STOCKS DOWN UNDER

7 AUGUST 2020

Stocks Down Under

"There are only three things that can kill a farmer: lightning, rolling over in a tractor, and old age."

- Bill Bryson (b. 1951), American-British author

CIMIC

The tough times aren't over

RURAL FUNDS GROUP

Harvesting a well-diversified Agriculture portfolio

PANORAMIC RESOURCES

Savannah rises from the dead

CIMIC

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Stocks Down Under rating: ★★

ASX: CIM
Market cap: A$ 6.8BN
Dividend yield: 3.1%

52-week range: A$11.87 / A$35.83
Share price: A$ 22.60

Like every other S&P/ASX200 company, the Sydney-based engineering and construction major CIMIC saw its stock rally strongly after the Corona Crash, from $13.00 on 19 March to $28.10 on 9 June. Since June, however, investors have once again been distancing themselves from the stock, and it's now down more than 20% from the post-March peak. Among their concerns are accounting issues, the potential for a business slowdown related to Coronavirus and risks on key contracts.

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ASX: RFF
Market cap: A$ 706M
Dividend yield: 5.2%

52-week range: A$1.57 / A$2.20
Share price: A$ 2.09

Rural Funds Group is a real estate investment trust (REIT) headquartered in Canberra. It is focused on agricultural properties and is one of the most experienced agricultural fund managers in Australia. RFF's goal is to generate distribution growth of 4% per annum by acting as a rural property landlord to improve its farms' future income potential. The fund was the country's first listed diversified agricultural property trust and had an adjusted NAV per unit of $1.84 as at 31 December 2019. We like the well diversified nature of the portfolio and its attractive 5.2% distribution per unit forecast.

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The price of nickel has recovered smartly since the Corona Crash low of just US$10,800 a tonne. The metal is now closer to US$14,000 a tonne. That recovery bodes well for Perth-based Panoramic Resources, which in early 2016 put its Savannah Nickel Mine in the Kimberley Region of Western Australia on care and maintenance. Four years later and Panoramic is now fully funded and actively working towards a re-start of Savannah, which could happen next year.

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Share price chart

Source: Tradingview

Ordinarily CIMIC is one of the more successful engineering and construction companies out there. Whenever there's a major infrastructure project being put together in Australia, a CIMIC civil engineering business called CPB Contractors is likely to be one of the participants. If someone is putting up critical assets like power or water utilities, CIMIC's UGL unit is there to help. And in the mining industry you know what they say: No one ever got fired for hiring Thiess to operate the mine, or for buying mineral processing equipment from Sedgeman.

CIMIC built this competitive edge over a long period, from the 1980s through to the current decade when it was called Leighton and it had a German construction major called Hochtief as its major shareholder. And it has continued to grow that ever since Spain's Grupo ACS became Hochtief's major shareholder in 2011 and encouraged Leighton to change its name to CIMIC (short for Construction, Infrastructure, Mining and Concessions). The basic ability of CIMIC/Leighton to deliver on time and under budget is why the company steadily grew earnings over the period 2013 to 2018, taking the stock from under $13 back in 2014 to over $51 in April 2019.

The day the music stopped

In July 2019, at the time of the results for the six months to June, investors turned away from this company in a serious way, marking the stock down by a third over the next seven weeks. In our view, the June 2019 result was okay, with stable revenues and margins, a solid balance sheet and, importantly, an order book up 8% on a year previous. The key issue was not that construction profits halved in the June 2019 period, because the decreased earnings here were more or less balanced by increased earnings in mining and mineral processing. What was really bothering the market was that overall operating cash flow came down by a third. The fear was that too many CIMIC clients were not paying their bills fast enough, something that could potentially lead to liquidity issues.

The calendar 2019 full year result didn't calm investors' nerves any better than the previous one had. Revenue was stable at $14.7bn and adjusted NPAT actually nudged up 3% to $800m, while the cash flow situation didn't seem to worsen. But this time around the market was annoyed that the January 2020 decision to get out of the Middle East, via the sale of its BIC Contracting business, would cost about A$1.8bn as a one-off post-tax impact.

A big factor in investor's thinking

One issue that has had a lot of CIMIC observers bothered since last year has been the company's use of 'reverse factoring'. In reverse factoring a company uses third-party financial institutions to pay its bills upfront at a slight discount and then it pays that financial institution back in full over time. It's a legitimate way for companies large and small to manage their working capital, particular in a business like construction where payment times can be long. But CIMIC's critics have suggested that reverse factoring means you don't know what the real working capital position is. We are not so concerned because in the December 2019 result CIMIC disclosed that it had an $851m reverse factoring position and a $1.96bn factoring balance, meaning that working capital was not a problem for this company. Meantime CIMIC's balance sheet was, as usual, in a net cash position.

