STOCKS DOWN UNDER

31 JULY 2020

Stocks Down Under

The worst time to have a heart attack is during a game of charades.

- Demetri Martin (b. 1973), American comedian and actor.

MIRVAC GROUP

Solid property play

INTEGRAL DIAGNOSTICS

Some COVID uncertainty, but attractively valued

BOUGAINVILLE COPPER

Panguna 2.0

MIRVAC GROUP

Solid property play

Stocks Down Under rating: ★★★★

ASX: MGR
Market cap: A$ 8.3BN
Dividend yield: 4.8%

52-week range: A$1.65 / A$3.52
Share price: A$ 2.10

Sydney-based Mirvac Group is a major property investment company that was founded in 1972. It is involved in several development sectors and is the first major property company to offer build-to-rent developments. Australian and international companies, major organisations and Government tenants make up its quality rental base. Cash flow visibility and security are high and its mixed-use urban properties are driving sustainable dividend growth. The shares come with a 4.8% yield and are trading below the $2.58 NTA.

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ASX: IDX
Market cap: A$ 724M

52-week range: A$ 1.78 / $ 4.39
Share price: A$ 3.76

Melbourne-based Integral Diagnostics is a leading provider of diagnostic imaging services across Australia and New Zealand. It provides these services to general practitioners, medical specialists and referrers and their patients at 64 radiology clinics of which 20 are situated in hospitals. As the third largest radiology provider in the country, it uses a technologically superior digital imaging (filmless) solution. The shares joined the ASX Top 300 last month and have been essentially flat since the start of the year. We believe the company’s current valuation is supported by the EBITDA growth projections, although uncertainty around COVID-19 restrictions remain.

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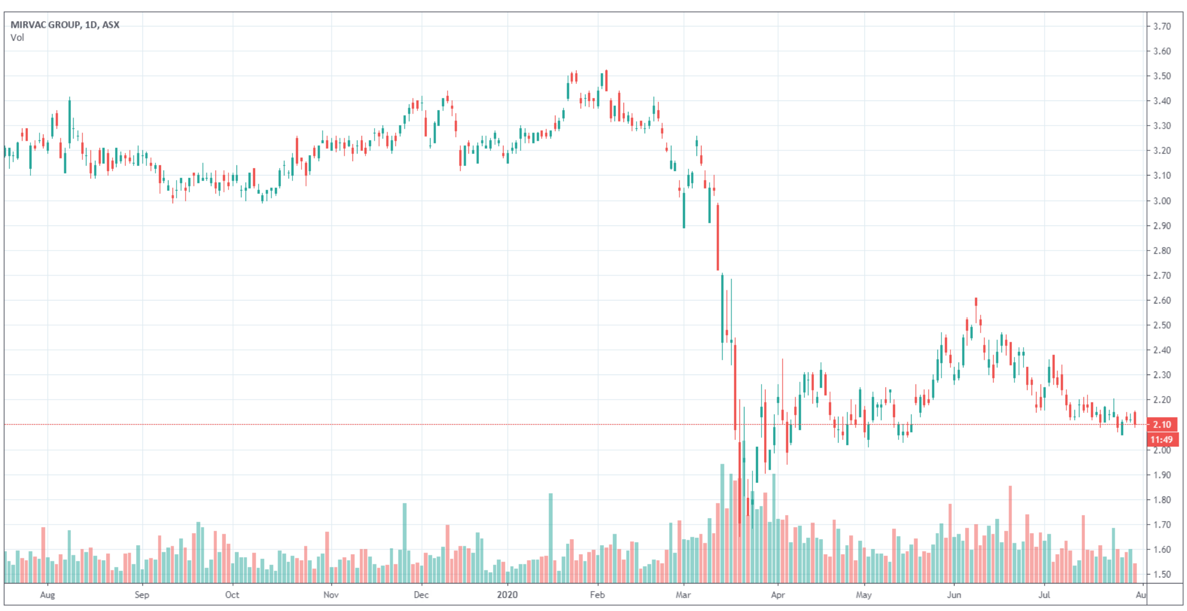
Share price chart



