group opened five new owned stores and purchased a pair of franchised stores that were converted to company stores.

In 1HY20 NPAT increased 8.7% to $12.7m on a 0.3% increase in underlying sales to $123.1m. Online sales grew strongly helping to offset modest company store sales growth and a sales decline for the emerging businesses. Underlying NPAT fell 21.6% to $9.02m. A $13.5m profit was realised on the $28.0m sale and leaseback of the Parkinson Distribution Centre, which reduced the group's net debt position to $7.7m. It purchased the franchised store at Myaree and announced the closure of solar project arm Beacon Energy Solutions.

The balance sheet is strong led by an increased cash position of $32.8m. Borrowings increased to $7.4m in 1HY20 to fund inventory while the new AASB 16 accounting rule caused the lease liability balance to increase significantly.

Emerging businesses performing well

Beacon recently purchased the Malvern-based premium lighting design store Custom Lighting. Custom Lighting will broaden its product range in design lighting given the company's exclusive portfolio of ceiling, wall, crystal, lamp and exterior lighting products sourced from Europe and America.

The Light Source Solutions Roadway segment is benefiting from a transformation of Australia's streetlight landscape from old inefficient technology to LED technology. Beacon is developing the technically complex LED products under the GE brand for residential and major road lighting. Once the mass streetlight replacement occurs, we believe the company will have further opportunities in smart lighting controls for cities.

Beacon International has also been a standout performer. The segment's strategy is based on leveraging Australian product development to suit international markets. Beacon has sales offices in Hong Kong, China, the United States and Europe. Hong Kong is a key sales office because it sells to customers in New Zealand, Greece, China, Vietnam, South African and other countries. Meanwhile a strong base of e-commerce customers in the United States and Europe (including through Wayfair, Home Depot, Amazon and Houzz) is contributing to strong results. In addition to local e-commerce, we like the growth potential here as Beacon increases its product range to current and new customers.

Share price rebound petering out

Looking at Beacon's EV/EBITDA valuation of 10.6x and 10.2x for FY21 and FY22 respectively, we believe these numbers don't align with the company's EBITDA growth of just 5.8% and 4% in these years. It appears the share price rebound post the Corona Crash has largely run its course with the stock about to hit the long term, downward, trend line around $1.20/$1.25.

We believe the 4.3% yield will support the stock at these levels, but we don't see much upside from here. So, we're neutral at this stage and give the company 3 stars.

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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.