STOCKS DOWN UNDER

13 AUGUST 2020

Stocks Down Under

The trouble with retirement is that you never get a day off.

- Abe Lemons (1922-2002), American college basketball player and coach

AMCOR

Proving that those who innovate thrive

LIFESTYLE COMMUNITIES

Another COVID-19 victim in the making

BASE RESOURCES

A billion dollar project for a fraction of that today

AMCOR

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Stocks Down Under rating: ★★★

ASX: AMC
Market cap: A$ 14.2BN
Dividend yield: 4.5% (Unfranked)

52-week range: A$9.87 / A$16.53
Share price: A$ 15.50

Amcor is a dual-listed global packaging design and manufacturing company. What started as a single paper mill in Melbourne in the 1870s has morphed into a packaging giant, demerging their paper business in 2000. In the last ten years Amcor began to transform, the pinnacle being their merger with packaging leader Bemis in an all-stock transaction and changing its primary listing to the NYSE. Amcor has seen consistently strong EBIT growth, due in part to their continued innovation. However, even the greats can get ahead of themselves on price.

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ASX: LIC
Market cap: A$ 899M
Dividend yield: 0.7%

52-week range: A$4.53 / A$9.87
Share price: A$ 8.60

Lifestyle Communities is a property owner, developer and manager. For their communities, homeowners must be over 50 years old and the communities are designed to have shops and amenities in the same location. Interestingly, after a community is constructed, Lifestyle Communities sellsl the houses but rents out the land. Things seemed to be going well for LIC in the beginning of the year with strong growth projected. However, their communities are in greater Melbourne and the second half of FY20 was where the growth was projected. With a high valuation it's difficult to see how LIC can live up to expectations.

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Share price chart

Source: Tradingview

When it comes to COVID-19 Amcor is as flexible as their plastic

The majority of Amcor's products are what is known as 'flexible packaging' (67% as of 31 March 2020), and most of that is plastic. We promise that was our first and last plastic joke. You see, if you say that Amcor makes 'plastic packaging' some people get upset, whereas if you say the packaging is flexible people aren't so concerned. In terms of disruptions to manufacturing during COVID-19, Amcor seems to be immune. As CEO Ron Delia said on Amcor's 12 May 2020 conference call, "We're making packaging for defensive consumer segments… These supply chains have been recognized as essential by governments … and that essential designation extends to Amcor and provides us with the license to continue operating. Almost all of the products we package are for home consumption or use in medical facilities or sold through retail." Since they have been granted essential status, up until 12 May 2020, they have not experienced any supply, transport, production issues or cash flow collection issues.

If their essential status would change, Amcor has 190 flexible packaging plants across 38 different countries and 60 rigid packaging plants in 12 countries, making their production base highly diversified. One flag on the play was that beverage packaging volume saw declines of 12% in Latin America in April year-over-year (YoY) However, beverage packing is only approximately 8% of Amcor's total sales mix and other, more significant, packaging lines saw YoY increases. While it is not clear exactly how COVID-19 will affect Amcor's 4Q20 performance, Amcor could be looking at a strong quarter if April was any indication.

Share buybacks prove organic growth is not just for food

When a company is buying shares, they are telling the market they believe their shares are undervalued and, therefore, removing shares from the market is the best way to improve shareholder value at this time. In FY20 Amcor embarked on a US$500m stock buyback program which, at the end of 31 March 2020, has succeeded in acquiring 52 million shares (3.2% of outstanding shares). The most recent guidance came during the 12 May 2020 Q3 conference call, and even during COVID-19 Amcor plans on completing the FY20 buyback program. We believe this is a definite sign that the company stands by its FY20 projections of US$0.646 – US$0.652 adjusted earnings-per-share (EPS) resulting in 11-12% EPS growth. COVID-19 may be forcing us to lock our economies down, but it seems, even then, that the world can't resist its need for packaging.