The thing to worry about with CIMIC right now is not factoring, but whether or not earnings can actually grow in the near term. We are concerned that the current economic crisis related to COVID-9 will impact infrastructure work as lockdowns and other problems related to the virus cause projects to slow or stop altogether. The June 2020 result, which saw a 14% fall in NPAT to $317m, showed that this is already happening. Sure, CIMIC ended 2019 with $37.5bn in work-in-hand and by June 2020 this was up to $38.1bn, but the latter figure was only 3% higher than a year previous.

A lot of digging but not much growth

And it's important to remember that not every new piece of work stays in hand. A good, recent example relates to Melbourne's new West Gate Tunnel motorway. CPB was a contractor to this project, but back in January took the unusual step of seeking a contract termination due to soil contamination. That's a $2.49bn contract that has now gone to the bottom of the Yarra as far as CIMIC is concerned.

Currently, CIMIC is trading on just 4.2x forecast FY21 EBITDA. However, the market is not expecting any earnings growth over the next two years. We think CIMIC's strong pipeline going in to the crisis will carry it through. And if CIMIC gets a good price for selling half of Thiess to an affiliate of activist hedge fund Elliott Management that might help stabilise the stock. However, until there's light at the end of the tunnel on earnings, this is a 2-star stock, in our view.

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Share price chart

Source: Tradingview

High quality portfolio of diversified agricultural assets

Rural Funds was established in 1997 and manages approximately $1.3bn of agricultural assets. The properties are in New South Wales, Queensland, South Australia, Western Australia and Victoria. More than $1bn of the assets are spread across four investment funds, the largest of which is the fund managed by Rural Funds Group (RFF). RFF owns and leases its properties to various farm operators who in return provide a stable revenue stream for the fund's quarterly distributions.

The $950.2m ASX-listed Rural Funds portfolio contains a diversified set of agricultural assets including almond and macadamia orchards, premium vineyards and water entitlements as well as cattle and cotton assets. There are currently 38 properties in the fund all of which are leased to quality, experienced tenants. Based on forecasted FY20 revenue, 45% of the portfolio is in almond orchards and 30% in cattle assets. Aside from commodity type diversification the fund also seeks climatic and lessee diversification. We also like the long length of the tenancies given the 11.5 year weighted average lease expiry (WALE).

Drought and bushfires have minimal impact

Fortunately for the company, none of its properties have been materially impacted by the 2019 drought and the bushfire events. Its almond orchards and vineyards are supported by water entitlements, such as high security and ground water. The cotton and cattle properties received rainfall and initiated pasture growth and water storage filling. Seasonal variations in rainfall are managed by the lessees and are not a direct risk to the fund. Meanwhile, all the group's properties have insurance and although two cattle properties sustained damage to their pasture and fences because of the bushfires, these were remediated by the lessee.

RFF has predominantly pursued infrastructure and natural resources acquisitions to grow and diversify earnings. Six properties and three cattle feedlots were acquired in FY19. It entered contracts to acquire six additional cattle properties including two feedlots in 1HY20. In August 2019 it completed the acquisition of the Beef City feedlot in Queensland for $12.8m as well as the adjacent cropping land, which settled two months later for $0.5m. In October 2019, the group purchased an unleased property in Queensland called Cygnet, for $1.6m, which is under development to 40 hectares of macadamia plantings.

Strong balance sheet has room for more takeovers

In FY19 the fund achieved adjusted funds from operations (AFFO) per unit growth of 4.7%, which was in line with its forecast. Property revenue increased 30% because of some JBS Australia transactions (including feedlot acquisitions and limited guarantee income), acquisitions, development capex and lease indexation. Earnings per unit decreased from 17.3 cents to 10.1 cents mainly because of a $18m non-cash revaluation of interest rate swaps. Distributions per unit increased 3.9% to 10.43 cents and adjusted NAV per unit increased 7% to $1.57.

The 1HY20 financial results included a 22% increase in property revenue to $37.6m, an 11% increase in AFFO per unit of 7.1 cents, and a 16% increase in earnings per unit of 8.9 cents.

Gearing was 26.4% as at 31 December 2019 and below the group's targeted range of 30% to 35%. This was aided by the December 2019 sale of its poultry assets. The cost of debt has been reduced to 3.7%. Adjusted total assets increased $222.2m to $945.9m primarily due to acquisitions, capex and the revaluations of almond orchards, vineyards and water entitlements.

