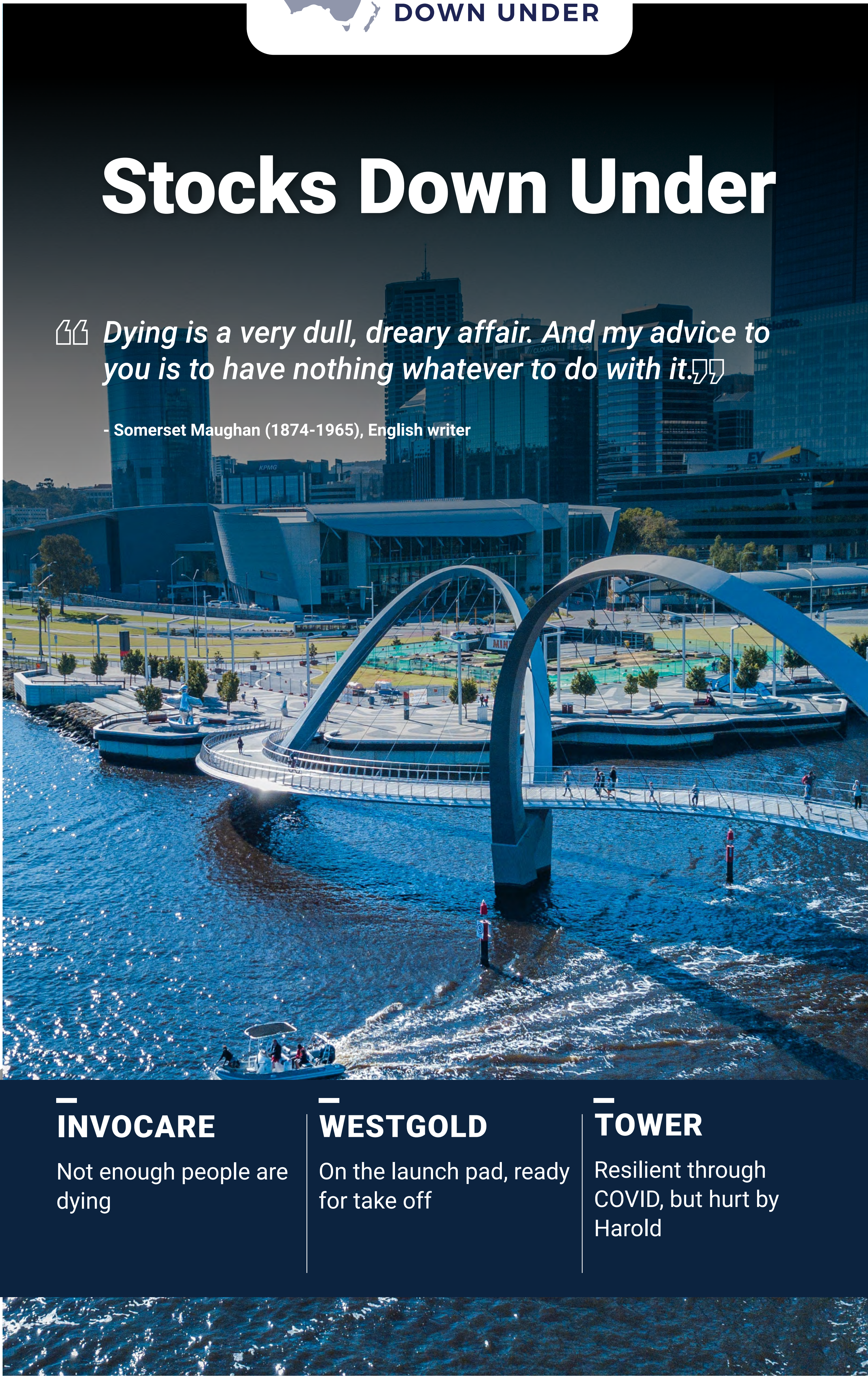
10 AUGUST 2020

Stocks Down Under



“*Dying is a very dull, dreary affair. And my advice to you is to have nothing whatever to do with it.*”

- Somerset Maughan (1874-1965), English writer

INVOCARE

Not enough people are dying

WESTGOLD

On the launch pad, ready for take off

TOWER

Resilient through COVID, but hurt by Harold

INVOCARE

Not enough people are dying

Stocks Down Under rating: ★★

ASX: IVC
Market cap: A$ 1.4BN
Dividend yield: 4.25%

52-week range: A$9.07 / A$15.79
Share price: A$ 9.85

The times haven't been auspicious for Invocare, Australia's leading operator of funeral homes, cemeteries and crematoria. Back in July 2019 this stock went as high at $16.67, but in the recent Corona Crash it fell to $9.83 and has now gone below that level. One would think that funeral services is one of the more dependable industries to be involved in right now, but it might be that not enough people are dying in 2020.

