STOCKS DOWN UNDER

21 AUGUST 2020

Stocks Down Under

In times of rapid change, experience could be your worst enemy.

- J. Paul Getty (1892-1976), American-born British petrol-industrialist

AMPOL LIMITED

A course yet uncharted

UNITI GROUP

A private fibre roll-up

4DMEDICAL

Don’t hold your breath

AMPOL LIMITED

A course yet uncharted

Stocks Down Under rating: ★★★

ASX: ALD
Market cap: A$ 7.1BN
Dividend yield: 2.9%

52-week range: A$18.32 / A$35.96
Share price: A$ 27.90

Operating through two main business segments, convenience retail and fuel and infrastructure, Sydney-based Ampol purchases, refines and distributes petroleum products across Australia, New Zealand and Singapore. Previously known as Caltex Australia Limited the company rebranded to Ampol Limited on 15 May 2020 and changed its ticker from CTX to ALD. Other than that, however, the company remains the same. Despite being up 56.3% since its 52-week low in March, Ampol shares seem unlikely to do much in the near future as the price of oil remains low and margins remain depressed.

READ MORE

UNITI GROUP

A private fibre roll-up

Stocks Down Under rating: ★★★★

ASX: UWL
Market cap: A$ 785M

52-week range: A$0.755 / A$1.835
Share price: A$ 1.61

Uniti Group listed on the ASX in February 2019 as Uniti Wireless and has since rebadged itself Uniti Group. The Adelaide-based Telecoms Infrastructure and Services company got started in 2014 and has expanded across Australia from its original Adelaide and Melbourne footprint. Uniti management is in the process of building a substantial player in the fibre infrastructure market, thereby becoming a notable competitor for NBN in this space. We believe Uniti's shares are quite cheap relative to the growth you're getting. Additionally, we believe one of the larger Telco's could come knocking to talk about a takeover once Uniti achieves more scale. Let's have a closer look.

READ MORE

4DMEDICAL

Don't hold your breath

Stocks Down Under rating: ★★★

ASX: 4DX
Market cap: A$ 442M

52-week range: A$1.25 / A$1.93
Share price: A$ 1.66

It was a great start to life as an ASX-listed company. The Melbourne-based medical imaging technology developer 4DMedical raised $56m at 73 cents per share, but the stock ended its first day of trading on 7 August at $1.59. It has stayed above $1.50 since then. That means this company is going to have to perform very strongly in a commercial sense if it is going to live up to expectations. We're a little skeptical.

READ MORE

AMPOL LIMITED

A course yet uncharted

Stocks Down Under rating: ★★★

ASX: ALD
Market cap: A$ 7.1BN
Dividend yield: 2.9%

52-week range: A$18.32 / A$35.96
Share price: A$ 27.90

Operating through two main business segments, convenience retail and fuel and infrastructure, Sydney-based Ampol purchases, refines and distributes petroleum products across Australia, New Zealand and Singapore. Previously known as Caltex Australia Limited the company rebranded to Ampol Limited on 15 May 2020 and changed its ticker from CTX to ALD. Other than that, however, the company remains the same. Despite being up 56.3% since its 52-week low in March, Ampol shares seem unlikely to do much in the near future as the price of oil remains low and margins remain depressed.

Share price chart

Source: Tradingview

The focus is international

Ampol operates on a calendar year (CY) basis and will be releasing its 1HY20 results on 25 August 2020.

There were three major developments at Ampol in CY19 and year-to-date CY20, two of which were international. The first was the opening of Ampol's first international fuel storage facility, in pilot, servicing South East Asia. With fuel storage capacity being reached during COVID-19 and demand for storage remaining high, this could be an interesting vertical expansion for Ampol as it already has the international connections necessary from its sourcing and wholesale businesses.

The second development centres around Ampol's plans to expand into the United States region with a Houston office. A quick side note here is we are unsure if there have been any delays or impacts here due to the drastic expansion of COVID-19 cases in Texas since this announcement. This should become clearer with Ampol's 1HY20 earnings release on 25 August 2020. The goal of this office will be to expand Ampol's sourcing reach, as well as provide new wholesale leads on the western side of the world.