Source: Tradingview

Urban focus on Australia's growth cities

Mirvac's portfolio includes office, industrial, retail, residential and build-to-rent properties located across Australia. Since 2015 Mirvac's strategy has been focused on Australia's urban centres. This has been supported by urban population growth and changing consumer preferences. Not to mention Government investments in infrastructure, which are reshaping residential and employment precincts. The group believes this is where the best investment opportunities exist. Its $23.1bn in assets under management (AUM) is spread across the key cities of Sydney, Melbourne, Brisbane and Perth. It takes a disciplined approach to selecting portfolio investments that are deemed attractive mixed-use urban sites.

The FY19 result included a 4% increase in operating profit to $631m and 4% EPS growth. The office and industrial segment had strong operating results growing profits 26%. The EPS result along with the 11.6 cents per share distribution were at the top end of guidance. The 12-month total return, the combination of the distribution and NTA growth, was an attractive 13%.

In 1HY20 Mirvac delivered 21% operating profit growth to $352m and EPS growth of 14%. This was driven by an increase in lot settlements within the residential segment that led to a 148% increase in residential operating EBIT. Roughly two-thirds of the 9.0 cents per share EPS was distributed to shareholders. Net tangible assets (NTA) was up 6% to $2.58, i.e. well above today's share price.

Robust balance sheet supports growth

Mirvac's capital management strategy has been supporting growth throughout the property cycle. Operating cash flow remained strong in 1HY20 thanks to the timing of residential settlements. The FY20 distribution is expected to be up 5% to 12.2 cents per share and be fully cash covered. Looking down the road, distribution growth will be primarily backed by the portfolio's passive recurring income stream generated by completed developments. Mirvac's credit ratings are solid at A3/A- with stable outlooks from Moody's and Fitch.

The company has a strong balance sheet. As at 24 April it had cash and undrawn facilities of $984m and only $200m in debt due for repayment through early CY22. Gearing is at the low end of the target range at 20.8%. Average borrowing cost slipped 30 basis points to 4.5% in 1HY20 and has further downside potential in this low rate environment. The average debt maturity is a healthy 7.7 years. The group is investing in technology to support future growth and in establishing its unique built-to-rent business.

Strong development pipeline

Mirvac's proven ability to form capital partnerships is driving solid external AUM growth. External AUM reached $9.1bn in 1HY20 from $8.7bn in FY19. It has increased every year since FY15 when it was $2.8bn. This growth has been supportive of the increase in asset and funds management fees.

The current development pipeline consists of eight office, three industrial, three retail, 17 residential and three build-to-rent assets. The $5.4bn future pipeline opportunities include assets in the Melbourne office, Sydney residential and Sydney mixed-use sectors. It has a $3.1bn active commercial pipeline under construction that is significantly de-risked with 90% tenant pre-commitments. This includes South Eveleigh and the Locomotive Workshops in Sydney, 477 Collins Street in Melbourne and 80 Ann Street in Brisbane. These properties are expected to generate over $90m in annual recurring net operating income (NOI) by FY23. The residential pipeline was restocked with more than 3k lots in FY19 and is expected to deliver over 2,500 residential settlements in FY20.

Mirvac has continued to work on its development pipeline during the COVID-19 crisis. As the economy Australian recovers, it may have opportunities to snatch up additional urban mixed-use properties. We like the group's track record, pipeline and capital discipline. Additionally, the shares haven't really bounced back after the Corona Crash, hence a 4-star rating for Mirvac.

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Source: Tradingview

Industry leading margins

Integral Diagnostics operates medical imaging facilities across the country under three brands -- Lake Imaging in Victoria, South Coast Radiology and Imaging in Queensland, and Global Diagnostics in Western Australia. Its New Zealand business operates through the SRG Radiology and Trinity MRI brands. The group employs a team of licensed radiologists and nuclear medicine specialists to deliver its medical leadership model focused on patient care and access. Its digital imaging technology drives efficiency gains and enhanced clinical functionality compared to traditional film imaging methods. Since MRIs are necessary regardless of the economic environment, we believe Integral Diagnostics shares are rather defensive.