READ MORE

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Market cap: A$ 1BN
Dividend yield: 0.8%

52-week range: A$1.21 / A$2.68
Share price: A$ 2.43

With gold going through US$2,000 last week, investors are scrambling to find gold stocks with significant upside. Westgold Resources is, in our view, significantly undervalued. Production guidance of 270,000+ ounces, operations in Western Australia, good infrastructure, an over 9-million-ounce Resource and no debt, make this a great story going forward as some analysts are forecasting that gold could reach US$3,000 within 18 months.

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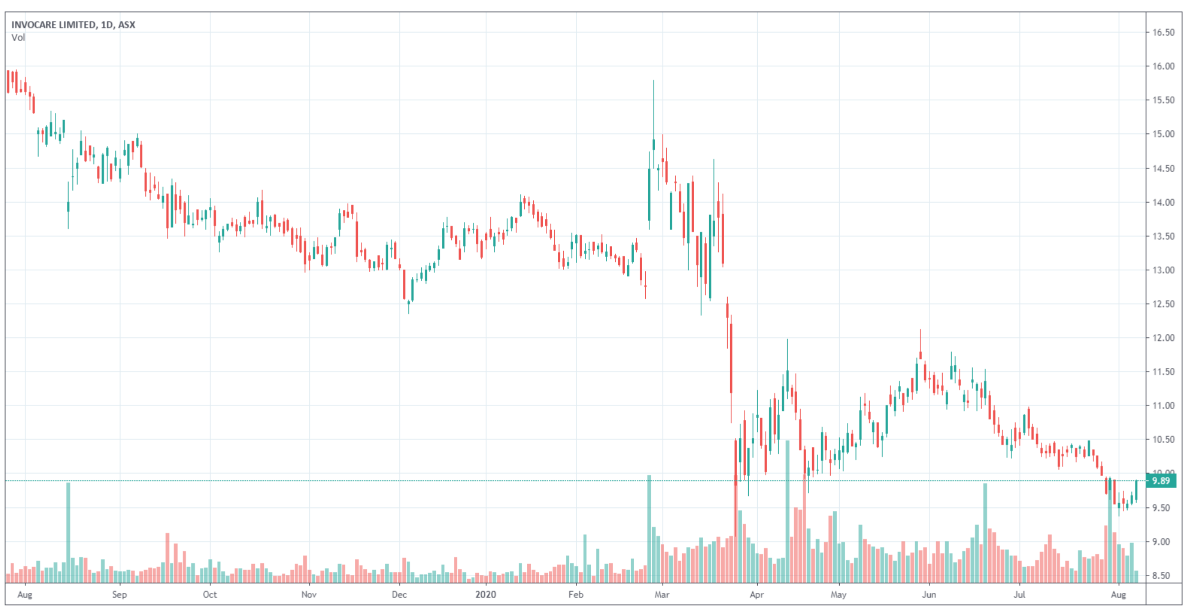

Source: Tradingview

'In this world,' wrote the great American sage Benjamin Franklin, 'nothing can be said to be certain, except death and taxes'. We've all heard the quote and acknowledged the truth thereof, which is why, when you ask investors who like emerging companies listed on ASX, they tend to have a soft spot for Invocare.

When someone dies in Australia these days there's about a one-in-three chance that the funeral will be handled by an Invocare business like White Lady Funerals, Guardian Funerals or Simplicity Funerals. And yes, White Lady Funerals is a real business, although in 2020 there might be some pressure to change the name from certain quarters. The staff can be of any skin colour but the women who front the funeral service wear white clothing.