As we have mentioned above, Amcor has had consistent organic growth across its flexible and rigid packaging lines. FY-to-date, currency-adjusted EBIT grew 11% YoY and while that is a strong metric in amongst itself, approximately 7%-points of that growth was organic. Organic growth is always an important metric to consider as it excludes growth due to acquisitions. While acquisitions are a valuable way for a company to grow its business, if an established company relies too heavily on acquisitions to fuel their growth it can often be an indication that their core business is in decline.

As Amcor's business has grown, they have also continued to innovate. Restructuring will save US$5-10m in FY20 and FY21, while margin expansion for EBITDA, EBIT and net profit after tax (adjusted for the Bemis acquisition and currency fluctuations) has been on a strong upwards trajectory. Weexpect this to continue.

To not innovate is to die

In 2018, Amcor pledged to invest US$50m into R&D infrastructure, manufacturing equipment and partnerships. This investment aimed to develop new packaging, to make all of Amcor's products recyclable or reusable by 2025, to increase recycling rates worldwide and to significantly increase the use of recycled content in the company's products.

However, the question remains, will these steps increase prices and turn off consumers? We asked Amcor, and they told us that the cost difference in using recycled resin versus virgin resin for the end consumer (assuming the cost is passed on) would only be approx. 0.45% for a typical beverage sold in a PET bottle or 0.25% more expensive for a product sold in a container. This is effectively the equivalent to a price increase of approximately US$0.01. Additionally, Amcor's research has found 66% of global consumers look for eco-friendly products and are willing to pay more for them. By catching this trend early, we believe Amcor has a lead on its competition.

To get down to the brass tacks of it all, what is Amcor worth? Amcor's current EV/Adjusted EBIT is 22.7x. However, growth is looking to be around 11% with a 4.5% (unfranked) dividend. While Amcor has a lot of potential and deserves a premium, a lot of these positives have already been factored into the price, in our view. Therefore, it's a three-star rating from us.

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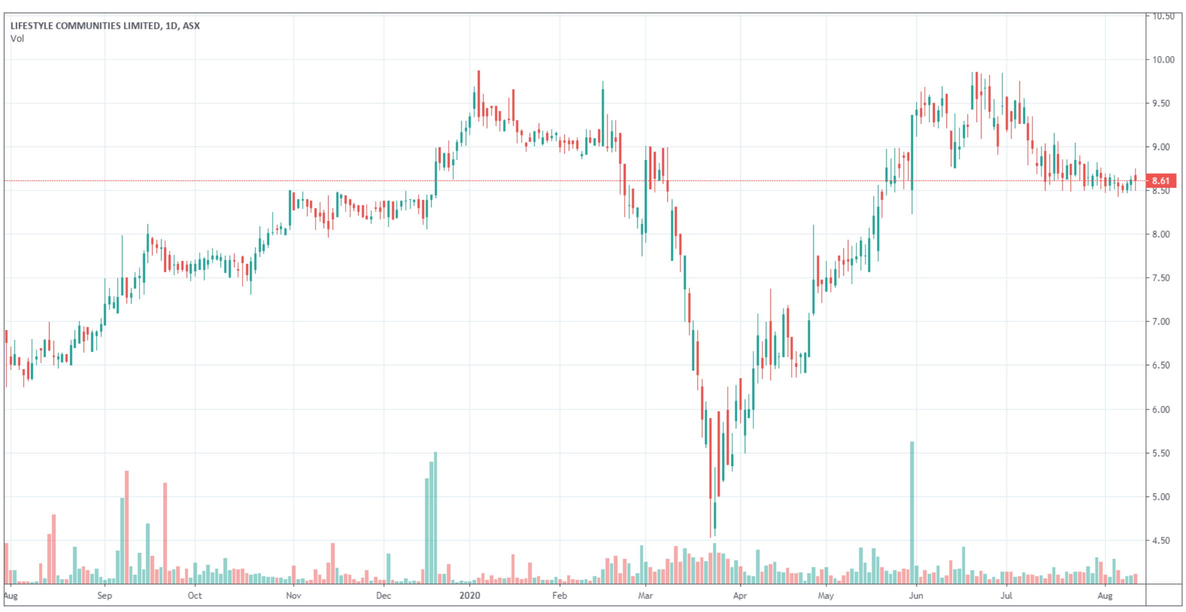

