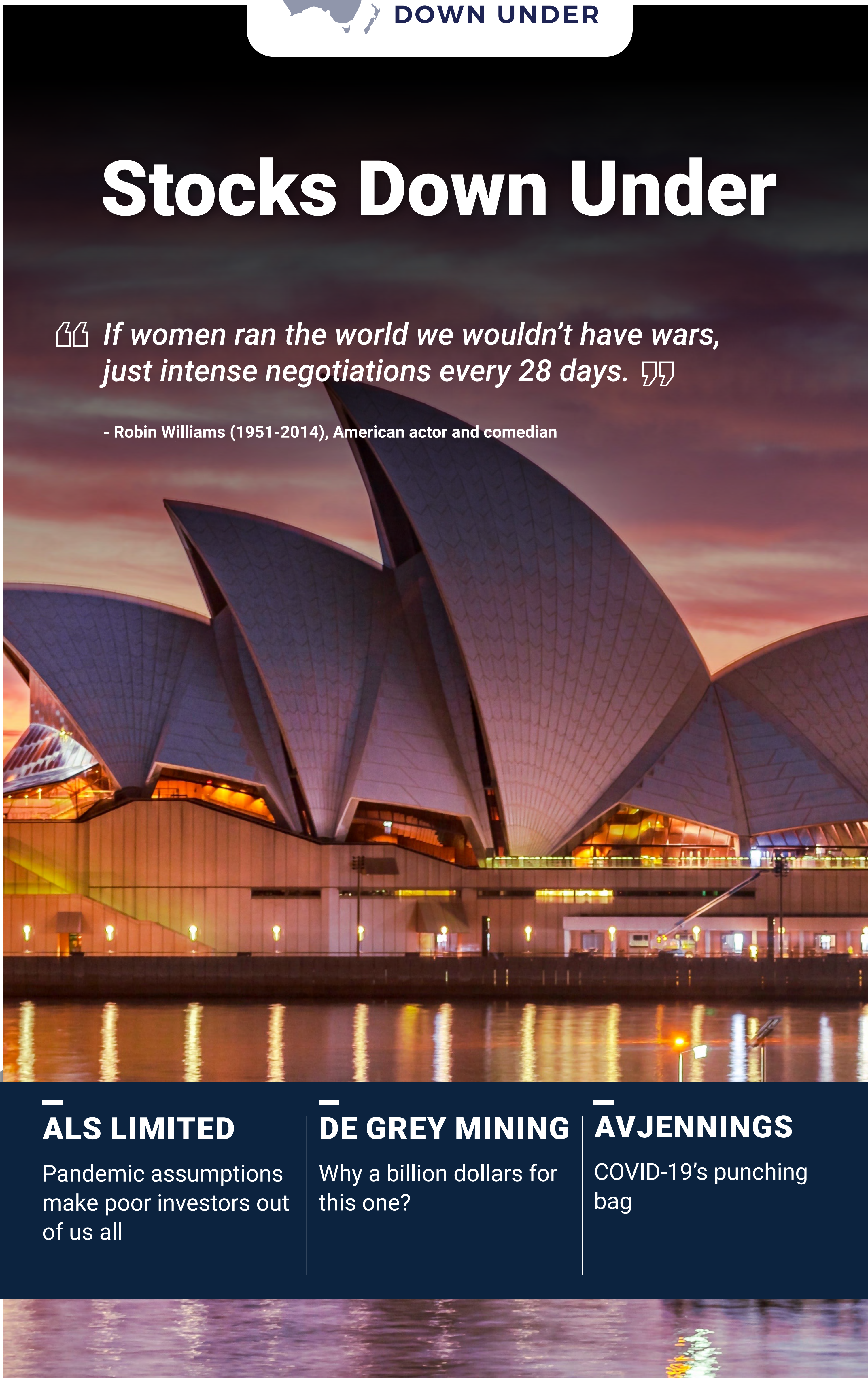
STOCKS DOWN UNDER

28 AUGUST 2020



Stocks Down Under

If women ran the world we wouldn't have wars, just intense negotiations every 28 days.

- Robin Williams (1951-2014), American actor and comedian

ALS LIMITED

Pandemic assumptions make poor investors out of us all

DE GREY MINING

Why a billion dollars for this one?

AVJENNINGS

COVID-19's punching bag

ALS LIMITED

Pandemic assumptions make poor investors out of us all

Stocks Down Under rating: ★★

ASX: ALQ
Market cap: A$ 4.360bn
Dividend yield: 1.92% (70% Franked)

52-week range: A$4.36 / A$10.20
Share price: A$ 8.92

ALS Limited is a provider of lab testing, inspection, certification and verification solutions across 65 countries in Africa, Asia, Australia, Europe and the Americas. The company is headquartered in Brisbane and operates out of 350 locations around the globe providing services to at least 12 different industries in addition to environmental testing. While an investor would be forgiven for assuming that COVID-19 was a boon to ALS Limited, the company has indicated that the opposite is true and even life sciences, the most COVID-19 relevant division, has seen a decline in revenue.