A service business with high margins

People don't tend to be too sensitive on price when it comes to the funeral of a family member. After all, it's one of the last services the departed person will ever have to pay for. Also, people don't tend to shop around much, partly because it's a time of grief and partly because a family will go with whoever looked after the funerals of other family members. Throw in the strategy of Invocare to be the premium-priced provider and that makes for a very good business in terms of margins. In calendar 2019 Invacare's EBITDA margin was

29%, with $144m in EBITDA from $494m in revenue.

In our view, many investors make three errors with Invocare. The most egregious is to assume that since the business is ‘defensive’ (i.e. people will still be paying for funerals even when they’re cutting back on holidays and dining out) it deserves a high multiple. That’s an error because people only die once, on top of which the death rate in Australia is gradually reducing because people are living longer before they die. This means that the funeral industry has a very low organic growth rate.

In Australia in 2018 around 158,000 people died. The comparable number for 2008 was 144,000, for a 1% per annum average growth rate over the decade. The number of living Australian residents rose by 1.6% per annum over the same period. So, you might say Invocare’s business is actually in structural decline and not even a grave event like a global pandemic is going to change that. COVID-19 may be the biggest health scourge in a century, but so far, it’s only yielded Invocare and its competitors in Australia another 255 customers. Not 255,000. Just 255.

Macquarie’s killer app in the funeral space

The second rookie error investors will make with Invocare regards its competitors. The basic assumption is that if you’re a listed company with a market capitalisation in excess of a billion dollars you must naturally attract more customers. We’re not so sure.

The funeral services industry in Australia was traditionally a large number of small mom-and-pop operators. There was a reason for this: people tended to trust families they knew personally with something as personal as laying to rest a family member. That’s why the buildings where many funerals are held are still called funeral ‘homes’. We think that the ‘shop local’ trend when it comes to funerals is coming back, to Invocare’s detriment.

The consolidation trend in the funeral industry in Australia only started in the 1990s. Invocare became the leading player because an American company called Service Corporation International acquired scores of funeral homes and then in 2001 sold them to a consortium led by Macquarie Bank, which in turn listed them as Invocare in 2003. A couple of decades later we’re hearing a lot of people blaming the high price of a funeral (i.e. something like $7,000 or $8,000 on average) on the likes of Invocare and advocating for the local, family-owned businesses where the cost is lower and the sense of working with someone who’s not ‘corporate’ is higher.

That competition means that sometimes Invocare underperforms its competition. Indeed, it’s the reason why the company has had to spend a lot of money in recent years on renovating its funeral home network. Capex in 2019 was $65m and in 2018 was $84m, way more than operating cash flows.

This is not a growth stock

Then there’s a third error in terms of investor understanding of Invocare. It relates to the fact that, unlike population growth, the growth in the death rate isn’t constant and there’s no rhyme nor reason for it. In 2014 in Australia there were about 153,600 deaths. The next year there were over 5,000 more, 159,100. Then in 2016 the number declined to 158,500. The numbers fluctuate. And of course, less people generally die in summer than in winter. What all this fluctuation around a small trend means is that every now and then Invocare misses consensus earnings forecasts, because not enough people died during an earnings period resulting in a panic sell-off in the stock. That is basically what happened last August after the result for the six months to June 2019 came out. The result was good – revenue up 7%, EBITDA up 17% thanks to a string of acquisitions – but not as good as the analysts were modelling.

What to think of Invocare right now? It probably won’t grow EBITDA by more than 3% per annum over the next two calendar years if the consensus numbers are any guide. The company has yet to realise value from its big network renovation and the market is still absorbing the $200m in new capital that was raised at $10.40 back in April to strengthen the balance sheet. However, the stock is on an EV/EBITDA multiple of 12x FY21 forecast EBITDA. That’s a little expensive for a stock facing competitive pressures and not enough people dying.