Source: Tradingview

Owning a property can be a great investment, if you own the land

LIC's business plan is rather interesting. Instead of just developing the community and then selling it off, they sign 90-year rental contracts for the land. Subletting is prohibited and all construction on the outside of the properties must receive approval from the company. Seeing how the World Bank found the average lifespan of an Australian in 2017 was 82.5 years, residents don't need to worry about their rental agreements expiring out from under their house. This arrangement, however, is a significant boon to investors as the value growth of most, if not all property, does not come from the house itself but rather the land beneath.

Additionally, as it is a rental agreement, homeowners pay fortnightly rent to LIC. If they sell their home, LIC provides the sale with a new 90-year lease allowing for the increase in the value of the land to be taken into account. LIC also takes a scaling, yearly 4% fee, known as a deferred management fee, on the sale of the home starting after the first year and capped at 20%. We believe this rental income, combined with the deferred management fee, will prove to be a powerful source of future income.

The name of the game is sales

The majority of LIC's annual revenue comes from the sale of the houses in their communities, comprising approximately 58% of the company's 1HY20 revenue and approximately 66% of its 1HY19 revenue. The reason for the year-over-year (YoY) drop in the revenue percentage is not because of a significant increase in other revenues, but rather a decrease of approximately 36% YoY in home settlement revenue.

There were some bright spots in LIC's 1HY20 earnings, however, as rental income increased approximately 26% to $11.4m. Rental revenue and fair value adjustments are the two numbers to watch in the coming years, in our opinion, as the growth in the value of the land and rent collected on the land should provide constant and regular earnings growth at substantial margins.

Deferred management fees also increased a healthy 21% YoY. As Australia's population continues to age, as well as drastically expand in size, land around the major cities should continue to increase in value, while demand for communities that provide independence as well as activities and interaction for older generations rises inexorably.

All of this means LIC provides aspects of both population growth and an aging population investment. While the drop in home settlement revenue was a point of concern, management cleared things by stating they had a healthy backlog of forward sales and that a large number of new homes was going to be finished in time to meet the 2HY20's demand. Therefore, after the release of the 1HY20 results the company seemed to be on track to meet its FY20 growth projections.

COVID-19 creates a crack in the foundation

However, things have changed quite drastically since January 2020 with Victoria, and more specifically Melbourne, being rocked by two significant COVID-19 waves forcing people back into stage 3 and stage 4 restrictions. With all of LIC's communities being located in the greater Melbourne area, it seems highly unlikely to us that the company will be able to meet FY20 growth projections.

Additionally, the reinstitution of stage 3 and 4 restrictions in Melbourne creates concern surrounding LIC's announced three-year construction agenda as most work in Melbourne has been forced to shut down with no clear end in sight. Even more concerning is the lack of guidance or updates supplied by management during all of this. While most companies have suspended guidance during COVID-19, with so much riding on the second half of FY20's performance the lack of any update from management does ring some warning bells.

Taking all of this into consideration, an EV/EBITDA valuation of approximately 49x on a trailing twelve-month basis seems too rich. Until things begin to improve and we have a better picture of how COVID-19 has affected both 2HY20 and the start of FY21, the risk appears to be too high. Therefore, it must be two stars from us.

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Share price chart

Source: Tradingview

Good times in mineral sands

Doubtless you've heard of mineral sands because Australia is a world-leader in their production. Mineral sands are simply sands, often on beaches, that are rich in three minerals - zircon, ilmenite and rutile. Ilmenite is the main source of titanium dioxide ($TiO2$) a white pigment used in paints, fabrics and plastics. Zircon is used in engines, electronics and ceramics.