We believe the balance sheet has the capacity for additional acquisitions which, combined with an 18-property development pipeline, should allow Rural Funds to cultivate growth over the next few years. So, its 4 stars from us.

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Share price chart

Source: Tradingview

The timing was exquisite. Panoramic Resources had gone public on the ASX in 2001 as 'Sally Malay Mining' in order to develop a nickel-cobalt-copper deposit in Western Australia of long standing called Sally Malay. That deposit had been discovered by Anglo American way back in 1974 and it had been named after a local indigenous stockman, Mr Sally Malay. 1974, when the collective economies of the Western world were not in the best of shape, wasn't a good year to be thinking about new nickel mines and, more significantly, the Sally Malay deposit was in the middle of nowhere, about 120 km north of Halls Creek, in the eastern part of the Kimberley Region. The location was considered by many to be too remote to develop cost-effectively, which is why a quarter of a century later the company now known as Panoramic was able to pick up the deposit from its previous owner for only A$1.7m.

From boom to bust…to potential boom again

Sally Malay's new owner succeeded where others had failed, getting the mine commissioned in 2004. The name change of the mine to Savannah and of the company to Panoramic was made in 2008 out of deference to the strict protocols that exist in Aboriginal societies regarding the use of the names of the deceased. Mr Sally Malay, you see, had died in Halls Creek back in 1989.

Not only did Panoramic turn Savannah into a real mine, at a cost of only $65m, but it did so just before the massive nickel boom of 2005-2007, allowing shareholders to make out very well indeed as their stock went above $4.00. The fun, however, wasn't to last. By January 2016 Panoramic was down below 8 cents a share after low nickel prices had caused the shuttering of Savannah.

What a takeover bid can tell you

A maxim of the mining industry is you can't keep a good company down. Almost immediately after the padlocks were in place at Savannah, Panoramic started work on a potential re-start and by October 2017 those efforts were bearing fruit, with a Feasibility Study showing a base case NPV of A$210m pre-tax after a mere A$36m in up-front capital expenditure. If things started to return to more like normal - which they proceeded to do over the succeeding two years - a value of A$380m was on the cards.

You know a company with a beaten-up share price is worth paying attention to when an unsolicited takeover offer shows up. Last November IGO Ltd, which owns the Nova Nickel Mine near Norseman in southern WA (ASX:IGO), lobbed in a bid of one of its shares for every 13 Panoramic shares. That valued Panoramic at A$312m or 47.6 cents per share.

Exit IGO, enter Western Areas

Panoramic's management figured it was worth more than that. An independent expert valued Panoramic at 46 to 52 cents per share, but the company complained that the expert's commodity price forecasts were too low and that there was no value for the exploration upside. Consequently, the IGO offer was rejected by the Panoramic board and lapsed in January. Panoramic stock fell in disappointment, a fall that was accelerated by COVID-19. By the time Panoramic stock had been halted from trading on 14 April it had dropped to 12 cents.

The trading halt and subsequent suspension went on until late May while Panoramic recapitalised itself for a Savannah restart. The company raised $90m at 7 cents per share in a placement and rights issue that, encouragingly, brought in Western Areas (ASX:WSA) as a strategic shareholder. That's right. The company that brought you Flying Fox and Spotted Quoll, two of the lowest cost and highest-grade nickel mines in the world, now owns 19.9% of Panoramic Resources. That company, like IGO, is well placed to understand the upside of Savannah, and also knows a thing or two about mining and processing nickel sulphide ores. Thanks to Western Areas anchoring the May 2020 raising, Panoramic itself is now debt-free and holds $31m in cash.

Restart next year

Late last month Panoramic provided an update on its restart plans. An increased ore reserve of 8.3 million tonnes at 1.23% nickel, 0.59% copper and 0.08% cobalt is now suggesting a mine life of 13 years, rather than the previous eight, at an all-in nickel cost of US$5.27 a pound. Okay, that's not the lowest cost mine out there but nickel is now over US$6.00 a pound and rising. Panoramic is starting pre-production development shortly and expects to complete that around the end of March 2021, suggesting a potential restart in the first half of next year. Importantly, the orebody on which the mine is based, called Savannah North, is open along strike and at depth, meaning that the geologists think that drilling both down and sideways can enlarge the size of the deposit.

We think the currently depressed Panoramic share price is undervaluing the potential of the restart by a wide margin. Just using consensus forecasts on metal prices Panoramic thinks the current project is worth A$343m pre-tax, or about 17 cents per share (mind you, that's pre-tax). With Panoramic now funded to make Savannah happen and with an increasingly favourable nickel price, this stock is a 4-star opportunity.

Pitt Street Research Pty Ltd

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