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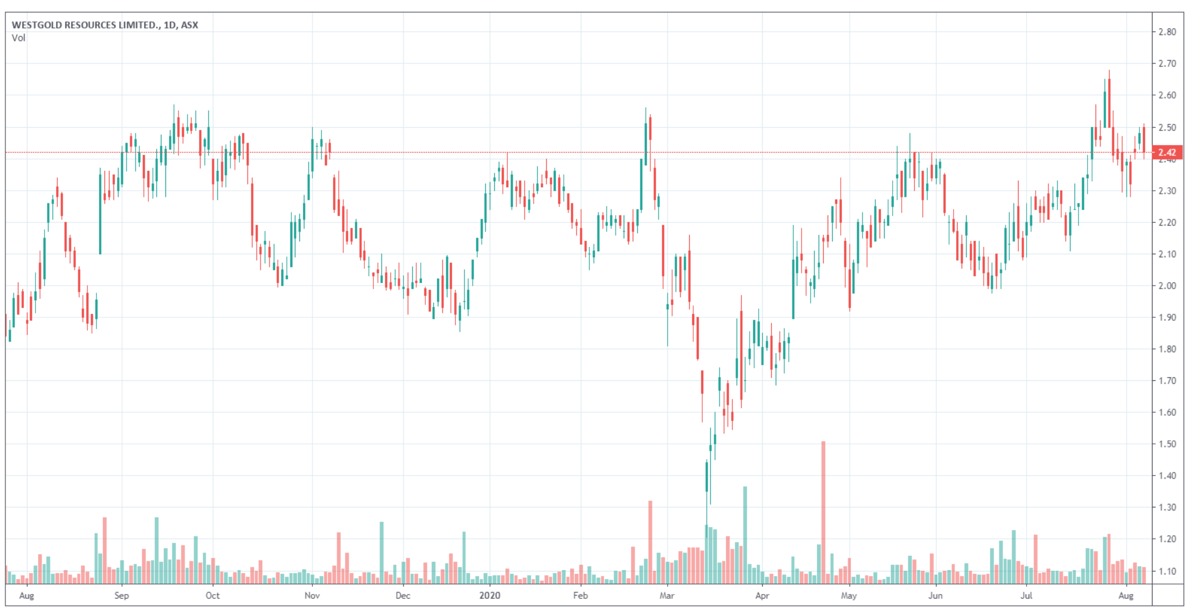

Source: Tradingview

Westgold Resources was formed in December 2016 by the demerger of the gold assets of Metals X (ASX:MLX). Metals X Ltd is now a leading base metals miner with Australia's largest tin producer and a nickel-cobalt project. In recent times, Westgold has divested its high-cost operations and demerged its polymetallic and copper-gold assets into Castile Resources (ASX:CST). This has paved the way for the company to focus on becoming a top 10 producer.

A 300,000 ounces per annum producer

The company now has three main producing operations – Fortnum (FGO), Meekatharra (MGO) and Cue. Each of the above areas has 8 to 10 years production capacity. All of the mines are in the Central Murchison area, which is northeast of the Western Australian capital of Perth.

Fortnum will produce 60,000 – 70,000 ounces per year, Meekatharra 100,000 –120,000 ounces per year and Cue / Big Bell will produce 100,000 – 110,000 ounces per year. This equates to 260,000 – 300,000 ounces per year in total. Each of the above areas has several underground mines and open pits with a processing centre attached to it. The company must be given credit for consolidating several mines with operational centres and investing in infrastructure, to maximise production at the best possible price.

One of the significant differences between Westgold Resources and its peers is that it uses its own mining fleet and can conduct its own drilling and other exploration activities. This ensures that mining costs are kept to a minimum and that contractors cannot hold the company to ransom with unreasonable mining costs and delays.

Problems with the hedge book

One of the reasons for the stock trading below its peers, has been poor management, cost blowouts at its Big Bell project and its hedge book. Management lost credibility with the market and its shareholders as it failed to meet production guidance and costs on Big Bell blew out. However, all these issues have been or are in the process of being resolved.

Westgold has over 9 million ounces in Resources and 2.6 million ounces in Reserves. It gave guidance for FY21 of 270,000 – 300,000 ounces with an All in Sustaining Cost (AISC) of A$1,500 per ounces. And the company is generating cashflows of A$1,350 per ounce, which at current gold price, is more than $365m in annual cashflows.

Recently, Goldman Sachs estimated that Australian gold producers have lost $2bn due to hedging exposures. Westgold has a hedge book of 200,000 ounces at A$2,062. At today's gold price, that is a loss of $240M due to the difference in the gold price versus the hedging cost. It is currently delivering 10,000 ounces per month, which is less than half of its estimated production and its exposure is steadily decreasing. However, if this is put into context, then that will be fully paid back in less than two years. Westgold has no debt and A$137m in cash and gold bullion. So, with analysts predicting further upside in the gold price, management may be tempted to buy-out part of this hedge book. Because if gold were to go to US$3,000 with an exchange rate of 0.75, the company's exposure would go to A$400M from its current level of $240m.