In FY19 the company achieved 40.7% NPAT growth to $25.6m. Operating revenue increased 22.9% to $231m as organic growth exceeded the industry averages. The operating margin expanded from 21.4% to 23% the company paid a 10 cents per share dividend marking a 25% increase on the prior year. The group performed 1.2m exams and consulted to over 600k patients, 20% more than the number of patients seen in FY18.

The 1HY20 financial highlights included 15.3% operating revenue growth and 10.1% operating NPAT growth. Unfortunately, the EBITDA operating margin slipped from 23.4% in 1HY19 to 22.2% due to the ramp of the North Melbourne Specialist and Research Centre, major refurbishments at two hospital locations and the acquisition of Imaging Queensland. Integral Diagnostics also successfully completed an oversubscribed equity raise of $72m.

COVID-19 crisis causes lower patient volume

Integral has a strong balance sheet that is being de-levered. Through 1HY20 it had a net debt position of $134.8m and leverage was reduced to 2.0x EBITDA from 2.2x in FY19. Net assets increased 77% to $225.6m. As at 9 June 2020 the company had cash reserves of approximately $55m and $75m of undrawn cash advance facilities. Debt facilities are not set to mature until December 2021 and we believe the balance sheet strength looks to be supportive of further organic growth and acquisitions.

As a health care service provider, the company has been significantly challenged by the COVID-19 crisis. The cancellation of elective surgery and sporting activities along with general patient reluctance to visit doctors contributed to a sharp decline in diagnostic imaging volumes. Meanwhile, shifting medical priorities, especially at its hospital-based clinics, have forced the company to adapt its policies in adherence with COVID-19 restrictions. It formed an Incident Management Team (IMT) to oversee the company's COVID-19 response and eight of Integral's smaller locations were closed. Despite the challenging conditions, it has continued to provide diagnostic imaging where permitted. Patient activity and revenue has picked up since May, but plenty of uncertainty remains, in our view.

Rapidly expanding New Zealand presence

Australia's Medicare covers diagnostic imaging services such as ultrasound, CT-scans, X-rays and MRI scans. This is good for companies like Integral Diagnostics in terms of patient volume, but the industry also looks to benefit from the Medicare reimbursement of diagnostic imaging equipment. Given the increasing demand and recognised benefits of imaging exams over the long run, the potential for an increase in Medicare reimbursement is favourable. Moreover, the Government's Capital Sensitivity measure rewards companies that use newer or upgraded equipment with higher Medicare reimbursements. Integral's focus on using the latest, state-of-the art equipment bodes well for its reimbursement prospects.

On 6 June 2020, the company announced the acquisition of Auckland-based radiology business Ascot Radiology. The purchase will give it more of a premium profile and expand the group's presence in the growing New Zealand market. Ascot becomes the fourth New Zealand-based acquisition in the last couple years. The $47.7m cash and shares deal is expected to be completed in September 2020 and Ascot is projected to contribute $5.3m to $6.1m to FY21 EBITDA. In FY19, Integral Diagnostics completed the acquisition of Imaging Queensland Group and integration and performance have thus far been in line with expectations.

In summary, we like Integral's prospects for organic growth and value-added acquisitions, but are concerned about the ongoing COVID-19 uncertainty. However, the current EV/EBITDA valuation of 12.1x and 10.9x for FY21 and FY22 is supported by the anticipated EBITDA growth of 22% and 11.4% in both years. So, despite the near-term uncertainty around COVID restrictions our diagnosis is 4 stars.

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Share price chart

Source: Tradingview

Say the name Bougainville and most Australians will know what you're talking about. It's an island that ostensibly belongs to Papua New Guinea (PNG) around 950 km northeast of Port Moresby. You may either know it as the place where Aussie troops squared off against their Japanese counterparts in '44 and '45 and where two of our boys won the Victoria Cross. Or they'll know it as the island where a bitter civil war shut down a major copper mine back in May 1989 and where that civil war is long over but the mine has yet to reopen.