The third major development was the sale of 49% of 203 of its freehold petrol stations to an unlisted real estate investment consortium made up of Charter Hall and GIC for $682m. The majority of the proceeds from the sale will be used to reduce the company's leverage in order to keep its net debt/EBITDA closer to 1.5x. The sale was sealed 17 August 2020.

Volume increases are great but it's a margin game

During 2019 volume increased approximately 3% for Ampol's fuel and infrastructure division. However, earnings before interest and tax declined 21% year-over-year, which was due in large part to continuing margin pressure from softer demand and prices, especially at the Lytton refinery. Excluding the results from the Lytton refinery, earnings before interest and tax declined 7% year-over year.

It is important to remember that WTI Crude never went above US$70 a barrel in 2019 and ICE Brent Crude only broke US$70 a barrel briefly. Since the crash at the beginning of the COVID-19 crisis neither has reached above US$50 a barrel and we believe the oil price is unlikely to return to pre-COVID-19 levels during 2020. While 1HY20 through June results have not been released yet, we do know that the Caltex refiner margin for YTD April was approximately 42% lower year-over-year and since May the refinery has been shut down. Earnings before interest and tax for CY19 were still positive, yet sharply down. However, the question for CY20 is not how low it will be but rather how negative.

While we don't have the results, or guidance, for the 2nd quarter through June, we do have Q1 results. Earnings before interest and taxes for fuels and infrastructure declined approximately 32% year-over-year excluding the Lytton refinery. Including the refinery, earnings before interest and taxes declined approximately 51%.

However, as excepted with sharp declines in wholesale fuel prices, the margins for convenience retail fuel sales were significantly higher, despite a decline in volume of 8%. This led to earnings before interest and taxes for convenience retail increasing approximately 155% year-over-year, allowing for a small group earnings before interest and taxes year-over-year increase of approximately 3%. However, we do not believe this will likely happen going forward and we expect 1HY20 earnings before interest and taxes will decline year-over-year. It is also important to note that Ampol was forced to take an inventory loss charge of $109m during Q1 due to the sharp drop in the price of oil.

The icebergs on the starboard bow won't you dance with me?

For 2019 Ampol released a sustainability report and while there is a lot of information in it, 62 pages worth, we want to focus on the medium to long-term critical risks Ampol outlined and the solutions it is pursuing. While Ampol discusses, briefly, the need to diversify its fuel offerings into biodiesel, hydrogen and others, the only concrete action outlined so far has been a partnership with EVIE to build 'ultra-fast' charging stations at six Ampol sites in NSW and Victoria. Besides this there have been no announcements regarding concrete steps to solve these risks. In our opinion this is a cause for concern as these risks are serious and not easily solved or mitigated.

No news is not good news

Ampol is trading at a rather steep EV/EBITDA ratio of 9.5x and a price to tangible book value of 2.7x. However, the compound annual growth rate over the last three years really says it all at -5.4%., Ampol does generate a rather significant amount of cash, but unless there is a significant change towards the upside in the global oil market, Ampol's margins will continue to be under significant pressure, in our opinion. Therefore, factoring in the current global economic environment we must give a 3-star rating.

UNITI GROUP

A private fibre roll-up

Stocks Down Under rating: ★★★★

ASX: UWL
Market cap: A$ 785M

52-week range: A$0.755 / A$1.835
Share price: A$ 1.61

Uniti Group listed on the ASX in February 2019 as Uniti Wireless and has since rebadged itself Uniti Group. The Adelaide-based Telecoms Infrastructure and Services company got started in 2014 and has expanded across Australia from its original Adelaide and Melbourne footprint. Uniti management is in the process of building a substantial player in the fibre infrastructure market, thereby becoming a notable competitor for NBN in this space. We believe Uniti's shares are quite cheap relative to the growth you're getting. Additionally, we believe one of the larger Telco's could come knocking to talk about a takeover once Uniti achieves more scale. Let's have a closer look.