Big things expected from Big Bell

Westgold has incurred significant capital expenditures, especially on the Big Bell Mine at Cue. We mentioned Big Bell in this publication on 10 July when talking about Musgrave Minerals (ASX:MGV), which is exploring in the neighbourhood. Big Bell has been around since the 1930s and Westgold thinks it is set for big things again. Since June 2019, the company has spent $140m on this mine.

Big Bell will be the largest mine in the Murchison area, with a 10 to 15-year mine life. The Big Bell Mine will be the foundation of the group's expected 300,000 ounces per year production. While AISC is currently A$1,500, it is expected that in the years to come this will decrease to approximately A$1,350. The capital expenditures have now been completed and Westgold is now able to reap the financial benefits.

The next Saracen? Or the next Ramelius?

Those benefits, once reaped, can lead to a significantly higher capitalisation if three companies - Saracen Resources (ASX:SAR – see our 9 July coverage), Regis Resources (ASX:RRL) and Ramelius Resources (ASX:RMS) - are any guide. The market caps of these three are A$6.6bn, A$3bn and A$1.8bn respectively. Their production costs are perhaps A$200 an ounce cheaper than Westgold's right now, but on our numbers, if you applied similar metrics on reserve, resources and production, Westgold is probably undervalued by a billion or so. That's what a temporarily unfavourable hedge book can do.

This company has done the heavy lifting. It has resolved management troubles, invested heavily and focused on mines that can produce 300,000 ounces per annum. And it has taken the pain on its hedge book with a view to reaping the benefits of a long-term gold price in excess of US$2,000. As the gold price continues its momentum, not only do we see it being re-rated, but it could also be the target of a takeover by a major gold producer or private equity. So, get on board and get ready for take-off. Four stars from us.

TOWER

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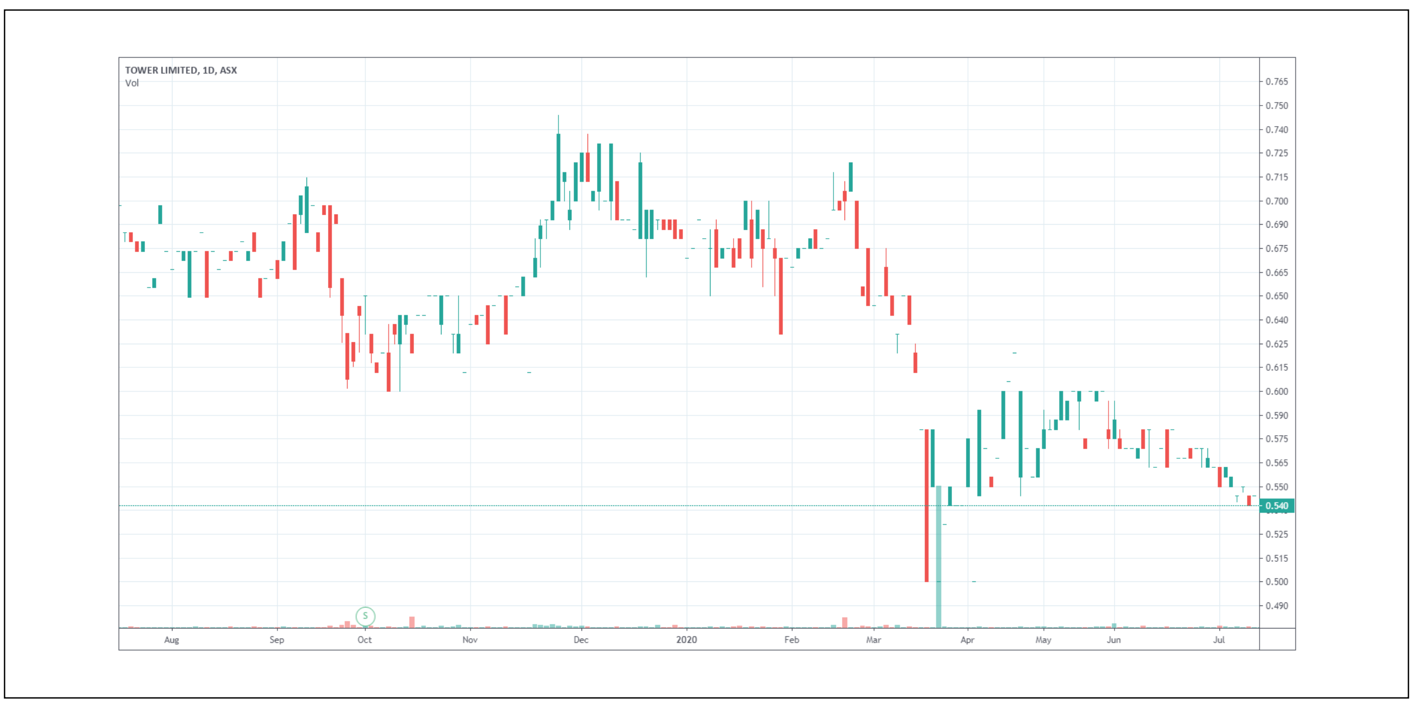