READ MORE

DE GREY MINING

Why a billion dollars for this one?

Stocks Down Under rating: ★★★

ASX: DEG
Market cap: A$ 1.058BN

52-week range: A$ 0.04 / A$1.07
Share price: A$ 0.99

When we last wrote about the Perth-based gold explorer De Grey Mining on 16 April 2020 we were gratified with its recent exploration success but felt that the stock had re-rated enough. We put a two-star rating on the stock. We didn't reckon on the amount of enthusiasm gold would generate as it raced towards US$2,000 an ounce. Also, De Grey continues to please with its exploration efforts. With all this in mind we are switching our rating to three stars. We think it's overvalued, but it could get more overvalued.

READ MORE

AVJENNINGS

COVID-19's punching bag

Stocks Down Under rating: ★★★★

ASX: AVJ
Market cap: A$ 203M

52-week range: A$0.32 / A$0.64
Share price: A$ 0.495

AVJennings is a residential property development company dual-listed on the ASX and the Singapore Exchange, headquartered in Hawthorn, Victoria, a suburb of Melbourne east of the CBD. AVJennings has a very specific business strategy of acquiring land, developing and subdividing it and then selling the property off as a mix of land and AVJennings' built homes throughout Australia and New Zealand. The second half of FY20 was unsurprisingly rough for AVJennings. However, indications are that FY21 has started off with a bang.

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Share price chart

Source: Tradingview

Before we continue, there are two unusual aspects of ALS Limited that require outlining. The first is ALS Limited's financial year ends 31 March. Therefore, when we say during FY20, we are referring to 1 April 2019 through 31 March 2020. The second is due to ALS Limited's global nature, which forces its cash holdings to be split between USD (69%), other (15%), AUD (9%), Euros (5%) and British Pounds (2%). Since the company reports in AUD, there can be significant fluctuations to its cash holdings that are not related to changes in the actual cash balances.

In a group of three one stands apart

ALS Limited's revenue is divided into three main divisions, life sciences (51% in FY20), commodities (35%) and industrials (14%).

The Life sciences division supplies testing, sampling and analysis services and remote monitoring for companies in the environmental, food, pharmaceutical and consumer product markets. The company has represented life sciences as the largest driver of future EBITDA growth. The division's EBIT margin grew 0.35%-point to 15.3% during FY20. Due to the demand-based nature of this division's costs, the EBIT margin remained stable during 1QY21. However, the life sciences division is the most exposed to growth opportunities from COVID-19 and still declined on a revenue basis during 1QY21, contributing to the company's year-over-year 9.8% decline in revenue for 1QY21.

The commodities division provides full-service testing for the global mining industry with a focus on geochemistry, metallurgy, inspection and coal quality. Despite the rally of certain commodities during COVID-19 this division still declined year-over-year during the first quarter of FY21.

Lastly, the industrials division provides diagnostic testing and engineering solutions for the energy, resources, transportation and infrastructure sectors. The company has warned that this division has relevant exposure to the United States oil and natural gas exploration industry, which continues to be under significant pressure as the price of oil remains low. Additionally, as COVID-19 has affected the global economy, companies have been deferring business with the asset care department, the largest driver of organic revenue growth in the industrial division.

Now I have become risk, the destroyer of reporting seasons

Upon witnessing the first detonation of an atomic weapon on 16 July 1945, Robert Oppenheimer is famous for a line from the Bhagavad-Gita, "Now I have become Death, the destroyer of worlds." For ALS Limited, COVID-19 has become risk, the destroyer of reporting seasons. Therefore, going forward, we believe the company is facing two principal risks, COVID-19 and foreign exchange fluctuations.

While Australia may have mostly contained COVID-19, ALS Limited is a highly global operation and the rest of the world has not contained the pandemic. Investors who assumed the pandemic would drive significant growth in ALS Limited's life sciences division, the company's largest driver of EBITDA growth, were warned during the company's annual shareholder meeting that life sciences had seen an undisclosed revenue and EBITDA decline during 1QY21. Management went on to call the company's 9.8% decline in year-over-year total revenue during 1QY20 a proof of the 'resiliency of our portfolio,' a sentiment we find concerning considering how ALS Limited is currently trading approximately 3.6% higher than before COVID-19.