Share price chart

Source: Tradingview

Private fibre optic networks

Uniti is not a regular Telecom company, like a mini Telstra, but is all about providing high-speed internet. The company does not have any activities in mobile. Uniti specifically focusses on building relatively small, local fibre optics networks in newly built offices, residential and commercial developments. But Uniti also offers broadband in more "traditional" third-party setups, e.g. through NBN.

The company generated revenues of $23.4m in FY19, but managed to increase its 1HY20 revenues by more than 600% to $22m, mostly on the back of a few acquisitions it did last year.

The company's management team comprises two Telco veterans; Vaughan Bowen and Michael Simmons who ran M2 Group back in the day before it merged with Vocus (ASX:VOC). Bowen set up M2, while Simmons joined M2 in 2008 and later on became Vocus CEO. So we believe it's fair to say that Uniti management have been around the block, which should be reassuring for investors given the company's ambitions.

Lean, mean acquisition machine

Uniti Group is in the middle of a fibre infrastructure roll up. Following its listing in February last year, Uniti acquired LBNCo at around $100m in August. Then in October it acquired OPENetworks for $27.5m and 1300 Holdings in December for around $85m.

The company's latest move is also its boldest to date. In June this year, Uniti announced its intention to acquire ASX-listed Opticomm (ASX:OPC) for $407m in cash and $125m worth of Uniti shares. This bid translates into $5.20 per Opticomm share. Not a bad outcome for OPC shareholders given that the company only listed on the ASX a year ago at $2 per share.

A bold move acquiring Opticomm

Opticomm designs, builds, owns and operates wholesale Telecoms infrastructure for new residential, commercial and retail developments, mostly in the Melbourne area, and is actually a bit larger than Uniti. The deal should get the green light from shareholders next month. The plan is to combine Opticomm's network of private fibre with Uniti's. The combo would be the sixth biggest ASX-listed Telco with activities across the eastern seaboard, Adelaide and Perth. It will be competing with NBN in new developments, specifically in the residential market. Pro forma revenues for the combination in FY20 are around $70m. Uniti expects about $10m in cost synergies to be realised once the acquisition is fully integrated.

In order to fund the Opticomm acquisition, Uniti raised $152m in institutional money in June and a further $118m in retail money in July, all at $1.40 per share. Additionally, the company increased its debt facility to $150m. Uniti expects the Opticomm deal to be 23% EPS accretive and its net debt/EBITDA to still be a modest 1.3x, which we believe should provide it with more firepower in case future acquisition opportunities pop up.

Very cheap growth stock

Adding Opticomm's FY20 EBITDA of $37.6m to Uniti's $26.5m mid-point EBITDA guidance gives us $64m for FY20 in total, not counting the $10m in future cost savings. But if we annualise Uniti's 2HY20 EBITDA number, because of the strong growth just in that period, and take into account cost savings we get a post-acquisition pro forma EBITDA number of $86.7m.

Using that number and taking the pro-forma net debt of $112m gives us an EV/EBITDA multiple for the new combination of 10.8x for FY20. We believe this is cheap for such a high growth company with a veteran Telco management team looking to do major roll up in this industry. With plenty of growth opportunities around Australia, we think Uniti would be a nice, growth-oriented, addition to investment portfolios. Longer term we would expect Uniti itself to potentially become part of a larger Telco's expansion ambitions.

In the near term there will integration risk stemming from the Opticomm acquisition if and when it is finalised, but that potential risk shouldn't be a show-stopper, in our view, especially given management's M2 pedigree. Four stars from us.

4DMEDICAL

Don't hold your breath

Stocks Down Under rating: ★ ★ ★

ASX: 4DX
Market cap: A$ 442M

52-week range: A$1.25 / A$1.93
Share price: A$ 1.66

It was a great start to life as an ASX-listed company. The Melbourne-based medical imaging technology developer 4DMedical raised $56m at 73 cents per share, but the stock ended its first day of trading on 7 August at $1.59. It has stayed above $1.50 since then. That means this company is going to have to perform very strongly in a commercial sense if it is going to live up to expectations. We're a little skeptical.