Source: Tradingview

Motor claims refund is good karma

Tower's products include house, car, contents, rural, boat and travel insurance. It earns most of its revenues from premiums paid by its diverse set of insurance customers. The company depends largely on its core New Zealand market for growth, but also has a Pacific division that accounts for about 15% of gross written premiums (GWP). It also engages in acquisition activity to generate inorganic growth. In January 2020 it completed the acquisition of Youi NZ's insurance portfolio to strengthen its domestic market position.

On 5 June, Tower announced the refunding of $7.2m to customers related to the lower cost of car claims during the COVID-19 lockdown period. All customers received some portion of the premiums they paid between 24 March and 13 May with most receiving 40% to 45% back. Tower incurred 70% lower motor claims during the level three and four lockdowns because there were far fewer vehicles on the road resulting in a windfall for the company. Although the move ultimately had no financial impact on Tower because the refund cost was offset by the reduced claims cost, it may have given the company some goodwill due to its transparency.

COVID-19 puts dividend on hold

Aside from the car insurance business, the COVID-19 crisis has had other impacts on Tower. It was deemed an essential business and remained committed to helping customers with claims by operating with a fully remote workforce. While most people tend to keep their most valuable assets insured, there has been increased risk of policy cancellation in the industry as people look for ways to save money. Tower put policies in place to support customers that experienced financial hardship. A small number of customers utilised options like payment deferrals and reductions, and policy cancellations have been minimal. The Reserve Bank of New Zealand (RBNZ) advised the country's financial sector to protect solvency positions and preserve capital due to the pandemic. In response, Tower's Board of Directors chose not to pay an interim dividend and noted the second half dividend is on hold pending economic developments.

For the six-month period ended 31 March 2020, Tower reported a 25% increase in profit to $14.9m and underlying profit of $16.9m. Revenue was up 11% to approximately $200m as gross written premium grew 8.2% to $183.6m. The claims expense ratio increased from 44.5% to 46.4% mainly due to large weather events. Net tangible assets per security slipped from $0.57 in the prior half-year period to $0.56.

Digital re-branding comes with challenges

As the insurance industry moves away from outdated norms, Tower has shifted its focus to its digital channels. Customers are being migrated to the new digital, self-service platform as their policies renew and most new business has been conducted online. In March 2020 nearly 60% of new business and 40% of claims came through digital channels.

Transitioning to be a digital brand comes with challenges, though, for a 150-year old company that has done business the same way for a long time. It is going head-to-head with larger, well-established industry incumbents. Second, it will need to incur high expenses related to the buildout of its digital platform, rebranding and generating marketing awareness. So, while this strategy could lead to improved profit growth over time from increased productivity and automation, near term margins will likely be under pressure.

Meanwhile, Cyclone Harold, which took place after the recent reporting period, is expected to have a meaningful impact on Tower's financials. The storm caused widespread damage in the Pacific Islands primarily in Vanuatu and Tonga where the company has significant exposure. Tower estimates that the claims incurred from the event will be $8.3m. Cyclone Harold will hurt second-half performance and negatively impact the group's full year 2020 profit.

In summary, Tower's business has been resilient during the COVID-19 pandemic but has been hit hard by recent adverse weather events across its markets. The difficulties ahead in transitioning into a digitally based insurance provider give us further reason for pause. For now, its 2 stars from us.

Pitt Street Research Pty Ltd

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