As we have mentioned above, ALS Limited is a highly global and geographically diversified company and therefore, the performance of the Australian dollar can heavily impact revenue and EBITDA growth. For example, 3% of the life science division's revenue growth during FY20 was due to favourable foreign exchange realisations. This is a rather significant portion of ALS Limited's most significant division's growth during FY20 and could very easily go the other way. The Australian dollar is one of the more volatile developed-nation currencies, and investors need to keep a close eye on the impact of those fluctuations on ALS Limited's growth.

COVID-19 is a bust, not a boon

While there has been no official guidance released by ALS Limited for FY21 since COVID-19 started, the comments made and the results presented during the company's 29 July 2020 AGM we find concerning rather than optimistic. In fact, the current consensus estimate for FY21 EBITDA is a decline of 8.7%, a figure we believe to be conservative. Furthermore, according to current consensus estimates, EBITDA is not estimated by the market to return to FY20 levels until approximately FY23. Therefore, we find the recent rally in ALS Limited's share price to be unwarranted as consensus EBITDA estimated growth between FY20 and FY23 of roughly 6.5% does not warrant the current FY23 estimated EV/EBITDA ratio of 11.9x. Taking everything into account, we believe the only appropriate rating would be two stars.

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Share price chart

Source: Tradingview

Sometimes investors get a little too enthusiastic about a great mineral exploration story. On 3 February 2020 you could buy De Grey Mining at just 3.2 cents a share. It had made a lot of progress over the previous few years developing its Mallina Gold Project up in the Pilbara Region of Western Australia and gotten to a 1.7 million ounce resource on the way to what it thought would be 3 million ounces. And then on 6 February it reported some particularly good drill intersections at a prospect called Hemi. De Grey stock promptly took off and by the time the Mallina total resource was upgraded to 2.2 million ounces on 2 April the stock was 22.5 cents. On 16 April, when we decided the exuberance had become irrational, the stock was 32.5 cents.

The Pilbara – is it the next Yilgarn?

Well, we shouldn't have underrated that exuberance because De Grey stock has now gone through $1.00. Part of it is our fault because we've had been adamant that 2020 was going to be a great year for gold – and we've been very right on that prediction. De Grey at $1.00 was achieved without the Mallina resource being enlarged beyond 2.2 million ounces. While we have yet to have a resource estimate from Hemi, we think what's happening is that investors are now taking a bet on the Pilbara as being as gold-rich in relative terms as the Yilgarn Craton to the south, which would leave a whole lot of very rich mines still to be discovered.

How did we get here? Well, De Grey has worked on this prospective company-maker for a long time. The company gets its name from a prominent Pilbara river– believe it or not, there are rivers in this hot and dry part of the Australian continent – which flows into the Indian Ocean north of Port Hedland. For years and years after its 2002 IPO, De Grey Mining kicked around the Pilbara in the belief that the Archaean-aged rocks there, and the proliferation of granite-greenstone belts, boded well for gold discoveries so long as the structural controls were properly understood.

An overnight success story 18 years in the making

How long have we been waiting for the Miracle of 2020? Go back in time to December 2003 when De Grey's project was called Turner River and you'll see the company talking about intersections better than 8 g/t at a place called Wingina Well. The MD at the time commented that the grades were 'the most significant in his 45-year involvement with the Pilbara.'

Wingina was the first of De Grey's gold discoveries in the Pilbara. Later came a discovery called Mt Berghaus and then a long hiatus. By early 2017, when De Grey bought a project next door to Turner River called Indee, which covered three deposits named Mallina, Toweranna and Withnell, there was probably around 800,000 ounces in resource. However, by that time De Grey had figured out how the Mallina Shear Zone and the Tabba Tabba Thrust worked to control gold mineralisation in the neighbourhood, and it was simply up to Dr. Drill to give his diagnosis. Enough investors had been paying attention over the period since the early 2000s so that they were ready when the De Grey geniuses hit the jackpot at Hemi back in February.

Hemi has been great, but in our view not as great as the market is saying

The Hemi part of the Mallina Project, which sits more or less in the centre of a triangle formed by Mt Berghaus, Wingina and Withnell, isn't just a prospect any more, but more like a whole gold-rich system stretching 1,500 metres in one direction and 1,200 metres in the other. The geologists have now broken it up into three deposits called Brolga, Crow and Aquila. All three have yielded some good intersections in drilling in the last couple of months – Aquila on 5 and 13 August, Brolga on 21 August and Crow on 27 August.

That last announcement had everyone excited because visible gold showed up in some drill core, with a 42 g/t gold intersection over 19 metres from 170m. Meanwhile, not far away De Grey reckons the next Hemi might lie among four lookalike deposits that have been given the names Scooby, Antwerp, Shaggy and … Alectroenas.