Share price chart

Source: Tradingview

The timing was exquisite. A few years ago 4DMedical developed a new respiratory imaging diagnostic, which represented a big step forward compared to the current standard of care. And then, right before a global pandemic where the virus that is causing all the trouble is a respiratory virus, this company gets the data it needs to show this product works well as a diagnostic. In May 2020, when everyone is panicking about COVID-19, it gets FDA approval. And, while people are still panicking, it does its IPO. No wonder this company is worth more than A$400m on ASX right now.

Impressive science and an FDA-approved product

Now, let's say it right up front – what 4DMedical has achieved since its 2012 founding is impressive. This company's XV Technology allows conventional X-Ray images of a patient's lungs to be processed using fancy algorithms into a four-dimensional image. That allows the doctors to look at what's going on inside those lungs in real time in a way that wasn't possible before. With 510(k) approval in the US, this technology is no longer experimental. And the product, called XV LVAS (short for Lung Ventilation Analysis Software), is a SaaS product, which means no investment in new equipment is required on the part of physicians when they start to use it.

All good, right? So why do we have only three stars on this one rather than four? Well, we think $400m or more is too steep a price to pay for a new imaging product where the company is only just starting to sell it. Remember, the medical profession is conservative by nature, so while doctors and hospitals will look at new technology where there is clear utility in terms of patients outcomes, they still have to get used to the offering. Also, and more importantly, health insurers have to look at the data and sign off on reimbursement, and the people who work in that industry tend to take a lot of convincing. So rollout of XV LVAS is going to take time and before the big money starts to roll in, investors may get bored with 4D Medical and move on.

A big market opportunity

There's an additional complication with this story – the fact that COVID-19 won't be with us forever. Lung imaging is very important to health care right now because Covid infections can cause serious and life-threatening lung inflammation in a tiny minority of infected people. However, when the first vaccines become available and Covid-19 starts to go away, so will the urgency around stories like this.

That doesn't mean 4DMedical isn't well placed to build a good business with XV LVAS and subsequent products. Respiratory medicine will still be a big deal after COVID-19 with all the patients who have asthma and so on. The company estimates the global market for respiratory diagnostics is worth at least US$30bn, a lot of which is the old spirometry tests that doctors have been using since the mid-19th century and which is noticeably inferior to XV LVAS.

4DMedical's product gives you the insights from spirometry with as much X-Ray exposure as a conventional 2D scan, but with the resolution of a CT scan. It will be available at a reasonable price compared to those other, older, imaging modalities. Indeed, if you add up the cost of conventional Pulmonary Function Testing using spirometry, 4DMedical's approach is about two-thirds cheaper. So we predict a very good future for this company, particularly since the it is so well-funded now thanks to a successful IPO.

Even with good stories investors can get bored waiting for the big money

Here's what we think could happen to 4DMedical. It's August 2021 and this stock is now a year old, but in the June 2021 quarter the annualised run rate in terms of revenue will only be US$5m or thereabouts. We think investors will be starting to ask this questions – where's the big revenue from this product we were hoping for? The company will answer, rightly, that reimbursement is starting to come through and that more will come over time. But investors are a fickle crowd and that might prompt a gradual de-rating.

Between now and then we think investors should put 4DMedical on their watch lists. If, as we expect, the stock gradually loses steam and heads down, they can dust off their August 2020 notes. For now, investors impressed with the IPO success should just take a deep breath.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

Pitt Street Research Pty Ltd is founded on more than 40 years of combined experience researching companies in a range of different sectors.

Stocks Down Under (Pitt Street Research AFSL 1265112) provides actionable investment ideas on ASX-listed stocks. The Content has been prepared for general information purposes only and is not (and cannot be construed or relied upon as) personal advice nor as an offer to buy/sell/subscribe to any of the financial products mentioned herein. No investment objectives, financial circumstances or needs of any individual have been taken into consideration in the preparation of the Content. Financial products are complex, entail risk of loss, may rise and fall, and are impacted by a range of market and economic factors, and you should always obtain professional advice to ensure trading or investing in such products is suitable for your circumstances, and ensure you obtain, read and understand any applicable offer document