May 1989 – The month that will live in infamy

The idle mine is called Panguna, and if it ever re-opens it'll be a big deal in the copper world. Rio Tinto discovered the Panguna copper-gold deposit in the middle of Bougainville in 1964, when PNG was a territory of Australia. Rio floated Bougainville Copper in 1971 in order to finance the commissioning of this mine but retained a majority stake. Panguna, after start-up in 1972, operated for the next 16 years to produce, on average, 188,000 tonnes of copper and 581,000 ounces of gold annually. At one stage around 7% of the world's copper was coming from the concentrates shipped out of Bougainville and this one mine was responsible for 45% of the export earnings of PNG, which became independent of Australia in 1975.

The reason the golden goose got cooked was that many Bougainvilleans came to dislike it intensely. They were concerned about its environmental impact, they didn't like the influx of different ethnic groups from other parts of PNG to work the mine and they felt that not enough Panguna money stayed on the island. The result was a secessionist rebellion in 1988 that targeted Panguna and managed to shut it down the following year.

The locals want independence

After years of fruitless efforts by the PNG Defence Force to defeat the rebels, during which time the government considered hiring mercenaries to do the job, a peace deal was finally reached in 1998 that turned Bougainville and neighbouring Buka Island into an autonomous region within PNG. Sadly, around 20,000 people are believed to have died in this war. Panguna stayed idle after the peace deal because autonomy didn't establish a framework that would remove the obvious sovereignty risk issues around this mine. However, a lot of observers started to wonder late last year if Panguna's hour was come round at last. Why 2019? Well, a referendum on independence was finally held, as per the terms of the 1998 peace deal, and the voters said they wanted independence. Sure, the referendum was non-binding, but the majority in favour of independence was a pretty decisive 98%.

Which brings us to Bougainville Copper stock. All this time Bougainville Copper has remained an ASX-listed company and traded most business days, with the stock fluctuating with the price of copper and the political situation in PNG. There was enough cash and investments in the company to keep the office opened (about A$47m as at December 2019), but from year to year nothing much changed. However, in 2016 Rio Tinto decided to cut ties with PNG and handed over, for no charge, its 53.8% of Bougainville Copper to the Autonomous Bougainville Government and the PNG government. The latter in turn gave part of its stock to a company representing local landowners, so that the Bougainville Government now holds 36%, the PNG government 19% and the landowners 17%.

A$100bn in copper and gold just waiting to get mined

This localisation of ownership meant that when the independence vote took place, Bougainville Copper stock re-rated sharply, from 9.2 cents on 10 October 2019 (under cash and investments backing of around 11 cents) to 49 cents on 26 November. Sure, that spike was short-lived and by the end of the Corona Crash Bougainville Copper was down to 16 cents, but that was still higher than before the vote. And no wonder. It's now in the interest of PNG to let Bougainville go, and for an independent Bougainville to seriously consider a Panguna restart.

Certainly, the mine site is in disrepair and would need extensive rehabilitation, including environmental rehabilitation, but Rio Tinto estimated a resource in February 2013 of 1.8 billion tonnes of ore grading 0.3% copper and 0.34 g/t gold. That rounds out to 5.3 million tonnes of copper and 19.3 million ounces of gold, which at current prices and exchange rates is close to A$100bn of copper and gold in the ground at Panguna. Not bad for the world's prospective newest country, population 250,000, to kickstart its independence.

What's Bougainville Copper stock worth in the event Panguna 2.0 gets a head of steam? One way to think about this is to simply put a nominal value on the resource of 1%. That would be $2.48 per share given there are 401 million shares on issue. Okay, it's a long shot, but with copper and gold both re-rating in mid-2020 - and gold fairly sharply - one's downside risk is fairly low for a while. That's why this stock gets four stars from us right now, but watch this space carefully.

Pitt Street Research Pty Ltd

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