De Grey's drilling campaigns have been exciting to watch. However, the market is now capitalising this breakthrough explorer at just over $1bn. If this was a real mine, we'd understand. However, this is just a 2.2-million-ounce project in an region that only ever produced 8 million ounces of gold historically. The market is now valuing those 2.2 million ounces at close to $500 per resource ounce, which is excessive in our view. We don't think the stock will go down in a hurry because the time is right for gold and the drill rigs continue to tell a good story. We remain cautious, however. Three stars.

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Share price chart

Source: Tradingview

If you have a niche and you know it clap your hands

AVJennings is a niche business, they purchase land and develop it for resale, developed or just as a lot. However, AVJennings stays out of inner cities, never contract builds and, as of FY20, has no exposure to foreign buyers. The allocation of the company's net funds employed, as of FY20, was 1% in WA, 9% in SA, 17% in New Zealand, 21% in Qld, 26% in NSW and 26% in Victoria. AVJennings is good at what they do, evident by the company being listed as one of Australia's Most Trusted Brands for the second consecutive year by Reader's Digest awards.

AVJennings's revenue consists of three specific branches, i.e. land sales, housing sales and apartment sales. Apartment sales are solely part of AVJennings' Victoria business and unsurprisingly saw a year-over-year decline of approximately 75% in revenue during FY20. The decline in apartment sales was the sole reason for the 11.5% year-over-year total revenue drop as land sales were effectively flat and housing saw a significant rise in sales revenue during FY20. While NSW and Victoria saw expected revenue declines across the business segments due to the unexpectedly bad bushfires combined with COVID-19, New Zealand met its target of approximately 30% year-over-year growth.

AVJennings knows where it shines and has a business plan that provides diversification across Australia and New Zealand that proved vital to weathering the first round of COVID-19 lockdowns. Additionally, we believe you cannot discount the Reader's Digest award during a time like COVID-19. We believe the company's strong reputation among consumers will be a noticeable help in mitigating additional fallout from COVID-19 compared to its peers.

COVID-19 means it's all about shareholder continuity

As we mentioned above, COVID-19 had a significant impact on AVJennings' FY20 performance, effectively wiping out its apartment revenue. In response, AVJennings' management opted not to issue a 2HY20 dividend, significantly cut back on land acquisitions, although not entirely, and reduced long-term debt. This led to a positive operating cash flow of approximately $10m during FY20 and a long-term debt reduction of approximately $10m.

The company currently has a completely manageable net debt to total assets ratio of 28.1% as of 30 June 2020 and an EBITDA to interest expense ratio of 42.9x. Therefore, if needed the company can take on more debt and not be forced to dilute shareholders. However, while there has been no indication that management is considering a dilution there has also been no statement ruling it out. We do believe though, if management was going to issue new shares they would have done so already.

I get knocked down and then I get up again

While AVJennings may have gotten punched hard by COVID-19 and the bushfires during FY20, FY21 seems to be a different matter. Despite the lockdowns in Victoria and the stage three lockdowns in Auckland, AVJennings has indicated that construction on its plots has continued apace and when not possible the company was able to revert to development and planning stages, preventing significant cost build-ups or issues. Additionally, AVJennings was able to sign a record number of contracts during FY20 compared to 2018 and 2019. While a big question for FY21 will be the company's EBITDA margin, FY20 dropped 1.9%-point to 5.7%, there is strong indication that both revenue and EBITDA will see strong growth.

The question does need to be raised, however, if AVJennings had so many contacts signed during FY20 why did revenue and EBITDA still collapse? The answer is the method of accounting used by AVJennings. Due to the requirements of its revenue recognition, 385 signed contracts' revenue will not be recognised until FY21. This is a significant portion of the company's 2020 signed contracts and the pace does not appear to be slowing with 76 contracts signed in July, a month that historically has seen no more than 60.

However, besides the number of contracts we have little information regarding the details of the pre-sales being rolled into FY21. Management has said we will receive more information during the annual general meeting, which took place last year on 27 November but has yet to have a date announced for this year. All investors should pay extreme attention to the speeches and presentations given at this year's annual general meeting as we believe highly price sensitive news will be released, such as more detail on the rolled-over contracts and how the trend for FY21 has been post July.

Consensus estimates suggest EBITDA will grow from $14.5m in FY20 to $25.9m in FY21 and then $37m in FY22. AVJennings is currently trading at 15.2x EV/EBITDA for FY21, which we believe is quite attractive given this EBITDA growth outlook. Therefore, taking everything into account, we believe a four-star rating is warranted at this time with an eye towards the information presented at this year's annual general meeting.

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