Mineral sands are very reliant on Chinese demand. With China-USA trade tensions last year and COVID-19 this year, there have been some supply and price problems. However, the price of these commodities has by and large continued to rise. Currently, the price for zircon is approximately US$1,500 per tonne, rutile is US$1,200 per tonne and ilmenite is US$260 per tonne. Prices have been going up since 2016 when zircon was trading at US$900 per tonne. We continue to see zircon and ilmenite appreciating, but there are signs of price weakness in rutile.

Base’s great foundation project in Kwale

Base Resources acquired its Kwale mineral sands project in Kenya in 2010 and production started in 2015. In FY19, the mine produced 92,000 tonnes of rutile, 400,000 tonnes of ilmenite and 32,000 tonnes of zircon. This achieved revenues of A$290m and EBITDA of A$160m. The cashflows have enabled the company to be able to fund the development of its flagship Toliara project in Madagascar.

The downside of Kwale is that there is only 6 million tonnes of in situ resources (i.e. actual mineral in the ground) and 2.3 million tonnes of reserves. That only allows another two to three years of production and that production will be lower grade and therefore higher cost. That said, Base Resources is currently looking at potential expansions of Kwale as well as other opportunities throughout Kenya.

Madagascar – Could this island nation be the making of Base Resources?

Meanwhile the elephant the company has been seeking to bag is the massive Toliara project in Madagascar, which is located near the port town of the same name in the isand’s southwest. Toliara is a world-class project in anyone’s books, with a potential 33-year mine life from a 1.3 billion tonne resource (66 million tonnes in situ) and 548 million tonnes (38 million tonnes in situ) reserve, at 6.5% Heavy Mineral. It is expected to produce 780,000 tonnes of ilmenite, 53,000 tonnes of zircon and 7,000 tonnes of rutile annually.

In December 2019 Base Resources completed the Definitive Feasibility Study at Toliara, which confirmed its world class status. On Base’s numbers it has a Net Present Value of US$671m, which in our money is a cool A$930m. Sure, Stage 1 capex for Toliara is US$439m (Stage 2 is only another US$67m), but that yields annual revenues of US$248m, EBITDA of US$164m and free cash flow of US$132m per annum. That’s a heck of a lot of cash to be generated over a multi-decade time horizon.

The downside, if there is one, is Madagascar. That island nation off the east coast of Africa, capital Antananarivo, population 25 million, has had more than its fair share of coups, violent unrest and disputed elections since France let it go 60 years ago. Indeed, a coup in 2009 led to five years of political deadlock at home and international condemnation as well as economic sanctions abroad. But that was then and this is now. Under the current President, Andry Rajoelina, who took office last year, Madagascar is lifting its game in terms of making itself attractive to foreign investors and is considered mining-friendly.

Positive cash flow and no debt

Toliara may be worth A$930m in NPV, but currently Base Resources has an Enterprise Value of only $142m – the $264m market cap less net cash of A$122m. And that A$142m is valuing another two or three years of Kwale, which could be good for A$420m in free cash flow, which will fund the Toliara project or at least guarantee any project finance associated with it.

There are many companies on the ASX that are in the mineral sands industry. The biggest of these would be Iluka (ASX:ILU) with an EV of $4bn, a Resource of 166 million tonnes and an EV/resource of $25. Image Resources (ASX:IMA) is probably the closest comparison to Base and it has an EV/resource of $32. Base Resources is trading significantly cheaper with an EV/resource tonne of just $1.80.

The market has taken a conservative view on Madagascar and the likelihood of project finance. Otherwise one would think that it should be trading 2–3 times higher. We believe the real benefit for shareholders is the life of the project being 33 years. Should Base Resources get to the finish line with Toliara, then there should be significant dividends flowing back to shareholders over a long period of time. Four stars from us.

Pitt Street Research Pty Ltd

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